

## Q-Review

### Business cycle analysis of Europe and the US

June 2013

- According to our forecasts, the world economy continues its slow recovery.
- The economic growth in Finland will be -0.3 per cent this year, but next year it increases to 1.7 per cent.
- We forecast that, this year, economic growth in the euro area stays in zero but, next year, it accelerates to one per cent.
- Nevertheless, the probability of a new global crisis has increased during the spring.

#### GDP growth forecasts

At the moment, the economy of the euro area shows mixed signals. Both the bond markets in the crisis countries and the confidence indicators in the biggest economies signal recovery but, surprisingly, also a threat of deflation. Even though the inflation of the euro area is still around 1.4 per cent, its trend is down in all member states. Greece and Cyprus are in a situation where the economy is shrinking and prices are falling. In principle, the European Central Bank can prevent deflation by more aggressive quantitative easing or by printing money. In that case, the ECB would provide liquidity for the member states through the national central banks or bond markets. However, it is likely that Germany would strongly resist such measures. Because of this, we consider deflation possible but still unlikely in the euro area.

The bond markets of the crisis countries have recovered recently. Basically three reasons explain this recovery. Markets have believed the threat from the ECB to buy the bonds of the crisis countries through its OMT program if needed. Even though the budget deficits in the crisis countries are still considerable, the governments have succeeded in assuring the markets in their commitment with the austerity programs. The countries of the euro area and other public organizations, such as the IMF, also own most of the state bonds of Greece. The future debt

restructuring in Greece would thus be mostly directed towards the European taxpayers, not to private investors. This is one of the reasons why, in spite of the continuing economic slump, the yield of the 10-year sovereign bonds has decreased under that of the 30-year bonds in three years.

The corporate loan markets show no signals of recovery. The spread between Germany and the crisis countries at the interest rates paid by small and medium-size companies are at a record level. Foreign financial institutions, especially those located in the creditor countries, such as Germany, have continued to withdraw from the crisis countries.

The economy of the eurozone is actually threatened by a triple threat. High unemployment, especially the enormous youth unemployment, threatens both economic growth and social stability. The share of the nonperforming loans in the banking sector keeps growing, threatening the weak solvency of banks. The manufacturing industry continues its flight to Asia and US, where cheaper labor and energy are provided. Problems of the banking sector arise uncertainty in the short run, whereas unemployment and outsourcing of the manufacturing sector weaken the long-term growth potential. At the same time, many countries intend to have a financial transaction tax that would divide the euro area further if

implemented. Therefore, the risk of the euro breakup has not disappeared.

Finland may be one of the winners if the financial transaction tax becomes effective. Finland wisely left herself out of the tax that has been found inoperative several times. The corporate borrowers may open affiliated companies in Finland to circumvent the financial transaction tax, which can facilitate the rather tight financial situation of firms in Finland. However, the current economic situation in Finland does not give reasons to celebrate. Unemployment has risen fairly distinctly from the year-ago numbers, consumers' confidence decreased during the spring and the views of the SME-sector have weakened.

The economy of the United States continues its sluggish recovery. In spite of the mediocre pace of economic growth, consumers' confidence is still high and employment seems to be improving gradually. The economic outlook of the United States is thus still good.

However, the situation in the global financial markets is increasingly problematic. The central bank of the central banks' (Bank of International Settlements, BIS) has warned from the market distorting effects of the continuing monetary easing. Stock markets of the US seem to be disconnected from the macroeconomic factors. Several alarming features are emerging in the world economy raising the probability of a new financial crisis

Perhaps the biggest concern is the ineffectiveness of the aggressive monetary policy. Zero-bound interest rates and the massive quantitative easing have not created the expected growth in the euro area and in the States the achieved growth has been only mediocre. Furthermore, the long-term effects of the zero-bound on the financial markets are not known. What is known, however, is that extended periods of monetary easing may lead to bubbles. During bubbles, the markets overprice certain assets, such as shares and minerals. At its worst, the major fraction of the current prices of

the assets are an outcome of easy money from the central banks. Bubbles can have only two directions: they can grow or burst. In some periphery countries, the bursting of the bubble in the sovereign bond, as well as the bursting of the bubble in the housing markets in the US lead to a financial crisis. In those cases, governments and central banks had plenty of ammunition to revive the economy. At the moment, only few measures are available, which makes the situation more serious.

*Abenomics* has also increased the risks in the financial markets. During *Abenomics*, the central bank of Japan has launched a massive quantitative easing combined with negative central bank interest rate. In practice, *Abenomics* is an attempt to form bubbles to help the revival of the economy of Japan from its 20-year deflation. For example, the former chairman of the FED, Alan Greenspan, used the same strategy many times. But is the economy of Japan ready for this kind of bubble economy? The public finance in Japan is in less fix than that in the United States in 2008 when the financial crisis began. The national debt is more than 200 per cent of the GDP in Japan, while in the United States it was only some 60 per cent in 2008. If the actions of the central bank would raise the interest of the sovereign debt by three percentage points in Japan, its interest payments could rise by six per cent of the GDP. It is unclear how well the economy of Japan would bear this.

When the above-mentioned economic problems of the euro countries are included in the analysis, a rather worrying picture of the world economy starts to emerge. It is possible that the banking sector and the world economy were be saved by using too strong methods in 2008. As a consequence of this, it is also possible that the world economy is more like *zombie* economy, where unprofitable banks and companies are kept alive with easy money and rescue packages from the governments. This kind of an environment is extremely sensitive to shocks or market

disturbances, and this is a reason to be worried although there is no reason to panic, yet.

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. From our March forecasts, the forecast of the growth for the United States has changed to somewhat more positive direction but that for euro area and Finland have changed to more negative. According to our forecast, the real GDP of Finland would diminish by -0.3 per cent this year. However, we forecast that the economy of Finland will develop an upward trend during the next quarter. Next year, the economy of Finland would increase by 1.7 per cent. We predict that the real GDP of the euro area will diminish by -0.96 per cent this year, but the euro area begins to recover during the next quarter. We predict that the economy of the United States will increase by 2.2 per cent this year and by 2.5 per cent next year.

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	1.66	-0.96	-1.60
2013:1	0.59	-0.21	-0.12
2013:2 (nc)	0.51	-0.14	-0.47
2013:3	0.60	0.11	0.25
2013:4	0.51	0.23	0.03
2013	2.21	-0.01	-0.31
2014	2.5	1.3	1.7

## Scenario forecasts

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

The figures that have been presented underneath describe the scenario forecasts of the economic development of Finland, euro area and the United States, namely the optimistic, the most probable and the pessimistic scenario. We suppose that the optimistic scenario holds true if the central banks try to normalize the functioning of the world

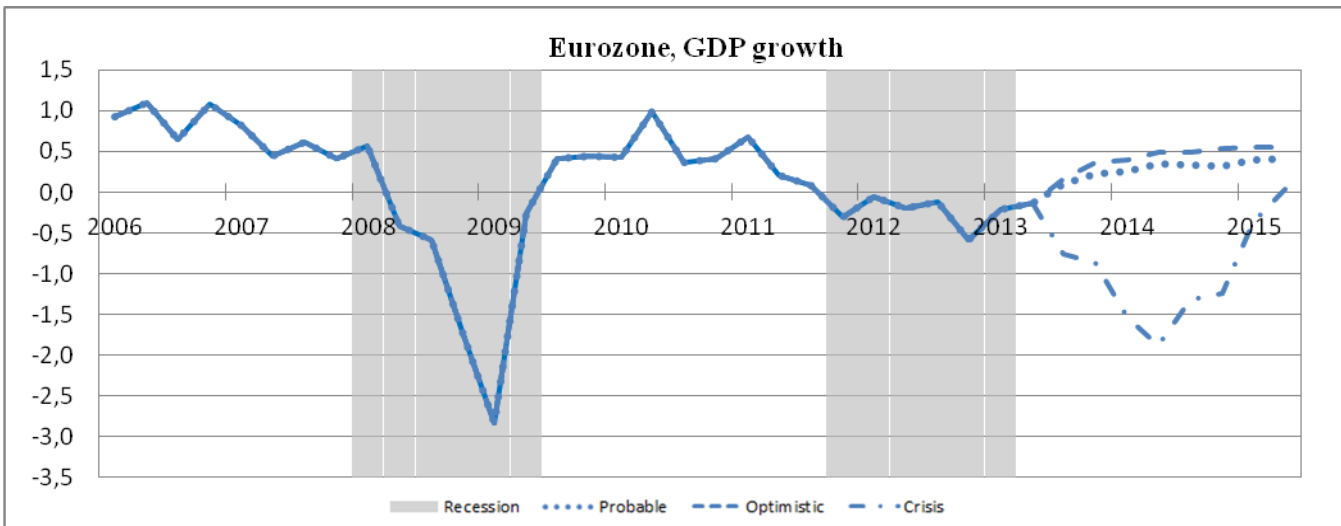
economy and, simultaneously, the governments try to support economic growth. Some available methods would be giving up the indirect quantitative easing, suitable tax reductions, the gradual reducing of the role of the government, the investments on public finance and loan arrangements in the crisis countries. According to our estimate, the likelihood of this scenario is 20%.

We suppose that the pessimistic scenario is realized in a situation where worldwide shocks induce a global financial crisis. Such shocks could be a bankruptcy of a big global bank, a collapse of a big stock market, a collapse of some bond market or a war in the Middle East. According to our estimate, the likelihood of this scenario is 10%.

In the most probable scenario, we suppose that the situation continues unchanged. The central banks try to revive economy with low interests and with quantitative easing. After the parliamentary elections in Germany in September, the negotiations on the restructuring of the debts of Greece will begin and they will be carried out during the winter or spring. This eases imbalances inside the euro area, but the economic problems in Portugal and Spain still slow down the growth in the euro area and world economy. According to our estimate, the likelihood of this scenario is 70%.

From the figures below, it is seen that the probable scenario is quite near the optimistic scenario at the moment. Thus, the growth potential of the nearest future of the economies of Finland and of the euro area indeed looks modest on the basis of our forecast. The growth of the United States could, at the best, accelerate next year into nearly three per cent.

Possible, but still quite unlikely financial crisis would throw a GDP in all the countries to a strong decrease. The biggest effect would be in Finland where the economy would collapse next year even more than 11 per cent in the crisis scenario.



## 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.

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

This GnS Economic report does not constitute a solicitation for the purpose of sale of any commodities, securities or investments. The information presented here is considered reliable, but its accuracy is not guaranteed. Persons using this report do so solely at their own risk and GnS Economics shall be under no liability whatsoever in respect thereof. The views expressed are those of GnS Economics, which do not necessarily reflect the views of the individual members of the company or the views of their background organizations.

## Contact information

Tuomas Malinen, PhD  
CEO

tel: +358 40 196 3909

email: [tuomas.malinen@gnseconomics.com](mailto:tuomas.malinen@gnseconomics.com)

<http://www.gnseconomics.com>