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.*

Economic activity in the transition economies of Central Europe and the Baltic area has remained distinctly buoyant in spite of slow output expansion in western Europe. In the second quarter of 2002, the region's real gross domestic product was almost 3 % higher than a year previously. Private consumption bolstered the economy, driven by what in some cases has been a substantial increase in real wages. On the other hand, there was little investment growth as monetary policy continued to chart a generally restrictive course; indeed, investments even declined in some cases. Given both the poor state of the economy in the EU and the appreciation of a number of the region's currencies in real terms, exports stagnated to a large extent. The weak level of investments led to a slowdown in the pace of import growth and an improvement in the balance of trade. On the whole, unemployment remained unchanged at a high level, partly because of ongoing corporate restructuring. Inflation continued to fall, and in a number of countries it is now below 5 %.

Economic prospects remain favourable. On the one hand, exports will grow at an accelerated rate as the economy in western Europe picks up. On the other hand, domestic demand remains robust as private consumption continues to expand briskly. Given the relaxation of monetary policy during the course of this year, investments can be expected to pick up in 2003. This is particularly true of Poland, where interest rate cuts have led to a reduction in what were previously exceptionally high real interest rates. In the accession countries, too, interest rate steps are now beginning to have a delayed effect on the real economy. This is due to the fact that, with reforms in the commercial banking sector already largely completed, interest rate measures are spreading to the real economy via the usual monetary policy transmission mechanisms. Fiscal policy will tend to have a slightly restrictive effect as many countries are expected to introduce spending cuts aimed at reducing what are in many cases considerable budgetary deficits.

During the forecast period, economic development will depend decisively on progress made in the EU accession negotiations. It is assumed here that, with the exception of Romania and Bulgaria, the EU will invite all the countries to the accession conference in Copenhagen in December 2002 and that the process of eastern enlargement will proceed as planned. This will boost confidence and improve the investment climate in the economies involved.

Under these circumstances, aggregate output in Central Europe and the Baltic area in 2003 will rise by 3.0 %, following 2.4 % growth this year. The region's economy will continue to be more dynamic than that of the EU. Any slowdown in the pace of price rises will be slight, and at 5 % the inflation rate will remain well above the EU average. There are no signs of an improvement in the labour market situation.

In Russia, real gross domestic product continued its strong expansion in the first half of 2002, albeit at a slightly reduced pace. Economic development was driven primarily by private consumption, which increased considerably in view of what continue to be substantial rises in real wages. Investment activity slowed as corporate sector earnings declined; moreover, institutional reforms have yet to achieve the desired effects. The Russian economy benefited from higher export income as a result of the rise in oil prices. Imports also increased markedly, particularly

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as the rouble once again rose in value in real terms. Real gross domestic product will grow by 4 % in 2002 and by 3.5 % next year. There will be little change in the unemployment rate. The rate of inflation continues to fall, but will remain in double figures.

Gradual Recovery in the Euro Area

The euro area economy has recovered since the start of the year. However, output growth has been restrained. Real gross domestic product increased in each of the first and second quarters of the year 2002 at an annualised rate of around one and a half per cent – perceptibly slower than the medium-term trend. Corporate investment continued its downward course up to the middle of the year. This was mainly due to a further reduction in the utilisation of capacity as well as unfavourable sales and earnings prospects which the expansive impulses provided by monetary policy were not able to offset. Consumption expenditure on the part of private households expanded only marginally in the first half of the year, partly because of a deterioration in the labour market situation. In fact, private consumption actually declined during the first quarter of the year. It appears that sharp price increases at the start of the year resulted in consumer restraint. Private consumption recovered again in the second quarter, particularly as real disposable incomes expanded at a perceptibly faster rate; this expansion was fuelled not only by stronger wage increases, but also by falling inflation. The slump in exports came to an end at the start of the year. They even increased substantially during the spring, largely as a result of economic recovery in the USA. Even so, there was little rise in net exports in the second quarter of 2002, since euro area imports also increased significantly.

The economic slowdown affected the labour market with the customary time lag, although the effects have been moderate compared to previous downturns. The unemployment rate increased only slightly from last summer's low of 8.0 % to 8.3 % in August 2002. Despite the weak economy, the number of people employed has hardly fallen at all since the start of the year. While the service sector continued to show an increase in employment, the manufacturing and construction industries have been shedding jobs continuously since the spring of 2001. The relatively favourable development in the tertiary sector is essentially due to the spread of part-time work, particularly in Italy.

This year's wage rises have been higher than before, partly as a reaction to the preceding unexpected price increases. Following a rise of 3.6 % last year, wages can be expected to increase by 3.9 % this year. Given a slight average fall in labour productivity during the year 2002, there is a temporarily accelerated increase in unit labour costs. As a result of the proliferation of part-time work, however, the increase on an hourly basis is not as high. In view of the weak economy and the relaxation of inflationary pressure it is assumed that pay increases will be lower next year. A development along these lines is already anchored in longer running pay settlements in some countries.

Fiscal Policy Returns to Consolidation Course

The budgetary situation of the public sector in the euro area countries has worsened considerably. This year, the aggregate deficit will probably amount to 2.3 % of gross domestic product following 1.5 % last year (without income from the sale of UMTS licences). The deterioration of the budgetary situation is due to the effects of automatic stabilisers in the guise of lower government receipts and higher expenditures brought about by the weak economy. In contrast, the structural budget deficit in the euro area remains more or less unchanged, an indication that fiscal policy is charting a generally neutral course.

With regard to the budgetary position there are marked differences between the individual countries of the euro area: while the majority of them can present a balanced structural budget or even a surplus and are thus in line with the requirements of the stability and growth pact, the larger countries Germany, France, Italy and also Portugal each have a high structural budget deficit. Against the background of the weak economy, Germany's deficit is slightly in excess of the ceiling of 3 % of gross domestic product stipulated in the stability and growth pact, and in France and Italy it continues to approach this mark. In Portugal, the 2002 deficit will be significantly higher at 4.8 % of gross domestic product.

In July this year, the Portuguese government was forced to concede that the budget deficit for the year 2001 did not – as initially reported – amount to 2.2 % of gross domestic product, but 4.1 %. Immediately upon publication of the revised deficit figures, the European Commission initiated the procedure provided for in the case of an excessive deficit in accordance with Article 104 III of the EU treaty, and in September passed a report on the budget situation in Portugal. On the basis of this report and the recommendations of the European Commission, the Council of Ministers of Finance and Economy (ECOFIN Council) will decide at its meeting on 5 November 2002 whether the Portuguese deficit must be classified as excessive. If the

ECOFIN Council does indeed come to this conclusion, the Portuguese government then has a period of four months to implement appropriate measures to reduce the 2003 budget deficit to less than 3 % of gross domestic product. For the forecast it is assumed that the government introduces an ambitious consolidation programme amounting to 2 % of gross domestic product. Even so, the weakness of the economy will push the deficit above the 3 per cent ceiling. During the course of next year, the ECOFIN Council must decide whether to regard the presumably foreseeable failure to achieve the target as grounds for the introduction of appropriate sanctions.

Germany and Italy will also introduce consolidation measures. With a neutral course being charted in the remaining countries, fiscal policy will tend to be restrictive across the euro area as a whole. At 1.9 % of gross domestic product, the budget deficit for the euro area is likely to be only slightly lower than this year (2.3 %). While the structural budget deficit is being reduced, the cyclical component of the deficit will continue to increase on average next year.

Monetary Environment Less Favourable

The key interest rate in the euro area has stood at 3.25 % since November last year. As a result of falling inflation, the short-term three month interest rate rose significantly in real terms during the spring; since July it has fallen again somewhat in the light of cloudier economic prospects and related expectations of interest rate cuts.[1] At the start of October, the real short-term interest rate stood at a low level of around 1 %. Monetary policy thus continues to be a source of expansive stimulus.

Capital market interest rates, measured in terms of yields of government bonds with a remaining term of ten years, currently stand at 4 ½ % following a temporary rise in the spring. The decline in recent months is primarily a reflection of deteriorating economic prospects. At 2 ¾ %, capital market interest rates are also relatively low in real terms.[2] Even so, financing conditions for the corporate sector have become less favourable, particularly as up to July loan interest rates did not significantly match the decline in capital market rates. As a result of the fall in stock market prices, capital procurement through share emissions has become less rewarding; what is more, shares can only be used to a smaller extent as collateral for bank loans. Unlike government bonds, moreover, yields for corporate bonds have not fallen, but have remained at their springtime level – no doubt the result of higher risk premiums demanded by investors. Taken together, new share emissions and bond issues account for around one third of corporate financing, the remaining two thirds being made up by bank loans. Although loan expansion has slowed markedly, this is not unusual given the weakness of the economy; the institutes do not regard this as an indication of a credit squeeze.

The economy will be further dampened by exchange rate developments. In the period from April to September, the euro has risen in value against the US dollar by 10.4 %, and by 5.7 % in real effective terms. The international competitiveness of enterprises within the euro area has suffered as a result.

In August, the money supply aggregate M3 expanded at a rate of 7.1 % compared to August of the previous year or at 7.0 % over the course of the year (annualised three-month average). This growth rate has been in excess of the ECB reference value of 4.5 % ever since the middle of 2001. However, the real money gap of just under half a percentage point is not particularly large.[3] In addition, the strength of money supply expansion probably exaggerates the increase in demand-effective liquidity as it is probably essentially due to the portfolio restructuring that has taken place following the sharp decline in stock market prices (sale of shares by non-banks to banks and/or to foreign agents). This view is supported by the relatively weak expansion of loans to private enterprises and households in the euro area; growth here recently amounted to 5.2 % on a year-on-year basis and 4.2 % over the course of the year (annualised three-month average).

Against the background of cloudy economic prospects and falling inflationary pressure, the ECB – contrary to expectations in the spring – will not raise the key interest rates in the euro area at first during the forecast period; not until output expansion accelerates at the end of 2003 will there be a marginal increase in the main refinancing rate. Given the stabilisation of stock market prices assumed in the forecast, and in the wake of global economic recovery, capital market interest rates will rise slightly during the forecast period. There will probably be a further moderate appreciation of the euro, which will be slightly above US dollar parity towards the end of 2003. Although

[1] The short-term real interest rate is defined here as the nominal rate minus inflation expectations. These are approximated using the current core rate (HICP excluding energy and unprocessed foods).

[2] The real interest rate is derived by deflating the nominal rate with long-term inflation expectations. These are approximated using the break-even inflation rate of French government bonds which are indexed to the euro area inflation rate.

[3] This calculation is based on a reference value of 5 %.

monetary conditions become less favourable, interest rates and the exchange rate remain below their long-term average values in real terms and continue to have a stimulating effect overall.

Prospects

In the second half of this year output growth will continue at the restrained pace seen so far. While early indicators have worsened slightly in recent months, it must be taken into account that at the start of the year they had pointed to an acceleration in economic recovery that has since failed to materialise. In this respect, the current drop could also be interpreted as a correction of over-optimistic expectations. It is thus unclear as to how reliable these indicators are at present for forecasting purposes.

Private consumption will expand more vigorously once again as real disposable incomes increase at a slightly accelerated rate. Impulses from abroad are on the wane, however; demand from the USA in particular is flattening out, due partly to the strong appreciation of the euro up to the middle of the year. Investments continue their weak development. Real gross domestic product will increase by an average of 0.8 % this year. The labour market situation suffers a further slight deterioration against the background of the sluggish economy. The unemployment rate will average 8.3 % for this year.

Positive cyclical forces gradually gain the upper hand next year. The institutes assume that the uncertainty surrounding the Iraq conflict will fade by the spring and that the financial markets will stabilise. The expansive course of monetary policy will then become increasingly effectual. Against this background, domestic demand will gain momentum during the course of the year. As sales and earnings expectations improve and utilisation of capacity increases, enterprises will gradually expand their investment activities once more. Subsequently, employment prospects will brighten and consumer confidence improve. As real wages rise continually and income taxes are cut in a number of countries, we can expect the increase in private consumption to accelerate slightly. In addition, exports will expand at a faster rate as of next spring because, on the one hand, the world economy will recover at a brisker pace and, on the other hand, the dampening effects of the appreciation of the euro will diminish. Altogether, real gross domestic product will increase by 1.8 % in 2003.[4] The economic upturn leads to an improvement in the labour market situation following the customary time-lag. Next year, too, the unemployment ratio will amount to 8.3 % on average.

Inflation is likely to remain moderate during the forecast period as a result of what continues to be a low level of utilisation of capacity in the economy as a whole. The rise in consumer prices will average 1.8 % for the year 2003. Here, several stabilising factors will work together. The price of oil will fall again as from the spring, and the euro will again increase in value a little against the dollar. In addition, the economic recovery is not strong enough to allow a perceptible increase in profit margins.

Rise of Economic Activity in the UK

In the spring of 2002, the UK's economy broke free of its winter stagnation. In the second quarter, aggregate output expanded at an annual rate of 2.4 %. The sluggishness of the economy was mild by international comparison, mainly because private consumption increased virtually unabated at rates of around 4 %. In addition, government demand rose sharply in the wake of a public infrastructure improvement programme designed to last a number of years. Although the value of the pound sterling remained high, worldwide economic resurgence led to a perceptible increase in exports in the spring; these had previously fallen sharply over a period of a year. The rate of decline in investments in plant and equipment slowed as a result of these developments.

The distinctive strength of private household demand in the UK can be explained on the one hand by the fact that – with little let-up in wage increases, further marked increases in employment, and ongoing moderate price rises – real disposable incomes expanded rapidly. A source of additional stimulus was the increase in property capital generated by the pronounced increase in real estate prices. For the forecast period, however, it may be assumed that there will be a marked decline in house price inflation; first indications are already becoming apparent. In view of the very strong recent price increases there is even a risk that property prices could fall, thus triggering negative wealth effects. In this case – which is not assumed for the forecast – the inclination of private households to spend money would suffer a considerable blow.

The central bank is faced with a delicate situation. On the one hand, the inflation rate – measured using the RPIX retail price index – is currently at the lower end of the target range of 1.5 % to 3.5 %; what is more, output and investment within manufacturing industry are tending to weaken not least as a result of the strength of the pound sterling. On the other hand,

[4] The DIW Berlin has a different opinion regarding economic trends in the euro area.

the dynamism of the service sector – spawned by the house-price-related strength of private consumption – does not support a relaxation of monetary policy. The assumed calming of the housing market and the dampening influence of negative wealth effects emanating from the stock market could normally be expected to lead to a marked decline in the dynamism of private consumer demand in the months ahead. Yet as real incomes continue to grow private consumption will again increase substantially, thus rendering interest rate cuts unnecessary. Should the economy develop less favourably than assumed here, however, the Bank of England can be expected to react quickly.

Aggregate output in the UK will probably expand at a slightly lower pace at first. On average this year, real gross domestic product will increase by 1.4 %; aggregate utilisation of capacity will fall slightly and there will be a marginal rise in the unemployment rate. During the course of 2003 foreign demand will increasingly be a source of stimulus as the world economy picks up. In addition, fiscal policy will maintain its stimulating effect on the economy next year, especially as the government continues to strongly increase its expenditures on infrastructure improvements. Slowly but surely, all this will lead to brighter sales and earnings expectations, and corporate investments will gradually gain momentum. Economic growth will slowly accelerate as a result; in the year 2003, real gross domestic product can be expected to increase by 2.3 %. Consumer prices will continue to rise at a slow rate.