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Marked Economic Recovery in the EMU

With its internal value stable, the euro's inaugural year proved to be a thoroughly successful one for the common currency, even though there was a marked decline in its external value against the dollar and the yen. As far as the economy is concerned, the first year of currency union was less favourable, as its start coincided with a considerable weakness in exports. A clear recovery set in during the course of the year, however, and will continue this year. It will be accompanied by a further marked improvement in the labour market situation while price levels remain stable.

Economic activity within the EMU picked up considerably during the course of last year.[1] Recovery was particularly prominent in the industrial sector, with a distinct increase in orders and a noticeable improvement in business confidence. The main cause of economic recovery is the same as that of the slump which preceded it, namely the development of foreign demand which, following a period of retraction in the final quarter of 1998 and the first quarter of 1999, has been gaining strength since last spring. The temporary decrease in exports had little negative impact on domestic demand which continued to increase rapidly in an environment characterised by an expansive monetary policy and effectively neutral fiscal policy.

The utilisation of capacity has also risen again markedly since last summer. At the same time there has been a renewed reduction in the output gap.[2] In contrast, economic recovery has yet to leave its mark on the labour market. Employment increased slowly during the course of last year, and the decline in unemployment was moderate on the whole. The price climate remained calm. However, there was a turnaround in price trends as a result of the strong increase in the price of crude oil. Price levels have begun to increase again moderately since the spring of 1999 following an extended period during which they remained unchanged.

Favourable Conditions For Further Recovery

Altogether, the global economic environment and economic policy conditions currently favour a continuation of economic recovery within the EMU. The emerging economies are now expanding rapidly once again and should continue to do so throughout this year and next. A dynamic upward trend is also to be expected in the other industrialised countries. Strong growth of foreign demand will thus continue, particularly as the international competitiveness of companies within the EMU remains favourable due to the low external value of the euro.

However, there are also external pressures on the economy such as the renewed increase in import prices following the drastic increase in crude oil prices. There also has been a distinct rise in long-term interest rates. At the end of last year, ten-year government bonds stood at a little over 5%, one percentage point above their springtime level. The renewed increase was primarily a reflection of the "normalisation" of international capital flows; in the wake of currency turmoil, considerable financial resources had previously flowed into the "safe haven" of the EMU – as they had into the USA – so that long-term interest rates had fallen to a very low level. This "bonus" has probably been largely exhausted now that the financial and economic crises in the emerging economies have largely been overcome. Meanwhile, global recovery during the course of last year led to an increase in demand for capital which also contributed to the rise in interest rates. Furthermore, changes in price expectations – due primarily to the strong rise in oil prices, but also as a result of the devaluation of the euro – have also had a part to play. This impression is supported by the fact that there was a further significant fall in long-term interest rates in the days before and after the ECB raised key interest rates. In real terms, long-term interest rates are up by little more than half a percentage point.

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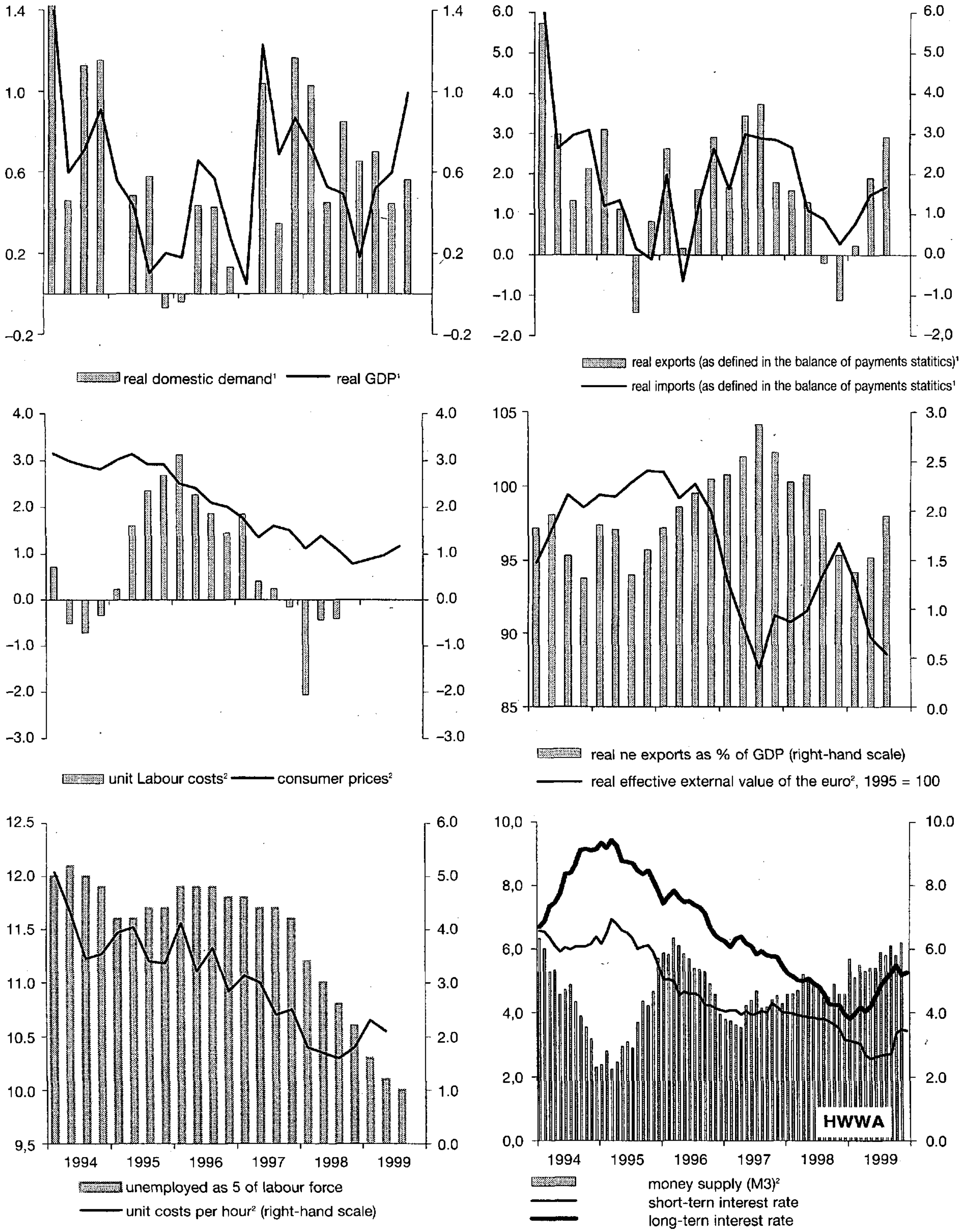
[1] Analysis of economic development within the EMU continues to be dogged by inadequate statistics. Given the estimates of development in individual member states, which will continue to be made by Eurostat, together with procedures for computing seasonal adjustments, which have still to be standardised, we can expect numerous revisions on the way to statistical "truth".

[2] According to OECD calculations, the output gap for 1999 amounted to 1.1%.

Figure 1
Economic Indicators in the EWU



¹ Change over the previous quarter in %. ² Change over the previous year in %.

Sources: Eurostat, EZB, OECD; own calculations.

Forecast Assumptions

The forecast is based on the following assumptions:

☐ Recovery in the rest of the world continues rapidly in 2000. World trade expands by around 7%.

☐ The price of crude oil will fall again during the course of the year, averaging 22 dollars over the year as a whole; in 2001 it will be around 20 dollars.

☐ The effective external value of the euro in real terms remains virtually constant; during the course of the year it will recover against the dollar.

☐ Wages increase moderately; an acceleration in some smaller countries has little influence on the trend within the EMU as a whole.

☐ Key interest rates are raised slightly this year. Long-term interest rates also increase, albeit moderately. Next year continues to see a moderate rise in interest rates, both at the short and the long end.

☐ In general, fiscal policy in the EMU remains on a more or less neutral course. However, government deficits will, in total, continue to fall as a result of the healthier state of the economy, so that public finances have a slightly dampening effect.

All in all, inflationary foreign trade impulses together with the rise in long-term interest rates are having a dampening effect on the development of the economy. However, this is more than offset by the positive influence of foreign demand. Oil prices, moreover, have probably reached their peak, and are more likely to fall again during the course of the year. While long-term interest rates will continue to rise, any increase will be slow.

Monetary policy can be expected to maintain its slightly stimulating effect on the economy even after the increase in key interest rates by half a percentage point at the start of November; this increase did no more than to reverse last spring's reduction. We can even expect quite a strong monetary stimulus for the time being, since the usual time lags mean that the highly expansive policy of the second and third quarters of last year is still in effect. As the economy strengthens, however, interest rates will probably be raised again slightly this year, especially as price expectations would be unfavourably affected if the reference value set by the ECB for the money supply M3 were to be exceeded for any sustained period of time. Monetary policy is thus likely to be more or less neutral.

Following a further reduction of the aggregate budgetary deficit last year, the effects of public finances on the economy are now more or less neutral. With automatic stabilisers taking effect, most countries are using the economic recovery either to reduce government deficits or – in the case of some smaller countries – to increase surpluses. On the other hand, only occasional discretionary measures are being taken to reduce structural deficits. Altogether, however, these are declining slightly, since public expenditure in countries which are lowering taxes and other duties is also not increasing very much.

Strong Export Growth Continues

Economic recovery within the EMU, like the slump before it, is largely driven by exports. Once the financial crises were essentially overcome, the economic weakness of regions outside the EMU was supplanted during the course of last year by renewed growth of sometimes surprising strength. This is particularly true of East Asia. Yet in the rest of western Europe, too, recovery has been faster than predicted. At the same time, the American economy remained unexpectedly strong. As far as the EMU member countries are concerned, this led to another marked increase in new orders from the rest of the world, and exports have been showing strong growth ever since last spring.

This development was encouraged by the devaluation of the euro. Its effective external value in December was just under 10% lower than in the same period of the previous year. Consequently, there has been a marked increase in the international competitiveness of companies within the EMU. Despite slightly lower export prices there has been a noticeable improvement in profit margins in manufacturing industry.

This year, exports will continue to benefit from the ongoing recovery of the global economy. Strong economic expansion will continue in the emerging economies of Southeast Asia in particular, and we can expect a consolidation of recovery in Latin America and eastern Europe. In the other western European countries, too, industrial production continues to expand at a substantial rate. In the USA, on the other hand, the economy will probably begin to slow down. During the course of the year, however, industrial production in the USA is not likely to grow at a much slower rate than global production, which is expected to increase by a little more than 3% in 2000 and by as much as 3_ % in 2001. On the other hand, certain dampening effects will take their toll. Last year, for example, the replenishment of stockpiles made a considerable contribution to the increase in foreign demand; this stimulus will be significantly lower this year. The encouragement of exports driven by the euro's weakness will also be less substantial as its external value vis-à-vis the dollar is likely to stage a recovery in view of the expected decline in economic and interest rate differentials between the USA and the EMU member countries. Altogether, exports from the EMU will continue their strong expansion, although there will be little or no acceleration in the rate of increase. We can expect to see a year-on-year increase in exports from the EMU countries of 7_% for both 1999 and 2000, following growth of barely 4% in 1998.

Robust Domestic Demand

In the past two years, the EMU's economic profile was dominated by export developments. Domestic demand meanwhile remained robust. A widely feared cumulative downward trend in demand sparked off by the export shock of the second half of 1998 failed to materialise. This was due in no small part to the strong build-up of stockpiles, which, though involuntary, played a considerable role in temporarily softening the negative effects on output caused by the drop in exports. By the time the stockpile situation started to have significant dampening effects on the economy early last year, however, foreign demand had begun to pick up again. This strengthened the belief that export weakness was of a temporary nature and would cause only a minor setback to economic development. With its clearly expansive orientation, monetary policy played an important role in stabilising expectations; this was particularly true after the key interest rates were lowered by half a percentage point last April.

Businesses had continued to increase investments despite both weaker exports and a drop in capacity utilisation. Enhanced profit margins and little or no increase in costs strengthened their propensity to invest. As far as investments in machinery and equipment are concerned, the strong upward trend continued during the course of the year. Investments in information technology (IT) maintained a particularly fast rate of expansion, a fact that was no doubt partly the result of measures taken to solve the Y2K problem.

The strong fundamental upward trend in IT investments will continue this year. In other areas, economic policy conditions and the global economic environment will strengthen the propensity to invest. All in all, there is likely to be a further distinct rise in investments in machinery and equipment both this year and next.

Investment in building and construction, on the other hand, saw only moderate increases during the course of last year. The building industry remained particularly weak in Germany but also in Italy. The primary reason for the lack of visible stimulus - in the large EMU member countries - from low interest rates is probably that there is an ample supply of both residential and commercial buildings, and that price expectations are thus largely depressed. In Spain and Ireland, on the other hand, the construction industry is experiencing a considerable boom.

As the economy continues to recover and income and employment perspectives improve, demand for construction services should also increase more clearly. Growing confidence in the construction industry as well as expectations of rising prices are among a number of indications that recovery will take place. Altogether, however, any increases in in investments building and construction will probably be restrained, and developments will vary widely between the individual countries.

Despite both the marked slowdown in the rate of growth of industrial output and the resulting virtual stagnation of real disposable income in the first half of 1999, the rate of expansion of private consumption has eased off only slightly thanks to a further reduction in the propensity to save of private households. Private consumption increased at a faster rate in the second half of the year as the economy recovered. This reflects the continuing high level of consumer confidence. The expected further economic recovery will also be accompanied by renewed growth in employment. In addition, tax rates are being lowered in some EMU member countries, and the rate of social security contributions is also falling in a few cases. However, some indirect taxes are being raised. On the other hand, consumer price rises continue to be moderate. Under these circumstances another marked increase in real disposal income within the EMU can be expected. Private consumption will expand more strongly than before, growing by 2½% over the previous year in both 2000 and 2001.

Slight Strengthening of Price Increases

Last year saw a turnaround in price developments. Up to the start of 1999, producer prices had been falling for over a year, and consumer prices had

Table 1
Economic Indicators

	Real Domestic Product (Year-on-year change in %)				Consumer Prices[1] (Year-on-year change in %)				Unemployment Rates[2] (Annual Average)			
	1998	1999	2000	2001	1998	1999	2000	2001	1998	1999	2000	2001
Austria	3.3	2.0	2.9	2.8	0.8	0.4	1.5	1.8	4.7	4.4	4.1	3.8
Belgium	2.9	2.0	2.8	2.7	0.9	1.1	1.6	1.8	9.5	9.0	8.6	8.1
Finland	5.6	3.5	4.1	3.7	1.4	1.3	1.9	2.2	11.4	10.3	9.3	8.4
France	3.4	2.7	3.2	3.1	0.7	0.6	1.3	1.5	11.9	11.1	10.6	10.0
Germany	2.2	1.4	2.7	2.7	0.6	0.6	1.4	1.8	9.4	9.0	8.5	8.0
Italy	1.3	1.3	2.5	2.6	2.0	1.7	2.2	2.5	12.3	11.6	11.3	10.9
Ireland	8.9	8.5	7.5	6.5	2.2	2.4	2.7	2.5	7.8	6.5	5.8	5.0
Luxembourg	5.7	5.0	4.5	4.0	1.0	1.0	1.9	1.5	2.8	2.8	2.8	2.7
Netherlands	3.7	3.1	2.8	2.6	1.8	2.1	2.3	2.4	4.0	3.3	3.0	2.8
Portugal	3.9	3.0	3.5	3.2	2.2	2.1	2.0	2.3	5.1	4.7	4.5	4.2
Spain	4.0	3.5	3.8	3.6	1.8	2.2	2.3	2.4	18.7	15.5	13.8	12.2
EMU[3]	2.8	2.1	3.0	2.9	1.1	1.1	1.7	2.0	10.9	10.1	9.5	8.9
Denmark	2.7	0.9	2.0	2.0	1.3	2.1	2.3	2.4	5.1	4.5	4.2	4.0
Greece	3.7	3.2	3.7	4.0	4.5	2.3	2.6	2.5	10.7	9.8	9.2	8.5
Sweden	2.6	3.5	3.2	3.0	1.0	0.6	1.5	1.3	8.3	6.9	6.2	5.5
United Kingdom	2.3	1.7	2.7	2.5	1.5	1.4	2.2	2.3	6.3	6.1	5.9	5.6
EU[3]	2.7	2.1	2.9	2.9	1.3	1.2	1.8	2.0	10.0	9.2	8.7	8.1
Norway	2.1	0.5	2.8	3.0	2.3	2.3	2.5	2.5	3.3	3.2	3.0	2.8
Switzerland	2.1	1.3	2.0	2.3	0.0	0.8	1.2	1.2	3.9	3.2	3.0	2.8
Western Europe3	2.7	2.1	2.9	2.8	1.2	1.2	1.8	2.0	9.8	9.0	8.5	8.0
Canada	3.1	3.7	3.1	2.5	1.0	1.8	2.6	2.5	8.3	7.6	7.6	7.5
Japan	–2.6	0.7	0.9	1.6	0.6	-0.2	0.3	0.6	4.1	4.7	4.7	4.5
USA	4.3	4.0	3.3	2.5	1.6	2.2	2.6	2.5	4.5	4.2	4.2	4.5
Industrial countries (total)[3]	2.3	2.6	2.7	2.5	1.3	1.4	1.9	2.0	6.9	6.6	6.3	6.1

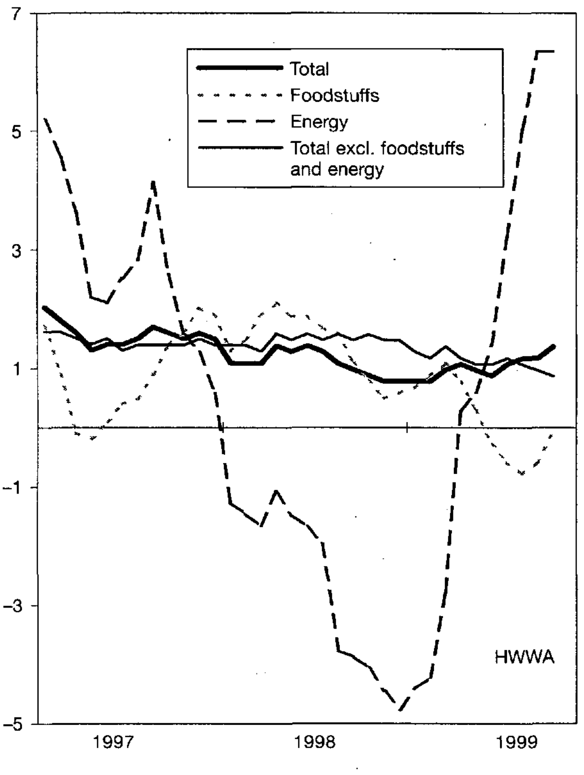
[1] European Union: harmonised consumer price indices. [2] Standardised; in % of labour force
[3] Weighted by gross domestic product, private consumption and size of the labour force respectively for 1998.

Sources: Eurostat;OECD; European Commission; national statistics; 1998 estimates; 1999 and 2000: HWWA forecasts.

remained constant for somewhat more than six months; they have been on the increase again since then. The cost of living for private households increased from January to November at an annualised rate of 1.9%. The change in price climate is primarily due to the dramatic increase in oil prices that has taken place since last spring, although other imports have also become slightly more expensive as a result of the effective devaluation of the euro in real terms. The reversal in price trends is all the more striking due to the fact that falling import prices, particularly the drastic slump in the price of crude oil, had made a decisive contribution to price stability in the period up to the beginning of last year. The highly volatile price of oil, but also of foodstuffs, in recent years has masked the fundamental trend in price developments. Indeed, the so-called core rate of inflation has even shown a marked decline for more than a year now. In October 1999 it was only 0.9% on a year-on-year basis; a year previously it was 1.6%.[3]

"Home grown" price increases thus remained moderate, partly helped by the intensification of competition in the telecommunications sector following deregulation in a number of countries. Above all, however, cost increases remained generally muted. Wages continued to increase with moderation. In the first half of 1999, as had already been the case in 1998, hourly wage costs in the economy as a whole (excluding agriculture and the health and education sectors) were just 2¼% higher than a year previously. Since labour productivity is likely to have increased by a similar amount, unit labour costs probably remained at approximately the same level as in 1998. Meanwhile, costs increased as a result of the drastic increase in the price of crude oil. However, given that specific oil consumption has fallen considerably compared to the 1970s, the resulting cost burden for businesses has been limited.

Figure 2
Harmonised Consumer Prices in der EMU[1]



[1] Change over the previous year in %.

Source: Eurostat.

Despite stronger price increases, the target of price stability – defined by the ECB as a rate of inflation of less than 2% – should not be in jeopardy for the time being. This is primarily because the factors behind the current price rises are only temporary. The external inflationary impulses in particular will slacken off, not least because the price of crude oil will decrease again. While other commodity prices, particularly those of industrial raw materials, will continue to increase, albeit moderately, their weight as far as general price developments are concerned is much slighter than that of oil. The possibility of rising import prices - triggered off by a fall in the level of intensity of competition abroad as the economy improves - will be offset by a recovery of the euro against the dollar. Moreover, internal upward cost pressure remains moderate. This year at least, wages should not rise much faster than in 1999, and with productivity increasing faster than last year as a result of the economic recovery there should even be a drop in unit labour costs. Moreover, the ECB is keen to prevent the development of inflationary potential. Under these circumstances, the rate of inflation in 2000should remain below the 2% mark.

Gradual Labour Market Improvement

Last year, improvements in the labour market situation within the EMU faltered as a result of the temporary economic setback. Employment virtually stagnated for a large part of the year. Unemployment

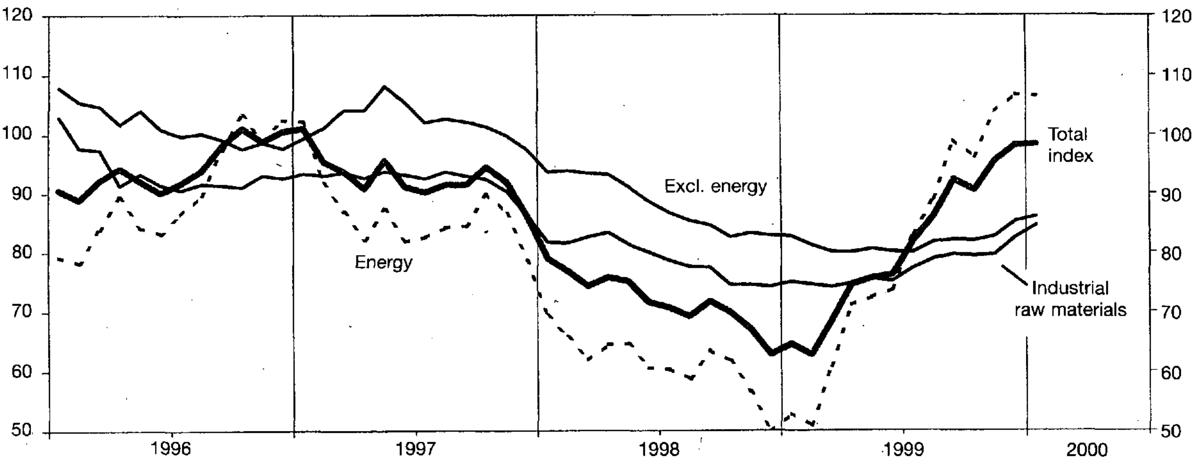
[3] The ECB computes the core rate of inflation from the consumer price index excluding energy and unprocessed foodstuffs. However, since data has only been available for this subgroup for a short period of time, total foodstuffs have been considered here. The discrepancy between these figures and the core rate computed by the ECB is insignificant due to the relatively small differences between price trendsfor foodstuffs as a whole and for the subgroup of unprocessed foodstuffs.

nonetheless continued to fall slightly, partly due to demographic factors. Last autumn, the unemployment rate was still slightly more than 10%, whereby considerable differences continued to exist between individual member countries. While there was little discernable improvement in the three largest countries, others witnessed a marked drop in the level of unemployment. These included Spain, Finland and Ireland, where there was a further substantial decrease in the unemployment rate.

As economic recovery continues to gain strength, there will be a perceptible improvement in the labour market situation within the EMU both this year and next, with the unemployment rate falling by around one percentage point in the course of each year. As a result, many countries could be considered to have largely dismantled the cyclical portion of unemployment as estimated by the OECD. However, the border between cyclical and structural unemployment is in a constant state of flux. Thus, for example, several changes in the legal framework are likely to mean a greater level of flexibility in the labour market. Labour laws and regulations have been relaxed in a number of countries. Moreover, job security is likely to be of major importance where wage negotiations are concerned. Even though labour market flexibility is still relatively low in many cases, all these factors should mean that the expected significant improvement in the labour market situation will not, as yet, lead to any marked acceleration in the rate of wage increases. This is only likely to occur in the Netherlands and Ireland where unemployment levels are already very low. There are no signs of any significant reduction in labour market tensions in these two countries as worker mobility within the EMU is likely to remain low. This is a clear indication that the labour markets within the EMU are still strongly segmented on a national basis. Employment trends are thus largely determined by national factors.

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

(1990 = 100)



Raw Materials and Groups of Materials[1]	1999	July 99	Aug. 99	Sep. 99	Oct. 99	Nov. 99	Dec. 99	Jan. 00[2]
Total Index	80.5 (11.8)	81.8 (15.7)	86.1 (24.4)	92.3 (28.6)	90.5 (29.4)	95.5 (42.4)	98.2 (56.4)	98.3 (52.3)
Total, excl. energy	81.5 (-7.7)	79.9 (-7.8)	81.7 (-4.3)	82.0 (-3.0)	81.9 (-0.7)	82.7 (-0.7)	85.2 (2.9)	86.0 (4.0)
Food, tropical beverages	94.2 (-18.7)	87.9 (-20.6)	89.9 (-17.1)	89.3 (-15.5)	89.6 (-15.7)	91.8 (-15.8)	93.3 (-13.8)	90.5 (_14.2)
Industrial raw materials	77.2 (-2.2)	77.3 (-1.7)	78.9 (1.7)	79.6 (2.8)	79.3 (6.5)	79.6 (6.8)	82.4 (11.1)	84.5 (12.7)
Agricultural raw materials	78.6 (-0.9)	78.3 (-1.0)	80.0 (2.4)	79.2 (1.7)	79.0 (6.1)	78.9 (5.7)	82.0 (8.3)	83.3 (7.2)
Non-ferrous metals	71.9 (1.0)	73.5 (5.5)	75.4 (9.2)	79.2 (13.6)	78.5 (16.4)	79.5 (17.6)	82.5 (27.7)	86.5 (36.3)
Energy	79.9 (30.1)	82.9 (37.6)	89.0 (51.6)	98.9 (56.1)	96.1 (55.7)	103.8 (83.8)	106.7 (114.5)	106.4 (101.7)

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