

Economic Trends

2004/2005

The World economy

The global upswing has begun. Driven by extremely dynamic expansion in the USA, growth has accelerated world wide. Macroeconomic growth is still strong in Asia, and Japan now appears to be emerging from the stagnation that has characterised its economy for many years. Only Europe is lagging behind the rest of the world as the pace of growth remains modest in the euro zone.

The upturn was mainly brought about by the highly expansionary stance adopted some time ago and maintained until this day by economic policy makers both in the USA and in Asia. This approach was taken in an effort to counteract the numerous burdens borne by the world economy over the last three years. Not only had the oil-price shock in the industrialised countries reduced the profitability of enterprises and weakened the purchasing power of private households, but the severe fall in share prices on the stock markets was dampening investment and consumption. In addition, terrorist attacks and the war in Iraq were generating widespread uncertainty. Even though the terrorist attacks have not ceased, this worry has diminished since the end of the war in Iraq. Stock prices have also recovered to some extent. This has improved the economic climate world wide and helped the positive impulses exerted by economic policy to take effect.

However, capacities are still under-utilised and unemployment is falling only slowly. Inflation has remained moderate, and Japan is gradually overcoming its problem of deflation. The global upturn will continue this year and also spread to Europe. The large Latin American economies will emerge from their lull and will expand to a much stronger extent over the forecast period than in 2003. Argentina will recover from the effects of the financial crisis in 2001, while growth will stabilise in Brazil. Although the crisis in Venezuela, which had negative repercussions on the world oil markets, has not yet been overcome, it should no longer interfere with the oil supply. This forecast assumes that the price of oil will decrease slightly and amount to around US \$ 25 per barrel over the forecast period.

The global pace of growth will slow down to some extent in 2005 as capital market interest rates increase world wide and the boost provided by economic policy in the large industrialised countries gradually wanes. However, the expansive forces will still be strong enough to keep the economy on an upward trajectory.

Against this background, the risks for the global upturn over the forecast period have probably diminished, although political uncertainty will persist because the danger of terrorist attacks remains. However, from a world economy perspective, the risks created by the USA's pioneering role in the upturn have probably been somewhat reduced. While the degree of absorption of world market output has remained high thanks to the robust domestic demand in the USA, Europe, in particular, is still importing much less. This situation has led to a growing current account deficit in the USA, with the inherent danger of a depreciation of the US dollar. This risk has been pointed out repeatedly in the past.¹ In fact, the US dollar has depreciated against the euro by around 17% over the last 12 months. However, the total depreciation since spring 2002 amounts to 27%; in other words, the risk of a sudden severe depreciation of the US dollar has diminished significantly. Should there be a further sharp depreciation, however, the upturn could come to a halt world wide. The most recent interventions by the Japanese and Chinese central banks, for instance, show that the Asian countries are making efforts to protect themselves against an appreciation of their currencies. The European Central Bank (ECB), by contrast, appears not yet to be willing to combat the appreciation of the euro. Thus, the euro zone is at particularly high risk in this respect (cf. tables 1 and 2).

Upturn in the USA

The pace of economic growth in the USA has accelerated perceptibly (cf. figure 1). National output expanded at an annual rate of 2.1% in the first half of 2003, and grew by a hefty 8.2% in the third quarter (cf. box).

The strong growth in investment shows that the economic recovery in the USA is not simply a flash in the pan created by an extremely expansionary economic policy. A sustainable upturn in investment seems to have set in. This development is reflected by the sharp increase in productivity (by an annualised rate of 9% in the third quarter) and by high profits. However, the upturn has as yet had little effect on the labour market.² Despite the strong growth of the economy, the unemployment rate has fallen by only 0.5 percentage points –

¹ Cf. 'Economic Trends 2003/2004'. In: *DIW Economic Bulletin*, vol. 40, no. 1, January 2003.

² Contrary to the results of enterprise surveys, which show a continuing decline in employment, household surveys indicate that employment has actually been rising since summer 2003. On the discrepancy between the two sets of statistics, cf. 'The World and the German Economy in Autumn 2003'. In: *DIW Economic Bulletin*, vol. 40, no. 11, November 2003, p. 371.

Table 1

Real GDP, Consumer Prices and Unemployment Rate in Selected Countries

	Weight (%)		GDP			Consumer prices ¹			Unemployment rate ²		
			Change (%) on the previous year								
	GDP	German exports	2003	2004	2005	2003	2004	2005	2003	2004	2005
Germany	8.1	–	0.0	1.4	1.4	1.2	1.0	0.7	9.3	9.2	8.9
France	5.8	13.0	0.1	1.5	2.5	2.2	1.7	1.3	9.4	9.6	9.3
Italy	4.8	9.0	0.5	1.6	2.1	2.8	2.1	2.1	8.6	8.4	8.3
Spain	2.7	5.6	2.4	2.8	3.2	3.1	2.5	2.8	11.3	11.1	10.8
Netherlands	1.7	7.7	–0.8	0.7	1.8	2.2	1.1	1.0	3.8	5.0	5.6
Belgium	1.0	5.9	1.1	2.1	2.7	1.4	1.3	1.4	8.0	8.1	8.0
Austria	0.8	6.4	0.8	1.7	2.5	1.2	1.2	1.4	4.4	4.7	4.6
Finland	0.5	1.3	1.5	2.9	3.1	1.3	0.7	1.2	9.0	8.9	8.6
Greece	0.5	0.9	3.9	3.7	2.5	3.4	3.3	3.0	9.3	9.1	9.2
Portugal	0.5	1.3	–1.0	1.2	1.8	3.3	2.2	2.4	6.5	7.4	7.5
Ireland	0.5	0.8	1.8	3.0	4.1	4.0	2.4	2.6	4.6	4.9	4.8
Luxembourg	0.1	0.6	1.0	2.0	2.8	2.5	2.1	2.6	3.7	4.0	3.9
EMU countries ³	27.0	–	0.4	1.7	2.1	2.1	1.6	1.5	8.8	8.8	8.7
EMU countries excl. Germany ³	19.0	–	0.7	1.8	2.5	2.5	1.9	1.8	8.5	8.7	8.6
EMU countries excl. Germany ⁴	–	52.5	0.6	1.7	2.4	2.2	1.7	1.7	–	–	–
Great Britain	6.4	10.2	2.0	2.9	3.1	1.5	1.6	1.5	5.1	5.1	5.0
Sweden	1.0	2.6	1.2	2.5	3.0	2.2	1.5	1.8	5.5	5.7	5.5
Denmark	0.7	2.1	0.8	2.2	2.6	2.0	2.3	2.4	5.5	5.2	4.9
EU ³	35.1	–	0.8	1.9	2.4	2.0	1.6	1.5	8.0	8.1	7.9
EU excl. Germany ³	27.0	–	1.0	2.1	2.7	2.2	1.8	1.8	7.6	7.7	7.6
EU excl. Germany ⁴	–	67.4	0.8	1.9	2.6	2.1	1.7	1.7	–	–	–
Poland	0.7	3.1	3.4	4.1	4.2	0.8	1.7	1.5	19.6	19.2	18.7
Czech Republic	0.3	3.0	2.7	3.8	4.1	0.0	3.2	2.3	7.7	7.5	7.1
Hungary	0.3	2.1	2.8	1.9	2.1	4.8	5.4	4.1	5.6	5.9	5.7
Slovakia	0.1	0.8	3.8	4.2	4.4	9.1	7.5	5.0	16.5	14.2	13.2
Slovenia	0.1	0.5	2.4	3.0	3.5	6.3	5.9	5.2	6.4	6.2	6.1
Lithuania	0.1	0.3	10.2	7.1	6.2	–1.0	2.5	2.2	12.4	11.5	10.5
Cyprus	0.0	0.1	2.5	3.3	3.8	4.1	2.5	2.1	4.0	3.8	3.5
Latvia	0.0	0.2	7.0	6.1	6.6	2.9	3.2	3.0	12.5	12.0	11.3
Estonia	0.0	0.1	4.5	4.9	4.1	1.3	4.0	3.2	8.8	8.6	8.1
Malta	0.0	0.0	0.5	2.2	3.0	1.3	1.7	2.0	7.2	6.8	6.6
Accession states	1.6	–	3.4	3.8	3.9	2.2	3.3	2.6	14.5	14.0	13.5
EU-25	36.7	–	0.9	2.0	2.4	2.0	1.7	1.6	9.0	9.0	8.8
Switzerland	1.1	5.1	0.1	1.0	1.5	0.5	0.6	0.8	3.5	4.0	4.0
Norway	0.8	0.9	0.5	2.5	3.0	2.3	1.5	1.8	4.5	4.5	4.2
Western and central Europe ³	38.6	–	0.9	2.0	2.4	2.0	1.7	1.5	8.9	8.9	8.6
USA	42.2	12.9	3.1	4.1	3.5	2.4	2.1	2.3	6.0	5.5	5.0
Japan	16.3	2.4	2.1	1.5	1.3	–0.2	–0.2	0.0	5.3	5.4	5.5
Canada	2.9	1.1	1.8	2.9	3.2	1.8	1.7	2.2	7.8	7.7	7.4
Non-European industrial countries ³	61.4	–	2.8	3.4	2.9	1.7	1.5	1.7	5.9	5.6	5.3
Non-European industrial countries ⁴	–	16.4	2.9	3.7	3.1	2.0	1.7	2.0	–	–	–
Total ³	100.1	–	2.0	2.8	2.7	1.8	1.5	1.6	7.3	7.2	6.9
Total excl. Germany ³	91.9	–	2.2	3.0	2.8	1.8	1.6	1.7	7.1	7.0	6.7
Memo item: Total weighted by exports ⁴	–	100.0	1.4	2.3	2.7	2.0	1.8	1.8	–	–	–

1 European Union and Norway: harmonised index of consumer prices. — 2 Standardised. — 3 Total of countries listed. GDP and consumer prices weighted by 2002 GDP in US dollars; unemployment rate weighted by 2002 labour force. — 4 Total of countries listed. Weighted by country's shares in German exports 2002.

Sources: OECD Economic Outlook; Eurostat; National Accounts; national statistics and DIW Berlin calculations; 2003 to 2005: DIW Berlin estimate and prognosis.

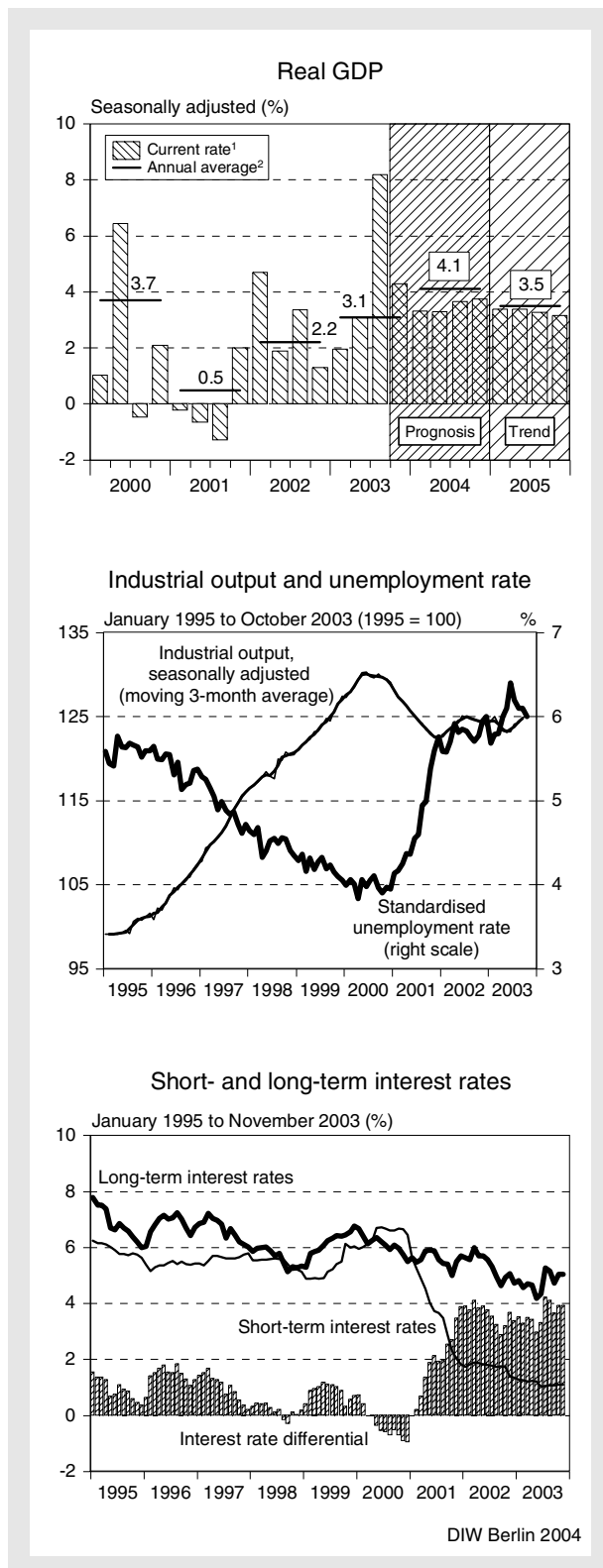
Table 2
Trends in GDP Components in Selected Countries
Real change (%) on the previous year

	Private consumption			Government consumption			Gross fixed investment			Goods and services					
										Exports			Imports		
	2003	2004	2005	2003	2004	2005	2003	2004	2005	2003	2004	2005	2003	2004	2005
Germany	-0.2	0.7	1.0	0.4	-0.3	0.4	-3.2	1.7	2.0	1.4	4.4	5.1	1.6	3.1	5.2
France	1.6	1.2	1.9	2.0	1.1	1.1	-0.7	1.4	3.9	-1.8	3.6	4.9	0.5	3.3	4.8
Italy	2.2	2.0	2.1	1.8	1.3	1.4	-3.3	1.7	4.0	-2.5	2.9	4.5	0.5	2.3	5.1
Spain	2.9	2.6	3.2	3.7	3.2	3.2	3.0	3.8	3.9	4.5	4.1	4.1	6.4	5.0	4.4
Netherlands	-1.1	-0.1	1.3	2.5	1.8	0.6	-2.9	-0.2	1.4	-0.7	0.2	2.8	-0.2	-0.3	2.4
Belgium	1.9	2.0	2.1	1.5	1.6	1.6	0.0	2.8	4.2	-1.0	3.6	5.2	-0.3	3.7	5.1
Austria	1.2	1.4	2.2	-0.5	0.0	0.0	2.3	2.9	4.0	0.6	4.4	6.0	0.9	4.4	5.8
Finland	3.8	2.8	2.4	0.9	1.0	1.2	-1.6	2.0	4.3	1.3	3.6	3.5	0.7	4.1	5.0
Greece	2.6	3.2	3.0	3.8	4.2	2.0	6.5	5.5	2.5	2.0	5.0	5.6	1.8	4.7	5.3
Portugal	-0.7	1.4	1.9	-0.4	-0.7	-0.4	-8.7	2.8	3.9	4.1	3.1	5.2	-0.5	3.2	4.6
Ireland	1.6	2.8	3.8	3.7	3.4	3.5	-7.8	3.8	5.2	-6.5	5.2	4.9	-8.7	4.9	5.2
Luxembourg	1.5	2.0	2.5	3.0	3.0	3.0	-0.2	1.9	2.9	1.0	3.5	4.5	1.5	4.0	5.0
EMU countries ^{1,2}	1.1	1.4	1.8	1.5	0.9	1.1	-1.6	2.0	3.2	-0.2	3.5	4.7	0.8	3.1	4.8
EMU countries excl. Germany ^{1,2}	1.8	1.4	2.2	2.1	1.5	1.4	-0.9	2.1	3.7	-0.6	3.1	4.5	0.9	3.0	4.6
Great Britain	2.5	3.2	3.2	3.7	3.4	3.4	2.2	4.2	2.8	-1.7	3.0	4.8	0.3	2.4	3.8
Sweden	1.8	2.2	2.8	1.5	1.0	1.5	1.0	3.5	4.5	4.3	4.5	6.0	4.0	4.5	6.0
Denmark	1.3	2.5	2.6	1.1	2.5	2.0	3.0	2.3	3.5	2.3	4.0	4.3	1.8	4.0	4.3
EU ¹	1.5	1.8	2.2	1.9	1.5	1.5	-0.8	2.4	3.2	0.0	3.4	4.7	1.1	3.0	4.6
EU excl. Germany ¹	2.0	2.2	2.5	2.4	2.0	1.8	-0.2	2.6	3.6	-0.5	3.2	4.6	1.0	3.0	4.5
Poland	2.9	3.3	4.1	-0.1	0.4	1.7	0.6	6.4	5.1	12.0	12.0	11.0	7.1	9.1	10.1
Czech Republic	4.9	4.3	4.4	-0.1	0.3	0.4	-0.8	4.1	5.2	7.2	7.9	7.8	6.4	7.1	6.3
Hungary	7.4	3.7	2.6	5.2	1.2	1.3	3.3	1.5	2.9	3.1	6.8	7.8	9.0	4.5	5.8
Slovakia	0.1	1.4	4.6	0.5	0.8	1.7	1.0	5.4	7.1	21.1	11.3	6.4	14.7	9.9	7.1
Slovenia	2.8	2.7	3.2	3.1	2.5	2.7	6.9	5.1	4.5	2.3	5.5	6.3	5.6	4.8	6.5
Lithuania	7.3	6.8	6.5	2.4	3.2	3.6	17.3	10.0	8.0	16.4	13.4	10.7	12.9	11.4	9.0
Cyprus	2.9	3.1	3.3	3.5	-2.0	1.0	-5.0	4.3	6.0	0.5	4.5	6.0	0.2	4.0	5.5
Latvia	7.8	5.1	6.3	2.0	1.9	2.2	11.1	7.9	7.6	7.4	8.1	7.2	8.9	7.6	7.3
Estonia	5.7	5.5	5.1	5.1	3.1	3.8	10.9	5.3	4.6	-0.1	5.8	7.4	5.8	5.7	5.1
Malta	1.0	1.5	2.5	4.5	0.2	0.2	4.0	4.5	3.0	2.0	3.5	4.5	3.0	3.2	4.0
Accession states	4.0	3.6	4.0	1.5	0.8	1.5	2.0	5.0	5.0	8.5	9.0	8.5	8.0	7.3	7.5
EU-25	1.6	1.9	2.2	1.9	1.4	1.5	-0.7	2.5	3.3	0.5	3.8	5.0	1.6	3.3	4.8
Switzerland	0.6	0.7	1.0	0.8	0.8	1.0	-2.0	2.0	2.5	1.5	3.5	5.0	2.5	4.5	5.5
Norway	3.0	4.0	3.5	1.0	1.0	1.0	2.0	1.5	2.5	-1.0	2.5	3.0	2.5	3.5	4.0
Europe ¹	1.6	1.9	2.2	1.9	1.4	1.5	-0.7	2.5	3.3	0.5	3.8	4.9	1.6	3.3	4.8
USA	3.2	3.8	3.3	3.6	3.3	3.2	4.0	7.2	6.2	1.3	4.8	5.4	3.6	6.8	7.2
Japan	0.5	0.5	0.3	0.9	0.9	0.7	2.3	2.3	2.4	9.3	9.6	8.7	4.9	6.7	6.5
Canada	3.4	3.2	3.0	3.1	3.4	3.2	3.3	5.0	4.6	-1.8	5.2	6.6	3.8	6.3	7.3
Non-European industrial countries ¹	2.6	3.0	2.6	2.8	2.6	2.5	3.5	5.5	4.9	2.8	6.1	6.5	3.9	6.7	7.1
Total ¹	2.2	2.6	2.5	2.4	2.1	2.1	1.9	4.4	4.3	1.3	4.6	5.5	2.5	4.7	5.7
Total excl. Germany ¹	2.4	2.8	2.6	2.6	2.3	2.2	2.3	4.6	4.5	1.3	4.6	5.5	2.7	4.9	5.8

¹ 2002 weights on dollar basis at 2002 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; 2003 to 2005: DIW Berlin estimate and prognosis.

Figure 1
Economic Developments in USA



¹ Change (%) on the previous quarter. Annualised rate. — ² Change (%) on the previous year.
Sources: OECD; DIW Berlin calculations.

to 5.9% on the most recent figures – since the middle of 2003. However, this is typical for the early days of an upturn and reflects the sharp rise in productivity. In view of under-utilised capacities, high unemployment and moderate wage increases relative to productivity growth, the price climate remained very calm. The price index, excluding non-processed foodstuffs and energy, was only 1.1% higher in November 2003 than one year previously.

The economy will continue to recover in the USA over the forecast period, albeit at a weaker pace. The rate of private consumption growth is likely to slow down because the spending behaviour of some consumers shows that they have already anticipated the income-tax refunds they are still due to receive in 2004.³ The effects of the upturn will gradually spread to the labour market. The increase in disposable income will then endure and result in self-supporting growth in consumption spending. Against this background, investments will continue to expand at an accelerated pace. Given the high government debt ratio, however, government expenditure will expand at a much slower pace over the forecast period. The government deficits will nonetheless remain unchanged at 5%. Thus, the tax reform has reduced the elasticity of the USA's tax revenue, which will weaken the consolidating effect of the upturn. Significant interventions on the expenditure side will be required in order to reduce the deficit ratio.

The forecast assumes that as a result of the strong upturn, monetary policy makers will increase the Federal Funds Rates by 1.5 percentage points in several steps between mid-2004 and the end of 2004. The short-term interest rate will amount to 3.25% at the end of 2005.

The economic recovery together with the persisting high deficit ratio over the forecast period will lead to an increase in long-term interest rates, which is likely to slow the pace of expansion next year. Capital market rates will amount to almost 6% at the end of next year.

All in all, GDP will grow by 4.2% in 2004, following an increase of 3.1% in 2003. Growth is likely to slow to around 3.5% in 2005. The price climate will remain calm.

Accession countries catching up

The European Union (EU) accession countries continued to show much higher growth rates than the EMU countries in the second half of last year. Estonian GDP showed a year-on increase of 4.3% in the third quarter of 2003, while the increase over the same period

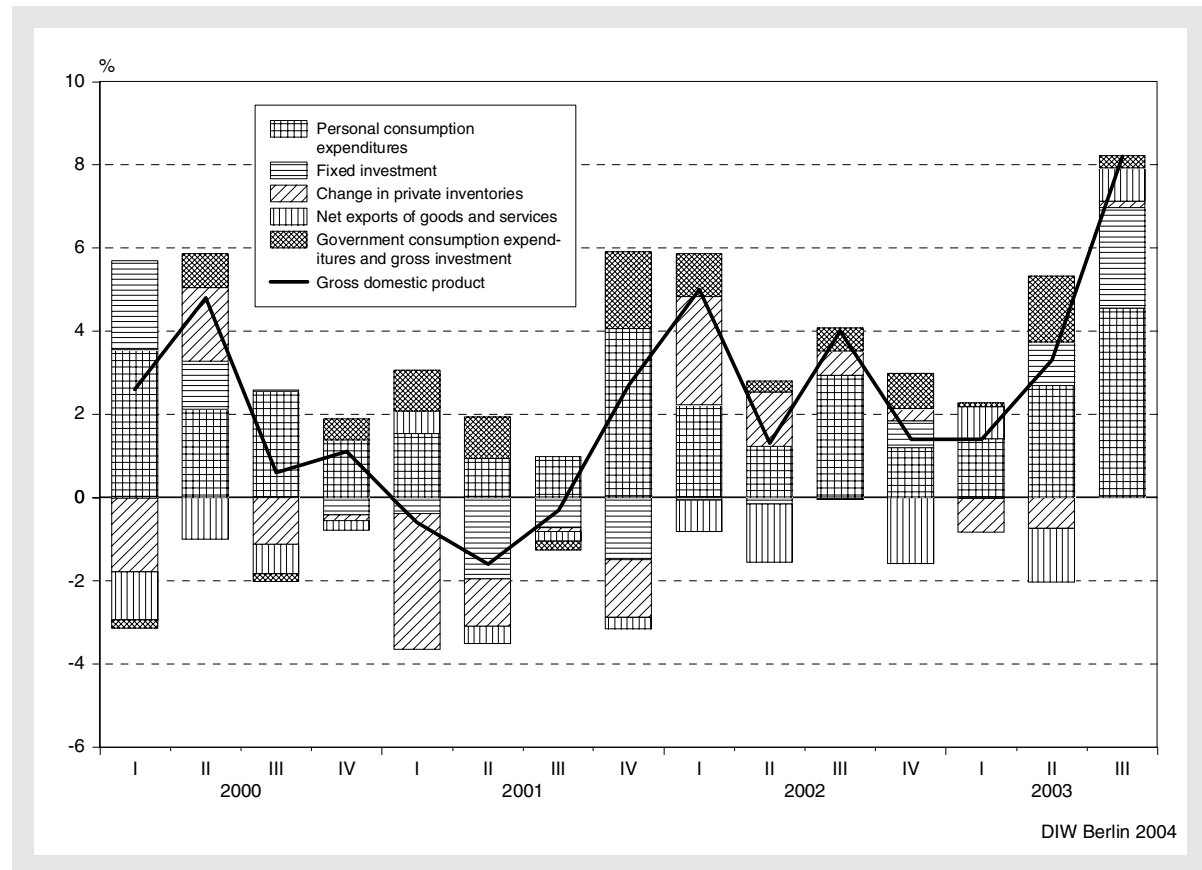
³ Nonetheless, the tax burden will remain light in the long term.

USA: extraordinary growth in the third quarter

The substantial acceleration in the pace of growth in the USA in the second half of 2003 was partly due to the payment of tax refund cheques as part of the early implementation of the tax reform, which further reinforced the basic economic trend. As the inflation rate remained low, real disposable income increased by over 8% (annualised rate) in the third quarter of 2003. At 2.3%, the savings ratio of private households remained low, however. Consumption spending by private households expanded at an annualised rate of 6.9%, while spending on durable consumer goods actually grew by over 28%.

Looking at the individual components, it emerges that not only private consumption, but also investments and government consumption, each made a significant contribution to growth (cf. figure 2 on growth components). Net exports also had a positive effect on growth in the third quarter. This was probably mainly a result of the depreciation of the US dollar and the related perceptible recovery in exports (10%). Since early summer 2002, the value of the US dollar has effectively decreased by over 11% against the currencies of a large number of countries.

Figure 2
USA: Contributions of Components to Real GDP Growth



Sources: BEA; DIW Berlin calculations.

amounted to 7.4% in Latvia, 12.8% in Lithuania, 4.2% in Slovakia, 3.4% in the Czech Republic and 2.9% in Hungary. The rate amounted to around 4% in Poland, where the two-year lull in the economy now seems to have been overcome. Thus, growth has accelerated again in the EU accession countries.

The positive dynamic is based on domestic demand. Private consumption is increasing robustly in most countries as a result of sustained high increases in productivity and thus also in real wages. In the Baltic states, and in Lithuania, in particular, investment has also expanded substantially. The accession countries

are also showing comparatively high export growth. The export trade between the accession countries, in particular, has shown an extremely sharp increase. But exports to the EU have also increased. The nominal and real depreciation of the currencies of most Central European accession countries played a part in improving their competitiveness. The Polish zloty was the currency that depreciated most, and Poland's current account deficit was reduced last year (as was Slovakia's). By contrast, the already high current account deficits in the Baltic countries rose further; Estonia's current account deficit appears to have increased to almost 15% of GDP over the past year.

Some countries still have relatively high budget deficits. Thus, they are likely to have exceeded 5% of GDP in 2003 in Poland, Malta, Hungary, the Czech Republic and Cyprus. Fiscal surpluses are being achieved in some of the Baltic countries.

Inflation rates remained low in the second half of last year. Lithuania's annual average inflation rate was actually negative; the country's price stability is mainly a result of the nominal effective appreciation of the Lithuanian lita in recent years. Slovakia, Slovenia and Hungary still have much higher inflation rates than the euro zone.

The unemployment rates of most of the accession countries are higher than the EU average and, despite the relatively strong rate of expansion, are generally declining only very insignificantly. Growth is mainly based on rising productivity and is accompanied only in a few countries by expanding employment.

Over the forecast period, the growth rate for national output in the accession countries will exceed the EU and euro zone averages. Private consumption will remain the most important source of demand. Investment activity will continue to expand, not least thanks to the considerable aid received from the EU's Cohesion and Structural Funds. The accession countries' export economies will benefit from the economic recovery in the current member states of the EU, so that a reduction in the current account deficits will also be made possible.

There will be a slight rise in inflation over the forecast period, not least because of increases in regulated prices and indirect taxes in the course of accession to the EU. The currencies of the accession countries are not likely to appreciate perceptibly over the next two years. Unemployment rates will fall only slowly, despite the relatively strong rate of growth.

In the run up to entry into the euro zone, the countries that still have relatively high inflation rates, in particular, will increasingly base their economic policy on the goal of compliance with the convergence criteria. The consolidation of the public budgets will in itself have a dampening effect on growth.

Economy livens up in the EU

After a year in which the economy in the EU was practically stagnant, overall output is likely to increase this year, although there will be no significant improvement in capacity utilisation. Growth in the euro zone will again be less strong than in Great Britain, where the economic slowdown was much less substantial and where the economy is also recovering much more rapidly. In the euro zone, the output gap is likely to widen even further this year, and then to remain more or less unchanged next year. Thus, the economic lull will persist for an unusually long time (cf. figure 3).

The main reason for the slightly brighter prospects in the euro zone this year and next year is, on the one hand, the manifest recovery of the world economy, so that despite the marked appreciation of the euro, export growth will gain significant momentum. It is assumed here that the appreciation of the euro will come to an end next year and that the annual average exchange rate will amount to US \$ 1.23. On the other hand, all the domestic indicators also suggest that the economy will liven up.

The acceleration of growth in Great Britain is based mainly on domestic factors. Building activity is extremely strong here and will gain further pace this year. The same applies to private consumption, while investments in machinery and equipment will expand only moderately (cf. figure 4).

Economic policy in the EU as a whole did much less to support growth than economic policy in the USA. This explains why the weak phase can only be overcome gradually. The ECB was hesitant in implementing measures to boost growth and its efforts were far less decisive than those of both the American Federal Reserve and the Bank of England. Unlike the situation in the euro zone, where the rapid consolidation of government finances took precedence over efforts to stimulate growth, British fiscal policy provided the economy with massive impetus. The budget deficit will have increased from 1.5% of GDP in 2002 to a probable 3.3% by the end of the current fiscal year (on the Maastricht Treaty definitions). As economic growth strengthens, fiscal policy will adopt a more reticent stance so that the deficit ratio will rapidly fall to under 3% again by next year. Budget deficits in the euro zone are likely to remain more or less unchanged now that the Stability and Growth Pact has been largely abandoned. Monetary policy makers in Great Britain have already reversed the interest rate trend, as short-term interest rates were raised last autumn for the first time since the beginning of 2000. The ECB is likely to maintain its expansionary stance until the end of the forecast period in order to avoid bringing the upturn to a premature end.

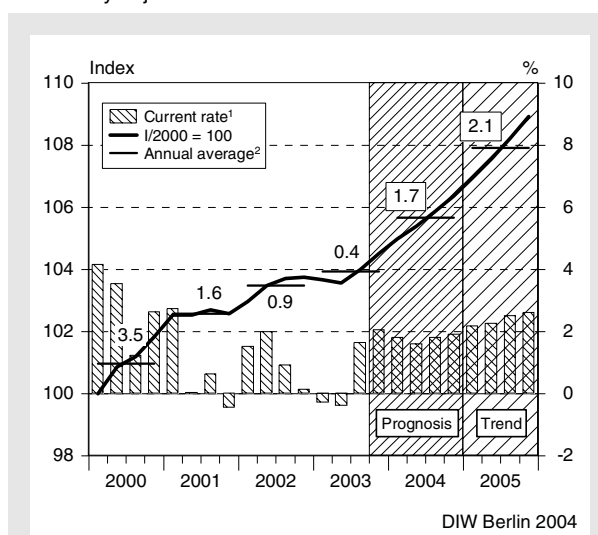
In 2004, overall output will increase by 1.7% in the euro zone and by a hefty 2.9% in Great Britain. The recovery appears likely to continue on trend in 2005 both in the euro zone and in Great Britain. Unemployment will fall slightly. The growth rates for GDP are then likely to amount to 2.1% for the euro zone and to 3.1% for Great Britain.

Euro zone emerges from stagnation

Following stagnation in the first half of last year, overall activity in the euro zone expanded again substantially in the third quarter of the year. The livelier growth was exclusively a result of the substantial increase in net exports, while domestic demand declined (cf. table 3). Exports to Great Britain, Asia and the USA, in particular, increased perceptibly. Exports to the EU accession countries also expanded more substantially again. Thus, it has been the recovery of the world economy that has boosted the economy in the euro zone, despite the strength of the euro.

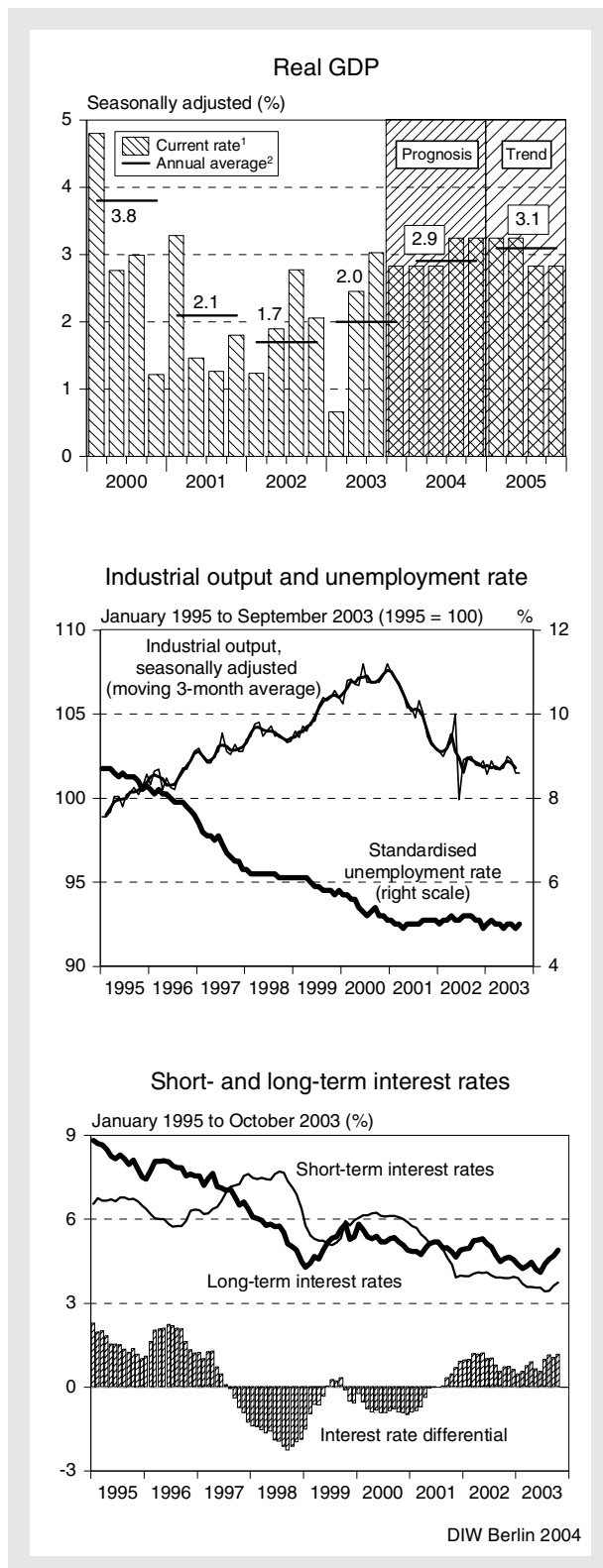
Imports stagnated, mainly because the domestic economy continued to grow at only a weak rate overall. Stagnating employment and low wage growth meant there was very little increase in private consumer spending. Households in the euro zone were particularly reticent as regards the purchase of durable consumer

Figure 3
Real GDP in the Euro Zone
Seasonally adjusted



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

Figure 4
Economic Developments in Great Britain



¹ Change (%) on the previous quarter. Annualised rate. — ² Change (%) on the previous year.
Sources: OECD; DIW Berlin calculations.

goods. Government consumption spending, by contrast, continued to expand perceptibly. Investment activity, despite a steady improvement in expectations, had not yet picked up again by autumn of last year. However, gross capital formation stabilised in the third quarter of the year. Building investments showed weak growth, while investment in machinery and equipment remained on a slightly downward trend. These indicators demonstrate that the upward trend has not yet been consolidated.

Despite the improvement in the terms of trade as the euro appreciated and wage growth remained moderate, the inflation rate still remained entrenched at just over 2% in November 2003. This was due partly to higher special excise duties in some countries, and partly to sharp price increases for foodstuffs as a result of the drought in summer 2003.

Although the situation was still unstable at the end of the year, the signs are increasing that a long-term upturn can be expected. A range of early indicators, such as the OECD's composite leading indicator (CLI), the recovery on the stock markets and, most recently, the European Commission's economic sentiment indicator (ESI), suggest that the brisker pace of growth will continue over the forecast period.

Despite the substantial appreciation of the euro, the economic recovery should be able to continue on the basis of the dynamic expansion of the world economy. The change in trend for the domestic economy will probably start with investments in machinery and equipment, not only because profit expectations have greatly improved again recently but also because enterprises will be keen to take advantage of the continuing low interest rates. The trend for building investments will also turn positive over the course of the forecast period.

However, the pace of growth will not be fast enough to generate a significant increase in employment. Thus, the average unemployment rate will remain entrenched at 8.8% this year, too. At the same time, wage growth will remain moderate. Thus, real incomes will increase only moderately despite a declining inflation rate. Private consumption spending is likely to expand by only 1.4%. As a consequence of efforts to consolidate the budgets in many EU countries, government consumption expenditure will rise at a slower rate this year than in 2003.

GDP growth rates are thus likely to remain below the trend growth rate this year, with the result that the output gap will widen further. Overall, GDP growth of 1.7% can be expected this year, following an increase of only 0.4% last year.

The rise in the euro exchange rate will significantly curb import prices. Unit labour costs are likely to increase only slightly over the forecast period. Thus,

Table 3

EMU Countries: Key Forecast Figures

	2002	2003	2004	2005
	Change (%) on the previous year			
Real GDP	0.9	0.4	1.7	2.1
Private consumption	0.5	1.1	1.4	1.8
Government consumption	2.8	1.5	0.9	1.1
Gross fixed capital formation	-2.8	-1.6	2.0	3.2
Construction	-2.0	-1.0	1.4	1.7
Machinery and other equipment	-3.6	-2.2	2.6	4.6
External surplus/deficit ¹	0.6	-0.4	0.3	0.1
Consumer prices ²	2.3	2.1	1.6	1.5
Unit labour costs	2.3	2.2	1.1	1.2
	As % of nominal GDP			
Budget surplus/deficit ³	-2.2	-2.8	-2.8	-2.5
Current account balance	0.9	0.1	0.1	0.2
	As % of labour force			
Unemployment rate ⁴	8.4	8.8	8.8	8.7

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; 2003 to 2005: DIW Berlin estimate and prognosis.

despite the rises in administered prices and indirect taxes, inflation can be expected to slow perceptibly this year. The annual average inflation rate is likely to fall from 2.1% last year to 1.6% this year.

Macroeconomic activity is likely to gain further momentum next year. Real GDP will rise to 2.1% on annual average, while the expansion of domestic demand will also accelerate to an extent. The employment trend is likely to remain only slightly positive, while the unemployment rate will show a slight decline.

The inflation rate can be expected to amount to 1.5% in 2005, and thus lie significantly below the ECB's target level. This is suggested not only by the strong euro and the return to lower oil prices, but also by the moderate rate of wage growth. Based on the growth rates forecast here, the EMU is still in no danger of price increases induced by an overheating economy.

Fiscal policy in the euro zone: deficit ratios remain high

The difficulties of the public budgets in the euro zone increased even further last year. The aggregate deficit amounted to 2.8% of GDP, as against 2.2% in 2002. An

increasing number of countries failed to fulfil the targets laid down in their stability programmes. The deterioration of the budget situation was caused first and foremost by the weak economy. Italy's deficit would have been even higher if not for one-off discretionary measures introduced by the government. Higher revenue was generated in particular by the Italian tax amnesty, which permitted repatriation of undeclared funds deposited abroad (normally subject to penalties) against payment of one-off special taxes. Germany, France and Portugal already breached the Maastricht criteria last year. On the most recent figures, the budget deficit in the Netherlands has now probably also reached the maximum permitted limit of 3% (cf. table 4); and this year Italy will probably also join the list of countries failing to meet the criteria. At 2.8% of GDP, the deficit in the euro zone will probably be almost as high this year as in 2003. As the economy recovers, government revenue will increase at a faster pace again. In addition, reforms in many countries – in particular of the systems of unemployment benefits and pensions – will also curb the increase in expenditure. Thus, the deficit ratio for the euro zone is likely to fall by around half a percentage point in 2005. Fiscal policy would then have a markedly restrictive effect.

Table 4
Public Budget Indicators for the EMU Countries

	Gross debt ¹					Financial balance ¹				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Germany	60.2	59.5	60.8	64.3	66.2	-1.2	-2.8	-3.5	-4.0	-3.4
France	57.2	56.8	59.0	61.7	63.4	-1.4	-1.6	-3.1	-4.0	-4.1
Italy	110.6	109.5	106.7	105.8	105.0	-1.8	-2.6	-2.3	-2.7	-3.1
Spain	60.5	56.8	53.8	52.0	50.5	-0.9	-0.3	0.1	-0.1	0.0
Netherlands	55.9	52.9	52.4	54.0	54.6	1.5	0.0	-1.6	-3.0	-3.2
Belgium	109.6	108.5	105.8	103.0	100.1	0.2	0.4	0.1	-0.2	0.0
Austria	66.8	67.3	67.3	68.5	68.5	-1.9	0.3	-0.2	-1.2	-1.5
Finland	44.6	44.0	42.7	41.5	40.0	7.1	5.2	4.2	2.8	1.5
Greece	106.2	106.9	104.7	103.0	101.0	-1.9	-2.0	-1.2	-1.7	-1.7
Portugal	53.3	55.5	58.1	60.0	60.5	-3.2	-4.2	-2.7	-3.7	-3.9
Ireland	38.4	36.1	32.4	31.8	31.5	4.4	0.9	-0.4	-1.0	-1.4
Luxembourg	5.5	5.5	5.7	5.7	5.7	6.4	6.1	2.5	0.0	-1.5
EMU countries ²	70.2	69.1	69.0	70.3	70.8	-0.9	-1.6	-2.2	-2.8	-2.8

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 2002 GDP in euro.

Sources: ECB; Eurostat; European Commission; 2003 and 2004: DIW Berlin estimate and prognosis.

Wages policy generally moderate in the euro zone

Wages and salaries per employee increased by 2.7% in the first half of last year and thus only moderately relative to the first half of 2002. However, as a result of the weak productivity growth, unit labour costs rose by 2.3% over the same period. The trends were extremely diverse in the individual countries of the euro zone. Wage growth was stronger in Italy and Spain, in particular, where unit labour costs showed a year-on increase of around 4% in the third quarter of last year. The increases in unit labour costs thus significantly exceeded the ECB's target value for inflation. The inflation rates in these two countries are still much higher than the EMU average.

The increase in unit labour costs in the euro zone, which is primarily a result of low productivity growth, will weaken substantially this year. On the one hand, the more rapid growth in overall output will accelerate productivity growth. Moreover, wage growth will slow compared with last year, to less than 2.5%. Unit labour costs are thus likely to show a year-on increase of just over 1% this year. Although unit labour costs will increase at a slower rate again in all countries, there will

be significant differences between the growth rates in the individual countries. While unit labour costs will fall by almost 1% in Germany, they will increase by more than 3% in Spain.

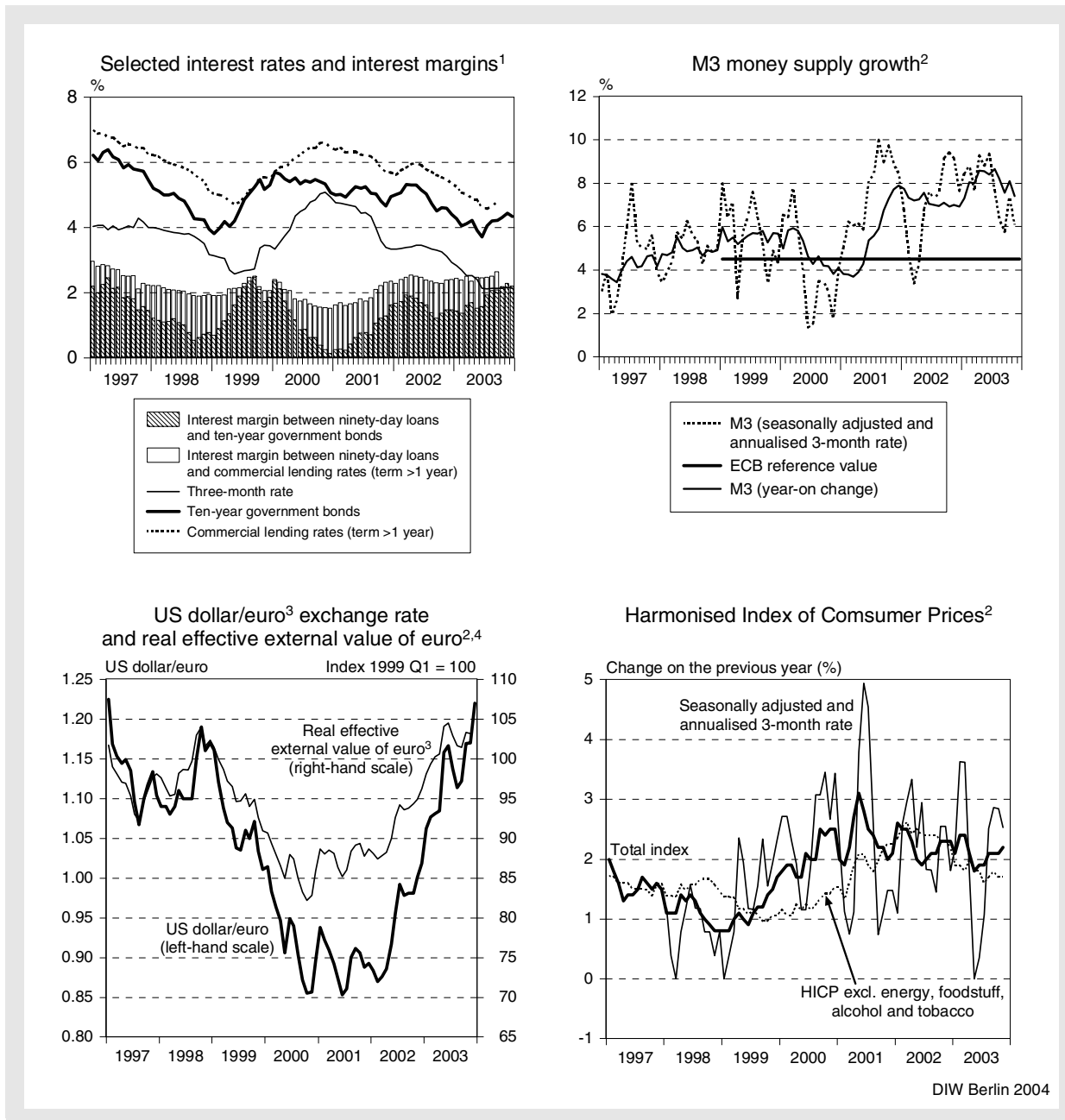
Wages are likely to rise at an only slightly higher rate next year, too, while employment will show somewhat stronger growth. Thus, unit labour costs can be expected to increase in 2005 at a similarly slow rate to this year's.

Monetary conditions to curb growth

Since the last interest-rate reductions in June of last year, the nominal three-month interest rate has been 2.1%, while the real rate has been almost zero (cf. figure 5). Thus, monetary policy is exerting a stimulating effect on the economy. The yield on government bonds maturing in ten years (nominally just under 4.5% and around 2.5% in real terms) is also lower than the average for many years.

The appreciation of the euro, by contrast, is unmistakably curtailing growth in Europe. In December of last year, the euro was worth 1.22 US dollars: 20% more

Figure 5
The Monetary Situation in the Euro Zone
 January 1997 to December 2003



¹ Lending rates from January 2003 onwards: 1 to 5 years, up to 1 million euro, new business, up to September 2003. — ² Up to November 2003. — ³ Preceding 1998 exchange rate between US dollar and synthetic euro. — ⁴ Compared with a wide group of countries, based on consumer prices.
 Sources: European Central Bank; Eurostat; DIW Berlin calculations.

than one year previously and around 37% more than in December 2001. The corresponding real effective appreciation amounted to 10% and 19%, respectively. The dampening effect of the appreciation on the economy in real terms probably more than offset the expansionary effect of the interest-rate reductions. Despite the recov-

ery in share prices, last year saw a deterioration in monetary conditions.

The expansion of loans to the private sector gained momentum somewhat in the second half of last year – increasing to 6.6% (annual rate) between July and November 2003, compared with 4.9% in the first half of

the year. In real terms, however, lending growth is still somewhat below the average for many years. Unlike that in the euro zone as a whole, lending growth is extremely weak in Germany. The continued robust expansion of money supply in the euro zone is still due to a large extent to the propensity of investors to favour short-term securities, and this exaggerates the increase in liquidity expected to have a positive effect on demand.

The increase in the Harmonised Index of Consumer Prices is likely to slow to substantially below 2% this year due to the fall in import prices and amount on average to 1.5% in 2005. In view of the large output gap, which will widen over the forecast period, and the forecast for inflation, which is below the ECB's stability target, interest rates can be expected to remain at the current level this year and next year, as long as the euro does not appreciate any further.

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