

# **QUARTERLY REPORT ON THE EURO AREA**

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**Highlights in this issue:**

- Recent economic developments and economic prospects
- Structural factors weighing on the investment recovery
- Current account developments in the euro area
- Focus: The export performance of the euro area

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## EDITORIAL

The Spring European Council in Brussels last month reached two agreements that I believe will, if rigorously implemented, restore credibility to the functioning of the EU's system of economic governance, safeguard the stability of our public finances and instil new dynamism into our efforts to boost Europe's, and more specifically the euro area's economic performance. Firstly, the Heads of State and Government endorsed a report on the Stability and Growth Pact by the Council of Ministers for Economic and Financial Affairs that paves the way for a new consensus on the importance of sound and stability-oriented budgetary policies. Secondly, they agreed to re-launch the EU's economic reform agenda for growth and jobs without delay. I would like to take this opportunity to draw attention to some of the key elements in these important agreements.

On the Stability and Growth Pact, I would first of all like to express my satisfaction that a compromise could be obtained at the Spring European Council. While obviously not all Commission objectives for the reform have been fully obtained, the compromise agreement presents a balanced package. I want to be clear that the Pact has neither been weakened nor loosened, contrary to what some media reports suggested. Indeed, it is important to note that the Pact has been confirmed as a strong instrument to foster budgetary discipline. It has been given new vigour and a better framework for an economically sensible implementation, allowing to better reflect the economic realities in the 25 Member States.

It is particularly important that the preventive arm of the Pact has been strengthened by ensuring that due attention is given to the fundamentals of fiscal sustainability when setting medium-term budgetary objectives. The strengthened commitment by Member States to actively

consolidate public finances under favourable economic conditions, and the possibility for the Commission to act if this is not the case are particularly noteworthy in this respect. The new agreement also includes incentives to embark upon structural reforms.

The agreement will also improve the implementation of the excessive deficit procedure by making economic analysis more central to the corrective arm of the Pact. In practice, this means that exceptions to the 3% deficit ceiling can be permitted when economic growth is negative or during protracted periods of very low growth. However, any deficit in excess of 3% should strictly be exceptional, temporary and remain close to this reference value. In making its assessment in this context, the Commission will also give due consideration to a range of economic factors, including potential growth, prevailing cyclical conditions, the implementation of policies in the context of the Lisbon agenda and policies to foster R&D and innovation.

Overall, I am glad to see that there is renewed consensus on a revised set of rules with more economic rationale, allowing more ownership and ultimately more effective implementation. In this context, it is particularly welcome that the Commission's responsibility as guardian of the Pact has been confirmed and strengthened in the direction of early policy advice and assessment of Member States' budgetary policies. You can rest assured that I will devote myself to a forceful implementation of the agreement reached and, in this context, ensure the impartial and equal application of the rules to all Member States. Over the coming months, the main challenge ahead is to transpose the agreement on the Pact into the legal framework and to make it work in practice. Given the increased sophistication of the new rules, this will indeed be challenging.

Following the request of the Spring European Council, the Commission will swiftly move on and present to the Council the legislative proposals which implement the changes that we have agreed. The Commission will do everything necessary to ensure that the Council will be able to adopt the amended Regulations before the summer.

Putting in place a framework for sound budgetary policies is a pre-condition for achieving a higher rate of sustainable growth in Europe; so too are structural reforms to promote efficient, flexible and adaptable markets in the face of globalisation, new technologies and changing cyclical conditions. Our estimates show that the combination of product and labour market reforms and increased knowledge investments foreseen within the Lisbon strategy could increase the EU's potential growth rate by three quarters of a percentage point. Over a ten-year period, this would imply an increase in the GDP level of up to 7 or 8 per cent. Given that ageing populations could reduce the EU's growth potential by as much as 1 percentage point by 2040, Europe cannot afford to forgo the potential gains from the Lisbon Strategy.

I am confident that the European Council's agreement on the Mid-Term Review of the Lisbon Strategy will provide a fresh impetus to the EU's economic reform agenda. The basic idea is to sharpen the focus of the reform efforts and to adjust the governance system in order to enhance the ownership at the national level.

The Commission will put growth and employment at the heart of the Lisbon Strategy by pursuing growth and stability oriented macroeconomic policies and well targeted structural reforms. Growth and jobs are fundamental prerequisites for social cohesion and an essential basis on which to build the political will to pursue environmental policies. It is essential to prioritise better by identifying a limited set

of concrete reform measures and then devote all efforts to achieving them. This is why the Integrated Guidelines that the Commission presented on 12 April identifies three priority areas for action. First, Europe needs to increase its attractiveness for investment. To this end, it is important to complete the Internal Market, particularly in services and financial markets, and to take measures to improve the business environment, regulation and infrastructure. Second, Europe should promote knowledge and innovation by encouraging investment in research and development, improving the dissemination of knowledge, facilitating innovation, and fostering the uptake of ICT. And third, actions need to be taken to generate employment. Appropriate measures should increase employment and participation rates, and the flexibility of labour markets.

The revitalised Lisbon Strategy will be accompanied by a more effective system of governance that will tackle the persistent implementation gap by encouraging a greater sense of ownership at the national level. Member States have agreed to streamline their follow-up to the renewed Lisbon Strategy by formulating comprehensive national action plans specifying their reform intentions for the 3-year coordination cycle. I am confident that these single national reform programs will ensure a more coherent national policy strategy and promote a deeper debate in the Member States by involving national parliaments and other stakeholders.

Of course, reaching a consensus on policy aims and putting in place a credible system of economic governance to back them up is only the first step towards raising Europe's growth potential. Implementation of agreed policies in each Member State over the next few years will be essential.

Joaquín ALMUNIA

MEMBER OF THE EUROPEAN  
COMMISSION



## I. Economic situation in the euro area

*In 2004, growth in the euro area was the highest in four years, rebounding to close to its potential. However, after a strong start, the pace of the expansion eased considerably during the second half of the year with GDP growth falling below 1% in annualised terms. Weaker growth in world trade, high oil prices and the strengthening of the euro all took their toll on activity, weighing in particular on the euro-area's export performance. On a more positive note, domestic demand began to send some signs of strengthening. A modest recovery in investment has been in place since the second quarter of 2004 while private consumption gathered momentum in the fourth quarter. Hard data point to a pick-up of GDP growth during the first months of 2005 as the deceleration of global trade growth comes to a halt and domestic demand continues to improve. However, business surveys have been sending mixed signals since the beginning of the year, suggesting that the underlying strength of the economy should not be overestimated. Inflation has shown signs of easing but oil prices pose an upside risk to the short-term outlook for consumer prices and for household purchasing power. In addition, the labour market has so far remained subdued, holding back gains in household disposable income and confidence. Investment is benefiting from supportive financing conditions, improved profitability and repaired balance sheets but there is some evidence that the slowdown in total factor productivity experienced in the euro area since the 1990s is still weighing on long-term trends in capital formation.*

### 1. Recent economic developments and short-term prospects<sup>1</sup>

#### In a context of subdued GDP growth during the second half of last year...

For the first time since 2000, economic activity in the euro area grew around potential once again last year. Despite rising oil prices and the appreciation of the euro, real GDP is estimated to have increased by 2.0% in 2004 (1.8% on a working day adjusted basis), mainly supported by strong global growth and trade. Accordingly, the

region experienced a considerable pick-up compared to the previous year, when growth reached 0.6%.

However, while showing a healthy performance over the year as a whole, the pace of economic expansion eased between the first and the second half of 2004. After surprising on the upside in the first two quarters, with growth rates above potential, quarter-on-quarter GDP growth was estimated at 0.2% in the fourth quarter of 2004, unchanged from a downwardly revised estimate in the third quarter. This compares to

Table 1: Euro-area growth components

	2004	2004	2004	2004	Carryover to 2005	Forecast (1)	
	Q1	Q2	Q3	Q4		2004 (2)	2005 (2)
<b>% change on previous period, volumes</b>							
GDP	0.7	0.5	0.2	0.2	0.4	2.0	1.6
Private consumption	0.8	0.0	0.1	0.5	0.4	1.3	1.6
Government consumption	0.2	0.4	0.4	0.2	0.4	1.7	1.4
Gross fixed capital formation	-0.1	0.5	0.6	0.6	0.9	2.1	2.8
Changes in inventories (% of GDP)	0.0	0.1	0.8	0.7	0.3	0.4	0.3
Exports of goods and services	1.4	2.7	1.3	0.5	1.7	6.0	5.4
Imports of goods and services	0.4	2.4	3.1	1.0	2.9	6.2	6.0
<b>% contribution to change in GDP</b>							
Private consumption	0.4	0.0	0.0	0.3	0.2	0.7	0.9
Government consumption	0.0	0.1	0.1	0.0	0.1	0.3	0.3
Gross fixed capital formation	0.0	0.1	0.1	0.1	0.2	0.4	0.6
Changes in inventories	-0.1	0.1	0.7	-0.1	0.3	0.4	0.0
Net exports	0.4	0.2	-0.7	-0.2	-0.4	0.1	-0.1

(1) Annual change in %. (2) European Commission Spring 2005 Forecasts.

Source: Commission services.

<sup>1</sup> The cut-off date for the statistics included in this issue was 7 April 2005.

Table 2: Selected euro-area and national leading indicators, 2004-2005

	SENT. IND <sup>1)</sup>	BCI <sup>2)</sup>	OECD <sup>3)</sup>	PMI Man. <sup>4)</sup>	PMI Ser <sup>5)</sup>	IFO <sup>6)</sup>	NBB <sup>7)</sup>	ZEW <sup>8)</sup>
Long-term average	100.0	0.00	2.86	52.2	54.3	95.6	-9.5	34.5
Trough in latest downturn	88.1	-1.25	-0.77	42.9	46.7	87.3	-26.5	-10.4
April 2004	99.8	0.36	5.05	54.0	54.5	97.7	-0.5	49.7
May 2004	100.2	0.27	4.49	54.7	55.8	97.7	-2.5	46.4
June 2004	99.6	0.38	3.7	54.4	55.3	96.0	-2.0	47.4
July 2004	100.0	0.56	3.09	54.7	55.3	97.1	4.1	48.4
August 2004	100.9	0.48	2.57	53.9	54.5	95.9	-2.1	45.3
September 2004	100.9	0.51	2.32	53.1	53.3	95.7	-1.1	38.4
October 2004	101.5	0.53	2.04	52.4	53.5	95.9	-0.5	31.3
November 2004	100.9	0.39	1.89	50.4	52.6	94.3	-6.6	13.9
December 2004	100.2	0.44	1.5	51.4	52.6	96.5	-5.3	14.4
January 2005	100.8	0.40	0.97	51.9	53.4	97.5	-5.0	26.9
February 2005	98.8	0.20	0.91	51.9	53.0	96.4	-11.4	35.9
March 2005	97.4	-0.08		50.4	53.0	94.6	-9.4	36.3

1) Economic sentiment indicator, DG ECFIN. 2) Business climate indicator, DG ECFIN. 3) Composite leading indicator, six monthly change. 4) Reuters Purchasing Managers Index, manufacturing. 5) Reuters Purchasing Manager Index, services. 6) Business expectations, West Germany. 7) National Bank of Belgium indicator for manufacturing. 8) Business expectations of financial market analysts, Germany.

the 0.6% average growth rate recorded in the first half of 2004.

To a large extent, the weakening of economic activity reflected the slower pace of foreign demand. The contribution of net trade to GDP growth turned negative in the second half of 2004, reducing the euro-area's quarterly GDP growth rate by about 0.5 of a percentage point. Apart from its impact on average growth in 2004, the slower pace of economic activity in the second half of the year limits the carry-over to annual GDP growth this year.

### ... domestic demand showed encouraging signs of a pick-up in Q4

Regarding the expenditure breakdown in the last quarter of 2004, the major positive stimulus was provided by private consumption, which showed an encouraging pick-up by 0.5% from a broadly flat pattern observed in the previous two quarters. Public consumption growth, on the other hand, moderated to 0.2% from 0.4% in the third quarter.

The acceleration of private consumption in the fourth quarter of last year is encouraging but there remains some uncertainty about the solidity of the rebound. In part, strong household spending may reflect some degree of correction following subdued consumption in the previous two quarters. In addition, private consumption

was partly inflated by extended discounting in winter sales in many countries. This price-effect on real consumption growth is confirmed by the deceleration of consumer price inflation to 0.3% (q-o-q) in the fourth quarter compared to 0.6% in the third quarter.

Furthermore, the persistent softness of the labour market still weighed on confidence and disposable income growth. The unemployment rate was 8.8% over the fourth quarter, broadly unchanged compared to previous months. Employment accelerated somewhat during the second half of last year (0.2%), but indicators for wage growth confirmed the continuation of the moderation observed in the last two years. Negotiated wages increased by 2.2% in the fourth quarter of 2004, a four year low. With inflation hovering around 2% since the beginning of the year, gains in real labour income were therefore limited. Overall, the positive fourth quarter performance for household consumption should be viewed with caution, as it may overstate the underlying strength of consumer spending in the euro area.

Growth in gross fixed capital formation was stable at 0.6% in the fourth quarter, though this marked a pick-up compared to the first half of 2004. The upward movement of investment was backed by rising capacity utilisation in the manufacturing sector, which edged up just above its 10-year average level for the first time since 1999. At the same time, industrial new orders





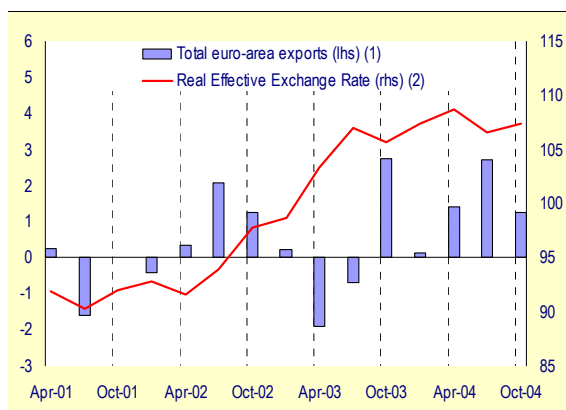
rose strongly by more than 5% on the quarter and the annual growth rate of loans to non-financial corporations strengthened from 2.1% in the third quarter to 3% in the fourth,<sup>2</sup> thus confirming the moderate upward trend observed since early 2004. In a context of improved profitability, corporate balance sheets also benefited from the revaluation of companies' large stock of share holdings. As to residential construction, the financing conditions of the household sector remained supportive in the fourth quarter of 2004 with interest rates on loans for house purchase at historically low levels. At the end of last year, annual growth in mortgage lending by Monetary and Financial Institutions (MFIs) was running at about 10%, fuelling house price dynamics and, to a lesser degree, residential construction in several parts of the euro area.

On the other hand, the very high level of inventory accumulation in the last two quarters of 2004 is of some concern as it may reflect a mini inventory cycle, with firms accumulating unsold goods as a consequence of the unanticipated slowdown in demand.

Meanwhile, growth in euro-area exports decreased further in the fourth quarter to 0.5%. Exports came under increasing pressure from the softening of global growth around the middle of 2004. In addition, the appreciation of the euro since 2002 appears to have been a gradually increasing burden on external competitiveness. Indeed, in the last quarter of 2004, the euro's real effective exchange rate based on the HICP<sup>3</sup> deflator moved to its highest level in seven years. Thanks, however, to a significant decline in import growth, the negative contribution of net foreign demand was less pronounced in the

fourth quarter (-0.2 percentage points) than in the third (-0.7 percentage points).

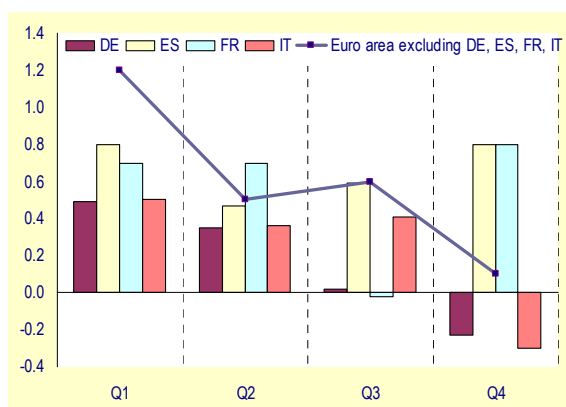
Graph 1: Total exports and real effective exchange rate, euro area (2001Q1 to 2004Q4)



(1) q-o-q % change, sa;  
(2) Index : January 2003=100 (based on Unit Labour Costs).  
**Source:** Commission services.

Overall, the breakdown of euro-area GDP components shows that domestic demand drove growth in the fourth quarter of 2004. This was in marked contrast with the first half of the year when it was disappointingly subdued.

Graph 2: GDP growth in selected euro-area countries (Quarter-on-quarter % changes in 2004)



**Source:** Commission services.

Divergence among Member States in quarterly growth rates was considerable in the final quarter of 2004 (see Graph 2). Among the largest Member States, GDP declined unexpectedly in Germany (-0.2%) and Italy (-0.3%), while growth

<sup>2</sup> In the meantime, loans granted by the narrower group of Monetary and Financial Institutions picked up from 4.5% to 5.4%. MFIs are the financial institutions which form the money issuing sector in the euro area. In addition to MFIs, some loans are also granted by non-MFI financial corporations including insurance companies, pension funds and other financial intermediaries. Non-MFI financial corporations account for about 15% of total outstanding loans to non-financial corporations but the share has shown a marked downward trend in the past few years.

<sup>3</sup> The same conclusion holds when different price deflators are used (e.g. unit labour costs or export prices).

remained robust in France and Spain (0.8%).<sup>4</sup> An important element influencing intra-area growth dispersion is the behaviour of private consumption. While in France and Spain consumption has been growing at a robust pace, in Italy and Germany household spending remained subdued. This may partly reflect the different performance of the labour market in these countries.

### Positive news from hard data but surveys send more mixed signals

The data available so far for the first quarter of 2005 are still limited and do not provide a clear message about how much momentum actually exists in the economy. Some data appear to imply a bounce-back of growth in the first quarter relative to the sluggish pace registered during the second half of last year, while others suggest that the underlying growth momentum remains relatively soft.

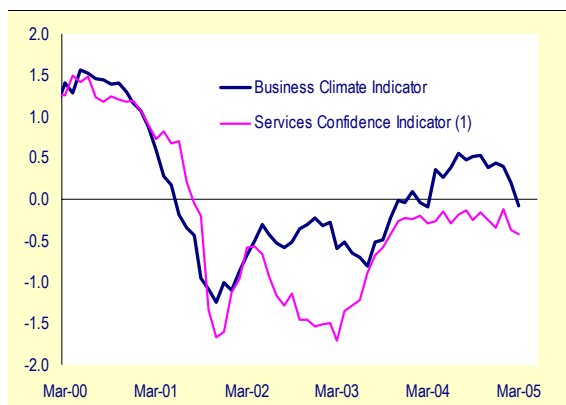
Judging by the hard data published so far, January was a positive month for euro-area activity. Manufacturing output was up by 0.5% relative to the previous month with a particularly strong increase in Germany (2.8%). Despite a sizeable correction relative to the December reading, industrial new orders in the euro area remained on an upward trend. In addition, retail sales rose by 0.3% in both January and February, after being flat in the previous two months. Retail spending bounced back strongly by 2.1% in Germany in January and regained strength in France and Spain in February.

On the other hand, euro-area survey data for the first quarter of the year have been more mixed. After a generally positive reading in January, most business surveys showed a setback in February and March, although in both industry and services they remain consistent with a continuation of moderate growth.

<sup>4</sup> However, it is worth noting that statistical working day adjustments partly related to the timing of public holidays have played a role in explaining the weak growth rate performance. In the case of Germany, in particular, output grew by 0.4% in the fourth quarter of 2004, when measured in non-working day adjusted terms.

Following sideways movements during the last quarter of 2004 up to January of this year, the Commission's Business Climate Indicator decreased significantly in February and fell again considerably in March, returning to a level comparable to that reached in March 2004 (see Graph 3). A similar but moderated trend is visible also for Reuters Purchasing Manager's Index (PMI) for manufacturing. Following an average reading of 51.4 in the final quarter of 2004, the index stabilised in January and February at 51.9, but fell substantially to 50.4 in March. While the average value for the index remains therefore unchanged at the beginning of 2005 compared with the fourth quarter of 2004, latest data point towards a weakening of the euro-area recovery.

Graph 3: Business confidence indicators, euro area (Mar 2000 to Mar 2005)



(1) Normalised

Source: Commission services.

According to the European Commission Business Survey, the services sector lost momentum in February and March, more than reversing the gains registered in January. Similarly, Reuters Index for services worsened between January and March, but remains above the index reading at the end of 2004. Across Member States, the declines in Germany and Italy more than offset the rise in France, reinforcing the familiar pattern of cross-country divergence in domestic performance. However, in the euro area as a whole, the current level of the index (53) is well above the threshold that separates expansions from contractions of economic activity.



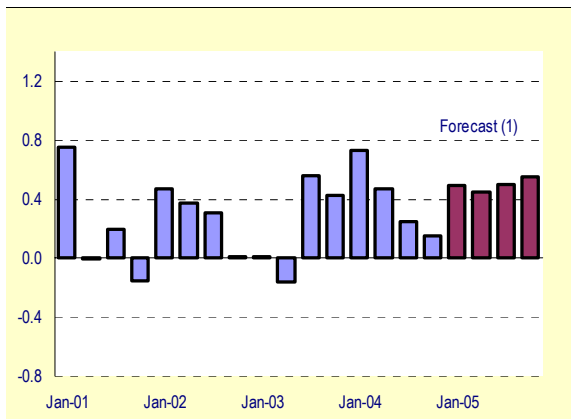


All in all, the mixed signals sent by recent indicators reflect, on the one hand, the positive support to growth stemming from an accommodative monetary policy, still buoyant global growth and improved corporate health and, on the other, the headwinds of a strong currency, high oil prices, subdued labour market developments and lack of confidence.

### A rebound of GDP growth in the first quarter of 2005

According to the European Commission's 2005 Spring Forecasts, GDP is estimated to have expanded by 0.5% q-o-q in the first quarter of 2005. The quarterly growth profile is forecast to remain relatively constant over the rest of the year, with growth averaging 1.6% for the year as a whole (Graph 4).

Graph 4: GDP growth, euro area (1)  
(Quarter-on-quarter changes in % – 2001Q1 to 2005Q4)



(1) European Commission's Spring 2005 Economic Forecasts.  
Source: Commission services.

Available monthly data suggest that the deceleration in world trade growth has probably come to an end. However, the momentum in world trade remains so far disappointing compared with the growth rates reached during the first half of 2004. In addition, euro-area exports will continue to be dampened by past losses in competitiveness, due to the strengthening of the euro. Overall, the contribution from net exports to euro-area growth is likely to be rather modest in the coming quarters. The contribution of net trade to GDP growth is forecast to be slightly negative in

the first quarter of 2005 and projected to remain close to zero over the forecast horizon.

By contrast, in an extension of the pattern that emerged towards the end of last year, growth in domestic demand should accelerate.

Private consumption growth is estimated to have expanded by 0.5% in the first quarter of the year, the same pace as in the previous quarter. In the remainder of the year, household purchasing power should benefit from decelerating inflation, a somewhat more supportive labour market and some return of confidence.

The pace of investment expenditure is estimated to have strengthened further, rising by 0.8% in the first quarter of the year. In the remainder of the year, a combination of continued wage moderation and output outpacing employment growth will help to bring real unit labour costs down, boosting corporate profits in the process and encouraging investment. In addition, historically low costs of debt financing should further support firms' investment plans. Nevertheless, as discussed further in Section 2, capital formation is likely to continue to be hampered by the trend deceleration of the pace of technical progress observed in the euro area since the late 1990s, and is therefore likely to experience only a moderate recovery.

An improvement of the labour market remains crucial for the medium-term sustainability of private domestic demand. To this end, survey data continue to suggest ongoing modest employment growth in the economy as a whole. At the sectoral level, the stabilisation of employment expectations in the European Commission Industry Survey and the slight improvement of the employment component in PMI for manufacturing since the beginning of the year suggest that the growth disappointment in the second half of 2004 has not triggered a sharpening of the labour market adjustment in industry. A broadly similar picture holds for the services sector. According to the European Commission Survey, employment expectations in the first quarter of 2005 were slightly less positive than in the last quarter of 2004 while the PMI index signals broadly stable conditions relative to the last quarter. However, the PMI indicator

remains compatible with ongoing employment growth in the sector.

### Risks tilted to the downside

The recent softening of business confidence and developments in the external environment of the euro area suggest that the risks to the growth outlook remain tilted to the downside.

Global imbalances continue to pose a downside risk, with the US current account balance deficit set to widen to 5.9% of GDP in 2005. The unwinding of such imbalances could lead to disorderly movements in exchange rates, which would also impact on confidence and real activity, including world trade.

Recent developments have increased the likelihood of a prolonged period of high and volatile oil prices. On a more positive side, however, a strong euro can partially shield the euro area from the increases in commodity prices.

A stronger-than-expected deceleration in inflation may be considered to be an upside risk for private consumption. On the other hand, overheating in specific housing markets may carry the potential for adverse corrections in consumer sentiment and spending.

Gross fixed capital formation appears to be the only area of economic activity where the risks are on the upside. Indeed, corporate investment has been rather subdued, when judged by the favourable financing conditions, improved profitability and the progress made in corporate restructuring. A more dynamic profile for investment as a result of the release of pent-up demand, cannot be excluded. Moreover, the past weakness of investment, which has led to a deterioration of the capital stock, should support replacement investment, particularly in the ICT sector.

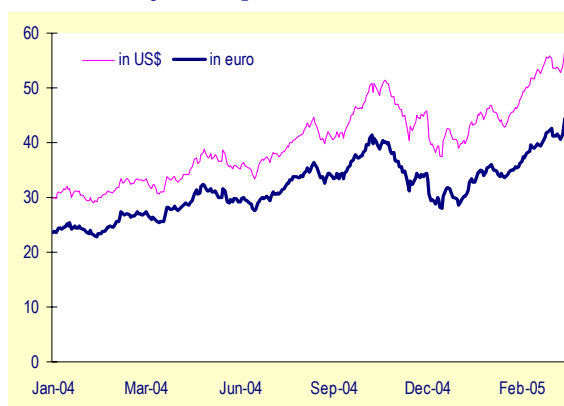
Finally, further deterioration in competitiveness in some Member States, which would dampen their growth, is also a downside risk for the euro-area's aggregate growth performances.

### World growth is becoming more unbalanced

The deceleration in world trade growth, that followed the very strong recovery observed in late 2003 and early 2004 seems to have come to an end. After a strong reading in November, monthly CPB data have shown relatively sluggish month-on-month growth in world trade in December and January. However, month-on-month changes in the CPB data can be highly volatile and smoother measures of growth, such as the change in the three month moving average, have shown a bottoming out of trade growth since December.

There are signs that global activity has become less balanced, with US, China and most emerging market economies ending 2004 on a strong note, while growth remained weak in the euro area and Japan. Partly because of this, global current account imbalances have widened, which, as already highlighted, could increase the risk of an abrupt adjustment later on.

Graph 5: Oil prices – barrel of Brent



Source: Datastream.

The recent surge in oil prices, which has taken the price of Brent to new record highs, could also dampen growth somewhat. Oil prices continue to be underpinned by ongoing strong growth in global demand, particularly from China and India, a lack of spare capacity, relatively low stock levels, and ongoing threats of disruption to supply. In a very tight oil market, there is a risk of prices rising further in the event of a supply or demand shock.



*Recent developments in the United States* - The US economy ended its third year of expansion with an estimated growth rate of 3.8% in the fourth quarter of 2004. For the year as a whole, real GDP expanded by 4.4%, the highest growth rate in five years. The main contributing factors were strong household and business spending. Private consumption was supported by a resumption in employment growth after two years of “jobless recovery”. The labour market continued to improve gradually in the first quarter of 2005 although payroll employment growth slowed somewhat.

Inflation, measured by the increase in the headline consumer price index (CPI), has edged up against the background of higher energy prices and a continuing downward trend in the dollar’s exchange value. Twelve-month “core” inflation, i.e. excluding the volatile components of food and energy, reached 2.3% in January 2005 when measured by the CPI. At the same time, inflation expectations have stayed well anchored. The Federal Reserve has removed monetary stimulus since June 2004 by raising short-term interest rates at a measured but steady pace.

The European Commission’s Spring 2005 Economic Forecasts points to a moderate slowdown in 2005. Household spending is expected to stay relatively strong in the first half of 2005, benefiting from still accommodative financial conditions and the related rise in home prices, in spite of the dampening effect of higher energy prices. A slowdown is expected to set in around the middle of the year as a result of rising interest rates and the withdrawal of fiscal stimulus. Residential investment, in particular, is likely to receive a setback from rising long-term interest rates. Business investment may also slow down somewhat from the very robust growth seen over the past two years, partly because profit margins are expected to be under pressure from the cyclical downturn in productivity growth. Net exports are not likely to make a positive contribution to output growth this year.

*Recent developments in Japan* - After experiencing a technical recession in the middle of last year, with output falling in both the second and the third quarter, the Japanese economy expanded modestly in the fourth quarter, with GDP

growth reaching 0.5% on the back of a build-up in inventories. In spite of the weak performance in the last three quarters of 2004, strong growth in late 2003 and early 2004 resulted in an annual growth rate of 2.7% for the year as a whole, the highest since 1996. With the global outlook remaining relatively favourable, the major inventory adjustment expected to end and corporate profitability improving, partly as a result of a high capacity utilisation rate, the economy should rebound in the first half of 2005. However, the growth rate for the year as a whole is expected to be dampened by carry-over effects from 2004.

The year-on-year change in headline CPI turned positive last autumn, but this was largely due to a strong rise in fresh food prices. Core CPI, on the other hand, continued to fall, and, in January this year, the year-on-year fall stood at 0.3%. Given the very slow deceleration in underlying deflation and the lower growth projections, the year-on-year change in core CPI may turn positive only around the turn of the year.

*Recent developments in other parts of the world* - In the rest of the world, GDP growth continues to be very strong. Asian economies continue to grow at a rapid pace, with the tsunami expected to have only a very limited macroeconomic effect. In China, GDP growth is estimated to have reached 9.5% in 2004. After decelerating sharply in the second quarter, as a result of measures taken to rein in investment in some sectors, growth regained strength in the second half of the year. In Latin America, economic growth is estimated to have exceeded 5½% in 2004, with most economies expanding rapidly. While supported by high commodity prices and favourable financing conditions, growth in the region has become increasingly domestic-driven. However, the region remains vulnerable to shifts in investor sentiment.

Economic growth also remains sustained in most of the euro-area’s closest neighbours. Most of the newly acceded Member States continued to show a strong growth performance in 2004. In the UK, growth was supported by strong domestic demand, averaging 3.1% last year. EU candidate countries and many CIS countries remain on a high growth path. In Russia, however, growth decelerated at the end of last year, partly due to

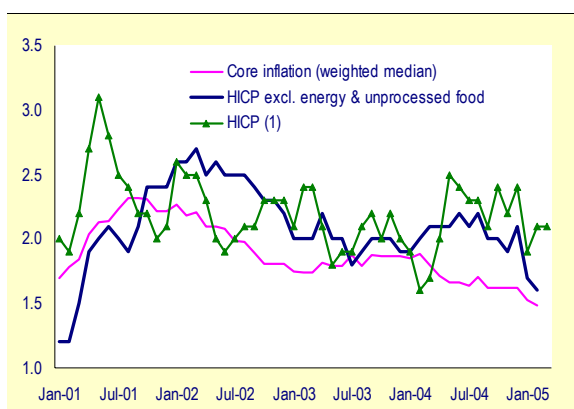
lower business confidence resulting from slower structural reforms and increased government intervention in the economy.

**Inflation is easing**

Euro-area annual HICP inflation decreased markedly at the beginning of 2005. After having reached 2.4% in December 2004, headline inflation came down to 1.9% in January 2005 and went up slightly in February, to 2.1%. Eurostat's latest Flash estimate points to a stable reading at 2.1% in March.

The rise in February was due to increases in food price inflation and energy price inflation. The rise in food prices is partly due to the effect of cold weather on some crops. Energy prices have kept rising in recent weeks and could put upward pressure in inflation in the next few months. On the other hand, base effects could offset these pressures as energy prices were also rising a year ago. Except for a small hiccup in December, core inflation has been on a clear downward trend since the summer. The HICP excluding energy and unprocessed food, fell to 1.6% in February, after 1.7% in January and 2.1% in December.

**Graph 6: HICP Inflation, euro area**  
(y-o-y changes in % – Jan 2001 to March 2005)



(1) March is only available for the HICP as whole (Flash estimate).  
**Source:** Commission services.

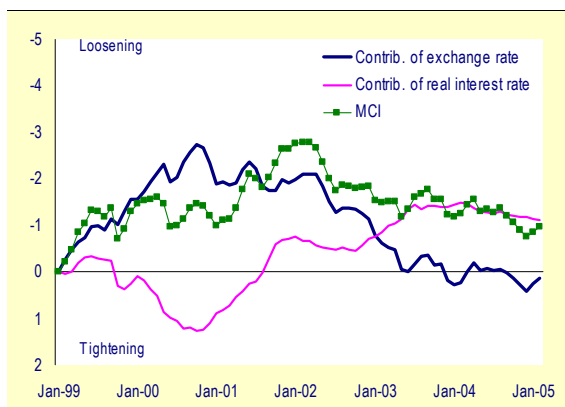
The European Commission's Spring 2005 Economic Forecasts project HICP inflation to average 1.9% in 2005. This is in line with other forecasts (Survey of Professional Forecasters, ECB staff macroeconomic projections) which project headline inflation in the euro area to

decrease further and to stay below 2% in 2005. More generally, both short and long-term inflation expectations appear relatively muted. According to DG ECFIN's *Business and Consumer Survey*, producers and consumers foresee downward pressure on prices in the months to come. In the meantime, developments in inflation-indexed bonds indicate that financial market participants expect a long-term inflation rate of around 2.1 percent. Overall the short-term outlook for inflation appears relatively benign. However, future oil price developments and possible changes in indirect taxes and administered prices are possible sources of upside risks for the inflation outlook.

**Monetary and financial conditions**

Monetary conditions in the euro area, as measured by the Monetary Conditions Index (MCI), tightened in the fourth quarter of 2004 but improved slightly in January and February 2005.

**Graph 7: The euro area MCI and its contributors**  
(inverted scale – Jan 1999 to Feb 2005)



**Source:** Commission services.

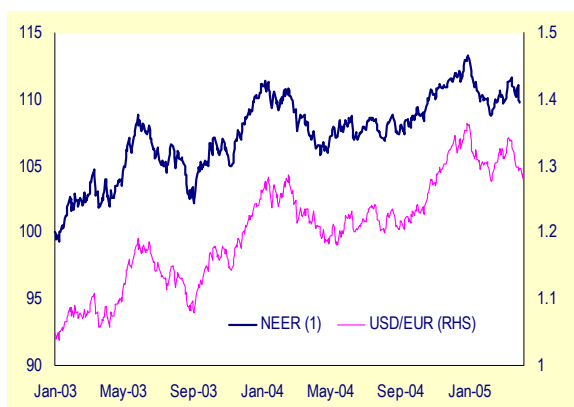
Movements in the MCI were driven by exchange rate changes as the ECB has left its key policy rate unchanged at 2% since June 2003. Nominal and real short-term interest rates are still very low by historical standards. Real short-term rates are currently still close to zero in the euro area, well below the 4.5% average registered in the 1990s. Financial market participants expect the ECB to keep interest rates on hold at least until the autumn. Market expectations, as derived from



future contracts, price in a first rate hike in the second half of 2005, followed by two more steps of 25 basis points each in 2006.

Since its rally in the last months of 2004, the euro exchange rate has been on a rollercoaster, moving from 1.36 USD/EUR in December to below 1.28 USD/EUR in February, back to 1.34 in March and below 1.29 at the end of March. On 7 April, the euro exchange rate stood at 1.29 USD/EUR. Explanations for the rollercoaster were alternating either positive news on the US economy when the dollar gained strength (as well as expectations about further Fed rate hikes) or renewed concerns about the US current account deficit when the euro was gaining strength.

Graph 8: Exchange rate developments  
(1 Jan 2003 to 7 April 2005)



(1) Nominal effective exchange rate against 41 countries  
1/1/03=100.

Source: Commission services and Datastream.

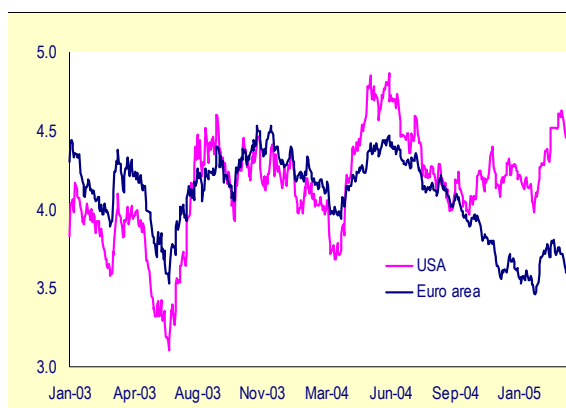
In the United States, the Fed has continued to remove monetary policy stimulus. Since 30 June, policy rates were raised seven times, totalling 175 basis points, to reach 2.75% in March 2005. Despite these rate hikes, monetary conditions in the United States are still accommodative with real short-term interest rates still close to zero and a depreciating currency.

On financial markets, the excess liquidity which has built up over the last years, has caught more attention recently. As a consequence of this excess liquidity, virtually all asset prices have surged over the last two years.

Government bond yields in the euro area and the United States declined until the beginning of

February. In addition to the excess liquidity argument, the most frequently cited explanations for the historically low levels of long-term interest rates include the selling of exchange rate reserves by Asian central banks for US bonds and a large appetite for long-duration assets among institutions such as pension funds and insurance companies.

Graph 9: 10- year government bond yields  
(in %– 1 Jan 2003 to 7 April 2005)



Source: Datastream.

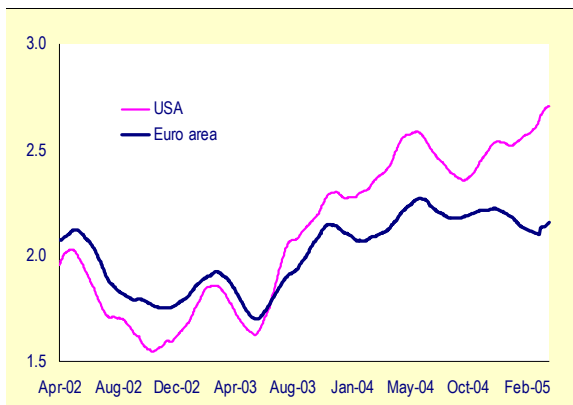
Since the beginning of February, long-term nominal bond yields in both the euro area and the USA have started to recover from their very low levels. In the euro area, long-term bond yields increased by about 20 basis points to reach 3.7% in March before declining in the first days of April to 3.6% on 7 April. US bond yields increased by 60 basis points until late March before easing slightly again to 4.4% in early April.

In the US, the increase in bond yields in February and March was largely prompted by market expectations about future Fed hikes and reactions to Alan Greenspan's testimony before the US Congress on 16 February in which he called the low level of long-term bond yields a "conundrum". The testimony was taken by market participants to mean that the Fed believes that long-term bond yields have become excessively low. Moreover, markets' inflation expectations seem to have shifted upwards in the USA (Graph 10). In contrast, economic data releases did not really explain the rise of long-term yields in the euro area, as inflation data was lower than expected, the outlook for growth did not improve and inflation expectations eased



slightly. Therefore, the driving factor behind the euro-area bond yields may also have been Mr Greenspan's testimony.

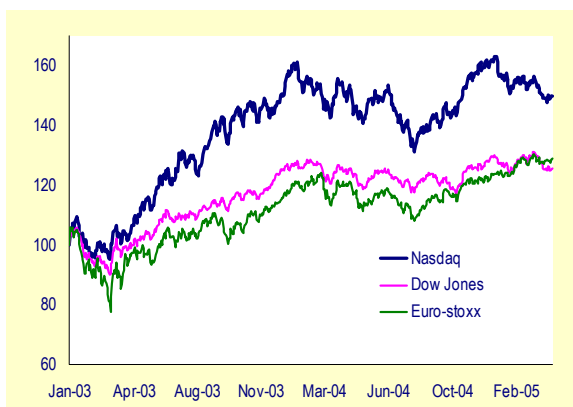
Graph 10: Break- even inflation rate (1)  
(in % – 1 Apr 2002 to 7 Apr 2005)



(1) Based on inflation-indexed bonds.  
Source: EcoWin.

The different developments at both sides of the Atlantic have further increased the spread on US/euro-area government bond yields to almost 100 basis points, the highest level since March 2000. The widening of the spread was probably strongly linked to the appreciation of the euro exchange rate in the fourth quarter of 2004, offsetting to some extent the negative trade effects from the stronger currency. By contrast, the recent increase in the spread rather coincided with a weakening of the euro exchange rate.

Graph 11: Stock market indices  
(1/1/03=100 – 1 Jan 2003 to 7 Apr 2005)



Source: Datastream.

Fuelled by excess liquidity, equities continued their upward trend. Major stock markets in the USA, Japan and the euro area gained between 30% and 40% between the first quarter of 2003 and the fourth quarter of 2004. Since the beginning of 2005, stock markets at both sides of the Atlantic have slightly diverged. In the euro area, stock markets have gained some 3% since January, while the Nasdaq and the Dow Jones have lost the gains of the last weeks of 2004. In particular the sharp rise in oil prices and the increase in long-term bond yields seemed to have had an overall dampening effect.



## 2. Structural factors weighing on the investment recovery

Euro-area investment has expanded by less than 2.5% in annualised terms over the past three quarters. The recovery has so far been disappointing in light of the prevailing sound macroeconomic fundamentals. Profitability has been improving steadily since mid-2003. Meanwhile real long-term financing costs are quite supportive and corporate balance sheets have improved significantly.

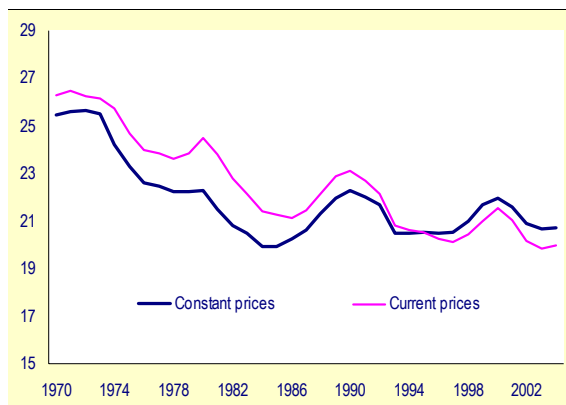
Yet, only a fraction of the increased liquidities resulting from loans and improved cash flows has so far been transformed into hard investment. On the corporate side, there is some evidence that companies are instead accumulating short-term liquid assets or using existing liquidities to boost dividend payments and engage in share buyback activities.<sup>5</sup> On the household side, the surge in mortgage credit in the past few quarters has been absorbed more by higher real estate prices than by increased residential construction activity.

These developments suggest that some negative forces are currently still weighing on capital formation in the euro area. Uncertainty regarding the short-term outlook for domestic demand is a possibility. However, other factors of a more long-term/structural nature seem to be also playing a role.

### A long-term view of investment shares

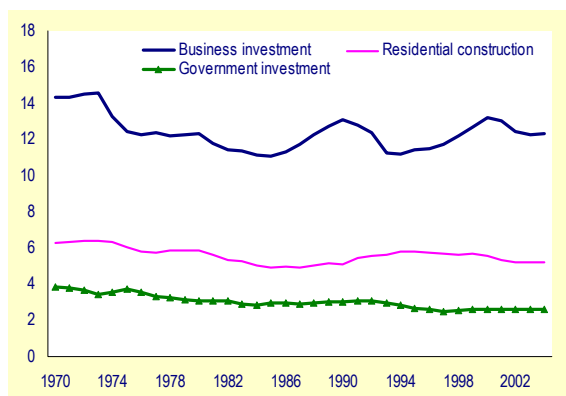
In order to put recent investment developments in a longer-term perspective, Graph 12 displays the share of total gross investment in GDP in the euro area over the past three decades. The share fell markedly in the 1970s. Since the late 1980s, it has been subject to large cyclical swings but has displayed no clear trend when measured in constant prices. However, a significant decrease in the investment deflator relative to the GDP deflator means that the investment share in nominal terms trended further downwards in the 1990s.

Graph 12: Gross fixed capital formation, euro area (share of GDP in % – 1970-2004)



Source: Commission services.

Graph 13: Gross fixed capital formation, euro area (share of GDP in % – constant prices – 1970-2004)



Source: OECD.

Turning to the sectoral composition of capital formation in the euro area, Graph 13 displays the respective shares in total GDP of business investment, residential construction and government investment. All three sectors experienced a fall in their share in GDP up to the mid-1980s. Subsequent developments have diverged somewhat:

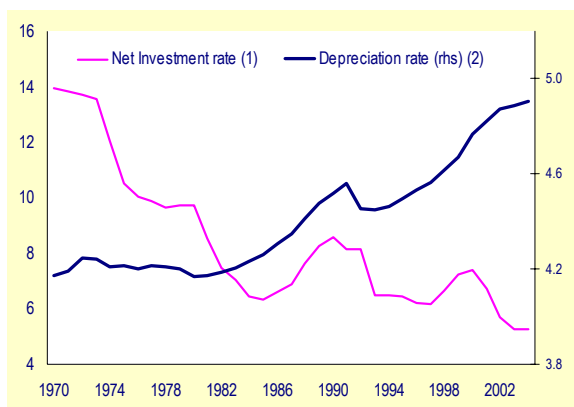
- Developments in total investment tend to be dominated by business investment, which is its largest component.
- The share of government investment in GDP dropped until the mid-1990s and stabilised thereafter.
- After a rise in the early 1990s, the share of residential construction fell during the second

<sup>5</sup> See Goldman Sachs Euroland Weekly Analyst 10<sup>th</sup> December 2004.

half of the 1990s and has remained broadly constant in the past few years.

Two arguments suggest that developments in investment in the 1990s were disappointing despite the absence of a clear downward trend in the overall gross investment share.

**Graph 14: Net fixed capital formation and depreciation rate of the capital stock, euro area**  
(in % – constant prices – 1970-2004)



(1) Net total investment as a share of GDP.

(2) As a share of the capital stock.

Source: Commission services.

First, the increasing importance of investment equipment with a short lifespan, particularly ICT, has translated into a noticeable rise of the speed of depreciation of the capital stock since the 1980s. As a result, and contrary to the relative stability observed in the case of gross investment, the share of net investment (i.e. excluding depreciation) in GDP has shown a persistent downward trend over the past two decades (Graph 14). The trend decline in net investment shares is particularly visible in the business sector in countries including Finland, Germany, and Belgium. This can be seen in Table 3 which displays the change in the ratio of net business investment to business value added between the peaks of the two latest investment cycles for some Member States.<sup>6</sup>

Second, large improvements in some key determinants of capital formation in the 1990s should, a-priori, have led to a trend rise of the

<sup>6</sup> The shares are based on OECD data, which are only available for some Member States and not for the euro area as a whole.

investment share over the same period. As discussed in a previous issue of this report, measures of profitability showed a sharp improvement in the euro area during much of the 1990s.<sup>7</sup> Furthermore, the cost of capital has been on a marked downward trend since the mid-1990s mostly due to falling real interest rates and, to a lesser degree, to a drop in the relative price of investment equipment (Graph 15).

**Table 3: Changes in net business investment shares(1) between cyclical peaks**  
(selected euro area Member States)

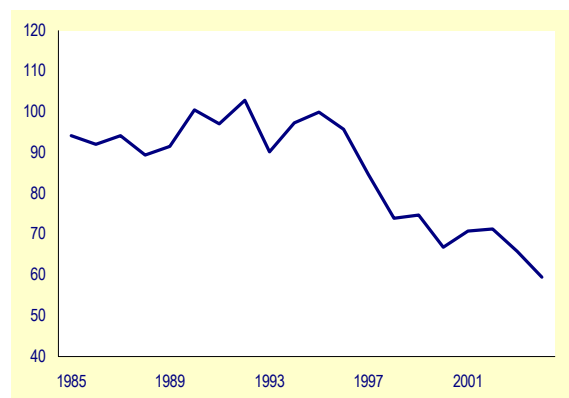
	Peak years	Change in, share (2)
Belgium	1990-2000	-2.5
Germany	1992-2001	-4.1
Spain	1991-2000	-1.0
France	1991-2000	0.0
Ireland	1990-1999	3.0
Italy	1990-2000	-0.8
Netherlands	1990-1999	1.3
Austria	1991-2000	0.4
Finland	1989-2001	-9.9

(1) Share of net business investment in constant prices divided by business value added in constant prices.

(2) Change in percentage points between the two peak years.

Source: based on OECD data

**Graph 15: Real cost of capital,(1) euro area**  
(index 1995=100 – 1985-2004)



(1) The real cost of capital is based on the Jorgenson formula. It takes into account changes in real interest rates, in capital depreciation and in the relative price of investment equipment.

Source: Commission services.

<sup>7</sup> Quarterly Report on the Euro Area Volume 3, No 3 (2004).

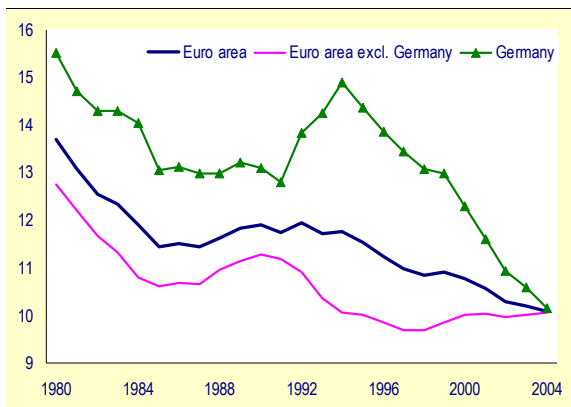


Overall, developments in investment since the 1990s suggest that some factors of a structural or longer-term nature were already weighing on capital formation in the euro area in the period of relatively sustained growth of the late 1990s and are probably still hampering the investment recovery today. The euro-area economy has undergone a number of shocks over the past 15 years, some of which may have left a lasting legacy on capital formation. Possible candidates include the construction boom/bust due the German unification process, globalisation, a significant slowdown in technical progress and a positive employment shock.

### The unification overhang

A possible explanation for the ongoing sluggishness of investment spending in the euro area is the negative effect of the capital overhang resulting from the construction boom that followed German unification in the early 1990s. Between 1990 and 1994, German construction investment increased by about 24% in constant prices, leading to a significant increase in the investment share. Although the surge reflected the one-off need to install a modern capital base and refurbish the housing stock in the new eastern Länder, it probably also led to some overinvestment.

Graph 16: Investment in construction as a share of GDP, euro area (in % – constant prices – 1980-2004)

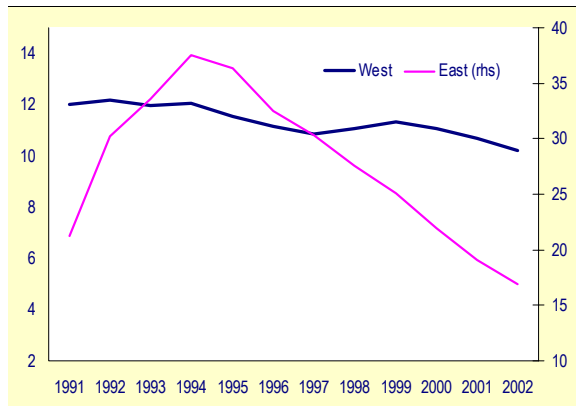


Source: Commission services.

Sluggish construction investment in Germany has unquestionably weighed on the euro-area investment share since the mid-1990s (Graph 16) and is continuing to hamper the recovery.

Nevertheless, in the past few years, it has become increasingly difficult to ascribe this trend to the unification overhang. First, the share of construction investment in GDP in Germany has dropped continuously and steeply since 1994 and is now far below its pre-unification level.<sup>8</sup> Second, the breakdown of investment data by regions shows that the current weakness of German construction is attributable to both eastern and western Länder, with the share of construction investment in GDP showing a moderate downward trend since the mid-1990s in the latter (Graph 17).

Graph 17: Investment in construction as a share of GDP in Germany, regional breakdown (in % – constant prices – 1991-2002)



Source: Arbeitskreis VGR dl.

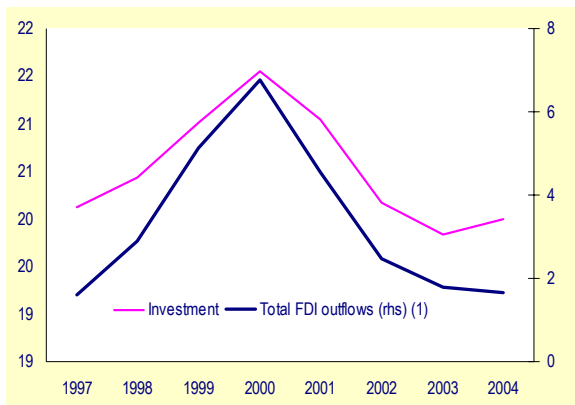
Overall, the analysis suggests that even if the German construction sector is still weighing on the euro area investment recovery, this can no longer be attributed to the unification overhang. Furthermore, although it has been an aggravating factor, the weakness of capital formation in Germany is not the only explanation for the sluggish performance of investment in the euro area in the past few years. Hence, the net total investment rate of the euro area excluding Germany has also displayed a clear downward trend since the 1990s.

<sup>8</sup> Calculations show that even if the entire additional capital stock attributable to the higher than pre-unification level of the rate of investment observed between 1992 and 1997 were to be considered excess capital – a quite extreme assumption – the overhang would have been totally absorbed by the end of 2002.

### The globalisation process

Globalisation and the associated increasing importance of foreign direct investment are popular explanations for the investment weakness in the euro area.

Graph 18: Total FDI outflows and domestic investment, euro area (in % of GDP 1997-2004)



(1) 2004 is estimated.  
Source: Commission services.

It is true that net outflows of FDI, after having dropped to close to zero in 2002-03, have resumed an upward path since 2004. However, as discussed in more detail in a previous issue of this report,<sup>9</sup> there is no firm evidence that FDI outflows have taken place at the expense of domestic investment in recent years. For the euro area as a whole, a positive correlation between total FDI outflows and domestic capital formation can be observed since the mid-1990s (Graph 18), suggesting that common factors are driving the two forms of investment. Furthermore, there is no evidence that those Member States which have invested more heavily abroad have tended to suffer from weaker domestic investment rates.

### The role of TFP and employment shocks

Total factor productivity (TFP) measures the efficiency with which primary factors (namely capital and labour) are used in the production process. Measures of growth in TFP can be

<sup>9</sup> Focus section on “Foreign direct investment in EMU”, Quarterly Report on the Euro Area, Volume 3, No 4 (2004).

interpreted as measures of the pace of technical progress. In this field, the performance of the euro-area economy in the past few years has been pretty disappointing, with a marked deceleration of trend TFP growth since the mid-1990s.

In the neo-classical growth model, a downward shift in the pace of technical progress entails a drop in the steady-state (i.e. long-run) investment rate under fairly general conditions.<sup>10</sup> A slowdown in the pace of technical progress negatively affects the marginal product of capital and thus weighs on capital accumulation. The effect is permanent in the sense that a permanent downshift in the pace of technical progress entails a permanent drop in the investment rate.

Box 1 analyses relative trends in TFP and investment in the euro area and the USA and also presents the results of a panel regression of investment based on data for 17 countries (the EU-15, US and Japan). Both the comparison between the USA and the euro area and the econometric analysis provide strong support for the argument of a positive impact of trends in TFP on investment growth. It is important to stress that, although there could be a positive causal link from investment to TFP<sup>11</sup>, the lags observed between trends in TFP and trends in investment suggest that the causality mostly runs from TFP to capital formation.

Turning to employment, a standard result of neo-classical growth models is that there is a positive long-run (i.e. in the steady state) relation between growth in the capital stock and trend employment growth. A positive employment shock resulting from labour market reforms or changes in the wage bargaining system will entail a temporary acceleration in employment growth that will be matched by a pick-up in capital formation until the long-run capital to employment ratio is restored. The graphs in Box 1 provide some evidence of both a positive employment shock in the euro area in the 1990s

<sup>10</sup> See for instance King, R. G., Plosser, C. I. and S. Rebelo (2002), “Production growth and business cycles: technical appendix”, Computational Economics, 20(1-2), pp 87-116.

<sup>11</sup> For instance, via the technological progress embedded in new generations of capital equipment.





### Box 1: Total factor productivity, labour supply and capital formation

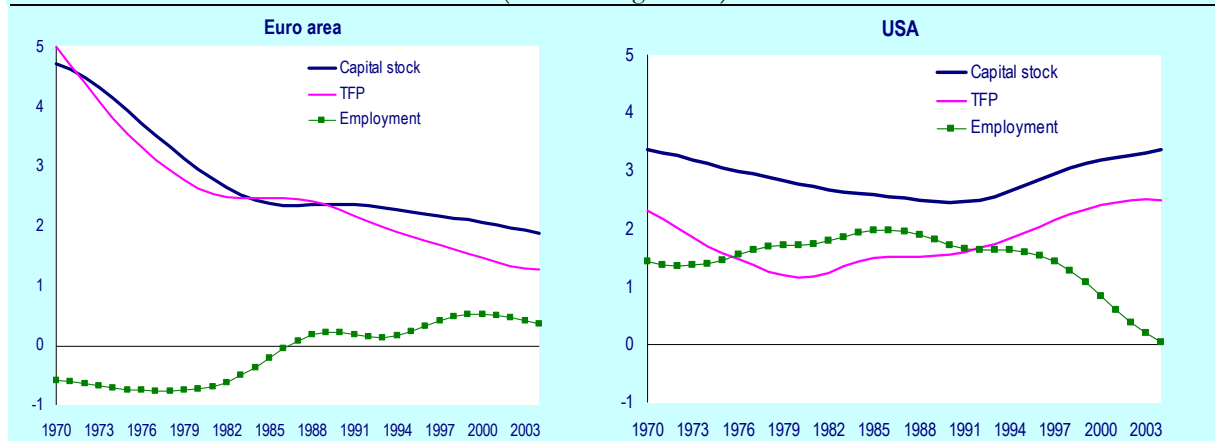
The most important prediction of standard growth models is that trend growth of the physical capital stock is determined by trend employment growth and the growth rate of technical progress. These factors also play a role in the short run but there are other short-run factors such as variations in aggregate demand which affect investment behaviour.

A good testing ground for assessing secular trends between employment and TFP on the one hand and capital formation on the other is a comparison between the euro area and the USA over the last few decades. Both regions have shown very distinct patterns of TFP growth. Starting from a declining growth trend of TFP in both areas in the 70s, a divergence emerged in the 80s. The US achieved an acceleration of TFP growth which has continued until the present. In contrast, euro-area TFP has declined persistently. According to standard growth models this development should be mirrored by trend growth rates in the capital stock. As can be seen from the two graphs below, this is indeed the case.

In the euro area the decline in the trend growth of capital accumulation closely follows the trend decline of TFP growth with a certain lag. Some inertia in the investment response must be expected because of the uncertain nature of trend revisions in real time. Since the late 1990s a divergence can be seen, with capital growth declining less than predicted by the TFP trend. This is due to stronger employment growth in the euro area.

In the case of the US the trend growth of the capital stock started to accelerate after the increase in TFP growth in the early 80s, though with a considerable lag. Apart from inertia in the investment response, an important factor preventing a rapid trend reversal in capital growth was the decline in the growth of labour input which started in the 80s. The parallel movement between capital and TFP growth in the 90s is surprising given the decline in the trend growth of employment. A possible explanation for the strong measured volume growth of capital in recent years is the use of hedonic deflators for ICT investment which represents a significant share of total US capital formation. (\*)

Trends of capital, TFP and employment growth (1)  
(annual changes in %)



(1) TFP growth is calculated as the difference between the growth rate of GDP and a weighted average of capital and labour input. Labour input is measured in total hours of work. All trend series are calculated via the HP filter.

Source: Commission services.

Does TFP and employment also affect investment in the short run? This is more difficult to assess since theory is less clear about the short run and also because there are other factors such as aggregate demand and short-term variations in capital costs which may affect the allocation of investment over time. In order to control for these additional factors a panel regression for the EU-15, the US and Japan has been conducted using time series information for the period 1980 to 2003. As can be seen in the next table, variations in TFP and shocks to employment have a significant effect on investment growth. For TFP a more delayed investment response can also be found in the regressions with significant lags up to two years. The elasticity of TFP growth to investment growth is close to two. The change in employment is also significant. The regression results show that TFP and employment remain important factors after controlling for the business cycle, capital costs and stock market effects. The business cycle effect is captured by the growth rate of GDP and has the expected positive sign. The two components of capital costs, the relative price of investment goods and the real interest rate have a sizeable negative

impact on investment. Finally expectations of the return on capital investment captured by stock market indices contribute positively to investment (but the t-stat is only significant when the sample is reduced to the last 15 years).

<b>Determinants of investment</b> (all variables in first differences except real interest rates)				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	-0.018537	0.007279	-2.546788	0.0114
TPF	1.257118	0.307747	4.084905	0.0001
TPF (-1)	0.419652	0.169892	2.470103	0.0141
TPF (-2)	0.425716	0.157039	2.710895	0.0071
Employment	1.422957	0.204825	6.947184	0.0000
Investment price	-0.655264	0.140327	-4.669540	0.0000
Real interest rate	-0.002926	0.001210	-2.418156	0.0162
Stock market index	0.011408	0.10447	1.092014	0.2757
GDP	0.598971	0.241701	2.478144	0.0138
<b>Effects specification</b>				
Cross-section fixed (dummy variables)				
Period fixed (dummy variables)				
R-squared	0.782928	Mean dependent var	0.022402	
Adjusted R-squared	0.748377	S.D. dependent var	0.060041	
S. E. of regression	0.030118	Akaike info criterion	-4.038335	
Sum squared resid	0.262144	Schwarz criterion	-3.504394	
<i>Source:</i> Commission services.				

(\*) The OECD (2001) has conducted extensive international comparisons using harmonised deflators. These estimates suggest that over the 90s, the acceleration of US investment growth would have been more modest if EU methods to deflate nominal investment had been used. Based on the EU methods, annual growth in the capital stock would still have picked up in the USA over the decade but the acceleration would have been significantly smaller (from 2.5% to 2.8% instead of 2.5% to 3.3%).

and a positive relation between capital and employment.<sup>12</sup> However, the positive employment shock observed in the euro area has only partly offset the negative impact on investment of the adverse TFP shock.

## Conclusion

The evidence presented in this section suggests that the sluggishness of the investment recovery in the euro area in the last three quarters may partly reflect longer-term structural trends and may not only be the consequence of short-term uncertainties related to the strength of consumer demand. This structural weakness is more likely to be related to the deceleration of the pace of technical progress registered in the euro area

since the 1990s than to globalisation or the unification overhang.

In the years to come, faster capital accumulation would require either a trend improvement in the rate of technical progress or a further increase in trend employment growth. Because of a continued decline in the growth rate of the population of working age, it is unlikely that employment will grow at a higher rate than seen since the mid-90s where growth was fuelled by both a continuous increase in the participation rate and a decline in the NAIRU. Also TFP growth has been sluggish since 2001 and so far there are no signs of a fundamental trend reversal in the rate of technical progress in the euro area as a whole

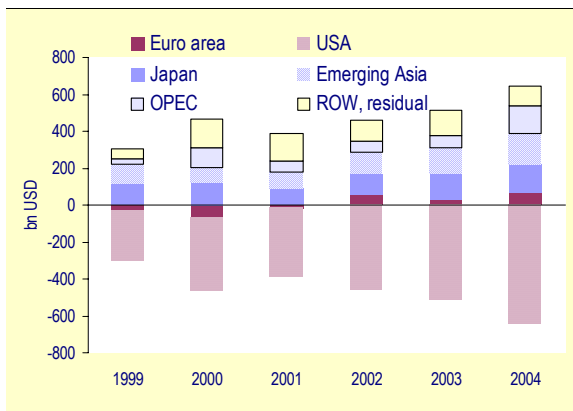
<sup>12</sup> It is important to stress that, although a positive employment shock will entail a temporary acceleration of capital accumulation, it will leave the long-run investment to GDP ratio unaffected. It may even temporarily depress the investment rate if capital adjustment is sluggish and capital accumulation responds to the acceleration of employment growth with a lag.



### 3. Current account developments in the euro area

While the US current account deficit has received a lot of attention, the position of the euro area current account has hardly been discussed. This might be due to the fact that the current account has remained close to balance since 1997. A small deficit was recorded in 1999-2001, which has turned into a surplus of less than 1% of GDP since 2002.

Graph 19: Global current account balances, (billions of USD – 1999 to 2004)

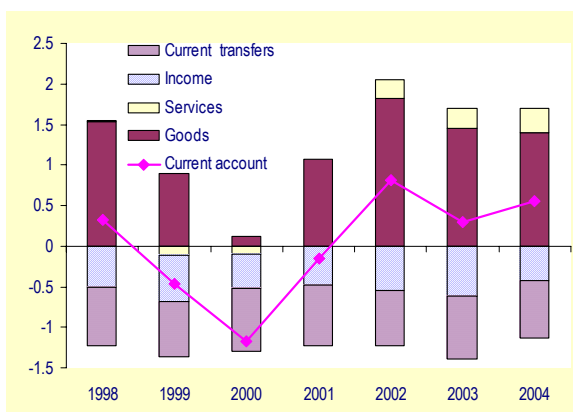


Source: Commission services.

#### Current account, trade and the exchange rate

As shown in Graph 20, changes in the euro area current account position are dominated by changes in net trade in goods, with the other components, notably income and current transfers remaining relatively stable.

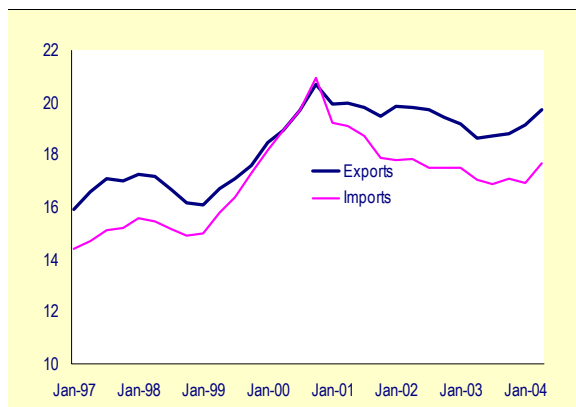
Graph 20: Composition of the euro area current account (% of GDP – 1998 to 2004)



Source: ECB.

Since 1997, export and import values have moved largely in parallel (Graph 21), suggesting that joint forces such as the global business cycle and production linkages are relatively important determinants of trade growth, compared to diverging forces such as movements in the exchange rate or growth differences.

Graph 21: Trade in goods and services, euro area (% of GDP – 1997Q1 to 2004Q2)

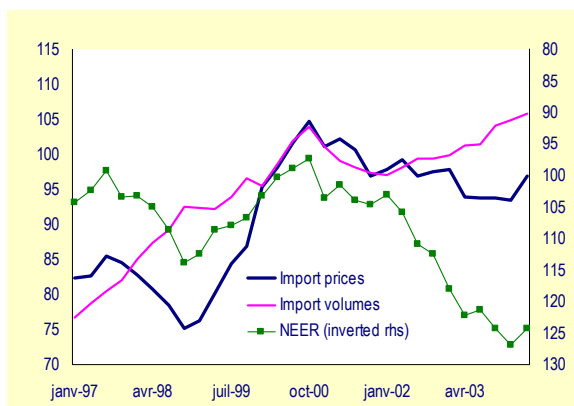


Source: Commission services.

Given the strong dependency of the change in the current account balance on net trade in goods, it is perhaps surprising that a current account deficit materialised in 1999-2001 when the euro depreciated, whereas a surplus was recorded in 2002-04 when the euro appreciated. However, a depreciating currency rarely causes an increasing current account surplus in the short term, given that depreciation increases the costs of imports, while substitution possibilities are limited in the short term (giving rise to the so called 'J-curve').

Graph 22 confirms that euro-area import prices increased when the euro depreciated between 1999 and end-2000. However, import volumes also accelerated, which suggests that it was both the lack of substitution possibilities and the impact of strong domestic demand in the euro area (which was then at the peak of its economic cycle) that caused the deficit. A surge in oil prices also contributed to the widening of the deficit in 2000. Import volumes declined throughout 2001 due to weakening domestic demand and despite falling import prices.

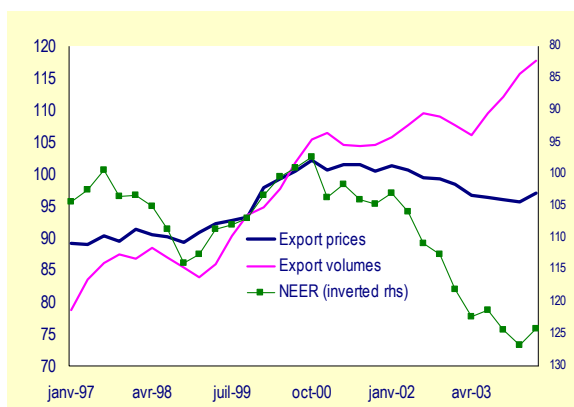
Graph 22: Imports of goods, euro area(1)  
(1997Q1 to 2004Q2 – index 2000 = 100)



(1) Based on extra-area trade data which (unlike BOP data) are only available for goods but not for services.  
**Source:** Commission services.

Following the euro’s appreciation from 2001, import prices declined, although the change in prices was less marked than during the depreciation period as oil prices remained high. With import volumes rebounding from 2002 onwards, it was mainly the exchange-rate-led reduction in import prices that initially raised the current account surplus from 2002 onwards.

Graph 23: Exports of goods, euro area (1)  
(1997Q1 to 2004Q2 – index 2000 = 100)



(1) Based on extra-area trade data which (unlike BOP data) are only available for goods but not for services.  
**Source:** Commission services.

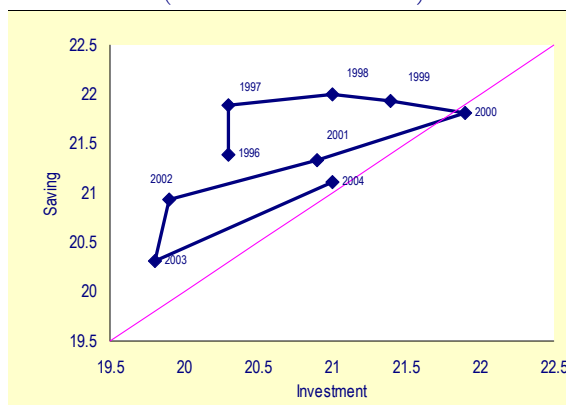
Strong export growth has played an increasingly important role in maintaining the surplus from mid-2003 onwards. Export growth has increased, despite the higher value of the euro, as a result of exporters reducing export prices in order to

preserve market shares and the robust recovery in world demand.

### Saving-investment gap and the financing of the current account

The current account surplus means that the euro area is a net exporter of capital and that, in turn, domestic saving is (slightly) larger than investment. Graph 24 shows the development of the euro-area’s national savings and investment shares over time, with the difference from the 45 degree line approximating the current account balance to GDP ratio.<sup>13</sup>

Graph 24: Investment and saving, euro area  
(% of GDP – 1996 to 2004)



**Source:** Commission services.

The changing sign of the euro-area current account balance over time appears to be mainly related to developments in the euro-area investment share. A deteriorating current account balance in 1997-2000 was accompanied by a rising investment share and stable saving rate. In 2001 and 2002, both investment and savings fell relative to GDP, although investment decreased much more strongly than savings, with the opposite happening in 2003.<sup>14</sup>

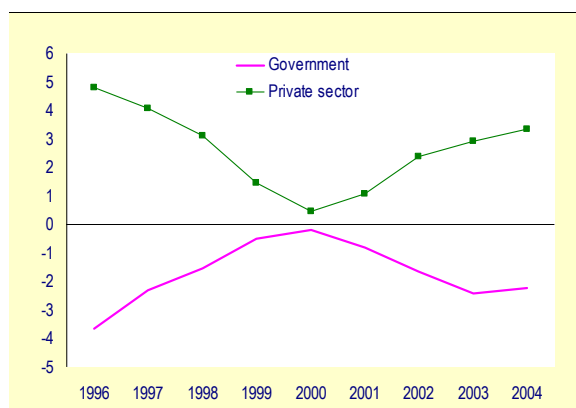
<sup>13</sup> In contrast to Graph 19, Graph 24 shows a current account surplus in 1999 and 2001. This is due to the fact that ECB BOP data is adjusted for reporting errors whereas saving and investment in national accounts is not.

<sup>14</sup> It is worth stressing that changes in the euro-area current account since 2000 have been dominated by the progressive build-up of a large current account surplus in Germany which, itself, owes both to an increase in the



The sector breakdown of the savings-investment gap reveals that a major factor behind the relative stability of the current account in the euro area (at least when compared with the USA) has been the almost complete offsetting effect of changes in the public and the private savings-investment gap (Graph 25). During the second half of the 1990s, improving government balances were offset by a deterioration of private sector balances. Since 2000 the opposite offsetting effect has been observed. The symmetry between the behaviours of the private and the public sector may be partly explained by the fact that both sectors have been affected in opposite ways by the same cyclical developments. It may, however, also be an indication that so-called Ricardian effects have, to some extent, been at play, with the private sector partly adjusting its savings-investment gap in response to changes in the government balance.

Graph 25: Sectoral breakdown of saving/investment gap, euro area (% of GDP – 1996 to 2004)



Source: Commission services.

Finally, it is interesting to note that developments in investment and savings behaviour were similar among non-financial corporations and households, suggesting that both sub-sectors have been exposed to similar factors.

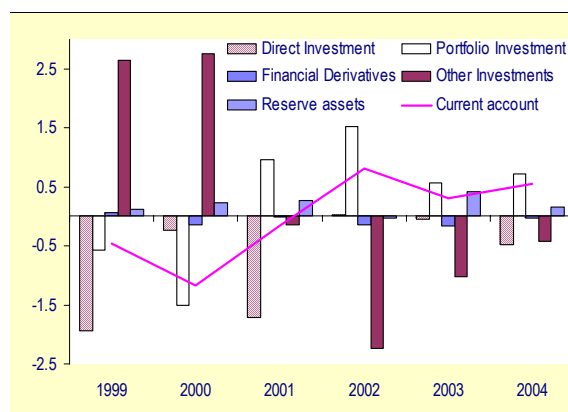
The euro-area current account surplus is accompanied by a deficit in the financial and capital account of the balance of payments. This signifies that the euro area is a net investor

national saving rate and, above all, a substantial drop in the investment rate.

overseas, with a negative figure in the financial account referring to positive net investment outside the euro area.

Interpreting changes in the financial and capital account is particularly difficult given the large weight of errors and omissions (which ensure that the different accounts of the balance of payments do balance) and the residual category of the financial account, 'other investment'.

Graph 26: Financial account components (1)  
(net flows as a % of GDP – 1999 to 2004)



(1) A positive (negative) number indicates a net inflow (outflow) into (out of) the euro area.

Source: ECB.

Graph 26 shows that there has been no firm trend in recent years as regards the financial account categories in surplus or deficit with the residual category, which includes trade credit and advanced payments for exports and imports, playing the dominant role as counterpart to changes in the current account.

The euro area has seen persistent net outflows of direct investment (FDI) since the late 1990s. After having reached a peak in 2000, net FDI outflows dropped dramatically to close to zero in 2002-03 before increasing slightly again in 2004.<sup>15</sup> Both inflows and outflows are now well below the peak levels reached in 1999-2000, mirroring a similar decline in global FDI flows. This can largely be related to the bursting of the equity bubble in 2000 with lower equity prices and a

<sup>15</sup> For a full discussion of FDI trends see Quarterly Report on the Euro Area Vol. 3, No.4 (2004).



lower level of mergers and acquisition activity both hampering FDI flows.

Portfolio investment was unusually volatile at the start of the decade due to one-off factors associated with the launch of the euro (increased euro bond issuance, selling of euro-area equities in order to reintroduce currency diversification and changing supervisory rules<sup>16</sup>), and the takeovers of Mannesmann by Vodafone<sup>17</sup> in 2000 and of Voicestream by Deutsche Telekom in 2001.

It now appears that these one-off factors have been played out with the euro area becoming a net recipient of portfolio investment since 2001. The euro area has seen a net inflow of portfolio equity investment in each of the last four years (Graph 27) having been a net investor overseas in 1999 and 2000. The largest portfolio flows are in bonds and notes, for which the balance continues to fluctuate. The overall trend since 1999 is of increasing net portfolio investment into the euro area in equities. Flows of debt instruments are almost in balance following an increased outflow of debt instruments over the last two years.

Graph 27: Portfolio Investment flows (1)  
(inflows and outflows as a % of GDP – 1999 to 2004)



(1) A positive (negative) number indicates an inflow (outflow) into (out of) the euro area.  
**Source:** ECB.

<sup>16</sup> See Quarterly Report on the Euro Area Vol. 1, No.2 (2002) for a more detailed analysis.

<sup>17</sup> Vodafone’s takeover of Mannesmann in 2000 resulted in direct investment into the euro area of €187 billion, balanced by portfolio investment outside the euro area.



## Focus

### II. The export performance of the euro area

*There are no apparent signs of structural weaknesses in the euro-area's export performance. The share of euro-area exports in total world trade has remained relatively steady over most of the past decade. Mirroring fluctuations in the euro exchange rate, it increased in 2000-01 but dropped again in 2002-03. In addition to price competitiveness, geographical and sectoral specialisation effects may play an important role in explaining a country's export performance. There is no evidence that export growth in the euro area has been hampered by less favourable specialisation than in the USA in recent years. In the past few years, the overall euro-area export performance has concealed large differences at Member State level. Diverging developments in price competitiveness have been a key source of cross-country disparities in export growth. However, these competitiveness effects have been partly masked by differences in geographical and, above all, sectoral specialisation. Differences in specialisation create the possibility for asymmetries in the transmission of common external shocks as countries respond differently to changes in the sectoral or geographical drivers of world trade. There is in fact some evidence that some shocks, mostly of a sectoral nature, have had a significant impact on country differences in export growth within the euro area since the late 1990s.*

Over the last few years, external demand has played a substantial role in shaping the euro-area's overall growth performance while making quite different contributions to the recovery, depending on the Member States considered. Against this background, this Focus section takes a closer look at the export performance of the euro area. A first section analyses aggregate euro-area export growth, focusing in particular on the role of trade specialisation in explaining market share developments. A second section explores the Member State dimension with a view to assessing the factors that explain the differences in individual countries' export performances.

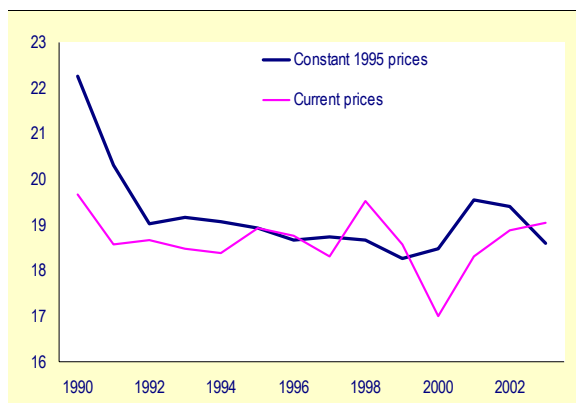
#### 1. The euro-area's position in world trade

##### Developments in the euro-area's share of world trade

Graph 28 displays the share of euro-area exports (excluding intra-area trade) in total world trade of goods for the 1990-2003 period. The share is calculated both in current and in constant prices. It is important to stress that both measures come with their shortcomings. On the one hand, price effects, and particularly changes in the exchange rates, may severely distort the information content of the share estimated in value. On the other hand, price adjustments in foreign trade data should be considered with caution insofar as they are based on less sophisticated statistical

procedures than is the case for domestic price indices.<sup>18</sup>

Graph 28: The euro-area's share of world exports of goods (1) (1990 to 2003)



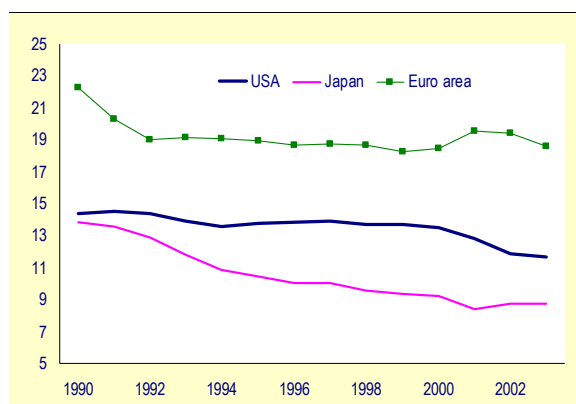
(1) Ratio of extra-euro-area exports to total world exports, excluding intra-area trade.

Source: WTO, Commission services.

Developments in the euro-area's share of world trade provide no evidence of systematic underperformance of euro-area exports over the last decade. After a significant deterioration in the early 1990s, the euro-area's export performance has remained fairly stable, especially when measured in constant prices. Some gains in export share were registered in 2000-01 but were subsequently reversed in 2002-03.

<sup>18</sup> Foreign trade price indices are generally calculated by dividing trade data in value by trade data in volume measured in physical quantities and are therefore not adjusted for changes in product quality.

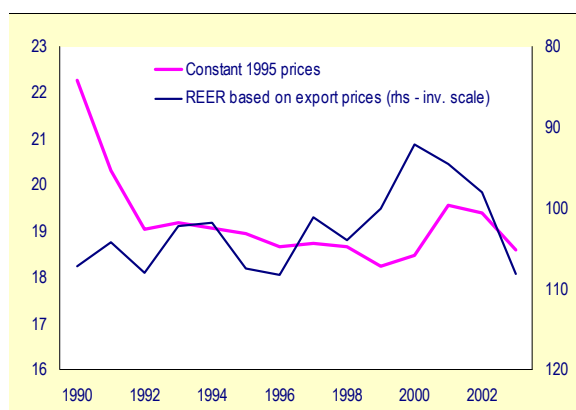
Graph 29: Share of world exports of goods, euro area, USA and Japan (1) (in % – constant prices – 1990-2003)



(1) Ratio of country/area's exports to total world exports. World and euro-area data exclude intra-area trade. **Source:** WTO and Commission services.

A comparison of developments in the share of world exports of the euro area, the USA and Japan, suggests a similar picture of relatively good performance of euro-area exports over the past 10 years. Between 1993 and 2003, the euro-area's share (extra-area trade only) declined by about 0.6 percentage points. Over the same period, market share losses in the USA and Japan were of the order of 2.2 and 3.0 percentage points respectively.

Graph 30: The euro-area's share of world exports of goods and the real exchange rate, (1) (in % - 1990-2003)



(1) Excluding intra-area trade. **Source:** Commission services.

Graph 30 shows that developments in the euro-area's share of world exports can partly be related to developments in the real exchange rate. The correlation between the two variables was weak

during the first half of the 1990s. It has increased since the mid-1990s, with the real effective exchange rate leading developments in export share by about one year. In particular, gains in competitiveness in the late 1990s were associated with a rise in export share whereas the appreciation of the euro since 2001 has clearly weighed on the euro-area's export performance in the past few years. Nevertheless, price competitiveness is not the only driver of changes in market shares. Another important determinant of a country's export performance is the nature of its trade specialisation. This aspect is discussed in the next two sections.

### The geographical and sectoral structure of euro-area exports

Empirical research has highlighted the importance of geographical proximity in determining trade flows. As shown in Table 4, exports from the euro area to other European countries clearly dominate euro-area exports, accounting for more than half of total shipments in 2003.

Table 4: Geographical structure of euro-area exports of goods (1)

	Share in total EU12 exports (value)		Growth (volume)
	1995	2003	1995-03
UK, SE and DK	24.8	24.2	60.7
10 New member states	7.4	11.0	141.4
Other western Europe	11.9	10.8	47.8
Other eastern Europe	4.0	5.4	118.2
India	1.1	0.9	30.6
China	2.1	3.3	159.0
Japan	4.1	2.9	16.9
Hong Kong, Taiwan, Singapore, Korea	6.3	4.3	11.8
Malaysia, Thailand, Indonesia, Philippines	3.2	1.6	-17.7
Other Asia	0.8	0.8	57.0
Africa	7.3	5.6	23.9
North America	13.5	17.0	105.5
Latin America	5.8	4.1	14.9
Near and Middle East	5.0	5.0	65.3
Other	2.7	3.1	75.1

(1) Extra-euro-area exports. **Source:** Commission services.

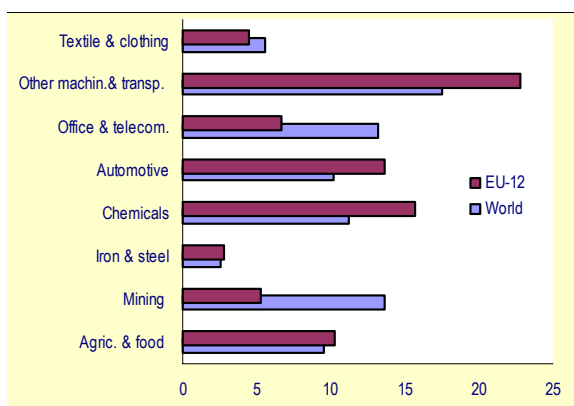
The euro-area's two largest single export destinations are the UK and the USA. As regards the most distant emerging and newly industrialised economies, exports to Asia are far



higher than to Latin America, with respective shares in total exports of 11% and 4% in 2003. Africa and Near and Middle Eastern countries are relatively important destinations for euro-area exporters, accounting for 5.6% and 5% respectively of total exports.

Looking at the growth picture, exports to the new EU Member States have been among the most dynamic, increasing by 140% in volume terms between 1995 and 2003. Other destinations which have experienced comparatively fast growth since the mid-1990s include other Eastern European countries, China and North America. In contrast, exports to Asia, excluding China, have been relatively sluggish, a development which may reflect several factors including the Asian crisis, intra-Asian trade integration and a deceleration of this region's contribution to world trade growth after the mid-1990s.

Graph 31: The relative sectoral specialisation of euro-area exports of goods (1) (in % - 2002)



(1) Share of each sector's exports in the regional exports of goods of the region considered. EU12 includes intra-area trade.  
*Source:* WTO.

As regards the sectoral structure of exports, the euro area is deeply integrated in the global value-added chain. This is evidenced by the fact that about half of euro-area exports are in intermediate goods. Consumer and capital goods constitute about 20% each. The euro area posts relative specialisation in manufacturing and particularly in the chemical, machinery and automotive sectors. This is shown by the fact that the share of these sectors in total exports is significantly higher for the euro area than for the world as a whole (Graph 31). In contrast, the

share of office and telecom equipment is lower than for the world as a whole, suggesting a relative weakness of the euro area in that sector.

Table 5: Sectoral structure of euro-area exports of goods (1) (in %)

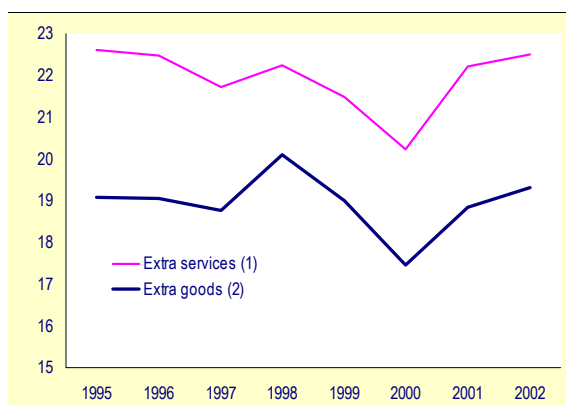
	Share in total EU12 exports in value		Growth volume 1995-03
	1995	2003	
Agricultural	9.4	7.7	29.5
Mining products	3.8	3.7	26.9
Fuels	1.9	2.2	18.5
Manufactures	80.3	82.3	70.1
Iron and steel	5.7	4.8	44.8
Chemical products	12.8	15.3	111.3
Machin. & transp. equip.	43.4	45.6	71.2
Office & telecom equip.	9.3	9.3	71.8
Textiles and clothing	6.8	5.5	25.1
Complete plants	0.6	0.3	-38.3
Miscellaneous	17.6	17.1	61.8
Total	100	100	63.1

(1) Extra-euro-area exports. The data displayed in this table are not directly comparable to those shown in Table 4

*Source:* Commission services.

Finally, while the focus of the analysis has so far been on goods, a word should be said about the importance of trade in services. Services account for about 20% of total world trade in goods and services and a similar share of total euro-area exports. Given this weight, services should a priori constitute an important part of any analysis of export performance.

Graph 32: The euro-area's share of world exports, goods and services (in % - current prices - 1996 to 2002)



(1) Share of extra-area exports of services in world exp. of services.  
(2) Share of extra-area exp. of goods in world exp. of goods.

*Source:* WTO, Commission services.

However, a problem with the inclusion of services in trade share analysis is the non-availability of trade data for services in volume. It

is thus impossible to calculate a joint share of goods and services in world trade that is undistorted by exchange rate movements. Since the mid-1990s, world trade in services has expanded much more rapidly than world trade in goods. However, graph 32 shows that developments in the euro-area's share in world exports of services in value have mirrored developments in the share in world exports of goods in the past few years, suggesting that the changes in the shares are driven by similar factors in the two sectors.

### The impact of trade specialisation on euro-area export performance

Constant market share analysis (CMS) can be used to calculate the incidence of a country's sectoral and geographical specialisation on its export performance (see Box 2 for more details on the methodology and data used). Using detailed export data broken down by sectors and geographical destinations, a CMS decomposition has been applied to the euro area (excluding intra-area trade), the USA and Japan. The results of the analysis are presented in Table 6. For each of the three countries/areas, the table displays a measure of the overall export performance and its decomposition into three effects. The overall performance is calculated as the difference between the country/area's export growth and the export growth of a benchmark group of 33 (mostly industrialised) exporting countries. Based on the CMS analysis, this total export performance is the sum of three effects: a pure market share effect (the export performance attributable to gains or losses in market shares on all individual markets<sup>19</sup>), an initial structure effect (the impact of the product and geographical specialisation observed at the beginning of the period of interest) and an adaptation effect (which captures the degree to which gains in market shares have been achieved on fast-growing markets).

An important caveat is necessary when interpreting the results of the table: in the absence of adequate price indices at sectoral level, the analysis was applied to value data and

<sup>19</sup> An individual market is defined by a combination of a specific sector and a specific geographical destination.

Table 6: Impact of specialisation on export performance (1) (in %)

	Euro Area	USA	Japan
<b>1994-2002</b>			
Total export perform.	3.9	-14.2	-44.7
of which:			
Pure market share	2.6	-12.1	42.1
Initial structure	4.0	-4.5	-2.4
Adaptation	-2.8	2.4	-0.1
<b>1998-2002</b>			
Total export perform.	-0.8	-13.7	-7.9
of which:			
Pure market share	1.3	-10.4	-11.7
Initial structure	0.9	-4.8	4.0
Adaptation	-3.0	1.6	-0.1

(1) Export performance is measured by the difference between export growth in the country considered and export growth in a benchmark group of 33 countries. Export growth is in value.

Source: Commission services.

results may therefore be distorted by price changes and exchange rate swings. Bearing this limitation in mind, four insights emerge from the analysis.

First, the mechanical effect of a country's product and geographical specialisation may have a substantial impact on its export performance. In the case of the euro area, about one third of the relative export growth over the 1994-2002 period can be explained by overall specialisation effects (as measured by the sum of the initial structure and the adaptation effects). For the shorter 1998-2002 period, specialisation effects even dominate pure market share effects.

Second, and not very surprisingly, the impact of trade specialisation may vary significantly depending on the period considered. This is due both to the fact that countries' specialisation may change over time and to the fact that a specific specialisation may be supportive in some periods and less supportive in others as sectoral and geographical sources of world trade growth fluctuate over time.

Third, the overall trade specialisation of the euro area does not appear unfavourable. Over the 1994-2002 period, structural effects have boosted the euro-area's export performance. The effects are negative when considering a shorter period (1998-2002) but less so than in the case of the USA. In recent years, the euro area has benefited from relatively strong specialisation in sectors



## Box 2: Constant market share analysis – an application to the euro-area export performance

### 1. The constant market share analysis

A country's export performance may be explained both by competitiveness developments and by a more or less supportive export structure. For a similar level of price competitiveness, a country exporting predominantly towards fast-growing markets will enjoy a stronger growth momentum than a country with a less favourable export structure. A large number of empirical studies have applied constant market share (CMS) analysis to try to disentangle pure competitiveness factors from structural factors. CMS analysis covers a set of accounting methods which decompose export growth into a pure market share effect and various forms of specialisation effects. There is no single formula to achieve such a breakdown. The decomposition applied in this Focus section is based on the (relatively standard) equation:

$$(1) \Delta\pi = \sum_{ij} \alpha_{ij} \times \Delta\pi_{ij} + \sum_{ij} \pi_{ij} \times \Delta\alpha_{ij} + \sum_{ij} \Delta\pi_{ij} \times \Delta\alpha_{ij}$$

Where:

$\Delta$ : change between period 0 and period t;

$X_{ij}$ : exports of the country considered for product i and geographical destination j;

X: total exports of the country considered;

$XW_{ij}$ : world exports for product i and geographical destination j;

XW: total world exports;

$\pi_{ij} = X_{ij} / XW_{ij}$  = share of the country considered in world exports for product i and geographical destination j;

$\alpha_{ij} = XW_{ij} / XW$  = share of world exports for product i and geographical destination j in total world exports.

In equation (1), the total change in the share of the country of interest in total world exports (i.e. its market share) is decomposed into three effects:

- a pure market share effect, which is the sum of the gains and losses in market shares on individual markets weighted by the structure of world exports,
- the impact of the country's initial export structure, which is the sum of the changes in the structure of world trade weighted by the country's initial market shares,
- an adaptation effect, which is positive if the country is gaining market shares on fast-growing world markets.

Two methodological points should be stressed. **First**, direct comparisons of changes in market shares across countries are complicated by the existence of a scale effect: for the same export growth a bigger country will post a bigger change in its market share in absolute value than a smaller country. To facilitate cross-country comparisons of export performance, equation (1) has been transformed so as to analyse the relative export growth of the country considered (i.e. the difference between its export growth and world export growth) rather than the change in its market share. The principle of decomposition into a pure market share, an initial structure and an adaptation effect remains, however, the same. **Second**, individual markets in equation (1) are defined by the combination of a product and a geographical destination. Unfortunately, the respective contributions of the sectoral and geographical dimensions are difficult to disentangle. The initial structure and adaptation effects can each be further decomposed into a sectoral (or product) and a geographical sub-effect. Nevertheless, a well-known result of the literature on the issue is that the sectoral and geographical dimension cannot be treated symmetrically. Their respective shares in the initial structure and the adaptation effects therefore depend, to some extent, on the formula chosen. To reach more solid conclusions regarding the geographical and sectoral dimensions in this study, the results provided by two alternative formulae were compared.

### 2. Analysing aggregate (extra)-euro-area exports

The CMS analysis was applied to exports of goods from the euro area as a whole (excluding intra-area trade) as well as from the USA and Japan (see Table 6). Export data were taken from the Annual International Trade by Commodity Statistics compiled by the OECD. The database provides annual trade data in value at SITC3 level for all destinations. The most recent data are available up to 2002. Reporting countries include the 30 OECD countries plus China, Hong Kong China and Chinese Taipei. Altogether, these countries make up about 80% of world exports if intra-euro-area trade is included.

Given that the 33 reporting countries do not add up to world trade, results derived from the CMS analysis based on equation (1) should be reinterpreted as a decomposition of the export performance of the country considered relative to the average of the 33 countries rather than an outright market share decomposition.



A major limitation of the OECD dataset is that it only provides data in value and in physical quantities. Given that aggregating tonnes of computers and vegetables does not make much sense, only value data were used in this part of the CMS analysis. Therefore, results should be considered with prudence insofar as changes in relative export performance may reflect changes in underlying volumes as well as fluctuations in prices and exchange rates.

### 3. Analysing euro-area Member States' exports performance

To analyse intra-euro-area differences in export performance, the CMS analysis was also applied to individual euro-area Member States (11 reporting countries with Belgium and Luxembourg considered as a single entity - see Table 7). Goods trade data from Eurostat were used for that purpose. The major advantage of Eurostat data is that they include price indices which allow (under certain assumptions) trade to be calculated in constant prices by sectors and destinations. Their major drawback is that only EU countries are available as reporting countries. The CMS calculations were therefore applied to Member States' relative share in total euro-area exports rather than to standard market shares. As a result, the analysis provides, for each Member State, a decomposition of the export performance relative to the euro-area average rather than the entire world, as is generally the case for most CMS analyses (or relative to industrialised countries, as above).

such as pharmaceuticals and the automotive industry, which have performed comparatively well in world trade. It has also benefited from the importance of its exports to fast-growing Eastern European countries. In contrast, comparatively weak specialisation in high-tech industries and relatively low export orientation to the most dynamic Asian economies dampened the euro-area's trade performance in the late 1990s.

Finally, although geographical and sectoral dimensions are somewhat difficult to disentangle theoretically in CMS analysis (see Box 3), there is some evidence that both effects matter. In the case of the euro area, the impact of geographical specialisation has generally proved to be somewhat bigger over the past decade than the impact of sectoral specialisation, but the latter remains far from negligible. In contrast, there is no clear domination of geographical effects in the USA and Japan. Overall, these results suggest that the standard macroeconomic analyses of trade performance that rely exclusively on the geographical dimension may significantly underestimate specialisation effects.

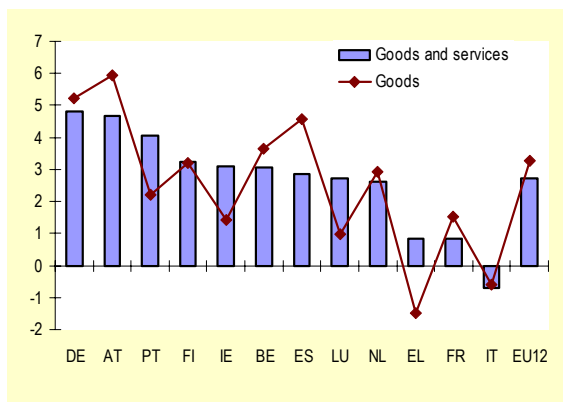
### 3. Trends at Member State level

#### Large differences in Member States' export performance

The overall euro-area export performance presented in the previous section masks significant country differences. Looking, for instance, at the past three years, Member States

such as Germany, Austria and Portugal have enjoyed export growth that has been well above average, while others, such as Italy, Greece, and France have recorded much weaker performance comparatively (Graph 33).

Graph 33: Exports of goods and services,<sup>(1)</sup>  
(average annual growth in % – constant prices – 2002-04)



(1) National accounts data – including intra-EU12 trade.  
Source: Commission services.

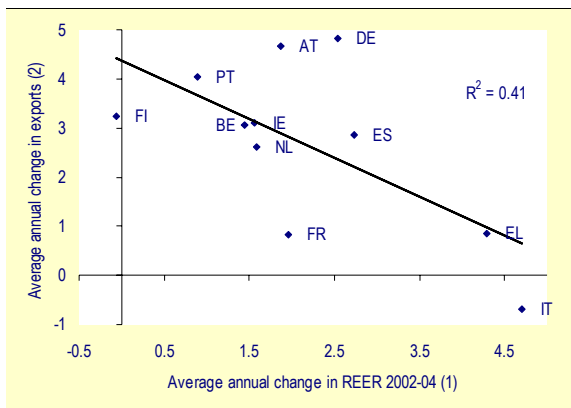
For data availability reasons, many empirical analyses of trade tend to focus on exports of goods while neglecting trade in services. It is, however, necessary to bear in mind that this choice may lead to a distorted picture when comparing Member States' export performance. Large differences between growth in goods and services can be observed in some countries. Hence, the recent export performance of Ireland, Portugal and Greece is significantly weaker when only goods are considered. The opposite holds true for Spain and Austria.



### Developments in price competitiveness play a key role in explaining export growth differences

Differences in price and cost competitiveness are the most obvious explanation for the large disparity in export performance across Member States observed in recent years. The explanation is supported by the data. Graph 34 displays the average changes in the real effective exchange rate based on the export price deflator and the average changes in real exports of goods and services for the 2002-04 period for all euro-area Member States (excluding Luxembourg).

Graph 34: Export growth and competitiveness  
(average annual growth in % – const. prices– 2002-04)



(1) Export growth is based on national accounts data and includes goods and services as well as intra-EU12 trade.

(2) The REER is based on the export price deflator.

Source: Commission services.

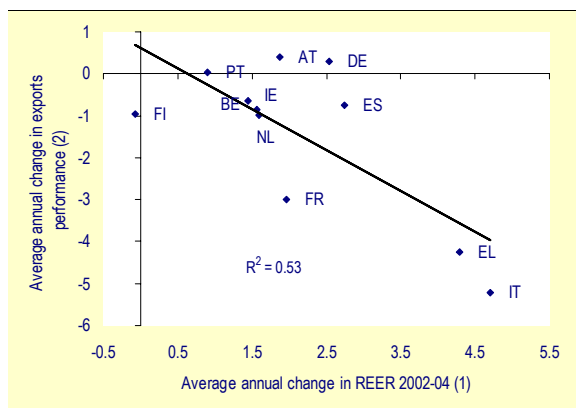
The graph suggests a close link between the two variables with developments in competitiveness accounting for more than 40% of the observed variance in national export growth rates.<sup>20</sup> The correlation is robust in the sense that extending the period does not alter it significantly. Nevertheless, with close to 60% of the dispersion of Member States' export performance remaining unexplained, differences in competitiveness can only be one of the determinants of the differences in export growth across Member States.

<sup>20</sup> The correlation between intra-area competitiveness and intra-area trade is weaker than as regards the extra and overall euro area dimension.

### But differences in geographical specialisation also matter...

A source of disparities in export performance is related to differences in Member States' geographical export specialisation. This is shown in Graph 35, which is constructed in a similar way to Graph 34, except that the vertical axis measures countries' relative export performance, taking into account the geographical dimension. For each Member State, export performance is measured as the change in the ratio of real exports of goods and services to a weighted sum of import demand in industrialised countries. The weight system is country-specific, reflecting the importance of each geographical destination in that country's total exports. The measure of export performance therefore takes into account that some Member States may benefit from stronger specialisation in the most dynamic export markets.

Graph 35: Export performance and competitiveness – adjusting for geographical specialisation (1) (2002-04)



(1) Export performance is measured as the change in the ratio of real exports (goods and services) to a weighted sum of import demand in industrialised countries. The weights reflect the country's geographical export structure.

(2) The REER is based on the export price deflator.

Source: Commission services.

The correlation between price competitiveness and this measure of export performance is somewhat higher than in the case of Graph 34, suggesting that differences in geographical specialisation can help explain some of the variance in export growth across Member States. However, the outliers in Graph 34 remain outliers in Graph 35, indicating that the geographical dimension is only part of the story.

### ... and the sectoral dimension should not be ignored

Due to a lack of detailed and up-to-date sectoral national accounts data, the sectoral dimension is generally ignored in macroeconomic analysis. However, to the extent that some Member States may have benefited from more growth-supportive sectoral specialisation than others, this dimension may have played an important role in accounting for disparities in export performance in recent years.

To assess the respective importance of sectoral and geographical specialisation effects, a CMS decomposition has been applied to the exports of each individual euro-area Member State. To circumvent the interpretation difficulties inherent in the analysis of market shares in value, the dataset has been restricted to euro-area goods export data for which volume data can be estimated (see also Box 2).<sup>21</sup> In this setting, the export performance of each individual country is assessed relative to the euro-area average rather than to a broader group (e.g. the industrialised countries benchmark used in Graph 35).

Table 7 presents the results of the CMS analysis for the 2000-03 period.<sup>22</sup> For lack of space, the table aggregates the initial structure and adaptation effects into a single specialisation effect. However, it provides a breakdown of this specialisation effect into a geographical and a sectoral component (last two columns of the table). The decomposition shows that neglecting the sectoral dimension may lead to a serious distortion of the export performance picture. For most Member States the sectoral effects dominated the geographical effects over the period considered. Ireland is the most extreme example of the importance of the sectoral dimension. Once sectoral effects are taken into account, the Irish export performance appears quite weak relative to the euro-area average for

the 2000-03 period. This is shown by a large negative pure market share effect (second column in the table). Large negative sectoral specialisation effects were registered in Finland, the Netherlands, Portugal, Greece and Italy for that period.

**Table 7: Impact of specialisation on the export growth of goods between 2000 and 2003 (in %)**

	Total relative export growth(1)	Pure market share effect	Specialisation effects (2)	
			Sectoral	Geograph.
BELU	6.8	5.1	3.8	-2.0
DE	3.9	2.3	0.5	1.1
EL	-10.0	-11.9	-2.8	4.7
ES	4.4	6.8	0.2	-2.6
FR	-9.5	-9.5	-0.5	0.5
IE	0.0	-11.3	13.1	-1.8
IT	-7.3	-5.0	-2.6	0.3
NL	2.1	6.7	-3.5	-1.1
AT	11.7	12.3	-1.6	0.9
PT	1.8	4.8	-3.0	-0.1
FI	-6.3	-4.4	-4.6	2.7

(1) Total relative export growth is measured by the difference between export growth in the country considered and export growth in the euro area as a whole. Exports are in constant prices.

(2) Specialisation in the sum of the initial structure and adaptation effects.

*Source:* Commission services.

Another reason for taking the sectoral dimension seriously is related to the measurement of price and cost competitiveness. The assessment of competitiveness may be seriously hampered by measurement issues in smaller Member States with strong sectoral specialisation. As discussed further in Box 3, standard macroeconomic measures of the real effective exchange rate may overestimate (underestimate) gains in competitiveness for those countries where the export industry is heavily specialised in fast (slow)-growing sectors. For instance, gains in competitiveness in Ireland in the late 1990s appear much less remarkable when corrected for the fact that the Irish export structure is skewed towards high-tech sectors where prices are falling rapidly. In that case, comparing average Irish export prices to the average prices of a basket of countries which are generally far less specialised in high-tech industries is quite misleading.

<sup>21</sup> Eurostat collects export data by product and geographical destination and some price indices for all Member States but not for non-EU countries. In the absence of detailed export volume data for a broader group of countries, individual Member States' export performance could only be assessed against the euro area average.

<sup>22</sup> Detailed sectoral-geographical trade data are only available up to 2003.



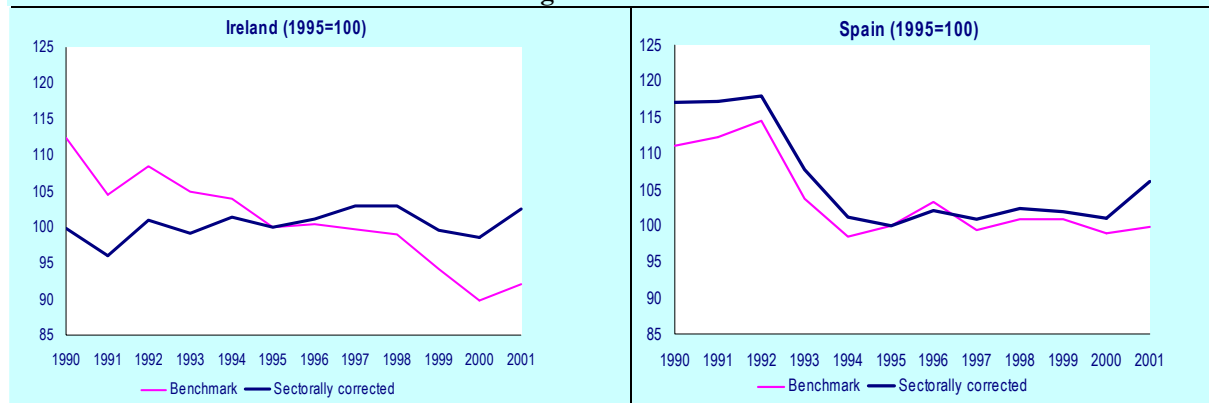
### Box 3: Measuring competitiveness - the sectoral dimension

As described in the December issue of the Quarterly Report on the Euro Area, the most common indicators to measure international competitiveness are real effective exchange rates (REERs) based on relative unit labour costs, relative consumer prices or relative export prices. A prominent shortcoming of these measures is that they do not take into account possible country differences in sectoral specialisation. For countries with export specialisation quite different from others, aggregate measures of the REER may not properly reflect true changes in competitiveness. Let's assume, for instance, that a country is more heavily specialised in ICT products than its competitors. Since the late 1990s, ICT production has generally been associated with fast productivity gains and falling labour costs and producer prices. In such a case, the traditional (aggregate) macroeconomic measures of the REER will tend to show gains in competitiveness in the ICT-intensive country as aggregate price and costs evolve more favourably in that country (thanks to a comparatively bigger ICT weight). However, it is easy to imagine a situation where the gains might be due to a purely sectoral bias and where the ICT-intensive country might in fact be losing competitiveness in all its main exporting sectors.

To further illustrate the sectoral influence on competitiveness measures, a new measure of the REER has been constructed. For a country X, "specialised" relative unit labour costs have been constructed by re-weighting the sectoral unit labour costs of all its trading partners according to the sector's weights in the exports of country X. The aggregate of these sectoral unit labour costs has then been used to calculate real effective exchange rates corrected for any possible sectoral bias. The sectoral data for exports and unit labour costs were taken from the OECD's STAN (STructural ANalysis) indicators database. Due to data limitations the standard reference group of 34 countries had to be reduced to 13 countries (United States, United Kingdom, Austria, Belgium/Luxemburg, France, Germany, Italy, Netherlands, Japan, Greece, Ireland, Portugal and Spain). In addition, for the extent of the sectoral bias to be assessed, "benchmark" real effective exchange rates have been calculated for the same 13 reference countries and standard macroeconomic unit labour costs data for the economy as whole. Except for a smaller country basket, these benchmark indicators are the same as those routinely calculated at DG ECFIN. Due to data limitations both the sectorally corrected and benchmark REERs have been calculated for the period 1990 to 2001. For both measures, the same methodology as described in DG ECFIN's quarterly report on price and cost competitiveness has been applied. (see

[http://europa.eu.int/comm/economy\\_finance/publications/priceandcostcompetitiveness\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/priceandcostcompetitiveness_en.htm))

Real effective exchange rates based on unit labour costs



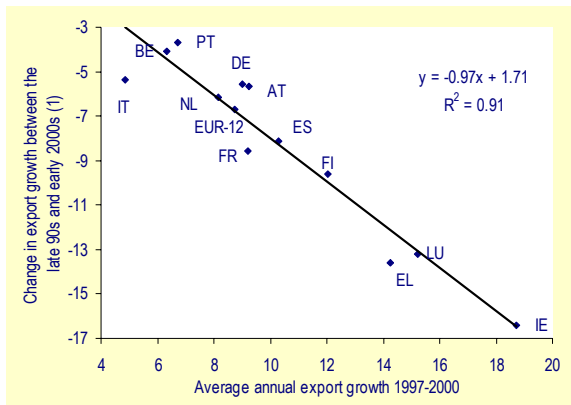
Source: Commission services.

For Ireland, the finding is that gains in competitiveness over the past decade look much less impressive if sectoral effects are taken into account. Indeed, the real effective exchange rate corrected for sectoral bias suggests that gains in competitiveness were fairly limited between 1995 and 2000 and were negative in 2001. In the case of Spain, the sectoral approach only leads to different results in 2000 and 2001, when the benchmark REER shows weaker appreciation than the sectorally adjusted measure. In other words, Spanish competitiveness may have deteriorated more significantly since 2000 than has generally been thought when looking at traditional macroeconomic REERs. However, with data only available up to 2001, such a conclusion should be considered with prudence. Finally, it is worth mentioning that sectorally adjusted REERs have also been calculated for the Netherlands and Finland. In the case of the Netherlands, correcting for sectoral bias does not make any substantial difference, suggesting that standard macroeconomic indicators can be used reliably in that country. More prudence is required in the case of Finland where the sectorally corrected REER shows better competitiveness developments in 2000-01 than the benchmark.

**On the role of temporary asymmetric shocks**

It is interesting to note that, despite the persistence of large differences, Member States' export performance has shown some convergence in the past few years. Graph 36 shows a strikingly close relation between the strength of export growth in the late 1990s and the ensuing export slowdown. Member States with above-average export growth in the late 1990s experienced a sharper export slowdown during the 2001-04 period than others.

**Graph 36: The correction to the export divergence of the late 1990s (average annual growth in %)**



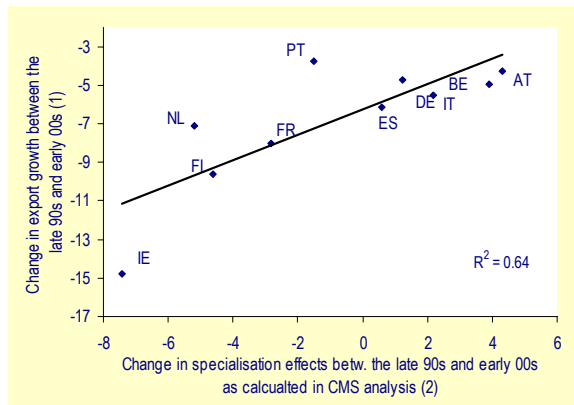
(1) Difference in the average growth of exports of goods and services between the 1997-00 and 2001-04 periods  
**Source:** Commission services.

Such a pattern reflects, in part, a competitiveness-related correction mechanism. Countries which enjoyed comparatively fast (slow)-growing exports in the late 1990s also experienced faster (slower) overall growth, stronger (weaker) price tensions and bigger (smaller) losses in competitiveness in the early 2000s. However, although this mechanism has been in operation in some countries (leading for instance to a deterioration of price competitiveness in Ireland, Greece and Spain), its overall explanatory power remains relatively limited. The correlation across Member States between the strength of export growth in the late 1990s and the ensuing increases in the real exchange rate is relatively small. This indicates that additional, more powerful, correction factors must also have been at play. A possible explanation is that one or several asymmetric shocks contributed to widening disparities in

Member States' export performance in the late 1990s. The reversal of these shocks after 2000 was a factor of cyclical convergence within the euro area in the early 2000s.

This interpretation is backed by the results of the CMS analysis. Running CMS decompositions over several periods of time shows that the importance and the signs of specialisation effects are not stable over time. Some Member States, which had benefited from positive specialisation effects in the late 1990s, experienced an (at least partial) reversal of these gains between 2000 and 2003 (e.g. Ireland, Finland and France). Other countries, which had suffered from negative or weak specialisation effects in the late 1990s, subsequently reported a noticeable improvement on account of these structural effects (Austria, Belgium and Italy). The strong link between the changes in specialisation effects and the change in export growth between the late 1990s and the early 2000s is shown in Graph 37.<sup>23</sup>

**Graph 37: Importance of specialisation effects in explaining differences in export slowdown (growth in %)**



(1) Difference in the average growth of exports of goods and services between the 1998-00 and 2001-03 periods.  
 (2) Change in specialisation effects between 1998-00 and 2001-03. Specialisation is measured as the sum of the initial structure and adaptation effects in the CMS analysis.  
**Source:** Commission services.

<sup>23</sup> The graph excludes a major outlier, namely Greece which has experienced large losses in markets shares in recent years despite a specialisation structure that has become much more supportive than in the past. These developments point to a serious competitiveness problem in that country.





The geographical and sectoral breakdown of CMS analysis also sheds further light on the nature of these asymmetric shocks. To some extent, changes in specialisation effect between the late 1990s and early 2000s can be related to geographical factors, probably reflecting the emergence of Eastern Europe as a major trade partner. Nevertheless, the changes in specialisation were clearly dominated by sectoral effects, particularly in countries such as Ireland, Finland and the Netherlands, indicating a possible important role of the ICT industries. Overall, the asymmetric shocks of the late 1990s were clearly more of a sectoral than of a geographical nature.

### A closer look at the largest Member States

Recent developments in export growth in some of the largest euro-area countries appear difficult to explain. Hence, both Germany and Spain have experienced a comparatively sustained export performance despite mediocre real exchange rate developments over the past few years (at least when measured on the basis of export prices). In contrast, France has experienced comparatively weak export growth without tangible signs of losses in price competitiveness. The sectoral and geographical specialisation effects in Table 7 offer only limited help to explain these differences. However, an analysis of the sectoral and geographical details of the pure market share gains (second column in Table 7) can be used to find some kind of explanation.

**Table 8 : REER and export performance, selected Member States (2002-2004)**

	Change in REER (1)	Change in export performance (2)
Germany	2.5	0.3
Spain	2.7	-0.7
France	2.0	-3.0
Italy	4.7	-5.2

(1) Based on export prices.

(2) See Graph 35 for a definition of the concept of export performance.

Source: Commission services.

Germany. Two factors seem to be important when assessing the robustness of the recent export performance of the German economy. First, most of the recent gains in market shares by

German exporters are concentrated in a few, essentially high-tech, sectors including office machinery, telecom equipment and electrical machinery and automotive vehicles. This suggests that a number of industry-specific factors (which would warrant closer research) have been driving the good German export performance.

Second, the appreciation of the real exchange rate based on export price in the past few years masks much more favourable developments in terms of unit labour costs. German exporters have taken advantage of favourable cost developments to rebuild margins, giving them some leeway to cut prices if necessary. Overall, therefore, the recent strong export performance of the German economy seems robust.

Spain. The situation of Spain appears quite different. First, the deterioration in price competitiveness in the past few years has been paralleled by an even larger deterioration of labour costs, and exporters have had to cut their margins. Second, there is some evidence that Spanish exports have been essentially boosted by a catching-up process in terms of integration in the world economy. Several arguments support this interpretation. The trade openness of Spain, as measured by the share of trade in GDP, remains relatively low for a medium-sized country. Furthermore, gains in market shares in recent years have been achieved with no improvement to the trade balance. Finally, gains in market shares have also been fairly broad-based covering a large number of sectors and destinations.<sup>24</sup> Overall, recent gains in market shares by Spanish exporters should not be interpreted as a sign that the losses in cost competitiveness experienced in the past few years have been harmless.

France. Recent losses in market shares since 2000 are broad-based both in geographical and in sectoral terms. However, significant losses were registered precisely in the sectors where neighbouring countries such as Germany and, to a lesser degree, Spain fared particularly well. In

<sup>24</sup> Although there is evidence that Spanish exports have particularly benefited from inflows of FDI in the transport sector and the associated build-up of an export-oriented production base in that sector.



addition, it is worth mentioning that losses in market shares by French exporters are not a recent phenomenon. Significant losses were already registered in the late 1990s but were masked at the time by relatively strong positive sectoral specialisation effects.

*Italy.* In contrast with the three countries analysed briefly above, recent developments in Italian exports are easier to explain. In the past few years, the country has experienced the largest real exchange rate appreciation in the euro area, whether measured in export prices or unit labour costs. These adverse cost competitiveness developments have led to significant losses in “pure market shares” (Table 7). In addition, but to a lower degree, Italian export growth has also been hampered by an unfavourable export specialisation.

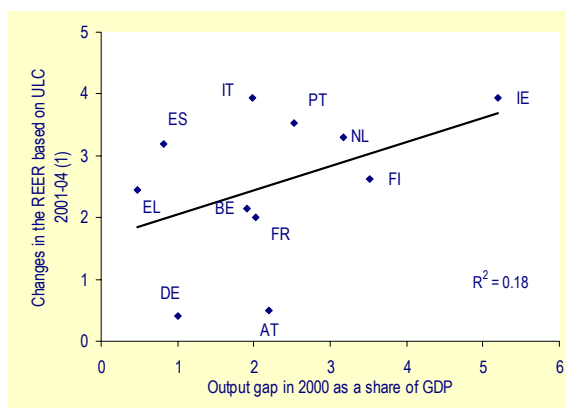
**The competitiveness adjustment mechanism revisited**

The special interest in Member States’ export performance is motivated by the key role of external price competitiveness as a correction mechanism to cyclical differences within the euro area. In the absence of independent monetary and exchange rate policies, differences in competitiveness become a central adjustment process in an economic and monetary union. For instance, a country enjoying better cyclical conditions than the euro-area average is also likely to experience stronger inflationary pressures and a deterioration of its competitiveness relative to other Member States. This competitiveness channel should help assuage cyclical differences within the euro area<sup>25</sup>.

As already highlighted, competitiveness effects can help explain differences in Member States’ export growth in recent years. However, their contribution to cyclical convergence in the euro area has been relatively limited in the past few years. As shown in Graph 38, there is a positive link (as predicted by economic theory) between Member States’ relative cyclical positions at the

peak of the cycle in 2000 and subsequent changes in the real effective exchange rate when measured in terms of unit labour costs. However, the link is only weak.<sup>26</sup> Some Member States with comparatively large positive output gaps in the late 1990s have managed to contain labour cost pressures (e.g. Finland) whereas other Member States with comparatively lower cyclical pressures have registered large losses in competitiveness in the last few years (e.g. Spain and Italy). Overall, adjustment to cyclical differences is only one of the factors explaining Member States’ differences in labour cost and competitiveness within the euro area. For instance, changes in the bargaining process or difficulties in adjusting to changes in trend productivity may lead to labour cost slippages and loss in competitiveness even in the absence of clear economic overheating.

Graph 38: Cyclical divergence and changes in the REER based on ULC (in %)



(1) Average annual change.  
 Source: Commission services.

Another factor that may dampen the effectiveness of the competitiveness adjustment mechanism is exporters’ margin behaviour. If improvements in competitiveness due to favourable developments in labour costs are first used to restore depressed profit margins, their impact on export performance may be mitigated and lag significantly. Hence, replacing real exchange rates based on labour costs (as in Graph 38) by real exchange rates based on export prices (as in Graph 39) turns the positive

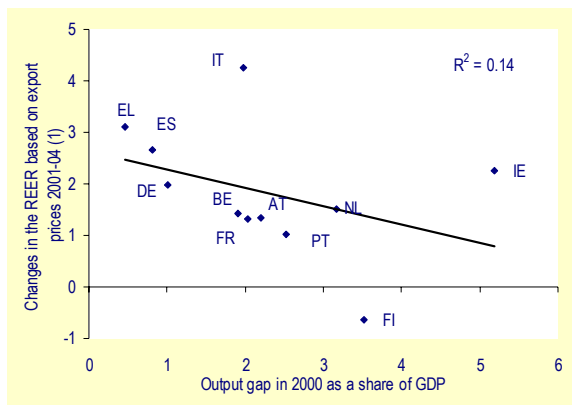
<sup>25</sup> See Deroose S., Langedijk S., and Roeger W., “Reviewing adjustment dynamics in EMU, from overheating to overcooling”, European Commission, Economic Papers, No. 198, January 2004.

<sup>26</sup> The correlation actually falls to around 0 if Ireland is excluded.



relation between the output gap and the REER into a negative one. This indicates that the last few years have seen large differences in margin behaviour across Member States. Since 2001, exporters in all Member States have responded to the appreciation of the euro by cutting their margins (as measured by the change in the ratio of export prices to unit labour costs). However, in some countries developments in costs have been sufficiently favourable to allow exporters to limit their losses in profitability (Germany and Austria) while in others the squeeze in profit margins has been quite substantial (Ireland, Portugal, the Netherlands, Spain and, to a lesser degree, Finland)<sup>27</sup>.

Graph 39: Cyclical divergence and changes in the REER based on export prices (in %)



(1) Average annual change.  
Source: Commission services.

Finally, the analysis presented in this Focus section suggests that some caution is necessary when trying to assess the importance of the competitiveness adjustment mechanism within the euro area. Although the mechanism has been at play in the past few years, the picture has been blurred by several factors.

- First, sectoral and geographical specialisation effects may have a strong and possibly fluctuating impact on Member States' export growth. Hence, asymmetric trade shocks or the asymmetric transmission of common trade shocks have partly concealed the effect of the competitiveness adjustment mechanism in the late 1990s and early 2000s.
- Second, differences in exposure to extra-area trade have entailed asymmetries in the transmission of the fluctuations in the euro exchange rate. All other things being equal, countries with a higher share of extra-area exports in total exports have also lost more competitiveness than others in the past few years.
- Finally, Competitiveness developments may not always be accurately captured by traditional macroeconomic measures of the real effective exchange rates, especially in the case of small countries with strong sectoral specialisation. For instance, traditional REER measures ignoring this sectoral dimension tend to underestimate the extent of the losses in competitiveness incurred by Irish exporters in the past few years. Hence, the competitiveness adjustment mechanism has probably been more at play in this country than is suggested in Graph 39.

<sup>27</sup> A more in-depth analysis of growth differences between Member States will be presented in a forthcoming June 2005 issue of the Quarterly Report on the Euro Area.

### III. Recent DG ECFIN publications

#### 1. Policy documents

EUROPEAN ECONOMY. No. 6. 2004

**The EU Economy: 2004 Review**

[http://europa.eu.int/comm/economy\\_finance/publications/the\\_eu\\_economy\\_review\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/the_eu_economy_review_en.htm)

EUROPEAN ECONOMY. No. 1. 2005

**The second report on the implementation of the 2003 - 2005 Broad Economic Policy Guidelines**

[http://europa.eu.int/comm/economy\\_finance/publications/european\\_economy/implement2004\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/european_economy/implement2004_en.htm)

EUROPEAN ECONOMY. No. 2. 2005

**The Economy for the euro area, the European Union, and Candidate countries in 2004 – 2006. Economic Forecasts, Spring 2005**

[http://europa.eu.int/comm/economy\\_finance/publications/european\\_economy/forecasts\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/european_economy/forecasts_en.htm)

EUROPEAN ECONOMY. No. 4. 2005 (forthcoming)

**Integrated Guidelines 2005-2008 including a Commission Recommendation on the Broad Economic Policy Guidelines**

[http://europa.eu.int/comm/economy\\_finance/publications/broadeconomypolicyguidelines\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/broadeconomypolicyguidelines_en.htm)

EUROPEAN ECONOMY. OCCASIONAL PAPERS. No.15. February 2005

**Improving the Stability and Growth Pact: the Commission's three pillar approach**

[http://europa.eu.int/comm/economy\\_finance/publications/occasional\\_papers/occasionalpapers15\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/occasional_papers/occasionalpapers15_en.htm)

EUROPEAN ECONOMY. OCCASIONAL PAPERS. No.16. March 2005

**The economic costs of non-Lisbon. A survey of the literature on the economic impact of Lisbon-type reforms**

[http://europa.eu.int/comm/economy\\_finance/publications/occasional\\_papers/occasionalpapers16\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/occasional_papers/occasionalpapers16_en.htm)

EUROPEAN ECONOMY. OCCASIONAL PAPERS. No.17. April 2005

**10 Years of Barcelona process: taking stock of economic progress in EU Mediterranean partners**

[http://europa.eu.int/comm/economy\\_finance/publications/occasional\\_papers/occasionalpapers17\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/occasional_papers/occasionalpapers17_en.htm)

**Communication by the Commission on "Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact" (COM(2004)581)**

[http://europa.eu.int/comm/economy\\_finance/publications/sgp/com2004581\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/sgp/com2004581_en.htm)

**Communication by the Commission on "The situation of Germany and France in relation to their obligations under the excessive deficit procedure following the judgement of the Court of Justice" (COM(2004)813)**

[http://europa.eu.int/comm/economy\\_finance/about/activities/sgp/edp/com\\_com\\_2004\\_en.pdf](http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp/com_com_2004_en.pdf)

#### 2. Analytical documents

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. 216.

Alfonso Arpaia and Giuseppe Carone

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[http://europa.eu.int/comm/economy\\_finance/publications/economic\\_papers/economicpapers216\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers216_en.htm)

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. 217.

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[http://europa.eu.int/comm/economy\\_finance/publications/economic\\_papers/economicpapers217\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers217_en.htm)

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. 218.

Gaëtan Nicodème (Directorate General for Economic and Financial Affairs) and Jacques-Bernard Sauner-Leroy (Banque de France)

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[http://europa.eu.int/comm/economy\\_finance/publications/economic\\_papers/economicpapers218\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers218_en.htm)

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. 219.

Daniel Grenouilleau (Directorate General for Economic and Financial Affairs)

**A sorted leading indicators dynamic (SLID) factor model for short-run euro-area GDP forecasting**

[http://europa.eu.int/comm/economy\\_finance/publications/economic\\_papers/economicpapers219\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers219_en.htm)

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. 220.

Marco Ratto, Werner Röger, Jan in't Veld and Riccardo Girardi (Directorate General for Economic and Financial Affairs)

**An estimated new Keynesian dynamic stochastic general equilibrium model of the Euro area**

[http://europa.eu.int/comm/economy\\_finance/publications/economic\\_papers/economicpapers220\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers220_en.htm)

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. 221.

C. Denis, K. Mc Morrow, W. Röger and R. Veugelers (Directorate General for Economic and Financial Affairs)

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[http://europa.eu.int/comm/economy\\_finance/publications/economic\\_papers/economicpapers221\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers221_en.htm)

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. 222.

Michele Cincera (DULBEA-CERT, ULB and CEPR) and Olivia Galgau (DULBEA, ULB)

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[http://europa.eu.int/comm/economy\\_finance/publications/economic\\_papers/economicpapers222\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers222_en.htm)

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[http://europa.eu.int/comm/economy\\_finance/publications/economic\\_papers/economicpapers223\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers223_en.htm)

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. 224.

Lars Jonung (Directorate-General for Economic and Financial Affairs) and Thomas Hagberg (Ekonomistyrningsverket, Stockholm)

**How costly was the crisis of the 1990s? A comparative analysis of the deepest crises in Finland and Sweden over the last 130 years.**

[http://europa.eu.int/comm/economy\\_finance/publications/economic\\_papers/economicpapers224\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers224_en.htm)

### ***3. Regular publications***

**Euro area GDP indicator** (Indicator-based forecast of quarterly GDP growth in the euro area)

[http://europa.eu.int/comm/economy\\_finance/indicators/euroareagdp\\_en.htm](http://europa.eu.int/comm/economy_finance/indicators/euroareagdp_en.htm)

**Business and Consumer Surveys** (harmonised surveys for different sectors of the economies in the European Union (EU) and the applicant countries)

[http://europa.eu.int/comm/economy\\_finance/indicators/businessandconsumersurveys\\_en.htm](http://europa.eu.int/comm/economy_finance/indicators/businessandconsumersurveys_en.htm)

**Business Climate Indicator for the euro area** (monthly indicator designed to deliver a clear and early assessment of the cyclical situation)

[http://europa.eu.int/comm/economy\\_finance/indicators/businessclimate\\_en.htm](http://europa.eu.int/comm/economy_finance/indicators/businessclimate_en.htm)

**Key indicators for the euro area** (presents the most relevant economic statistics concerning the euro area)

[http://europa.eu.int/comm/economy\\_finance/indicators/key\\_euro\\_area/keyeuroarea\\_en.htm](http://europa.eu.int/comm/economy_finance/indicators/key_euro_area/keyeuroarea_en.htm)

**Monthly and quarterly notes on the euro-denominated bond markets** (looks at the volumes of debt issued, the maturity structures, and the conditions in the market)

[http://europa.eu.int/comm/economy\\_finance/publications/bondmarkets\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/bondmarkets_en.htm)

**Price and Cost Competitiveness**

[http://europa.eu.int/comm/economy\\_finance/publications/priceandcostcompetitiveness\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/priceandcostcompetitiveness_en.htm)

## IV. Key indicators for the euro area

<b>1 Output</b>		2001	2002	2003*	Oct-04	Nov-04	Dec-04	Jan-05	Feb-05	Mar-05
Industrial confidence <sup>1.1</sup>	Balance	-10	-12	-11	-3	-3	-4	-5	-6	-8
Industrial production <sup>1.2</sup>	mom % ch	0.2	-0.9	0.2	-0.6	-0.4	0.5	0.5		
		2001	2002	2003*	03Q4	04Q1	04Q2	04Q3	04Q4	05Q1
Gross domestic product <sup>1.3</sup>	Qtr. % ch				0.4	0.7	0.5	0.2	0.2	
<b>2 Private consumption</b>		2001	2002	2003*	Oct-04	Nov-04	Dec-04	Jan-05	Feb-05	Mar-05
Consumer confidence <sup>2.1</sup>	Balance	-6	-11	-18	-13	-13	-13	-13	-13	-14
Retail sales <sup>2.2</sup>	mom % ch	1.2	1.1	0.1	0.4	0.0	0.0	0.3	0.3	
		2001	2002	2003*	03Q4	04Q1	04Q2	04Q3	04Q4	05Q1
Private consumption <sup>2.3</sup>	Qtr. % ch	1.9	0.6	1.1	0.0	0.8	0.0	0.1	0.5	
<b>3 Investment</b>		2001	2002	2003*	Oct-04	Nov-04	Dec-04	Jan-05	Feb-05	Mar-05
Capacity utilization <sup>3.1</sup>	%	83.5	81.2	80.7	80.9	80.5	80.6	81.4	81.7	82.0
Gross fixed capital formation <sup>3.2</sup>	Qtr. % ch	-0.3	-2.7	-0.4	1.1	-0.1	0.5	0.6	0.6	
Change in stocks <sup>3.3</sup>	% of GDP	-0.2	-0.1	0.0	0.2	0.0	0.1	0.8	0.7	
<b>4 Labour market</b>		2001	2002	2003*	Oct-04	Nov-04	Dec-04	Jan-05	Feb-05	Mar-05
Unemployment <sup>4.1</sup>	%	8.0	8.2	8.4	8.9	8.8	8.9	8.8	8.9	
		2001	2002	2003*	03Q4	04Q1	04Q2	04Q3	04Q4	05Q1
Employment <sup>4.2</sup>	Ann. % ch	1.4	0.5	0.1	0.3	0.3	0.4	0.5		
Shortage of labour <sup>4.3</sup>	%	7.8	3.8	2.5	2.0	2.4	2.6	2.4	2.2	
Wages <sup>4.4</sup>	Ann. % ch	2.8	2.9	2.5	2.3	2.4	2.3	2.0	1.8	
<b>5 International transactions</b>		2001	2002	2003*	Oct-04	Nov-04	Dec-04	Jan-05	Feb-05	Mar-05
Export order books <sup>5.1</sup>	Balance	-14	-22	-24	-10	-11	-12	-10	-12	-15
World trade <sup>5.2</sup>	Bn. EUR	121	125	132	149	151	152			
Exports of goods <sup>5.3</sup>	Bn. EUR	767.4	776.9	1038.6	96.1	97.6	97.1	97.8		
Imports of goods <sup>5.4</sup>	Bn. EUR	802.2	781.6	970.4	93.2	94.2	92.6	94.3		
Trade balance <sup>5.5</sup>	Bn. EUR	-34.8	-4.7	68.2	2.9	3.4	4.5	3.5		
		2001	2002	2003*	03Q4	04Q1	04Q2	04Q3	04Q4	05Q1
Exports of goods and services <sup>5.6</sup>	Qtr. % ch	3.4	1.7	0.2	0.1	1.4	2.7	1.3	0.5	
Imports of goods and services <sup>5.7</sup>	Qtr. % ch	2.1	-1.6	2.1	1.7	0.4	2.4	3.1	1.0	
		2001	2002	2003*	Oct-04	Nov-04	Dec-04	Jan-05	Feb-05	Mar-05
Current account balance <sup>5.8</sup>	Bn. EUR	2.0	44.9	18.1	1.4	1.7	2.8	3.2		
Direct investment (net) <sup>5.9</sup>	Bn. EUR	-104.6	-11.0	-18.4	-9.7	0.1	7.3	-13.1		
Portfolio investment (net) <sup>5.10</sup>	Bn. EUR	36.5	64.4	-9.4	5.9	-10.5	37.1	-18.2		
<b>6 Prices</b>		2001	2002	2003*	Oct-04	Nov-04	Dec-04	Jan-05	Feb-05	Mar-05
HICP <sup>6.1</sup>	Ann. % ch	2.3	2.3	2.1	2.4	2.2	2.4	1.9	2.1	2.1
Core HICP <sup>6.2</sup>	Ann. % ch	1.9	2.5	2.0	2.0	1.9	2.1	1.7	1.6	
Producer prices <sup>6.3</sup>	Ann. % ch	2.2	1.7	1.6	4.1	3.7	3.5	3.9	4.2	
Import prices <sup>6.4</sup>	Ann. % ch	102.2	102.4	102.5						
<b>7 Monetary and financial indicators</b>		2001	2002	2003*	Oct-04	Nov-04	Dec-04	Jan-05	Feb-05	Mar-05
Interest rate (3 months) <sup>7.1</sup>	% p.a.	4.3	3.3	2.3	2.2	2.2	2.2	2.2	2.1	2.1
Bond yield (10 years) <sup>7.2</sup>	% p.a.	5.0	4.8	4.1	3.9	3.8	3.7	3.6	3.6	3.7
ECB repo rate <sup>7.3</sup>	% p.a.	3.25	2.75		2.00	2.00	2.00	2.00	2.00	2.00
Stock markets <sup>7.4</sup>	Index	4047	3053	2420	2794	2883	2926	2957	3050	3066
M3 <sup>7.5</sup>	Ann. % ch	5.3	5.6	7.8	5.9	6.1	6.3	6.5		
Credit to private sector (loans) <sup>7.6</sup>	Ann. % ch	7.9	7.7	5.0	6.6	6.7	7.0	7.3	7.2	
Exchange rate USD/EUR <sup>7.7</sup>	Value	0.90	0.95	1.13	1.25	1.31	1.34	1.31	1.30	1.32
Nominal effective exchange rate <sup>7.8</sup>	Index	91.5	95.1	106.4	110.8	112.2	113.7	112.5	111.6	112.5



Number	Indicator	Note	Source
<b>1</b>	<b>Output</b>		
1.1	Industrial indicator confidence	Industry survey, average of balances to replies on production expectations, order books, and stocks (the latter with inverted sign)	ECFIN
1.2	Industrial production	Volume, excluding construction, wda	Eurostat
1.3	Gross domestic product	Volume (1995), seasonally adjusted	Eurostat
<b>2</b>	<b>Private consumption</b>		
2.1	Consumer indicator confidence	Consumer survey, average of balances to replies on four questions (financial and economic situation, unemployment, savings over next 12 months)	ECFIN
2.2	Retail sales	Volume, excluding motor vehicles, wda	Eurostat
2.3	Private consumption	Volume (1995 prices), seasonally adjusted	Eurostat
<b>3</b>	<b>Investment</b>		
3.1	Capacity utilisation	In percent of full capacity, manufacturing, seasonally adjusted, survey data (collected in each January, April, July and October).	ECFIN
3.2	Gross fixed capital formation	Volume (1995 prices), seasonally adjusted	Eurostat
3.3	Change in stocks	In percent of GDP, volume (1995 prices), seasonally adjusted	Eurostat
<b>4</b>	<b>Labour market</b>		
4.1	Unemployment	In percent of total workforce, ILO definition, seasonally adjusted	Eurostat
4.2	Employment	Number of employees, partially estimated, seasonally adjusted	ECB/ Eurostat
4.3	Shortage of labour	Percent of firms in the manufacturing sector reporting a shortage of labour (unfilled job openings) as a constraint to production, seasonally adjusted	ECFIN
4.4	Wages	Not fully harmonised concept, but representative for each Member State (mostly hourly earnings)	ECFIN
<b>5</b>	<b>International transactions</b>		
5.1	Export order books	Industry survey; balance of positive and negative replies, seasonally adjusted	ECFIN
5.2	Exports of goods	Bn. EUR, excluding intra euro-area trade, fob	Eurostat
5.3	Imports of goods	Bn. EUR, excluding intra euro-area trade, cif	Eurostat
5.4	Trade balance	Bn. EUR, excluding intra euro-area trade, fob-cif	Eurostat
5.5	Exports of goods and services	Volume (1995 prices), including intra euro-area trade, seasonally adjusted	Eurostat
5.6	Imports of goods and services	Volume (1995 prices), including intra euro-area trade, seasonally adjusted	Eurostat
5.7	Current account balance	Bn. EUR, excluding intra euro-area transactions; before 1997 partly estimated	ECB
5.8	Direct investment	(net) Bn. EUR, excluding intra euro-area transactions	ECB
5.9	Portfolio investment	(net) Bn. EUR, excluding intra euro-area transactions	ECB
<b>6</b>	<b>Prices</b>		
6.1	HICP	Harmonised index of consumer prices	Eurostat
6.2	Core HICP	Harmonised index of consumer prices, excluding energy and unprocessed food	Eurostat
6.3	Producer prices	Without construction	Eurostat
6.4	Import prices	Import unit value index for goods	Eurostat
<b>7</b>	<b>Monetary and financial indicators</b>		
7.1	Interest rate	Percent p.a., 3-month interbank money market rate, period averages	Datastream
7.2	ECB repo rate	Percent p.a., minimum bid rate of the ECB, end of period	Datastream
7.3	Bond yield	Percent p.a., 10-year government bond yields, lowest level prevailing in the euro area, period averages	Datastream
7.4	Stock markets	DJ Euro STOXX50 index, period averages	Datastream
7.5	M3	Seasonally adjusted moving average moving average (3 last months)	ECB



7.6	Credit to private sector (loans)	MFI loans to euro-area residents excluding MFIs and general government, monthly values: month end values, annual values: annual averages	ECB
7.7	Exchange rate USD/EUR	Period averages	ECB
7.8	Nominal effective exchange rate	Against 13 other industrialised countries, double export weighted, 1995 = 100, increase (decrease): appreciation (depreciation)	ECFIN

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