Editorial: What type of recovery after the crisis?

It's hard to find another period in economic history that may guide our forecasts not only for the quarters ahead but also for the years to come. Concerning the magnitude of the decline of activity, the 1930's seem to be the most appropriate reference, which holds for a large number of indicators. The expected contraction of world trade in 2009 (more that 10 %), for instance, has no precedent since WWII. If we refer to policy reactions, however, we can hope that the future will be less gloomy than in the 30's thanks to the resolute actions of governments and central bankers to avoid a deflationary spiral.

The IMF, amongst others, has shown in its analyses that it takes longer for economies to recover when the initial shock has its origin in a financial crisis or the burst of a bubble in the housing market. This is why the EUREN institutes forecast only a moderate revival in 2010, after the sharp downswing in 2009. Nevertheless, one of the tougher topics this time is the future profile of growth trend. Basically, three scenarios can be drawn for the medium term.

The first one assumes that potential growth will not be affected by the current crisis. For sure, investment and therefore capital stock growth will be pushed down for a while by the recession. Nevertheless, it can be argued that they will return to their previous trend in a longer perspective. Moreover, the apparently rapid improvement of the financial situation of many American banks since the beginning of this year supports the view that the worst of the financial crisis might be over. In this case, the current downturn can be interpreted as a traditional, although unusually strong business cycle.

In a second scenario one can suppose that the current economic crisis will translate into a permanent loss of output, but growth trend will not be very different from the one that prevailed before the crisis. The main element behind this assumption is that emerging economies, especially China, will continue to drive the world economy, as their catching up process will proceed.

A third scenario is that the current crisis will not only cause a permanent loss of output, but that potential growth will also be reduced compared to the past decade. Two strong arguments underpin this idea. Firstly, in many countries in the past ten years growth has been supported by growing indebtedness of households and firms, leading to a real estate bubble and in the end also to a financial bubble. Now it is questionable whether financial industries can continue to contribute to growth as they did it in the past in particular in the Anglo-Saxon countries, as a hopefully more appropriate regulation will make an end to excesses. Secondly, strong tensions in the raw material markets just before the crisis warned that the previous trend of world economic growth might be not sustainable. The economic development of China, India and other emerging countries has to be put on a new basis regarding the use of natural resources, both for economic and ecological reasons. Rising oil prices in the first half of this year while the developed economies were still in recession give the same signal. Thus, it is likely that trend growth will be more moderate than it was in the recent years.

However, these adjustments may translate into a few tenths of growth potential. The output gap therefore remains considerably negative now, meaning that a cyclical upswing can be expected. However, when it will occur, this should not be interpreted as a comeback of good old times.

Contact:
Alain Henriot (ahenriot@coe-rexecode.fr)

The EUREN Summer Forecast 2009

Further deterioration of global environment

In the first half of this year, the international environment has deteriorated more than the EUREN institutes predicted in their forecast published in January 20009. Actually, the decrease of GDP in the three largest economies (the US, Japan and the Euro area) can be expected to be almost twice as strong as forecasted six month ago.

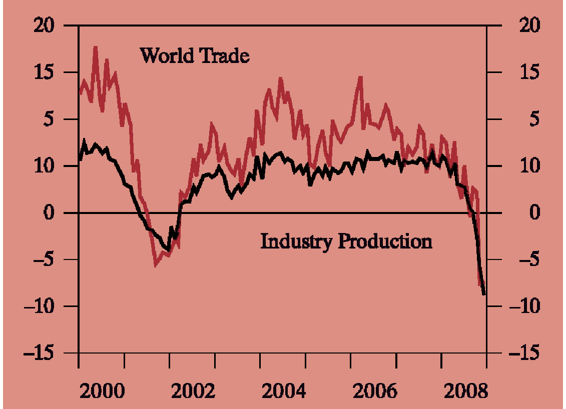
The financial crisis caused a shrinking of global expectations after September 2008, as we stated in our previous forecast. But we underestimated the strength of the downward trends of world trade, which mainly reflects the synchronicity in which almost all economies in the world were hit by the recession.

In fact, the figures in Graph 1 show an extremely sharp decline in the world trade volume since the end of 2008. If this trend will prevail, the world trade volume could fall in the current year at an annual rate close to 14%, which is far beyond our experience hitherto. Such a fall can partially, if not fully, be explained by a parallel trend in industrial production, which is also shown in Graph 1. In addition, financial restrictions may have played a role, as financing international trade seems having become more difficult, which could have also damaged the world trade flows.

Graph 1

World Trade and Global Industry Production

2001-2009, year over year change in %



Source: International Monetary Fund (IMF) and COE-REXECODE June 2009.

As already mentioned, the change in world trade trends has pushed down almost all forecasts for GDP growth rates around the world in 2009, and this is also the case of EUREN's assessment of the international environment (Table 1).

In our current forecast we expect a large fall in the world trade volume in the current year and a very slow recovery in 2010. This kind of profile is reflected in the predicted GDP growth rates, both for the US and Japan, with just a slight recovery in 2010 after the large correction in 2009. This recovery is expected to come both from internal demand, fuelled by stimulation packages and financial stabilisation, and from external markets, which should follow the world trade trends.

For oil prices, we assume they will fluctuate around the equilibrium level of around 70$/Barrel (Brent). This price is close to the average marginal cost of production of current oil fields.

Even if this means that oil prices will be somewhat higher on average in the next year, inflation will remain under control,

Table 1

Exogenous and international variables

2007 to 2010; percentage changes unless otherwise indicated

	2007	2008	2009[a]	2010[a]
World trade	5.9	1.9	–13.5	3.0
United States				
GDP	2.0	1.1	–3.0	1.5
Inflation	2.9	3.8	–0.2	1.8
3m interest rates	5.3	3.3	0.8	0.8
10y Gvt bond yield	4.6	3.7	3.6	4.4
Japan				
GDP	2.0	–0.7	–6.0	1.0
3m interest rates	0.8	0.9	0.5	0.5
10y Gvt bond yield	1.7	1.5	1.3	1.3
China, GDP	13.0	9.0	6.0	8.0
US dollar/euro	1.37	1.47	1.36	1.40
Yen/US dollar	117.8	103.4	97.9	100.0
Oil price Brent				
US$/barrel	72.7	97.6	62.3	70.0
Percentage changes	10.7	34.3	–36.2	12.4

[a]EUREN Forecast.

due to a very moderate final demand growth, and it will allow monetary policy to keep an expansionary stance till the end of 2010.

Historic drop of Euro area GDP

Since the second quarter 2008, real GDP in the Euro area has been decreasing, amounting to a decline by 1.8% qoq between October and December. In the first quarter 2009, the speed of decline increased further to -2.5%. Except for stagnant public consumption, all expenditure components dropped.

As world trade continued to plummet, Euro area exports fell by as much as 8.1% qoq. All industrialised countries are facing a recession, and production growth in the emerging markets has moderated markedly, in many cases also reaching negative territory. Therefore, investment activities are presently very sluggish. Hence, those euro area countries specialised in producing and exporting investment goods, such as Germany, were particularly hit by the plunge in world demand.

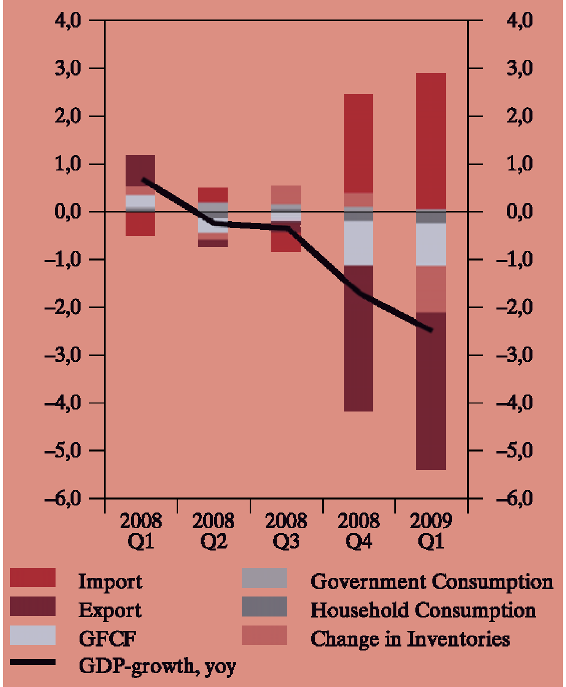
In line with weary demand, industrial production continued to decline. As a consequence, at 70.5%, capacity utilisation has reached a level not observed in the euro area since the start of the series in 1985. Gloomy perspectives for sales and profits caused companies to cut their investment plans significantly. In addition, worsening financing conditions, caused by the ongoing financial crisis, weighed on investment. Altogether, gross fixed capital formation fell by 4.2% qoq in the first quarter, after having been cut back in the same order of magnitude in the previous quarter. The bulk of the contraction fell on investment in machinery and equipment, while construction activities were less sharply reduced.

Although considerably falling inflation supported real disposable income, private households reduced their consumption expenditures. Rising unemployment weighs on disposable income, and deteriorating labour market prospects caused private households to increase their precautionary savings. In the first quarter 2009, employment in the Euro area dropped by 0.8% qoq, after having declined by 0.4% in the previous quarter. As a result, the unemployment rate increased to 8.7%, as compared to 8.0% in the fourth quarter and 7.2% in the first three months of 2008. Labour market conditions worsened most in Spain and Ireland as these countries were particularly hit by the housing sector and financial market crisis. Against the backdrop of a large share of the car industry, a significant increase in unemployment occurred also in Slovakia.

Graph 2

Euro area: GDP-growth and its Components

2006 and 2007; %



Source: EUROSTAT.

Monetary policy

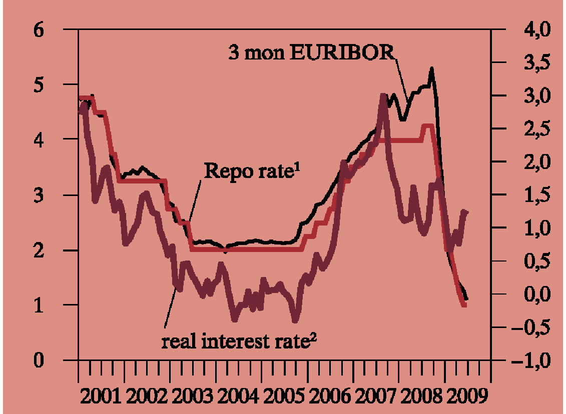
In the first half of this year the ECB cut the main refinancing rat four times to a historic low of 1.0%. However, inflation was zero in May and is thus far below the ECB's target, and the real interest rate is higher than one year ago. As the output gap is negative and has widened in recent months, the Taylor rule, e.g., even would suggest a markedly negative policy rate, which of course is not possible. Different from the Federal Reserve and the Bank of England, the ECB is nevertheless very hesitant to lower the repo rate further, as it considers monetary policy to become ineffective with interest rates too close to zero.

Instead, the ECB prolonged its liquidity support measures. The Eurosystem continues to conduct liquidity-providing refinancing operations with a maturity of one year. Up to now, the ECB refrained from purchasing corporate or government bonds as an instrument of quantitative easing. To be fair, such a policy would be more difficult to conduct in the Euro area as it is in the United States. The market for corporate bonds is rather limited in continental Europe, as banking-based finance is still dominant. Purchasing government bonds may cause conflicts, as the ECB would have to decide about the country of issuance of the bonds it is willing to buy.

All in all, the ECB has taken a less expansionary stance than the central banks in other countries, in particular compared to the Federal Reserve. However, it is also worthwhile noting that the financing conditions for corporations are still less restrictive in the Euro area than in the U.S. Firstly, financing in the capital market is less important for European companies. Secondly, loans to corporations are still rather stable in Europe, whereas they decline clearly in the U.S.

Graph 3

Euro area: Short term interest rates
2001 to 2009; %



Source: ECB. – [1]End of month. – [2]3 mon EURIBOR minus HICP inflation, right scale.

In their forecast, the EUREN institutes assume that the ECB will leave its key interest rate unchanged for the rest of this year and for the most time in 2010. Late in 2010, when the macroeconomic conditions start to improve, we expect a first monetary signal.

Recession and stimulus measures causes huge fiscal deficits

In reaction to the sharp drop in economic activity, the European Commission called for co-ordinated action, and most Euro area members adopted fiscal stimulus packages. The total volume of the packages announced in the Euro area countries amount 1.1% of GDP in this year and another 0.8% in the next. About half of the measures consist of an increase of public expenditure, and half of a reduction of government revenues (European Commission (2009), Public Finances in the EMU 2009. http://ec.europa.eu/economy_finance/publications/publication15390_en.pdf).

Moreover, nearly all EU members took measures to stabilise the financial sector. However, many of them do not appear in the current budgets yet, and it remains to be seen whether the state guarantees to banks will come into effect and lead to payments.

Above all, the automatic stabilisers started to work and leave their trace in the budget. On the one hand, tax receipts were hit more and more by the recession and social transfers were rising sharply due to the increase in unemployment. All these factors contributed to surging fiscal deficits in the Euro area. The European Commission (2009: 21) expects in its latest forecast that the aggregate deficit will reach 5.4% of GDP in 2009, compared to 1.8% in 2008. About one third of the swing in the balance can be explained by cyclical factors, one third by structural measures, and another third by one-off measures. For 2010 a further increase of the deficit to 6.5% of GDP is expected.

Hence, the fiscal stance is expansionary in this year, and it will be still, though less expansionary in 2010. As the debt ratio is climbing, a consolidation of the budgets will be necessary sooner or later. In their forecast, however, the EUREN institutes expect no switch in the budgetary stance until the end of 2010.

A recovery is not expected before the second half of 2009

The EUREN institutes expect that the sharp decline of GDP in the Euro area in the first quarter of 2009 was followed by a milder deterioration in the second one. This means that the crisis reached its bottom in the first half of the year and in the second half a slight increase of GDP can be expected. Exports and the end of t^he contraction in inventories will be the main support of this improvement. Private consumption will still be affected by the deterioration of the labour market while the disinflation process will not support anymore households' real disposable income. Because of the extreme low rate of utilisation of capacities, gross fixed capital formation will contract further. In the entire year, a GDP decline of 4.3 percent seems to be most likely for the average of the Euro area.

For 2010, a return to moderate growth rates is expected. Driving forces will be a slight recovery of world trade and a bounce back of investment after the extraordinary strong decline in this year. Private consumption, on the other hand, will remain weak, as the recession will continue to hit the labour market progressively as initial measures to overcome the effects on employment of the contraction of activity will come to a halt (e.g. support to short-term unemployment, lay off of employees with temporary contracts) . The EUREN institutes forecast an increase of the unemployment rate throughout the entire year.

Inflation will remain moderate in 2009 (0.8 percent) due to weak demand. During summer, the HICP even will decrease. But we do not consider this to be a sign of a deflationary pressure, because the decline originates from the fall of the oil price since August 2008. From the end of the year on, however, inflation might slightly accelerate, as the negative base-effect from the oil price is expected to phase out. However, core inflation should continue to be low, because capacity utilisation will remain low.

All in all, GDP will increase only by 0.7% in 2010.

Contact:
Roland Döhrn (doehrn@rwi-essen.de)
Eva Palocz (eva.palocz@kopint-tarki.hu)
Julián Pérez (julian.perez@ceprede.es)
Klaus Weyerstraß (klaus.weyerstrass@ihs.ac.at)

Table 2

Euro area forecast

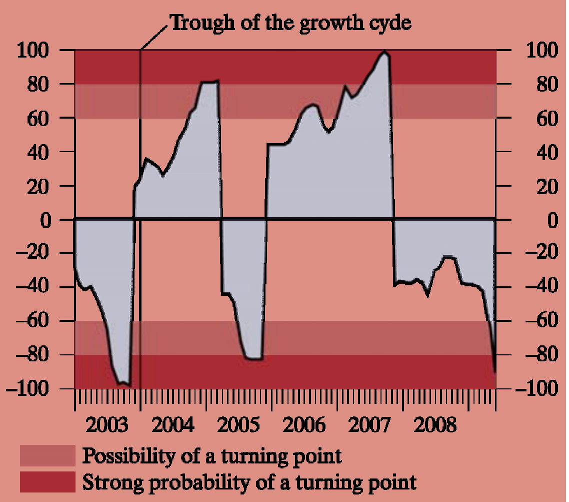
	2006	2007	2008	2009[f]	2010[f]	2009				2010			
						I	II	III	IV	I	II	III	IV
	Annual % change (unless indicated otherwise)					q-o-q%, seasonal adjusted (unless indicated otherwise)							
Private consumption	2.1	1.6	0.5	–1.0	0.1	–0.5	–0.1	–0.2	0.0	0.0	0.1	0.2	0.2
Public consumption	1.8	2.2	2.0	1.3	1.9	0.0	0.3	0.4	0.5	0.5	0.5	0.5	0.5
Gross fixed capital formation	5.9	4.3	0.6	–9.9	–0.4	–4.2	–2.0	–0.8	–0.3	–0.1	0.2	0.7	1.3
Change in inventories[1]	–0.1	–0.6	0.2	–0.7	0.0								
Domestic demand	2.9	2.3	0.7	–3.1	0.4	–2.1	–0.7	–0.1	0.2	0.1	0.1	0.3	0.4
Exports	8.5	5.9	1.6	–14.0	2.2	–8.1	–1.0	0.0	0.5	0.8	0.8	0.8	1.0
Imports	8.3	5.3	1.7	–11.5	1.3	–7.2	–1.3	–0.4	0.2	0.5	0.6	0.9	1.3
Net exports[1]	0.2	0.3	0.0	–1.2	0.3								
GDP[1]	3.0	2.6	0.7	–4.3	0.7	–2.5	–0.6	0.1	0.3	0.2	0.2	0.3	0.3
Unemployment (% of labour force)	8.3	7.5	7.6	9.4	10.5	8.7	9.2	9.6	10.0	10.2	10.4	10.6	10.7
Compensation per employee1, yoy	2.2	2.5	3.4	1.4	1.7								
Consumer price (HICP), yoy	2.2	2.1	3.3	0.8	1.9	1.0	0.4	0.4	1.6	2.2	1.8	1.8	1.7
Current account balance (% GDP)	–0.1	0.4	–1.0	–1.2	–1.2								
3m interest rates (% per annum)	3.07	4.26	4.63	1.48	1.38	2.00	1.30	1.30	1.30	1.30	1.30	1.40	1.50
ECB repo (end of period)	3.8	4.3	4.3	4.0	4.3	3.8	4.0	4.0	4.0	4.1	4.2	4.3	4.4
10y Gvt bond yields (% per annum)	3.50	4.00	2.50	1.00	1.25	1.50	1.00	1.00	1.00	1.00	1.00	1.00	1.25

[f]EUREN estimates. – [1]Contribution to growth.

COE-Rexecode Leading Indicator for the Euro Area

Currently, the indicator is in search of the next trough of the current growth cycle slowdown. The leading indicator must pass in turn the –60 and the –80 threshold to send a strong signal of an imminent economic recovery. In May 2008, the indicator surged from – 64.9 to –91.2, thus passing the –80 threshold for the first time in this downswing. Therefore, there is a strong probability of a trough in the growth cycle of the euro area in the third quarter of 2009. This implies that the underlying monthly growth rate should climb above the trend growth rate (estimated in the present time at 1.1% at an annual rate) in the last quarter of 2009 or in the first quarter of 2010. Right now, the Coe-Rexecode "underlying" monthly growth indicator in the euro area is assessed at –6.4 %, slightly improving from an extreme historical negative growth rate of –7.8 % in March. Of course, the signal of the leading indicator implies first an exit of the recession.

Contact:
Jacques Anas (janas@coe-rexecode.fr)



[1] This coincident monthly indicator is computed by Coe-Rexecode to detect in real-time the start and the end of an economic recession phase for the Euro area. The methodology is based on Markov-Switching processes popularized in economics by Hamilton. By using a set of four monthly time series, this start-end recession indicator (SERI) is able to reproduce all the recession phases experienced by the Euro area since 1970.

Forecast of the EUREN/CEPREDE High Frequency Model

Last update: June 19, 2009

	08Q3	08Q4	2008	09Q1	09Q2	09Q3	09Q4	2009
May-08	1,5 ; *0,4*		1,8					
Jun-08	1,6 ; *0,4*	1,7 ; *0,4*	1,9					1,7
Jul-08	1,3 ; *0,3*	1,4 ; *0,4*	1,6					1,5
Aug-08	1,1 ; *0,2*	1,3 ; *0,5*	1,5					1,2
Sep-08	0,9 ; *0,0*	1,1 ; *0,6*	1,4					0,9
Oct-08	0,8 ; *0,0*	0,7 ; *0,2*	1,3	0,5 ; *0,5*				0,5
Nov-08	0,8 ; *0,0*	0,4 ; *0,0*	1,2	–0,2 ; *0,1*				0,0
Dec-08	0,7 ; *–0,1*	0,0 ; *–0,4*	1,1	–0,6 ; *0,1*				–0,5
Van-09	[0,6 ; *–0,2*]	–0,7 ; *–1,0*	0,9	–1,8 ; *–0,4*	–2,0 ; *–0,4*			–2,0
Feb-09		–0,9 ; *–1,2*	0,8	–2,4 ; *–0,8*	–2,7 ; *–0,5*	–2,9 ; *–0,4*	–2,7 ; *–0,5*	–2,7
Mar-09	[0,6 ; *–0,2*]	[–1,3 ; *–1,5*]	[0,7]	–2,7 ; *–0,8*	–3,5 ; *–1,1*	–3,6 ; *–0,3*	–2,6 ; *–0,5*	–3,1
Apr-09			[0,7]	–2,7 *–0,7*	–3,2 ; *–0,8*	–3,1 ; *–0,1*	–2,0 ; *–0,4*	–2,7
May-09			[0,7]	–3,8 *–1,7*	–3,0 ; 0,XX]	–2,5 ; *0,3*	–1,2 ; *–0,4*	–2,6
Jun-09	[0,6 ; *–0,2*]	[–1,4 ; *–1,6*]	[0,7]	[–4,7 *–2,6*]	–3,9 ; *0,6*	–2,9 ; *0,8*	–1,0 ; *0,3*	–3,1

In brackets; GDP-Data published by EUROSTAT. In italics: quarter on quarter rates.
After the EUROSTAT figure for Q1 being integrated into the model, the average estimate for 2009 fell to –3%. Nevertheless, after a very negative qoq rate for the first quarter, the model shows some positive figures for coming quarters, which gives some hint that the worst could have been passed. Compared to previous estimates, quarterly profile appears to be more sharply in first quarter followed by a more pronounces recovery at the end of this year.

Contact: Julián Pérez (julian.perez@uam.es)

Impressum
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