# THE BALANCING ACT

## EBF Outlook N°31 on the euro area economies 2011-2012

## Mid-Year Economic Outlook

EBF

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## 1. The EMAC consensus

Over the past six months, the euro area economy has been performing a balancing act. On the one hand, buoyant growth in export markets has led to the re-start of economic growth, mainly in the export-led core euro area countries; on the other, domestic demand remains depressed, with risks tilted to the downside due to the onset of fiscal and monetary tightening. The Chief Economists of the EBF's Economic and Monetary Affairs Committee (EMAC) agree that this year and next, the euro area economic growth will be shaped by:

- the behaviour of food and energy (notably oil) prices and the associated unrest in the Middle East;
- the scale of impact of fiscal consolidation, varying across the euro area countries;
- the ability of the euro area economies to boost domestic demand;
- the ability of policymakers to provide a convincing resolution to the sovereign debt issues in the euro area; and
- the international environment, in particular the growth outlook of the emerging markets.

**The EMAC consensus for the euro area GDP growth is 1.7% for this year and next. Inflation is expected to spike to 2.5% this year, and moderate to 1.9% in 2012.**

## 2. Global environment

Despite the modest recovery in the developed world, strong growth in emerging markets led to a fast increase in commodity prices. In addition, supply disruptions due to political unrest in the MENA region, has added a risk premium to the already high oil prices. As a result, Brent oil reached as high as 113 USD/barrel at the time of writing. It is expected to remain at elevated levels throughout the forecast horizon, hovering at over 105 USD / barrel. Japan's nuclear power plant disaster at Fukushima-Daiichi, which was triggered by the Tōhoku Earthquake[1], has put in question the use of nuclear energy around the world, and added to the tensions related to the global energy supply and choice of its sources.

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[1] Eastern Japan Great Earthquake Disaster was a magnitude 9.0 (Mw) undersea megathrust earthquake off the coast of Japan that occurred at 14:46 JST on Friday, 11 March 2011, with the epicentre approximately 70 km east of the Oshika Peninsula of Tōhoku and the hypocenter at an underwater depth of approximately 32 km. It was the most powerful known earthquake to have hit Japan, and one of the five most powerful earthquakes in the world overall since modern record-keeping began in 1900. The earthquake triggered extremely destructive tsunami waves of up to 38.9 m that struck Japan, in some cases travelling up to 10 km inland. (source)

**Figure 1: Brent Crude Oil Price, USD/barrel (source)**


Amid the distress of natural disasters and increasing uncertainty over the price of oil, the strong driver of economic expansion both for the rest of the world and for the euro area is the continued growth in the **emerging and developing markets**. According to the International Monetary Fund's (IMF) World Economic Outlook, the Chinese economy (which, in 2010, overtook Japan as the world's second biggest economy) will grow by over 9% this year, the Indian by over 8%, while Russia, Latin America, the Caribbean, and Sub-Saharan Africa will see growth tipping over 4%. It is increasingly apparent that the world's economic power balance is shifting from the USA and Europe over to developing Asia and Latin America. However, emerging markets are most likely to experience a soft landing in 2011. As a result, a decline in global trade will likely weigh negatively on the euro area growth. The IMF expects growth in the world trade volumes to slow down from 12% last year to around 7% this year and next.

The continued recovery of the **US economy**, forecasted to grow by 2.8% and 2.9% in 2011 and 2012 respectively, is expected to play out positively for the euro area growth. Non-farm payrolls have posted strong increases recently, suggesting solid growth in private demand. However, risks for the US and the global economy stem from an aggressive monetary policy tightening in the case of persistent inflationary pressures due to energy price hikes. Much less likely, although still possible, is the chance of global financial markets being thrown into unrest in the event of a sharp increase in long US bond yields as a result of increasing sovereign concerns.

These economic developments are taking place in parallel to the **financial markets' regulatory reform**, with the leaders of the G20 taking key decisions on the level of capital and liquidity that banks must hold to ensure financial stability and resilience. The implementation of such financial reforms will likely create a dampening effect on economic growth through increased cost of borrowing and reduced banks' appetite for risk. Such an evolution will have an impact on investors who might prefer faster-growing and higher-yielding jurisdictions. The adoption of the Dodd Frank Wall Street Reform and Consumer Protection Act[2] (including the Volker Rule[3]) in the United States, marks a sweeping reform of the financial industry, and is, in effect, a deviation from the G20 developed package of financial reform dubbed Basel III, thus putting in question the level-playing field for globally operating financial institutions.

## 3. Domestic economy

### *a. Fiscal challenges*

Developments in the euro area have added to the kaleidoscope of events around the world, as concerns about the debt sustainability of several periphery members persist. Since the last publication of the EMAC's outlook, the sustainability of public finances in the euro area countries has been monitored very closely. The two key highlights were:

- approval of the bailout package for Ireland by the European Commission and the IMF, in consultation with the ECB, totalling EUR 85 billion, and
- Portugal's request for bailout in April, and the Commission and the IMF's approval of a EUR 78 billion bailout package within a month's time.

In parallel, the austerity programme implemented in Greece has been having mixed results. Due to a high degree of uncertainty as to the results of the programme, the financial markets have been considering the possibility of restructuring Greek public debt. However, this is seen as having a potentially highly destabilising effect on the euro area, and is therefore reserved as a measure of last resort.

Overall, the **government deficit** in the euro area is expected to reach -4.6% of GDP this year, and decline to -3.8% next. That translates into the euro area **State debt** level of 86.6% of GDP and 87.8% respectively.

With the aim of stabilising the fiscal situation in the EU, the European Commission has developed an **Economic Governance Package** (EGP[4]), a package of six legislative proposals, the purpose of which is to make the Stability and Growth Pact (SGP) more rules-based, which will effectively translate into the imposition of tough sanctions on countries that breach the SGP rules. Part of the budget surveillance procedure is the newly established *European Semester*,

[2] The stated purpose of the Act is "*To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes*" (source)

[3] In essence, the Volker Rule prohibits depository banks from proprietary trading.

[4] See also http://www.europarl.europa.eu/en/headlines/content/20110429FCS18371/html/Economic-governance-package-explained.

where national budgets are first discussed at the EU level in the first half of each year, and only then taken home to be translated into respective national legislation. The EGP is being currently discussed within the EU *trialogue*, with the final outcome expected to be ready by summer.

### b. The economy

Public finances aside, the euro area economies are recovering from the crisis at different paces. While Greece, Ireland and Portugal have been struggling to re-start their economic engines, Germany has been leading the **recovery** with its stellar 4% year-on-year growth in Q4 2010 (by the end of 2010 its unemployment fell to 6.3%) owing to a post-crisis pickup in growth in the export markets. The Chief Economists' strong consensus is that in the context of the lacklustre domestic demand (private sector does not yet have the capacity to start spending again, and public sector is making a strong consolidation effort), the euro area growth will be certainly export-led. Indeed, **export growth** this year could reach 6.8%, easing somewhat to 5.3% next (in tune with the moderating world trade). In parallel, imports are expected to grow by 5.6% and 5% respectively.

The euro area **labour markets** have seen an improvement: the unemployment rate started inching downwards (9.9% in March, compared with 10.1% a year before). This improvement is unevenly distributed across countries: the lowest rate was observed in the Netherlands (4.2%), Austria (4.3%) and Luxembourg (4.5%). On the other end of the scale were Spain (20.7%), Ireland (14.7%), and Slovakia (13.9%). The average level of unemployment in the euro area is expected to remain at a 9.8% level this year, and gradually ease to 9.3% in 2012.

**Figure 2: Euro area annual GDP growth rate, %, quarterly frequency** (source)

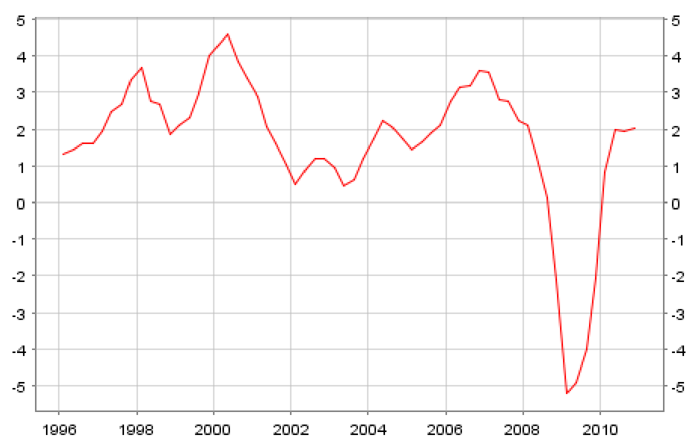
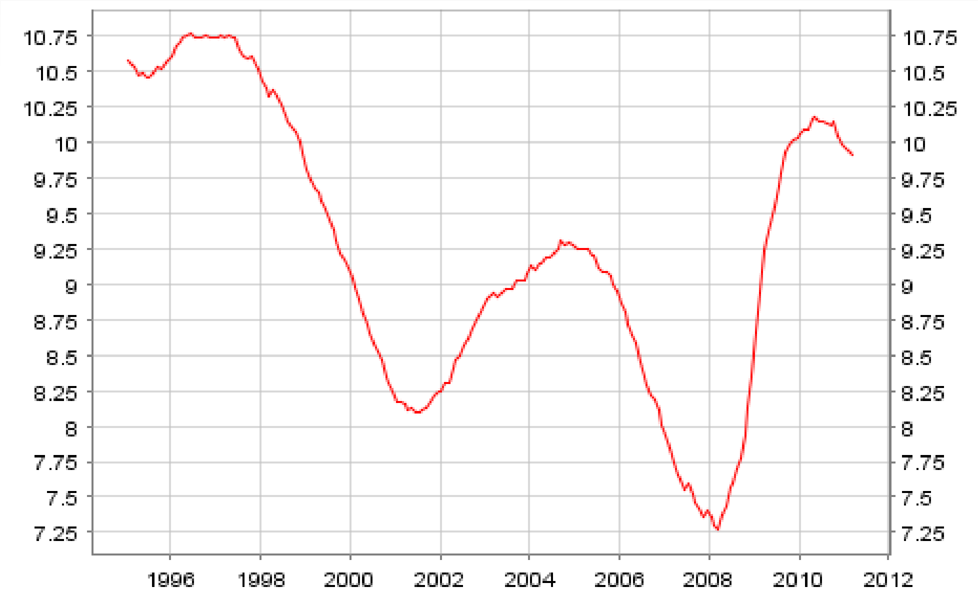


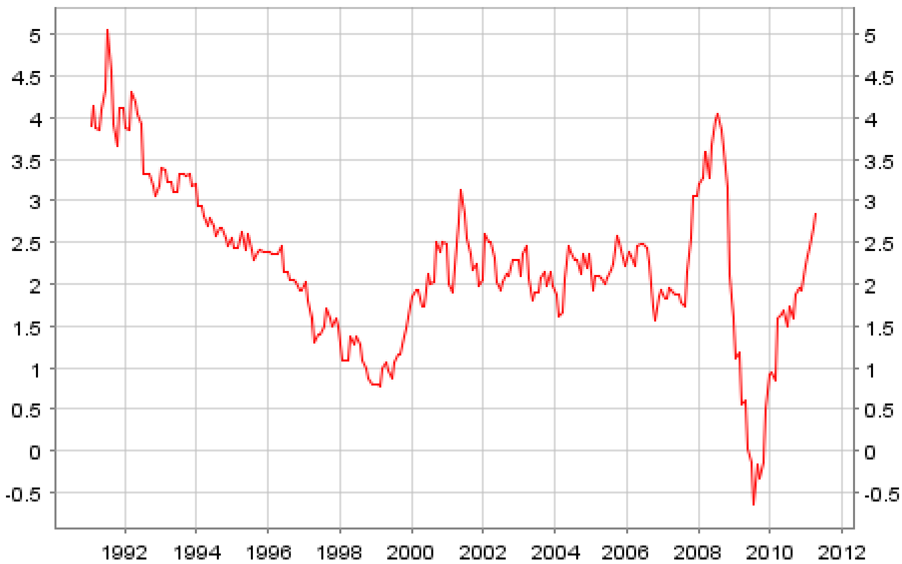
**Figure 3: Euro area unemployment rate, % (source)**




### *c. Inflation and monetary policy outlook*

Rising commodity and food prices will cause **inflation** to peak at about 2.5% in 2011. However, given the negative market conditions, the inflationary pressures are expected to ease in the second half of 2011, letting inflation fall to 1.9% in 2012.

**Figure 4: Euro area inflation, % (source)**




The **ECB monetary policy stance** is widely viewed by the EMAC's Chief Economists as justified. They largely share the expectation of quarterly 25 basis-point official interest rate hikes until the end of 2012 (implying an interest rate of up to 3% by December 2012). The recovery in the euro area from the 2008-2009 recession is uneven, with countries, such as Germany, booming, and the periphery stagnating, or in a deepening recession. The "one size does not fit all" has been never so true as now. As a result, monetary tightening should proceed very carefully so as not to deepen the growth imbalances within the euro area while at the same time taming inflationary pressures in booming economies and providing the necessary liquidity to troubled peripheral banks to support their economies. Moreover, the divergence in monetary policy stance between the European Central Bank (ECB) and the US Federal Reserve (the Fed) strengthens the euro and diminishes the chances of the troubled peripheral countries being able to exit from the current recession.

### *d. The euro*

Chief Economists of the EBF's Economic and Monetary Affairs Committee believe that at its recent peak in April of USD 1.50, the **euro** was likely overvalued. While economic fundamentals are favourable for the US dollar to start strengthening, it may remain weak for some time as the main driver of the EUR/USD cross is the divergent monetary policy followed by the Fed and the ECB. The US dollar may start rising towards the end of the year as we move closer to the reversal of the Fed's monetary policy stance.

**Figure 5: Euro / US dollar exchange rate** (source)


### *e. Bank lending and supervisory reform in different countries*

Q1 of 2011 has seen a slight quarter-on-quarter fall of about 2% in the overall bank lending, although the development across different euro area countries is uneven. For example, in Luxembourg, bank lending has normalised, and a stable development is expected in the coming years, while other countries have a less smooth recovery:

- Mortgage loans are booming in Austria, France and Belgium owing to low interest rates. The expectation is that the interest rate will increase in the future, thus causing a consequent slowdown in new issuances. Also in Germany, mortgage lending is in the positive, and is expected to continue strengthening this year and next, given the strong economic rebound. In Denmark, mortgage lending is on the rise, both to non-financial companies and individuals. In UK, mortgage loans are largely stagnant.
- Growth of loans for consumption purposes still remains close to zero in Belgium, and in Austria it is even in the red.

- Loans to non-financial corporations (NFC) are recovering in Austria. In Belgium and France, the expectation is that loans to NFC will continue growing, following the economic upswing. In Denmark and the UK, bank lending to NFC continues to decline.

Bank deposits in the euro area have been stagnant in Q1 2011 compared with the last quarter of 2010.

While experiencing these uneven patterns of bank lending and insipid deposit taking, banks are preparing for the introduction of the new capital and liquidity requirements under Basel III, as well as implementing EU regulation in other areas of financial services, such as investment markets. The new requirements are expected to place a heavy burden on banks in the coming decade, and to diminish banks' appetite for risk. The consequences for trade and for small business lending, are of particular concern.

Also the supervisory arrangements in some countries are undergoing change. For example, in Belgium, the National Bank of Belgium (NBB) has taken over the micro-prudential supervisory role, on top of its already existing macro-prudential responsibilities, from the Financial Services and Markets Authority, which will keep its remaining responsibilities of a Belgian market authority. The introduction of this "twin peaks" model aims to integrate the micro- and macro-prudential supervision of the financial sector more effectively by bringing them together within the central bank. The NBB's responsibilities are extended, *inter alia*, to the prudential supervision of individual credit institutions and insurance companies, in addition to its existing responsibility for macro-prudential supervision. By the end of 2015 at the latest, the NBB will extend its responsibilities to the prudential supervision of pension funds.

In the UK, the Financial Supervisory Authority (FSA) is to become a subsidiary of the Bank of England (BoE) and re-named as the Prudential Regulatory Authority (PRA). Their focus is on supervision, as customer protection comes under another body, the Financial Conduct Authority (FCA). Macro-prudential policy is to be executed by the BoE. Finally, a new body has been set up, the interim Financial Policy Committee (FPC), which is tasked with identifying the instruments that the statutory body (FPC) will use, and with monitoring the developments in the meantime.

In Denmark, a central aspect of the new regulatory environment is the introduction of a new "quasi"-resolution regime. This regime could potentially imply losses for depositors and senior creditors in the event of bankruptcy. Recently, the regime received international attention on account of the transfer of a bankrupt bank (Amagerbanken) to a public winding down company. A subsequent reaction to this was the downgrading of five Danish banks' senior ratings by Moody's. Further, the Danish FSA has introduced a so-called Supervisory Diamond for banks. The diamond is a benchmark tool indicating banking activities which initially should be regarded as having a higher risk profile. Among other things, banks should not be too exposed to the real estate development sector. Finally, the Danish FSA publishes the full results of inspections online shortly after these are made public by the bank in question.

## 4. Risks to the scenario

The Chief Economists outline a number of risks to the scenario. The **positive risks** are:

- stronger than expected export growth and related world trade;
- stronger than expected growth in the US and in emerging countries;
- faster and stronger than anticipated labour market recovery;
- a growing need to replace and modernise corporate investment;
- the economy may "recoup" part of the lost momentum after 2 years of restraint.

In parallel, a number of **negative risks** could hamper the euro area's economic recovery:

- escalation of the European debt crisis;
- sharper than expected inflation surge owing to commodity price hike;
- anæmic domestic demand due to restrictive fiscal policy and persistently high unemployment;
- insufficient competitiveness owing to the continuously overvalued euro;
- lower than expected growth in emerging countries;
- weak credit growth due to higher cost of regulatory measures for banks.

### *Probabilities to the growth scenario*

The calculation of the probabilities of the EMAC's growth scenario is relatively symmetric for 2011 and 2012, with the highest GDP growth probability for 2011 reaching 1.6% and for 2012, 1.7%. The two graphs reveal the fact that the estimated probability of positive risks playing out in 2012 is significantly higher than that of the negative ones; while for 2011 the picture is much more balanced.

**Figure 6: Probability Histograms of GDP Projections for 2011**

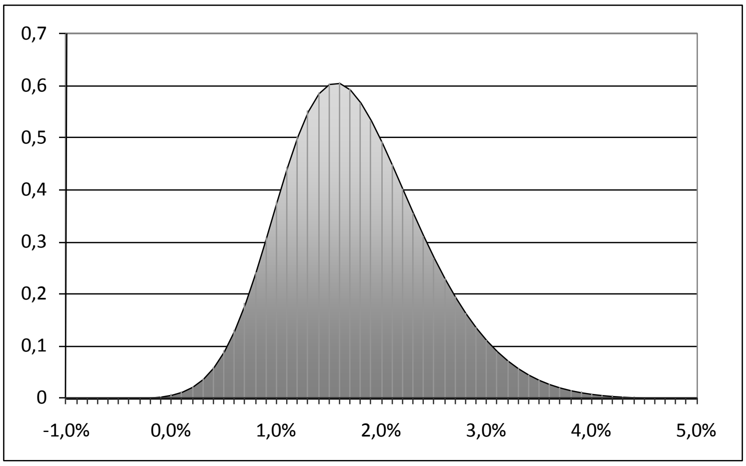
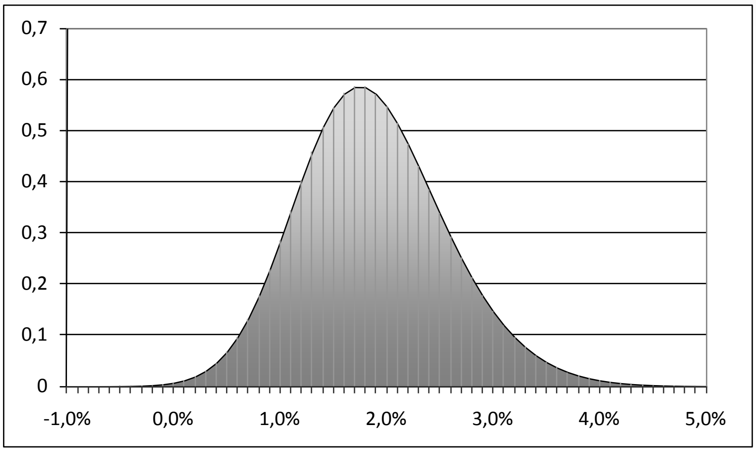


**Figure 7: Probability Histograms of GDP Projections for 2012**




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).

## ANNEX 1 – TABLE OF EMAC FORECASTS FOR 2011

| TABLE 1 | | 2008 | 2009 | 2010 | Forecasts for 2011 | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | EMAC Consensus | | | EMAC Outlook | | COM Forecast | | |
| | | | | | 2011 mean | 2011 range | | end-year 2010 | mid-year 2010 | Spring 2011 | Autumn 2010 | Spring 2010 |
| **1. Output and aggregate demand:** | (Ann.% change) | | | | | | | | | | | |
| Gross domestic product | | 0.6 | -4.1 | 1.8 | **1.7** | 1.5 | 2.0 | 1.4 | 1.5 | 1.6 | 1.5 | 1.5 |
| Private consumption | | 0.4 | -1.1 | 0.8 | **1.1** | 0.7 | 1.6 | 0.8 | 0.9 | 0.8 | 0.9 | 1.1 |
| Public consumption | | 2.1 | 2.4 | 0.7 | **0.3** | -0.1 | 0.9 | 0.5 | 1.1 | 0.2 | -0.1 | 0.3 |
| Gross investment (GFCF) | | -0.8 | -11.4 | -0.8 | **2.3** | 1.0 | 4.4 | 2.6 | 2.5 | 2.2 | 2.2 | 1.8 |
| Exports | | 1.0 | -13.2 | 11.2 | **6.8** | 5.7 | 8.0 | 5.6 | 4.9 | 6.9 | 6.1 | 5.0 |
| Imports | | 0.8 | -12.0 | 9.3 | **5.6** | 4.2 | 7.8 | 4.6 | 4.5 | 5.4 | 5.1 | 4.2 |
| **2. Labour market and prices:** | (Ann.% change) | | | | | | | | | | | |
| Unemployment rate (%) | | 7.5 | 9.5 | 10.1 | **9.8** | 9.1 | 10.0 | 10.0 | 10.3 | 10.0 | 10.0 | 10.4 |
| Wages (Unit Labour Cost) | | 3.4 | 4.0 | -0.5 | **1.3** | 0.7 | 2.1 | 0.0 | 0.8 | 0.8 | 0.6 | 0.1 |
| Prices (HCPI) | | 3.3 | 0.3 | 1.6 | **2.5** | 1.8 | 2.8 | 1.6 | 1.5 | 2.6 | 1.8 | 1.7 |
| Core HCPI | | | | | **1.5** | 1.2 | 1.7 | 1.3 | 1.2 | | | |
| **3. Public finances:** | (% GDP) | | | | | | | | | | | |
| Government Balance | | -2.0 | -6.3 | -6.0 | **-4.6** | -6.2 | -3.7 | -5.4 | -6.2 | -4.3 | -4.6 | -6.1 |
| Government Debt | | 69.4 | 79.1 | 85.4 | **86.6** | 85.0 | 88.9 | 88.1 | 88.1 | 87.7 | 86.5 | 88.5 |
| **4. External sector:** | (% GDP) | | | | | | | | | | | |
| Trade Balance | | 0.2 | 0.6 | 0.7 | **0.7** | 0.3 | 1.0 | 0.4 | 0.5 | 0.6 | 1.0 | 1.0 |
| Current Account Balance | | -0.8 | -0.6 | -0.4 | **-0.4** | -2.2 | 0.3 | 0.1 | -0.2 | -0.2 | 0.0 | -0.5 |
| **(p.m.) US growth** | (Ann.% change) | 0.0 | -2.7 | | **2.8** | 2.5 | 3.0 | 2.4 | 2.8 | 2.6 | 2.1 | 2.8 |
| **(p.m.) Oil price (Brent)** | (US$/bl) | 97.0 | 62.0 | 80.2 | **105.7** | 90.0 | 115.0 | 85.3 | 85.3 | 117.4 | 88.9 | 89.2 |
| **5. Monetary and financial indicators:** | | | | | | | | | | | | |
| Interest rate on ECB's main refinancing operations | Jun-11 | 4.00 | 1.25 | 1.00 | **1.29** | 1.25 | 1.50 | 1.02 | 1.58 | | | |
| | Dec-11 | 2.50 | 1.00 | 1.00 | **1.75** | 1.50 | 2.00 | 1.32 | 2.10 | | | |
| 3 month interest rate (EURIBOR) | (year-end) | 3.29 | 1.22 | 1.02 | **1.95** | 1.20 | 2.30 | 1.54 | 2.38 | | | |
| 10 year government bond yield (Bund) | (year-end) | 3.69 | 3.76 | 3.36 | **3.75** | 3.40 | 4.20 | 3.25 | 4.24 | | | |
| M3 growth | (annual growth) | 7.6 | -0.3 | 1.7 | **3.63** | 2.10 | 5.50 | 5.23 | 4.37 | | | |
| Credit to private sector (M3 definition) | (annual growth) | 7.7 | 0.7 | 1.9 | **2.50** | 2.50 | 2.50 | 4.38 | 4.84 | | | |
| Exchange rate USD/EUR | (year-end) | 1.47 | 1.39 | 1.34 | **1.32** | 0.72 | 1.45 | 1.33 | 1.27 | 1.43 | 1.39 | 1.35 |

## ANNEX 2 - TABLE OF EMAC FORECASTS FOR 2012

**MID-YEAR POLL ON THE EURO AREA ECONOMIC OUTLOOK FOR 2011-2012**

| TABLE 2 | | 2008 | 2009 | 2010 | Forecasts for 2012 | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | EMAC Consensus | | | EMAC Outlook | COM Forecast | |
| | | | | | 2012 mean | 2012 range | | end-year 2010 outlook | Spring 2011 | Autumn 2010 |
| **1. Output and aggregate demand:** | (Ann.% change) | | | | | | | | | |
| Gross domestic product | | 0,6 | -4,1 | 1,8 | **1,7** | 1,4 | 1,9 | | 1,8 | 1,8 |
| Private consumption | | 0,4 | -1,1 | 0,8 | **1,2** | 0,8 | 1,4 | | 1,2 | 1,4 |
| Public consumption | | 2,1 | 2,4 | 0,7 | **0,4** | -0,1 | 1,0 | | 0,3 | 0,2 |
| Gross investment (GFCF) | | -0,8 | -11,4 | -0,8 | **2,7** | 0,9 | 4,4 | | 3,7 | 3,6 |
| Exports | | 1,0 | -13,2 | 11,2 | **5,3** | 4,0 | 6,9 | | 6,2 | 6,3 |
| Imports | | 0,8 | -12,0 | 9,3 | **5,0** | 3,2 | 7,0 | | 5,9 | 5,9 |
| **2. Labour market and prices:** | (Ann.% change) | | | | | | | | | |
| Unemployment rate (%) | | 7,5 | 9,5 | 10,1 | **9,3** | 8,8 | 9,7 | | 9,7 | 9,6 |
| Wages (Unit Labour Cost) | | 3,4 | 4,0 | -0,5 | **1,6** | 0,8 | 2,2 | | 1,2 | 0,9 |
| Prices (HCPI) | | 3,3 | 0,3 | 1,6 | **1,9** | 1,6 | 2,3 | | 1,8 | 1,7 |
| Core HCPI | | | | | **1,6** | 1,2 | 2,0 | | | |
| **3. Public finances:** | (% GDP) | | | | | | | | | |
| Government Balance | | -2,0 | -6,3 | -6,0 | **-3,8** | -5,3 | -3,0 | | -3,5 | -3,9 |
| Government Debt | | 69,4 | 79,1 | 85,4 | **87,8** | 86,0 | 89,2 | | 88,5 | 87,8 |
| **4. External sector:** | (% GDP) | | | | | | | | | |
| Trade Balance | | 0,2 | 0,6 | 0,7 | **0,1** | -2,2 | 1,1 | | 0,7 | 1,1 |
| Current Account Balance | | -0,8 | -0,6 | -0,4 | **-0,3** | -2,2 | 0,4 | | -0,1 | 0,1 |
| **(p.m.) US growth** | (Ann.% change) | 0,0 | -2,7 | | **2,9** | 2,2 | 3,5 | | 2,7 | 2,5 |
| **(p.m.) Oil price (Brent)** | (US$/bl) | 97,0 | 62,0 | 80,2 | **105,2** | 83,0 | 115,0 | | 117,2 | 90,8 |
| **5. Monetary and financial indicators:** | | | | | | | | | | |
| Interest rate on ECB's main refinancing operations | Jun-12 | 4,00 | 1,25 | 1,00 | **2,13** | 1,75 | 2,50 | | | |
| | dec/12 | 2,50 | 1,00 | 1,00 | **2,50** | 2,00 | 3,00 | | | |
| 3 month interest rate (EURIBOR) | (year-end) | 3,29 | 1,22 | 1,02 | **2,67** | 1,80 | 3,30 | | | |
| 10 year government bond yield (Bund) | (year-end) | 3,69 | 3,76 | 3,36 | **4,02** | 3,58 | 4,50 | | | |
| M3 growth | (annual growth) | 7,6 | -0,3 | 1,7 | **3,98** | 2,80 | 6,00 | | | |
| Credit to private sector (M3 definition) | (annual growth) | 7,7 | 0,7 | 1,9 | **3,50** | 3,00 | 4,00 | | | |
| Exchange rate USD/EUR | (year-end) | 1,47 | 1,39 | 1,34 | **1,30** | 0,75 | 1,60 | | 1,45 | 1,39 |

Data not available

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