The recent problems in global financial markets have been triggered by – among other factors – the end of the housing boom in the U.S. In the Euro area, housing investment enjoyed a significant expansion, which had contributed to sustained GDP growth. In fact, between 2003 and 2006, when housing investment’s share in GDP was around 6%, the net contribution to GDP growth increased to about two tenths of a percentage point, meaning that almost 10% of Eurozone GDP growth originated in the housing sector.

Nevertheless, this positive trend seems to have come to an end last year. Housing investment growth decelerated from 5.3% in 2006 to 2.8% in 2007, i.e. it has been more or less proportionate to the expansion of GDP. Recent indicators point an additional decline in housing activity in most countries. So we can easily forecast a sharp fall in the coming quarters, which will be associated with a dampening effect on GDP growth.

The impact of the real estate sector on growth was not the same for all Euro area members. It has been particularly strong in some countries, like Ireland and Spain, which experienced – similar to the U.S. – a “real estate bubble”. Here expansion has been significantly higher than in the rest of the Euro area in the past. But now, the adjustment following the bursting of the bubble can be expected to be more marked as well.

Beyond this direct impact on GDP growth, and probably more negative, could be the indirect effects of a slowdown in housing investment. First of all, significant employment effects can be expected, because the construction sector is highly labour-intensive, both directly and indirectly. In Spain, for example, almost 50% of the 5 million new jobs created between 1997 and 2007 were related to construction.

A second transmission channel will be via income and wealth effects. Private household consumption expenditure will be depressed in an environment in which mortgage payments are going to rise and real estate assets will lose their value.

The question is: will the bursting of the real estate bubble hurt the Euro area in a similar way as observed currently in the U.S? The answer surely is no, and for several reasons. Firstly, real estate markets developed quite differently in the individual Euro area countries. Whereas there was a sharp price hike in some countries, others experienced only moderate gains, and in some – such as Germany – prices even declined temporarily. Secondly, financing of real estate activities is obviously sounder in the Euro area, in that subprime mortgages do not play an important role. This is one reason why secondary effects on financial institutions are smaller.

Nevertheless, the Euro area will not be unaffected by the problems in global financial markets. Obviously, it will suffer from the pass-through of the problems in the real estate markets above all in the U.S. Here, housing activities have fallen more sharply than in the Euro area, affecting their internal demand and, of course, import growth. Although the overall effect is difficult to evaluate, the immediate impact on external trade can already be felt clearly. Import growth in the U.S. slowed from 5.9% in 2006 to 1.9% in 2007.

Even more difficult to assess are the consequences of the financial market turmoil that has been triggered by the decline of the US real estate market. On the one hand, banks in the Euro area invested considerable amounts in structured products such as mortgage-backed securities. Therefore, they are fully hit by the crisis in securitisation. On the other hand, the banking sector in the Euro area seems to be more robust than its counterpart in the U.S. Firstly, the impact of the financial crisis is restricted to a small number of banks, albeit large ones. Secondly, tighter regulations in the Euro area seem to have played a role.

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EMU housing sector: common trends but different markets

Housing investment in the Euro area grew on a stable path during the last ten years and contributed significantly to growth in the Euro area (graph 1). Nevertheless, this trend has not been shared by all members. As we can see in graph 2, at least three groups of countries can be distinguished: those showing high growth (Greece, Ireland, Spain and Finland), some with medium growth (France, Italy and Netherlands) and, finally, Portugal, Germany and Austria, where housing investment did not grow at all.

These divergences can be explained by various factors. The first concerns monetary policy, before and after EMU. The high growing countries experienced a sharp decline in real interest rates. Second, demographic and socio-economic factors such as migration flows or family structures have pushed up housing demand. Finally, in France and Spain the residential housing sector received significant inflows of foreign direct investment.

In line with these factors, house prices moved up to a very different extent in the individual countries (graph 3) and accordingly generated a different feedback on demand through wealth effects and profitability of housing investments. In Ireland and Spain house prices almost doubled within 7 years, while the general price level (GDP deflator) increased by only 22% and 31%, respectively. In the group including France, Netherlands and Finland, house prices increased 10-20% above GDP prices. In the last group, housing investment grew slowly.

Bearing in mind these country-specific factors, it becomes evident that problems in

Graph 1

Housing Investment in the Euro Area 1996 to 2007 %

Graph 2

Growth of Housing Investment in selected Euro area countries 1996 to 2007

Graph 3

Relative Housing Prices in Euro Area Countries 2000 = 100

Source: Destatis. Five month moving averages.

Source: Eurostat. 1Construction costs of houses divided by GDP deflator.
the real estate market can differ quite substantially between Euro area members, both in real terms and price effects.

The problems in the housing market were triggered by changing trends in interest rates and housing prices influencing affordability ratios (namely financing cost to disposable income). Concerning prices, problems became evident in the second half of 2007, when the growth of real house prices slowed in most countries. For Spain or France, a decrease can be forecast for 2008. This will generate negative wealth effects that will impact negatively on housing investment. As we have seen in the past, these residential slowdowns take almost two years to work through. In volume terms, the slowdown also started last year. Growth of gross fixed capital formation in housing peaked in the first quarter of 2007 with a year-on-year rate close to 7%, but at end-2007 the rate was 3.7%.

This situation seems to have worsened in the first quarter of 2008 as reflected in the construction confidence indicator. Spain and Ireland contributed most to this negative tendency. In other countries the index remains weak but shows some indications of resilience. Other indicators such as production in construction and civil engineering show similar tendencies. Only in Germany is a significant expansion reported, which could offset the slowdown in the Euro area as a whole.

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France: a slowdown but still many resilient factors

During the last four years, the building sector showed a dynamic growth, especially in 2007. Activity grew by 4.3% in real terms and the contribution of the building sector to employment remained strong (one job in five – or 80,000 jobs – have been created in this sector). The high level of production has been supported by an increase in investment both in the residential sector and the non-residential sector.

Non-residential construction, triggered by vigorous office building (+10% yoy in 2007 for surfaces authorisations) was still buoyant. In the residential sector, the number of housing starts recorded its highest level (425,000 in 2007) and the number of sales of new property (127,400) reached its highest since 1980. Despite a decrease of available supply, the stock of unsold new dwellings climbed again by 35% in 2007 to reach during the final quarter its highest level since 1992. In fact, household demand for new dwellings slowed in the second half of last year and in the first quarter of 2008.

The latest INSEE surveys of the construction industry and consumers show a weakening in the confidence indicator and a decline of some leading indicators both in the residential and non-residential market. The building permits and starts describe a striking inversion of trend since last autumn. Even if these figures are affected by of a recent reform of the building permits legislation (October, 1-2007), so that they are underestimates. Many signals suggest that a slowdown of residential and non-residential investment has begun. And French property prices continued to slow in 2007, with second-hand prices rising by only 5.7%, according to the INSEE-Notaires Index (graph 4).

Even though these prices rise strongly, they reflect a substantial slowdown
from the annual increase of 12-15.5% registered between 2004 and 2006. House prices are obviously way down from their peak in 2004. Both apartment and house prices increased in 2007, respectively by 6.3% and 5.1%. But the slowdown is more significant outside the Paris region: the index was 10.5% higher than a year ago in Q4 2007 in Paris, including a 7.1% rise in Ile de France and 4.9% in other regions on average.

Furthermore, in contrast to Spain, the French property market is characterised by the absence of bubble, which suggests that a soft landing is the most likely scenario. Several factors support this view: the first one is the shortfall in dwellings supply due to a vigorous demographic situation. Every year, the number of households and one-person households (+250,000) has grown faster than the number of dwellings constructed. The housing supply has simply been insufficient, with 350,000 new dwellings each year necessary to meet demand and the actual deficit of supply is estimated at 800,000.

Another factor may be strong growth of demand from foreign buyers, who account for one sale in five in Paris (and one sale in two in holiday areas). Even though Russians are increasingly buying in France, mostly more exceptional properties in the South East, the major purchases came from the British, who account for around 60% of all foreign buyers. Another possible reason for France’s strong housing market is the substantial level of subsidies provided by the government; about 40% of new housing receives some sort of subsidy. Even if households are less sensitive to interest rate changes, as 80% of all mortgage loans are on fixed rates, the solvency of French households has suffered from the subprime crisis and its effects on tightening in lending conditions. In consequence, the tax credit on interest reduction of the rate of mutation rights may partly compensate for the impact of house prices and interest rate increases.

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Germany: Decline may have come to an end

After almost ten years of decline, the construction sector has recovered in the recent years and it contributed positively to GDP growth. The unsatisfactory development since the mid-1990s was above all due to the special situation in Eastern Germany, which had a sustained influence on the market. In the early years after reunification, subsidising construction of new houses and renovation of existing ones was an important part of the package to stimulate reform in Eastern Germany. These programmes triggered high investments in the real estate sector, but in the end they led to an oversupply, which had a dampening effect on real estate prices. The problems in Eastern Germany were aggravated by migration from East to West Germany, which reduced demand for housing.

However, even though investment in construction picked up again, it may not be considered as a homogenous sector. Residential construction has been influenced by many special factors. At the beginning of 2006 the First Home Owner Grant was abolished, and at the beginning of 2007 VAT was raised. Both caused some pull-forward effects, which resulted in a 4.3% rise in housing construction in 2006 but then a slowdown to just 0.6% in 2007. For 2008 there are some reasons to expect an improvement in the residential sector. In particular, higher real income and the improved employment situation may support investment. Furthermore, an important share of housing investment is related to existing buildings, predominantly to improve their energy efficiency. Moreover, unlike other European countries there was no hike in real estate prices in Germany. Therefore, no correction in the market can be expected, and interest rates on housing loans are still low.

Nevertheless, the main impulse for the building sector came and will come from the non-residential construction. On the one hand the commercial construction expanded at quite high rates in 2006 (4.0%) and 2007 (3.7%). Partly, this was a consequence of the strong increase of investment in machinery and equipment, which made it
Greece: weakening of a key growth driver

From the beginning of the current decade until about 2006, housing investment in Greece expanded almost continuously, providing significant support to GDP growth, while Greek house prices followed a rapidly upward path, contributing to a considerable rise in real housing wealth. In 2007, Greek housing market conditions weakened, albeit not as sharply as in Spain, Ireland or the UK.

More specifically, real investment in housing shrank by 6.8% in 2007, following a peak growth of 21.5% in 2006 and an average rate of 4.3% over the period 2001-2005. Thus, while housing investment boosted Greece’s real GDP growth by 1.4 percentage points in 2006 and on average by 0.3 percentage points over the period 2001-2005, it had a negative contribution to growth of –0.5 percentage points in 2007. The evolution of housing investment reflects developments in the volume of private buildings covered by granted permits. Following a sharp increase of 35.2% in 2005, this volume fell by 19.5% in 2006 and a further 5.0% in 2007.

When interpreting the aforementioned figures, it should be noted that, while easier access to housing loans and low interest rates contributed significantly to Greece’s housing sector growth in recent years, the sharp rise in permits observed in 2005 and the subsequent housing boom in 2006 were mostly the effect of a rush of investors to obtain permits and complete housing transactions prior to the enactment of a series of tax measures announced to be introduced by early 2006. Once these measures – which included the imposition of VAT on sales of new houses – were put in place, it was natural for housing construction activity to subside.

Turning to other factors shaping Greece’s housing market conditions, it is important to note that despite higher interest rates, housing loan growth remained very robust in 2007. More particularly, the outstanding balance of housing loans reached 63.6 bn Euro compared to 52.5 bn Euro in 2006, an increase equivalent to 69.4% of total housing investment in 2007. With total household debt standing at 41% necessary to establish new factory buildings. Furthermore, the substantial overhang of office buildings was melting down and induced a more vivid activity in this branch. On the other hand the public investment in structures expanded strongly, growing by 4.9% in 2006 and 6.8% in 2007. The main reason was the improved financial situation of the municipalities, which are the most important investor in the public sector. All in all, investment on constructions eased off somewhat in 2007, growing only by 2.3% after a strong 2006 when it increase by 4.3%.

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of GDP in 2007, which is one percentage point below the Euro area average, the margins for further credit expansion to Greek households are considerable, and therefore a scenario of robust housing loan growth supporting demand and investment in the short-term horizon appears feasible. However, the extent to which this scenario will materialise will depend considerably upon the path of interest rates and the household disposable incomes.

With respect to house prices, information to date suggests they remained more or less stable in 2007. This is in sharp contrast to the price race experienced between the mid 1990s and 2006, when urban area house prices reached 2.4 times their level in 1997. Given that house supply currently appears to exceed demand, with real estate agent associations reporting an unsold stock of 350,000-400,000 homes and apartments countrywide, the outlook on house prices in the near future is quite uncertain. On the one hand, since nominal house and land prices have not declined in recent Greek history, and Greeks have traditionally maintained a very large share of housing and land in their asset portfolios, the possibility of major decline in house prices appears somewhat remote. However, a lot will depend upon the evolution of non-performing housing loans, which reached 3.6% of total housing debt in 2007. An increase in defaults, combined with an effort by banks to liquidate their collateral, could place significant pressure on prices.

Following these considerations, the most likely short-run scenario for Greek housing market would appear to be one of moderately falling investment and more or less stagnant prices. This forecast implies at least for 2008 that the housing sector’s contribution to GDP growth will not be positive. The balance of risks to this outlook appears to lie on the downside, with the main concerns being related to interest rates, household disposable income growth, the scale of non-performing housing loans and the extent to which sellers currently unable to close transactions will succumb to pressure to reduce prices.

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Italy: a turnabout after a decade of growth

In the first period of this decade the building sector showed a continuous growth: between 2000 and 2007 the investment in construction increased at an annual rate of 2.4% in real terms. The incidence of this component on the total gross capital formation expenditure was equal, on average, to 49%. In terms of GDP, this expenditure has been of 10% on average.

The national accounts signal that the growth in recent years has been supported by the strong increase recorded in the residential investments, while in the non residential sector the trend has been fluctuating; in 2005 and 2006 the investments in this sector recorded a reduction, only partially recovered by the growth observed in 2007 (+1.5%). The investments in the residential sector, in contrast, recorded an acceleration of the growth pace across the years until 2006. In 2007 the growth decelerated, but the rate was not negligible (+3.5%).

The increase of investment in construction in 2007 reflects a good start, aid by favourable weather conditions in the first months of the year. Instead, the available data for the second half of the year suggest a striking inversion in the trend. The quarterly national accounts for the latest part of the year will be available only in two months, given some statistical revision; but the indicators suggest that a slowdown has begun. Household demand for mortgages has shown a sharp fall, bringing a slowdown in residential investment and a halt to the long period of rising house prices.

Some leading indicators, computed on the basis of the Isae surveys conducted among the construction sector firms, suggest a fall both in investment and in the activity level (the added value produced in the sector). The confidence indicator is quickly deteriorating since last summer.

Furthermore, industrial production in the sectors that reflect activity in the
construction industry (i.e. bricks, cement, tiles and metal products used in the buildings etc.) is showing an intense fall.

On the basis of these signals, and taking into account the probably severe slowdown recorded in the last part of 2007 which has given an unfavourable starting point for the new year, we believe that 2008 will be the year in which, for the first time after 9 years of prolonged growth, the investments in construction will decrease. The estimated fall (of 1.1%) is not very large, but this is one the most risky elements of the scenario.

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Spain: the end of a golden era

In recent months, Spain has suffered from a more pronounced economic slowdown due mainly to the residential sector contraction. As in the U.S., residential sector activity has experienced a decline as a consequence of the end of a long period of low interest rates, which has translated into an increase in the proportion of household income that is devoted to housing mortgage payments. Besides the increase in the latter, house price trends, credit loans duration, household income, and finally and more determinate movements in interest rates have finally squeezed the housing market. Moreover, the supply of houses has continued to expand and has generated an excess in the residential sector, aggravating the problem. It brought about an adjustment in production generating potential losses as consequence of the lack of liquidity linked to the subprime crisis.

During the last few years Spain has experienced a boom in the construction sector in two waves. The first occurred after local interest rates came down to European levels with the convergence process to reach the Maastricht criteria. The second wave happened when the ECB eased monetary policy, by cutting its reference rate to the level of 2%.

Additionally, demographic factors have also contributed to support the housing sector, as a large increase in migration and the expansion of foreign demand from a large number of Europeans also increased the demand for houses. Those factors have generated a rise in prices and have been at the root of Spain’s internal growth model. In 2007, residential gross fixed capital formation grew by 3.1%, more than three points lower than in 2006. This sharp decline was triggered by the end of the rise in house prices: in the first quarter of 2007, they fell 0.6% in real terms. Additionally, it was also the consequence of rising problems of access to new houses because

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the theoretical affordability ratio climbed to 46%, far from the 30-33% considered desirable by financial entities.

In 2007, 603,214 new residential units were started, some 20% below 2006. Even when adjusting for an outlier in September 2006, when construction laws were changed, this sharp fall has implied a reorganisation in employment, and the latest data exhibit a sharp downward trend. So the number of workers employed in the construction sector increased by only 3.3% in 2007 after an increase of 8.7% in 2006 and it declined by 2.8% in the first quarter of 2008.

Moreover, bearing in mind the length of the maturing process in the residential sector, which is about 22 months, we can expect that the current slowdown will affect GDP through lower GFCF in housing investment over the next two years. On the other hand, the potential demand for houses in Spain is estimated at around 450,000 houses every year. Therefore, the accumulated excess supply could cause more negative impacts than expected.

In conclusion, residential sector is going to suffer from a recession during the next few years. Policy could help to smooth the decline by new laws as the extension in the loans duration attributed by banks, letting facilities to households, promoting renting and increasing the civil construction. But the real problem, the high level of residential prices (estimated to be 16-20% above their equilibrium level), obviously needs to be corrected. There are many factors that could support the housing market, such as an ECB rate cut, a smaller decrease or even a stabilisation of prices in the next three or four years, and modification of banking practices such as increasing the period of loans.

Graph 9

All those measures should be considered to reduce the proportion of household income that is devoted to housing mortgage payments in order to encourage the latent expenditure. Actually, the second factor is already well engaged and the first one will probably be effective at the end of the year. So, even though the fall in the residential sector will be hard, there is also the chance for medium-term stabilisation.

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Content

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Methodological issues in estimating potential output
Measuring the Euro area potential growth
Why was growth so sluggish in Germany:
  A growth accounting approach
Recent trends in the Italian labour market
COE-Rexecode Leading Indicator for the Euro Area

In March 2008, the “underlying” monthly growth in the Euro area was at 1.6% on an annual basis, according to a new Coe-Rexecode indicator. This is clearly below the Euro area trend growth rate estimated at 2.2%, confirming the current economic slowdown. We are now looking for the next trough of this slowdown. The leading indicator will have to overpass in turn the -60 and the -80 threshold to send a strong signal of an imminent economic recovery. In March 2008, the indicator stood at –36.4 and thus still far away from these thresholds, showing no sign of possible recovery in the short term.

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

Forecast of the EUREN/CEPREDE High Frequency Model

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In brackets: GDP-Data published by EUROSTAT. In italics: quarter on quarter rates.

The May update of the EUREN/CEPREDE model confirms the slowdown of the Euro area. In the reach of the model, which covers three quarters of the current year, growth could be below 2.0%. The monthly estimates exhibit a downward trend. The driving force is the continued fall of the sentiment indicators in recent months and the slowing of growth in two of the large Euro area countries, Spain and Italy. The model forecast for the first quarter of 2008, however, is somewhat below the first figures released on May 15, which showed quarter-on-quarter growth in Eurozone GDP of 0.7%.

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Impressum
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