

NEW EU ECONOMIC SENTIMENT INDICATOR AND IFO BUSINESS CLIMATE WEST GERMANY

In October the EU Commission published a new version of the Economic Sentiment Indicator (ESIN) which reflects, to a large degree, proposals made by the ifo Institute.¹ The most important features of the new EU Economic Sentiment Indicator are the following:

1. The share price index is no longer a component of ESIN. The volatility of share prices is only partly related to developments in the real economy. Apart from that, the construction of ESIN is based on trendless series. Thus, the share price index always had to be transformed into deviations from trend. This transformation causes ex-post revisions of ESIN which reduce the value of an overall leading indicator.
2. The retail trade confidence indicator is now used in the calculation of ESIN.
3. The consumer confidence indicator was modified. It now focuses exclusively on consumers' expectations and no longer includes assessments of developments in the past 12 months.
4. The weight of the components was changed. New ESIN: Industrial confidence (40%), consumer confidence (20%), construction confidence (20%) and retail trade confidence (20%).

¹ G. Goldrian, J.D. Lindlbauer, G. Nerb (with a contribution of B. Ulrich), Evaluation and development of confidence indicators based on harmonised business and consumer surveys, Economic Paper Number 151, European Commission, Directorate General for Economic and Financial Affairs, Brussels May 2001.

As a result, the new ESIN is entirely based on business and consumer survey results, the main advantage being that the ESIN will no longer be subject to back revisions.

As Figure 1 shows, the new ESIN tracks the development of GDP growth in the Euro area relatively well though it is more coincident than leading. To be sure, even a coincident nature of this indicator is not a negligible advantage as the quantitative data (e.g. GDP or industrial production) are published with a significant lag and sometimes are subject to marked ex-post revisions. Thus, a good coincident indicator has an important lead at the very end of the time series.²

² Moreover, it has to be taken into account that a series transformed into annual growth rates (like the GDP series in Graph. 1) will always show turning points earlier than the corresponding series of level data (e.g. GDP in form of an index). Thus, a transformation of the ESIN indicators into rates of annual changes will clearly improve the lead. However, due to this transformation the volatility of the indicator will increase, which suggests the use of some type of smoothing.

Figure 1

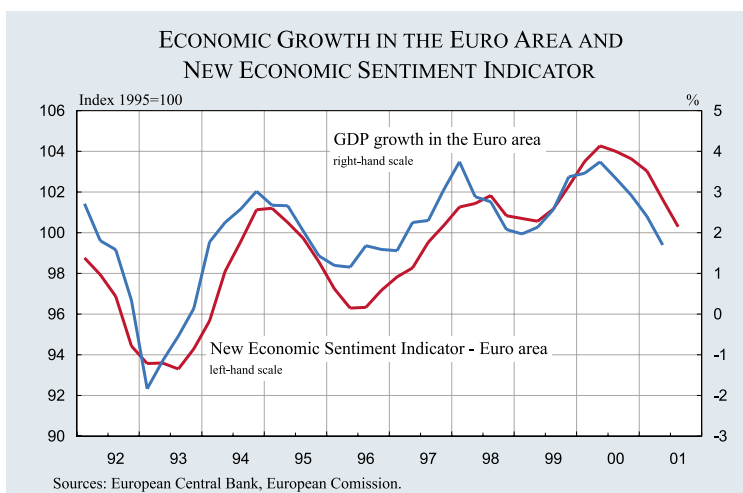
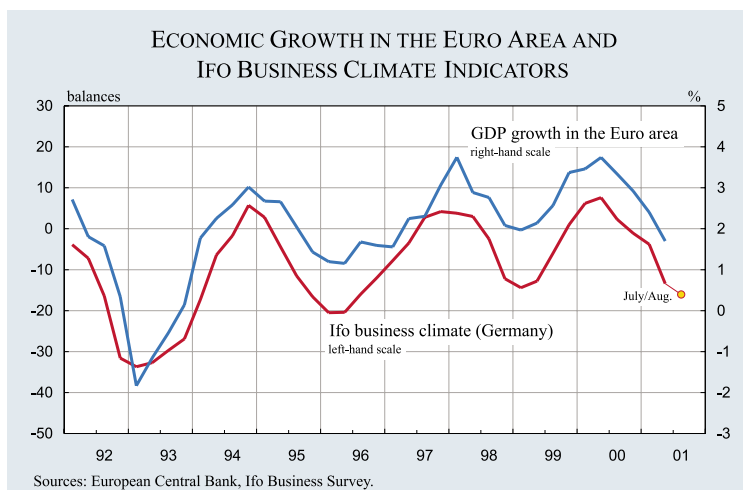


Figure 2



However, even better than an information lead would be a factual one. Here, the Ifo Business Climate Indicator appears to have some advantage (see Fig. 2). This might be because the Ifo Climate Indicator focuses more on profit assessments and expectations which appear to contain more forward looking information than e.g. production plans. It is somewhat surprising that the German Business Climate Indicator is not only a good predictor of the economic trend in Germany but also of that in the Euro area, although Germany accounts for only about one third of the Euro area gross domestic product (GDP).

Both composite indicators, the new ESIN as well as the Ifo Business Climate, signal a continuation of the economic downward trend in coming months, although the Ifo indicator points to a softening of the decline. It will be interesting to see if this message will also be given by Ifo's September indicator which will be collected in the first half of October and thus will better reflect any impact of the tragic events in New York and Washington; Ifo's August survey only reflected these events in part as only about one quarter of the companies polled returned the completed questionnaires after September 11. G.N.