The Economic Outlook in Europe in 2003-2004

Summer Report

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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 third 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. Copies of the report can be downloaded from each Institute's web site.

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Content

Chapter 1

EXECUTIVE SUMMARY

Some uncertainty has lifted…

Although the fall of Baghdad removed one major source of uncertainty for the world economy, recovery is not guaranteed. But there are some positive signs: equity prices have rebounded 23% in the US, 25% in the UK and 40% in Germany from the pre-war lows, while improvements in US consumer confidence have been sustained. And even though oil prices briefly crept over $27 pb in the last month, they are well below Q1 levels, and have now fallen back - US inventories are rising and immediate cuts to OPEC production quotas are ruled out. Meanwhile, the impact of SARS seems to be receding, with decisive progress in both Hong Kong and Singapore, and a sharp fall in the number of new cases in China.

…but no green shoots yet

But neither the containment of SARS or indeed the end of the war is a "cure-all" for the global economy. World GDP growth has been below potential since the start of 2001, a state of affairs set to persist until the middle of next year. Our forecast shows the US leading the way yet again in 2003H2, reflecting the boost consumers are now getting from tax cuts, together with a modest recovery in business investment.

Rise in the Euro makes life difficult for exporters…

Since the start of the year the massive US current account deficit has come into sharp focus, and it is this, rather than relative growth rates, that now seems to be determining the path of the dollar. While this will help US exporters, it's not so good for their Eurozone counterparts. The bulk of the exchange rate adjustment has fallen on the Eurozone and Canada. While the dollar has fallen around 11% against the Euro since January 1 and around 18% against the Canadian $, the fall in the US's effective trade-weighted index has only been around 6%. The main reason for the disparity is determination of authorities in emerging Asia to resist appreciation in their currencies. Asian countries recycling their export receipts back into US assets provide a large proportion of the capital flows required to sustain the US current account deficit. This keeps their currencies ultra-competitive.

The swing in the Euro since our last forecast is one of the major changes in the inputs to the forecast. As a result, net trade is no longer supportive of economic growth. This was true in the published data for Q1 and is the situation in our forecast for this year on average. Clearly the region has lost competitiveness as a result of the Euro's rise, although it is important not to paint too bleak a picture. As our special article on competitiveness shows, the single currency has simply made up the ground it lost in previous years, while price factors are not the final story when it comes to competitiveness. Germany in particular remains competitive on a number of other important factors, including quality. One policy conclusion we reach is that government's must enhance productivity in manufacturing industries and promote non-price competitiveness. Practically, this means encouraging research-development activities and provided a high level of education

…but allows the ECB to act

Nevertheless, the rise in the Euro, which our forecast shows staying around 1.15 $/€ through next year, means we expect inflation in the Eurozone to fall to 1.5% next year, offering up a rare chance to rebalance growth in the world economy. The ECB's 50bp cut in interest rates in June, and we expect one more 25bp cut towards the end of summer, is a move in the right direction and supports the modest recovery in domestic demand towards the end of this year shown in our forecast. Our analysis using a global macroeconomic model shows a further rise in the Euro could threaten to snuff out any such recovery. The ECB needs to be alert and react quickly in this event.

Deflation has become a hot topic recently. With interest rates now at 2.0% in the Eurozone, 1.0% in the US and virtually zero in Japan, central banks have little ammunition left to fight this battle. Until growth picks up to normal rates, the negative gap between actual and potential output will widen, keeping downward pressure on inflation. Although producer prices are falling in many places, we don't expect deflation – by which we mean a sustained fall in prices – in the Eurozone as a whole. However, the level of ECB interest rates and the low level of inflation in Germany, which is likely to average 0.7% this year, are ringing some alarm bells. Monetary policy is tighter in Germany than in the region as a whole and with the ECB setting interest rates for the needs of the Eurozone rather than Germany, the central bank's mandate gives it no reason to act, even if it does appear Germany is slipping into deflation. Clearly is this were to happen it would be deeply damaging for the whole area; arguably the ECB should be guarding against the possibility in the big countries as well as the region at large.

Clearly, many have identified Germany as the large country most likely to follow Japan into deflation, and some of the discussion of a possible credit crunch discussed in our special study in Chapter 4 will fan these fears. However, as we point out in Chapter 3, periods of very low inflation in Germany are not uncommon, and, while the chance of negative year-on-year inflation rates is growing, we don't current believe a sustained period of falling prices is likely.

Main features of the forecast

	2002	2003	2004
World trade	2.5	4.0	7.0
Oil price ($/b)	25.0	26.9	25.0
GDP growth			
- United States	2.5	2.0	2.9
- Japan	0.1	1.0	1.3
Euro Area			
- GDP growth	0.8	0.7	1.9
- Inflation (HCPI)	2.2	1.9	1.5
- Unemployment rate (%)	8.4	8.9	9.1
UK Economy			
- GDP growth	1.8	1.9	3.0
- Inflation (HCPI)	1.3	1.1	1.4
- Unemployment rate (%)	3.1	3.1	3.2

Chapter
2

THE INTERNATIONAL OUTLOOK

A third year of below trend global growth looms…

The world economy has now suffered more than two years of below par performance, and, as yet, there is little in the current timely indicators to suggest any dramatic immediate improvement. Indeed, our forecast suggests full speed won't be reached until near the end of 2004. However, many of the problems that have held back global growth have receded in the last few months.

Table 1.1: Exogenous and international variables

percentage changes unless otherwise indicated

	2001	2002	2003	2004
World trade	-0.1	2.5	4.0	7.0
United States				
GDP	0.3	2.5	2.0	2.9
Consumer price index	2.8	1.4	2.1	1.3
3m interest rates	3.4	1.6	1.1	1.6
10y Gvt bond yield	5.0	4.6	3.8	4.6
Japan				
GDP	0.4	0.1	1.0	1.3
Consumer price index	-0.8	-0.9	-0.4	-0.6
3m interest rates	0.2	0.1	0.1	0.1
10y Gvt bond yield	1.4	1.3	0.8	1.2
US dollar/euro	0.90	0.94	1.14	1.15
Yen/US dollar	121.4	125.1	120.0	120.0
GBP/US dollar	0.69	0.67		
Oil price, US$/barrel	24.4	25.0	26.9	25.0
Percentage changes	-14.7	+2.5	7.6	-7.1

Sources: OECD, ECB, EC, EUREN forecasts for 2003 and 2004.

The difficulties encountered by the world economy over the last two years fall into three broad (but very interrelated) categories.

i) The bursting of the dotcom bubble and the collapse in investment. The realisation that the rapid build up in ICT spending was ill advised has brought about a massive retrenchment in capital spending.

ii) The collapse in equity markets. This followed the realisation that the expectations of future profits from hi-tech companies were unrealistic.

iii) Terrorism. The terrorist attacks on the US and the subsequent wars in Afghanistan and Iraq were a major shock to the world economy. The uncertainty created has hit both investment and share prices, while pushing up oil prices.

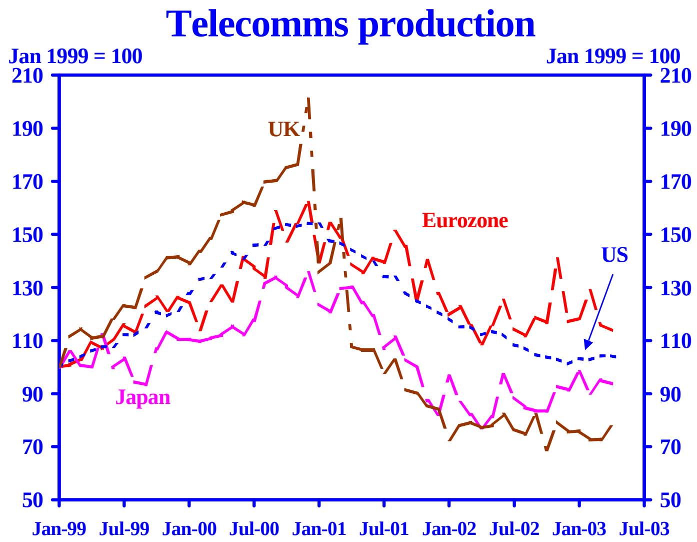
…but is business investment finally set to recover?

After the collapse in the new economy at the start of 2001, business investment slumped. From the peak in 2000, private sector non-residential capital spending has fallen by 12.7% in the US, 7.3% in Japan, 13.3% in Germany, 4.0% in France, and 10.9% in the UK. Consequently, business investment as a proportion of GDP has returned to more normal levels in most places, although the level in the US is still well above that seen in the 1980s. One of the features of the dotcom boom was the over-investment in extra capacity that was never needed. Not only did this put downward pressure on prices, harming profitability, it meant firms had no need to acquire extra capital to meet demand. Most measures of capacity utilisation suggest this is still not a constraint.

However, as much of the capital spending in the boom years was of questionable quality, the usefulness of the capital equipment it provided is also doubtful: measures of capacity utilisation may overstate the current degree of slack. With the major economies more dependent on hi-tech equipment than ever, the equipment bought five years ago may no longer be appropriate; “making-do” with old technology is not a strategy that can work into the medium term – to remain competitive, firms eventually need to upgrade their capital equipment.

And there have already been some signs of life in business investment. There was modest growth in 2003Q1 in the UK and France, while spending increased in the US at the end of last year before the uncertainty surrounding the situation in Iraq set in. Even in the sector arguably worse hit when the dotcom bubble burst – telecomms – there have recently been signs that output has at last stabilised and in some areas is creeping up.

Chart 2.1



Source: OEF

Equity prices; a Baghdad bounce…

Share prices slumped when the dotcom bubble burst, as expectations of future profits were scaled back. Subsequently the terrorist attacks on the US, worries about the qualities of company accounts after the Enron affair and the uncertainties created by the wars in Afghanistan and Iraq have all helped drag equity prices even lower. But since Baghdad fell around two months ago, equity prices have bounced back, and with the exception of Japan, roughly half the loss has been reversed, with slightly better performance in the US and Germany (which fell further in the first place).

Despite this rebound, the falls late last year and early in 2003, mean share prices are still lower now than the average level in 2002, and so investors, while grateful for the rises seen so far, will still feel poorer than last year. But if current gains can be maintained and built upon, then the OEF macroeconomic model suggests a significant boost to GDP in the

US and UK next year, where consumers are more sensitive to changes in financial wealth.

Table 2.1: Stockmarket performance

	Peak fall from All time high	Rebound
	(%)	(%)
US – S&P500	-49	30
Japan – Nikkei	-80	16
Germany – Dax	-73	48
France CAC40	-65	32
UK FTSE All	-53	26
Source: Datastream		

…as war related uncertainty lifts

If there is to be any sustained improvement in share prices and investment, then the removal of the uncertainty created by the terrorist attacks on the US in September 2001 and the subsequent conflicts in Afghanistan and Iraq is essential. Clearly the end of the major hostilities in Iraq has helped, although with many issues still unresolved in the Middle East, and the threat of further terrorist attacks still around, it's too early to say that normal service has been resumed. However, as well as the Baghdad bounce in equities, the oil price has fallen back from the $30+ levels seen in the first quarter of 2003. This boost to the world economy needs to be kept in context though; the current level of around $26 pb is still higher than the average for 2002 as a whole, and we expect only a modest fall next year, with the price averaging $25 pb.

US to lead the way once more

All this positive news explains our forecast of gradual recovery in the world economy in the second half of this year. And we expect the US once again to lead the way, although potential won't be reached until well into next year. At the moment, despite the improvements outlined above, there is little concrete sign that recovery is just around the corner. The COE leading indicator for the US – shown in Box 2.1 below – suggests that a modest upturn is on the cards, but without any signs yet of above trend growth.

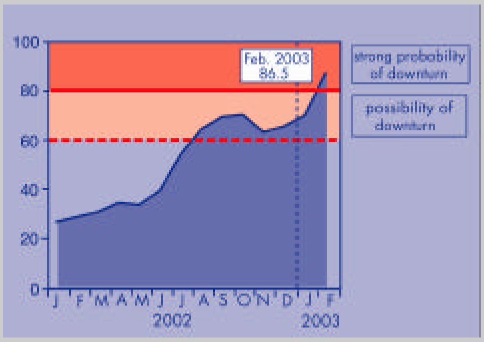
It is true that the data on the economy in May – the first that are reasonably undistorted by the uncertainties surrounding the military action in Iraq – offered some encouraging signs. Along with the equity rebound, consumer confidence rose, building on the April post-war rebound, to reach the highest level since last November.

Box 2.1: The COE leading indicators for the United States

Last February, the COE leading indicator for the United States, amidst international geopolitical turmoil, gave a signal of a downturn. In view of the special circumstances, there was obvious doubt about the persistence of that signal. Since then, the COE indicator has been used to detect the next upturn. By May 2003, it entered the range indicating the possibility of an upturn within the next 9 months. However this first signal needs to be confirmed by a pass through the –80 threshold shown in Chart B-2.1.2 before it could be accepted that there was a strong probability that the US economy will be back in its high growth regime within the next three months. If this happened, the GDP growth rate would climb over its trend growth rate estimated to be 2.5%. If this scenario materialises, the present slowdown will have proved to be temporary and just a blip in the recovery that started in December 2001.

Chart B-2.1.1

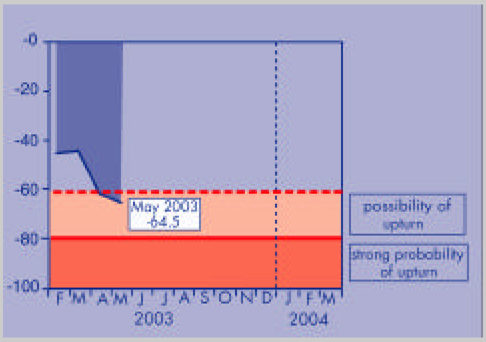
Growth cycle leading indicator:
Search for the next peak



Source: COE

Chart B-2.1.2

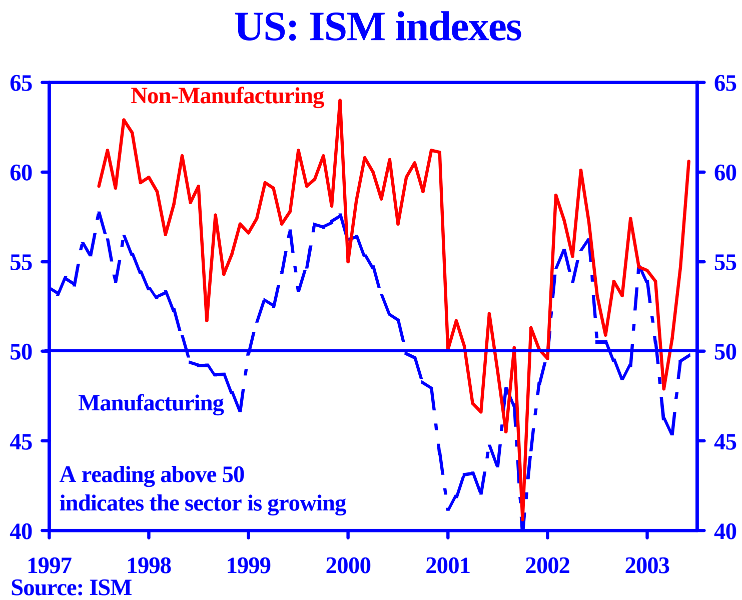
Growth cycle leading indicator:
Search for the next trough



Source: COE

In addition, the ISM indexes (the equivalent of Eurozone's Purchasing Managers' Index) for both the manufacturing and non-manufacturing sectors improved markedly in May. The manufacturing index climbed 4.0 points to 49.4, less than a point below the line separating expansion from contraction in the sector. The non-manufacturing index rose 3.8 points to 54.5, suggesting relatively strong growth. In both cases, there were considerable improvements in the sub-indexes for orders, backlogs, and even employment. Industrial production rose 0.1%, with manufacturing up 0.2%, the first gain since January. And June brought even better news as the non-manufacturing PMI surged above 60, indicating quite robust activity in the sector.

Chart 2.2



However, there has been bad news as well. Chain stores have reported modest improvements in same store sales, and while the gains are welcome, they fall short of expectations in view of the sharp increase in consumer confidence. Constrained by falling gasoline prices, retail sales managed only a 0.1% gain. And after holding steady in April, payrolls shrank by 17,000 in May as the unemployment rate edged up by a tenth to 6.1%.

The most recent readings on new orders and construction, for April, were weak. The May data for these indicators will be watched closely, to see whether the scales will tilt in favour of the stronger growth forecast for the second half of the year.

...on the back of a massive policy easing

Our relative optimism about the US reflects the massive relaxation in both monetary and fiscal policy seen over the last two years, as shown in Table 2.2 below. And there is little doubt that further measures would be taken by both the Fed (which has already explored possible unorthodox measures to counter deflation) and the government, which would be willing to cut taxes again now and worry about the deficit again later.

Table 2.2: Policy changes

	Change between 2000 and 2003		
	US	**UK**	**Eurozone**
Fiscal policy*	-5.7	-3.2	-0.6
Interest rates**	-5.5	-2.3	-2.8
Real short-term Interest rates***	-5.4	-4.6	-2.1

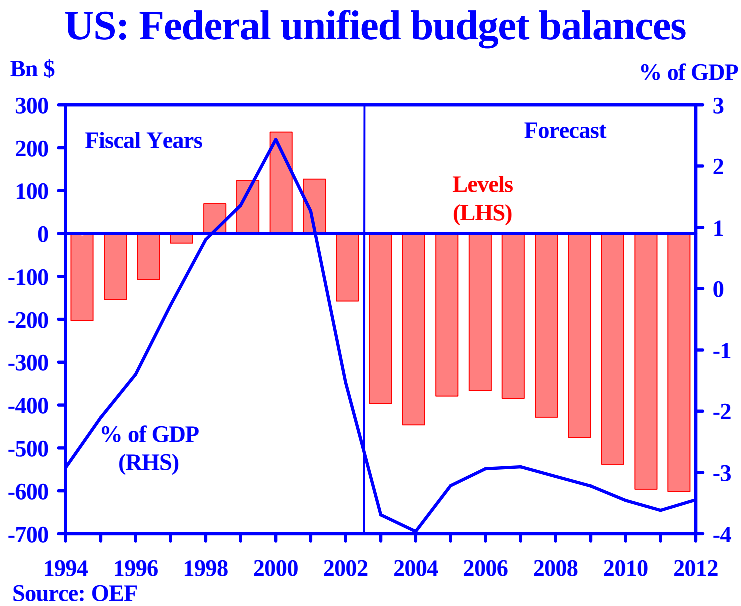
* OECD estimates of cyclically-adjusted primary budget balance
** Current level – level at end 1999
*** Deflated by EUREN estimate of CPI index one year ahead

The Jobs and Growth Tax Relief Reconciliation Act of 2003 puts more money in taxpayers' pockets no later than early July. All employers must switch to the new tax withholding schedules by July 1, so the marginal rate reductions will be felt then. In addition, since the bill included an advance payment mechanism for the expansion of the child credit, checks of up to $400 per child will be sent to about 25 million middle-income households starting in July. As a result, federal tax collections will fall sharply in 2003Q3, boosting real disposable income growth to an annual rate of about 10%.

The boost to real disposable income is expected to help push consumer spending to over 3% growth in the second half of 2003. The business tax incentives, mainly liberalization of depreciation and deductibility of equipment purchases, should also provide some boost to business fixed investment. The centrepiece of the legislation, the reduction of taxes on dividend and capital gains income will also boost disposable income, although the gain will be concentrated among wealthy taxpayers, who are less likely to spend the increase than others.

And of course monetary policy is also incredibly supportive. In recent weeks, in statements and speeches by several members of the FOMC, the Federal Reserve has indicated a strong inclination to cut rates once again. Thus, although deflation fears have ebbed somewhat and circumstances continue to favour a rebound in growth this year, the Fed implemented another quarter point cut at its meeting on June 25. The Fed has made it clear that rates will stay low for some time, so rises aren't expected now until sometime in 2004.

Chart 2.3



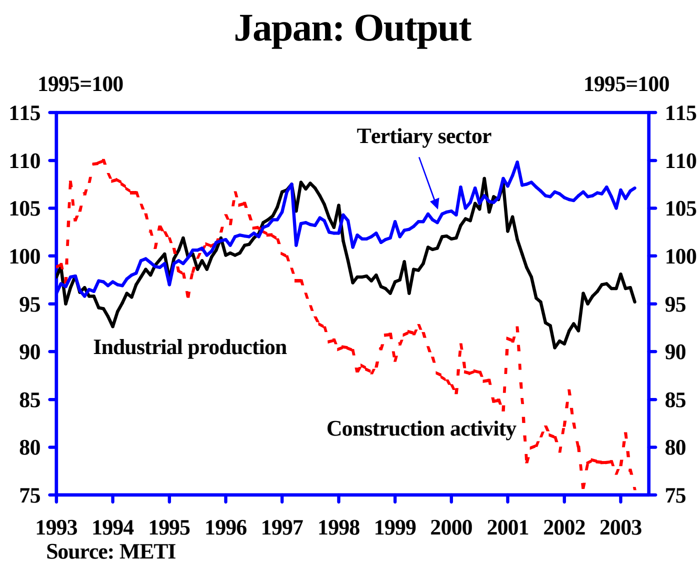
There are still risks

Clearly there are still risks to the US outlook. That massive budget deficit (shown in Chart 2.3) will have to be dealt with eventually and the personal savings ratio is still low by historic comparisons. Given this, and the fall in stockmarkets, the resilience of the US consumer has been remarkable over the last two years. However, sizeable rises in unemployment combined with concerns about levels of debt mean the possibility of a retrenchment by consumers cannot be completely ruled out. This would clearly postpone any prospective recovery in investment.

Japan continues to "muddle through"

Meanwhile in Japan, the picture is one of more "muddling through". On the basis of the official GDP data the Japanese recovery came virtually to a halt in 2003Q1, growth of just 0.1% on the quarter was the weakest performance since the same period a year earlier. Moreover there is a real danger that Q2 will actually see a contraction as both the global and domestic backgrounds remain very problematic. First, the US economy is still subdued, and yet to show any signs of the significant acceleration that many forecasters expect in 2003H2. Second, the SARS outbreak has dampened activity across China and much of Asia during Q2. And third, the government's rescue of Resona bank in mid-May once again illustrates the perilous position of the Japanese financial system. We expect GDP growth of only 1.0% for 2003 as a whole despite the fact that year-on-year growth was over 2.5% in Q1.

Chart 2.4

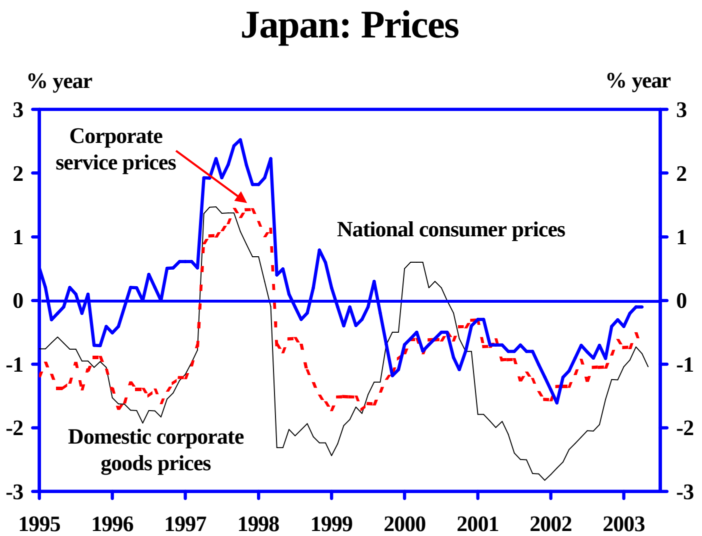


Looking at the detail of the GDP release, consumer spending continued to increase modestly, offsetting the steady falls in government investment. However, the most striking development in Q1 was the continued expansion of business investment, up 0.7% on the quarter, taking the year-on-year growth rate to 5.6%. But this trend seems unsustainable given the flat trend in exports, down 0.4% in Q1, the stronger yen and the recent turn down in profits.

Growth may be lower than reported

Another major concern raised by the latest news is the scale of deflation: down 3.3% on the year when measured in terms of the GDP deflator. This implies that though the recorded real growth rate over the last year has been quite respectable, the economy in actual money terms has continued to contract. However, while this may well be true there is a strong suspicion that the statisticians have got the split wrong between deflation and real growth. The large difference between the behaviour of the GDP deflator and that of the other price indicators (the CPI fell 0.2% year-on-year in Q1 while the domestic corporate goods price index was down 0.9%) suggest that actual deflation has probably been less severe while real growth has been more modest than reported.

Chart 2.5



Source: OEF

SARS has hit export growth

Though the latest monthly data are a fairly mixed bag, a deterioration in exports is likely over the next few months. Industrial output fell 1.5% on the month in April, with a particularly sharp fall in the general machinery sector, but shipments actually increased and inventories are at low levels. Meanwhile seasonally adjusted export volumes also moved higher in the same month, helped by the fact that the value of exports to China (in yen terms) was up 39% on a year ago (though sales to the US were down 7%). However, although the severe outbreak of SARS in

China seems to be over, it highlights a risk to the forecast. Any reoccurrence would expose Japan's dependence on exports to that country – probably for a few months at least. Other indicators suggest no forward momentum in the economy. The unemployment rate remained at 5.4% in April, while the ratio of job offers to applicants has not increased from 0.6 for several months.

Structural problems set to persist

Further to the worries about the external side of the economy, the government's injection of 2 trillion yen into Resona bank, the fifth largest in Japan, highlights once again the precarious position of the Japanese financial system. Accountants auditing the bank's end-financial year position realised that the bank's capital adequacy ratio was a dismally low 2%, compared to the minimum of 4% required for a domestic bank to operate. The government immediately intervened. However, though much of the senior management has been removed, it remains to be seen how much pressure the government will exert on the bank to dispose of existing bad loans and end lending relationships with companies that are clearly never going to repay their debts. While a much harder line with the banks is crucial to ensure that this crippling problem is eventually resolved, it will inevitably cause a wave of restructuring and job losses across the economy, as well as negative repercussions for other parts of the financial system. Until these deep structural problems in the economy are tackled, it is hard to see Japan enjoying anything more than a cyclical upturn on the back of a stronger world economy. But in our view, "muddling through" will continue for some time yet.

3

Chapter

The Outlook in Europe

Part I – Recent developments in the Euro Area economy

Economic activity

Net exports were the key driver of growth last year

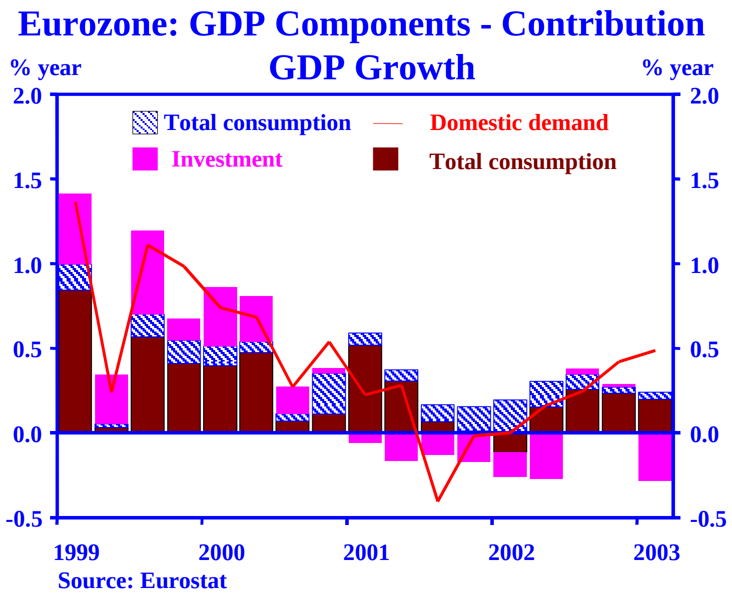
In 2002 Eurozone GDP grew by 0.8%, compared with 1.5% in 2001 and 3.5% in 2000. After recovering in the first quarter of the year the pace of economic activity slowed down. This reflected, among other things, the growing uncertainty connected to geo-political tensions and the protracted weakness of stock markets; in the fourth quarter growth was just 0.7% on an annualised basis. As in 2001, the main contribution to Eurozone growth in 2002 came from net exports, which accounted for 0.6 percentage points of the 0.8% rate. Consequently, the slowdown in economic activity was entirely down to the weakness of domestic demand as seen in Chart 3.1. Household consumption contracted in the first quarter but recovered somewhat in subsequent quarters, while gross fixed investment contracted by 2.6% after a fall of -0.6% in 2001, restrained by high levels of spare capacity and continued uncertainty; the contraction would have been even more severe if floods in Germany had boosted expenditures.

The slowdown in 2002 growth affected particularly Germany (0.2%) and Italy (0.4%), while France and Spain experienced somewhat higher rates (1.2% and 2% respectively); in the last two countries growth was mainly sustained by private consumption.

Economy standing still at the start of 2003...

In the first few months of 2003 economic activity has slowed further and first quarter GDP was actually no higher than at the end of 2002; GDP contracted in Germany, Italy, the Netherlands and Finland. The weak performance of the Eurozone in the first quarter of this year mainly reflects a drop in exports (-0.6% q/q) coinciding with the slowdown in world trade and the appreciation of the Euro against other main currencies in 2002 (when the common currency in particular appreciated by more than 15% the US dollar). There was also a sharp decrease in investment (-1.4%), negatively affected by a weak cycle as well as the high indebtedness of firms. The growth of household consumption and government consumption plus a large rise in stockbuilding only just offset the reduction in investment and foreign demand.

Chart 3.1

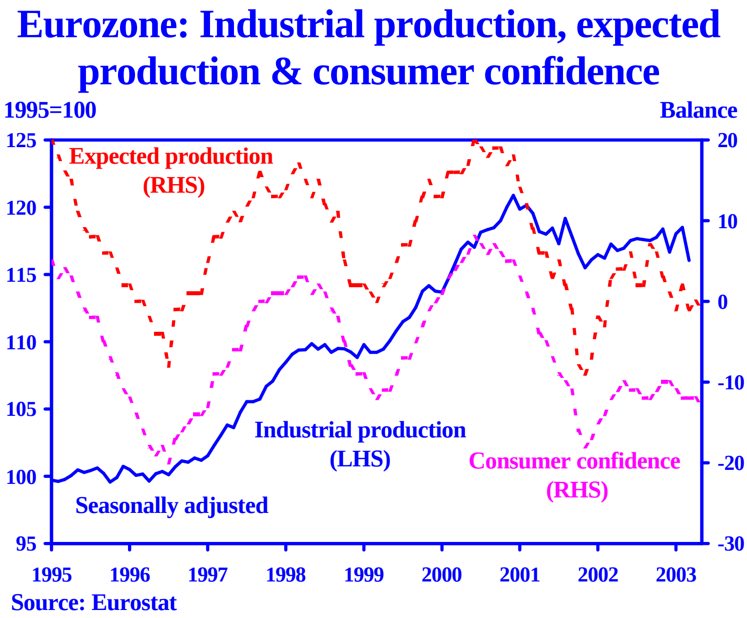


Meanwhile, industrial production saw the same stagnation as the economy as a whole in Q1, remaining virtually at the level as in 2002Q4 (see chart 3.2).

...with timely indicators suggesting no pick up yet

During the second quarter, the more timely indicators – including surveys of households' and firms' expectations – are not very encouraging; both suggest "more of the same" in the second quarter. Indeed, households' confidence is almost at the pre-recession levels of 1993 (chart 3.3). But interest rates are low, inflation is falling, with falling prices of key raw materials and the strength of the Euro, while productivity should soon start improving; the indicators of a better second half to 2003, should be apparent soon.

Chart 3.2



Investment and households' consumption

In 2003Q1 investment fell 1.4%; large amounts of spare capacity and continued pressure on profitability and access to credit have led firms to put off investment plans and concentrate on improving their balance sheets.

There are however positive signs resulting from the reduction of official interest rates, as well as from the expected development of profits. Productivity should increase as a result of firms lay off workers, easing some of the pressure on profits.

Consumers are worried about their jobs

Meanwhile, households' consumption increased by 0.3%, spending is being held back by worries about the labour market – a direct by-product of the efforts firms are making to improve their productivity. With unemployment still rising, this theme is likely to reoccur through 2003, into 2004. This uncertainty of consumers has already had an impact on propensity to save. In 2002 consumers' propensity to save increased by nearly a percentage point in the major countries of the euro area. On the contrary, the appreciation of the euro, which will contribute to keep imported inflation low, has had a positive impact on households' consumption. And one more positive effect supporting consumption at the moment is the fact the so-called “changeover” (to Euro notes and coins) has worked through; last year inflation was perceived to be much higher than official statistics revealed. The underlying assumption is that consumers will gradually get used to the new currency and slowly shed the habit of comparing it to the previous one, therefore perceived inflation will tend to coincide with actual inflation towards the end of the year (chart 3.4). Given this, prospects for private consumption are starting to improve, albeit modestly.

Chart 3.3

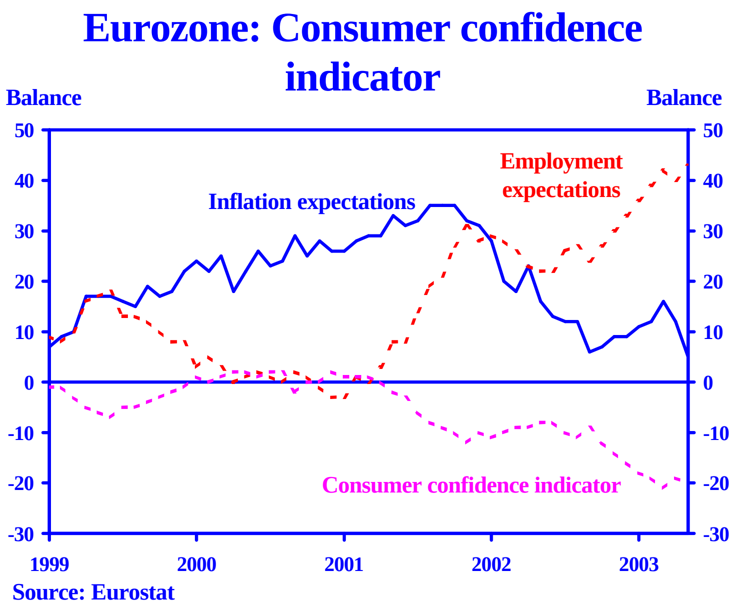
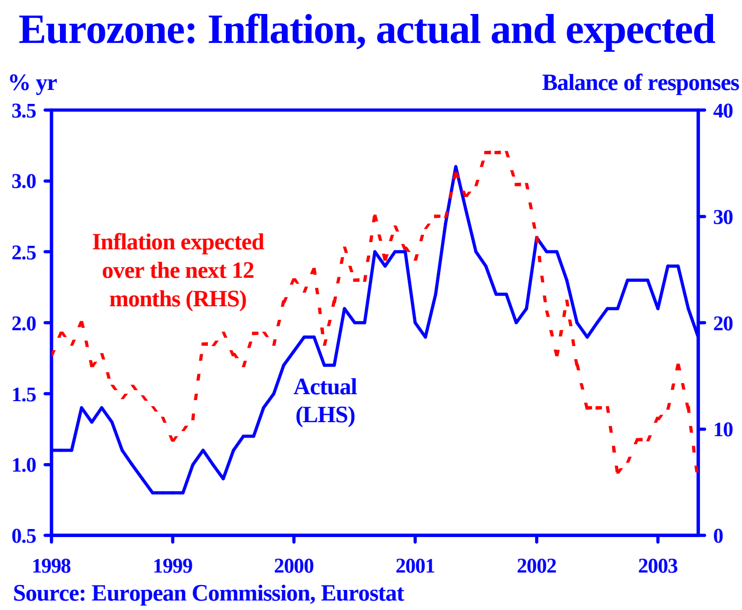


Chart 3.4

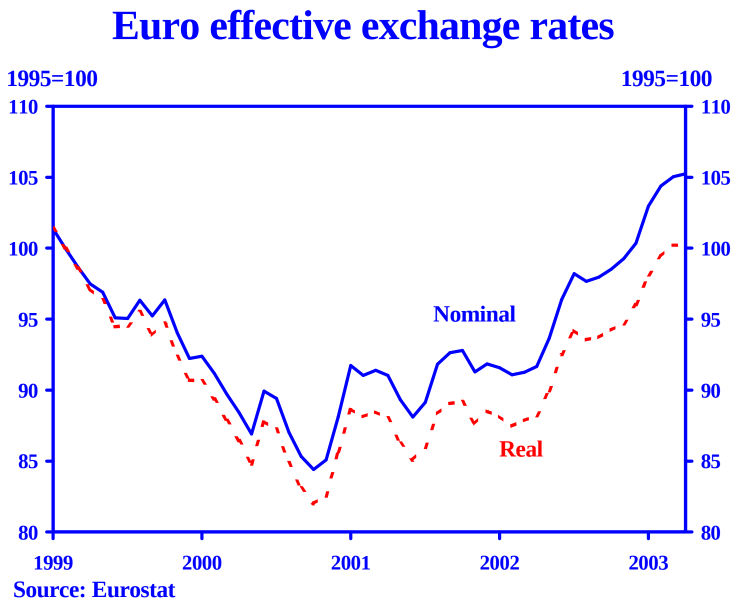


Exports and imports

The rise in the Euro is hurting exports

In 2003Q1, net exports dropped 0.6%, dragging down growth, In 2002 the share of exports from the Eurozone to third countries increased (from 49.6% to 50.1%). But with an appreciation of the euro (+9.1% in the first four months of the year against major currencies) exports from the euro area will be adversely affected in 2003 (Chart 3.5). So far it seems Eurozone exporters have reduced their profit margins to contain the increases in the dollar prices of their products, a strategy that can hardly be followed for a long time. Our special article in Chapter 4 examines (among other issues) the impact of a stronger Euro on margins. With the stronger currency persisting, the drag on growth from trade continues.

Chart 3.5



Employment, unemployment and labour costs

Job losses continue to mount

2002 was a year of stagnation for the European labour market. After the positives in 1999-2000 (about 4.8 million more people in employment compared to 1998), employment growth began to slow down in the third quarter of 2001. On average in 2002, the increase in the number of employed people was 0.4%, a third less than the previous year (+1.4%). The employment balance was negative in all economic sectors except services, which after three consecutive years of increase, is now showing a slowdown. The available data do not point to any short-term improvement in the European labour markets. The forecast indicators of expectations of firms collected by the European Commission in the first half of 2003 show that the 2002 malaise continues.

In the first months of 2003 the unemployment rate went up by a further tenth of a percentage point (to 8.7%). The European average continues to be afflicted by the negative trend in the German labour market; between 2001 and 2002 this registered an overall loss of about 230.000 employed people (-0.6%). In the 2003Q1 employment is believed to have suffered a 1.3% loss against 2002Q1, pushing the April unemployment rate to 9.4%. Many other countries, haven't suffered as much; employment in many areas has been creeping up in a few other countries (albeit not as fast as the labour force); but now there are clear signs that employment itself is falling (Table 3.1).

Given the strong slowdown shown by employment, on average the employment rate in the euro area for the year 2003 (62.6%) will be only slightly higher than that of the previous year (62.3%); therefore, the convergence process towards the Lisbon target (70% by 2010) is slowing.

Table.3.1–Employment growth in major countries of the euro area[(a)]

(yearly changes)

Countries	1996	1997	1998	1999	2000	2001	2002[(b)]
France	0.4	0.4	1.5	2.0	2.6	1.8	0.8
Germany	-0.3	-0.2	1.1	1.2	1.8	0.4	-0.6
Ireland	3.6	5.6	8.6	6.0	4.7	3.0	1.4
Italy	0.3	0.4	1.0	0.6	1.7	1.7	1.1
Netherlands	2.3	3.2	2.7	2.6	2.2	1.9	0.7
Spain	1.2	2.9	3.9	3.5	3.3	2.4	1.3
Euroarea	0.5	0.8	1.8	1.8	2.2	4.5	0.4

(a)Data on Italy concern labour units, for the other countries they refer to employed people. (b) Partially estimated data.

Source: Eurostat data processed by Confindustria's Research Department.

Price developments

Inflation is back at target…

Following the slight decrease to 2.1% in January 2003 (mainly because of a positive base effect), inflation in the Eurozone started accelerating again, increasing to 2.4% in February and March 2003. This temporary increase can mainly to be traced back to the dynamics of the more volatile components - unprocessed food and energy prices - as shown in table 3.2. The energy component reflected, with about one month lag, the sharp increases in oil price associated with developments in the Iraqi crisis: from the 3.7% of December, the twelve-month percentage change rapidly grew to 7.6% in February 2003, exerting a strong upward contribution.

Since then, inflation has fallen, first to 2.1% in April, and then below the ECB's 2% target ceiling in May, before edging back up to 2% in June. The recent fall in the rate above all reflects the positive effects on energy prices of the rapid normalisation of oil prices in April (25 dollars per barrel on average, -17% on March), thanks to the easing of tension in Iraq.

…as the core rate tumbles

Over the last twelve months core inflation has been on a slow and gradual decreasing trend (starting from April 2002), arriving at 2.0% in March 2003. In particular, from December 2002, inflation in the service sector has started to slow. Last year prices in these industries rose 3,3%, but the fall has intensified in the first months of 2003, taking the rate down to 2.7% in March. April saw a slight increase, but this was almost entirely down to a negative base effect. At the same time, non-energy industrial goods inflation shows a strong deceleration, down to 0.8% on an yearly basis in April (1.7% twelve months before).

In particular, in Germany core inflation decreased to 0.8% on March 2003 (it was at 2.0% twelve months before); then it increased again, but only temporarily, to 1.1% on April. This development mainly reflects service price inflation, which slowed down to 1.4% in March 2003 (picking up again to 1.9% on April). Overall the impression is of flat price developments in non-energy industrial goods prices (-0,5% on an yearly basis on April 2003). But even taking the Eurozone without Germany, core inflation (up to 3,0% in some months during 2002) is actually slowing down, at 2,6% on April 2003 again reflecting the decreasing inflation in services. The core inflation differential between Germany and the other euro area members remained almost constant in April, at 1.5 percentage points.

One interesting aspect of inflation dynamics in the region is that, whilst there is no clear trend in the inflation rate dispersion among the twelve members during 2002 and the first months of 2003 a distinct trend, it is possible to see an increasing trend in core inflation dispersion starting in the second half of 2002. This seems to reflect the decrease of core inflation in Germany and in other “small” economies (like the Netherlands) and the stability observed in France, Italy and a number of other countries.

Inflation perceptions have come down

And turning to the debate which broke out during 2002 about the measurement methods for consumer prices by national statistics institutes in various countries in the area, it should be noticed that from February 2003, at last, a turning point in inflation perception by consumers in the area was registered; now we can maybe expect a gradual unwinding of the gap with measured inflation, which remains anyway, at the moment, still particularly large.

Table 3.2 – Euro area inflation
(Harmonized index, twelve-month % changes)

	weights 2003	2002		2003			
		(a)	Dec	Jan	Feb	Mar	Apr
General index	100,0	2,2	2,3	2,1	2,4	2,4	2,1
Goods	59,1	1,7	1,8	1,7	2,2	2,3	1,5
Food, alcohol and tobacco	19,3	3,1	2,2	1,4	2,1	2,3	2,5
Processed food, alcohol e tobacco	11,7	3,1	2,7	2,9	3,3	3,3	3,4
Unprocessed food	7,6	3,0	1,4	-0,7	0,3	0,9	0,9
Industrial goods	39,8	1,0	1,8	1,7	2,2	2,1	1,1
Non energy industrial goods	31,5	1,4	1,2	0,7	0,8	0,8	0,8
Energy	8,2	-0,6	3,7	5,9	7,6	7,5	2,2
Services	40,9	3,1	2,9	2,9	2,7	2,7	2,9
General index excl. unpr. food and energy	84,2	2,5	2,3	2,0	2,0	2,0	2,2

(a) Yearly percentage change
Source: CsC calculations based on Eurostat data.

Market shares and the balance of payments

Large current account surplus last year

According to provisional data for 2002, the balance of payments on current account of the Eurozone showed a surplus of 62 billion euros, as against a deficit of 13.7 in 2001. As in the previous year, the improvement mainly reflects an increase in the trade surplus that went from €75.7 to €132.7 billion; in addition there has been a substantial growth in the surplus of services (from €0.9 to €13.3 billion). The deficit in transfers has been reduced by about €6 billion. The deficit in income remained practically unchanged, against a backdrop of losses suffered by the stock exchanges and the cut in interest rates, which brought about strong reductions of both credit and debit flows.

The trade surplus increase was helped by the favourable trend in the terms of trade, which have shown a clear improvement thanks to the appreciation of the Euro. Changes in the quantities of traded goods have also contributed to the increase in the trade surplus, given that the increase in exports was matched by a decrease in imports. The latter reflects the weakness of domestic demand and especially those components that are believed to rely more on imports, such as investment. On the contrary, changes in imports result from a notable increase in exported volumes of intermediate and consumer goods and a general stability of investment goods. The growth in exports witnessed in 2002 was mainly determined by the strong increase (that started in 2000) of export volumes to China, OPEC and Russia. A contribution was also made by the slight increase (which is now slowing) of demand in Canada and the United States. Meanwhile, exports from the Eurozone to Latin America, the Asean countries and Japan were weak.

Turning to the financial account, in 2002 the debit balance went up to €171.4 billion, up from €40.4 in the same period of 2001. This worsening almost entirely reflects the balances of “other investment” (from €8.8 to €184.4 billion), including the marked reduction in deposits and savings abroad by Eurozone banks (the outgoing flows have exceeded incoming ones by about €137 billion) and the growth in trade loans granted to foreigners by banks and financial institutions of the Eurozone (as against a slight increase of foreign loans).

The overall balance of flows for direct investment, portfolio investment and derivatives has gone up from a €67 billion deficit to a €15.6 billion surplus. This result is entirely ascribable to the improvement in the balance of direct investment (up from €–101.5 to €–21.1 billion); the slight improvement in the surplus of portfolio investment was actually offset by a worsening in the deficit for derivatives.

The balance of portfolio investment registered inflows equal to €50.5 billion (as against €38 in 2001). Evidently, international uncertainty and the weakness of stock markets has led investors to favour the most liquid forms of financial investment in their portfolios and borrowers to concentrate issues in this segment. Flows in both directions have decreased; overall flows have gone down by 66% against 2001, with incoming flows exceeding outgoing flows by €39.2billion. The general picture is one of turnaround from previous years; investment in the Eurozone now exceeds investment outside the Eurozone borders.

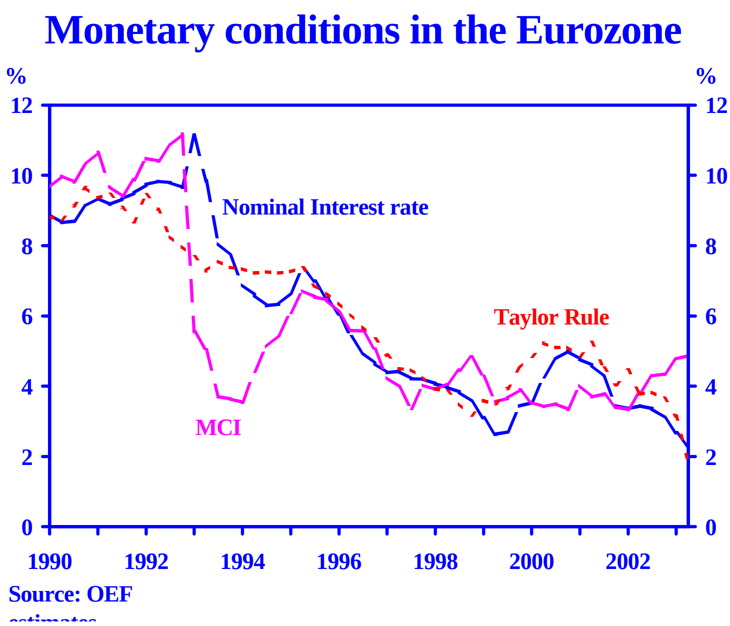
Part II - EUREN forecast for 2003 and 2004

a) Policy assumptions

Monetary Policy

In the first half of 2003, the ECB lowered its key interest rate in two steps by 75 basis points. So since 5 June the minimum bid rate on the main financing operations of the Eurosystem is 2.0 % - the lowest rate observed in the EU since the 1960s. The real short-term interest rate came down close to zero, indicating that monetary policy has an expansionary stance, when judged purely by looking at interest rates. Other measures suggest that the ECB still hasn't completely offset the effect of the soaring Euro this year. The graph below shows OEF's estimate of a monetary conditions index (MCI) for the Eurozone, which calculates the monetary stance based on the exchange rate and long-term interest rates as well as short-term rates[1]. This suggests policy is still quite tight when judged on this measure but around neutral when a Taylor rule is estimated.

Chart 3.6

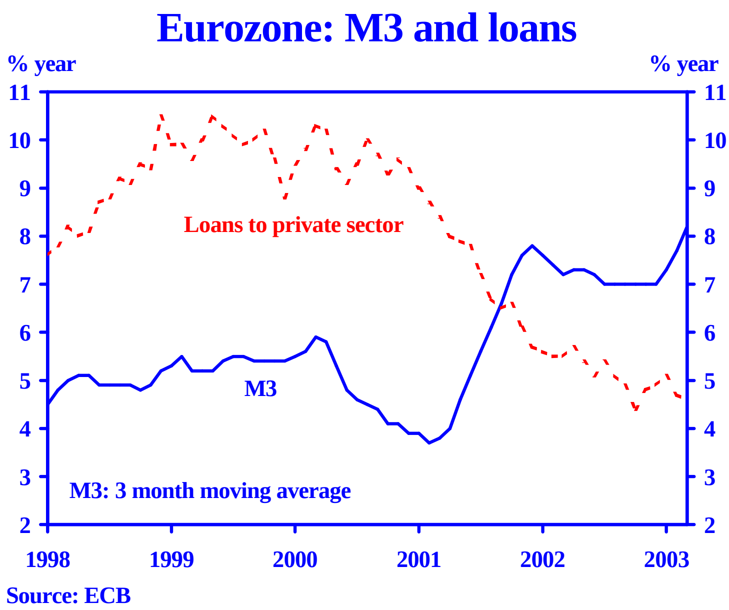


[1] Weights used: 1.0 on short-term interest rates, 0.25 on long-term interest rates and 0.15 on the nominal effective exchange rate

The ECB's decision was based on its assessment that the outlook for price stability improved significantly a judgement that followed the fall in inflation to 1.9% in May – the lowest rate since the end of 1999 – as the oil price fell from its Q1 highs and the Euro soared. At the same time, the Eurosystem's staff projections of inflation were revised considerably downward, accompanied by a similar scaling down of expectations for economic growth. For 2003, the ECB's June forecast saw GDP growth between 0.4 and 1.0 %, way below the increase of between 1.1 and 2.0 % predicted in December 2002. For 2004, the median forecast also was lowered by 1 percentage point. The inflation forecast for 2004 was revised down to a range between 0.7 and 1.9%, from the 1.0 to 2.2 % expected in December 2002. Clearly the ECB is much less worried about inflation than it was.

At the same time, M3 growth remained above its reference value (the three months average February to April 2003 was 8.2%). However, this still does not indicate excess liquidity, as monetary developments continue to be driven by short-term factors as investors shift their portfolios between different classes of assets. In its conclusions on the monetary policy strategy in May 2003, the ECB council underscored the longer-term nature of the reference value of M3 and decided to communicate it accordingly. Under the present circumstances, M3 growth gives no reason to tighten monetary policy. In contrast to M3, loans to the private sector grew at a much more moderate pace of 4.6% in the same period – as shown by Chart 3.7, indicating weak aggregate demand in the Eurozone. For Germany it is likely, that restrictions in credit supply also contributed to the low growth of loans. Our special article in Chapter 4 examines the possibility of a credit crunch in Germany.

Chart 3.7



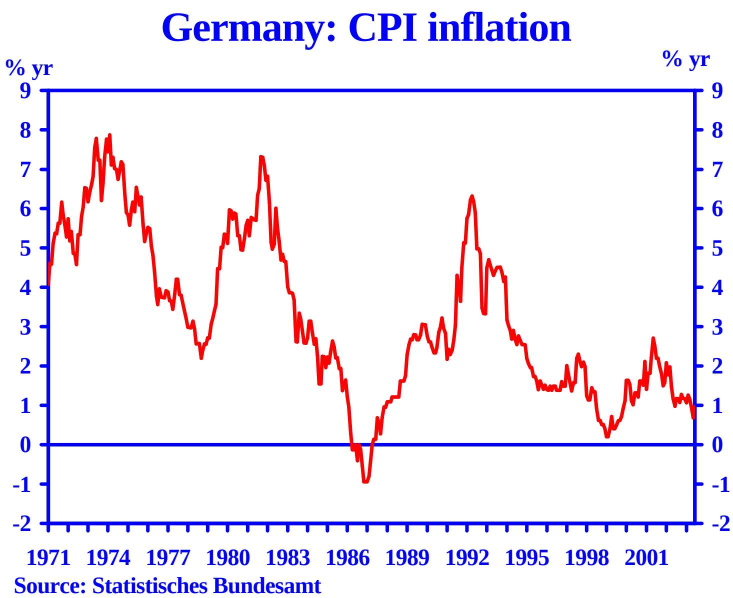
Since our last report, the ECB council has clarified its interpretation of price stability. On the one hand, the council confirms its goal of keeping the year-on-year increase of the HCPI below 2%. On the other hand it also points out that the pursuit of price stability is consistent with maintaining inflation close to 2%. The intention here is to show the ECB is equally concerned with guarding against the risk of deflation at it is with inflation. The target is now supposedly symmetric.

With an inflation forecast of 1.9% in 2003 and 1.5% in 2004, the risk of deflation in the Eurozone is currently low, although more concern has been raised over the possibilities of falling prices in Germany, although as Box 3.1 below explains, as long as the upturn in our forecasts materialises, this prospect is likely to be avoided. For the Eurozone as a whole, for 2004 the EUREN forecast expects a more moderate price increase of 1.5%. Taking into account measurement errors the lower bound for inflation is only slightly above zero. Considering this and the still negative output gap, the EUREN institutes expect that the ECB will reduce its key interest rate once more by 25bp towards the end of the summer. In the second half of 2004, when growth will be more buoyant, the ECB is likely to start modestly raising rates again.

Box 3.1: Is there a risk of deflation in Germany?

With inflation rates coming down and GDP growth remaining sluggish, concerns arose that Germany may slip into a deflation. This view is supported by the fact that unit labour costs have grown at a moderate rate for five years now, equity prices have fallen sharply, the number of bankruptcies is at record levels, and domestic credit is low – as shown in the special study in Chapter 4 - and bank profitability is weak.[1] If this leads into debt deflation, growth in Germany would be affected seriously. The real value of debt would get higher which would reduce consumption and investment. At the same time, monetary policy would lose power, as nominal interest rate cannot become negative. All in all, some spectators see parallels to Japan, which slipped into deflation in 1999 and has not found a way out since. In the case of Germany, the problem would even be worse, as macroeconomic policy is constrained; fiscal policy by the Stability pact, as Germany's deficit already exceeds 3% of GDP, monetary policy by the ECB, which has to target Eurozone inflation and cannot focus on developments in a single country.

Chart B-3.1.1



But the y-o-y increase of CPI in May was only 0,7 %, and the flash estimate for June is 1.0 %. Taking into account measurement error in inflation data, this could mean that the 'correct' inflation rate has already become negative. However, the recent decline is influenced to a large extent by special factors, i.e. the decrease of oil-prices, lower prices for vegetables and fruits, and the reduction of import prices due to the devaluation of the Euro. Even if, according to our forecast, oil prices will not rise again and the exchange rate of the Euro remains more or less stable, these factors will not put additional pressure on the prices, but the effects will level out. Furthermore, low rates of inflation are not unusual in Germany (Chart B-3.1.1). Therefore consumers as well as investors should not be too worried by the recent rates and it is not very likely they will behave in way that a deflationary process is propagated.

A reason of concern is that German banks seem to be hesitant to give loans (again see our special study in Chapter 4). However, the main factor behind this decision seems to be the deteriorating asset market, whilst neither company profits nor debt/income ratios are in unusually bad shape. Contrary to Japan, there is no bubble in the German real estate market that needs correcting, which helps stabilise the situation in the banking sector as well as the private household wealth. There is evidence from history that the bursting of a bubble in the share market has lower impact on real economic activity than a decline of housing prices. Hence, loans can be expected to get stronger as soon as share prices rise.

At the moment, it seems Germany will avoid deflation. However this is only true, if there is an upswing in 2004. The longer the period of stagnation lasts, the greater the probability of deflation.

[1] IMF (ed.) (2003), Deflation: determinants, Risks, and Policy Options – Findings of an Interdepartmental Task. Force. Washington D.C., IMF: 40-41.

Fiscal Policy

In 2002, fiscal policy in the Eurozone was only just expansionary. The cyclically-adjusted deficit grew slightly to 2.2 after 2.1 % in 2001. And as interest rates were lower, the cyclically-adjusted primary balance – probably the best measure of fiscal stance – deteriorated by slightly more; it went from +1.8% in 2001 to +1.5% in 2002. Thus, fiscal policy gave the economy a marginal boost in 2002. However, significant differences exist within the Eurozone. Whereas in some countries, including Belgium, Ireland and Spain, deficits are already ‘close to balance’, Germany and France violated the Stability and Growth Pact in 2002 and they are expected to violate it again in 2003. Furthermore, the EU commission expects that Italy will also surpass the 3% deficit margin in 2004. In Germany, the problems are mainly of a cyclical nature; on a cyclically-adjusted basis the deficit will be reduced almost one percentage point of GDP this year. In France (in 2003) and Italy (in 2004), however, the cyclically-adjusted deficit will increase.

Table. 3.3

Stability programs: goals and forecasts compared
budget balances as % of GDP[1]

Countries	Data		Stability Programs Dec 2002		EC Apr 2003		IMF Apr 2003		OECD May 2003	
	2001	2002	2003	2004	2003	2004	2003	2004	2003	2004
Austria	0.2	-0.6	-1.3	-0.7	-1.1	-0.4	-0.6	-	-1.3	-1.1
Belgium	0.3	0.1	0.0	0.3	-0.2	-0.1	-	-	0.0	0.2
Finland	5.2	4.7	2.7	2.1	3.3	3.0	1.8	1.6	3.1	2.9
France	-1.6	-3.1	-2.6	-2.1	-3.7	-3.5	-3.5	-3.0	-3.6	-3.3
Germany	-2.8	-3.6	-2.8	-1.5	-3.4	-2.9	-3.6	-2.7	-3.7	-3.3
Greece	-1.9	-1.2	-0.9	-0.4	-1.1	-1.0	-1.4	-1.3	-1.0	-0.7
Ireland	1.2	-0.3	-0.7	-1.2	-0.6	-0.9	-0.8	-1.0	-0.8	-1.2
Italy	-2.6	-2.3	-1.5	-0.6	-2.3	-3.1	-2.4	-2.3	-2.4	-2.8
Luxembourg	6.4	2.6	-0.3	-0.7	-0.2	-1.2	-0.1	0.2	0.2	-1.0
Netherlands	0.1	-1.1	-1.0	-0.7	-1.6	-2.4	-1.8	-2.6	-1.6	-2.0
Portugal	-4.2	-2.7	-2.4	-1.9	-3.5	-3.2	-3.9	-4.3	-3.2	-2.7
Spain	-0.1	-0.1	0.0	0.0	-0.4	-0.1	-0.3	-0.2	-0.4	-0.2
EU-12	-1.6	-2.2	-1.8	-1.1	-2.5	-2.2	-2.4	-2.0	-2.5	-2.4

Sources: EC (2003), Public Finances in the EMU 2003; IMF World Economic Outlook, OECD Economic Outlook.- [1]Excluding receipts from UMTS licenses.

The problems facing the three largest economies in the Eurozone now are not the result of actions taken in the last couple of years. The mistakes were made in the past, when the governments where not sufficiently ambitious in consolidating their budgets. Now the EU commission and the European Council are in a difficult situation: Will they insist on reducing the deficits below the Maastricht threshold in the short run? If so, fiscal policy will be unduly pro-cyclical in this year. Will they allow for higher deficits now the Stability and Growth Pact (SGP) is in danger? If this happens those countries that reduced their deficits successfully may feel that not all EMU members are treated in the same way. Despite of all problems arising at the moment, a Stability Pact is needed to prevent excessive deficits in the Eurozone countries. The current rules did this quite successfully in the past in the run up to EMU. However, as already pointed out in the EUREN Autumn Report 2002, an effort has to be made to make the SGP more accountable. Therefore, the fiscal developments should be measured and judged by looking at cyclically-adjusted deficits, a view that is widely accepted in the Eurozone now. Furthermore, fiscal policy must be symmetric: When economic conditions are favourable, efforts to reduce deficits must be more ambitious.

Germany: No clear signal of where policy is heading

In Germany, there are no clear signals on the course of fiscal policy. On the one hand, the government always committed itself to reduce the deficit below the 3 % margin by announcing cuts to subsidies and reduced outlays. On the other hand, most measures that have already actually been decided result in higher tax receipts and not in lower expenditure. Furthermore, the “Agenda 2010” was presented, an initiative of the federal government to enhance growth in Germany by introducing many structural reforms. But most of the issues announced – such as reforming the pension and the health insurance, improving the financial situation of the communities or reforming the labour market – are not really new, and it’s hard to see how the measures will be designed and when they will be set into force. Finally, in the light of the downward revision of GDP forecasts for Germany, the government recently proposed to bring forward from 2005 the third step of the income tax reform, to stimulate aggregate demand. The chancellor has pointed out several times that he will do everything to carry through this proposal, but, again, it is not clear how this should be done, in particular in the light of the SGP. If the tax reform will be given priority, it can be expected that the government will limit the consequences for public deficit by cutting expenditures such as subsidies to some extent, which would reduce the fiscal stimulus.

Whether these proposals actually materialise, they have no effect on fiscal policy in 2003. Some measures have already been put in place to limit structural deficit. The cyclically-adjusted balance will be reduced by 0.9 percentage points. At the same time the automatic stabilisers will work so that public deficit will reach 3.8 % of GDP for business cycle reasons. In particular, social transfers will increase, and the government will not succeed in reducing federal payments to the unemployment insurance to zero as it was planned earlier this year. In 2004, the public deficit will be reduced also for cyclical reasons, whereas the fiscal stance will be less restrictive than this year. In the forecast given here, it is not assumed that the third step of the income tax reform will be introduced early in 2004. However, a smaller reduction of the income tax (second step of the income tax reform) will come into effect, which should have taken place already in 2003 but was delayed last year to cover the expenses necessary to overcome the flood disaster in Eastern Germany. But as it is most likely that social security contributions must be increased again, and also some – even if minor – tax increases will come into force, the impact on aggregate demand will be limited. The Public deficit will be around 3%. If the 2005 tax reform did come in during 2004, an additional fiscal stimulus of 18 bn € would be given, which would increase the deficit markedly, unless it is accompanied by cuts of subsidies and social outlays.

France: towards a deterioration of public finances in 2003

France registered a significant increase in its public deficit from 1.4 % of GDP in 2001 to 3.1% in 2002. And, in contrast to Germany, the government plans another increase in the public deficit in 2003 with an official forecast of 3.4% of GDP. The actual deficit will probably turn out even larger than this estimate in 2003.

The government projection is based on a forecast of GDP growth of 1.3 % for 2003 - too optimistic given the weakness of activity for the first months of this year. Moreover, new tax cuts have been voted for 2003: €1.1 billion for households, €2.6 billion for firms. In addition, slow growth and tax decreases are depressing public receipts. Business tax receipts decreased 12.8% for the January-April 2003 period (compared to the same period of last year). The Budget law for 2003 planned a 0.6% increase for this tax. Tax on Added Value receipts increased of 0.8% for the January-April 2003 period (compared to the same period last year).

Again, this is well below what the Budget law for 2003 planned (+3.9 %). The official forecast for the growth of social contributions (for the employees covered by the General Regime) for 2003 made in September 2002 was 4.5 %. It has been lowered to 3.3 % in the new forecast realised in May 2003.

French authorities have taken some measures to try to control expenditures. €4 billion of state expenses have been put in reserve (of which €1.44 billion have been cancelled). Other measures to try and control health expenditures have been decided. Nevertheless, public expenditures do not seem to be slowing down. There has been an acceleration in the value of unemployment benefits, reflecting poor labour conditions. And other social expenditures have maintained a high growth path (for example, social expenses for working days missed due to illnesses have still been very dynamic during the first quarter of 2003), matching the structural inability of the government to control this type of expense. And, mirroring government priorities, military expenses registered growth of 11.3% for the first four months of 2003 compared to the same period in 2002.

In this environment, we expect an increase in the central government deficit. For the first four months of 2003, the State deficit has increased by €7.5 billion compared to the deficit of the same period last year. The deficit of the social institutions, which reached €4.7 billion in 2002, should increase in 2003. Another state organisation, Unedic, which manages the unemployment system, could register a slight increase of its deficit in 2003 compared to 2002 (€-2.5 billion) despite some corrective measures approved at the end of 2002. So, it looks like the official forecast for the public deficit in 2003 (3.4 % of GDP) is over-optimistic. Last April, COE has forecasted a deficit of 3.6% of GDP in 2003. But, with lower GDP growth than expected, the deficit could get closer to 4 % of GDP this year. It's also noted that, according to COE's forecast, the public debt should breach the 60% of GDP reference value in 2003. This is bound to provoke further confrontation with the European authorities.

These developments confirm that the tensions between the EU Commission and France will not calm. After an early warning in January 2003, the Council of the European Union decided in June 2003 that there is an excessive deficit in France. This assessment mainly reflects the conclusion that the deterioration in the 2002 budgetary position resulted chiefly from a worsening in the cyclically adjusted budgetary position. Besides, the Council thinks (rightly) that the deficit will be higher than 3% in 2003, contrary to the Council recommendation made in January 2003. On top of all this, it will be very difficult for the French authorities to respect their own Stability Program for 2004-2006. First, the so-called "cautious" scenario, with real GDP growth at 2.5% a year on average over the period, looks a bit optimistic if one takes account of the fact that the government growth forecast for 2004 is now close to 2 %. Besides, in the cautious scenario, the deficit was projected to decline by 0.5 % of GDP a year. As the previous official forecast for the deficit in 2003 was 2.6 % of GDP, this would have brought the deficit to 1% of GDP in 2006. But as the deficit will probably be close to 3.6% of GDP in 2003, the effort required to bring the gap close to balance in 2006 will be greater than previously expected. Will the government delay the adjustment or will it apply a more restrictive fiscal policy? In reality, the French authorities have already established ambitious targets to control expenditures in its Stability Pact. Nevertheless, these are based on structural reforms (reform of the State, decentralisation, reform of the health system) that could be difficult to put in place because of possible social tensions. Another uncertainty concerns the tax cuts planned for 2004-2006 (€9 billion in the cautious scenario). It is possible that the government will not be able to achieve this goal if it wants to ensure a decline of the deficit.

Belgium: no balanced budget without additional measures

The Stability Program presented last November by the Belgian government aims at achieving a balanced budget in 2003 and a surplus of 0.5% of GDP in 2005. According to the latest forecasts, these objectives will not to be reached without additional measures. Nevertheless, the total public debt to GDP ratio should continue to fall, declining by about 10 percentage points between 2002 and 2005.

The 2003 budget announced further cuts in personal income tax, continuing the implementation of the tax reform and the progressive phasing out of the crisis contribution that reduces tax revenue by 0.35% of GDP. The budget also foresees corporate income tax reform, which, combined with offsetting measures enlarging the tax base, should be revenue neutral. Extra reductions in employers' social security contributions are also scheduled (albeit less important than in previous years - labour costs per employee are to be cut by 0.1 percentage point). To compensate for this decrease in revenue, excises on tobacco and some regional and local taxes were raised and expenditure restrained on the basis of the 'anchor principle'. The objective of a balanced budget also relies on a continued fall in debt interest payments, reflecting lower interest rates and a declining government debt ratio.

Initially, the 2003 budget was built on a real GDP growth assumption of 2.1%. This hypothesis was revised downwards in February this year to 1.4%. With the latest forecasts pointing to a growth figure around 1%, a government deficit of 0.7% of GDP is now foreseen. In cyclically adjusted terms, these forecast imply that the government balance should move from a surplus of 0.3% in 2002 to a deficit of 0.1% of GDP in 2003, indicating that without new measures, fiscal policy will be slightly expansionary. However, following the federal elections of 12 May 2003, the political parties negotiating the formation of a new federal government expressed their commitment to take action to reduce the deficit. Indeed, one has to keep in mind that although a small deficit is not unacceptable in a period of weak growth, Belgian public finances are constrained by the high level of public debt - more than 105% of GDP in 2002.

Italy: an end to one-off measures is needed

In Italy, as elsewhere, there has been a conflict for fiscal policy in 2002 and 2003: on one hand there is the necessity to achieve the deficit goals set out in the Stability programme (particularly to reduce the debt/GDP ratio); on the other hand there is the need not to further depress economic activity. Using “una tantum” (one-off measures) solved this dilemma: “extraordinary finance” measures which, according to Confindustria’s calculations, decreased the underlying deficit/GDP ratio by a little more than one percentage point each year.

In 2002 the actual deficit/GDP ratio in Italy decreased from 2.6% to 2.3%. However, it remains one of the highest public deficits in the Eurozone after Portugal (2.7%), France (3.1%) and Germany (3.6%). The debt/GDP ratio (106.7%) is decreasing at a faster pace: it was 122.1% in 1996, but dropped to 109.5% in 2001 and to 106.7% last year, thanks also to extraordinary finance measures. But of course it is still well above 60% (the ceiling set by the Maastricht Treaty) and is the highest in the Eurozone. In 2002, fiscal pressures reduced by half a point to 41.6%. And according to the EC, the structural deficit reduced by 1 percentage point of GDP in 2002.

The slowing of economic activity forced the government to revise its GDP growth estimate for this year downward, from 2.3% to 1.1% in April.

The deficit/GDP ratio is now expected to be the same as in 2002, i.e. 2.3%, while the debt/GDP ratio should decrease by a bit less than one percentage point, to 105.9%. The government is assuming an increase in total revenues by 0.3 percentage points, to 45.2% of GDP, with total expenditures increasing by the same to 47.5% (and the debt service further decreasing to 5.5% of GDP). According to Confindustria the 2003 budgetary data are quite likely to be achieved; final figures, however, will depend not so much on the extraordinary measures adopted by Government, but on its ability to really reduce expenses as forecast - in particular on wealth and local Governments. As for 2004, the government will certainly have to find a substitute for the many “una tantum” (one-off) measures adopted in the 2003 bill while continuing the process of public finance restructuring. According to Confindustria, even if, as widely expected, 2004 world and Eurozone growth accelerates, the Italian deficit will probably rise to 3.2%-3.3% of GDP next year.

The EC holds a similar view. Based on the updates of the Stability and Growth Pact programme, Italy does not face excessive deficit proceedings; but it has the area's highest level of public debt and could, according to the Commission, have some difficulty in achieving the 2003-2004 deficit goals set out in the Stability programme. The Commission, while appreciating the measures enacted by the Italian government to contain public spending, has focussed attention on the one-time measures called for in the budget adjustment for 2003. The question is raised of how these measures are to be replaced in 2004 and beyond. The Commission expects that the government's next Finance Programme (DPEF), expected in July 2003, will indicate the structural measures it intends to use to reach the targets set for 2004.

b) EUREN forecast for 2003 and 2004

Recovery expected towards the end of the year

As discussed earlier, the world economy has been hit by some severe shocks between 2001 and early 2003 and the cyclical downturn in growth experienced by the European economy during this period teaches is that, notwithstanding its relatively closed character, the economy of the euro area has been significantly affected by the external real and financial turbulence. This turbulence has created huge uncertainty among European consumers and investors and led to cautious behaviour. Despite the end of the war in Iraq, recent survey indicators in the Eurozone do no yet suggest an improvement in confidence. Nevertheless, confidence is expected to return progressively to levels more in line with an economic recovery, the probability of which is increasing according to the COE indicator (see box 3.2).

Looking back at our report last autumn, the basic thrust of the analysis made six months ago still prevails. Indeed, as reported last year, given the lack of rooms of manoeuvre of economic policy, the expected euro area recovery would again be an export-led one. The external environment would be characterised by better prospects in the course 2003. As a consequence, world demand addressed to the euro area will reaccelerate in 2003. And stronger external demand will have progressively positive spill-over effects on internal demand in the euro area.

World demand weaker… and the Euro stronger than expected

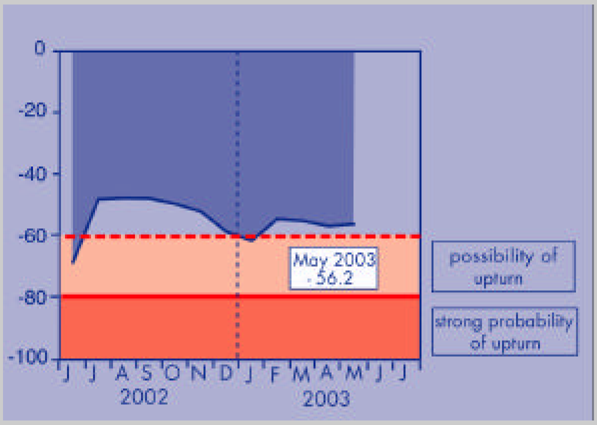
Two majors differences, however, must be pointed out with our last forecasts. First of all, world demand unexpectedly declined in the first quarter of 2003 and will probably not reaccelerate before the second half of 2003; world trade growth has consequently been scaled down for this year (from 7 to 4%). Secondly, the significant and rapid appreciation of the Euro exchange rate against the US dollar is, and will, exert a drag on European exports throughout 2003 and most probably also in 2004. By consequence, one of the major revisions in our forecasts for this year reflects a reassessment of net exports, which are set to exert a drag on GDP growth in the Eurozone this year of around 0.75%. The price competitiveness of European exporters is declining very rapidly and the relative export performance of the region has started to deteriorate. This tendency will probably continue in the coming quarters. Next year, despite the expected recovery in world trade, net exports are anticipated to contribute only marginally to economic growth (by less than 0.1%).

Box 3.2 COE Leading indicator for the Euro Area

The COE leading indicator for the Euro area failed to cross the –60 threshold at the end of last year, but has remained close to it in the last months. This threshold and the following one (- 80) will have to be breached to send out a signal of short-term recovery. Under those conditions, the Euro area would switch back to a high growth regime and recover a growth rhythm above its trend level - assessed to be 2%. This scenario is strongly dependent on any signal of upturn that may be given by the COE leading indicator of the United States.

Chart B-3.2.1

Search of next trough



Source: COE

Even if the recent disappointing evolution of economic growth in the Eurozone during the few first months of 2003 can be explained away in the light of the high level of uncertainty afflicting the global economy, one should nevertheless not just put the blame for this sluggish growth and weak confidence on external factors. Inside the Eurozone, the weakness of the German economy and the strong decline in investment throughout the area also contributes significantly to the fragility of the recent developments and short-term prospects.

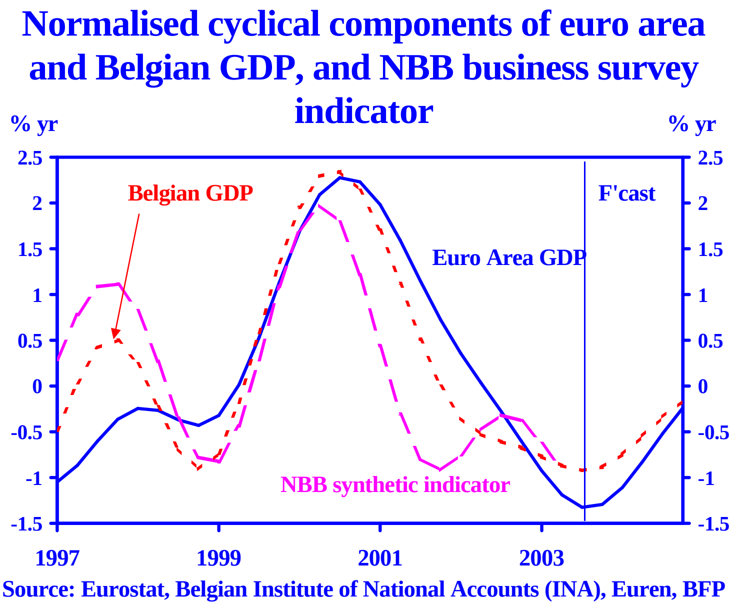
As showed in the two latest Euren reports, the Belgian business cycle and the NBB business survey indicator can be considered as leading indicators for the euro area business cycle. On average, over the period 1980-2001, they led the euro area business cycle by, respectively, one and two quarters.2

In the previous Euren report, the scenario of a mild recovery in the euro area during 2003-04 was supported by the development of the cyclical

[2] A detailed analysis of the relations between the euro area and the Belgian business cycle and the NBB synthetic indicator can be found in the Euren 2002 Spring Report, pp. 65-70.

components of Belgian GDP and of the NBB synthetic indicator. In fact, the NBB indicator had been on a gradually rising path since 2002Q1 and the first signs of bottoming out showed up in the Belgian business cycle. Although the expectations component of the NBB indicator had already worsened from the middle of 2002 onwards, this, at the time was put down to overoptimistic expectations during the first half of 2002; it was not expected that the assessment of the current economic situation would deteriorate significantly. However, the unexpected happened and the cyclical component of the NBB synthetic indicator started to decline from 2002Q4 onwards.

Chart 3.8



NBB indicator rose slightly in May

The increase in uncertainty at the beginning of 2003 and the downward pressures on economic activity were reflected in the continued fall in the NBB indicator during the first quarter of this year. In May, the indicator rose somewhat, but it's still too early to say if this is going to show up in the cyclical component of the indicator. Looking at the NBB indicator, there are no clear signs of a robust upturn of the Belgian (and by consequence the Eurozone) economy, although we raise the possibility that Belgian entrepreneurs may have overreacted to the situation in the Middle East, which would imply a correction on the upside in the near future.

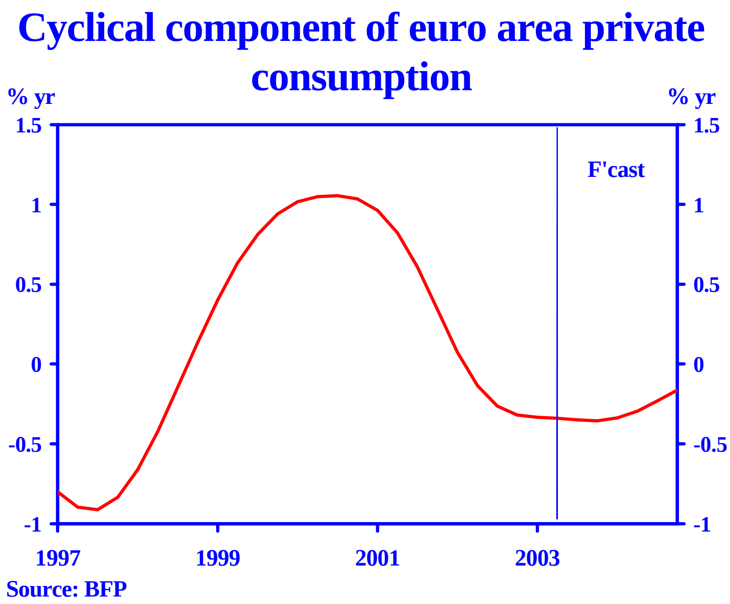
On basis of this information, no vigorous cyclical movements can be expected. In fact, this year should be characterised by a slow bottoming out, but the cyclical upturn should not be expected before 2004Q1. From then on, the cyclical position of the euro area economy should improve gradually. The upward cyclical movement should be less strong than during the previous upswings and the trend growth in GDP will probably not be reached by the end of 2004, which shows that the central Euren scenario for next year is very cautious.

All this means that the early recovery we were expecting in 2003 is once again postponed and that real GDP growth for the whole euro area is stagnating in the first half of this year. Only modest strengthening is expected from the second half of 2003 onwards. GDP growth in the Eurozone is expected to be only 0.7% in 2003. Economic growth in the region, expected to reach 2% in the last quarter 2003 (in terms of year-on-year growth rates) in our previous report, will only exceed 2% in the second half of 2004. On average, we expect Eurozone GDP to rise 1.9% in 2004.

The worst should be over for domestic demand

When we take a look at the cyclical parts of the two main components of Eurozone GDP, consumption and gross fixed capital formation, it is clear that first signs of improvement are already visible in the first category, but not yet in the second. The Eurozone private consumption cycle indeed started to bottom out from 2002Q3 onwards, while the investment cycle is still downward oriented, although this movement is losing strength, indicating that the trough is near.

Chart 3.9



As far as private consumption is concerned, its growth is dampened by the increase in unemployment. The unemployment rate in the euro area in the beginning of the current year is just under 9%, compared to an average of 8.4% in 2002. Because of the lag between employment growth and the economic upswing, it should pick up to 9.2% in 2004Q2 before decreasing in the second half of next year.

Fiscal policy offers little support

Fiscal policy3 in the Eurozone is unlikely to be supportive to household income during the forecast horizon. Indeed, given the low GDP growth profile, the general government balance in the euro area is expected to deteriorate in 2003 from a deficit of 2.2% of GDP in 2002 to 2.5% and to improve slightly next year to 2.4% of GDP. As large Member States (Germany, France and Italy) are among the countries that have not yet reached satisfactory budgetary positions, the effects of automatic stabilisers are hampered in the region. Even if some of the Member States do not intent to consolidate their fiscal position, because it could hamper growth (such as France), most of them (including Germany and

[3] Those figures are taken from the last Economic forecasts of the European Commission, spring 2003.

Italy) started to try to rein in deficits in 2003. For the average of the region, the overall budgetary stance is expected to be broadly neutral over the forecasting horizon, as the cyclically adjusted primary balance should only increase by 0.1% in 2003 and decrease by 0.1% in 2004.

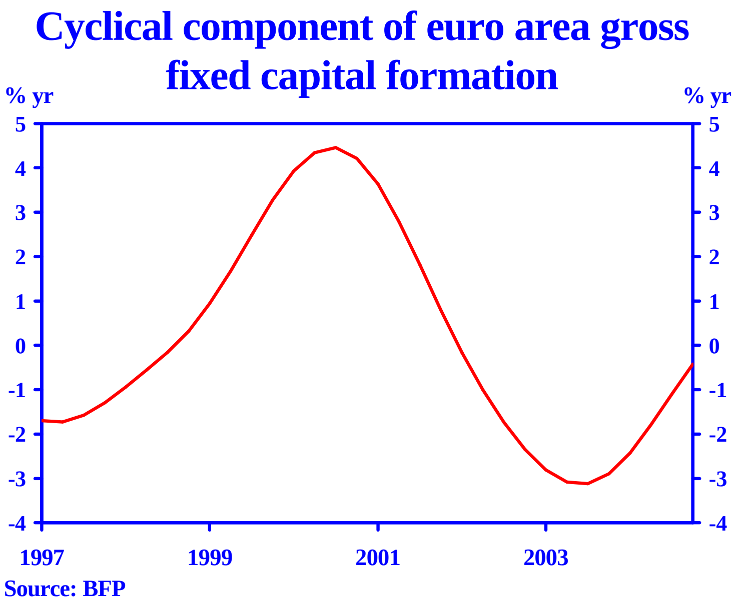
On the other hand, households' purchasing power will be supported by the reduction in the inflation rate, which in our forecasts is set to fall by 1 percentage point between 2003Q1 and 2004Q1. This reduction results mainly from the appreciation of the effective exchange rate of the euro as well as from the moderation in oil prices, implying positive terms of trade effects. Consumers are also expected to progressively narrow the gap between their perception of inflation and the effective increase in prices. Moreover, contrary to the situation in the US, there are no significant imbalances in the household sectors that could hamper households' spending. Private consumption should then increase by 1.4% and 1.5% respectively in 2003 and 2004.

After trade, the second largest downward revision to our forecasts for this year comes from investment - more precisely business investment. After two consecutive years of real decline, total investment is again likely to drop by more than 1% in 2003. Although the investment cycle is still moving downward, this movement is losing strength, indicating that the trough should be near. During 2003Q1, firms were particularly concerned by the tension in the Middle East and the associated decline in stock markets that has led to the postponement of their investment projects. However, most of the negative factors that have hold back business investment over the past two years should progressively vanish in the coming quarters.

Business investment stabilising in 2003H2

Business investment is therefore expected to stabilise in the second quarter of 2003 before progressively accelerating over the rest of the forecast horizon, helped by the gradual unwind of uncertainty and the expected improvement in demand prospects and capacity utilisation rates. The historically low level of short and long-term interest rates should also contribute to the expected upswing in investment. Indeed, although the decline in long-term rates probably reflects renewed pessimism over future economic growth in the euro area as well as the believe that short-term interest rates could stay at lower levels for a longer period than earlier anticipated, it should help to improve the financial position of non-financial corporations by decreasing their debt financing conditions. This is especially true since the spread between government and corporations bond yields is also declining, partly reflecting market perceptions of balance sheet restructuring in corporations - this should provide more favourable financing conditions for domestic corporations. Lower import prices in national currency and lower growth of unit labour costs (reflecting both higher productivity gains and wage moderation) should also help firms to restore their profit margins and improve their financial positions.

Chart 3.10



Although the uncertainties surrounding these rather cautious forecasts are more balanced than they were six months ago, as the strength of the US and world economy outlined in this report might be underestimated, some downside risks still remain. The first one relates to the potentiality of a further appreciation of the euro against the US dollar in the near future and its impact on the European competitiveness. The second one relates to the question of a credit crunch in Germany. Those two issues are debated in more detail in the two special studies presented in Chapter 4 of this report.

Table 3.4

Euro Area Forecast

	2000	2001	2002	2003	2004	2003 I	2003 II	2003 III	2003 IV	2004 I	2004 II	2004 III	2004 IV
	q-t-q, saar (unless otherwise indicated)												
Private consumption	2.5	1.8	0.5	1.4	1,5	1.4	1.2	1.2	1.3	1.4	1.6	1.8	1.8
Public consumption	2.1	2.2	2.7	1.3	1.3	0.9	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Gross fixed capital formation	4.9	-0.6	-2.6	-1.3	2.8	-5.5	0.0	1.0	2.0	3.0	3.5	4.4	5.0
Inventories, contr. to growth	0.0	-0.4	-0.1	0.7	0.1	-	-	-	-	-	-	-	-
Domestic demand	2.9	1.0	0.2	1.5	1.8	2.0	1.1	1.3	1.6	1.9	2.0	2.3	2.5
Exports	12.6	3.0	1.2	1.7	4.8	-2.6	1.0	3.5	5.0	5.0	5.5	5.5	5.5
Imports	11.3	1.7	-0.4	3.9	4.9	2.5	2.5	4.0	4.5	5.0	5.5	5.5	5.5
GDP	3.5	1.5	0.8	0.7	1.9	0.0	0.6	1.2	1.8	1.9	2.1	2.4	2.5
Unemployment (% of labour force)	8.4	8.0	8.4	8.9	9.1	8.7	8.9	9.0	9.1	9.2	9.2	9.1	8.9
Compensation per employee[1], yoy	2.5	2.8	2.6	2.0	2.4	-	-	-	-	-	-	-	-
Consumer price (HICP), yoy	2.1	2.3	2.2	1.9	1.5	2.3	1.9	1.7	1.6	1.3	1.4	1.6	1.6
Current account balance (%GDP)	-1.0	-0.3	0.9	0.6	0.6	-	-	-	-	-	-	-	-
GGFB/GDP[2]	-1.0	-1.6	-2.2	-2.5	-2.4	-	-	-	-	-	-	-	-
3m interest rates (% per annum)	4.4	4.3	3.3	2.2	2.0	2.7	2.3	1.9	1.8	1.8	1.8	2.2	2.4
10y Gvt bond yields (% per annum)	5.4	5.0	4.9	3.7	4.3	4.2	3.6	3.5	3.6	3.8	4.1	4.4	4.7

EUREN estimates - [1]Seasonally adjusted. – [2]EC estimates: General Government financial balance, excluding UMTS revenues.

A Baghdad bounce?

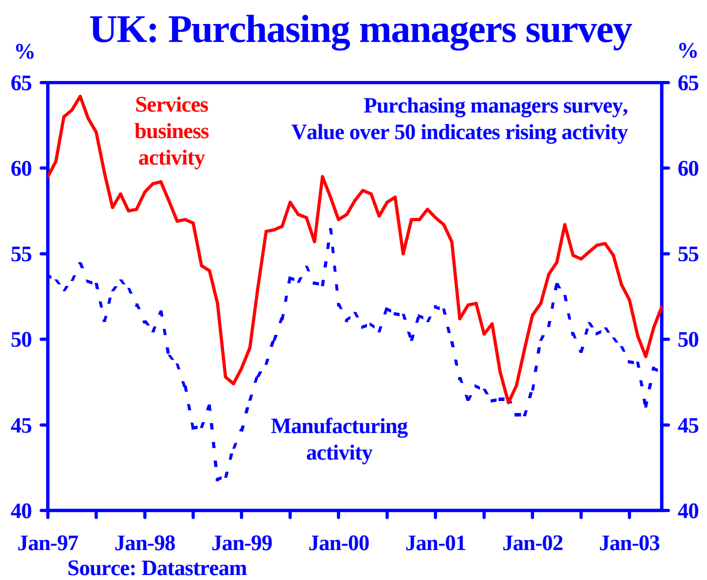
The equity market has bounced back sharply since the end of the Iraq war, with the FTSE all-share index now 25% up from its mid-March trough. However, evidence of a 'Baghdad bounce' elsewhere in the economy is more mixed.

On the one hand, the purchasing managers survey showed activity in the service sector rising in May at its fastest since January; the May CBI distributive trades survey reported retail sales growth at its highest for six months; both the Halifax and Nationwide report that house prices rose by about 1½% in May, after a subdued April; consumer confidence has started to recover according to the EU/GfK survey; and manufacturing output in April recovered most of its March fall.

Manufacturing remains depressed

On the other hand, the purchasing managers survey for manufacturing weakened in May; the CBI survey showed manufacturers' order books remaining very depressed; and the CBI service sector survey reported consumer services firms (eg hotels, restaurants) at their most pessimistic about business prospects since this survey began in 1998.

Chart 3.11

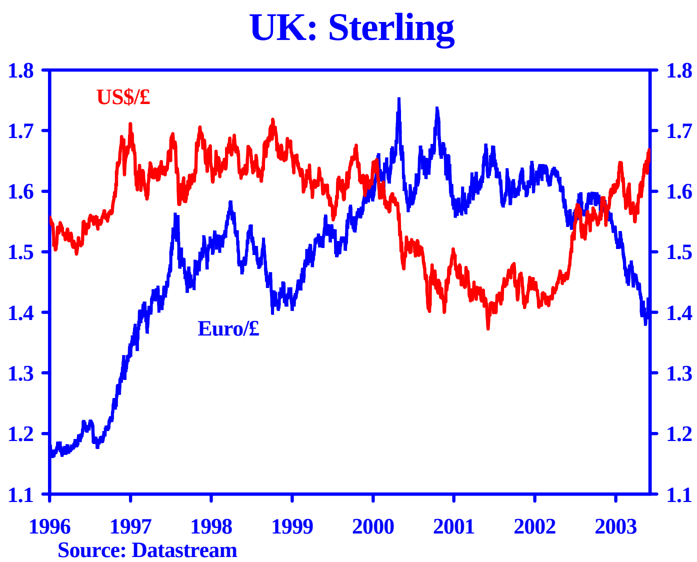


Overall, these recent indicators suggest that GDP is likely to rise in Q2 by more than the 0.1% increase seen in Q1, but that growth is likely to remain below its trend rate of around 2½% pa. As a result, growth will have been below its trend rate in seven of the last nine quarters.

But lower pound will boost growth in H2

While we are cautious about the strength of the economy in the short term – and therefore continue to assume one further 25 bp interest rate cut – we remain optimistic about prospects for a rebound through the second half of the year and in 2004. In particular, the fall in sterling – down about 10% since 2002Q4 against the euro and 7½% in effective terms – should breath new life into UK exports. Simulations with the OEF Model suggest that the effect of a 5% fall in the exchange rate on GDP growth is broadly equivalent to a 100 bp reduction in interest rates. Overall, we estimate that the monetary stimulus from the lower exchange rate should boost GDP by over 1% point next year, and as a result we continue to expect growth to rise from around 2% in 2003 to 3% in 2004.

Chart 3.12



The continuing improvement in the company sector's financial position also bodes well for recovery (and, indeed, should be bolstered by the impact of the lower pound on exporters' margins). Preliminary national accounts show the gross operating surplus of corporations rising 2.5% in

Q1 to a level 7.6% higher than a year earlier. Business investment rose 0.8% in Q1, its second consecutive quarterly increase, although it remains over 10% below its peak in late 2000.

A bubble in housing: not necessarily

The main reason the UK economy has performed relatively well over the last couple of years is the consumer, and this can be traced back to the boost from wealth from rapid increases in house prices. Many commentators have identified this as a bubble waiting to burst. But a more careful analysis looking at both demand and supply side issues shows that there is no generalised bubble, although houses in some areas of London do look well over-valued. The ratio of house prices to incomes – now back at levels reminiscent of the late 1980s – is often cited as an indicator of the overvaluation, but there are other factors that need to be considered.

Low interest rates means the cost of servicing mortgage debt is very low. A major factor behind the collapse of the late 1980s was the increase in interest rates to 15%. Not even the gloomiest pessimist expects a return to such levels again.

As well as incomes and interest rates, the OEF model of the housing market includes housing supply, wealth, tax changes, demographics and shifts in the income distribution. All these factors taken together suggest the “desired” level of the housing stock implicit in the model equations is in line with the actual housing stock: another argument that suggests “no bubble”.

The Euro: “not yet”…

To no-one’s surprise, the Treasury’s assessment of the five economic tests led to the conclusion that it was not appropriate for the UK to join EMU at the present time. Although none of the allegedly one and a half million words issued by the Treasury on 9 June appear at first glance to apply anything as unambiguous as the words ‘pass’ or ‘fail’ to any of the tests, the assessment is clear that the financial services test is met and that the convergence test is not. The conclusion on flexibility looks like a ‘fail’ since it cannot be confident that flexibility is sufficient. The remaining tests – on investment and on growth, stability and employment

– were not given a definite current assessment, but the Treasury is confident that they will be met if sustainable and durable convergence is achieved, implying that these are not a sticking point to producing an overall ‘pass’ verdict. In particular, the Treasury is concerned about the danger that EMU membership would trigger a ‘boom-bust’ in the housing market – a risk that we highlight in box 3.4 below.

Box 3.3: The five economic tests for UK EMU membership

Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?

If problems emerge is there sufficient flexibility to deal with them?

Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?

What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?

In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?

Source: HM Treasury

Ultimately, therefore, convergence is the key issue, with flexibility required to ensure that if and when convergence is achieved it will last. Here, the assessment pointed to structural differences between the UK and Eurozone economies, with a particular emphasis on the housing market – an area that OEF have been stressing as a key issue for UK membership of EMU for several years. As the box below indicates, there are several outstanding issues here that need resolving. Our own view here is that it is difficult to see how this particular aspect of the assessment can change quickly, since structural differences in the housing market can only be eliminated very gradually, if at all, and Chancellor Gordon Brown proposed no specific policies to deal with this.

Box 3.4: The UK housing market and convergence with the Eurozone

The OEF Global Macroeconometric Model has been used to assess the impact of the housing market on the UK's convergence with the Eurozone. The OEF Model provides the ideal framework for such analysis, as it incorporates a detailed system for forecasting UK house prices, transactions, mortgage borrowing and their interaction with consumer spending and the wider economy, within the context of a model of the Eurozone economy. Moreover, the OEF Model has proved to be a very good predictor of movements in house prices and consumer spending, including the boom in house prices over the last two years.

A. How would the UK housing market have behaved if the UK had joined EMU in 1999? The OEF Model suggests that joining EMU in 1999 would have created a boom and bust in the UK economy over the last four years even though the ECB would have taken some account of economic conditions here in setting Eurozone interest rates:

- GDP growth would have been over 4% pa in 1999 and 2000, as lower interest rates boosted consumer spending and the housing market.

- Joining EMU would have pushed UK house prices up by an additional 30% or so over the last four years, even compared with the strong growth actually seen.

- The current account deficit would have been over £50 billion worse on a cumulative basis over the last four years, as higher domestic demand sucked in extra imports.

- The stronger economic growth in 1999 and 2000 would have led to a significant pick-up in UK inflation, to over 4% pa in each of the last three years.

- Higher inflation would have undermined UK competitiveness within the Eurozone and led to a technical recession (ie two consecutive quarters falling GDP) in late 2001/early2002.

The OEF Model suggests that the housing market would have been a significant source of the economic instability the UK would have faced had it joined EMU in 1999. But it would by no means have been the only source. Even if there were no impact on house prices, lower interest rates within EMU would still have pushed GDP growth to 3¾% in 1999 and 2000, with inflation then rising to over 3½%.

B. How much more interest rate sensitive is the UK economy?

The OEF Model suggests that the peak impact of a change in interest rates on GDP is up to four times greater in the UK than in the Eurozone:

- Raising interest rates by 1% point for two years would reduce the level of UK GDP within EMU by about 2% after eight quarters, compared with the level it would otherwise have been.

- In contrast, GDP across the Eurozone as a whole would be reduced by only ½%.

- Since the impact on GDP of higher interest rates is four times greater in the UK than in the Eurozone, there are correspondingly greater impacts on other variables too. Unemployment in the UK increases by more in response to higher interest rates than it does in the Eurozone. Higher unemployment and lower GDP lead to a larger impact on inflation: in the UK, RPIX inflation falls by a peak of 1.0% in this scenario, compared to only 0.7% in the Eurozone. The UK's extra interest rate sensitivity sets in train a sequence of weaker demand, higher unemployment, lower inflation and therefore higher real interest rates that damage demand further.

But the OEF Model suggests that only part of the difference between the interest sensitivity of the UK and Eurozone economies reflects the response of the UK housing market. Assuming that the UK housing market is exogenous, a 1% point increase in interest rates would still reduce GDP (relative to its base level) by about 1½% after eight quarters. So, even excluding effects via the housing market, UK GDP appears three times as interest sensitive as Eurozone GDP.

C. The influence of the housing market on UK prospects within EMU over the next five years

Joining EMU in the near future would also be likely to lead to a more pronounced economic cycle unless the government were to take measures to offset the impact of lower interest rates on demand. For example, the OEF Model suggests that joining EMU on 1 January 2005 at an exchange rate of €1.50 (DM 2.925) would:

- boost GDP growth by around 1% point in 2005 and a further ¾% point stronger in 2006, mainly reflecting a significantly stronger outlook for consumer spending.

- add about 1% point to RPIX inflation in the medium term, and lead to a cumulative deterioration in the current account of around £25 billion.

The influence of looser monetary policy within the Eurozone on the housing market and in turn onto consumer spending accounts for about a third of the overall impact of EMU membership on economic growth and inflation. The OEF Model suggests that house prices would rise by about 15% more over the next five years if the UK were in EMU than if it were to remain outside. This is sufficient to add around ¼-½% point to both GDP growth and inflation in 2005 and 2006.

The UK economy would be much more vulnerable within EMU than outside to shocks to consumer confidence that affect spending and the housing market, since interest rates would no longer be based purely on conditions in the UK. For example, a shock to confidence that leads to a fall of around 20% in the long-term demand for housing in the UK and rise of around 4% points in the household saving ratio (relative to their base levels) would:

- reduce GDP (relative to base) by up to 3¼% over a three-year period if the UK were part of EMU.

- cut GDP by only half this level – by about 1½% after three years if the UK were outside EMU.

- Outside EMU, the fall in growth might raise unemployment by around 50,000. Inside EMU, unemployment rises by 275,000 over four years.

- Outside EMU, UK inflation falls by around 1% points (relative to base), suggesting that there could be scope for the Bank of England to cut interest rates even more aggressively than we have assumed. In contrast, within EMU, inflation falls by up to 2% points – implying that the UK could be on the brink of facing deflation (ie a falling general price level).

- The weaker growth inside EMU also leads to a more serious deterioration in the public finances – of up to 1½% of GDP (about £15 billion) a year, about twice as large as would occur outside EMU.

D. Implications for policy

The simulation exercises underlying this exercise highlight the UK's greater sensitivity to interest rate changes and the extent to which this is the result of the behaviour of the UK housing market. It suggests that, if the government were to wish to take the UK into EMU, action to reduce the impact of changes in interest rates on the housing market would be beneficial in improving the UK's economic stability.

· While we are sceptical that private sector housing market behaviour will change significantly as a result of EMU membership – in particular, we doubt that it would encourage greater take-up of fixed rate mortgages – there are policy measures the UK government could consider to make the UK housing market more like the typical continental market, such as reforming the system of property taxation or relaxing planning constraints on new housebuilding.

· But while such measures may be helpful in reducing the UK's relative interest-sensitivity, this study has shown that most of the differences in the response of the UK economy to interest rate changes compared with the Eurozone reflect differences in behaviour elsewhere in the economy – in particular, the direct stimulus of lower interest rates on consumer spending.

· Reforms to the housing market would therefore still leave the UK economy significantly more responsive to changes in interest rates in EMU than the Eurozone as a whole, and therefore potentially subject to more marked cycles in economic activity. This is an important risk that must be weighed against the potential benefits of EMU membership for the UK.

…but adoption of harmonised inflation measure is a step on the way

One policy change the chancellor did announce (subject to confirmation at the time of this November's Pre-Budget Report) was to set the MPC's inflation target in terms of the harmonised index of consumer prices (HICP) rather than the retail price index excluding mortgage interest payments (RPIX). HICP is produced by all EU countries using a common methodology and is monitored by the ECB when setting Eurozone interest rates. The first chart above shows that RPIX inflation in the UK has generally been higher than HICP inflation - the exception in the early 1990s was caused by changes in local authority taxation, which temporarily lowered RPIX but not HICP inflation. The second chart shows similar movements in HICP for both the UK and the Eurozone during the run up to EMU in January 1999. But the two measures diverged after that, largely because of the decline (until recently) in the EUR, and since then HICP has averaged 1.9% in the Eurozone compared to 1.2% in the UK over the same period.

There are a number of differences between the indices in how they are calculated. These include some differences in the coverage of certain types of spending and in the expenditure data used to construct the weights allocated to each category of spending. But the only two differences that really matter for most purposes are:

- The HICP uses the geometric mean to aggregate prices at the most basic level whereas the RPIX uses the arithmetic mean. A geometric average can never be greater than an arithmetic average. This apparently purely technical difference in fact reduces HICP inflation by around 0.4-0.5 percentage points a year compared with the alternative methodology.

- The HICP excludes a number of housing costs, including all costs of owner occupied housing, while the RPIX only excludes mortgage interest payments. So, for example, the HICP excludes both the council tax and housing depreciation (proxied in the RPI by an indicator related to house prices) that have been pushing up the rate of RPIX inflation recently. The exclusion of these housing components reduces HICP inflation by as much as 1.3 percentage points at the moment, but in general there is no particular reason to think that over the medium term this should bias the HICP in one direction or the other relative to RPIX.

Clearly the chancellor will need to reconsider the level of the target at the time the index used is switched over, given that HICP inflation is currently running at only 1.2% compared with 2.9% for RPIX inflation. Allowing for these differences, the bookmakers’ favourite is a target of 2% for HICP inflation, with a presumption that the requirement will remain to write to the chancellor explaining what is going on if the target is missed by more than 1% on either side.

Chart 3.13

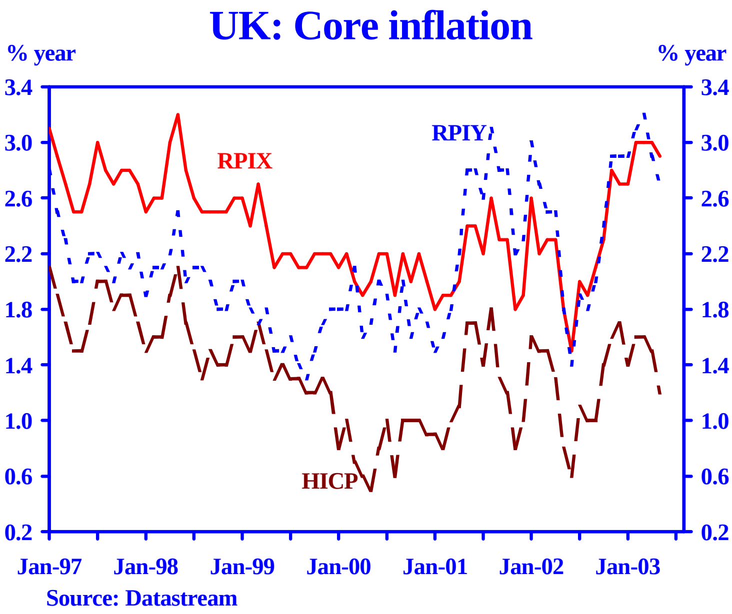

UK: Core inflation
% year
% year
3.4
3.0
2.6
2.2
1.8
1.4
1.0
0.6
0.2
RPIX
RPIY
HICP
Jan-97
Jan-98
Jan-99
Jan-00
Jan-01
Jan-02
Jan-03
Source: Datastream

Table 3.5

UK Forecast

	2000	2001	2002	2003	2004	2003 I	2003 II	2003 III	2003 IV	2004 I	2004 II	2004 III	2004 IV
	q-t-q, saar (unless otherwise indicated)												
Private consumption	5.1	4.1	3.9	3.1	2.5	1.5	3.5	2.9	2.6	2.3	2.2	2.1	2.1
Public consumption	2.1	2.5	3.8	3.6	4.1	5.9	4.1	4.1	4.1	4.1	4.1	4.1	4.1
Gross fixed capital formation	1.9	1.0	-3.2	1.2	3.5	-0.6	1.0	4.0	3.5	3.0	3.8	4.5	4.4
Domestic demand	4.0	2.6	2.5	3.2	3.0	1.7	1.3	3.6	3.6	3.3	2.5	2.3	2.7
Exports	10.1	0.9	-1.0	-0.8	7.0	0.2	2.6	5.4	6.3	7.1	8.6	9.1	7.0
Imports	11.7	2.3	1.5	3.1	6.1	3.0	2.0	7.8	6.4	5.9	5.9	6.4	6.6
GDP	3.1	2.1	1.8	1.9	3.0	0.6	1.4	2.5	3.3	3.4	3.1	2.8	2.5
Unemployment (% of labour force)	3.6	3.2	3.1	3.1	3.2	3,1	3,2	3,1	3,1	3,1	3,1	3,1	3,1
Compensation per employee[1], yoy	4.1	5.2	3.9	4.0	4.5	3.5	3.9	4.2	4.3	4.3	4.5	4.6	4.5
Consumer price (HICP), yoy	0.8	1.2	1.3	1.1	1.4	1.5	1.1	0.8	0.9	0.9	1.3	1.7	1.6
Current account balance (%GDP)	-2,1	-1.3	-0.9	-1.5	-1.6	-1.4	-1.4	-1.6	-1.7	-1.7	-1.6	-1.5	-1.5
GGFB/GDP [2]	1.6	0.9	-1.2	-3.3	-2.4	-4.8	-2.7	-3.0	-2.6	-2.6	-2.4	-2.5	-2.3
3m interest rates (% per annum)	6.1	5.0	4.0	3.7	4.4	3.8	3.6	3.5	3.8	4.0	4.3	4.5	4.8
10y Gvt bond yields (% per annum)	5.3	4.9	4.9	4.3	4.7	4.3	4.3	4.2	4.4	4.5	4.6	4.8	4.8

EUREN calculation – [1]Seasonally adjusted - [2]General Government financial balance, excluding UMTS revenues.

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. How much is Euro Area competitiveness affected by the Euro appreciation?

Keith Church, OEF, Oxford and Alain Henriot, COE, Paris

This paper tries to assess the effects of the recent appreciation of the Euro on the competitiveness of Eurozone members. In the first section, we try to assess the current strength of the Euro from a comparison with historical developments and looking at structural features of the Eurozone economies. The second section is devoted to a description of recent trends in the region's competitiveness and market shares. The third section presents the consequences of a further appreciation of the Euro using the OEF global macroeconomic model. Finally, the last section stresses the point that besides price competitiveness shocks, non-price competitiveness also matters on a long-term basis.

1.1. *How strong is the euro?*

Euro-dollar rate is back to the level of January 1999

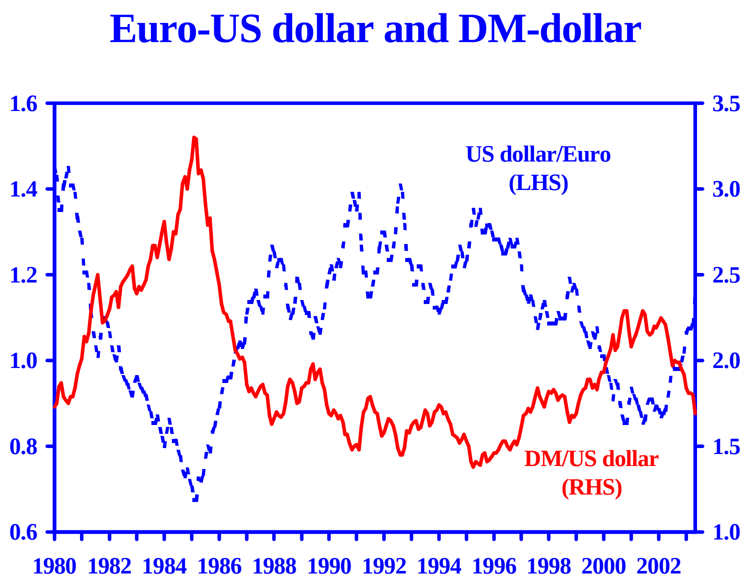
In January 1999, at the start of Stage Three of Economic And Monetary Union (EMU), the Euro traded at 1.16 $/€[4]. Then, it depreciated almost continuously, before reaching a trough in October 2000 (0.83 $/€). Afterwards, the European currency began an upward trend, although it was affected by short periods of weakness (in June 2001, the Euro stood at US$0.854). In May this year, it was quoted at US$1.16 on average, the same level than in January 1999. If the Euro area companies largely benefited from the weakness of the Euro in 1999 and 2000 through gains in market shares, the question that has been raised by the recent appreciation is whether the current level is sustainable or not for Eurozone companies.

[4] January 1999 average.

The current level is not yet an historical peak

One way to answer to this question is to refer to the historical level of the Euro, or more exactly to the level reached in the past by a basket of European currencies corresponding to the countries that have joined EMU. Alternatively historical levels of individual currencies can also be used (in that case, a fix conversion rate with Euro is applied from 1st January 1999). First, it is noted that the appreciation of the dollar didn't begin with the launch of the Euro. Indeed, as the US economy seemed to offer better economic perspectives than the Euro area, the US currency appreciated from mid-1995 vis-à-vis the DM and even from early 1990's (just before the EMS 1992 crisis) against an index of European currencies. By comparison, the DM reached a peak at \$1.38 in April 1995 (compared to \$1.69 in May 2003 if we multiply the fixed value of the DM against the Euro and the Euro-dollar rate) and the Euro index \$1.38 in November 1990 (even more in early 1980's (\$1.44 in January 1980). Consequently, even though the European currency appreciated sharply in 2002 and in the first half of 2003, the current level is not particularly high if we take a long-term view. It still stands 15% below previous peaks (or 20% if we look at the DM/dollar rate).

Chart 4.1.1

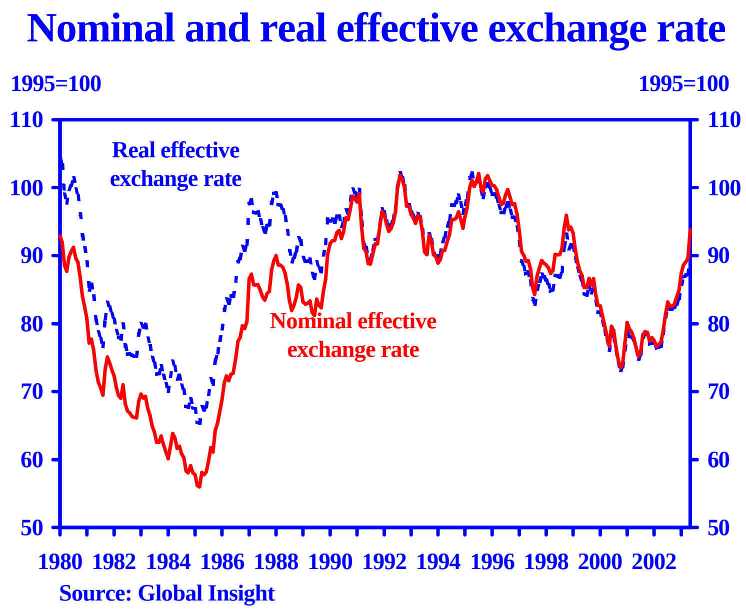


Source: Global Insight

The Euro has appreciated not only against the US Dollar but against a large basket of currencies

When trying to gauge the current strength of the Euro, merely looking at the bilateral nominal rate vis-à-vis the US dollar is not sufficient. First, it is important to take into account inflation and look at the real rate and second, because the trend against other currencies also matters. One striking feature of the recent period is that the Euro not only appreciated against the dollar (40 % between October 2000 and May 2003), but also against the Japanese yen by 47% over the same period and, more recently, the British pound. It also must be noticed that the Euro strengthened against currencies which move closely with the US currency or which are formally pegged to it, such as the Chinese renminbi or the Taiwanese dollar. It also appreciated against Latin American countries currencies. As a result, a broad measure of the effective exchange rate of the Euro shows an appreciation of 27.5% of the Euro in nominal terms between October 2000 and May 2002, and 23.7% in real terms[5]. Moreover, with the exception of the last weeks, the nominal and real effective exchange rates moved closely together, as nominal movements didn't reflect any excess of inflation in the Euro area compared to other regions in the world. Both in nominal and real terms, the Euro effective exchange rate is now close to the previous peak reached in the mid-1990s (around 10% below).

Chart 4.1.2



(1) Calculations are based on a broad measure of the effective exchange rate (50 countries for the real rate and 33 countries for the nominal rate, excluding from the latter index countries with very high inflation)

[5] deflated by consumer prices

The current level of the Euro is close to what is assumed to be the equilibrium level

Is the Euro too high now? Is there any overshooting given the fundamentals underlying economic developments in the Eurozone? The question of a "fair value" of a currency is well documented, both in economic literature and empirical studies[6]. Several approaches can be adopted to explain the development of a currency, depending on the time horizon considered. Purchasing power parity, productivity growth and external balance are the main variables that influence exchange rates movements. Other factors can play a temporary or cyclical role, like interest rates differentials and relative growth expectations. Short-term changes can also be influenced by market expectations, sometimes based on technical tools (i.e. those used by chartists). These different approaches lead to various assessments of what could be the equilibrium level of the exchange rate. To some extent, the spread between the actual and the calculated value must be interpreted according to the economic and statistical models used, so that the "fair value" of the Euro could correspond to different values accoriding to whether the short term, medium term or long term was of interest[7]. At the end of 2000, most studies concluded the Euro was undervalued (see the ECB survey quoted above). The medium-term approach led to an equilibrium exchange rate ranging from 1.13 $/€ to 1.17 $/€, a value close to the current level[8]. The OECD estimates the PPP level between the US dollar and the Euro at 1.12 for 2002. This suggests that part of the recent appreciation of the Euro is a bounce back towards equilibrium after a phase of undervaluation, so that if the appreciation of the Euro is painful for members' competitiveness in the short term, it doesn't undermine the growth potential of the Euro area on a long-term basis.

Price or costs differential among EMU Members lead to different "fair values" of the Euro

However, two additional remarks must be made. First, exchange rates are almost never at equilibrium. Phases of overshooting are the norm. Thus, the fact that the Euro/dollar parity is close to the equilibrium

[6] See ECB monthly Bulletin, January 2002, for a detailed presentation.

[7] H.P. Lorenzen and N. Thygesen (2000), "The relation between the euro and the dollar", *paper presented at the EPRU conference, Copenhagen*.

[8] Some studies point to even higher value of the equilibrium exchange rate, like Roudet (2000) which gives 1.24 as a reference value ("Euro/dollar : quelles perspectives, conséquences macroéconomiques d'une correction sur le marché des changes", Modèles et Diagnostics, COE, 1er trimestre 2000).

doesn't rule out a further appreciation. Conversely, if market expectations change, focusing for instance again on growth differentials between the US and the Euro area rather than on current account imbalances, the Euro appreciation could come to an end. The equilibrium level cannot be considered as a forecast of the future level of exchange rates, at least not in the very short run. Second, in a monetary union, the level of equilibrium of the exchange rate calculated for the union as a whole can differ strongly from the equilibrium level corresponding to economic fundamentals of each Member country. For instance, when looking at purchasing power parity or wage costs, a large spread exists between what could be considered as a "fair value" of the Euro for Germany or Portugal. The following table provides different assessments of what could be considered as a "fair value" of the Euro/dollar rate for the Euro area countries.

German unit labour costs exceed both the US and intra-EMU unit labour costs

The PPP based comparison is the most common approach. But it includes non-tradable goods, so that it introduces a spread between countries according to their different price levels, reflecting differences of development (the Balassa effect). Comparing the level of costs in manufacturing industries gives an idea of the differences purely evolving from the tradable sector. However, the labour costs differential is also the consequence of productivity gaps. A better approach is thus to compare the level of unit labour costs in a common currency, although the measurement problems of the productivity level are still an obstacle.

Table 4.1.1

The "fair value" of the Euro against the dollar for the Euro area Members according to different approaches

	PPP (1)	Hourly wage costs (2)	ULC (3)
Austria	1.06	1.02	0.83
Belgium	1.10	0.97	0.97
Finland	1.01	1.12	1.13
France	1.08	1.03	0.90
Germany	1.04	0.89	0.67
Greece	1.33	2.84	n.a.
Ireland	1.02	1.45	n.a.
Italy	1.23	1.35	1.04
Luxembourg	1.01	n.a.	n.a.
Netherlands	1.06	1.05	0.93
Portugal	1.44	3.40	0.86
Spain	1.30	1.56	0.70

Source: OECD, Eurostat, COE calculations

(1) OECD PPP levels (2002), *Main Economic Indicators*

(2) The calculated level of US dollar/€ exchange rate is the level which corresponds to an equalisation of hourly wage costs with the US hourly wage costs (in 2001).

(3) The calculated level of US dollar/€ exchange rate is the level which corresponds to an equalisation of unit labour costs with the US unit labour costs. The level of productivity in manufacturing industries is derived from D. Pilat (1996), "Labour Productivity Levels in OECD countries: Estimates for Manufacturing and Selected Service Sectors", *OECD Working papers, N°169* and is updated by data from the Bureau of Labor Statistics. The US/Germany comparison is used as a benchmark for other Euro area Members. Then, in a second step, the comparison between Euro area countries are based on the added value per hour worked in constant prices. The data refer to 2001.

Because of all these deficiencies in the methodology, the results of the table above must be interpreted very carefully. However, whatever the indicator used, it shows a large gap between what could be consider the "fair value" of the Euro for Member states. For unit labour costs, two conclusions can be drawn. Firstly, the current level of the Euro seems to lead to an absolute advantage of the US industry vis-à-vis the Euro area countries. Secondly, German labour costs appear to exceed substantially the level that could be justified by productivity gap, both relative to the US and to other Euro area members.

1.2 Recent developments of price competitiveness and market shares of the Euro area

A global deterioration of Euro area competitiveness … more pronounced for Spain, the Netherlands and Portugal

According to the indicators calculated by the European Commission[9], the appreciation of the Euro exchange rate led to a deterioration in cost competitiveness of Eurozone manufacturing industries of 4.5 % in the first quarter of 2003. Compared to one year ago, the cost competitiveness of Euro area dropped by 12%. This is in line with the evolution of the effective exchange rate. It means that recent deterioration in competitiveness of the Eurozone, which to some extent compensates past improvements linked with exchange rates developments, is not due to a widening of unit labour costs growth between the US and the Eurozone. Indeed, if the Eurozone suffered from higher unit labour cost growth early in 2002 because of lower productivity growth, the gap with the US unit labour costs (in manufacturing industries) has been reduced over the year, as adjustments of labour demand translated into higher productivity: in the last quarter of 2002, unit labour costs in the Eurozone in manufacturing industries were down by 0.5% against a year ago, while their were up by 1.2% in the US.

Turning to relative unit labour costs changes in manufacturing industries, it appears that within the Eurozone, Germany performed better than the rest of the region over the last two years, along with Austria and France. By contrast, as a result of tensions in the labour market, the Netherlands saw a deterioration in cost competitiveness relative to other EMU members. And consistent with a catching up of the level of their labour costs vis-à-vis the Euro area average, Spain and Portugal also registered a deterioration of their cost competitiveness.

9 "*Price and Cost Competitiveness"*, European Commission, DG Ecofin, first quarter 2003. These indicators refer to price or cost competitiveness between 24 industrial countries.

Chart 4.1.3

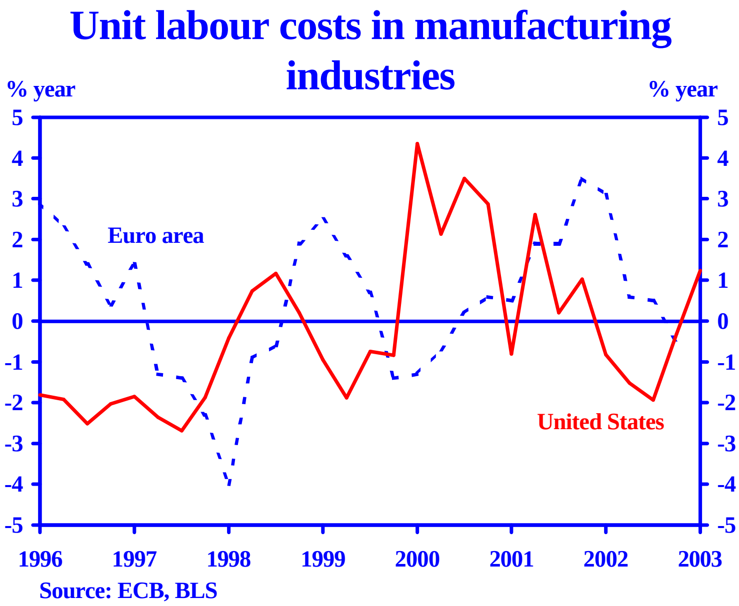
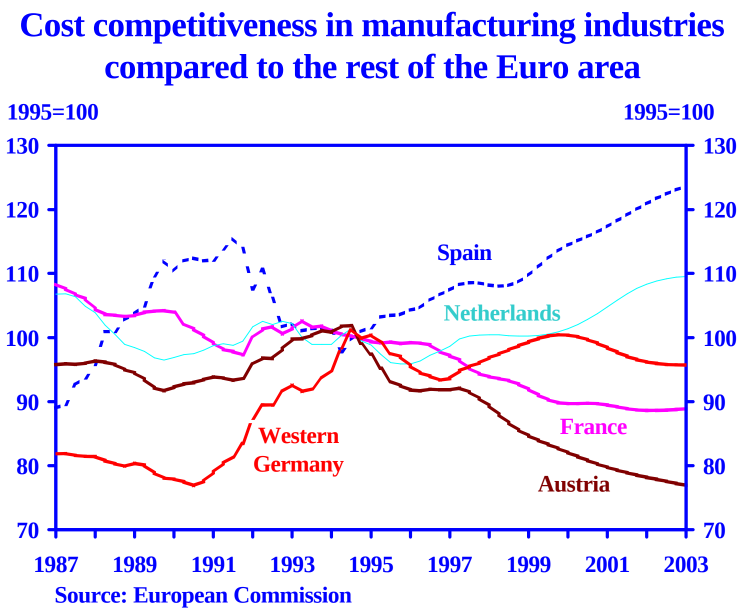
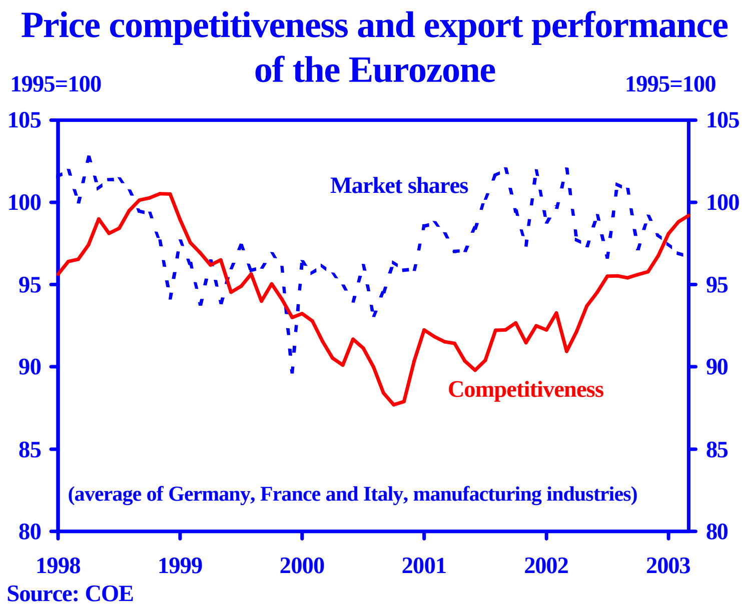


Chart 4.1.4



As a consequence of the overall deterioration in price competitiveness, the Eurozone lost market share over the year 2002, a trend which has continued in the first quarter of 2003. This contrasts with the gains obtained in 2000 and 2001, in the wake of the depreciation of the Euro.

Chart 4.1.5



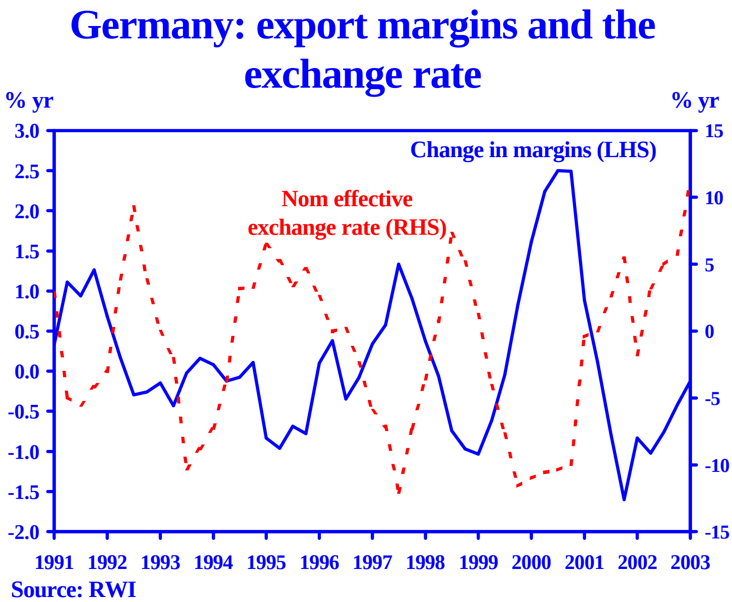
(1) Export price of country i / export price of competitors in a common currency (six competitors are included : USA, Japan, Germany, France, Italy and UK)

(2) Exports growth/ Export markets growth (in volumes)

Industrialists may try to maintain market share by reducing margins

To alleviate the burden of the appreciation of their currency, and if this degradation is felt as temporary, the Eurozone exporters can reduce their margins in order to keep market share. On a micro-economic level, this kind of behaviour can be explained by the fact that it can be more painful to enter a market than it is to reduce profit margins temporarily. A measure of export margins is given by the ratio between export price and producer price for the tradable sector, identified generally as the manufacturing industries. At an aggregated level, this ratio can be influenced by the composition of the two indexes - international specialisation can lead to changes in the structure exports. On a medium-term basis, export price can be put under pressure by the fact that the competition on external markets may be stronger than on the internal market (an outsiders/insiders phenomena). Moreover, even if export prices are generally modelled as a linear function of producer price, with the elasticity between the two variables illustrating the flexibility of export margins, industrialists often refer to a threshold of a sustainable exchange rate. Finally, in some cases, export margin changes do not correspond to specific behaviour. If international price are settled in dollar terms (e.g. in aeronautics), any change of the Euro/dollar rate is translated automatically in export margins measured in Euro terms.

Chart 4.1.6



An example of the reaction of export margins to changes in exchange rates shifts in Germany is given in Chart 4.1.6 above[10]. On the one hand, it describes the difference between the year-on-year changes of export prices and producer prices in manufacturing industries, the latter weighted with export weights. On the other hand, it shows the year-on-year changes of the nominal effective exchange rate. A clear negative

[10] We would like to thank Roland Döhrn (RWI) for having raised this point during discussion and providing us data for Germany.

relation appears: when the DM/Euro depreciates, export prices rise faster than producer prices and conversely.

Another example of the link between changes in the Euro/dollar rate and export margins is given below, using the ratio between export prices and producer prices in the French manufacturing industries.

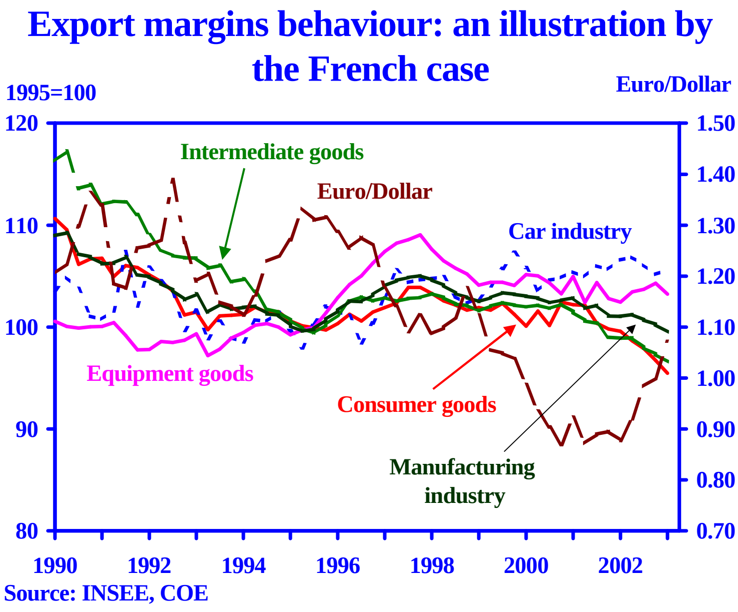


Chart 4.1.7

Looking at manufacturing as a whole, the graph shows a sensitivity of export margins to the Euro/dollar rate. However, exporters do not seem to react in the same way to changes in exchange rates. In the mid-1990's, the appreciation of the dollar was seen as an immediate relief and triggered a significant rise in export margins. But the following appreciation did not always have the same consequences. Probably, it illustrates the intensity of competition on export markets, which is no doubt also affected by the arrival of new comers like China. Thus, the recent appreciation of the Euro only exacerbates the medium-term downward trend shown in export margins. Export margins behaviour also differ among industries. As it is mainly an intra-European market, the car industry seems less sensitive than other industries to the Euro/dollar rate, illustrated by a relative rigidity of export margins. The equipment goods industry, which admittedly is rather eclectic in this very aggregated breakdown, reacted quite strongly to changes in Euro/dollar rate in the 1990's. But export margins seem less volatile in this sector in recent years. As transaction prices of many intermediate products (e.g. non ferrous metals) are denominated in dollars, export margins largely reflect changes in exchange rates in this industry. And for consumer goods, it seems that the increasing competition of emerging countries in a larger set of products leads to downward pressure on export prices.

1.3 - *What would be the impact of a stronger Euro?*

Further rises in the Euro can't be ruled out

Although our analysis suggests that the recent rise in the Euro merely takes it to levels that might be seen as "fair value", there is clearly a danger that the surge in the currency could continue. The US government has tacitly abandoned its strong dollar policy and the Fed has made it clear that short-term interest rates will stay low for some time. Typically exchange rates don't adjust smoothly to "fair value" and often exhibit periods of over or undershooting. What would be the impact of a sustained further rise in the Euro? Could it push the region into deflation? These questions are addressed using the OEF Global Macroeconomic model.

Two simulation experiments are conducted. In the first, the Euro effective exchange rate rises by 10% from the baseline from 2003Q3 onwards, while in the second a 25% appreciation is considered. In both cases we show the ECB can mitigate much of the damage done to export demand by lowering interest rates and crowding in domestic demand. But in the more extreme scenario, there is a question mark over whether the bank has enough ammunition to deal with the consequences of such a large shift.

But a prompt reaction from the ECB could mitigate the damage

The results of the simulations are shown in the Table below. One conclusion that is quickly reached is that even if the ECB reacts promptly, the lags in the monetary policy process means inflation falls by roughly the same amount in the first few quarter regardless of whether or not interest rates are cut. Assuming that the ECB does react decisively, the level of GDP falls 0.2% below base this year and 0.5% in 2004, cutting the EUREN growth forecast for the Euro area to 0.5% from 0.7% this year and 1.6% from 1.9% in 2004.

Table 4.1.2

Impact of a 10% rise in the effective exchange rate (changes from base)

	With ECB policy reaction				Without ECB policy reaction		
	GDP(a)	Consumer prices(a)	Interest rates(b)		GDP(a)	Consumer prices(a)	Interest rates(b)
2003	-0.2	-0.1	-0.4	2003	-0.3	-0.1	-
2004	-0.5	-0.7	-1.2	2004	-0.9	-0.8	-
2005	-0.6	-1.2	-1.4	2005	-1.3	-1.6	-

Impact of a 25% rise in the effective exchange rate

	With ECB policy reaction				Without ECB policy reaction		
	GDP(a)	Consumer prices(a)	Interest rates(b)		GDP(a)	Consumer prices(a)	Interest rates(b)
2003	-0.4	-0.3	-0.7	2003	-0.6	-0.3	-
2004	-1.5	-1.6	-1.8	2004	-2.1	-1.7	-
2005	-1.7	-2.9	-2.8	2005	-3.0	-3.5	-

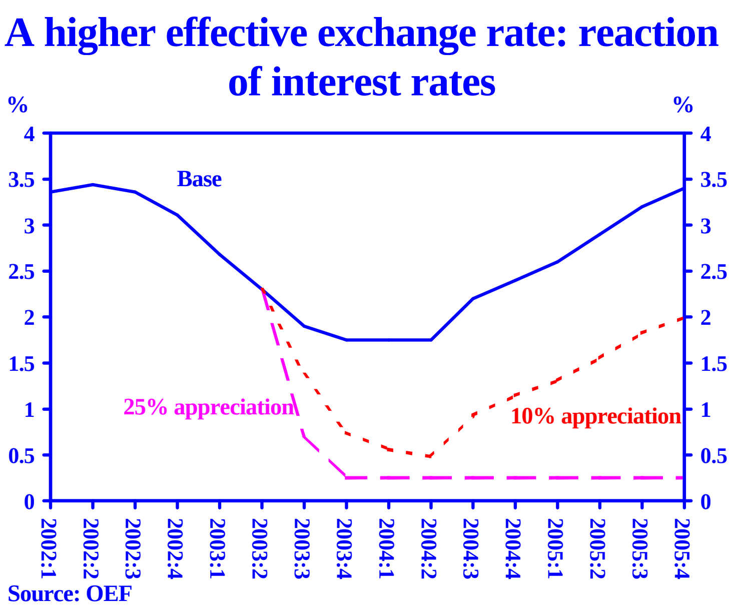
(a) percent difference from base
(b) percentage points difference from base

A big shock could mean rates can't fall far enough

By 2005, output is stabilising, even in the case where the shock is much larger. However, in this case, the model shows the ECB can't do as much as it might like. The OEF model sets interest rates by looking at inflation and the output gap and initially the equation suggests that given slower growth and low inflation, interest rates need to be significantly negative when the exchange rate rises by as much as 25%. Of course this is not possible, so rates are fixed at 0.25% and the outcomes for GDP and inflation shown in the table are then calculated. With rates as low as 1.75% in the central forecast, there is a danger that the ECB might not have enough conventional ammunition to fight off a large deflationary shock of this kind. The chart below shows the path of interest rates in the two scenarios.

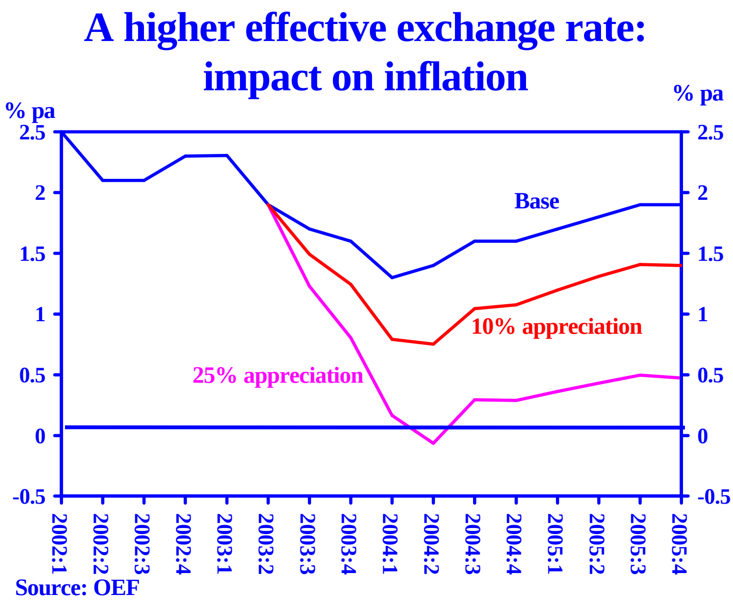
After the 25% appreciation, rates fall quickly to 0.25% and stay there over the three-year simulation horizon. This actually enough to avoid a prolonged period of deflation (by which we mean a sustained fall in prices and output) in the Eurozone as a whole, with year-on-year inflation just dipping below zero briefly during 2004Q2.

Chart 4.1.8



Clearly the experience wouldn't be the same across all countries in the region. Some, like Germany would suffer more than others. The results from this exercise need to be interpreted carefully. Macroeconomic models are useful tools for analysing the impact of small changes around the historic experience used to estimate the equations. The way economies function could well change if persistent deflation hit Germany, in this simulation inflation falls by 1 percentage point below base in both 2004 and 2005, which means the country at least flirts with the more pernicious deflation discussed at the end of Chapter 3. In this event consumption and investment could be hit harder than conventional econometric equations suggest, dragging down the region as a whole.

Chart 4.1.9



The ECB must be ready to take decisive action

These simulations highlight some of the risks to the forecast. They also suggest that only a combination of an even stronger Euro and a lack of action from the ECB would deliver a sustained period of deflation similar to that seen in Japan in the Eurozone – i.e. a far worse outcome that presented in any of the scenarios here. Of course this does not remove worries about individual countries. The results, and what they tell us about monetary policy transmission, also highlight the need for prompt action by the ECB. The peak impact of increases in exchange rates only occurs after 12-18 months. By concentrating too much on current inflation, rather than where the rate is heading, there is a risk that avoidable damage is caused. Hopefully the recent decision of the bank to target inflation “around 2%” makes this sort of indecision slightly less likely.

1.4 - *Beyond price competitiveness*

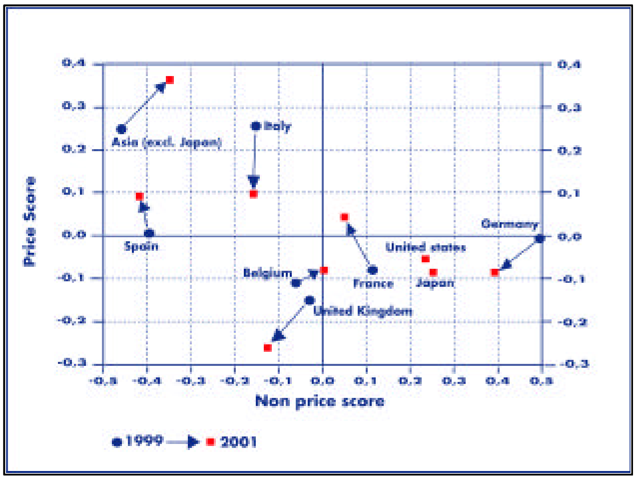
If price competitiveness is essential to explain short-term developments in external performance, the long run literature in international economics also mentions non-price criteria as an important factor of competitiveness[11]. But non-price competitiveness is hard to measure. For more than 10 years, COE has carried out an annual survey in order to assess non-price (and price) competitiveness of main suppliers on the European market. The 2001 and 2002 surveys were respectively devoted to consumer goods (excluding cars) and equipment goods. In this survey, European importers are questioned if products of a country are more, equally or less competitive than those of other suppliers, according to various criteria. Those qualitative answers are aggregated in quantitative indicators measuring the spread between the answer for each country and the average[12].

[11] E. Helpan and P. Krugman (1985), “*Market Structure and Foreign Trade*”, MIT Press.

[12] For a detailed presentation of the methodology see coe.ccip.fr.

Chart 4.1.10

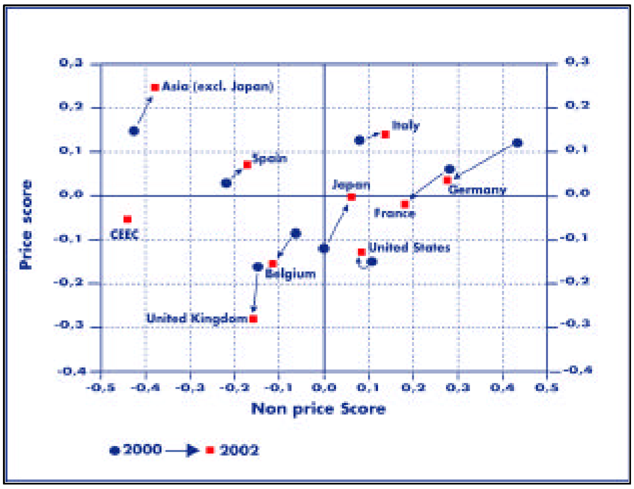
COE survey: price and non price competitiveness on the European markets (consumer goods)



Source: COE

Chart 4.1.11

COE survey: price and non price competitiveness on the European markets (equipment goods)



Source: COE

Germany in good position on non-price competitiveness

A first remark that can be drawn from this survey is that there is a trade-off between price and non-price competitiveness that more or less reflects the level of development of the countries. For instance, if emerging Asia is highly competitive on prices, it is less competitive on the non-price criteria that include quality of products, the innovation content and the design. Comparing Europe as a whole with the US and Japan doesn't make sense here, as the position among European countries differ substantially. For equipment goods, Germany is on the top of the list regarding non-price competitiveness. However, the US and Japan are not far away, especially on aspects concerning the quality of products or their content in innovation. A large disparity exists on non-price criteria among other European countries, Spain obtaining the worst ranking. On consumer goods, German and French products perform better than others, but Italy is very close thanks to the design of the products. The US and Japan are ranked just behind these three countries. Spain, Belgium and the UK suffer from a poor image on non-price criteria.

Maybe the most striking feature that derives from this survey is that Germany keeps a specific advantage on non-price competitiveness that can more or less compensate for the high level of costs.

Conclusion

To some extent, the current appreciation of the Euro counterbalances previous depreciation. Naturally the Eurozone market shares are negatively affected by the appreciation of the European currency, but on the other hand they were positively influenced by its depreciation in 1999 and 2000. Clearly, a further appreciation of the Euro would undermine Eurozone economic growth, above all if it is not compensated by lower interest rates. But on different methods for determining what could be the “fair value” of the Euro vis-à-vis the dollar, it seems that the current level of the Euro/dollar exchange rate is close to the equilibrium when looking at PPP or even more sophisticated methods. However, this relative optimistic diagnosis hinders a bleaker aspect on the competitive position of the Euro area vis-à-vis the US.

Table 4.1.3

Productivity in the US and in Europe (United States = 100)

	Value added per hour Manuf. Ind. 1995 (1)	Value added per hour Manuf. Ind. 2001 (2)	Value added per employee Manuf. Ind. 1995 (1)	Value added per employee Manuf. Ind. 2001 (2)	GDP per employee Manuf. ind. 1999 (3)	GDP per hour worked 1999 (4)
United States	100	100	100	100	100	100
Austria	n.a.	n.a	n.a.	n.a.	71	95
Belgium	105	101	81	81	90	110
Finland	101	n.a	83	n.a.	76	82
France	85	88	70	69	69	97
Germany	81	74	63	55	62	94
Greece	n.a	n.a	n.a.	n.a	34	56
Ireland	n.a.	n.a	n.a.	n.a	88	96
Italy	n.a.	n.a	n.a.	n.a	63	106
Luxembourg	n.a.	n.a	n.a.	n.a	83	120
Netherlands	97	89	74	69	74	109
Portugal	n.a.	n.a	27	n.a	38	53
Spain	68	n.a	40	n.a	95	76
Denmark	n.a.	n.a.	n.a.	n.a.	54	93
UK	70	64	60	56	60	87
Sweden	90	105	75	88	70	84

Source: OECD, Eurostat, COE calculations

(1) D. Pilat (1996 op. cit.)

(2) D. Pilat (1996) updated by figures from the *US Bureau of Labor Statistics* (www.ubs.gov)

(3) M. Mahony "Productivity and convergence in the EU", National Institute Economic Review, n° 180, April 2002.

(4) OECD scoreboard, 2001.

A large productivity gap in manufacturing industries between the US and Europe is an obstacle to the Euro area competitiveness

For the economy as a whole, productivity levels in the US and in Europe are very close, especially if hourly productivity is considered. But in manufacturing industries, empirical studies converge to say that a productivity gap remains between the US and the Euro area[13]. It's even widened since the mid-1990s. So even if the current level of the Euro is close to the equilibrium level for the whole economy, it is not true for manufacturing industries, especially in Germany where unit labour costs levels seem to be inappropriate. This is the consequence of divergence of the economic system in both sides of the Atlantic. In the US, a very productive industry cohabits with low productivity in the services sector (not in all industries, but in some of them), which enables the economy to be competitive on the international front and to create enough jobs to keep a low level of unemployment. In Europe, the level of productivity is too low in industry to keep pace with international competition and maybe too high in the services sector, or, to put it another way, not enough jobs have been created in these latter activities to reduce unemployment.

Economic policy can help …

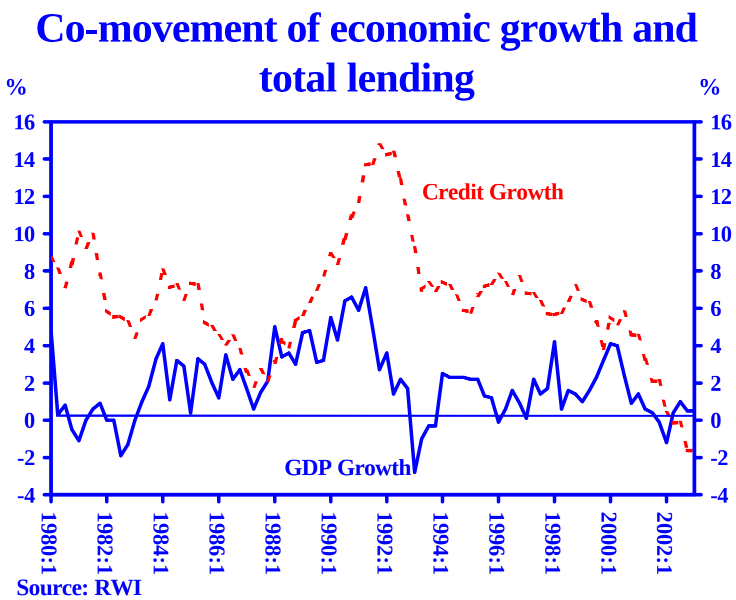
It means that if Eurozone countries want to be able to support a relatively high value of their currency, which not only has disadvantages in terms of market share, but has also advantages in terms of international purchasing power, economic policy has to act in two directions: first, to enhance productivity in manufacturing industries and second to promote non-price competitiveness. Practically, this means encouraging research-development activities and to provide a high level of education, two actions that have been clearly identified as increasing the long-term potential growth of an economy.

2. Is there a credit Crunch in Germany?

Hiltrud Nehls and Torsten Schmidt, RWI, Essen

The slowdown of credit growth in Germany since 2001 raises the question whether, at present, this is caused by a credit crunch. The possibility arises because the decline is much more severe than in former business cycle downswings. A credit crunch occurs when the supply of credit is restricted below the range usually identified with prevailing market interest rates and the profitability of investment projects. As this is a supply-side phenomenon, to identify it, it is necessary to distinguish credit demand from credit supply.

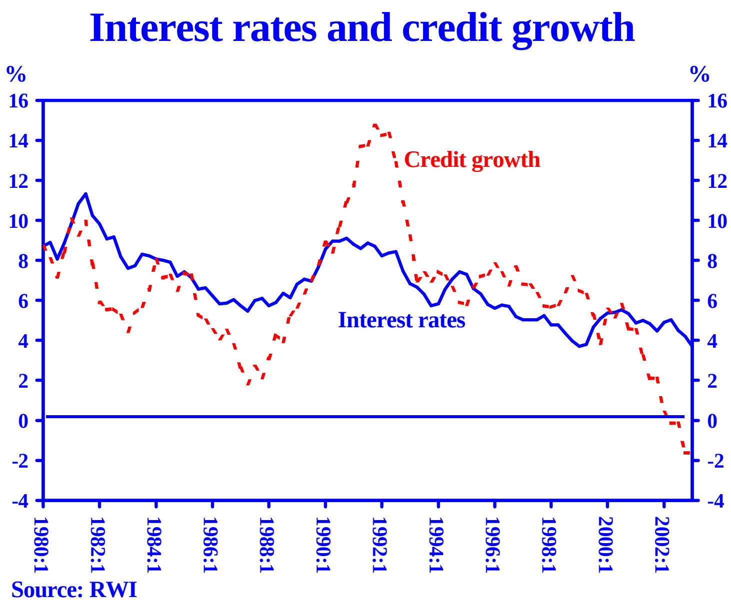
Chart 4.2.1



On the demand-side, economic activity is an important determinant (see Chart 4.2.1). An unfavourable economic outlook leads to a decline in business investment and the demand for loans. In a slowing economy firms are more likely to come into financial distress, therefore banks will be less willing to concede requests for loans. This causes cyclical fluctuations in credit volume. The recession in 2001/2002 was different from former economic slumps in that the decline in GDP growth was not very pronounced – unlike the marked drop of loans. During the economic slowdown at the beginning of the nineties, GDP quarterly growth rates declined from around 6% in 1991 to -3% during 1993. At the same time, credit growth declined from around 14% in 1992 to 6% in 1993. During the recession of 2001/02, GDP growth declined from 4% at-end 2000 to -1% in the first quarter 2002, while credit growth declined from 5 % to -1%. And even though GDP growth is in positive year-on-year territory since the second quarter of 2002, credit growth remains negative.

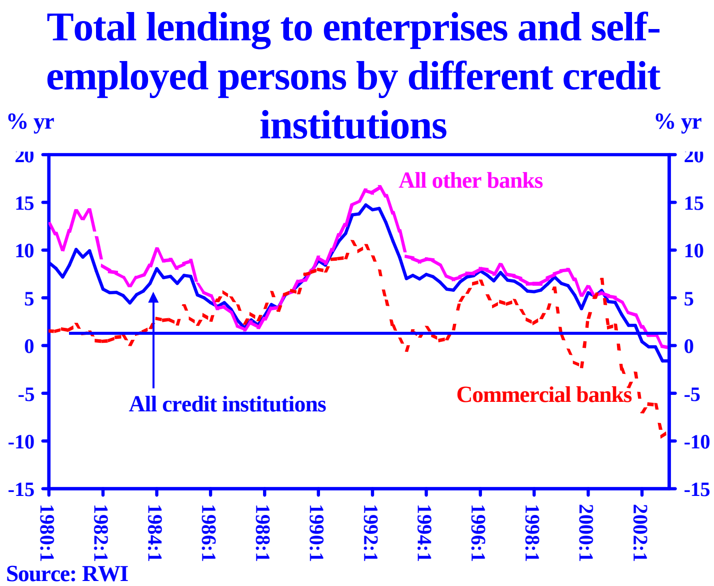
Interest rates are a second important determinant of credit demand. However, they affect the credit volume in different ways. First, the loan rate is the price for credit, so that under normal conditions an increase in loan rates lowers demand and increases supply. Second, capital market rates are an indicator of opportunity costs of investment. Therefore higher interest rates lower investment demand and the demand for loans. Despite this negative link between capital market rates and credit growth, Chart 4.2.2 indicates a co-movement between these two variables. But again, the strong drop of credit growth beginning in 2001 is not in line with the slight decline of interest rates.

Chart 4.2.2



Another hint that the reduction of available liquidity resources is more than a usual reaction to a business cycle slowdown is that the fall of credit granted by commercial banks is more pronounced than by other banks (Figure 4.2.3). This leads to the presumption that other factors, affecting in particular commercial banks, might play a decisive role in this credit slowdown. In particular three aspects might hit the various groups of banks to different degrees. The first is the recent trend towards bond issuance. The second is the strong decline in share prices since 2000. And thirdly, the new accord about capital requirements (Basel II).

Chart 4.2.3



Since 1999, issues of industrial bonds increased sharply, which might have lowered the demand for bank loans. As large firms, which are more likely to be customers of commercial banks are particularly able to get direct access to the capital market, this could also explain the extraordinary slowdown in credit of commercial banks. Anyway, the volume of issued bonds is still too small to explain the total weakness of credit growth.[14] Furthermore, it is far from being clear whether the

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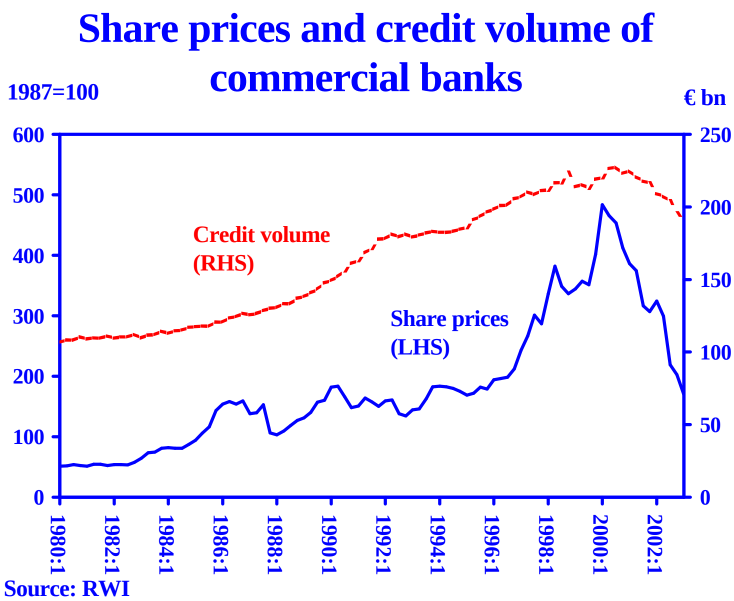
14 Even if one assumes that the new issued bonds are substitutes only for commercial banks loans, the increase of bonds amounts only about half of the decrease of loans. Hence the volume is too small to explain the decrease of commercial bank credit. In addition, normally in a recession the credit volume does not decrease but still grows, although at a lower rate.

increase in issued bonds has caused the reduction of the demand for bank loans, or whether it is a reaction to constraints in credit supply.

As for the decline of share prices, three aspects have to be considered. First, the slump in share prices reduces the net worth of incorporated companies. This deterioration of their balance sheets reduces their lending opportunities. Second, banks in Germany, in particular commercial banks hold a considerable amount of shares. So share prices also affect the balance sheets of banks. The need to adjust the risk structure of their equity holdings reduces their optimal level of lending.

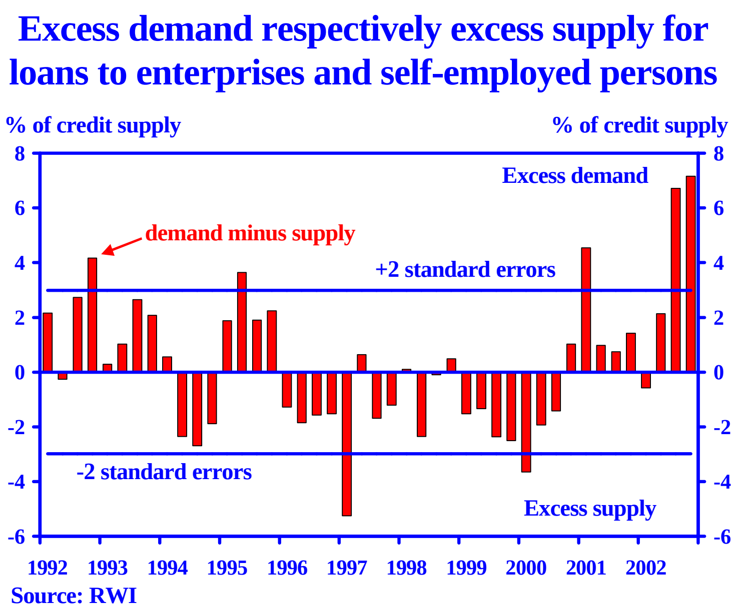
Chart 4.2.4



Third, banks may also anticipate the new capital requirements of the Basle II accord that will be implemented in 2006. If banks have to adjust the risk structure of their equity portfolios, it is not easy to discriminate this effect from the effects of the fall in share prices. Anyway, quantitative impact studies indicate that, in particular for commercial banks, the necessity to adjust their portfolios in preparation for the new capital requirements is not very high, but they – as pointed out above – reduced total lending more pronounced than other banks.

To test whether supply side factors play a role – in particular the decline in share prices – we estimate a disequilibrium model of the German credit market.[15] By doing this, we estimate the credit demand one would expect at the present level of economic activity and interest rates. In the same way we calculate the credit supply in accordance to the current level of interest rates, banks' lending capacity and share prices, the latter turning out to be an influential variable in the supply equation. Comparing estimated demand and supply we find a substantial excess demand in the credit market since 2001 exceeding the usual error margins in the second half of 2002 (see Chart 4.2.5).

Chart 4.2.5



All in all, there is evidence that the current decline in credit to enterprises and self-employed persons in Germany is more than "normal", compared

[15] For a more formal analysis and the regression results, see Nehls, Schmidt "Credit Crunch in Germany?" RWI Working Paper (forthcoming).

to earlier business cycle downturns. Our analysis identifies factors that directly affect the banks' capacity to lend. First of all, banks suffered from the strong decline of share prices – this has been more pronounced in Germany than in other countries. This effect could be reinforced by the necessity to prepare for the new capital requirements. Both factors force banks into the direction of a more restrictive credit policy than in other business cycle downturns. This is often called a credit crunch. Anyway, as the experience from the United States in the early nineties indicates, this might be a transitory phenomenon. Banks can be expected to expand their credit supply after adjusting their risk structure. It is difficult to assess how much time this will take, but the ongoing stabilisation of share prices is working in favour of this process.