Box 4

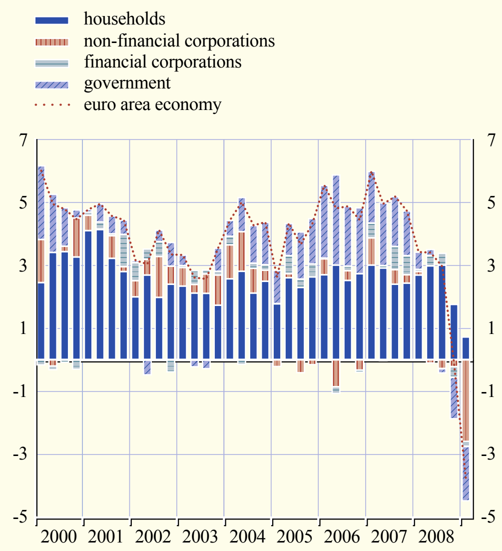
INTEGRATED EURO AREA ACCOUNTS FOR THE FIRST QUARTER OF 2009

The integrated euro area accounts released on 30 July 2009 offer comprehensive and consistent information on the income, spending, financing and portfolio decisions of all sectors of the euro area economy up to the first quarter of 2009,[1] and show how economic agents have reacted to the acute contraction of activity brought about by the intensification of the financial crisis and the associated rise in uncertainty since September 2008. Relative to other data sources, the euro area accounts offer three main benefits. First, they include some new information not previously reported, in particular on the non-financial private sectors (households and non-financial corporations). Second, they contain consistent information on each institutional sector taken as a whole, integrating the financial and non-financial sides of the accounts. Third, they bring together the data within a unified framework, thus enhancing the scope for analysing interactions between financial and real economy variables, as well as interrelations across institutional sectors.[2]

Following a moderate cyclical slowdown in production and income up to the summer of 2008, the euro area economy recorded an exceptionally large contraction of activity in the fourth quarter of 2008 and in the first quarter of 2009, when disposable income of the euro area as a whole experienced the largest annual nominal decline on record, impacting all sectors, with the non-financial corporations sector the most severely affected (see Chart A).

Chart A Euro area gross disposable income-contribution by sectors

(annual percentage changes; percentage point contributions)



Sources: Eurostat and ECB.

Behaviour of institutional sectors

In the first quarter of 2009, the growth of *households'* nominal income declined again, continuing along the path of rapid slowdown that had started in the last quarter of 2008. The pronounced deceleration in the growth

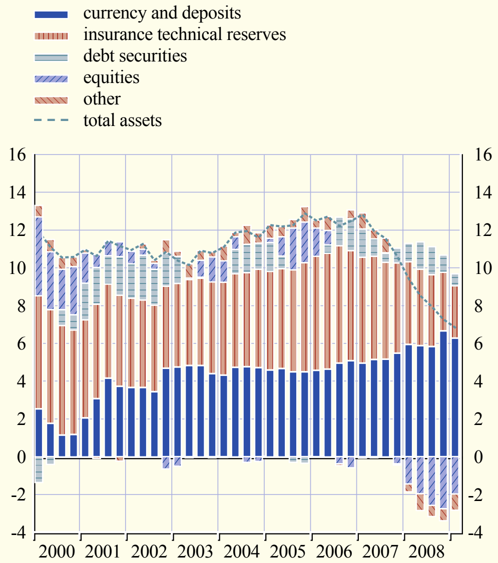
1 These data can be found on the ECB's website at http://sdw.ecb.europa.eu/browse.do?node=2019181.

2 For an introduction to the euro area accounts, see the article entitled "The introduction of quarterly sectoral accounts statistics for the euro area" in the November 2007 issue of the Monthly Bulletin.

of compensation of employees (and self-employment income) was somewhat mitigated by a large positive net impact of social transfers and a substantial increase in net interest received (reflecting a larger decrease in interest paid than in interest received). Although a renewed and sizeable deceleration in the consumption deflator supported real disposable income growth, worsening employment prospects, as well as adverse confidence effects associated with weaker housing markets and another steep drop in household net financial worth (mainly as a result of losses on shares), prompted a deeper retrenchment of real consumption (which fell by 1.3%, year on year, in the first quarter of 2009) and a further marked increase in savings (whose composition is structurally dominated by wealthier households). Thus, the household saving ratio again increased rapidly to 14.8% in the first quarter of 2009 (on a four-quarter moving sum basis), 1 percentage point up on the year before, thereby returning to the peak seen in 2002-03. Coupled with falling household capital investment (mainly housing), this resulted in a further large rise in households' net lending,[3] and in reduced loan borrowing. On the financial assets side, the heightened uncertainty continued, resulting in a preference for liquidity, namely currency and deposits, a reduction in holdings of riskier assets (shares) and a slower accumulation of less liquid assets (insurance technical reserves) – see Chart B.

Chart B Households' financial investment

(four-quarter moving sum; percentage of gross disposable income)



Source: ECB.

As a result of both the sharp contraction in activity and the rapid decline in inflation in the first quarter of 2009, the nominal value added of *non-financial corporations* (NFCs) fell markedly, namely by 5%, year on year. Their gross operating surplus also decreased sharply as compensation of employees was not adjusted as rapidly as activity, despite considerable further efforts to keep labour costs contained. Savings by NFCs, which had been resilient in the fourth quarter of 2008, shrank abruptly. Against the background of falling global demand, dropping capacity utilisation and persistently tight financial conditions, the annual growth of NFCs' capital formation contracted sharply (by 15.6%, compared with an increase of 6.5% in the third quarter of 2008). Even so, NFCs' net borrowing increased further in the first quarter of 2009 (on a four-quarter moving sum basis) as the adverse impact of the recession on profit margins outweighed investment cutbacks. The annual growth rate of NFCs' external financing slowed further and its composition changed. Net incurrence of loans dropped to very low levels in the first quarter of 2009 (to €31 billion in the quarter, compared with €156 billion a year earlier), largely reflecting the impact of net redemptions of short-term loans on the back of a reduced need for working capital, in particular on account of reduced inventories. Issuance of debt securities,

3 The net lending/net borrowing of a sector is the balance of its capital account, i.e. measuring the excess of saving and net capital transfers received over capital investments (net lending) or the reverse (net borrowing). It is also the balance of the financial accounts, measuring the difference between transactions in financial assets and transactions in liabilities. Chart C depicts the net lending/net borrowing by sector, as a percentage of GDP.

by contrast, picked up further in the first quarter of 2009, rebounding strongly after the complete freeze observed in the securities market in the wake of the bankruptcy of Lehman Brothers. The reopening of this market, albeit at high yields, offered an attractive substitute for bank financing, with banks arranging issuance for a fee, instead of carrying assets on their balance sheets. The dynamic issuing activity probably also reflected a growing need for finance by firms that had postponed issuance in the first part of 2008, or attempts to lock in more favourable financing conditions in the corporate bond market. Similarly, issuance of quoted shares picked up as well. At the same time, NFCs again reduced their net purchases of quoted equity in the first quarter of 2009, and continued to draw down their liquidity buffers, as their accumulation of deposits decelerated further, while the pace of net disposals of securities and mutual fund shares slowed down.

The further and rapid deterioration of the *general government* accounts largely reflected the impact of automatic stabilisers, with an increase in the growth of social benefit expenditure, a sharp decline in the growth of social contributions, falling indirect taxes and declining direct taxes on households and NFCs. Treasuries continued to step up their debt issuance considerably in the first quarter of 2009, in order to finance not only existing deficits, but also the large-scale purchases of assets (loans, debt securities and unquoted equity) carried out in the context of financial rescue packages (around €190 billion in the fourth quarter alone) and massive accumulation of cash. This increasing net debt issuance was absorbed by accelerated MFI purchases, seeking safe placements, rather than directly by households, while non-residents likewise remained large-scale purchasers thereof.

The disposable income of *financial corporations* contracted, albeit less rapidly than in the fourth quarter of 2008, but remained at a high level. This decline was due mainly to reduced net interest earned, while the gross operating surplus grew solidly, the latter reflecting increased bank margins on deposits and loans (which, according to national accounts conventions, are not recorded under "interest" – but rather as "output", thus entering value added) and falling compensation of employees. In the context of ongoing pressures for deleveraging, additions to their balance sheets decreased markedly (at less than €100 billion per quarter in the fourth quarter of 2008 and the first quarter of 2009, compared with up to €1 trillion per quarter during the preceding leverage boom) and entailed a shift towards safer assets, with massive acquisitions of government securities and a general reduction of cross-border exposures.

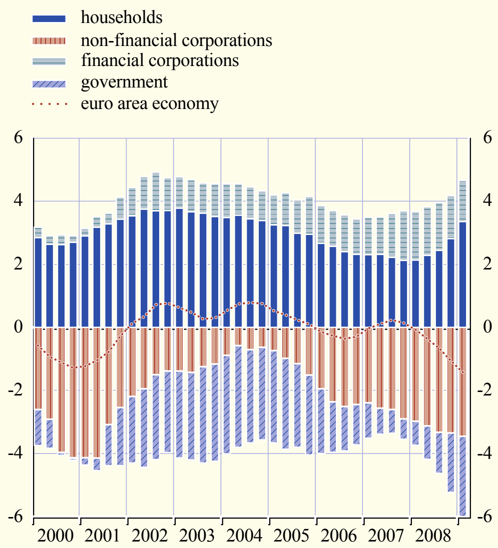
Euro area income and net lending/net borrowing

Gross disposable income in the euro area fell by 3.8%, year on year, in nominal terms in the first quarter of 2009 (after -0.1% in the fourth quarter of 2008 and +3.0% in the third quarter of 2008), on the back of the sharp contraction in nominal GDP. The disposable income of NFCs, which had hitherto held up well, shrank by 22.9%, year on year, in the first quarter of 2009 (after -2.9% in the fourth quarter of 2008). Household income growth continued to decelerate, with year-on-year growth standing at 1.1% (after 2.7% in the fourth quarter of 2008 and 4.7% in the third quarter). Government gross disposable income again dropped sharply, namely by 8.6%, year on year, in the first quarter of 2009, after -5.2% in the fourth quarter of 2008. The net disposable income of financial corporations also fell in year-on-year terms in the first quarter of 2009 (see Chart A).

The decline in gross saving for the euro area as a whole accelerated dramatically in the first quarter of 2009 (to -18.8%, year on year, after -7.6% in the fourth quarter of 2008), with the sharp reduction in saving by the government and NFCs (in roughly equal measure) more than compensating for increased household saving. Gross fixed capital formation in the euro area, which had started abruptly to fall on a year-on-year basis in the fourth quarter of 2008, contracted more rapidly in the first quarter of 2009, namely by 10.6%. Nominal capital investment was retrenched in the case of both households (residential investment and capital formation by unincorporated businesses, -11.6% in the year to the first quarter of 2009) and NFCs (-12.8%, after -4.9% in the fourth quarter of 2008 and +5.8% in the third quarter of 2008).

Chart C Euro area net lending/net borrowing

(as a percent of GDP; four-quarter moving sum)



Sources: Eurostat and ECB.

As saving contracted more than capital investment, net lending/net borrowing in the euro area deteriorated yet again, to a deficit of 1.4% of GDP in the first quarter of 2009 on a four-quarter moving sum basis. This development over one-and-a-half years was due, in about equal measure, to a deterioration of the trade balance and to reduced net property income received. From a sectoral point of view, the negative trend in euro area net lending/net borrowing reflects the sharp increase in net borrowing by the government sector, which was higher than the increase in net lending by households (see Chart D).

The euro area thus again had a net financing requirement. The protracted financial turbulence led to a considerable slowdown in gross cross-border transactions in both the fourth quarter of 2008 and the first quarter of 2009. As interbank cross-border relationships were seriously affected by the insolvency of Lehman Brothers, substantial redemptions of interbank deposits were reported, after elevated "net inflows" (i.e. inflows net of outflows) in the three previous quarters. Accelerated net inflows in debt securities compensated for these significantly reduced net inflows in deposits. Furthermore, the euro area recorded net annual outflows in equity securities (notably quoted shares) and loans.

Non-financial sectors financing and the financial markets

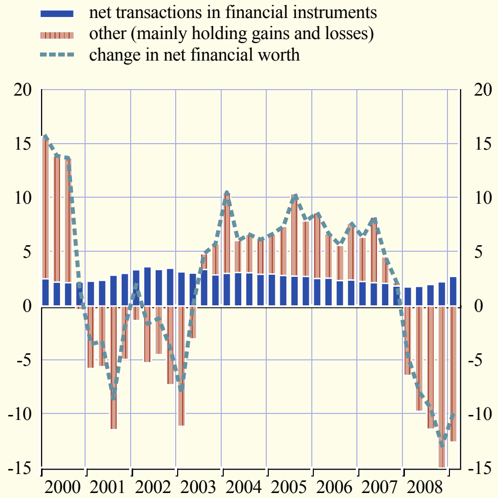
After the rebound observed in the fourth quarter of 2008, caused by very active government debt issuance, the annual rate of growth in the total financing of the non-financial sectors resumed its course of gradual moderation, as non-government financing continued to slow down.[4] On the financial investment side, net acquisitions of financial assets by the non-financial sectors slowed down as well, after a government-driven rebound in the fourth quarter of 2008.

4 The annual growth rate of total financing available from the euro area accounts is more subdued than the growth rate of the financing components available from both the ECB's money and banking statistics and its securities statistics, owing to a broader coverage and other methodological differences.

Viewed in terms of individual instruments, the market for *debt securities* saw a further massive increase in net issuance by the government. MFIs were large net purchasers of debt securities (notably government debt securities), while their net issuance remained negative for the second consecutive quarter. NFCs, too, increased their net issuance. The rest of the world expanded its net purchases, while purchases by both households and insurance corporations and pension funds declined. In the market for *mutual funds*, net redemptions accelerated (with considerable redemptions in non-money market mutual fund shares). In the market for *quoted shares*, there was a resumption of net issuance by NFCs and financial corporations. NFCs diminished their purchases, and households and the rest of the world suspended their massive selling, while MFIs continued to sell holdings of quoted shares.

Chart D Change in net financial worth of households

(four-quarter moving sum; percentage of gross disposable income)



Source: ECB.

Balance sheet dynamics dominated by holding losses

Balance sheet movements were often dominated by valuation changes, i.e. holding gains or losses, during recent quarters. In particular, falling global equity prices had a negative impact on the net financial worth[5] of households, in the order of a cumulated €1.1 trillion in the year up to the first quarter of 2009. Chart D shows the contributions of financial transactions (i.e. the net lending/net borrowing) and other economic flows (mostly holding gains or losses) to the change in the net financial worth of households. Valuation changes (and other flows) constitute the most volatile component of the change in their net financial worth. At the same time, in the bond market, increases in the prices of government bonds (and exchange rate effects) over the three most recent quarters translated into substantial holding gains, which offset the large holding losses on the "toxic assets" held by financial corporations.[6]

5 Defined as the difference between financial assets and liabilities.
6 It should be noted that, where loans are concerned, which are valued at nominal value in the ESA 95, impairment only has an impact on the financial wealth of creditors when they are actually written off, so that there is generally a noticeable delay.