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BUSINESS REUTERS 11



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CULTURE & MORE 9

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# Euro zone ensnared in global slowdown

## Economy contracts for first time since debut of its currency

By Carter Dougherty

**FRANKFURT:** The European economy, until now resilient in the face of choppy financial markets and slowing global growth, is finally buckling.

The economy of the 15-nation euro area contracted 0.2 percent in the three months ended June 30, data released Thursday showed, in what was the first quarterly shrinkage since the euro was introduced on Jan. 1, 1999. Figures released in Germany, France and Spain also showed receding or flat growth.

The information was the clearest evidence yet that a weaker global economy, high oil prices and the strong euro have taken a serious toll on Europe. But the European Central Bank, which has bucked the trend of other major central banks by raising interest rates in July, appears determined to stick to its mandate to tame inflation, arguing that higher inflation is still a greater threat than lower growth.

"There is no reason, in my view, to dramatize the situation," Jürgen Stark, a member of the ECB executive board, said during an interview. "However, there is a risk that analysts and politicians talk down the euro area economy. which might have a negative impact on business and consumer sentiment."

With Europe's economic health fading fast, the ECB will probably avoid raising rates again anytime soon. But it is unlikely to cut them either unless it sees clear signs that inflation is easing.

The data Thursday from the EU statistical agency Eurostat set off fevered head-scratching about whether Europe can formally dodge a recession, often defined as two successive quarters of shrinking economic activity. The consensus seemed to be that it still might — but just barely.

"We can probably scrape by and avoid another negative quarter," said Julian Callow, chief Europe economist at Barclays Capital. "But we are in for stagnation here."

The ECB has said it will "look through" the volatility of quarterly numbers, since the euro area grew 0.7 percent in the first quarter, but officials have conceded that they were surprised by the speed of the slowdown.

Stark, a former Bundesbank vice president who epitomizes the German tradition of digging in to fight inflation, talked up the threat, even as oil prices have slid from a July 11 high of $147.27 a barrel. The annual inflation rate in the euro area was 4.1 percent in July, double the ECB's target of 2 percent.

Stark took note of jibes from analysts that the ECB, modeled on the Bundesbank in Germany but a thoroughly multinational institution, is "all bark and no bite" by highlighting the bank's rate increase last month.

"We made it clear in July that we are

**ECONOMY, Continued on Page 12**

# Economy of euro zone contracts

**ECONOMY, From Page 1**

prepared to bite if need be," Stark said.

Though a cooler economy generally eases pressure on inflation, any assumption that this is always the case grates on ECB officials, and Stark was no exception. The central bankers complain analysts assume the bank will cut rates in the face of an economic slowdown, even though the ECB has given no such signal.

"We cannot be sure that inflation will go down significantly as growth slows," Stark said. "It may be true in some regions of the world but not in the euro area as a whole."

The new figures put Continental Europe in the same camp as other major industrialized economies, where the shock of financial turmoil and expensive energy has upended the rosy outlook of just a few months ago. The Japanese economy also contracted in the second quarter, and most economists now expect a recession in Britain, though no Group of 7 economy has yet been declared to be at that point.

In the United States, the government reported Thursday that consumer price inflation rose in July to a level not seen since 1991, confirming the economy's precarious position between rising prices and near-recession.

In Europe, the biggest surprise Thursday came in France, which unexpectedly joined the ranks of shrinking economies. Its economy contracted 0.3 percent in the second quarter, the clearest sign yet that French consumers, long the bright spot in that economy, were reining in spending as energy costs and lower home prices sapped demand.

"There are a lot of headwinds and not many tail winds," said Kenneth Wattret, chief euro zone economist at BNP Paribas. "That's now particularly true for France."

Output in Germany, which has been in recent years the hardy European locomotive, contracted 0.5 percent in the period, data released Thursday showed. Economists anticipated the decline because Germany's 1.2 percent growth in the first quarter had been powered by technical factors and brisk construction activity that would not be repeated.

The Spanish economy eked out 0.1 percent growth in the second quarter, its slowest rate since a deep recession after the 1992 Barcelona Olympics, and a direct outgrowth of a collapsing property sector.

Following an emergency cabinet meeting, the Spanish government on


Charles Platiau/Reuters

**Summer sales in Paris. The French economy contracted as consumers curbed spending.**

Thursday approved a €20 billion, or $29.6 billion, package of business and consumer financing in a bid to halt the economy's slide.

Central banks worldwide are grappling with slower growth and higher inflation, but the ECB has been notable for its single-minded focus on prices.

A recent study by the ECB staff, Stark said, has fortified the bank's resolve to stay focused on inflation. The inquiry looked at central banks in the 1970s, and concluded that the two with independence from politicians and a strong anti-inflation mandate — the Bundesbank and the Swiss National Bank — did the best job of protecting their economies.

"Those central banks with solid

**'There are a lot of headwinds and not many tail winds.'**

monetary policy frameworks succeeded in containing the external inflationary pressures better than others," Stark said.

The ECB's guarded attitude stems from mounting evidence that inflation may not decline alongside growth, Stark said. Oil prices are now finding their way into other prices, he said, like transportation services.

"What we see increasing are the indirect effects of past upward shifts in the price of oil and of other commodities," Stark said. "It is happening and there is a risk that it spreads."

Stark also said that Europe was home to "sticky prices and sticky wages." Elsewhere, slower growth helps ease price increases because unemployment rises, but economists believe strong labor unions and regulation dampen this effect in Europe.

Moreover, in Europe unit labor costs — a measure that combines employee pay and productivity — have edged upward, Stark said, raising the odds that higher expenses will get passed on to consumers in the form of higher prices. They averaged 1.4 percent from 1999 to 2007, but hit 2.4 percent in the six months ended in March, he noted.

The ECB is also still fretting about expectations of inflation, a gauge central banks monitor closely through financial markets and consumer surveys because it influences future price-setting.

The expectations ticked downward after the ECB tightened credit in July, but Stark argued that "they have not come down enough."


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*Watch video: Official warns that Germany's economy could shrink again.*