European Economic Network

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The Economic Outlook in Europe in 2002-2003

Autumn Report

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About the European Economic Network

The European Economic Network (EUREN) is a network of six leading European economic institutes. EUREN was formed in 1999 to facilitate improved analysis of developments and prospects across the European economy, by developing closer links between leading economic research groups. All Euren institutes regularly publish forecasts, both on national economies and on EU and Euro Area as well.

Members of the Euren group have been co-operating in a number of ways over the three last years: meeting regularly to discuss economic developments and prospects; holding annual economic issues conferences, in Paris, to discuss major challenges for the European economic policy, contributing to joint and partner's research reports and economic outlook seminars and conferences (this includes the regular report, *La Tribune d'Euren,* http://www.coe.ccip.fr/05/tribune.htm),working together on economic research projects.

This is the second joint report on the European economic outlook. In this report Euren intends presenting a broad view on recent economic developments in the Europe as well as offering some special studies aiming to discuss key elements on a more structural basis. Copies of the report can be downloaded from each Institute's web site.

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1

EXECUTIVE SUMMARY

Since last spring, the short-term outlook for the international economy has deteriorated markedly. World trade growth, after a rebound at the beginning of 2002, slowed again, triggered by setbacks to the U.S. economy, the downward trend of stock markets, and increases in oil prices, following a rise in political tensions in the Middle East. These factors, which dampened growth world wide, should be overcome in 2003 and international trade will recover.

The U.S. recession in 2001 was deeper than initially estimated, mainly as a result of a sharp decline of corporate investment. The recovery in 2002 was partly due to more technical factors, but also resulted from the huge expansionary stance of economic policy. However, in mid 2002 consumer and business confidence indicators started to wane and the probability of another downturn increased. GDP growth slowed again and it should be only very moderate in the last quarter of 2002.

However, we do not expect the U.S. economy to fall back into recession. It will recover gradually in 2003, above all because investment rebounds, as the financial situation of the business sector improves. But it will not improve as strongly as in previous upturns, as there still is a capacity overhang. Furthermore, consumption will be tempered by the weak labour market and the negative wealth effect. Therefore, GDP will grow at an annual average rate of 2.4 %. For the international economy there is still a risk that the U.S. current account deficit will increase again and put the dollar exchange rate under pressure.

The Euro Area economy saw resumption of GDP growth in the first half of 2002, but only at a moderate rate. Also in Europe, industrial confidence stopped improving in the second quarter of 2002. Export growth slowed, reflecting a weaker international demand but also a loss of price competitiveness, following the appreciation of the euro against the dollar and the increase in unit labour costs. Private consumption remained hesitant and consumer confidence deteriorated due to inflation accelerating and the situation in the labour market worsening. All in all, GDP is expected to have grown at a rate of only 0.8 % in 2002 as a whole.

Monetary policy in the Euro Area was slow to react to the slowdown of growth. It was not until December 2002 that the ECB lowered its key interest rate. This reflects the difficult conditions the ECB faced: monetary expansion was above the ECB reference value and inflation, although mainly triggered by transitory developments, did not fall significantly. As loans to the corporate sector grow slower than M3, some market observers doubt whether the recent interest rate cut will stimulate the Euro Area economy. We do not expect a credit crunch, as the slowing expansion of corporate loans mirrors GDP growth and, thus, is a result of lower demand and not a consequence of shortages in supply.

In the second half of 2002, there was increasing pressure for fiscal policy in the Euro Area to be consolidated further; in particular in Portugal and Germany, but also in France. Instead of 0.9 % of GDP, as it was planned in the stability programmes, the latest forecast for the combined budget deficit in the Euro Area in 2002 is 2.3 % of GDP. As long as this increase reflects lower growth rates only, it does not imply a major problem. It is the aim of the Stability Pact to bring deficit down so far that automatic stabilisers can work without violating the 3 % margin of the Stability and Growth Pact. Some governments are in trouble now because of the mistakes that were made earlier, when consolidation efforts did not go far enough. This, in part, was the outcome of deficiencies of the Stability Pact that should be corrected: the fiscal balance should be assessed on the basis of the structural deficit; care should be taken that the consolidation strategy is symmetric, i.e. the reduction of the deficit must be strong enough when economic conditions are favourable; and finally, stability programmes must be based on realistic assumptions about the economy.

All in all, fiscal policy will become more restrictive in the Euro Area in 2003, mainly thanks to Germany, where public expenditures are to be cut and taxes increased to keep the deficit under 3 % next year. In France, there is a clear indication that government will be unable to respect an even adjusted Stability Pact next year.

Given the lack of room of manoeuvre in economic policy, the recovery in the Euro Area will be export led. Stronger external demand will increasingly spill-over to investment and will lead to an end to de-stocking. However, the recovery of investment will be mild at first and gain momentum as capacity utilisation becomes higher later in the year. Private consumption will lag behind in this recovery: On the one hand, households will benefit from better conditions in the labour market only late in 2003; on the other hand, indirect tax hikes will be implemented in several countries. GDP will remain rather low in the last quarter of 2002, but the slowdown of economic activity will bottom out and growth will accelerate through 2003. On average, GDP will grow at a rate of 1.6 % in 2003 as a whole and it will stand above 2 % at end-2003.

The UK's recovery remains subdued, as financial markets remain fragile and the world economy depressed. In 2002, consumer demand is strong, supported by the increase of house prices that mitigated the impact of falling equity markets on the consumers. However, investment and exports were weak and industrial production declined considerably. But also the strong labour market – unemployment has remained extremely low, despite the slowdown in economic growth – has supported private consumption. At the same time, inflation remains low. In 2003, the UK economy will gain momentum; the annual GDP growth rate will be 2.6 % after 1.6 % in 2002. Increasingly growth will be supported by investment, whereas private consumption will grow at a slightly slower pace.

Main feature of the forecast

	2001	**2002**	**2003**
World trade	-0.1	2.5	7.0
Oil price ($/b)	24.4	24.6	25.0
GDP growth			
- United States	0.3	2.3	2.4
- Japan	-0.2	-0.1	1.5
Euro Area			
- GDP growth	1.4	0.8	1.6
- Inflation (HICP)	2.5	2.4	1.8
- Unemployment rate (%)	8.0	8.3	8.4
UK Economy			
- GDP growth	2.0	1.6	2.6
- Inflation (HCPI)	1.2	1.2	1.4
- Unemployment rate (%)	3.2	3.1	3.1

Chapter

2

THE INTERNATIONAL OUTLOOK

Since last spring, the short-term international outlook has deteriorated markedly. Even if the worldwide recovery is expected to be slower and weaker than anticipated a few months ago, a central scenario of a gradual pick-up of the world economy in the course of 2003 remains nevertheless the most likely outcome.

Table 1.1: Exogenous and international variables

percentage changes unless otherwise indicated

	2000	2001	2002	2003
World trade	12.8	-0.1	2.5	7.0
United States				
GDP	3.8	0.3	2.3	2.4
Consumer price index	3.4	2.8	1.4	2.0
3m interest rates	6.5	3.8	1.7	1.7
10y Gvt bond yield	6.0	5.0	4.5	4.5
Japan				
GDP	2.1	-0.2	-0.1	1.5
Consumer price index	-0.7	-0.7	-1.0	-0.7
3m interest rates	0.24	0.17	0.1	0.1
10y Gvt bond yield	1.8	1.3	1.3	1.2
US dollar/euro	0.92	0.90	0.95	1.00
Yen/US dollar	107.7	121.4	125.1	120.5
GBP/US dollar	0.66	0.69	0.67	0.64
Oil price, US$/barrel	28.4	24.4	24.6	25.0
Percentage changes	60,7	-14,7	+0.8	+1.6

Sources: OECD, ECB, EC, EUREN forecasts for 2002 and 2003.

World Trade

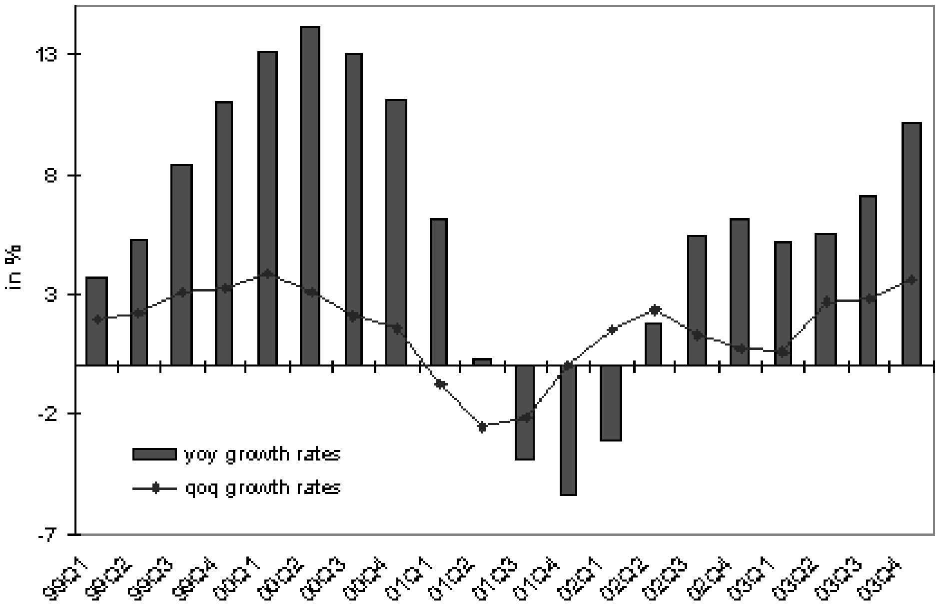
After three consecutive quarters of decline and a stabilisation in the last quarter of 2001, world trade picked up strongly in the first half of 2002. However, as global economic activity lost momentum, triggered by the setback of the US economy, the pace of international trade fell back and is unlikely to recover before the second quarter of next year. From a geographical point of view, this revival in trade should be broadly based. According to this scenario, world trade is expected to reach a real growth rate of about 7% in 2003 after only 2.5% this year.

Since the beginning of this year, one of the main features of international trade was the strong upswing of import volumes of the Asian countries (excluding Japan), which was fed by an improving IT sector and robust domestic demand, and the still vigorous expansion in China due to strong public investment. The crisis in Latin America sharply enhanced the financial risk perception of the continent, but contrary to the Asian crisis of 1998, financial turbulence did not spread to all emerging countries and the impact on industrialised countries should remain very limited.

The slowdown in Europe had an impact on economic activity in Central and Eastern Europe. However, economic growth remained robust thanks to domestic spending, which was fed by wage increases, FDI inflows, as well as strong export price competitiveness. The only exception is Poland, which faced a persistent economic slowdown after several years of strong economic activity although the first signs of improvement showed up recently.

Chart 2.1

World Trade and World GDP



Source: EUREN

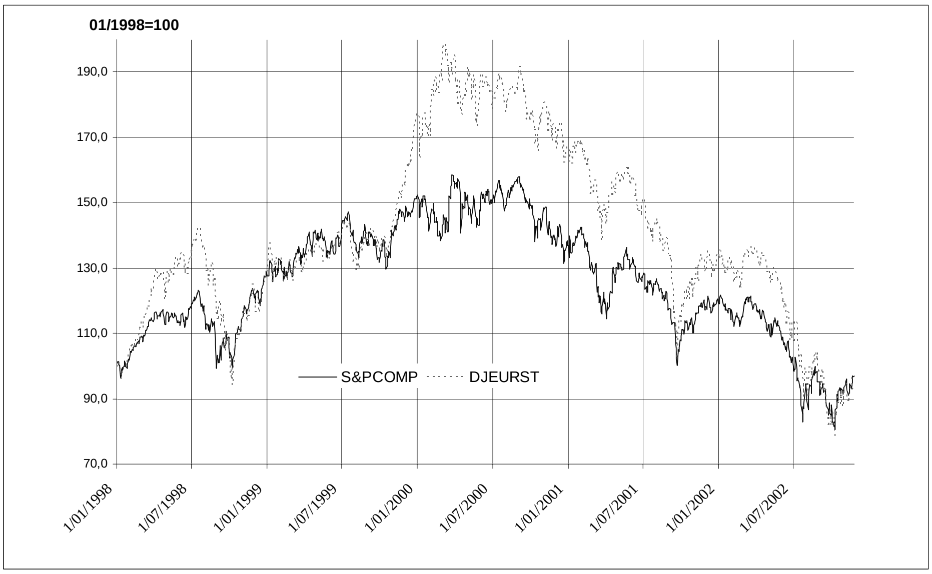
Financial markets seem to bottom out

Triggered by the bursting of the technology bubble, equity prices in most industrialised countries have seen an almost continuous downward trend since their peak in March 2000. After a short recovery in autumn 2001, stock market prices fell precipitately again in the last few months. This collapse in equity prices is different this time round, in the sense that it was widespread and not mainly concentrated in the ICT sector. It partly reflects a loss of credibility of audited accounts, as a result of some accounting scandals in the United States. These developments led to a sharp reversal in business and consumer confidence not only as for the state of the corporate sector but also for the economic outlook in the US and in the rest of the world. The rise in risk aversion also led to a substantial portfolio shift towards government bonds around the world.

However, after the sharp decline between the beginning of September 2002 and mid-October, most global stock markets rebounded. Both, the S&P500 and the Dow Jones Euro Stoxx indices increased by more than 20% between their lowest levels – reached in the second week of October – and early December. Once again, this stock price reversal was broadly based. Investors returned to stock market as earnings of US corporations in the third quarter of 2002 turned out to be better than expected. On the other hand, signs related to the strength of the economic activity were mixed, so that stock prices' volatility remains important, which reflects the high current uncertainties.

Chart 2.2

Stock Markets in the U.S. and the Euro Area



Source: Thompson Financial

It seems hazardous to assess whether this rebound indicates that stock prices have reached their lowest level. We can, therefore, not totally exclude the risk that a simultaneous correction on the major stock markets could jeopardise the expected recovery, since a renewed fall in equity prices could further hamper investment and consumption through a variety of channels (such as wealth, confidence and financing conditions).

Oil prices remain in the OPEC target range

In the first two weeks of October, the Brent oil price was 28.5 USD, and was estimated to include a risk premium between 3 and 5 USD, that should gradually disappear, provided tensions in the Middle East fade away. Since then, thanks to the diplomatic agreement reached between Iraq and the United Nations and the prospects of increased OPEC supplies in the near future, oil prices decreased to less than 23 USD by mid-November, before rising again recently.

In the current context, even if oil prices could be subject to some volatility linked to the developments in the Middle East, they are expected to change little, on average they will reach 25 USD per barrel in 2003 after 24.6 USD in 2002. The underlying scenario is considering that a mild global recovery will not put pressure on oil prices, as oil production is expected to adjust to the higher oil demand.

However, the risk still exists that the international economic environment darkens because of a further lasting rise in oil prices in the context of a war scenario. Although it is impossible to assess the magnitude and the duration of such a shock, it is expected that not only would households' purchasing power be eroded, but also that consumer and investor confidence would be affected. At this phase in the economic cycle, such a shock might then be a heavy burden on the recovery expected in industrialised countries.

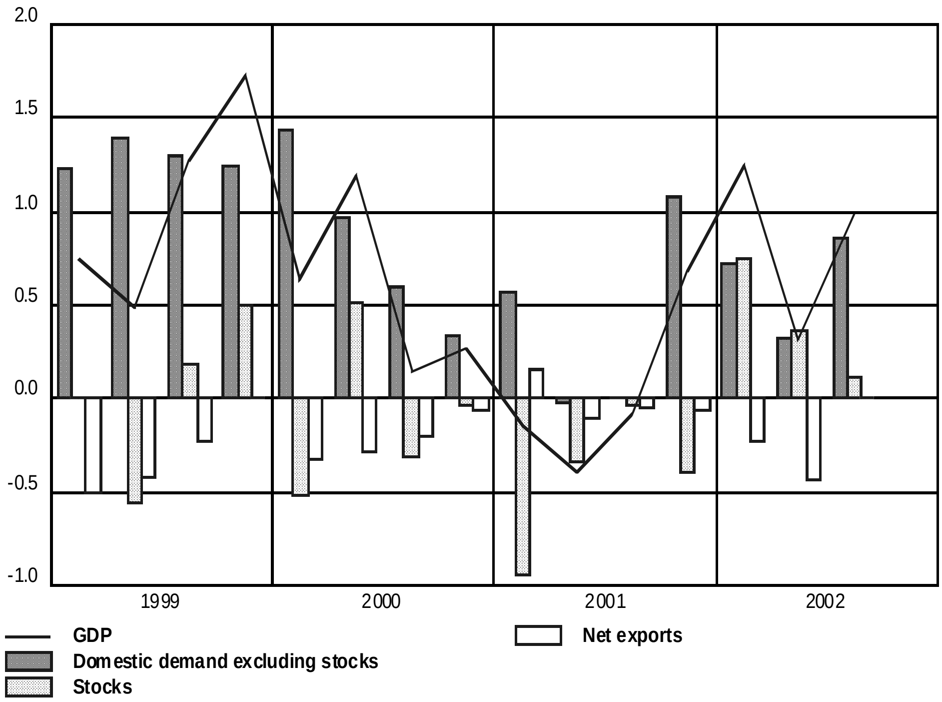
Growth in the United States sustained by huge expansionary economic policies

The US recession in 2001 was deeper than initially estimated as economic activity declined for three consecutive quarters. This setback was the result of a sharp decline in firms' investment as well as a massive de-stocking. The recovery, which started at the end of 2001, was partly technical as slower de-stocking temporarily boosted GDP growth in the first quarter of 2002. It also resulted from the huge expansionary stance of economic policies. On the one hand fiscal easing and credit incentives, notably in the motor vehicle sector, encouraged private consumption. On the other hand, public spending (mostly security and military spending) was boosted in the aftermath of the 11 September attacks. During the second quarter of 2002, growth slowed sharply as both private and public consumption lost momentum and the contribution of changes in stocks halved. Most consumer and business confidence indicators also started to wane, probably because of falling stock markets and unrealistic growth anticipations made at the beginning of the current year.

In the third quarter of this year, US GDP registered a quite robust quarterly growth (1.0%). However, this result was mostly due to the stimulation of household expenditures driven by the reactivation of zero rate credits granted by motor vehicle firms. As these programs are fading out and demand of new cars is declining, US GDP in the last quarter of 2002 could see almost no growth.

Chart 2.3

United States - Contribution to GDP growth
Constant prices, seasonally adjusted qoq – rates in %



Source: Thompson Financial

Gradual recovery in 2003

Thanks to the strong rebound of the first quarter of 2002 and sustained growth in the third quarter, US GDP should rise by 2.3% this year. Even if the recovery in the United States is abating, there is no “double-dip” recession in our central scenario. However, in the short run, the American economy will not sustain the rapid growth path observed at the beginning of 2002, as private consumption is expected to lose momentum. The improvement in corporate profits and the gradual recovery of business investment should, however, contribute to steady growth acceleration during 2003. Taking into account a small carry-over of about 0.5%, US GDP should grow on average by 2.4% in 2003.

Box 2.1: The COE leading indicators for the United States

A/ The **COE's leading indicator** is a monthly indicator that aims to predict the turning points in the growth cycle using a probability-based approach. The growth cycle is by definition the deviation from the trend of economic activity. It is worth noting that a peak in the growth cycle can precede a peak in the classic cycle (cycle in level). In this case the slowdown in growth changes into a recession (as in 1990). The indicator combines information supplied by series that are ahead of the cycle.

The six series that make up the IARC indicator for the United States are:

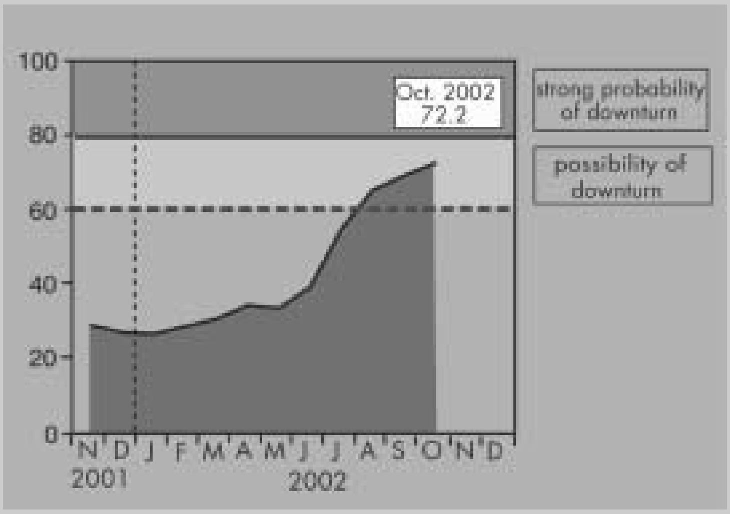
- The Standard & Poor's 500 index;
- The interest rate spread (10 years government bond less three months treasury bond);
- The ISM survey;
- Consumer expectations regarding their own situation and the economic outlook (Conference Board survey);
- An indicator of manufacturing industry inventories (the Census Bureau index);
- New house building permits.

These six series have been selected for their ability to predict cycle turning points. The following properties have been taken into account: economic pertinence, advance, timeliness and consistency with the growth cycle. The probability of a turning point for each one of those six series is carried out monthly based on the sequential probability Nefçi's formula. It is assumed that cycles do not exhibit duration dependence. These individual probabilities are then each linked to the probability of a shift in the global economic cycle using a Bayesian formula that takes into account the risk of a false signal or of missing the economic cycle. Then they are aggregated. The Hodrick-Prescott filter is used to calculate trends. A review study on the period 1970-2000 was carried out to test the validity of the indicator and to determine the critical thresholds that allow the emission of probabilistic signals. The first threshold for the search of a peak of the growth cycle is 60 (possibility of a peak in the next nine months) and the second one is 80 (strong probability in the coming three months). When looking for a trough, the thresholds are identical but negative by pure convention.

B/ The **probabilistic start-end recession index (SERI)** developed by the COE is based on a Markov-Switching model introduced by Hamilton in 1989. It provides an instantaneous probability of being in a recession phase of the economy. The Hamilton model is applied to a finite number n of series that coincide with the reference business cycle. For the United States the series selected are the unemployment rate, the industrial production index in the manufacturing sector, the construction spending in the private sector and the help-wanted advertising index released by the Conference Board. The individual probabilities are then aggregated taking into account the risks of false signals and missed signals. At each time t, the SERI index is thus defined as the aggregate of these probabilities. The signal of change in regime (expansion or recession) is given when the SERI index crosses the significant threshold of 0.5.

Chart B-2.1.1

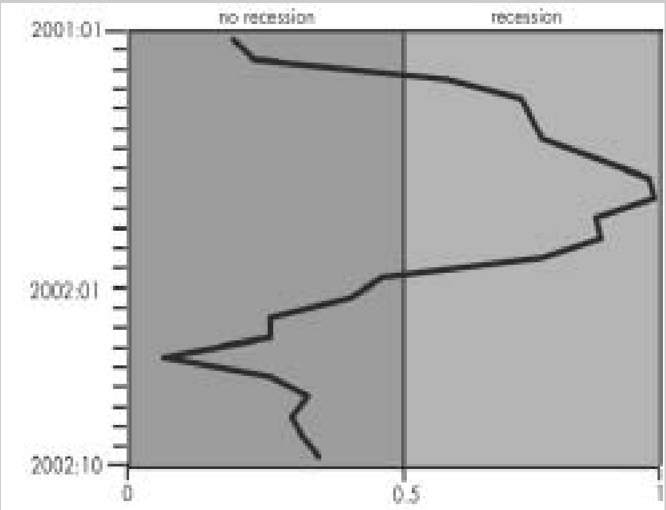
Growth cycle leading indicator:
search of next peak



Source: COE

Chart B-2.1.2

Classical cycle coincident indicator :
Search for a recession



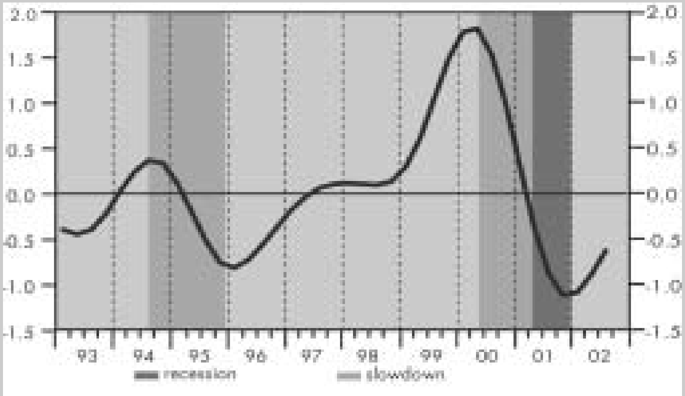
Source: COE

Interpretation: The COE growth cycle leading indicator aims at anticipating the peaks and troughs of the growth cycle (defined as the deviation to trend). When a peak is reached, it means that the growth rate will decrease below the trend growth rate (currently estimated at 2.7%). For more details, see www.coe.ccip.fr

The COE’s growth cycle leading indicator for the United States has emitted a signal of rebound in December 2001. In January, the recession index crossed the 50% threshold indicating an exit of the American recession in December 2001. The leading Indicator is now used to search for a peak of the growth cycle (chart B-2.1.1). Since June, there has been a progressive deterioration of this indicator showing a possibility of downturn but the threshold of 80 will have to be passed to get a strong probability of downturn in the following three months. Meanwhile, the performance of the American economy is back to the upside, as can be seen in chart B–2.1.3, implying a growth rate on average above the trend growth rate estimated at 2.7%. In addition, there is no sign of coming recession despite the index increase to 0.31 in October (chart B-2.1.2).

Graph B-2.1.3

Growth cycle of the American economy



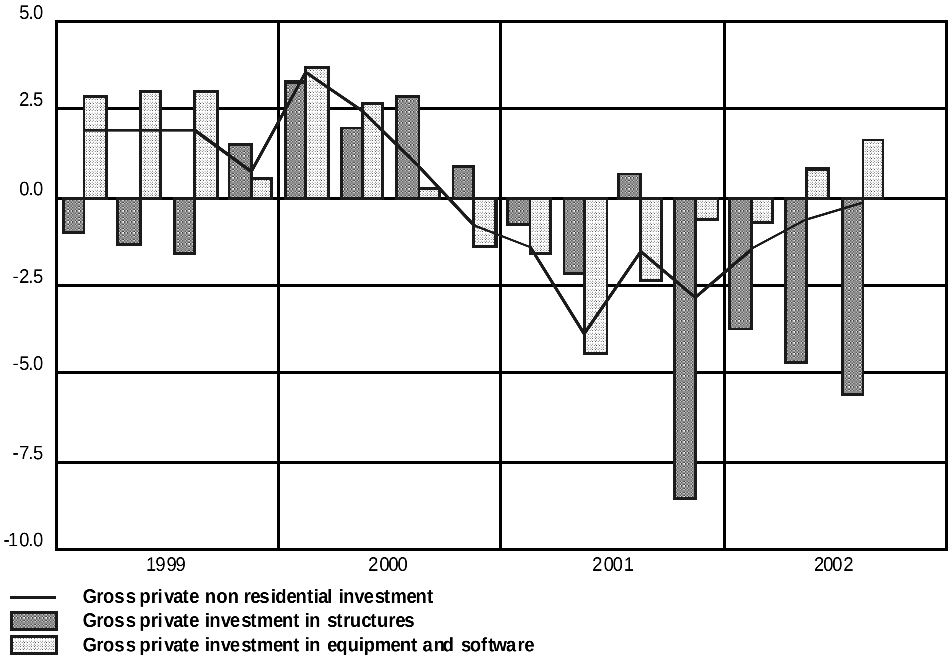
Rebound in US investment not as strong as in previous upturns

A recovery in business investment is needed to underpin the upturn in economic activity. Up to now, signals remained rather mixed. On the one hand, according to national accounts, the downturn of the information technology sector seems to have bottomed out. The correction of over-investment (which raised the corporate capital stock to an exaggerated high level by the end of 2000) appears to come to an end gradually. Indeed, investment in equipment and software, which accounts for about 80% of gross private non-residential investment, registered positive growth rates from the second quarter 2002 onwards. On the other hand, the continuing fall in investment in structures is still weighing on firms’ total fixed investment.

Chart 2.4

United States - gross private non residential investment

Constant prices, seasonally adjusted qoq – rates in %

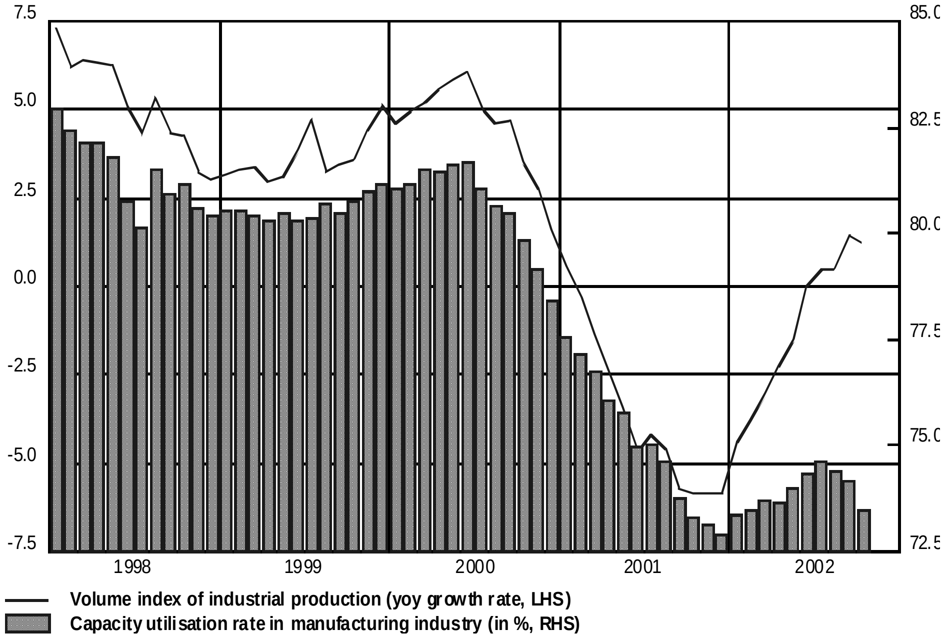


Source: Thompson Financial

Moreover, the still very low level, in historical terms, of the capacity utilisation rate (CUR) in manufacturing confirms that capital overhang still has to be eliminated (notably in the telecommunication sector, where utilisation rates remain below 70%) and continues to be a drag on firms' profitability and capital spending. The decrease in the CUR registered from August 2002 onwards also reflects the weakness in industrial production. Year-on-year growth of industrial production turned out to be slightly positive in recent months. However, monthly growth rates indicate a setback in the last three months and most statistics suggest that this decline, driven by the decrease in the production of motor vehicles and industrial machines, went on in November. Growth of gross private non-residential investment should remain negative on average this year.

Chart 2.5

United States - industrial production and capacity utilisation rate

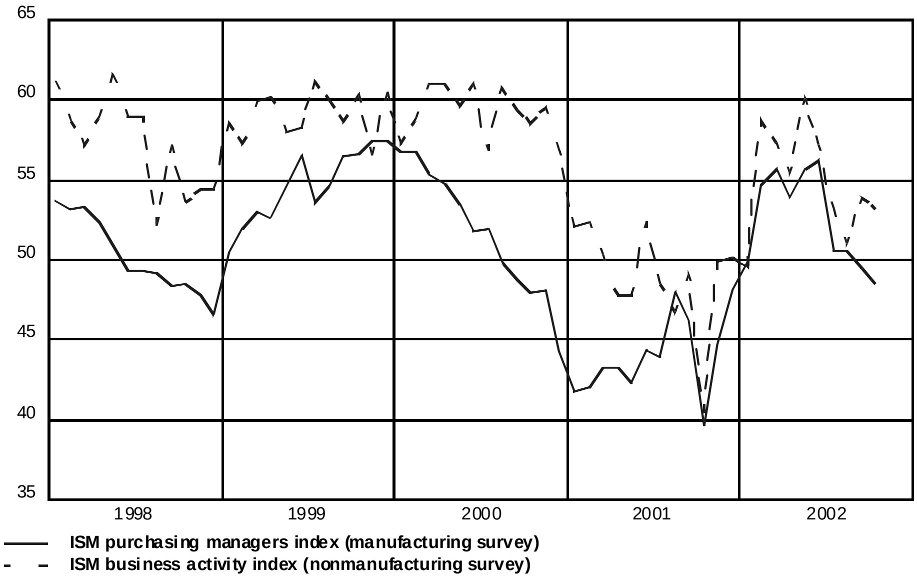


Source: Thompson Financial

The expected recovery in business investment for next year should be more modest than in previous upturns. The weakness in business confidence, as reported by the deterioration in the ISM indices as from the middle of the year, is weighing heavily on business investment plans.

Chart 2.6

United States - business cycle indicators
Seasonally adjusted indices

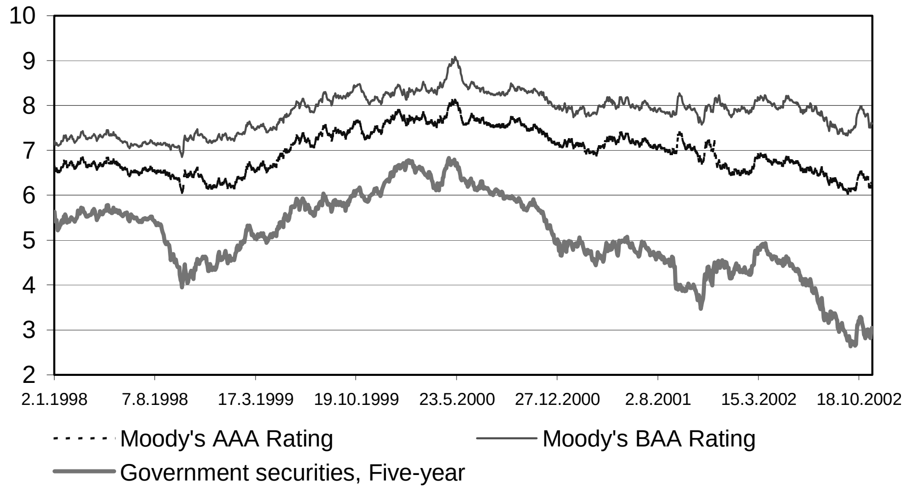


Source: Thompson Financial

Despite the considerable loosening of the monetary policy, firms have to face the deterioration of their financial conditions. On the one hand, as a decline in equity price increases the financing cost of investment by issuing new shares, firms might be inclined to decrease their investment spending, as some projects previously perceived as profitable will be cancelled. Moreover, decreasing equity prices erode corporate collateral and reduce the firms' ability to borrow and consequently to invest. On the other hand, the risk premium imposed on the corporate borrowings increased and led to a widening of the corporate yield spreads. This was more particularly the case for lower investment grade borrowers and was reinforced by some downgrading reclassifications made by rating agencies. This yield spread widening, combined with the tightening of banks' lending standards might hamper the investment recovery. This is particularly risky since as from the middle of the nineties, firms relied more and more on borrowings to finance their capital spending both through bond market and bank loans. One has to keep in mind that this spread widening could also partly reflect an increased demand in corporate borrowings through the bond market.

Chart 2.7

United States – Corporate bond yield spreads



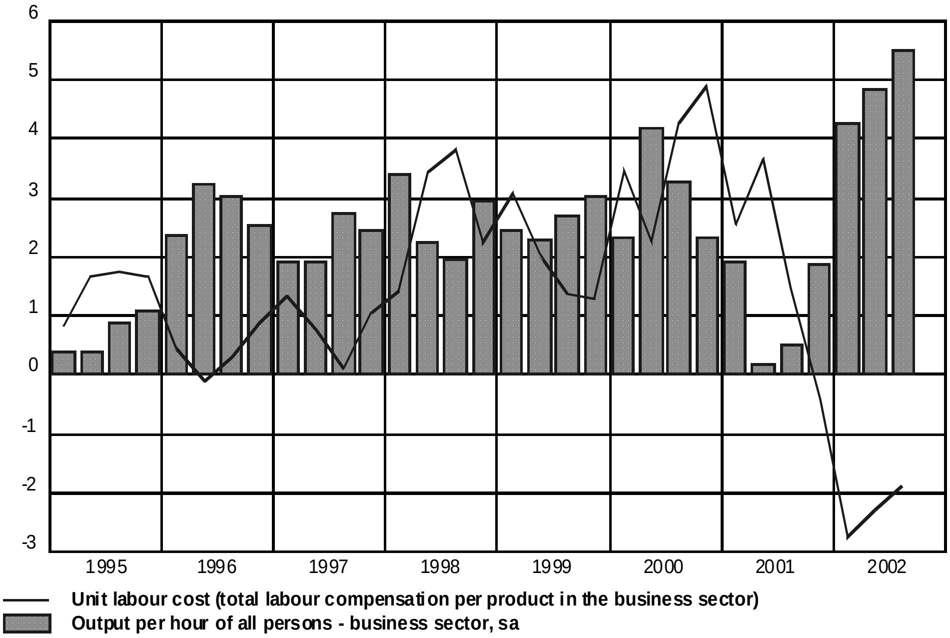
Source: Thompson Financial

Up to now, the slight improvement in profits was mainly fed by cost reductions (such as labour costs) and sharp productivity gains, rather than by a real increase in demand. As prices remain relatively low, profit margins stay under pressure. Business investment should gradually accelerate next year, when the recovery of profits consolidates. The improvements in corporate balance sheets and in profit prospects should then reinforce the recovery in firms' investment.

As stated by the Federal Reserve, the upswing in productivity, reflected by the increase in output per hour, is due to a more efficient use of firms' equipment as well as to a more intensive use of the existing workforce. It is therefore difficult to assess whether this productivity performance will only be temporary or long-lasting. In the latter case, it should reflect innovations and structural adjustment in the use of capital that would support economic activity.

Chart 2.8

United States - productivity and labour cost indices
Yoy rates in %



Source: Thompson Financial

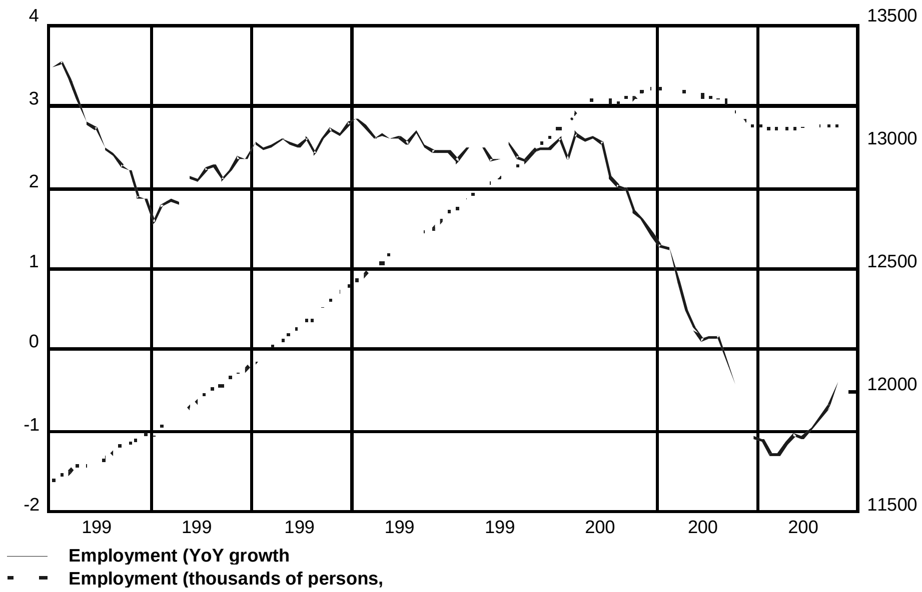
US private consumption tempered by weak labour market and negative wealth effects

Despite the weakness of the labour market, households' expenditure has been the main driving force behind growth in the US up to now.

Private consumption has been boosted by an aggressive counter-cyclical budgetary policy as well as by extremely favourable credit conditions resulting from the drastic loosening of monetary policy.

Chart 2.9

United States - employment in non-farm industries



Source: Thompson Financial, EUREN calculations

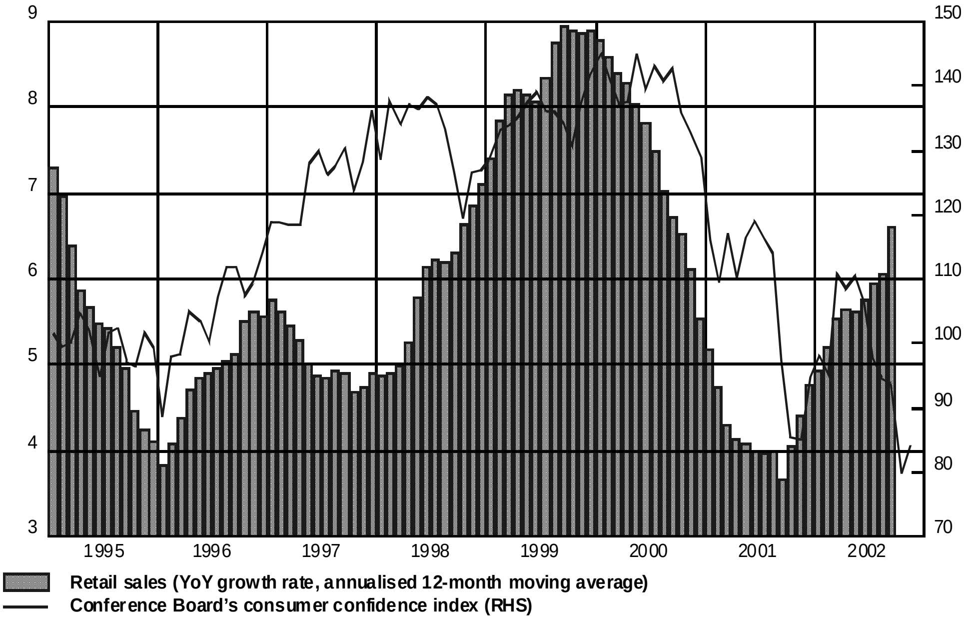
The demand for new cars has been stimulated by substantial discounts granted by vehicle manufacturers. US households also benefited from very low interest rates granted by commercial banks for consumption credits and mortgage interest rates. They took advantage of those very low rates to renegotiate the conditions of their mortgages and alleviate the interest burden on their debt.

Lower interest rates also boosted the demand for home and housing starts leading to a strong increase in home prices. As housing is the main component of households' wealth[1], this rise in home values has partly offset the sharp decline of the value of household financial assets on their net wealth. It is clear that the rises in house prices at current rates are unlikely to continue forever. Even if a fall in real estate prices increases the risks weighing on the sustainability of households' expenditure, there is, up to now, no strong evidence that a housing bubble is currently growing in the United States.

[1] OECD, October 2002.

Chart 2.10

United States - Consumer confidence and retail sales



Source: Thompson Financial

Private consumption is now expected to slow down somewhat in the next few quarters. Despite higher house prices, the fall of stock markets is estimated to have a negative net impact on US household wealth and thus weighs on consumers spending. The US household savings rate has already jumped from about 2% of personal disposable income in 2001 to about 4% in 2002. Moreover, as the decline in equity prices is linked to increased risks concerning prospects for economic growth and employment, it has not only harmed confidence of US households owning equities[2] but even confidence of households who do not possess equities. More recently, consumer confidence in the US has also been negatively affected by the geopolitical tensions in the Middle East.

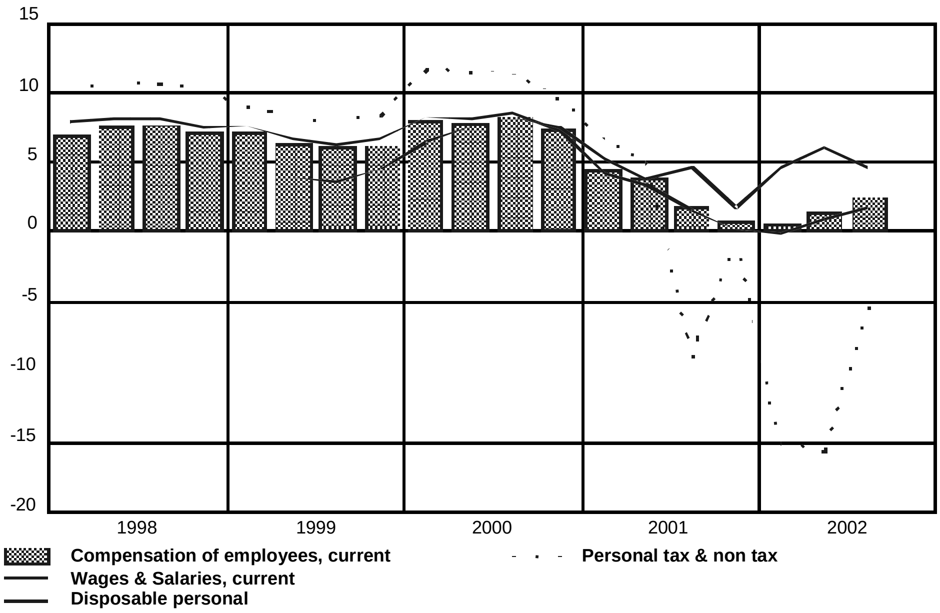
In the short run, employment growth should remain subdued until the recovery in demand and profits strengthens. Thanks to low wage inflation, and a flexible labour market, employment is expected to pick up gradually in the course of the second half of 2003.

[2] The OECD estimates that at least 50% of US households have some form of exposure to the equity market.

The impact coming from expansionary economic policies on household spending will progressively fade out. Tax cuts granted to households by mid 2001, the extended unemployment insurance and the stimulus package approved in March 2002 sustained the rise in disposable personal income in 2001 and 2002, while, during the same period, wage and salary increases remained relatively moderate. Fiscal stimuli are expected to fade during the quarters to come as the financing capacity of the general government sharply deteriorated in 2001 and 2002. However, the recent electoral success of the Republicans at the Congress could pave the way to a further expansionary fiscal policy in 2003.

Chart 2.11

United States - Disposable personal income (current prices)
Yoy growth in %



Source : Thompson Financial

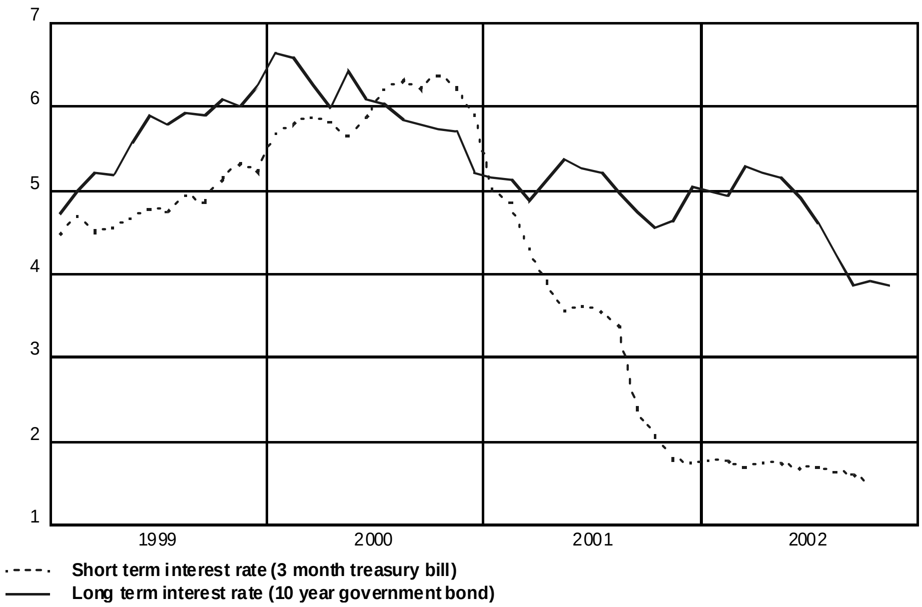
US monetary policy at the end of its relaxing stance

Since the end of 2001, and for nearly one year, the uncertainty related to the state of the US economy and to the strength of its expected rebound, conducted the FED to keep its short-term official interest rates unchanged at the historical low level of 1.75%. However, in the beginning of November, given the current weak confidence and US economic activity, the Fed cut its fund rates further by 50 basis points.

Due to the reasons mentioned above, this rate cut, which is expected to be the last one in this current business cycle, is not expected to give a similar boost to households' spending as it did in the last quarters. In the same way, one could wonder if this loosening could really boost private non-residential investment as long as CURs remain low and firms face financial troubles. Nevertheless, the main objective of the Fed was probably to preserve and/or to restore confidence in the financial system.

Chart 2.12

United States - Interest rates



Source: Thompson Financial

After its recent easing, the Fed is expected to remain cautious until the rebound in activity firmly materialises. In the absence of inflationary pressures, an increase in short-term interest rates is only expected in the course of 2003 when economic growth gains in strength. In the last quarter of 2003, Fed fund rates should be around 2%. This should result in stabilisation, at annual averages, of short-term market rates at 1.7% in 2002 and 2003.

US current account imbalances should increase again …

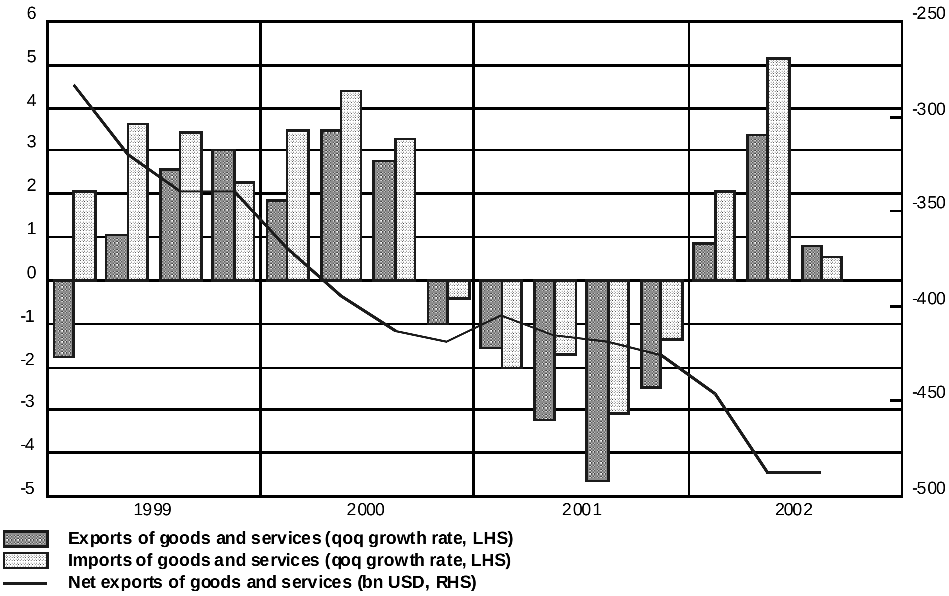
Despite the likely revival in exports, US domestic demand is expected to remain the main driving force behind growth. A further deterioration of the US current account is then again anticipated for this and next year in favour of the European and mainly Japanese current accounts, even if the recent depreciation of the US dollar could improve the competitiveness of US exporters.

In recent years, the low level of US domestic savings has been quite easily financed by portfolio investment and FDI. Up to now, there are no signs showing that investors consider the level in the US current account deficit as unsustainable.

However, if financial markets were to become more cautious in financing the current account deficit, this could trigger a further depreciation of the American currency and an increase of the interest rates in the United States, thus undermining the recovery scenario both in the United States and in other parts of the world.

Chart 2.13

United States: external trade
Seasonal adjusted



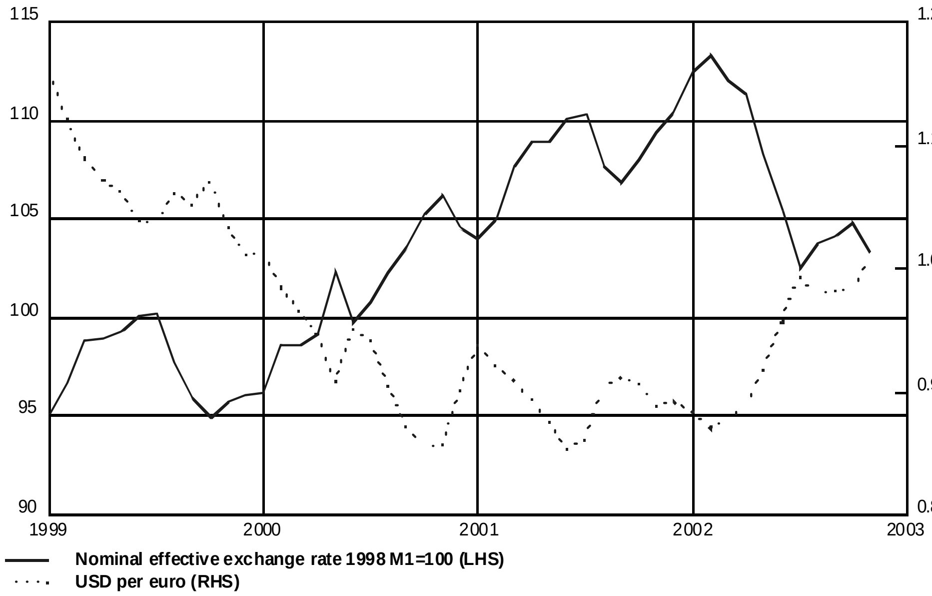
Source: Thompson Financial

…and put the dollar exchange rate under pressure

Several factors explain the fall in the nominal effective exchange rate of the US dollar throughout the current year. One can mention the deterioration of the US current account combined with the re-emergence of a US public deficit, disappointing cyclical indicators that failed to confirm the upward trend seen at the beginning of the year, and an interest rates differential with the euro zone. The US dollar depreciated against the euro by about 11% between March and October 2002, and dropped again in November so that the euro exceeded parity.

Chart 2.14

US dollar exchange rate



Source: Thompson Financial

The decrease of the USD against the euro in November was linked to the fall in US consumer spending and sentiment causing fear about the strength of the US activity, while the cut in the Fed fund rate had no significant impact on foreign exchange markets.

The US dollar is not expected to depreciate further against the euro in the coming quarters as economic growth and productivity gains should indeed remain higher in the US than in Europe. Moreover, political tension in the Middle East could reinforce the role of a safe haven of the US dollar. On average, the US dollar should then be at parity with the euro in 2003.

Weak prospects for the Japanese economy

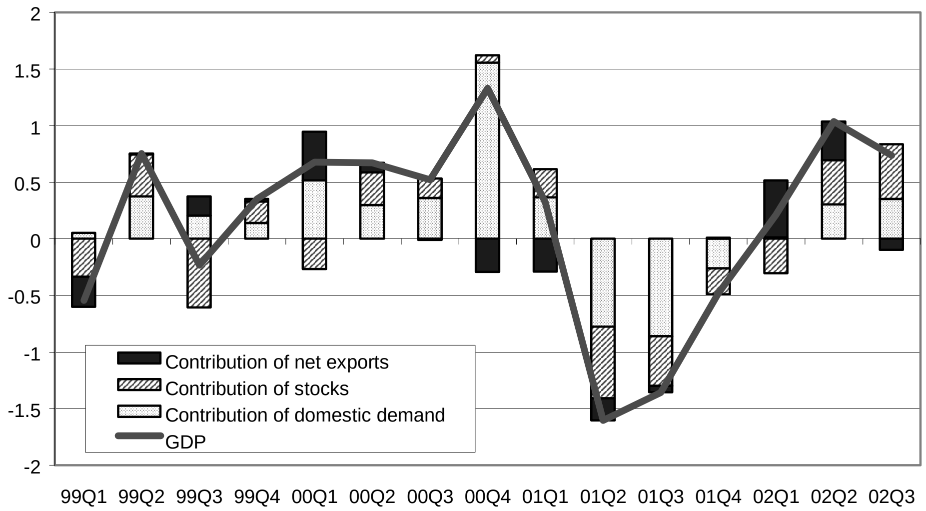
The Japanese recession that started in the second quarter of 2001 seems to have come to an end in the first quarter of this year. According to the latest version of the national accounts[3], Japanese GDP increased respectively by 0.2% and 1.0% (qoq) in the first and the second quarter of 2002. The positive growth rate in the first quarter was entirely due to the positive contribution of net exports, while the pick-up of domestic demand and the slowdown of destocking were an extra stimulus to GDP growth in the second quarter of 2002. In the third quarter, however, exports lost momentum despite several interventions of the BoJ to pull the yen down, while domestic demand growth remained more or less constant. Consequently, qoq GDP growth fell back to 0.7%. The trends observed in the third quarter are expected to persist in the fourth quarter. The deterioration in the international environment during recent months should further dampen Japanese exports, while Japanese indicators levelled off in the recent past, suggesting that not much should be expected from domestic demand either. Therefore, GDP growth should further weaken in the fourth quarter, implying a 0.1% decline of GDP for 2002 as a whole.

The prospects for 2003 are not very buoyant either. Although foreign economies are expected to recover gradually, stimulating Japanese exports, domestic demand should remain sluggish. Private consumption will only grow moderately reflecting ongoing deflation, historically high unemployment rates and falling nominal wages. Investment is expected to continue its decline as the capacity utilisation rate has remained at a very low level. These developments should give way to a growth rate of 1.5% next year.

[3] The Japanese national accounts were subject to several substantial revisions during the last couple of months. In part, these revisions were due to methodological changes. The figures in the text refer to national accounts published on November 15th 2002.

Chart 2.15

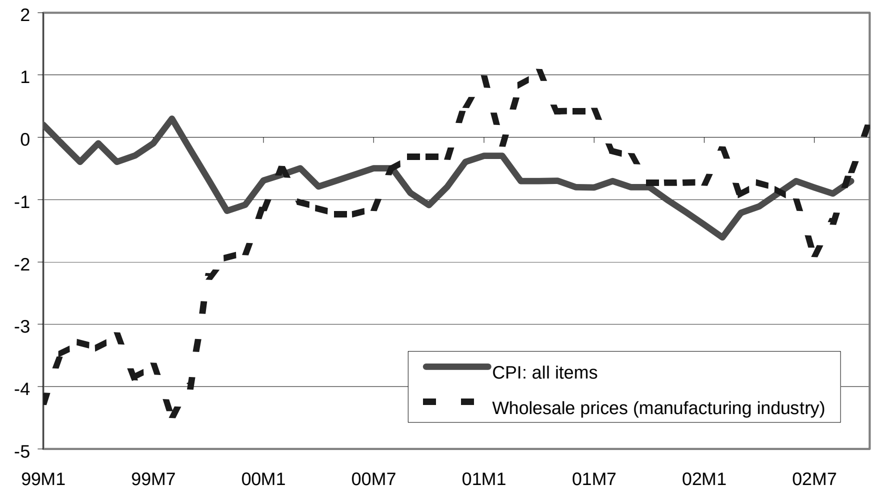
Japan - Decomposition of quarterly GDP at constant prices
seasonally adjusted, qoq changes in %)



Source: Thompson Financial

Chart 2.16

Japan - Prices
yoy changes in %)



Source: Thompson Financial

The Japanese economy still finds itself in a deflationary spiral. Although wholesale prices recently increased as a consequence of the rise in import prices, the fall of consumer prices is not expected to come to an end yet because of weak demand conditions. In this respect, the BoJ has announced that it will further relax monetary conditions by expanding the monetary base. Budgetary policy will not be able to stimulate the economy, as government has to start consolidating in view of a public debt that is approaching 140% of GDP.

The main risk for the Japanese economy at present is the huge amount of non-performing loans, which is officially estimated to be 8% of GDP, although other estimates are two or even three times higher. Hopeful reforms were announced by the Prime Minister and the Minister for Economic and Fiscal Policy, but at the time the government released its "Comprehensive Measures to Accelerate Reforms" it became clear that both ministers have not been able to put these promises into practice due to political pressure. In fact, the plan relies on new timetables and promises made by bankers to reduce the amount of non-performing loans, which is not seen as sufficient to assure a swift cleaning up of the banking sector.

Chapter

3

The Outlook in Europe

Part I - Euro Area economy in 2002

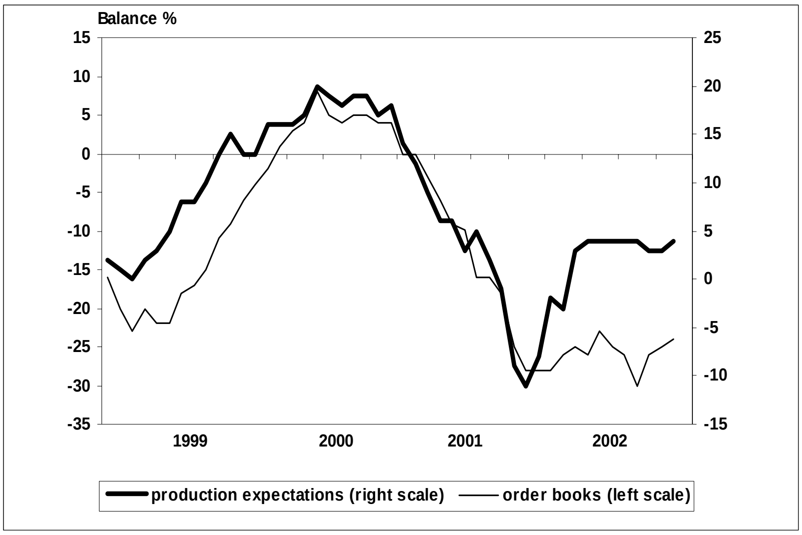
Economy activity in 2002

In the first half of 2002, the Euro Area saw a resumption in GDP growth, but at a modest rate (around 1.5% annualised). In the third quarter, GDP growth was of the same magnitude as in Q2 (0.3 % compared to previous quarter). However, surveys on the economic activity published in the summer showed a clear deterioration of the business climate (see box 3.1 for an analysis of the implications of recent developments of the synthetic indicator of the National Bank of Belgium).

According to the EC survey, the industrial confidence indicator in the Euro Area stopped to improve at the end of 2002Q2. Besides highly erratic month on month changes, the improvement in production expectations halted. The deterioration of order books was the concluded around the start of 2002, but there has been no rebound. Firms' judgement on the level of stocks showed that no restocking process has yet been triggered. However, the very last data (November survey) could signal the beginning of an upward trend for the business climate in industry as opinions about production expectations and total order books slightly increased. However, after rather strong growth in the first half of 2002, activity in the services sector has deteriorated, as is shown by the worsening of the economic sentiment of managers in this sector. The confidence index in the construction sector remains weak too.

Chart 3.1

Euro Area - Production expectations and order books



Source: European Commission

Slowdown of exports

From last summer, the weakening global economic situation has had a direct impact on the order books of European businesses at a time when they find themselves in a much less competitive position than a few months ago reflecting the effects of a stronger euro and a rise in unit labour costs. As a result extra-Euro Area exports in value terms grew only by 0.4% qoq in the third quarter of 2002. This slowdown mirrored lower world demand addressed to the Euro Area in volume terms[4], which contracted by 0.5% on average in July and August compared to the second quarter, after 2.9% growth between the first and the second quarter of 2002. According to national accounts, exports of goods and services (which include intra-zone expeditions) increased by 1.6% qoq in the second quarter after five quarters in a row of decline or stagnation. They grew by 2.2% in the third quarter, reflecting mainly the intra-zone trade increase.

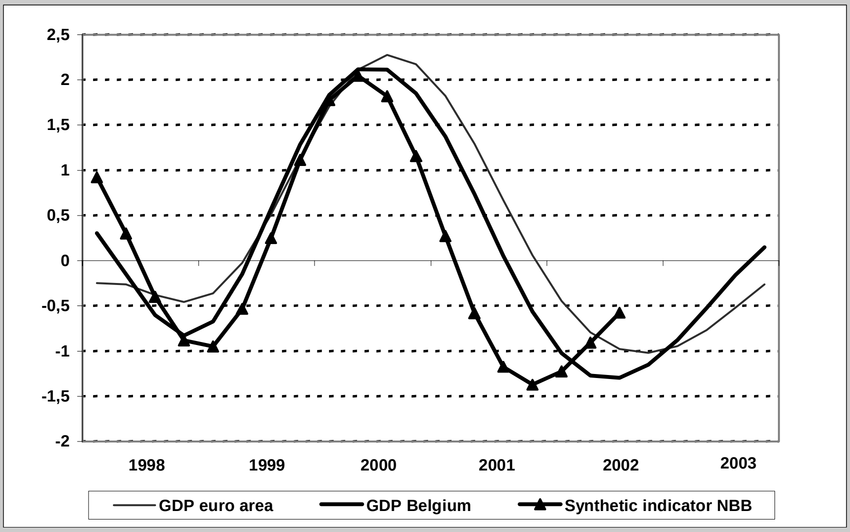
[4] Calculations based on the COE's world trade monthly indicator.

Box 3.1 – Belgian business survey indicator announces scenario of moderate upturn

In the EUREN Spring Report of this year, the cyclical behaviour of the Belgian business cycle vis-à-vis the Euro Area cycle was examined. The main conclusion of the study was that a turning point in the Belgian business cycle generally occurs one quarter earlier than the corresponding turning point in the Euro Area cycle. Moreover, the Belgian and Euro Area cycle appeared to be well correlated. In view of these two features, the Belgian business cycle can be considered as a leading indicator for the Euro Area economy. An even more interesting indicator in this respect is the business survey indicator of the National Bank of Belgium (NBB) as it performs very well when it comes to predicting turning points. Moreover, this indicator had an average lead of two quarters with respect to the Euro Area business cycle over the last two decades and it is more quickly available than national account data. In what follows, the latest EUREN forecast will be evaluated on the basis of these characteristics.

Chart B-3.1.1

Normalised cyclical components of Belgian and Euro Area GDP, and NBB business survey indicator



Source: FPB calculations based on Eurostat, INA (Institute of National Accounts, Belgium) and NBB data. The GDP cycles for the Euro Area and Belgium were calculated on the basis of EUREN and FPB forecasts from 2002Q3 onwards. These forecasts were respectively finalised in December and September 2002.

As it appears from the graph above, the last peak in the Euro Area business cycle was reached in the third quarter of 2000. The Belgian GDP cycle as well as the NBB indicator anticipated this turning point as they peaked one quarter earlier. Since then, the economic situation has greatly deteriorated and all cycles initiated a downward movement that intensified during 2001.

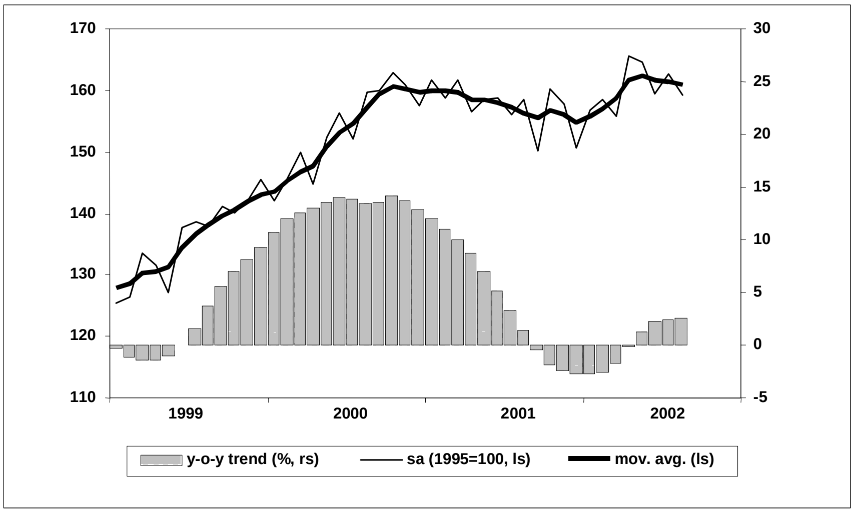
In the beginning of 2002, the cyclical component of the NBB survey indicator started to increase again due to an improvement of order books and demand expectations in the manufacturing industry. In our spring forecasts this pick-up of the Belgian business cycle indicator supported the view that economic activity in the Euro Area should improve progressively from the second half of 2002 onwards. During the second quarter of this year, however, demand conditions did not recover as vigorously as expected and consequently the NBB indicator failed to gain momentum. These developments suggest that the economic upturn will be rather U-shaped than V-shaped, which is clearly in line with EUREN forecasts. In fact, the Euro Area GDP cycle should bottom out very steadily in the course of this year and reach its trough only in the fourth quarter of 2002, while the recovery in 2003 is expected to be a lot less powerful than that in 1999. This implies that the Euro Area GDP cycle should reach its trough four quarters later than the NBB business survey indicator, which is mainly explained by too optimistic expectations in the beginning of 2002. The Belgian GDP cycle should reach its trough one quarter earlier than the Euro Area business cycle, which is in line with past observations.

The Euro Area competitiveness has been affected in recent months by two elements. Firstly, the nominal effective exchange rate of the Euro Area has appreciated as a result of the appreciation of the euro against the dollar (around 15% between the end of 2000 and the end of 2002) and the yen (30% in the same period). In the Euren's Spring report, it was estimated that if the euro hit parity against the dollar in 2002Q3 rather than during 2004 as it was assumed in the central forecast, without reaction from the ECB, GDP growth would be cut by 0.1% in 2002 and by another 0.4% in 2003. This simulation also showed that ECB could offset most of the adverse effects by loosening monetary policy[5].

[5] "What are the implications of a stronger Euro", Euren's Spring Report, p.54-60.

Chart 3.2

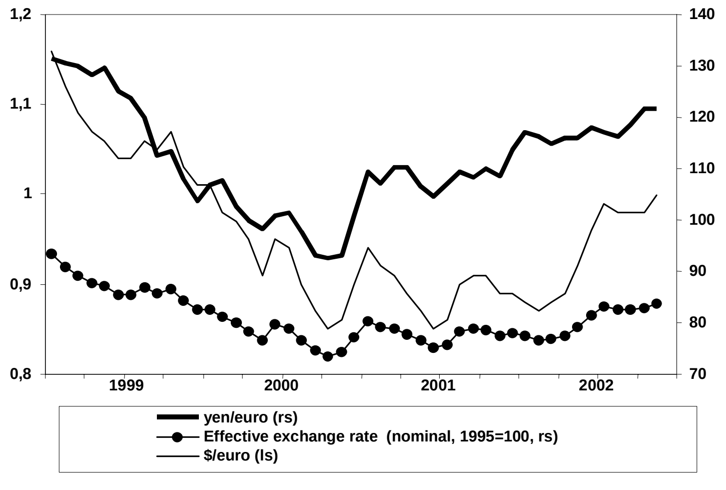
World demand addressed to the Euro Area



Source: Euren calculations

Chart 3.3

The euro exchange rate

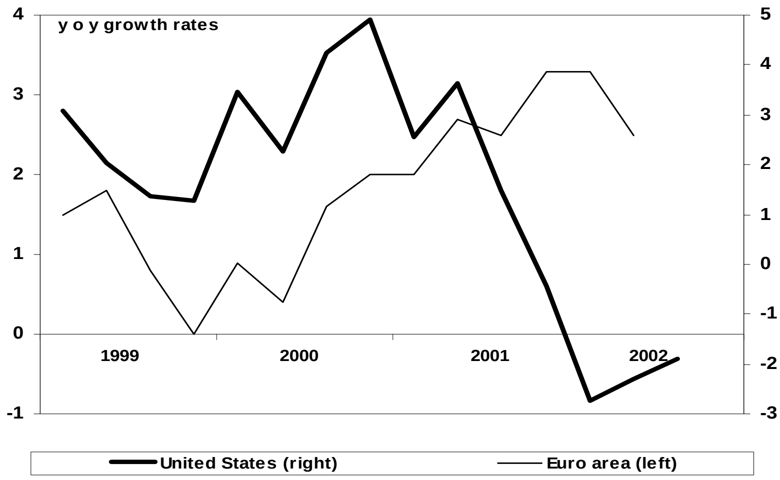


Source: TELECO

The increase of unit labour cost in the Euro Area has also meant a deterioration of the competitive position of European exporters. In nominal terms, wage growth in the Euro Area has stabilised on a trend slightly below 3%. But subdued economic activity is mirrored in lower productivity. As a consequence, the year-on-year unit labour cost rise is now over 3%, whereas continuing increases in productivity have led to a reduction of unit labour costs of more than 2% yoy in the U.S. This marked contrast between the U.S. and the Euro Area regarding labour costs developments has weakened the competitive position of Euro Area producers. The productivity gap which is building up between the US and the Euro Area raises the issue why these differences exist, which are not only rooted in the business cycle. To some extent, this gap is probably the result of lower reactivity of European firms to weaker activity when viewed against US firms. This resilience of US productivity also probably demonstrates the positive effects drawn from previous efforts regarding investment in ICT.

Chart 3.4

Unit labour costs in the US and in the Euro Area

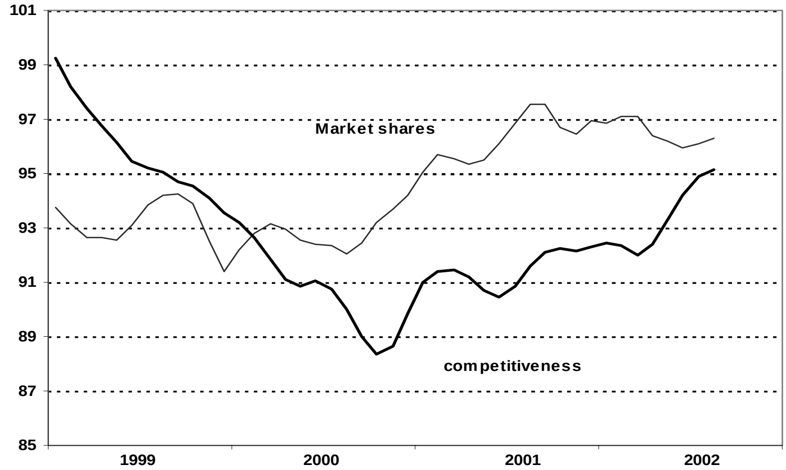


Sources: European Commission, Survey of Current Business

As a consequence of exchange rates and unit labour costs developments, Euro Area competitiveness has been deteriorating since the beginning of 2002, even if it still displays some gain since the launch of the euro. This deterioration in the competitive position of the Euro Area producers has helped bring a halt to the gains of market share of Euro Area exporters.

Chart 3.5

Market shares[1] and competitiveness[2] of the Euro Area
manufacturing industries



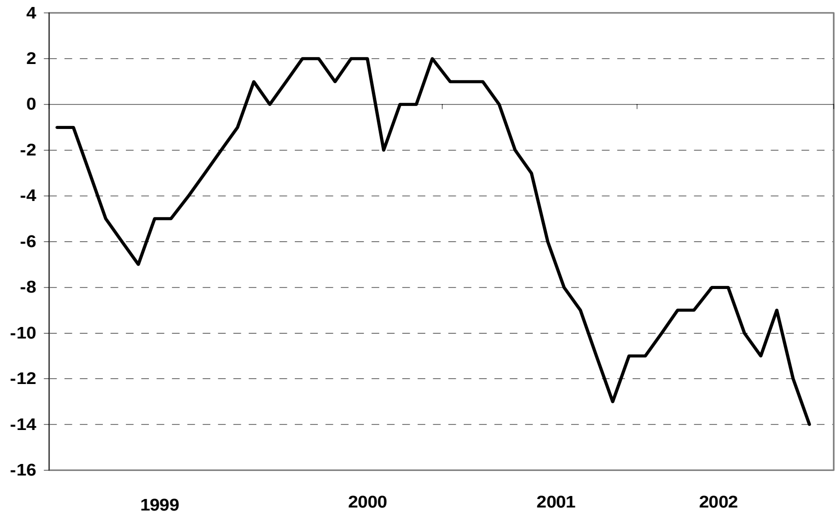
Source: Euren calculations - [1]Euro Area exports/world demand addressed to the Euro Area (in volume terms, intra-zone trade included).- [2]Euro Area export price/competitors export price (in a common currency). The results for the Euro Area are based on the average of Germany, Italy and France.

Internal demand remains weak

Private consumption remains hesitant, although, after a rise in household spending in the second quarter, a slight acceleration occurred in the third quarter. This can be explained by the gains of purchasing power from which households benefited in the first half of 2002: Indeed, while wage growth remained stable, inflation decreased. However, consumer confidence has been highly deteriorated in recent months. This is the result of several elements.

Chart 3.6

Euro Area - Consumer confidence

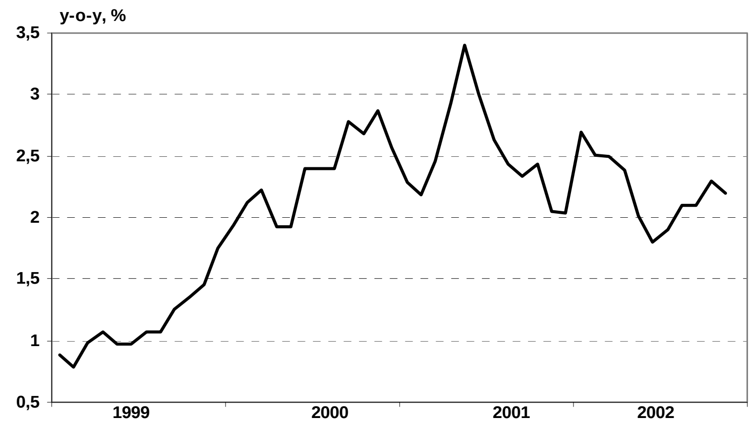


Source: European Commission

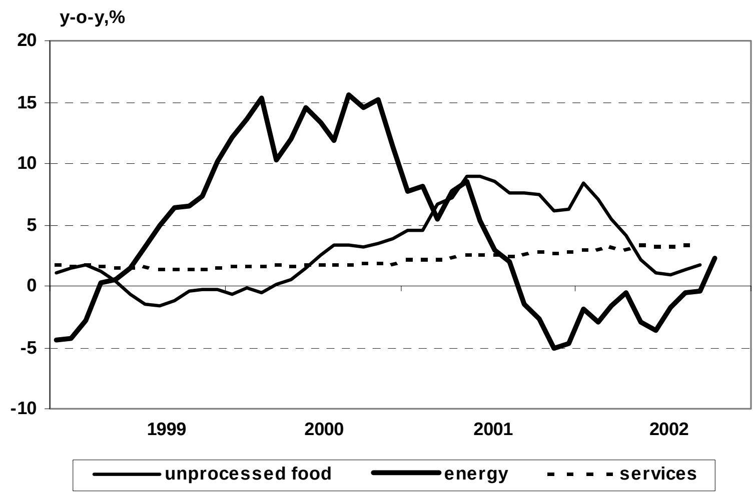
Firstly, inflation accelerated last summer because of tensions on the oil market. Inflation in the Euro Area jumped again over the 2% threshold. Even if the agreement of the U.N. resolution allowed a decrease of oil price in November, it remains true that underlying inflation was fuelled by an acceleration of prices of services under the influence of the euro changeover and the increase in unit labour costs. According to preliminary estimates, inflation was 2.2% in November.

Chart 3.7

Euro Area – Inflation and its main components



main components

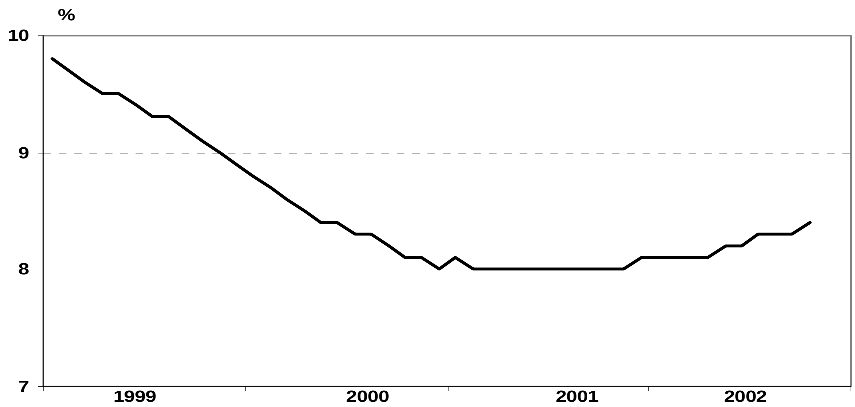


Source: Eurostat

The deterioration of household confidence is also linked to the situation on the labour market. Lower economic growth has almost led to a stagnation of employment (0.1% qoq in the first and second quarters of 2002). The service sector was the only sector to create jobs, while the number of employees has continued to be reduced in the industry and construction sectors. Nevertheless, the increase in unemployment has been rather limited compared to the magnitude of the slowdown of the economic activity. This can be explained by a limited expansion in the labour supply (0.8% in 2002 against 1% over the period 1996-2001) and the increase in the labour content of economic growth thanks to structural reforms in the labour market (e.g. reduction of employers' social contributions). In October 2002, the unemployment rate stood at 8.4% (4 tenths above the October 2001 level). It is noted that in the Consumer November survey, households appeared pessimistic about the labour market outlook.

Chart 3.8

Euro Area - Unemployment rate

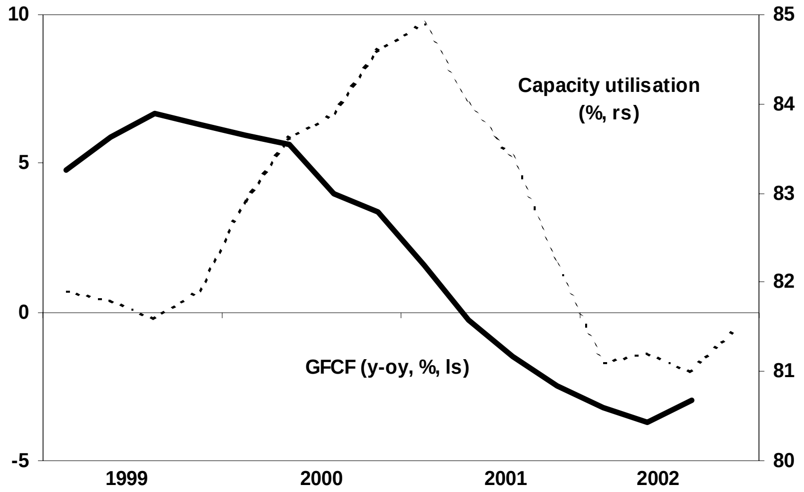


Source: Eurostat

Weak investment is one of the main disappointments regarding economic developments in the Euro Area and also the main source of worry. Total investment stabilised in the third quarter of 2002 after a long period of decline. The utilisation rate of production capacity increased slightly in October (to 81.5 %) but is still below the long-term average (82.1%).

Chart 3.9

Euro Area - Gross fixed capital formation and rate of utilisation of capacity

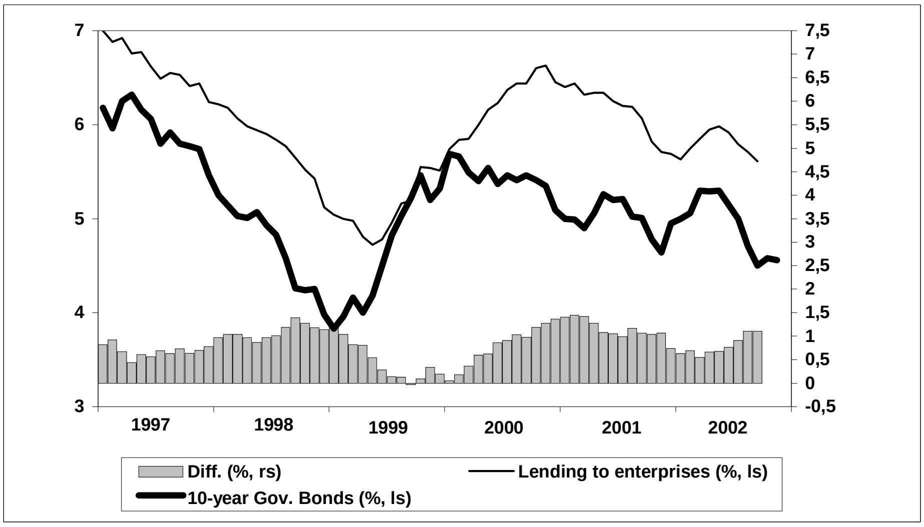


Source: Eurostat

A slowdown in growth of loans to non-financial corporations is another sign of weakness of business investment in the Euro Area: it was only 4.8% in the second quarter of 2002 compared to around 10% a year before. This trend can mainly be explained by a "demand" effect. Risk premium have increased in recent months, but they are not on average at a particularly high level.

Chart 3.10

Euro Area - Lending interest rates to enterprises (over 1 year) and 10-year government bond yields

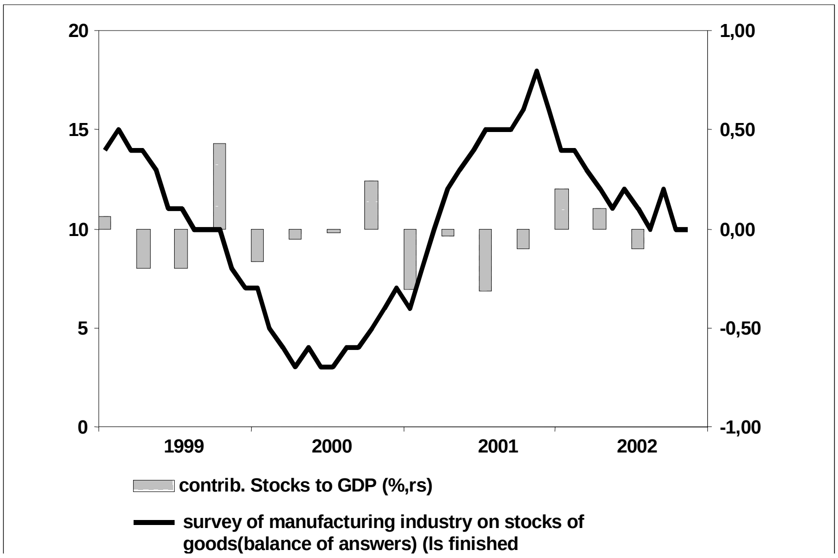


Source: ECB

Besides fixed investment, inventories didn't contribute to growth as was expected. The contribution of changes in inventories was only 0.2% and 0.1% in the first two quarters of 2002, before being negative in the third quarter (-0.1%). Surveys in industry show that the level of stocks is still considered as above normal.

Chart 3.11

Euro Area - Contribution of stocks to growth and judgement on inventories in industry (balance of answers)



Sources: European Commission, Eurostat

To sum up, results regarding economic growth in the Euro Area have been disappointing since last summer. This can be related to the burst of financial scandals and the worsening geopolitical context that led to a marked downturn of the stock markets and deterioration in global confidence around the world. As in the US, the Euro Area was negatively affected by these negative shocks. As soon as positive signals were emitted on both these concerns (the stock market rebound last October and lower tensions regarding the Iraqi crisis), economic sentiment showed signs of improvement. It may hint at a temporary break in the recovery rather than a definitive reversal. But it remains that *a priori*, the Euro Area would have been less directly affected by these problems, as they were mainly rooted in America. But, contrary to the US, economic policy didn't succeed in counterbalancing these exogenous shocks. Thus, when the tentative pick-up in exports weakened, internal demand was unable to take the lead role in the recovery.

Part II - EUREN forecast for 2002 and 2003

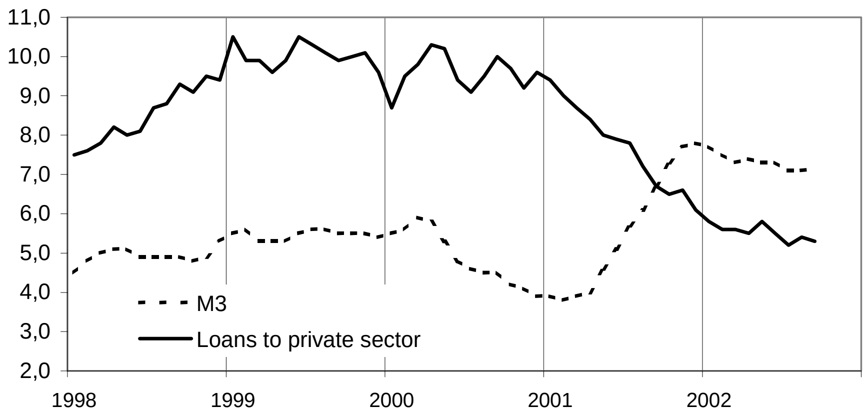
a) Policy assumptions

Monetary policy

After having kept interest rates unchanged for more than one year, the ECB lowered its key interest rate by 50 basis points to 2.75 % on December 5th 2002. This decision was based on two main arguments: First, the ECB pointed out that the reference value for monetary growth is a medium-term concept. Deviations of M3 from the reference value do not necessarily have implications for future price developments. At the time being, the strong growth of M3 (three month average from August to October 2002 7.1%) reflects portfolio re-allocations and must not be taken at face value. At the same time, the growth of loans to the private sector decelerated (chart 3.12).

Chart 3.12

Euro Area – M3 and loans
yoy percentage change[1]



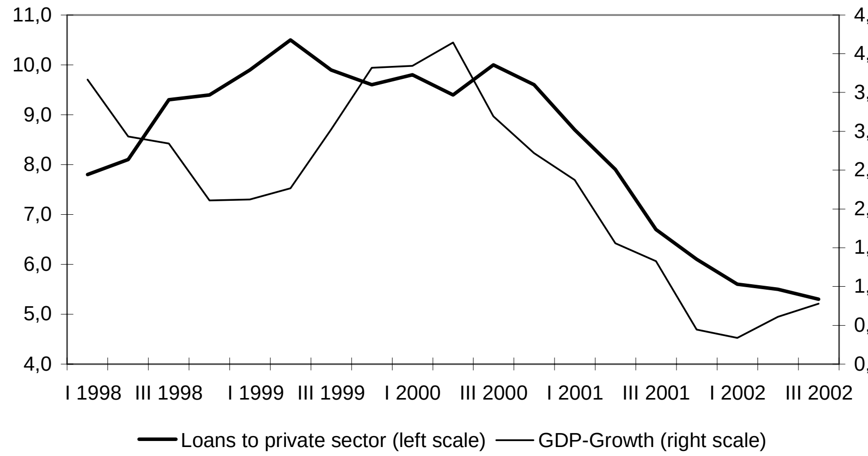
Source: ECB – [1]M3: three months moving average.

Second, the sluggishness of real GDP growth gives reason to expect inflationary pressure to decline. However, up to now inflation has not come down significantly (Chart 3.7). The ECB interprets persistently high inflation as a consequence of transitory developments, such as higher oil and food prices. But also structural factors such as rigidities in the labour and product markets play a role. They are mirrored in an upward trend in wages and high price increases for services. There are significant disparities in inflation between the members of the Euro Area. On the one hand they reflect differences on the demand side: In high growing countries prices tend to increase faster. On the other hand they hint at divergence in the need for structural reforms. Therefore, the recent interest rate cut certainly bears some risk, as it might fuel inflation in some economies and widen the gap in inflation rates.

The question is, whether the interest rate cut will have an impact on economic activity in the Euro Area. Recently, some market observers argue that there are signs of a credit crunch, so that the effectiveness of monetary policy is diminished. One observation that could point in this direction is, that from the beginning of 2001 the expansion of loans to non-financial enterprises has slowed considerably, despite of the more expansionary stance the ECB took since then. In Germany, the slowing of credit expansion was particularly pronounced.

Chart 3.13

Euro Area – Loans to private sector and GDP-growth
yoy percentage change



Source: ECB, Eurostat

However, we do not expect a credit crunch for two reasons: Firstly, the development of new loans in the Euro Area almost perfectly mirrors GDP growth (chart 3.13). Therefore, the slowing of credit expansion is a result of a lower demand for loans and not of shortages in the supply. Secondly, as mentioned earlier (chart 3.10), interest rate differentials between corporate and government bonds are not unusually high.

Therefore, the forecast given below assumes that monetary policy is effective and it will stimulate the Euro Area economy next year. In the last quarter of 2003, when growth becomes slightly more buoyant, the ECB might even raise its key interest rate slightly. But even so, it still will have an expansionary stance then.

Fiscal policy

In the second half of 2002 it became increasingly clear that some countries in the Euro Area are struggling to keep their public deficit under 3 % of GDP. In the Euro Area as a whole, the latest forecast is a deficit of 2.3 % of GDP, compared to a deficit of 0.9 % of GDP planned in the stability programmes (Table 3.1). In Portugal, the deficit turned out to be too high already in 2001, which was hidden for a long time by 'creative bookkeeping'. In Germany, government admitted for the first time in October that the 2002 deficit will exceed 3 %. In France, the deficit can be expected to come close to the Maastricht threshold. On the other hand, in many countries the budget is close to balance.

As long as the increase of deficits only reflects lower growth rates, it would not mean a problem for the Stability Pact, providing of course budgets were close to balance before. It is its aim to bring deficits down to be able to allow for cyclical fluctuations without coming into danger of violating the 3 % margin during a recession. But the problems some countries face are not only of a cyclical nature. Rather they reveal that the deficit was too high in some areas when the downswing started. Hence, the mistakes have been made in the past, when some governments were not sufficiently ambitious in consolidating the budgets. The problem, policy in these counties faces now, is to intensify their consolidation efforts in a downswing.

Table. 3.1

Stability programs: goals and forecasts compared
budget balances as % of GDP[1]

Countries	Data		Stability Programs Oct-Dec 2001			EC Oct 2002		IMF Sep 2002		OECD Nov 2002	
	2000	2001	2002	2003	2004	2002	2003	2002	2003	2002	2003
Austria	-1.9	0.2	0.0	0.0	0.1	-1.8	-1.6	-0.5	-0.3	-1.6	-1.4
Belgium	0.1	0.2	0.0	0.5	0.6	-0.1	0.0	-0.1	-0.3	0.0	0.0
Finland	7.0	4.9	2.6	2.1	2.6	3.6	3.1	3.1	3.0	3.2	2.9
France	-1.3	-1.5	-1.4	-1.0	0.0	-2.7	-2.9	-2.5	-2.1	-2.7	-2.9
Germany	-1.4	-2.8	-2.0	-1.0	0.0	-3.8	-3.1	-2.9	-2.1	-3.7	-3.3
Greece	-0.8	-1.7	0.8	1.0	1.2	-1.3	-1.1	0.8	0.7	-1.1	-1.0
Ireland	4.5	1.5	0.7	-0.5	-0.6	-1.0	-1.2	-0.4	-0.1	-0.5	-1.3
Italy	-1.7	-2.2	-0.5	0.0	0.0	-2.4	-2.2	-2.0	-1.0	-2.3	-2.1
Luxembourg	5.8	6.1	2.8	3.1	3.4	0.5	-1.8	1.0	0.7	1.8	0.3
Netherlands	1.5	0.1	0.4	0.2	0.5	-0.8	-1.2	-0.8	-0.7	-0.8	-0.6
Portugal	-3.2	-4.1	-1.8	-1.0	0.0	-3.4	-2.9	-3.6	-3.2	-3.4	-3.0
Spain	-0.4	-0.1	0.0	0.0	0.1	0.0	-0.3	0.0	0.0	0.0	-0.1
EU-12	-1.0	-1.5	-0.9	-0.5	0.0	-2.3	-2.1	-1.9	-1.5	-2.2	-2.1

Sources: Commission autumn forecast, Broad Policy Guidelines 2002, IMF World Economic Outlook, OECD Economic Outlook (OECD).- [1]Excluding receipts from UMTS licenses.

Recognising some deficiencies of the Stability Pact, the European Commission made some proposals to reform, or at least to re-interpret the pact. Three of them are supported by the EUREN institutes, as they would have prevented the problems coming up now, if the Stability Pact was understood in the way proposed already earlier:

- The yardstick of government fiscal balances should be the structural deficit, which is not influenced by the business cycle, instead of the nominal balances, that were focused hitherto.
- The consolidation strategy should be symmetric. There must not only be an upper bound for deficits as laid out in the 3 %-rule of the EU-Treaty. When economic conditions are favourable, it must also be made sure that consolidation efforts are strong enough. In other words: in an economic upswing, deficits must be reduced sufficiently to bring down the structural deficit.
- Finally, consolidation must be accountable. Therefore, the stability programmes must be based on realistic assumptions about the

economy and the time frame to reach a balanced budget must be foreseeable.

All in all, fiscal policy will become more restrictive in the Euro Area, above all because of Germany, where public expenditures are to be cut and taxes increased to keep the deficit under 3 % next year. In France, there is a clear indication that government will be unable to respect an even adjusted Stability Pact next year.

Germany: Reduction of the deficit through tax increase

In Germany, the estimates of public deficit were considerably revised during 2002. The latest estimate is that it will be above 3¾ % of GDP. In part, the higher deficit was a consequence of a weakening of growth. A small part was caused by the flood disaster in Eastern Germany. However, the lion's share of the deficit is a result of a deterioration of tax receipts, in particular of the corporate income tax. In 2001, there was a reform of the corporate income tax, aiming at reducing the tax burden for companies. Up to then, two tax rates were applied: profits distributed to the shareholders or owners were taxed less than profits kept in the company. After the reform, only one lower tax rate is applied. For profits not distributed up to then (and taxed with the high rate in the past), the taxes paid earlier are reimbursed, when the profits are distributed (but they are subject to the personal income tax afterwards). The government expected the companies would use the 15 years term laid down in the law, to distribute profits generated in the past. But obviously, the companies used their reserves to stabilise their dividends in the downturn, so that they paid almost no corporate income tax at all, but the reimbursement of tax paid formerly even exceeded the tax payments.

In August 2002, the government decided to postpone the income tax reduction, scheduled to come into force in January 2003, because of the additional expenditure necessary to overcome the consequences of the flood disaster. After the federal elections in September, the government decided to reduce public expenditure, but above all to raise its receipts to reduce the public deficit. Taxes on energy are increased. Furthermore some exemptions from energy taxes and from the value-added tax are abolished, meaning higher taxes on some products. Finally, the contributions to the social security system are raised and the income level, up to which the full rate has to be paid, is raised too. The final package has not been fully decided yet for sure. But if all measures proposed are implemented, together with an increase of taxes on energy (5th stage of the ecological tax reform) and tobacco that were decided already earlier, approximately 22 bn € (1.1 % of GDP) of extra burden will be placed on private households and companies in terms of higher taxes and lower public expenditure. This will reduce the public deficit in 2003 – in the OECD and EU forecasts in table 3.1 the measures are not taken into account – and keep it under 3 % of GDP. But the way to achieve this increases the tax burden and therefore neglects an important aspect of consolidation.

France: The adjustment is postponed

The concerns about whether the French government would be able to reach its goals fixed in the stability program for 2002-2005 was justified. These doubts were firstly motivated by the fact that the projection submitted by the previous government to the European Commission was based on a 2.5% GDP growth scenario. Then, as it became obvious that this objective could not be reached after the slowdown in 2001, the previous government revised its growth forecast for 2002 from 2.5% down to 1.5%, implying a deficit of 1.8 – 1.9% of GDP in 2002 and of 1.7 –1.8% in 2003 instead of 1.4% in 2002-2003.

The doubts on whether France would respect the Stability and Growth Pact did not disappear with the arrival of the new government. There were still concerns about the strength of the recovery and furthermore, president Jacques Chirac's economic programme contained large tax and social contributions cuts, this programme being based on very optimistic macro-economic assumptions (a 3% annual growth during the 2003-2007 period). The new government presented a modified budget law for 2002 in July 2002. This new law was based on an audit on the state of the French public finances decided by the new government which concluded that the deficit should be around 2.3 - 2.6% of GDP in 2002 (with the assumption of 1.3% growth for 2002). The new government also included in this law a new income tax cut for 2002 of 2.55 billion euros as promised during the presidential election. This was decided as the reductions of taxes and social contributions planned for 2002 already amounted to 7.3 billion euros. This new budget law forecast a public deficit of 2.6% for 2002. This autumn, the government presented its budget for 2003. It planned new tax cuts of 3.8 billion euros (1.1 billion euros for the households mainly through another income tax reduction of 0.6 billion euros and an extension to part-time workers of the tax credit of 0.3 billion euros for low wage earners to increase the incentives to work), 2.7 billion euros for the firms with a 1.9 billion euros decrease of the professional tax (the "taxe professionnelle" is based on the assets and the wages of the firm). This budget law was based on a growth forecast of 2.5% for 2003. An important point was the freezing of the cut in social contributions for the firms applying the 35 hours week. Instead, the decrease of social contributions (1 billion euros) is allocated to low-wage earners.

These new governmental projections for the deficit in 2002 and 2003 made the goal of reaching a fiscal balance in 2005 (as defined in the “cautious” scenario of the stability program) impossible. This target looks even more unrealistic given the new projections might underestimate the deficit for 2002 and 2003. For 2002, low growth (the forecast of the COE for GDP growth is 1%), important tax reductions, and an acceleration of social expenses could boost the deficit to 2.9% of GDP. For 2003, GDP growth could be lower than the government forecast of 2.5%. Besides the new tax reductions, the budget law does not seem to include a real slowdown in public expenditures as some ministries (defence, interior, justice) have benefited from large budgetary increases. Moreover, it will be highly difficult to cut social expenses. So, it is possible that the deficit will still be large in 2003 (the COE sees it at 3.0% of GDP). This has been corroborated by recent data. The receipts of Value Added Tax for the first 9 months of 2002 (compared to the same period of 2001) have registered a 0.8% increase (the budget planned a growth of 2.3%). During the same period, the expenses of the General Budget have accelerated. For example, growth of military expenses has reached 8.9% for the first 9 months of 2002 (compared to the same period of 2001) compared to 4.7% for the first nine months of 2001. The government deficit amounted to 51.9 billion euros during this period (compared to a deficit of only 27.9 billion euros from January until September 2001). Indeed, the French government has acknowledged these difficulties by presenting a modified budget law for 2002 at the end of November that includes a forecast of 2.8 % of GDP for the public deficit in 2002. To reach this goal, the government has decided to freeze some credits for 2002. Nevertheless, at the same time, is has also decided to allocate 2,2 billion euros of new credits for 2002 expenses (with 300 million euros for the defence budget). This is another clear indication of the ambiguities of the French Fiscal Policy regarding the Stability Pact. The government has maintained its forecast of 2.6 % of GDP for the public deficit in 2003. To reach this goal, it has decided to look for additional receipts of 700 millions euros for 2003 partly based on the implementation of a special tax on building societies for which should add around 300-500 million euros to the public receipts.

These new developments in French fiscal policy are a clear indication that the French government feels unable to respect even the adjusted Stability Pact. The Budget for 2003 does not plan a reduction of the structural deficit of 0.5% - as the total deficit should be very closed to the level of 2002 despite higher growth. Nevertheless, the French authorities have declared that they will start to reduce the structural deficit in 2004. Besides, the French government does not plan to balance its budget in 2006 but rather in 2007-2008. It has to be noticed that these problems are the logical consequences of the budget for 2003. In other words, the respect of the adjusted Stability Pact implies the vote of a modified budget for 2003.

Italy: Deficit decreasing very slowly

According to our estimates, the government deficit will be 2.6% in 2002, 2.3% in 2003 and 2% in 2004. Thus, we are less optimistic than the official government estimates (2.1% in 2002, 1.5% in 2003 and 0.6% in 2004). However, given the different predictions on growth, for 2002-2003 they are essentially in line with the interpretation of the Stability Pact that has emerged in Europe in recent months, based on which the countries that still show a deficit should improve their structural deficit balance (that is, eliminating all economic cycle effects) by 0.5% annually. Using the Commission’s method to calculate the output gap and its effects on the balance (built-in stabilisers), we find that Italy’s structural balance improves by 0.4 points in 2002, to 2%, even though the nominal deficit (i.e., not corrected for the economic cycle) increases by 2.2% in 2001 to 2.6%. In 2003, using our growth forecasts (1.4% rather than the 2.3% predicted by the government last September), the nominal deficit is 2.3% and the corresponding structural deficit is 1.5%. The structural deficit, then, decreases by 0.5% compared to 2002. For 2004, we feel that, without any further action from the government, the deficit will rise to 2.9% in the absence of the one-time measures implemented in 2003. Using the official government estimates, these measures come to almost 19 billion euro (of which 7 billion are from privatisation already included in the budget forecast). In our basic scenario, we hypothesize strong measures for next autumn, which will bring the effective deficit down to 2% in 2004.

Public debt expected to rise slightly in 2002

Forecasting *public debt* would become much more complicated in Europe if the idea of forcing countries exceeding the 60% limit to reduce their deficits by four points a year prevailed. According to our estimates, unless there are significant financial measures taken before year’s end, the debt-to-GDP ratio will rise slightly in 2002 and then start falling again, very gradually, thereafter.

Our forecasts for *revenues in* 2002 differ from those of the government essentially in terms of tax revenue (+0.5%, rather than the +2.3% in the government's Budget Forecast Report), though we do feel that the results of the November advance self-assessment will be solid (in part also due to the effects of fiscal decree 209) and will help to avoid an overall drop in tax revenue for the year, as happened over the first ten months, when revenues fell 7.3 billion euro. There is still a good deal of uncertainty in both directions, however, as to the effective outcome of self-taxation, the likelihood that the government's second phase of property privatisation – launched November 8th and totalling 7.8 billion euro - will be completed by year's end, and the effects of the "spending freeze" decree.

That our predictions for the 2003 deficit are higher than the government's (2.4% versus 1.5%) can be explained by the net effect of the following factors: the drag effect on 2003 of the higher 2002 deficit (+0.4%), lower 2003 growth than in official forecasts (impacting the deficit by a further 0.4 points), lower spending on interest payments in our estimate (-0.2%), and a different evaluation of the effects of the government's budget (+0.2%).

Budgetary measures for 2003

Regarding the budget, our uncertainty concerns primarily the revenues from the special tax settlements and the fact that it is still not clear which provisions a not insignificant part of the budgetary measures should be ascribed to. In the government's official September press releases, it said that the budgetary measures totalled more than 20 billion euro, before tax cuts in the Pact for Italy, and some 13 billion euro net of said cuts. From the technical report quantifying the effects of the Budget, however, we see that the net total of the budgetary measures is 9.6 billion euro. Thus, 3-4 billion euro are missing, which various sources (Bank of Italy, ISAE) classify as "Other" or "Other, Post Office and State Railway". These are spending cuts where the government has never really clarified which measures they refer to. It should also be noted that the technical report indicates that the Pact for Italy's tax cuts, with respect to current legislation, are worth not 7 billion euro, but rather 4.3 billion euro, meaning that the budgetary measures before tax cuts total 13.9 billion euro (16 billion if spending increases are included) and not 20 billion euro.

Overlooking the differences between the official report (which is important, however, as all the commentary and opinions in the following weeks are based on it) and the figures in the technical report, is remains true that still today we do not have clear unambiguous official assessments of the size and effective makeup of the budgetary measures. The Budget Forecast Report adds some information, but it does not answer the questions described above.

b) EUREN forecast for 2003

An export-led recovery

Given the lack of rooms of manoeuvre of economic policy, the Euro Area recovery should again be an export-led one.

Under the assumption of continuing improvement in the financial markets and a political solution to the Iraqi crisis, the external environment should be characterised by better prospects in the course of next year. As a consequence, world demand addressed to the euro Area will reaccelerate early 2003. It will be translated into a resumption in exports growth after the soft trend observed in the second half of this year. Although market shares will still be affected by the past appreciation of the euro during the first half of next year, Euro Area producers will take advantage of the moderation of unit labour costs. Indeed, as it is usual in an early phase of a recovery, labour productivity will pick up with the acceleration in economic activity.

Stronger external demand will have progressively positive spill-over effects on internal demand. As a first step, it can be expected that firming activity will lead to the end to the destocking process. Thus, from the first quarter of 2003, changes in inventories will have a positive contribution to growth.

In this context, households should benefit from better conditions in the labour market. Unemployment will still increase in the first half of 2003, but moderately, as employment growth will begin to recover, lagging

Table 3.2

Euro Area Forecast

	1999	2000	2001	2002	2003	2002 I	2002 II	2002 III	2002 IV	2003 I	2003 II	2003 III	2003 IV
	q-t-q, saar (unless otherwise indicated)												
Private consumption	3.5	2.5	1.8	0.5	1,5	-0.6	1.0	1.9	1,4	1.0	1.6	2.0	2.4
Public consumption	2.0	1.9	1.9	2.4	1.5	3.8	3.0	1.1	1.2	1.5	1.5	1.5	1.5
Gross fixed capital formation	6.0	4.8	-0.7	-3.0	1.0	-3.9	-4.8	0.1	0.0	1.2	2.0	2.8	3.6
Inventories, contr. to growth	-0,2	0.0	-0.4	0.0	0.2	-	-	-	-	-	-	-	-
Domestic demand	3.5	2.9	0.9	0.1	1.6	0.3	0.7	1.1	1.1	1.6	2.0	2.2	2.5
Exports	5.3	12.7	2.8	1.2	5.9	0.2	6.2	8.8	4.0	4.8	5.6	6.4	7.2
Imports	7.4	11.3	1.4	-0.6	6.1	-3.8	5.4	8.9	3.6	5.6	6.0	6.8	7.6
GDP	2.8	3.5	1.4	0.8	1.6	1.7	1.2	1.3	1.3	1.4	2.0	2.2	2.5
Unemployment (% of labour force)	9.4	8.5	8.0	8.3	8.4	8.1	8.2	8.3	8.4	8.5	8.5	8.4	8.3
Compensation per employee[1], yoy	2.3	2.8	2.8	2.9	2.8	-	-	-	-	-	-	-	-
Consumer price (HICP), yoy	1.1	2.4	2.5	2.4	1,8	2.5	2.4	2.4	2.2	2.0	1.8	1.8	1.8
Current account balance (%GDP)	-0.3	-0.9	-0.1	0,6	0.6	-	-	-	-	-	-	-	-
GGFB/GDP[2]	-1.3	-1.0	-1.5	-2,3	-2,0	-	-	-	-	-	-	-	-
3m interest rates (% per annum)	3.0	4.4	4.3	3.3	2.8	3.4	3.4	3.4	3.1	2.8	2.8	2.8	3.0
10y Gvt bond yields (% per annum)	4.7	5.4	5.0	4.9	4.8	5.1	5.3	4.8	4.6	4.6	4.7	4.8	5.1

EUREN estimates - [1]Seasonally adjusted. - [2]General Government financial balance, excluding UMTS revenues.

the economic upswing. The unemployment rate will reach a peak at the end of the second quarter of 2003, before slightly declining. Inflation will also be gradually reduced, which will improve households' purchasing power. However, indirect tax hikes, which will be implemented in several countries (Germany, France and Italy) in the Euro Area, will contribute to delay and soften the reduction in inflation. More generally, contrary to this year, fiscal policy will not have a positive effect on household income in 2003. In some countries, fiscal measures could even dent household income. A moderation of household spending can be expected at the end of 2002 and maybe early 2003, in the wake of a lack of confidence. Then, private consumption will improve progressively, but at a moderate pace. After a meagre 0.5% growth this year, it will only increase by 1.5% in 2003.

Total investment growth rate will remain subdued until a clear improvement of business conditions, regarding economic activity, financial markets and the geopolitical context, is confirmed. However, investment in construction will be stimulated in coming months by the expenditures implied by the reconstruction works after the floods that hit Germany at the end of the summer. In the second half of 2002, the end of fiscal advantages stemming from the Tremonti law in Italy led firms to bring forward investment. Thus, a setback is expected early 2003. For the region as a whole, a mild recovery in investment is projected in the first half of next year. Then, it will gain momentum, as economic growth will leads to an intensification of the utilisation of capacity production. The moderation in unit labour costs due to higher productivity will also allow better profitability for firms.

Growth below the potential until the end of 2003

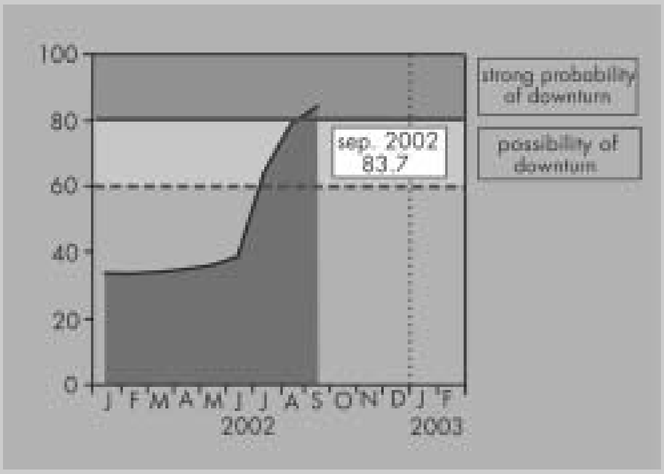
As a whole, GDP growth is projected to remain rather low in the fourth quarter of 2002. Economic growth will then accelerate in the course of 2003. However, the year-on-year growth rate will stand above 2% (a rate which can be approximately considered as the potential growth of the Euro Area) not before the last quarter of next year. This forecast is consistent with the implications of recent development in the COE's leading indicator for the Euro Area (see box 3.2). Indeed, the need to restore fiscal imbalances in the big countries of the Euro Area will limit the positive effects on growth stemming from the improvement of the international environment. On average, the Euro Area GDP will grow by 1.6% in 2003 after 0.8% in 2002.

Box 3.2 COE Leading indicator for the Euro Area

The COE leading indicator aims at anticipating the peaks and troughs of the growth cycle (defined as the deviation from trend). When the trough is reached, it means that the growth rate will overpass the trend growth rate (estimated now at 2 % for the Euro Area). See box 2.1 for a detailed presentation of the methodology.

Chart B-3.2.1

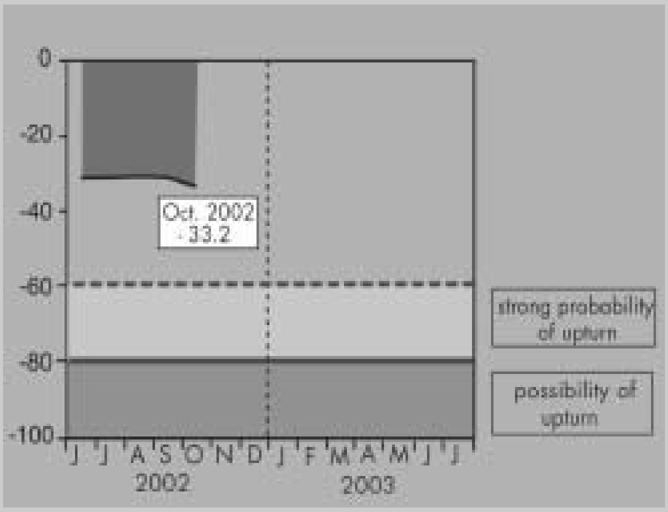
Search of next peak



Source: COE

Chart B-3.2.2

Search of next through



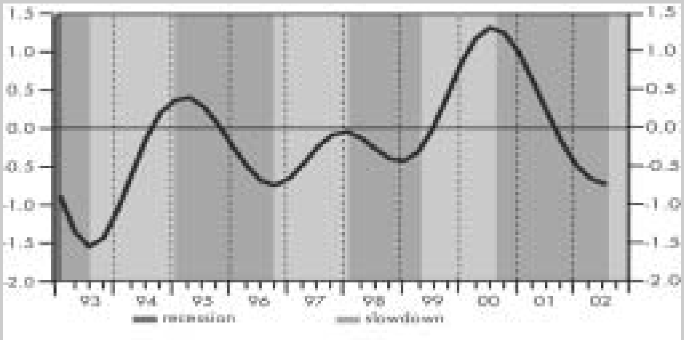
Source: COE

After the signal of an economic rebound in the Euro Area given in March 2002, the leading indicator quickly revealed a growing risk of abortion of the cyclical upturn, as can be seen in graph 3.2.1

In September, the threshold of 80 was passed, meaning a definitive invalidation of the previous signal. This can be explained by adverse exogenous shocks (financial scandals, worsening geopolitical context) that have impacted the Euro Area economy negatively. As a consequence, the growth rate in the Euro Area remained largely under its trend, now assessed to be 2 per cent, and the cycle is still on the downside (chat B – 3.2.3). We are back to searching for the exit of the descending phase of the Euro Area growth cycle. The index, at –33.2 in October (chart B-3.2.2) does not show any possibility of recovery in the short-term, i.e. before mid 2003.

Chart B-3.2.3

Growth cycle of the euro-zone[1]



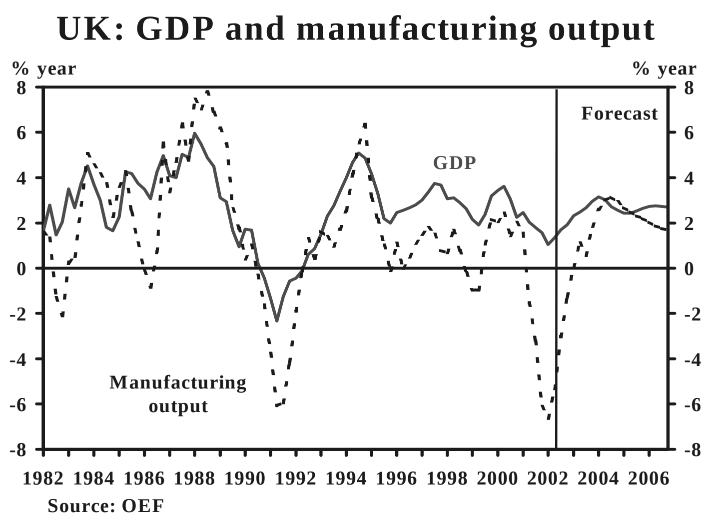
Source; COE. - [1]*The Growth cycle is defined as the deviation from trend*

Part III: The UK Economy

Subdued recovery…

The UK's recovery remains very subdued. While GDP rose 0.8% in Q3 – slightly in excess of its long-term trend rate – after growth of 0.6% in Q2, recent indicators suggest that the economy has not maintained this momentum. Industrial production in Q3 was only 0.3% above its Q2 average, despite a sharp bounce-back in manufacturing output from June's holiday-induced fall and output has contracted since. Exports in Q3 were 1.7% down from Q2. And although the CBI survey reported an improvement in manufacturers' orders books in November, the underlying trend is sideways and output expectations are deteriorating. Our forecast shows growth falling back below trend over the winter, so that GDP is now expected to rise only 1.6% in 2002 and 2.6% in 2003. While industry is suffering, the consumers may be in danger of overstretching themselves on the back of the boost to their wealth from rapid increases in house prices. We can't rule out another decrease in interest rates, but the next move in our central forecast by the Bank of England is upwards, sometime in the middle of 2003.

Chart 3.15



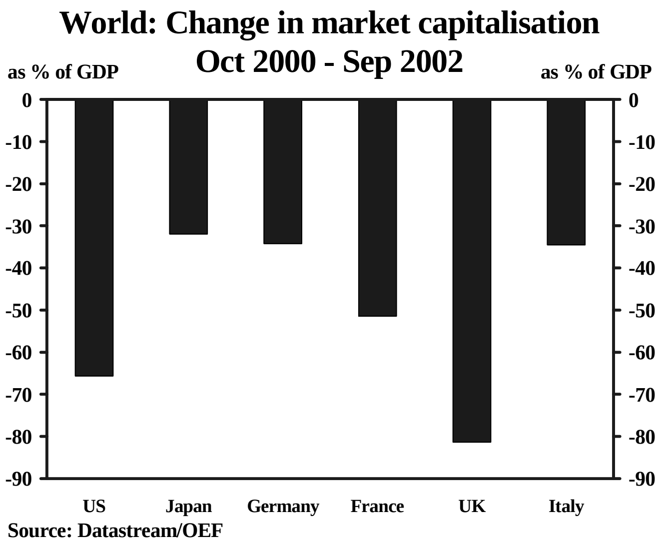
…as financial markets remain fragile…

The continued weakness in financial markets is one factor holding back recovery. The capitalisation of the UK equity market has fallen by 70% of annual GDP over the last two years, twice the fall seen in the Eurozone and greater even than that in the US. But the main impact is not being felt through lost wealth for consumers. Rather, it is the impact on business confidence and the willingness and ability of companies to spend that is of greatest concern. Business investment has dropped over 16% since late-2000, with a drop of 2.8% in 2002Q3 alone. With profits down 3% in Q2, and falling equity prices pushing the cost of capital higher, we expect business investment to remain very weak until next spring. As a result, overall investment is set to fall 5.4% in 2002, although strong growth in public spending should ensure a return to modest growth from this point on.

… and the world economy depressed

Weak financial markets are also depressing overseas demand, although the UK's main trading partners in the EU are suffering from policy factors that weigh down on domestic demand. We estimate that UK export markets are likely to expand by only 1.3% in 2002, having shrunk by 0.2% in 2001. As a result, we expect net trade to cut GDP growth by around ¾% point this year and ½% next, with the current account deficit widening to over £21 billion in 2003.

Chart 3.15



But consumption likely to remain robust

Strong growth in house prices is helping to mitigate the impact of falling equity markets for consumers. There is little sign yet that the housing market boom is coming to an end – the Halifax and Nationwide reported strong rises in house prices in November, with annual inflation over 25%. There has been much speculation that a 'house price bubble' is now underway. While there may be some truth in this (especially in some parts of the country), it is worth emphasising that most of the recent rise in house prices is explained by its traditional drivers – ie by the strength of household income growth and the low level of interest rates. The national-average level of house prices in Q3 was in line with the OEF Model forecast. Clearly, with interest rates low, housing remains very affordable: mortgage payments accounted for only 13% of a typical first-time buyer's average income in Q3.

Table 3.3

Housing Market Indicators

	Change in prices 1995-2001, %	**Owner occupation rates, %**
US	40	65
Japan	-15	60
Germany	-16	40
France	30	54
UK	73	69

*Source: Bank of International Settlements and OEF***.**

The labour market has remained strong despite the sharp slowdown in economic growth over the winter and worries about company finances. The rise in employment in the latest quarter largely reflects higher labour demand from the public sector and the distribution, hotels and catering sector. Employment in the manufacturing and construction sectors continued its historic downward trend. But employment has also fallen in the finance and business services sector, reflecting the weakness of equity markets and cutbacks in company spending on advertising, consultancy services, etc. This reallocation of employment away from finance and business services towards the public sector may imply some fall in average earnings per employee, with implications both for consumer spending and income tax receipts.

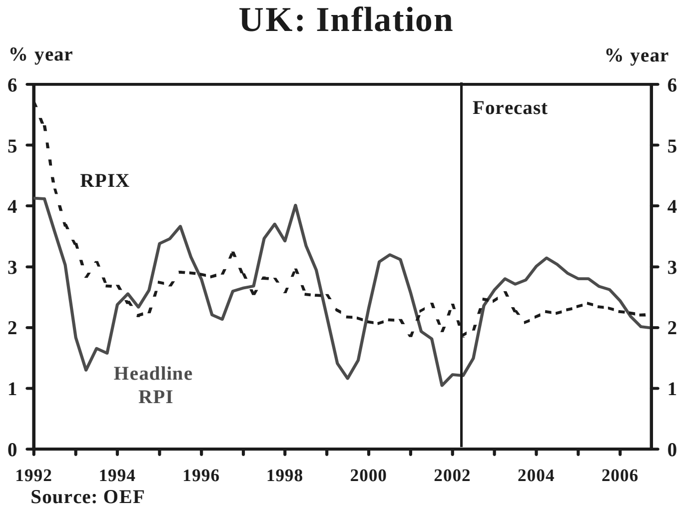
It appears that, with the labour market very tight, firms have been concerned that, if they shed experienced workers too quickly, then it may be difficult to replace them when the economy picks up again. Combined with the pressure on company finances, this suggests that the pick-up in economic growth we are forecasting over the next 18 months is not likely to be ‘job-rich’. As a result, unemployment is expected to remain close to current levels at around 3% on the claimant count basis.

With interest rates expected to remain at low levels and the labour market robust, we expect house prices to continue to rise strongly through this year, increasing by 20% in the year to Q4. And this momentum is likely to be sustained in early 2003. This will support confidence and consumer spending. Our forecast shows consumer-spending growth slowing only to 3¼% in 2003 from 3¾% in 2002, with house prices rising by another 13% over the next year. But with taxes increasing from the spring, household income growth slowing, and households’ financial wealth undermined by the weakness of the stockmarket, we expect house price inflation to ease to 12¾% by end-2003.

Output gap means sub-target inflation …

The weakness of growth over the last year means that GDP is now around ¾% below its long-run trend level, having been about ¾% above at the end of 2000. This “output gap” is squeezing firms’ profit margins, and competitive pressures remain intense – for example, prices for high street goods have fallen 2.5% over the last year, with competition particularly intense in the electronic goods and clothing segments of the High Street. Inflation continues to undershoot its target, with RPIX at 2.3% in October, having fallen to 1.5% in June, a whisker away from the rate at which the Governor of the Bank of England would have had to write to the Chancellor to explain why the inflation target had been missed by more than 1% point. In addition to goods prices, the price of food has kept inflation in check.

Chart 3.16



There is little in the pipeline pointing to inflation rising above its target over the next few years:

- The slowdown in growth over the winter means that there is now an 'output gap' of spare capacity, which will tend to put downward pressure on firms' profit margins.
- Headline whole economy average earnings growth was only 3.8% in the three months to September, with private sector wage inflation 3.8%. Cuts in bonuses are no longer pulling down annual wage inflation. But pay settlements in the private sector are still running at only 2.5%, down from 3.0% through most of 2001, implying that wage inflation is unlikely to rise above the 4.5% rate the Bank of England considers consistent with the inflation target.
- Headline producer output price inflation was only 0.5% in October.
- Import prices (excluding oil) in the three months to August were 2.9% down on a year earlier.

Clearly, a sharp spike in oil prices (eg triggered by military action against Iraq) would push inflation higher in the short term. But with private sector average earnings growth remaining below 4%, we expect RPIX inflation to continue to undershoot its target over the next two years.

However, RPI will rise towards 3% by end-2003 on the back of interest rates rises over the coming year.

… but pay pressures risk to public finances

There may be a longer-term threat to inflation if renewed militancy among unions leads to sharply higher public sector pay. Given the tightness of the labour market, especially in the South East, we would expect that large pay awards in the public sector would force private sector pay higher as well.

More worryingly, substantial increases in public sector pay would undermine the government's public spending plans and limit its ability to improve public services. The 2002 Spending Review published this summer builds in very large increases in spending: current spending is set to increase by 5.1%, 3.1% and 3.5% respectively over the next three years, and public sector net investment is planned to rise from 1.4% of GDP in 2002-03 to 2% by 2005-06. The government consumption deflator is already rising at 4% pa, double the rate of general inflation. Moreover, developments in the first half of the fiscal year put pressure on government finances: difficulties faced by the corporate sector are reflected in substantially weaker corporation tax receipts than anticipated by the Treasury; despite the buoyancy of consumer spending, VAT receipts are now running slightly below Budget projections; and net departmental outlays – probably the best guide to the underlying picture of government spending – suggest departments may no longer be consistently undershooting spending targets.

The Finance Minister revised his optimistic opinion during his pre-Budget statement and adjusted the growth forecast for this year to a much more reasonable 1.6%. At the same time he announced an increase in the anticipated public sector net borrowing of £9 billion to £20 billion, rather than raising taxes or reduce the planned improvement in public services. He is looking for growth of 2.5 - 3% next year, compared to the 2.6% forecast by EUREN. As a consequence the expected public sector net borrowing rose to £24 billion (2.2% of GDP), compared to his April estimate of £13 billion. Though it seems he may have donned them again to produce his forecast for beyond next year, expecting 3-3.5% in 2004 (EUREN 2.9%), and when he was considering the composition of demand growth over the next few years: the Treasury foresees a swift turnaround in investment, offset by a slowdown in consumer spending. These two assumptions together – growth and its composition – help the

Table 3.4

UK Forecast

	1999	2000	2001	2002	2003	2002 I	2002 II	2002 III	2002 IV	2003 I	2003 II	2003 III	2003 IV
	percentage changes over previous period, unless otherwise indicated												
Private consumption	4,6	5,1	4,1	3,8	3,2	0,5	1,4	0,8	1,0	0,8	0,6	0,6	0,6
Public consumption	3,1	2,1	3,1	4,1	3,2	2,9	-2,7	1,3	1,0	1,0	1,0	1,0	1,0
Gross fixed capital formation	0,6	1,9	0,3	-5,4	-0,1	-1,6	-0,1	-2,0	0,3	0,2	0,2	0,5	0,8
Domestic demand	3,6	4,0	2,6	2,2	3,0	0,7	-0,3	1,0	0,7	0,7	0,8	0,9	0,7
Exports	5,3	10,1	1,2	-1,6	4,8	-0,1	3,5	-1,7	1,0	1,2	1,8	2,0	2,0
Imports	8,7	11,7	2,8	0,5	5,3	1,4	0,6	-0,7	1,5	1,5	1,8	1,9	1,8
GDP	2,4	3,1	2,0	1,6	2,6	0,1	0,6	0,8	0,5	0,5	0,7	0,9	0,7
Unemployment (% of labour force)	4,1	3,6	3,2	3,1	3,1	3,1	3,2	3,1	3,1	3,1	3,1	3,1	3,1
Compensation per employee[1], yoy	3,8	4,3	5,1	3,9	4,3	3,5	3,9	3,9	4,3	4,4	4,3	4,1	4,3
Consumer price (HICP), yoy	1,4	0,8	1,2	1,2	1,4	1,5	0,9	0,9	1,5	1,4	1,5	1,3	1,2
Current account balance (%GDP)	-2,2	-2,0	-2,1	-1,6	-1,9	-1,5	-1,6	-1,7	-1,70	-1,8	-1,9	-2,0	-2,0
GGFB/GDP [2]	1,1	1,6	0,8	-1,6	-2,1	-1,5	-0,8	-1,7	-2,3	-2,5	-1,7	-2,0	-2,2
3m interest rates (% per annum)	5,4	6,1	5,0	4,0	4,2	4,00	4,11	3,96	3,92	4,00	4,10	4,33	4,50
10y Gvt bond yields (% per annum)	5,0	5,3	4,9	4,9	4,8	5,0	5,2	4,7	4,6	4,7	4,8	4,9	4,9

EUREN calculation – [1]Seasonally adjusted - [2]General Government financial balance, excluding UMTS revenues.

fiscal position considerably. If they again prove to be overoptimistic, then the £26 billion cumulative increase in borrowing over the next three years that he now expects could grow to £35 billion or even more.

However, even if growth and its composition evolve as we expect them too, the fiscal position would be worse but still not terribly bad – neither by historical standards nor in comparison with other countries. Government debt in the UK is low – standing at 31% of GDP – and even a sustained deterioration in the current account would leave debt levels sustainable. The real risk for the chancellor is what happens if there is another negative shock to the global or the UK economy now, whether it be a war in Iraq, a collapse in the housing market or a slide into recession in the US and Europe. Fiscal prudence in its first term has meant the government has been well placed to ride the global slowdown that has just occurred. But the spending commitments announced in the last budget have made the fiscal position vulnerable to further deterioration in revenues. The next choice between extra borrowing on the one hand and higher taxes or lower spending on the other may be harder to make than this one was.

Decision on EMU membership to be delayed until after the next election

We continue to assume that EMU membership will be delayed until after the next general election. This implies that the Treasury's assessment of the Chancellor's 'five tests', to be published before next summer, will conclude that the UK and Eurozone economies have not yet fully converged.

Chapter

4

SPECIAL STUDIES

(Each study presented in this chapter provides background material to the EUREN report. The views expressed here do not necessary reflect those of all EUREN institutes)

1. Household consumption, the stock and the housing markets in the United States and the Euro Area

Ugo Inzerillo and Beatrice Pierluigi, CSC, Rome

Changes in the structure of household wealth

During the second half of the 1990s, while savings rates declined in most countries, changes in wealth mainly reflected changes in asset prices. The composition of household wealth, as a percentage of disposable income, has changed significantly (Table 4.1), as it gradually shifted towards financial assets. Growth in stock assets held by households was particularly strong in France and Italy (respectively, up 25% and 12% on average between 1996 and 2000), two countries where household investment in the stock market has traditionally been low.

Table 4.1

Household Wealth (in % of disposable income)

	Non-financial Assets		**Financial Assets**	
	United States	Euro Area (a)	United States	Euro Area (a)
1981-85	209		317	
1986-90	222		347	
1991-95	202	337	373	231
1996-00	205	353	472	291
2001	**221**	**360**	**434**	**299**

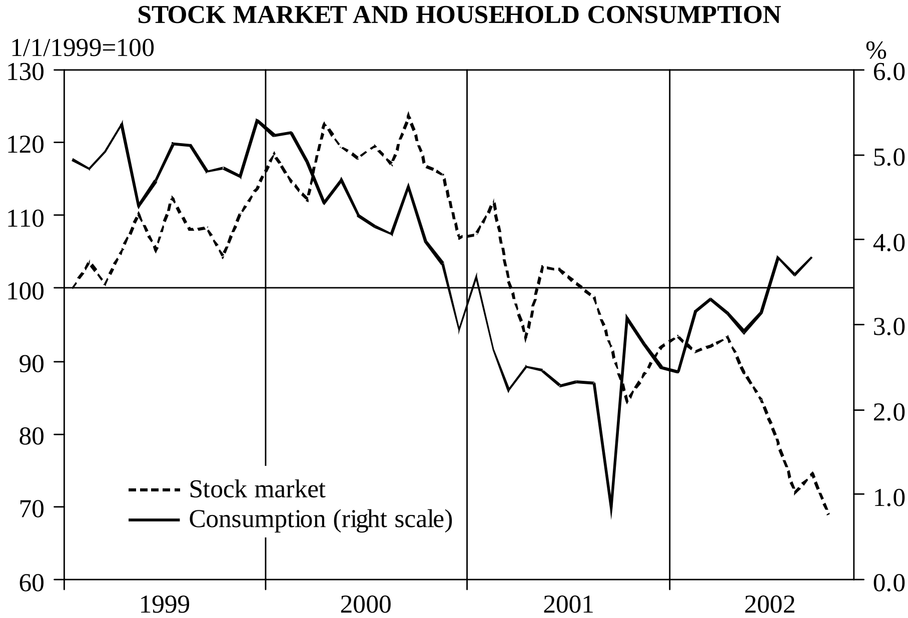
Sources: OECD and national central banks - (a) Weighted average of France, Germany and Italy

Over the last two-and-a-half years, the collapse in stock prices has exceeded 40% in both the United States and the Euro Area. In the US, despite this enormous correction, household consumption has remained stable: in 2001, together with public spending, it was the only part of

GDP that contributed positively to growth. Similarly, the recovery in 2002, which was also hit hard by a fall in stock prices (down 23% over the first ten months), was sustained primarily by the growth in private spending (Chart 4.1). In the Euro Area, however, following the sharp drop in 2001, household spending has remained at low levels throughout 2002.

Chart 4.1

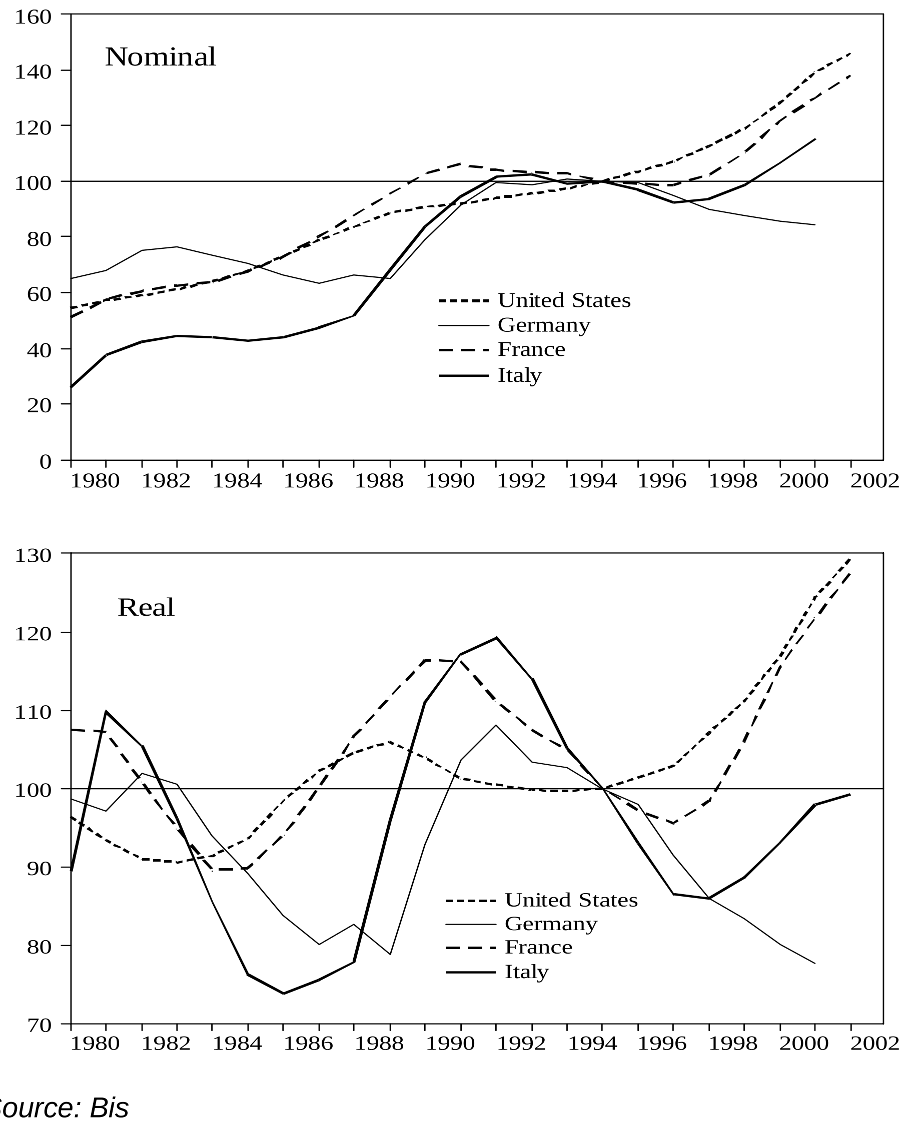
United States



Source: Thomson Financial.

Running counter to the stock market trend, since mid-2000 United States housing prices have risen on average by 8.2%, against 4.2% over the last 20 years. In the Euro Area, the rise has been 6.5% (one exception being Germany, where prices continue to fall, although slowly, from post-unification boom levels). With the 2001 recession, the synchronism observed in the past between financial and non-financial asset prices was interrupted (Chart 4.2). In part, the housing market acted as a place to redirect household savings disinvested from the stock market. As showed in Table 4.1, in the United States, between 2000 and 2001, whereas financial assets fell 9.4% against disposable income, non-financial assets rose 3%. In the Euro Area the fall in financial assets was 5.6%, while the increase in non-financial assets was 1.7%. From Table 4.1, we can also see that there is a large gap between the United States and the Euro Area in the composition of private wealth, which in the United States is still heavily concentrated in the stock market.

Chart 4.2 **House prices in selected countries**



Source: Bis

Measuring the wealth effect

In economic theory the wealth effect - traditionally analysed in the "permanent wealth" or the "life cycle" models (Friedman, 1957, Ando and Modigliani, 1963) - impacts on consumer spending through two direct channels: either the sale of assets or borrowing, using wealth as collateral. The ability and the amount of lending are linked to the development's degree of financial markets. The wealth effect depends on: the fact that changes in the stock of assets held is perceived as permanent, the type of asset held by households (financial/non-financial), and the nature/imperfections of the financial systems.

There is extensive empirical literature showing that changes in share and house prices have significant effects on private spending[6]. Estimates of the size of these effects vary considerably from country to country. Much of the existing literature focuses on the United States, where the effects of share prices on consumer spending ranges between 3 and 5 cents per additional dollar of wealth, over a time span of two to three years. The evidence for other countries is less clear. Most studies find that wealth effects are significant but smaller than in the United States, with an effect that ranges between 1 and 4 cents. This difference reflects both the lower percentage of shares held compared to other financial assets, and their greater concentration in the highest income brackets in Europe. Additionally, current estimates demonstrate that changes in residential wealth have a greater effect on household spending than do changes in stock wealth[7]. In the United States, the effect ranges from 4 to 7 cents per additional dollar of housing wealth.

There are two main explanations for that:

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[6] Boone L., Giorno C., Richardson P., 1998, *Stock Market Fluctuations and Consumption Behaviour: Some Recent Evidence*, OECD working paper n. 21. Bank of England, 2002, *Equity wealth and Consumption – the experience of Germany, France and Italy in an international context,* Inflation Report, August 2002. Economic Outlook, 2000, *House prices and economic activity,* OECD, December 2000. Maki D., Palumbo M., 2001, *Disentangling the wealth effect: a cohort analysis of household saving in the 1990s,* Finance and Economics Discussion Paper n. 21, Board of Governors of the Federal Reserve System.

[7] Cf.: IMF, 2002, *Is Wealth Increasingly Driving Consumption?*, World Economic Outlook, May 2002; Girouard N., Blondal S., 2001, *House prices and economic activity,* OECD working paper n. 279; Greenspan A., 1999, *Mortgage markets and economic activity*, Remarks before a conference on "Mortgage markets and economic activity" Washington DC; OECD, 2000, *House prices and economic activity*, Economic Outlook n. 68, December 2000.

- Since stock prices are more volatile than house prices, it is usually more difficult to assess whether a change in stock wealth is temporary or permanent. This means that households prefer to borrow against an increase in housing, as opposed to stock assets, from which there plausibly derives a higher housing wealth impact on spending.
- Recent surveys on American household wealth (Maki and Palumbo, 2001) have shown that the distribution of shares is even more concentrated near the upper end of the income bracket than the distribution of homes. This observation, combined with empirical evidence that the marginal propensity to consume decreases as income rises, is consistent with the hypothesis that, at an aggregate level, the wealth effect deriving from changes in financial assets is smaller than that deriving from changes in non-financial assets.

Spending support deriving from housing assets in the United States

In the United States in 2001, an exceptional number of mortgages were refinanced (Table 4.2), spurred by both the increase in home values and by decreasing fixed mortgage rates. Over the first half of 2002, refinancing continued to increase. Last August, 30-year mortgage interest rates reached record low levels of 6.22%. These operations played, and continue to play, an important role in keeping consumer spending high. Mortgage refinancing can increase household purchasing power in two ways. First, through additional borrowing deriving from increased housing values. This "extraction" of income from the property requires the new mortgage to be taken out for a greater amount than the amount to be extinguished. The difference between the new and the old loan provides consumers with immediate liquidity. Secondly, if the rate on the new mortgage is lower than the one you want to close, the reduced interest payments increase disposable income, given equal loan sizes.

Table 4.2

United States: Refinancing indicators

	Refinanced mortgages (millions of US $)	Ratio between old and new interest rates
1997	2.8	1.07
1998	6.7	1.18
1999	4.4	1.12
2000	2.4	0.97
2001	11.2	1.18

Source: BIS

Estimates of the wealth effect in the United States and the Euro Area

To estimate the effect of changes in prices of different assets on consumer spending, we need to know:

1. the change in the share of financial assets and non-financial assets in relation to disposable income;
2. marginal propensity to consume (MPC) in relation to share and residential wealth (that is, the long-term change in consumer spending as wealth changes);
3. the extent to which changes in wealth are deemed to be permanent (that is, the length of the adjustment in spending to a shock).

On the basis of the changes that occurred in financial and housing assets in 2001, an estimate of the wealth effect on changes in spending for both last year and 2002 is provided below. The assumptions for the estimates are based on the results of previously cited empirical studies. In particular, Table 4.3 shows marginal propensity to consume (MPC) and the percentage of adjustment in spending growth rates. For the MPC we have used central values' estimates reported in Maki and Palombo (2001) and in Boone et al. (1998); for the percentage of adjustment we have referred to IMF results (2002). Table 4.4 shows year-end results. We see that both in the United States and the Euro Area the overall decrease in the value of household wealth played a part in reducing spending growth in 2001 and 2002. Given the greater weight of stock wealth on disposable income for American households compared to Euro Area families, and their higher marginal propensity to consume, wealth effects are much higher in the United States. Indeed, calculations show that the lower spending deriving solely from the change in American stock wealth was 0.9% in 2001 and 0.6% in 2002. On the other hand, the higher spending deriving from the change in house wealth was 0.5% in 2001 and 0.3% in 2002. This is therefore a significant adjustment given that house wealth weighs less on disposal income than does financial wealth.

Table 4.3

Marginal propensity to consume out of wealth and adjustment times[8]

	MPC on shares	**MPC on houses**	**% adjustment 1st year**	**% adjustment 2nd year**
United States	0.04	0.07	60	40
Euro Area	0.03	0.04	60	40

Source: Maki and Palomo (2001), Bone et al. (1998), IMF (2002)

Table 4.4

Changes in asset prices in 2001-2002 and impact on consumer spending growth

	Change share prices	Change house prices	Stock wealth effect		Residential wealth effect		Total effect on spending	
			2001	2002	2001	2002	2001	2002
United States	-14%	+8.6%	-0.9	-0.6	0.5	0.3	-0.4	-0.3
Euro Area	-22%	+6.0%	-0.3	-0.2	0.2	0.1	-0.1	-0.1

Source : Authors' calculations.

Actually, without the housing market wealth effect, in 2001 US consumption would have grown by 1.6% rather than 2.5%; in the Euro Area it would have grown by 1.5% rather than 1.8%. The resilence of US consumption is therefore partly explained by the housing market wealth effect.

[8] The equation for long-term consumption can be written as follows: C=*a*+ *b*Yd+*c*Ws+*d*Wh, where: C is the expenditure on real consumption, Yd is disposable income and Ws and Wh are, respectively, stock wealth and residential wealth. In this equation *c* is the marginal propensity to consume out of stock wealth and *d* the marginal propensity to consume out of residential wealth.

Though the data at hand for the current year are still provisional, we can say that in 2002 there appears to have been an adjustment in the value of stock and housing assets not less than the one in 2001. The residential market, therefore, has continued to compensate for the downturn in private spending. Some analysts have however pointed out that in several countries house prices have also been somewhat pushed up by speculative factors; there is consequently a risk the current situation may not be sustainable for too long.

2. Financial globalisation and the savings-investment balances

Emilio Fontela, CEPREDE Madrid

Globalisation of finance is a key characteristic of the current stage of development of the world economy. Stimulated in the 1970s and 1980s by the advent of information technologies and the need for a liberalisation of international capital flows (in the context of floating exchange rates), financial globalisation is at the core of economic globalisation. Essentially, the term ‘financial globalisation’ refers to the fact that savings and investments are now supranational phenomena.

This new situation entails several important consequences. The automatic re-equilibrium mechanisms for current account disequilibria (via prices or incomes) can no longer be verified, and countries can remain permanently in deficit or surplus. Furthermore, interest rates do not need to increase to help finance a deficit in the current account, and exchange rates are no longer directly linked to the current account balance. If a country can massively attract foreign savings, its currency can appreciate, even with a large current account deficit, as has been the case in the United States in recent years.

The savings deficit of the US economy

As shown in Table 4.5, although the US government deficit turned into a surplus in the past decade, households and firms moved from a surplus of net savings (savings minus investments) to a sizeable deficit. This amounted to close to 2% of gross domestic product (GDP) for households and 3% of GDP for firms. The result of these developments is that the American investment boom has been increasingly financed by savings from the rest of the world.

Table 4.5

United States net savings and current account balance as percentage of GDP

	Government	Households	Firms	Current account
1992	–5.9	4.4	0.7	–0.8
1993	–5.0	2.8	0.9	–1.2
1994	–3.6	1.8	0.2	–1.7
1995	–3.1	1.7	–0.1	–1.5
1996	–2.2	0.9	0.2	–1.5
1997	–0.9	0.3	–1.1	–1.7
1998	0.3	0.5	–3.2	–2.5
1999	0.8	–1.4	–3.0	–3.5
2000	1.7	–2.3	–3.9	–4.5
2001	0.5	–1.8	–2.8	–4.1

Source: IBS (2002)

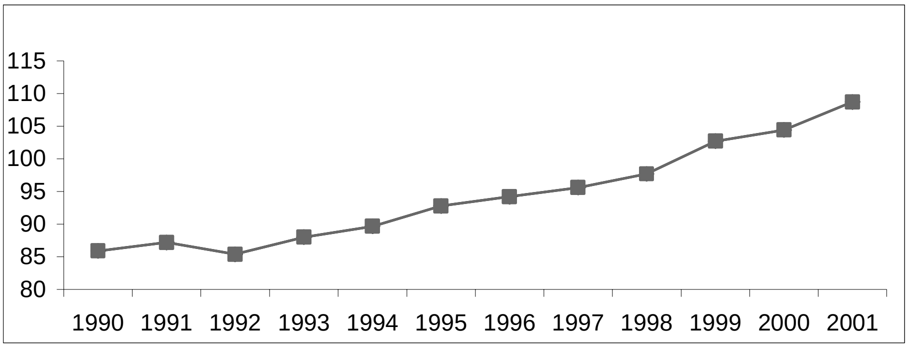
In 2001 there was a slowdown of the trend towards negative savings in households and firms and a slight decline of the US current account deficit, but recent trends point rather to an increase in the future, with some likelihood of a move above 5% of GDP in 2003.

There are several reasons for this trend. First, the events following September 11, 2001 have induced a more expansive fiscal policy, with tax cuts and increasing defence expenditure. The decline of the fiscal surplus observed in 2001 has lead to a deficit already in 2002, the first since 1997. In some sense, the US economy seems to be returning to the ‘twin deficits’ scenario of the 1980s.

Secondly, in recent years, household savings have sharply slowed, and households have been inclined to expand their level of indebtedness, stimulated by capital gains and falling real interest rates.

Chart 4.3

US households indebtedness: debt over disposable income



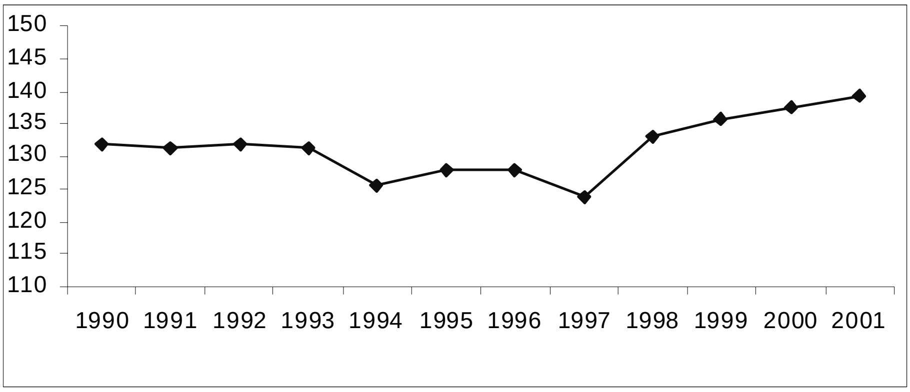
For the time being, households are restructuring their debts, calling more upon mortgages, but if unemployment rises and if the economy does not maintain the early 2002 signs of recovery, household demand might be curtailed by a trend towards higher savings—a trend that has already been perceived during the first months of 2002. This is a possible mechanism for a re-equilibrium of macroeconomic net savings and current account imbalances. However, at the same time, it might negatively affect the real economy by reducing the growth of final demand.

Thirdly, the wealth effect of the declining value of financial assets is, as commented before, compensated to a large extent by the increasing value of housings—but, again, this equilibrium is fragile, and a general decline of asset values is likely to stimulate a further increase in the net savings deficit of households.

Fourthly, the lower net savings lead to an increase in the indebtedness of firms, as portrayed in Chart 4.4. In the context of low equity values, any increase in investments is likely to be reflected in higher debt and a larger savings deficit.

Chart 4.4

United States firms' indebtedness: debt over value added



Fifthly, the improvement in the cash flows of firms observed in 2001 involved reduced inventories and a decrease in investments. Should the investment cycle recover, the net savings deficit of firms is due to increase and, consequently, an improvement in net savings is likely to be associated with a weakening of expectations inducing a cut in investment projects.

If the current recovery is consolidated, the current account balance—the overall net savings deficit of the United States and its requirement for foreign finance—is likely to deteriorate even further.

The US government tends to disregard the current account deficit, as long as foreign savings are sufficiently attracted by American assets, and as long as the capital balance surplus can be maintained without a tightening of monetary policy. Thus the former US Treasury Secretary, Paul O'Neill, has dismissed the current account deficit as a "meaningless concept" that has no value from a policy-making perspective.

But how long can this situation continue? Is the 5% current account deficit expected for 2002–03 really sustainable without increases in interest rates and/or a large depreciation of the dollar? Is the indebtedness of households and firms really sustainable in a system of decreasing equity values? Is the increasing value of some fixed assets another speculative bubble?

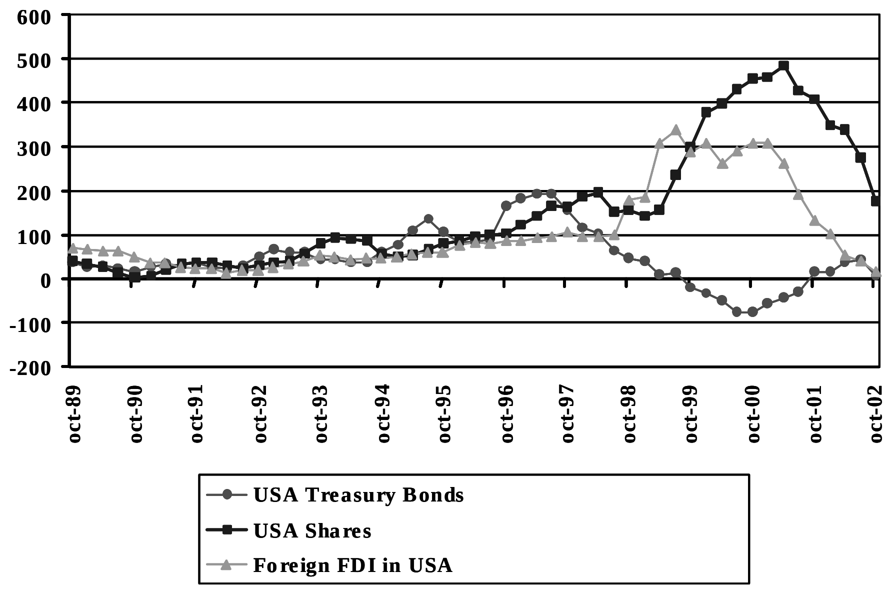
Furthermore, factors such as the loss of confidence of the financial markets in many aspects of the 'New Economy' and concerns regarding the lack of transparency of the accounting systems *do* affect the behaviour of portfolio managers all over the world. The weakness of the dollar in the second half of 2002 is a clear indicator of the fact that the surplus of capital movements towards the US is now insufficient to cover the current account deficit.

Net foreign private portfolio investment which, in recent years, represented 120% of the US current account deficit, is now only at 80%, and has been steadily declining since early 2001. Foreign central banks are now starting to act as a cushion, as is the private banking system.

Chart 4.5 portrays the profound change that is taking place in the sources of finance of the American current account deficit.

Chart 4.5

Private financing of the US current account deficit
quarterly, sums of four previous quarters in US$ billions



Source: US balance of payments

With low interest rates, Treasury bonds have lost their attractiveness. Foreign direct investment (FDI), which exploded in 1999, has started to decline since then, and is now totally irrelevant. And net foreign investments in US stocks is rapidly declining from the record level of nearly half a trillion US$ in 2000.

Until now, one of the justifications for the massive flow of savings towards the United States—mainly from Japan, but also from the EU—has been productivity. Increased productivity, associated with the rapid renewal of the American productive capital stock, provided the world's financial markets with the promise of high future returns on investment. More investments, higher productivity, increasing expected returns and, again, more investments, created a virtuous circle fuelled by massive inflows of FDI and other financial investments.

During the 1990s, total fixed capital formation in the US grew at an average annual rate of 6.5%. Annual growth in real spending on equipment investment climbed to double-digit levels between 1993 and 2000 and, for ICT investment, the average annual growth rate for the second half of the decade was above 25%. These were solid arguments for attracting foreign savings.

But if foreign savings start to lose confidence in the potential for US growth and in the strength of the dollar, investments might well be constrained. Of course, it is still possible to imagine that increases in productivity lead to higher capital returns, thus providing more flexibility in the investment strategies of firms. However, even this situation is doubtful. Productivity gains are fully transferred to capital only in monopoly situations; with perfect market competition the expected result is, rather, a decrease in prices favouring consumers.

The financial and real spheres of the economy are interdependent, and a growth process of production is necessarily associated with a financing scheme. It is increasingly evident that the financial mechanisms that allowed for the extraordinary growth of the US economy in the 1990s have ceased to exist. This does not mean that a return to growth is impossible. However, one cannot rely upon enthusiastic foreign savings any longer, and such a significant structural change in the financial sphere is likely to force upward movements of interest rates and a serious downward readjustment of the dollar.

The financial markets are starting to take account of this new situation. American corporate bonds are facing high-risk premium rates in international markets, and the dollar is becoming increasingly weak.

Europe's equilibrium between savings and investments

The Commission Services of the EU consider that the lacklustre investment performance of the Euro Area during the 1990s explains the area's relatively poor economic growth. Equipment investment, and especially ICT investment, started later in the Euro Area than it did in the United States.

As shown in Table 4.6, investment in equipment registered particularly high growth rates in 1998, 1999, and 2000 when the prospects of a 'New Economy' growth path in Europe became brighter. The slowdown observed in equipment investment, as well as in all other components of total investment, clearly corresponds to the deceleration of the growth expectations of the European economy.

Table 4.6

Gross investment (GFCF) in the Euro Area

% annual change

	1991–95	1996	1997	1998	1999	2000	2001
Total investment	0.1	1.4	2.4	5.3	5.4	4.4	0.4
Equipment	–0.8	4.5	5.5	9.6	7.4	7.3	1.3
Construction	0.9	–1.0	–0.4	1.5	3.8	1.7	–0.6
Housing	2.4	0.6	0.8	1.5	3.4	0.7	–2.1
Non-resid. cons.	–0.6	–2.7	–1.7	1.6	4.2	2.7	1.0
Construction excl Germany	–1.2	0.4	0.4	3.5	5.5	4.6	2.4

Source: Commission services

The relatively low level of investments and the relatively high propensity of households to save help to explain why the fluctuations in net savings have been relatively small during the past decade—with a maximum of +1.3% in 1996 and a minimum of –0.9% in 1992 and 2000. Net savings were at a zero level in 2001, and are expected to remain so in 2002 and 2003. There is no structural deficit of the current account balance, as is the case in the United States, or a surplus, as in Japan. Table 4.7 portrays this evolution.

Table 4.7

Net savings and current account balances in the Euro Area

% of GDP

	Government	Households	Firms	Current account
1992	–5.1	6.1	–1.9	–0.9
1993	–5.8	6.8	–0.6	0.4
1994	–5.1	4.9	0.5	0.4
1995	–5.0	5.6	0.3	0.8
1996	–4.3	5.1	0.5	1.3
1997	–2.6	4.8	–1.1	1.1
1998	–2.3	4.2	–1.4	0.5
1999	–1.3	4.2	–3.1	–0.3
2000	0.2	4.5	–5.7	–0.9
2001	–1.3	4.7	–3.4	0.0

Source: IBS (2002)

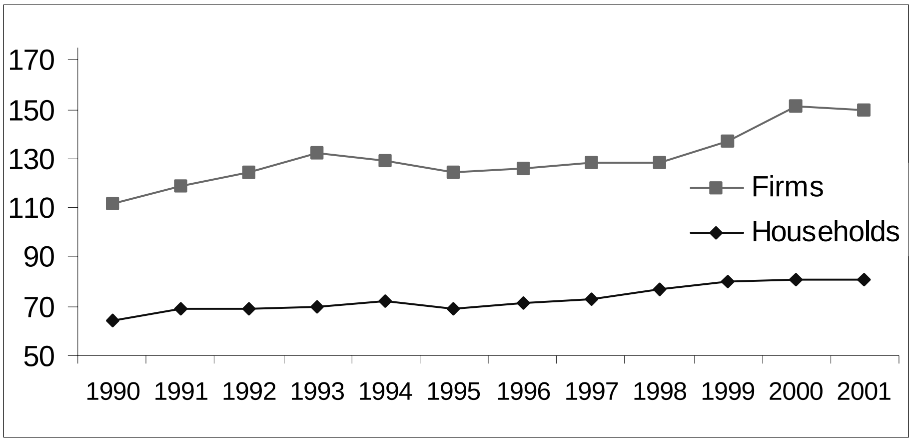
Looking at the components of the net savings situation, fiscal consolidation associated with the Maastricht policy agreements had steadily reduced the government deficits and, by 2000, the overall public net savings were slightly positive. The Stability Pact should help avoid a return to the deficits of the past even if, in 2001 and 2002, many countries, including Germany, are facing difficulties in this respect.

Households savings have shown a slight decrease over the years, but remain high and provide the main source of finance for firms—with lower returns than in the United States. Even with comparatively low investments, the net savings deficit of firms is rather large.

Both households and firms have increased their levels of indebtedness during the past decade, as portrayed in Chart 4.6. Compared with Charts 4.3 and 4.4, it can be observed in Chart 4.6 that household debts are well below the level observed in the United States. On the contrary, the situation of European firms has greatly deteriorated in relative terms, especially since 1998, reflecting the effect of the sudden financial requirements of the telecommunications sector.

Chart 4.6

EU household debt over disposable income and firms' debt over value-added



Should the European economy move to a higher growth path of investment and GDP, this will probably imply a deficit in the current account and a growing need for capital inflows, with a likely reversal of the balance of capital movements.

In the late 1990s, the FDI balance of the Euro Area has been largely negative, confirming the perception by European firms that their return rates inside the area were lower than abroad, especially in the United States. Mergers and acquisitions have been especially relevant in this respect.

At the same time, there has also been a net outflow of portfolio investment, especially to the United States—attracted not so much by interest rates, as by the prospects of capital gains associated with the productivity boom. Some technical factors contributed to this evolution. With the adoption of the euro, institutional investors began to consider euro assets as domestic, and substantially moved into the dollar area for currency risk diversification. Nevertheless, a change has been apparent from 2000 onwards. In 2001, the EMU countries demonstrated a positive balance for portfolio investments (+36 billion €), but this was still insufficient to compensate for the deficit in FDI.

As a result of these developments, the risks associated with the dollar have increased for European firms and households. The reasons that favoured both FDI and portfolio investments are a direct function of the strength (or the expectations of the future strength) of the United States economy. The fact that the 'New Economy' growth model is facing increasing difficulties could produce a decrease in European financing of United States investment and an increase in the use of these savings for investment projects in Europe. The process is already under way. In the first five months of 2001 the EU deficit on capital account was estimated at 125 billion €; during the same months in 2002 this deficit was down to 15 billion.

In the medium term, the Euro Area is likely to keep close to equilibrium in both its current account balance and its balance of capital movements, following a growth model that is financially self sufficient.

The world financial balance

Although it is clear that there is a large net savings deficit in the United States, and that the EU is close to equilibrium, the estimates have a high margin of error. Even if the question is envisaged from the point of view of current account balances, the statistical estimate demands a cautious attitude when looking at the global financial system.

As shown in Table 4.8, the total of regional deficits is systematically higher then the total of surpluses. In 2002, the IMF forecasts the account discrepancy to be more than US$200 billion.

Table 4.8

Current account balances in major regions (US$ billions)

	1997	**1998**	**1999**	**2000**	**2001**	**2002** [1]
United States	–140	–217	–324	–445	–417	–435
European Union	107	62	5	–28	29	30
Japan	97	119	115	119	89	110
Other advanced industrial economies	9	–5	8	54	55	47
Emerging Asia	20	115	107	92	99	78
Middle East	7	–12	15	65	45	12
Rest of the world	–102	–142	–78	–20	–43	–55
World [2]	–2	–90	–152	–163	–143	–213

Source: IMF, World Economic Outlook [1] ***IMF forecast*** **-** [2] ***reflects errors*****, omissions, and asymmetries in balance of payments statistics**

The Japanese current account surplus shows that Japan savings have been strongly attracted by American investments, and this implies that Japanese firms and households own sizeable amounts of American assets. In an ageing country that seems to have lost the stimulus for increasing production, the surplus of savings over investments has become a structural characteristic of recent times, but the question now is whether these savings will continue flowing into the United States, or if they will find other, more profitable, destinations.

Apart from Japanese net savings, the United States will look to other sources of finance for the investment they require for a solid recovery. As has already been indicated, this finance is unlikely to come from the EU. There remain few other sources.

Oil prices dictate the evolution of the net savings capacity of the Middle East, and American markets generally attract this financial surplus. Increasing oil prices might therefore help finance the US current account deficit—at least in the short run. In the medium and long run, increasing investment needs in the region, and in other Arab countries, might reduce the size of the financial surplus. The IMF has already forecast a decline in the Middle East surplus—from US$65 billion in 2000 to US$12.3 billion in 2002—and a deficit of US$3.6 billion has been forecast for 2003.

Asia in general, and China in particular, have emerged in recent years, and provided a savings surplus of US$45 billion in 2000 and US$40 billion in 2001. After the 1997 crisis in the region, savings rates have remained very high, but investments have, relatively, slowed down—thus encouraging large current account surpluses. Is this likely to continue in the medium run? Considering the growth potential of the Asian countries, investment can be expected to start growing quickly again, once situations of overcapacity are reabsorbed. A development model based on export promotion and large savings rates is not likely to continue—given the pressure of growing internal demands for quality of life. The IMF projects a decline of the surplus of developing Asia to only US$11 billion in 2003.

The rest of the world, including the Eastern European countries and South America, are capital importers, and their development requires large FDI inflows.

These remarks point to the fact that a United States deficit of 5% of GDP, needing 10% of the savings of the rest of the world, will become increasingly difficult to finance.

Only a fast return of the United States to a high path ‘New Economy growth’ could autonomously encourage the continuous inflow of international finance. Increasing doubts about this scenario explain more about the emerging fall of the dollar than any other explanation.

The Spanish situation

The balance between savings and investments is somewhat different in Spain from the situation in the rest of the EU, but the trends are rather similar.

A comparison of Table 4.7 (EU) with Table 4.9 (Spain) shows:

- the reduction of the public deficit has been slightly higher in Spain than in the EU; in recent months, whereas the Spanish administration has kept its budget at equilibrium, many other larger European economies are facing difficulties in this respect;
- the trend to the reduction of net savings of households has been much larger in Spain than in the rest of the EU, an evolution that has probably contributed to a fuelling of domestic demand, especially for durables and housing; and
- with respect to firms, net savings have been negative in the past four years, although slightly less in Spain (due to higher returns associated with a more expansionary market) than in the rest of Europe.

Table 4.9

Net savings and current account balance as % of GDP, Spain

	Government	Households	Firms	Current account
1995	–6.6	5.4	2.2	1.0
1996	–4.9	5.0	1.1	1.2
1997	–3.2	4.4	0.4	1.6
1998	–2.6	3.1	–0.1	0.5
1999	–1.1	1.7	–1.7	–1.1
2000	–0.6	0.5	–2.4	–2.5
2001	–0.3	0.5	–2.2	–2.0

Source: IBS (2002)

In general, the Spanish current account balance has shown a deficit during the last three years, a development probably associated with the higher rate of economic growth in Spain compared with the EU average. Following a model rather similar to the one observed in the United States, the decrease of net savings has been more than compensated for by capital inflows, especially from the rest of the EU. Although it is difficult to ascertain the complete picture of the balance of payments in the framework of a monetary union, the relatively higher pressures on prices (in a situation in which costs are not especially determined by wages and salaries, and the import price components are similar to those of the rest of the Union) seems to indicate a net surplus on FDI and incomes from abroad (explaining, in part, the boom of residential building demand).

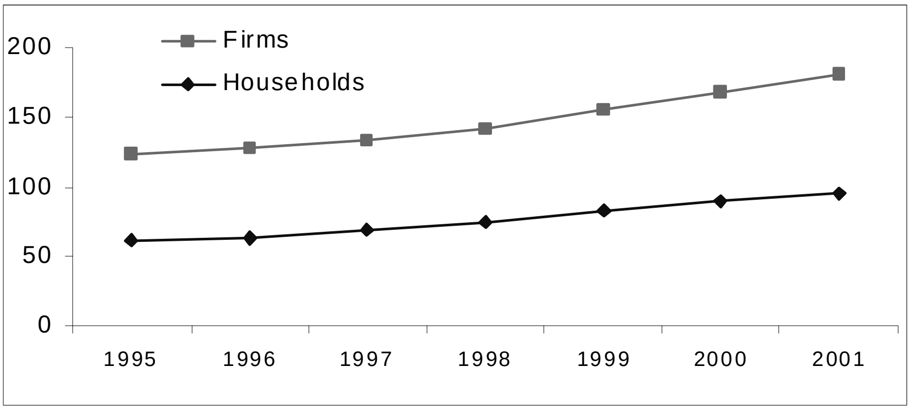
The impossibility of an exchange rate adjustment, and the fact that interest rates are low and cannot be used to fight the relatively higher inflation rates, are both acting in this case in favour of a relatively higher growth in Spain as compared with the rest of the EU.

The indebtedness of households has increased, but remains in range of the European average, as portrayed in Chart 4.7. The process of increase of Spanish household debt (from 40% of disposable income in 1995 to 77% in 2001) can be linked to the low interest rates and to the rapid expansion of mortgages (which grew by 20% in 2001 to reach a level of more than 300,000 million €, or 8,000 € per capita). It should be noted that the level of housing ownership in Spain is high compared with most other European countries.

However, as can also be observed in Chart 4.7 compared with Charts 4.4 and 4.6, the level of indebtedness of Spanish firms is structurally well above the US and EU averages.

Chart 4.7

Spain: household debt over disposable income and firms' debt over value-added



Traditionally, as in Japan, Spanish industry has developed on the financial basis of banking loans—a fact that is also playing a positive role in the present context, when Spanish real growth increases the rates of return and when interest rates are historically at a very low level. This same structural fact mitigated against Spanish competitiveness in the early 1990s, when interest rates were very high and were fuelling cost-push inflation.

During the next two years, in the context of the financial equilibrium that characterises the European economy—with relaxed monetary policies and a relatively low trade exposure to the possible depreciation of the American dollar—the Spanish economy is in a favourable position to continue recovering the income gap in relation to the average of the EU.