The European economy in 1998 and 1999: An update

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The European Economy in 1998 and 1999
An Update

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A. Situation and Prospects for the European Economy

I. Slower Growth of the World Economy

In the course of 1998, world economic activity has continued to decelerate. The adverse effects of the Asian crisis on the Western countries appear stronger than expected earlier. In the summer, renewed pressures on the financial markets hit Russia and Latin America involving also Western markets. Although these shocks have been partially absorbed, the increased volatility in the stock market raised uncertainty worldwide and business confidence worsened substantially in recent months. Reflecting weaker demand, raw material prices have continued to decrease at an unexpected pace. So far, domestic demand in the United States and Europe has counterbalanced the worsening of net exports largely thanks to the improved terms of trade and declining interest rates. Measures to counter the problems of the Japanese financial system have not been able to revive the Japanese economy. Moreover, the dollar exchange rate weakened from the spring peak, adversely affecting the competitive position of Europe. The deterioration in the international environment also affects the European economy.

The US economy is losing its buoyancy. High third-quarter growth was largely based on inventories changes while business investments growth slowed considerably. The recent turmoil in the financial markets seems to be absorbed, but the economy remains vulnerable to stock market changes. Huge stock market gains have contributed to the extremely low private savings ratio in the past four years to only a half per cent in the first months of this year. A second weak element in the US cycle is the increased cost of investments evidenced by the strong increase of the yield spread between corporate and public bonds. The gradual slowdown of the economy is expected to result in a GDP growth rate of 1.5 per cent. In this scenario, the Federal Funds rate could come down somewhat further.

Since mid-October, the Japanese currency has appreciated against the US dollar by over 15 per cent. The stronger yen produces at least three effects on the Japanese economy. First, it worsens the competitiveness of the Japanese industrial sector. Second, it has a deflationary impact. Last, it helps the banking system to satisfy BIS standards to meet the required reserve ratios. The rescue plan for the banks has not been sufficient to improve private sector confidence. Restructuring of the financial markets is far from completed. GDP is likely to remain near stagnant next year, due to a fragile domestic demand.

One year after the burst of the financial crisis, the economic situation in South East Asia can be characterised as weak, but with some positive elements for the four countries most involved (Indonesia, Malaysia, South Korea and Thailand). Their trade balance has turned to be positive in the first part of the year. In Thailand and South Korea, industrial production has picked up thanks to export growth. The process of financial restructuring is continuing. The recent reduction of Thailand’s interest rates followed by an appreciation of the Thai bath is also a signal of improvement. A similar development could be observed in Korea. In Indonesia, on the other hand, political uncertainties undermine the fragile economic situation. Also Malaysia will need a longer time to stabilise the economy.
and start to recover. For the area as a whole, the appreciation of the yen could help to sustain the exports.

China and, in Latin America, Brazil are now facing the highest risks of financial disturbances. For China, tensions on the domestic market and on the international market exerted pressures on the Chinese yuan, despite the strong yen. The fragility of the financial system and the inefficiency of the state-owned firms will constrain GDP growth in the coming years and may affect the whole region. The economic growth in Latin America will be very slow next year.

Finally, the Russian economy remains fragile. There are no indications of a quick recovery. The effects of the turmoil of this summer will materialise in a further decline of real GDP next year, which has a negative impact on the economies of the region.

The events in East Asia and in the other emerging markets were associated with a major reversal of capital flows and significant losses by Japanese, US and also European banks. Table 1 gives details of the structure of lending to emerging areas for 1997.1 The major increase in lending to East Asia last year came to a large extent from continental Europe. German banks increased their exposure from 2.8 per cent of GDP in 1994 to 5.5 per cent in 1997, and French banks increased theirs from 3.4 per cent to 5.2 per cent over the same period.

Table 1: Bank Exposure in Developing Economies (December 1997) (as a percentage of GDP)

<table>
<thead>
<tr>
<th></th>
<th>All</th>
<th>All less Offshore</th>
<th>Eastern Europe</th>
<th>Russia</th>
<th>Latin America</th>
<th>Asia</th>
<th>Asia less Offshore</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>15.3</td>
<td>9.1</td>
<td>2.4</td>
<td>1.5</td>
<td>1.7</td>
<td>5.5</td>
<td>2.3</td>
</tr>
<tr>
<td>France</td>
<td>13.1</td>
<td>8.6</td>
<td>0.8</td>
<td>0.5</td>
<td>1.8</td>
<td>5.2</td>
<td>3.1</td>
</tr>
<tr>
<td>UK</td>
<td>13.3</td>
<td>7.4</td>
<td>0.2</td>
<td>0.1</td>
<td>1.7</td>
<td>7.1</td>
<td>2.5</td>
</tr>
<tr>
<td>Italy</td>
<td>4.7</td>
<td>3.3</td>
<td>0.5</td>
<td>0.4</td>
<td>1.1</td>
<td>1.2</td>
<td>0.4</td>
</tr>
<tr>
<td>Spain</td>
<td>11.5</td>
<td>9.4</td>
<td>0.2</td>
<td>0.1</td>
<td>6.9</td>
<td>1.4</td>
<td>0.5</td>
</tr>
<tr>
<td>Netherlands</td>
<td>20.8</td>
<td>15.5</td>
<td>1.7</td>
<td>0.6</td>
<td>5.1</td>
<td>7.9</td>
<td>4.8</td>
</tr>
<tr>
<td>United States</td>
<td>2.1</td>
<td>1.6</td>
<td>0.1</td>
<td>0.1</td>
<td>0.8</td>
<td>0.5</td>
<td>0.4</td>
</tr>
<tr>
<td>Japan</td>
<td>9.1</td>
<td>3.9</td>
<td>0.1</td>
<td>0.02</td>
<td>0.4</td>
<td>6.0</td>
<td>2.7</td>
</tr>
</tbody>
</table>


The adjustment of portfolios and the re-evaluation of risks by Western financial institutions were an important factor behind the withdrawal of capital from Russia in the summer, and the subsequent pressures faced by the Latin American economies. Events in Latin America are much more important for the United States, but the Russian ones are mainly affecting Europe. However, it is again clear from the table that the problems in Latin America could spill-over into Europe, with banks, notably from Spain, relatively heavily exposed in the region.

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1 The offshore centres inevitably make interpretation of the structure of lending difficult.
The recent instability has led to systemic pressures within part of the financial system, with several large multinational banks announcing sizeable provisions against potential losses. A wave of bankruptcies threatened in the US in late September after the large hedge fund, Long Term Capital Markets, almost collapsed. Also because of that, the Fed lowered its key interest rates.

II. Weaker Expansion of the European Economy

Until summer 1998, production and demand in Western Europe had been affected by the Asian crisis only to a limited extent. On the one hand, as expected, exports to the region decreased substantially and imports at the same time tended upwards. The changes in trade with Asia shaved off about one half of a percentage point from GDP growth, albeit with significant differences from country to country. On the other hand, the pronounced improvement of the terms of trade as a result of the real appreciation against Asian currencies and the fall in raw material prices that followed the outbreak of the crisis raised the purchasing power of the European consumers and stimulated domestic demand. Furthermore, the shift of portfolio capital from emerging markets into “safe havens” has contributed to a protracted decrease in long-term interest rates, which has also helped domestic demand to continue to firm. As a result, the negative contribution of external demand has been largely offset by increased internal demand, and GDP growth hardly slowed. The marked slowdown of quarterly GDP growth from 0.8 per cent in the first quarter to 0.2 per cent in the second quarter of this year can to a large degree be attributed to special factors; as an example, the VAT hike effective on April 1 in Germany led to a shift of activity into the first quarter.

During the summer, however, with the outbreak of the Russian crisis and with developments in Latin America getting increasingly critical, the picture changed for the worse. For one thing, an ever-increasing number of countries struggling with recession will contribute to the weakness of European exports. In addition, this time the turmoil in financial markets also spread to Western Europe. Stock prices declined considerably, if only temporarily, and the yield spread of corporate bonds over government bonds increased markedly indicating that investors have favoured less risky assets.

Volatility of the stock prices may contribute to a more cautious attitude of consumers. However, despite the fact that investing in the stock market has become more popular in recent years, in European countries on average still only a relatively small share of private savings comprises stocks, compared for example with the US. The negative wealth effect of a decline in stock prices on private consumption may also be compensated by wealth effects working in the opposite direction stemming from a rise in bond prices which often is associated with a decline in the stock market.

In Europe, there is no reason for concern about cost and availability of funds for corporate investment, as the issuing of shares as a source of financing is of minor importance for investment. The increase of the yield spread of corporate bonds, particularly of lower ratings, over government bonds is also of little significance in Europe, compared for instance with the US, because bank loans are of greater importance for corporate financing. Currently, there is no indication of a credit crunch in Europe.

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2 Indeed there are huge differences among individual European countries with respect to the share of stocks in household assets which are related to various institutional differences, particularly the insurance system (i.e. social insurance and old-age pensions).
Judged from survey data, the worsening of the external environment combined with increased volatility on financial markets and a general perception of increased risks has depressed the corporate outlook in recent months. This points to a slowing of economic growth in the months ahead. However, some of the detrimental factors are likely to fade gradually: financial markets seem already to have stabilised, and the recession in Asia is projected to pass its trough during the winter. Assuming this, most probably cyclical developments will not deteriorate further in the course of 1999, particularly in the major economies of continental Europe. Apart from the UK where policy has been considerably restrictive mainly due to a tight stance of the Bank of England, economic policy is expected to give no significant impulse in neither direction: In Euroland, monetary policy has been more or less neutral with the average interest rate gradually declining to the level prevailing in the countries of the DM-bloc, and key interest rates will most likely not be changed in the near future. Fiscal policy, which had switched from restrictive to neutral in 1998 will, if anything, lean somewhat to the expansionary side. While wage increases will accelerate slightly, they will still be moderate. Unit labour costs will rise only moderately, and there remains room for further expansion of corporate profits.

Given these assumptions, there will be a lower increase in GDP next year than this year, but the outlook for Europe is still for an average growth of around 2.3 per cent in 1999, compared with 2.8 per cent this year (Table 2). The UK will be a notable exception: due to the tight monetary policy, the GDP growth rate will fall from around 2.5 per cent in 1998 to approximately 1 per cent next year. In Euroland on aggregate, growth will be particularly subdued during the winter semester 1998/99. In the course of next year, the drag from external demand will gradually fade, but the expansion will still be centred on domestic demand. Corporate investment will remain on its upward trend reflecting high capacity utilisation, a high level of profits and low interest rates. Private consumption will generally benefit from an accelerated increase in real disposable incomes due to the combination of higher wages, continued low inflation and an improved labor market.

Table 2: Real Gross Domestic Product and Consumer Prices 1997–1999 (Percentage change over previous year)

<table>
<thead>
<tr>
<th></th>
<th>Real GDP</th>
<th></th>
<th>Consumer Prices</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>2.2</td>
<td>2.8</td>
<td>2.3</td>
<td>1.8</td>
<td>1.0</td>
</tr>
<tr>
<td>France</td>
<td>2.3</td>
<td>3.0</td>
<td>2.6</td>
<td>1.2</td>
<td>0.8</td>
</tr>
<tr>
<td>Italy</td>
<td>1.5</td>
<td>1.5</td>
<td>1.9</td>
<td>1.8</td>
<td>1.9</td>
</tr>
<tr>
<td>EUROLAND</td>
<td>2.5</td>
<td>2.9</td>
<td>2.5</td>
<td>1.7</td>
<td>1.3</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>3.3</td>
<td>2.8</td>
<td>1.1</td>
<td>3.1</td>
<td>2.6</td>
</tr>
<tr>
<td>EU COUNTRIES</td>
<td>2.6</td>
<td>2.8</td>
<td>2.3</td>
<td>1.9</td>
<td>1.6</td>
</tr>
<tr>
<td>United States</td>
<td>3.9</td>
<td>3.4</td>
<td>1.5</td>
<td>2.3</td>
<td>1.6</td>
</tr>
<tr>
<td>Japan</td>
<td>0.8</td>
<td>−2.4</td>
<td>0.4</td>
<td>1.8</td>
<td>0.4</td>
</tr>
</tbody>
</table>
Employment growth will continue, albeit at a reduced pace, and contribute to the expansion of demand. Consumer price inflation will remain to be low at a rate of around 1.5 per cent. However, as raw material prices seem to have hit bottom and the dampening effects of the real appreciation of European currencies will gradually fade, prices will tend to accelerate slightly in the course of next year also reflecting somewhat higher wage increases.

To sum up, the outlook for Europe has become less positive in recent months due to the spreading of the financial crisis to Russia and Latin America, renewed volatility on the equity markets and weakened business confidence in the industrial countries. The downward revisions for GDP growth concentrate on the coming year. But adverse movements are already visible in the second half of 1998: slowing down of exports and export orders, and a weakening of confidence indicators. In the central projection the slowdown is expected to be temporary: the situation in the emerging economies is beginning to improve, the financial turmoil is ending soon, and confidence is restored in the industrial countries. For Europe that would permit a moderate pickup of output growth in the course of next year.

The risks are clearly on the downside, however, as the negative elements are highly interactive. The crisis in the emerging markets may not yet have reached the bottom, also given the persistent weakness of the Japanese economy, the risks concerning the Chinese and the Brazilian economies, and weaker world demand. Financial tensions could affect European countries as well, especially the banking system. This may lead to a further erosion of confidence. Recent figures, which admittedly have a larger than normal margin of error in the present hectic situation, raised concern that also world trade could be much more affected than assumed in the central projection. If the mentioned risks materialize, growth in Europe may be considerably lower next year.

III. Economic Policy

Monetary Policy

The East Asian turmoil and the Russian crisis have been a test for the credibility of the euro. No speculative attack has endangered the levels of the parities that were announced in early May. Conversely, Danish short-term interest rate spreads with German rates have increased by almost one percentage point. The Asian and Russian crises have delayed the convergence of interest rates in the euro area though. The flight to quality has also widened the spread between the earnings of German assets and those of the rest of the euro area, which is not to help the homogeneity of public bonds markets in Europe. In the first days of November 1998, interest rates were still much higher in Ireland and Italy than in the core countries. But convergence has since resumed as Spain, Portugal, Ireland and Italy lowered their key interest rates.

The way the ECB will conduct monetary policy has only recently been clarified. The European Central Bank has a clear mandate to achieve price level stability. On the basis of the Harmonised Index of Consumer Prices, it will tolerate a maximum rate of inflation of 2 per cent for Euroland. To meet this goal, it announced in October of this year that it will pursue a mixed approach. It will focus on a broad money aggregate as an intermediate target and will announce a target path. Furthermore, it will analyse a broad set of indicators to evaluate the inflation tendencies. Among these are likely to be
the output gap, wage costs, labour market developments, the exchange rate, raw material prices and long-term interest rates. Monetary targeting will be achieved within a medium-term perspective whereas inflation targeting will be given a short-term horizon.

The current stance of monetary policy may be assessed by using different indicators: the money and credit developments in EMU countries, the yield curves, and the Taylor rule: The yield curves have significantly flattened as a consequence of the flight to quality and the increased preference for low-risk investments. According to the Taylor rule, based on present inflation and growth rates, output gaps derived from OECD estimates, and taking into account the alleged inflation target of the ECB, the euro interest rate would have been settled around 3.5 per cent in 1998. According to our forecasts, its level consistent with this rule would be fairly unchanged in 1999. Thus the expected convergence and settling of short-term rates at the lower end of the present range will imply a more or less neutral stance of the monetary policy at the onset of the EMU. As already mentioned in the first EBCA report, a single interest rate in Europe will have quite different consequences for the cyclical development in the individual countries, because the situation in terms of inflation and output gap differs significantly. Those in a relatively high cyclical position will get an extra boost from lower rates, while those lagging will find the policy rather restrictive.

It is now foreseen that monetary authorities will not increase interest rates, accounting for the uncertainties on the consequences of the crises in emerging countries and for the volatility in stock exchanges. The ECB does not currently follow the US in a joint cut in interest rates. As a departure from our central projection, several factors might lead to a further depreciation of the dollar in 1999: the slowdown of the US economy, the prospects of larger cuts in interest rates in the US than in Europe, the changes in portfolio allocations resulting from the launch of the euro. This would hamper growth, enhance competition, and reduce inflation in Europe in 1999.

In such circumstances, the ECB would be receptive to the dampening effect of a dollar drop, for both money demand and inflation expectations would be revised downwards, triggering a cut in short-term rates. Long-term rates would fall in anticipation of such a loosening of the monetary stance, thereby offsetting, at least partly, this external shock.

**Fiscal Policy**

Most of the European countries have implemented restrictive fiscal policies in 1997. According to our estimates, the restrictive impact was about 1 percentage point of GDP in the European Union. Fiscal tightening was particularly significant in Sweden, the United Kingdom, and in Italy. Most countries will not continue fiscal tightening in 1998 and 1999, but follow a more or less neutral stance, the decline in interest rates and the continuation of economic growth allowing for a further improvement in public accounts. In a few countries, such as Germany, fiscal policy will become slightly expansionary in the coming year.

According to usual measures of cyclical sensitivity of public deficits, these deficits would stop decreasing only if economic growth in Europe was smaller than 1.5 per cent in 1999, which is much below our central forecast. If growth turns out slower, national fiscal policies will have to accept some increase in public deficits, allowing automatic stabilisers to play their role, thus cushioning the slowdown. They should avoid to pursue pro-cyclical policies, keeping in mind that the requirements of the
Stability Pact have to be looked at as a medium-term objective, and will be all the more achievable that they accompany a healthy European economy.

B. Country Reports

I. Germany: Upturn Continues Despite Financial Turbulence

The recovery in Germany accelerated slightly during the first half of 1998. Real GDP increased at an annual rate of 3.3 per cent, compared with 2.5 per cent in the second half of 1997. The quarterly profile was rather unsteady due to special factors. The strong GDP growth in the first quarter was followed by a slight decline in the second quarter. The current indicators such as industrial production suggest a rebound for the third quarter.

The effects of the recent fall in share prices seem to be of little importance for the German economy. With respect to the financing of investment activities, companies mainly rely on their cash flows and on bank credits. Also, shares constitute only a small part of total assets of German households. Empirical evidence shows that a decline in share prices is only followed by a recession if it is accompanied by a substantial rise in key interest rates. Recently, however, interest rates have remained at a low level.

The outlook for the coming months has deteriorated somewhat as indicated by the weaker business confidence; so economic growth will be fairly slow during the winter. This reflects to a great extent the negative impact from abroad. With those factors slowly fading, the economy will gain more strength in the course of next year.

The conditions for this remain favourable. Long-term interest rates have declined since the beginning of the year to a record low. Short-term rates have been stable. While fiscal policy is more or less neutral in 1998, there will be considerable positive impulses due to tax reform and other measures next year. The first phase of the reform will imply lower taxes mainly for low-income groups and an increase of child benefits. Enterprises will experience a somewhat bigger tax burden. Government expenditures will rise faster than previously expected. On the revenue side, the start of the ecological tax reform will bring higher taxes on mineral oil, gasoline and electricity. All in all, fiscal policy will benefit private consumption expenditures and dampen investment activity somewhat. Wages will rise considerably faster in 1999 than this year. Real GDP will increase by 2.8 per cent in 1998 and by 2.3 per cent in 1999. The lower growth rate next year reflects mainly a smaller carry over as the underlying rate will remain above potential growth. Inflation is likely to pick up slightly as import prices and labour costs stop falling in the course of the year. Supported by the continuing upswing and a reduction in the labour supply, unemployment is likely to come down further.

II. Confidence Still High in France, Though Off Its Peak

Foreign trade put a brake on economic growth since early 1998. GDP growth slowed down somewhat, but was in the second quarter still around 3 per cent higher than a year before. Private consumption
has been the driving force, while exports have stabilized since the fourth quarter of 1997. The Asian
slump shaved 1 per cent off total exports. Investment lagged, but is recovering, being now 3.4 per cent
above last year.

Public finance has largely benefited from a high elasticity of revenues to GDP. For 1999, the draft
budget will allow for a slightly expansionary stance: some taxes levied on labour, electricity and real
estate transactions will be cut; central government spending will grow by 1 to 2 per cent next
year, with a renewed focus on education and employment; the debt servicing will be alleviated by now
lower interest rates. On the whole, the public deficit on Maastricht definition could reach 2.9 per cent
of GDP in 1998 and 2.3 per cent in 1999.

Confidence was still good in October, but has retreated from its summer peaks. Output expectations
surveyed for manufactures point to a 3–4 per cent growth rate, inventories are back to normal, and
order books have shifted from plentiful to satisfactory. The business climate is no longer buoyant in
the industrial sector, but remains upbeat at the retail and gross trade level, thanks to a still booming
consumption. Nevertheless, stocks are now considered too high, especially for household equipment.

Car sales and real estate are yet benefiting from consumer confidence, given low interest rates, and
a steady improvement of purchasing power. But households have recently shown less upbeat about the
unemployment prospects, and paid a renewed attention to saving. Employment gains remain the key to
future spending. It is expected that more than 400,000 jobs be added to employment in 1998 and
around 300,000 in 1999, of which, respectively 325,000 and 300,000 in market activities. Major forces
behind these record increases are a relatively low trend productivity, past cuts in wage costs of low-
paid workers and a larger use of part time and interim workers increasing the reaction of employment
to an output surge. The unemployment rate is expected to drop from the present level of 11.9 per cent
of the labour force to 11 per cent at the end of 1999.

Productive investment would grow by around 6 per cent in both 1998 and in 1999. Profitability has
again been enhanced by relatively good returns on capital and the fall of interest rates; but stock prices
have not fully recouped their recent losses and global uncertainties as well as an expected keen foreign
competition have probably led enterprises to revise downwards their equipment plans for next year,
especially the larger enterprises in the industrial sector. The investment revival will continue to be
broadly self-financed, in spite of a decreasing corporate saving rate.

Consumer price inflation has moderated, as a result of low labour costs, falling raw material prices,
and subdued import prices. Core inflation hovers around 1 per cent, with stable manufactured goods
prices. Sustained competition, enhanced by the recent and expected drop of the dollar will largely
offset the impact of labour costs, assumed to rise by 1.5 per cent in 1999. Contrary to last year, real
wages will not be boosted by an overestimation of future price developments, and nominal hourly
wages are to be fixed between 2.5 and 3 per cent, possibly somewhat less. Given the high probability
that nominal short-term rates will stay near the current level of 3.5 per cent, the stance of monetary
policy can be considered as more or less neutral for Europe, though rather cautious for France.

III. Downturn in the UK Economy

The forecast for the UK is flavoured by increasing pessimism on the part of business and consumers,
and on the basis of past relationships this would signify a fall in activity in 1999. However, the Bank
of England has responded to the potential for a recession and it has cut interest rates again, this time by 0.5 points in early November 1998. Hence, the main forecast is for a growth slowdown rather than falling output in 1999. The economy will grow at 1.1 per cent in 1999, after a reasonably strong growth of 2.8 per cent in 1998. However, manufacturing output will decline by 0.5 per cent in part because of the cumulating effects of the high exchange rate on net exports in this sector. Recent changes to the National Accounts, and the adoption of the new standard European System of Accounts have made past data more problematic to interpret in part because trend growth in the 1990s has probably been revised up by 0.2 percentage points a year.

Unlike the position before the last two recessions, the private sector is not over-borrowed now. High interest rates are less likely to cause consumers liquidity problems. Underlying inflation is now at the target rate of 2.5 per cent and likely to fall substantially without sharp cuts in interest rates. Even with a reduction in rates to 5.75 per cent by the end of 1999, inflation should fall below the target rate in 2000 as increasing slack in the economy offsets the effects of the recent and anticipated fall in the exchange rate, well below its peak of DM 3.09 in the summer of 1997.

The new spending plans announced in July will also support the economy, with government consumption contributing by almost 1 per cent to GDP growth in 1999. However, the increase in public expenditure and the weakening economy mean that the public finances will deteriorate. Public sector borrowing may well be in excess of net investment of £8 billion in 1999–2000. This means that the golden rule of matching investment with borrowing may be broken, and that government deficit at 2 per cent of GDP may be rather high by the standards imposed by the Maastricht Treaty and the Stability Pact.

The economic slowdown is expected to push unemployment up by 140,000 in 1999. However, the unemployment rate will remain relatively low, rising to 7 per cent in 1999. Earnings are forecast to grow at 4.5 to 5 per cent through 1999, a higher rate than normal at this stage in the economic cycle, reflecting the predicted upward impact of the newly legislated National Minimum Wage. World developments could, however, lead to a sharper rise in unemployment if activity slows elsewhere, and the risks to the UK are largely on the downside, with the current forecast being the most likely outcome.

IV. Italy: A Fragile Recovery

Forecasts about Italian economic growth have been revised downwards to around 1.5 per cent this year (instead of 2 per cent or more predicted three months ago), and 1.9 per cent next year. This would be the worst result among Euroland countries.

Several factors can account for this weak performance and reveal a specific fragility of the Italian situation. First, the ending of the car incentives scheme has slowed domestic demand: after the surge in 1997, consumer spending is now coming back towards trend. In 1997, additional car sales contributed 0.4 percentage points to GDP growth, the end may reduce GDP growth by 0.2 percentage points this year. Second, in 1998 the Italian economy has been hit more than the other main countries by adverse trade developments. Exports to the Asian countries have dropped more and the inflow of Asian imports has been stronger. Finally, the collapse of the stock markets came in a phase of a double transformation for Italy. On the one hand, there was a huge reallocation of savings formation since
1997, from the private sector towards the public sector. On the other hand, a similar reallocation in the use of savings, from government bonds to shares and unit trusts, took place. In that situation, the reduction of interest rates could give households the feeling of a lower future expected wealth and consequently induce households to increase savings.

For 1998 the growth of household consumption will decelerate by around 1 percentage point compared to 1997, with a growth rate of 1.1 per cent, despite households’ increase of disposable income close to 2.0 per cent; this is the first significant increase since 1991. Investments in plant and equipment are expected to be the most dynamic GDP component, with a rate of growth of 5 per cent. Net exports will likely give a negative contribution to GDP growth (−0.5 per cent) due to the absorption effect linked to the improvement of the terms of trade.

Assuming reduced volatility of the financial markets and a reduction in the interest rate, Italian GDP growth may accelerate starting from the beginning of 1999, with a stronger domestic demand and a continued negative contribution of net exports.

Consumer price inflation is now around one percentage point higher than in France and Germany, while producer price inflation has sharply decelerated. Liberalisation of the house rents and the new pricing policies of the local and national public utilities on the eve of their privatisation are supporting the services’ price inflation even if the price of market services substantially slowed down. Once these factors will vanish, wage moderation should allow inflation to converge more rapidly towards the Euroland level.

The 1999 budget will include larger expenses and receipts with respect to the three-year budget plan of last April. The goal is to provide the government a more active social policy (the financial support to new firms in the south of Italy, the reorganisation of the incentives for the employment of the young and the unemployed). As a result the public sector deficit is expected to decline only gradually as a percentage of GDP, from 2.6 per cent in 1998 to 2.5 per cent next year.