

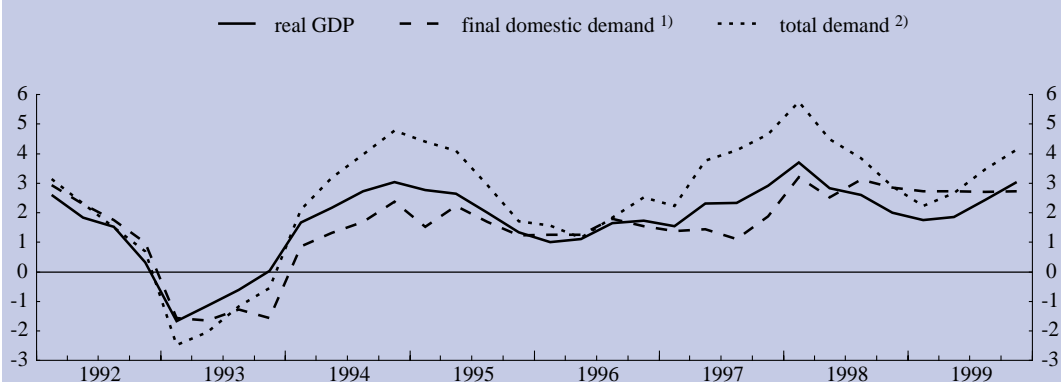
Box 3

The relative importance of domestic and foreign demand for output growth in the euro area

Looking at the pattern of economic growth in the euro area over the past two years, the overriding feature is the sustained growth in final domestic demand, i.e. excluding changes in inventories, which greatly mitigated the effects of the temporary slowdown in exports on GDP growth (see the chart below). Compared with the economies of the individual Member States, the euro area is a large and relatively closed economy. In such an economy, shocks to domestic demand would be expected to be at least as important a cause of changes in overall output growth as external developments. However, when assessing the relative importance of internal and external demand, a complicating factor is the fact that national accounts do not make a distinction between intra-euro area and extra-euro area exports. Such a distinction, offering helpful additional information, is provided by trade statistics, although it should be noted that trade data refer to goods only. These data show that the volumes of exports of goods within and outside the euro area are roughly equal in size. This box uses this information to review the relative importance of internal and external demand for the cyclical movements in output growth in the 1990s in what is now the euro area economy.

Output and demand growth in the euro area

(annual percentage changes; quarterly data)



Source: Eurostat.

1) Domestic demand excluding changes in inventories.

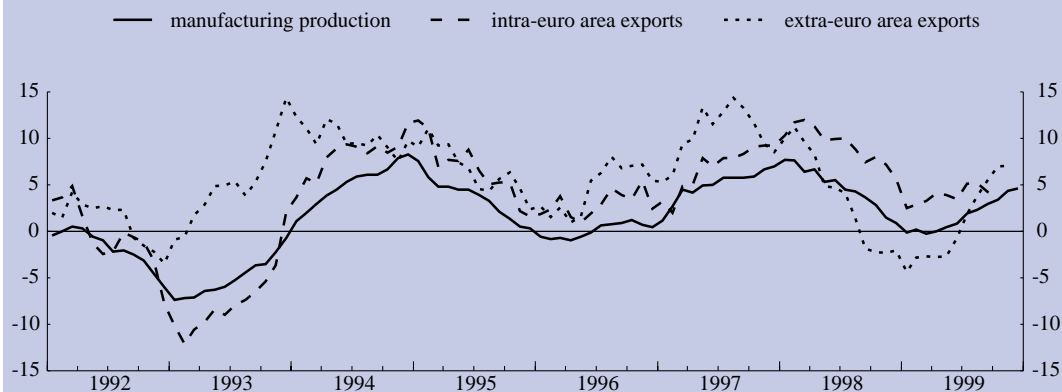
2) Domestic demand plus exports.

Manufacturing production growth closely in line with growth in intra-euro area exports of goods

At the sectoral level, fluctuations in overall output growth largely reflect the cyclical movements in industrial activity, even though the weight of manufacturing production in total output is only around one-third. In turn, in the small and open economies of the individual Member States, the relatively high volatility of production is mostly a reflection of the high exposure of the manufacturing sector to fluctuations in foreign demand. However, in so far as this foreign demand includes demand from other euro area countries, from an area-wide perspective it constitutes internal demand. With regard to cyclical developments in the 1990s, growth in euro area manufacturing production appears to have been rather closely in line with growth in intra-euro area exports, while the relationship with growth in extra-euro area exports was clearly weaker (see the chart below). In this context, it should be borne in mind that changes in inventories can play a significant role as a buffer between production and demand developments.

Growth in manufacturing production and exports of goods in the euro area

(annual percentage changes; monthly data)



Source: Eurostat.

Note: Calculated from three-month centred moving averages. Trade data are volumes.

Cyclical pattern in output growth in the 1990s reflects different developments in domestic and foreign demand

On the basis of the combined information shown in the above charts, three periods can be identified in which the relative importance of internal and foreign demand for the cyclical movements in euro area real GDP growth differs. First, developments in 1998 and 1999 show that the temporary slowdown in output growth, most noticeably in manufacturing, was largely the result of a decline in exports to countries outside the euro area following the crises in emerging market economies, while intra-euro area export growth was affected to a far lesser extent. As growth in final domestic demand in particular remained robust, real GDP growth only slowed to just below 2% in early 1999. By contrast, the recession in 1993 was mainly due to the continued and significant weakening of final domestic demand in the individual Member States in preceding years, together with the associated strongly negative effects on intra-euro area trade volumes. This was mainly a consequence of policy measures to contain the inflationary pressures that resulted from the period of strong economic growth in the late 1980s and the subsequent German unification. In 1991 the expansionary effects of German unification in terms of strong internal demand in the euro area completely overshadowed the effects of the slump in foreign demand as the US economy went into recession in the same year. In the course of 1993 the rate of growth of extra-euro area exports picked up strongly, but depressed domestic activity was the more important factor for GDP growth, as witnessed by strongly negative effects on intra-euro area trade. Finally, the slowdown in output growth in 1995 and 1996 appears to have been broadly based in terms of a weakening of final domestic demand in the individual euro area countries and a similar slowdown in extra-euro area and intra-euro area export growth. This reflects both factors originating at the domestic level, such as excessive wage growth in some countries, and external factors, such as the appreciation of European currencies vis-à-vis the US dollar. In this case, therefore, the slowdown in foreign demand does not appear to have reflected changes in world economic activity.

Overall, output and demand developments in the 1990s in what was to become the euro area seem to confirm the characteristics usually attributed to a large and relatively closed economy. First, the effect of foreign demand shocks on GDP growth is limited by the lower degree of openness. Moreover, such shocks do not necessarily affect internal demand. Second, major cyclical movements in GDP growth will normally result from the intrinsic cyclical dynamics of the domestic economy or from major internal shocks to the economy and the policy reactions to them.