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## Western Europe: Upswing Loses Momentum

**A**fter the vigorous upswing in Western Europe throughout last year, the expansion has slowed down somewhat since early 1995: real gross domestic product in the first half of the year was nevertheless 3% up on the same period last year. The utilization of national production capacity has risen again, though it remains below the long-term average; only in the case of capacity utilization in industry is it already higher. The number of employed has so far risen little in the course of the upswing in most countries and the number of unemployed has dropped only slightly. Under these conditions, most wage rises have remained moderate and consumer prices have generally risen at a modest pace.

The economic climate, which had improved rigorously from autumn 1993 up to the beginning of this year, has since cooled down a little. A not unimportant contributory factor here was probably the unexpectedly sharp rise in capital market interest rates up until the end of last year, which tended to dampen the propensity of both investors and consumers to spend. On top of this were sizable rises in various taxes and charges as part of the ongoing efforts to consolidate government finances. This frequently offset the factors stimulating private household income, so that private consumption has risen little this year. In the business sector the stimuli from the upturn in stockbuilding, emanated – as usual – in the early upswing phase, have diminished. Business investment in plant and equipment, however, has expanded considerably in most countries although the expansion in demand for investment goods has slowed down due to higher interest rates, which have depressed sales and earnings prospects.

Another impediment to growth has been the deterioration in the world economic climate. The economic slowdown in the United States has made itself felt, although US imports continued to rise substantially in the first half of the year and imports in many developing countries, especially newly industrializing countries, and in Eastern Europe evidently continued to expand rapidly. For another, the competitiveness of many West European suppliers has suffered from the sharp drop in the dollar in the early months of this year. General conditions in foreign trade diverged a great deal from country to country, however, in particular because

currency relations shifted again, mostly in the same direction as in 1992/93. Worst hit have been suppliers from Germany and Switzerland with their competitors from Italy and the United Kingdom benefiting most. With the recent “corrections” following the partial recovery of the dollar a good part of the exchange rate shifts from spring have been reversed, although the high risk of pronounced exchange rate fluctuations is likely to continue to cloud the economic climate.

Since the boom on world industrial commodity markets came to an end with the slower pace of the economy in the industrial countries in spring, and oil prices also came under pressure, the cost push from this direction in Western Europe disappeared. Benefiting from the lower exchange rate of the dollar, raw materials imports have even become a little cheaper in the course of the year in most countries, although previous price rises have still been passed on. This was a major contributory factor to the fact that the latest figure for the average rise in producer prices as compared with a year ago was over 5%. At the same time, despite persistent moderate wage rises unit labour costs have risen again slightly, as productivity growth has entered a cyclical slowdown. On the consumer side, however, the leeway for passing on higher costs has narrowed further due to the relative weakness of demand. The cost of living has therefore again risen only moderately on last year, mostly between 1% and 2%, according to the latest figures. After the steep devaluations in recent years, the rates for Spain (5%) and Italy (5.5%) were the highest.

The slowing down of the upswing in Western Europe is an impediment to the desired reduction in budget deficits. One reason for this is the persistent shortfalls in revenue and increased spending due to the low utilization of productive capacity. A more significant factor is that discretionary spending cuts are also more difficult to implement when the economic outlook is not as bright. In view, though, of the high overall tax ratio in Western Europe of over 45% of gross domestic product, this is essential; the aggregate government financing deficit, which this year is still nearly 5% of gross domestic product, is structural in nature. With a view to the 3% criterion for membership of the final phase of European Economic and Monetary Union alone, which has been met by only a few countries so far, the consolidation efforts

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will continue into next year, so no demand stimulus can be expected to come from fiscal policy. Governments are all the more likely to pursue this course as the countries that came under heaviest pressure during the foreign exchange turbulence in spring were those with very high budget deficits and this triggered monetary restrictions.

The central banks in Italy, Sweden and Spain attempted to halt the fall in exchange rates by raising their discount rates. In France and Denmark, too, the monetary reins were temporarily tightened for the same reason. Only in the United Kingdom were the increases in interest rates primarily due to economic trends and the resultant price rise expectations. The other countries, in contrast, went on slowly lowering the discount rate. There was, however, an easing on financial markets due above all to the drop in capital market interest rates spearheaded by the USA. In the countries with strong currencies, the interest rates rise of last year has already been reversed for the most part, whereas the reduction in weak-currency countries, such as Italy, Spain, Sweden and the United Kingdom, has kept within narrow bounds. It is to be expected that the recent trends toward a more relaxed monetary policy will persist in Western Europe for the time being, particularly as the money supply is for the most part expanding relatively slowly, despite

a slight speed-up. The interest rate gap from one country to another will, however, close only gradually.

With the decline in capital market interest rates in many countries and a partial recovery of the dollar, major retarding influences in Western Europe have weakened. The prospects that the moderate upswing will continue are therefore again brighter as a whole. One important effect of this will be to encourage the propensity to invest; business investment ought to pick up markedly. At the same time, the cyclical impetus will gradually make itself felt more on disposable income and private consumption. Altogether, production will continue to increase at a moderate pace; gross domestic product in Western Europe will be 2¾% up on the previous year in 1995 and 2½% in 1996. Yet, utilization of capacity will hardly increase at all. As a whole, the economy will develop insufficient momentum to bring about any marked improvement on the labour market, similar to the situation to begin with in the mid-eighties. Such an improvement will require an all-round improvement in conditions for growth, which would appear impossible to achieve without a lasting overhaul of government finance.

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

### Key Data on Economic Trends in Western Europe

	1992	1993	1994	1995 <sup>a</sup>	1996 <sup>a</sup>
Real gross domestic product (% change on previous year)	0.9	-0.6	2.9	2¾	2½
Rate of unemployment (% of labour force) <sup>1</sup>	9.2	10.5	11.0	10½	10
Net gov. financial investment (% of GDP) <sup>2</sup>	-5.2	-6.5	-5.7	-5	4½
Consumer prices (% change on previous year)	3.8	3.2	2.8	3	3¼
Hourly wages (% change on previous year) <sup>3</sup>	5.4	4.6	3.7	3½	4
Value of the ECU in dollars (% change on previous year)	4.8	-9.8	1.6	9 <sup>b</sup>	-1 <sup>b</sup>

<sup>1</sup> OECD standardised rate. <sup>2</sup> As defined in the national accounts. <sup>3</sup> Manufacturing. <sup>a</sup> Forecast. <sup>b</sup> Assuming the value does not change after the beginning of September 1995.

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	1994		1995					
	AA <sup>2</sup>	August	May	June	July	August	8. 9.	22. 9.
Total index	147.8	157.0	170.1	164.4	158.0	158.8	160.8	157.1
Total, excl. energy raw materials	143.2	149.0	164.5	166.7	165.2	162.3	159.5	160.2
Food, tropical beverages	113.5	122.3	119.8	119.7	117.5	119.0	115.8	112.9
Industrial raw materials	165.9	169.3	198.5	202.4	201.6	195.3	192.8	196.2
Agricultural raw materials	171.8	176.7	222.0	222.4	215.9	204.1	203.9	209.1
Non-ferrous metals	171.2	173.5	198.9	210.4	217.1	217.3	209.0	208.1
Energy raw materials	150.4	161.7	173.3	163.2	153.8	156.7	161.5	155.3

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