EUREN-News

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Editorial: Declining oil prices – winners and losers in the Euro area

The impressive decline in oil prices in the last months is a real "game changer" for economic growth in the Euro area in the short term. Alongside the depreciation of the Euro and the new step in the softening of monetary policy, it implies a positive impulse for growth. This impulse is nevertheless highly differentiated both among countries as well as among economic activities.

If oil prices were to stabilize all along 2015 at the level reached in January (about 44 € per barrel of Brent as compared to 76 € per barrel in 2014), the trade balance for the Euro area as a whole would see an increase of its surplus by about 0.9 % of GDP, in relation with the reduction in the value of net imports of both crude and refined petroleum products. The first countries to benefit from this "manna" would be The Netherlands, Belgium and Greece, with an improvement of their trade balance by about 1.4 % of GDP. On the opposite, the Italian trade balance would see an improvement limited to 0.7 % of its GDP. This evolution can be seen as a return in gross disposable income for the whole economy.

Households are among the main winners of this decrease in oil prices through a reduction in imported inflation. Considering the weight of oil products in the basket of goods and services consumed by households on the one hand, and the evolution of producer prices of refined petroleum products in the Euro area that we can expect from the decline in crude oil prices on the other hand, households may benefit from an improvement of about 1 point of their gross disposable income for 2015. In the case of Greece, this return should be equivalent to 1.9 % of households' gross disposable income. Second round effects also have to be taken into account, both on the positive (decline in prices of goods using oil to be produced) and the negative side (higher pressure on wage moderation in relation with a slowing down inflation rate). But, even factoring in these aspects, this decrease is highly beneficial for households and hence for their consumption expenses.

Enterprises will benefit from this decrease in accordance with, first, the intensity of their use of oil and, second, their ability to retain this cost reduction in their margins. The main "winners" in terms of reduction of their energy costs are the transportation and the manufacturing industry. In the case of France for example, the former may see a reduction of its costs equivalent to 27 % of its gross operating surplus while, for the latter, it should be about 7 %. This amount is only an ex-ante effect, and it will be minimized by the likely reduction in selling prices authorized by the cost reduction. It is probably too early to have a clear idea of the sectors which will benefit in the end from the main positive impulse for their results and thus to estimate the impact on corporate spending.

The first rank losers are the enterprises involved in exports towards oil producing and exporting countries. During the previous permanent drop in oil prices that happened in the middle of the 1980's, imports from Saudi Arabia for example fell by about 40 % in 1985 and 1986 cumulated. For the Euro area, exports to OPEC countries plus Russia were close to 200 billion Euros in 2014. A drop in imports of these countries by about 20 % would consequently imply a negative shock of 0.4 point of GDP.

Last but not least, considering the impact of falling oil prices on public finances, the results are quite mitigated and depend highly on the type of taxation of energy and specifically of oil products. Taxation systems on oil products mix two elements, a taxation of the volume consumed and a taxation of the value of the products. VAT receipts will probably drop in relation with the decrease in pre-tax prices but it is far from clear that receipts associated with the volume will increase in such a way they can compensate the decline in VAT receipts. At best, the effect of the decline in oil prices is neutral for public finances.

Everything taken into account, the impact of the oil prices decline on growth will remain positive for Euro area as a whole. Such a positive external factor creates the conditions to enforce structural reforms that still have to be conducted in many countries as regards to the decrease in their potential growth.

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The EUREN Winter Forecast 2015

A sluggish recovery

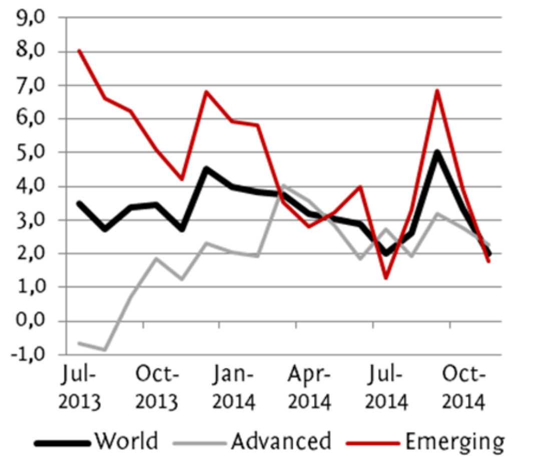
The gradual recovery of global economic growth observed in mid-2014 has been slightly decelerating in recent months. Most of the indicators of international environment are below the lines that we marked out in our previous report.

The pace of real GDP growth decelerated in some of the major world economies even more than we expected – especially in Japan that is approaching the technical recession. Regarding the Euro area, economic sentiment worsened (also reflecting geopolitical tensions in Ukraine) which contributed to GDP growth being lower than assumed last summer. Also many emerging economies (including China) have undergone a certain moderation in their growth rates, which is in line with our expectations. Among the major advanced economies, only the United States have experienced successful recovery as the GDP growth accelerated despite the expectations.

The slowing down of GDP growth rates across the most of advanced and emerging countries is also reflected in the trend of world trade volume - the average growth of world trade decelerated at the end of last year following a peak in imports rates in the second half of the last year. Both advanced and emerging economies showed a coincident decrease of imports during the last months (Graph 1). Consequently, the average growth of world trade is lower than expected. Long-term government bond yields have declined further in major advanced economies reflecting the weaker activity.

Graph 1

Index of World Imports
yoy change in %



Source: CPB World Trade Monitor

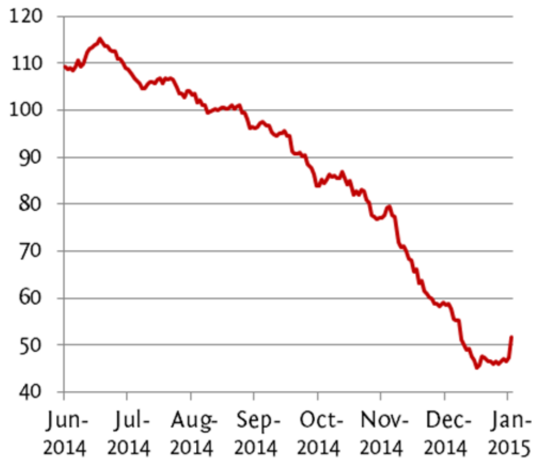
Contradictory influence of decrease in oil prices

The reasons for the real economy to grow mostly below the expectations can be found to some extent in low investment activity associated with worse expectations concerning medium-term growth in most of the major economies. Notwithstanding, the world economy is recently influenced primarily by the surprising changes in both the commodity and foreign exchange markets.

Especially, crude oil prices decreased dramatically in the last two quarters. The price of Brent oil in US dollar has declined by

Graph 2

Oil price Brent
in US Dollar per barrel



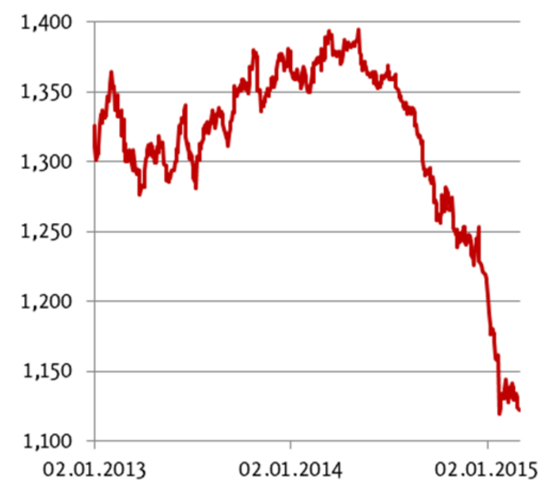
Source: US Energy Information Administration.

about 54 percent since June 2014 (Graph 2). The decline in oil prices is a positive incentive for developed countries importing oil; on the other side, oil exporters like Russia suffer significantly.

The situation in foreign exchange markets is influenced by falling oil prices and divergent monetary policies of the FED and ECB. Many emerging economies' currencies have weakened, particularly those of oil exporters (e.g. Russian ruble). On the other hand, the announced end of QE3 in the United States and easing of monetary policy in Europe and Japan contributed to the strengthening of the US dollar. The euro depreciated against the US dollar by 18 percent since May 2014 (Graph 3). Due the low oil prices and the dollar appreciation, US inflation remains still moderate.

Graph 3

Euro-Dollar exchange rate
$/€



Source: ECB.

After the end of QE3 in October 2014 investors are now looking forward when the Fed is ready to raise interest rates. In response to these events, considerable volatility can be seen in the markets. Though the situation in the financial markets improved globally, the volatility increased as well as the risk of a negative turn of the situation.

Forecasted recovery is postponed

In view of recent developments, our current assessment of the international environment is less optimistic than in the previous forecast. Our new forecasts show lower growth rates for world trade and GDP in Japan and China. Our forecast of world trade growth was revised downwards, to 3.4% in 2014 and 4.5% in 2015, down from 4.3% resp. 5.4% as compared to the EUREN summer forecast. More robust growth is expected not before 2016. As the prospects for the United States improved, our estimate of US GDP growth was slightly revised upwards, to 2.4% in 2014 and 3.2% in 2015, up from 2.3% resp. 2.9%.

Our expectations for the oil price were considerably revised downwards to $ 58.6 per barrel this year and $ 66 next year. In line with the development of the oil price we also revised the forecast for US inflation downwards, by 0.4 p.p. in 2015. The futures on crude oil started to increase only a little, but the scenario of a sharp increase cannot be ruled out.

Table 1

Exogenous and international variables

2013 – 2016; Percentage changes unless otherwise indicated

	2013	2014	2015[e]	2016[e]
World trade	3.0	3.4	4.5	5.2
United States				
GDP	2.2	2.4	3.2	3.0
Inflation	1.5	1.7	1.5	2.0
3m interest rates	0.17	0.12	0.67	1.47
10y Gvt bond yield	2.35	2.54	2.64	3.20
Japan				
GDP	1.6	0.7	1.0	1.2
3m interest rates	0.10	0.09	0.09	0.30
10y Gvt bond yield	0.69	0.63	0.49	0.66
China, GDP	7.7	7.3	7.2	6.9
US dollar/euro	1.33	1.33	1.13	1.13
Oil price Brent				
US$/barrel	108.7	99.1	58.6	66.1
percentage change	-2.7	-8.8	-40.9	12.9

[e]*EUREN Forecast*

Meanwhile, interest rates should remain relatively stable around current values; we revise upwards only the US short-term interest rates in line with market expectations. Regarding the exchange rate of the euro against the US Dollar, we have revised the forecast to about 1.13 dollars per euro for this and next year.

The global recovery seems to be relatively stable, though still weak. Risks may arise mainly from unexpected future developments of oil prices and from too low confidence bounded to still weak expectations of activity in major advanced economies.

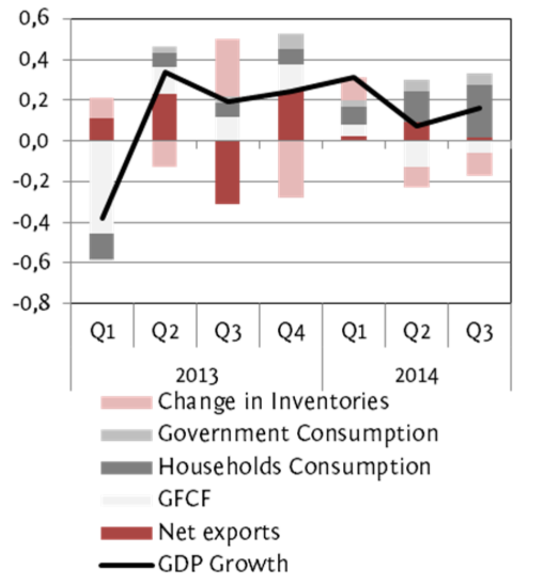
Euro area: Subdued recovery

Economic growth in the Euro zone remains subdued and recovery keeps unfolding on a slow pace. GDP growth amounted to 0.9% in the nine-month period from January to September 2014, on a y-o-y basis, while the q-o-q Euro area growth for the third quarter of 2014 amounted to 0.2%, following the 0.1% rate of growth recorded in the second quarter of 2014.

Graph 4

Euro area: Growth of GDP and its components

Contributions to growth percentage points



Source: Eurostat.

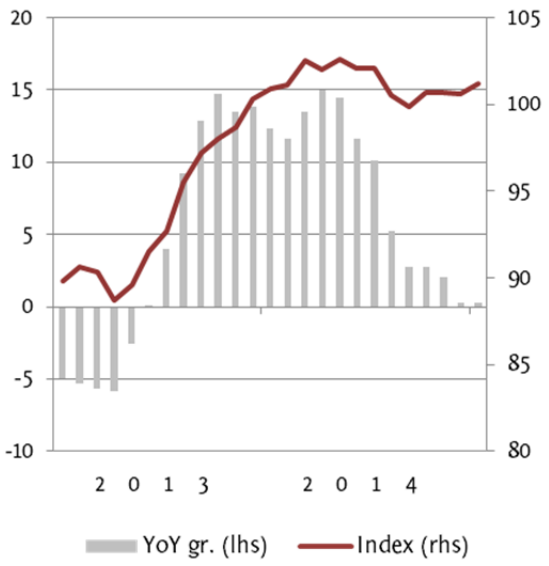
With reference to the contributions of the individual GDP components, in contrast to the more balanced picture for the second 2014 quarter, the main driver of positive q-o-q GDP growth in the third quarter of 2014 was private consumption (0.3) (Graph 4). Gross fixed capital formation contributed negatively (-0.1), while the contribution of net exports remained neutral (0.0).

It is interesting to observe that the overall weak impact of the external sector did not vary greatly in the course of the first three quarters of 2014. This is mainly due to the fact that the positive q-o-q growth rates of exports and imports have been moving into the same direction and were characterised by similar magnitudes. Recent developments in euro area exports and imports reflect the lack of improvement of external demand as well as internal demand, but also the downward course of the exchange rate of the euro.

The continuation of modest growth and subdued recovery seems to be reflected in the most recent course of the Economic Sentiment Indicator for the Euro area.

Graph 5

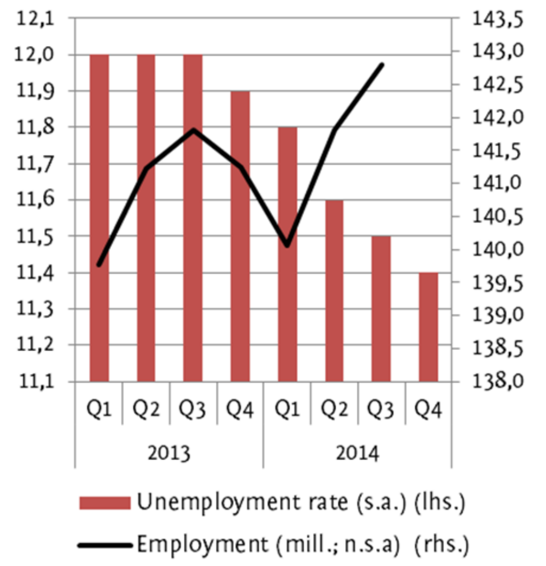
Euro area Economic Sentiment Indicator
2013-2015



Source: Eurostat.

Graph 6

Euro area Labour Market Performance
2013-2014



Source: Eurostat.

Expectations with regard to the upcoming general economic conditions have been weakening in the second half of 2014, with the indicator even marginally falling below 100 in September (Graph 5). Still, the recorded slight upturn in January 2015 might be a signal for more optimistic anticipations.

Persisting high unemployment levels and negative inflation render the recovery fragile

One of the most severe problems in the Euro area is the situation in the labour market. Even though the unemployment rate has slightly come down from 12% in 2013 to 11.4% in the fourth quarter of 2014 (Graph 6), its level remains unacceptably high. Furthermore, substantial differences between member states continue to exist. The small increase by 0.7% in employment in the third quarter of 2014, as compared to the respective quarter in 2013, might also provide an indication for slightly improving conditions. Still a lot has to be done in terms of national and European labour market policies to combat these unfavourable conditions, threatening the strength and sustainability of economic growth in the Euro area.

Another key factor menacing the recovery in the Euro area is the continuous downward movement of prices. HICP inflation turned negative in December 2014 and declined further in January 2015, basically driven by significantly falling energy prices, due to the fall in oil prices. Changes in the prices of unprocessed food also kept moving in negative territory, but negative rates narrowed in the second half of 2014. As a result, core inflation kept lying above headline inflation up to the first month of 2015. A potential continuation of these trends is partly seen to increase deflation fears related to a possible negative impact on growth.

Monetary policy becomes even more expansionary

In the course of 2014, the ECB monetary policy became ever expansionary. The first unusual measure in this sequence of events was the introduction of a negative interest rate on deposits held by private banks at the ECB in June 2014. In September, the interest rate on main refinancing operations was further reduced to a record-low level of just marginally above zero, and the negative value of the deposit rate was increased. Since September 2014, the ECB interest rates have been 0.5 percent for the main refinancing operations, 0.3 percent for the marginal lending facility, and -0.2 percent for deposits.

In January 2015, the next extraordinary policy measure was taken by the ECB. It decided to launch an expanded asset purchase programme, encompassing the existing purchase programmes for asset-backed securities and covered bonds. Under this programme, the ECB announced to buy public and private sector securities in the amount of 60 billion euro per month. This purchase programme shall be executed until end-September 2016.

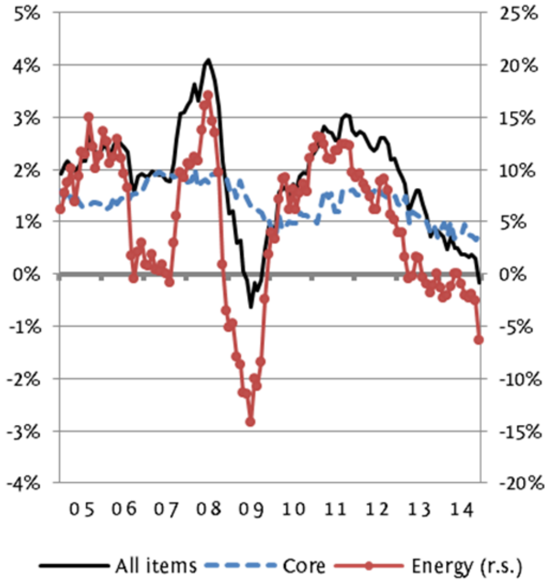
The ECB justifies this policy of Quantitative Easing (QE) with the very low inflation rate which has been declining over the last couple of months (Graph 7). However, this downward trend of inflation – showing even a negative rate in December 2014 – is clearly the result of the drastic fall in energy prices which itself was caused by the plunge of the oil price since last summer. It cannot be taken for granted that the extremely large amount of liquidity now provided by the ECB will effectively stimulate demand and thereby fight deflation. This would require that private banks increase credit supply, support investment and thereby raise inflation toward the target of near 2 percent.

For an extended period, loans to non-financial corporations in the Euro area have been declining. However, this development seems mainly to be a reflection of low demand for loans, due to reluctance to invest and hence only moderate financing needs by companies. In the recent past, there have been sings of a recovery of credit demand. According to the ECB Bank Lending Survey, in the fourth quarter banks reported increasing credit demand for financing fixed investment. It is important that rising investment is not hindered by a lack of credit supply. In some segments there might be tight credit supply, e.g. for small and medium sized companies in some countries. However, this seems to be

Graph 7

Euro area inflation

Change over the same month of the previous year



Source: Eurostat – Core inflation measures inflation excluding energy, food, alcohol and tobacco

caused by equity rather than liquidity problems. In such cases, the additional liquidity does not help to support credit supply.

The bond purchase programme bears the risk that the additional liquidity does not support the real economy, but rather causes bubbles on financial and housing markets. Furthermore, the additional demand for public bonds reduces their yields. This might cause moral hazard problems since it reduces incentives to continue the process of structural reforms and balancing the budget.

Restrictive fiscal policy is fading out

In 2014 Euro area fiscal deficit continued to fall. According to the latest estimate by the European Commission it reached 2.6% of GDP, which is 0.3 percentage points lower than in 2013. The primary balance was slightly positive. Since the cyclically adjusted deficit remained almost unchanged fiscal stance was more or less neutral.

However, there still were considerable differences between Euro area members. Headline deficits range from a slight surplus in Germany and Luxembourg to deficits higher than 5% in relation to GDP in Spain and Slovenia.

According to its Winter forecast the European Commission expects a further reduction of the Euro area fiscal deficit in 2015 and 2016. It will be borne increasingly from the expenditure side, whereas the share of total revenues in GDP is expected to be stable. The main driver of public deficits will be the economic recovery. The fiscal stance is forecasted to stay more or less neutral.

The European Commission's forecast was finalised before the elections in Greece. Thus the uncertainty about future fiscal stance has grown. The immediate impact of a change in the Greek fiscal policy will be small, given the small share of Greece in Euro area GDP. However, it might be associated with indirect effects. If the European Commission would agree to a reduction of consolidation efforts in Greece, other countries could claim the same rights. Furthermore, the uncertainty about Greece also could have an impact on the risk premium of government bonds in other countries, increasing their refinancing costs. In a worst case scenario, a Greek default, the consequences for the rest of the Euro area even could be harder. However, since the programme for Greece has been prolonged now, the Greek government has got some time to re-adjust its fiscal policy.

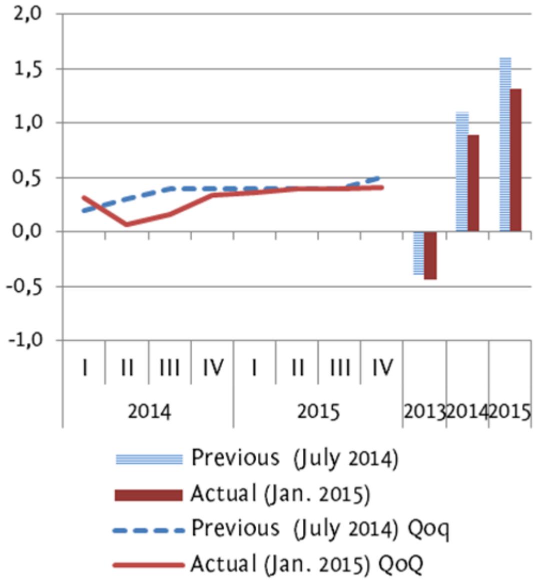
Lower than expected GDP growth in the short run

The new forecast of the EUREN institutes postpones the recovery of the Euro area economy in line with the changes discussed in the international environment. Thus, we expect GDP to grow by 1.3% in this year compared to 1.6% in mid-2014 (Graph 8). The size of the downward revision is in line with the changes of other institutions made during the last six months.

Graph 8

Revision of the forecast of Euro area GDP against the summer forecast 2014

qoq rate and annual averages



Source: EUREN estimates.

Looking at the GDP components, it can be seen easily that this reduction of the GDP forecast has focused on the investment component, where we currently estimate an increase by slightly below 1% compared to 3% six months ago. This downward revision is closely linked to the deterioration of expectations registered in recent months together with the increased uncertainty associated with the Greek situation, currency markets, or the conflict in Ukraine.

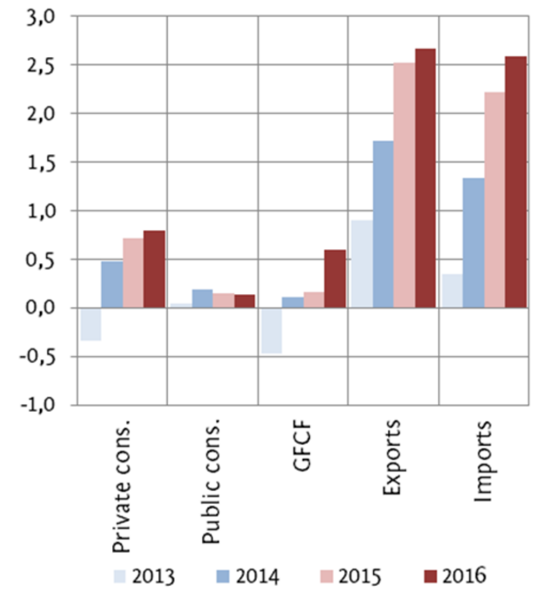
For 2016, under the assumption that doubts about the future of the Euro have been cleared and confidence among companies will be improving, we can expect some recovery of growth driven by domestic demand. Indeed, and as reflected in Graph 9, the contribution to GDP growth of gross fixed capital formation in 2016 could increase by around half a point, although the largest relative increase in imports will tend to partially compensate this contribution.

Concerning the other components, spending on private consumption will continue restricted by the limited progress expected in the labour market and only one would expect

Graph 9

Euro area GDP forecast by components

Contribution to growth in %



Source: Eurostat; EUREN Forecast.

a positive effect from the containment of inflation and from the savings coming from lower oil prices, as was commented in the editorial.

In light of the comments made about fiscal policy, it does not appears that we can expect new cuts in public spending, since the necessary continuity of the process of fiscal consolidation is left to automatic stabilizers linked to the recovery of activity.

Exports of Euro area member countries to the rest of the world would benefit from the weakening of the euro and could reach a significant growth this year 2015. However, this revival of exports will be accompanied by a greater import dynamics, so the net exports contribution to GDP growth would be slightly lower than that observed in 2014, where imports remained in a very moderate growth.

Reflecting the postponed recovery of the European economy the expected progress in the short term for the labour market are quite limited, estimating that the unemployment rate is going to be reduced by only one tenth to the end of this year and around half point in late 2016.

Meanwhile, the fall of oil prices could generate a slightly negative inflation rate in the early months of the year and that would be gradually recovering throughout the year, but in any case it is substantially below ECB inflation targets.

Thus, we do not expect significant changes in the ECB intervention rates for the short term and only at the end of next year 2016, when

Table 2

Euro area forecast

	2013	2014	2015[f]	2016[f]	2014	2015				2016[f]			
					IV	I	II[f]	III[f]	IV[f]	I	II	III	IV
	Annual % change (unless indicated otherwise)					q-o-q%, seasonally adjusted (unless indicated otherwise)							
Private consumption	-0,6	0,9	1,3	1,5	0,3	0,3	0,3	0,3	0,4	0,4	0,4	0,4	0,4
Public consumption	0,2	0,9	0,7	0,7	0,1	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2
Gross fixed capital formation	-2,3	0,6	0,9	3,1	-0,2	0,4	0,6	0,7	0,8	0,8	0,8	0,8	0,8
Change in inventories[1]	-0,2	-0,3	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Domestic demand	-1,0	0,5	1,1	1,6	0,2	0,3	0,4	0,4	0,4	0,4	0,4	0,4	0,4
Exports	2,1	4,0	5,7	5,8	1,9	1,5	1,0	1,1	1,2	1,5	1,6	1,7	1,7
Imports	0,9	3,4	5,6	6,2	1,7	1,5	1,0	1,2	1,3	1,6	1,7	1,8	1,8
Net exports[1]	0,6	0,4	0,3	0,1	0,2	0,1	0,0	0,0	0,0	0,0	0,0	0,0	0,0
GDP[1]	-0,4	0,9	1,3	1,6	0,3	0,4	0,4	0,4	0,4	0,4	0,4	0,4	0,4
Unemployment (% of labour force)	12,0	11,7	11,3	11,0	11,4	11,4	11,3	11,4	11,3	11,2	11,0	10,9	10,8
Compensation per employee, yoy	1,6	1,6	1,7	2,0	1,3	1,5	1,6	1,7	1,8	1,9	2,0	2,1	2,1
Consumer price (HICP), yoy	1,3	0,4	0,1	0,8	0,2	-0,1	0,0	0,1	0,5	0,9	1,0	0,8	0,7
Current account balance (%GDP)	2,4	2,1	2,0	1,6									
3m interest rates (% per annum)	0,2	0,2	0,2	0,4	0,1	0,1	0,2	0,2	0,2	0,2	0,3	0,4	0,5
10y Gvt bond yields (% p.a.)	2,9	1,9	1,7	2,5	1,4	1,4	1,6	1,8	1,9	2,3	2,6	2,6	2,6
ECB repo (end of period)	0,3	0,1	0,1	0,3	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,3

This forecast was finished on 20 February 2015. – [f]EUREN forecast. – [1]Contribution to growth the recovery of growth could be consolidated, we could expect some kind of normalization of these intervention rates.

Regardless of the downside risks linked to some deterioration of the socio-political environment, at present, the forecast risk could be on the positive side, tending to slightly raising the current forecasts for GDP growth in the Euro area for this year 2015.

Thus, for example, the deterioration of expectations that had been recorded in recent months seems to have slowed earlier this year and recent data on the closure of 2014 and some indicators for early 2015 are presented somewhat better than expected.

Moreover, quantitative easing measures implemented by the ECB could, as mentioned, end up the containment trend in loans to private sector and encourage increased private investment in an environment of improved expectations for economic recovery.

On the other hand, the relative increase in import prices derived from the weakening of the euro could reduce import growth below our current estimates, so that the net exports contribution would end up being slightly superior to that shown in our current scenario.

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Imprint

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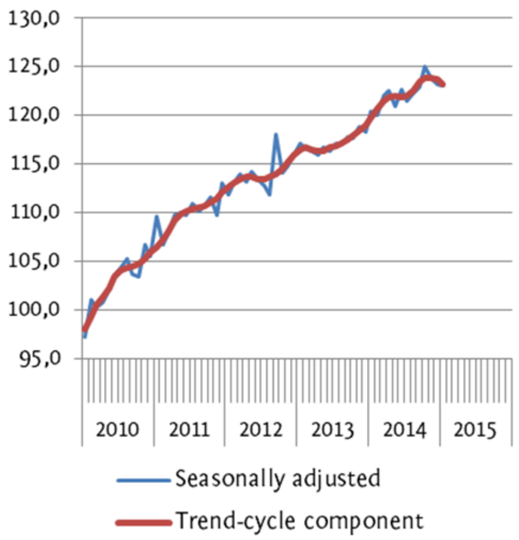
RWI/ISL Container Throughput Index: Slightly declining

The RWI/ISL Container Throughput Index improved significantly in the autumn of 2014. It peaked in October but it is receding since then which indicates that world trade is back in stagnation. However, the latest data have to be interpreted with some caution since they are influenced by the celebrities of the Chinese New Year which has a strong impact on activities in Chinese ports which have a high weight in the index.

The index is based on data of 75 world container ports covering approximately 60% of worldwide container handling. The ports are continuously monitored by ISL as part of the institute's market analyses. Because a large part of international merchandise trade is transported by ship, the development of port handling is a good indicator for world trade. As many ports release information about their activities only two weeks after the end of the respective month, the RWI/ISL Container Throughput Index is a reliable early indicator for the activity of the global economy.

Updated February 18th, 2015



RWI/ISL calculations. 2008 = 100. September 2014: flash estimate.

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Forecast of the EUREN/CEPREDE High Frequency Model

Last update: February 17th, 2015

	14Q1	14Q2	14Q3	14Q4	15Q1	15Q2	2013	2014	2015
Sep-13	0,4;*0,0*	0,8;*0,7*					-0,5	0,8	
Oct-13	0,5;*-0,1*	0,7;*0,5*					-0,4	0,8	
Nov-13	1,0;*0,2*	1,0;*0,3*					-0,4	1,1	
Dec-13	1,1;*0,2*	1,1;*0,3*					-0,4	1,1	
Jan-14	1,1;*0,2*	1,2;*0,4*					-0,4	1,1	
Feb-14	0,8;*0,1*	1,1;*0,5*					**[-0,4]**	1,2	
Mar-14	1,0;0,3	1,2;0,4					**[-0,4]**	1,3	
Apr-14	1,0;*0,2*	1,2;*0,5*					**[-0,4]**	1,3	
May-14	[**0,9**;*0,2*]	1,3;*0,8*	1,5;*0,3*	1,4;*0,2*			**[-0,4]**	1,2	
Jun-14	[**0,9**;*0,2*]	1,2;*0,7*	1,4;*0,3*	1,4;*0,2*			**[-0,4]**	1,2	1,5
Jul-14	[**0,9**;*0,2*]	1,1;*0,6*	1,4;*0,4*	1,7;*0,6*			**[-0,4]**	1,3	1,7
Sep-14	[**1,0**;*0,2*]	[**0,6**;*0,0*]	0,7;*0,3*	1,0;*0,6*			**[-0,4]**	0,8	1,2
Oct-14	[**1,0**;*0,2*]	[**0,6**;*0,0*]	0,6;*0,1*	1,0;*0,6*			**[-0,4]**	0,8	1,4
Nov-14	[**1,0**;*0,2*]	[**0,6**;*0,0*]	0,6;*0,2*	1,0;*0,5*			**[-0,4]**	0,8	1,4
Dec-14	[**0,9**;*0,2*]	[**0,7**;*0,0*]	[**0,8**;*0,3*]	0,9;*0,4*			**[-0,4]**	0,8	1,3
Jan-15	[**0,9**;*0,2*]	[**0,7**;*0,0*]	[**0,8**;*0,3*]	0,9;*0,3*	0,9;*0,3*	1,1;*0,1*	**[-0,4]**	0,8	1,2
Feb-15	[**0,9**;*0,2*]	[**0,7**;*0,0*]	[**0,8**;*0,3*]	1,0;*0,6*	1,0;*0,4*	1,2;*0,3*	**[-0,4]**	0,8	1,3

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

The Flash Estimate for GDP growth in the fourth quarter recently published by Eurostat, has been slightly above forecasts made by the high frequency model, which were 0.9% (yoy) resp. 0.3% (in qoq terms). These results, however, confirm that a gradual recovery of the European economy is on its way. The forecasts have been raised by one tenth per quarter in the last three quarters, reaching an annual average of 0,9% in 2014 after two consecutive years of recession. There is still limited information on the start of 2015. Figures seen so far seem to confirm that this recovery will continue. Thus, economic climate indicators were slightly higher in January compared to December, They improved particularly strong in Italy and Spain offsetting a slight decline in France.

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