European Economic Network
EUREN

EUREN-News

4|2012
29|6|2012

Editorial: Joining EMU again? A View from New Member State

In the recent weeks, the future of Euro area was shifted into the focus. All eyes have been attracted by the elections in Greece the result of which was seen as a fateful question by many. The news coming from every corner of Europe are raising doubts whether the establishment of European Monetary Union was the right step, and from the view of new member states the joining of EMU is even more questionable.

Firstly, it is worthwhile to look shortly back to the birth of European Monetary Union. In 1999, i.e. at the start of EMU there was clearly no guarantee that it will be a success story. On the one hand, positive outcomes were expected. Reduced exchange rate risks for the business sector and lower exchange rate transactions costs for both businesses and tourists would bring an increase in economic welfare. And there was also the political goal that a European (common) currency would strengthen the European identity and Euro would belong to the strongest currencies in the world. On the other hand, it has been considered as possible that the monetary union would not be sustainable; countries that discovered themselves to be in difficulties might cancel their membership and re-establish an independent currency and an own, potentially more inflationary monetary policy. This is what was at the beginning. Where do we stand today?

Crucial for recent development in the Euro area was the global financial crisis which exceeded all expectations. The assessment of risks has changed dramatically at the same time when growth models were challenged. A large banking sector e.g., tailored for European markets, has become a problem when a small country like Ireland had to guarantee for the liabilities of these banks. Thus, the expected economic welfare has been turning towards the economic recession in most of Eurozone's countries.

Slovakia joined the Euro area on January 1st 2009, shortly after the start of global financial crisis. The advantages of joining were seen mainly in attracting foreign capital, which is very important for a small and extremely open country like Slovakia. For such a type of economy it could be particularly beneficial to be part of the monetary area. However, the period of entry was not very favourable for this kind of action. As a typical side effect of economic crises the demand of Slovakia's most important trading partners had started to decline and the same happened to foreign direct investment. Therefore, paradoxically, Slovakia's joining the Euro area was connected with a weakening of economic activity. Doubts about inflation were also associated with joining the Euro area, though no additional increase in prices was observed at that time. Nowadays Slovakia is one of few still growing economies in the Euro area. This is only due to increasing net exports which are prevailingly dependent on the demand from the Euro area.

Although the current situation in Euro area is very fragile and further steps are sluggish and careful, since the establishment of EMU the global environment has changed a lot. The fact that common European currency can strengthen European identity has been confirmed and showed the next directions of European Union in a changing global world. If we want to be competitive and partners to be taken serious by other economies like U.S. and China, we should have an interest to retain the common European currency and further institutionalization of EU should follow. And in this respect the decision to join Eurozone looks as a necessity though the solution of debt crisis is still not in view.

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The EUREN Summer Forecast 2012

Euro area in recession

Slowdown in global growth, but brighter prospects for 2013

The still unsolved debt crisis in the Euro area, the threat of sovereign default, and consequently fragile financial markets continue to be a risk for the world economy as whole. This year the economic performance will differ quite substantially between regions: declining GDP in the Euro Area, a slight acceleration of the US and some slowing down in emerging countries will generate a lower global growth compared to the last year. As a result world trade growth will decelerate to 3.8% reflecting partly the lower export performance of China, and partly the moderate rate of growth of other big trading countries. The prospects for 2013 in world trade are a bit brighter due to an acceleration of growth in most emerging countries and a recovery of the Euro area's imports.

However, taken as a whole the global growth forecast of EUREN Institutes for 2012-2013 is less optimistic now than it was at the beginning of the year as there are substantial downside risks like the still unpredictable outcome of the Greek crisis, the growing number of countries with financing and debt problems or the instability of financial markets and the disorientation of investors as a consequence of missing efficient policy responses. The present forecast is based on the assumptions that the problems of the Euro area will be kept under control, that the US recovery will continue without being dampened decisively by fiscal constraints, and that the slowdown in China will be temporary only. Since capacity utilisation continues to be low in most countries, and a weak demand will keep raw material prices low, we assume inflation remaining moderate. Therefore, monetary policy will continue to be on the expansive stance keeping interest rates at the prevailing low level.

Regional disparities will persist

The economic outlook for the *US* has improved somewhat during the recent months. A solid acceleration of GDP growth, some advances in the labour market and a slow pick up of private consumption can be reckoned with this year. There are signs of a recovery in the housing sector but with still a huge number of unsold houses construction activities will grow moderately. The high level of public debt will force the government to consolidation measures which have been avoided so far. Most likely it will come to fiscal retrenchment in 2013 and this will affect growth as well. However, some of the temporary fiscal measures phasing out at the end of 2012 will be prolonged to avoid a substantial restrictive impulse. Nevertheless, with GDP growth remaining under potential no monetary tightening is to be expected.

Table 1

Exogenous and international variables

2010 – 2013; Percentage changes unless otherwise indicated

	2010	2011	2012[f]	2013[f]
World trade	12.9	5.8	3.8	6.0
United States				
GDP	3.0	1.7	2.2	2.0
Inflation	1.6	3.1	2.4	2.5
3m interest rates	0.3	0.3	0.4	0.4
10y Gvt bond yield	3.2	2.8	2.0	2.2
Japan				
GDP	3.0	1.7	2.5	1.4
3m interest rates	0.2	0.2	0.2	0.2
10y Gvt bond yield	1.2	1.1	1.0	1.1
China, GDP	10.4	9.2	8.1	8.4
US dollar/euro	1.33	1.39	1.27	1.25
Yen/US-Dollar	116.5	111.1	101.8	100.0
Oil price Brent				
US$/barrel	79.7	110.9	107.2	109.5
Percentage changes	29.5	39.2	-3.4	2.1

[f] *EUREN Forecast*

In *Japan* growth will be supported by public reconstruction spending, whereas due to sluggish global growth and a strong yen exports remain subdued. A slightly easing deflation and high unemployment will be characteristic of the forecast period. High public debt will make consolidation measure more urgent, however under the present economic conditions there is no room for any fiscal constraint.

The *Chinese economy* showed signs of a slowdown since the last months of 2011 and the expected GDP growth rate for this year will be below the long run average as a result of gloomy exports outlooks. However, growth will be supported by lively household expenditures and more expansionary fiscal and monetary policies.

Stabilisation of commodity prices

After having increased substantially in the first quarter of the year due to supply constraints and market uncertainties, oil prices have fallen sharply over the recent month. Partly this was due to a better supply situation (both inventories and global oil supply recovered), but partly it also reflects concerns about future demand, also because of China's slowdown. Furthermore, investors remain careful under the prevailing global uncertainties. Thus there will be no demand side push on prices. Considering moderate growth outlook in the forecast period EUREN institutes assume a somewhat lower Brent oil price for 2012 than the last year's average and an only slight increase is expected for 2013.

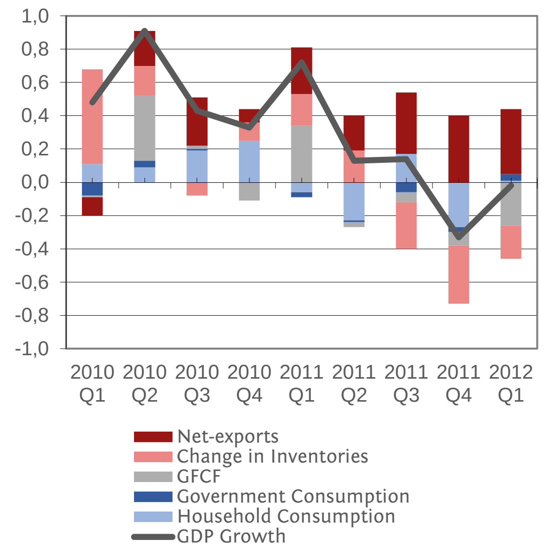
Euro area economy remained weak

In the first quarter of 2012, Euro area GDP stagnated in seasonally adjusted terms, following a decline of 0.3% in the last quarter of 2011 (Graph 1). Compared with the first quarter of 2011, GDP increased by 0.3%, which was the same rate as in the previous quarter. On a seasonally adjusted base, private and public consumption stagnated, while gross fixed capital formation declined by 1.4%. This decrease was in particular due to weak investment in transport equipment, but also construction investment and purchases of machinery were lower than in the fourth quarter of 2011. Exports increased by 1.0%. Imports stagnated more or less (0.1%), reflecting weak domestic demand in the Euro area.

The sluggish development of private consumption was mainly caused by low real income growth, which in turn reflects high unemployment and elevated inflation. For the second quarter, survey indicators and hard facts signal a further weakening of private consumption. In April, retail sales and passenger car registrations declined, and both retail and consumer confidence indicators decreased. Private consumption is held back in many Euro area countries by the elevated risk of becoming high unemployed as well as the uncertain outlook.

Graph 1

Euro area: Growth of GDP and its components
Contribution to growth, percentage points



Source: Eurostat

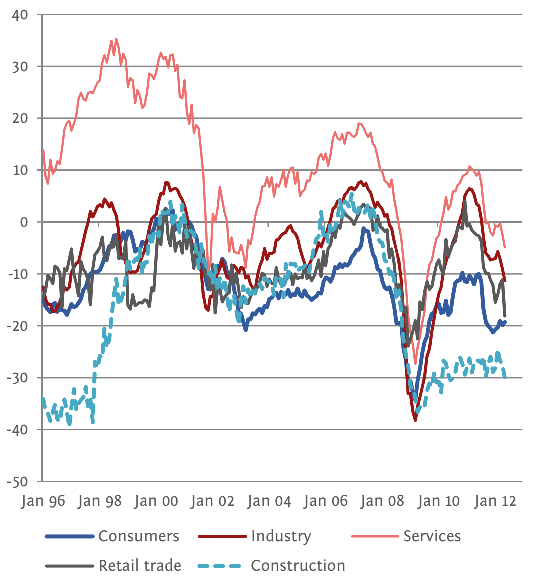
The decline in investment reflects tight financing conditions in many Euro area countries as well as subdued demand. In the second quarter the capacity utilisation rate declined further to 79.7%, which is markedly below the long-term average of 81.5%. This suggests a continuation of sluggish capital formation, a view also supported by recent indicators. New orders of capital goods continued to decline in the first quarter, and the Purchasing Managers Index (PMI), the industrial confidence indicator as well as industrial new orders suggest that industrial production is weak (graph 2), which discourages capital formation.

At the current junction, investors are cautious because the economic perspectives are dimmed by high uncertainties. These are reflected in the rise of Italian and Spanish sovereign bond yields in June. Furthermore, financing conditions remained difficult, which also dampened construction investment. Due to uncertain income prospects, private households are reluctant to engage in real estate. Furthermore, prices continued to decrease in many countries house. In addition, government investment is likely to have declined against the backdrop of continued fiscal consolidation.

Graph 2

Euro area: Confidence indicators

Balance of positive and negative replies



Source data: Eurostat

In most Euro area countries the labour market worsened further. In the Euro area as a whole, the seasonally adjusted unemployment rate reached 11% in April, up by 1.1 percentage points from a year earlier. The large heterogeneity of the labour market situation prevailed. The unemployment rate ranged from 3.9% in Austria to 24.3% in Spain. Employment has been declining since the third quarter of 2011. In the first quarter of 2012, the number of people in employment was down by 0.2%.

Inflation remained high in the first quarter of 2012, but started to decline in the recent months. Following 2.7% in the first quarter, inflation reached 2.6% in April and 2.4% in May. Fuel prices remained the main source of consumer price inflation. Core inflation (excluding energy, unprocessed food and tobacco) dropped from 1.9% to 1.6%.

Tight fiscal policy is a common feature of almost all Euro area economies

As a whole, the Euro area fiscal deficit was reduced substantially in 2011, reaching 4.1 % of GDP compared to 6.2% in 2010. This consolidation was largely shared across all members, although both the level of deficits and the dynamics of the debt differed markedly.

After the two LTRO operations of the ECB, sovereign debt interest rates decreased markedly in the first quarter. Especially short-term bonds issued by Spain and Italy showed lower rates. But this relief has been short-lived as the sluggish economy has put into question the adjustment programs of public finance in some key countries. As a result, investors have again shown growing signs of distrust. This has been translated into very high long term interest rates for Italy and above all for Spain.

Since economic activity can be expected to remain weak, this limits the reduction of the public deficit. In the Euro area as a whole, it is estimated to be cut by half a percentage point relative to GDP. However, the structural measures implemented to reduce the fiscal deficit might represent around 1 percentage point, compared to 2% in 2011. Next year, structural deficit is again expected to be reduced by around 1%, allowing the Euro area public deficit to shift below the 3% of GDP threshold. However, behind this general pattern there are significant differences between countries.

In *Germany*, the fiscal stance will be only slightly restrictive if not neutral this year and the next. Some of the consolidation measures planned by the government will not be realized or will come into effect in a lower extent than announced. On the other hand, some additional expenditure measures can be expected to come into effect 2013. Not taking into consideration one off measures eventually necessary in the context of the Euro crisis, the fiscal deficit will decrease in 2012 and also in 2013. The main reasons are declining interest payments due to the extremely low interest rates on government bonds and the more tax efficient structure of aggregate demand

In *France*, the new government has confirmed two targets: the 3% threshold will be reached next year and in 2017 budget should be balanced. This adjustment would be mainly conducted through tax hikes. However, if economic growth is below the government's expectations, those two targets would be difficult to reach without a second-round tightening of fiscal policy. . Indeed, the government has already announced a freeze in the State expenditures (excluding pensions and interest payments).

Italian fiscal policy is facing deteriorating growth prospects, affecting the original Government plan to reach the balance budget target in 2013, which now should be achieved two years later. The fiscal correction was repeatedly tightened in the course of 2011 in order to stay able to achieve a close-to-balance budget in 2013. Italy is therefore still close to reaching its fiscal targets, but risks are to the downside: On the one hand, dull or dampening growth prospects may influence the effectiveness of the correction measures negatively; on the other hand, the recent rise of the spread of Italian vs German bonds could generate a spiral of increasing interest expenditure and need for further fiscal correction despite a primary surplus that will reach its historical peak (almost 5.7% of GDP in 2015 according to the latest Government projections).

If Italy is under pressure of financial markets, the situation of *Spain* appears to be even worse. The Stability Programme projects a reduction of fiscal deficit from 8.5% in relation to GDP in 2011 to 5.3% in 2012 and 3% in 2013, and then continuing this process to reach 1.1% in 2015. This trend is associated with an increase of the debt to GDP ratio from 68.5% in 2011 to 82.3% in 2013, and a subsequent decline to 80.8% in 2015. For 2012, the budget targets require a reduction in General Government fiscal balance by € 35 bn. Given that spending on social benefits could increase according to official estimates by more than € 6.3 bn and interest payments by another € 7.2 bn, the reduction in other costs (taking into account increased income of € 10 bn) should amount to 38 bn, of which slightly less than 33 bn would be cuts in government consumption (about 8% in real terms) and investment (approximately 50%) and the remaining 5 bn would be saved in other expenses, primarily transfers. For subsequent years, additional expenditure containment would be very limited. As it will be necessary to continue the rebalancing, a new rise in the VAT rates is expected. This seems plausible, since even after the increase in 2010 the general rate (18%) is still one of the lowest in the Euro area.

Finally, in *Greece*, the successfully completed debt exchange with private sector involvement substantially reduces interest expenditure and is expected to contribute to the
.

Greece after the elections

In the recent legislative election in Greece, the centre-right New Democracy party won the majority of votes (with 29.66%) and, thereby, obtained 129 seats (including 50 bonus seats for the leading party) in the country's 300-seat Parliament. It has agreed with the socialist PASOK and Democratic Left upon the formation of a coalition government. The Radical Left SYRIZA party, with 26.89% of the votes second in the election, declined participation in the coalition and refused support to the new government scheme. It is oriented towards a hard opposition against the memorandum stance. Representatives of the three coalition parties are now working, as a first step, on a document incorporating the policy principles to function as a framework agreement.

The result of the Greek June election appears to have put an end to the political deadlock that threatened to compromise the ongoing efforts to consolidate the Greek economy. Undoubtedly, this development brought about a temporary relief within the closer European and wider international environment. Domestically, the great anxiety over the impact of a potential renewed inability to form a government settled. Nevertheless, the severity of the economic situation facing the country leaves no room for general complacency and no time to waste before overtaking responsibilities and undertaking actions.

The country and its newly formed government are again confronted with undisputed facts and serious challenges. Fact is that the reference point for policy is dictated by the terms and conditions of the second loan agreement and the economic adjustment programme 2012-2014, even in the case of a successful renegotiation. Fact is also that due to the worse than anticipated economic conditions, as well as failures and delays, there is underperformance in the process of economic adjustment. Fact is, finally, that a great part of the Greek population has reached the limit of feasible sacrifices.

Under these circumstances, the three-party coalition government, in order not to lead itself and the country to another impasse, has to stand up to the most crucial challenge: start, as soon as possible, to create conditions for reciprocity, namely a solid balance between what is expected and required and what is rendered and provided, both to Greek citizens and European partners. This will be the cornerstone for building and sustaining the chain of effective policy actions, enhancement of confidence, achievement of targets, and improvement of economic conditions towards sustainable growth and long-term prosperity.

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medium term sustainability of the debt. Still, fiscal policy faces the challenge to meet the revised 2012 fiscal targets (general government balance and primary balance targets set at -7.3% and -1.0% of GDP, respectively), given the 2011 fiscal adjustment underperformance and the non-improving macroeconomic conditions. Beside the necessity for a strict commitment to budgetary discipline, a more rigorous implementation of structural fiscal reforms remains absolutely imperative.

In less problematic countries, like *Slovakia*, the fiscal stance has also to be adapted to common targets. To keep the deficit as planned at 3% for 2013, the newly elected government has prepared a proposal for 22 diverse measures on revenue side of the budget. These shall be borne mainly by rich as a symbol of solidarity, included are bank tax, tax on deposits, gambling, tobacco, property, dividends, land and also higher corporate income tax (thus abolishing the flat tax). The government claims there is no room for structural changes or larger cuts on the expenditure side due to short time.

In *Austria* the general government budget deficit ratio declined in 2011 on the back of the good economic performance to 2.6%. However, due to the economic stimulus measures of 2008 and 2009, the financial assistance programmes to Greece, Ireland and Portugal, as well as banking recapitalisation packages, the debt ratio increased further to 72.2%. According to the April 2012 Stability Programme, in the period 2012 to 2013 structural consolidation will be reinforced by the measures adopted in the "stability package". Against the background of the economic slowdown in the first half of 2012 and one-off effects (state aid to banks), however, the

Is a bailout needed for Spain?

In the middle of this June, the risk premium on Spanish debt came dangerously close to the levels that triggered the interventions in the cases of Greece, Portugal, and Ireland, firing all alarms on a future rescue of the Spanish economy. In fact, if we look at the situation of the financial markets in these three Euro area economies at the eve of the interventions, the position of the Spanish on June 18th. may be considered practically in intervention zone.

Country	Date	10 years government bond yield	S&P	Rating Moodys	Fitch
Greece	23/04/2010	8,92	BBB+	A3	BBB
Ireland	21/11/2010	8,32	AA-	-	BBB+
Portugal	06/04/2011	8,96	A-	-	BBB
Spain	18/6/2012	7,10	BBB+	Baa3	BBB

But beyond market expectations it would be interesting to analyse to what extent the Spanish economy really needs to be intervened or rescued by the Troika.

According to the latest EUROSTAT data the Spanish debt to GDP ratio published by Eurostat in 2011, Spain presented a level of public debt equivalent to was at 68,5% in 2011, significantly below the average of the Euro area countries (87.2%) and far from the levels in Greece (165.3%), in Ireland (108.2%) or in Portugal (107.8%). This moderate debt level means, although the share of government revenues in GDP in Spain is with 35.1% one of the lowest in the Euro area (45.3% on average) that the total burden of interest payments on current revenues stood at 6.8%, very close to 6.6% average in the Euro area, and significantly below the levels of Greece (17.1%), Italy (10.4%), Ireland (9.5%) or Portugal (8.7%).

In the light of these data it does not appear that the Spanish economy urgently needs outside help to finance their public accounts. In fact, the Spanish treasury continues covering all its needs in the market, showing demand emission ratios greater than two for most of the instruments offered. Nevertheless, it is also true that the interest rate it is required to pay in the primary markets has increased significantly in the recent months, and in the last issue of one year bills on June 19th the average rate was set at 5.074%, while on June 7th the 10-year bond closed with an average rate of 6.044 %.

Since the comparison of the situation of public finances does not seem to justify these huge spreads in interest rate on Spanish bonds, the elevated risk assessment of the financial markets obviously reflect concerns about the potential costs of recapitalizing the banking sector.

But according to the recently published report by two independent auditors, Oliver Wyman and Roland Berger, the capital needs of Spanish banks would fall in a range between 25 and 62 billion Euros, depending on alternative scenarios.

Even if the Spanish government had to deal with the total amount without help from outside, public debt would rise only by between 2.3% and 5.8% of GDP in 2012. Together with the 5.3% deficit estimated for this year, this would lift the total debt to about 80% in the worst scenario, and this would still be well below the 91.8% which European Commission estimated for the entire Euro area.

In any case, it appears that financial markets do not totally trust in the Spanish economy. From January to March this year, foreign investment in Spanish public securities has been reduced by more than € 22 bn, to be added to another 12 bn reduction in 2011.

If this trend will continue and if you keep emission rates at 6% during this year 2012, (compared to 3.5% in 2011) the additional cost Spain would have to face would stand between 3.7 and 4.6 bn Euros, because of a net emission of € 188 bn as a sum of the total maturities of debt till the end of the year of 70 bn, the deficit of 56 bn and the capital needs for banks between 25 and 62 bn Euros.

Even if we add this additional cost to the estimated amount of debt, it would remain significantly lower than those estimated for Euro area as a whole. All in all, the tensions Spain experiences now seem not to be fully justified by the debt situation observed.

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Maastricht deficit will deteriorate in 2012 as compared to 2011 and is expected to amount to 3% of GDP. By 2013 at the latest, the Maastricht deficit will be reduced sustainably and significantly below 3% of GDP. It must be noticed that on 7 December 2011, the Austrian Parliament adopted a debt brake inspired by the German model. The debt brake specifies that the federal budget has to be structurally balanced by 2017. This obligation will be considered to be respected, if the Federal Government balance does not fall below 0.35% of GDP in structural terms. As of 2017, the budget of states and municipalities will be regarded as structurally balanced as long as the structural balance does not fall below 0.1% of GDP. Therefore, a structural balance of 0.45% of GDP represents the threshold at the general government level.

Can ECB do more?

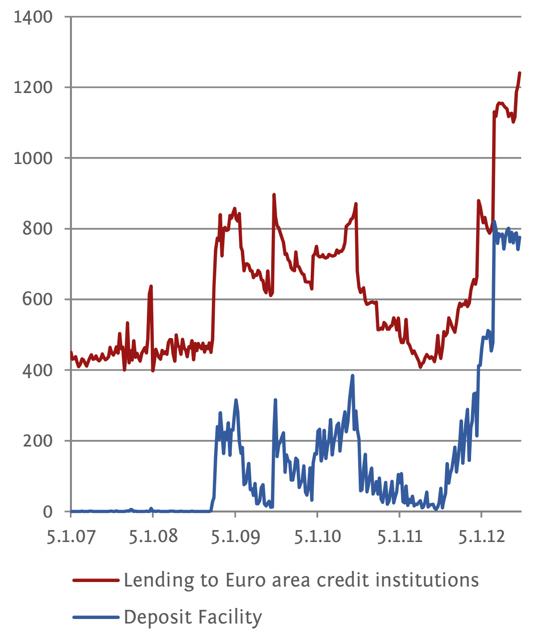
Since the 14th December 2011, key interest rates have remained unchanged. ECB action has been focused on non-conventional measures. In particular, ECB launched two long-term refinancing operations (LTRO) with an exceptional maturity of three years, which has contributed to inject around one trillion of euros in the economic system. The ultimate target of this strategy is to unfreeze the banking sector and thus allowing a better transmission of monetary policy. However, around 800 billion of euros went back to the ECB as deposits because banks fear to be short of liquidity (graph 3). ECB is more reluctant to buy public bonds on the secondary market. At the moment it has stopped this kind of action. Of course, contrary to what is observed in the US and in UK, ECB is not allowed to buy public bonds on the primary market.

At this stage, what can be done by the ECB if economic growth disappoints again? A cut in interest rates is always possible. But monetary authorities seem not keen to put the reference rate close to zero, let us say 0.5%. However, this option cannot be totally excluded, especially if inflation remains low. A new LTRO might be implemented, if the banking system shows renewed signs of weaknesses. Finally, a reactivation of public bonds purchases on the secondary market is another option. Moreover, according to the last political arbitrages, ECB might be in charge in the future to supervise the European banks in case of creation of a formal banking union. Indeed, the creation of a banking union might help breaking the vicious spiral between the banking system and the public deficit, which is currently at the heart of the crisis.

Graph 3

ECB lending to banks and deposit facilities

€ bn,



Source: ECB

Euro Area GDP will decline this year

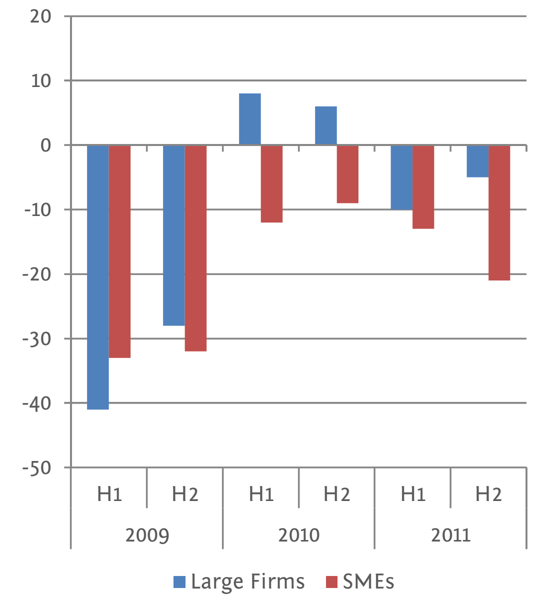
A less dynamic international environment, a restrictive fiscal policy, and a deteriorated confidence among consumers and investors form an unfavourable setting for the economic development in the Euro area in this year and the next. The stagnation of GDP in the first quarter was mostly owed to the unexpectedly strong expansion in Germany; most of the Euro area countries have already been in recession. For the second quarter, indicators already hint at a further decline of GDP. However, since the situation in Germany, Austria and some other countries, where the fiscal drag is modest and therefore stimulating effects of low interest are stronger, the decline of GDP on average is expect to be not very sharp. For the year 2012, the EUREN institutes forecast GDP to shrink by 0.3% (table 2), with large differences between Euro area members. Whereas economic activity is expected to increase in Germany, Austria, Slovakia and some other countries, a strong decline can be awaited in particular for Greece, Spain and Italy.

Driving force of the downswing will be gross fixed capital formation. Investment in construction is not out of the doldrums yet after the burst of real estate bubbles in some countries. At the same time, access to external funding has become less favourable to firms (graph 4) and the loss of confidence makes companies to postpone investments. Also consumer expenditure will decline due a growing risk to lose the job or to experience cuts in income for many workers in various countries. Fiscal consolidations measures,

Graph 4

Availability of external financing for Euro area firms

Net percentages



Source: ECB Survey on the access to finance of small and medium sized enterprises in the Euro area. Difference between the percentage of firms reporting an increase of funding and those reporting a decrease.

Table 2

Euro area forecast

	2010	2011	2012[f]	2013[f]	2012				2013[f]			
					I	II[†]	III[†]	IV[†]	I	II	III	IV
	Annual % change (unless indicated otherwise)				q-o-q%, seasonal adjusted (unless indicated otherwise)							
Private consumption	0.9	0.2	-0.5	0.2	0.0	-0.2	-0.1	0.0	0.0	0.1	0.2	0.2
Public consumption	0.7	-0.3	-0.8	-1.1	0.2	-0.5	-0.5	-0.4	-0.2	-0.2	-0.2	0.0
Gross fixed capital formation	-0.2	1.6	-2.8	0.1	-1.4	-0.8	-0.6	-0.2	0.2	0.3	0.5	0.7
Change in inventories[1]	0.6	0.2	-0.6	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic demand	1.2	0.6	-1.6	-0.1	-0.4	-0.4	-0.3	-0.1	0.0	0.1	0.2	0.3
Exports	11.0	6.3	2.1	4.2	1.0	0.1	0.7	0.9	1.2	1.2	1.3	1.4
Imports	9.4	4.1	-0.6	2.3	0.1	-0.3	0.3	0.6	0.6	0.7	0.9	0.9
Net exports[1]	0.7	1.0	1.2	0.9	-	-	-	-	-	-	-	-
GDP[1]	1.9	1.5	-0.3	0.8	0.0	-0.2	-0.1	0.1	0.3	0.4	0.4	0.5
Unemployment (% of labour force)	10.1	10.2	10.9	11.1	10.8	10.7	11.0	11.2	11.4	11.2	11.1	10.9
Compensation per employee, yoy	1.6	2.2	1.9	2.0	1.9	1.9	1.9	1.9	2.0	2.0	2.0	2.0
Consumer price (HICP), yoy	1.6	2.7	2.3	1.9	2.7	2.4	2.1	1.9	1.8	1.8	1.9	2.3
Current account balance (%GDP)	-0.1	0.3	0.3	0.7	-	-	-	-	-	-	-	-
3m interest rates (% per annum)	0.8	1.4	0.7	0.9	1.0	0.7	0.5	0.6	0.7	0.8	0.9	1.0
10y Gvt bond yields (% per annum)	3.6	4.4	4.3	3.9	4.4	4.4	4.3	4.2	4.1	4.0	3.8	3.7
ECB repo (end of period)	1.0	.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0

This forecast was finished on 15 June 2012. – [f]EUREN forecast. – [1]Contribution to growth.

finally, will cause declining public consumption expenditures. All in all, domestic demand will shrink by 1.6%.

For 2013 a stronger global economy will boost exports and, under the assumption that the problems in the Euro area will be settled by and by, companies will do some of the investments which have been postponed. Furthermore, fiscal drag can be expected to become somewhat smaller, although due to a negative carry over the annual average rate of government consumption will be more negative than 2012. Thus domestic demand will start to increase again, leading to an increase of imports. All in all GDP will turn back to growth and it will increase by 0.8%. The large differences between Euro area members, however, will persist.

Given the weak growth of production, unemployment can be expected to continue its upward trend over the next quarters. According to our forecast, the situation will improve somewhat during the next year. Partly this is due to stronger economic growth. But it also will play a role that some of the unemployed might withdraw from the labour market after having not been able to find a job for quite a long time. The annual average of the unemployment rate will reach 10.9% in this year and 11.1% in the next.

Inflation is expected to decline during this year because on the one hand raw material prices have decreased considerably in the recent month. On the other hand capacities in the Euro area continue to be under-utilized so that the inflationary pressure from this side is low. Thus, HICP inflation is expected to drop below the ECB target during the forecast period. However, due to consolidation needs some governments may increase taxes which may result in a somewhat higher inflation. The annual inflation rate is expected to go down to 1.9% in 2013 after 2.3% in this year. Towards the end of 2013, raw material prices are expected to rise again, because global demand will be somewhat stronger then. Furthermore, a better internal demand may enable producers to raise their prices somewhat stronger.

Despite of the more optimistic outlook for 2013, there are years of diminished expectations ahead for the Euro area. Fiscal policy will concentrate on consolidation also after 2013. Moreover, a part of the capital stock, in particular buildings, has lost its value. Finally, for many countries financial conditions will be less favourable as they have been in the first years of the EMU, which will drag fixed capital formation.

Finally it should not be forgotten that this forecast is based on the assumption that problems in the Euro area will not aggravate. This can, however not be taken for sure. The risk of new turbulences is quite high, and the question is, how long those countries that stabilize the Euro area economy now can stand the problems of their most important trading partners.

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Impressum

The European Economic Network (EUREN) is a network of European economic research institutes, which was formed in 1999. Members of EUREN are:

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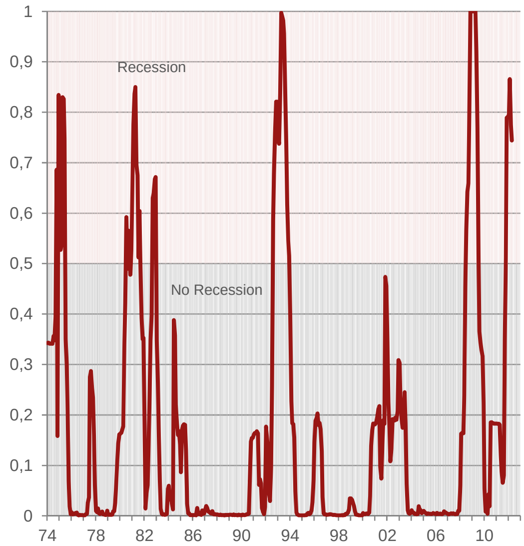
Editor of this issue: Roland Döhrn

Coe-Rexecode Start-End Recession Index for the Euro Area: Weak recession

The IARC indicator stands at 72.1 in May and is possibly receding below 60 in June, which would mean that there will be no end of the slowdown during the coming nine months. The uncertainty in the Euro area has never been so high despite a global environment still supportive. The start-end recession indicator (IESR) is above the 0.5 threshold since September 2011 without however converging towards one because the industrial production has not yet turned globally into recession. It stands at 0.74 in April but could diminish because the contribution of the household confidence index is turning less negative in May. In addition, the underlying growth rate in May 2012 is positive at 0.2 % (annual rate). Insofar, the zero growth of the first quarter gives an accurate summary of the current situation: economic stagnation rather than strong recession.



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Forecast of the EUREN/CEPREDE High Frequency Model

Last update: June 26th, 2012

	11 Q1	11 Q2	11 Q3	11 Q4	12 Q1	12 Q2	12-Q3	12_Q4	2011	2012
Jan-11	1.5;-0.1	0.9;0.4							0.5	
Feb-11	1.5;-0.1	0.9;0.4							0.9	
Mar-11	1.5; -0.1	0.9;0.4	0.5;0.2	0.6;0.1					0.9	
Apr-11	1.5; -0.1	0.9;0.3	0.5;0.2	0.6;0.2					0.9	
May-11	[2.5;0.8]	2.1;0.5	1.8;0.3	2.0;0.2					2.1	
Jun 11	[2.5;0.8]	2.1;0.6	1.8;0.3	2.0;0.2					2.1	
Jul-11	[2.5;0.8]	2.0;0.5	1.6;0.2	1.7;0.2					2.0	
Sep-11	[2.5;0.8]	[1.7;0.3]	1.6;-0.2	1.7;0.4					1.6	
Oct 11	[2.5;0.8]	[1.7;0.3]	1.2;-0.1	1.4;0.5	1.7;1.2	1.8;0.2	1.7;-0.3	1.6;0.4	1.7	1.7
Nov-11	[2.5;0.8]	[1.7;0.3]	[1.4;0.1]	1.0;0.2	1.4;1.1	1.3;0.2	1.3;-0.4	1.4;0.3	1.5	1.3
Dec 11	[2.5;0.8]	[1.7;0.3]	[1.4;0.1]	0.7;-0.4	0.6;0.7	0.6;0.2	1.2;0.7	1.9;0.3	1.5	1.1
Jan 12	[2.5;0.8]	[1.7;0.3]	[1.4;0.1]	0.6;-0.4	0.3;0.5	0.4;0.2	1.1;0.8	1.9;0.4	1.5	0.9
Feb 12	[2.4;0.8]	[1.7;0.3]	[1.4;0.1]	[0.7;-0.4]	0.0;0.2	0.0;0.1	0.8;1.0	1.8;0.5	[1.5]	0.7
Mar 12	[2.4;0.8]	[1.7;0.3]	[1.4;0.1]	[0.7;-0.4]	0.2;0.3	-0.3;-0.4	-0.5;0.0	-0.2;-0,1	[1.5]	-0.2
Apr 12	[2.4;0.8]	[1.7;0.3]	[1.4;0.1]	[0.7;-0.4]	0.3;0.4	-0.2;-0.3	-0.3;0.0	0.1;0.0	[1.5]	0.0
May 12	[2.4;0.8]	[1.7;0.3]	[1.4;0.1]	[0.7;-0.4]	[0.0;0.1]	-0.4;-0.3	-0.6;-0.1	-0.6;-0,3	[1.5]	-0.4
Jun 12	[2.4;0.8]	[1.7;0.3]	[1.4;0.1]	[0.7;-0.4]	[0.0;0.1]	-0.4;-0.3	-0.7;-0.2	-0.7;-0,3	[1.5]	-0.4

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

Almost all indicators coming in during the last month have deteriorated. Only the real retail trade turnover has a bit, but the figures relate to March. The confidence and sentiment indicators increasingly reflect the uncertainties about the euro crisis and future of the single currency. Taking into account all these trends, our HFM shows a lower GDP growth rate for the rest of this year reaching an annual average of -0,4%, two tenths below previous month's estimate.

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