

## Q-Review

### Business cycle analysis of Europe and the US

March 2013

- According to our forecast, the economy of Finland will change its direction during the spring
- The growth in the eurozone remains sluggish
- The positive trend in the United States continues despite the uncertainty generated by the Capitol Hill
- The political instability in Europe is reflected in the forecasts.

#### GDP growth forecasts

The problems in the eurozone have been less detrimental to the world economy at the beginning of this year. Partly, this is due to the Outright Monetary Transactions program published by the ECB last fall, but the strengthening economy of the United States also explains the change. The only core variable in the US, still below the 2007-level, is employment. Retail sales, industrial production, and the real income of households have all reached the peak of the years 2006–2007.

The so-called *fiscal cliff* was avoided, but the *sequester*, the automatic shredder of government expenditures, became effective in the US in March. The effects of the shredder start to materialize only in April as the state workers' 30 day terms of notice ends. Even though the shredder will have a negative effect, we believe that the good drive of the economy will outpace the cuts. The biggest risks for the economic recovery in the United States also lie in the old continent.

This is because the effect of the eurozone on the world economy may gain strength unexpectedly. The banking sector of the eurozone is in a bad shape. According to the recent report from Ernst & Young, their non-performing loans extend to €916 billion. This corresponds to 7.6 % of all the loans admitted in the eurozone. The leverage ratios of the European banks are still almost 30, while the leverage ratio in the US has decreased close to ten. Record levels of unemployment in the eurozone

and the continuous weakening of the crisis economies may indicate that the debt crisis has just been in a peaceful intermediate stage created by the ECB.

While the ECB calmed down the sovereign bond markets, citizens' dissatisfaction has risen to threaten the European integration. The European-wide austerity measures have hit hard on the crisis countries, causing people to vote against these measures. The conditions of the rescue package of Cyprus also included details that raise the instability. Although the savers under 100 000€ of deposits were saved, all the deposits above this will face a big, but yet undetermined haircut. This may cause some capital flight from the periphery, but it will certainly worsen the bank runs in countries that need bailouts in the future.

The OMT program of the ECB has created a situation in which the risk premiums in sovereign debts do not cover the actual economic positions. The recent election in Italy, for example, indicated that the market-priced risk does not correspond to the real risk in sovereign debt. The condition of the OMT program of the ECB is that a country commits itself to the austerity programs of the ERVV or ESM. This condition is the same than that of the austerity program now run in Italy. As the citizens of Italy apparently voted against this program, it is markedly hard for the government to commit itself. This may induce a considerable raise in the interests of the bonds in Italy. What could the ECB do in this kind of a situation? Could it begin to support the sovereign bond

market of Italy without conditions? In practice, the ECB has to choose between debt restructuring and direct financing of Italy. The direct financing would break the rules of the ECB and Germany would probably object fiercely. The restructuring of the debt in one country would lead to similar demands from other crisis countries but the banking sector in Europe would not tolerate the rearrangements of several countries.

The relatively peaceful situation in the eurozone thus seems to be an illusion. This makes forecasting difficult. The changes may be unpredictable as the situation in Cyprus shows. Many open questions remain. What parties would win the possible new election in Italy? How will German September-elections go? How long do the EU-positive governments stand, if the society begins to deteriorate in the crisis countries, as is now happening in Greece?

The economy of Finland is in recession even though, in the light of the latest data from the Statistics Finland, the technical definition of recession is not fulfilled. The marginal, however, is narrow as an increase of 0.07 % during the third quarter of 2012 separated Finland from what is called “technical recession”. The economy of Finland contracted by -1.29% and by 0.52% in the second and fourth quarters of 2012 so that, de facto, Finland has been in recession for almost one year. The political uncertainty in the eurozone also complicates forecasting. In Table 1, we present the nowcasts and the most probable growth forecasts for the real GDP of Finland, the United States and the eurozone.

According to our forecasts, the real GDP of the United States will increase by some two per cent this year. Next year, the growth will accelerate to more than two per cent. The eurozone will not grow this year but next year its GDP will increase by more than one percent. In Finland, the GDP

will increase by half percent this year, but the growth accelerates into two per cent next year.<sup>1</sup>

Table 1. Forecasts for the growth rate of real GDP in the US, eurozone and Finland. Source: OECD, Bureau of Statistics and GnS Economics.

Quarter	US	Eurozone	Finland
2012	1.59	-0.89	-1.39
2013:1	0.37	-0.32	0.07
2013:2	0.33	0.02	-0.35
2013:3	0.51	0.07	0.45
2013:4	0.49	0.23	0.13
2013	1.7	0.0	0.3
2014	2.4	1.4	1.9

## Scenario forecasts

In this Section, we provide three growth scenarios (the optimistic, the pessimistic, and the most probable scenario) along with their estimated likelihoods.

### Eurozone

In the most probable scenario, the economy of the eurozone stays in recession but will recover somewhat towards the end of the year. In the positive scenario, the quantitative easing of the ECB revives the economy and the debts of Greece, Spain and Portugal will be restructured during the fall. In the negative scenario, several crisis countries will leave the eurozone during the fall. This will prompt a financial crisis in the eurozone.

Table 2 gives the scenario forecasts for the growth rate of the real GDP in the eurozone. We give the probability of 70 % for the realization of the most probable scenario, 20 % for the optimistic scenario, and 10 % for the pessimistic scenario. Because the eurozone also affects the recoveries of the United States and Finland, they share these scenario probabilities.

A banking crisis and partial breaking up of the currency area would cause the GDP of the eurozone to fall by more than four percent this

<sup>1</sup> For more information about nowcasting, see the process description at the end of the report.

year and by more than two percent next year. The growth in the eurozone would accelerate to almost two per cent if a sustainable solution will be found for the European debt crisis.

Table 2. Current and previous (in brackets) forecasts for the growth rate of the real GDP in the eurozone.

Quarter	Optimistic	Probable	Crisis
2013:1 nowcast	-0.32	-0.32	-0.32
2013:2	0.20	0.03	-0.71
2013:3	0.23	0.07	-1.58
2013:4	0.32	0.23	-1.75
<b>2013 (December)</b>	<b>0.4 (1.4)</b>	<b>0.0 (0.5)</b>	<b>-4.4 (-4.4)</b>
<b>2014 (December)</b>	<b>1.9 (2.2)</b>	<b>1.4 (1.9)</b>	<b>-2.2 (-0.7)</b>

## United States

The economy of the United States may suffer from the sequester but the real threats come from the problems in the eurozone. A banking crisis in Europe would transmit to the whole world because its banking sector in Europe is so large. The total GDP of the European Union is only somewhat larger than that of the US. However, the value of assets of the banks is about 350 % of the GDP in Europe while the corresponding ratio is 80 % in the US. Table 3 gives the scenario forecasts for the growth rate of the real GDP in the United States.

Table 3. Current and previous (in brackets) forecasts for the growth rate of the real GDP in the US.

Quarter	Optimistic	Probable	Crisis
2013:1 nowcast	0.37	0.37	0.37
2013:2	0.44	0.33	-0.60
2013:3	0.63	0.51	-1.38
2013:4	0.57	0.49	-1.61
<b>2013 (December)</b>	<b>2.0 (2.5)</b>	<b>1.7 (2.1)</b>	<b>-3.2 (-2.5)</b>
<b>2014 (December)</b>	<b>2.8 (3.0)</b>	<b>2.4 (2.9)</b>	<b>-0.3 (0.8)</b>

According to the scenario forecasts in Table 3, the banking crisis and the partial breaking up of the eurozone would throw the United States into a

recession for the next two years. On the other hand, if nothing dramatic takes place in the eurozone, the economic growth in the US will accelerate to almost three per cent next year.

## Finland

The economy of Finland is in recession even though in the light of the latest data of the Statistics Finland the technical definition of the recession has not been fulfilled. However, only a fairly small margin, Finland's economy increased by 0.07 % during the third quarter, separates Finland from a technical recession. So, in practice, the Finland is in recession. The political uncertainty in the eurozone also affects the forecasting of Finland's economic development. In Table 1 we present the nowcasts and the most probable growth forecasts for the real GDP of Finland, the United States and eurozone.

The development of the economy of Finland has been tied to the development of the eurozone so that the problems of the eurozone affect it strongly.

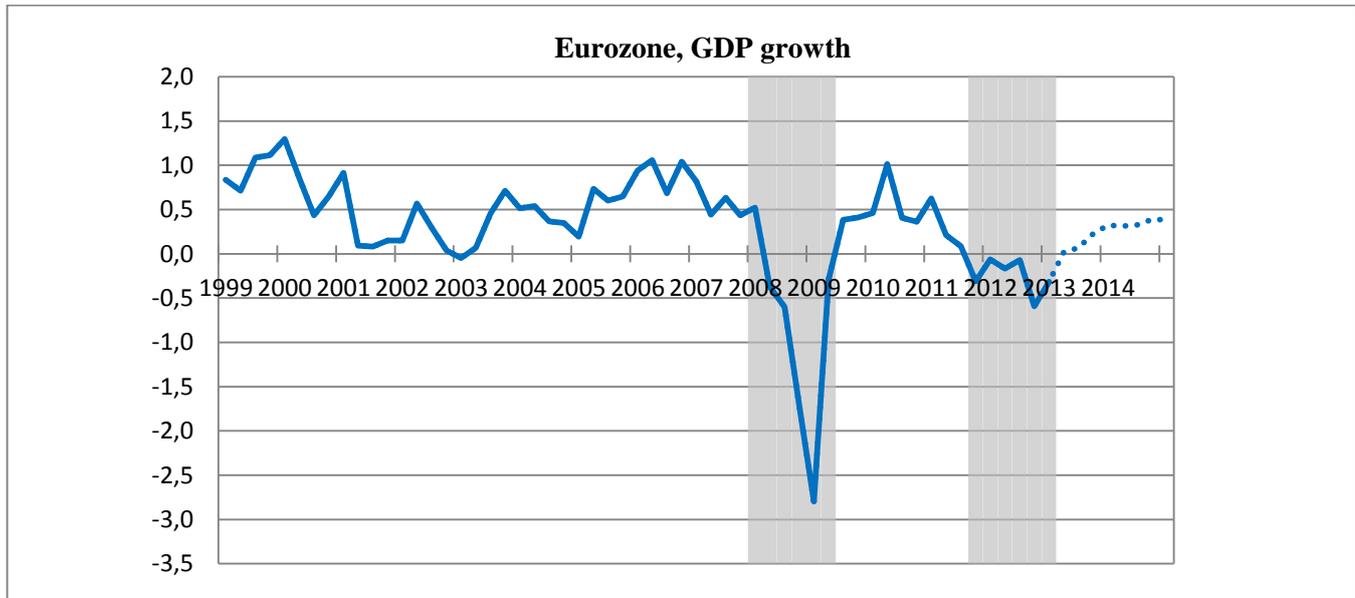
Table 4. Current and previous (in brackets) forecasts for the growth rate of the real GDP in Finland.

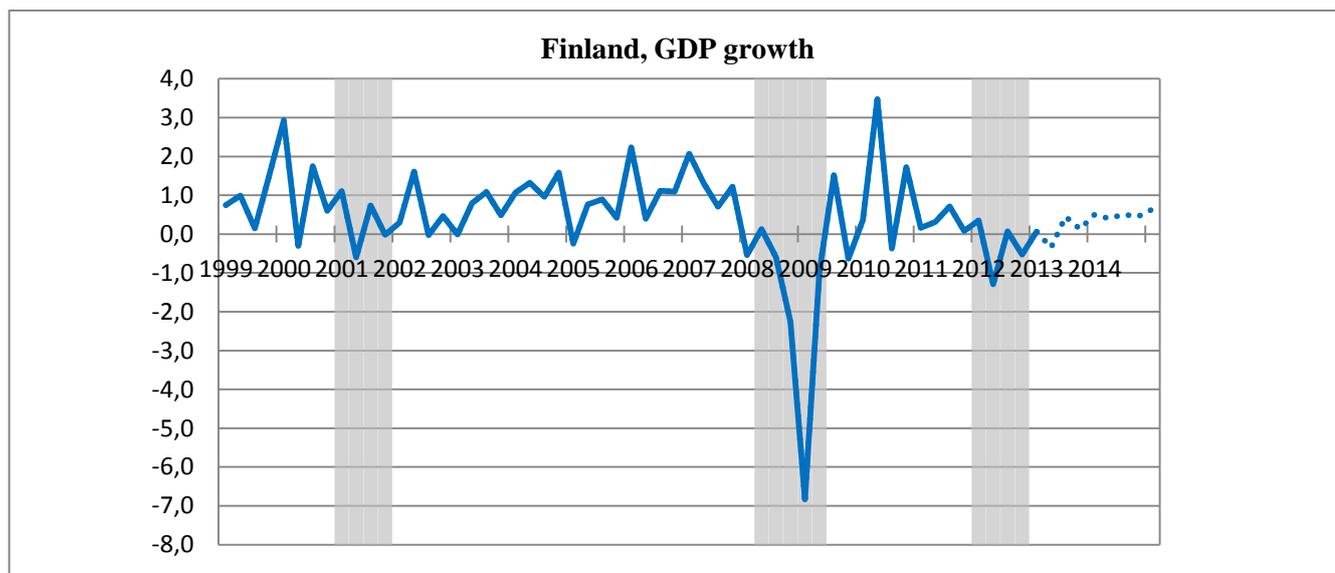
Quarter	Optimistic	Probable	Crisis
2013:1 nowcast	0.07	0.07	0.07
2013:2	-0.26	-0.34	-1.52
2013:3	0.74	0.45	-2.50
2013:4	0.29	0.13	-3.55
<b>2013 (December)</b>	<b>0.8 (1.0)</b>	<b>0.3 (-0.5)</b>	<b>-7.5 (-8.6)</b>
<b>2014 (December)</b>	<b>2.9 (2.6)</b>	<b>1.9 (2.0)</b>	<b>-5.1 (2.5)</b>

Table 4 gives the scenario forecasts for the growth rate of the real GDP in Finland. A banking crisis in Europe would lead the GDP of Finland to decrease by almost eight percent this year and by five percent next year. In the optimistic scenario, the GDP of Finland would increase by some one percent this year and by some three percent the year after.

## Forecasts as figures

Below, the realized and forecasted for economic growth rates in the eurozone, the United States and Finland are illustrated for the most probably scenario. The grey areas show the recession periods in each country. The recession periods in Finland are based on the Makrosuhdanne blog (see <http://blogs.helsinki.fi/makrosuhdanne/>).





### Process descriptions

The forecasts reported in this Q-review are based on the statistical modeling methods from the most recent academic research on predicting business cycle fluctuations. Nowcasts refer to the forecasts of the growth rates of the real Gross Domestic Product (GDP) for the current quarter. Nowcasts are needed because the standard measures for the GDP are published after a considerable lag and are typically subject to subsequent revisions, indicating that the coincident state of the economy is always uncertain. Our nowcasts for the current quarter are based on statistical models where all relevant information available at the time of nowcasting is utilized.

The GDP forecasts for longer horizons (over the current quarter) are based on the dynamic forecasting models where forecasts are constructed iteratively. This means, for example, that the three-quarter forecast is essentially based on the two-quarter forecasts and so on. Forecasts are constructed for all three economic areas (eurozone, Finland and the US) indicating that they depend on each other. Finally, note that the forecast scenarios considered in this Q-review are based on the expert view of GnS Economics.

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The next Q-review will be published in June 2013.  
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