

usefulness of this indicator for the assessment of private consumption developments.

Cross-country differences in consumer confidence

The recent improvement in consumer confidence in the euro area as a whole masks diverse developments across countries (see Chart A). Looking at developments since the most recent trough in confidence in March 2009, significant improvements in consumer confidence have been recorded in Germany and Spain. In France there has been a limited improvement, while in Italy consumer confidence, after having initially recovered, gradually declined to reach levels similar to those observed during the 2008-09 recession.

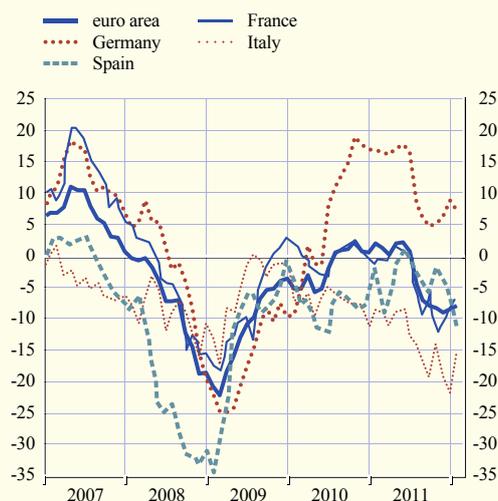
Factors driving consumer confidence

To analyse in more detail what has been driving developments in consumer confidence since early 2009, it is necessary to look at all four components of the indicator, which correspond to questions from the European Commission's monthly consumer survey. Among other things, it asks respondents about their expectations regarding developments over the next 12 months in (i) the general economic situation, (ii) unemployment, (iii) their household's financial position, and (iv) their intentions with regard to saving. The consumer confidence indicator is the arithmetic mean of the survey balances¹ of these questions, with equal weights applied to all the questions. Chart B shows the contributions of the four components to the overall euro area consumer confidence indicator since its trough during the most recent recession.

At the euro area level, changes in expectations relating to unemployment developments made

Chart A Developments in consumer confidence

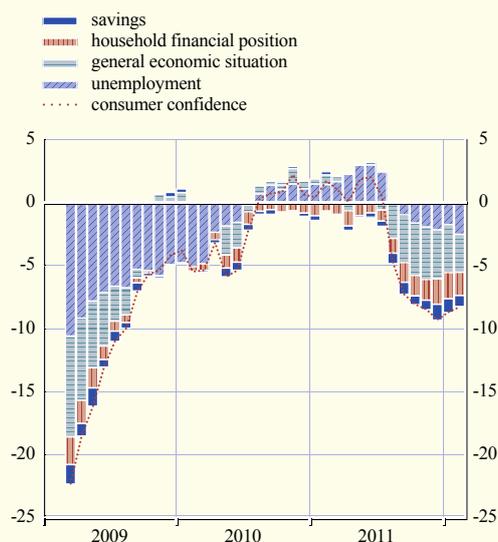
(percentage balances; deviations from long-term averages)



Sources: European Commission and ECB calculations.

Chart B Consumer confidence in the euro area and contributions of components

(percentage balances; deviations from long-term averages)



Sources: European Commission and ECB calculations.

¹ The survey balances for each component are computed as the percentage of respondents expecting an improvement minus the percentage of respondents expecting a deterioration, with the responses of "stayed the same" and "I don't know" being disregarded. They are expressed as percentage balances.

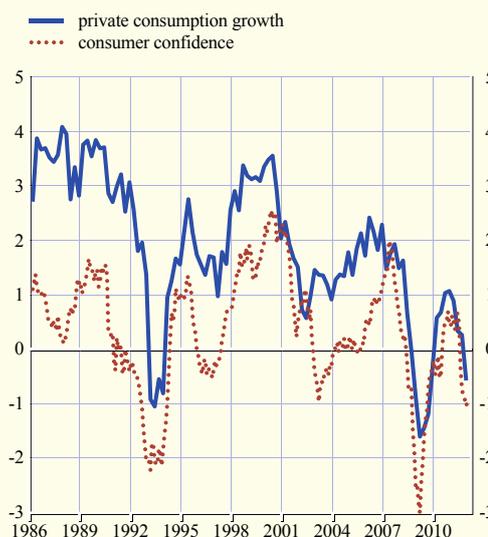
the largest contribution to the improvement in consumer confidence between March 2009 and June 2011, followed by changes in expectations regarding the general economic situation. The respondents' views on their expected savings and their household's financial position also improved, albeit to a lesser extent. In general, answers to the questions concerning the economy as a whole display far more variation over the business cycle than responses to the questions regarding the situations of individual households. Taking this into account, the contributions of the four components to the overall improvement in the consumer confidence indicator since early 2009 are broadly in line with long-term patterns. All the components show a high degree of co-movement, with all four contributing to the recovery in consumer confidence since the most recent trough, as well as to the drop in consumer confidence in the second half of 2011. Since the middle of 2011 all four components have stood below their long-term average levels, as shown in Chart B.

The link with private consumption developments

The usefulness of consumer confidence for the assessment of private consumption developments in the euro area can be illustrated by looking at correlations between the survey balance and year-on-year and quarter-on-quarter real private consumption growth. Overall, the consumer confidence indicator displays a relatively high correlation of 0.72 with year-on-year private consumption developments (see Chart C and the table), while the correlation with quarter-on-quarter private consumption growth is 0.49.² Looking at sample periods of five years, the correlations vary significantly over time (see Chart D). In particular, over the period 2001-07 a temporary disconnect between the two variables occurred. In this period episodes of high uncertainty and geopolitical tensions

Chart C Private consumption and consumer confidence in the euro area

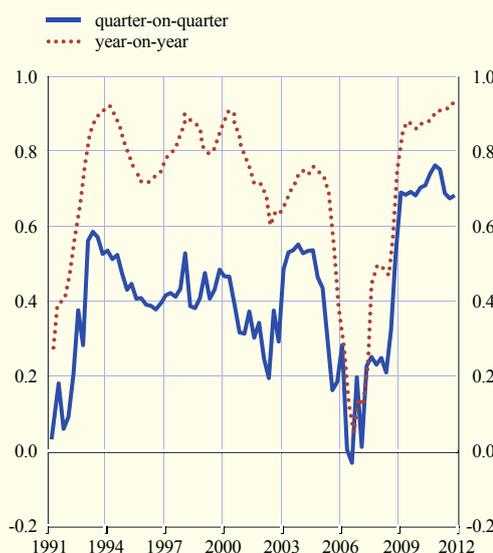
(annual percentage changes; percentage balances, standardised)



Sources: European Commission, Eurostat and ECB calculations.

Chart D The correlation between private consumption growth and consumer confidence in the euro area

(correlation over rolling five-year periods)



Sources: European Commission, Eurostat and ECB calculations. Note: The date on the x-axis denotes the end of the respective five-year period over which the correlation is computed.

² The survey questions are forward-looking, i.e. the results would be expected to correlate with future consumption. In practice, however, contemporaneous correlations are higher than correlations of current private consumption with past consumer confidence.

affected consumer confidence, while private consumption growth was rather stable. Thereafter, the correlation between the two variables increased markedly to a level above the historical average. This may reflect structural changes in the relationship between the two variables. This is also suggested by robustness checks on estimated parameters of simple regressions of private consumption growth (both in year-on-year terms and quarter-on-quarter terms) on consumer confidence over different sample periods.

Contemporaneous correlation between consumer confidence and real private consumption growth

	in year-on-year terms	in quarter-on-quarter terms
Germany	0.34	0.18
Spain	0.75	0.70
France	0.63	0.37
Italy	0.60	0.38
Euro area	0.72	0.49

Sources: European Commission, Eurostat and ECB calculations.
Notes: The data refer to the period from the first quarter of 1985 to the fourth quarter of 2011 (for Italy, data are available only up to the third quarter of 2011).

The correlation between consumer confidence and real private consumption growth differs significantly across countries. Focusing on the four largest euro area countries, the correlation with year-on-year private consumption growth is relatively high for Spain, while somewhat lower for France and Italy and particularly poor for Germany (see the table). All four countries show fluctuations in the correlation over time, with the most recent five-year period showing a higher correlation than the preceding five-year period.

Overall, the usefulness of developments in consumer confidence for the assessment of real private consumption developments varies across countries and periods. Caution should be exercised in deriving conclusions about consumption growth on the basis of consumer confidence owing to the instability of relationships at both the country and euro area levels. However, this information can be useful in conjunction with other short-term indicators of consumption. The recent improvement in euro area consumer confidence may thus be seen as a positive signal for real private consumption growth in the period ahead.

INVESTMENT

The gradual improvement in gross fixed capital formation over the past two years was interrupted in mid-2011. Quarter-on-quarter investment growth shrank by 0.7% in the fourth quarter, implying a third quarter of consecutive contraction.

The full breakdown of capital formation is not yet available for the fourth quarter of 2011. Short-term indicators suggest that non-construction investment – which accounts for half of total investment – is likely to have been weak. Subdued overall economic and profit developments, together with tight financing conditions, are expected to have dampened non-construction investment growth in the fourth quarter of 2011. Declines in euro area capacity utilisation and manufacturing confidence as well as available aggregated country data support this picture. Residential and non-residential construction investment is likely to have fallen in the fourth quarter, as suggested by the deterioration in monthly production indicators and confidence in the construction sector. Overall tighter financing conditions may also have dampened construction investment in the fourth quarter. In addition, ongoing fiscal consolidation in many euro area countries continued to weigh on government investment.

The few early indicators available for the first quarter of 2012 suggest continued weakness in non-construction capital formation in the euro area. New orders of capital goods from the euro area declined further in December 2011. The capacity utilisation rate has broadly stabilised

at a level below its long-term average. The availability of financing has remained tight, dampening productive capital formation. While survey data on industrial confidence, such as the manufacturing PMI and its new orders component, showed some improvement in January and February 2012, the levels recorded still point to a contraction in the sector. Although the outlook for construction investment is slightly more favourable for the first quarter of 2012 than for the previous quarter, activity is still expected to be subdued owing to gradual adjustments in those regions where it had expanded extraordinarily in the pre-crisis period. Survey data also point to subdued activity in the sector.

Non-construction investment is expected to strengthen modestly during the course of 2012 in line with a gradual recovery in overall economic activity. More limited growth is envisaged for construction investment. There are downside risks to the outlook, and uncertainty is high.

GOVERNMENT CONSUMPTION

Recently growth in government consumption has been moderate, reflecting fiscal consolidation efforts in a number of countries. Following a slight quarter-on-quarter decline in the third quarter of 2011, real government consumption continued to decline in the fourth quarter.

Looking at individual components, restraint in compensation of government employees, which accounts for close to half of total government consumption, has been a major dampening force on total nominal government consumption. This restraint stems from moderate wage developments and employment reductions in several countries. Intermediate government consumption expenditure (which accounts for slightly less than a quarter of the total) has also been declining, owing to the ongoing consolidation efforts of governments. Social transfers in kind, which also account for almost a quarter of government consumption, have been growing more in line with historical averages. This is because social transfers in kind include items such as health expenditure, which have a somewhat autonomous dynamic.

Looking ahead, the impetus to domestic demand from government consumption is expected to remain limited in the coming quarters as a result of further fiscal consolidation efforts expected in a number of euro area countries.

INVENTORIES

The pronounced inventory depletion that accompanied the deep recession of 2008 and 2009 and the subsequent partial replenishment thereof during the recovery left producers with fairly lean inventories. Nevertheless, the slowdown in activity still required some reduction in the pace of net restocking observed in early 2011, with significant negative contributions of inventories to growth occurring in the second half of 2011.

The restocking reported in the national accounts since the third quarter of 2010 was probably more a reflection of the stronger than anticipated recovery in activity, rather than a deliberate attempt by firms to relax the tight inventory policies that had been gradually put in place, notably after the bankruptcy of Lehman Brothers. Indeed, surveys and other anecdotal evidence tend to point towards tightly managed inventories along the supply chain from 2010 to mid-2011. Nonetheless, the conjunction of substantial net additions of inventories observed in mid-2011 (0.7% of GDP in value in the second quarter of 2011) and the marked deterioration in business perspectives in summer 2011 led firms to swiftly reassess inventory levels in a matter of a few months. According to the European Commission's business surveys, these levels are now considered to be close to the norm. Indeed, the balance of assessment (as to whether inventories are above, below or close

to normal) has returned to its historical average. Until recently, PMI surveys also tended to point towards a pattern of accelerated reduction in input and retail inventories in the fourth quarter of 2011 and, to a lesser extent, in finished goods inventories by manufacturers (reflecting some involuntary additions to such inventories or smaller declines than expected).

This new configuration explains the negative contributions of inventories to growth of -0.2 percentage point in both the third and fourth quarters of 2011, reversing the sequence of mostly positive contributions observed in the previous eight quarters. Taking into account the slowdown in activity and the pace of restocking in national accounts, there is potential for some further negative contributions over the coming quarters. However, given the starting point of fairly lean inventories, the scope for a pronounced destocking similar to that observed after the bankruptcy of Lehman Brothers is very limited at this stage. More recent survey evidence (both from the European Commission and the PMI) in February 2012 that points towards a fairly abrupt slowdown in the pace of destocking might suggest an earlier than expected reversal.

EXTERNAL TRADE

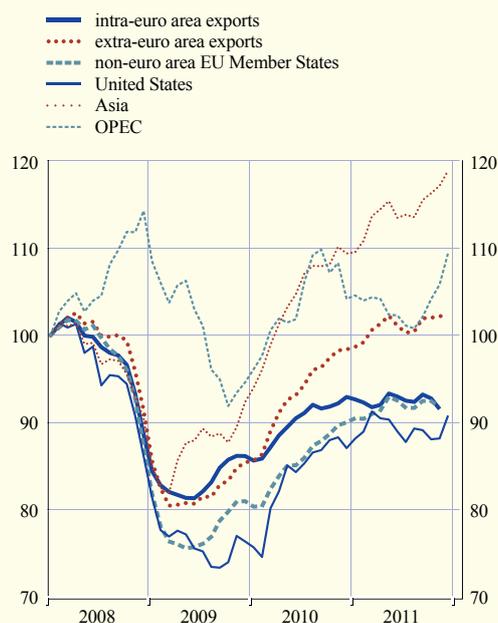
Euro area imports continued to lag behind exports in the final quarter of 2011 in line with the pattern seen throughout the year. In fact, imports and exports of goods and services declined quarter on quarter by 1.2% and 0.4% respectively in the fourth quarter. These developments resulted in a positive contribution from net trade of 0.3 percentage point to euro area GDP growth in the fourth quarter of 2011. Remarkably, net trade has supported GDP growth since the euro area started to recover from the global financial crisis in mid-2009, except for a marginally negative contribution in the first quarter of 2010.

The contraction in euro area imports in the final quarter of 2011 was mainly driven by lower domestic demand, although the depreciation of the euro in nominal effective terms over the second half of 2011 also played a role. The weakness in exports appears to have largely reflected a contraction in intra-euro area trade and exports to non-euro area EU Member States, at least as far as trade in goods is concerned (see Chart 53). Typically these destination markets together account for around two-thirds of total euro area exports of goods. Meanwhile, exports of goods to Asia, OPEC and, to a lesser extent, the United States expanded at a robust pace. Against this backdrop, Box 9 discusses the longer-term developments in extra-euro area and intra-euro area trade.

Despite the weak trade dynamics towards the end of 2011, short-term indicators suggest that euro area exports may gain momentum in the near term amid signs of stabilisation in foreign

Chart 53 Euro area export volumes to selected trading partners

(indices: January 2008 = 100; seasonally adjusted; three-month moving averages)



Sources: Eurostat and ECB calculations.