Editorial

In the Euro area, activity has remained dynamic since the beginning of 2007. After a buoyant year, with annual GDP growth reaching 2.8%, capacity utilisation has been rising significantly. According to surveys in manufacturing industries, it reached 84.8% in April 2007, which is above the previous peak registered at the end of 2000.

A positive consequence of this situation has been a recovery in gross fixed capital formation. Investment in equipment increased substantially in 2006 (at a year over year rate of 4.6% during the first nine months). But the most striking feature of the last year was a renewed dynamism of non residential investment in the Euro area: Its annual growth rate reached a peak in the third quarter of 2006 (last figure available) at 4.9%, up from a 2% decline at the beginning of 2005. This shows that companies facing tight production capacities are now seeking to enlarge their capital stock. In a recent survey carried out by the European Commission on the motives of investors in the industry sector, extension of capacities is mentioned as the main reason to invest in 2007. The share of expenditures to enlarge capacities in total investment dominates the rationalisation motive and is at its highest level since 2000. In the past, such a structure of investment was mostly observed when the business cycle was mature.

The apparent tensions of production capacities raise the question whether the risk of inflationary pressures has increased. It is true that producer prices of capital goods as well as of durable consumption goods have started to rise. At the beginning of 2006 they increased at an annual rate slightly above to 2%. However, this is well below the rate observed at the end of the 1980's, when the capacity utilisation was similar to the level observed now. Producer prices of intermediate goods grow at a higher pace (around 6% year-on-year), but this is mainly the consequence of the rise of raw material prices.

A higher risk of inflation can also derived from the labour market, as unemployment rate in the Euro area (7.2% in March 2007) is at its lowest level for twenty years. However, contrary to what has been observed in the US, this improvement has not led to higher wages yet. In the last quarter of 2006 negotiated wages were 2.4% up against one year before. This does not indicate a strong acceleration. This is mainly the result of wage moderation in Germany. Recent wage negotiations in this country suggest that wages may rise somewhat stronger this year, but not enough to jeopardise price stability.

Indeed, inflation in the Euro area was still below the 2% threshold in the fourth months of 2007 (1.8% year-on-year in April). Core inflation (excluding food and energy) was up by 1.9% in March 2007, a slight acceleration compared to the rate of 1.5% that prevailed during a large part of 2006. But this was mainly the result of the VAT hike in Germany January the 1st. The risk of stronger inflationary pressure remains. However, economic growth in the Euro area could be slightly affected in the coming quarters by the developments in international environment (lower world trade, appreciation of the Euro). This may alleviate price tensions.

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Expansion continues to be strong in the New Member States

In 2006, growth in the new EU member states hit all previous records. On average GDP grew by 6.3%. Among the EU25 countries, Latvia and Estonia once again performed best repeating the double-digit growth of 2005. However, this buoyant pace of growth is evidently unsustainable, in particular in Latvia, where a hard landing – which could be triggered by a currency crisis – becomes more likely, as long as no measures are applied to restrict demand. However, there are also two factors that decrease the financial vulnerability of the two countries: Public debt is extremely low, and the Baltic States managed to consolidate the banking sector successfully after the turbulences in the 1990's. Today, Baltic banks can count on the support of their Scandinavian mother banks in the case of a new crisis.

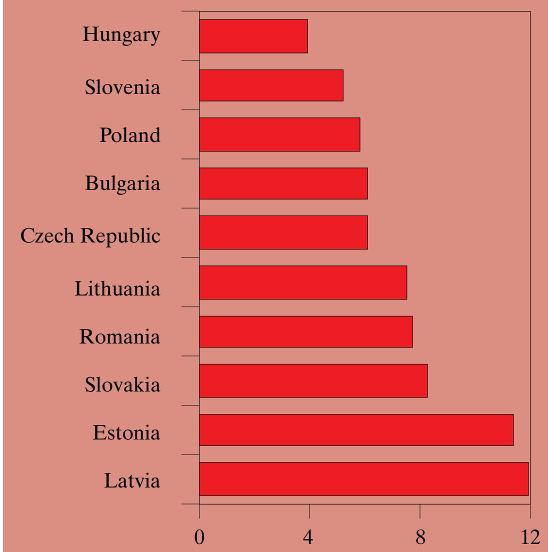
In the Slovak Republic GDP also expanded conspicuously, but without major imbalances. In addition, the structure of growth is rather healthy in this country. On the one hand, while becoming the new European centre of car manufacturing, there is a buoyant investment activity and a marked increase of imports. On the other hand, exports grew by more than 30% last year which is the highest rate in the region.

Romania and Bulgaria, which became members of the EU at the beginning of 2007, have followed the positive regional trend: In 2006, GDP growth was above 6%, while structural changes in the manufacturing sector accelerated and the export performance improved significantly.

Graph 1

Real GDP Growth in the New EU Member States

2006; change in %



Source: Eurostat.

The strong economic performance had a positive impact on the labour market. In most of the countries, the employment increased significantly (by almost 2%) in 2006 whereas unemployment rates decreased. In 2004, the average unemployment rate in the

Table 1

Forecast of the Main Macroeconomic Indicators in the New EU Member Countries

in %

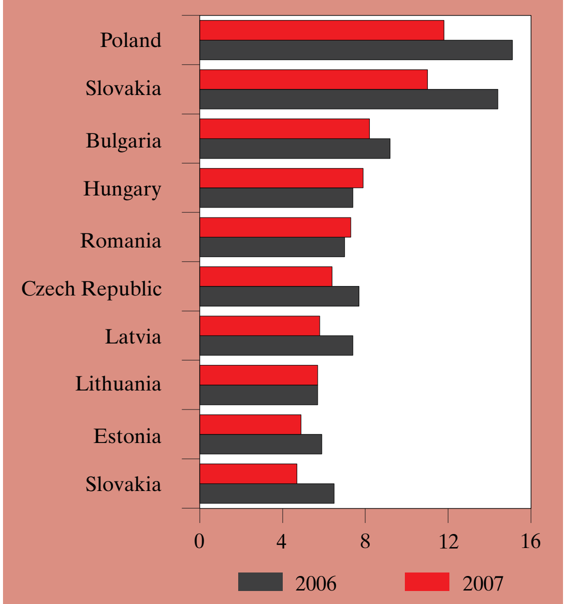
	Real GDP Growth[1]			Inflation (HICP)[1]			Unemployment Rate		
	2006	2007	2008	2006	2007	2008	2006	2007	2008
Slovenia	5.2	4.5	4.2	2.5	2.5	2.4	6.0	5.6	5.4
Hungary	3.9	2.8	3.2	4.0	6.8	3.5	7.5	7.8	7.5
Czech Republic	6.1	5.0	4.7	2.1	2.4	3.0	7.2	6.4	6.0
Slovakia	8.3	8.6	6.7	4.3	2.6	2.5	13.3	10.7	9.0
Poland	5.8	5.7	5.2	1.3	2.1	2.5	14.0	11.8	10.3
Estonia	11.4	9.0	7.5	4.4	4.2	3.8	5.6	4.8	4.6
Latvia	11.9	8.5	6.5	6.6	6.3	5.0	6.9	5.8	5.5
Lithuania	7.5	7.0	6.2	3.8	3.9	2.5	5.9	5.7	5.6
Romania	7.7	6.2	5.7	6.6	4.3	4.0	7.4	7.2	7.0
Bulgaria	6.1	6.0	5.5	7.4	5.3	4.2	8.9	8.2	7.8
NMS-10	6.3	5.6	5.1	3.2	3.4	3.1	10.1	9.0	8.2

Source: Kopint-Tárki Database. – [1]% change compared to the previous year.

Graph 2

Harmonized Unemployment Rates

2006 and 2007 (February); %



Source: Eurostat.

region was still close to 13%, which was almost 5%-points higher than in the EU-15 countries. In 2006, the unemployment rate fell to 10%, cutting the difference to the EU-15 average by a half. As a result, at the end of 2006 only three countries (Poland, Slovakia and Bulgaria) registered an unemployment rate higher than in the Euro area. But it decreased strongly in these countries.

The structure of growth, however, points to some imbalances: in Hungary, but in the other Visegrád countries too, even if to a lower extent, the general government deficit is the most serious problem. In the Baltic States, Romania and Bulgaria the current account deficit is the critical point. In the meantime, the fast catching-up of the region is reflected in the rapid convergence of the wages and consumption as well. It is accompanied by a high increase of loans to private households which aggravates the problem of imbalances (the 'best' example of that is Latvia).

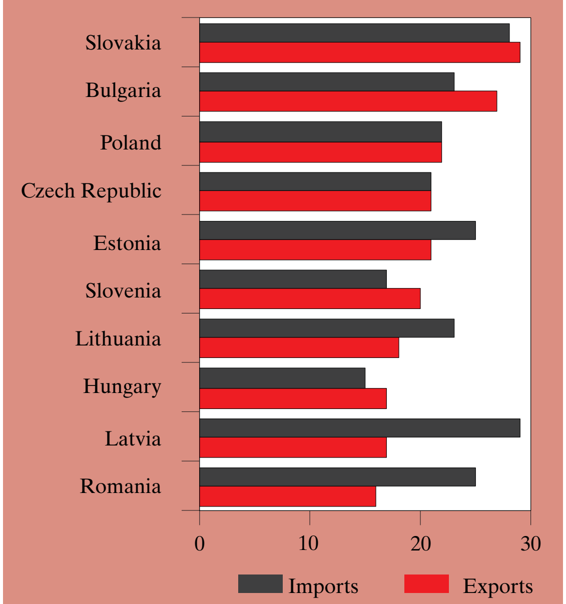
Inflation continues to be a problem for most countries in the region. Because of the fixed exchange rate regimes in the ERM II, they lack the opportunity of nominal appreciation. Therefore it is fairly difficult to accomplish the Maastricht inflation criterion. This is even true if the general government budget is in balance or even in surplus, in particular when a country experiences a fast real convergence and a high wage growth as it is the case in the Baltic States and in Bulgaria now. From the countries of the region, only Slovenia could join the Euro area until now. Only Slovakia's accession to the EMU seems to be probable until 2010 (in addition to Cyprus). In Slovakia, the nominal appreciation of the central parity of the koruna by 8.5% may untie the knot of the real vs. price convergence dilemma. Therefore, a process of disinflation has become more realistic.

To sum up, the growth prospects for the new EU member countries continue to be good in 2007 and 2008; even if the growth will slow down somewhat. In both years, GDP is likely to increase by more than 5%.

Graph 3

External Trade

2006; change in %



Source: Eurostat.

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COE-Rexecode Leading Indicator for the Euro Area

The leading indicator for the Euro area (IARC) is used to anticipate the next economic slowdown[1]. The indicator moved upwards, crossing 60% threshold at the end of 2006 to reach a maximum of 77.4 in February. It subsequently receded to 70.5 in March and 71.2 in April. Therefore, although there still is a possibility of an economic slowdown in the next nine months, the indicator is moving away from the 80 threshold which indicates a strong probability that an economic slowdown will be observed in the following three months. In that case, the growth rate of the Euro area would decrease under its trend growth rate re-estimated at 1.8% in early 2007.

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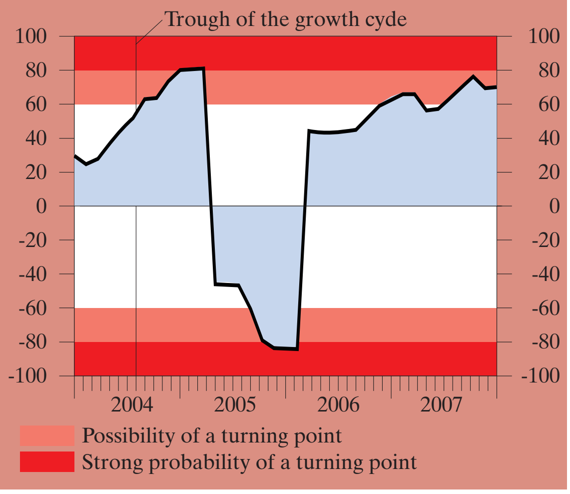
[1] An economic slowdown occurs when the current GDP growth rate decreases under its trend growth.



Forecast of the EUREN/CEPREDE High Frequency Model

Last Update: 04 May 2007

	GDP (year on year)					
	06Q2	06Q3	06Q4	2006	07Q1	07Q2
jul-06	2,29	2,29	2,37	2,24		
aug-06	2,70	2,63	2,48	2,48		
sep-06	[2,7]	2,54	2,41	2,51		
oct-06		2,73	2,66	2,57		
nov-06		2,83	2,81	2,64	2,78	
dec-06		[2,6]	2,68	2,54	2,61	
jan-07	[2,8]	[2,7]	2,78	2,62	2,86	
feb-07			3,01	2,68	2,85	
mar-07	[2,7]	[2,7]	[3,3]	[2,7]	3,00	2,86
apr-07	[2,8]	[2,8]	[3,3]	[2,8]	2,81	2,38
may-07					2,88	2,73

	GDP (quarter on quarter)					2007
	06Q2	06Q3	06Q4	07Q1	07Q2	
jul-06	0,69	0,71	0,37			
aug-06	1,10	0,63	0,15			
sep-06	[0,9]	0,64	0,17			
oct-06		0,75	0,26			
nov-06		0,73	0,38	0,72		
dec-06		[0,5]	0,34	0,67		
jan-07	[1,0]	[0,5]	0,48	0,88		
feb-07			0,71	0,64		2,51
mar-07	[1,0]	[0,6]	[0,9]	0,50	0,85	2,62
apr-07	[1,0]	[0,6]	[0,9]	0,31	0,57	2,27
may-07				0,38	0,85	2,51

In brackets: GDP-Data published by EUROSTAT

The May update of the EUREN/CEPREDE model shows that GDP rates have started to go down in the Euro area. Measured by year over year rates, the maximum of the cycle seems to have been reached in the latest quarter of 2006. However, business survey indicators published recently have been better than the market expected and the slowing of growth in the first quarter may be not as strong as we thought. The quarterly rate in 2007Q2 was revised upward again following according to the indicators released in the recent month.

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Impressum
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