EFN REPORT

The Euro Area and the Acceding Countries

SPRING 2004

Available at http://www.efn.uni-bocconi.it

The EFN Network

- The purpose of the European Forecasting Network (EFN), launched in 2001 on behalf of the European Commission by leading research institutes from EU Member States, is
  - to improve the understanding of euro-area economic developments and policies,
  - to augment the analytical basis for economic policy decisions in the euro area, and,
  - to increase the visibility of Economic and Monetary Union (EMU) in the Member States.

The EFN Network

- To achieve these objectives, the EFN will produce independent, rigorous and joint assessments of the economic situation, the aim being to identify key policy challenges in the euro area.
- Two reports will be produced each year, including:
  - A detailed analysis of the economic situation and outlook, including quantitative forecasts.
  - An examination of policy issues in key areas
  - Thematic analyses, focusing on euro-area economic characteristics

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EFN REPORT

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The EFN Report on the Euro Area and the Acceding Countries

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- The European Union is about to experience its largest increase in population since its creation in the 1950s with the accession of new countries.
- The institutional implications of this enlargement have already delayed agreement on a new constitution for EU, but there are also important implications for labour and capital markets.
- The question is whether the conditions are in place for the Acceding Countries to move smoothly towards economic and monetary union.

The EFN Report on the Euro Area and the Acceding Countries

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- For this reason, this fifth Report of the Network extends the analysis in the previous report on the different economic aspects of the Acceding countries.
- In particular, we focus on the macroeconomic outlook and forecasts for Acceding countries, the sustainability of their current accounts, the transmission of monetary policy and the challenges of their banking sector stability.
- Moreover, as previous reports, it also analyses the current state of the euro area economy and provides forecasts for key macroeconomic variables for 2004 and 2005.

The EFN Report on the Euro Area and the Acceding Countries

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- To address these issues, econometric and statistical tools are used, but all results are reported and commented upon in a clear and non-technical manner.
- Additional details on the topics considered in this report can be found in a set of annexes available on the web site of the European Forecasting Network:

http://www.efn.uni-bocconi.it

The report is structured in six chapters:

- Chapter 1: Acceding Countries Macroeconomic Outlook and Forecasts
- Chapter 2: Forecasting Methods for Acceding Countries
- Chapter 3: The Sustainability of Current Accounts in Acceding Countries
- Chapter 4: Monetary Transmission in Acceding Countries
- Chapter 5: Challenges to Banking Sector Stability in Selected Acceding Countries
- Chapter 6: Euro Area Outlook and Forecasts

Chapter 1. Acceding Countries Macroeconomic Outlook and Forecast

Acceding Countries Outlook

- The accession of eight Central and Eastern European Countries into the European Union makes forecasting their key macroeconomic variables of special policy interest.

- In this chapter, we provide forecasts for the period 2004-2007 for the four largest Acceding countries (the Czech Republic, Hungary, Poland and Slovakia) regarding GDP, inflation and their fiscal positions.

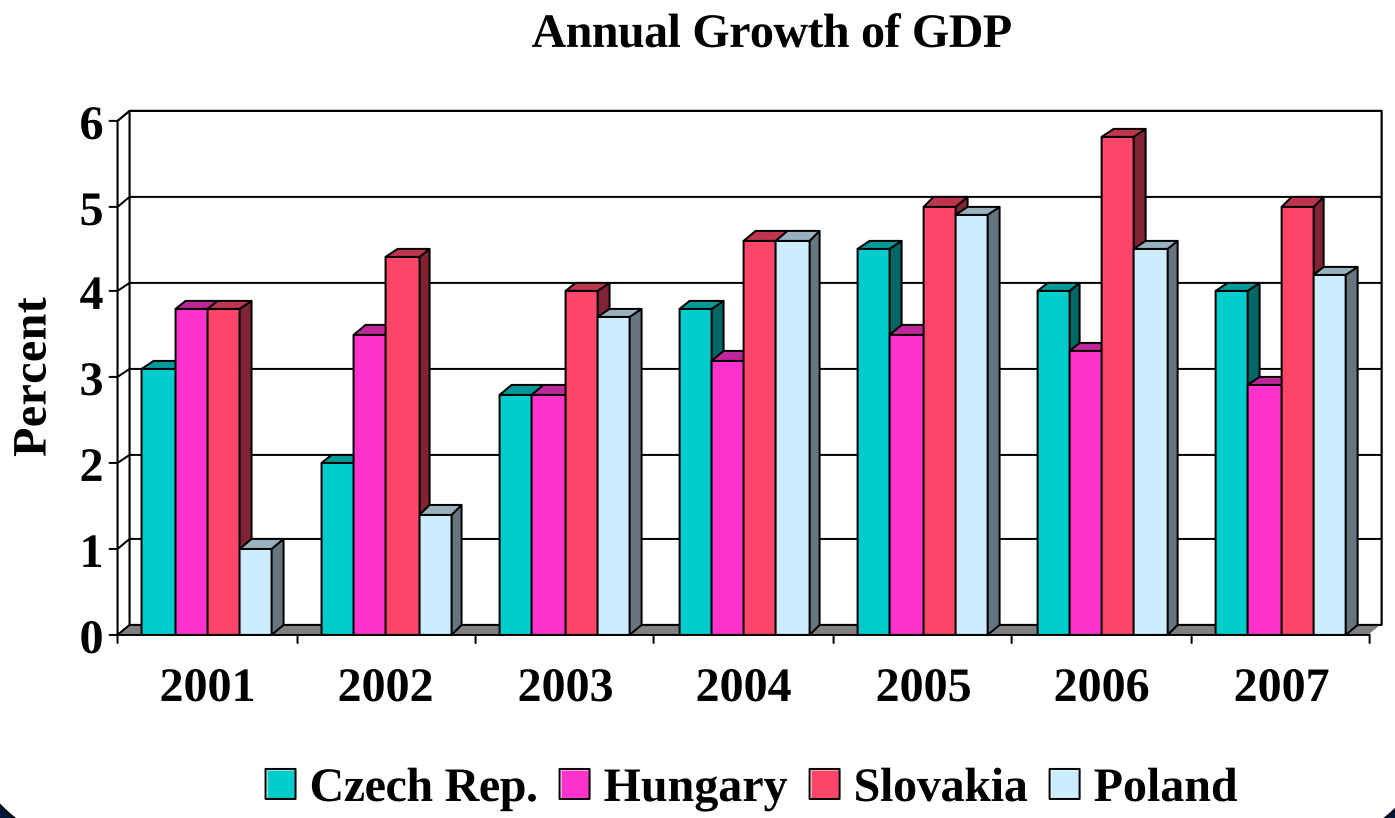
Acceding Countries Outlook: GDP

- In the last years, there has been a continued improvement in outlook despite the modest recovery in the rest of Europe.

- Among the factors explaining this differential behaviour we find that:

  - Export growth has strengthened
  - A moderate acceleration of investment activity is taking place
  - Consumer spending continues to grow at a steady pace

Acceding Countries Outlook: GDP



Acceding Countries Outlook: GDP

- External conditions have been good for short to medium-term growth:
  - boosting growth of industrial production.
  - improving the financial situation of local enterprises.
  - negative contribution of net exports to GDP in most countries will be reduced.

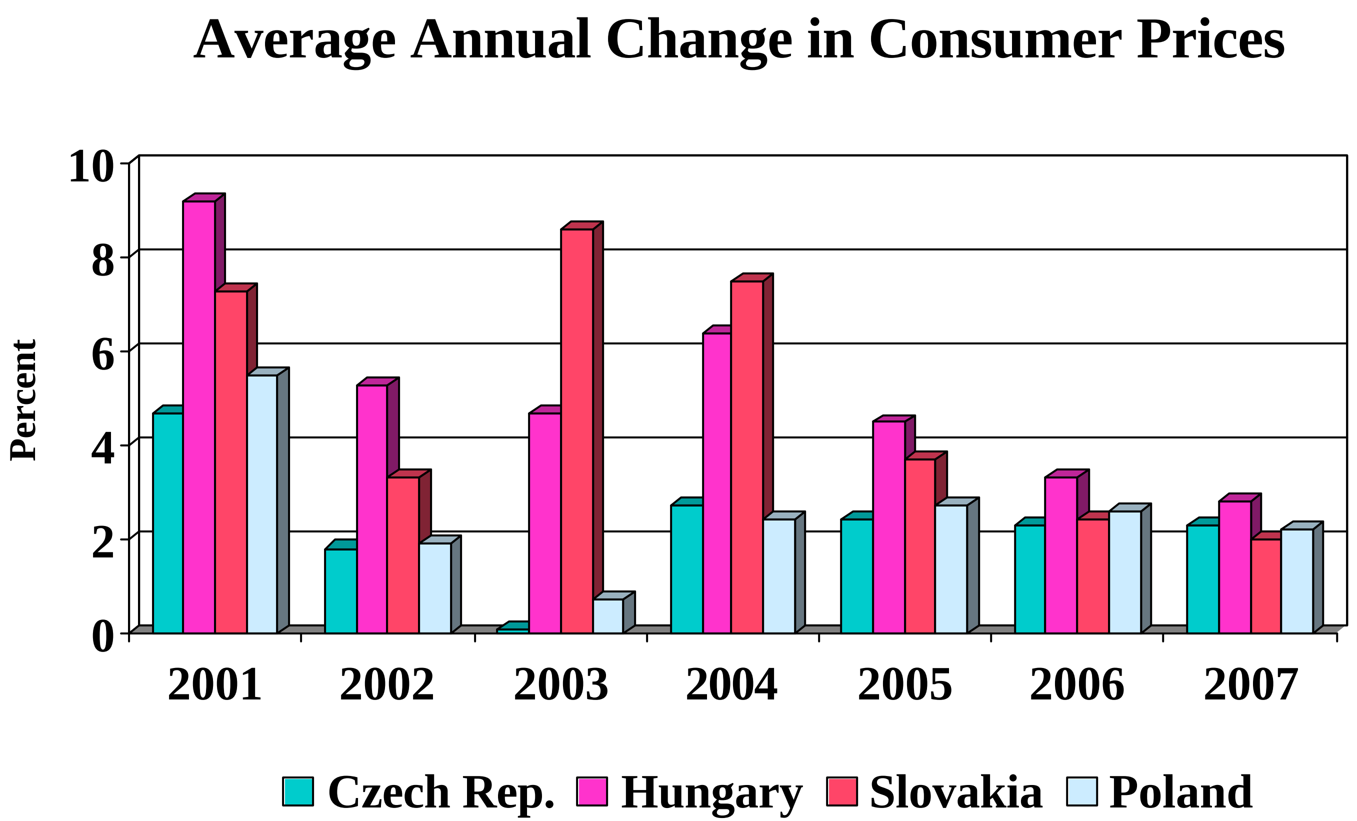
Acceding Countries Outlook: GDP

- In fact, the developments in domestic demand are key, even where net exports have contributed strongly to growth, role diminishing.
- For sustained robust growth of aggregate output, a continued rebound in investment activity and steady growth of household consumption are required.
- Domestic demand growth will be supported by greater access to EU structural and regional funding for local infrastructure.

Acceding Countries Outlook: Inflation

- Performance on inflation is mixed since mid-2003:
  - Impact of poor grain harvests.
  - Continued high world market oil prices despite winding down of hostilities in Iraq.
  - In some countries, harmonization of tax rates with EU requirements boosted inflation.
  - Core inflation is under control, but sharp price hikes may have a lasting effect on expectations.

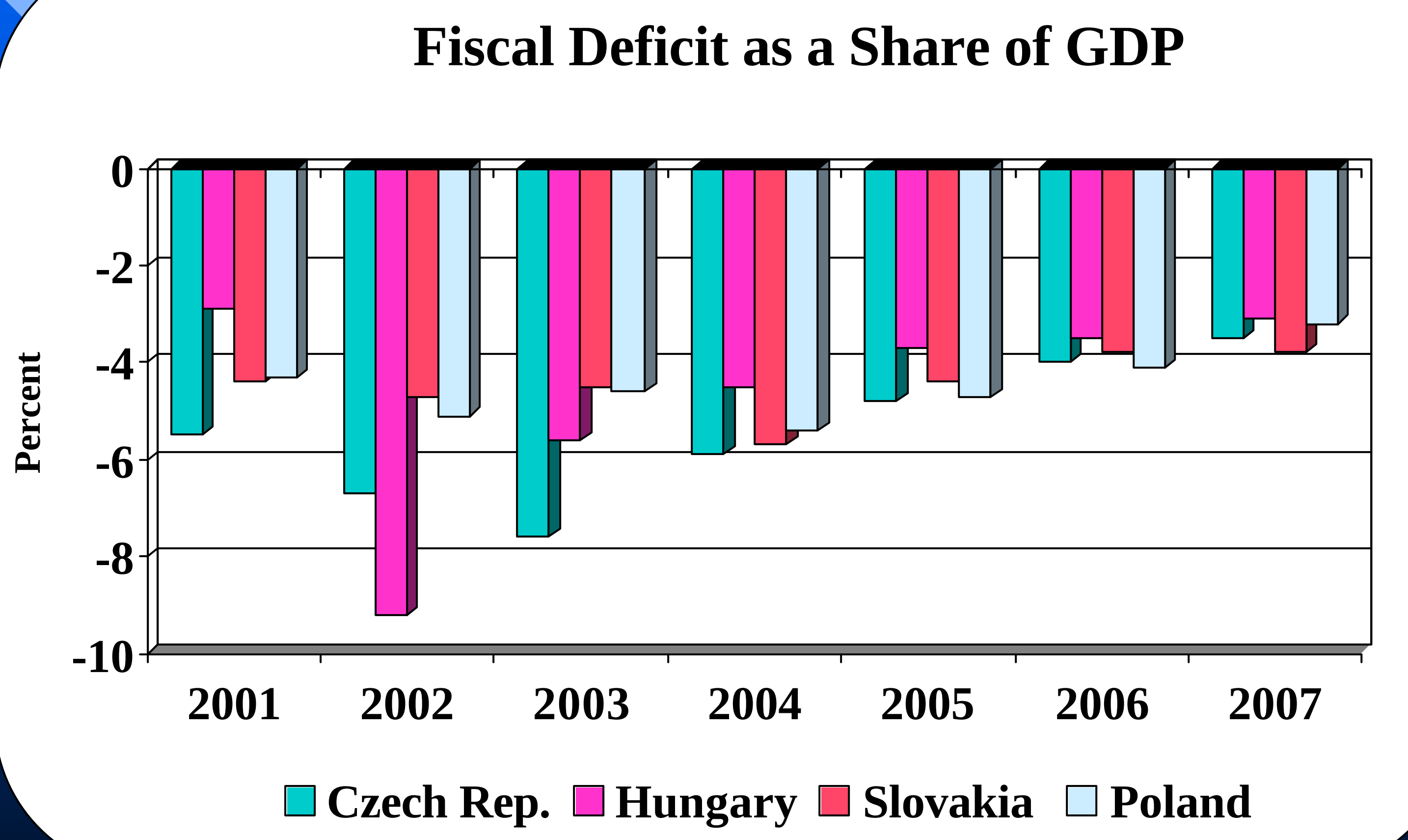
Acceding Countries Outlook: Inflation



Acceding Countries Outlook: Fiscal deficit

- The uncertainty of public finance situation also fuels inflationary expectations:
  - Structural fiscal rigidities relate to social security systems and bureaucratic waste.
  - Governments in Poland, Hungary, Slovakia and Czech Republic show little resolve to tackle problems.
  - Reluctance relates to political costs of unpopular actions, hesitancy to limit fiscal stimulus to still fragile economic recovery.
  - Continued fiscal problems could delay euro adoption.
- The chances are becoming remote of bringing these public sector deficits below 3% soon.

Acceding Countries Outlook: Fiscal deficit



Acceding Countries Outlook: Fiscal deficit

- Monetary authorities remain cautious:
  - Rapid cutting of policy interest rates seen in 2001-2002 has come to an end.
  - Fiscal uncertainty has prompted new caution in monetary policy.
  - Central banks have chosen not to institute cuts in policy interest rates that would only require boosting rates again later in the year.
  - The case of Hungary stands out against consistent policies elsewhere.

Chapter 2. Forecasting Methods for Acceding Countries

Motivation

- The forecasts reported in the previous chapter are mainly judgemental, since the implementation of formal methods is difficult, because the transition period to a market based economy only provides short spans of reliable data over time.
- One way of overcoming this problem is to exploit the data on a wide variety of aspects of the economy.
- In this approach, the short time span of the data is augmented by a large number of macroeconomic variables in the longitudinal dimension and factors are extracted from the resulting large data set and used for forecasting.

Motivation

- In this context, series models provide a valid alternative forecasting tool, because of their parsimonious specification and good performance in similar analysis.
- In fact, the availability of short time series requires the use of simple forecasting models …
- … while the quite large number of series available make dynamic factor models a viable tool already applied to US and EU countries: Stock and Watson (1999, 2002) and Marcellino, Stock and Watson (2001, 2003).

Motivation

- Among the advantages of dynamic factor models for forecasting macroeconomic variables in acceding countries, we would highlight that:
    - These economies are rapidly changing and, as a result, it is hard to find stable leading indicators.
    - Factor models enable us to remain agnostic about the structure of economy and use all available information in forecasting (Bernanke and Boivin, 2003).

Objective

- The analysis in this chapter compares time-series models and dynamic factor models as forecasting devices by
  - Simulation experiment.
  - Empirical application to 5 acceding countries.
- AR and VAR models (with intercept correction and second differencing) are compared with factor based forecasts also incorporating Euro Area information.

Forecast comparison

- Countries: Czech Republic, Hungary, Poland, Slovakia and Slovenia.
- Variables: GDP growth, inflation, short-run interest rate.
- Recursive estimation from 1994:1–2000:2 to 1994:1–2002:2.
- For each recursion, 1-step-ahead forecast (8 forecasts).
- Models compared with simulated out-of-sample mean square forecast error (MSE) relative to MSE of benchmark AR model.

Results and conclusions

- Monte Carlo simulations show that in the small panels of macro data that are available for acceding countries AR models can be hard to beat.
- Empirical results reveal good performance of factor models for larger countries under analysis.
- Results for Slovakia and Slovenia are disappointing, partly also due to smaller number of variables.
- In “short” panels it may be better to use models with fixed structure.

Results and conclusions

- It helps adding AR components.
- Robustifying techniques against structural breaks improve forecasting precision only in few cases.
- Regarding the role of Euro area information:
    - It appears to be virtually irrelevant for forecasting in this context.
    - This finding is due to the decreased synchronisation of the Acceding Countries with the Euro area because of the convergence process, as discussed in the EFN Autumn 2003 Report.

Chapter 3. Current Accounts in Acceding Countries

Motivation

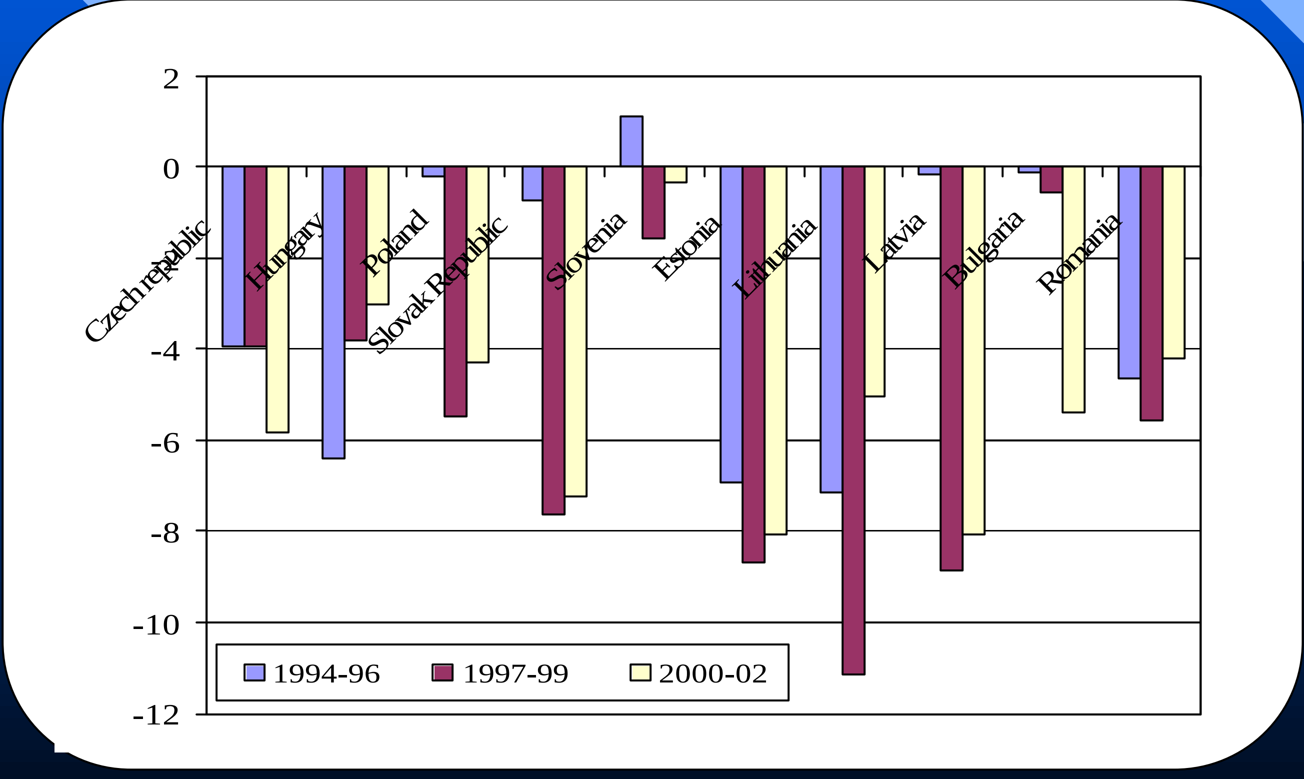
- A potential problem for the good expected performance of the Acceding Countries relates to the sustainability of their current accounts, with the episodes of exchange rate and balance of payment crisis during the 90s highlighting the danger of having too large current account deficits.
- Moreover, after the entry into the EU, they will try to join the monetary union, and the transition to the single currency will have to be designed taking into consideration current account imbalances.

Objectives

- The objectives of this chapter are the following:
  - To analyse the determinants of external (in)balances in Acceding countries.
  - To assess their sustainability.
  - And to evaluate the possible policy answers.

Current situation: diversity

- Most acceding countries show large, and in some cases widening deficits originated both by a surge in investment and by expansionary fiscal policies.



The Role of Foreign Direct Investment

Net FDI flows as a percentage of current account deficit

	1999	2000	2001	2002
Czech Republic	424.5	183.8	184.0	217.6
Estonia	75.4	110.2	100.2	23.0
Hungary	71.6	39.6	128.6	22.3
Latvia	50.5	81.0	20.7	58.8
Lithuania	40.0	55.6	76.5	96.4
Poland	58.0	93.3	108.3	54.9
Slovak Republic	63.2	292.5	83.1	196.7
Slovena	8.4	12.9	-1199.1	-466.5
Bulgaria	115.3	143.1	95.4	66.5
Romania	79.0	77.3	52.7	69.3

Sources: IFS and EBRD Transition Report 2003

How to assess sustainability?

- Using standard accounting methods, and given reasonable assumptions on real growth and interest rates, we have estimated the value of sustainable current accounts deficits.
- Looking at the results, most of the countries under analysis have sustainable external balances.
- However, projections obtained using a simple econometric model point out a widening of the imbalances in the medium term.
- And, as previously seen, the contribution of FDI will be crucial to keep the external debt under control.

Results

Sustainable current account deficit

	No FDI	Stable FDI	Baseline	Average (2000-2002)
Bulgaria	-5.7	-9.7	-11.3	-5.5
Czech Republic	-1.8	-5.8	-15.5	-5.5
Estonia	-3.3	-7.3	-12.3	-8.0
Hungary	-2.7	-6.7	-7.9	-3.0
Latvia	-6.5	-10.5	-13.0	-5.1
Lithuania	-3.6	-7.6	-9.6	-8.1
Poland	-4.5	-8.5	-10.9	-4.3
Romania	-2.4	-6.4	-6.4	-4.3
Slovakia	-2.4	-6.4	-18.1	-7.0
Slovenia	-2.4	-6.4	-8.6	-0.4

Results

Implied debt in 2007

	No FDI	Stable FDI 4% of GDP	Baseline	Debt in 2002
Bulgaria	102.3	78.3	69.3	70.9
Czech Rep.	70.4	46.4	-7.6	38.2
Estonia	114.5	90.5	60.5	51.6
Hungary	95.8	71.8	87.2	58.3
Latvia	121.3	97.3	83.6	75.6
Lithuania	92.7	68.7	56.8	43.8
Poland	61.0	37.0	43.4	35.4
Romania	63.5	39.5	40.1	30.1
Slovakia	95.0	71.0	0.8	54.4

Policy issues

- From a policy perspective, three issues stand out:
  - First, economic authorities will have to design fiscal policies so that a higher domestic savings will offset to a large extent the expected surge in investment.
  - Second, microeconomic policies aimed at guaranteeing steady inflows of FDI and at building a sound financial system capable of managing these inflows should have a top position in the policy agenda.

Policy issues

- Last, the exchange rate regimes prior to the full adoption of the Euro should allow the economy enough flexibilility to cope with large external imbalances.

Chapter 4. Monetary Transmission in Acceding Countries

Monetary transmission

- The analysis of the monetary transmission mechanism tries to describe the channels through which monetary policy decisions are transmitted to the economy and affect policy objectives.
- This analysis is especially relevant in these countries because it is clear that their goal after they are part of the European Union is to join the euro and take part in the single monetary policy.
- In fact, as more central banks move towards inflation control, good knowledge of transmission mechanism in the economy becomes crucial for implementing appropriate policies.

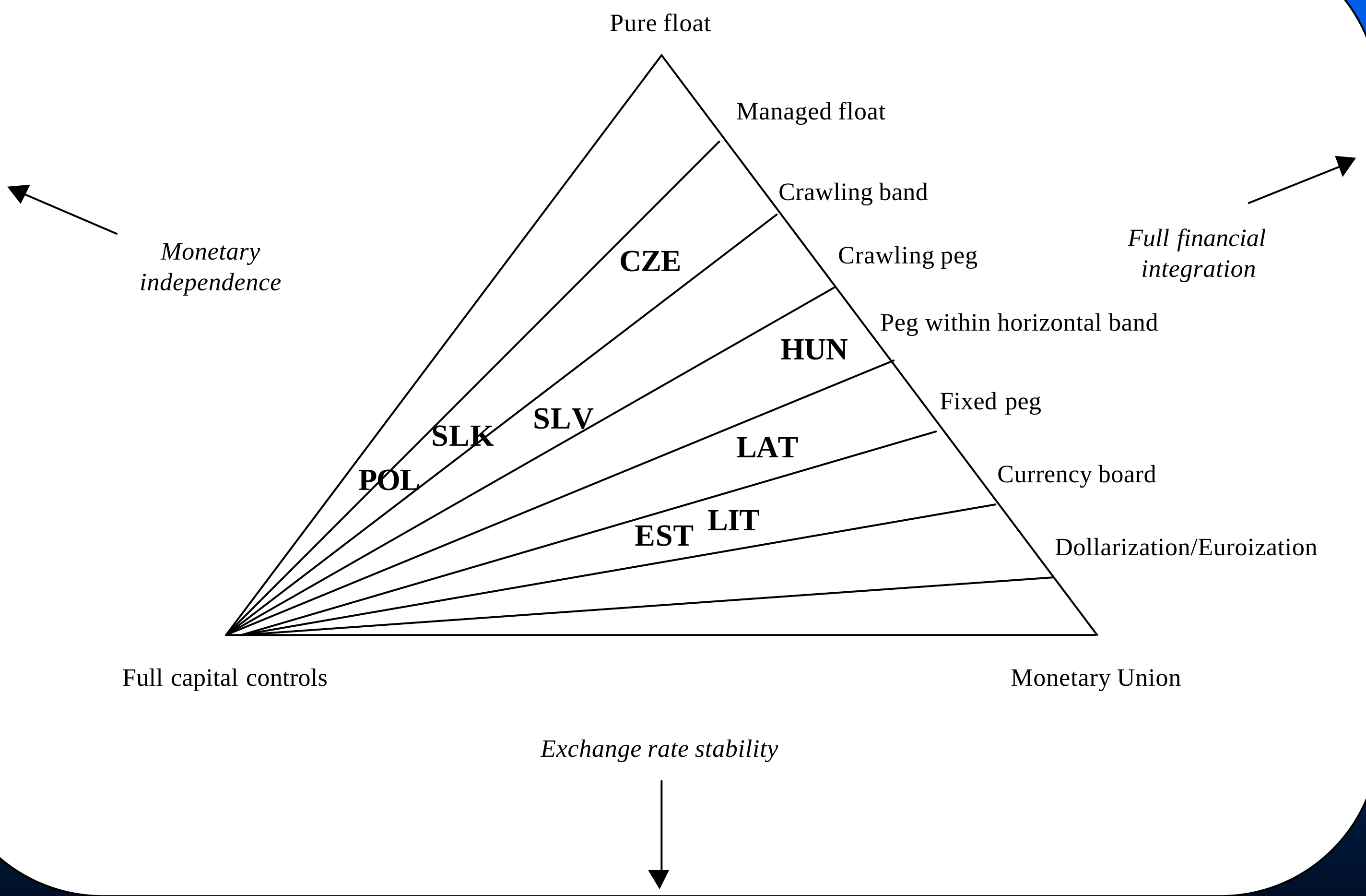
Monetary transmission

- In this chapter, we analyze the transmission mechanism in eight Acceding Countries: the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia.
- One important aspect that should be taken into account is that there is a clear link between the exchange rate regime and the way monetary policy affects real economy. In fact, the use of monetary policy (and the way it is transmitted) is not independent from the exchange rate system adopted.

Monetary transmission

- In particular, Acceding Countries that are relying on fixed exchange rates have tied hands in monetary policy. On the other hand, those countries which opted for floating exchange rate regimes, particularly free floaters with inflation targeting, retain independence in their monetary policies, while those relying on intermediate regimes, such as managed floating are somewhere in between.
- Moreover, the degree of monetary independence is not only clearly related with the exchange rate system but also with the level of capital controls in the considered economy.

Exchange rate systems



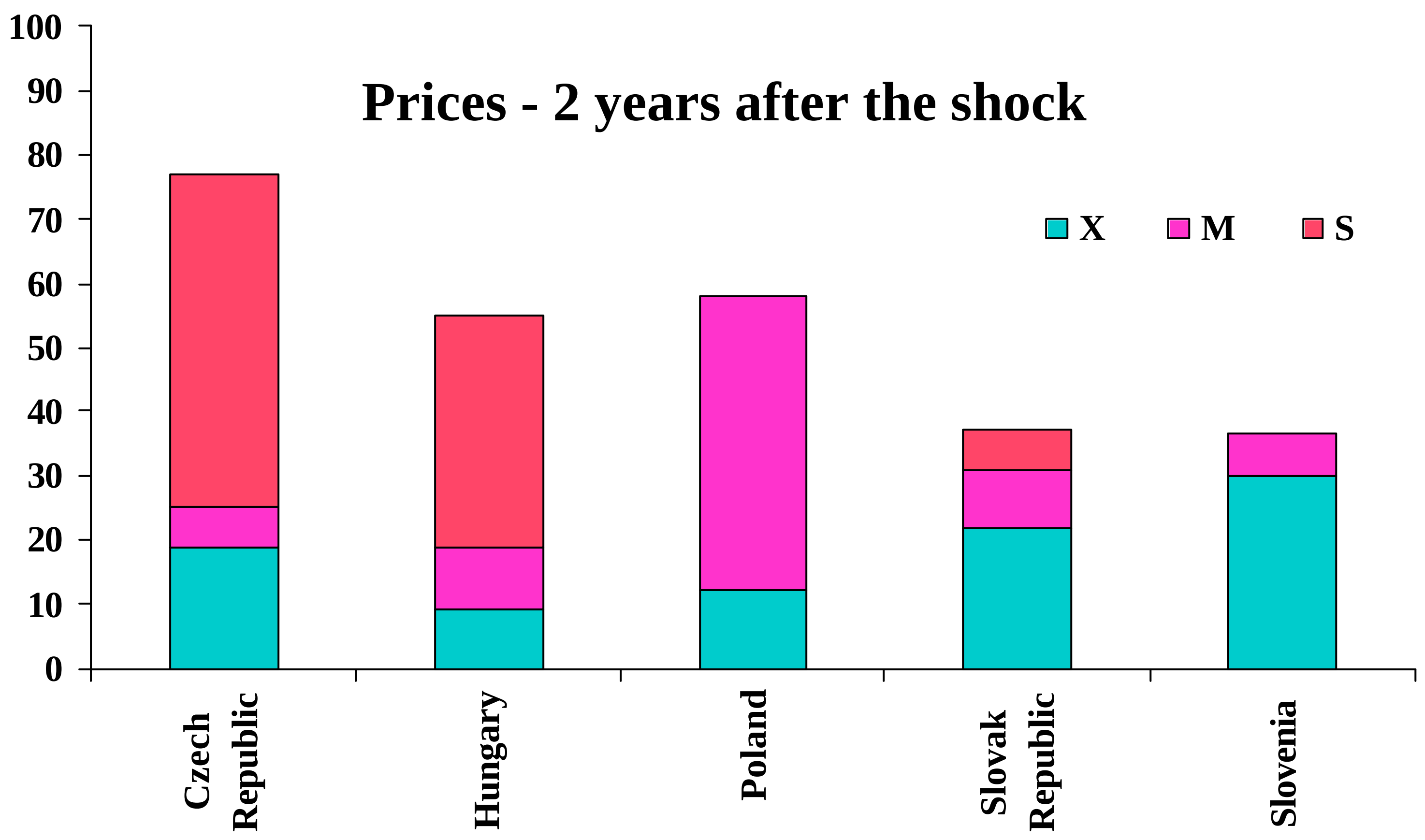
Empirical analysis

- In order to analyze the role of monetary policy and the relevance of the different monetary transmission channels, we use different VAR models trying to capture their different dynamics of the relationships between output, prices, interest rates, money and the exchange rate and taking into account their institutional differences.
- The results permits to conclude that monetary policy has been effective to fight against inflation or to stabilize output in nearly all the considered Acceding Countries. In particular, it has operated through the interest rate channel combined, in some cases, with the exchange rate channel.

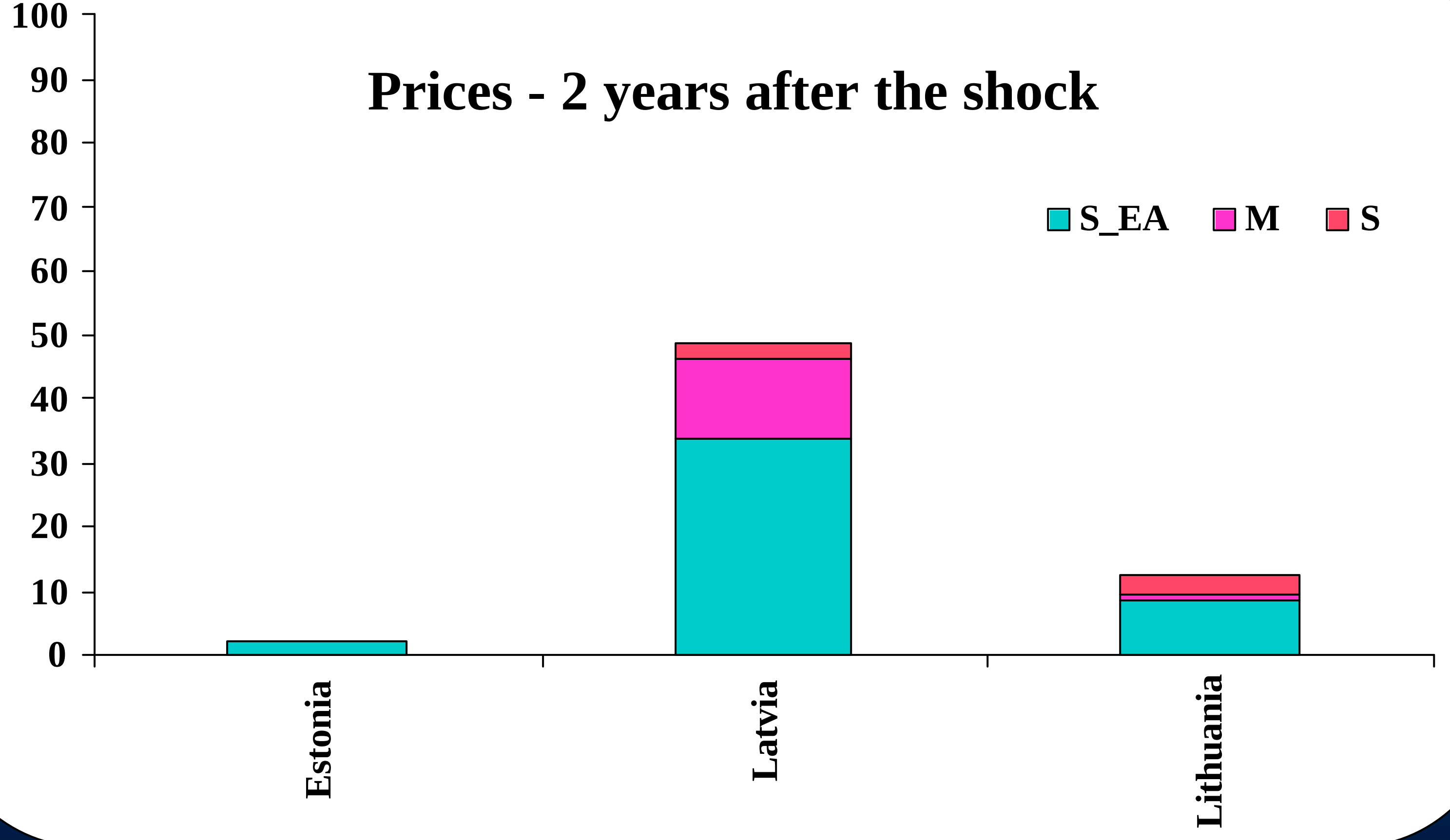
Empirical analysis

- It is worth mentioning the cases of the Slovak Republic and Slovenia, where there is clear evidence of an exchange rate channel, but the interest rate channel remains blocked.
- In this context, and given the critical importance of joining the Euro Area as soon as possible, the monetary authorities should shift to a balanced conduct of monetary policy relying on the interest rate channel that would contribute to prepare the financial sector to the ECB policy-operating environment, where monetary policy is implemented and transmitted primarily through interest rates, and only to a minor extent through the exchange rate.

Empirical evidence



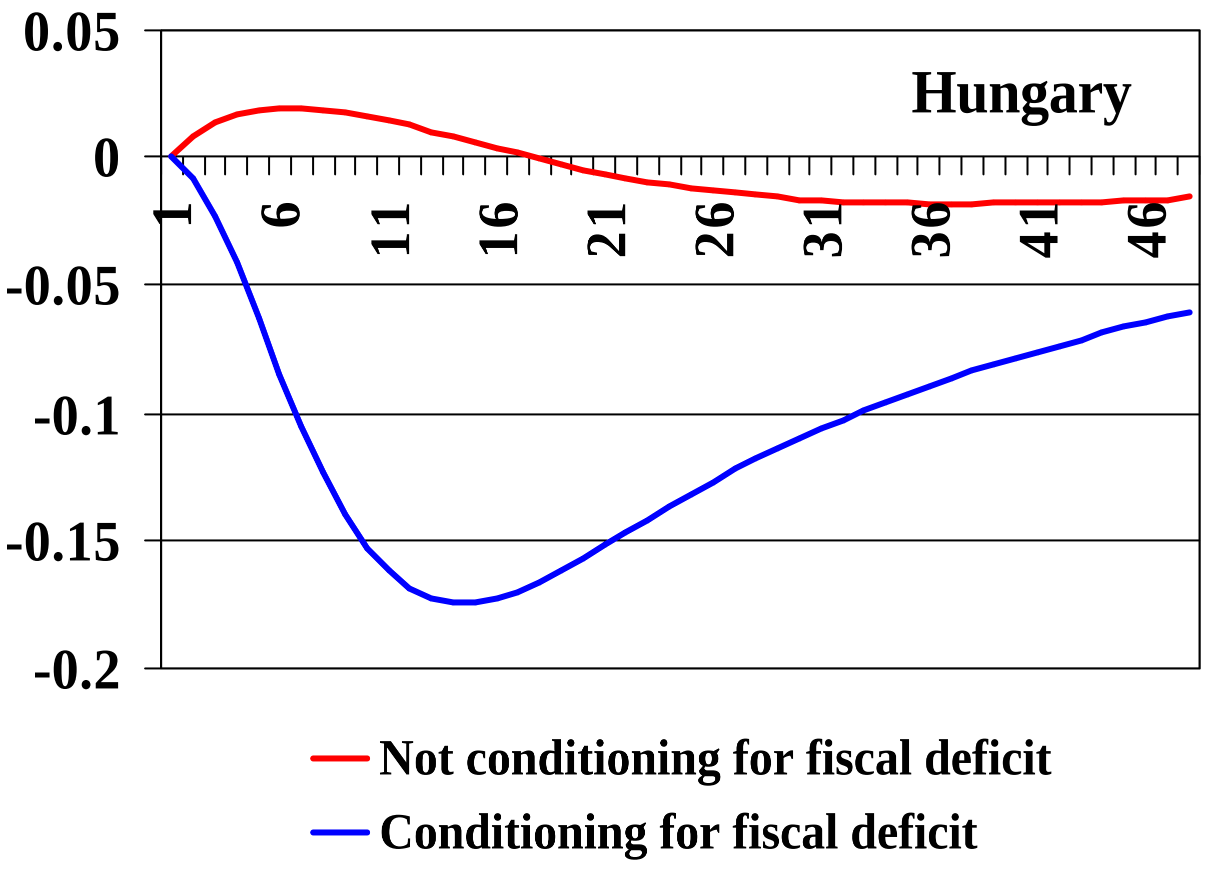
Empirical evidence



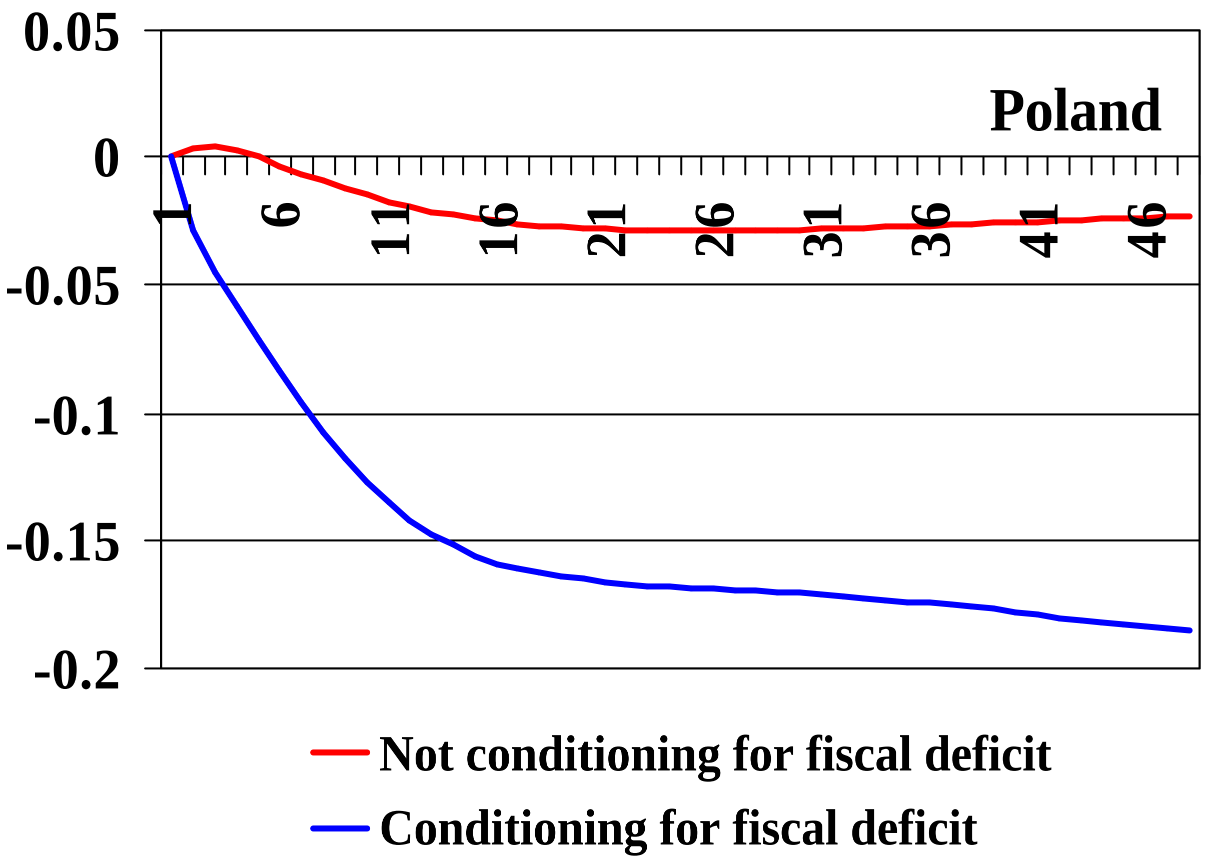
Interactions with fiscal policy

- As highlighted in the EFN 2003 Spring report, an additional aspect that should be considered when analyzing monetary policy in the context of Acceding Countries is the interactions with fiscal policy.
- From the analysis of the impulse response functions of prices to a monetary shock in these countries, it seems clear that interactions between fiscal and monetary policy have negatively affected the efficiency of the second to fight against inflation.

Empirical evidence



Empirical evidence



Conclusions

- Summarizing, it seems that monetary policy can play an important role as a stabilization tool in Acceding Countries.
- For this reason, more attention should be focused on the analysis of transmission channels using micro data on banks and firms, as it provides a better knowledge of how monetary policy works.
- The experience for current Euro Area members in the context of the Euro system Monetary Transmission Network should provide an excellent guideline.

Chapter 5. Challenges to Banking Sector Stability in Selected Acceding Countries

Motivation

- Another aspect we focus on in this report is the scope for the banking structures in the Acceding Countries to contribute to orderly financial markets and to aid the efficient allocation of capital.
- All of the Acceding Countries have made dramatic strides in improving the stability and efficiency of their banking sectors as well as eliminating restrictions on capital flows.
- However, these processes are not complete and there is the need for further progress in increasing competition.

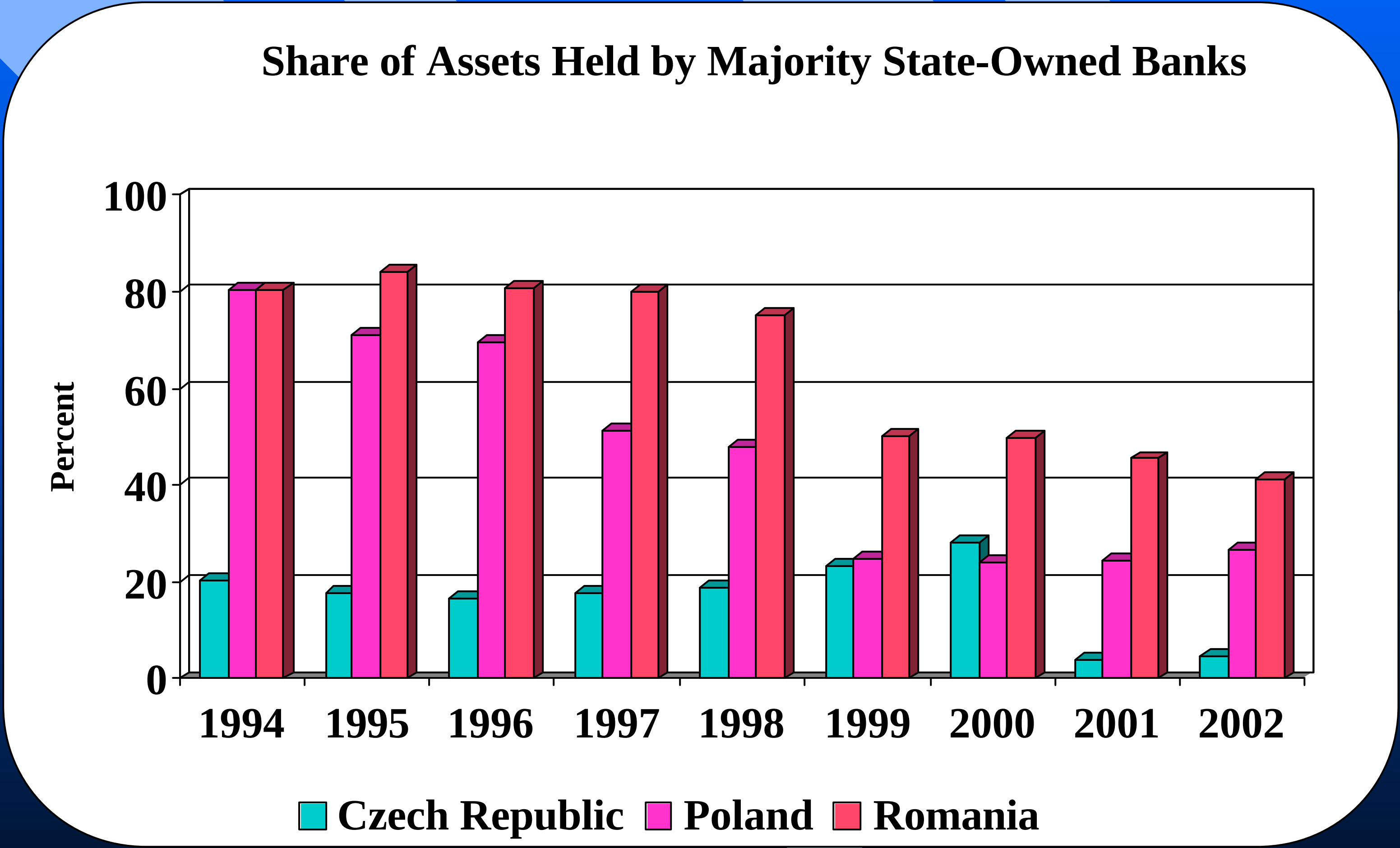
Motivation

- Extensive restructuring of the banks was required because of the substantial burden of non-performing loans that threatened their viability as financially independent institutions.
- The privatisation of the banking systems was aimed at decreasing these non-performing loans, but also at attracting capital injections and increasing efficiency.
- The growth of domestic credit has increased substantially, but the profitability remains low by EU standards and may be eroded by additional competition.

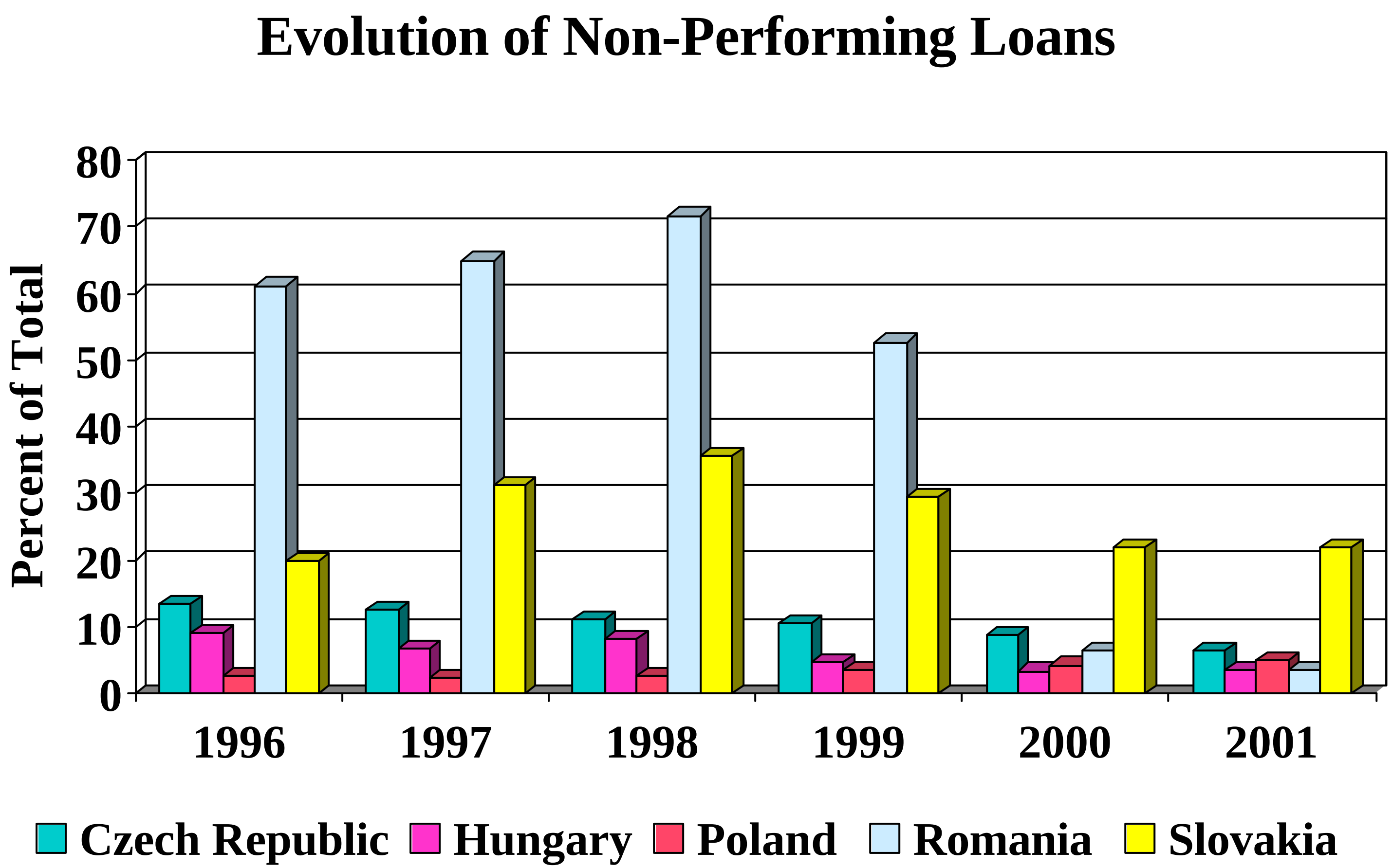
Objectives

- This chapter analysis in more detail the recent developments in the banking sector in Poland, the Czech Republic and Romania.
- In these three banking sectors, recent developments indicate significant achievements, after 1998 with the privatization and restructuring of the sector.
- Now, it is largely in private hands, dominated by foreign capital, although an extensive restructuring was required due to non-performing loans.

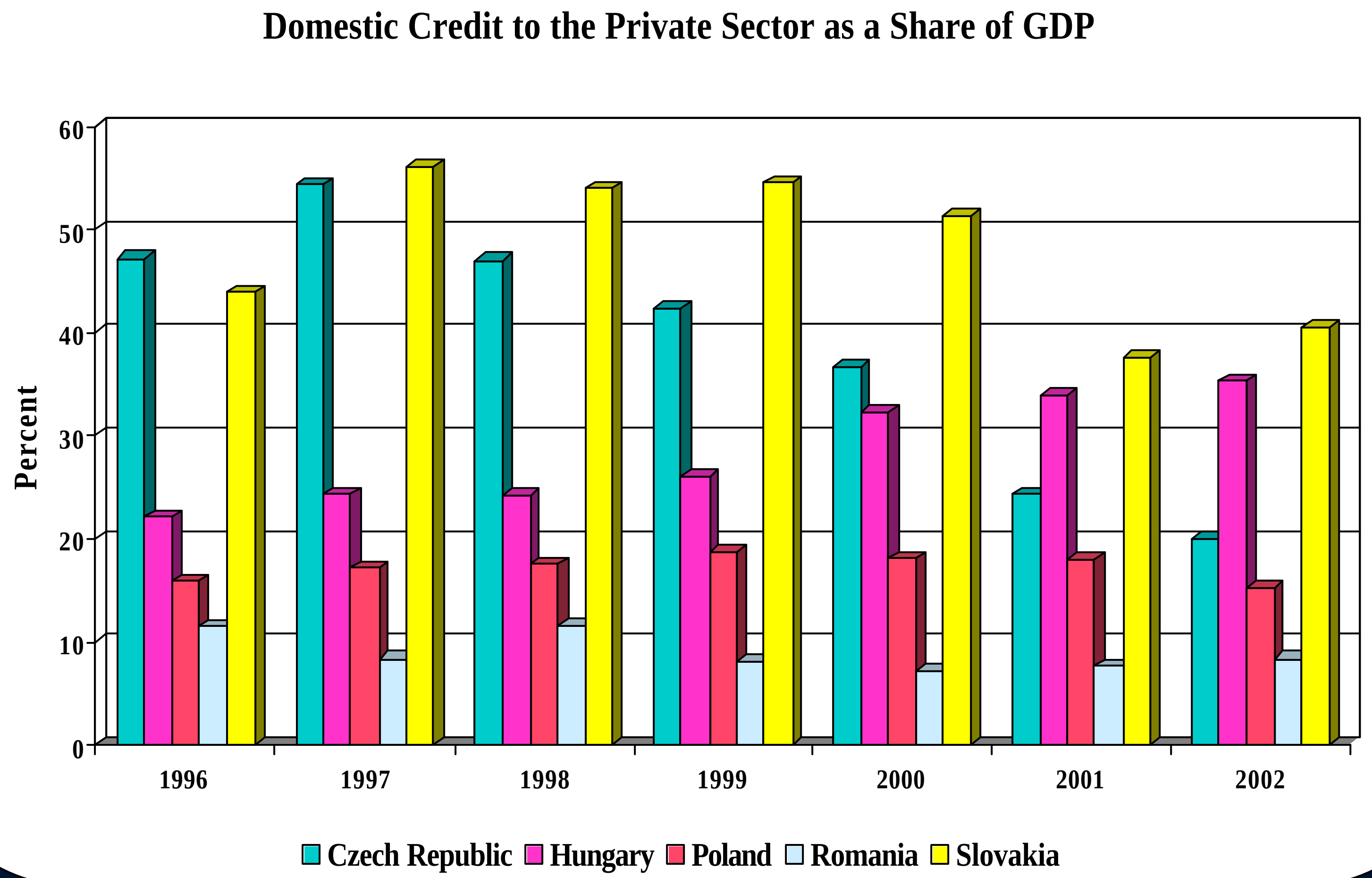
Recent developments: State-owned banks



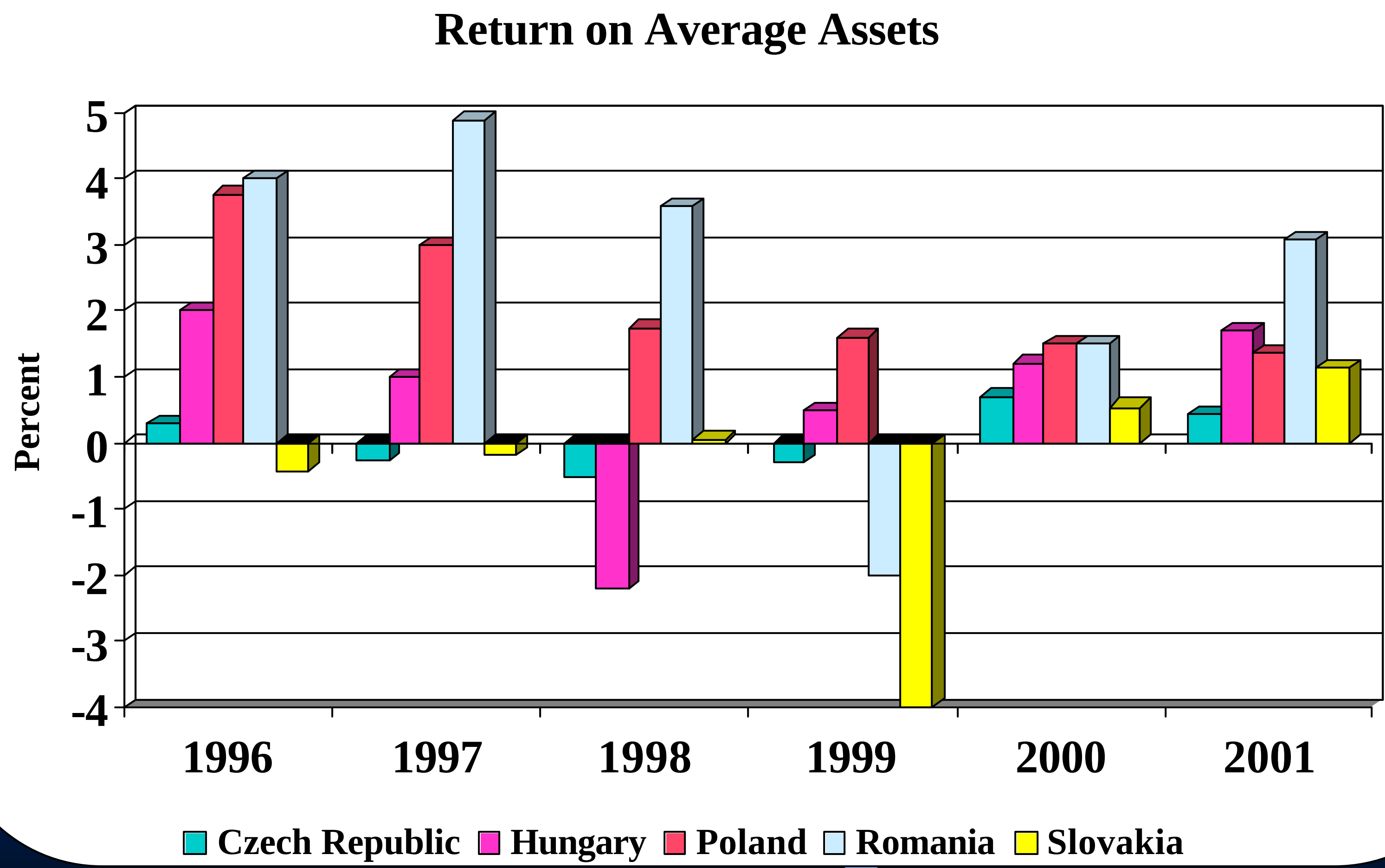
Recent developments: Non-performing loans



Recent Developments: Intermediation



Recent developments: Profitability



Assessment of the situation

- There have been improvements in the efficiency and scope of their roles in financial intermediation through restructuring and privatization, the opening of the banking markets to foreign participation and the enhancement of bank regulation and supervision, both in principle and practice.

- The Accession countries have been aided in this reform process by technical advice and resources from international financial institutions and the European Union.

Assessment of the situation

- In fact, the process of harmonizing the national legislation and practice with the EU's own banking directives has provided a critical road map for domestic policy makers and legislators in preparing the bank sectors to cope with the stresses and opportunities of the post-transition and post-accession economic and financial environment.

- However, there are certain areas where additional progress is required if there is to be substantial certainty that these bank sectors will continue to promote financial stability and provide and improved financial intermediation function and help to drive robust economic growth.

Policy advice

- In particular, it is essential to:
  - strengthen the independence of supervisory agencies,
  - enforce avoidance of conflict of interest,
  - and impose exposure limits,
  - encourage the principles of good corporate governance,
  - and improve standards for auditing.

Chapter 6. Euro Area Outlook and Forecasts

Introduction

- In this last chapter of the report, the current state of the euro area economy is analysed and forecasts for key macroeconomic variables for 2004 and 2005 are also provided.
- Forecasts are obtained either from a medium-scale macroeconometric model, or from sophisticated time series models. The forecast accuracy and statistical adequacy of the models have been carefully checked.

Economic outlook for 2004 and 2005

- A first aspect to highlight from the results in our previous report, is that the joining of Acceding Countries to the European Union will not substantially increase growth perspectives in the Euro area (they represent less than 5% of overall GDP).
- The recovery of the world economy is on the way. After the new economy bubble, the ICT sector has come up with new innovations (consumer electronics).
- US and Asia are the centres of the global upswing. Acceleration of growth is due to a strong rebound of business investment. Due to advances in productivity, the upturn has not reached the US labour market yet. Risk of jobless growth.

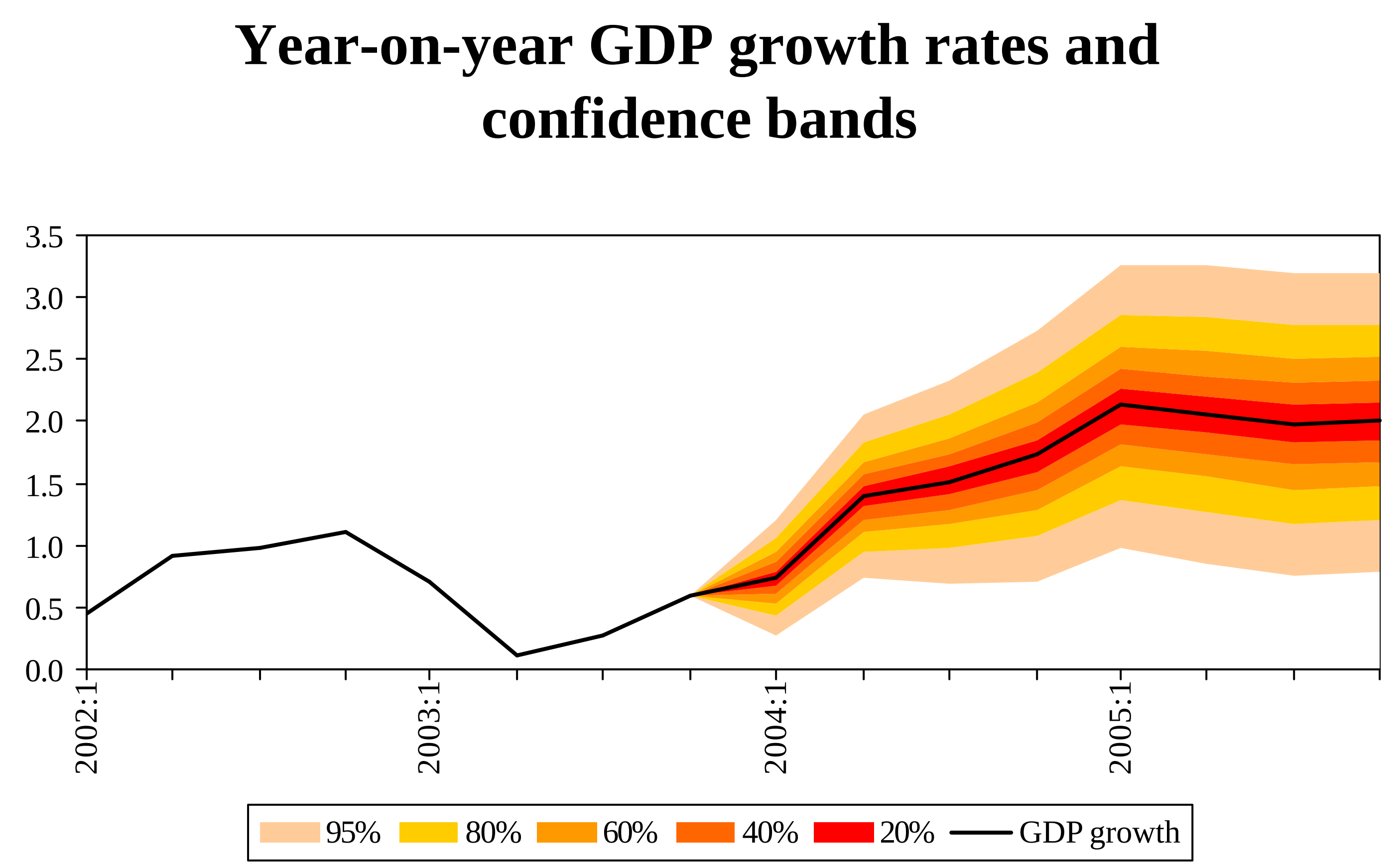
Expected evolution of the world economy

	2004	2005
US GDP Growth Rate	4.6	3.7
US Consumer Price Inflation	1.7	1.9
US Short Term Interest Rate	1.2	1.8
US Long Term Interest Rate	4.1	4.2
Japan GDP Growth Rate	2.8	1.6
Japan Consumer Price Inflation	-0.2	-0.2
Japan Short Term Interest Rate	0.1	0.1
Japan Long Term Interest Rate	1.3	1.3
World Trade	8.2	8.2
Oil Price	30.0	30.0
USD/Euro Exchange Rate	1.20	1.14
100Yen/Euro Exchange Rate	1.21	1.13

Economic outlook for 2004 and 2005

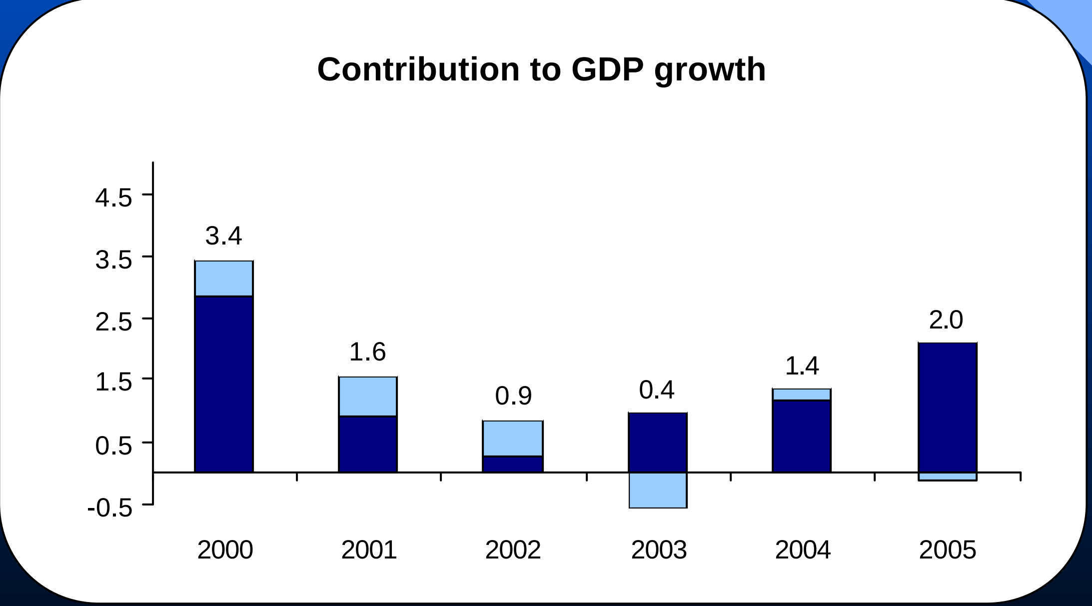
- However, the Euro area has lagged behind.
- Consumption hampered by weak performance of labour markets (decline of labour participation), unsolved problems in financing the social security (pensions and health) system and the need of public consolidation.
- Investment is supported by favourable monetary conditions. But, sales perspectives are not optimistic. Since productivity tend to improve, a decline in real unit labour costs is forecasted at least for 2005. But this will not compensate for the recent increase in this measure. Thus, investment will mainly accelerate to ensure competitiveness in international markets.
- Exports have been stimulated by the acceleration of world trade.

Economic outlook for 2004 and 2005



Economic outlook for 2004 and 2005

- Euro area growth will be driven by the evolution of domestic components (dark area), while the contribution of net exports is expected to be minor: exports profit from the global upturn, but effects will be partly compensated by the Euro appreciation. Due to the modest recovery in demand and the appreciation, imports tend to increase.



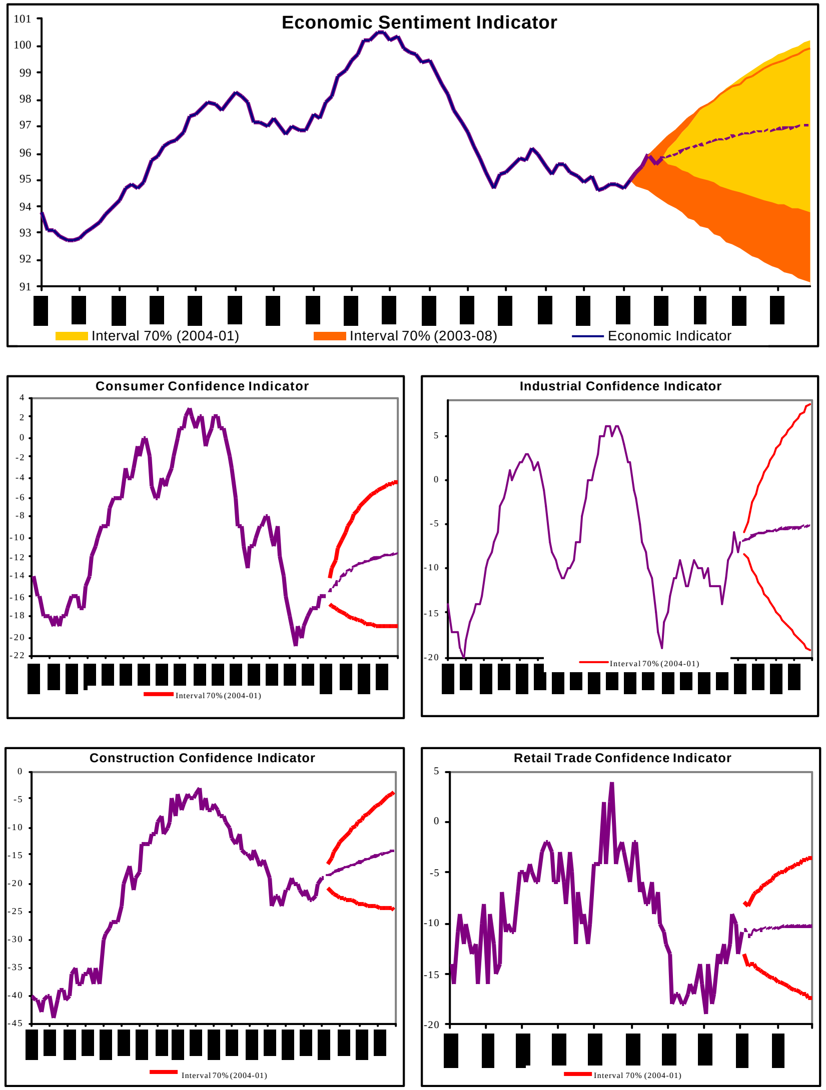
Expected developments

	2001	2002	2003	2004: 1st half		2004: annual		2005: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	1.6	0.9	0.4	1.1	0.7 1.4	1.4	1.0 1.8	2.0	1.4 2.7
Potential Output	2.5	2.4	1.9	1.9	1.6 2.3	1.9	1.5 2.5	1.7	1.0 2.4
Private Consumption	1.8	0.1	1.0	0.8	0.3 1.3	1.1	0.6 1.5	1.7	1.0 2.4
Government Consumption	2.4	2.7	1.9	2.0	1.7 2.4	2.0	1.6 2.4	1.8	1.2 2.3
Fixed Capital Formation	-0.1	-2.9	-1.2	0.2	-1.3 1.7	1.0	-0.7 2.7	3.5	1.1 5.7
Exports	3.3	1.7	0.0	3.9	2.6 5.1	4.8	3.3 6.3	7.2	4.8 9.3
Imports	1.7	0.1	1.5	3.6	2.2 5.0	4.7	3.2 6.2	7.6	5.3 10.0
Unemployment Rate	8.0	8.4	8.8	8.8	8.6 9.0	8.9	8.6 9.1	8.8	8.3 9.2

Percentage change in the average level compared with the same period a year earlier, except for unemployment rate and NAIRU that are expressed in levels. Point forecasts and 80% confidence bounds are taken from EFN forecasting model and based on 2000 stochastic simulations.

Economic outlook for 2004 and 2005

- Labour market prospects will not improve in 2004 and 2005 with unemployment close to 9%.
- Related to this fact, expectations of households and firms are not overwhelmingly optimistic, as shown by the indicator of economic sentiment. While the observations in the last quarter of 2003 are in the upper band of the forecast interval, the improvement has slowed down since then.
- The results are also similar when looking at the different components of the economic sentiment indicator: consumer, industrial, construction and retail trade.



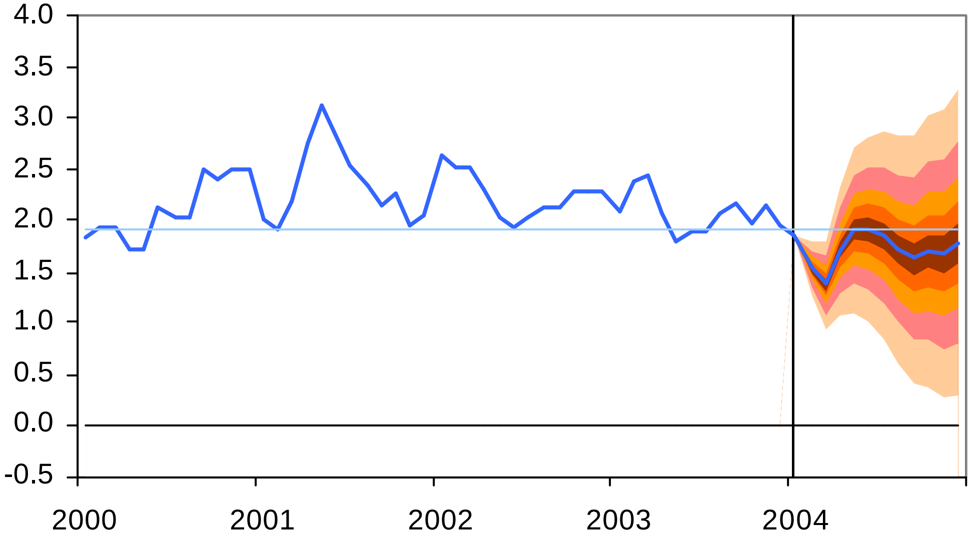
Source: Eurostat & IFL.
Date: March 2004.

Economic outlook for 2004 and 2005

- Regarding inflation, in the last five months, it behaved quite closed to our previous forecasts.
- The monthly profile forecast for the year-on-year inflation rate during 2004 and 2005 shows some oscillations, with low values in February and March of 2004 and a subsequent recovery from April.
- The year-on-year inflation in 2005 shows an increment at the end of the year.

Economic outlook for 2004 and 2005

ANNUAL FORECASTS FOR THE EMU INFLATION
(year-on-year rates)



Confidence intervals at: 95% 80% 60% 40% 20%

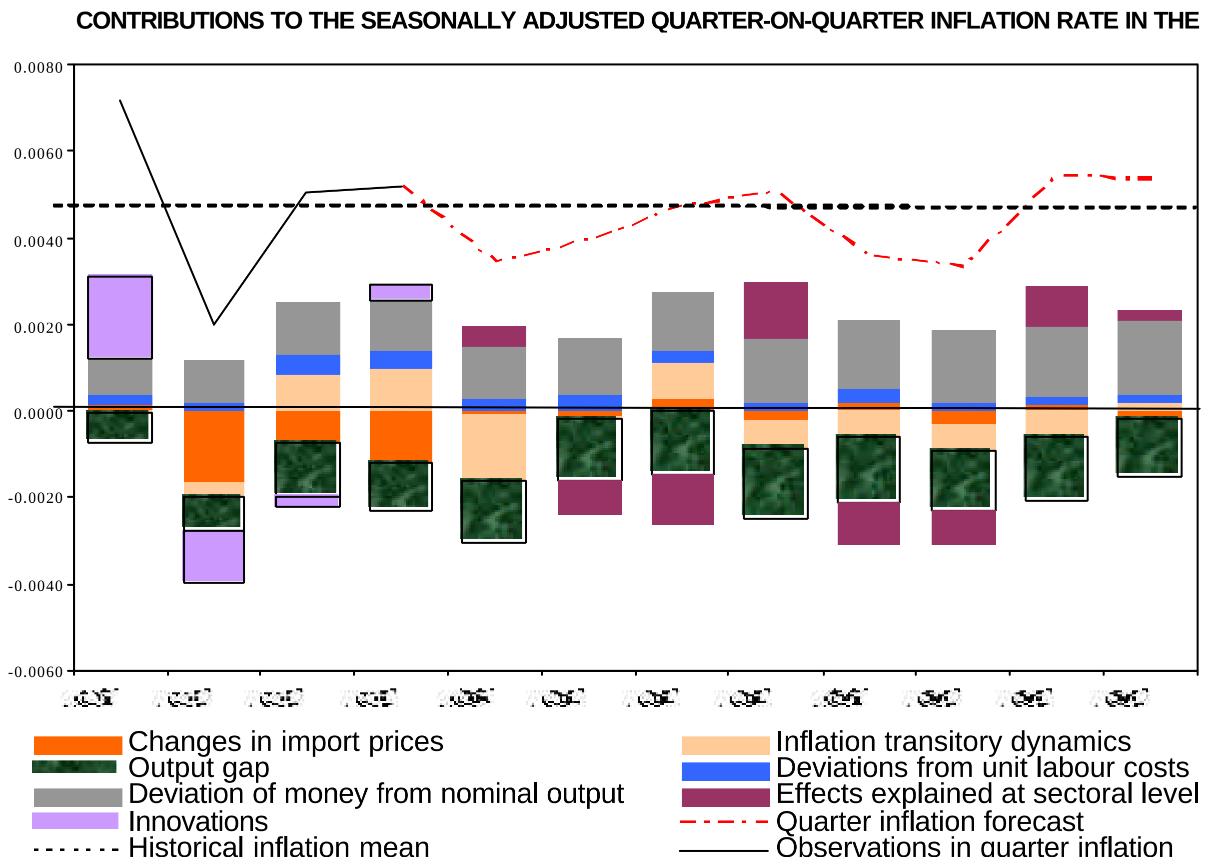
Historical Inflation mean (1995-2003)

Source: Eurostat & IFL Date: March 2, 2004

Economic outlook for 2004 and 2005

- A causal explanation of the inflation expected is also given in the report by relating forecasts from disaggregated time series models with the forecasts from the macroeconometric model.
- The results from this analysis permit to conclude that at the end of 2005, the output gap will not compensate other factors pushing inflation and, then, a tighter monetary policy could be adopted.

Economic outlook for 2004 and 2005



The contributions refer to the deviations of inflation rate from their mean.

Expected developments

	2001	2002	2003*	2004: 1st half		2004: annual		2005: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
NAIRU	8.6	8.3	8.2	8.3	8.1 8.5	8.4	8.2 8.6	8.6	8.2 9.0
Labour Costs	3.3	3.4	2.9	2.6	2.4 2.8	2.7	2.5 3.0	3.1	2.7 3.5
Labour Productivity	0.4	0.3	0.5	0.5	-0.1 1.1	0.8	0.1 1.4	2.0	1.1 2.9
HICP	2.3	2.2	2.1	1.8	1.2 2.3	1.8	1.1 2.5	1.9	1.0 2.9
IPI	0.5	-0.5	0.4	1.5	1.3 1.6	2.1	1.2 3.2		

Percentage change in the average level compared with the same period a year earlier, except for unemployment rate and NAIRU that are expressed in levels. Point forecasts and 80% confidence bounds are taken from EFN forecasting model and based on 2000 stochastic simulations.

Highlights for the Euro area economy

- The euro area will grow by 1.4% in 2004 and 2.0% in 2005.
- Inflation in the HICP is forecast to average 1.8% in 2004 and to slightly increase in 2005 to 1.9%.
- Exports will increase by 4.8% in 2004 and by 7.2% in 2005 as a result of the recovery in world trade.
- Investment remains weak, increasing only by 1.0% in 2004 but starting a more clear recover in 2005 rising 3.5%.
- Private consumption, after growing by only 1.0% in 2003, rises by 1.1% in 2004 and 1.7% in 2005.
- Unemployment rate will stay around 8.8% during the two years.

Comparison of EFN forecasts with alternative forecasts

- The comparison with alternative forecasts (European Commission, IMF, ECB, OECD and Consensus Economics Inc.) is biased because of the different information sets.
- For both years of the forecasting horizon, the EFN outlook is more pessimistic, in particular regarding the development of private consumption.
- All inflation forecasts show a nearly constant inflation rate in the years of the forecasting horizon.

Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF	
	2004	2005	2004	2005	2004	2005
GDP	1.4	2.0	1.8	2.3	1.9	-
Private Consumption	1.1	1.7	1.6	2.0	1.9	-
Gov. Consumption	2.0	1.8	1.3	1.4	1.4	-
Fixed Capital Form.	1.0	3.5	2.4	3.0	3.1	-
Unemployment rate	8.9	8.8	9.1	8.9	9.2	-
HICP	1.8	1.9	1.9	1.7	1.6	-

	ECB		OECD		Consensus	
	2004	2005	2004	2005	2004	2005
GDP	1.6	2.4	1.8	2.5	1.7	2.1
Private Consumption	1.6	2.2	1.7	2.4	1.4	2.0
Gov. Consumption	1.1	0.8	1.0	1.0	1.5	1.2
Fixed Capital Form.	1.7	3.9	2.3	3.9	2.1	3.3
Unemployment rate	-	-	9.0	8.7	8.8	8.6
HICP	1.8	1.6	1.5	1.4	1.7	1.6

Changes from previous EFN outlooks

- The growth rates of GDP and most demand components, in particular private consumption, have been successively revised downwards.
- This points to a central policy task for Euro area growth: confidence of private households is of key importance.
- This can be achieved by means of more sustainable policies concerning public households and social security systems. This would also contribute to a more optimistic outlook on business investment. Higher investment rates will strengthen potential GDP and productivity growth, thereby supporting the competitiveness of Euro area products in international markets.

Changes from previous EFN outlooks

	Spring 2003		Autumn 2003		Spring 2004	
	2003	2004	2003	2004	2003	2004
GDP	1.2	2.1	0.5	1.5	0.4	1.4
Private Consumption	1.0	2.0	1.1	1.3	1.0	1.1
Government Consumption	1.8	1.3	1.9	2.0	2.0	2.0
Fixed Capital Formation	0.9	4.3	-1.8	1.2	-1.2	1.0
Exports	3.3	6.3	-0.5	4.0	0.0	4.8
Imports	4.0	7.7	1.4	3.9	1.5	4.7
Unemployment rate	8.8	9.0	9.0	9.3	8.8	8.9
HICP inflation	2.4	1.8	2.1	1.7	2.1	1.8
Industrial Production	0.8	2.0	-0.1	1.4	0.4	2.1

Policy implications

- Modest Euro area growth is due to weak evolution of domestic demand, in particular private consumption. Thus, it is important for policies to restore confidence of private households, that could also have positive effects on investment.
- Higher investment rates will strengthen potential GDP and productivity growth, thereby supporting the competitiveness of Euro area products in international markets.
- Expansionary US style fiscal policy is not feasible in the Euro area and real interest rates are already close to zero or negative. However, the outlook permit to concludes that a tighter monetary policy could be adopted in the second half of 2005.

Policy implications

- The stronger exchange rate of the euro damages net exports, but we do not expect further appreciation because Dollar pessimism does not rest on economic grounds. In this context, the ECB should not depart from its strategic focus on internal stability.
- The best provision against the pressure from an appreciation would be to convince Asian monetary authorities of the merits of more flexible exchange rates. This would mean that the effects of the Dollar volatility were spread more evenly instead of falling predominantly on Euro area producers.

European Forecasting Network

Next report: Autumn 2004