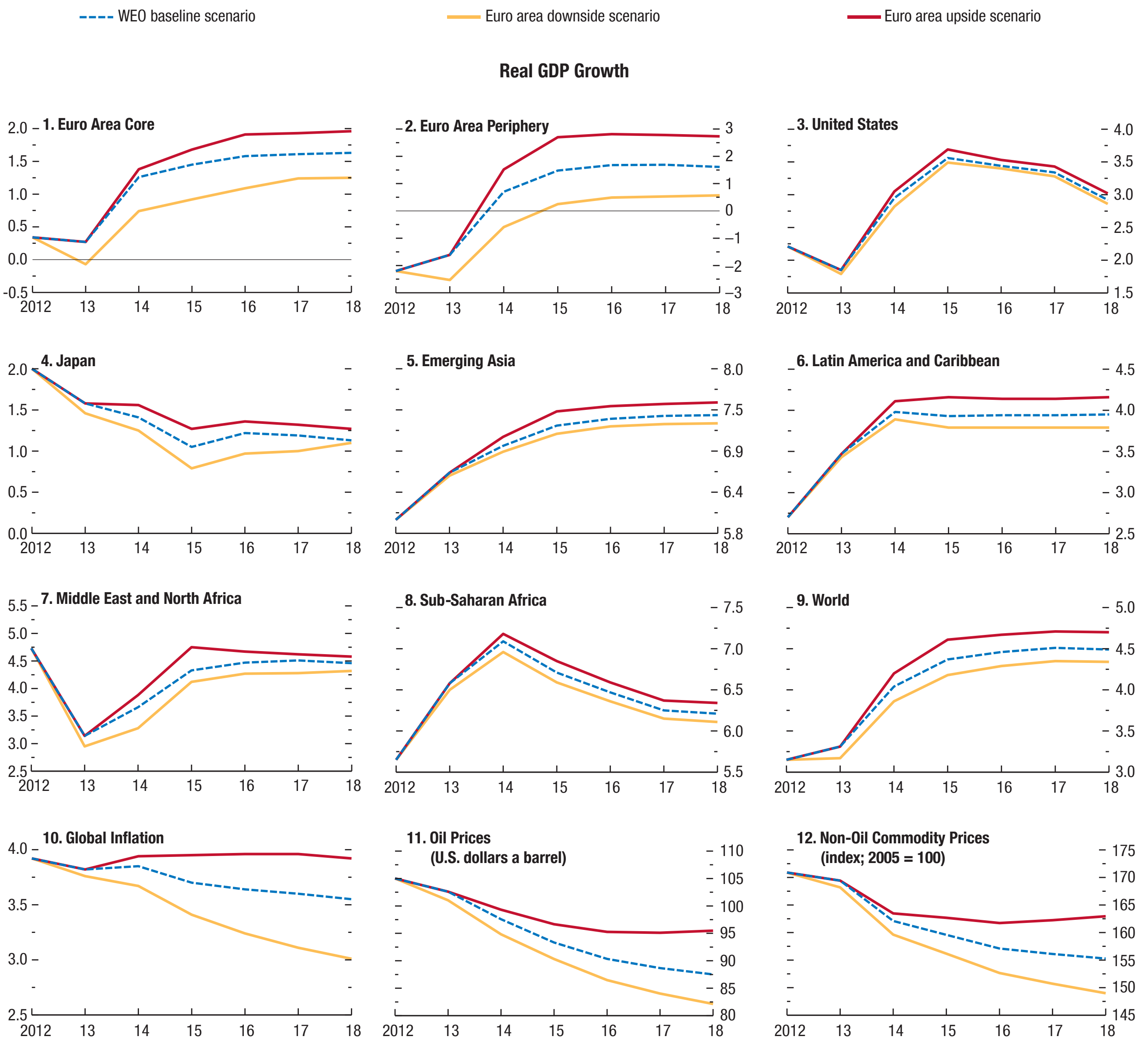
Figure 1.15. Euro Area Scenarios

(Percent unless noted otherwise)

These scenarios are simulated using EUROMOD, a new IMF model of the global economy, and consider the implications of two alternative paths for the euro area. The downside scenario (yellow line) embodies a continual process of deterioration whereby weaker-than-expected macroeconomic outcomes from a reduction in investment (as confidence wanes) heighten concerns about fiscal sustainability. This heightened concern leads to rising risk premiums and additional tightening in fiscal policy, further weakening the macroeconomic environment and confidence, notwithstanding easing by the European Central Bank (ECB). Specifically, in this scenario investment in the periphery economies falls by about 6percent each year, corporate interest rates are about 3 percent higher, and the average (of the short- and long-term) sovereign rate is 1 percent higher than in the WEO baseline by 2018. The higher sovereign rate prompts periphery economies to tighten the fiscal stance by an additional ¼ percent of GDP each year. In core economies, ECB easing eclipses a modest increase in risk premiums and interest rates end up lower than in the WEO baseline. The increase in risk premiums spills over into other regions of the world.

In the upside scenario (red line), faster-than-expected progress both on establishing the Single Supervisory Mechanism (SSM) and on giving the European Stability Mechanism (ESM) the ability to recapitalize banks sets the stage for better-than-expected macroeconomic outcomes in 2014 and beyond. Furthermore, the reforms implemented at a national level begin to pay off sooner than expected, starting in 2014, with some offsetting effects from an increase in the policy rate by the ECB. As a result, sovereign and corporate risk premiums start to decline. Declines in the average sovereign and corporate interest rates are largest in the periphery, amounting to about 0.7 and 1.5 percentage points, respectively, relative to the WEO baseline. In the core countries, the tightening of monetary policy is the dominant effect on all interest rates, so the average sovereign and corporate rates rise relative to the WEO baseline. Starting in 2014, the annual increase in productivity is roughly 0.5 percent in periphery countries and 0.1 percent in core countries, while the annual increase in investment is almost 5 percent in the periphery and 0.8 percent in the core.



Source: IMF staff estimates.