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The Economic Outlook in Europe in 2003-2004

BACK TO GROWTH

Autumn Report

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December 2003

About the European Economic Network

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

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

This is the fourth 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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Chapter

1

EXECUTIVE SUMMARY

In our report last summer, we expressed cautious optimism over a recovery of the world economy during the second half of 2003 followed by a more pronounced and dynamic upturn in 2004. Since then hard figures and survey results have confirmed this scenario. In fact, the world economy bounced back faster than expected in the third quarter of 2003, with all parts of the world sharing in recovery to a certain degree.

The United States experienced its fastest economic growth in the last two decades with an annualised GDP growth rate of 8.2% in 2003Q3. This vigorous growth largely reflects two years of unprecedented monetary and fiscal policy easing. In particular, tax cuts have reinforced the positive push on consumer spending arising from the refinancing of mortgage credits. However, the business sector also supported economic activity in 2003Q3.

During the same quarter, Asian emerging economies, and more particularly China, provided a second powerful engine to growth alongside the United States. The growing importance of China in world trade and the new deal it creates for other countries in the world is probably one of the most striking features in very recent years. The first special study of this report is devoted to the Chinese economy, paying particular attention to its specific structure, the imbalances it generates in the world economy and the possibility that these imbalances might be reduced by a revaluation of the Yuan.

In the first half of 2003, the Japanese economy saw a stronger cyclical recovery than anticipated six months ago, with activity supported by favourable developments in East Asian countries and by some revival in domestic demand. In 2003Q3, real GDP increased for the sixth consecutive quarter. The main driving force behind economic growth in the last quarters has been exports, though real business investment also plays an important role in the current recovery.

All in all, with the recovery now well on track, most regions are expected to achieve stronger economic growth in 2004 than in 2003. World trade of goods is expected to gain pace in the coming quarters and to grow by around 7.5% next year after 3.8% in 2003.

In the euro area, economic activity has also started to gain momentum, although at a more subdued pace. Thanks to weak activity in the first half of 2003, euro area real GDP growth is expected to settle at only 0.4% in 2003 (compared to 0.9% in 2002). This rather poor outcome reflects the negative contribution of investments (-0.4%) and net foreign demand (-0.2%). The current dynamism in euro area exports is not sufficient to completely offset the losses recorded during the first six months of 2003.

Because of the current “excessive” deficits (in terms of the Stability and Growth Pact) recorded by the two largest economies of the euro area, namely Germany and France, fiscal policy will not provide a stimulus for expansion next year. On the monetary policy front, we see little reason for the ECB, except in case of a further appreciation of the euro, to change interest rates within our forecast horizon.

As a result, we expect the role of world trade in revamping the euro-area’s economy to be only progressively overcome by domestic demand. Private consumption should gradually rise as the gap between effective and consumer-perceived inflation narrows and will continue to be favoured by low interest rates. Household consumption should also benefit, at least in the second half of next year, from a gradual recovery in employment and the subsequent increase in disposable income. The rebound in international economic activity, the improvement in business profitability and an overall favourable monetary stance should finally favour the resumption of a positive investment cycle. As a whole, real GDP growth should rise 2.1% in 2004. Note that this economic performance will also be helped by an exceptionally high number of working days.

The cyclical improvement should be felt in most of the euro area countries. The German economy is also expected to recover in 2004, sustained by an accelerating world trade and possibly less restrictive fiscal policies. The latter will depend on the final decision of the *Bundesrat* on whether or not to implement the third step of the income tax reform in 2004.

In the UK, the release of revised economic data by the Office for National Statistics show that economic growth has been much stronger over the last five years than previously realised – averaging 2.5% pa since 1998Q2 compared with 2.2% pa. The new data also suggest that demand has been more balanced in recent years than previously estimated. With the increase in GDP in Q3 revised up to 0.7%, growth in 2003 is now set to reach 2%, within the Treasury's Budget forecast range of 2-2½%. And the Treasury forecast for 2004 growth of 3-3½% is a lot easier to defend now that the world economy is strengthening and company finances are improving – our own forecast is 2.9%.

In 2004, the European Union will welcome ten new member states. Although this enlargement has major political and cultural implications, the economic impact, at least in the short run, should remain limited. As we show in our second special study, the enlargement represents an increase of only 8% in EU-15 GDP, while in terms of population the increase is around 18%. In the medium term however, between 0.2 and 0.3 percentage points could be added to the potential growth rate of the EU.

Main features of the forecast

	2002	**2003**	**2004**
World trade	3.2	3.75	7.5
Oil price ($/b)	25.0	28.7	26.0
GDP growth			
- United States	2.4	3.0	4.0
- Japan	0.2	2.4	1.8
Euro area			
- GDP growth	0.9	0.4	2.1
- Inflation (HCPI)	2.3	2.1	1.8
- Unemployment rate (%)	8.4	8.9	8.8
UK Economy			
- GDP growth	1.7	2.0	2.9
- Inflation (HCPI)	1.3	1.4	1.6
- Unemployment rate (%)	3.1	3.1	3.0

Chapter

2

THE INTERNATIONAL OUTLOOK

Uncertainty is fading away

The geopolitical uncertainty, which has gripped the world economy since the late summer of 2002, faded considerably as the war in Iraq came to an end. This helped oil prices fall, albeit briefly, and a worldwide recovery in share prices, after a downward price correction which lasted for more than two years. In that context, the growth of the world economy and international trade were expected to improve slightly during the second half of 2003, followed by a somewhat more dynamic recovery next year.

Surprising global growth in 2003Q3

The world economy, however, bounced back faster than expected in the third quarter of 2003, with all parts of the world sharing in recovery to a certain extent. During this quarter, global activity may even have grown at its fastest pace for the last two decades. A large part of this rebound came from Asian emerging economies, and more particularly from China – now a second powerful engine providing growth alongside the United States. Several South-East Asian economies also showed vigorous growth rates, confirming their recovery, even if part of this reflects the aftermath of the weakness registered during the previous quarter when economic activity was depressed by the impact of the SARS. The staggering rebound of the US economy and the strong growth in Japan also contributed in a major fashion to this world revival. And at the lower end of the scale, the euro area registered moderate, but positive GDP growth.

The US and Asia are leading the way

Table 1.1: Exogenous and international variables

(*percentage changes unless otherwise indicated*)

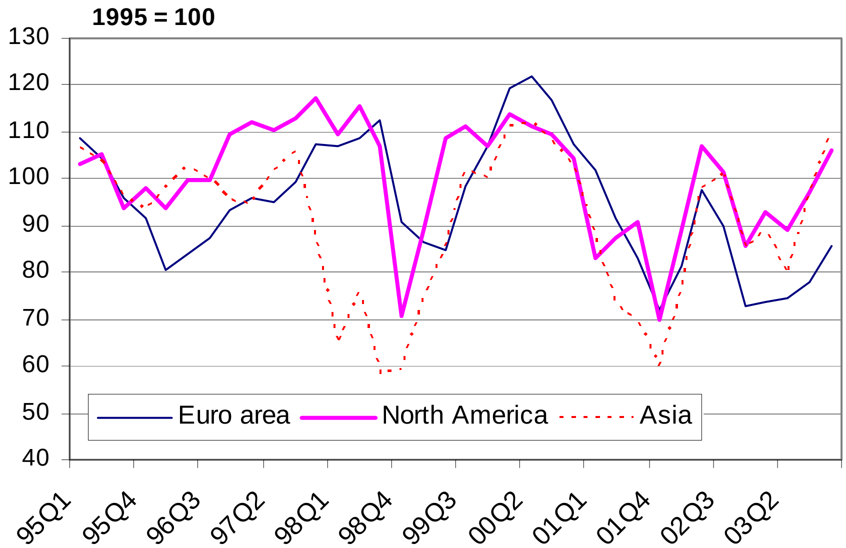
	2001	2002	2003	2004
World trade	*-0.1*	3.2	3.75	7.5
United States				
GDP	0.3	2.4	3.0	4.0
3m interest rates	3.7	1.6	1.0	1.5
10y Gvt bond yield	5.0	4.6	4.0	5.0
Japan				
GDP	0.4	0.2	2.4	1.8
3m interest rates	0.1	0.1	0.0	0.0
10y Gvt bond yield	1.3	1.3	1.1	1.4
US dollar/euro	0.90	0.94	1.13	1.20
Yen/US dollar	121.5	125.2	116.0	107.0
Oil price, US$/barrel	24.4	25.0	28.7	26.0
Percentage changes	-14.7	+2.5	+15.0	-9.4

Sources: IMF, OECD, EUREN forecasts for 2003 and 2004.

World trade should gain strength in the coming quarters

A widespread improvement in the world economic climate occurred in recent months. Both the assessment of the global current economic situation as well as world economic prospects are now on a rising trend. Hence, most regions are expected to achieve stronger economic growth in 2004 than in 2003. World trade of goods is expected to gain pace in the coming quarters and to grow by around 7.5% next year after 3.75% in 2003.

Chart 2.1: Economic climate by regions



Source: IFO; WES survey

Since our last report, most of the factors that held back global growth have faded.

i) Equity prices on most stock markets are still on a rising trend, reflecting an improvement in actual earnings as well as strengthened market expectations.

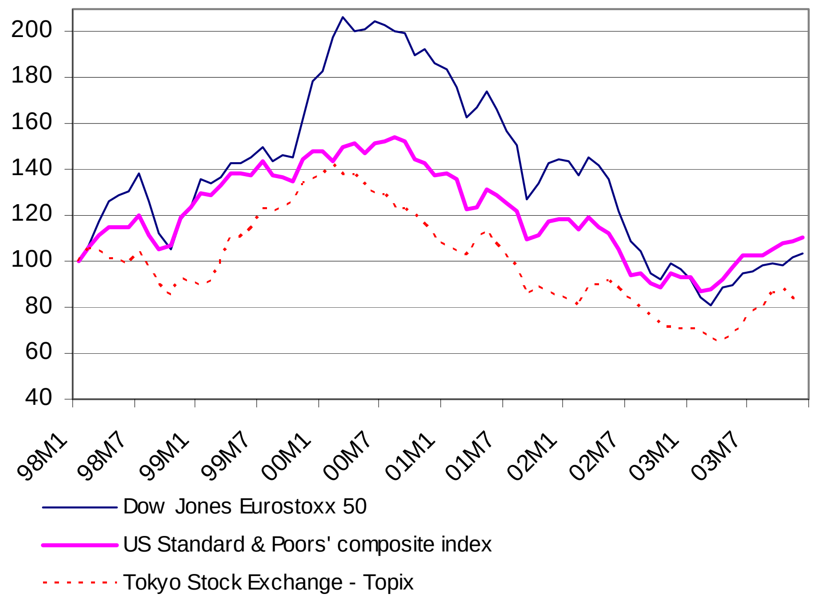
ii) Firms restructuring is going on (though more rapidly in the US than in Japan and the euro area), profits are rising, credit crunch and deflation risks are fading away and corporate spreads are receding.

A corporate-led recovery

iii) Business confidence is improving, confirming the view that this recovery is corporate rather than consumer-led (as unemployment rates remain high in many parts of the world) and is gaining ground, at least in the US and in Japan.

Chart 2.2: Equity prices

Monthly averages, 98M1= 100



Source: ECB, Standard & Poors

New developments have emerged in recent months.

Higher oil prices and tighter monetary conditions

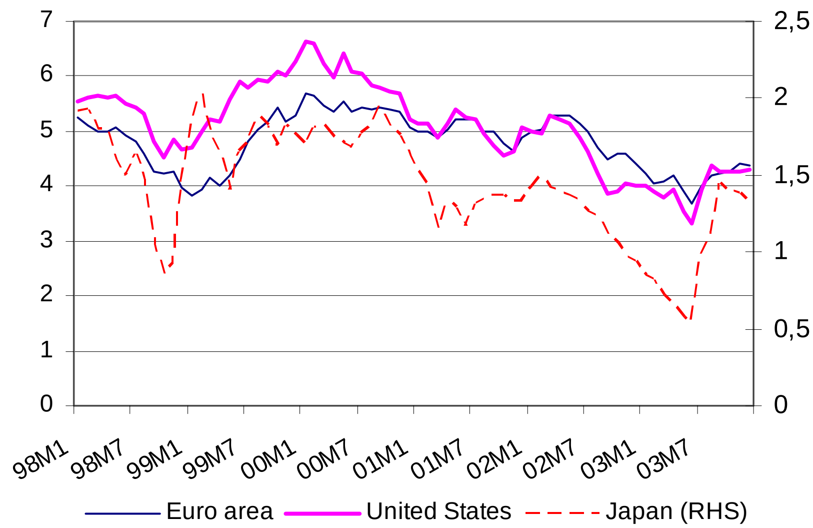
i) Oil prices remain higher and more volatile in recent months than anticipated in the summer, since Iraqi production is taking more time to regain full speed and because OPEC cut its production quotas last September. However, crude oil prices should decrease from around 28.7 US dollar per barrel on average in 2003 to 26 US dollar next year.

ii) The dynamism of the Chinese economy led to a surge in raw material prices in 2003, but pressure on headline inflation rates remains restrained in most industrialised countries.

iii) Long-term interest rates have recently moved up in the US, the euro area and even in Japan, reflecting better economic prospects, portfolio reallocations but also the deterioration in public finances. Even if long-term interest rates are probably going to be higher in 2004 than expected in our last report, they should however not be a drag on the recovery.

iv) As a result of their recent appreciation against the dollar, the euro and the yen will be more expensive next year than anticipated in the previous report (1.20 against 1.15 dollar/euro and 107 against 120 Yen/dollar).

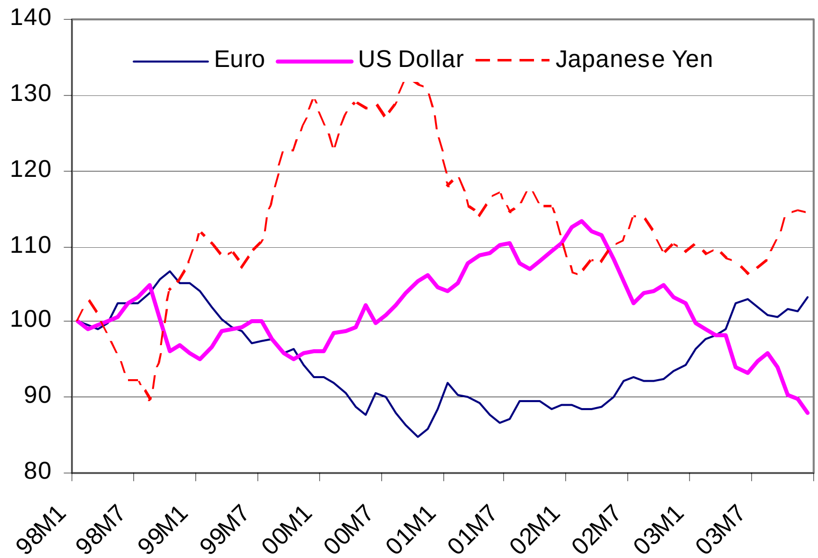
Chart 2.3: Long-term interest rates



Source: Datastream

Chart 2.4: Nominal effective exchange rates

Monthly averages of trade weighted indices, 1998M1=100



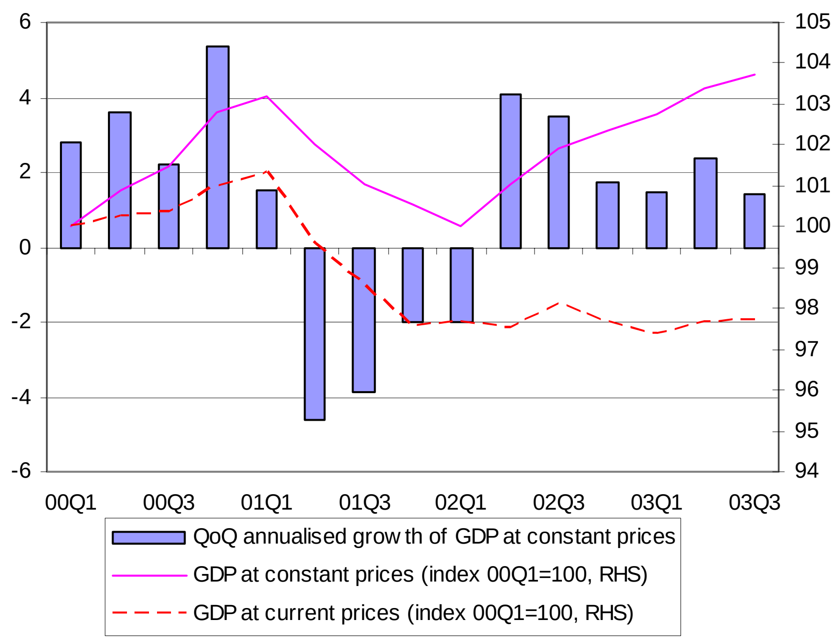
Source: Bank of England

Japan

Japanese growth stronger than expected

In the first half of 2003, the Japanese economy recorded a stronger cyclical recovery than anticipated six months ago, with activity supported by favourable developments in East Asian countries and by some revival in domestic demand, particularly as we outline below, business investment. In 2003Q3, real GDP grew for the sixth consecutive quarter. In nominal terms, however, GDP hardly increased in 2003Q3 since the GDP deflator growth rate remained negative.

Chart 2.5: Real and nominal Japanese GDP



Source: Economic and Social Research Institute

Investment surge fuelled by profits rise

The main driving force behind economic growth in the last quarters has been real business investment. Part of the rebound in real investment is, however, explained by the large decline in the deflator thanks to the hedonic pricing of capital expenditures that takes into account quality improvements. Nevertheless, even if corrected for this statistical issue, the cyclical investment recovery is gaining strength. The restoration of profits, especially in the manufacturing sector, has been the key to this investment rebound and also explains the surge of Japanese equity prices since the end of April.

Even if the contribution of net exports to growth remained limited, though positive in the three last quarters, exports play an important role in the current recovery. Indeed, from the middle of 2003 on, Japanese exports are again on a rising trend, and their pace has accelerated in 2003Q3, sustained by the dynamism of the Chinese economy. This is, however, mainly true in volume terms and contributes to the improvement of firms' profits. But at the same time, and offsetting this to an extent, Japanese export prices are decreasing - exporters have to squeeze their profit margins in the Asian and US markets in order to counteract the appreciation of the yen.

Exports stimulated by China

During the last six months, most of the additional external demand came from Asian countries. These exports largely consist of high-tech components (electronic parts and devices) and reflect the segmentation of manufacturing activities in this region. As Japanese exports to China[1] have increased by around 30% since mid 2002 (due to outsourcing activities), China has become the second largest export market for Japan behind the US, although the latter remains the main market for Japanese exporters, in particular because of demand for high value added compiled products.

Private consumption on the low side

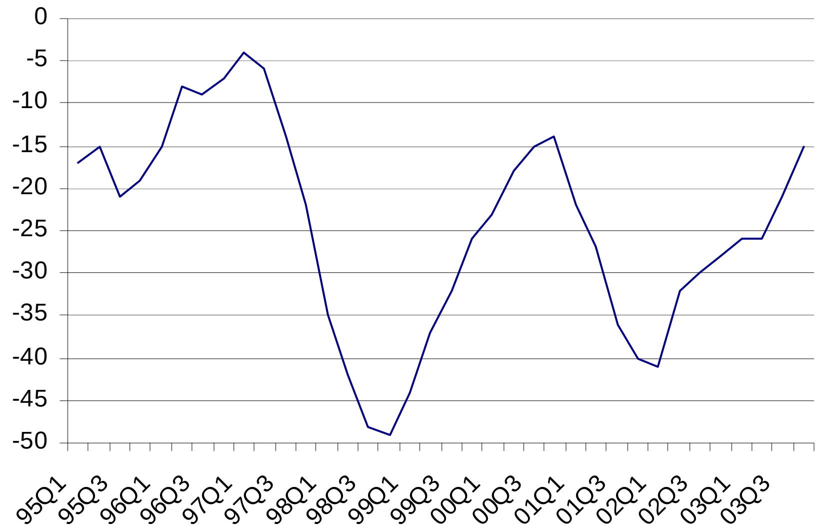
Up to now, improvement in Japanese firms' profitability has been realised through cost cutting and at the expense of wages and employment. Consequently, household disposable income hardly improved in 2003Q3 and private consumption decreased slightly in real terms and even more in nominal terms (reflecting the decline in consumer prices).

Recent surveys point to a widespread increase in business confidence during the last six months, associated with an improved assessment of capacity utilisation rates and stock levels. This greater confidence of firms led to a modest improvement in the labour market. The unemployment rate has slightly fallen (the unemployment rate was 5.2% in October against 5.5% in January) and employment has risen somewhat in the service sector while employment in the manufacturing and construction sectors is still falling. Since households decreased their saving rates in 2000-2002 in order to compensate for the decline in their

[1] The first Special Study in Chapter 4 is devoted to the emergence of the Chinese economy.

incomes they could take advantage of the recovery to restore their savings.

Chart 2.6: Business conditions- Tankan survey



Source: Bank of Japan

GDP growth dampened by the strength of the yen

As economic growth during the three first quarters of 2003 was stronger than expected, yearly average forecasts for the Japanese economy in 2003-2004 have been revised upward since our summer forecasts. Real GDP growth should be around 2.4% in 2003 and 1.8% next year (compared to respectively 1.0% and 1.3% in our July report).

This yearly deceleration reflects the fact that the ongoing recovery should remain moderate. Business investment is not expected to grow at the same pace in 2004 as in 2003 since profits growth should slow down next year. Moreover, despite the expected acceleration in US imports, Japanese exports could be held back by the yen appreciation.

Though domestic demand seems to be more resilient than six months ago, and the impact of the appreciation of the effective exchange rate of the yen since mid-September on business confidence appears to be very modest so far, a further appreciation of the yen against the US dollar might threaten the recovery of the Japanese economy. The Bank of Japan is well aware of this risk and has made several interventions on financial markets in order to hinder a further appreciation of the yen.

Monetary policy has no scope to further reduce short-term interest rates but has attempted reflation of the Japanese economy by making more liquidity available to commercial banks and also by lending directly to small and medium-sized companies. It is expected that the Bank of Japan will pursue this "quantitative easing policy" until deflation is overcome. In order to reduce the large public imbalances, the government has already planned to broaden the income tax and value-added tax bases in 2004, but social expenditures linked to the ageing of the population should rise.

Structural problems set to persist

This cyclical recovery is more than welcome but not sufficient to solve the huge structural economic problems. Balance sheet problems, exacerbated by the ongoing deflation (even if receding) still persist. The largest banks have already benefited from the measures taken to clean up their balance sheets, but these actions should be extended to the less-well monitored financial institutions. The Japanese public debt is now well above 150% of GDP and will require major adjustments in the medium term.

United States

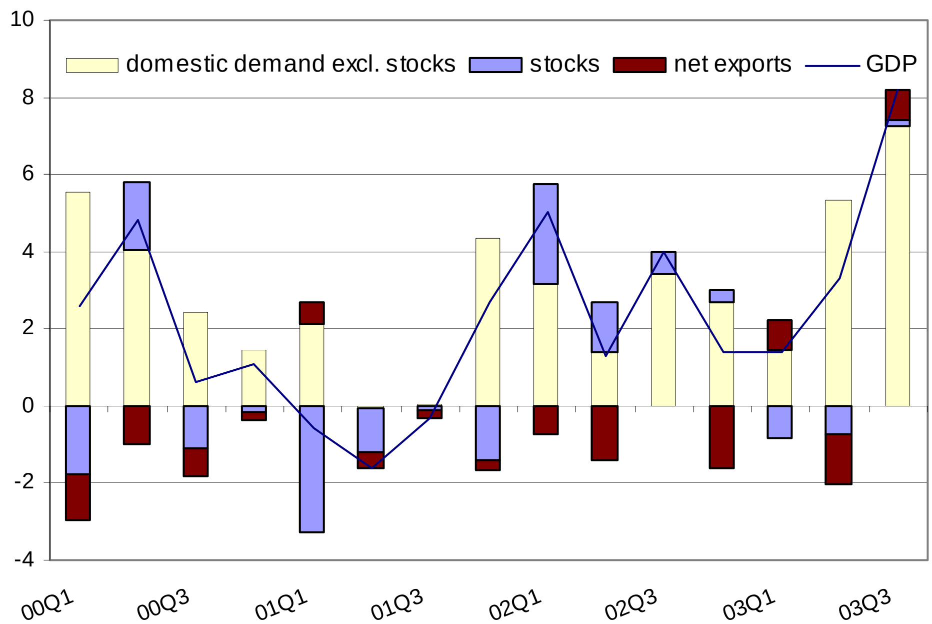
After a modest increase at the beginning of 2003, economic activity in the US accelerated in 2003Q2. The main contributors to this pick up were private consumption and federal defence spending, both GDP components stimulated by expansionary economic policies. The improvement in private non-residential investment in Q2 also brought signs of a change for the better.

Sharp rebound in 2003Q3

Subsequently, in 2003Q3, the United States experienced the fastest economic growth for the last two decades with an annualised GDP growth rate of 8.2%. This vigorous GDP growth largely reflects two years of unprecedented monetary and fiscal policy impulses.

Indeed, during 2003Q3, the massive contribution from private consumption spending towards GDP growth mainly came from additional tax cuts granted during the summer, such as advance childcare credit refunds. These tax cuts have reinforced the impulses arising from the refinancing of mortgage credits. Residential investment soared by nearly 23% in this quarter (annualised q/q growth rate), and, despite the rise in long-term interest rates, housing starts rose by 2.9% in October to their highest level since 1986.

Chart 2.7: United States: decomposition of quarterly GDP at constant prices
(seasonally adjusted, q/q changes in % at annual rates)



Source: Bureau of Economic Analysis

Surging investment in equipment

However, the business sector also supported economic activity in 2003Q3. Real business investment surged by 14% (annualised q/q growth rate). This is the result of a dynamic revival in investment in equipment while investment in building remained flat - the latter usually reacts with some delay during an economic upswing. As in Japan, the hedonic pricing of capital expenditures probably influences measured real US investment growth. Nevertheless, even if somewhat overestimated, the rebound in business investment is significant and mainly comes from replacement needs in computers and peripheral equipment (high-tech equipment with a shorter life expectancy). This rebound has been stimulated by a further improvement in firms' financial situation and the very strong rise of corporate profits. Post tax profits rose by more than 10% in 2003Q3 at an annualised rate, the strongest growth for about 10 years.

The US recovery is on track

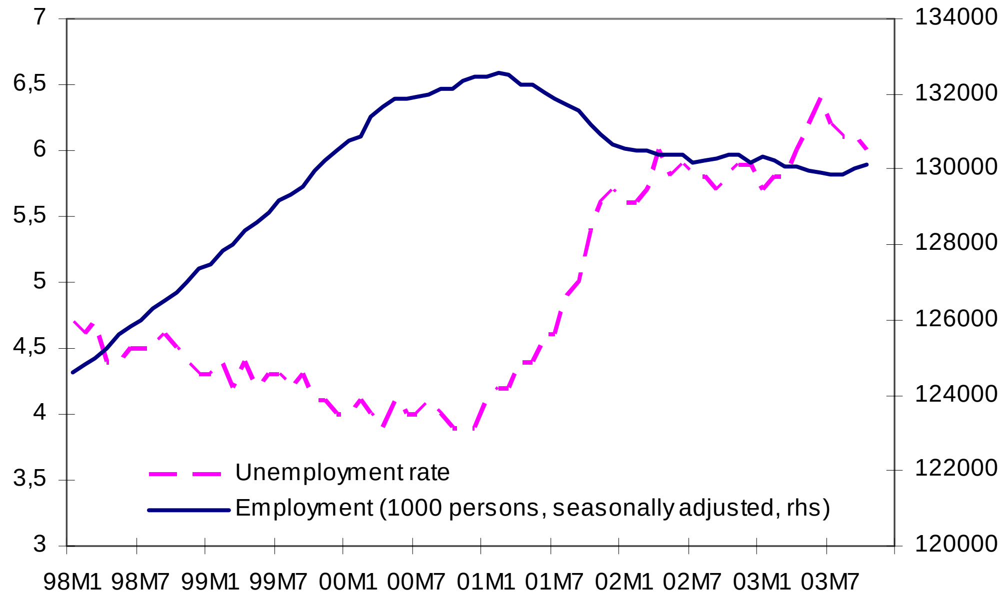
The US recovery really seems to be on track.

i) Though households' confidence remained hesitant for some months after the end of the war in Iraq, confidence jumped in November to its highest rate for one year. This jump is probably linked to growing optimism in the labour market as the Conference Board survey reports that the number of people considering jobs as hard to get is diminishing. Net employment indeed rose in the August-November period by around 328.000 jobs finally bring to an end a period where falls in employment were almost uninterrupted since March 2001.

ii) The moderate rise in hourly wages in the non-farm private sector in the last two quarters is more than compensated by the vigorous increase in productivity (in 2003Q3, productivity soared to 9.4%, its highest quarterly annualised growth in twenty years). The consecutive decrease in unit labour costs contributes to the improvement in firms' margins and should reinforce the investment surge.

iii) Most US business leading indicators have been on an upward trend for several months and the stock-sales ratio has fallen to historical lows. In 2003Q3 stocks were reduced less heavily than in the previous quarter, resulting in a positive contribution of stockbuilding towards economic growth. The rise in non-defence capital goods orders in September and October suggests that the recent pick-up in business investment will continue.

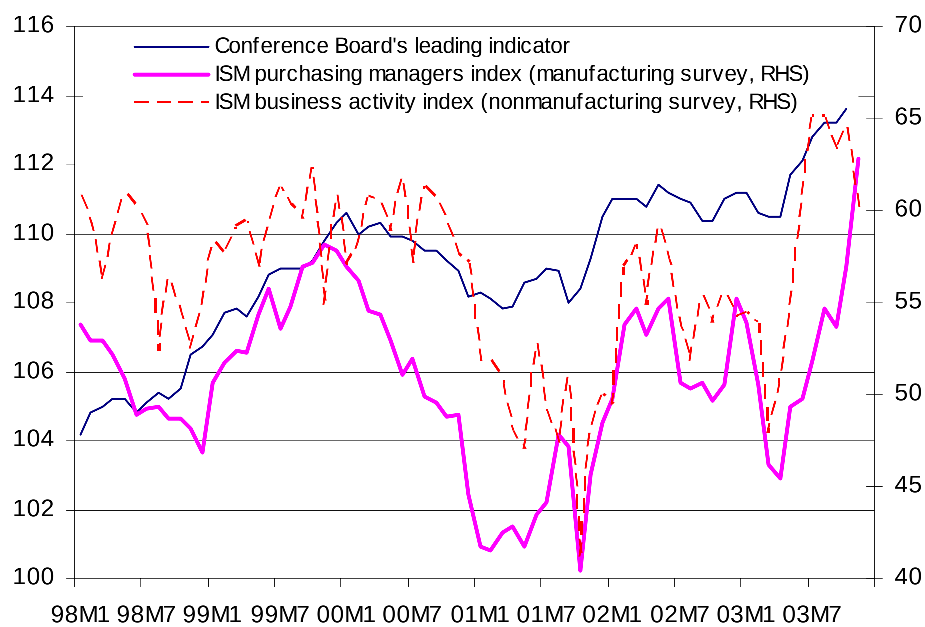
Chart 2.8 Labour market situation



Source: Eurostat, Bureau of Labor Statistics

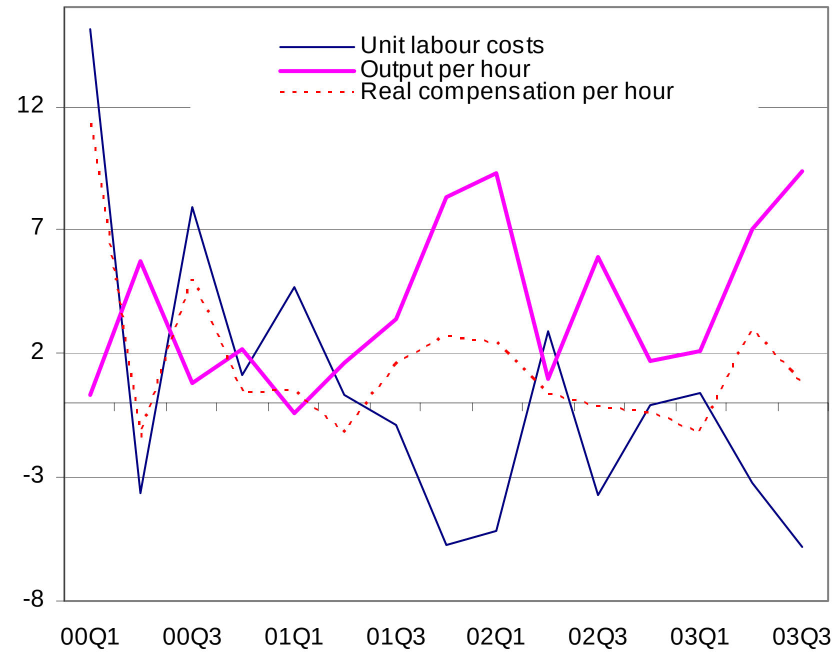
Chart 2.9 Business indicators

Seasonally adjusted indices



Source: Conference Board, Institute for Supply Management

Chart 2.10 Labour costs and productivity
qoq annualised growth rates



Source: Bureau of Labor Statistics

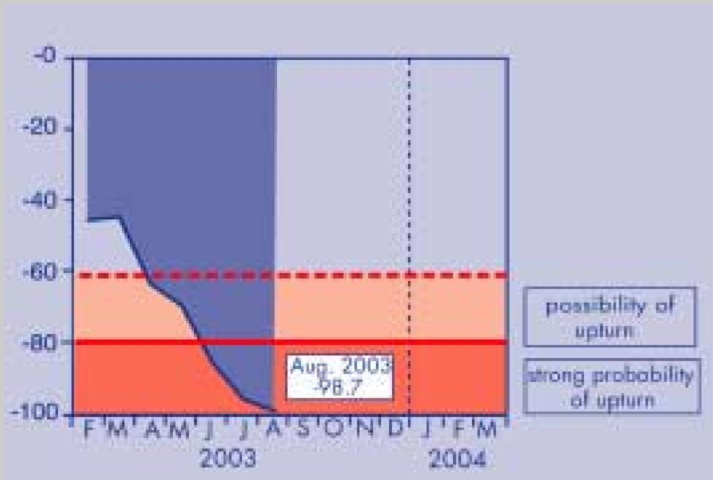
Box 2.1: The COE leading indicators for the United States

Last July, the COE leading indicator for the United States (chart B-2.1.1) passed through the –80 threshold and remained persistently below in the following three months, giving a clear signal of an economic upturn. As anticipated, the slowdown of the American economy registered at the beginning of 2003 proved therefore to have been only temporary and just a blip in the recovery that started in December 2001.

The second indicator (chart B-2.1.2) is used to anticipate the next economic downturn. At 18.6 in October, this indicator is far away from the first threshold of 60. Based on the current available information, there is not even a slight chance for an economic downturn in the coming nine months

Chart B-2.1.1

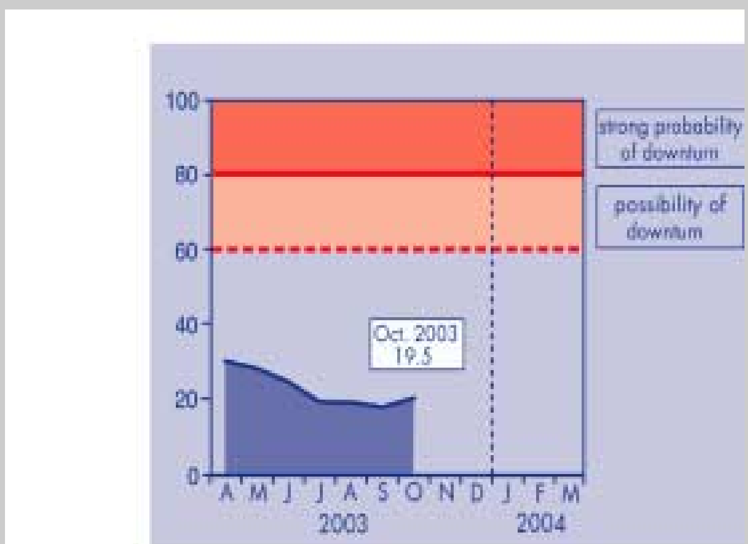
Growth cycle leading indicator:
Search for the next peak



Source: COE

Chart B-2.1.2

Growth cycle leading indicator:
Search for the next trough



Source: COE

Growth should moderate from 2003Q4 onwards

However, the pace of growth of the US economy is expected to moderate significantly from 2003Q4 onwards. Given the large positive carry over from the end of 2003, US GDP growth in yearly average terms is expected to accelerate from 3% in 2003 to around 4% next year, compared to our summer forecasts of 2% and 2.9% respectively.

A tricky task for the Fed

The conduct of US monetary policy in the coming quarters will be very tricky. On the one hand, some tightening of US interest rates might be prudent in order to slow down domestic demand, thus avoiding an increase in the level of indebtedness of the private sector. On the other hand, the sensitivity of the residential and labour markets to any change in the monetary policy stance calls for a cautious management in terms of timing and speed. As inflation remains under control and the output gap is still negative, the Federal Reserve will most probably keep its federal funds rate unchanged until the improvement in the labour market proves to be robust. This could progressively be the case from spring 2004 onwards. Under the assumption that fed funds rate reaches around 2% at the end of next year, the yearly average is projected at 1.5% in 2004 (as compared to less than 1% at the end of the year and 1% in average in 2003).

With the US structural public deficit coming close to 5% of GDP and the fact that States and local expenditures account for about two third of total public expenditures and that they have the obligation to reach balance at the end of their fiscal cycle, the room for a further increase in public spending next year is extremely limited.

Less stimuli for private consumption

Private consumption is expected to decelerate significantly in 2003Q4. The fact the impact effect of the tax cut is fading has already proved a drag on real household disposable income in September and October 2003. Though car sales had been one of the most vigorous components of consumer spending during the third quarter of 2003, the reported decrease in car sales and weekly chain store sales in October support the view that consumer spending will be considerably weaker in the three last months of 2003. However, this year’s tax cuts should still boost disposable income till spring 2004 and compensate for the expected deceleration of mortgage refinancing operations. But, fears of a tightening in fiscal policy in the aftermath of the November elections could imply an increase in the households' savings rate in 2004. Moreover, given the growth of the labour force, the current pace of job creation is encouraging but not ample enough to seriously curb the unemployment rate.

Real net exports are unlikely to support growth again in 2003Q4 as they did in the third quarter. Indeed, even if US export growth is sustained by the recovery of the rest of the world and by the depreciation of the effective exchange rate of the US dollar, the strength of domestic demand (mainly gross capital formation and stockbuilding) will actually reinforce US imports.

Chapter 3

The Outlook in Europe

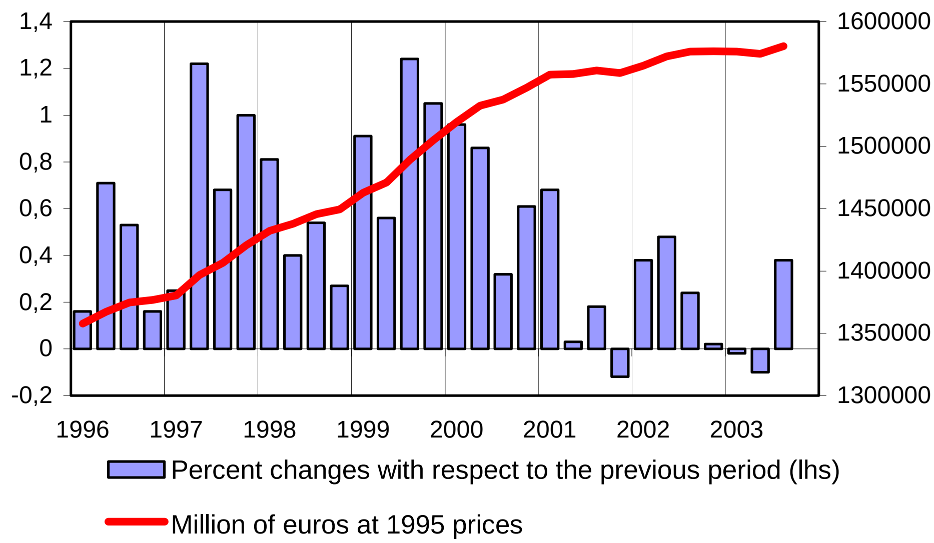
Part I – Recent developments in the euro area economy

Economic activity

GDP increased in 2003Q3

According to the Eurostat preliminary estimate, GDP grew by 0.4% in 2003Q3 compared to the previous quarter (Chart 3.1), following two periods of stagnation. This would suggest, therefore, that the expected recovery in economic activity has already started. The situation is, however, still rather uncertain and doubts remain about the sustainability of the current recovery. It is useful to recall that in the first half of 2002, economic activity had already showed some signs of strengthening, but the hopes for a recovery were premature then. In fact, as it is addressed in the world economy chapter, the strong appreciation of the euro, the beginning of the Iraq crisis, and the deceleration in world trade, which took place between the end of 2002 and the beginning of 2003, combined to stifle the first sign of economic awakening.

Chart 3.1: GDP in the euro area



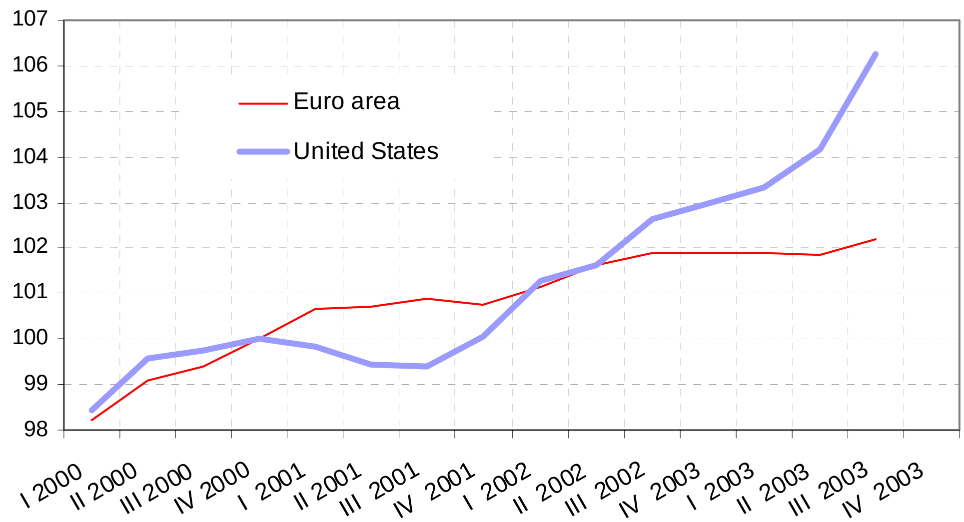
Source: Eurostat

Exports have headed upwards in 2003Q3

Looking at the sources of economic growth, the contrast with the United States is notable (Chart 3.2). In the US, the rebound from the recession in 2001 was exclusively borne by domestic demand, while almost nothing was owed to the external sector. Public and private consumption have been the driving forces in the beginning, whilst investment regained momentum in the recent quarters. The current recovery in the euro area has, instead, been primed by foreign demand. In fact, after the shrinkage suffered in the first half of 2003, exports of goods and services have headed upwards again in the third quarter. Thus, the growth in demand from the rest of the world seems to be sufficiently strong to overcome the negative impact of the euro appreciation.

Chart 3.2 - US and euro area GDP

(seasonally adjusted data; IV quarter 2000=100)



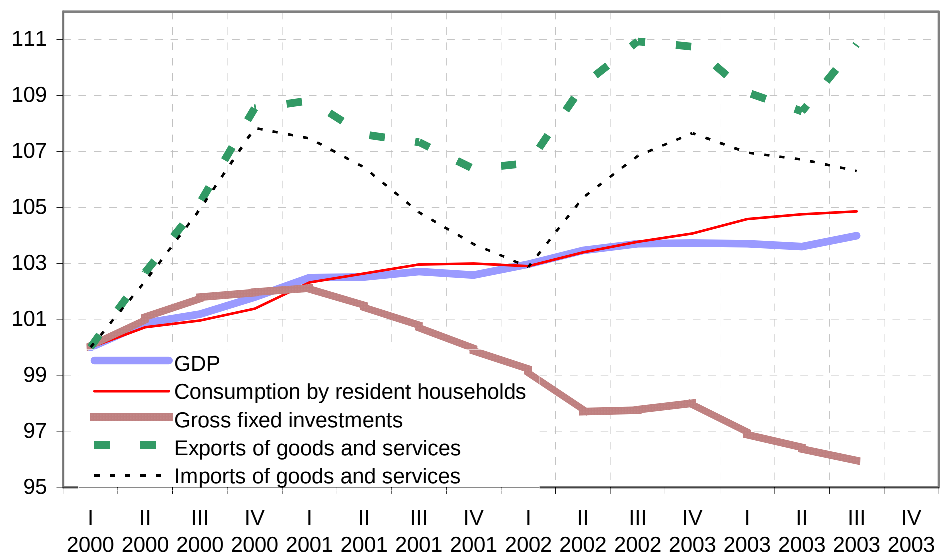
Source: CSC calculations based on Eurostat data

Investment recovery is still delayed and consumers remain cautious

Investment, the other demand component needed to provide the necessary fuel to economic growth, appears to still be stumbling (Chart 3.3). Despite recent positive developments in financial and equity markets, investment recovery has been further delayed by the lasting effects of past corporate scandals and the equity market bubble which created difficulties for some euro area banks with consequent negative knock-on effects on business loans. The presence of significant unused production capacity and uncertainty regarding the economic recovery all contributed to postponement of investment spending. Household consumption continues to provide no contribution to growth. A long-lasting lack of confidence, a perceived rate of inflation much higher than that officially measured, decreasing employment rates in most countries and uncertainties raised by announced social reforms are the main causes behind a still cautious consumer attitude.

Chart 3.3 - GDP and its components in the euro area

(seasonally adjusted data; I quarter 2000=100)



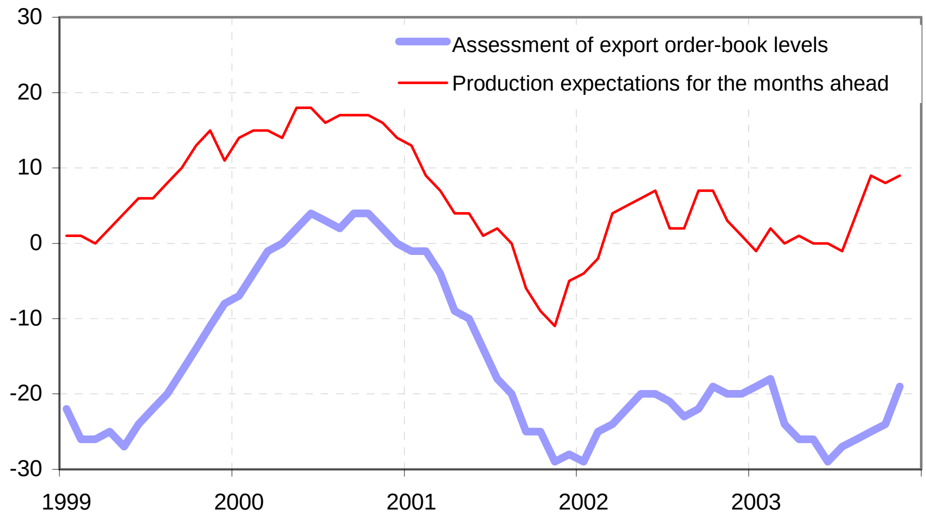
Source: CSC calculations based on Eurostat data

Business confidence is improving

Recent surveys however indicate improvements in confidence among manufacturing (Chart 3.4) and service sector firms (Chart 3.5). The view on trends in foreign order books expressed by those interviewed are also providing some positive signals: after the dip reached in the month of June, this indicator has begun, in fact, to improve again in recent months (Chart 3.4). It seems, therefore, that the positive effects of world demand recovery, which was neutralised by the euro's strength in the first half of 2003, but which helped to pull the economy out of the slump in the third quarter, will continue to stimulate euro area growth in 2003Q4 as well.

Chart 3.4 - Euro area: Survey of manufacturing industry

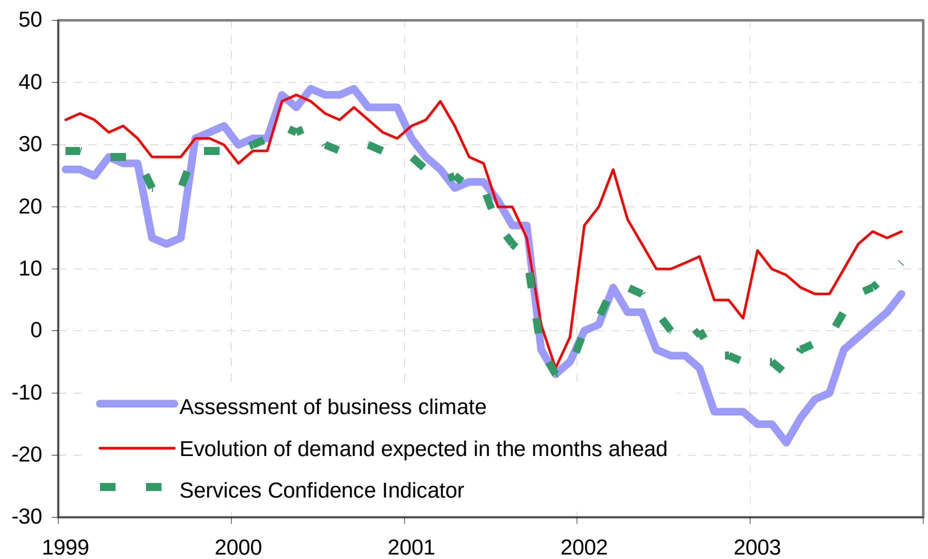
(Seasonally adjusted balances)



Source: Eurostat

Chart 3.5 - Euro area: Survey of services

(Seasonally adjusted balances)



Source: Eurostat

All indicators of economic expectations improved significantly over recent months. The ZEW's indicator, which asks for the expectations over the next 6 months, jumped to 78.1 in December, which is close to the all time high in early 2000. However, indicators giving an assessment of the economic current situation just started to improve.

The Belgian leading indicator, based on the Belgian central bank survey of manufacturing, construction and retailing sectors, continued to improve in November. The indicator rose to a twelve-month high of –7.9 in November, from a –9.4 in October and a ten-year low of – 21.5 in June. Thanks to Belgium's tight business and trade links with the rest of the region, the indicator is considered a proxy for the euro area outlook as a whole (see box 3.1). The indicator is highly negative at the depth of a recession and slightly positive at the top of the cycle.

Box 3.1 The NBB business cycle indicator

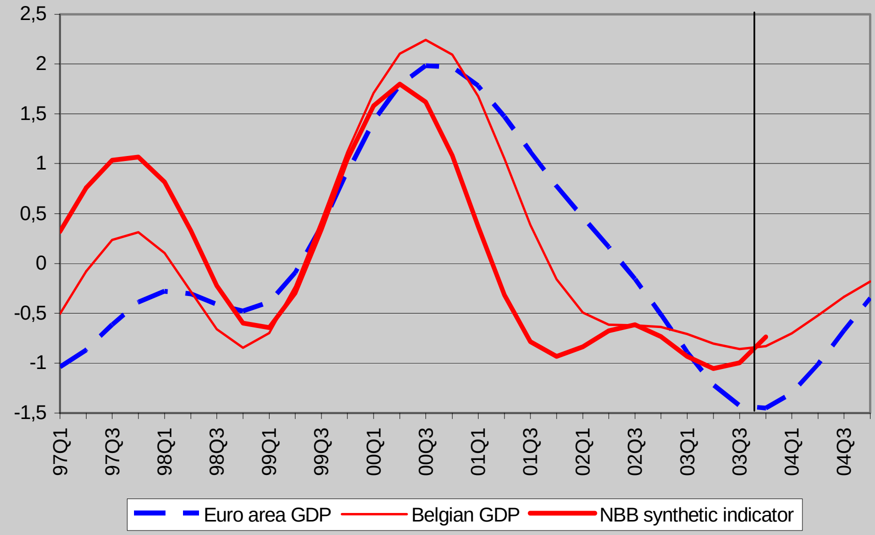
It was shown in a previous Euren report that the Belgian business cycle and the business survey indicator of the National Bank of Belgium (NBB) can be considered as leading indicators of the euro area GDP cycle[2]. On average, in the period 1980-2001, turning points in the first two series occurred respectively one and two quarters earlier than those in euro area business cycle.

In the Euren 2003 Summer Report, it was foreseen that the euro area economy would bottom out during the second half of 2003, which would then be followed by an upturn in 2004. At that time there were not many business cycle indicators confirming this scenario, but it was said that the declining geopolitical uncertainties would stimulate economic growth. Since then, however, most indicators have significantly improved this is also the case for the NBB business cycle indicator. In June the indicator reached its lowest level since 1993, but has rebounded markedly since thanks to a more optimistic expectations and a moderate improvement of the current situation assessment.

These developments are also reflected in the cyclical component of the NBB synthetic indicator. This reached a trough in the second quarter of 2003 and now provides stronger signs of an upswing compared to the more cautious improvement of the indicator in the first quarters of 2002. Looking at the cyclical components of Belgian and euro area GDP, the trough of the euro area business cycle should be reached with a lag of two quarters vis-à-vis the NBB indicator and a lag of one quarter vis-à-vis the Belgian GDP cycle.

[2] A detailed analysis can be found in the Euren 2002 Spring Report, pp.65-70.

Chart 3.1.1 - Normalised cyclical components of euro area and Belgian GDP, and NBB business survey indicator



Source: Eurostat, Belgian Institute of National Accounts, National Bank of Belgium, Euren, Federal Planning Bureau

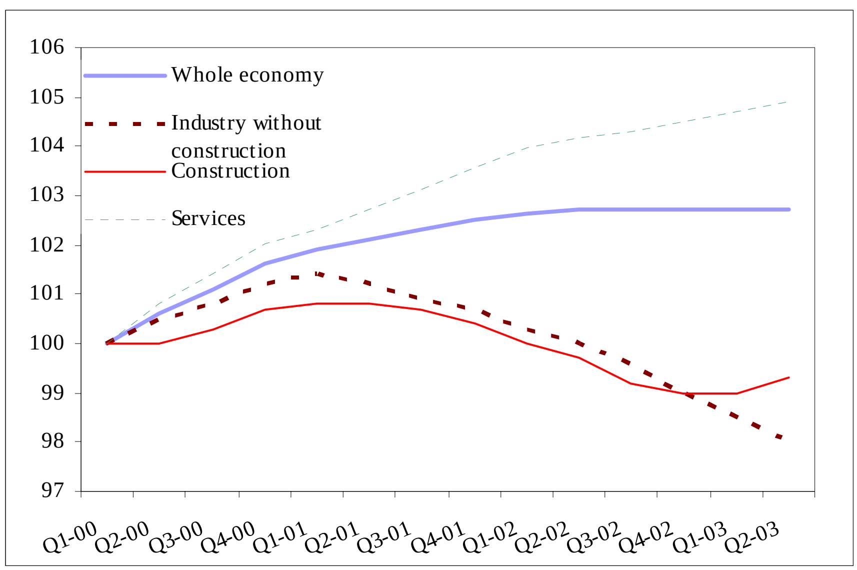
Finally, the OECD composite indicator for the euro area rose to 122.9 in September, up from 121.5 in August and 120.6 in July. September marked the fifth consecutive increase and the rate of improvement has continued to accelerate. Three successive rises in the indicator are normally considered to signify a turnaround in economic activity. Taken together, all these forward-looking indicators seem, therefore, to confirm that an upturn in activity is underway, driven by improved export performance and business confidence. Consumer confidence, by contrast, continues to remain rather subdued, as people are still worried about labour market conditions and uncertainty about incoming pension and welfare reforms.

Employment, unemployment and labour costs

Labour market still stagnant

On the whole, the European labour market continues to be stagnant. Disregarding seasonal factors, total employment growth remained flat in both the first and the second quarter of 2003 (Chart 3.6), while the rate of unemployment climbed from 8.7 to 8.8% between February and March, remaining unchanged at that level until October (the latest available data; Chart 3.7). A closer look at sectoral employment trends, however, shows that this is the result of a marked decline (-0.5% in both the first and the second quarter) in industry excluding construction, stability in the service sector (+0.2% in both the first and the second quarter) and a rebound in the construction sector, where employment began to pick up in the second quarter of 2003 (+0.3% with respect to the preceding quarter), after recording negative or zero rates of growth since the second quarter of 2001.

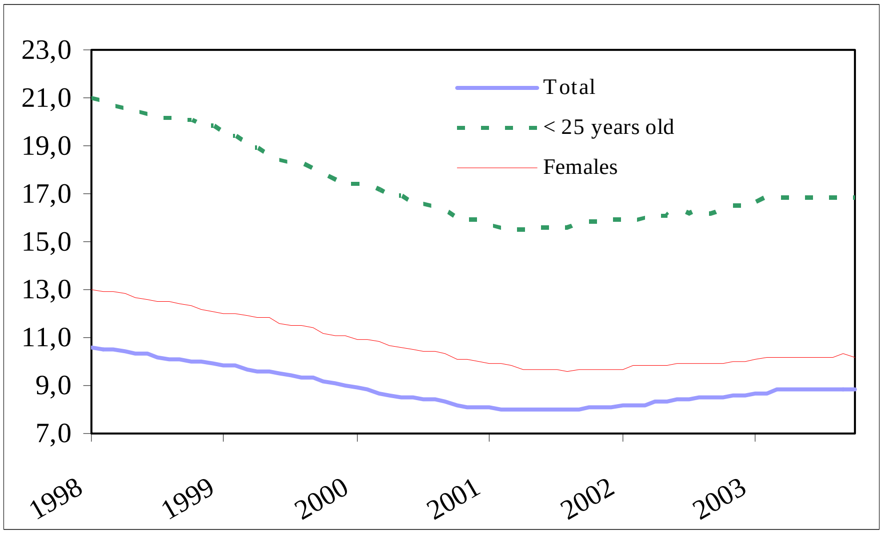
Chart 3.6 - Employment by economic sector in the euro area
(Quarter on quarter percentage change; indices:Q1-2000=100, s.a.)



Source: BCE

Chart 3.7 - Unemployment rate in the euro area

(Persons looking for a job in % of the labour force of the corresponding group; seasonally adjusted)



Source: Eurostat, Newcronos database

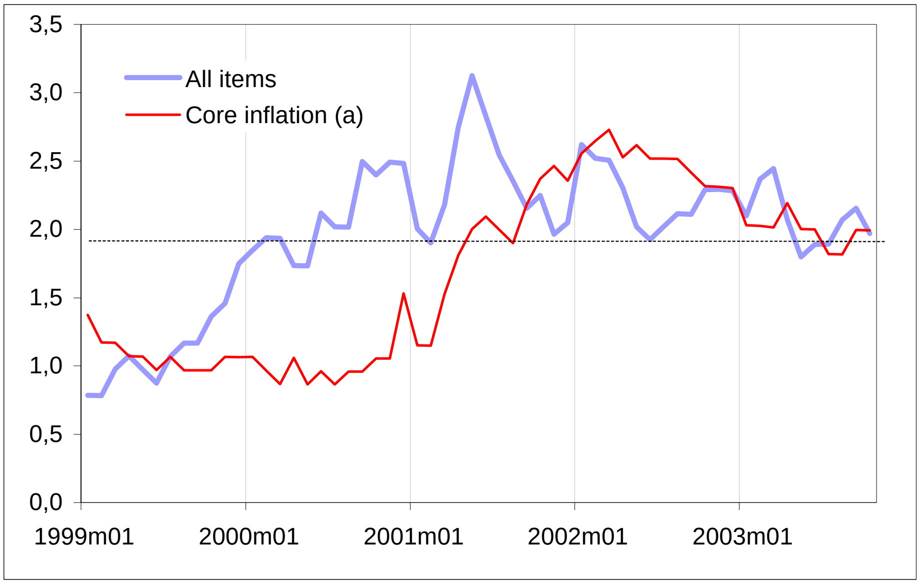
Price developments

Inflation close to the ECB threshold

Thanks to a temporary decline in Brent oil prices between the end of August and the first half of September, and to a renewed appreciation of the euro vis-à-vis the dollar, growth in energy prices dampened. This brought inflation back to 2.0% in October, exactly on the ECB reference threshold (tab. 3.1 and Chart 3.8). In these months, among the major countries of the area, inflation remained nearly stable in Germany and in Italy and headed upwards again in France (from 2.0% to 2.3%), while declining appreciably in Spain (from 3.1% to 2.7%).

Chart 3.8 – Inflation in the euro area

(12-month % changes)



(a) excluding energy and fresh food

Source: Eurostat

The October inflation figures reflect the stability in the underlying consumer price components: the gradual decline in core inflation which begun last year now appears complete, with the rate settling at 2.0% for the second consecutive month (Chart 3.8). In particular, price rises for services in the area continue to be moderate (their monthly increases constantly topped 3% last year) and stabilised at around 2.5% after having touched a low of 2.3% in July. At the same time, prices of non-energy industrial goods continued to remain decisively stable or are rising quite moderately (+0.8% the y-o-y variation in October).

The sharp reduction in consumer- perceived inflation recorded between February and June 2003 seems, however, to have come to a halt. In fact, during the last four months, consumers' perceptions have followed the same light fluctuations of measured inflation; in October expectations were little changed from those in June. Therefore, for now, the discrepancy with measured inflation (which had opened with the introduction of the euro in January 2002) has only partially narrowed. But perhaps, what counts the most is that the two measurements have started to move together again.

Table 3.1 – Euro area inflation
(Harmonized index, twelve-month % changes)

	Weight 2003	2002	2003				
		(a)	Jun	Jul	Aug	Sep	Oct
General index	100,0	2,2	1,9	1,9	2,1	2,2	2,0
Goods	59,1	1,7	1,6	1,7	1,7	1,8	1,7
Food, alcohol and tobacco	19,3	3,1	3,0	3,0	3,2	3,5	3,6
Processed food, alcohol and tobacco	11,7	3,1	3,2	3,1	3,0	3,0	3,6
Unprocessed food	7,6	3,0	2,6	2,8	3,3	4,3	3,9
Industrial goods	39,8	1,0	0,9	1,0	1,0	1,0	0,7
Non energy industrial goods	31,5	1,4	0,9	0,8	0,7	0,8	0,8
Energy	8,2	-0,6	1,6	2,0	2,7	1,6	0,8
Services	40,9	3,1	2,6	2,3	2,5	2,5	2,5
General index excl. unpr. food and energy	84,2	2,5	2,0	1,8	1,8	2,0	2,0

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

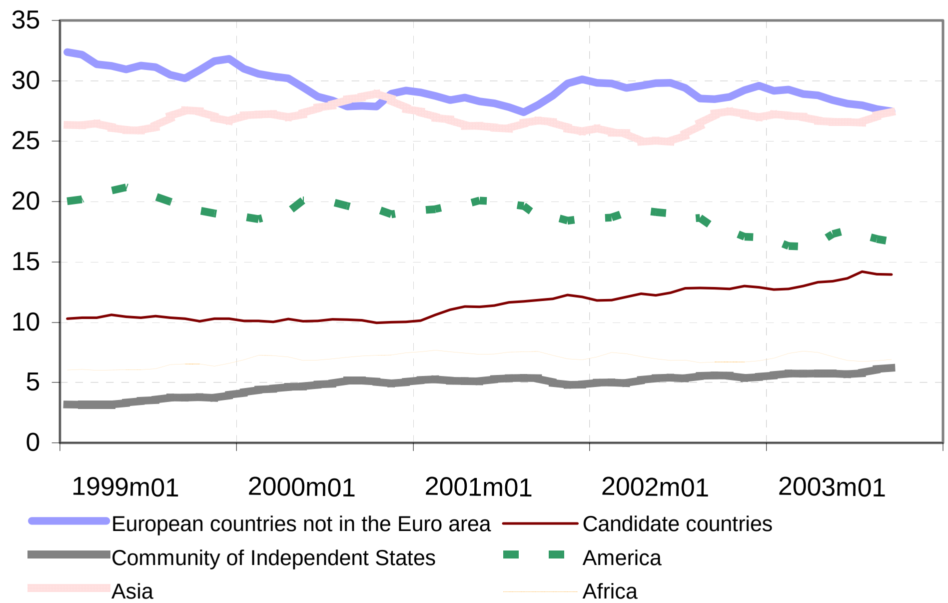
Market shares and the balance of payments

During the first nine months of 2003, the euro area's current account surplus shrank significantly against the level in the corresponding period of the preceding year (from €44 to €11.7 billion). Only the balance on services improved slightly. The deterioration occurred, in particular, in the merchandise trade surplus, which dropped from €96.2 to €80.3 billions and in net income from abroad.

The rise in imported quantities mainly reflects the increase in imports from China, Russia, Japan, Latin America and the EU acceding countries. By contrast, imports from the United Kingdom and the United States, the two countries with the highest market shares in the euro area, have strongly contracted. The recent developments in euro area's imports reflect a trend that has been underway since 1999. In fact, during this period, the euro area's share of American and non-euro European countries has gradually shrunk (Chart 3.9). In particular, in these two groups, the United Kingdom and the United States are the two countries that have suffered the greatest losses in market shares (Chart 3.10). The EU acceding countries, having by now attained almost 15% of the euro area export market (Chart 3.9) and China, which, after overtaking Japan, has become, since 2001, the third larger exporter to the euro area (Chart 3.10), have been able to significantly increase their market shares.

Chart 3.9 - Market shares in the euro area

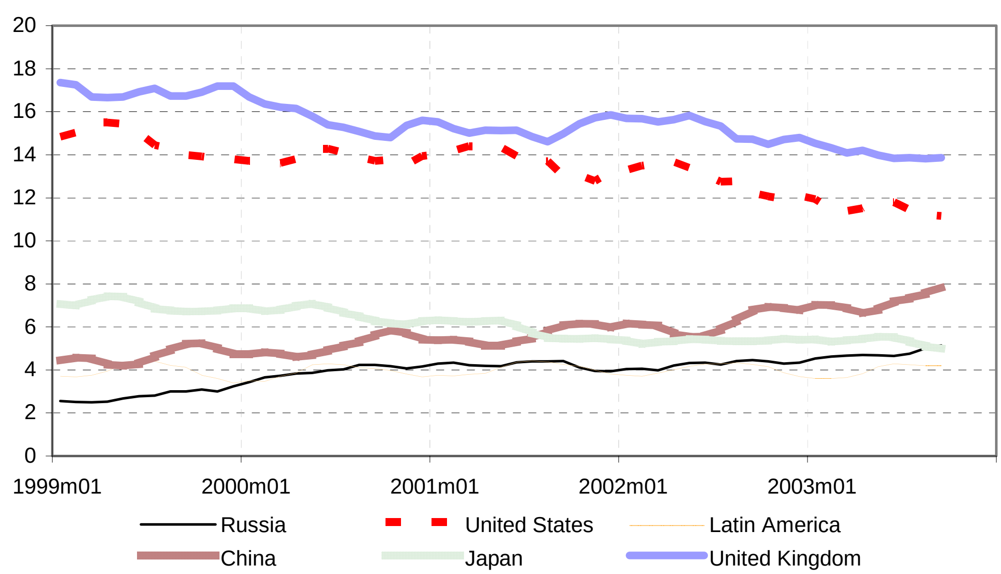
(Percentages of extra-euro area imports; three-month moving averages)



Source: Eurostat

Chart 3.10 - Market shares in the euro area

(Percentages of extra-euro area imports; three-month moving averages)



Source: Eurostat

During the first nine months of 2003 the area's financial account deficit, dropped to €89.3 billion from €48.7 billion in the same period in 2002. This result reflects to a large extent a heavy decline in portfolio investments. By contrast, the negative balance on direct investments improved (from –€35,4 to –€10.8 billion).

In a situation of great uncertainty, the tendency for domestic and foreign investors to expand their portfolio shares of liquid assets is continuing. The consistent portfolio investment outflows mirrored the rising attraction among the area's residents towards foreign monetary assets and bonds (from €109.5 to €169.5 billion). Non-resident inflows of this kind of investment have only slightly risen.

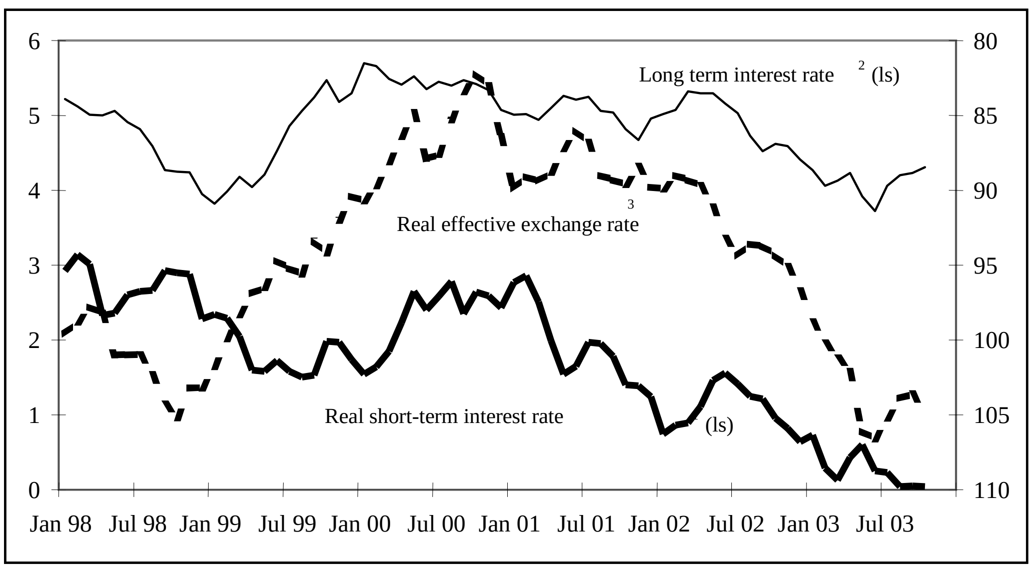
Part II - EUREN forecast for 2003 and 2004

a) Policy assumptions

Monetary Policy

After the rate cut in June the ECB kept its key interest rate unchanged. On the one hand, inflationary pressure eased. Since May, HICP increased at an annual rate around 2 %, which is in line with the ECB's definition of price stability. Furthermore, the survey among professional forecasters indicates that inflation is expected to stay below 2 % in 2004 as well as 2005. When measured by the real short term interest rate, which is close to zero now (Chart 3.11), monetary policy has an expansionary stance. However, monetary conditions have become tighter recently with the revaluation of the euro against the Dollar and rising capital market rates.

Chart 3.11: Monetary conditions in the euro area



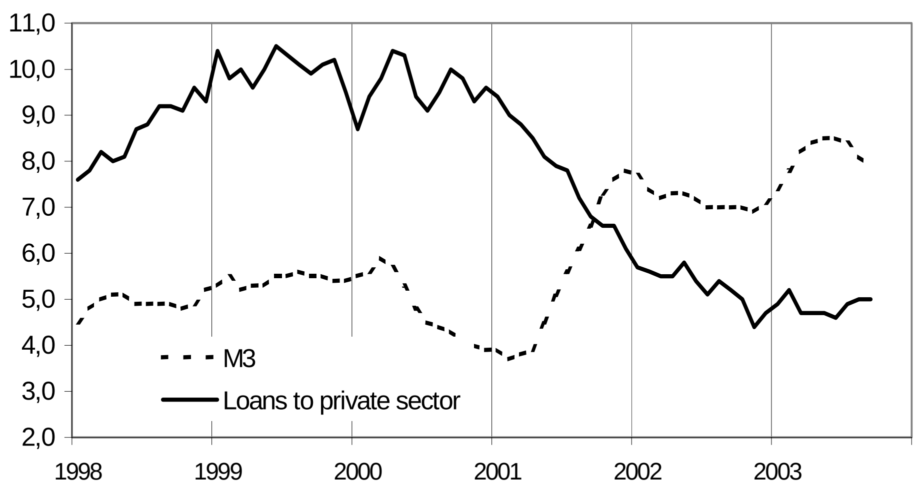
Source: ECB – 1Deflated with HICP. – 210 years government bond yields – 3CPI-Deflated, narrow group of countries. Scale inverted.

Also in the second half of 2003, M3 growth remained markedly above the reference value of the ECB, indicting that there still is ample liquidity. Most recently, the rates came down slightly to 8.0 (three month average August – October) from 8.5 in the middle of 2003. This gives some evidence that indeed portfolio shifts are the main explanation for the high

M3 rates in the past. As the share prices are increasing, M3 growth should come down further in the months to come. At the same time, loans to non-financial corporations and private households continued to grow moderately.

All in all, there is little reason for the ECB to change interest rates within our forecast period. This is at least true, as long as the current devaluation of the Dollar is a transient phenomenon. If exchange rate shifts will continue, however, the ECB should be ready to cut rates once more in the wake of the lower inflation which can be expected in this case.

Chart 3.12: Euro area – M3[1] and loans
yoy percentage change[1]



Source: ECB – 1M3: three months moving average.

Fiscal policy

Fiscal policy increasingly came under stress in 2003. Germany and France violated the Stability and Growth Pact (SGP) in the second year in a row and, on top, did not present a budget for 2004 in which the deficit was pushed below the 3 % of GDP threshold. Therefore, the European Commission initiated an excessive deficit procedure, but the European Council did not follow the Commission's recommendation. Hence, the EU will tolerate that the two countries violate the SGP once more, which damages the SGP, if it is not its end at all.

Despite of these difficulties, in a monetary union rules are needed to prevent excessive deficits. Abolishing the SGP would help little as long as no other agreement is at hand. However, it will be difficult to agree on a new pact. Therefore, interpreting the existing pact in a sensible way will be the only option in the short run. In their earlier reports, the EUREN institutes mentioned three recommendations to re-interpret the SGP, which are still valid:

- The yardstick of government fiscal balances should be the structural balance, which is not influenced by the business cycle. This idea has become part of the EU's understanding of the SGP in the meantime. However, the difficulties to fill it with life should not be underestimated. The size of the structural balance is strongly influenced by the estimate of potential output. If potential output is revised, also structural balances will change. Therefore, policy recommendations should take into account the uncertainties in measuring structural balances, too.
- The consolidation strategy should be symmetric. Concerning this point, the most important mistakes have been made in the past. In 1999 and 2000, when the business cycle conditions were favourable in the euro area, consolidation efforts were not strong enough, and also the European Commission did not put emphasis on reducing structural deficits, as the nominal deficits were below the 3 % threshold.
- The consolidation must be accountable, based on realistic assumptions about the economy. In the past, a the projected balanced budget often was reached by higher economic growth only, without presenting concrete proposals, which measures will be taken to reduce deficits.

If governments as well as the EU commission follow along these lines, fiscal consolidation could be made more reliable. Then, it also will be easier to accept a violation of the SGP in the short run.

Germany: Short term stimulus and structural reforms

Contrary to the expectations at the beginning of the year, the 2003 fiscal deficit increased in Germany. It is expected to reach 4% of GDP and thus will surpass the Maastricht criteria significantly. The worsening fiscal balance reflects above all the slowdown of the economy, leading to lower tax receipts than expected and additional spending mainly caused by higher unemployment. On the other hand, the government has refrained from taking measures to stimulate aggregate demand up to now. Taking the discretionay measures on both sides of the budget as a yardstick, the stance of fiscal policy was restrictive. This assessment contradicts the latest forecast by the European Commission, who see an increase in the cyclical adjusted deficit in 2003. However, the latter reflects a downward revision in trend output growth compared to the spring forecast, which therefore illustrates the problems in measuring the stance of fiscal policy.

Earlier, in Spring 2003, the government announced it would bring forward the third step of the income tax reform to 2004; this was originally scheduled for 2005. However, by early December no decision was made on this, as the *Bundesrat* didn't manage to pass the law by th etime of writing - currently it is under disussion in a mediation commission. Whatever the decision, the public deficit can be expected to stay above 3 % of GDP, and the stance of fiscal policy will be restrictive – somewhat less when the tax reform is brought forward, somewhat more if it takes place in 2005. The main policy problem policy, however, is the push for structural reforms. Some labour market reforms as well as a reform of the health insurance system were set in force in 2003. In other fields, e.g. improving the financial situation of communities, combining unemployment and welfare, the reforms are part of the ongoing mediation process. Turning to the issue of subsidies, which is important to give fiscal policy room of manouevre in the years to come, little progress has been made up to now.

France: Fiscal policy takes a restrictive stance

As in Germany, the present difficulties of the French government with the Stability Pact are mainly the result of weak activity. In 2003, the cyclical deficit should increase by around 0.8 % of GDP thanks to slow growth. Among others problems, deterioration of the labour market is expected to lead to an increase of unemployment benefits of about 20 %. On the other hand, discretionary measures like reducing the income tax for household and the *taxe professionnelle* for firms is only expected to lead to an increase of the structural deficit of 0.2 % of GDP. All in all, the public deficit should reach 4.1 % of GDP, after 3.1 % of GDP in 2002.

Although economic growth is expected to accelerate in 2004, it will be on average still below its potential. Therefore, the cyclical deficit should slightly increase once more. Contrary to the previous year, however, the structural deficit should not be affected by the planned tax cuts. On the one hand, the government will continue its policy to reduce income tax (and increasing the premium for new workers with low income, the so-called *prime à l'emploi*). On the other hand, taxes on gas and cigarettes, and social charges (financing unemployment benefits) will be raised and it is also planned to lower social paybacks on medicines or hospital expenses. All in all, the impact of fiscal policy on private households should be more or less neutral. However, the government has announced a decrease in the structural deficit by 0.7 % of GDP in 2004[3]. To reach this objective, a substantial slow-down of expenses is envisaged. Looking at the budgetary outlays, the objective is to stabilise them in real terms, which means a 1.5 % increase in nominal terms. However, expenditures in the field of justice, the interior security and defence will grow. Furthermore, the government promised that the budgets of education, culture and research would not be affected by this restrictive stance. Therefore, significant cuts in other budgets will be needed, an objective that seems to be difficult to achieve - it will be difficult to rein social expenses. In particular in the health care system, where expenses grew nearly 7 % in 2003, it will be difficult to achieve restraint. These doubts about the ability of the government to control expenses explain why the public deficit could be larger than that expected by the government. It could still be around 4 % of GDP in 2004.

Against this background, it's no wonder France has been in trouble with the European commission. Nevertheless, the excessive deficit procedure has been stopped for the time being, and the French government also successfully opposed to the Commission's request to reduce the structural deficit by 1 % of GDP in 2004. To reach this agreement, the French authorities have presented a public finance programme for 2005-2007, aiming at a public deficit below 3 % of GDP in 2005 and at 1.5 % in 2007. To reach this, the government plans to stabilise the budgetary expenses in real terms and to an increase social expenses at the same rate as nominal GDP growth. To be able to reach these ambitious objectives, the government will have to implement important structural reforms. A reform of the health care system has been announced for next autumn. Besides, this non-observance of the rules of the SGP requires clearly the definition of new rules or, even, of a new pact.

[3] - In a recent meeting with the ministers of finance of the Euro zone, the French government agreed to put it at 0.8 % of GDP.

Belgium: a balanced budget helped by one-off revenues

After three decades of uninterrupted public deficits, Belgium reached surpluses in 2000 and 2001 and a balanced budget in 2002. In 2003, the budget is expected to turn in a small surplus (0.2 per cent of GDP) and the government is aiming to achieve a balanced budget in 2004. However, the outcomes for 2003 and 2004 is shored up by the transfer to the government of the Belgacom[4] pension fund and the expected revenues from a planned tax amnesty in 2004 (legalising financial assets detained abroad and having so far illegally escaped taxation). Correcting for these large one-off revenues (1.3 per cent of GDP in 2003 and 0.8 per cent of GDP in 2004) a deficit of about 1.1 per cent of GDP appears in 2003 and one of about 0.8 per cent in 2004. The reappearance of (thus corrected) public deficits is to a large extent down to below trend economic growth over the period 2001-2003 (real GDP growth rates between 0.5 and 1%) and next year (expected growth figure of 1.8%).

The Belgian budgetary policy designed for the next years aims at sustaining the economic recovery, mainly by way of stimulating employment growth, but in the meantime respecting the medium-term budgetary framework according to the growth and stability programme and the debt-reduction strategy, which is a central element of preparing for population ageing. The government has decided on further reductions in employers' social security contributions, amounting to 0.2 per cent of GDP in both 2004 and 2005. Part of these reductions target specific labour categories, both at the very low-wage and at the very high-wage end and in favour of young low-skilled first-time job seekers. Employment should also benefit from different other measures (e.g. extension of the services-cheque system, fiscal advantages in favour of shift work). The 2001 personal income tax reform will be further implemented as scheduled, reducing the tax burden by 0.1 per cent of GDP in 2004 and 0.2 per cent in 2005, thus sustaining households' purchasing power. Increased indirect taxation (mainly on energy products) should compensate part of this shortfall in direct taxes and social security contributions. To meet the budget objectives during the next years, real growth in primary expenditure should be limited, despite planned substantial increases in public health care expenditure.

[4] The main telecom operator in Belgium.

Italy: One off measures reduce deficit

The slowdown in economic growth since 2001 saw Italy in a situation where the process of adjusting its public accounts was not complete. On the one hand, like Germany and France, Italy had to maintain its European commitments set in the Stability Pact, but on the other hand the government tried to make sure that fiscal policies did not unduly depress the economy. Subsequently, Italy managed to keep its net borrowing requirement below the 3% ceiling and no particular worries have emerge in 2003 and looking forward to 2004.

Excluding the €5 billion in interventions aimed at promoting development, the 2004 budget measures are expected to raise €16 billion in additional resources. The plan is to improve the public administration account by approximately €11 billion, equivalent to 0.8% of GDP. Revenues are expected to rise €14.4 billion, above all thanks to public real estate sales, an amnesty for past building violations and fiscal settlements. Expenditures are expected to drop by €1.8 billion, reflecting, above all, a block on labour turnover in the public administration and the effects of the transformation of the *Cassa Depositi e Prestiti* (a public savings and loans institution) into a public company. Lower revenues are predominantly expected from some tax cuts, and higher expenditures from less burdensome public labour contract renewals. Thus, one-off measures will play a crucial role in 2004 as well. Resorting to amnesties and securitisations has inevitable negative aspects, but the alternative was to revert to budget policy that would also aim at reviving the economy. The attempt to accompany rigor with interventions directed at favouring development characterises the government's plans for 2004: all in all, it is neutral with respect to the business cycle.

The pension reform won't show sizeable consequences in 2004, although its structural impact is, indeed, evident and appreciable. Its financial effects, in fact, won't be felt until 2008. Thus, while its benefits will only be felt in the future and may be subject to even further delays, its political and social costs are seen now and, therefore, provoke resistance against the reforms straightaway.

Italy's worrisome disadvantage compared to most other euro area countries, including France and Germany, is its high national debt, which remains above 100% of GDP, and, according to government estimates, will stay there until at least 2007. This implies high interest payments, which withdraw considerable resources from the economic system, making the country's efforts to improve its public accounts less credible.

Potentially this leads to a deterioration in Italy's credit rating with a further increase in interest spending. Unless additional extraordinary operations are undertaken before the year ends, Italy risks not being able to reduce the debt to GDP ratio in 2003 when compared to last year (about €10 billion). Given the high level of fiscal pressure, a credible program of debt reduction must be based on a reduction of current expenditures.

Spain: Balanced budget

The budget for 2004, which includes Central Government and the Social Security System, focuses on economic growth, fiscal consolidation, tax cuts, new changes in Regional Governments' sources of financing (increasing regional shares on taxes), and public services reinforcement.

The main goal of the 2004 budget is more on the "stability" than on the "growth" side. Total revenues as a percentage of GDP are projected to be slightly under the 2003 level, so there will be no expansionary effects coming from tax cuts. On the expenditure side some cuts are planned that count for a half point of GDP. Special emphasis is put on internal security and justice, where the budget will grow by respectively 6% and 7,5% compared to the previous budget, and social expenditures (6,8%). The focus on growth is mirrored in an increase in public investments (mainly transport infrastructures) at a rate of 6%, and public expenditures for R&D at a rate of 7.5%. However, these relatively high rates are very close to the expected growth of nominal GDP, so the related shares on GDP will remain at the previous year levels. Therefore, fiscal policy is not expected to have additional expansionary effects on Spanish GDP. The underlying macroeconomic assumption is that GDP will grow at a rate of 3.0% in real and 6.4% in nominal terms, that the inflation rate will come down to 2.4% (HICP), and employment will grow at a rate of 2.0%. These facts are consistent with the Spanish policy guidelines which have become one of the greatest holders of the Stability and Growth Pact between Europeans partners.

Finally, the 2004 Budget shows a small deficit for Central Government and Social Security System, which should be compensated by a regional surplus in order to achieve the full equilibrium promoted by policy authorities.

b) EUREN forecast for 2003 and 2004

Growth

The recovery is weak and uncertain…

There is no question that the economic recovery in the euro area is still weak and uncertain. In particular, it appears evident that a sustained recovery rests almost exclusively on the evolution of the international economy. Structural rigidities, fiscal policies that can provide only a limited stimulus for expansion and a monetary policy aimed primarily at price stability are the main factors behind the weakness in domestic demand.

We expect real GDP growth to settle at 0.4% in 2003 (compared to 0.9% in 2002). This rather poor outcome is reflects the negative contribution of net foreign demand (-0.2%) and investments (-0.4%), which were particularly weak in the first half of the year. The current dynamism in the euro area exports is not sufficient to completely offset the losses recorded during the first six months of 2003.

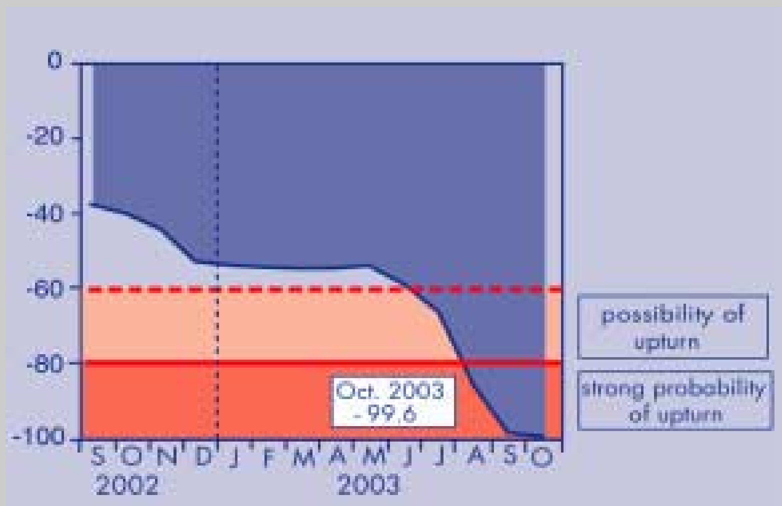
The recent appreciation of the euro (approximately 5.0% vis-à-vis the dollar in a month) presents, however, a risk to our forecasts[5].

[5] For a general discussion on the impact of the euro appreciation, see the Euren Summer report 2003, chapter 4. .

Box 3.2 COE Leading indicator for the euro area

Last August, the COE leading indicator for the euro area crossed the significant –80 threshold as shown in Chart B-3.2.1, and remained persistently below in the following months, sending out a signal of a growth cycle trough in the last quarter of 2003. This change of regime ends a four-year period of low growth (from end 2000-to end 2003). The implication of the leading indicator signal registered in last August was that the euro area growth rate would be back over its trend growth rate (around 2%) as soon as the beginning of 2004.

Chart B-3.2.1: Search of next trough



Source: COE

For next year, we expect the role of world trade in revamping the euro-area's economy to be gradually overcome by domestic demand. Real GDP growth should rise 2.1% in 2004. Externally, the euro area economy should benefit from the expected acceleration in world trade. On the domestic front, private consumption should gradually rise as the gap between effective and consumer-perceived inflation (which has already shrunk significantly) definitively disappears. Consumption of durables will continue to be favoured by low interest rates. Household consumption should also benefit, at least in the second half of next year, from a gradual reversal in the employment trend and the subsequent increase in disposable income. We expect, however, household consumption to rise by 1.3% only in 2004, mainly thanks to consumers' concern about the labour market and welfare system reforms that will be implemented in some major countries of the area. Its contribution to GDP growth will, however, be significant (0.7%). The rebound in international economic activity, the improvement in business profitability and an overall favourable monetary stance should finally favour the resumption of a positive investment cycle.

…but should spread across all euro area members

The cyclical improvement should be felt in most of the euro area countries. The German economy should also recover in 2004, sustained by an accelerating world trade and less restrictive fiscal policies. For next year, in fact, the second leg of the fiscal reform approved in 2000 is likely to be implemented: its positive effects on household disposable income should help sustain private consumption. Germany's economic performance should also be helped by an exceptionally high number of working days in 2004: many national or regional holidays will fall next year on Saturday or Sunday (see box 3.3 bellow).

Box 3.3 The working day effect in 2004

EUREN's forecasts are based on seasonally and working day adjusted statistics for GDP and its aggregates. Therefore, adding up the quarterly figures will not give the annual data because of a working day effect. As a rule, this effect will be small and will not be visible in annual growth rates. In 2004, however, the working day effect will be more important than in previous years, thanks to the leap year and the particular timing of holidays in the calendar. The economic impact of a larger number of working days may come through different channels. When workers receive a fixed monthly wage, more working days mean that companies may be able to increase production without additional labour costs, which will lead to temporarily lower labour unit costs and higher profits. When wages are based on the hours work, more working days will generate more income. In some sectors, e.g. in tourism, more working days may even have a negative impact on value added. However, taking all effects together production will be higher with more hours worked.

The size of this effect is difficult to quantify, as practices how to deal with more working days differ among countries of the euro area, and the reaction also depends on the economic situation as well as on the structure of the economy. In Germany, the working day effect in 2004 is considered to be rather strong. As many national and regional holidays fall on weekends, the number of working days will be 1.3 % higher than in 2003. Based on the working day factors used by the Federal Statistical Office, this will lead to a 0.6 % higher GDP. In other countries the effect will be smaller. e.g., because workers will get a free day instead of a feast on weekends. Furthermore, the working day effect depends on the estimation procedure. For Austria, e.g., an additional 3 working days in 2004 will boost GDP only by 0.1 percent[6].

For the euro area, no generally accepted estimate of the working day impact is at hand. Therefore, the EUREN institutes follow the approach of the European commission, who takes into account an effect of 0.2 percent of GDP in 2004.

Employment and Unemployment

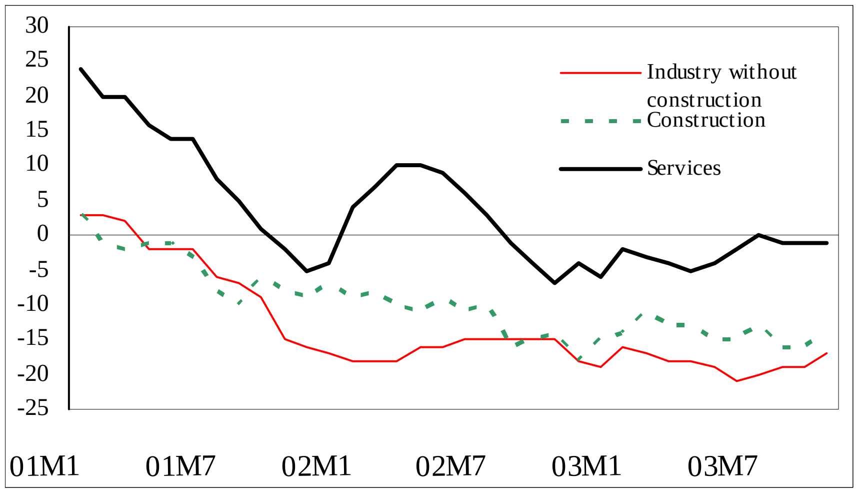
The labour market should improve in 2004

The recovery in the construction sector, accompanied by a slightly positive trend in the service sectors may represent the first signs of a revival in the European labour market. Indications of a possible reversal the recent weak employment picture seem also to emerge from the most recent surveys of business employment expectations (Chart 3.13). Improvements in the labour market will not, however, materialise before 2004, when employment should return to grow at a yearly rate of approximately 0.8%. On average, overall employment growth will be stagnant in 2003 (0.3%), more or less mirroring the disappointing performance of the preceding year (0.4%), while the rate of unemployment will climb by almost half of a percentage point (to 8.8%) with respect to 2002. Given the economy's slow pace of growth, the unemployment rate will only slightly improve (to 8.7%) in 2004.

[6] M. Scheiblecker, Der Arbeitstageeffekt im vierteljährlichen Bruttoinlandsprodukt. Wifo-Monatsberichte 11/2003, 829-839.

Chart 3.13 - Employment expectations in the euro area

(Percentage balances)



Source: European Commission

Inflation

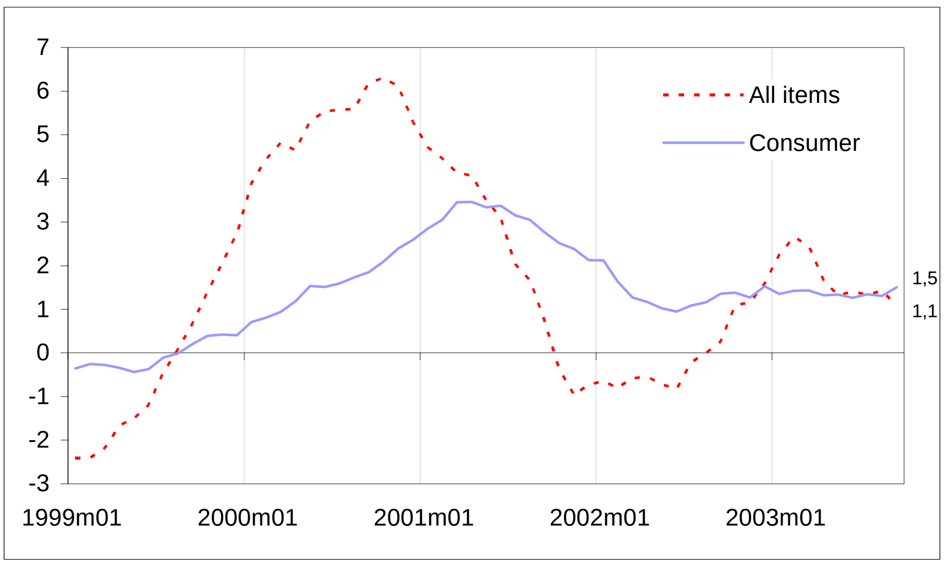
On the basis of preliminary data, Eurostat estimates an increase in inflation in November, to 2.2%. This increase could have been caused by lasting tensions on unprocessed food prices, especially in Germany, and by the effects of the new rise in oil prices ($29.3 per barrel, on average, between October and November, from $27 per barrel in September). The latter is linked to persisting tensions in Iraq and a new wave of terrorist attacks, which have set a “risk premium” on the price. In our forecast, however, both these phenomena are assumed to be temporary and will not, therefore, significantly affect the underlying downward trend in inflation.

Inflation should decrease from early 2004 onwards

In fact, the new appreciation of the euro vis-à-vis the dollar (it rose to more than 1.20 dollars per euro at the beginning of December, +11.8% from the beginning of September) and the slow pace of the area’s current recovery are bound to start favouring a decline in the area’s inflation below the 2% threshold as early as the beginning of next year. Considering the unused productive capacity still present in the area, the strengthening in economic activity in the course of next year should also not exercise excessive pressures on consumer prices in 2004.

Furthermore, the trend in producer prices for final consumption goods during the first three quarters of the year (1.3%, y-o-y in October 2003, Chart 3.14) has remained substantially stable since the end of 2002. Even though the moderate pace of this trend has already been partly transmitted to consumer prices, as evidenced by the decline in core inflation, it continues, nevertheless, to provide positive indications for the coming months. The overall producer price index is also posting quite moderate rates of growth (0.9%, y-o-y in October), thanks, above all, to falling energy prices.

Chart 3.14 - Producer prices in the euro area
(12-month % changes)



Source: Eurostat

With regard to costs, the trend in wages should be essentially stable with respect to recent years. Positive indications for the coming months come from non-fuel raw material prices in euro terms, which should close the year at below the level recorded at the end of 2002, mostly thanks to the appreciation of the exchange rate against the dollar. Oil prices should remain, instead, at the current levels for the remaining part of 2003, settling at $28.7 a barrel, on average, for the year.

With these hypotheses, euro area inflation should remain stable in December (settling at 2.1%, on average, in 2003), before gradually declining in the first months of 2004, indeed for the entire first half of the year. From mid-2004 on, oil prices should start heading downwards towards what can be considered their equilibrium level (to $25 a barrel at year-end). Nevertheless, in the last part of 2004, the area's inflation should remain pretty stable, since the benefits provided by the drop in oil prices should be partially offset by some upward pressure from a revival in economic activity which should push growth to near its potential. And the impact of the exchange rate appreciation should be waning by then. Thus, inflation should settle at around 1.8%, on average, in 2004.

Balance of payments

The current account surplus should drop to 0.4% of GDP in 2003 from the 0.9% recorded in 2002. This deterioration is mostly down to the strong appreciation of the euro, which heavily affected trade volumes in the first half of the year. In this second part of 2003, however, a net improvement in the trade balance seems to be taking place. A strong rebound in exports outside the area seems to be underway thanks to rapid growth in the United States and Asian economies. We expect the current account to increase to 0.6% in 2004, reflecting the European economy less dynamic growth when compared to the American and Asian economies.

Table 3.2 : 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	2.7	1.8	0.1	1.1	1.3	2.1	0.8	-0.1	1.0	1.6	1.6	2.0	2.2
Public consumption	2.1	2.4	2.8	1.6	1.2	1.6	1.7	1.9	0.8	1.2	1.2	1.2	1.2
Gross fixed capital formation	4.9	-0.1	-2.9	-1.8	1.9	-4.5	-2.1	-1.9	1.5	2.4	3.4	3.8	4.6
Inventories. contr. to growth	-0.1	-0.5	0.3	0.0	-0.1	-	-	-	-	-	-	-	-
Domestic demand	2.9	1.0	0.3	0.6	1.3	1.0	0.2	-2.5	1.4	1.8	2.0	2.3	2.5
Exports	12.6	3.3	1.7	0.6	5.7	-5.9	-2.5	8.9	4.5	5.5	6.0	6.5	7.0
Imports	11.2	1.8	0.1	1.1	4.4	-2.6	-0.9	-1.5	4.5	5.5	5.8	6.4	6.8
GDP	3.5	1.6	0.9	0.4	2.1*	-0.1	-0.4	1.5	1.4	2.1	2.5	2.6	3.0
Unemployment (% of labour force)	8.5	8.0	8.4	8.9	8.8	8.7	8.8	8.8	8.8	8.8	8.8	8.7	8.7
Compensation per employee[1]. yoy	2.8	2.9	2.7	2.8	2.6	-	-	-	-	-	-	-	-
Consumer price (HICP). yoy	2.1	2.4	2.3	2.1	1.8	2.3	2.0	2.0	2.0	1.7	1.7	1.8	1.8
Current account balance (%GDP)	-0.2	-0.5	0.9	0.4	0.6	-	-	-	-	-	-	-	-
3m interest rates (% per annum)	4.5	4.3	3.3	2.3	2.0	2.7	2.4	2.1	2.1	2.0	2.0	2.0	2.0
10y Gvt bond yields (% per annum)	5.4	5.0	4.9	4.1	4.8	4.1	3.9	4.1	4.3	4.4	4.7	4.8	5.2

EUREN estimates - [1]Seasonally adjusted. –
*** See box 3.3 on the working day effect**

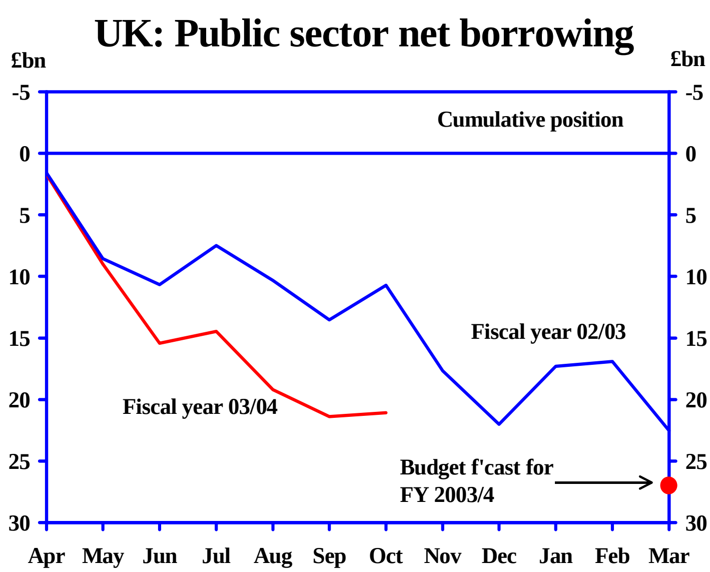
Part III. The UK economy

Goalposts moved in Pre-Budget Report

The Chancellor, Gordon Brown, is moved the goalposts of UK macroeconomic policy when he presents his Pre-Budget Report (PBR) on 10 December. The government's targets for both fiscal and monetary policy are likely to be restated, making it easier to meet its objectives.

On the fiscal side, we are likely to see a change in emphasis rather than an explicit restatement of the government's rules. In particular, the continuing overshoot on public borrowing – with our forecast implying a deficit on the current budget of £19 billion in 2003 compared with the Treasury's Budget forecast of £8 billion – makes it increasingly likely that the government will breach the so-called 'golden rule'. Of course, as our forecast shows, the 3% deficit limit set out under the SGP has now been breached.

Chart 3.15



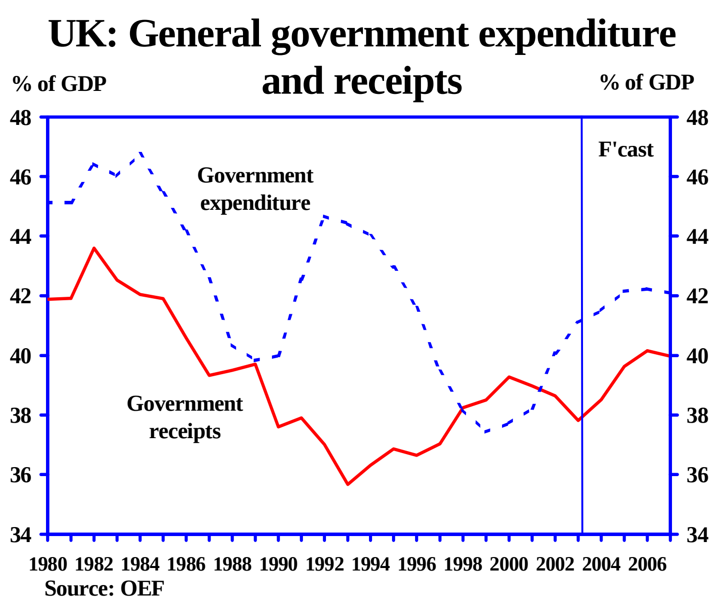
Source: Datastream

Sustainable investment is the key

The Chancellor was keen to stress the importance of 'sustainable investment'. This rule requires that government net debt be held below 40% of GDP. This, of course, is a target he can expect to meet comfortably over the next few years – the debt-GDP ratio is currently only 32% of GDP.

While focusing on debt rather than the budget position may make it easier for the Chancellor to claim that the UK fiscal position is sound, the PBR was largely an austere affair. In particular, Brown implicitly warned Cabinet colleagues that he cannot afford to increase government spending. So far there are few hints of possible future 'stealth tax' increases, for example on housing, aviation and companies, but these can't be ruled out in next year's budget.

Chart 3.16

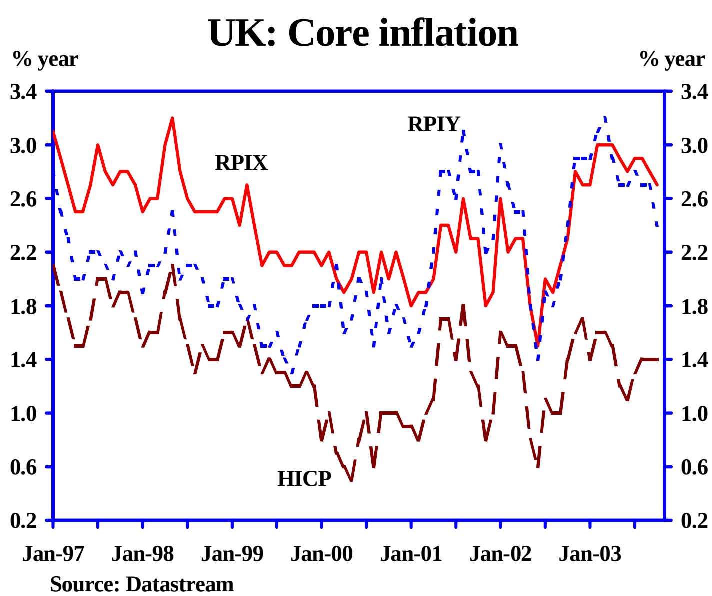


New inflation target

The change to monetary policy has effectively already been announced as part of the Chancellor's response to the Treasury's assessment of EMU membership in June. As part of the strategy to prepare the UK for eventual EMU membership, the inflation target is to be expressed in terms of the EU's harmonised index (HICP) rather than RPIX.

A target of 1.75% for HICP would be broadly consistent with the 2.5% target for RPIX, given the different way in which the measures are constructed (eg HICP excludes house prices and Council Tax). However, the Chancellor has opted for a target of 2% on presentational grounds – both because it is a round number and because the ECB targets 2% inflation. As a result, the change will imply a loosening of the underlying monetary stance. The MPC will also have the immediate presentational problem that inflation will be below target on the HIPC basis, whereas it is above target on RPIX.

Chart 3.17



Around ½% point of the gap between RPIX and HICP inflation reflects the different formulae used to weight prices together. (The RPI uses arithmetic weighting while HICP uses geometric weights.) But over 1% point of the gap reflects the impact of housing costs that are included in RPIX but are excluded from HICP – both housing depreciation (which is proxied by house price inflation) and Council Tax.

The Governor of the Bank of England has expressed reservations about switching to an inflation measure that excludes these housing elements. In part, this reflects concern that the government could be judged to have ‘moved the goalposts’ by choosing a measure of inflation that excludes some of the prices that have been rising particularly rapidly in recent years. But the Governor is also concerned that the change will cause the MPC to understate the importance of housing market developments in its policy decisions, since house prices are no longer in the measure of inflation that it is targeting.

While we have sympathy with concerns over the public presentation of policy, we see no reason why the MPC should not take due account of housing by monitoring the wide range of data published independently of the consumer price statistics (as it does when allowing for the impact on inflation of GDP growth, the exchange rate and wages). And it could be that a switch in the target to a lower measure of inflation could itself help to reduce the actual rate of inflation via the wage bargaining process.

Forward-looking indicators suggest that inflationary pressures will remain subdued over the next 18 months or so:

- Despite a fall of over 5% in sterling in 2003, import prices have barely risen – presumably because foreign companies are ‘pricing-to-market’ (ie fixing their sterling prices to maintain market share and absorbing exchange rate changes in their profit margins).

- Wage inflation remains subdued, with headline private sector earnings growth just 3.6% up on a year earlier in September. (4.5% is the figure assumed consistent with the inflation target and productivity growth.)

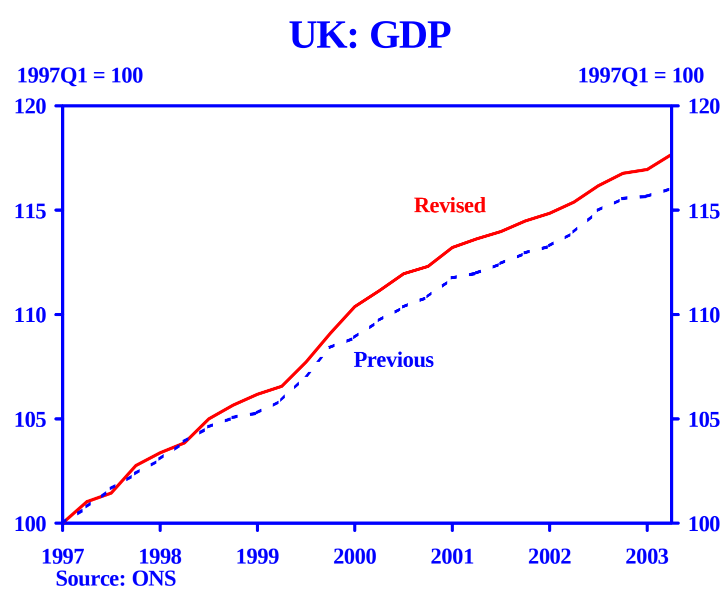
- Unit wage cost inflation was just 1.2% across the whole economy in the year to Q2.

Consequently, we expect the harmonised measure of inflation to average just 1.6% in 2004, following 1.4% in 2003.

Economic history rewritten…

Another factor complicating the Bank of England’s monetary policy decisions are the large changes in economic data in recent months. Since the EUREN forecast in July, UK economic history has been completely rewritten. The Office for National Statistics (ONS) has just completed a major overhaul of UK economic data. This both modifies the way in which inflation-adjusted measures of demand and activity are constructed (updating the weights used in these calculations through annual rather than five-yearly chain-linking) and takes into account the impact of VAT fraud on the reporting of UK imports from the EU, as well as introducing a number of other methodological improvements. The revisions to recent economic history have, however, been substantial:

Chart 3.18



- The new data suggest that UK economic growth has been much stronger over the last five years than previously realised – averaging 2.5% pa since 1998Q2 compared with 2.2% pa.

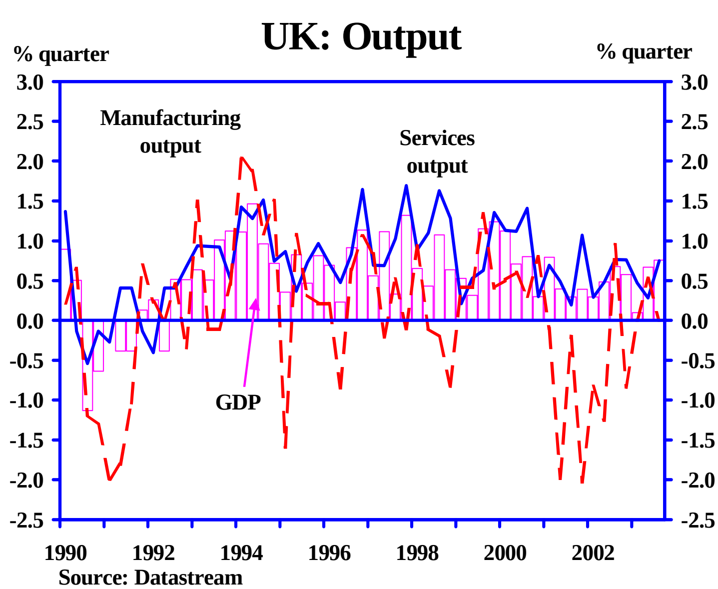
- But the new data show that demand has been more balanced in recent years than previously estimated. On the one hand, consumer spending growth has been revised down to 2.4% in the year to 2003Q2 (3.3% previously). On the other, investment growth has been revised up to 1.5% in the year to Q2 (-1.4% previously), with the fall in business investment since its peak in 2000 now put at only 4% rather than the previous estimate of over 11%.

- Similarly, the new data suggest that the recession in manufacturing has been less deep than previously shown, with output now reported to have fallen 6% from peak to trough (rather than almost 8%). And manufacturing output is now estimated to have risen 0.5% in 2003Q2 (0.1% previously).

…with growth outlook promising

All in all, the revisions have helped justify the Chancellor's relatively bullish assessment of the UK economy – his PBR made much of the contrast with the large EMU countries. With the increase in GDP in Q3 revised up to 0.7%, growth in 2003 is now set to reach 2%, within the Treasury's Budget forecast range of 2-2½%. And the Treasury forecast for 2004 growth of 3-3½% is a lot easier to defend now that the world economy is strengthening and company finances are improving – our own forecast is 2.9%.

Chart 3.19



The new data mean more balanced growth that we previously expected and this is reflected in the short-term forecast. Private consumption is expected to grow 2.5% in 2004, little changed from 2003. House prices are still rising modestly, stock markets have rebounded and unemployment (on the claimant count measure) is expected to remain around 3%, all of which is supportive for consumers. There are worries about the growing levels of consumer indebtedness, but with debt service costs low thanks to low interest rates, and unemployment unlikely to take off, this is not a major concern, at least not yet.

Meanwhile, investment has not been as depressed over the last two years as we thought earlier. Consequently, we now expect growth of 2.9% in 2004, in line with GDP.

Has the trend rate of growth increased?

The revisions to GDP growth in the last few months also raise the obvious question of whether the economy's 'potential' or 'sustainable' trend rate of growth has been higher than we previously realised, or instead whether there is now less spare capacity in the economy (ie the 'output gap' is smaller). The answer to this question is critical both for prospects for inflation and interest rates, and for the public finances given that the Chancellor's fiscal rules apply 'across the economic cycle'.

We have therefore recalculated our estimates of trend growth using the latest National Accounts data. In doing so, we have not only allowed for the new GDP estimates but also for new estimates of the company sector's capital stock. These show much stronger growth in the capital stock than previous estimates, in turn reflecting the more buoyant business investment shown by the latest National Accounts.

We have also taken the opportunity to review our estimate of the NAIRU or natural rate of unemployment. The continued weakness of wage inflation suggests that unemployment is unlikely to be below the NAIRU at present, and we have therefore revised our estimate of the NAIRU down to 5% on the ILO measure of unemployment.

This analysis suggests that UK trend output growth has been significantly stronger in recent years than we previously estimated. In particular, we calculate that the late 1990s investment boom, combined with improving labour market performance, pushed trend growth to over 3% pa between 1998 and 2000. However, the subsequent recession in business investment pulled trend growth down to under 2½% in 2002.

Table 3.3: 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	4.5	3.1	3.6	2.4	2.5	-1.0	2.7	3.0	3.0	2.3	2.2	2.1	2.1
Public consumption	1.9	1.7	2.4	3.8	4.0	10.7	2.1	2.6	5.6	4.1	4.1	4.1	4.1
Gross fixed capital formation	3.6	3.6	1.8	1.8	2.9	-2.8	5.1	-5.3	6.6	2.7	3.5	4.2	4.2
Domestic demand	3.8	2.7	2.9	2.6	2.9	-0.2	2.0	4.0	3.7	2.2	2.8	2.8	2.9
Exports	9.4	2.5	-0.9	-1.8	4.3	12.1	-9.9	0.4	2.8	6.4	7.7	7.4	7.0
Imports	9.1	4.5	3.6	0.5	4.3	6.8	-9.7	4.1	6.1	4.1	5.5	6.3	6.9
GDP	3.8	2.1	1.7	2.0	2.9	0.7	2.5	3.0	2.8	2.8	3.3	3.0	2.9
Unemployment (% of labour force)	3.6	3.2	3.1	3.1	3.0	3.1	3.1	3.1	3.0	3.0	3.0	3.0	3.0
Compensation per employee[1], yoy	5.0	5.1	3.8	3.6	4.1	3.9	2.9	3.6	3.8	3.9	4.1	4.2	4.4
Consumer price (HICP), yoy	0.8	1.2	1.3	1.4	1.6	1.5	1.3	1.4	1.5	1.6	1.7	1.6	1.7
Current account balance (%GDP)	-2.1	-1.8	-1.8	-2.2	-1.7	-0.9	-3.2	-2.6	-2.3	-1.9	-1.7	-1.6	-1.6
GGFB/GDP [2]	1.6	0.8	-1.4	-3.3	-3.0	-2.8	-3.4	-3.7	-3.3	-3.2	-2.9	-3.0	-2.7
3m interest rates (% per annum)	6.1	5.0	4.0	3.7	4.4	3.8	3.6	3.5	3.9	4.0	4.3	4.5	4.8
10y Gvt bond yields (% per annum)	5.3	4.9	4.9	4.5	4.6	4.3	4.2	4.5	4.9	4.7	4.5	4.6	4.7

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. China in the World Economy: a New Deal

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

The take off of China has led this country to get major positions both on the demand side and on the supply side

Although on average it can still be considered as a low income country, ranked at only 129th largest according to the World Bank estimates of GDP per capita in current dollars, China has become within the last few years one of the big players in the world economy. In 2002, China was estimated to be the second largest economy in the world, after the US (12% of the world GDP on PPP estimates). And of course, it is also the largest country in terms of population. But the most striking feature when looking at China is the growing importance of this country, both on the demand and on the supply side for some specific sector of the economy. Indeed, in 2002, China outpaced the US in terms of demand for machine-tools. China also produced as many computers as the US last year[7]. One consequence of this exceptional expansion can be seen on raw material prices, in which China can be consider as a price maker, either on the demand side when China is a major supplier or on the demand side when it becomes a net importer.

Will an appreciation of the Yuan reduce trade imbalances between China and the US or Europe?

Thus, because of the size of this country, these quick changes lead to a new deal for other countries in the world. This is especially true for the US and Japan, but this is also true for Europe. Firstly, this paper presents main stylised facts showing the growing importance of China in the world economy, particularly regarding global trade. However, this growing importance of China in world trade has also been accompanied by major imbalances. It is thus sometimes viewed as an unfair competitor, mainly because the supposed undervaluation of its currency. The second part of

[7] Source: OEF (see www.oef.com).

the paper discusses the main consequences of a revaluation of Yuan, and especially the consequences of such changes for Europe.

1.1. *Emerging China*

1.1.1. China in world trade: the leading role of foreign companies

China will probably export more than Japan in 2003

In the last decade, the trade performance of China has been very impressive. World market shares rose steadily at the beginning of the spurred by the accession of China to the World Trade Organisation (WTO). Thus, China's world export market share has increased dramatically. According to our own estimate, China may even have exported more than Japan in 2003[8].

Table 4.1: Share in world exports (in value terms, %)

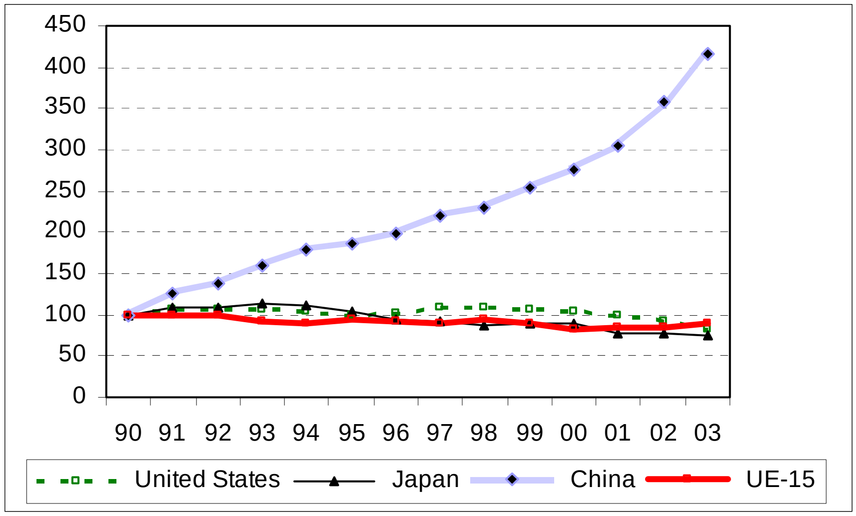
	Total goods				Manufactured goods		
	1980	1990	2001	2003 (est)	1980	1990	2001
United States	11.2	11.0	11.0	9.2	13.8	11.8	12.4
Japan	6.6	8.6	6.7	6.5	11.2	11.6	8.5
EU-15	38.6	44.1	36.9	39.0	51.8	50.1	40.9
Euro area	30.4	35.8	30.5	32.2	41.4	41.1	34.2
China	0.9	1.7	5.1	7.0	0.6	1.6	6.2
World	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Cepii-chelem databank; Euren estimates and calculations

Chinese trade performance is naturally even more impressive when it is compared to trade performance of "old" countries.

[8] Because of the difficulty to assess bilateral trade between China and Hong Kong, data differ between Chinese statistics and the statistics of its trading partners. In this paper, we use a databank from the Centre d'Etudes Prospectives et d'Informations Internationales (CEPII), in which exports and imports flows are recalculated to be equal at the world level, and to be consistent on a bilateral basis.

Chart 4.1: Share in world exports (1990 = 100)



Source: Cepii-Chelem databank; Euren calculations

The penetration of Chinese products is less pronounced in Europe than in the US or in Japan

Favourite markets for Chinese exports are the US, Japan and other emerging Asian countries. The penetration of the European market by Chinese products has also recently increased, but to a lesser extent. However, China is now the second largest extra-EU supplier after the US.

Table 4.2: Share of China in imports (%)

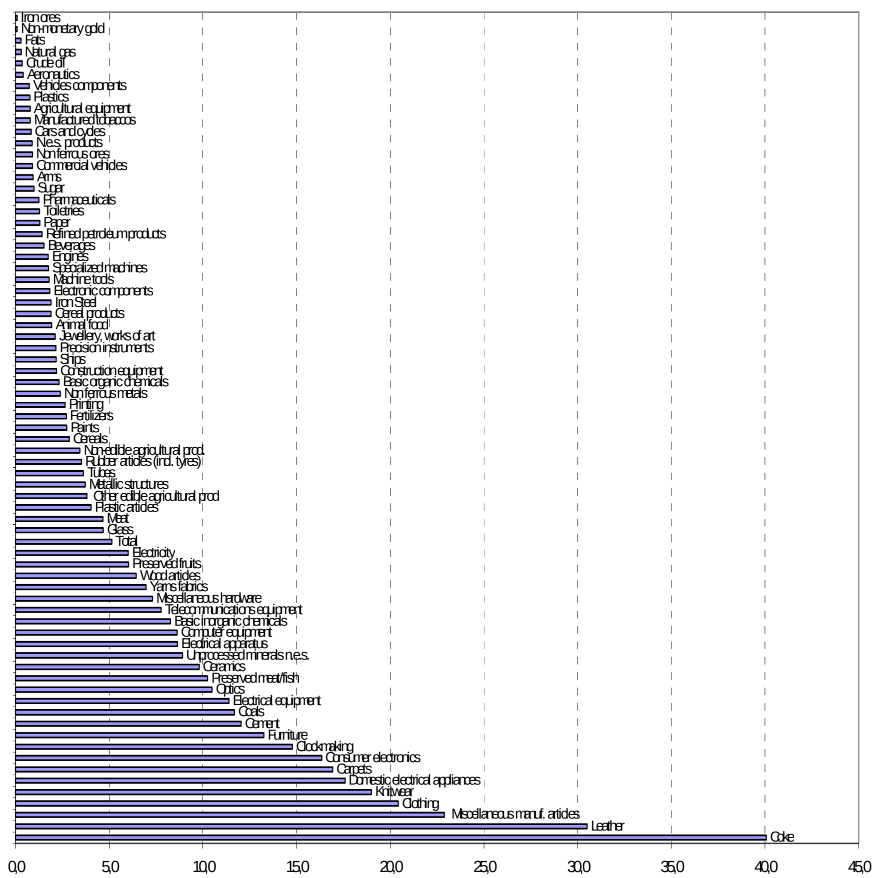
	1990	1995	2002
United States	3.9	6.1	10.8
Japan	5.1	10.7	18.3
EU-15	0.9	1.7	3.3
Emerging Asia (excluding China)	3.7	4.1	6.9

Source: OECD, Eurostat, Cepii-Chelem; Euren calculations

Uneven performance of China by industries

The share of China in world exports is uneven according to industries. On the one hand, excepting coke, the main export industries of China are concentrated in textiles and leather products and some electric and electronic consumer goods. On the other hand, the share of China in world exports of cars or aeronautics is still very limited. This specialisation is characteristic of a low wage country.

Chart 4.2: Share in world exports of China by industries (2001)



Source: Cepii-Chelem, Euren calculations

Chinese trade is heavily dependant of foreign firms

One the main characteristic of Chinese trade is the importance of foreign firm affiliates (ffa's). This chiefly reflects the fragmentation of the production processes. In the context of globalisation, China hosts a growing share of the downstream labour intensive stages of the production of multinationals. In 2003, ffa's should account for 54 % of total Chinese exports, against 20% in 1992. Besides, more than half of Chinese exports are the result of processing activities. Ffa's represent more than two thirds of this type of exports. The Chinese government has encouraged these activities in the 1990's by lowering export tariffs and promoting duty exemptions for some selected categories of products. Schematically, this policy leads China to import intermediate goods from other Asian countries that are then re-exported as finished goods to Europe and the US. As a consequence, China processed exports have a high content of imported Asian goods: 10 $ of processed exports include 5$ of intermediate goods from Japan and the 3 Dragons[9]. This specificity of the structure of Chinese trade must be kept in mind when we assess the consequences of a revaluation of the Yuan. An appreciation of the Chinese currency should lead indeed to lower import prices that should translate into lower export prices in a second round effect. The sensitivity of foreign firms to an appreciation of the Yuan could also be lower than domestic firms' exports as in many cases it concerns intra-firm trade, where prices and margins are internally defined. Moreover, Chinese wages on average represent around 4% of US wages, while Chinese productivity is estimated to be 6% of US productivity. But, foreign companies have a higher productivity than local firms. Thus, an appreciation of the Yuan will probably only marginally influence the decisions of location of multinational companies as the attractiveness of China in terms of costs of production would not be dramatically changed.

1.1.2 Chinese trade imbalances: the US well ahead

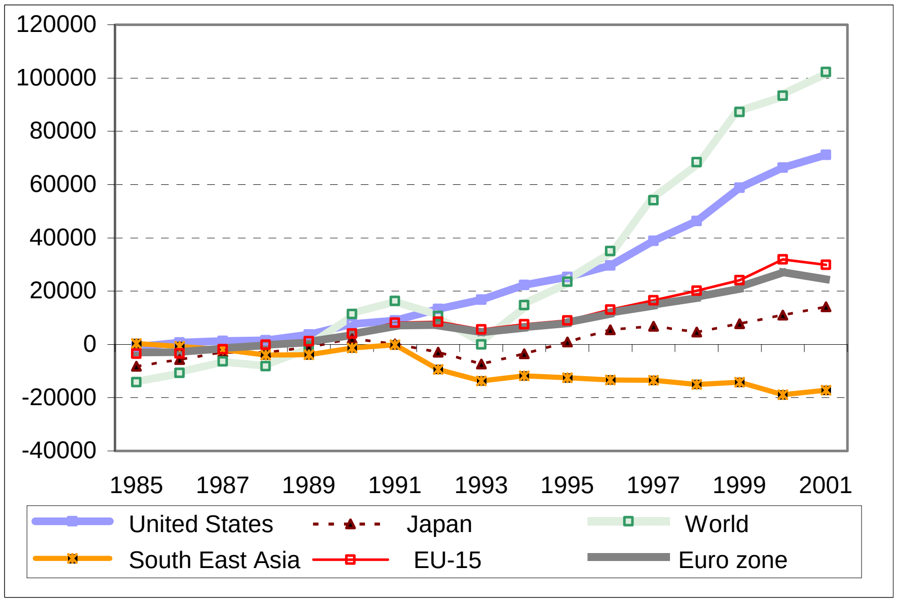
Major imbalances between China and the US

During the second half of the 1990's China has seen a progressively growing trade surplus. As a developing country, this is quite atypical, as China has registered its main surplus with developed countries – usually at this stage in its development the need to import capital leads to deficits. This development of the surplus has been particularly marked with the US. It has been less pronounced with Europe, and the surplus of China with Japan is both more limited and more recent. Meanwhile, as a result of the segmentation of trade described above, China has recorded a growing deficit with emerging Asian countries. Recently, in the context of the accession of China in WTO, Chinese trade flows skyrocketed. Imports growth was even more pronounced than exports (respectively

[9] F. Lemoine and D. Unal-Kesenci, China in the International Segmentation of Production Processes, CEPII Working Paper n°02, March 2002.

+41 % in the first ten months of 2003 compared with the same period of 2002 and +33 %), so that trade surplus shrunk.

Chart 4.3: Trade balance between China and other countries (millions of US dollars)



Source: Cepii-Chelem databank, Euren calculations

Although Chinese data differ from data reported by its main trading partners, it appears clearly that the US runs the most significant deficit with China. Even if the European deficit with China is far from negligible, it is not of the same magnitude than that seen with the US. These differences regarding trade imbalances can thus be interpreted in two ways. First, rather than a global overvaluation of the Yuan, these results highlight structural imbalances between the US and China. To a certain extent this is also a consequence of global imbalances in the US economy. Actually, from a European perspective, the depreciation of the dollar against the euro is the key question, as *de facto* the Yuan has depreciated against the euro by about 30 % in the last two years because of the changes in the Euro-Dollar parity. It also must be stressed that China's main surplus vis-à-vis Europe and the US is mainly concentrated in a small number of industries and has a rather similar pattern. This largely reflects the comparative advantages of China, partly shaped by foreign companies, rather that an undervaluation of the currency - this would be illustrated by widespread surplus across a large number of industries. A look at China's trade with its Asian neighbours also show large differences regarding the surplus and deficit structure by industries compared to Western trading partners. It confirms the rather narrow sectoral bias of Chinese trade.

Chinese surplus between China and the US, on the one hand, and between China and Europe on the other hand, are concentrated in the same industries

Table 4.3: Main surplus of China by trading partners and by industries

(2001, million of US dollars)

USA		EU-15	
Leather	13551	Misc. manuf. Art.	6268
Misc. Manuf. Art.	13317	Computers	5755
Computers	7937	Leather	4388
Electrical apparatus	5581	Clothing	3263
Consumer electronics	4951	Knitwear	2522
Furniture	4670	Electrical apparatus	2211
Miscellaneous hardware	3852	Miscellaneous hardware	2046
Clothing	3746	Consumer electronics	1979
Telecom. Equipment	3278	Domestic electrical appliances	1428
Domestic electrical appliances	3253	Optics	1323
Knitwear	2174	Carpets	1057
Plastic articles	1340	Furniture	924
Ceramics	1006	Plastic articles	898
Japan		**Emerging Asia**	
Clothing	7463	Coals	1537
Knitwear	6113	Knitwear	1307
Leather	3641	Other edible agric. prod	962
Misc. manuf. Art.	2270	Basic inorganic chemicals	751
Preserved meat/fish	1546	Meat	748
Consumer electronics	1527	Electrical equipment	663
Carpets	1387	Consumer electronics	558
Other edible agricultural prod	1300	Electricity	539
Computers	1290	Cereals	530
Meat	1250	Beverages	396
Furniture	1225	Unprocessed minerals	386
Preserved fruits	1026	Preserved fruits	382
Coals	963	Electrical apparatus	344

Source: Cepii-Chelem databank, Euren calculations

1.1.3 The US perspective: the dyke's breaking?

A China-US problem, with Europe stuck in the middle?

As the analysis above illustrates, China is principally a "problem" for the US. With presidential elections in November next year and US manufacturing jobs continuing to disappear, there are clear electoral arguments for a Yuan revaluation from the US perspective, even if the economic arguments are harder to win. There has been little grumbling from Europe on this issue – the argument seems mainly between the US and China, as illustrated by recent moves to discourage some textile exports. But Europe is not oblivious to this problem. Without any action on revaluation from China (and indeed elsewhere in emerging Asia) the downward pressure on the dollar falls disproportionably on the euro as one of relatively few world currencies that are free to float.

US deficit will get worse before it gets better…

With the US economy forging ahead once more, undoubtedly US imports will surge as well, almost certainly putting the trade balance further into deficit next year. The deficit with China alone is likely to be about $115bn in 2003. It is worth noting that this still leaves a deficit of over $400bn with other countries but, as with the fact that China-US trade is 'balanced' because both have 10% of each other's imports, such arguments will fall on stony ground. 'Panda bashing' is in vogue and China has become the 'new Japan' as far as the DC lobby groups are concerned.

Trying again to be fair, there is not much evidence of this bilateral deficit being caused by Chinese companies dumping in the US market (unless 'unfair exchange rates' are included in the argument) - in the usual sense, most trade is 'fair' and cannot be shutdown. As mentioned before, US imports from China focus on a mix of investment goods (equipment and components) and consumer goods: furniture, clothing, toys – the kind that helped produce the widely quoted figure that WalMart alone is responsible for about $10bn of the US-China bilateral trade deficit. Analysts regularly point out that US companies are responsible for much of the trade with China through their operations and sourcing of components (this is not the case for Japan-US trade).

In as much as US-China trade has been driven by such US company operations, this clearly begs the question of what would happen to these if the lobbyists got their way. Presumably US companies would stand to lose money on investments if they closed operations in China and/or would face higher operating costs. Possibly, it would not be China that would face a loss (in exports) but US companies that would see profits fall: the US deficit with China would hardly change. And, of course, to a lesser extent the same is true of Europe as well.

…and a stronger Yuan is not necessarily good for the US

Attempting to close down trade with China might also damage US companies by letting in other foreign competition instead. If US car companies cannot use low cost components from China to maintain low US car prices, then foreign competitors from the likes of Korea and Japan may force some US producers out of the car market. The survival strategy of some US manufacturers may depend on sourcing from China. This relationship may well not suit other NE Asian exporters, which should be taken into account when considering the possible impacts of Yuan revaluation.

To turn the tide on the trend for sourcing goods from low cost China, an extremely large swing in Chinese wages would be needed anyway. The table below illustrates the scale of the world's wage differentials. Even if a rising Yuan pushed China's wage up to $1-2 per hour, goods may simply be sourced from other emerging markets, say Mexico, rather than from the US. This might rebalance growth across the emergers, but it would do little for the US's imbalances.

Hourly wage costs

Manufacturing	US$ 2001 estimates
China	0.5
Mexico	2
Hong Kong and Taiwan	6
Singapore and Korea	8
Japan	20
USA	20
Eurozone average	22
Spain	11
Portugal	6

Source: US BLS, Foreign Lab Stat, China Year Book

1.2 Testing revaluation scenarios

1.2.1 The impact on China

How damaging would revaluation be for China?

Needless to say, the country most affected by a revaluation of the Yuan is China. Against a background of high GDP growth and still rising exports, how damaging to the Chinese economy would a revaluation of the Yuan be? What impact could we expect? Without considering any further policy adjustments at this stage, we can identify that a revaluation has certain rather definite effects:

- Local prices would be depressed as import prices fall in Yuan terms.
- Even with low competitiveness elasticities (at least compared to demand elasticities which tend to dominate these scenarios), export volumes would tend to fall and import volumes rise (at least initially).
- Profits of exporters fall as they face higher dollar costs (most costs are in Yuan), lower sales volumes and, probably, only slightly higher US$ export prices. Adjustments over time may bring down local wages and prices to improve competitiveness, so exports would start to recover.
- There would be job losses and less investment in export industries, which have excess capacity.
- Interest rates may start to edge down in-line with lower inflation.

But effects on other variables are more ambiguous:

- Consumers would see import prices fall but low wage growth and job losses act as depressants.
- Imports: lower exports and investment create less demand for inputs for production and new equipment. As consumers turn cautious as well, then total import demand could fall back sharply.
- The net effect on China's US$ import bill may be negative, although an initial surge may be seen.
- Whilst export volumes fall, the impact on revenues will depend on how much US$ export prices rise – prices are unlikely to rise by as much as the Yuan and may even remain stable. Thus export

revenues in US$ terms may not fall a lot (in Yuan terms this is still a large loss – impacting on producer profits as noted above).

- The overall impact on the trade balance may be larger in the first year than subsequent years as imports adjust down and exports start to recover. Overall it is likely that the trade balance would fall but possibly not by a lot.
- The capital account results depend on how confident markets are that this is a sustainable move in the Yuan – if it appears unsustainable, then China could see a return to heavy net capital outflows (as seen in 1997-2000) and face a potentially serious balance of payments problem. If markets continue to believe the Yuan is not only sustainable but could see progressive appreciation, then this may encourage inflows into Yuan assets and, possibly, overheating in financial markets.

GDP sharply lower for two years

Using the OEF global model, we can examine the likely consequences of a rise from 8.3 to 6 Yuan/US$. The model reproduces all the features described above and tends to predict that Yuan revaluation would cause a fairly sharp fall in GDP over 2 years before any recovery would start to be seen. Inflation would remain around zero instead of rising as predicted in the base forecast, so here we assume that interest rates would fall from their current rate of 5% to 2% by 2006, helping stimulate a recovery in the economy.

Yuan revaluation: from 8.3 to 6

Effects in on	2004	2005	2006	2007
GDP % loss and	-2.3	-3.9	-2.4	-1.1
Change in:				
Exports $bn	-6	-23	-30	-25
Imports $bn	22	16	-8	6
Current acc and	-28	-39	-23	-34
Job losses	3m	8m	7m	5m

Source: OEF

1.2.2 The impact elsewhere

Little trade gains for the US and euro area

The impact on trade partners such as the US and Europe is positive but not very large (in-line with comments made above). In fact we would argue that devaluation in itself is no cure for the US current account “problem”. The OEF model shows a 10% dollar depreciation against all currencies would eventually reduce the current account deficit by less than 1% of GDP.

In this scenario we assume there may be some slight appreciation amongst other Asian currencies against the dollar but these changes would typically not match the rise in the Yuan - the rest of emerging Asia would try and maintain competitiveness as far as possible. Of course the gain in competitiveness would be offset to a certain extent by the more subdued growth path in China – this would hit those US and European firms trying to get a foothold in the Chinese market.

It’s also fair to say that China would try and offset the adverse impact of revaluation with government action. What policy offsets could be envisaged to ‘improve’ the high Yuan outcome for China? In the case of a relatively modest Yuan revaluation, then government spending increases could offset the net trade impact on GDP and limit job losses. This would be essential in order to maintain consumer confidence and thus spending. It is clear that maintaining higher demand this way would keep imports high. The consequence of this would dominate the trade balance result, with a serious deterioration. In this example, it is even possible that China would have to step on the brakes to avoid a serious balance of payments crisis by 2007-2008. China has committed to liberalise its capital account as part of the WTO deal, possibly starting as early as 2005. Of course the possibility of current account problems emerging at the same time as the capital account is freed up would make a bad problem far worse.

With or without a revaluation, import growth could be encouraged as a way of making China’s export boom acceptable to its trade partners – but more attention would have to be paid to increasing the share of US imports in this growth to avoid trade disputes and/or pressure for alternative policies. Given the existing trade structure (by origin and type of goods), it looks unlikely that Yuan revaluation alone can achieve much redress in the US-China trade balance. So trade officials may need to identify specific areas in which US goods could be promoted in China. This is probably the best way of tackling the problem from a positive point of view (rather than the negative view of the US trying to cut imports from China).

1.3 Conclusions: only a modest change likely

Wholesale change is not on the cards...yet

We can summarise the case for and against revaluation from the arguments put forward above. Firstly, the case against changing the Yuan/$ rate:

- A stronger/floating Yuan may destabilise the Chinese economy and Asian region – risky to rock the boat, very unpopular in China.
- China's export growth may fall sharply in the next 6-12 months anyway as the WTO effect fades.
- China's imports growth is now faster than export growth and the total trade balance is projected to fall in 2003 and 2004.
- As a share of trade or GDP, China's trade surplus is not as large as Japan's and China runs trade deficits with a number of countries (and a rather low surplus versus the EU).
- China's reserves position of $350bn is not as massive as its portrayed – not scaled against total trade (which is higher than Japan's) or in terms of months of imports cover (10).
- China's capital flows could turn around and head out again: 'hot money' flows can be anywhere from outflows of $50-60bn (1997-2000) to inflows of $20-30bn (2003). This behaviour is unusually difficult to predict.
- On a long-term basis, starting from near zero (officially), Chinese investors may want to build up diversified portfolios outside China (when they can legally move capital out of the country). This could lead to a stream of capital outflows.

- To allow for large uncertainties over capital flows and prevent a serious crisis of the kind that engulfed Asia in 1997, China will need to maintain a high level of reserves (and possibly other forms of capital controls as a backstop).
- The Chinese banking sector is still fragile and hampered by bad debts.
- Interest rate policy has been domestically oriented and rather pedestrian in the past: this will need to be reviewed to fit with a more flexible exchange rate and monetary system.
- To be effective, interest rates must have an impact. This is still limited by banking sector structure, with low levels of household credit and high borrowings from state enterprises.

On the pro-revaluation side:

- Export growth, and thus GDP, could stay stronger next year than most forecasters expect, with more new investment coming on stream and upgrades of products to boost demand.
- Continued GDP growth of 8% plus would put a lot more pressure on China to revalue.
- Forex reserves may continue to soar too, with FDI hitting new peaks and hot money still coming in.
- From China's point of view handling this money inflow and preventing speculative bubbles in property may be an increasing problem, although there is no overheating in the full sense (prices and wages are rising only modestly).
- Whilst China has a rather modest overall trade balance and a deficit with a number of countries, the problem is the rising US-China imbalance, which is a large part of the total US deficit.
- Continuation of recent trends may put this bilateral balance on course to reach $150bn by 2004, up from $103bn in 2002. At some point a rising imbalance of this size will be seen as intolerable in the US and might well result in recourse to trade sanctions if no concessions are forthcoming from China. So a move to a flexible exchange rate may be helpful in avoiding other threats.

- The additional rationale for pressing China to revalue is that it could encourage other Asian exchange rates to loosen up. A combined exchange rate move might have a larger impact on the US.

- Revaluations in China's (and Asia's) currencies may help improve growth for other developing countries, such as Mexico and the rest of Latin America: this might 'rebalance' the emergers and also reduce Asia-US tensions.

- Chinese wage rates are incredibly low by international standards – a revaluation of the Yuan would help redress this and raise per capita US$ incomes more quickly than any likely trends in Yuan wage growth.

- If a Yuan revaluation could be handled without destroying growth and jobs, this would make Chinese workers feel richer in the world economy. The 2004 forecast for current US$ GDP in China could rise from $1500bn to over $2000bn based on 6 Yuan/US$ instead of 8.3.

- It is estimated that China will otherwise have to wait until 2007 before achieving per capita GDP over $1500 - with a strong Yuan, 2007's income might be $2000 per capita versus an estimated $1100 last year (PPP adjustments are not used).

All in all, it's not all that likely that China will undertake any substantial changes in exchange rate policy. Provided the economic outlook stays healthy, an incremental change to a fixed or floating Yuan, perhaps around 7.5, may be the most likely scenario. A change of this magnitude could be accompanied by other measures to ensure that GDP growth and jobs didn't suffer any detrimental consequences. Some additional concessions to encourage imports from the US would also help reduce trade tensions – and would be necessary to redress the US-China imbalance whether the Yuan is 8.3 or 6 – as changes in the Yuan alone would guarantee very little in terms of modifying this source of acrimony.

2. The EU enlargement of 2004

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2.1 The Size of the Enlargement

In 2004, EU-15 becomes EU-25. The new member countries (Acceding Countries, AC-10) means a new economic geography, with a New North (Estonia, Latvia and Lithuania), a New Centre (Poland, Hungary, Czech Republic, Slovakia and Slovenia) and a New Mediterranean (Cyprus and Malta). In total this enlargement adds a population of 75 million to the existing EU-15 and GDP (measured at Parities of Purchasing Power) of some 785 billion €. The average per capita income of the new area stays at 45% of the EU-15 average.

Table 4.2.1

Demographic and Economic Weight of AC-10

	GDP (billions € PPP)	Population (millions)	GDP per capita-€ PPP	GDP per capita EU-15=100
New North (Estonia, Latvia and Lithuania)	61.8	7.3	8,600	37
New Center (Poland, Hungary, Czech Republic, Slovakia and Slovenia)	704.4	66.4	10,600	46
New Mediterranean (Cyprus and Malta)	18.7	1.2	16,200	70
Total AC-10	784.9	74.9	10,500	45

Source: EC-Doc. SEC (2002) 1400-1412 with new PPP.

The AC-10 countries will account for 18% of a EU-25 population of 460 million and 8% of a EU-25 GDP of 10 trillion € (ppp)

Measured in PPP, the enlargement represents an increase of 8% of the EU-15 GDP, while in terms of population the increase is of some 18%; the order of magnitude is of a growth increase corresponding to an additional middle-sized member country such as Spain (7% of GDP, 10.5% of population).

Inspection of table 4.2.2 shows a relatively high level of car ownership in relation to GDP, as well as a relatively high level of University graduates, but always below 2/3 of present European averages.

As an arithmetic consequence of the enlargement, the average per capita income of EU-25 will be reduced to 90% of the EU-15 average level.

Table 4.2.2

Economic indicators (EU-15, EU-25 and AC-10 in 2002)			
	EU-15	AC-10	EU-25
GDP (trillions €-PPP)	9.2	0.8	10.0
	92%	8%	100%
Population (millions)	379	75	459
	82%	18%	100%
GDP per capita (PPP, EU-15=100)	100	45	90
			AV. AC-10/ AV. EU-15
Population with higher education (%)	21.6%	12.7%	58.8%
PC (p. 100 pers.)	30	11	36.7%
Internet users (p. 100 pers.)	31	13	41.9%
Mobiles phones (p. 100 pers.)	72	38	52.8%
Automobiles (p. 100 pers.)	47	29	61.7%
Source: Eurostat			

2.2 Some macroeconomic characteristics

Table 4.2.3 portrays some relevant economic indicators for each one of the AC-10. Inspection of this table points to several great disparities: income per capita ranges from 18,500€ to only 7,700€, the unemployment rate from 4% to 18.4%, the inflation rate from 1.3% to 6.9%, current account deficits (a common characteristic), from –0.4% of GDP to –9.7% of GDP. Despite the policies for greater economic convergence adopted in recent years, the AC-10 still shows great structural differences that will shape a variety of local responses to the challenges of adhesion.

Table 4.2.3

Macroeconomic indicators of AC-10

	Estonia	Latvia	Lithuania	Cyprus	Malta	Poland	Hungary	Czech Rep.	Slovakia	Slovenia
A.- GDP										
GDP (billion €, -PPP)	13.4	18.1	30.3	14.1	4.6	355.5	121.3	136.0	59.7	31.9
GDP per capita (€, PPP)	9,800	7,700	8,700	18,500	11,700	9,200	11,900	13,300	11,100	16,000
GDP per capita (EU15 = 100)	42	33	38	80	55	40	51	57	48	69
GDP growth rate (av.% 2001-2004)	5.2%	6.4%	5.3%	3.0%	2.3%	2.1%	3.7%	3.0%	4.0%	3.3%
B.- Population and employment										
Population (millons)	1.4	2.4	3.5	0.8	0.4	38.6	10.2	10.2	5.4	2.0
Unemployment (% active pop.)	12.4%	13.1%	16.5%	4.0%	6.5%	18.4%	5.7%	8.0%	19.4%	5.7%
Rural employment (% employment)	7.1%	15.1%	16.5%	4.9%	2.2%	19.2%	6.1%	4.6%	6.3%	9.9%
Employment growth rate (av.% 2001-2004)	0.8%	2.1%	-0.5%	0.9%	0.4%	-1.1%	0.2%	0.8%	2.7%	
C.- Prices and salaries										
Inflation rate (CPI av.% 2001-04)	4.2%	2.5%	1.3%	2.8%	2.6%	2.7%	6.0%	2.6%	6.7%	6.9%
Minimum wage (€/month)	138	116	125	..	535	201	212	199	118	451
D.- Foreign trade and investment balance										
Current account (GDP%)	-4.7%	-9.7%	-4.8%	-4.5%	-4.8%	-4.1%	-2.2%	-4.7%	-8.8%	-0.4%
Exports to EU-15 (% total exports)	69.4%	61.2%	47.8%	49.0%	41.3%	69.2%	74.3%	68.9%	59.9%	62.2%
Imports from EU-15 (% total imports)	56.5%	52.6%	44.0%	55.5%	63.6%	61.4%	57.8%	61.8%	49.8%	67.7%
FDI (€ per capita)	2,084	970	720	..	..	952	1,790 (*)	2,284	521	1,527
FDI (GDP %)	9.7%	2.3%	3.7%	1.8%	8.8%	3.2%	4.7%	87%	6.3%	1.9%

Source: Eurostat and Doc. SEC (2002) 1400-1412.

When the new region is considered as a single entity, as in Table 4.2.4, and when the analysis is focussed on growth, it appears that AC-10 is a growth pole in the EU context, with expected GDP rates of 3.1% for 2003 and even 4.0% for 2004, well above EU-15 rates. This growth performance is achieved with a high unemployment rate, and an inflation rate still above European averages; the public deficit is progressively under control, as well as the current account balance. In terms of the Maastricht criteria for a monetary convergence, the AC-10 are progressively moving towards a stable macroeconomic framework allowing for the adoption of the euro before the end of the decade.

Within the EU-25, AC-10 is expected to be a growth pole during the coming years

Table 4.2.4

Macroeconomic projections for AC-10		
	Acceding Countries (AC-10)	
	2003	2004
GDP (% real change)	3.1	4.0
Inflation (% average consumer price)	2.7	3.3
Employment (% change)	0.0	1.0
Unemployment (% of civil labour force)	15.3	14.7
General Government Balance (% GDP)	-4.4	-3.9
Current account balance (% GDP)	-4.2	-3.7

Source: Economic forecast for the Candidate Countries, Spring 2003, European Economy nº15, April 2003.

2.3 Opinions on economic impacts of the enlargement

The new enlargement with the AC-10 has raised concerns both in the general public and in business.

The economic agents expect favourable results of the enlargement both in EU-15 and AC-10

The EC has consulted the European citizenship on this issue, in the form of the Eurobarometer opinion surveys.

Some of the results of Eurobarometer are portrayed in Table 4.2.5 and Table 4.2.6.

Looking at the socio-political impacts, the Europeans see positive results enhancing the international weight of the Union, but they fear increasing difficulty for decision-making; specially in Germany, where it is generally assumed that the enlargement brings new costs into consideration.

Table 4.2.5

European socio-political impacts			
	EU-15	Maximum	Minimum
Enlargement will mean that the European Union will have a stronger weight on the international scene	78%	86% (Ireland)	71% (Austria)
It will be more difficult to take decisions in an enlarged European Union	76%	88% (Finland)	66% (United Kingdom)
We have a moral duty to re-unite Europe after the divisions of the Cold War	72%	90% (Greece)	50% (Finland)
Enlargement will be very expensive for our country	68%	79% (Germany)	52% (Italy)
New countries joining the European Union is, historically and geographically natural and therefore justified	68%	77% (Ireland)	60% (Denmark)
Enlargement will reduce risks of war and conflicts in Europe	65%	76% (Greece)	58% (United Kingdom)
A larger European Union will inevitably be more remote from citizens	46%	62% (Denmark)	29% (Spain)
Enlargement will mean our country will play a less important role in Europe	33%	56% (Finland)	27% (France)
Source: Flash Eurobarometer Enlargement of the European Union, march 2003.			

Table 4.2.6

Economic incidence on the future of the EU			
	EU-15	Maximum	Minimum
Enlargement will allow our companies to expand to new markets	86%	93% (Ireland)	76% (Portugal)
Enlargement will mean that it will be easier to tackle environmental problems all over Europe	67%	76% (Greece)	46% (Austria)
Enlargement will allow our agricultural sector to expand to new markets	63%	75% (Ireland)	38% (Finland)
Enlargement will mean that many citizens of the new Member States will settle in our country	62%	77% (Spain)	34% (Finland)
Enlargement will make it harder to tackle crime and drug smuggling	51%	68% (Finland)	39% (Spain)
Enlargement will increase unemployment in our country	43%	64% (Portugal)	31% (Finland)
Enlargement will mean that it will be easier to control illegal immigration	42%	59% (Spain)	27% (Denmark)
Enlargement will mean that the standard of social welfare in our country will fall	41%	56% (Germany)	28% (Italy)

Source: Flash Eurobarometer Enlargement of the European Union, march 2003.

More specifically, table 4.2.6 deals with economic factors, and the positive impact of the widening of the European market is fully recognised. Confirming the previous assessment of costs, the German population is more sensitive to a possible loss of economic welfare in their country.

In order to identify the main characteristics of the position of international business in relation to the enlargement, The Economist Intelligence Unit, has surveyed the opinions of 315 executives (some 50% in the EU and 20% in the USA) finding a large majority (91%) expecting favourable results from the new enlargement; 59% see new business opportunities in the process.

International business is attracted by the market growth potential and low wages in AC-10

Table 4.2.7 summarises the main expected macroeconomic impacts: half of the executives feel FDI will increase in AC-10, and growth will be stimulated in the area. For the development of business in these countries, many see as the main assets the growth of consumer markets on the demand side and the lower labour costs on the supply side. In general, however, the results of the survey are showing doubts and reflect cautions attitudes.

Table 4.2.7

Macroeconomic and business impacts (% of "high impact" answers)	
Macroeconomic	Business
New flows of FDI to AC-10 (52%)	Consumer markets growth (61%)
	Low labour costs (57%)
Higher growth in AC-10 (48%)	New partnership opportunities (45%)
	Access to highly qualified manpower (37%)
Impacts on EU-15 will depend on internal policies (38%)	New opportunities for outsourcing (37%)
It will take 3-5 years before adoption of Euro in AC-10 (58%)	Opportunities for acquisitions (36%)
	New FDI by my company AC-10 (21%)

Source: Economist Intelligence Unit / Accenture (2003).

2.4 Possible macroeconomic growth impacts

As already mentioned, the passage from EU 15 to EU 25 increases the size of population and GDP, and decreases the average per capita income.

It is interesting to summarise the expected dynamic effects: as AC-10 has a higher growth rate in GDP and prices, and higher rates of unemployment, and public deficits, we should expect some higher but more unbalanced growth for EU-25 in relation to EU-15.

As AC-10 is expected to converge to EU averages, the rate of potential growth of EU-25 is slightly higher than for EU-15

In terms of GDP growth, as AC-10 will account for some 8-10% of the EU-25 GDP, and as the difference in the annual rate of growth in relation to EU-15 is between +1.0 and +1.5 percentage points, we may expect the enlargement to directly raise the EU potential growth rate by 0.1 percentage points, in relation to EU-15.

This direct arithmetic impact only measures the fact that AC-10 is a set of countries with low average income, on a convergence path. Of course there are other indirect impacts coming from trade integration and export growth, both in EU-15 and AC-10, and resulting from the working of the income multipliers and of the price elasticities. These indirect impacts may be relatively more important for Germany and Italy, the two main trading partners of AC-10, but overall are expected to be small.

Several econometric studies have been made in recent years, often upon request by the EC, in order to assess the macroeconomic expansionary impulse coming from the enlargement, under different scenarios, for several EU countries and for the total EU. It has been reasonably confirmed that the impact is slightly positive for EU-15 and more clearly beneficial for AC-10.

The potential GDP growth rate of EU-25 should be between 0.2 and 0.3 percentage points above the EU-15 rate, including a purely arithmetic effect of 0.1 points due to the expectation of a convergence of AC-10 to EU averages

To make a very simple approximation of the growth impact, it is to be noted that for EU-15, imports from AC-10 totalled 26.6% of total imports in 2002, and exports to AC-10 some 14.5% of total exports, up from 14.6% and 10.4% in 1997. The increase in exports to the AC-10 during these past five years roughly accounts for 0.1 (0.07% in 2002) percentage point of GDP. And with a production multiplier of the order of 1.5 to 2.0, we are talking of a maximum impact of the order of +0.2 percentage points on the EU-15 growth rate in recent years. Of course the total impact should consider the extra dynamic impact in AC-10 and should be reduced to take into account the fact that some of the trade is a simple consequence of a natural trade diversion process, and that some imports from AC-10 may also have affected negatively EU-15 production.

As furthermore, a substantial part of the enlargement trade effects may have taken place already, the final dynamic consequences of the enlargement cannot be accurately ascertained at the present moment, but we consider that the most probable range is that between 0.2 and 0.3 percentage points will be added to the medium term potential growth rate of the EU-25 in relation to the EU-15 (including the arithmetic effect mentioned above).