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The euro area: *Coping with a new reality*

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Coping with a new reality

Recession and high anxiety have aggravated the effect of a cyclical slowdown

Since the publication of the last Outlook, in June 2008, seismic changes have taken place in the financial world. Governments have been obliged to intervene in the markets to an unprecedented degree. Their efforts, which were at first focussed on protecting the financial markets and banking system, have now turned into a broader programme of support for the economy. Politically and economically, the landscape has been transformed. There is still extreme uncertainty about the future.

The suddenness and sheer speed of the change in perception has caused an exaggerated collapse in the price of financial assets; raised funding costs for banks; and closed off of some important channels of financing, such as asset-backed markets. Although governments and central banks have mounted an impressive rescue operation, the economic consequences of the crisis have started feeding through. Among the chief economists of the EBF's Economic and Monetary Affairs Committee, as elsewhere, the debate is now about how far the economy will weaken, and for how long.

The financial crisis is magnifying the effect of the end of a business cycle which had begun to be observed in the third quarter 2008 around the world[1]. EMAC's economists agree in forecasting for the euro area a deepening of the technical recession (two quarters of negative growth) which has just been recorded. While growth in 2008 is widely expected to reach 1.1% (after 2.6% in 2007), forecasts for 2009 diverge widely, between -1.3% and + 0.3%, providing the average of -0.4%. Although the survey forecast horizon goes no further than 2009, the longer term outlook is highly uncertain. It is still difficult to reach a view on whether we are close to the turnaround in confidence on financial markets.

Particularly now, developments in Europe are inextricably linked to those in the **United States**. There, despite the fiscal and monetary stimulus being provided, the prospect for nearly all components of demand is negative, and most economists forecast a recession. The average of the US GDP growth forecasts suggests a fall of -0.7% next year, with a range between no growth and -1.7%. This represents an economic setback, compared with the

[1] Eurostat's Business Cycle Clock:
http://epp.eurostat.ec.europa.eu/cache/BCC/xdis_en.html?country1=eu27&country2=us&une=true&gdp=true&con=true&ppi=true&emp=true&imp=true&exp=true&pi=true&pc=true&inv=true&esi=true&tov=true

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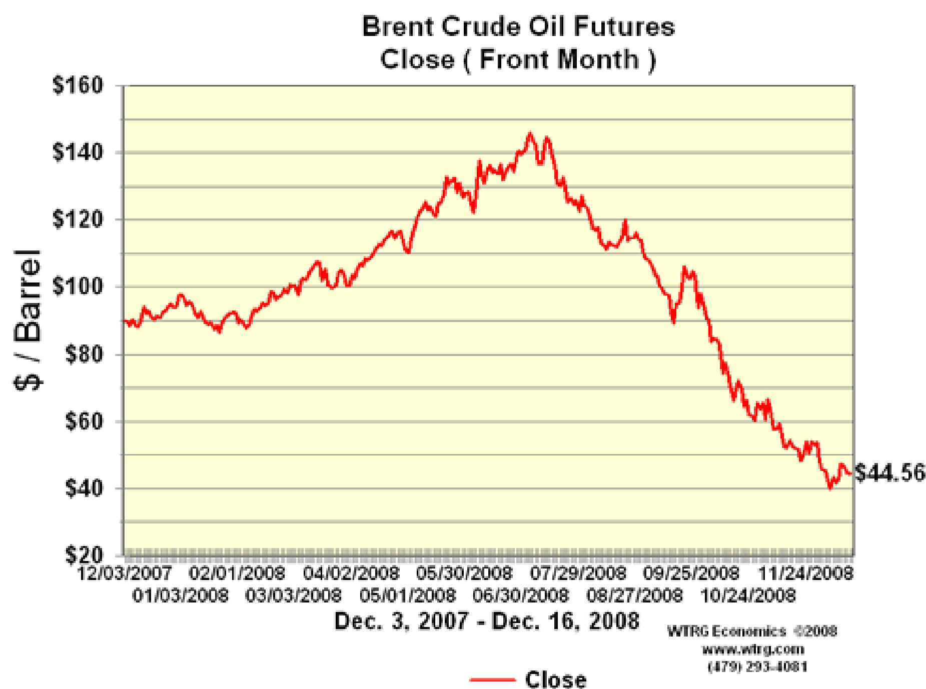
gradual cyclical decline which had been underway: following growth of 2.9% in 2006, 2.2% in 2007, and an expected 1.3% average for 2008.

The rapidly growing, newer industrialised countries are also experiencing the slowdown. **China's** economic growth has decelerated to single digits (9.7% in 2008 and a projected 8.5% in 2009). **Russia's** economic growth slowed to an annual rate of 6.8% in 2008 and is expected to slow down further to 3.5% in 2009[2]. Against this background, there is an increasing chance that a global recession will not be avoided. This would inflict direct damage on euro area exports and growth. A positive consequence of the general slowdown is that the pressure is off commodity prices - particularly for fuel, after six months of oil prices far in excess of 100$ per barrel - and inflation.

Figure 1. **Brent crude oil price (USD/Barrel)**[3]



Great effort is being made by **both national and international authorities** to reduce the impact of the crisis. Lessons learned since the 1930s have ensured a greater readiness to cooperate in times of financial crisis and a more suitable policy response than in the past. Many observers have been surprised by the scale of international coordination in past months, although the market reaction has been mixed. In Europe, coordinated steps have

[2] The International Monetary Fund's World Economic Outlook (November 2008 update): http://www.imf.org/external/pubs/ft/weo/2008/update/03/pdf/1108.pdf (page 5)

[3] Source: http://www.wtrg.com/daily/brentcrudeoilprice.html

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been taken with the aim of restoring liquidity to financial markets, and ensuring the viability of the banking system. The level of payout of deposit guarantee schemes has been increased to € 50,000 and is to be increased further to € 100,000 by 2012. The speed of the payout has also reduced dramatically from over 30 days to just three. The "European Economic Recovery Plan" set out in the package of measures approved at the European Council on 11th/12th December is designed to address the economic consequences of the crisis while furthering some longer-standing political objectives. The longer term elements include a better adaptation to climate change, and a deepening of the structural reforms which are not only essential to the future growth and employment prospects of the EU, but also urgent short term requirements in some cases.

This interventionist industrial policy is an important feature of the new landscape, which will govern economic developments over the next year. The policy spans the whole of the EU, although the scale of the problems varies considerably between Member States. Now that the initiative has been adopted by the Council, the chief economists ask national governments to make efforts to minimise market distortions and resist the temptation to give unjustified support to parts of their economy which are in need of adjustment. There is much to be gained if the plans are well-crafted. As well as helping to rebuild confidence, they should give Europe's governments the opportunity to reorient the European economy, and possibly, as the Commission suggests, to "reinforce and accelerate reforms already underway under the Lisbon Growth and Jobs Strategy", and to create "clean growth and more and better jobs in the future". The banking sector is working with the EU institutions to frame appropriate new rules or amendments to existing rules, with the aim of protecting the financial system from systemic risk.

Risks to the scenario

Given the rapidly evolving financial and economic landscape, the level of uncertainty is very high. Some of the possibilities which do not feature in the main scenario are positive. Most important, the still-evolving efforts to boost the world economy, including the **EU Recovery Plan**, may take effect more rapidly, and have a more profound effect, than can be foreseen at present. The seriousness of governments' commitment to do what it takes to support the economy - which should become even clearer as the months pass - may help to dispel the gloom more rapidly than expected. Reductions in interest rates, alongside falling energy and household goods prices, could add to the forces in favour of a quicker recovery in confidence and resolution of the crisis.

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On the other hand, the greatest risk to the scenario is a mirror image of what was just described. The financial turmoil may last longer than currently anticipated and it may take longer than expected for **confidence** to return. Also, in times of recession and great uncertainty, the financial industry tends to react with a reduction in leverage and tightening of standards. In the current context, the economists point to the possibility that this necessary reaction may go beyond what is expected. Although not necessarily, the financial crisis has the potential to slow down the supply of credit, amplifying the turn of the credit and investment cycle which was already underway. Banks are strengthening their balance sheets so that they can fill their role as credit providers in a sustainable manner.

Other risks for the broad economy include the possibility that housing markets weaken sharply or more generally than has so far been the case. Oil prices might be under upward pressure in the course of next year. In addition, emerging economies may experience a more significant growth slowdown than anticipated, further damaging global growth. Global imbalances have not diminished over recent months and sentiment is volatile: instability in the foreign exchange markets could deal a further blow to the prospects for recovery.

The vulnerability of sentiment overshadows the outlook for 2009 and beyond, but shifts in sentiment are by their nature often unpredictable and sudden. It is to be hoped that movements in the near future will overall be on the upside.

Bank lending

Trends in **bank lending** are a source of considerable uncertainty and fear. This concern is understandable, as banks are primary providers of funding which will support growth and the eventual economic recovery. However, EMAC members point out that in recent years many enterprises have strengthened their financial positions (through reinvesting their profits and reducing dependence on bank lending), and that the spillover of the crisis into lending activity has at the time of writing been moderate in most euro area countries. Banks are reducing the size of their loan books, and are more cautious and risk-sensitive in times such as these, when the economy has entered recession and when asset values are uncertain. The weakness of markets in asset-backed securities has also made it more difficult to fund bigger-ticket, and/or longer term lending. In spite of the difficult conditions, banks are competing more intensely for customers and are continuing to seek profitable business, particularly in their core activities. In the meantime, banks have tended to withdraw from the business lines in which excessive risks were taken, which contributed to the crisis.

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Latest ECB monthly lending data (for November[4]) show that lending to business continued to grow at a strong pace, by 11.9% year-on-year. Although this may partly reflect the absence of other sources of corporate funding, e.g. switching from the capital markets, it shows that banks have retained an appetite for such business. The latest (end-October[5]) edition of the ECB's quarterly Bank Lending Survey indicated that in general banks have become increasingly sensitive about risk as the economic prospects have worsened. However, so far lending to small and medium-sized enterprises is relatively less affected by tightening credit standards than lending to larger companies. EBF members also report that SME lending volumes are holding up well, with sound business propositions continuing to obtain finance.

The chief economists agree that, in the coming months, the lending figures will reflect more clearly the recessionary conditions, with demand for finance also declining as companies and individuals retrench.

There is a new political element to the bank lending issue in Europe, because governments are imposing conditions in exchange for giving public support to the commercial banking sector. Over the coming months, we will learn more about the balance being struck between two official policy objectives, which are not easily reconcilable: to see banks reducing leverage (in order to improve balance sheet ratios), and to encourage banks to maintain financial support for industry and households (to limit the depth of the economic downturn).

Domestic consumption will be propped up by public spending

Domestic demand will at best remain sluggish during 2009. Consumer and industrial confidence has suffered a shock, with the result that business and consumer indicators are likely to show serious weakness for some time to come.

The average of EMAC members' forecasts indicate that **private consumption** will be flat in 2009 (0% per annum after an expected 0.4% this year), but the individual 2009 forecasts range from -0.3% to +0.4% growth, reflecting the uncertainty, and the risks are considered to be on the downside. Some forecasters consider that household spending may be encouraged by the fall in inflation and possible tax cuts, and begin to pick up in the course of the year, after having been held back in 2007 and 2008 by the slow growth in real disposable income. Others see household spending remaining weak throughout the year due to the deterioration in the labour market - which, as a lagging indicator, is only now showing

[4] Source: http://www.ecb.int/pub/pdf/mobu/mb200811en.pdf

[5] Source: http://www.ecb.int/stats/pdf/blssurvey_200810.pdf

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weakness - and resulting falling wealth. This depressive influence is likely to be combined with an increase in the savings rate as a precautionary measure. The economists' employment forecasts indicate on average a return to an unemployment level close to that of 2006, at 8.2%, after a dip to 7.4% in 2007 and an expected 7.5% this year. The favourable jobs trend of the past two years will therefore be sharply reversed. On the wage front, there may be a lengthy carryover into 2009 of increases which were agreed this year to compensate for the higher cost of living. The average of the economists' forecasts shows wages growing by 2.8% this year and 2.3% in 2009, compared with 1.0% and 1.5% for 2006 and 2007 respectively.

Estimates for growth in **gross investment**, after a modest outturn for 2008 (average 2.1% p.a.), point to a flat or, more likely, negative result for 2009, on average -2.7%, with a range of -4.9% to +0.3%. Accentuating the downward pressure on investment, slow growth outside Europe will hit demand for euro area exports over the next year, with the result that the **trade balance** is expected to have a neutral effect at best. Beyond the forecast period, measures to revive the US economy should lead to an improvement in global trading conditions.

The European Economic Recovery Plan

It will be difficult to begin to undo the economic damage done by the financial crisis; much of it is still to become apparent. The EU's Recovery Plan, approved by the Council earlier this month, will provide a valuable transfusion of domestic demand, through its short term measures to boost purchasing power, such as increases in transfers to low-income households, targeted at boosting confidence and consumption. These steps, together with the longer term "smart" investment programmes and structural measures designed to strengthen the economic fabric, should feed through into improvements in the job market and, in turn, increasing purchasing power. The fall in inflation should reinforce these supportive elements. One of the Plan's main objectives is to reduce human distress. If it succeeds in giving reassurance, consumer sentiment could next year begin the difficult journey back to more normal levels.

With the approval of the Plan, the economic impetus from growth in **public consumption** will overshadow other sources of demand. Disbursements under the Plan (equivalent to about 1.5% of EU GDP) would primarily be made from national budgets. Since the funding is expected to be provided over a short period, the increase in public indebtedness next year will be rapid and very large.

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The fiscal impact

Some observers interpret the stimulus package to imply that the EU's budgetary rules will be relaxed, but the Commission appears confident that the fiscal effects can be conducted within the terms of the Stability and Growth Pact, with its emphasis on the long-term sustainability of the fiscal position. In the form approved in 2005, the Pact allows for co-ordinated budgetary expansion in case of extraordinary circumstances, such as the current combination of a recession with a financial crisis. If, in order to finance the temporary fiscal stimulus, some Member States' budget deficits exceed the 3% GDP reference value and an "excessive deficit" is identified, the required corrective action may be permitted to take place over a period which takes account of the recovery of the economy.

The effects of a government stimulus are reflected in the EMAC economists' projections. **Public sector deficits and debt** will increase significantly from their 2007 levels of 0.6% and 66% respectively for the euro area, caught in the pincer between falling tax revenues and greatly increased spending. EMAC forecasts predict levels of (on average) -1.4% deficit and 66.5% debt for 2008, worsening to -2.5% and 68.2 next year.

A favourable inflation outlook has left room for aggressive ECB rate-cutting

The receding **oil price** has been the main factor contributing to a fall in inflation which began after last July, when it reached a peak of 4% per annum (HICP). The sharpness of the drop from the July levels to 2.1% in November has given rise to fears of deflation. Looking forward, there will be strong downward pressures on prices from the lower oil prices combined with the slowdown in economic activity and widening output gap, which will limit pressures on the core components. The upward trend in wage costs will stall, as the very weak economic outlook filters through to the employment market. Lower commodity prices, particularly for energy and food, should work in the same direction.

The risk of deflation is a concern. However, a number of factors are expected to help to keep deflation at bay: a pick-up in the oil price (noticeable when the past year's peaks fall out of the annual comparison); the feeding through of second round effects from previous price increases; and possibly a weakening of the euro.

Few of the chief economists see the oil price remaining long at current low levels, which would present serious difficulties for oil-producing countries and possibly prompt a supply

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reaction. Following an average of around 100$ per barrel for 2008, a modest decrease to 65.5$ is the mean of forecasts for 2009, although a minority see a return to the 80$ mark.

The result of these various influences is, in EMAC's view, headline **inflation** of 3.4% this year and 1.7% in 2009, with the core level falling below 2% in 2009. Most of the forecasters see some recovery in ten year government bond yields in the course of 2009 (average of 3.6%), in the context of the greatly increased supply of public debt. The estimates range between 2.6% and 4.0% for the end of 2009.

The remarkable evaporation of inflation pressures has put the ECB in a very much more benign environment from that which it perceived at the time of the mid-year Outlook. Since then, the chief economists consider that the central bank has reacted well and very flexibly in its monetary management, for example in helping to alleviate banks' funding difficulties through changing collateral eligibility, and in lengthening the maturity of its liquidity injections in recent months. Confidence in the inter-bank market will however need more time to re-emerge, and it is possible that other temporary adaptations to ECB practice will be considered helpful to the restoration of normal liquidity conditions.

EMAC members have anticipated and strongly supported the aggressive action taken in the past two months by the ECB, in lowering the **main refinancing rate** to 2.5%. (A minority of survey respondents believe that the ECB could have reacted more quickly in beginning to reduce rates.) These steps should give important support to domestic demand, provided that the monetary transmission mechanism returns to working order.

EMAC's estimates of trends in **money supply** diverge greatly: the average of estimates for M3 growth by the end of 2009 is 5.6%, with a range of 3.5% to 8.0% (7.2% end 2008). This reflects a significant cool-down compared with the double-digit rates, which caused concern, in the two previous years.

The risk of instability on exchange markets is high

Uncertainty, over the effectiveness of government measures to support the financial system and economy, and the economic fundamentals, is reflected in the broad diversity of forecasts for the **dollar/euro exchange rate** among the chief economists of the European Banking Federation. Disorderly exchange rate movements remain a risk, not least because of the crisis, but also due to the persisting global imbalances, and the scale and speed of monetary and fiscal reactions to the crisis.

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Figure 2. **Euro-Dollar exchange rate**[6]

Factors which would support euro strengthening include a possible quantitative easing of money supply by the Fed, stock adjustments and portfolio diversification from the US dollar into euro. On the other hand, the markets have re-evaluated the dollar since the peak of the crisis, and the base interest rate differential between dollars and euro has fallen as the ECB has lowered rates. A cyclical factor could also play a part: since the US entered the recession earlier, it could therefore emerge from the downturn earlier than the European economy.

The extremes of the estimates for the euro exchange rate by the end of 2009 range from 1.15 to 1.45 dollars, but the weight of opinion points to a euro value of 1.29 dollars.

As hard as it is to forecast in the current volatile conditions, EMAC members look ahead to 2009 with considerable caution. They put much emphasis on the downside risks for private consumption, and external conditions. Most forecasts project a future characterised by uncertainty over the exchange rate, a stagnant oil price, and rising government deficits and debt as the national and EU support plans get into action. The recovery from recession, both for the US and the EU, is likely to be difficult and slow.

[6] Source: http://www.ecb.int/stats/exchange/eurofxref/html/eurofxref-graph-usd.en.html

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