
<http://www.euren-network.org>



The Economic Outlook in Europe in 2006

***A CYCLICAL UPSWING, BUT WHAT ABOUT
TREND GROWTH?***

Winter Report

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

January 2006

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 eighth 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>.

Participating Institutes:

Bureau fédéral du Plan (BfP), Bruxelles, Belgium

Team Leader : Bart de Ketelbutter (bk@plan.be)

Centre d'Observation Economique de la Chambre de Commerce et d'Industrie de Paris (COE), France - *Team Leader* : Alain Henriot (ahenriot@ccip.fr)

Centro de Predicción Económica (CEPREDE), Madrid, Spain

Team Leader : Emilio Fontela (emilio.fontela@ceprede.com)

Centro Studi Confindustria (CSC), Rome, Italy

Team Leader : Pasquale Capretta (p.capretta@confindustria.it)

Oxford Economic Forecasting Ltd (OEF), Oxford, United Kingdom

Team Leader : Keith Church (kchurch@oef.co.uk)

Rheinisch-Westfälisches Institut für Wirtschaftsforschung (RWI), Essen, Germany

Team Leader : Roland Döhrn (doehrn@rwi-essen.de)

Economic Research, Marketing and Computing (KOPINT-DATORG), Budapest, Hungary

Team Leader : Éva Palócz (palocz@kopdat.hu)

Editor of this report: Roland Döhrn

Report closed on January 6, 2006

List of Contributors to this Report

BFP

Bureau Federal du Plan, Brussels, Belgium

Bart de Ketelbutter
Ludovic Dobbelaere
Filip Vanhorebeek

CEPREDE

Centro de Predicción Económica, Madrid, Spain

Emilio Fontela
Julián Pérez

COE

Centre d'Observation Economique de la Chambre de
Commerce et d'Industrie de Paris, France

Jacques Anas
Thierry Coville
Frédérique Cerisier
Alain Henriot

CSC

Centro Studi Confindustria, Rome, Italy

Guiseppe Schlitzer
Pasquale Capretta

KOPINT-DATORG

Economic Research, Marketing and Computing
Company Limited, Budapest, Hungary

Éva Palócz
Attila Bartha
Gyula Takác

OEF

Oxford Economic Forecasting, Oxford, United Kingdom

Keith Church
Simon Knapp
Vanessa Rossi

RWI

Rheinisch-Westfälisches Institut für
Wirtschaftsforschung (RWI), Essen, Germany

Roland Döhrn

Content

About the European Economic Network
List of participating Institutes
List of contributors to this Report

CHAPTER 1

Executive summary

CHAPTER 2

The International Outlook

Box

The COE leading indicator for the United States

CHAPTER 3

The outlook in Europe

1. Recent developments in the euro area economy
2. EUREN forecast for 2005 and 2006
3. The UK economy
4. The new member states

Boxes

The Belgian business cycle indicator

The COE leading indicator for the euro area

CHAPTER 4

Special Study

The housing market: a risk for European growth?

1. Introduction
2. The Housing boom in Spain
3. The French housing market: How far will the rise in prices be sustainable for households?
4. UK housing market shows renewed life
5. Housing price developments in the Baltic States

EXECUTIVE SUMMARY

Euro area economy in an upswing

In the second half of 2005 the euro area experienced a revival of economic activity. The turnaround was driven by investment and exports. The surge of export growth reflects that the global environment remained positive despite of the oil price hike, but also that the euro depreciated markedly against the dollar since March 2005, which improved competitiveness of euro area exporters. However, as imports expanded even stronger, the contribution of net exports to growth was slightly negative.

Since 2004 investment conditions have been quite favourable: firms have widened their profit margins, corporate balance sheets have become healthier, ample liquidity was available and financing costs were extremely low. Investment growth has nevertheless been disappointing so far in this recovery compared to the previous one. It appears that firms were reluctant to invest as long as domestic demand failed to pick up decisively. In the third quarter of 2005, however, investment growth accelerated to 1.6% which is the strongest increase since 2000Q1. This should not be taken as a sign that an investment boom is about to materialise in the euro area, since capacity utilisation is still quite low. Nevertheless, investment should be supportive to economic growth in 2006.

International environment remains supportive

The international environment is expected to remain supportive in 2006. On the one hand private consumption in the U.S. and investment in China, which have been the main drivers of world trade in the past, are forecast to cool down. This should be compensated by a speeding up in Japanese and German demand. Altogether, world trade growth is expected to reach 7.5% in 2006 after 6.9% in 2005, which is in line with trend growth. At the same time we assume exchange rates to be more or less stable, although global imbalances will not be reduced and will continue to be a risk for foreign exchange markets. The oil price is expected to remain at its current level. In our scenario the oil market will be well supplied, and demand will rise only moderately. However, this will lead to little improvement in refinery capacity, which drives the price of refined products.

Economic policy will continue to be supportive in the euro area. The latest interest rate rise of the ECB does not mark the beginning of an escalating process, but is rather aimed at sending a preventive message to economic agents. Although it is not excluded that the ECB raises the refinancing rate by another 25 basic points, this would leave monetary policy in expansionary territory. Fiscal balances will change little according to the recent stability programmes.

Exports less buoyant, but domestic demand more vivid

Against this background, the EUREN institutes forecast the current upswing in the euro area to continue. Whereas exports are predicted to expand less buoyantly than in the second half of 2005, we expect domestic demand to gain momentum. Gross fixed capital formation will be the driving force, benefiting from low interest rates and higher corporate profits. Moreover, companies will be more inclined to expand capacities as business confidence has improved. All in all, we forecast investment to grow at an annual rate of 4.2% in 2006 after 2.4% in 2005. Private consumption should grow by only 1.4% this year, which is nearly the same rate as in 2005, because households' disposable income is expected to increase only moderately. GDP is forecast to grow at a rate of 1.9 % in 2006, which marks a significant improvement compared to 2005. During the year, the recovery will slightly lose momentum, because world trade should grow less buoyantly and effects of the depreciation of the euro will fade out.

Labour market situation will improve little

The situation in the labour market will only improve little. On the one hand capacity utilisation is expected to rise, which will enhance productivity growth. On the other hand, the labour force in the euro area increases at a rate of almost 1%. On balance, there is little room to reduce the number of jobless. As a result, the unemployment rate will fall only slightly to 8.3% in 2006 from 8.6% in 2005.

Inflation will come down significantly in the course of 2006. Higher productivity growth and moderate wage increases will keep cost pressures under control. Moreover, the effects of higher energy prices will phase out given our oil price assumption. In the second half of 2006 headline inflation should fall below 2%, which would reduce pressure from the ECB to tighten monetary policy further. On average, HICP will rise by 2.1%, which is slightly weaker than in 2005.

Euro area economy remains vulnerable

Even if the euro area economy has started a cyclical upswing, which is supported increasingly by indicators, the economy remains vulnerable. Compared to previous expansions domestic demand remains lacklustre, above all due to weak private consumption. Hence, external shocks leading to a slowdown of world trade or an appreciation of the euro would endanger the euro area expansion.

For the UK economy the signs are mixed. On the one hand the worst seems to be over for the housing market. On the other hand the industrial sector appears to be in retreat again. Manufacturing output fell and surveys point to a worrying deterioration of order books. As a result the UK economy looks to be stuck in a sub-trend rut. We expect GDP to rise by only 2.1% in 2006.

In the new member states GDP growth accelerated in 2005, reflecting mainly a rebound of investment and soaring exports. Under these conditions, the labour market situation improved in most countries. We forecast these positive developments to continue in 2006. However, inflation remains a problem to the region, in particular in the Baltic states, endangering their accession to the EMU.

Table 1.1 Main features of the forecast

<i>Percentage change unless otherwise indicated</i>			
	2004	2005^e	2006^f
World trade	10.3	6.9	7.5
Oil price (Brent/b)	38.2	54.4	60.0
GDP growth			
- United States	4.2	3.6	3.1
- Japan	2.7	2.4	1.8
Euro area			
- GDP growth	1.8	1.4	1.9
- Inflation (HICP)	2.1	2.2	2.1
- Unemployment rate (%)	8.9	8.6	8.3
UK Economy			
- GDP growth	3.2	1.7	2.1
- Inflation (HICP)	1.3	2.1	2.1
- Unemployment rate (%)	4.7	4.7	4.8
New EU member states			
- GDP growth	5.2	4.3	4.7
- Inflation (HICP)	4.1	2.6	2.5
- Unemployment rate (%)	13.5	12.4	11.8

Source: EUREN. - ^eestimate - ^fforecast

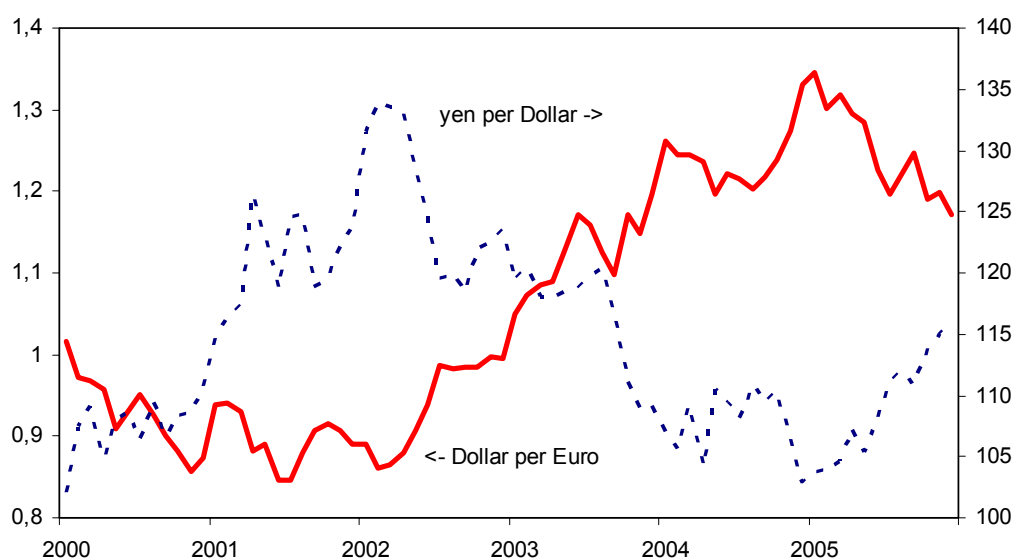
THE INTERNATIONAL OUTLOOK

1. The global environment

***Some signs
of
deceleration
of world
GDP growth***

Since the beginning of 2005 the dollar has appreciated by approximately 15% against the euro and more than 16% with respect to the yen (Graph 2.1). In the last several months the euro-dollar rate has been fairly stable but recently the euro has been heading downwards dropping below 1.17 dollars per euro in mid-November. The progressive strengthening of the dollar must be attributed to several factors such as the interest rate differential, growth expectations, and the fiscal relief on capital repatriation accorded to American companies until the end of 2005. The differential between the US and the euro area long term interest rates, which was negative in 2004, became positive during the last year and is expected to increase further to more than 2.0% in 2006. The spread with respect to Japan is, and will remain, even wider. Attracted by higher rates than anywhere else in the industrialized world, international investors, in particular Asian central banks, have purchased great amounts of government bonds and other U.S. assets thus contributing to finance the American current account deficit.

Graph 2.1 Dollar exchange rate



Source: Thomson Financial

Exchange rates will change little

The final estimate of the third quarter GDP figures and the most recent positive data on business and consumer confidence, while suggesting that the shock provoked by the natural disasters and the upswing in oil prices have been rather easily overcome, are bound to feed expectations of further U.S. interest rate hikes. On the contrary, in both Europe, where growth is expected to be rather weak, and Japan, not yet entirely out of deflation, prospects of significant increases in interest rates remain rather weak.

In July China entered a “managed float” exchange rate regime. Since then, the renminbi has appreciated by only 2.4% with respect to the dollar while strengthening by more than 10% against the yen. The depreciation of the Japanese currency against the dollar, due to strong outflows of capital, as well as the notable worsening of the Japanese trade balance caused by higher energy costs, even if temporary, may help to explain why the Chinese authorities were cautious to revalue the renminbi stronger. They were fearful losing competitiveness as well as stirring up deflationary pressures, since the economy is still characterized by strong imbalances between demand and supply.

While we believe that the exchange rate instrument won't be sufficient to re-establish the balance in the U.S. current account, we assume that the differentials in interest rates and growth will determine the level of the dollar exchange rate in the short and medium term. In particular, expectations of increasing returns on capital will continue to sustain the dollar as long as the U.S. economy grows at rates close to its potential. When fiscal relief for the repatriation of foreign capitals ends and interest rates will increase, albeit

moderately, in the euro area and, probably in the second half of the year, also in Japan, the dollar will lose strength gradually. Nevertheless, as growth and interest rate differentials between the euro area and the U.S. will persist, the pressure exercised on the dollar by the U.S. current account deficit will be counterbalanced. In substance, therefore, the weakening of the dollar during 2006 will be rather contained and the dollar/euro exchange rate should settle, on average, at 1.23 dollars per euro in 2006, substantially unchanged with respect to 2005.

World trade still strong

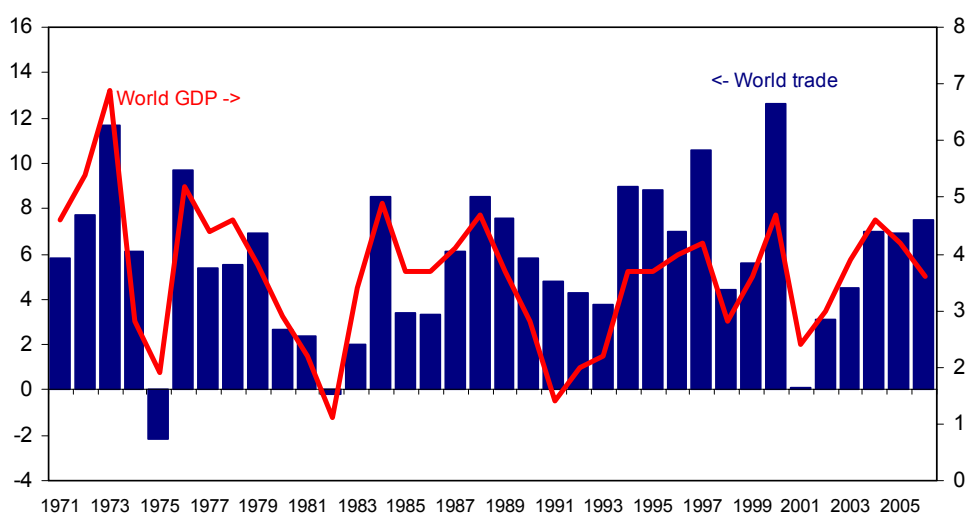
Following the strong deceleration during the first half of the year, world trade has started last summer to increase at very sustained rates, close to those recorded in 2004, when it posted an exceptionally high growth (10.3%). The deceleration during the first half of the year, mainly due to the slowing of US and Japanese imports, will affect the 2005 annual average which will, thus, settle at around 7%. The strong deceleration in U.S. imports recorded in the third quarter is almost exclusively due to an inventory adjustment. Therefore, it should remain at least in size only a temporary phenomenon. However, the expected deceleration of consumption should significantly affect the course of world trade in coming years. The other driver of world trade in recent years, Chinese investments, is also expected to slow down during 2006, following the Chinese authorities' attempt to cool down their economy and achieve a more balanced growth. Greater buoyancy in Japanese and European demand should, at least partially, compensate for the smaller contribution to world demand growth by the United States and China.

The impact of the in oil prices hike in world trade is mixed: On the one hand, oil-importing countries suffer terms of trade losses that dampen their demand. On the other hand, oil-exporting countries are expected to increase their import of finished goods at very sustained rates (in the order of 20% per year in volume).

Finally, the stalemate in the Doha Round, which was initially set to end by December 2005 but was successively extended to 2007 and beyond, will deprive world trade of the traditional impulse that a generalized tariff reduction and further opening of global markets would have provided.

Altogether, we forecast world trade to grow at a rate of 6.9% in 2005 and 6.9% 7.5% in 2005 which is in line with the long term trend (Graph 2.2).

Graph 2.2 GDP and World Trade yoy changes in %



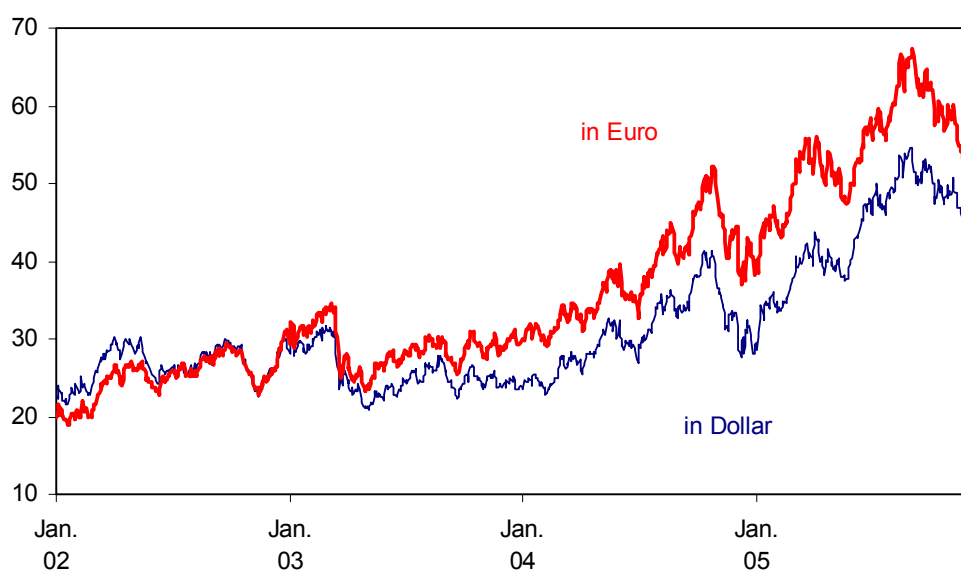
Source: Thomson Financial, EUREN forecasts

The oil market remains tight

Since the beginning of September, crude oil prices have been showing a slightly downward trend, alternating with sudden and temporary hikes; this has brought Brent prices to settle at around \$53.5 per barrel for the whole second half of November (Graph 2.3). Prices have been heading downwards since the impact of hurricane Katrina in the Gulf of Mexico – with a lull in US extraction and refinery capacity - was both limited in time and moderated by the use of reserve stocks. Furthermore, fears of possible shortages of oil distillates with the arrival of the winter season have subsided, given current above average temperatures.

Crude oil markets have been and continue to be well-supplied: in the third quarter of 2005 world production topped demand by more than 1.9 mbd. In detail, effective OPEC production in October 2005 was above 30 mbd despite a sudden and unexpected decrease in Iraqi oil extraction (down to 1.77 mbd). Compared to the previous year, overall non-OPEC production should have increased by 0.56 mbd on average in 2005. The greatest increases have come from developing countries and Russia while production in OECD countries has been significantly declining. Growth in world demand has, instead, significantly decelerated (+1.2 mbd in 2005 compared to a +2.9 mbd in 2004). Thus, OECD commercial stocks have continued to expand to record high levels; in Western Europe, for instance, they are at the highest in the last six years.

Graph 2.3 Oil prices, Euro and Dollar per barrel



Source: Thomson Financial

In the course of 2006, crude oil demand should continue to accelerate (+1.5 mbd), but non-OPEC production should rise even more (+1.7 mbd). Moreover, the increase in OPEC's production capacity decided in recent months should create additional spare capacity within the cartel. Whereas the oil market can be expected to be very well supplied, there are concerns about refinery capacity and the shift in demand towards light oil derivatives (gasoline, naphtha, light heating oil).

Our scenario presumes that demand will rise moderately in 2006, but there will be little improvement in refinery capacity and the availability of refined products. Prices should, therefore, slightly rise compared to recent months. Since September, Brent oil prices dropped from 63.3 dollars a barrel, to 55.3 dollars in November (Graph 2.3). In the first three quarters of 2005, crude oil supply kept topping demand by an ample margin, bringing commercial stocks to satisfactory levels. Despite that, however, prices remain high because of current refinery shortages and uncertainties regarding the adequacy of crude oil supply that has led to greater activity in futures markets. Both an upstream and a downstream capacity expansion is necessary to meet the future and present demand of crude and refined oil products. OPEC countries are investing significantly to expand extraction capacity from today's 32.5 mbd to at least 38 mbd by 2010. The cartel's unutilized capacity is estimated at around 2 mbd, equal to 8.5%, a sharp increase with respect to 4.9% at the end of 2004. But the persisting lack of refinery capacity remains one of the principal reasons of oil price increases and volatility. The OPEC countries have also begun to invest in downstream projects, but volatility is, however, destined to remain a market feature for some time. It is, in fact, likely that the

market will continue to be driven by oil by-products, remaining sensitive to further unexpected closings of refineries or demand developments during the winter which will continue to allow speculative behaviours to push prices over the level justified by fundamentals.

Table 2.1 Exogenous and international variables

<i>Percentage changes unless otherwise indicated</i>				
	2003	2004	2005^e	2006^f
World trade	5.4	10.3	6.9	7.5
United States				
GDP	2.7	4.2	3.6	3.1
3m interest rates	1.0	1.4	3.5	4.6
10y Gvt bond yield	4.0	4.3	4.3	5.2
Japan				
GDP	1.4	2.7	2.4	1.7
3m interest rates	0.06	0.05	0.0	0.2
10y Gvt bond yield	1.1	1.5	1.4	1.8
US dollar/euro	1.13	1.24	1.25	1.23
Yen/US dollar	115.9	108.2	109.8	109.0
GBP/euro	0.69	0.68	0.68	0.69
Oil price, Brent, US\$/barrel	28.8	38.2	54.4	60.0
Percentage changes	15.7	32.6	42.3	10.4

Source: IMF, OECD, EUREN. - ^eestimate - ^fforecast

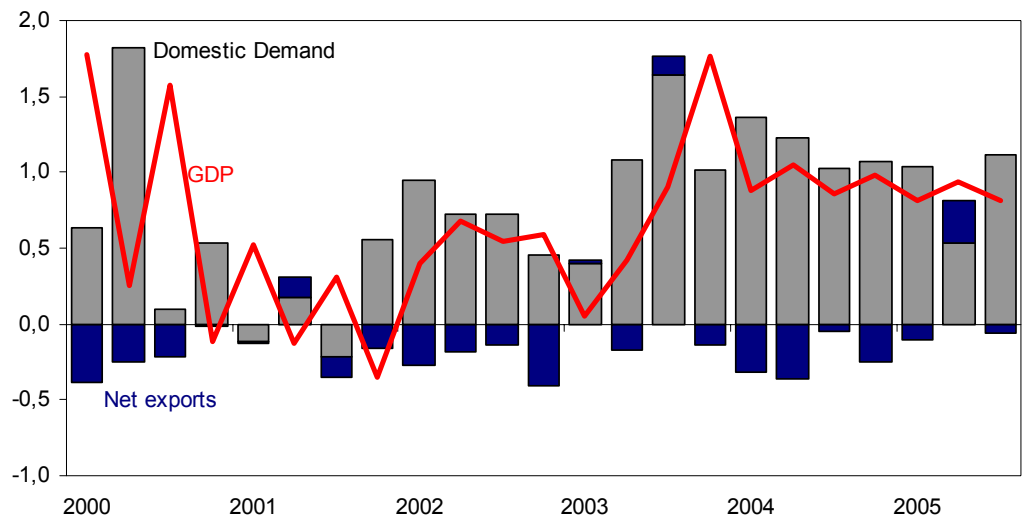
2. The US economy

The expansion continues

Despite a less-expansionary fiscal policy than in the past, rising interest rates and oil price increases the U.S. economy did not lose its dynamism. In the third quarter of 2005 GDP increased by 1.0% (Graph 2.4), in acceleration with respect to the preceding quarter (0.8%), despite the negative impact of hurricanes Katrina and Rita which, however, should have subtracted from 0.1 to 0.25 percentage points from GDP growth. Third quarter growth was once more driven by household consumption (+1.0%), with a strong acceleration in the durable goods (+2.5%), and cars in particular, that have further reduced the household savings rate to well below zero (-1.1%). Although decelerating with respect to the preceding quarters, both residential and non-residential fixed investments continued to provide a positive contribution to growth (0.3%) with investments in machinery and software particularly strong (+2.6%). Federal government expenditures grew rapidly as well (+2.0%), mainly due to interventions in the areas struck by the hurricanes. The foreign sector contribution to GDP growth was slightly negative (-0.1%). After a strong improvement recorded in the second quarter (+2.6%), exports remained substantially unchanged (+0.2%) as the damage to production and ports

limited trade in the areas struck by the hurricanes. Imports (+0.5%) reflected the inventory adjustment made by most firms during the summer months.

Graph 2.4 USA: Contributions to GDP growth in %

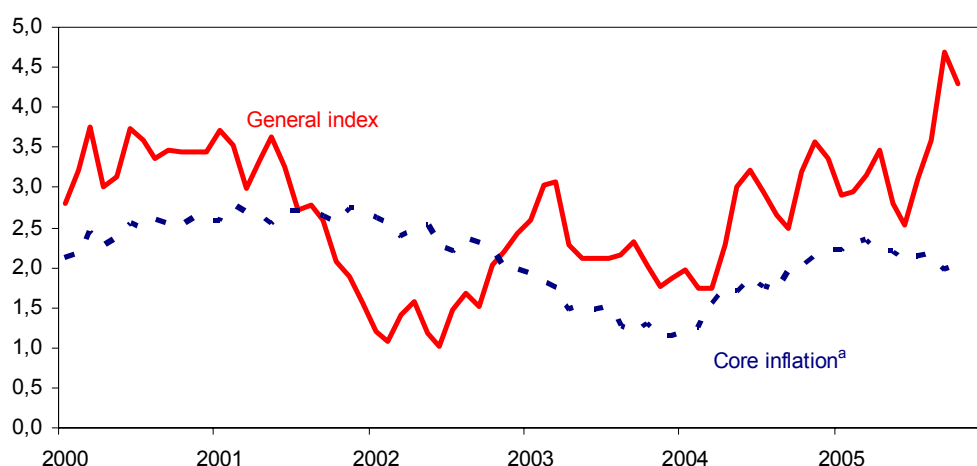


Source: CSC calculations based on Thomson Financial data

Inflation decelerates

Following the September hike (+1.2%) reflecting difficulties in the supply of energy products caused by the hurricanes, consumer prices began to decelerate in October (+0.2% with respect to the previous month) and decreased strongly in November (-0.6%). Energy costs, which had increased drastically during the summer months and had accounted for more than 90% of the general index total increase in September, dropped significantly in October (-0.2%) and, especially, November (-8.0%), with transportation costs down by 1.3% and 4.8% respectively in the two months due to a rapid decline in gasoline prices. On an annual basis, inflation eased back to a much more reassuring level (3.9%) from the peak reached in September (4.7%). After five consecutive months of rather contained increases (+0.1% a month), core inflation increased by 0,2% in both October and November confirming a gradual, although limited, transfer of higher energy costs to consumer prices (Graph 2.5). The deceleration in energy prices which had already begun, the continuous increase in productivity (+4.3% in the third quarter) and the moderate trend in the prices of manufactured products exposed to international competition should, nevertheless, bring inflation back in line with its long-term target and prevent inflationary expectations from excessively rising.

Graph 2.5 USA: Inflation, yoy percentage change



Source: Thomson Financial – ^aExcluding energy and fresh food

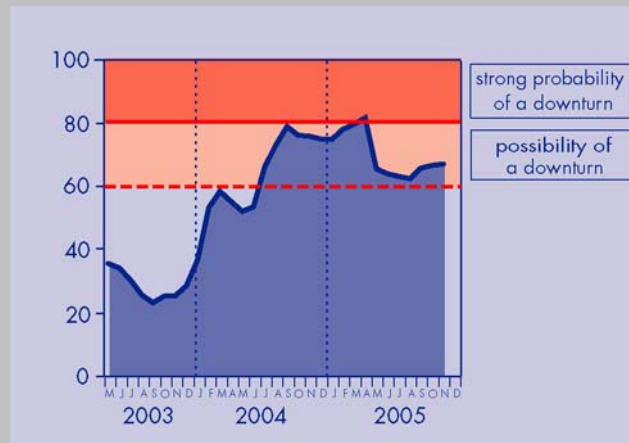
The Fed aims at one more increase

The data on third quarter growth, more positive than most analysts had expected, seem to confirm the FED's conviction that the economy is still too dynamic and, therefore, exposed to inflationary risks. In the FOMC meetings on November 1st and December 13, the Fed proceeded to increase the rate on federal funds by another 25 basis points each time bringing it to 4.25%. The increase since the beginning of 2005 equals 200 points. The fear of possible second round effects, mainly due to operators' attempt to compensate for their increased costs from higher oil prices (+0.7% the increase in producer prices in October after a 1.9% increase recorded in September), has led the Fed to move ahead towards its goal of gradually normalizing interest rates. As already mentioned, however, inflationary expectations should quickly subside and further monetary tightening should, therefore, be limited to only one additional FED increase in coming months.

Box 2.1 COE Leading indicator for the United States

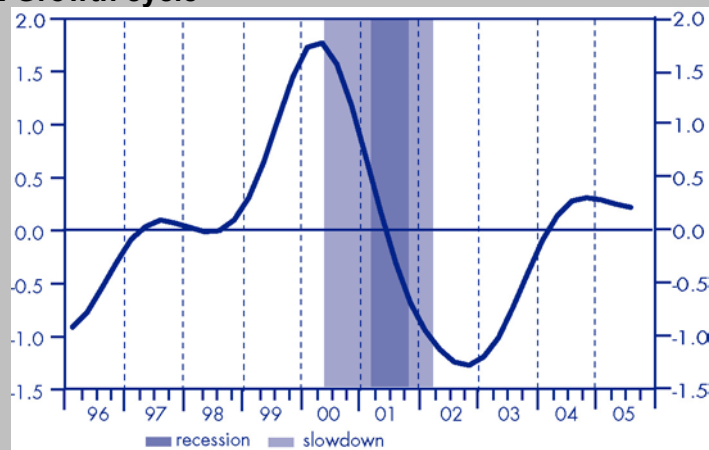
The COE leading indicator (IARC) for the United States is still used to anticipate the next economic downturn¹. In April 2005, the index climbed over the 80 threshold which gave a signal of a downturn within the next three months. However, the signal was not subsequently persistent because of a buoyant stock market, a continuing strong housing market and a rebound of the ISM index starting in May 2005. The IARC index remained over 80 for only one month and descended thereafter to 62.3 in August. It stands at 67.0 in November but will probably drop further to less than 60 once the rebound of household confidence is confirmed. In conclusion, despite the surge in oil prices and the negative effects of the hurricanes, the probability of a proximate economic downturn has dropped since April 2005. Therefore, at least during the coming three quarters, the growth rate is expected to stay above its trend growth rate estimated currently at around 3%.

Graph B-2.1 Growth cycle leading indicator:
Search of the next peak



Source: COE

Graph B-2.2 Growth cycle



Source: COE

¹ The components of the COE leading Indicator for the USA are: Conference Board's Consumer Confidence expectations Index, Manufacturing ISM index, Inventories of manufactured goods, Privately-owned housing units authorized by building permits, Standard & Poor's Index, Interest rate spread.

As a result of a series of factors, such as the huge purchases of U.S. government bonds by some Asian central banks and rather moderate long-term inflation expectations, long-term interest rates remained nearly stable at rather low levels until September. The sudden change in expectations caused by rising energy costs and the central bank's continuous announcements that it intends to honour its commitment to safeguard price stability has pushed the 10-year bond rate above 4.5% in the last month. We expect that the rates on 10-year government bonds to progressively rise until the end of 2006 to settle at 4.3%, on average, in 2005 and 5.2% in the following year.

Consumption is crucial

The U.S. economy is crucially dependent on household consumption. American households have until now benefited not only from lower interest rates and relatively easy access to credit but also and especially from

increases in housing prices which, in addition to generating a significant wealth effect, have also encouraged mortgage financing. Although decelerating, the real estate market has recently been given a boost by the introduction of new financing instruments which, although riskier because usually offered at variable rates, make the access to credit easier even to relatively lower income buyers.

Moreover, the risk linked to higher interest rates, in a context of strong household indebtedness, has not materialize yet only because long-term interest rates have remained and are still now at surprisingly low levels due to very moderate inflation expectations.

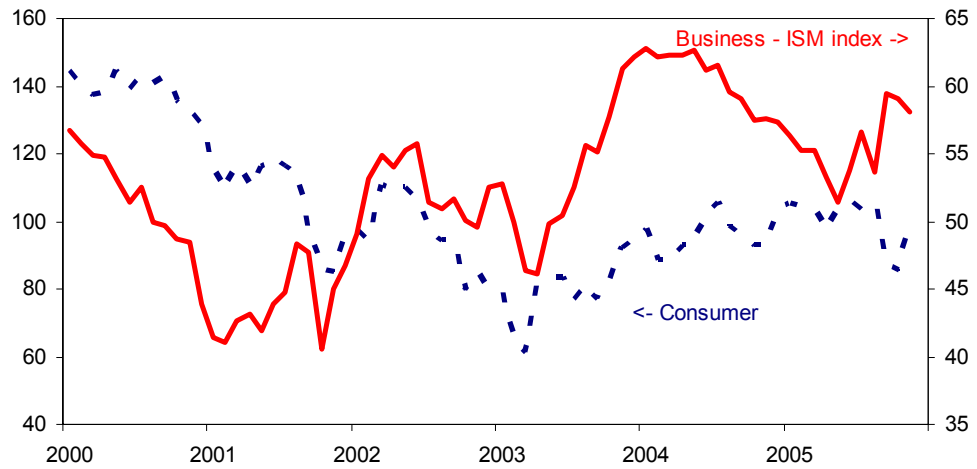
The gradual and progressive increase in long-term rates, accompanied by the effect of energy price increases, could significantly affect disposable income and drastically reduce consumers' ability to spend, especially if the higher production costs are reflected in income and employment. The latter has already shown some signs of weakness with a rather contained increase in October following a slight decrease in September when 35,000 jobs were lost, most of them, however, as a consequence of the hurricanes. The unemployment rate, which had been rather stable since May, dropped slightly in October from 5.1% to 5.0%.

Consumer confidence recovers ...

After falling by 18 point in September (from 105.5 to 87.5) due to the impact of hurricane Katrina and another decrease in October (from 87.5 to 85), consumer confidence headed upwards recently (November: 98.9, Graph 2.6). Although the index is still below the level before the arrival of Katrina, the shock seems to have been definitely overcome. The rapid decline in gasoline prices and the slow but progressive return to normal production activity have certainly contributed to restore a optimism even though consumers were still worried about the high prices for gas, heating oil and electricity as the winter months were approaching. The improved consumer confidence will be probably reflected in higher consumption in the coming months and will contain the expected GDP slowdown in the last quarter of this year.

Industrial production headed upwards again by 0.9% in October with a strong recovery in the manufacturing sector (+1.4%). Production had slowed down during the first two summer months when most firms chose to satisfy demand by resorting to inventories and then decreased strongly in September (-1.5%), when the damage caused by the hurricanes and a series of strikes in one of the largest aviation industries had significantly reduced production capacity in many sectors. The production loss in September attributable to the impact of the hurricanes is estimated at approximately 1.7%: while in the manufacturing sector production decreased altogether by 0.7% due, for the most part, to the strikes at Boeing, in the hurricane zone's most stricken sector, the mining sector, it collapsed by some 8.6 percentage points.

Graph 2.5 USA: Consumer and business confidence



Source: Thomson Financial

The ISM indicator relative to the manufacturing sector calculated by the Institute of Supply Management, although slightly declining, marked its twenty-ninth consecutive month of expansion in October settling at 59.1% (59.4% in September; Graph 2.6). In survey responses, it is not difficult to see how optimistic managers are about opportunities provided by reconstruction programs for the areas struck by the hurricanes while acknowledging the need to replenish inventories considered inadequate by most of them to satisfy the expected increase in demand in coming months. Most of those interviewed are, in fact, expecting a strong expansion in industrial orders, production and employment in the next months accompanied by significant increases in prices. This latter expectation could also indicate that production capacity may have already reached a critical point in some sectors.

The trade deficit widens...

In September, the trade deficit jumped to \$66.1 billion, mainly resulting from the strong decrease in the exports of goods, due to both the effect of the hurricanes, which put exports and production at a standstill in the gulf area, and the strikes which strongly reduced exports in the aviation sector. In August, the current account deficit widened further mainly due to the rising oil bill. In the January-to-August period, the deficit deteriorated by more than \$50 billion with respect to the same period of 2004. Despite the deceleration in domestic demand expected for 2006, with the consequent deceleration in imported quantities, the balance of payments deficit will continue to worsen mainly because of larger oil payments and the insufficient absorption of U.S. products from the rest of the world and Europe in particular.

... while the federal deficit improves

The federal deficit for fiscal year 2005 is now estimated at 2.6% of GDP, a much better result than the one achieved in 2004 (3.6%) and the CBO's

projections at the beginning of the year. The improvement was exclusively due to much higher revenues than originally expected. The government appropriations for emergency spending linked to the hurricanes (\$110 billion in four years) won't permit, however, the consolidation of the deficit adjustment for the years to come and will make Congress approval of current tax cuts' extension quite doubtful. Altogether, although slightly deteriorating with respect to 2004, the deficit-to-GDP ratio in 2006 and 2007 would, in any case, result much lower than the administration had originally planned.

***Growth towards
its potential***

On the whole, the U.S. economy seems to show a growth potential superior to expectations. Its domestic demand is in continual expansion despite the need to correct current account imbalances, rising interest rates, a stronger dollar and a series of natural disasters of unusual proportions. We expect GDP to increase by 3.6%, on average, in 2005 to, then, slow down to 3.1% in 2006, substantially in line with our forecast formulated last July. Although still providing a significant contribution to growth, household consumption, favoured by the gradual recovery in employment, will notably decrease with respect to recent years due to higher energy costs, rising interest rates and the expected slowdown in the real estate market.

Favourable expectations regarding industrial orders, a healthier trend in business profits (+16.5% in the third quarter with respect to the year before and despite the unexpected payments for hurricane damage) and abundantly available cash flows should sustain investments and, at least partially compensate for the negative effect of gradually-rising interest rates. Investments should also benefit from the federal government spending program on reconstruction.

3. Japan

***Japan is
slowing down
again but...***

In the third quarter, Japan's GDP grew by 0.4%, at a slower pace than in the first part of the year. The deceleration was due to both a slowdown in domestic demand and a zero contribution to growth from net exports. Following a notable performance during the first half of the year (+2% with respect to the corresponding period of the preceding year), domestic demand increased only modestly in the third quarter (+0.4%). Despite a strong increase in exports, the foreign sector's contribution to growth was almost nil due to a parallel strong increase in imports (+3.9%) (Graph 2.7).

Private consumption (+0.3% in the third quarter) has been until now sustained by higher employment and improvements in consumer confidence. However, the drop in retail sales in October (-0.3%) and uncertainties regarding the labour market raise some doubts about consumer spending for the last part of

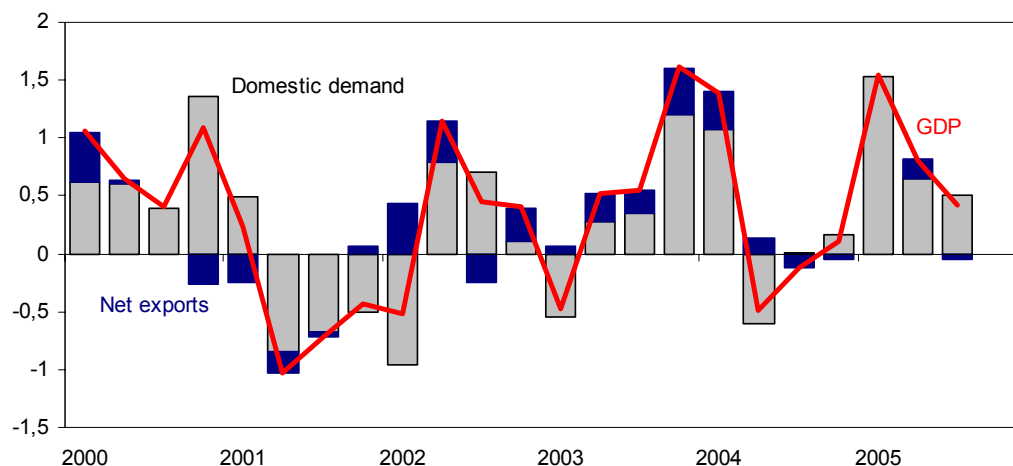
the year. Productivity growth, rather modest wage increases and very strong profits especially among Japanese international companies, have contributed in raising the confidence climate among companies, above all, among large-sized firms, which should guarantee a good rate of growth of investments in the last quarter of 2005 as well.

The unemployment rate dropped to 4.2%, the lowest level in the last five years. This reduction, however, is only partially due to an increase in employment (+0.5%) since the labour force declined as well. The economy's restructuring induced many people without a job to drop out of the market: total labour force went from 68 million workers at the end of the nineties to 66 millions in 2005.

... is finally out of deflation

In the course of 2006 the economy is expected to come out of deflation. In fact, increases in oil and import prices which have pushed producer prices upwards have not been reflected yet in consumption and investment goods. The Bank of Japan, which has announced its commitment to an expansionary monetary policy until the country exits from deflation (exit strategy), has maintained a fundamentally neutral monetary stance during 2005 in response to a good performance in domestic demand. According to Central Bank's projections, the inversion of the trend in consumer prices should take place in mid-2006. It's not clear yet, however, whether the Bank of Japan will start raising interest rates as soon as prices start reflecting higher energy costs or, instead, will continue to maintain its expansionary stance. Our opinion is that the Bank will raise interest rates by 25 basis points in mid-2006.

Graph 2.7 Japan: Contributions to GDP growth in %



Source: CSC calculations based on Thomson Financial data

We expect GDP to settle at 2.4%, on average, this year to then decelerate (to 1.8%) in 2006. Growth will be driven, above all, by fixed investments, sustained by continuing strong business profits.

4. China

Tumultuous growth continues

In the third quarter of 2005 the Chinese economy grew at the same rate as in the previous two quarters (9.4% year over year). The expansion continued to be driven by net exports and fixed investments (+27.7% yoy in the third quarter and +26.1% on average in the first three quarters) which sustained the strong expansion of the industrial sector (+16.3%). Export increased much faster in the January-September period (+31.3%) than imports (+16%). In October, the trade balance surplus settled at \$12 billion; total surplus amounted to \$80.4 billion since the beginning of the year, which is more than double the amount during the entire 2004. The rebound of imports (+23.4% yoy) could indicate that speculations about a revaluation of the Renminbi, which may have induced many operators to postpone purchases from abroad, may be fading, so that we expect imports to grow in the coming months.

The consumer price index rose by 1.2% on an annual basis in October, which is just a slightly faster rate than in September (0.9%), but it means a sharp deceleration compared to the first quarter of 2005 (+2.8%). On average, consumer inflation was 2.0% until October 2005. However, producer prices grew stronger: They were up 4 % over the previous year in October. But there is a downward trend in the rates since in the second half of 2004. The deceleration in producer prices should contribute in restoring business profit margins. Many firms, in fact, have been having difficulties in transferring higher energy costs to final consumer prices since final consumption grows at much more moderate rates than the other GDP components.

In October, retail sales, a very reliable measure of the trend in consumption, increased by 12.8% in real terms with respect to the previous year, substantially in line with the average of the first three quarters of the year (+12.1%). In comparison to investments and exports which have increased at rates of near 30% in the last three years, retail sales have, on average, increased at about 10%. In an economy which grows at a very fast pace, the relative weakness of consumption is one of the reasons for the rather moderate trend in inflation. Inflation so moderate with such high growth rates is evidence of strong imbalances within the system. On the one hand, the enormous investments made by public companies (often generously financed by banks which are also public) generate an excessive production capacity; on the other hand, measures aimed at sustaining consumption are not sufficient enough to stimulate demand so that it can keep up with supply.

The tumultuous growth of the Chinese economy continues, therefore, to be mainly driven by investments and exports confirming the hypothesis that the government's attempt to cool off an overheated economy and drive it towards a soft landing is proceeding more slowly and with greater difficulty than

expected. The authorities probably fear stirring up a deflationary process. The slowness in the process of revaluating the renminbi is not only due to the need to preserve competitiveness but also to the authorities' cautious monetary policy.

***... as does
internal
restructuring***

We assume that restructuring of the Chinese economy will continue and that the government's efforts to bring the economy back on a path of more sustainable growth will be, at least partially, successful.

Consumption should gradually accelerate and progressively replace investments. Altogether, GDP should settle at around 9.3% on average in 2005. The effort towards a more balanced growth, the slowdown in international trade, and in the U.S. economy in particular, toward which a significant part of Chinese exports is directed, high energy costs and a moderate but progressive revaluation of the exchange rate should slow down the rate of growth of Chinese GDP to approximately 8.5% in 2006.

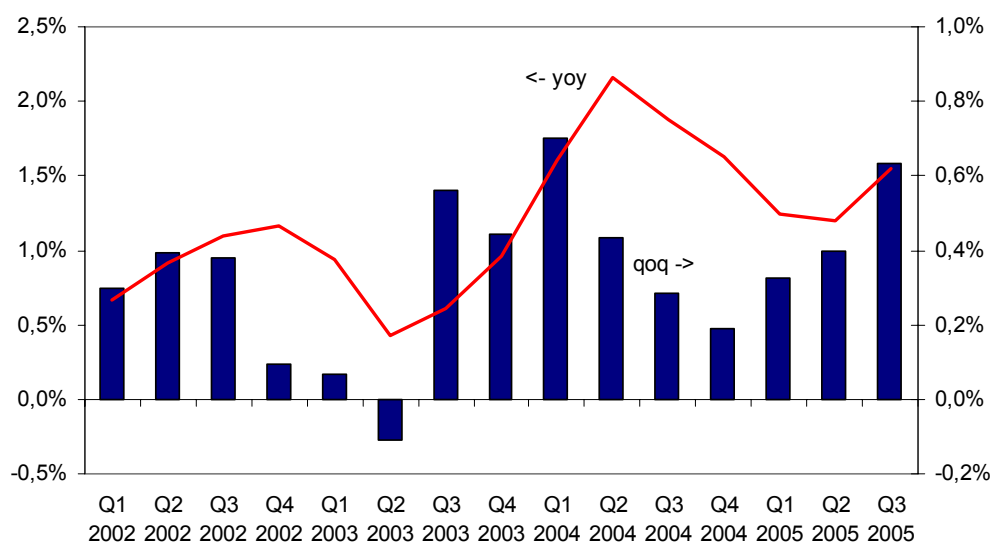
THE OUTLOOK IN EUROPE

1. Recent developments in the euro area economy

Weak growth in H1 2005

In the second half of 2004, economic growth in the euro area decelerated as the slowdown in worldwide GDP and trade growth and the appreciation of the euro weighed on exports. The increase in domestic demand during this period was insufficient to compensate for the drag of net exports on GDP growth. In the first quarter of 2004, economic activity accelerated slightly to 0.3% qoq (from 0.2% in 2004Q4), but the composition of growth was unfavourable: domestic demand almost stagnated and exports declined. It was only thanks to the sharp drop in imports, that a positive quarterly growth figure for the first quarter was obtained. In the second quarter of 2005 economic growth picked up to 0.4% qoq, driven by a stronger contribution of investment and government consumption. Export growth also turned stronger, but as the rise in import growth was even bigger, the external side of the economy did not contribute positively to the quarterly GDP growth figure.

Graph 3.1.1 Euro area GDP



Source : Datastream

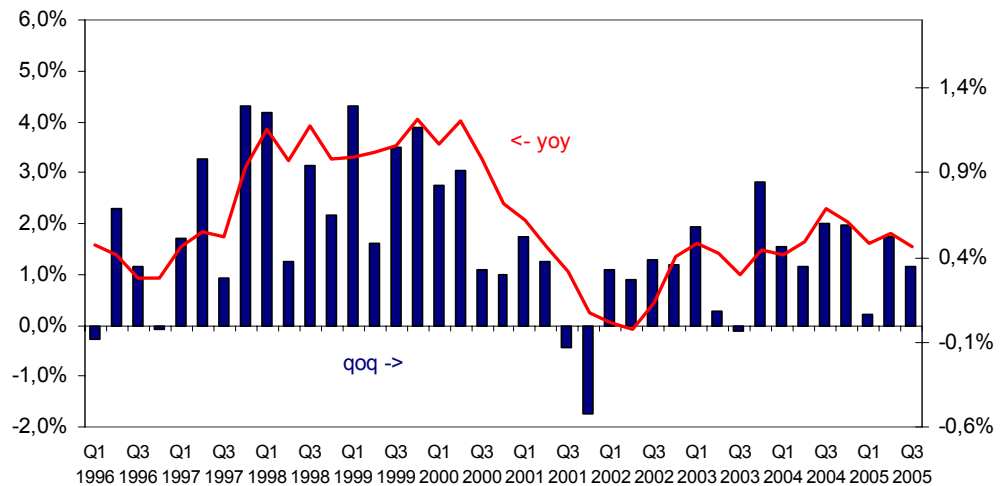
Acceleration of activity in Q3 2005

Euro area GDP growth accelerated markedly in the third quarter (+0.6% qoq), thanks to a surge in export growth and a noticeable acceleration of investment growth. Despite the strong third quarter, caution is in order as the recovery in the euro area failed to take hold several times during the past year and a half.

Economy remains vulnerable as domestic demand is lackluster

This quarterly overview underlines the vulnerability of the euro area economy to external shocks (appreciation of the euro, slowdown of world trade, rise in interest rates) in the absence of healthy domestic demand. This has been more or less the story of the euro area over the past few years. Compared to the previous expansion domestic demand remained lacklustre, hardly surpassing the 2% threshold on a year-on-year basis in 2004Q3 and currently close to 1.5%.

Graph 3.1.2 Euro area domestic demand



Source : Datastream

Divergences among countries slightly reduced

Over the past five quarters the divergence in economic growth of the six biggest euro area economies was reduced somewhat, although Italy (weaker) and Spain (stronger) remain outliers. Looking into the composition of growth however, the divergences among the countries remain quite large. **Germany** has experienced a noticeable pick up in economic activity in 2005 driven almost entirely by exports, while private consumption and private investment showed continued weakness. In 2005Q3 however, investment grew by 2.2%, the strongest quarterly growth rate in more than six years. This could bode well for the future, although the new coalition awaits a difficult task in trying to combine a revival of domestic demand, an implementation of further structural reforms and a reduction of the government deficit. Quarterly economic growth in **France** is somewhat erratic, but continues to be driven by domestic demand, while net exports remained a drag on growth until 2005Q2. In the third quarter of 2005 however, exports boomed and net exports contributed positively to the quarterly growth figure for the first time in two years.

Following two quarters of negative growth, the **Italian economy** rebounded in 2005Q2, thanks to a strong improvement in both private consumption and investment. A remarkable feature of the Italian economic situation is strong employment growth owing to the implementation of the last phase of labour market reforms (lowering of lay-off costs for new workers) and the regularization of immigrant workers. This strong employment record implies weak or even negative productivity growth. Combined with rising wages this has caused a strong increase of unit labour costs, which is hurting Italian firms' competitiveness and results in a dismal export performance.

Table 3.1.1 Quarterly GDP growth in the main euro area economies

	Q3 04	Q4 04	Q1 05	Q2 05	Q3 05	Average
Euro area	0.3%	0.2%	0.3%	0.4%	0.6%	0.4%
Germany	-0.1%	-0.1%	0.6%	0.2%	0.6%	0.3%
France	0.0%	0.7%	0.3%	0.1%	0.7%	0.4%
Italy	0.4%	-0.4%	-0.5%	0.7%	0.3%	0.1%
Spain	0.7%	0.9%	0.9%	0.8%	0.8%	0.8%
Netherlands	0.5%	0.2%	-0.8%	1.1%	0.3%	0.3%
Belgium	0.8%	0.3%	0.1%	0.2%	0.4%	0.4%

Source : Datastream

**Indicators
have
improved**

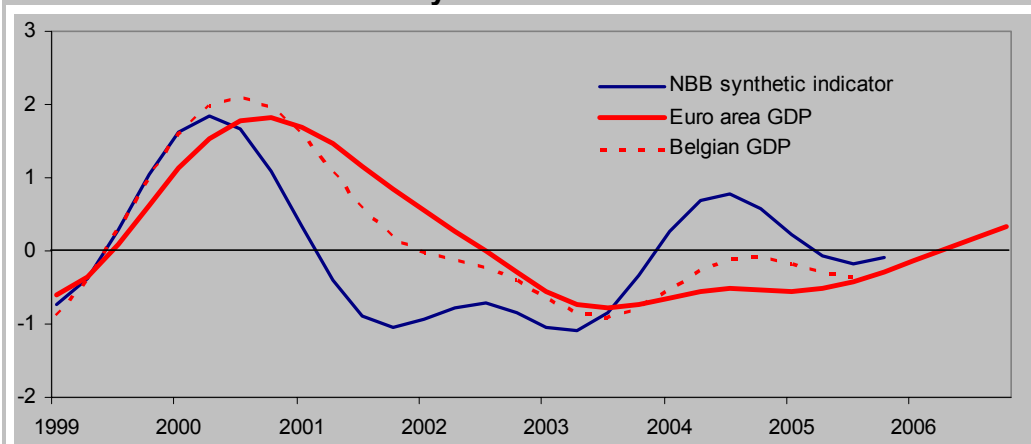
Leading indicators seem to point to a continuation of a moderate recovery for the euro area. The Belgian National Bank survey, which is considered to be a leading indicator for economic activity in the euro area as a whole has improved markedly since this summer. In October the indicator reached its highest value since January, and roughly stabilized in November. The same evolution can be observed in the German IFO, the French INSEE, the Italian ISAE business confidence indicators and the comprehensive industrial confidence indicator of the European Commission. All reveal a strong improvement in business sentiment, due to the weakening of the euro, an acceleration of world trade and some strengthening of domestic demand. Consumer confidence, however, has strengthened only moderately, which is not surprising in the light of the strong rise in the prices of oil-related products. Improvements in consumer confidence were seen in Germany, Italy, the Netherlands and Belgium, while it more or less stabilized in France and Spain.

Box 3.1.1 Belgian business cycle indicator confirms forecast of an upswing

As shown in an earlier EUREN report 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 over the period 1991-2001.¹

The evolution of the euro area as well as the Belgian business cycle has been rather atypical since 2002. While the euro area GDP cycle witnessed a prolonged phase of bottoming out between mid-2003 and mid-2005, the Belgian cycle has shown a minor, short-lived cycle. In fact, the NBB synthetic indicator and the Belgian business cycle started to recover during the second half of 2003 due to the acceleration in foreign demand. This upturn lasted for only a few quarters as worldwide economic growth slowed down again by the end of 2004.

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, NBB, EUREN, FPB

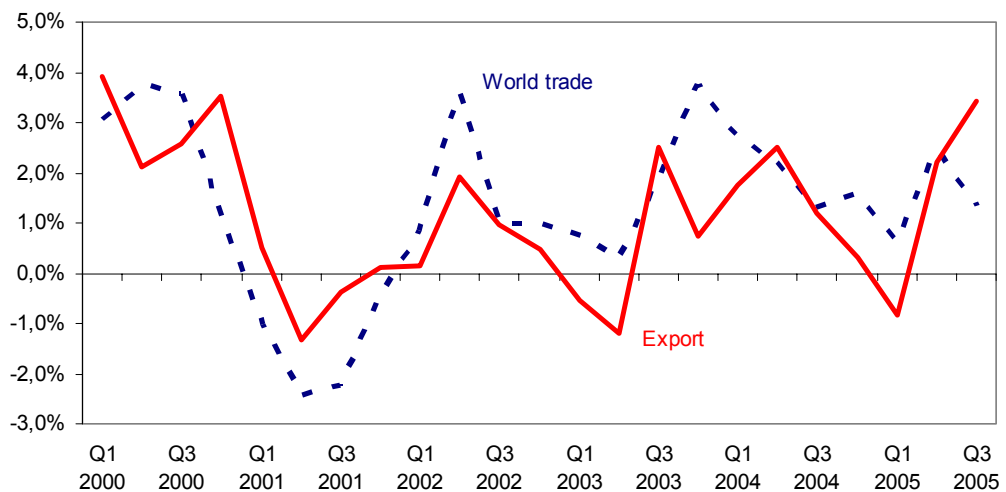
After a short period of deterioration, the NBB business cycle indicator started to improve from the middle of 2005 onwards, which was again due to more optimism among entrepreneurs regarding external demand. Those survey results were confirmed by the national accounts for the third quarter of this year that showed that GDP growth in the euro area and Belgium was mainly driven by an improved performance of exports. According to the current EUREN-scenario, euro area GDP should continue to increase at a pace of around 0.5% (qoq). Since this is slightly above trend growth (which is 0.4% qoq), the euro area business cycle should recover throughout the projection period, albeit at a moderate pace.

¹ "The Belgian business cycle as a leading indicator for the euro area", EUREN Spring Report 2002, pp. 65-70

World trade pushed exports up in Q2 and Q3 2005

In the second half of 2004 world trade growth halved compared to the first half of 2004, which resulted in a serious slowdown of euro area exports. The average quarterly export growth rate fell back from 2.1% in the first half of 2004 to merely 0.8% in the second half of 2004. In the first quarter of 2005 exports even declined by 0.8% qoq as world trade growth stagnated and the effects of the past appreciation of the euro were weighing on European firms' competitiveness. Indeed, in the first quarter of 2005, the nominal effective euro exchange rate reached its highest level in many years, following an appreciation of almost 21% over the previous three years. In the next two quarters, export bounced back strongly (+2.2% and +3.4% respectively), owing to a surge in world trade growth and an improvement in competitiveness (thanks to a depreciation of the exchange rate, which started in the beginning of 2005). In November 2005 the nominal effective euro was some 4.5% lower than its value at the end of 2004.

Graph 3.1.3 World trade and euro area export growth (qoq)

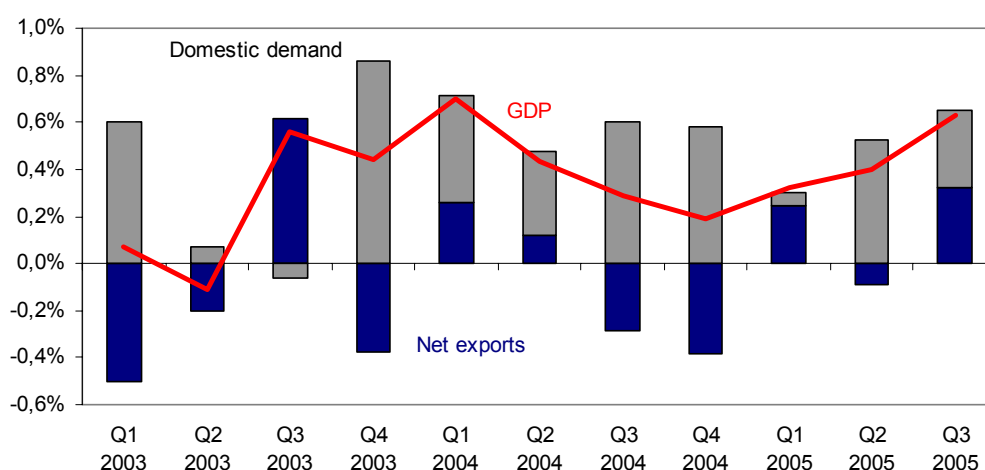


Source : Datastream & COE

Contribution of net exports turned positive again in 2005

Import growth declined much faster than export growth in the first quarter of 2005, due to weak domestic demand. In the next quarter imports bounced back and even grew somewhat faster than export growth. The substantial drag from net exports in the second half of 2004 was hence changed in a small positive contribution in H1 2005. In 2005Q3 finally, import growth turned out lower again than export growth, resulting in a strong positive contribution of net exports to overall GDP growth.

Graph 3.1.4 Euro area: Contributions to GDP growth

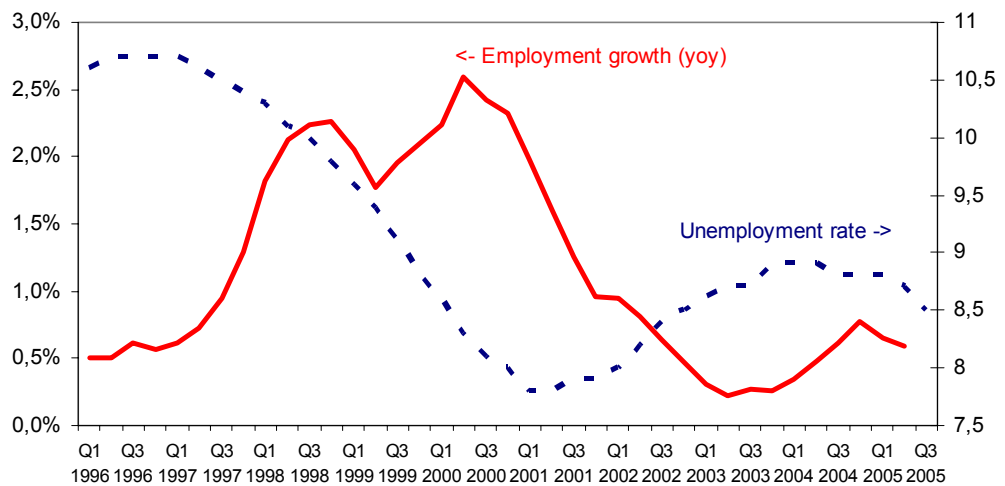


Source : Datastream

Private consumption remains weak

Following a sharp one-off acceleration in the fourth quarter of 2004 (+0.8%), private consumption growth slowed down to 0.2% qoq in the first two quarters of 2005. In the third quarter private consumption growth turned out slightly stronger again (+0.3%). The reasons behind the weakness are twofold: the situation on the labour market and persistently high oil prices. The first reason might seem odd at first sight as the unemployment rate has declined from a level of 8.8% in March to 8.3% in October. However the decline has to be put in perspective as the very volatile German unemployment rate measure declined from 9.8% in August to 9.1% in November and pulled down the unemployment rate for the whole euro area. Furthermore, most of the decline in the German unemployment rate is due to the creation of mini-jobs (low-wage jobs), which do not add much to disposable income. A better picture of the state of the labour market is obtained by looking at employment growth, which has remained very moderate and even declined on a year-on-year basis in 2005Q2. This is partly due to labour hoarding in the last economic slowdown, which created an in-house stock of employees from which companies are drawing now. Furthermore firms remain reluctant to engage workers due to the uncertainties about future demand.

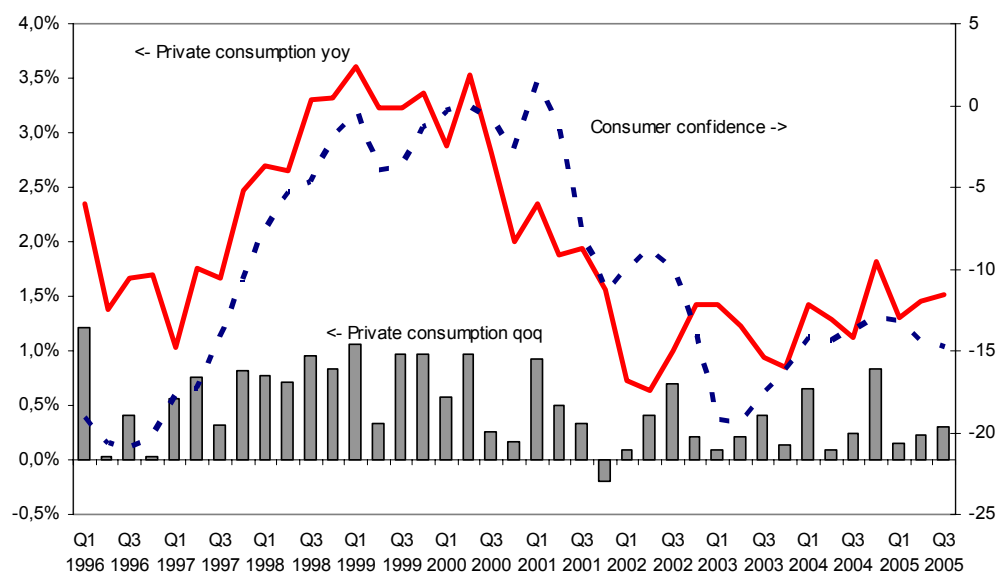
Graph 3.1.5 Euro area employment growth and unemployment rate



Source : Datastream

As the labour markets has hardly tightened yet, employees have little bargaining power to demand stronger wage increases, even more so with ever increasing globalisation. More and more employees and unions realize that production facilities can be easily relocated to another part of the world if their wage demands are exaggerated. This has resulted in small wage increases (especially in Germany). Combined with oil prices, this has led to feeble increases of real disposable income. Furthermore, the wave of structural reforms increases consumers' uncertainty about their future jobs and income. It is hence no surprise that consumers have been very cautious in their spending behaviour.

Graph 3.1.6 Euro area private consumption and consumer confidence

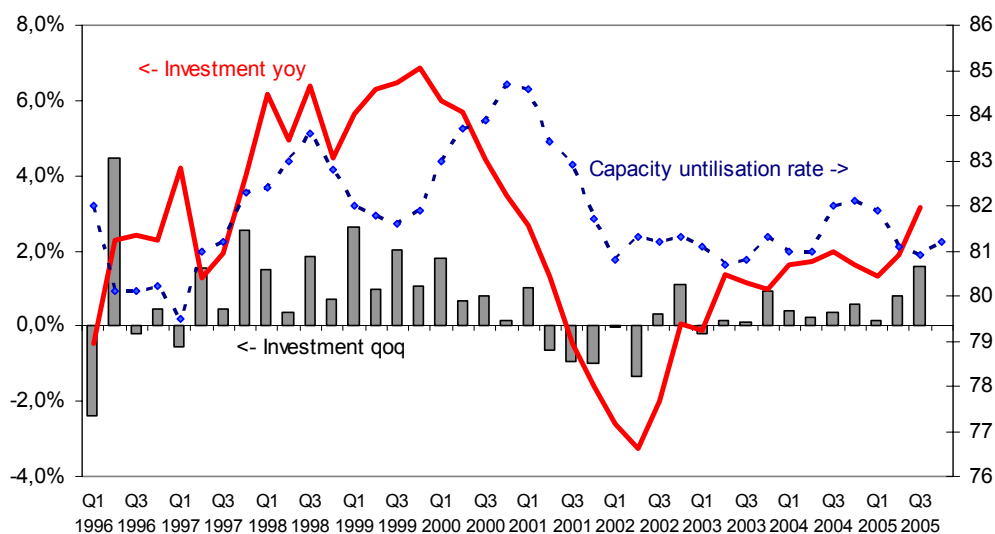


Source : Datastream

Investment finally accelerates but uncertainties remain

Following an increase of investment growth in the second half of 2004, conditions were in place for a further acceleration in the next quarters. Firms had widened their profit margins, corporate balance sheets were healthier, ample liquidity was available and financing costs were extremely low. Yet in the first quarter of 2005 investment growth dropped to merely 0.1% qoq (from 0.6% in 2004Q4). Part of the explanation was the sharp drop in investment in the construction sector (influenced by bad weather conditions, especially in Germany). In the second quarter investment growth accelerated again (0.8%) on the back of a rebound in construction investment. Despite this acceleration, investment growth had been disappointing so far in this recovery compared to the previous expansion. It appears that firms were reluctant to invest as long as domestic demand failed to pick up decisively. In the third quarter of 2005, however, investment growth surged by 1.6% (the strongest increase since 2000Q1). This should not be taken as a sign that investment in the euro area is about to boom in 2006, especially with capacity utilisation rates still being quite low. Investment growth should nevertheless be supportive to growth in 2006.

Graph 3.1.7 Euro area: Investment growth and capacity utilisation

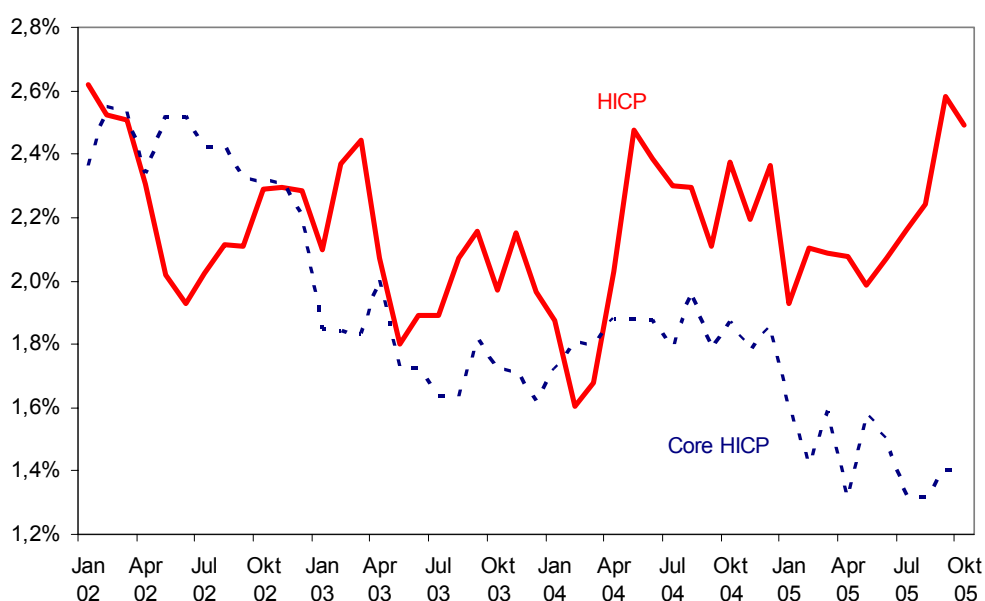


Source : Datastream

Headline inflation at 2.5%, core inflation stable

Annual headline inflation, as measured by the HICP, rose to 2.5% in October (from 2% six months ago), while annual core inflation (HICP excluding energy, food and tobacco) declined somewhat over the last few months. The evolution of headline inflation is a direct effect of the oil price rise. In October, the energy component of the HICP, which accounts for 8.6% of the indicator's consumption basket, was up by 12.2% yoy.

Graph 3.1.8 Consumer prices



Source : Datastream

So far the second round effects of higher oil prices appear to remain contained. Upward movements in some components of the HICP (transport), have been partly offset by decreases in the prices of other components (recreation & culture, communications, education). Moreover, labour costs do not appear to be accelerating at all. There are hence no signs that underlying inflationary pressures are building up.

Table 3.1.2 HICP decomposition (yoy rates)

	April	October
Main indices		
HCPI	2.0%	2.5%
Excl. energy, food & tobacco (core inflation)	1.6%	1.4%
Main aggregates		
Energy	6.8%	12.2%
Unprocessed food	1.0%	1.2%
Processed food	1.5%	2.4%
Non-energy industrial goods	0.4%	0.4%
All services	2.4%	2.2%

Source : Datastream

Substantial differences between the different member states can be observed, with countries like Spain, Ireland and Greece experiencing inflation rates above 3%, while inflation is close to 2% in France, Germany and Italy. A further convergence of inflation rates since the beginning of the monetary union has not appeared. The average deviation from the euro area inflation average remains close to 1%, which is twice as big as the average between the different states in the US. It should be noted however that some of the

divergence in euro area inflation rates is caused by policy measures (e.g. rise of excise duties on tobacco in Germany, lowering of property tax in the Netherlands, etc.).

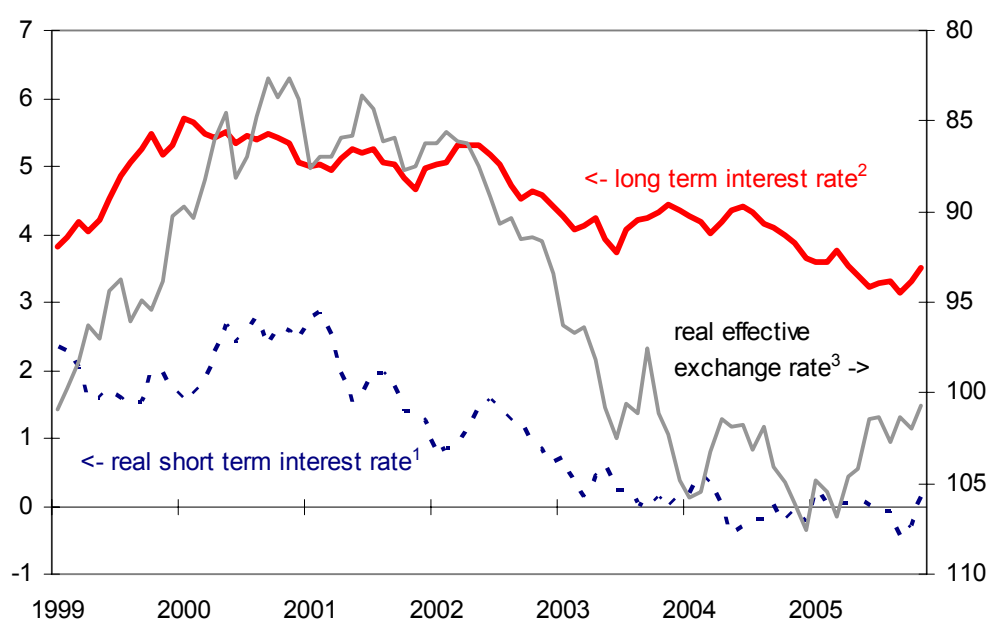
2. EUREN forecast for 2006

A - Policy assumptions

ECB has increased intervention rate after a long period of stability

On December 1 the ECB has brought the intervention interest rate at 2.25%, meeting the expectations of financial markets

Graph 3.2.1 Monetary conditions in the euro area (%)



Source: ECB ¹Deflated with HIPC.- ²10 years government bond yields. -³CPI-deflated against 25 countries. Scale inverted.

This recent move of interest rates has taken place earlier than estimated in our last perspectives, when we were expecting the increase to take place in the second half of 2006.

The analysis of the reasoning supporting the ECB decision shows that it is basically a preventive move; the basic components of monetary policy have not changed substantially in recent months and the underlying inflation rate is also relatively stable.

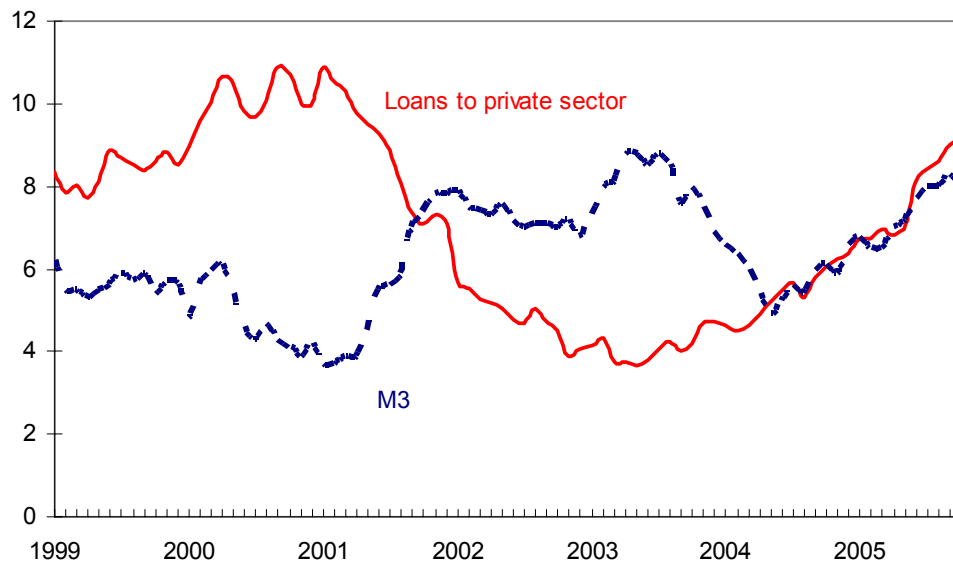
If we take into consideration the central objective of the ECB, keeping a constant and low level of inflation, it appears that the increases in oil prices

have only affected the energy component of consumer prices and has not induced further secondary effects.

However, the fact that tensions in the oil markets remain high, and that expected oil prices at equilibrium levels are now higher than a year ago, together with the weakening of the euro (the high value of the euro had previously compensated the increase of oil prices), have probably changed the position of the ECB, introducing a preventive restriction of monetary policy. The ECB has also considered that, at the same time, the slight indications of an improvement of economic growth in the euro area could also put some pressure on prices if internal demand recovers and with it monetary demand.

The increase of interest rates sends a preventive message to the economic agents.

Graph 3.2.2 Euro area: M3 and loans
(% change, year-on-year)



Source ECB.

Furthermore, it is clear that the European decision cannot be considered independently from the increases dictated by the Federal Reserve in the USA that have induced a large interest differential between the USA and the EU. The current question analyzed by the financial markets has to do with the interpretation of the ECB move.

ECB interest rate increase is not the beginning of a continuously escalating process.

For EUREN, in our current estimates, we consider only the possibility of another increase by 0.25 points during the second to the third quarter period. We think that the euro area does not need further monetary restrictions and that the two increases considered (the December 2005 increase and the one expected in the next months) could have a sufficient impact on long rates to keep under control money demand.

Inflation is forecasted to fall below ECB target

Unless totally unexpected and undesirable events happen in the oil market, our forecast points to a progressive slowdown of inflation to levels below the ECB central objective before the end of 2006, and to continuous moderate growth of GDP during the year. In the financial sphere, the spread between long rates (10 years public bonds) and short interest rates should continue increasing, reaching 220 percentage points at the end of 2006, much closer to historical patterns.

Small advances in fiscal consolidation

As to fiscal policies, the national debates between the requirements of fiscal consolidation and the pressure for fiscal stimulus for growth and employment, continue along the lines described in previous reports. The first estimates provided by the EC on Table 3.2.1 show a deterioration of public accounts in 6 out of 12 countries of the euro area in 2005, with a slight increase of the overall deficit.

For 2006, the forecasts are not especially optimistic, and even if the deficits are expected to settle at slightly lower levels, 5 countries could still remain above the 2% deficit level. In this sense, the increase of interest rates will not help fiscal consolidation, as it increases the cost of the debt, and may also decrease the level of tax receipts.

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

Countries	Data		Stability Programs		EC		IMF		OECD	
	2003	2004	Dec 2005		Nov 2005		Sep 2005		Nov 2005	
			2005	2006	2005	2006	2005	2006	2005	2006
Austria	-1.2	-1.0	-1.9	-1.7	-1.9	-1.8	-2.0	-1.8	-2.0	-2.0
Belgium	0.1	0.0	0.0	0.0	0.0	-0.3	-0.8	-2.0	0.0	-0.4
Finland	2.5	2.1	1.8	1.6	1.9	1.9	1.5	1.5	2.1	1.8
France	-4.1	-3.7	-2.9	-2.2	-3.2	-3.5	-3.5	-3.9	-3.0	-3.0
Germany	-4.1	-3.7	-3.0	-2.5	-3.9	-3.7	-3.9	-3.7	-3.9	-3.7
Greece	-5.7	-6.6	-3.5	-2.8	-3.7	-3.8	-4.3	-4.1	-4.5	-3.2
Ireland	0.2	1.4	0.3	-0.6	-0.4	-0.3	-1.1	-0.6	-0.9	-0.6
Italy	-3.2	-3.2	-2.7	-2.0	-4.3	-4.2	-4.3	-5.1	na	na
Luxembourg	0.2	-1.2	-2.3	-1.9	-2.3	-2.0	-1.7	-2.1	-2.3	-2.1
Netherlands	-3.2	-2.1	-2.6	-2.1	-1.8	-1.9	-2.3	-2.5	-1.6	-1.8
Portugal	-2.9	-3.0	-6.2	-4.8	-6.0	-5.0	-6.2	-4.8	-6.0	-4.9
Spain	0.0	-0.1	0.1	0.2	0.2	0.1	0.3	0.3	0.3	0.3
EU-12	-3.0	-2.7			-2.9	-2.8	-3.0	-3.1	-2.1	-2.0

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

**Germany: Deficit
quota above 3 %
once more**

The new government which came into office in November announced a package of fiscal measures that contains a mixture of lower subsidies and tax credits, expenditure cuts and higher taxes on the one hand, but also stimulative measures on the other hand. In 2006, fiscal policy will be slightly restrictive. On the one hand, personnel expenditure will be cut further and pensions will not rise. Furthermore, some subsidies and tax credits have already been abolished. However, the latter will show little impact in the short run, as the new legislation will not apply to contracts signed before 2006. On the other hand the depreciation rules for corporate investment have been liberalized and a four years programme has been announced to foster investment in infrastructure, science and technology, and education, which will cause additional expenditure of about € 6 bn per year. Against this background, the fiscal deficit will be reduced primarily for cyclical reasons, but in relation to GDP it will stay above the 3 % threshold of the Maastricht treaty.

For 2007, the government announced to raise the normal rate of the value added tax by 3 percentage points to 19 % and the insurance tax accordingly. At the same time the contributions to the unemployment insurance will be lowered by 2 percentage points, but the contribution to the old age pension funds will be raised slightly. Furthermore, the reduction of subsidies will show a stronger impact. All in all, the fiscal policy will take a more restrictive stance; the cyclical adjusted deficit is estimated to be reduced by more than 1 percentage point. Then, fiscal deficit could drop below 3 % of GDP. However, fiscal consolidation is brought forward by higher taxes instead of by showing more ambition in cutting subsidies or reducing expenditure. This will have a negative impact on growth.

**France: Deficit
still higher than
3 % GDP in 2006**

In France, the public deficit decreased to 3,6 % of GDP in 2004 after 4,2 % in 2003. In 2005, economic might be slightly under its potential. Nevertheless, receipts from some taxes like the VAT have been sustained by a relatively strong private consumption. Besides, the structural measures decided to reduce the deficit have been quite effective. The increase of the social tax -the CSG- has led to its acceleration. Unemployment benefits have decreased due to a previous reform and the health care plan seems to effectively slow down expenses. Nevertheless, receipts from other taxes like the business tax have not reached their official targets due to base effects. And public pensions have registered solid growth connected with the impact of the reform of 2003 (which facilitates early retirement). All in all, in 2005, the public deficit will fall under the limit of 3 % of GDP only because of EDF's equalisation payment (0.5 % of GDP) and the public debt should again increase from 64,7 % of GDP in 2004 to 65,8 %.

In 2006, the impact of growth on the public deficit would be neutral. Public wages and salaries may accelerate with the planned increase of public employment. The increase of interest rates (caused by a tightening of the

European monetary policy) should lead to higher public debt payments. And since the major one-off revenue will vanish¹ (EDF payment), one can expect the public deficit to stay closed to 3 % of GDP. That would mean that the public debt would also get higher in 2006.

Italy: Will the ambitious package be implemented?

The Italian government is committed to reduce the public deficit to below the Maastricht ceiling (3% of GDP) by 2007. The objective of the budget manoeuvre is to contain general government net borrowing at 3.8% in 2006. Considering Italy's quite disappointing economic performances and on the basis of currently available information regarding the 2005 public finance's situation, the achievement of these targets appears to be quite difficult.

In the absence of a corrective manoeuvre, net borrowing in 2006 was first estimated to reach 4.7% of GDP and, successively, revised to a more realistic 5.1%. The initial estimate of the deficit trend in absence of interventions published in the DPEF included, in fact, €5 billion of expected revenues from real estate sales which were, successively, only partially replaced by other measures. The corrective measures included in the Budget Law, the related provisions and the successive amendments to the law presented by the Government add up to €16.5 billion, 16.3 of which aimed at reducing the primary deficit. Such a correction is composed of interventions aimed at reducing the deficit by cutting expenditures and increasing revenues for a total of €22.9 billion to which are added interventions in the opposite direction – with the effect, therefore, of increasing the deficit - for €6.7 billion.

Expenditures are cut by €15.7 billion, of which approximately 9 concern public consumption and health: €6.4 billion should, in fact, come from cuts to purchases of goods, services and wages and €2.5 billion from cuts to health expenditures. These interventions, if fully implemented, would not only cut the 2006 projected expenditures but would also reduce spending with respect to 2005's. The government estimates, in fact, that, in 2006, personnel spending would decrease by 2.1% while intermediate consumption by 1.0%.

Savings for €1.1 billion will come from lower transfers to public enterprises and €1.2 billion from lower appropriations for technological innovation. When considering this type of interventions it must be remembered that cuts refer to trend-projected expenditures; the limits set in the law should, therefore, allow most of the expenditure items to remain at basically the 2004 level. The manoeuvre also includes interventions aimed at increasing revenues for €7.3 billion. Some of them specifically concern credit institutions, firms in the energy sector and insurance.

¹ - Due to the integration of the employees of the French Postal Company in the general pension scheme, this company may again make an equalisation payment of 2 billion euros to the State.

With the measures aimed at containing the deficit, there are also measures aimed at stimulating development by cutting taxes for €3.5 billion and increasing expenditures for €3.2 billion. With regard to revenues, a reduction of one percentage point in the social security contribution rate is included, with an estimated €2 billion reduction in firms' labour costs. The extension of various current tax relief, the elimination of the tax on patents, an experimental intervention in support of production districts are also included. Fiscal pressure is expected to slightly decline in 2006 from 41.3% of GDP to 40.8%. Among the additional expenditures (€3.2 billion), the most notable item is the institution of a fund aimed at supporting families through a one-off endowment of €1.1 billion. In order to support investments in research and innovation a new fund for innovation, through a one-off financial endowment of €3 billion (in addition to the proposed additional spending included in the law) has also been created. Its implementation will depend, however, from the realization in 2006 of real estate sales for at least €4 billion.

The crucial point is whether this rather ambitious package can be entirely implemented. Based on past experience, we believe that the manoeuvre will be only partially effective and that it will correct the deficit by approximately 0.8 percentage points of GDP, a result which, if achieved, could be considered a great success.

At the October conclave, the Belgian federal government announced its public finance objectives for 2006. The most important assumptions are an economic growth of 2.2% and an inflation rate of 2.9%. The general government budget would remain balanced. The federal authority as well as the state governments (communities and regions) would record a 0.1% of GDP surplus, whereas the local governments would run a deficit of 0.3% of GDP (due to a temporary surge in infrastructure investment ahead of the next municipal elections). The debt-to-GDP ratio should decrease from 94.3% by the end of 2005, to 90.7% by the end of 2006.

The government intends to keep expenditure growth strictly under control, both in the federal departments and in the social security sector. However, the budget preserves some room for manoeuvre for new initiatives regarding mobility, justice, health care and social allowances.

Additional cuts in social security contributions have been decided, targeted on categories of workers with the lowest rate of activity (young low-wage earners and workers aged 50 or above). These wage cost reductions are part of the "Generation Pact" proposed by the government together with the 2006 budget, containing also various proposals to discourage early retirements from the labour market. Besides, wage subsidies to night-time labour or labour organized in work shifts are reinforced, as well as wage subsidies for researchers.

***Belgium:
The govern-
ment aims to
maintain a
balanced
budget in 2006***

Taxation in the 2006 budget is marked by the introduction of new levies on previously exempted financial revenues of households (bond funds and insurance related saving vehicles). The recently decided corporate tax reform (the “notional interests” deduction) encourages the financing of companies through risk capital rather than debt. This reform reinforces the attractiveness of the Belgium tax system for foreign investors by reducing the corporate tax burden and provides a replacement for the special regime for coordination centres, which is to be dismantled.

As it was the case in previous years, the 2006 budget partly relies on non-structural measures, notably the creation of public/private investment trusts for the management of public real estate properties, new sales of real estate and a second wave of securitization of future cash flows from tax arrears. A so-called “tax regularization operation” is also envisaged, together with a reinforcement of the anti-fraud machinery.

Spain: Stability keeps on track, with a surplus larger than expected.

In Spain, the budgetary lines for 2006 continue previous policies of financial stability and increase of the productivity and transparency of the regulatory frame. In this context a Plan for Stimulating the Economy and Fostering Productivity has been adopted; this Plan has led to the introduction in the national budget of a Programme for R&D and innovation (Ingenio 2010), a programme for the Information Society and new technologies and a Strategic Plan for Transport and infrastructures (PEIT)

The basic objective of Ingenio 2010 is to push R&D expenditures up to 2.5% of GDP (at present 1.0%), with an initial investment of 6 billion € (75% of which for Information Society actions). The PEIT is designed for the period up to 2020, with total investments of 250 billion € (2% of GDP each year). The trend for fiscal consolidation is confirmed, and a slight surplus is expected in 2006; with current estimates the surplus could be of the order of 0.2% of GDP in 2005 and 0.6% of GDP in 2006.

B. Forecast summary

Business cycle in an upswing again

In their last report, the EUREN institutes favoured a scenario, according to which the weakness of the euro area economy in the first half of 2005 was a soft patch only, allowing cyclical forces to play a role again in the second half of the year. The latest data seem to confirm this view. In particular fixed capital investment gained momentum in the recent quarters, and this gives reason to expect the upswing will continue, even if 2005 Q3 data might look a bit better than the situation is because of an unusually strong increase of construction investment in Germany. Furthermore exports recovered since the Euro has depreciated against the dollar by about 10 % since the beginning of 2005 and international demand showed no sign of fatigue. However also imports grew

faster than predicted, so that GDP can be expected to grow by 1.4% in 2005, which is the same rate as forecasted in EUREN's summer report.

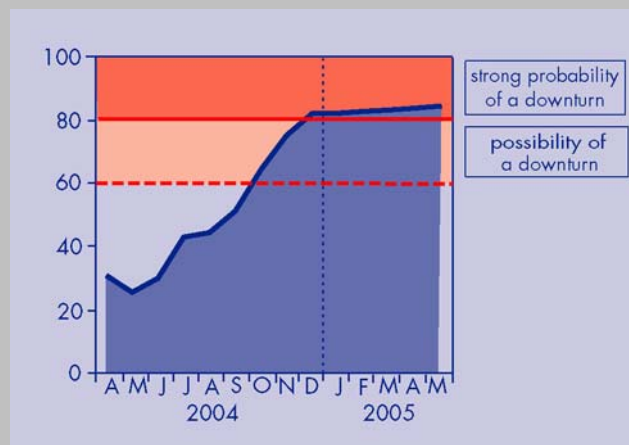
In the upcoming year, we expect the international environment to be still strong but less supportive. As depicted above, world trade will grow somewhat slower than hitherto, and a slight appreciation of the Euro appears plausible. Therefore, exports will expand less buoyantly than in the second half of 2005; but the annual rate could reach 7.2% after 4.4% in 2005. At the same time, domestic demand is expected to become stronger. Driving force will be gross fixed capital formation, which will benefit from several factors: Interest rates are still low, even if the ECB will raise policy rates further; corporate profits have improved, and companies will be more inclined to extend capacities as their expectations have improved. All in all, we forecast investment to grow at an annual rate of 4.2%.

Box 3.2 COE Leading indicator for the euro area

The economic recovery in the euro area, starting at the end of 2003, was short-lived. As soon as December 2004, the COE Leading indicator (IARC) for the euro area sent a strong signal of economic downturn¹.

Graph B-3.2.1 Growth cycle leading indicator:

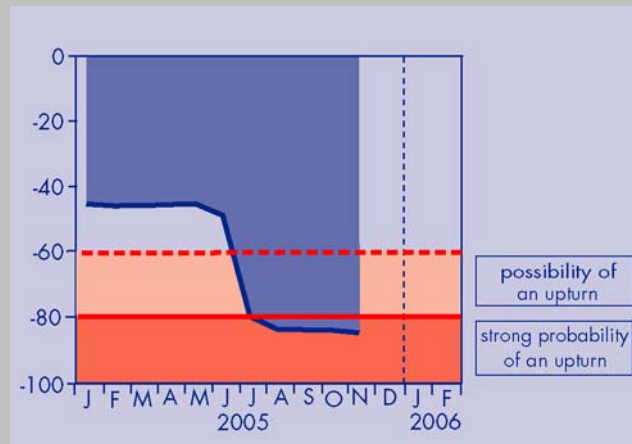
Search of the next peak



Source: COE

As a matter of fact, the growth rate in the euro area dipped back in 2005 below its trend growth rate which is estimated to be 1.5% in 2005. Soon after, in August 2005, the IARC index passed through the significant threshold of -80, indicating an economic rebound in the following three months:

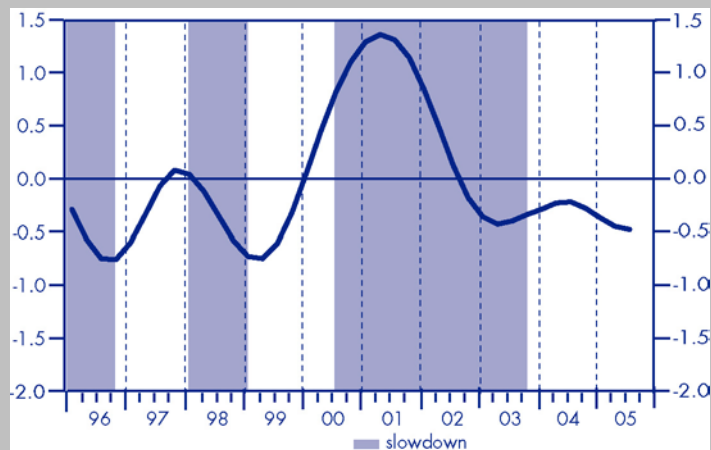
Graph B-3.2.2 Growth cycle leading indicator:
Search of the net trough



Source: COE

The short time difference between the two successive signals certainly proves that the economic deceleration observed in the first half of 2005 had just been a “soft patch” in the ascendant phase of the euro area growth cycle which started in 2003. The IARC index has remained beyond this threshold until November 2005 (- 83.9), indicating that the signal is persistent and that the euro area growth rate should remain over its trend growth rate currently estimated at 1.5 % at least during the coming three quarters.

Chart B-3.2.3 Growth cycle



Source: COE

¹ The components of the COE leading Indicator for the euro area are: 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

Private consumption remains weak

Private consumption remains on the shady side. We predict it will grow by 1.4% which is nearly the same rate as in 2005. Disposable income can be expected to increase moderately only, because the employment situation will improve little. However, significant differences between the EU members will persist. Spanish consumers will continue to increase their expenditure at high rates. On

the other hand, private household spending in Germany will be more or less stagnant once more. If the German VAT will be raised in 2007, it might become attractive for consumers to bring forward purchases of durable goods, which can give some impulse to private consumption in the second half of 2006. However, this will dampen consumption in 2007.

As the import content of exports is high and because domestic demand will be more vivid, imports will speed up and grow by 7.7% after 4.8% in 2005. Thus, net exports will remain nearly unchanged. All in all, GDP growth will reach an annual average of 1.9%, which marks a significant improvement compared to 2005. During the year, expansion will slightly loose momentum, because world trade will grow less buoyantly and effects of the devaluation of the Euro will phase out.

Employment situation will improve little

Even if growth speeds up, the labour market will improve little in 2006. On the one hand capacity utilisation can be expected to rise, which will enhance productivity growth. On the other hand, the labour force in the euro area increases at a rate of almost 1%. On balance, there is little room to reduce the number of jobless. The unemployment rate therefore will fall only slightly to 8.3% in 2006 from 8.6% in 2005.

Inflation will come down significantly during 2006. On the one hand, higher productivity growth and moderate wage increases will keep the cost pressure under control. On the other hand, the effects of higher energy prices will phase out under our assumption on oil prices. In the second half of 2006 headline inflation is foreseen to be below 2%, which would take pressure from the ECB to tighten monetary policy further. On average, HICP will rise by 2.1% which is slightly weaker than in 2005.

Table 3.2.3 Euro area forecast

	2002	2003	2004	2005 ^e	2006 ^f	2005 I	2005 II	2005 III	2005 IV ^e	2006 I ^f	2006 II ^f	2006 III ^f	2006 IV ^f
	Annual % change (unless otherwise indicated)					q-o-q%(unless otherwise indicated)							
Private consumption	0.9	1.1	1.4	1.3	1.4	0.1	0.2	0.3	0.3	0.3	0.4	0.4	0.5
Public consumption	2.6	1.6	1.1	1.3	1.7	0.3	0.6	0.6	0.4	0.4	0.4	0.3	0.3
Gross fixed capital formation	-2.0	0.8	1.7	2.4	4.2	0.1	0.8	1.6	0.8	1.0	1.1	1.0	0.9
Domestic demand	0.4	1.4	1.8	1.5	2.0	0.1	0.5	0.3	0.3	0.6	0.6	0.5	0.5
Exports	1.8	1.3	5.9	4.4	7.2	-0.8	2.2	3.4	1.6	1.5	1.5	1.3	1.3
Imports	0.4	3.1	6.1	4.8	7.7	-1.5	2.6	2.8	1.5	1.7	1.8	1.7	1.7
GDP¹	1.0	0.7	1.8	1.4	1.9	0.3	0.4	0.6	0.4	0.5	0.5	0.4	0.4
Unemployment (% of labour force)	8.3	8.7	8.9	8.6	8.3	8.8	8.7	8.5	8.4	8.3	8.3	8.2	8.2
Compensation per employee¹, yoy	2.6	2.3	2.1	1.8	2.2	1.8	1.6	1.8	1.8	1.9	2.1	2.3	2.3
Consumer price (HICP), yoy	2.3	2.1	2.1	2.2	2.1	2.0	2.0	2.3	2.5	2.5	2.3	1.8	1.9
Current account balance (%GDP)	0.9	0.3	0.6	-0.1	-0.3								
3m interest rates (% per annum)	3.3	2.3	2.1	2.1	2.4	2.1	2.1	2.1	2.2	2.2	2.3	2.6	2.6
10y Gvt bond yields (% per annum)	4.9	4.2	4.1	3.5	4.4	3.7	3.4	3.3	3.6	3.9	4.4	4.6	4.7

e: estimation ; f: forecast

EUREN estimates – ¹Not seasonally adjusted.

3. The UK economy

***Two-speed
economy
re-
emerging?***

The latest data paint a very mixed picture for the UK economy and, while interest rates were held at 4.4% at the December Monetary Policy Committee meeting, the debate about the next move in rates remains finely balanced. Particularly worrying are the signs of the re-emergence of something of a 'two-speed economy'.

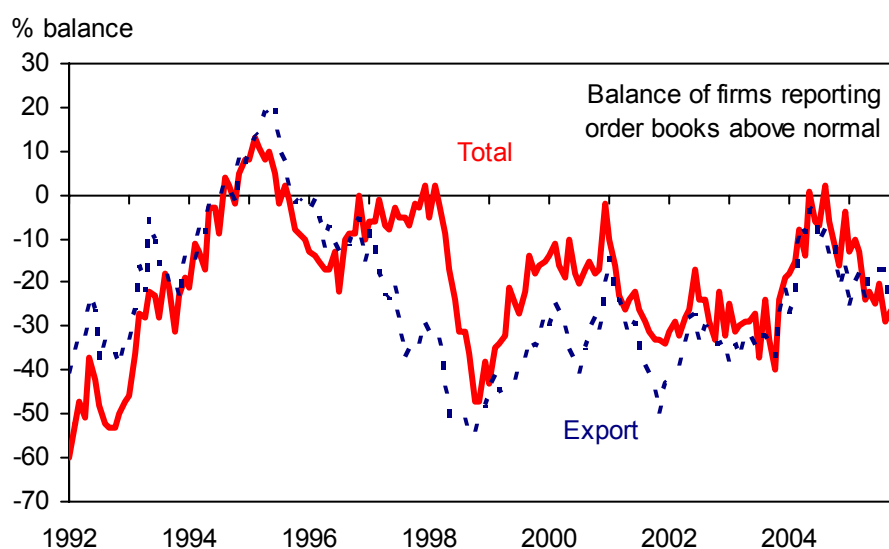
On the one hand, there are encouraging signs that the worst is now over for the UK housing market and, in particular, it looks increasingly unlikely that the UK will suffer a major house price collapse in this economic cycle. The improvement in the housing market primarily reflects a change in interest rate expectations, supported by August's rate cut. With interest rates peaking in this cycle at less than 5%, this has given confidence to potential house purchasers that they will not face a sharp increase in their monthly repayments. It is also helping to support retail sales, which rose 0.7% in volume terms in September, although in Q3 as a whole they were only 1% higher than a year earlier.

But, clearly, short-term movements in house prices should be interpreted with caution and it would be wrong to suggest that a new boom in house prices is now underway. While continued low interest rates mean that mortgage service costs do not appear to be a constraint for most households, house prices remain around 12% higher than our models suggest would be consistent with their fundamental determinants, such as interest rates, household incomes, demographics and the rate of housebuilding. And affordability is a key issue for many first-time buyers. Our forecast therefore still shows house prices rising by less than 2% through 2006.

***..as
manufac-
turing
struggles
again...***

In contrast to the housing market, the industrial sector appears to be in retreat again, with production in Q3 0.6% lower than in the previous quarter. In part, this reflects very weak North Sea activity. But it is worrying that manufacturing output fell for the third consecutive month in October. Indeed, we have revised down our forecast for manufacturing output again following this latest 0.7% fall. In particular, it would appear that UK capital goods producers are not benefiting as much as, for example, their German competitors from strong Asian demand. This in turn reflects both the UK's still high unit labour costs and non-price competitiveness issues – notably the UK's relatively weak trade links with China. The Purchasing Managers survey suggests that the official data are overstating the problems of manufacturers. However, both the CBI and BCC surveys point to a worrying deterioration in order books. And while recent export figures have been strong, these appear to have been heavily distorted by fraudulent trading activity.

Graph 3.3.1 UK: CBI order books



Source Datastream.

***...leaving
GDP
growth
stuck
below
trend***

As a result, UK growth looks to be stuck in a sub-trend rut, with GDP expected to rise by only 2% at an annualised rate in Q4 – the sixth consecutive quarter growth will have been below its long-term trend of 2½%. In normal circumstances, we might expect this to prompt an early interest rate cut. However, the Bank of England is clearly concerned both about the risk of a strong rebound in housing and consumer demand, and also about the potential second-round effects of high oil prices on inflation. We think both of these worries are overdone and therefore rates could well fall early 2006, probably after the February Inflation Report. Ironically, tough talk from Mervyn King this month may well increase that possibility if it unsettles consumer confidence.

***Chancellor
halves his
growth
forecast...***

At the same time, the Chancellor has eventually been forced to admit that UK economic growth this year will be only half his March Budget forecast. The Pre-Budget Report shows GDP now expected to rise only 1¾% in 2005 and 2-2½% in 2006, down from the Treasury's previous forecasts of 3-3½% and 2½-3% respectively.

These revisions have brought the Treasury forecast into line with OEF's view on growth prospects. However, the Treasury remains significantly more optimistic than we are about the outlook for business investing, forecasting a rise of 3-3½% in 2006, whereas we expect the recent weakness of output and concerns about profitability to cause business investment growth to slow to 2.3%. And the Treasury is also more optimistic than OEF about the outlook for the manufacturing sector, where it expects output to rise over 1% in 2006, compared to our forecast of almost no growth.

...and low saving assumption a risk

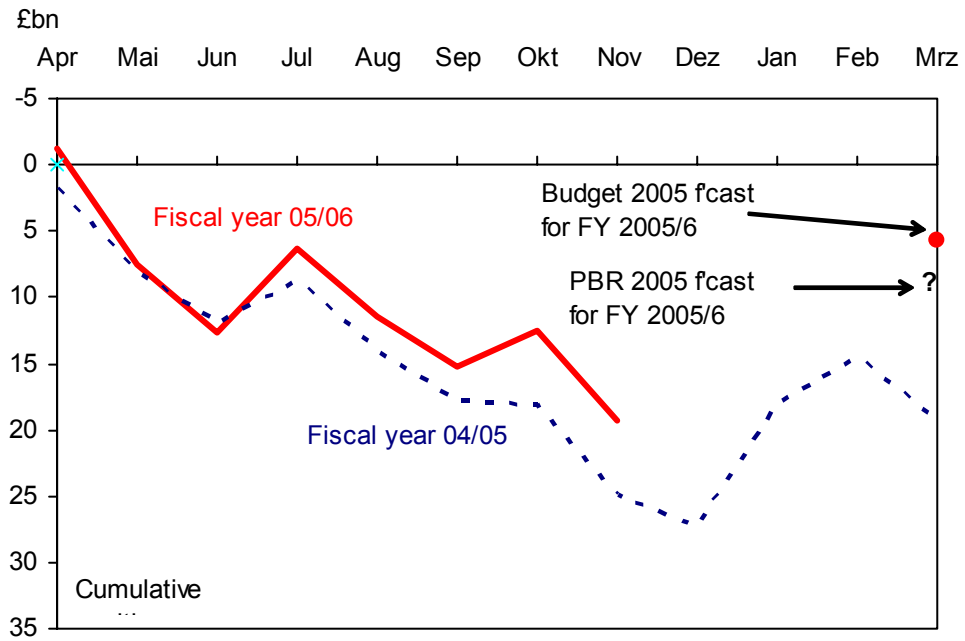
Other aspects of the Treasury's new economic forecast are broadly similar to our own, with GDP growth expected to rise above trend in 2007/8 as oil prices ease and the world cycle turns up again; inflation expected to fall back below its 2% target, at least temporarily; and the current account continuing to deteriorate. It is worth highlighting, however, that the Treasury forecast shows the household saving ratio stuck below 5% - this is a key area of downside risk to its forecast given concerns about debt levels, pensions etc.

Brown still expects to meet Golden Rule

Despite growth being only half the Budget forecast this year, there has not been a dramatic collapse in the public finances – mainly because unemployment has risen only modestly and public spending growth has been below plans so far this year. However, the Chancellor has revised up his forecast for the deficit on the government's current budget in 2005-06 to £10.6 billion from £5.7 billion previously. And another deficit, of £4 billion, is now expected for 2006-07, whereas the Budget projections showed a £1 billion surplus. One puzzle, however, is the Treasury now estimates that the cyclically-adjusted deficit will narrow to just 0.1% of GDP in 2005-06 from 1.3% in 2004-05. It is far from clear what underlines this apparent large improvement in the structural budget position; the tax increase on North Sea companies the Chancellor announced in the PBR only increases government revenues from next April.

While we are a little more pessimistic than the Treasury about short-term prospects for the public finances, a much bigger issue is the medium-term position, where the Treasury still projects a current budget surplus of £11 billion by 2009-10. This implies - in combination with a dubious change to the timing of the economic cycle - that the Chancellor will still meet his Golden Rule of balancing the budget over the cycle. In contrast, our forecast shows continuing small deficits.

Graph 3.3.2 UK: Public sector current balance



Source Datastream.

**...but can
he keep to
spending
targets**

We have concerns with two aspects of the Treasury medium-term projections. For one thing, we doubt that the Treasury will see the sharp further rise it expects in the tax burden, which would take it above the peak levels it reached in the early 1980s. But we are also sceptical that the Treasury can hold public expenditure growth to below 2% in real terms in the medium term, which is the assumption underlying the fiscal arithmetic in the PBR. That said, while the Golden Rule may not be met, our forecast still shows a very sustainable position for the UK public finances. It is unfortunate, however, that the Chancellor's raid on oil companies adds further to business mistrust of government policy and could undermine investment performance.

Table 3.3.1 UK Forecast

	2002	2003	2004	2005 ^e	2006 ^f	2005 I	2005 II	2005 III	2005 IV ^e	2006 I ^f	2006 II ^f	2006 III ^f	2006 IV ^f
	Annual % change (unless otherwise indicated)					q-o-q%(unless otherwise indicated)							
Private consumption	3.5	2.6	3.7	1.8	2.0	0.4	1.4	1.9	2.0	2.0	2.1	2.1	2.2
Public consumption	4.4	4.5	2.6	1.5	2.4	2.2	2.0	1.2	3.0	2.5	2.5	2.6	2.6
Gross fixed capital formation	3.0	0.0	4.9	2.8	3.3	-0.2	3.9	4.3	4.0	2.3	3.0	3.2	3.7
Domestic demand	3.2	2.7	3.7	1.8	2.3	0.9	-0.3	3.3	2.3	2.3	2.4	2.5	2.7
Exports	0.2	1.2	3.9	5.0	6.0	-2.7	18.6	3.0	6.1	5.3	5.3	5.5	5.6
Imports	4.5	1.8	5.9	4.9	6.2	-3.1	7.8	8.7	6.1	5.6	5.5	5.8	5.8
GDP	2.0	2.5	3.2	1.7	2.1	1.0	2.0	1.6	2.2	2.1	2.2	2.4	2.5
Unemployment (% of labour force)	5.2	5.0	4.7	4.7	4.8	4.7	4.7	4.7	4.7	4.8	4.8	4.8	4.8
Compensation per employee ¹ , yoy	3.6	3.0	3.9	4.3	4.4	4.3	4.2	4.2	4.2	4.8	4.5	4.3	4.2
Consumer price (HICP), yoy	1.3	1.4	1.3	2.1	2.1	1.7	2.0	2.4	2.1	2.2	2.2	2.0	2.0
Current account balance (%GDP)	-1.6	-1.5	-2.0	-1.9	-2.1	-2.5	-1.0	-2.3	-1.7	-1.9	-2.1	-2.2	-2.2
GGFB/GDP ²	-1.6	-3.2	-3.1	-3.3	-2.8	-3.3	-3.0	-3.4	-3.3	-2.8	-2.7	-2.8	-2.9
3m interest rates (% per annum)	4.0	3.7	4.6	4.7	4.3	4.9	4.8	4.6	4.6	4.3	4.3	4.3	4.3
10y Gvt bond yields (% per annum)	4.9	4.5	4.9	4.4	4.5	4.7	4.4	4.3	4.3	4.4	4.4	4.5	4.6

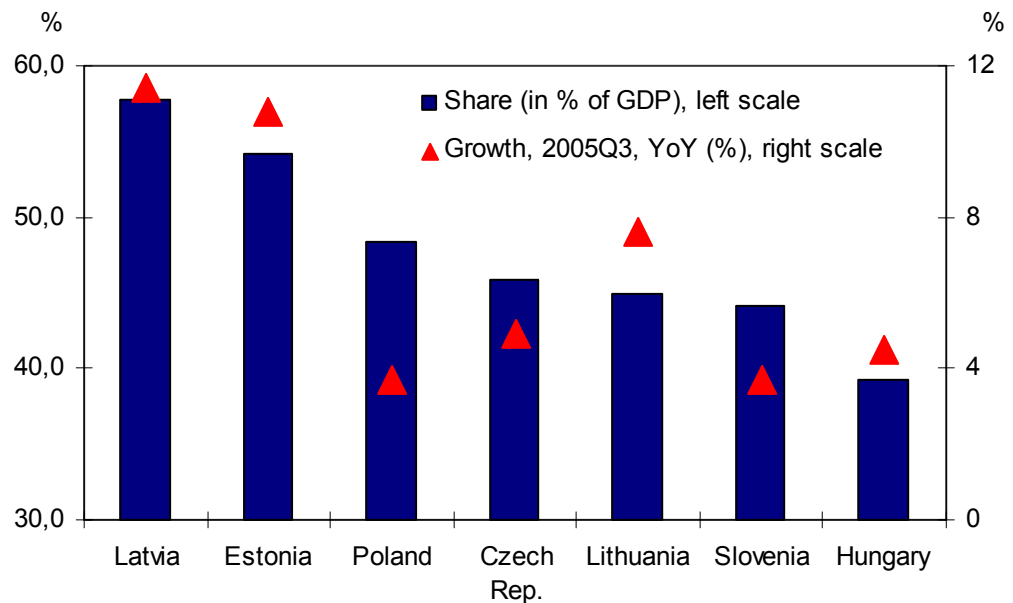
EUREN calculation ¹ Seasonally adjusted – ² General Government financial balance, excluding UMTS revenues. - ^e estimation - ^f forecast

4. The new member states

GDP growth accelerated further in Q3

The new member states' GDP rose by 4.7% in 2005Q3 (year-on-year), after a growth of 3.8% in the first half of the year. The acceleration in growth largely reflects the rebound in investment and the soaring exports. However, two different patterns of growth stand out in the NMS. In the Central-European countries manufacturing exports (especially manufacture of electrical and transport equipment) are the main drivers, meanwhile in the Baltics mostly market service branches (first and foremost financial intermediation, transport, storage and communications) contribute to the GDP growth.

Graph 3.4.1 GDP growth and the weight of market services in new EU members



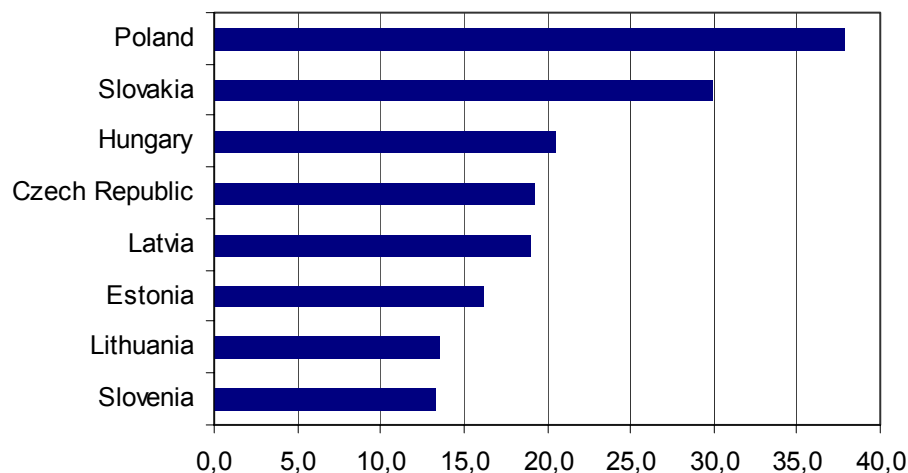
Source: Kopint-Datorg Database

Surprisingly positive labour market developments

The two patterns have different consequences on employment and labour market developments in general. Productivity gains are markedly smaller in the Baltics and in Slovenia, but entrepreneurship and consequently, employment creation is more buoyant. As a result, these countries have had an excellent record in subduing the unemployment, especially the unemployment of youth, for several months. Compared year-on-year, seasonally adjusted unemployment rates of the cohort under 25 years decreased by 3.3 percentage points in Estonia and by 5.6 percentage points in Lithuania since October 2004. Regarding this indicator, the improvement is significantly smaller in other countries where the growth is rather fuelled by manufacturing. Moreover, in Hungary there was an increase of 3.9 percentage points in the unemployment rate of youth.

Tendencies are similar concerning the unemployment rate of the entire working-age population: unemployment decreased in a remarkable manner in Estonia and Lithuania, there was a slight improvement in other NMS countries, meanwhile there was a deterioration in Hungary. However, the rosy picture of labour market developments is overshadowed in the Baltics as well: the massive outflow of young well-educated population to Ireland and the United Kingdom resulted in a 'national panic' and it has already been included in the political agenda. Apart from Poland, where labour market tensions are markedly higher than in other new EU members, gross wages increased rapidly and the wage differences among countries of the region narrowed. Spectacular wage growth in Slovakia and in the Baltic countries is well-founded by the impressive real convergence and compared to the euro area, real effective exchange rates did not change significantly.

Graph 3.4.2 Seasonally adjusted unemployment rates under 25 years (% of labour force, Oct. 2005)



Source: Eurostat

Rising inflation will likely cause a delay in the EMU accession of the Baltics

However, fixed exchange rate regimes will likely cause a problem in the Baltic countries in the completion of the Maastricht inflation criterion. As pegged to the euro, these currencies cannot appreciate; strong consumption growth coupled with the ongoing financial deepening has evidently led to higher inflation rates. Besides constantly high world energy prices, domestic credit expansion also fuelled consumer price inflation. Increases in housing, transport and catering prices were particularly strong. As a result, the completion of the Maastricht inflation criterion for EMU accession by 2007 is doubtful in Lithuania and unlikely in Estonia. We expect a delay of one year in the case of both countries. The prospects of Latvia's adoption of the euro by 2008 are even worse: inflation expectations seem to stabilize around 6-7%. In addition, financial stability might be heavily endangered by bubble-formation in asset and real estate prices (again, especially in Latvia where economic trends clearly indicate signs of overheating).

Better than targeted fiscal position in Slovakia and in the Czech Republic

In the meantime, Slovenia has a reasonable chance to fulfil all Maastricht criteria in order to introduce the euro in 2007. Up to the autumn months, the Czech Republic and Slovakia accomplished a better than targeted fiscal position which makes realistic the smooth completion of their convergence programs, respectively. After a visible initial distrust, capital, financial and money market players seem to regard somewhat more positively the new Polish government. However, Poland's intention to follow the present official convergence program remains dubious and the cooperation between fiscal and monetary authorities raises concern. Upcoming elections weaken the chances of the unavoidable fiscal adjustment in Hungary, although both present government parties and opposition forces seem to be willing to make the necessary decisions after the elections.

Table 3.4.1 Main indicators of real and nominal convergence in the NMS

	GDP/cap., PPS (EU-25=100)	Monthly gross avg. wages, €	Inflation (HICP), last 12 m	General Gov. Bal. (GDP %)	Gross gov. debt (GDP %)	10 year Gov. bond yields (%)
Time/period	2004	Q3 2005	Nov. 2005	2004	2004	30 Nov. 05
Czech Rep.	71	634	1,6	-3.0	36.8	3.5
Estonia	51	498	4.2	+1.7	5.5	4.1
Hungary	60	611	3.7	-5.4	57.4	6.7
Latvia	43	356	6.9	-1.0	14.7	4.1
Lithuania	48	399	2.7	-1.4	19.6	3.8
Poland	49	584	2.5	-3.9	43.6	5.3
Slovakia	52	435	2.9	-3.1	42.5	3.7
Slovenia	79	1154	2.5	-2.1	29.8	3.8

Sources: Eurostat, Kopint-Datorg Database

Downside risks 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, major downside risks are in Hungary, in Poland and – concerning financial stability – in Latvia. In Hungary, both fiscal and external imbalances are critical which results in high risk premium – a marked currency depreciation in 2006 is far from being unrealistic. In Poland very serious labour market structural problems may block the prospects, while in Latvia real estate price bubbles and stubbornly high inflation expectations raise concerns. On the other hand, short-term prospects of Estonia, the Czech Republic, Lithuania, Slovakia and Slovenia are undoubtedly favourable.

Table 3.4.2 New member states forecast

<i>Percentage changes unless otherwise indicated</i>				
	2003	2004	2005^e	2006^f
GDP real growth	4.0	5.2	4.3	4.7
Czech Republic	3.2	4.7	4.9	5.1
Estonia	6.7	7.8	8.8	7.0
Hungary	3.4	4.6	4.2	4.3
Latvia	7.2	8.3	9.2	7.5
Lithuania	10.5	7.0	7.0	6.4
Poland	3.8	5.3	3.3	4.3
Slovakia	4.5	5.5	5.5	5.7
Slovenia	2.7	4.2	4.0	3.8
Inflation (HICP)	2.0	4.1	2.6	2.5
Czech Republic	-0.1	2.6	1.7	2.5
Estonia	1.4	3.0	4.2	3.0
Hungary	4.7	6.8	3.5	1.9
Latvia	2.9	6.2	7.0	5.4
Lithuania	-1.1	1.1	2.7	2.5
Poland	0.7	3.6	2.3	2.4
Slovakia	8.4	7.5	3.0	3.3
Slovenia	5.7	3.6	2.7	2.4
Unemployment rate	13.6	13.5	12.4	11.8
Czech Republic	7.8	8.3	7.8	7.5
Estonia	10.0	9.7	7.6	6.8
Hungary	5.9	6.1	7.2	7.5
Latvia	10.6	10.4	9.0	8.5
Lithuania	12.4	11.4	8.2	7.0
Poland	19.4	19.0	17.8	17.0
Slovakia	17.4	18.1	16.4	15.8
Slovenia	6.7	6.3	5.8	5.7

Sources: National Statistical Offices, Eurostat, EUREN forecasts for 2005 and 2006. – ^eestimate. – ^fforecast.

SPECIAL STUDY

The housing market: a risk for European growth?

(The studies in this chapter provide background material to this report. The views expressed here do not necessary reflect those of all EUREN institutes)

1. Introduction

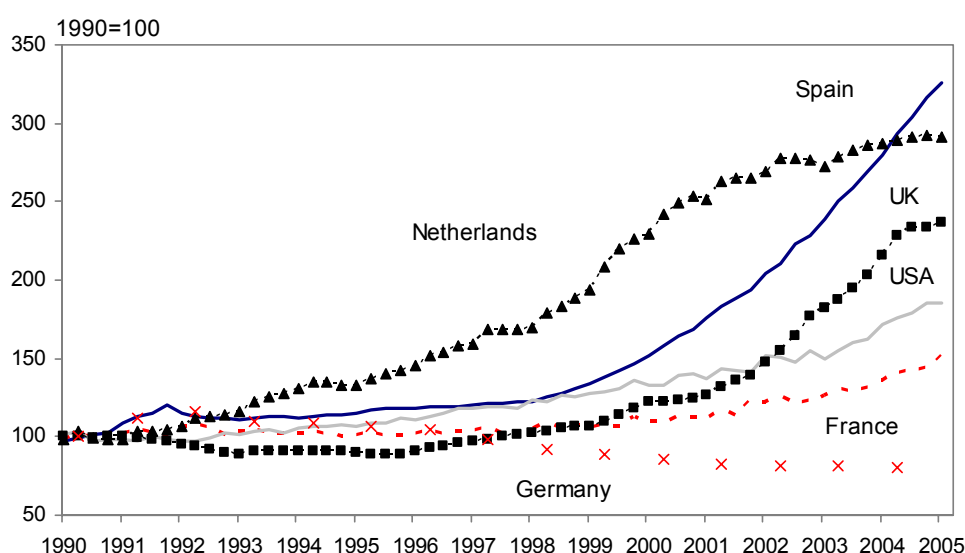
Alain Henriot, COE, Paris

**House prices:
a widespread
rise in Europe**

...

With the major exception of Germany, the housing sector has been booming in Europe in recent years and house prices have been rising in most of European countries.

Graph 4.1.1 House prices



Source: National Banks, Global Insight

Note: the indexes above are not always based on the same reference (houses or apartments, new buildings or average index)

This has had both direct and indirect effects on GDP growth. Firstly, the housing sector's dynamism has pulled the construction sector, which has had a positive contribution on global activity and employment in most of European

countries, especially in the new Member States and also in Spain. Secondly, the question of the indirect impact of the buoyant housing sector on households' consumption can be raised. Although some mechanisms, that generate wealth effects, are less developed in continental Europe than in the U.S., a potential link between the housing sector and private consumption can not be totally excluded².

**... for both
general and
country
specific
reasons**

The main question that arises is to know whether the increase in house prices, observed in most European countries, is sustainable or not, or in other words whether this upward trend can be attributed to a bubble. If this was the case, what could be the collateral damage for the European economies if this bubble bursts? According to different methods, the level of house prices appears now relatively high compared to the levels that can be derived from fundamentals³. This can be a useful hint to gauge the maturity of the cycle. However, besides the historical and statistical approach, we need to come back to the underlying factors that have contributed to this upward trend of house prices. The decrease in long term interest rates to historical lows over the last six years, both in nominal and in real terms, has been a key element. It is also the reason why this upward trend in the house prices has been so widespread, not only across European countries, but also in the U.S. As long term rates will come back to an upward trend in 2006, although moderately, this may contribute to limit house price rises or even to trigger a downward trend. However, other structural factors, like demographic trends, may also continue to support the housing market, as it seems to be the case in France and Spain. Two lessons can be drawn from the UK example which to some extent has led the housing cycle in Europe: first, interest rates really matter for house prices; second, even after a sharp rise in prices, a soft landing is possible if monetary policy is sufficiently reactive.

² See « Consumption, Income and Wealth: a time series based panel data study of the Euro area », by Ai Al-Eyd, Ray Barrel, E. Philip Davis and Olga Pomerantz, paper presented at the AIECE (Association des Instituts Européens de Conjoncture) working group on medium term and structural changes, Brussels, 2nd November 2005.

³ See OECD Economic Outlook, November 2005.

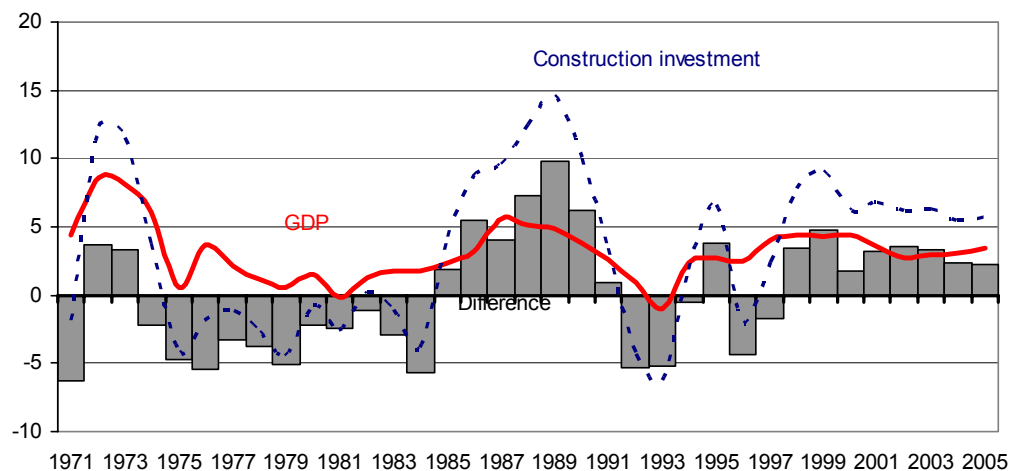
2. The Housing boom in Spain

Julian Perez, CEPREDE

The current construction cycle is the largest observed in Spain in recent history

Since 1997 the construction activity in Spain has remained in constant expansion, and while there are records of even higher activity levels in the past, this is the largest sustained period of growth since 1971, as portrayed in Graph 4.2.1.

Graph 4.2.1 Construction Investment Cycle, (% growth)

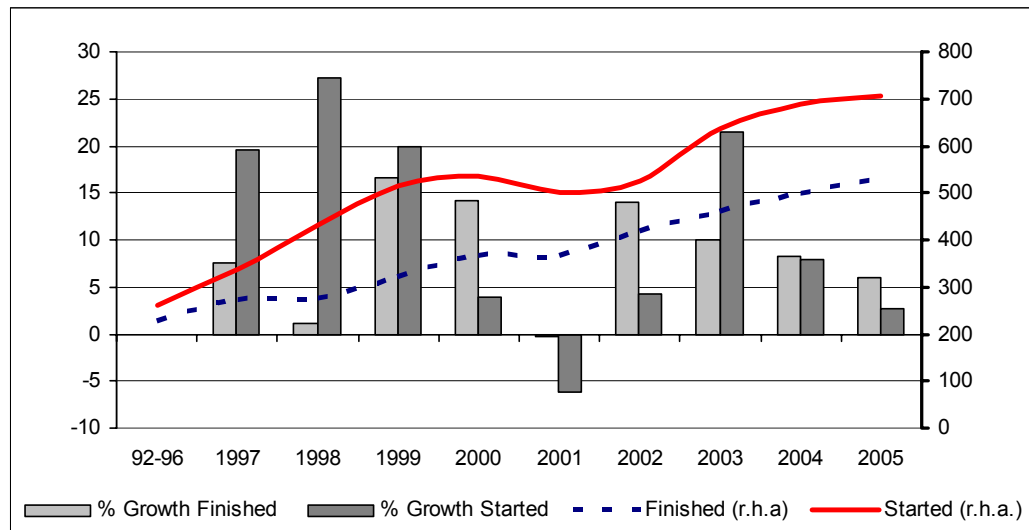


Source: CEPREDE

The expansion of construction activity has acted as a powerful engine for the rest of the economy, and it is estimated that half of the 4 million jobs created during the past 8 years are directly or indirectly related to the construction boom.

Growth in construction has been stimulated both by infrastructural development (its contribution to GDP has increased by 1.5 points since 1997), and by residential investment

Graph 4.2.2 Spanish Housing Market



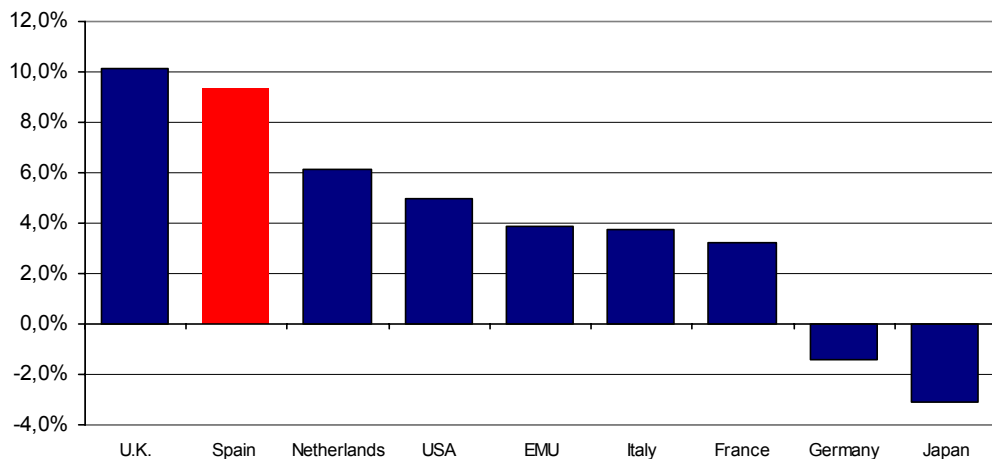
Source: CEPREDE.

Housing investments are leading the construction cycle

As portrayed in Graph 4.2.2, while in the early nineties some 200.000 dwellings were completed each year, in the early years 2000, the output range has doubled up to 400.000, and it is even moving above half a million in 2005. While growth rates are slowing down, the number of housing starts continues to increase (some 700.000 in 2005), and this obviously grants a continuation of high construction activity at least in the short term. This growth of housing demand has stimulated prices up to record levels among OECD countries.

Graph 4.2.3 Housing Prices

1997-2004 average annual growth rates



Source: CEPREDE.

500.000 new dwellings and prices increasing at 15% each year

As shown in Graph 4.2.3, since 1997, housing prices have been growing at an average of 9% each year (a rate only below the UK rate) and recently it has been growing at rates above 15%. In absolute terms, a square meter of

finished dwellings has jumped from 700€ in 1997 up to close to 1.900€ during the first quarter of 2005.

Can we talk of a speculative bubble?

Many institutions, in Spain and in international discussion panels, have pointed to the possible existence of a speculative bubble that could generate serious financial problems in the future. It seems however that the growth of housing construction and real estate prices are justified by the strong increase of demand, due both to demographic factors, as well as to the availability of low cost financing and easier accessibility.

Taking an apartment of 90 sq. m. financed with a 15 year mortgage as a reference, table 4.2.1 shows the effort required for the acquisition of this apartment measured as the ratio of annual mortgage debt servicing to the annual average wage in Spain.

Table 4.2.1 Simulation of the cost of a standard apartment
(90 sq. m. mortgage 15 years, at average interest rates of each year).

	Housing Price in Euro	Mortgage Rate in %	Annual Mortgage Payment in Euro	Annual Wages in Euro	Affordability Ratio ¹
1990	50.883	16.2	9212	14614	63.0%
1991	58.171	14.7	8456	16086	52.6%
1992	57.392	15.4	8789	17906	49.1%
1993	57.158	11.7	8258	19239	42.9%
1994	57.560	10.2	7654	19953	38.4%
1995	59.584	11.0	8291	20683	40.1%
1996	60.689	8.1	7134	21620	33.0%
1997	61.632	6.2	6429	22096	29.1%
1998	64.497	5.5	6426	22750	28.2%
1999	71.308	4.6	6685	23363	28.6%
2000	81.626	6.0	8404	24143	34.8%
2001	92.692	4.8	8810	25090	35.1%
2002	103.320	4.8	9833	26021	37.8%
2003	118.485	5.0	11277	26895	41.9%
2004	139.083	4.7	12948	27785	46.6%
2005	156.592	4.5	14346	28570	50.2%

Source: CEPREDE. – ¹Mortgage payment in % of wages.

As it can be easily observed, the effort required has decreased since the early nineties, from 63% in 1990 to 28.2% in 1998, and the price increase since then has brought this level up to 50% at present, but still below the initial level.

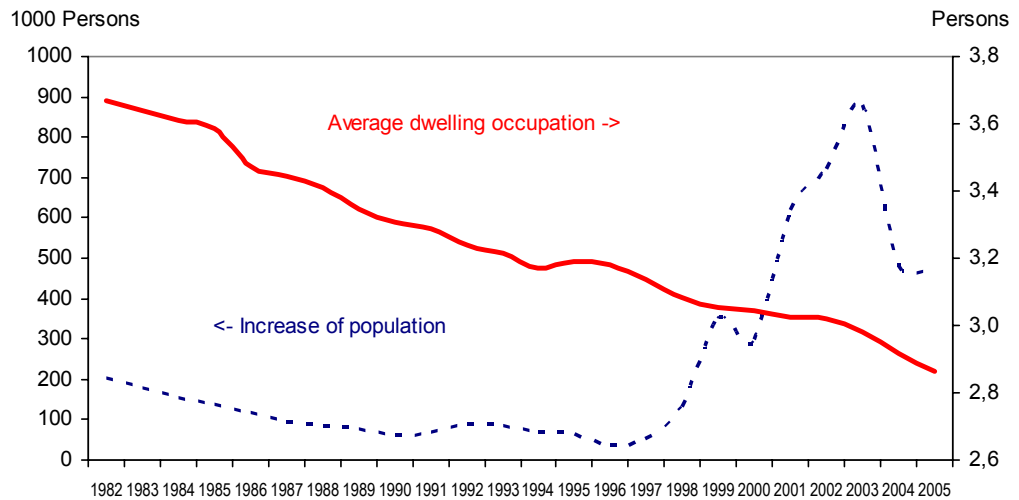
Moreover, the recent increase is partly compensated by the fact that the length of mortgages has increased and is at present of the order of 24 years.

To this greater accessibility to new housing, the influence of demographic growth should be added (see Graph 4.2.4).

Demographic factors also justify the growth of housing demand

Since the late nineties the total Spanish population has been increasing by some 600,000 per year, mainly as a result of massive immigration. At the same time, the size of the households has continually decreased and is now below 3 persons on average. As result of these trends the total number of households is increasing by 470.000 a year since 2001.

Graph 4.2.4 Demographic Housing Demand Factors



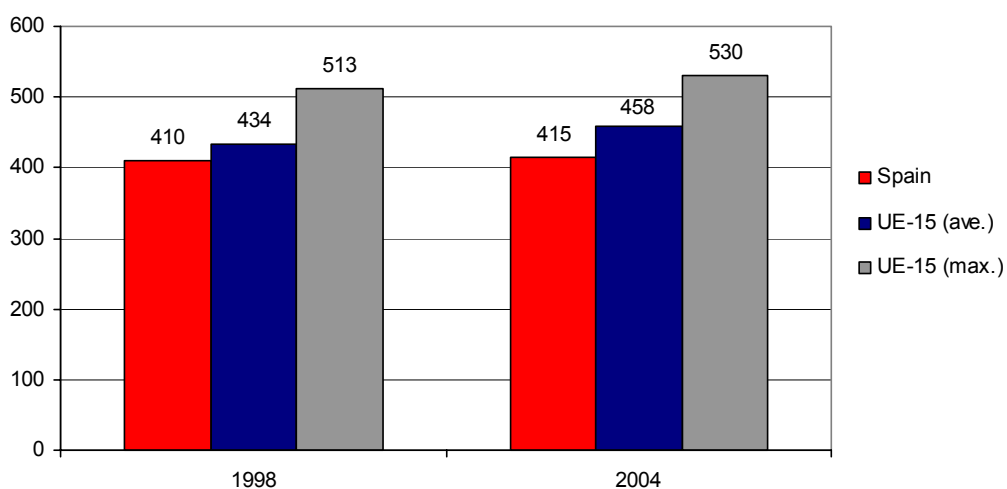
Source: CEPREDE.

Furthermore, to this demographic factor the strong increase of the demand for second residences should be added, as well as the demand from non-resident citizens mainly in the seaside. Consequently it can reasonably be considered that the construction boom is supported by robust demand, and does not have a high speculative content.

There is still sufficient growth potential in the context of EU convergence. In spite of the spectacular growth of sales and prices in recent years, the stock of dwellings/1000 inhabitants has only changed from 410 in 1998 to 415 in 2004, and remains 10% below the EU-15 average (see Graph 4.2.5)

Graph 4.2.5 Housing Stock
(per 1000 inhabitants)

There is still room for additional growth looking at the convergence path to European standards



Source: CEPREDE.

3. The French housing market: How far will the rise in prices be sustainable for households?

Frédérique Cerisier and Alain Henriot, COE, Paris

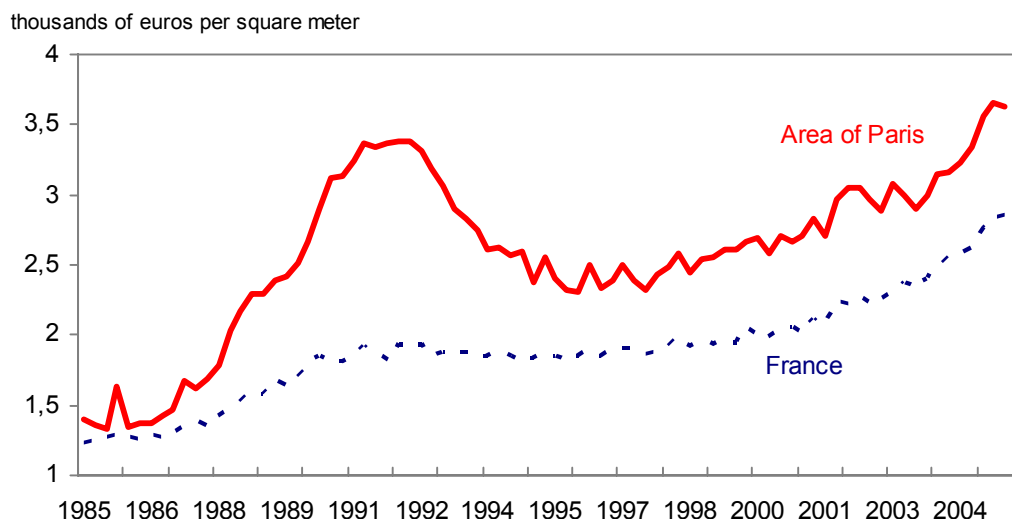
Since 1970, France has experienced three major price cycles in the housing market. The one preceding the current cycle started in the middle of the eighties and ended in 1991. Between 1985 and 1991, the prices of the new apartments increased by 133% in the area of *Ile de France*, those of the old apartments of 153% in Paris. In fact, the increase in prices at that time was mainly specific to the French capital and its area (over the same period, the whole France registered only 48% increase in prices). This underlines the speculative character of this rise. The "housing bubble" of the end of the eighties burst in 1991, with a drop in prices of more than 34% in Paris between 1991 and 1997.

Prices doubled since 1998

The present cycle is common to the whole French territory and started in 1998. It started with an acceleration of the prices of old residences. On this market, the rise of prices was, on an annual basis and for the whole France, only about 2% in 1998, but as early as the following year, the increase reached around 8% per year and did not ceased accelerating since, to reach 15.4% in 2004. Taking account the first two quarters of the year, growth should reach at least 10.7% in 2005. Regarding the market of new residences, the acceleration of the prices started to be felt more clearly during the year 2000 (2.5% on annual average), to accelerate thereafter regularly up to 10.6% in 2005 (growth acquired at the third quarter year). Today, the prices of

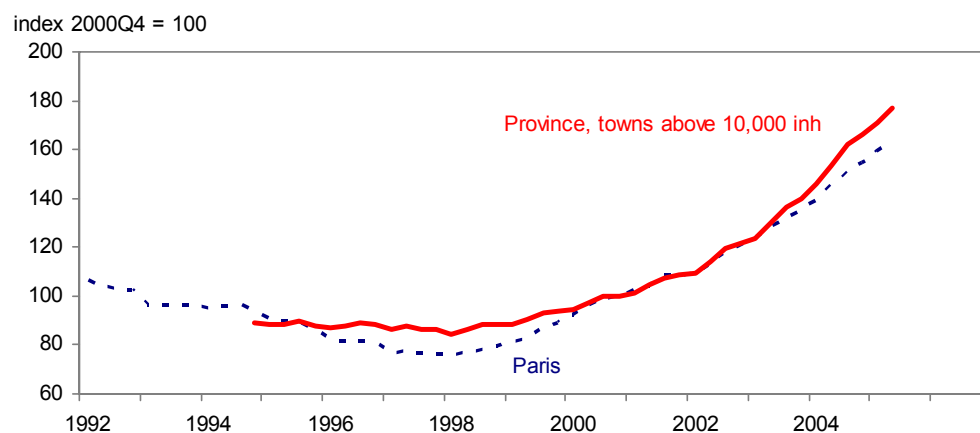
housing knew a cumulated rise of 49% since the first quarter of 1998 for the new residencies, and of 103% for the old ones.

Graph 4.3.1 French housing market: prices of new apartments



Source : Global Insight

Graph 4.3.2 French housing market: prices of old apartments

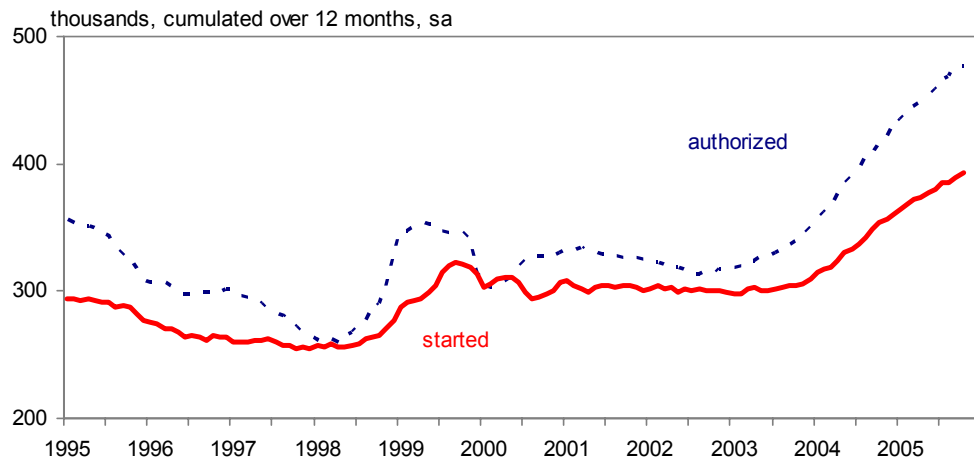


Source: Global Insight

These rises in price were of course accompanied by a strong increase in the number of transactions. Those reached a ceiling in the old housing market segment of around 600 000 per year, and register a light slowdown because of the weakness of the available supply. The sales of new houses continue to accelerate clearly, and should establish around 110 000 transactions this year. In fact, after the devastating effects of the bursting of the real bubble in 1990-1991, the residential construction sector awaited mid-2003 to react to the excess of demand present on the housing market and to increase its

supply very appreciably. In 2005, the number of housing starts in France could thus reach 400 000, after 340 000 in 2004 and less than 300 000 per year from 2001 to 2003.

Graph 4.3.3 French housing market: Authorisations of buildings and houses starts



Source: Global Insight

The structural factors for an excess of demand on the housing market

The buoyant restarting of residential building since the end of 2003 did not allow for a significant easing of the French housing market yet. The tightness of the market, regarding at the same time purchasing or leasing, is reflected in the proportion of vacant residencies in the housing stock which has, according to the National Institute of the Statistics and the Economic surveys (INSEE), fallen in 2004 to 6.1 %, a historical low of 40 years.

The excess of demand for residencies partly results from structural sociological factors which are not specific to the French case. The rise in the number of unmarried households and single-parent families on the one hand, induced by the rise in the average age of the wedding (or of the cohabitation) and by the increase in the numbers of divorces, and the lengthening of the lifespan on the other hand imply a basic tendency to the increase in the demand for residencies. Between 1999 and 2004, the average number of persons per household in France quickly dropped, and reached 2.3. A French study⁴ thus recently showed that before the beginning of the acceleration of the residential house starts in 2003, the number of new houses started per years was barely enough to cover the annual increase in the number of households in France (270 000 in 2004), without filling the gap accumulated in this field.

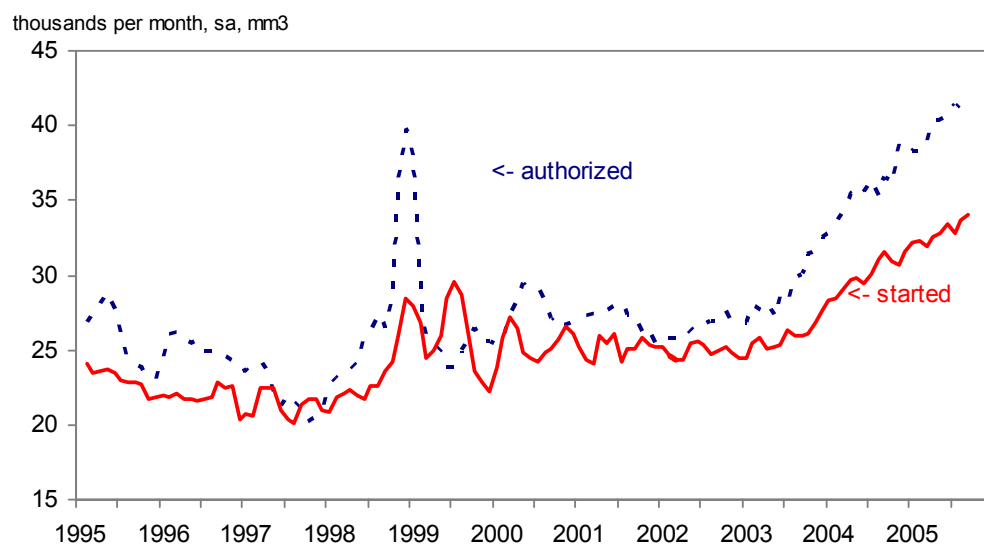
Taking into account the completion times, the recent acceleration of the house starts of new residencies could thus contribute to ease the housing market

⁴ Olivier Eluere, *Eco Immobilier*, Octobre 2005, Crédit Agricole.

somewhat this year. In fact, to try to accelerate and to amplify the response of the supply to the shortage of residences, French governments created new mechanisms aimed at supporting rental investment.

Indeed, in 1996, a first temporary mechanism of tax redemption called "*amortissement Périissol*" had been created in order to stimulate rental investment on the market of new housing. It actually boosted sales, particularly in 1998 and 1999, the last years of its validity. It also induced a light recovery of the prices, which dropped by 1992 to 1996, following the bursting of the bubble in 1990. For 2003, the "*amortissement Robien*", a broadly equivalent mechanism, has been set up. This mechanism is more of an incentive to investors and, above all, has no limitation in time. It has met a significant success. Nearly 60 000 sales would be related to this device in 2004, that is to say more than 50 % of the total sales of new residencies this year. These redemption mechanisms succeed in supporting an increase in the supply of rental housing. However, by stimulating the demand for purchase of new houses, in a context of supply of grounds to be built relatively forced, they exert a rising pressure on the prices of the housing market.

Graph 4.3.4 French housing market: authorisations of buildings and housing starts



Source: Global Insight

The major influence of low interest rates

However, it is quite clear that these factors (tax devices and the structural tendency of increase of the number of households) cannot explain by themselves the current flight of the prices in the French housing market. The fall of the long-term interest rates in these last years to a very low level probably explains a significant share of the acceleration of prices, as well as the concomitance of the phenomenon in many countries. Regarding the

**Sustainability
and
households
solvability**

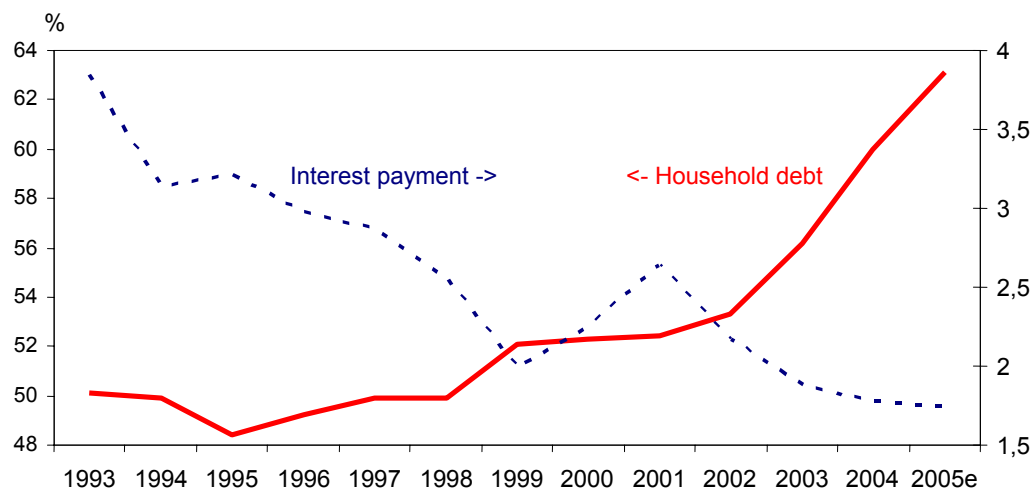
French case, a study of INSEE⁵ tries to evaluate the respective influences of the evolutions of the income of households and of the interest rates in the rise of housing prices. Cumulated over the period 1997-2004, the rise is evaluated to 85 %. Several approaches of evaluation are proposed. Other things being equal, they approximately lead to charge 50 % of the rise in prices registered over this period with the cumulated roles of the evolution of the income (globally favourable over the period, increasing by 28 % in value) and of the fall in interest rates. For example, keeping monthly payments and duration of loan (15 years) unchanged, the fall in the interest rates would have made it possible to increase the borrowing power of the households by 16.4%. Taking into account the evolution of income, borrowing power increases by 45%. Actually, and to face the rise of the prices, the average duration of loans appreciably increased in the last years, just as the amount of the monthly payments the households are now engaged to pay.

The assessment of sustainability of the present cycle in house prices can be based on the level of prices, compared to previous historical peaks. As shown in graphs 4.3.1 and 4.3.2; current levels of prices are already high in historical terms. This is true for nominal prices, but also in real terms. Thus, the first intuition is that the present cycle is already mature. However, as it has been shown above, the main specificity of this cycle is to have been supported both by structural factors and by a decrease in interest rates. In that sense, the sustainability of the cycle is also closely related to the solvability of households.

In recent years, the rise in loans to households for housing has increased dramatically. Although there was a slight deceleration since mid-2005, loans to households for house purchase increased by 13.5% in October 2005 compared to October 2004. It must be noticed that once deflated by house prices increases, the rise in the amount of loans is much less impressive. In other words, the increasing debt contracted by households, facilitated by cheap credit conditions, has been generated by higher house prices and not so much by a volume effect. As a consequence, the level of households' debt compared to their disposable income has increased dramatically. From close to 50% in the middle of the 1990's, it has reached about 63% in 2005. Moreover, it must be mentioned that loans for house purchase have represented a growing share of households' debt in recent years, from 61.9% of total lending in 1997 to more than 70% in 2005.

⁵ « La hausse des prix du logement depuis 1998 : éléments d'explication » in *L'Economie française 2005-2006*, INSEE.

Graph 4.3.5 Households debt and interest payments (% of household disposable income)



Source: Global Insight

To some extent, this continuous increase of households' debt may cause worries about their solvability. However, two other observations lead to a less pessimistic view. Firstly, and this is the main paradox of the current housing cycle, the debt burden of households has been considerably alleviated by lower interest rates. In 2005, it still continued to decrease, as interest payments represented only 1.7% of the household disposable income, against 3.8% in 1993. The increase in duration of loans has also contributed to this trend. Secondly, the level of debt of French households compared to their disposable income is still lower than the ratio observed in most European countries (Table 4.3.1). This leaves room for further increase. The reform of mortgages may also contribute to the enhancing of the capacity of households to borrow.

Table 4.3.1 Household's debt in % of disposable income

	1995	2000	2004
Belgium	54.2	62.9	66.9
Denmark	151.7	191.3	198.1 (2002)
Germany	89.2	106.1	100.7
Spain	47.3	72.6	93.8 (2003)
France	53.8	56.1	62.5
Italy	25.3	32.4	39.6
Netherlands	113.1	172.3	214.0
Austria	62.1	71.5	78.5
Portugal	39.1	92.6	111.6 (2003)
Finland	59.4	58.0	72.3
Sweden	93.6	99.3	102.9 (2001)
UK	97.3	99.7	124.9 (2003)
USA	92.1	101.2	116.6

Source: Eurostat, Federal Reserve

The accessibility to the housing market can also be assessed through a complementary approach derived from microeconomic tools used by bankers. It consists of a comparison of the amount of an annuity of a new loan with the average disposable income (or the average wages). For France, this kind of indicator leads to the conclusion that the degree of accessibility of households to the housing market has been reduced by the rise in house prices, but it remains much better than at the beginning of the 1990's. Moreover, the profile of households acceding to the housing market is changing: the share of rich households is increasing. 42.5% of borrowers earned more than four times the minimum wage against 23% in 1989. The financial constraint of those households is of course lower than the average.

Towards a more balanced market but the solvability of households is not yet an obstacle

The rise in house prices has thus contributed to rebalance the market. The supply has been boosted and the demand may be less strong as prices appear relatively high on historical standards, although sociologic elements appear more structural. As a consequence, the likelihood of a slowdown in prices has increased, but the solvability of households doesn't appear too deteriorated. This may contribute to avoid a marked downturn. Of course, a sharp increase in interest rates may jeopardize this conclusion. However, around 70% of debt of French households is based on fixed rates. Thus, it will also delay the effect of a potential increase of interest rates.

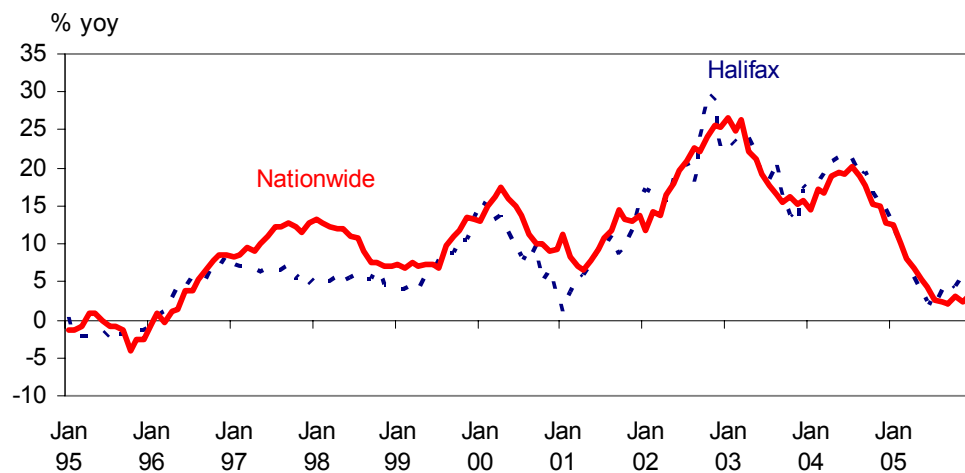
4. UK housing market shows renewed life

Keith Church, OEF, Oxford

Prices are not decelerating anymore ...

It looks increasingly unlikely that the UK will suffer a major house price collapse in this economic cycle. House price inflation has, of course, fallen sharply, to just 2.3% in November compared with 15% a year earlier (on the Nationwide measure). And prices have been broadly flat since the spring, with small falls in several months, although prices did rise 1.3% in October, more than reversing the falls of 0.2% seen in August and September. These renewed signs of life in the housing market are shared by the Halifax index, where prices in November were 5.9% higher than a year ago, compared to 1.6% in July.

Graph 4.4.1 UK: House prices



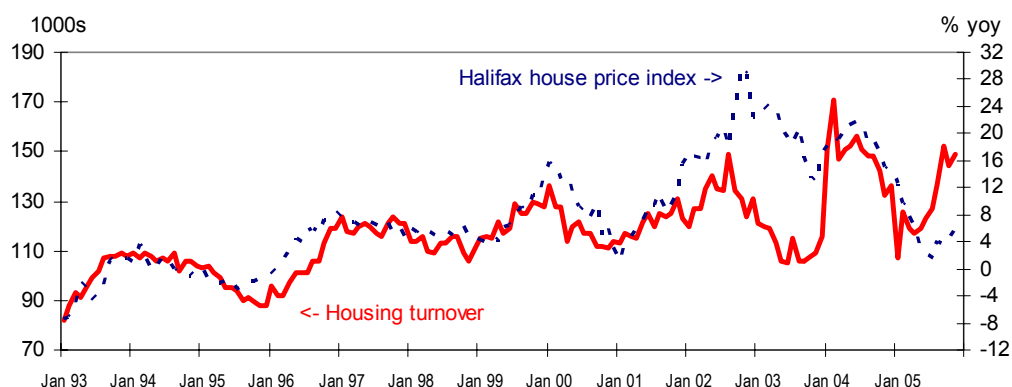
Source: Datastream

... and activity in the housing sector is moving up again

And, the indicators of activity have also been much more positive lately. For example:

- The number of housing transactions in the three months to October was 16% higher than in the previous three months, and only 2% lower than a year earlier.
- Similarly, while loan applications are still well down on their peak, they are bouncing back strongly.
- Net mortgage lending has stabilised during the summer.

Graph 4.4.2 UK: House prices and turnover



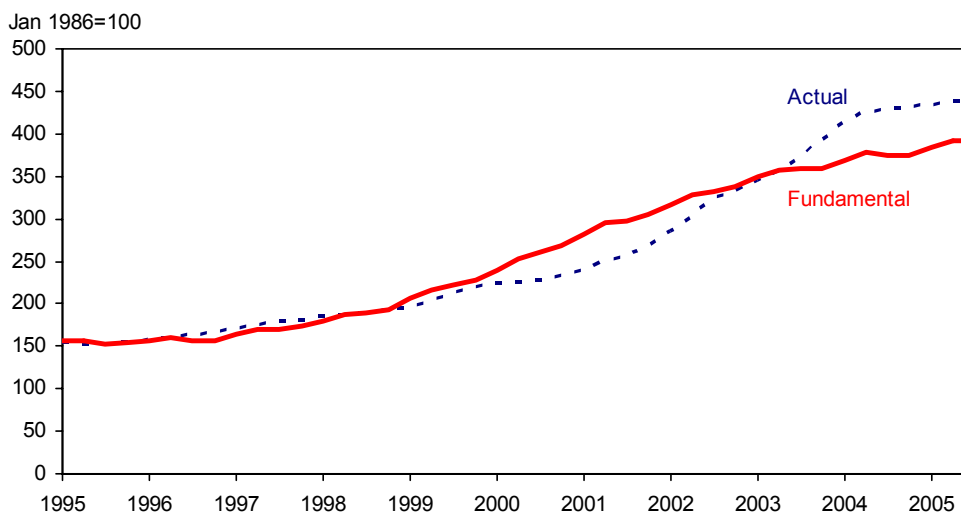
Source: Datastream

The key role of interest rates

The improvement in housing activity primarily reflects a change in interest rate expectations, supported by August's rate cut. With interest rates peaking in this cycle at less than 5%, this has given confidence to potential house purchasers that they will not face a sharp increase in their monthly repayments. And, the next move in UK interest rates is increasingly expected to be downwards removing a little more of the risk. Having worried last summer that interest rates might reach 5.5%, markets now take the view that rates have peaked at 4.75% - with inflation now falling, there is a good chance of another rate cut in February.

But, clearly, short-term movements in house prices should be interpreted with caution, and it would be wrong to suggest that a new boom in house prices is now underway. While continued low interest rates mean that mortgage service costs do not appear to be a constraint for most households, house prices remain around 12% higher than our models suggest would be consistent with their fundamental determinants, such as interest rates, household incomes, demographics and the rate of house building. And affordability is a key issue for many first-time buyers. Our forecast therefore still shows house prices rising by less than 2% through 2006.

Graph 4.4.3 Nationwide/Halifax house prices: actual and 'fundamental'



Source: OEF

5. Housing price developments in the Baltic States

Gyula Takács, Kopint-Datorg

Recent strong, 6 to 9 percent real GDP growth has been raising concerns of overheating in the Baltic economies. One salient symptom is often seen in buoyant housing prices, which might lead to a sudden downturn, or a 'bubble' effect. Thus, the question could be whether housing prices are or tend to become significantly overvalued, or are they still close to economic fundamentals.

House price to earnings (or: affordability) ratio is a common measure to determine the long term optimal level of house prices. However, figures of acceding countries are not readily comparable to long time series of old MS-s in the EU. As prices in general, house prices are expected to be closer to the European average than earnings. Therefore, a higher ratio is sustainable until convergence is in place. Indeed, between 1999-2002 a climb of affordability ratios in Tallinn and Riga from 3.55 to 5.77 was captured while the United Kingdom long term average is about 3.24 and even peaks fall short of recent Baltic data. On the other hand, official income data might well differ from the 'real world' figures.

In general, the following major determinants of housing prices could be identified.

Supply side elements

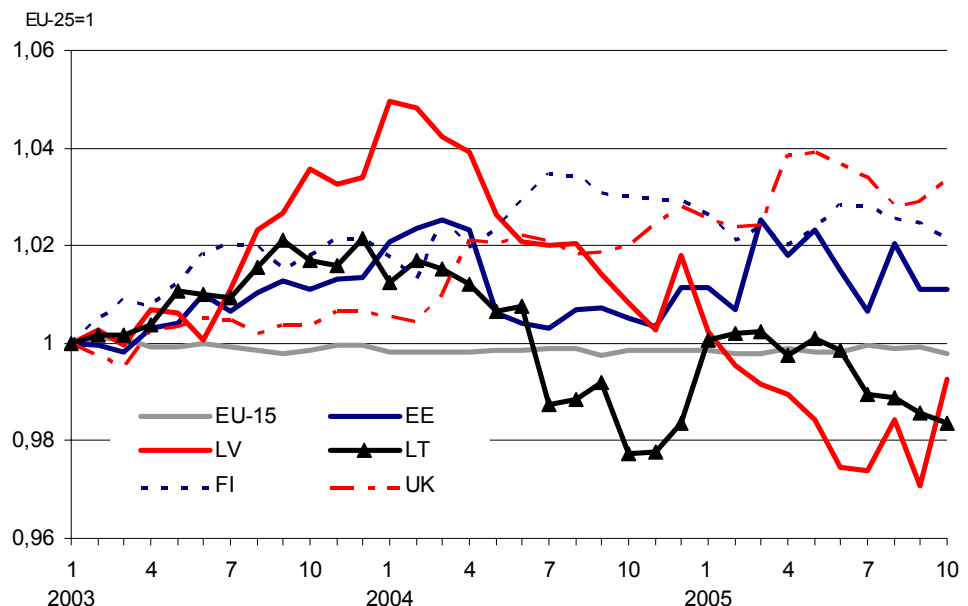
- Quantity and quality (age, urban/rural etc.) of the housing stock
- Size of the active housing market (mobility, average house price to income ratio)

- Pace and price elasticity of construction
- Scarcity of urban land for new buildings
- Housing transaction costs (including time needed for procedures)
- Property tax payable if the property is not held for a minimum number of years (a barrier to sell).

Demand side elements

- Demographic patterns of demand (like ratio of younger to older generations)
- Degree and distribution of purchasing power (the first measurable by the national house price to earnings ratio; the second by the proportion of speculative buyers versus those who cannot afford a purchase without governmental, parental etc. help)
- Credit conditions
- Interest on loans (interest rate; fixed vs. variable rate; government sponsoring)
- Maturity of mortgage loans, term of lending (longer terms help to keep debt service to income ratios affordable)
- Loan to value (LTV) ratio, i.e. the value share of the property that banks intend to finance (high LTV ratios allow taking out more debt)
- Tax deductible of mortgage interest (an incentive to buy)
- Consumer inflation variability and expectations.

**Graph 4.5.1 Real housing price index
Changes relative to the EU-25 average**



Source: Eurostat

In order to see real house price movements, nominal house prices can be deflated using the private consumption deflator. With given available data, the graph 4.5.1 represents a relation between harmonized housing price and

consumer price (HCPI) indexes. To add further context and exclude external effects, price movements are here put against the average EU figure which is shown as constant throughout the time scale. As the graph suggests, real housing prices grew faster in new member states and slower in old ones than altogether (which actually made a relatively calm climb to 104.1% in the 20 months shown).

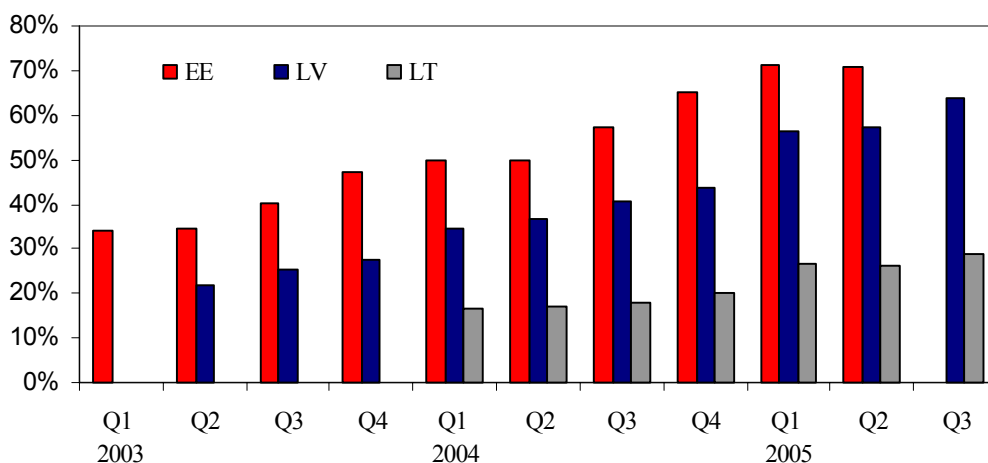
The other main conclusion may be that the most recent Baltic trends in real housing prices have not been extraordinary in European comparison. Two examples have been included to the chart, Finland for its economic ties with the three countries in question, and the UK for its most advanced mortgage market across the EU⁶. In both countries, the last data display a stronger growth of housing prices relative to their own HCPI.

Finally, the volatility in some curves should be noted. Generally it is not surprising if a small market behaves more volatile than a larger one. However, there are differences in the tendencies among the three Baltic States which are certainly of comparable sizes. While the Estonian curve has been contained in a relatively narrow band not far from the European trend, and Lithuania remains relatively close to that, Latvian prices swung a lot.

The differences might not be explained by a single factor. Lithuanian households' outstanding housing debt is minimal in comparison to its fellow countries, but it might not be a sign of weak financial structure (Graph 4.5.2). It is rather a fast growing construction sector that made large debts unnecessary. Most recent construction data suggest that supply of new buildings should come on time to facilitate a soft landing of house prices (Graph 4.5.3). However, halting Q2 bank data and lacking Q3 figures leave some concerns about whether lenders might start feeling a growth in risk, eventually delivering a sudden end to housing market buoyancy. Latvian (relative to GDP) housing loan stock also tends to saturate, and supply may not be able to follow demands in the fastest expanding economy of the region.

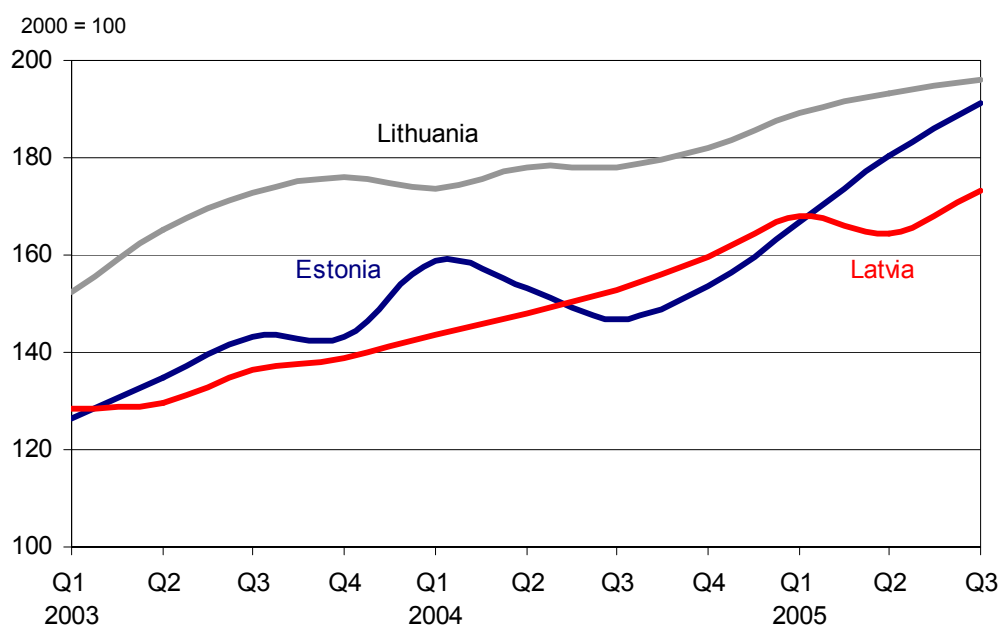
⁶ OECD Economic Outlook No. 75, June 2004

Graph 4.5.2 Loan stock lent for house purchase as a percentage of GDP



Source: Central banks, national statistical offices

Graph 4.5.3 Construction volume indices in the Baltic States (seasonally adjusted)



Source: Eurostat

Because house price movements tend to lag behind cyclical peaks and troughs, current upward trends may continue after the Baltic expansion settles. Structural reserves like interest rates to be eased should remain for that time to flatten the downturn, while today supply side developments would be most welcome.

Also, the at least apparent 'wealth effect' of rising house prices, i.e. housing equity withdrawal through mortgage debt for consumption purposes should be reduced so that lenders' and borrowers' risks could be somewhat contained at loans serving the purchase in housing.