

III.3. Dissecting the recovery with survey data

The European Commission has been running the Joint Harmonised EU Programme of Business and Consumer Surveys (BCS) since 1961. The programme now embraces 7 major surveys (industry, services, construction, retail, consumers, financial services and investment) in 30 countries, with more than 125 000 firms and 40 000 consumers surveyed every month across the EU. This section draws on this wealth of information to analyse the ongoing recovery, notably by comparing it to major cyclical recoveries in the past. ⁽⁵⁰⁾

Business and consumer survey data are important tools for short-term forecasting. They can, however, also be used to analyse the business cycle with two major advantages over the hard data generally used for this purpose (quarterly national accounts, industrial production, etc.). First, confidence surveys are easier to interpret than hard data: usually they don't require filtering methods to disentangle trend and cycle, ⁽⁵¹⁾ they are available early and subject to only limited revisions. Second, surveys can help track features of the business cycle that cannot be measured with hard data, including various expectations on the part of households and companies, their assessment of specific risks (e.g. unemployment or financial) and their assessment of the general economic situation.

A synchronised but unbalanced recovery...

Based on the Commission's Economic Sentiment Indicator (ESI), which summaries confidence in major sectors of the economy, the euro-area business cycle peaked in spring 2007 and began falling abruptly in the ensuing summer. ⁽⁵²⁾ The indicator reached an unprecedented trough in March 2009, but has since recovered significantly and almost continuously to reach levels

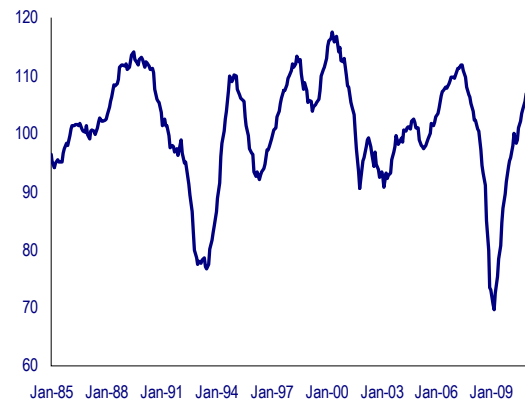
⁽⁵⁰⁾ This section is based on survey data up to February 2011. Therefore, the recent dramatic events that have hit Japan are not reflected either in the analysis or in the underlying figures.

⁽⁵¹⁾ There is general agreement that survey data are stationary and track cyclical conditions, even if filters may sometimes be needed to remove possible high frequency noise. Most (but not all) confidence indicators should be interpreted in terms of cyclical growth.

⁽⁵²⁾ The ESI is a weighted average of sentiment in industry, services, retail and construction as well as among consumers. Further information on the ESI and other BCS data can be found on DG ECFIN's BCS website: http://ec.europa.eu/economy_finance/db_indicators/surveys/index_en.htm.

approaching the cyclical peak of summer 2007 (Graph III.3.1).

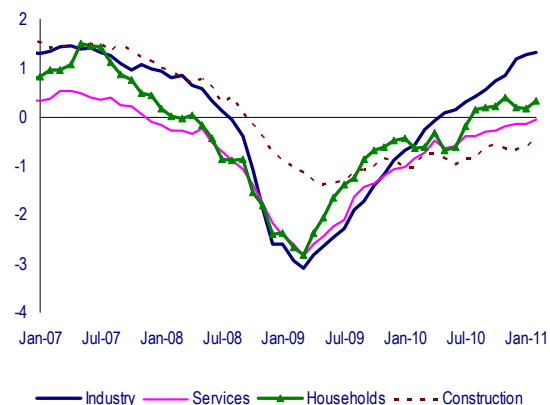
Graph III.3.1: Economic Sentiment Indicator, euro area (Jan 85 to Feb 11)



Source: Commission services.

The ongoing recovery in sentiment has generally been closely synchronised across sectors: confidence has picked up in the same month (April 2009) in industry, in services and among consumers, with only construction lagging behind by 2 months (see Graph III.3.2). This contrasts with the previous two major recoveries of the early 1990s and early 2000s which were considerably less synchronised and were characterised, in particular, by substantial lags in the rebound of consumer confidence.

Graph III.3.2: Confidence indicators in various sectors, euro area (Jan 07 to Feb 11) (balances) (1)



(1) To facilitate sectoral comparisons all balances are normalised. Source: Commission services.

Notwithstanding this close synchronisation, the strength of the upswing in confidence since March 2009 has varied significantly across sectors. Sentiment in the euro area has been primarily driven by industry, where confidence is now approaching its pre-crisis peak (Graph III.3.2).

Interestingly, sentiment in the financial sector (which is tracked in a dedicated survey) has also recovered strongly to levels last seen in summer 2007, i.e. right before the onset of the financial crisis. In contrast, the recovery has been more muted for (non-financial) market services and for consumers, with sentiment at or slightly above the long-term trend, respectively. It has been extremely weak in the construction sector where activity probably remains in contraction mode.

This sectoral pattern supports the idea that the main engine of recovery in the euro area has so far been a sharp rebound in world trade, which has mainly boosted industrial activity, while domestic demand has been slower to get traction. A comparison with the two major previous recoveries, further confirms the unbalanced pattern of the ongoing recovery. The rise in confidence since March 2009 has been characterised by a stronger role of industry than in the early 1990s and early 2000s, which may also be a testimony to the unusually large drop in industrial activity during the Great Recession.

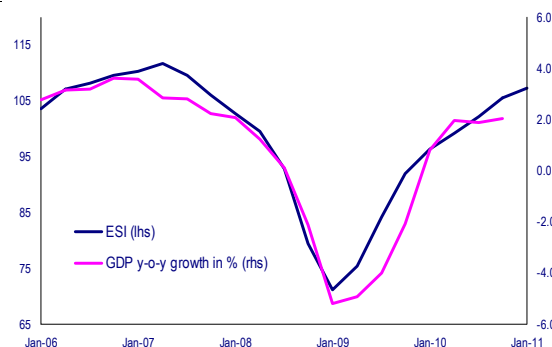
... characterised by unusually sluggish growth

In addition to an unbalanced pattern, the ongoing recovery is also characterised by unusually sluggish GDP growth. Signals from hard data have so far not been as strong as relatively upbeat survey readings would have suggested (see Graph III.3.4). There are several possible explanations for this decoupling:

- There was a well-known decoupling between hard and soft data around the trough of the cycle which can be mainly explained by the existence of non-linearity at times of very deep recession.⁽⁵³⁾ At this stage of the cycle, however, the non-linearity should not affect data anymore.
- The present decoupling could signal a period of overshooting in household and business confidence. Statistical tests suggest, however, that the decoupling has been in place for several years now. This appears quite long for a period of overshooting of confidence.
- Finally, the decoupling could reflect the fact that the euro-area economy has shifted onto a

significantly lower growth path. This explanation would be in line with the information provided by Commission estimates of potential output.⁽⁵⁴⁾ It would also be in line with a range of empirical studies which point to significant and lasting losses in GDP growth in the aftermath of major financial or banking crises.⁽⁵⁵⁾

Graph III.3.3: GDP growth and Economic Sentiment Indicator, euro area (2006Q1 to 2010Q4)



Source: Commission services.

Short-term prospects remain reasonably upbeat in most sectors

Sentiment indicators do not send clear signals of having reached a peak, suggesting that the recovery remains on track. This is particularly clear from survey data for industry which show that *order books* are still rising and that activity is still picking up momentum. By contrast, during the 1993-95 recovery, a stabilisation of order books was already visible at this stage of the cycle. Another positive signal comes from the relationship between stocks and production expectations, which is now normalising after diverging from its usual path during the recession period. Manufacturers' *assessment of stocks* is at historical lows, suggesting that stock-building will contribute significantly to demand in the coming months (Graph III.3.4).

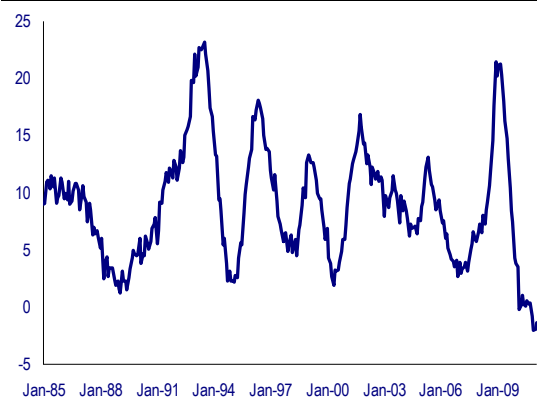
Regarding short-term prospects for services, the latest readings of the surveys are also encouraging, although somewhat weaker than in industry. *Demand expectations* have levelled off in the past couple of months but *observed demand*

⁽⁵³⁾ Whereas there is, in practice, no lower bound to a rate of contraction of GDP, there is a lower limit to confidence indicators due to the fact that, once 100% of respondents report a deterioration in activity, no further loss in the confidence indicator is possible.

⁽⁵⁴⁾ See, European Commission's [AMECO database](#)
⁽⁵⁵⁾ See for instance Reinhart, C and K. Rogoff (2009), 'This time is different: Eight centuries of financial folly', Princeton University Press.
 IMF (2009), 'What's the damage? Medium-term output dynamics after financial crises', *World Economic Outlook* (October).

remains on an upward path. Positive signals for domestic demand are also coming from the retail trade sector, where confidence has followed an upward, albeit volatile, recovery path since March 2009, settling now well above its long-term average and at pre-crisis peak levels.

Graph III.3.4: Assessment of stocks, euro-area industry (Jan 85 to Feb 11) (balances)



Source: Commission services.

The only industrial sector where the short-term outlook remains clearly sluggish is construction. The sector has so far shown limited signs of recovery. Confidence remains well below historical averages and since the last fall it has shown very limited gains, with discontinuities due to temporarily constrained activity following adverse weather conditions in December and January. Weather-related constraints have now faded away, but despite very low interest rates the sector's outlook remains hampered by weak demand and order books still well below historical averages. Overall, the euro-area construction sector seems to be in for a long period of adjustment following its pre-crisis boom.

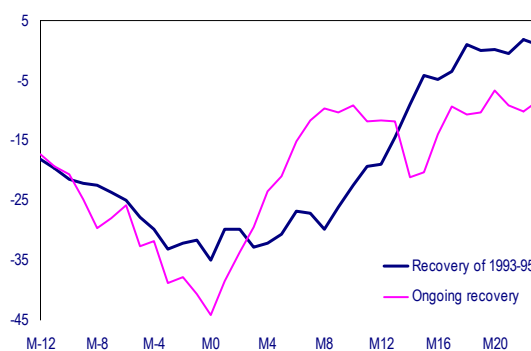
But there are causes for concern on medium-term recovery prospects on the consumer side...

Notwithstanding these positive short-term signals, surveys also point to a number of possible impediments to the ongoing recovery that could weigh on growth in the medium term. A systematic comparison with developments in sentiment in the aftermath of the 1992-93 recession (i.e. the recovery of 1993-95) points to a number of worrying patterns in the ongoing recovery, including lingering uncertainties among consumers, weak corporate investment plans and possible supply constraints in industry.⁽⁵⁶⁾ The

comparison also shows that the ongoing recovery has so far been comparatively uneven across euro-area countries, pointing to an unusual degree of divergence among Member States.

Turning first to consumers, the ongoing recovery in sentiment has shown, so far, a dynamic relatively similar to that observed after the 1992-1993 recession: a strong and fast rebound during the first year, followed by a deceleration/stagnation period. However, while the 1993-1995 recovery saw the stagnation phase start once crisis losses had been broadly recouped, consumer confidence currently remains well below the peak levels registered in 2007, and also lower than at a similar stage of the 1993-95 recovery. This suggests a premature stabilisation of sentiment, which could weigh on medium-term prospects for consumption.

Graph III.3.5: Consumers' expectations as to the general economic situation, euro area (balances) (1)



(1) M0 marks the trough of the downturns (as measured by the confidence indicator for consumers) in March 1993 and March 2009.

Source: Commission services.

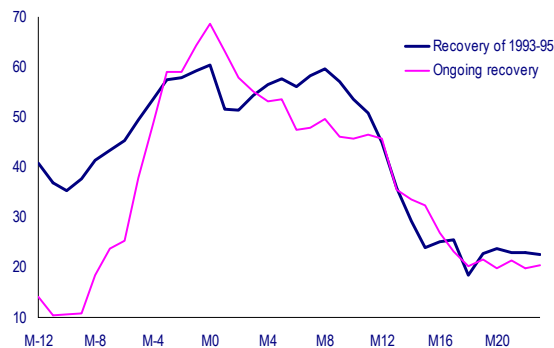
As in the 1993-1995 recovery, consumers' views on overall prospects for the economy (namely their expectations about the *general economic situation* and *unemployment* fears) have been the main driver of confidence. In particular, consumers' assessment of general economic prospects began to stall at the end of 2009, i.e. much earlier than in the recovery of the previous decade (see Graph III.3.5). The recent dynamics of that indicator, in particular its temporary sharp drop in May and June 2010, could suggest that the sovereign debt tensions are having a significant

⁽⁵⁶⁾ In the remainder of this section, comparisons with previous major recoveries are restricted to the 1993-95 recovery. Comparisons with the recovery of the early 2000s are less meaningful as the downturn of the early 2000s was relatively shallow and not a recession per se. Comparisons with the recession of the early 1980s are unfortunately not possible as survey data are only available since 1985.

effect on consumer confidence in the euro area. In any event, consumers' concerns about the general economic situation are now greater than at a similar stage of the 1993-95 recovery.

Consumers' concerns in terms of *unemployment fears* have evolved in broadly similar ways during the two recoveries. It is noteworthy, however, that the deterioration in sentiment regarding unemployment was far bigger in the latest recession than during its predecessor of the 1990s (Graph III.3.6). As a result, whereas unemployment fears had receded to their pre-crisis level in 1995, they are now still substantially higher than before the onset of the global financial and economic crisis. This is somewhat surprising given that job losses or rises in unemployment registered rather similar magnitudes during the two recessions. Despite substantial improvements in labour market performance in the 2000s compared with the previous decade (measurable notably in terms of lower structural unemployment), in the wake of the latest recession, consumers in the euro area thus continue to be suspicious about the functioning of labour markets.

Graph III.3.6: Consumers' unemployment expectations, euro area (balances) (1)



(1) M0 marks the trough of the downturns (as measured by the confidence indicators for consumers) in March 1993 and March 2009

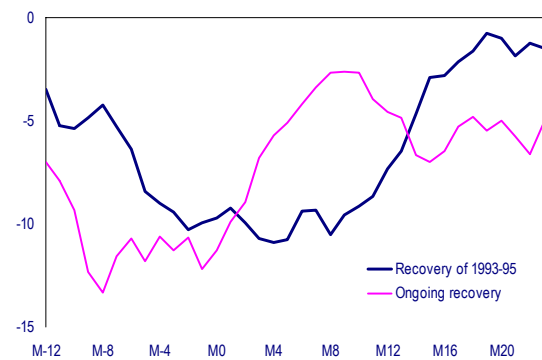
Source: Commission services.

Finally, and not very surprisingly, the latest recession has left deep scars in sentiment via its impact on consumers' perception of their individual financial situation. This is particularly visible in consumers' assessments of their *expected financial position over the next 12 months* (see Graph III.3.7). The indicator saw a rapid increase in the early stage of the ongoing recovery, which came to halt at the end of 2009 and was followed by significant drops in the period from February to July 2010 with the

escalation of sovereign debt tensions. The indicator is now well below its 1995 level.

Overall, the comparison with the cycle of the early 1990s points to lingering worries among consumers involving both general macroeconomic uncertainties and concerns about the effect of the crisis on their personal financial situation. This means that precautionary savings could remain high for some time, weighing on prospects for private consumption.

Graph III.3.7: Consumers' expected financial situation, euro area (balances) (1)



(1) M0 marks the trough of the downturns (as measured by the confidence indicator for consumers) in March 1993 and March 2009

Source: Commission services.

... and possible impediments to medium-term recovery prospects on the corporate side

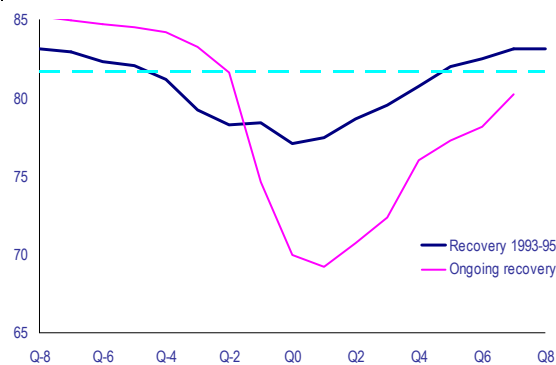
Business surveys also point to possible impediments to the recovery on the supply side. Capacity utilisation reached a trough between 2009Q2 and 2009Q3, following an abrupt and deep downturn leading to its lowest level ever (and well below the level reached in the 1993 crisis — see Graph III.3.8). Against the backdrop of a strong recovery in industrial activity, capacity utilisation has rebounded since 2009Q3, but is currently (7 quarters after the trough) still below its long-term average and significantly below its level at the same stage of the recovery in 1993-95.

The current subdued rate of capacity utilisation in the manufacturing sector points to sluggish growth in investment in the near term. This is indeed consistent with manufacturers' investment plans as reported in business surveys. According to the latest investment survey (November 2010), manufacturers intend to raise investment by 2% in volume in 2011. This is well below their investment plans at a similar stage of the business

III. Special topics on the euro-area economy

cycle in the 1990s.⁽⁵⁷⁾ A more systematic comparison of investment cycles as reported in surveys actually shows that capital formation reached a similar trough in 1993 and 2009 (with a contraction of close to 20% in real terms), but rebounded more strongly in 1993-95 than in 2010-2011. Contrary to the recovery of the 1990s, manufacturers' investment plans are currently more geared at replacing equipment than expanding capacity and suffer from more sluggish demand prospects.

Graph III.3.8: Capacity utilisation, euro-area industry (in %) (1)



(1) Q0 marks the trough of the downturns in 1993Q3 and 2009Q2. The dashed line represents the long-term average

Source: Commission services.

Beyond short-term prospects for domestic demand, persistent weakness in corporate investment plans also raises concerns about the euro-area's supply capacity. Graph III.3.9 displays an indicator tracking developments in production capacity in industry. The indicator combines information from surveys (capacity utilisation rate) and hard data (industrial production) to give an assessment of production capacity in industry, i.e. the maximum level of production that manufacturers can attain by mobilising all resources at their disposal.⁽⁵⁸⁾

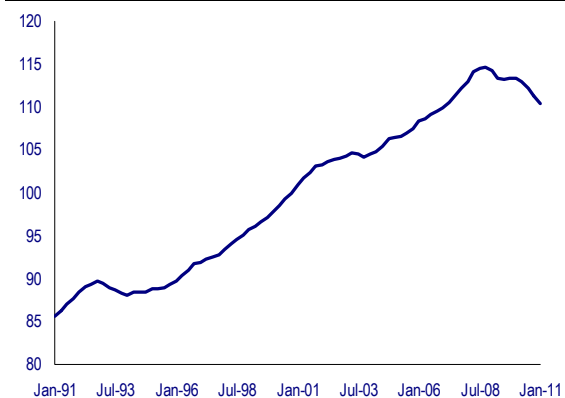
As can be seen from the graph, production capacity in industry generally trends upwards over time, most likely due to a combination of capital accumulation, labour force expansion and technical progress. Major cyclical downturns are associated with a downward inflection of the indicator, most likely due to a number of factors that temporarily hamper supply capacity,

⁽⁵⁷⁾ In November 1994, manufacturers anticipated an increase in investment of 8% in 1995.

⁽⁵⁸⁾ More precisely, the indicator is constructed as the ratio of industrial production to capacity utilisation in industry. The indicator is smoothed by taking a four-quarters moving average. It can be interpreted as a measure of industrial capacity consistent with the capacity utilisation rate reported in surveys.

including slower capital accumulation, lost employee skills, temporary losses in supply due to sectoral reallocation, etc. Such inflections are visible in 1993 and, to a lesser degree, in 2002-03. The latest recession, however, stands out with a sharp drop in the estimated level of production capacity in industry, well above anything recorded in the previous decades. This suggests that in the absence of a rapid recovery in investment, the recovery in the euro-area industry could face supply constraints in the near future.⁽⁵⁹⁾

Graph III.3.9: Production capacity, euro-area industry (index base 1992=100) (1)



(1) The indicator is constructed as the ratio of industrial production to capacity utilisation in industry (Jan-91 to Jan-11).

Source: Commission services.

A multispeed recovery across Member States

During the 1993 crisis, sentiment reached its trough in euro-area Member States in a less synchronised way than in the latest crisis, when almost all the euro-area countries bottomed out in March 2009. In contrast, the ensuing recovery was much more homogeneous across countries in 1993 than what can be observed currently. The divergence among Member States as shown in Graph III.3.10 has almost tripled since the beginning of the ongoing recovery, pointing to a much more uneven recovery in sentiment among euro-area Member States than in 1993-95.⁽⁶⁰⁾

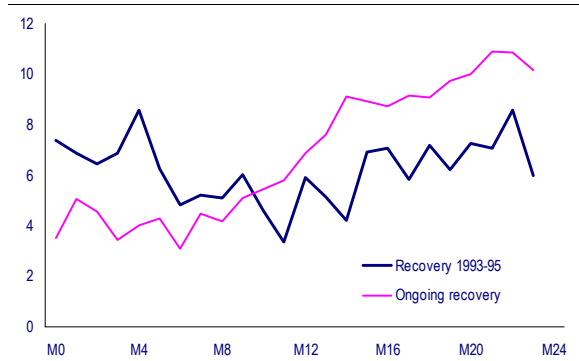
In particular, the divergence mirrors the fact that the rebound of the ESI (Graph III.3.11) observed in core countries (with Germany, Belgium and the Netherlands firmly in the lead) has so far been significantly stronger than in periphery countries

⁽⁵⁹⁾ It is worth stressing that corporate investment is probably not the only area where action is needed to restore capacity. Improving labour skills and facilitating the sectoral reallocation of production resources triggered by the economic crisis are important areas as well.

⁽⁶⁰⁾ Divergence is measured as the standard deviation of the ESI across countries over two years.

(Greece, Portugal and Spain), where confidence has recovered only partially and still stands below 'normal' levels (long-term average).

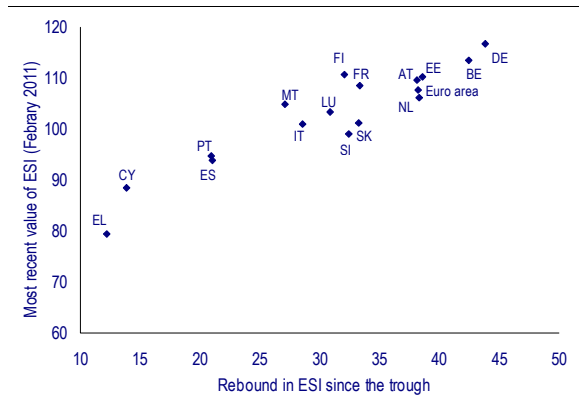
Graph III.3.10: **Standard deviation of the ESI across EA-17 Member States (in %)**



(1) M0 marks the trough of the downturns in July 1993 and March 2009.

Source: Commission services.

Graph III.3.11: **ESI rebound vs ESI level**



Source: Commission services

Conclusion

Business and consumer survey data are an important tool to analyse business cycle developments. Survey data show that the recovery which began in spring 2009 and is still ongoing has been closely synchronised across sectors but has also been unbalanced – mostly driven by industry – and associated with unusually sluggish GDP growth.

At this stage, sentiment indicators do not send clear signals of having reached a peak, suggesting that the recovery from the Great Recession remains on track. Nevertheless, a systematic comparison with developments in sentiment in the aftermath of the 1992-93 recession points to a number of patterns in the ongoing recovery. Lingering uncertainties among households, particularly about their financial situation, unemployment risks and general economic prospects point to downside risks on private consumption. On the corporate side, manufacturers' investment plans remain sluggish and there is evidence that the crisis may have brought about significant losses in production capacity. Finally, the recovery is also characterised by more marked differences in the pick-up of activity across countries than in previous similar cyclical episodes, a factor that calls for differentiated policy approaches across the euro area.