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.*

Despite the deteriorating international environment, the economies of Central Europe and the Baltic area have been showing relatively little sign of weakness. Real gross domestic product increased by an average of 2.9% in 2001, and several countries even achieved significantly higher growth than in the previous year. The region's economy was driven by a strong increase in both investments and private consumption. On the other hand, weaker demand from western Europe held back industrial production and thus dampened aggregate economic activity. Poland provided an exception to the rule, with economic expansion coming to a virtual standstill during the course of the year. Here, domestic demand also tended to weaken as a result of the country's restrictive monetary policy.

Economic prospects for the region are favourable, and exports will also pick up during the summer months as the economy in western Europe recovers. The momentum of the economy as a whole will accelerate once more as a result. Investment activity will be very lively, partly in connection with the forthcoming accession of some countries to the EU. Given the strong increases in real incomes in the region, the trend in private consumption remains positive. Economic policy is expansive in many cases at present, whereby budget deficits – which are substantial in some cases – are tolerated. Current account deficits will rise in many cases as import demand remains strong and the region's currencies appreciate in real terms, in some cases substantially. These deficits have already reached worrying proportions in some countries, so that – in spite of a great influx of foreign direct investments so far – there is a growing risk of financial and currency crises. This is true, for example, of the Czech Republic, where a rising current account deficit is joined by a large budget deficit. As far as the forecast is concerned, however, the situation is not expected to reach crisis proportions. Real gross domestic product in the region will increase by 2.6% in 2002 and – given significantly improved foreign trade conditions and a continuation of strong growth in domestic demand – by 3.5% the following year. Although there are no signs of labour market tensions easing despite the favourable economic situation, there will be a further reduction in the inflation rate during the forecast period.

In Russia, output growth slowed during the course of 2001, while gross domestic product again expanded strongly at an average rate of 5% for the year. Here, too, domestic demand was lively. Private consumption increased very substantially as real wage increases topped the 20% mark. Although investments in plant and equipment – the main focus of which continued to be the energy sector – fell somewhat during the course of the year, they still increased strongly on average over the year. The ongoing real appreciation of the rouble and an unfavourable foreign trade environment dampened demand for Russian products, and net exports fell appreciably – especially as there was even an accelerated increase in imports. During the forecast period, economic development can be expected to improve as the global economy gradually recovers and reform measures aimed at improving supply side conditions are intensified. Domestic demand will initially be driven by private consumption, investments will not gain momentum until next year. The increase in production is likely to be around 3.5% this year and 4% next year. Against this background and in view of the declining size of the workforce, the unemployment rate will continue its downward trend. The rapid rise of wages and pensions and the increase in administrated prices in the energy sector are hardly likely to slow down the inflation rate.

Last year, the economy in the European Union cooled off considerably, and in the final quarter of 2001 there was even a decline in real gross domestic product. This was primarily due to the slowdown of

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the global economy and the effects of the tighter monetary policy instigated in the year 2000 as well as the after effects of the strong increase in oil prices. The labour market situation deteriorated only slightly. While the underlying increase in consumer prices slowed, temporary factors caused inflation to pick up again following the turn of the year.

UK Overcomes Weak Economy

Compared to the euro area, there was little weakening of economic expansion in the United Kingdom last year. The main reasons lie in the country's fiscal policy which, in contrast to that of the euro area, was extremely expansive. Private consumption increased considerably, supported by a strong rise in real incomes. On the other hand, corporate sector investments have fallen substantially since last summer as a result of a distinct drop in foreign demand. While there was a strong decline in industrial output, the service sector continued to expand appreciably. Aggregate production stagnated in the fourth quarter.

Meanwhile there are increasing indications that the economy is picking up once more. Business expectations in the manufacturing sector have improved again for the first time since the summer of 2001, and there will again be considerable export growth as rapid economic recovery takes hold in the USA.

In March, the year-on-year increase in the Harmonised Index of Consumer Prices (HICP) stood at no more than around 1.5%, while that of the retail price index (RPIX) – the reference rate for the Bank of England – was below the target level of 2.5% at 2.3%. It was partly because of the subdued inflation rate that the Bank of England lowered its key interest rate from 6% to 4% and so counteracted the downward phase of the economic cycle. Money market interest rates have fallen below the capital market yield again for the first time since 1999. State expenditure, particularly with regard to investments in public infrastructure and the national health service, is to increase again appreciably this year. This will probably result in the first, albeit modest, budget deficit for some time.

Against this background the expansion of the economy will gain strength during the course of the year, partly because the UK – which has particularly close economic ties with the USA – will benefit from the upturn in the American economy. With real incomes rising at only a slightly slower rate than last year, there will again be a strong increase in private consumption both this year and next. Because of the low level at the turn of the year 2001/2002, the average annual growth rate of real gross domestic product in 2002 will, at 1.8%, be considerably lower than next year when it is expected to reach 2.7%. At 5 %, the unemployment rate remains relatively low during the forecast period. The increase in consumer prices (HICP) will be 1.5% in the coming year after 1.4% this year.

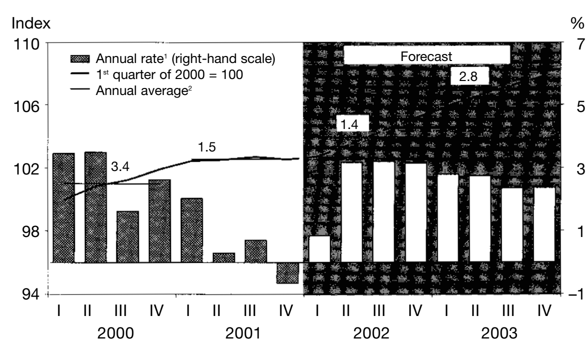
Upturn Imminent in Euro Area

An economic upturn is also at hand in the euro area. A number of indicators suggest there could be a strong recovery during the course of the first half of the year. The economic indicator published by the European Commission, for example, has been showing a marked improvement since December last year.

The downturn in 2001 was characterised in particular by a decline in investments and exports throughout the entire year. Weak investments resulted from adverse earnings expectations following the interest rate increases in the year 2000, as well as from the sluggishness of the world economy. The decline in exports intensified during 2001. Following substantial tax cuts in a number of countries, it was private consumption that became the mainstay of the economy, though it, too, lost momentum as real incomes declined. Real gross domestic product contracted slightly in the final quarter of 2001 (Figure 1).

All in all, however, the weakening of the euro area economy turned out to be relatively minor. This is reflected in the labour market situation. In contrast to

Figure 1
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 2002: forecast by the institutes.

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earlier periods of economic slowdown, employment has continued to rise, albeit at a much slower rate than before. The year 2001 saw little change in the unemployment rate, which stood at 8.4% in January 2002 – the same level as a year previously. Labour market developments were varied, however, with unemployment falling continuously in some countries (e.g. Italy) and rising significantly at times in others (e.g. France).

The increase in consumer prices had slowed down considerably by the end of 2001, particularly because energy prices had fallen during the course of the year. Upward pressure on prices intensified again in the new year as excise duties were increased in some countries, unusually bad weather made foodstuffs more expensive and oil prices soared. No substantial inflationary impulses arose from the introduction of the euro, however.

Wage Increases in the Euro Area Remain Moderate

Last year's wage increases were little higher than those of the year 2000 even though there was a considerable rise in inflation. Workers' pay across the economy as a whole increased by an annual average of 2.5% in 2001; hourly labour costs rose by 3.2%, a slower rate than the previous year. The existence of long-running pay settlements and income tax cuts meant that there was no wage political reaction to inflationary impulses in many cases. Furthermore, the weakness of the economy and related unfavourable employment prospects contributed to workers' accepting a loss of purchasing power. Trade unions' adverse experience with compensatory wage rises in the wake of previous oil price shocks also helped moderate pay claims.

The brighter economic outlook suggests that wages will rise at a stronger rate during the forecast period. However, in view of what remains an unfavourable labour market situation in the larger member states in particular, wage acceleration should stay within bounds. With productivity increasing again at an accelerated rate as the economy recovers, rises in unit labour costs will remain moderate both this year and next.

Fiscal Policy Charting Slightly Restrictive Course

The economic downturn has left a considerable mark on the public sector. The aggregate deficit in the euro area countries amounted to 1.3% of gross domestic product compared to 0.8% the previous year (excluding income from the sale of UMTS licences). The structural budget deficit remained virtually unchanged in 2001, an indication of a neutral fiscal policy. However, there were marked differences between the individual countries. While Austria, for example, achieved a balanced budget thanks to extensive consolidation measures, Germany's structural deficit grew appreciably, particularly as a result of extensive tax cuts. Taxes were also reduced substantially in France, Italy and the Netherlands – albeit accompanied by a less pronounced increase in expenditure than in Germany. The volume of tax reductions totalled just under 1% of gross domestic product for the euro area as a whole. In view of the increased budget deficit, the government debt ratio fell only slightly, to around 69% (Table 1).

Fiscal policy will move to a slightly restrictive course this year. Even so, the aggregate budget deficit will be slightly higher than in 2001 at 1.4%, because the cyclical component will rise faster than the decline in the structural budget deficit. The governments of most of the member states will accept the cyclical deterioration of their budgetary position. Only in Germany and Portugal will the governments counteract the effects of the automatic stabilisers in order to continue the pursuit of their respective consolidation targets. The decline in the structural deficit is largely due to the fact that government expenditure in the euro area as a whole is increasing at a slower rate than that of nominal gross domestic product in the medium-term trend. As far as

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

	Gross Debt[1]					Budget Surplus or Deficit[1]				
	1999	2000	2001	2002	2003	1999	2000	2001	2002	2003
Germany	61.3	60.3	59.8	60.6	59.9	–1.6	–1.3	–2.7	–2.3	–1.6
France	58.5	57.4	57.2	57.5	56.5	–1.6	–1.3	–1.4	–1.9	–1.6
Italy	114.5	110.6	109.4	106.5	104.3	–1.8	–1.7	–1.4	–1.9	–1.6
Spain	63.1	60.4	57.2	55.5	53.5	–1.1	–0,4	0.0	0.1	0.4
Netherlands	63.1	56.0	53.2	52.5	51.0	0.4	1.5	0.2	–0.1	0.1
Belgium	115.0	109.3	107.5	105.0	103.0	–0.6	0.1	0.0	0.0	0.3
Austria	64.9	63.6	61.7	59.5	57.0	–2.2	–1.9	0.1	–0.1	0.2
Finland	46.8	44.0	43.6	42.5	41.0	1.9	7.0	4.9	2.3	2.9
Greece	103.8	102.8	99.7	95.5	92.5	–1.7	–0.8	–0.2	–0.2	0.2
Portugal	54.2	53.4	55.6	53.5	53.0	–2.2	–1.8	–2.4	–2.5	–1.9
Ireland	49.6	39.0	36.6	34.5	32.5	2.3	4.5	1.7	0.4	1.0
Luxemburg	6.0	5.6	5.5	5.5	5.5	3.8	5.8	5.0	4.0	3.9
EMU	72.0	69.5	69.1	68.4	67.0	–1.3	–0.8	–1.3	–1.4	–1.0

[1] In % of gross domestic product; as defined in the Maastricht Treaty. Budget surplus/deficit excluding extraordinary revenues from the granting of mobile licenses.

Sources: Eurostat; 2002 and 2003: forecast by the institutes.

taxes are concerned, there will be further relief this year, albeit substantially less than last year. While taxes were cut by a significant amount at the start of this year not only in some smaller countries – such as Greece and Finland in particular – but also in France and the Netherlands, the tax burden in Germany is to increase this year. In view of the fact that Italy's 2001 budget deficit turned out to be greater than planned, and given the unrealistic growth assumptions in the 2002 budget, the Italian government has decided not to implement the tax cuts planned for this year.

Fiscal policy will continue its slightly restrictive course next year as well. At 1.0% in relation to gross domestic product, the euro area aggregate budget deficit is expected to be lower than this year (1.4%). This will also be the result of the strengthening economy, which will bring both greater revenues and expenditure relief in its wake. The expenditure ratio will probably fall again in the coming year, the tax burden will decline slightly. In this, the government debt ratio will fall considerably faster than in the previous two years, and will amount to 67% on average for the year.

Favourable Monetary Environment

In November last year, the ECB lowered its key interest rates by a further 0.5 percentage points. Since then, the minimum bid rate for main refinancing operations has been 3.25% and the three-month money market rate 3.4%. The short-term real interest rate[1] is at a low level at around 1%. Monetary policy is thus having an expansive effect.

From their November low to early April, capital market interest rates rose by well over half a percentage point to 5.3%; this is due in particular to expectations of rising short-term interest rates in the euro area and in the USA in the wake of economic recovery. In real terms, capital market interest rates are still somewhat lower than the long-term average. The US dollar/euro exchange rate as well as the real effective exchange rate of the euro have remained virtually unchanged since last autumn. Since the summer of 2001, M3 has been expanding considerably faster than the ECB reference value of 4.5%. The three-month moving average of year-on-year rates recently stood at 7.8%.[2] The strong increase is probably due primarily to portfolio shifts resulting from the great uncertainty in the financial markets; the money supply expansion involves little in the way of inflationary risks. The view that the current money supply development exaggerates the increase in demand-effective liquidity is supported by the restrained expansion of book credits to the private sector. Most recently these increased at a year-on-year rate of 5.6%, and projected for the year the seasonally adjusted annual growth rate of the last three-months ran to 3.1% compared to an average of just under 9% between 1999 and 2001. The rate of increase of M3 has slowed down substantially since the start of this year; in February, on a seasonally and calendar effect adjusted basis, it actually fell slightly compared to the previous month.

At present, the monetary environment is favourable. It will deteriorate somewhat during the forecast period. The institutes expect that the ECB will raise its interest rates in two steps during the final quarter of this year and the first quarter of next year by a total of half a percentage point. In doing so, it will react to the scope for price rises afforded to companies by the economic recovery. On the other hand, the ECB will not try to counteract the price rises caused by extraordinary factors since the start of the year, especially as wage developments in the euro area remain moderate from today's vantage point. There will be a

Table 2
Economic Indicators for the EMU

	2001	2002	2003
	change over previous year in %		
Real gross domestic product	1.5	1.4	2.8
Private consumption	1.8	1.2	2.5
Public consumption	2.0	1.1	1.2
Gross fixed capital formation	–0.3	0.2	3.4
Exports[1]	3.4	1.9	7.6
Imports[1]	1.8	1.4	7.4
Net export[2]	0.6	0.1	0.3
Consumer prices[3]	2.5	2.0	1.8
	in % of nominal GDP		
Balance on current account	–0.1	0.3	0.0
Budget surplus or deficit[4]	–1.3	–1.4	–1.0
	in % of labour force		
Rate of Unemployment[5]	8.3	8.5	8.2

[1] Exports and imports of goods and services including cross-border trade within the Euro area. [2] Change over previous year in % of the real GDP of previous year. [3] Harmonised Index of Consumer Prices. [4] Excluding extraordinary revenues from the granting of mobile licenses. [5] Standardised.

Sources: Statistics of national and internatinal institutions; calculations and estimates by the institutes; 2002 and 2003: forecast by the institutes.

[1] The short-term real interest rate is defined here as the nominal interest rate minus expected inflation, which is approximated by the core rate (HICP excluding energy and unprocessed food).

[2] The statistical distortions previously cited by the ECB and caused by non-EMU residents' holding marketable financial instruments have been removed by an adjusted series which has been published since the end of November 2001.

further rise in capital market interest rates during the course of this year, and they will stay at around 5.5% in the coming year. A slight effective real appreciation of the euro is assumed for the forecast period.

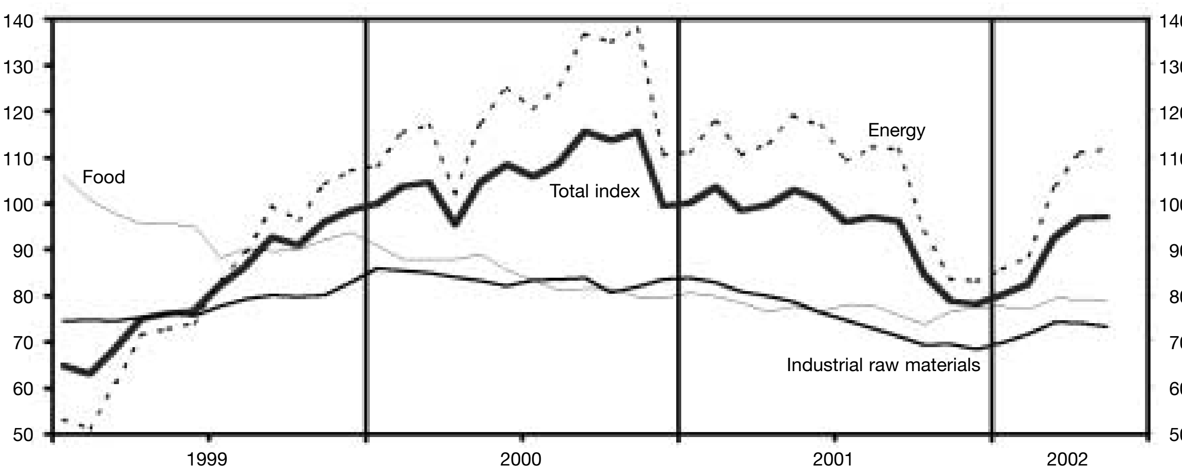
Outlook: Strong Upturn

A number of indicators suggest a strong upturn starting in the spring of 2002. Consumer and industry expectations in particular, as well as the level of new orders point to a recovery. Impulses will emanate above all from the global economy: the upturn in the USA will stimulate exports. Investments, moreover, will be encouraged by low interest rates. In addition, we can expect a turnaround in stockpile investments. Private consumption will not pick up significantly until the second half of the year when there is also an appreciable improvement in the labour market. Altogether, real gross domestic product will grow by an annual average of 1.4% (Table 2), whereby the slight expansion in the first quarter will be followed by a considerable acceleration during the further course of the year.

In 2003 the upturn remains strong, though the pace of expansion declines during the course of the year. This is partly the result of a loss of momentum in the global economy; monetary impulses also ebb away while fiscal policy remains slightly restrictive. Nonetheless, real gross domestic product growth in 2003 will still be strong at a rate of 2.8%. The employment situation improves further, and the unemployment rate can be expected to fall to 8.2%. The rise in consumer prices will contract during the course of 2003 and average 1.8% for the year, following 2.0% in 2002.

HWWA Index of World Market Prices of Commodities[1]

(1990 = 100)



Commodity Groups[1]	2001	Nov.01	Dec.01	Jan. 02	Feb. 02	Mar. 02	Apr. 02	May 02
Total Index	94.3 (-10.9)	78.4 (-31.9)	77.8 (-21.5)	79.8 (-19.9)	82.1 (-20.5)	92.3 (-6.0)	96.6 (-2.7)	96.7 (-5.8)
Total, excl. energy	75.8 (-9.2)	70.9 (-12.4)	70.3 (-14.4)	71.4 (-13.6)	72.7 (-11.0)	75.1 (-6.0)	74.9 (-4.7)	74.3 (-4.7)
Food, tropical beverages	77.1 (-8.6)	76.3 (-3.9)	77.2 (-2.6)	77.3 (-3.7)	76.7 (-3.6)	79.0 (1.2)	78.9 (3.5)	78.7 (1.8)
Industrial raw materials	75.3 (-9.4)	69.1 (-15.2)	68.0 (-18.2)	69.4 (-16.9)	71.4 (-13.4)	73.8 (-8.4)	73.6 (-7.4)	72.8 (-6.9)
Agricultural raw materials	73.7 (-10.2)	66.5 (-18.7)	64.1 (-22.8)	65.9 (-20.3)	69.0 (-15.6)	71.8 (-10.5)	71.7 (-9.4)	70.6 (-7.0)
Non-ferrous metals	72.7 (-12.4)	66.1 (-16.3)	67.1 (-18.3)	69.2 (-15.8)	69.6 (-14.0)	72.0 (-7.2)	71.4 (-6.6)	70.4 (-10.1)
Energy	106.4 (-11.7)	83.3 (-39.4)	82.7 (-24.9)	85.3 (-23.0)	88.2 (-24.8)	103.6 (-5.9)	110.7 (-1.8)	111.2 (-6.3)

[1] On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change.

Further information: http://www.hwwa.de → Commodity Price Index