European Banking Federation

THE SECOND CURVE OF THE W-SHAPED RECESSION

EBF Outlook N°32 on the euro area economies 2011-2012

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

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THE SECOND CURVE OF THE W-SHAPED RECESSION

1. THE EMAC CONSENSUS

Since the mid-year issue of the EBF's Economic and Monetary Affairs Committee' Outlook on the euro area economies, the situation took a turn for the worse. EMAC's Chief Economists see a number of critical *domestic* factors that play a role in the well-being of the euro area economy in this decisive period, including:

- euro area governments' ability to solve the sovereign debt crisis in an orderly way;
- persistent tensions and high level of uncertainty in the financial markets;
- the deleveraging of the banking sector and its impact on the supply of credit;
- the implementation of structural reforms and fiscal consolidation programmes in crisis countries;
- the depth and duration of the fall in euro area's economic growth, that is expected around the turn of the year;
- governments' commitment to introduce credible structural changes needed to sustain long-term growth.

Some *external* factors also play a role: some cooling off of global trade growth, a related high level of uncertainty, and elevated commodity prices. This should be viewed against the background of grave structural problems (persistently high unemployment, lower potential growth, high public debt) in many industrial countries as a result of burst asset bubbles.

A relatively strong start to the year 2011 was followed by economic deceleration**: euro area GDP is expected to grow by 1.5% this year and by 0.3% next**. Given the slowing momentum of economic growth, **inflation is also expected to recede to 1.8% in 2012, after 2.6% this year**. These figures are based on the expectation that the euro area sovereign debt crisis is gradually solved through decisive political measures and the situation in the financial markets start to stabilise in the course of 2012. As an essential part of the solution to the crisis, European governments will continue implementing structural reforms and fiscal consolidation measures aimed at reducing public deficits and increasing economic competitiveness. At the same time, the banking sector in many countries will continue the process of deleveraging – reinforced by the new capital requirements set by the European Banking Authority in October 2011 – which will affect negatively the supply of credit to households and corporations. In total, the high uncertainty, current financial market tensions, on-going deleveraging and fiscal consolidation measures will have a negative impact on the euro area's domestic demand in the near term. Growth in gross fixed capital formation is expected to decelerate substantially, while public consumption growth will remain around zero, dipping into the low negative of -0.2% in 2012. In light of the families and companies' negative sentiment, which in turn causes loss of confidence, private consumption growth will remain at a modest 0.2-0.4% throughout the forecast period. This is a result of a mix of factors. On the one hand, persistent high unemployment of about 10% will keep citizens away from the shops, while on the other, the wages of those employed are expected to experience a modest rise between 1.4% and 1.7% this year and next.

Given deteriorating economic conditions and weak inflation pressures, **the ECB is expected to lower its main refinancing rate** by 25 basis points to 1% before the end of 2011, with possible further rate cuts in 2012 (the ECB's refinancing rate of 1% no longer being considered as a floor). It is expected to continue to conduct the non-standard measures, in particular, buying government bonds of troubled euro area economies. To improve the transmission mechanism of the monetary easing to the real economy, the ECB is likely to scale up liquidity provision, including the introduction of refinancing operations with duration longer than 12 months. Even at those lower predictions, risks are on the downside.

The EMAC's Chief Economists emphasise the fact that the **euro is a strong and successful currency**; it is an important and indispensible element of an 'ever-closer Union'. However, Europe's single currency's survival is at risk in the long term if the Monetary union is not supported by a new fiscal framework which sets strict and well-defined rules for public finances in the euro area countries. Chief Economists call for the EU Leaders to make the necessary steps beyond countering the on-going crisis that would be aimed at medium- and long-term financial and economic stability of the EU.

Table 1: Main indicators of EMAC consensus
(mean of forecasts), y-o-y growth rates unless specified otherwise, in %

	2010	2011*p*	2012*p*
Gross domestic product	1.8	1.5	0.3
Private consumption	0.8	0.4	0.2
Public consumption	0.7	0.2	-0.2
Gross investment (GFCF)	-0.8	2.1	0.0
Exports	11.2	5.6	3.2
Imports	9.3	4.7	2.3
Unemployment rate (%)	10.1	10.0	10.2
Prices (HCPI) (%)	1.6	2.6	1.8
Government budget balance (% DGP)	-6.0	-4.3	-3.6
Government debt (% GDP)	85.4	89.0	90.8

NB: 2010 figures are fact (DG ECFIN); 2011 and 2012 are current EMAC projections

2. DOMESTIC ECONOMY

a. Fiscal policy and the economy

After a head start in Q1 and Q2 2011, euro area's economy slowed in Q3 2011. Furthermore, **gross domestic product** is expected to contract in Q4 2011 and Q1 2012. This fall in GDP is mainly attributed to a continued deterioration in economic sentiment, as policy makers failed to prevent the debt crisis from spreading to more systemic euro area members, most notably Italy. Economic activity is also affected by the **fiscal consolidation programmes** implemented by a number of euro area governments, which aim at bringing government deficits within 3% of GDP allowed under the Stability and Growth Pact, and are expected to drag down GDP growth in the following year. The Chief Economists forecast the general government deficit to remain at an elevated -4.3% in 2011, which should be reduced to -3.6% by the end of 2012. This translates into a euro area public debt accumulation to near 91% of GDP by end-2012 (see Table 1).

Figure 1: Euro area annual GDP growth rate, %, quarterly frequency (source)

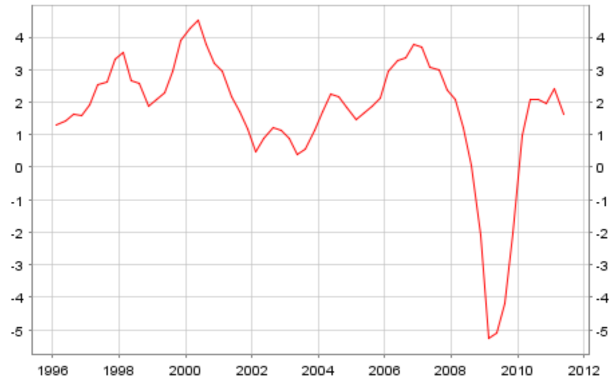
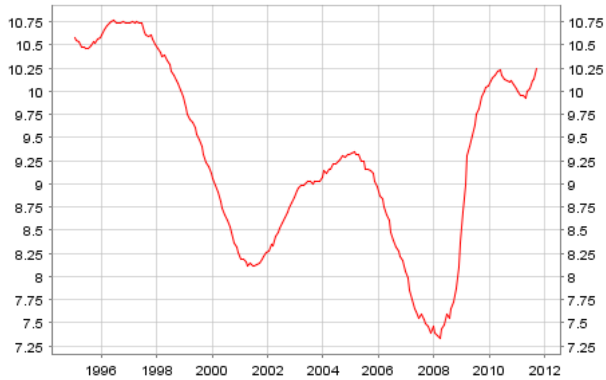


Figure 2: Euro area unemployment rate, % (source)



The situation in the **government bond market** has worsened considerably over the past months. Elevated 10-year government bond yields are now observed not only in the countries under the EU/IMF programmes (Greece, Ireland and Portugal), but also in Italy and Spain. Investors fly to safety, i.e. they shed the riskier government bonds of the peripheral euro area countries, to invest in the safe haven of the German government's Bund. Even France, the Netherlands, Finland and Austria have seen the yields on their debt move upwards. However, German Bund yields have also increased recently, quoting now around 2¼% (end-November). This puts the euro area into an increasingly unbalanced and unsustainable position, which risks tipping over, as markets grow more nervous about the EU leaders' ability to handle the situation. That said, the deterioration of the situation in the euro area is not only that of fundamentals, but also that of confidence. Should a sound long term solution to the sovereign debt problems be found, the euro area economy should be able to get back on track. This will, however, take time, as there are no easy and quick solutions available.

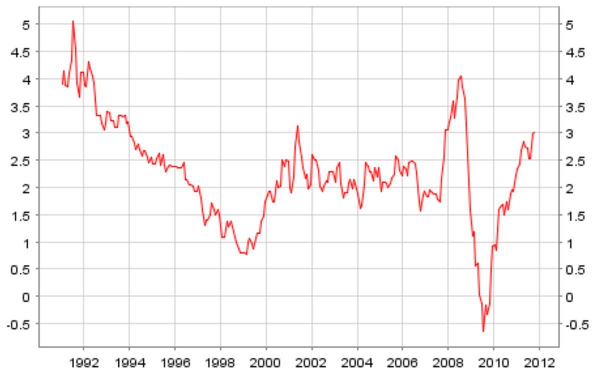
In this vein, the 9 December EU summit is expected to be a deal maker in restoring confidence in the financial markets of both the EU and globally, thus bringing the desperately needed stability back on the table.

Another factor playing a central role in the economic slowdown is the continued **deleveraging** of banks, as they attempt to get in line with the new Basel III capital and liquidity requirements, even before they are transposed into EU law. The 26 October 2011 announcement by the European Banking Authority of the requirement for 70 European banks to bring their core Tier 1 capital ratio to 9% by 30 June 2012 effectively brings forward the implementation of the capital-side of Basel III from 2019 to 2012, pushing banks to build up their capital base and deleverage faster than initially expected. In the current economic conditions of dried-up liquidity and scarce market funding, banks struggle to comply with these tough and pro-cyclical demands. A combination of these policy actions renders aggregate demand and bank lending subdued. Moreover, as banks fear that a Private Sector Involvement scheme might be extended to other weak periphery members besides Greece, uncertainty over potential losses on government paper intensifies the need for deleveraging, putting additional pressure on credit supply to the real economy (although latest news seem to discard this option).

b. Inflation and monetary policy outlook

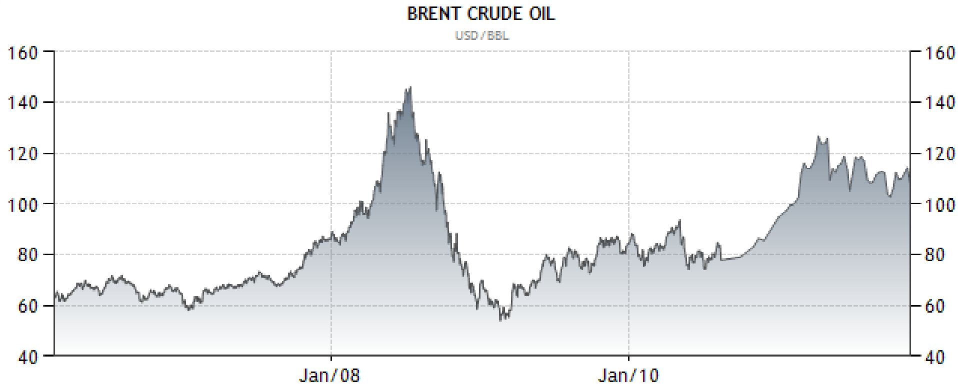
Inflation will peak by the end of the year (annual average at 2.6% in 2011), but the base effect from high energy prices will ease in 2012 leading to a much lower annual inflation of 1.8% in 2012. The core inflation is more stable at around 1.5%-1.7% *per annum* over the forecast horizon in an environment of weak economic performance and high unemployment.

Figure 3: Euro area inflation, % (source)



Persistently elevated prices for commodities and food, as well as VAT hikes, present an upside risk for inflation in the coming year. Coupled with rapidly rising domestic prices in China, a major exporter of goods to a number of industrialised countries around the world, this creates an upward pressure on euro area inflation as well.

Figure 4: Brent Crude Oil Price, USD/barrel (Source)



The **ECB monetary policy stance** is considered by the EMAC's Chief Economists as justified. The shared view is that the ECB's interest rate and liquidity policies as well as non-standard policy measures have been appropriate. However, the main refinancing rate is expected to be lowered again in tune with deteriorating economic conditions and easing inflationary pressures. The Chief Economists expect the main refinancing rate to be reduced by 25 basis points to 1% before the end of 2011, with possible further rate cuts in 2012 (the ECB's refinancing rate of 1% no longer being considered by some Chief Economists as a floor).

EMAC´s Chief Economists recognise that the **ECB** is under great pressure to purchase government bonds on the secondary market. However, it is the role of the ECB to ensure price stability and maintain its credibility by adhering to the rules, laid out in the Treaty, prohibiting government debt monetisation. This is why the functioning of the European Financial Stability Facility, including its size, leverage and mode of operation, needs to be finalised so that it starts working, directing its efforts towards the euro area countries in need. It will relieve the ECB of some of its current burden and shall bring more confidence to the markets. Also, an increased role for the International Monetary Fund (IMF) would help share the responsibility of solving the euro area sovereign debt crisis in a sustainable way.

c. The euro

The Chief Economists of the EBF's Economic and Monetary Affairs Committee believe **that today's crisis is not a currency crisis; it is a sovereign debt crisis of some euro area economies**. This partly explains the continued strength of the euro. Another explanation lies in the fact that the central banks of some major economies outside the euro area are undertaking quantitative easing. Ample liquidity in the respective currencies keeps those currencies' exchange rates weak against the euro. Furthermore, the relative strength of the world currencies is a mirror image of the current account balances.

An oscillation of the euro exchange rate between 1.35-1.45 against the US dollar throughout the crisis period has been observed. For as long as the sovereign debt crisis, fuelled by political uncertainty and financial market instability, is not over, there is a risk of large rapid movements in the exchange rate.

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

3. GLOBAL ENVIRONMENT

Economic growth in the United States appears to have been just as strapped as the euro area's. The relentless level of unemployment and ballooning state debt in the US have been weighing on economic growth in 2011. The following year promises to be slightly more upbeat, should the US non-farm payroll continue increasing as it has have been in H2 2011, and, not least, should the Obama administration's tax proposals pass through Congress.

On the other hand, buoyant growth of the emerging and developing economies (6.4% in 2011 and 6.1% in 2012, according to the IMF) is expected to influence the export demand of the euro area positively, and in this way, help sustain economic growth. However, the euro area's domestic problems are seen to be just as important. The sovereign debt crisis has created a negative feedback loop for European banking groups and their domestic and international market positions.

Moreover, current EU-level discussions to introduce an EU-only or euro-area-only Financial Transaction Tax or Financial Activity Tax threaten to drive financial trading activity outside the EU/euro area, thus reducing access to finance and risk-hedging for European companies.

4. RISKS TO THE SCENARIO

The EMAC's Chief Economists see a number of risks to the main scenario. They believe that risks weigh on the downside. A number of **negative risks** could hamper the euro area's economic recovery:

- deepening of the sovereign debt crisis in the euro area countries (including the possible inability of Italy and Spain to refinance their debts at reasonable rates) because of poor implementation of measures agreed upon on 26 October 2011, as well as increasing uncertainty in the financial markets about a sustainable solution to the crisis;
- a credit crunch due to the accelerated deleveraging of the banking sector;
- elevated and persistent unemployment levels in Europe;
- unsustainable fiscal policy in the US.

In parallel, the **positive risks** are:

- stabilisation of financial markets by means of finding a viable long-term solution to the crisis, removing pressure from every economic actor (governments, banks, corporations, citizens);
- positive developments in the emerging markets that could give an extra boost to the euro area;
- positive effect from a change in the market behaviour, which currently tend to overdo trends.

ANNEX

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

TABLE 1		2008	2009	2010	2011 Forecast								
					EMAC Consensus			EMAC Outlook		COM Forecast			
					2011 mean	2011 range		mid-year 2011	end-year 2010	Autumn 2011	Spring 2011	Autumn 2010	Spring 2010
1. Output and aggregate demand:	(Ann.% change)												
Gross domestic product		0.6	-4.1	1.8	**1.5**	1.0	1.7	1.7	1.4	1.5	1.6	1.5	1.5
Private consumption		0.4	-1.1	0.8	**0.4**	-0.1	1.0	1.1	0.8	0.5	0.8	0.9	1.1
Public consumption		2.1	2.4	0.7	**0.2**	0.0	0.4	0.3	0.5	0.1	0.2	-0.1	0.3
Gross investment (GFCF)		-0.8	-11.4	-0.8	**2.1**	1.0	2.6	2.3	2.6	2.0	2.2	2.2	1.8
Exports		1.0	-13.2	11.2	**5.6**	5.0	6.8	6.8	5.6	6.1	6.9	6.1	5.0
Imports		0.8	-12.0	9.3	**4.7**	4.0	5.2	5.6	4.6	4.8	5.4	5.1	4.2
2. Labour market and prices:	(Ann.% change)												
Unemployment rate (%)		7.5	9.5	10.1	**10.0**	9.7	10.1	9.8	10.0	10.0	10.0	10.0	10.4
Wages (Unit Labour Cost)		3.4	4.0	-0.5	**1.4**	1.0	2.3	1.3	0.0	1.0	0.8	0.6	0.1
Prices (HCPI)		3.3	0.3	1.6	**2.6**	2.2	2.7	2.5	1.6	2.6	2.6	1.8	1.7
Core HCPI					**1.7**	1.6	1.8	1.5	1.3				
3. Public finances:	(% GDP)												
Government Balance		-2.0	-6.3	-6.0	**-4.3**	-5.0	-4.0	-4.6	-5.4	-4.1	-4.3	-4.6	-6.1
Government Debt		69.4	79.1	85.4	**89.0**	86.3	95.6	86.6	88.1	88.0	87.7	86.5	88.5
4. External sector:	(% GDP)												
Trade Balance		0.2	0.7	0.6	**0.3**	-0.1	0.5	0.7	0.4	0.2	0.6	1.0	1.0
Current Account Balance		-0.7	-0.1	0.1	**-0.4**	-1.0	0.0	-0.4	0.1	-0.1	-0.2	0.0	-0.5
(p.m.) US growth	(Ann.% change)	-1.3	-4.4	2.2	**1.7**	1.2	2.0	2.8	2.4	0.8	2.6	2.1	2.8
(p.m.) Oil price (Brent)	(US$/bl)	97.0	62.0	80.2	**107.4**	93.5	110.0	105.7	85.3	111.1	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	**1.31**	1.25	1.50	1.29	1.02				
	Dec-11	2.50	1.00	1.00	**1.13**	1.00	1.25	1.75	1.32				
3 month interest rate (EURIBOR)	(year-end)	3.29	1.22	1.02	**1.32**	1.20	1.50	1.95	1.54				
10 year government bond yield (Bund)	(year-end)	3.69	3.76	3.36	**1.96**	1.50	2.65	3.75	3.25				
M3 growth	(annual growth)	7.6	-0.3	1.7	**2.53**	2.00	3.00	3.63	5.23				
Credit to private sector (M3 definition)	(annual growth)	7.7	0.7	1.9	**2.50**	2.50	2.50	2.50	4.38				
Exchange rate USD/EUR	(year-end)	1.47	1.39	1.34	**1.34**	1.25	1.39	1.32	1.33		1.43	1.39	1.35

END-YEAR POLL ON THE EURO AREA ECONOMIC OUTLOOK FOR 2012

TABLE 2		2008	2009	2010	2012 Forecast						
					EMAC Consensus			EMAC Outlook	COM Forecast		
					2012 mean	2012 range		mid-year 2011	Autumn 2011	Spring 2011	Autumn 2010
1. Output and aggregate demand:	(Ann.% change)										
Gross domestic product		0.6	-4.1	1.8	**0.3**	-0.8	1.1	1.7	0.5	1.8	1.8
Private consumption		0.4	-1.1	0.8	**0.2**	-0.5	0.7	1.2	0.4	1.2	1.4
Public consumption		2.1	2.4	0.7	**-0.2**	-0.5	0.3	0.4	-0.2	0.3	0.2
Gross investment (GFCF)		-0.8	-11.4	-0.8	**0.0**	-3.3	2.0	2.7	0.5	3.7	3.6
Exports		1.0	-13.2	11.2	**3.2**	0.5	5.4	5.3	3.4	6.2	6.3
Imports		0.8	-12.0	9.3	**2.3**	0.2	4.4	5.0	3.0	5.9	5.9
2. Labour market and prices:	(Ann.% change)										
Unemployment rate (%)		7.5	9.5	10.1	**10.2**	9.3	10.7	9.3	10.1	9.7	9.6
Wages (Unit Labour Cost)		3.4	4.0	-0.5	**1.7**	1.2	2.3	1.6	1.4	1.2	0.9
Prices (HCPI)		3.3	0.3	1.6	**1.8**	1.3	2.1	1.9	1.7	1.8	1.7
Core HCPI					**1.5**	1.2	1.7	1.6			
3. Public finances:	(% GDP)										
Government Balance		-2.0	-6.3	-6.0	**-3.6**	-4.0	-3.0	-3.8	-3.4	-3.5	-3.9
Government Debt		69.4	79.1	85.4	**90.8**	88.6	96.5	87.8	90.4	88.5	87.8
4. External sector:	(% GDP)										
Trade Balance		0.2	0.7	0.6	**0.4**	-0.1	0.9	0.1	0.3	0.7	1.1
Current Account Balance		-0.7	-0.1	0.1	**-0.2**	-0.7	0.1	-0.3	0.0	-0.1	0.1
(p.m.) US growth	(Ann.% change)	-1.3	-4.4	2.2	**1.9**	1.5	2.2	2.9	0.7	2.7	2.5
(p.m.) Oil price (Brent)	(US$/bl)	97.0	62.0	80.2	**102.1**	90.0	115.0	105.2	103.8	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	**0.96**	0.50	1.00	2.13			
	Dec-12	2.50	1.00	1.00	**0.98**	0.50	1.25	2.50			
3 month interest rate (EURIBOR)	(year-end)	3.29	1.22	1.02	**1.14**	0.70	1.40	2.67			
10 year government bond yield (Bund)	(year-end)	3.69	3.76	3.36	**2.56**	2.00	3.00	4.02			
M3 growth	(annual growth)	7.6	-0.3	1.7	**3.45**	2.00	5.00	3.98			
Credit to private sector (M3 definition)	(annual growth)	7.7	0.7	1.9	**2.50**	1.00	4.00	3.50			
Exchange rate USD/EUR	(year-end)	1.47	1.39	1.34	**1.32**	1.25	1.40	1.30		1.45	1.39

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