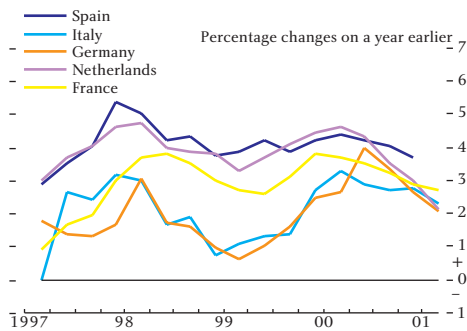


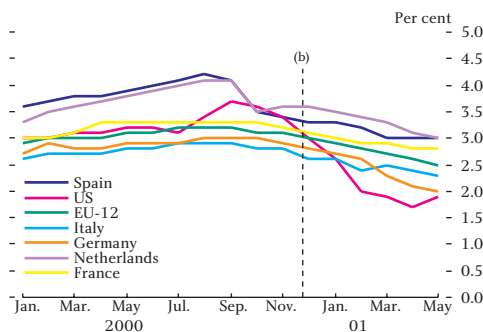
III Europe

Chart 48:
Real GDP



Source: Eurostat.

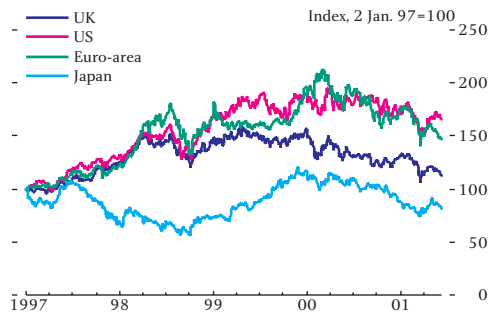
Chart 49:
Consensus Forecasts for 2001 GDP growth^(a)



Source: Consensus Forecasts.

- (a) Mean of forecasts compiled by Consensus Forecasts.
- (b) December 2000 Review.

Chart 50:
Equity indices (excluding multinational companies)^(a)



Source: Thomson Financial Datastream.

- (a) Denominated in US dollars.

While economic activity is slowing across the euro area, the downturn currently seems unlikely to be as sharp as in the United States, given the lower starting point; and, for the region taken as a whole, underlying imbalances and potential pressures on sectoral balance sheets are not so obviously apparent. Nevertheless, in some countries increased private sector gearing, rapid property price increases and falls in GDP growth rates continue to pose some risks.

Recent conjunctural developments: the euro area

Annual euro-area growth has slowed to 2.9 per cent in 2000 Q4 and 2.5 per cent in 2001 Q1 from 3.3 per cent in 2000 Q3. Growth in Germany and the Netherlands has slowed most (Chart 48). While decelerating domestic demand has been the main factor in Germany, a lower net trade contribution has so far been more important in France, as well as in more open economies such as Ireland. France, Germany and Italy account for most of UK-owned banks' total consolidated on-balance sheet claims¹¹ on European countries, representing 8 per cent, 5 per cent and 4 per cent, respectively, of total foreign claims.

There are indications that the extent of the slowdown and its implications for the medium-term outlook have surprised market participants. Since their peak in mid-2000, forecasts for German GDP growth in 2001 have been revised down by one percentage point, and GDP growth forecasts for Spain and the Netherlands by more than a percentage point each (Chart 49). Business confidence has continued to fall since its peak in June last year. And equity prices, including share prices of firms with predominantly domestic markets, have fallen since the December Review (Chart 50).

Sources of uncertainty regarding the outlook include the possible impact on the euro area of slowing US growth; the extent of any vulnerability to lower global demand for ICT; and the possible impact on demand of equity price falls. The likelihood of any of these turning into a major negative shock for the euro area, however, currently appears slim.

First, although far from immune to the slowing pace of US and world growth, the euro area as a whole is a relatively closed economy: trade exposures to the United States are not large for most countries (Chart 51). However, there may be common factors at work; the correlation of equity prices in the euro area and the United States has increased since the beginning of 2000 (Chart 52).

Second, the euro area may be less vulnerable than the United States to falling output in the ICT sector, since ICT represents a

¹¹ Includes claims of foreign affiliates in all currencies on local residents.

significantly smaller share of value-added in most continental European countries (Chart 53). On the other hand, French and particularly German TMT equity indices have fallen more than US TMT indices from their (higher) peaks last year, perhaps suggesting a more significant downward revision in growth expectations in Europe for the industries covered or that the TMT 'bubble' was more exaggerated there.

Third, although falling equity prices will tend to reduce current demand via wealth effects and increased costs of investment, the impact is likely to be less than in the United States. Stock market capitalisation in 2000 was higher in the US in relation to GDP (around 140 per cent) than in Germany (60 per cent), France (100 per cent) or Italy (65 per cent)¹². And quoted equities represent a smaller share of euro-area household wealth (as low as 3 per cent in Germany and France) than they do in the United States (20 per cent). By contrast, housing represents a significantly greater share of household wealth¹³.

Fourth, overall credit conditions appear stable so far. Euro-area bank lending has moderated slightly, but continues to grow at an annual rate of around 8.5 per cent. Similarly, liquidity in capital markets has held up in the euro area as it has in the United States (Chart 54). On the other hand, ratings downgrades of ICT firms by some rating agencies have significantly outnumbered upgrades during Q1 partly as a result of a perceived weakening in issuer access to liquidity.

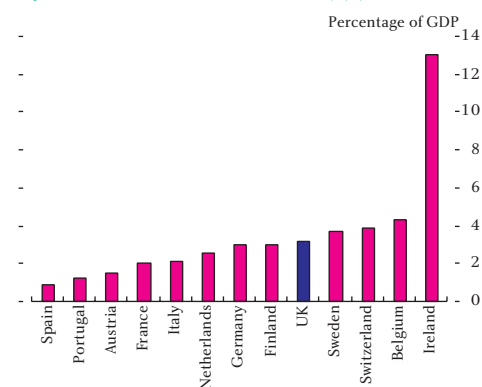
Sectoral balance sheets

Although a major setback to euro-area growth seems unlikely, any slowdown would be likely to lead to further rises in the private sector debt-to-GDP and income gearing (ie interest payments-to-GDP) ratios. According to new data published by the European Central Bank in May 2001, the ratio of private sector debt to GDP in the euro area increased steadily between December 1997 and June 2000, one consequence of robust credit growth (Chart 55). The ratio of household debt to GDP increased from about 44 per cent in December 1997 to about 48 per cent in June 2000, compared with about 78 per cent in the UK in 2000 Q4 and about 70 per cent in the US in 2001 Q1. Income gearing also rose, in line with rising interest rates, reaching an estimated 3 per cent in June 2000, compared with about 6 per cent in the UK (2000 Q4) and US (2001 Q1). Although euro-area household saving as a share of disposable income has declined steadily in recent years to about 9.5 per cent, it remains high relative to the US and continues to offer some protection against a further increase in gearing ratios.

¹² Source: Thomson Financial Datastream and IMF.

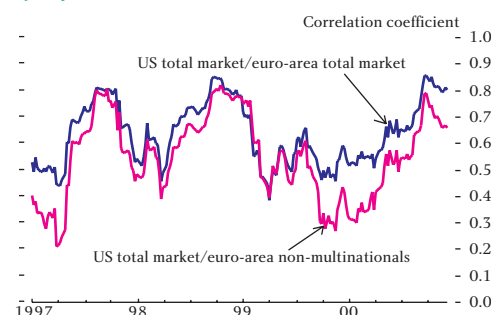
¹³ Girouard and Blondal, S (2001) 'House Prices and Economic Activity', Economic Department Working Paper 279, OECD.

Chart 51:
Exports to United States – 1999



Sources: IMF and Thomson Financial Datastream.

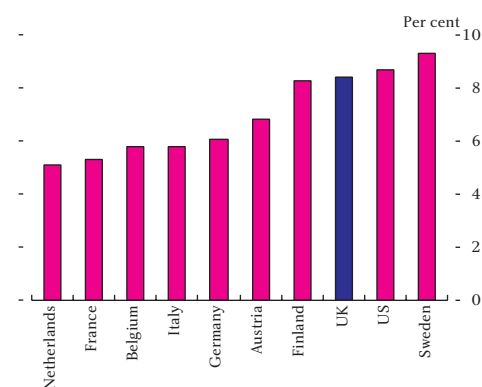
Chart 52:
Correlations between US and euro-area equity markets



Source: Thomson Financial Datastream.

(a) Rolling six-month correlations of weekly price changes.

Chart 53:
Share of ICT^(a) value-added in total business sector^(b)

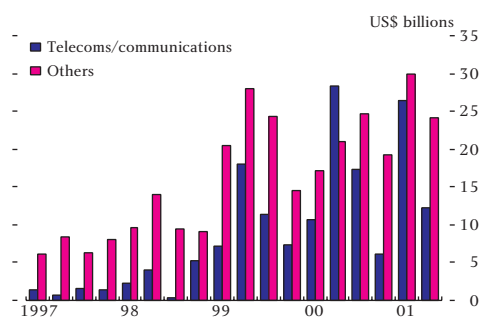


Source: OECD.

(a) Information, communications and technology.

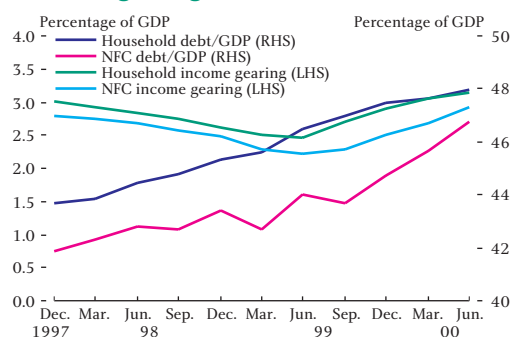
(b) 1997.

Chart 54:
Bond issuance by non-financial corporates resident in the euro area



Source: Capital Data.

Chart 55:
Euro-area gearing ratios^(a)



Source: European Central Bank.

(a) NFC: non-financial corporates.

Among non-financial corporations (NFCs), debt has also risen as a proportion of GDP from about 42 per cent at end-1997 to about 47 per cent in June 2000, compared with 58 per cent in the UK in 2000 Q4 and about 72 per cent in the US at 2001 Q1. Income gearing rose from about 2 per cent in mid-1999 to about 3 per cent in June 2000, compared with about 4 per cent in the UK in 2000 Q4 and nearly 5 per cent in the US in most years¹⁴. Euro-area debt-to-GDP ratios are likely to have increased further subsequently, given that credit growth rates, although moderating, have continued to exceed GDP growth rates.

The European banking sector

Table 6 shows the pattern of on-balance sheet credit exposures of the domestic banking systems of eight continental European countries, ordered by the scale of UK-owned banks' claims on their residents. In the five largest euro-area countries, lending to the domestic non-bank private sector accounts for a majority.

One particular issue over the past year or so has been the scale of banking system exposures to telecoms. While data are hard to come by, exposure to the telecoms sector is likely to have diminished somewhat as large companies have taken measures to reduce their debt and convert short-term commercial paper and bank debt into longer-term bond and equity liabilities (Section II).

The growth of a market for securitised loans in Europe (eg through asset backed securitisation and collateralised debt obligations) may give banks greater flexibility in managing credit and balance sheet risk. For example, the German Kreditanstalt für Wiederaufbau (KfW) has since September 2000 sponsored a

Table 6:
Distribution of European banking system's exposures

Country (percentage of UK-owned banks' overseas exposures)^(a)

Percentage of total banking sector assets (excluding domestic interbank claims) on:

	Non-bank private sector	Public sector	Overseas sector
France (7.7)	54	12	34
Germany (4.8)	59	15	26
Italy (4.0)	69	16	15
Netherlands (2.1)	61	6	33
Ireland (1.9)	31	2	68
Spain (1.6)	68	14	18
Belgium (1.3)	33	20	47
Switzerland (0.8)	45	4	51

(a) Total consolidated on-balance sheet claims of UK-owned banks, including claims of foreign affiliates, in all currencies on local residents. Not including claims on overseas entities resident in the UK; eg on overseas banks' offices in London, via the interbank market.

¹⁴ Corporate debt service figures relate to gross interest payments. Comparisons between the euro area, UK and US are indicative only; differences between each country and region may reflect definitional differences between official sources.

collateralised loan obligation (CLO) scheme ('PROMISE') for banks participating in its existing programme of support for small and medium size enterprises (the so-called Mittelstand). The scheme allows banks to transfer the credit risk associated with portfolios of such loans. KfW acts as an intermediary credit default swap provider between banks and investors. The initial PROMISE transaction in December 2000 was for more than US\$2 billion¹⁵.

Turning to the sector's robustness, profitability among the larger banks in Europe was strong in 2000 following several years of improving performance. Results in the last quarter of last year and the first quarter of this year, however, suggest that profits growth may be moderating. Although bank equity prices have declined since the December Review, they have outperformed the Euro Stoxx index as a whole (Chart 56).

Looking forward, banks have the challenge of the final changeover from legacy currencies to the euro at the end of this year, with potential operational risks for them and their customers.

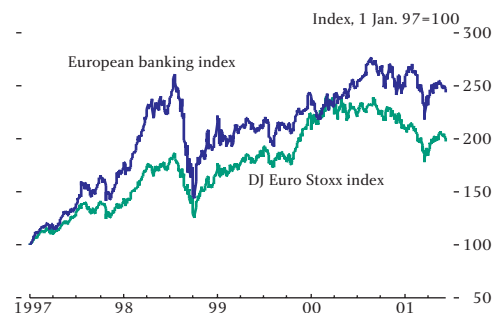
Possible risks in individual economies

Over and above Europe-wide developments, there do seem to be some noteworthy country-specific risks.

In Germany (and increasingly elsewhere in the euro area), economic prospects are subject to the risk of slowing real income growth stemming in part from a stronger-than-expected tick up in inflation. Annual real income growth has slowed from just over 3 per cent at the end of 1999 to around 1.5 per cent in 2001 Q1, reflecting higher than expected oil and petrol prices, stronger food (and particularly meat) price increases and the continuing decline of the euro. Banks are also likely to be affected by exposure to further weakness in the non-financial corporate sector, including sharply falling industrial production growth rates (Chart 57).

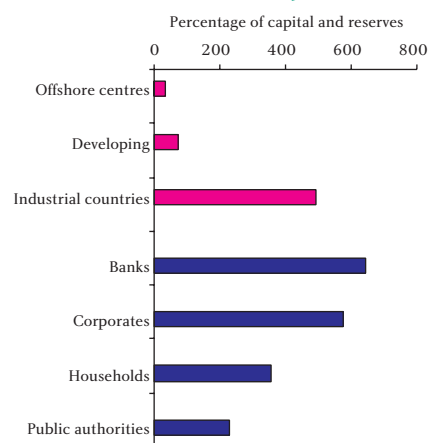
There also seem to be issues confronting some particular types of German banks. Average property price inflation in Germany has been negative or weakly positive since reunification, when prices rose modestly. In Berlin, however, weak office rent inflation in recent years followed a peak of about 80 per cent in 1990 (Chart 58). Any banks that lent extensively to the commercial property sector may have suffered losses as a result of the decline in returns and collateral value. For instance, the supervisory board of the Bankgesellschaft Berlin group (BGB) recently announced a €2 billion capital requirement for the group stemming, inter alia, from value adjustments in the real estate loan portfolios of its two member banks, Berlin Hyp and Landesbank Berlin, apparently

Chart 56:
Euro Stoxx indices



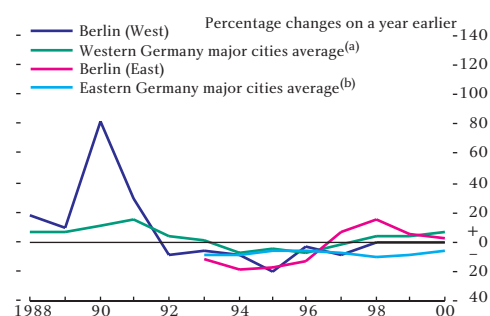
Source: Bloomberg.

Chart 57:
German-owned banks' exposure



Sources: Bundesbank and BIS.

Chart 58:
Berlin office rents



Source: Bulweil AG.

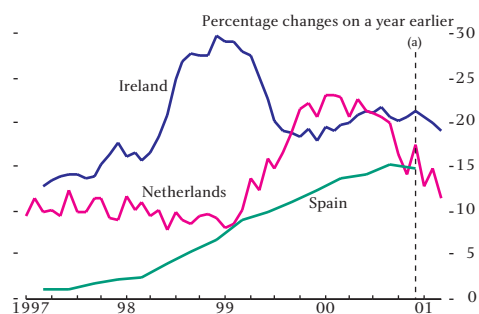
(a) Western Germany major cities includes Düsseldorf, Frankfurt (Main), Hamburg, Köln, München and Stuttgart.

(b) Eastern Germany major cities includes Leipzig, Potsdam, Rostock, Magdeburg and Dresden.

¹⁵ Moody's Investors Service, 16 November 2000, 'KfW's programme for "Mittelstand" – loan securitisation "PROMISE"'. See also the article by David Rule in this Review.

entered into between 1993-97. Although not technically a Landesbank itself, BGB is majority-owned by the Land of Berlin, and is the fourth biggest of the Landesbank peer group. Landesbanks currently receive top ratings from rating agencies, partly because of government support. Underlying ratings are lower, reflecting a weaker business base. For example, most Landesbanks are rated Aaa or Aa1 by Moodys; financial strength ratings, however, average about C.

Chart 59:
Residential property prices



Sources: Irish Permanent, Netherlands Land Registry and Bank of Spain.

(a) December 2000 *Review*.

As noted in the *December Review*, property prices have been rising rapidly in three countries – Ireland, Spain and the Netherlands (each representing about 2 per cent of total UK banks' foreign exposure as at end-2000), raising the question of whether their current levels are sustainable (Chart 59).

In Ireland, annual residential property price inflation has moderated slightly since the *December Review*, but has remained high (18 per cent in April). There is evidence that annual commercial property price inflation is also moderating, although it was still above 20 per cent in Q1¹⁶. The pace of bank private sector credit growth has also moderated as the ratio of private sector bank debt to GDP has risen above the euro-area average. Rapid asset price inflation has been associated with robust GDP growth and an economy-wide inflation rate significantly above the euro-area average. But tradable sector inflation – as proxied by producer price inflation in the manufacturing sector – has not been significantly higher than the euro-area average, probably reflecting strong price competition in the tradables sector. Strong productivity growth in that sector may have spilled over into higher wage growth in the wider Irish economy, thus pushing up domestic non-tradables inflation. But overall, economy-wide indicators of increasing inflation in Ireland have not necessarily been accompanied by a loss of competitiveness.

To the extent, however, that inflation begins to reflect an excess of economy-wide output over its equilibrium value, inflationary pressures may build in both traded and non-traded sectors, acting as a necessary restraining influence on growth rates via an appreciation of the real exchange rate. This effect would be reinforced if fiscal policy were set to be contractionary. While a gradual restoration of equilibrium via a slowing of growth would represent little cause for concern, a sharper shock to GDP growth could precipitate a deeper correction in asset prices. A more severe economic downturn in the United States could conceivably precipitate such a correction; Irish exports to the United States account for over 13 per cent of GDP and there are further links via cross-border ownership of firms which could lead to investment cut-backs. Whether any such developments would pose a material problem for the banking system would depend on its diversification. That may be more of an issue for

¹⁶: As measured by changes in the Jones Lang LaSalle Property Price Index.

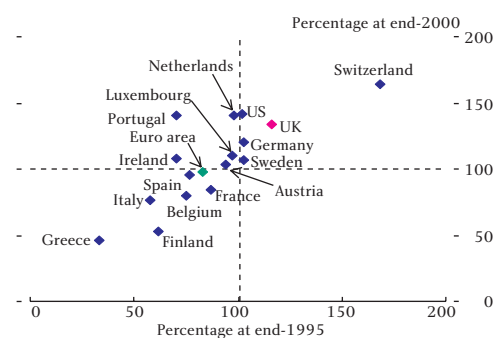
smaller banks. In this context, in February, the Central Bank of Ireland urged banks to tighten lending conditions to households.

Developments in Spain have been similar to those in Ireland in several respects. Annual inflation has been significantly above the euro-area average over the past six months at around 4 per cent. GDP growth has also been well in excess of euro-area averages during recent years, as has the growth rate of bank credit to the private sector. The extent to which the causes of relatively higher inflation in Spain mirror those in Ireland is an open question; productivity data are subject to considerable uncertainty. However inflation in the manufacturing sector remains only slightly above the euro-area average, which is suggestive of some similarity with the Irish case. As in Ireland, property prices have increased markedly, perhaps reflecting an increase in expected disposable incomes.

In the Netherlands, annual house price inflation fell back to 13 per cent in April, down from annual rates of over 20 per cent a year ago. It is possible that housing demand has, to some extent, been predicated upon a continuation of output growth at rates difficult to sustain in the longer run. Annual output growth remained at or above 3 per cent during 1998-2000, but dipped to 2.5 per cent in 2001 Q1. Inflation reached 5.3 per cent in April. Bank credit has also expanded rapidly and the ratio of bank private sector credit to GDP has increased significantly in recent years. New tax measures introduced in January reduce the tax relief available on mortgage interest payments in certain respects.

In two countries, Portugal and especially Greece, private sector bank credit has been growing particularly rapidly relative to GDP (Chart 60). In Greece, the ratio of bank debt outstanding to the private sector to GDP is still the lowest in the euro area and the growth rate of credit relative to GDP there may simply reflect financial intermediation 'catching up' with the rest of Europe. Nevertheless, it poses a question of how long banks can maintain adequate prudential standards under such conditions. In Portugal, on the other hand, where the growth of bank credit relative to GDP has also been rapid, the financial 'catch-up' argument no longer applies: the ratio of outstanding bank credit to GDP is now over 140 per cent, the highest in the euro area. Bank credit does not represent a significantly larger share of total private sector credit in Portugal than in the euro area as a whole. Moreover the growth of bank debt-to-income ratios has been rapid for a sustained period: it was 70 per cent in 1995. (In the UK, the ratio of bank credit to GDP is about 130 per cent, up from 116 per cent in 1995. See Section VIII.) External liabilities are also accumulating rapidly in Portugal; the current account deficit has averaged about 9 per cent of GDP in recent quarters. Nor do recent productivity growth rates there obviously suggest that debt has been financing investment with high rates of return which will facilitate repayment of debt in the future.

Chart 60:
Bank private sector credit as share of GDP^(a)



Sources: IMF, OECD and Bank calculations.

(a) Greek credit data for 2000 measured at January 2001, Swedish data at 2000 Q3.