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# QUARTERLY REPORT ON THE EURO AREA

No II / 2003

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# Editorial

Economic activity was sluggish in the euro area during the first half of 2003. Growth, which had been decelerating since mid-2002, came to a halt at the beginning of the year as geopolitical uncertainties undermined confidence. The dissipation of uncertainties related to the Iraq crisis has not been associated with a significant recovery of business and consumer confidence. Available evidence suggests that growth remained anaemic during the spring and is unlikely to bounce back strongly over the summer.

Although the scenario of a gradual pick-up of activity during the second half of the year still remains the most likely one, significant downside risks exist. At this juncture, concerns regarding the sources of short-term economic growth revolve around both domestic and external demand.

On the domestic side, it is unclear how far corporate adjustment still has to go. Whereas private consumption has proved to be rather resilient since the middle of last year, demand from the corporate sector has so far not shown any tangible signs of recovery. Corporate balance sheets have stabilised but it is difficult to assess whether further improvements are necessary. In addition, efforts to restore profitability have been hindered by a slow adjustment of the labour market. Hence, although an upturn in investment is still possible during the second half of the year, the slow speed of corporate adjustment will weigh on the pace of the recovery.

On the external side, the strengthening of the euro is seen by some commentators as a threat to the short-term outlook in the euro area. But it is important to put the current level of the euro's external value into perspective. Recent developments mark a return of the euro to a level in line with economic fundamentals and price competitiveness remains close to its long-term average.

Turning to the impact on growth, the appreciation of the euro will weigh on the export performance of the euro area but will also contribute to stronger domestic demand. The abatement of geopolitical tensions has set the stage for a pick-up of the world economy that will partly offset the impact of lower price competitiveness on exports. Furthermore, the strong euro will boost household purchasing power, paving the way for a strengthening of private consumption. As fluctuations in exchange rates are only passed on to domestic prices with a significant time lag, this effect will only become visible in the months to come. Overall, the appreciation of the euro will be beneficial to growth in the euro area.

The rise in the value of the euro, combined with reports of a sluggish economic growth and falling inflation, have fuelled concerns about possible deflationary trends in at least some parts of the euro area. Nevertheless, an analysis of inflation trends suggests that whilst the risks of deflation may have increased, they are still minor in the euro area. Headline inflation remains at 2% and neither monetary indicators nor wage developments provide convincing evidence of strong deflationary pressures in the euro area.

The recent weakening of the contribution of trade to economic activity underlines the importance of policies geared to reinforcing domestic sources of growth in the euro area. These policies are gradually being put in place.

With short-term interest rates now at historical lows, monetary policy has become quite conducive to domestic demand. The latest ECB rate cut of 50 basis points on 6 June 2003 has brought the cumulated decrease in the main refinancing rate to 225 basis points in less than a year. The impact of this substantial monetary-policy easing on domestic demand has been reinforced by a significant improvement in long-term financial conditions. Long-term yields on government bonds have decreased and there are signs that risk aversion in lending to the corporate sector is receding on the corporate bond market. In addition, stock prices have strengthened significantly in the past two months.

The contribution that other economic policies can make to strengthen growth in the euro area over the next three years is presented in the Broad Economic Policy Guidelines (BEPGs) which were endorsed by the European Council in Thessaloniki on 21 June 2003 and will be formally adopted by the ECOFIN council later this month.

As to fiscal policy, the BEPGs urge Member States to maintain budgetary positions of close to balance or in surplus over the economic cycle. Until this has been achieved, euro-area countries are requested to take all the necessary measures to ensure an annual improvement in the cyclically-adjusted budget position of at least 0.5% of GDP. The costs of the consolidation are limited and should be weighed against the losses that would otherwise be incurred by undermining the credibility of the EMU fiscal framework. In the medium run, net gains are expected from the consolidation itself. Moreover, when accompanied by structural reform, a credible and adequately designed fiscal consolidation can lead to positive growth effects even in the short run as empirical evidence shows.

The disappointing growth registered in the euro area during the past two years highlights the need to lift the economy's potential for growth and to improve its resilience and capacity to absorb shocks. In particular, taking advantage of the potential benefits of a strong euro will require a flexible response of the economy to changes in price signals. This will not only require adequate macroeconomic policies but, above all, further progress with structural reforms.

The BEPGs also present the detailed structural measures that are necessary in this context. In particular, the Guidelines highlight the need to step up efforts to remove barriers to employment, to raise productivity and to encourage business dynamism. There is evidence that past structural reforms have started to pay off and it is important to recall that reforms can also have short-term benefits, for instance via their impact on confidence. In this context, the recent resolve of some Member States to implement far-reaching structural reforms is welcome and encouraging.

Pedro SOLBES

MEMBER OF THE EUROPEAN COMMISSION

# I. Economic situation in the euro area

*The euro area economy has experienced virtually no growth in economic activity in the first half of 2003 and leading indicators point, at best, to a modest pick-up during the summer. At the same time the uncertainty associated with the conflict in Iraq is now lifted, inflation is decelerating and financial conditions are becoming more supportive. These positive factors will support growth during the second half of the year. The stronger euro and lower interest rates suggest a higher contribution to growth from domestic rather than foreign demand. Private consumption is relatively resilient and will benefit from decelerating inflation. However, corporate adjustments have probably not fully run their course. Slow cyclical adjustment in the labour market has adversely affected productivity and profit margins and will act as a brake on investment recovery in the months ahead. Traditionally, the service sector has had an important role in cushioning economic activity during slowdowns. However, due to a number of factors related both to households and the corporate sector, services have contributed considerably less to cyclical stabilisation in the current downturn than in the late 1990s.*

## 1. Economic situation[1]

### Growth has stalled in the euro area

There is now broad evidence that growth has come to a virtual standstill in the euro area. GDP increased only marginally, by 0.1% quarter-on-quarter, in the fourth quarter of last year and, according to Eurostat's first estimate, remained flat in the first quarter of 2003. Recent figures for industrial production are not much more encouraging, showing a modest pick-up of activity in the first three months of 2003 after a slight contraction at the end of 2002. The very modest industrial recovery is at odds with manufacturing surveys which showed stable or deteriorating assessments of past production trends over the same period. It reflects a technical correction in inventories but may also partly be due to calendar effects.

The sectoral breakdown of GDP data suggests that the weakness in the economy is broad-based. The slight pick-up of industrial activity in the first quarter was offset by a strong contraction in the construction sector and a significant deceleration in services. The services sector experienced its slowest quarter-on-quarter growth rate since the 1992-93 recession.

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

| | 2002 Q1 | 2002 Q2 | 2002 Q3 | 2002Q4 | 2003Q1 |
|---|---|---|---|---|---|
| **% change on previous quarter, volumes** | | | | | |
| GDP | 0.4 | 0.4 | 0.3 | 0.1 | 0.0 |
| Private consumption | -0.2 | 0.3 | 0.5 | 0.4 | 0.3 |
| Government consumption | 1.0 | 0.8 | 0.4 | 0.2 | 0.2 |
| Gross fixed capital formation | -0.7 | -1.3 | 0.2 | 0.1 | -1.4 |
| Changes in inventories (% of GDP) | -0.3 | -0.2 | -0.3 | -0.2 | 0.4 |
| Exports* of goods and services | -0.2 | 2.1 | 2.0 | -0.2 | -0.6 |
| Imports* of goods and services | -1.4 | 1.6 | 2.0 | 0.8 | 0.6 |
| **% contribution to change in GDP** | | | | | |
| Private consumption | -0.1 | 0.2 | 0.3 | 0.2 | 0.2 |
| Government consumption | 0.2 | 0.2 | 0.1 | 0.0 | 0.0 |
| Gross fixed capital formation | -0.1 | -0.3 | 0.0 | 0.0 | -0.3 |
| Changes in inventories | 0.1 | 0.1 | -0.1 | 0.1 | 0.5 |
| Net exports | 0.4 | 0.2 | 0.1 | -0.4 | -0.5 |

* Including intra-euro area trade.
**Source :** Commission services.

1 The cut-off date for statistics included in this issue was 1 July 2003.

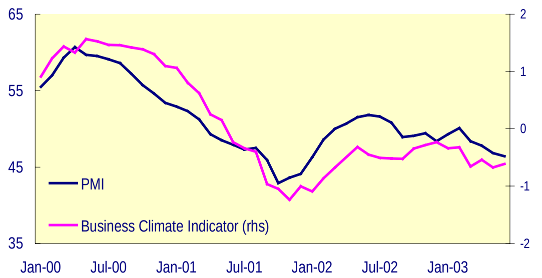
**Table 2: Selected euro area and national leading indicators, 2002-2003**

| | SENT. IND1) | BCI2) | OECD3) | PMI4) | Reuters Ser7) | IFO5) | NBB6) | ZEW |
|---|---|---|---|---|---|---|---|---|
| Long-term average | 99.2 | -0.18 | 2.0 | 52.4 | 54.4 | 100.1 | -10.1 | 33.2 |
| Trough in latest downturn | 97.8 | -1.24 | -3.0 | 42.9 | 46.7 | 89.7 | -21.1 | -10.4 |
| September | 99.2 | -0.52 | 3.4 | 48.9 | 49.1 | 99.1 | -9.8 | 39.5 |
| October | 99.0 | -0.34 | 3.0 | 49.1 | 50.1 | 97.9 | -10.5 | 23.4 |
| November | 98.7 | -0.28 | 2.3 | 49.4 | 50.8 | 95.9 | -9 | 4.2 |
| December | 98.5 | -0.23 | 1.6 | 48.4 | 50.6 | 97.9 | -12.9 | 0.6 |
| January 2003 | 98.3 | -0.34 | 1.2 | 49.3 | 50.0 | 98 | -15.5 | 14.0 |
| February 2003 | 98.4 | -0.32 | 0.8 | 50.1 | 48.9 | 98.4 | -10.5 | 15.0 |
| March 2003 | 97.8 | -0.66 | 0.3 | 48.4 | 47.7 | 97.2 | -17.4 | 17.7 |
| April 2003 | 98.1 | -0.54 | 0.2 | 47.8 | 47.7 | 94.9 | -20.5 | 18.4 |
| May 2003 | 98.1 | -0.68 | | 46.8 | 47.9 | 97.2 | -18.3 | 18.7 |
| June 2003 | 98.2 | -0.61 | | 46.4 | | 98.6 | -26.3 | 21.3 |

1) Economic sentiment indicator, DG ECFIN. 2) Business climate indicator, DG ECFIN. 3) Composite leading indicator, six monthly change. 4) Reuters Purchasing managers index, manufacturing. 5) Business expectations, West Germany. 6) National Bank of Belgium indicator for manufacturing. 7) Reuters Services purchasing manager index.

Several factors account for sluggish growth in services. First, spending on travel and tourism is hindered by fears of terrorism. Second, corporate demand for financial and business services has been particularly hard hit in the current downturn as companies have striven to improve profitability and restore balance sheets. Finally, growth in public services is constrained by the need to restore sound public finance. As a result of these factors, the traditional cycle-smoothing role of services is somewhat reduced in the current downturn. As these negative forces are unlikely to unwind in the short-term, further weakness is likely in the services sector in the coming months.

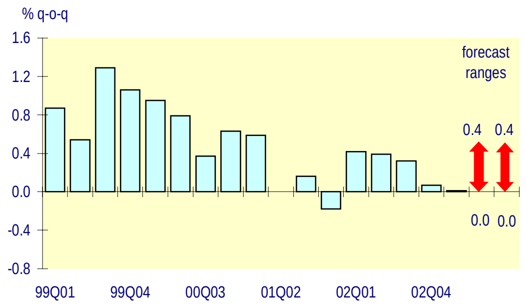
**Manufacturing confidence, euro area**




***Source:*** Commission services, Reuters.

Only limited figures on production are yet available for the second quarter. Industrial production came in somewhat stronger than expected in April but business surveys do not provide a clear indication of a pick-up of growth in recent months. DG ECFIN's Business Climate Indicator fell in May to its lowest level in 15 months, before improving slightly in June. Reuters manufacturing PMI index came in much weaker than expected in May and June and is now well below 50, suggesting that manufacturing activity is on a downward path.

**Euro area : GDP growth rate**




***Source:*** Commission services.

DG ECFIN's indicator-based short-term forecast model points to GDP quarter-on-quarter growth in the range of 0-0.4% in both the second and the third quarters of 2003. Expectations are still for a progressive recovery during the second half of the year although cumulative growth in 2003 may turn out to be slightly lower than expected earlier. Overall, leading indicators suggest that, despite the dissipation of geopolitical uncertainties, short-term downside risks are non-negligible.



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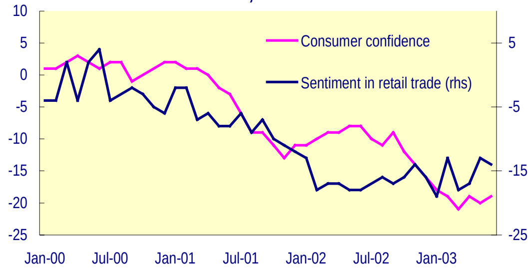
## The consumer remains the backbone of the economy

Household spending continues to be relatively resilient. Private consumption decelerated only very modestly in the past two quarters, growing by an annual average of 1.5% over the period. In the absence of data on disposable income at euro-area level, recent trends in saving behaviour are difficult to assess. However, consumption is now expanding much more rapidly than labour income. With simultaneous stagnation of real wages and employment, progress in real income from labour has been minimal since mid-2002.

**Consumer confidence and sentiment in the retail trade sector, euro area**




***Source:*** Commission services, Reuters.

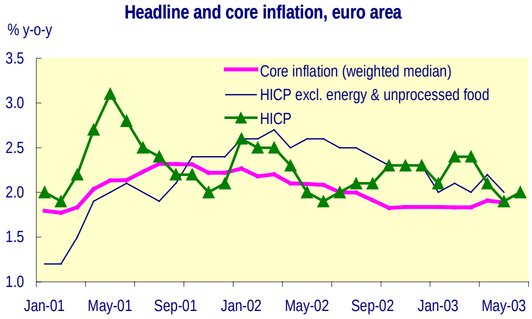
Recent survey statistics on consumer spending paint a mixed picture of the second quarter of 2003. Household confidence, has remained broadly stable in May and June and has not been boosted by the dissipation of geopolitical uncertainties. Nonetheless, recent surveys have also begun to send a number of positive signals. Households have reported improvements in the their financial situation. In addition, their worries related to future price trends and their assessments of past price developments have moderated substantially. Finally, confidence has strengthened significantly in the retail sector since May. It is worth noting that sentiment in the retail sector tends to be a better coincident indicator of developments in private consumption than household confidence.

A mixed reading of consumption-related surveys reflects the fact that household spending is subject to two conflicting forces.

On the one hand, a deteriorating labour market is squeezing wage income and increasing the risk of unemployment. The unemployment rate has drifted only slowly upwards since the beginning of the year and remained stable at 8.8% in April and May. Nevertheless, the deterioration of employment expectations in most business surveys in the past two months shows that the upward trend is not over yet.

On the other hand, the recent ebbing of inflation is fuelling purchasing power. HICP inflation decreased from 2.4% in March to 1.9% in May. It was estimated at 2.0% in June in Eurostat's latest Flash estimate. The deceleration of inflation between March and May mainly reflects the drop in oil prices associated with the dissipation of geopolitical uncertainties in the Middle-East. As the strong euro feeds progressively into consumer prices, inflation will decline further in the months to come.

**Headline and core inflation, euro area**



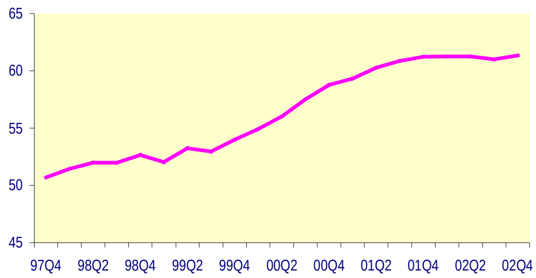

June 2003 : Flash estimate.
***Source:*** Commission services.

## Lingering uncertainties as to the extent of corporate adjustment

A major source of uncertainty at this stage is attached to the financial health of the corporate sector. Companies entered the current downturn at a record level of debt and experienced a significant decrease in profitability during the first stages of the deceleration in activity. They have first responded to financial pressures by reducing investment, inventories and debt. Since the second half of 2002, deleveraging has been accompanied by efforts to restore profit margins.

Corporate adjustment has brought about a stabilisation of the corporate debt to GDP ratio since the beginning of 2002 and, more recently, improvements in labour productivity and profitability. The delayed response of employment and profitability is generally interpreted as a sign of labour hoarding but, as discussed in Section 3 below, there is also evidence that rigidities in the labour market have not facilitated the adjustment of employment to the slowdown in activity.

**Corporate debt as a share of GDP, euro area**
(in %)



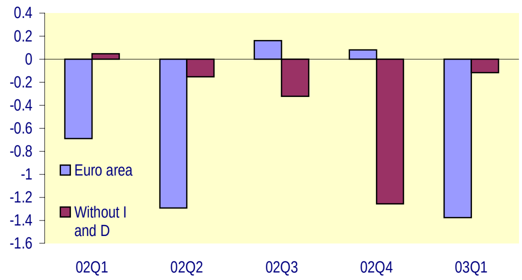

***Source:*** ECB and Commission services.

At this juncture, it is difficult to say to what extent corporate adjustment is largely completed or will continue to weigh on corporate demand in the months to come. With no data on debt or profitability available for the beginning of the year, an analysis of recent developments can only be based on observed corporate spending in investment and inventories.

In this respect, the latest quarterly accounts have sent mixed signals. After two quarters of stability, investment dropped again in the first quarter of 2003. At 1.4% on a quarter-on-quarter basis, the pace of contraction was the fastest since the beginning of the downturn. The March issue of the Quarterly Report on the Euro Area had emphasised the fragility of the stabilisation in investment spending registered during the second half of last year. Over that period, investment growth was inflated by special developments in Italy and Germany. The fading away of these factors was a major drag on investment in early 2003. Excluding data from Italy and Germany, investment experienced a small negative growth rate at the beginning of the year, which is an improvement on last year's performance.

After seven quarters of contraction, inventories registered their first increase in the first quarter of 2003, accounting for the largest positive contribution to GDP growth. This turnaround in inventory building should, however, be interpreted with caution. It may be an early signal that cost-cutting in the corporate sector is coming to an end but, contrary to previous upswings, it was not accompanied by a significant change in the assessment of stocks in business surveys. It may therefore be mainly a technical rebound which could be partly explained by precautionary stock building of oil products ahead of the military conflict in Iraq.

**Real investment growth in the euro area with and without Germany and Italy** (q-o-q growth in %)




***Source:*** Commission services.

Overall, with continued weakness in business confidence and mixed recent developments in corporate spending, it is likely that corporate adjustment has not fully run its course and will continue to weigh on investment in the months to come, albeit less heavily than in the past.

## Downward momentum of exports is gathering pace

Trade has begun to take a sizeable toll on GDP growth in the euro area. Exports have been contracting on a quarter-on-quarter basis since the last quarter of 2002. After a positive contribution during most of the present



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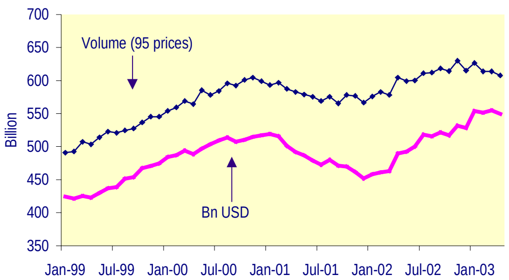
downturn, net trade shaved off almost half a percentage from GDP growth in the past two quarters.

Much of the weakening of exports observed in national accounts can so far be attributed to a relapse in demand from the world economy. DG ECFIN's indicator for world trade shows that, after a rebound during the first half of 2002, volumes of world trade came to a near standstill in the final months of the year and at the beginning of 2003.



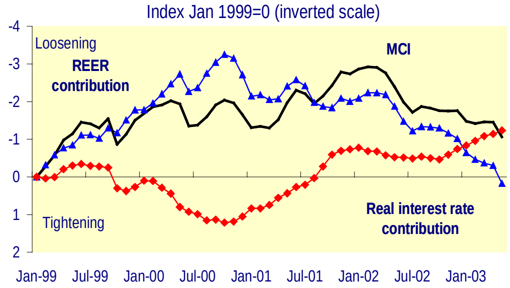

***Source :*** Commission services.

Some of the forces that have weighed on the global economy in the past months, including high oil prices and uncertainties linked to the conflict in Iraq, have weakened recently, paving the way for stronger global activity in the months ahead. Nevertheless, at this juncture any pick-up in world trade largely hinges on the US economy. In this respect, recent data should be interpreted with caution. A strong economic rebound after the end of the Iraq War has not been observed in the USA yet. The US recovery is only proceeding slowly, characterised by a low level of capacity utilisation, no employment growth, and a trend toward disinflation. Consumer confidence and the ISM indices of business activity have strengthened recently, but these are only tentative signs of improvement which need to be confirmed by hard economic data.

Even if the global economy gains momentum, foreign trade is likely to be less the driving force that it was in past euro-area recoveries in the 1990s. The appreciation of the euro will weigh on external price competitiveness. Fluctuations in exchange rates traditionally affect trade volumes with a lag as exporters and importers first absorb changes in price competitiveness by modifying their margins. Price competitiveness will likely deteriorate further in the months to come, hampering export growth.

## Financial conditions are becoming more supportive to domestic demand

According to the MCI, monetary conditions in the euro area tightened somewhat in January before stabilising between February and April 2003. Based on this indicator,[2] the effects of the policy rate cuts between December and March have been slightly more than offset by the higher trade-weighted euro exchange rate.




***Source:*** Commission services.

The ECB decided to cut its interest rates by 50 basis points on 6 June 2003, bringing its minimum bid rate down to 2%. With inflation and real exchange rate data only available to May, the MCI does not cover the ECB's latest move yet. However, the 50 basis point cut decided in June to some extent offsets the appreciation of the euro registered since April.

In parallel with the near stability of monetary conditions, recent months have seen a

[2] The MCI tries to capture the combined impact on economic activity of changes in the real effective exchange rate and the real short-term interest rate. Long-term interest rates are also important for economic activity and will be included in a financial conditions index, on which work is ongoing.

significant improvement in long-term financial conditions. There are signs that risk aversion in lending to the corporate sector is receding. The spread on BBB bonds has decreased sharply since Autumn 2002 and is now back to levels last seen before the beginning of the downturn. There is parallel evidence that investors are returning to high yield corporate bond markets. Finally, stock prices have strengthened in the past two months. By mid-June, the Dow Jones EURO STOXX 50 had regained about 30% relative to its low in mid-March.

On a more negative note, there is evidence that bank lending conditions remain rather tight. The ECB's April survey of bank lending conditions suggests that banks tightened their lending conditions further during the first months of the year, especially for loans to the corporate sector. However, the survey is new and, in the absence of historical data, its results must be interpreted with caution.

## 2. Weakness of activity in the service sector

*Stylised facts.* The service sector demands attention for at least three reasons. First, the sector accounts for roughly 2/3 of euro-area GDP and thus has a substantial bearing on economic growth. Second, the service sector is the mainstay of job creation. Employment growth in services exceeded 0.5% quarter-on-quarter in each quarter between 1997 and 2000. While still positive at the end of 2002, the rate has more than halved to about 0.2%. Third, strong activity in the services sector in 1998/99 was an important reason for resilience in economic activity during the Asian crisis. This experience contributed to fuel initial expectations of a swift weathering of the current slowdown.

Business cycle analysis usually focuses on industrial data. One of the reasons for the scant attention paid to the services sector is that growth in the service sector is decidedly less volatile than manufacturing output and therefore its contribution to cyclical variation is relatively small. The rising share of service activity over time is seen as a major reason behind declining output volatility and less severe cyclical downturns than in the past.

At the same time, it has been argued that limited potential for productivity growth in the service sector can cause a decline in the economy's growth rate. If demand for services were less sensitive to prices and if labour costs in the service sector followed those in sectors with higher productivity growth, the consequence would be a rising share of labour employed in services and a rising relative price of services (cf. Balassa-Samuelson effect). Table 3 supports these theoretical conjectures for the euro area in the 1990s. It shows that although labour productivity growth was weaker in services, the sector had a positive effect on economic growth due to stronger employment growth.

*Current developments.* According to sectoral value added data, activity in the service sector registered virtually no growth in the first quarter of 2003, implying a further weakening from already depressed growth in 2001/02. Real value added in the service sector grew at about 0.4% quarter-on-quarter in 2001/02,

**Table 3: Some stylised facts on activity in the service sector, y-o-y % change average (1992Q1-2002Q4)**

| | Value added | Employment | Productivity* | Prices** | Real wages+ | Volatility++ |
|---|---|---|---|---|---|---|
| Services | 2.4 | 1.6 | 0.8 | 2.1 | 0.8 | 0.9 |
| Industry | 1.3 | -1.3 | 2.6 | 0.9 | 1.0 | 2.8 |

* Value added in constant prices per person employed; ** Value added deflators of both sectors; + 1996Q1-2002Q4, estimate for services partly unadjusted for hours; ++ Standard deviation of annual growth in real value added.



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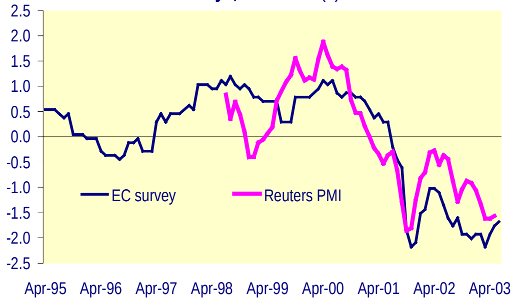
down from above 1% in the late 1990s. The recent weakness is equally shared by the three sub-sectors that form the aggregate service sector (for the composition of the sector, see Box 1).

**Activity in the services sector according to business surveys, euro area** (1)

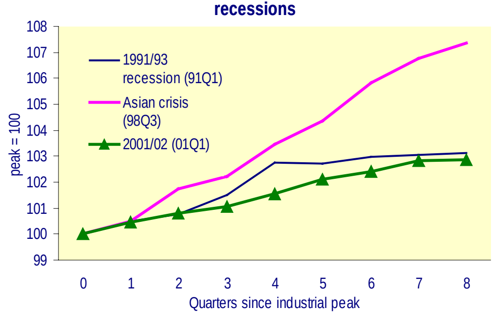



(1) Harmonised scale with zero being the average since the beginning of the surveys and the scale expressed in standard deviations.
***Source:*** Commission services.

Recent survey data bode ill for a fast rebound in the service sector. Sentiment in the monthly Commission survey on services reached its lowest value in March 2003 and recovered only slightly in May. A similarly downbeat message can be read from the Reuters purchasing managers index for services, which indicates contracting activity in the sector.

*Assessing the severity of the current slowdown in services.* Comparing the current deceleration in service growth with that observed in previous economic downturns reveals that the current slowdown in service activity is comparable to the one during the 1990-93 recession and that both are considerably more severe than that during the Asian crisis (see next graph page).

**Value added in services during industrial recessions**




***Source:*** Commission services.

The comparability with the recession of the early 1990s is also confirmed by the calculation

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Box 1: **Statistical coverage of the services sector in the euro-area national accounts**

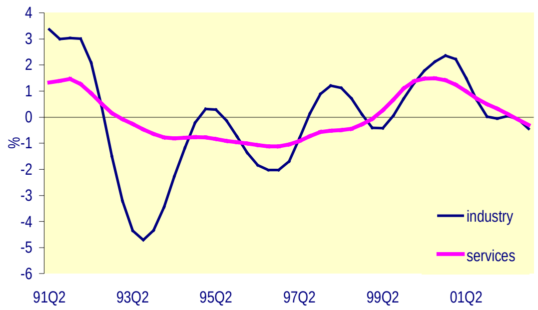
Statistical coverage of the service sector has increased considerably over the past years, but data availability for business cycle analysis is still limited. Currently, a breakdown into three broad services sectors is available for the euro area in quarterly national accounts (see table below). A major problem is the sector's heterogeneity, encompassing output produced with a lot of capital and high-skilled labour as well as output generated by low-skilled labour and without much capital. Moreover, measurement of value added in real terms is often difficult and productivity comparisons have to be treated with caution.

**Statistical coverage of the euro-area service sector in quarterly national accounts**

| Sector | Consists of | Share in total value added | Share in employment |
|---|---|---|---|
| Trade | NACE G-I: Wholesale and retail trade, hotels and restaurants, transport, storage, communication | 22 | 25 |
| Financial intermediation | NACE J-K: Financial intermediation, real estate, business activities | 27 | 14 |
| Other services | NACE L-P: Public administration, education, health, etc. | 21 | 30 |

of output gaps for the service and the industrial sector (see graph below). Value added in services was below trend throughout most of the 1990s, recovering only from 1996 onwards. Interestingly, the services sector had only two cyclical peaks, in 1991 and 2000, compared to four in the case of industry during the 1990s. Only strong industrial booms and downturns seem to spill-over and to influence significantly the business cycle in the service sector. This may suggest that industrial demand is not the main determinant of cyclical fluctuations in the service economy.

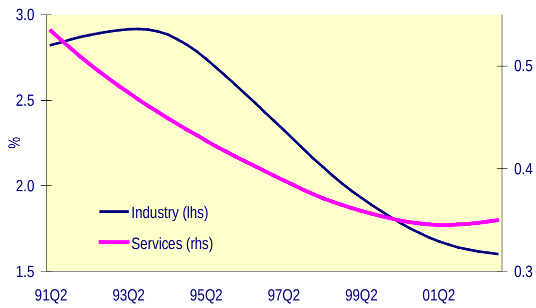
**Sectoral output gaps, euro area**




***Source:*** Commission services.

*Productivity in services.* The decomposition of output data into labour productivity and employment suggests that productivity growth has been driven by similar factors in industry and services. While productivity growth – measured in output per person employed – is significantly lower for services than for industry (see Table 3), trend productivity growth almost halved in both sectors during the 1990s. Since the mid-1990s, the amplitude of the cyclical component of productivity in services has tended to increase. In particular, the cyclical slowdown in productivity has been quite pronounced in the service sector in the current downturn.

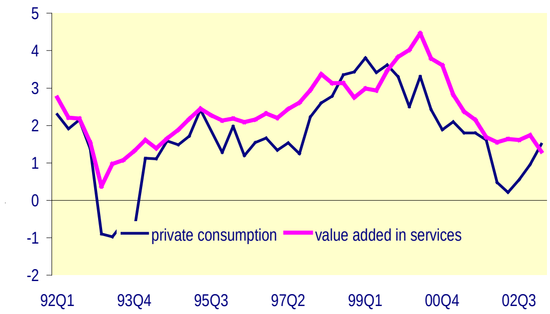
**Trend productivity growth in sectors, euro area**




***Source:*** Commission services.

*Potential explanations for the current weakness in growth in services.* The reason for resilient demand for services in the late 1990s is to be found in domestic forces, as witnessed by the development of external trade in services. The Asian crisis had a clear negative impact on export growth but import growth remained strong during that period as a result of sustained domestic demand.

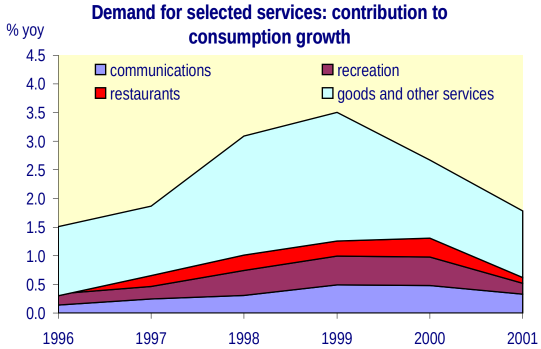
**Services activity and consumption, euro area**
(y-o-y changes in %)




***Source:*** Commission services.

Strong growth in private consumption was an important factor in overcoming the Asian crisis, as borne out *inter alia* by the fact that value added in distributive trades and tourism grew strongly, in contrast to now. Particularly strong was demand for communications, recreation and restaurants. According to the data available so far, these are also the sectors where demand has declined sharply in the current downturn. Specific factors have weighed on household demand for services in the past two years. As the pace of deregulation in transport and telecom has become slower, prices cuts in these sectors have moderated relative to the late 1990s, providing a more muted stimulus to demand. Worries related to terrorism have also hit demand for travel and transport services.

**Demand for selected services: contribution to consumption growth**




*Source:* Commission services.

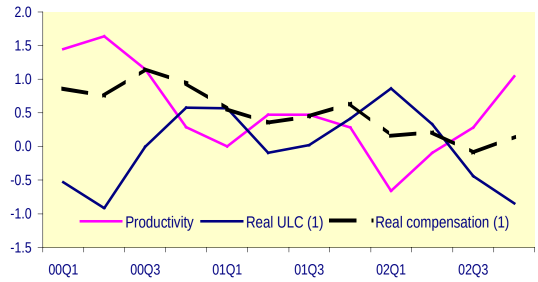
Turning to demand from the corporate sector, value added growth has been particularly weak in the current downturn in financial intermediation, which includes also business services. Demand for these services benefited in the mid 1990s *inter alia* from corporations' preparation for EMU, deregulation (airlines, telecom) and technical progress in the ICT sector, but is now hit by companies' efforts to cut operating costs and restore profit margins.

*Conclusions.* Overall, it seems as if the strength of activity in services during the Asian crisis was primarily related to specific factors including (1) rapid technical progress in the ICT sector which raised demand for financial and business services; (2) the introduction of the euro, which had a positive impact on economic sentiment and has probably given impetus to activity in financial services; and (3) deregulation which boosted growth and employment in some service sectors; The absence of these positive factors in the current climate may have contributed to the relatively weak demand for services.

## 3. Labour market adjustment in the current period of slow growth

The labour markets plays a central role in the response of an economy to a downturn. Adjustments in employment and wages have an impact on disposable income and profitability and, through this channel, on private consumption and investment as well as on the length and the strength of the downturn. Progress with structural reforms and wage moderation in the 1990s has lifted the job content of growth in the euro area, allowing employment to be more resilient than initially expected in the current downturn. However, employment resilience has been associated with a slow adjustment of the labour market, marked by a sharp deceleration of growth in labour productivity and pressures on profitability (see graph below).

**Labour productivity, real unit labour costs and real wages, euro area** (y-o-y change in %)



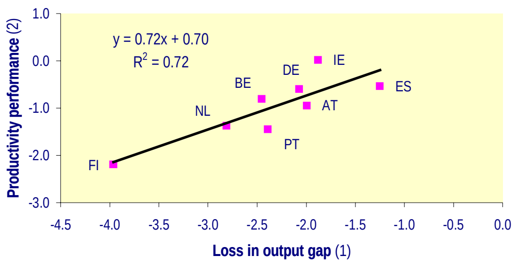

(1) GDP deflator.
*Source:* Commission services .

An interesting feature of the current downturn is that the average euro-area picture conceals large differences at Member State level. Labour market adjustments to the slowdown in activity have also been quite different in some countries outside the euro area, most notably in the UK and the USA. These country differences provide interesting insights as to the cyclical adjustment process of labour in the euro area and are explored in this section.

*Cyclical adjustment in labour productivity.* A sharp slowdown in labour productivity[3] can be observed in all euro-area countries during the first stages of the downturn in 2001. In about half of the Member States, the initial slowdown was followed by a significant improvement in 2002. As a result, differences between Member States' individual productivity performances widened significantly in the euro area in 2002.

There is some evidence that Member State differences in the productivity performance since the beginning of the downturn can be largely related to cyclical factors. Excluding France and Italy, where recent reforms have temporarily affected the cyclical response of employment, differences in the output gap explain more than 70% of differences in growth in labour productivity in the downturn (see graph below).

**Productivity and output gap 2001-02 downturn, euro area (excl. It and Fr)**




(1) Change in output gap between 2000 and 2002.
(2) Difference betw. average and trend growth in real GDP per head (2001-02).
***Source:*** Commission services.

The strong link between productivity and output gap indicates a relatively limited response of employment to the cycle in the euro area. In general, a weak cyclical response of employment reflects the existence of hiring and firing costs. These can be linked to employment protection legislation (EPL) but also to imperfections in the labour market, such as imperfect information in the job search process or the need to acquire company specific knowledge. In the case of the euro area, the next table suggests that EPL has played an important role in dampening the cyclical response of employment in the downturn.

**Table 4: EPL and productivity performance in the current downturn**

| | Low EPL countries (1) | euro area |
|---|---|---|
| Productivity performance (2) | -0.1 | -1.2 |
| Loss in output gap (3) | -1.9 | -1.7 |
| EPL | 0.8 | 3.0 |

(1) IRL, DK, UK, USA.
(2) Difference between average and trend growth in real GDP per head over 2001-02.
(3) Difference in output gap between 2000 and 2002.
Source: Commission services and OECD.

The table compares the average productivity performance in the downturn for the euro area as a whole and for a group of four countries posting the lowest level of EPL[4] in the EU and the USA.[5] The two groups of countries have gone through a cyclical slowdown of similar magnitude but, contrary to the euro area, the low EPL group has managed to contain the deceleration of productivity relative to trend.

In theory, rigidities linked to hiring and firing regulations do not automatically lead to a deterioration of productivity and profitability in a downturn. Adjustments in working hours or wage moderation can be used to offset the negative impact of employment rigidities on unit labour costs. Before analysing Member States' overall profitability performance, these two possible sources of flexibility are examined successively.

*Working hours as a form of flexibility.* Enterprises can respond to a cyclical slowdown by cutting on overtime or by reducing the number of hours performed by interim employees. The euro area has clearly responded to the current

[3] In the absence of adequate measurements of hours worked, labour productivity always refers to GDP per head.

[4] The EPL indicator is the one compiled by the OECD. See Nicoletti et al. (2000), 'Summary Indicators of Product Market Regulation with an Extension to Employment Protection Legislation', OECD, WP 226.

[5] Only Ireland has a low EPL level in the euro area and non-euro-area countries had to be used as a reference.



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slowdown with shorter working hours. Based on Eurostat's survey on weekly working hours, such a reduction can be observed in virtually all Member States in 2001 and, above all, in 2002.

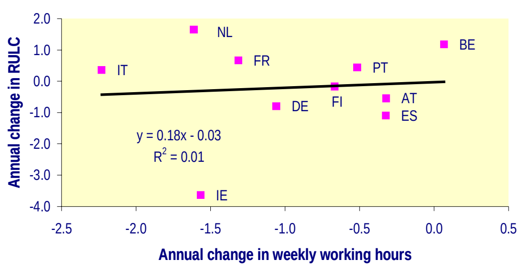
**Table 5: Weekly hours worked, euro area** (annual change in %)

| | 2001 | 2002 |
|---|---|---|
| Belgium | -0.1 | 0.1 |
| Germany | -0.5 | -1.1 |
| Greece | 0.5 | -0.7 |
| Spain | -0.1 | -0.3 |
| France | -0.8 | -1.3 |
| Ireland | -1.0 | -1.6 |
| Italy | -0.1 | -2.2 |
| Netherlands | -0.9 | -1.6 |
| Austria | -0.3 | -0.3 |
| Portugal | -0.6 | -0.5 |
| Finland | -0.5 | -0.7 |
| Euro Area | -0.4 | -1.2 |

Source: Eurostat Labour Force Survey

Nonetheless, there is little evidence that changes in working hours have been a sufficient response to contain cyclical labour cost pressures in the euro area as whole. There is no correlation across Member States between the adjustment in working hours and changes in real unit labour costs (see graph below). This suggests that Member States that have reduced working hours sizeably have generally been no more successful than others in restoring profitability.

**Real unit labour costs and weekly working hours in 2002, euro area** (change in %)



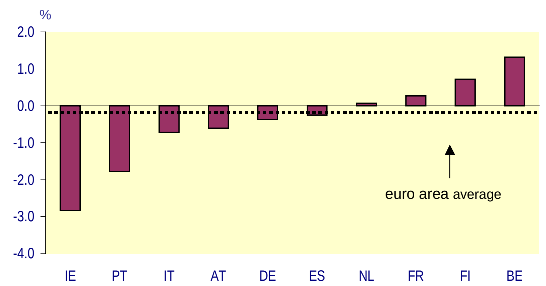

***Source:*** Commission services.

Overall, although adjustment in working time may have helped to preserve profitability in some individual countries, there is little evidence that it has been an effective way of containing cyclical labour cost pressures in the euro area as whole.

*Cyclical adjustment in wages.* Both in nominal and real terms, wage growth has remained fairly stable in the euro area since the beginning of the downturn. In this regard, the situation in the euro area stands in contrast to developments in the USA and the UK where a substantial deceleration of real and nominal wages was observed in 2001 or 2002.

A striking feature of the recent downturn is a relatively large dispersion of wage responses at Member States level. Some countries responded to the downturn with a slowdown in real and nominal wage growth, while others experienced a sizeable acceleration of wage growth. The largest group of countries, only saw limited changes in real and nominal wage growth over 2000-02.

**Changes in real wages,**(1) **euro area 2001-02 downturn**

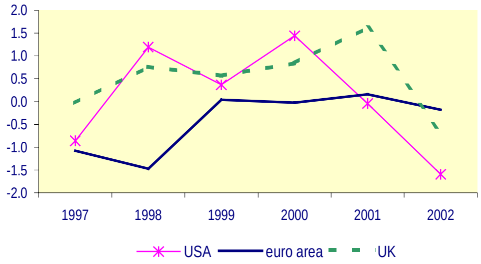



(1) Change in real wage growth between 2000 and 20002. Consumption deflator.
***Source:*** Commission services.

Traditional cyclical determinants of wages offer little help to explain differences in Member States' wage responses to the downturn. In particular, Member States which have experienced a sharper slowdown in productivity in the downturn have not tended to post more wage moderation than others. In a similar vein, differences in unemployment performance do not account for the observed differences in the response of wages to the downturn. On the other hand, in several countries, recent wage developments still appear to be driven by lagged adjustments to specific developments in the late 1990s, including reforms in the labour market and overheating at the peak of the cycle.

*Cyclical adjustment in profitability.* Contrary to the USA, the downturn has been associated with a near stabilisation of profitability in the euro area. Interpreting real unit labour costs (RULC) as an inverted measure of profit margins, adjustments in profitability since 2000 have been fairly limited in the euro area but quite significant in the USA and, to a lesser degree, in the UK. It may be argued that a recovery in profitability was necessary in the latter two countries where profit margins had been seriously eroded in the late 1990s. In the absence of conspicuous losses in profitability in the late 1990s, such a correction seems a-priori unnecessary in the euro area.

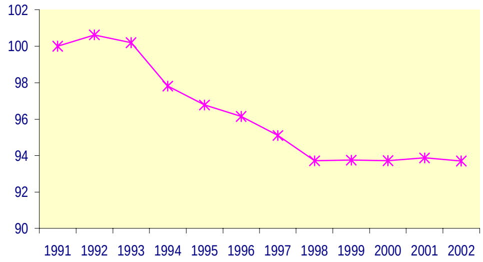
**Real unit labour cost, 1997-2002**
(change in %)




***Source:*** Commission services.

Nevertheless, the last few years have seen a significant break in the trend in profitability observed throughout most of the 1990s in the euro area. RULC growth in the euro area decreased continuously between 1992 and 1998 but has remained more or less stable thereafter. The downward drift of the 1990s is a consequence of the wage moderation which prevailed over the period but it also reflects structural factors specific to the euro area. There is, for instance, evidence that the drift is partly due to changes in the sectoral composition of the economy.[6]

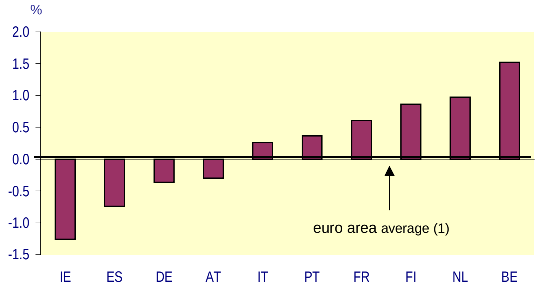
**Real unit labour cost, euro area**
**1991-2002** (index 100 in 1991)




***Source:*** Commission services.

In several Member States, profit margins in 2001-02 have been squeezed by a slow cyclical adjustment of employment and wages combined with persistent effects from specific developments in the late 1990s such as overheating or regulatory changes. On a more positive note, it is worth stressing that several Member States have managed to respond to the drop in activity with enough flexibility to preserve profitability. In 2001, flexibility in these countries essentially took the form of wage moderation. In 2002, the burden of adjustment shifted somewhat on employment and productivity.

**Changes in real unit labour costs, euro area**
(average 2001-02)




(1) Euro-area average is equal to 0
***Source:*** Commission services.

*Labour market flexibility and consumer spending.* It may be argued that labour market rigidities can smooth the private consumption cycle. To the extent that countries with more rigid labour markets experience a more subdued response of employment and wages to the cycle, they could also benefit from more stable income and stronger private spending during downturns, at

[6] See De Serres et al. (2002), "Sectoral Shifts in Europe and the USA: How they Affect Aggregate Labour Shares and the Properties of Wage Equations", OECD Working Paper 12.



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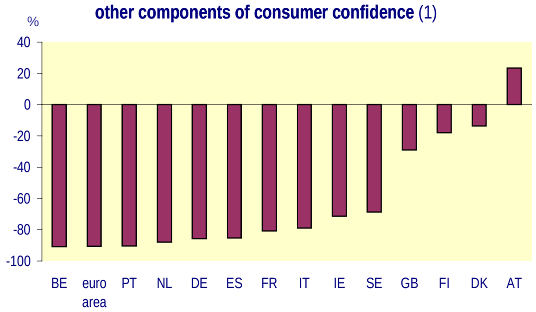
the cost of a slower pick-up of consumption and investment during cyclical upswings.

Unfortunately, data on the current cycle do not provide much evidence to back this hypothesis. The USA and the UK, where the corporate sector has staged a strong recovery of profit margins in the past two years, have both enjoyed stronger growth in private consumption than the euro area. Within the euro area, Member States which have managed to contain cyclical pressures on profits have not suffered from weaker private consumption than others.

Household expectations are a possible channel through which labour market flexibility may affect private consumption positively in a downturn. Whereas labour market rigidities probably lead to a smoothing of disposable income across the cycle, they may also affect consumption negatively via household expectations. Insofar as rigidities are frequently associated with hysteresis effects, households may assess a spell of unemployment as more damaging for their short to medium-term revenue prospects if labour markets are rigid.

**Correlation between unemployment expectations and other components of consumer confidence** (1)




(1) Correlation between unemployment expectations and an index of other forward looking measures of consumer sentiment. Period covered is mid-2000 to April 2003.
***Source:*** Commission services.

Against this background, a striking feature of the EC consumer surveys is that the link between worries concerning unemployment and other measurements of household sentiment varies sizeably depending on the countries considered. The previous graph displays the correlation since the beginning of the cyclical downswing between household expectations regarding unemployment and an average of three forward-looking measurements of household sentiment not directly related to unemployment.

Overall, the correlation tends to be lower in Member States where EPL is less strict or where long-term unemployment is low. All Member States cumulating signs of ineffective labour markets with a high EPL index, high unemployment and limited progress in the NAIRU in recent years also post a high correlation between the two variables. In those countries, cyclical developments in employment clearly have a more pervasive bearing on overall consumer confidence than in countries enjoying more efficient labour markets.

*Concluding remarks*. The analysis presented here suggests that, despite progress accomplished in the 1990s, euro-area labour markets remain characterised by slow adjustment to cyclical fluctuations. More specifically, four conclusions stand out. *First*, the slowdown in labour productivity observed in the euro area since 2000 has an important cyclical component which owes much to the slow adjustment in employment. *Second,* there are significant differences between Member States' wage responses to the downturn but in only few countries has there been a sufficient degree of wage flexibility to offset the cyclical slowdown in productivity. *Third,* the cyclical response of employment has involved cuts in working hours in most Member States but these cuts seem to have been insufficient to contain labour costs. *Fourth,* there is no evidence that the slow adjustment of the labour market has been beneficial to domestic demand so far.

# *Focus*

# II. Fiscal policy: mid-year review

*A comparison of the updated stability programmes with the Commission's Spring 2003 forecasts indicates that budgetary results are likely to fall short of the targets in most euro-area Member States. In 2003, the shortfall would amount to 0.7% of GDP for the euro area in the aggregate in both actual and cyclically-adjusted terms. Concerning the prospects for 2004, for a number of countries the size of the emerging budgetary gap relative to plans is such as to make it highly implausible that the adjustment path implicit in the programmes will be adhered to. Member States are still bound to make every possible effort to approach the close-to-balance medium-term budgetary objective. To this end the 2003 BEPGs specifically recommend that euro-area countries, which have not reached budgetary positions of close to balance or in surplus throughout the economic cycle, seek to achieve an annual improvement in the cyclically-adjusted budget position of at least 0.5% of GDP. In addition, Member States in a situation of excessive deficits need to correct such deficits in line with the individual recommendations addressed to them.*

## *1. Budgetary developments in 2003*

Most updated stability programmes were submitted between October and December last year, when growth prospects for 2003 appeared to be more favourable than those experienced in 2002. A relatively strong recovery was expected, in particular in those countries (Germany, France, Portugal and Italy) where deficits were the highest.

According to the updated programmes, for the euro area as a whole the improvement was estimated at 0.4% points of GDP, from a deficit of 2.2% of GDP in 2002 to 1.8%. For 2003, only four out of twelve euro-area countries expected to be "close to balance or in surplus" in both actual and cyclically adjusted terms and only six euro-area countries foresaw an improvement in their actual budget balances.

The projected improvements between 2002 and 2003 for the euro area were largely based on relatively strong recoveries expected in Germany and Italy. In Germany, a 1% adjustment resulting, mainly from structural improvement on the expenditure side, was planned to bring the deficit below the 3% threshold in 2003. In Italy, the expected improvement was 0.6% of GDP, from -2.1% in 2002 to -1.5% in 2003. Of the two other Member States with a significant deficit, France envisaged a deliberately small improvement of 0.2% of GDP, while Portugal expected to consolidate further below the 3% threshold.

Several countries in sound budgetary positions at the onset of the slowdown in 2001 expected their budget balances to continue to deteriorate. In particular, Ireland, Austria and the Netherlands planned to move from a surplus in 2001 to a deficit in 2003 despite favourable growth prospects, at least in the first two countries.

*Comparison of programmes with Commission forecast.* The updated programmes were largely prepared in the Autumn of 2002 on the basis of budgetary estimates for that year that were inevitably made with incomplete information. The growth assumptions accompanying the budgetary targets were similarly made before the economic figures for 2002 were fully established. In general, the updated programmes, like the budget proposals for 2003 which they reflected, presented a more optimistic view of the prospective results for 2002 and their evolution in 2003 than validated by subsequent developments. This appears to be a recurrent behaviour of recent years.



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**Table 6: Comparison between Commission Spring 2003 forecasts (COM) and most recent stability programme updates (SP) for 2003.**

| % of GDP | Real GDP growth in 2003 | | Budget balance | | | | Cyclically adjusted budget balance | |
|---|---|---|---|---|---|---|---|---|
| | **SP scenario** | **COM forecast** | **SP target** | **COM forecast** | **Difference COM - SP** | **p.m. different 2002 outcome[1]** | **SP implicit target [2]** | **COM forecast** |
| BE | 2.1 | 1.2 | 0.0 | -0.2 | -0.2 | 0.1 | 0.3 | 0.2 |
| DE | 1.5 | 0.4 | -2.75 | -3.4 | -0.65 | 0.1 | -2.0 | -2.6 |
| EL | 3.8 | 3.6 | -0.9 | -1.1 | -0.2 | -0.1 | -1.5 | -1.8 |
| ES | 3.0 | 2.0 | 0.0 | -0.4 | -0.4 | 0.1 | -0.1 | -0.4 |
| FR | 2.5 | 1.1 | -2.6 | -3.7 | -1.1 | -0.4 | -2.6 | -3.5 |
| IE | 3.5 | 3.3 | -0.7 | -0.6 | 0.1 | 0.2 | -0.6 | -0.3 |
| IT | 2.3 | 1.0 | -1.5 | -2.3 | -0.8 | -0.2 | -0.9 | -1.8 |
| LU | 1.2 | 1.1 | -0.3 | -0.2 | 0.1 | 2.9 | - | - |
| NL[3] | 0.75 | 0.5 | -1.0 | -1.6 | -0.6 | -0.4 | 0.3 | -0.4 |
| AT | 1.4 | 1.2 | -1.3 | -1.1 | 0.2 | 0.0 | -0.9 | -1.0 |
| PT | 1.3 | 0.5 | -2.4 | -3.5 | -1.1 | 0.1 | -1.6 | -2.6 |
| FI | 2.8 | 2.2 | 2.7 | 3.3 | 0.6 | 0.9 | 2.7 | 3.7 |
| **EU12** | **2.1** | **1.0** | **-1.8** | **-2.5** | **-0.7** | **0.0** | **-1.3** | **-2.0** |

[1] Difference between budget balance for 2002 reported in the Commission forecast and the estimate for the same year in the stability programme.
[2] Commission estimates based on the production function approach except for DE, ES and AT for which the Hodrick-Prescott filter is used. Calculations are based on information provided in the SCPs.
[3] The figures for the Netherlands are those of the updated stability programme submitted in December 2002. Following general elections and the formation of a new government, a revised update was submitted in June 2003. The revised growth and deficit figures are 0.75% and 1.6% respectively.
**Source** : Commission services.

Table 6 compares the budgetary targets and growth assumptions for 2003 in the updated programmes with the corresponding figures in the Commission Spring 2003 Forecasts. For all countries, the Commission forecasts show lower growth than the programme updates.

In turn, according to the Commission forecasts, nearly all Member States will miss their budgetary targets for this year. The margin is more significant in those countries with the highest deficits, namely Germany, France, Italy and Portugal. Only Ireland, Luxembourg, Austria and Finland are expected to be in line with the programmes or to do better.

A less favourable than initially assumed macroeconomic scenario clearly plays a role in the expected failure to achieve this year's budgetary targets. In this connection, one might note that the distance from the targets is roughly the same whether one looks at the actual balances or their equivalents in cyclically-adjusted terms. This appears to be the case for both the euro-area in the aggregate and for nearly every Member State. This might suggest that the shortfall from targets projected by the Commission is structural rather than cyclical.

However, the estimate of the shortfall in cyclically-adjusted-terms requires careful interpretation. The figures presented in Table 6 imply that the measured output gaps do not differ significantly between the two sets of scenarios. Given that for most countries and for the euro-area actual output is significantly lower in the Commission Spring forecasts than in stability programme updates, this means that the estimates of potential output have been revised downwards by roughly the same amount. In turn, this downward revision relative to the programmes' scenarios mechanically translates, for unchanged expenditure programmes, in a worsening of the cyclically-adjusted balances without necessarily implying that policies have deviated from stated plans.

*Debt developments.* The debt to GDP ratio is estimated to be above 60% of GDP in six countries: Belgium, Germany, Greece, France, Italy and Austria (Table 7). For all these countries the Commission Spring forecasts for 2003 project higher debt to GDP ratios than the programme updates. This in spite of the fact that, for four countries out of six, the 2002 outcome was a lower debt ratio than estimated in the programmes (in the case of Italy by almost 3 percentage points).

The changes in the debt ratio projected by the Commission for 2003 are less favourable than those in the programmes mainly on account of lower growth and lower primary balances. In the case of Germany, the effect of inflation and interest payments also contributes to a higher-than-planned debt ratio. The projected outcome for Italy, by contrast, would be significantly worse but for higher inflation and lower interest payments than planned.

## 2. Budgetary prospects for 2004

*Comparison of programmes with Commission forecast.* While the Commission figures for real GDP growth are in generally lower than those in the updates, the differences are less significant than for the 2003 figures. Indeed, the updates and the forecasts share the assumption that growth would pick up by the second half of 2003 and converge around potential GDP in 2004.

As regards budgetary prospects, on a 'no-policy-change' basis the Commission figures show an aggregate shortfall with respect to the programme targets well in excess of 1% of GDP. To some extent this can be seen as reflecting the gap already accumulated in 2003. For the rest it needs to be stressed that the 2004 figures in the updates are targets

**Table 7: Comparison between Commission Spring 2003 forecasts (COM) and most recent stability programme updates (SP): changes in the government debt ratio in 2003**
(countries with debt ratios above 60 per cent of GDP)

| | Debt ratio 2003 | | | Difference (COM-SP) in : | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| % of GDP | **SP scenario** | **COM forecast** | **p.m. different 2002 outcome[1]** | **Annual change in the ratio** | **Real GDP effect** | **Deflator effect** | **Primary balance** | **Interest payments** | **Stock-flow adjustment** |
| BE | **102.3** | **102.7** | -0.8 | **1.2** | 0.9 | -0.2 | 0.2 | -0.1 | 0.4 |
| DE | **61.5** | **62.7** | -0.2 | **1.4** | 0.8 | 0.3 | 0.5 | 0.2 | -0.4 |
| EL | **100.2** | **101.0** | -0.4 | **1.2** | 0.2 | -0.5 | 0.3 | -0.1 | 1.3 |
| FR | **59.1** | **61.8** | 1.0 | **2.3** | 0.8 | -0.1 | 1.1 | 0.0 | 0.5 |
| IT | **105.0** | **106.0** | -2.7 | **3.7** | 1.4 | -0.7 | 1.5 | -0.7 | 2.2 |
| AT | **67.0** | **68.5** | 0.9 | **0.6** | 0.1 | 0.3 | -0.1 | -0.1 | 0.4 |

[1] Difference between debt ratio for 2003 reported in the Commission forecast and the estimate for the same year in the stability programme.

**Source** : Commission services.



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**Table 8: Comparison between Commission Spring 2003 forecasts (COM) and most recent stability programme updates (SP) for 2004.**

| % of GDP | Real GDP growth in 2004 | | Budget balance | | | | Cyclically adjusted budget balance | |
|---|---|---|---|---|---|---|---|---|
| | **SP scenario** | **COM forecast** | **SP target** | **COM forecast** | **Difference COM – SP** | **p.m. different 2002 outcome[1]** | **SP implicit target [2]** | **COM forecast** |
| BE | 2.5 | 2.3 | 0.3 | -0.1 | -0.4 | *-0.2* | 0.2 | 0.0 |
| DE | 2.25 | 2.0 | -1.5 | -2.9 | -1.4 | *-0.65* | -0.9 | -2.4 |
| EL | 4.0 | 3.8 | -0.4 | -1.0 | -0.6 | *-0.2* | -1.2 | -1.9 |
| ES | 3.0 | 3.0 | 0.0 | -0.1 | -0.1 | *-0.4* | 0.0 | -0.1 |
| FR | 2.5 | 2.3 | -2.1 | -3.5 | -1.4 | *-1.1* | -2.1 | -3.3 |
| IE | 4.1 | 4.5 | -1.2 | -0.9 | 0.3 | *0.1* | -0.6 | 0.1 |
| IT | 2.9 | 2.1 | -0.6 | -3.1 | -2.5 | *-0.8* | -0.2 | -2.7 |
| LU | 2.4 | 2.7 | -0.7 | -1.2 | -0.5 | *0.1* | - | - |
| NL[3] | 2.75 | 1.7 | -0.7 | -2.4 | -1.7 | *-0.6* | 0.3 | -1.1 |
| AT | 2.0 | 2.0 | -0.7 | -1.1 | -0.4 | *0.2* | -0.3 | -0.4 |
| PT | 2.7 | 2.0 | -1.9 | -3.2 | -1.3 | *-1.1* | -1.1 | -2.1 |
| FI | 2.6 | 2.9 | 2.1 | 3.0 | 0.9 | *0.6* | 2.4 | 3.3 |
| **EU12** | **2.7** | **2.3** | **-1.1** | **-2.4** | **-1.3** | ***-0.7*** | **-0.8** | **-2.0** |

[1] Difference between budget balance for 2003 reported in the Commission forecast and the estimate for the same year in the stability programme.

[2] Estimates based on the Production Function approach except for DE, ES and AT for which the Hodrick-Prescott filter is used. Calculations are based on information provided in the SCPs.

[3]The figures for the Netherlands are those of the updated stability programme submitted in December 2002. Following general elections and the formation of a new government, a revised update was submitted in June 2003. The revised growth and deficit figures are 1.5% and 1.7% respectively.

**Source** : Commission services.

which are not only conditional on the associated growth assumptions but also rely to varying degrees on yet to be defined budgetary measures. Such undefined measures could not be included in the Commission forecasts, which are based on a 'no-policy-change' assumption, that is, including only currently known measures. Finally, in the updates growth is projected to be already above potential in 2004, which would lead to a narrowing of the output gap. By contrast, in the Commission forecasts the gap is expected to widen still further as growth in 2004 would still be below potential. As a consequence, the cyclical component contributes marginally to improving the nominal balance in the updates and to worsening it in the Commission forecasts.

Concerning the differences in cyclically-adjusted budget balances, they appear to be roughly of the same order of magnitude as those for nominal balances. This difference provides an approximation of the gap that the budget plans for 2004 updates (assuming that no further measures are taken in the course of 2003) should seek to bridge to maintain the cyclically-adjusted targets and therefore the adjustment path implicit in the programme updates.

While there are a number of reasons explaining the differences between the

Commission forecasts and the updates of the programmes, the bottom line is that the forecasts signal the risk that, without further correction, nominal balances may be in excess of 3% of GDP in France, Portugal, Italy and Germany and would be close to that value in the Netherlands.

*Widening fiscal slippage calls for adjustment.* The comparison between the updated programmes and the Commission forecasts presented in Tables 6 and 8 suggests that a significant slippage has taken place in several Member States with respect to the targets set for 2003 and that this discrepancy is widening further in the course of this year and possibly in 2004. Indeed, for a number of countries, even after adjusting for the cycle, the size of the gap foreseen for 2004 is such as to make it highly implausible that the adjustment path implicit in the programme updates will be adhered to. Given such prospects, it is necessary to assess how Member States are likely to overcome the difference and achieve the medium-term target of the programmes within a reasonable time.

While it has been clear already since the end of last summer that balanced budget positions would not be achieved by all Member States by 2003 or 2004 as previously agreed, countries are still required to make all possible efforts to achieve such positions without delay. To this end, the Broad Economic Policy Guidelines (ECOFIN draft endorsed by the European Council in Thessaloniki on 21 June 2003) urge Member States which have not achieved close to balance positions to 'improve their cyclically-adjusted positions'. In particular, and as long as the budgetary positions of close to balance or in surplus throughout the economic cycle in cyclically-adjusted terms have not yet been achieved, euro-area Member States should 'take all the necessary measures to ensure an annual improvement in the cyclically-adjusted budget position of at least 0.5% of GDP'.

The BEPGs also specify that 'countries with excessive deficits need to correct them in line with the stability and growth pact'. This implies that countries found to be in a position of excessive deficit for 2001 or 2002 have to meet the specific recommendations addressed to them by the Council for the correction of the deficit. In particular, the French and German authorities have been recommended to put an end to the excessive deficit situation as rapidly as possible and by 2004 at the latest, while the deadline for Portugal has been set at 2003. These countries, therefore, while ensuring an annual adjustment in the cyclically-adjusted balance as recalled above, have also to make sure that the nominal balance is brought below the 3% of GDP Treaty ceiling by the set deadline.



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# *Focus*

# III. Recent developments in the euro exchange rate

*This focus examines recent developments in the euro exchange rate. Over the last 18 months, the euro has appreciated by over 30% against the US dollar and about half of that against the yen and the pound. Hence, recent exchange rate fluctuations reflect both a strengthening of the euro against other major currencies and a general weakening of the dollar. The competitiveness position of euro-area companies is now back at its long-term average but the appreciation is putting downward pressure on profit margins. Looking into some of the explanatory factors that have been given for the recent evolution of the bilateral euro-dollar exchange rate, fundamentals, such as the interest rate differentials between the two currencies, seem to have gained strength in explaining short-term currency movements. Changes in the composition of capital flows into the US also seem to indicate that investors have taken a more cautious approach towards the US economy, including with respect to expected increases in productivity.*

## *1. Nominal exchange rate movements*

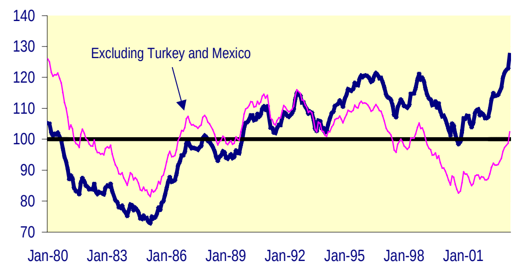
On 25 June 2003, the euro was trading 1.16$/€, 135.7 ¥/€ and 0.70 £/€. Since January 2002, it has appreciated by more than 30% against the US dollar and about half of that against the yen and the pound. Large appreciations have also been registered against Asian currencies linked to the dollar such as the South Korean won, the Singapore dollar and the Chinese renmibi. This evolution is a reflection of two major trends observed over the last 18 months – an overall strengthening of the euro against other major currencies and a general weakness of the dollar, in particular against the euro.

**USD/EUR bilateral exchange rate**
**(daily data)**


Min = 0.8578 (28/01/02) - Max = 1.1901 (27/05/03)
Latest: 16 June 2003
***Source:*** Commission services.

After trading close to parity in the second half of 2002, the euro resumed its upward trend against the dollar from the beginning of 2003. Increased uncertainty, geopolitical tensions and concerns about the faltering recovery in the USA were quoted by market analysts as exerting renewed downward pressure on the US currency. Markets also became more aware of the large financing needs (some $2 billion a working day) associated with the large US current account deficit. Towards the end of May 2003, the euro rose for the first time above its launch level against the dollar against a backdrop of concerns about the US economy and doubts about Washington's commitment to a strong dollar.

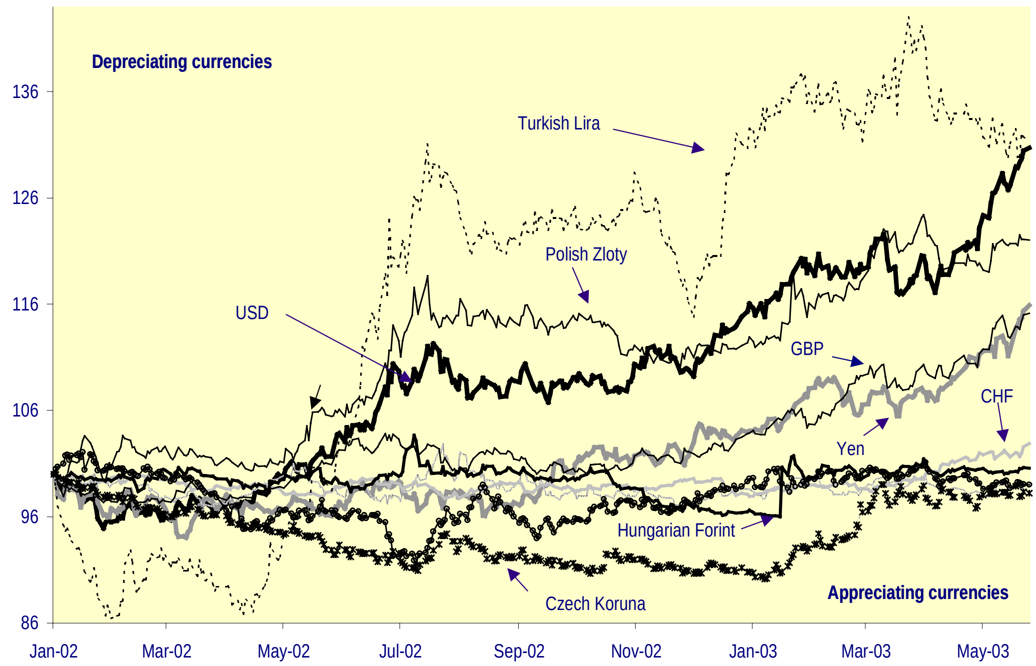
**Nominal effective exchange rate of the euro**
**(Monthly data, 1980 - 2002 = 100)**




***Source:*** Commission services.

In nominal effective terms, the euro has appreciated against the currencies of the major industrialised countries by some 18% since January 2002. In a longer-term perspective, the recent euro appreciation has brought the euro effective exchange rate to some 27% above its 1980-2002 average. It should be noted, however, that a non-negligible part of the fluctuation in the nominal effective euro rate is due to the strong depreciation of the Turkish lira and the Mexican peso against the euro as a

**Bilateral exchange rates against the euro**




***Source:*** Commission services.

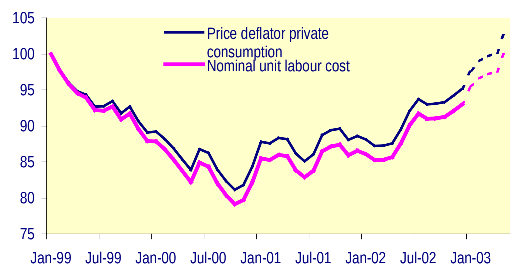
result of high inflation in those countries. When these countries are removed from the basket, the nominal effective exchange rate is roughly in line with its long-term average.

Turning to the short-term prospects for the euro exchange rate, the latest available market forecasts for the USD/EUR exchange rate reveal a wide range of expectations by different commentators. The consensus forecast is for the euro to remain at approximately the same level against the dollar over the next year. However, forecasts range from an expected appreciation of around 15% from the current spot rate by June 2004 to an expected depreciation of 9%. For 2005, the consensus among those institutions which publish a forecast for the USD/EUR is for a small depreciation from the current spot rate. However, the range is also quite wide with some commentators predicting a further significant euro appreciation (to above $1.30), whilst others foresee a depreciation of the euro towards parity.

## *2. Competitiveness position*

To evaluate the deterioration in price competitiveness entailed by the appreciation of the euro, developments in nominal exchange rates have to be assessed against developments in prices or unit labour costs. The graph below presents two indicators of real effective exchange rate constructed respectively with the deflator of private consumption and nominal unit labour costs.

**Real effective exchange rate of the euro**
(Monthly data, Jan 99 = 100)




N.B.: 2003 figures for deflators are based on Commission's spring forecasts
***Source:*** Commission services.



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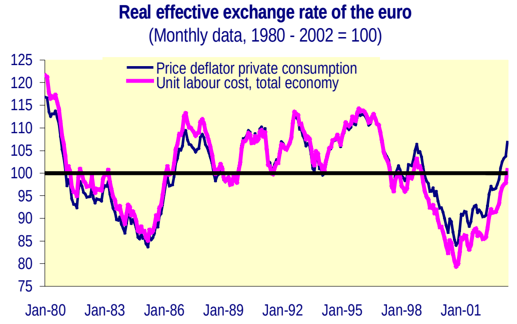
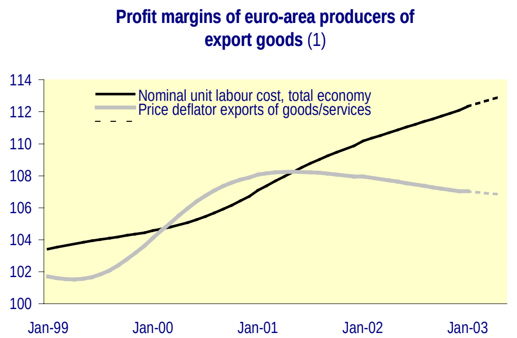



N.B.: 2003 figures for deflators are based on Commission's spring forecasts
***Source:*** Commission services.

Taking both measurements as a basis, the real effective exchange rate of the euro has increased by around 27% since the trough in October 2000. If exchange rates are deflated by unit labour costs, the competitiveness position of euro-area exports is broadly in line with the average over the period 1980–2002. The gap between the long-term average and the present level of the real effective exchange rate of the euro increases to 7% with the private consumption deflator (see previous graph) and to 11% with an export price deflator (not displayed in the graph).




(1) Proxied by the difference between unit labour cost in the whole economy and export price deflator of goods and services.
N.B.: 2003 figures for deflators are based on Commission's spring forecasts.
***Source:*** Commission services.

The graph above plots the evolution of unit labour costs and export prices, expressed in domestic currency, for the euro area over the period 1999-2002. While only a rough proxy, the relative slopes of these curves could be seen as an indicator of the evolution of exporters' profit margins. Although unit labour costs have continued to increase over the whole period, exporters adjusted their export prices upwards in the period of euro exchange rate depreciation (1999-2000) and have been adjusting them downwards only very gradually.

Two tentative conclusions can be drawn from this chart. First, profits margins improved until October 2000 as the increase in unit export price revenue outpaced the increase in unit labour costs. Since then, increases in unit export prices have slowed down and started to decrease, while unit labour costs have continued their upward trend, resulting in a likely continued reduction of profit margins. Second, the recent evolution of export prices does not yet fully reflect the appreciation of the euro exchange rate. Consequently, exporters will have to either squeeze their profit margins further in order to keep their market shares, or lose market shares if profit margins are maintained. As large exporters usually hedge their currency risk, the adjustment process is, however, likely to be gradual.

It is however important to stress that an assessment of the impact of the appreciation of the euro on growth in the euro area should not be restricted to direct trade effects. The negative impact on the external sector may be balanced by the positive impact of the appreciation of the euro on the euro area's inflation rate and therefore on real disposable income. An appreciation of the euro associated with higher capital flows into the euro area may also support consumption and investment.[7] In addition, the real appreciation of the euro should work as an incentive to increase productivity and to improve overall export performance in the euro area (see also Box 2).

7 See Box 1 on the impact of the appreciation of the euro in the March 2003 issue of the Quarterly Report on the Euro Area.

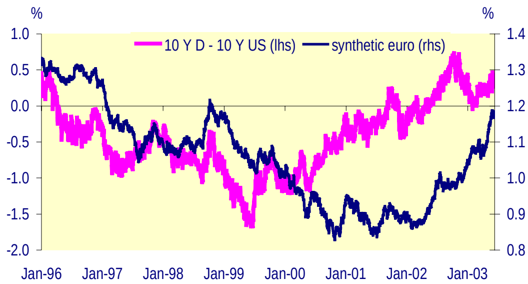
## *3. Some potential driving forces of the USD/EUR exchange rate*

This section examines some of the factors that may be driving the USD/EUR exchange rate. A preliminary conclusion is that traditional fundamental factors (interest-rate differentials and current account positions) now provide a better explanation of recent exchange rate developments.

### Interest rate differentials

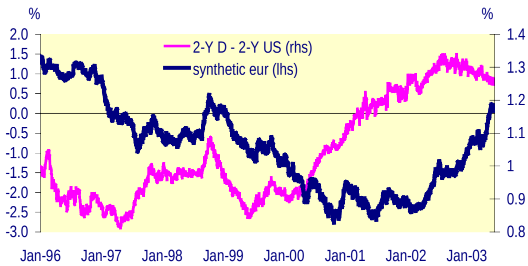
Interest rate differentials are important because they drive portfolio flows in fixed income securities. The next two graphs show that the interest rates differential helps to explain movements in the euro/dollar exchange rate from 1996 onwards. Higher interest rates in the USA than in the euro area were associated with a depreciation of the euro against the dollar in the early years of the euro. When the differential turned positive (in favour of the euro) in the course of 2001, the euro started to strengthen.

**Long-term interest rate differential (Euro-US) and the USD/EUR exchange rate**




***Source:*** Datastream.

**2-year interest rate differential (Euro-US) and the USD/EUR exchange rate**



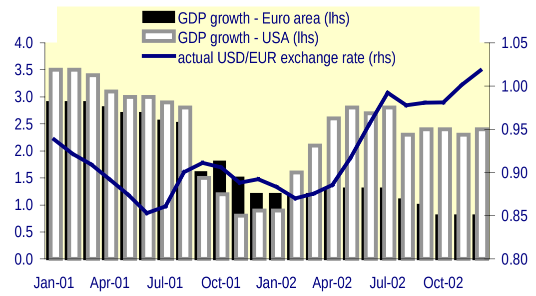

***Source:*** Datastream.

The market perception is that the US dollar is now suffering from relatively low returns on dollar-denominated fixed-income securities, and that investors are increasingly seeking higher yields elsewhere.

### Expected GDP growth differentials

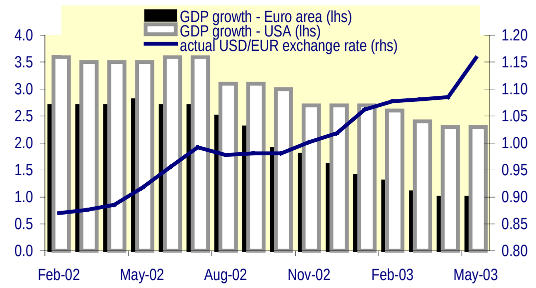
For some time, markets seemed to focus on the expected GDP growth differential between the USA and the euro area. The higher cyclical position of the USA was associated with higher returns on fixed-income securities and expectations of higher returns on equities. Moreover, upward revisions of the US economy's relative growth potential may have supported the expectations that future returns on US assets would outperform those of the euro area.

**Consensus forecast for 2002**
GDP growth (%) and the USD/EUR exchange rate




***Source:*** Consensus forecasts and Commission services' calculations.

**Consensus forecast for 2003**
GDP growth (%) and the USD/EUR exchange rate




***Source:*** Consensus forecasts and Commission services' calculations.

While the correlation between the bilateral euro-dollar exchange rate and the expected growth differential is significant for some



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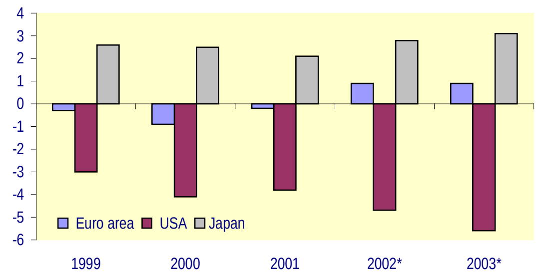
subperiods, the link has more recently become less apparent, with the euro strongly appreciating, while relative growth expectations continue to move in favour of the US. One explanation for this decoupling could be linked to revisions of the perception of expected productivity growth (permanent versus temporary).

## Balance of payment positions

The next graph displays the current account balances of the major economies over the recent past. Whilst the external position of the euro area has been close to balance, Japan has experienced a persistent current account surplus, and the USA has seen its current account deficit widen dramatically to some 5% of GDP.

**Current account balances 1999-2003**
(as % of GDP)

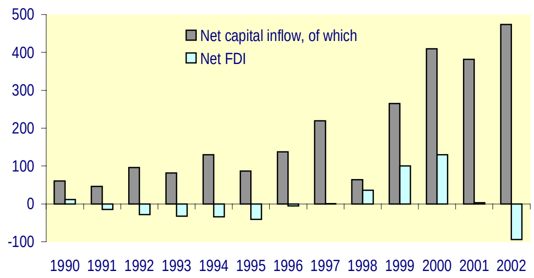



* Provisional
***Source :*** Commission's Spring 2003 forecasts.

Although past US current account deficits were associated with an appreciating dollar, the existence of growing deficits and worries about their sustainability are increasingly seen as a cause for the present weakening of the currency (see Box 2 on the sustainability of the US current account).

The declining willingness of the rest of the world to finance the US current account is also reflected in the change in the composition of net capital inflows into the USA. The net contribution of FDI turned negative in 2002. On the other hand, inflows of capital into US government bonds have increased substantially since 2000.

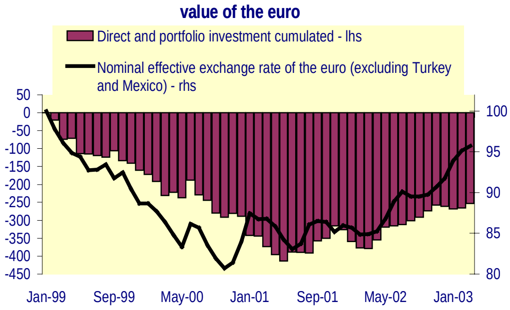
**US net capital inflows, 1990-2002**




***Source :*** Bureau of Economic Analysis.

From a euro area perspective, the next graph shows the accumulated direct and portfolio investment together with the external value of the euro. For the period between January 1999 and March 2003, capital outflows from the euro area and the nominal effective exchange rate moved roughly in parallel. Assuming that these flows are driven by long-term profitability expectations, expectations of high productivity growth in the USA and their subsequent return to more realistic levels could help to explain the appreciation and subsequent depreciation of the dollar.

**Euro area cumulated capital outflows and the external value of the euro**




***Source:*** Commission services.

## Box 2: The US current account deficit – a cause for concern?

### Is the US current account deficit sustainable?

The rise in the US current account deficit to record levels since the mid-1990s has led to increased concerns about whether such enormous borrowings by the world's largest economy are sustainable. There are several ways of addressing this issue.

*A first approach* is to look at the underlying reasons for the US current account. This involves examining savings and investment behaviour in the US. Recalling that a country's current account position equals the difference between saving and investment, a current account deficit is not necessarily a bad thing, as it may allow a more efficient allocation of investment as well as the smoothing of consumption. Arguably, what matters is whether a deficit is used to finance higher consumption or higher investment. A deficit that arises because of the latter is more likely to be sustainable. Higher investment will increase the economy's potential to repay any increase in net indebtedness to the rest of the world.

In the case of the US economy, it is helpful to distinguish between the second half of the 1990s and the period since 2000. The current account deficits that arose during the second half of the 1990s were generally thought to be sustainable. Saving and investment both rose as a share of national income during that period and the rise in investment reflected increased private investment in productive potential. In contrast, the current account deficits registered since 2000 increasingly reflect the change in the government's saving behaviour. Government saving as a share of GNP has dropped very abruptly since 2000 and had become negative by the end of 2002. This has led to concerns about the re-emergence of the so-called 'twin deficits' observed in the 1980s.

*A second approach* to the issue of sustainability is to look at the current account balance as the equivalent of the change in a country's net foreign asset position. The net international investment position of the USA (the value of US-owned assets in other countries less foreign-owned assets in the USA) deteriorated from a surplus of 13% of GDP in 1980 to a deficit of around 20% of GDP in 2001 (i.e. the USA now has net foreign liabilities). It is estimated that if the current account deficit were to remain at roughly the same share of US GDP over the next few years, the stock of net foreign liabilities could rise to around 36% of GDP by 2007 (see Hunt B. (2002), "US Productivity Growth, Investor Sentiment, and the Current Account Deficit – Multilateral Implications" in "United States: Selected Issues", IMF Country Report No. 02/165, August 2002).

With the decline in its international investment position, the country's net investment income (US income from investments abroad less foreign income from investments in the USA) has also fallen over time. What is perhaps surprising, however, is that until recently it has remained positive. There are two ways of looking at this. The first is that, although debt servicing by the USA has now become a net transfer to the rest of the world, the share of national income owed to foreigners is still quite small. This suggests that, for the moment at least, the USA has no difficulty in sustaining large net foreign liabilities. The second is that because foreigners seem to have been earning a lower return on the assets they own in the USA than US citizens have been earning on the assets they own in other countries, the relative attractiveness of dollar-denominated assets may have been overestimated. If foreign investors were to draw such a conclusion, they would be likely to reduce their exposure to dollar-denominated assets, implying that current account would have to adjust.

*A final approach* to addressing the sustainability of a country's current account position is to look at the composition of capital inflows. After a surge during the second half of the 1990s, total net capital inflows into the USA fell back slightly in 2001 before recovering again in 2002. The annualised figure for net capital inflows in the first quarter of 2003 was in excess of $600bn, against $410bn for 2000 as a whole. Nevertheless, the latest figures confirm that the composition of net capital inflows into the USA has changed quite significantly since 2000. There has been a sharp rise in net purchases of US government and corporate bonds since then, and an equally sharp falloff in net purchases of US equities and inflows of FDI. Net purchases of US government securities by foreigners rose from $50bn in 2000 to $266bn on an annualised basis in the first



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quarter of 2003. On the other hand, net purchases of US corporate equities fell from $194bn in 2000 to -$8bn in 2003Q1 (annualised), while FDI fell from $308bn to $75bn over the same period.

These trends suggest that, whilst global investors have thus far been keen to continue purchasing dollar assets, their risk preferences have changed. They are less willing to hold riskier dollar assets. It is difficult to extrapolate from these trends to predict future movements in capital flows. However, increased risk aversion by international investors, coupled with a deterioration in the government's fiscal position and a rise in net foreign indebtedness, may indicate that the US economy is now more vulnerable to a sudden reversal of capital flows than it was prior to 2000.

**Possible consequences for the euro area of an adjustment of the US current account**

Overall, the above analysis suggests that the sustainability of the US current account deficit is now much less assured than in the late 1990s. In this context, a major concern is the possible consequences for the euro area of a disorderly correction of the US imbalance.

Without a full explanation of exchange rate movements one cannot predict what the macroeconomic consequences of a currency appreciation will be, as this will depend on the underlying shock that causes the exchange rate correction. Nevertheless, simulations run with the Commission's QUEST model suggest that a positive productivity shock in the USA combined with changes in the risk perception of US assets can be associated with exchange rate developments that are similar to what has been observed in recent years between the dollar and the euro. These simulations also suggest that, if the underlying factors behind the recent appreciation of the euro are linked to a change in the risk perception of the US assets and a reversal of capital flows, then the economic consequences of the appreciation do not have to be very negative for growth in the euro area. A 15 per cent appreciation of the euro would only shave off 0.2-0.3 per cent of growth and reduce inflation by 0.1-0.2 percentage points. The major reason for such a benign result is that the growth impact of weaker exports due to losses in price competitiveness would be partly offset by the boost to domestic demand, and particularly investment, provided by the reversal of capital flows.

## A Productivity Shock

A commonly-held view is indeed that the perceived or actual productivity performance of the USA in recent years may help to explain the evolution of capital inflows into the US, and, consequently, of the exchange rate of the dollar.

In most standard macro models, a positive productivity shock is associated with a depreciation of the currency in the long run. This leads to an increase in exports and a reduction in imports, and restores equilibrium between demand and supply. For a productivity shock to be linked to long-term appreciation, one would have to introduce a distinction between tradable and non-tradable goods or assume additional world demand for new varieties of goods. However, although these factors may have played a role, they are difficult to reconcile with the magnitude of the dollar appreciation in the second half of the 1990s or with observed developments in the US current account.[8]

Nevertheless, a short-term positive link between productivity and the exchange rate can be established when anticipatory effects are taken into account. Expectations of higher future productivity growth can fuel an increase in demand now. According to this view, presented by Bailey et al,[9] there are three main channels through which perceptions of higher US productivity growth would feed through into the exchange rate.

8 See Meredith, G. (2001), "Why has the euro been so weak?", IMF Working Paper 01/1555

9 Bailey, A., Millard, S. and S. Wells (2001), "Capital flows and exchange rates", Bank of England Quarterly Bulletin, Autumn 2001, pp. 310-318.

Firstly, a positive productivity shock will induce consumers to expect that their future income will be higher, and this will encourage them to borrow in order to smooth their consumption profiles between the present and the future. Secondly, such a shock will induce investors to expect higher future profits, which will tend to encourage investment. Thirdly, foreign investors, also observing this shock, will be willing to take advantage of higher rates of return. This, together with the low level of private saving, implies that at least some part of the increase in investment demand will be financed by capital inflows.

While the new economy paradigm, based on substantially higher increases in productivity, was high on the list of factors cited by market participants in the years that the stock market and the dollar exchange rate surged, expectations of permanently higher returns on investment have subsided over the last 18 months. To the extent that the productivity increase was there, investors have realised that it may lead to higher wages rather than higher profits. Indeed, between 1996 and 2000, the growth of labour costs outpaced the growth of productivity and profit growth fell back. Productivity increases were also translated into lower prices for end-users, as illustrated by the continued fall in prices in the ICT sector. Irrespective of this, the jury is still out on whether expectations of substantially and permanently higher productivity increases have been too optimistic.

## *4. Conclusion*

Over the last 18 months, the euro has appreciated by over 30% against the US dollar and about half of that against the yen and the pound. These developments reflect both a strengthening of the euro against other major currencies and a general weakening of the dollar. The competitiveness position of euro-area companies is now back at its long-term average. However, exporters' profit margins have been under pressure since the beginning of 2002 and the recent evolution of export prices does not yet fully reflect the appreciation of the euro exchange rate. Consequently, exporters will have to either squeeze their margins further in order to keep their market shares, or lose market shares if profit margins are maintained.

Looking into some of the explanatory factors that have been given for the recent evolution of the bilateral euro-dollar exchange rate, fundamentals, such as the interest rate differentials between the two currencies and current account positions, seem to have gained strength in explaining short-term currency movements. Changes in the composition of capital flows into the US also seem to indicate that investors have taken a more cautious approach towards the US economy, including with respect to expected increases in productivity. The dollar depreciation could also be an indication that investors are starting to worry about the sustainability of the US current account deficit.



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# IV. References to further work

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**Economic Forecasts, Spring**
http://europa.eu.int/comm/economy_finance/publications/european_economy/forecasts_en.htm

EUROPEAN ECONOMY. No. **3**. 2003
**Public finances in EMU - 2003**
**Communication from the Commission to the Council and the European Parliament COM(2003) 283 final**
In the Communication on the state of public finances in EMU - 2003, the European Commission calls for a coherent medium-term strategy for the Union, which simultaneously tackles the problem of growing budgetary imbalances and the need to raise growth in line with the Lisbon strategy. The Commission Communication is published at the same time as the fourth annual report on Public finances in EMU prepared by the Directorate General for Economic and Financial Affairs.
http://europa.eu.int/comm/economy_finance/publications/european_economy/public_finances2003_en.htm

EUROPEAN ECONOMY. No. **4**. 2003.
**The Broad Economic Policy Guidelines BEPGs for the 2003-05 period. COM(2003)170 final**
For the first time, the European Commission adopted on the same day, 8 April 2003, and in streamlined form its proposals for the Broad Economic Policy Guidelines (BEPGs) and for the employment guidelines and recommendations, in order to ensure greater cohesion and effectiveness of the EU reform agenda in the medium term (2003-2005).
http://europa.eu.int/comm/economy_finance/publications/european_economy/broadeconomypolicyguidelines2003_en.htm

EUROPEAN ECONOMY. ENLARGEMENT PAPERS. No. 15.
**Spring 2003 economic forecasts for the Candidate Countries**
http://europa.eu.int/comm/economy_finance/publications/enlargement_papers/elp15_en.htm

OCCASIONAL PAPERS. No.3.
**Economic Policy Committee EPC :Annual report on structural reforms**
Ongoing structural reform is a central feature of the EU agenda. It has to be so if Member States are to deliver to their citizens continuing and improving material and social well-being. Sustained progress is essential if the ambitious goals set in Lisbon are to be achieved. In accordance with its statutes, the Economic Policy Committee has a duty to report each year on the progress that the Union has made.
http://europa.eu.int/comm/economy_finance/publications/occasional_papers/occasionalpapers3_en.htm

**Giovannini Group: Second Report on EU cross-border clearing and settlement arrangements**
http://europa.eu.int/comm/economy_finance/giovannini/clearing_settlement_en.htm

**Activities:** Pre-accession economic programme (PEP)
http://europa.eu.int/comm/economy_finance/about/activities/activities_thirdcountrieseconomic_pep_en.htm

**Activities**. Stability and Growth Pact (SGP) and fiscal surveillance
http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

## 2. Analytical documents

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. **182**.
Kieran Mc Morrow and Werner Röger (DG Economic and Financial Affairs)
**Economic and financial market consequences of ageing populations**
The focus of the present paper is to quantify and analyse the nature, extent and geographical reach of the "real" economy and budgetary aspects of ageing populations as well as providing an initial assessment of the financial market implications of this phenomenon.
http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers182_en.htm

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. **183**.
Christophe Planas (DG Joint Research Centre), Werner Roeger (DG Economic and Financial Affairs) and Alessandro Rossi (DG Joint Research Centre)
**How much has labour taxation contributed to European structural unemployment?**
This paper analyses the effect of labour taxes on Euro area unemployment. By using an unobserved component model, we find a significant tax effect that is in the middle of the estimates that can be found in the empirical literature.
http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers183_en.htm

EUROPEAN ECONOMY. ECONOMIC PAPERS. No. **184**.
Staffan Lindén (DG Economic and Financial Affairs)
**Assessment of GDP forecast uncertainty**
This paper develops an approach to measure the uncertainty surrounding expected GDP growth that prevails in the economy. This is accomplished by making use of consensus forecasts of GDP growth and by studying the properties of distributions of forecasted euro area GDP growth. Two graphs are proposed to be used as a regular monitoring tool, illustrating the measured uncertainty and balance of risks.
http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers184_en.htm

**Past Events:** The Brussels Economic Forum, 10-11 April 2003: Speeches and presentations
http://europa.eu.int/comm/economy_finance/events/2003/events_brussels_0403_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



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# V. Key indicators for the euro area

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|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **1** | **Output** | | 2001 | 2002 | 2003 | Jan-03 | Feb-03 | Mar-03 | Apr-03 | May-03 | Jun-03 |
| | Industrial confidence [1.1] | Balance | -10 | -12 | | -11 | -11 | -12 | -12 | -13 | -12 |
| | Industrial production [1.2] | Mom %ch | 0.2 | -0.9 | | 0.9 | 0.3 | -0.7 | 0.5 | | |
| | | | 2001 | 2002* | 2003* | 02Q3 | 02Q4 | 03Q1 | 03Q2 | 03Q3 | 03Q4 |
| | Gross domestic product [1.3] | Ann. % ch | 1.5 | 0.8 | 1.8 | 1.0 | 1.2 | 0.8 | | | |
| | | Qtr. % ch | | | | 0.3 | 0.1 | 0.0 | | | |
| **2** | **Private consumption** | | 2001* | 2002* | 2003* | Jan-03 | Feb-03 | Mar-03 | Apr-03 | May-03 | Jun-03 |
| | Consumer confidence [2.1] | Balance | -6 | -11 | | -18 | -19 | -21 | -19 | -20 | -19 |
| | Retail sales [2.2] | Ann. % ch | 1.3 | 1.3 | | 2.5 | -0.8 | 4.0 | 3.1 | 0.7 | |
| | | | 2001* | 2002* | 2003* | 02Q3 | 02Q4 | 03Q1 | 03Q2 | 03Q3 | 03Q4 |
| | Private consumption [2.3] | Qrt. % ch | 1.8 | 0.6 | 1.7 | 0.5 | 0.4 | 0.4 | | | |
| **3** | **Investment** | | 2001 | 2002* | 2003* | 02Q3 | 02Q4 | 03Q1 | 03Q2 | 03Q3 | 03Q4 |
| | Capacity utilisation [3.1] | % | 83.5 | 81.2 | | 81.2 | 81.7 | 81.3 | 80.8 | | |
| | Gross fixed capital formation [3.2] | Qrt. % ch | -0.3 | -1.9 | 2 | 0.7 | 1.2 | | | | |
| | Change in stocks [3.3] | % of GDP | -0.2 | -0.1 | 0.1 | -0.3 | -0.2 | 0.4 | | | |
| **4** | **Labour market** | | 2001 | 2002* | 2003* | Jan-03 | Feb-03 | Mar-03 | Apr-03 | May-03 | Jun-03 |
| | Unemployment [4.1] | % | 8.0 | 8.2 | 8.3 | 8.7 | 8.7 | 8.8 | 8.8 | 8.8 | |
| | | | 2001 | 2002* | 2003* | 02Q3 | 02Q4 | 03Q1 | 03Q2 | 03Q3 | 03Q4 |
| | Employment [4.2] | Ann. % ch | 1.4 | 0.4 | 0.4 | 0.3 | 0.2 | | | | |
| | Wages [4.3] | Ann. % ch | 2.8 | 2.9 | 2.8 | 2.9 | 2.8 | 2.7 | | | |
| **5** | **International transactions** | | 2001 | 2002* | 2003* | Jan-03 | Feb-03 | Mar-03 | Apr-03 | May-03 | Jun-03 |
| | Export order books [5.1] | Balance | -14.25 | -22 | | -22 | -23 | -26 | -27 | -27 | |
| | Exports of goods [5.2] | Bn. EUR | 767.4 | 776.9 | 823.4 | 82.1 | 84 | 87.2 | | | |
| | Imports of goods [5.3] | Bn. EUR | 802.2 | 781.6 | 828.1 | 83 | 78.9 | 85.6 | | | |
| | Trade balance [5.4] | Bn. EUR | -34.8 | -4.7 | -4.7 | -0.9 | 5.2 | 1.6 | | | |
| | | | 2001 | 2002* | 2003* | 02Q3 | 02Q4 | 03Q1 | 03Q2 | 03Q3 | 03Q4 |
| | Exports of goods and services [5.5] | Qrt. % ch | 4.3 | 0.7 | 6.1 | 2 | -0.2 | -0.6 | | | |
| | Imports of goods and services [5.6] | Qrt. % ch | 2.1 | -1.6 | 6.2 | 2.0 | 0.8 | 0.6 | | | |
| | | | 2001 | 2002* | 2003* | Jan-03 | Feb-03 | Mar-03 | Apr-03 | May-03 | Jun-03 |
| | Current account balance [5.7] | Bn. EUR | -12.3 | 9.6 | 11 | -6.5 | 3.2 | 1.4 | -8.1 | | |
| | Direct investment (net) [5.8] | Bn. EUR | -104.6 | -90.4 | | -0.9 | 2.8 | -8.5 | -19.8 | | |
| | Portfolio investment (net) [5.9] | Bn. EUR | 36.5 | 38 | | -5.5 | -0.8 | 19.5 | 5.4 | | |
| **6** | **Prices** | | 2001 | 2002* | 2003* | Jan-03 | Feb-03 | Mar-03 | Apr-03 | May-03 | Jun-03 |
| | HICP [6.1] | Ann. % ch | 2.5 | 2.2 | 2 | 2.2 | 2.4 | 2.4 | 2.1 | 1.9 | |
| | Core HICP [6.2] | Ann. % ch | 2 | 2 | | 2 | 2.1 | 2 | 2.2 | 2.0 | |
| | Producer prices [6.3] | Ann. % ch | 2.2 | 1.7 | | 2.2 | 2.6 | 2.4 | 1.7 | | |
| | Import prices [6.4] | Ann. % ch | 0.4 | -1.4 | 0.3 | | | | | | |
| **7** | **Monetary and financial indicators** | | 2001 | 2002 | 2003 | Jan-03 | Feb-03 | Mar-03 | Apr-03 | May-03 | Jun-03 |
| | Interest rate (3 months) [7.1] | % p.a. | 4.3 | 3.3 | | 2.8 | 2.7 | 2.5 | 2.5 | 2.5 | |
| | Bond yield (10 years) [7.2] | % p.a. | 5.0 | 4.8 | | 4.2 | 4.0 | 4.0 | 4.2 | 3.9 | |
| | Stock markets [7.3] | Index | 4047 | 3053 | | 2377 | 2176 | 2089 | 2278 | 2301 | |
| | M3 [7.4] | Ann. % ch | 5.3 | 5.6 | | 7.2 | 7.9 | 7.9 | 8.6 | 8.3 | |
| | Credit to private sector (loans) [7.5] | Ann. % ch | 7.9 | 7.65 | | 4.9 | 5 | 4.7 | 4.6 | 4.6 | |
| | Exchange rate USD/EUR [7.6] | Value | 0.9 | 0.94 | 0.98 | 1.06 | 1.08 | 1.0802 | 1.0854 | 1.15 | |
| | Nominal effective exchange rate [7.7] | Index | 80.1 | 82.2 | 83.7 | 102.63 | 104 | 104.69 | 105.27 | 108.9 | |

* ECFIN Spring 2003 forecasts (*European Economy*, No 2/2003 -April 2003)

| 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 utilization | In percent of full capacity, manufacturing, seasonally adjusted, survey data (collected in each January, April, July and October). | ECFIN |
| 3.2 | Gross fixed capital formation | 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 | 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 values 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 | Stock markets | DJ Euro STOXX50 index, period averages | Datastream |



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

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

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