The Economic Situation in Europe

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

The institutional framework in the Central European and Baltic states has undergone further improvement, not least in view of achieving accession to the EU. There was strong expansion of aggregate production into the summer of this year, and for the first time since the beginning of the reform process, gross domestic product is increasing in all the transformation countries at the same time. These developments have been supported by strong private demand as well as by foreign trade impulses generated by the vibrant state of the western European economy. Current account deficits remain high, partly also as a result of dearer oil imports.

During the forecast period, economic expansion can be expected to be somewhat weaker, but nonetheless distinct. It will be sustained primarily by vigorous domestic demand as companies continue to show a strong propensity to invest and private consumption remains robust. Here too, however, internal demand will be dampened by the increase in energy costs. In addition, exports will expand at a slightly lower rate than this year due to the weakening dynamism in western Europe and to the appreciation in real terms of a number of currencies against the euro. In 2001, real gross domestic product will increase at 3.6% – slightly less than this year (4.0%). Given that a continuation of the strong rise in crude oil and food prices is improbable, consumer prices will increase at a slower rate during the forecast period.

In Russia, output growth in the first six months of this year was particularly pronounced; the level of economic activity is now much higher than before the outbreak of the country's crisis in 1998. In this respect, Russia has benefitted considerably from the increase in world prices for crude oil and natural gas. In addition, companies' price competitiveness has increased following the marked depreciation of the ruble in real terms that took place in 1998. With strong export growth and improved terms of trade, there has been a strong rise in the balance of trade surplus. Investments have risen considerably in view of the companies' improved profitability. In addition, private consumption picked up perceptibly in the first half of the year 2000 as real incomes rose by 21% compared to the previous year. The rise in consumer prices, which had weakened considerably during the course of last year, continued at an annual rate of 20%. While the money supply is currently expanding at a much faster rate of 55%, this does not necessarily mean that the rate of inflation is accelerating because money holding is also on the increase as barter trade declines. With the depreciation of the ruble losing effect, there are already indications that expansion in Russia is beginning to flatten out. As a result of the high growth rates at the start of the year, real gross domestic product will grow by 6.5% in the year 2000. Growth in 2001 will be somewhat slower, at around 4%.

Flagging Expansion in the UK

In the United Kingdom aggregate output expanded strongly in the first half of 2000. Real gross domestic product grew at an almost unchanged annual rate of around 3%. In contrast to most western European countries, the economy benefitted from the rise in oil prices because the UK is a net exporter of crude oil.

With employment increasing and real incomes on the rise, the economy was bolstered by lively demand from private households. There was also a considerable increase in government consumption. Exports grew at a significantly accelerated rate, stimulated by the dynamism of the world economy and by the marked depreciation of the pound sterling against the US dollar. Since imports did not increase to the same degree, there was a decline in the negative value of net exports in real terms; moreover, the current account deficit was reduced as a result of the sharp increase in oil revenues. The only loss of momentum has been in the field of company investments, where construction activities in particular were dampened by higher interest rates.

* 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 20 October 2000.

During the forecast period, economic policy has various, yet on the whole essentially neutral effects on the economy. Following a relatively long consolidation phase, fiscal policy, for example, is increasingly expansive. Expenditures in particular are on the increase; this is equally true of both public investments and government consumption. On the other hand, the Bank of England has been tightening the reins on monetary policy since the summer of 1999. With real interest rates well above the long-term average and an inverted interest rate structure, monetary policy is now manifestly restrictive. We assume that the key interest rates will remain unchanged during the forecast period. In view of the strong upward trend in wages and the very low level of unemployment at 5%, it is unlikely that interest rates will be cut in the near future. Nor is an increase in interest rates to be expected, since, to begin with, a number of indicators such as the level of new orders in manufacturing industry, the development of retail trade sales and economic climate indicators all point to a further slowdown in domestic demand. Secondly, exports will be dampened appreciably by the less favourable condition of the world economy as well as by unit labour costs which are increasing at a faster rate than in most other countries; these factors will be compounded by the fact that the real effective exchange rate of the pound is still high. Finally, the inflation rate, which – despite the oil price rise – until recently stood below the target of 2.5%, offers no grounds for a tightening of monetary policy.

Despite the marked expansion of government demand along a wide front and despite the continuing strength of private consumption, the economy will gradually lose momentum during the course of 2001. This is largely the result of a slower rate of increase in corporate investments due to poorer sales and earnings expectations, a continued loss of impetus in residential construction due to the relatively high level of interest rates, and a significant slowdown in export growth. In 2001, real gross domestic product expands at 2.7% after 3% in 2000. Employment increases at a much slower pace. Any acceleration in the upward price trend will probably be only slight.

Upturn in Euro Area Losing Momentum

The economic upturn in the Euro area continued in the first half of the year. With an annual growth rate of just over 3½%, real gross domestic product increased just as fast as in the second half of 1999.

The upswing continued to be stimulated by foreign demand. Exports maintained their strong expansion, bolstered by the ongoing potency of the US economy as well as by a marked recovery among the emerging economies of Southeast Asia and the reform countries of Central and Eastern Europe. Further momentum was provided by the depreciation of the euro, which led to an improvement in companies' price competitiveness.

Internal demand also maintained its strong growth. Rising employment and tax relief measures caused a slight acceleration of private consumption, while favourable export expectations and a high level of capacity utilisation led to a further marked expansion of investments in plant and equipment. In contrast, there was little increase in construction investments. Expenditure growth for government consumption remained modest. Since imports also expanded at a rapid rate thanks to the strength of the euro area economy, there was no more than a slight increase in real net exports, in spite of the healthy state of the export economy. Worsening terms of trade meant there was actually a clear drop in the balance of trade surplus. The current account ran to a deficit of € 14 billion in the first seven months of this year, following a surplus of € 21 billion in the same period of last year.

Output growth has been accompanied by an appreciable increase in employment, which rose at an annual rate of approximately 2% up to the summer. Unemployment has fallen noticeably. The unemployment rate for the euro area fell to a mid-year level of 9.0 % and was thus 0.6 percentage points lower than at the start of the year. In recent months, consumer price developments have been primarily dictated by foreign trade. During the summer, the price increase accelerated once more as the price of oil again climbed above 30 US dollars per barrel and the depreciation of the euro against the dollar continued. In September, the Harmonised Index of Consumer Prices (HICP) was 2.8% higher than last year.

Price rises and higher interest rates have already led to a deterioration of the economic climate. A number of indicators suggest that production growth has slowed considerably since the middle of the year. Those indicators which capture the assessment of the economic situation from the point of view of companies and consumers imply that there has been a marked darkening of the general mood. The strong drop in retail trade confidence suggests that private consumption in particular is now suffering from the loss of purchasing power caused by the rise in oil prices.

Moderate Wage Rises

Wage policy within the euro area takes on a particular significance against the background of rising oil prices. Due to the unsatisfactory situation with regard to the availability of wage and income statistics, it is still not possible to paint a coherent picture of wage developments in the euro area which could be used to draw reliable conclusions concerning possible inflationary dangers. While the labour cost index rose in the first half of 2000 by 3.5% compared to the same period of last year, after just 2.2% in 1999, the results of this index must be interpreted with caution (see box). Other statistics do not yet point to an acceleration of wage developments in the euro area as a whole. The earnings index, for example, which comprises employees' gross wages and salaries (excluding non-wage labour costs), does not show any trend towards higher wage increases in the first half of 2000 than a year previously. The situation is similar with regard to unit labour costs. On average across eight countries in the euro area,[1] these actually increased less rapidly than last year due to the stronger increase in productivity that was spawned by the economic upturn. While unit labour costs fell in Germany and Belgium, and were largely unchanged in France, Austria and Finland, they rose rapidly in Spain and the Netherlands.

Both the collective pay settlements which have already been concluded and statements issued by unions and management suggest that there will be no deviation from a policy of moderate pay rises. In Germany and France, long-term collective pay settlements have been concluded in important sectors of the economy which will determine wage developments until well into next year.

In Italy, collective pay negotiations for more than one-third of all workers are on the agenda this autumn. Since 1993, collective pay negotiations in the various industries have been geared to central agreements. A key point of reference for wage increases is the so-called programmed inflation rate – a target rate of inflation jointly established by unions, management and the government. The current central agreement is also valid for next year, and while it does not include any compensation for external price shocks, negotiations can be reopened if there is a significant difference between the current inflation rate and that upon which the central agreement is based. A renunciation of the current course, which is geared to stability, is unlikely – particularly in those sectors facing international competition. Wage settlements will probably average around 3%, only marginally higher than last year's level. Total wage costs will increase slightly less, since non-wage labour costs are being reduced by a total of three percentage points up to the year 2003.

In Spain, the collective pay contracts concluded so far allow for pay improvements of just under 3%.

Interpretation of the Labour Cost Index in the Euro Area

A superficial examination of the increase in the euro area labour cost index in the year 2000 presents a different picture than other wage development indicators. This is largely due to the way in which the index is computed. For example, the labour cost index for Germany shows a growth rate of more than 3% for the first six months of the year 2000, following a rate of around 2% in 1999. This contrasts with hourly labour income as defined for the national accounts which shows no acceleration during this period. The disparities are also a result of different definitions. While the national accounts encompass the entire economy, the labour cost index covers only some of the sectors – in Germany, for example, the public sector as well as the hospitality and transport industries are not included. Yet these are precisely the areas which are currently characterised by below-average wage increases. In addition, the way in which it is computed means that the labour cost index is very sensitive to changes in average working hours. It is computed by dividing total labour costs – i.e. including the employers' share of social security contributions – by the number of hours worked. In doing so, the number of working hours estimated for the whole year is distributed equally over the four quarters of the year. However, in Germany there are three working days less in the year 2000 because some public holidays fall on a weekday this year rather than on a weekend as was the case last year. The number of days worked is thus approximately 1.5% lower than last year. Consequently, the greater rise in the labour cost index compared to last year is not due to an acceleration in wage increases, but is purely the statistical result of a reduction in the number of hours worked. According to information from Eurostat, a similar effect regarding the number of working days in the year 2000 can also be observed in other countries of the euro area. When interpreting the labour cost index it is therefore important to take into account the fact that a development of this kind only leads to an increase in companies' wage cost burden and thus only represents a danger to price stability if production also declines by a corresponding amount as a result of the lower number of working days, in other words if the greater hourly wage costs are not accompanied by similar increase in hourly productivity. It is probable, however, that the loss of production due to public holidays is at least partly offset, so that in total there is also an increase in hourly productivity. In this case, unit labour costs rise little, if at all. Indeed, there has been no acceleration of the increase in average unit labour costs for the eight largest coutries in the euro area in the first six months of the year 2000.

[1] Germany, France, Italy, Spain, the Netherlands, Belgium, Austria and Finland.

However, three-quarters of the pay agreements include review clauses which enable adjustments to be made should the actual inflation rate differ from expectations. At the moment it is impossible to judge whether these clauses will be applied at all and, if so, to what extent. However, the trade unions have already announced that they wish to reopen negotiations. Given that the country's economic expansion is expected to weaken, however, they will probably have limited success in asserting their position. Nonetheless, wage increases in Spain will be higher than the European average.

For the euro area as a whole, gross wages will thus show little acceleration. In many countries, moderate wage policies will find additional support in fiscal policies that aim to cut taxes and lower social insurance contributions.

Fiscal Policy Provides Stimulus

This year, public budget deficits have been declining considerably faster than originally expected. For the first time since the early 1970s, there will probably be a slight budget surplus for the countries of the euro area as a whole. The debt ratio, too, is rapidly approaching the reference value of 60% laid down for the individual countries in the Maastricht treaty. The improvement of the budgetary situation is above all due to exceptional revenues from the allocation of mobile telephone licences (UMTS) to the tune of 1% of gross domestic product. Greater revenues and lower expenditures are also the result of the current business cycle situation. After adjusting for exceptional revenues, however, there is little change in the structural deficit which was cut back considerably last year. In this respect the consolidation efforts of the member states have slackened.

Table 1
Economic Indicatiors for the EMU

	1999	2000	2001
	Change over previous year in %		
Real gross domestic product	2.4	3.3	2.8
Private consumption	2.7	2.8	2.7
Public consumption	1.4	1.4	1.4
Gross fixed capital formation	5.3	4.9	4.3
Exports[1]	4.5	12.2	8.8
imports[1]	6.1	11.3	9.1
Net exports[2]	–0.5	0.5	–0.1
Consumer prices[3]	1.1	2.3	2.1
	in % of nominal GDP		
Balance on current account	0.4	–0.4	–0.4
Budget surplus or deficit	–1.3	0.3	0.5
	in % of labour force		
Rate of unemployment[5]	9.9	9.0	8.3

[1] Exports and imports comprise goods and services including cross-border trade within the euro area.
[2] Change in net exports over preceding year in % of real gross national product of preceding year.
[3] Harmonised Index of Consumer Prices.
[4] All levels of government.
[5] Standardised.

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

In most cases, there has been only a minor increase in expenditures this year. This was partly due, on the one hand, to the fact that social welfare expenditures remained below budgeted levels as a result of favourable labour market developments. On the other hand, there was a decrease in the debt burden. At the same time, tax revenues are increasing rapidly in spite of the fact that there have been tax reductions in a number of countries; any loss of income resulting from these tax cuts is being more than offset by additional revenues generated by the economic upturn.

In several countries, the public budget is being augmented this year and next by exceptional revenues from the sale or auction of mobile telephone licences. In Germany, Spain and the Netherlands, licences have already been allocated. In Italy and Austria the allocation is to take place in the near future. For the euro area as a whole, this year's proceeds correspond to approximately one percent of gross domestic product. They will be lower in the year 2001, when France will be the only country to generate significant revenues.[2]

Fiscal policy in the euro area will be relaxed in the coming year. There will be tax cuts – some of which will be considerable – in most countries. In the three largest economies of Germany, France and Italy in particular, the tax burden is to fall appreciably. Emphasis is being placed on the reduction of income tax rates. In the euro area as a whole, the volume of tax relief will probably total around ¾% of gross domestic product.

In 2001, too, there will be little increase in expenditures. However, many countries are to implement additional compensation measures in view of the rise in oil prices. These include one-off or temporary heating cost grants, aid for the fishing industry and agricultural businesses. In some countries, moreover, the compensation measures include a reduction in fuel tax or cuts in the value added tax on diesel, petrol and heating oil as well as

[2] According to a Eurostat decision, the revenues are to be accounted for in full as negative expenditures in the year of allocation, irrespective of the actual mode of payment.

the postponement of planned eco-tax increases in the Netherlands and in Italy. However, the volume of these measures is relatively small.

Next year there will be a public budget deficit in the euro area of around 0.5% of gross domestic product. Considering that the UMTS revenues will equate to 1% of gross domestic product this year and probably around $\frac{1}{4}$% next year, the adjusted deficit runs to about $\frac{3}{4}$% in both years. As a result of the considerable tax cuts, there will be a slight increase in the structural deficit; fiscal policy is therefore charting an expansive course, and will thus interrupt its programme of consolidation next year.

Monetary Conditions Have Neutral Effect

Since the spring, the ECB has raised its key interest rates in four steps by a total of $1\frac{1}{4}$ percentage points – and thus by a much greater amount than had been expected by the institutes. The main refinancing rate now stands at 4.75%, or $2\frac{1}{4}$ percentage points higher than it did one year ago. The three-month Euribor has climbed to 5%. Short-term real interest rates are probably somewhat higher than the German average over the past 25 years.[3] As a result, short-term interest rates are having a slightly restrictive effect on the economy.

Since the start of the year, ten-year government bond yields in the euro area have persistently remained at around 5.5% in spite of the increase in money market interest rates. The marked decline in yields in the USA, a lower level of public sector borrowing in the euro area, and – despite the rise in oil prices – low expectations regarding medium-term inflation have probably all had a dampening influence on capital market interest rates. In real terms, assuming an inflation rate of around 1.5% in the medium term, today's capital market interest rates of around 4% equate more or less to the long-term average in Germany.

Following a period of rapid growth in February and March, expansion of the M3 money supply aggregate has weakened markedly. In the months from June to August, M3 increased at an annual rate of only 3.8%, whereas the year-on-year rate of increase for this period still totalled 5.3%. While the money supply growth rate thus remained above the ECB reference value (4.5%), it was nonetheless close to the value regarded by the institutes as being compatible with medium-term monetary stability (5%), especially as it is financing the inevitable primary price level increase arising from the rise in crude oil prices. Account should also be taken of the fact that the increase in the money supply in August is slightly exaggerated by short-term liquidity requirements in connection with the auction of UMTS licences in Germany.

The low external value of the euro is having a stimulating effect on the economy. The price competitiveness of companies compared to those outside the euro area is thus distinctly higher than the 1990s average. These stimulating impulses have grown even stronger following the renewed depreciation of the euro in recent months. In September, the real effective exchange rate of the euro was around 10% lower than at the start of the year. All in all, monetary conditions can be expected to have a neutral effect on the economy.

The institutes anticipate that the ECB will leave the main refinancing rate at its current level throughout the forecast period. A tightening of monetary policy is unlikely given the economic slowdown, as long as oil price-induced inflation does not translate into appreciably higher wage settlements. The latter is not to be expected. In addition, the increase in consumer prices will slow down in the coming year. While the core rate of inflation will probably still increase in the first half of the year due to a further increase in the level of capacity utilisation, the rate of increase of the HICP will weaken if oil prices develop in line with the assumptions made in the forecast. It is assumed that the real effective exchange rate of the euro will remain constant during the period of the forecast. All in all, monetary conditions will continue to have a neutral effect on the economy.

Outlook: Economy Loses Momentum

Tighter monetary policy and the loss of momentum in the global economy will lead to a levelling off of the underlying economic trend in the euro area during the forecast period. This development will be compounded by the dampening effects of the oil price rise. Next year the economy will be bolstered by the expansive impulses emanating from fiscal policy.

The levelling off of the underlying economic trend is primarily due to the more restrained development of foreign demand. In addition, the stimulus provided by

[3] In most euro area countries in the past, nominal interest rates were in part considerably higher than the German level. This difference primarily reflected higher expectations of inflation and/or resulting expectations regarding a depreciation of the currency in question against the deutschmark. Since the ECB has taken over control of monetary policy and exchange rates have been fixed irrevocably, such expectations no longer exist. It thus appears justifiable to base the longer-term average on the level of real interest rates in Germany.

the depreciation of the euro will begin to wear off next year. Exports will thus increasingly lose momentum during the forecast period.

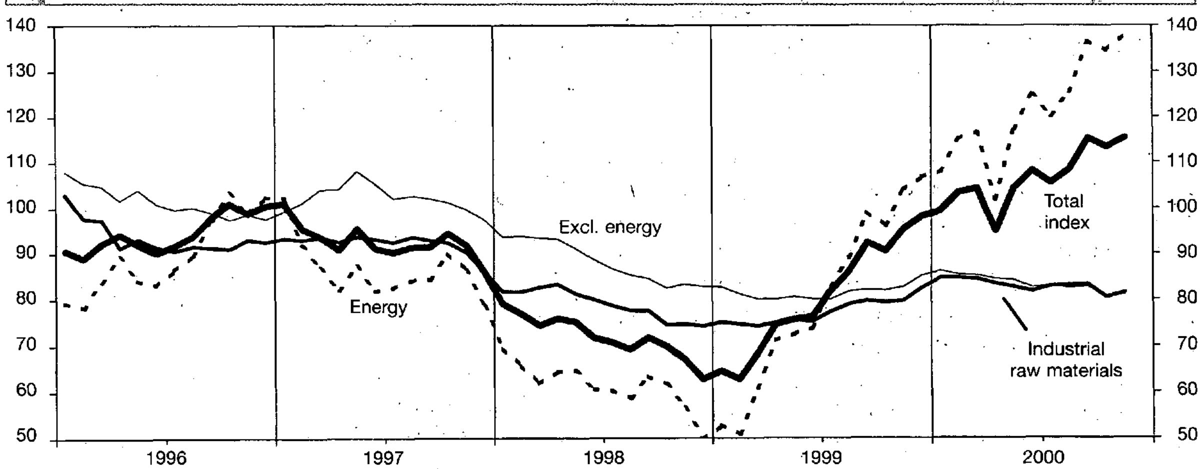
Initially, private households will face a loss of real income as a result of the rise in oil prices. In many countries, however, they will benefit from tax cuts next year; in addition, their real incomes will also improve during the latter part of 2001 if oil prices fall as expected. Following a period of temporary weakness, private consumption will probably pick up again noticeably next year as a result of stimulating fiscal policy measures.

Investments in plant and equipment are still increasing vigorously, even though growth rates are gradually beginning to slow down. On the one hand, these investments are being dampened by unfavourable foreign sales prospects, but on the other hand consumer demand remains robust, capacity utilisation is still favourable and corporate taxation levels are reduced appreciably. In contrast, construction investments continue to expand at a very restrained rate. As in recent years, government consumption increases with moderation. All in all, internal demand will next year expand only marginally slower than this year. As a result, there will continue to be a significant increase in imports, and net exports will gradually diminish in the course of next year.

Under these circumstances, real gross domestic product will grow by 2.8% next year – a somewhat slower rate than this year (3.3%). Employment will expand at a slightly slower rate, and the average annual unemployment rate will fall from 9.0% to 8.3%. If crude oil prices develop as assumed here, the increase in consumer prices will slow down again considerably; on an annual average, however, it will probably still be around 2.1%.

HWWA Index of World Market Prices of Raw Materials[1]

(1990 = 100)



Raw Materials and Groups of Materials[1]	1999	May 00	June 00	July 00	Aug. 00	Sep. 00	Oct. 00	Nov. 00[2]
Total Index	80.5 (11.8)	104.3 (38.0)	108.1 (41.9)	105.4 (28.9)	108.3 (25.8)	115.2 (24.8)	113.2 (25.1)	115.3 (20.8)
Total, excl. energy	81.5 (–7.7)	84.2 (4.6)	82.6 (3.2)	82.9 (3.7)	82.4 (0.9)	82.7 (0.8)	80.6 (–1.7)	80.9 (–2.2)
Food, tropical beverages	94.2 (–18.7)	88.6 (–7.0)	85.1 (–10.0)	83.0 (–5.6)	80.7 (–10.2)	81.2 (–9.1)	81.3 (–9.3)	79.4 (–13.6)
Industrial raw materials	77.2 (–2.2)	82.7 (9.6)	81.7 (8.8)	82.9 (7.3)	83.0 (5.2)	83.2 (4.6)	80.3 (1.2)	81.4 (2.2)
Agricultural raw materials	78.6 (–0.9)	81.5 (5.1)	80.4 (3.3)	81.7 (4.4)	82.3 (2.9)	80.6 (1.8)	78.4 (–0.8)	81.8 (3.6)
Non-ferrous metals	71.9 (1.0)	82.3 (19.2)	80.9 (20.0)	82.7 (12.6)	82.5 (9.5)	86.8 (9.5)	81.3 (3.6)	78.7 (–1.0)
Energy	79.9 (30.1)	117.4 (62.1)	124.8 (69.4)	120.1 (44.8)	125.2 (40.8)	136.4 (37.8)	134.5 (40.0)	137.8 (32.8)

[1] On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change.
[2] Up to and incl. 24th November.