The Economic Situation in Europe

In its spring report on the economic situation, the Association of German Economic Research Institutes reached the following conclusions for Europe.*

In the Central and Eastern European countries that are striving for accession to the EU, output growth accelerated – substantially in most cases – during the course of 1999. Real gross domestic product was 2.3% higher than it was in 1998. In Poland, Hungary, Slovenia and Bulgaria, economic momentum was largely driven by domestic demand, while vigorous export expansion helped overcome the recession in the Czech Republic. In contrast, developments were less favourable in Slovakia and Romania where restrictive economic policies led to a slump in domestic demand. The Baltic states were more severely affected by the Russian crisis than the reform economies of Central Europe. Here, the economy did not pull out of its trough until the second and third quarters of 1999; on an annual average, real gross domestic product declined by 1.8%. In the entire region, upward price pressure accelerated once again – against the backgound of rising oil prices – towards the end of the year. Despite the distinct upward trend in output, there was a further deterioration in the labour market situation as rationalisation and modernisation in the industrial sector increased.

In Central Europe and the Baltic states, real gross domestic product is expected to expand again strongly in 2000; compared to 1999 it will increase by 3.4%. Apart from strong domestic demand – due not least to rising real wages – western European demand growth is making its presence increasingly felt. In 2001, economic activity will increase at much the same rate as this year. Domestic demand and exports will continue to steer a distinctly upward course. However, as a result of the robust performance of the region's economies, high import levels of intermediate inputs and the – in some cases quite pronounced – real appreciation of local currencies, there will also be strong import growth, thus reducing the net export of goods and services. Growing current account deficits will be accompanied by an increasing susceptibility to currency crises.

In the Russian Federation, real gross domestic product rose by 3.2% in 1999. Industry in particular profited from the depreciation of the ruble in 1998. The net export of goods and services improved, primarily as a result of the drastic fall in imports. While there was a severe slump in private consumption early in the year, investments expanded for the first time since 1990. Inflation has settled down again following a temporary surge in the wake of the depreciation of the ruble. After the summer, consumer prices rose at an annual rate of 20 to 25%. Real gross domestic product will grow at a rate of 4.0% this year, with domestic demand picking up momentum. Higher labour and transfer incomes together with increasing employment will lead private consumption to recover slightly. Investments will expand in response to improved yield prospects. Given that it is not clear what economic policy will be pursued under the new president, the output growth forecast of around 2.5% in the year 2001 is subject to considerable uncertainty.

UK: Expansion Losing Momentum

In the United Kingdom, demand and production have improved noticeably since last summer. Real gross domestic product grew in the second half of 1999 at an annual rate of just over 3%. The main reason for the strength of the economy was the relaxation of monetary policy which continued into 1999. This was augmented by a turnaround in exports: while there had been a distinct drop in exports up to the spring, they have since been on the increase, stimulated by the more favourable development of the world economy. There was no improvement in the net export of goods and services, however, since strong import growth continued unabated.

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* Participating institutes: Deutsches Institut für Wirtschaftsforschung, Berlin; Hamburgisches Welt-Wirtschafts-Archiv (HWWA); ifo Institut für Wirtschaftsforschung, Munich; Institut für Weltwirtschaft an der Universität Kiel; Institut für Wirtschaftsforschung, Halle; Rheinisch-Westfälisches Institut für Wirtschaftsforschung, Essen. The report was finalised on 14 April 2000.

On the whole, domestic demand proved to be robust. With a growth rate of 4.5% private consumption expanded strongly last year, buttressed by a further decline in the savings rate and facilitated by the fact that the increase in the level of employment continued at much the same pace in spite of the weaker economy. Gross fixed capital formation still increased perceptibly, albeit at a markedly slower rate. Public consumption, on the other hand, expanded faster than in 1998.

Fiscal policy will have a slightly stimulating effect during the forecast period. Public sector investments in particular are expected to undergo strong expansion, thus leading to a reduction in the budget surplus (1999: 1.2% in relation to gross domestic product). In contrast, monetary policy will be restrictive. Expectations of higher wage increases and strong increases in house prices have led to a rise in interest rates totalling one percentage point since last summer. Given that the acceleration of consumer price rises observed in the past few months will continue for the time being, the institutes expect the Bank of England to tighten the reins still further.

Initially, the economic upswing in the UK will continue at much the same fast rate as before, but will flatten off thereafter. On the one hand, the dampening impact of monetary policy means that domestic demand will not expand as rapidly as before. On the other hand, the stimulus afforded by foreign demand is on the wane, particularly as a consequence of the economic slowdown in the USA. Real gross domestic product will grow at 3.0% this year and 2.6% in 2001.

EMU: Strong Economic Upturn

The EMU economy strengthened markedly during the course of 1999. In the second half of the year, real gross domestic product expanded at an annual rate of 3.5%. The cyclical divergencies between the member countries diminished appreciably.

Economic revitalisation was driven primarily by exports, which – as a result of a return to more robust expansion in the emerging economies of East Asia, economic recovery in the transition economies and ongoing dynamic growth in the USA – picked up considerably. These factors were underscored by the improved price competitiveness enjoyed by EMU companies thanks to the low valuation of the euro against the dollar and other currencies. The export recovery benefited Italy and Germany in particular. Domestic demand proved highly dynamic last year as a result of a distinctly expansionary monetary policy. In 1999, private consumption growth was only marginally lower than the previous year, and gross fixed capital formation increased just as strongly as in 1998. In 1999, the rise in employment was only slightly lower than the previous year's figure, despite the cloudier state of the economy at the start of the year. There were, however, considerable differencies between the individual member countries. While the level of employment increased continuously in most countries, it fell in Germany and Italy initially and did not begin to pick up again slightly until the end of last year.

Inflation in the EMU accelerated markedly during the course of 1999 under the influence of higher crude oil prices and the depreciation of the euro. In February this year, consumer prices were 2.0% higher than a year previously. The core rate, however, remained stable; it recently stood at 1.2%.

Wage Policy Remains Restrained

With total output expanding less strongly in the first half of last year, and with labour costs increasing marginally faster, unit labour costs rose at an accelerated rate up to the summer. The rise in unit labour costs has since slowed down again.

Upward wage pressure will not accelerate in the forecast period. The first collective pay settlements in Germany suggest that wage developments will remain moderate. This should act as a signal for the rest of the EMU. Although there is no formal wage policy coordination between individual countries, wage negotiations devote an increasing amount of attention to major trading partners' pay settlements. Altogether, wage increases in the EMU will remain moderate. Little increase is expected in the level of unit labour costs as economic expansion continues. This is also true of France, where the increase in labour costs remains small in spite of extensive reductions in working hours, which were not accompanied by fully equivalent pay cuts. For the EMU as a whole, wage policy does not give rise to inflationary pressure .

Fiscal Policy Strengthens Growth

Last year saw another marked decline in the level of public budget deficits in the EMU countries; in relation to gross domestic product it amounted to a weighted average of just 1.2% compared to 2.0% in 1998. The reduction in the structural budget balance was even more apparent, because the total utilisation of capacity in 1999 was lower than that of the previous year. There was no confirmation of fears that, following the start of the third stage of the European

Monetary Union, fiscal policy would abandon the consolidation course of the previous years. On the contrary, in most cases public sector budgets clearly developed even more favourably in 1999 than had been envisaged in the stability and growth programmes.[1] Four states (Finland, Ireland, Luxembourg and the Netherlands) already enjoyed budget surpluses.

As a rule, expenditure increases remained strictly limited. In relation to gross domestic product, government expenditures in the EMU fell by one percentage point. Since 1993, when the public sector share in GDP had reached a high-water mark at just under 54%, it has fallen by around five, since 1996 by 3.5 percentage points. In 1999 it was nudged downwards primarily by a further reduction in the burden of debt service. Despite recent interest rate increases the average rate of interest on outstanding government bonds fell even further, since relatively high interest bonds issued in the 1990s expired and were replaced by bonds with a lower value interest warrant. There was little fall in primary government expenditures (expenditures excluding interest payments) in relation to gross domestic product.

In 1999, government revenues turned out to be higher than had been expected following the tax reductions and in view of the relatively unspectacular economic performance during the first half of the year. The fact that tax revenues flowed so copiously was due in part to the relatively robust state of domestic demand, but also to a number of exceptional factors: in Germany, for example, substantial back-payments on assessed taxes accrued for profits made in previous years, and in several countries, such as Italy and Portugal, the efficiency of tax collection was improved.

Expenditure increases will remain low in the forecast period; some countries even plan to cut government expenditures in real terms. The decline in the public sector share in GDP is helped by the fact that the burden of interest payments will again diminish as a result of debt-restructuring, even though capital market rates are no longer quite as low as last year. Complete implementation of what are in part decid-

[1] Exceptions are Portugal, where the deficit/GDP ratio of 2.1% was slightly higher than planned (2.0%), and Austria, which just managed to reach the target value. While Italy was only slightly below the value of 2.0% put forward in the original stability programme, a revised stability programme drawn up in view of the foreseeable weakness of the economy had been approved by the Commission that envisaged new government borrowings to the amount of 2.4% of gross domestic product. Measured by this standard, the performance was much better. Favourable developments in some countries are qualified by the fact that the deficit has been reduced on a purely statistical basis with the changeover to ESA 95; plans had been drawn up on the basis of ESA 79. This factor is of particular relevance for Germany, France and Belgium.

Considerable Gaps in EMU Statistics

More than a year after the introduction of the euro there is still no satisfactory foundation for the collation of data in the monetary union. This is true of a range of statistics, but is particularly apparent with regard to national accounts as well as labour cost and employment statistics. As a result, diagnoses, forecasts and economic policy decisions relating to the EMU are still made on a very uncertain statistical basis. There is thus a pressing need to improve the official statistics.

No Complete and Consistent Quarterly National Accounts

The European System of Accounts 1995 (ESA 95) represents a unified guideline for EMU countries' national accounts. Even so, there are still no complete and consistent quarterly accounts for the euro area.

Only very short time series are available for a number of countries, and some countries still do not compile quarterly values. Furthermore, there is still no coherent approach to seasonal adjustments. Another grave inadequacy is that trade flows between the member countries are still not registered separately within the framework of the national accounts. For the EMU as a whole, figures relating to the output side are published by Eurostat only for the period 1995 to 1998 and these are presented in a very coarse structure. Time series for the expenditure side exist as from 1991. For these figures, Eurostat had to carry out makeshift retrospective calculations for individual countries on the basis of ESA 79. However, only the main aggregates are available in current prices and in 1995 prices. For such an important aggregate as gross fixed capital formation in particular, there is still no differentiation between equipment and buildings. The limited availablity of data hampers the examination of the EMU as a single currency area.

No Unified Wage Statistics

The situation regarding wage development indicators in Europe remains poor. Although Eurostat has been compiling a labour cost index for some years now that is intended to reveal the development of total labour costs per hour, these data are still collected by the national statistics offices using sometimes widely differing procedures and definitions. The method used in Germany, in particular, differs considerably from those applied in other countries. Moreover only the total index for the euro area is published, but not the index for each individual country. Data regarding pay settlements in the member countries of the EU are collected by the European Industrial Relations Observatory. Here, however, wage drift and non-wage labour costs are not recorded, so that these statistics also prevent the collation of comprehensive information on the development of labour costs. The situation is even more precarious where data for forecasting purposes are concerned. For example, there is still no quarterly indicator for the EMU that could correspond to the German Bundesbank's pay rate index and that could provide a basis for forecasting the development of wages and effective incomes.

edly ambitious plans is highly unlikely. On the one hand, it is not improbable that some important countries will experience stronger public sector wage rises than their budgets assume. On the other hand, abundant revenues probably mean that demands for greater spending in other areas will be more readily met.

At the same time, there will be tax cuts in most countries this year and next. The tax burden is being reduced particularly strongly in Germany; notable cuts are also to take place in France, the Netherlands, Spain and Finland. In a number of countries – e.g. Finland, Ireland, the Netherlands and Italy – the government plays a decisive role in achieving wage policy consensus. In such cases, income tax reductions serve as "rewards" for moderate pay settlements. They thus represent a component part of an incomes policy that aims to limit the rise of wage costs and to reduce the risks to stability that arise in the course of rapid economic expansion. Seen from this perspective, stability is not necessarily jeopardised by tax cuts even in countries with a particularly high level of capacity utilisation.

In view of these developments in expenditures and revenues it becomes apparent that in spite of the strong increase in production there will only be a negligible reduction in the deficit/GDP ratio in the EMU (Table 1). This means there will be no further reduction in the structural budget deficit this year; for 2001 a temporary slight increase is expected as a result of the tax cuts. This will stimulate the economy this year and even more next year.

Table 1
Indicators of the State of Government Budgets in the EMU

	Gross Debt[1]				Budget Surplus or Deficit[1]			
	1998	1999	2000	2001	1998	1999	2000	2001
Germany	60.7	61.1	60.8	60.2	−1.7	−1.1	−1.1	−1.6
France	59.3	58.6	58.0	57.8	−2.7	−1.8	−1.4	−1.2
Italy	116.3	114.9	111.5	108.5	−2.8	−1.9	−1.5	−1.1
Spain	64.9	63.5	61.7	60.5	−2.6	−1.1	−0.4	−0.1
Netherlands	67.0	63.8	60.5	59.0	−0.8	0.5	0.5	0.0
Belgium	117.4	114.4	111.0	109.0	−1.0	−0.9	−0.5	−0.3
Austria	63.5	64.9	64.0	63.0	−2.5	−2.0	−2.0	−1.5
Finland	49.0	47.1	42.0	38.5	1.3	2.3	4.4	4.8
Portugal	56.5	56.8	56.5	55.5	−2.1	−2.0	−1.5	−1.2
Ireland	55.6	52.4	48.5	46.0	2.1	2.0	1.2	2.0
Luxembourg	6.4	6.2	6.0	6.0	3.2	2.4	2.5	2.5
EMU[2]	72.9	72.2	70.7	69.5	−2.0	−1.2	−1.0	−1.0

[1] In % of gross domestic product; as defined in the Maastricht treaty.
[2] Total of the listed countries. Weighted with the 1998 gross domestic product in Ecu.

Sources: Eurostat; 2000 and 2001: forecast by the institutes.

However, all this does not mean that fiscal policy in the EMU countries is losing sight of the target of budgetary consolidation. This emerges from the revised stability and growth programmes. Compared with the progress made in consolidating budgets in recent years, however, the planned pace at which public sector finances are to be improved is slow.

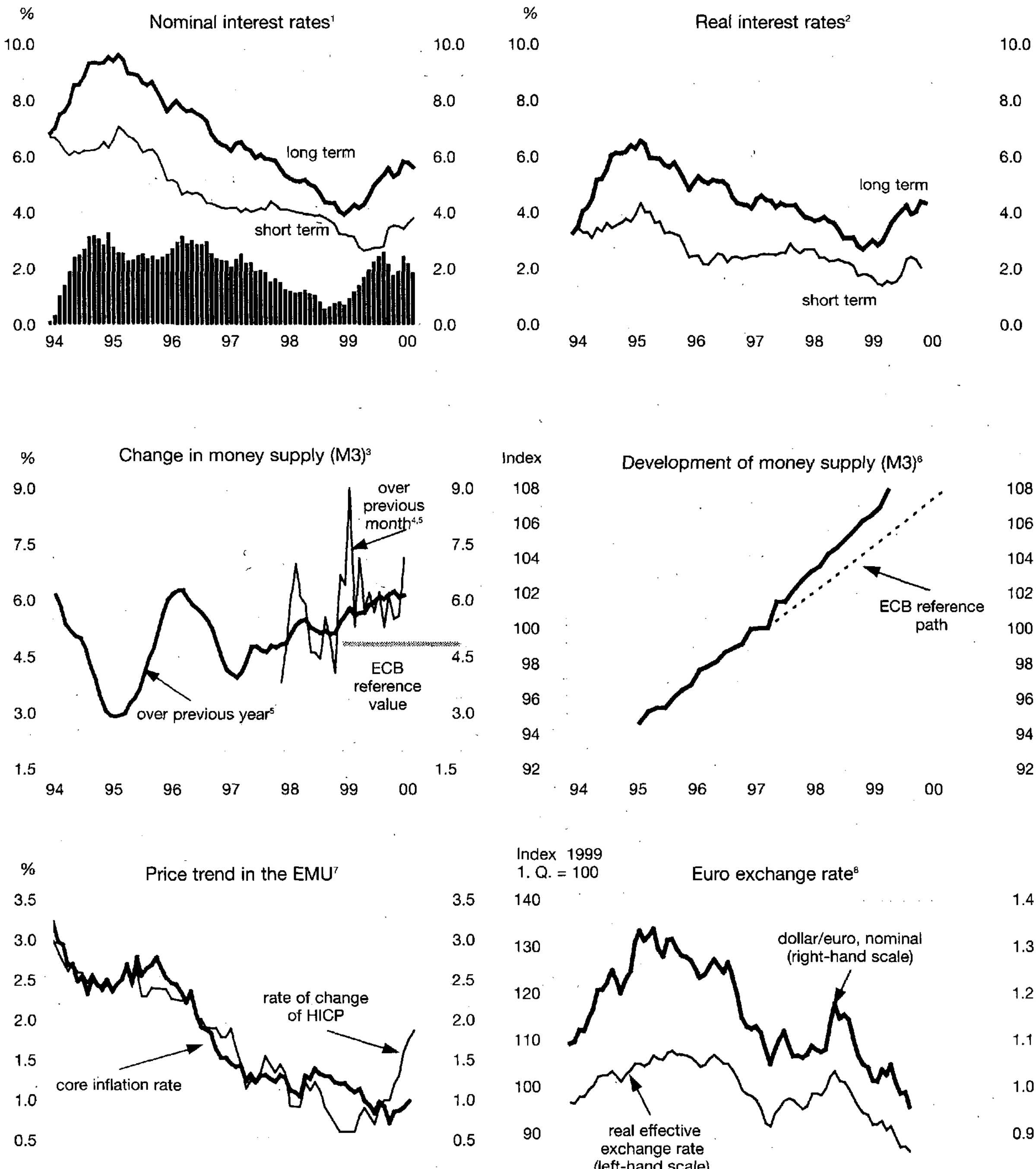
In view of the favourable economic climate, the slow pace of consolidation in important countries has been criticised from various quarters including the ECB and the OECD. The critics maintain that some countries have not yet ensured a budgetary position, which, in the case of an economic downturn, would allow automatic stabilisers to take effect without exceeding the limit of 3.0% of gross domestic product laid down in the Stability and Growth Pact. Furthermore, debt levels in some countries are still very high. Against this background, the critics argue, it would be appropriate to use additional revenues for budgetary consolidation rather than loosening restrictive spending policies just yet.

More important than the question of whether the target of a balanced budget in the medium-term is reached sooner or later is, however, whether or not fiscal policy is actually on the right track. This is the case in the euro area at present: the combination of spending restrictions and tax cuts promises to bolster the forces of growth. Fiscal policy is thus helping to solve what still remains the most pressing problem – high unemployment. The institutes arrive at this positive assessment of the fiscal policy in the EMU strictly on the condition that government spending discipline is maintained as planned. The impulses for medium-term growth emanating from these policies would be particularly strong if the reduction of the public sector share in GDP were to be accompanied by an increase in the proportion of investive expenditures, in other words if the cuts were to be made in consumptive spending. The resolutions made at the latest meeting of the heads of state and government in Lisbon, where the major focus of future spending was on training and education as well as on research and development, indicate that the intention is indeed to implement just such a policy. The institutes welcome the fact that the debate on consolidating government finances also extends to cover qualitative aspects.

Monetary Policy Tacking a Neutral Course

In November 1999, the ECB changed direction on interest rates; the main rate for refinancing operations was raised in three steps by a total of one percentage

Figure 1
Indicators of the Monetary Situation in the EMU



[1] Short term = three-month Euribor; long term = government bonds with a remaining maturity of ten years. [2] Nominal interest rate less consumer price increase over previous year. [3] M3 includes currency in circulation, overnight deposits, deposits with an agreed maturity of up to two years, deposits redeemable at notice up to three months, repurchase agreements, money market fund shares and money market papers, debt securities with maturity of up to two years; changes over previous year. [4] seasonally adjusted, converted to annual rate, in %. [5] Three-month centered moving average. [6] Index, seasonally adjusted. [7] HICP = Harmonised Index of Consumer Prices; core inflation rate = rate of change of HICP excl. energy and unprocessed food. [8] Before 1999: Ecu.

Sources: European Central Bank; Deutsche Bundesbank; calculations by the institutes.

point to 3.5%. In line with the development of ECB rates, the three-month EURIBOR has now risen to 3.8%. The yield on ten-year government bonds, which had been 5.7% at the start of the year, is now at 5.4% – the same level as in the autumn of last year.

At present, monetary policy has a generally somewhat less expansionary effect than it had six months ago. The short-term real interest rate – taken as being the nominal interest rate less expected inflation, approximated here by the core rate – is probably around 2.5% and is thus only slightly below the long-term average for Germany.[2] At around 4%, assuming long-term inflation of 1.5%, today's real capital market ten-year interest rates roughly correspond to the long-term average for Germany. The low valuation of the euro continues to be a source of expansionary impetus. Its effective exchange rate in real terms has further weakened in recent months and in March was around 6.5% lower than it was six months ago.

The money supply M3 increased in the first half of 1999 at an annual rate of 7.1% (Figure 1). This growth rate slackened to 5.6% in the second half of the year; however, it was still clearly above the ECB reference value (4.5%) and was also above the value, which, in the estimation of the institutes, is compatible with monetary stability in the medium-term (5%). Money supply growth again accelerated at the start of the current year. In February, the money supply expanded at a very fast – seasonally adjusted – annual rate of 11.6% compared to January. The increase of the Harmonised Index of Consumer Prices (HICP) has accelerated markedly. As a result of the strong oil price rises, however, the current rate of increase considerably exaggerates the medium-term dynamics of inflation. During the forecast period, the core rate is expected to speed up slightly. The main cause of this acceleration is likely to be the growing scope for passing on price increases as the utilisation of capacity increases, but it will also be due to higher crude oil costs gradually trickling through into producer prices. Conversely, the moderate pay settlements assumed here will have a dampening effect on the core rate.

[2] In most EMU countries, nominal interest rates were sometimes well above the German level in recent years. This primarily reflected higher inflation expectations and the subsequent expectations of a depreciation of the local currency against the deutschmark. Given that control of monetary policy has passed on to the ECB and that the exchange rates have been irrevocably fixed, such expectations no longer exist. It thus appears justified to base the longer-term average on the level of real interest rates in Germany (cf. the institutes' autumn report 1999, Table 3.1.).

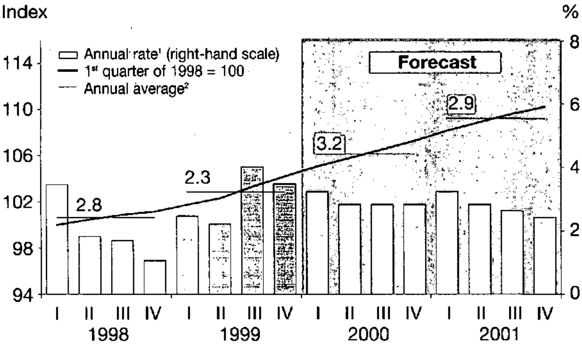
The institutes thus expect the ECB to raise the main rate for refinancing operations by a total of 0.5 percentage points by the autumn. Capital market rates will not increase quite as much as the short-term rates. As for the nominal exchange rate of the euro against the dollar, it is assumed that there will be a slight appreciation in the forecast period. Altogether, the monetary climate will then be neutral.

Rapid Expansion Continues

The strong expansion of economic activity in the EMU will continue for the time being, as is suggested by the level of new orders and by economic climate indicators. A slight slowdown can be expected later in the year (Figure 2). Following the dynamic developments of the final quarter of 1999 and the first quarter of this year, export growth will be distinctly slower as demand in important foreign markets, particularly in the USA, increases less vigorously. Moreover, the stimulus provided by the weakness of the euro will gradually peter out. On the other hand, rapidly expanding aggregate demand will lead to a continuation of the strong increase in imports, so that the net export of goods and services will decline as a result (Table 2).

While domestic demand will continue its robust expansion, it will grow at a slightly slower rate during the course of next year. This is primarily due to the development of gross fixed capital formation that will intially rise further as capacity utilisation increases and sales and earnings expectations remain positive. Next year the rate of expansion is expected to weaken noticeably as the monetary stimulus disappears. Private consumption will again expand strongly, stim-

Figure 2
Real Gross Domestic Product in the EMU Adjusted for Seasonal Variation



¹ Change over previous quarter in %, converted to annual rate.
² Numerical data: change over previous year in %.

Sources: Eurostat; calculations by the institutes; from 1st quarter 2000: forecast by the institutes.

Table 2
Economic Indicators for the EMU

	1999	2000	2001
	Change over previous year in %		
Real gross domestic product	2.3	3.2	2.9
Private consumption	2.5	2.8	2.9
Public consumption	1.2	1.1	1.2
Gross fixed capital formation	4.5	5.2	4.3
Net export[1]	1.6	1.9	1.7
Consumer prices[2]	1.1	1.8	1.7
	in % of nominal GDP		
Balance on current account	0.7	0.5	0.3
Budget surplus or deficit[3]	−1.2	−1.0	−1.0
	in % of labour force		
Rate of unemployment[4]	10.1	9.2	8.5

1 In % of real gross domestic product. [2] Harmonised Index of Consumer Prices. [3] All levels of government. [4] Standardised.

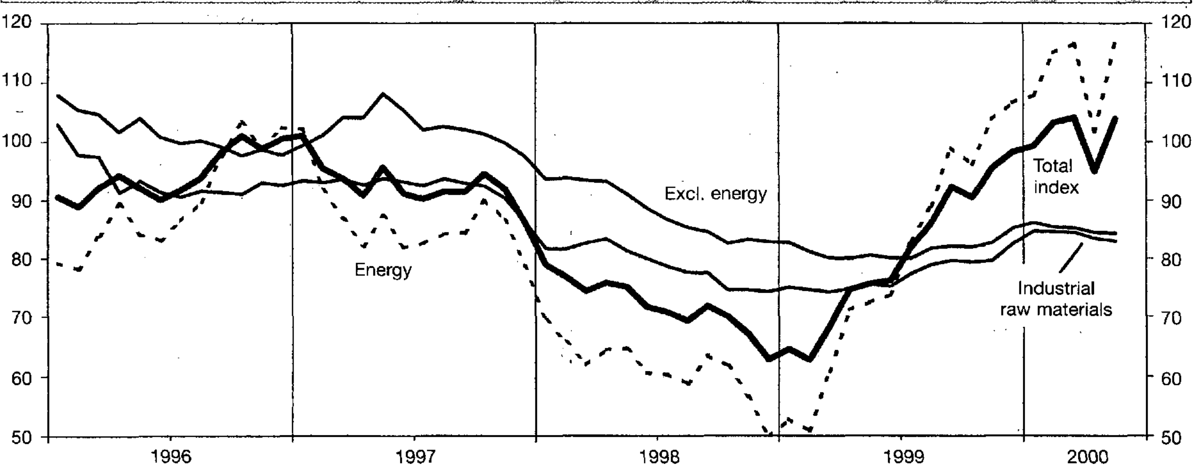
Sources: Statistics of national and international institutions; calculations by the institutes; 2000 und 2001: forecast by the institutes.

ulated next year by renewed tax relief measures planned in several countries.

Real gross domestic product in the EMU will increase by 3.2% this year and by 2.9% next year, whereby the cyclical divergencies between the individual countries will continue to diminish. Strong employment growth can be expected given the ongoing strength of economic expansion. During the course of the year 2000, the unemployment rate is expected to drop below the 9% mark for the first time since the beginning of the 1990s.

Altogether, consumer prices will not rise at an accelerated rate during the forecast period. Here, the effects of crude oil price rises and the depreciation of the euro are expected to gradually diminish during the second half of the year. The inflation rate will be 1.8% this year and 1.7% next year.

HWWA Index of World Market Prices of Raw Materials[1]
(1990 = 100)



Raw Materials and Groups of Materials[1]	1999	Nov. 99	Dec. 99	Jan. 00	Feb. 00	Mar. 00	Apr. 00	May 00[2]
Total Index	80.5 (11.8)	95.5 (42.4)	98.2 (56.4)	99.3 (53.8)	103.3 (64.6)	104.2 (52.4)	94.9 (27.2)	103.9 (37.5)
Total, excl. energy	81.5 (−7.7)	82.7 (−0.7)	85.2 (2.9)	86.2 (4.2)	85.4 (5.2)	85.2 (6.5)	84.4 (5.6)	84.3 (4.8)
Food, tropical beverages	94.2 (−18.7)	91.8 (−15.8)	93.3 (−13.8)	90.5 (−14.2)	87.5 (−12.9)	87.5 (−10.1)	87.6 (−8.1)	88.6 (−7.0)
Industrial raw materials	77.2 (−2.2)	79.6 (6.8)	82.4 (11.1)	84.7 (13.0)	84.6 (13.5)	84.4 (13.9)	83.4 (11.5)	82.9 (9.8)
Agricultural raw materials	78.6 (−0.9)	78.9 (5.7)	82.0 (8.3)	83.4 (7.3)	82.9 (5.9)	83.4 (7.3)	83.8 (8.7)	81.6 (5.3)
Non-ferrous metals	71.9 (1.0)	79.5 (17.6)	82.5 (27.7)	86.9 (37.0)	86.9 (37.3)	84.6 (33.4)	80.1 (19.2)	82.3 (19.2)
Energy	79.9 (30.1)	103.8 (83.8)	106.7 (114.5)	107.8 (104.4)	115.0 (126.5)	116.5 (91.8)	101.7 (43.1)	116.7 (61.2)

[1] On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change.
[2] Up to and incl. 26th May.