EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 27 March 2002
ECFIN/198/02 – EN

QUARTERLY REPORT ON THE EURO AREA

No. 2002/I

Table of contents

Editorial

In its 2001 Communication on "Strengthening economic policy co-ordination within the euro area", the Commission highlighted the importance of improving the economic assessment of the euro area, as well as the quality of the public debate surrounding the area's economic policy. In order to further enhance and smoothen the policy co-ordination process, the Commission announced the publication of a regular report on economic developments in the euro area. The Report is to present an analysis of the general situation and of economic policy issues. It contains analytical notes on current economic trends, forecasts and risks, as well as articles of a more analytical nature dealing with particular aspects of multilateral surveillance.

I am pleased to herewith introduce the first issue of this Report, which will be published on a quarterly basis, in March, June, September and December. It contains two analytical parts, which are of special importance for the euro-area economy at the current juncture. The first part undertakes an assessment of the economic situation in the euro area, considering the evidence that the trough of the slowdown has been passed. The second part focuses on inflation developments, with the specific intention of substantiating whether the introduction of euro coins and bills has spurred inflation.

Price stability is a key element in the macro-economic framework of the euro area. A stable macroeconomic environment is a precondition for growth and employment. Fiscal discipline, wage moderation and low inflation rates over the 1990s have helped reduce uncertainty and enhance the efficiency of the price mechanism in allocating resources. A stable macroeconomic environment with flexible markets reduces the impact of economic shocks to output growth. Such an environment underpins business and consumer confidence and increases an economy's ability to adapt to shocks.

Once more, a stable macroeconomic environment has been proven to be very valuable in times of economic uncertainty. The euro-area economy seems to be at the brink of a recovery after the sharp economic slowdown in 2001 interrupted an extended period of strong economic activity. The unwinding of the impact of a series of mostly global shocks, the judicious response of economic policy, sound fundamentals and a gradual revival in confidence provide the platform for the emerging recovery in the euro area. The smooth introduction of the euro in 1999 and of notes and coins in 2002 brings a welcome note of stability and confidence. Recent indicators are in line with the view that the slowdown bottomed out in the last quarter of 2001 and the odds seem to be in favour of economic growth accelerating to a rate close to or above potential in the course of the second half of 2002.

Uncertainty concerning the global outlook remains but risks have become more balanced now. US economic data in the first couple of months was encouraging, but US-households remain highly leveraged. The sustainability of their balance sheets is therefore vulnerable to a change in income expectations. If private consumption becomes unsustainable and declines, a "W-shaped" scenario, in which an initial recovery is followed by a renewed slowdown, cannot be excluded. Furthermore, the Japanese economy is not expected to recover in the immediate future. The crisis in Argentina has heightened the uncertainties surrounding the emerging market economies, even if contagion to other emerging market economies has not become an issue. Finally, political risks may drive up oil prices, with potentially harmful consequences for the global economy. If any of the risks were to materialise, the rather positive outlook for the euro-area economy may become more clouded.

At first glance, the euro area's inflation figures for the start of 2002 seem disappointing, especially considering the current absence of inflationary pressures stemming from the economic cycle. After a continuous decline from a high of 3.4% in May 2001 to 2% in December, the year-on-year rate jumped to 2.7% in January.

However, the outlook for price developments in 2002 is benign, as the sudden rise in the headline inflation rate was mainly due to temporary factors. In particular, the upsurge in the prices of fresh fruit and vegetables due to the cold weather has been identified as the single most important element. In addition, increases in indirect tax rates and in some tariffs and less favourable developments in energy prices also contributed to the inflation up-tick. In February, the headline inflation rate resumed a declining path, dropping to 2.4% year-on-year. Dissipation of temporary factors and base effects point to a further decline in inflation during the first half of this year, followed by stabilisation below 2%.

As the hiccup in inflation coincided with the cash changeover, the public attention was focused on the effect of the introduction of notes and coins on the price developments. Anecdotal evidence and several reports from consumer's associations revealed significant price changes for individual products and services. Yet, there is little evidence - both in theory and in data - supporting fears of a more general price increase. Moreover, the official price statistics indicate that the effect of the cash changeover on headline inflation has been minimal. Eurostat has estimated the euro changeover effect to be 0.16% at maximum. The observation that the inflation uptick was a European-wide phenomenon, not restricted to the euro-area Member States, confirms this view.

In the medium term, the outlook for price stability is rather bright. The introduction of the euro can be expected to lead to increased competition and efficiency across the euro area, and therefore assert downward pressure on consumer prices. This will reinforce the ongoing effects of progressing economic reforms such as the liberalisation of network industries. The benign outlook for price developments is reflected in inflation expectations derived from financial markets, corroborating the impression that the ECB's commitment to low inflation is credible.

Moreover, there is emerging evidence of significant changes in labour market behaviour since the introduction of the euro in 1999. On average, wage demands take increasingly account of the ECB's price stability objective and productivity developments. Still, high wage claims in some Member States jeopardise wage formation conducive to sustained employment growth and price stability. As the recovery sets in and gathers pace, a continuation of appropriate wage developments will be important in order to preserve the low inflation environment while enabling a return to sustained job-rich growth.

Pedro SOLBES

MEMBER OF THE EUROPEAN COMMISSION

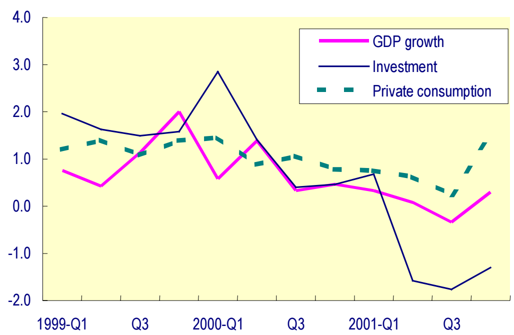
I. Economic situation in the euro area[1]

Although risks to the global economy continue to exist, the economic prospects for the euro area have brightened since the beginning of the year. The recent development of leading indicators is in line with the view that the recovery will unfold gradually and gain strength in the course of 2002. Even though the evidence is so far restricted to survey indicators, and supporting official data on actual economic activity is still awaited, the odds seem to be in favour of economic growth accelerating to or above the potential rate in the second half of this year.

1. The global economic context

Positive signals in the United States. There are growing indications that the economic situation is improving in the USA. With real GDP having actually grown by 0.3% in the last three months of 2001, the downturn in 2001 does not technically qualify as a recession. The downturn in 2001 was mainly triggered by a contraction in business investment. Unlike the typical US cycle, consumption has remained robust although this has been at the expense of a deterioration in household balance sheets.

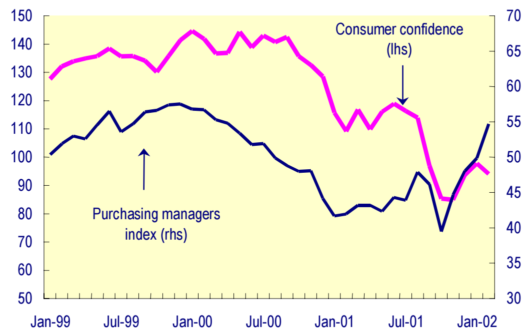
Demand components of GDP growth in the US (1)



(1) percentage change on previous quarter.
Source: Commission services.

Looking ahead, the latest releases of different leading as well as labour market indicators suggest that economic activity is now gaining momentum and that a recovery may be well underway. Importantly, the leading indicators with an established track record in reflecting the economic situation have entered a solid upward path. The labour market – usually a lagging indicator – is also showing signs of stabilisation. With the exception of one week in mid-February, initial unemployment claims have been steadily decreasing since late January. Claims remained below the 400,000 level for ten consecutive weeks, perhaps indicating that the economy is indeed at a turning point. Finally, actual industrial production started to grow in January and gained pace in February, after declining for fifteen of the past sixteen months.

Business and and consumer confidence in the USA



Source: Conference Board, ISM.

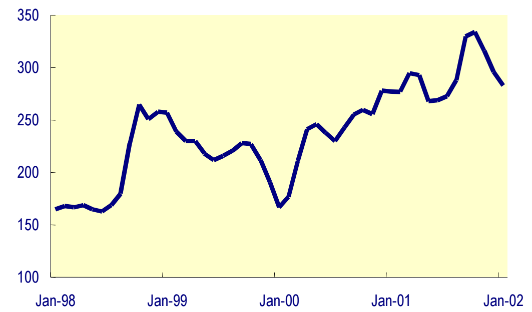
Somewhat less reassuring have been indicators on private consumption. Both the University of Michigan and the Conference Board consumer sentiment indexes dipped in February and the latest increase in retail sales was below expectations. Both observations point to the fragility of the previously high pace of consumer demand, which was the main feature

[1] The cut-off date for statistics included in this issue was 22 March, 2002.

of the US economy in stabilising aggregate demand during the slowdown and the very early phase of the recovery.

Despite some clear signs of improvement in the US economy, there are risks on the horizon. The financial situation of the corporate sector could be one source of concern. Corporate bond spreads remain very wide, suggesting that firms still face difficult financing conditions despite the dramatic fall in policy interest rates from 6.5% in January 2001 to 1.75% in December. The observed yield spread probably understates the degree of credit tightening in the bond market, as many companies have seen their debt sharply downgraded. Market seems to think that the corporate sector has too much debt and not enough pricing power to support it. The corporate debt service burden, as measured by the ratio of interest expenses to cash flow before interest, taxes, and depreciation rose from approximately 30% at the beginning of 2000 to 110% in the third quarter of 2001, reflecting the rapid deterioration in profits.

Corporate bond spreads
(Baa-rated minus 10-year Treasury yield) in basis points



Source: Commission services.

The structure of corporate debt is also of concern. There has been a massive increase in convertible bond issuance in recent years. Whether such bonds are treated as debt or equity is a key issue in determining how leveraged US corporations are. When stock prices are rising, the embedded call option in convertibles is usually exercised and the security becomes equity. When equity prices fall, however, the option becomes less attractive and the convertible is treated more like debt, thus raising balance sheet leverage. If last year's convertible bond issuance is treated as debt, net corporate bond issuance was about 40% higher than it would appear otherwise.

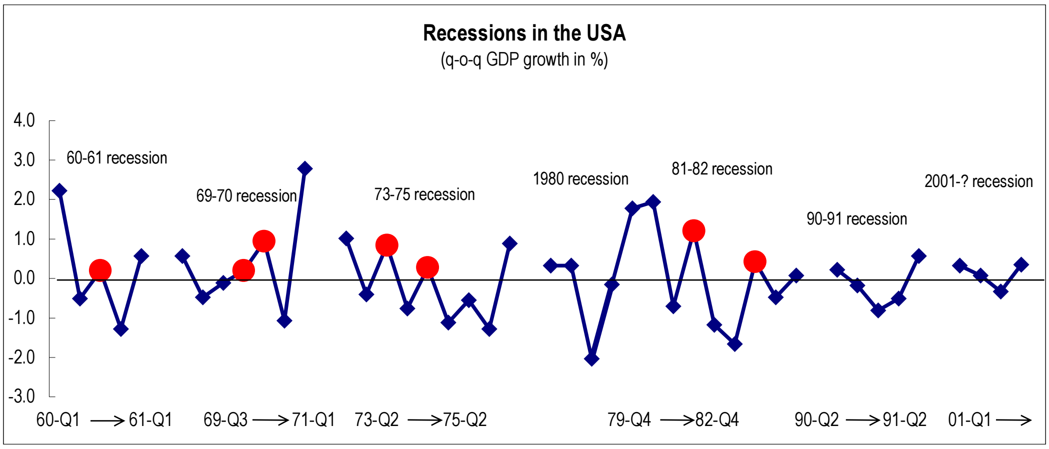
As for firms' pricing power and profitability in general, this is constrained by factors such as the subdued growth of nominal income, the low rate of capacity utilisation and the strong US dollar. On the other hand, profitability has been supported by higher productivity. The most recent figures suggest that productivity surged by 5.2% in 2001 Q4 in the non-farm business sector.

In the immediate future, the combination of wide corporate bond spreads and high levels of corporate debt could weigh on investment decisions. Furthermore, the Enron affair has raised serious concerns about accounting irregularities and this has encouraged markets to place a greater emphasis on the quality of past and future earnings. In an environment in which corporate balance sheets are subjected to greater scrutiny, corporations are less likely to want to rush to take on higher debt in order to finance higher capital expenditure.

Box 1: **Assessing the risks of a double-dip in the USA**

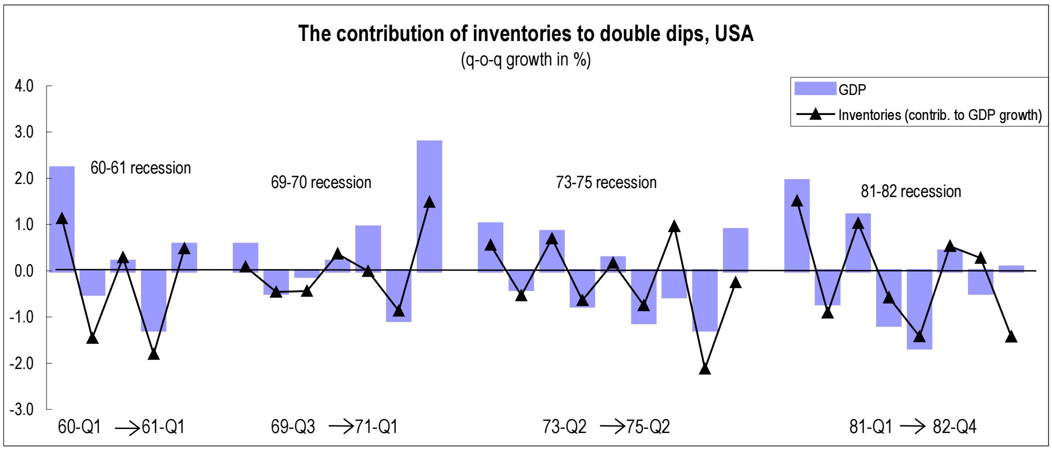
W-shaped recessions in US business cycle history

Double-dip or W-shaped recessions have been a recurring feature of the US business cycle in the past 40 years. In a double-dip recession, one or several quarters of GDP contraction are followed by a short-lived turnaround, with one or two quarters of positive growth that relapses into another recessionary phase. As illustrated in the graph below, 4 of the last 6 US recessions have been characterised by double or even triple dips. The only exceptions are the 1980 and the 1990-91 recessions.



Source: BEA. The bullets indicate a "false" start to recovery.

The conventional explanation of the double-dip pattern rests on a combination of inventory volatility and producers' tendency to forge over-optimistic expectations regarding the timing of the recovery. The story is generally the following. Large cutbacks in inventories during the first phase of the recession and the anticipation of an imminent recovery lead producers to believe that the pruning work is completed. As inventories are being re-built, the economy begins to gather momentum and GDP growth turns briefly positive. However, expectations of a recovery turn out to be premature and a relapse of final demand or a failure of demand to recover as rapidly as expected trigger a renewed inventory adjustment that drags the economy into another period of GDP contraction.



Source: BEA.

Overall, existing data fit relatively well with the conventional story. In all past double-dip recessions, the false-start period and the subsequent relapse of GDP growth into negative territories were associated with large swings in the contribution of inventories to growth (see graph). In nearly all cases, the return to the recessionary phase was also accompanied by a relapse of final demand.

The risks of a double-dip recession in the USA

The frequent occurrence of double dips in past US recessions calls for some prudence when assessing the probability of a V-shaped recovery in the months to come. Furthermore, downside surprises in terms of final demand remain a distinct possibility. Scenarios of a V-shaped recovery rest on the assumption of continued growth in private spending. However, such an assumption carries substantial downside risks. Private consumption was much more resilient than anticipated in 2001 but this strength was partly the result of aggressive and temporary pricing measures in the automotive sector. In addition, several factors could weigh on household spending in the next few months, including the negative wealth effects of past declines in share prices and a high level of households' indebtedness. The latter is a particular source of concern. Household indebtedness surged to record highs in the late 1990s and, whereas all previous US recessions led to improvement of households' balance sheets, the real level of debt continued to expand rapidly in 2001.

Nevertheless, if the risk of a double-dip recession should not be underestimated, a number of arguments also weigh against such a scenario. First, very aggressive cutbacks on inventories starting before the recession have left the inventory-to-sales ratio at a historical low despite the past weakening of sales. In this context, further large cuts in inventories seem unlikely even if sales were to surprise on the downside. Furthermore, household sentiment recovered significantly in late 2001 thereby reducing the probability of a significant relapse of private consumption in the months to come. In this context, the alternative scenarios to the consensus V-shaped recovery could be a very sluggish recovery similar to a double-dip recession.

Japan: no light at the end of the tunnel yet. The economic situation in Japan remains a major source of concern. GDP registered its third successive decline in 2001 Q4 and, despite an improvement in some leading indicators, there is little reason to expect the outlook to improve dramatically in the short term. Domestic sources of growth are particularly weak, driven by the slump in business investment and by declining private consumption. Japan's export sector has also been hit by the slowdown in the global economy. Despite a clearly loose monetary policy, there is still no end in sight to deflationary pressures.

NIKKEI - Stock market index

Source: Commission services.

The dire condition of the real economy is, however, overshadowed by the difficulties in the financial sector. The Nikkei has lost nearly 40% of its value since the beginning of 2001, with the most recent weakness driven by increasing concerns about the solvency of Japanese banks. Official estimates suggest that the total value of non-performing loans (NPLs) in the banking system amounts to 7% of GDP, but this is generally regarded as an underestimate.

The solvency of the banking system is also under threat from two other sources. The first is banks' equity holdings, the value of which is declining with the weakness in the Nikkei, which in itself is driven by fears about bank solvency. This sort of vicious circle has occurred before, but with the introduction of market-to-market accounting rules in April 2001, banks can no longer conceal the massive losses they are incurring on their equity holdings. The second source is banks' bond holdings. In the last few years, in the absence of a profitable bank lending business, the banks have invested heavily in Japanese government bonds (JGBs). The value of these bond holdings is at risk from a rise in long-term interest rates. As international credit ratings agencies have placed the credit rating of JGBs on downward review from a rating, which is already one of the lowest in the OECD, long-term rates may well need to rise in response to increased risk premia. As banks' balance sheets deteriorate, their capital adequacy comes into question.

Crisis in Argentina did not spread to other emerging markets. While the outlook for Argentina remains mixed after the default and devaluation, contagion – as seen in financial market developments – to neighbouring countries has been very subdued so far. As the Latin American countries differ strongly – in the importance of export markets, export products, exchange rate policies and debt situations – a Latin American crisis similar to what East Asia experienced in 1997-1998 seems unlikely. Only Uruguay and Paraguay, who have strong trade links with Argentina, have been significantly affected.

2. Recovery of economic activity in the euro area still in its infancy

The weakening of economic activity in the euro area throughout 2001 was caused by the interplay of three major global economic shocks. These were the inflation hiccup induced by surging food prices and by lagged effects of high oil prices, the crisis in the ICT sector and the collapse in world trade. Following a trough at the end of the year, economic growth was predicted to gradually gain strength in the course of 2002. Thus far, the main downside risks are not materialising and recent data releases point to a nascent recovery of economic activity.

Last year ended on a weak note. Eurostat's first estimates reveal that after two quarters of negligible rates of growth, seasonally-adjusted real GDP has fallen by 0.2% in the final quarter of 2001 compared to the previous quarter. This is the first time that the euro area has registered negative growth since the first quarter of 1993.

On the expenditure side, investment in particular acted as a drag on economic activity. Both gross fixed capital formation and the change in inventories triggered a 0.2 percentage point reduction in quarterly real GDP growth. Private consumption growth did not decelerate further and delivered only a modest 0.1 percentage point contribution to overall economic growth. Thus, consumption could not compensate for the shrinkage in investment activity.

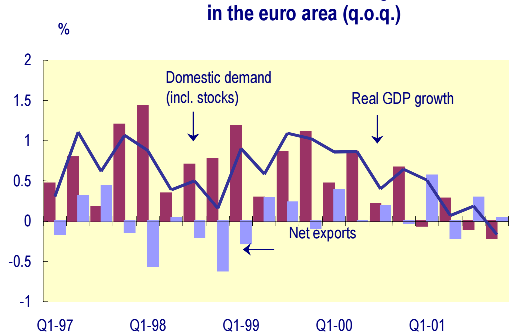
Weak overall domestic demand was also evidenced by a further decline of import growth, albeit at a slightly lower pace than in the third quarter of 2001. As in the previous quarter, external demand fell less than import

Table 1: Selected euro area and national leading indicators, 2001

	SENT. IND[1)]	BCI[2)]	OECD[3)]	PMI[4)]	IFO[5)]	NBB[6)]
Long-term average[7)]	99.2	-0.2		53.3	100.2	-9.7
March	102.5	0.61	-4.5	51.2	97.0	-13.1
April	102.1	0.39	-4.7	49.3	96.6	-15.9
May	101.6	0.08	-4.4	48.5	94.9	-13.4
June	101.1	-0.01	-4.4	47.9	93.5	-17.1
July	100.7	-0.34	-4.4	47.3	94.9	-14.0
August	100.1	-0.44	-5.4	47.5	95.8	-15.4
September	100.1	-0.54	-5.7	45.9	90.5	-21.1
October	99.1	-1.12	-5.6	42.9	89.6	-17.0
November	98.6	-1.19	-3.7	43.6	90.9	-19.0
December	98.8	-1.18	-1.3	44.1	94.3	-16.9
January 2002	99.1	-1.02	0.3	46.3	94.8	-14.1
February 2002	99.2	-0.86		48.6	101.0	-9.9

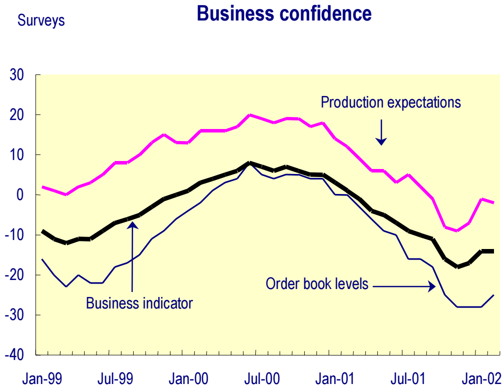
1) Economic sentiment indicator, DG ECFIN. 2) Business climate indicator, DG ECFIN. 3) Composite leading indicator, six monthly change. 4) Purchasing managers index, manufacturing. 5) Business expectations, West Germany. 6) National Bank of Belgium indicator for manufacturing. 7) Jan-92 till last observation available, for PMI (manufacturing) since beginning of series in June-97.

Contribution to real GDP growth in the euro area (q.o.q.)



Source: Commission services.

Business confidence



Source: Commission Services.

demand, which in sum generated a positive 0.1 percentage point contribution to quarterly GDP growth.

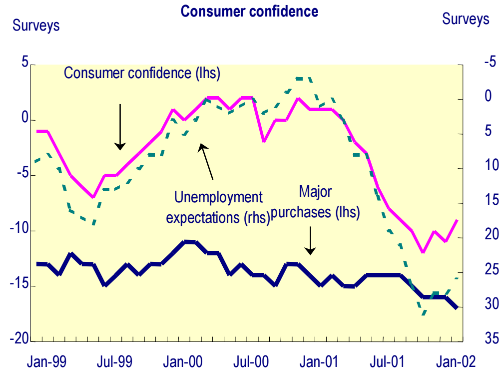
Seen from the production side, last year's slowdown of growth in the euro area can be considered predominantly as a matter of disrupted activity in manufacturing. The trough in the fourth quarter had already been foreshadowed by declining industrial production for three consecutive months between September and November and positive monthly growth was only registered in December. The disturbances in economic trade and business confidence after the terrorist attack in the USA of September certainly took their toll on the manufacturing activity in the euro area, which had already been depressed by the global shocks mentioned above.

Among the services sectors, the formerly vibrant trade, transport and communication services sector cooled-off considerably under the impact of weakening industrial activity. Overall, the service sector and even construction posted positive quarter-on-quarter growth during the final quarter of 2001, but not sufficiently high enough to counterbalance the negative impact of activity in manufacturing.

Signs pointing to a gradual economic improvement in the manufacturing sector have begun to emerge. In particular, the main leading indicators, while remaining significantly below their long-run averages, have picked up almost exceptions. Firstly, the expectation component of the German Ifo index overshot its average in February. Secondly, the Commission's Economic Sentiment Indicator has been rather close to long-term average. It should be noted this is due to the inclusion of a wider range of sectors than manufacturing, contrary to the other indicators considered.

In contrast to recent trends in the USA, consumer demand in the euro area is unlikely to drive economic growth at this early stage. Consequently, economic activity is likely to experience only a gradual recovery in the first half of this year. The Commission's consumer confidence indicator reached a trough in November, but has not yet entered a consistent upward path. The euro-area consumers' intention to engage in major purchases, in particular, has not yet recovered, which may be related to only slight improvement in

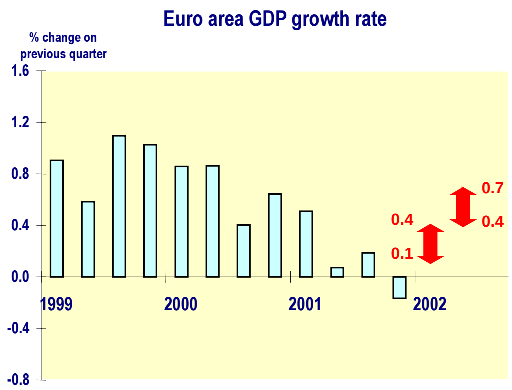
Consumer confidence



Source: Commission Services.

unemployment expectations so far. Accordingly, business confidence in the retail sector has not yet bottomed out and that in the service sector has been slow to gain lost ground.

Currently, DG ECFIN's indicator-based model predicts quarter-on-quarter real GDP growth in the range of 0.1 to 0.4% in the first quarter of 2002, accelerating to 0.4 to 0.7% in the second quarter of 2002. This picture is in line with the view underlying the Commission's Autumn forecasts that the euro area avoided recession and would enjoy a gentle upswing in the course of the first half of 2002.



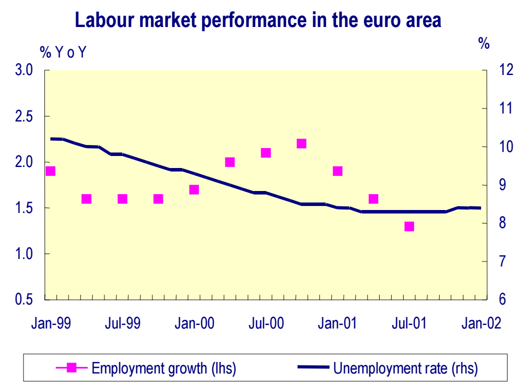
Source: Commission Services.

The euro area does not seem to be saddled with domestic supply or demand imbalances, factors that would hamper a steady recovery. While the euro area's recovery is led by domestic forces, economic growth is expected to accelerate to the rate of potential output only in the second half of this year, supported by a general improvement in the external environment. The key driving forces of the nascent recovery are the unwinding of the impact of a series of mostly global shocks, a judicious adjustment of the policy mix and a gradual revival in confidence.

3. Relative strength of the labour market

It is well known that labour market developments typically reflect the economic situation with a lag, which for the case of the euro area can be estimated to amount to two to three quarters. In the course of 2001, employment growth decelerated progressively to 1.3% year-on-year in the third quarter of 2001, against 1.6% and 1.9% in the previous two quarters. However, despite slowing down, this rate is still considerably above the pace of job creation seen in the past. If compared to the historical record of employment growth, it is not in line with the image of a cooling economy.

Whereas unemployment has begun to edge higher in several Member States, in the area as a whole the rate is rather steady and presently at 8.4% (January 2002), the same level as a year earlier and only 0.1 percentage point higher than at its trough in 2001. Hence, while the downward trend in unemployment had been interrupted, the absence of any significant increase in the rate of unemployment contrasts notably with the media attention to labour shedding in the past months. However, considering the lagged nature of employment developments with respect to the economic situation, the possibility of some deterioration cannot be excluded in the next couple of months.



Source: Commission services.

4. Inflation dominated again by volatile factors

In January 2002, annual consumer inflation in the euro area was 2.7%, up from 2.0% in December 2001. On a month-to-month basis, inflation in January was up 0.5% compared to December 2001. This up-tick seemingly supports anecdotal evidence that points to sometimes substantial price increases following the introduction of the euro bills and coins. However, while the latest official price statistics at the euro area level lend some support to the emergence of another inflation hiccup, they also indicate that the effect of the cash changeover on headline inflation was minimal.

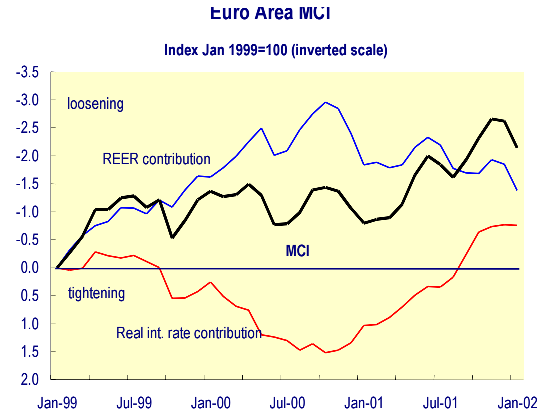
Underlining the expected transitory nature of the inflation up-tick in January, the inflation rate for February resumed falling on account of stabilising food prices as well as low industrial producer price inflation and more medium-term influences like the cyclical position of the economy and continued wage moderation. Indeed, Eurostat's latest release sees the HICP inflation rate declining to 2.4% in February.

A more detailed assessment of the euro changeover on the euro area's inflation performance is presented in Part II of this report.

5. Macroeconomic policy mix

Monetary policy responds to domestic economic developments. Each individual summary indicator to assess the appropriateness of monetary policy has its limitations. Ideally, such an assessment would take into account all factors, which might play a role in the transmission of monetary impulses to real activity and inflation.[2] With these limitations in mind, a number of tools, which have been developed by central banks, private analysts and academics can shed some light on the stance of monetary policy. These tools have the advantage of illustrating in a simple way the essential things one might want to look at, in order to form one's own views on the stance of policy, but they need to be interpreted with care.

Overall, the monetary stance has eased gradually in the course of 2001, with the ECB having cut its key intervention rate in four steps from 4.75% to 3.25%. In the second half of last year, the easing pace has become more rapid in response to declining risks to price stability over the medium term. Since 5 December 2001, the ECB has left its key rates unchanged.



Source: Commission services.

The Monetary Condition Index (MCI) suggests that conditions turned increasingly conducive to growth.[3] The easing in monetary conditions observed during 2001 owes essentially to moves in real short-term interest rates, while changes in the effective exchange rate were more muted.

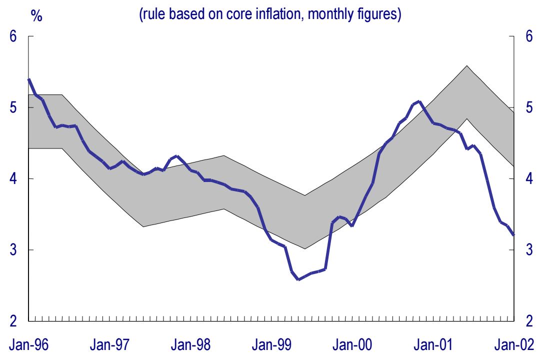
The Taylor rule is a tool sometimes used for benchmarking monetary policy. It prescribes how the short-term interest rate could be adjusted in a systematic way in response to developments in the economy to keep inflation close to target.[4]

[2] The ECB carries out a comprehensive analysis under its two-pillar strategy; it is however, not very explicit in public with respect to the details and the weighting of various factors.

[3] The MCI reflects movements in the short-term real interest rate (3-month interest rate deflated by core inflation) and the real effective exchange rate (in terms of relative unit labour cost), weighted by their respective model based impact on output,

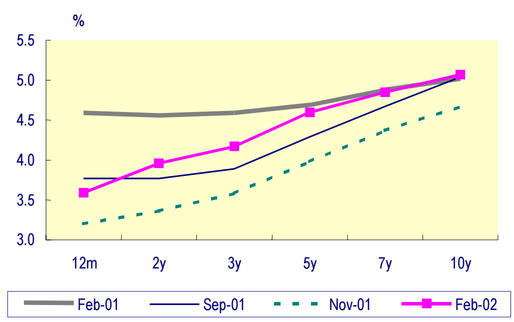
[4] According to the Taylor rule, the appropriate short-term interest rate is conditional on two variables, the actual rate of inflation and the size of the output gap. Any

Euro area interest rate: actual and implied by the Taylor rule



Source: Commission services.

Term structure of interest rates



Source: ECB.

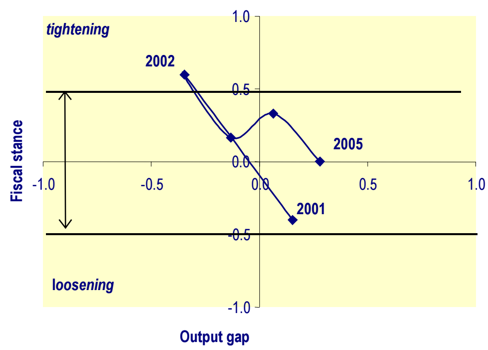
Short-term rates were within the corridor identified by the Taylor rule during the first months of 2001. However, since spring 2001, rates have been declining more rapidly than suggested by the corridor, indicating that monetary policy has been accommodative.

The yield curve, which describes the maturity structure of interest rates at a given point in time, has become steeper compared to its essentially flat shape a year ago. While long-term rates have remained practically unchanged, with the exception of the short-lived decline in reaction to the 11 September events, rates fell substantially at the short end. The yield curve seems to have some predictive power for future activity. It would indicate that financial conditions have moved from a neutral to an accommodative stance.

In the past 6 months, M3 growth has clearly outstripped the ECB's 4.5% reference value. Whether the first signs of moderation of growth in December and January are already indicating a turning point must still be awaited. Overall, strong money growth has not been seen as a risk to price stability, as the acceleration was essentially the result of portfolio shifts towards shorter term assets in a period of heightened uncertainty on financial markets.

Budgetary prospects for 2002. As growth slowed during the course of 2001, actual budget balances deteriorated due to automatic stabilisers. Whereas the actual budget deficit for the euro area as a whole rose accordingly, the cyclically-adjusted balance remained almost unchanged. The interest burden continued to fall, while the cyclically-adjusted primary surplus declined by 0.4 percentage point, exerting a slight expansionary impact on the economy.

Euro area fiscal stance and output gap



Note: The fiscal stance is measured by the change in the cyclically-adjusted primary surplus. A change of up to 0.5 percentage point is considered as broadly neutral.
Source: Commission services and Stability Programmes.

deviation of both variables from their target value should lead to adjustments of the short-term interest rate according to the weights of both variables in the Taylor rule. In the graph, the core inflation rate and the output gap estimates of the OECD and the Commission determine the corridor.

For the current year, in an environment of a gradually unfolding recovery, a further rise in the actual deficit was projected, based on the budget plans that were available for 2002. A slight improvement can be expected for the cyclically-adjusted balance, thanks to lower debt service payments. The latest updates of the Stability Programmes point to an additional moderate tightening of the policy stance in 2002, which would reduce the actual deficit. According to these programmes, the cyclically-adjusted primary balance in the euro area is set to improve by 0.6 percentage point in 2002.

Although improving steadily, the implications of the fiscal stance for the economy should be very modest in the coming years. The achievement of a balanced budget will however be delayed to 2004 compared to 2003 in the previous updates. Excluding UMTS proceeds, actual budget balances in the euro area are set to move from a deficit of -1.3 percentage point of GDP in 2001 to a modest surplus of 0.1 percentage point of GDP in 2005.

Table 2: Euro area: Actual budget balance and primary balance in the 2001 updates of stability programmes

	2000	2001	2002	2003	2004
	outcome	outcome	SP	SP	SP
Budget balance	-0.8	-1.3	-0.9	-0.5	0.0
Interest payments	4.1	3.9	3.6	3.5	3.4
Primary balance	3.3	2.6	2.8	3.1	3.5
Cyclically-adjusted balance	-1.3	-1.5	-0.7	-0.4	0.0
Cyclically-adjusted primary balance	2.8	2.4	3.0	3.2	3.5

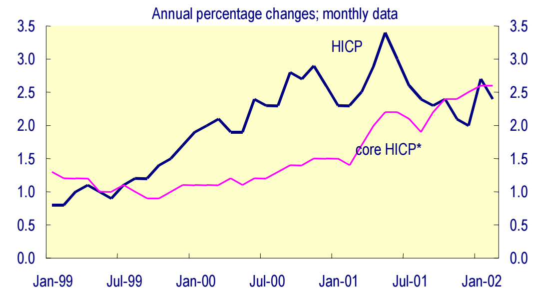
Source: Commission services and national stability programmes (SP), excluding proceeds relative to the allocation of mobile phone licences (UMTS).

II. Focus on inflation

1. Temporary hiccup of inflation in January 2002

The euro area experienced a "hiccup" in consumer price inflation in 2001. Second round effects of past increases in import prices and a domestic supply shock in the food sector pushed headline inflation up to 3.4% in May. During the second half of 2001, receding external inflationary influences, combined with some favourable base effects linked to the increases in energy prices in 2000, allowed for a steady reversal of inflation, with y-o-y growth in the headline HICP falling to 2.0% in December.[5]

Headline and core HICP inflation in the euro area



*core HICP is HICP excluding energy and unprocessed food
Source: Commission services.

The beginning of 2002 was marked by another inflation hiccup with an acceleration of headline inflation to 2.7% in January. On a month-on-month basis, inflation was up 0.5% compared to December 2001. The up-tick was due to a number of temporary or one-off factors and Eurostat's latest release points to a deceleration of inflation to 2.4% in February.

The main elements[6] responsible for the acceleration of inflation in January are the following:

- A surge in prices of fresh fruit and vegetables, which suffered from unusually cold weather, can be identified as the single most important factor. The inflation in vegetables was 19.1% y-o-y in January, up from an already high 7.1% in December 2001.

- Indirect taxes were raised in some Member States. For example, tobacco prices increased by 6.6% y-o-y, up from 4.1% in December 2001.

- As is usual at this time of the year, some tariffs were raised in sectors such as health services, passenger transport by road, water supply, sewage and refuse collection, etc.

- Oil prices exerted a less favourable influence in January. Energy inflation was -1.7% y-o-y in January, up from -4.5% in the previous month.

The picture for *core inflation*, defined as HICP inflation excluding the volatile energy and unprocessed food components, is quite different. Core inflation showed a steady upward trend between summer 2000 and fall 2001. In October 2001, it climbed above headline inflation for the first time in over two years, indicating that the direct effects of past hikes in oil and food prices have come to an end, while the indirect and second-round

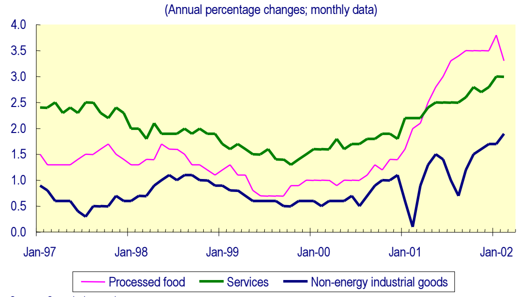
[5] HICP inflation data presented in the report are based on the definition of the euro area applied by Eurostat where euro-area aggregates correspond to the EU11 before 2001 and the EU12 after that year.

[6] The postponement of winter sales in some Member States had been mentioned as a possible additional element explaining the January inflation increase, as it could lead to an overestimation for items such as clothing. However, this effect on the month-on-month rate appears to have been mitigated by the inclusion for the first time of sales periods in the HICP coverage of Spain and Italy. Thus, Eurostat reports that the effects of winter sales on the HICP at the euro-area level this year were comparable to those in 2001.

effects are still playing a role. Core inflation has increased only modestly in the past few months, reaching 2.6% in February, and has not followed the hiccup pattern experienced by headline inflation in January.

A decomposition of core inflation for the euro area reveals that all the main sub-groupings have accelerated since mid-2000. Inflation in services and industrial goods (excluding energy) seemed to stabilise in late spring 2001 but has recently picked up again, while inflation in processed food has increased sharply since the beginning of 2001.

Components of core HICP inflation: euro area
(Annual percentage changes; monthly data)



Source: Commission services.

Lately the pace of disinflation has slowed down in sectors that exerted strong downward influence on prices during previous years, like those where productivity growth is high (e.g. telecommunications) or where a process of deregulation is gradually increasing competitive pressures (e.g. utilities, postal services).

2. A limited impact of the euro cash changeover

Although the euro cash changeover has met with remarkable smoothness, public attention on its alleged impact on prices has been strong. These concerns have been mostly substantiated by anecdotal evidence provided by consumer associations and surveys by the media. Lately, such anecdotal evidence has pointed to substantial price increases in January, particularly in some services sectors (bars, restaurants, hair cuts) and in some other items bought frequently (cinema tickets, newspapers, etc). While the latest official price statistics at the euro-area level lend support to an inflation up-tick in those product categories, they also indicate that the effect of the cash changeover on headline inflation was minimal.

Disentangling the inflationary impact of the changeover with any degree of precision is a difficult exercise. This is because it is hard to separate out, inter alia:

- the various sources of potential changeover inflation (rounding, conversion, psychological price levels, abusive windfall gains, etc.);
- the possibility that such price increases may not be limited to January but might have started already six months ago; and
- the obvious difficulty of mistakenly attributing to the changeover price increases that would in any case have taken place, for example because of depressed margins.

Acknowledging the difficulties involved in isolating the effects due solely to the changeover, Eurostat estimates that of the 0.5% m-o-m January inflation rise, 0.34% was accounted for by increases in vegetable prices (due to bad weather) and increases in indirect taxes (notably on tobacco), leaving a maximum of 0.16% that could be attributed to the euro cash changeover. The Eurostat estimate implies that the euro cash changeover has not been the dominant impulse on the euro-area headline HICP inflation up-tick in January.

Finally, it is noteworthy that the inflation up-tick in January was not restricted to the euro area but was a European-wide phenomenon. This suggests that the euro cash changeover effect was not substantial. For example, the UK registered a January 2002 headline HICP inflation of 1.6% y-o-y, up noticeably from 1.0% in the previous month. Also, among the key developments behind the inflation spike, the price of vegetables showed broadly similar increases, both within and outside the euro area.

-

3. More favourable developments in the external environment

The sharp global slowdown registered in the second half of 2001 has had two positive implications for inflation in the euro area. It has entailed downward pressure on commodity prices. It has also curbed final demand both through a slump in world trade and, to the extent that financial, corporate and confidence linkages play a role, through weaker domestic demand. While the disinflationary impact of the global slowdown is still largely in the making, other key elements of the external environment have already started to provide some relief to inflation in the euro area. These include favourable developments in oil prices and the euro exchange rate.

Table 3: Consumer energy prices in the euro area

	Energy	of which electricity	of which gas	of which fuels
		1999		
Annual change (%)	2.3	-0.2	-2.4	5.9
Weight in HICP (%)	8.7	2.4	1.3	4.3
HICP (pp)	0.2	0.0	-0.0	0.3
		2000		
Annual change (%)	13.4	-1.3	11.9	21.1
Weight in HICP (%)	8.9	2.2	1.3	4.8
HICP (pp)	1.2	-0.0	0.2	1.0
		2001		
Annual change (%)	2.8	2.1	15.2	-2.4
Weight in HICP (%)	9.5	2.2	1.5	5.1
HICP (pp)	0.3	0.1	0.2	-0.1

Source: Commission services.

Oil prices have been on a declining trend during much of 2001, leading to a sharp fall in energy inflation and reducing the contribution of the energy component to headline inflation by more than half its 2000 level. One of the main elements underlying the rapid pass-through of changes in crude prices to the energy component of the HICP is the behaviour of fuels. Inflation in fuels more than tripled in 2000 compared to 1999, running at an annual rate of 21.1%. During 2001, inflation in fuels registered an even more abrupt fall to –2.4%. On the other hand, the lagged effect of past increases in oil price can still be observed in gas (often contractually linked to oil prices) and, despite ongoing deregulation, in electricity prices. In 2001 inflation in gas was 15.2%, up from 11.9% in 2000, making price rises in gas alone account for over half of the energy component's contribution to headline inflation in that period.

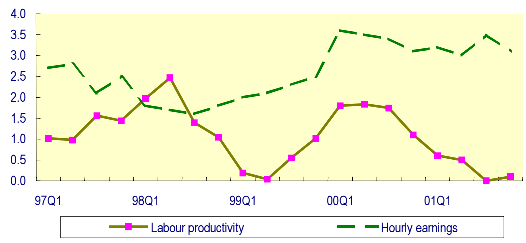
Price developments in non-energy industrial goods – which would be expected to be the component in core HICP most sensitive to exchange rate changes - signal that since mid-2000 hikes in import prices (excluding energy) have begun to be passed-through to higher consumer prices. The pass-through of exchange rate changes to consumer prices generally depends on a number of factors, including whether the exchange rate weakness is expected to persist, policy regime changes, the size and openness of an economy, etc. In the euro-area Member States, for example, the changeover to a single currency regime in 1999 may have reduced the pass-through, especially in smaller countries or countries whose currencies were prone to depreciation. Also, the sheer size of the euro market and producers' confidence in price stability may work to enhance 'pricing-to-market' behaviour.

4. Subdued wage pressures

Wage increases are one of the key elements behind medium-term inflation developments in the euro area. Notwithstanding a significant pick-up in consumer price inflation, sustained reductions in the aggregate unemployment rate and rapid employment growth, wage increases in the euro area remained moderate in 2000. The weakening of activity and the stabilisation of unemployment contributed to further wage moderation in 2001 despite the inflation hiccup.

Labour costs - euro area

Annual percentage changes



Source: Commission services.

Several factors may explain why in a period of falling unemployment, the increases in oil and later food prices have not influenced wage developments. They range from time lags in adjusting to exogenous shocks and lags resulting from the effect of past contracts, to the perception that the rise in oil and food prices were temporary. There are also reasons to believe that labour market behaviour may have changed under EMU. Hence wage moderation may reflect confidence on part of employers and trade unions in the ability of the ECB to contain present inflationary pressures and ensure price stability. Also, with a common currency and monetary policy, wage negotiations must take into account more than ever before the negative impact of excessive wage claims on competitiveness, as offsetting adjustments in exchange rates are no longer an option.

Assisted by a pause in the fall of unemployment and in employment growth, wage moderation is expected to continue to prevail this year. Despite some acceleration in a few countries, upcoming wage negotiations are expected to internalise the price stability objective of the ECB and not deviate from the moderate wage growth trend of the last few years. Several elements support this scenario of moderate wage growth.

- Wage settlements already concluded have "locked-in" low inflation expectations and those scheduled for this year do not seem to reverse the pattern of wage moderation.

- The anticipated deceleration of inflation will support gains in households' purchasing power during the year, with a likely dampening effect on wage claims.

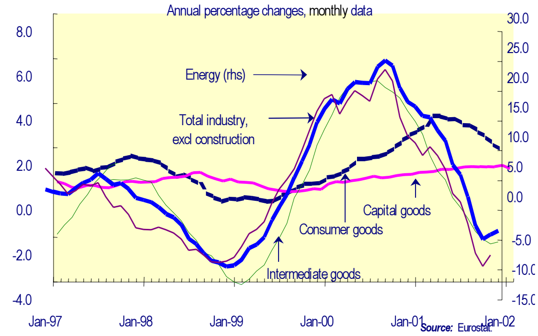
- The development of part-time and temporary jobs in recent years has helped to reduce labour market rigidities.

5. The outlook for inflation

The January inflation hiccup was largely the result of one-off or temporary factors and headline inflation is expected to resume rapidly its downward trend observed in the second part of last year. Disinflation will be supported by favourable base effects associated with past increases in energy and food prices, a normalisation of food prices and by the continuous and strong past deceleration in industrial prices. Inflation in industrial producer prices has decelerated steadily and markedly since its peak in late 2000. Producer prices have actually dropped steadily since October 2001 although the latest readings suggest a moderation of the deflation trend.

Industrial Producer prices: euro area

Annual percentage changes, monthly data



Source: Eurostat.

In addition to the factors reviewed above, developments in the fundamental determinants of inflation all point into the same direction. Persistent wage moderation, subdued economic activity and low inflation expectations all suggest that inflation pressures will remain moderate over the coming months. In particular, business and consumer inflation expectations have been on a downward trend since the beginning of last year and autumn 2001, respectively (see Box on inflation

-

expectation). Information on inflation expectations embedded in financial asset prices also suggests that the credibility of the ECB's objective of price stability is now well established.

As regards core inflation, the pass-through effect of previous increases in import prices to domestic prices seems to have peaked already. Although indirect and second round price effects are still being felt in less energy sensitive sectors, the degree of pass-through is expected to recede soon due mainly to the emergence of excess capacity in manufacturing and the weakness of the economy. With less favourable domestic and foreign demand prospects for goods and services, firms have less room to increase profit margins, as keeping up sales becomes more difficult. Overall, a trend reversal in core inflation is expected to take place later this year. This is further supported by developments in producer prices, which usually lead consumer prices by about 12 months.

Deregulation and greater competition in telecommunications and electricity markets is anticipated to resume lowering the inflation rate by 0.2-0.3 percentage points in 2002. Furthermore, the sharp fall in prices observed in information processing and equipment industries is expected to have some impact on other sectors. Increased use of the internet by both business and consumers is expected to result in cost savings, productivity improvements and more price transparency - all of which would exert downward pressure on prices in an environment of increasing competition. Restructuring and more competitive retailing, spurred by the euro and increased globalisation, should reinforce this tendency.

Risks to the outlook are essentially related to the external environment. Exchange rate and oil price developments appear to carry the highest degree of uncertainty, and given that most of previous inflationary pressure has sprung from these sources, they also seem to carry the largest weight.

Wage inflation constitutes another source of risk. By and large, wage agreements reached in 2001 seem to confirm expectations of future nominal wage growth in line with price stability. The spring 2002 wage negotiations in Germany are expected to result in moderate wage agreements but some worrying signs have recently emerged which could translate into a less benign outlook for wage inflation.

Box 2: **Measuring inflation expectations**

Inflation expectations play a central role in modern macroeconomic theory. They are important for the evolution of interest rates, for determining the credibility of a central bank and as a leading indicator of actual price movements. Thus inflation expectations deserve careful attention both from a forecasting and policy making point of view. However, a recurring problem confronting economists and policy makers is that expectations about the future behaviour of prices are not directly observable. Several tools have been developed to measure inflation expectations. Most of them can be grouped into two broad categories: information on expectations can be gathered directly through surveys or it can be extracted indirectly from asset prices.

Surveys of inflation expectations

Two types of surveys of inflation expectations may be distinguished.

A first type consists of questionnaires directly addressed to a representative sample of the relevant economic agents: households and/or firms. The European Commission conducts regular business and consumer surveys that include questions on past and future price developments. However, the Commission's surveys are of a qualitative nature and they do not provide a precise quantitative measure of the perceived and expected rate of inflation.

A second type of survey consists of gathering perceptions and forecasts from professional experts. Private sectors companies such as Consensus Economics have been doing this for a number of years, the ECB conducts its own Survey of Professional Forecaster (SPF) and even publications of wider circulation like *The Economist* have such polls.

Extracting information on inflation expectations from asset prices

Information on expected inflation can be extracted from a variety of different financial instruments. The ones that have received most attention are: (a) the term structure of interest rates, (b) forward rates, (c) options and (d) index-linked bonds.

(a) The term structure – It can be shown that movements in interest rates primarily reflect fluctuations in expected inflation (the so-called Fisher effect) rather than changes in real interest rates. In this context, although the term structure is also determined by expectations of future growth, it can be argued that a downward sloping yield curve reflects expectations of a falling rate of inflation, while a steeply upward sloping yield curve indicates expectations of a rising rate of inflation.

(b) Forward rates – Forward interest rates (nominal interest rates agreed upon today for a period starting in the future) may serve as an indicator of expectations of future short-term interest rates, the future path of inflation and risk premia. Although forward rates contain the same information as the yield curve, it may be argued that the forward-rate curve presents the information in a manner more easily interpreted for monetary policy purposes. In principle, forward rates allow a separation of expectations for the short, medium and long term more easily than the yield curve

(c) *Options* – These relatively recent type of financial instruments can be used to derive information about the degree of uncertainty in market's expectations, and whether that uncertainty is skewed to the left or right.

(d) I*ndex-linked bonds* (ILBs) are assets that provide protection against inflation. Like conventional bonds, inflation-linked bonds offer coupon payments determined by a fixed rate of interest and return the principal at maturity. Both the coupon payments and the redemption payment are adjusted to keep pace with inflation, thus preserving the real value of both income and capital. Comparing the yield on ILBs with yields on conventional bonds with similar terms to maturity and risk characteristics allows for the measure of inflation expectations. Due to its simplicity, this method is quite popular. The ECB and other market participants often use information extracted from French ILBs as a proxy for euro-area long-term market inflation expectations, mainly because France is the only Member State that has issued this type of financial instrument. French ILBs are now indexed to euro-area inflation rather than French inflation as in the past, making this extrapolation more justifiable.

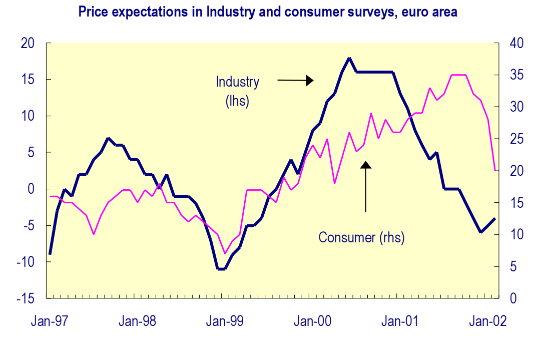
Nevertheless, the methods described here suffer from several serious limitations. Firstly, as an illustration of both technical and policy implications of the Lucas critique, previous research indicates that the relationship between nominal interest rates and inflation tends to shift with monetary regime changes. This has important implications for using information derived from financial instruments in the initial stages of EMU. Secondly, while the information extracted is certainly useful, it should be recalled that high frequency information, like expected inflation derived from financial instruments, has a tendency to be very volatile.

Finally, it is worth mentioning two problems specifically associated with the popular ILBs method. Firstly, the limited size and liquidity of the ILB market in the euro area may sometimes make comparisons between ILBs and conventional bonds difficult to interpret. Secondly, at times of heightened uncertainty about future inflation, investors in conventional bonds may demand a premium to compensate them for the risk of unexpected future inflation. The existence of an inflation-risk premium would thus cause the yield differential between ILBs and conventional bonds to *overstate* inflation expectations.

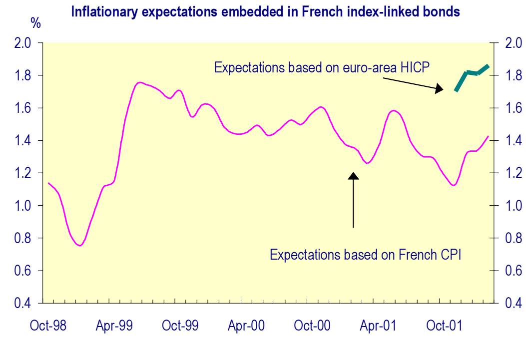
-

Empirical results for the euro area

Several conclusions can be drawn from developments in the price components of consumer and industry surveys for the euro area. Price expectations as measured by the surveys follow the evolution of actual inflation quite closely when inflation is measured by the HICP (consumer surveys) and by producer prices (industry surveys). Households' price expectations have been on a steep downward trend since autumn 2001. Producers in the manufacturing sector reported a similar downward trend in price expectations starting early 2001. However, producers' expectations seem to have stabilised in the past few months whereas households' expectations are still on a downward trend.



Source: Commission Services.



Source: French treasury, Reuters.

Information extracted from French ILBs is of a more long-term nature. Inflation expectations for France assessed on the basis of long-term bonds *indexed on the French CPI* have fluctuated in a relatively narrow band of 1.1-1.8% since mid-1999. Limitations highlighted above imply that some of these fluctuations are likely to reflect technical factors rather than actual changes in inflation expectations. Overall, expectations have been little affected by previous surges in oil and food prices. French bonds *indexed on the euro-area HICP* have only been available since last November. Corresponding estimations of inflation expectations for the euro area have remained below 2%, averaging 1.8%. Over the same period, inflation expectations for France have been about 50 basis points lower. In general, the information extracted form ILBs suggests that the ECB's objective of medium-term price stability is considered credible by financial markets.

III. References to further work

1. Policy documents

EUROPEAN ECONOMY 1/2002
The Implementation Report of the 2001 Broad Economic Policy Guidelines
http://europa.eu.int/comm/economy_finance/publications/european_economy/implement2001_en.htm

ECONOMIC PAPER. No. **167**
Directorate General for Economic and Financial Affairs / Economic Policy Committee (EPC): **Annual report on structural reforms 2002**
http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers167_en.htm

Economic Policy Committee: **Report on Research and Development**
http://europa.eu.int/comm/economy_finance/epc/epc_reports_en.htm

Communication from the European Commission to the European Council. Review of the introduction of euro notes and coins
http://europa.eu.int/comm/economy_finance/publications/euro_related/eurorelated_communication0302_en.htm

Announcement: The Brussels Economic Forum 2-3 May 2001
Thursday 2 and Friday 3 May 2002, Rue de la Loi 170, 1040 Brussels Simultaneous translation : 3 languages (EN-FR-DE)
Thursday 2 May - 13.45 to 18.00
Session N° 1: The Economic Outlook and the Broad Economic Policy Guidelines.
Friday 3 May - 8.30 - 18.15
Session N° 2 Equity Markets
Session N° 3 Enlargement and convergence.
http://europa.eu.int/comm/economy_finance/events/2002/events_brussels_020502_en.htm

2. Analytical documents

ECONOMIC PAPER. No. **166**.
F. Ballabriga and C. Martinez-Mongay: **Has EMU shifted policy?**
Abstract: This paper assesses the extent to which the macroeconomic policy architecture of EMU represents a break with the past. This is carried out by estimating forward-looking fiscal and monetary policy rules for the Member States and by analysing them within the conceptual framework of the Fiscal Theory of the Price level.
http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers166_en.htm

ECONOMIC PAPER No. **165**.
Lars Jonung: **EMU and the euro – the first 10 years. Challenges to the sustainability and price stability of the euro area - what does history tell us?**
Abstract: EMU and the euro will face a number of challenges in the future. Two such challenges are examined here: First, the endurance prospects for the euro, and second, the inflation performance of the euro area during the coming ten years. How will it respond to them? This report provides a set of tentative answers based on the history of monetary unions and of stabilization policies. This body of evidence is exploited as the prime basis for conjectures and forecasts presented.
http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers165_en.htm

-

ECONOMIC PAPER No. **164**

Harry Huizinga and Gaëtan Nicodème : **Deposit insurance and international bank deposits**

Abstract: This paper examines how international depositors respond to national deposit insurance policies. Countries with explicit deposit insurance are found to be relatively attractive to international non-bank depositors. Deposit schemes characterized by co-insurance, a private administration, and a low deposit insurance premium appear to be particularly favored by these depositors. The sensitivity of non-bank deposits to deposit insurance policies opens up the possibility of international regulatory competition in this area. The EU directive on deposit insurance imposes minimum standards on national deposit insurance policies. This directive, however, is silent on several important features of deposit insurance such as the level of the deposit insurance premium. Hence, it may not preclude regulatory competition in Europe.

http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers164_en.htm

ECONOMIC PAPER. No. **163**

Giovannini Group: **Cross-border clearing and settlement arrangements in the European Union**

Abstract: The findings reported here raise some serious concerns. Relative to domestic transactions, transactions within the European economy that occur across Member Sates are far more complex, are hindered by a number of significant barriers and, given the data that the group has been able to collect, are much more costly than domestic transactions. It is perhaps no exaggeration to conclude, from the analysis in this report, that inefficiencies in clearing and settlement represent the most primitive and thus most important barrier to integrated financial markets in Europe. The removal of these inefficiencies is a necessary condition for the development of a large and efficient financial infrastructure in Europe.

http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers163_en.htm

ECONOMIC PAPER No. **162**.

K. Mc Morrow and W. Roeger: **EU pension reform - An overview of the debate and an empirical assessment of the main policy reform options**

Abstract: This paper on European Union (EU) pension reform provides an overview of the debate and, on the basis of a series of model simulations, makes an empirical assessment of the main pension policy reform options at the EU, not the Member State, level. It estimates what it would take to bring the public PAYG pension system back into equilibrium and assesses the case for a shift to funding. The main conclusion of this paper is that the EU pension system should in the very long run (i.e. over more than one generation) be fully funded, with this being achieved using a two-stage optimal transition path. Stage one of this transition process should concentrate on stabilising the PAYG system and achieving a partial shift to funding, with stage two only occurring once circumstances permit. The fully funded system, once established, should have public and private pillars, with the public system in effect replacing the old PAYG system with a similar compulsory, defined benefit, system and with the private pillar being a voluntary, defined contribution, system.

http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers162_en.htm

EUROPEAN ECONOMY SPECIAL REPORT 1/2002 (forthcoming)

Responses to challenges of globalisation. A study on the international monetary and financial system and on financing for development

In this report the European Commission focuses on two main issues: The discussion on the reform of the international monetary and financial architecture as a response to global financial crises, and of financing and promoting development as a means to reduce global inequality.

http://europa.eu.int/comm/economy_finance/publications/globalisation/global1_en.htm

ECONOMIC PAPER No. **161**.

S. Davies and M. Hallet: **Policy responses to regional unemployment: Lessons from Germany, Spain and Italy**

Abstract: The paper examines the causes of high regional unemployment in Germany, Spain and Italy, and identifies a number of areas where policy action is needed. Lower unemployment rates will not only depend on stability-oriented macroeconomic policies and a sufficiently flexible labour market, but also on moves towards

- more decentralised wage bargaining systems;
- efforts to reduce regions' long-term dependency on fiscal transfers;
- changes in tax-benefit systems to improve incentives to create and take up jobs;
- efficient public expenditure on physical and human capital and
- action to reduce obstacles to labour mobility.

http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers161_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

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

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

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

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

Eurobarometers (The Eurobarometer surveys track changes in public opinion in Europe during the run-up to the introduction of euro notes and coins)
http://europa.eu.int/comm/economy_finance/publications/euro_related/eurorelated_eurobarometer_en.htm

-

IV. Key indicators for the euro area

1	**Output**		2001	2002*		Sep-01	Oct-01	Nov-01	Dec-01	Jan-02	Feb-02
	Industrial confidence [1.1]	Balance	5			-11	-16	-18	-17	-14	-14
	Industrial production [1.2]	Ann. % ch	5.7			-0.7	-2.5	-4.3	-4.1		
			2001	2002*	2003*	00 Q4	01 Q1	01 Q2	01 Q3	01 Q4	02 Q1
	Gross domestic product [1.3]	Ann. % ch	1.5	1.3	2.9	2.8	2.4	1.6	1.4	0.6	
		Qtr. % ch				0.6	0.5	0.1	0.2	-0.2	
2	**Private consumption**		2001	2002*		Sep-01	Oct-01	Nov-01	Dec-01	Jan-02	Feb-02
	Consumer confidence [2.1]	Balance	1			-9	-10	-12	-10	-11	-9
	Retail sales [2.2]	Ann. % ch	2.7			1.6	-0.3	1.6	0.4		
			2001*	2002*	2003*	00 Q4	01 Q1	01 Q2	01 Q3	01 Q4	02 Q1
	Private consumption [2.3]	Ann. % ch	2.0	1.6	2.5	1.9	2.0	1.7	1.7	1.6	
3	**Investment**		2001	2002*	2003*	00 Q4	01 Q1	01 Q2	01 Q3	01 Q4	02 Q1
	Capacity utilization [3.1]	%	83.2			84.4	84.4	83.6	83.0	81.8	80.8
	Gross fixed capital formation [3.2]	Ann. % ch	0.7	1.3	3.9	3.2	1.8	0.3	-1.1	-1.9	
	Change in stocks [3.3]	% of GDP	-0.1	0.0	0.2	0.1	0.4	0.1	-0.2	-0.4	
4	**Labour market**		2001	2002*	2003*	Sep-01	Oct-01	Nov-01	Dec-01	Jan-02	Feb-02
	Unemployment [4.1]	%	8.4	8.6	8.2	8.3	8.3	8.4	8.4	8.4	
			2001	2002*	2003*	00 Q4	01 Q1	01 Q2	01 Q3	01 Q4	02 Q1
	Employment [4.2]	Ann. % ch	1.2	0.2	1.2	2.2	1.9	1.6	1.3		
	Wages [4.3]	Ann. % ch	3.2	0.3	1.3	3.2	3.2	3.2	3.1		
5	**International transactions**		2001	2002*	2003*	Sep-01	Oct-01	Nov-01	Dec-01	Jan-02	Feb-02
	Export order books [5.1]	Balance	-14			-21	-25	-28	-28	-28	-25
	Exports of goods [5.2]	Bn. EUR	1046.3	2365.0		82.0	96.1	89.1	81.4	77.2	
	Imports of goods [5.3]	Bn. EUR	999.1	2294.2		77.8	87.2	82.8	73.0	77.9	
	Trade balance [5.4]	Bn. EUR	47.3			4.2	8.9	6.3	8.4	-0.6	
			2001	2002*	2003*	00 Q4	01 Q1	01 Q2	01 Q3	01 Q4	02 Q1
	Exports of goods and services [5.5]	Ann. % ch	3.6	2.1	6.5	12.0	8.6	5.6	1.8	-1.8	
	Imports of goods and services [5.6]	Ann. % ch	2.0	2.8	6.4	10.7	6.9	4.4	0.2	-3.7	
			2001	2002*	2003*	Sep-01	Oct-01	Nov-01	Dec-01	Jan-02	Feb-02
	Current account balance [5.7]	Bn. EUR	-17.2	23.9		-1.3	0.1	2.8	2.9		
	Direct investment (net) [5.8]	Bn. EUR	-89.5			-13.1	5.3	7.8	0.6		
	Portfolio investment (net) [5.9]	Bn. EUR	51.7			43.0	0.3	11.5	-11.7		
6	**Prices**		2001	2002*	2003*	Sep-01	Oct-01	Nov-01	Dec-01	Jan-02	Feb-02
	HICP [6.1]	Ann. % ch	2.5	1.8	1.8	2.3	2.4	2.1	2.0	2.7	2.4
	Core HICP [6.2]	Ann. % ch	2.0			2.2	2.4	2.4	2.5	2.6	2.6
	Producer prices [6.3]	Ann. % ch	2.2			0.7	-0.7	-1.3	-1.1	-0.9	
	Import prices [6.4]	Ann. % ch	1.2	0.0	2.2	-5.8	-10.5	-11.3			
7	**Monetary and financial indicators**		2001	2002*	2003*	Sep-01	Oct-01	Nov-01	Dec-01	Jan-02	Feb-02
	Interest rate (3 months) [7.1]	% p.a.	4.3			4.0	3.6	3.4	3.3	3.3	3.4
	Bond yield (10 years) [7.2]	% p.a.	4.8			4.8	4.6	4.5	4.8	4.9	4.9
	Stock markets [7.3]	Index	4050			3292	3440	3676	3711	3690	3538
	M3 [7.4]	Ann. % ch	5.3			6.2	6.8	7.4	7.8	8.0	
	Credit to private sector (loans) [7.5]	Ann. % ch	7.9			6.9	6.8	6.9	6.8	6.3	
	Exchange rate USD/EUR [7.6]	Value	0.90			0.91	0.91	0.89	0.89	0.88	0.87
	Nominal effective exchange rate [7.7]	Index	91.0			92.7	92.9	91.3	92.0	91.4	90.6

* ECFIN Autumn 2001 forecasts (*European Economy*, Supplement A, No 10/11 - October/November 2001)

Number	Indicator	Note	Source
1	**Output**		
1.1	Industrial confidence indicator	Industry survey, average of balances to replies on production expectations, order books, and stocks (the latter with inverted sign)	ECFIN
1.2	Industrial production	Annual percentage change, volume, excluding construction, wda	Eurostat
1.3	Gross domestic product	Annual percentage change, volume (1995), seasonally adjusted	Eurostat
1.3.3	Gross domestic	Quarterly percentage change, volume (1995)	Eurostat
2	**Private consumption**		
2.1	Consumer confidence indicator	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	Annual percentage change, volume, excluding motor vehicles, wda	Eurostat
2.3	Private consumption	Annual percentage change, volume (1995 prices), seasonally adjusted	Eurostat
3	**Investment**		
3.1	Capacity utilization	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	Annual percentage change, volume (1995 prices), seasonally adjusted	Eurostat
3.3	Change in stocks	In percent of GDP, volume (1995 prices), seasonally adjusted	Eurostat
4	**Labour market**		
4.1	Unemployment	In percent of total workforce, ILO definition, seasonally adjusted	Eurostat
4.2	Employment	Annual percentage change, ECFIN calculations on basis of Eurostat figures, partly estimated	Eurostat
4.3	Wages	Annual percentage change; not fully harmonized concept (mostly hourly earnings)	ECFIN
5	**International transactions**		
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	Annual percentage change, volume (1995 prices), including intra euro area trade, seasonally adjusted	Eurostat
5.6	Imports of goods and services	Annual percentage change, 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
6	**Prices**		
6.1	HICP	Annual percentage change, harmonized index of consumer prices	Eurostat
6.2	Core HICP	Annual percentage change, harmonized index of consumer prices, excluding energy and unprocessed food	Eurostat
6.3	Producer prices	Annual percentage change, without construction	Eurostat
6.4	Import prices	Annual percentage change	Eurostat
7	**Monetary and financial indicators**		
7.1	Interest rate	Percent p.a., 3-month interbank money market rate, period averages	Datastream
7.2	Bond yield	Percent p.a., 10-year government bond yields, lowest level prevailing in the euro area, period averages	Datastream
7.3	Stock markets	DJ Euro STOXX50 index, period averages	Datastream

-

7.4	M3	Annual percentage growth rate of seasonally adjusted flows, moving average (3 last months): from 1997 onwards corrected for holdings by non-residents	ECB
7.5	Credit to private sector (loans)	Annual percentage change, MFI loans to euro area residents excluding MFIs and general government, monthly values: month end values, annual values: annual averages	ECB
7.6	Exchange rate USD/EUR	Period averages, until December 1998: USD/ECU rates	ECB
7.7	Nominal effective exchange rate	Against 13 other industrialized countries, double export weighted, 1995 = 100, increase (decrease): appreciation (depreciation)	ECFIN

Comments on the report would be gratefully received and should be sent to:

Servaas Deroose
Coordination of economic policies of the Member States and the euro area
European Commission
Rue de la loi 200 BU1 0/147
B-1049 Brussels

or by e-mail to Greta.de-pauw@cec.eu.int or servaas.deroose@cec.eu.int