

FORECAST FOR THE EUROPEAN ECONOMY

WILLI LEIBFRITZ*

At an economic growth rate of around 3½%, the Euro area and Western Europe as a whole achieved the best growth performance since 1990. But the year 2000 was exceptional. Most forecasters agree that growth will be lower this year, but views differ on how pronounced the slowdown will be and also on the medium-term growth path of Europe.

Current situation

The Euro area passed the cyclical peak at the middle of last year. Since then the business climate indicator collected by the ifo institute from experts in these countries (Economic Survey International) has declined (as has the Ifo business climate indicator for Germany) and economic growth in the Euro area decelerated (Figures 1 and 2).

Main driving forces of the European business cycle

There are many supply side and demand side factors which affect economic developments. In analysing the cyclical fluctuations of the European economy one can, however, identify a few factors which in the past played an important role and which will also be of key importance this year and next.

There is, first, the growth of the *global economy*. It is true that foreign trade is less important for the Euro area as a whole than it is for its individual member countries as a good part of their trade is intra-Euro area trade. Nevertheless, the Euro area

is still an open economy, more open than the US or the Japanese economies. Last year the share of exports of goods and services of the Euro area (excluding intra-area trade) was around 19% of GDP compared to export shares of around 12% in the United States and in Japan.

Another important driving force of the cyclical development in Europe is the economic policy stance with respect to both, *fiscal policy* and *monetary conditions*.

With these three factors, i.e. world trade growth, fiscal policy and monetary conditions (the latter comprise interest rates and the exchange rate) one can fairly well explain the business cycle in the Euro area in past years, reflected in changes in the output gap, i.e. the difference between actual GDP and trend-GDP (Figure 3).

- The *boom in the early 1990s*, which was greatly affected by German unification and expansionary fiscal policy, was followed by the recession of 1993 which was caused by a combination of slowing world trade growth and restrictive macro policies in Europe. Fiscal policy became restrictive when countries started to cut back their structural deficits which had gone out of control. Monetary policy was tight until the recession began because the inflation rate exceeded the inflation target.¹
- In the period between *1994 and 1999* cyclical recoveries remained moderate and short-lived. During the entire period governments were cutting budget deficits to meet the Maastricht criteria and abide by the Stability and Growth Pact. Monetary conditions tightened in 1995 when the deutschmark (and the currencies which were linked to it) appreciated sharply against the dollar. World trade growth was also unstable during this period: strong growth in 1994/95 helped Europe to recover from the recession. The temporary slowdowns in the



The Euro area business cycle is well explained by world trade growth, fiscal policy and monetary conditions

* Willi Leibfritz is Head of the Department of Economic Forecasting and Financial Markets at the Ifo Institute.

¹ But during the recession in 1993 the Bundesbank reduced the discount rate in five steps from 8% in February to 5¾% in October.

expansion of world trade in 1996 and in 1999 dampened growth in Europe.

- In the year 2000 there was a combination of booming world trade and very favourable monetary conditions which were also a result of the weak euro. These two positive factors outweighed the higher oil prices so that economic growth could reach a new peak.

Forecast for 2001 and 2002

The Ifo indicators (as well as other indicators) for the *global economy* show a significant slowdown in economic activity in all major regions of the world with the biggest decline in the United States (Figure 4). Obviously Europe cannot be insulated from the slowdown in the United States and in the world economy. Given the sharp decline of some of the indicators one cannot preclude a hard landing scenario for both the United States and Europe, although this is not our most likely forecast. A hard landing scenario for Europe would require:

- that the United States enter a recession and that this will be accompanied by
- significant losses in confidence all over the world including Europe, and
- a fall in the exchange rate of the dollar and a sharp appreciation of the euro.

Hard landing of
European economy
unlikely

In such a pessimistic scenario, growth in Western Europe would decline from 3.4% last year to around 1½% this year. In the United States, growth would decline from 5% last year to around 1% or lower this year. There are various reasons why this is not our most likely forecast. First, there are good chances that the slowdown of the US economy will remain moderate, in particular as monetary policy was eased quickly and may be eased further. In addition, in Europe macroeconomic policies are currently better suited to prevent a severe downturn than in past recessions.

- Fiscal policy will stimulate demand in 2001 because of tax-cutting programmes in some countries like Germany, France, and the Netherlands (Figure 5). Furthermore, as the average budget deficit in the Euro area is now relatively small (Figure 6), there is room for an increase in the cyclical component of the deficit in case of a more severe downturn without violating the 3% deficit ceiling. Such an increase in

the deficit (if tolerated by the policymakers) would then provide an automatic stabiliser effect. By contrast, during past slowdowns (like that of 1993) European fiscal policy often restrained aggregate demand.

- With the increases in interest rates last year the European Central Bank tightened monetary conditions in the Euro area. The level of the monetary conditions index constructed by Ifo for the Euro area by weighting together the real short-term interest rate and the real effective exchange rate of the euro is, however, still above its medium-term average. This implies that monetary conditions are currently not restraining aggregate demand. But a further appreciation of the euro would continue to depress the monetary conditions index unless the ECB cuts interest rates (Figure 7). The growth of the money stock M3 has decelerated from a high rate and is now close to the reference value (4½%) which reflects a neutral policy stance. By contrast, the monetary policy stance (excluding the exchange rate) is found to be restrictive if instead it is assessed by the Taylor rate and assuming that the ECB is currently aiming to keep the *core* inflation rate below 2% rather than to push the actual inflation rate below 2% which is currently above this target because of the oil price effect (Figure 8). The yield gap, i.e. the difference between long and short-term interest rates, also indicates a tight monetary policy stance. In our forecast we have assumed that the ECB will cut interest rates by 50 basis points this year and that the euro will strengthen from currently 0.91 to around 0.97 dollars towards the end of the year.
- The actual inflation rate is still above the ECB target but this is due to the oil price increase which we assume to have been temporary. Headline inflation has come down somewhat but core inflation has picked up. One reason is the effect of higher oil prices on the cost of domestic production. As we assume no further rise in oil prices, this second round effect should also be temporary. Most recently European food prices have increased in the wake of the spreading mad-cow disease, but this should also be temporary. The big question, however, is if and how wages in the Euro area will respond to higher headline inflation. So far wage increases have been moderate and in many cases they have a term of two years. Hence next year's wage round will be of key importance for the sustainability of price stability. The greater (the smaller) the

Table 1
Euro Area
Key Forecast Figures

	1999 (*)	2000 (*)	2001 (s)	2002 (s)
Percentage change over previous year ^{a)}				
Private consumption	2.8	2.6	2 ¹ / ₄	2 ¹ / ₄
Government consumption	1.6	1.6	1 ¹ / ₂	1 ¹ / ₄
Gross fixed capital formation	5.3	4.6	3 ¹ / ₂	4
Domestic expenditure	3.1	2.8	2 ¹ / ₄	2 ¹ / ₂
Exports	4.7	11.7	7 ¹ / ₂	7 ¹ / ₂
Imports	6.7	10.4	7	7 ¹ / ₂
Gross domestic product (GDP)	2.5	3.4	2 ¹ / ₂	2 ¹ / ₂
Employment ^{b)}				
(% change over previous year)	1.8	2.0	1 ¹ / ₄	1 ¹ / ₄
Unemployment rate ^{c)} (in %)	10.0	9.1	8 ¹ / ₂	7 ³ / ₄
Consumer prices ^{d)}				
(% change over previous year)	1.1	2.3	3 ¹ / ₄	1 ³ / ₄
Public sector financial deficit ^{e)}				
- in % of GDP	- 1.3	0.3	- 3 ¹ / ₄	- 1 ¹ / ₂
memo item:				
Real GDP in USA				
(% change over previous year)	4.2	5.0	1 ³ / ₄	2 ³ / ₄
Real GDP in Japan				
(% change over previous year)	0.8	1.7	1	1 ¹ / ₂

* Preliminary. - (s) Forecast by the Ifo Institute. - ^{a)} At 1995 prices. - ^{b)} Domestic employment. - ^{c)} Unemployment as a percentage of civilian labour force (employed and unemployed). - ^{d)} Harmonised index of consumer prices (HICP). - ^{e)} On national accounts definition (ESA 1995), in 2000 including revenue from the auction of UMTS licenses.

Source: Bureau of Economic Analysis, Economic and Social Research Institute, European Central Bank, Eurostat, calculations by the Ifo Institute.

risk of higher wages and increased inflation expectations perceived by the ECB, the more (the less) it will hesitate to cut interest rates.

Based on these assumptions on the global economy and on macro policies we expect (see Table 1) that in the Euro area

- exports will increase by 7¹/₂% this year and next year (the major slowdown in export growth occurring in the first half of the year) (broadly in line with the growth of world trade), following a 11.7% expansion last year;
- growth of fixed investment (equipment and construction) will decelerate from 4³/₄% last year to 3³/₄% this year and 4% next year;
- private consumption will increase by around 2¹/₂% this year and next. In view of the fact that taxes are being cut in major countries, this rather conservative outlook may be surprising. It follows from a low starting base due to the negative oil price effect and the assumption of a recovery of consumer spending during the course of this year.
- GDP growth in the Euro area will - after a deceleration in the second half of last year - accelerate during the first half of this year,

mainly driven by consumption. At average rates of around 2¹/₂% this year and next, growth will be lower than last year and similar to that achieved in 1999 and also similar to the rate of potential (or trend) output.

- As the slowdown will be more pronounced in the United States (1³/₄%), economic growth in the Euro area (and also in Western Europe as a whole) will be higher than in the U.S. The United States is, however, assumed to recover in 2002 when it may again achieve slightly higher growth than Europe. In the forecasting period there will be no growth differential in favour of the United States which is an important difference to the second half of the last decade (Figure 9).
- Employment in the Euro area will continue to rise and unemployment will fall to under 8% next year. Compared to a peak unemployment rate of almost 12% this may be considered an achievement. However, while it takes only a short time in Europe to increase unemployment during a recession it takes a very long time to reduce it to its pre-recession level (Figure 10). This points to major structural rigidities in European labour markets which differ, however, among the various countries. Furthermore, some European countries have made more progress to reduce structural unemployment than others.

Medium-term outlook

There is a good chance that the growth path in Europe will be higher than it has been in the past. Several reasons may be put forward:

- Given fewer fiscal problems and lower inflation, both fiscal policy and monetary policy could be less restrictive than they have been in the second half of the 1990s.
- Structural reforms in product and labour markets could make the European economy more dynamic. There are clear signs for such effects already. But structural reforms in labour markets are still lagging in particular in the large continental European countries.
- The spread of new economy effects could also help Europe achieve a higher medium-term growth path. But some caution is in order here. First, measuring any new economy effects is not an easy task as it is difficult to separate the tem-

Growth of Euro area GDP projected to accelerate in the first half of 2001, but to be lower than in 2000

Table 2
Determinants of Growth 1990–1999
 Comparison between the United States and Europe^{a)}

	GDP	Labour input	Capital stock	Labour productivity	Change in productivity caused by:	
					Capital deepening	TFP
United States						
1990–1995	2.4	1.4	1.9	1.0	0.2	0.9
1996–1999	4.4	2.1	3.7	2.3	0.5	1.8
1990–1999	3.4	1.8	2.8	1.7	0.4	1.4
Western Europe ^{b)}						
1990–1995	1.4	- 0.4	2.3	1.9	1.0	0.9
1996–1999	2.2	0.9	2.2	1.3	0.5	0.8
1990–1999	1.8	0.3	2.3	1.6	0.8	0.9
of which: high growth countries:						
Finland						
1996–1999	5.5	2.3	0.9	3.1	- 0.5	3.7
Ireland						
1996–1999	9.9	5.8	4.7	4.0	- 0.4	4.5

^{a)} Average annual percentage change, in constant prices. – ^{b)} Weighted average of following countries: Germany (1992–95, 1996–99), Finland, France, Ireland, Italy, Netherlands, Norway, Sweden, Spain, United Kingdom.

Source: C. Gust and J. Marquez, Productivity Developments Abroad (<http://www.federalreserve.gov>) and own calculations.

Europe to achieve a higher medium-term growth path

porary cyclical effects from overall productivity growth to find the rate of growth which is sustainable over the medium and longer term. So far no significant new economy effects can be detected in overall growth and in productivity growth in Western Europe (as officially measured). But in a few European countries like Finland and Ireland such effects are noticeable (Table 2).

- Further integration of Europe could also provide positive effects on medium-term European growth. Here much will again depend on how structural policies in Europe will be adjusted to these new challenges.

Figure 1

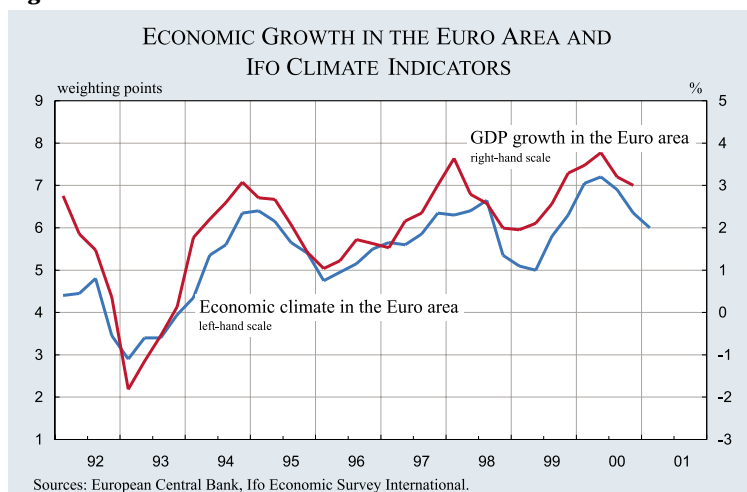


Figure 2

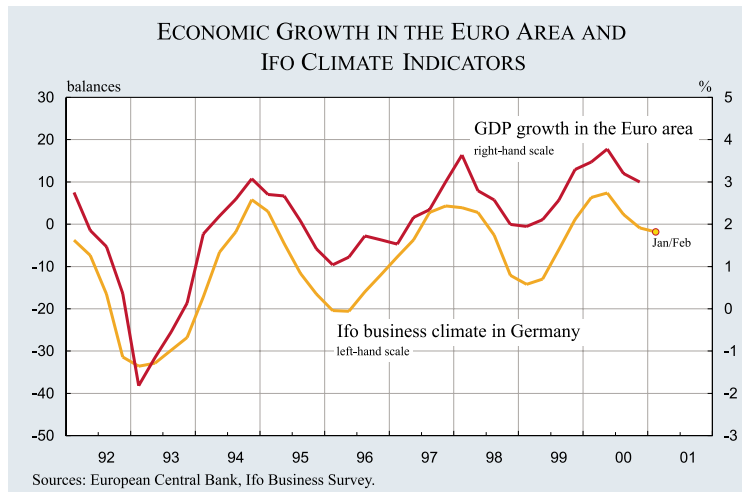


Figure 3

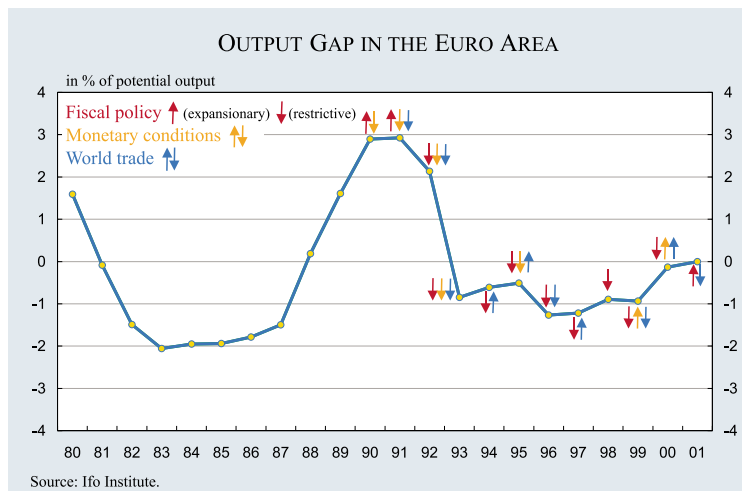


Figure 4

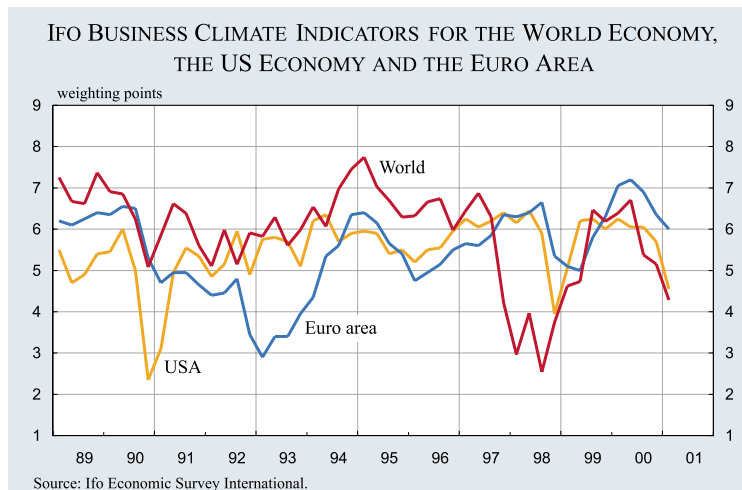


Figure 5

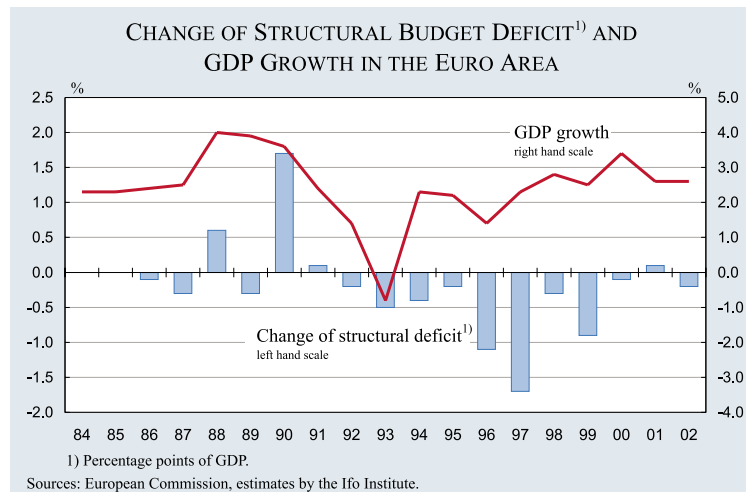


Figure 6

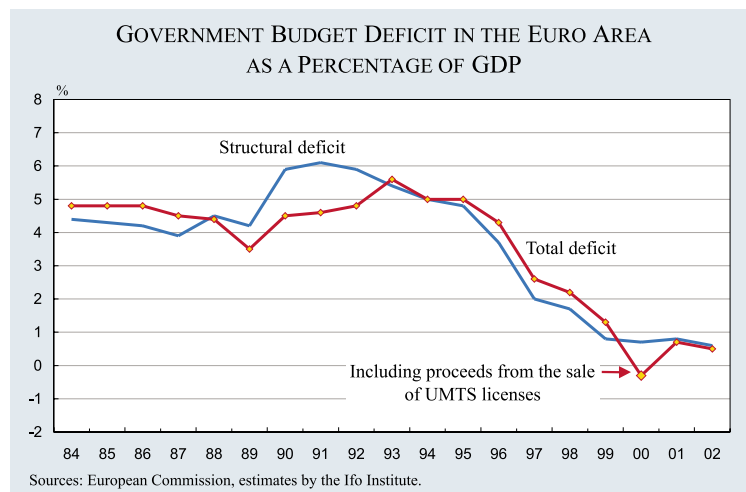


Figure 7

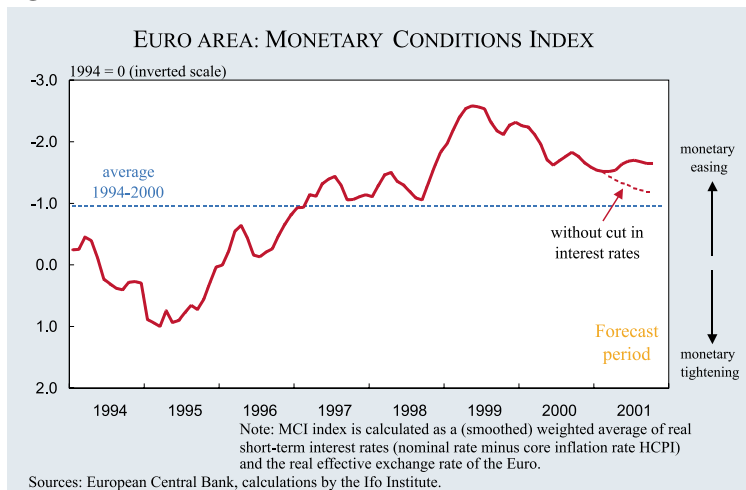


Figure 8

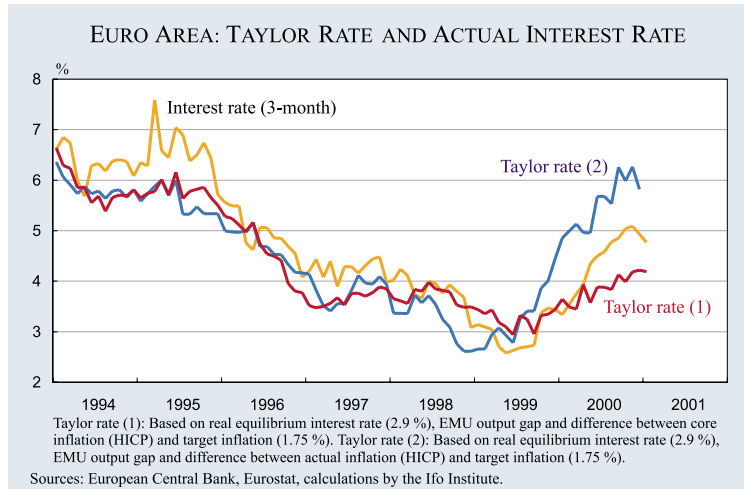


Figure 9

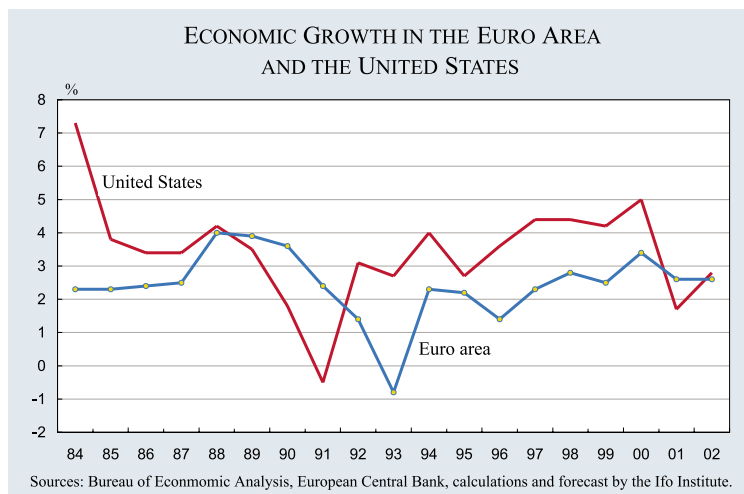


Figure 10

