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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.*

Although the economies of Central Europe and the Baltic region expanded at a slower rate in the first half of the year 2001, they nonetheless remained on course for further growth. In Poland, however, economic development was markedly more restrained. Here, domestic demand weakened as a result of the considerable tightening of monetary policy that took place at the end of 1999 in order to avert the danger of a currency crisis. Together with expenditures for infrastructure programmes linked to EU accession and the budgetary burdens arising from the reform of Poland's pension system, the drop in state revenues caused by the general economic situation has led to a considerable increase in the public sector budget deficit and has contributed to Poland's current budgetary crisis. In the other countries, capital investment and private consumption both increased at a strong rate, whereas exports expanded at a significantly slower pace as a result of the weakness of the western European economy.

A further weakening of economic activity can be expected in the Central European and Baltic countries in the early part of the forecast period. The dampening effects emanating from the economies of western Europe continue to make themselves felt into the year 2002. However, buttressed by the lively investment activity in preparation for EU accession, and with marked increases in real wages, there will be no significant weakening of domestic demand. In 2001, gross domestic product will grow at 2.7 %, following 3.8 % last year. During the course of next year, the gradual recovery in western Europe and the ongoing expansion of domestic demand should lead to a pickup in economic activity. In a year-on-year comparison, aggregate output will increase at approximately the same rate as this year. With currencies appreciating in real terms – in some cases at a striking rate – there will continue to be considerable import growth and, in most cases, an increase in the current

account deficit. At the same time, the influx of foreign direct investments will diminish, partly because of the expected lower volume of privatisation. The risk of a currency crisis will increase in some countries as a result. Inflation slows down during the forecast period, especially as a result of lower prices for crude oil and food.

In Russia, economic expansion remained robust in the first half of 2001 as domestic demand continued to grow with considerable vigour. Private consumption was stimulated by strong increases in real income. While there continued to be marked growth in capital investment up to July 2001 (up 8 % compared to a year previously), the rate of expansion is considerably lower than that of last year. It is somewhat disturbing to note that, since 1999, investments have been stepped up exclusively in the energy and transport sectors, while they have stagnated in the other sectors of the economy. Industrial output increased at just 3 % compared to the previous year. Given the fall in oil prices, the marked appreciation of the rouble in real terms, as well as the current rapid growth in import demand, there is little likelihood of foreign trade being a source of economic stimulation during the forecast period. At the same time, however, private consumption will expand rapidly as wages increase in real terms. The expansion of aggregate output will continue to slow down during the forecast period. It is likely to grow at 5 % this year and 3.5 % next year. Although upward price pressure is tending to weaken, significant increases in administrative prices will lead to a similarly high rate of inflation as compared to the previous year. Unemployment will fall slightly, primarily as a result of a continuing decline in labour supply.

Within the European Union, the economy has cooled off markedly since the start of the year. Aggregate output virtually stagnated in the second quarter of 2001. Prompted by the slowdown in the USA, European exports declined strongly and the investment climate turned increasingly gloomy. The labour market situation also became less favourable. The rate of increase of consumer prices has flattened out considerably in the second half of the year following the removal of a number of adverse 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 19 October 2001.

UK: Robust Domestic Demand

In the United Kingdom, in contrast to the euro area, there was little slowdown in economic expansion in the first half of 2001, and real gross domestic product grew by 2.2 %. This was largely the result of stronger growth in domestic demand. Private consumption expanded at an annual rate of 4.1 %, primarily due to an increase in real disposable incomes, for while there was virtually no change in the low rate of increase of consumer prices, earned incomes rose strongly and families benefited from a programme of tax relief measures. There was also a marked increase in house prices, and given the wide distribution of property ownership this increase in property values had a stimulating effect on consumption. Public expenditure increased appreciably following the initiation of a programme of infrastructure improvement measures. On the other hand, tight monetary policy and worsening export expectations caused private investment to stagnate. Exports slumped – as in almost all of the industrialised countries. With imports also slowing, there was a slight deterioration in net foreign demand.

There has been a remarkable difference between the development of manufacturing industry and that of the service sector. While manufacturing has been in the doldrums for some time now and has even been contracting since the start of the year, the service sector has continued to expand with almost unchanged vigour. The most important causes of the country's industrial weakness are to be found in the strong increase in unit labour costs in recent years and in the strength of sterling, both of which have led to a continual decline in the country's international competitiveness. Many services, on the other hand, are largely unaffected by foreign competition and benefit from the great propensity of the British people to consume. In addition, London in particular – as a major banking location – has benefited from the expansion of international financial services.

In view of the moderate level of inflation and the strong exchange rate of the pound, the Bank of England lowered its short-term interest rate in several steps by a total of one percentage point up to August; following the terrorist attacks in the USA, further reductions totalling 0.5 percentage points brought the rate down to 4.5 %. A further interest rate reduction of 25 basis points can be expected by the end of the year.

Fiscal policy is markedly expansive both this year and next. Aimed at expanding the country's infra-

structure, particularly in the transport, education and health sectors, programmes designed to last a number of years have been initiated which will lead to expenditure growth of around one percentage point of gross domestic product this year and around 0.5 percentage points next year. The budget surplus, which last year amounted to 1.9 % of gross domestic product, will be reduced this year, and a slight budget deficit can be expected next year.

Real incomes will continue to bolster private consumption next year too. Average wage incomes increase at 4 %, while price rises, following a temporary acceleration this year, will average 1.6 % (HICP). Investments pick up again during the course of next year as export expectations improve. Following a slight weakening during the course of 2001, aggregate output can be expected to accelerate again next summer. Gross domestic product will reach an average growth rate, in real terms, of 2.2 % in 2002, following 2.0 % this year. There will be no more than a slight improvement in the labour market situation.

Euro Area: Upswing Delayed

In the euro area, the forces of economic growth have ground to a halt. Aggregate output stagnated in the second quarter of this year, primarily as a result of the export slump; deliveries to the USA in particular have suffered a marked downturn since the start of the year. Since imports did not decline to the same extent as exports, there was a substantial drop in net foreign demand.

There was little expansion of domestic demand in the first half of the year 2001, whereby private consumption proved to be relatively robust – due, in part, to the stimulating effects of the tax relief measures implemented in many countries as well as the expansion of employment. Contrary to expectations investments declined. The climate for investments deteriorated primarily as a result of the increasing gloom surrounding the global economic outlook as well as the slightly restrictive monetary policy. There was also a decline in the level of capacity utilisation in the manufacturing sector.

The weaker economy also had a detrimental effect on the labour market. The unemployment rate, which had been falling since 1997, stagnated from mid-year at 8.3 %. The inflation rate (HICP, year-on-year rate) reached a peak of 3.4 % in May. Since then, the upward pressure on prices has declined, and inflation recently stood at 2.7 %. This fall, like the previous

acceleration, was largely due to crude oil and food price developments; the core rate of inflation recently stood at 2.1 %.

Wage Increases Remain Moderate

Trade unions and employers have so far reacted judiciously to what, at times, have been quite considerable price rises, and few instances of second-round effects have arisen. With a year-on-year growth rate of 2.7 % in the second quarter of the year, labour costs¹ per hour even increased at a slower rate than in the previous quarter (3.1 %). Employee remuneration per worker increased in the first months of this year by around 2¼ %; in real terms, it has fallen slightly during the course of the year so far.

Pay settlements concluded this year suggest that average nominal wage increases across the euro area will continue to be moderate. However, greater pay increases than before have been implemented in the Netherlands and Ireland, where the labour markets were very stretched, as well as in Spain and Belgium as a result of wage indexing. In some countries, including Germany and Italy, pay settlements valid for more than one year will run out next year; given the less favourable labour market developments and falling inflation rates in these countries, however, we can expect pay settlements to remain in reasonable bounds. In France, too, wages growth will be moderate, not least because the trade unions pledged to practise medium-term wage restraint when the 35-hour working week was introduced.

With productivity growth at a cyclical low ebb, average unit labour costs across the euro area are increasing at an accelerated pace. Should wage policy, however, continue on a path of moderation next year, any increase in unit labour costs can be expected to be significantly smaller again as economic recovery sets in. Wage policy is thus not regarded as a source of inflationary danger.

Fiscal Policy Shifts to a Slightly Restrictive Course

This year, the aggregate public sector budget deficit in the euro area will probably amount to 1.6 % of gross domestic product, following 0.8 % last year (excluding revenues from the sale of UMTS licences). This is primarily due to the economic downturn. Experience has shown that the budget deficit or

budget surplus has an elasticity of around 0.5 in relation to the output gap; this implies a cyclical component in any shift in the budget deficit of 0.5 % of gross domestic product. In addition, the deficit has increased in some countries as a result of discretionary measures which have also led to an increase in the structural budget deficit. For example, Germany, France and Italy, in particular, introduced considerable tax cuts at the start of the year, without any corresponding reduction in government spending. The net volume of tax relief runs to just under 1 % of gross domestic product for the euro area as a whole. Meanwhile, the debt ratio has fallen more slowly.

Next year, fiscal policy will shift to a slightly restrictive track following its markedly expansive course in 2001. The structural budget deficit is thus likely to fall by around 0.3 percentage points. Nonetheless, the total aggregate budget shortfall is just as high as in 2001, because the cyclical component of the deficit increases as a consequence of the widening output gap. In those euro area member states with budget surpluses or only slight deficits, the cyclical deterioration of the budgetary position will be accepted. The governments of Germany, Italy and Portugal on the other hand, taking their objective of medium-term budgetary consolidation into account, will try to counteract the automatic stabilisers. Fiscal policy in France will be expansive despite an already sizable budget deficit; here, taxes are to be reduced by around 0.7 % of gross domestic product next year.

There is little to be expected in the way of additional tax relief in the year 2002. Besides France, only a few smaller countries – notably Greece and Finland in particular – are planning to cut taxes to any significant degree. In Germany, on the other hand, they are to be raised, while Italy has decided to forego the introduction of tax relief measures for companies and private households. State expenditure in most countries is growing at a slower rate than production potential, thus having a retarding influence on the economy. All in all, fiscal policy is charting a slightly restrictive course.

Stimulating Monetary Climate

Since May this year, the ECB has lowered its refinancing interest rates in three steps by a total of one percentage point. The key rate² has been at 3.75 % since mid-September. During the same period, the

¹ For the entire economy excluding agriculture, public administration, teaching and health.

² Minimum bid rate in the main refinancing operations.

rate for three-month money has fallen by a good three quarters of a percentage point and now stands at just under 4 %. Taking the current core rate of around 2 % as a measure of short-term inflation expectations, the short-term real interest rate is around one percentage point below its long-term average.³ Monetary policy is thus having an expansive effect.

Long-term nominal interest rates, measured in terms of 10-year government bond yields, have hardly fallen at all in spite of markedly lower central bank interest rates, and today stand at just under 5 %. Developments on the US American capital market are likely to have played a part in this. Here, the level of interest rates fell by a small amount only, despite considerable cuts in key rates; this was probably due in part to the fact that, given the current economic situation, expectations regarding the volume of bond buy-backs by the US government – which, previously, have had the effect of dampening interest rates – were corrected downwards. The acceleration of inflation up to the summer caused no notable change in long-term inflation expectations as measured in terms of the difference between the yields of indexed and non-indexed 10-year French bonds⁴; this difference continues to stand at 1.5 percentage points. The real long-term interest rate calculated on this basis is currently just under 3.5 %; this is half a percentage point less than the long-term average for Germany. However, corporate financing conditions have deteriorated as a result of the drastic decline in share prices. Following a short-lived weak spell, the nominal exchange rate of the euro against the US dollar is back at its March level and is thus 6 % higher than last October's low-tide mark. The euro continues to be somewhat undervalued. Altogether, the monetary climate is having a stimulating effect on the euro area economy.

Money supply expansion has accelerated. On an average for the months from June to August, the seasonally adjusted supply aggregate M3 increased at an annual rate of 10 % compared to the three previous months. The three-month average of year-

on-year rates was 6.6 % and was thus two percentage points above the ECB's reference value. The rates include several statistical distortions, however, due in particular to an increase in the stocks of money market paper and short-dated bonds held by non-euro area residents which, taken for themselves, account for three quarters of a percentage point of the increase. With one-off effects and portfolio restructuring also having had an effect, the institutes do not regard the sharp acceleration as an inflationary risk. This conclusion is supported by the low level of monetary capital formation and in particular by the perceptibly weaker development of loans to the private sector – the annual growth rate of the three-month average of book credits stood at no more than 4.4 %.

Given both the weak economic development in the euro area and declining inflation rates, a further ECB interest rate cut of one quarter of a percentage point can be expected in the fourth quarter of this year. This would take three-month interest rates to around 3.5 %, a level that will probably remain unchanged until the end of the forecast period. Since the institutes assume no more than a slight appreciation of the euro exchange rate, the monetary climate will remain favourable on the whole.

The economic forecast for the euro area is based on relatively favourable assumptions, and entails considerable uncertainty bearing in mind the synchrony of the economic weakness in all the regions of the global economy as well as the events in connection with September 11. In connection with the US current account, the exchange rate of the euro against the dollar could represent an increased risk for the economy. In recent years, as the economy boomed and the dollar strengthened, the US current account deficit grew at an accelerated rate and in the year 2000 it stood at over 400 billion US dollars or 4 % of the country's gross domestic product. Should the USA, as the institutes expect, again act as the "growth engine" in the next upswing, the current account deficits would increase. However, it could become more difficult for the USA to attract foreign capital to the extent seen in the past, because the perspectives for growth and earnings in the USA have deteriorated. A hasty exodus of foreign capital born of increasing doubts regarding the ability of US debtors to repay their borrowings would lead to a strong depreciation of the US dollar. A shock of this magnitude to the global pattern of exchange rates would have considerable negative consequences for the rest of the world and so too for the euro area.

³ During the 1990s, nominal interest rates in most countries of the euro area were higher than in Germany, in some cases considerably higher. This difference primarily reflected higher inflation expectations and consequent expectations regarding a depreciation of the currency in question vis à vis the deutschmark. Since the ECB has taken over control of monetary policy and the exchange rates have been irreversibly fixed, such expectations no longer exist. As a result it appears justifiable to base the long-term average on the level of real interest rates in Germany.

⁴ Within the euro area, France is the only country with indexed and non-indexed government bonds of equal terms whose yield spread is suitable for measuring inflation expectations.

**Outlook: Buoyant Forces
Gradually Gaining Control**

Unfavourable global economic developments place a considerable burden on the euro area economy during the forecast period. Early indicators collated before September 11 had pointed to a hesitant recovery towards the end of the year. Following the attacks in the USA, however, a significant increase in output cannot now be expected until next year. In view of the substantially higher risks, investors and consumers are adopting a "wait and see" attitude for the time being.

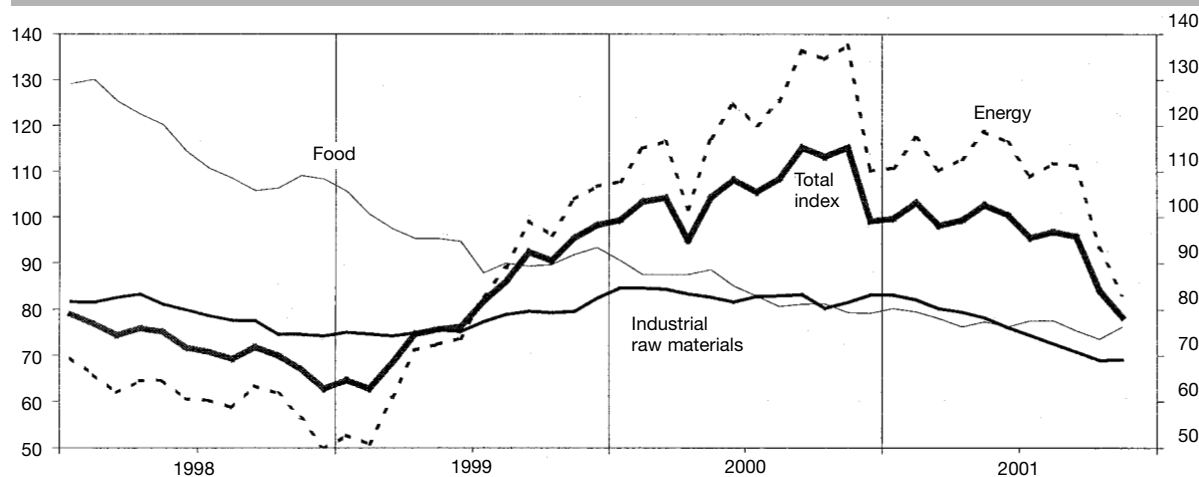
The stabilisation of the global political situation assumed here leads to a renewed strengthening of business and private household confidence in the first half of 2002. Stimulated by the global economic recovery and, later in the year, by a more expansive monetary policy, the economy in the euro area will gradually gather momentum. Exports increase

considerably during the course of next year, albeit at not quite as strong a rate as in the year 2000. This is primarily due to slower output growth rates in the world economy. Furthermore, and in contrast to last year, the exchange rate of the euro – which is likely to see a slight appreciation next year – will not provide any impulses for economic activity. Domestic demand will recover again. Real private consumption benefits from lower inflation, and the corporate sector will expand its investments significantly in view of more optimistic sales and earnings expectations.

All in all, real gross domestic product will probably increase by 1.8 % in 2002, following 1.5 % this year. The labour market situation does not improve until later in the year. The unemployment rate averages just under 8½ % both this year and next. In view of the slow pace of the world economy, inflation will continue to fall up to the spring; consumer prices will rise at 1.8 % next year, following 2.7 % this year.

HWWA Index of World Market Prices of Raw Materials¹

(1990 = 100)



Raw Materials and Groups of Materials ¹	2000	May 01	June 01	July 01	Aug. 01	Sep. 01	Oct. 01	Nov. 01
Total Index	105.9 (31.5)	102.6 (-1.6)	100.5 (-7.1)	95.5 (-9.4)	96.8 (-10.6)	95.8 (-16.9)	84.2 (-25.7)	78.4 (-31.9)
Total, excl. energy	83.3 (2.3)	78.0 (-7.3)	76.1 (-7.8)	75.2 (-9.3)	73.8 (-10.4)	72.0 (-13.0)	70.1 (-12.9)	70.9 (-12.4)
Food, tropical beverages	84.3 (-10.5)	77.4 (-12.6)	76.2 (-10.5)	77.6 (-6.5)	77.5 (-3.9)	75.4 (-7.1)	73.6 (-9.5)	76.3 (-3.9)
Industrial raw materials	83.0 (7.5)	78.2 (-5.4)	76.1 (-6.9)	74.3 (-10.3)	72.6 (-12.5)	70.8 (-14.9)	69.0 (-14.1)	69.2 (-15.2)
Agricultural raw materials	81.9 (4.2)	75.9 (-6.8)	74.0 (-7.9)	72.8 (-10.9)	71.1 (-13.6)	69.2 (-14.1)	67.4 (-14.0)	66.6 (-18.7)
Non-ferrous metals	83.0 (15.5)	78.3 (-4.9)	74.6 (-7.8)	71.1 (-14.1)	68.5 (-17.0)	66.3 (-23.6)	63.7 (-21.7)	66.1 (-16.3)
Energy	120.6 (50.9)	118.7 (1.1)	116.4 (-6.7)	108.8 (-9.4)	111.8 (-10.7)	111.3 (-18.4)	93.3 (-30.6)	83.3 (-39.4)

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