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 year 2000, aggregate production increased in all the countries of Central and Eastern Europe simultaneously for the first time since the beginning of the transformation process. Here, too, however, expansion weakened markedly during the course of the year. Growth was dampened by a loss of purchasing power caused by the high price of oil, the economic slowdown in Western Europe and the appreciation of local currencies against the euro, which, in real terms, was substantial in some cases. Despite a deteriorating balance of trade situation in most countries the favourable development of services exports led to a widespread decline in current account deficits, although these did remain high in certain individual countries. Consumer prices, which had accelerated during the first half of the year 2000 as a result of the rise in oil prices – and also, in many cases, as a result of considerably higher food prices – have increased at a slower rate again since the middle of last year. Ongoing corporate restructuring led to a rise in the unemployment rate which was considerable in some cases.

In most cases, domestic demand will probably remain vigorous during the forecast period, in part supported by a range of investments – in the fields of infrastructure and the environment, for instance – which are necessary for the planned accession to the EU. At the same time, the economic slowdown in Western Europe will have a dampening effect. In Poland, an increase in demand is further hampered by the country's restrictive monetary policy. As a result, real gross domestic product in the Central European and Baltic countries will expand at 3.1% in the year 2001, a slower rate than last year. Next year, a gradual improvement in the global economic environment and generally stronger domestic demand will help the rate of economic growth accelerate to just under 4%. Current account deficits will increase in view of the high level of capital goods imports and the further appreciation, in real terms, of local currencies. Financing these deficits should not be a problem in most countries, however, since the influx of foreign direct investment can be expected to remain high. The rise in price levels will continue to slow down during the forecast period, with single-digit inflation rates in most countries. There is unlikely to be any substantial decline in unemployment as corporate sector restructuring continues.

Favoured by a drastic rise in oil and gas revenues, Russia's real gross domestic product increased very strongly last year at a rate of 7.6%. Domestic demand expanded strongly in view of perceptibly higher profits and sizeable increases in real wages. Investments rose by just under 18%, and private consumption expenditure increased by more than 8% in real terms. Economic expansion weakened towards the end of the year 2000, however, and recently there has even been a contraction of industrial production. Prices again increased at an accelerated rate, partly as a result of the significant increase in the pace of money supply expansion. On average, the inflation rate stood at 20.2% for the year 2000. Since structural reforms are making only hesitant progress and the country's international competitiveness is deteriorating continually in view of the stark rises in real wages, gross domestic product can be expected to grow at a significantly slower rate during the forecast period.

The countries of the European Union also started the year 2000 with high growth rates, only to see a perceptible slowdown in economic expansion during the further course of last year. The primary reasons for this slowdown were a loss of purchasing power due to the rise in oil prices and tighter monetary policy. At the same time, the unemployment rate did not fall to the same degree as it had previously. While wages developed with moderation, consumer prices (HICP) increased at an accelerated rate, particularly because of the higher cost of energy.

Fiscal Policy Bolstering the British Economy

The long-running upturn in the United Kingdom continued last year, with real gross domestic product expanding strongly at a rate of 3%. The economy slowed down relatively little during the course of the year, and the weakness seen in the final quarter was largely due to exceptional factors.

* 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 6 April 2001.

With strong growth in real incomes, private consumption remained the major driving force behind the economy. Employment expanded appreciably; in addition, wages rose in real terms because of a fall in inflation and an increase in state transfer payments. Growth was weak in the field of corporate investments where the annual rate of increase stood at around 2%. The high exchange rate of the pound meant that the British economy did not benefit as much as others from the vitality of the world economy.

Following several restrictive years, fiscal policy is now the source of strong impulses to the economy. The government has resolved to introduce expenditure programmes amounting to 1% of gross domestic product this year and 0.5% next year. It is planned to increase public investment expenditure from a little more than £ 10 billion to around £ 20 billion in real terms between 2000 and 2003. Despite these considerable increases in expenditure, this year's budget will show no more than a modest deficit.

Monetary policy will be relaxed again in the months ahead, particularly as the retail price index, which acts as a benchmark for the Bank of England, has been rising at 1.9% recently – well below the target value of 2.5%. The harmonised index of consumer prices (HICP) rose even less, increasing at a rate of just 1%. The cuts in interest rates will stimulate investment and fuel private households' credit demand during the forecast period. In addition, private consumption is shored up by the sound labour market situation. With the economy in the rest of the world cooling off – particularly in the USA, Britain's most important trade partner – export growth will be much weaker than before.

The outbreak of foot and mouth disease (FMD) will have an appreciable negative impact on aggregate production in the UK this year (see box). Although estimating the effects of the epidemic involves considerable uncertainties, a deduction of 0.5% of gross domestic product has been made for 2001. A return to normality and a correspondingly higher growth rate for gross domestic product are assumed for 2002.

In view of the stimulus provided by fiscal policy the underlying economic trend remains comparatively strong. As a result of the effects of FMD, aggregate expansion will fall to 2%. Next year, the impulses emanating from fiscal policy will be less pronounced; at the same time, the revival of economic activity in both the USA and the euro area, together with the relaxation of monetary policy, will tend to have a stimulating effect on the British economy. This will also be supported by the disappearance of the FMD effect. Real gross domestic product is thus expected to grow at an average of 3%. Consumer prices will rise by a good 1% this year and by around 1.3% next year. There will be little change in the labour market situation.

Euro Area Economy Cooling Off

On the whole, the expansion of aggregate output in the euro area slowed down appreciably during the course of last year. In the second half of the year 2000, real gross domestic product increased at an annual rate of 2.5% following a rate of 3.5% in the first half of the year.

Domestic demand in particular has increased at a slower rate since the middle of 2000. This was primarily due to the tightening of monetary policy and the loss of purchasing power caused by the oil price shock. Private consumer expenditure rose at an appreciably slower rate during the second half of the year. In a number of countries, tax cuts helped prevent a further loss of demand. Investment in equipment remained highly dynamic, partly because the utilisation of capacity in manufacturing industry is above its long-term average. Strong impulses were

On the Consequences of Foot and Mouth Disease

The outbreak of foot and mouth disease (FMD) in some member states of the EU presents a considerable risk as far as the forecast is concerned. Direct effects on production can be observed in the livestock industry and related areas. The areas that are indirectly affected include tourism and the transport sector in particular, since passenger and goods transport is restricted in an effort to contain the epidemic. Deep and enduring cuts can even hamper industrial output by creating bottlenecks in the supply of intermediate products. These effects can be more severe than the direct consequences and are not limited to the regions and countries immediately afflicted by the disease. This is also true of the effects the disease may have on prices. While premature slaughter could lead to a decline in prices in the short term, subsequent supply is less abundant due to the reduction in livestock and a sharp rise in prices can be expected. For a number of reasons, however, the effects on economic growth are difficult to quantify. First, they depend largely on the duration and spread of the epidemic, neither of which can be accurately predicted at the present time. Second, any loss of production suffered in areas affected indirectly by the outbreak can be made up for, in part at least, at a later date. Third, it is difficult to estimate the actual burden on consumers, since consumer behaviour can change in response to the epidemic.

Despite these difficulties, estimates on the economic effects of the disease have already been published for the UK, where the disease has broken out across the entire country. These estimates put the negative consequences of the outbreak at up to 1 % of gross domestic product, with the indirect consequences clearly outweighing the direct effects. For the Netherlands, where the first cases of foot and mouth disease have been detected, it is feared that aggregate production could be dampened by around 0.75 %, should the epidemic spread to the same extent as in the United Kingdom.

provided by foreign demand, and further stimulus was drawn from the continuing low external value of the euro. Exports to the Western European countries outside the euro area, to Central and Eastern Europe and to Southeast Asia saw particularly strong expansion. Imports rose at an accelerated rate.

The number of people in employment increased by around 2% last year. The unemployment rate fell to 8.8% in January 2001, the lowest level for ten years. Inflation in the euro area, measured in terms of the Harmonised Index of Consumer Prices (HICP), has recently exceeded the target level set by the European Central Bank, and in February this year it stood at 2.6%. This is largely due to the increase in crude oil quotations which took place up to the start of the winter. Higher energy costs have for the most part been passed on to the consumer, a course of action that was also made possible by the healthy state of the economy and one that has been at least partly responsible for a marked increase in the core rate of inflation (i.e. excluding the prices of energy, food, alcohol and tobacco). At the same time there are no signs of any “second round” effects.

Wage Increases Marginally Stronger

Wage increases remained moderate during the course of last year. At 2.2%, per capita workers’ pay increased only slightly faster than the previous year; earnings in manufacturing industry grew at a similar rate. As a result, labour income remained practically unchanged in real terms; in the fourth quarter it probably even fell slightly. Hourly labour costs increased only marginally faster. While there was a considerable acceleration in the corporate sector (excluding agriculture), this was primarily due to the lower number of working days[1] in certain countries due to the pattern of public holidays as well as the reduction of the number of working hours per week in France and one-off payments in certain sectors in Italy. In the public sector, for which no EMU level statistics are available, the increase was probably even lower. This assumption is supported in particular by the modest increases in public services wages and salaries in most countries.

Unions and management have so far shown little reaction to the unexpectedly strong increase in prices; in many countries, however, existing pay agreements are valid until well into the current year. Up to now there have also been few signs that pronounced catching-up effects are to be expected. This is probably partly due to the cuts in income tax which took effect in most countries at the start of the year. In several smaller countries, however, wage growth – which is already running at a faster pace compared to the euro area – will probably strengthen still further. In these countries, employment has increased so strongly as a result of the favourable economic developments during the past several years that there is a degree of tension within the labour market which will continue to build up in the short term. Elements of index-related increases still exist in Spain and Greece. In Italy, the three-year national wage agreement which began at the start of 1999 is based on a projected inflation rate[2] which was lower than the actual one; a certain degree of compensation for the under-estimation of inflation in the current agreement cannot be ruled out when negotiations begin again at the end of this year.

All in all, wage increases in the euro area should remain moderate this year and next. Given that labour productivity is increasing at a somewhat slower rate than last year’s average, unit labour costs will probably increase slightly during the forecast period.

Expansive Fiscal Policy

The public budget deficit in the euro area declined by around half a percentage point last year to 0.8% of gross domestic product. Taking the one-off revenues from the sale of mobile telephone licences (UMTS) into account, there was even a surplus of 0.3%. The improvement in the budgetary situation was almost entirely due to the healthy state of the economy. The upturn meant both a faster increase in revenues, despite various tax reductions, and a decline in labour market-related expenditures. At the same time there was a reduction in debt service. There was a marked positive primary balance – i.e. government net borrowing or net lending excluding interest payments on government debt – in all countries.

Last year, the level of gross debt fell in relation to gross domestic product by around two percentage points; in only three countries – Italy, Belgium and Greece – did it clearly exceed the target level of 60% established in the Maastricht treaty, whereas it was already well below this level in several other countries. In the year 2000, the average level of debt across the euro area was just under 70% of gross domestic product.

Fiscal policy is being relaxed this year, with impulses coming from the revenue side. Altogether, cuts in direct and indirect taxation will reduce the tax burden in the euro area by around ¾% of gross domestic product in the year 2001. Tax relief is particularly pronounced in Germany, France and Italy. In

[1] For an interpretation of labour cost comparisons, cf. Herbstgutachten 2000 der Institute, pp. 15f.

[2] Cf. Die Lage der Weltwirtschaft und der deutschen Wirtschaft im Herbst 2000.

France, where excise duties were reduced by a considerable amount last year, the focus is now being placed on relieving the direct tax burden. The abolition of the country's motor vehicle tax (vignette) carries particular weight. Moreover, taxes on oil products were reduced in France and Italy, dampening the increase in consumer prices. In Italy, moreover, income tax was reduced retroactively for the fourth quarter of the year 2000, favouring in particular families and low-income workers. In Germany, Italy, Belgium, the Netherlands and Finland, social security contributions were also reduced in order to lower non-wage labour costs.

In some countries, however, the tax impulses are being dampened by the fact that other duties and fees have been raised or tax bases broadened (Germany, Portugal). In Germany, the motor vehicle tax has been increased, and here, as in the Netherlands, the eco-tax was increased at the start of the year. In the Netherlands, where cuts in income taxes were particularly strong, an increase in the level of value added tax from 17.5% to 19% will have a dampening effect; the increase in indirect taxes has the effect of forcing prices up.

Budget plans released so far indicate that tax-related impulses in the euro area will be significantly weaker in the coming year than they were in 2000. The aggregate budget deficit in the year 2002 will amount to 0.8% of gross domestic product – following 1.1% this year – and the level of debt in relation to gross domestic product will fall to 66.4%.

Monetary Conditions Mildly Stimulating

The ECB has not changed its interest rate policy since the start of October last year. The key interest rate[3] has stood at 4.75% ever since. During the same period, the interest rate for three-month funds has fallen to this level. At around 3%, the short-term real interest rate – using the present core inflation rate to measure short-term inflation expectations – is close to its long-term average level.

On the whole, the monetary conditions can be expected to have a modest stimulating effect on the economy in the euro area. Between November and the end of March, long-term nominal interest rates – measured in terms of ten-year government bond yields – fell by almost half a percentage point to 5%. This fall is probably due in part to expectations of a cut in central bank interest rates in the euro area, but also to developments on the US capital markets. Despite the rise in the level of inflation during the last quarter of 2000 and the first quarter of 2001 caused by the rise in oil prices, there has been no change in long-term inflation expectations measured in terms of the differential between inflation-indexed and non-indexed ten-year French bond yields.[4] They continue to stand at 1.5%. The real long-term interest rate measured on this basis is thus currently running at just under 3.5%, half a percentage point lower than Germany's long-term average.[5] The nominal exchange rate of the euro against the US dollar had strengthened between November and January, but has weakened again since then. Until recently, the real effective exchange rate probably had a marked stimulating effect on exports and on the economy as a whole. The deceleration of M3 money supply growth did not continue in February when it stood at 4.7% compared to the previous year, the same level as in January. The three-month average of year-on-year rates fell to 4.8%. On the other hand, the current seasonally adjusted rate of growth compared to the previous quarter increased again slightly in February. On a projected annual basis it is running at 5.4%, although the three-month average is also 4.8%.

In the past half-year, the increase in consumer prices (HICP) has shown few signs of slowing down, primarily as a result of the delayed effects of the oil price rises and the higher cost of food caused by BSE and FMD. In February, the year-on-year increase stood at 2.6%, still well above the ECB's medium-term ceiling of 2%. In view of the economic slowdown and the more favourable foreign trade conditions, there will be a marked slide in inflation during the forecast period, falling to below 2% next year. This is supported by the rate of expansion of M3, which has now fallen to below 5% – a rate considered by the institutes to be compatible with medium-term monetary stability.

In view of this favourable outlook for price developments, the institutes expect the ECB to lower its interest rates this spring by around 50 basis points. Capital market interest rates will fall a little further in the current year; in the year 2002 they are likely to increase again slightly, partly under the influence of international developments. As far as the real effective exchange rate of the euro is concerned, a degree of appreciation is assumed during the course of this year. As a result, the exchange rate will have a distinctly less stimulating effect on the economy.

[3] Minimum bid rate on the main refinancing operations.

[4] Within the euro area, France is the only country with indexed and non-indexed government bonds of identical maturity with a yield differential suitable for measuring inflation expectations.

[5] Here, for the comparison of real interest rates with long-term average values, we do not use the aggregated averages of the countries in today's euro area as these contain distortions as a result of both risk premiums and exchange-rate expectations.

Altogether, monetary conditions will stimulate the economy in the euro area this year. Next year this stimulation will decline.

Outlook: Economic Revitalisation Next Year

It would appear that the slight acceleration in the increase in production in the euro area at the turn of the year was only temporary in nature. Early indicators suggest that the rate of expansion will slacken in the coming months. Thus, for example, both consumer and industrial sector confidence have returned to presenting a cloudier picture recently.

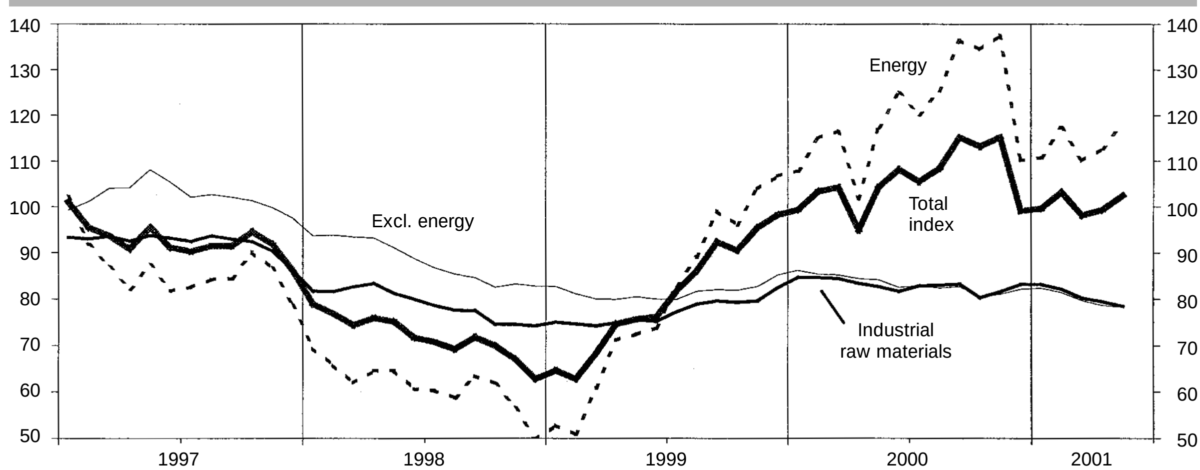
The decisive reason for the economic slowdown is weaker foreign demand. During the course of this year, third market effects triggered by the loss of dynamism in the USA will make themselves increasingly felt. Renewed export stimulation will set in when the US economy begins to recover in the second half of the year.

In the first half of 2001, private consumption will benefit from an accelerated increase in disposable income. After that, the effects of cuts in taxation will gradually fade away. Initially, investments will continue to reflect the slowing economy. As the global economic climate brightens, sales and earnings expectations should strengthen, so that stronger investment activity can be expected during the latter part of the year. Next year, investments will also be encouraged by monetary relaxation. Altogether, real gross domestic product in the euro area will expand at 2.6% both this year and next. The unemployment rate will not fall as much as last year.

Inflation in the euro area will gradually weaken. This will be primarily due to the lower quotations on the oil markets. Initially, however, the core rate of inflation will continue to rise, especially as higher energy costs have not yet been passed on in full. Consumer prices will rise at 2.3% in 2001 and 1.8% next year.

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

(1990 = 100)



Raw Materials and Groups of Materials	2000	Nov. 00	Dec. 00	Jan. 01	Feb. 01	Mar. 01	Apr.01	May 01[2]
Total Index	105.9 (31.5)	115.2 (20.7)	99.1 (0.9)	99.6 (0.3)	103.1 (–0.2)	98.1 (–5.8)	99.3 (4.6)	102.4 (-1.8)
Total, excl. energy	83.3 (2.3)	81.0 (–2.0)	82.1 (–3.6)	82.4 (–4.4)	81.4 (–4.6)	79.7 (–6.5)	78.6 (-6.9)	78.3 (-7.0)
Food, tropical beverages	84.3 (–10.5)	79.4 (–13.5)	79.2 (–15.1)	80.2 (–11.4)	79.5 (–9.2)	78.1 (–10.8)	76.2 (-13.0)	77.7 (-12.2)
Industrial raw materials	83.0 (7.5)	81.6 (2.5)	83.1 (0.8)	83.1 (–1.8)	82.1 (–3.0)	80.2 (–5.0)	79.5 (-4.7)	78.5 (-5.1)
Agricultural raw materials	81.9 (4.2)	81.9 (3.8)	83.0 (1.2)	82.8 (–0.7)	81.8 (–1.4)	80.3 (–3.7)	79.1 (-5.6)	76.4 (-6.3)
Non-ferrous metals	83.0 (15.5)	79.0 (–0.6)	82.1 (–0.5)	82.1 (–5.5)	81.0 (–6.8)	77.6 (–8.3)	76.4 (-4.6)	78.5 (-4.7)
Energy	120.6 (50.9)	137.5 (32.4)	110.1 (3.2)	110.8 (2.8)	117.3 (2.0)	110.1 (–5.5)	112.7 (10.9)	118.2 (0.7)

[1] On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change.
[2] Up to and incl. 25th May.