The Economic Outlook in Europe in 2002-2003

Spring Report

BFP - Bruxelles
COE - Paris
CSC - Rome
OEF - Oxford
RWI - Essen
UAM - Madrid

June 2002

About the European Economic Network

The European Economic Network (EUREN) is a network of six leading European economic institutes. EUREN was formed in 1999 to facilitate improved analysis of developments and prospects across the European economy, by developing closer links between leading economic research groups. All Euren institutes regularly publish forecasts, both on national economies and on EU and Euro zone as well.

Members of the Euren group have been co-operating in a number of ways over the three last years: meeting regularly to discuss economic developments and prospects; holding annual economic issues conferences, in Paris, to discuss major challenges for the European economic policy, contributing to joint and partner's research reports and economic outlook seminars and conferences (this includes the regular report, *La Tribune d'Euren,* http://www.coe.ccip.fr/05/tribune.htm),working together on economic research projects.

This is the first joint report on the European economic outlook. In this report Euren intends presenting a broad view on recent economic developments in the Europe as well as offering some special studies aiming to discuss key elements on a more structural basis. Euren intends to produce this report on a semi-annual basis, at mid year and at year end. Copy of the report can be downloaded from each Institute's web site.

Participating Institutes*:*

Bureau fédéral du Plan (BfP), Bruxelles, Belgium
Team Leader : Igor Lebrun (il@plan.be)

Centre d'Observation Economique de la Chambre de Commerce et d'Industrie de Paris (COE), France - *Team Leader* : Alain Henriot (ahenriot@ccip.fr)

Centro Studi Confindustria (CSC), Rome, Italy - Coordinator
Team Leader : Ugo Inzerillo (u.inzerillo@confindustria.it)

Oxford Economic Forecasting Ltd (OEF), Oxford, United Kingdom
Team Leader : Keith Church (kchurch@oef.co.uk)

Rheinisch-Westfälisches Institut für Wirtschaftsforschung (RWI), Essen, Germany
Team Leader : Roland Doehrn (doehrn@rwi-essen.de)

L. R. Klein Institute, Universidad Autonoma de Madrid (UAM), Spain
Team Leader : Emilio Fontela (emilio.fontela@uam.es)

Responsible for this report: Ugo Inzerillo, Confindustria, Italy
We gratefully acknowledge valuable assistence provided by Gianna Bargagli for editing, graphics, typesetting and layout

Report closed on June 18 2002

List of Contributors to this Report

Institution	Contributors
BFP Bureau Federal du Plan, Brussels, Belgium	Bernard Michel Ludovic Dobbelaere
COE Centre d'Observation Economique de la Chambre de Commerce et d'Industrie de Paris	Alan Henriot Thierry Coville
CSC Centro Studi Confindustria (Coordinator)	Ugo Inzerillo Giovanni Foresti Beatrice Pierluigi Anna Ruocco
OEF Oxford Economic Forecasting	Keith Church
RWI Rheinisch-Westfälisches Institut für Wirtschaftsforschung (RWI), Essen, Germany	Roland Doehrn
UAM L.R. Klein Institute, Universidad Autonoma de Madrid (UAM), Spain	Emilio Fontela Julian Perez

Content

About the European Economic Network

List of participating Institutes

List of contributors to this Report

CHAPTER 1
Executive summary

CHAPTER 2
The International Outlook

Boxes
The USA-EU trade conflicts and the "steel war"
US economic policy since September 2001 and prospects for 2002 and 2003
Wage developments in the euro area

CHAPTER 3
The Outlook in Europe
Part I - The Euro-area economy in 2001 and early 2002
Part II - EUREN forecasts for 2002 and 2002
Part III -The Uk economy
Box
Wage developments in the euro area

CHAPTER 4
Special Studies
1. What are the implications of a stronger euro?
2. The effects of the Argentina crisis on the Spanish economy
3. The Belgian business cycle as a leading indicator for the euro area
4- The Stability and Growth Pact: open issues

Chapter

1

EXECUTIVE SUMMARY

Compared to six months ago, the framework of global economy has completely changed. The pessimism that followed the terrorist attacks of last September – that had induced the leading international research centers to strongly review downwards world growth forecasts – has been quickly replaced by a much more positive vision. The timely support action to output carried out by policy makers in the main industrial countries, combined with the favourable evolution of the conflict in Afghanistan, have much contributed to modify market expectations, as it can be seen from the general rise of confidence indicators to levels above that of last September.

The ongoing recovery is largely due to US massive expansionary policies. During the last twelve months, expansionary budget measures for approximately 2% of US GDP have been taken; interest rates are still at their lowest historical level and practically zero in real terms. According to our forecasts, in 2002 and 2003 the US economy returns to grow consistently with its long-term potential trend. The rise in private and public consumption proceeds together with a gradual increase of investments which in turn strengthens economic growth. It is unlikely, however, and perhaps undesirable, that, in the medium term, the United States will return to the rates of growth it experienced during the second half the nineties (around 4%), when investments and consumption were held aloft by unrealistic evaluations regarding the stock market and the effects of the new economy.

The more favourable international scenario should also favour a (limited) recovery of output in Japan too. There have been some signs of recovery in recent months, but production remains more than 10 percentage points below the level of a year ago. It is lower than it was in 1990. The ongoing recovery is largely due to US expansionary policies.

Euro area is expected to grow at 1.3% this year, therefore less than a half that of the US; this figure however implies a strong acceleration in the second half thanks to higher domestic demand and investment in particular, as anticipated by the Belgian leading indicator (see our Special Study in Chapter 4). In 2003 euro area growth should stabilize around its potential; due to the carry over effects of high growth in the second half of 2002 (4% annualised) growth in 2003 should reach 3%. Such a situation should benefit the Euro appreciation towards the US dollar.

A higher output growth should occur in Asian emerging economies and in those countries applying for joining the European Union. Latin America should in contrast experience another year of slow growth due mainly to the Argentina crisis (see our study in Chapter 4).

On the whole, this year global economy growth (2.8%) should overcome last year data (2.4%), mainly due to the US contribution, the lively Asian economies and the transition countries, with the euro area economy joining in the second half of this year. In 2003, assuming no shocks in the oil and FX markets, global economy would return above 3.5%.

Interest rates will increase both in Europe and in the US, even if inflation is subsiding. Inflation has dropped more rapidly in the US than in Europe because in our continent, nominal rigidities are much stronger. In particular, wages and salaries are less sensitive to firms' economic conditions. Producer price inflation is negative, that is, prices are declining, due to lower raw material prices (oil) and shrinking profit margins, which is typical during a phase of low demand.

With such a scenario, marking a return of global economic growth, several worries remain.

The first one concerns the several areas of political and military crisis in various parts of the world, starting from the persisting terrorism threat, likely to undermine the market operators confidence, to the risks of a new outbreak of conflicts which could induce sharp rises in crude oil price.

Then there is the risk represented by the so-called double dip in the US. After September 11th firms were expecting a much stronger fall in demand. This explains the record collapse in inventories both in the United States and in Europe. Today, inventories are being replenished and the GDP recovery in the first quarter reflects this. A levelling off is probable. In light of the available leading indicators, a new downturn appears, however, unlikely.

Worries remain concerning US unbalances. The external deficit is growing toward 5% of GDP, because the indebtedness of households and businesses is increasing and the public sector is again running into deficit. The dollar has weakened due to the Enron case, but this is of slight consequence. It is not enough to rebalance the external account. The risk of a strong fall of the dollar remains, which would mean the loss of price competitiveness for the other areas of the world, including Europe. In our scenario the US currency weakens, but not enough to eliminate of the enormous US deficit trade. In order to adjust it, the exchange rate correction should be particularly large. According to our forecasts, the US dollar, after slipping to 96 cent to the euro, is likely to start appreciating again, due to the fact that US economic growth expectations remain constantly higher if compared to those of the euro area.

In this report we present a study on the effects for Euro area growth if the current euro appreciation goes significantly further, let us say to parity in the 3Q this year and 1.1 dollar per euro in the 4Q. The model suggests that such a move could knock 0.4 percentage points off growth in 2003. This assumes that the ECB doesn't accommodate the positive shock to inflation by lowering rates and crowding in more domestic demand. The

model also shows that the ECB could lower rates in response to the shock, thereby virtually eliminating the impact on output, but without threatening the inflation target.

In spite of the positive trend of the economic framework and favourable forecasts for global growth, stock exchange indices are slowing down in nearly all financial markets. This is in part due to the loss of confidence in the US market by investors, as a consequence of the Enron collapse. It could also reflect the fact that the US market is still overvalued, whatever indicator is used.

A final point regards fiscal policy in the Euro area, to which we reserve one of the special studies presented in this report. For the first time since 1993, net public borrowing in the Euro area increased, going from 0.8% of GDP in 2000 (net of revenues from UMTS licenses) to 1.3%. The countries that still show a deficit – among these there are the three largest members – did not meet the goals set out in their respective stability pacts. These results are explained for the most part by the economic slowdown and the consequent deterioration in the public accounts due to the effect of the automatic stabilisers. In some cases, tax cuts were only partially compensated for by spending reductions.

The point remains, however, that the transition from a deficit to a balanced budget (or surplus) is proving to be more difficult than was initially thought. Problems are made bigger by the fact that it is precisely the largest European economies that find themselves in this situation. Germany has made a commitment to reach a balanced budget in 2004; Italy's Stability programme still calls for budget balance to be reached in 2003; for both countries to achieve these targets seems quite unlikely. France's position, too, seems uncertain. If largest countries simply begin to ignore the goals of the Excessive Deficit Procedure (Edf) and the Stability and Growth Pact (Sgp), there is a significant risk that other states follow and the fiscal framework of EMU falls apart.

Largest countries' fatigue to achieve a balanced budget and the decisions not to send early warnings to Germany (and Portugal) helped to further

fuel the debate on the Sgp at both the government and academic level. In essence, some ask whether the Sgp, in its current form, is the best way to solve the problem of keeping public finances in check in an economic area whose monetary policy is devolved to the Ecb and whether there are any possible alternatives.

In the Communication accompanying the Annual Report on public finances (Public Finances in EMU 2002), the EU Commission renewed its request to France, Italy, Germany and Portugal to respect their programmes, stating that it is against any deferment of medium-term commitments. The Commission also reiterated that every tax cut must be accompanied by adequate reductions in spending, without counting on automatic effects from expected growth, as tax cuts are rarely self-financing. The clear message that the markets must receive here is that member states will effectively be called to answer for their medium-term as well as short-term results. The idea of adding other parameters to the Sgp currently appears less practical and, in any case, would not have any different effect than to tolerate higher deficit levels in the transition phase.

Chapter 2

THE INTERNATIONAL OUTLOOK

After grinding to a halt in the second half of 2001, growth returned to the world economy at the start of this year (Table 2.1). Although the standing start to 2002 means world GDP is expected to expand "only" 2.8% this year (2.3% in 2001 and 4.7% in 2000), this understates the speed of recovery. Growth in the current quarter is above trend and this momentum should carry the world economy to growth of around 3.5% in 2003.

Table 2.1 Exogenous and international variables

(percentage changes unless otherwise indicated)

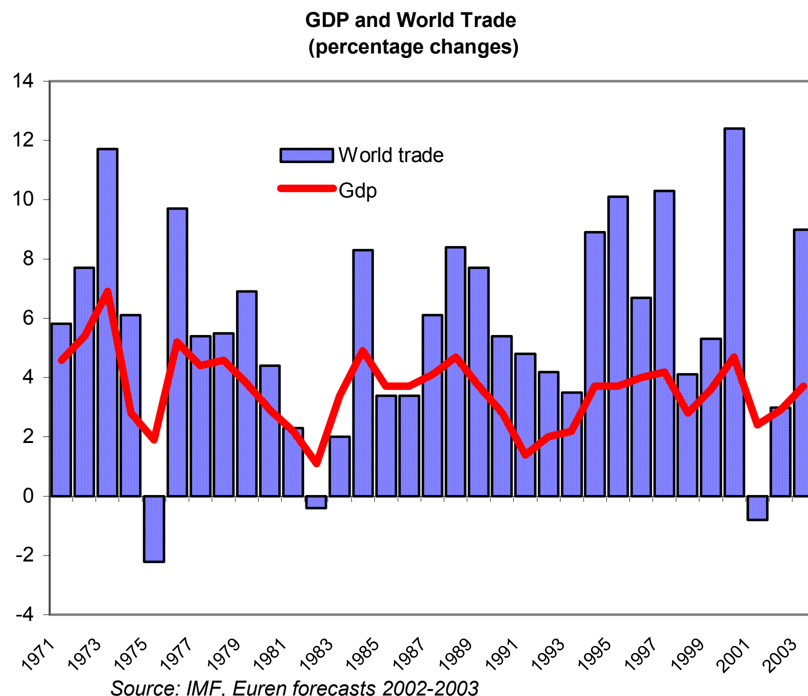
	1999	2000	2001	2002	2003
World trade	5.3	12.4	-0.8	3.0	9.0
United States					
GDP	4.1	4.1	1.2	2.7	3.2
Consumer price index	2.2	3.4	2.8	1.7	2.1
3m interest rates	5.4	6.5	3.8	2.2	4.0
10y Gvt bond yields	5.6	6.0	5.0	5.2	5.5
Japan					
GDP	0.8	1.5	-0.5	-0.4	1.0
Consumer price index	-0.3	-0.6	-0.7	-1.3	0.5
3m interest rates	0.2	0.3	0.2	0.1	0.1
10y Gvt bond yields	1.8	1.8	1.3	1.4	1.5
US dollar/euro FX	1.07	0.92	0.90	0.93	0.96
Yen/US dollar FX	113.8	107.8	121.4	127.0	123.0
GBP/US dollar FX	0.60	0.70	0.7	0.7	0,7
Oil price, US$/barrel	17.8	28.6	24.4	24.5	25.0
percentage changes	36.9	60.7	-14.7	0.4	2.0

Source: Central Banks Bulletin; Euren forecasts for 2002 and 2003.

Trade

World trade is set to grow slightly higher than GDP this year, at 3%. After one year of deep crisis (a contraction of 0.8% when compared to 2000), trade growth turned positive at the beginning of this year; recovery even seems to have started in the hi-tech sectors that generated the crisis in 2001 and in services, which were particularly badly affected by events last September. This year's expected trade growth implies a significant acceleration in coming quarters and this momentum that is being gathered helps explaining the 9% growth we expect next year. To global trade it is essential that negotiations on liberalisation, agreed on last November in Doha and due to start already last January, be re-started (Chart 2.1); the recent protectionist decisions taken by the US administration risk starting a trade war with Europe, and are likely to produce serious deflationary and distortion effects on global trade as the box below shows.

Chart 2.1



Source: IMF, Euren forecasts 2002-2003

The USA-EU trade conflict and the "steel war"

In early 2001, following a two Bush administration decisions (the failure to sign the Kyoto protocol on the environment; and repudiation of the ABM anti-missile treaty), several observers remarked on a change of direction in US foreign policy and spoke of America's "new isolationism". This interpretation would seem to be confirmed by the Administration's recent decision (White House "Steel Products Proclamation", March 5, 2002) to impose a series of tariffs on a wide range of iron and steel product imports. In particular, a 30% tariff is imposed on laminated iron products, and a 15% tariff on stainless steel products and steel pipes. The places hardest hit by the new tariffs, which took effect on March 20, 2002 and will remain in force for three years, are Japan, Korea, China, and the European Union.

The US decision appears extremely contradictory, given the current Administration's position on international trade liberalisation. Indeed, the decision comes on the heels of the annual WTO meeting in Doha (November 2001), where America's efforts were a decisive factor in overcoming resistance from developing countries and reaching an agreement that is key to jump-starting the liberalisation process (the so-called Millennium Round, see the December 2001 CSC Report). The US Administration, naturally, says its measures are justified. According to a December 2001 report by the US International Trade Commission (ITC), iron and steel product imports rose in such a manner as "to cause serious damage, or to threaten serious damage" to its domestic industry, therefore the protectionist measures were justified by the 1974 Trade Act (section 201). In reality, the American measure deal a heavy blow to the trade liberalisation process and runs the risk of damaging the credibility of the WTO, the organisation that must resolve the dispute.

The severe crisis dogging the American iron and steel industry (out of a total of 142,000 jobs, 20,000 were lost between 1997, the year imports from Asia boomed, and 2001Q2) set off an intense debate in the country. In reality, there is wide consensus on the causes of the crisis, which are essentially excess production capacity and high labor costs. Indeed, despite continuous downsizing in the industry (it employed 521,000 people in 1974), hourly pay is 10 dollars higher than the average pay for unionised workers.

However, there is a great variety of positions regarding remedies. According to researchers from the authoritative Institute for International Economics in Washington[1], trade protectionism in the last 30 years, in a sector with great political weight, despite its small size, because it is very geographically concentrated, has helped to maintain the wage differential in favour of the steel industry. A long-lasting solution to the US steel crisis should focus on further reductions in production capacity of at least 15 million metric tons, by means of an effective restructuring plan that would close down the least efficient plants. In particular, the trend towards small-sized production units must continue, as these

---

[1] Hufbauer G. and Goodrich B., *Time for a Grand Bargain in Steel?*, Institute for International Economics, Policy Brief 02-1, January 2002.

account for approximately half of all American production today, having grown 500% since 1976. The path taken by Bush, on the other hand, has revived the protectionist solution, which only delays the needed restructuring of the US iron and steel sector – a process that has already been carried out in Europe.

The steel issue is one of the thorniest in the current trade conflict between the USA and the EU (which also includes the sanctions imposed by the EU on meat containing hormones, and US export subsidies through the so-called Foreign Sales Corporations, previously condemned by the WTO; see the September 2001 CSC Report). The new tariffs will hit approximately one-third of the EU's steel exports to the USA, totaling some 2.4 billion Euro annually (average for the period 1999-2001). And a further blow could come when East Asia, in all likelihood, redirects its products into Europe. As well, Brazil, Russia and perhaps China could receive favoured treatment from the USA, further hitting the EU steel industry. It is also noted that the average European Union tariff on steel products is very low – approximately 2% in 2000 – and that, in line with commitments made in the Uruguay Round, European tariffs are to be eliminated in 2004.

The Commission immediately denounced the US measure as illegitimate in terms of the agreement on safeguarding the WTO, and on March 7 2002 it filed for arbitration with the trade organisation. As the parties await the arbitration decision, which could take up to two years, the Commission took a number of compensatory measures on March 28th. These include tariffs on imports of 15 types of steel products, to be applied in a non-discriminatory manner (that is, on exports from all countries), but excluding nations whose exports do not account for 3% of total EU imports. These measures will remain in force for six months, during which time the Commission will decide whether to make them definitive or to modify them. In any case, though, they will be revoked only when the United States tariffs are ended.

On April 19th, the Commission also presented an EC regulation proposal, to be submitted to the European Council, which sets additional tariffs on a wide range of exports from the USA. These are retaliatory measures worth an estimated 337 million Euro, to be imposed on a broad range of products such as citrus fruit, textiles, motor vehicles, and arms. The aim is to hit primarily the US regions that Bush intended to help with the Steel Products Proclamation. These measures are to go into effect on June 18th, should the European request for compensation be rejected by the United States.

According to the statement made by Commissioner Lamy, the counter-measures passed by the EU are legitimate in terms of the WTO Agreement, and needed to contain "anti-free trade sentiment in Europe". In reality, the aim is to obtain compensation from the USA, in the knowledge that the Bush Administration, in the opinion of a number of authoritative voices, took illegitimate measures on both sides of the Atlantic. Compensation, though, is unlikely. The main risk is that the USA-EU trade war might spread, thereby hindering the start of the Millennium Round negotiations decided in Doha. In this case, the real losers in the conflict would be developing countries.

Following the terrorist attack last September, oil price fell below 18 dollars per barrel in the last quarter of 2001. In the first months of this year, the oil price regained the level preceding last September's events, even surging to 27 dollars on the back of heightened Middle-east tensions. Currently oil prices range between 23 and 25 dollars, with a substantial balance between oil supply and demand; with Opec maintaining oil prices virtually stable, risks for a new price rise should be lessened. Euren Institutes assume therefore oil price to remain around 24 dollars and to slightly rise, at 25 dollars, due to global demand increase.

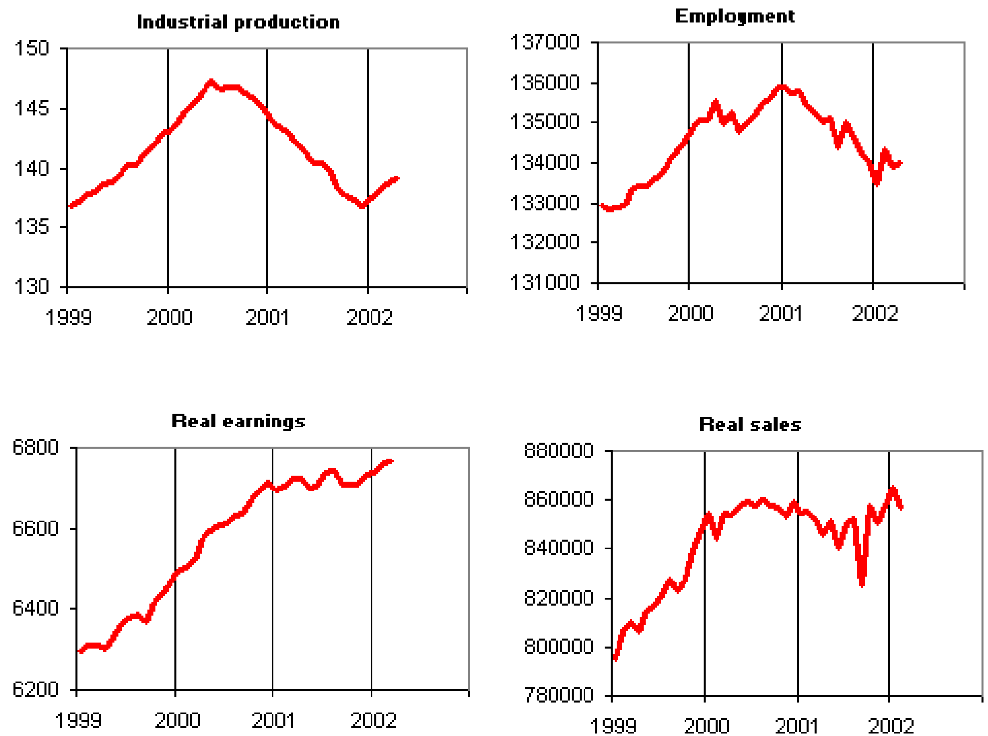
Once again the United States leads the way

According to NBER chronology, the US recession started in March 2001, ending the longest US expansion witnessed in the post-war period. The recession probably finished last December, which if confirmed would indicate the shortest ever period of recession[2]. At the beginning of this year economic indicators used by NBER to identify the turning point of the cycle (industrial output, retail sales, employment, real income), started growing again. (Chart 2.2)

In the first quarter of this year US GDP grew at a massive annualised rate of 5.6% (against +1.7% in the fourth quarter of 2001). With hours worked falling nearly 2%, productivity climbed 8.6%, a nineteen-year high (and compared to +5.5% in last quarter 2001). Stocks have contributed strongly (3.5%) to GDP growth; after six quarters of heavy de-stocking, firms are running down inventories at a slower pace. Consumption held up; both private consumption, growing at a yearly rate of 3.2% (notwithstanding a contraction in durable goods of 9,6%) and public consumption (+6.7%), pushed higher by rising expenditure following the terrorist attack. The contraction in investment, which lasted well over five quarters, partly came to an end because of the recovery of housing and technological investment. (Chart 2.3).

[2] The Nber definition of recession differs from the traditional one which, as a rule of thumb, requires two consecutive negative quarters in terms of GDP growth.

Chart 2.2



Source: Euren calculations based on Thomson Financial data.

Starting from the second quarter, a minor contribution from stocks is likely to be joined by recovery of non-housing investments – in line with raising business confidence, increased industrial orders (+1.1% in April) and semiconductors sales. Actually the ISM index (purchasing managers'index), after falling to a new low last September, is steadily recovering and it is now well above the threshold which separates expansionary and recessionary phases.

Household expectations too are consistent with consumption growth being maintained in the coming quarters, though at a rather lower pace

Chart 2.3

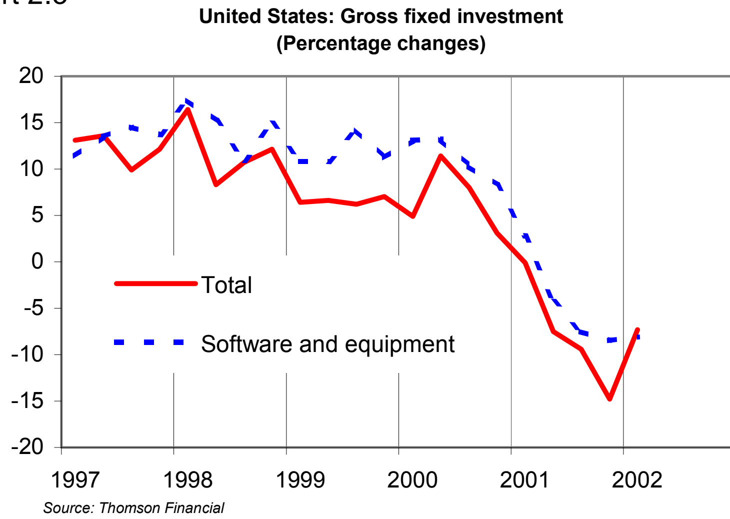
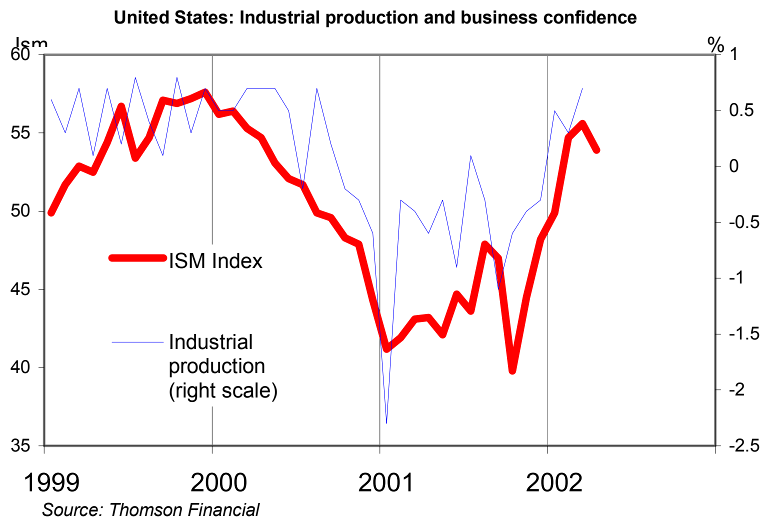


Chart 2.4

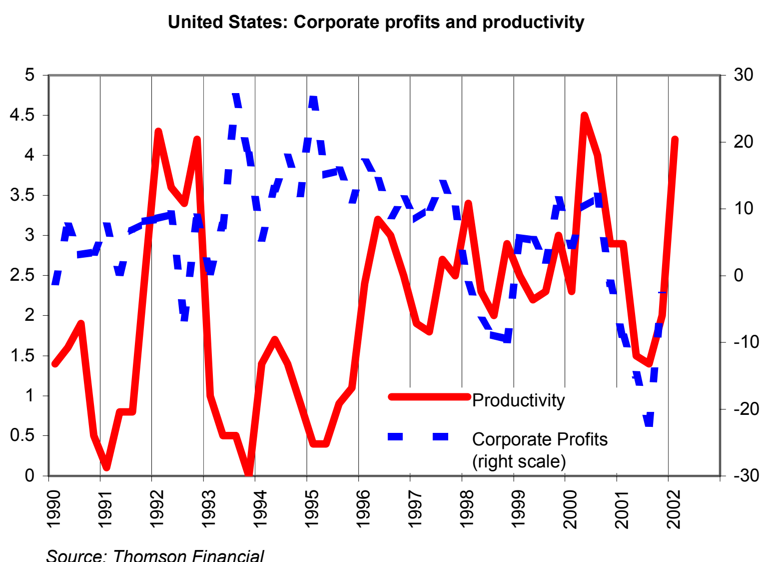


than that recorded in the previous expansion phase of the US economy. This reflects labor market uncertainties, the expected rise of interest rates and the absence of pent-up demand that is usual at this stage of the cycle. According to our forecasts, consumption growth rate should stay around 3% this year and next year (compared with a 5% on average between 1998 and 2000); in 2002 consumption should be slowed by higher interest rates and raising unemployment, which in April reached

the highest level since August 1994, at 6%, before slightly declining at 5.8% in May. The increases in unemployment (it was 4% at the end of 2000) emphasises the risk that a sustained revival in domestic demand cannot be taken for granted.

On the other hand, although the economy was in recession, productivity has continued to strongly increase at 2%, a phenomenon which is probably linked to ICT dissemination in the productive system (Chart 2.5). Combined with low real wage increases, this has allowed a profit recovery.

Chart 2.5



On the base of all this information, we expect US GDP growth of 2.7% this year. This forecast assumes a slowing in 2002H2. Forecasts for 2003 show an economy stabilising around its potential, at 3%. This growth rate, far from those of late 90s, stresses the hypothesis of a greater balance among aggregate demand components.

Economic policies

Economic policy has played a crucial role in pulling the US economy out of recession. Budgetary and monetary policy has been extraordinary expansionary since early 2001, supporting economic production and, after September the 11th, household confidence too. In particular, the long-term economic stimulus package (Economic Growth and Tax Relief

Reconciliation Act) approved in July 2001 – mainly based on tax reductions – the extension of unemployment benefits and the big rise in Government consumption have strongly stimulated household consumption and raised business expectations (see: *US economic policy since 2001* on the following page). The stimulus to economic growth in the current year 2002 provided by the long-term plan is impressive as well. The package approved by the US administration will give an expansionary impulse to the economy of almost 1.5% of GDP; if we add to that the additional package currently under scrutiny, and expected to be shortly approved, the total fiscal stimulus will reach 2.5% of GDP.

US economic policy since 2001 and prospects for 2002 and 2003

Starting from 2001, US economic policies have become extraordinary expansionary. This has been in part the answer by policy makers to the sharp economic slowdown and, after September the 11th, to a slump in confidence. It can also be argued, with specific regard to fiscal policy, that there has been a structural change aimed at increasing the permanent income of the US private sector, which has been made possible thanks to a balanced budget in the past and the “slim” weight of the State in the economy (in terms of expenditures and revenues).

On the fiscal side, in May 2001 the US Administration approved a 10-year plan of permanent tax reduction equivalent to nearly 13% of GDP (Economic Growth and Tax Relief Act, Egtr), mainly benefiting families. In 2001 actually taxes have been decreased by 70 US billions and this year they should decrease by a further 40 billion, i.e. beyond 1% of GDP in total. The fiscal stimulus turned out to be particularly timely, as it limited the negative effects on household of the sluggish stock market in 2000 and the negative consequences deriving from the shock of September 11 terrorist attacks. According to the Council of Economic Advisors, without fiscal deductions foreseen by Egtr, the fall of GDP in the third quarter of last year would have been sharper (2.5% against 1.3%), the contraction would have also continued into the fourth quarter (-1%, instead of an increase of 0.2%) and this year’s increase would be 0.5% percentage points lower than that forecast by the US Administration (2.7%). Equally relevant, the Council has shown that the long-term fiscal plan raises permanent income of the private sector. Summing up, the massive actions taken to support US economy after September 11 events combined with the outcome of the fiscal maneuver started by Egtr has seen fiscal expansion in the last twelve months (increase of expenses and reduction of taxation income) amounting to 190 billions US dollars, nearly 2% of US GDP. According to Central bank estimates, this second package of actions should add approximately 0.4% growth to fiscal year growth, taking into account that military expenses, included in this package, have an immediate impact on growth.

The Federal Reserve supported this expansionary budgetary policy in 2001 with a particularly aggressive monetary policy stance. Before September 11, Federal

Reserve had already lowered the federal funds rate by 3 percentage points to 3.5%, to offset the progressive slowing down of the economy. After the terrorist attacks, the Fed successfully helped to counteract the risk of a dramatic loss of confidence by the households, to reduce the predictable fall of the stock exchange prices and to favour the smooth running of financial transactions. The Federal Reserve cut the federal funds rate by another half percentage point; in the three following months rates have been lowered by additional 1.25 percentage points, reaching 1.75%, the lowest level recorded since the early Sixties.

This offered a formidable spur to families to take on debt to fund purchases, in particular cars. The limited level of debt cost also revived sales in the real estate market, where the mortgage rate has been stable at 6.5% from the third quarter of last year, on the historically prevailing low levels of 1999 preceding the Federal Reserve restrictive policy.

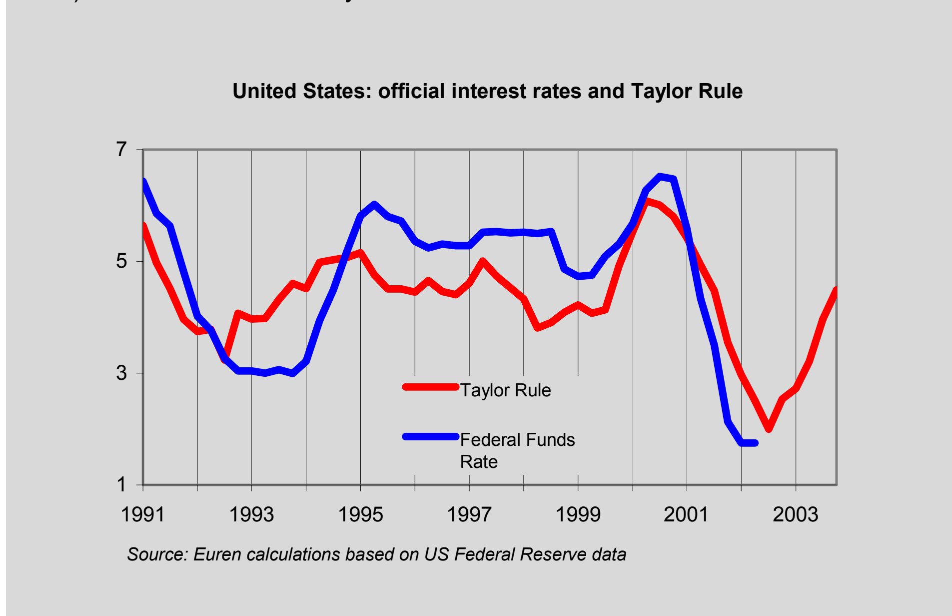
The expansionary stance of monetary policy appears only partially mitigated by two factors: on one side long-term interest rates on government bonds increased by nearly one percentage point (from 4.4% to 5.2%) as of last October; on the other, the constant appreciation of the exchange rate (until recently) and labor cost increases contributed to an important loss of competitiveness of the US economy. The US real effective change appreciation in fact has been of the order of 30% from January 1999 and approximately 10% from January last year.

In our scenario the US Central bank first brings official rates back on levels preceding the September 11 terrorist attacks, and then moves from a neutral to a more restrictive monetary policy stance. Two considerations in particular suggest this outcome.

First of all, budgetary policy remains highly expansionary; the above mentioned 10-years fiscal deduction plan is in fact fated to stimulate family consumption in the next two years, thereby generating tension in consumer prices. Secondly, inflation already appears to be increasing; after slowing down to 1.1% in January this year, it jumped to 1.6% in April. These levels, although rather limited when compared to the Euro area ones, will nevertheless rise in the short term in spite of recent productivity increases.

The weakening of the dollar seen in the first part of 2002 strengthens expectations of a gradual inflation increase, especially during the next two years, and the necessary preventive action by the Federal Reserve. Indications on timeframe and levels of rate increase can be derived from the Taylor rule, which forecasts the estimated rate on federal funds according to the gap of estimated potential output growth and estimated inflation when compared to its middle-long term target. In the case of the US, this simple policy rule explains well the Central bank action (see Chart). As for the current situation, the rule shows the adequacy of current levels of official rates at least for the remainder of the summer. The restrictive monetary policy phase starts in the last quarter of this year with a strong increase in official rates, around three quarters of a percentage points by year end, before increasing even more in the next year, when the total increase should reach two percentage points.

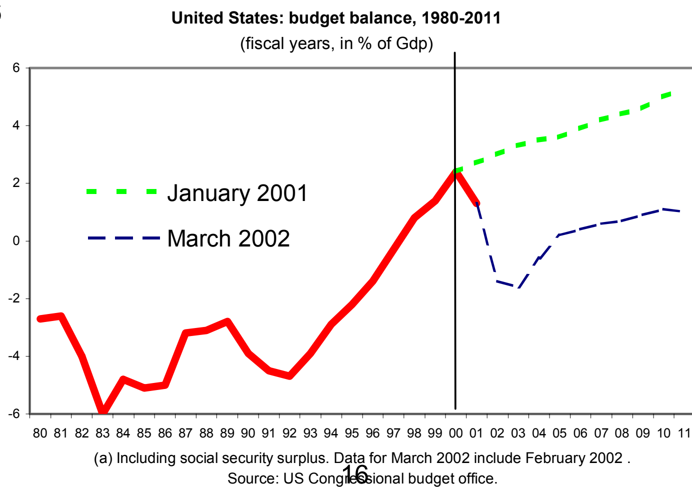
The indications that one can derive from the Taylor rule appear generally in line with the prevailing expectations derived from futures on the three month euro-dollar). Markets in fact already build in an increase of interest rates in



Q3 and a more consistent increase in the last quarter of this year, when the money market rates, currently at 1.9%, should reach 3%. Interest rate increases should continue in 2003, in parallel with the US economy approaching potential income growth paths.

The long-term fiscal plan and the package prepared in response to the consequences of the terrorist attack are expected to reduce the CBO planned budget surplus. They should actually lead to a deficit until 2004 (Chart 2.6).

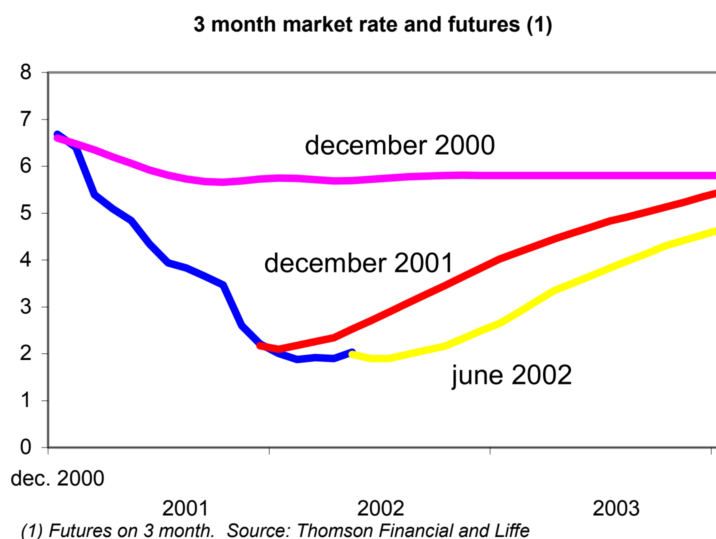
Chart 2.6



As in the previous year, in 2002H2 expansionary budgetary policy combined with a particularly expansionary monetary policy by the Federal Reserve; three months money market rates have been left unchanged at 1.9% in nominal terms and at zero in real terms, as was the case during the previous recession, between 1991 and 1992. The expansionary stance of monetary policy appears only partially mitigated by the rise in long-term interest rates and the appreciation of real exchange rate.

Markets in fact are already assuming an increase in interest rates, although expectations as of mid of June 2002 are less strong than they were at the end of last year (Chart 2.7).

Chart 2.7



(1) Futures on 3 month. Source: Thomson Financial and Liffe

In our scenario we forecast a change in the stance of monetary policy starting from the end of this year (see: *US economic policy since 2001*) We assume a gradual strengthening of all components of the US growth, particularly a recovery of investment, which leads the US Fed to raise official interest rates. In our forecast, money market rates rise by half a percentage point in the second half of the current year and around 2% percentage point in the following year; on a yearly average, money market rates reach 2.2% this year and rise to 4.3% in 2003.

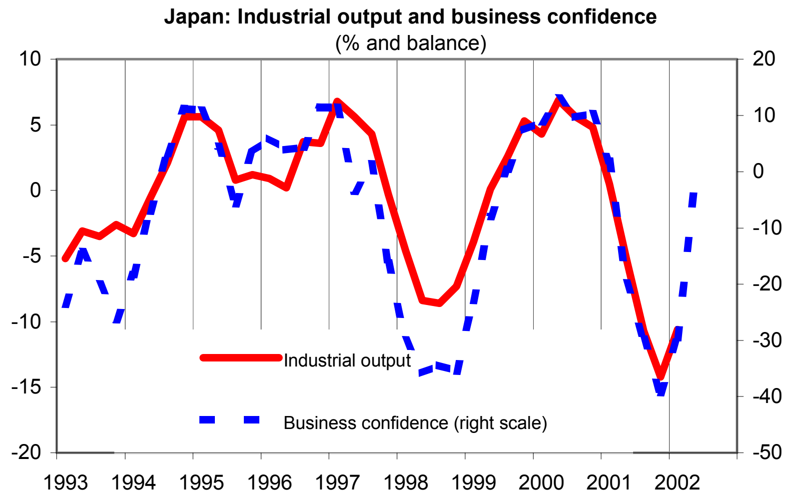
Japan: still in recession

After negative GDP growth last year (-0.4%) and three quarters of contraction, Japanese real GDP surprisingly increased by 1.4% (not annualised) in the first quarter of this year, growth as strong as that seen in the US or Canada. While the monthly trade data had clearly signalled that the economy was receiving a major boost from rapidly rising export volumes (up 6.4%), the major surprise was the strength of domestic demand, particularly private consumption (up 1.6%); public investment also was up 4.1%, government consumption 1.2%. The substantial rise in consumer spending followed an equally strong (and surprising) advance in Q4, resulting in a year-on-year increase of 1.1%. By contrast real employment compensation was 1% lower in Q1 than a year ago, implying that the saving ratio has been falling – a position that is unlikely to be maintained when there remains so much concern about the size of the budget deficit and the future value of pensions. The two negative components for GDP in Q1 were business investment (down 3.2% after – 12% in Q4) - which reflects the poor profitability of the corporate sector - and residential investment, down 2.3%.

But there are some positive signs

Optimism however has continued to rise among both manufacturing and non-manufacturing small businesses according to some analysts (Chart 2.8). Also the unemployment rate has edged down, from 5.5% in December to 5.2% in April, though this overstates the true extent of the improvement as many discouraged workers appear to have left the workforce. On the other end, the sharp boost to Japanese exporters seems to have been prompted by large inventory turnarounds in the US and parts of Asia. Going forward Japanese exports will have to rely more on increasing final demand in these key export markets and recent evidence on the US economy suggests a solid, rather than a rapid, recovery. Recent yen appreciation is threatening competitiveness. Therefore while a continued pick up in exports, though at a slower pace than in Q1, will continue to support the industrial sector, much of the sharp rise in GDP in Q1 will be unwound in Q2. Notwithstanding this, we have significantly raised our forecast for 2002 GDP. We now expect a 0.4% decline for the year as a whole and +1% next year. These results are anyway at risk as the structural problems remain.

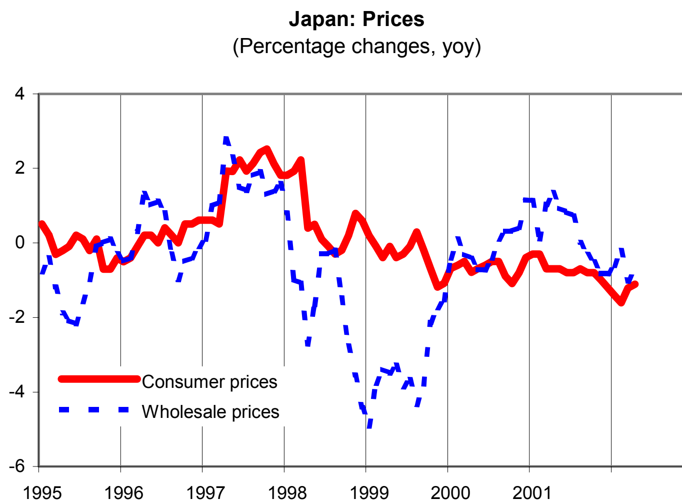
Chart 2.8



Source: Thomson Financial.

Deflation continues unabated and the banking sector cannot expect much relief from the cyclical recovery as so many of the bad loans are to firms in domestic sectors such as construction, real estate and wholesaling (Chart 2.9). Even the fiscal tool appears a dulled weapon. Public debt could,

Chart 2.9



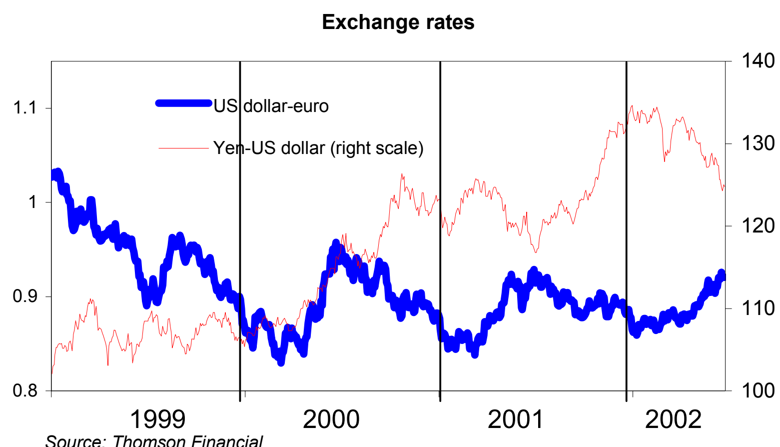
Source: Thomson Financial

according to forecasts taking into account current policies, reach 200% of GDP by the end of the decade, and international rating agencies, that already operated six downgrading of sovereign Japanese debt, start preparing for additional actions, also in consideration of “hidden” liabilities connected to banks sufferings.

Exchange rates

On the foreign exchange markets, the perspective of a stable return to growth for the US economy continued to support the dollar at the beginning of this year (to USD 0.86 cent per euro in February). Since then, increasing uncertainties on firms’ profits and on the real consistency of the US growth – and above all the consequences of the Enron collapse - favoured a reshuffling of portfolio investments by institutional investors, followed by a gradual weakening of the US currency: in mid June the dollar was around 0.95 cent per euro, a 17 month low (Chart 2.10). In the last five months the US dollar has depreciated over 10% against the euro.

Chart 2.10



Source: Thomson Financial

Looking to the future, fundamentals, in special way the wide US current balance deficit, call for a further appreciation of the European currency with respect to the US dollar. However, we think that prospects of recovery among the two areas will continue, except in phases of uncertainty as is the case now, to influence the exchange rate. According to our forecasts, the euro will continue to strengthen against the US currency (mainly reflecting the chain effects of the clamorous Enron collapse). The strengthening of growth in both areas in 2003 suggests the

dollar will stabilise around USD 0.96 cents per euro, but clearly there are risks to this forecast. Our forecasts are consistent with the widening, in favour of the dollar, of its differential with the euro on short-term rates and with a greater capital flow towards the US stock market, after the confidence crisis – which mirrors worries over the quality of financial information on listed firms - comes to the end.

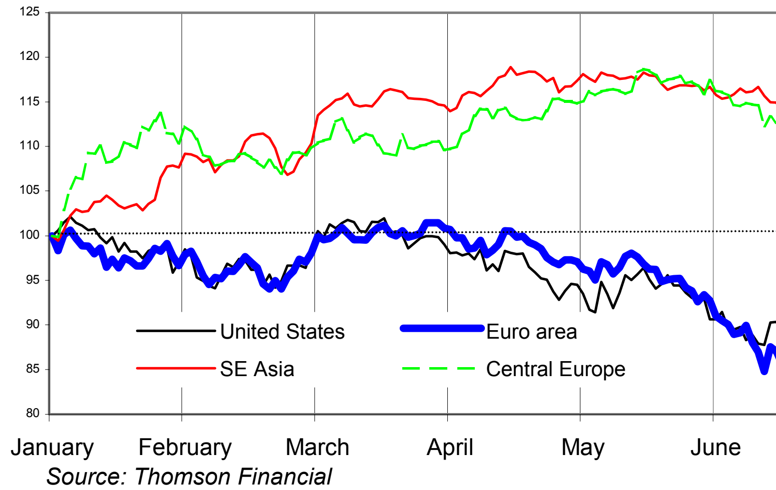
As for the yen, between the end of 2001 and February of this year the Japanese currency abruptly depreciated against all main currencies (at 132 yen per USD, almost a 7% depreciation in two months, and 115 yen per euro, a 8% depreciation in the same period). In the following months the weakness of the US currency favoured an appreciation of the Japanese currency, which rose to 123 yen per dollar, in spite of the repeated interventions of the Bank of Japan aimed at preventing, upon request of the government, an excessive appreciation of the exchange rate. In our forecasts the Japanese currency tends to appreciate slightly more in comparisons with the main currencies, to 121 yen per USD and 114 yen per euro in 2003. The appreciation of the yen appears in line with the persistent and wide Japanese trade surplus. And the emergence of a (modest) recovery of the Japanese productive activity contributes to a strengthening of the Japanese currency in our forecasts, in spite of the widening of short-term rates differential with both the USD and the euro.

Stock market

In spite of the positive trend of the economic framework and favourable forecasts for global growth, stock exchange indices are slowing down in nearly all financial markets (Chart 2.11).

As mentioned before, this trend mainly reflects the loss of confidence which followed the Enron collapse. Exceptions must be made, among largest economies, for Japan, where the stock exchange index has risen since the beginning of the year by around 15% because of the strong increase in telecommunication stocks (+15%). Even stronger signals arrive from the emerging markets, where prices have recorded massive increases since the beginning of the year (Chart 2.11). This trend mainly stresses two things; on one side, the good performance of industrial output in several countries, on the other, the reshuffling of institutional investors portfolios

Chart 2.11



and a cautious return of interest in emerging markets, which have been favoured by the implementation, in some countries of the governance mechanisms for firms and the banks as suggested by IMF.

Another consequence of the portfolio reshuffling was to drive flows out of stocks and into bonds. This generated a decrease in long-term interest rates in major economies. In mid-June 10 year government bond rates were at 4.9% in the US (down by almost half a point in one month) and 5.1% in the euro area.

Chapter

3

THE OUTLOOK IN EUROPE

Part I - The Euro area economy in 2001 and early 2002

Economic activity in 2001

After three years of strong growth, economic activity in the euro area slowed sharply in 2001: economic growth was more than halved compared to 2000 (1.5 per cent after 3.4 per cent). GDP even contracted slightly in the fourth quarter. The euro area proved unable to resist the global downturn. Indeed, after the world growth slowdown was transmitted to Europe through trade channels, economic policy didn't succeed in stimulating internal demand enough to compensate for the external downturn.

Exports depressed by slowdown in trade

After a boom in 2000, euro area exports plunged in 2001, contracting four quarters in a row. This downward trend mainly reflects the decline of world demand, communicated to the euro area as a consequence of the synchronised downturn in most regions of the world. World demand conditions faced by the euro area (including intra-zone trade) decreased by around 0.5 per cent last year after a double-digit growth in 2000. To some extent, this contraction of exports was surprising as it was initially thought that Europe was less exposed than Asia to a U.S. slowdown. Indeed, the share of exports to the U.S. in total exports or in GDP is significantly weaker in Europe than in Japan or emerging Asia. However, once intra-zone trade (Table. 3.1) is subtracted, the share of exports to the US in total exports appears relatively high for the euro area, higher than for UK for instance. The multiplicative effect of the U.S. slowdown on intra-euro area trade also played a big role in the contraction of the euro area

exports[1]. This is one of the reasons why euro area exports were so affected by the U.S. demand contraction.

Tablele 3.1 - Share of exports to the U.S. in total exports and GDP (1999)

(%)	Share of exports to the U.S. in total exports of goods	Share of exports of goods in GDP	Share of exports of goods to the U.S. in GDP
Euro area	16.4	12.7	2.1
France	7.8	20.5	1.6
Germany	9.5	24.9	2.4
Italy	9.6	19.3	1.9
U.K.	13.9	18.3	2.5
Canada	85	36.1	30.7
Mexico	84.1	27.3	23
Brazil	22.2	9.2	2
Japan	30.8	9.4	2.9
South Korea	20.6	34.6	7.1
Emerging Asia	25.7	29	7.5

Source: EUREN calculations on Cepii-chelem data base

Moreover, one special feature of the last downturn was the contraction of the IT sector (Table 3.2). Even if Europe generally lags well behind the U.S. on the production of such equipment, Europe's share in IT world trade is rather high especially in telecommunications. It can be explained by the fact that a large share of the U.S. production of IT equipment is oriented towards the domestic market, which is larger than the European market. Some countries were particularly affected by the recession in the IT sector either by the difficulty that the national blue-chips faced (e.g.

[1] It is of corse more interesting to exclude intra-zone trade of world demand addressed to the euro area. However, exports as well as imports in Eurostat national accounts estimates are obtained by adding up individual countries data, so that intra-trade is included by construction. Thus, it can be said that intra-trade developments affected euro area exports.

Nokia in Finland), or by the spill-over effect of the adjustment of the activity of some multinational companies (e.g. in Ireland).

Table 3.2 - Share in world exports (1999)

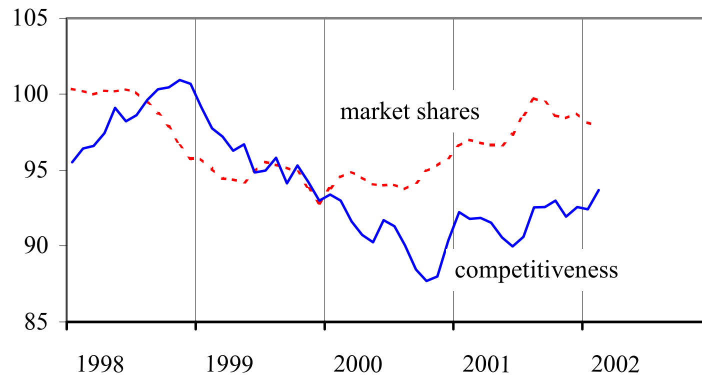
Export country	Computer equipment	Electronic components	Telecommunications equipment
United States	12.3	18.9	14.2
European Union:	32.5	19.3	44.7
- France	3.4	3.5	5.9
- Germany	4.8	4.3	7.9
- Italy	1.2	1.1	2.1
- U.K.	8	3.1	7.7
- Ireland	5.8	1.2	1.8
- Finland	0.3	0.2	4.6
- Sweden	0.3	0.2	8.1
Japan	9.4	15.2	7.9
Emerging Asia	37.3	39.6	19.9
World	100	100	100

Source: EUREN calculations on Cepii-chelem data base

Lastly, after improving sharply in 1999 and 2000, the price competitiveness of the euro area has deteriorated slightly since the start of 2001. This turnaround above all reflects exchange rate movements, namely the euro's stability against the dollar and the depreciation of the yen. The weakening of the euro in 1999 and 2000 led to significant market share gains, to some extent erasing the losses of the second half of the 1990s. This trend continued during the first half of 2001, but euro area market shares slightly decreased in the second part of 2001.

Chart 3.1

Market shares (1) and competitiveness (2) of the euro area (manifacturing industries)



(1) Euro area exports in volume terms/world demand adressed to the euro area. (2) Euro area export prices/euro area competitors export prices (in a common currency). *Source EUREN calculations.*

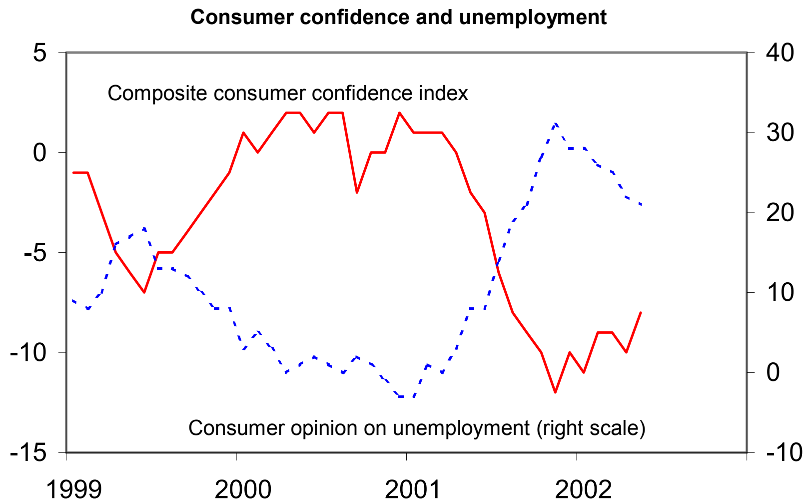
A weakening of internal demand

Private consumption remained buoyant during the first six months of 2001, thanks to tax cuts implemented in several countries in the euro area. But it almost stagnated in the second half of the year. Its contribution to GDP growth was thus almost null during this period, which contrasts with a positive contribution of 0.6 per cent in the first half of 2001. Consumer confidence weakened as the labour market deteriorated and also because of growing uncertainties in the aftermath of the 11 September attacks Chart 3.2). Unemployment stopped falling in the second quarter of 2001. The unemployment rate, expressed as a percentage of total labour force, reached 8.3 per cent in March 2001 (compared to a peak of 11.4 per cent in 1997), a level at which it stayed for several months before reaching 8.4 per cent at the end of the year. This was the consequence of a continued moderation of employment growth last year. For the whole economy, it was close to zero in the fourth quarter of 2001, compared to an annual growth of 2 per cent in the second half of 2000.

Until spring 2001 food and energy price hikes also contributed to the deterioration of the confidence of households as it reduced their purchasing power. Year-on-year inflation reached a peak in May 2001 at

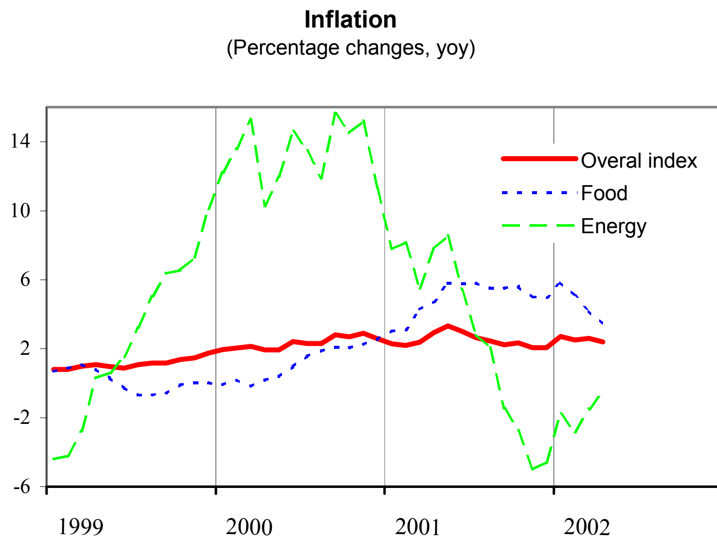
3.4 per cent according to the Harmonised Index of Consumer Prices (HICP), well above the ECB target (Chart 3.3).

Chart 3.2



Source: Wefa.

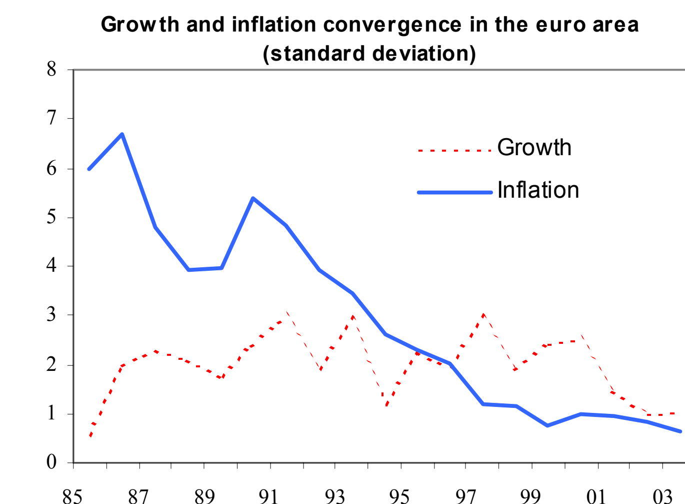
Chart 3.3



Source: Wefa.

Unprocessed food price increases peaked at 9.1 per cent in May 2001, thus explaining around 0.7 per cent of the overall index increase. At the same time, the energy price increase was 8.7 per cent in the wake of oil price tensions and euro weakness, explaining around 0.8 per cent of total inflation. In the second part of 2001, inflationary pressures eased. The global index increase was only 2 per cent in December 2001. Food prices slowed, but not so much (from 9.1 per cent year-on-year in May to 6.4 per cent year-on-year in November). However they accelerated again at the beginning of 2002. Energy prices moderation was more pronounced, from 8.6 per cent year-on-year in May to -4.5 per cent year-on-year in December, in line with the decline of oil prices on the international market. However, because of increasing political tensions in the Middle East oil prices were again on an upward trend at the beginning of 2002, thus pushing up energy prices in the euro area. As a consequence, headline inflation jumped to 2.7 per cent year-on-year in January. Effects of euro cash changeover have differed according to sectors. It mainly affected some services. On the overall index, the effects remained rather limited. After the January hike to 2.7 per cent year-on-year, inflation fell to 2.0 per cent year-on-year in May, exactly on the threshold of 2 per cent that represents the upper ceiling of the ECB target. Beyond short-term developments, it must be noticed that inflation rates converged more and more among the euro area countries, which is not the case for growth performance.

Chart 3.4



Source: EUREN calculations on Wefa data base

Facing a slowdown in global demand, firms reacted rather quickly, reducing both investment and inventories. Total investment contracted four quarters in a row in 2001 (-0.5 per cent quarter-on-quarter in the 2001Q4). After a peak at the end of 1999 at 6 per cent, total investment was 2 per cent below year ago levels at the end of last year. At the same time, as a sign of the weakness of the demand, the rate of capacity utilisation was also reduced by more than four points. However, when compared to the US, the fall was less pronounced. Operating rates were higher than during the 1993 recession. It also suggests that, as opposed to the U.S., the contraction in investment in Europe was more the result of a reaction to lower demand and reduced profits than the consequence of past over-investment.

Economicy policy

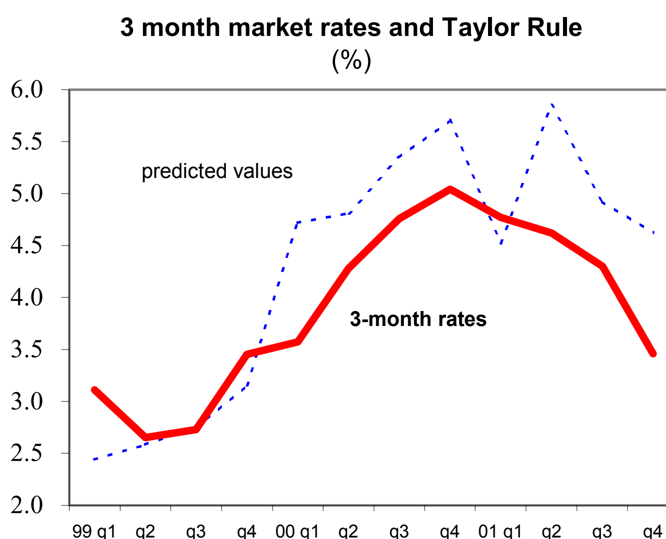
Although it did not succeed in maintaining internal demand growth momentum, economic policy was characterised by a global loosening in 2001, both on the monetary side and on the fiscal side.

Loosening of monetary policy…..

Taking monetary policy first, key ECB rates were adjusted for the first time on 11 May (from 4.75 to 4.50 for the REPO). Subsequently, three cuts occurred (31 August, 18 September and 9 November), leading the REPO to 3.25 per cent. One could argue the ECB reacted with a lag to the slowdown of the economic activity in the first half of 2001. It is true that in line with most thought at the time, the ECB predicted early in 2001 that Europe would not be too affected by the U.S. slowdown and thus maybe did not feel an immediate need to adjust monetary policy. But even when the economic slowdown was broadly acknowledged, the ECB faced a dilemma in Spring 2001: although economic activity was slowing, inflation was on the rise. True, the acceleration of inflation was mainly due to two temporary factors (energy and food prices hikes). But the ECB feared that this could lead to an increase of core inflation with a lagged response of wages to the higher inflation rate. At the end of the first half of 2001, it appeared that wages were under control and that inflationary pressure eased. This environment made a further reduction of key ECB rates possible. In the second half of 2001, another source of concern was the annual M3 growth rate, which jumped 8 per cent in December 2001. This

strong rise was driven by portfolio shifts from long-term to short-term assets, because of increasing preference for liquid assets after growing uncertainty in the wake of the 11 September terrorist attacks. Even though the annual M3 growth rate exceeded the ECB reference value (4.5 per cent), it doesn't appear that the ECB was frightened by these developments. Normalisation of financial markets was expected to lead to a moderation of M3 growth rate. This has actually been the case since the start of this year. Moreover, the steepening of the yield curve has led to a moderation of M3 annual growth rate since the start of 2002. However, some uncertainties remain about the existence of excess liquidity. There are fears that an excess of liquidity would lead to a financial bubble, although goods and services inflation is under control. But, if look at the Euro stocks 50 index, there is little sign of a finacial bubble, stock markets have remained subdued after a recovery late in 2001. Besides, it is often argued that ECB cuts were less pronounced then FED cuts. This is naturally true in absolute terms as total FED cuts amounted to more than 400 basis points. But expressed in real terms, short-term interest rates were historically low in the euro area. ECB cuts even exceeded what was implied by a standard Taylor rule.

Chart 3.5



Source: EUREN calculations on Wefa data.

We use here the following Taylor rule:
r=2.5+p+0.5 output gap + 0.5 (p-2) where
r is the estimated interest rate (3-months rate) and p is the year-on-year inflation (average of the quarter).
2.5 is supposed to be the level of equilibrium of short-term interest rates in real terms. It is close to potential growth. It can be noticed that added to the ECB inflation target (2 per cent per annum) it exactly equals the official target of M3 growth rate. The output gap is estimated using annual output gaps published by OECD, converted into quarterly data using year-on-year GDP growth as a reference. The weights used for the output gap and the inflation gap are calculated by Taylor for the Us. It can be interpreted as what could be the level of interest rates if Ecb would have adopted the same behaviour of the Fed.

Meanwhile, long-term interest rates in the euro area followed the U.S. long-term interest rate relatively closely. Euro area 10-year government bond yields decreased constantly from the start of 2000 (5.6%) and reached a trough, at 4.4%, in November when business confidence was depressed after the 11 September terrorist attacks. But as some signs of economic recovery in the US translated into an increase in U.S. long-term interest rates late 2001, the euro area long-term interest rates followed a similar profile. Since then uncertainties on the intensity of the recovery on both sides of the Atlantic have reduced pressures on long-term rates; at the beginning of June, the euro area long-term interest rate was around 5.2%. It must be noted that the mild increase in long-term rate has led to somewhat more restrictive financial conditions in the euro area, although the ECB has kept rates on hold until now. The slight appreciation of the effective exchange rate of the euro has had the same consequence.

…..and rising fiscal imbalances

Public balances suffered from the slowdown of activity through a reduction of fiscal receipts. In general, the euro area countries governments chose to let automatic stabilisers operate. The cyclical component affected the euro area fiscal balance, but not that much: according to the European Commission assessment, the primary balance as a percentage of GDP for general government reached 2.6 per cent in 2001 compared to 3.2 per cent (excluding one-off proceeds relative to UMTS licences) while the cyclically adjusted primary balance reached 2.4 per cent in 2001

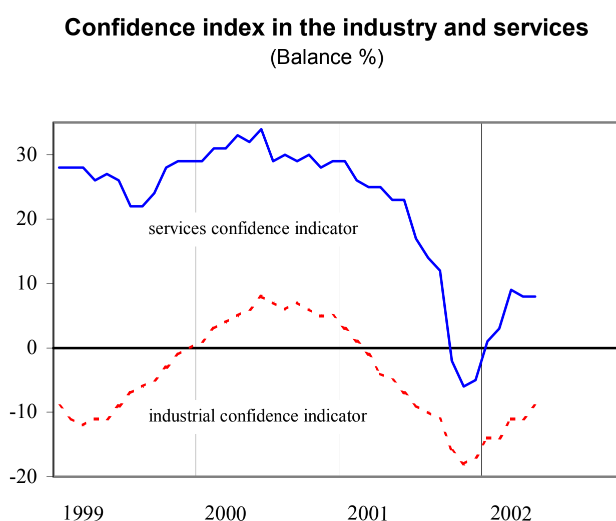
compared to 2.7 per cent. In other words, the worsening of the business cycle explained around 0.3 per cent of the reduction of the primary balance, a magnitude that can be compared to the effect of discretionary measures (mainly tax cuts). All in all, the general government deficit for the euro area reached 1.3 per cent of GDP in 2001 against 0.9 per cent in 2000 (excluding UMTS receipts). But if these developments for the euro area as a whole didn't seem too alarming, increasing fiscal imbalances in some member countries look more worrying.

Business climate in early 2002

After a sharp deterioration in 2001, the business climate has improved in the euro area since the start of 2002, in industry as well in services (Chart 3.6). This upward trend was also well anticipated by the BNB business climate index, which confirms that Belgium is generally ahead of the euro area business cycle[2].

Chart 3.6

Confidence index in the industry and services
(Balance %)



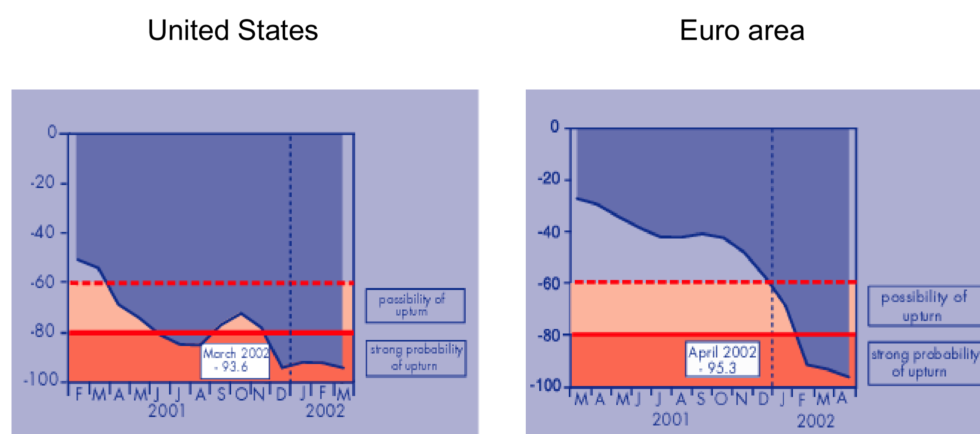
Source: European Commission

Moreover, in February, the COE leading indicator for the euro area entered the range indicating a strong probability of recovery within the next three months (Chart 3.7). It means that the euro area GDP growth

[2] For a detailed discussion of the leading role of the Belgium business cycle vis-à-vis the euro area cycle, see chapter 3.

should be above its trend -which is now assessed to be 2 per cent- in the third quarter of 2002[3]. It can be noticed that the COE's leading indicator for the U.S had already signalled a short-term recovery in December 2001. It means that the euro area growth cycle (understood as the deviation from trend) is lagging around three months behind the U.S. growth cycle.

Chart 3.7 – Leading indicators for the U.S. and the euro area (search of next trough)



Source: EUREN calculations on Coe data base

In the first months of 2002, the recovery has seemed relatively narrow-based, and significantly less marked than in the United States. According to Eurostat estimates, the euro area's GDP only increased by 0.2% in the first quarter. The improvement in the international environment was the main factor supporting economic activity. Exports to EU partners picked up early 2002. In the first quarter estimate for national accounts, exports were up 0.9%. As, at the same time imports declined by 1.1% illustrating the weakness of internal demand, net exports contribution to growth was rather large (0.7%). Inventories' contribution to GDP growth was again negative in the first quarter of this year (-0.3%), after having made a

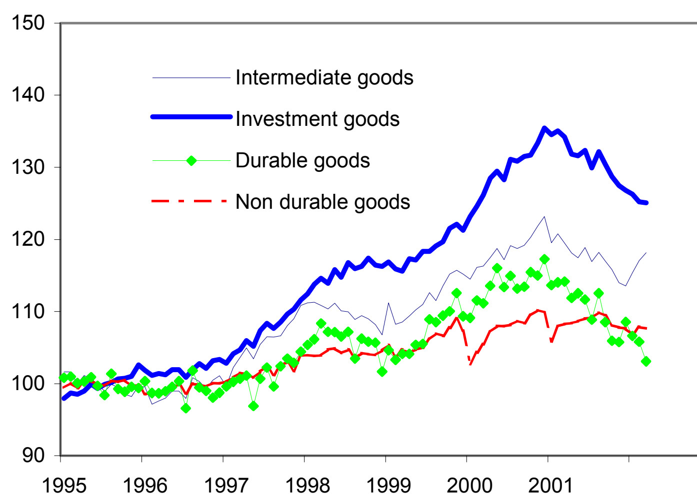
---

[3] According to the methodology used to build this indicator, it means that the centred three quarters moving average of quarterly changes should overpass 2% in annual terms in the third quarter of 2002.

contribution to growth of minus half a percentage point in 2001. However, manufacturers have been reporting less overstocking since the end of last year, suggesting they are rebuilding their inventories. Consumption, by contrast, appears to be a lot more hesitant - as suggested by weak retail sales and falling new car registrations. Consumer confidence has improved slightly since the end of last year, but is still a long way off the peaks achieved in late-2000; it seems that households are expecting an improvement in the labour market. Business investment also lacks steam, with capacity utilisation at low levels. It will not be until the second half of the year that there is any real recovery in equipment spending. All these developments were reflected in a moderate increase in industrial production in the first quarter, driven mainly by a recovery in intermediate goods production. On the other hand, production of consumer goods remained flat while the production of capital goods declined.

Chart 3.8

Production in the euro area by main industries
(Index: 1995=100)



Source: Eurostat

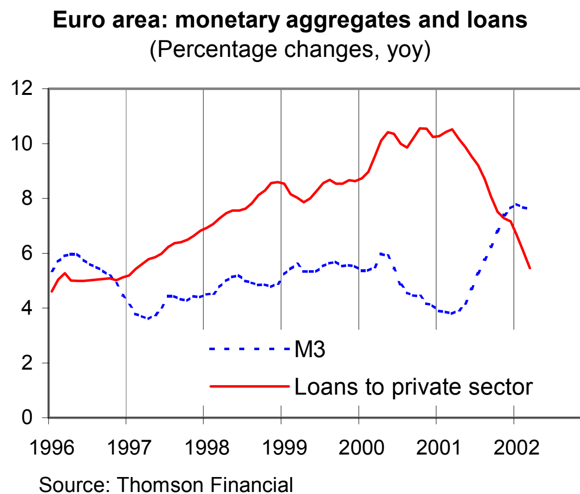
Part II - EUREN forecast for 2002 and 2003

a) Policy assumptions

Monetary policy

Since November 2001, when it was lowered by half a point, ECB has left its key interest rate unchanged at 3.25%. Taking the two pillars of its monetary strategy as a yardstick, it was not easy for the ECB to justify its decisions taken in the recent months: as already mentioned, both M3 growth and inflation were clearly above the target in 2001. However, a closer look reveals that both indicators were dominated by special factors. The first pillar, M3 growth, continued to be strongly influenced by portfolio shifts to liquid assets, which led to a strong expansion. In the meantime, a normalisation seems to have taken place, above all the annual rate of growth of loans to the private sector continues to decline (Chart 3.9).

Chart 3.9



Turning to the second pillar, inflation was higher than expected in the first months of 2002. To a large extent, price developments reflected temporary factors, such as higher food prices (because of a strong winter in the Mediterranean region), oil prices, the euro changeover and increases in public tariffs and excises. In April actually inflation decreased to 2.4% and then fell further in May to 2%. Nevertheless, core inflation remains high (2.7% in May), giving some cause for concern. At the same time, growth of production, even if speeding up, is only moderate, indicating that from the demand side inflationary pressure is weak. Therefore, ECB will be cautious in raising interest rates, even if wage

increases in some German industries have been somewhat higher than anticipated (see box on "Wage development in the Euro area") .

Wage developments in the Euro area

Overall wage increases have been moderate in the Euro area in the second half of the 1990s. However, in recent years rates accelerated slightly, from 1.8 % in 1999 to 2.5 % in 2000 and 2.7 in 2001. At the same time, differences between the individual countries became wider, ranging in 2001 from a 9.2% increase in Ireland and a 1.6% rise in Germany. In general, wages grew faster in countries with low unemployment rates and slower in the large economies with high unemployment.

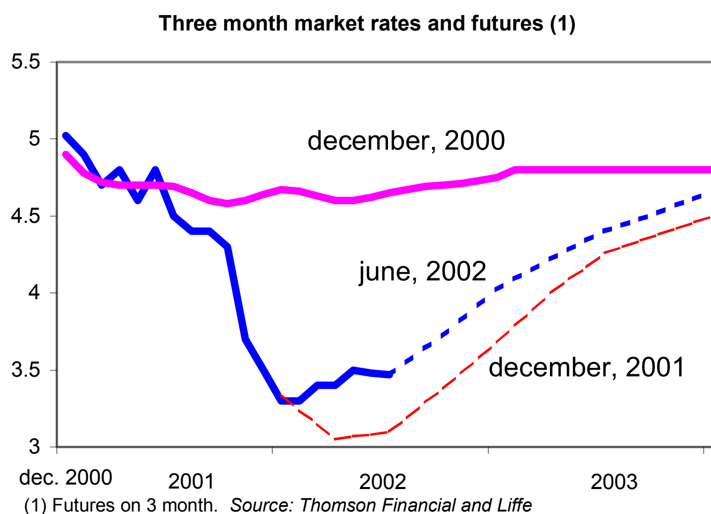
Wage policy in France and Germany is of special interest for the Euro-Zone, it serves as a guide for policies in other countries, such as Belgium, the Netherlands and Austria. In France, a continuation of moderate wage increases can be expected. The rise of nominal wages in 2002 should be approximately the same as registered in 2001 (2.5%). After an increase of 0.8% in the first quarter of this year compared to the fourth quarter of 2001, the monthly wage rise is expected to be quite pronounced in the 3rd quarter following the increase in the minimum wage (the « SMIC ») on first July. The minimum rise, according to the specific calculation of the increase, should reach 2.4% for people who still work 39 hours a week and 1.7% for others. In 2003, as the unemployment rate would still be quite high and inflation is expected to be rather moderate, nominal wages shouldn't increase faster than in 2002 (we forecast a rise of 2.4%).

After several years of pronounced moderate wage increases, negotiated wages only rose at a rate of 2% in 2000 and 2001, Germany was shaken by a series of labour disputes in the spring of 2002. As a consequence, the annual average of negotiated wages will rise by 2.8% in this year and approximately the same rate in the next. However, the results of recent wage rounds required a more sophisticated inspection. The "headline" wage increase was around 3.5% in many sectors, but the result of the negotiations was a combination of months with no increase, a flat rate for other months and a term for new contacts that often exceeds 12 months. Furthermore, in many contracts the wage increase for 2003 has already been fixed, which is lower as a rule than the increase in 2002. Finally, in some cases regulations are included allowing special arrangements on a company level to pay lower wages in case of economic problems. Therefore, wage drift in Germany will be negative, i.e. wage paid per working hour will increase at a lower rate than negotiated wages.

In many other countries of the Euro-Zone, wages can be expected to rise moderately. In Spain, trade unions and employer association agreed to keep wage growth in a range of 2% to 3%; in Italy, an increase in a similar range can be expected; in Finland, where a centralised wage setting applies, a general wage rise of 2.3 % in 2002 has already been agreed last year, and in Austria, first contracts signal moderate growth too. Even if in most countries wage drift is positive, wage policy is on a moderate course. On average, wage per worker in the Euro-Zone will rise in 2002 somewhat more than in 2001; and in 2003 the increase will slow down again. As the economy is in an upswing, productivity will speed up, so that labour unit costs will increase only moderately. Therefore wages should not endanger price stability.

We think they will have only a small impact on inflation, as it will be difficult for many companies to pass through higher wages to their prices due to weak demand and strong competition in the goods markets. The EUREN institutes assume that the minimum bid rate in the main financing operations will be raised starting from the second half of this year; we expect two steps of half a percentage point each, which will bring three month interest rates at 4,5%. Thereafter, the key interest rate will remain unchanged till the end of 2003.

Chart 3.10



Fiscal policy

Fiscal policy in the euro area took a moderately expansionary turn in 2001. Some member countries, which had not sufficiently reduced public deficits in the past, were in the danger of missing the 3% target of the Stability Pact. In the case of Germany and Portugal, the European Commission took action towards an early warning. Finally, the governments of the two countries avoided the EC's initiative in a formal sense by committing themselves to reduce the public deficit ‘close to balance’ by the end of 2004. In the meantime Portugal implemented a consolidation package, including tax rises.

Germany: additional consolidation required

Given Germany's high share in euro area economic activity, the German reaction is particularly important. Up to now, no concrete plans about how the government is going to reach the aim of a budget 'close to balance' in 2004 have been published and the probability to agree on any concrete measures before the general elections in September is low. Based on the fiscal projections for Germany valid hitherto, a government budget close to balance in 2004, which may be interpreted as a small deficit of 0.5 % of GDP, appeared out of reach, since the deficit in 2002, which is the starting level for the consolidation process, is higher than anticipated for cyclical reasons. One option the German government might have chosen in reaction to the impending early warning was to extend the time frame of the stability programme to 2006.

After the commitment given in February 2002, this way is blocked, and Germany has to strengthen its endeavours to achieve a balanced budget by 2004. Compared to the original fiscal projections, an additional consolidation of about € 16 bn is required. Assuming that the package will be implemented in two steps in 2003 and 2004, public spending will have to be 0.5% of GDP lower than said in the National Stability Programme in both years. Encouragingly, one major cause of excessive public debt in Germany, the autonomous fiscal policy of the *Laender*, has been tackled recently. In March, the *Laender* and the federal government agreed to limit the rise of the expenditure of the former to 1 % per year on average, whereas on the federal level, expenditures will be reduced by 0.5% per year. At the same time the competences of the co-ordinating committee for the budget on the federal and the *Laender* level (*Finanzplanungsrat*) were strengthened.

Table. 3.3 – **Stability programs: goals and forecasts compared**
(budget balances as % of GDP

Countries	Data (1)			Stability Programs (October 2001 January 2002)			EU Commission (1) April 2002		IMF (2) April 2002		OECD (3) April 2002	
	2000	2001		2002	2003	2004	2002	2003	2002	2003	2002	2003
Austria	-1.9	0.1	(0.0)	0.0	0.0	0.2	-0.1	0.3	-0.1	-0.1	-0.3	0.0
Belgium	0.1	0.0	(0.2)	0.0	0.5	0.6	-0.2	0.2	-0.3	0.1	0.0	0.0
Finland	7.0	4.9	(4.7)	2.6	2.1	2.6	3.3	2.7	1.8	1.9	3.2	3.3
France	-1.3	-1.5	(-1.0)	-1.8	-1.5	-0.5	-2.0	-1.8	-2.1	-1.9	-2.0	-1.8
Germany	-1.3	-2.7	(-1.5)	-2.5	-1.5	-1.0	-2.8	-2.1	-2.7	-2.0	-2.8	-2.1
Greece	-0.8	-0.4	(0.5)	0.8	1.0	1.2	0.3	0.5	0.6	1.2	0.4	1.0
Ireland	4.5	1.7	(4.3)	0.7	-0.5	-0.6	0.4	0.2	0.4	-0.8	0.1	-0.3
Italy	-1.7	-1.4	(-0.8)	-0.5	0.0	0.0	-1.3	-1.3	-1.2	-0.2	-1.4	-1.3
Luxembourg	5.8	5.0	(2.6)	2.8	3.1	3.4	2.0	2.5	1.0	1.1	2.2	1.8
Netherlands	1.5	0.2	(0.7)	0.4	0.2	0.5	0.0	-0.4	-	-0.5	0.1	-0.3
Portugal	-1.9	-2.7	(-1.1)	-1.8	-1.0	0.0	-2.6	-2.5	-3.0	-2.5	-2.4	-1.8
Spain	-0.4	-0.2	(0.0)	0.0	0.0	0.1	-0.3	0.0	-0.5	-0.6	-0.3	0.0
EU-12	-0.8	-1.3		-0.9	-0.5	-0.2	-1.5	-1.2	-1.6	-1.1	-1.5	-1.2

Source: (1) UE Commission spring forecasts (2002); figures in brackets are goals of Stability Plans presented between October 2000 and February 2001; (2) World Economic Outlook (IMF); (3). OECD Economic Outlook (OECD)

France: uncertainties on future fiscal policy

Recently, concerns have also grown on the French fiscal position and whether the government will be able to reach the goals fixed in its stability program for 2002-2005. Indeed, for 2002 the general government deficit of 1.4% of GDP cannot be maintained. This projection submitted to the European Commission was based on 2.5 % GDP growth, which is out of reach after the slowdown in 2001. In February, the government revised its growth forecast for 2002 down to 1.5%, implying a general government deficit of 1.8 – 1.9% of GDP in 2002 and of 1.7 – 1.8% in 2003. These projections included reductions of taxes and social contributions of about 0.5 % of GDP in 2002 and 0.3 in 2003: income tax cuts of € 2 bn in 2002 and 1.4 bn in 2003, € 1.1 bn for the "*Prime pour l'emploi*" programme (a tax credit for low-wage earners to increase the incentive to work) in 2002 and 2003 each; corporate tax cuts of € 1.4 bn in 2002 and 1 bn in 2003, and a reduction of social contributions of € 1.9 bn in 2002 and 0.8 bn in 2003 directly connected to the reduction in working time.

For 2003-2005, the most recent stability programme provides two macro-economic scenarios: according to the cautious scenario (2.5 % GDP growth on average), a balanced budget is expected in 2005, in a more favourable scenario (3.0 % GDP growth) already in 2004. As the deficit in 2002 will be higher than initially expected, the restrictions by the Stability Pact are even tighter, whatever the growth scenario is. The previous government did not say anything in this respect. Furthermore, president Jacques Chirac's economic programme for the presidential elections contained tax and social contributions cuts of € 30 bn during the 2003-2007 period, half of it a reduction of income tax (with a 5 % cut in 2002), the remainder a € 7 bn reduction of corporate taxes and lower social contribution (€ 6 bn) for low-qualified jobs. Moreover, the emphasis the French president put on internal security should lead to additional expenses. The President's programme is based on rather optimistic macro-economic assumptions, an annual growth of GDP of 3 %, whereas the potential growth rate of the French economy usually is supposed to be closed to 2,5 %. However, the plans should not be taken at face value, as they were made before the June 2002 parliamentary elections. their realisation depends on the outcome of the parliamentary elections in June 2002. Any change to the budget law for 2002 has to be adopted by the parliament, which will be possible in July 2002 at the earliest.

Actually, the new government has now two options concerning the stability programme. Firstly, it may reduce public expenditures or increase taxes to be able to achieve a balanced budget in 2004 or 2005. Secondly, which is more likely, it will start new negotiations with the European Commission to delay the adjustment process till 2007, which is implied in Mr. Chirac's programme.

Italy: deficit declining but not enough

In Italy, the public deficit was 1.4% of GDP in 2001. This result was an improvement on the 1.7% of 2000 but it was higher than the 0.8% goal set initially in the Stability Pact, later raised to 1.1% in the Forecast and Planning Report (FPP) for 2001. Reduced interest expenditures and revenues from securitisation (0.6% of GDP) both had an impact on the deficit. The primary budget balance improved over 2000 (from 4.7 to 4.9% of GDP) but it was lower than the 5.4% set in the FPP. The failure to reach these goals is due to lower economic growth in 2001 (1.8%, versus the FPP's predicted 2.9%) and to the difficulty in containing current expenditures, in particular health care and public employee wages and benefits.

In 2002, the deficit should reach 1.3% of GDP, versus the 0.5% estimated by the government. Net current expenditures are projected to rise from 37.5% of GDP in 2001 to 37.8%, primarily refeclting the increase in spending on pensions, unchanged in the government's estimates. Total revenues are likely to grow by 4%; therefore staying around 45.8% of GDP, compared to the government's estimate of 46.2%. Looking at the difference in the deficit, some 0.4-0.5 percentage points of GDP stems from growth that is lower than our expectations; for the remaining part it depends primarily on different estimates of the revenues obtained through the government's measures on the underground economy and certain spending cuts. The Finance Ministry, in updating the Stability Program last November, had estimated the deficit increase resulting from economic growth 1.1% lower than that anticipated for 2002 was around 0.5% of GDP.

It seems rather difficult for Italy to achieve a balanced budget over the next two years. In 2004, the deficit is still likely to be around 0.7% of GDP. The primary budget balance is set to worsen in 2002 compared to 2001 and then improves in 2003 and 2004. Debt as a percentage of GDP would decrease from 109.4% in 2001 to 102.8% in 2004. The basic scenario, though, is not one of public finances that are out of control. In terms of spending, public administration purchases will continue to be rationalised, health spending will be contained within the set limits and contractual raises for 2002-2003 will

not exceed the limits set in last year's budget and in subsequent agreements between government and unions. Securitisations are expected to proceed. With regard to revenues, the scenario does not consider implementation of the measures contained in the proposed tax reform. There is, therefore, no reduction in fiscal pressure, and revenues rise essentially in line with nominal GDP.

Gradual implementation of the proposed tax reform could change this picture. Assuming that corporate income tax reform begins in 2003, with the gradual elimination of IRAP in 2004 providing for 20% deductibility on labour costs, and assuming also that tax rates on financial income would be spread out over 2003 and 2004, then in relation to GDP this alternative scenario implies an *ex ante* 0.2% reduction in tax pressure in 2003, another 0.8% reduction in 2004 and 2005, and a further 0.9% in 2006, for a total of some 2.7%. On the spending front, the hypothesis is to make sufficient structural corrections in 2003 to eliminate the budget deficit. Total spending should, at most, grow by around 1.5% annually in 2003, compared to 4.5% in the predicted scenario. To obtain this deceleration, we assumed a reduction of around 0.7% annually in the number of public employees and that public sector wages grow at an average rate equal to that in the private sector. Growth in purchases of goods and services and in health care services should be contained within planned inflation rates.

Spain: surplus expected in medium term

As for Spain, in 2001 budgetary equilibrium has been attained with deficits from regional and central Governments compensated by a clear surplus of Social Security (reaching 0.8% of GDP); the latter development is explained by rapid growth, well beyond expectations, of the number of affiliates. Estimates for 2002 generally assume a small deficit of some -0.5% of GDP; revenue is expected to slowly decrease as a results of the economic slowdown and of reforms of direct taxation, and expenditures stimulated by public investment, may increase by as much as 0.3% of GDP. Medium run projections of the Government contemplate a sustained budgetary surplus of some +0.3%.

b) Forecasts for the year 2002 and 2003

Economic activity in 2002-2003

In sum, the impulses given by fiscal and monetary policy in the Euro area are mixed. The easing of monetary policy in 2001 will stimulate demand for some time. Even after the ECB raises interest rates, which is assumed to take place by the end of 2002, monetary policy will be on a neutral course and not yet restrictive. Fiscal policy will be more or less neutral this year, with tax reductions in some, but higher taxes in other member countries. Next year it will take a more restrictive stance, again with differences between countries: In Germany, a consolidation package will have taken effect, whereas policy will even be slightly stimulatory in France. A more favourable international environment is already evident, as foreign new orders start to rise.

After GDP declined slightly in the last quarter of 2001, growth in the Euro area has gained momentum. Industrial production stopped declining, new orders increased and business sentiment has improved. A recovery is on the way, though it will be moderate at first. In the first quarter of 2002, the expansion was mainly driven by net exports. Export of good and services picked up again, after having been going down during 2001. Public consumption also was strong in the first quarter of 2002, whereas investment and private consumption once again shrank. As international demand remains strong, exports will give additional impulses the Euro area growth. In the second half of this year, as capacity utilisation increases, investment will gain momentum (Table 3.4). Later in the upswing, private consumption will accelerate too, on one hand because inflation calms, down giving room for higher real demand, on the other hand because employment improves. Stronger demand will also stimulate imports, the driving force of the upswing will shift from the external to the internal side. This year, annual average growth of GDP will be 1.3 %. In 2003, internal demand will continue to grow. Investment will expand with rates almost unchanged; private consumption will accelerate with the employment situation improving further. Public consumption, on the other hand, will grow only moderately, as consolidation packages will come into force in some EMU countries. At the same time, impulses from external demand will become weaker, as the Euro is expected to revalue slightly against the dollar, with imports growing somewhat stronger than exports in late 2003, reflecting more dynamic internal demand. Quarter-to-quarter increases of GDP will be somewhat lower than in the second half

of 2002. However, the annual average growth rate of GDP will be 3.0 % in 2003.

Given this macroeconomic performance, the slight deterioration of the labour market, already observable by the second half of 2001, will continue in the first half of this year. Later in 2002, however, growth will be strong enough to raise labour demand. The annual average unemployment rate will be nearly the same in 2002 as it was last year (8.3 %). In 2003, the employment situation will continue to improve, and the unemployment rate will decline to an annual average of 8.0 %.

Inflation has been unexpectedly high at the beginning of 2002 (2.7 %). One reason, as already said, was unusually bad weather in parts of the Mediterranean region that pushed the prices for vegetables and fruits. In some countries direct taxes were raised also, e.g. in Germany those on gasoline and tobacco were hiked. Furthermore, the introduction of the Euro may have had a slight inflationary impulse in some countries, especially in the service sectors. Already in February inflation started to slow down, in May 2002 it was 2.0%, which is more or less in line with the ECB target. However, core inflation (without energy, food, tobacco and alcohols) is proving stubborn (2.7% in May). Soon, headline inflation will be below 2 %, also for technical reasons, as the strong surge of meat prices one year ago will now be mirrored in lower price increases. However, core inflation should come down, as wages rise moderately and a more buoyant economy will enhances productivity, keeping labour unit costs under control. Finally, the slight revaluation of the Euro will also reduce import prices. The annual average inflation will come down to 2.1 % in 2002 and 1.9 % in 2003.

Table 3.4 Euro area forecasts
(1995 prices)

	1999	2000	2001	2002	2003
percentage changes over previous period, unless otherwise indicated					
Private consumption	3.2	2.5	1.8	0.7	2.2
Public consumption	2.1	1.9	2.0	1.6	1.2
Gross fixed capital formation	5.5	4.4	-0.2	-0.9	3.2
Exports	5.3	12.2	3.4	1.8	8.0
Imports	7.2	10.9	1.8	-0.5	8.1
GDP	2.6	3.4	1.5	1.3	3.0
Unemployment (% of labour force)	9.7	8.8	8.3	8.3	8.0
Compensation per employee*, yoy	2.3	2.6	2.7	3.1	3.0
Consumer price (HICP), yoy	1.1	2.3	2.5	2.1	1.9
Private consumption deflator, yoy	1.7	2.1	2.4	1.6	2.1
M3 (growth rate), yoy	4.7	5.4	8.9	6.6	4.4
Current account balance (%GDP)	-0.3	-0.9	-0.1	0.8	1.0
GGFB/GDP *	-1.3	-0.8	-1.3	-1.5	-1.2
3m interest rates (% per annum)	3.0	4.4	4.3	3.7	4.3
10y Gvt bond yields (% per annum)	4.7	5.4	5.0	5.2	5.3

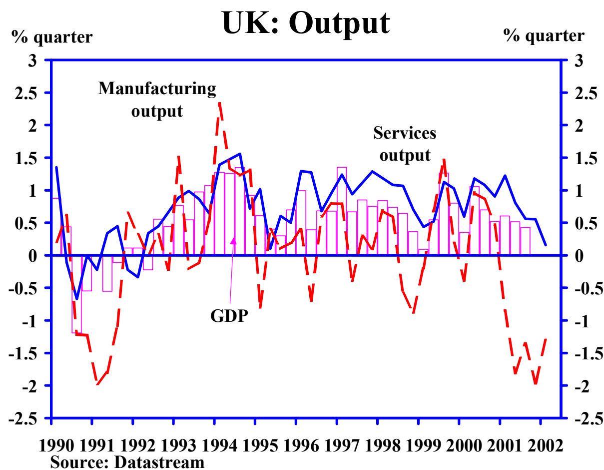
Table 3.4 follows

	2002 I	2002 II	2002 III	2002 IV	2003 I	2003 II	2003 III	2003 IV
percentage changes over previous period, unless otherwise indicated								
Private consumption	-0.2	1.2	2.4	2.4	2.0	2.2	2.4	2.4
Public consumption	2.0	1.6	1.2	1.2	1.2	1.2	1.2	1.2
Gross fixed capital formation	-2.6	0.0	3.2	4.0	4.0	4.0	4.0	4.0
Exports	3.2	5.0	8.0	8.4	8.0	8.0	7.6	7.2
Imports	-3.6	4.4	7.6	8.0	8.4	8.4	8.0	8.0
GDP	0.9	2.1	4.1	4.0	2.4	2.5	2.8	2.4
Unemployment (% of labour force)	8.4	8.4	8.3	8.2	8.1	8.0	7.9	7.9
Compensation per employee*, yoy	2.8	2.9	3.2	3.3	3.3	3.0	2.9	2.8
Consumer price (HICP), yoy	2.5	2.2	2.0	1.8	1.8	2.0	1.9	1.9
Private consumption deflator, yoy	1.4	1.6	1.7	1.8	2.0	2.1	2.1	2.2
M3 (growth rate), yoy	7.5	7.0	6.2	5.8	5.0	4.4	4.2	4.0
Current account balance (%GDP)	0.5	0.7	0.9	1.00	1.0	1.1	0.9	0.9
GGFB/GDP *	-1.5	-1.5	-1.4	-1.4	-1.3	-1.2	-1.1	-1.1
3m interest rates (% per annum)	3.4	3.5	3.8	4.0	4.3	4.3	4.3	4.3
10y Gvt bond yields (% per annum)	5.1	5.2	5.2	5.3	5.3	5.3	5.3	5.3

Stagnant for six months…

Having been the fastest growing of the major economies in 2001, UK economic growth apparently slumped over the winter. Revised estimates suggest that GDP was unchanged in 2002Q1, having also not grown in 2001Q4 – the worst six-month performance since 1992. The weakness of growth over the last six months in large part reflects the impact of the downturn in world trade and the hi-tech sectors on manufacturing output. But the service sector has not been immune: overall output rose just 0.2% in Q1, with output of financial and business services falling 0.2% - the first quarterly drop in this sector since 1992. Much of this probably reflects cutbacks on advertising, consultancy spend etc by companies concerned to preserve cash in case of a major economic downturn in the wake of 11 September. Turnover in financial markets has also been depressed.

Chart 3.11

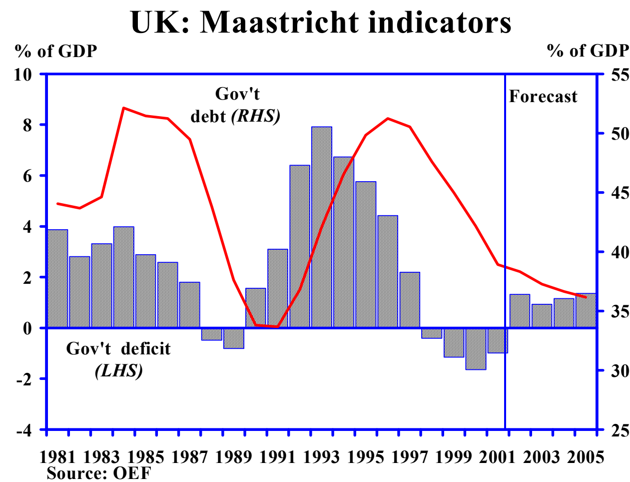


…but weakness may be overstated

That said, it is surprising that UK growth was so weak in Q1, especially in comparison with the strong growth seen in the US and Japan. It is also striking that the labour market statistics show employment continuing to rise in Q1, which seems inconsistent with the reported weakness of output. One issue here may be problems with splitting sales into value and volume terms:

the GDP deflator jumped 1.3% in Q1 to a level 3.6% up on a year earlier, which is well ahead of other measures of underlying inflation, such as RPIX.

Chart 3.12



There may well be upward revisions to growth when the ONS undertakes its summer ‘Blue Book’ national accounts review.

Some signs of strong rebound in Q2

Moreover, we continue to expect growth to rebound strongly from Q2. Manufacturing output rose 0.8% in April. Although the purchasing managers index for manufacturers slipped slightly in May, it remains well above 50, indicating continued growth, while the services index has risen back to levels seen through 1999 and 2000. Retail sales jumped 1.7% in volume terms in April and in the latest three months were 1.8% up on the previous three months. And house prices continue to soar, with both the Halifax and Nationwide reporting prices up about 18% over the last year.

… as policy remains highly stimulative…

The main factor driving the recovery - and why the UK performed so well during the early stages of last year's global economic downturn - is the still highly stimulative macro policy stance. While the Chancellor announced tax increases of over £6 billion in the Budget, these only take effect from April 2003 and then are matched by increased spending on the NHS. But this

year there is still a discretionary relaxation of fiscal policy equivalent to almost 1% of GDP, as the full impact of the last public spending review comes through. Likewise, last year's interest rate cuts are also boosting domestic demand.

… and inflationary pressure subdued

There is little sign that the house price boom is spilling over into general inflation. RPIX (which excludes the price of mortgage interest payments) dropped sharply to at 1.8% in May. The pace of deflation on the high street appears to have intensified again over the spring; producer output price inflation remains close to zero; and private sector underlying wage inflation remains subdued. The Monetary Policy Committee has therefore been relatively relaxed about its monetary stance, maintaining interest rates at 4%. And while rates may rise in the second half of the year, this will be more gradual than appears to be assumed by financial markets. We expect the repo rate still to be only 4.5% by December.

Can consumers afford to keep spending?

Consumers continue to make the most of low interest rates. 2002 will be the seventh consecutive year in which consumer spending has risen by over 3.5% in real terms. And last year households borrowed over 6% of their annual disposable income through either consumer credit or mortgage equity withdrawal, to fund the spending boom, pushing the debt-income ratio well above its late 1980s peak.

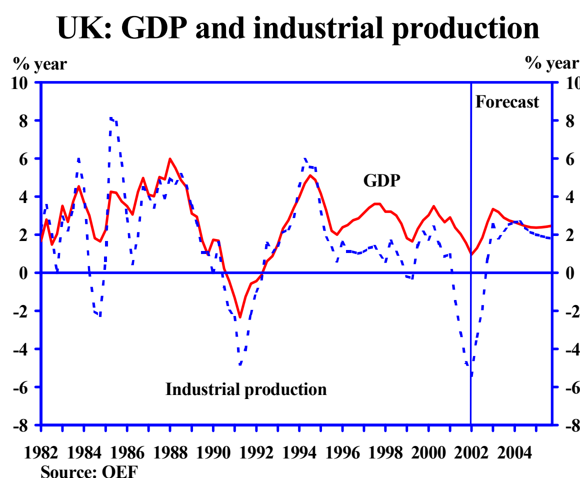
There is growing concern that some consumers are borrowing beyond safe limits, and would be exposed if interest rates or unemployment were to rise sharply. But it is not clear that this is a serious risk at the macroeconomic level. The personal sector debt-GDP ratio in the UK is not out of line with that in other leading economies.

Personal sector net wealth in the UK is relatively high compared with our peers, and strongly rising house prices have boosted wealth, helping to offset the impact of weaker equity prices. And even with interest rates expected to rise to over 5% next year, household debt interest costs remain low compared with the late 1980s.

Moreover, it is now clear that the economic slowdown has barely affected the labour market, with employment rising through the winter and despite the

marginal increase in unemployment in April, the numbers out of work remain at levels not seen since 1975. We now expect unemployment to end the

Chart 3.13



year at just under 900,000, supporting continued strong consumer confidence, although the Budget increase in employers' national insurance contributions may hold back employment growth in 2003.

A tax-and-spend Budget

There were few surprises in the Budget in April, with substantial increases in spending on the health service funded by higher taxes. Nevertheless, while there was no change in the fiscal stance as a result of the measures announced last month, the public finances are expected to remain extremely stimulative over the next two years as a result of previously announced increases in public spending. The Treasury estimates that the cyclically-adjusted budget moved from a surplus of 1.2% of GDP in 2000-01 to a deficit of 0.2% in 2001-02, and expects a deficit of 0.9% in 2002-03 and 1.2% in 2003-04. So, over the three years to 2003-04, fiscal policy will have loosened in underlying (discretionary) terms by the order of 2.4% of GDP. That said, we doubt that the Budget will affect the Bank of England's views on interest rates.

…although Treasury forecast optimistic…

We are not as optimistic as the Treasury about growth over the next 18 months – their Budget forecast is for GDP to rise 2-2.5% this year and 3-3.5% next, while we see growth of 1.7% this year and 3.0% in 2003. The

main source of the Treasury's relative optimism about the speed of the recovery, particularly in 2003, appears to be on investment, where it is expecting government investment to rise over 26% in real terms this year and over 12% next, with business investment forecast to rise well over 5% in 2003 after a fall of 0.5 -1% this year. We would particularly question the assumption of such a strong revival in business investment given the weakness of company finances, the increased taxes the Budget imposes on companies, worries over debt (especially after the Enron scandal) and past over-investment.

…as Budget trend growth assumptions

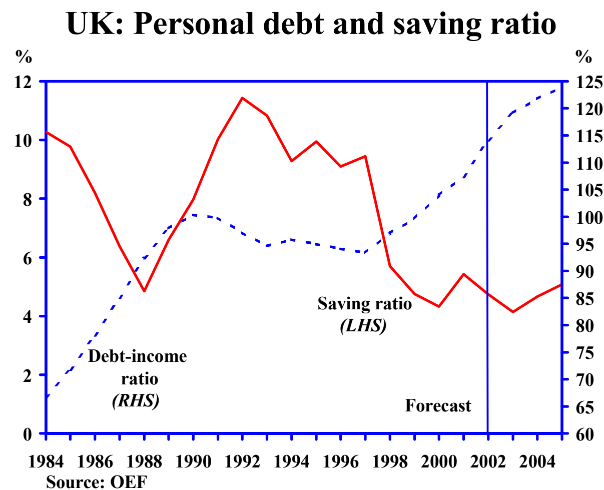
As well as revising up its short-term growth forecast, the Treasury also announced in the Budget an upward revision to its forecast for the UK's sustainable trend rate of growth, to 2.5% pa from 2.75% pa previously. The revision to the trend growth assumption (which has been approved by the National Audit Office) appears to mainly reflect a more optimistic view about future trends in labour participation and faster growth in the working age population, in turn reflecting an assumption of continued substantial net inward migration to the UK.

However, while our own estimates suggest that trend growth has averaged around 2¾% pa over the last five years or so, we believe that a significant element of this reflects the steep fall in the 'natural rate of unemployment' (or NAIRU) that has occurred. But with unemployment on the ILO measure now close to 5% (compared with 9% in the mid-1990s), and the claimant count measure just 3.2%, it is difficult to see that falling unemployment can continue to boost trend growth. And UK labour productivity growth has averaged just 1.5% pa over the last five years. We would therefore feel more comfortable with an assumption for trend growth of 2.5% pa – although this would not cause us to worry about the Treasury forecast for public borrowing since that is the assumption that they use for the public finance anyway. If anything, the Budget measures, by increasing taxes on labour, are likely to raise the NAIRU.

EMU entry unlikely before next general election

Sterling has fallen recently against the Euro recently, taking it closer to rates that most would regard as compatible with EMU entry. Opinion polls suggest that the public has become less opposed to EMU membership since the introduction of euro notes and coins at the start of the year. It is likely,

however, that a key consideration in the Chancellor's assessment of whether or not his tests are met is the performance of the European Central Bank.
Chart 3.14



Without reform of the ECB to make it more like the MPC – ie symmetric inflation target, regular publication of meeting minutes, etc – we consider it unlikely that the Treasury will recommend that the UK joins EMU. It is possible that Wim Duisenberg's departure from the ECB will allow such reforms, for which there is growing support among commentators across the Eurozone. Our forecast continues to assume, however, that the UK will not join EMU until after the next election in three to four years time.

Table 3.5 Forecasts for United Kingdom

(Annual percentage changes unless specified)

	2000	2001	2002	2003	2004	2005
Domestic demand	3.6	2.8	3.1	3.1	2.7	2.6
Private consumption	4.1	3.9	3.4	2.7	2.1	2.2
Fixed investment	3.9	0.1	0.1	3.3	3.9	3.0
Stockbuilding (% of Gdp)	0.3	0.1	0.4	0.5	0.4	0.4
Goverment consumption	3.3	2.7	3.6	4.2	4.1	3.7
Export of goods and services	10.3	1.0	-1.3	7.4	6.9	6.0
Import of goods and services	10.9	2.8	2.8	6.9	6.5	6.0
Gdp	3.0	2.2	1.7	3.0	2.5	2.4
Industrial production	1.6	-2.1	-2.5	2.3	2.5	1.9
Rpix	2.1	2.1	2.0	2.1	2.3	2.4
Current balance (% of Gdp)	-1.8	-1.8	-2.0	-2.3	-2.4	-2.4
Government budget (% of Gdp)	1.6	1.0	-1.3	-0.9	-1.2	-1.4
Short-term interest rates (%)	6.11	4.97	4.21	5.13	5.25	5.19
Long-term interest rates (%)	5.26	4.91	5.09	4.95	4.96	4.99
Exchange rate (Us$ per £)	1.52	1.44	1.45	1.44	1.48	1.54
Exchange rate (Euro per £)	1.64	1.61	1.58	1.51	1.46	1.43

Chapter

4

SPECIAL STUDIES

(Each study presented in this chapter provides background material to the EUREN report. The views expressed here do not necessary reflect those of all EUREN institutes)

1. What are the implications of a stronger Euro?

(OEF. United Kingdom)

Introduction

Since its launch at the start of 1999, the weakness of the euro is well documented. By October 2000, one Euro was worth around $0.83, nearly 30% below its level at the beginning of the previous year. Since then, a gradual and stuttering recovery has occurred, which has gathered pace in the last month. The Euro has strengthened over 7% against the dollar since the start of May alone.

After these initial gains, OEF's current forecast shows the Euro remaining relatively flat against the dollar in the short-term, and then gradually appreciating, reaching parity during 2004 and $1.10, our estimate of the equilibrium rate – which is broadly in line with most recent estimates- by end 2005. There is much debate about the factors that determine the equilibrium rate; in the long term, purchasing power parity (PPP), the rate that equalises the cost of a basket of goods in different countries is often cited as a good guide, although it suffers from the drawback that not all goods are tradeable and prices often are distorted by local taxes. The most recent OECD estimate of the Euro PPP exchange rate is 1.13 $/€.

Another approach is to calculate the exchange rate consistent with medium term macroeconomic equilibrium. Most of these methods are

variants on the Fundamental Equilibrium Exchange Rate (FEER) approach. The FEER is the value of the exchange rate consistent with internal equilibrium (when unemployment is at the NAIRU and the economy is growing at its trend rate) and external equilibrium (when the current account balance is consistent with 'normal' capital flows). This framework can also be extended to incorporate productivity differentials, real interest rates, the impact of fiscal policy and the overall international investment position. The ECB conducted a survey in its January Monthly Bulletin that showed that all these different approaches (and some others) came to similar conclusions; the euro is undervalued, although the range of different estimates makes it hard to be precise about the size of the gap

Although our estimate of equilibrium is in line with much of this work, these models are silent on when that equilibrium is likely to be reached. Realignments can occur very rapidly and by using the OEF world model we can examine the macroeconomic implications of a more rapid adjustment than in our central forecast. But first, we briefly outline the possible reasons why the euro might bounce back quicker than in our projections, before discussing the channels through which this shock would hit the Euro area economy. Finally we present our results and draw conclusions.

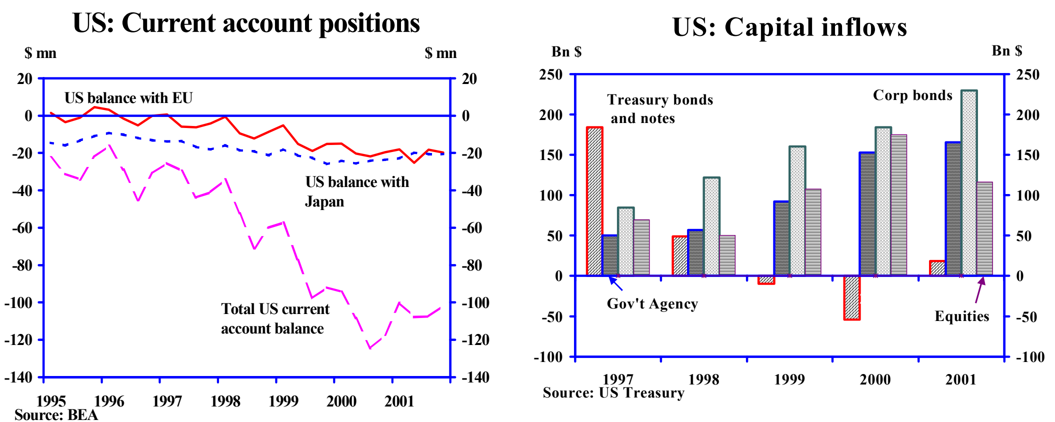
What might trigger a rapid euro recovery?

- Despite narrowing slightly last year, the US current account deficit is still more than 4% of GDP and widening as demand in the US picks up more rapidly than elsewhere. Doubts have been raised about the sustainability of this deficit, although we believe they are overstated. Even if the widening of the deficit is an indicator of an overvalued dollar, it is not clear that this is a sign that the $/€ rate is inappropriate. As the chart below shows, the US current account position has weakened against both the EU and Japan, the growing deficit mainly reflects developments elsewhere, particularly in emerging Asia which has reaped the benefits of devalued currencies after the crisis in 1998.

- Of course the counterpart of this deficit is a need to generate large offsetting flows of capital. This has not been a problem up to now as

Chart 4.1 demonstrates. Higher productivity growth than elsewhere has continued to make investment relatively attractive and money has continued to pour into US assets, which corporate bonds proving particularly popular in the last year. While the US economy is expected to continue to be the locomotive of growth for the world economy, there are some risks – and these risks are probably growing - that might make it hard to attract the $1.2bn a day needed to cover the gap. The US stockmarket remains flat, and despite falls since the hi-tech bubble burst, there are still concerns that shares remain overvalued. Worries about the true profitability position of companies post-Enron will deter overseas companies who might wish to buy up firms in the US, as well as portfolio investment. Finally, if worries mount over a possible dramatic fall in the dollar, investors with dollar denominated assets – and foreign ownership of 25-30% of US assets indicates rather a large exposure - could sell and repatriate their money because of concerns that a large currency swing could wipe out much of their investment.

Chart 4.1



The economic impact for the Euro area

There are two obvious channels through which a rapid recovery in the euro would have an impact on the eurozone economy.

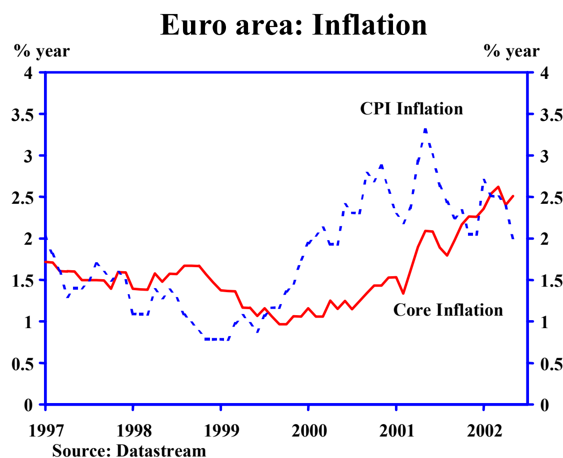
- An appreciation could hinder the Euro area's tentative export-led recovery. Net exports contributed 0.6 percentage points to GDP growth in 2001 and a similar contribution is expected again this year.

With domestic demand still fragile, a rapid rise in the euro could postpone robust recovery.

- But a stronger currency would undoubtedly be welcomed by the ECB. The weakness of the Euro over the past three years has pushed up import prices, with the largest impact in the more open economies like the Netherlands and Ireland. Although Euro weakness is not the only explanation for the rise in core inflation since 1999, it clearly hasn't helped.

While the first of these points suggests a dampening effect on growth, the second indicates that the ECB could have room to cut interest rates as the rise in the exchange rate puts downward pressure on import prices. But there is some doubt about how aggressive the ECB would be in these circumstances. They may prefer to wait and see if inflation actually comes down, given the stubborn recent performance shown in Chart 4.2. And the asymmetric nature of their target means that they probably won't be concerned about the rate dropping well below 2%, as this is entirely consistent with the inflation-targeting framework that they operate under. This is in contrast to the objectives in the UK, where the Monetary Policy Committee is mandated to be equally concerned about inflation undershooting its target as it is about overshooting.

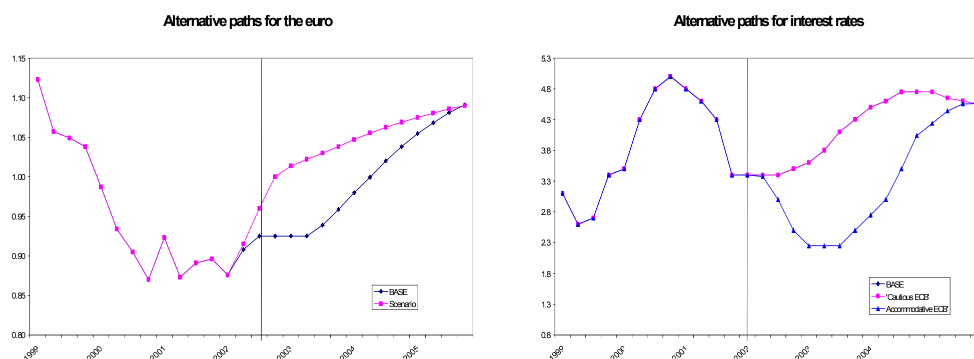
Chart 4.2



Simulation results

Our scenario assumes that the $/€ exchange rate hits parity in 2002Q3, rather than during 2004, as in our central forecast. It then appreciates fairly quickly to $1.10, our estimate of equilibrium. In the first variant – "cautious ECB", where the results are shown in Table 1, the central bank makes no policy moves beyond the modest increases pencilled in for the base forecast. This is an extreme assumption, but the bank may wish to see the impact of the higher Euro on prices; this will not be instantaneous. In the second variant – "accommodative ECB", with results shown in Table 2, the bank slashes interest rates aggressively in anticipation of the pressure on prices that is in the pipeline. Chart 4.3 illustrates the exchange rate path and policy responses.

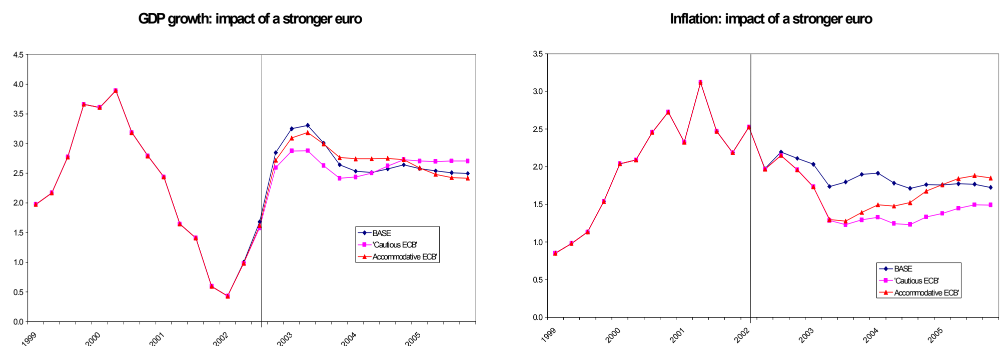
Chart 4.3



Because the impact of an exchange rate shock is not instant, the model shows that the main impact on growth would be next year rather than this. And for similar reasons, even when the ECB does anticipate the likely implications of the devaluation and reacts before it sees the impact, monetary policy operates with such a lag that there would be little that could be done to prevent inflation falling well below the 2% target ceiling. Without cuts in interest rates, worsening net trade would knock 0.4 percentage points off growth next year, but an aggressive easing could almost entirely offset the impact by stimulating domestic demand instead. The results in Table 2 show consumers expenditure benefiting from the easier monetary policy, while investment also holds up slightly better. In both variants, it is industry that suffers most, reflecting the loss of competitiveness.

Unsurprisingly, and as Chart4.4 shows, if the ECB cuts rates, inflation is higher than would be the case if they take no action, but is still below target. The model suggests that in the absence of ECB action, inflation would stay persistently below baseline values. But this would help restore competitiveness after the appreciation and consequently growth would return back to baseline values fairly quickly. GDP growth is slightly above base in 2005 in this scenario.

Chart 4.4



Conclusions

Without a reaction from the ECB, the model suggests that a rapid rise in the euro could knock 0.4 percentage points off growth next year and regardless of policy response, the model suggests such a shock would bring much needed downward pressure on prices. By aggressively accommodating the rise in the currency, the bank could offset most of the adverse effects from the trade side by crowding in more domestic demand. It seems unlikely that the ECB would react as aggressively as outlined here; given the experience of the last few years, they would want to see the impact of the stronger Euro on prices before easing substantially. Consequently, these two scenarios probably define the range of possible outcomes in these circumstances. Finally, there is another risk, although the probabilities attached to it are small. The fall in dollar could coincide with a retrenchment by US consumers, worried about the financial imbalances outlined in Chapter 1. In these circumstances, the shock could be transmitted to the Eurozone economy both through

lower domestic demand, and via an adverse impact on confidence and the effects would be substantially larger than outlined here.

Table 1: Cautious ECB

(Differences from base)

	GDP(a)	Consumers' expenditure(a)	Investment(a)	Industrial Production(a)	Unemploy-ment(b)	Earnings(a)	Consumer prices(a)	Interest Rate(c)	Exchange rate ($/€)(a)
2002	-0.1	0.0	-0.1	-0.2	39	0.0	-0.1	0.0	4.3
2003	-0.5	0.0	-0.5	-0.8	180	-0.4	-0.6	0.0	11.0
2004	-0.5	0.0	-0.7	-0.9	198	-0.9	-1.2	0.0	7.3
2005	-0.4	0.1	-0.6	-0.7	109	-1.3	-1.6	0.0	2.1

(a) percentage difference, (b) thousands, (c) percentage points

Table 2: Accommodative ECB

(Differences from base)

	GDP(a)	Consumers' expenditure(a)	Investment(a)	Industrial Production(a)	Unemploy-ment(b)	Earnings(a)	Consumer prices(a)	Interest Rate(c)	Exchange rate ($/€)(a)
2002	-0.1	0.0	0.0	-0.1	30.2	0.0	-0.1	-0.2	4.3
2003	-0.2	0.2	-0.1	-0.5	87.2	-0.3	-0.6	-1.1	11.0
2004	-0.2	0.3	-0.1	-0.4	39.5	-0.6	-1.1	-0.9	7.3
2005	-0.1	0.4	0.0	-0.3	-26.7	-0.8	-1.2	-0.5	2.1

(a) percentage difference, (b) thousands, (c) percentage points

2. The effects of the Argentinian crisis on the Spanish economy

(UAM-Ceprede, Spain)

Introduction

By the end of 1989 the Argentine economy was suffering a severe crisis: hyperinflation (with monthly price increases of 200%), unemployment, and public protests. Policies were adopted for stabilisation and the parity peso-dollar was fixed. The success of these measures was immediate. Argentina regained international confidence and the average GDP growth rate reached 7.7% between 1991 and 1994.

By 1995 the *tequila* effect in Mexico helped to identify the main weakness of the new Argentinian growth model. With a low savings rate, the country depended on foreign investment and, in particular, on short-term capital inflows that could easily be reversed. Thus in 1995, in a few weeks, bank deposits decreased by some 20% and reserves by 30%. The immediate recession lead to a decrease of production of some 15% in the last two quarters of that year. But the IMF brought a 12 billion dollars package to support the Convertibility Plan, and at the end of 1999 the situation was again under control and the financial markets closed the year with high expectations.

This 1993 crisis was an early warning for more recent events. During 1999, Argentina moved into recession, and slowly started to loose international confidence again. In July 2001, bank deposits decreased by 5.4 billion dollars, but the Director General of the IMF, was praising the Convertibility Plan on August 3, 2001. However, it was impossible to push the IMF into a rescue package, which this time would have been of the order of 40 billion dollars.

By the end of 2001, the peso could not be linked to the dollar any longer; financial markets fell, and the economy moved into a depression, with dramatic consequences: massive unemployment, loss of monetary

confidence, with many organizations issuing new currencies, freezing of bank deposits, bankruptcies.

The Argentinian crisis is probably the best example of a complete collapse of a modern economic system.

The current forecasts

In a depression it is almost impossible to forecast future developments. In general the figures that are announced are more an indication of hope, than a result of economic analysis.

GDP growth rates (% annual)	2002	2003
IMF (April 2002)	-10/15	0/3.0
Dresdner (April 2002)	-8.0	2.0
LINK (April 2002)	-10.0	1.0

All these projections assume some support from the IMF, and a situation that improves in the second half of 2002, but without signs of any strong recovery (different from what was observed in Korea after the 1998 crisis when the growth rate jumped from –6.7% to 10.9%, and more in line with the example of Indonesia, when the observed move was from –13.1% to +0.8%).

The key strategic element, that has greatly influenced the behaviour of the IMF, is found in the robustness of the Brasilian economy, which is expected to continue growing both in 2002 (2.0%-2.5%) and in 2003 (3.0%-3.5%). There has been no Latin American epidemiological process in this financial crisis, and the weight of Argentina on world GDP is rather small. The lack of contagion makes the IMF less eager to react.

Impacts on Spain and the Euro area

Argentina and Latin America have attracted European investment in recent years, specially from Spain. Consequently there has been some

concern about possible impacts of the Argentinian crisis, starting as a specific shock in Spain.

There are three possible lines of impact of the crisis on Spain:

- the trade effect;
- the capital income effect;
- the wealth effect;
- exports to Argentina have decreased but the overall trade balance is not much affected.

As for trade, Spain's exports to Argentina only represent 1% of total exports.

Turning to the capital income effect, we can observe an average decrease of the average returns of Spanish assets abroad from 9% in the first quarter of 2001, to 7% in the first quarter of 2002. These returns were increasing at a rate of 50% in early 2001, and this rate has decreased and even become negative (-6.0%) in February 2002. But this evolution cannot only be caused by the Argentinian crisis, as it mirrors other similar international developments.

The wealth effect can be proxied by the stock exchange index; since the beginning of 2002 up to the present (20.05.02), the IBEX has declined by 5.3% but Frankfurt, Milan and Paris have registered smaller declines between 3.5% and 4.9%.

Since 1999, Spanish FDI flows towards Argentina have been very low, and a reorientation has taken place towards Europe, thus decreasing the relative overall exposure.

However the large Spanish banks and some basic energy industries, are still heavily involved in Argentina, and they are directly affected by the

decline of revenues and market values and this should slow down their investment in Europe.

The direct effects of the Argentinian crisis on the Spanish economy are almost negligible and have been estimated at less than 0.1% of GDP. There is no real structural dependence. However, the indirect effect, in terms of more cautious investment strategies, is one of the factors that explain why the growth rate of gross capital formation in Spain is expected to remain at the 2.0-2.5% level in 2002, and why the recovery will be slightly delayed in relation to the rest of the euro area.

3. The Belgian business cycle as a leading indicator for the euro area

(BFP, Belgium)

In this special topic we analyse the oft-cited 'leading character' of the Belgian business cycle vis-à-vis the euro area cycle. First, we check whether empirical evidence can be found for this theory and if so, whether a reason for this characteristic of the Belgian economy can be found. In the second part, the relevance of a Belgian business cycle indicator for the euro area economy will be assessed. Finally, the implications of the recently observed turning point in this indicator will be discussed.

To compare the business cycles of the euro area and Belgium, seasonal and incidental factors and trend[1] have been eliminated from GDP and the main elements[2] of final demand. The remaining component, the cycle, can be interpreted in the same way as an output gap[3]. For example, when the cyclical component of exports has a value of –1, this means that exports are 1% below their trend value at that moment.

Timing of the Belgian business cycle vis-à-vis the euro area

The Belgian business cycle is often considered as a leading indicator for the euro area. It is claimed that Belgian exports consist mainly of intermediate goods, while final goods are more prevalent in euro area exports. Since intermediate goods are influenced by business cycle movements earlier in the cycle than final goods, the nature of Belgian exports could explain the leading nature of the Belgian economy.

---

[1] Seasonal and incidental factors were eliminated with Census X11, while the Hodrick-Prescott filter was used to calculate the trend. The method used to calculate the cyclical component is very similar to that used in Lebrun I., 1999, "Le système d'indicateurs avancés du BfP. Un nouvel outil pour l'analyse conjoncturelle", *Working Paper 2-99*, Federal Planning Bureau, June

[2] Note that 'element' is used to refer to the different uses of goods and services, such as consumption, investment and exports, while we use 'component' to talk about the trend, the cycle, the seasonal and the irregular component of a variable.

[3] Note that quarterly national accounts were used for those calculations.

To check whether those claims can be supported by empirical evidence, we first calculate correlations between the GDP cycles of the euro area and Belgium for different leads and lags. First of all, the high contemporaneous correlation between the euro area and the Belgian business cycle should be noted. This correlation is higher than the one between the euro area and the German cycle[4] for example, despite the much higher share in euroland GDP of Germany. Although this high correlation in the past does not guarantee the same behaviour in the future, it does illustrate an interesting feature of the Belgian economy with regards to the cyclical behaviour of the euro area economy.

Table 4.3 - Correlation between the cyclical components in the euro area and Belgium

	-3	**-2**	**-1**	**0**	**1**	**2**	**3**
GDP	0.66	0.81	0.91	0.93	0.88	0.77	0.62
Private consumption	0.51	0.67	0.76	0.77	0.73	0.65	0.56
Gross fixed capital formation	0.71	0.77	0.78	0.75	0.70	0.58	0.40
Exports	0.24	0.60	0.83	0.90	0.81	0.57	0.22

Note: A negative sign in the first row indicates the possibility the Belgian cycle lags the euro area cycle is being checked, ie corr(EURt,BELt-x) is calculated where EURt represents the euro area cycle at time t and BELt-x represents the Belgian cycle at t-x. The opposite goes for a positive sign.

Source: own calculations on the basis of Eurostat and INA (Institute of National Accounts, Belgium) data

As is clear from table 4.1, correlations for all variables decline at a slower pace when we move from column ‘0’ to the left side, than when we move from column ‘0’ to the right side of the table. This can be considered as a first indication that Belgium at least is not lagging vis-à-vis the euro area business cycle. The fact that the correlation profile is more or less the

[4] The figures can be found in Dobbelaere L., Hertveldt B. and I. Lebrun, 2002, “De Belgische conjunctuurcycli vroeger, nu en straks: alles komt terug…”, Maandschrift economie, jaargang 66, nr. 1, pp. 6-29

same for the main elements of final demand does not support the claim that this behaviour can be linked exclusively to a difference in the structure of exports.

Drawing conclusions from correlation profiles alone would be dangerous. First, correlations depend on the whole cycle while it is more important to focus on turning points to determine whether a certain variable is leading another one. Second, it is difficult to assess by how many quarters Belgium could lead the euro area cycle on the basis of the above correlations, and neither do they allow us to test the statistical significance of the lead. To get an answer to these problems, the so-called 'randomisation test for matched pairs'[5] was carried out for GDP and export cycles for Belgium and the euro area. To use this test, it is necessary to determine the turning points of the cycles that are compared. This was done by taking the peaks and the troughs of the cyclical components.

Table 4.4 – Lead profile of Belgian GDP and exports

Confidence level to reject the null hypothesis (the lead of Belgium is not more than x quarters)	**0**	**1**
GDP	96.9	12.5
Exports	55.6	0.0

Source: own calculations on the basis of Eurostat and INA (Institute of National Accounts, Belgium) data

As is clear from table 4.4, the hypothesis that the Belgian business cycle does not lead that of the euro area can be rejected with a confidence level of 96.9%, while the hypothesis that this lead is more than one quarter is not very likely (it can only be accepted with a certainty of 12.5%). Those statistics lead to the conclusion that a turning point in the euro area cycle

---

[5] More information about this test can be found in Banerji A., 1999, "The lead profile and other non-parametric tools to evaluate survey series as leading indicators", presented at the 24th CIRET Conference, Wellington, New Zealand, URL: http://www.businesscycle.com/pdfs/lead_profiles.pdf

generally occurs one quarter after a turning point has been observed in the Belgian business cycle. Once again, the test does not confirm that this phenomenon can be explained by the differences in export structure between Belgium and the euro area. A possible explanation could be that the Belgian final demand cycle leads that of the euro area because domestic demand in Belgium is more sensitive to exports as compared with the euro area as a whole.

Business cycle indicators

Since the correlation between the business cycles of Belgium and the euro area is quite high and because turning points in the Belgian cycle generally occur one quarter ahead of those in the euro area cycle, the Belgian business cycle can be considered as a leading indicator for the euro area economy. In view of these properties, the evolution of the business cycle indicator of the National Bank of Belgium (NBB) could be very interesting from a euro area perspective because data for this indicator are available more quickly. This indicator is based on a business survey in which respondents are asked to assess the current economic situation and to forecast future developments. The general synthetic indicator, which is published monthly, is a weighted mean of the indicators of the manufacturing industry, the building industry and trade.

Just like most qualitative indicators, the NBB indicator performs very well when it comes to predicting turning points, but the amplitudes of the business cycles and the indicator are generally quite different. For the remainder of this special topic, we concentrate on normalised cyclical components of each variable to eliminate those differences in amplitude.

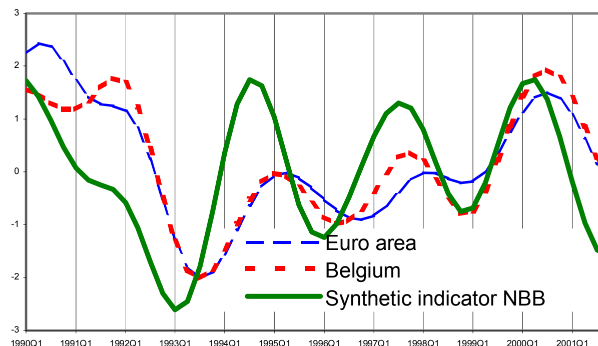
Current business cycle movements

An inspection of graph 4.5 confirms that the euro area business cycle lags the Belgian cycle. It also seems that the business cycle indicator of the NBB leads the Belgian business cycle. This is confirmed by the randomisation test for matched pairs that points to a lead of one quarter. Summing up those leads, it can be said that the NBB business cycle indicator leads the euro area business cycle by two quarters.

Chart 4.6 gives a more detailed picture of the most recent evolution of the cycles of interest. The quarterly forecasts for the euro area and for

Chart 4.5

Normalised cyclical components of Belgian and euroland GDP, and the NBB business cycle indicator



Source: own calculations on the basis of Eurostat, NBB and INA data

Belgium[6] is also taken into account, which allows us to assess the current cycle in the euro area. As is clear from the graph, the historically observed lead of the Belgian vis-à-vis the euro area GDP cycle is not seen during this cycle. The last peak was reached in the third quarter of 2000 in both GDP cycles. From then on world trade growth slowed heavily, GDP growth fell and a downward movement in the business cycle started which gained momentum from the first quarter of 2001 on. But the indicator of the NBB, which reached its peak one quarter ahead of the GDP cycles, correctly anticipated those developments.

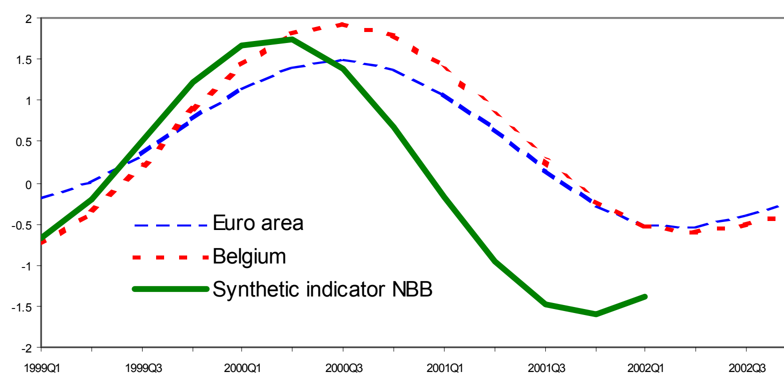
According to Euren forecasts, GDP growth should progressively improve from the first quarter of 2002 onwards, driven by rising export growth and restocking, which should be followed by a pick up of investment. This improvement in q-o-q GDP growth rates does not immediately lead to an upward phase in the cyclical component of GDP because the latter only starts to increase when q-o-q growth rates exceed trend growth. As a consequence, the GDP cycle should reach its trough in the second quarter of 2002 both in Belgium and the euro area. Driven by improved

---

[6] The quarterly forecasts for the euro zone were made by Euren, while the Belgian forecasts are those of the Federal Planning Bureau. They were finalised in May 2002 and February 2002 respectively.

Chart 4.6

Normalised cyclical components: the last cycle and a glimpse at the future



Source: own calculations on the basis of Eurostat, NBB and INA data

expectations, the NBB business cycle indicator bottomed out two quarters earlier. In this respect, EUREN forecasts are compatible with past observations.

4. The stability and growth pact: open issues

(CSC, Italy)

Origin of the Pact

On January 1, 1999, with the start of the third and final phase of the European Monetary Union (EMU), the task of handling monetary policy was given to the ECB with the primary aim of maintaining price stability. The situation at the outset demanded an effort by all member countries, though with different intensities, to readjust their public finances, an essential condition to sustainable, non-inflationary growth with high employment levels. In moving towards the medium-term target of a balanced budget or surplus, it was important for member states, especially during economic turndowns, to limit (or even avoid) the use of counter-cyclical budget policies, so as not to incur excessive deficits. Article 104[7] of the Treaty on European Union states that a nation's deficit to GDP ratio may not exceed 3%[8]. The Treaty also calls for a monitoring process and the ability to sanction member states that exceed the 3% limit. The process and the ability for sanctions provided for in the Treaty only guaranteed monitoring on budgetary discipline for admission to the EMU. The Stability and Growth Pact (SGP) was adopted (in 1997, Treaty of Amsterdam)[9] precisely to strengthen monitoring and budgetary discipline,

---

[7] formerly Art. 104C of the Maastricht Treaty (1992)

[8] Art. 104 (subsection C): "The ratio between budget deficit, predicted or real, and GDP at market prices cannot exceed 3%, unless: - the ratio has declined substantially and continuously, and has reached levels near that of the ceiling; - or alternatively, exceeding the ceiling is an exceptional, temporary situation and the ratio remains near the ceiling.

[9] Legally it is made up of 3 parts: a Council Resolution, in which member states agree to respect the target, set in their Stability Programs, of a balanced budget or surplus in the medium-term, and 2 Council Regulations: one preventive (strengthen monitoring on balance positions and economic policies), the other dissuasive (regarding acceleration and

and to accelerate and to specify procedure when faced with excessive deficits in the third EMU phase. The SGP obliges Euro area states to present a Stability Program[10], to be updated annually, which specifies medium-term budget goals and an adjustment path designed to bring budget balances into line. The ultimate goal is to have all member countries (participating in EMU) operating in a nearly balanced or surplus position, so automatic stabilizers can work freely. Countries are committed to take all necessary action to achieve the targets laid out in the programs. The Commission and Ecofin examine the Stability Programs and monitor member states' performance in relation to their medium-term goals and adjustment paths. When the risk arises that one of the member states will show an excessive deficit, the Council is obligated to make a recommendation to the country in question (ie an *early warning*[11]).

---

clarification of how procedures for excessive deficits are to be implemented).

[10] Each year, member states present a three-year stability program to the Council. Said programs set values for individual years starting in 1999 (short-term), defined as government aims in the path towards a balanced budget by 2003-2004. The programs also list the main predictions on the economy's performance and a sensitivity analysis on the deficit and debt situation, as well as a list of the actions taken to achieve their goals. As part of the monitoring process, member states not participating in the Euro area must present convergence programs, containing similar information to that provided in the stability programs.

[11] Article 6, Regulation 1466 (1997), subsection 2 and 3: "Should the Council identify an appreciable deviation in the budget position from the medium-term goal or from the adjustment path towards that goal, the Council will, for the purpose of preventing an excessive deficit, make a recommendation to the member state in question, as per Article 103, paragraph 4, that it adopt the necessary budget adjustment measures"; "Should the Council, in performing subsequent monitoring, deem that the deviation in the budget position from the medium-term goal or from the adjustment path towards said goal continues or has worsened, the Council will make a recommendation to the member state in question, as per Article 103, paragraph 4, that it promptly adopt corrective measures,

As is explicitly stated by Regulation 1466, the Council, "in examining and monitoring stability programs and convergence programs, in particular their medium-term budget goal or their adjustment path towards said goal, must take into account the pertinent structural cyclical characteristics of each member state's economy". In this perspective, and with the intention of clarifying the definition of structural deficit, in view of its possible official use, ECOFIN stated in late 2001 that as of 2003, in assessing how well a nation respects its budget goals, it would take the structural deficit into greater consideration. The basic problem, though, is that there has been no agreement on the assessment methods to use to calculate structural budget balances; and depending on which method is used, results are often very different.

Possible advantages to budget restrictions

One reason to restrict the indiscriminate use of budgetary policy is the uncertainty of its impact on the real economy: even supposing that the goals pursued by economic policy makers are appropriate, their intervention could actually worsen the situation at the outset. For instance, using budget deficits in a recessionary phase could have negative effects on financial markets and interest rates, thereby hindering recovery. In addition, reaction times for the economy are hard to predict and, considering how slow the legislative process can be, governments run the risk of intervening in the economy later than originally intended. These are factors that would suggest very cautious, well-targeted use of corrective measures, which in any case should not be used for *fine tuning*.

Another issue is the *time inconsistency* of any announced policy. Policy-makers could be induced to change budget strategies in the course of their application in order to improve short-term results. The subsequent reaction by economic agents, which would not only adapt to the new policies, but also learn to anticipate possible unannounced moves by the government, would lead to medium-term situations that are generally worse than those that would have been obtained had the announced goals been pursued. How, then, can one become credible? In this case,

---

and the Council may, as per the aforementioned article, make said recommendation public".

too, one can spontaneously renounce one's power of action, or else set simple rules that do not permit deviation from the announced policy path.
The idea of voluntary or self-restriction by policy-makers requires that governments be very strong and, above all, independent from political pressures, but often this is not easy to achieve. One example would be during the electoral period (political economic cycle), when politicians tend to promise and implement policies to boost aggregate demand, pursuing primarily short-term goals (for instance, tax cuts not balanced by corresponding cuts in public spending, which gives rise to systematic deficits). Another delicate period is the transition to a new government, when there is a lack of continuity between those who have made commitments and those who have to fulfil them. Furthermore, supranational rules and pressure from other states can spur individual governments to proceed with structural reforms, such as the pension system, which otherwise would not be undertaken because they are politically costly and complicated to outline. For these reasons, it is clear that the alternative of imposing budget restrictions offers practical, concrete advantages.

One problem, however, is the fact that there is no perfect way to impose such budget restrictions. SGP restrictions only concern deficit levels, and leave governments free to decide how to achieve their goals: whether through increased taxes or cuts in spending. Despite that, figures for the Euro area from 1997 to 2001 show that, whereas tax revenue as a percentage of GDP declined, though by only 0.3%, public spending fell by some 1.4%[12]. But the rules imposed by the SGP seem to have been less effective in countries with high debt levels. For example, the reduction in spending as percentage of GDP in Italy and Belgium (the two member states with the highest debt in the euro area) almost entirely reflects reduced interest rates. And in addition, spending cuts have typically affected items under investment expenditures, rather than items under public consumption[13].

---

[12] Economic Forecasts, April (2001) and April (2002), European Economy

[13] Despite the potentially negative effects, imposing rules designed to achieve balance goals net of investment expenses does not seem a

Another problem is that the SGP demands the same deficit ceiling for every country. To its credit the rule is simple. But it is not always justified. There are also those who have suggested linking the ceiling to the state of the economy (ie a *contingent rule*); in this case one would face the same methodological problems as those presented when calculating structural balances.

Finally, there are those who state that it is primarily the debt stock level that pushes member states to pressure the ECB to lower interest rates: a small rate reduction, in fact, can make large differences in highly indebted countries' balances. This would mean reformulating goals in terms of the debt-to-GDP ratio, something that would reward prudent policies, while also leaving room for temporary deficit increases in cases of exceptionally problematic economic conditions. Alternatively, these indicators could be combined with deficit indicators[14].

Empirical evidence

The difficulty in making an empirical evaluation of the SGP is that it is the first time a group of sovereign nations has adopted common budgetary policies and worked out a multilateral monitoring mechanism. As there are no historical precedents the only reference point is the United States, though it has a completely different set of regulations to the SGP. First, the rules are not supranational, as they are enacted by individual states (except for Vermont) and require a balanced budget (in very different forms from state to state, though without any sort of enforcement mechanism). The empirical evidence shows that budget regulations are more effective as they are more binding: in other words, deficits tend to be lower and reactions to negative shocks faster, the more binding are budgetary restraints[15]. Poterba has calculated that a dollar of deficit

---

practical solution. Indeed, many spending items are hard to classify and could be entered in the end as investment expenditures.

[14] B.Canzonieri and B.T. Diba, 2001, *The SGP: Delicate Balance or Albatross?* in The Stability and Growth Pact, The architecture of fiscal policy in EMU, by Brunila, A., Buti M. and Franco D., Palgrave.

[15] See J.M. Poterba, 1996, Budget Institution and Fiscal Policy in the US States, American Economic Review, Papers and Proceedings, vol. 86, 395-400

entails a 17-cent reduction in spending for states with less binding restraints, whereas it entails a 44-cent cut for states whose rules are stricter.

One lesson that can be taken from the American experience is that, if budgetary restraints in some way limit that possibility of enacting anti-cyclical policies, this reduced budget flexibility has practically no effect on GDP “variability”. A possible explanation is that budgetary restraints not only restrict the positive effects of anti-cyclical policies, they also limit the effects of budgetary policies enacted to pursue purely political aims that could have destabilising effects on GDP. This would be a good reason to impose similar rules in Europe as well.

The comparison with the United States cannot be taken too far though, because European states, unlike the American states, have greater taxation powers and, given their debt stock, have also developed greater access to financial markets. Having these means at their disposal, they are much less hesitant than the American states to incur budget deficits.

Policy implications

Once a balanced budget situation has been achieved, leaving the automatic stabilisers to operate freely significantly reduces the risk that states in the monetary union will exceed the 3% ceiling during an economic slowdown. However, the transition from a deficit situation to a balanced budget (or surplus) is proving to be longer and much more difficult than was thought at the time the SGP was formulated. The problems are further accentuated by the fact that it is precisely the largest European economies – Germany, France and Italy – that find themselves in this situation. In the Communication accompanying the Annual Report on public finances (Public Finances in EMU 2002), the EU Commission renewed its request to France, Italy, Germany and Portugal to respect their programmes; the Commission is against any deferment of medium-term commitments. The Commission also reiterated that every tax cut must be accompanied by adequate reductions in spending, without counting on automatic effects from expected growth, as tax cuts are rarely self-financing. The clear message that the markets must receive here is that member states will effectively be called to answer for their medium-term as well as short-term results. The idea of adding other parameters to

the SGP currently appears less practical and, in any case, would not have any other effect than to tolerate higher deficit levels in the transition phase.

Overall, the Commission's assessment of the SGP's effectiveness remains positive: even during the recent economic slowdown, the SGP seems to have worked effectively. This economic turndown was not particularly serious or prolonged, however, so more severe recession in the future may be a better test of the pact's resilience. In particular, in the future the pension system financing could create additional serious budget problems, unless appropriate structural reforms are made.