

Q-Review

Business cycle analysis of Europe and the US

September 2012

- The business cycle condition in Finland, Europe and USA is still subordinate to the solutions in the euro area.
- The expected restarting of the bond-buying program by the ECB helps, but does not solve the crisis.
- The diverging financing costs of firms increases the probability of the breakup of the euro area further.
- Our forecast shows that, in 2012, the real GDP diminishes in Finland and in the euro area. In 2013, it starts to grow again.

1. Business cycle conditions

Last spring, the debt crisis in Europe celebrated its second anniversary, showing no sign of subsidence this far. In contrast, the economic woes of the euro area are considerably larger now than two years ago. In spite of occasional reliefs, the methods applied to solve the problems have unfortunately intensified the crisis. The global recession since 2008, only interrupted by a short-lived recovery in Southeast Asia and the United States in 2009 – 2010, indicates that the resources to solve the euro crisis are scarce and still diminishing.

As the global economic perspectives are now markedly sensitive to the decisions of the Euro-leaders, we focus on the debt crisis of Europe in our business cycle analysis. A novel feature of the crisis is the increase in the firm's financing costs in the crisis-hit countries compared with those costs in stronger Euro countries. Already, there is a difference of more than two per cent in the interest rates of the 1- 5-year bonds of small and medium-size companies in Italy and Spain compared with those in Germany and France. In practice, this is the consequence of the risk leveling executed by international banks within the euro area. In this leveling, banks try to minimize the risk associated to the breaking up of the euro area by balancing their country-specific loans and savings. In other words, international banks try to keep their credit at the same level as their deposits and allowances in the countries in question. Because many crisis-

hit countries are experiencing an accelerating flight of deposits, this practice raises the price of the enterprise financing in these countries. The foreign owners' share of sovereign bonds in Spain and Italy has also decreased during the past year. The decision of the ECB to start the bond-buying program is thus expected, yet unable to solve the debt crisis itself. The ECB's program is likely to lower the interest paid by the companies in the countries in crisis, but it is unlikely to lead to equalization of the interest rates within the euro zone.

Business cycle forecasts

The business cycle condition in Finland and in the euro zone has distinctly changed to worse during the summer. The business cycle condition in the United States remains uncertain, but some positive signals are shown as well. The unemployment has decreased, although not much, the housing market seems to have reached its bottom and the railroad transports, among other things, have increased. Even so, the debt crisis of Europe has an extensive effect on the economic prospects in the United States. Uncontrolled breaking up of the euro area, for example, would most likely paralyze the financial markets worldwide. This, in turn, would freeze the economy in the US.

In all three areas, business cycle forecasts are thus subordinate to what takes place in the euro area. To

comprehend the big picture, we present three scenarios for the future evolution of the euro area.

In the most optimistic scenario, the Euro-leaders agree that the debts of Greece, Ireland and Portugal will be cut to sustainable levels. This means that sovereign debt of Greece is cut by, at least, 50%, the sovereign debt of Portugal is cut by 20 %, and the foreign debt in Ireland financial sector is cut by about 50%. Further, the European Stability Mechanism (ESM) is allowed to capitalize the banks in the EU directly. However, strict rules are set on this capitalization, including that ESM gets as an equivalent of the non-voting shares of the bank capitalized by it. The mandate of the ECB is extended to securing the solvency of the euro countries indicating that the ECB takes, or is granted to take, a more active role on the bond markets of euro countries. This would succeed most efficiently if the ECB defines certain limits for the interests of the bonds over which it would not allow them to rise. This limit could be, for example, the interest rate spreads of sovereign bonds in Germany. This means that limits would be put on how high the interest rates of the bonds of the countries in crisis are allowed to rise in terms of those paid in Germany. However, the ECB refused to grant such limits in 6.9.2012. LTRO3, the third long-term financing program directed to the banks of ECB may also be necessary in the future. We give 20 % as the probability for the realization of this most optimistic scenario.

The most pessimistic scenario for global economic development is an uncontrolled break-up of the euro area. This may start either as an internal bank flight within the euro area or as an announcement from Greece of inability to meet the obligations from Brussels and/or IMF. As a consequence, its loan program would be interrupted and Greece would resign from the euro by the end of the year. The resignation of Greece will lead to an accelerated bank flight from the other countries in crisis, and to speculative attacks against their bond markets. The bank flight paralyzes the euro system and compels several countries in crisis to restrict

the free movements of capital. The national central banks of the countries in crisis have to support their banking sector by printing their "own euro". The market begins to price the euro of different countries separately and the euro system disintegrates. As a consequence, several countries will leave the euro area during the winter. Debt restructuring in these countries, including their banks and companies, leads to marked losses in the banking sector of Europe and causes a global crisis in financial markets. The aggregate demand in the euro area collapses, which leads to a surge of bankruptcies in the production and service sectors. This throws the remaining euro area, the United States and Finland to recession, possibly to a depression. We give 20 % as the probability for the realization of this most pessimistic scenario.

At the moment, we consider the most likely scenario to be the one with the slow disintegration process in the euro area continues, but is damped by continuous efforts from the ECB and the Euro-leader. The financing authority of the ESM is extended to bank recapitalization and the ECB will start a bond-buying program as announced. The major difference with the optimistic scenario is that the debts of Greece, Ireland and Portugal are not restructured, because of which these economies are unable to take off. We give 60 % as the probability for the realization of this scenario.

Table 1 shows the forecasts for the growth rates of the real GDP in the euro area according to the above-mentioned scenarios and the nowcast forecasts for the present quarter. The economic situation in the euro area has continued to deteriorate during the summer and the change in the real GDP remains distinctly negative for the entire year. However, according to our forecast, the real GDP of the euro area will increase by one percent during the next year.

Table 2 shows the growth forecasts for the real GDP in Finland. The business cycle condition in Finland has turned markedly worse during the summer. According to our forecast, the GDP of

Finland will drop this year even in the most optimistic scenario.

Table 1. Forecasts for the growth rate of the real GDP in the euro area.

Quarter	Optimistic	Consensus	Pessimistic
2012:3 nowcast	-0.66	-0.66	-0.66
2012:4	0.04	-0.02	-0.23
2012:1-4	-0.77	-0.85	-1.16
2013:1	0.24	0.08	-0.72
2013:2	0.25	0.13	-1.55
2013:3	0.52	0.32	-1.09
2013:4	0.52	0.40	-1.02
2013	1.53	0.93	-4.38

Table 2. Forecasts for the growth rate of the real GDP in Finland.

Quarter	Optimistic	Consensus	Pessimistic
2012:3 nowcast	-0.53	-0.53	-0.53
2012:4	-0.10	-0.19	-0.44
2012:1-4	-0.86	-0.96	-1.20
2013:1	0.28	-0.006	-1.23
2013:2	0.12	-0.05	-2.73
2013:3	0.80	0.48	-2.31
2013:4	0.82	0.54	-1.66
2013	2.02	0.96	-7.93

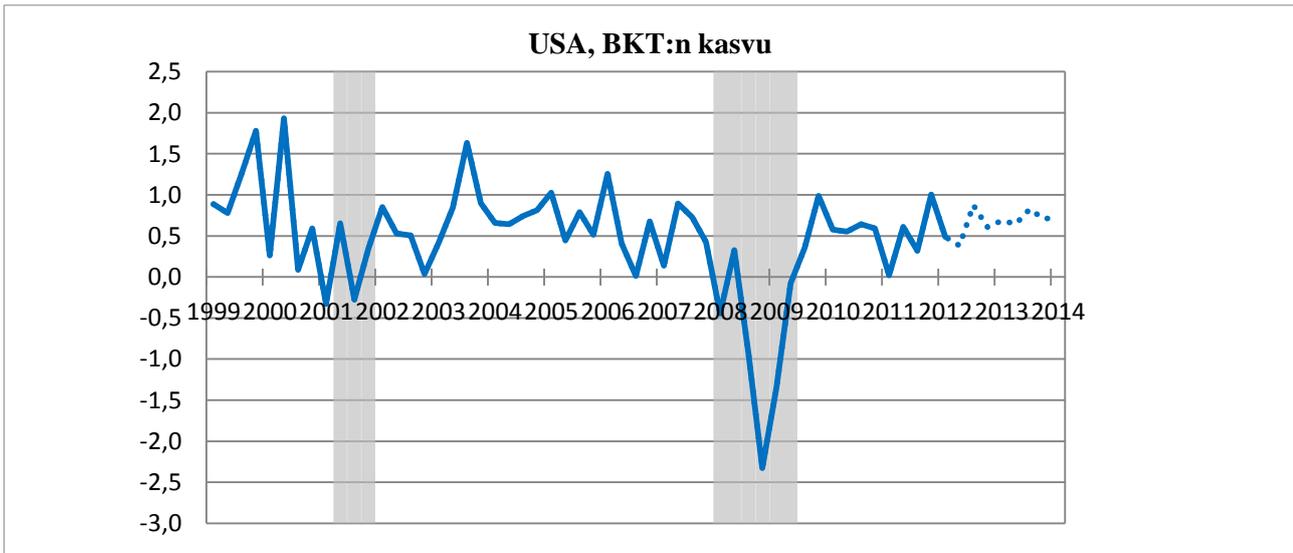
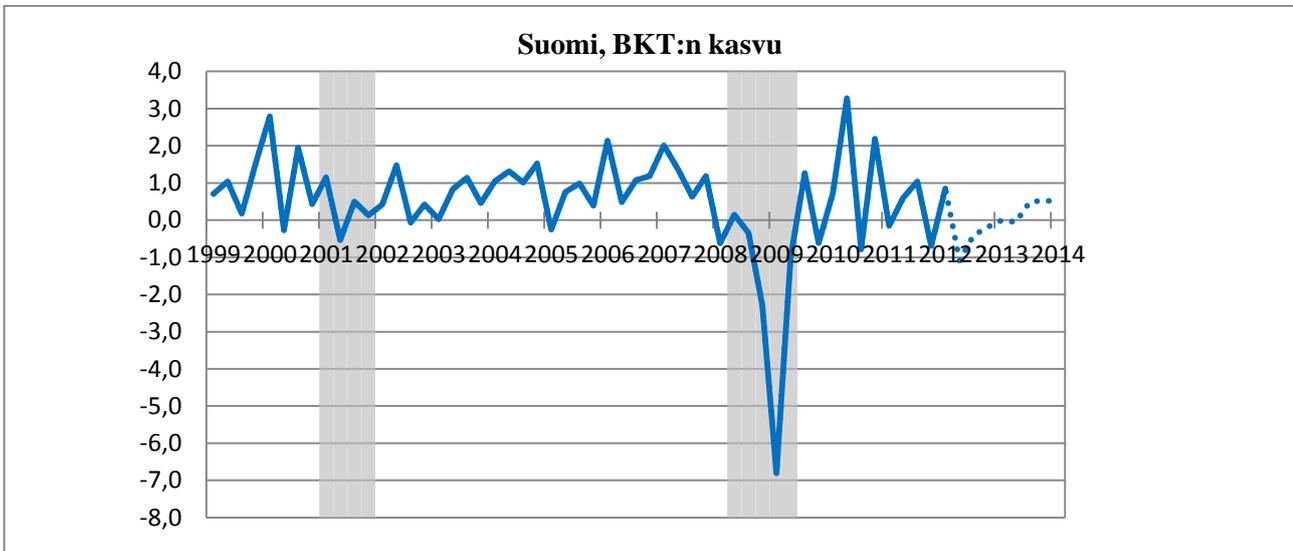
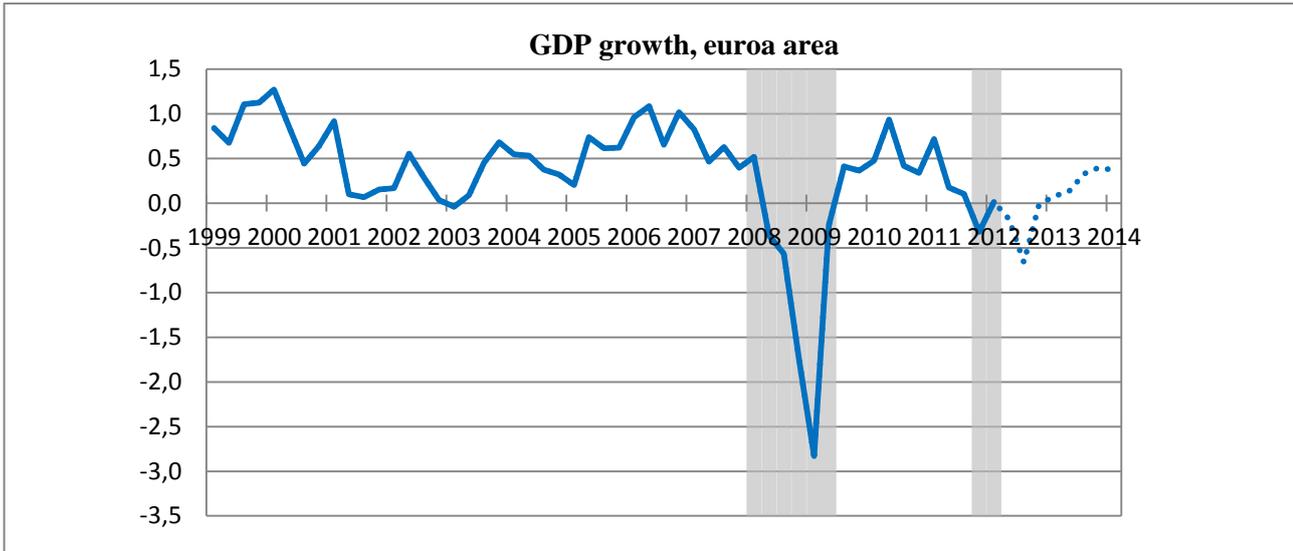
Table 3 shows the growth forecasts for the real GDP in the United States in an analogous way. The United States has been able to expand its economy better than Finland and the euro area. Even our most pessimistic scenario does not decrease the growth rate of the GDP in the US towards the end of the year. The coming year looks strong as well. According to our forecast, the economy of the United States will increase by about 2.8 % next year. However, if the crisis in the euro area gets worse, this would lead fall of about -2.5 % in the GDP.

Table 3. Forecasts for the growth rate of the real GDP in the US.

Quarter	Optimistic	Consensus	Pessimistic
2012:3 nowcast	0.88	0.88	0.88
2012:4	0.66	0.61	0.25
2012:1-4	2.40	2.35	1.99
2013:1	0.74	0.68	-0.35
2013:2	0.72	0.65	-1.21
2013:3	0.94	0.82	-0.57
2013:4	0.83	0.71	-0.44
2013	3.23	2.86	-2.57

Forecasts as figures

Below, the realized and forecasted growth rates for GDP in the euro area, the United States and Finland are illustrated in the most likely consensus scenario. The grey areas describes the recession periods of each economy. The recession periods for Finland are based on the Makrosuhdanne blog (see <http://blogs.helsinki.fi/makrosuhdanne/>).



Process descriptions

The forecasts reported in the Q-review are based on statistical modeling methods from the most recent academic research on predicting business cycle fluctuations. Nowcast refers to forecasts for the growth rate of the real Gross Domestic Product (GDP) for the current quarter. This is needed because the standard measures for the GDP are published after a considerable lag and are typically subject to subsequent revisions. Thus, the coincident state of the economy is always uncertain, indicating that those forecasts, referred to as nowcasts, are useful. Our nowcasts for the current quarter are based on statistical models where all relevant information available at the nowcasting time 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 that, for example, three-quarter forecast is essentially based on the two-quarter forecasts and so on. Forecasts are constructed for all three economic areas (Euro area, Finland and the US) indicating that they depend on each other. Finally, note that the forecast scenarios considered in the Q-review are based on the expert view of GnS economics.

The next Q-review will be published in week 51

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