

Economic Trends

2001/2002

The world economy: upturn continues at a reduced pace

Last year the world economy experienced stronger growth than for many years. As a result employment expanded significantly and unemployment fell perceptibly. The state of public finances also improved, and a number of countries even managed to record budget surpluses. In the second half of the year, though, the first signs of economic fatigue began to appear. The steep rise in the oil bill caused a loss of purchasing power in the industrialised countries, a loss unmatched by a corresponding rise in the demand for imports by the oil-exporting countries. Monetary policy, too, is increasingly acting as a drag on economic activity.

The cyclical slowdown is particularly pronounced in the USA, as for some time now the monetary authorities have maintained a pronounced restrictive stance, while the high external value of the dollar is increasingly exerting pressure on the competitiveness of US-American firms. Although the euro zone is still drawing benefit from the low external value of its currency, the rate of economic growth has eased down, primarily as a result of the oil-price shock. This factor is a particular burden on the members of European monetary union because of the low value of the euro. At the same time the cooling of the US economy is dampening the growth of European exports. In Japan the very strong expansion of economic activity at the start of 2000 – which was primarily a reflection of government demand-stimulation policies – has not led on to a self-sustaining upturn.

The Asian tiger economies have enjoyed a strong rise in output, although the growth prospects are no longer so favourable, as real wages have risen strongly and the countries' currencies have appreciated. As a result, some of the cost advantages that accrued following the financial crisis as a result of currency depreciation and real wage cuts – which in some cases were dramatic – have been lost. The economic slowdown in the industrialised countries can be expected to further depress growth prospects in Asia. The same is true of Latin America, particularly in view of its close trading links with the USA.

Whether global economic developments as a whole remain positive in the face of the cyclical weakening hangs largely on two factors. Firstly, it will depend on whether the US economy manages to make a soft landing. Currently the prospects of this seem good. During the 1990s US economic policy has repeatedly reacted

pragmatically to threats of a slowdown in growth, and there are signs that it is again moving from a restrictive to an expansionary stance in time. The US Federal Reserve has already indicated its willingness to cut interest rates if necessary. Although inflation is currently still substantially higher than the rate it considers acceptable in the medium term, the falling oil prices and the decline in wage growth expected as the economy cools down will both exert a dampening effect on price rises. Moreover, given the substantial budget surpluses, there is considerable scope for fiscal policy to counter the cooling of economic activity. Ongoing economic trends are, however, constrained by the still widening current account deficit, which now represents around 4.5% of GDP. If the deterioration in profitability expectations in the USA and the foreign trade deficit bolster expectations of currency depreciation, leading to a massive outflow of capital, this will create serious turbulence on the international currency markets. Thus, the core danger is not only the weakening of demand in the USA as an export market, but also the risk of a strong and sudden appreciation in the euro exchange rate. In the past there have been frequent cases of such overshooting, and this danger cannot be precluded in future. Such an overreaction by the foreign exchange markets could seriously weaken the competitiveness of firms in the euro zone. For the purposes of the prognosis, however, a steady exchange-rate trend was assumed.

The second factor on which the global economic trend depends is whether the upswing in Europe is robust enough to compensate for the declining strength of the US 'economic locomotive'. This is only possible if the domestic economic expansion in the euro zone is strengthened. Yet the current monetary policy parameters are a factor preventing a smooth transition between the locus of the forces for global economic growth. To this extent the rate of global economic growth can be expected to slow perceptibly.

Japan's difficult path out of crisis

The foundations underpinning economic recovery in Japan remain shaky. Although the economy entered the year 2000 with remarkable dynamism, the expansion was running out of steam by the summer months (cf. figure 1). According to provisional figures, annualised GDP growth in the second and third quarters was just 0.8%.¹ Recently both private consumption and exports

¹ Japanese statistics are currently subject to repeated and very pronounced revisions. The annualised rate of growth of 4% initially given for the second quarter was subsequently revised to just 0.8% (<http://www.epa.go.jp/>).

Table 1

Industrialised Countries' Real Gross Domestic Product, Consumer Prices and Unemployment Rate

	Weight in %		GDP			Consumer prices ³			Unemployment rate ⁴		
	GDP	Ger- man exports	% change on the previous year						in %		
			2000	2001	2002	2000	2001	2002	2000	2001	2002
Germany	9.2	–	3.0	2.5	2.7	2.0	1.4	1.3	8.3	7.6	7.2
France	6.2	15.3	3.1	2.5	2.6	1.8	1.4	1.3	9.6	8.7	7.8
Italy	5.1	9.9	2.7	2.5	2.5	2.5	2.0	1.7	10.5	9.8	9.5
Spain	2.6	5.9	4.0	3.1	2.9	3.5	2.9	2.7	14.2	13.2	12.5
Netherlands	1.7	8.7	3.8	3.1	3.1	2.4	2.7	2.2	2.8	2.6	2.5
Belgium	1.1	7.4	3.8	3.0	2.9	2.8	2.0	1.7	8.5	8.0	7.7
Austria	0.9	7.1	3.3	2.6	2.3	2.1	1.5	1.4	3.3	3.1	3.1
Finland	0.6	1.5	4.9	4.0	3.3	3.2	2.4	2.1	9.5	8.4	7.8
Greece	0.5	1.0	3.9	4.0	4.0	2.9	2.5	2.3	11.4	10.5	10.2
Portugal	0.5	1.5	3.3	2.9	2.8	2.6	2.2	1.9	4.0	3.7	3.5
Ireland	0.4	0.8	9.9	7.3	7.0	6.3	5.0	4.0	4.5	4.1	4.0
Luxembourg	0.1	–	8.0	5.5	5.0	3.6	2.8	2.4	2.2	2.1	2.1
EMU countries ¹	28.8	–	3.3	2.8	2.7	2.3	1.8	1.6	9.1	8.4	7.9
EMU countries excl. Germany ¹	19.6	–	3.5	2.9	2.8	2.5	2.0	1.8	9.5	8.8	8.3
EMU countries excl. Germany ²	–	59.1	3.5	2.9	2.8	2.5	2.0	1.8	–	–	–
Great Britain	6.2	11.3	3.1	2.9	2.9	1.0	1.6	1.7	5.5	5.3	5.1
Sweden	1.0	3.0	4.1	3.5	3.3	1.4	1.6	1.8	6.1	5.5	5.3
Denmark	0.8	2.2	2.5	2.2	2.3	2.9	2.4	1.9	4.8	4.6	4.5
EU ¹	36.8	–	3.3	2.8	2.8	2.1	1.8	1.7	8.4	7.8	7.3
EU excl. Germany ¹	27.7	–	3.4	2.9	2.8	2.1	1.9	1.8	8.4	7.8	7.4
EU excl. Germany ²	–	75.6	3.4	2.9	2.8	2.2	2.0	1.8	–	–	–
Switzerland	1.1	6.0	3.0	2.5	3.0	1.5	1.3	1.2	2.2	2.0	2.0
Norway	0.7	1.0	3.0	2.8	2.6	3.1	2.7	2.6	3.4	3.2	3.1
Western Europe ¹	38.6	–	3.3	2.8	2.8	2.1	1.8	1.7	8.2	7.6	7.2
USA	39.9	13.6	5.1	2.3	2.9	3.3	2.8	2.2	4.0	4.4	4.6
Canada	18.7	2.8	1.8	1.0	1.3	–0.6	–0.2	0.5	4.7	4.8	4.8
Japan	2.8	0.9	4.7	2.8	3.0	2.7	2.6	2.2	6.8	6.7	6.8
Non-European industrial countries ¹	61.4	–	4.1	1.9	2.4	3.8	4.4	2.7	4.4	4.7	4.8
Non-European industrial countries ²	–	17.3	4.5	2.1	2.7	4.5	5.0	2.8	–	–	–
Total ¹	100.0	–	3.8	2.2	2.6	2.1	1.9	1.7	6.1	6.0	5.9
Total excl. Germany ¹	90.8	–	3.8	2.2	2.6	2.1	1.9	1.7	5.8	5.8	5.7
Memo item: Total excl. Germany ²	–	100.0	3.6	2.7	2.8	2.3	2.0	1.8	–	–	–

1 Total of countries listed. Weighted by 1999 GDP; unemployment rate by 1999 labour force. — 2 Total of countries listed. Weighted by country's shares in German exports in 1999; Luxembourg's share is included under Belgium. — 3 Western Europe (excl. Switzerland): harmonised index of consumer prices. — 4 Standardised.
Sources: OECD Economic Outlook; Eurostat; National Accounts; national statistics and DIW calculations; 2000 to 2002: DIW estimate and prognosis.

have been stagnating; only investment provided a positive impulse. The investment dynamic primarily reflects modernisation measures that aim to improve the endowment with information technologies. On annual averages growth is expected to be slightly less than 2%.

According to the Tankan report (business confidence index), firms have started to revise their profit expectations downwards to a serious extent. The main factors here are the fact that deflation has still not been overcome and the cooling down of the world economy. Following renewed bankruptcies, the commercial banking sector is seriously constrained by non-performing loans.

In view of the declining economic dynamic, the Japanese government has adopted a substantial supplementary

budget; however, this will merely ensure that fiscal policy does not exert a contractionary impulse. Thus Japan remains confronted with the problem that both fiscal and monetary policy have exhausted the scope for the effective use of their traditional instruments. The central bank has not been decisive enough in creating inflationary expectations, and has thus not made a sufficient contribution to overcoming deflation.

Against this background, economic growth in 2001 is set to weaken. Unemployment will rise slightly. Prices will continue to decline somewhat: thus, the spectre of deflation has yet to be banned. As the global economy picks up in 2002 and progress is made with the required structural reforms in the banking sector, there is a chance of stabilising the economic growth trend – albeit

Table 2

Trends in GDP Components in Western Industrial Countries

Real % change on the previous year

	Private consumption			Government consumption			Gross fixed investment			Goods and services					
										Exports			Imports		
	2000	2001	2002	2000	2001	2002	2000	2001	2002	2000	2001	2002	2000	2001	2002
Germany	1.9	2.4	2.3	1.1	0.6	0.8	2.1	1.4	3.2	11.3	7.4	7.3	9.3	6.8	6.4
France	2.4	2.4	2.7	1.3	2.1	2.4	6.0	3.6	3.5	12.5	7.6	6.6	13.6	9.2	8.0
Italy	2.5	2.6	2.6	1.5	1.3	1.2	6.5	3.4	3.4	8.6	4.8	4.8	6.0	5.2	5.8
Spain	3.9	2.8	2.7	1.0	1.6	1.6	6.1	6.7	5.3	10.1	7.9	5.6	10.7	8.1	6.9
Netherlands	3.8	4.1	4.0	2.8	2.4	2.0	4.8	3.6	4.0	7.2	6.0	5.2	7.7	6.4	5.8
Belgium	3.1	2.8	2.5	1.8	1.7	1.5	3.9	5.5	4.8	11.3	6.2	5.9	10.2	6.8	6.3
Austria	3.1	2.0	1.8	1.6	1.1	1.0	4.4	3.1	2.7	8.6	5.8	5.5	8.1	5.3	5.1
Finland	3.6	3.1	3.0	1.2	1.1	1.4	3.5	5.2	4.5	8.6	7.0	5.7	9.7	6.8	7.0
Greece	3.0	3.2	3.0	0.0	0.0	0.5	8.0	7.5	8.0	7.0	6.0	7.0	6.8	5.9	6.1
Portugal	3.3	3.0	2.9	3.5	3.0	3.0	6.2	4.5	4.0	8.5	5.5	5.8	7.5	6.2	6.0
Ireland	9.1	7.4	7.0	4.5	4.4	3.4	11.0	8.6	8.0	16.2	10.3	8.0	16.3	10.7	9.0
Luxembourg	3.8	4.5	4.0	3.0	3.0	3.0	1.5	4.7	4.2	13.0	9.2	8.2	9.5	8.7	7.9
EMU countries ^{1,2}	2.7	2.7	2.7	1.6	1.4	1.6	4.6	3.4	3.8	10.8	7.0	6.3	9.9	7.4	6.6
EMU countries excl. Germany ^{1,2}	3.0	2.8	2.8	1.7	1.9	1.9	5.9	4.4	4.1	10.2	6.7	5.9	9.8	7.3	6.7
Great Britain	3.5	2.9	2.6	1.8	4.3	3.3	1.6	1.7	2.1	7.8	7.1	7.2	8.3	6.5	6.2
Sweden	5.0	3.5	3.2	-0.5	1.0	1.0	6.5	7.0	7.0	9.5	7.5	7.5	9.0	8.0	7.5
Denmark	1.0	1.3	1.5	1.0	1.5	1.5	7.0	2.0	3.0	6.5	7.0	6.5	6.0	5.0	5.5
EU ¹	2.9	2.7	2.6	1.4	1.9	1.8	4.3	3.2	3.6	10.0	6.9	6.4	9.4	7.0	6.6
EU excl. Germany ¹	3.2	2.8	2.7	1.5	2.3	2.1	5.1	3.9	3.8	9.6	6.8	6.2	9.4	7.1	6.6
Switzerland	2.0	2.0	2.1	0.2	0.5	0.5	5.5	5.0	4.0	6.0	5.0	5.5	5.0	4.5	4.5
Norway	2.5	2.6	2.5	2.0	2.0	2.0	-5.5	4.0	3.5	7.0	5.5	6.0	0.5	5.5	5.5
Western Europe ¹	2.8	2.7	2.6	1.4	1.9	1.8	4.1	3.3	3.6	9.8	6.8	6.4	9.1	6.9	6.5
USA	5.3	2.4	2.3	2.5	2.8	2.3	9.5	3.3	5.2	10.5	10.4	10.0	14.3	9.0	8.4
Canada	0.6	0.3	1.4	3.1	2.1	2.0	1.7	3.2	1.2	11.2	-0.8	5.2	8.8	5.2	6.7
Japan	3.7	3.4	3.0	2.0	2.1	2.2	11.7	4.9	5.3	10.7	4.6	5.0	12.5	5.6	6.0
Non-European industrial countries ¹	3.8	1.9	2.1	2.6	2.6	2.2	6.8	3.3	3.8	10.7	6.5	7.9	13.0	7.8	7.7
Total ¹	3.5	2.2	2.3	2.0	2.2	2.0	5.8	3.3	3.7	10.1	6.7	7.0	10.6	7.3	7.0
Total excl. Germany ¹	3.6	2.1	2.3	2.1	2.5	2.1	6.2	3.5	3.8	10.0	6.6	6.9	10.8	7.3	7.1

¹ 1999 weights on dollar basis at 1999 exchange rates (annual average); exports and imports: weighted average of the countries concerned. — ² Exports and imports incl. intra-EMU trade.

Sources: OECD Economic Outlook; Eurostat; National Accounts; national statistics and DIW calculations; 2000 to 2002: DIW estimate and prognosis.

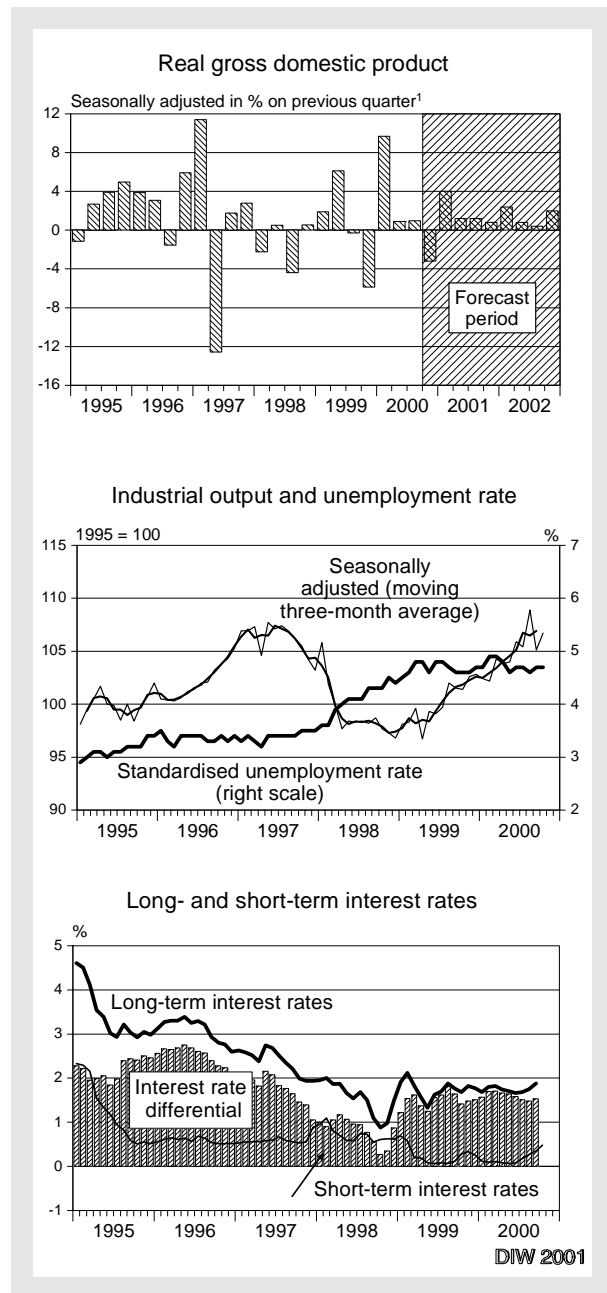
at a low rate. It remains to be seen whether the yen will once again appreciate strongly at the first signs of such an improvement, exacerbating the contractionary external economic influences.

USA: economy heading for a soft landing

In the USA the signs that the cyclical dynamic is cooling down are becoming ever more apparent. Whereas in the first two quarters of last year total output grew at annualised rates of 4.8% and 5.6%, the rate of growth declined substantially in the second half of the year (cf. figure 2). By the third quarter the annualised rate of GDP growth had fallen to 2.4%. Thus, the earlier tightening of the monetary policy stance and the demand withdrawal resulting from the rise in energy prices are

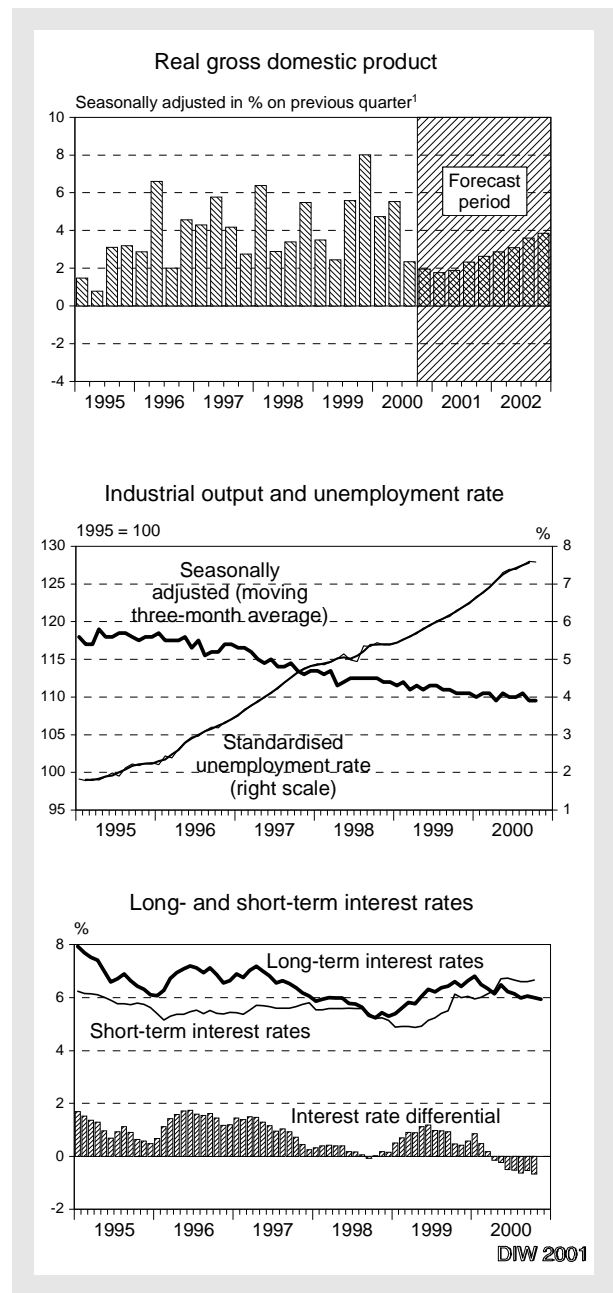
increasingly starting to bite. Corporate investment was still buoyant in the third quarter – with a growth rate of 5.6%. However, measured against the average of the six preceding quarters, when investment in equipment had risen by an annualised 16%, investment was clearly much weaker. The more restrained growth of investment activity primarily reflects the bleaker profitability prospects. In the third quarter of last year firms achieved profit growth of US-\$ 3.5 billion (1.5%), compared with profit growth of almost \$ 50 billion (25%) and \$ 22 billion (9.8%) in the first and second quarters, respectively. Profits per unit of output actually declined. Against the background of declining rates of productivity growth, the reasons for this lie, firstly, in the deterioration of the corporate cost position. At 4.3% the increase in labour costs per working hour in the summer was around one percentage point higher than in the previous year, the acceleration being largely due to the rise

Figure 1
Japan



1 At annual rate.
Sources: OECD, Main Economic Indicators; DIW calculations.

Figure 2
USA



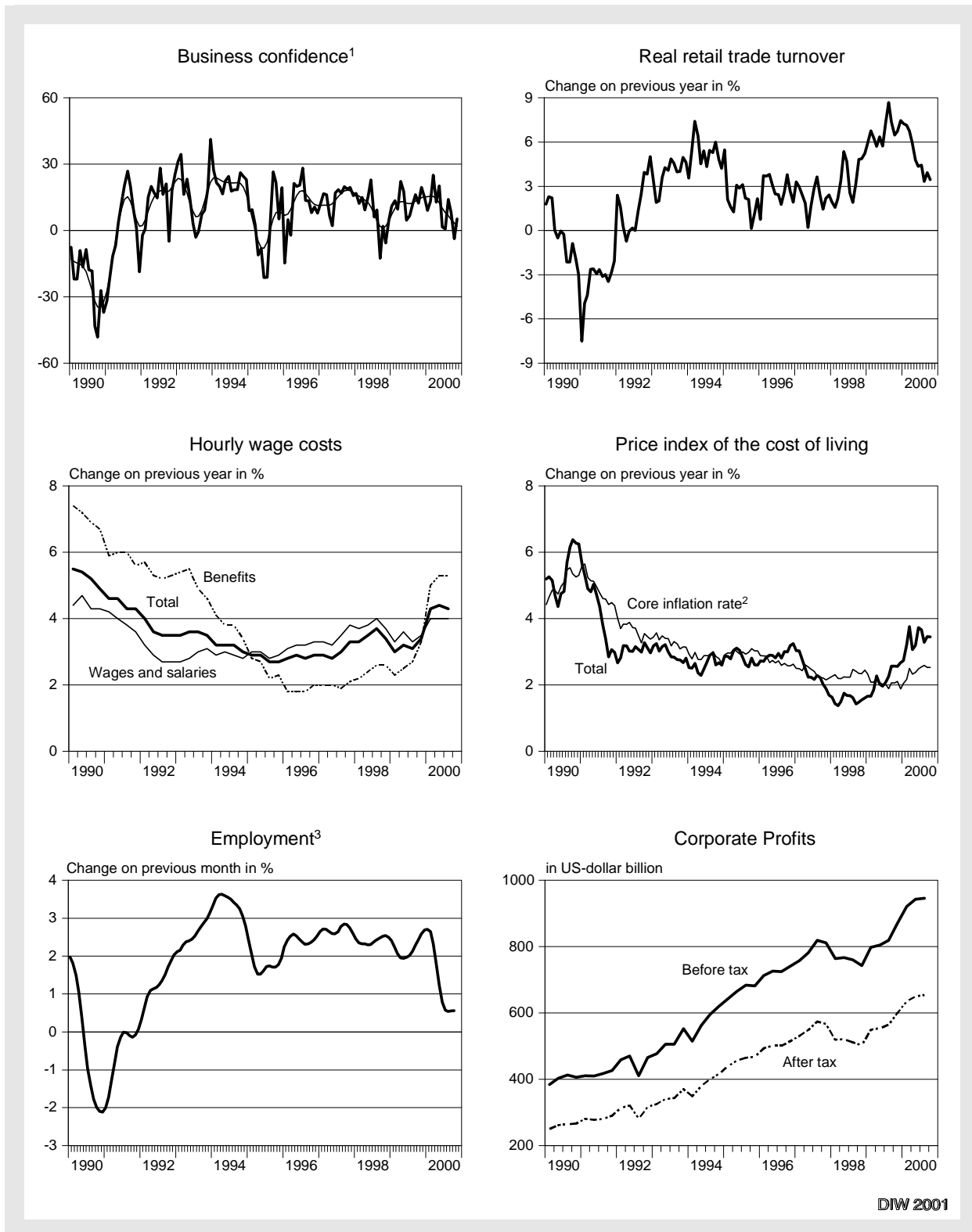
1 At annual rate.
Sources: OECD, Main Economic Indicators; DIW calculations.

in indirect labour costs. The rise in the costs of energy and external finance also served to restrain profitability growth. Firms were unable to pass on the higher costs to consumers in full. In the course of last year the price trend of domestically produced value added flattened out. The GDP price deflator rose in the third quarter of 2000 by just 1.9%, compared with 3.3% and 2.4% in the first and second quarters, respectively. The consumer

price index, on the other hand, rose at a faster rate, largely reflecting the higher oil prices.

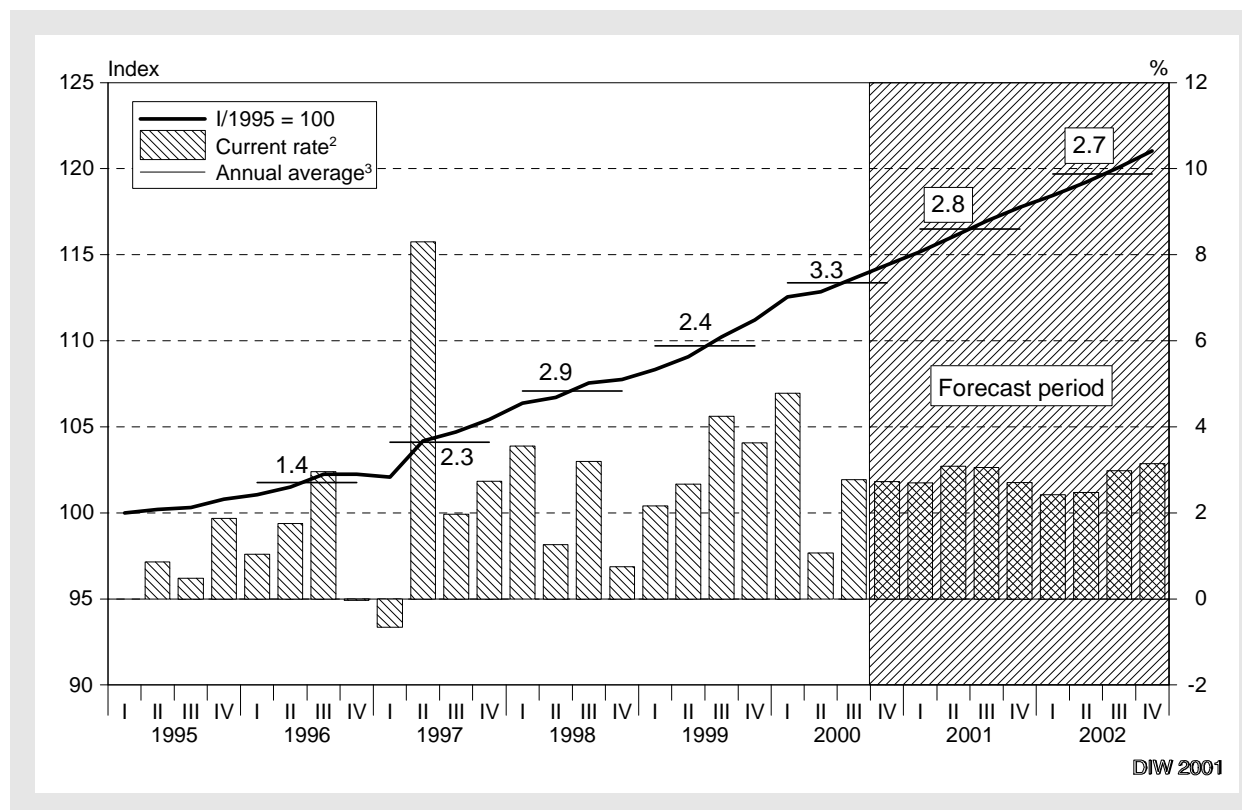
Given the dynamic growth recorded in the first half of the year, on annual averages the growth rate of real GDP in 2000 was in excess of 5%. The indicators currently available (cf. figure 3) suggest that the US economy is set to expand far less strongly. Already employment growth has virtually come to an end and, with

Figure 3
USA – Economic Development Indicators



1 Current Activity Index, Business Outlook Survey, Federal Reserve Bank of Philadelphia. — 2 Excl. energy and unprocessed food. — 3 Classified according to place of work, seasonally adjusted and rounded figures; annualised rate of growth on previous month.
Sources: Bureau of Economic Analysis (Survey of Current Business); Bureau of Labor Statistics; US Federal Reserve System; The Financial Forecast Center; DIW calculations.

Figure 4
Real GDP in the EMU Countries
 Seasonally adjusted¹



1 Adjusted with TRAMO/SEATS. — 2 Change on previous quarter in % at annual rate (right-hand scale). — 3 Change on previous year in %.
 Sources: OECD; Eurostat; DIW calculations; from fourth quarter of 2000 onwards prognosis by the DIW. The calculations and forecasts were made on the basis of the DIW's quarterly national accounts.

inflation rather high, real disposable incomes are increasingly only marginally. The deterioration on the stock markets means that the asset-wealth effects are not as strong as in past years, depressing private consumption.

Experience suggests that US economic policy will react swiftly and decisively to this trend. The Federal Reserve is expected to cut interest rates sharply in the spring, and fiscal policy has already announced major tax cuts, which will stimulate the economy. The fact that, in the course of the long upswing, the scope for fiscal policy to stimulate the economy has grown is important here. Given these policy parameters, the American economy can be expected to recover from the autumn of this year. For the coming year – provided economic policy reacts as assumed here – economic growth is expected to pick up once more. Overall, on annual averages GDP growth of around 2.3% is expected in 2001 and of about 2.9% in 2002.

This prognosis is subject to considerable uncertainties. The savings-to-income ratio might increase in both

years, for example: this would depress private consumption below the level assumed here. Moreover, it cannot be precluded that investors might withdraw en masse from the American capital market, leading to a corresponding reaction on the financial markets.

Euro zone: economic growth to weaken

In the European monetary union² economic activity increased strongly last year. Since last summer, though, the pace of the cyclical upturn has been declining somewhat (cf. figure 4). On annual averages output in 2000 increased by around 3.3%.

Domestic demand, in particular, began to run out of steam in the course of last year. The sharp rise in the price of oil and the resulting acceleration of inflation

² Alongside the initial EU-11 (Germany, France, Italy, Spain, Netherlands, Belgium, Austria, Finland, Portugal, Ireland and Luxembourg), Greece is now also considered: it joined the union on 1 January 2001.

dragged down the growth of real disposable income, despite strong employment growth. Household consumer spending lagged behind that recorded in the first half of the year: on annual averages it increased by around 2.7% in real terms. Public sector consumption continued to rise only sluggishly.

Since last summer the growth of gross fixed capital formation has been markedly weaker. This reflects the sharp contraction in the German construction industry. Excluding Germany from the figures, investment in buildings grew significantly (6%). With capacity utilisation above average, there was further strong growth in investment in equipment.

Last year foreign demand offered a strong growth impulse. In the wake of the substantial depreciation of the euro and dynamic global economic growth, euro-zone exports rose at a double-digit rate in real terms, whereas import growth was in most cases slower. As a result real net exports rose to 1.9% of GDP.

Employment rose by 2% last year. On annual averages the unemployment rate in the euro zone fell to 9.1% from 10.1% the previous year. Yet wage growth remained moderate, unit labour costs increasing by just 0.9%.

The decline in the external value of the euro and the rise in the price of oil caused inflation to accelerate in the course of last year. In the autumn of 2000 the harmonised index of consumer prices for the euro zone was 2.7% above the previous year's figure. The average annual rate of inflation was 2.3%.

This year restrictive effects will emanate from the weakening of economic growth in the USA, in particular, and also from the still restrictive impact of the monetary policy stance of the ECB. Given the expected appreciation of the euro against the US-dollar in 2001, the monetary parameters as a whole will also become restrictive. Even so, GDP growth in the euro zone is expected to reach 2.75% in both the current and the coming year, compared with 3.3% in 2000 (cf. table 3). The export trend will experience a particularly sharp slowdown, owing to the reduced foreign demand and the slight deterioration in competitiveness resulting from the expected currency appreciation.

On the other hand, positive impulses will emanate from the planned reductions in the tax burden on private households in Germany, France, Italy and the Netherlands. The increase in disposable income is likely to lead to a perceptible boost in private consumer spending in the course of the year, partially offsetting the weakening of export growth. On top of this, the restrictive effects of the rise in oil prices will recede. In both the current and the coming year private consumer spending will rise by 2.7% in real terms. Public sector consumption, though, will continue to expand only marginally,

with growth rates of 1.4% in the current and 1.6% in the coming year.

Overall, the deterioration in the prospects for exports – which will run on into 2002 – together with the restrictive impact of monetary policy, will lead to a marked decline in the rate of growth of investment in equipment. Investment in buildings will be characterised by a very gradual stabilisation in Germany and a slight weakening in the rest of the euro area. Overall the growth of fixed capital formation will fall to 3.4% this year, following 4.6% last year.

In the second half of the coming year economic growth in the euro zone will accelerate slightly. Given the swift reaction by fiscal and monetary policy assumed here, euro-zone exports will also benefit. As export prospects improve, the growth of investment in equipment will pick up once more.

Overall, economic growth in the current and the coming year will remain so strong that employment growth is expected to continue, albeit at a slightly slower rate. The unemployment rate will continue to decline: on annual average figures it is expected to be 7.9% in 2002, compared with 8.4% this year. Wage growth will remain moderate. Unit labour costs will rise slightly faster, at 1.3%, this year than in 2000; a rate of just 1.1% is expected in the coming year.

Only in Greece will cyclical trends differ significantly from those in the remainder of the euro area. As already seen in Spain, the substantial fall in interest rates resulting from the convergence process will unleash strong expansionary forces, boosting domestic demand. As a result GDP growth – which was 3.9% in

Table 3
EMU Countries: Key Forecast Figures

	1999	2000	2001	2002
	% change on the previous year			
Real GDP	2.4	3.3	2.8	2.7
Private consumption	2.7	2.7	2.7	2.7
Government consumption	1.5	1.6	1.4	1.6
Gross fixed capital formation	5.3	4.6	3.4	3.8
of which: Construction	3.6	2.6	1.9	2.5
Machinery and other equipment	7.2	6.7	4.9	5.1
External surplus/deficit ¹	1.5	1.9	1.8	1.8
Consumer prices ²	1.2	2.3	1.8	1.6
Unit labour costs ³	1.4	0.9	1.3	1.1
	% of nominal GDP			
Balance of payments	-0.1	-0.7	-0.9	-0.6
	% of labour force			
Unemployment rate ⁴	10.1	9.1	8.4	7.9

1 In % of real GDP. — 2 Harmonised index of consumer prices. — 3 Excl. Greece and Luxembourg. — 4 Standardised.

Sources: National and international statistics and forecasts; DIW calculations; 2000 to 2002: DIW estimate and prognosis.

Table 4
Public Budgets' Indicators for the EMU Countries

	Gross debt ¹					Financial balance ¹				
	1998	1999	2000	2001	2002	1998	1999	2000	2001	2002
Germany	60.7	61.1	59.3	59.1	58.1	-2.1	-1.4	-1.2	-1.8	-1.0
France	59.7	58.6	58.0	56.5	55.5	-2.7	-1.8	-1.3	-1.2	-0.5
Italy	116.2	114.9	110.5	106.0	102.5	-2.8	-1.9	-1.3	-1.0	-1.0
Spain	64.6	63.3	61.0	58.5	56.0	-2.6	-1.1	-0.3	0.1	0.2
The Netherlands	66.6	62.9	57.0	52.0	47.0	-0.7	1.0	1.1	0.5	1.5
Belgium	119.7	115.9	111.0	105.0	99.0	-0.9	-0.7	0.1	0.2	0.8
Austria	64.0	64.6	64.4	63.0	61.0	-2.3	-2.1	-1.7	-0.8	-0.5
Finland	48.7	46.6	42.5	39.0	37.0	1.3	1.9	4.2	4.3	4.8
Greece	105.5	104.6	103.5	99.5	96.5	-2.5	-1.8	-0.5	-0.2	0.2
Portugal	55.6	55.4	56.0	56.5	56.5	-2.3	-2.0	-1.6	-1.4	-1.4
Ireland	55.0	50.1	41.5	33.5	26.5	2.1	1.9	4.2	4.5	4.5
Luxembourg	6.4	6.0	5.5	5.5	5.0	3.7	4.4	5.0	4.3	3.7
EMU area ²	73.6	72.6	70.2	68.0	65.8	-2.1	-1.3	-0.8	-0.9	-0.3

¹ In % of GDP; as defined in the Maastricht Treaty. Excl. one-off receipts from the sales of UMTS licenses. — ² Total of countries. Weighted by 1999 GDP in Euro.
Sources: Eurostat; 2000 to 2002: European Commission and DIW estimate and prognosis.

2000 – will reach 4% in both the current and the coming year.

Fiscal policy restrains the downswing

Last year the overall government deficit of the euroland countries fell by half a percentage point to 0.8% of GDP (cf. table 4): when the one-off receipts from the sale of UMTS licences were included, a slight surplus was recorded. Thus, in the wake of the cyclical upturn the goals set in the stability and convergence programmes presented under the framework of the Stability and Growth Pact were, in most cases, exceeded. The fall in the deficits was the result both of the limited rise in public spending and of the boost to tax receipts.

This year will not see further progress in consolidation in a number of countries: in many cases deficits will widen or surpluses decline once more. This primarily reflects the major tax reforms planned by various member countries, whose net effect is to reduce tax burdens. Cuts in income and corporation tax are envisaged in virtually all countries; in France and Belgium indirect taxes are to be reduced; in Belgium, Germany, Italy, the Netherlands and Finland social insurance contributions are to be lowered. Public spending programmes, as in Great Britain, are not foreseen in the euro zone countries. Of quantitative importance are, in particular, the tax-cutting programmes planned in the three largest economies which, while in some cases they run on into the year 2005, will have the greatest impact in the next two years. All in all, the cuts in taxes and social contributions will primarily benefit private households, giving a significant boost to private consumption in the countries concerned. However, the expansionary stance

adopted by fiscal policy will be only temporary: as early as next year, the restrictive impact of public spending policies will once again gain the upper hand.

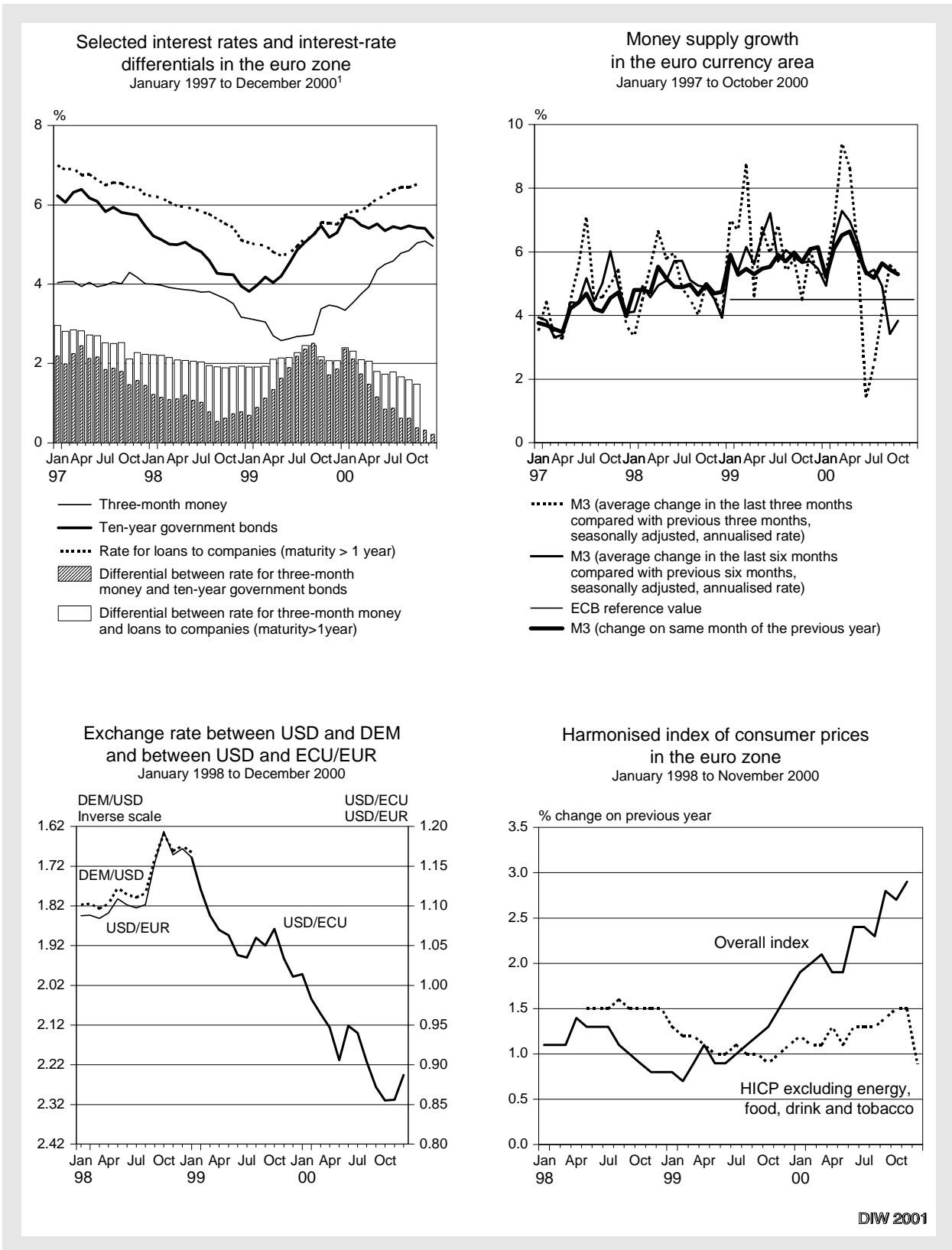
Wage trends still moderate

In spite of the significantly higher rates of inflation last year, there has been no marked acceleration of wage growth in the euro zone. In nominal terms employee compensation per worker rose by just 2.5% on the previous year, while in real terms (deflated using the consumer price index) it has been more or less constant. Unit labour costs rose only marginally (0.9%), and there was a slight decline in the wage share. This primarily reflects the wage restraint observed in the large EMU countries, especially Germany and Italy. Wage increases in France were somewhat higher. Here the agreed reduction in weekly working time was accompanied by an increase in overtime, for which bonuses are due.³ Thus, average incomes grew more rapidly. In Spain, on the other hand, wage growth has certainly accelerated. Here collective agreements contain revision clauses providing for supplementary pay bargaining if the actual inflation rate proves higher than that expected.

This year the moderate wage growth in the euro zone as a whole is expected to be maintained. In Germany most collective agreements run until the start of 2002, and in France, too, long-term settlements were reached within the context of working time reduction. In Italy the two sides of industry are expected to stick to

³ Cf. Direction de la Prévision, Ministère de l'Economie, des Finances et de l'Industrie, La situation économique en France. Comptes Prévisionnels (<http://www.finances.gouv.fr>).

Figure 5



¹ Credit interest rates are only available until October 2000.
Sources: ECB; Eurostat; DIW calculations.

the guideline agreed in 1998. In Spain, though, supplementary bargaining is again expected this year. This means that once again wage increases in Spain will be substantially above the European average. In the euro zone as a whole, though, wage trends do not pose an inflationary threat. Wage increases in those countries with strong economic growth and low unemployment will be in excess of productivity, however, so that such countries face a decline in their competitiveness. For the average of all countries, wage increases in the current year are expected to be marginally higher than last year.

Monetary parameters

Although in the summer of last year the European Central Bank (ECB) tightened its restrictive stance, the monetary parameters as a whole – allowing for the marked decline in the external value of the euro – must be seen as neutral. They are thus compatible with economic growth equal to the growth of potential output, i.e. just over 2%. They are an obstacle, however, as is described in detail in the section on monetary policy in the report on the German economy, to GDP growth above that level.

Since the start of November 1999 the ECB has increased its main refinancing rate by a total of 2.25 percentage points, to 4.75%. Three-month interest rates in the euro zone have also risen substantially, and are currently around 5%, whereas the yield on ten-year treasury bonds with a period to maturity of ten years, at around 5%, is at around the same level as a year earlier. This means that short-term interest rates are currently slightly above the long-run average figures for Germany and the USA. If all these indicators are taken as signifying a neutral policy stance, then monetary policy in the strict sense is at present exerting a slightly restrictive impact.⁴ Long-term interest rates are slightly below the long-run rate for Germany, but slightly above the US rate, and must be considered to be broadly compatible with a neutral stance. There has been a sharp narrowing of the differential between short and long-term rates in recent months; the figure is currently virtually zero and thus substantially below long-run averages. This probably reflects expectations of falling short-term interest rates in the future, which is an indicator of a restrictive impact of monetary policy.

The exchange rate of the euro, in contrast, is giving an expansionary boost to economic activity. In the past 12 months the euro has depreciated by one-eighth against the US-dollar, while the trade-weighted real external value has fallen by 6.4%.⁵ This makes exports

⁴ 'Crucial role of monetary policy in economic upturn', *Economic Bulletin*, vol. 37, no. 12, December 2000.

more price competitive and raises the price of imports, thus stimulating demand for domestic products.

The view that the monetary parameters are neutral overall is supported by money supply trends. In October 2000 the supply of M3 was 5.3% above the same month of the previous year. Seasonally adjusted and annualised, the average monthly rate of expansion in the past three months was also 5.3%; in the last six months it was just 3.8% (cf. figure 5). Given that the ECB's reference value of 4.5% for M3 growth must be considered rather low, current money supply trends must be seen as adequate, rather than ample.⁶

Given the expected weakening of economic growth, a result not least of the monetary parameters, a marked decline in inflation is likely in the course of this year. In particular, the base effect of last year's drastic rise in the price of oil will increasingly decline in importance, while the underlying inflationary dynamic will remain moderate. A dampening effect on inflation will come from unit labour costs, which, with growth rates of just over 1% in both 2001 and 2002, will remain restrained. Given the reduced pace of economic growth, the virtually unchanged capacity utilisation and the expected appreciation of the euro, the scope for firms to raise prices will remain limited. One-off effects on the price level are likely to cancel one another out in the current year. These include the rise in the rate of VAT in the Netherlands, the increase in ecological taxes in Germany and the decline in the price of oil. The rise in the HICP forecast for 2001, at 1.8%, is expected to be substantially smaller than the rise in 2000 (2.3%), with a further slight fall expected in 2002.

During the prognosis period the ECB is expected to leave its base rates more or less unchanged. On the one hand inflation will subside, while on the other the forecast rate of economic growth is higher than the rate of just over 2% that the ECB considers neutral in inflationary terms. Capital markets rates are also expected to remain broadly constant. Even so, the monetary parameters will tighten, as it is forecast that the euro will appreciate by around 10% in 2001. The decisive factor behind this appreciation will be the cooling down of the US economy, the resulting cuts in interest rates by the US Federal Reserve, and the necessary reaction to last year's exaggerated rise in the dollar on the foreign exchange markets.

'Arbeitskreis Konjunktur' in the DIW
(Study Group 'Business Cycle')

⁵ Weighted real exchange rate against the currencies of 39 partner countries, calculated using ECB figures.

⁶ See the section on monetary policy in the report on the German economy.