Economic Trends 2003/2004

World economy on fragile course

The world economic situation continues to be marked by great uncertainty. Contrary to expectations, a strengthened upturn, in the wake of the stabilising tendencies of the first half of 2002, did not materialise. Although U.S. economic policy provided strong incentives, in part also to take into account the increased uncertainty, there were some dramatic setbacks on stock markets, and financial markets continue to suffer from a strong crisis of confidence. Company risk ratings are very high, and banks are demonstrating greater restraint with regard to granting credit. To this must be added increased political uncertainty, especially speculation about a U.S. war with Iraq, which is reflected in oil price increases. Furthermore, the fear of further terrorist attacks is having a paralysing effect; in particular, it continues to hamper the worldwide tourist trade.

These factors are making both investors and consumers very insecure and have dampened their spending tendencies. Investment activity in particular has still not recovered from the previous year's recession. Consequently, on an annual average, a fall was recorded almost without exception in the large industrialised countries (cf. tables 1 and 2).

The worldwide crisis of confidence has affected the different regions in different ways, however. In Europe, the economy is growing only slowly; in Japan, the recession has been overcome, but deflation continues; in South America, the crisis is proving persistent. By contrast, the United States and South-East Asia are demonstrating trends toward economic recovery, which provides hope for an improvement in the economic situation in the rest of the world – even if it is only gradual.

The U.S.'s expansionary economic policy could become noticeable in an acceleration of economic production during the course of this year. This will also spread to Europe. Here, however, recovery will be halting, since no noticeable incentives, other than those generated by exports, are anticipated. In Europe, economic policy, i.e., monetary policy, will react to the cyclical pressures with much greater restraint than in the United States.

Those who trust that, as so often, the United States will be the engine behind the world economy in the upturn should keep their optimism in check. This engine will run more slowly than even in the late 1990s. In any case, the U.S.'s current account deficit will continue to recover even with slow growth. The threat here is that the strong but relatively steady devaluation of the U.S. dollar could be replaced by a drastic slump of the dollar rate. This would immediately massively restrict exports to and stimulate imports from the United States. Even in the medium term, such a negative effect could arise if the United States, in the face of its rapid dollar devaluation, were to veer off its expansionary course.

The inflationary tendencies, which, following the most recent oil price shock, were much less pronounced than previously, have been largely overcome. Given the long-lasting cyclical weakness, some countries may have to fear deflation. All this shows that it is not yet possible to speak of a worldwide economic recovery on a firm footing. Although a revival is becoming apparent, the risks remain high. In the forecasts below it should be noted that the figures for 2004 are not presented as an exact prognosis but rather to indicate trends. Given the many changes that could occur by then, these forecasts are more uncertain.

The United States: sluggish upturn

The U.S. economy has become stronger. Over the past year, it is anticipated to have increased by about 2.4% (cf. figure 1).

There are a number of overlapping developments in this context. The strong fall in private investment, which is characteristic of a weak economic phase, seems to have stopped. In particular, investments in equipment and software have been on an upward trend since mid-2002. Recently, however, private construction activity has fallen quite considerably, especially because of a pronounced weakness in industrial construction.

As a result of concerted price-slashing activities, the expansion of real private consumption was strongly marked by purchases of durable consumer goods within a short time frame. Car dealers in particular ran spectacular sales promotions with favourable financing conditions – at historically low interest rates. On an annual average for 2002, real consumption is expected to have increased by 3.1%. As such, private consumer demand remained important in supporting the U.S. economy. The labour market situation continues to be strained; the seasonally adjusted unemployment rate has remained virtually unchanged since last summer.

In the past year, exports and imports are expected to have risen substantially once again ; on an annual average, owing to the slow pace up to late 2001/early 2002, a 1% decline in exports was recorded. The devaluation of the U.S. dollar supported the revival of exports, while

Table 1

Indutrialised Countries' Real GDP, Consumer Prices and Unemployment Rate

	Weight (%)		GDP			Consumer prices[1]			Unemployment rate[2]		
			% change on the previous year						(%)		
	GDP	German exports	2002	2003	2004	2002	2003	2004	2002	2003	2004
Germany	8.0	–	0.2	0.6	1.0	1.3	1.2	1.0	8.2	8.4	8.3
France	5.6	14.9	0.9	1.5	2.3	1.9	1.4	1.3	8.8	9.0	8.8
Italy	4.7	10.1	0.4	1.5	2.2	2.6	2.0	1.8	9.0	9.3	9.1
Spain	2.5	6.0	2.0	2.4	2.8	3.6	2.8	2.6	11.3	11.6	11.0
Netherlands	1.7	8.5	0.1	0.7	1.8	4.0	2.7	1.7	2.8	3.8	4.6
Belgium	1.0	6.7	0.8	2.0	2.6	1.6	1.6	1.6	6.8	6.9	6.7
Austria	0.8	7.1	1.0	1.6	2.3	1.7	1.2	1.0	4.1	4.2	4.0
Finland	0.5	1.4	1.1	2.1	3.0	2.0	1.5	1.4	9.8	9.6	9.4
Greece	0.5	1.1	2.9	3.2	3.5	3.9	3.4	3.2	10.0	9.7	9.5
Portugal	0.5	1.4	1.4	1.0	1.7	3.7	3.0	2.4	4.5	4.8	4.5
Ireland	0.4	0.8	4.5	4.1	4.3	4.7	3.5	3.2	4.6	4.5	4.3
Luxembourg	0.1	0.6	0.5	2.0	3.5	2.0	2.1	2.1	2.3	2.5	2.2
EMU countries[3]	26.3	–	0.8	1.4	2.0	2.2	1.8	1.6	8.3	8.5	8.4
EMU countries excl. Germany[3]	18.3	–	1.0	1.7	2.4	2.6	2.0	1.8	8.3	8.6	8.4
EMU countries excl. Germany[4]	–	58.6	0.9	1.6	2.4	2.6	1.9	1.7	–	–	–
Great Britain	6.1	11.3	1.6	2.6	2.1	1.2	1.5	1.6	5.2	5.1	5.1
Sweden	0.9	2.8	1.3	2.4	2.5	1.8	1.8	1.8	5.1	4.9	4.8
Denmark	0.7	2.2	1.2	2.2	2.5	2.0	2.1	2.0	4.5	4.2	4.3
EU[3]	34.0	–	0.9	1.6	2.0	2.0	1.7	1.6	7.6	7.8	7.7
EU excl. Germany[3]	26.0	–	1.2	1.9	2.3	2.3	1.9	1.7	7.5	7.6	7.5
EU excl. Germany[4]	–	74.9	1.1	1.8	2.3	2.3	1.9	1.7	–	–	–
Switzerland	1.1	5.9	0.8	1.7	2.0	1.0	1.1	1.2	2.4	2.1	2.2
Norway	0.7	1.0	1.5	2.5	2.5	2.2	2.4	2.5	3.4	3.2	3.2
Western Europe[3]	35.8	–	1.0	1.6	2.0	2.0	1.7	1.6	7.5	7.6	7.5
USA	43.4	14.3	2.4	2.5	3.0	1.5	1.6	1.7	5.7	5.3	4.6
Japan	17.8	2.8	–0.2	1.2	1.5	–1.1	–0.6	–0.4	5.4	5.8	6.1
Canada	3.0	1.1	3.4	3.2	3.9	2.0	1.8	1.7	7.5	6.9	6.0
Non-European industrial countries[3]	64.2	–	1.7	2.2	2.6	0.8	1.0	1.1	5.8	5.6	5.1
Non-European industrial countries[4]	–	18.2	2.1	2.4	2.8	1.2	1.3	1.4	–	–	–
Total[3]	100.0	–	1.4	2.0	2.4	1.2	1.3	1.3	6.5	6.5	6.2
Total excl. Germany[3]	92.0	–	1.6	2.1	2.5	1.2	1.3	1.3	6.3	6.3	5.9
Memo item: Total weighted by exports[4]	–	100.0	1.2	1.9	2.4	2.0	1.7	1.6	–	–	–

1 Western Europe (excl. Switzerland): harmonised index of consumer prices. — 2 Standardised. — 3 Total of countries listed. GDP and consumer prices weighted by 2001 GDP in US dollars; unemployment rate weighted by 2001 labour force. — 4 Total of countries listed. Weighted by country's shares in German exports 2001.
Sources: OECD Economic Outlook; Eurostat; National Accounts; national statistics and DIW Berlin calculations; 2002 to 2004: DIW Berlin estimate and prognosis.

the high speed of expanding imports could largely be due to robust consumer demand. The development of the current account is strongly negative, with a most recent balance of −5% of nominal GDP.

Table 2

Trends in GDP Components in Western Industrial Countries

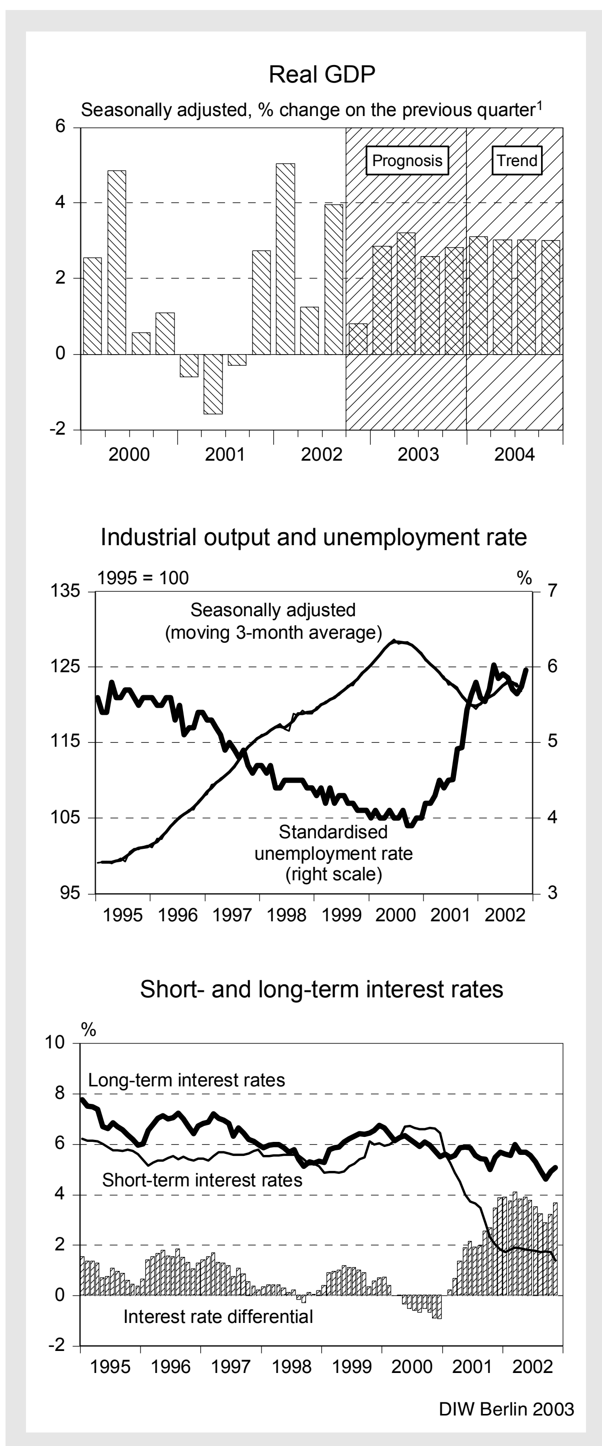
Real % change on the previous year

	Private consumption			Government consumption			Gross fixed investment			Goods and services					
										Exports			Imports		
	2002	2003	2004	2002	2003	2004	2002	2003	2004	2002	2003	2004	2002	2003	2004
Germany	–0.6	0.5	1.1	1.6	0.3	0.0	–6.5	–1.0	–0.9	2.6	5.5	5.9	–1.8	5.4	5.8
France	1.8	1.5	2.1	2.7	1.5	1.5	–0.3	0.1	3.1	1.7	5.0	5.1	1.4	6.0	6.2
Italy	0.4	1.8	2.1	1.6	1.6	1.6	–0.6	2.8	3.6	0.5	5.7	5.1	2.4	6.2	5.7
Spain	1.6	1.9	2.6	3.1	2.6	2.4	1.8	3.9	4.5	0.4	3.4	5.1	0.2	3.1	5.8
Netherlands	0.7	1.1	1.5	2.7	2.0	2.0	–3.4	0.0	3.3	–2.3	3.2	4.2	–3.0	4.4	5.0
Belgium	0.9	1.9	2.2	1.6	1.6	1.5	–3.2	0.3	4.5	–1.5	4.3	5.2	–2.0	4.3	5.5
Austria	0.7	1.6	2.3	0.2	0.3	0.4	–3.6	1.6	3.8	–1.2	5.4	6.2	–3.5	4.2	6.0
Finland	2.2	1.4	2.3	1.8	1.5	1.6	–1.2	2.7	3.7	2.0	4.0	4.8	–0.5	6.0	5.7
Greece	2.6	2.7	3.0	0.8	0.8	1.0	7.0	7.0	6.5	4.2	7.1	7.5	5.0	7.0	7.0
Portugal	1.1	1.5	1.9	0.8	0.3	0.4	–2.5	1.8	4.1	2.6	3.0	4.3	–0.3	2.9	4.9
Ireland	3.3	3.3	4.1	5.6	3.8	4.8	–1.7	3.1	4.1	4.6	4.4	4.8	2.8	4.3	5.2
Luxembourg	2.5	2.0	3.5	6.0	7.0	5.0	–2.0	2.4	3.5	–3.0	3.0	5.5	–3.5	4.0	6.5
EMU countries[1,2]	0.7	1.3	1.8	2.1	1.3	1.2	–2.3	1.0	2.4	1.0	4.8	5.4	–0.5	5.1	5.8
EMU countries excl. Germany[1,2]	1.3	1.7	2.2	2.3	1.6	1.7	–0.6	1.9	3.8	0.3	4.5	5.1	0.0	5.0	5.7
Great Britain	3.7	3.4	2.7	4.1	2.8	3.1	–4.5	5.0	4.0	–1.6	3.5	5.2	0.3	3.2	4.8
Sweden	1.5	2.3	2.4	1.0	0.8	1.0	2.0	4.0	4.5	2.0	5.0	5.5	2.0	5.0	5.5
Denmark	1.3	1.8	2.2	1.2	1.3	1.5	2.0	3.0	3.0	2.0	4.0	5.0	2.0	3.5	4.5
EU[1]	1.3	1.8	2.0	2.4	1.5	1.5	–2.4	1.7	2.7	0.7	4.6	5.4	–0.2	4.8	5.6
EU excl. Germany[1]	1.9	2.2	2.3	2.6	1.9	2.0	–1.2	2.6	3.8	0.1	4.3	5.1	0.2	4.6	5.5
Switzerland	1.5	2.1	2.2	2.0	2.0	2.0	–2.0	1.0	2.0	2.5	4.0	4.5	3.5	4.0	4.5
Norway	2.5	2.8	2.6	2.0	2.0	2.0	1.5	3.0	3.5	3.0	3.5	4.5	2.0	3.5	4.5
Western Europe[1]	1.3	1.8	2.1	2.3	1.5	1.5	–2.3	1.7	2.7	0.8	4.6	5.3	–0.1	4.7	5.5
USA	3.1	2.6	3.0	4.2	3.0	3.2	–1.7	3.8	4.9	–1.2	5.5	6.0	3.3	6.7	7.8
Japan	1.6	0.3	0.1	2.7	3.6	2.6	–6.4	–2.2	2.6	5.7	8.4	10.4	0.5	7.0	7.1
Canada	2.8	3.6	3.8	1.7	2.8	3.1	3.4	2.3	3.0	0.7	4.5	5.0	0.1	5.0	4.5
Non-European industrial countries[1]	2.7	2.1	2.3	3.6	3.2	3.0	–3.0	1.7	4.1	0.8	6.0	6.9	2.3	6.5	7.2
Total[1]	2.3	2.0	2.2	3.1	2.5	2.4	–2.8	1.7	3.6	0.8	5.1	5.9	0.9	5.5	6.2
Total excl. Germany[1]	2.5	2.1	2.3	3.2	2.7	2.6	–2.5	2.0	4.0	0.5	5.0	5.8	1.3	5.5	6.3

1 2001 weights on dollar basis at 2001 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 Berlin calculations; 2002 to 2004: DIW Berlin estimate and prognosis.

Despite a high rate of price increases, especially due to oil prices, there are currently no signs of inflationary dangers. The core inflation rate is falling slightly. With the surprisingly high productivity trend, unit labour

Figure 1
USA



1 At annual rate.
Sources: OECD; DIW Berlin calculations.

costs could even have fallen during 2002. Real disposable income fluctuated strongly, but rose again noticeably, by an annual rate of almost 3%.

In the face of the difficult economic situation, U.S. monetary and financial policy steered a clear expansionary course. Financial policy retained its spending course and accepted a definite rise in the budget deficit. Public spending expanded by 4.3% last year. The 2002 deficit is expected to have reached 1.5% of GDP; it is anticipated to be of a similar order this year. In the course of the gradual upturn, it will be gradually reduced to about 1% in 2004.

The U.S. central bank has lowered the base rate to an historically low level of 1.25%. With this, economic policy left no stone unturned in an effort to stimulate economic dynamism quickly. Consequently, there have been fears in recent months that monetary policy has reacted too strongly to the downturn. The course pursued by the central bank up to now is not unusual, however, as a simulation on the basis of previous reactions under the explicit account of stock market turbulence shows (cf. box 1).

On the whole, a stabilisation of the upward trend is to be anticipated for the forecast period. Economic performance will rise by 2.5% this year; in 2004 the increase in real GDP could be in the region of 3%. This slightly accelerating trend is due particularly to the expansionary economic policy. There will be no acceleration of inflation, with modest nominal wage increases and a strong increase in productivity. The rise in prices will be 1.6% in 2003, and 1.7% in 2004. Unemployment will stand at 5.3% in 2003, and fall to 4.6% in 2004.

However, clear risks are associated with this forecast. Thus, international economic development is marked by an expansion of the imbalance in the current account. During the forecast period, the deficit will rise to over 6%. Should the U.S. economy's prospective earnings look to be worse than anticipated, this could lead to an abrupt and sharp exchange rate adjustment; initially, this would adversely affect particularly the economic performance of the U.S.'s most important trading partner nations, and later it would fall back on the United States itself. With a clear reduction in the U.S. trade deficit compared with the rest of the world, as would be expected in such a case, one of the global economy's most important sources of demand would also dry up.

A further problem is the high level of debt of private households. The fall in share prices has noticeably wiped out wealth. At the same time, however, private households have raised their indebtedness. In the first nine months of 2002, outstanding consumer debt rose by 7%. According to the U.S. central bank, private households' debt-servicing payments in the past two years amounted to 14% of disposable income – one percentage point above the average of the second half of the 1990s. Simultaneously, interest pressures on private households eased noticeably, thereby raising available bud-

Box 1

Is the expansionary orientation of U.S. monetary policy exceptional?

Most recently, monetary policy is increasingly being assessed in terms of monetary policy rules; the most prominent example of this could well be the version proposed by John Taylor.[1]

According to this, monetary policy determines the base rate (more precisely, its deviation from a neutrally viewed real interest rate, plus the inflation rate) dependent on the gap in production and the deviation of the current inflation rate from the target inflation rate. According to the rule proposed by Taylor, the following is true for an appropriate base rate:

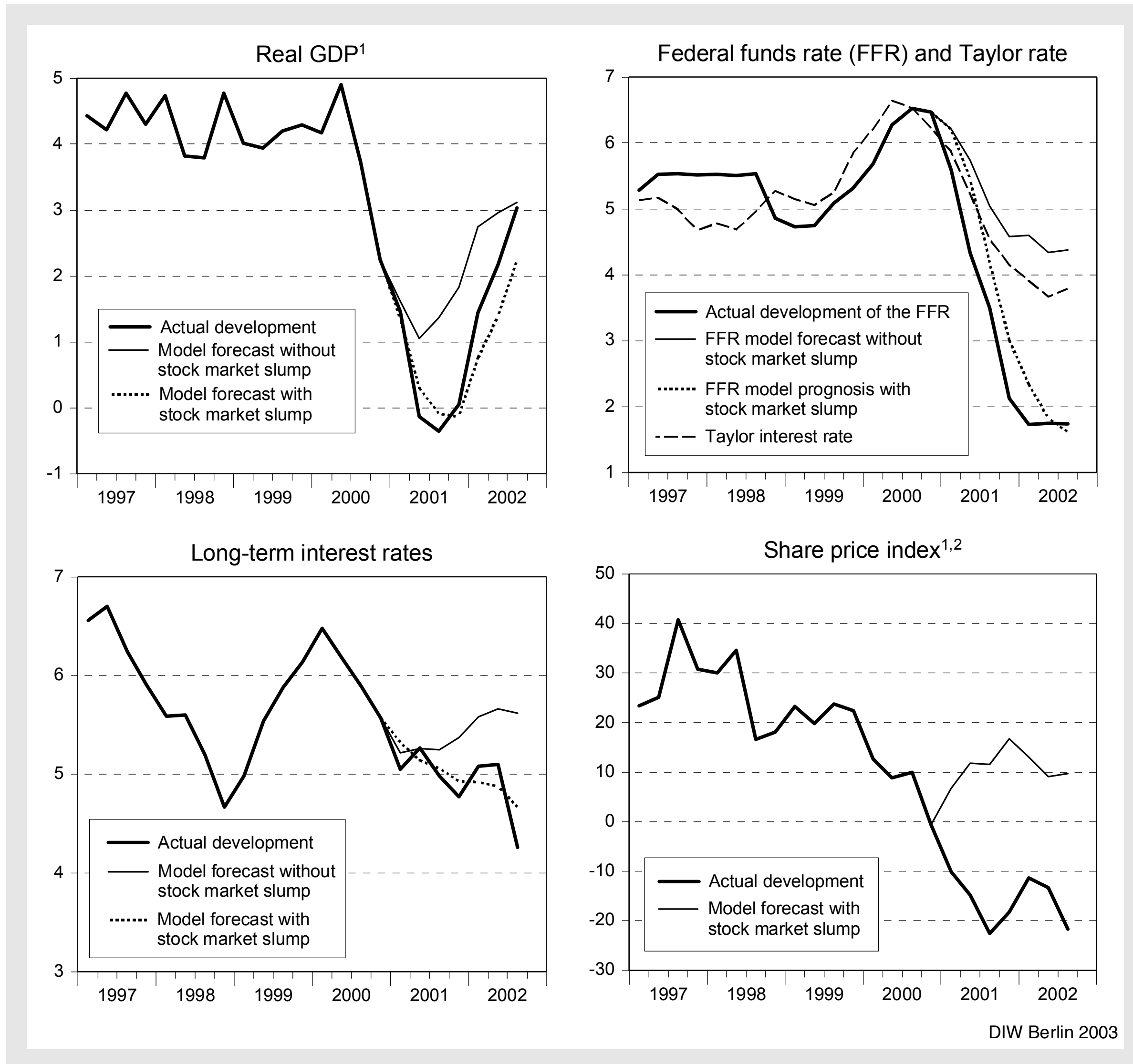
$$i = r^* + \pi + \beta_1 (y - y^*) + \beta_2 (\pi - \pi^*)$$

[1] For an overview of the debate, cf. the following homepage: http://stanford.edu/~johntayl/PolRulLink.htm

Figure

Stock Market Slump and the US Monetary Policy Reaction

Results of a VAR-supported forecast with exogenous/endogenous share price trends



1 Change in % on previous year. — Standard & poors composite index: monthly reinvested returns.
Sources: Federal Reserve Bank of St. Louis; DIW Berlin calculations and estimates.

where i is the base rate, r* is the corresponding balanced real interest rate, π and π^* are the current and balanced inflation rate, and y and y^* are GDP and production potential. In the originally proposed form, the central bank applies the same weighting to the deviations of product from potential and of actual inflation from target inflation ($\beta_1 = \beta_2 = 0.5$). One part of the figure shows the result of a standard Taylor interest rate calculation for the United States.[1] Based on the Taylor calculation, the interest rate would therefore be markedly higher than the current base rate. This begs the question as to whether the US central bank, the Federal Reserve, has not reacted exceptionally vehemently – and therefore excessively – to the weakening of the cycle and whether the cyclical upturn is not nurturing the seed of inflationary development.

It is necessary to clarify whether, on the one hand, such a strong expansionary orientation during cyclically weak phases is, indeed, something unusual. For example, the Federal Reserve also kept the base rate low for a long time, and significantly lower than the Taylor-calculated rate, during the recession of the early 1990s. On the other hand, the very low interest rate counteracts the negative effects of a strong crash in the share price index. In the past, too, the Fed reacted to share market slumps with decisive interest rate cuts. Therefore, this result should be brought into play when assessing the appropriateness of U.S. interest rate policy.

In order to evaluate whether current interest rate trends deviate from historical precedent, a vector-auto-regressive model (VAR) was specified up to the fourth quarter of 2000 (i.e. until just before the onset of the current cyclical weakness). Using a reduced-size model, an attempt was made to simultaneously explain the gap in production, inflation, short- and long-term interest rates and changes in share prices.[2] Based on the estimate for the period of the first quarter of 1955 and the last quarter of 2000, a model forecast was then established for the first quarter of 2001 to the third quarter of 2002 (described in the figure as model forecast without stock market crash). This shows that share prices were forecast incorrectly; instead of a crash, growth rates of more than 10% were actually forecast. The fall in real GDP is, according to the forecast, noticeably lower, the short-term interest rate falls only slowly, and the long-term rate actually rises.

This incorrect prognosis suggests that the trends in share prices should be treated as an exogenous variable. In this case an entirely different scenario emerges: The second model prognosis (described in the figure as model prognosis with share market crash) implies that US monetary policy, with its strong drop in interest rates, has reacted absolutely typically – measured against the historical experiences of stock market fluctuations in the post-war period. Both the development of short- and long-term interest rates and that of GDP have been predicted with remarkable accuracy. Therefore there is no indication that monetary policy has reacted excessively to the crash on stock markets.

[1] For the balanced real interest rate and the target inflation rate, values of 2% were assumed.

[2] On the demonstration of the method, cf. Walter Enders, Applied time Series Econometrics, New York, 1995. The VAR was estimated with quarterly values for the period 1955:1 to 2000:4. The production gap is defined as a deviation of actual GDP from production potential as published by the Congressional Budget Office. According to the Akaike information criterion, six delays were included in the estimate. The oil price is considered an exogenous variable in both variants of the estimate.

gets to finance this private consumption. According to the convention of U.S. statistics, interest rate payments do not form part of private consumption. When interest rate pressures ease, the freed-up financial means can be used both to expand private consumption and to save. This explains that, currently, both factors can increase.[1] However, it also means that the expansion of consumer spending cannot be sustained at this speed. With a rising level of interest, as assumed for the duration of this forecast, a dampening effect will make itself felt on private consumption through increased interest rate spending. This interest rate effect is higher the greater the indebtedness of private households.

[1] At the same time, property prices also rose, which had a positive effect on the valued wealth of private households.

Latin America: the situation remains critical

The situation in Latin America is very strained. Following the debt crisis of the 1980s and the relative stability in the 1990s, Argentina and Brazil have again reached a stage they knew well some 20 years ago: finding themselves on the brink of a debt and currency crisis and with high debt commitments in U.S. dollars.

In 2002, Argentina experienced one of the saddest chapters in its economic history: the collapse of the exchange rate system, unilaterally bound to the U.S. dollar, led to a massive upward revaluation of its foreign debt. A crisis in banking could be shored up only by freezing virtually all assets. Industrial production fell, by up to 20% compared with the previous year. After a long deflationary phase, inflation most recently stood at 50%, the real interest rate last year stood at 40% for a long time, and unemployment most recently reached 22%. Currently available indicators suggest stabilisation at a low level. The economic crisis was accompanied by a social and political crisis with a number of government changes. The underlying economic causes of this development can be found, on the one hand, in the effects resulting from the over-valuation of the exchange rate and, on the other, from the restrictions on the ability of economic policy to act that result from the accumulation of high foreign debt.[2] A sustained upward trend is not foreseeable for Argentina. International capital markets still impose a 60% risk premium on the country.

It is increasingly suspected that Brazil, too, is heading into crisis. Here, however, the problem is not so much the political orientation of the newly elected president as is generally assumed.[3] The main economic problem in Brazilas – in Argentina – is the constellation of a creeping real upward revaluation (especially in relation to the U.S. dollar) with simultaneously markedly higher real interest rates than in the United States and high government debt – a substantial amount of which is denominated in U.S. dollars. Monetary policy thus finds itself in a dilemma: if the central bank attempts to fix the exchange rate, for example to the U.S. dollar, inflation rates, for the most part higher than for the U.S. dollar, would bring about a real revaluation. The nominally fixed exchange rate can only be defended if the central bank is prepared to push through a noticeably higher real interest rate than in the anchoring country. This, however, dampens economic activity and, above all, increases the default risk of investments. If, by contrast, the central bank were to strive for a relatively low real interest rate and were to allow interest rates to fluctuate freely, its own currency would be devalued. With a high share of foreign currency commitments, the debt burden would increase, paralysing economic activity. Moreover, devaluation leads to price hikes, which would drive up domestic prices and wages and set in motion further devaluations. In the case of Brazil, there is a combination of both restrictive effects: thus, for three years now, the real interest rate has been above 10%, and the peso value of commitments denominated in U.S. dollars rises with every devaluation.

A long-term solution for Latin America presupposes a re-orientation of economic policy. In this context, three points are decisive:

- The chosen exchange rate and price fixing system must not lead to imbalanced real revaluation processes. For this, a coordination of monetary, fiscal, and wage policy is required.
- The accumulation of high debt levels in a foreign currency (for the most part in U.S. dollars) must be avoided. In this context, Chile could serve as an example; in the 1990s, this country successfully applied capital import controls.
- An international debt agreement must be negotiated to enable such countries as Argentina to make a fresh start.

Without such measures, it will be extremely difficult for the countries concerned to free themselves of the corset restricting economic policy action.

[2] Cf. 'Argentinien in der Krise'. By: Gustav A. Horn and Ulrich Fritsche. In: *Wochenbericht des DIW Berlin,* no. 12/2002, pp. 197-204.

[3] In the run-up to the presidential election, Brazil was caught up in a series of speculative attacks, for it was insinuated that the left-wing candidate, who had good prospects of winning, was planning an economic policy *volte face* aimed at excessive deficit spending and inflation, and possibly also at breaking off debt payments.

The Economic Situation in the European Union

Euro zone: brake on upturn

The economy in the euro zone remains restrained. Until the end of last year, a significant acceleration of economic production was not discernible; on an annual average, growth stood at 0.8% in real terms (cf. table 3). In general, the international economic backdrop was too unfavourable. The worldwide crisis of confidence on financial markets continued, putting pressure on investment in particular, especially since monetary policy reacted only hesitantly to the obstacles for a new upturn (cf. figure 2).

In the euro zone, little has remained of the economic dynamism of 1999/2000. The U.S. downturn dragged the euro zone with it. However, the internal economic braking effects generated by the European Central Bank (ECB), which had raised interest rates quite substantially up to October 2000, also added to this. Another factor was the oil price shock, which increased both production costs for companies and consumer prices, but without an adequately compensating revival in demand from the oil-producing countries. At the same time, however, this oil price shock was overcome quite well in the euro zone compared with previous such shocks, which had all led to drastically accelerated inflation. On the whole, the development of inflation in the euro zone is in no way cause for concern.

In the meantime, the oil price shock has subsided, the U.S. economy is on a distinct upward trend, and monetary policy has changed course in an expansionary direction – and, most recently, with even greater accentuation. Does this point to an imminent upturn? If the usual conditions prevailed, the upturn should have started last summer. However, this expectation – which the DIW Berlin also shared – was not fulfilled. Unusual pressures are therefore acting as a brake on a revival of this dynamism. Primarily, these are deficits in confidence, which are evident in all appropriate indicators. The dashing of the exaggerated hopes of returns in the technology sector, as well as worldwide political insecurity, have restrained the investment climate. This is even more the case since economic policy in the euro zone, compared with the United States, has reacted with greater restraint to these manifestations of crisis. Here, weak growth is more readily considered a structural crisis, which can only be alleviated with structural reforms.

Table 3

EMU Countries: Key Forecast Figures

	2001	2002	2003	2004
	% change on the previous year			
Real GDP	1.4	0.8	1.4	2.0
Private consumption	1.8	0.7	1.3	1.8
Government consumption	1.9	2.1	1.3	1.2
Gross fixed capital formation	–0.5	–2.3	1.0	2.4
Construction	–0.4	–1.6	–0.4	0.4
Machinery and other equipment	–0.5	–3.3	2.2	4.2
External surplus/deficit[1]	0.6	0.6	0.0	0.0
Consumer prices[2]	2.5	2.2	1.8	1.6
Unit labour costs	2.9	2.6	1.9	1.5
	% of nominal GDP			
Budget surplus/deficit[3]	–1.5	–2.3	–2.1	–1.7
Current account balance	–0.2	0.5	0.5	0.5
	% of labour force			
Unemployment rate[4]	8.0	8.3	8.5	8.4

1 Contribution to GDP growth. — 2 Harmonised index of consumer prices. — 3 Total government surplus/deficit. — 4 Standardised.
Sources: National and international statistics; DIW Berlin calculations; 2002 to 2004: DIW Berlin estimate and prognosis.

EMU economy remains weak

Private consumer spending in the euro zone has been weak. The increasingly unfavourable labour market situation acted as a brake on the expansion of disposable incomes and therefore also on consumption. Furthermore, both the excessive price increases in the wake of the introduction of the euro and the uncertainty surrounding further economic development made consumers insecure and led to restraint in purchasing.

Exports, which had fallen quite strongly for a year, have increased decisively since the summer of 2002. However, imports have also risen, so that the external surplus has increased only marginally. As such, neither consumption nor exports developed enough dynamism to keep in check the downward trend of investment in equipment and machinery, which had been on-going for about two years. Given the clear capacity under-utilisation, the reduction of interest rates by the ECB in the spring of 2001 was insufficient to revive investment activity. In the construction sector, too, the negative trend of earlier quarters continued. Only Spain, where experts have warned of a bubble on property markets for some time now, saw a dynamic expansion of investment in construction throughout last year.

With the very modest development of the economy, employment in the euro zone increased only marginally. This increase was insufficient to absorb the additional supply of workers. Thus, the unemployment rate increased from 8.1% at the beginning of the year to 8.4%. The increase in unit labour costs slowed somewhat, with a levelling out of employment dynamics toward mid-2002, but is still noticeably above 2%.

Measured against the Harmonised Consumer Price Index (HCPI), the rate of increase in prices in November 2002 stood at 2.2% over the preceding month, thus remaining virtually unchanged since May 2002. And yet, the difference between the lowest and the highest national inflation rate is about 3%.

This year, too, overall economic development will remain restrained. In the course of the gradual recovery of the world economy, slight impulses will be derived from exports. However, increasing worldwide economic activity will not be felt to the fullest extent on euro zone exports, since the revaluation of the euro worsens the international competitiveness of EMU countries and leads to a loss of market share. Exports are expected therefore to rise only slowly; imports, on the other hand, will increase more rapidly.

Domestic demand will remain weak in 2003. Private consumer spending will revive only marginally in the coming quarters. For Italy and Spain, tax cuts have been planned; Germany, meanwhile, will experience decisive hikes in taxes and other contributions. The incentives generated by foreign trade will impact only gradually on domestic demand via incomes and employment effects, so that private consumer spending will not be on an upward trend until towards the end of this year.

Against this backdrop, investment activity will, for the time being, also remain dampened. Investment in equipment and machinery will increase again this year, although the current rate will remain under 4% on an annual basis and therefore be much weaker than earlier upturns. In terms of investment in construction, no upward trend is yet in sight. Investment in this sector will virtually stagnate over the course of the year. On the whole, investment activity in the forecast period will accelerate only marginally. Although the previous interest rate decreases, as well as the further drop in the base rate expected in the first quarter, are having an effect, this is insufficient to counterbalance the many pressures.

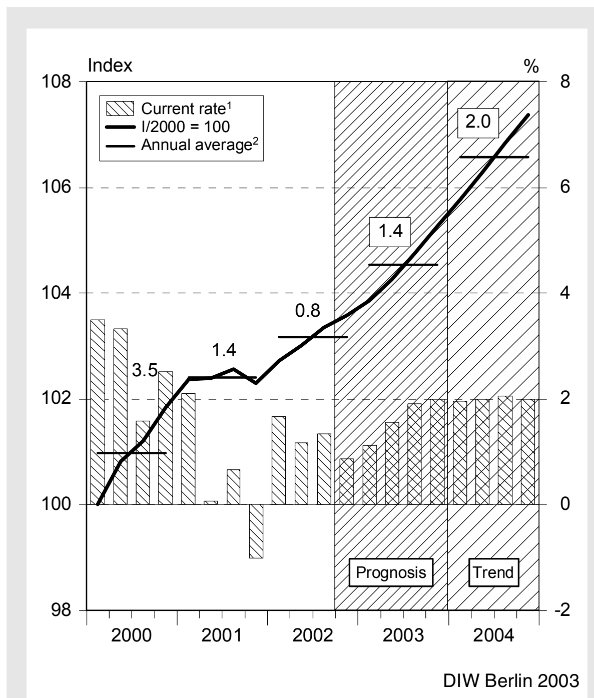
Therefore, a decisive improvement of the labour market cannot be expected this year. Employment will at best improve slightly throughout the year, while the unemployment rate will, on an annual average, rise to 8.5%, following 8.3% last year.

Buoyancy in prices will continue to slow down in the coming months. Imports, which have become cheaper as a result of the revaluation of the euro, as well as restrained demand, will ease the pressure on prices quite considerably. Furthermore, with increased productivity growth, the increase in unit labour costs will continue to slow down. On an annual average, unit labour costs in the euro zone are set to rise by 1.9%, following 2.6% last year. With this, the inflation rate will fall to below the 2% mark already in the next few months, and constitute 1.8% on an annual average. Overall economic production this year will increase by 1.4%.

Figure 2

Real GDP in the Euro Zone

Seasonally adjusted



1 Change in % on previous quarter, extrapolated on yearly rate (right-hand scale). — 2 Change in % on previous year.
Sources: Eurostat; DIW Berlin calculations.

For the coming year, too, no dynamic upturn is to be expected. Monetary policy, which has a greater expansionary orientation, will be faced with more restrictive financial policy. The world economy will generate only modest impulses – also a consequence of the strengthening euro.

On the whole, GDP in the coming year will rise by 2%. With this, an annual growth rate of above 2% will probably only be achieved in the second half of 2004. With the slightly more quickly accelerating productivity, the increase in unit labour costs will continue to fall. The rate of the price increases could therefore, with a probably strengthening euro, fall to 1.6%. Unemployment will fall to 8.3% on an annual average in 2004.

Wage policy difficulties in the euro zone

Since the introduction of the single currency, the significance of wage policy for the competitiveness of the individual countries has continued to increase, since a correction of relative prices within the euro zone can be achieved neither with interest rate policy measures nor with exchange rate changes. The need for a stability-oriented wage policy has also been underlined by the European Commission in its annual 'Economic Policy Guidelines': wage trends must be compatible with the goal of price stability; otherwise, monetary restriction would become necessary, which would impede growth and employment. In addition, wage policy, via the price trends in individual countries, has consequences for all the member states, as soon as this alters the EU average significantly.

It is therefore of some concern that, following a period of comparatively moderate wage changes in the run-up to, and at the onset of, currency union, the rises in both wages and in unit labour costs in the past two years, in the course of the oil price shock, have accelerated quite significantly. In this context, it is remarkable that the oil price shock was overcome quite differently in the individual countries.

If we observe wage trends on the basis of different indicators (cf. table 4), it becomes evident that the increase has accelerated in the euro zone in the past two years. In a phase of economic slowdown, a temporary acceleration in unit labour costs is to be expected, given the cyclically dependent slowdown in the increase in production. At the beginning of 2002, higher wage agreements were added to this.

For some time now, the increase in unit labour costs in Germany has been lower than the EU8 average. Most recently, this trend has increased. While wage increases were very close to the EU8 average in France and Italy, a particularly high upward divergence is being charted in the Netherlands. Here, a combination of a strained labour market, an increase in indirect taxes, and a strong rise in food prices has unleashed a price-wage spiral that is settling only slowly. The still stronger increase of unit labour costs to over 6% in late 2001 and early 2002 points to the fact that the labour market reaction to the strongly reined-in economic growth since early 2001 was initially very restrained. Since progress in production between the countries observed varies less strongly, the difference in unit labour costs between Germany and most of the other euro zone countries is just as strongly pronounced. Only Austria, on average, also shows below-average increases.

If one observes the standard deviation as a measure of divergence, it becomes evident that the wage increases as a result of the oil price increase have moved apart more strongly between all EU8 countries since the end of 2000. This could, however, be only a temporary phenomenon. Independently of this, one should expect a clear lagging behind of wage trends in Germany in comparison with the other EU8 countries. In the euro zone as a whole, individual wages will rise by close to 3%.

The most recent development shows, therefore, that while the heterogeneity of wage development has only increased marginally between the individual euro zone countries, wage developments in Germany clearly stand apart. Wages here remain further behind the euro zone average than ever before since the introduction of currency union. In the case of wages, Germany is currently pursuing its own path.

Financial policy: conflicting goals

In the wake of the continuing cyclical weakness, the aggregate deficit of public budgets has risen markedly. For the past year, a deficit of about 2.5% has been estimated (cf. table 5). Higher unemployment in particular has led to a fall in incomes and an increase in spending; on the spending side, only the slightly falling interest rates were able to account for some relief.

The financial policy situation in the individual countries is very different. In Finland, there continues to be a high, albeit reduced, surplus; a number of other countries show up an almost balanced budget, or one that is at least compatible with the stipulations of the Stability and Growth Pact; France and Italy are close to the 3% deficit reference value; Germany and Portugal, meanwhile, have quite definitely exceeded it. For these two countries, the European Commission has, for the first time, initiated the excessive deficit procedure contained in Article 104 of the EU Treaty.

Overall, financial policy in the euro zone may still have been expansionary last year, since the deficit rose appreciably. However, particularly with the sharper consolidation policy in Germany, there is now a more restrictive, and thereby pro-cyclical, orientation of financial policy.

The pressure for consolidation has led not only to spending cuts, which have often occurred in the investment area, but in many countries – especially in Germany and Italy – also to tax increases or to the delay of originally planned comprehensive tax cuts. A counter-example on the orientation of financial policy in the euro zone is the United Kingdom. In the early 1990s, this country at times had a deficit of up to 8% of GDP; then, as the only larger European country, it achieved noticeable budget surpluses due to strong economic growth in the second half of the 1990s – and is therefore in a situation to steer an anti-cyclical financial policy course.

Table 4

Wage trends[1] in the Euro Zone

	EU12/ EU8[2]	Belgium	Germany	Spain	France	Italy	Nether-lands	Austria	Finland	Standard deviation from EU12/EU8[2] average
Standard deviation from EU12/EU8[2] average										
1997	2.5	2.1	1.4	4.3	2.7	3.6	2.8	2.4	2.5	0.9
1998	2.3	2.5	1.6	2.2	2.1	2.7	4.4	2.6	3.6	0.9
1999	2.6	2.3	2.5	2.3	2.4	2.3	3.8	2.9	3.1	0.5
2000	3.0	2.5	2.6	1.4	4.6	2.1	4.2	2.5	4.3	1.1
2001	2.9	2.8	1.5	3.6	4.7	1.7	5.2	3.1	4.8	1.4
2001 I	3.2	1.9	2.0	3.7	4.8	2.0	5.6	3.0	5.1	1.4
II	3.0	2.6	1.8	3.8	4.8	1.2	4.9	3.2	5.0	1.4
III	2.8	3.7	1.3	3.2	4.6	1.8	5.1	3.3	4.6	1.4
IV	2.8	3.2	1.1	3.8	4.5	1.8	5.0	3.1	4.3	1.4
2002 I	2.6	3.0	1.2	3.8	3.9	2.2	3.2	3.0	3.1	0.9
II	2.7	2.6	1.1	4.1	4.0	3.0	3.1	3.0	3.7	1.0
III					3.8			3.0		
Standard deviation from EU12										
2001/1997	x	–0.1	–0.8	0.4	0.8	–0.4	1.1	0.1	0.9	x
II 2002 / I 2001	x	0.0	–1.4	0.9	1.6	–0.9	1.6	0.3	1.5	x
Remuneration per employee										
1997	1.9	3.0	0.8	2.5	2.2	4.3	2.1	1.1	1.2	1.1
1998	1.2	1.7	1.0	3.1	1.7	–1.5	3.7	2.1	3.9	1.8
1999	1.9	3.3	1.2	2.9	2.4	1.9	3.1	1.7	1.9	0.8
2000	2.5	2.5	2.0	3.6	2.1	2.8	4.2	2.3	4.1	1.0
2001	2.5	3.6	1.7	4.0	2.6	2.6	4.9	1.4	4.3	1.3
2001 I	2.6	3.6	2.0	3.4	1.6	3.0	5.0	3.5	5.5	1.5
II	2.9	4.0	1.8	4.0	2.7	2.8	5.3	3.4	5.6	1.5
III	2.8	4.3	1.4	4.7	2.7	3.5	5.1	3.4	4.6	1.4
IV	2.8	3.8	1.6	4.3	2.8	3.4	5.7	3.3	4.4	1.4
2002 I	2.8	2.9	1.5	3.8	3.2	3.8	4.7	2.4	1.4	1.1
II	2.7	3.2	1.5	3.7	2.8	3.4	4.8	2.2	2.9	1.0
III			2.3	3.6	2.7					
Average deviation from EU8										
2001/1997	x	0.6	–0.6	0.8	0.0	0.2	1.4	0.0	0.8	x
II 2002 / I 2001	x	0.9	–1.1	1.2	–0.2	0.5	2.3	0.3	1.3	x
Productivity										
1997	1.5	2.8	1.6	1.1	1.6	1.8	0.6	1.1	2.9	0.8
1998	1.2	0.8	0.8	0.7	1.9	0.9	1.6	2.9	3.2	1.0
1999	0.9	1.8	0.8	0.7	1.3	0.4	1.3	1.3	1.3	0.5
2000	1.2	2.1	1.1	1.1	1.4	0.9	1.1	2.8	3.9	1.1
2001	–0.1	–0.4	0.1	0.1	–0.2	0.1	–0.6	0.0	–0.4	0.3
2001 I	0.3	–0.2	0.4	0.0	0.3	0.4	–0.4	2.2	1.6	0.9
II	0.0	–0.1	0.0	–0.2	–0.3	0.7	–0.2	0.6	–0.7	0.4
III	0.1	–0.3	0.2	0.6	0.0	0.5	–0.8	0.3	–0.3	0.4
IV	–0.5	–1.0	0.0	0.8	–0.9	–1.0	–1.1	0.0	–2.1	0.9
2002 I	–1.1	–0.6	–1.0	0.6	–0.8	–2.4	–1.3	0.8	–2.7	1.2
II	0.1	0.6	0.8	0.6	0.2	–1.5	–0.9	1.1	2.1	1.1
III			1.7	0.4	0.6					
Average deviation from EU8										
2001/1997	x	0.1	0.1	0.2	0.1	–0.2	–0.3	0.6	0.3	x
II 2002 / I 2001	x	–0.1	0.2	0.6	–0.1	–0.4	–0.6	1.0	–0.2	x
Unit labour costs										
1997	0.4	0.2	–0.7	1.4	0.6	2.5	1.5	0.1	–1.6	1.2
1998	0.0	0.9	0.2	2.3	–0.2	–2.4	2.1	–0.7	0.7	1.5
1999	1.0	1.5	0.4	2.2	1.1	1.5	1.7	0.4	0.6	0.6
2000	1.2	0.4	1.0	2.5	0.7	1.9	3.1	–0.5	0.2	1.2
2001	2.6	4.0	1.5	3.9	2.8	2.5	5.5	1.4	4.8	1.5
2001 I	2.3	3.8	1.7	3.3	1.4	2.6	5.4	1.3	3.8	1.5
II	2.9	4.2	1.8	4.3	3.0	2.1	5.5	2.8	6.3	1.7
III	2.7	4.6	1.2	4.0	2.7	3.1	5.9	3.1	5.0	1.7
IV	3.3	4.8	1.5	3.5	3.7	4.4	6.8	3.3	6.6	1.9
2002 I	3.9	3.6	2.6	3.1	4.0	6.3	6.1	1.6	4.2	1.5
II	2.6	2.6	0.6	3.1	2.5	5.1	5.8	1.2	0.8	1.8
III			0.6	3.2	2.1					
Average deviation from EU8										
2001/1997	x	0.5	–0.7	0.7	–0.1	0.4	1.7	–0.6	0.5	x
II 2002 / I 2001	x	1.0	–1.4	0.6	–0.1	0.9	3.0	–0.8	1.5	x

1 % change on previous year. — 2 Total gross wages and salaries: EU12.
Sources: Eurostat; DIW Berlin calculations.

Table 5
Public Budget Indicators for the EMU Countries

	Gross debt[1]						Financial balance[1]					
	1998	1999	2000	2001	2002	2003	1998	1999	2000	2001	2002	2003
Germany	60.9	61.2	60.2	61.8	64.2	65.8	–2.2	–1.5	–1.4	–2.8	–3.6	–2.7
France	59.5	58.5	57.3	57.3	58.6	59.4	–2.7	–1.6	–1.3	–1.4	–2.8	–2.9
Italy	116.4	114.5	110.6	109.9	110.6	109.0	–3.1	–1.8	–1.7	–2.2	–2.6	–2.7
Spain	64.6	63.1	60.5	57.1	55.0	54.0	–2.6	–1.1	–0.7	–0.1	–0.5	–0.8
Netherlands	66.8	63.1	55.8	52.8	51.0	50.3	–0.8	0.7	1.5	0.1	–0.9	–1.2
Belgium	119.3	114.9	109.6	108.6	105.6	102.0	–0.9	–0.5	0.1	0.4	–0.3	–0.1
Austria	63.7	64.7	63.0	62.7	63.2	62.0	–2.5	–2.3	–1.9	0.2	–1.8	–1.6
Finland	48.8	46.8	44.0	43.4	42.4	42.0	1.3	1.9	7.0	4.9	3.6	3.1
Greece	105.8	105.1	106.2	107.0	105.8	106.0	–2.5	–1.9	–1.8	–1.2	–1.3	–1.1
Portugal	55.0	54.4	53.4	55.5	57.5	58.5	–2.6	–2.4	–3.3	–4.2	–3.4	–2.9
Ireland	54.9	49.3	39.3	36.7	35.3	35.0	2.4	2.1	4.4	1.6	–1.0	–1.0
Luxembourg	6.3	6.0	5.6	5.6	4.6	4.0	3.2	3.6	5.6	6.1	1.0	–1.5
EMU countries[2]	73.7	72.6	70.2	70.0	70.7	70.7	–2.2	–1.3	–0.9	–1.5	–2.4	–2.2

1 As % of gross domestic product; apportionment according to Maastricht Treaty; financial balance excluding extra revenue from the sales of mobile transmission licences. —
2 Total of countries listed. Weighted by 2001 GDP in euro.
Sources: ECB; Eurostat; European Commission; 2002 and 2003: DIW Berlin estimate and prognosis.

In the euro zone, the consolidation measures either planned, or carried out, this year will mean that the aggregate financing deficit will fall slightly – by about 0.25% – to around 2.2% of GDP. Especially the consolidation measures in Germany will make a difference here.

Monetary conditions not expansive in general

The ECB lowered the base rate by 0.5% at the beginning of December, having left this rate unchanged for more than a year. The banks' decisive refinancing rate[4] now stands at 2.75%.

The three-month interest rates had been lowered in anticipation of the interest rate policy decision of recent weeks and stood at 3.1% in late November; in December, they fell further, to 2.9% on a monthly average (cf. figure 3). They are thus 0.4% below the yearly value and at a low level both in nominal and real terms. In real terms, short-term interest rates were about 2 percentage points below the comparable long-term average value;[5] nominally these roughly correspond to the co-called Taylor interest rate.[6] The long-term interest rate, measured against the yield of 10-year government bonds, is also below a neutral level, at a nominal 4.5% and a real 2.75%, if one takes as a yardstick a comparable long-term average value and the Taylor interest rate, increased by the balanced interest rate scale between short-term and long-term interest rates. It is 0.5% lower than in the summer and 0.2% below the level before year-end. Lending rates have also fallen, although to a lesser degree. Moreover, share prices have recovered

4 This decisive monetary policy base rate is the refinancing rate, the minimum tender rate for main refinancing business.

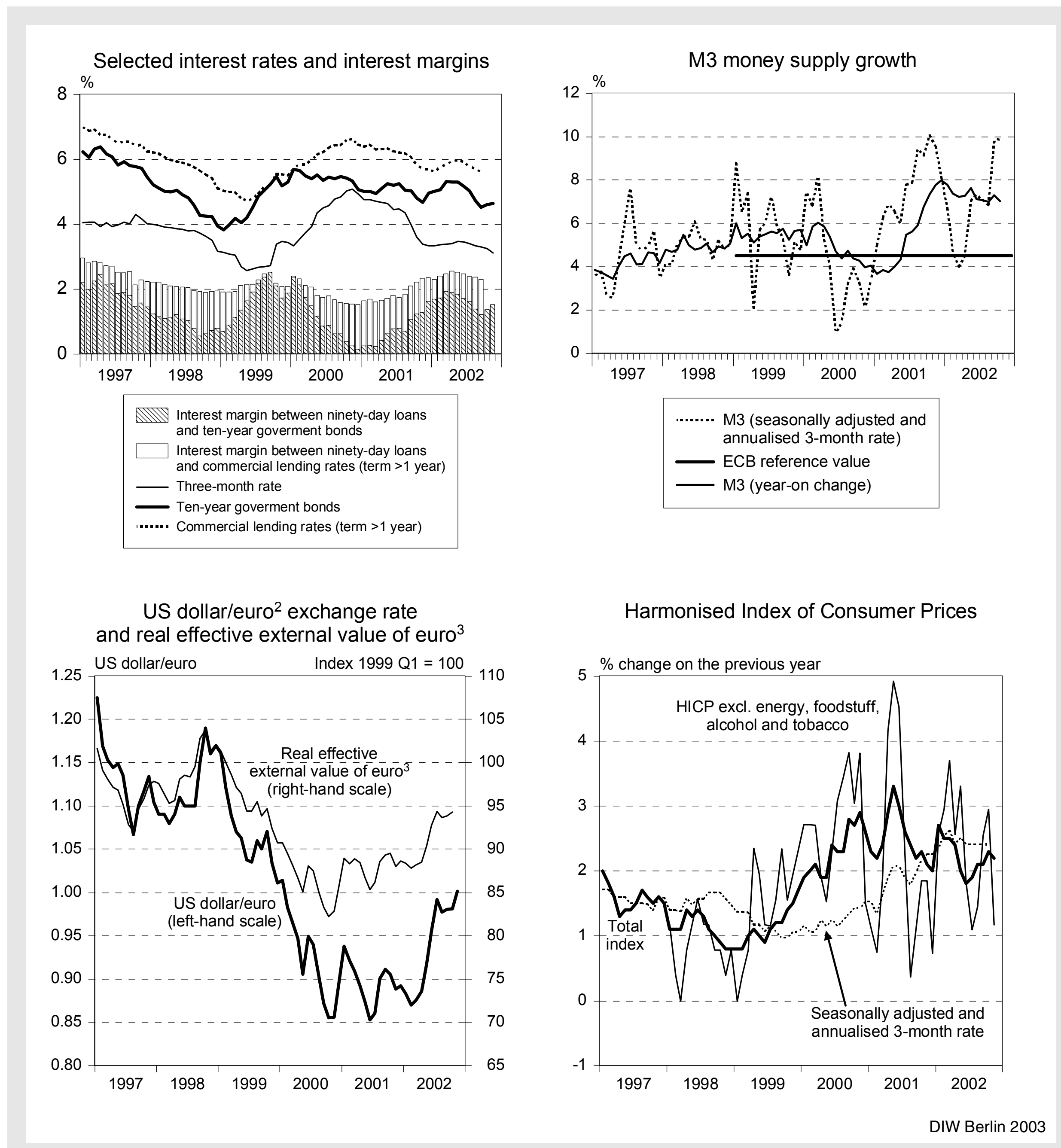
5 Cf. Geldpolitik in besonderer Verantwortung für den Aufschwung. By Silke Tober. In: *Wochenbericht des DIW Berlin,* no. 47/2000, Table 1, p. 802. For the comparison of real interest rates with long-term average values, the aggregate averages of the countries of today's euro zone are not applied, since these contain distortions through risk premiums and exchange rate expectations. Instead, those for Germany and, for additional orientation, those for the United States, are used.

6 The Taylor interest rate is derived from a monetary policy rule, into which the balancing interest rate, the gap in production and the deviation of the rate of price increases from the monetary policy inflation target. See also the section on monetary policy in this report, and also: Europäische Geldpolitik: Expansionskurs beibehalten. By Silke Tober. In: *Wochenbericht des DIW Berlin,* no. 12/2002, box 1, p. 207/8.

Figure 3

The Monetary Situation in the Euro Zone

January 1997 to December 2002

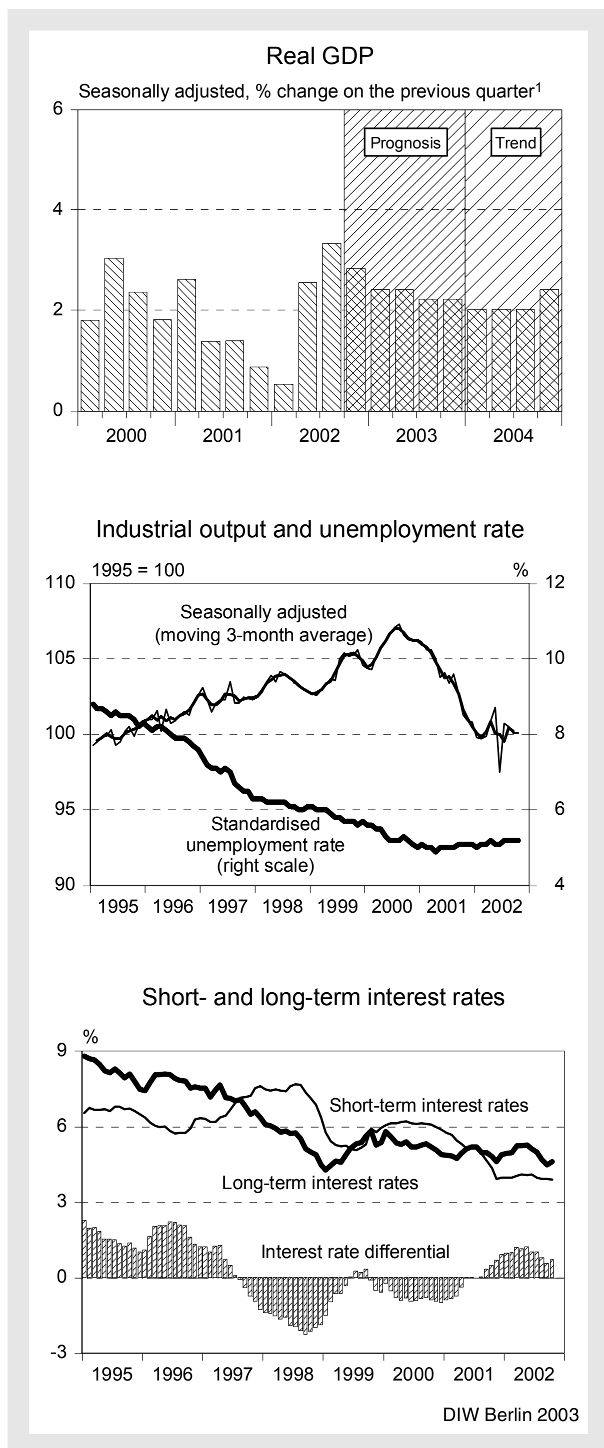


1 Up to November 2002. — 2 Preceding 1998 exchange rate between US dollar and synthetic euro. — 3 Compared with a wide group of countries, based on consumer prices.
Sources: European Central Bank; Eurostat; DIW Berlin calculations.

slightly from their low point in early October of last year, but they are at 13% and therefore still firmly below the level at the beginning of the year, and about 45% below their highest level in February 2000. Financing conditions for companies, as well as the wealth status of shareholders and therefore also of banks, have thus deteriorated noticeably.

Owing to the continuing undervaluation of the euro, the price competitiveness of goods produced in the euro zone remains high. However, the revaluation of the euro

Figure 4
Great Britain



1 At annual rate.
Sources: OECD; DIW Berlin calculations.

has reduced this competitive advantage and has therefore given a negative cyclical impulse. Compared with December 2001, the euro saw a real effective upward revaluation of 7.5%, and by 2.5% in the past six months; compared with the U.S. dollar, the revaluation, in increments of 12% and 5%, was even stronger. With this, the combined cyclical impulse generated by the conditions determined by financing conditions and exchange rates has hardly been expansive.

The expansion of the money supply could continue to firmly oversubscribe the development of demand-effective liquidity, since, as a consequence of the drop in shares since early 2000 and as a reaction to the increased uncertainty concerning future economic development, there have been considerable portfolio shifts in favour of short-term investments. The M3 money supply has now been increasing for over a year at rates clearly above the ECB reference value (cf. figure 3). In November 2002, the previous year's rate stood at 7%, and the three-month average (on annual basis) was even higher, at 9.9%. That this is not wholly a case of demand-effective liquidity is illustrated by the strong expansion of the M3 market instruments. Especially the increase of current account credit to private individuals has weakened and, at 5% compared with the same month one year earlier, was low.[7] Nevertheless, there is no threat of an acceleration of inflation from this side.

With the widening production gap in the euro zone, price increases could be further reduced. Companies' scope for price increases remains low and wage development generally moderate. In 2003, the HCPI will contribute 1.8% on average; in 2004, this figure will be 1.6%.

Against this background, a further drop in the base rate is to be anticipated in the first quarter. Share prices will stabilise, and capital market interest rates will even rise slightly in the course of the worldwide cyclical recovery up to the end of 2004. The euro could continue to increase in value in 2003.

Private consumption sustains UK's cyclical upturn

In the United Kingdom, the economy has, in the past year, managed to gain a firm footing (cf. figure 4). Following already strong economic growth in the second quarter, total output in the third quarter increased at an annual rate of 3.2%. Consequently, economic development in the United Kingdom differs significantly from that of other large European national economies. Decisive for the cyclical recovery was – and continues to be – the fact that private consumption is still increasing vigorously, most recently at rates of approximately 4%. In

[7] Current account credits to private individuals in the euro zone.

addition, the United Kingdom is the only country in which government demand, due to a multi-annual programme to improve public infrastructure, including that in the health and transport sectors – has noticeably expanded. Compared with this, fixed capital formation – primarily in equipment – is still declining; also, the current account deficit rose somewhat during the third quarter. Growth therefore continues to be unbalanced.

Strong demand of private households could continue for the time being. With wage increases that have hardly decreased, a continuing increase in employment and a still moderate increase in prices, real disposable incomes will continue to rise noticeably. However, there are fears that the property boom will not continue and that, as a consequence of a slump in prices, there will be negative income effects.

Given the differentiated cyclical development, the central bank has sat back and waited. Inflation continues to be low. Measured against the harmonised consumer price index, which recorded an increase of approximately 1.25% last year, the United Kingdom is, in fact, one of the countries with particularly low inflation. This also does not point to inflationary expectations. If the economy were to develop less favourably, the central bank would certainly have the scope to lower interest rates.

With the anticipated world economic development – especially a slight cyclical revival in the United States – and more stagnant economic development in continental Europe – the speed of expansion of overall economic production could slow somewhat this year. Economic development continues to be supported by the steady increase of real disposable incomes and government spending. By now, the budget surpluses have diminished; for 2002, there could even be a deficit of 1% – no reason, however, for the British government to change course. For 2003, investment activity might also gain a firmer footing owing to continuing strong domestic demand. For 2003, an increase of GDP of 2.6% – following a good 1.5% last year – is anticipated; next year, growth could be at around 2.1%. The unemployment rate will continue to remain low this year and next, standing at about 5%. The rise in consumer prices will accelerate slightly.

Downturn in the EU accession states

In the 10 countries that are expected to join the European Union in May 2004, growth continues to be stronger than in the EU. This difference is most pronounced in the three Baltic states, which look to have achieved economic growth of over 5% in 2002 (cf. table 6). In the other countries, meanwhile, both exports and overall economic growth have slowed as a result of the cyclical downturn in the EU. Moreover, exports were pushed down by currency revaluations in a number of these countries. Thus, growth in both the Czech Republic and Slovenia will amount to less than 2.5% this year. In the other central European countries, too, growth rates could be lower than those required for speedy convergence with the EU. Domestic demand provides the main support for this nevertheless still comparatively robust growth. On the one hand, rising real incomes support demand of private households. On the other, these countries distinguish themselves by their vibrant investment activity, which also receives impulses from the continuingly high foreign direct investment.

Price increases were successfully reduced or kept at a low level. However, some countries still did not achieve the target value stipulated in the Maastricht Treaty, which is set at 1.5% above the inflation rate of the three EU countries with the lowest rate. At present, this primarily concerns Slovenia (6.7% in November 2002) and Hungary (4.9% in October 2002). Partly, the accession countries have considerable fiscal problems, which became stronger in the course of 2002. Thus, for this year – according to Eurostat's delimitation – budget deficits in the region of 10% are expected in the Czech Republic, and of almost 9% in Hungary.

The current account deficits, on average, look to have risen slightly in 2002. A clear deterioration of the current account is anticipated in 2003 for Hungary and Estonia; here, expansion of exports had slowed, while imports continued to rise strongly, a consequence of the noticeably higher incomes of private households and the real revaluation of the currencies.

After two years of low economic growth, there are signs of a gradual recovery in Poland, the largest EU accession state. The strong drop in the growth rate, from over 5% (2000) to only about 1% (2001 and 2002), was mainly due to the fact that monetary policy was battling a stubborn price-wage spiral by means of a pronounced restrictive course. At times, real interest rates were over 12%, and the reduction of the inflation rate from over 10% at the beginning of 2000 to 1.2% in October 2002 was unprecedented; even the current account deficit has fallen. The economic downturn was marked by a fall in investment activity, with the unemployment rate rising to 20%. However, thanks to exports and private consumption, growth rates remained positive. Falling real interest rates during last year should revive investment activity and, together with strong exports, lead to a recovery of the Polish economy.

Growth in the accession states will continue to remain above the EU average during the forecast period.

Table 6

Real GDP, Consumer Prices and Unemployment Rate in the EU Accession States

	Weight GDP (%)	GDP			Consumer prices			Unemployment rate		
		% change on the previous year						(%)		
		2002	2003	2004	2002	2003	2004	2002	2003	2004
Poland	48.8	1.3	2.3	3.6	1.9	1.5	1.9	18.2	17.5	17.1
Czech Republic	15.7	1.8	1.9	3.7	1.8	1.3	1.8	9.5	9.1	8.8
Hungary	14.3	3.2	3.0	3.7	5.2	5.5	4.0	5.9	5.8	5.7
Slovakia	5.7	4.1	4.0	4.2	3.3	2.9	2.8	18.3	17.8	17.2
Slovenia	5.2	2.3	2.6	3.9	7.1	6.5	5.5	6.4	6.5	6.3
Lithuania	3.3	5.3	4.8	4.6	0.2	0.9	1.2	16.5	16.2	16.0
Cyprus	2.4	2.0	3.2	3.5	3.1	4.0	2.5	4.4	4.1	4.0
Latvia	2.1	7.2	5.0	5.2	1.6	1.5	1.5	13.2	13.0	12.5
Estonia	1.5	5.9	5.3	5.1	3.6	3.3	3.2	10.4	9.8	9.5
Malta	1.0	1.9	2.6	3.4	2.9	2.0	1.9	6.8	6.5	6.2
Total[1]	100.0	2.2	2.7	3.8	2.7	2.5	2.4	13.7	13.3	12.9
Memo item: weighted by exports[2]	–	2.4	2.6	3.8	–	–	–	–	–	–

1 Total of countries listed. Weighted by 2001 GDP in US dollars. — 2 Weighted by country's shares in German exports 2001.
Sources: National and international statistics; DIW Berlin calculations; 2002 to 2004: DIW Berlin estimate and prognosis.

Expansion could, however, be restricted by the weak development in Germany and the euro zone. A further damper on growth might also be the fact that some countries will have to consolidate their public budgets in preparation for accession to the euro zone.

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