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Editorial: From convergence to divergence and disparities

An implicit objective of introducing a single currency in Europe was to ensure that living standards in the whole euro area will converge in the medium and long-term. During the first part of last decade, successful implementation of policies led to first encouraging results. The level of Greek GDP per capita was about 27% lower than the average GDP capita in the euro area in 1999 when the euro was first introduced. Eight years later, it was only 17% lower. The same applies to Spain, where the gap with the average Euro area GDP per capita was reduced from 14% to only 4% during the same period. However, the financial crisis revealed that this convergence process was built on deep imbalances such as unprecedented current account deficits (11 % of GDP in Greece in 2007, 9 % in Spain). Those imbalances were illustrating a fast growing internal demand through easy access to credit and thus a sharp increase in the level of both public and private debt

The direct effects of the financial turmoil, in particular the post-crisis fiscal tightening, slowed down the convergence process. Even more, opposite to the previous period, living standards are now diverging. In Greece, Portugal, Spain, and Italy, they have already reached historical lows, going back to levels before the introduction of the euro. Greek GDP per capita will be close to 55 % of the euro zone average in 2013 and probably 50% by 2015. Spain GDP per capita will be at about 87 % of Euro area average this year. However, current account deficits have been significantly reduced or have even disappeared as it is the case for Spain, This reduction is mostly caused by a decrease of imports rather than by an improvement of export competitiveness of these economies.

The soundness of this improvement and its ability to ensure a more stable and strong economic growth will be now highly dependent on the evolution of factors determining competitiveness. Those factors are, in a first round, cost of labour and cost of capital. A positive point is that the gap between unit labour costs in the Euro area economies has already narrowed. The main drivers of this process are the impressive reduction in labour cost per hour in Greece, its stabilization in Southern part of Europe (except Italy) and its acceleration in Germany. As regards to capital cost, the process is still much more a diverging than a converging one. First, Interest rates for business lending (for credits under one million euros) are still about 300 basis point higher in Spain than in Germany or France. Second, implicit tax rates on capital and business income as well as on income of corporations have spread out. They have climbed to their highest level ever measured in France while they are on a decreasing trend in Germany. Fiscal harmonization is in fact much more a policy debate than it appears in the figures. From this point of view, the Euro area is definitely not an optimal monetary union characterized by the unification of cost of capital throughout its different components!

In a longer term perspective, the reduction of external imbalances will be highly dependent of the evolution of the factors of production. A growing issue is the outflow of migrants from the Southern European countries. It means a way of escaping unemployment for people concerned. These flows, however, are also undermining potential growth in the medium term as long as the people leaving the countries are among the younger and the more qualified. Also, a second issue is the financing of productive investment. This issue is particularly relevant for countries which face a weakening of their financial and banking systems. The Euro area has to gradually switch its focus from the short-term goal of overcoming the crisis and fighting against weaknesses and shortcomings to an emphasis on targets such as the enhancement of economic activities for ensuring stable and strong economic growth in the future (see EUREN-News editorial 2013:1).

More generally, after hopes for convergence, the Euro Area has now to cope with deep and long-lasting disparities. Such a process implies a new vision for a European economic policy

Contact: *Denis Ferrand // dferrand@coe-rexecode.fr*

The EUREN Summer Forecast 2013

The Euro area will recover in 2014

Despite of a slight upturn in various sentiment indicators the global economic environment is still characterized by downward risks. Due to the consequences of the hard winter Q1 growth rates fell short of expectations in many of the developed countries. Notwithstanding this, there is in general some hope that economic growth will gain momentum in the second half of the year and thus a more vivid expansion will be seen in 2014. However, expectations of an economic recovery hinge on higher exports in many countries, resulting from a stronger global demand. Insofar expectations could turn out to be inconsistent, since exports cannot be the cure for all countries' problems.

There is still the danger that overall growth will be dampened by fiscal constraints and deleveraging efforts of households in a number of countries. Although international financial markets have become more stable in the recent months, risk aversion among investors is still high dampening investments in the real sector.

Growth in advanced economies dampened by fiscal constraints and weak demand

Since dampening factors are still working, the EUREN institutes reckon that the expansion of world trade will be moderate this year (3.6%). However, in the second half of this year global growth will accelerate, leading to a more dynamic pick up in the next year. Domestic demand will remain subdued in most regions over the forecast horizon despite of the highly expansive monetary policies and low interest rates. Consequently export performance of developed countries will be less dynamic this year. Although the Fed has been communicating that the period of quantitative easing will come to an end, EUREN Institutes expect only a moderate upward correction of interest rates as neither business outlook nor the situation in the labour market give much room too for a more restrictive policy.

The inflation climate will remain mild. There will be no significant cost push from the raw material markets. Due to sluggish demand the oil price will settle at a lower level than the years before. However, recent geopolitical conflicts may cause some upward pressure. The rise of food prices might push up inflation rates, but only to a moderate extent. At the same time capacity utilization is low in many countries which limits the increase of labour costs.

Table 1

Exogenous and international variables

2011 – 2014; Percentage changes unless otherwise indicated

	2011	2012	2013^{f}	2014^{f}
World trade	6.3	2.4	3.6	5.5
United States				
GDP	1.8	2.2	2.0	2.7
Inflation	3.1	2.1	1.6	2.0
3m interest rates	0.34	0.43	0.3	0.5
10y Gvt bond yield	2.8	1.8	2.0	2.5
Japan				
GDP	-0.5	1.9	1.7	1.4
3m interest rates	0.19	0.19	0.2	0.2
10y Gvt bond yield	1.1	0.85	0.8	0.9
China, GDP	9.3	7.8	7.5	8.0
US dollar/euro	1.39	1.29	1.31	1.30
Oil price Brent				
US$/barrel	111.1	111.7	104.9	102.0
Percentage changes	39.5	5.4	-6,1	-2,7
World trade	6.3	2.4	3.6	5.5

^{f}*EUREN Forecast*

GDP growth in the OECD area is estimated to reach 1.3% this year and to pick up slightly to 2.3% in the next year. For the U.S. EUREN institutes forecast a slowdown of GDP growth to 2% in this year. For 2014 there are signs that domestic demand, especially private consumption will become livelier, and that will improve, making GDP grow by 2.7%. This scenario is based on the assumption that neither fiscal consolidation nor the recently signalled change in the monetary stance of the Fed will dampen US growth considerably. In Japan investment activity is sluggish, whilst exports benefited from the depreciation of the Yen. Fiscal policy is stimulative this year but it will have negative effects on Japanese GDP in the coming years, which cannot be counterbalanced by monetary policy, which is highly expansionary anyway. In the EU 27 countries GDP growth will be lower as expected before, especially due to the on-going recession in the Euro area. New member states outside the Euro area suffer from shrinking external demand and internal imbalances are also hindering growth in some of the countries.

Emerging markets suffer from sluggish global demand

Emerging markets also suffer from weak external demand, thus a slowdown of growth can be expected for the most countries. For the Asian region but also for the rest of the world it is important how the situation in China will develop. Recently, China experienced a marked slowdown of growth. Both investments and the credit business showed negative signs, business expectations are less positive and a temporary liquidity squeeze drew attention to the structural problems and the risky lending practices of the Chinese banking sector. The Chinese government tries to move towards a more sustainable growth model which is to a lover extent driven by credit and investment and may lead to a lower headline GDP growth.

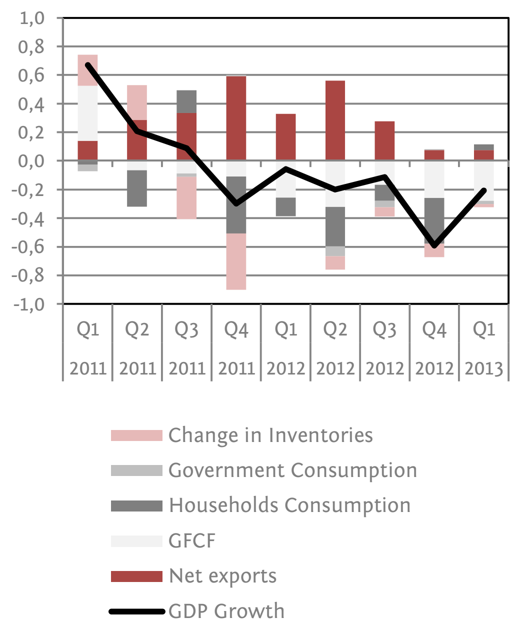
Domestic demand remains sluggish

Since the first quarter of 2011, the Euro area economy is caught by a process of constant deceleration of growth. The first quarter of 2013 was the sixth quarter in a row showing a decline of GDP, even if the recent decrease has been somewhat milder (-0.2%) compared to a negative rat of -0.6 in the last quarter of 2012.

Looking at the contributions of different components of aggregate demand, we can see that the slowdown was mainly caused by domestic demand, which reached the most negative contribution in late 2011 (Graph 1). The contribution of net exports has been positive over the last two years. However in the recent quarters they lost momentum considerably. In this sense, one might argue that the deterioration of the external environment was the main cause for the relapse of the GDP growth rate at the end of the last year.

Graph 1

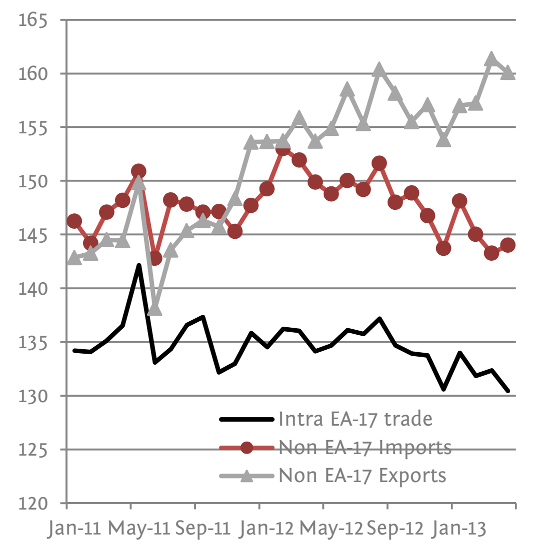
Euro area: Growth of GDP and its components.
Contributions to growth percentage points



Source: Eurostat

Graph 2

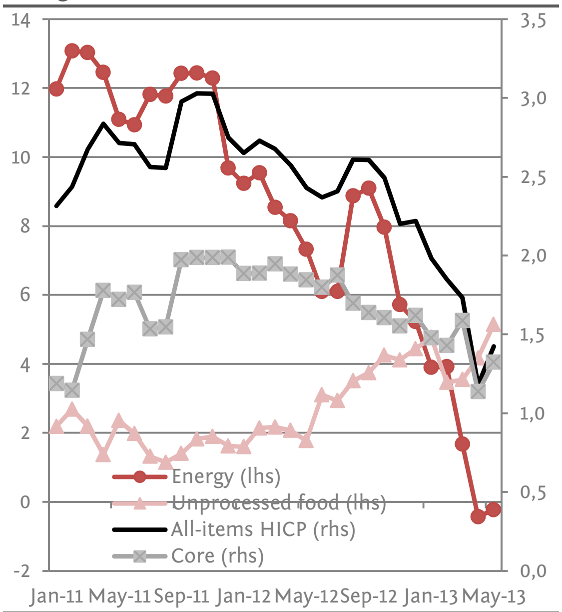
Euro area: Exports performance
€ bn, seasonally and working day adjusted



Source: Eurostat

Graph 3

Euro area Harmonized Price Index
YoY growth rate.



Source: Eurostat.

Nevertheless, when analyzing the exports and imports of goods in more detail, it can be seen that the decline in the rate of export growth originated from intra-Euro area trade (graph 2). At the same time sales to the rest of the world grew more or less constantly at a year over year rate of about 6% since January 2012. Exports to the Euro shrank by about 1% on average over the same period.

Looking ahead, the recent indicators seem to hint at a change in trend of real GDP. While soft indicators such as business and consumer confidence and expectations have already surpassed their cyclical minimum in the second half of last year, the hard indicators such as industry production have reached their minimum in the first quarter of this year.

Regarding inflation, it is interesting to note that the general price indicator converged towards the core inflation (excluding energy and unprocessed food) significantly after having shown a huge gap in early 2012 (graph 3). Narrowing this gap reflects a continuous moderation energy price inflation, which even compensated for the slight acceleration of the prices of unprocessed food starting in mid-last year.

FED and ECB soon out of sync?

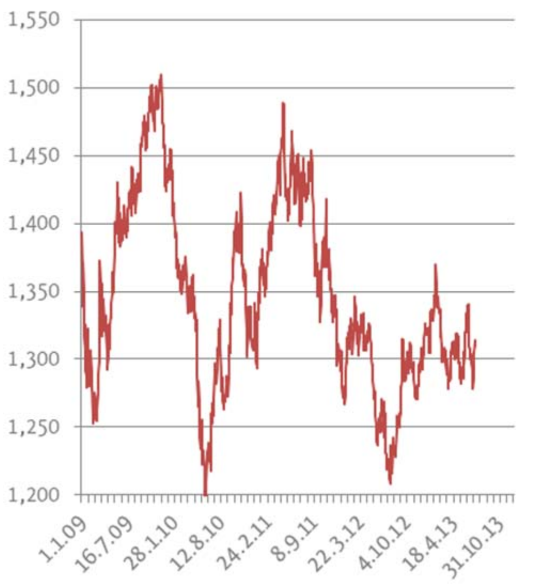
With its decision from 2nd of May, the ECB lowered its interest rate on the main refinancing operations by 25 basis points to the all-time low of 0.50%. This cut was mainly owed to the overall economic weakness and the low underlying pressure on prices over the medium term. But as it seems this might have been the last cut in a while even though recent inflation data do not provide any reason to put a hold on the expansionary monetary policy.

But the biggest stimulus for the Euro area might not be generated by the ECB, but by the fed. Chairman Bernanke's tapering statement which indicated an end of the very expansive monetary policy put pressure on the stock markets as well as on the Euro. Relaxing his statement through members of the Federal Open Market Committee (FOMC) did not last long since strong US employment data led to another drop of the Euro right after the announcement. At the beginning of July 2013 the Dollar-Euro rate reached a three-month low (graph 4). In a very recent statement, however, Mr Bernanke signalled no change in QE3 policy, which again triggered immediate reaction on stock and exchange markets. But still, the condition out there is clear: Once US economic data will show signs of strong recovery, the ECB will start fading out the expansionary monetary policy.

Graph 4

Euro-Dollar exchange rate

$/€, business daily



Source: Feri.

Thus, if the US economy recovers faster than the economy of the Euro area, and the signs look like it, US expansionary monetary policy will eventually come to an end while the ECB has no reason at all to follow its American counterpart. This should rather later than sooner depreciate the Euro against the US-Dollar which simply translates into an increasing cost advantage for Euro area goods and services. In the end Euro area exports will benefit while on the other hand a hardening of energy prices denoted in Euro does not constitute a credible thread.

Fiscal policy remains restrictive

Concerning fiscal policy little has changed since our last forecast. Even if the European commission agreed that some countries will have more time to consolidate their budgets, fiscal policy continues to be restrictive. According to the latest European Commission forecast cyclically adjusted fiscal balance in the Euro area improved by 0.9 percentage points. For 2013 an improvement by another 1.2 percentage points is expected which indicates that fiscal stance will be slightly more restrictive in this year.

For 2014, the current projections assume that the structural balance will be about the same. This could indicate that the consolidation process will be at least interrupted. However, since some countries successfully negotiated for a longer adjustment period, some consolidation measures could be postponed to 2014. Thus the impulse from fiscal policy could become smaller but it continues to be negative.

Contraction in 2013, recovery in 2014

Compared to the winter forecast the EUREN institutes have revised their expectations for 2013 downward, indicating that economic slack will continue in the Euro area. The annual rate of change of the GDP is projected to amount to -0.7%. A weaker first half is expected to be followed by positive q-o-q GDP growth rates in the third and fourth quarters of 2013. Recovery is forecasted for 2014, but growth is projected to remain subdued and lie below 1.0%.

The expected unfavourable developments in GDP in 2013 will be basically driven by domestic demand. The external sector – despite the expected only marginally above-zero growth in exports – will positively contribute through imports projected to decrease by a higher rate than in 2012.

Among the domestic demand components, the strongest downward drag will be exerted by the further deceleration in gross fixed capital formation, at the back of predominantly tight credit conditions and in the absence of a strong upturn in economic sentiment. The particularly adverse developments in the labour markets in several member countries, severely impacting on incomes, and only gradually rebounding consumer confidence in others will not allow a recovery in private consumption in 2013. At the same time, still weakening internal demand, against the background of ongoing fiscal consolidation, will hold imports down in most countries and will not support intra-Euro area exports, hence delaying the sought acceleration in export activity.

Nevertheless, the downward movement in general economic activity is not projected to continue in 2014. Improvement in sentiment and confidence in connection with the gradual slowing down of the deleveraging process and the progressive attenuation of financial strains will bring about positive rates of change in both private consumption and investment. Public consumption is not expected to continue to be negative since the great bulk of adjustment is assumed to lie behind. Still the respective component will move around zero in 2014, since binding deficit targets will continue to play a restrictive role for a longer period of time. A positive, even though not broad, contribution is expected also from the external sector in 2014, through a considerable rebound in exports which will be, however, compensated by accelerating imports.

As regards the conditions in the labour market, in the absence of any favourable developments in consumption and investment in 2013, and given that structural reforms are still in process in several Euro area countries, they are expected to worsen in 2013. The proportion of the labour force projected to be unemployed will reach historical heights in 2013 and, on the basis of its cyclical timing feature to lag behind economic activity, it is projected to remain at over 12% in 2014 as well. Consistent with these developments in unemployment, compensation of employees is not expected to increase significantly in both 2013 and 2014.

With reference to the EUREN projections for consumer prices, inflation is set to decrease in 2013 and remain almost unchanged in 2014,

Table 2

Euro area forecast

	2011	2012	2013†	2014†	2013 I	II†	III†	IV†	2014† I	II	III	IV
	Annual % change (unless indicated otherwise)				q-o-q%, seasonal adjusted (unless indicated otherwise)							
Private consumption	0,2	-1,3	-0,7	0,3	0,1	-0,1	0,0	0,0	0,1	0,1	0,2	0,2
Public consumption	-0,1	-0,4	-0,4	0,0	-0,1	-0,1	-0,1	0,0	0,0	0,0	0,1	0,1
Gross fixed capital formation	1,5	-4,2	-4,0	1,2	-1,6	-0,6	-0,2	0,0	0,3	0,6	0,8	1,0
Change in inventories[1]	0,2	-0,5	-0,1	0,1	0,0	0,0	0,0	0,1	0,0	0,0	0,0	0,0
Domestic demand	0,6	-2,2	-1,4	0,5	-0,3	-0,2	0,0	0,1	0,1	0,2	0,3	0,3
Exports	6,5	2,9	0,1	3,9	-0,8	0,4	0,5	0,7	0,9	1,2	1,5	1,6
Imports	4,3	-0,7	-1,5	3,3	-1,1	-0,1	0,3	0,6	0,8	1,1	1,4	1,6
Net exports[1]	0,9	1,6	0,7	0,4	-	-	-	-	-	-	-	-
GDP[1]	1,5	-0,5	-0,7	0,9	-0,2	0,0	0,1	0,2	0,2	0,3	0,4	0,4
Unemployment (% of labour force)	10,2	11,4	12,2	12,2	12,1	12,2	12,3	12,3	12,4	12,3	12,2	12,0
Compensation per employee, yoy	2,1	1,7	1,3	1,4	1,3	1,3	1,3	1,2	1,2	1,3	1,4	1,4
Consumer price (HICP), yoy	2,7	2,5	1,4	1,5	1,9	1,4	1,2	1,2	1,3	1,5	1,6	1,6
Current account balance (%GDP)	0,2	1,2	2,0	2,5								
3m interest rates (% per annum)	1,40	0,60	0,25	0,45	0,20	0,20	0,30	0,30	0,30	0,40	0,50	0,60
10y Gvt bond yields (% per annum)	4,40	4,00	2,85	3,20	3,10	2,80	2,70	2,80	2,90	3,10	3,30	3,50
ECB repo (end of period)	1,00	0,75	0,50	0,50	0,75	0,50	0,50	0,50	0,50	0,50	0,50	0,50

This forecast was finished on 15 June 2012. – †EUREN forecast. – [1]Contribution to growth mainly at the back of weak economic activity, and decelerating energy prices. Particularly low inflation rates –in the case of Greece even negative rates – are expected not only in the periphery but also in some of the major core countries of the Euro area.

Short term interest rates are projected to remain in both 2013 and 2014 at levels lower than in 2012, with the 2013 rates lying as low as 0.25%. Long term rates are also expected to reach low average levels in 2013, since downward movements are not seen only in periphery countries but also in some of the core Euro area countries. Still, anticipated upward adjustments in some countries in 2014 will move the rate upwards. Finally, the recent cut in the refinancing rate by the ECB is expected to be sustained throughout the projection period.

Upward, downward risks to the outlook

Several factors appear to exist which might work in the direction of either upward or downward risks to the outlook, depending on progress made and speed of implementation. Faster than anticipated advances in fiscal consolidation processes, strict implementation of necessary structural reforms and effective restoration of the banking systems, finally and successfully transformed in the Banking Union, might result in a stronger than anticipated recovery process. Significant delays in all the above, potentially amplified by increased policy uncertainty, could lead to an unwanted postponement of the turn in economic activity beyond 2014. The impact of developments emanating from the international environment can also work in either direction. A monetary policy change in the U.S., leading to a depreciation of the Euro against the dollar, might stimulate Euro area exports. Geopolitical tensions could, on the opposite side, cause additional uncertainty, hold back investment and create counterproductive volatility.

Contact:

Roland Döhrn || doehrn@rwi-essen.de
Sebastian Koch || koch@ ihs.ac.at
Katalin Nagy || katalin.nagy@kopint-tarki.hu
Julián Pérez || julian.perez@uam.es
Ekaterini Tsouma || etsouma@kepe.gr

Impressum

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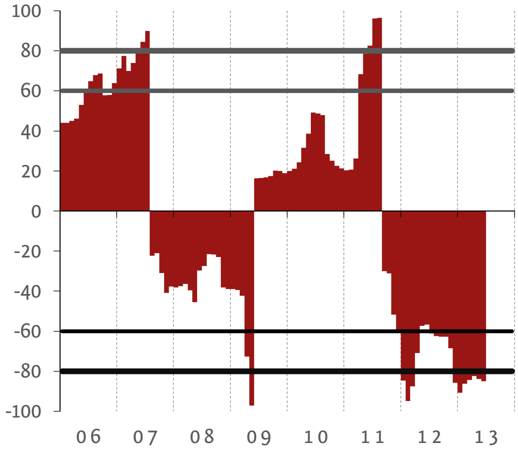
Editor of this issue: Roland Döhrn

COE-Rexecode Leading Indicator: Persistent but weak signal of rebound in 2013

The IARC indicator is now below the -80 threshold since December 2013. This sends a signal of a growth cycle trough in the second quarter of 2013 implying that growth will climb above its trend rate estimated at 0.9% in yoy terms in the fourth quarter of 2012. Financial variables continue to be positively oriented: low short-term interest rates and bullish stock market. Survey results concerning the intermediate goods in the industry are slightly improving since last October. The global world-wide environment is still supportive: a soft landing in China in terms of growth but not in absolute terms, a beneficial monetary impulse in Japan and a resisting American economy where household confidence and the construction sector are on the rise.



An indicator above 80 signals a slowdown (peak of the cycle), an indicator below -80 a rebound (trough of the cycle).

Updated July 11, 2013

Contact: Jacques Anas || janas@coe-rexecode.fr

Forecast of the EUREN/CEPREDE High Frequency Model

Last update: July 10th, 2013

	12 Q3	12 Q4	13 Q1	13 Q2	13-Q3	13-Q4	2012	2013
May-12	-0,4;0,0	-0,2;-0,2					-0,2	
Jun-12	-0,6;-0,1	-0,6;-0,3					-0,4	
Jul-12	-0,5;-0,1	-0,5;-0,4					-0,3	
Sep-12	-0,7;-0,1	-0,7;-0,4	-0,6;0,1	-0,5;0,1	-0,3;0,1	0,2;0,1	-0,5	-0,3
Oct-12	-0,6;-0,2	-0,9;-0,6	-1,0;-0,1	-0,9;-0,1	-0,5;0,2	0,3;0,2	-0,5	-0,5
Nov-12	-0,6;-0,2	-0,9;-0,5	-1,2;-0,3	-1,0;0,0	-0,7;0,1	0,2;0,4	-0,5	-0,7
Dec-12	[-0,6;-0,2]	-0,9;-0,6	-1,1;-0,2	-1,1;-0,1	-0,6;0,3	0,1;0,1	-0,5	-0,7
Jan-13	[-0,6;-0,2]	-1,0;-0,6	-1,2;-0,3	-1,1;-0,1	-0,7;0,2	-0,1;0,0	-0,5	-0,8
Feb-13	[-0,6;-0,2]	[-0,9;-0,6]	-1,1;-0,3	-1,1;-0,0	-0,6;0,4	0,0;0,0	-0,5	-0,7
Mar-13	[-0,6;-0,2]	[-0,9;-0,6]	-1,1;-0,3	-1,1;-0,1	-0,7;0,3	0,0;0,1	-0,5	-0,7
Apr-13	[-0,6;-0,2]	[-0,9;-0,6]	-1,0;-0,2	-0,8;0,1	-0,6;0,1	0,0;0,0	-0,5	-0,6
May-13	[-0,6;-0,2]	[-0,9;-0,6]	-1,0;-0,2	-0,8;0,1	-0,6;0,0	-0,5;-0,5	-0,5	-0,7
Jun-13	[-0,6;-0,2]	[-0,9;-0,6]	[-1,0;-0,2]	-0,8;0,1	-0,4;0,3	0,2;0,0	-0,5	-0,5
Jul-13	[-0,6;-0,2]	[-0,9;-0,6]	[-1,0;-0,2]	-0,7;0,3	-0,3;0,3	0,1;-0,3	-0,5	-0,5

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

As the latest data included into the High Frequency Model were slightly more positive than anticipated. Therefore, they caused slight upward revisions of the estimated growth rate for the full year 2013. Although the data suggest a positive qoq rate in the second quarter this year, the yoy rates will remain negative until the fourth quarter of the year, generating an annual average contraction of GDP similar to last year.

Contact: Julián Pérez || julian.perez@ceprede.es