Caboto

Macroeconomic Outlook

Research Department

April 2004

Banca Intesa

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Italy stands out

From an Italian perspective, the economic situation as it stands gives little cause for cheer. Judging from domestic industrial activity, the economy remains stagnant and the outlook gloomy. The government, which in the last few years has often given over-optimistic growth forecasts, appears ever more inclined to reject fiscal stability (which until recently was an important objective) in favour of stimulatory measures. And yet elsewhere, things have been looking up over the last few months. Economic recovery has occurred almost everywhere, in a way not seen for many years. The US is flourishing, with GDP growth seen at more than 4.5% y/y this year. Asia is experiencing an upturn, with Japan emerging from a decade of deflation thanks to the central bank, and China seeing an industrial boom. Even Europe is doing relatively well: the strong euro has not prevented a moderate recovery in services and industry.

One of the results of this widespread recovery has been a rise in commodities prices on the international markets. Some episodes, like the jump in the price of steel, have even made it into the newspapers. As for oil (see page 6), the strength of demand appears to be the biggest driver of the upward price pressures seen lately. The price increases, which have affected industrial commodities and fossil fuels most of all, have already translated into significant rises in industrial inputs, even in sectors that until recently were protected by the strong euro. However, the inflationary impact is greater for the emerging markets than for the west: even in the US, where the dollar has been in free fall, the drop in unit labour costs is more than offsetting the rise in labour inputs.

Commodity Prices

	2001	2002	2003	2004	2005	2006
Oil price; Brent crude spot$/barrel	24.4	25.0	28.8	29.1	26.0	26.1
	-13.8	+2.4	+15.3	+0.8	-10.7	+0.4
Non-fuel commodities price index	73.1	76.0	81.7	92.7	95.7	89.3
	-5.4	+3.9	+7.5	+13.5	+3.3	-6.6
World price of metals	73.9	71.9	80.5	105.2	105.4	93.2
	-9.8	-2.7	+11.9	+30.8	+0.2	-11.6
Agricultural raw materials world price	77.0	78.2	81.2	86.3	89.9	88.5
	-4.9	+1.6	+3.8	+6.2	+4.2	-1.5

Levels and average annual rate of change.

The recovery appears both strong and widespread, but is unlikely to accelerate further. In the US, the end of the tax cuts will cause expansion to settle at lower levels than those seen in late 2003. Japanese growth too is expected to stabilise at lower levels, thanks partly to the appreciation of the yen. It is to be hoped that this will not happen in Europe, where a modest upturn in domestic demand and a more favourable than expected exchange rate trend should cause economic growth to gather pace slightly. Doubts still remain in the short term, however: although the leading indicators are still giving off positive messages, figures for this period are rather unclear, and it is by no means certain that the economy will not start slowing again. It's no coincidence that in the eurozone the markets have for some time been incorporating expectations of an interest rate cut this summer.

GDP Growth

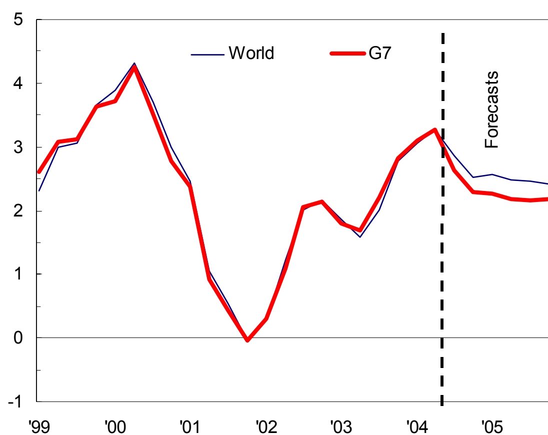
	2001	2002	2003	2004	2005	2006
USA	0.5	2.2	3.1	4.1	3.0	2.6
Japan	0.4	-0.3	2.7	2.8	1.4	1.1
Eurozone	1.6	0.9	0.4	1.5	2.1	2.3
Eastern Europe	4.4	3.6	5.6	5.1	4.9	4.5
Latin America	0.2	-0.7	1.5	3.8	4.5	4.1
OPEC	2.3	1.6	-0.1	5.9	5.5	3.4
East Asia	3.8	5.7	5.7	6.7	6.7	5.4
Africa	3.3	3.4	3.0	1.9	2.3	3.0
World growth	1.3	1.8	2.5	3.6	3.1	2.8

Average percentage changes over year ahead.

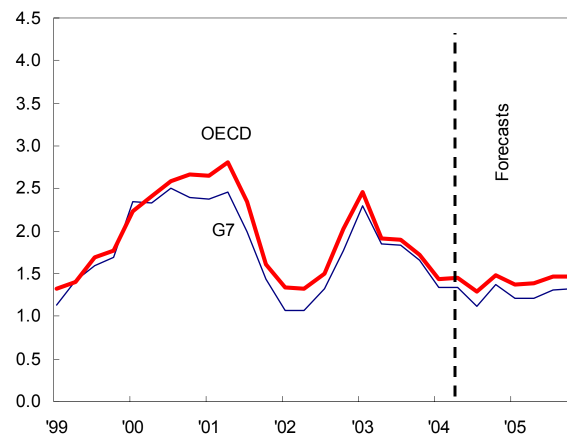
Monetary policies remain expansive. Although cuts in official interest rates look out of the question in the US, and still unlikely in Europe, we are certain that nominal rates will remain very low for some time to come. We do not expect interventions from either the Federal Reserve, the ECB or the Bank of Japan this year.

But returning to Italy, an interest rate cut by the ECB would most likely have only negligible benefits for the Italian economy. As our section on Italy shows (see page 27), Italy's industrial malaise has many facets, including labour costs, delocalisation pressures, fluctuating exchange rates and the negative effects of Italy's traditional manufacturing specialisation. The likelihood is that resolving these problems will require a painful period of restructuring entailing the rotation of economic activities rather than a recovery in the sectors in crisis.

International economic cycle



Inflation



This is true as long as the euro does not start falling again, as the lira did. A decline towards 1.13-1.15 cannot be ruled out, given the closeness of the euro to its critical support levels. Such a drop would only happen in the event of positive

US data taking the markets by surprise, which we doubt will happen. Our forecast scenario therefore incorporates a euro/dollar exchange rate remaining steady at current levels, the dollar/yen falling to below 100 and a weaker dollar than in 2003 overall. As we expected, the market has lost faith in an unstoppable rally in the euro, owing to signs of relatively weak European growth and the risk of cuts in official interest rates, whereas it has continued to bet on the yen despite the harsh punishment inflicted by the Japanese monetary authorities with their massive interventions in 1Q04.

(Luca Mezzomo)

Oil: demand will be the main price trigger in 2004

March figures on OPEC production and US stocks appear to show that the main driver of the current high oil prices is demand (from China and the US) rather than any production cuts by OPEC.

Once again, OPEC output remained unchanged last month at 26 mb/d, some 2.5 mb/d above the hypothetical quotas for April (23.5 mb/d) and 1.5 mb/d more than those of the last few months. In other words, producers have not actually begun cutting production as they should have done at least by mid-February in order to implement the official cut. US import figures have remained consistently above 10 mb/d in the last few weeks, and show that the market is currently well supplied.

Keeping production high also allowed commercial stocks to be rebuilt to a certain extent: crude levels returned to 292 mb/d. Petrol stocks also increased (although less sharply), reaching 200 mb/d, and although they cannot yet be considered to be at safe levels, there is certainly no fear of supply shortages even in the summer, the period of highest petrol consumption. However, although the market was expecting stock rebuilding to continue in the first week of April, reserves actually fell.

Note that in recent months the US government has been replenishing its strategic reserves, storing more than 50 mb/d, and these could be brought into play in the case of supply shortages. Such an eventuality is in fact feared by OPEC, which has not forgotten that in 1998 President Clinton ordered that 20 mb/d of strategic reserves be released onto the market, causing the price of crude to fall by more than USD 5/b in just a few days.

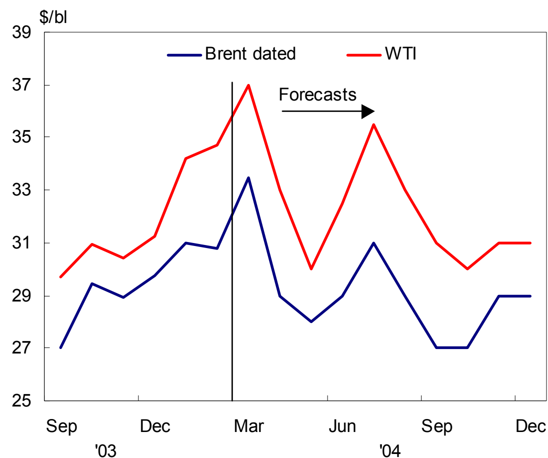
The market reacted to events as expected: following the improvement in stocks and the lack of a production cut by OPEC, Brent fell from its peak of USD 33.5/b to USD 30-31/b, while WTI dropped from USD 37/b to around USD 34/b, partly as a result of the liquidation of long positions by investment funds (which also caused backwardation on the forward curve to flatten off somewhat). The market believes that even if OPEC does proceed with production cuts over the next few months to counter the seasonal fall of 2-2.5 mb/d in demand in April and May, it will nevertheless maintain a certain level of over-production (estimated at 1-1.5 mb/d). However, the bearish price trend came to a halt with the stock figures published on 7 April, which triggered fears of a new cycle of commercial stock reduction, and caused both Brent and WTI to jump by more than a dollar. However, if reserves rise over the next few weeks, prices could begin to fall once again, although not to less than USD 27-28/b.

Although the fundamentals are improving in the short term, they indicate that the market may experience further rallies over the next few months in response to increased demand in the summer and winter—not to mention any shocks that may arise from the still unstable geopolitical situation. In addition to stock levels (which are in any case rather low historically), another main driver will be demand. Estimates of growth in crude demand this year range from the EIA’s 1.4 mb/d to the IEA’s 1.65 mb/d. These valuations are based on two factors. First, US demand for petrol, which has already reached peaks of more than 9 mb/d—a level not normally seen until the driving season gets under way at the end of May—while the first-quarter average stands at an all-time record of 8.8 mb/d. Demand for petrol may increase by more than 2% year on year, even though

prices are expected to reach their highest levels since 1985 this summer[1]. This is certainly an indication that the US economy is in excellent health, although this will probably be most evident in the first half of the year[2]. The second factor is demand from China, which jumped by 7% between 2002 and 2003, and this year could well beat all records, with growth of 500,000 b/d—around 10%.

In the medium term therefore, the market is looking rather bullish, and this will tend to keep prices high. Moreover, under these conditions, the market is highly sensitive to any unforeseen events (as the unexpected data on stocks shows). We believe that the most likely scenario for 2004 is an average annual price of USD 29-29.50/b for Brent and around USD 33/b for WTI[3]. Brent prices may fall in the short to medium term (although not below USD 27/b), and will then move back up to USD 30/b, perhaps with peaks of USD 33/b during the summer (while WTI may experience severe pressure and head towards USD 40/b), unless stocks grow so much as to create a situation of over-supply, which looks unlikely if OPEC does in fact reduce its output in the next two months. Brent may then ease back below USD 30/b this autumn, and stabilise at around USD 29/b towards the end of the year.

Monthly prices and trend of Brent Dated and WTI forecast to end-2004



Source: Banca Intesa

(Luigi Napolano)

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1 *The EIA's estimate puts the average national petrol price at USD 1.74/gallon for the period April-September, with peaks of more than USD 1.85/gallon. In California, petrol prices have already overshot the USD 2 /gallon threshold.*

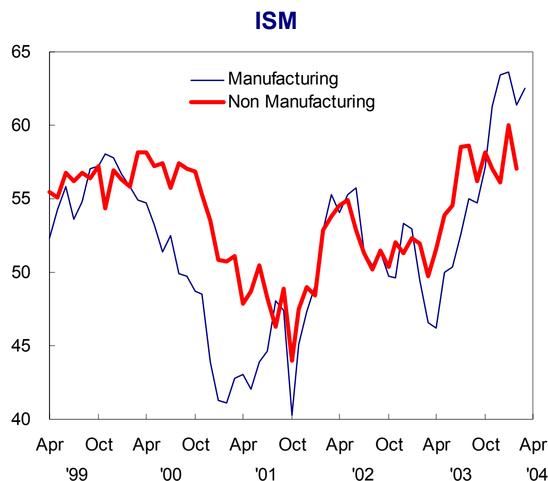
2 *In its analysis of the US oil market, the EIA estimates GDP growth for 2004 at 4.7%. We put the growth figure at 4.2%.*

3 *The average price of Brent dated in 1Q04 was just over USD 32/b, while WTI recorded an average value of USD 35.30/b.*

United States: moderately pessimistic

We have **nudged down our 2004-2005 growth forecasts for the United States** compared with a month ago. Ours is still by far the most pessimistic view: our revision has in fact widened the gap between our forecasts and those of the consensus, which now stands at 0.5% for 2004 and 0.7% for 2005. **We now put growth at 4.1% for 2004, and at 3% for 2005**; these two estimates are lower than even the most cautious of forecasts in the Consensus Economics panel for March 2004. The reasons for our relative pessimism are related mainly to corporate investment, on which the gap between our estimates and those of the consensus is even more marked: our growth forecast stands at 7.3% compared with 10.6% for the consensus in 2004, and 5.5% against 9.1% for 2005. We have revised private consumption (the main component of GDP) down by about 0.1% for 2004: it now stands at 3.7%, in line with the consensus. We see greater likelihood of a slowdown in consumption in 2005, when growth in disposable income will be offset by slower rises in hourly wages and a tighter fiscal policy. Despite clear signs of a slowdown, our scenario on investment in residential building has eased: stable mortgage rates and increasing house prices could well offset stagnation in the sector over the year, although a more decisive reversal is not likely to come until just before the Fed begins raising interest rates. Finally, unemployment remaining steadily above the NAIRU level of 5% indicates an inflation rate of 1.8% in 2005, slightly below our previous forecast of 2%.

Our growth scenario for 2004 sees **GDP growth slowing significantly in the second half of the year**. This will come just as the stimulatory effect of the tax refunds has tailed off, and therefore just as private consumption slows and corporate investment stabilises on a more sustainable growth path. Geopolitical uncertainty may once again play a key role in the economic outlook by impacting on companies' spending decisions. GDP growth is likely to fluctuate at around 3.6% in 1H04, and will then slow to 3.1% in the second half.



National accounting figures for 1Q04 are expected to show growth of 3.7% q/q, or 4.8% y/y. This estimate, based on an analysis of the components of demand, is backed up by our main supply indicator. Although the shortness of the historical series sharply limits its usefulness, the non-manufacturing ISM index contains information on this macro sector which is far more relevant to the US economy. By aggregating the components of the non-manufacturing ISM index into an overall diffusion index for the sector, and combining this last with the

manufacturing index on the base of the value added of the two macro sectors (manufacturing and non-manufacturing), we have built an ISM-Total index. As we said, the shortness of the non-manufacturing series limits the usefulness of the index in making GDP growth estimates, but since these estimates are in line with those based on the components of demand, this is at least a sign of consistency that is fairly encouraging. The quarterly average of this new index has risen from 4Q03 (from 58.1 to 60.3) and this is in line with our estimate of 4.8% growth y/y in 1Q04.

Consumption

Our scenario sees saving rates stabilising at their current level of 1.9% in 2004, and rising slightly in 2005. As we have highlighted several times in the past, saving rates are much lower than the economic fundamentals would require, but it is difficult to forecast how and when there will be a reversal in the trend. We can reasonably suppose that the correction will be gradual rather than sudden, and so will not have a major impact on US consumer spending.

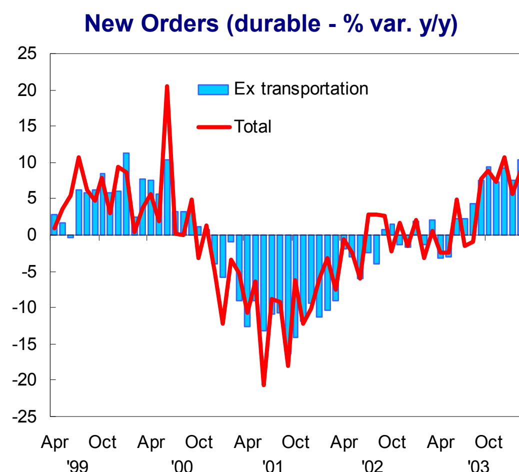
Our consumer growth forecast for the first quarter (3.6% q/q ann.) is based on a sharp acceleration in consumption in March. Weekly sales figures continue to give off mixed signals about retail sales trends. In the past, both the Redbook and the ICSC surveys have proved widely inadequate in giving reliable forecasts in this respect. In general, however, the clearest signals come from the yearly figures, and here, both surveys indicate that private consumption of non-durables is holding firm this quarter.

That said, the lower than expected private consumption figures continue to fuel doubts over whether the tax refunds can actually boost the US economy significantly. They are trickling down only slowly to households, and so are unlikely to have a huge effect on consumer spending this quarter. And even in 2Q04 the effects will be felt mainly by the medium- to high-income bands, which have a lower propensity to spend. The figures available to date suggest consumer spending growth of around 3.6% q/q (ann.) in 2Q04, the same as in 1Q04, with the job market recovery working alongside the tax cuts to sustain the growth in disposable income.

Corporate investment

The outlook for corporate investment in machinery and software over the next 6-9 months remains positive, but must be revised downwards in light of the drop in orders and deliveries of capital goods (excluding defence and aircraft). The jump in productivity, the slowdown in salaries growth, low interest rates, tax cuts and the fall in the dollar have all led to record growth in corporate earnings as a percentage of GDP. Although we expect labour productivity to drop sharply over the next few months, continuing overcapacity is likely to cause a further slowdown in wage growth and thus keep company profit margins high.

New Orders (durable - % var. y/y)



In the short term the signs that have emerged in the last few months point to a smaller role for corporate investment in fuelling the recovery. In February, orders for capital goods (excluding defence and aircraft)—the indicator most correlated to companies' investment in machinery—rose by 0.4% m/m, counterbalancing the 0.4% drop seen in January. This slowdown indicates that investment has stabilised following the peak of 12.8% q/q ann. seen in 3Q03. Unless things change radically, the scenario of new orders (+1.1% q/q ann. in 1Q04) and the order backlog (-2% q/q ann.) does not support the view of a trend reversal in the near term: investments have already peaked in the second half of 2003, and this year we expect them to stabilise.

Building

Barring a further fall in mortgage interest rates, we are likely to see a sharp downturn in residential building. During the 2001 recession this demand component was a key factor in easing the effects of the slowdown. Figures for 1Q04 show clear signs of a downturn. The number of new developments fell by 4% m/m in February, the second consecutive decline from the peaks seen in December. The same has happened with another crucial real estate market indicator: the number of building licences went down by 1.5% m/m in February. For 1Q04, assuming the deflator remains in line with house price trends, our estimate of a drop of 3% q/q (ann.) indicates nominal growth of 3.7% q/q (ann.) in construction spending.

Exports

Last year we saw the US trade deficit stabilise, although the accelerating economic recovery and rising crude prices stopped the economy from benefiting fully from the fall of the dollar. This weakening in the real effective exchange rate (both past and future) has yet to manifest itself fully, and the downturn in growth expected in the second half of the year should help reduce import growth and close the trade gap somewhat. Exports seem to have lost the dynamism they showed in the second half of 2003, while imports will continue to accelerate for now: all this indicates a wider trade deficit (already at all-time highs) in the near term.

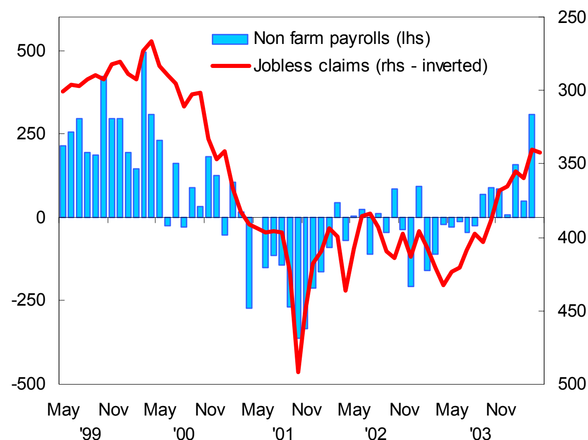
Job market

After months of waiting for the US job market to reawaken, the sharp rise in March (+308,000 new jobs), together with the revision of January and February data (which added a further 87,000 new jobs to each month), following the hiatus of last winter, have injected a touch of optimism into the macroeconomic outlook. Average growth in 1Q04 was 171,000, a sharp jump on the 60,000 jobs created in 4Q03. Employment growth is crucial for the sustainability of the recovery: as the effects of the tax cuts tail off, the economy will have to find its own momentum, so a recovery in the job market and disposable income is absolutely necessary for consumer spending to keep rising. Over the next few months we expect to see a further progressive improvement in employment, although the figure for March may be misleading and should not be taken as a guide.

Unless labour productivity plummets, we are unlikely to see growth of 300,000 new jobs a month in the non-farm payrolls sector. Diffusion indices for the private sector (whose growth is one of the most positive factors at present, together with the payrolls growth) confirm that employment growth is on the up, but is still far from that kind of rate. Aside from contingent factors that may have contaminated the February and March figures (bad weather as regards the construction sector and continuing strikes by supermarket workers), some of the indicators contained in the March report are less encouraging. The aggregate index of hours worked was down 0.1% m/m, putting growth at 1.5 q/q (ann.) in 1Q04, down from the 1.9% q/q (ann.) recorded in 4Q03. Unemployment rose from 5.6% in February to 5.7%, and all the alternative indicators of labour force under-utilisation have worsened compared with February. The mean and median duration of periods of unemployment remains broadly stable, approaching the high point of the last 20

years. The number of hours worked a week has declined and is in line with the figure for the last six months. Finally, hourly wages continue to grow at the same rate as inflation, or more slowly. None of these factors indicate that the job market will be able to repeat the excellent performance of March. In fact, we think it more likely that the March figure will be revised downwards, putting average quarterly growth at nearer 140,000. This rate is not far off the average employment growth we expect to see over the next six months. Based on our econometric models, the job market does not yet seem to be in a position to go into a higher gear. On a 3-month horizon (March-May), average monthly growth should fluctuate at around 120,000. Surprisingly, this rate is likely to remain the same on a 6-month horizon (March-August) too, which seems to be the top speed the US economy is capable of at present. With average growth at this level, it will take more than a year for employment to climb back up even to its pre-recession levels.

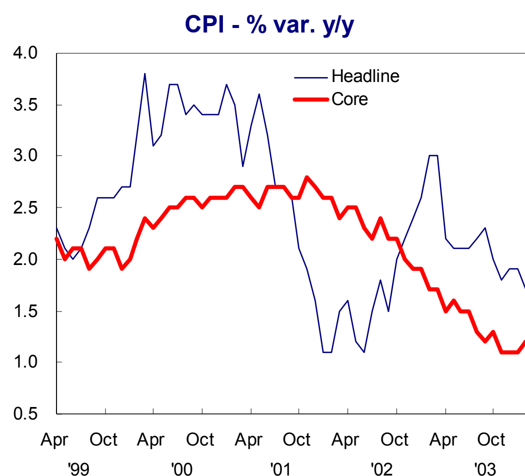
Non Farm Payrolls & Jobless claims ('000)



The jump in employment seen in 1Q04 is a trend consistent with a recovery scenario, but does not pose a serious obstacle to interest rates remaining the same until 2005 (see section on monetary policy). The low level of job creation has undoubtedly been the most disappointing aspect of the recovery, which officially began in November 2001, and the March figures merely served to prevent the Fed's patience from turning into anxiety.

Inflation

As we have said on a number of occasions, the depreciation of the dollar and the rise in the oil price have helped offset the disinflationary pressures generated elsewhere. Latest consumer price figures show that inflation has steadied at extremely low levels. In 4Q03 two out of three components of the total index were down, while the acceleration seen in January and February was triggered by a jump in energy prices. Stripping out food and energy, prices actually moved in line with their recent trend, rising 0.2% m/m on average in the first two months of 2004. The rise in producer prices of intermediate goods and commodities indicates that companies' non-labour costs are on the up, while increased labour productivity and moderate wage rises have led to a decline in unit labour costs. Given the weighting of this these last in businesses' total costs, profit margins have clearly not suffered much from the rise in non-labour costs. Finally, the fall in the dollar has not yet significantly affected import price trends. And March figures bear this out: excluding oil, import prices rose by only 1% y/y, despite a drop in the dollar of around 10% in the same period.



Inflation is likely to remain well below the 2% threshold in the second half of 2004. CPI inflation is seen falling from 2.3% in 2003 to 1.7% in 2004, and should then stabilise at around 1.8% in 2005. Overcapacity and falling unit labour costs will once again be the main driver of prices in the medium to long term.

(Sergio Capaldi)

United States

	2003	2004	2005	2003			2004				2005
				2	3	4	1	2	3	4	1
GDP (1996 US$,y/y)	**3.1**	4.1	3.0	**2.4**	**3.6**	**4.3**	4.8	4.9	3.6	3.3	3.2
q/q annual rate				**3.1**	**8.2**	**4.1**	3.7	3.5	3.1	3.1	3.3
Private consumption	**3.1**	3.7	2.8	**3.4**	**6.9**	**3.2**	3.6	3.6	2.7	2.3	2.9
Fixed investment - nonresid.	**3.0**	7.3	5.5	**7.0**	**12.8**	**10.9**	6.7	4.4	3.8	5.3	5.7
Fixed investment - residential	**7.5**	4.6	-2.0	**4.4**	**21.9**	**7.9**	-3.0	4.2	1.6	2.4	-3.9
Government consumption	**3.3**	1.6	1.4	**7.4**	**1.8**	**-0.1**	1.6	1.5	1.6	1.4	1.4
Export	**2.0**	8.1	11.0	**-1.1**	**9.9**	**20.5**	-0.8	8.7	9.5	11.2	12.1
Import	**4.0**	6.5	2.8	**9.1**	**0.8**	**16.4**	3.8	7.7	3.6	1.0	1.7
Stockbuilding (% contrib. to GDP)	**-0.1**	0.5	-0.1	**-0.1**	**0.0**	**0.2**	0.3	0.1	0.0	0.0	0.0
Current account (% of GDP)	**-4.9**	-4.9	-4.0	**-5.1**	**-5.4**	**-4.7**	-5.2	-5.1	-4.9	-4.6	-4.4
Federal Deficit (% of GDP)	**-3.8**	-4.5	-4.0								
Gov. Debt (% of GDP)	**85.7**	89.1	92.4								
CPI (y/y)	**2.3**	1.7	1.8	**2.2**	**2.2**	**1.9**	1.6	1.8	1.4	1.7	1.6
Industrial production	**0.3**	2.4	2.6	**-4.0**	**3.8**	**5.4**	2.5	0.5	1.8	3.6	3.2
Unemployment (%)	**6.0**	5.7	5.8	**6.1**	**6.1**	**5.9**	5.6	5.7	5.7	5.7	5.7

Percentage annualised growth rates over previous period, if not otherwise specified.

Astounding US labour productivity growth continues: is this a "new economy"?

Labour productivity has further increased in the last two years, despite the extraordinary levels attained in the second half of the 1990s

Over the last ten years, the US economy has seen unprecedented **output growth and productivity rates**. This long period of expansion has been marked by big investment in and the spread of Information and Communication Technologies (ICT). Numerous papers[4] point to ICT as the main driver behind the US economy's extraordinary performance. However, after the internet bubble burst and high-tech stocks went into free fall in 2001, many financial operators started to doubt the beneficial effects of the new technology, and began to wait for a huge slump in US productivity, which has yet to occur. **Labour productivity has in fact picked up the pace in the last two years,** growing by an annual average of over 4.5%, two percentage points above the already strong 1996-2001 average of 2.4%. Two main questions spring to mind in light of these results: 1) is the acceleration of the last two years due to the production and use of high-tech equipment as it was in the second half of the 1990s, or are other factors behind it? 2) Do these figures represent a sustainable long-term growth trend or is labour productivity set to return to more "normal" levels?

To answer these questions and to gain a clearer understanding of US growth prospects, we have conducted a growth accounting exercise to divide labour productivity into its three components: growth in capital, expansion of labour, and the rate of technological progress. Under the basic assumptions of the neoclassical growth model, we attempt to determine how much output growth is attributable to ***capital deepening***, ***labour quality*** and ***multi-factor productivity***[5].

Growth of output per hour in the non-farm business sector may be expressed as:

$$\dot{Y} - \dot{H} = \alpha_k \left(\dot{K} - \dot{H} \right) + \left(1 - \alpha_k\right) \dot{q} + \dot{MFP}$$

where Y represents real output, H the hours worked, and K the services provided by the capital used in production (capital services), while q denotes labour quality; α_k is the capital share and $1-\alpha_k$ represents the labour share, since, under the neoclassical assumption of constant returns to scale, capital share and labour share add up to 1. Lastly, MFP measures technological progress. $\dot{Z}$ indicates the growth rate of any variable Z.

Our analysis of the non-farm business sector clearly shows that the acceleration of productivity growth over the last two years is largely due to an exceptional increase in labour quality, which has grown at a rate rarely seen in previous years.

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4 *D.W. Jorgenson and K.J. Stiroh (2000), "Raising the speed limit: US Economic Growth in the Information age"; S.D. Oliner and D.E. Sichel (2000), "The resurgence of Growth in the Late 1990s: Is Information Technology the Story?"*

5 *The analysis is based on the non-farm business sector; figures for output, hours worked and investment are those published by the Bureau of Labor Statistics; input shares are estimated based on the trend of real investments.*

Contribution of labour productivity to growth

	1980-1990 (1)	1991-1995 (2)	1996-2001 (3)	2002-2003 (4)	(4) - (3)
Labor productivity	1.47%	1.59%	2.41%	4.67%	**2.25%**
Capital deepening	0.78%	0.57%	1.09%	1.62%	**0.53%**
Labor quality	0.44%	0.42%	0.34%	2.43%	**2.09%**
MFP	0.25%	0.61%	0.99%	0.62%	**-0.36%**

Note: details may not sum to totals due to rounding.

Labour quality is the difference between the labour input index[6], compiled and published by the Bureau of Labor Statistics, and the total number of hours worked: **in 2001-2003, the number of hours worked in the non-farm sector fell sharply (-1.75% a year), and this clearly boosted labour quality. Total productivity of all factors has however slowed on the** previous period and returned to pre-1995 levels, while the **accumulation of physical capital continues to grow** strongly.

The answer to our first question is therefore that even in the last two years, high-tech capital has continued to make a very important contribution to productivity growth, even though growth has mainly been driven by improved labour quality.

Our analysis of growth determinants has also gone a long way towards answering our second question, namely whether or not this growth trend is sustainable in the long term and therefore represents the new norm. The answer greatly depends on the causes of the extraordinary increase in labour quality over the last two years: ie whether this increase is a cyclical event or reflects a long-term change within the economy. We therefore need to ascertain whether the increase in labour quality is mainly attributable to the fall in the number of employed people in the wake of the US recession that began in early 2001, or whether we are witnessing an improvement in labour quality set to last over the long term.

The graph shows that much of the increase in labour quality was due to the drastic cut in hours worked, which leads us to believe that this effect will be significantly reduced when the US job market recovers.

Stripping out the effects of the cycle for the last two years, **the annual productivity growth rate returns to around 2.5%**, in line with the average growth since 1995 which, **according to many studies[7], represents steady-state productivity growth rate in the US**. These results support the theory of a "new economy" in the US, which can generate large and lasting gains in productivity, clearly greater than the average before the information technology revolution.

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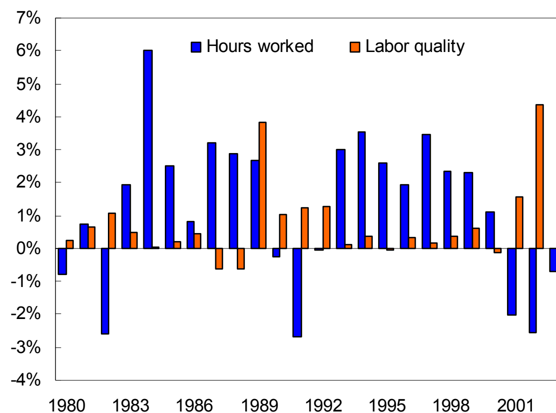
6 *To determine this index, the BLS divides the whole workforce into different categories according to age, sex and qualifications, and then calculates average growth in hours worked for each sub-group, weighted according to each group's share of total labor compensation.*

7 *Jorgenson, Ho, Stiroh, (2002), "Projecting productivity growth: Lessons from the US growth resurgence"; Martin, B., (2001), "American potential"; De Long, (2002), "Productivity growth in the 2000s"*



In light of these considerations, we may conclude that the performance of the last two years does not represent the long-term growth trend of US productivity, but is rather a surprising set of results due to a series of cyclical factors, which will disappear as the job market picks up.

(Benedetta Angrilli)

The Fed will continue to play the waiting game

March employment data confirms our forecast that monetary policy will remain unchanged for the rest of the year

Once again, the employment report has upset the markets' vision of the US economy and the Fed's monetary policy. Despite renewed forecasts of rate rises in the summer, **we do not share the markets' view, and expect the first rise in the Fed funds rate in 1Q05, based on an employment growth forecast of around 150,000 jobs a month for the rest of the year.** An increase in non-farm payrolls of this size will stabilise and then gradually reduce overcapacity on the job market. How the **market will get rid of its existing slack** remains key to the Fed's decisions: despite the 308,000 jobs created in March and the revision of January and February data, the economy is still two million jobs short of its pre-recession levels. The market looks at the flow of new jobs, but often fails to assess this in relation to total jobs lost over the last two years. We therefore believe the Fed will remain patient.

In light of the importance of the job market: 1) in sustaining economic growth and 2) for monetary policy decisions, it is useful to outline alternative scenarios for the job market that may influence monetary policy.

With an average of 150,000-200,000 new jobs created a month, there should be a gradual reduction of overcapacity on the labour market

1) **Central scenario: the Fed raises rates in 1Q05, following employment growth of 150,000 jobs a month in 2004.** As we discuss in greater detail in the section on economic forecasts, our central scenario—which sees growth averaging around 150,000 jobs a month—is based on both econometric estimates and information from other job market indicators, including the duration of unemployment, the low labour force participation rate and productivity growth.

   The central point is that, with growth of 150,000-200,000 jobs a month, the job market would absorb the stock of unused manpower gradually, leaving unemployment at over 5.5% at the end of the year, still far from the equilibrium rate of 4-5%, and with the number of employed people still lower than before the recession. In this scenario, inflation will stabilise at between 1

and 1.5% and, while the spectre of deflation is receding, there do not appear to be any significant inflationary pressures, while the output gap remains in positive territory.

Our forecast that the Fed is ready to raise interest rates between December and March is based on a generally positive view of the job market. While **rates are at 40-year lows, the same is also true of inflation**; furthermore, the economy is set to slow in 2005 as the effects of the tax refunds abate. Growth in consumer spending (the **savings rate is also at its lowest for 45 years**) must be financed by employment income in 2H04 and in 2005. The US economy cannot run any risks on this front, because from next year, there will be no more room for further measures to support household disposable income. The Fed is aware of this risk factor, as the minutes from various FOMC meetings confirm. With 150-200,000 jobs created a month from now until end-December, the Fed could change rates in the knowledge that employment income would sustain growth in consumer spending next year.

We do not consider the Fed as being particularly patient in comparison with 1993-94. It may be useful for reference purposes to recall the main statistics of the early post-recession period of 1994.

a) Once the recovery started, an **average of 96,000 jobs a month were created in 1992, and 232,000 in 1993**, before the Fed raised rates in February 1994.

b) The outlook for inflation was very different ten years ago to what it is today: then, the Fed clearly acted “pre-emptively”, but reacted with extreme caution to the growth in job creation.

The forecast of unchanged rates until end-2004 is consistent with how the Fed reacted ten years ago and does not suggest a particularly “patient” monetary policy

c) **Real short-term rates**, measured as the difference between Fed funds and core CPI inflation**, were negative from April 1992 to December 1993** at between –0.1 and –0.5%, **while core inflation fell very gradually from 3.5% in mid-1992 to 3.2% at end-1993**. Assuming a similar performance from the job market this time, **the current outlook for inflation could mean that the Fed acts more** cautiously than in 1992-1994. In the current cycle, **real intervention rates have been negative since autumn 2001**, but following the sharp fall in core inflation over the last year, real rates have risen, nearing zero in 4Q03 and stabilising around –0.2%. Inflation seems to have settled at just over 1%—ie falling within the definition of stable prices—confirming that there is no incentive for the Fed to launch a pre-emptive strike.

Our view that the Fed will leave rates unchanged for the whole year could therefore indicate even better employment growth than that forecast by our models. We outline **an alternative scenario** below, **to put market forecasts into perspective, and shed light on the margins for error in our central scenario: how big would our margin of error have to be** for the alternative scenario to unfold, and in particular, **for the market to be right in its forecast of a rate rise this summer?**

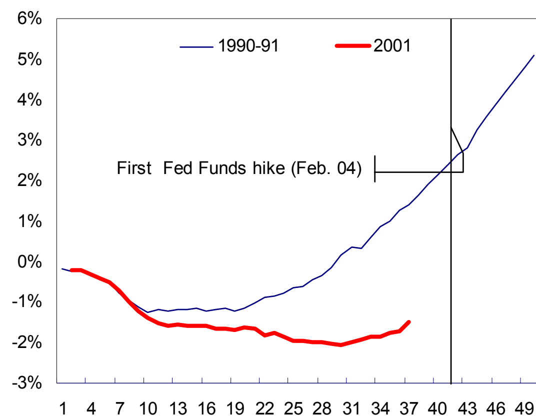
Incidentally, note that if the March figures had not significantly increased the average number of jobs created in 1Q04 to 170,000, we would now have to seriously consider a third scenario, based on a cut in the Fed funds rate. Unless the figures for March are heavily revised down, this scenario appears extremely unlikely for the moment. However, the difficulty in forecasting productivity growth and the expectation that consumer spending will slow down in 2H04 means there are still some risks on employment, a point certainly not lost on the monetary authorities.

The alternative scenario for monetary policy, with the first rise in the summer, depends on an employment trend that is extremely unlikely

2) **Optimistic alternative scenario: the Fed raises rates in August 2004 following employment growth of 400,000-450,000 jobs a month to July.** This scenario is highly unlikely, but would be the **watershed for any rate hikes**. In the event that between April and July, employment growth totals around 1.5 million jobs, the Fed may consider that the trend of shrinking overcapacity on the job market is sufficiently well-established to allow monetary policy to be reversed, with the target of gradually steering rates back to neutrality. Employment is still 1.9 million down on the figure provided by the establishment survey in March 2001 at the start of the recession, and the Fed would normally not raise rates until payrolls have at least returned to their pre-recession levels.

Note however that **the US has never seen average growth of over 300,000 jobs** in a few months**,** not even during the employment boom of the late 1990s: 250,000 new jobs a month were created on average in 1998, and 264,000 in 1999. Furthermore, growth statistics way above the average are almost always followed by below-average figures. **A series of non-farm payroll figures that fit in with this scenario would therefore seem extremely unlikely.** Average growth of between 150,000 and 200,000 jobs until the end of the year would however be in line with average job creation of the previous cycle and pave the way for an interest rate hike between end-December 2004 and March 2005: if the Fed raised rates in 1Q05, this would be consistent with how it reacted in 1994, and would not even take into account that inflation was so close to price stability.

New jobs created since the cyclical trough (nonfarm payrolls)



Source: BLS, Census Bureau. Banca Intesa computations

Conclusions

Before raising rates, the Fed must be convinced that salaries will be able to sustain consumer spending growth in 2005

Although the market will continue to be moved by changes in forecasts regarding the timing of the first rate hike following the publication of labour market data, our forecast of an initial rise between December and March is based on a trend that is in line with the previous cycle and therefore not particularly pessimistic on employment growth. November's elections do not impose any restrictions on the Fed's decisions, in light of expected job growth over the year**. The Fed can afford to be patient for the whole of 2004, while we wait for a sustained recovery in employment income to take over the role played by tax breaks in the last two years in supporting consumer spending.**

(Giovanna Mossetti)

Euro area: moderate recovery will continue if consumers begin spending again

Economic indicators for 1Q04 show that activity slowed slightly compared with the previous quarter. The composite PMI lost around 1.5 points in February and March, while the average for 1Q04 was slightly below that of the previous quarter, mainly because of a correction in the services PMI, which had reached high levels. However, although the composite index remains at a respectable 55.4, GDP growth does not appear to have picked up particularly in 1Q04 compared with end-2003. This information is summarised in our coincident €-index, which suggests growth of 0.4% q/q in 1Q04, little higher than the 0.3% posted in 4Q03, but better than the average q/q growth of 0.2% seen last year.

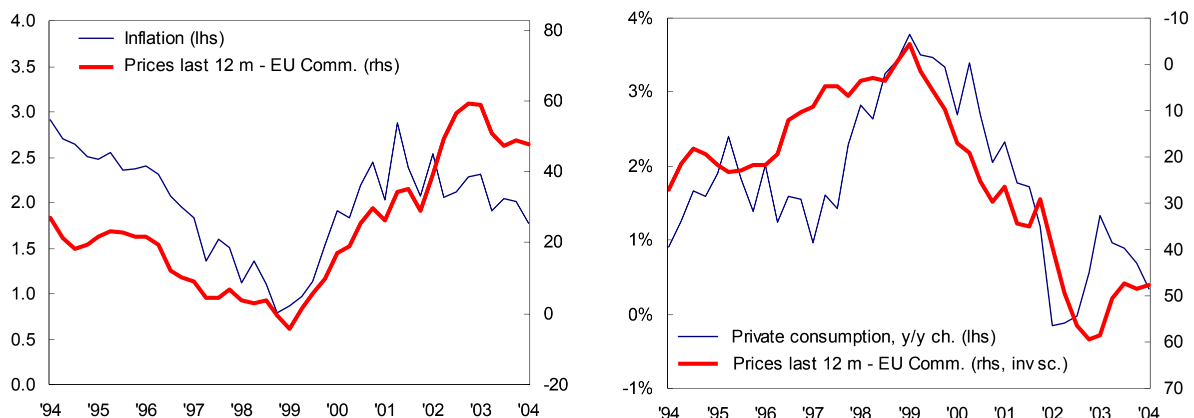
Recent figures are therefore consistent with our scenario of moderate growth, at least in early 2004. The biggest risks for the euro area recovery lie in developments over the next six months. A breakdown of growth in 1Q04 already shows a further increase in domestic demand, especially private consumption, following the signs of a turnaround in investment, which were seen as early as 4Q03. If this upturn in demand continues, and is enough to offset the easing off of foreign demand (which has been very strong over the last few quarters), our scenario of moderate recovery will be confirmed. Therefore private consumption must pick up for growth to gather pace in the euro area (see paragraph below). **Our 2004 growth estimate for the euro area remains unchanged at 1.5%.** However, we have changed the country breakdown: we are more pessimistic on Italy (growth revised from 1.2% to 0.8%) and Germany (from 1.2% to 1%), but this is offset by a more rapid upturn than expected in France (with growth now expected at 1.7% this year) and Spain (2.8%). In 2005 the situation should improve further, thanks to a gradual improvement in the European job market, but average growth will still not exceed 2.1%.

The real key to the sustainability of the recovery will be European consumers. Private consumption grew by an average of 0.2% q/q last year, showing signs of a slowdown in the second half. The y/y rate fell to 0.7% in 4Q03, well below the average growth of 2.3% seen in the period 1995-2001. What's needed for European consumers to start spending again? A consumption function aggregated for the whole euro area shows that private consumption growth in the second half of the 1990s was buoyed up by two main factors: i) **employment growth** (which was 1.3% a year on average in 1995-2001) and ii) **falling real interest rates,** which led to a **reduction in the propensity to save.** Unlike in the previous decade, however, growth in real wages was only slightly positive. In the last two years, neither of these factors has come into play: employment grew by only 0.5% in 2002 and 0.2% in 2003, while, despite the further fall in real interest rates in 2003, the need to make up for lost household wealth has caused the savings rate to rise. Moreover, the downturn in consumption—which began in late 2000—has been associated with a steady increase in perceived prices according to surveys of European consumers. Until 2001 this was reflected in actual inflation data, but since 2002 the steady decline in price pressures has not been accompanied by a parallel easing back of consumers' perceptions—which have instead continued to worsen. The risk, highlighted by the ECB, is that erroneous views of inflation, currently reflected in low consumer confidence, are leading to distorted views of household purchasing power, thus further holding back the upturn in spending.

These factors suggest that in **2004 too consumer spending will not pick up significantly compared with 2003.** Even though signs of a stabilising job market have emerged since 4Q03, the GDP growth expected for 2004 (1.5%) will be

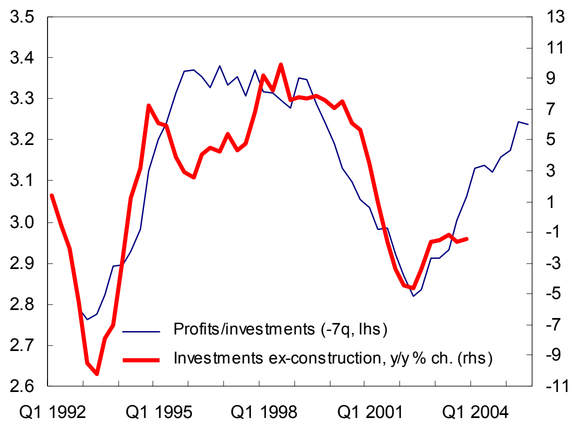
based mainly on increased productivity—which hit its lowest point only in mid-2003—rather than on job creation. Employment growth will be only slightly above the rate seen in 2003. With inflation expected to fall and short-term interest rates forecast to remain stable, the best-case scenario is that real rates will remain at the same levels as last year, and will not do anything to reduce saving rates. The outlook could however be improved over the next few months by consumers' price perceptions adjusting themselves to the real downtrend in inflation. We have already seen some hints of this in the EU Commission consumer surveys published in 1Q04. With perceived inflation aligning itself with the real trend and the job market improving slowly, there should be a moderate upturn in **private consumption, seen growing by an average of 1.3% in 2004.**

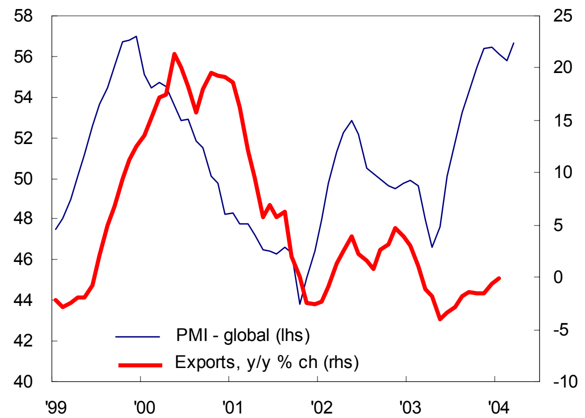
The high perceived inflation may curb consumer spending



Investments seemed to be showing the first signs of turnaround in 4Q03 in all the euro area countries except for Italy. So the prolonged rationalisation process finally appears to have come to an end: the ratio of investment (excluding construction) to GDP returned to around its historical 20-year average in 4Q03, and capital spending now seems set to head upwards. This slightly improved outlook is backed by the gradual improvement in European businesses' finances: the ratio of profit to investments, a good indicator of companies' spending decisions, has been gradually rising since the beginning of 2002. We therefore expect the recovery to continue this year and next, although the growth rates forecast—2.5% in 2004 and 3.2% in 2005—will be lower than those seen in previous upturns.

The boost provided by **foreign demand** will continue for at least the first half of 2004. As the graph shows, taking a weighted average of the manufacturing PMIs of the euro area's eight main trading partners (which together account for around 80% of Europe's exports) as a measure of foreign demand, we can see that in early 2004 growth in foreign demand reached the peak levels seen during the boom of 2000. However, euro area exports have not yet increased significantly y/y. This may be because the strong euro is preventing exports accelerating in the way they did in previous recoveries. The situation has hit some countries more than others, and has led to varying export growth rates within the euro area (see next article). Nevertheless, despite the strong euro we expect **exports to rise progressively over the next few months**, and to make only a slightly negative contribution to GDP growth in 2004.





Inflation in line with ECB targets

The inflation trend in early 2004 was more benign than the ECB expected, falling to 1.6% in February, its lowest level since end-1999. This rate has been provisionally confirmed by Eurostat as remaining at the same level in March too, although we expect that the figure may be revised upwards as far as 1.8%. Short-term prospects depend on oil price fluctuations, which we think will push the rate temporarily towards the critical threshold of 2%. In the medium term, **prospects for price stability are favourable, and in line with the ECB's target** of an inflation rate only slightly below 2%. **We think the rate will stand at 1.8% in 2004 and 1.9% in 2005,** from our previous forecast of 1.8%.

Commodities prices are a cause for concern...

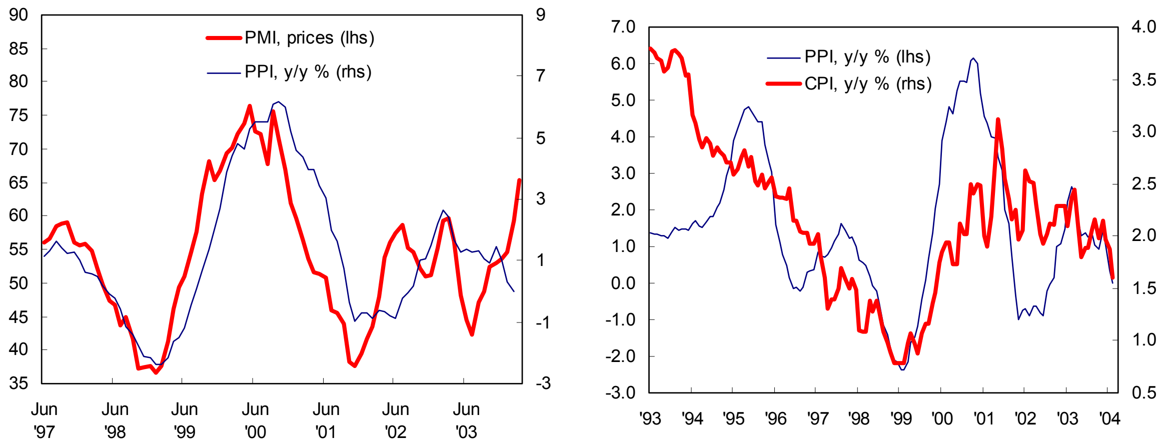
Nonetheless, at the last press conference, Jean-Claude Trichet indicated a number of risk factors, including commodities prices. The ECB stated that "***the increase in commodity prices and the evolution of long-term inflation expectations deserve close attention***", since "*any increase in the price of oil creates a problem as regards price stability and inflation. And it also has an impact on the global recovery*". Note that Trichet placed the emphasis first on inflation, and then on growth, unlike Wim Duisenberg, who usually concentrated on growth first. This may indicate that the ECB believes the prospects for economic recovery are fairly sound overall.

...but their impact on CPI inflation will be minor and will be diluted over time

Since OPEC decided to cut production quotas in mid-February, the price of Brent has increased, and now appears to have stabilised at USD 31-32. The increase was greater in euro in percentage terms, as the currency fell against the dollar, from 1.27 to 1.21. Until now however, this effect has been seen most clearly in terms of a jump in the PMI index of prices paid by manufacturing companies, which shot up to 65.3, its highest level since February 2001. It's not just oil that has led to this trend, but also rising prices of other commodities, no longer hidden by the strong euro. According to the index of the Hamburg Institute of International Economics (HWWA), **the price of non-energy commodities in euro jumped by 15.8% between December 2003 and March 2004.** Over the next few months, this upward trend will translate into increased producer price growth, which is seen rising from the current 0% y/y to more than 2%. However, **the impact on CPI inflation will be only minor,** and will be diluted over time. We made an econometric estimate of how a shock in PPI inflation is passed through to CPI inflation, which shows an impact of around 10% after about a year. Producer prices will push up CPI inflation by **only around 0.2%** and in any case not before this summer. Based on these results, and noting that euro area

inflation is currently 1% excluding government-sponsored price rises, **inflation does not at present constitute an obstacle to a cut in interest rates if this becomes necessary.**

The spike in commodities prices poses only a maodest risk to CPI inflation

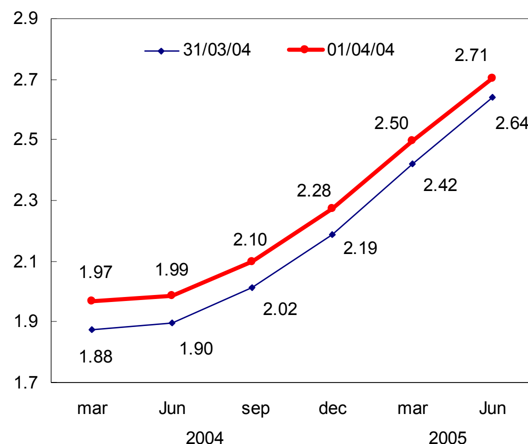


Monetary policy: rates on hold, with risks both ways

The ECB is unwilling to state a bias

As we expected, the ECB left the refi rate unchanged at 2% at its April meeting, disappointing observers who had expected a rate cut after the hints that emerged in the run-up to the meeting. Moreover, the **tone of the press conference gave little hope of a rate cut in future**, which eased the expectations caused by the statements of previous days. On this issue, Trichet specified that his statement on the possibility of the central bank's changing its stance on the economy, if the recovery were not to materialise as expected, was purely aimed at reassuring the public that the ECB is aware of the risks weighing on the euro area, and that it will intervene if necessary. Concerns over confidence were a main theme of the press conference, and much stress was placed on consumers, whose cautious attitude to spending is weakening the recovery. **The lack of further hints following that of the previous week was therefore sufficient to disappoint the expectations of the markets, which reacted with a sharp correction in rate cut expectations.**

Trichet triggered a correction in market expectations on official rates



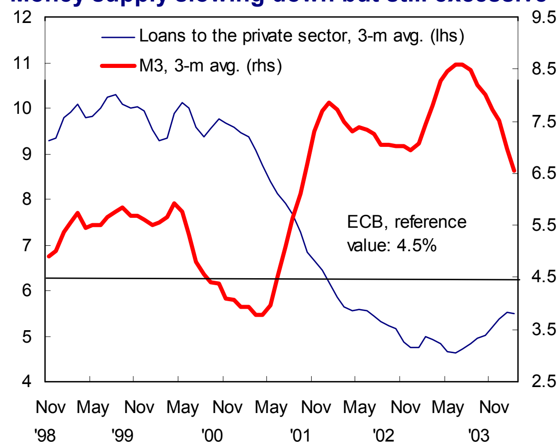
Aside from the performance of the euro area economy and consumer spending in particular, the ECB has taken other factors into account in its stance. First, **dynamic global demand**, which is higher than expected earlier this year, and is now supported by US job market data, means that exports will remain strong and, all other things being equal, that an upturn in domestic demand is now less crucial. This trend will be helped by exchange rates: **the euro has fallen by 3.7% in nominal terms from its average January level, equivalent to a 50bp cut in short-term interest rates.** The nominal effective exchange rate is today 2.5% lower than it was at the time of the last rate cut, and is equivalent to a 33bp reduction in 3-month rates.

The falling euro makes monetary conditions more expansive even without interest rate cuts

Another factor causing the ECB more concern now than in the recent past is the M3 money supply. Despite the slowdown to 6.6% y/y in February, the lowest rate since September 2001, and a sharp drop from the 8.6% seen in July 2003, ***"there is currently more liquidity in the euro area than is needed to finance non-inflationary growth….Should excess liquidity persist, it could lead to inflationary pressures over the medium term"*****.** Here, more than over consumer prices, **the ECB is most likely worried that the M3 trend is the prelude to speculative bubbles on the financial and/or property markets.** In a recent conference, "Asset prices and monetary policy", organised by the ECB itself, it was highlighted how distortions arising from a speculative bubble are "*costly as agents consume or invest too much compared with a situation without bubbles, which, in turn, normally increases macroeconomic instability*". In addition to the sharp rise in asset prices, another sign of a possible bubble is a "*relatively high growth rate in certain key variables, such as money, credit and investment*". A study of 38 previous bubbles in 18 countries shows that "***it cannot be excluded that on some occasions too lax (current and expected) monetary policy has accommodated the asset price booms and prolonged their existence.***"

The money supply remains excessive given current growth rates

Money supply slowing down but still excessive



The bursting of speculative bubbles often leads to a drop in aggregate demand and an increased risk of deflation, especially if the stability of the financial system is put in jeopardy. This could mean that nominal rates would head towards zero, and so monetary policy would be of little use in attempting to achieve price stability. However, "*to the extent that monetary policy can prevent a prolonged period of deflation once the bubble bursts, the argument for a pre-emptive loosening in case of an anticipated asset price crash becomes….less convincing*". In conclusion, **the ECB highlighted that when making interest rate decisions, it pays close attention to the possible repercussions on financial variables.**

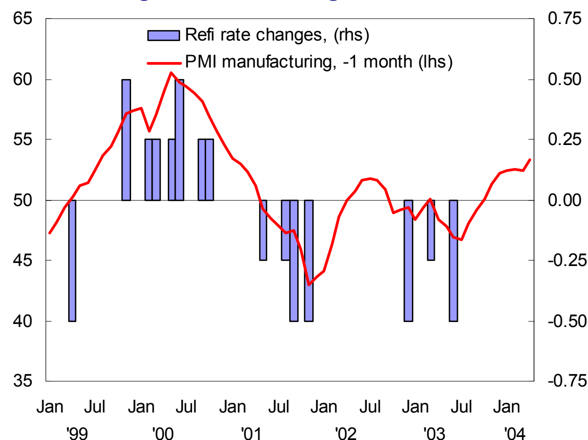
Fiscal policy is still not as disciplined as the ECB would like

Finally, in the ECB press conference **Trichet was particularly severe on the subject of reform and fiscal policy, as the bank was last autumn when it was defending the Stability and Growth Pact.** The ECB President stated that "*the pace of reform needs to be significantly stepped up and the critical issue now is the need for better implementation of the commitments already made*", and expressed even more concern over the performance of euro area public finances: "*recent information indicates that significant imbalances are emerging in a growing number of countries and….current policies would not be sufficient to attain the consolidation objectives specified in the latest stability programmes. We strongly urge governments to take corrective action in a timely and sustained fashion, where and when necessary.*"

These themes were taken up again by ECB Vice-President Lucas Papademos in a later speech. Referring to budget deficits, he stated that the bank's Governing Council "*can get quite irritable if we have to count above three percent*". The bank's worries over fiscal laxity relate mainly to its effects on the public welfare: "***if excessive deficits persist and public debt levels remain high or, even worse, increase, there will eventually and inevitably be a cost in terms of lower growth and employment***". For the moment, the ECB believes it "*should not be alarmist*" and "*should maintain a reasonable perspective*", but the bank would like to see the European Commission and Ecofin send early warnings to countries that look like breaching the 3% limit even after corrective measures have been introduced. The first step will be taken in the next few weeks, following the publication of the Commission's spring forecasts, and once it has been confirmed that the procedures set out in the Maastricht Treaty are to be implemented. What's **less certain is whether Ecofin will accept the recommendations of the Commission**, whose position is currently weak given the imminent expiry of its mandate.

In conclusion, **official rates look set to remain stable over the next few months**, and in our view, well into 2005. **The risks are still to the downside however, since the strength and sustainability of the economic recovery are still uncertain**, while current and forecast inflation is in line with ECB targets. The key factor will therefore be economic activity, which will have to see a downturn before the central bank decides to change its stance. The most immediate and reliable barometer for euro area interest rates is the PMI manufacturing survey: the refi rate has never been cut if the index was above 50—and in March it stood at 53.3. Based on our scenario of a moderate but steady acceleration in growth in the euro area, the index is unlikely to drop below this threshold over the next few months.

Manufacturing PMI, a reliable guidance for ECB rates

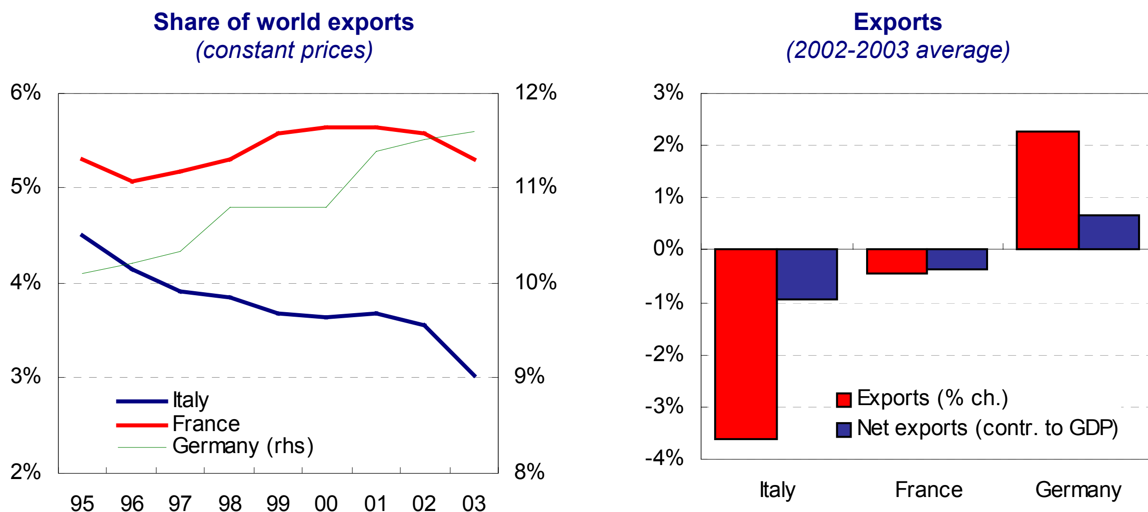


(Giada Giani - GianLuigi Mandruzzato)

Focus: competitiveness compared in Euro Area

Italy appears to be the country hit hardest by the firming of the euro. In reality, the strong euro has merely highlighted the structural problems of scant competitiveness of the Italian system, which make it more fragile than its European partners.

The firming of the euro in the last two years has turned the focus back onto the question of competitiveness on foreign markets, especially in respect of countries like Italy and Germany, whose economic growth is, structurally, increasingly dependent on a positive contribution from exports. The entry of new players to the international trade arena is a phenomenon that hits all the “old” actors: given the slowness with which these transformations take place, the jump in China’s share from 4.7% to 7.6% of world exports is undoubtedly the most remarkable case.



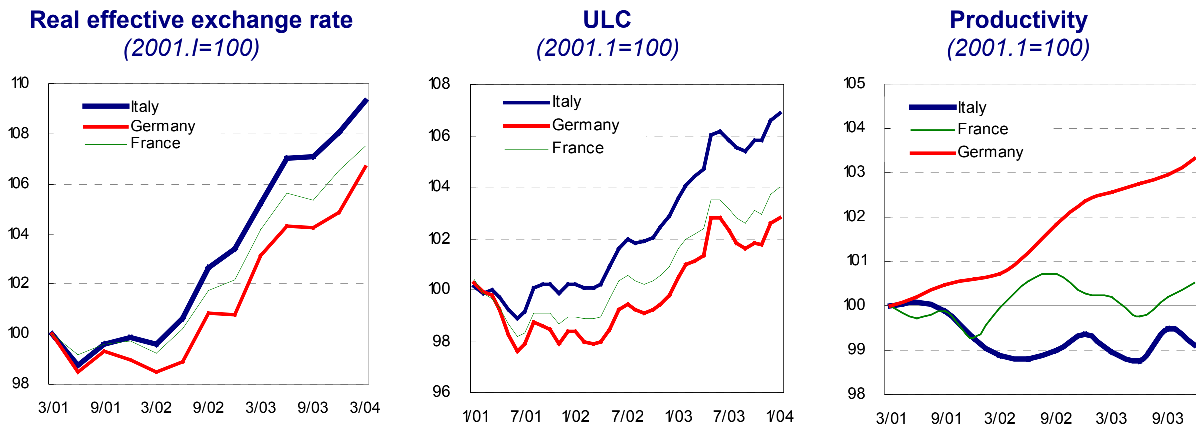
In Europe, Italy is the country that suffers most from these changes. Apart from the post-devaluation high in 1994-95, **since the start of the 1990s Italy has steadily lost trade share,** which fell to 3% in 2003 (in real terms, Bank of Italy estimate). By contrast, among its European partners, France managed to keep its share broadly unchanged, while Germany’s share actually grew. These differences have become more marked in the last two years: Italy’s net exports in 2002-2003 shaved an average of around 1% off GDP growth, compared with a positive contribution of around 0.7% to Germany’s GDP growth.

It is not all the euro’s fault!

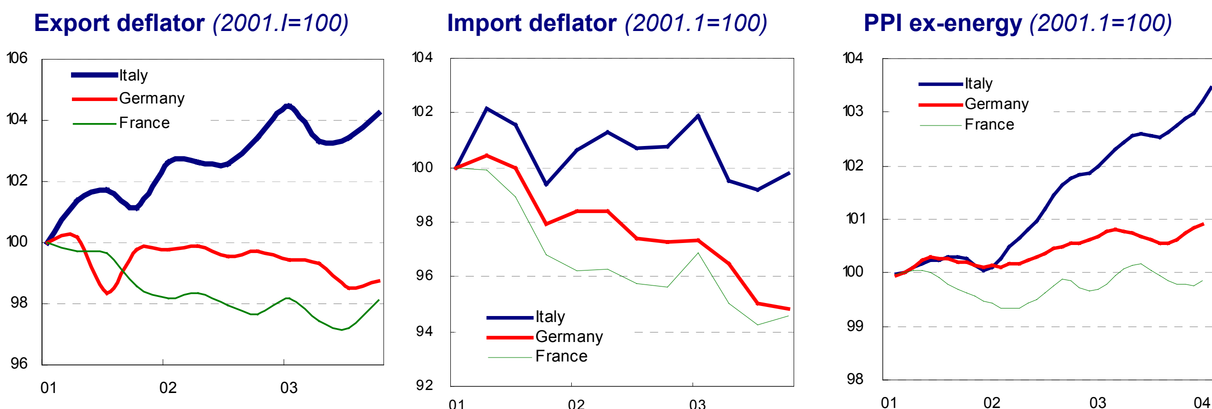
The loss of competitiveness cannot be blamed entirely on the strong euro. **The discriminants of competitive performance lie in the divergent dynamics of domestic prices and factor productivity,** rather than in currency fluctuations. Ex euro appreciation, in fact, a higher inflationary trend produced in Italy an appreciation in the average real effective exchange rate in 2002-2003 of 3.6% vs. 2.5% for Germany.

The charts on the next page seem to bear out the following thesis. Inflationary differences accurately reflect the divergent dynamics in the unit labour cost. The cumulative growth difference in the ULC since 2001 between Italy and Germany is over four percentage points. In its last Bulletin the Bank of Italy reported that cumulative ULC growth between 1995 and 2003 in industry was 18.6%, vs. a

euro area average of 6%. The differences are due not so much to the wage dynamic as to the difference in productivity performance, which fell by over one percentage point in Italy vs. the robust gain recorded in Germany, corresponding to over 3% in cumulative terms since the start of 2001. Whereas total output showed similar growth, the resilience of employment in Italy in the last two years vs. the job losses in Germany lies behind these differences in productivity.



A higher labour cost dynamic erodes competitiveness both on the foreign and the domestic market. It is reflected in much higher growth in the prices charged on export markets – as measured by the export deflator – by Italy compared with other European partners. Italian export prices have actually risen since 2001, instead of falling as they have in Germany and France, to offset, at least in part, the firming of the euro. On the domestic market, higher growth in producer prices makes domestic products less competitive than imported products. Indeed, despite the appreciation of the euro, Italian import prices have remained broadly unchanged since the start of 2001, vs. the marked deflationary pressures recorded in France and Germany. Owing to the high price dynamics on the domestic market, importers to Italy still manage to win market share without necessarily lowering their prices.

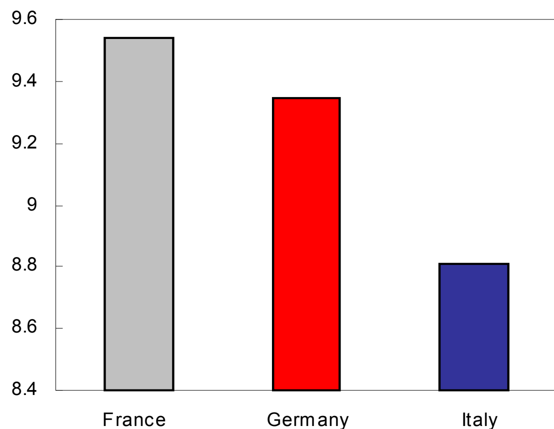


Other peculiarities of Italy

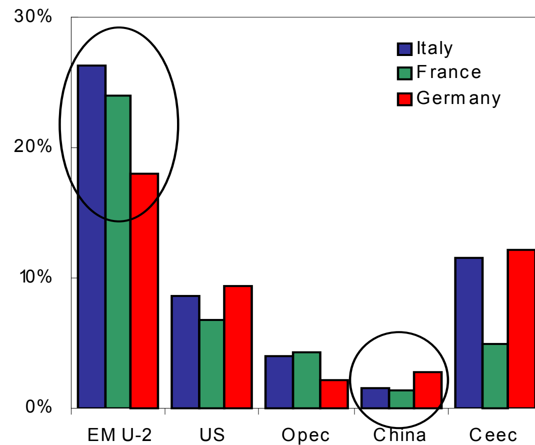
A higher cost dynamic, in labour as in services to business too, is not the only reason for Italy's inferior competitive performance. The country's particular **product specialisation** in respect of exports and the distribution of the main

outlet markets for Italian products are other aspects of the problem. The traditional sectors in which Italy specialises, namely consumer goods for individuals and the home, and industrial engineering, have shown far less intense global trade flows than the areas in which Germany and France specialise, namely transportation and high R&D intensive goods. This finding is even more worrying when one considers that Italy has only a limited presence in electronics, a sector plunged into deep crisis in the period considered. Moreover, the most intense competitive pressures arriving from Asia are found in the very sectors in which Italy is traditionally strong: although there are major differences in product range, the comparative advantages developed by China are very similar to those offered by Italy. The **destination of Italian exports** vs. (for example) German exports is also penalising, notably on account of Italy's greater exposure to low-growth European markets vs. the higher-growth emerging countries. In spite of a similar degree of exposure to central-eastern Europe, Italian exports to this region are mainly intra-industry trade, and therefore are not directly linked to the economic cycle in these countries.

Global demand weighted by sector of specialisation of countries *(% chg., 1999-2002 average)*



Outlet markets: share of total exports *(2003 average)*



Conclusions

Competitiveness on export markets is key to the growth of Europe's major economies. The appreciation of the euro in the last two years has not impacted to the same extent on the various countries: higher domestic cost dynamics have resulted in a net loss of competitiveness for Italy – vs. France and especially Germany – both on the foreign and the domestic market. Italy's loss of competitiveness is compounded by the firming of the euro, which has highlighted more structural weaknesses in the Italian economy, notably in terms of productivity growth. Given the scant difference in terms of domestic demand growth potential, and with no marked depreciation in the euro foreseeable in the coming years, **these weaknesses will in the coming years lead to an Italian economic growth performance below that of its main European partners.**

(Giada Giani)

Euro Area

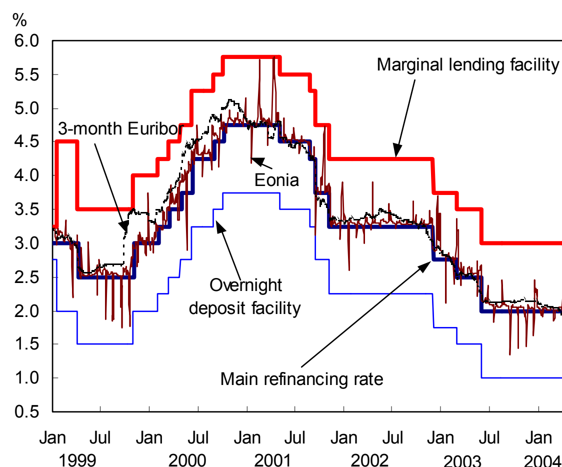
	2003	2004	2005	2003 Q2	2003 Q3	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1
GDP (constant prices, y/y)	**0.4**	1.5	2.1	**0.1**	**0.3**	**0.6**	1.0	1.5	1.6	1.8	2.0
- q/q change				**-0.1**	**0.4**	**0.3**	0.4	0.4	0.5	0.5	0.5
Private consumption	**1.0**	1.3	2.2	**0.0**	**0.2**	**0.1**	0.4	0.4	0.5	0.6	0.6
Fixed investment	**-1.2**	2.5	3.4	**-0.4**	**-0.2**	**0.6**	1.2	0.7	0.5	0.9	1.1
Government consumption	**1.9**	2.0	1.3	**0.6**	**0.6**	**0.6**	0.6	0.3	0.3	0.3	0.4
Export	**0.0**	4.3	6.8	**-0.9**	**2.3**	**0.2**	0.8	1.5	1.6	1.7	1.6
Import	**1.5**	4.9	7.0	**-0.4**	**0.8**	**2.1**	0.5	1.6	1.7	1.8	1.7
Stockbuilding (% contrib. to GDP)	**0.3**	0.0	-0.1	**0.1**	**-0.4**	**0.7**	-0.4	0.0	0.1	-0.1	-0.1
Current account (% of GDP)	**0.4**	0.5	0.3	**-0.4**	**0.8**	**1.0**	0.8	0.5	0.7	0.2	0.2
Deficit (% of GDP)	**-2.8**	-2.8	-2.6								
Debt (% of GDP)	**69.0**	70.5	71.1								
CPI (y/y)	**2.1**	1.8	1.9	**1.9**	**2.1**	**2.0**	1.7	1.9	1.7	1.8	1.8
Industrial production (y/y)	**0.4**	2.3	2.3	**-0.3**	**0.6**	**1.1**	0.5	0.6	0.4	0.4	0.6
Unemployment (%)	**8.8**	8.8	8.5	**8.8**	**8.8**	**8.8**	8.8	8.8	8.7	8.7	8.7

Percentage variations over previous period, if not otherwise specified.

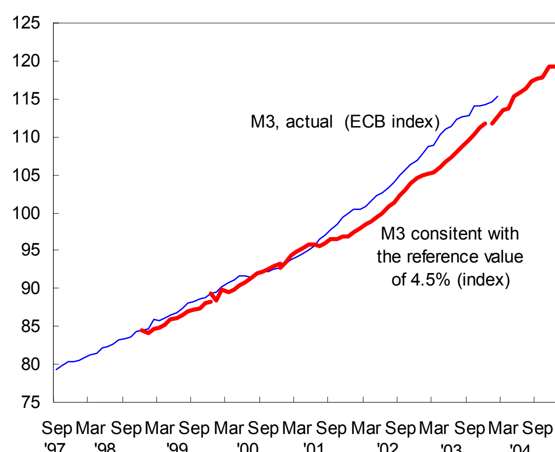
Growth and inflation by country

	GDP (y/y)			HICP (y/y)		
	2003	2004	2005	2003	2004	2005
Germany	**-0.1**	1.0	1.7	**1.1**	1.2	1.2
France	**0.2**	1.7	2.2	**2.2**	2.2	1.6
Italy	**0.3**	0.8	1.5	**2.8**	2.3	1.9
Spain	**2.4**	2.8	3.1	**3.1**	2.5	2.8
Netherlands	**-0.8**	0.6	1.9	**2.2**	1.6	2.2
Belgium	**1.1**	2.4	2.1	**1.5**	1.4	2.2
Austria	**0.7**	2.0	2.8	**1.3**	1.2	1.7
Finland	**1.9**	3.2	3.8	**1.3**	0.9	3.6
Ireland	**1.0**	3.4	5.4	**1.1**	1.2	1.2
Portugal	**-1.1**	1.5	3.0	**2.2**	2.2	1.6
Greece	**4.7**	5.1	3.2	**2.8**	2.3	1.9
Luxembourg	**0.3**	1.3	3.7	**3.1**	2.5	2.8
EU-12	**0.4**	1.5	2.1	**2.1**	1.8	1.9

Main short-term rates

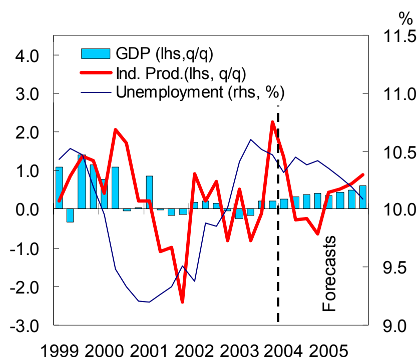


Monetary aggregates dynamics



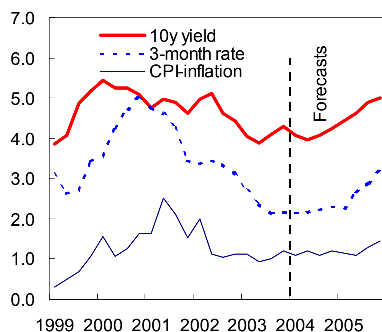
Germany

GDP production and unemployment



Germany continues its slow march towards a more sustainable economic recovery. After being in recession from end-2002 to mid-2003, the country registered moderately positive quarterly growth rates in the second half of last year. We expect the recovery to gain further ground in 1H04, and to gradually become more balanced. While exports were the driving force behind the country's emergence from recession, investment is now also making a contribution, fuelled by high profits and low taxes. Consumer spending has still not responded, and continued to fall until the end of 2003. Preliminary indications on 1Q04 are however consistent with a return to growth in consumer spending, and lead us to be moderately optimistic. Before a sustainable recovery can be confirmed, disposable income must also be supported by an improved employment situation. This too has shown signs of a turnaround in surveys, but has yet to be reflected in economic data. Overall, we maintain our growth estimate of around 1%, lower than the consensus forecast of 1.4%.

Inflation and interest rates



Prices in Germany virtually reached price stability and inflation is unlikely to rise much above 1% over the next two years. This year, increases in health care charges and tobacco prices are behind much of the rise in prices: excluding these, annual average CPI inflation would be 0.9% lower. The low inflation rate is largely due to the slowdown in unit labour costs, which is helping to improve the competitiveness of German products both within and outside the eurozone.

Germany's public finances are set to remain on the critical list, at least in the short term, despite the measures implemented by the Schroeder government over the last twelve months to contain the deficit. The greatest risk is that growth will be lower than the rather optimistic official forecasts (1.5-2% for 2004), but the possible increase in the nominal deficit is unlikely to be reflected by a worsening of the structural deficit. In the medium term, welfare, health and pension reform will help stabilise Germany's public finances and the debt/GDP ratio should stabilise at projected end-2005 levels.

(GianLuigi Mandruzzato)

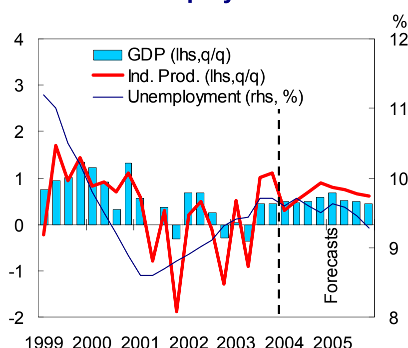
Germany

	2003	2004	2005	2003			2004				2005
				2	3	4	1	2	3	4	1
GDP (1995 prices, y/y)	**-0.1**	1.0	1.7	**-0.3**	**-0.3**	**0.0**	0.5	1.0	1.2	1.4	1.5
- q/q change				**-0.2**	**0.2**	**0.2**	0.3	0.3	0.4	0.4	0.4
Private consumption	**-0.1**	0.1	1.8	**-0.4**	**-0.3**	**-0.4**	0.1	0.3	0.4	0.5	0.5
Fixed investment	**-2.9**	2.0	4.0	**-0.8**	**-0.5**	**1.7**	0.7	0.2	0.2	0.9	1.6
Government consumption	**0.9**	0.8	0.7	**0.7**	**0.7**	**-0.2**	0.2	0.2	0.1	0.2	0.2
Export	**1.1**	6.2	6.1	**-2.6**	**3.8**	**0.3**	3.0	0.8	1.3	1.5	1.5
Import	**2.5**	6.8	7.6	**-2.3**	**0.2**	**2.7**	2.6	1.7	1.5	1.9	1.9
Stockbuilding (% contrib. to GDP	**0.8**	0.3	0.0	**0.3**	**-1.0**	**0.9**	-0.2	0.3	0.1	0.0	-0.2
Current account (% of GDP)	**2.4**	3.8	3.4	**1.6**	**2.4**	**3.7**	3.9	3.8	3.8	3.7	3.6
Deficit (% of GDP)	**-3.9**	-3.5	-3.0								
Debt (% of GDP)	**64.3**	66.6	67.8								
CPI (y/y)	**1.1**	1.2	1.2	**0.9**	**1.0**	**1.2**	1.1	1.2	1.1	1.2	1.1
Industrial production (y/y)	**0.2**	2.3	0.7	**-0.8**	**-0.1**	**2.3**	1.4	-0.3	-0.2	-0.7	0.4
Unemployment (%)	**10.5**	10.4	10.2	**10.6**	**10.5**	**10.5**	10.3	10.4	10.4	10.4	10.4
3-month Euribor	**2.34**	2.20	2.75	**2.37**	**2.14**	**2.15**	2.12	2.17	2.21	2.29	2.28
10-year yield	**4.09**	4.09	4.74	**3.89**	**4.10**	**4.30**	4.08	3.97	4.07	4.23	4.43
Effective exch.rate (1990=100)	**124.6**	125.2	123.9	**125.1**	**125.2**	**125.4**	126.5	124.7	125.3	124.3	124.1

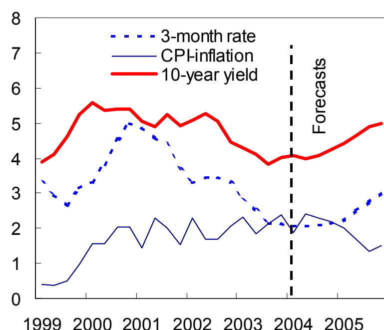
Percentage variations over previous period, if not otherwise specified.

France

GDP production and unemployment



Inflation and interest rates



We maintain our growth forecast for the French economy at 1.7% for 2004, well up on the 0.2% recorded in 2003. With growth forecasts for Germany and Italy revised down, our strong growth estimate for France is significant.

The recovery has been driven by domestic demand. Consumer spending has increased little on 2003, but growth is still greater than that of GDP. This was particularly evident **in the first quarter**, when **the upturn in consumer spending from 0.3% to 0.6% q/q actually bumped up GDP growth from 0.4% to 0.5% q/q**. In 1Q04, consumer confidence had its best quarter since 1Q01, with a significant improvement in the perception of both wealth and job prospects. The review of government spending plans **following the defeat of the centre-right** in the regional elections in March, is likely to fuel optimism particularly in the second half of the year, following a possible hiatus in 2Q04 due to uncertainty concerning the "changing of the guard". The new programme will again **prioritise growth and employment**. Policies are expected to include a cut in income tax and an increase in the minimum wage (in July), while the recently-introduced time limit on unemployment benefits will probably be suspended. We are also likely to see a relaxation of France's 35-hour week, the introduction of youth employment policies, and—following the new law on pensions that came into force in January—around 100,000 people taking early retirement by the end of the year.

New incentives for companies further support our forecast of **a strong recovery in investment**. Business confidence is clearly on the up, led in 1Q04 by growth in orders, particularly from abroad, following the permanent easing back of the euro. The fall of the euro also helped reduce the negative contribution of exports.

Public spending remains excessive, despite the cuts, which will mainly fall on healthcare. **We believe the government's deficit/GDP target of 3.6% in 2004 will prove difficult to meet,** as will its plan to reduce it to below 3% in 2005.

We expect consumer price inflation to rise slightly from 2.1% in 2003 to 2.2% in 2004 on the back of rising oil prices.

(Asmara Jamaleh)

France

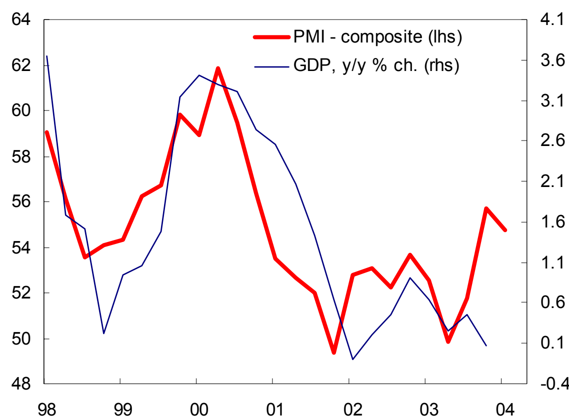
	2003	2004	2005	2003			2004				2005
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	**0.2**	1.7	2.2	**-0.4**	**-0.2**	**0.6**	1.0	1.9	1.9	2.1	2.2
- q/q change				**-0.4**	**0.4**	**0.4**	0.5	0.5	0.5	0.6	0.7
Private consumption	**1.6**	1.8	1.9	**0.0**	**0.5**	**0.3**	0.6	0.5	0.4	0.6	0.7
Fixed investment	**-0.8**	2.2	2.1	**0.3**	**0.1**	**0.7**	0.8	0.6	0.4	0.7	0.6
Government consumption	**2.4**	2.7	1.6	**0.3**	**0.7**	**1.0**	0.8	0.5	0.4	0.4	0.4
Export	**-2.1**	3.6	8.6	**-1.1**	**0.9**	**1.0**	0.2	1.3	1.8	2.2	2.0
Import	**0.9**	6.5	7.9	**0.5**	**0.0**	**2.1**	1.7	1.7	2.0	2.3	2.0
Stockbuilding (% contrib. to GDP)	**-0.3**	0.4	0.2	**-0.1**	**-0.3**	**0.2**	0.2	0.0	0.2	0.1	0.0
Current account (% of GDP)	**1.0**	1.0	0.9	**1.1**	**1.2**	**0.5**	1.0	0.9	1.4	0.8	0.6
Deficit (% of GDP)	**-4.1**	-3.8	-3.4								
Debt (% of GDP)	**62.5**	64.6	65.7								
CPI (y/y)	**2.2**	2.2	1.6	**1.8**	**2.1**	**2.4**	1.9	2.4	2.3	2.2	2.0
Industrial production	**-0.3**	2.4	3.0	**-0.9**	**1.0**	**1.1**	0.3	0.5	0.7	0.9	0.8
Unemployment (%)	**9.6**	9.6	9.5	**9.4**	**9.7**	**9.7**	9.6	9.7	9.6	9.5	9.6
3-month Euribor	**2.41**	2.09	2.63	**2.51**	**2.15**	**2.12**	2.06	2.07	2.10	2.14	2.24
10-year rate	**4.07**	4.09	4.74	**4.11**	**3.83**	**4.02**	4.08	3.97	4.07	4.23	4.43
Effective exch.rate (1990=100)	**119.9**	120.4	119.5	**120.3**	**120.5**	**120.5**	121.4	120.1	120.5	119.7	119.6

Percentage variations over previous period, if not otherwise specified.

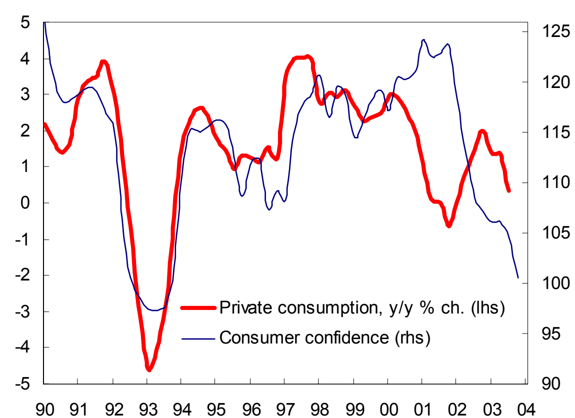
Italy: growth to remain below 1% in 2004

The signs of recovery that emerged in the Italian economy from last summer were frustrated by the 4Q03 GDP figures, which showed zero growth in the quarter, and a slowdown to 0.1% y/y from 0.5% y/y in 3Q03. Average growth in 2003 came to 0.4%, the same rate as 2002. As at the start of 2002, the rebound in the economic indicators was not accompanied by a commensurate recovery in real activity. And the information arriving from the January-February economic surveys – PMI down for the third straight month – indicates that the stagnation will persist through the first half of 2004. This outlook is also corroborated by the breakdown of demand at end-2003, with inventories making the only positive contribution to GDP growth and private consumption surprisingly negative. Lower-than-expected growth in 4Q03 and a scaling back of the growth forecasts for the first two quarters of the current year lead to a **reduction in our average growth forecasts for Italy in 2004 to 0.8%, from 1.2% before.** The “more leading” indicators on the GDP cycle also suggest that the improvements in the second half of the year will fall short of expectations: **2005 growth is therefore revised down to 1.5% from 1.7%.**

Real activity slows down by end 2003



Consumption possibly halted by drop in confidence



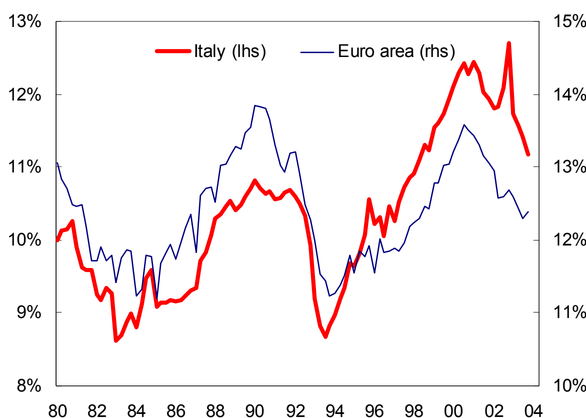
The most drastic revision is in private consumption. Consumer spending continues to be the only—albeit limited—growth driver, rising 1.2% in 2003, compared to GDP growth of 0.4%. Following a drastic revision of historical data, we have revised down our previous growth estimate of over 2% for 2003, and have also adopted a more cautious stance for this year. Looking ahead, we believe the collapse in spending in real terms in 4Q03 (-0.4% q/q) is an isolated case and will be recouped in the following quarters. Indeed, around two-thirds of the fall is due to the reduction in consumption by Italians abroad, which is back to more “normal” levels after the highs recorded in the previous quarters. The rest of the fall comes from an unprecedented contraction in food consumption (-1.5% q/q), which may have been impacted by a below-average Christmas spend. In this case, the positive seasonality on the first quarter should lead to a jump in food spending in seasonally adjusted terms in 1Q04. More generally, work income will continue to grow at a vigorous pace in the first half of 2004, despite stagnation in job creation, thanks to a wage dynamic slightly below 3% y/y. We expect **the trend in private consumption in 2004 to be similar to 2003, at 1.1%.** There are however some risks weighing on this central forecast. Although

the link between confidence and consumer spending is weak, the slump in Italy's already feeble consumer confidence in 1Q04—to its lowest point since 1994—could lead to more cautious spending habits. Furthermore, if the recovery expected in 1Q04 following the downturn at end-2003 fails to materialise, average annual growth in consumer spending could fall to 0.7%, wiping off around 0.2% from GDP growth in 2004.

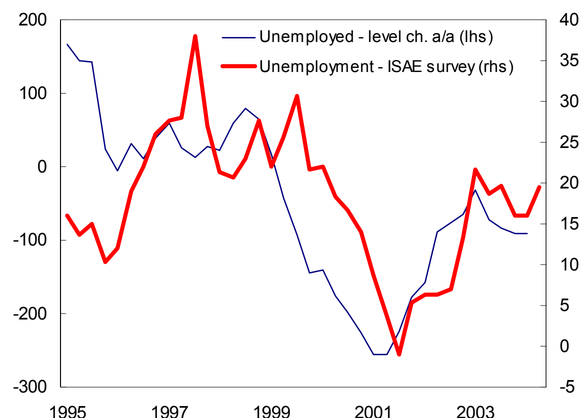
On the corporate sector front, **no signs have yet emerged of a turnaround in the investment cycle.** In 4Q03 investments both in machinery and transport equipment contracted at a faster rate than in the previous quarter; the year ended with a downturn of 4.9% in investments ex-construction. The stagnation of final demand and a strong euro that squeezes margins do not stimulate firms to expand production capacity; but most of all, the rationalisation of the capital factor in Italy lags well behind the rest of the euro area. This pushes back the timing of the turnaround in Italian investments. Production-side investments are expected to make up ground very slowly over the course of the year**, with an estimated average of 1.2% in 2004.** Although clear signs are emerging that the real estate sector has peaked, and that we have entered a downward phase in the construction sector cycle, the slowdown will be very slow and construction-side investments may still show marginally positive growth in 2004 (+0.8%).

Italy's job market deserves special attention. Unlike in other European countries, employment growth in Italy has been surprisingly strong over the last two years of economic stagnation. After the slowdown in the second half of 2003, January's data showed an increase of 45,000 jobs compared to October, up 0.7% on January 2003. This constant growth is partly due to a real improvement in conditions on the labour market, following the introduction of greater flexibility in job creation over the last five years. **Unemployment continues to fall,** although more slowly recently than in the past. However, **some of these new jobs are undoubtedly the result of incentives to suppress the black market and mostly the granting of work permits to immigrants.** There were 700,000 applications for permits, which represents around 3% of the total workforce. These measures improve employment figures, but do not really relate to real new jobs, so will have less of an impact on disposable income and consumer spending. Furthermore, their effects could tail off in 2004, possibly leading to a decline on Italy's job market just at a time when its European neighbours are showing the first signs of recovery.

Fixed investments ex-construction/GDP

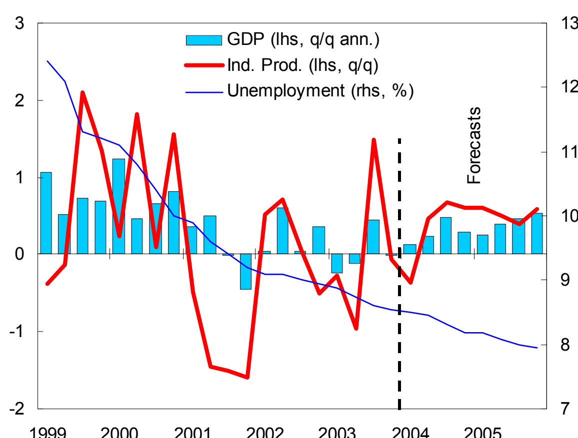


Number of unemployed still decreasing

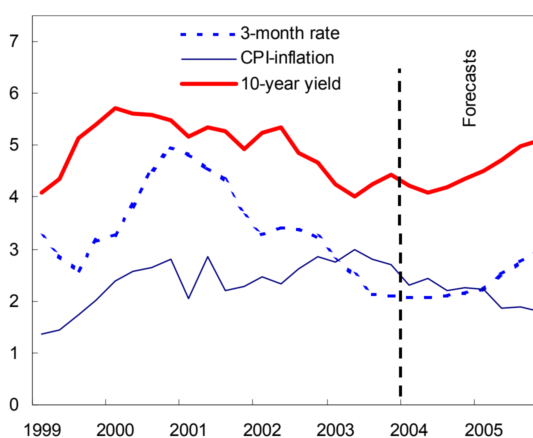


On the international front, the euro will continue to impact negatively on export performance, especially from the second half of the year, since a partial slowdown is expected in global demand. Following the unexpected jump in exports in 3Q03 – the immediate result of the robust stimulus provided by international demand – the negative impact of the strong euro returned in 4Q03, with exports falling 3.8% q/q; the downturn was particularly marked in relation to the trend in foreign demand and might lead to a recovery in the first half of 2004. The firming of the euro at the start of 2004 will impact on the following quarters and will result in export growth falling well short of the growth in global trade. Given the high elasticity of imports to exports, especially at a time of sluggish domestic demand, the foreign channel will not impact more negatively on GDP growth than it did in 2003. A slow adjustment to the strong euro situation by export firms might lead to a gradual reduction in the negative contribution of net exports in the course of the year, which in yearly average terms is expected to amount to –0.5% (-0.9% in 2002 and 2003).

Cycle and unemployment



Inflation and interest rates



(Giada Giani)

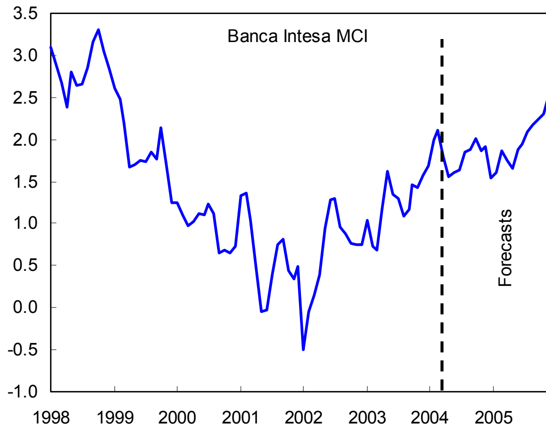
Italy

	2003	2004	2005	2003 Q2	2003 Q3	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1
GDP (constant prices)	**0.3**	0.8	1.5	**0.0**	**0.5**	**0.1**	0.4	0.8	0.8	1.1	1.3
- q/q change				**-0.1**	**0.5**	**0.0**	0.1	0.2	0.5	0.3	0.3
Private consumption	**1.2**	1.1	2.2	**0.1**	**0.4**	**-0.3**	0.4	0.5	0.4	0.6	0.5
Fixed investment	**-2.1**	1.2	2.5	**-1.0**	**-0.9**	**-1.2**	1.7	1.0	0.3	0.9	0.5
Government consumption	**2.2**	1.8	1.7	**0.5**	**0.5**	**0.0**	0.7	0.5	0.4	0.4	0.6
Export	**-3.9**	2.4	5.3	**-0.1**	**5.7**	**-3.8**	0.2	1.2	2.2	1.4	1.0
Import	**-0.6**	4.1	6.5	**0.1**	**5.2**	**-3.2**	1.1	1.8	2.0	1.9	1.4
Stockbuilding (% contrib. to GDP)	**0.6**	0.1	-0.4	**0.0**	**0.2**	**0.6**	-0.3	-0.2	0.0	-0.2	-0.1
Current account (% of GDP)	**-1.4**	-1.8	-2.2	**-2.9**	**0.7**	**-1.3**	-1.5	-1.8	-1.8	-2.1	-2.3
Deficit (% of GDP)	**-2.4**	-3.0	-3.5								
Debt (% of GDP)	**108.6**	110.3	111.3								
CPI (y/y)	**2.8**	2.3	1.9	**3.0**	**2.8**	**2.7**	2.3	2.4	2.2	2.3	2.2
Industrial production	**-0.5**	0.9	2.2	**-1.0**	**1.5**	**-0.1**	-0.4	0.5	0.7	0.6	0.6
Unemployment (%)	**8.7**	8.4	8.1	**8.7**	**8.6**	**8.5**	8.5	8.5	8.3	8.2	8.2

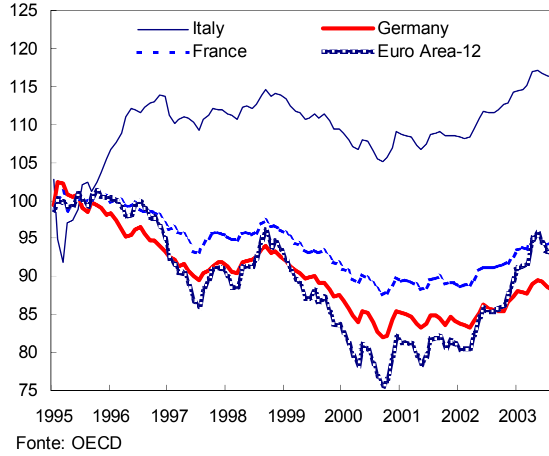
Percentage variations over previous period, if not otherwise specified.

The situation at a glance

Monetary conditions in the Euro Area

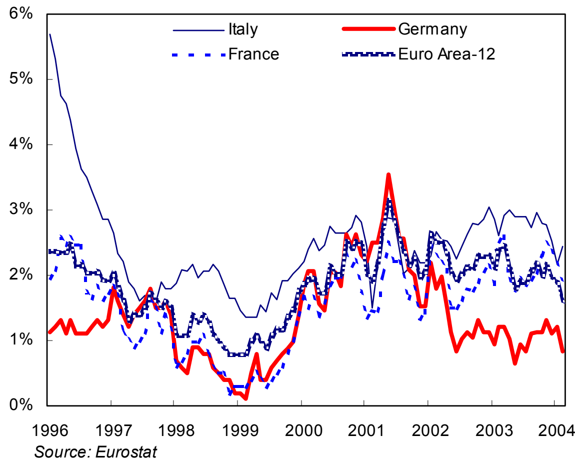


Effective exchange rate (1995=100)



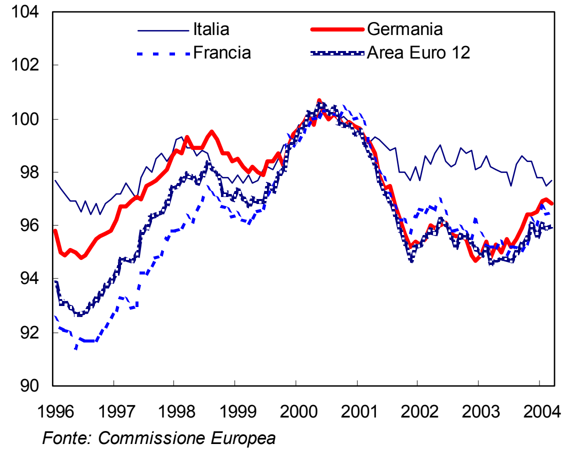
Fonte: OECD

Harmonised inflation rate



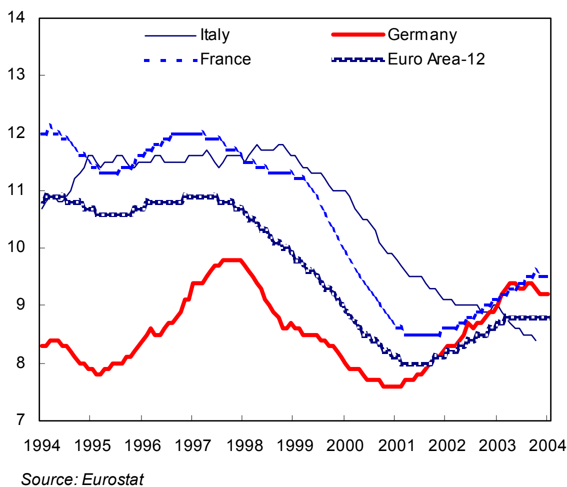
Source: Eurostat

Business confidence



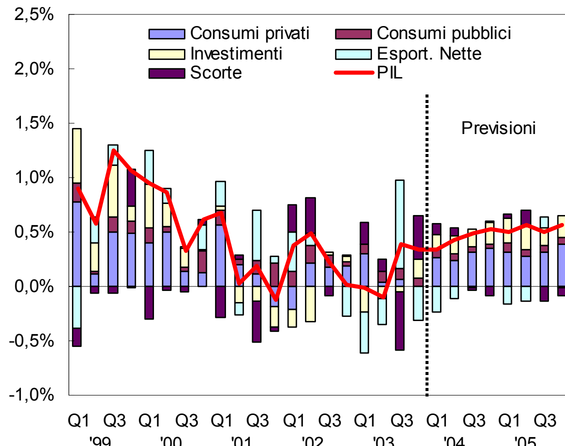
Fonte: Commissione Europea

Unemployment rate



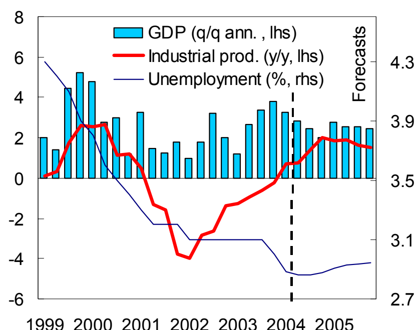
Source: Eurostat

Euro Area -12: contributions to GDP

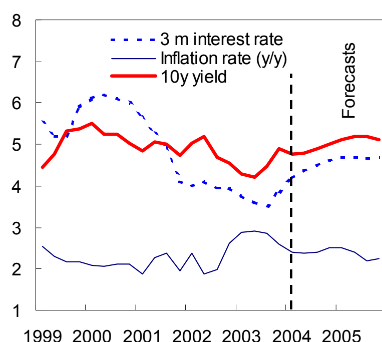


United Kingdom

GDP production and unemployment



Inflation and interest rates



The UK economy remains robust and has started the year well. Growth looks set to accelerate to over 3% in 2004, above potential. 1Q04 kept pace with 4Q03, slowing only slightly from 0.9% to 0.8% q/q. **Consumer spending, although down slightly, remains strong**. The labour market continues to be healthy: unemployment is down from 3.1% a year ago to 2.9%, and the rate has fallen continuously for the last nine months. House price inflation, which has stayed at between 15% and 20% year on year, is helping to finance the consumer boom. Consumer price growth however is set to remain below target over the next few months—at 2% according to the latest HICP forecast—and this will cause disposable income to stabilise on an upward trend.

After the upturn in investment in 4Q03, we can expect a slowdown in 1Q04, followed by further growth over the year. **Exports are likely to have the biggest impact on investment in 1Q04**. Sterling gained 4% in real terms over the quarter, widening the trade deficit and hampering the recovery of the manufacturing sector. The sector's performance was very disappointing in the first two months of the year, and poses a downside risk to 1Q04 GDP estimates. The outlook for companies is still bright however, particularly in light of the latest soundings from confidence indicators and PMI surveys, which, while not yet fully reflected in reality, probably say more about the near future than the recent past.

Public spending is likely to offer further support to growth, particularly given the increases announced in health and education spending. This will however weigh on the deficit/GDP ratio, which could breach 3.5%.

Consumers' reluctance to curb spending and spiralling household debt require a **restrictive monetary policy**. However, with the pound set to return to February's highs against the dollar and again hover below 0.65 against the euro, a gradual approach is likely. At present therefore, we forecast a further two rate hikes for a total of 50bp by the end of the year.

(Asmara Jamaleh)

United Kingdom

	2003	2004	2005	2003			2004				2005
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	**2.3**	3.1	2.5	**2.3**	**2.3**	**2.8**	3.3	3.3	3.1	2.6	2.5
- q/q change				**0.7**	**0.8**	**0.9**	0.8	0.7	0.6	0.5	0.7
Private consumption	**2.8**	3.2	2.2	**1.0**	**1.1**	**1.1**	0.7	0.6	0.5	0.4	0.6
Fixed investment	**2.6**	3.5	3.7	**1.6**	**0.9**	**1.6**	0.3	0.7	0.6	0.9	1.2
Government consumption	**2.1**	3.3	3.7	**0.2**	**0.1**	**1.9**	0.2	1.0	1.0	1.0	1.0
Export	**-0.5**	3.6	5.8	**-2.6**	**0.1**	**1.8**	1.0	0.8	1.7	1.5	1.4
Import	**0.8**	5.8	6.8	**-2.5**	**1.1**	**2.2**	1.6	1.8	1.7	1.5	1.8
Stockbuilding (% contrib. to GDP)	**0.0**	0.4	0.1	**-0.4**	**0.3**	**-0.3**	0.4	0.3	0.0	-0.1	0.1
Current account (% of GDP)	**-2.4**	-3.3	-4.0	**-2.9**	**-3.0**	**-2.9**	-3.0	-3.3	-3.4	-3.6	-3.8
Deficit (% of GDP)	**-3.1**	-3.4	-3.0								
Debt (% of GDP)	**38.7**	40.1	41.4								
RPIX (y/y)	**2.8**	2.4	2.3	**2.9**	**2.8**	**2.6**	2.4	2.4	2.4	2.5	2.5
Industrial production	**-0.8**	1.2	1.7	**0.2**	**0.0**	**-0.1**	0.6	0.3	0.6	0.5	0.4
Unemployment (%)	**3.1**	2.9	2.9	**3.1**	**3.1**	**3.0**	2.9	2.9	2.9	2.9	2.9
3m GBP Libor	**3.69**	4.41	4.68	**3.59**	**3.52**	**3.88**	4.17	4.36	4.50	4.60	4.68
Long Gilt	**4.46**	4.87	5.15	**4.20**	**4.47**	**4.90**	4.76	4.80	4.90	5.00	5.10
GBP/USD	**1.63**	1.88	1.79	**1.62**	**1.61**	**1.71**	1.84	1.88	1.91	1.88	1.84
Effective exch.rate (1990=100)	**100.2**	106.5	104.9	**99.1**	**99.2**	**100.2**	104.1	107.4	107.2	107.5	106.6

The poisoned chalice

The future eurozone candidates have been much more vocal in their criticism of the criterion of currency stability than that of fiscal stability. Most consider it as the price to be paid to join the euro club, but want to limit the period they remain in the mechanism to the minimum. Many small countries can easily comply, but some of the larger ones will need to carefully co-ordinate fiscal policy and inflation rate conversion to avoid any incidents in the observation period.

The first ten new members of the EU[8] are set to join on 1 May 2004. Many of the new entrants will in the future replace their national currencies with the euro, but to do so, will need to comply with a series of convergence criteria imposed by the Maastricht Treaty during the observation period (see Panel 1).

Panel 1 – Convergence criteria

1. **High degree of price stability.** This means a "sustainable" price trend (ie, not due to extraordinary or temporary measures), together with an average inflation rate over the year prior to the examination that does not exceed the average of the three member states with the lowest rates by more than 1.5 percentage points.
2. **Public finances under control**. To avoid an "excessive deficit", public debt must not be more than 60% of GDP (or falling towards 60%), and the budget deficit (actual and forecast) must not be more than 3% of GDP.
3. **Stable exchange rates**. Countries must show their currencies "can keep within normal fluctuation margins of Europe's exchange rate mechanism for at least two years without devaluing against currencies of other countries" and without serious tensions. The benchmark currency is now the euro.
4. **Sustainable convergence.** Long-term interest rates as observed for a year before the examination must be no more than 2 percentage points above those of the three EU countries with the lowest inflation rates.

The main sticking point for the new candidates is exchange rates. ERM I, the exchange rate agreement that bound the current eurozone members for around ten years, was beset with serious difficulties and, following the removal of limits on capital movements, the mechanism only managed to stay on its feet thanks to the widening of the fluctuation band from ±2.25% to ±15% in August 1993. The EU has however repeatedly and firmly defended the exchange rate criterion using the following arguments:

- exchange rate stability is proof of lasting convergence of economic fundamentals;
- to ensure their exchange rates remain stable, EU candidate countries must gear their economic policies towards convergence.

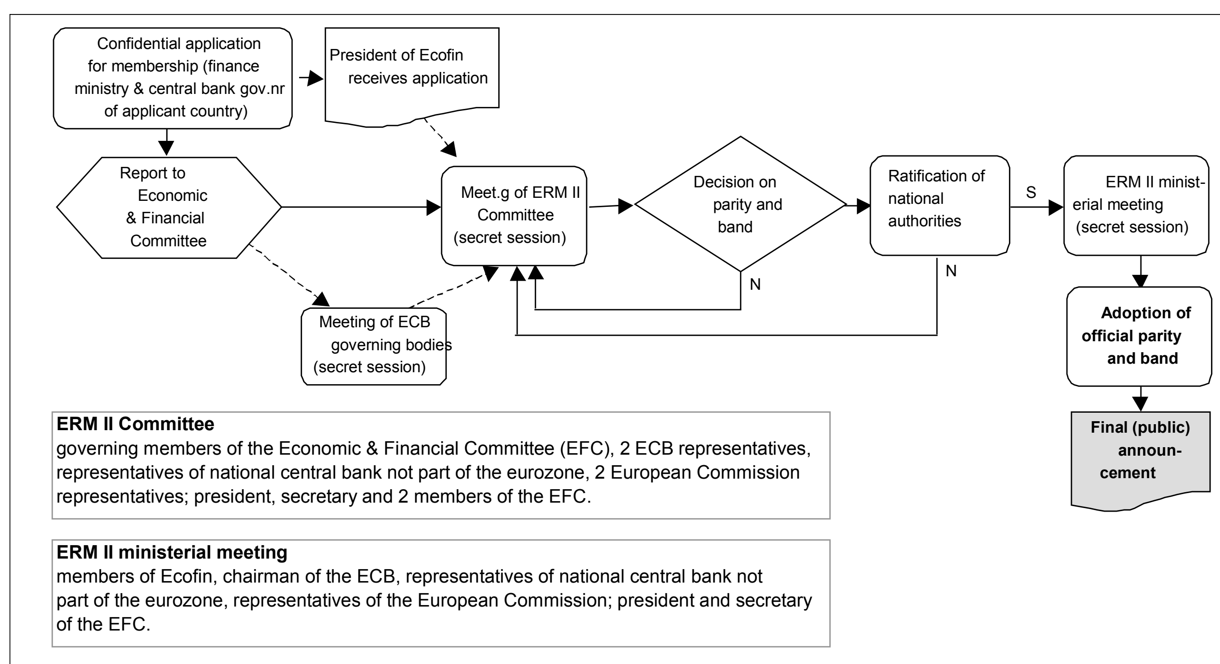
Despite the criticisms expressed by much of the academic world and widespread confusion among new entrants, the exchange rate conversion criterion remains

8 *Poland, Hungary, Czech Republic, Slovakia, Slovenia, Lithuania, Latvia, Estonia, Malta and Cyprus.*

an important part of the valuation process, as the ECB confirmed in its position paper of 18 December 2003[9]. This is because the difficulty of maintaining exchange rate stability in a context of economic and financial imbalances obliges candidate countries to plan their euro-adoption strategy carefully, and makes it more likely that countries unable to converge will be excluded. The European Commission writes that "in certain cases, staying outside ERM II for some time may be useful, in light of large and volatile capital flows, large fiscal imbalances and/or risks of large economic shocks". Participation in ERM II would however help "identify potential misalignments in the central parity that have not been detected before"[10].

How does ERM II work? What problems might countries joining it encounter? And what strategies are the new entrants planning to adopt to manage their exchange rates?

Panel 2 – Procedure for admission to ERM II



ERM II: instructions for entry

Since the introduction of the euro, the ERM has lost its original multilateral quality (based on a parity grid connecting the currencies of its members) and has taken on a bilateral character: in the new system—of which Denmark is currently the only member—the currencies of participating countries are pegged to the euro.

Setting and revising the central parity with the euro is based on agreement. The decision-making process involves finance ministers, the ECB, the governors of national central banks and the European Commission. This is important, as it means members cannot unilaterally peg their currencies at a level they believe

[9] *ECB,* Policy Position of the ECB on Exchange Rate Issues Relating to the Acceding Countries*, 18 December 2003.*

[10] *Peter Backé, Christian Thimann et al., " The Acceding Countries' Strategies Towards ERM II and the Adoption of the Euro: An Analytical Review",* ECB Occasional Papers *no. 10, February 2004, p. 22.*

best serves their national interests. The power that the ECB and eurozone countries exercise in this process explains why the ECB does not unconditionally support fixed pegging systems like currency boards, which deprive the European authorities of any control over the management of bilateral exchange rates.

The procedures for joining the ERM[11] are shown in Panel 2. Of course, given the sensitivity of exchange rate regimes, membership of ERM II is completely voluntary.

The fluctuation band is 15%, but a narrower band may be adopted via the procedure described in Panel 2. The setting of a fluctuation band means that monetary authorities must undertake to keep their exchange rates within the established limits. To comply with this undertaking, they may intervene directly on the currency market. Unlike when a currency is unilaterally pegged, the ECB makes co-ordinated interventions automatically at the extremes of the fluctuation band, although it may suspend them if they are clearly working against price stability.

The ECB is also free to offer its assistance by intervening within the bands decided on by the central banks of the ERM members, which may be a crucial factor in ensuring they comply with the convergence criteria on exchange rate stability. The European authorities have stated that the official fluctuation bands are not the yardstick against which convergence will be judged; the real parameter (which the bank will not necessarily announce publicly or maintain rigidly), may be closer to the old narrow bands of ±2.25%. This suggests that the candidate countries' central banks must intervene well within the official bands. The problem is that they are not allowed to intervene unilaterally without the agreement of the ECB, if—as is likely—this involves operations in euro. Furthermore, the ECB may propose realigning the parities if it deems it necessary.

Within the exchange rate mechanism, participating central banks are given the facility to grant very short-term loans of up to three months, which can be extended for a maximum further three months. Access to funding, which is remunerated at the three-month money market rate prevailing on the date of the operation, is dependent on the use of the country's own currency reserves.

ERM II: the risks

For countries that have lowered restrictions on capital movements, keeping exchange rates within fluctuation bands may prove impossible, particularly if flows with other countries are significant and if monetary policy is concentrating on other objectives. New member states, which are removing all obstacles to capital flows as they require them to finance large trade deficits, could face even more serious problems than those experienced by the members of ERM I, since they do not have the option to cut out speculative flows and rely on direct investment as their sole means of financing.

The first issue—theoretically of great interest but probably of little importance given the short observation period set out for ERM II—is that **convergence of yields** will either require nominal exchange rates to rise and inflation to be in line with that of the eurozone; or inflation to be higher than the eurozone and exchange rates to remain stable. Judging by recent trends, this would mean that the real exchange rate would have to rise by 2-4% a year, which is compatible with the functioning of ERM II.

[11] *European Commission,* Procedural Steps to allow participation in ERM II*, 28 May 2003.*

Of much greater concern is the **impact of speculative flows** on the volatility of exchange rates in emerging countries. In 2001-2002, the Hungarian forint rose 16% against the euro and the markets frequently expected the parity to be revised. In 2003 however, an insufficient correction in the fiscal imbalance and the inflation trend went against expectations, and the exchange rate started to weaken. The markets began to bet on a devaluation, which occurred in June. In 2001-2003, the EUR/HUF exchange rate fluctuated in a band of ±8% around the average.

Unfortunately, speculative flows will remain a serious threat to all the major countries wishing to join ERM II. There are many risk factors:

- International portfolios are still diversifying towards emerging countries, and huge amounts of capital are ready to be moved between them. Since the local financial markets are fairly small, slight readjustments in international portfolios could lead to relatively **large reserve flows** for the country concerned.
- A rigid exchange rate regime can create a situation of **moral hazard** for investors, building up pressure that may then be released in sudden currency crises. In practice, when exchange rates are expected to remain stable, speculating on the convergence of local interest rates with the eurozone becomes more appealing; this structure is, however, intrinsically unstable: the mass of liquid capital invested in local currency would increase the intensity of outward flows, which the central bank could be forced to cover if market sentiment changes direction following the decline of fundamentals or a speculative bubble.
- In light of fundamental imbalances (large current account deficits, excessive growth of foreign debt, huge budget deficits etc), the **credibility of the exchange rate regime** would sooner or later be cast into doubt. As we saw during ERM I, these conditions can lead to expectations of a devaluation of the parity, or of a dispute between a country's central bank and the ECB, which prevent co-ordinated intervention to support the currency within the band. This is not just a hypothetical issue, given the size and persistence of the external imbalances of many new entrants[12].

The ECB's view on ERM II entry

The ECB does not deny the intrinsic risks of the exchange rate mechanism. However, it concludes that countries with significant economic imbalances should not join until they have dealt with these problems, or at least until they have a credible plan to do so. The bank has set out details on what it believes are the best strategies for the new entrants to adopt, which are outlined in Panel 3[13].

The ECB recommends that the larger countries stick with the flexibility offered by wide fluctuation bands and choose their date of entry to the ERM II bearing in mind their fiscal position, and possibly after the introduction of a sound medium-term fiscal strategy. It also believes that countries whose membership of ERM II would force them to abandon their inflation targets (Poland Hungary, the Czech Republic and Slovakia) should act with even more prudence.

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[12] *All the countries together have a national savings deficit of 3-5% of GDP, which is 6-7% for the Baltic states. For these last, which have strictly pegged their exchange rates, net exports trim 1-2 points from GDP growth per year. The problem could get worse if convergence leads to a fall in domestic interest rates and thereby stimulates domestic demand.*

[13] *Peter Backé, Christian Thimann et al. (2004), cit.*

Panel 3 – Strategies for ERM II membership

Country	Adopting the euro in:	Current exchange rate regime	Recommended strategy for the ERM II
Cyprus	2007	Limited fluctuation (pegged to the euro, band ±15%) since 13/08/2001. Previously: the same system, band ±2.25%	Maintain current strategy. The Cypriot government plans to join ERM II **as soon as possible**.
Estonia	2006	Fixed peg to the euro (currency board).	Maintain current strategy. The Estonian government plans to join ERM II **as soon as possible**.
Latvia	2008	Peg to the SDR (euro weight 35%). Band (±19%)	Increase the weight of the euro to 100%. Narrow the band. **Latvia plans to join ERM II from 1/1/2005**.
Lithuania	2007	Fixed peg to the euro (currency board) since February 2002.	Maintain current strategy. The Bank of Lithuania supports **immediate entry into ERM II**.
Malta	2007-08	Fixed peg to a basket (euro weight 70%)	Maintain current strategy. Take the weight of the euro up to 100%. **The central bank plans to join ERM II in early 2005** (Central Bank of Malta, 1/3/2004).
Poland	2007-...	Free fluctuation, inflation target (since 2000)	(?).The Polish central bank wants to ensure that participation in ERM II is as brief as possible.
Czech Republic	2007-...	Free fluctuation, inflation target (since 1998)	(?).The Czech central bank believes that participation in ERM II is only appropriate two years before converging on other criteria. "ERM II is merely the waiting room for the eurozone"
Slovakia	2008	Limited fluctuation (peg to the euro) implicit inflation target (since 1998).	(?). The Slovakian authorities plan to join ERM II **in 2005**.
Slovenia	2007	Limited fluctuation (weak peg to the euro, gradual depreciating trend).	Stabilise the parity. **The government and the central bank want to join at the beginning of 2005 and certainly before mid-2005.**
Hungary	2008	Limited fluctuation (peg to the euro, band ±15%), inflation target (since 2001)	(?). If the country meets its entry date target, it will join **between mid-2004 and mid-2005**.

Source: ECB, national central banks, Reuters. (?) means that the ECB has expressed an indirectly unfavourable judgement regarding immediate entry.

The plans of the new entrants

The ECB admits that most countries consider membership of ERM II as an inevitable institutional obligation, albeit a debatable one. To limit the damage that could result from joining the mechanism, the candidate countries plan to:

1. restrict their membership to the minimum two years required; this means that the entry date must be co-ordinated with fiscal convergence plans and a falling inflationary trend;
2. keep fluctuations within a narrower band than the official one, which need not be symmetrical and need not be announced to the markets;
3. adopt a central parity consistent with control targets, ideally matching the future conversion rate to the euro.

If countries can stick to this plan, then the intrinsic risks of the ERM will be limited. All the countries that have already rigidly pegged their currencies to the euro (Estonia, Latvia, Lithuania and Malta) or those with fluctuation bands similar to ERM II (Cyprus and Slovakia) could join the ERM quickly, by early 2005. The case of Hungary, which in theory could be included among the above group of countries, is more problematic, given that exchange rate convergence does not sit well alongside the country's domestic inflation target, and given its serious fiscal and external imbalances. Slovenia plans to join at the beginning of 2005 and already intervenes in foreign currency transactions. Poland and the Czech Republic, which have let their currencies float freely and have benefited greatly from exchange rate flexibility in the last few years, face the most difficult

challenge; if official targets on the date for adopting the euro are to be believed, both countries will have to apply for admission to ERM II by the end of 2005.

To conclude, the new members have adopted an understandably sceptical attitude to the exchange rate mechanism, which should foster a cautious approach to joining the euro. The most significant risk is that, if the austerity policies necessary to ensure fiscal convergence prove difficult to implement, ERM II will have to be used as a means to impose discipline in the face of public opposition, and neither fiscal discipline nor exchange rate stability may then be achieved.

(Luca Mezzomo)

Japan: sustainable growth at last

The Japanese economy is emerging from deflation...

The Japanese economy has turned the corner and the risks of a return to spiralling deflation have now abated considerably. After two years of growth well above potential and an extremely accommodative monetary policy, overcapacity has fallen to such an extent that inflation is now back up to zero, despite the appreciation of the yen. The output gap will be practically closed in 2005 and will open the way for a return to positive inflation, albeit at extremely low levels.

...but the growth drivers of 2003-04 will be less apparent in 2005

The Japanese economy will however hit a peak in 2003-04 before slowing in 2005, with growth forecast at 1.4%. Consumer spending and investment will probably be less spectacular in 2005 than in 2003-04. Two central growth drivers in 2003-04 will be less in evidence from end-2004. First, **plummeting saving rates are likely to limit spending growth in 2005** (see below). For consumption to rise, there will have to be a recovery on the job market, which however is likely to see its most sustained growth in 1H04. We expect job creation over the next year to lead to growth in consumer spending, but at a slower rate. Second, exports to south-east Asia are likely to provide less of a stimulus to growth; we believe that Asia is set to feel the effects of China's new monetary policy stance, aimed at moderating growth.

Tankan data for March exceeded expectations and suggests a rosy outlook despite a rising yen

Tankan data for March confirmed the marked improvement in the economy: results for all types of businesses and sectors exceeded expectations and reached their highest levels since 1997. Growth registered by large manufacturing companies has now definitely trickled down to smaller companies and the services industry, and supports forecasts that domestic demand will continue to rise steadily this year. Note that **companies expect conditions to improve over the second quarter**, and the yen is expected to appreciate by 5% in the same period. Overall, company investment plans are cautious—but fairly strong for the manufacturing sector—so investment growth is likely to slow in 2004 compared to the 9% posted in 2003 (see table).

Japan

	2003	2004	2005	2003			2004				2005
				2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	2.7	2.8	1.4	2.4	2.0	3.8	3.5	3.1	2.9	1.6	1.6
q/q annual rate				3.4	2.5	7.0	1.2	1.9	1.6	1.5	1.4
Private consumption	1.0	1.5	1.2	1.2	2.0	3.3	0.6	1.3	0.8	1.2	1.4
FI - private nonresidential	9.1	6.4	3.6	18.8	-0.8	22.0	-1.1	5.1	4.9	4.7	4.0
FI - private residential	-0.7	2.0	3.5	-0.5	12.2	-3.9	2.0	1.6	2.7	3.4	3.7
Government investment	-10.4	-6.2	-0.7	-14.0	-19.0	-1.0	-6.5	-2.5	-2.3	-1.4	0.4
Government consumption	1.2	1.4	1.4	-0.4	2.8	1.9	0.8	0.7	2.5	1.3	1.4
Export	9.9	9.9	6.6	6.5	13.4	17.9	11.1	4.2	5.9	5.8	9.5
Import	4.7	7.5	8.3	-4.6	10.8	5.7	7.8	9.5	8.8	9.1	8.2
Stockbuilding (% contrib. to GDP)	0.5	0.4	-0.3	-0.1	0.3	0.0	0.1	0.1	0.0	0.0	-0.2
Current account (% of GDP)	3.2	3.1	3.0	3.2	3.5	3.3	3.3	3.1	3.0	3.0	3.0
Deficit (% of GDP)	-7.7	-7.8	-7.8								
Debt (% of GDP)	133.3	139.8	147.2								
CPI (y/y)	-0.3	-0.5	-0.5	-0.3	-0.2	-0.3	-0.3	-0.6	-0.7	-0.5	-0.4
Industrial production	3.3	5.0	2.0	-2.9	5.2	15.7	4.4	1.8	1.8	1.7	3.3
Unemployment (%)	5.3	5.0	4.9	5.4	5.2	5.1	5.0	5.0	5.0	4.9	4.9
3-month CD rate	0.09	0.10	0.16	0.08	0.09	0.09	0.09	0.09	0.11	0.12	0.12
10-year rate	0.99	1.31	1.39	0.61	1.12	1.41	1.35	1.29	1.28	1.30	1.31
JPY/USD	115.9	107.3	113.3	118.5	117.4	108.8	106.1	105.7	107.2	110.0	111.9
Effective exch.rate (1990=100)	131.5	134.7	129.6	129.4	129.1	135.9	136.5	136.2	134.5	131.6	130.0

Percentage annualised growth rate over previous period, if not otherwise specified.

The Tankan survey also showed that the situation was better in March than companies had anticipated in December 2003. The strength of foreign demand and the domestic consumer spending trend more than offset the restrictive effects of the strengthening yen, which rose from 110 In December to 105 in February. Lastly, pressure on input prices has also begun to bear down on output prices.

The three factors behind the Japanese recovery: exports to Asia, a credible monetary policy and a fall in household saving rates

From exports, growth has been transmitted to investments, employment and then consumer spending. The factors that contributed to the likely end of deflation are: 1) Asian economic growth, 2) a drop in household saving rates, and 3) an expansive monetary policy. As BoJ governor Toshihiko Fukui said, the economy is "progressing towards achieving sustainable growth and overcoming deflation". Once sustainable growth has been reached therefore, Japan will be less dependent on the factors listed above, thanks to the consequent further improvement of the job market.

Asia led growth in exports

1) **Asian growth**. The Japanese economy's exposure to south-east Asia has driven growth and stimulated investment. The contribution of China, and more generally south-east Asia, was the main factor in Japan's emergence from deflation in 2003 and the reason why it has not suffered excessively as a result of the appreciation of the yen over the last year. Japan's total exports rose 14.7% overall from end-1999 to end-2003. Export trends by region have a clear message: **Japanese exports to the US fell 8% from end-1999 to end-2003, while total exports to Asia rose 43.2%.** In the same period, the proportion of Japanese exports to China rose from 5.5% to 12.2%, shooting up by 155% overall. Following the increase in manufacturing capacity use in 1999-2000, investments returned into positive territory in 2003.

Monetary policy has anchored expectations on rates to the end of deflation

2) **Monetary policy** made a positive contribution to the fight against deflation and reflected a point recently made by the Fed: monetary policy is even effective with interest rates at zero, as long as the central bank is prepared to use the full arsenal at its disposal and manages to ground expectations. With its aggressive liquidity creation policy, the Bank of Japan aimed to anchor expectations on prices on a path towards positive growth, **making the end of deflation a condition to its zero rates policy.**

The fall in the household saving rate has been a decisive factor in achieving sustainable growth

3) **Household savings.** This is a crucial factor in explaining Japan's performance over the last two years. The household savings trend has partly followed the change to a monetary policy that targets deflation more credibly and more explicitly. With interest rates remaining at zero, Japanese households reacted by slashing their saving rates. According to data, the recovery—triggered by exports and boosted by investment—**only became sustainable because Japanese households sharply reduced their savings following years of falling employment.** Despite the employment crisis and deflation, consumer spending has continued to grow, sustained by the gradual decline in the saving rate. The figures illustrate the relationship between the two variables: between 2000 and 2003, consumer spending picked up (average annual growth of 1.1%), as **the saving rate plummeted from 9% of disposable income at the beginning of 2000 to 1.75% at end-2003.** We can see the importance of savings in financing consumer spending in the last three years even more clearly by comparing it to the job market in the same period: unemployment rose from 4.8% at end-1999 to 5.4% in mid-2003, and only began falling in 3Q03. After 2005, when the dangers of deflation will have passed, the problem of public finances will return to the

fore and will be aggravated by the extremely low levels of household savings. Until then, however, continued high levels of consumer spending will be a decisive factor in boosting final demand and increasing employment.

Outlook for 2004

Two years of growth equal to three times potential will close the output gap in 2005

In 2003, demand grew unevenly in Japan. Growth in 1Q04 is forecast at only 1.2% q/q ann., a slowdown on the strong performance of 7% q/q ann. posted in 4Q03. The trends underlying the various demand components are strong enough to indicate that **this year, the economy will register growth of over three times potential**—at 2.8%, compared with estimated potential of 0.8% (OEF estimate). With the closure of the output gap by the end of next year, this forecast implies that barring any unforeseen events, the worst is really over as regards deflation, and Japan could afford a year of rising exchange rates without any negative impact on demand growth.

Consumer spending will pick up and investment will slow in 2004

In light of the expected improvement on the job market and the forecast end to deflation, we anticipate that **consumer spending will make an increasing contribution to growth, while investment will slow**. We expect consumer spending growth to increase from 1% in 2003 to 1.5%, while investment is set to decline from 9% in 2003 to 6.4% in 2004. Exports will probably stabilise (+9.9% in 2004 as in 2003), while imports are expected to rise (from 4.7% in 2003 to 7.5% in 2004), limiting overall growth.

The signs for consumer spending have been positive in early 2004. Consumer confidence has been rising gradually since 4Q03, and salaried workers' spending has risen sharply in real terms in the same period: y/y growth went up from almost –2% in September to +6.9% in February 2004, as real salaries increased by 4.1% in February, compared to a fall of 2% y/y in August 2003.

Consumption growth will be led by an upturn in employment and salaries

As in the US and the eurozone, **consumer spending** in Japan this year **will depend crucially on job market trends**, in the absence of any new boost from economic policies. In February, unemployment stabilised at 5% despite forecasts that it would fall, but this should not be seen as cause for concern. In February, the number of jobless fell by 190,000 y/y, while the number of employed people rose by 160,000. Job leavers totalled 90,000, a positive sign of household confidence regarding the probability of finding work, and furthermore in line with the stable jobs-to-applicants ratio, which has reached a ten-year high (stable at 0.77 since December 2003 and up from the 1H03 average of 0.6). In light of the falling saving rate over the last three years, job market recovery will be crucial if consumer spending is to rise over the year. However, although the job market will continue to improve, the job creation rate is set to slow towards the end of the year, so consumer spending will likely follow suit and steady off at a more moderate level.

With the end of deflation, Japan will prepare for the battle against its deficit and debt in 2006

To conclude, 2004 will undoubtedly be an excellent year for the Japanese economy. 2005 will also be positive, but less so than in the previous two years. Once Japan has finally become completely deflation-free, and its banking system is less at risk, **the problem of its public finances will return to the fore, and will require restrictive fiscal policies, given the current debt/GDP ratio** (seen at 140% of GDP in 2004, and 147% of GDP in 2005).

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