



Economic Research Department



Monitoring the Euro Area Business Cycle
International Conference

**Opening address by Antonio Fazio
Governor of the Bank of Italy**

Rome, 7 September 2001

Ladies and Gentlemen,

It is a great pleasure for me to open this conference on the analysis of the business cycle in the euro area.

The interest of this topic, in the new context of the single European currency, is borne out by the standing of the participants, who include many of the world's most distinguished scholars in this field, and by the quality of the papers presented and the richness of the programme.

A good monetary policy requires efficient investigative tools that provide full information on the economy. It is necessary to be able to evaluate the long-term trend of economic activity and the extent to which current output diverges from it. The divergence generates pressures that can jeopardize price stability in the short and medium term, with adverse implications for growth. An incorrect assessment of an economy's position in the business cycle can lead to monetary policy decisions that later prove to have been wrong.

The aim of the conference is to contribute to the improvement of our knowledge in this field by concentrating on quantitative methods of analysis.

To start, some indicators will be presented that have been developed recently with a view to evaluating the euro-area's position in the cycle and contributing to research on the issue within the Eurosystem. This will be followed by a discussion of the role played in monetary policy decisions by data on economic developments and the various ways in which they can be processed and disseminated. There will then be an analysis of the econometric methods employed in constructing cyclical indicators and making short-term forecasts. A special session will be devoted to measuring and forecasting inflation in the area.

The closing event tomorrow will be a panel discussion chaired by Otmar Issing, member of the Executive Board of the ECB, in which there will be an exchange of views between eminent practitioners and academics.

The euro area is made up of national economies of various sizes and with different structures. It is reasonable to ask whether it is possible to observe a common business cycle.

The term “cycle” refers, as in other fields, to the fluctuations that occur around a trend. Economic cycles are marked, as regards both their frequency and their amplitude, by pronounced irregularity, which makes them hard to analyze. The fluctuations occur in many macroeconomic variables, which tend to move together or in rapid succession, a feature that can be exploited for measurement and forecasting.

Business cycle studies have made important progress. Economists believe, correctly in my opinion, that their analyses have contributed to the greater relative stability of economies in recent decades.

The method developed in the 1920s and 1930s at the National Bureau of Economic Research by Wesley Mitchell and Arthur Burns was based on the detailed and meticulous observation of a very large number of macroeconomic series over the cycle.

These studies were essentially empirical and lacked an adequate theory for the interpretation of the findings. They nonetheless permitted the identification of some stylized facts in the development of the US economy that today’s more modern techniques and better data have found to be still valid.

Subsequent theoretical research has combined new methods of time-series analysis with the interpretation of the structure of the economy. Some of you here today have made important contributions to this line of thinking.

The cyclical fluctuations of an economy correspond to the propagation of exogenous shocks via interactions between the endogenous components of the system.

Apart from supply shocks such as those produced by oil crises, important examples of exogenous impulses are technological innovation, changes in consumer preferences and shifts in economic policies.

The dynamic interactions between the main economic variables explain the persistence of the effects of the original shock and create countervailing forces that cause them to be gradually reversed.

The fluctuations in GDP tend to be accompanied, with a regular pattern, by a cycle in investment, profits, wages, credit and other aggregates. If a common cycle exists in the euro area, it will be reflected in correlated movements of these variables in the different countries.

The foregoing considerations also help to answer a methodological question that has been raised in various fora since the inception of the single monetary policy: whether the dynamics of the euro area can be understood better with an aggregate approach that looks only at area-wide data or with a disaggregated approach, that does not ignore the differences between the various economies but extracts information from national data in order to arrive at a synthesis.

The importance of co-movements in the business cycle suggest that a disaggregated approach is not just preferable but in practice indispensable. However, I do not want to prefigure conclusions that should stem from our reflections during the next two days.

In recent decades cyclical fluctuations have tended to become smaller: in the downswing output has often grown less fast rather than actually falling. Important factors in this respect are the higher average rate of growth and the increased weight of the public sector.

The lengths of the different phases of the cycle also appear to have changed. Notably in the United States, since the middle of the last century the upswings have lasted longer than the downswings.

Cyclical fluctuations have social costs because their adverse effects are concentrated among the weaker members of the population. The reduction in their amplitude and frequency should be recognized as an important advance that needs to be consolidated.

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Forecasts of world growth for this year have been revised downwards several times. The latest figure is just over 2.5 per cent, as against 4.7 per cent in 2000. This would be the sharpest slowdown since 1974.

In the United States growth this year may not exceed 1.5 per cent, even assuming that household spending continues to fuel demand, thanks in part to the boost to disposable income provided by the recent tax cut. Domestic demand has been weakened by the deterioration in labour market conditions that began in the summer and the decline in share prices. Recent reports on the climate of confidence among manufacturing firms point to the possibility of a recovery.

In Japan, consumer price deflation intensified again during the summer; output is set to contract this year, albeit only slightly.

In the second quarter of this year GDP virtually stagnated in Germany and Italy; in France the growth rate is likely to have been approximately half that of the first quarter.

In the euro area the slowdown occurred above all in manufacturing. The area-wide index of industrial production, excluding construction, fell by more than 1.5 per cent in the second quarter after remaining virtually unchanged in the first. In Italy the decline was somewhat more moderate.

There are nonetheless signs of an improvement in the outlook. Recent data suggest that the worst phase of the cycle may be coming to an end in the main euro-area economies.

In Germany construction activity appears to be recovering from its low level in the second quarter. There are also signs in retail trade of the positive effects of an increase in household spending, encouraged by the tax relief introduced at the beginning of the year and the easing of inflationary pressures. The short-term expectations of manufacturers are improving modestly, thereby strengthening the possibility of a recovery in the next few months.

In France the modest growth of the economy is being sustained by the service sector and by the rise in household spending. Though this has slowed down slightly, it continues to benefit from existing and planned tax reliefs and from the deceleration in consumer prices.

A further decline in inflation can be expected throughout the euro area. It is important that the price pressures of the past year should not be reflected in domestic costs. To date, wage moderation has contributed significantly to attenuating the impact of external shocks on costs and prices. Structural reforms remain of fundamental importance for a return to soundly-based growth.

In Italy industrial production bottomed in April; preliminary estimates indicate that the recovery that had begun in May gathered strength in July and August. Manufacturing firms' expectations regarding orders are on the rise. After about one year, the indicator developed by the Bank of Italy and ISAE for the Italian economy, which leads the cycle by five to six months, pointed in June to the possibility of an upturn in economic activity. The expansion in exports continues to outpace that in imports.

If output in the second half of the year were to remain at the level of the second quarter, the average annual growth in 2001 would be 1.7 per cent. The latest data on the economy show that economic activity will tend to accelerate in the second half. The annual growth rate could turn out to be significantly higher. The recovery should produce its full effects next year.

Trusting that the necessary structural economic policy measures will go forward, it is important that firms should promptly grasp the opportunities offered by the increase in demand, with investment plans of an adequate quantity and quality.

A climate of collaboration among the social partners will foster the start of a new period of growth in output and employment.

A strengthening of growth expectations will help to overcome the difficult situation in share markets.

With this important conference the Bank of Italy has taken another step towards its goal of offering a contribution, at the scientific level, to the harmonious development of the Italian economy and that of the Union.