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# Economic Upturn in Western Europe

*In its autumn report on the economic situation, the Association of German Economic Research Institutes\* reached the following conclusions for Western Europe.*

In the countries of western Europe outside the European Monetary Union aggregate output staged a distinct recovery following a period of pronounced sluggishness during the winter months of 1998/99. With foreign demand no longer the source of dampening effects, and with the pronounced relaxation of monetary policy which had taken place previously, there was a marked increase in real gross domestic product. As global economic conditions continue to improve, and given the generally neutral character of fiscal policy, this recovery can be expected to continue in the year 2000. Any dampening effect caused by the change of course in monetary policy introduced in the United Kingdom in September will probably be minor.

Exports are providing strong impulses to growth. Private consumption is gradually beginning to gain momentum, spurred on by persistently high increases in real wages and by slightly faster increases in employment. Investment in plant and equipment is being stimulated by more favourable sales and earnings expectations as well as by increases in capacity utilisation. There is a restrained upward trend in construction investments.

On the whole, gross domestic product in the non-EMU countries should grow by 1.7% this year and 2.7% next year. Consumer prices will rise by 1.4% in 1999 compared to 1998, whereby the pattern of price rises during the course of the year is determined to a great extent by the strong increase in prices for energy products. The inflation rate will run at 1.8% next year, primarily as a result of the overhang at the

beginning of the year. The situation on the labour market will continue to improve, with the unemployment rate falling to 6.0% in 1999 and 5.7% in the year 2000.

## EMU Economy Gaining Strength

Following the virtual stagnation of gross domestic product during the winter months, there has been a period of discernible economic recovery within the European Monetary Union in recent months. This economic recovery – like the slump before it – is largely the result of external influences. Renewed stronger expansion in the emerging economies of East Asia, recovery in the transition countries of central Europe and Russia, and the concurrent ongoing vitality of the North American economy, have all helped generate a strong increase in external demand since the spring. This has been encouraged by the low external value of the euro. Domestic demand, which had proven relatively robust in the winter months, continued to increase apace. Thus there has been no change in the fast growth of capital investment. In contrast, private consumption expanded more moderately due to weaker growth of real disposable incomes. While wages and salaries continued to increase at a year-on-year rate of 2½%, there has been little increase in employment on the whole, with the unemployment rate stagnating at a level of more than 10% since March.

Consumer prices have been rising again since the beginning of the year after remaining more or less unchanged for a period of nine months. The temporary acceleration which took place in the spring was largely due to higher import prices. Besides the depreciation of the euro, the doubling of oil prices since the start of the year has, in particular, contributed to the increase in the cost of living. Conversely, the core rate of inflation remained low.

\* Participating institutes: Deutsches Institut für Wirtschaftsforschung, Berlin; HWWA - Institut für Wirtschaftsforschung, Hamburg; ifo Institut für Wirtschaftsforschung, Munich; Institut für Weltwirtschaft an der Universität Kiel; Institut für Wirtschaftsforschung Halle; Rheinisch-Westfälisches Institut für Wirtschaftsforschung, Essen.

Unit labour costs increased slightly as productivity growth slowed. Altogether, wage pressure remained moderate and there are as yet no signs of any significant acceleration. In August, the year-on-year inflation rate stood at 1.2%.

### **Fiscal Policy Predominantly Neutral**

The process of budgetary consolidation in the euro area continued this year at much the same speed as last. The budget deficit in relation to gross domestic product (deficit ratio) will be around 1.6% this year compared to 2.5% in 1997 and 2.1% in 1998. The gross debt ratio, on the other hand, will see only a minor reduction to just under 73%. Individual countries' budgetary results should correspond more or less with the targets set out in their stability programmes which were presented to the European Commission at the start of the year. However, the development of economic activity proved weaker than expected during the first half of the year. As a result, the effects of the automatic stabilisers should in themselves have led to a less favourable deficit development. This was prevented by the fact that measures implemented in previous years (enlargement of the tax base, tighter controls) are coming into effect, but also as a result of tax payments for prior years.

The differentials between individual national deficit ratios remain distinct. In France, despite the country's relatively good economic development, the government has chosen not to forge ahead with budgetary consolidation. In Italy, the deficit target was raised to 2.4% in the spring, a decision which led to short-term irritation on the European financial markets. Now, however, in spite of poor economic developments, the ratio appears to be not much greater than 2% even though 60% of the one-off euro tax levied in 1997 is being paid back this year. In Germany, the deficit ratio in 1999 and 2000 should be well below the 2% target level envisaged in the Federal Government's stability programme. The Netherlands and Spain are close to achieving a balanced budget next year. Finland, Ireland and Luxembourg already have significant surpluses.

When considering budgetary deficits, analysts often differentiate between a cyclical and a non-cyclical component. In practice, this differentiation is highly problematic since there are considerable uncertainties regarding the development of potential output and thus of the level of capacity utilisation in the economy as a whole. Despite the practical problems involved in differentiating between deficit

components in this way, it is postulated that while structural deficits should be dismantled, cyclical deficits more or less have to be accepted. According to OECD calculations, there has indeed been a considerable reduction in structural deficits in the euro area as a whole since 1990; they are currently running at approximately 1% of gross domestic product. Of the larger EMU countries, it is Italy which according to these figures boasts the lowest structural deficit ratio and the largest long-term improvement.

While taxes were frequently raised in the past few years in order to meet the Maastricht criteria, consolidation policy strategies among the EMU countries now concentrate almost exclusively on limiting increases in expenditure. The scope gained in this way is to be used to lower tax payments and social security contributions in relation to GDP. On the whole, savings are being made above all in the field of social expenditure, including old age pension systems. Government consumption and investments are also being cut by varying degrees. Although several countries either introduced or raised taxes and other levies, this also served to finance a reduction in social insurance contributions so that there was no overall increase in the share of contributions and tax payments in GDP. Many countries have already reduced rates of direct taxes or plan to do so in the next few years (Germany, Netherlands, Finland, among others), often in conjunction with a further broadening of the tax base. In the shortterm, however, the desire to stimulate economic growth by means of tax cuts can conflict with the requirements of budgetary consolidation.

On the whole, fiscal policy, as measured by the change in structural budgetary deficits, will be of a virtually neutral nature in the year 2000. During the forecasting period, the aggregate state deficit of the EMU countries will continue to decline in the wake of economic recovery. Slight dampening effects will emanate from the automatic stabilisers; this is typical for a phase of economic expansion.

### **Monetary Policy Underpins Economic Recovery**

From the drop in interest rates in April until the time of writing (late October, the editor) the ECB has kept its key rates unchanged. The interest rate on main refinancing operations is 2.5%. The three-month interest rate (Euribor) stood at around 2.7% up to the end of September. The sharp increase in three-month Euribor in the first week of October is probably a reflection of precautionary measures on the part of market participants with regard to a possible shortage

of liquidity at the year 2000 transition; at present, however, expectations of a rise in key interest rates are also pushing three-month interest rates up slightly. Nonetheless, the level of short-term interest rates is currently a clear source of stimulation for the economy.

Another indication of an expansionary monetary policy is the monetary aggregate M3,<sup>1</sup> which has been expanding at a year-on-year rate of around 5½% since April, and has thus been continuously in excess of the ECB reference value of 4½%.<sup>2</sup> It is possible, *inter alia*, that uncertainty regarding the supply of liquidity at the turn of the millenium has strengthened the short-term propensity to maintain a cash balance.

Capital market interest rates in the euro area have been moving upwards since the start of the year. At a little over 5%, 10-year government bond yields are approximately 1½% higher than at the beginning of the year. This increase has been caused by both external and domestic factors. Besides the withdrawal of capital which, in reaction to the financial crisis in East Asia, had been invested in the euro area, the main reason has probably been the growing demand for capital in the wake of global economic recovery. However, long-term interest rates have recently been rising faster in the euro area than in the USA. This was probably due in the main to firmer expectations of a marked economic recovery in the euro area as from the second half of 1999.

The low valuation of the euro against the US dollar also has a stimulating effect on the economy. The decisive reasons for this are the pronounced cyclical differentials between the USA and the euro area and the related interest rate expectations. Following its July low, the exchange rate of the euro against the US dollar has strengthened to a certain extent in anticipation of economic recovery in the euro area. By mid-October it stood at 1.08 US dollar per euro.

The average annual inflation rate will be slightly higher next year than this. To a considerable extent, however, this reflects this year's oil price rise and the depreciation of the euro. At 1.6% next year, the change in the Harmonised Index of Consumer Prices (HICP) will again remain below the 2% ceiling defined by the ECB for the increase in the price level, and with moderate increases prevailing with regard to unit

labour costs any rise in the core inflation rate will be slight.

In order to prevent the build-up of an inflation potential which could develop if the current expansionary course continues, the institutes expect an increase in key interest rates of half a percentage point in the first half of next year. Thus, monetary policy will still remain moderately expansionary. Given the cyclical recovery, a further modest increase in capital market interest rates is also to be expected.

### Upswing Continues

Given the favourable economic policy and global economic conditions a brisk continuation of the upswing within the EMU can be expected next year. Exports continue to provide distinct impulses. There will be a rapid increase in exports to East Asia in particular. Exports to central and eastern Europe and to South America as well as to the other western European countries will expand markedly once again. In addition, strong demand growth from the Gulf region is to be expected as a result of a strong increase in foreign exchange earnings following the rise in oil prices. Exports to the USA, on the other hand, increase at a slower rate as American economic expansion begins to slow down. The exchange rate continues to favour exports from the EMU countries.

Good export prospects, the expansionary effects of monetary policy and a favourable earnings situation will all strengthen the propensity to invest. A number of indicators point to a rapid increase in private-sector investment in plant and equipment in particular: thus, according to surveys, companies are planning a brisk expansion of capital expenditure; the business climate in manufacturing industry has improved considerably since the spring; and sales and earnings expectations have also risen again in the mechanical engineering industry. Moreover, the utilisation of productive capacity is on the increase. Furthermore, financing conditions remain on the whole favourable, even though capital market interest rates have risen markedly. Private-sector construction investment will show a slightly stronger upward trend. Finally, there will be only a small rise in public-sector investment.

Private consumption will continue to expand briskly: real disposable incomes increase at an accel-

<sup>1</sup> M3 includes currency in circulation, overnight deposits, deposits with an agreed maturity of up to two years, deposits redeemable at notice up to three months, repurchase agreements, money market fund shares and money market papers as well as debt securities with maturity of up to two years.

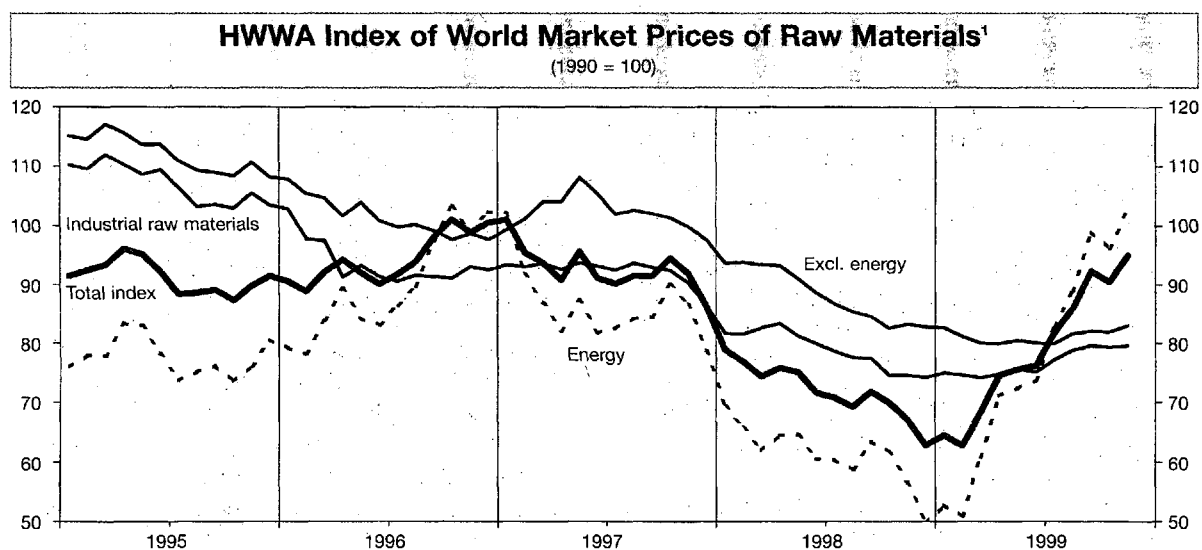
<sup>2</sup> The ECB computes the 4.5% reference value for M3 from a 2% to 2.5% increase in production potential, a surcharge for the trend decline in the velocity of circulation of M3 of 0.5% to 1% and price inflation of 1.5% to 2%.

erated rate as a result of a renewed perceptible increase in hourly wages, a return to more favourable employment trends, as well as tax reductions in many cases. Moreover, in view of the moderate improvement in the labour market situation there will be a slight drop in the savings rate. Conversely, any expansion of government consumption will continue to be restrained in view of consolidation policy considerations.

Real gross domestic product in the euro area will probably increase by 2.9% next year following 2.1% this year, and the cyclical differentials between the various countries will diminish. There will be a continuous improvement in the labour market situation, with employment increasing markedly in the wake of

economic recovery during the forecasting period. In the euro area as a whole, the unemployment rate in 2000 will probably fall to 9.6%, a good half a percentage point lower than this year.

Consumer prices will continue to increase with moderation. External pressure on prices is on the wane; oil prices in particular are not expected to rise much further. Internal factors provide no significant impetus for an acceleration of inflation. While the scope for price rises increases as the economy recovers, this is counteracted by continued liberalisation and deregulation measures as well as by competition, which remains intense. Altogether, the inflation rate will average 1.6% next year.



Raw Materials and Groups of Materials <sup>1</sup>	1998	May 99	June 99	July 99	Aug. 99	Sep. 99	Oct. 99	Nov. 99 <sup>2</sup>
Total Index	72.0 (-22.4)	75.6 (0.7)	76.2 (6.3)	81.8 (15.7)	86.1 (24.4)	92.3 (28.6)	90.5 (29.4)	95.3 (42.1)
Total, excl. energy	88.2 (-13.7)	80.5 (-11.6)	80.0 (-9.7)	79.9 (-7.8)	81.7 (-4.3)	82.0 (-3.0)	81.9 (-0.7)	82.7 (-0.6)
Food, tropical beverages	115.8 (-12.2)	95.2 (-20.8)	94.6 (-17.3)	87.9 (-20.6)	89.9 (-17.1)	89.3 (-15.6)	89.6 (-15.7)	81.8 (-15.8)
Industrial raw materials	78.9 (-14.5)	75.5 (-7.0)	75.1 (-6.1)	77.3 (-1.7)	78.9 (1.7)	79.6 (2.8)	79.3 (6.5)	79.8 (6.8)
Agricultural raw materials	79.3 (-14.4)	77.5 (-5.2)	77.8 (-4.3)	78.3 (-1.0)	80.0 (2.4)	79.2 (1.7)	79.0 (6.1)	79.0 (5.9)
Non-ferrous metals	71.1 (-20.8)	69.0 (-5.6)	67.4 (-3.4)	73.5 (5.5)	75.4 (9.2)	79.2 (13.6)	78.5 (16.4)	79.3 (17.4)
Energy	61.4 (-29.0)	72.4 (12.1)	73.7 (21.7)	82.9 (37.6)	89.0 (51.6)	98.9 (56.1)	96.1 (55.7)	103.6 (83.4)

<sup>1</sup> On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change.

<sup>2</sup> Up to and incl. 26th November.