

EUROPEAN ECONOMIC PERSPECTIVES



July 15, 2005

***Darren Williams**

Sr. European Economist
Global Economic Research

*Darren Williams is not licensed by the Hong Kong SFC and does not intend to provide investment advice in Hong Kong.

European Economic Perspectives

The Euro Area and Japan: Similarities Only Skin-Deep

The weakness of the euro-area economy sometimes invites comparison with Japan, and there are certain similarities between the two. Both Europe and Japan have rapidly ageing populations and consensus-based political systems that are poorly equipped to deliver urgent reforms. However, there are also important differences which suggest Japan is not a particularly useful guide to euro-area developments.

The Euro Area is Not Japan

A key difference between the euro area and Japan is that monetary policy still seems to be working in the euro area, albeit rather slowly. This is evident in the evolution of credit growth and asset prices.

There has been a significant contrast between bank-lending growth in the euro area and Japan over the last ten years (**Display 1**). In Japan, bank-lending growth has been negative since 1998 and has fallen by an average 2.9% per annum. In the euro area, meanwhile, bank lending has risen by an average 6.5% per year. Moreover, having reached a low in early 2003, there has been a steady upward trend in euro-area credit growth.

Housing developments show a similar pattern. Since 1990, residential property prices have fallen by 33% in Japan, but have risen by 86% in the euro area (**Display 2**). Indeed, euro-area house prices have risen by almost as much as in the US. Without easy recourse to equity-release products, it is difficult for households in most euro-area countries to extract money from their property. However, this is slowly changing, and falling savings rates in countries like France suggest that, in some countries, rising house prices probably are having a wider positive impact on growth.

For the euro area as a whole, developments in credit growth and asset prices suggest that monetary policy

is loose and that low interest rates are slowly starting to work. For several reasons, this seems to be taking longer than usual to filter through to faster growth. However, there is little evidence to suggest that the euro area is experiencing a Japan-style liquidity trap.

Disaggregated Data Reveal Some Concerns

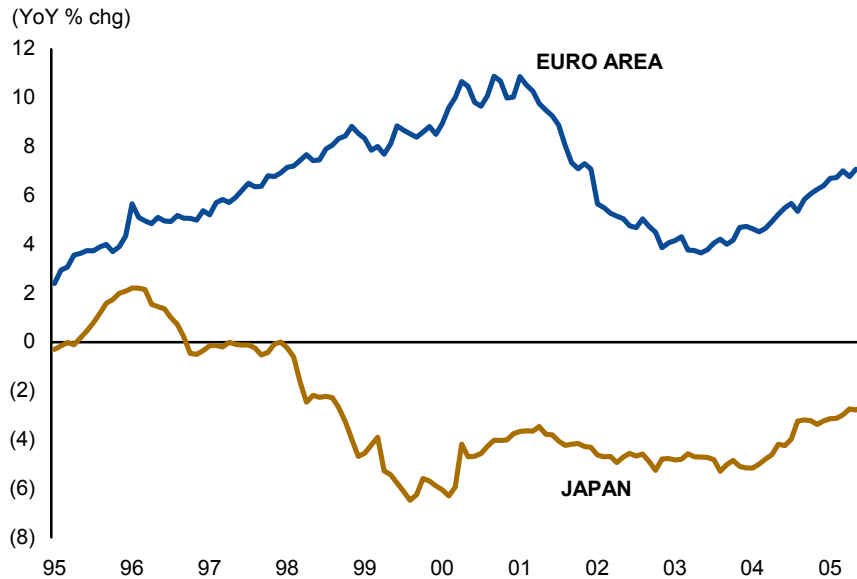
Although developments in bank lending and asset prices shed a reassuring light on the euro area as a whole, disaggregated data reveal a familiar story: marked divergence between individual countries.

Display 3 shows bank-lending growth in Germany and Spain over the last decade. Since the euro was launched in January 1999, bank-lending growth has averaged 14.9% per annum in Spain but only 2.6% in Germany. These growth rates have diverged further in recent quarters, and credit growth is now slightly negative in Germany. Growth is nowhere near as weak as it is in Japan, but is still a cause for some concern.

Developments in housing markets have been equally divergent. Although house prices in France and Italy have moved more or less in line with the euro-area average, this has not been the case in Germany and Spain (**Display 4**). While German house prices have risen just 6% since 1990, Spanish house prices have tripled over the same period. In part this is structural. Low Spanish prices have been catching up with the rest of the euro area, and Germany has had an excess supply of housing since reunification in the early 1990s. Nonetheless, it seems quite likely that these structural differences are being exacerbated by the euro and the need for the European Central Bank to set a common interest rate for both Germany and Spain.

*Darren Williams
Global Economic Research
July 15, 2005*

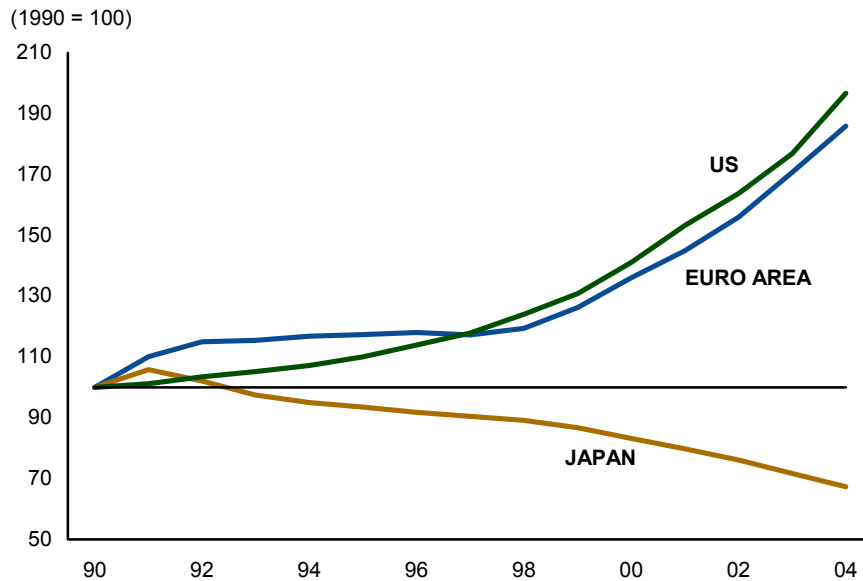
**Display 1: Monetary Policy Is Still Working in the Euro Area, If Slowly
Bank-Lending Growth in the Euro Area and Japan**



Source: Haver Analytics and Alliance Capital Fixed Income; July 15, 2005

Markets sometimes try to draw a parallel between the euro area and Japan. But bank-lending growth has been much stronger in the euro area and is slowly responding to low interest rates.

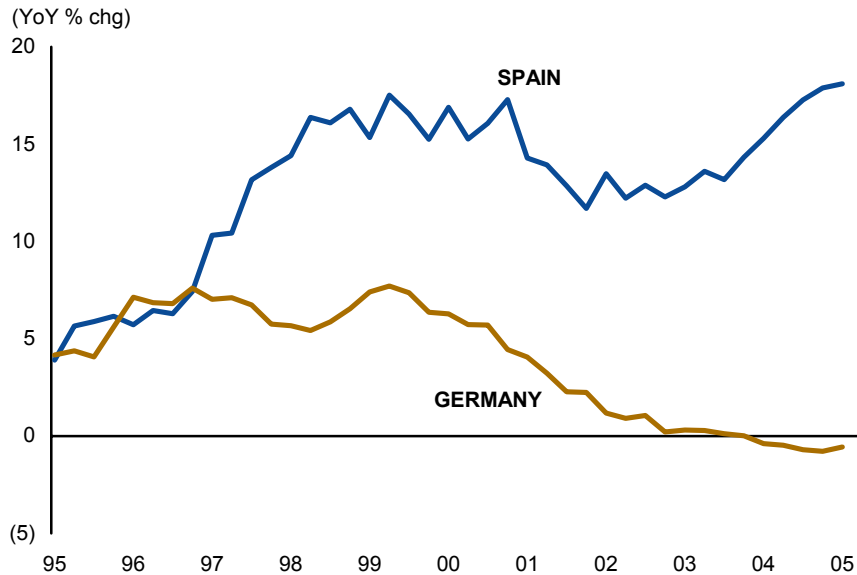
Display 2: Aggregate Euro-Area House Prices Have Risen Strongly Residential Property Prices, 1990 to 2004



Source: Bank for International Settlements and Alliance Capital Fixed Income estimates; July 15, 2005

House-price developments have also been very different. Indeed, euro-area house prices have risen almost as much as in the US in recent years. The problem is that a less developed financial system means it is more difficult for euro-area households to extract equity from their property.

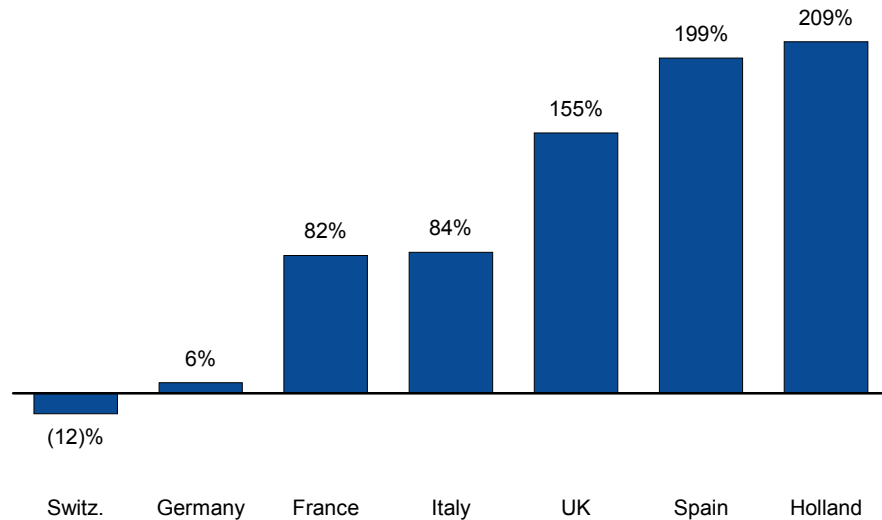
Display 3: Marked Divergence of Credit Growth Within the Euro Area
Bank-Lending Growth in Spain and Germany



Source: Haver Analytics and Alliance Capital Fixed Income; July 15, 2005

There is a significant divergence of bank-lending growth within the euro area. For example, Spanish credit growth is very strong, while German bank-lending growth is stagnant.

Display 4: Marked Variation in Euro-Area House-Price Inflation
Change in Residential Property Prices, 1990 to 2004



Source: Bank for International Settlements and Alliance Capital Fixed Income estimates; July 15, 2005

House price inflation also varies within the euro area. German house prices have hardly changed since 1990, but in Spain and the Netherlands they have tripled. Part of this is a structural phenomenon, but it is hard to believe that monetary policy has not also played a role.