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## Recovery in Western Europe

In the course of this year the West European economy has made a distinct recovery. Real gross domestic product in the first half-year was 2% higher than in the recession low a year previously. The gap between levels of economic activity inside Europe that had been caused largely by Great Britain's lead has now narrowed again. Demand from non-European economies has continued to act as the main stimulus. However, the interest cuts as of September 1992 have also made themselves increasingly felt: they have helped decisively in improving the business climate as of autumn of last year. Utilization of overall capacity did not drop any further in the first half of 1994. The decline in employment, too, came to a standstill while the number of unemployed stagnated at about 11% of the labour force.

The strong rise in West European exports, which had already acted as a buffer to the recession in 1993, was largely in response to the rapid expansion of demand in North America and most of the emerging economies in Southeast Asia and Latin America, although exports to Central and Eastern Europe also rose. West European suppliers benefitted from the exchange-rate induced improvement in competitiveness as against Japan and – up to the spring – the dollar bloc countries. Demand impulses were also disseminated via a faster expansion of merchandise trade amongst the West European economies. Most pronounced was the stimulus to exports in countries whose currencies had depreciated significantly against those of other West European countries, e.g. in Italy, Finland, Norway, Spain and Sweden. Exports also grew powerfully in the rest of Western Europe, however.

Up to the end of last year domestic demand had hardly picked up at all in Western Europe. The external demand stimuli and the improvement of the general economic and especially the monetary environment, however, created the conditions for this. There has been a trend reversal particularly in the business sector. This was reflected first in the expansive stockbuilding as indicated by the increased demand for primary products. In most countries, the propensity to invest also revived and business investment started to rise. Residential building, too, was spurred by falling interest rates up to the beginning of this year. The disposable income of private households has

continued to expand but slowly. Private consumption has, though, been underpinned in most cases by a decline in the propensity to save.

In Western Europe, the recession's aftermath of low wage and price rises is now coinciding with the marked increase in productivity at the onset of recovery. Despite the heavy increase in the prices of imported raw materials, price rises have therefore still tended to decline. The average rise in the cost of living in the first half-year was under three per cent on last year. At 4% and 5% resp., there was a significantly higher rate only in Italy and Spain. The uptrend of wages as a whole has lost still a little more momentum. The increase in hourly wages on last year exceeded the rate of inflation only slightly and in some countries real wages even dropped. With the simultaneous accelerated increase in productivity, unit labour costs ought only to have risen slightly. It is particularly remarkable here that this trend also applied to "depreciation" countries such as Finland, Great Britain, Italy and Sweden. This has largely been the achievement of a monetary policy geared to stability in recent years.

The general monetary conditions are marked by a split interest trend: on the one hand, after a persistent three-year decline, capital market interest rates have risen again markedly since the beginning of this year in the wake of the increase in the USA; recently, the yield on government bonds in most West European countries was some 2 percentage points up on the start of the year. On the other hand, under the leadership of the Bundesbank, key rates were still cut distinctly up to the middle of the year. The structure of interest rates alone – with short-term rates 2 to 3 percentage points under the long-term rates almost everywhere – indicates that monetary policy is now steering a fairly expansionary course; the largely increased growth in money supply points in the same direction. In recent months, however, limits to this policy have become apparent on various occasions. The central banks of Italy and Sweden, faced with worsening mistrust in these countries' fiscal policies, were only able to relieve the pressure on the exchange rates of the lira and krona by raising interest rates. In some other countries short-term interest rates have gone up again slightly, too. Although specific factors have played a part – e.g. in the case of Great Britain its recovery lead – against the background of

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a largely expansionary monetary policy, there is much to indicate that the decline in key rates is now coming to an end.

Fiscal policy this year in Western Europe has slightly restraining effects on demand. After the high growth in indebtedness of recent years, several countries took action which has already resulted in lower budget deficits in 1994, at the onset of the recovery. A major goal here is to meet the Maastricht criteria. Examples of the urgent need to consolidate are Italy and Sweden, where the heavy expansion of public indebtedness is threatening to jeopardize the creditworthiness of the state on the financial markets. Prospects of lower deficits in themselves tend to curb interest rates, but many countries are consolidating by raising taxes and social security contributions instead of curbing spending more strongly. In view of the high public sector share of GNP, this policy is in danger of going beyond curtailing demand in the short term and acting in addition as a brake on growth in the medium term.

Even assuming that this development does not continue, higher interest rates on the European capital markets will weaken the interest-driven stimuli. Nevertheless, in view of the impetus emanating from monetary policy over the last two years and the rapid export

growth to non-European countries, the upswing in Western Europe can be expected to gain further momentum. This is not least due to the fact that the earnings expectations of businesses have brightened, partly thanks to the measures taken to cut costs during the recession. Business investment can therefore be expected to grow faster. Residential building, on the other hand, will expand at a relatively moderate pace. A dampening factor, in addition to the higher interest rates, is the continuing rise in taxes and other fiscal charges which means that a recovery-induced improvement of income expectations in Western Europe is long in coming. Despite the trend towards less saving, then, private consumption will pick up only slightly. Altogether, the economic expansion next year – with a slowdown in stockbuilding – will be comparatively moderate. In Western Europe as a whole we can expect a rise in real gross domestic product of over 2% this year and 3% next year with growth rates largely converging amongst the individual countries. Utilization of capacity and employment will gradually rise. Unemployment will go down only a little in the course of next year.

*Compiled by the Department of World Business Trends of the Hamburg Institute for Economic Research (HWWA).*

### Key Data on Economic Trends in Western Europe

	1991	1992	1993	1994 <sup>a</sup>	1995 <sup>a</sup>
Real gross domestic product (% change on previous year) <sup>1</sup>	1.4	0.9	-0.5	2	3
Rate of unemployment (% of labour force) <sup>2</sup>	8.4	9.4	10.7	11	11
Net gov. financial investment (% of GDP) <sup>3</sup>	-4.4	-5.2	-6.3	-6	-5
Consumer prices (% change on previous year) <sup>4</sup>	4.8	3.8	3.3	3	2.5
Hourly wages (% change on previous year)	7.4	5.8	4.3	3.5	3.5
Value of the ECU in dollars (% change on previous year)	-2.7	4.8	-9.8	1	-

<sup>1</sup> Including east Germany as of 1992. <sup>2</sup> OECD standardised rate. <sup>3</sup> As defined in the national accounts. <sup>4</sup> Manufacturing. <sup>a</sup> Forecast; rounded to the nearest 0.5%.

Sources: National statistics, OECD, IMF, own calculations.

### HWWA Index of World Market Prices of Raw Materials<sup>1</sup> (1975 = 100)

Raw Materials and Groups of Materials	1993		1994					
	AA <sup>2</sup>	Aug.	May	June	July	Aug.	9. 9.	23. 9.
Total index . . . . .	144.3	141.7	146.7	154.0	160.8	157.0	156.1	157.8
Total, excl. energy raw materials . . . .	120.0	118.5	137.7	142.3	148.9	149.0	154.9	157.9
Food, tropical beverages . . . . .	91.4	91.3	108.6	114.8	124.4	122.3	127.9	131.0
Industrial raw materials . . . . .	141.7	139.2	159.2	163.3	167.5	169.3	175.7	178.4
Agricultural raw materials . . . . .	140.9	136.0	165.7	167.0	171.4	176.7	185.0	187.3
Non-ferrous metals . . . . .	145.0	144.9	159.8	172.0	177.3	173.5	179.7	184.9
Energy raw materials . . . . .	158.5	155.2	152.1	160.7	167.8	161.7	156.7	157.7

<sup>1</sup> On dollar basis. <sup>2</sup> Annual Average.