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# The euro area will not be immune to the global slowdown

European Banking Federation

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# EBF OUTLOOK ON THE EURO AREA

## "The euro area will not be immune to the global slowdown"

### The US slowdown will feed through to world economy

Next year the euro area economy will be under pressure on a number of fronts. The single most important influence is the cyclical slowdown in the USA, which is now magnified by the crisis of confidence originating from the sub-prime mortgage market. The turmoil in financial markets has started translating from the financial sphere to the real economy. In the euro area, its effect is compounded by the strengthening of the euro against the dollar, which is lessening the attraction of euro area goods and services on world markets; a tightening of credit standards, and higher oil prices. Despite these dampening pressures, the euro area should grow at close to its estimated potential of around 2% next year.

The chief economists of the EBF's Economic and Monetary Affairs Committee (EMAC) have accordingly scaled back their growth forecasts since the mid-year Outlook was issued in July. The revised figures show euro area growth slipping back to 2% in 2008, after a strong outturn for this year at 2.6%. The Outlook figures are averages based on the individual estimates of members of EMAC.

Representatives of three out of the four biggest euro zone economies, i.e. Germany, Spain and Italy, have lowered growth expectations for their countries, accounting for the bulk of the dampening effect on growth in 2008, despite a more positive outlook for smaller euro zone economies such as Luxembourg and Finland. France is alone among the top four in expecting the same level of expansion for both 2007 and 2008. Underlying the mean of growth forecasts for the euro area in 2008 is a range of 1.6% to 2.2%, and the economists report a greater degree of uncertainty than usual. This range compares with the latest (6 December) Eurosystem staff macroeconomic projections of 1.5% to 2.5% for 2008.

The international picture has worsened over the past six months. Globalisation brought many benefits to the euro area: first and foremost, new markets and cheaper sourcing of intermediate products, which helped the economy to reap the benefits of recent structural reforms in the major economies. It continues to support growth: without the easy flow of goods, services and finance internationally, the US and the euro area would be at greater risk of recession at present. On the other hand, the international nature of financial markets has facilitated the rapid spread of the consequences of the sub-prime crisis originating in the US. Borrowing costs have risen and credit standards tightened generally, and confidence has been dented around the world.

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Set up in 1960, the European Banking Federation (EBF) is the voice of the European banking sector. It represents the interests of over 5000 European banks, large and small, from 31 national Banking Associations, with assets of more than EUR 30 000 billion and over 2.4 million employees.

As pointed out in previous Outlooks, the euro area is less affected by trends in US growth than in past decades: the so-called "de-coupling" of Europe from the US. This is because of the greater importance of intra-EU trade (35.5% of euro countries' export business is now within the EU, compared with 14.4% with the USA[1]) and the growth of export markets in other rapidly-growing economies such as China and India. Nonetheless the US slowdown (particularly sharp in the area of private consumption, i.e. demand for tradeable goods) will exert a drag on world growth, to which open trading economies such as the euro area and Japan cannot be immune. In the case of the euro area, the effect is accentuated by a stronger euro, which is expected to persist through 2008. We are now witnessing the limits of de-coupling.

A soft landing is likely for the US, although there is a risk – a high risk according to a few forecasters – of a recession. The average of EMAC's estimates points to an L-shaped flattening of US growth to about 2% *per annum* in both 2007 and 2008, after two years at a pace in excess of 3%. If the US does slip into a recession, there is a risk that Europe and Japan would follow. The emerging economies would be much less affected but would be likely to grow less rapidly.  China and Asia are important markets for European exporters. Much depends on how long the financial market turbulence (currently exacerbated by year-end covering of positions) will last, and on the underlying developments in the US housing and sub-prime loan markets.

Forecasts for the individual economies making up the euro area show that the dampening effects of the financial crisis are widespread, with credit volumes – particularly in real-estate related lending – generally lower, and borrowing costs higher. The credit figures may show some distortions resulting from the turmoil, as important operations, previously off-balance sheet, are taken onto balance sheets, and the effects on capital weigh on credit supply. The EMAC poll results show a deceleration in credit growth from the 11.5% recorded in 2006 to 7.3% *per annum* by the end of 2008 (range of forecasts 6-8%). The forecasts imply a challenging period for the banking industry, with the expectation of lower credit volumes and possibly a continued need to offer more attractive rates for term deposits, increasing the cost of gathering assets.

The degree of vulnerability to the worsening of the economic fundamentals (slower global growth and the higher levels of the euro and the oil price) varies considerably around Europe, with the smaller, open Northern European economies among the more exposed. As far as the oil price is concerned, the chief economists' main scenario is for prices to average $80 *per* barrel through 2008. The stronger euro is expected to continue to neutralise its effects, although this time oil price effects on demand will not be offset by easy credit and a lower savings ratio. The pick-up in the economy this year has fed through to improvements in the financial position of the private sector. This will be the main source of economic strength in the euro area – unlike the US – over the coming months. Overall, the euro area is in a better state to weather the difficult conditions than would have been the case just a year ago.

The recent improvements in the industrial sector in Germany, the power-house of the euro area, are an important support for the economy going forward into 2008. Here, external competitiveness has been boosted by private sector investments. The corporate sector has little need for debt, having been financed largely by internally-generated funds in its recent

[1] Source: Statistics Pocket Book, ECB, November 2007

expansion. However, in the export-oriented sectors, the stronger euro will partly offset the gains from recent quality improvements. The adverse conditions internationally are expected to push growth back to the lacklustre levels seen before 2006/7, with a decline from 2.4% this year to below 2% in 2008. Moreover, disappointment over the pace of structural reform on the part of the public sector and concern over the outlook for wages - particularly after the announcement in early December of a minimum wage for the postal sector - is dampening optimism. This may hold back new investment.

Similar trends will be seen in the other major economies of the euro area. The window of opportunity to undertake structural reform without much pain appears to be closing even more quickly than expected.

Italy is experiencing decelerating exports, although so far compensated by a rise in domestic consumption. On the supply side, the main driving force for growth is the services sector. In the case of Spain, growth of the construction sector is decelerating, as does private consumption. The significant flow of immigration in Spain calls for creation of new jobs for the migrant population, most probably in the field of services. With a period of high inflation and a cooling down in growth, Spain is anticipating a soft landing scenario for next year. In France, a modest slowing in growth is expected. Despite improvements in the labour market, the less buoyant economic climate may discourage consumer spending.

Risk factors for EMAC's main scenario for the next year and beyond have become more negative. A continuation of the nervousness in financial markets and a persistence of the tighter credit conditions could clearly cause more lasting damage. The dollar could weaken further, possibly sparked by an increase in the euro/dollar interest rate spread or a change in attitude on the part of sovereign investors, but more likely reflecting general concern about US economic performance. A further slide of the dollar would also worsen the downward bias of the forecasts.

Oil prices are another important negative risk factor. Up to now, an oil price close to around $100 per barrel has not caused great difficulty, with the stronger euro partly shielding domestic consumers. It is estimated that a significant proportion of the current price is due to valuation effects from the weak US dollar, as well as to technical factors, in particular the opening of long futures contracts. Fundamentals are also at play, in particular the strong growth in emerging markets. It is possible that because of these varied influences, the oil price has not yet reached its peak, although the economists see a persistently higher oil price as highly unlikely.

## Can domestic demand drive the economy forward?

Taking account of the subdued prospects for growth in most regions of the world, the trade balance is likely to make a modest contribution to growth in the euro area as a whole, down from 0.3% of GDP in 2006 to 0.5% this year and 0.1% in 2008. The euro area will need to look for a domestic impetus to growth. Yet here, too, business and consumer confidence has been hit by the sub-prime problem. The expected further tightening of banks' credit standards for enterprises and households will dampen business and housing investment. Next year, the pace of growth in gross investment is set to fall to 2.7%, after 4.9% for this year.

Perhaps by default, private consumption could become the main growth driver next year. But in fact there are good reasons to expect continued strength in consumer spending despite the tighter credit conditions, at least through 2008. The succession of yearly improvements in the labour market is set to carry through into next year, with unemployment falling from 7.3% to

7% in 2007/2008 (7.9% 2006). The recent economic momentum will also push wages ahead, with wage growth advancing from 2.3% this year to 2.6% next, partly because of the long lead time in reaching wage settlements in Germany, although in real terms wage growth will probably be pared by slightly higher inflation. Improved disposable incomes will support growth in household consumption of 2% in 2008, after 1.6% this year.

The chief economists do not expect the greater caution seen in the housing market to become pronounced. It is more likely that credit tightening and uncertainty about asset markets will encourage a continuation of this attitude, which may allow markets in some countries to undergo a healthy correction.

Public finances over the euro area are expected to continue to improve. EMAC members expect progressive modest deficit reductions over this year and next, with the result for the euro area as a whole a general government deficit quite stable at 1% GDP, after 2.5% and 1.6% for 2005 and 2006. Government debt levels should also stabilise, at below 70%. The benefits of past reform are evident and this is a welcome trend. But the chief economists are concerned that structural reform is not being given the priority it requires. One way for governments to reinforce the confidence of the markets and other economic actors is to demonstrate that government budgets are being put to good use. It is particularly important to show that the euro area is prepared to deal with the major economic challenges which can be foreseen, such as the ageing population and competition from emerging economic powers.

## Inflation remains under control

The ECB's reaction to recent market troubles has been sensitive and appropriate, and the chief economists endorse its decision to step back from any rate hike in the last quarter of the year. In their view, the financial market turmoil has tightened monetary conditions considerably, through higher short term rates and the appreciation of the euro. With the improved terms of trade and a slowing economy, the poll results show inflation risks to be benign, on the assumption that oil prices will be brought down from current levels. Inflation will remain relatively stable in 2008, with the headline (HICP) and core inflation rates averaging 2.2% and 2% respectively.

In view of the downside risks for output growth, it is possible that there will be calls in some quarters to lower official rates. But with the expectation that the annual rate of HICP inflation (3.1% in November) will diminish only gradually during 2008, and concern about second-round effects in the form of increased wages, the ECB's Governing Council is taking the view that risks to the medium term outlook for prices lie on the upside. The economists see it as likely to keep rates on hold – and its inflation objective in mind - unless output growth slows to the lower end of the forecast range.

The majority of the economists expect that the ECB refinance rate will stay flat at 4% to the end of 2008. Their forecasts for long term bond yields show a low level of concern about inflationary pressures, with a premium of about 30 basis points over 3-month Euribor and 50 basis points above the ECB refi rate at end-2008.

The increase in the monetary aggregates remains a cause for concern for the ECB, and it will be monitoring development of the monetary aggregates with care so as to understand better the shorter term dynamics resulting from the market turbulence as well as to judge the longer term inflationary pressures. On balance, the chief economists expect growth of M3 to be brought down close to 8% *per annum* by the end of 2008, after having been pitched into double figures by financial market events among other factors.

## Risk of euro overshoot?

Following a 25 basis points cut last week, the Federal Reserve may be inclined to cut rates again pre-emptively to forestall further crises of confidence and encourage growth, although this strategy carries the risk of dollar weakness. On balance, the economists expect one or two further rate cuts from the Federal Reserve. They anticipate that the euro will remain relatively strong over the forecast horizon. The difficulties in the US housing market and sub-prime lending have focused attention for the time being on the weak dollar fundamentals. However, dollar weakness will over time help to offset some of the economic problems. The declining US budget and current account deficits may now be structural, and will contribute to support the USD against the euro.

EMAC members on average see a still-strong euro at 1.41 to the dollar by end-2008. There is as usual a wide range of individual forecasts (1.33 to 1.60), with the majority seeing the euro at 1.40 or below at that point.

***This edition of the EBF Economic Outlook is written by the Economic and Monetary Affairs Committee of the EBF (EMAC) which has the following members:***

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## POLL ON THE ECONOMIC OUTLOOK FOR THE EURO AREA 2007-2008

| TABLE 1 | | 2005 | 2006 | 2007 Forecast | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | EMAC Consensus | | | EMAC | | COM Forecast | |
| forecasts from: | | | | 2007 mean | 2007 range | | mid 2007 | end 2006 | Oct-07 | Spring-2007 |
| **1. Output and Aggregate demand:** | **(Ann.% change)** | | | | | | | | | |
| Gross domestic product | | 1,4 | 2,7 | **2,6** | **2,4** | **2,7** | 2,7 | 1,9 | 2,6 | 2,6 |
| Private consumption | | 1,5 | 1,8 | **1,6** | **1,5** | **1,9** | 1,9 | 1,6 | 1,7 | 2,1 |
| Public consumption | | 1,4 | 2,1 | **1,9** | **1,8** | **2,1** | 1,9 | 1,5 | 2,0 | 1,8 |
| Gross investment (GFCF) | | 2,5 | 4,7 | **4,9** | **4,5** | **5,3** | 4,9 | 3,3 | 4,7 | 4,4 |
| Exports | | 4,2 | 8,2 | **5,9** | **5,0** | **6,5** | 6,5 | 4,7 | 5,8 | 6,7 |
| Imports | | 5,2 | 7,7 | **5,2** | **4,6** | **6,4** | 6,4 | 4,8 | 5,3 | 6,7 |
| **2. Labour market and prices:** | **(Ann.% change)** | | | | | | | | | |
| Unemployment rate (%) | | 8,6 | 7,9 | **7,3** | **6,9** | **7,5** | 7,1 | 7,6 | 7,3 | 7,3 |
| Wages | | 1,9 | 2,2 | **2,3** | **2,0** | **2,6** | 2,5 | 2,2 | 2,6 | 2,4 |
| Prices (HCPI) | | 2,2 | 2,2 | **2,1** | **2,0** | **2,3** | 1,9 | 2,1 | 2,0 | 1,9 |
| Core HCPI | | 1,3 | | **1,9** | **1,8** | **2,0** | 2,0 | 1,9 | | |
| **3. Public Finances:** | **(% GDP)** | | | | | | | | | |
| General Government Balance | | -2,5 | -1,6 | **-0,9** | **-1,8** | **0,8** | -1,1 | -1,9 | -0,8 | -1,0 |
| General Government Debt | | 70,5 | 69,0 | **67,6** | **66,5** | **69,0** | 67,4 | 69,8 | 66,5 | 66,9 |
| **4. External sector:** | **(% GDP)** | | | | | | | | | |
| Trade Balance | | 1,2 | 0,4 | **0,5** | **0,1** | **1,4** | 0,0 | 1,4 | 0,8 | 0,9 |
| Current Account Balance | | 0,0 | 0,0 | **0,1** | **-0,2** | **0,5** | 0,0 | -0,3 | 0,0 | 0,2 |
| **(p.m.) US growth** | **(Ann.% change)** | 3,2 | 3,3 | **2,1** | **1,8** | **2,2** | 2,1 | 2,4 | 2,1 | 2,2 |
| **(p.m.) Oil price (Brent)** | **(US$/bl)** | 54,1 | 66,2 | **76,1** | **70,0** | **90,0** | 65,2 | 62,9 | 70,6 | 66,2 |
| **5. Monetary and Financial Indicators:** | | | | | | | | | | |
| Interest rate on ECB's main refinancing operations | Jun-07 | 2,25 | 3,50 | **4,00** | **4,00** | **4,00** | 4,00 | 3,64 | | |
| | Dec-07 | | | **4,00** | **4,00** | **4,00** | 4,28 | 3,64 | | |
| 3 month interest rate (EURIBOR) | Jun-07 | 2,18 | 3,08 | **4,14** | **4,07** | **4,20** | 4,16 | 3,79 | | |
| | Dec-07 | | | **4,44** | **4,00** | **4,70** | 4,41 | 3,78 | | |
| 10 year government bond yield (Bund) | Jun-07 | 3,44 | 3,86 | **4,50** | **4,41** | **4,60** | 4,49 | 3,98 | | |
| | Dec-07 | | | **4,19** | **4,00** | **4,50** | 4,51 | 4,01 | | |
| M3 growth | Jun-07 | 7,3 | 9,8 | **10,99** | **10,97** | **11,00** | 10,27 | 6,73 | | |
| | Dec-07 | | | **10,37** | **8,00** | **11,00** | 8,29 | 6,17 | | |
| Credit to private sector (Ann.% change, M3 definition) | Jun-07 | 9,6 | 11,5 | **10,79** | **10,79** | **10,79** | 10,10 | 7,97 | | |
| | Dec-07 | | | **10,05** | **8,20** | **11,00** | 9,56 | 7,36 | | |
| Exchange rate USD/EUR | Jun-07 | 1,19 | 1,32 | **1,35** | **1,34** | **1,35** | 1,35 | 1,31 | | |
| | Dec-07 | | | **1,48** | **1,44** | **1,50** | 1,36 | 1,32 | | |

# POLL ON THE ECONOMIC OUTLOOK FOR THE EURO AREA 2007-2008

| TABLE 1 | | 2005 | 2006 | 2008 Forecasts | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | EMAC Consensus | | | EMAC | | COM Forecast | |
| forecasts from: | | | | 2008 mean | 2008 range | | Mid-2007 | End-2006 | Oct-07 | Spring-2007 |
| **1. Output and Aggregate demand:** **(Ann.% change)** | | | | | | | | | | |
| Gross domestic product | | 1,4 | 2,7 | **2,0** | **1,6** | **2,2** | 2,2 | | 2,2 | 2,5 |
| Private consumption | | 1,5 | 1,8 | **2,0** | **1,6** | **2,3** | 2,1 | | 2,1 | 2,4 |
| Public consumption | | 1,4 | 2,1 | **1,7** | **1,3** | **2,3** | 1,6 | | 2,1 | 1,8 |
| Gross investment (GFCF) | | 2,5 | 4,7 | **2,7** | **1,2** | **3,9** | 3,0 | | 2,9 | 3,6 |
| Exports | | 4,2 | 8,2 | **4,8** | **2,9** | **6,0** | 5,3 | | 5,3 | 6,0 |
| Imports | | 5,2 | 7,7 | **5,2** | **3,7** | **6,3** | 5,5 | | 5,5 | 6,2 |
| **2. Labour market and prices:** **(Ann.% change)** | | | | | | | | | | |
| Unemployment rate (%) | | 8,6 | 7,9 | **7,0** | **6,1** | **7,4** | 6,9 | | 7,1 | 6,9 |
| Wages | | 1,9 | 2,2 | **2,6** | **2,3** | **3,0** | 2,5 | | 3,1 | 2,8 |
| Prices (HCPI) | | 2,2 | 2,2 | **2,2** | **2,0** | **2,4** | 2,0 | | 2,1 | 1,9 |
| Core HCPI | | 1,3 | | **2,0** | **1,7** | **2,3** | 2,0 | | | |
| **3. Public Finances: (% GDP)** | | | | | | | | | | |
| General Government Balance | | -2,5 | -1,6 | **-1,0** | **-2,0** | **0,9** | -1,0 | | -0,9 | -0,8 |
| General Government Debt | | 70,5 | 69,0 | **66,6** | **65,0** | **70,0** | 65,9 | | 65,0 | 65,0 |
| **4. External sector: (% GDP)** | | | | | | | | | | |
| Trade Balance | | 1,2 | 0,4 | **0,6** | **-0,1** | **1,2** | 0,3 | | 0,8 | 0,8 |
| Current Account Balance | | 0,0 | 0,0 | **0,1** | **-0,3** | **0,2** | 0,1 | | 0,0 | 0,1 |
| **(p.m.) US growth** **(Ann.% change)** | | 3,2 | 3,3 | **2,2** | **1,7** | **2,6** | 2,6 | | 1,7 | 2,7 |
| **(p.m.) Oil price (Brent)** **(US$/bl)** | | 54,1 | 66,2 | **80,0** | **70,0** | **93,0** | 66,0 | | 78,8 | 70,3 |
| **5. Monetary and Financial Indicators:** | | | | | | | | | | |
| Interest rate on ECB's main refinancing operations | Jun-08 | 2,25 | 3,50 | **3,98** | **3,75** | **4,25** | 4,29 | | | |
| | Dec-08 | | | **3,96** | **3,50** | **4,25** | 4,31 | | | |
| 3 month interest rate (EURIBOR) | Jun-08 | 2,18 | 3,08 | **4,18** | **3,85** | **4,40** | 4,43 | | | |
| | Dec-08 | | | **4,20** | **3,85** | **4,70** | 4,42 | | | |
| 10 year government bond yield (Bund) | Jun-08 | 3,44 | 3,86 | **4,41** | **4,00** | **4,67** | 4,52 | | | |
| | Dec-08 | | | **4,54** | **4,00** | **4,80** | 4,52 | | | |
| M3 growth | Jun-08 | 7,3 | 9,8 | **8,60** | **8,00** | **10,00** | 8,50 | | | |
| | Dec-08 | | | **8,22** | **6,00** | **10,00** | 7,47 | | | |
| Credit to private sector (Ann.% change, M3 definition) | Jun-08 | 9,6 | 11,5 | **8,50** | **8,00** | **9,00** | 9,00 | | | |
| | Dec-08 | | | **7,33** | **6,00** | **8,00** | 8,75 | | | |
| Exchange rate USD/EUR | Jun-08 | 1,19 | 1,32 | **1,45** | **1,40** | **1,55** | 1,34 | | | |
| | Dec-08 | | | **1,41** | **1,33** | **1,60** | 1,35 | | | |