

RECENT DEVELOPMENTS IN EURO AREA CAPACITY UTILISATION AND FACTORS LIMITING ECONOMIC ACTIVITY

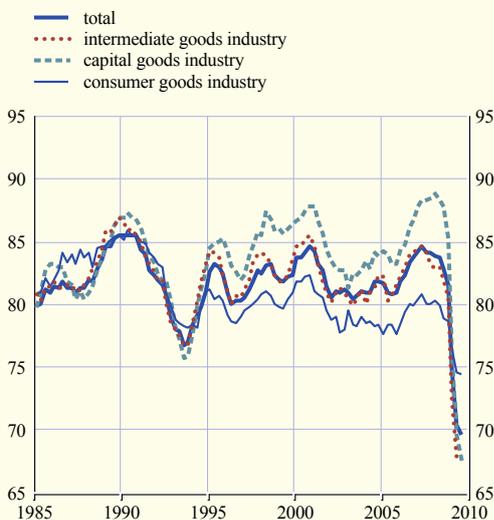
The euro area economy has recorded a sharp decline in GDP in the current recession. Measured from its peak in the first quarter of 2008 to the second quarter of 2009, at 5.0% the decline in GDP is about twice as large as in the previous most severe recession since 1970. Activity across all economic sectors has been significantly affected, but, as in previous recessions, industrial activity has been hit hardest. While Eurostat's first full release of national accounts for the second quarter of 2009 shows a sharp moderation in the pace of the decline in GDP, value added data point to a notable fall in industrial activity in that quarter, albeit of a smaller magnitude than in the previous two quarters. This box discusses how capacity utilisation in the euro area industrial sector has developed in the wake of the sharp decline in activity in that sector. Based on survey data from the European Commission, it also examines which factors have limited euro area activity in the recent past.

Capacity utilisation in the euro area industrial sector

The capacity utilisation rate, an indicator of the amount of economic slack in the industrial sector, has fallen to record lows repeatedly over the past few quarters in the euro area (see Chart A). Following exceptionally steep declines in January and April 2009, capacity utilisation continued to decrease in July 2009, although at a more moderate pace, in line with the recent deceleration in the pace of the decline in industrial activity. In July the rate of capacity utilisation in the euro area stood at 69.5%, which is significantly below its long-term average of 81.6% since the series began in 1985 and also far below the trough it reached in the 1992-93 recession.

Chart A Capacity utilisation in industry and in the main industrial groupings

(percentages of full capacity)



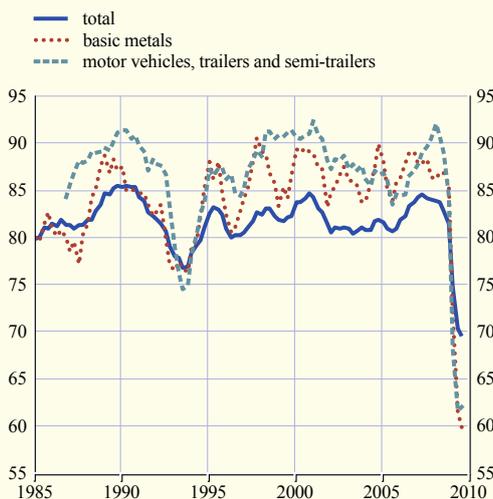
Source: European Commission.

There are significant differences in capacity utilisation across the main industrial groupings. By far the steepest fall (from a record high in January 2008) was recorded in the capital goods industry where capacity utilisation declined by more than 20 percentage points, to stand at a record low of 67.6% in July 2009. Capacity utilisation in the intermediate goods industry fell to a similarly low value, albeit from a somewhat lower level recorded prior to the recession. In the consumer goods sector, capacity utilisation also reached a record low in July. However, reflecting the typically smaller cyclical movements in consumer goods production, the amount of spare capacity in this sector has increased less than in the other two main industrial groupings.

Some industries within the main industrial groupings display even more pronounced under-utilisation of resources. The largest spare

Chart B Capacity utilisation in manufacturing of basic metals and of motor vehicles, trailers and semi-trailers

(percentages of full capacity)



Source: European Commission.

capacities were recorded in manufacturing of basic metals and of motor vehicles, trailers and semi-trailers (see Chart B). The capacity utilisation rates in these industries fell to levels of around 60% in July and, despite the car scrapping premiums that have been introduced in several euro area countries, capacity utilisation in the latter sector has edged up only marginally so far.

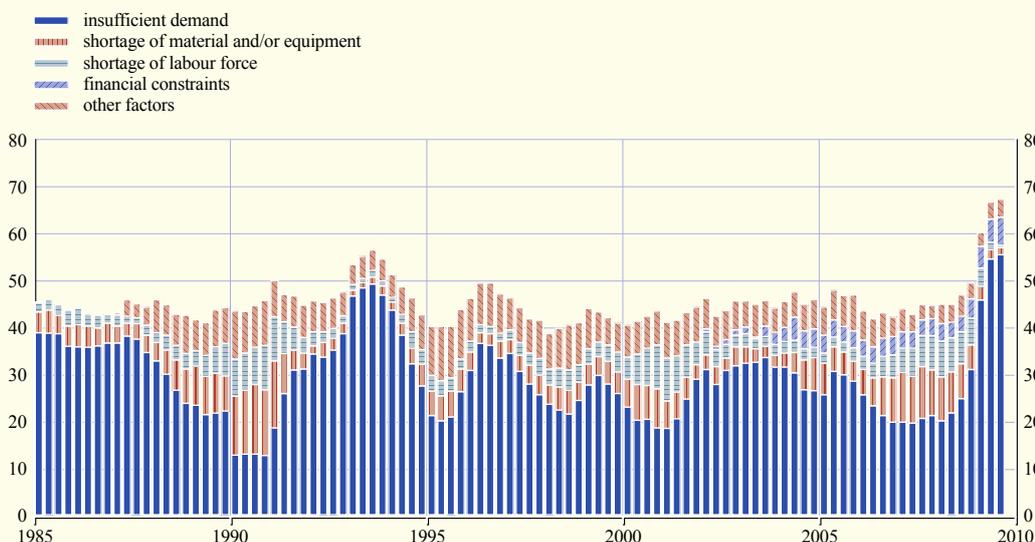
Factors limiting euro area activity

The European Commission Business and Consumer Surveys provide information on the factors limiting activity in the euro area. They distinguish between six categories and respondents can flag more than one: insufficient demand, shortage of labour force, shortage of material and/or equipment, financial constraints, other factors limiting activity and none (i.e. no factors limiting activity). Chart C summarises

the percentages of replies given to the different limiting factors in the industrial sector (i.e. it excludes the category of no factors limiting production). The chart highlights the fact that, overall, limits to euro area industrial production have risen to unprecedented levels in the current recession and have clearly exceeded those reached in the 1992-93 recession. It indicates that insufficient demand is the factor that has had by far the greatest influence on the fall in production. The importance of

Chart C Limits to industrial production

(percentages)



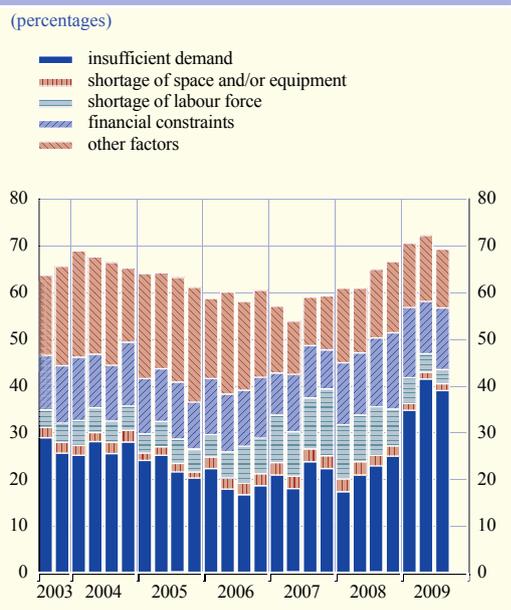
Source: European Commission.

this factor continued to increase substantially in the three months to April 2009, but increased only slightly further in the period to July 2009. Compared with insufficient demand, the importance of all other limiting factors, including financial constraints, appears much more moderate, at least in relative terms. Financial constraints, the second largest impediment to production, however, gained somewhat in relative importance over the three months to July 2009. By contrast, as in the 1992-93 recession, the impact of shortages of labour force and of material and/or equipment has declined to very low levels.

The data on the services sector, which are only available from mid-2003, show that limits to services business have also increased since the start of the recession (see Chart D). While their overall level appears to be less extraordinary, the importance of insufficient demand has risen to record highs and, as in the case of industry, it represents by far the largest impediment to services business, followed by financial constraints and other factors. The relative importance of insufficient demand appears to have decreased somewhat in the three months to July 2009, while that of financial constraints has increased. Financial constraints account for a larger share of limits to services business than for industrial production but it is not clear if this is also the case in absolute terms. Nevertheless, as for industry, it appears that insufficient demand is a much more important limit to services business than financial constraints at present.

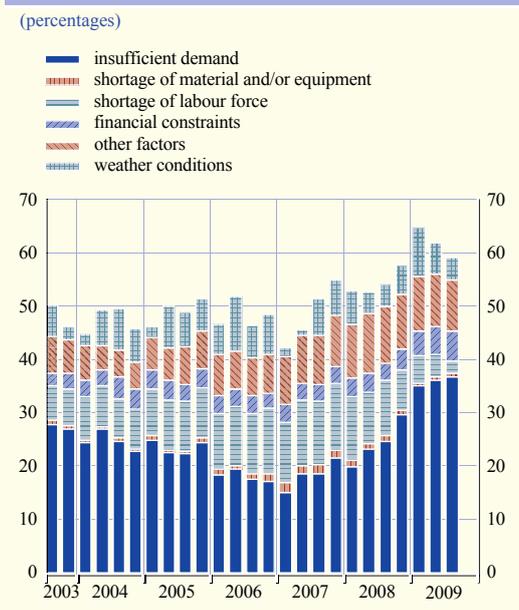
The picture is similar for the construction sector, where weather conditions are included in the survey as an additional category of factors limiting building activity. Limits to building activity rose to a very high level at the beginning of 2009, mainly on account of the increasing importance of insufficient demand. Unfavourable weather conditions at the start of the year also played a role (see Chart E). The subsequent decline in total limits to building activity has mainly been

Chart D Limits to services business



Source: European Commission.

Chart E Limits to building activity



Source: European Commission.

related to weather conditions, while the relative importance of insufficient demand and financial constraints has increased somewhat.

Overall, the sharp recession in the euro area has led to a steep decline in capacity utilisation in the industrial sector to a historically low level of below 70% in July, and some industries have recorded even sharper falls. This illustrates the high degree of vulnerability of some economic sectors at present. It is not clear how normal levels of capacity utilisation will be restored in the future, i.e. through higher demand or lower capacity, the latter implying lower potential output. With regard to the factors limiting economic activity, by far the largest impediment to activity in the current recession in all sectors has been insufficient demand. By comparison, the importance of financial constraints appears relatively small, even though it has increased somewhat recently.