QUARTERLY REPORT ON THE EURO AREA

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Highlights in this issue:

- Recent economic developments and short-term prospects
- Recent financial market developments
- The financial health of the private sector in the euro area
- Focus: Global current account imbalances and the euro area

EUROPEAN COMMISSION
DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

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EDITORIAL

Economic growth in the euro area slowed slightly in the second quarter of the year, reflecting stagnation in private consumption and continued sluggishness in investment spending. However, there are good reasons to be optimistic about the prospects for an acceleration in economic activity in the second half of the year.

The pick-up in industrial production, the expansion in world trade and the strengthening of business confidence indicators in recent months suggest that the recovery is gathering momentum. This is also captured by our short-term models, which predict a return to potential growth by the end of the year.

Obviously, there are risks to this outlook. In the first instance, the current level of asset prices suggests that a strong economic recovery and a sustained low inflation rate may already be fully discounted by financial markets. The corollary is that an abrupt change in these expectations could lead to a sharp fall in some asset prices. This could result in a deterioration in the balance sheets of households, companies and financial intermediaries, with negative knock-on effects on economic growth and financial stability in the euro area.

A second risk is the potential for a disorderly unwinding of global imbalances. This report devotes a special focus section to this issue, exploring the factors driving the rising current account deficit of the United States and the matching surplus of East Asia and the Middle East. It notes that although the euro area can only provide a limited contribution towards reducing global imbalances, particularly from its balanced starting position, it can strengthen its capacity to absorb the shock of a disorderly unwinding by enacting structural reforms.

Another major source of uncertainty facing the euro area, and the world economy more generally, is rising oil prices. Since the beginning of the year, the price of a barrel of crude oil has increased by 60% in dollar terms and more than 70% in euro terms. It reached record nominal highs at the end of August following the devastation caused in the United States by Hurricane Katrina, before falling slightly in September.

Rising oil prices cannot be dismissed as a short-term anomaly. They are driven by a range of deep-seated, structural factors, including growing global demand for oil, a shortage of spare capacity in oil-producing countries, a lack of investment in oil exploration and production in recent years and, of course, geo-political uncertainties. High oil prices appear, at least for some time, to be here to stay, with the markets predicting crude oil prices to remain in excess of 60 US dollars a barrel throughout 2006 and 2007.

Last month, in response to surging oil prices, the Commission discussed a five-point action plan presented by Commissioner Andris Piebalgs. Over the short- to medium-term, it recommends an increase in the supply of oil and gas, more refining capacity and better coordination of oil stocks at the Community level in response to emergency situations. Over the medium- to long-term, it calls for measures to promote greater transparency and predictability in oil markets and a switch to using alternative energy sources.

In addition, it should be recognised that reducing excise duties or value-added taxes on oil products would not be appropriate. Such policies treat the high price of oil as a temporary shock from which consumers can be shielded, when in fact it is a long-term challenge that has, sooner or later, to be faced up to. In addition to the risk that indirect tax cuts will reduce disincentives to consume oil, they could lead to a rise in government borrowing at a time when

Member States should be saving for the budgetary costs of ageing populations and using tax payers' money effectively to stimulate growth and employment.

If high oil prices persist over time, significant structural adjustment might be triggered, putting the global economy on a less oil-dependent path. For the euro area, this also means that new business opportunities will be created, alternative fuels will become more competitive and all kinds of energy-saving technologies, industries and services will be boosted. However, in the short-run, before such structural adjustments can be made, the reduction in disposable income from high oil prices is likely to have some dampening effect on short-term growth.

On a more general note, the challenge of rising oil prices can be viewed as yet another example of how economic and political developments in one part of the world reverberate across the globe. While some might prefer to respond to globalisation by shirking its challenges or throwing sand in the wheels of international economic integration, these do not seem to be attractive options.

The euro area has since long embraced the process of international trade integration, well defending its share in world markets. However, more recently, it has seemed less than ideally positioned to realise fully the potential gains from deeper international economic integration. An examination of the structure and geographical direction of trade flows suggests that the euro area may not have taken full advantage of opportunities in newly emerging markets.

In order to make globalisation work for the euro area, its production structures will have to shift considerably towards both further specialisation and increased diversification into new areas of relative comparative advantage, and this process is likely to be associated with considerable frictions.

Well-functioning labour markets that enable workers to move smoothly from declining to expanding activities will ease tensions in the adjustment process. In practice, this may often mean ensuring a better balance between income support for job losers, adequate job-finding assistance, training and proper re-employment incentives. However, meeting the broader challenge from globalisation requires policy responses that extend far beyond labour market and social-safety-net policies.

The euro area needs to enhance its ability to create new activities and jobs in order to "take the high road" in the emerging new international division of labour. Producing only goods and services reflecting traditional comparative advantage will not be enough in the long-run. Rather, creating new high value-added activities with deeply rooted comparative advantage requires a dynamic and competitive framework where innovation and R&D, fostered by excellent education systems, can spur productivity and job growth. Clearly, without such a dynamic approach, no new jobs will be created to replace the jobs lost, thus jeopardising public support for economic openness. The Lisbon strategy, with its focus on employment and productivity, has a key role to play in this respect.

Klaus REGLING
DIRECTOR GENERAL

I. Economic situation in the euro area

After a modest acceleration in the first quarter of the year, GDP growth in the euro area slowed slightly to 0.3% in the second quarter. The high level of oil prices has taken its toll and is a major source of uncertainty surrounding the short-term outlook. Nevertheless, although market developments indicate that oil prices could remain high for a longer period than previously expected, several factors suggest that the recovery in the euro area is gathering momentum. After a soft patch at the beginning of the year, world trade has shown signs of an improvement and is expected to withstand the negative impact of high oil prices and Hurricane Katrina. Euro-area exporters will also benefit from the lagged effect of the weakening of the euro registered during the first half of the year. On the domestic side, business confidence strengthened over the summer while industrial production edged up again in June and July. In addition, recent developments in bond and equity markets have been particularly conducive to growth. Both government bond yields and risk premiums on corporate bonds have declined to historical lows. The rising trend in equity prices has accelerated in the course of 2005 and equity markets in the euro-area have tended to outperform US markets. Developments in asset prices reflect investors' expectations of strong growth and sustained low inflation in the global economy. Combined with improved bank-lending conditions, rising equity and bond prices have led to a further easing of long-term financing conditions in the euro area. The easing has been associated with early signs of a pick-up in corporate demand for external funding and continued rapid expansion in loans to households.

1. Recent economic developments and short-term prospects[1]

Higher oil prices are weighing on the recovery

The high level of oil prices has weighed on growth during the first half of the year and is presently one of the main sources of uncertainty surrounding the outlook for both the euro area and the world economy. Over the summer, oil prices continued to increase, driven by concerns about supply disruptions and shortage of refining capacity. In particular, Hurricane Katrina is estimated to have halted production of oil by around 1.5 million barrels per day (mb/d.) according to the US government. In comparison, global production was 84.7 mb/d. in July, according to the International Energy Agency (IEA). As a result, oil prices initially jumped to new record levels in nominal terms, with the price of Brent crude futures climbing to around 68 USD/bl. around the end of August and the

Table 1: **Euro-area growth components**

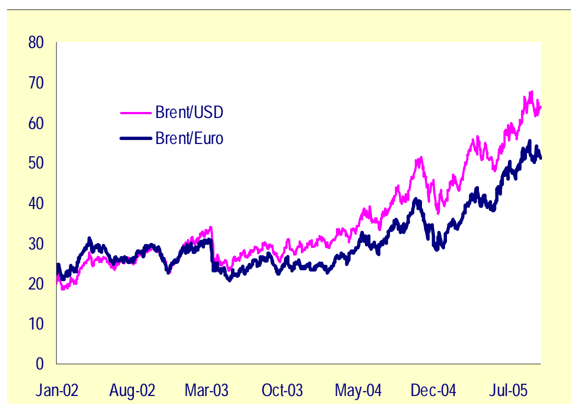
	2004 Q3	2004 Q4	2005 Q1	2005 Q2	Carryover to 2005	Forecast (1)	
						2005 (2)	2006 (2)
Percentage change on previous period, volumes							
GDP	0.3	0.2	0.4	0.3	1.0	1.6	2.1
Private consumption	0.2	0.8	0.2	-0.1	0.9	1.6	1.8
Government consumption	0.4	-0.3	0.5	0.3	0.8	1.4	2.0
Gross fixed capital formation	0.5	0.4	-0.2	0.2	0.6	2.8	3.7
Changes in inventories (% of GDP)	0.0	0.0	0.0	0.1	0.4	0.3	0.3
Exports of goods and services	1.3	0.5	-0.7	2.1	2.5	5.5	5.9
Imports of goods and services	2.5	1.4	-1.4	2.1	3.1	6.0	6.4
Percentage point contribution to change in GDP							
Private consumption	0.1	0.5	0.1	0.0	0.5	0.9	1.0
Government consumption	0.1	-0.1	0.1	0.1	0.2	0.3	0.4
Gross fixed capital formation	0.1	0.1	0.0	0.1	0.1	0.6	0.8
Changes in inventories	0.4	0.0	-0.1	0.2	0.4	0.0	0.0
Net exports	-0.4	-0.3	0.3	0.0	-0.1	-0.1	-0.1

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

[1] The cut-off date for the statistics included in this issue was 30 September 2005.

beginning of September before easing somewhat.

Graph 1: **Oil prices**
(1 Jan 2002 to 26 Sept 2005)

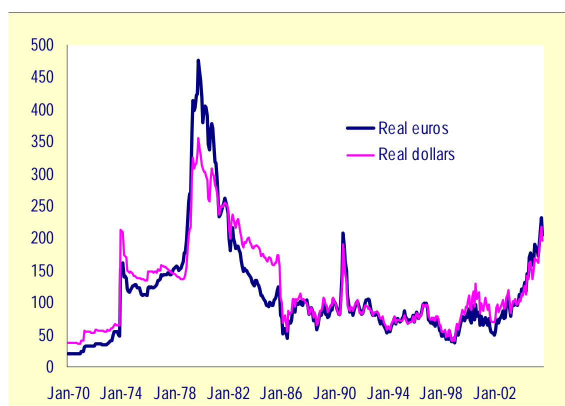


Source: Commission services.

An even bigger concern may, however, be the impact of Hurricane Katrina on US refinery capacity, which was already stretched to the limit. Hurricane Katrina initially disrupted up to 20% of US refinery capacity leading to a more than 30% rise in US gasoline prices. The shortage of petrol in the US also led to an increase in prices in Europe, as petrol is being exported to the US.

The decision of IEA Member States on 2 September to release an equivalent of 2 mb/d. of crude oil from reserves for an initial period of 30 days brought crude oil prices down from their record levels and reduced the pressure on petrol prices, but the prices of both remain high. On 30 September the Brent was trading at around 63.5 USD/bl.

Graph 2: **Real oil prices in perspective** (1)
(Jan 1970 to Sept 2005)



(1) Deflator of private consumption.
Source: Commission services.

Since the end of last year, the price of oil (monthly averages) has risen by close to 60% in US dollars and more than 70% when measured in euro terms. However, the current price level in real terms and the pace of the recent price increases remain below the supply-driven price shock of the late 1970s and early 1980s. In real terms, the current price level is approximately 30% below the record highs of the early 1980s in

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

	SENT. IND[1)]	BCI[2)]	OECD[3)]	PMI Man.[4)]	PMI Ser [5)]	IFO[6)]	NBB[7)]	ZEW[8)]
Long-term average	100.9	0.00	2.75	52.1	54.2	95.6	-10.8	29.4
Trough in latest downturn	88.1	-1.25	-0.77	42.9	46.7	87.3	-26.5	-10.4
September 2004	100.9	0.52	2.23	53.1	53.3	95.7	-1.1	38.4
October 2004	101.5	0.54	1.96	52.4	53.5	95.9	-0.5	31.3
November 2004	100.9	0.40	1.88	50.4	52.6	94.3	-6.6	13.9
December 2004	100.2	0.45	1.44	51.4	52.7	96.4	-5.3	14.4
January 2005	100.8	0.41	1.17	51.9	53.4	97.5	-5.0	26.9
February 2005	98.8	0.21	0.79	51.9	53.0	96.3	-11.4	35.9
March 2005	97.5	-0.09	0.25	50.4	53.0	94.6	-9.4	36.3
April 2005	96.5	-0.28	-0.17	49.2	52.8	93.6	-15.9	20.1
May 2005	96.1	-0.37	-0.43	48.7	53.5	92.4	-16.1	13.9
June 2005	96.3	-0.27	-0.31	49.9	53.1	92.9	-14.4	19.5
July 2005	97.3	-0.10	0.03	50.8	53.5	95.1	-13.8	37.0
August 2005	97.8	-0.10		50.4	53.4	95.4	-14.1	50.0
September 2005	98.6	0.10		51.7	54.7	95.5	-7.0	38.6

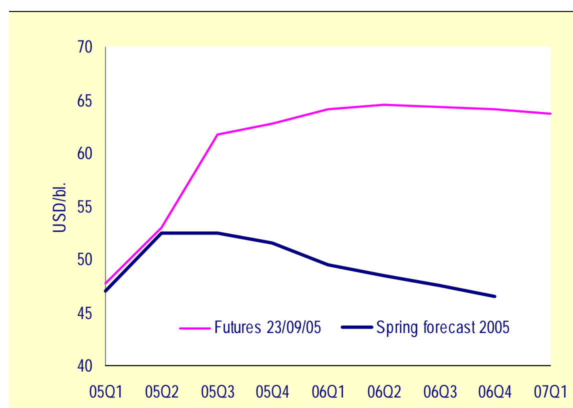
1) Economic sentiment indicator, DG ECFIN. 2) Business climate indicator, DG ECFIN. 3) Composite leading indicator, six monthly change. 4) Reuters Purchasing Managers Index, manufacturing. 5) Reuters Purchasing Manager Index, services. 6) Business expectations, West Germany. 7) National Bank of Belgium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

US dollar terms and 50% below its peak of the 1980s in euro terms (Graph 2).

Several factors imply upside risks to oil prices. Although slowing, demand is projected to remain strong. In its September report, the IEA projected oil demand to increase by 1.6% in 2005 and 2.1% in 2006. This is still robust in a historical context, although down from 3.7% in 2004. In addition, in a more short-term perspective, the approaching northern hemisphere winter season could also create some upward pressure on prices.

But the recent surge in oil prices is mostly seen to be due to concerns about supply developments. Under-investment in both crude production and refinery capacity, as a reaction to low oil prices and excess capacity in the refining sector between the mid-1980s and the turn of the century, constrained supply capacities. Ongoing price volatility can be expected until new supply capacity comes on line. While higher prices should boost investment in new oil production and alternative energy sources, it takes 3–10 years for new investment in supply capacity to enter the market, so the low level of spare capacity is likely to persist for some time. Lastly, ongoing geopolitical tensions and political stability issues are likely to continue to feed the uncertainty about supply, thereby adding to the risk premium in oil prices.

Graph 3: **Oil price expectations**
(Brent in USD – 2005Q1 to 2007Q1)



Source: Commission services.

All in all, it is likely to take some time for prices to seriously affect the balance of supply and demand. This increases the probability that prices will remain high in the medium term or even that further price spikes will occur in the coming months. Current futures prices indicate that the price of Brent crude oil will remain well above 60 USD/bl. in the medium to longer term (Graph 3). Compared to the assumption in the Commission services' spring forecast of an average price of 48 USD/bl. in 2006, the oil price currently suggested by futures prices would be about 35% higher at around 65 USD/bl.

The pace of global economic growth has withstood rising energy prices quite well and the recycling of oil revenues should provide a boost to European exports in particular. However, the prospect of prolonged higher price levels and further volatility in oil prices needs to be considered as a risk factor for sustained economic recovery and growth, especially in oil-importing countries. Calculations based on simulations with DG ECFIN's QUEST model suggest that a permanent 35% increase in oil prices would shave off 0.4 of a percentage point of GDP growth in the first year and 0.2 of a percentage point in the second while pushing inflation by about 0.3 of a percentage point during the two years (Table 3).[2]

Table 3: **Effect of a permanent oil price shock, euro area** (35% increase from 48 to 65 USD/bl)

	Year 1	Year 2	Year 3
GDP	-0.43	-0.64	-0.76
GDP growth	-0.43	-0.21	-0.11
Consumer price level	0.32	0.66	0.63
Consumer price inflation	0.32	0.34	-0.04

Source: Commission services.

This result reflects two offsetting factors. On the one hand, non-linearity effects may play an important role in the relationship between energy prices and economic growth, in that a one percentage-point rise in the price of oil from a

[2] These calculations take into account the repercussions of global trade, with lower demand from oil-importing countries counterbalanced somewhat by higher demand from the oil-exporting countries, which benefit from the higher price of oil. They also take into account the fact oil prices affect natural gas prices with a lag of about 6 months.

relatively high level (as observed since 2002), may lead to a stronger adverse impact on the economy than the same rise from a lower price level. On the other hand, there is some evidence that the demand for imports by oil exporting countries is now strongly increasing to the benefit of euro-area exporters, whose market share is rising in those countries.[3] It is likely that higher oil revenues will continue to be partly channelled into imports from the euro area, thus allowing foreign demand to provide ongoing support to growth in the euro area.

The growth momentum was weak in the first half of the year…

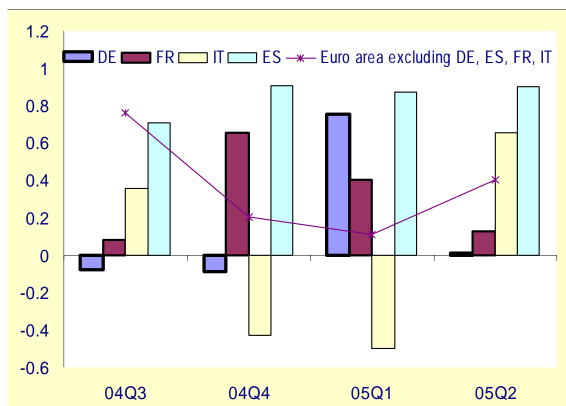
The latest national account data show that growth in the euro area slowed slightly from 0.4% q-o-q in the first quarter to 0.3% in the second on the back of a weakening of domestic demand in a number of Member States. Private consumption contracted slightly as higher energy prices weighed on households' confidence and disposable income. Investment spending recovered slightly in the second quarter, but it continues to be relatively weak.

More encouraging, however, was the strong rebound of exports, which grew by 2.1% q-o-q, benefiting from the earlier weakening of the euro exchange rate. However, imports also increased at a similar pace, so that net external demand made no positive contribution to GDP growth in the second quarter. Overall, therefore, the main contribution in the second quarter mostly came from inventories.

Given the fact that the slightly stronger first-quarter growth (although revised down to 0.4% q-o-q from 0.5% q-o-q) was partly due to working day adjustments, it appears that the euro-area economic recovery was not able to regain pace in the first half of the year following the slowdown in the second half of 2004.

Growth dispersion among euro-area countries remained wide in the second quarter of the year, with a 1.2% q-o-q contraction in Finland, almost flat activity in Germany (0.0%) and France (0.1%), and relatively strong activity in Italy (0.7%), the Netherlands (1.2%) and Spain (0.9%). However, some of the recent dispersion in growth rates is also likely to be due to the effects of working day adjustments.

Graph 4: **GDP growth in selected euro area countries** (2004Q3 to 2005Q2)



Source: Commission services.

A weakening of domestic demand, following the improvement in the second half of 2004, was behind the moderate level of growth in the first half of the year. Consumer confidence fell somewhat in the first half of the year, partly reflecting the impact of higher energy prices on disposable income. Nevertheless, modest employment growth continued to provide some support to private consumption. Euro-area employment grew by 0.1% in the first quarter of 2005, while the unemployment rate in the second quarter, at 8.8%, was unchanged for the third quarter in a row.

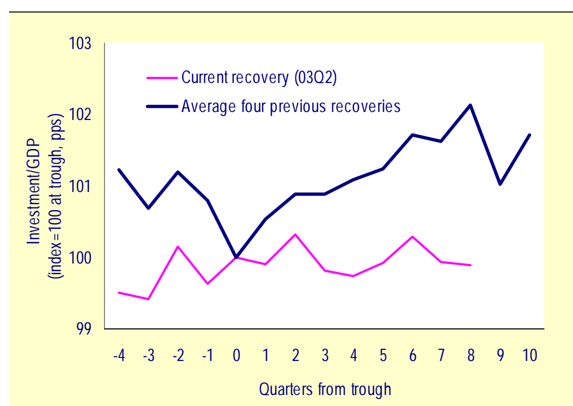
Investment spending failed to build on the momentum achieved in the second half of last year. Despite solid earnings growth and supportive financing conditions, it was considerably weaker than expected in the first half of the year. Although revised national accounts data show a more modest drop in gross fixed capital formation in the first quarter (0.2% q-o-q compared to the previous estimate of 0.7%), data also show that the growth in investment was weaker than previously estimated in the fourth quarter of last year. Furthermore, investment spending only rebounded modestly in the second quarter (0.2% q-o-q).

[3] Since 2003, euro-area exports to OPEC, the CIS and Norway have increased twice as fast as total extra-area exports. See also ECB Monthly Bulletin, July 2005.

The breakdown of investment spending by sector is not yet available for the second quarter. Available data for the first quarter show that the weakness of capital formation in the first months of the year was essentially attributable to construction. Bad weather conditions, in particular, contributed to a contraction in construction investment, especially in Germany and Italy. In contrast, investment in equipment experienced some positive momentum, picking up from 0.4% in the last quarter of 2004 to 0.8% in the first quarter of 2005.

All in all, investment spending remains well below the level seen in previous recoveries, even taking into account the fact that this recovery is relatively modest. Contrary to previous recoveries, investment spending has not increased as a share of GDP, so far (see Graph 5). This suggests that on top of the effects of the sluggishness of the recovery, investment may be being held back by a number of longer-term factors related to the slowdown in total factor productivity growth in the euro area and by labour force developments.[4]

Graph 5: **The investment/GDP ratio in the euro area during different recoveries**



Source: Commission services.

[4] See 'Structural factors weighing on the investment recovery', Quarterly Report on the Euro Area, Volume 4 No. 1 (2005).

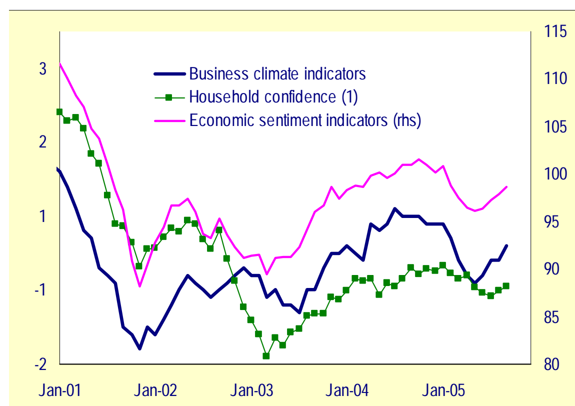
…but growth is expected to pick up in the second half of the year

After the slowdown in the second quarter, in line with a soft patch in the global economy, some signs of an improving economic climate emerged over the summer. The improvement in industrial production figures in the early summer has resulted in a positive three-month moving average growth rate for euro-area industrial production, driven in particular by strong industrial activity in Germany. In July, the available data were mixed, with continued strong momentum in Germany, whereas activity was weak in France. On the whole, the advance in industrial production may suggest a further expansion of equipment investment, although the rise in capital spending is likely to remain constrained by the prevailing low level of capacity utilisation.

On the consumer side, hard data point to continued weak momentum, judging from the retail-sales data. Retail sales were down in July, following an already relatively weak performance in June. Car-sales data (which are not included in the retail-sales data), on the other hand, are indicating more optimism. In June 2005, new passenger-car registrations in the euro area reached their highest level since April 2001. According to Commission services' calculations, second-quarter car registrations should be up 4.4% q-o-q (seasonally adjusted).

Latest surveys indicate that, after a substantial deterioration in the second quarter, business confidence strengthened again over the summer. The improvement was particularly significant in the export-oriented manufacturing sector where the Business Climate Indicator (BCI) returned above its long-term average in September. In contrast, gains were only modest in the more domestic oriented service sectors. However, the construction sector showed a marked improvement in August and September. Overall, development in business surveys suggest that the recent improvement of sentiment is probably largely a reflection of better export prospects, which in turn have been supported by the relative weakness of the euro (compared to the start of the year) and robust growth in international trade.

Graph 6: **Main surveys indicators, euro area**
(Jan 1989 to Sep 2005)

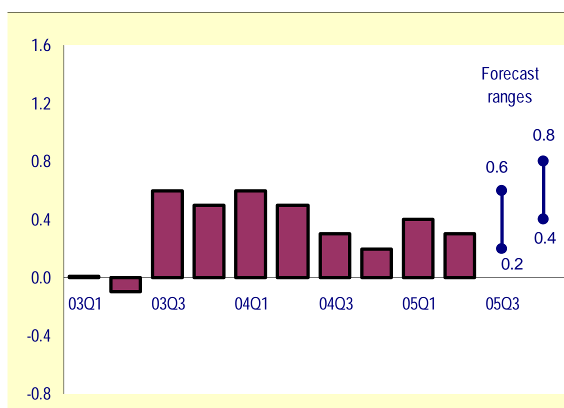


(1) Normalised.
Source: Commission services.

The recent evolution of consumer survey results contrasts with the developments in business survey, as higher energy prices (accentuated by the weaker euro) have dented household sentiment. The Commission consumer confidence indicator stood in July at its lowest level since end-2003 and improved only marginally in August and September. Weak sentiment reflects expectations of higher prices and concerns about economic growth. Households' concerns regarding unemployment intensified in the spring but eased slightly again during the course of the summer. This is in line with a very mild improvement in labour market conditions in the past few months. The unemployment rate edged down slightly from 8.8% in April to 8.6% in July. Over the summer, business surveys also showed some encouraging signs of a pick-up of employment expectations, mostly in the services and construction sectors.

Overall, survey results seem to suggest that the euro-area economy is heading, in the short-term, towards a pattern of modest growth in consumption, stronger investment and a significant growth contribution from net exports. Looking forward, DG ECFIN's indicator-based model for quarterly GDP growth for the euro area forecasts a range of 0.2% to 0.6% for the third quarter and 0.4% to 0.8% for the fourth quarter of 2005. The lagged effects of favourable exchange rate developments and an improved international environment are the main factors behind the higher fourth-quarter projection of the model. A mechanical calculation, using the projected quarterly growth rates for the third and fourth quarters along with the outcome for the first two quarters, would suggest annual GDP growth in 2005 of around 1.2% (non-working-day-adjusted). This is below the spring forecast of 1.6%, mainly as a consequence of weaker-than-expected growth in the first half of the year.

Graph 7: **Euro-area GDP growth rate**
(% change on previous quarter – 2003Q1 to 2005Q4)



Source: Commission services.

Risks to the growth outlook are again tilted to the downside

Despite the projection of a gradual return to potential growth in the second half of the year, the outlook is subject mainly to downside risks linked to the international environment and domestic demand.

Regarding the international environment, Hurricane Katrina is likely to impact US growth adversely in the second half of the year. Furthermore, the energy market remains tight and further increases in the prices of crude oil and refined oil products cannot be ruled out. Although the global economy has so far coped well with higher oil prices, and financial markets appear to be relatively sanguine about downside risks emanating from soaring oil prices, oil prices should be considered a risk factor for sustained economic recovery and growth, particularly in countries that are heavily dependent on oil imports.

Another downside risk related to the global economy is the possible disorderly unwinding of global imbalances associated with the rising

current account deficit of the USA and the matching surplus in East Asia and the Middle East (see Focus section in this issue). Finally, a possible abrupt shift in investor expectations regarding global economic growth and inflation could lead to a severe correction in some asset prices. The current level of asset prices suggests that a sustained economic recovery and low inflation are fully discounted in asset prices. Revisions in these expectations would impact both financial markets and the real economy.

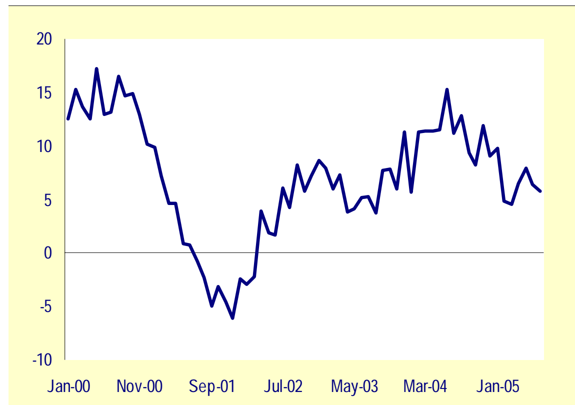
Domestic demand remains fragile, and risks are mainly on the downside, notwithstanding supportive financial conditions. The outlook for private consumption is held back by weak consumer confidence, which may partly reflect the adverse effect of higher energy prices on real disposable income growth. Moreover, it remains unclear whether labour market conditions will improve sufficiently to provide a boost to consumer confidence and spending.

The more positive outlook for the industrial sector, together with the support from low interest rates and improving balance sheets, provides some grounds for optimism regarding a pick-up in investment spending. On the other hand, the sluggish investment performance to date during this recovery would argue for that optimism to remain cautious.

Global growth is expected to remain resilient

There are some signs that the deceleration in world growth observed in the second half of 2004 and early 2005 has come to an end. Notably, world trade seems to have somewhat picked up recently, with the year-on-year rate of increase rising from a 19-months low of 4.5% in March to almost 8% in May, before easing again to about 6% in June and July. ***Survey results*** also point to a bottoming out of the world cycle. According to the latest reading of the quarterly World Economic Survey from August 2005[5], the world economic climate stabilised at a level above its long-term average in the third quarter, following five consecutive negative readings. The indicator showing expectations for six months ahead even picked up slightly. The improvement has been concentrated in North America and Asia.

Graph 8: **World trade**
(% y-o-y changes in volume, Jan 2000 to July 2005)



Source: CPB Netherlands Bureau of Economic Policy Analysis.

The ***US economy*** expanded at an annual rate of 3.3% in the second quarter, with consumer spending and fixed investments continuing to advance robustly. An inventory correction exerted a strong drag on growth, but most of it was offset by a positive contribution from external trade, as export growth accelerated and import growth stagnated in volume terms. Stagnating real imports reflected the relative softness in the manufacturing sector in the second quarter, but the improving trade performance should also be seen against the background of the 15% real effective depreciation of the dollar in the preceding three years.

GDP growth in the third quarter will benefit from strong growth in personal consumption expenditure in June and July, which was spurred by a boom in auto sales. Also, the momentum in investment activity seems to have been maintained. However, Hurricane Katrina has caused output loss from disruptions to economic activity in the region (see Box 1). The disaster has also reduced energy supplies, resulting in hefty price increases, for petrol in particular, on top of already surging energy prices. This is cutting into consumers' purchasing power and is reducing their overall spending in real terms. The direct effects of the hurricane will already dampen

[5] 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.

Box 1: **The economic consequences Hurricane Katrina on the US economy**

Hurricane Katrina hit the US Gulf coast at the end of August causing a large loss of life and enormous material damage. Less than a month later, the Gulf coast was hit by another severe hurricane, named Rita. Munich Re, the world's largest reinsurance company, estimated on 28 September that Katrina and Rita would lead to claims on the insurance industry of $30 billion and $5-10 billion, respectively. These figures do not include the flood and storm-surge losses covered under the National Flood Insurance Program, nor uninsured losses which typically run up to a similar size as insured losses. This means, that the two hurricanes together may have destroyed material wealth of around $100 billion although accurate estimates are still difficult to make at this stage. However, wealth destruction has only an impact on the national income accounts to the extent that consumer and business spending is affected. While private spending may decline temporarily, the process of cleaning up and rebuilding productive capacity and distribution facilities will show up as production, contributing positively to GDP growth. Apart from the wealth destruction, a number of economic consequences will follow:

Disruption: The "first round" negative impact of the disaster is the loss of output caused by the disruptions. Katrina may have pushed down the level of US GDP by 0.5 – 1 % because the three states affected by the hurricane account for 3.2% of US GDP and the level of economic activity in this region is estimated to have fallen by 15-30% below normal. The duration of this effect may be a few months.

Higher energy prices: In the second quarter of 2005, US households spent 5.4% of their disposable personal income on energy goods and services. A 15% rise in energy prices in the wake of Katrina (petrol went up from $2.60 to $3.00 per gallon) implies that their disposable income available for other spending and saving has been reduced by 0.8% during the price spike. Real consumer spending is therefore likely to have received a dent in September although part of the effect probably has been absorbed by a further drop in the already negative personal saving rate. The inflation rate for September will receive a significant push upwards.

Lower consumer confidence: The two most prominent indicators for consumer confidence dropped sharply in September. The Conference Board's index fell by 19 points from 105.6 in August to 86.6 in September, the third-largest setback on record. Although a partial rebound in confidence is widely expected for October, it cannot be excluded that, as a consequence, consumer spending growth will be curbed for a while.

Rebuilding: GDP growth will receive a "second round" boost when rebuilding of damaged homes and infrastructure takes off. Rebuilding worth $50 billion in 2006 (half of the currently estimated damage) would directly add 0.4 percentage points to growth. To this one could add multiplier effects.

Higher public spending: So far the Administration has requested, and Congress has approved, $62.3 billion for relief and clean-up after Katrina. More public funding for reconstruction has been announced. By most estimates, hurricane-related public spending could total $200 billion, or 1.6% of current annual GDP. Although the appropriations are likely to be spent over several years, the main part will probably fall into fiscal year 2006. The worsening budget outlook may put upward pressure on interest rates. On 20 September the Federal Open Market Committee continued its gradual withdrawal of monetary policy accommodation by raising the federal funds target rate to 3.75% in spite of the Katrina-induced uncertainty for the economic outlook. Although longer-term interest rates fell in the immediate aftermath of Katrina, they had more than recouped this decline by the end of September. A trend towards higher interest rates would counteract the expansionary effect of publicly financed hurricane relief.

growth in the third quarter, but the main effect will be on the fourth-quarter growth rate, which may be lowered by 1 percentage point (annualised) according to first estimates. On the other hand, the clean-up and rebuilding of the hurricane-affected area should raise GDP growth next year and restore the level of output relatively quickly.

The labour market has continued to improve with non-farm payrolls growing at an average annual rate of 1¾% since the beginning of the year and the unemployment rate drifting down to 4.9% in August. But the absence of any wage acceleration seems to indicate that there is not yet any real labour market tightness. Labour productivity growth has slowed to 2.2% year-on-year in the non-farm business sector in the second quarter, down from 4.2% one year earlier.

Rising energy prices have pushed CPI inflation to 3.6% y-o-y in August, up from 3.0% at the beginning of the year, while core inflation has remained relatively subdued at 2.1%

The **Japanese economy** is emerging from the soft patch registered at the end of 2004. GDP grew by 3.3% at an annualised rate in the second quarter of 2005, following growth of 5.4% in the previous quarter. While there was a noticeable slowdown in exports (particularly to Asia), the recovery was mainly fuelled by a rebound in domestic demand. Private consumption improved in the first half of 2005. Indicators of consumer confidence continue to be favourable on the whole. Household income has been rising moderately as a result of an improving employment situation and the interruption of the decline in real wages. Moreover, bank lending rose in August for the first time since 1998, giving more evidence of the recovery in the domestic economy. Non-residential investment was also a significant contributor to GDP growth in the first half of the year. The June Tankan survey showed an increase in business confidence across all sectors.

Deflationary pressures are continuing to ease, albeit slowly. In July, the headline CPI decreased by 0.3% year-on-year, while the core index fell by 0.2%, despite the narrowing of the output gap. The end of asset price deflation also seems on track, with signs of increasing land prices in some regions. The Bank of Japan has committed itself to maintaining the current monetary policy framework of quantitative easing in place until deflation has been brought to a definite end.

Looking ahead, the Japanese economy is expected to continue to expand moderately in the coming quarters, with the global economic environment remaining supportive of GDP growth and domestic demand maintaining its current momentum. The re-election of Prime Minister Koizumi should boost structural reforms and probably increase household and business confidence.

Economic growth in ***China*** continued to be very strong in the first half of 2005, growing by 9.4% and 9.5% year-on-year in the first and second quarter respectively. The contribution from net exports increased, as export growth remained very strong and import growth decelerated due to some moderation of investment and an increase in the supply of some domestic import substitutes. As a result, the trade balance strengthened further, with the trade surplus in the first half of 2005 already exceeding its level for 2004 as a whole. Notwithstanding higher raw material and energy costs, inflation continued to show a downward trend in the first half of 2005, falling to 1.6% year-on-year in June from 3.9% year-on-year on average last year. Growth is projected to slow down somewhat during the remainder of 2005, averaging about 9% in the year as a whole.

On 21 July 2005, the People's Bank of China announced that, following a 2.1% revaluation of the Renminbi (RMB), it would replace the 11-year long peg against the US dollar with a managed floating exchange-rate regime, based on market supply and demand with reference to a basket of currencies. The exact composition of the basket remains undisclosed.

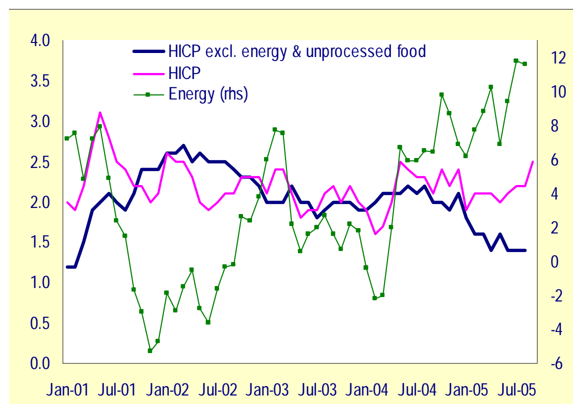
Growth momentum in the ***rest of Asia*** decelerated in the first half of 2005, due to slower external demand. However, in the second half of 2005, the region should experience some acceleration in growth, as the IT sector gradually turns upward and domestic demand strengthens. Growth also slowed in ***Latin America*** in the first half of the year, as a tighter monetary policy took its toll on domestic demand. With continued robust global growth, high commodity prices and favourable financing conditions, however, growth is expected to remain resilient. The rising price of oil should sustain growth in oil-exporting countries, such as those in the ***Commonwealth of Independent States*** and ***the Middle East***.

Oil prices push up headline inflation, but underlying prices pressures are contained

Inflation has edged up in the euro area in the past few months. Annual HICP inflation rose from 2.0% in May to 2.2% in July and August and Eurostat's latest Flash estimate shows a further increase to 2.5% in September. These developments mostly reflect the impact of higher oil prices. In August, the energy component of the HICP (which represents 8.6% of the

indicator's consumption basket) was close to 12% higher than a year earlier. In contrast, core inflation as measured by the HICP excluding energy and unprocessed foods, has remained unchanged at 1.4% since June. There are some signs that the rise in oil prices is progressively feeding through into other components of the HICP, with inflation picking up in particular in the transport sector. However, these indirect effects remain contained and have been offset by a drop in prices in other consumption categories such as clothing and recreational services.

Graph 9: **Inflation in the euro area**
(y-o-y change in % – Jan 2001 to Sep 2005 (1))



(1) September data are only available for total HICP (Eurostat Flash estimate).
Source: Commission services.

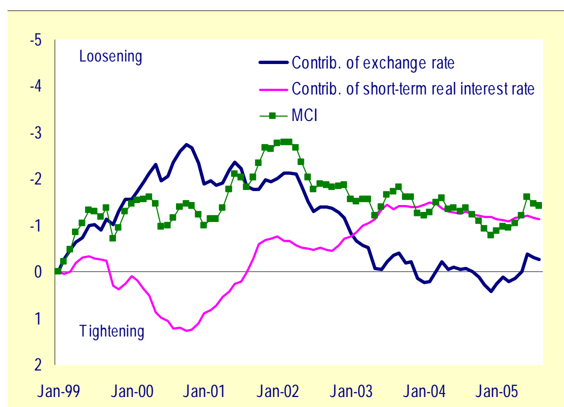
In the coming months, inflation in the euro area is expected to remain above 2% due to recent oil price developments. However, there is no evidence of underlying inflationary pressures building up in the euro-area economy. Inflationary pressures from the labour market remain subdued with no signs so far of second-round effects from higher oil prices. Growth in compensation per employee as derived from quarterly national accounts increased slightly in the first quarter of the year (most recent available data). However, other data available for the second quarter such as the ECB's indicator of negotiated wages and Eurostat's hourly labour cost index suggest that the pick-up was short-lived. In addition, price expectations remain fairly contained. Inflation expectations as derived from inflation-indexed bonds have stayed on a broad downward trend since the beginning of the year. Price expectations derived from consumer surveys have increased since the beginning of the year but remain well below the peaks reached during the spike in oil prices of 1999-2000.

Monetary and financial conditions

Monetary and financial conditions in the euro area have remained accommodative over the last few months. Although the depreciation of the euro observed since the beginning of the year has come to a halt since July, monetary conditions as measured by the Monetary Conditions Index (MCI) are still accommodative. Meanwhile, long-term financial conditions have improved further on the back of rising equity and bond prices.

Regarding short-term interest rates, earlier market expectations about a possible ECB cut dissolved between the two rate-setting meetings of the Governing Council in July and August. Since the last rate-setting meeting of the ECB Governing Council in early September, most commercial banks expect the ECB to keep its policy rates on hold until the second half of 2006. Futures contracts have priced in more than a full 25 basis points rate hike by the ECB before end-2006.

Graph 10: **Euro-area monetary conditions**
(inverted scale – Jan 1999 to August 2005)

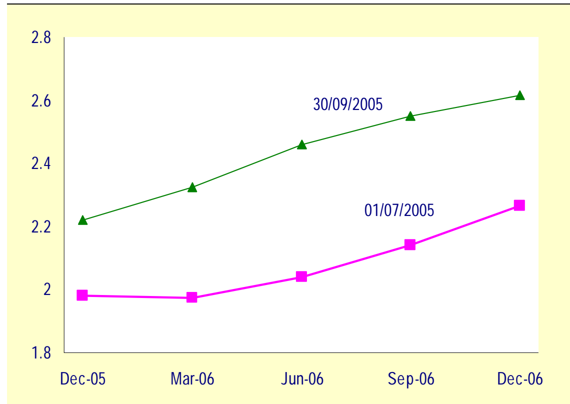


Source: Commission services.

In the USA, the Federal Reserve Board has raised interest rates by 275 basis points since 30 June 2004, bringing the target for the federal funds rate to 3.75 percent. After the last FOMC meeting in September, the Fed took some in the market by surprise when it said in its post-meeting statement that economic disruptions triggered by Hurricane Katrina did not pose a

lasting threat and that it remained vigilant about the risks of inflation. Earlier, Hurricane Katrina had evoked some doubts about the timing of future Fed hikes.

Graph 11: **3-month Euribor future implied rates (LIFE)** (in %)

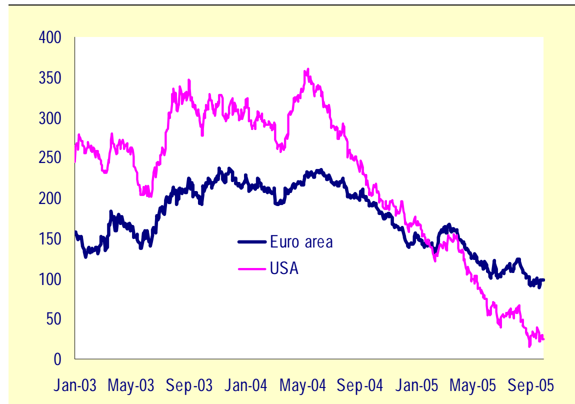


Source: EcoWin.

Buoyancy in equity markets was the main driver of government bond yields in July and the beginning of August. The healthy corporate earnings season fuelled equity prices, making bond prices somewhat less attractive. The slight rise in bond yields seemed also to have been supported by the change in the currency regime in China (which could lead to lower purchases of US bonds by the Chinese Central Bank) and better than expected economic data in the euro area and the USA. However, when the recent oil price hike took centre stage in the middle of August, European and US bond markets rallied again, bringing government bond yields back down to their pre-summer lows. This drop in bond yields was also driven by mixed confidence indicators. In the days before the last FOMC meeting, US bond yields started to climb up, giving higher probability to a Fed rate hike. This trend continued throughout September and US bond yields stood at 4.31 percent on 30 September (see also Section 2 for further analysis of recent developments in bond and equity markets).

In the euro area, 10-year government bond yields reached a new record low of 3.04 percent on 5 September and stood at 3.14 percent on 30 September. As a result of different expectations about inflation and growth developments in the US and the euro area and consequently about the future paths of monetary policy in the two regions, the yield differential between US and euro-area government bonds increased from around 100 basis points in August to almost 120 basis points in September.

Graph 12: **Yield curve** (10-year minus 3-month interbank) (1 Jan 2003 to 30 Sep 2005)



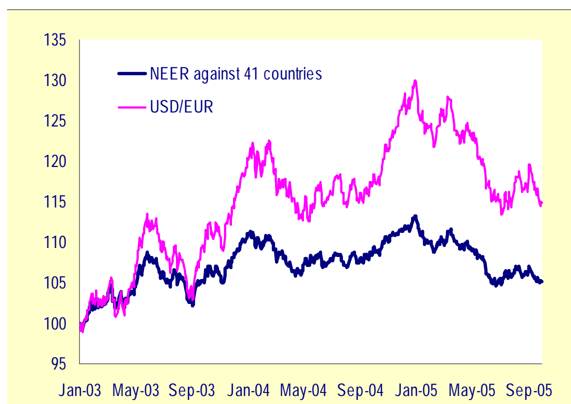
Source: EcoWin.

The flattening of the yield curve, in particular in the USA, has raised financial markets' attention in recent weeks. While many analysts interpreted a flattening yield curve as a sure sign of an economic slowdown, Fed chairman Greenspan expressed some scepticism backed by the last flattening episode in the second half of the 1990s. At that time, the spread between long- and short-term interest rates narrowed by almost 400 basis points, while growth averaged around 4 percent.

Stock markets in the euro area continued this year's rally and seemed to have experienced only a temporary shift in sentiment when they slightly dropped at the end of August driven by the increase in oil prices. The decline in confidence indicators in the USA contributed to the perception that high oil prices had started impacting US consumers and might cause a soft patch in global economies. Since the beginning of September, stock markets have rallied again, reaching their early-August levels. On 30 September, the EuroStoxx was more than 20 percent above its 2004 average. The surprising resilience of equity markets is still in contrast to bond market expectations according to which

global economic growth would be mainly negatively impacted by the increasing oil prices.

Graph 13: **Nominal effective and bilateral USD/EUR exchange rate**
(1/Jan/03=100 – 1 Jan 2003 to 30 Sep 2005)



Source: Commission services.

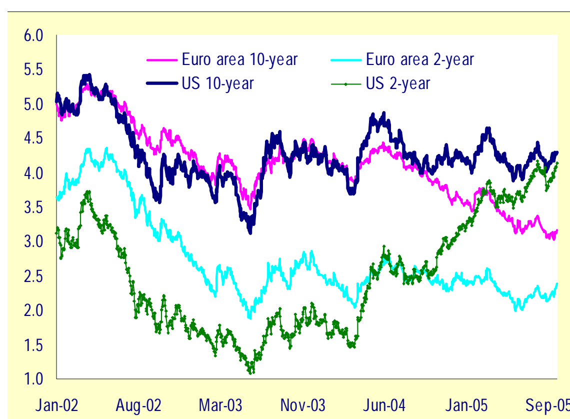
This year's downward trend of the euro exchange rate reversed in July, when the euro slowly started to appreciate. The trend accelerated when markets started to expect some discontinuation of the Fed's interest rate hikes and the dollar-euro-exchange rate moved close to 1.26 USD/EUR early September. In the wake of inconclusive German election results and increased market expectations about future Fed rate hikes after the last FOMC meeting, the euro lost its earlier gains during the course of September. On 30 September, the dollar-euro exchange rate stood at 1.20 USD/EUR, only slightly above this year's low of 1.18 USD/EUR and slightly below last year's average.

2. Recent financial market developments

Bond yields decline to historically low levels

Following a brief up-tick at the beginning of 2005, euro-area benchmark bond yields have resumed a downward trend, reaching new historical lows in September. With yields at the shorter end of the curve underpinned by unchanged ECB policy rates, there has been a flattening in the euro yield curve. Nevertheless, the curve remains clearly upward sloping, with the two-year/ten-year spread currently at about 77 basis points at the end of September. The trend in euro-area yields has been broadly in line with developments in the United States. While the evolution in the euro-area yield curve can be linked to moderate inflation expectations in conditions of sluggish economic growth, developments in the US curve are more difficult to explain in terms of economic fundamentals. US ten-year benchmark yields have remained close to historical lows, despite a marked strengthening in the domestic economy and some evidence of inflation pressure. A gradual but sustained tightening in monetary policy by the Federal Reserve since June 2004 has been accompanied by a notable flattening in the yield curve, and the two-year/ten-year spread declined to only 16 basis points at the end of September.

Graph 14: **Evolution of euro area and US benchmark yield** (in % – 1 Jan 2002 to 30 Sep 2005)



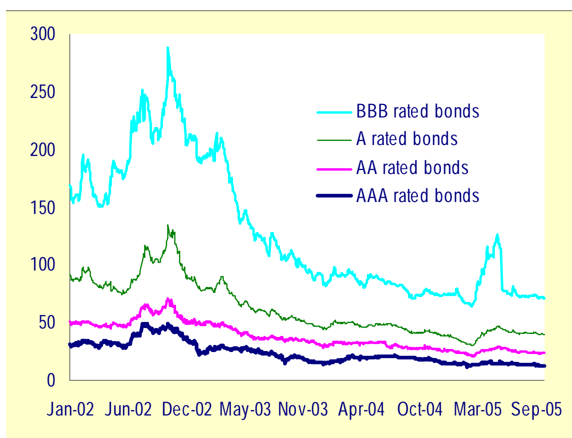
Source: EcoWin.

Risk premiums tightly compressed

Within the euro area, the spreads between national benchmark yields remain tightly compressed and have been only moderately affected by EU-specific factors such as breaches of the Stability and Growth Pact and difficulties in ratifying the Constitutional Treaty. So far, these factors have weighed more on the euro exchange rate than on the bond market. There has, however, been a limited widening in yield spreads in Italy, Greece and Portugal, where the rating of government debt has recently been downgraded.

In the corporate bond market, risk premiums have fallen to historical lows in all risk segments (Graph 15). This phenomenon is also evident in US markets (as well as in emerging-market debt) and has been attributed to a range of factors, notably (a) improvements in the creditworthiness of companies, amid efforts to reduce costs and restructure balance sheets, (b) a generalised decline in risk aversion amid ample global liquidity and (c) a perceived switch in portfolio preferences among institutional investors from equities to fixed-income securities.

Graph 15: **Euro area corporate bond spreads** (1)
(in % – 1 Jan 2002 to 30 Sep 2005)



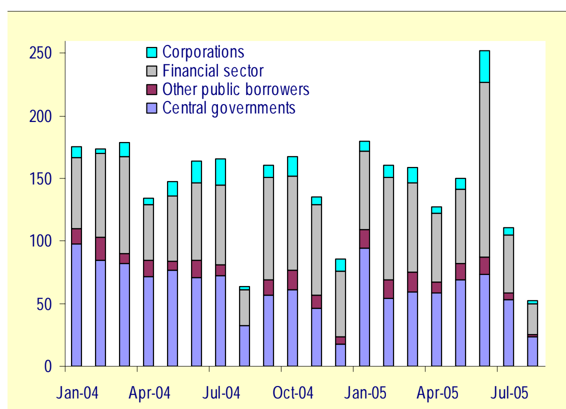
(1) Based on MCI Euro Credit spreads in basis points.
Source: EcoWin.

There was a temporary correction in risk premiums in mid-April linked to the high-profile downgrading of issuers in the US automobile sector to below investment grade. This mainly impacted the higher-risk segments of the market but, by mid-May, risk premiums were again declining rapidly and are now only marginally above their level at the beginning of 2005. The episode demonstrates the recent resilience of lenders to negative events. By implication, access to direct financing has been facilitated even for those companies which would typically experience difficulty in tapping the corporate bond market.

Steady issuance in most market segments, except the corporate sector

Reflecting favourable issuing conditions, the (gross) volume of bond issuance in euro has been steady in 2005. Central governments remain the dominant issuers, although financial institutions have also been very active in the market (Graph 16). By contrast, the supply of corporate bonds remains subdued despite a receptive market even for low-rated issues.[6] Given that restructuring is fairly advanced, the weakness in corporate bond issuance is likely to reflect low levels of investment. The limited supply of corporate debt to the market has created conditions of excess demand, particularly among institutional investors in search of higher yielding fixed-income assets. As a result, there has been a significant increase in the use of structured products (i.e. derivatives linked to underlying corporate bonds) by these investors.

Graph 16: **Gross issuance of euro-denominated bonds by type of issuer** (Jan 2004 to Aug 2005, in bn euro)



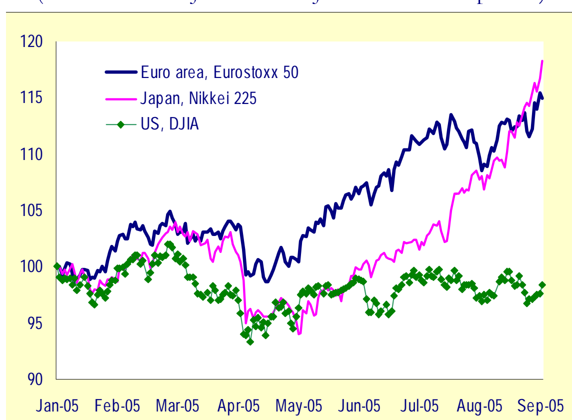
Source: Commission services.

6 A spike in corporate issuance in June was an aberration in trend and reflected the bringing forward of issuance plans ahead of the 1 July deadline for implementing the EU Directive on Prospectuses. As the Directive will require an updating of borrowing programmes, many issuers opted to bring forward their planned borrowing.

A robust pick-up in equity prices

The rising trend in euro-area equity prices, which began in the second half of 2004, has accelerated in the course of 2005. Prices stalled temporarily in April (amid disappointing earnings results in some large US companies and weaker-than-expected macroeconomic data) and more recently in August (on concerns about the implications of high oil prices), but have quickly resumed their upward trend. So far this year, equity markets in the euro-area and Japan have tended to outperform the US market. End-September, the EuroStoxx index was 15 percent higher, compared to a rise of 18 percent in the Nikkei and a largely unchanged DJIA (Graph 17).

Graph 17: **Performance of the main global equity markets**
(indices 100 = 1 Jan 2005 – 1 Jan 2005 to 30 Sep 2005)



Source: EcoWin.

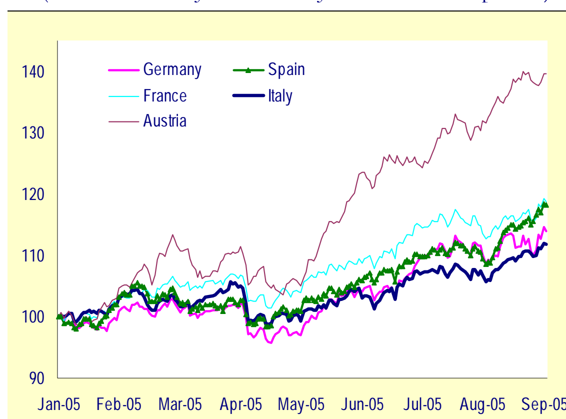
A slower pick-up in equity issuance

Equity issuance in the euro area, which has been largely absent since the major market correction in 2000, picked up slightly in the first half of 2005. As in the corporate bond market, at least part of the increase in equity issuance can be attributed to the approaching deadline for the EU Directive on Prospectuses. Although the bulk of EU issuance activity was located on AIM (London's smaller companies market), there was more limited activity in euro-area markets such as Germany, France, Italy, Austria and Belgium. However, in parallel with the recovery in issuance activity, there were further de-listings from exchanges, mainly as a consequence of restructuring in international companies.

Diversity in market performances across countries and sectors

There has been considerable diversity in the performance of national equity markets within the euro area (Graph 18). The Austrian equity market has been the strongest performer, reflecting its economic links with the faster-growing economies of Central and Eastern Europe, as well as the privatisation of state-owned companies and implementation of economic reforms. Among the other relatively strong markets are France (led by the robust performance by the oil company Total), Spain (reflecting a relatively high rate of economic growth and its exposure to rapidly growing Latin American economies) and Germany (supported by strong corporate earnings, low initial valuations and an anticipated positive effect of the recent euro depreciation on the export sector).

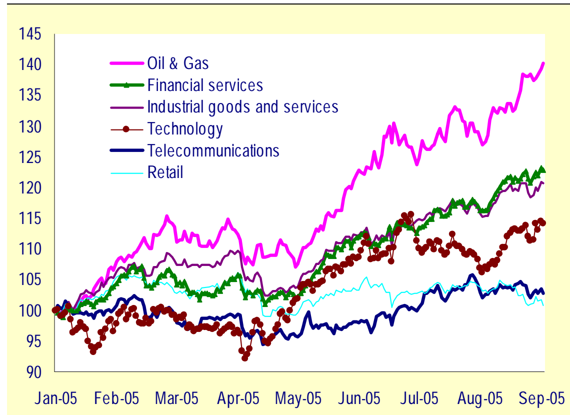
Graph 18: **Euro-area equity indices**
(indices 100 = 1 Jan 2005 – 1 Jan 2005 to 30 Sep 2005)



Source: EcoWin.

Some diversity is also evident across sectors. The oil and gas sector (and other commodity-linked sectors) recorded sharp price increases, while the retail sector remained flat (Graph 19). Otherwise, prices in most sectors have moved within a broadly similar range, except for the poor performance of telecommunications and the rather erratic performance of the technology sector.

Graph 19: **EU sectoral equity indices**
(indices 100 = 1 Jan 2005 – 1 Jan 2005 – to 30 Sep 2005)



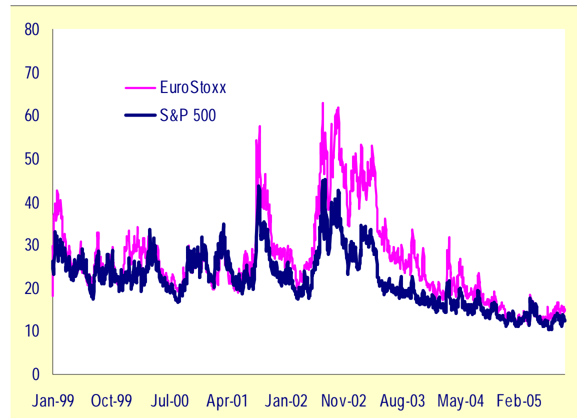
Source: EcoWin.

Mixed signals from bond and equity markets

Typically, bond and equity prices are negatively correlated. The expectations of higher economic growth, which underlie rising equity prices, tend to be associated with expectations of higher inflation, which depress bond prices – vice versa. Accordingly, the current market environment in which the prices of both bonds and equities have been rising simultaneously could imply a possible divergence in expectations of growth and inflation among investors in bonds and equities, respectively. However, an alternative explanation for this positive correlation is that both markets are being driven mainly by factors other than the economic cycle.

Among the non-cyclical factors which have been cited to explain historically high bond prices, not only in the euro area but more globally are (a) increased credibility of monetary policy to deliver sustained low inflation even in conditions of strong economic growth; (b) the continued ample supply of global liquidity which is fuelling an investor search for yield; (c) structural demand for longer-dated sovereign debt among institutional investors, as well as among Asian central banks; and (d) net savings in the US corporate sector.[7] Similar non-cyclical factors may be playing a role in driving equity prices higher. In line with global trends, the level of implied volatility[8] in euro-area equities remains well below historical averages, despite short-lived increases in mid-April (due to concern about US economic prospects) and in mid-July (in response to the terrorist attack in London). Low volatility is associated with the reduced risk aversion of equity investors in search of yield, particularly in a context of low-yielding bond markets.

Graph 20: **Implied volatility on main euro area and US equity indices** (1 Jan 1999 to 30 Sep 2005)



Source: EcoWin.

Other factors, which may explain the specific buoyancy of euro-area equity markets – particularly in a context of sustained low economic growth and consumer demand – include (i) the improved profitability and – more importantly - expected profitability of EU companies[9] due to cost-cutting; (ii) the use of expanding corporate cash balances to pay dividends or to buy back shares; and (iii) an acceleration in merger and acquisition activity. Moreover, the price-earnings ratio of 14.5 for EU equities is well below 20 for US equities, and may be attracting investors in search of higher returns.[10]

[7] While saving in the overall economy (including households and government) remains very low, net corporate saving has pushed down corporate interest rates by depressing spreads.

[8] Implied volatility is the estimated volatility of a security's price and is calculated from option prices.

[9] It is generally considered that companies have more leeway for further cost-cutting and productivity increase in the EU than in the US where unit labour costs are rising.

[10] European equities have historically traded at a discount to US equities. Though they are not at their most attractive level compared to US equities over the last ten years (December 2001), they are currently at a discount significantly above the historical average.

Is the current situation sustainable?

The current trends in euro-area bond and equity markets are generally favourable, but significant risks remain. The main risk relates to a possibly abrupt reversal in investor expectations of economic growth and inflation. While non-cyclical factors may be at play in driving both markets, the current level of prices suggests that a strong economic recovery and a sustained low inflation rate are both fully discounted. The concern must be that, after many years of ample liquidity and investor search for yield, asset valuations have been stretched to a point that investor risk is being mis-priced. If so, these markets – bond markets in particular – could be vulnerable to disturbance if expected growth and/or inflation rates were not to materialise. Any such correction would take place against a background of major imbalances in the international financial system, which have long raised the spectre of a disorderly adjustment in exchange rates (see the focus section on global imbalances in this issue).

Such a correction in asset prices and exchange rates could create a vicious circle by aggravating problems in the real economy via a deterioration in the balance sheets of households, companies and financial intermediaries. There could also be possible implications for financial stability, if the deterioration in corporate and household balance sheets was sufficient to significantly diminish the creditworthiness of bank clients (see Section 3 on the financial health of the private sector below).

In considering the likelihood of such a scenario, attention is inevitably drawn to high oil prices as a possible trigger. Financial markets have reacted calmly to the very sharp and sustained rise in oil prices so far this year. This muted reaction can be attributed to the fact that cost pressures from higher energy prices have not been reflected either in the pace of global economic activity or in core CPI inflation. There are also indications that the credit cycle is turning and that the corporate sector – particularly in the United States – may soon return to a position of significant net borrowing. Both these developments would point to upward pressure on expected yields and credit risk premiums in the future.

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

In assessing conditions in the EU non-financial private sector the main question to be addressed is whether the financing opportunities and costs facing the corporate and household sectors remain supportive of economic growth. More specific questions to be addressed are (a) whether the phase of subdued net demand for external funding in the corporate sector since 2001 is now coming to an end, thereby presaging a recovery in investment spending; and (b) whether the accumulation of household debt associated with housing market booms in some Member States poses a threat to economic performance and, possibly also to financial stability.

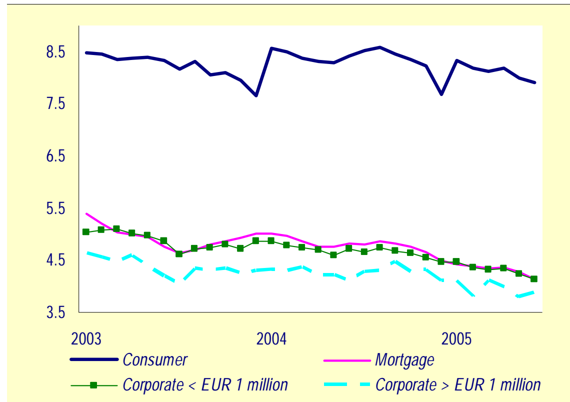
Financing conditions and costs

Financing conditions and costs, which were already favourable one year ago, have improved further for both non-financial corporations and households in the euro area. Interest rates on both bank lending and direct financing remain at very low levels, both in nominal and real terms.[11] Interest rates on bank lending, which is still the predominant source of external funding for both sectors, have declined steadily since 2003 and have remained at very low levels in recent months. The decline in interest rates has been pronounced in respect of corporate and mortgage lending, while rates for consumer credit retreated more modestly (Graph 21).

Further evidence of increasingly favourable financing conditions can be derived from the ECB bank lending survey, which shows a continuous amelioration in the terms of credit conditions for both the corporate sector and households. More recently, however, the banks' credit stance toward the two sectors has begun to diverge, continuing to ease in respect of companies but reverting toward neutral for households (Graph 22).

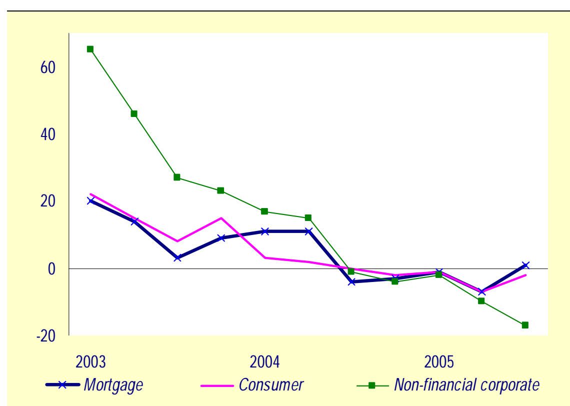
[11] In the context of this note, the term bank is used for Monetary and Financial Institutions (MFIs).

Graph 21: **Bank interest rates for the non-financial private sector, euro area** (in % – 2003 to 2005) (1)



(1) Rates refer to over 5 year loan interest rates for all but lending for house purchase, where the category "over 5 years and up to 10 years" was selected.
Source: ECB.

Graph 22: **Evolution of banks' credit stance towards the non-financial private sector, euro area** (1) (2003Q1 to 2005Q3)



(1) Values below (above) 0 signify a net easing (tightening).
Source: ECB bank lending survey.

Investor demand for corporate debt has been high and rising in recent years, providing companies with expanded opportunities for direct financing. As demand has grown, corporate bond yields have been on a downward trend across the different risk categories and have moved to new lows in recent months, amid historically low risk-free rates and a continued narrowing in credit-risk spreads. A notable development in this context has been the relatively pronounced decline in yields for both longer-term and higher-risk issues.

In addition, euro-area equity prices have been on a sustained upward trend in 2005. However, evidence suggests that companies have yet to return to equity issuance as a major external funding option.

Balance-sheet conditions and financing demand

While financing conditions and costs remain favourable for both the corporate sector and the household sector, the demand for external funding is equally determined by the condition of sectoral balance sheets. In a context of high accumulated liabilities, companies and households may choose to take advantage of favourable financing conditions to consolidate their balance sheets via re-financing rather than embarking on new expenditure plans. If so, low interest rates may not be reflected – as much as would typically be expected – in an increase in economic activity. Such considerations seem relevant in explaining the rather different performance of the corporate and household sectors in the euro area since the late 1990s.

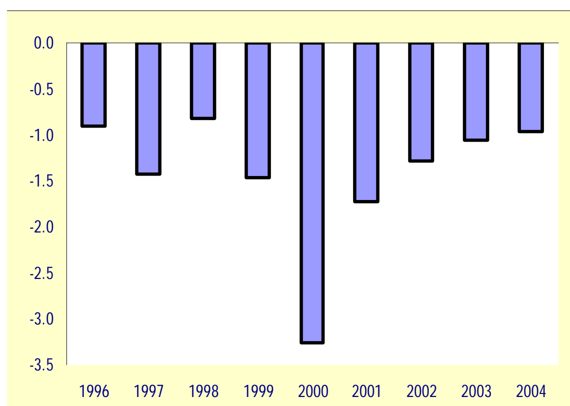
(i) Non-financial corporate sector

The favourable overall financing conditions, which have prevailed for several years, appear to have had little impact on the investment activity of the euro-area corporate sector, with net borrowing of the sector gradually declining since 2000 to about 1% of GDP in 2004 (Graph 23). This apparent failure to respond to lower interest rates and improved financing opportunities can be explained as a reaction to the very sharp increases in net funding recorded between 1999 and 2001. These increases in net funding gave rise to accumulated debt liabilities, which became progressively unsustainable as the global economy slowed in the aftermath of the 2000 stock market correction.

Thus, for much of the period since 2002, companies have been engaged in balance-sheet restructuring, benefiting from low interest rates to re-finance existing debt while simultaneously limiting their investment activity. In response to these consolidation measures, the level of accumulated corporate debt has stabilised at

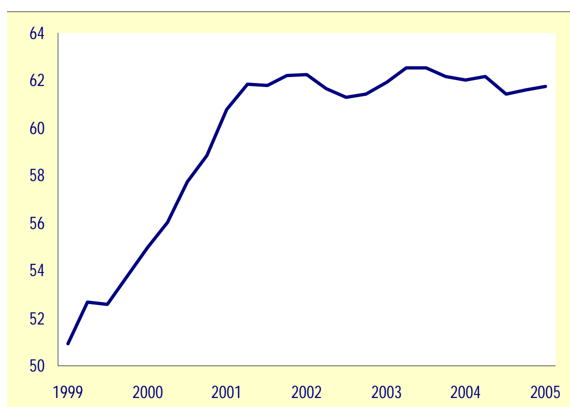
about 62% of GDP since 2002 (Graph 24). However, this stabilisation of gross indebtedness does not necessarily indicate an end to the process of consolidation

Graph 23: **Net financial position of non-financial corporations, euro area** (1) (in % of GDP – 1996 to 2004)



(1) Financial accounts data.
Source: Eurostat, Deutsche Bundesbank, own estimations.

Graph 24: **Ratio of debt to GDP in non-financial corporations, euro area** (in % – 1999Q1 to 2005Q1)

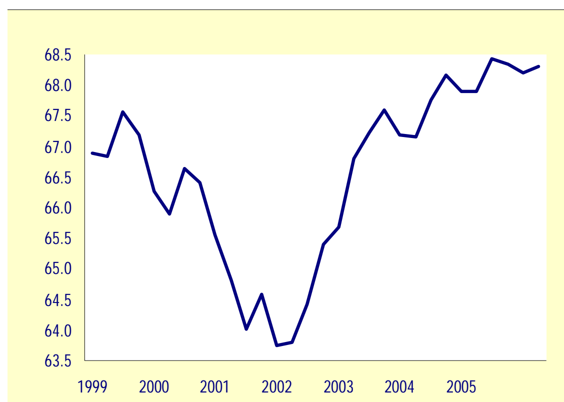


Source: ECB, own calculations.

Further evidence of balance-sheet restructuring can be found in companies' progress in locking in low longer-term interest rates, leading to an ongoing replacement of short-term debt since 2001 (Graph 25).

Companies have also been able to reduce net interest payments to the banking sector to slightly over 1.5% of GDP in Q1 2005 (Graph 26). Mirroring the fall in interest payments, the year-on-year growth rate of non-financial corporate deposits at banks is continuously outpacing the corresponding growth of bank loans to the sector in recent years (Graph 26). While the available evidence would suggest that the restructuring of companies' balance sheets is now advanced, net growth in demand for external funding has remained low and there is evidence of an important accumulation of cash balances within the corporate sector. The counterpart of these various balance-sheet developments has been the continued weakness of investment activity in the euro area.

Graph 25: **Ratio of non-financial corporate long-term debt to total debt, euro area** (1998Q1 to 2005Q2)

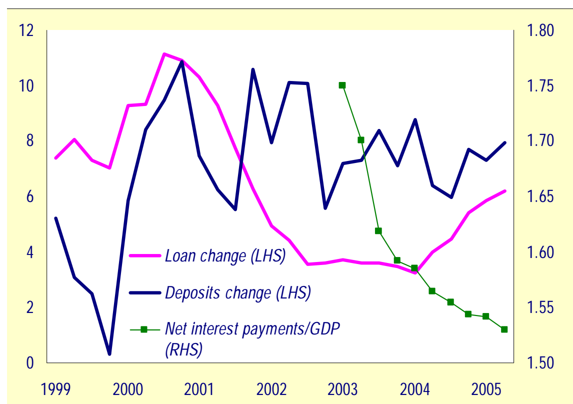


Source: ECB, own calculations.

More recently, however, there have been the first signs of a pick-up in companies' external funding demand and the gap in the growth rates between corporate deposits at banks and corresponding bank loans has narrowed since 2004. In addition, the most recent ECB bank lending survey predicts higher loan demand from non-financial corporations later this year. On the basis of this – admittedly partial – evidence, one might tentatively conclude that the weak trend in external funding demand has bottomed, with positive implications for investment activity going forward. However, the fragility of the current recovery in external funding demand means that any negative shock to domestic or global demand in the coming quarters and/or a sharper-than-expected pick-up in inflation and interest rates would be a cause for concern, insofar as the recent improvement in corporate creditworthiness might not be sustained – in

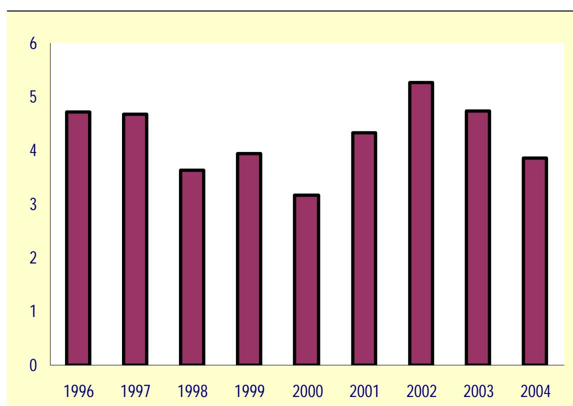
which case, further repair of balance sheets might be deemed necessary, with detrimental implications for corporate spending on investment.

Graph 26: **Bank loans to and deposits from corporations, euro area,** (growth rate in %) **and net interest payments of the corporate sector to banks, euro area** (in % of GDP – 1999Q1 to 2005Q2)



Source: ECB, own calculations.

Graph 27: **Net lending to other sectors by households** (in % of GDP – 1996 to 2004) (1)

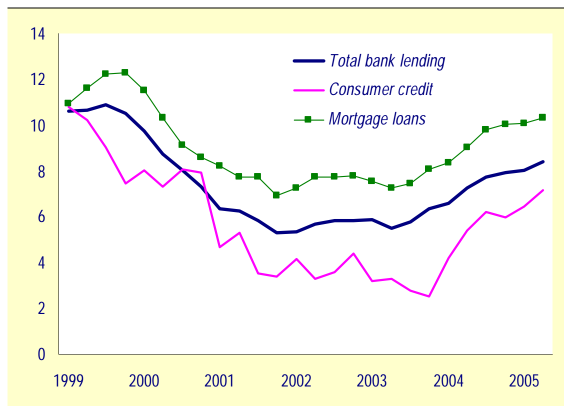


(1) Financial accounts data based on individual euro-area Member States.
Source: Eurostat, Deutsche Bundesbank, own estimations.

(ii) Household sector

In contrast to the non-financial corporate sector, euro-area households have responded to favourable financing conditions by accumulating additional debt in recent years. The household sector remains a net lender in the economy, but with a diminished net financial surplus when compared to previous periods. Net lending to other sectors has progressively diminished from over 5% in 2002 to below 4% of GDP in 2004 and bank lending to households has picked up progressively since the beginning of 2003 (Graph 27).

Graph 28: **Bank loans to households, euro area** (y-o-y growth rate in % – 1999Q1 to 2005Q2)

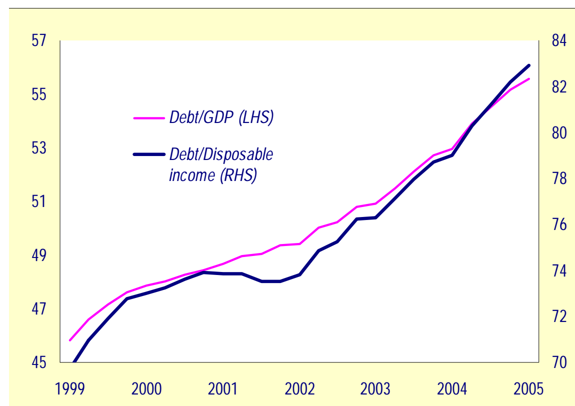


Source: ECB, own calculations.

Bank credit growth has accelerated to an annual rate of 8% in the first two quarters of 2005, with provisional figures for July indicating a continuation of that trend. The pick-up in the growth rate of consumer loans has been especially pronounced, accelerating from an annual rate of 2% at the end of 2003 to over 7% at the beginning of 2005.

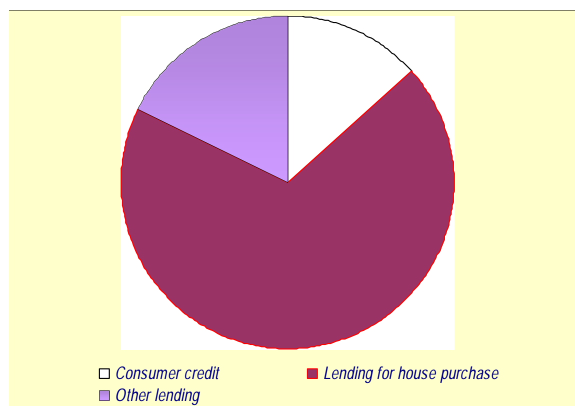
Although starting from a higher rate of growth, mortgage lending has also accelerated to an annual 10% in the first half of 2005 (Graph 28). The financial outlook for the household sector is far from clear. While a positive wealth effect might be expected from the recent further rise in asset prices, increased mortgage liabilities and surging oil prices are a cause for concern. In recent years, household debt ratios have soared, with accumulated debt up from about 45% of GDP in 1999 to about 56% in 2005 and from 70% to 82% of disposable income over the same period (Graph 29).

Graph 29: **Household debt as a share of GDP and of disposable income, euro area** (1)
(in % – 1999Q1 to 2005Q1)



(1) Quarterly disposable income data are based on estimations.
Source: ECB, Eurostat, own estimations.

Graph 30: **Components of banks' loans to households, euro area, 2005**



Source: ECB, own calculations.

Although the bulk of these liabilities are secured against real estate, the rise in household debt ratios and the increased exposure of banks to mortgage lending (i.e. currently about 68% of total bank loans to households – see Graph 30) is a source of concern in respect of both economic performance and financial stability. While a very sharp rise in interest rates would be necessary to trigger a correction in house prices on a scale that could threaten financial stability, a relatively small rise in rates (possibly due to the surge in oil prices) could have implications for household balance sheets, notably in countries with a high proportion of variable-rate borrowing.

The negative effect of higher interest rates on house prices would be greatly amplified, if accompanied by a rise in unemployment. On the other hand, while the higher debt accumulated by households in some Member States has certainly increased their vulnerability to shocks, the structure of housing and mortgage markets in most of the euro-area Member States is thought to be less conducive to wealth effects than those in the United Kingdom or the United States.

(iii) Financial sector

The financial position of EU banks continued to improve in 2004 and the first half of 2005, with most large EU banks posting strong earnings growth, higher profitability and sound prudential ratios. Though performance has varied somewhat across the Member States, both profitability and solvency measures improved even among the banks with a weaker performance.

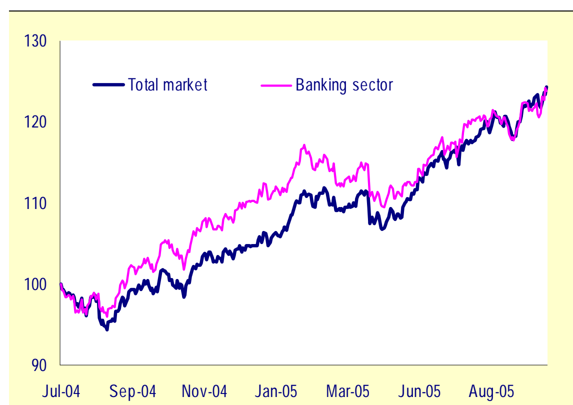
The main drivers of this favourable performance have been (i) increased revenues from retail business, where robust demand for household credit has more than offset the impact of intense competition in narrowing interest margins; (ii) sustained growth in non-interest income from recovering equity markets and revived interest in mutual funds and other savings products; (iii) continued efficiency improvements due to cost-cutting and restructuring measures undertaken in recent years, and (iv) a substantial drop in loan-loss provisions, reflecting an improvement in asset quality due to a strengthening performance in the corporate sector and in emerging-market economies.

Market indicators reflected the favourable situation of EU banks, with the banking sector equity index out-performing the total market in the second half of 2004, positive rating changes, and distance-to-default indicators which continued to increase from an already high level.[12] Despite this generally favourable situation, several potential risks can be identified. The prospects of further increases in profitability in the course of 2005 could be dampened by

[12] Since the beginning of 2005, however, banking sector equity indices have been under-performing the total market, but this has been due mainly to the oil sector's strong performance.

slower-than-expected economic growth, and particularly a decline in demand for retail services. With respect to lending behaviour, an increased exposure to real estate markets is notable, while credit standards for house loans appear to have been loosened somewhat (e.g. loan-to-value ratios on new mortgages seem to have significantly increased). Meanwhile, credit-risk premiums on bank loans to companies may well have been unjustifiably compressed by the development of a corporate bond market in the euro area. Overall, however, EU banks display robust capital and solvency ratios and should be in a position to weather adverse developments.

Graph 31**: Relative performance of the EU banking sector index** (1 July 2004 to 30 Sept 2005)



Source: EcoWin.

Non-bank financial intermediaries also continued to improve their performance in 2004 and the first half of 2005. Several of the biggest EU insurance companies have posted strong positive interim results for 2004 and the first half of 2005. Overall, the insurance sector appears to be adequately capitalised. However, some concerns remain about the sector's increased exposure to risk, and Hurricane Katrina could put some pressure on reinsurers' financial situation. Similarly, the funding levels of EU pension funds have further recovered in the course of 2004 and the first half of 2005.

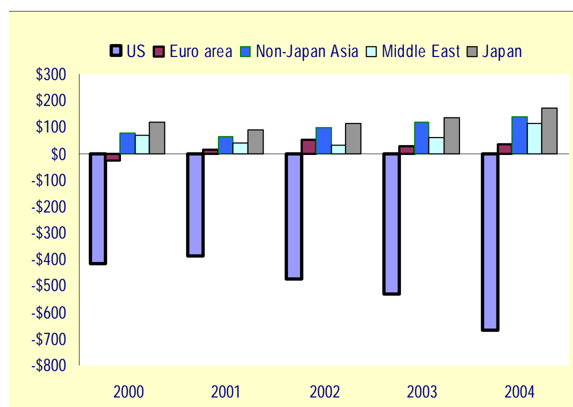
Focus

II. Global current account imbalances and the euro area

Global current account imbalances have dominated discussions among policy-makers already for a number of years. The most important imbalances concern the large and rising current account deficit of the United States and the matching surplus of East Asia and the Middle East, while the current account for the euro area is roughly balanced. Nevertheless, the euro area would likely be substantially impacted by any disorderly unwinding of the global imbalances. Different scenarios show that the euro area could suffer from substantial current account and output losses, if the adjustment involves a sharp depreciation of the dollar and a recession in the United States. On the other hand the impact would be mitigated if East Asia were to increase its imports. The euro area on its own can make only a limited contribution to reducing global imbalances, primarily because its own starting position is balanced. Even a sizable increase in the euro-area's trend output growth would not result in substantial and lasting improvements in the US external balance. However, the euro area can prepare itself to better absorb the shock that any disorderly unwinding would bring by implementing structural reforms that improve the flexibility and resilience of its constituent economies.

Increased global financial integration makes it easier for countries to run large current account imbalances than in the past. Recent years have seen the build-up of large current account deficits in the United States, which are matched by an increasing current account surplus in particular in East Asia and the Middle East. However, the unprecedented scale of these imbalances has led to fears that their eventual correction could give rise to disruptive exchange rate realignments, with significant global implications.

Graph 32: **Current account balances**
(bn US $ – 2000 to 2004)



Source: IMF.

In sharp contrast to the United States and its East Asian and Middle Eastern lenders, the euro area has a roughly balanced current account. Nevertheless it could find itself at the heart of the economic disruption caused by a possible disorderly correction of global imbalances. This focus examines these issues as follows: the first section takes stock of the recent developments in global current account imbalances; the second section discusses possible ways in which the these imbalances could be corrected through adjustments in the United States or Asia; a third section considers what, if anything, the euro area could do to reduce the global imbalances; and a final section concludes, stressing the need for the euro area to implement economic reforms to brace itself for the possibility of a disorderly unwinding of the global imbalances.

1. Global imbalances

US current account deficit

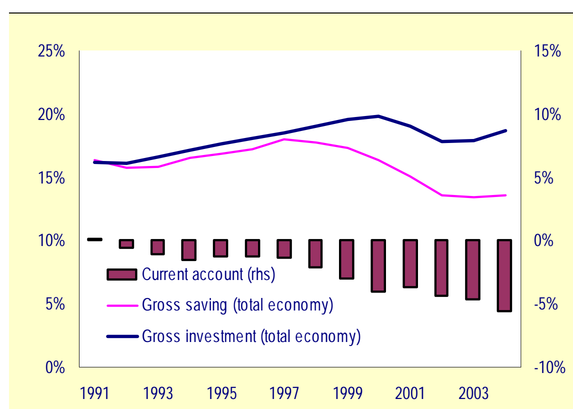
The US current account deficit is the focal point of the concerns about global imbalances. In 2004, the US deficit rose to nearly 670bn US dollars (5.7 percent of GDP – Graph 32).[13] This represents around 1.6 percent of world GDP. This is significantly higher than the US external deficits of the 1980s, which never rose above 3.5 percent of US GDP and 1 percent of world GDP, values which the US has now exceeded for six years in a row. The US current account deficit is unprecedented in its magnitude and duration for an industrialised country. The USA is now absorbing around 70 percent of the net capital outflows of all countries running current account

[13] The IMF's *World Economic Outlook* September 2005 provides an in-depth analysis of global savings and investment trends.

surpluses, despite an already significant fall in the value of the US dollar since 2001.

The external imbalances reflect domestic imbalances in the US economy (Graph 33). While investment rates have not changed much over the last ten years, the savings rate has declined sharply since the late 1990s. US households have reduced their personal saving as a percentage of disposable income, from 7% at the beginning of the 1990s to a mere 1% in 2004. Over the last five years there has also been an important deterioration in public finances, which went from a surplus of 1.3% of GDP in 2000 to a deficit of 4.3% of GDP in 2004. The resulting savings–investment gap was filled by a substantial capital inflow into the USA. The late 1990s witnessed a surge of private equity inflows connected with the ICT boom. After the ICT bubble burst, private capital flows diminished substantially. Instead foreign central banks started to buy ever-increasing volumes of dollar-denominated bonds, thus financing both the US current account and the US budget deficit.

Graph 33: **United States internal and external balance**
(% of GDP – 1991 to 2004)



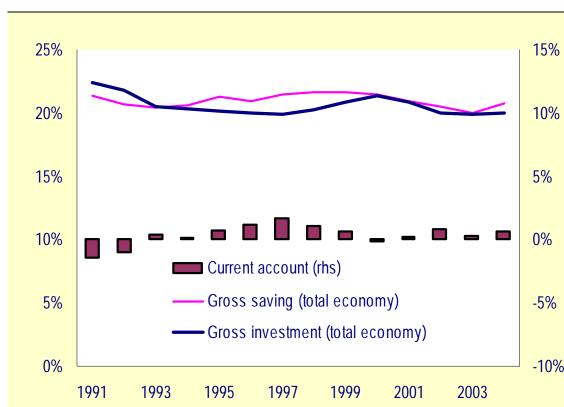
Source: Commission services.

Surplus in East Asia and the Middle East

The counterbalancing improvement in the current accounts accrued mostly in East Asia and the Middle East. Other countries, such as Japan, retained a positive but relatively unchanged current account balance. The Middle Eastern current account surplus is explained mostly by windfalls from high oil prices. The dominating factor in East Asia is the central banks which have accumulated huge dollar reserves in recent years through interventions aimed at stabilising their exchange rate vis-à-vis the dollar, thus supporting their exports. At the current rate, the build-up of foreign reserves by East Asian central banks (some 530 billion US dollars in 2004) finances about three-quarters of the US deficit.

The dilemma of the Asian central banks is that an appreciation of their currencies would not only reduce their countries' external competitiveness but would also imply a devaluation of their huge dollar reserves in terms of national currencies. Although the current situation becomes more difficult the longer it lasts, it is likely that most Asian central banks will continue to accumulate foreign exchange reserves at a high pace in the near future. The decision of China in July 2005 to suspend the dollar peg and to move instead into a managed floating regime based on a basket of currencies will have only a moderate impact.

Graph 34: **Euro-area internal and external balance**
(% of GDP – 1991 to 2004)



Source: Commission services.

External balance in the euro area

Unlike the United States and the surplus regions, the euro-area current account is very close to balance (Graph 34). In 2004, the euro area current account registered a small surplus of 48 billion euro, 0.6% of GDP. It had been mildly positive for most of the past ten years. The achievement of this balanced position is also remarkable in the light of the substantial

appreciation of the euro vis-à-vis the US dollar since 2001 – but this appears to have been more than compensated by a high global import demand, while domestic demand in the euro area was weak.

Intra-euro-area current account balances

However, the aggregate current account position of the euro area hides some substantial differences among euro-area Member States. Germany alone runs a large current account surplus of 80 billion euro (3.7%) of GDP. Without this, the euro area would have had a negative current account. Other countries, such as Belgium, the Netherlands, Austria and Finland, also have positive balances, but only in Finland are the surpluses as high as those of Germany in relative terms.

Table 4: **Current account in the euro area**

	In billion €					
	1994	1996	1998	2000	2002	2004
BE	11	11	12	9	14	9
DE	-28	-12	-13	-27	48	82
EL	0	-1	-1	-7	-9	-9
ES	-5	6	1	-20	-18	-34
FR	1	14	32	17	12	-10
IE	2	3	1	1	-1	-2
IT	11	32	23	1	-4	-4
NL	16	15	10	18	11	13
AT	-4	-4	-2	-2	5	5
PT	-1	-1	-5	-10	-7	-8
FI	1	4	7	10	10	6
Euro Area	4	65	65	-10	61	48
	As % of GDP					
	1994	1996	1998	2000	2002	2004
BE	5.5	5.1	5.3	3.8	5.2	3.1
DE	-1.6	-0.7	-0.7	-1.3	2.2	3.7
EL	-0.7	-1.0	-1.4	-5.5	-6.3	-5.4
ES	-1.2	1.2	0.2	-3.2	-2.5	-4.1
FR	0.1	1.1	2.4	1.2	0.8	-0.6
IE	3.6	4.4	1.9	0.8	-0.9	-1.1
IT	1.3	3.2	2.1	0.1	-0.3	-0.3
NL	5.6	4.9	2.8	4.6	2.6	2.7
AT	-2.7	-2.3	-0.9	-1.1	2.3	2.1
PT	-1.6	-1.3	-4.5	-9.0	-5.8	-6.0
FI	1.6	4.1	5.8	7.3	7.4	4.3
Euro Area	0.1	1.1	1.1	-0.1	0.8	0.6

Source: Commission services.

Other euro-area countries run significant deficits. In the cases of Portugal, Greece and Spain, the deficits are of a similar order of magnitude to that of the United States. However, such current account deficits are to be expected as a part of a normal income catching-up process and therefore are likely to be relatively unproblematic. Furthermore, in the absence of intra-euro-area nominal exchange rate fluctuations, current account adjustments in these countries can only take place via slow changes in prices and factor cost.

Net foreign asset position

The evidence suggests that the United States economy is extremely vulnerable to a fall in international investor confidence. However, the current account deficit is only one factor determining the evolution of the net-foreign-asset-to-GDP ratio, which is the best indicator for assessing the sustainability of the external position.[14] Current account deficits in past decades explain why both the euro area and the US show negative net foreign asset positions of some 15 and 23% of GDP respectively.[15] Another factor is obviously GDP growth. With nominally constant net assets, higher GDP lowers the net-asset-to-GDP ratio.

The ratio can also be significantly affected by net external asset revaluations. The magnitude of these revaluations again depends on a number of parameters. One aspect is whether the nominal rate of return on external assets and liabilities differs. For instance it appears that American investments abroad, which are concentrated in equities, yield a substantially higher return than foreign investments in the USA, which mostly consist of bonds. The higher the internationally held assets and liabilities are, the higher is the impact of differentials in the rates of return.

Finally, and very significantly, the evolution of the asset position depends on the exchange rate. Just like the nominal rate of return, the impact of the exchange rate depends on the composition of the international asset holdings. For advanced economies like the United States and the euro area, foreign assets are usually denominated in

[14] See, Lane, P. and G. Milesi-Ferretti, "A Global Perspective on External Positions" in R. Clara, ed. (2005 forthcoming): *G7 Current Account Imbalances: Sustainability and Adjustment*; Chicago University Press, accessible at: http://www.nber.org/books/curracct/lane-milesiferretti8-19-05.pdf

[15] Unlike flow parameters, data on asset stocks are subject to substantial uncertainties.

foreign currencies; liabilities are denominated in the home currency. Consequently, an unexpected depreciation (not reflected in ex-ante interest differentials) will increase the domestic currency rate of return on external assets and hence improve the net foreign asset position.[16] This puts a country in the advantageous position that depreciation leads to an immediate improvement in its net asset position, notably when cross-country holdings are dominated by fixed interest bonds. Investors from the appreciating currency would consequently see their assets lose value.

Table 5 shows that these factors can be extremely important at least in the short run. Over the last four years, the net-asset-to-GDP ratio in the United States and the euro area deteriorated at practically the same rate of 5.6 and 5.8 pp, respectively, in spite of large differences in their current account position.

Table 5: **Evolution of net asset ratio in the euro area and the United States** (2000-2004)

	Euro area	United States
Initial net foreign asset-position (1)	-9.8	-16.7
Change in net foreign assets (1) of which	-5.6	-5.8
• Cumulative current account GDP growth	1.6	-18.8
• GDP growth	1.4	3.9
• Capital gains	-9.0	10.1
• Errors, omissions	0.4	-0.9
Selected parameters (2)		
Change in REER	31.5	-14.8
Stock prices (foreign minus domestic)	4.4	11.6
Avg. real return on assets	-2.7	4.8
Avg. real return on liabilities	-0.5	-0.4

(1) Percentage of GDP.

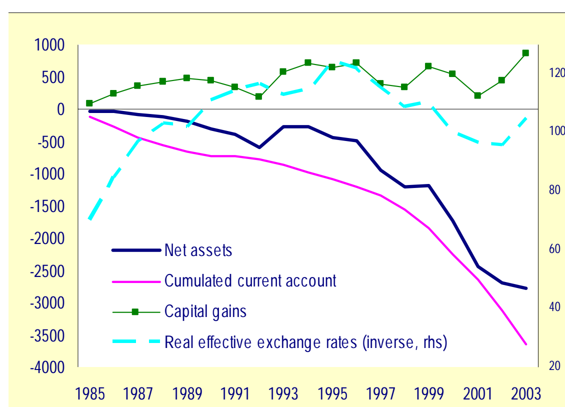
(2) Percent.

Source: Lane and Milesi-Ferretti.

The United States' cumulative current account deficit of 18.8% of GDP was to a significant extent neutralised by the fact that capital gains of US-held foreign assets exceeded those of the foreign-held US assets by 10% of GDP. This was helped significantly by an effective depreciation of the dollar by 15% in real terms. In addition, US investors enjoyed a markedly higher rate of return for their foreign assets than foreigners yield in the USA.

The euro area, by contrast, suffered relative capital losses far in excess of the cumulative current account surplus. Most of the loss is explained by a considerable (30%) revaluation of the euro over the period in question. Even without this, European investments abroad yield lower returns than those of their American counterparts. Furthermore, low growth reduced the euro area's net foreign asset-to-GDP ratio only by 1.4 pp, while the US net asset ratio was reduced by nearly 4 pp between 2000 and 2004.

Graph 35: **Change in US net foreign asset position since 1985** (bn US $ – 1985 to 2003)



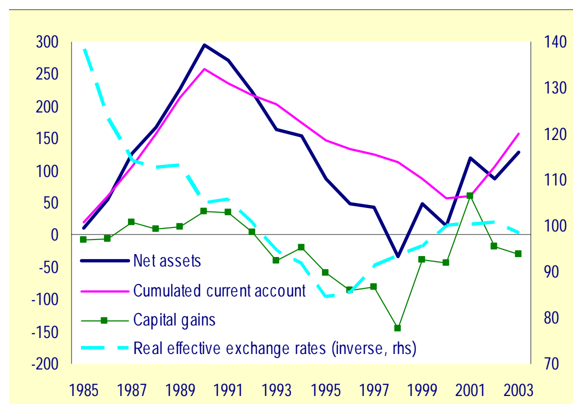
Source: IMF.

Like the current account balances, the net asset positions in the euro area are far from homogenous. While some countries, such as Belgium, France and Germany, enjoy positive net asset positions, in others such as Spain, Portugal, Greece, Ireland and Finland, the net asset position is highly negative with values of between 20 and 70% of GDP. It is, however, difficult to draw direct conclusions from these figures about the sustainability of the external balances for individual Member States.[17]

[16] Developing economies which are net debtors and whose liabilities are primarily denominated in foreign currency increase their debt ratio when their currency depreciates.

[17] For instance, a Finnish net asset position of minus 150% in 2000 was a sign more of economic strength than weakness at the time, as it mostly reflected the stock market valuation of Nokia.

Graph 36: **Change in German net foreign asset position since 1985** (bn US $ – 1985 to 2003)



Source: IMF.

In spite of these recent trends and having a net asset imbalance two thirds that of the United States, the euro area's external sustainability is not at risk. This is because, in the long term, net assets are clearly dominated by current account balances. Even an impressive 900 billion dollar in capital gains for the US over the last twenty years does not change the long-term picture, in particular as these gains depend also on short-run exchange rate movements (Graph 35). In other countries, the situation is comparable (Graph 36). Also, unlike the United States, the euro area does not need to attract huge sums of foreign capital each year. The recent deterioration of the net asset position is almost exclusively due to a euro appreciation. Even a stabilisation, let alone a depreciation of the euro would substantially improve the euro area's net asset position.

2. *Correcting the global imbalances*

While the analysis of the evolution of net assets modifies the estimation of the necessary current account improvement, the United States external balance is clearly unsustainable. The current account does not need to be zero to stabilise the debt ratio. This could already be achieved at a deficit of 1% of GDP[18], but depends on US growth, as well as the degree to which it can maintain the unequal exchange of high-yielding foreign assets against low-yielding US assets. Even in the best of cases, there needs to be a substantial improvement in the current account. It would certainly make matters more difficult if foreign buyers of US assets achieved higher returns on their investments. If investors demanded a higher risk premium, making the US foreign position less tenable, a disorderly unwinding could ensue.

It is not easy to determine exactly what impact an adjustment of external imbalances on the euro area would have, because it hinges on the underlying shifts in economic parameters as well as the size and speed of adjustments in the exchange rate. It is unlikely that the current account gap now prevailing in the United States could be corrected by exchange-rate adjustments alone, even if the dollar devaluation were very large. An important part of the rebalancing must come from changes in economic fundamentals, i.e. changes in savings rates and productivity.

Adjustment channels

Before discussing possible scenarios to correct the imbalances it is useful to review briefly the various channels by which adjustment, and notably a rising euro exchange rate, would affect the euro area economy.

Trade channel: An appreciation of the euro increases the price of exports and lowers the price of imports. Over the medium term, this relative loss in European price competitiveness will have a negative impact on the trade balance, the magnitude of which is influenced by a number of parameters. These are the extent of the pass-through of the exchange rate to import prices; the degree to which exporters reduce their profit margins and cut their prices to maintain market shares; the relative elasticities of export and import substitution; and the starting position. In addition, the reaction of the trade balance to exchange rate changes depends on the lag times between placing international orders and receiving the products. Because exports tend to be denominated in domestic currency (i.e. euros) and imports in foreign currencies, the immediate impact might even be a widening of the trade balance.

Purchasing power channel: While a euro appreciation leads to a loss of competitiveness for producers of tradable goods and services,

[18] Roubini, N. and B. Sester: The US as a Net Debtor: The Sustainability of US External Imbalances, mimeo Nov. 2004. http://www.stern.nyu.edu/globalmacro/Roubini-Setser-US-External-Imbalances.pdf.

consumers might actually benefit. A rising euro means lower import prices and, hence, an increase in purchasing power.

Asset price channel: As seen from the euro area, liabilities are usually denominated in euros, while assets are denominated in dollars. Mechanically, a dollar devaluation leads to a proportional reduction in the value of dollar-denominated assets. This in turn reduces the value of euro area companies with US assets, insofar as they are not hedged, and might limit their capacity to borrow and invest. On the other hand, these companies might benefit from the increased competitiveness of their foreign subsidiaries.

Interest rate channel: A fall in the dollar triggered by reduced demand or an increased risk premium for US-held assets would lead to higher interest rates in the US and lower interest rates in Europe through increased demand for euro-denominated bonds. This effect would be reinforced, if investors expected further euro appreciations in the future. This channel would benefit Europe unless the demand for a higher risk premium also spilled over into the euro area, which would have the effect of reducing investment.

Relative price channel: A change in exchange rates will not affect all sectors equally. Prices of tradable goods and services are likely to fall noticeably, while prices for non-tradable goods will remain practically unchanged. Even within the tradable sectors, the impacts can vary depending on market structure, import and export ratios, relative exposure to the dollar, and price elasticity. In the wake of the euro appreciation, substantial shifts of consumption and production could take place between the tradable and non-tradable sectors.

Confidence channel: A euro appreciation is also likely to affect consumer and producer confidence. Much depends on whether the appreciation is the result of an improved outlook and hence capital inflows for the euro area or the result of a deterioration in the USA. In the latter case, private sector confidence is likely to fall, in the light of strong linkages between US and European financial markets. If falling confidence leads to lower spending, and hence lower imports, the contractionary effect of lower exports to the USA might be aggravated. A countervailing effect would be a rise in consumer confidence as a result of lower import prices.

Adjustment scenarios

Three core scenarios can be identified that reduce global imbalances without involving the euro area as a policy actor. A first scenario involves the reduction of US internal imbalances through an increase in the household savings rate. Table 6 shows the result of such a scenario using the DG ECFIN's QUEST model. This scenario (like the following two) is normalised to achieve a 0.5% of GDP reduction in the US current account deficit in the third year after the policy change. The scenario requires a substantial 6% reduction in private consumption. In the first year US GDP falls by 3.8%. This drop is dampened in the following years as a result of lower real interest rates. The improvement in the trade balance takes place mostly through lower imports amidst lower domestic demand. Clearly, the scenario is costly in terms of GDP loss. It also has sizeable spill-overs into the euro area, which suffers from a loss of its GDP by 0.5 % after three years, as its trade balance deteriorates in the in the order of 0.65% of GDP. The costs of this scenario become even more substantial if one keeps in mind that the required current account adjustment for the United States needs to be significantly larger than the values assumed in the scenario.

Table 6: **US savings rate increase** (1)(2)

	Year	1	2	3
Euro area	GDP	-0.83	-1.01	-0.51
	Trade balance	-0.35	-0.66	-0.65
USA	GDP	-3.84	-2.57	-2.58
	Trade balance	0.59	0.50	0.50
Exchange rate (€/$)		-3.71	-2.19	-0.06

(1) Percentage deviation from baseline.
(2) 6 percent reduction in private consumption.

A second scenario that is based on correcting US internal imbalances is a fiscal contraction. To achieve an improvement in the current account by 0.5% of GDP, the United States needs to increase its taxes by 6.5% of GDP in the QUEST simulation (Table 7). Like the previous scenario, the current account improvement stems

from a strong reduction in domestic demand. While the output reduction in the United States is similar to that of the higher savings rate scenario, negative spill-overs of US budget consolidation into the euro area are relatively smaller, because the Euro area benefits from lower interest rates and import prices.

Table 7: **US fiscal contraction** (1)

	Year	1	2	3
Euro area	GDP	-0.23	-0.21	-0.11
	Trade balance	-0.19	-0.45	-0.47
USA	GDP	-1.74	-1.98	-2.63
	Trade balance	0.31	0.42	0.50
Exchange rate (€/$)		-2.81	-2.16	-0.98

(1) Fiscal contraction of 6.5% of GDP modelled as increase in labour income tax and corporate taxes (by 3.25% of GDP each).

A third scenario considers the possibility of a reduction of global imbalances as a result of lower savings in Asia. This is modelled as an increase in Asian imports by 10% (Table 8). In this case GDP and exports rise in both the United States and the euro area compared to the baseline. Due to the higher export share, the euro area benefits more than the USA from this situation. In addition, the United States is more affected than the euro area by the dampening effect of rising interest rates.

Table 8: **Reduction in Asian savings rate** (1)

	Year	1	2	3
Euro area	GDP	0.64	0.34	0.38
	Trade balance	0.64	0.64	0.68
USA	GDP	0.34	0.16	0.18
	Trade balance	0.44	0.50	0.50
Exchange rate (€/$)		-0.62	-0.56	-0.48

(1) Increase in imports of Asian region (non-Japan) of 10 %.

Even though, net asset positions apart, the euro area's current account is in balance and is not implicated in the bilateral imbalances between the United States and its lenders, the costs of a disorderly unwinding could be substantial for Europe, if it is accompanied by a recession in the United States.

It is not clear, what combination of the three core adjustment scenarios just described is the most likely. Various authors have made the case that the driver of global imbalances lies in either the US fiscal deficit, the lack of US savings, East Asian central bank interventions, a global savings glut, a lack of global investment opportunities, or a combination of these. Other authors argue that global imbalances are not even a problem, but rather the result of optimal resource allocation. The solution to the imbalances varies depends on the viewpoint. A hard landing with spill-overs into the rest of the world is not therefore inevitable.

As the simulations have shown, one important factor in determining the outcome is the degree to which an adjustment in the US external balance would be accompanied by a reduction in the imbalances of the lender countries. A reduction in the current account surplus of East Asia and the Middle East would ease the adjustment pressure on the euro area proportionately. This would mean that, from a European perspective at least part of the shock of a rising euro-dollar exchange rate would be cushioned by a simultaneous rise in Asian currencies. Even in a benign scenario, a correction for the US deficit is likely to be accompanied by a sizeable devaluation of the dollar, with an according rise in the exchange rate of the euro. This exchange rate realignment would require substantial adjustments in the euro area to an altered price structure.

3. *European options to address global imbalances*

Policy scenarios

It has been suggested (mostly by US authors) that the relative attractiveness of the United States to absorb global excess savings is partly linked to the unattractiveness of investing in Europe. This could be eased by higher growth rates in the euro area and higher net imports.

Expansionary fiscal and monetary policies might be considered to be the fastest way to bring about higher growth and import demand in the euro area. Such policies can, however, only induce a cyclical acceleration of growth, while having no or even a negative impact on long-term growth. As the short-run expansionary effect of the policy change wears out and turns negative, so would the increased import demand. Fiscal and monetary policies therefore would not

bring about a lasting improvement in the US current account deficit. Furthermore, there is no room for manœuvre on the fiscal side in the euro area and monetary policy is already accommodating.

Although the role of structural reforms in helping to reduce current account imbalances has taken a prominent place in the policy debate, empirical research on the issue has so far remained relatively sparse. A common tenet in policy circles seems to be that growth-enhancing structural reforms in the euro area will foster euro-area import demand and thereby contribute to reduce the US trade deficit. Neither economic theory nor empirical evidence provide much support to the idea of a long-term negative relation between growth and the level of the current account. However, theory does not rule out the possibility that reforms may temporarily bring a deterioration of the trade balance by providing a bigger stimulus to demand than to supply (see Box 2).

Labour and product market reforms rank among the most important means of raising euro-area growth in the medium run. However, QUEST simulations show that such reforms, while lifting the euro area's growth potential, have very limited implications for trade balances.

Table 9: **Effect of euro-area wage reductions** (1)(2)

	Year:	1	2	3
Euro area	GDP	0.41	0.78	1.00
	Trade balance	-0.11	-0.19	-0.22
USA	GDP	0.00	0.01	0.02
	Trade balance	0.04	0.05	0.07
Exchange rate (€/$)		-0.30	-0.11	-0.01

(1) Reduction in ex-ante wages by 3.7%.
(2) Percentage deviation from baseline.

Table 9 shows the simulation of labour market reforms that lead to a 1% increase in euro area GDP after three years. This is modelled as a change in the wage-setting rule, which lowers ex ante wages by 3.7%. Wage moderation stimulates investment spending and leads to an increase in output and employment levels and to lower unemployment, which also boosts private consumption in spite of the original income loss. The scenario results in a negligible appreciation of the euro-dollar exchange rate, and practically no improvement in the US trade balance. This result is intuitive, because the scenario has no built-in mechanism that would drive aggregate demand to rise faster than aggregate supply. In addition, it should be noted that only a part of the changes in the euro area current account is mirrored in the United States' current account, because other countries, notably European states outside the euro area, absorb a substantial share of the current account impulse.

A slightly larger current account deficit can be generated by product market reforms, which increase competition amongst producers of goods and services and increase the process responsiveness of demand. Such a liberalisation can be simulated in QUEST as a reduction in mark-up prices.[19] As a consequence, firms increase output – together with investment – while real wages also increase in the medium term. The boost in consumption due to higher employment, higher wages and lower prices exceeds the increase in GDP, leading to a slightly negative trade effect in Europe. The euro appreciates vis-à-vis the dollar and the US trade balance shows a small improvement (Table 10). Clearly, however, this scenario does not do enough to solve the US current account problem.

Table 10: **Effect of euro-area product market reforms**(1)(2)

	Year:	1	2	3
Euro area	GDP	0.63	0.72	1.00
	Trade balance	-0.42	-0.95	-1.05
USA	GDP	-0.16	-0.15	-0.11
	Trade balance	0.11	0.32	0.32
Exchange rate (€/$)		-8.21	-7.89	-7.37

(1) Reduction in mark-ups over marginal costs by 5.2 percentage points.
(2) Percentage deviation from baseline.

The only viable euro-area policy option to affect the US current account deficit over a more extended time period is for international investor preferences to switch from the United States to the euro area. This can be modelled as a higher risk premium for investment in the United States

[19] This requires a decrease in the mark-up over marginal costs by 5.2 percentage points.

Box 2: **Structural reforms and current account imbalances: some recent literature**

The available empirical evidence suggests that structural reforms in the euro area may temporarily alleviate current account imbalances although their effect may be only modest and depends on the types of reforms considered. Furthermore, in most model simulations, it seems that the only way in which reforms can be shown to have a significant negative effect on the euro-area current account is by making the assumption that reforms will foster capital inflows into the euro area.

Kennedy and Slok (2005) explore the link between current account balances and structural reforms with a panel regression on 14 OECD countries. The authors find no support for the idea of a systematic link between the current account position and trend growth. Product and financial market deregulation, however, may have a negative impact on the current account. In contrast, regression coefficients are not meaningful in the case of labour market indicators and show a wrong sign in the case of FDI restrictions. The authors conclude that structural reforms may impact the current account in the short- to medium-run although the link may be tenuous and may vary with the types of reforms put in place.

Faruqee et al. (2005) use a variant of the GEM model of the International Monetary Fund to simulate scenarios of adjustment to global imbalances, among them the possible contribution of structural reforms in the euro area. They conclude that labour market reforms can only have a limited impact on the euro-area's net saving, particularly if uncertainties related to the reform process weigh on consumer confidence. Product market reform may have a somewhat more significant effect on the current account but spillovers from the euro area to the USA remain fairly small and seem to partly depend on concurrent assumptions regarding increased appetite for euro-area assets. Also based on the GEM model, **IMF (2005)** concludes that the build-up of the US trade imbalances and the rise in the dollar in the late 1990s can be explained by the combination of a productivity shock in the USA and increased appetite for US assets (in most macroeconomic models, the impact of productivity shocks on exchange rates and trade balances are relatively modest). Following this line of reasoning, a pick-up in productivity in the euro area combined with increased demand for euro-area assets would help restore global imbalances.

Obstfeld and Rogoff (2005a; 2005b) construct a simple general equilibrium model with fixed endowments and assess the changes in relative prices that would result from a closing of the US current account deficit. The central assumption is that current account imbalances are resolved by a shift in demand from the USA to the rest of the world. Several interesting conclusions can be drawn from the exercise:

- First, the magnitude of the required depreciation of the dollar real effective exchange rate would be substantial, ranging from 15% to 30% depending on the model assumption. This shows that an adjustment to global current account imbalances cannot take place without significant price changes.
- Second, whereas discussions on the implications of the adjustment to current account imbalances tend to focus on the tradable sector, reducing the US trade deficit will also have a strong impact on prices in the non-tradable sector both in the USA and in the rest of the world. A reversal of the US trade deficit will weigh on the euro-area's export sector but also give a boost to its non-tradable sector.
- Finally, the necessary dollar depreciation will be larger if prices are sticky. On the other hand, it could be mitigated by factor mobility across sectors and an acceleration of productivity gains in the rest of the world (but only provided that it takes places in the non-tradable sector).

References

Faruqee, H., Laxton, D., Muir, D. and P. Pesenti (2005), "Smooth landing or crash? Model-based scenarios of global current account rebalancing", paper presented at the NBER conference on G7 Current account imbalances: sustainability and adjustment. June.

IMF (2004), "Global rebalancing of current accounts: a euro-area perspective", in "Euro Area Policies: Selected Issues", Country report, August.

Kennedy, M. and T., Slok (2005), "Structural policy reforms and external imbalances", Economics Department Working Papers, OECD, No. 415.

Obstfeld, M. and K., Rogoff (2005a), "The unsustainable US current account position revisited", in "G7 Current Account Imbalances: Sustainability and Adjustment", National Bureau of Economic Research.

Obstfeld, M. and K., Rogoff (2005b), "Global current account imbalances and exchange rate adjustments", Brookings Papers on Economic Activity 1:2005, pp.67-123.

compared to that in Europe, for instances as a result of structural reforms (Table 11).

Table 11: **Product market reforms and risk premium shock** (1)

	Year	1	2	3
Euro area	GDP	0.11	0.46	1.00
	Trade balance	-0.61	-1.65	-1.71
USA	GDP	-0.07	-0.11	-0.18
	Trade balance	0.12	0.63	0.69
Exchange rate (€/$)		-14.50	-14.88	-15.06

(1) Percentage deviation from baseline.

The effects of the scenario on the euro area follow several channels. The euro appreciation results in a loss of competitiveness, leading to a notably negative trade balance. The negative impact of this effect on GDP is, however, more than offset by higher consumption due to lower import prices and higher investment as a result of capital inflows in the wake of shifting investor preferences. Notably, if combined with structural reforms, this scenario increases euro area GDP despite the substantial negative trade shock.

The USA, on the other hand would improve its trade balance although owing to the dollar depreciation, the nominal trade balance would only improve by about half the real shift in trade. The negative impact of the interest rate premium and higher import prices, however, reduce GDP. But even the risk premium scenario shows that the impact that the euro area can have on the US deficit is very limited.

Desirability of euro-area options

It is, of course, one question to examine what policies might create a euro-area current account deficit, and ostensibly reduce global imbalances. Whether it is desirable to deliberately create a current account deficit is a separate matter. Clearly the policies that lift growth potential, such as product and labour market reforms should be pursued in their own right. The benefits of a current account deficit are less obvious.

First, with the East Asian and Middle Eastern current account surplus unchanged, a higher euro-area deficit would mean that the imbalances are carried by more shoulders, namely the United States and the euro area together. This might increase the sustainability of the global financial system somewhat, but does not remove its fundamental problem. If the euro area contributes to a further accumulation of large negative global net asset positions, the eventual global adjustments might be only delayed rather than avoided altogether, and ultimately become more violent.

Second, it must be considered that the euro area starting position from which to create a current account deficit is not as comfortable as is often suggested. While the situation is clearly not as menacing as that of the United States, it nevertheless limits the ability of the euro area to borrow large sums over an extended period.

Third, the desirability of a current account deficit in the euro area is also determined by the structural differences between the euro area and the lender countries. Two aspects appear particularly pertinent. First, in terms of the global allocation of resources it is odd that poor labour-abundant countries lend money to wealthy capital-abundant countries. The flow of resources would be more efficient the other way round. Second, in order to prepare for the effects of an ageing society and the foreseeable need to finance pensions, it is economically efficient to build up net assets in younger and more dynamic countries.[20] The build-up of a net debtor position by contrast exacerbates the financial problems associated with the ageing of the population.

Finally, the fact that only a part of a euro area current account deficit actually improves the current account in the United States means that there is a risk that not only might it not prevent or significantly mitigate a disorderly unwinding of the US imbalances, but might also leave the euro area worse prepared than it otherwise would be.

[20] This argument might not hold strictly for China, which as a result of its one-child policy is also facing a substantial ageing problem. In the light of the enormous labour market reserve, however, even here the growth is likely to continue at a rapid pace for a foreseeable future.

4. Conclusions

The counterpart to the US current account deficit is to be found in Asia (which is posting large surpluses) and not in the euro area (where the current account is close to balance). A transfer of demand from the US to Asia is therefore most important for an orderly adjustment to the imbalances. The contribution of the euro area to this process can only be relatively modest particularly since demographic ageing requires the euro area to improve its net foreign asset position and its starting position is negative. As a consequence, a reduction of external imbalances will require a much steeper devaluation of the dollar against Asian currencies than against the euro. However, if imbalances were to unwind disorderly and the Asian currencies do not appreciate, the burden of the dollar depreciation could fall disproportionately on the euro.

The euro-area's macroeconomic policies are very restricted. There is no room for manœuvre on the fiscal side and monetary policy is already accommodating. Structural reforms in Europe could help the rebalancing process to the extent that they boost domestic demand. However, empirical evidence suggests that their contribution to reducing the US deficit will probably be modest (even if their positive impact on the euro-area economy is substantial).

This does not mean that the role of structural reforms in the euro area should be downplayed. In addition to boosting long-term growth, more flexibility would enhance the economy's resilience in face of shocks. An unwinding of global imbalances can potentially imply massive restructuring of the euro area economy, accompanied by the necessity to move factors from one type of output to another. Where factor mobility is low, the misallocation and loss in output and welfare, respectively, are likely to be high. Reforms that reduce rigidities may therefore prove to be crucial in the event of a disorderly rebalancing of current accounts.

V. Recent DG ECFIN publications

1. Policy documents

EUROPEAN ECONOMY. No. 6. 2004
The EU Economy: 2004 Review
http://europa.eu.int/comm/economy_finance/publications/the_eu_economy_review_en.htm

EUROPEAN ECONOMY. No. 1. 2005
The second report on the implementation of the 2003 - 2005 Broad Economic Policy Guidelines
http://europa.eu.int/comm/economy_finance/publications/european_economy/implement2004_en.htm

EUROPEAN ECONOMY. No. 2. 2005
The Economy for the euro area, the European Union, and Candidate countries in 2004 – 2006. Economic Forecasts, Spring 2005
http://europa.eu.int/comm/economy_finance/publications/european_economy/forecast_en.htm

EUROPEAN ECONOMY. No. 3. 2005
Public finances in EMU –2005
http://europa.eu.int/comm/economy_finance/publications/publicfinance_en.htm

EUROPEAN ECONOMY. OCCASIONAL PAPERS. No.16. March 2005
The economic costs of non-Lisbon. A survey of the literature on the economic impact of Lisbon-type reforms
http://europa.eu.int/comm/economy_finance/publications/occasional_papers/occasionalpapers16_en.htm

EUROPEAN ECONOMY. OCCASIONAL PAPERS. No.17. April 2005
10 Years of Barcelona process: taking stock of economic progress in EU Mediterranean partners
http://europa.eu.int/comm/economy_finance/publications/occasional_papers/occasionalpapers17_en.htm

EUROPEAN ECONOMY. OCCASIONAL PAPERS. No.18. April 2005
European Neighbourhood Policy: Economic Review of ENP Countries
http://europa.eu.int/comm/economy_finance/publications/occasional_papers/occasionalpapers18_en.htm

Communication by the Commission on "Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact" (COM(2004)581)
http://europa.eu.int/comm/economy_finance/publications/sgp/com2004581_en.htm

Communication by the Commission on "The situation of Germany and France in relation to their obligations under the excessive deficit procedure following the judgement of the Court of Justice" (COM(2004)813)
http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp/com_com_2004_en.pdf

2. Analytical documents

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. 223.
Elena Flores, Gabriele Giudice and Alessandro Turrini (Directorate General for Economic and Financial Affairs)
The framework for fiscal policy in EMU: What future after five years of experience?
http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers223_en.htm

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. 224.
Lars Jonung (Directorate-General for Economic and Financial Affairs) and Thomas Hagberg (Ekonomistyrningsverket, Stockholm)
How costly was the crisis of the 1990s? A comparative analysis of the deepest crises in Finland and Sweden over the last 130 years.
http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers224_en.htm

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. 225.
Fernando C. Ballabriga (ESADE Business School) and Carlos Martinez-Mongay (Directorate-General for Economic and Financial Affairs)
Sustainability of EU public finances
http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers225_en.htm

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. 226.
Christoph Walkner and Jean-Pierre Raes (Directorate-General for Economic and Financial Affairs)
Integration and consolidation in EU banking - an unfinished business
http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers226_en.htm

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. 227.
Lars Jonung (Directorate General for Economic and Financial Affairs)
Proceedings of the 2004 first annual DG ECFIN research conference on "Business Cycles and Growth in Europe"
http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers227_en.htm

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. 228.
Michael R. Bryan (Federal Reserve Bank of Cleveland) and Stefan Palmqvist (Sveriges Riksbank)
Testing near-rationality using detailed survey data
http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers228_en.htm

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Salvador Barrios (Directorate-General for Economic and Financial Affairs) and Eric Strobl (Ecole Polytechnique, Paris)
The dynamics of regional inequalities
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EUROPEAN ECONOMY. ECONOMIC PAPERS. No. 230.
Heikki Oksanen (Directorate-General for Economic and Financial Affairs)
Actuarial neutrality across generations applied to public pensions under population ageing: effects on government finances and national saving
http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers230_en.htm

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. 231.
David R Collie (Cardiff Business School, Cardiff University)
State aid to investment and R&D
http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers231_en.htm

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. 232.
Gilles Mourre (Directorate General for Economic and Financial Affairs)
Wage compression and employment in Europe: First evidence from the structure of earnings survey 2002
http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers232_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/priceandcostcompetiteveness_en.htm

V. Key indicators for the euro area

		2001	2002	2003	Apr-05	May-05	Jun-05	Jul-05	Aug-05	Sep-05
1 Output		2001	2002	2003	Apr-05	May-05	Jun-05	Jul-05	Aug-05	Sep-05
Industrial confidence [1.1]	Balance	-10	-12	-11	-9	-11	-10	-8	-8	-7
Industrial production [1.2]	mom % ch	0.2	-0.9	0.2	0.8	-0.4	0.4	0.2		
		2001	2002	2003	04Q2	04Q3	04Q4	05Q1	05Q2	05Q3
Gross domestic product [1.3]	Qtr. % ch				0.4	0.3	0.2	0.4	0.3	
2 Private consumption		2001	2002	2003	Apr-05	May-05	Jun-05	Jul-05	Aug-05	Sep-05
Consumer confidence [2.1]	Balance	-6	-11	-18	-13	-15	-15	-15	-15	-15
Retail sales [2.2]	mom % ch	1.2	1.1	0.1	-1.1	1.2	0.0	-0.5	0.9	
		2001	2002	2003	04Q2	04Q3	04Q4	05Q1	05Q2	05Q3
Private consumption [2.3]	Qtr. % ch	1.9	0.6	1.1	0.1	0.2	0.8	0.2	-0.1	
3 Investment		2001	2002	2003	04Q2	04Q3	04Q4	05Q1	05Q2	05Q3
Capacity utilization [3.1]	%	83.5	81.2	80.7	81.1	82.0	82.1	81.9	81.2	81.2
Gross fixed capital formation [3.2]	Qtr. % ch	-0.3	-2.7	-0.4	0.4	0.5	0.4	-0.2	0.2	
Change in stocks [3.3]	% of GDP	-0.2	-0.1	0.0	-0.2	0.1	0.0	0.0	0.1	
4 Labour market		2001	2002	2003	Apr-05	May-05	Jun-05	Jul-05	Aug-05	Sep-05
Unemployment [4.1]	%	8.0	8.2	8.4	8.8	8.7	8.7	8.5	8.6	
		2001	2002	2003	04Q2	04Q3	04Q4	05Q1	05Q2	05Q3
Employment [4.2]	Ann. % ch	1.4	0.5	0.1	0.6	0.7	0.9	0.8		
Shortage of labour [4.3]	%	7.8	3.8	2.5	2.6	2.4	2.2	2.3	2.4	
Wages [4.4]	Ann. % ch	2.8	2.9	2.5	2.3	2.0	1.8			
5 International transactions		2001	2002	2003	Apr-05	May-05	Jun-05	Jul-05	Aug-05	Sep-05
Export order books [5.1]	Balance	-14	-22	-24	-18	-19	-20	-18	-18	-17
World trade [5.2]	Bn. EUR	121	125	132	154	156	159	157		
Exports of goods [5.3]	Bn. EUR	767.4	776.9	1038.6	99.4	101.0	100.5	101.8		
Imports of goods [5.4]	Bn. EUR	802.2	781.6	970.4	95.0	96.7	97.1	100.9		
Trade balance [5.5]	Bn. EUR	-34.8	-4.7	68.2	4.4	4.2	3.4	1.0		
		2001	2002	2003	04Q2	04Q3	04Q4	05Q1	05Q2	05Q3
Exports of goods and services [5.6]	Qtr. % ch	3.4	1.7	0.2	2.7	1.3	0.5	-0.7	2.1	
Imports of goods and services [5.7]	Qtr. % ch	2.1	-1.6	2.1	2.7	2.5	1.4	-1.4	2.1	
		2001	2002	2003	Apr-05	May-05	Jun-05	Jul-05	Aug-05	Sep-05
Current account balance [5.8]	Bn. EUR	2.0	44.9	18.1	0.8	1.9	-1.0	-5.9		
Direct investment (net) [5.9]	Bn. EUR	-104.6	-11.0	-18.4	-6.4	3.3	-9.9	-80.1		
Portfolio investment (net) [5.10]	Bn. EUR	36.5	64.4	-9.4	-2.8	22.7	102.6	73.7		
6 Prices		2001	2002	2003	Apr-05	May-05	Jun-05	Jul-05	Aug-05	Sep-05
HICP [6.1]	Ann. % ch	2.3	2.3	2.1	2.1	1.9	2.1	2.2	2.2	2.5
Core HICP [6.2]	Ann. % ch	1.9	2.5	2.0	1.4	1.6	1.4	1.4	1.4	
Producer prices [6.3]	Ann. % ch	2.2	1.7	1.6	4.3	3.5	4.0	4.1	4.0	
Import prices [6.4]	Ann. % ch	100.2	97.9	102.5	101.7	101.5	103.9			
7 Monetary and financial indicators		2001	2002	2003	Apr-05	May-05	Jun-05	Jul-05	Aug-05	Sep-05
Interest rate (3 months) [7.1]	% p.a.	4.3	3.3	2.3	2.1	2.1	2.1	2.1	2.1	2.1
Bond yield (10 years) [7.2]	% p.a.	5.0	4.8	4.1	3.5	3.3	3.2	3.2	3.3	3.1
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	2420	3014	3021	3152	3268	3303	3352
M3 [7.5]	Ann. % ch	5.3	5.6	7.8	6.9	7.2	7.6	7.9		
Credit to private sector (loans) [7.6]	Ann. % ch	7.9	7.7	5.0	7.4	7.5	8.0	8.3	8.4	
Exchange rate USD/EUR [7.7]	Value	0.90	0.95	1.13	1.29	1.27	1.22	1.20	1.23	1.23
Nominal effective exchange rate [7.8]	Index	91.5	95.1	106.4	111.6	110.5	107.6	108.3	109.1	108.5

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	Exports of goods	Bn. EUR, excluding intra euro-area trade, fob	Eurostat
5.3	Imports of goods	Bn. EUR, excluding intra euro-area trade, cif	Eurostat
5.4	Trade balance	Bn. EUR, excluding intra euro-area trade, fob-cif	Eurostat
5.5	Exports of goods and services	Volume (1995 prices), including intra euro-area trade, seasonally adjusted	Eurostat
5.6	Imports of goods and services	Volume (1995 prices), including intra euro-area trade, seasonally adjusted	Eurostat
5.7	Current account balance	Bn. EUR, excluding intra euro-area transactions; before 1997 partly estimated	ECB
5.8	Direct investment	(net) Bn. EUR, excluding intra euro-area transactions	ECB
5.9	Portfolio investment	(net) Bn. EUR, excluding intra euro-area transactions	ECB
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	Bond yield	Percent p.a., 10-year government bond yields, lowest level prevailing in the euro area, period averages	Datastream
7.3	ECB repo rate	Percent p.a., minimum bid rate of the ECB, end of period	Datastream
7.4	Stock markets	DJ Euro STOXX50 index, period averages	Datastream

7.5	M3	Seasonally adjusted moving average moving average (3 last months)	ECB
7.6	Credit to private sector (loans)	MFI loans to euro-area residents excluding MFIs and general government, monthly values: month end values, annual values: annual averages	ECB
7.7	Exchange rate USD/EUR	Period averages	ECB
7.8	Nominal effective exchange rate	Against 13 other industrialised countries, double export weighted, 1995 = 100, increase (decrease): appreciation (depreciation)	ECFIN

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