

Box 3

WHAT LIES BEHIND THE RECENT DECLINE IN ECONOMIC SENTIMENT?

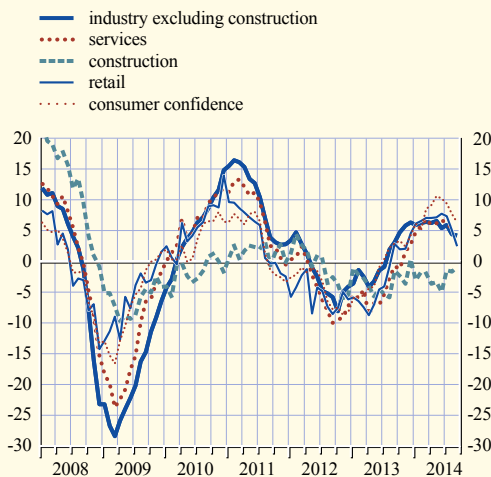
Following four quarters of moderate expansion, euro area real GDP was flat in the second quarter of 2014. Although this outcome partly reflected one-off factors relating to weather conditions, the number of “bridge days” and the timing of school holidays, it also appears that there was some loss of growth momentum at the beginning of the summer. More recent survey data, available for the full third quarter, suggest that this cyclical slowdown has continued. This is, for instance, the case for the Economic Sentiment Indicator (ESI), a summary indicator published by the European Commission and derived from the confidence surveys for different economic sectors (industry, services, construction and retail trade) as well as households (as measured by consumer confidence).¹ After being on an upward trend since the autumn of 2012, the ESI started to flatten out at the start of this year before beginning to fall from May onwards. This box looks at recent developments in the ESI, from both a country and a sectoral perspective, to better understand the reasons behind the recent slowdown.

The recent slowdown has been relatively broad-based across countries

The decline of the ESI between May and September 2014 was relatively widespread across countries, as illustrated by Chart B. Among the larger countries, Italy and Germany recorded the sharpest declines, followed by France. By contrast, the ESI for Spain and, to a lesser extent, for the Netherlands, has been more resilient in the last few months.

Chart A Business confidence across sectors

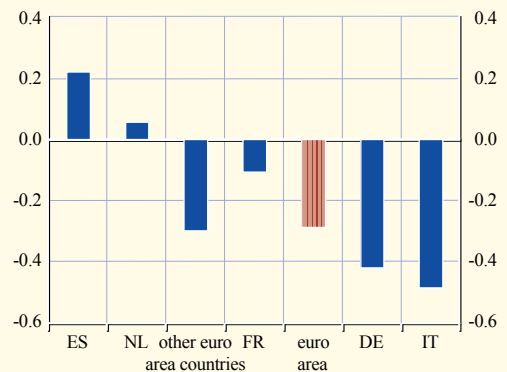
(percentage balances; mean-adjusted)



Sources: European Commission and ECB calculations.

Chart B Economic Sentiment Indicator: breakdown by country

(index change between May 2014 and September 2014)



Sources: European Commission and ECB calculations. Note: The data are adjusted with a mean of zero and a standard deviation of one.

¹ The weights in the ESI are as follows: 40% for industry, 30% for services, 20% for households, and 5% each for the construction and the retail sectors. For more information on the European Business and Consumer Surveys, please refer to *A User Manual to the Joint Harmonised EU Programme of Business and Consumer Surveys*, European Commission, March 2014.

It appears difficult to clearly identify reasons for the slowdown. Notably, several financial factors, such as the accommodative monetary policy stance and the exchange rate, should support the recovery in the period ahead. At the same time, it appears plausible to assume that the impact of the crisis in Ukraine and uncertainty regarding the implementation of structural reforms help to explain the decline in economic sentiment. The importance of these factors, however, seems to differ across countries.

Sentiment in the services sector has held up better than that in industry

Although the decline in the ESI has also been widespread across most economic sectors, a closer look at the sectoral developments shows that the main drivers behind the recent slowdown have been developments in the industrial and retail trade sectors, as well as in consumer confidence. Services confidence, on the other hand, has remained broadly stable. Sentiment in the construction sector has improved somewhat, which contrasts with developments in the other main sectors. However, this improvement has taken place from a very low level and this sector's weight in overall confidence is relatively small.

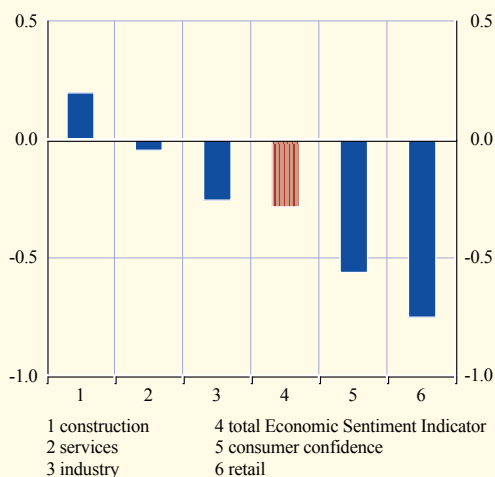
The recent weakening of sentiment in industry is expected to continue in the coming months, as the forward-looking survey results are worse than those depicting the current situation. (The indicator on industrial confidence is derived from questions on the level of order books and the stock of finished products, which relate to current developments, and on production expectations, which are forward-looking.) Expectations are also weak in the consumer and retail sector confidence surveys. This contrasts somewhat with the outcome in the services sector, for which the forward-looking results (on demand expectations) have increased slightly, while the results for the current situation have declined (based on questions on the business and demand situation). For this sector, it appears that the recent weakening is perceived as being more temporary in nature.

Conclusions

Following the weaker than expected outcome for GDP growth in the second quarter of this year, survey data suggest that this cyclical slowdown continued in the third quarter, although they remain consistent with modest growth. The recent decline in the ESI, which started in May this year, reflects relatively broad-based developments across countries. As regards sectoral developments, it appears that the industrial and retail sectors are the main drivers of the recent decline, while the services sector has remained more resilient. The forward-looking elements of the ESI suggest that the decline may continue for industry as well as for consumer and retail sector confidence in the coming months, while the short-term outlook for the services sector is less gloomy. Thus, the surveys suggest that the composition of value-added growth may change in the third quarter relative to the second quarter, with positive growth for services alongside more muted developments for industry.

Chart C Economic Sentiment Indicator: breakdown by sector

(index change between May 2014 and September 2014)



Sources: European Commission and ECB calculations.
Note: The data are adjusted with a mean of zero and a standard deviation of one.