Short Term Prospects for the European Economy : evaluating the current slowdown and the aftermath of the September 11th attack on the USA

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Short Term Prospects for the European Economy

Evaluating the current slowdown and the aftermath of the September 11th attack on the USA

9th November 2001

This report was produced by the EUROFRAME group of European Research Institutes. The Institutes involved are WIFO in Austria, ETLA in Finland, OFCE in France, IfW and DIW in Germany, Prometeia in Italy, CPB/NBEPA in the Netherlands and NIESR in the UK

The views reflect a consensus of those of the Institutes involved, inevitably with compromises. In this and in future reports all members reserve the right to append a minority report if they disagree strongly with the majority. The forecast numbers have been co-ordinated using the NIESR global model, NiGEM

1. International environment

The September 11th attacks on the United States and the consequent combat against international terrorism have clouded the short-term outlook for the world economy. World economic growth had already slowed considerably from the final quarter of last year. This was in part the consequence of past monetary tightening in reaction to persistently high growth rates in the US and the impact of rising energy prices. A major impetus, however, came from the bursting of the high-tech investment bubble, accompanied by a marked fall in equity prices, generating a sudden world-wide decline in confidence. Leading indicators in late summer suggested that the bottom of the cycle might have been near, at least for the United States, although the accumulation of debt by the private sector and the related large current account deficit remained a serious risk to growth. The attacks of September 11 have altered this picture drastically. A further deepening of the international cyclical downturn in the remaining part of the year now seems unavoidable, while the previously expected recovery of the international economy will be delayed by at least one to two quarters into early 2002.

Recent movements in leading indicators for OECD production and recent confidence indicators strengthen the belief that recovery will be delayed. US consumer confidence in October dropped to its lowest level in more than seven years, and the purchasing managers index for industry fell to its lowest level since February 1991. Unemployment has risen sharply, to 5.4 per cent in October. The US economy is clearly in recession at the present time. Japan is in an even more serious situation. Output and prices are both is falling, the public deficit is extremely high and the financial sector is burdened by bad loans.

Inflation in the industrial world is clearly receding, partly due to falling oil and other commodity prices on the world market due to weakening demand. The price of Brent oil fell to below $20 per barrel in early November, down from $27 just two months earlier, while other commodity prices have dropped to their lowest levels since the early 1970s.

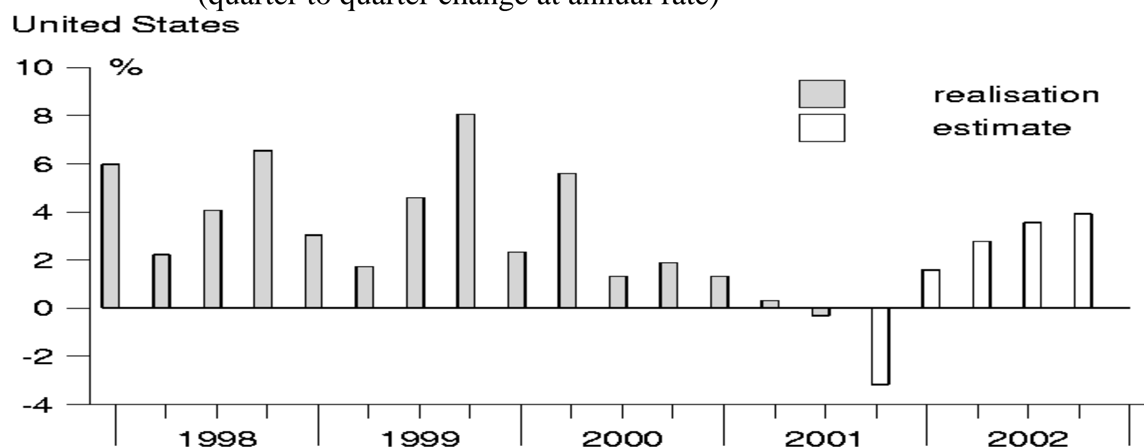
The direct economic effects of the attacks in terms of destruction and disruption of activity are rather limited and confined to specific sectors like aviation, transport and tourism. Much more damaging is the worldwide loss of confidence due to increased uncertainty, causing expenditure decisions to be delayed. Consumers will tend to save more, and investments will be postponed, including investment in the emerging economies. This will depress demand not just in the United States, but all over the world, partly through spillover effects.

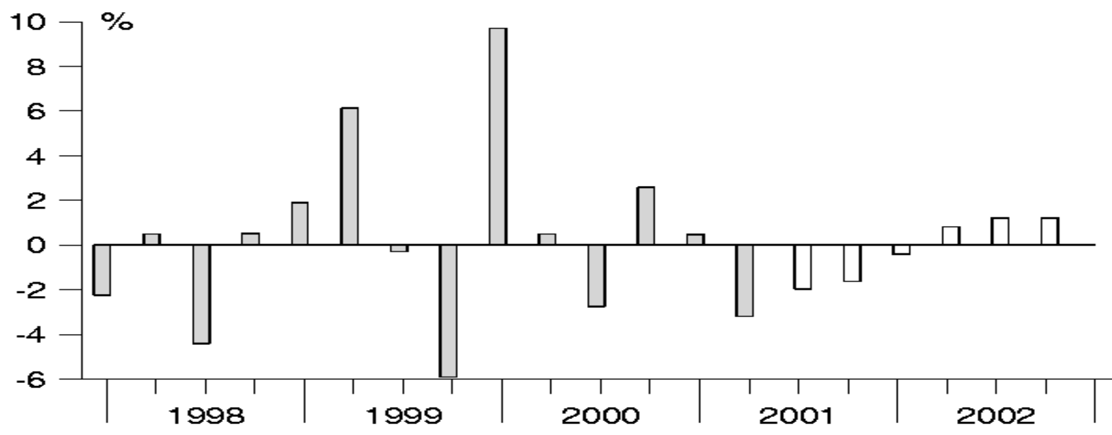
The timing of the recovery, and the extent to which expenditure weakens, partly depend on future developments in the battle against terrorism. Uncertainties surrounding this outlook are high. Our projection starts from the assumption that possible further attacks will not have major negative effects on sentiment, and that oil supplies from the Middle East will not be disrupted. Under these conditions, confidence could rebuild gradually, and policy incentives could do their work and foster a solid recovery particularly in the second half of 2002.

Policy reactions

Economic policy in the industrial world responded rapidly to the terrorist attacks, particularly in the United States. In a co-ordinated action, central banks in the major industrial countries reduced their lending rates, and injected large amounts of liquidity into their economies. The US Federal Reserve System had already reduced its official rates repeatedly this year in reaction to slowing activity and better inflation prospects. Since the start of this year short-term rates have been cut by 4½ percentage points, bringing the federal funds target rate to a record low of 2% in November. The rate could be raised again in the second half of next year if the economy strengthens as expected. Long-term rates have fallen slightly since September 11th, reflecting lower short rates, weaker cyclical prospects and lower inflation expectations. The Bank of Japan has no room for manoeuvre as its short-term rates are already close to zero, where they are likely to remain next year.

Chart 1 Real GDP-growth United States and Japan, 1998-2002
(quarter to quarter change at annual rate)




Japan
%
10
8
6
4
2
0
-2
-4
-6
1998
1999
2000
2001
2002

Fiscal policy has been eased, notably in the United States. Federal expenditure has been raised by at least $55 billion, of which $20 billion will be used to rebuild Manhattan, $15 billion to support the airline industry and the remaining $20 billion for military expenses and airport security. In addition, the Bush administration has announced a further economic programme of $60 billion to stimulate the economy, mainly consisting of tax cuts (although this is still in discussion in Congress). In Japan the government has limited room for manoeuvre. The government is preparing a package for structural reform, aimed in part at consolidation of the ailing banking sector, which may depress activity in the short term but which should aid prospects in the medium term. In Europe we anticipate that most governments will let automatic stabilisers do their work, and accept a deterioration of the government balance.

Prospects

Table 1 shows the expected economic growth in the major regions. According to our forecasts, the cycle will bottom out early next year, supported by strong monetary and fiscal responses. In particular, the United States recovery could be strong. But the Japanese economy is expected to remain sluggish, with structural reforms by the government having a negative impact on short-term domestic demand. The impulse from net exports could support activity to some extent, particularly if demand in Asia picks up with the expected reversal of the ICT downturn.

Table 1. International developments

(annual percentage changes)

	1990-97	1998	1999	2000	2001	2002
Real GDP: World	3.0	2.8	3.6	4.7	2.0	2.2
European Union	2.0	2.8	2.6	3.4	1.7	1.8
Non-EU world	3.2	2.8	3.8	4.9	2.3	2.3
United States	2.7	4.3	4.1	4.1	1.0	1.0
Japan	2.2	-1.1	0.8	1.5	-0.7	-0.5
Non-Japan Asia	8.3	4.7	6.6	7.0	4.7	4.6
Central and Eastern Europe	-5.0	-0.8	3.6	6.3	2.5	2.2
Other developing countries	3.7	0.7	0.9	3.9	2.1	2.0
World trade volume (goods)	6.7	5.5	6.2	12.9	0.3	2.3
World price manufactured goods ($)	1.1	-1.4	-1.7	-5.4	-1.4	2.4
Consumer prices: United States	3.3	1.5	2.2	3.4	2.9	1.4
Japan	1.5	0.7	-0.3	-0.6	-0.7	-0.4

Note: regional aggregates using PPP-weights.

Inflation in the industrial world is expected to remain subdued next year. Low capacity utilisation and increased unemployment will help to keep domestic wage and price developments in check, although the firming of activity could lead to some price pressures in

the course of next year. Commodity prices could recover somewhat during the course of next year, but the year-on-year percentage change will remain negative. The demand for oil is much lower than earlier envisaged, partly due to the problems in the aviation industry. OPEC is not likely to reduce its production significantly, as it does not want to lose market share to non-OPEC competitors. In this situation oil prices are expected to remain at the lower end of the OPEC price band. Profits as well as household disposable incomes should benefit from low inflation in most of the industrial countries.

Table 2. Key economic assumptions

	Interest rates (%) Short-term			Interest rates (%) Long-term			Exchange rates (per euro)		Oil prices ($ per barrel)
	US	Euro area	UK	US	Euro area	UK	US	UK	
1998	5.5	3.9	7.3	5.3	4.7	5.5	1.11	0.67	12.4
1999	5.3	3.0	5.4	5.6	4.6	5.1	1.07	0.66	17.3
2000	6.5	4.4	6.1	6.0	5.4	5.3	0.92	0.61	27.1
2001	3.8	4.3	5.1	5.0	5.0	4.9	0.90	0.62	23.7
2002	2.7	3.3	4.9	4.9	4.8	5.0	0.95	0.67	21.0

Notes: Short-term interest rates are 3 month money market rates. Long-term rates are the yields on 10 year government bonds. Oil prices are a weighted average of Dubai and Brent spot prices.

International trade

The growth of world trade volumes had already slowed sharply before the September 11 attack, and these events will weaken trade prospects further. The weakening has been particularly marked in the United States, Japan and other Asia (excluding China). Trade growth this year is projected at close to zero, which is the weakest performance since 1982. World trade is expected to rebound in the course of next year, but the negative carry-over from this year will keep the projected average growth rate at less than 2½ per cent in 2002. Even this figure implies strong growth of close to 10 per cent during the year to the fourth quarter. Import growth is expected to pick-up strongly in the US and a number of South-East Asian countries. European imports could pick up somewhat later and at a slower pace. Japanese imports will probably remain weak next year.

Risks

The projection includes considerable upward and downward risks. When the world economy is near a cyclical low, projections can easily over or undershoot. The slowdown can prevail longer, but there is also the possibility of a stronger and quicker rebound given the substantial

policy incentives. Downward risks can be large if uncertainty persists and/or in case of new adverse events. This could keep confidence low for a much longer time than in our projection. Households could defer spending for longer and save more. Investment could resume later, due to weaker profit expectations and equity prices. Thus domestic demand could slow even more than in our main forecast. Imports in the non-industrial world could also be adversely affected by financing problems, if foreign investors become more risk-averse. Oil prices could rise again as a consequence of (politically motivated) supply disruptions. Finally, the dollar could weaken substantially in response to the unsustainable US external position.

The major downside risk we foresee is that consumption in the US is significantly weaker than we currently anticipate. If it is, US and European GDP growth would be well below that suggested in our forecast. We have simulated weaker consumption using the NiGEM model, which is the framework within which we have produced our forecast. We have assumed that the US savings ratio rises by 2 percentage points to around 5 percent by the end of 2002. This would imply that US GDP would continue to shrink by 0.5 per cent a quarter or more in 2001q4 to 2002q2, giving four successive quarters of negative growth despite a strong reaction from the Federal Reserve. Our model-based interest rate reaction suggests that US interest rates would be cut by 50 basis points once the authorities became clear that this scenario was developing, and that further cuts would follow. The contagion from such a decline in US output would be hard to contain, and we would anticipate that the level of output in the Euro Area would be half a per cent lower by the end of 2002 than in our main forecast despite a robust initial reaction from the ECB. Our model-based reaction function suggests European interest rates would also be cut by half a percentage point, but the euro might strengthen against the dollar by around 5 per cent, partly offsetting the expansionary effects of the interest rate cut.

Longer-term economic effects of 11th September.

The effects of the terrorist attacks on world activity can manifest themselves over a longer period. Structural growth could be depressed for some time. Non-productive costs have risen, e.g. costs of security and transportation, higher insurance and higher risk premiums. Over the medium term one can expect a shift towards (generally less productive) investment aimed at reducing such costs. The increased preference of investors for domestic equities and bonds reduces the diversification of investment portfolios, enlarging the so-called non-systemic risk. Internationalisation trends, often considered as the driving force of the world economy, could slow under continued terrorist threats. Patters of demand could change as well in reaction to the attacks. For instance, travel could be substituted by electronic communication, air travel by rail and road transportation, while investments in security could boom. Also inventory formation could change, as companies want to hold higher stock levels as a precaution

against possible supply disruptions, from just-in-time to just-in-case. All of these factors may reduce growth in the short term as adjustment takes place.

The ICT sector and American growth

The slowdown in US growth since 2000 was mainly driven by the collapse of ICT demand which had been strong because of Y2K investments, the growth of the internet and related developments in financial markets. The ICT sector's strong growth represented a technology shock, but the evidence of a strong impact of ICT use on productivity growth outside the ICT sector is mixed (see 1, 2 and 3). The growing size of the ICT sector and the use of ICT have obviously raised the efficiency of the American economy by increasing total factor productivity growth from less than 0.5 per cent per year in 1974-95 to around one per cent in the latter part of nineties. As a result, the potential growth rate may have risen by around 0.5 per cent to 3-3.5 per cent (see 3).

It will take some time to reduce existing overcapacity in the sector. In the first half of this year, shipments of computers and communication equipment dropped by 10 to 20 per cent compared to the latter half of 2000 (see 4). There is still no sign of a recovery, but a turn-around in ICT demand is expected to take place in tandem with the general cyclical upturn. Increased demand for security investment due to terrorist threats, the ageing of ICT products and lower prices because of excess capacity will contribute to the sector's recovery by the end of 2002. E-business activity will go on maturing, finally generating some of the promised productivity gains. The ICT diffusion process is at its beginning, and the creative use of ICT products, not their production, may become the key to growth acceleration (see 5).

Europe is expected to follow the US recovery in ICT, with the exception of wireless technology, where some positive developments are already visible in the mobile phone sector in spite of the UMTS problems inside the EU for instance in Finland.

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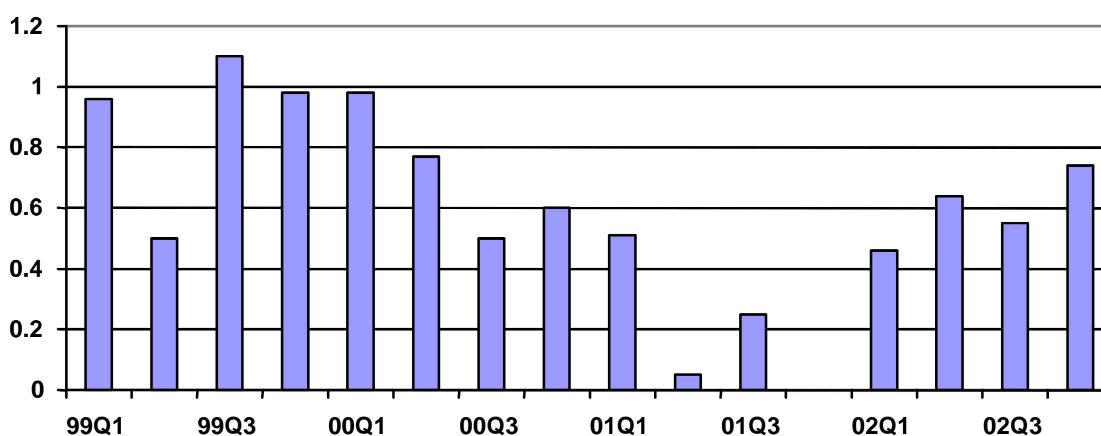
2. Euro Area Recovery Postponed

After having peaked in the second quarter of 2000, economic growth in the Euro Area continued to slow in the course of 2001 and almost came to a halt in the summer. At the same time the unemployment rate, which had been on a downward trend since 1997, has stopped falling. This is the third major slow down in growth since the recession in 1992/93. In 1995 and 1998 the deterioration in GDP growth was mainly due to weakening external demand. The downturn in the international business cycle and the sudden end of exceptionally rapid growth in the ICT sector have also adversely affected external demand this year, but there are also signs that domestic demand has slowed considerably as well. Rising energy prices had a negative effect on domestic disposable incomes in the first half of 2001 and a jump in food prices generated by animal diseases in the agricultural sector further eroded households purchasing power. The effects of the rise in key interest rates in the course of 2000 also began to be felt. All these factors have dampened economic activity this year, more than offsetting the positive impact coming from the tax cuts that were implemented at the beginning of 2001 in a number of countries.

The economic situation had already deteriorated by more than had been generally expected before September 11. However signs of stabilisation did emerge in August in some components of industrial surveys and industrial production did not fall further on average in July and August. This apparent improvement in the economic climate reflected both hopes that the slowdown in the world economy was about to bottom out and also the fact that the dampening impact of higher prices had started to fade as inflation began to decline.

Chart 4. Quarterly GDP growth in Euro Area (%, quarterly rate)



The short-term outlook has clearly deteriorated since September 11, as can already be seen from recent qualitative indictors (see charts 3-4). A deterioration of the outlook in the immediate future is also indicated by the latest results of the Euroframe/FTD-Indicator. The

Euro Area economy will be adversely affected through three different channels. First, exports will be hit as US import demand falters and the economic slowdown deepens world-wide, reducing demand from other countries as well. Second, uncertainty in financial markets has risen. European stock markets, which had already weakened considerably over the spring and summer, fell further in the aftermath of the attacks, although much of the immediate fall has subsequently been recovered. Thirdly, and probably most importantly, the resulting loss of confidence of European investors and consumers will dampen domestic demand. As a consequence the previously anticipated recovery of European growth towards more normal levels will be delayed into next year. Our central forecast suggests that the Euro Area will avoid falling into outright recession, although we recognise that there is still a risk that it might do so. However, prior to September the economy was in a less vulnerable cyclical position than the US, and there are likely to be smaller negative effects on transportation, tourism and entertainment industries in Europe than in the US.

Euro Area GDP is forecast to grow by 1.6 per cent this year, almost 2 percentage points less than in 2000 (see table 3). The positive contribution of the external sector to growth, which amounted to 0.6 percentage points last year, will almost vanish with export growth slowing more rapidly than import growth. Private consumption is expected to hold up relatively well due to healthy increases of real disposable income. Investment growth has slowed significantly, reflecting diminished expectations for profits and sales brought about by the world economic slowdown, the rise in interest rates last year and the decline in the terms of trade. The slow down in growth is most pronounced in Finland and Ireland (see table 4), which are particularly exposed to the global ICT downturn, and in Germany, mainly due to a specific weakness in the construction sector.

Inflation will continue to moderate in the remaining months of this year due to continued declines in energy and food prices. Nevertheless, annual inflation as measured by the Harmonised Index of Consumer Prices (HICP) is expected to average 2.7 per cent, ranging from 5 per cent in the Netherlands to 2 per cent in France (see table 5). Labour market conditions will start to slacken, reflecting the emergence of a negative output gap. However, the unemployment rate, at 8.4 per cent, will still be 0.5 percentage points lower this year than the year before.

For 2002, we expect a gradual recovery in output growth in the Euro Area. Investor and consumer sentiment are expected to gradually recover as the immediate impact of the recent events starts to fade. This will help demand to pick up in the first half of next year, with the quarterly growth rate accelerating to just under 3 per cent at an annualised rate by the end of

the year. Nevertheless, the minimal carry-over from 2001 will keep the annual GDP growth rate projected for 2002 at the same level as this year at 1.6 per cent. Global monetary easing and fiscal stimuli (particularly in the US) will increasingly be felt, and with the world economy on an increasingly firm recovery track export growth will pick-up and corporate investment will strengthen. The recovery will, however, in all likelihood not be strong enough to prevent a rise in the number of unemployed. The unemployment rate is expected to average 8.7 per cent next year, some 0.3 percentage points higher than this year.

Consumer price inflation is expected to be subdued next year, with the annual inflation rate averaging 1.5 per cent, well within the target band of the ECB. Price pressures should be reduced by lower prices of raw materials including oil, the weaker dollar and the normalisation of food prices. In addition, in some countries, most notably the Netherlands, increases in indirect taxation at the beginning of 2001 will drop out of the annual inflation rate. The lower level of inflation will help support real incomes and household expenditures.

Risks

The risks to our forecast come mainly from the international environment. On the domestic side, the main risk is that uncertainty about economic prospects reduces the propensity to consume and to invest by more, or for longer, than expected. The current Euroframe-FTD indicator for the first quarter of 2002 indicates that this risk should not be neglected, particularly if business and household sentiment do not recover from depressed figures in October. In this event GDP growth could be easily closer to 1 per cent next year and it is possible that a recession – as defined by two quarters of consecutive negative growth – could occur. Domestic demand would also be hit if governments fail to allow automatic fiscal stabilisers to work.

Table 3. The Euro Area

(percentage change unless otherwise stated)

	1999	2000	2001	2002
GDP at constant prices	2.6	3.4	1.6	1.6
Private Consumption	3.2	2.6	1.9	2.0
Government Expenditure	2.4	1.9	1.6	1.5
Private Investment	5.5	4.8	1.3	3.9
Stockbuilding (chg as % of GDP)	-0.2	0.0	-0.2	0.2
Domestic Demand	3.2	2.9	1.5	2.4
Exports (goods and services)	5.1	11.9	3.5	2.9
Imports (goods and services)	7.0	10.7	3.2	4.9
Unemployment Rate (%)	10.0	8.9	8.4	8.7
Average Earnings	2.1	3.4	2.9	3.2
Harmonised Consumer Price Index	1.1	2.4	2.7	1.5
Household Real Disposable Income	2.4	2.2	2.2	2.9
General Govt. Balance (% of GDP)	-1.3	0.8	-1.1	-1.1
General Govt. Gross Debt (% of GDP)	72.1	69.6	68.2	66.6

Note: The general government balance numbers include the receipts from the sale of UTMS licences.

Table 4. GDP Growth (% per annum)

	1999	2000	2001	2002
Austria	2.8	3.4	1.3	1.5
Belgium	2.7	4.0	1.8	1.5
Finland	4.0	5.7	1.0	2.0
France	3.0	3.4	2.0	1.8
Germany	1.7	3.2	0.8	1.3
Greece	3.4	4.1	3.6	2.8
Ireland	9.8	11.0	7.0	3.5
Italy	1.6	2.9	1.8	1.4
Netherlands	3.7	3.5	1.6	1.5
Portugal	3.3	3.3	1.9	1.9
Spain	4.1	4.1	2.4	2.0
Euro Area	2.6	3.4	1.6	1.6
Denmark	2.1	3.2	1.1	1.9
Sweden	3.9	3.5	1.8	1.5
UK	2.1	2.9	2.3	2.3
European Union	2.6	3.4	1.7	1.8

Table 5. Harmonised Consumer Price Inflation (% per annum)

	1999	2000	2001	2002
Austria	0.5	2.0	2.6	1.7
Belgium	1.1	2.6	2.5	1.9
Finland	1.3	3.0	2.8	1.5
France	0.6	1.8	2.0	1.3
Germany	0.6	2.1	2.6	1.3
Greece	2.2	2.9	3.6	3.3
Ireland	2.5	5.2	3.9	2.2
Italy	1.6	2.6	2.6	1.6
Netherlands	2.0	2.4	5.0	2.2
Portugal	2.1	2.8	4.3	2.3
Spain	2.3	3.5	3.6	2.0
Euro Area	1.1	2.4	2.7	1.5
Denmark	2.1	2.7	2.5	2.0
Sweden	0.6	1.3	2.6	1.4
UK	1.4	0.8	1.2	1.2
European Union	1.2	2.1	2.5	1.6

Table 6. Standardised Unemployment Rates (%)

	1999	2000	2001	2002
Austria	4.0	3.7	3.8	3.9
Belgium	8.8	7.0	6.8	7.0
Finland	10.2	9.7	9.1	9.2
France	11.2	9.5	8.6	8.8
Germany	8.6	7.9	7.9	8.3
Greece	12.0	11.3	11.2	11.1
Ireland	5.6	4.2	3.8	3.9
Italy	11.4	10.5	9.5	9.8
Netherlands	3.3	2.8	2.3	2.7
Portugal	4.5	4.1	4.3	4.5
Spain	15.9	14.1	13.1	13.0
Euro Area	10.0	8.9	8.4	8.7
Denmark	5.2	4.7	4.6	4.5
Sweden	7.2	5.9	5.1	5.3
UK	6.0	5.5	5.0	5.3
European Union	9.1	8.2	7.7	7.9

Table 7. General Government Fiscal Balance (% of GDP)

	1999	2000	2001	2002
Austria	-2.2	-1.1	-0.8	-0.4
Belgium	-0.6	0.1	0.3 (0.2)	0.1
Finland	1.9	6.8	4.5	3.0
France	-1.6	-1.3	-1.3 (-1.4)	-1.7
Germany	-1.6	1.2 (-1.3)	-2.5	-1.9
Greece	-1.8	-1.1	-0.2	0.2
Ireland	2.3	4.6	3.1	2.5
Italy	-1.8	-0.3 (-1.5)	-1.3	-1.1
Netherlands	0.4	2.2 (1.5)	1.2	0.6
Portugal	-2.2	-1.5 (-1.8)	-1.4	-1.5
Spain	-1.1	-0.3 (-0.4)	-0.2	-0.2
Euro Area	-1.3	0.3 (-0.8)	-1.1	-1.1
Denmark	3.1	2.8	2.2	1.7
Sweden	1.8	4.1	4.5	2.1
UK	1.3	4.3 (1.9)	1.1	-0.3
European Union	-0.7	1.2 (-0.1)	-0.7	-0.9

Note: Inclusive of receipts from the sale of UTMS licences. Figures excluding UTMS revenues shown in parentheses.

Chart 3. Euro Area: Industry Indicators

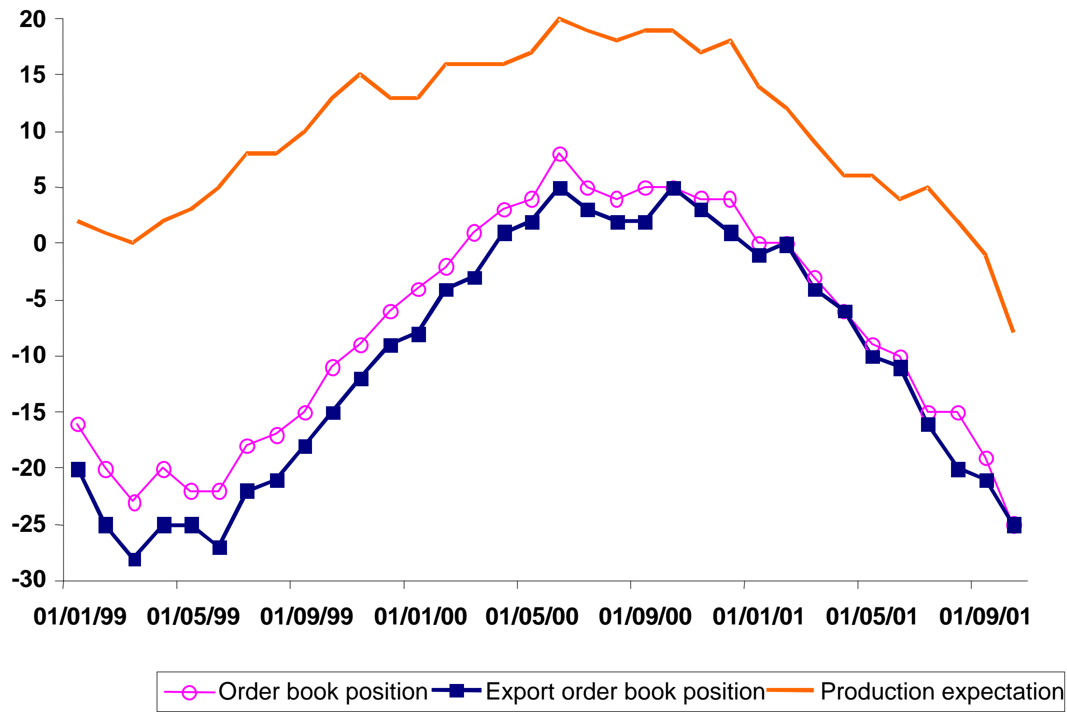
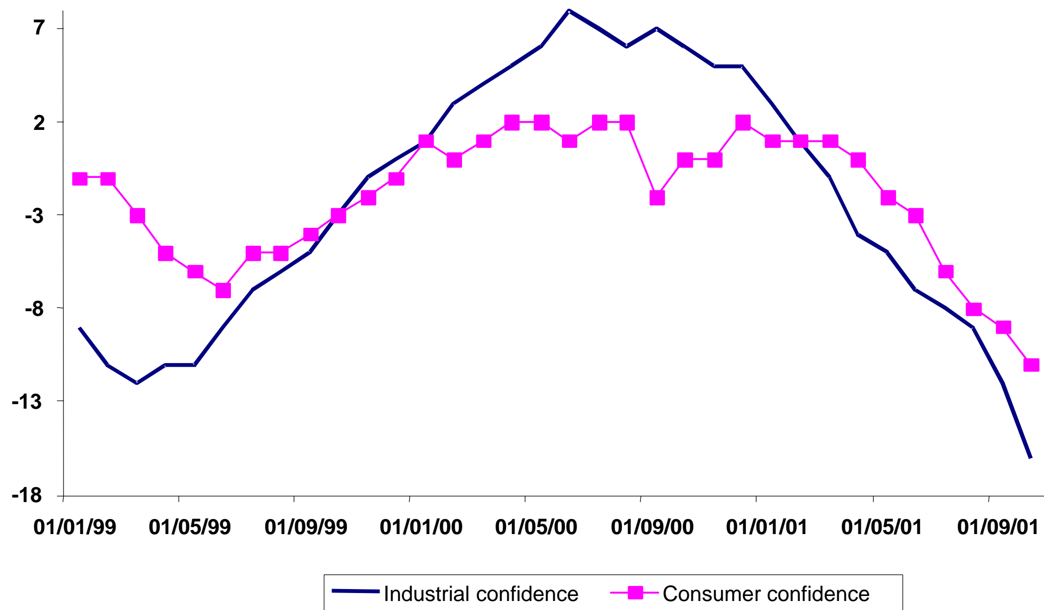


Chart 4 Euro Area: Confidence Indicators



3 Monetary and Fiscal Policy

Monetary Easing

The European Central Bank has lowered interest rates four times since May 2001. The most recent reduction in early November took the main refinancing rate down to 3¼ per cent, bringing the cumulative reduction since May to 1½ percentage points. Given the benign inflationary outlook, the ECB has reacted to the marked slowdown in actual and expected growth in the Euro Area.

Long-term interest rates have also decreased this year, although by less than short-term rates. The yield on 10-year government bonds is currently 4½ per cent, some 75 basis points below the level of one year ago, when the ECB last increased rates (see Chart 5). Consequently the yield spread between long-term and short-term interest rates, which had been very narrow for a while, has widened. Interest rates suggest that monetary conditions are expansionary at present, particularly if the past average level of real rates in Germany is used as a benchmark indicator of neutral levels.[1] However the euro has appreciated over the past 12 months both against the US-dollar (by 6 per cent) and in real effective terms (by 8 per cent). While we still judge the euro to be undervalued relative to its longer term equilibrium rate, the expansionary effects emanating from past devaluations have certainly diminished.

At first glance the current rate of monetary growth would seem to indicate that monetary conditions are very expansionary. But this view cannot be sustained when taking a closer look. The annual growth rate of M3 of 7.6 per cent in September was distorted upwards because of the inclusion of non-resident holdings of money-market paper and short-term debt securities in M3. The steep increase – relative to the ECB's reference value of 4.5 per cent for monetary growth – also reflects the past jump in prices and overstates the rise in liquidity because of portfolio shifts from longer-term to shorter-term assets.

The continuous decline in the growth rate of credit to the private sector over recent months and the low growth of longer-term financial liabilities of the MFIs suggests that recent monetary growth does not signal the build-up of inflationary pressures. We have also argued previously that a liquidity overhang from past money growth does not exist because one-off events can account for monetary growth in excess of the reference value.[2]

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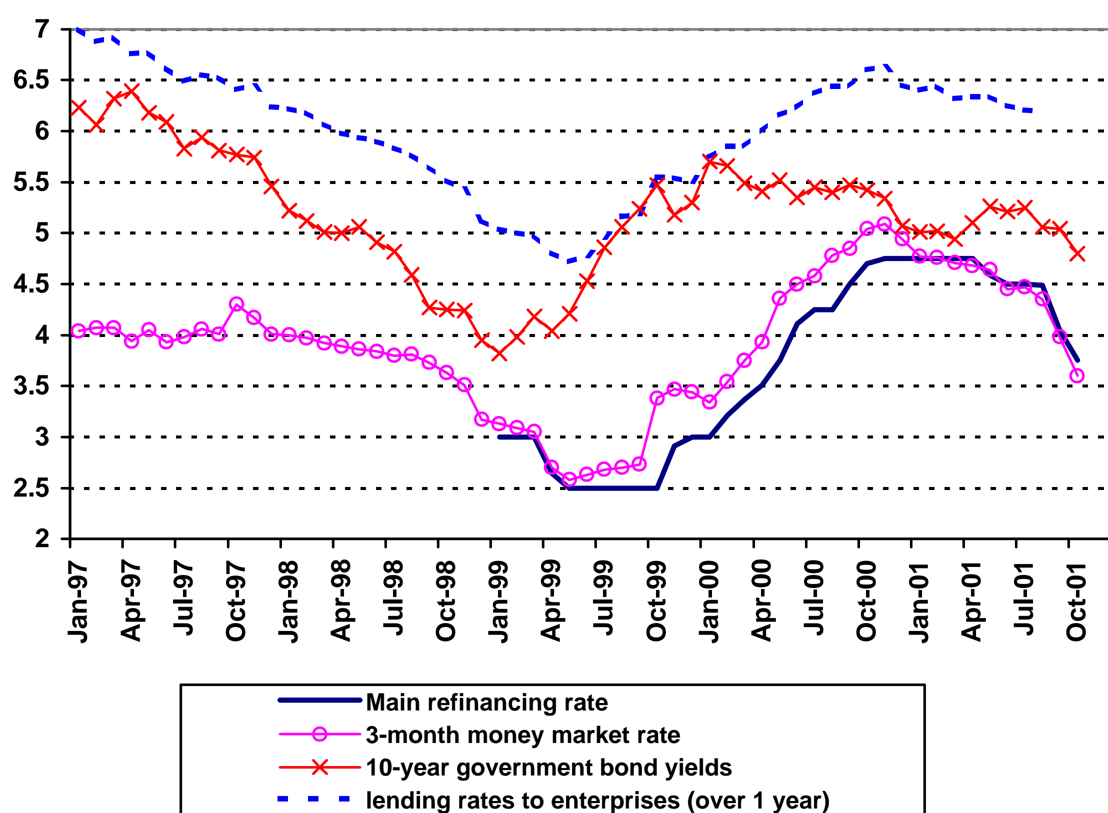
[1] We feel this is necessary given the short time span in which the Euro Area has been in existence and differences in exchange rate depreciation expectations across member states in the past. Cf. Euroframe (2001): The Economic Situation of the European Union and the Outlook for 2001-2002 (ECON 126 EN-01/2001), p. 19.

[2] Cf. Euroframe (2001): The Economic Situation of the European Union and the Outlook for 2001-2002 (ECON 126 EN - 01/2001), p. 21.

Overall, monetary conditions are presently expansionary. Given that recent rises in energy and food prices have not generated a price-wage spiral, with wage developments continuing to be moderate, we do not see any danger of a sustained rise in underlying inflation at the present time. Headline inflation is expected to decrease in the coming months. We expect that the European Central Bank will keep rates at the current level throughout next year. Clearly the ECB should act rapidly and cut rates once again if the Euro Area economy were to slow down more than we forecast or the euro were to appreciate by more than we anticipate.

Chart 5: Interest rates in the Euro Area January 1997 – October 2001 (% points)



Fiscal Balances

Fiscal Deficits in Europe will rise significantly in 2001. The overall fiscal balance in the European Union was in surplus last year (1.2% of GDP including UMTS proceeds) and it is expected to swing into deficit this year by 0.7% of GDP. The surplus in 2001 was mainly acquired by revenue from sales of mobile transmission licenses in a number of countries. Without UMTS proceeds the European Union 15 were slightly in deficit last year by –0.1% of GDP. However, the relatively small underlying deficit was the partly result of strong growth creating high tax revenues and reducing expenditures on unemployment benefits and other social welfare programmes. The economic environment has changed a great deal since the start of the year, and is much worse than in 2000. Some of the beneficial impacts of

strong tax receipts from buoyant incomes and net profits will last throughout this year, because in particular corporate taxes are paid with a delay. There will however, be an overall shortfall of revenues and an unexpected increase of unemployment-related expenditures. On the other hand interest payments on government debt stocks should decrease at least slightly, given that the ECB has lowered short-term rates and long-term rates have also fallen to relatively low levels. We anticipate that deficits will rise this year by more than one percentage point of GDP. Given our projection of relatively weak growth, a further rise can be expected next year. Growth in the EU will very probably be below trend, and hence we would expect that automatic stabilisers will still induce reductions in revenue and increases in expenditures, and hence the accounts will show a larger deficit than they otherwise would.

There are differences in the possibilities for fiscal policy in Europe. The UK government and many other, predominantly smaller, countries are running surpluses and are able to relax their fiscal policy stance without major difficulties. However, the larger countries of the Euro Area Germany, France and also Italy will probably violate restrictions set out in the Stability programmes agreed with the European Commission. Neither Germany nor France will reach their targets next year and Italy will have difficulties in doing so. The targets were set when output growth was expected to rise much more than now forecast for 2001 and 2002. These assumptions have turned to be far too optimistic. We expect output to rise only by 1.6 per cent this year and next in the Area. The current economic situation shows that it was unrealistic to set out last year to undertake three-year public finance programmes based on deficit reduction without taking account of the business cycle. These programmes should at best have set structural orientations for public receipts and expenditure in the medium-term. Consequently governments now face the difficult task of achieving the budgetary targets set out in the Stability programmes, without implementing pro-cyclical fiscal policies that would add to the deceleration of activity. The fundamental problem is that fiscal targets set out in order to achieve the objectives of the Stability Programme do not take account of the possibility of a serious cyclical setback. Therefore the present situation could create problems for the credibility of the consolidation process if governments do not behave in a way that can be seen as responding to current difficulties. There are two ways to avoid them. Governments could set up additional saving programmes, which might lead to an undesirable pro-cyclical stance of fiscal policy and thus increase the danger of a recession. In the current cyclical context, the alternative we prefer is to let automatic stabilisers operate fully and use structural deficits as targets since they are independent of the state of the business cycle.

This strategy would allow deficits to prevail as long as economic activity is slack. In particular it is possible that a pro-cyclical fiscal policy stance then can be avoided. This objective should be widely accepted by all major European economic policy institutions. In particular we would suggest that the ECB must not interpret the higher than planned deficits as posing a danger for price stability. If it were not to take our advice an overly restrictive monetary stance would offset, either in part or completely, any stabilising impact of fiscal policy.