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Article

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Economic outlook for the Euro area 2003

Das IWH erstellt seit 2002 im Rahmen des *European Forecasting Network (EFN)* zusammen mit sieben weiteren europäischen Forschungszentren im Frühjahr und Herbst im Auftrag der Europäischen Kommission Gutachten zur konjunkturellen Entwicklung des Euroraums.²³ Diese umfassen Prognosen der wichtigsten makroökonomischen Aggregate sowie Untersuchungen zu Aspekten der europäischen Integration.

Die Konjunkturprognose wird für den Euroraum als Ganzheit abgegeben. Im Frühjahrsbericht vom März 2003 wird ein Anstieg des realen Bruttoinlandsprodukts von 1,2% in diesem und 2,1% im kommenden Jahr erwartet. Während im vergangenen Jahr die Konjunktur fast ausschließlich Impulse von der Außenwirtschaft erhielt, verlagern sich im Prognosezeitraum die Auftriebskräfte zunehmend auf die Binnenwirtschaft. Die Entwicklung bleibt jedoch verhalten und die Arbeitslosigkeit verharrt auf hohem Niveau. Die Beschäftigung wird zudem von den über den Produktivitätsfortschritt hinausgehenden Lohnabschlüssen belastet. Die Inflation wird auch in diesem Jahr leicht über der von der Europäischen Zentralbank als noch mit Preisniveaustabilität vereinbar angesehenen Marke von 2% bleiben. Erst für das kommende Jahr wird infolge sinkender Ölpreise ein Rückgang erwartet. Die EFN-Prognose wurde Ende März unter der Annahme nur begrenzter Auswirkungen des Irak-Krieges erstellt. Diese Setzung scheint sich inzwischen zu bestätigen.

Im Vergleich zu Prognosen anderer Institutionen wird für 2004 eine etwas verhaltenere Aufwärtsentwicklung erwartet. Regionale Wachstumsdisparitäten werden bestehen bleiben. Dies wird tendenziell dadurch verstärkt, dass die einheitliche Geldpolitik in den einzelnen Ländern unterschied-

lich wirkt. Bei gleichem Nominalzinssatz führen Divergenzen in den erwarteten Inflationsraten zu Differenzen in den Realzinsen, die die Nachfragebedingungen mit bestimmen. Die Wachstumsschwäche im Euroraum hat jedoch vor allem strukturelle Ursachen. Zu nennen sind insbesondere die in den meisten Ländern wenig flexiblen Arbeitsmärkte.

Uncertainty about the Iraq crisis has called the global economic recovery into question. During the winter of 2002/03 this uncertainty was reflected in weak stock markets, strong movements in the oil market and of exchange rates. Should the oil price remain at high levels over a prolonged period of time or go up even further, increasing production costs would squeeze profits of firms and impair the purchasing power of consumers. Immediately after the beginning of the war in Iraq the oil prices dropped significantly, but they have increased since then. While the appreciation of the Euro versus the Dollar has dampened the effects of the oil price hike, a continuation of this process will harm exports, which have been an important source of growth in the Euro area during the last few years. Very high oil prices and a continuing depreciation of the Dollar are however not expected to continue much further into 2003 and 2004. Instead, we believe that the current oil price level reasonably reflects the present risks for world oil supply and that the exchange rate for the Dollar is partly determined by expectations about the possible future costs of the US engagement in the Middle East. At 1.10 the Euro is indeed approaching the bottom value of what is generally considered to be its long run equilibrium exchange rate. Thus, further price and exchange rate movements are not the main driving forces for our forecasts as the oil price is assumed to fluctuate around 24.5 for the remainder of 2003 and 23.5 US Dollar per barrel for 2004.

Our forecasts for GDP growth are 1.2% and 2.1% for 2003 and 2004 respectively. These forecasts hinge on the assumption that political uncertainty in the Middle East will decrease rapidly and will not lead to significant disruptions in the world economy. In the second half of 2003, economic re-

²³ Das EFN besteht aus dem IGIER (Innocenzo Gasparini Institute for Economic Research, Università Bocconi), Mailand, dem CEPII (Centre d'Etudes Prospectives et d'Informations Internationales), Paris, dem European University Institute (EUI), Florenz, dem Gruppo de Recerca "Anàlisi Quantitativa Regional" (AQR, Universitat de Barcelona), dem Instituto Flores de Lemus (IFL, Universidad Carlos III), Madrid, dem Department of Applied Economics (DAE, University of Cambridge), Global Insight, Mailand, und dem IWH. Die vollständigen Berichte sind im Internet unter www.efn.uni-bocconi.it verfügbar.

covery in the major world regions will slightly gain momentum. Expansionary fiscal and monetary policies will stimulate economic activities in the US. In Japan, sustained growth is still hampered by the lack of structural reforms. It should be noted however that in some world regions economic activity has remained robust, in particular in Central and Eastern Europe as well as Southeast Asia. Summing up, the stimulus for the Euro area from world trade is expected to gain momentum, though only very gradually, over the forecast horizon.

The expected sluggish economic recovery in the US is likely to affect the Euro area countries to different degrees. Each country benefits not only directly from the economic recovery in the US by its bilateral trade linkages, but also due to the linkages with the other countries which are also posi-

tively influenced by the US expansion. Furthermore, international trade is not the only channel of business cycle transmission. A further source of shock propagation is the increasing interdependence of capital markets, which are currently very adversely affected by the uncertainty in the world economy. In addition, the investment decisions of multinational companies are also important. Therefore, an overall measure of the influence of economic developments abroad on the domestic economy is required. France and Germany, for example, depend to a larger degree on external economic developments than Italy and Spain. If the growth rate of industrial production in the US increases by one percentage point, the cumulative gain in the growth rate of industrial production after the adjustment processes have run their course

Table 1:
Economic outlook for the Euro area

	2000	2001	2002	2003: 1st half		2003: annual		2004: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	3.5	1.4	0.8	1.1	0.6 1.7	1.2	0.6 1.8	2.1	1.4 2.8
Potential Output	2.9	2.8	2.1	2.1	1.8 2.4	1.9	1.4 2.3	1.9	1.4 2.4
Private Consumption	2.5	1.8	0.6	1.0	0.2 1.8	1.0	0.2 1.8	2.0	1.0 3.1
Government Consumption	2.0	2.1	2.6	1.9	1.7 2.2	1.8	1.6 2.1	1.3	0.9 1.7
Fixed Capital Formation	4.9	-0.6	-2.6	-0.6	-2.5 1.3	0.9	-1.1 2.9	4.3	1.9 6.5
Exports	12.6	2.8	1.2	3.7	1.7 5.8	3.3	1.0 5.6	6.3	3.4 9.0
Imports	11.3	1.4	-0.4	3.7	1.2 6.2	4.0	1.3 6.7	7.7	4.4 10.9
Unemployment Rate	8.5	8.0	8.3	8.7	8.6 8.8	8.8	8.7 8.9	9.0	8.7 9.4
NAIRU	9.1	8.6	8.2	8.2	8.1 8.3	8.2	7.9 8.4	8.6	8.3 9.0
Labour Costs	3.2	3.3	3.6	3.1	2.6 3.5	3.0	2.6 3.4	3.0	2.4 3.6
Labour Productivity	1.3	0.4	0.1	1.0	0.4 1.6	1.3	0.9 1.8	2.1	1.5 2.6
HICP	2.1	2.4	2.2	2.3	1.8 2.8	2.2	1.5 2.9	1.8	0.8 2.8

Percentage change in the average level compared with the same period a year earlier, except for unemployment rate, exchange rate, NAIRU and interest rates that are expressed in levels. Point forecasts and 80% confidence bounds are taken from EFN forecasting models and based on 2000 stochastic simulations. Exports and imports include trade between Euro area countries.

Based on data up to 27 March 2003.

amounts to more than 0.8 percentage points in France and Germany. The corresponding figures for Spain and Italy are somewhat lower. For 2003 we forecast a 2.2% rate of growth for the annual average of industrial production in US and only 0.8% for the Euro area.

Improvements in the global economy in the course of 2003, expected to arise after the end of the Iraq crisis, will help to restore investor and consumer confidence. In the last two years overcapacity has already been reduced considerably, and the increase in demand will encourage companies to invest more. In addition, the financing conditions will be supported by low interest rates in the Euro area. Furthermore, the rise in unit labour costs will be significantly lower than in previous years. Capital obsolescence, especially of new technologies and in the rising share of ICT goods in capital stock which depreciate very rapidly, could reinforce such a process. However, persistently high unemployment will mean that private consumption will only accelerate at a low pace. The forecasts of the main macroeconomic aggregates are summarised in Table 1.

The recent pronounced appreciation of the Euro, together with sluggish demand on export markets, started to take its toll. In the fourth quarter of 2002, exports stagnated. We expect that also in the first half of the current year Euro area exports will be hampered by these factors. With increasing world demand and the fading out of the effects of the Euro appreciation we expect Euro area exports to gain momentum in the second half of the year. Our forecast, however, hinges on the assumption that the war in Iraq will only be rather

short and that repercussions on the world economy remain limited. In this context, the monetary factors pushing up inflation are compensated by the deviation of prices from the trend in unit labour cost and the transitory effects due to the output gap, changes in unit labour costs, etc. Therefore, our inflation forecasts, 2.2% in 2003 and 1.8% in 2004, tend to their mean level which turns out to be constant in the recent years at about 1.9%.

Comparison with alternative forecasts

The forecasts presented above are obtained by the EFN macroeconomic model, described in detail in the Spring 2002 report. Table 2 reports a comparison of the EFN forecasts of the main macroeconomic aggregates with alternative forecasts, notably those of the European Commission, the OECD, the IMF, and Consensus Economics Inc.

For 2003, the EFN forecast for GDP growth and the expenditure components is close to the other forecasts. However, the EFN forecast is slightly more optimistic regarding fixed capital formation. As in the EFN forecast the recovery of investment already begins in 2003, in 2004 the acceleration is less pronounced. The increase of working days in 2004 is expected to have only a negligible effect on the economic performance.

Our inflation forecasts are slightly higher than all the alternatives in Table 2.

Forecast comparison with previous outlook

Table 3 shows a comparison between our spring forecast for 2002 and 2003 with the forecasts in

Table 2:
Comparison of EFN Forecasts with alternative Forecasts

	EFN		EU		IMF		OECD		Consensus	
	2003	2004	2003	2004	2003	2004	2003	2004	2003	2004
GDP	1.2	2.1	1.0	2.3	1.1	2.3	1.0	2.4	1.0	2.0
Private Consumption	1.0	2.0	1.2	2.0	1.3	2.2	1.2	2.1	1.1	1.8
Government Consumption	1.8	1.3	1.6	1.5	0.9	0.8	1.6	1.2	1.6	1.4
Fixed Capital Formation	0.9	4.3	0.3	3.2	0.1	3.1	0.2	2.7	-0.1	2.7
Unemployment Rate	8.8	9.0	8.8	8.8	8.8	8.7	8.8	8.7	8.8	8.7
HICP Inflation	2.2	1.8	2.1	1.7	2.0	1.5	1.7	1.4	1.9	1.6

EU: European Commission, European Economy, No. 2, 2003; IMF: World Economic Outlook, April 2003; OECD: OECD Economic Outlook, No. 73, April 2003; Consensus: Consensus Economics Inc., Consensus Forecasts, April 2003. OECD: Inflation refers to the private consumption deflator.

Table 3:
Comparison of spring forecast with previous outlooks

	Actual	Spring 2003	Autumn 2002		Spring 2002	
	2002	2003	2002	2003	2002	2003
GDP	0.8	1.2	0.9	2.2	1.2	2.2
Private Consumption	0.6	1.0	0.5	1.4	1.8	2.1
Government Consumption	2.5	1.8	1.7	1.2	1.5	0.9
Fixed Capital Formation	-2.5	0.9	-1.7	2.3	-1.4	0.2
Exports	1.2	3.3	1.7	8.7	2.3	9.1
Imports	-0.3	4.0	0.1	8.6	2.1	8.3
Unemployment Rate	8.3	8.8	8.3	8.6	8.4	8.1
HICP Inflation	2.1	2.2	2.3	2.1	2.0	2.2
World Trade	2.2*	6.1	4.6	10.2	1.7	10.3

* estimate.

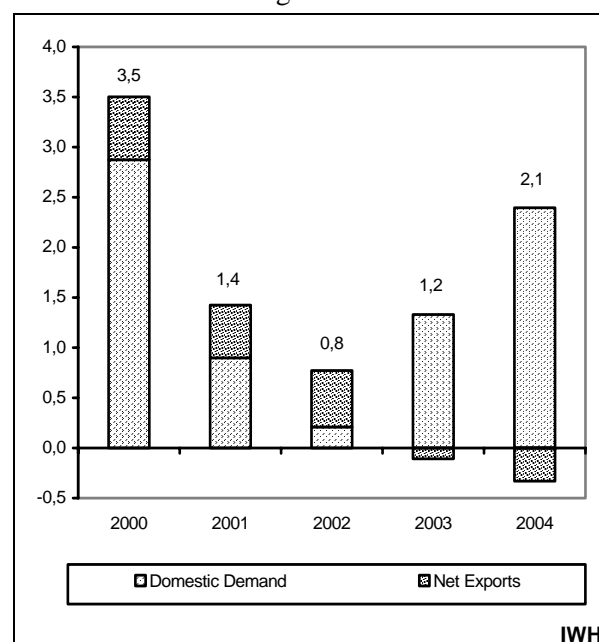
the previous reports and with the actual outcome in 2002. In autumn 2002, no forecast for 2004 was published. Over time the growth rates of GDP and all expenditure aggregates have been slightly revised downwards, except for government consumption. The changes can be explained partly by data revisions and the longer time span of available data, implying a different starting point of the forecast. In addition, the outlook concerning the recovery of the world economy has become more pessimistic. This is reflected in the lower predicted growth rate of world trade. Accordingly, the forecast for exports has been revised downwards. Due to the weaker domestic demand in the Euro area, imports are expected to increase at a slower pace. It should be kept in mind that especially the data at the end of the sample are subject to revisions in the future.

Structural factors hamper growth

The Euro area will be able to benefit from its large size only if domestic conditions permit it to do so. In 2003 and 2004, domestic factors will be the driving force of GDP growth (see Figure). It is however striking that potential output growth of the Euro area is continuously decreasing over the years in our forecast horizon. Similarly, the NAIRU remains extremely high and productivity gains are limited. In total, despite the fact that domestic demand will recover gradually, compared to the last economic upswing, domestic demand will remain subdued. The lack of private investment is critical

in this regard, as it hampers capital accumulation and potential GDP. Therefore, policies devised to strengthen long-term growth are required.

Figure:
Contributions to GDP growth



In the current situation, supporting domestic demand implies restoring confidence of consumers and investors. Fiscal and monetary policy measures could be embedded in a comprehensive political strategy. But the requirements of the Stability and Growth Pact (SGP) and the already low levels of the interest rate cast doubts on the efficacy of traditional economic policies.

Thus, structural reforms are at stake. For instance, restoring confidence in the pension systems, by adapting their design to the ongoing ageing of the labour force could restore consumer confidence. Moreover, private consumption growth is hampered by high unemployment in the Euro area. Therefore, any progress on the front of employment, for example reforms to bring more flexibility to the labour market, may translate into additional demand and production. In the same way, increasing integration of goods and services markets and deregulations of formerly sheltered industries would stimulate employment and overall growth in the long run.

The labour market

Since 2000, labour productivity has been growing slower than wages, lowering profit margins and investment. Consequently, the creation of employment having come to a halt, we expect the unemployment rate to rise to 9.0% over the next two years. According to OECD estimates, the bulk of unemployment is long-term and caused by micro-economic factors, such as unfavourable institutional structures, especially in labour markets. Because much of the wage bargaining process is centralised, wages and labour costs are not flexible enough to reflect labour market conditions adequately. Sector wide agreements ignore heterogeneity at the level of the individual firm, while opening clauses are not easy to apply. However, one should also stress that reforms of factor markets are currently in progress in Europe, and thanks to the internal market programme, the deregulation of goods and services markets is precisely what Europe has embarked upon. While the pace of reforms needs to be maintained, simplistic recommendations should be avoided, since social cohesion is a necessary condition for long run growth. This is particularly true in episodes of slowdown of the economy, where safety nets are required to ease adjustments.

As far as potential output is concerned, early retirement is exerting a negative impact on labour supply and potential output. Trying to generate a higher participation rate of the elderly by introducing a later retirement age is one strategic policy that could be adopted to offset these effects. This

would also serve to ease the pension squeeze evident in many Euro area countries, since contributions for social security can hardly be increased repeatedly.

Inflation differentials, real interest rates and monetary policy

This report forecasts annual harmonized consumer price inflation for 2003 over the upper limit of the inflation range considered to be compatible with price stability by the ECB. Among member countries, however, inflation rates for 2002 differed considerably, varying from 1.3% in Germany to 4.7% in Ireland and for 2003 this variation is forecast from 1.0% to 4.5%. This phenomenon is due partly to structural convergence processes, and partly to differences in the strength of demand among member countries. Data from financial markets show however that inflation rates are not expected to converge significantly any time soon. On the other hand, nominal interest rates are uniform in the Euro area so that low inflation countries experience higher real interest rates, and this in turn limits spending decisions and leads to downward pressures on prices (vice versa for higher inflation countries).

On the other hand higher inflation countries typically start from lower price levels and increase the quality of their products faster than other countries of the Union in order to remain competitive. Since the HICP does not correct practically for quality increments, it could be the case that estimates of inflation in lower-price countries is upwardly biased. These biases should be corrected but data on quality of goods and consumers satisfaction on services are required.

After this correction the true inflation would be smaller in the lower price countries implying a partial convergence of real interest rates. A more accurate measurement of the HICP would help the conduct of the monetary policy and the indexing of wages to the proper inflation rate.

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