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The Economic Outlook in Europe in 2004-2005

***END OF THE CYCLE? OR JUST A TEMPORARY
SLOW-DOWN IN EUROPE?***

Winter Report

BFP	- Brussels
CEPREDE	- Madrid
COE	- Paris
CSC	- Rome
KOPINT-DATORG	- Budapest
OEF	- Oxford
RWI	- Essen

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About the European Economic Network

The European Economic Network (EUREN) is a network of seven leading European economic institutes. EUREN was formed in 1999 to facilitate improved analysis of developments and prospects across the European economy, by developing closer links between leading economic research groups. All Euren institutes regularly publish forecasts, both on national economies and on EU and Euro Area as well.

Members of the Euren group have been co-operating in a number of ways over the six last years: meeting regularly to discuss economic developments and prospects; holding economic issues conferences, in Paris and Brussels, to discuss major challenges for the European economic policy, contributing to joint and partner's research reports and economic outlook seminars and conferences (this includes the regular report, *La Tribune d'Euren*, <http://www.coe.ccip.fr/05/tribune.htm>), working together on economic research projects.

This is the sixth joint report on the European economic outlook. In this report Euren intends presenting a broad view on recent economic developments in the Europe as well as offering some special studies aiming to discuss key elements on a more structural basis. Copies of the report can be downloaded from Euren's web site, <http://www.euren-network.org>.

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EXECUTIVE SUMMARY

Boosted by an improvement of the international environment since mid 2003, the euro area experienced a revival of economic activity in the first half of 2004. The recovery was mainly driven by exports. However, engines of growth have been uneven across countries. On the one hand, the economic upswing was only fuelled by exports in Germany, as domestic demand remained desperately stagnant. On the other hand, domestic demand was quite dynamic in other countries like France and Spain. Meanwhile, economic growth was also strong in the UK and in the new member States (NMS) of the European Union.

Higher oil prices and stronger euro lead to a downward revision of the euro-area GDP

In their summer report published at the end of June 2004, Euren institutes expected that this export-led growth recovery in the euro area would trigger a pick-up in domestic demand in the coming quarters. However, from last summer, strong oil demand, coupled with tensions on the supply side, have propelled oil prices to historical highs in nominal terms. As a consequence, oil prices could reach 38.7 dollars per barrel on average this year and 43 dollars next year, against 32 dollars and 28 dollars forecasted in the summer forecast. According to simulations carried out with the Oxford Economic Forecasting Global Model, changes in assumptions on oil prices and euro exchange rate would have cut the euro-area GDP by 0.1 point in 2004 and 0.6 point in 2005, everything else equal. Indeed, a stronger euro help to compensate inflationary pressure stemming from higher oil prices, but it also contributes to a deterioration in euro area competitiveness. The net impact of higher oil prices and stronger euro is thus negative for euro-area economic growth. This is the main reason behind the downward revision between Euren summer and winter forecasts.

The international environment of Europe has remained relatively strong in 2004, although signs of weakness in world trade have appeared since the middle of year. In the US, economic growth has returned to a more moderate level, although it remains much more buoyant than in the euro area. In 2005, GDP could be around one percentage point lower, at 3.4%. First, the recent rise in oil prices will translate into a weakening of household purchasing

power. Secondly, the Federal Reserve will continue to increase its key rate. Even so, the rise in interest rates represents a return to more normal, positive, real rates and not a pronounced tightening of monetary policy, but could still limit private consumption expansion slightly. However, after the George W. Bush's re-election last November, it seems that fiscal policy will not be restrictive next year. Indeed, expectations of a continuing expansionary fiscal policy was the main reason behind the recent weakening of the dollar. Thirdly, while they will be supported by a weaker dollar against the euro and the yen, U.S. exports will probably be affected by lower demand in some regions, especially Asia. Here, China is the key factor. In the central scenario, Chinese economy is assumed to slow gradually in 2005, as a result of measures undertaken by Chinese authorities to cool down activity. However, a special study in this report considers the consequences of a gloomier scenario for Chinese economy. It is shown that if Chinese economic growth came back in the range 6%-7%, the expansion of the world economy could be cut by about 0.5%. However, the US and the euro area would be relatively lightly affected, with growth reduced as little as 0.2%. Japan would be hit more significantly. Indeed, China is especially important for Japan, as besides business investment, exports played a key role in Japanese expansion in the first half of 2004. Therefore, while Japan will report in 2004 a rise in GDP unmatched since the beginning of the 1990's, growth will weaken in 2005, since exports and business investment slowdown will not be compensated by a recovery of private consumption.

***Slowdown
in the euro-
area
exports will
not be
compensate
d by an
acceleration
of domestic***

As a whole, the international environment faced by the euro area will be less supportive next year than in 2004. After having led the economic upswing, exports will thus increase at a lower pace. Moreover, after stabilisation through 2004, euro area competitiveness will again deteriorate in 2005 because of the euro appreciation. Therefore, the euro area will lose market shares in the course of next year. However, exchange rates movements are not the only factor influencing export market shares as is shown in a special study focusing on the analysis of trends in world export market shares during the last decade. Geographical and sectoral specialisation also matter. Between 1991 and 2001, the EU-15 suffered from a decline of its world export market share. It was caused by a deterioration in export competitiveness and by unfavourable market specialisation, especially between 1991 and 1997, before the Asian crisis. Between 1997 and 2001, besides the two previous factors mentioned, the decline in EU-15 market shares was also down to the structure of products exported.

In this context, it seems very unlikely that domestic demand could take over from exports to lead expansion in the euro area. The labour market will remain weak next year and the unemployment rate is expected to stabilise but not to decrease. This will limit the expansion of private consumption. However, households will probably benefit from a slowdown of inflation in the course of

2005. Indeed, while the oil price hike is contributing to upward pressure on producer and consumer prices at the end of this year, the year-on-year increase will decline from the beginning of next year in the absence of further rise in oil prices and thanks to the deflationary impact of the euro appreciation. And even if investment rebounded in the third quarter of 2004, uncertainty about the economic outlook will not help to spur investment outlays in the coming quarters.

As a whole, after the modest rise observed in the third quarter, the euro area GDP is expected to increase only slowly in the fourth quarter. Growth momentum could remain slightly under potential growth in the coming quarters. The euro area GDP is expected to have grown by 1.8¹% in 2004 and to be up 1.6% in 2005. In the UK, economic growth will remain substantially stronger, while real convergence will continue in the NMS. However, persistent external imbalances remain in most countries of the region and the slow fiscal consolidation may cause a delay in the euro-area accession of the three largest economies of the region (Poland, Czech Republic and Hungary).

In this context, what can economic policy do in the euro area? First, as inflationary pressures observed recently are only transient, it would be better if ECB postpones any upward adjustment until mid-2005. The appreciation of the euro and probably an increase in long-term interest rates in the wake of a rise in US long-term rates would contribute to tighten monetary conditions. A cut in short term interest rates could be necessary if the activity slowdown is more pronounced than the Euren forecast. But it is unlikely, as US interest rates would be on the rise in 2005. A relatively relaxed monetary policy is also necessary to allow a reduction in fiscal imbalances. On the one hand, because of rather weak economic growth, the business cycle will not contribute a lot to reduce fiscal deficits, especially in the big three countries (Germany, France and Italy). On the other hand, a reduction in fiscal deficits is needed as one or two more years of high deficit will aggravate the debt burden and thus reduce further the room for manoeuvre for fiscal policy in the near future.

If oil prices begin to decrease and the euro stabilises as expected at the end of 2005, the slowdown of the euro area economic growth could only be temporary. In that sense, the business cycle is probably not mature (for instance business investment has just began to increase and employment has remained weak until now). Nevertheless, the euro area will face an enormous challenge in the coming years. Fiscal deficits will have to be reduced, while the global cycle is probably entering its downward phase. It must be stressed that this squeeze on economic policy is the consequence of probably too low potential growth, which is assessed to be around 2% per year by international

¹ An extra working days effect will increase GDP growth by 0.2 point in 2004.

organisations. Partly, this is the result of ageing population and stagnation in labour force, which explains around one percentage point of difference between the potential growth in the US and in the euro area. But this cannot be changed overnight. The only way for the euro area to grow more rapidly is thus to enhance productivity. Some recipes are well known to improve productivity and are widely admitted among observers: boosting investment in the IT sector, increasing research R&D expenditures are some of them. Emphasis must therefore be put on that point for the sake of European growth.

Table 1.1 Main features of the forecast

<i>Percentage change unless otherwise indicated</i>			
	2003	2004e	2005f
World trade	5.1	9.7	7.0
Oil price (Brent/b)	28.7	37.8	42.5
GDP growth			
- United States	3.0	4.3	3.4
- Japan	1.4	2.9	1.4
Euro area			
- GDP growth	0.5	1.8	1.6
- Inflation (HICP)	2.1	2.1	1.9
- Unemployment rate (%)	8.9	8.9	8.8
UK Economy			
- GDP growth	2.3	3.2	2.7
- Inflation (HICP)	1.4	1.4	1.8
- Unemployment rate (%)	3.0	2.7	2.5
New EU member states			
- GDP growth	3.9	4.9	4.6
- Inflation (HICP)	2.0	4.0	3.3
- Unemployment rate (%)	13.6	13.6	13.0

e: estimate; f: forecast

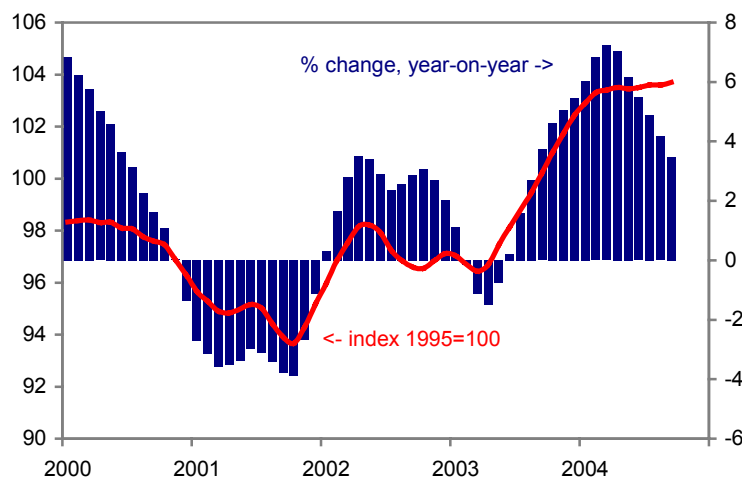
THE INTERNATIONAL OUTLOOK

Some signs of deceleration

The world economy appears to be decelerating during the second half of 2004, after reaching a cyclical peak around the second quarter of this year.

In fact, as can be seen in graph 2.1, the Composed Leading Index elaborated by the OECD, which collects leading indicators for the main developed economies, shows a declining path in terms of annual growth rates after the second semester of 2004.

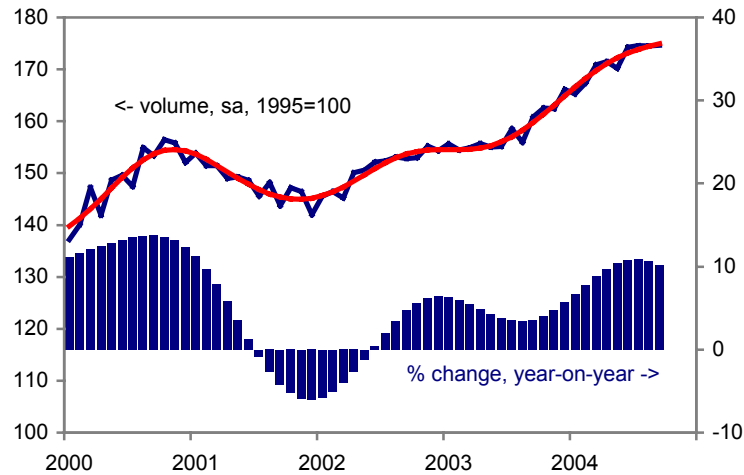
Graph 2.1 OECD Composite Leading Indicator



Sources: EUREN, OECD data

The decline of global activity has been mirrored by the growth rates of world trade, which after showing strong growth close to 10% during the first months of the year, seems to be losing momentum in the second semester, according to the figures collected in the COE world trade indicator portrayed in graph 2.2.

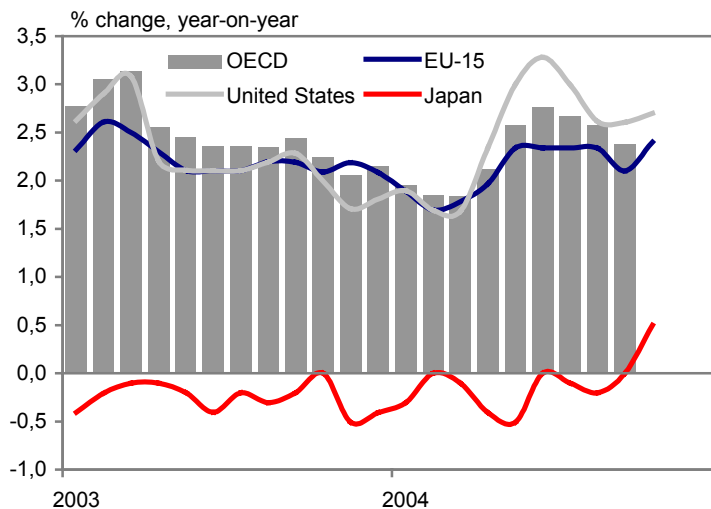
Graph 2.2 World Trade (COE's indicator : world imports in volume terms)



Source: EUREN

At the same time, that deceleration in activity has been accompanied by a slight moderation in inflation rates that, after the oil price shock induced a pick-up turn during the first months of the year, has been showing a declining path in the third quarter. Nevertheless, the more recent figures have been less optimistic, and for the three biggest economies, (Japan, US, and EU) the October figures and the first estimates for November show rates slightly higher than in previous months; a small increase of inflation rates in the forthcoming months should not come as a surprise.

Graph 2.3 Inflation rates



Source: EUREN

Inflation trends are still on doubt

These trends of economic activity and inflation rates have been accompanied by an Euro appreciation against dollar that seems to have no ceiling, and that has put the \$/Euro exchange rate very close to its historical records.

On the commodity markets side, the demand pressure coming mainly from East Asia has pushed prices up, not only for crude oil, but for most raw materials and energy (some of these other commodities like coal, tin, steel, copper or nickel, have increased their prices even more than crude oil in 2004). Some of these commodity prices, including crude oil, have already started to show some signals of deceleration in recent months.

In this context for growth and price changes, monetary policy has remained constant in the euro area and the ECB has not changed interest rates.

On the contrary, US Federal Reserve has increased the intervention rates from their exceptionally low levels at the beginning of the year to slightly less expansionary values, closer to the European ones, at the end of the year.

Taking into account these recent developments, the EUREN institutes have made new assumptions about the external environment in the current forecast, which are shown in the following table.

Table 2.1 Exogenous and international variables

<i>Percentage changes unless otherwise indicated</i>				
	2002	2003	2004e	2005f
World trade	3.3	5.1	9.7	7.0
United States				
GDP	1.9	3.0	4.3	3.4
3m interest rates	1.7	1.1	1.5	2.5
10y Gvt bond yield	4.8	4.2	4.3	4.8
Japan				
GDP	-0.3	1.4	2.9	1.4
3m interest rates	0.1	0.1	0.1	0.2
10y Gvt bond yield	1.3	1.0	1.5	1.8
US dollar/euro	0.94	1.13	1.25	1.33
Yen/US dollar	125.2	115.9	107.7	104.0
GBP/euro	0.63	0.69	0.68	0.70
Oil price, Brent, US\$/barrel	25.0	28.7	37.8	42.5
Percentage changes	2.5	14.9	31.7	12.4

e: estimate; f: forecast

Sources: IMF, OECD, EUREN forecasts for 2004 and 2005

Slight deceleration forecasted for 2005

Looking at the table, the EUREN network forecasts a small deceleration of the activity growth rates that affects both the real growth rate of GDP in Japan and the US, and the world trade volume.

For the world trade volume, a decrease of almost two points is expected for 2005, when the growth rate is forecast to be around 7%, coming down from a 9.7% rate estimated for 2004.

A very significant share of this growth reduction for 2005 is expected to come from the Chinese economy and consequently imports growth for China will go down from the very high 30% rate reached in 2004. For this reason, the final impact of world trade deceleration on real GDP growth rates should be higher in the Japanese economy than in the US, as a result of the higher dependence of Japan growth with respect to China imports.

As table 2.1 shows, while the US GDP growth rate forecast for 2005 would be a bit higher than in 2003, just 0.9% point below the expected rate for 2004, for the Japanese economy the estimates for GDP growth in 2005 are 2.3% points below the 2004 values. The Japanese economy should return to a quite low growth level after the upsurge in 2003/2004.

As for prices, the forecast scenario shows a progressive decline of crude oil prices that could go down from the highest levels reached at the end of 2004 to somewhat close to 40\$/bl. (Brent terms) at the end of 2005. This evolution yields an additional increase in the average annual price for next year of around 12%, which is in any case just one third of the expected rate for this year (32%).

Inflation could come down

As a result of this oil price evolution, joint to a similar moderation in other commodity markets, the above-cited moderation of the activity growth rates and the small increase forecasted for interest rates, inflation rates are expected to come down in 2005.

Last but not least, the exchange rate of the US dollar against the Euro is expected to maintain the dollar weakness observed during the last months. The EUREN forecast assumes that the exchange rate will go up to levels around 1.35 \$/Euro or even more for the coming months and then stabilise in a technical level of 1.30 \$/Euro.

Box 2.1 The COE leading indicator for the United States

The COE leading indicator for the United States is used to anticipate the next economic downturn. Since July 2004, the index has climbed over the first 60 threshold, which indicates a possible economic slowdown within the next nine months. Most of the components contribute to that evolution: an accumulation of inventories in the industrial sector, a progressive worsening of household and business surveys and a significant narrowing of the interest rate spread. In November, the COE index stands at 77,7, which is very close to the 80 threshold which would represent, if it is passed, a signal with a strong probability of an economic downturn in the coming three months. In that case, the year-on-year growth rate would come back under the trend growth rate estimated at 3% today.

Components of the COE leading indicator for the United States

The Conference Board's Consumer Confidence expectations Index

The Manufacturing ISM index

Inventories of manufactured goods

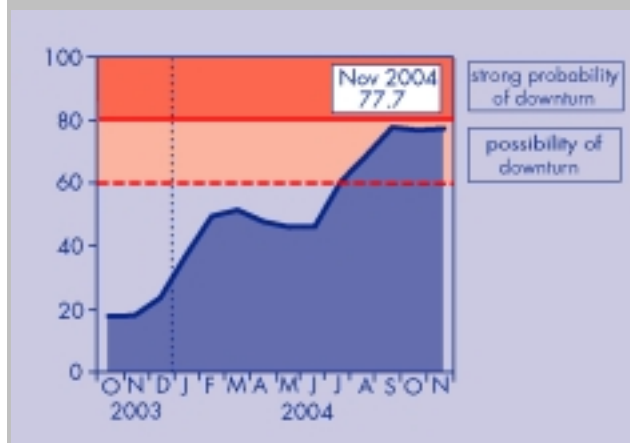
Privately-owned housing units authorised by building permits

Standart & Poor's Index

Interest rate spread

Graph B-2.1 Growth cycle leading indicator

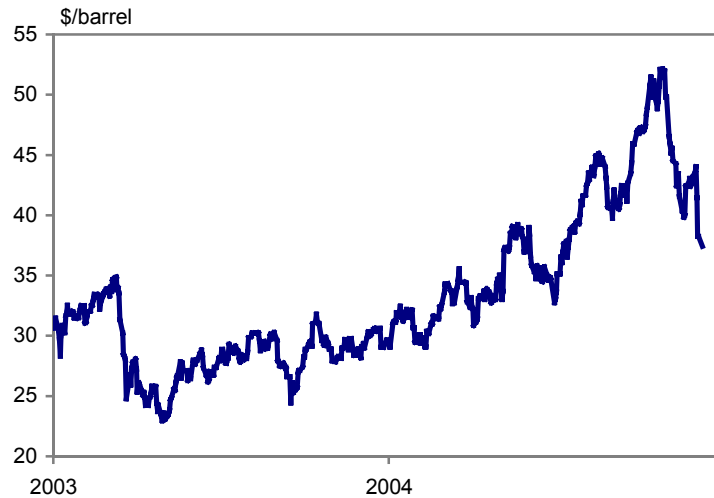
Search of the next peak



Source: COE

The main uncertainties about developments in the world economy in 2005-2006 concern the price of oil and the exchange rate of the US\$ with other currencies, and specially with the Euro (this is why a special analysis on the impact of higher oil prices and stronger euro has been included in the euro area forecast chapter). As for the price of oil, the tensions observed during the first half of 2004 are now decreasing as reflected in the crude oil futures.

Graph 2.4 Oil prices (Brent)



Source: Global Insight

Oil markets would reach a new equilibrium

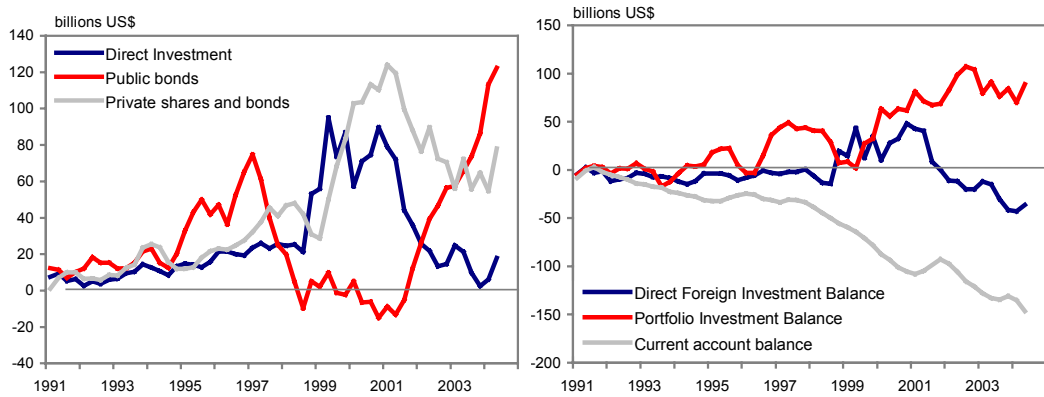
It is now clearly assumed by the markets that the growth of demand had been underestimated, mainly due to the evolution of China, but that supply was indeed ready to meet the challenge, using OPEC extra-capacity.

The new equilibrium price is at a level probably below \$40 for Brent and it may take some time before the full supply response takes place and stocks are again full, but it is now understood that it is unlikely that Brent will again move above the 50\$/bl. ceiling. At the same time, the disruptions in the market have been shown to have relatively small effects on prices, and the fears of serious negative real impacts have started to dissipate. The EUREN scenario sets the price of Brent at a 42.5 \$/bl. for 2005 on average, while for 2004 the average is computed at 37.8 \$/bl. As for the dollar, on the contrary, the tension continues to increase. It is well known that the US has a current account deficit of sizeable dimensions (some 5% of GDP) and that a loss of value over 40% against the euro has not helped close his deficit. The fact is that national saving in the US is still low and that foreign savings are compensating for that, being the main source of the current account deficit. Up to now, the financial markets continued investing in the US so that the dollar at times even faced excess demand.

It could be that these foreign savings are attracted by higher returns offered by long term American investment projects, but this seems unlikely: foreign direct investment in the US continues to decline and financial investment in the stock exchange and in real estate is not sizeable enough. Most of the current account deficit is presently financed by foreign purchases of Treasury bonds.

Graph 2.5 Financing the US

**US
disequilibrium
financed by
foreign
savings**



Source: EUREN

The buyers of these bonds help to cover at the same time the public fiscal deficit and are confident that the value of the dollar will remain constant, at least in relation to their own currency. They come mainly from Japan, China, other Asian countries and OPEC, and are relatively uninterested on the development of the Euro/\$ rate, as most of their economic foreign interest (both for trade and assets) are directly priced in dollars.

The operators that finance the US deficits may miss profitable operations when the Euro moves upwards but they seem to be more concerned by the danger of an eventual appreciation of their own currency against the dollar, should their eventual move out of the dollar zone contribute to an overall depreciation of this currency.

Of course, this type of reasoning has little sense for private operators who are expected to look for profit maximisation, but the bulk of the funds now financing the US current account deficit comes from foreign central banks and other public bodies that are using portfolio criteria including national economic and political considerations. The financial investment strategy of a public bank is radically different from those of private banks.

**Nobody
likes a
weaker
dollar**

The situation is particularly obvious with China as this country is enjoying rapid export-led development, with an undervalued exchange rate that is both stimulating exports and attracting foreign direct investment. Because of the importance played in the relation with the American economy, there is a national interest in keeping stable the yuan against the dollar and supporting American economic growth. The value of this national interest is higher than the possible short-term financial gains from a more aggressive strategy of national reserves management.

Japan has the same interest in preserving a stable rate ¥/\$, and is well aware of the importance of keeping a fast growing Chinese economy that stimulates its exports and its industrial production.

The same considerations apply to the rest of Asian countries that are delocalising part of their production capacities into China, where wages are lower and can be expected to remain so for years to come (given the continuous inflow of new workers from agriculture).

We have therefore a virtuous circle in which all the partners are mutually interested in taking advantage of the growth of China, to finance their own growth. In this context the dollar is much stronger than the direct reading of the current account deficit would indicate, as many relevant countries are fully committed to preserve its value and are satisfied with the present state of affairs, that is the twin deficits in the US. Furthermore, the idea of a soft-landing is imbedded in this virtuous circle, as fast growth in China will progressively be more oriented towards internal demand, in parallel with a smooth change in the US towards higher savings at increasing income levels, confirming that the debts (private and public) have been correctly used to push investments and allow growth returns to repay them. The theoretical propositions of the overlapping generations models, that continuous indebtedness can bring higher growth paths, are finding an unexpected confirmation in the current world (US) situation.

The new stability of the international monetary system relies in a dollar order built around Asia and the United States, the two engines of current world economic growth.

The dollar is still in a hegemonic situation

The role of the Euro and the EU appears to be rather marginal; it is true that the Euro is slowly gaining importance as a reserve currency, or that the EU, with its broadening and deepening strategy, gains further weight in the world economy, but these evolutions do not affect the virtuous circle of growth in the Pacific. Somehow the EU seems to be divorced from the new American driven process of globalisation. The EU is apparently dropping out of FDI projects and is losing interest in stock exchanges.

At the present moment, with the strength provided by the virtuous circle, the dollar and the US are clearly in a hegemonic economic situation; should the Euro/\$ rate decrease we should be speaking of an appreciation of the Euro rather than of a depreciation of the \$, even if the cause is ultimately to be found in the excess of dollar liquidity.

The situation can be described as a “dollar trap”. Any radical depreciation of the dollar would mean an important loss of wealth for owners of US\$ denominated assets.

The Central Banks are playing a dangerous game and any shift of reserve strategies against the high dollar risk may drive a collapse of this currency.

In this context of extreme uncertainty, when after crossing the 1.30 technical barrier, the \$/Euro rate seems to be moving out of any reasonable range, EUREN has adopted some kind of “technical” forecast around the present level: 1.33 \$/Euro as average for 2005, going to values close to 1.30 \$/Euro at the end of next year.

This is only an indicator of the fact that at the present stage of our knowledge the rate may be anywhere between 1.10 and 1.50 during next months, and that the market has left the economic arena and moved to the political sphere.

Box 2.2 How much would a significantly stronger Euro hurt the euro area economy?

Although EUREN's central forecast does not envisage a sustained slump in the dollar, this is clearly a major downside risk to the forecast. At the moment financial markets are focussed exclusively on the US's massive current account, and budget deficits, ignoring the relatively weak growth performance of the euro area. With many commentators suggesting the dollar needs to lose another 30% of its value to bring the US current account down to a sustainable level, this note illustrates the likely impact of a further 30% rise in the Euro against the dollar, using the Oxford Global Model. We assume (for simplicity) that emerging Asian countries maintain their current exchange rates against the dollar – clearly both these economies and the US have a vested interest in the prevailing situation, even if Asian central banks might start to worry about potential capital losses on their dollar assets. In any case, given the structure of trade, it is not clear the euro area would gain a great deal if emerging Asian currencies revalued in line with the Euro. We also assume Japan is able to confine its appreciation to around 10%.

The “benign devaluation” case indicates what may happen if the dollar fell to around \$1.70 to the Euro in 2005. In this benign case, we assume the US is able to hold short-term interest rates down, rather than raising them as in the central forecast. Inflation does pick up (although there must be a chance that this is overstated given the lack of pricing power enjoyed by firms). Consumption falls because of the loss in purchasing power and we believe the Fed would be reluctant to compound this by raising short-term rates aggressively. The story behind these projections also recognises the upside risks to the US economy from faster growth in business investment, driven by

the healthy state of the corporate sector and low interest rates. Consequently, US growth may even be slightly higher than base in 2005 and 2006, while the current account improves by around 1.2% points of GDP. The euro area of course suffers from the loss of competitiveness, although the impact is mitigated slightly by lower ECB interest rates – however, we assume rates would not go lower than 1½%. Around ½% point would be knocked off GDP growth in the first year.

What would happen in a less benign case? Clearly it may be impossible for the Fed to keep US rates down and this would have repercussions elsewhere. In the scenario outlined above the US savings ratio stays at its current 0-1% levels but suppose instead that it jumps to 4% as consumers decide they need to save more. In this case, the US economy would suffer a sharp and fairly severe recession, with 2% knocked off GDP growth in 2005 and 4% in 2006. With around 15% of euro area exports going to the US, the impact on Europe would also be more severe. Around 1% point would be knocked off growth in both 2005 and 2006. The impact on the US current account would be positive to the tune of 2% of GDP in 2006 in this scenario.

Overall, the model suggests that a sizeable dollar depreciation, confined mainly to the Euro, would make a significant dent in the US current account deficit. And if the ECB was willing to step in and act decisively, the impact on the euro area economy could be mitigated somewhat. However, exchange rate movements are not the only means by which the US current deficit could be reduced. Shifts in relative domestic demand (mainly consumer spending) play a major role in both scenarios presented here. Unfortunately, a retrenchment by US consumers would more than halve euro area growth next year. The most benign solution to the US current account “problem” would be stronger spending in the euro area and elsewhere – but this looks unlikely to happen.

Table 2.2 Impact of a 30% appreciation in the Euro against the dollar
% diff from base (GDP,CPI), % pt diff (interest rate), % pts of GDP diff (current account)

	US				Euro area			
	GDP	CPI	Interest rate	Current account	GDP	CPI	Interest rate	Current account
“Benign devaluation”								
2005	0.2	1.4	-1.1	0.6	-0.5	-1.0	-0.6	0.2
2006	0.9	4.1	-1.6	1.2	-0.5	-2.0	-1.9	-0.3
“Hard landing”								
2005	-2.0	1.8	0.0	0.8	-0.9	-0.7	-0.2	-0.8
2006	-6.1	2.9	0.0	2.0	-2.0	-1.9	-1.4	-1.2

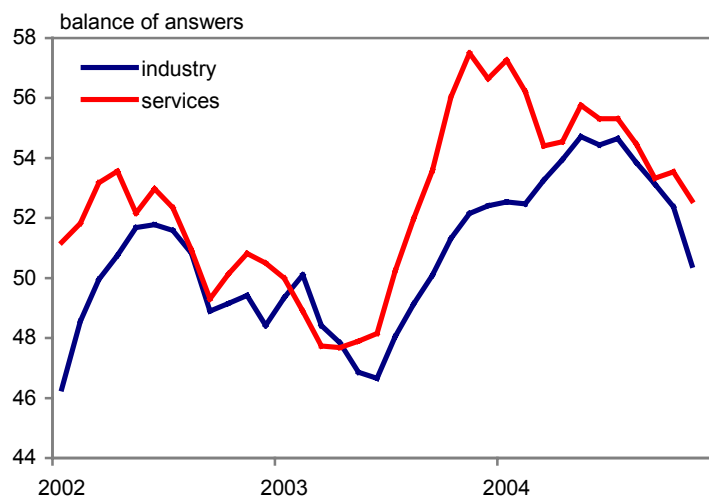
THE OUTLOOK IN EUROPE

1. Recent developments in the euro area economy

***Business
climate has
deteriorated
since last
summer***

After six months of stagnation, economic activity has been on the rise from mid-2003 in the euro area. However, signs of weakening have appeared since last summer. GDP increased only by 0.3% in the third quarter of 2004, a much lower rate than in the two previous quarters (respectively 0.7% and 0.5%). Recent surveys point to a slowdown in economic activity. The purchasing managers' index (PMI) for manufacturing industries fell again in November, dropping to a fourteen-month low (50.4). For the first time in sixteen months, the order book component was below the 50 threshold signalling a contraction in orders. The industrial confidence index released by the European Commission has followed a less negative trend in recent months, but it stopped showing signs of improvement in early summer. In the service sector, signs of weakness have also appeared recently, especially on the European Commission's measures. In this context of lower expansion of activity in industry and services, the construction sector is an exception, as confidence indicator has continued its slow upward trend in November. However, this global trend covers very different situations across countries, with Germany - where this sector is struggling with a structural adjustment- and Spain -where activity in construction is buoyant- at the two extremities.

Graph 3.1.1 PMI index



Source: Global Insight

The Belgium national bank survey, which is considered as a leading indicator of global activity in the whole euro area, has also shown signs of weakness recently.

Box. 3.1.1 The Belgian business cycle indicator

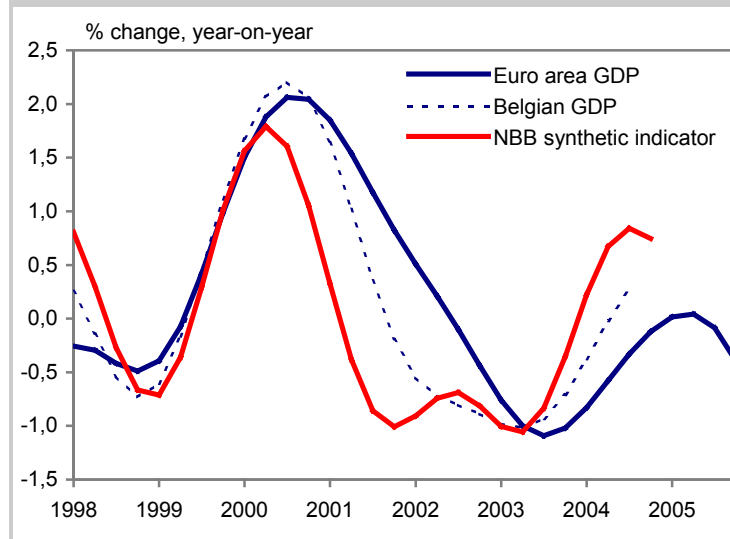
The Belgian business cycle and the business survey indicator of the National Bank of Belgium (NBB) can both be considered as leading indicators of the euro area GDP cycle, which they lead by respectively one and two quarters on average.²

In the second quarter of 2003, the NBB business cycle indicator reached its trough and provided robust signs of a recovery from then onwards. After a prolonged period of bottoming out, the Belgian business cycle also started to improve in the third quarter of last year. The upturn in the euro area business cycle began one quarter later, but it was much less pronounced than in Belgium. This was also seen in qoq growth rates of GDP, which have been higher in Belgium than in the euro area since the beginning of 2003. Increasing oil prices and worries about the strength of Belgian export markets have caused a decline of the cyclical component of the NBB synthetic indicator during the last quarter of 2004. Although the Belgian business cycle has not yet shown any signs of weakening, quarterly economic growth rates in the euro area have already fallen to 0.3% in the third quarter of this year. In

² 'The Belgian business cycle as a leading indicator for the euro area', Euren Spring Report 2002, pp. 65-70

the current EUREN forecast, quarterly economic growth is projected to remain around 0.4%, which is slightly below trend growth. Consequently, the euro area business cycle should level off during the first half of next year and start to deteriorate from the third quarter onwards, roughly two to three quarters later than the cyclical component of the NBB synthetic indicator.

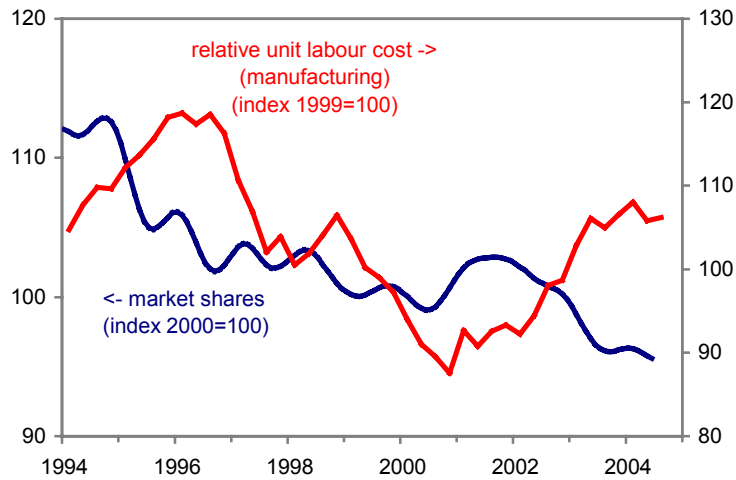
Graph B-3.1.1 Normalised cyclical components of euro area and Belgian GDP, and NBB business survey indicator



Sources: Eurostat, Belgian Institute of National Accounts, National Bank of Belgium, Euren, Federal Planning Bureau

In the first half of 2004, exports were clearly the main engine of economic growth, boosted by strong world demand and a stabilisation in price competitiveness. Exports of goods and services in volume terms slowed in the third quarter, rising only by 1.2% compared to previous quarter. This mainly reflected a deceleration in global demand, as price competitiveness had not worsened on the period despite a slight appreciation of the nominal effective of the euro. According to the European Commission survey, export order books have continued to slightly deteriorate in the manufacturing industries in November.

Graph 3.1.2 Market shares¹ and competitiveness of the euro area²



Source: European Commission, ECB; Euren calculations –

¹ Euro area exports/world demand addressed to the euro area (in volume terms, intra-zone trade excluded)

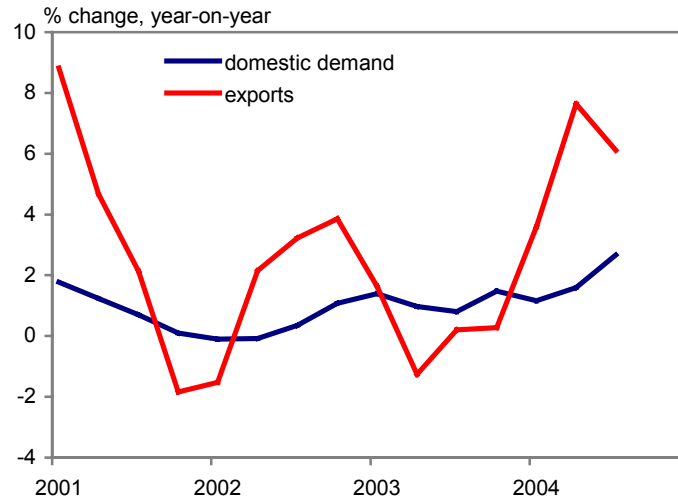
² Relative unit labour costs in the manufacturing industries

Moreover, as a consequence of higher oil prices, the euro area trade balance (extra zone) has deteriorated since the beginning of this year (€4.2 bn in the 2004Q3), nearly halved compared to 2004Q1. This is the consequence of a sharp rise in import prices.

Lower exports ...

The gap between exports and domestic demand has been steadily increasing since mid-2003, the economic upswing being mainly driven by exports. In spite of a rebound in the final quarter, domestic demand rose only by 2.7% in the year to 2004q3 while exports increased by 6.1%.

Graph 3.1.3 Domestic demand and exports



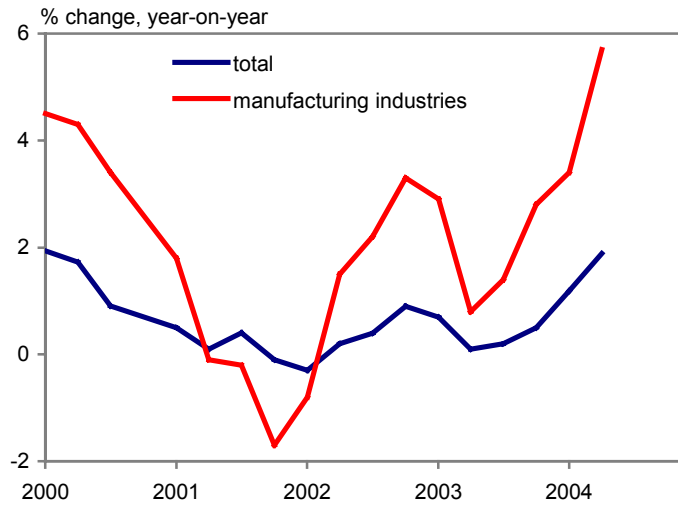
Source: Global Insight

According to national accounts, private consumption remained almost flat in the third quarter. Those data confirmed information earlier provided by retail sales and car registrations. Moreover, the latter have remained weak in October. Besides, the EC survey of retailers dropped in November, suggesting no improvements in households spending in the coming quarter.

... and no acceleration in domestic demand

Two main reasons can be identified to explain the weakness of private consumption. First of all, labour market developments remain very disappointing up to now. In the second quarter, the number of persons employed grew only by 0.1%, mainly thanks to a rise in self-employment as the number of employees stagnated. While services and construction created jobs, industry displayed again a reduction in staff. The employment component of the PMI index contracted sharply in October and November in the manufacturing industries and has begun to weaken in the service sector. Those developments in the labour market can be partly explained by rather low economic growth. But they also cover a rise in productivity. Indeed, since the beginning of the decade, labour productivity had only risen marginally. In other words, employment had been resilient to the slowdown in economic activity. The pick-up in productivity observed since the end of 2003 can therefore be considered as a compensation of previous trends. This is also the consequence of what is generally described as the traditional cycle of productivity, which mentions that employment is lagging behind economic growth because of adjustment costs. Labour productivity per person employed was therefore up by 1.9% in the second quarter of 2004 compared to the same period of last year, and even by 5.7% in manufacturing industries.

Graph 3.1.4 Productivity trends

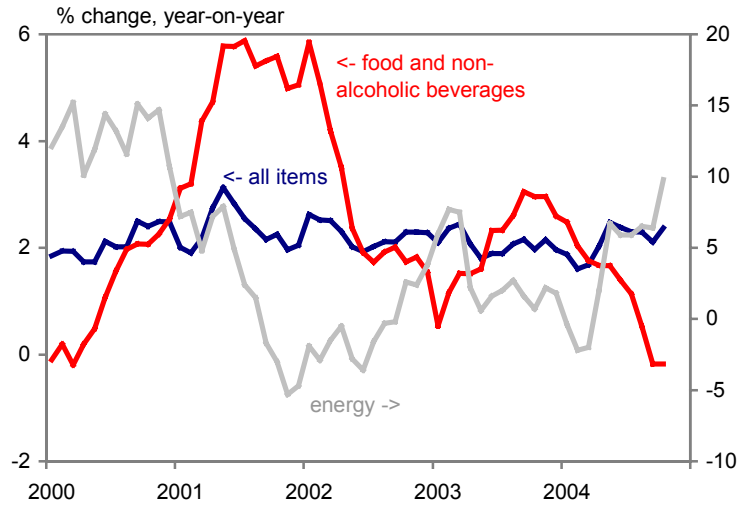


Source: Global Insight

Inflationary pressures

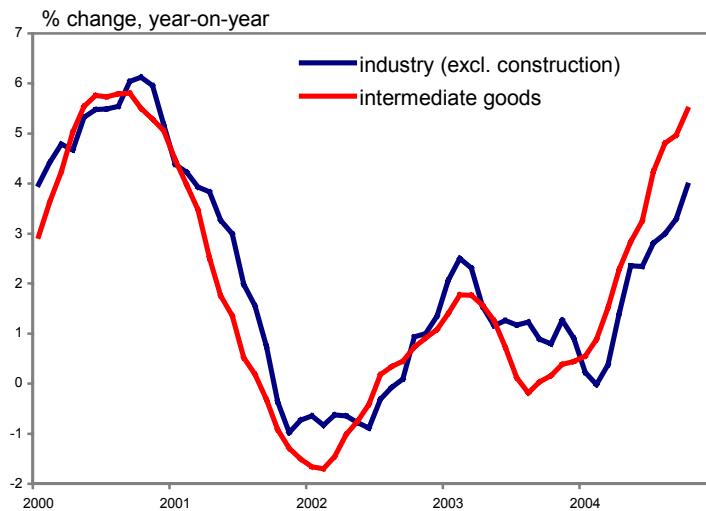
Household purchasing power was also affected by rising inflation, while wage developments remained stable. After reaching a peak in May 2004 (2.5% compared to May 2003), inflation slowed down till September (2.1%). This deceleration was mainly due to the downward trend observed in food prices, which was the result of good climate conditions. But the surge in oil prices led to further acceleration in consumer prices in October (2.5% on a year ago). Meanwhile, producer prices also sped up. They increased by 2.7% in October 2004, as compared to October 2003, in industry (excluding the energy sector). During the same period, intermediate goods prices grew by 5.5%, signalling that the risk of transmission of the rise in oil and other industrial raw material prices to consumer prices cannot be ignored. However, the appreciation of the euro will soon contribute to calm down inflationary pressures. As a consequence, as early as November, in the context of a temporary relief in oil prices, the flash estimate of euro area inflation revealed a drop to 2.2% in the year to November.

Graph 3.1.5 Consumer prices (HICP)



Source: Global Insight

Graph 3.1.6 Producer prices



Source: Global Insight

Stability of unemployment

In that context, household's confidence has remained rather subdued, although slightly improving. This is also the consequence of the absence of a significant reduction in unemployment: in October 2004, although absolute figures showed for the first time a fall in the number of unemployed persons, the unemployment rate was still 8.9%, a level that has been unchanged since the beginning of 2003. The only element that has contributed to support private consumption is a rise in credit. Thanks to very attractive interest rates,

the loans to households have been on the rise since the beginning of 2004. This is true for consumer credit (+6.2% in September 2004 as compared to September 2003). But growth was higher for house purchase credit (+9.8%), which were stimulated by dynamic housing markets in some countries (notably France and Spain).

***A rebound
of
investment
in 2004q3
but
uncertainty
on future
trends***

Meanwhile, investment was weak until mid-2004. However, according to national accounts, total investment rebounded at a 0.6% rate in the third quarter compared to the previous quarter. A breakdown of total investment (only available to 2004q2) showed that machinery equipment has begun to recover (+3.5% in 2004q2 on a year ago). It can also be noticed that loans to non-financial corporations has sped up a bit recently (5.2% in October 2004 on a year earlier, compared to 3.3% in March), a trend that could be interpreted as a sign of growing dynamism of investment in equipment. Indeed, more and more firms are declaring they have production constraints. However, this information has to be considered carefully. First, the rate of capacity utilisation is still below the long-term average. Indeed, investment in construction (excluding the housing market) declined again in the first half of 2004. Second, because of the situation of financial markets and low interest rates, firms may have preferred to finance their investments by loans rather by other types of financing. Regarding the housing market, national data show very different situation among countries, with Germany (on the negative side) and Spain (on the positive side) as the two extremes. Since the beginning of the year, housing permits for the whole euro area have stagnated through very erratic month on month changes. As a result, housing construction in quarterly national accounts grew moderately in the first half of this year, while signs of moderation could have perceived in the quarter on quarter developments.

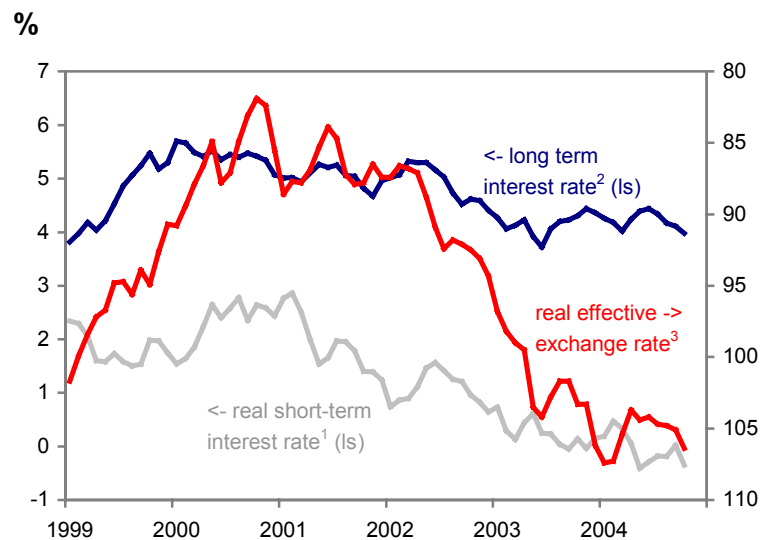
2. EUREN forecast for 2004 and 2005

A - Policy assumptions

Monetary policy : No move before the end of 2005

Monetary policy stayed on track in the second half of 2004. The key interest rate remained unchanged since August 2003. Therefore, monetary conditions in the euro area continued to be favourable (graph 3.2.1). Real short-term interest rates are slightly negative, long term rates remained more or less unchanged. The real effective exchange rate revalued most recently because of the devaluation of the dollar against the Euro, indicating that the inflationary pressure from this source will ease.

Graph 3.2.1 Monetary conditions in the euro area

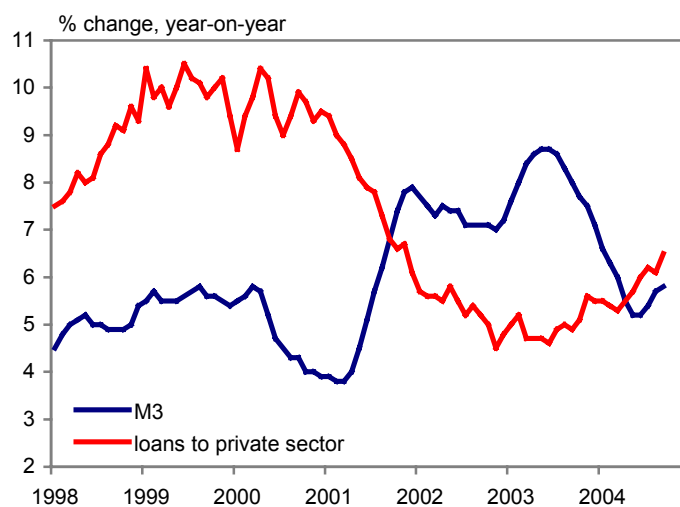


Source: ECB

¹ Deflated with HICP. – ² 10 years government bond yields – ³ CPI-deflated, against 23 countries. Scale inverted.

Some months ago, the ECB changed its tone, stressing the risks for price stability to prepare the markets for a change of the stance of its policy. More recently the ECB's wording became more cautious on interest rates. The slowing of GDP growth in the third quarter suggests that underlying inflationary pressure continues to be low, which is underpinned by the fact that wage increases are still low, despite the oil price hike. Furthermore, core inflation remained unchanged, whereas headline inflation is still above the reference value, but it is expected to come down when energy prices start to fall. In addition, the appreciation of the Euro counters the oil price hike and dampens exports and, thus, economic activity.

Graph 3.2.2 Euro Area – M3¹ and loans



Source: ECB – ¹M3: three months moving average.

However, in the medium term there is an upside risk for inflation, as the monetary analysis indicates that there is still excess liquidity in the euro area. M3 growth picked up again, after having come down to a rate close to the ECB's reference value (graph 3.2.2). Furthermore, loans to the private sector speeded up, suggesting that the favourable monetary conditions have started to work. Therefore the ECB will also be cautious about lowering its key interest rate e.g. to react to the Euro revaluation. For the next months, the EUREN institutes therefore assume that the ECB will leave its key interest rate unchanged. Later in 2005, when growth will speed up again, we expect a slight increase of the key interest rate. Even then, monetary conditions, will continue to be favourable.

Fiscal policy : A need to adjust the deficits ... without breaking economic growth

Public finances in the euro area are in a worse shape than expected in our last report. According to EU commission's latest forecast, four countries (Germany, France, Italy, and Greece) will violate the Stability and Growth Pact, and in another two countries – the Netherlands and Portugal – the deficit ratio comes very close to the 3%-threshold (table 3.2.1.). Aggregate public deficit of the euro area will be 2.9% of GDP. For 2005, the outlook is not much brighter. As growth remains rather weak, there will be no cyclical improvement of the budget situation. Germany as well as France have announced reductions in their deficits below the 3 %-margin. However, doubts remain over whether they will be able to do so. International institutions forecast a deficit above 3%. For the euro area as a whole, the EU commission forecasts the nominal as well as the cyclical adjusted deficit to be lowered, which would mean the fiscal policy will take a slightly restrictive stance. As EUREN's GDP forecast is somewhat lower, deficits can be expected to be somewhat higher.

**Table 3.2.1 Stability programs: goals and forecasts compared
(budget balances as % of GDP)**

Countries	Data		Stability Programs		EC		IMF		OECD	
	2002	2003	Dec 2003		Nov 2004		Sep 2004		Nov 2004	
			2004	2005	2004	2005	2004	2005	2004	2005
Austria	-0.2	-1.1	-0.7	-1.5	-1.3	-2.0	-1.2	-1.8	-1.5	-2.1
Belgium	0.1	0.4	0.0	0.0	-0.1	-0.3	-0.2	-0.4	-0.1	-0.4
Finland	4.3	2.3	1.7	2.1	2.3	2.1	2.5	2.5	2.3	2.1
France	-3.1	-4.1	-3.6	-2.9	-3.7	-3.0	-3.4	-2.8	-3.7	-3.1
Germany	-3.7	-3.8	-3 ¼	-2 ½	-3.9	-3.4	-3.9	-3.3	-3.9	-3.5
Greece	-3.7	-4.6	-1.2	-0.5	-5.5	-3.6	-3.4	-3.5	-5.3	-3.5
Ireland	-0.2	0.1	-1.1	-1.4	-0.2	-0.6	-0.3	-0.5	0.2	-0.1
Italy	-2.3	-2.4	-2.2	-1.5	-3.0	-3.0	-2.9	-2.8	-2.9	-3.1
Luxembourg	2.8	0.8	-1.8	-2.3	-0.8	-1.6	-2.1	-2.7	-0.4	-0.8
Netherlands	-1.9	-3.2	-2.3	-1.6	-2.9	-2.4	-3.0	-2.7	-2.9	-2.7
Portugal	-2.7	-2.8	-2.8	-2.2	-2.9	-3.7	-4.1	-4.0	-2.9	-3.0
Spain	-0.1	0.4	0.0	0.1	-0.6	-0.1	-0.7	-	-1.1	-0.1
EU-12	-2.2	-2.8			-2.9	-2.5	-2.9	-2.5	-2.9	-2.6

Sources: National sources, EC, IMF World Economic Outlook, OECD Economic Outlook.

The fact that an increasing number of countries are in trouble with the Stability and Growth Pact (SGP) has fuelled the discussion on revising it. The question is, whether the proposals discussed will really improve the situation. Already in the past, many countries kept their deficit down by creative accounting, which is exemplified by the case of Greece. The proposed revision of the SGP would even broaden the possibilities to interpret it creatively. Using structural deficits as a yardstick to assess fiscal policy – as some propose – would inevitably cause a discussion, how potential growth and the output gap are measured, as both indicators cannot be determined sufficiently accurate. Excluding e.g. investment in infrastructure or education from the calculation of the deficit, as it is proposed by others, would lead to controversies about the definition of investment. In the end fiscal policy must be assessed on the basis of a bundle of indicators. However, this is also possible without changing the pact.

Whether the SGP is reformed or not, a reduction in fiscal deficits is inevitable, as the debt burden is still on the rise in most euro area countries. The best way to escape from the squeeze on fiscal policy in the long run will be to increase potential growth. In the past, consolidation efforts were often to the detriment of growth, as governments found it easier to cut public investment than to reduce consumption expenditure. In future, the “quality” of

consolidation must be improved; i.e. the investment share in public expenditure has to be raised. In the 2005 budgets presented by many countries hitherto, no change in this direction can be seen.

**Germany :
Still in
trouble with
the SGP**

Germany made less progress in consolidating the budget than the government had announced at the beginning of the year. In the end, fiscal policy had a slightly restrictive stance only in 2004. Almost all types of expenditures – once again including public investment – were reduced, indirect taxes raised and tax credits cut. Nevertheless, despite economic recovery, the government did not succeed in reducing the deficit. According to the revised stability programme from January 2004, a deficit of 3 ¼ % of GDP was scheduled. Finally, it turned out to be almost 4 %. This unexpected rise is down to several factors. On one hand, employment has not risen yet in the current upswing, so that income tax is still weak. On the other hand, experience shows that an export led growth causes a modest rise of tax receipts only, as it has no immediate impact on the value added tax that accounts for one third of total tax receipts. Furthermore, gasoline consumption declined due to the rise of oil prices, which led to lower receipts, too.

For 2005, the government has announced a slightly restrictive policy to keep the deficit below the 3%-threshold. On the one hand, income tax will be reduced once more, this time benefiting households with a high income above all. Furthermore, due to the reform of the health sector, the contributions to health insurance will also be lowered. At the same time, some tax credits will be abolished, the electronic toll system for trucks will start operating, and pensioners and persons without children have to pay higher contributions to the compulsory long term care insurance. On the expenditure side, personnel expenditure will be reduced once more and transfers will be cut to reduce the deficit. Furthermore, the government announced plans to reduce the deficit by € 5½ billion euro using measures “not harming the business cycle”; i.e. by capitalizing a part of the pension obligations of the formerly state owned postal service. However, that will only reduce the current deficit, whereas later on additional expenditures are required to pay the interest. Taken these measures together, the deficit will be reduced by 0.2 percentage points of GDP. Under the growth assumption of the government, which is over optimistic in our eyes, this could be sufficient to push the deficit below the 3 % margin. If this will be not the case, the government has announced “additional measures” without having specified anything yet.

**France :
Too good to
be true**

In France, the fiscal deficit should decrease in 2004. Revenues have been accelerating thanks to buoyant activity in the first half of this year. VAT receipts have registered an increase of 7 % during the first nine months of 2004 compared to the same period of last year, this being in line with vigorous private consumption during the first half of 2004. Besides, the government plans to reach its objective to limit the increase of its expenses to 1.9 % for

2004 (which means a stabilisation in real terms). This effort requires a severe slow-down of public wages and public employment. Nevertheless, this improvement of public finances seems to be limited to the central government budget, which has registered a decrease of its deficit of € 5.4 billion during the first nine months of 2004 compared to the same period of last year. However, the situation of the social accounts has worsened. According to official projections, the main budget for social affairs, the “general scheme”, will register a deficit of 14 € billion euro this year compared to € 11.5 billion in 2003. Besides, the deficit of the budget of the unemployment insurance system could reach around € 4.1 billion in 2004. Indeed, the social contributions are not dynamic in the context of a stagnant job market. Moreover, the reintegration in the unemployment insurance system of people previously excluded³, and the large increase of anticipated retirements due to the new reform, has sustained the social expenses despite a slowdown of health expenses. All in all, the public deficit should decrease from 4.1 % of GDP in 2003 to 3.5 % of GDP in 2004.

The picture looks more uncertain in 2005. The stance of fiscal policy will be restrictive. On one hand, the government has announced the suppression of the additional tax of 3 % on the business tax and increased the employment bonus again (*prime pour l'emploi*). But, the cuts on income tax have been interrupted and the rate of the CSG (a social contribution directly levied on wages and financial income of households) has been increased and its base enlarged. Besides, the policy of containing expenses, in particular social transfers, will be maintained. The cyclical impact on the deficit should be quite weak. But EDF will make a one-off windfall payment of € 6.9 billion euro (0.4 % of GDP) to the state to compensate for the cost of the transfer of the company's pension system to that applied to the private sector (due to the partial privatisation of EDF). Therefore, the fiscal deficit could come close to the official objective of 3 % of GDP.

**Italy:
Additional
measures
required to
reduce
deficit**

After the corrective measures of € 7.5 billion euro decided upon last July, the government expects the 2004 deficit to settle at 2.9% of GDP. These measures should reduce expenditures by € 4.2 billion, increase taxes by 1.5 billion euro and insure additional one-off savings obtained through administrative measures, like the expenditure cut “taglia-spese” decree.

For 2005 the government forecasts a deficit of 4.4% of GDP, which is based on the legislation currently in force. Hence, to correct its budget position, the Italian government announced extraordinary budgetary measures of about

³ There had been a collective agreement between the social partners and the government to harden the conditions to get unemployment insurance. As a result, a large number of people were excluded from the unemployment insurance system. Then, due to the social turmoil following this decision, the government decided to reintegrate those people in the system.

€ 24 billion, 17 billions of which should come from structural measures. Within the one-off measures no tax amnesties should be included.

The more controversial point is the Italian government's still undefined plan to cut taxes. The latest proposal is to cut personal income tax (by about € 6 billion) and Irap, a tax on value added of the net income type (by € 0.5 billion). These tax reductions will have to be financed with further government savings. The challenging task of the Italian government is to keep the deficit below the 3% limit while reducing the amount of one-off measures and cut taxes.

The Budget Law for 2005 should be approved by the end of the year. If all the announced measures will be approved, the deficit should be reduced to 2.7% of GDP. For 2004 public debt is projected to remain steady at 106% of GDP, while a slight reduction should take place next year (104.1% of GDP). The long run goal of the Italian government is to reduce the public debt-to-GDP ratio to 100% by 2007. This reduction should be achieved by cutting the stock of debt by about € 25 billion each year, mainly through further privatisations.

**Belgium:
Will a public
deficit
reappear in
2005?**

After four consecutive years of budgetary surpluses, the OECD expects the Belgian public balance to reach a small deficit of -0.1 per cent of GDP in 2004. This means that the general government balance in per cent of GDP should go down by 0.4 percentage points compared to 2003, which is mainly the result of lower revenues coming from one-off measures. Last year, the federal government took over the liabilities of the Belgacom pension fund (the main telecom operator in Belgium), which raised receipts by 5 € billion (1.9 per cent of GDP). This was partially offset by advancing part of the subsidies to the national railway company (0.4 per cent of GDP) for this year to 2003, which lowers expenditures in 2004 by the same amount. The special temporary tax aimed at legalising financial assets detained abroad and having so far illegally escaped taxation is another non-recurrent measure in 2004 which was expected to bring in € 800 million, although it now seems that this target will not be reached. All in all, revenues from one-off measures as well as the primary balance should be roughly one per cent of GDP lower this year than in 2003, which is partly compensated by lower interest charges due to the decline of public debt and historically low interest rates.

The government aims at achieving a balanced budget in 2005. On the one hand public revenues will be negatively affected by the further reductions of personal income taxes and a lower contribution coming from one-off measures. On the other hand, government receipts will benefit from increases of other taxes such as excises on tobacco and fuels. The expenditure side will also be influenced by some counteracting factors: while earlier decided measures to increase budgets in some departments (e.g. justice) are set into practice, other departments have to economise on personnel and operational

costs. It remains however a point of discussion whether a balanced public budget will be achieved without additional measures as most international organisations forecast a small deficit.

**Spain:
Balanced
budget, but
difficult to
achieve**

The new socialist government elected after the March 14th general elections, has presented last September the new budget for 2005, which includes Central Government and Social Security System. As it is stated in the official project the main targets for fiscal policy are a balanced economic growth and keeping of stability across cycle. In order to achieve those global targets the guidelines that lead the new policy are budgetary stability, supporting productivity gains and improving the transparency and quality of the regulatory framework.

Some figures illustrate these policy orientations.

The deficit for the consolidated system of Central Government and Social Security System is expected to remain at a level of 0.2% of GDP, which is very similar to the figure shown in the previous 2004 budget (-0.1% of GDP). Nevertheless, there are some signs that call for a more cautious position, both for 2004 and 2005.

For the present year, some additional expenditure has already been announced by the new government that, according to their own calculations, could put the global public deficit at a level of about -1% of GDP (the main expenditures are the depreciation of an accumulated debt with the regional government of Andalusia and of the public television organisation).

For 2005, the main doubts came from the macroeconomic forecast upon which the budget is based, that estimates a growth rate for the Spanish real GDP of 3%; this seems very difficult to reach. So, in a less expansionary environment the final revenues would be lower, and the fiscal deficit should be a bit higher than forecast. On the productivity gain impulse side, an increase of total R&D expenditures by 25.4% is projected, joint with a 9.1% growth rate for public infrastructures investment, and a 6 % growth rate for education expenditures.

B - Higher oil price and stronger euro: what consequences for the euro area?

In our July 2004 Report we thought that oil prices represented the single major threat to world and euro area's recovery over the next couple of years. We recalled then that recessions in the post-war period had almost always been preceded by large increases in crude oil prices. While higher oil prices may not have caused the recession in each instance, they had certainly contributed

to the downturns through a reduction in disposable income and/or a tightening in monetary policy in response to rising inflation. While warning that, from an historical perspective, current oil prices weren't at extremely high levels, we had, however, concluded that a \$10 a barrel permanent increase in oil prices would have had a significant impact on the euro area's economy and estimated the eventual GDP loss of 0.3% and 0.4% respectively in a two-year simulation period. Higher oil prices since 1999 contributed to the global economic slowdown in 2000-2001 and have certainly affected the successive cyclical upturn. It can now be safely assessed that world GDP could have been approximately one percentage point higher in the last three years had oil prices remained at the levels they were at the end of 2001.

On the whole, factors affecting and pushing up oil prices are today the same as they were last July and can be briefly summarised as the following: 1) Geopolitical tensions in the Middle East, Iraq in particular, and in other troubled regions of the world such as Nigeria; 2) Stronger-than-originally-expected demand from the world most dynamic economies like the United States, China and the rest of the Pacific Area which the oil exporting countries had not fully anticipated. Rapid industrialisation of some large economies have notably raised energy demand above production capacity, especially for high-grade crude oil; 3) Meteorological conditions in oil exporting countries (such as the late-summer hurricanes in the Gulf of Mexico) and in oil importing countries (winter or summer temperatures in developed countries, in particular); 4) The Yukos vicissitudes in Russia.

Oil prices rise : A negative shock on world economy

Oil price effects can be either immediate (impact or first-round effects) or delayed (second-round effects). Both impact and second-round effects are today smaller than in the past since most industrialised economies are today less energy-intensive and, with the sole exception of the United States, less energy-dependent than they were during past oil shocks. Market conditions (in a more competitive market, firms have more difficulties in raising prices) and cyclical conditions (when demand is high it's easier to raise prices) can also significantly influence the transmission of oil price increases to producer and consumer prices. Second-round effects can, on the other hand, develop when market operators perceive oil price increases as permanent and consequently tend to modify their expectations.

The overall effect of an oil shock on the world economy is clearly negative. In fact, while oil exporting countries are bound to gain from oil price increases, given the size of their economies and the lag before their greater oil revenues are reinvested in the industrialised countries, the increase in their GDP will only have a mildly positive effect on global growth. Furthermore, in the longer run, part of the oil-exporting countries gain will be offset by losses generated from lower demand for both oil and non-oil products from their trading partners. Moreover, since oil price increases can often lead to central banks'

interventions, the overall long-term consequences of an oil price shock may be the sum of both the (direct and indirect) effects of the shock itself and those stirred by eventual policy responses to it. For instance, after the 1973-1974 oil shock, the Fed implemented strongly expansionary monetary policy measures in order to limit the shock's negative impact on economic activity. The federal funds rate was reduced to 6% in 1975, from 11% in mid 1974, resulting in negative real interest rates. The consequence of this policy was a price increase that subsequently forced the Fed to increase interest rates again, causing a far deeper recession than originally expected. In later oil shocks, in 1979-1980 and in 1990-1991, the Fed and other central banks acted quite differently, raising interest rates in order to contain inflation.

***The dollar
depreciation
is
threatening
Europe***

With respect to last July, another major factor, the dollar depreciation, is today threatening European recovery. The dollar is undergoing a phase of sharp depreciation. Notwithstanding the wide positive differential in growth rates and productivity between the United States, on the one hand, and the euro area and Japan, on the other hand, this devaluation addresses the need to reduce the American current account deficit, which currently exceeds 5% of GDP. So far, the euro area has borne most of the burden of the adjustment. Asian central banks have, in fact, made huge purchases of American government securities in order to prevent or mitigate the appreciation of their currencies with respect to the dollar. In particular, Japan is the largest foreign investor in American government securities, having accumulated a portfolio of over \$720 billion, approximately 40% of the total held by non-Americans. China comes in second place, albeit far behind the Japanese economy, with a share of 9.4% of the total. By comparison, the percentage of American government securities purchased by Italy, Germany, and France totals around 5%. If Japan, China, and the newly industrialised economies of Asia continue intervening in foreign exchange markets, there is a real risk that the dollar would decline even further with respect to the euro, thus undermining the fragile economic recovery in the euro area. Although the US seem quite content with an undervalued dollar, which would not only help in their effort to readjust current trade imbalances but would also make the repayment of foreign debt advantageous, a weak dollar would only partially reduce the American current account deficit. Rather than limiting US demand for foreign goods and services through higher import prices, a co-ordinated effort aimed at sustaining foreign demand for US exports through higher growth in Europe and Japan would certainly be a better solution (and one with fewer excessive negative repercussions on the rest of the world). Other than in East Asia, however, growth does not appear to be strengthening anywhere else. The euro area, in particular, which has been so far almost entirely dependent on the foreign sector, is seeing its recovery prospects deeply threatened.

A global negative impact on euro area GDP...

We have tried to assess the combined effects of permanently higher oil prices and the dollar depreciation on the real economy of the euro area. We have also tried to evaluate if the dollar depreciation is in itself sufficient to eliminate the US current account imbalance. In order to do so, we have applied today's assumptions on oil prices and exchange rates to the simulation that we ran last July and measured the difference in euro area's growth between the simulations. The exercise would thus also give us the opportunity to see what would have been our July 2004 forecast if we had then assumed today's oil prices and exchange rates. Table 3.2.2 presents the different assumptions in each of the simulations: assumptions for exchange rates and oil prices in our baseline simulation are exactly equal to those assumed in our July forecast while those used in our alternative simulations are the ones that we are assuming in our current forecast. In Sim1 short-term interest rates are fixed at their baseline values and are expected to rise from 2.1% in 2004 to 2.45% and 3.5%, on average, in the following two years; in Sim2 they are allowed to react and adjust to the new exchange and inflation rates. In both hypotheses, inflation would remain firmly under control as the impact of higher oil prices is almost entirely compensated for by the downward pressure exercised by the appreciating euro. In the first hypothesis, however, pressured by higher oil prices and their possible effects on inflation, the European Central Bank (ECB) tends to follow the Fed and pursues a non-accommodative monetary policy preventing interest rates from adjusting to the new situation. The decrease in imported inflation caused by the appreciation of the euro would lead, in this case, to higher real interest rates with dampening effects on growth. GDP would drop by a tenth of a point in the first year and would be six tenths of a point lower than in the baseline in 2005. GDP would be 1.3% lower in the third year. In the second hypothesis, the ECB would not follow the Fed in raising interest rates which remain, therefore, substantially unchanged with respect to today's rates (at around 2-2.3%).

... but ECB attitude is key

The difference in growth with respect to the previous simulation is particularly striking in the third year when the negative effect of oil prices on inflation wanes and the positive effect of low real interest rates is being felt. The loss in GDP would be substantially the same as in Sim1 in 2005 but would be much lower in 2006 (-0.8% rather than -1.3%). Our July forecast for euro area's GDP growth in 2004-2005 (2% and 2.4% respectively) should have been 0.1 and 0.6% percentage points lower had we assumed then today's oil prices and exchange rates. As shown in table 3.2.2, inflation is not a problem in either simulation. In Sim2, the expansionary effect of monetary policy is not such as to create excessive inflationary pressure. The ECB behaviour is, therefore, crucial if the combined negative repercussions of the euro appreciation and oil price increases are to be limited.

Table 3.2.2 Assumptions and simulations results

Exogenous assumptions						
	Dollar/euro		Yen/dollar		Oil prices	
	July 2004	Dec. 2004	July 2004	Dec. 2004	July 2004	Dec. 2004
2004	1.21	1.25	110	108	32	37,8
2005	1.15	1.33	113	104	28	42,5
2006	1.12	1.30	115	105	25	33.5

Higher oil prices and dollar depreciation (% difference from baseline)						
	GDP		CPI		Interest rates	
	Sim1	Sim2	Sim1	Sim2	Sim1	Sim2
2004	-0.1	-0.1	0.1	0.2	0.0	0.2
2005	-0.6	-0.7	0.4	0.4	0.0	-0.2
2006	-1.3	-0.8	-0.3	-0.4	0.0	-1.7

C. Forecast summary

After a rather disappointing third quarter, early information doesn't suggest a marked improvement in economic activity in the fourth quarter. Indeed, IFO index declined in November and other national business sentiment surveys have been also recently oriented on the downward direction.

Exports will be hit by lower world trade and stronger dollar

In the coming quarters, two adverse effects will affect exports. On the one hand, as a result of expectations on global activity, world demand addressed to the euro area will grow at a lower pace than in the first half of 2004. On the other hand, export market shares of the euro area will again come under pressure in the wake of the recent appreciation of the euro. This negative trend could however come to an end towards the end of 2005, once the exchange rate would have reached a kind of new equilibrium around 1.30 dollar per Euro. Because of loss of market shares on the external markets as well on the internal market, and under the influence of a deterioration of terms of trade derived from higher oil prices, the euro area current account balance may be close to the equilibrium next year, while it was in surplus in 2003 (0.3% of GDP) and 2004 (around the same amount).

One positive aspect of the euro appreciation is that it will also limit inflationary pressures. Under the assumption of a moderate decrease in oil prices in the course of 2005 (that nevertheless means an increase of the annual average), inflation, measured by the trend of consumer prices, may decelerate in the

course of next year. After peaking at 2.4% at the end of 2004, the HICP⁴ annual change would be progressively reduced to 1.7% at the end of 2005. This is naturally a strong argument to postpone any upward move of ECB key interest rates. As no major changes are expected for the developments in compensation per employee, household purchasing power may slightly improve in the second half of next year, after rather poor developments at the turn of this year. This could help to support private consumption a bit towards the end of the horizon forecast. However, labour markets will not show signs of improvement in the coming months, economic growth remaining too weak to trigger a major rise in the number of persons employed. Unemployment rate will thus stabilise next year around 8.8%.

Weak domestic demand expected in 2005

In this context, business investment may continue to be weak. The absence of strong capacity tensions and limited economic growth are the two main arguments supporting this forecast. Moreover, companies' profit margins will come under pressure, because of the increase in oil prices and a rise in intermediate consumption cost, and also because of the appreciation of the euro. Changes in inventories will evolve along economic growth development in the coming quarters, after that the unexpected rise in 2004q3 would have been compensated in the coming quarter. Regarding, the housing market, another key element for the investment in construction, the main concern is a risk that the bubble will burst in the leading countries. It is too early to give any judgement on the likelihood of such event. However, if it does occur, a negative wealth effect could encourage households to be more cautious about their spending.

As a result, private domestic demand will not be dynamic enough to counterbalance the soften trend in exports. Neither will public demand help. Because of restricted public expenditures in most of countries in order to adjust fiscal deficits, public consumption will not contribute to support economic growth.

As a whole, economic growth in the euro area is thus expected to reach 1.8% this year and 1.6% next year. This means that again the growth gap between the euro area and the US would be quite substantial. This also means that effective growth will remain below potential growth -estimated around 2% per year both by ECB and the European Commission- for the fifth consecutive year.

Is the business cycle already over?

However, at this stage of the business cycle, the main question that arises is to know whether the current slowdown must be interpreted as the end of the upward phase of the business cycle or as a temporary movement? Traditionally, the business cycle comes to an end when strong growth creates

⁴ Harmonised index on consumer prices.

tensions or imbalances in the economy. Obviously, this is not the case in the euro area. No tensions can be observed on the labour market. At the same time, it is hard to see any hints of over-investment in the euro area economy. In that context, low economic growth expected in 2005 in the euro area may be considered as the consequence of adverse effects of exogenous negative shocks (oil prices rise, depreciation of the dollar, weaker global activity). Once some of them are reversed (relief on the oil market, stabilisation of the dollar in the second half of 2005), economic growth in the euro area may again reaccelerate. Although 2006 is beyond the horizon forecast, some better developments in economic activity may be observed at that time.

Box 3.2.1 The COE leading indicator for the euro area

The leading indicator is used to anticipate the next growth cycle peak. The progressive deterioration of the US leading indicator did not impact much on the euro indicator until October when the sudden deterioration of the industrial survey in the intermediate goods sectors combined with a progressive drop of the interest spread impacted negatively on the indicator. As a result, the euro area indicator climbed over the first threshold of 60 in October and reached the level of 70,9 in November, which represents a possibility of downturn within the next nine months. If that negative prospect materialised, the future growth rate would drop below the trend growth rate estimated in 1,7%.

Components of the COE leading indicator for the euro area :

A synthetic index of the Euro area industrial survey (intermediate goods sector)

An indicator of the interest rate spread in the euro area

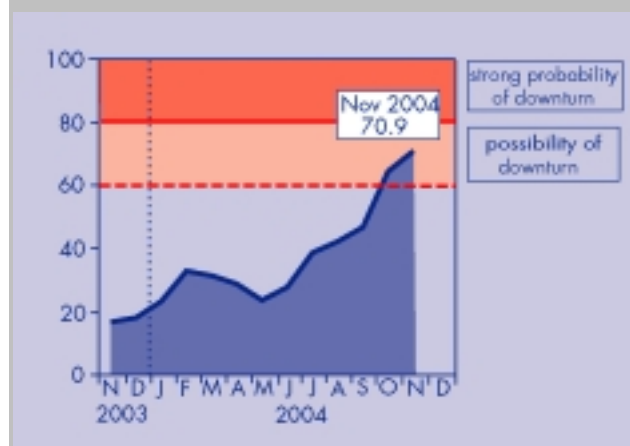
A weighted aggregate of major stock indices in the euro area

An indicator of the wholesale price index of the euro-area

The COE leading indicator for the United States

Chart B-3.2 Growth cycle leading indicator:

Search of the next peak



Source: COE

***A great
need to
boost
potential
growth***

However, the euro area is now jeopardised by the lack of room for manoeuvre in economic policy, as public finance imbalances make impossible any action from the fiscal side and as interest rates already stand at a low level in real terms. Thus, the worst scenario would be that the global cycle reverses before any revival of economic activity in the euro area.

Indeed, the euro area seems to be squeezed between fiscal imbalances, which require restrictive measures that will have a short-term negative impact on growth, and the need to maintain a high level of growth in the medium term. Potential growth in the euro area is too low to allow a quick reduction of fiscal imbalances without strong adjustment costs. The only way to escape from this dilemma is to boost potential growth. Here, we will not develop an extensive list of measures to reach this major target. However some recipes are well known. One of them is to increase research and development (R&D) expenditures. Some simulations carried out using the macro-econometric model NEMESIS show that if R&D reached the threshold of 3% of GDP as requested at the Barcelona's European Council in March 2002, Western Europe GDP would be up 1.7% in 2010 and 12.2% in 2030 as compared to the baseline scenario. In average, this would increase potential growth by around 0.5% per year, with however uneven results by country or by sector⁵.

⁵ See D. Brécard and al., *A 3% R&D effort in Europe in 2010 : an analysis of the consequences, using the Nemesis model*, DG Research, European Commission.
http://europa.eu.int/comm/research/era/3pct/pdf/3pct-erasme-study_fr.pdf

Table 3.2.3 Euro Area Forecast

	2001	2002	2003	2004 ^e	2005 ^f	2004 I	2004 II	2004 III	2004 IV ^f	2005 I ^f	2005 II ^f	2005 III ^f	2005 IV ^f
	Annual % change (unless otherwise indicated)					q-o-q%(unless otherwise indicated)							
Private consumption	1.9	0.6	1.0	1.1	1.4	0.6	0.2	0.2	0.3	0.4	0.4	0.4	0.5
Public consumption	2.4	3.1	1.6	1.7	1.5	0.1	0.4	0.8	0.3	0.3	0.3	0.3	0.3
Gross fixed capital formation	-0.4	-2.7	-0.5	1.2	2.3	-0.3	0.3	0.6	0.6	0.6	0.6	0.6	0.6
Domestic demand	0.9	0.3	1.2	1.9	2.1	0.2	0.3	1.1	0.4	0.5	0.5	0.5	0.5
Exports	3.3	1.9	0.2	6.1	5.5	1.5	3.1	1.2	1.3	1.3	1.2	1.1	1.2
Imports	1.6	0.5	1.9	6.6	7.2	0.6	1.1	1.1	0.6	0.7	0.7	0.6	0.7
GDP¹	1.6	0.9	0.5	1.8	1.6	0.7	0.5	0.3	0.4	0.4	0.4	0.4	0.4
Unemployment (% of labour force)	8.0	8.4	8.9	8.9	8.8	8.9	8.9	8.9	8.9	8.8	8.8	8.8	8.8
Compensation per employee¹, yoy	2.8	2.5	2.4	2.2	2.2	2.1	2.1	2.2	2.2	2.2	2.2	2.1	2.1
Consumer price (HICP), yoy	2.3	2.3	2.1	2.1	1.9	1.7	2.3	2.2	2.3	2.2	1.9	1.8	1.7
Current account balance (%GDP)	-0.2	0.8	0.3	0.2	0								
3m interest rates (% per annum)	4.2	3.3	2.3	2.1	2.2	2.0	2.0	2.0	2.0	2.0	2.0	2.1	2.3
10y Gvt bond yields (% per annum)	5.0	4.9	4.2	4.3	4.7	4.2	4.4	4.1	4.3	4.5	4.6	4.8	4.9

e: estimation ; f: forecast

EUREN estimates - ¹Seasonally adjusted.

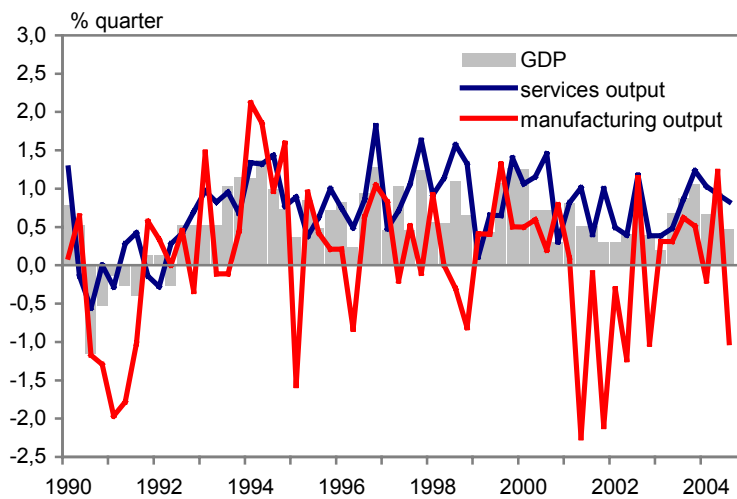
1 In 2004, extra working days will add 0.2 point to annual change (2.0 % instead of 1.8%).

3. The UK economy

GDP growth below trend in Q3...

UK GDP rose by only 0.4% in 2004Q3, although it was still 3.0% higher than a year earlier. The drop in growth to below trend largely reflects the recent sharp decline in industrial production – down 1.4% in Q3. In contrast, service sector output remained robust, rising 0.8% in Q3, although this was down from 0.9% in Q2 and over 1% in each of the previous two quarters.

Graph 3.3.1 UK Output



Source: Datastream

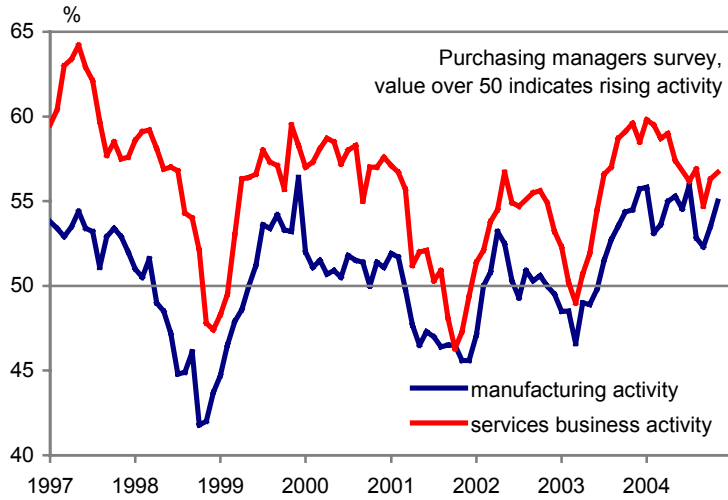
...as manufacturing output contracts...

The sharp fall in manufacturing output in recent months is a puzzle. While business surveys suggest that growth has slowed since the spring, they do not suggest a return to recession. Moreover, the detail of the manufacturing output figures is suspicious – for example, there was apparently a fall of over 3% in chemicals output in July followed by a rise of over 4% in August, while engineering output rose over 1% in July but then dropped almost 3% in August. The volatility of these data suggests that there may be significant revisions to come.

...and the housing market weakens

The housing market has continued to slow over recent months, with the Nationwide reporting prices down 0.4% in October - the first monthly decline since October 2001 - and the Halifax reporting a fall of over 1%. Moreover, the number of applications for loans for house purchase fell over 6% in September to a level over 32% lower than at the end of last year. And mortgage lending fell to £7.7 billion in September from £8.4 billion in August and an average of £9.2 billion a month in the first half of the year. However the Nationwide index suggests a 1% rise in November, so it is too early to write the housing market off yet.

Graph 3.3.2 Purchasing managers survey

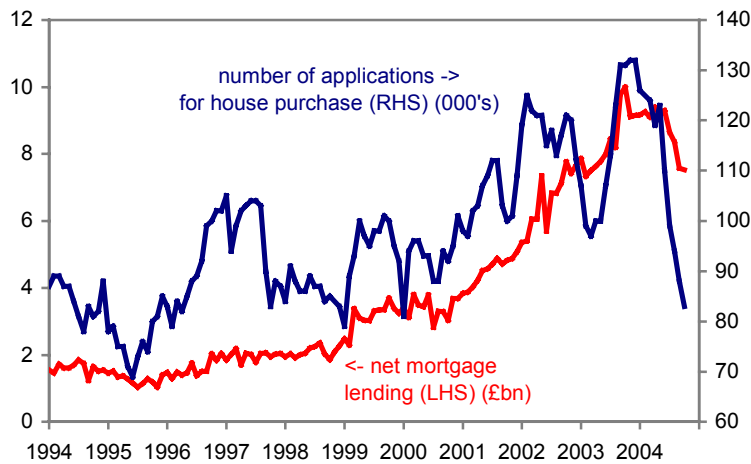


Source: Datastream

But retail sales are still strong

But while the housing market may have weakened, consumer spending remains robust. Retail sales rose 1% in September, and the CBI report that sales strengthened in October. With business investment also strong, buoyed by increasing company profits and liquidity, and export performance improving, we expect GDP growth to rise back above trend in Q4, averaging 3.2% in calendar-2004 and 2.7% in 2005. The MPC is unlikely to raise interest rates again this side of Christmas, but we still would not be surprised to see one further 25bp increase at the time of the February Inflation Report.

Graph 3.3.3 Housing market activity

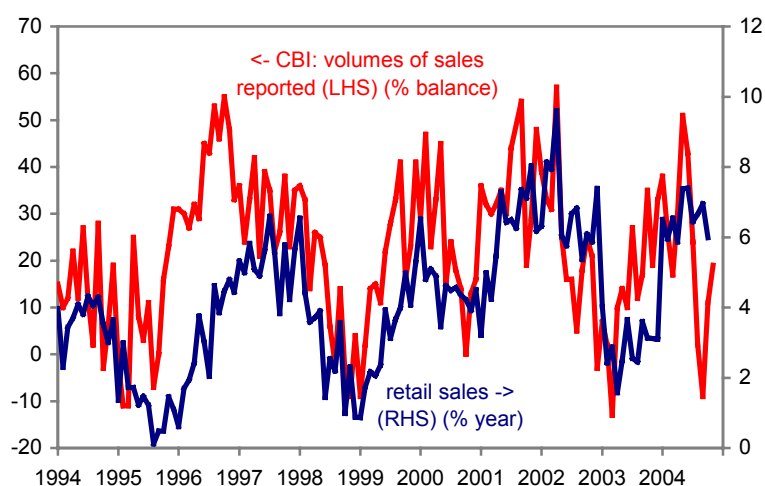


Source: Datastream

Brown remains optimistic on growth

With a general election likely next May, it was no surprise that Gordon Brown maintained his optimistic forecasts for 3-3½% growth in 2005. And there are encouraging signs of stronger activity in Q4, with the purchasing managers and CBI distributive trades survey both strengthening in November, and consumer confidence also improving. Our own forecast of 2.7% GDP growth next year is more cautious than the Chancellor's, largely reflecting a less optimistic view on prospects for government investment (where the Treasury is projecting a staggering 30% increase next year!) and net trade. But as long as a severe housing market crash is avoided the economic backdrop to the election should nevertheless be robust.

Graph 3.3.4 CBI distributive trades survey



Source: Datastream

...but real danger he'll breach golden rule

But while growth has so far been in line with Treasury forecasts, government revenues have yet again been falling short of Treasury expectations. Not surprisingly, the Chancellor claimed that it is too soon to write off his public borrowing forecasts for this financial year, and that his 'golden rule' should still be met – in part, thanks to higher revenues from North Sea oil and increased City bonuses. This does look like wishful thinking, and the Chancellor is likely to have to admit to a budget shortfall of around £10 billion just ahead of the election. But such concerns did not stop him announcing some sweeteners, most notably extra money to prevent steep increases in Council Tax.

Is there a UK productivity revival?

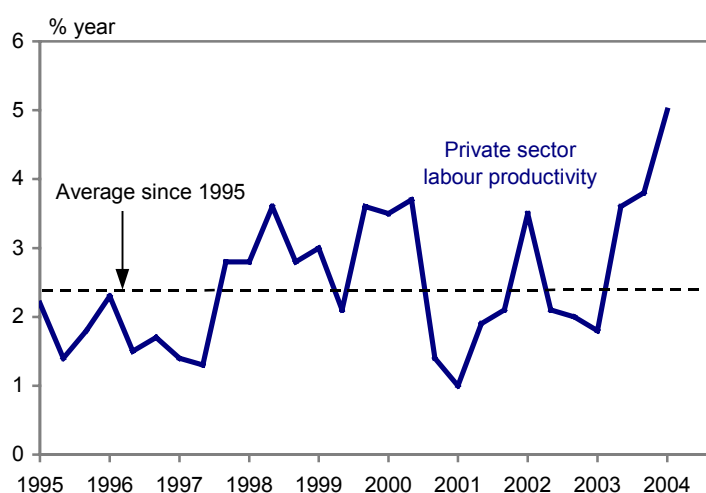
It may be that the Chancellor already has in mind how he will deal with any breach of the golden rule in his next Budget. For example, if he could claim that UK trend growth going forwards will be higher than previously assumed, he would be able to argue that the fiscal gap from the cycle just finishing will close of its own accord over the next cycle, without the need for any tax increases. And here he may have luck on his side.

UK employment has been surprisingly subdued so far this year. For example, the workforce survey suggests that total employment rose only 10,000 in Q2 after an increase of just 5,000 in Q1, albeit after an increase of over 100,000 in 2003 Q4. And the LFS survey shows employment in Q3 only 6,000 higher than in Q1. Moreover, the recent increase in employment is more than accounted for by the education, health and public administration sector; private sector employment fell in both Q1 and Q2.

The counterpart of this subdued employment performance has been strong productivity growth. Whole economy output per worker grew by 2.9% in the year to 2004Q2, up from just 0.8% in 2003Q3. However, these headline figures understate the acceleration in underlying productivity performance since they include the public sector, where output is not well-measured. According to estimates prepared by the Bank of England, private sector productivity growth – measured on an output per hour basis – has risen to 5%, double its average rate over the last decade.

It is unclear why productivity growth has accelerated so sharply this year. The downturn in investment following the collapse of the high-tech boom means that the capital-labour ratio has not been rising particularly quickly recently. So, higher productivity growth does not appear to reflect capital deepening. Nor does it seem plausible that productivity growth is being boosted by investment in IT – why should these effects suddenly have come through this year?

Graph 3.3.5 CBI distributive trades survey



Source: BOE

At this stage, we are therefore inclined to attribute the recent strong productivity growth to either measurement problems or a temporary blip. However, it may be that the UK is at last emulating the acceleration in trend productivity growth seen in the US in recent years. This represents a key upside risk to our forecast. It would imply that the UK has more spare capacity than the Bank of England estimates, and therefore a more relaxed

interest rate stance may be appropriate. And it would suggest that the medium-term outlook for the public finances is much healthier. So, do not be surprised to see Gordon Brown to start heralding a UK productivity miracle.

Table 3.3.1 UK Forecast

	2001	2002	2003	2004 ^e	2005 ^f	2004 I	2004 II	2004 III	2004 IV ^f	2005 I ^f	2005 II ^f	2005 III ^f	2005 IV ^f
	Annual % change (unless otherwise indicated)					q-o-q%(unless otherwise indicated)							
Private consumption	3.1	3.2	2.3	3.2	2.5	1.2	0.6	0.5	0.7	0.7	0.6	0.6	0.5
Public consumption	2.6	3.8	3.5	4.6	3.1	0.8	0.4	1.4	1.0	0.6	0.6	0.6	0.6
Gross fixed capital formation	2.6	2.7	2.2	6.1	4.6	1.6	2.4	-0.1	1.7	1.3	1.0	1.0	0.9
Domestic demand	2.9	2.9	2.5	3.9	2.9	1.0	0.8	0.4	0.7	0.9	0.7	0.7	0.6
Exports	2.9	0.1	0.1	2.4	6.9	-1.0	1.5	1.9	2.2	1.2	1.5	1.8	1.8
Imports	4.9	4.1	1.3	4.7	7.1	0.3	1.1	1.6	1.7	2.0	1.8	1.7	1.5
GDP	2.3	1.8	2.3	3.2	2.7	0.7	0.9	0.4	0.8	0.7	0.6	0.7	0.6
Unemployment (% of labour force)	3.2	3.1	3.0	2.7	2.5	2.8	2.7	2.7	2.6	2.6	2.5	2.5	2.5
Compensation per employee ¹ , yoy	5.2	3.7	3.3	4.2	4.3	4.4	4.7	3.7	4.0	4.2	4.3	4.4	4.4
Consumer price (HICP), yoy	1.2	1.3	1.4	1.4	1.8	1.3	1.4	1.2	1.6	1.7	1.9	1.9	1.7
Current account balance (%GDP)	-2.3	-1.8	-1.9	-2.3	-2.7	-1.9	-2.2	-2.6	-2.4	-2.7	-2.7	-2.7	-2.7
GGFB/GDP ²	0.8	-1.7	-3.1	-3.1	-3.2	-3.2	-3.0	-3.2	-3.2	-3.4	-3.0	-3.2	-3.2
3m interest rates (% per annum)	5.0	4.0	3.7	4.6	5.0	4.1	4.5	4.9	4.9	4.9	5.0	5.0	5.0
10y Gvt bond yields (% per annum)	4.9	4.9	4.5	4.9	4.7	4.8	5.1	5.0	4.7	4.6	4.6	4.7	4.8

e: estimation ; f: forecast

EUREN calculation

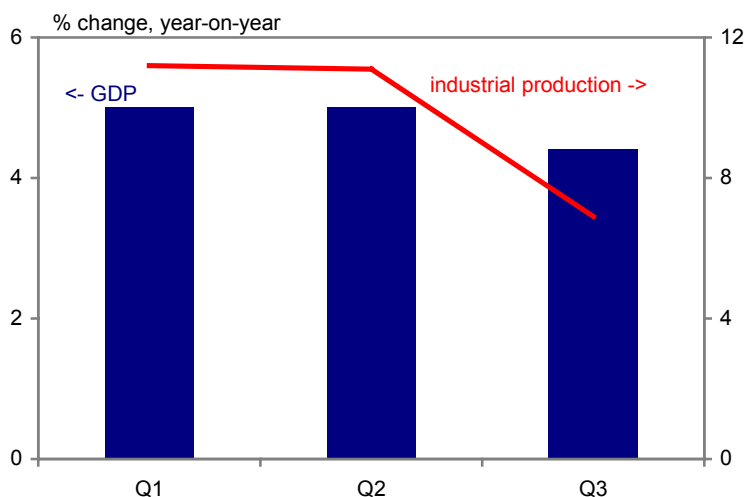
¹ Seasonally adjusted – ² General Government financial balance, excluding UMTS revenues.

4. The new member states

GDP growth slowed down markedly in Q3...

The new member states' GDP rose by only 4.6% in 2004Q3 (year-on-year), after a growth of 5.4% in the first half of the year. The drop in growth largely reflects the sharp deceleration in previously soaring manufacturing exports.

Graph 3.4.1 GDP and industrial production in new EU members (2004)

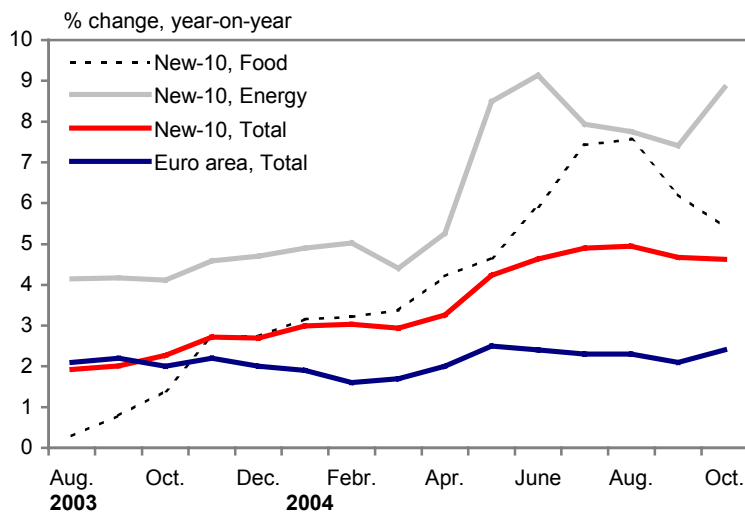


...because of deceleration in manufacturing exports

Source: Kopint-Datorg Database

In the present economic structure new members could not substitute the moderation of import demand in the euro area by stimulating domestic components of growth. However, this year GDP growth will be close to 5% – a historical record for the region. The service sector continues to be robust, infrastructure modernisation needs are feeding construction output, while agriculture had an excellent year.

Graph 3.4.2 Consumer prices (HICP)



Source: Kopint-Datorg Database

After a peak of inflation in Summer, disinflation again?

Consumer prices increased sharply in the first half of the year, but from the Autumn months a new trend of disinflation commenced. The peak of the regional 12-months HICP rate was 4.9% in July and August – caused basically by the temporary coincidence of two trends: a local maximum in food prices and the delayed pass-through of increases in world energy prices. From September, the remarkable decrease in food prices is coupled with generally weakening household consumption demand. This has given a slowdown in inflation till end-2004, which is likely to continue into 2005 as well. As a result, next year annual average inflation may decrease by 0.7 percentage points (3.3% after 4% of this year).

During the previous decade, the traditional policy response of the former transition countries to offset deterioration in external business cycles was the depreciation of the local currencies against the main foreign trade partners and competitors. The intention of introducing the Euro, however, makes this economic policy non-viable: partly because of the formal requirements of ERM-2 (direct effect), partly because of the pass-through into the inflation rates (indirect effect). In addition, the room for manoeuvre for a fiscal stimulus is also strictly limited because of the Maastricht criteria.

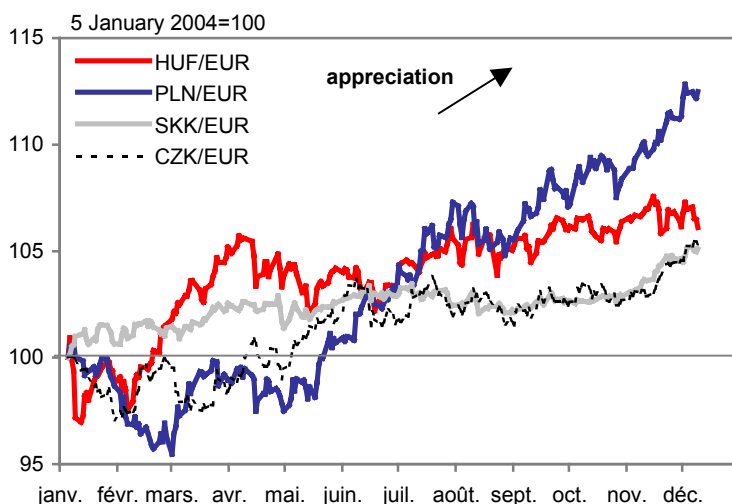
Stable exchange rates in the Baltics and in Slovenia...

This year, exchange rates have typically developed in two ways. In the countries which intend to adopt the common currency in 2007 (Estonia, Lithuania and Slovenia) they were absolutely stable – either due to the currency board arrangement (by definition), or due to the fact that exchange rate stability became a key monetary policy goal. Moreover, these countries have preserved their sound fiscal position as well – for them, the only problematic Maastricht criterion could be inflation. (Latvia has had also

problems with the exchange rate volatility, but the announced re-peg of the lat to the Euro instead of the SDR currency basket will likely solve this difficulty.)

Graph 3.4.3 Exchange rate development of Central-European currencies against the euro

... while continuous appreciation of local currencies damaging Central-European exporters price and cost competitiveness



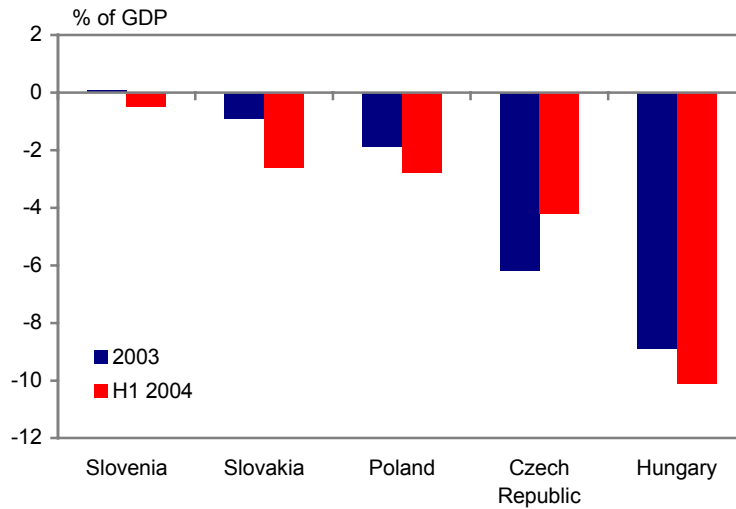
Sources: ČNB, MNB, NBP, NBS

Exchange rates development followed a different path in Central Europe: the Czech, Hungarian, Polish and Slovak currencies have been gradually appreciating during the year. And until the beginning of December, the Czech and Slovak koruna as well as the Hungarian forint appreciated by somewhat more than 5%, and the Polish zloty by more than 12% against the Euro. And in the meantime the Euro appreciated markedly against the US dollar, Central-European economies have been suffering an obvious deterioration in price and cost competitiveness compared to the major export market competitors of Asia and Eastern-Europe.

Promising results of the Slovakian tax reform

Fiscal policy practices basically remained unchanged in the individual countries: the Czech Republic and Hungary were unable to significantly improve their fiscal balance. More promising signs of fiscal consolidation can be perceived in Polish developments, while Slovakia – the investors' regional favourite this year – tends to converge strongly towards a sustainable fiscal position in the medium-term. The ambitious tax reforms introduced in January 2004 – a flat tax rate of 19% in PIT, VAT and corporate profit tax – improved not only the general government position, but also spurred FDI inflow and the much delayed industrial restructuring (the speed-up of Slovakian inflation and the increase of unemployment likely have a temporary character.)

Graph 3.4.4 Current account balances



Source: Kopint-Datorg Database

Downside risks in the Czech Republic, in Hungary and in Poland, bright short-term prospects elsewhere

In the short-term, the current path of real convergence is expected to continue in the new members. However, there are major downside risks in Hungary, in the Czech Republic and in Poland. In Hungary, both fiscal and external imbalances are critical - this results in high risk premia – a marked currency depreciation in 2005 is far from unrealistic. In the Czech Republic the stubbornly high general government deficit remains the main concern, while in Poland very serious labour market structural problems may block the promising developments of the last 12 months. On the other hand, short-term prospects of the Baltic States, Slovenia and Slovakia are undoubtedly favourable.

Table 3.4. New member states forecast

<i>Percentage changes unless otherwise indicated</i>				
	2002	2003	2004e	2005f
GDP real growth	2.5	3.9	4.9	4.6
Czech Republic	1.5	3.7	3.6	3.9
Estonia	7.2	5.1	6.2	5.4
Hungary	3.5	3.0	4.0	3.9
Latvia	6.4	7.5	8.0	6.5
Lithuania	6.8	9.7	6.5	5.8
Poland	1.4	3.7	5.5	5.0
Slovakia	4.6	4.5	5.3	5.0
Slovenia	2.9	2.3	4.1	3.8
Inflation (HICP)	2.6	2.0	4.0	3.3
Czech Republic	1.4	-0.1	2.6	2.8
Estonia	3.6	1.4	2.8	2.6
Hungary	5.2	4.7	6.8	4.4
Latvia	2.0	2.9	5.8	3.4,
Lithuania	0.4	-1.1	0.9	2.8
Poland	1.9	0.7	3.4	3.2
Slovakia	3.3	8.5	7.6	4.0
Slovenia	7.5	5.7	3.7	2.9
Unemployment rate	13.8	13.6	13.6	13.0
Czech Republic	7.3	7.8	8.3	8.1
Estonia	10.3	10.0	9.4	8.9
Hungary	5.8	5.9	6.0	6.0
Latvia	12.0	10.6	10.0	9.6
Lithuania	13.8	12.3	11.3	10.4
Poland	19.9	19.4	19.2	18.5
Slovakia	18.5	17.4	18.2	17.0
Slovenia	6.4	6.7	6.0	5.9

e: estimate; f: forecast

Sources: National Statistical Offices, Eurostat, EUREN forecasts for 2004 and 2005

4

SPECIAL STUDIES

(Each study presented in this chapter provides background material to the EUREN report. The views expressed here do not necessarily reflect those of all EUREN institutes)

1. Would a sharp slowdown in China derail the global economy?

Keith Church, Simon Knapp and Vanessa Rossi, OEF-Oxford

China's boom has been a major pillar of the global economic recovery from early 2002 onwards. The country's import bill in 2004 is forecast to be about \$327bn higher than in 2001.

However, emerging Asia, Japan and raw materials producers have been the principal beneficiaries of these developments, as export performance indicates (see tables 4.1.2 and 4.1.3). The boost to US, euro area and UK exports has been much more modest, largely because sales to China and the rest of Asia account for a smaller share of total exports than is the case for, say, Japan.

Earlier this year fears that the economic boom was threatening to run out of control prompted the Chinese authorities to implement a number of targeted measures to restrain activity in the most overheated sectors.

Data since the policy change suggest that the economy is slowing down in broadly the way the government wants, with the greatest deceleration in the previously overheated sectors but relatively little impact on the export and consumer sectors. However, growth in bank lending has come to an abrupt halt and there remains the possibility that this leads to a severe loss of business confidence and a much "harder" landing for the Chinese economy over the next year.

In this event, growth in the world economy could be cut by about 0.5%, with Japan and emerging Asia suffering larger losses. However, the US, euro area and the UK would be relatively lightly affected, with growth reduced by as little as 0.2%, given their limited dependence on exports to Asia and their ability to make offsetting policy changes.

**China :
a major
engine of
growth**

The boom in the Chinese economy, together with the rebound in the US economy, has been the pillar of the global economic recovery from early 2002 onwards. And while an enormous easing of both fiscal and monetary policy delivered a large part of the US pick-up, the acceleration in the Chinese economy has mainly been driven by both companies and households, who have responded favourably to the country's improving structural situation. However, given the importance of trade in China's take-off, there is little doubt that WTO entry was a key factor. In addition, the US recovery has also boosted the scale of China's boom, for without it the country's exporters would have been gaining a rising share of a flat world market rather than an expanding one.

About six months ago the Chinese authorities began to be greatly concerned that the boom was threatening to turn into destabilising overheating, with risks of severe power shortages, rapidly rising inflation and excess credit growth (which could turn into a bad debt crisis later). As a result they sharply raised banks' reserve requirements and instructed them to be much more cautious about lending to the sectors that were already overheating – especially property, steel and cement. And since March the year-on-year growth rate of industrial value added has shown a steady decline (except in August, when it was affected by a surge in energy output), with the greatest deceleration occurring in those sectors that were previously overheating, while those sectors linked to exports and consumer spending remained largely unaffected. In addition bank lending has abruptly stopped increasing. Though the evidence so far is supportive that the government's hopes of a controlled slowdown can be achieved, some commentators fear that the measures will not be sufficient to stop overheating and the inevitable, resulting crash. Others fear that the slowdown risks gaining too much momentum, depressing investment so much that a U-turn in government policy would not be able to stabilise the economy – leaving growth well below the 7% level that China and the world has become used to.

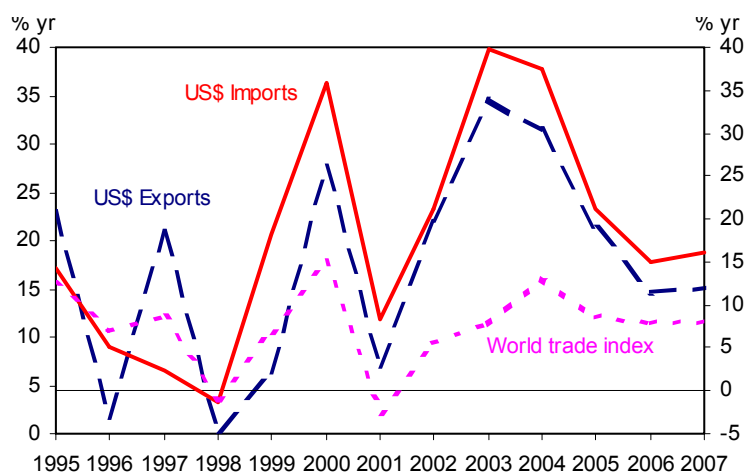
If a crash landing does materialise, what might be the impact of this on the world economy? With regard to the US, euro area and UK it seems likely that the effect will be small unless the Chinese slowdown is so severe that it punctures the growth prospects of the rest of Asia. This reflects the fact that outside of the region itself few countries have a very high exposure to trade with China and the rest of Asia. Although the US's sales to Asia are 24.5% of total exports, this share has been fairly stable over the last five years. The corresponding figure for the UK is 9% and that for the euro area is higher at 19.5%, though the latter reflects the fact that most trade activity occurs between fellow members of the zone rather than with countries outside. However, a Chinese "hard" landing, particularly if it appeared probable that it might last several years, could wreak additional damage via emerging market risk premia, global business confidence and stock markets, as expectations of a robust China (and emerging Asia) have been basic assumptions for several years now.

**Growth is
slowing...to
'just' 8% !**

Even with the slowdown in 2004H2, Chinese GDP is expected to achieve 9% real growth this year, following on from a slightly higher figure in 2003 (despite the SARS

outbreak) and 8% in 2002. By contrast, in each of the previous four years, 1998 – 2001, growth stayed in the 7 to 8% range. Clearly over the last three years the Chinese economy has accelerated noticeably, particularly when one considers that nearly 15% of GDP is still agriculture, which is only growing at around 2% per annum. Indeed the scale of the take-off is much more striking when one considers other indicators. Chinese exports in US\$ terms increased by 22% in 2002, 34% in 2003 and are expected to rise by 31% this year – to over \$570bn. This reflects the country's rapid integration into the global economy, facilitated by WTO entry at the end of 2001 and the steady build-up of foreign direct investment over the last decade (exceeding \$40bn a year from 1996 onwards), with many global and regional multinationals seeing the country as a key location for their manufacturing operations – attracted by the low costs of labour and land. These growing links with the rest of the world have ensured that Chinese imports have also surged over the last two and a half years, as many of the country's exports require imported key components and capital machinery.

Graph 4.1.1 China: Trade growth versus market growth



Source: OEF

In addition, the rise of imports has also reflected the fact that China does not either make the desired product, such as raw materials and luxury cars, or enough of the product to keep up with recently rampant domestic demand, such as steel. The relentless rise in the export sector has boosted confidence across the wider economy, particularly in Beijing and along the eastern seaboard. Consumers experiencing a substantial rise in their standard of living are now demanding a wider and better range of products - for example the ownership of cars has soared in recent years. Moreover the business sector focused on production for the domestic market has also expanded rapidly, with huge increases in investment to raise the production capacity of industries such as cement and steel. Much of this activity has been financed by bank loans, and the generally favourable credit environment has prompted a booming property market in some areas. In 2003 the stock of loans outstanding increased by 21.5% year-on-year, after 15.1% in 2002. Total outstanding bank loans reached some \$2500bn (nearly 200% of GDP) by the start of 2004, up some \$400bn on the year before.

**Boosting
the global
recovery**

This acceleration in Chinese growth has greatly added to the strength of the global recovery. Measured at market exchange rates China's surging economic performance is likely to have contributed over 10% of the cumulative increase in the world economy since 2001; by comparison the US contributed 32%, the euro area 6% and the UK less than 4%. And when exchange rates are used that account for purchasing power parity China's contribution increases to over 31% of global growth while the US's share drops to under 17%. Also indicative of the country's key role is the fact that China's import bill in 2004 is forecast to be \$327bn higher than in 2001, while the corresponding increase in US goods' imports is expected to be around \$310bn.

Table 4.1.1 Real GDP (annual % change)

<i>% of world economy:</i>	US	Japan	UK	Euro area
<i>at MER</i>	29.2	14.1	4.3	18.1
<i>at PPP</i>	21.1	6.8	3.1	15.5
Annual % chg				
2000	3.7	2.8	2.9	3.5
2001	0.8	0.4	2.3	1.6
2002	1.9	-0.3	1.8	0.8
2003	3.0	2.5	2.2	0.5
2004	4.3	4.3	3.4	1.8
2005	3.7	2.4	2.8	2.2

<i>% of world economy:</i>	China	Rest of Asia	World at MER (2000 weights)	World at PPP (2000 weights)
<i>at MER</i>	3.2	5.8		
<i>at PPP</i>	13.0	12.7		
Annual % chg				
2000	8.0	6.8	4.0	4.8
2001	7.5	2.1	1.4	2.4
2002	8.0	4.6	1.7	2.8
2003	9.4	4.4	2.8	3.8
2004	9.1	6.0	4.2	5.1
2005	7.9	5.5	3.6	4.5

Box 4.1 China and raw material prices

The strong growth in China has not just been one of the pillars of the global economic recovery. It has also been accompanied by huge imports of raw materials, which have led to price hikes in a number of commodity markets. China's massive demand is one of the key explanations behind the steep rise in oil prices. And there have been even stronger consequences for iron and steel and related products.

Since 2001, steel consumption in China grew by 30 million tons on average per year. In 2003 it absorbed one quarter of world steel production – more than the combined consumption of the U.S. and Japan. Although China raised its production from 154 million tons in 2001 to 220 million tons in 2003, a considerable quantity was imported

to meet soaring demand. In 2003 steel imports climbed 50% and reached 43 million tons. For comparison, this comes close to total German steel production.

Being the world's most important steel producer and consumer, China's economic boom had an enormous impact on prices for steel and the inputs of steel mills. The reactions were particularly hefty for two reasons: Firstly, the supply of many raw materials is relatively price inelastic. Secondly, China is one of the most important producers of input materials of the steel industry. Consequently, rising demand in the world market for these products was met by shrinking supply.

In particular, China is

- the world's most important producer of coal. Although its coal production rose considerably, the country has become a net importer in the meantime. As a consequence, the world market price for coal has tripled since July 2002.
- the most important producer of coke. For a long time, China flooded the world market with cheap coke. Now, China is a net importer. Coke prices skyrocketed from 120 to 400 \$US/t (April 2004) within one year, fluctuating around this level since then. Compared to early 2000 prices rose by a factor of eight.
- holds the third position in the production of iron ore after Brazil and Australia. Nevertheless, 225 million tons have been imported in 2003, which is nearly the same as Brazil's total production. This represents an increase of 15% on 2002, within which imports of high quality ore grew much faster. As a consequence, the price of iron ore rose considerably, too.

Prices of other inputs of the steel industry grew in the same way. In August 2004, scrap cost about 260 \$ per ton, which was the highest price ever noted. Nickel, chrome, and molybdenum, which are needed to produce stainless steel, were also substantially higher in the commodity markets. Finally, transportation costs rose considerably as China seemingly chartered every ship available to ensure sufficient capacities.

Thus, steel prices were driven by demand and costs at the same time. Hot rolled white strip (coils), which mostly serves as a reference price, cost 610 \$ per ton. This is the highest price level ever reached. In the meantime, the steel price hike has started to spill over to other products. Car producers have already announced raised prices thanks to higher costs. Given the average steel content of a car, the steel price hike led to an increase in production costs by 100 to 200 Euro per car.

There is little hope that prices will come down soon, which makes the situation different from earlier price hikes. Steel consumption per capita is still low in China (200 kg) compared to industrialised countries (Japan 600 kg, Germany and the US 450 kg). Of course, new steel mills are under construction in China, solving at least the problem of

restricted capacity in the medium term. However, the demand for iron ore, coke, and metals will continue to be high.

Hence, the China boom not only stimulates growth in the rest of the world. It also brings about higher price for many commodities, not at least coal, coke, metals and – most probably – also oil. On the other hand, in case of a hard landing of the Chinese economy also the situation in the commodity markets will ease.

Roland Döhrn and Hans-Karl Starke, RWI-Essen

Who are the major winners from China's imports surge ?

The table on Chinese import growth gives the obvious answer. The rest of Asia, including Japan, have experienced a huge surge of exports to China over the last two and a half years, supplying most of the manufacturing components and capital equipment required by exporters and a considerable percentage of the raw materials and fuel. All the major Asian exporters sold more to China in the first six months of 2004 than they did in the whole of 2001; this was not the case for either the US or Europe, although both blocs have experienced strong export growth to China since early 2003. As a result, while Asia's share of Chinese imports has climbed steadily between 2001 and 2004H1 (Japan, Korea, Taiwan, Thailand, Singapore and Malaysia accounted for 47.2% of Chinese imports in 2004H1 against 45% in 2001), the US and Europe's combined share has shrunk from 30.6% to 24.9% over the same period. The other countries that have gained market share over this time have been producers of oil, raw materials and foods (Brazil has been a notable gainer in the latter two categories). And because much of emerging Asia is very export dependent (accounting for upwards of 35% of GDP), the increase in Chinese demand has greatly stimulated their own domestic economies. This has been particularly true for Taiwan and Korea.

Table 4.1.2 Chinese imports

	% of total in 2004H1	Annual % change (in US\$)		
		2002	2003	2004H1
<i>US</i>	8.6	3.9	24.4	38.4
Europe	16.3	10.4	30.5	33.9
UK	0.8	-5.4	7.0	34.1
Europe ex UK	15.5	11.6	32.1	34.0
Japan	16.9	25.0	38.7	32.8
Korea	11.0	22.2	51.0	55.5
Taiwan	11.5	39.2	29.7	40.6
Malaysia	3.2	49.8	50.5	42.7
Singapore	2.5	37.5	48.7	40.8
Thailand	2.0	18.8	57.6	34.6
World	100.0	21.2	39.8	42.6

The impact on Europe and the US is modest

By comparison with these extraordinarily dynamic trade developments, the gains made by US, euro area and UK exporters to China appear rather more modest (see table 3). US exports to China (in US\$ terms) increased by 28.9% in 2003, and in 2004H1 were up 36.7% on a year ago. This was – of course – a much stronger performance than exports in aggregate, where the corresponding figures were 4.6% and 13.6%. However, even in the latest period sales to China only accounted for 4.4% of all US exports (equivalent to 0.3% of GDP, partly reflecting the US's low dependence on external trade). In 2003 the share of euro area exports going to China was 3.3% of total exports (0.48% of GDP), for the UK in 2004H1 it was 1.2% (0.19% of GDP), but for Japan it was 12.8% (1.5% of GDP). Consequently at the level of the total economy the effect of China's boom has been very small in direct terms for all of the major industrialised countries except for Japan.

And even when one considers the stimulus that China has given to the rest of Asia, the total effect on US, euro area and UK exporters is still fairly modest compared to that for Japan. The latter's sales to emerging Asia (including China) rose by 21.7% in 2003 and 31.1% in 2004H1, and accounted for 48.1% of aggregate Japanese exports. If over the last year and a half Japanese exports to the region had grown in line with those to the rest of the world their exports would be about 8.7% lower than they are now (\$47.4bn in annual terms, equivalent to 1% of GDP). By contrast, because US exports to Asia ex China have been very sluggish over the last year, the US appears to have only received a direct boost from strong sales to China and no gains from the repercussions of the China boom on the rest of Asia. If US exports to China had grown in line with those to the rest of the world, exports would now be about \$9.3bn lower on an annualised basis (0.08% of GDP).

The UK and the euro area are somewhat different from the US in that both appear to have experienced a boost from both China directly and indirectly via the rest of Asia. If the euro area's total exports had only grown in line with sales ex Asia they would be about \$13.3bn lower than they are currently (equivalent to 0.15% of GDP). For the UK the drop would be \$3.2bn (also 0.15% of GDP).

However, US and Europe have also experienced some negative influences from China's boom via its impact on boosting oil and other commodity prices. And these factors have increased inflationary pressures and reduced companies' margins.

Table 4.1.3: Trade developments

US exports to:	% of total in 2004H1	Annual % change (in US\$ terms)				
		2000	2001	2002	2003	2004H1
EU-15	21.2	8.8	-3.7	-9.7	4.7	11.2
Japan	6.8	13.2	-10.8	-10.8	1.2	4.3
China	4.4	23.9	14.6	14.6	28.9	36.7
Rest of Asia	13.3	19.6	-2.1	-2.1	3.4	17.0
Total	100.0	13.1	-5.4	-5.4	4.6	13.6
Japanese exports to:						
	% of total in 2004H1	Annual % change (in US\$ terms)				
		2000	2001	2002	2003	2004H1
EU-15	15.6	4.7	-17.7	-4.7	17.7	21.2
US	22.5	10.5	-14.9	-1.9	-2.5	9.1
China	12.8	29.1	2.0	29.3	43.5	35.8
Rest of Asia	35.3	25.3	-21.2	6.5	15.5	29.5
Total	100.0	14.1	-15.8	3.4	13.0	23.1
Euro area exports to:						
	% of total in 2004H1	Annual % change (in US\$ terms)				
		2000	2001	2002	2003	2004H1
US	15.3	10.1	1.7	7.8	7.9	14.5
UK	17.5	2.1	4.0	7.2	12.4	14.3
Japan	2.9	12.0	-2.6	1.2	12.8	19.1
Rest of Asia	16.6	12.6	4.8	8.7	19.7	24.5
<i>Of which: China*</i>	5.0	13.8	15.0	20.5	41.1	37.0
Total	100.0	5.9	3.1	7.7	16.5	20.2
<i>* Exports to China are for total EU rather than Euro area, and 2004 data refer to January – April not H1.</i>						
UK exports to:						
	% of total in 2004H1	Annual % change (in US\$ terms)				
		2000	2001	2002	2003	2004H1
US	15.0	14.0	-4.0	-0.5	11.9	7.0
EU-15	55.9	3.3	-3.4	4.5	4.1	7.0
Japan	2.0	4.2	-3.1	0.0	12.5	17.4
China	1.2	13.5	12.3	-10.2	40.1	32.8
Rest of Asia	5.7	10.9	-7.0	-2.1	21.2	7.4
Total	100.0	5.9	-3.9	2.4	9.6	8.8
Note: In each of the above tables the data for exports to China exclude trade via Hong Kong – which may be particularly significant for Japan.						

Chinese policy moves to stop general overheating ... to 'just' 8% !

In early 2004 the Chinese authorities became increasingly concerned that the country's economic boom, fuelled by a potentially dangerous credit surge, was threatening to run out of control – into widespread overheating and energy shortages. The country's soaring demand for raw materials, intermediate products and crude oil was widely considered to be a key driver behind the surge in global commodity prices throughout 2003 and early 2004. Such a situation risked ending in an economic crash landing, with numerous, negative repercussions for such key issues as social stability,

internal migration, banks' bad loans and business confidence in the country's long-term future.

As a result, the government implemented a number of targeted measures to try and restrain activity in the most dangerously overheated sectors – property, steel and cement – by raising banks' reserve requirements and instructing banks to limit their lending to these sectors. Since these sectors were all very dependent on loan finance these measures appeared much more likely to be effective than any general policy move, like raising interest rates or revaluing the currency. In this way, it's hoped to reduce the threat of specific dangers such as excessive investment (according to the monthly series, cumulative investment was up 31% on a year ago in H1 of this year after growth of more than 40% in Q1), increased bad debts in the long term and unsustainable demands for energy in the short term. Moreover the government did not wish to constrain either the consumer or the export sector (where expansion might still be financed by FDI or retained profits).

A controlled slowdown seems the most likely outcome...

So far the recent monthly data are supportive of the possibility that the government may be able to achieve its target of a controlled slowdown. In March the year-on-year growth rate of real value-added in the industrial sector peaked at 19.4%; since then it steadily subsided each month to stand at 15.5% in July before edging slightly higher in August, with much larger decelerations apparent in the problem areas of steel and cement (although the growth in steel was higher in July and August than in May as domestic production replaced imports). By contrast, the equivalent growth rate for the real value of retail sales has barely altered, 8.7% in August compared to 9.4% in March. Meanwhile exports (in US\$ terms) were up 39.1% on a year ago in the three months to August against a 34% annual increase in 2004Q1. These figures illustrate that some areas of the economy have been much more affected by the policy measures than others.

Graph 4.1.2 China: Industry value added



Source: Datastream

***...but
uncertainties
remain***

However, some commentators fear that the measures will be reversed too quickly to make a sufficiently long-lasting impact on overheating, while others fear that the new environment for bank lending is now so hostile that it will damage business confidence, and moreover that this might not quickly recover even once the policy measures were abandoned. At this stage it is too early to assess either the full consequences of the measures on bank lending or how quickly the government may be tempted to reverse its course. What can be seen, however, is a very rapid slowing in the pace of bank lending growth. In March 2004 outstanding bank loans were up 21.2% on the year, in May that pace had fallen to 18.7% and in July to only 12.3%. In addition the actual level of the stock of loans fell in both June and July. As well as hitting the target sectors, the lending clampdown has also reduced the demand for cars, many of which were financed by loans. Year-on-year sales growth here has fallen from 76% in 2003 to 3.7% in July. Though it does not appear the most probable outcome given the continued strength of the export sector, these signals do suggest that the effective freeze on lending could produce a “hard” landing for the Chinese economy. How severe that might be and its consequences for the world economy are examined in the following section.

***An
investment
crash is still
a threat***

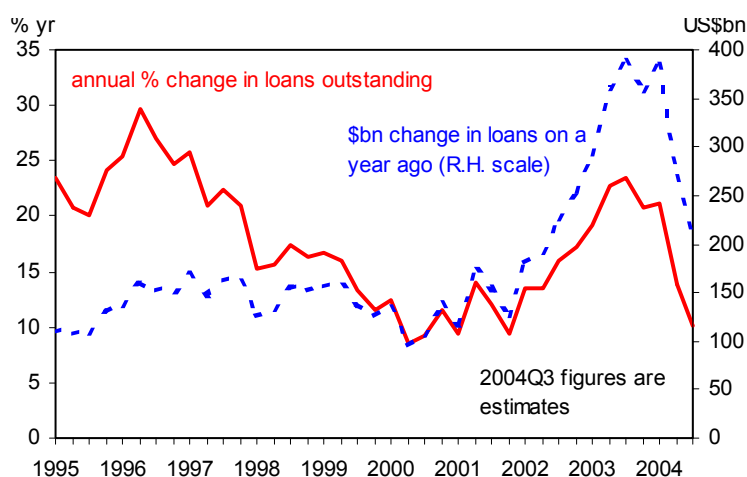
After several years of very rapid growth, helped along by strong credit growth, an effective halt to new bank lending (and thus investment – which accounted for about 50% of GDP in 2003) could start to hit business confidence across the whole Chinese economy, not just in the sectors targeted by such a policy. And, by the time the government could act to reverse policy, the previous mood of optimism may have been well and truly deflated, with companies much more cautious about the future. With growth prospects badly dented and sentiment hit even harder, foreign multinationals might slow their pace of FDI in China, lowering investment further. This might be particularly true of Asian multinationals whose exporting performance would be hardest hit by the slowdown in the Chinese economy. Indeed just as this region has benefited most from China’s boom over the last two years, so it would be worst affected by any ensuing bust. In the case of Korea, a dramatic slowing in the Chinese economy might even bring the economy close to recession as exports have provided most of the driving force behind growth over the last eighteen months, with consumer spending hit by debt worries. The increase in Korean exports to China and Hong Kong accounted for nearly 40% of the country’s increase in exports between 2002H1 and 2004H1.

***Worse case
impact on
world
economy
would be
limited***

Unlike several countries in the region, the Chinese government could increase government spending and investment to prop up the economy, bringing forward construction projects required for the 2008 Beijing Olympics. However, growth could still fall into the 6-7% range (assuming that overall investment in 2005H1 is broadly unchanged from a year earlier). Using the OEF Global Model, we can simulate the likely repercussions of this downside scenario on the world economy. Included in the scenario is the assumption that this dampening of one of the major positives in world economic prospects will reduce global equity prices from what they otherwise would be, and also cut the valuation of the many investments in China made by global multinationals. (According to UNCTAD US firms invested \$18.5bn of FDI into China between 1999 and 2002, those from the euro area \$11.8bn and those from the UK

\$4.2bn. These investments, however, are modest compared to those made in China by the rest of Asia over the same period, \$14.4bn by Japanese companies and \$90.6bn by other Asian countries – principally Hong Kong and Taiwan.) But for many economies there would be some mitigating factors. A “hard” landing in China would lower oil and commodity prices, and this, together with slower output growth, would allow a lower interest rate profile in the US, UK and euro area.

Graph 4.1.3 China: Bank loans’ growth



Source: OEF

As table 4 illustrates, while growth in the overall global economy (measured at market exchange rates) might only be lowered by 0.5%, the losses in Asia would be greater, with Japanese growth being reduced by 0.6% and the rest of Asia by 1.1%. The US, the euro area and the UK would be much less affected, helped by lower oil prices and slightly lower interest rates, and their limited exposure to both China and the rest of Asia, with overall GDP growth lower by about 0.2%.

To have a significant effect on the US, euro area or UK economy, the shock to emerging Asia would have to be nearly on a par with that of the Asian crisis of 1997/98 when Korea, Thailand, Malaysia and Indonesia all experienced massive reductions in domestic demand, the rest of the region slowed sharply and Japan moved into recession. For example, in 1998 UK exports to Asia fell by nearly \$7.6bn, while total exports dropped by over \$9.7bn (0.7% of 1998’s GDP). Similarly, in that year US exports to Asia dropped by over \$28bn (0.3% of GDP). Unless the situation in China is handled disastrously there seems little likelihood that any Asian slowdown could be on such a scale as to repeat the impact of 1998. But a word of caution here: few analysts expected the 1998 crisis – or indeed its depth.

Table 4.1.4: Impact of a sharp China slowdown in the world economy

<i>Real GDP</i>	% difference from base in 2005
US	-0.2
Euro area	-0.2
UK	-0.2
Japan	-0.6
China	-3.2
Emerging Asia	-1.1
World	-0.5

China's boom has been a major pillar of the global economic recovery from early 2002 onwards and exceptionally stimulative for Asia and other emerging markets, particularly commodity producers. However, earlier this year the Chinese government implemented targeted measures to slow the economy on fears that it was about to experience widespread overheating. So far the data since the policy change suggest that the economy is slowing down in broadly the way the government wants, and our central view is that a controlled slowdown will be achieved. However, there are significant downside risks and a "hard" landing is by no means impossible. In this event global growth could be cut by about 0.5%, with the US, the euro area and the UK suffering less, about 0.2%, given their limited dependence on exports to Asia.

2. Long term trends in export market shares

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Trade patterns reflect the specialisation of a country's exports in certain geographical markets and commodities, while the world export market share of a country quantifies how much of the relevant world import demand is covered by the country's total exports. The aim of the analysis conducted in this special topic is to find out to what extent a country's export specialisation in terms of markets and products accounts for the growth or decline of its world export market share. In this context, the following type of questions must be answered: would a country's export market share have grown faster if its exports had been focused on different markets? Has the product specialisation of a country's exports contributed to the decline in its world export market share? Are changes in relative prices and improvements in competitiveness the cause for the increase in a country's world export market share? Did a country export the right commodities to the right markets?

These questions can be answered by applying Constant Market Shares Analysis (CMSA) to a country's world export market share. This will be done here for the world's three main trading powers, the EU-15, the US and Japan, over the decade 1991/2001. But first of all, it is necessary to get to know more about the method.

Constant Market Shares Analysis

It seems useful to begin with a brief definition of the aggregate or world export market share of a country. This share is calculated by dividing the total exports of the country by total world imports minus the total imports of the country, and, in the present context, it stands for the relative export performance of the country.

CMSA is an accounting method that is applied ex post to a country's (or country group's) world export market share in order to link changes over time in this share to the country's export specialisation in terms of geographical markets and commodities. This yields a decomposition of the total change in the world export market share, which will be called 'total effect'. This 'total effect' is split into two terms: a 'structural effect' and a 'competitiveness effect', and the former is further broken down into a 'market distribution effect', a 'commodity composition effect' and a 'combined commodity-market effect'. For the empirical application, the CMSA method developed in Milana (2004)⁶ has been adopted since it solves several problems that occurred in earlier versions of CMSA⁷.

⁶ Milana C. (2004), "A note on the general formulation of Constant Market Shares Analysis", unpublished, ISAE, Rome.

⁷ Those problems relate to the symmetrical decomposition of the change in the world export market share, the use of a homogeneous definition of world exports and the choice of index numbers that becomes necessary in discrete time.

As a first step it is important to fully understand how the effects are calculated in order to be able to interpret them.

The 'competitiveness effect' quantifies the impact on the country's world export market share of changes in its export market shares for individual commodities and geographical markets while keeping the commodity and market distribution of world exports constant. To some extent, this effect has a residual character. It is linked to price and non-price competitiveness.

The 'market distribution effect' is the first of the three terms that belong to the 'structural effect'. The aim is to show how the aggregate export market share of the country would have developed over a certain period if the country had maintained its export market share in every geographical market. Under that assumption, changes in the country's aggregate export market share originate from changes in the shares of markets in world trade. A specialisation in markets with an increasing (decreasing) share in world imports leads to a rise (decline) in the aggregate export market share, i.e. a positive (negative) 'market distribution effect'. It may then be said that the geographical or market specialisation of the country's exports has a positive (negative) impact on its world export market share.

The 'commodity composition effect' is based on the same type of reasoning as the 'market distribution effect'. It measures the impact on the country's world export market share of shifts in the commodity distribution of world imports when its export market shares for individual commodities remain constant over time. This effect shows whether a country is favoured or handicapped by the commodity specialisation of its exports.

The 'combined commodity-market effect' shows to what extent a country has been able to benefit from niches for certain commodities on certain markets. It represents the average impact on the country's world export market share of changes in particular market-product combinations in world imports given the country's export specialisation in individual markets and commodities.

CMSA is often described as shift-and-share analysis applied to international trade. Although it is not based on causal relationships, it allows quantification of the link between a country's export specialisation as regards geographical markets and commodities and its export performance as measured by its world export market share.

The data

The data come from the international trade database CHELEM of the 'Centre d'Etudes Prospectives et d'Informations Internationales' (CEPII), which provides data in current dollar value of all international bilateral trade flows in goods. This means that price and exchange rate movements, which cannot be identified separately from the development of the export quantities, influence the results.

The set of countries or country groups examined here contains the EU-15, the US and Japan. For the EU-15, only external trade is taken into account. Furthermore, the CMSA is applied to two sub-periods: 1991/1997 and 1997/2001. For the interpretation of the results, it should be kept in mind that the two periods are thus not of equal length. The cut is arbitrary, but is justified by the impact of the Asian crisis of 1997.

Finally, to be meaningful, the decomposition implied by the CMSA should be computed at the most disaggregated level. The sectoral and geographical breakdown of the data covers 62 destination countries or markets and 72 product groups. When applying CMSA for any country, the four effects are determined for each market-commodity combination. The global results are obtained by summing over both markets and commodities. Moreover, this also makes it possible to calculate the contributions of 9 geographical areas and 12 commodity groups to the global results for each effect for each country.

Trade patterns

Before analysing the results of the CMSA, it is useful to take a look at the trade patterns of the EU-15, the US and Japan in terms of destination markets and commodities. Knowledge of these trade patterns turns out to be useful at a later stage for the interpretation of the results of the CMSA. In order to present the major trends in trade patterns the above-mentioned 9 destination areas and 12 commodity groups have been used.

But first, the changes in the shares of those 9 destination areas and 12 commodity groups in world imports must be briefly summarised. As noted above, these changes are crucial for the size and sign of the 'market distribution effect' and the 'commodity composition effect'. Table 4.2.1 indicates, which destination areas and commodity groups experience an increase in their share in world imports over the periods 1991/1997 and 1997/2001.

Table 4.2.1 Changes in the shares in world imports of the geographical areas and commodity groups for the periods 1991/1997 and 1997/2001

	Sign of change (+/-)			Sign of change (+/-)	
	91/97	97/01		91/97	97/01
North America	+	+	Energy	-	+
South America	+	-	Food industry	-	-
EU-15	-	+	Textile	-	-
Eastern Europe*	+	-	Wood&Paper	-	-
Other Europe	-	-	Chemical	+	+
Africa Middle East	-	-	Steel industry	-	-
Japan	-	-	Non-ferrous	-	-
South East Asia°	+	-	Mechanical	-	-
Oceania	+	-	Vehicles	-	+
			Electrical	+	+
			Electronics	+	+
			Others	+	+

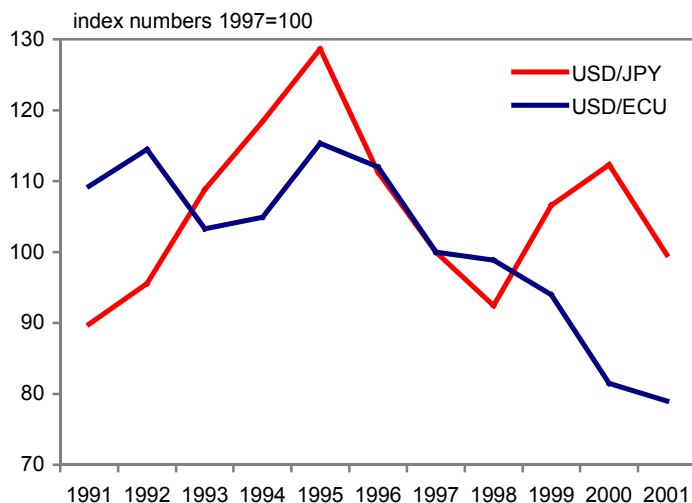
Source: Own calculations; CHELEM database (CEPII)

Notes: *: including former USSR; °: including India and China.

As noted before, the international trade data used are in current dollar value. Hence, trade patterns are also influenced by exchange rate movements. This is particularly true for the destination areas. Graph 4.2.1 presents the exchange rate movements of the US dollar with respect to the ECU⁸ and the Japanese yen. The noteworthy trends are: there is an appreciation of the ECU with respect to the dollar between 1991 and 1997, which occurs mainly at the end of this period. The depreciation of the ECU continues at a faster pace until 2001. After a strong appreciation between 1991 and 1995, the yen depreciates until 1998. Nonetheless, the dollar value of the yen in 1997 is still above that of 1991. The value in 2001 is the same as in 1997 despite some variations in intermediate years.

⁸ European Currency Unit (Euro from 1999 onwards).

Graph 4.2.1 Exchange rate developments 1991/2001 (index numbers 1997 = 100)



Source: Ameco (European Commission).

Notes: ECU = European currency unit (Euro from 1999 onwards); JPY = Japanese yen; USD = US dollar.

Table 4.2.2 provides information on the geographical distributions of the exports of the EU-15, the US and Japan for the years 1991, 1997 and 2001. The main external trading partner of the EU-15 is North America, which comprises the US and Canada. While the share of the area Africa Middle East in EU-15 exports is on the decline, a growing share of EU-15 exports goes to Eastern Europe. There is a noticeable trend in the share of exports going to South East Asia: a sizeable increase between 1991 and 1997 is followed by a marked fall up to 2001.

Four partners dominate the geographical distribution of US exports through the years with shares between 15% and 25%: the EU-15, South America, Canada and South East Asia. There is a marked downward trend for the EU-15 and a clear upward trend for South America between 1991 and 1997. Note also that, the share of South East Asia in US exports is characterised by the same hump-shaped trend as in EU-15 exports.

Finally, Japan has three main trading partners: South East Asia, North America and the EU-15 with respective shares of around 40%, 30% and 15% in 2001. Again, the share of the EU-15 is on the decline between 1991 and 1997 and that of South East Asia rises strongly. The decline in the share of the latter area during the period 1997/2001 is smaller than for the EU-15 and the US.

Table 4.2.2 Geographical distribution of exports (1991-1997-2001)

	EU-15			US			Japan		
	1991	1997	2001	1991	1997	2001	1991	1997	2001
North America	21.73	21.75	26.82	18.85	19.37	20.61	31.96	29.67	32.07
South America	6.35	6.84	6.47	15.46	20.64	22.45	3.91	4.86	4.20
EU-15	0.00	0.00	0.00	26.09	21.23	22.93	19.99	15.30	16.05
Eastern Europe*	11.26	17.03	18.38	1.29	1.28	1.06	0.99	0.62	0.64
Other Europe	20.36	17.16	15.60	3.16	2.91	3.04	1.99	1.60	1.44
Africa Middle East									
East	18.01	12.68	12.09	5.00	4.15	3.58	5.14	3.63	3.57
Japan	6.24	5.20	4.80	11.84	9.80	8.18	0.00	0.00	0.00
South East Asia*	13.76	17.04	13.84	15.74	18.35	16.19	33.45	42.00	39.75
Oceania	2.29	2.30	1.99	2.56	2.26	1.97	2.56	2.31	2.28
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Own calculations; CHELEM database (CEPII).

Notes: Cells shaded in grey mark shares above 10%; *: including former USSR; *: including India and China.

In table 4.2.3, the commodity distributions of the exports of the EU-15, the US and Japan are presented for the years 1991, 1997 and 2001. The exports of the EU-15 are dominated by four product groups: 'Mechanical', 'Chemical', 'Electronics' and 'Vehicles'. While the shares of 'Electronics' and 'Chemical' are on the rise, that of the group 'Mechanical' declining.

US exports are less and less dependent on natural resources and traditional industrial products, although in 2001 the product group 'Mechanical' still comes first in terms of the share of total exports. The other two important commodity groups are 'Electronics' and 'Chemical'. A clear shift can indeed be identified over the period 1991 to 2001: away from mechanical and food products towards electronic and chemical products.

The product pattern of Japanese exports is very similar to the dominant pattern in Europe with the following main export product groups: 'Electronics', 'Vehicles', 'Mechanical' and 'Chemical'. Their weights are all relatively stable over the period 1991 to 2001. However, Japan is characterised by a greater export specialisation in 'Electronics' and 'Vehicles' than the EU-15, while the product group 'Chemical' is of a lesser importance.

Table 4.2.3 Sectoral distribution of exports (1991-1997-2001)

	EU-15			US			Japan		
	1991	1997	2001	1991	1997	2001	1991	1997	2001
Energy	2.60	2.10	2.71	3.02	2.06	1.92	0.41	0.50	0.35
Food industry	8.62	7.71	6.53	12.96	10.65	9.07	0.68	0.59	0.80
Textile	6.99	6.57	6.07	2.65	3.12	2.76	2.65	2.02	1.68
Wood&Paper	5.98	6.26	6.07	6.67	6.32	5.80	3.95	3.36	3.43
Chemical	16.48	16.62	18.53	13.37	14.05	15.65	8.44	10.41	10.89
Steel industry	3.77	2.74	2.22	1.43	1.16	1.03	4.36	4.01	3.57
Non-ferrous	1.50	1.44	1.50	2.06	1.66	1.51	0.72	1.01	1.14
Mechanical	25.89	23.64	22.02	24.41	22.86	22.74	19.25	20.86	19.06
Vehicles	9.01	9.30	10.20	7.86	8.69	8.76	22.40	18.70	20.24
Electrical	5.12	6.02	6.13	4.68	5.32	5.32	7.02	7.98	8.14
Electronics	8.99	12.43	13.95	16.27	19.88	20.58	28.37	27.53	26.28
Others	5.04	5.18	4.07	4.61	4.23	4.87	1.75	3.03	4.42
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Own calculations; CHELEM database (CEPII).

Note: Cells shaded in grey mark shares above 10%.

**The results
of the
CMSA**

What have thus been the trends in world export market shares over the decade 1991/2001? Graph 4.2.2 presents the levels of the world export market share for the countries (or groups of countries) for the years 1991, 1997 and 2001.⁹ The exact values of the changes in these shares, i.e. the 'total effect' can be found in tables 4.2.4 and 4.2.5.

The world export market share of the EU-15 still amounted to a bit more than 25% in 1991¹⁰. But it was on a clear downward path over the decade 1991/2001 falling to just less than 23% in 2001. The pace of the decline accelerated during the second period (1997/2001). In percentage terms, the fall represented 3.3% in 1991/1997 and 5.6% in 1997/2001.

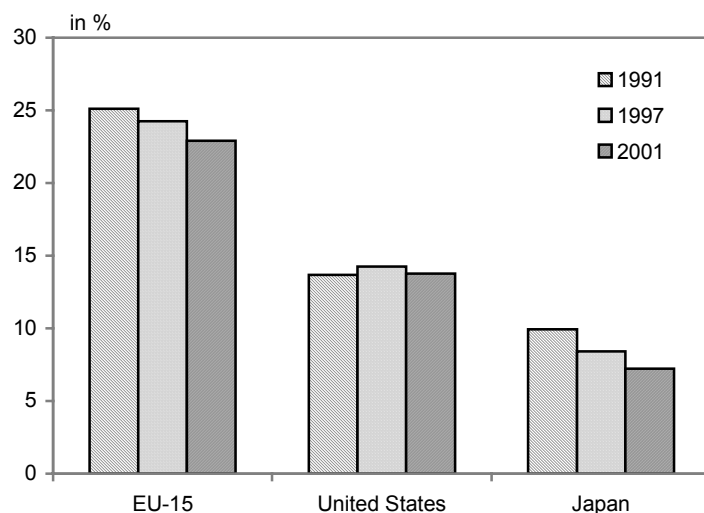
The US had a world export market share of roughly 14%. The profile over the period examined here was hump-shaped. Indeed, in 1991/1997 the share rose from 13.7% to 14.3%, which implies an increase by 4.2%. The US is the only country of the three that increased its aggregate export market share during this period. Between 1997 and 2001, the US suffered world export market share losses of 3.4% so that its world export market share fell back to 13.8% in 2001, which is just slightly above the 1991 level.

⁹ The definition of the world export market share of a country that has been set out above includes a correction for the imports of the country. This correction is indeed very important given the size of the share of the three countries (or groups of countries) in world imports.

¹⁰ Although Austria, Finland and Sweden joined the European Union only in 1995, they are included in the country group EU15 already in 1991.

Over the decade 1991/2001, the decline in the world export market share of Japan was quite dramatic. Starting off at roughly 10% in 1991, it plummeted first to 8.4% in 1997 and then to 7.2% in 2001. The falls amounted to 15.5% and 14.1%.

Graph 4.2.2 World export market share (1991-1997-2001)



Source: Own calculations; CHELEM database (CEPII).

The aim is now to decompose these 'total effects' for the two periods 1991/1997 and 1997/2001 into the four terms described above: the 'competitiveness effect', the 'market distribution effect', the 'commodity composition effect' and the 'combined commodity-market effect'. These effects are shown in tables 4.2.4 and 4.2.5. Further information is provided by the contributions of the 9 geographical areas and 12 commodity groups to the change in the world export market share (or 'total effect') that are presented in tables 4.2.6 and 4.2.7.¹¹

¹¹ The presentation of these contributions has been limited to the 'total effect', but contributions to the other effects can also be calculated.

Table 4.2.4 Global results of the CMSA (1991-1997)

	World export market share		Total effect		Competitiveness effect		Market distribution effect		Commodity composition effect		Commodity market effect	
	t=0	t=1	Diff.	Diff.	Diff.	Diff.	Diff.	Diff.	Diff.	Diff.	Diff.	Diff.
	wt	wt	abs	Share 91	abs	Share 91	abs	Share 91	abs	Share 91	abs	Share 91
EU-15	25.108	24.273	-0.835	-3.3	-0.528	-2.1	-0.628	-2.5	0.118	0.5	0.203	0.8
United States	13.670	14.250	0.580	4.2	-0.673	-4.9	0.918	6.7	0.445	3.3	-0.110	-0.8
Japan	9.929	8.394	-1.534	-15.5	-2.898	-29.2	0.933	9.4	0.573	5.8	-0.143	-1.4

Source: Own calculations; CHELEM database (CEPII).

Notes: wt = in % of world trade; abs = in absolute terms (percentage point change); share91 = in % of the 1991 world export market share; cells shaded in grey mark negative values.

Table 4.2.5 Global results of the CMSA (1997-2001)

1997-2001	Export market share		Total effect		Competitiveness effect		Market distribution effect		Commodity composition effect		Commodity market effect	
	t=0	t=1	Diff.	Diff.	Diff.	Diff.	Diff.	Diff.	Diff.	Diff.	Diff.	Diff.
	wt	wt	abs	Share 97	abs	Share 97	abs	Share 97	abs	Share 97	abs	Share 97
EU-15	24.273	22.912	-1.361	-5.6	-0.882	-3.6	-0.369	-1.5	-0.203	-0.8	0.093	0.4
United States	14.250	13.766	-0.484	-3.4	-0.942	-6.6	0.413	2.9	-0.020	-0.1	0.065	0.5
Japan	8.394	7.208	-1.186	-14.1	-1.017	-12.1	-0.001	0.0	-0.034	-0.4	-0.134	-1.6

Source: Own calculations; CHELEM database (CEPII).

Notes: wt = in % of world trade; abs = in absolute terms (percentage point change); share97 = in % of the 1997 world export market share; cells shaded in grey mark negative values.

The CMSA for the external trade of the EU-15 reveals several interesting features. The fall in the world export market share of the EU-15 between 1991 and 2001 can be attributed to two trends: a decline as regards the 'competitiveness effect' and an unfavourable market specialisation. The negative 'competitiveness effect' accounted for an important part of the decline in the world export market share of the EU-15 during both periods.

It is important to be very careful with interpretations of the 'competitiveness effect' given its residual character. For sure, this effect is strongly influenced by price and exchange rate movements. Nonetheless, it measures changes in both price and non-price competitiveness. It can be shown for a larger sample of countries that the relationship between the 'competitiveness effect' and traditional measures of

competitiveness such as the change in the effective exchange rate or unit labour costs is indeed negative, i.e. as expected, but weak.¹²

However, the world export market share of the EU-15 also dropped due to the continuously negative 'market distribution effect'. The impact of the commodity specialisation of EU-15 was positive in 1991/1997 and negative in 1997/2001, but rather small during both periods. Moreover, the results for the 'combined commodity-market effect' reveal that the exporters of the EU-15 placed the right products on the right markets during both periods.

The EU-15 suffered substantial export market share losses in the areas Africa Middle-East and Other Europe between 1991 and 1997, but also experienced sizeable gains in Eastern Europe. Trade barriers between the EU-15 and Eastern Europe were quickly dismantled after the changes in regimes in that area, and the EU-15 was indeed well-placed geographically to benefit from the emergence of Eastern Europe as an import area. In South East Asia appreciable gains in 1991/1997 were followed by rather large losses up to 2001. Moreover, the positive contribution of Eastern Europe to the change in the world export market share of the EU-15 was squeezed during the period 1997/2001, while the areas Other Europe and Africa Middle East continued to have a negative impact, although this negative impact was now smaller than in the previous period.

Finally, the decrease in world export market share of the EU-15 between 1991 and 1997 originated in particular in the commodity groups 'Mechanical', 'Food industry' and 'Steel industry', while 'Electronics' made a big positive contribution to the EU-15 world export market share during that period. In 1997/2001, the main positive contributions came from the commodity groups 'Chemical' and again 'Electronics', but their role was largely outweighed by the negative contribution of the groups 'Mechanical', 'Food industry', 'Textile' and 'Others'.

¹² For greater detail on this relationship see the forthcoming paper Michel, B. (2004), "Trends in export market shares between 1991 and 2001", Working Paper, Federal Planning Bureau, Belgium.

Table 4.2.6 Contributions of the geographical areas to the ‘total effect’ in absolute value (percentage point change) for the periods 1991/1997 and 1997/2001

	EU-15		US		Japan	
	91/97	97/01	91/97	97/01	91/97	97/01
North America	-0.176	0.865	0.184	0.077	-0.682	-0.179
South America	0.067	-0.179	0.829	0.149	0.019	-0.105
EU-15	0.000	0.000	-0.542	0.131	-0.700	-0.127
Eastern Europe*	1.308	0.078	0.007	-0.038	-0.046	-0.006
Other Europe	-0.948	-0.589	-0.018	0.004	-0.063	-0.031
Africa Middle East						
East	-1.445	-0.308	-0.092	-0.100	-0.206	-0.048
Japan	-0.305	-0.161	-0.222	-0.271	0.000	0.000
South East Asia°	0.680	-0.965	0.463	-0.386	0.204	-0.660
Oceania	-0.016	-0.101	-0.028	-0.051	-0.060	-0.030
Total	-0.835	-1.361	0.580	-0.484	-1.534	-1.186

Source: Own calculations; CHELEM database (CEPII).

Notes: Cells shaded in grey mark negative values; *: including former USSR; °: including India and China.

Table 4.2.7 Contributions of the commodity groups to the ‘total effect’ in absolute value (percentage point change) for the periods 1991/1997 and 1997/2001

	EU-15		US		Japan	
	91/97	97/01	91/97	97/01	91/97	97/01
Energy	-0,143	0,111	-0,119	-0,029	0,001	-0,017
Food industry	-0,294	-0,375	-0,255	-0,269	-0,018	0,008
Textile	-0,160	-0,204	0,082	-0,066	-0,094	-0,048
Wood&Paper	0,018	-0,128	-0,011	-0,102	-0,110	-0,035
Chemical	-0,103	0,211	0,174	0,153	0,036	-0,089
Steel industry	-0,281	-0,157	-0,030	-0,024	-0,096	-0,079
Non-ferrous	-0,028	-0,005	-0,045	-0,029	0,014	-0,003
Mechanical	-0,764	-0,692	-0,079	-0,127	-0,160	-0,377
Vehicles	-0,005	0,078	0,163	-0,032	-0,654	-0,110
Electrical	0,174	-0,055	0,118	-0,026	-0,027	-0,083
Electronics	0,759	0,179	0,609	0,001	-0,505	-0,417
Others	-0,009	-0,324	-0,027	0,067	0,080	0,064
Total	-0,835	-1,361	0,580	-0,484	-1,534	-1,186

Source: Own calculations; CHELEM database (CEPII).

Notes: Cells shaded in grey mark negative values; *: including former USSR; °: including India and China.

For the US, the decomposition shows that losses due to the ‘competitiveness effect’ were steady throughout the decade. The size of the (always positive) ‘structural effect’ therefore determined whether there was a rise or a fall in the aggregate export market share. In 1991/1997 it outweighed the ‘competitiveness effect’, but this was no longer true in 1997/2001. Among the components of the ‘structural effect’¹³ the ‘market distribution effect’ stands out. The impact of the geographical specialisation of US exports on the country’s export market share is positive, to very positive, in both periods. Furthermore, the commodity specialisation of US exports entails export market gains in 1991/1997 and has no impact in 1997/2001. Finally, the ‘combined commodity-market effect’ is rather small in both periods.

During the period 1991/1997, the contributions of the areas South America and South East Asia were the driving force behind the US export market share gains. Negative contributions came from the EU-15 and Japan. It is noteworthy that the US unlike the EU-15 did not draw any benefit from the emergence of Eastern Europe as an import area. The period 1997/2001 is marked by a reversal in the contributions of South East Asia and the EU-15. Indeed, the US suffers from the slower import growth of South

¹³ As explained above, the ‘structural effect’ corresponds to the sum of the ‘market distribution effect’, the ‘commodity composition effect’ and the ‘combined commodity-market effect’.

East Asia in the wake of the Asian crisis of 1997, but gains from the stronger import growth of the EU-15 during that period. The contribution of Japan was again negative.

As regards the contributions of the commodity groups to the 'total effect' for the US, they are globally small in both periods. In 1991/1997 only the strongly positive contribution of the group 'Electronics' stands out. Between 1997 and 2001, the

contributions of a vast majority of commodity groups are negative, the most important coming from the group 'Food products'.

The CMSA for Japan reveals several important characteristics. First of all, a very negative 'competitiveness effect' was the driving force behind the continuous downward trend in Japan's world export market share over the decade 1991/2001. This very negative 'competitiveness effect' was partly compensated by a significantly positive 'structural effect' during the period 1991/1997. On the one hand, Japan drew a sizeable benefit from the geographical specialisation of its exports, and, on the other hand, the commodity specialisation of its exports also had very positive impact on its export market share. This was not the case anymore during the period 1997/2001. All components of the 'structural effect' were negative during that period.

Japan's export market share losses in 1991/1997 were concentrated in the destination markets of North America and the EU-15. These negative contributions were hardly compensated by the positive contribution of South East Asia. During the period 1997/2001, Japan's export market share shrank in all geographical areas. The most important negative contribution to the 'total effect' now comes from South East Asia, which had still contributed positively in 1991/1997.

Finally, turning to the contributions of the commodity groups to the change in Japan's world export market share, most of them were negative in both periods. Japan lost the largest part of its aggregate export market share in the commodity groups 'Vehicles', 'Mechanical' and most of all 'Electronics'. The very negative contribution of the latter commodity group is surprising at first sight. However, by calculating a decomposition for Japan's market share in that commodity group it can be shown that this is mostly due to a very negative 'competitiveness effect'.

Summing up the findings, a few points can be made. The EU-15 and Japan suffered continuous aggregate export market share losses over the decade 1991/2001, while the US experienced a slight increase in its aggregate export market share. However, the path was hump-shaped for the US share. Losses in competitiveness were the main driving force for the decline in aggregate export market shares for all three countries or country groups. During the period 1991/1997, those competitiveness losses were partly compensated by export market share gains due to a favourable market and commodity specialisation for the US and Japan. This was not the case for the EU-15.