Editorial: Two key questions raised by the present recovery in the Euro area

After having reached a strong growth in 2006 (2.8%), the Euro area should be able to expand at an almost similar rate this year (2.6%). This favourable development raises two questions, which are central for the economic future of the Euro Area.

Firstly: Has the Euro area economy decoupled from the United States? If so, one of the goals, the EU members had in mind when they decided to form a currency union, would have been reached. The Euro area would have become more robust against external shocks. Indeed, the recovery in the Euro area coincides with a slowdown in the US. In the past, cyclical turning points in the US had a lead against turning points in the European business cycle of six months on average. Since the beginning of this decade, the correlation between business cycles around the world has even increased for two reasons. First, the segmentation of the process of production in the manufacturing industries has intensified the spill over effects between countries. Consequently, industrial production became closely correlated across regions in the short run, even if differences trends continued to exist (for instance between emerging countries and Europe). Secondly, in the wake of financial globalisation, long-term interest rates have move more or less parallel in most countries, the US rates keeping the lead. But recently the cycles in the US and the Euro area have diverged One plausible explanation is that the deceleration of activity in the US was mostly the consequence of the contraction in the construction sector. Therefore, time as to show whether really there is a decoupling. A true test would be if consumption of US households would start to slow down now significantly triggering a major downswing in US trading partners' exports. It must be doubted whether Europe would be able to stand such a situation without experiencing a slow down, too. But compared to two years earlier, it now can rely more on its own strengths.

Secondly: Must the recent improvement in the Euro area be attributed solely to the business cycle or does it signal also a rise in potential growth? According to the latest estimates of the European Commission, the Euro area's output gap was still negative in 2006, and it will remain so in 2007, even if GDP growth reached 2.6% as forecasted by the EUREN institutes. However, there must be some doubts whether this can be sustained. By the end of this decade, according to Eurostat projections, potential growth will be dampened because the working age population can be expected to stagnate. This downward pressure should be compensated by other elements. Labour supply would benefit from an increase in the employment rate and a decrease in unemployment, which could be enabled by reforms in the labour market. The recent rise in labour productivity is another source of optimism concerning potential growth. However, it still is concentrated on the manufacturing sector, and not in service sector (trading and financial activities) which was the source of the acceleration of labour productivity in the US in the mid-1990's. All in all, there is the chance that potential output growth in the Euro area remains close to 2% in the medium-term, if other factors compensate the downward pressure coming from demography. But it seems unlikely that a strong acceleration occurs.

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The EUREN Forecast Summer 2007

International economy continued to loose momentum

In the first quarter of 2007 the international economy continued to loose momentum. Nevertheless, world GDP growth was still strong compared to long term trends. According to RWI Essen estimates it grew (in purchasing power parities) at a year over year rate of 5.0% compared to 5.2% in 2006Q4. However, behind this moderation there have been diverging trends in the different parts of the world. On the one hand, growth accelerated in China and some other Asian countries including Japan. On the other hand, it markedly slowed down in the United States. Over the next one and a half year, these tendencies will reverse to some extent. In the US the worst seems to be over, whereas the government in China has taken measures to dampen the expansion which is considered to be not sustainable.

The slowdown in the US was mainly triggered by the housing sector. With interest rates rising and the increase of house prices slowing or, according to some indicators, even falling the previous building excesses were corrected. This led to a sharp drop in residential construction. However, the negative development did not spill over to private consumption expenditure so far. On the contrary: it remained quite stable because employment continued to increase. The EUREN institutes expect that the US economy will regain momentum in the next quarters. During 2008 it will approach its trend rate. On annual average, this translates in growth rates of 1.9% and 2.5%. Driving forces will be private consumption and non-residential investment. Also net exports can be expected to contribute to growth. Residential investment will continue to fall for some time, but according to recent construction activity indicators a stabilisation has come in sight. Against this background we expect that the Federal Reserve will keep its interest rates constant. However, the increasing share of non performing sub prime loans to private households indicates that there still is the risk of a more pronounced slowdown in the US.

Table 1

Exogenous and international variables
Percentage changes unless otherwise indicated

	2005	2006	2007	2008
World trade	7.4	9.0	7.0	8.0
United States				
GDP	3.2	3.3	1,9	2.5
3m interest rates	3.5	5.2	5.1	5.1
10y Gvt bond yield	4.3	4.8	4.9	5.1
Japan				
GDP	2.7	2.2	2,3	1.9
3m interest rates	0.0	0.3	0.6	0.8
10y Gvt bond yield	1.4	1.8	2.2	2.5
China, GDP	10.2	10.8	10,5	9.8
US dollar/euro	1.24	1.26	1.35	1.35
Yen/US dollar	110.1	116.2	120.3	120.0
Oil price Brent US$/barrel	54.5	65.3	63.5	67.0
Percentage changes	42.4	19,9	–2,8	5.5

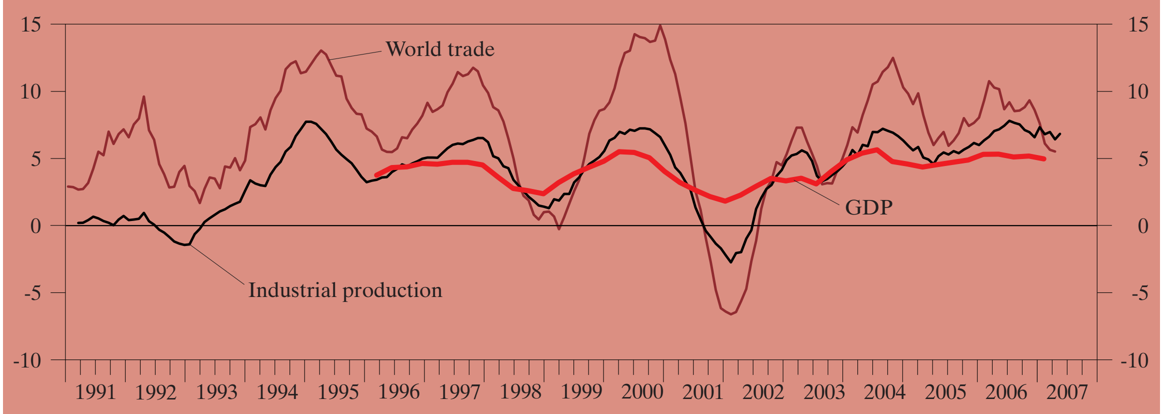
Source: OECD, IMF, EUREN forecast.

The upswing in Japan continued during the first quarter of this year. It was driven mainly by exports and private consumption, whereas residential investment shrank and non-residential investment increased only slightly. In the forecast period growth in Japan will slow down. On the one hand, fiscal policy can be expected to have a slightly restrictive stance, given the high level of public debt. On the other hand, we assume exports to loose momentum, as the devaluation of the Yen should end. GDP is predicted to grow at a rate of 2.3% in this year and 1.9% in the next. The Bank of Japan will continue to raise its policy rates carefully because deflation seems to be not over yet.

The Chinese economy grew unexpectedly strong in the first quarter of 2007, although the government had already taken some dampening measures as it considers growth to be not sustainable. In the recent months, policy took an even more restrictive stance, with raising interest rates and announcing a greater flexibility of the exchange rate against the dollar. In the mean time revaluation of the Renminbi is somewhat stronger than it was before. Furthermore, the slowing of the US economy now should spill over to Chinese exports. Therefore, the EUREN institutes forecast a

Graph 1

World economy: GDP, industrial production, and world trade
1991 to 2007; yoy percentage changes



Source: EUREN

growth moderation in China to 10.5% in 2007 and 9.8% in 2008.

All in all, the moderation already experienced in the US and the expected slowing in some emerging countries will lead to a deceleration of world trade growth. The EUREN institutes forecast it to increase by 7% in this year and by 8% in 2008.

Euro area economy had a buoyant start into 2007

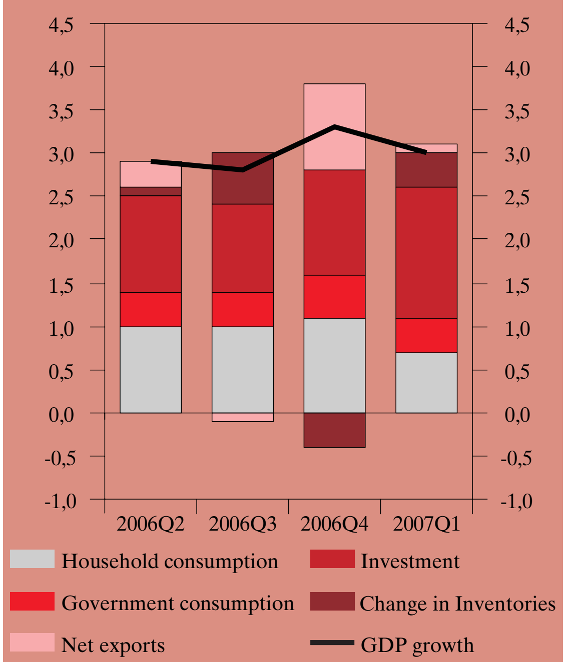
The Euro area economy grew at 3% in the first quarter of 2007 (year on year), which is 0.3 percentage points slower than in the previous. Quarter on quarter growth was 0.6%. The strength of the expansion was determined by Germany and Spain, and it was based on buoyant investment which contributed 1.5 percentage points to GDP growth in annual terms (graph 2).

Another 0.4 percentage points came from inventories. At the same time, household consumption clearly slowed down on a quarter on quarter base, even if the rate remained almost stable in annual terms (1.3%). This reflects dampening effects of the fiscal policy measures implemented in some countries such as the rise of the VAT in Germany. So the contribution of private consumption to growth came down to 0.7 percentage points. Net exports contributed an insignificant 0.1 to growth recently, because growth of exports normalized whereas imports, which are highly correlated with investment, grew around their trend rate.

Looking at GDP by sectors, the most remarkable result is the strong expansion in the construction sector. Its output grew at a quarterly rate of 1.9%, respectively 7.4% in year on year. However, this was supported by the unusually mild weather, which allowed continuing construction work during winter. Industry output remained stable and grew by 4% year on year.

Graph 2

Euro area: Contributions to GDP growth
2006 and 2007; %



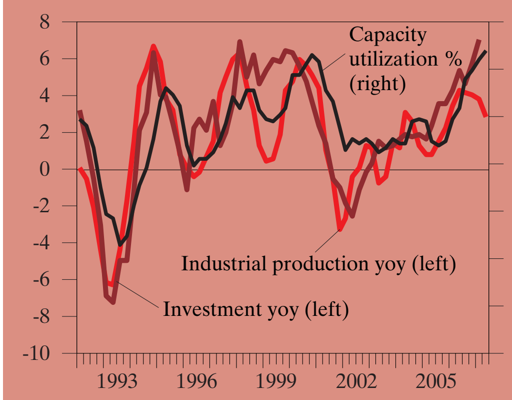
Source: Eurostat

Recent data for the second quarter of 2007 indicate that GDP growth rates will slow down one again, even if moderately only. In particular qualitative indicators, as business surveys, hint at a slight decline in the annual rates of GDP. However, mainly due to the excellent data for Germany, some indicators still are close to the maximum they reached recently. At the same time, industrial production decreased by 2.8% in April, which also speaks in favour of a deceleration of GDP growth. In addition, a look at graph 3 suggests that also some slowing of investment growth can be expected. Capacity utilisation has reached a high level, and having in mind the close relationship between industrial production and investment, the downward trend in industrial production growth could strengthen in the months to come.

Graph 3

Euro area: Capacity utilisation, industry production, and investment

1992 to 1997; %



Source: Eurostat

However, income situation has improved, since the upward trend in the Euro area labour market continued. In 2007Q1 employed was increased by 0.4% on a quarterly base respectively 1.4% year on year. Most recent data confirm this trend; unemployment went down to 7.1% of labour force which is the lowest rate observed since the start of the currency union. Therefore, the upswing in the Euro area should be quite robust, despite of a less favourable development in investment. Inflation seems to be under control with rates slightly below 2% despite of the rise of petroleum and raw material prices. However, some indicators such as labour costs (2.2% up in the first quarter) and money supply reflect some inflationary pressures.

Monetary policy has taken a more restrictive stance

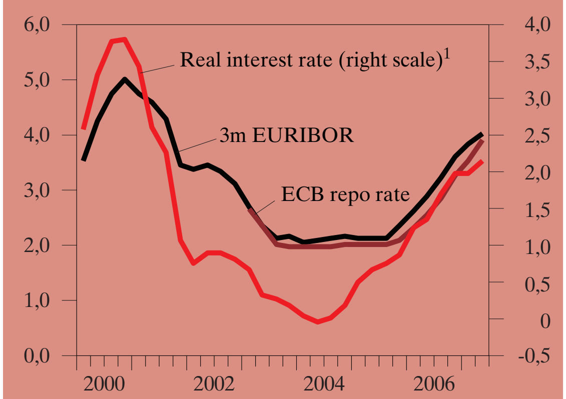
The ECB had these risks in mind when it raised its key interest rate in June, which was for the second time in this year. The minimum bid rate on the main refinancing operations in the Eurosystem was increased by 25 basis points to 4 percent in early June, which was the 8th rise since the ECB started to tighten its policy in December 2005. The ECB justified the monetary tightening by risks to price stability over the medium term horizon. The reasons given were the stronger domestic demand, in particular the increase of capacity utilisation, and the risk that wages could rise stronger than expected. Furthermore, the monetary and credit expansion remained strong in the context of already ample liquidity.

The ECB had sent out clear signals on its policy throughout the year and thus had influenced market expectation. Therefore, the money market rates had risen already before the ECB took action. By the end of May the 3-month EURIBOR exceeded 4%. The real short-term interest rate, using core inflation as a deflator, rose slightly in the second quarter of 2007 and is now slightly above 2% (graph 4). For the near future, the EUREN institutes expect that the key interest rate will be left unchanged at 4 percent for the rest of the year as inflation

Graph 4

Euro area: Short term interest rates

2000 to 2007; %



Source: ECB, EUREN calculation - [1]3m-EURIBOR minus HICP yoy change pressures are abating with prices and labour costs falling short of expectations. Assuming that the ECB will behave in the same way as in the past, the key interest rate can be expected to remain constant in the course of 2008, too, in view of the forecasted slow down of economic activity.

Progress in fiscal consolidation

With the stronger economic growth and due to consolidation efforts in some countries public finances in the European Union improved substantially in 2006 and in the first half of 2007. The development was particularly marked in Greece, which strengthened its effort to exit the "excessive deficit procedure", and in Germany, which benefited from the higher growth and – in addition – the VAT hike in 2007. According to the recent spring forecast of the European Commission, which is based on the official budget plans announced by the Member States, the overall deficit-to-GDP ratio for the euro area is projected to decline to 1.0% in 2007 and 0.8% in 2008.

The EUREN institutes come to a similar assessment, under the assumption of unchanged fiscal policies. Italy is expected to bring down the deficit ratio below the 3% threshold this year, which would enable to escape from the "excessive deficit procedure" in 2008. In Spain, the General Government Balance will remain in surplus. The German budget situation can be assumed to improve further. In 2008, the general budget could even be slightly in surplus. For Greece and France, the deficit quota is forecasted to remain below the reference level in 2007 (2.4 resp. 2.6%) and to remain unchanged in 2008.

The European Commission is pursuing a policy of further budgets adjustments in the coming years, in line with the provisions of the Stability and Growth Pact. The EU governments have also committed themselves recently to specific fiscal policy targets for the coming years. These are likely to affect the fiscal policies in deficits countries. In the countries with surpluses the fiscal stance is likely to remain neutral.

Forecast for 2007: Approaching speed limits

Even if most indicators still suggest a quite favourable outlook and the results for the first quarter were encouraging, there are some factors that can limit the speed the Euro area will grow.

Most important is the slowing of *external demand*. The international economy – as pointed out above – is expected to loose momentum during 2007 due to the slowdown in the United States since the second half of 2006 and the forecasted moderation in some emerging economies. In addition, the appreciation of the Euro will put a brake on European exports. Our forecast is based on the assumption that the exchange rate of the Dollar against the Euro will go up from 1.26 \$/ in 2006 to an annual average of 1.35 \$/ in 2007, which means an appreciation of about 7%. Against the yen the Euro will appreciate by 11% even. Therefore, the EUREN institutes expect that exports will only grow by 6.3% in 2007 after 8.5% in the year before. This will result in a negative contribution of net export to GDP increase.

Furthermore, *private consumption* will be a bit less buoyant than it was in 2006 even if it is still markedly stronger than it was in the first part of the decade. As discussed in previous issues of this newsletter, the hike of VAT in Germany (the regular rate was lifted from 16% to 19% on January 1st) affected German household consumption in the first quarter; it decreased of 1.4% quarter on quarter. Consumers have reacted to the higher tax by putting forward purchases of durable goods such as cars and furniture. This has affected private consumption in the Euro area as a whole, which was sluggish in the first quarter. However, a rebound in the second quarter is very likely. Labour market performance is still favourable and real wages have started to grow after a quite long period of stagnation. Therefore the real disposable income of household is on the rise. Nevertheless, the bad start will affect the annual rate for 2007. *Public consumption* will contribute to GDP growth approximately to the same extent as in 2006. Some economies with large deficits have announced measures to control government outlays.

The strongest impetus for the upswing still originates from *investment*. GFCF grew in the first quarter at a quarterly rate of 2.5%. Several factors contributed to the expansion. The export led upswing in 2006 made corporate profits rise; furthermore the income distribution was shifted in favour of income from capital, as real wages stagnated. Moreover, the financial conditions are still advantageous. However, the first quarter obviously was also affected positively by the special situation in the construction sector which benefited from exceptionally good weather condition. This will lead to a technical reaction dampening investment growth in the second quarter. Nevertheless, with capital accumulation dragged by equipment investments, the annual growth of GFCF will reach the highest level since 1999. Thus, domestic demand will compensate the deceleration of the external sector to a large extent. All in all, the EUREN institutes forecast GDP to grow at a rate of 2.6%, which is only slightly less than in the last year.

Slight deceleration in 2008

In 2008, the Euro area economy will probably lose pace, even if the forecasted growth rate of 2.2% is still above the long term trend. World trade is expected to recover, but the external sector will not be able to compensate for the domestic demand losing pace. This assessment is based on the assumption that there will be another slight appreciation of the euro against the dollar (+0.2%). This will limit the possibilities to recuperate the price competitiveness eroded during 2007. On the other hand, imports will be more lively, thanks to the recovery in households' consumption. Import penetration of consumption has probably increased making import elasticity with respect to private consumption rise. After some years of stagnation, Euro area private consumption will grow at rates which were recorded at the beginning of the decade. It will benefit from a continued improvement in labour market – unemployment rate is forecasted to fall to below 7% at the end of 2008 – and a further

Table 2

Euro area forecast

	2004	2005	2006	2007[1]	2008[1]	2001		2007		2008[1]			
						I	III1	IIIV	IV[1]	I	II	III	IV
	Annual % change (unless indicated otherwise)					q-o-q%, seasonal adjusted (unless indicated otherwise)							
Private consumption	1.5	1,3	1,8	1,6	2,4	–0,1	0,7	0,6	0,6	0,6	0,6	0,6	0,6
Public consumption	1.2	1,4	2,2	1,9	1,9	0,8	0,3	0,4	0,4	0,5	0,5	0,5	0,4
Gross fixed capital formation	2.1	2,6	4,9	5,8	3,4	2,5	0,5	0,9	1,0	0,8	0,9	0,9	0,9
Domestic demand	1.8	1,7	2,5	2,7	2,5	1,1	0,6	0,6	0,7	0,6	0,6	0,6	0,6
Exports	6.8	4,2	8,5	6,3	6,8	0,3	1,4	1,3	1,5	1,6	1,6	1,8	1,8
Imports	6.7	5,3	7,9	6,9	7,6	1,6	1,6	1,7	1,9	1,8	1,8	2,0	2,0
GDP[2]	1.9	1,4	2,8	2,6	2,2	0,6	0,5	0,5	0,5	0,6	0,6	0,6	0,5
Unemployment (% of labour force)	8.9	8,6	7,9	7,4	7,1	7,6	7,4	7,2	7,2	7,2	7,1	7,0	6,9
Compensation per employee[2], yoy	2.1	1,6	2,1	2,7	2,8	2,5	2,7	2,8	2,8	2,8	2,8	2,8	2,8
Consumer price (HICP), yoy	2.1	2,2	2,2	2,0	1,8	1,8	2,0	2,0	2,3	2,1	1,7	1,8	1,8
Current account balance (% GDP)	0.8	0,0	–0.1	0,0	0,0								
3m interest rates (% per annum)	2.10	2,20	3,08	4,11	4,30	3,82	4,03	4,25	4,35	4,3	4,3	4,3	4,3
ECB repo (end of period)	2.00	2,25	3,41	4,00	4,00	3,50	3,75	4,00	4,00	4,00	4,00	4,00	4,00
10y Gvt bond yields (% per annum)	4.14	3,44	3,85	4,37	4,60	4,08	4,29	4,50	4,60	4,6	4,6	4,6	4,6

[1]EUREN estimates. – [2]Not seasonally adjusted.

acceleration in real wages. Moreover, real income will be supported by a lowering of inflation, as we assume energy prices to be stable at the current level.

The tighter financing conditions will have a negative impact on investment, in particular on construction. Investment in equipment will probably remain lively, but there will be a dampening effect coming from Germany. As the favourable depreciation rules will only be valid until the end of 2007, companies will try to put forward investment to the last quarter of this year. Therefore, expenditure on new equipment will only partially compensate for the slowdown in construction, and investments as a whole will grow at a slower pace.

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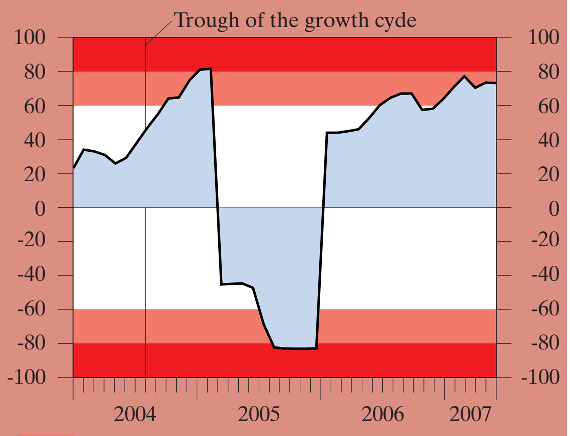
COE-Rexecode Leading Indicator for the Euro Area

The leading indicator for the Euro area (IARC) is used to anticipate the next economic slowdown. The indicator has receded from 77.2 in February to around 73 in April and May. Although it is still above the 60-line, there is some possibility of an economic slowdown in the next nine months, the indicator is moving away from the 80 threshold. Main factors behind were the reversed trend in the wholesale price index for intermediate goods, indicting a still strong demand, and the higher long-term interest rates, leading to an increase in the interest rate spread. If these tendencies will continue, the IARC indicator could continue to fall. Meanwhile, the opinion survey in intermediate goods was less positive in May. The IARC indicators for France and Germany already dipped under the 60 threshold in May, so that there should be no risk of a slowdown in the nine months to come. However, the indicator for Italy still indicates some risk of slowdown.

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



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Forecast of the EUREN/CEPREDE High Frequency Model

Last update: 8 June 2007

	06Q3	06Q4	2006	07Q1	07Q2	07Q3	2007
jul-06	2,29 ; *0,71*	2,37 ; *0,37*	2,24				
aug-06	2,63 ; *0,63*	2,48 ; *0,15*	2,48				
sep-06	2,54 ; *0,64*	2,41 ; *0,17*	2,51				
oct-06	2,73 ; *0,75*	2,66 ; *0,26*	2,57				
nov-06	2,83 ; *0,73*	2,81 ; *0,38*	2,64	2,78 ; *0,72*			
dec-06	[2,6 ; ***0,5***]	2,68 ; *0,34*	2,54	2,61 ; *0,67*			
jan-07	[2,7 ; ***0,5***]	2,78 ; *0,48*	2,62	2,86 ; *0,88*			
feb-07	;	3,01 ; *0,71*	2,68	2,85 ; *0,64*			2,51
mar-07	[**2,7** ; ***0,6***]	[**3,3** ; ***0,9***]	[**2,7**]	3,00 ; *0,50*	2,86 ; *0,85*		2,62
apr-07	[**2,8** ; ***0,6***]	[**3,3** ; ***0,9***]	[**2,8**]	2,81 ; *0,31*	2,38 ; *0,57*		2,27
may-07	;	;		3,05 ; *0,55*	2,83 ; *0,78*		2,56
jun-07	[**2,8** ; ***0,6***]	[**3,3** ; ***0,9***]	[**2,8**]	[**3,0** ; **0,6**]	2,78 ; *0,68*	2,53 ; *0,35*	2,61

In brackets: GDP-Date published by EUOSTAT. In italics: quarter on quarter rates.

The June update of the EUREN/CEPREDE model confirms the results presented in our previous newsletter: GDP growth in the Euro area can be expected to recede in course of 2007. There are no major changes between the May and the June forecast, except that the rate for the second quarter is seen to be a bit lower. But the forecast for 2007 as a whole remained almost unchanged at 2.6%. Business surveys as well as employment or and industrial production data continue to signal that the Euro area economy is keeping momentum. But other indicators as new car registration, interest rates or retail sales pull down the forecast. Nevertheless, the indictors as a whole support the view, that 2007 will be another year with above trend growth.

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