European Banking Federation

PER ASPERA AD ASTRA

EBF Outlook N°30
on the euro area economies 2010-2011
End-Year Economic Outlook

This bi-annual report is prepared by the members of the European Banking Federation's Economic and Monetary Affairs Committee. It reflects a consensus (based on arithmetic averages) on the outlook for the euro area economies. This report is available on the EBF website: http://www.ebf-fbe.eu/index.php?page=economic-outlook

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TERMS & CONDITIONS

Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of almost 5,000 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU only.
The EBF is committed to supporting EU policies to promote the single market in financial services in general and in banking activities in particular. It advocates free and fair competition in the EU and world markets and supports the banks' efforts to increase their efficiency and competitiveness.

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1. EMAC consensus

The euro area economies are broadening their focus from fighting the financial crisis to a path of renewed growth. Nevertheless, the various factors at play will keep a lid on optimism for the rest of this year and next. The three decisive elements favouring economic growth of the euro area in 2010 and 2011 will be the replenishment of inventories, gradual pick up in domestic demand, and responding to external demand, thereby helping exports to grow considerably in 2010 and, to a lesser extent, in 2011.

However, the financial crisis will have left its mark. Reform of public finances and resulting fiscal tightening will dampen economic growth throughout the forecasted period. Low growth will undermine euro area governments' efforts to reduce unemployment, which, together with the continuing efforts of euro area Member States to reduce budget deficits, will prevent domestic consumption from taking off. These factors will be even more important in the peripheral countries, where fiscal austerity measures continue weighing on their economies.

The Chief Economists of the Economic and Monetary Affairs Committee have reached a consensus in expecting that this year's euro area economy will grow at 1.6%, but that a slowdown in 2011 to 1.4% is likely to be observed, with inflation remaining well below the European Central Bank's medium-term target level.

Chart 1: Historical dynamics and current projections of the annual GDP growth (%)

Source: ECB's Statistical Data Warehouse, EMAC projections

Table 1: Main indicators of EMAC consensus (mean of forecasts)

	2009	2010*p*	2011*p*
Gross domestic product	-4.1	1.6	1.4
Private consumption	-1.1	0.6	0.8
Public consumption	2.4	1.0	0.5
Gross investment (GFCF)	-11.4	-0.8	2.6
Exports	-13.2	9.3	5.6
Imports	-12.0	8.6	4.6
Unemployment rate (%)	9.5	10.1	10.0
Prices (HCPI)	0.3	1.5	1.6
Government Deficit	-6.3	-6.2	-5.4
Government Debt	79.1	84.6	88.1

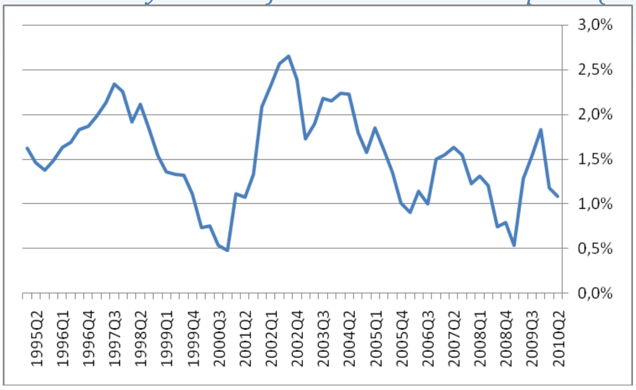
NB: 2009 figures are fact, while 2010 and 2011 are current EMAC projections.

The domestic situation in the euro area over the coming year will be shaped, on the one hand, by the way the euro area governments deal with the sovereign debt crises, and, on the other, by the rebound of growth in Germany and other countries which are not adversely affected by difficulties in public finances. This dynamic is taking place in a context of high unemployment, heightened commodity prices, low ECB refinancing rate, and high interest rate spreads in countries such as Greece and Ireland, not to speak of low but recovering bank lending.

2. Global environment

A pick-up in world growth, underpinned by an intensification of international trade in 2010, will slow down somewhat in 2011, while still remaining buoyant. **Euro area exports** are expected to grow by 5.6%, with imports not far behind at 4.6% in 2011, both projected rates almost half of those expected in 2010, as global trade growth is expected to settle to a more normal path. Nevertheless, these developments will help slightly improve the euro area's net export position: the trade balance is expected to increase to 0.4% of GDP by the end of 2011, from 0.3% of GDP in 2010.

Chart 2: Historical dynamics of the euro area net exports (% of GDP)



Source: ECB

The overall growth dynamics next year will be founded on a marked divergence between the modest pick-up in the developed world and a much stronger one in the emerging markets.

High leverage, falling house prices and weak credit growth, coupled with the persistence of high unemployment, present a risk of a delayed recovery in the **US** economy. Nonetheless, EMAC's Chief Economists take an optimistic view on the US growth prospect, estimating a 2.4 – 2.6% GDP increase in this year and next.

In contrast to the developed world, the **emerging markets** are a strong pillar of growth in the coming years; they are seen as the main driving force of the global economic recovery. It must not be ignored that most of those countries are registering high levels of inflation, mostly led by the boom in commodity prices: food inflation is 10.1% in China, 15.7% in India and 16.1% in Turkey[1]. A number of warning signs have been made with regards to the inflating asset bubbles in the emerging economies. Indeed, currency tensions between the US and China sparked a debate on the need for the revaluation of emerging markets' currencies.

Although the global economy is expected to continue expanding at a healthy pace in 2011, downside risks remain high. The increased competition of fiscally weak countries to roll-over their debt may lead to a global surge in government bond yields, affecting global growth negatively. Food-driven inflation in emerging economies may lead to aggressive tightening of monetary policy in China and other major emerging economies. Prolonged US dollar depreciation may spark competitive devaluations, increasing volatility in foreign exchange markets and disruptions of global trade.

[1] *FT article from 15 November 2010: source: FT*

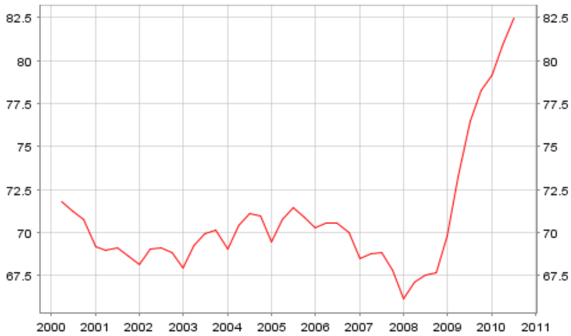
3. Domestic Situation

Fiscal challenges present important obstacles to the economic growth in the euro area

The government budgets of the euro area countries have moved further out of balance, as was anticipated in the 29th EMAC Outlook, published in May 2010 under the title *From Recession to Growth amidst Uncertainty*. Nevertheless, the second quarter of 2010 shows some early signs of improvement: back to -5.2% from -8.1% of GDP in Q1 2010. The EMAC projections for the 2010 government balance are at around -6% of GDP at most, reducing to -5.4% in 2011.

These public finance developments have led to an accumulation of public debt in the euro area countries, in Q2 2010 standing at 82.4% of GDP. This figure is expected to increase further to 84.6% by the end of 2010 and further still to 88.1% by the end of in 2011. It must be noted that compared with the debt levels in such developed countries like the US (92.2% of GDP in 2010) and Japan (192.3% of GDP in 2010), the euro area average debt is still relatively low.

Chart 3: Historical dynamics of the euro area government debt, % of GDP



Source: ECB's Statistical Data Warehouse

Since the publication of the 29th EMAC Outlook on the euro area economies, when a grave problem with Greece's public finances was uncovered, Greece received financial support from the EU and the IMF, conditional upon the implementation of a solid programme of fiscal tightening and restructuring. This effort to implement the adjustment programme was backed by the Stabilisation Fund controlled the European Commission, with support from the IMF. In addition, the ECB took a decision to buy government bonds on the financial markets. Despite the public unrest experienced in Athens following the announcement of the IMF intervention, the months that followed have already displayed significant progress in bringing the country's government deficit, and consequently public debt, back on track.

In the meantime, the situation in Ireland has reached its peak. Having put all the effort into bailing out the *Anglo-Irish Bank*, the Irish government now faces a fiscal deficit of 11.9% in 2010 (the figure rises to 32% if the bail-out of the Anglo Irish is included). Their four-year budgetary strategy aims to solve this by front-loading EUR 6 billion in 2011 as part of a total consolidation effort of EUR 15 billion, alongside the implementation of structural reforms and the budgetary adjustments. These efforts should bring the country's fiscal deficit to below 3% of GDP by 2014. Ireland is highly inter-connected with other European countries, especially the United Kingdom. Having weighed the threat to both the domestic and the international situation, the Irish government agreed on the rescue package of EUR 85 billion, to be channelled through the European Financial Stabilisation Mechanism (EFSM) and European Financial Stability Facility (EFSF). The UK put forward additional bilateral assistance to Ireland (EUR 3.8 billion), followed by announcements by Sweden and Denmark to extend additional bilateral support.

All these euro area developments are balanced by the fact that Germany has restored its name as Europe's powerhouse. Germany has shown outstanding economic performance in the first half of 2010, with the country's annual GDP growth standing at 2% in Q1-2010 and 3.7% in Q2-2010. These rates reflect a return of Germany's economy to its full capacity utilisation, owing to the pick-up in the world trade, rapid reduction in the country's unemployment and prospect of a strong increase in private consumption.

Inflationary expectations are to remain subdued

The economic recovery will not create any impetus for **inflation**, and core inflation will remain subdued, with the only significant upward pressure coming possibly from creeping energy and food prices. Overall, inflation is expected to remain low throughout the forecast horizon: 1.5% and 1.6% in 2010 and 2011 respectively.

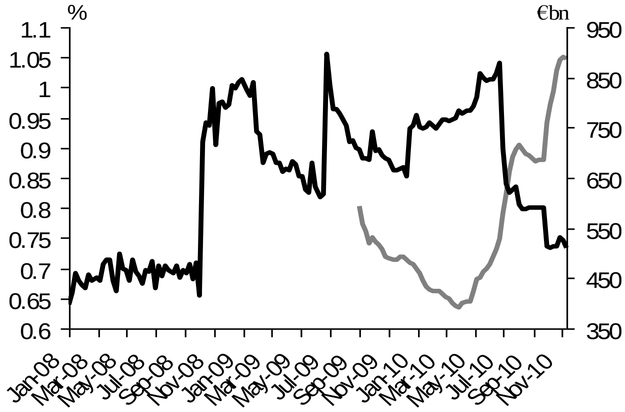
By the end of next year, **Brent oil** prices are generally expected to remain moderately high at USD 85 *per* barrel, although the EMAC Chief Economists' views are quite dispersed, the range of forecasts being from 78 to 90 USD *per* barrel.

Chart 4: Historical dynamics of Brent crude oil futures contracts (USD/barrel)

Source: [Trading Economics]

As a result of amplified volatility in financial markets, funding costs in the interbank market have increased significantly over the past few months.

Chart 5: Historical dynamics of the ECB's outstanding market operations (black line, right-hand scale) and the 3-month Euribor (grey line, left-hand scale)



The EMAC's Chief Economists consider the **ECB official interest rate**[2] as remaining at an appropriate level. From the start of the crisis in mid-2007, when the transmission mechanism of standard measures became disrupted, the ECB started implementing non-standard policy measures. In broad terms, the ECB response to the crisis consisted of a series of interest rate reductions, and enhanced credit support measures. However, in spring 2010, when the threat of a sovereign debt crisis became critical, the ECB put forward its third measure, the Securities Markets Programme, under which the Eurosystem's (sterilised) interventions started being carried out in the euro area's public and private (secondary) debt securities markets. Some of the non-standard measures were re-introduced, i.e. the fixed-rate tender procedure with full allotment in the regular three-month longer-term refinancing operations (LTROs) for the period starting at the end of May 2010, and a new six-month refinancing operation with full allotment; the temporary liquidity swap lines with the Federal Reserve System were also resumed.

The economists share the expectation that the ECB will not start hiking the main refinancing rate before H2-2011, in small steps of 25 basis points, and not exceeding the level of 1.5% by the end of 2011.

The **euro** is expected to remain volatile against the US Dollar (range of forecasts for both years is between 1.20 and 1.50 USD *per* euro), with several factors pulling the euro / US Dollar exchange rate in different directions. First, the euro area sovereign market worries are still not over, creating a depreciative effect on the euro. Second, the euro might depreciate in 2011, as the concerns about the double dip in the US wane, although the recently launched second round of Quantitative Easing (QE2)

[2] For more detail and analysis, see The ECB's response to the financial crisis in the ECB Monthly Bulletin article, October 2010, access: http://www.ecb.int/pub/pdf/other/art1_mb201010en_pp59-74en.pdf

in the USA suggests further dilution of the position of the US Dollar. Third, the ECB exit strategy from their emergency liquidity provision may cause an appreciative effect on the euro, as the US Federal Reserve and other major central banks embark on a new programme of QE. Appreciation of the euro presents an important risk for the euro area recovery, which has been export-driven so far. The mean of the Chief Economists' forecasts for the euro / US dollar exchange rate is to ease gradually throughout 2011.

Chart 6: Historical dynamics of the euro / US dollar exchange rate

Source: [ECB]

Bank credit growth will come from lending to households and non-financial corporations

While banks in countries like Germany, Austria, France, Belgium, and Luxembourg have noted a slight pattern of renewed credit growth, some of the peripheral states are experiencing difficulties with non-performing loans and / or access to funding. The improvement in bank lending is generally due to household lending for house purchases. In some countries, lending to non-financial corporations has entered positive territory since the outbreak of the crisis.

The banking sector across the euro area is undergoing a process of restructuring, consolidation and cost-cutting in light of the fact that the banks' business models need to be adapted to the new regulatory and economic reality.

In the context of low interest rates and the recovering economic environment, bank lending to retail and commercial customers is seen to continue its recovery in 2011. Also deposit business is expected to pick up the pace. These developments will be somewhat dampened by the Basel Committee's announced capital and liquidity requirements for banks. The overall final impact of the new set of requirements for banks remains un-quantified; nevertheless it is certain to lead to increased collateral requirements, stricter lending practices, shrinkage of the banks' balance sheets, and lower bank returns, to name but a few.

4. Risks to the scenario

The EMAC's Chief Economists outline a number of risks to the scenario; risks which indicate a continuously high degree of uncertainty with regard to the future of the euro area economy.

Positive risks

- Sustained economic **performance in Asia** may help the euro area economy grow faster than anticipated.
- **Euro area periphery** and the **US economy** may recover faster than expected.
- **Low inflation** and **low interest rates** may contribute to a positive financial climate.

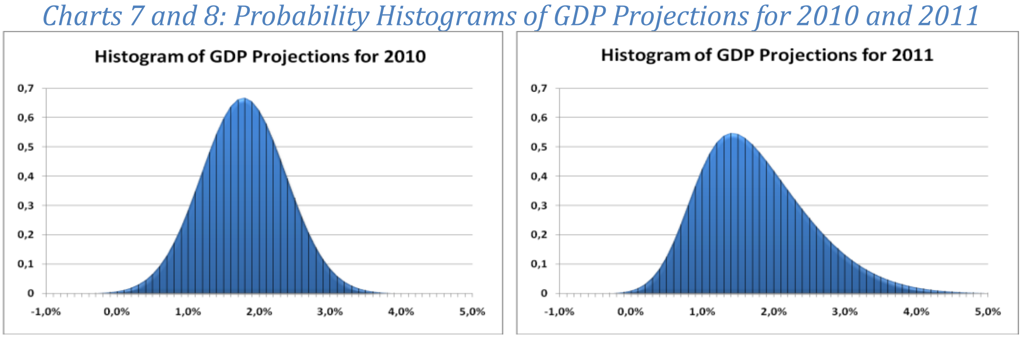
Negative risks

- Unsatisfactory performance of the **US economy** may put a break on the euro area's economic growth.
- The European economy is facing high uncertainty on future currency developments and the risk of sharp movements of the **euro** against the US dollar.
- **Commodity prices** may start climbing before the economic recovery strengthens.
- **Persistently high unemployment** may restrict economic growth in the euro area.
- Further **debt crises** in the euro area economies are not excluded, potentially provoking more pronounced **risk-aversion,** harmful not only for the refinancing needs of the governments but also for economic growth.
- Private financing risks being **crowded out** by public sector fund-raising.
- **The financial sector** may prove dangerously exposed to the troubled public finances, and possibly unable to deal with the situation, especially in the context of the need to adjust to the new regulatory requirements.

Probabilities to the growth scenario

As seen in Chart 7, the spread of risks to this year's forecast is rather symmetric, whereas the spread for next year (Chart 8) may indicate that the Chief Economists are more pessimistic in their central forecast whilst putting, at the same time, more hope in the important role that positive risks may play in the final outcome.

Charts 7 and 8: Probability Histograms of GDP Projections for 2010 and 2011



We acknowledge the assistance of Andrés MANZANARES in estimating derived probability densities, following the methodology of J.A. GARCÍA & A. MANZANARES, "What can probability forecasts tell us about inflation risks" ECB WP No. 825 (2007)

END-YEAR POLL ON THE EURO AREA ECONOMIC OUTLOOK FOR 2010-2011

TABLE 1		2008	2009	2010 Forecasts								
				EMAC Consensus			EMAC		COM Forecast			
				2010 mean	2010 range		mid-year 2010	end-year 2009	Autumn 2010	Spring 2010	Autumn 2009	Spring 2009
1. Output and Aggregate demand: (Ann.% change)												
Gross domestic product		0.6	-4.1	**1.6**	1.6	1.8	1.2	1.3	1.7	0.9	0.7	-0.1
Private consumption		0.4	-1.1	**0.6**	0.5	0.8	0.3	0.5	0.6	0.0	0.2	-0.3
Public consumption		2.1	2.4	**1.0**	0.8	1.2	1.4	1.5	1.0	0.9	1.1	1.7
Gross investment (GFCF)		-0.8	-11.4	**-0.8**	-1.1	-0.3	-0.6	-0.2	-0.8	-2.6	-1.9	-2.7
Exports		1.0	-13.2	**9.3**	9.0	10.0	5.1	4.0	10.7	4.9	2.1	-0.3
Imports		0.8	-12.0	**8.6**	0.5	10.2	3.9	3.1	8.7	2.9	1.1	-0.8
2. Labour market and prices: (Ann.% change)												
Unemployment rate (%)		7.5	9.5	**10.1**	9.8	10.3	10.3	10.4	10.1	10.3	10.7	11.5
Wages (Unit Labour Cost)		3.4	4.0	**-0.9**	-3.5	0.1	0.3	0.5	-0.6	-0.6	-0.5	0.1
Prices (HCPI)		3.3	0.3	**1.5**	1.4	1.6	1.3	1.2	1.5	1.5	1.1	1.2
Core HCPI				**1.0**	0.9	1.0	1.0	1.1			1.0	
3. Public Finances: (% GDP)												
Government Deficit		-2.0	-6.3	**-6.2**	-7.0	-4.0	-6.8	-6.8	-6.3	-6.6	-6.9	-6.5
Government Debt		69.4	79.1	**84.6**	83.9	85.0	84.3	83.3	84.1	84.7	84.0	83.8
4. External sector: (% GDP)												
Trade Balance		0.2	0.7	**0.3**	-0.1	0.8	0.3	-0.6	0.6	0.8	0.8	0.1
Current Account Balance		-0.8	-0.7	**-0.3**	-0.6	0.2	-0.3	-0.5	-0.5	-0.6	-0.5	-1.5
(p.m.) US growth (Ann.% change)		0.0	-2.7	**2.6**	2.2	2.8	3.0	2.2	2.7	2.8	2.2	0.9
(p.m.) Oil price (Brent) (US$/bl)		97.0	62.0	**79.4**	76.0	83.0	80.6	79.7	79.9	84.5	76.5	63.5
5. Monetary and Financial Indicators:												
Interest rate on ECB's main refinancing operations	Jun-10	4.00	1.25	**1.06**	1.00	1.25	1.00	1.02	1.00			
	Dec-10	2.50	1.00	**1.00**	1.00	1.00	1.06	1.43	1.00			
3 month interest rate (EURIBOR)	Jun-10	4.46	1.23	**0.75**	0.75	0.75	0.85					
	Dec-10		0.71	**0.96**	0.70	1.10	1.18	1.70				
10 year government bond yield (Bund)	Jun-10	3.69	3.99	**2.59**	2.59	2.59	3.36					
	Dec-10		3.76	**2.35**	1.95	2.70	3.63	4.06				
M3 growth	Jun-10	7.6	-0.3		0.00	0.00	1.64					
	Dec-10			**2.31**	1.60	4.00	2.96	4.41				
Credit to private sector (Ann.% change, M3 definition)	Jun-10	7.7	0.7		0.00	0.00	0.51					
	Dec-10			**2.30**	1.20	3.50	2.34	3.75				
Exchange rate USD/EUR	Jun-10	1.58	1.41	**1.23**	1.23	1.23	1.32					
	Dec-10	1.39	1.44	**1.39**	1.30	1.50	1.31	1.43	1.33	1.36	1.39	

END-YEAR POLL ON THE EURO AREA ECONOMIC OUTLOOK FOR 2010-2011

TABLE 2		2008	2009	2011 Forecasts							
				EMAC Consensus			EMAC		COM Forecast		
				2011 mean	2011 range		Mid-year 2010	End-year 2009	Autumn 2010	Spring 2010	Autumn 2009
1. Output and Aggregate demand: (Ann.% change)											
Gross domestic product		0.6	-4.1	**1.4**	1.0	2.2	1.5		1.5	1.5	1.5
Private consumption		0.4	-1.1	**0.8**	0.5	1.7	0.9		0.9	1.1	1.0
Public consumption		2.1	2.4	**0.5**	-0.2	1.1	1.1		-0.1	0.3	1.0
Gross investment (GFCF)		-0.8	-11.4	**2.6**	1.3	3.9	2.5		2.2	1.8	2.1
Exports		1.0	-13.2	**5.6**	4.9	7.5	4.9		6.1	5.0	3.9
Imports		0.8	-12.0	**4.6**	0.5	7.0	4.5		5.1	4.2	3.6
2. Labour market and prices: (Ann.% change)											
Unemployment rate (%)		7.5	9.5	**10.0**	9.5	10.4	10.3		10.0	10.4	10.9
Wages (Unit Labour Cost)		3.4	4.0	**0.0**	-2.5	1.3	0.8		0.6	0.1	0.3
Prices (HCPI)		3.3	0.3	**1.6**	1.4	1.8	1.5		1.8	1.7	1.5
Core HCPI				**1.3**	0.8	1.8	1.2				
3. Public Finances: (% GDP)											
Government Deficit		-2.0	-6.3	**-5.4**	-6.5	-5.0	-6.2		-4.6	-6.1	-6.5
Government Debt		69.4	79.1	**88.1**	87.0	89.0	88.1		86.5	88.5	88.2
4. External sector: (% GDP)											
Trade Balance		0.2	0.7	**0.4**	-0.2	1.2	0.5		1.0	1.0	0.8
Current Account Balance		-0.8	-0.7	**0.1**	-0.3	0.8	-0.2		0.0	-0.5	-0.7
(p.m.) US growth (Ann.%change)		0.0	-2.7	**2.4**	1.9	3.0	2.8		2.1	2.8	2.0
(p.m.) Oil price (Brent) (US$/bl)		97.0	62.0	**85.3**	78.0	90.0	85.3		88.9	89.2	80.5
5. Monetary and Financial Indicators:											
Interest rate on ECB's main refinancing operations	Jun-11	4.00	1.25	**1.02**	1.00	1.25	1.58		1.00		
	Dec-11	2.50	1.00	**1.32**	1.00	1.50	2.10		1.00		
3 month interest rate (EURIBOR)	Jun-11	4.46	1.23	**1.18**	1.00	1.35	1.72				
	Dec-11		0.71	**1.54**	1.30	1.98	2.38				
10 year government bond yield (Bund)	Jun-11	3.69	3.99	**2.76**	2.25	3.20	4.02				
	Dec-11		3.76	**3.25**	2.70	3.75	4.24				
M3 growth	Jun-11	7.6	-0.3	**4.03**	2.50	6.00	3.14				
	Dec-11			**5.23**	3.50	7.00	4.37				
Credit to private sector (Ann.% change, M3 definition)	Jun-11	7.7	0.7	**3.00**	3.00	3.00	3.80				
	Dec-11			**4.38**	3.10	6.00	4.84				
Exchange rate USD/EUR	Jun-11	1.58	1.41	**1.35**	1.25	1.45	1.28				
	Dec-11	1.39	1.44	**1.33**	1.20	1.45	1.27		1.39	1.35	1.48

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