EUROFRAME Forecast

EU and Euro Area Economies

November 2002

1. Overview of the *Euroframe* Forecast

Global economic activity has weakened significantly in recent months after strengthening considerably in the first half of 2002 and while the outlook remains uncertain the prospects bode well for a recovery in 2003 and 2004. As 2002 progressed activity slowed and events over recent months regarding corporate governance, volatility in equity prices and the possibility of military action on Iraq have served to depress both consumer and business confidence. For the year as a whole we continue to expect global GDP growth (measured at Purchasing Power Parity exchange rates) to be around 2.8 per cent, which whilst below long-term trend levels, would be a welcome improvement on the growth of under 2.2 per cent seen in 2001. Most of the major world economies are now expected to return towards potential growth levels during 2003 and sustain this momentum into 2004. We expect world trade growth having been flat in 2001 to increase modestly by 2.7 per cent this year. The anticipated improvement in global conditions has led to a forecast growth in world trade of 6.5 per cent in 2003 and 8.3 per cent in 2004.

Our view is that the Euro area and broader EU economy will grow by 1 and 1.1 per cent respectively this year in real Gross Domestic Product (GDP) terms. The Euro area is expected to grow by 1.6 per cent in 2003 and 1.9 per cent in 2004 in real GDP, still somewhat below potential growth levels. The EU economy is expected to grow in real GDP terms by 1.8 per cent and 2.2 per cent in 2003 and 2004 respectively. The outlook for price developments in Europe using the Harmonised Index of Consumer Prices (HICP) is for inflation to moderate from just over 2 per cent in 2002 to around 1.5 per cent in 2003. In 2004, the HICP in the Euro area is expected to fall to 0.8 per cent and 1.3 per cent in the EU economy. The euro exchange rate is expected to continue its appreciation over the next two years towards a bilateral rate of €0.95 per US$ by the end of 2003 and remaining close to this in 2004. This forecast appreciation of the euro, in both real and nominal effective exchange rate terms, help modify the inflationary outlook for 2003 and 2004 given the anticipated recovery in output growth. Interest rates in Europe are expected to move downward through 2003 before rising back towards current levels by 2004.

The lower interest rate and inflation environment is expected to lead to increased domestic demand growth throughout Europe. The growth in domestic demand for the Euro area is expected to rise from 0.7 per cent in 2002 to 2.3 per cent in both 2003 and 2004. The contributing factors include a strong rebound in private sector investment from a decline of 1.1 per cent in 2002 to increases of 3.9 per cent and 3.8 per cent in 2003 and 2004 respectively. Private sector consumption is also expected to rise in the Euro area from 0.8 per cent in 2002 to 2.0 per cent in 2003 and 2.2 per cent in 2004. The contribution from the public sector is expected to be more muted than in recent years. Government expenditure is expected to moderate from rises of 1.8 per cent in 2002 to 1.5 per cent and 1.2 per cent in 2003 and 2004 respectively. The general government deficits in the Euro area are forecast to improve marginally from 2.1 per cent of GDP in 2002 to 2 per cent and 1.7 per cent of GDP in 2003 and 2004.

The combination of currency appreciation and increased domestic demand in the Euro area is expected to lead to import volume growth exceeding export volume growth in 2003 and 2004. Export growth is expected to be 0.6 per cent in 2002, but with increased world trade Euro area exports are forecast to rise by 3.2 per cent in 2003 and 3.7 per cent in 2004. Import growth in contrast declined in 2002 by 0.5 per cent but is expected to rise sharply to 5.7 and 4.9 per cent in 2003 and 2004. The implied dis-improvement in the trade balance means that the surplus on the current account of the Balance of Payments is expected to decline from 0.6 per cent of GDP in 2002 to 0.4 and 0.3 per cent of GDP in 2003 and 2004.

The below potential growth outlook for the Euro area means that the rate of unemployment is set to rise from 8.3 per cent in 2002 to 8.4 per cent in 2003 and 8.6 per cent in 2004. Average earnings growth in the Euro area is expected to moderate from 3.6 per cent in 2002 to 3.3 per cent and 2.8 per cent in 2003 and 2004 respectively. Real personal disposable income growth is expected to rise from 1.9 per cent in 2002 to 2.4 per cent in 2003 before easing to 2.1 per cent in 2004.

2. Recent International Economic Developments

Following a year of below-potential growth in 2001, the international economy underwent a tentative recovery in the first half of 2002. With monetary and fiscal policies in the major economies having become increasingly accommodative over the past year, and likely to remain so over the next year, it appears that, on balance, conditions remain in place to support a gradual further strengthening of global activity. Global GDP growth is projected to strengthen to 3.3 per cent in 2003 and 3.7 per cent in 2004. The OECD economies are still expected to pick up from 1.7 per cent in 2002 to 2.2 per cent next year and 2.8 per cent in 2004. The accommodative macroeconomic policies are being reinforced by the favourable environment provided by an increasingly open global trading system, and the expected continuation of the strong growth of demand in China and India. Evaluated using purchasing power parity exchange rates in 2001, these two economies now account for 16.7 per cent of world GDP. Their expected contribution to global growth this year and next is likely to be much higher, accounting for over a third of the annual increase in output. Current internal reforms and external liberalisation in both economies should, if continued, offer a significant positive stimulus to the world economy for some time to come.

The forecast has not sought to make any specific allowance for potential conflict in the Gulf, although oil prices are expected to average $26.5 per barrel in 2003, up from $24.8 this year and expected to average $23.7 in 2004. The impact of this rise is likely to be relatively muted, slowing growth in the industrialised economies by 0.1 percentage points in 2003 and adding 0.2 percentage points to consumer price inflation. The declines in equity markets over much of 2002 have been reversed somewhat in the current quarter. The overall impact is likely to prove deflationary and has led to further monetary easing by monetary authorities in an effort to retain their current inflation targets in the US and prospectively in the European context.

Short-term interest rates were previously expected to rise in North America and Europe in 2003, but we now expect rates to remain unchanged in the US and the UK for most of next year. The European Central Bank (ECB) is expected to cut by 0.5 percentage points in the Euro area by the start of 2003. In 2004, the interest rate cycle is expected to turn upwards in all the major economies. Some decline in nominal long-term government bond rates was to be expected given the changing perceptions of likely future short-term rates. The increasing evidence of fiscal indiscipline in several major economies would normally act to raise interest rates if it was expected to persist for any length of time. A combination of discretionary policy relaxation, below-trend growth and statistical revisions to past data now mean that the US general government budget deficit is expected to rise to 3 per cent of GDP this year, after having been in surplus by 1.5 per cent of GDP as recently as 2000. Although a modest drop in the deficit ratio is projected in 2003, this could easily be offset by the costs of any military action against Iraq.

Growth in the United States is projected at 2.2 per cent in 2002 and 2.3 per cent in 2003 and 3.4 per cent in 2004. The maintenance of positive rates of productivity growth during the recent recession and its immediate aftermath suggests that the pick-up in productivity growth experienced since the mid-1990s might well be sustained for some time. The US external deficit has recently widened significantly, reaching 5 per cent of GDP in the second quarter. This is the largest deficit recorded in the post World War 2 period. Whilst the size of the private sector deficit has been reduced over the past 18 months, the overall impact on the external deficit has been more than offset by the swing into deficit of the public sector. It is unlikely that external deficits of this magnitude can be sustained indefinitely, as this would imply that, with nominal GDP also growing at 5 per cent per annum, net external liabilities would ultimately reach 100 per cent of GDP, around five times their present level.

Considerable uncertainty remains about the speed at which any adjustment might occur. Given the current exchange rate trajectory implied by expectations of future interest rate differentials, it appears unlikely that any correction will be rapid. Conditions in the labour market are stabilising with almost flat employment growth in both the second and third quarter of 2002.

The Japanese economy is likely to continue to be the slowest growing major economy this year and next. Revised national accounts data indicate that activity picked up in the first half of this year, but this largely reflected higher net export levels, with private domestic demand remaining weak. For the year as a whole we expect GDP to decline by 0.6 per cent, before rising modestly by a little over 1 per cent in 2003 and 1.7 per cent in 2004. Progress on implementing structural reforms continues to be slow, and widespread price deflation appears likely to persist until 2004 at least, despite the renewed weakness of the yen. The GDP deflator is forecast to drop again this year, which would be the fifth consecutive annual decline.

Price level deflation is also currently occurring in several other Asian economies, notably Hong Kong, Singapore, Taiwan and mainland China. In part this reflects the exposure of these economies to developments in the IT sector where prices are extremely volatile, with production of semi-conductors now accounting for almost 20 per cent of GDP in countries such as Singapore and Malaysia, but it also reflects the impact of domestic deregulation and greater competition, especially in China.

The importance of the Asian economies in global trade means that there is a possibility that deflation in these economies can, in effect, be exported to other economies as their product markets become more contestable. With economy-wide price inflation in the US having recently dropped to its lowest level for 40 years, and the prices of many domestically produced goods now declining in Europe and North America, fears have emerged that persistent Japanese-style deflation may appear in other economies as well. Whilst our forecast shows that low rates of inflation are expected to persist for some time, with consumer prices in the OECD forecast to rise by around 2 per cent per annum over 2002-04, it does not point to sustained outright deflation. In part this reflects a judgement that monetary policy would be eased further if required in order to prevent this. Monetary policy is difficult to operate in a low inflation environment, but it is clear that many central banks have taken the lesson from Japan that prompt action should be taken if the perceived risk of sustained deflation were to rise significantly.

Another notable feature of the recovery to-date in the major industrialised economies has been that private investment has continued to decline, especially in the business sector. If the recovery is to be soundly based, investment must revive. Economic fundamentals have begun to improve, with greater stability of sales, rising corporate profits and lower nominal interest rates helping to improve cash flow. Yet excess capacity undoubtedly still remains in some industries and any revival may be slower than in the past.

3. Prospects for the EU and Euro Area Economies

Against the backdrop of the uncertain international recovery, the prospects for the Euro area and broader EU economy are somewhat mixed. Output is expected to grow modestly, price inflation is expected to diminish, unemployment is expected to rise somewhat, the trade position is forecast to deteriorate along with currency appreciation and the short term prospects are for lower interest rates.

Recovery in the Euro area appears to be lagging behind that in North America and the smaller Asian economies, largely as a result of continued weakness in final domestic demand. Core inflation in the Euro area has remained stubbornly high, at over 2 per cent per annum, since the start of this year, helping to prevent the ECB from reducing short-term interest rates thus far. Monetary growth has also continued to exceed the medium-term reference value of 4½ per cent per annum specified by the ECB. In these circumstances it has been understandably difficult for the ECB to lower interest rates, even though such a reduction would clearly be suitable for some member states. However, the appreciation of the nominal euro effective exchange rate since the spring of this year should help to reduce inflationary pressures. This should create an opportunity for the ECB to lower rates, and we expect the Euro area interest rate to decline to 2.75 per cent by the start of 2003 and remain at this level throughout next year.

Clear signs of a recovery in the Euro area have been slow to emerge. Persistent falls in investment are largely responsible for this weakness, while the recovery in external demand has progressed more gradually than elsewhere. In Table 1 we forecast GDP growth in 2002 of 1 per cent for the Euro area and 1.1 per cent for the EU. The outlook for GDP growth in 2003 in the Euro area is 1.6 per cent and 1.9 per cent for 2004. The private consumption deflator growth in the Euro area is forecast to decline from 2.2 per cent in 2002 to 1.4 per cent in 2003 and 0.8 per cent in 2004. In the broader EU economy the decline in the private consumption deflator growth is less pronounced from 1.9 per cent in 2002 to 1.5 per cent in 2003 to 1.3 per cent in 2004.

The larger European economies are forecast to experience increased output growth in the next two years as set out in Table 1. The German economy is expected to grow by 0.4 per cent in 2002 and by 1.3 per cent in 2003 and 1.8 per cent in 2004. The Italian economy is forecast to have a similar growth pattern of 0.5 per cent in 2002, 1.4 per cent in 2003 and 1.7 per cent in 2004. The French economy is forecast to have slightly higher growth rates of 1.3 per cent in 2002, up to 1.8 per cent in 2003 and levelling out at 1.9 per cent in 2004. The UK economy is forecast to rise significantly to 3.0 per cent in 2003 and 3.1 per cent in 2004 from 1.4 per cent forecast for this year.

TABLE 1. Forecast Summary (percentage change)

	GDP												World Trade (Goods)
	World	OECD	NAFTA	EU	Euro Area 12	USA	Japan	Germany	France	Italy	UK	Canada	
1999	3.6	3.1	4.2	2.8	2.8	4.1	0.8	1.9	3.2	1.6	2.4	5.4	5.9
2000	4.7	3.8	4.0	3.4	3.5	3.8	2.4	3.1	4.2	2.9	3.1	4.5	12.7
2001	2.2	0.7	0.3	1.5	1.4	0.3	-0.3	0.7	1.8	1.8	2.0	1.5	0.3
2002	2.8	1.7	2.3	1.1	1.0	2.2	-0.6	0.4	1.3	0.5	1.4	3.4	2.7
2003	3.3	2.2	2.6	1.8	1.6	2.3	1.0	1.3	1.8	1.4	3.0	3.0	6.5
2004	3.7	2.8	3.4	2.2	1.9	3.4	1.7	1.8	1.9	1.7	3.1	3.0	8.3

TABLE 1. Forecast Summary (continued)

	Private Consumption Deflator											World Prices	
	OECD	NAFTA	EU	Euro Area	USA	Japan	Germany	France	Italy	UK	Canada	Manufac tures($)	Oil ($ per barrel)
1999	2.1	3.4	-7.1	1.2	1.6	-0.5	0.4	0.2	2.1	1.6	1.7	-2.5	17.3
2000	2.5	3.4	1.8	2.2	2.5	-1.1	1.5	1.2	2.8	0.7	2.1	-6.0	27.1
2001	2.1	2.6	2.0	2.5	2.0	-1.5	1.9	1.4	2.9	0.4	1.9	-2.0	23.5
2002	1.8	2.2	1.9	2.2	1.4	-1.4	1.4	1.6	2.4	1.0	1.7	1.8	24.8
2003	1.9	2.7	1.5	1.4	1.3	-0.7	0.9	1.1	1.6	2.3	2.3	4.6	26.5
2004	1.8	2.4	1.3	0.8	1.3	0.1	0.5	0.8	0.9	3.6	2.7	0.8	23.7

TABLE 2. Interest Rates (per cent)

	Short-term interest rates					Long-term interest rates							
	USA	Canada	Japan	Euro	UK	USA	Canada	Japan	Euro	Germany	France	Italy	UK
1999	5.3	4.9	0.2	3.0	5.5	5.6	5.6	1.8	4.7	4.5	4.6	4.7	5.1
2000	6.5	5.8	0.3	4.4	6.1	6.0	5.8	1.8	5.4	5.3	5.4	5.6	5.3
2001	3.7	3.7	0.1	4.3	5.0	5.0	5.5	1.3	5.0	4.8	4.9	5.2	4.9
2002	1.7	2.7	0.1	3.4	4.0	4.5	5.3	1.3	5.0	4.8	4.8	5.0	4.9
2003	1.3	3.4	0.1	2.9	4.0	3.7	5.3	1.2	4.7	4.4	4.4	4.6	4.5
2004	2.0	4.2	0.2	3.4	4.5	4.0	5.4	1.5	5.0	4.7	4.7	4.9	4.9
2001Q1	5.3	4.7	0.4	4.8	5.6	5.1	5.4	1.3	5.0	4.8	4.9	5.2	4.8
2001Q2	4.1	4.4	0.0	4.6	5.2	5.3	5.7	1.2	5.2	5.0	5.1	5.4	5.1
2001Q3	3.3	3.5	0.0	4.3	4.9	5.0	5.3	1.3	5.1	4.9	5.0	5.3	5.1
2001Q4	2.1	2.1	0.0	3.4	4.1	4.8	5.4	1.3	4.8	4.6	4.7	4.9	4.8
2002Q1	1.8	2.2	0.1	3.4	4.0	5.1	5.8	1.4	5.1	5.0	5.1	5.3	5.1
2002Q2	1.8	2.8	0.0	3.4	4.1	5.1	5.4	1.3	5.3	5.1	5.2	5.4	5.2
2002Q3	1.8	2.8	0.0	3.4	4.0	4.3	5.1	1.2	4.8	4.6	4.7	4.9	4.7
2002Q4	1.5	3.1	0.0	3.3	4.0	3.7	5.1	1.1	4.7	4.3	4.4	4.6	4.5
2003Q1	1.3	3.3	0.0	2.9	4.0	3.7	5.2	1.1	4.7	4.3	4.4	4.6	4.5
2003Q2	1.3	3.4	0.1	2.9	4.0	3.7	5.3	1.1	4.7	4.3	4.4	4.6	4.5
2003Q3	1.3	3.4	0.1	2.9	4.0	3.7	5.4	1.2	4.7	4.3	4.4	4.6	4.5
2003Q4	1.5	3.6	0.1	3.0	4.0	3.8	5.4	1.3	4.8	4.4	4.4	4.7	4.6

TABLE 3. Nominal Exchange Rates

	Percentage change in effective rate								per US dollar			
	US Dollar	Can Dollar	Yen	Euro	D-mark	Franc	Lira	Ster ling	Can Dollar	Yen	Euro	Ster ling
1999	-1.9	-0.7	14.2	-3.6	-1.4	-1.2	-1.5	0.0	1.49	113.7	0.939	0.618
2000	2.6	0.8	9.4	-8.5	-3.6	-3.1	-3.0	3.8	1.49	107.8	1.085	0.661
2001	5.7	-3.2	-8.3	0.3	0.3	0.3	0.2	-1.7	1.55	121.5	1.118	0.695
2002	-0.1	-2.0	-5.1	1.6	0.6	0.6	0.6	0.2	1.58	125.7	1.067	0.668
2003	-0.7	-2.6	-0.2	7.1	2.8	2.3	2.3	-3.7	1.61	123.5	0.976	0.653
2004	1.0	-2.1	1.6	3.1	1.2	1.0	1.0	-3.4	1.64	121.8	0.959	0.670
2001Q1	0.8	-0.1	-7.5	4.5	2.0	1.8	1.7	-3.0	1.53	118.1	1.084	0.686
2001Q2	2.1	-0.3	-1.8	-3.0	-1.2	-1.0	-1.0	1.7	1.54	122.6	1.146	0.704
2001Q3	-0.6	-0.5	0.3	1.2	0.5	0.3	0.4	-0.2	1.55	121.5	1.124	0.695
2001Q4	0.9	-2.2	-1.8	0.1	-0.1	0.1	0.0	0.0	1.58	123.7	1.117	0.693
2002Q1	2.1	-0.4	-6.0	-0.9	-0.3	-0.3	-0.3	0.6	1.59	132.4	1.141	0.701
2002Q2	-2.9	2.0	2.2	1.6	0.6	0.7	0.6	-1.5	1.55	126.7	1.089	0.684
2002Q3	-2.8	-1.3	3.8	2.7	1.0	0.8	0.9	0.4	1.56	119.3	1.016	0.645
2002Q4	2.0	-1.5	-3.7	0.0	0.1	0.0	0.0	1.1	1.59	124.5	1.022	0.642
2003Q1	-0.1	-0.5	0.0	2.4	0.9	0.8	0.8	-1.9	1.60	124.1	1.000	0.646
2003Q2	0.0	-0.5	0.1	1.8	0.7	0.6	0.6	-1.5	1.60	123.7	0.985	0.651
2003Q3	0.0	-0.6	0.1	1.8	0.7	0.6	0.6	-1.5	1.61	123.3	0.970	0.655
2003Q4	-0.1	-0.6	0.0	2.3	0.9	0.8	0.8	-1.9	1.62	123.0	0.950	0.660

The forecast pattern of interest rates for the EU economies are set out in Table 2. The Euro area short-term interest rate is expected to fall by 0.5 percentage points from current levels by the start of 2003. The forecast for 2004 is a reversal of the 0.5 percentage point cut to bring short-term rates in the Euro area back up to the current level of 3.25 per cent. Short-term interest rates in the UK are expected to be held constant at 4 per cent over 2003 before rising by 0.5 percentage points in 2004. The long-term interest rates are expected to fall somewhat in 2003 before returning to current levels close to 5 per cent again in 2004.

The nominal exchange rates forecasts contained in Table 3 anticipate an appreciation in the euro exchange rate during 2003 and into 2004 in terms of the nominal effective rates. The bilateral rate for the euro per US dollar is forecast to appreciate from €1.067 on average in 2002 to €0.976 in 2003 and €0.959 in 2004. The nominal effective exchange rate for the UK is expected to depreciate on average over the next two years. The appreciation in the nominal effective exchange rates, which account for trade patterns, for the major Euro area economies is forecast to be much less significant than for the area as a whole. The real effective exchange rate, which takes inflation into account, is forecast to bring currency appreciation for the Euro area and its major economies while the UK is expected to experience depreciation.

TABLE 4. Real Effective Exchange Rates (1994=100)

	USA	Canada	Japan	Euro	Germany	France	Italy	Spain	UK
1998	115.3	92.7	78.4	96.4	96.2	97.2	106.0	99.7	120.5
1999	112.0	92.0	87.7	92.3	93.7	94.9	105.4	99.6	120.9
2000	115.2	92.5	92.5	84.4	89.6	91.1	103.1	98.0	123.6
2001	121.9	89.5	81.6	85.9	89.6	90.6	104.2	99.3	119.2
2002	121.4	88.0	74.9	88.0	89.6	90.9	105.5	101.6	118.5
2003	119.2	86.6	72.9	94.0	91.5	92.7	108.2	104.6	115.2
2004	119.4	85.9	72.9	95.3	91.7	93.2	108.9	105.3	114.1
2000Q1	111.8	93.8	92.1	86.8	91.0	92.4	103.7	98.3	125.3
2000Q2	114.5	92.5	93.5	84.5	89.6	91.3	103.2	97.8	123.9
2000Q3	115.6	92.8	92.5	83.7	89.3	90.7	103.0	97.7	121.9
2000Q4	118.9	90.7	91.9	82.5	88.6	90.0	102.6	98.0	123.1
2001Q1	120.5	89.9	84.1	86.9	90.3	91.1	104.4	99.4	118.4
2001Q2	122.7	90.3	81.7	84.6	89.0	90.3	103.5	98.5	119.8
2001Q3	121.7	90.0	81.4	85.9	89.5	90.6	104.2	99.4	119.6
2001Q4	123.0	87.6	79.3	86.3	89.5	90.4	104.6	99.8	119.1
2002Q1	125.2	87.6	73.9	85.7	89.1	90.2	104.1	99.8	119.5
2002Q2	121.8	89.5	74.9	87.2	89.3	90.6	105.3	101.2	117.2
2002Q3	118.3	88.1	77.1	89.5	89.9	91.4	106.3	102.6	117.9
2002Q4	120.2	87.0	73.7	89.6	89.9	91.4	106.4	102.7	119.3
2003Q1	119.7	86.9	73.3	91.7	90.9	92.0	107.2	103.5	117.2
2003Q2	119.4	86.7	73.1	93.2	91.3	92.4	107.9	104.3	115.9
2003Q3	119.1	86.5	72.8	94.6	91.6	92.9	108.5	104.9	114.7
2003Q4	118.7	86.3	72.5	96.3	92.2	93.5	109.3	105.6	113.2

The forecast resumption of economic growth in the Euro area over the next two years is expected to be driven by strong private sector growth, both in terms of personal consumption and investment. Table 5 shows that personal consumption growth is forecast to rise from 0.8 per cent in 2002 to 2 per cent in 2003 and 2.2 per cent in 2004. Private investment growth is expected to recover from a fall of 1.1 per cent in 2002 to rise by 3.9 per cent in 2003 and 3.8 per cent in 2004. The growth in government expenditure is expected to moderate from 1.8 per cent in 2002 to 1.5 per cent and 1.2 per cent in 2003 and 2004 respectively. The general government balance for the Euro area is forecast to improve only slightly from a deficit of 2.1 per cent of GDP in 2002 to 2 per cent in 2003 and 1.7 per cent in 2004. In terms of government debt a modest improvement is anticipated from 69.2 per cent of GDP in 2002 to 68.5 and 68.3 per cent in 2003 and 2004 respectively.

TABLE 5 Euro Area 12

	1999	2000	2001	2002	2003	2004
Consumption	3.5	2.5	1.8	0.8	2.0	2.2
Private investment	6.0	5.0	-0.9	-1.1	3.9	3.8
Government expenditure	2.3	2.0	1.8	1.8	1.5	1.2
Stockbuilding ch % of GDP	-0.2	0.0	-0.4	0.0	0.1	0.0
Total domestic demand	3.4	2.9	0.9	0.7	2.3	2.3
Export volumes	5.3	12.7	2.6	0.6	3.2	3.7
Import volumes	7.4	11.2	1.3	-0.5	5.7	4.9
GDP	2.8	3.5	1.4	1.0	1.6	1.9
Average earnings	2.4	0.9	3.9	3.6	3.3	2.8
Harmonised consumer prices	1.1	2.4	2.5	2.3	1.4	0.8
Private consumption deflator	1.2	2.2	2.5	2.2	1.4	0.8
RPDI	2.8	2.3	2.2	1.9	2.4	2.1
Unemployment, %	9.3	8.4	8.0	8.3	8.4	8.6
Govt. balance as % of GDP	-1.3	0.1	-1.5	-2.1	-2.0	-1.7
Govt. debt as % of GDP	72.0	69.5	69.1	69.2	68.5	68.3
Current account as % of GDP	-0.3	-0.9	0.0	0.6	0.4	0.3

Export volumes in the Euro area are forecast to rise from 0.6 per cent in 2002 to 3.2 per cent next year and 3.7 per cent in 2004. Import volume growth in contrast is forecast to fall by 0.5 per cent this year before rebounding to the rises of 5.7 per cent in 2003 and 4.9 per cent in 2004. The current account of the balance of payments is forecast to remain in surplus though declining from 0.6 per cent of GDP in 2002 to 0.4 per cent in 2003 to 0.3 per cent in 2004. The Harmonised Index of Consumer Prices in the Euro area is expected to declines from inflation rates of 2.3 per cent in 2002 to 1.4 per cent next year and 0.8 per cent in 2004 which is in line with the growth pattern forecast for the private consumption deflator.

The forecast for Euro area average earnings is 3.6 per cent in 2002, moderating to 3.3 per cent and 2.8 per cent in 2003 and 2004 respectively. The unemployment rate is expected to rise modestly from 8.3 per cent this year to 8.4 per cent next year and 8.6 per cent in 2004. The growth in real personal disposable income is expected to rise next year to 2.4 per cent from 1.9 per cent in 2002 and then back to 2.1 per cent growth in 2004.

Economic weakness is widespread throughout Europe, with growth in 2002 expected to be weaker than in 2001 everywhere except in the Nordic economies of Sweden, Denmark and Finland, who have been helped by the rebound in their high tech sectors. Austria is also expected to have marginally higher growth. Growth of just 0.5-1 per cent is expected this year in Belgium, Germany, Italy, the Netherlands and Portugal. Greece, Spain and Ireland continue to fare relatively well, but are still likely to experience slower growth this year than in 2001, see Table 6.

TABLE 6. Prospects For Europe

	GDP Growth				
	2000	2001	2002	2003	2004
Austria	3.0	1.0	1.1	0.8	2.2
Belgium	4.0	1.0	0.7	1.0	1.9
Denmark	3.0	1.0	1.5	2.9	3.4
Finland	6.1	0.7	1.8	2.6	3.0
France	4.2	1.8	1.3	1.8	1.9
Germany	3.1	0.7	0.4	1.3	1.8
Greece	4.1	4.1	3.6	2.6	2.4
Ireland	10.0	5.7	4.0	4.2	4.0
Italy	2.9	1.8	0.5	1.4	1.7
Netherlands	3.3	1.3	0.6	1.0	2.2
Portugal	3.6	1.7	0.7	1.5	2.2
Spain	4.2	2.7	2.0	2.1	1.8
Sweden	3.7	1.4	1.8	2.9	3.5
UK	3.1	2.0	1.4	3.0	3.1
EU	3.4	1.5	1.1	1.8	2.2
Euro Area	3.5	1.4	1.0	1.6	1.9

TABLE 7. Prospects For Europe (CONTINUED)

	Harmonised Consumer Price Inflation				
	2000	2001	2002	2003	2004
Austria	2.0	2.3	1.9	1.4	0.6
Belgium	2.6	2.4	1.6	1.0	0.5
Denmark	2.7	2.2	2.3	1.8	2.6
Finland	3.0	2.6	2.2	1.6	0.9
France	1.8	1.8	1.9	1.1	0.8
Germany	2.1	2.4	1.5	0.9	0.5
Greece	2.9	3.7	3.9	3.7	2.5
Ireland	5.2	4.0	4.4	3.7	3.0
Italy	2.6	2.4	2.4	1.6	0.9
Netherlands	2.4	5.1	3.9	1.6	1.0
Portugal	2.8	4.4	3.6	2.6	1.6
Spain	3.5	2.8	3.4	2.1	1.1
Sweden	1.3	2.7	2.0	1.9	2.6
UK	0.8	1.2	1.2	2.0	3.3
EU	2.1	2.3	2.1	1.5	1.3
Euro Area	2.4	2.5	2.3	1.4	0.8

In Table 7, the forecast for price inflation in the Euro area is to trend downwards over the next two years. In the European context the three EU countries outside the Euro area – Denmark, Sweden and the UK – are forecast to dip in 2003 and rising back up to 2004. The differential in inflation rates across the Euro area is expected to decline moderately in 2003 to 2.8 percentage points from 2.9 percentage points between the highest and lowest in 2002. The differential narrows to 2.5 percentage points in 2004.

In Table 8 the fiscal balances as a percentage of GDP improve across the Euro area over the next two years from the levels in 2002. Surpluses are forecast for the Nordic countries of Denmark, Finland, Sweden as well as Greece. The deficits forecast for the other Euro area countries are expected to be reduced both next year and into 2004, though the EU Stability and Growth Pact deficit limits are forecast to be breeched in 2002 by Portugal and Germany, with the latter forecast to do so again in 2003.

TABLE 8. Prospects For Europe (CONTINUED)

	Fiscal Balance (% of GDP)				
	2000	2001	2002	2003	2004
Austria	-1.5	0.2	-1.5	-1.5	-1.4
Belgium	0.1	0.4	-0.3	-0.1	0.2
Denmark	2.5	3.1	2.5	2.2	2.4
Finland	7.0	4.8	3.1	2.4	2.5
France	-1.4	-1.4	-2.8	-3.0	-2.7
Germany	1.2	-2.7	-3.4	-3.0	-2.6
Greece	-0.7	0.1	0.5	1.0	1.0
Ireland	4.5	1.6	-1.0	-1.2	-1.2
Italy	-0.6	-2.2	-2.2	-2.0	-1.7
Netherlands	2.2	0.1	-0.6	-0.9	-0.7
Portugal	-2.9	-4.1	-3.3	-2.3	-2.2
Spain	-0.6	-0.1	-0.3	-0.2	-0.3
Sweden	3.7	4.8	1.7	1.3	1.3
UK	1.6	0.8	-1.3	-1.6	-1.6
EU	0.6	-0.8	-1.8	-1.8	-1.6
Euro Area	0.1	-1.5	-2.1	-2.0	-1.7

The rate of unemployment is expected to rise in the Euro area this year and next. The unemployment rate for the Euro Area as a whole reached 8.3 per cent in 2002, up from 8.0 per cent a year earlier. Unemployment in Greece and Spain will remain well above the Euro area average. Only in the case of non-euro countries - Denmark and Sweden – are unemployment rates are expected to decline, see Table 9.

TABLE 9. Prospects For Europe (CONTINUED)

	Standardised Unemployment Rate (%)				
	2000	2001	2002	2003	2004
Austria	3.6	3.6	4.2	4.5	4.7
Belgium	6.9	6.6	6.9	7.1	7.3
Denmark	4.4	4.3	4.3	4.2	3.5
Finland	9.8	9.2	9.2	9.2	9.1
France	9.3	8.5	8.9	8.9	9.2
Germany	7.8	7.8	8.2	8.2	8.3
Greece	11.1	10.5	10.1	10.2	10.4
Ireland	4.3	3.9	4.4	5.0	5.3
Italy	10.4	9.4	9.0	9.0	9.0
Netherlands	2.8	2.4	2.8	3.4	3.7
Portugal	4.1	4.1	4.5	5.0	5.0
Spain	11.3	10.7	11.2	11.4	12.1
Sweden	5.8	4.9	4.9	4.7	4.5
UK	5.5	5.1	5.2	5.4	5.3
EU	7.8	7.4	7.6	7.7	7.8
Euro Area	8.4	8.0	8.3	8.4	8.6

4. Summary

The forecast from *Euroframe* is for a recovery in economic activity in Europe along with an improved international context over the next two years. The recovery is expected to be driven by domestic demand factors, particularly strong private sector investment growth boosting productivity, and coinciding with a diminution in price pressures as the euro appreciates. Macroeconomic policies are expected to remain accommodative with monetary policy remaining loose in the short-term, even with government expenditure declining modestly to underpin Euro area public finance positions given their deterioration in recent years. Although there is a forecast increase in growth prospects over the next two years, the Euro area is still under-performing its potential growth with a consequent rise, albeit modest, in the rate of unemployment.