Weekly Briefing– European Economy

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Keeping Control

There has never been a successful monetary union without a significant degree of political co-ordination– and that means centralised rules on tax and spending. Like it or not, a single currency comes at a price

Lea Paterson,

The Times

13 February 2002

PROSPECTS FOR THE EURO ZONE ECONOMY IN 2002

In this edition of the Weekly Briefing, we consider the performance of the Euro Zone economy in 2001 and focus on the prospects for the twelve member nations in 2002– the first year in which Euro notes and coins are in common circulation.

The successful launch of Euro notes and coins into common circulation has tended to obscure the fact that the Euro Zone faces significant short term and long-term macroeconomic problems. For most of 2001, the Euro Zone suffered a downshift in economic growth. Real GDP growth dropped from 3.5% in 2000 to just 1.5% in 2001 and the consensus forecast is that output will rise by less than 2% this year. Indeed EU (12) is now close to technical recession and the slowdown is the worst since the European recession of 1993.

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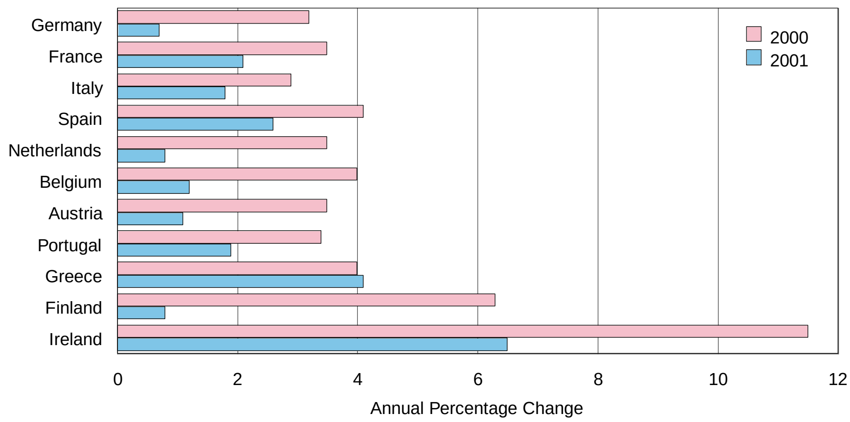
REAL GDP GROWTH IN THE EURO ZONE



Special Report: Rising Unemployment and Budget Worries in the Euro Zone

Unemployment has started to rise in most Euro zone economies with the potential for greater increases as the slowdown bites on employment. Unemployment in the Euro zone has been on a gently downward path in recent years, falling from 11.7% in 1997 to 8.4% in 2001. A turning point has now been reached. Unemployment is forecast to increase to 8.9% this year.

There is a wide spread of unemployment rates within the Euro zone - member countries have a long way to go to achieve real economic convergence. Spain (13.3%) and Greece (11.0%) had the highest unemployment last year. In contrast, unemployment in Ireland fell below 4% for the first time, and the Netherlands enjoyed a jobless rate of just 2.1%.

The German economy is now in the grip of a technical recession. Real capital investment fell by 4% in 2001, consumer spending is static leading to substantial de-stocking by German industry. Export growth declined sharply from 5.6% in 2000 to just 1.6% in 2001 – contributing to a

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DE-STOCKING & THE ECONOMIC CYCLE

A slowdown or fall in consumer demand often leads to an increase in inventories (or stocks). These can be expensive to store, so the response of businesses is to cut back on current output and also a reduction in output prices in a bid to control excess stock levels.

De-stocking can play a significant part in explaining turning points in a country's economic cycle.

Drastic de-stocking by German manufacturers has contributed to the technical recession in the final quarter of 2001 and the first quarter of 2002

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Explaining the downturn

The root causes of this slowdown differ from the recessions experienced in many EU countries during the early 1990s which was mainly the result of increases in real interest rates as countries attempted to curb inflation. This time, recession conditions follow from a number of factors

(1) **External demand-side shocks** caused by the global economic slowdown have led to a sharp fall in business exports and investment. Export sales to the USA have been badly affected and business and consumer confidence has been dented. Many industries are now downsizing their capacity to control operating costs. The European airline industry is estimated to have contracted by 30% in the last six months alone.

(2) **Consumers** appear unwilling to borrow money to finance spending when real incomes temporarily decline. And in several countries, cuts in incomes taxes appear to have been saved rather than spent.

(3) The opportunities to use fiscal policy to actively manage demand are constrained by the conditions of the **Fiscal Stability Pact**

(4) The inertia shown by the **European Central Bank** in responding to the negative demand shocks in the second half of 2001. The ECB tightened monetary policy by 2% between November 1999 and October 2000 and the delayed impact of this on economic activity really started to kick in during 2001. But the ECB appeared reluctant to cut rates in the second half of 2001 as the depth of the slowdown in growth has become apparent. Fortunately rates have been cut by 1.5% since September.

(5) The European economy seems more exposed than most to the steep decline in demand and output in the **technology industries** (the so-called "Tech Wreck"). Euro zone share prices have fallen by more than 30% in the last fifteen months – enough according to economists at HSBC to shave 0.4% off Euro zone economic growth

What are the consequences of this drop in economic growth? Heading into recession territory has clear implications for the Euro Zone.

Unemployment rises

German unemployment has climbed above the four million level in recent weeks and some analysts are predicting that the jobless total might even reach five million in the next couple of years.

Mind the Gap

The Euro Zone economy is operating with quite a sizeable **output gap**. Actual GDP is well below potential GDP. This puts downward pressure on price inflation and it should mean that the ECB can cut rates further in the second half of 2002. The ECB has been reluctant to ease monetary policy until the outlook for EU inflation has become clear. This has led to criticism of the ECB (and Chairman Wim Duisenberg in particular).

Profits are Squeezed

The economic slowdown is causing a sharp profits squeeze for companies - and this , combined with falling capacity utilization is likely to lead to a fall in planned capital investment spending

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UNEMPLOYMENT RATES IN THE EUROPEAN UNION			
% of the labour force	2000	2001	2002 (Forecast)
Euro Zone average	8.8	8.4	8.9
Germany	9.8	9.3	9.3
France	9.6	8.8	9.2
Italy	10.6	9.6	9.8
Spain	14.2	13.3	13.8
Netherlands	2.6	2.1	2.8
UK	3.6	3.2	3.8
Forecast for 2002 from HSBC European Economics Analyst			

sharp fall in industrial production last year. Manufacturing output was falling at an annual rate of 4.4% in the first quarter of 2002 leading to heavy job losses in German industry.

Gerhard Schroder is unlikely to achieve his election target of cutting German unemployment below 3.5%. And this problem makes it more difficult to introduce additional labour market reforms designed to increase the flexibility of the domestic German economy.

EURO ZONE ECONOMIC GROWTH			
% change in real GDP	2000	2001	2002 (Forecast)
Euro Zone average	3.5	1.5	1.4
Germany	3.2	0.7	0.9
France	3.5	2.1	1.7
Italy	2.9	1.8	1.3
Spain	4.1	2.6	1.9
Netherlands	3.5	0.8	1.3
Finland	6.3	0.8	2.2
Ireland	11.5	6.5	4.0
UK	2.9	2.2	1.9
Forecast for 2002 from HSBC European Economics Analyst			

Budget Deficit – A Rap on the Knuckles

Slower growth always hurts government finances. The German budget balance as a share of GDP increased to 2.5% in 2001 – stretching the limits placed by the Fiscal and Growth Stability Pact. The EU Commission has backed down from imposing fines on Germany (and Portugal) for running excessive budget deficits. Germany has agreed to take steps to bring their finances back towards balance by 2004. This will require stricter control of government spending together with a fiscal dividend from an expected rebound in economic activity in 2002 and 2003.

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Softer Cycle for the French

France has experienced a softening in growth. The French economy is less exposed to the collapse in production in the European ICT sector, and demand has been supported by substantial cuts in household and corporate taxation over the last three years. As a consequence, consumer spending has proved more resilient than in Germany and the growth in real capital spending has stayed positive. Better than expected growth has maintained the fall in unemployment and the French government's budget position is in better shape as a result of this.

Irish Eyes Stop Smiling

Ireland enjoyed phenomenal economic growth in the second half of the 1990s. Real GDP growth surged above 10% in 1999 and 2000 and industrial production increased in excess of 14% in each year from 1998-2000. Last year the rate of expansion fell away sharply with real GDP growth slowing to a more modest 6.5%.

IRISH ECONOMY CHANGES GEAR				
% change unless stated	**1999**	**2000**	**2001**	**2002F**
GDP	10.9	11.5	6.5	4.0
Consumption	8.2	9.9	7.2	5.0
Investment	14.0	7.0	5.5	3.0
Exports	15.7	17.8	10.0	8.5
Industrial Production	14.7	15.5	10.0	6.0
Consumer Price Inflation	2.5	5.2	3.9	2.8
Budget Balance (% of GDP)	2.1	4.7	4.0	2.5

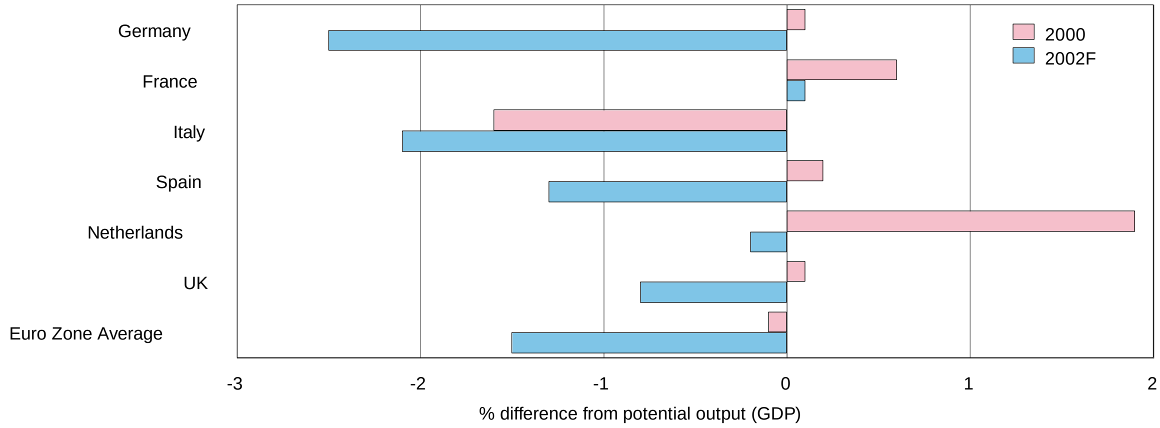
The Irish economy is highly export-dependent. Indeed it is probably the most open economy in the whole of Europe. So the economic recession in the United States allied to a general weakening of Euro Zone growth has hit exporting industries badly. According to the Irish Industrial Development Agency, more than 10% of total employment in ICT has been lost in the last twelve months.

The benefits of rapid growth for the Irish economy are plain to see. Her position in international league tables of real GDP per capita has improved; the unemployment rate has declined from 7.8% in 1998 to 3.8% last year. And, the Irish government has accumulated large budget surpluses allowing it to reduce her net public sector debt (as a % of GDP) from 55% in 1998 to just 30% in 2001.

But economic booms bring risks as well as rewards. Consumer price inflation jumped from 2.5% in 2000 to 5.2% last year and rampant house price inflation in Dublin has damaged housing affordability for thousands of native Dubliners.

SELECTED WEB LINKS ON THE EUROPEAN ECONOMY	
BBC BUSINESS NEWS– EURO ZONE SPECIAL	http://news.bbc.co.uk/hi/english/in_depth/uk/2001/uk_and_the_euro/
EUROPEAN CENTRAL BANK	www.ecb.int
GUARDIAN SPECIAL ON EUROPE	www.guardian.co.uk/euro/0,11306,606524,00.html
BLOOMBER TOP EUROPEAN BUSINESS STORIES	www.bloomberg.co.uk/bbn/europe_top.html

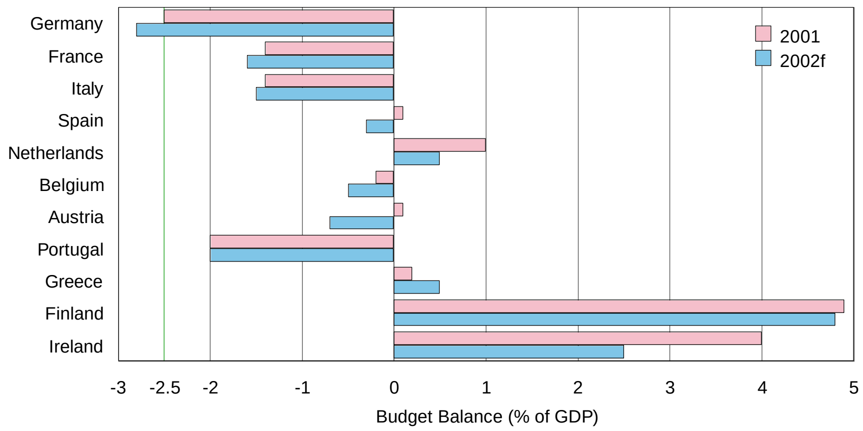
MIND THE GAP - OUTPUT GAP FOR SELECTED ECONOMIES



The Fiscal Stability Pact

The European Fiscal Stability Pact is intended to safeguard the euro from profligate fiscal policies in member states. The pact sets a ceiling for a budget deficit of three per cent of national income. A country should also aim to balance its budget over the medium term and aim to reduce the level of net government debt as a percentage of GDP towards a target of 40%.

SLOWDOWN BRINGS BUDGET DEFICIT PROBLEMS



Economic Masochism

The stability and growth pact was designed in the mid-1990s as a way of reassuring the German public that it was safe to give up the mark, but is now being used as an instrument of economic masochism

The Guardian 12th February

Paradoxically the fiscal rules were introduced originally by Germany who wanted smaller countries joining the Euro to be subject to the same fiscal disciplines as the core Euro Zone members.

Gordon Brown wants greater flexibility to be built into the Fiscal Stability Pact before the UK joins the single currency. His own fiscal rules include the Golden Rule which says that current spending should be financed by current taxation, and that over the economic cycle, the government should only borrow to fund capital investment.

Brown has come under pressure from the European Commission in recent weeks because of his plans for a major increase in public sector investment over the next few years. Labour has decided that a significant infusion of government funding is needed to partially offset under-investment over the last twenty five years in health, education and transport. But higher projected borrowing might produce a clash with the EU over the terms of the Fiscal Stability Pact.

For the moment, Britain remains outside European monetary union and therefore has the autonomy and flexibility to determine its own fiscal policy rules. UK government finances are as susceptible to the global economic slowdown as in other European countries, but Chancellor Brown appears to have accepted that major increases in real spending may require higher taxation for him to stay within his own fiscal guidelines.