

The background of the cover features a stylized map of Europe in shades of orange and yellow. Overlaid on the map are several white, five-pointed stars of varying sizes, arranged in a pattern reminiscent of the European Union flag. The overall aesthetic is clean and professional, with a focus on the geographical and institutional context of the report.

QUARTERLY REPORT ON THE EURO AREA

Volume 3 N° 3 (2004)

Highlights in this issue:

- Recent economic developments and short-term prospects
- Assessing developments in profitability
- The financial health of the private sector in the euro area
- Focus: The pro-cyclicality of fiscal policy in EMU

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EDITORIAL

Following the positive growth surprise in the first quarter of this year, the recovery of the euro area has pursued its course. The economy has actually expanded slightly faster than expected during the first half of the year, with growth accelerating towards potential, and should continue to expand at a similar pace throughout the rest of the year.

While the higher growth prospects are of course welcome, there are no grounds for complacency. The recovery still looks relatively timid and unless growth accelerates further it would take a long time for the negative output gap to be closed and for employment creation to accelerate.

In a context of a softening global economic environment, the contribution from exports to euro area growth will gradually diminish. An acceleration of growth will therefore depend upon an upturn in domestic demand. However, the indicators here remain mixed. While housing construction is showing early signs of a moderate recovery, business investment remains subdued. On the other hand, continued progress in redressing corporate balance sheets, supportive financial conditions and improved profitability on the back of a cyclical recovery in productivity have set the stage for a recovery in investment. Meanwhile private consumption picked up at the beginning of the year, but then decelerated in the second quarter. And while some consumption indicators have recently shown signs of strengthening, short-term prospects remain mixed as household spending is hampered by low confidence and a sluggish employment recovery.

Since a more forceful recovery seems to be held back by a lack of confidence and uncertainty over the future policy course, policy makers must show the way ahead, by pursuing and setting in motion structural reforms that instil new dynamism and lift

growth potential, and by clarifying the future policy agenda. I am therefore looking forward to the report by the High-Level Group on the Mid-Term Review of the Lisbon Strategy chaired by former Dutch Prime Minister Mr Wim Kok. I also welcome discussions on the proposals that I put forward in the Commission's Communication "Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact" of September 3rd 2004. This Communication responds to the June European Council's call to strengthen and clarify the implementation of the Stability and Growth Pact. It builds on ideas contained in the Communication of June 24th 2004 on "Public Finances in EMU – 2004". Here I would like to draw attention to some of its key measures.

First of all, I would like to stress that the two nominal anchors – the 3% reference value for the deficit to GDP ratio and the 60% for the debt to GDP ratio – have proven their value and that they will continue to be the centrepiece of multilateral fiscal surveillance. The obligation on any Member State that breaches the rules to take prompt corrective action still stands.

However, given the increasing economic diversification in an EU of 25 Member States, in particular with regard to explicit and implicit debt levels, a uniform medium-term target for all countries does not appear to be appropriate. In view of this fact and given the experience of 5 years in EMU, I believe that we can enhance the credibility and enforceability of our fiscal framework by emphasising the economic rationale for the Pact, by taking greater account of economic fundamentals and by better interlinking the instruments for EU economic governance in order to enhance the contribution of budgetary policy to

economic growth. This will involve a number of practical steps.

First, the Pact should place greater emphasis on debt and sustainability in the surveillance of budgetary positions. I have proposed, therefore, that multilateral surveillance should focus more on debt dynamics than has been the case so far in order to complement the continued rigorous attention to deficit developments.

Secondly, the Pact needs to pay closer attention to economic circumstances and developments when setting the medium-term budgetary objective for each Member State in a Union of 25. Let me stress that this is not about creating an “à la carte” Pact but rather about applying economic rationale in a more economically diverse EU of 25 Member States. At the same time, this medium-term objective should ensure compliance at all times with the 3% of GDP rule and therefore guarantee equal treatment within the Union.

Thirdly, there is a need to ensure earlier action to correct inappropriate budgetary developments during more favourable periods of the economic cycle. With hindsight, it is all too obvious that if some

Member States had made more consolidation efforts during the good years, 1999 and 2000, then the excessive deficits that exist today might have been avoided. To do this we must strengthen peer pressure, possibly also by using actively early warnings.

Finally, let me reiterate that a greater effort is needed in the EU to coordinate action on structural reforms and efforts to implement the Lisbon agenda. Europe needs to raise its growth potential, create more jobs and prepare itself for the future. Although the Stability and Growth Pact has a leading role to play in this process, full use should be made of all policy instruments. The Broad Economic Policy Guidelines in particular have an important contribution to make because of their focus on broader issues of macroeconomic stability and structural reform in the EU.

Joaquín ALMUNIA

MEMBER OF THE EUROPEAN
COMMISSION



I. Economic situation in the euro area

The recovery of the euro-area economy is continuing. GDP expanded slightly faster than expected during the first half of the year with growth accelerating to around its potential. The expansion is set to continue during the second half of the year but a recent softening of some leading indicators suggests that a further acceleration of growth is unlikely in the months to come. A strongly supportive global environment has been the main engine of the euro-area recovery while domestic demand has, so far, failed to gather sustained momentum. Exports will continue to support growth in the months to come but some evidence of a softening of the global economy has recently emerged as surging oil prices have taken their toll. On the domestic side, housing construction is showing early signs of a moderate recovery but business investment remains subdued. Companies have restructured their balance sheets, financial conditions remain supportive and profitability has improved on the back of a cyclical recovery in productivity. Hence, the lacklustre performance of investment is more likely to be related to uncertainties regarding the medium-term outlook for demand than to supply-side constraints. Private consumption picked up at the beginning of the year but decelerated again in the second quarter. A number of indicators related to consumption have recently shown some strengthening but short-term prospects remain mixed as household spending is hampered by low confidence and a sluggish employment recovery.

1. Recent economic developments and short-term prospects¹

The euro-area recovery is pursuing its course

Recent indicators suggest that the euro-area recovery is pursuing its course with growth close to its potential rate. According to Eurostat's latest national account release, GDP increased by 0.5% quarter-on-quarter in the second quarter of 2004, i.e. only marginally below the 0.6% registered in

the first quarter. Most of the growth momentum came from the external sector. Exports surged, registering their fastest quarterly rate of expansion since early 2000 and allowing net trade to make a strong positive contribution to GDP growth despite a sharp acceleration of imports. In contrast, domestic demand remained nearly flat as a result of sluggish private consumption and anaemic capital formation. After a moderate build-up in the previous two quarters, inventories were cut slightly during the three months to June.

Table 1: Euro-area growth components

	2003	2003	2004	2004	Carryover to 2004	Forecast (1)	
	Q3	Q4	Q1	Q2		2004 (2)	2005 (2)
% change on previous period, volumes							
GDP	0.5	0.4	0.6	0.5	1.5	1.7	2.3
Private consumption	0.2	0.0	0.6	0.3	0.9	1.6	2.3
Government consumption	0.6	0.4	0.1	0.6	1.3	1.2	1.3
Gross fixed capital formation	0.0	0.8	-0.2	0.1	0.5	2.4	3.6
Changes in inventories (% of GDP)	-0.4	0.2	0.1	0.0	0.0	0.1	0.2
Exports of goods and services	2.5	0.4	1.4	3.7	5.5	4.9	5.9
Imports of goods and services	1.3	1.9	0.3	2.9	4.5	5.0	6.6
% contribution to change in GDP							
Private consumption	0.1	0.0	0.3	0.1	0.5	1.1	1.6
Government consumption	0.1	0.1	0.0	0.1	0.3	0.1	0.0
Gross fixed capital formation	0.0	0.2	0.0	0.0	0.1	0.5	0.7
Changes in inventories	-0.3	0.6	-0.1	-0.1	0.1	0.0	0.1
Net exports	0.5	-0.5	0.4	0.4	0.5	0.0	-0.1

(1) Annual change in %. (2) European Commission Spring 2004 Forecasts.

Source: Commission services.

¹ The cut-off date for the statistics included in this issue was 30 September 2004.

Table 2: Selected euro-area and national leading indicators, 2003-2004

	SENT. IND ¹⁾	BCI ²⁾	OECD ³⁾	PMI ⁴⁾	Reuters Ser ⁵⁾	IFO ⁶⁾	NBB ⁷⁾	ZEW ⁸⁾
Long-term average	101.8	0.15	2.55	52.3	54.4	96.1	-11.2	
Trough in latest downturn	87.7	-1.45	3.71	42.9	46.7	87.2	-26.5	
November 2003	98.9	0.07	6.76	52.2	57.5	100.9	-8.8	67.2
December 2003	97.2	-0.01	6.54	52.4	56.6	102.3	-6.9	73.4
January 2004	98.5	0.15	6.29	52.5	57.3	102.8	-5.6	72.9
February 2004	98.9	0.02	6.06	52.5	56.2	100.3	-6.8	69.9
March 2004	98.9	-0.06	5.85	53.3	54.4	98.8	-4.1	57.6
April 2004	100.1	0.39	5.25	54.0	54.5	97.7	-0.5	49.7
May 2004	100.3	0.32	4.57	54.7	55.8	97.7	-2.5	46.4
June 2004	99.7	0.43	3.83	54.4	55.3	96.0	-2.0	47.4
July 2004	99.8	0.56	3.07	54.7	55.3	97.1	4.1	48.4
August 2004	100.9	0.51		53.9	54.5	95.9	-2.1	45.3
September 2004	100.7	0.48				95.7	-1.1	44.8

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 Services purchasing manager index. 6) Business expectations, West Germany. 7) National Bank of Belgium indicator for manufacturing. 8) Business expectations of financial market analysts, Germany.

Only government consumption showed some strength, accounting for a large fraction of the meagre overall growth in domestic spending.

Encouragingly, the growth momentum in Q2 was broad-based both in sectoral and geographical terms.

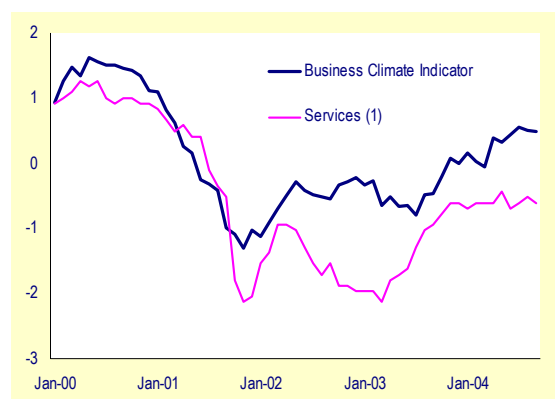
Except for the Netherlands and Greece, where GDP contracted in the second quarter, activity expanded robustly in most euro-area countries. Furthermore, second-quarter growth – when positive – was both above potential and slightly accelerating in most cases with only Italy and Spain reporting a moderate deceleration of activity.

Activity picked up momentum in construction as well as in most service sectors in the second quarter, while the industrial sector continued to show sustained growth.² A moderate deceleration was only registered in the trade, transport and communication sector. Overall, the total value added of all sectors increased by 0.7% in Q2, a level of growth similar to that registered in Q1 and superior to GDP growth. The discrepancy between growth in total value added and GDP was actually unusually large in the second quarter, a fact that seems to be attributable to changes in indirect taxation

² Based on Eurostat’s breakdown of euro-area GDP into 6 broad industrial sectors.

(most notably in Germany). This suggests that second-quarter GDP data may have slightly underestimated the strength of growth in the euro area.

Graph 1: Confidence indicators, euro area



(1) Normalised.
Source: Commission services.

Turning to the second half of the year, industrial production increased by 0.4% in July relative to June (2.4% y-o-y) but is likely to lose some momentum. An inflexion in business confidence has in fact been noticeable since August. ECFIN’s Business Cycle Indicator improved markedly in June and July but shed some of its gains in August and September as a result of a weaker assessment of export orderbooks, stocks and production trends.

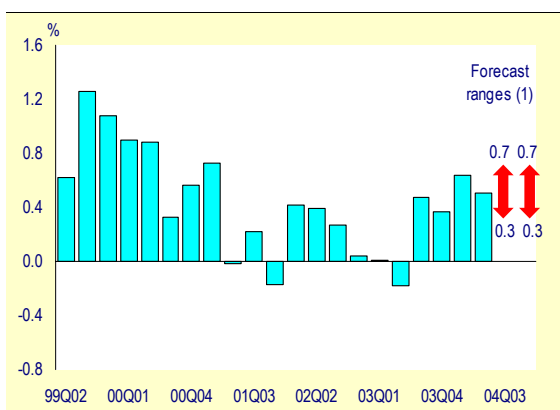


Reuters PMI also dropped significantly in August. To a lesser degree, signs of weakening have also been visible in the service sector. ECFIN's service survey remained broadly stable over the summer months but Reuters services activity index fell significantly in August.

The recent softening of business confidence probably mostly reflects the downshift in global industrial production (see next section), as shown by a moderate weakening of export orders. However, it may also translate emerging concerns about prospects for domestic demand in the euro area as suggested by the fact that some indicators of confidence in the service sector are also affected.

Nevertheless, indicators of business sentiment remain consistent with a continuation of the expansion in the euro area. In particular, Reuters manufacturing and service indices are still well above the 50 line that separates growth from contraction. This suggests that the recovery remains on track, although growth is unlikely to gather further momentum during the second half of the year. This assessment is confirmed by ECFIN's indicator-based model for quarterly GDP growth, according to which GDP growth should be in a range of 0.3-0.7% in the third and fourth quarter (Graph 2).

Graph 2: GDP growth, euro area
 (quarter-on-quarter growth)



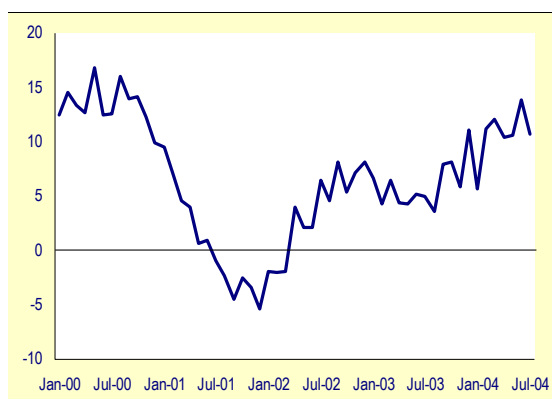
(1) ECFIN's indicator based forecast model.
 Source: Commission services.

A supportive but softening global environment

According to the estimates of the CPB Netherlands Bureau of Economic Policy Analysis, world trade was still expanding at double digit growth rates in the summer. In July – latest available data – year-on-year growth in world trade in volume stood at 10.7%, down from the 13.7% peak registered in June.

These recent trade data are somewhat at odds with the signs of softening in the world economy registered during the second quarter. World GDP growth is estimated to have halved from 1.7% q-o-q in the first quarter to 0.9% in the second quarter as higher interest rates, surging oil prices and a policy tightening in China took their toll. As a result of these factors, the world economy is likely to be somewhat less buoyant during the second half of the year than during the first months of 2004 and the trade momentum should soften. In line with this assessment, the July reading of the quarterly World Economic Survey points to a deterioration of expectations regarding the future economic situation.³ ECFIN's quarterly survey in the euro-area manufacturing sector also shows a moderate weakening in companies' export expectations in the third quarter.

Graph 3: World trade
 (year-on-year % changes in volume)



Source: CPB Netherlands Bureau of Economic Policy Analysis.

³ The WES is carried out by the IFO institute with the financial support of the European Commission. It is based on interviews with economic forecasters, researchers and policy makers around the world.

Recent development in the United States - The US expansion slowed down to an annual rate of 3.3% in the second quarter from a very robust 5% growth rate over the preceding twelve months. The slowdown was primarily due to a softening of private consumption owing not only to the substantial rise in energy prices, but probably also to a weakening effect of the fiscal and monetary policy stimulus injected in 2001-2003. The available data for the third quarter are somewhat mixed, but again an annualised growth rate close to the economy's long-term potential (3-3.5%) is likely. The Federal Reserve has started to raise short-term interest rates at a measured pace, as announced.

Employment growth, which had been strong in the spring, fell back in the summer months to an unusually low rate for the third year of an economic upturn. The unemployment rate also drifted lower, reaching 5.4% in August. Inflation picked up in the first half of the year partly reflecting the increase in oil and commodity prices. But price developments became more benign in the third quarter with various measures of core inflation settling in the 1-2% range. The current account deficit increased to 5.7% of GDP in the second quarter, reflecting both a widening goods and services deficit and a sharp deterioration of the net foreign investment income balance.

Recent developments in Japan - The economic recovery in Japan has turned into a fairly broad-based expansion, supported not only by external demand but also by structural improvements in the corporate and financial sectors. GDP growth decelerated markedly in the second quarter to an annualised 1.3%, down from 6.2% in the first three months of the year. However, the slowdown is, to some extent, distorted by problems related to seasonal adjustment. In addition, while public investment and inventories contributed negatively to growth, private consumption and private investment continued to show robust momentum. Overall, recent indicators point to a continuation of the expansion in Japan during the second half of the year although the peak of the upturn has probably passed.

Recent developments in other parts of the world - Economic growth in Latin America gathered strong momentum in the first half of the year on the back of strong global demand, higher commodity prices, the return of foreign investors' confidence and competitive exchange rates. Asian economies continue to make a substantial contribution to global growth with robust exports and rebounding domestic demand. Chinese authorities have responded to a built-up of inflationary pressures by tightening policy, which seems to have had some effect on the economy as evidenced by a deceleration of investment in the second quarter. Nevertheless, real GDP seems to be continuing to grow at a rate of about 9%. Growth also remains robust in the euro-area's immediate neighbourhood. In the UK, GDP accelerated slightly from 0.7% in the first quarter to 0.9% in the second on the back of sustained investment and private consumption. Recent evidence also points to continued strong momentum in the economies of the new Member States.

Signs of a rebalancing of growth towards domestic demand are still limited

The contribution of domestic demand to GDP growth in the euro area was smaller in the second quarter of the year than in the first. Against the background of a possible softening of the external stimulus, the continued lack of vigour of domestic demand in the euro area may be seen as a source of concern for the sustainability of the euro-area recovery. Recent developments in investment and consumption provide only limited grounds for optimism in this respect.

Gross fixed capital formation - After a mild contraction in the first quarter of the year (-0.2% q-o-q), gross fixed capital formation increased marginally in the second quarter (+0.1%). Two points relating to developments in capital formation since the beginning of the year are worth stressing. First, the lacklustre investment performance of the euro area as a whole masks large country differences. Second, the ongoing weakness of investment spending can be largely ascribed to the business sector.



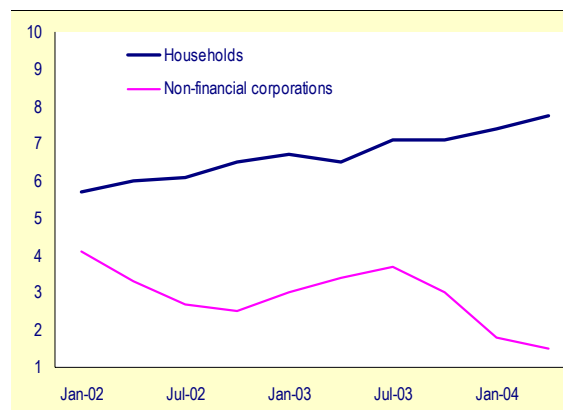
A polarisation of investment performance is beginning to be visible at the Member State level. More than half of the countries for which data are available showed relatively sustained investment growth in Q2 with several of them registering an acceleration relative to Q1 (France, Spain and Portugal). In contrast, capital formation was still moving along a contractionary path in Germany in the second quarter. It also dropped in the Netherlands and Belgium after a relatively strong showing in the first three months of the year.

The analysis of the sectoral breakdown of fixed capital formation – only available up to the first quarter – indicates that the ongoing sluggishness of capital spending stems essentially from the business sector. After a pick-up in the second half of last year, spending on machinery and equipment remained flat in the first quarter. Following a relatively strong performance at the end of last year, non-residential investment dropped significantly in the first months of 2004. These developments contrast with the moderate recovery observed in the housing sector since the last quarter of 2003 in most Member States with the notable exception of Germany.

Recent indicators related to capital spending convey mixed messages and do not suggest a strong acceleration of business investment in the months to come. Although the high volatility of industrial new orders makes them difficult to interpret, they seem to have stabilised between May and July after sharp increases in the first months of the year.⁴ ECB data on financial flows also show a stabilisation of the annual growth rate of the total financing of the non-financial corporate sector at a low level of around 2% in the second quarter (Graph 4).⁵ More positively, household debt is expanding rapidly on the back of strong demand for mortgages. In the second quarter,

total household financing was rising at only slightly below 8% in annual terms. There is early indication that momentum in mortgages remained strong in July with annual growth in lending by monetary and financial institutions for housing purchase above 9% (see also Graph 26). These developments suggest that the incipient recovery in the housing sector remains on track.

Graph 4: Financing of the non-financial private sector, euro area (2002Q1-2004Q2 - annual growth in %)



Source: ECB.

Overall, recent developments and the short-term outlook for investment are disappointing, given the existence of supportive fundamentals and the recovery in activity registered since the beginning of the year. Interest rates are still low and profitability has improved (see Section 2 “Assessing developments in profitability”). Furthermore, companies have improved the structure of their balance sheets by lengthening the maturity of their debt. The ECB bank lending survey for July also showed the first easing in banks’ credit standards for loans to enterprises since the survey began in 2003. Overall, balance sheet and financing constraints are unlikely to account for the persistent weakness in corporate investment spending (see Section 3 “The financial health of the private sector in the euro area”), the source of which is more likely to be related to uncertainties regarding the medium-term outlook for demand.

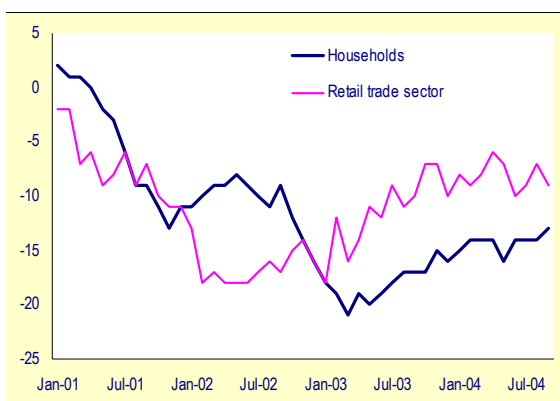
Private consumption - Recent developments regarding household consumption are mixed. After increasing by 0.6% in the first quarter,

⁴ This is based on the indicator’s trendline. The year-on-year growth of the actual indicator fell sharply over the same period.

⁵ However, there is some evidence of a moderate pick-up of the growth of loans from monetary and financial institutions to the non-financial corporate sector since the spring, at least for loans of short to medium-term maturities. See ECB Monthly Bulletin September 2004.

euro-area private consumption grew by a more modest 0.3% in the second quarter. The deceleration was relatively broad-based at the country level, likely reflecting the negative incidence of higher oil prices. However, as in the case of investment, a marked polarisation of the growth performance can be observed. Countries such as France, Spain and, to a lesser degree, Belgium, have experienced a relatively sustained consumption recovery since the beginning of the year whereas household spending has so far remained lacklustre in Germany and the Netherlands.

Graph 5: Confidence in the household and retail trade sectors, euro area



Source: Commission services.

Sluggish developments in private consumption are in line with evidence from surveys. Consumer and retail trade confidence strengthened during the course of last year but have remained broadly stable since the beginning of this year (Graph 5). At their present level, both indicators are consistent with positive but only sluggish growth in consumer spending. High oil prices, subdued household confidence and lacklustre employment growth will continue to hamper consumption growth in the months to come. Some prudence is therefore required when assessing the short-term outlook for consumption. There are, however, several reasons for cautious optimism:

- Firstly, the surge in oil prices since the spring does not seem to have weighed on consumer confidence.
- Secondly, households have so far taken a benign view of recent inflation

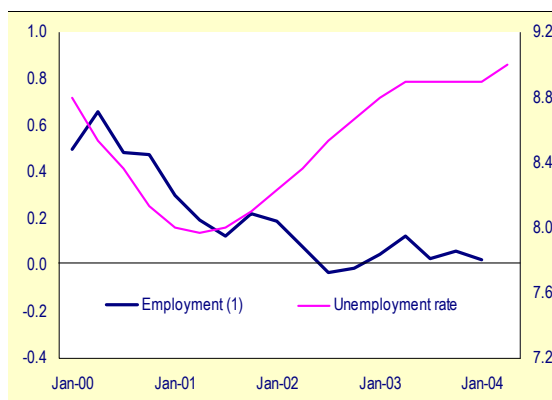
developments. Their assessment of past price developments, which had deteriorated markedly in the wake of the euro changeover, has continued to improve in the past months.

- Thirdly, a few indicators have recently sent positive signals. Loan data show an inflexion in consumer credit growth alongside fast growth in loans for house purchases (see also Graph 26). Furthermore, the volume of retail sales in the euro area rose significantly in June and July.
- Finally, sustained growth in mortgages shows that households are not reluctant to spend but prefer to opt for estate assets rather than other forms of consumption. This might suggest that uncertainties regarding medium-term income prospects continue to weigh on their spending decisions.

A slow cyclical recovery of employment

Labour markets have so far shown little signs of a recovery in the euro area as a whole. Total employment remained virtually unchanged in the region last year and recent developments do not suggest any noticeable pick-up since the beginning of the year.

Graph 6: Employment growth and unemployment, euro area (quarterly data - in %)



(1) Quarterly year-on-year growth in %.

Source: Commission services.

Employment was flat in the first quarter of the year – latest available data – and there is indirect evidence that the situation did not improve



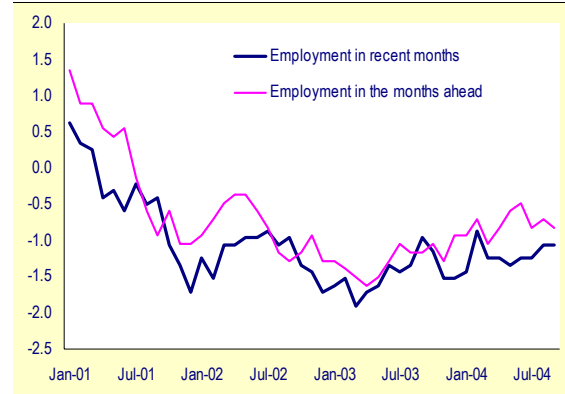
markedly in the second quarter. After a year of stability, the unemployment rate drifted slightly upwards from 8.9% to 9.0% in April and stayed at that level over the summer. Meanwhile, employment assessments in recent business surveys have remained mixed.

Graph 7 displays companies' assessment of the employment situation in the service sector as reported in ECFIN's business survey. It includes both a backward- and a forward-looking component as companies are asked to gauge the evolution of employment in recent months and its expected evolution in the months ahead. Both components have shown a modest upward trend since spring 2003. However, the improvement took place against the background of significant volatility and should therefore be interpreted with caution. Furthermore, a gap between companies' expectations and their assessment of the recent past built up in the spring. It narrowed somewhat over the summer but remains positive, as current employment developments have recovered more slowly than expectations.

The employment components of ECFIN's business survey in the service sector track actual developments in total employment in the economy relatively closely with slight leading properties.⁶ On the basis of this correlation, it is likely that job growth in the second quarter was at best modest. Looking ahead, a significant acceleration of employment growth during the second half of the year appears unlikely unless surveys improve markedly.

With the euro area enjoying a firm recovery of activity since the beginning of the year, recent developments in employment appear, on the face of it, disappointing. However, the analysis presented in Box 1 shows that employment and activity cycles tend to be lagged in the euro area and that the employment recovery is not at this stage unusually late compared with previous cycles.

Graph 7: Assessment of employment in ECFIN's business surveys, euro-area service sector (1)



(1) Series are normalised with averages and standard deviations calculated over the 1997-2003 period.

Source: Commission services.

Nevertheless, the analysis presented in the box also suggests that employment growth could remain modest during the next few quarters. Employment was unusually resilient in the euro area in the latest downturn. It increased by more than 1% between the peak of the business cycle in late 2000 and its trough at the end of 2003. By way of comparison, employment fell by 1 to 3% during the previous three major downturns in the mid-1970s, late 1970s and early 1990s. The comparatively strong performance in the latest downturn may be attributed to two factors: a trend increase in the employment content of growth that started around the mid-1990s and a cyclical slowdown in productivity. The respective roles of the two factors are difficult to disentangle but Box 1 concludes that a substantial cyclical deceleration of productivity took place in 2001-03 on top of the structural increase in the employment content of growth. In other words labour hoarding was important during the downturn and labour productivity is likely to pick up significantly during the early stages of the recovery, allowing only modest growth in employment in the next few quarters.

⁶ The correlation between the backward-looking employment component of the survey in the service sector and total employment growth is about 85% for the relatively small sample over which the survey is available (i.e. 1997 to now).

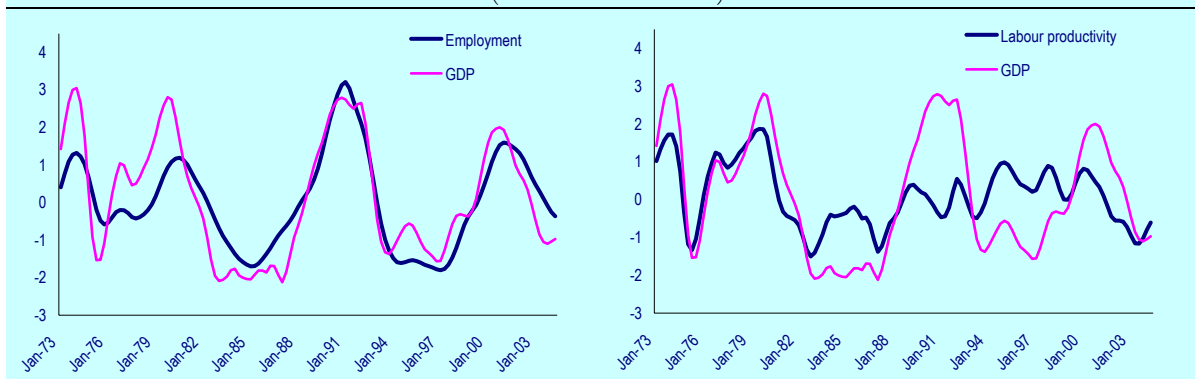
Box 1: Is the employment recovery unusually late?

After several quarters of stagnation, euro-area GDP has again been on an expansionary path since the third quarter of 2003. The progressive pick-up in activity has fuelled hopes that an employment recovery could be imminent but developments in employment indicators have so far remained disappointing. The present box examines the recent employment cycle in order to shed some light on the short-term outlook for employment.

1. The employment cycle

The analysis of short-term developments in employment is complicated by the existence of shifts in trend employment and productivity growth. Statistical filters can be used to disentangle short-term cyclical changes in employment from longer-term developments. The graphs below display the cyclical components of employment (on the left) and labour productivity (on the right) as extracted with a Baxter-King filter. Both cycles are plotted against the GDP cycle.

Employment, productivity and GDP cycles (1), euro area
(as a share of trend in %)



(1) Extracted with a Baxter-King filter.

Source: Commission services

Since the 1970s the employment cycle has tended to respond to changes in the business cycle with an average lag of 1-2 quarters. However, this average picture conceals a significant asymmetry between the speed of the response in upturns and downturns. Whereas the employment cycle has generally peaked at the same time as or shortly after the GDP cycle, longer lags can be observed in the case of cyclical troughs. Lags were particularly long when the recovery in activity was sluggish or short-lived as was the case in the early 1980s and after the 1992-93 recession.

Looking into recent cyclical developments, the left-hand graph suggests that the latest employment cycle was somewhat milder than its predecessor in the first half of the 1990s. The difference can only partly be ascribed to a less pronounced GDP cycle. This can be verified by looking at developments in the productivity cycle (right-hand graph). Reflecting the fact that productivity acts as a buffer against short-term variations in activity, the cyclical component of productivity is subject to more frequent short-term fluctuations than the employment component. However, the right-hand panel shows that the latest downturn was characterised by a sharp cyclical slowdown similar to what was observed in the recessions of the 1970s and much more pronounced than during the 1992-93 recession.

Overall, the analysis of de-trended employment data suggests two conclusions.

- First, relatively long lags between the cyclical recovery in activity and employment are not unusual, especially if the pick-up in activity is moderate. Given that the trough in activity in the euro area only took place at the end of last year, the absence of clear signs of an employment upswing at this stage of the business cycle is not surprising.
- Second, the latest downturn was characterised by a strong cyclical slowdown in productivity which presages a relatively soft cyclical recovery of employment as past labour hoarding reduces the potential for a strong employment pick-up.



2. Assessing the short-term outlook for employment

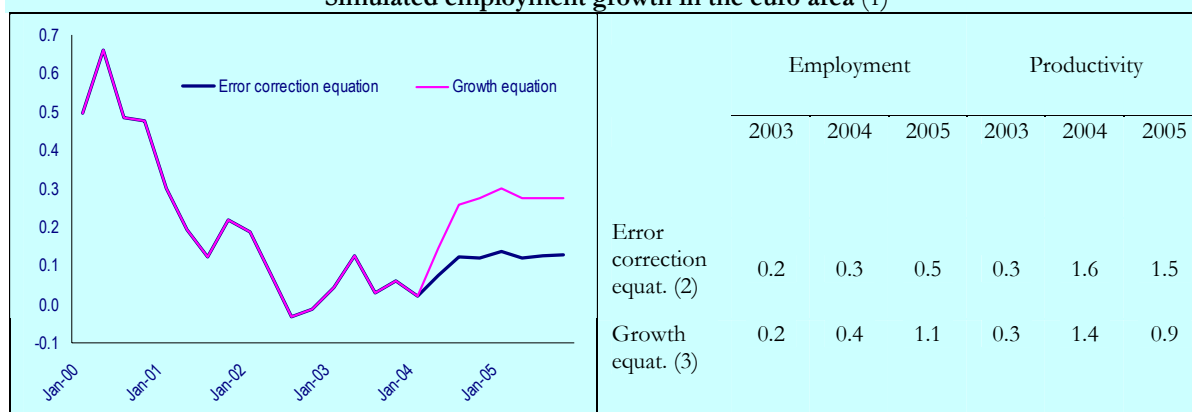
To better assess the timing and strength of the forthcoming employment recovery, two employment equations were estimated.

The first one simply relates quarter-on-quarter growth in employment to past GDP growth for various lags. A major difficulty with estimated employment equations is the structural downward shift in trend labour productivity which presumably took place in the 1990s. In the case of a simple growth specification the problem can be overcome by restricting the estimation period considered (here 1996 to 2003). Over the short sample considered the fit of the equation is quite good with, an R-squared of 0.85 indicating the key role played by GDP dynamics in explaining short-term employment developments.

A major limitation of the simple equation described above is that it does not rest on solid theoretical underpinnings. Economic theory predicts that employment demand will depend not only on activity but also on the level of real wage and that its response to shocks will be slow owing to adjustment costs. To allow for these features, an employment demand equation modelled as an error correction mechanism was estimated over the 1970Q1-2004Q1 period. The equation is similar to the one proposed in Mourre (2004) (“Did the pattern of aggregate employment growth change in the euro area in the late 1990s?”, ECB Working Paper Series, No. 358, May 2004). Its long-term specification relates employment to GDP, real wages and a time trend. To account for the downshift in trend productivity registered in the 1990s, a structural break is introduced in 1997.

The two equations were simulated over the 2004Q2-2005Q4 period based on the GDP projections presented in the Commission’s Spring 2004 Forecasts (adjusted for the positive growth surprise registered during the first half of 2004). The corresponding two scenarios for the short-term employment outlook are shown in the graph and table below.

Simulated employment growth in the euro area (1)



(1) The employment and productivity growth presented for 2004 and 2005 are only benchmark simulation exercises and do not represent a Commission forecast.

(2) Employment demand equation specified as an error correction model. See text for an explanation.

(3) Equation relating growth in employment to growth in GDP. See text for an explanation.

Source: Commission services.

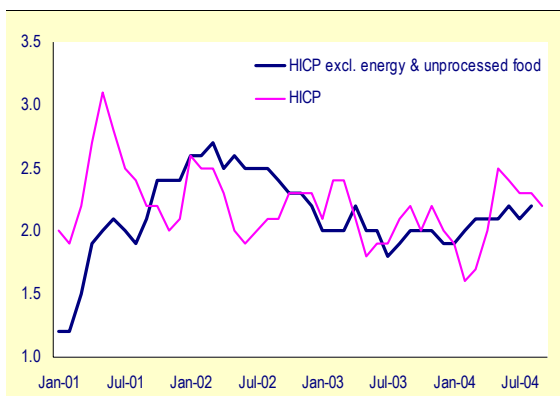
Both equations suggest a return to employment growth during the second half of 2004 but with notable differences in the strength of the recovery. Based on the simple growth equation, employment should rapidly renew with expansion rates exceeding 1% in annualised terms. However, if the cyclical slowdown in productivity and the lagged effect of past increases in real wages are taken into account (as in the error correction model), the employment recovery could turn out to remain sluggish through 2005, with annualised growth rates not exceeding 0.5%. The first scenario is difficult to reconcile with the weak level of employment still currently reported in business surveys. It is also difficult to reconcile with the analysis of the employment cycle presented above and the idea that a non-negligible part of the productivity slowdown in recent years was of a cyclical nature. However, the second (more pessimistic) scenario should also be considered with caution insofar as shifts in trend productivity are difficult to capture in estimated equations.

Overall the analysis presented in this box suggests that the employment recovery is so far not unusually late but could be disappointingly moderate.

Persistent inflation pressures from oil prices

HICP inflation remained clearly above 2% over the summer, easing slightly to 2.2% in September (Flash estimate), down from a peak of 2.5% in May. The higher level of headline inflation observed in the euro area since the spring is essentially attributable to a sharp increase in oil prices. The price of a barrel of Brent has been fairly volatile in the past months, climbing to 44\$ in August before falling slightly during the first half of September and rising again to reach 46\$ at the end of the month. Movements in oil prices tend to feed rapidly into headline inflation via an increase in the HICP energy component.⁷ In August, the annual change in the energy component was running at 6.5%, against -2% five months earlier.

Graph 8: Consumer price inflation, euro area (annual change in %)



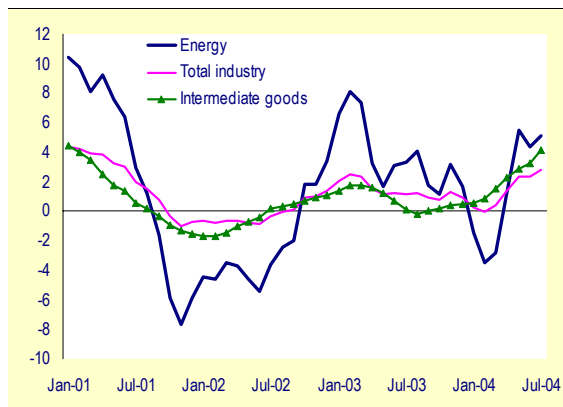
Source: Commission services.

Recent developments in the oil market do not suggest a rapid decrease of oil prices, and so associated inflation pressures are likely to persist for some time. In the months to come, the direct impact of higher oil prices via the energy component of the HICP will be compounded by indirect effects as producers pass through higher input costs into final prices. This pass-through effect is beginning to be visible in producer price statistics. Producer prices have edged higher in the past months. The

⁷ In April and May the effect of the surge in oil prices was compounded by the reversal of the favourable base effect associated with the rapid fall in oil prices after the beginning of the Iraq war last year.

acceleration can partly be ascribed to developments in the energy sector but also reflects increasing price pressures in the intermediate good sector, which themselves translate the delayed effect of higher oil and other commodity prices (Graph 9).

Graph 9: Producer price inflation, euro area (annual change in %)



Source: Commission services.

A major source of uncertainty regarding the short-term outlook for prices in the euro area relates to forthcoming developments in wages and the possibility of second-round effects as consumers try to recoup losses in purchasing power. However, recent developments in terms of labour costs and inflation expectations are encouraging, showing persistent wage moderation and decelerating unit labour costs.

- Based on Eurostat’s quarterly accounts, annual growth in wages per employee decelerated to 2% in the last quarter of 2003 and the first quarter of 2004, according to the last available data (Graph 10).⁸ Eurostat data on hourly labour cost paint a similar picture of persistent wage moderation. Only limited more recent data are as yet available but the annual growth in the ECB’s indicator of negotiated wages slowed marginally to 2.2% in the second quarter, from 2.3% in the first quarter.
- Higher oil prices have not led to an upward drift in inflation expectations. Households’

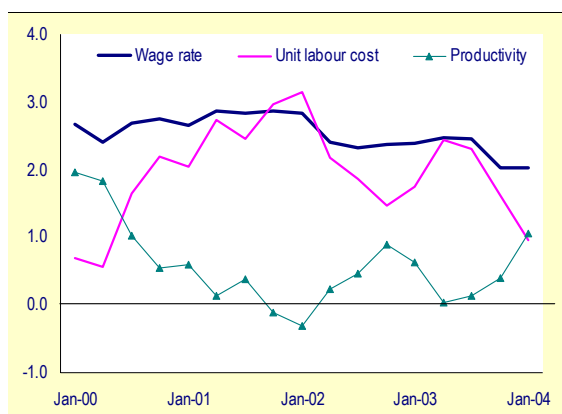
⁸ Wage rates are calculated as the ratio of the wage bill to the total number of employees.



assessment of the short-term outlook for prices (as measured in consumer surveys) increased in May and June but receded again over the summer. Inflation expectations derived from indexed bonds peaked in June at close to 2.4% before falling back to below 2.2% in August despite a further-pick up of the oil price (see Graph 13).

- Besides wage moderation, the ongoing cyclical recovery in labour productivity is translating into a deceleration of unit labour costs. In the first quarter of this year, year-on-year growth in unit labour costs was at 1%, its lowest level since 2000.

Graph 10: Labour costs, euro area
(quarterly data – year-on-year change in %)



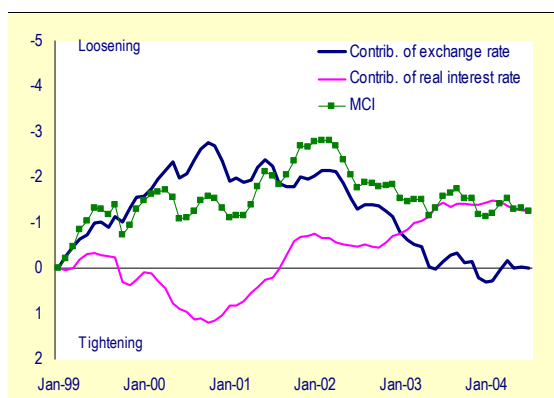
Source: Commission services.

Monetary and financial conditions remain favourable

Monetary conditions in the euro area continue to be conducive to the economic recovery. With fairly stable real interest rates and a euro exchange rate that has continued to fluctuate in a relatively narrow range against most currencies, the MCI has remained almost unchanged since May (Graph 11). Short-term financial conditions in the euro area have remained favourable throughout the summer period. The ECB has kept its key policy rate unchanged for more than a year now, leaving nominal and real interest rates at historically low levels. Throughout the summer months, financial markets have expected a tightening in the euro area towards the first quarter of 2005.

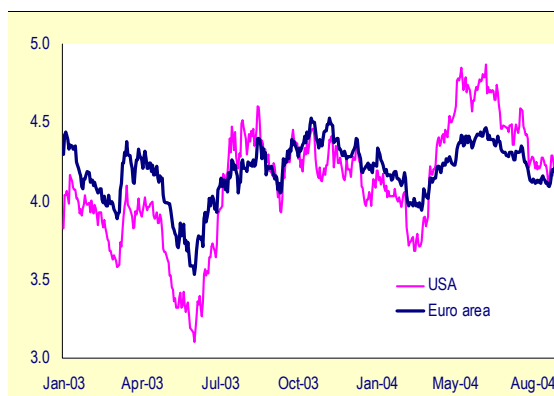
In the US, the Federal Reserve started to raise its key policy rates and to gradually withdraw monetary stimulus from the US economy. Key rates were raised by 25 basis points at each of the last three meetings of the FOMC reaching a level of 1.75%.

Graph 11: Monetary conditions, euro area
(index January 1999= 0)



Source: Commission services.

Graph 12: 10-year government bond yields, euro area and USA (daily data)

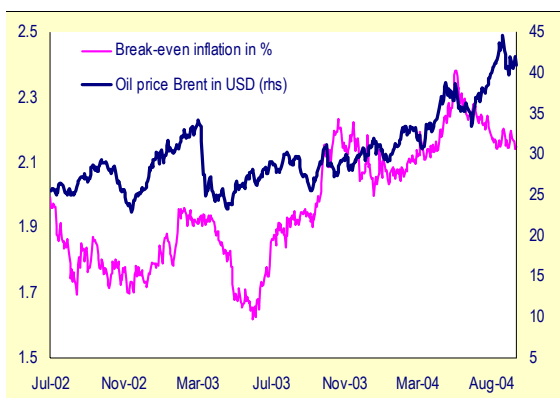


Source: Datastream.

Recent developments in longer-term financial conditions were more favourable over the summer than in the second quarter of the year. Bond yields edged up sharply in May and June, in the US even reaching the highest level in almost two years. This increase seemed to reflect changing perceptions among market participants of the Federal Reserve's future monetary policy stance. Positive employment

data raised investors' confidence in the strength of the US economic recovery, which led to expectations that the Fed would tighten its policy stance earlier than previously expected. In the euro area, bond yields rose in the spring with the confirmation of a more optimistic outlook and in the face of concerns about inflationary pressures, possibly related to oil prices (Graph 13).

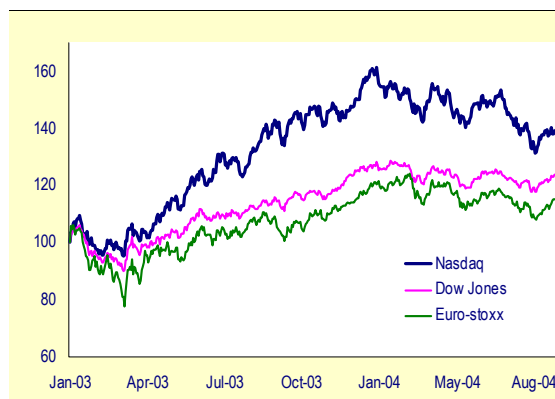
Graph 13: Break-even inflation rate and oil prices, euro area



Source: EcoWin.

Nevertheless, since the end of June, ten-year government bond yields in the US and the euro area have again declined substantially, as market expectations about future growth have shifted downwards. During August, financial markets were mainly driven by geopolitical events, oil price developments and doubts about the sustainability of the US recovery. Markets traded a scenario that higher oil prices would slow down economic growth rather than being passed through into higher inflation. In addition, June and July data on the US labour market cast doubts on the robustness of the US recovery, implying that the moderation of economic growth observed in the second quarter in the US might continue longer than previously expected.

Graph 14: Stock indices, (daily data – index 1 Jan 2003 = 100)



Source: Datastream.

Turning to stock markets, the trend throughout the year has rather been flat with short periods of downward and upward developments. During July and early August global factors such as high oil prices and growth uncertainties put downward pressure on stock prices. Moreover, equity markets tended to ignore positive reports on second quarter earnings and instead focused on warnings about future profits. Since the second half of August, lower long-term interest rates and some easing in oil prices have translated into some upward movement on stock markets. By end-September stock market prices in the US, Japan and the euro area were slightly below their closing levels of end-2003. Compared to the average of 2003, stock market prices still have gained between 11% and 18% in 2004, depending on the index.



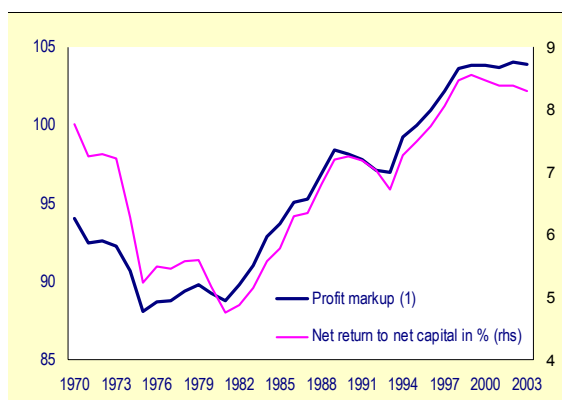
2. Assessing developments in profitability in the euro area

Developments in profitability play an important part in determining inflationary pressures through wage-price dynamics and in determining firms' investment and employment decisions. This article discusses both the long-term trends in some macroeconomic profitability concepts in the euro area and their more recent developments.

The long-term picture

Graph 15 displays trends since the 1970s in two widely used measures of profitability, the net return on net capital and the profit mark-up (for an explanation of the two concepts and the associated measurement problems see Box 2 "Measuring profitability – some conceptual issues"). The two measures have displayed similar trends since the 1970s. Both show a marked deterioration in profitability in the 1970s followed by a recovery in the 1980s. There were further, although more moderate, pressures on profitability in the early 1990s and an improvement during the second half of the 1990s. During the 2001-03 downturn, the profit mark-up remained broadly stable while the return on net capital edged slightly downwards.

Graph 15: Two macroeconomic measures of profitability, euro area (1970-2003)



(1) Index 1995 = 100.

Source: Commission services

Fluctuations in profitability reflect a variety of factors of both a cyclical and a more structural nature.

Reflecting slow adjustment in employment and the capital stock, profitability measures tend to display a marked cyclical component with profitability being eroded during downturns. This is true for the recession of the 1970s and of 1992-93 and, to a lesser degree, for the 2001-03 downturn. Terms-of-trade shocks due to sharp fluctuations in exchange rates or swings in oil prices can also impact on profitability.

Structural factors also play an important role in explaining changes in profitability. In the 1970s, a slow response of the labour market to a structural downshift in productivity growth took a heavy toll on profitability in the euro area. Conversely, wage moderation and improvements in the labour market permitted significant gains in profitability in the 1980s and the second half of the 1990s. Gains during the latter period were all the more remarkable in that they took place against the background of another deceleration of trend productivity growth.

Changes in competition forces may also have a significant bearing on profit measures. Hence, some of the changes in profitability in the euro area in the late 1980s and the 1990s are likely to have been the result of the impact of the implementation of the Internal Market programme. Sauner-Leroy,⁹ using company-level data, observes falls in price-cost margins between 1989 and 1993 consistent with increases in competition during the implementation period of the single market programme. It is only from about 1994 that firms are able to take advantage of efficiency gains resulting from heightened competitive pressures in the Internal Market to raise price-cost margins and profitability.

⁹ Sauner-Leroy J-B., "The impact of the implementation of the Single Market Programme on productive efficiency and on mark-ups in the European Union manufacturing industry", European Commission, DG ECFIN Economic Papers, No. 192.

Box 2: Measuring profitability – some conceptual issues

Several measures of profitability can be derived from national account data. The most frequently used concepts, as well as some of the associated methodological and measurement problems, are briefly presented in this box.

1. Most frequently used macroeconomic profitability concepts

Two broad families of profitability concepts can be distinguished. The first one is akin to the profit margin measures to be found in companies' financial statements and includes concepts such as the wage share, the profit share and the profit mark-up. The second one is closer to the return on equity of companies' financial statements and covers measures of profits divided by estimates of the capital stock.

A few selected profitability concepts:

Concepts	Definitions	Comments
Profit share	Ratio of gross operating surplus (GOS) to total value added	The GOS is calculated as GDP (corrected for taxes and subsidies on production) minus the compensation of employees
Wage share	Ratio of the wage bill to total value added	
Profit mark-up	Ratio of value added deflator and unit labour costs (i.e. inverse of the real unit labour cost)	Unit labour costs are calculated as the ratio of total compensation to total value added in constant prices
Net return on net capital stock	Ratio of net domestic product minus compensation of employees to nominal capital stock	The net domestic product is the gross domestic product (GDP) corrected for the depreciation of capital

Note: in all these concepts, total compensation is generally augmented by the imputed wages of the self-employed.

As far as possible, a representative of each family is used throughout this section. For data availability reasons, the analysis is restricted to the profit mark-up and the net return on net capital. The main advantage of the profit mark-up is that it can be calculated both from annual and quarterly national account data. In contrast, measures of the profit share are not available at the quarterly level for the euro area as a whole. The net return on net capital was taken from ECFIN's AMECO database. Its major limitation is that, in the absence of quarterly data on the capital stock of the euro area, it is only available on an annual basis.

2. Measurement problems

Profits calculated as a residual – In the national accounts for some euro-area countries, profits are calculated as a residual, i.e. value added minus compensation to employees and other expenses, although a number of countries used data provided by companies (for further information regarding the methodology used to calculate profitability in OECD economies, see Walton R., "Sources of data for international comparisons of company profitability (methodology)", paper prepared for the OECD meeting of national accounts experts, October 2002). Calculating profitability as a residual means that measurement errors may arise if other variables are incorrectly measured, while differences in collection methods between national statistical institutes are a further potential source of differences. Notwithstanding such issues, it is widely accepted that the adoption by all EU countries of the ESA 95 statistical framework has minimised differences in calculations and made comparisons of profitability across countries and over time more meaningful. However, more caution should be exercised in making comparisons of levels for any given year, particularly between the euro area and the USA.

Treatment of self-employment – An important consideration in aggregate macroeconomic measures of profitability is the treatment of income from the self-employed, where earnings will reflect both a payment to labour and a return to entrepreneurial activity. In this note, an adjustment has systematically been made for this so-called mixed income – apportioning only part of the income of the self-employed as profits. An alternative would have been to calculate measures of profitability for the corporate sector alone. However, detailed national account data for the corporate sector are only available at the annual level and for a limited number of countries.



Furthermore, comparisons between developments in profitability for the corporate sector and the economy as a whole do not point to conspicuously different patterns in those countries for which the data is available.

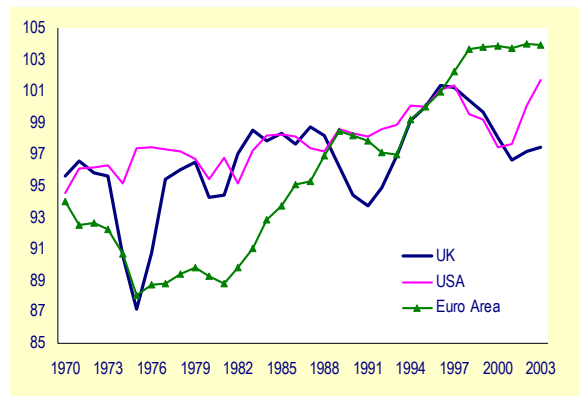
Treatment of corporate taxes and financial expenses – A major limitation of the measures of profitability used in this note is that they are calculated gross of corporate taxes and interest payments. This means that improvements or deteriorations in profitability related to changes in corporate taxation, interest rates and debt levels are not taken into account.

Capital depreciation – Difficulties in measuring capital depreciation present an argument for calculations of measures of return on capital to be made on a gross basis. But differences in the composition of the capital stock between countries, or changes in its composition over time, particularly the shift towards ICT capital with a higher depreciation rate, militate in favour of using a net calculation (for further discussion of the impact of different depreciation rates on profitability, see Metz R., Riley R., Weale M., 'Economic performance in France, Germany and the United Kingdom: 1997-2002', National Institute Economic Review Number 188, April 2004).

Graph 16 displays trends in the profit mark-up in the euro area, the USA and the UK while Graph 17 displays a comparison for the net return on net capital. Due to methodological differences in national accounts, cross-country comparisons of profit measures should be approached with caution. However, several points stand out:

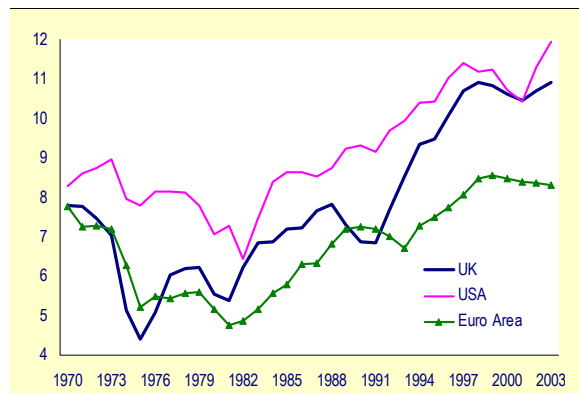
- The US and the UK labour markets responded more swiftly to the shocks of the 1970s (surge in oil prices, slowing labour productivity) allowing a much faster recovery of profitability.
- The profit mark-up has increased more rapidly in the euro area than in the USA and the UK since the 1980s. However, until the mid-1990s the trend owed much to a more rapid capital-labour substitution in the euro area. As a result, the profitability gap in favour of the USA and the UK with the euro area widened over the same period for measures of profitability based on capital such as the net return on net capital.
- Pressures on profitability emerged in the late 1990s in the UK and the USA leading to a narrowing of the gap with the euro area in terms of net return on net capital. However, the convergence trend was short-lived. The UK and US economies staged a rapid recovery in profitability during the downturn and the gap widened again in 2002-03.

Graph 16: Profit mark-up, euro area, UK and USA (1970-2003 – index 1995 = 100)



Source: Commission services

Graph 17: Net return on net capital, euro area, UK, USA (1970-2003 – In %)

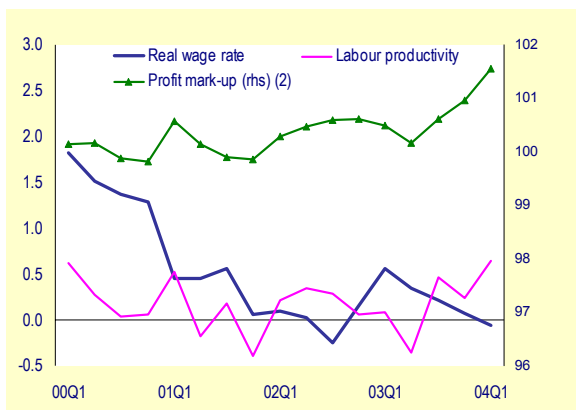


Source: Commission services

Recent developments in profitability, labour productivity and wages

Looking more closely into developments in profitability during the latest downturn, Graph 18 shows quarterly estimates of the profit mark-up.¹⁰ As fluctuations in the mark-up reflect the combined effect of changes in real wages and labour productivity, the graph also displays year-on-year growth for these two variables. In the absence of capital stock data at the quarterly level, measures of return on capital cannot, unfortunately, be calculated at that frequency.

Graph 18: Profit mark-up, labour productivity and real wages,⁽¹⁾ euro area
(y-o-y changes in % unless otherwise specified)



(1) Real wages are measured as the total compensation per employee deflated by the GDP deflator.
(2) Index 100 = 1995
Source: Commission services

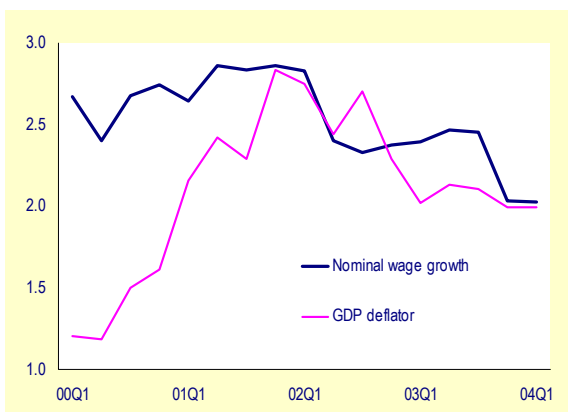
The stabilisation of profit margins in the latest downturn took place despite a significant slowdown in labour productivity and was the result of a marked deceleration of real wages. The improvement of profitability since the middle of last year reflects the “scissors effect” of a combined cyclical pick-up in productivity and a further deceleration in real wages.

Real wage developments during the downturn reflect both changes in nominal wages and

¹⁰ These estimates are calculated from *quarterly* national accounts, whereas the estimates presented in the previous section were based on *annual* national accounts. The two sources are broadly consistent although some differences can sometimes be observed. Hence the profit mark-up fell slightly in the late 1990s based on quarterly data while it remained stable based on annual data.

changes in the GDP deflator (Graph 19).¹¹ Nominal wages reacted to the cyclical deterioration in activity with a lag, with a first phase of deceleration taking place in 2002 and a second one at the end of 2003. Until the end of 2001, profit margins were essentially maintained by pushing up production prices, an increase which was rendered possible by the low external value of the euro. Since the second half of 2002, however, competitive pressures from the strengthening of the euro have curtailed producers’ pricing power. As a result, the deceleration in real wages registered in the past few quarters can be ascribed exclusively to nominal wage moderation rather than faster growth in prices.

Graph 19: Nominal wage growth, euro area
(y-o-y changes)



Source: Commission services

Distinguishing developments in profitability in industry and service sectors

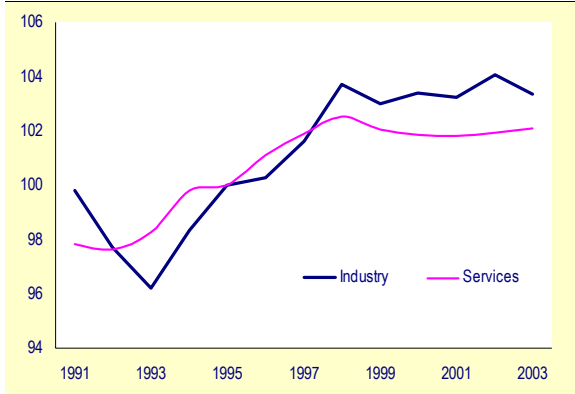
National account data can be used to shed some light on the sectoral developments in profitability underlying the aggregate macroeconomic picture. Eurostat quarterly accounts provide a breakdown of the economy into 6 broad sectors for value added, wages and employment data. Based on these data, Graph 20 displays developments in profit mark-up in the industry and the service sector in the euro area. The profit mark-up tends to post a high quarterly volatility in the

¹¹ Real wages in Graph 18 are measured by the nominal wage rate deflated by the GDP deflator.



manufacturing sector. To allow an easier reading, the graph is therefore based on annual averages.

Graph 20: Profit mark-up by sector, euro area (1)
 (index 1995 = 100)



(1) Annual averages of quarterly data.
 Source: Commission services.

Sharp improvements in the profit mark-up were registered during the second half of the 1990s in industry as well as in the service sector. Some tensions on profitability were visible in the late 1990s in the two sectors, but developments were somewhat divergent in the ensuing downturn:

- In industry, tensions on profitability were progressively reversed during the downturn and the mark-up reached a new peak in 2002 before falling again somewhat in 2003. This cyclical development stands in sharp contrast with the pronounced deterioration in profitability registered in industry during the 1992-93 recession.
- In the service sector, profit margins remained broadly stable in 2001-02, before recovering slightly in 2003.

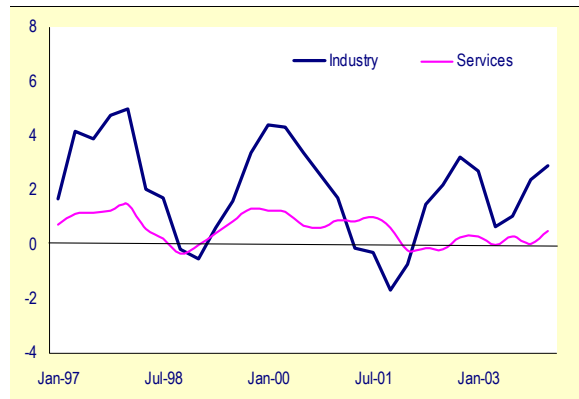
Differences in the profitability performance of the two sectors during the downturn can be traced back to a number of factors:

- In the early stages of the slowdown in activity, labour productivity was hit more strongly in industry than in services but industry staged a much more rapid recovery in productivity growth (Graph 21).
- Developments in nominal wages were fairly similar in the two sectors except in 2003 when a significant divergence results from both a

pick-up in the growth of compensation per employee in industry and a slowdown in services (Graph 22). Wage moderation is actually the main explanation for the slight improvement in profit margins in the service sector that year.

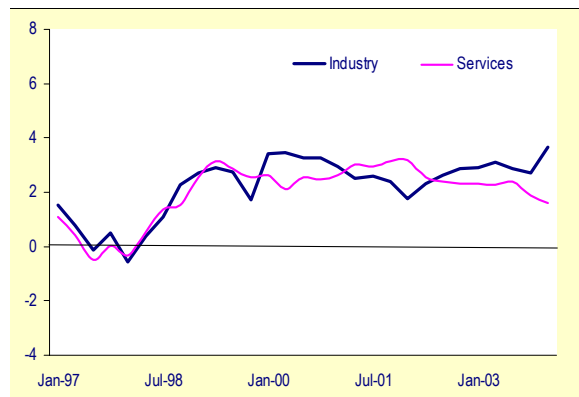
- Due to differences in trade exposure and probably also in competitive pressures and pricing power, the two sectors registered quite different developments in final prices during the downturn. In the past two years, the deflator of value added increased much more rapidly in the service sector than in industry. Although a slight pick-up of wages also played a role, most of the deterioration in profit margins in industry in 2003 can be attributed to the euro appreciation.

Graph 21: Labour productivity by sectors, euro area
 (year-on-year growth in %)



Source: Commission services.

Graph 22: Nominal wages by sectors, (1) euro area
 (year-on-year growth in %)



(1) Total compensation per employee.
 Source: Commission services.

Large country differences in recent profitability developments

Average euro-area developments in profitability mask significant country differences. Table 3 displays the average change in the profit mark-up during the downturn for individual euro-area Member States. A small number of countries experienced an improvement in profitability over the period (Germany, Greece, Spain and Austria). A larger number registered a more or less pronounced deterioration (Belgium, France, Italy, Luxembourg, the Netherlands, Portugal and Finland).

Table 3: Changes in profits mark-up, euro area (2000-03 – average annual change in %)

	Labour productivity	Real wages	Profit mark-up
BE	0.6	1.6	-1.0
DE	0.7	0.3	0.4
EL	3.4	2.8	0.6
ES	0.6	-0.3	0.8
FR	0.4	0.7	-0.3
IE	2.7	2.6	0.1
IT	-0.8	-0.4	-0.5
LU	-1.7	1.7	-3.3
NL	-0.4	0.7	-1.0
AT	0.7	0.2	0.5
PT	0.0	0.4	-0.3
FI	1.0	2.0	-1.0
EU12	0.3	0.3	0.0

Source: Commission services.

Some of the country differences in the recent profitability performance may be attributed to cyclical factors. The countries which have experienced a sharper downturn – as measured by the loss in output gap between 2000 and 2003 – have also experienced a more pronounced deterioration in profitability, the main exception in this respect being Ireland. It is worth noting that the magnitude of the loss in output gap during the downturn can, to a large extent, be related to the size of the positive output gap at the peak of the cycle in 2000. Hence, there is some evidence that, in some Member States (Netherlands, Portugal and Finland), the profit

erosion during the downturn is also the price to pay for a period of overheating in the late 1990s.

However, the strength of the cycle is not the only factor and only goes part way to explaining differences in profitability performance between countries such as Germany, Spain and Austria (where the profit mark-up improved) and France, Italy and Belgium on the other (where it deteriorated). This suggests that medium-term and structural factors, particularly in relation to the labour market, also play an important role in explaining recent differences in profitability.

Three additional points are worth stressing:

- Whereas euro-area Member States generally registered a significant slowdown in output per worker during the downturn, Germany and Spain managed to maintain their (admittedly low) pre-downturn productivity performance over 2001-03.
- Positive developments in the mark-up are not always a sign of economic strength. In Spain, gains in the profit mark-up during the downturn appear somewhat fragile insofar as they were achieved largely by pushing up final prices and at the expense of external competitiveness.
- In several Member States nominal wages were slow to respond to the deceleration of activity (Belgium, Spain, France and the Netherlands). In Italy, nominal wages were slow to adjust to a particularly sharp slowdown in productivity.



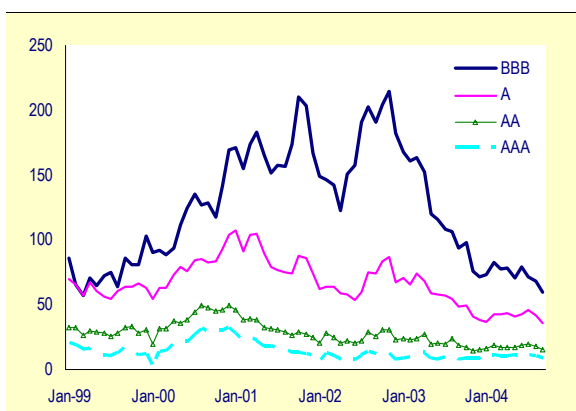
3. The financial health of the private sector in the euro area

Financial conditions exert a crucial influence on short- and medium-term developments in the real economy. Changes in the leverage of the private sector can have profound economic implications as was illustrated in recent years when the corporate sector reduced investment spending to restore its balance-sheets. This section reviews the current financial state of non-financial corporations, households and the banking sector and discusses the likely implications on the cycle.

Clear improvements in the non-financial corporate sector...

Over the last year the corporate sector has continued to benefit from low financing costs, allowing for further balance-sheet repair. Favourable financing conditions are visible in higher equity-prices and short- and long-term bank lending rates, which remain low in absolute levels and in real terms. Moreover, corporate bond spreads continue to move around historical lows (see Graph 23).

Graph 23: Corporate bond spreads over government bonds, euro area (in basis points)



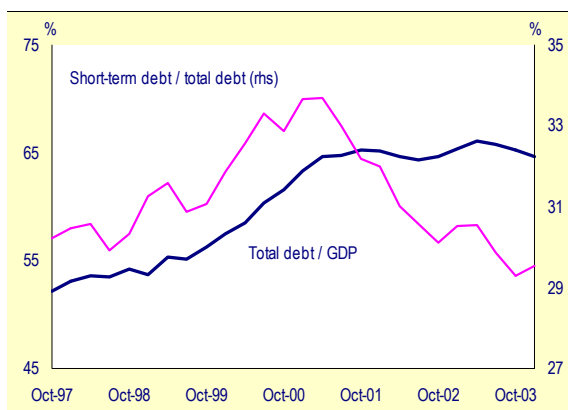
Source: Datastream.

In the past few years, the focus of companies has been mainly on debt-restructuring. The reduction of debt levels has been supported by the disposal of core assets and the use of higher cash balances to finance buy-back transactions. As a result of these efforts, the ratio of total debt to GDP of the non-financial corporate sector has started to decline since the second half of 2003. However,

the decline has so far been limited and the overall level at around 65% of GDP remains high. Companies have also lengthened the average maturity of their liabilities (see Graph 24). With the exception of a short interval in the first two quarters of 2003, the ratio of short term debt to total debt has declined rapidly to 29.1% in the fourth quarter of 2003.

Apart from debt reduction and restructuring, companies' financial positions have benefited from a recovery in profitability. Higher profits were initially mainly generated by cost-cutting, but since mid-2003 also by rising revenues. These favourable developments do not so far extend to SMEs. Typically, SMEs have more difficulty in exploiting positive financial market conditions and benefit less from strong growth abroad. The latest ECB Bank Lending Survey however points to a substantial easing of standards for SMEs in the second quarter and a pronounced increase in loan demand.¹²

Graph 24: Non-financial corporations' debt level and maturity structure, euro area



Source: ECB.

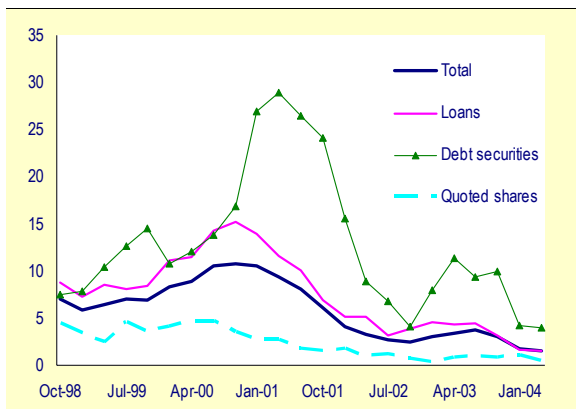
While the conditions for a sustained increase in investment seem to be in place, capital spending has been slower than expected. After a pick-up in the fourth quarter of last year, investment spending contracted again in the first quarter and stagnated in the second. This is one of the factors explaining the deceleration in bank borrowing and the net issuance of corporate bonds during the first half of the year (see Graph 25). The distribution of bond issuance suggests that

¹² See July 2004 ECB bank lending survey for the euro area.

another explanation may have been the fact that companies anticipated higher interest rates in 2004 and moved some of their issuance forward to 2003.

Overall, the financial situation of the corporate sector has clearly improved over the last two years. Financial conditions are unlikely to constrain investment demand, as evidenced by an unusually large amount of liquid financial assets in companies' balance sheets. The source of the current weakness in investment is therefore probably more related to uncertainties about medium-term demand.

Graph 25: Non-financial corporations' financing, euro area (annual growth rates in %)



Source: ECB.

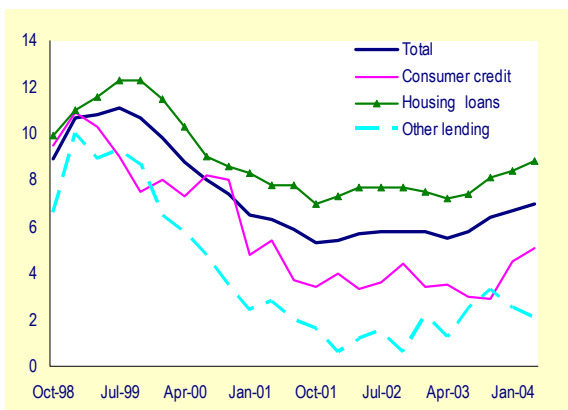
The financial behaviour of the corporate sector has nevertheless differed substantially across Member States. In Germany, companies have run financial surpluses in both 2002 and 2003, which were largely achieved by cutting investment. In France and Italy, on the other hand, companies continued to be net borrowers.

...while the situation in the household sector has not changed

The increase of household debt in recent years has raised worries about the possible effects on private consumption. Historically low interest rates have supported the continued expansion of household borrowing, which is mostly related to house purchases. While total household borrowing in the euro area grew in the first two quarters of 2004 by almost 7% on an annual

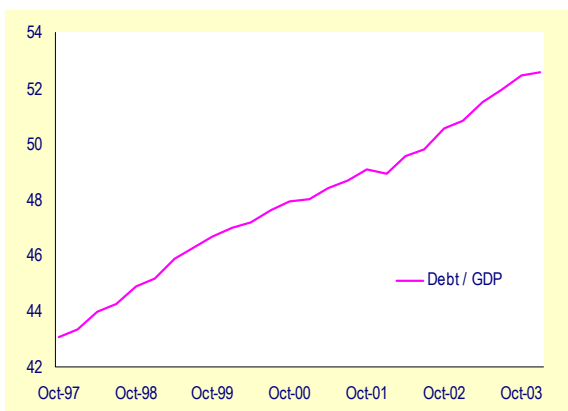
basis, mortgage lending in the same period showed an increase of nearly 9% (see Graph 26).

Graph 26: Bank loans to households,(1) euro area (annual growth rates in %)



(1) MFI sector only.
Source: ECB.

Graph 27: Household debt, euro area (as a % of GDP)



Source: ECB.

The stock of household debt now exceeds 80% of disposable income and 53% of GDP. By international standards, these levels are not particularly high. The degree of dispersion within the euro area, however, is considerable with debt/disposable income ratios varying between 33% in Italy and 203% in the Netherlands. These high levels of indebtedness have so far not raised solvency concerns: the net worth of households is generally positive and debt-servicing costs have been limited due to low interest rates. Nevertheless, with the rising share of mortgages

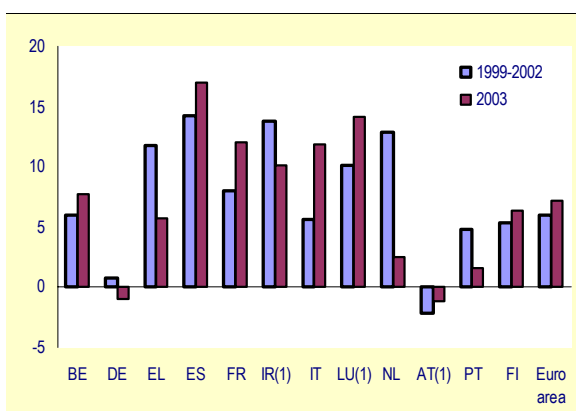


with flexible interest rates, the potential impacts of a sharp rise in interest rates on households' mortgage payments has become greater.

Rapid house price inflation has continued in recent years in the euro area as a whole. House prices rose by more than 7% in both 2002 and 2003. In some Member States, house prices have already peaked and growth rates are now clearly decelerating. In these countries, e.g. in the Netherlands, a negative wealth effect may be dampening household spending. Looking ahead, country-specific factors play a significant role in the outlook for house prices. They include the degree of overvaluation of current prices, the evolution of supply and demand for houses and the sensitivity of house prices to higher interest rates.

Overall, the vulnerability of the household sector to adverse movement in house prices and interest rates is greater than in the past. Nevertheless, the risks from house price inflation to the euro area as a whole are limited, as price increases in the larger euro-area Member States have been moderate. Moreover, the structure of household liabilities limits the vulnerability to a rise in interest rates. Nevertheless, a decline in house prices or a sharp deceleration in the growth of house prices in individual Member States with an overvaluation in the housing market will weaken private consumption through the wealth effect.

Graph 28: Residential property prices, euro area
 (annual change in % 1999 - 2003)



(1) Data for 2002 instead of 2003.
 Source: ECB.

The banking sector has proven to be resilient to shocks

During the economic downturn the banking sector suffered from a decline in profitability due to increases in loan-loss provisions and falling non-interest income. Profitability remained above the levels of the mid-1990s, as it was supported by buoyant retail lending activity in many Member States and by restructuring. The economic recovery and favourable financial market conditions have led to a recovery in non-interest income and a decline in provisioning. Though declining slightly, solvency ratios have remained robust, with average regulatory capital ratios around 11%.

Developments in market indicators confirm the improvement in the health of the banking sector. The sector's credit ratings have improved with the balance of those banks that have been upgraded and those that have been downgraded moving from negative to balance. Indices of bank share prices have performed in line with total market indices. Other indicators of risk such as credit default swap premia fell substantially in 2003 even for those institutions for which they had risen substantially in the years before, and have remained low in the first half of 2004.

Loan provisions to the SME sector, which shows still increasing insolvencies, pose a limited risk to the banking sector. High levels of household debt and high house prices do not form a threat to financial stability risk for the banking sector, but could lead to a slowdown in interest income when mortgage lending decelerates from the current high growth rates. In sharp contrast to residential property prices, commercial property prices fell in 2003 in practically all industrialised countries. However, these price declines remain limited by historical standards. Property borrowing has continued to grow rapidly in some Member States, but banks seem to have adopted a more cautious attitude towards lending for commercial development.¹³

In light of the shocks experienced since 2000, the banking sector has shown considerable

¹³ See BIS Annual Report 2004.

resilience.¹⁴ Banks could continue to re-assess the way they price credit risk, with negative implications for some classes of borrowers. In the medium term, this process should foster a better allocation of resources and is unlikely to be a drag on aggregate investment.

¹⁴ See ECB Monthly Bulletin of July 2004.



Focus

II. The pro-cyclicality of fiscal policy in EMU

The ECOFIN Council has reiterated on several occasions its commitment to pursuing a symmetrical approach to fiscal policy through budgetary discipline in good times, with the objective of gradually achieving budgetary surpluses. This is in line with the spirit of the EU fiscal framework which is designed to let the automatic stabilisers operate freely throughout the cycle thus avoiding pro-cyclical fiscal policies. However, discretionary fiscal policy has tended to be pro-cyclical throughout the past decades, mainly on the revenue side, being tighter during downturns and looser during cyclical upturns, thereby reducing the effectiveness of automatic fiscal stabilisation. The EU fiscal framework has not completely eliminated the pro-cyclical bias of fiscal policy for the euro-area as a whole. Its persistence in the euro area is mainly attributable to countries that are not close-to-balance or in surplus over the cycle as the SGP prescribes. Euro-area countries with larger deficits tend to have a more pro-cyclical stance both in good times and in bad times. Since 1999, this has been especially pronounced in good times. A more thorough analysis indicates that sustainability concerns, associated with developments in government debt are a key determinant of the fiscal policy stance. Governments consolidate more in downturns than in upturns. This is particularly because spending increases in a context of high budget deficits raise more concerns about sustainability and may be perceived more negatively by the public (the voters) than doing so when the budget posts a surplus or only a small deficit. The unfolding recovery provides an opportunity to break with the past pro-cyclical pattern and to ensure that the necessary margin of manoeuvre is created for the next downturn. Thus the temptation should be resisted to use budgetary “windfall” gains to increase spending or to cut taxes.

1. Introduction

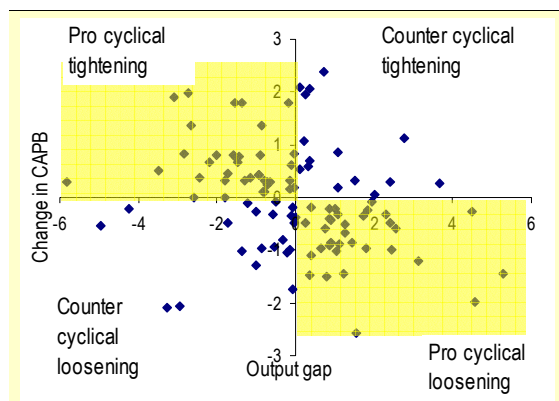
On 18 June 2004, the European Council adopted a Declaration on the Stability and Growth Pact. One of the elements that the Declaration addressed was the conduct of budgetary policy over the cycle and - in particular – the need to actively use periods of economic recovery to enhance the budgetary position: “The Conference agrees that Member States should use periods of economic recovery actively to consolidate public finances and improve their budgetary positions. The objective is to gradually achieve a budgetary surplus in good times which creates the necessary room to accommodate economic downturns and thus contribute to the long-term sustainability of public finances.” In its Communication of 3 September 2004 on “Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact”, the European Commission also stressed “the need to conduct prudent and symmetric-over-the-cycle policies and achieve surpluses in good times”.

A recovery is underway in 2004 and is set to continue in 2005. Previous upswings, in particular in 1999-2000 but also before the start of EMU, were characterised by pro-cyclical fiscal policy behaviour, which worsened the underlying situation of public finances and led

to an unfavourable policy mix. It also hampered fiscal stabilisation in the subsequent downturn. An analysis of fiscal behaviour and the factors underlying pro-cyclical policies can provide insight into how to avoid repeating mistakes of the past.

In this context, this Focus section analyses developments of the budget deficit and the fiscal stance throughout the cycle. The development of the aggregate budget balances over the cycle is important from two

Graph 29: Fiscal stance in the euro-area Member States – Changes in cyclically-adjusted primary balances and output gap (1994-2003 – in % of GDP)



Source: Commission services.

perspectives: sustainability of public finances and the role of aggregate budget balances in stabilising the economy.

2. Theoretical explanations for the pro-cyclical bias

Explanations for the pro-cyclical fiscal policy bias are extensive in the economic literature.¹⁵ Most have either an institutional or political economy origin and differentiate between explanations for pro-cyclical policy in downturns and upturns. Below, some explanations are discussed.

Uncertainty and erroneous forecasts

The overall fiscal stance may turn out to be pro-cyclical, even when it is not intended to be so. Trend or potential output, and consequently output gaps, may be measured and forecast erroneously. Procedures for calculating fiscal aggregates on a cyclically-adjusted basis are prone to a high degree of uncertainty and subject to ex-post adjustment. Policymakers may therefore be unable, at the time, to distinguish budgetary changes of a structural nature from those which are driven by automatic stabilisers. In particular, potential output growth may be overestimated during periods of buoyant economic activity, implying a higher output gap than accounted for, a higher cyclical component of the budget balances and an overestimation of the strength of the cyclically-adjusted balance and revenue base in the longer term. The misperception of structurally higher revenues may trigger unsustainable tax cuts and expenditure increases during upswings. When the potential growth rates and output gap estimates are adjusted downward ex-post, the fiscal stance will appear to have been pro-cyclical and the resulting cyclically-adjusted balance will have deteriorated.

Moreover, deviations in the budget balances may be temporary, even though they are not cyclical due to fluctuations in the elasticity of tax revenues. The erroneous diagnosis of

cyclical or temporary revenue increases as structural will inflate revenue forecasts, and subsequent shortfalls during downturns may only be remedied pro-cyclically.

Forni and Momigliano (2004)¹⁶ find evidence that reliance on the information actually available to policy-makers in real time is important for the assessment of past policies. They show that estimating fiscal policy rules based on ex-post revised data tend to give a misleading picture of the sensitivity of intentional discretionary policies to cyclical conditions. Using ex-ante estimates of the output gaps which were available at the time, captures the intentions of the government much better. They suggest that an overoptimistic assessment of the state of the economy in European countries around the cyclical peak of 2000 was a cause for the deterioration of budgetary positions.

Political economy, fiscal rules and institutional issues

Various authors discuss political economy reasons for the pro-cyclicity of fiscal policy, including nominal balanced budget rules in lower levels of government, the constraints imposed by the EU fiscal framework and incumbent influential groups trying to influence voting patterns.¹⁷

Even if borrowing is not constrained by forces such as balanced budget rules, governments may respond less forcefully to downturns than to upturns because spending increases in a context of high budget deficits raise more concerns about sustainability and may be perceived more negatively by the public (the voters) than doing so when the budget posts a surplus. In particular, sustainability concerns, associated with indebtedness and increasing indebtedness are a key determinant of fiscal tightening during *downturns*, as illustrated by the analysis in Box 3.

¹⁵ OECD Economic Outlook No 74 (2003) provides an overview and tests several explanations empirically.

¹⁶ Forni, L. and S. Momigliano (2004), "Cyclical Sensitivity of Fiscal Policies Based on Real-time Data", mimeo.

¹⁷ Lane, P and A. Tornell (1999): "Voracity and Growth in Discrete Time", *Economics Letters*, Vol. 62, No 1 (January 1999): pp 139-145.



Political institutions also matter, and undesirable pro-cyclical retrenchment seems less prevalent in countries with more politically fragmented governments and electoral systems based on proportional representation and coalitions, rather than plurality. One reason for this may be that coalition governments need to rely on ex-ante agreed budgetary commitments for the term of the government, while one-party governments may set their budgets more discretionary on an annual basis. Moreover, pro-cyclical fiscal loosening appears to be more common in election years,¹⁸ highlighting the importance of political incentives as an explanatory factor for the pro-cyclical policy bias. The increase in spending before elections is more attractive in upswings than in downswings, when sustainability concerns may reduce spending incentives.

Certain types of fiscal rules, particularly those requiring actual, rather than cyclically-adjusted, budgets to be in balance, automatically damp cyclical fluctuations in the budget balance. They restrict the ability of the government to let automatic stabilisers work freely and symmetrically in tandem with fluctuations in economic activity, leading to pro-cyclical budgeting.

Evidence for the United States for example, where the individual states have had a variety of balanced budget rules, suggests that rules-induced pro-cyclicality is fairly common. It can, however, be mitigated by accumulating “rainy day” funds in good times.¹⁹ This is in line with the spirit of the EU fiscal framework in which surpluses in good times are required. When nominal budget rules are accompanied by a nominal cap on expenditure growth, the pro-cyclical upward drift in spending during upturns is curbed. Conversely, sharing the revenues with sub-national levels of government may result in pro-cyclicality, particularly if sub-national governments account for a large share of total

¹⁸ Buti and Van den Noord (2004) find a significant impact of elections in euro-area countries in 1999-2002 on the pro-cyclicality of fiscal policy (‘Fiscal policy in EMU: Rules, discretion and political incentives’, European Commission, *DG ECFIN Economic Paper*, No. 206).

¹⁹ Sorensen and Yosha, “Is State Fiscal Policy Asymmetric Over the Business Cycle?”, Federal Reserve Bank of Kansas City Economic Review, 3rd Quarter 2001.

government spending and revenue, and are not allowed to run budget deficits.

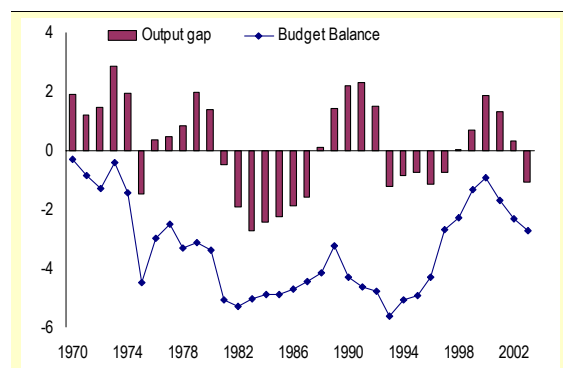
The EU fiscal framework embedded in the Treaty and the Stability and Growth Pact (SGP) has been under close scrutiny on the grounds that it may have contributed to an increased pro-cyclical bias in the euro-area wide fiscal stance. The IMF (World Economic Outlook October 2004) and the OECD (Economic Outlook No 74, 2003) confirm, however, that constraints imposed by the EU fiscal framework have not created a discernibly pro-cyclical bias during downturns in the euro-area as a whole. Discretionary shifts in fiscal stance, measured by the primary budget balance, seem to have become less pro-cyclical after the start of EMU. In particular, the policy stance became less countercyclical in bad times. However, while pro-cyclical fiscal tightening in bad times was reduced, it has not been balanced by additional deficit reduction in good times, so that a deficit bias may have re-emerged.

3. Budgetary developments and the cycle since 1994

Distinguishing between the automatic and discretionary components of fiscal policy

How has fiscal policy behaved de facto in EMU? Graph 30 shows that aggregate budget balances for the euro area and cyclical developments – reflected by the output gap – have generally moved in the same direction.

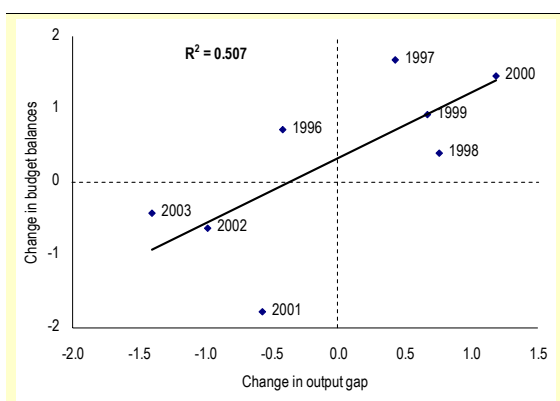
Graph 30: Nominal budget balances (1) and the output gap, euro area (1970-2003 – in % of GDP)



(1) Excluding UMTS proceeds.
Source: Commission services.

This link between cyclical and budgetary developments becomes clearer when looking at the *changes* in the output gap. These reflect the annual difference between actual and potential growth. Graph 31 shows a significant positive correlation between changes in the euro-area budget balances and changes in the output gap.²⁰ These developments of public finances over the cycle can be split into an *automatic* and a *discretionary* component.

Graph 31: Development of euro-area budget balances (1) versus changes in the output gap (in % of GDP)



(1) Excluding UMTS proceeds.
Source: Commission services.

On the revenue side, the **automatic** changes stem from the correlation between the tax base (income, consumption, wealth) and the cycle. On the expenditure side, social security benefits move with economic developments. The cyclical component²¹ of the development of the budget balances - by definition - mutes deviations of actual growth from potential, i.e. the working of the automatic stabilisers. Brunilla, Buti and In't Veld (2002)²² find that

²⁰ The scatter diagrams in this section illustrate the occurrence of pro-cyclical policy in EMU; they do not, however, give a causal relationship between the cyclical situation and the fiscal policy reaction.

²¹ The cyclical or automatic component of the changes in the budget balances is commonly estimated by multiplying the output gap by the sensitivity of the budget balance to the cycle. The result is a measure of the part of the budget balance that is explained by the deviation of output from its potential level.

²² Brunilla A., Buti M. and J. in't Veld (2002), "Fiscal policy in Europe: how effective are automatic stabilisers?", European Commission, DG ECFIN Economic Paper, No. 177.

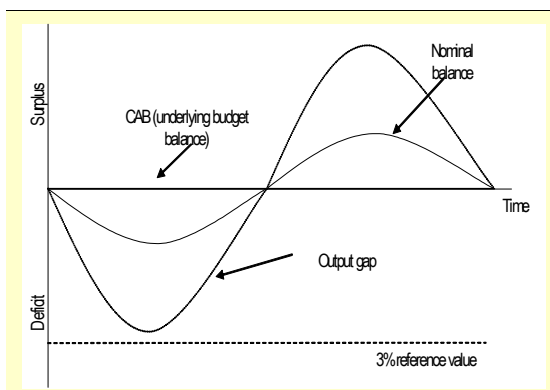
the automatic stabilisers smooth around 30% of GDP fluctuations caused by private consumption shocks.²³

A common measure of **discretionary** fiscal policy is the cyclically-adjusted primary balance (CAPB). The cyclical component of the budget and interest expenditures are deducted from budget balances: what is left summarises budgetary components that are under the control of fiscal authorities and that change as a result of new policy measures.

The discretionary component may be pro- or counter-cyclical, intended or unintended to strengthen or weaken the stabilising effect of the automatic stabilisers.

There has been growing scepticism on the intentional use of discretionary fiscal policy for cyclical purposes: long and uncertain time lags, institutional constraints and irreversibility of fiscal decisions hamper the effectiveness of fiscal fine-tuning of the economy. As the drawbacks of fiscal demand management became more apparent, the focus of fiscal policy gradually shifted to sustainability and quality of public finances, also in the context of ageing populations.

Graph 32: The EU fiscal framework over the cycle



Source: Commission services.

Therefore, the EU fiscal framework has been designed to let the automatic stabilisers operate freely as shown in Graph 32. Over the cycle, the

²³ The smoothing effect is estimated to be much lower in the case of investment shocks, export demand shocks and productivity shocks.

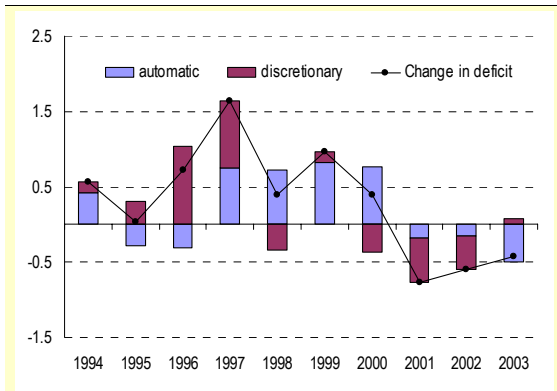


budgetary position should be in balance, as reflected by an unchanged cyclically-adjusted balance (CAB). The budget balances should than automatically show a surplus position in good times, when the output gap is positive and a deficit position when the output gap is negative. Discretionary changes in the aggregate budget balances should be mainly targeted at reaching and maintaining the medium-term objective of ‘close-to-balance or in surplus’ over the cycle.

The conduct of *discretionary* fiscal policy in the euro area

Has discretionary fiscal policy behaved along the lines intended by the fiscal framework? This section will look into the behaviour of the fiscal stance.

Graph 33: Automatic and discretionary annual changes in the euro-area budget deficit (1) (in % of GDP)

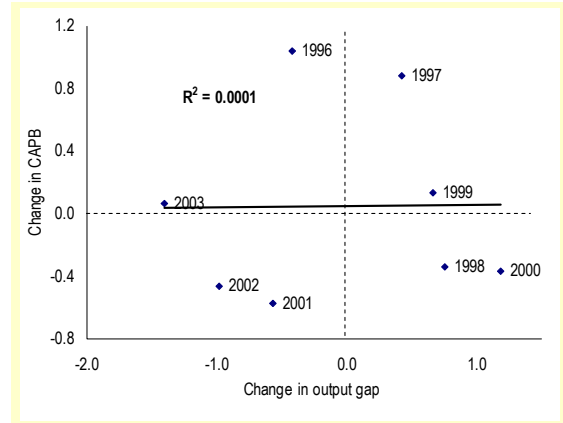


(1) The discretionary component of the change in the budget balance is represented by the change in the Cyclically-Adjusted Primary Balances (CAPB). The automatic component is represented by the difference between the actual annual change in the budget balance and the CAPB. Deficits exclude UMTS.

Source: Commission services.

Graph 33 shows that since 1994, the discretionary component of the change in the budget deficit has reinforced the working of the automatic stabilisers in 5 out of the 10 years. Considering that the steady state of close-to-balance or in surplus has not been achieved in all countries, a tightening fiscal stance, reflected by a positive change in the discretionary component over the cycle, should have been realised. Instead, since 2000, a deterioration has been observed.

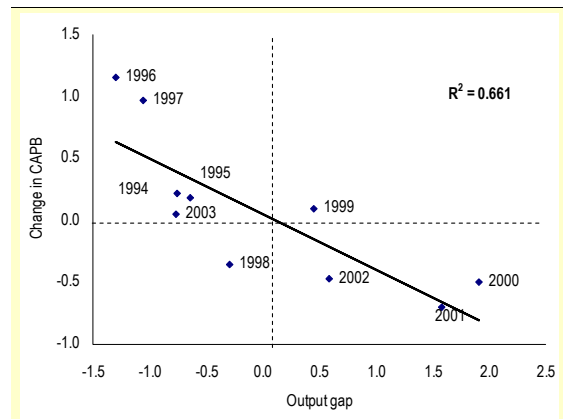
Graph 34: Fiscal policy stance measured against change in the output gap



Source: Commission services.

This is also reflected in Graph 34, which shows no correlation between the changes in the output gap (i.e. the difference between actual and potential growth in a specific year) and the cyclically-adjusted primary balance. However, considering the *level* of the output gap rather than the *changes* in the output gap reveals a significant pro-cyclical bias of the fiscal policy stance, both in good times and in bad times. Data points in the bottom-right quadrant of Graph 35 reflect years of pro-cyclical loosening and data points in the upper-left quadrant indicate pro-cyclical tightening.

Graph 35: Fiscal policy stance measured against the output gap



Source: Commission services.

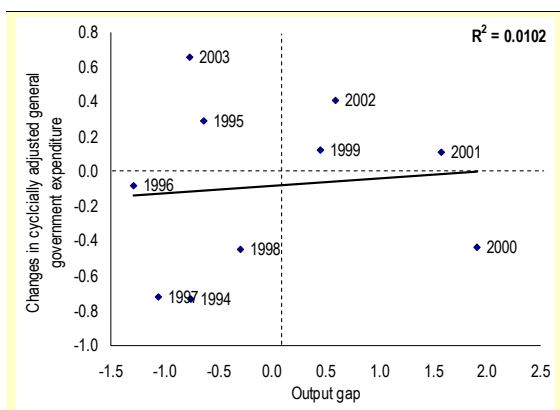
4. Some characteristics of the pro-cyclical nature of discretionary fiscal policy

To gain better understanding of the underlying forces, more analysis of the nature of the pro-cyclical bias and its characteristics is needed. Has it mainly been induced by discretionary changes in revenue or expenditure? Do the aggregate developments for the euro area reflect common practice amongst Member States, or is the sample blurred by different behaviour in groups of Member States? Is the pro-cyclical behaviour of fiscal policy stronger in good times or in bad times?

Revenue and expenditure

Graphs 36 and 37 show that the aggregate pro-cyclical bias stems largely from the revenue side: both tax cuts and tax increases contributed to pro-cyclicality. In particular changes in direct tax revenue (adjusted for the cycle) tend to correlate negatively with changes in the output gap.

Graph 36: Discretionary changes in expenditure measured against the output gap

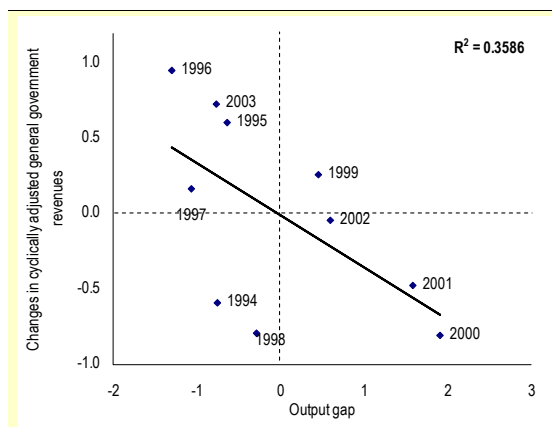


Source: Commission services.

This is in line with the findings of the OECD (Economic Outlook No 74, 2003) that tax cuts are at the heart of pro-cyclicality. They argue that the public reaction to high tax rates provides a strong political incentive for funds generated during upturns to be used to make tax cuts as economies approach their cyclical peaks. Moreover, as argued in section 2, high revenues may be mistakenly perceived to be permanent and returned to the tax payer. Pro-

cyclical retrenchment is then required in bad times when budget balances deteriorate and sustainability concerns rise.

Graph 37: Discretionary changes in revenue measured against the output gap



Source: Commission services.

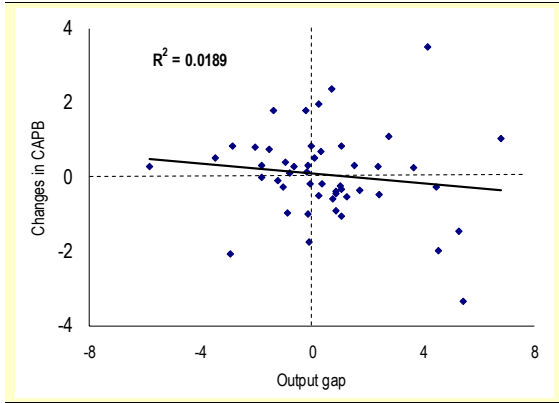
Country-level data

The aggregate developments at euro-area level may hide certain developments and relations which are due to country-differences.

Looking at country-level data provides more insight into the origin of the pro-cyclical bias. Graphs 38 and 39 split the data into two groups. In the first group, the cyclically-adjusted deficit (CAB) is smaller than 2 % of GDP, i.e. they are relatively close to having achieved balanced budgets over the cycle. This group identifies the countries that have – in the year in which they belong to this group – a certain margin vis-à-vis the 3% of GDP reference value for the budget balance of the EU fiscal framework and are either close-to-balance or in surplus over the cycle or not far from it. In this group, the behaviour of the fiscal stance does not show any systematic link with the output gap. This is in line with the spirit of the SGP, i.e. to let the automatic stabilisers play freely around a budgetary position of close-to-balance or in surplus over the cycle and a rather constant cyclically-adjusted primary balance.



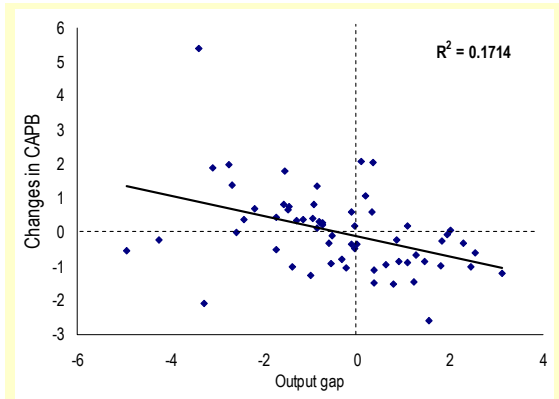
Graph 38: Fiscal policy stance in countries with small cyclically-adjusted deficits (1) or surpluses (1994-2003)



(1) Cyclically-adjusted deficits below 2% of GDP.
Source: Commission services.

The second group is composed of data points for which the cyclically-adjusted deficit is larger than 2 % of GDP, meaning that they are close to the 3% reference value of the SGP. In this group the data appears clustered in the upper-left and lower-right quadrants, reflecting a pro-cyclical policy bias.

Graph 39: Fiscal policy stance in countries with significant cyclically-adjusted deficits (1) (1994-2003)

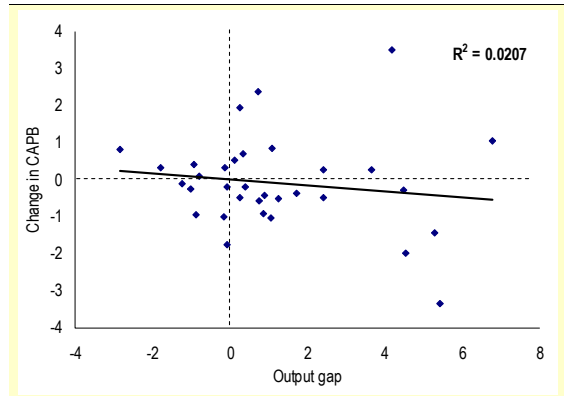


(1) Cyclically-adjusted deficits above 2% of GDP.
Source: Commission services.

After the SGP came into force in 1999, a more countercyclical stance could have been expected in the good times in this group than in the other group of countries, considering that more progress is needed to achieve a medium-term position of close-to-balance or in surplus. This second group could have been expected to show a pro-cyclical policy in the downturns, when the output gap is negative, in order to

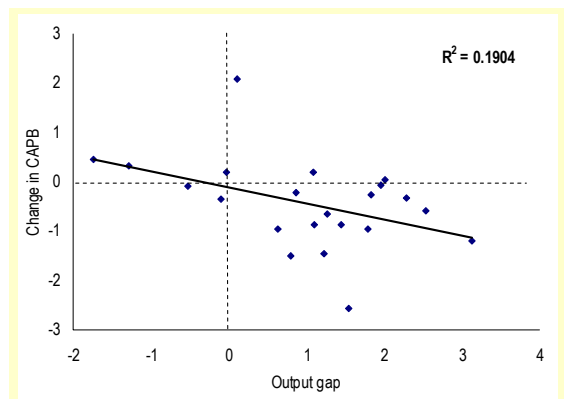
reduce sustainability concerns and avoid or correct any breach of the 3% of GDP reference value for the budget balance. Remarkably, this has not been the case, as reflected in graphs 40 and 41. Graph 41 shows that, since 1999, there have been virtually no data points in the upper-right quadrant, i.e. little or no fiscal retrenchment has been undertaken in countries that most need progress towards medium-term positions of close-to-balance or in surplus. The cyclically-adjusted budgetary position that showed on average no change in the first group, deteriorated in the second group. This implies that the underlying situation in these countries actually worsened and that the divergence between countries adhering to the spirit of the SGP and the other group has increased.

Graph 40: Fiscal policy stance in countries with small cyclically-adjusted deficits (1) or surpluses (1999-2003)



(1) Cyclically-adjusted deficits below 2% of GDP.
Source: Commission services.

Graph 41: Fiscal policy stance in countries with significant cyclically-adjusted deficits (1) (1999-2003)



(1) Cyclically-adjusted deficits above 2% of GDP.
Source: Commission services.

Symmetry over the cycle

Box 3 illustrates results from an analysis on panel data. The results presented in the Box indicate that the response of fiscal policy to cyclical conditions is non-symmetric. It is dependent on the starting cyclical conditions. In weak cyclical phases (negative output gap) an increase in the output gap leads to an improvement in the CAPB, while in phases with a positive output gap, a deterioration of the CAPB is more likely. This is an indication that pro-cyclical loosening in good times is at the

root of problems of missing stabilisation opportunities via fiscal policy in the euro area.

Box 3 also confirms that the introduction of the EU fiscal framework did not lead fiscal policy to become more pro-cyclical. Prima facie evidence pointed to stronger pro-cyclical behaviour due to the EU fiscal framework. However, once the analysis includes a variable for the level of debt, the response of CAPBs to output gaps becomes non-significant. These results indicate that debt levels and developments are an important determinant of the discretionary fiscal policy stance and are in line with IMF (2004).

Box 3: Asymmetric response of discretionary fiscal policy to the cycle. Findings from the estimation of fiscal rules for the euro area

A rigorous analysis of the impact of the cycle should be made by a model suited to analysing the behaviour of fiscal authorities. This is necessary to avoid omitting any relevant variables that contribute, together with the economic cycle, to determining changes in the cyclically-adjusted primary balance (CAPB). In recent years, it has become common practice to analyse the determinants of discretionary fiscal policy through the estimation of so-called 'fiscal rules', summarising the behaviour of fiscal authorities. The purpose of such analytical exercises is to identify a limited set of macroeconomic determinants that explain developments in measures of discretionary fiscal policy. Most of the fiscal rules that have been proposed so far in the literature find that the CAPB depends on the cyclical conditions of the economy and on debt levels. The idea is that fiscal authorities are motivated by objectives of output stabilization (so that budget balances should respond positively to output gaps) and debt stabilisation (so that a positive response of budget balances to the existing stock of debt is expected). The output gap is generally used as a measure for the cycle, while the lagged debt/GDP ratio is normally used to capture the debt stabilisation motive of fiscal authorities. The lagged dependent variable (e.g., the primary budget balance) is normally included in the empirical specification to allow for a role of inertia in budgetary policy.

Existing work estimating fiscal rules for EU countries has highlighted a number of relevant features:

- There is no strong evidence of counter-cyclical discretionary fiscal policy for euro-area countries in the past decades.
- After the introduction of the EU fiscal framework, fiscal policy did not become more pro-cyclical.
- CAPBs are strongly and significantly positively affected by debt levels.
- The effect of debt levels on the CAPB has become more pronounced since the introduction of the EU fiscal framework.

In most of the analyses carried out so far, the cycle is assumed to exert a symmetric effect on budget balances. An additional point of output gap is considered as having the same impact on the budget balance both when the starting level of the output gap is negative and when it is positive. Similarly, no distinction is made for periods in which the output gap is falling or rising. However, as reported in Section 2, there are several reasons why the cyclical behaviour of fiscal policy may exhibit a non-symmetric pattern. One of the few exceptions is the analysis contained in OECD (2003). There, a particular specification of fiscal rule is estimated for a panel of OECD countries, which distinguishes between the impact of the cycle in downturns (falling output gap) and upturns (rising output gap). Results show that, while for the overall sample fiscal policy is (weakly) pro-cyclical, the behaviour of fiscal policy becomes weakly counter-cyclical when restricting the sample to the periods in which the output gap is falling (downturns). This evidence is consistent with the view that the occurrence of pro-cyclical fiscal policy is mainly related to pro-cyclical loosening during upturns rather than to fiscal policy tightening during downturns.

The aim here is to test for possible asymmetries in the response of discretionary fiscal policy to the cycle, focusing the analysis to euro-area countries and taking into account the presence of the EU fiscal framework. Compared with the analysis provided in OECD (2003), the analysis is based on the estimation of a type of fiscal rule in line



with those commonly found in the literature (e.g., Galí and Perotti (2003), Ballabriga and Martínez-Mongay (2002). Moreover, the control for the asymmetry of the cycle is performed differently compared with OECD (2003). There, the distinction is made between periods of falling and rising output gap. In the following analysis, the distinction is made instead between periods of positive and negative output gap. This definition better captures the occurrence of conditions in which revenues (expenditures) are below (above) levels associated with the economy working to its potential, so that the contribution of the cycle to the budget balance is negative.

The next table reports the results for panel data estimation of fiscal rules across EU-11 countries. Annual data for the period 1970-2003 are taken from the AMECO database. The dependent variable is the primary cyclically-adjusted budget balance. The explanatory variables included are the output gap, the 1-year lagged debt/GDP ratio and the lagged dependent variable. To avoid an issue of endogeneity of the output gap (i.e. the fact that not only the output gap affects budget variables but also that budgetary policy has an impact on the cycle), the output gap as an explanatory variable is used with a 1-year lag.

**The response of the primary CAB to cyclical conditions:
estimation of fiscal rules in a panel of euro-area countries (EU-11, 1970-2003):**

a) Average response of fiscal policy to the output gap

	Debt variable not included among explanatory factors		Debt variable included among explanatory factors	
	1970-2003	1994-2003	1970-2003	1994-2003
OG(-1)	-0.048 (-1.45)	-0.09** (-2.06)	0.002 (0.009)	0.054 (0.089)
Debt/GDP(-1)			0.029*** (7.34)	0.064*** (3.57)
PCAB(-1)	0.85*** (29.77)	0.58*** (7.92)	0.74*** (24.29)	0.47*** (6.25)
Constant			-1.45*** (-6.27)	-3.29** (-2.59)
Number of observations	363	110	348	110
R square within groups	0.72	0.4	0.77	0.47
R square between groups	0.99	0.98	0.72	0.79
F test	469	33.61	366.33	29.37

b) Response of fiscal policy to output gaps distinguishing between weak and strong phases of the cycle

	Debt variable not included among explanatory factors		Debt variable included among explanatory factors	
	1970-2003	1994-2003	1970-2003	1994-2003
OG(-1)	-0.097* (-1.9)	-0.137 (-1.47)	-0.056 (-1.15)	0.017 (0.018)
OG(-1)*D _{OG<0}	0.095 (1.26)	0.07 (0.5)	0.11 (1.6)	0.068 (0.49)
Debt/GDP(-1)			0.03*** (7.4)	0.064*** (3.55)
PCAB(-1)	0.85*** (29.79)	0.58*** (7.67)	0.75*** (24.34)	0.47*** (6.07)
Constant	0.2** (2.17)	1.2*** (4.65)	-1.38*** (-5.9)	-3.22*** (-2.51)
Number of observ.	363	110	348	110
R square within groups	0.72	0.41	0.76	0.47
R square betw. groups	0.99	0.99	0.71	0.78
F test	313.73	22.31	276.6	21.9

N.B. Estimation method fixed effect panel regression. The output gap variable is instrumented using its own lag and the lagged US output gap. All variables are expressed as a percentage of trend output.

T statistics reported in parenthesis. ***, **, * denote statistical significance at, respectively, 1, 5, and 10% level.

OG=output gap; PCAB=primary CAB; D_{OG<0}=dummy with a value of 1 if current output gap is negative. -1 in parentheses indicates that the variable is taken with a 1-year lag.

Source: Commission services.

The top half of the table (Part a) presents results concerning the average response of fiscal policy to the cycle without distinguishing between the different responses in weak or strong phases of the economic cycle. Estimates are shown with and without including the lagged debt as an explanatory variable, in order to help understand to what extent controlling for debt levels may alter the results. Regressions are also run separately for the whole 1970-2003 period and for the 1994-2003 sub-period, coinciding with the years following phase II of EMU, taken as the start of the working of the EU fiscal framework.

The regression results show that, in all cases, the CAPB exhibits a great deal of persistency (captured by a high, positive and significant value for the coefficient for the lagged dependent variable), even if there is a considerable reduction in the degree of persistency after the introduction of the fiscal framework. There is evidence of a significant positive impact of debt levels on the CAPB, which becomes stronger after the introduction of the EU fiscal framework. As far as the response of the CAPB to the output gap is concerned, regression results show that, without controlling for debt levels, the coefficient for the output gap is negative and significant if the sample is restricted to the years following 1993. However, when debt is included among the explanatory variables, the coefficient for the output gap turns positive and becomes highly insignificant, irrespective of the sub-period considered. This means that the *prima facie* evidence of overall pro-cyclical behaviour of fiscal policy (captured by a negative regression coefficient for the output gap variable) depends crucially upon the omission of debt levels among the determinants of CAPBs. Once the analysis controls for the level of debt, the response of CAPBs to output gaps becomes non-significant.

The bottom half of the table (Part b) distinguishes the impact of the cycle on discretionary fiscal policy depending on whether the initial output is negative or positive. In order to operate this distinction, an additional explanatory variable is introduced, consisting of the output gap multiplied by a dummy variable with a value of 1 when the lagged output gap is negative (weak initial cyclical conditions) and 0 otherwise. The regression coefficient for the output gap must be interpreted in this regression as the response to the cycle when cyclical conditions are strong. The coefficient for the output gap multiplied by the dummy is interpreted instead as the difference between the coefficient when cyclical conditions are weak and the coefficient when cyclical conditions are strong. If this coefficient is significantly different from zero, then this should be taken as evidence that the impact of the cycle is non-symmetric. If the coefficient is positive, discretionary fiscal policy is more counter-cyclical when the cycle is weak, the opposite being the case if the coefficient is negative.

Results show that in all cases the coefficient for the output gap variable interacting with the dummy is positive, indicating a stronger pro-cyclical response of fiscal policy in good times. Controlling for the debt level, for the overall period, the coefficient for the output gap is negative when cyclical conditions are strong and positive when they are weak. Restricting the analysis to years following 1993, it appears that the coefficient of the output gap is more strongly positive when cyclical conditions are weak. These results are broadly consistent with the view that the response of fiscal policy to cyclical conditions is non-symmetric, being dependent on the starting cyclical conditions. In weak cyclical phases (negative output gap) an increase in the output gap is more likely to lead to an improvement in the primary CAB, i.e., fiscal policy is more likely to be counter-cyclical. This is an indication that pro-cyclical loosening in good times is at the root of problems of missing stabilisation opportunities via fiscal policy in the euro area.

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5. Conclusion

Fiscal policy plays an important role in the stabilisation of output and inflation in the euro area. In particular, the automatic fiscal stabilisers are large and lead to oscillations in the budget balances over the cycle. However, the behaviour of discretionary fiscal policy tends to be pro-cyclical, being tighter during downturns and looser during cyclical upturns, thereby reducing the effectiveness of automatic fiscal stabilisation. The pro-cyclicality stems mainly from tax cuts in good times using temporary budgetary windfall gains. During downturns these unfunded tax cuts require pro-cyclical retrenchment.

The EU fiscal framework promotes the full working of the automatic stabilisers in good times and in bad times. Looking ahead, to the extent that the aggregate euro-area cyclically-adjusted budget deficit is brought down from its current level towards balance, fiscal rules would allow the full working of the automatic stabilisers and avoid the need for a recourse to pro-cyclical fiscal tightening in bad times.

If the results of the analysis of the period 1994-2003 presented in this focus are projected into the future, an improvement in the cyclically-adjusted primary balances can be expected in the initial phases of the recovery. The main challenge will be to curb spending pressures and unfunded tax cuts in the later stages of the recovery. It will be crucial to resist incentives to spend budgetary windfall gains and address fiscal problems in order to prepare for the next economic downturn and to ensure sustainability in the long run in the light of ageing populations.

Enforced national expenditure rules, based on prudent growth assumptions, help to counteract forces leading to pro-cyclical fiscal policy in good times and thus prevent the need to retrench in bad times. In addition, more emphasis on debt reduction in the EU fiscal framework may also contribute to fiscal stabilisation and reduce the pro-cyclical bias.

III. References to further work

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Miriam Manchin

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http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers212_en.htm

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. 213.

Hielke Buddelmeyer, Gilles Mourre and Melanie Ward

The determinants of part-time work in EU countries: empirical investigations with macro-panel data

http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers213_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

Price and Cost Competitiveness

http://europa.eu.int/comm/economy_finance/publications/priceandcostcompetitiveness_en.htm

IV. Key indicators for the euro area

1 Output		2001	2002	2003*	Apr-04	May-04	Jun-04	Jul-04	Aug-04	Sep-04
Industrial confidence ^{1.1}	Balance	-10	-12		-5	-5	-4	-4	-4	-3
Industrial production ^{1.2}	mom % ch	0.2	-0.9		0.3	0.6	-0.2	0.4		
		2001	2002	2003*	03Q2	03Q3	03Q4	04Q1	04Q2	04Q3
Gross domestic product ^{1.3}	Qtr. % ch				-0.1	0.5	0.4	0.6	0.5	
2 Private consumption		2001	2002	2003*	Apr-04	May-04	Jun-04	Jul-04	Aug-04	Sep-04
Consumer confidence ^{2.1}	Balance	-6	-11		-14	-16	-14	-14	-14	-13
Retail sales ^{2.2}	mom % ch	1.3	1.3		1.6	-2.6	2.1	0.4		
		2001	2002	2003*	03Q2	03Q3	03Q4	04Q1	04Q2	04Q3
Private consumption ^{2.3}	Qtr. % ch	1.8	0.6	1.7	-0.1	0.2	0.0	0.6	0.3	
3 Investment		2001	2002	2003*	03Q2	03Q3	03Q4	04Q1	04Q2	04Q3
Capacity utilization ^{3.1}	%	83.5	81.2		80.7	80.3	80.9	80.5	80.6	
Gross fixed capital formation ^{3.2}	Qtr. % ch	-0.3	-1.9	2.0	-0.3	0.0	0.8	-0.2	0.1	
Change in stocks ^{3.3}	% of GDP	-0.2	-0.1	0.1	0.1	-0.4	0.2	0.1	0	
4 Labour market		2001	2002	2003*	Apr-04	May-04	Jun-04	Jul-04	Aug-04	Sep-04
Unemployment ^{4.1}	%	8.0	8.2	8.3	9.0	9.0	9.0	9.0		
		2001	2002	2003*	03Q2	03Q3	03Q4	04Q1	04Q2	04Q3
Employment ^{4.2}	Ann. % ch	1.4	0.5	0.2	0.1	0.0	0.1	0.03		
Shortage of labour ^{4.3}	%	7.8	3.8		3.0	2.0	2.0	3.0	3.0	
Wages ^{4.4}	Ann. % ch	2.8	2.9	2.8	2.5	2.5				
5 International transactions		2001	2002	2003*	Apr-04	May-04	Jun-04	Jul-04	Aug-04	Sep-04
Export order books ^{5.1}	Balance	-14	-22		-13	-15	-11	-8	-9	-10
World trade ^{5.2}	Bn. EUR	6454	6309							
Exports of goods ^{5.3}	Bn. EUR	767.4	776.9	823.4	93.6	92.9	100.0	99.8		
Imports of goods ^{5.4}	Bn. EUR	802.2	781.6	828.1	86	85.1	91.18	87.2		
Trade balance ^{5.5}	Bn. EUR	-34.8	-4.7	-4.7	7.5	7.8	9.0	12.6		
		2001	2002	2003*	03Q2	03Q3	03Q4	04Q1	04Q2	04Q3
Exports of goods and services ^{5.6}	Qtr. % ch	4.3	0.7	6.1	-0.9	2.5	0.4	1.4	3.7	
Imports of goods and services ^{5.7}	Qtr. % ch	2.1	-1.6	6.2	-0.5	1.3	1.9	0.3	2.9	
		2001	2002	2003*	Apr-04	May-04	Jun-04	Jul-04	Aug-04	Sep-04
Current account balance ^{5.8}	Bn. EUR	-12.3	9.6	11.0	8.8	6.0	0.4	1.8		
Direct investment (net) ^{5.9}	Bn. EUR	-104.6	-90.4		-2.9	-1.6	-7.8	-8.3		
Portfolio investment (net) ^{5.10}	Bn. EUR	36.5	38.0		-3.0	-24.0	31.2	-30.5		
6 Prices		2001	2002	2003*	Apr-04	May-04	Jun-04	Jul-04	Aug-04	Sep-04
HICP ^{6.1}	Ann. % ch	2.3	2.3	2.1	2.0	2.5	2.4	2.3	2.3	2.2
Core HICP ^{6.2}	Ann. % ch	1.9	2.5	2.0	2.1	2.1	2.2	2.1	2.2	
Producer prices ^{6.3}	Ann. % ch	2.2	1.7		1.4	2.4	2.4	2.8		
Import prices ^{6.4}	Ann. % ch	102.2	102.4							
7 Monetary and financial indicators		2001	2002	2003*	Apr-04	May-04	Jun-04	Jul-04	Aug-04	Sep-04
Interest rate (3 months) ^{7.1}	% p.a.	4.3	3.3		2.0	2.1	2.1	2.1	2.1	2.1
Bond yield (10 years) ^{7.2}	% p.a.	5.0	4.8		4.1	4.3	4.3	4.2	4.1	4.0
ECB repo rate ^{7.3}	% p.a.	3.25	2.75		2.00	2.00	2.00	2.00	2.00	2.00
Stock markets ^{7.4}	Index	4047	3053		2861	2729	2791	2730	2647	2749
M3 ^{7.5}	Ann. % ch	5.3	5.6		5.5	5.2	5.2			
Credit to private sector (loans) ^{7.6}	Ann. % ch	7.9	7.7		5.5	5.7	6.0	6.2		
Exchange rate USD/EUR ^{7.7}	Value	0.90	0.95	1.13	1.20	1.20	1.21	1.23	1.22	1.22
Nominal effective exchange rate ^{7.8}	Index	91.5	95.1	106.2	107.0	108.6	108.4	108.9	108.7	



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	Volume, excluding construction, wda	Eurostat
1.3	Gross domestic product	Volume (1995), seasonally adjusted	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	Volume, excluding motor vehicles, wda	Eurostat
2.3	Private consumption	Volume (1995 prices), seasonally adjusted	Eurostat
3	Investment		
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
4	Labour market		
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
5	International transactions		
5.1	Export order books	Industry survey; balance of positive and negative replies, seasonally adjusted	ECFIN
5.2	World trade	Bn; EUR, current prices, seasonally adjusted	ECFIN
5.3	Exports of goods	Bn. EUR, excluding intra euro area trade, fob	Eurostat
5.4	Imports of goods	Bn. EUR, excluding intra euro area trade, cif	Eurostat
5.5	Trade balance	Bn. EUR, excluding intra euro area trade, fob-cif	Eurostat
5.6	Exports of goods and services	Volume (1995 prices), including intra euro area trade, seasonally adjusted	Eurostat
5.7	Imports of goods and services	Volume (1995 prices), including intra euro area trade, seasonally adjusted	Eurostat
5.8	Current account balance	Bn. EUR, excluding intra euro area transactions; before 1997 partly estimated	ECB
5.9	Direct investment	(net) Bn. EUR, excluding intra euro area transactions	ECB
5.10	Portfolio investment	(net) Bn. EUR, excluding intra euro area transactions	ECB
6	Prices		
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
7	Monetary and financial indicators		
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 (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

Contributors to this issue are:

Recent economic developments and short-term prospects

Carsten Brzeski, Hans Feddersen and Eric Ruscher

Assessing developments in profitability in the euro area

Eric Ruscher and James Watson

The financial health of the private sector in the euro area

At Draaisma and Massimo Suardi

Focus: The pro-cyclicality of fiscal policy in EMU

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