

## CHAPTER 2

# THE GLOBAL CONTEXT AND WESTERN EUROPE

### 2.1 The global context

#### (i) The broad picture

Global economic activity got off to a good start in early 2002, led by changes in inventory investment in industrial countries. But instead of strengthening, as was widely expected in the spring,<sup>35</sup> it lost momentum, particularly in the final quarter of the year, despite accommodating monetary policy in the major economies and, in some of them, especially the United States, an expansionary fiscal policy.

Economic developments in 2002 were shaped by sharp falls in business and consumer confidence in the industrialized countries in the second half of the year, a reflection of the disappointment about the weakening of economic performance and its adverse implications for sales, profits and labour markets.<sup>36</sup> The deteriorating outlook for profits, in turn, led to massive selling pressure in the international equity markets, where prices are still high by historical standards. In addition, investors' trust in company valuations and profit statements was eroded by a series of corporate financial and accounting irregularities in the United States and other major industrialized countries, which intensified selling pressures. The negative wealth effects of the plunge in share prices have tended to dampen household and business spending. Moreover, the large fall of share prices led to stress in the financial markets, raising risk premia for corporate borrowers, especially for those with lower and sub-investment credit ratings. The fall in share prices also created balance sheet problems for banks and insurance companies and pension funds, which had significantly raised their holdings of equities during the preceding stock market boom. As a result, banks tightened their lending criteria, raising fears of a possible credit crunch. Consumer and business confidence and spending were also

dampened by the rise in oil prices in the second half of the year and by the uncertainty created by the looming prospect of a war with Iraq and the associated risk of still higher oil prices. Industrial production in the industrialized countries was lacklustre in the second half of the year. On the demand side, private consumption remained the mainstay of economic growth for the industrialized countries as a whole in 2002. In contrast, business fixed investment was generally weak in the face of large excess capacities and the more uncertain economic outlook. The rise in government consumption generally accelerated and had a counter-cyclical effect, contributing positively to economic growth.

In the United States, the locomotive of global growth from 1995 to 2000, the economic recovery from the recession of 2001 has been hesitant, although there were positive spillovers, at least temporarily, to eastern Asia, i.e. Japan and the east Asian emerging markets. Strong domestic demand and closer intraregional trade links also supported economic activity in that region. This partly reflected the bottoming out of the severe downturn in global demand for ICT products in 2000-2001. Regional growth was also supported by China, where real GDP rose by more than 8 per cent in 2002. In Latin America, the economic situation has deteriorated and is now quite precarious in many countries. In western Europe, the average rate of economic growth was only modest in 2002, heavily influenced by the pronounced weakening of the German economy, which virtually stagnated in 2002. In central and eastern Europe and the CIS, relatively strong domestic demand proved rather resilient to the weakening of the external economic environment.

Among the major industrialized economies, economic growth was quite uneven in the course of 2002 (table 2.1.1). In the third quarter of 2002, sluggish growth in France, Germany and Italy contrasted with stronger output gains in Canada, Japan, the United Kingdom and the United States

<sup>35</sup> For a more skeptical assessment see UNECE, *Economic Survey of Europe, 2002 No. 1*, chap. 1.

<sup>36</sup> There is, of course, no unidirectional causal link between economic conditions and the confidence of economic agents. In fact, the two are mutually dependent and can become mutually reinforcing.

TABLE 2.1.1

Quarterly changes in real GDP in the major seven economies,  
2001Q1-2002QIII

(Percentage change over previous quarter)

	2001				2002		
	QI	QII	QIII	QIV	QI	QII	QIII
France .....	0.4	-0.1	0.4	-0.4	0.6	0.4	0.2
Germany .....	0.6	-	-0.2	-0.3	0.3	0.2	0.3
Italy .....	0.7	0.1	-	-0.2	0.2	0.2	0.3
United Kingdom .....	0.6	0.3	0.3	0.2	0.1	0.6	0.8
Canada .....	0.2	0.1	-0.1	0.7	1.4	1.1	0.8
United States .....	-0.2	-0.4	-0.1	0.7	1.2	0.3	1.0
Japan .....	1.0	-1.5	-1.4	-0.5	0.2	1.0	0.7
<b>Total above</b> .....	<b>0.3</b>	<b>-0.4</b>	<b>-0.2</b>	<b>0.2</b>	<b>0.8</b>	<b>0.5</b>	<b>0.7</b>
<i>Memorandum items:</i>							
<b>Euro area</b> .....	<b>0.5</b>	<b>-</b>	<b>0.2</b>	<b>-0.3</b>	<b>0.4</b>	<b>0.3</b>	<b>0.3</b>
<b>European Union</b> .....	<b>0.5</b>	<b>0.1</b>	<b>0.2</b>	<b>-0.2</b>	<b>0.4</b>	<b>0.4</b>	<b>0.4</b>
<b>Western Europe<sup>a</sup></b> .....	<b>0.5</b>	<b>0.1</b>	<b>0.2</b>	<b>-0.2</b>	<b>0.3</b>	<b>0.4</b>	<b>0.4</b>
<b>Total industrialized countries<sup>b</sup></b> .....	<b>0.3</b>	<b>-0.3</b>	<b>-0.1</b>	<b>0.2</b>	<b>0.7</b>	<b>0.5</b>	<b>0.7</b>

Source: National statistics; Eurostat, New Cronos Database.

(chart 2.1.1). But the available short-term economic indicators suggest that the dominant feature of the final months of 2002 was a weakening cyclical momentum in all of these economies.

World output is estimated to have increased by some 2.75 per cent in 2002, slightly up from 2.5 per cent in 2001.<sup>37</sup> The volume of world trade (goods and services) rose by only some 2 per cent in 2002, following a slight fall in 2001, the first in more than 20 years. This was the second consecutive year that the growth rate of world trade remained below that of world GDP. World trade in 2002 was supported by a recovery in the demand for *ICT goods and services*: this had collapsed in 2001, following its very rapid expansion in the second half of the 1990s.<sup>38</sup>

The slump in the ICT sector had been brought about by the conjunction of several factors:

- Overinvestment in the ICT producing sector, which was often associated with rising levels of

indebtedness (e.g. telecom companies) and a large expansion of manufacturing capacity, leading to falling capacity utilization rates;

- Overinvestment by ICT using industries, which did not always reap the expected benefits from their expenditures on ICT equipment and software. This led to large cuts in their demand for ICT goods and services;
- The bursting of the equity market bubble of the late 1990s. This not only affected the demand for ICT products by ICT using industries, but also had a negative impact on capital formation in the ICT sector itself, given the latter's strong reliance on equity financing;<sup>39</sup>
- Saturation was reached in certain markets, such as consumer PCs in the United States and mobile phones in some European countries.<sup>40</sup>

The sectoral downturn led to a sharp increase in the number of bankruptcies in the ICT sector in the industrialized countries during 2001. The output of ICT products fell steadily for about a year starting in late 2000 (chart 2.1.2). The loss of production was shorter and milder in the United States (with a fall from peak to trough of 17 per cent). It was longer and deeper in the EU and Japan. The latter suffered the worst setback, with output falling by one third. In western Europe, production declined by one fifth, the downturn affecting all the major ICT producing countries. As a result, there was a steep fall in capacity utilization rates in ICT manufacturing in the 18 months from mid-2000.

The downturn in demand and supply in the ICT sector was reflected in international trade in ICT goods. From its peak in the second half of 2000 to the end of the following year, the value of international trade in these products fell by approximately one third in the United States and by even more in Japan (chart 2.1.3). In both cases, the largest fall was in trade in electronic components, which was down by almost half.<sup>41</sup> In the EU, the downturn was milder but trade in mid-2002 was still almost a quarter down from its peak

<sup>37</sup> IMF, *World Economic Outlook* (Washington, D.C.), September 2002.

<sup>38</sup> Short-term indicators of ICT expenditures are not readily available and therefore there is no direct measure of short-term developments in demand for ICT sector products. However, cyclical analysis of developments in the sector can be made on the basis of short-term indicators of production and international trade: these have been compiled by the UNECE.

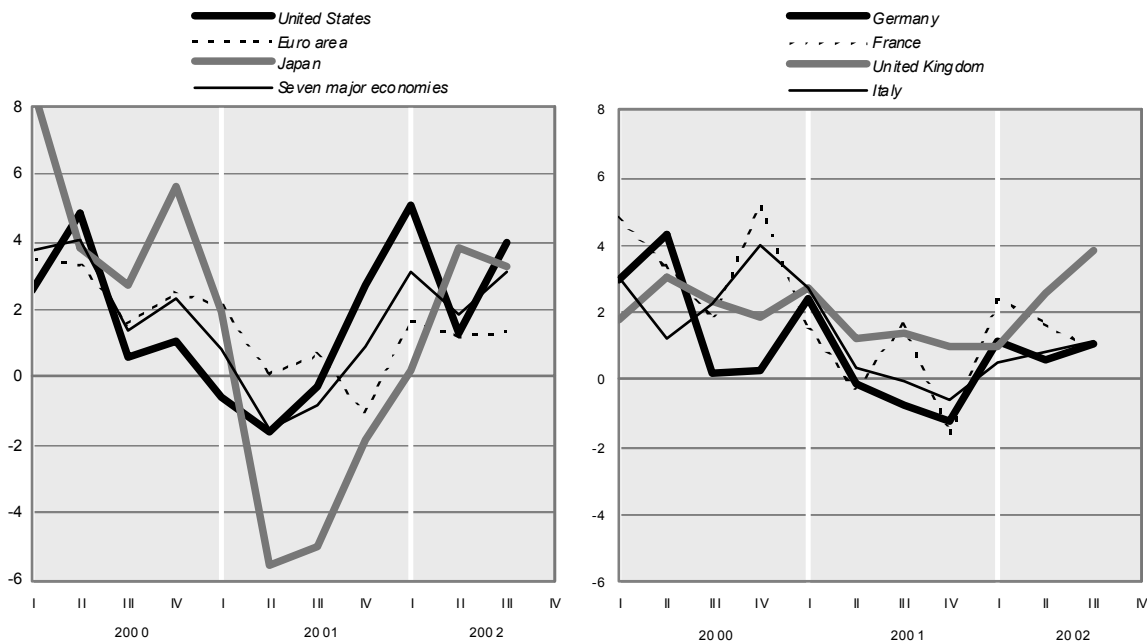
<sup>39</sup> This is particularly true of hardware and software firms, as opposed to telecom services firms.

<sup>40</sup> *OECD Information Technology Outlook, ICTs and the Information Economy* (Paris), 2002.

<sup>41</sup> Japan is the world's largest producer of components and this category is the most important in the country's international trade in ICT goods.

CHART 2.1.1

Quarterly changes in real GDP in the developed market economies, 2000Q1-2002QIII  
(Percentage change over previous quarter, seasonally adjusted at annual rate)



Source: National statistics; Eurostat, New Cronos Database.

Note: Seven major economies: Canada, France, Germany, Italy, Japan, United Kingdom and United States.

value: computers and office equipment (the largest category of the EU's trade in ICT goods) was less affected by the downturn than in the United States and in Japan.

Output, capacity utilization and international trade in ICT goods picked up during the first half of 2002. Towards the end of 2002, production in the United States was close to its previous cyclical peak, although in the EU<sup>42</sup> and Japan it was still some 20 per cent below that point (chart 2.1.2). At the same time, capacity utilization in the United States and Japan rose slightly during 2002, but remained well below its average of the previous decade. The value of trade also picked up somewhat during the first half of 2002, but the recovery has since petered out (chart 2.1.3). Thus, the ICT sector has recovered somewhat from the sharp downturn of 2001, but after a short cyclical upswing between late 2001 and mid-2002, activity has stagnated.

*Emerging market economies* in 2002 suffered from the economic slowdown in the industrialized countries, which led to weak growth of international trade and a retrenchment of

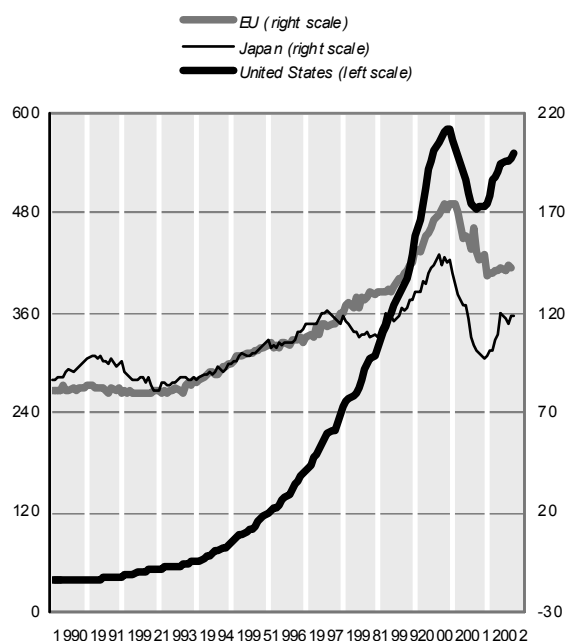
international investment. In the major Asian developing countries the adverse external environment was partly offset by strong domestic demand growth, but in South America and Turkey – which are more dependent on foreign capital – the fall in private inflows greatly aggravated domestic problems.

In *Turkey*, uncertainties concerning the country's general election of November 2002 led to financial market instability, with a large rise in domestic interest rates, the virtual cessation of foreign short-term capital inflows, a rising country risk premium and a weakening of the exchange rate. However, these developments were largely reversed after the elections, which produced a majority government that was generally considered likely to pursue the adjustment programme previously agreed with the IMF. This includes achieving a primary fiscal surplus of 6.5 per cent of GDP. Real GDP had contracted by 7.4 per cent in 2001, the worst outcome since the Second World War, seriously hit by a banking and financial

<sup>42</sup> In the EU, with the exception of Finland, ICT output has been slow to recover from the slump.

CHART 2.1.2

**Industrial production in the information and communications technology manufacturing sector, January 1990-September 2002**  
(Monthly indices, 1995=100)



**Source:** UNECE secretariat calculations, based on data from Eurostat New Cronos Database; METI (Japan) [www.meti.go.jp]; United States Federal Reserve Board (Washington, D.C.) [www.federalreserve.gov].

crisis.<sup>43</sup> But the economy recovered with a growth rate of 3.7 per cent in 2002, mainly due to an increase in private consumption and stockbuilding. Industrial production rebounded strongly from the previous year's slump. Despite the depreciation of the exchange rate, inflation declined steadily throughout 2002, from 73 per cent in January to 30 per cent in December, the latter rate being below the target agreed with the IMF, thanks to the disinflationary impact of good harvests and the still large output gap.

The rate of economic expansion strengthened in *developing Asia* in 2002, real GDP rising by 5 per cent. This expansion was based on exports and domestic demand, boosted by private consumption and expansionary fiscal policies. Trade accelerated (particularly during the first half of the year) thanks to increased extraregional flows (particularly in ICT goods) and a strengthening of

intraregional trade.<sup>44</sup> Several of these economies (Malaysia, Republic of Korea, Singapore, Taiwan Province of China and Thailand) had been hit hard by the slump in ICT trade in 2001 (see above).<sup>45</sup> Domestic demand was particularly buoyant in China, India, the Republic of Korea and Thailand. In China, real GDP increased by more than 8 per cent in 2002. It continued to attract increasing inflows of FDI – despite the worldwide slowdown in these flows – of which it became the largest recipient in 2002, surpassing the United States. As the major emerging economies in the region had been accumulating current account surpluses and foreign reserves since the 1997 crises, the region's financial markets were more resistant to international instability.

In *Latin America* the unfavourable external environment, domestic financial turmoil, unsustainable public debt dynamics and political uncertainty combined to bring about a 0.5 per cent fall in GDP.<sup>46</sup> This was the second year of falling per capita GDP, the 2001-2002 period being the worst for the region since the debt crisis of the early 1980s. In Brazil there was a currency crisis, financial turmoil and a slowdown in output growth in the run-up to the presidential elections in October. When the post-election stance of economic policy had become clearer, the exchange rate strengthened and domestic output recovered somewhat, but in both cases the previous losses were only partially reversed. Argentina's economy slumped as it went through related currency and banking crises and a default on foreign debt. In late 2002 the steep falls in output and the exchange rate were halted and inflation stabilized. Although the country reached an agreement to regularize its debt obligations with official creditors, its more

<sup>44</sup> Regional trade was partly boosted by the strong growth of China's foreign trade. This dynamism highlights the increasing importance of the country as a trader not only regionally but also globally. In 2001 the country had become the world's fourth largest trader, accounting for over 5 per cent of global trade (excluding intra-EU shipments).

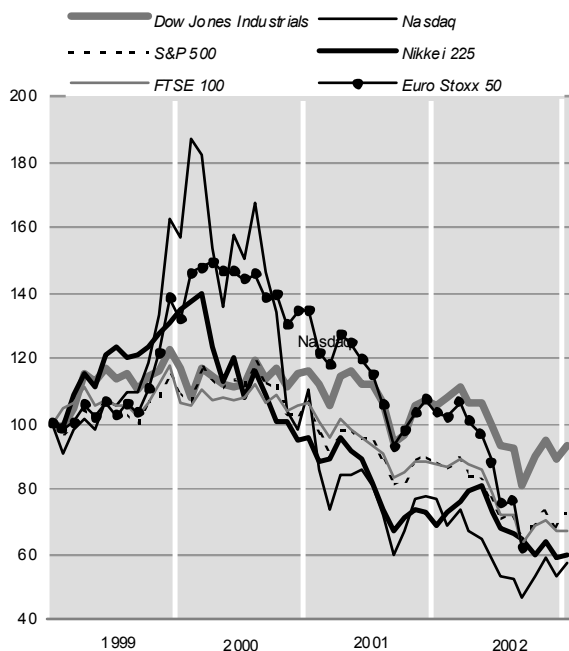
<sup>45</sup> Asian Development Bank, *Asian Development Outlook 2002. Update* (Manila), September 2002 [www.adb.org]; World Bank, *Global Economic Prospects and the Developing Countries 2003* (Washington, D.C.), 2002 [www.worldbank.org].

<sup>46</sup> The regional average was pulled down by the fall of GDP by 10 per cent or more in Argentina, Uruguay and Venezuela, while most other countries stagnated. ECLAC, *Preliminary Overview of the Economies of Latin America and the Caribbean 2002* (United Nations publication, Sales No. E.01.II.G.126) [www.eclac.org].

<sup>43</sup> For a more detailed analysis see UNECE, *Economic Survey of Europe, 2001 No. 1*, pp. 38-41.

CHART 2.1.4

Changes in international share prices, January 1999-January 2003  
(Indices, January 1999=100)



Source: Internet websites [www.yahoo.com] and [www.stoxx.com].

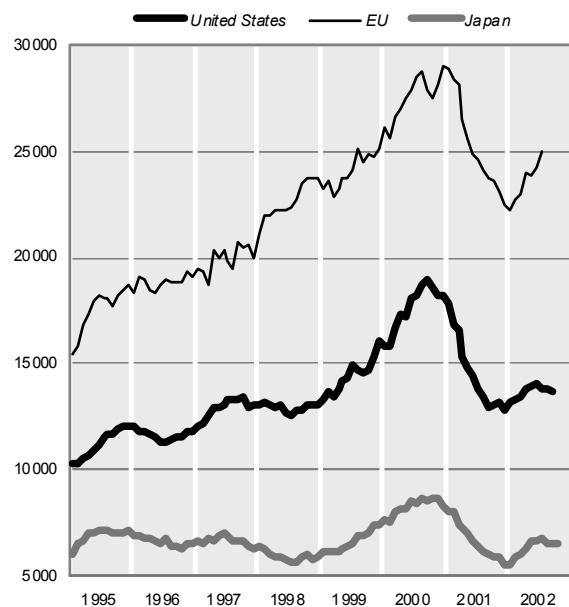
Note: End of month data

difficult relations with private creditors were not re-established. The country's crisis had contagion effects on neighbouring countries, particularly Uruguay and Paraguay, both of which went into deep recession.

Stock markets generally fared poorly in 2002. An initial recovery during the early months of the year was not sustained and from May strong selling pressures resumed. All the major stock indices, barring the Nikkei 225, reached low points in September 2002 but the subsequent rebound in October and November was followed by renewed declines in December (chart 2.1.4). In the event, world stock markets fell for the third consecutive year, the most severe downturn since the Great Depression of 1929-1932. At the end of December 2002, equity values had fallen on average by more than 50 per cent in western Europe, some 40 per cent in the United States and nearly 60 per cent in Japan as compared with their previous peaks in early 2000 (table 2.1.2). Indeed, the fall in the United States equity market surpassed even that of the 1970s in both duration and magnitude. The "high-tech" Nasdaq

CHART 2.1.3

Total trade in information and communications technology goods, January 1995-October 2002  
(Average of imports and exports, values in million dollars, seasonally adjusted)



Source: UNECE secretariat calculations, based on data from United States International Trade Commission (Washington, D.C.) [dataweb.usitc.gov]; Eurostat, Comext (CD-Rom), various issues; Ministry of Finance (Japan) [www.customs.go.jp]. EU data include intra-EU trade.

Composite fell by as much as 32.5 per cent during 2002 and lost nearly 75 per cent of its value compared with its peak during the stock market boom in 2000. In the euro area, the Euro Stoxx 50 index dropped by 36.5 per cent in the course of 2002; in Germany the DAX Xetra fell by 44 per cent, the worst performance among the European indices. Despite their sharp falls, however, equity markets still appeared to be overvalued in relation to traditional benchmarks such as historical price-earnings ratios. The downward trend of stock markets during 2002 has been attributed to increasing doubts about the sustainability of a United States recovery, the spread of business cycle pessimism in western Europe, corporate governance irregularities and the economic uncertainty associated with the tensions involving Iraq and, later in the year, North Korea.

During 2002, international commodity prices recovered from a severe cyclical downturn. Non-energy prices (in dollars) closed the year 14 per cent above their low point in late 2001, although

this only brought them back to the levels of two years earlier and they remained well below their cyclical peak of the mid-1990s (chart 2.1.5). The rise in prices was underpinned by supply shortages (particularly of agricultural commodities) and by expectations during the first half of the year, that a recovery of global economic activity would boost the demand for industrial raw materials.

Petroleum prices in 2002 rose from \$19/barrel in January to \$31/barrel in late December (spot price for Brent crude), the highest level in two years (chart 2.1.6). At the end of the year, world petroleum demand strengthened, as a result of seasonal factors and the rebuilding of stocks, but crude oil production rose in several OPEC and other countries. While these developments approximately balanced each other, the uncertainty generated by the possibility of war in the Middle East drove up the price of oil. From the point of view of market balance, possible military action in Iraq need not per se be very disruptive, since even a complete halt to the country's exports could be offset by the available spare capacity in other OPEC countries. However, there is great uncertainty concerning the length, intensity and the aftermath of such a conflict, including its likely consequences on other producing countries.

The situation in the oil market has been further aggravated since December 2002 by a strike in Venezuela, the world's fifth largest oil exporter and the second largest supplier of United States petroleum imports. The strike has led to an estimated 90 per cent reduction in oil exports from Venezuela.<sup>47</sup> While the market price of oil had already incorporated a "war premium", this supply shortfall raised market anxiety, and although it was partly eased by higher output in other oil producing countries, prices rose 17 per cent during December and in early January 2003 reached \$32/barrel. OPEC reacted to this situation in early 2003 by raising output quotas by 13 per cent to 24.5 million barrels per day. Although it appears to have stemmed further price rises, it is unlikely to have

TABLE 2.1.2  
Changes in international share prices  
(Per cent)

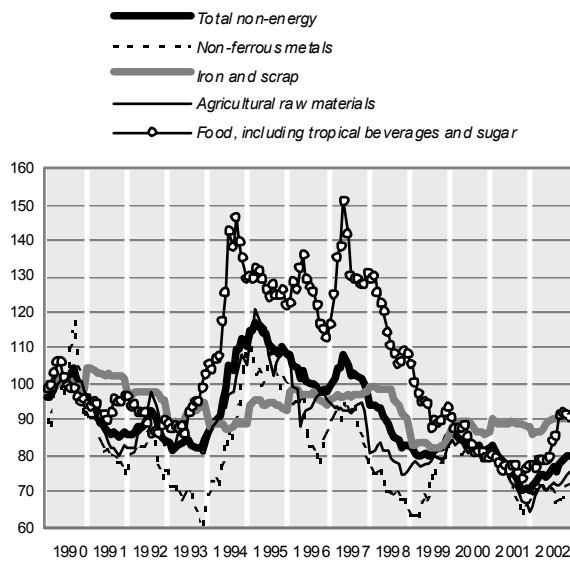
	December 2002 value compared with:	
	Recent daily peak in 2000	January 2002
<b>United States</b>		
Nasdaq .....	-73.5	-32.5
Dow Jones Industrials ...	-28.8	-17.2
S&P 500 .....	-42.4	-23.8
<b>Europe</b>		
Stox x 50 .....	-53.6	-33.6
Euro Stox x 50 .....	-56.3	-36.5
DAX Xetra .....	-64.1	-44.0
CAC 40 .....	-55.7	-33.1
FTSE 100 .....	-43.1	-24.5
<b>Japan</b>		
Nikkei 225 .....	-58.8	-21.1

had a significant impact on actual supply, since OPEC members had already been overproducing in late 2002. Given the overall tightness of the market and the risks of war, oil prices are likely to remain very volatile throughout 2003. An actual war in Iraq would drive prices up, at least initially and temporarily. However, a significant fall in prices cannot be ruled out if the political uncertainty were to ease, given the recent increase in production by several countries. Oil prices are thus expected to remain a major source of uncertainty for the world economy.

<sup>47</sup> In addition to the cutback in current supplies to world markets there are concerns that the longer the stoppage, the longer it will take to bring output back to pre-strike levels once production is resumed. At the time of writing the strike had lasted 50 days and a return to normal levels of oil production and exports was not in sight.

CHART 2.1.5

Changes in non-energy commodity prices, 1990-2002  
(Indices, 1990=100)



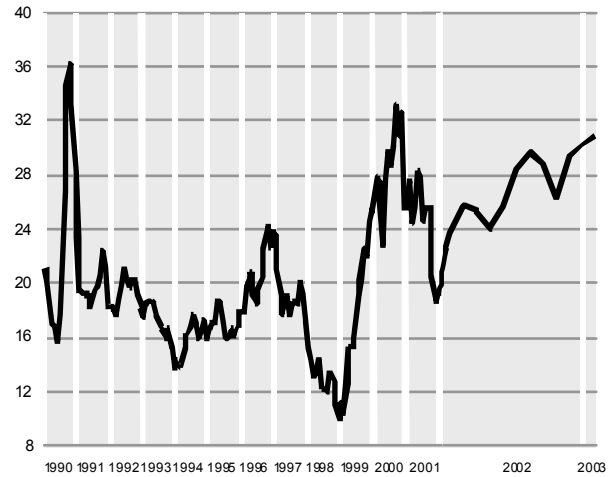
Source: Hamburg Institute for Economic Research (HWWA).

Note: Indices calculated on the basis of current dollar prices and weighted by commodity imports of industrialized countries.

In the *foreign exchange markets*, the dollar depreciated against the euro and the yen and other major currencies during 2002 (chart 2.1.7). In November and December, the average monthly dollar-euro exchange rate rose above parity for the first time since January 2000. On average, the euro appreciated against the dollar by 15.3 per cent between January and December 2002. Over the same period, the euro appreciated by 4.2 per cent against sterling and by 6 per cent against the yen. The dollar depreciated by 8 per cent against the yen. The Bank of Japan intervened on several occasions to stem the appreciation of the yen, which was seen as eroding the country's external price competitiveness and thus restraining the incipient economic recovery. More generally, downward pressures on the dollar reflected the underlying weakness of growth in the United States economy, sharp falls in equity values, the interest rate differential in favour of the euro (see section 2.2(i) below) and the perception of increased geopolitical risk. The broad, real effective exchange rate of the dollar depreciated by 2.8 per cent between January and December 2002, but its depreciation against the major currencies was much

CHART 2.1.6

Changes in crude petroleum prices, January 1990-January 2003  
(Dollars/barrel)<sup>a</sup>



Source: United States Department of Energy, *Weekly Status Petroleum Report* (Washington, D.C.), various issues [[www.eia.doe.gov](http://www.eia.doe.gov)].

Note: Brent spot price, monthly averages.

<sup>a</sup> January 2003 data based on first half of the month greater at 8 per cent. Over the same period, the broad measure of the euro's real effective exchange rate rose by 7.3 per cent and the narrower measure against core currencies by 5.8 per cent.

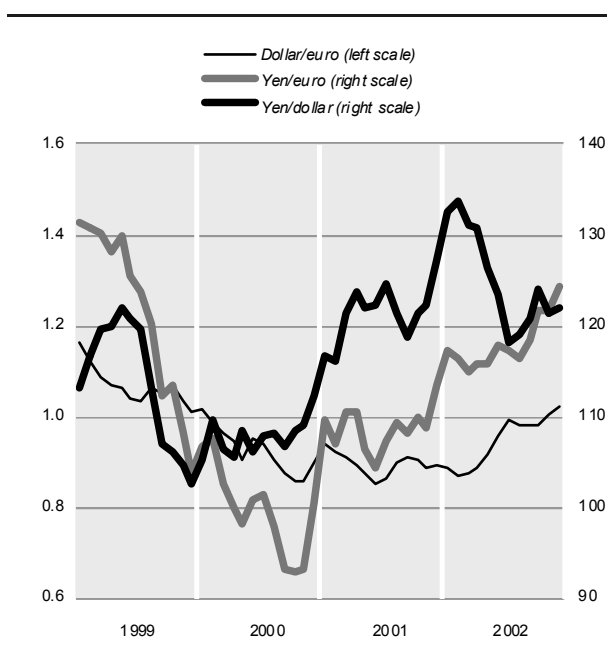
## (ii) North America

In the *United States*, the recovery from the mild recession in 2001 was quite uneven in 2002 (table 2.1.3). Real GDP rose by 1 per cent in the third quarter of 2002 compared with the preceding quarter and by 3.3 per cent compared with a year earlier. But there appears to have been little growth in the final quarter of 2002, with weak consumer demand (except for motor cars), soft labour markets and limited business investment spending, although the housing market remained strong.<sup>48</sup> For the year as a whole, real GDP increased by some 2.3 per cent, compared with 0.3 per cent in 2001. The upturn in manufacturing output in the first half of 2002 was not sustained in the second half. Capacity utilization in late 2002 was still some 7 percentage points below the long-term average for 1972-2002. The Institute for Supply Management (ISM) index, a gauge of overall activity (output, orders, inventories,

<sup>48</sup> The Federal Reserve Board, *The Beige Book*, 27 November 2002 [[www.federalreserve.gov](http://www.federalreserve.gov)].

CHART 2.1.7

Bilateral exchange rates between the dollar, the euro and the yen,  
1999-2002  
(Currency units)



Source: Eurostat, New Cronos Database.

Note: Average monthly values.

employment conditions) in the manufacturing sector, however, rose above the threshold of 50 per cent in December 2002, pointing to a general improvement in business conditions in the sector. This contrasts with a slowdown in the rate of expansion of activity in the non-manufacturing sectors (chart 2.1.8).

Private consumption remained the mainstay of economic activity in 2002. Households' real disposable incomes were supported by moderating inflation, higher average wages and salaries, and lower tax payments resulting from the tax cuts in the second phase of the tax reform of 2001. These factors more than offset the impact of falling employment on aggregate income growth. Private consumption was also supported by further increases in real estate prices, which partly offset the negative wealth effects of falling equity prices. Household spending was also stimulated by the marked decline in mortgage rates over the past two years, which encouraged many households to borrow funds against the equity accumulated in their homes. These funds, in turn, were spent on home improvements and durable consumer goods, but also for the repayment of other debts ("cash-

TABLE 2.1.3

Changes in real GDP and major expenditure items in the United States, 2002QI-2002QIII  
(Percentage change)

	Change from previous period			Change from same period of previous year		
	2002			2002		
	QI	QII	QIII	QI	QII	QIII
Private consumption .....	1.2	0.3	1.0	3.0	3.1	3.3
Government expenditures <sup>a</sup> .....	1.4	0.4	0.7	5.1	4.0	5.0
Gross fixed investment .....	-0.1	-0.2	-0.1	-6.3	-3.7	-2.8
Structures .....	-3.8	-4.7	-5.8	-13.3	-15.6	-21.0
Equipment and software .....	-0.7	0.8	1.6	-8.0	-2.9	1.1
Residential .....	3.4	0.7	0.3	2.4	3.2	3.4
Changes in inventories <sup>b</sup> .....	0.7	0.3	0.1	-	0.6	0.6
Total domestic expenditures .....	1.4	0.6	1.0	1.8	2.8	3.7
Net exports of goods and services <sup>b</sup> .....	-0.2	-0.3	-	-0.4	-0.7	-0.4
Exports .....	0.9	3.4	1.1	-9.3	-3.0	2.8
Imports .....	2.1	5.1	0.8	-4.1	2.6	6.7
Real GDP .....	1.2	0.3	1.0	1.4	2.2	3.3

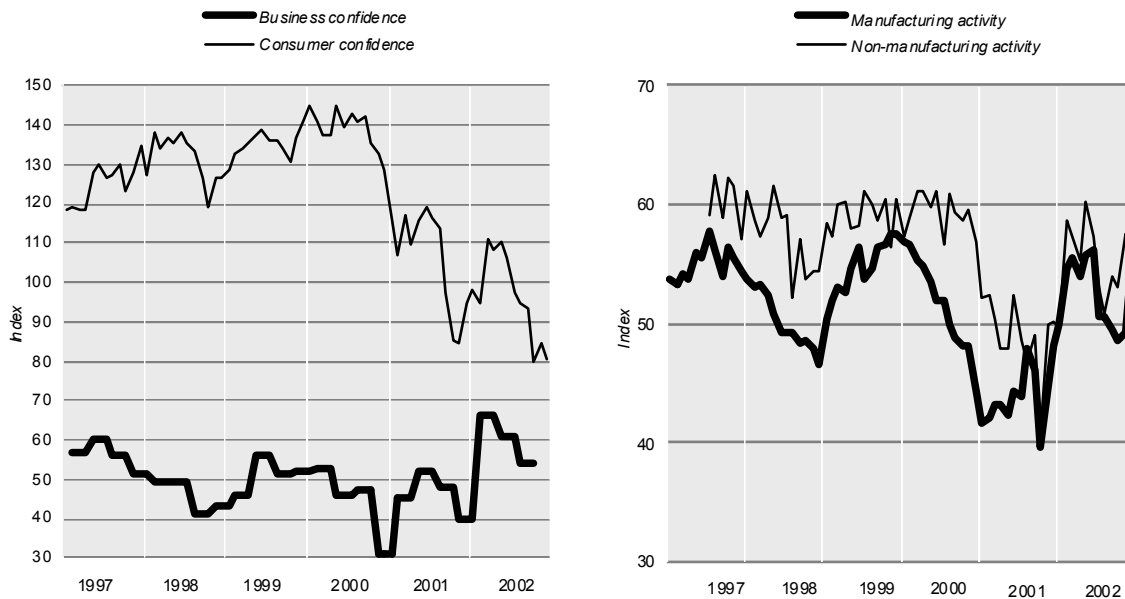
out refinancings").<sup>49</sup> Demand for motor cars was spurred by zero interest rate financing packages offered by car producers, but for other products demand appears to have weakened in the final months of the year as the household savings ratio edged upward in the face of a more uncertain outlook for employment and the considerable financial losses incurred in the equity markets.

Residential investment lost momentum after the first quarter of 2002, but the upward tendency was maintained, supported by mortgage rates falling to their lowest levels in more than 30 years. Sales of new homes were at a record high in November 2002, but median prices fell 0.5 per cent year-on-year suggesting some emerging price resistance from buyers. The strong spending on consumer goods and residential investment was accompanied by a further accumulation of debt, which has lifted debt service burdens to record levels despite low interest rates.

<sup>49</sup> It is estimated that the aggregate value of funds raised through this so-called cash-out refinancing amounted to \$131.6 billion in 2001 and the first half of 2002, of which some \$20.7 billion was used to fund consumer spending on vehicles, vacations, etc. and some \$46.3 billion on home improvements, which fall under the category of residential investment in the national accounts. G. Canner et al., "Mortgage refinancing in 2001 and early 2002", *Federal Reserve Bulletin*, December 2002, pp. 469-481.



CHART 2.1.8  
**Business and consumer surveys in the United States, 1997-2002**  
*(Indices, per cent)*



**Source:** Business and consumer confidence: The Conference Board [www.conference-board.org]; manufacturing and non-manufacturing activity: Institute for Supply Management [www.ism.ws].

Consumer confidence peaked in the summer of 2000. There was only a brief recovery from the shock of 11 September 2001 and in the second half of 2002 confidence was falling sharply against the backdrop of rising unemployment, a bleak outlook for jobs and increasing geopolitical risks: in December, it was at its lowest level since February 1994. Business confidence also weakened sharply after the first quarter of 2002 (chart 2.1.8).

Business spending on equipment and software recovered somewhat in the course of 2002, largely due to rising demand for information processing equipment and software; nevertheless the total annual expenditure remained significantly below the level of 2001. Overall business investment continued to be restrained by the large margins of spare capacity in many sectors of the economy. There was a particularly sharp fall in spending on offices and industrial buildings for which vacancy rates are high. In total, non-residential fixed business investment fell by some 6 per cent in 2002 following a fall of more than 5 per cent in the previous year. The change in inventory investment supported overall economic activity in 2002 and it appears that the reduction of inventories has been largely completed in many

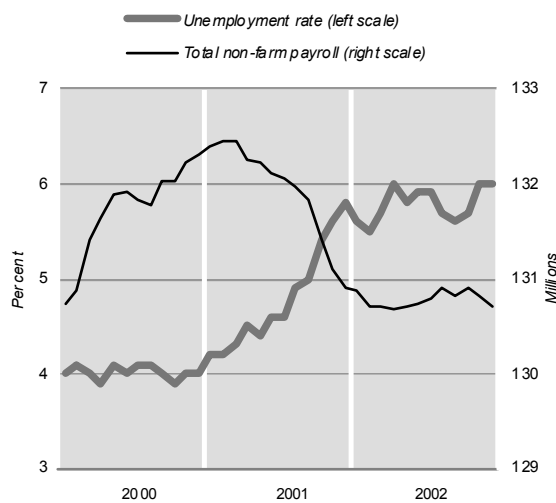
sectors. Real government consumption and investment expenditures provided substantial support to overall GDP growth, largely reflecting higher spending on national defence and security. Changes in real net exports subtracted from overall economic growth for the year as a whole (table 2.2.1)

Developments in the labour markets in 2002 reflected the efforts of companies to maintain profit margins in the face of weak pricing power and intense competition on domestic and foreign markets. The associated layoffs, however, were mainly concentrated in the manufacturing sector, where the level of employment fell by 9.5 per cent from its peak in 2000. But there were also significant cutbacks in retail trade and construction. The total number of persons on non-farm payrolls fell by nearly 1 per cent in 2002. The unemployment rate edged up to 6 per cent in the last two months of 2002, the annual unemployment rate averaging 5.8 per cent, up from 4.8 per cent in 2001 (chart 2.1.9).

A striking feature of 2002 was the rebound in productivity growth in the business sector, which to a large extent reflected the reduction in employment. Total hours worked in the non-farm business sector fell by some 2.5 per cent in the first

CHART 2.1.9

**Employment and unemployment in the United States, 2000-2002**  
(Millions, per cent of civil labour force)



Source: Bureau of Labor Statistics (Washington, D.C.) [www.bls.gov].

three quarters of 2002 (compared with the same period of the previous year). Given an increase in output of 2.5 per cent over the same period, this translated into productivity growth of 5 per cent. This is one of the largest, if not the largest, annual productivity gain in 30 years.<sup>50</sup> The trade-off between employment and productivity growth was even sharper in the manufacturing sector: productivity also rose by 5 per cent, but this was the outcome of a 1.4 per cent decline in output and a sharp cutback in hours worked by 6.1 per cent. These strong productivity growth rates reflect in the main the lagged adjustment of hours worked to the cyclical slowdown in output growth. Productivity gains can therefore be expected to fall back to close to trend once this adjustment process has been completed. An open question is to what extent other factors, such as lower adjustment costs associated with earlier investment in capital goods, especially computing and communication technologies, have also influenced the acceleration in productivity growth.<sup>51</sup>

Large productivity gains more than offset upward pressures on costs from higher wages. As a result, unit labour costs fell in 2002, and there was

an improvement in profit margins. Corporate profits (adjusted for inventory valuation and capital consumption) rose in 2002.

The annual rise in consumer prices slowed to some 1.5 per cent in 2002, from 2.8 per cent in 2001. This reduction in the inflation rate was largely due to the lower annual increase in energy prices.<sup>52</sup> Core inflation was falling throughout the year, averaging some 2.4 per cent against 2.7 per cent in 2001 (chart 2.1.10).

There was a sharp deterioration in the external balances in 2002. The merchandise trade deficit rose by some \$50 billion in 2002 and there was a swing from surplus to deficit on the invisibles balance. As a result the annual current account deficit rose to some \$500 billion or 5 per cent of GDP, up from 3.9 per cent in 2001.

The stance of monetary policy remained very expansionary in 2002 following the cut in the federal funds target rate to 1.75 per cent in late 2001, its lowest level in more than 40 years. The target rate remained unchanged until early November 2002, when it was reduced to 1.25 per cent. The additional stimulus was intended to help the economy overcome the increased uncertainty which was seen to be restraining spending, production and employment.<sup>53</sup> This reduction in the target interest rate was larger than expected by market participants as overall monetary conditions had already become more accommodating due to the real effective depreciation of the dollar.

<sup>52</sup> While energy prices had a disinflationary impact on an annual average basis, this effect was reversed during the year. In early 2002, energy prices were some 15 per cent below the level of a year earlier; however, they rose sharply towards the end of the year. In December 2002 energy prices increased by 11 per cent compared with the same month of the preceding year, thus pushing up total inflation.

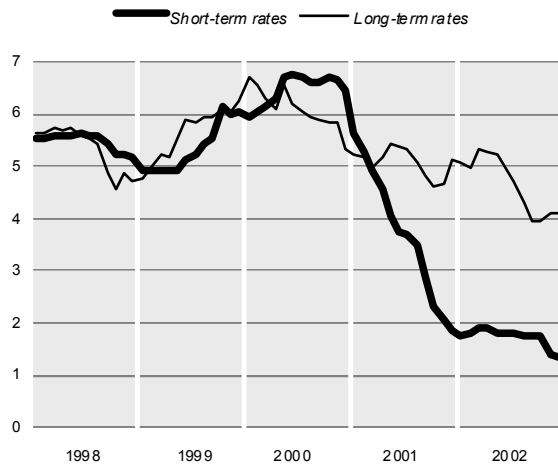
<sup>53</sup> In August and September 2002, the Federal Open Market Committee had already emphasized that given the long-run goals of price stability and sustainable economic growth, "the risks are mainly weighted toward conditions that may generate economic weakness". Between March and June 2002, the risks with respect to the prospects for both goals were judged to be balanced. With this additional policy action, statements released in November and December 2002 judged these risks to be evenly balanced again [www.federalreserve.gov/boarddocs].

<sup>50</sup> "Productivity", remarks by Chairman Alan Greenspan at the United States Department of Labor and American Enterprise Institute Conference (Washington, D.C.), 23 October 2002 [www.federalreserve.gov/boarddocs].

<sup>51</sup> Ibid.

CHART 2.1.11

**Nominal short-term and long-term interest rates in the United States, 1998-2002**  
(Per cent per annum)



**Source:** OECD, *Main Economic Indicators* (Paris); United States Federal Reserve Board (Washington, D.C.) [[www.federalreserve.gov](http://www.federalreserve.gov)].

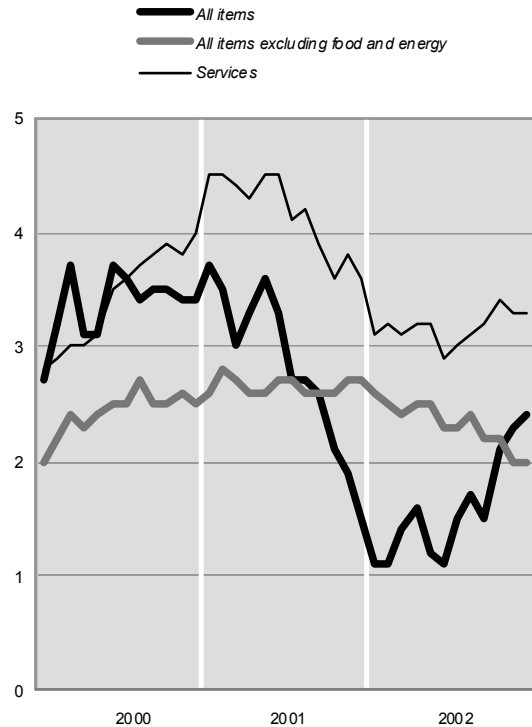
**Note:** Three-month certificate of deposit rate; yields on 10-year treasury bills (average monthly values).

Three-month nominal interest rates fell to only 1.3 per cent on average in December 2002; real short-term interest rates are negative. At the longer end of the maturity spectrum, yields on 10-year treasury bills fell to some 4 per cent in late 2002, about 1 percentage point less than at the beginning of the year (chart 2.1.11). Contemporaneous real long-term yields fell below 2 per cent in late 2002. The yield curve, approximated by the maturity spread between nominal long-term and short-term interest rates, flattened again in the second half of 2002, an indication of moderate inflationary expectations in the face of weak growth prospects and of expectations that monetary policy will not be tightened in the near future.

Fiscal policy was strongly expansionary in 2002. For the fiscal year ending September 2002, the *federal government* budget was in deficit for the first time after five years of surpluses. The deficit (including off-budget items) reached \$158 billion (or 1.5 per cent of GDP), after a surplus of \$127 billion in fiscal 2001. Revenues declined by nearly 7 per cent, the largest decline since 1946, while expenditures rose by 8 per cent. These trends continued unabated into the fourth quarter of 2002, when the federal budget deficit was \$109 billion, up

CHART 2.1.10

**Consumer prices in the United States, 2000-2002**  
(Percentage change over same month of preceding year)



**Source:** Bureau of Labor Statistics (Washington, D.C.) [[www.bls.gov](http://www.bls.gov)].

from \$35 billion a year earlier. For the calendar year 2002, the federal budget deficit is estimated at some 2¼ per cent of GDP. The *general government* deficit was 3.1 per cent of GDP in 2002, up from 0.5 per cent in the preceding year. In 2000, there was still a surplus of 1.4 per cent of GDP.<sup>54</sup> In other words, there has been a reversal in the fiscal balance equivalent to 4.5 percentage points of GDP over the past two years. Whereas in 2001 most of the deterioration in the budget balances was due to the direct effects of the recession, in 2002 it was largely the result of structural factors (chart 2.1.12), in particular the tax cuts enacted in 2001 and the increased spending on defence, homeland security and the war on terrorism. The swing in the government's financial balance has led to the re-emergence of the "twin deficits", i.e. the simultaneous existence of large budget and current account deficits, which were a prominent feature of the 1980s.

<sup>54</sup> OECD *Economic Outlook*, No. 72 (Paris), December 2002.

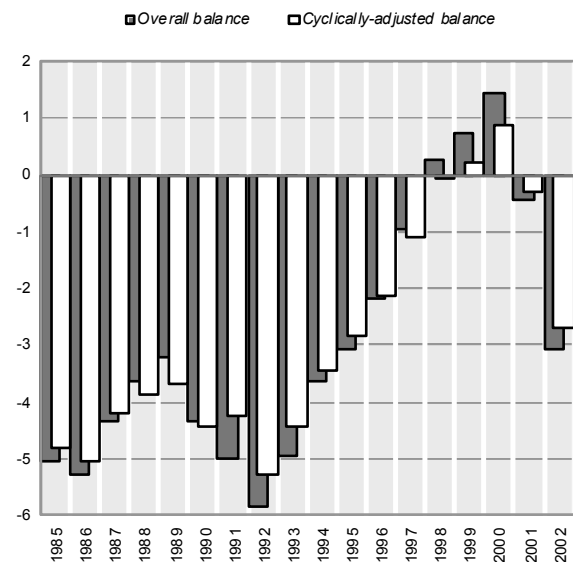
In January 2003, the administration proposed further tax cuts to support economic activity. If approved, these would reduce the federal tax take by \$674 billion over a 10-year period, more than half of it coming from the elimination of dividend taxation. Another \$213 billion would result from bringing forward the tax cuts already agreed by Congress as part of the administration's 2001 tax reform. Depending on if and when Congress passes the latest proposal, \$40-\$45 billion of tax cuts could be realized in 2003.<sup>55</sup> Thus the immediate fiscal stimulus amounts to a little more than 2 per cent of federal budget revenues and is equivalent to around 0.4 per cent of GDP.

Beyond this immediate stimulus, the centrepiece of the proposal, the dividend tax cut, is intended to boost growth in the medium term by encouraging savings and by eliminating distortions in the allocation of capital created by the double taxation of dividends. While current tax laws do indeed distort capital allocation, the growth effects of the corporate tax reform are likely to remain rather weak. They could be strengthened if the reform were made more comprehensive, including the elimination of tax advantages of debt over equity, and the elimination of loopholes and tax shelters.

A more comprehensive reform might also be less detrimental to the longer-term outlook for the federal deficit than is the case under the present proposal. The current (January 2003) projections of the Congressional Budget Office still foresee a cumulative federal budget surplus of roughly \$630 billion over the coming 10-year period. The impact of the proposed additional tax cuts on the budget balance will, of course, depend crucially on the extent to which they succeed in boosting economic growth above current projections. On the basis of these projections, the proposed tax cuts would eliminate the surplus in the Congressional Budget Office's baseline scenario. Under a more pessimistic scenario assuming discretionary spending grew at the same rate as GDP, however, the outcome would likely be closer to a cumulative deficit of some \$1 trillion. While such a deficit would not be large by international or historical standards relative to cumulative GDP, these projections do not allow for the risks arising

CHART 2.1.12

**General government financial balances in the United States, 1985-2002**  
(Per cent of GDP)



Source: OECD Economic Outlook, No. 72 (Paris), December 2002.

Note: Cyclically adjusted balances as a per cent of potential GDP. Data for 2002 are preliminary estimates.

on the expenditure side of the budget in connection with a possible war with Iraq or for the growing funding gaps in the social security and Medicare programmes.<sup>56</sup>

There was a strong economic recovery in Canada in 2002, but the rate of expansion slowed down in the final months, a reflection of weakening growth in the United States, its major trading partner. Real GDP increased by some 3¼ per cent in 2002, the highest growth rate among the major seven economies. This largely reflects a strong growth of domestic demand (private consumption, residential and public investment) but there was also an increase in the volume of net exports. Business fixed investment also edged upwards in response to the rising levels of activity in the course of 2002. In the labour market over half a million net new jobs were created during the first 11 months of 2002, the largest increase in employment since 1976. But the unemployment rate averaged 7.6 per cent for 2002 as a whole, significantly higher than in 2000 (6.8 per cent) and

<sup>55</sup> Oxford Analytica, *United States: Modest Stimulus Seen From Bush Package*, 10 January 2003.

<sup>56</sup> Congressional Budget Office, "The impact of social security and Medicare on the federal budget", *Long-range Fiscal Policy Brief*, No. 6, 14 November 2002 [www.cbo.gov].

2001 (7.2 per cent). Consumer price inflation edged up in 2002, reaching 4.3 per cent in November. Core inflation accelerated to 3.1 per cent, slightly above the Bank of Canada's target range of 1 to 3 per cent.

Against a background of rapid economic growth and rising capacity utilization, monetary policy was tightened in a series of steps between April and July 2002, the key interest rate being raised by a total of 0.75 percentage points to 2.75 per cent. Interest rates are still low, however, and the stance of monetary policy is still expansionary.

Fiscal policy continued to support the economy in 2002. The surplus on the general government financial balance fell to some 0.5 per cent of GDP in 2002, down from 1.8 per cent in 2001 and 3.1 per cent in 2000. This deterioration in the fiscal position reflects both earlier tax cuts and the working of the automatic stabilizers in 2001, when there was a pronounced weakening of economic activity. The current account balance remained in comfortable surplus in 2002.

### (iii) Japan

In *Japan*, real GDP fell by 0.7 per cent in 2002, prolonging the economic stagnation to more than a decade. The economy had fallen back into recession in 2001, the third recession in 10 years. Although activity edged up in the second and third quarters of 2002, the recovery appears to have stalled again in the final quarter. In November, industrial production fell for the third consecutive month, hit by sluggish exports. During the first half of the year, activity was sustained by net exports, which benefited from a weaker yen and the dynamism of east Asian foreign trade.<sup>57</sup> The stimulus from net trade, however, failed to spur business fixed investment, which has been declining for almost two years. The government supported demand through fiscal policy, which led to a widening budget deficit corresponding to nearly 8 per cent of GDP and raised the level of government debt above 140 per cent of GDP. Although private household consumption

supported GDP growth in 2002, its rate of expansion was constrained by shrinking employment, which depressed household disposable incomes, and by the persistent deflationary tendency. Consumer prices fell for the fourth consecutive year in 2002, while equity prices reached their lowest level in 20 years. The unemployment rate reached a postwar high of 5.5 per cent in October, but fell slightly in November.

Since the early 1990s the adoption of a decisive policy stance to reverse deflation and stagnation has been blocked by the lack of political consensus and support. Nevertheless some signs seem to be emerging that more decisive action may eventually be taken. The government has announced a more forceful plan to tackle the problems of the country's crisis-prone financial system, where the volume of non-performing loans continued to increase and the capital base was further eroded by falling equity values. The plan is intended to quantify the true size of such bad loans and to compel banks to make provisions in order to write them off.<sup>58</sup> The consequent capital deficit would be covered by an injection of public funds and possibly the nationalization of some institutions. The announcement of the plan has spurred banks to undertake some restructuring, including a limited disposal of equities, some restructuring of assets and operations, the shedding of staff and reductions in wages. Although a solution to the crisis in the financial sector is a condition for economic recovery, in the short term such measures will inevitably depress economic activity and risk deepening the deflationary process.

The Bank of Japan in 2002 maintained its policy of keeping short-term interest rates at zero,<sup>59</sup> which were nevertheless positive in real terms, given the fall in prices. The central bank continued to shy away from the more aggressive monetary easing that has been proposed by many commentators. This would include measures such as the adoption of an inflation target, dramatically increasing the purchase of government bonds and,

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<sup>57</sup> The rising significance of Asian markets was confirmed throughout the year. Between January and November 2002, the value of Japanese exports to China soared by 31 per cent (year-on-year, on a yen value basis); in contrast, those to its largest market, the United States, were virtually stagnant.

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<sup>58</sup> Under the proposal, these loans would be taken over by a government agency that would in effect undertake the corporate restructuring of the indebted firms that appeared to still be viable.

<sup>59</sup> The official overnight call rate has been zero since 19 March 2001.

possibly, of foreign financial assets as well. The objective would be to reverse deflation, inject liquidity into the economy (bypassing banks, which are not performing this function adequately due to their non-performing loans and capital problems), to increase government spending and weaken the exchange rate (an outcome desired by Japanese authorities). It remains to be seen to what extent the Bank of Japan will adopt some or all of these measures in 2003, when a new governor takes office.

## 2.2 Western Europe

Western Europe experienced a progressive cyclical slowdown in 2001, and between the third and final quarters real GDP actually fell. Economic activity edged up again in the first quarter of 2002, but the recovery failed to gather any significant momentum in the course of the year. Domestic demand remained sluggish and changes in real net exports provided only little support to economic activity. For the year as a whole, real GDP rose by only about 1 per cent. Against this background, inflation remained moderate. Labour markets proved quite resilient to the cyclical downturn, but the decline of unemployment in recent years was partly reversed in 2002. The average performance, however, conceals considerable differences within western Europe. Relatively strong GDP growth in Greece, Ireland and Turkey contrasts with more moderate increases in France and the United Kingdom and virtual stagnation in Germany and Italy. In Iceland, Israel and Switzerland GDP declined in 2002 (table 2.2.1).

### (i) Euro area

#### (a) *Main macroeconomic developments*

During the first quarter of 2002, economic activity in the euro area recovered from its setback at the end of 2001, but the recovery was rather sluggish throughout the rest of the year. On average, real GDP in the euro area rose by just 0.8 per cent in 2002, much less than the previous year's already modest 1.5 per cent.

During the first quarter of 2002 the nascent recovery was driven by net exports and inventory investment (chart 2.2.1). However, these impulses waned in the following quarters and were not followed by a rebound in domestic demand, as had

been expected at the start of the year. For the year as a whole, total domestic demand rose by only 0.3 per cent: real private consumption rose just 0.7 per cent, down from 1.8 per cent in 2001. This slowdown was mainly due to the impact of lower employment growth on aggregate incomes. Moreover, households stepped up savings in the face of increased uncertainty, which in turn was partly related to rising unemployment and mounting geopolitical risks. These factors combined to subdue consumer confidence, which in the last quarter fell to its lowest level in six years (chart 2.2.2). Household confidence was also hit by the plunge in share prices, although the direct impact on spending was probably fairly limited given the relatively low importance of equity holdings in total household wealth in the euro area.

Gross fixed capital formation fell by 2.3 per cent in 2002, following a smaller decline in 2001. Within the total there was a stronger cutback in business spending on machinery and equipment, which reflected the deteriorating outlook for sales and profits and ample spare capacity in industry. Moreover, financing conditions deteriorated significantly due to the sharp fall in share prices and the tightening of credit conditions by banks. It is likely that investment was also restrained by the need to work off excess capital spending and capital misallocation in the ICT sector during the boom of the second half of the 1990s. Against this background, industrial confidence remained well below its long-term average in 2002, but nevertheless edged up somewhat in the second half of the year. This conflicts, however, with the pronounced decline of the euro area Purchasing Managers Index (PMI) for manufacturing and of the Ifo business climate index for Germany during the second half of 2002 (chart 2.2.2).

Government consumption expenditures rose relatively strongly, by some 2 per cent, in 2002, about the same as in 2001 (table 2.2.1). They thus provided a larger contribution than private consumption to economic growth in 2002. This partly reflects government efforts to support economic activity with expansionary fiscal policies. This was particularly the case in France, Ireland and the Netherlands.

The volume of exports of goods and services rose by only 0.8 per cent in 2002, a reflection of

TABLE 2.2.1

## Annual changes in the major expenditure items on GDP in western Europe, North America and Japan, 2001-2002

(Percentage change over preceding year)

	GDP at market prices		Private consumption		Government consumption		Gross fixed capital formation		Changes in stock-building <sup>a</sup>		Total domestic expenditures		Exports of goods and services		Imports of goods and services		Net exports <sup>a</sup>	
	2001	2002	2001	2002	2001	2002	2001	2002	2001	2002	2001	2002	2001	2002	2001	2002	2001	2002
	France .....	1.8	1.0	2.6	1.7	2.5	3.2	2.3	0.1	-0.8	-0.7	1.7	1.0	0.5	0.4	0.1	0.4	0.1
Germany .....	0.6	0.2	1.5	-0.5	0.8	1.5	-5.3	-6.4	-0.6	-	-0.8	-1.3	5.0	2.9	1.0	-1.3	1.4	1.5
Italy .....	1.8	0.4	1.1	-0.1	2.2	1.6	2.4	-2.2	-	0.9	1.6	0.7	0.8	-0.7	0.2	0.1	0.2	-0.2
Austria .....	0.7	0.7	1.5	0.8	-0.5	0.2	-2.2	-2.6	-0.5	-0.1	-0.1	-0.3	7.4	0.1	5.9	-1.8	0.7	1.0
Belgium .....	0.8	0.7	0.9	0.8	2.2	1.4	0.5	-2.8	-0.6	0.3	0.5	0.4	1.1	-0.6	0.8	-1.1	0.3	0.4
Finland .....	0.7	1.4	1.1	2.7	2.1	1.9	4.0	-1.6	-0.8	-0.6	2.0	0.9	-2.2	2.5	0.1	1.6	-1.0	0.5
Greece .....	4.1	3.5	3.2	3.0	0.5	1.0	5.9	7.3	0.2	-0.1	3.5	3.6	-1.3	1.0	-1.9	2.2	0.3	-0.4
Ireland .....	5.7	3.3	5.0	3.7	10.5	7.0	-0.4	0.8	-0.4	-0.1	4.8	3.5	6.7	4.9	6.1	5.3	1.4	0.3
Luxembourg .....	1.0	0.1	3.6	2.3	7.5	6.0	5.9	-2.7	1.3	0.1	6.1	1.7	1.2	-2.6	4.5	-1.9	-4.2	-1.5
Netherlands .....	1.3	0.2	1.2	1.0	3.1	2.4	-0.8	-3.3	0.2	0.1	1.4	0.4	1.7	-1.6	1.9	-1.4	-	-0.2
Portugal .....	1.7	0.7	0.9	1.0	2.4	1.4	0.1	-3.4	-	-	0.9	-0.1	2.9	2.6	0.9	0.2	0.6	0.8
Spain .....	2.7	1.9	2.7	1.7	3.1	2.2	2.5	1.5	0.1	0.1	2.7	1.8	3.4	-0.4	3.5	-0.5	-0.1	-
<b>Euro area</b> .....	1.5	0.8	1.8	0.7	2.0	2.1	-0.2	-2.3	-0.4	-	1.0	0.3	2.7	0.8	1.4	-0.4	0.5	0.4
United Kingdom .....	2.0	1.6	4.1	3.5	3.1	3.7	0.3	-4.0	-0.7	-0.2	2.5	2.0	1.2	-	2.8	1.4	-0.5	-0.4
Denmark .....	1.0	1.7	0.8	2.1	1.2	1.4	-	2.3	0.3	-0.1	1.1	1.8	3.7	3.6	4.3	4.1	-	-
Sweden .....	0.8	1.6	0.2	1.4	0.9	1.7	0.8	-1.6	-0.4	-0.3	0.1	0.5	-1.4	1.8	-3.5	-0.6	0.8	1.0
<b>European Union</b> .....	1.6	0.9	2.2	1.2	2.1	2.3	-0.1	-2.4	-0.4	-	1.3	0.6	2.4	0.8	1.5	-0.1	0.3	0.3
Cyprus .....	4.1	1.8	5.0	3.0	11.5	6.1	2.5	3.5	-1.1	0.6	4.1	3.6	4.0	-3.6	3.9	0.6	-0.1	-2.0
Iceland .....	1.5	-0.6	-1.2	-0.6	3.7	3.2	-5.5	-13.7	-0.4	0.1	-1.7	-2.7	5.5	-	-3.0	-5.0	3.1	2.0
Israel .....	-0.9	-1.0	2.5	-0.6	3.3	5.5	-6.1	-8.9	0.7	-	1.7	-0.4	-11.7	-5.4	-4.5	-3.0	-2.7	-0.6
Malta .....	-0.8	2.5	1.9	2.9	2.9	5.2	-11.4	-5.1	-4.6	0.3	-5.4	1.8	-4.8	-1.8	-9.6	-2.4	5.9	0.7
Norway .....	1.4	2.1	2.5	3.2	2.0	1.6	-4.6	1.4	-0.8	-	-0.3	2.4	4.2	2.5	-	3.3	2.0	0.2
Switzerland .....	0.9	-0.2	1.8	1.0	2.6	3.1	-5.2	-6.1	1.0	0.2	1.2	-0.2	-0.9	-1.8	-0.1	-1.8	-0.3	-0.1
Turkey .....	-7.4	3.7	-9.0	2.2	-8.6	2.1	-31.7	-4.5	-4.9	3.6	-18.4	5.1	7.4	6.5	-24.8	11.5	9.6	-1.1
<b>Western Europe</b> .....	1.2	1.0	1.6	1.3	1.8	2.3	-1.7	-2.5	-0.6	0.1	0.3	0.8	2.5	0.9	0.5	0.2	0.7	0.2
Canada .....	1.5	3.3	2.6	2.6	3.3	1.9	1.7	3.4	-1.3	0.1	1.1	2.8	-3.8	1.6	-5.8	0.3	0.6	0.6
United States .....	0.3	2.3	2.5	3.1	3.7 <sup>b</sup>	4.2 <sup>b</sup>	-3.8 <sup>c</sup>	-2.0 <sup>c</sup>	-1.3 <sup>c</sup>	0.3 <sup>c</sup>	0.2	2.8	-5.4	-1.2	-2.9	3.4	-0.2	-0.6
<b>North America</b> .....	0.4	2.4	2.5	3.1	3.6	4.0	-3.3	-1.5	-1.3	0.3	0.3	2.8	-5.0	-0.5	-3.4	2.8	-0.1	-0.5
Japan .....	0.3	-0.7	1.7	0.8	2.5	2.4	-1.5	-5.5	-	-0.7	1.0	-1.4	-6.5	5.5	-0.9	-1.2	-0.6	0.7
<b>Total above</b> .....	0.7	1.4	2.0	2.1	2.7	3.1	-2.3	-2.6	-0.8	0.1	0.4	1.4	-0.1	0.8	-0.9	1.0	0.2	-

Memorandum items:

**4 major west****European**

<b>economies</b> .....	1.4	0.7	2.3	1.1	2.0	2.5	-0.8	-3.4	-0.5	-	1.1	0.4	2.4	1.0	1.0	-0.1	0.4	0.3
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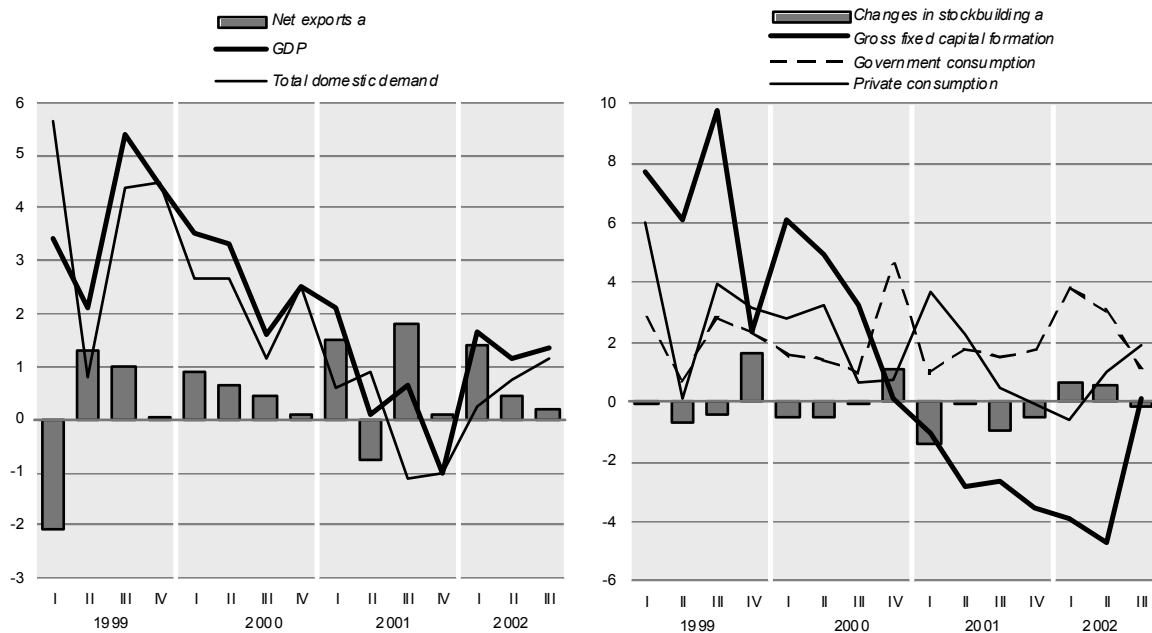
**Western Europe and**

the weak global economy and the slow recovery of world trade. Imports of goods and services even fell by about half a percentage point. As a result, changes in real net exports contributed 0.4 percentage points to overall economic growth, the largest contribution from among the major demand components (table 2.2.1).

Industrial production recovered from the severe downturn of 2001 but the month-to-month changes were quite uneven. In November 2002, output was nearly 3 per cent above its level of 12 months earlier, when the cyclical downturn was at its trough. For the year as a whole, industrial output was still some 1 per cent below its level in

CHART 2.2.1

Quarterly changes in real GDP and major expenditure items in the euro area, 1999Q1-2002QIII  
(Percentage change over previous quarter, seasonally adjusted at annual rate)



Source: Eurostat, New Cronos Database.

<sup>a</sup> Growth contribution in percentage points.

2001. Developments in the manufacturing sector followed a broadly similar trend. The decline in capacity utilization rates bottomed out, and in the autumn of 2002 utilization rates were some 3 percentage points below their previous peak in the same period of 2000 (chart 2.2.3).

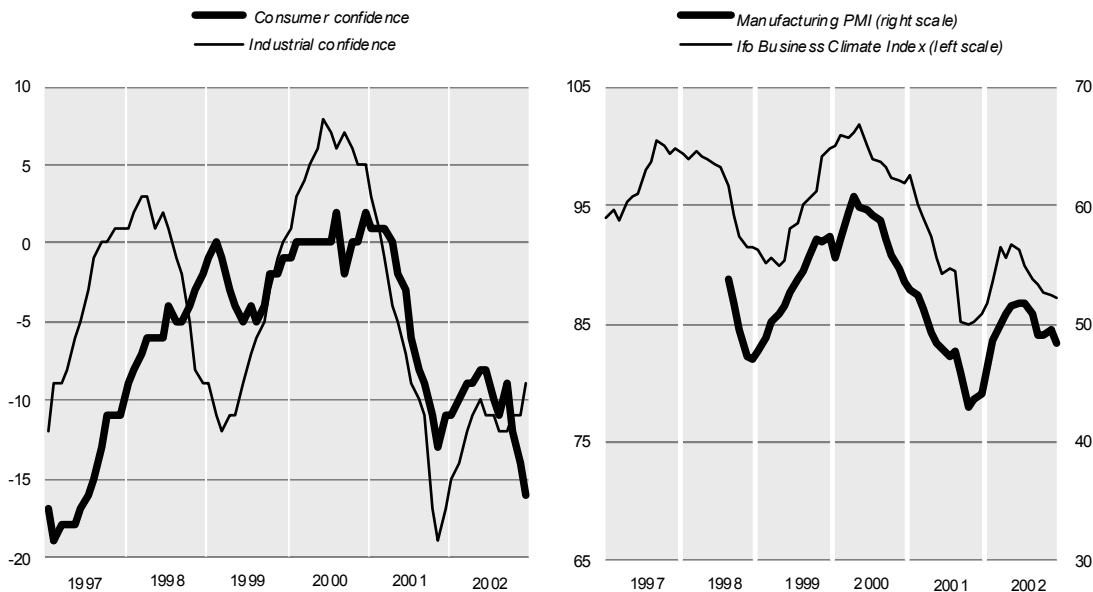
In the labour markets, the steady increase in employment during 2001 petered out in the second quarter of 2002 (the latest period for which complete data were available at the time of writing), reflecting the lagged adjustment to changes in production expectations (chart 2.2.4). For the year as a whole, total employment is likely to have increased by somewhat less than half a percentage point compared with 2001, when it rose by 1.4 per cent. This relative resilience of labour markets in the face of the cyclical downturn is also reflected in only a small increase in the unemployment rate, which edged up to 8.4 per cent in November 2002, after reaching a low of 8 per cent one year earlier.

Inflationary pressures were largely absent in the euro area in 2002. Against the backdrop of a progressive cyclical slowdown, the average annual rise in the consumer price index (HICP) was 2.2

per cent, down from 2.5 per cent in 2001. This was the third consecutive year that headline inflation remained above the ECB's 2 per cent upper limit of its inflation target. Inflation rates in the course of 2002 were influenced by statistical base effects for the prices of unprocessed food and energy (chart 2.2.5). In fact, energy prices fell on average in 2002 compared with 2001. Rising energy prices (year-on-year) in the final quarter of 2002, however, helped to maintaining the overall inflation rate above 2 per cent. The appreciation of the euro contributed to falling import prices from the rest of the world. The annual rate of core inflation (a measure which excludes the prices of unprocessed food and energy) was about 2.4 per cent in 2002. Price increases for services remained relatively steady at some 3.2 per cent, slightly higher than in 2001. This stickiness of services prices reflects relative wage and productivity developments, partly related to the real convergence process, but possibly also limited competition in the non-tradeable sector, which allows increases in unit labour costs to be passed on to consumers in the form of price increases.



CHART 2.2.2  
**Business and consumer surveys in the euro area, 1997-2002**  
 (Indices, 1995=100, percentages)



**Source:** Consumer and industrial confidence: European Commission, *Business and Consumer Survey Results* (Brussels), various issues; Ifo Business Climate Index for Germany: Ifo Institute (Munich) [[www.ifo.de](http://www.ifo.de)]; Manufacturing Purchasing Managers' Index (PMI): Reuters.

However, the average euro area figure for headline inflation masks large variations between individual countries (table 2.2.2), ranging from 4.7 percent in Ireland to 1.3 per cent in Germany. These differences translate more or less fully into corresponding differences in real interest rates across the maturity spectrum (see below). Intercountry differences were broadly similar for the core inflation rate.

The large increases in labour costs in 2001 appear to have levelled off in 2002. But cyclical factors (such as labour hoarding) continued to depress labour productivity growth in 2002, although there were signs of a reversal in the second quarter, which contributed to a slowdown in the growth of unit labour costs (chart 2.2.6).

### (b) Monetary policy

After reducing its key policy rate in November 2001, the ECB left the stance of monetary policy unchanged for more than a year despite a significant deterioration in the short-term economic outlook and a general lowering of growth forecasts for 2002 and 2003. In addition, the real effective appreciation of the euro led to a

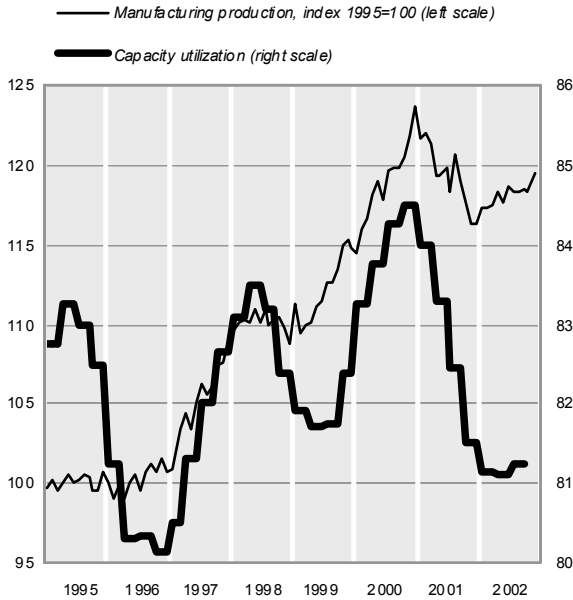
tightening of monetary conditions in the course of 2002, which reduced the external support to domestic activity.

It was only on 5 December 2002 that the Governing Council decided to lower its key interest rate by half a percentage point to 2.75 per cent, explicitly acknowledging the easing of inflationary pressures in the face of a widening output gap and the important downside risks to economic growth in the short run.

Money supply growth (M3) continued to exceed the reference value of 4.5 per cent in 2002. M3 rose on average by some 7 per cent compared with the preceding year. This strong expansion of the money supply, however, did not reflect an accumulation of potentially inflationary liquidity but, rather, portfolio adjustments from equity holdings to more liquid, low risk assets that are included in M3. These shifts were triggered by the heightened uncertainty and distress in the financial markets, especially the sharp decline in share prices. For the same reasons, there was also a flight-to-safety into government bonds. Although headline inflation remained slightly above the ECB's upper limit of 2 per cent throughout 2002, there was no risk of rising inflationary expectations given the deteriorating economic

CHART 2.2.3

Manufacturing output and capacity utilization in the euro area, January 1995–November 2002 (Indices, percentages)



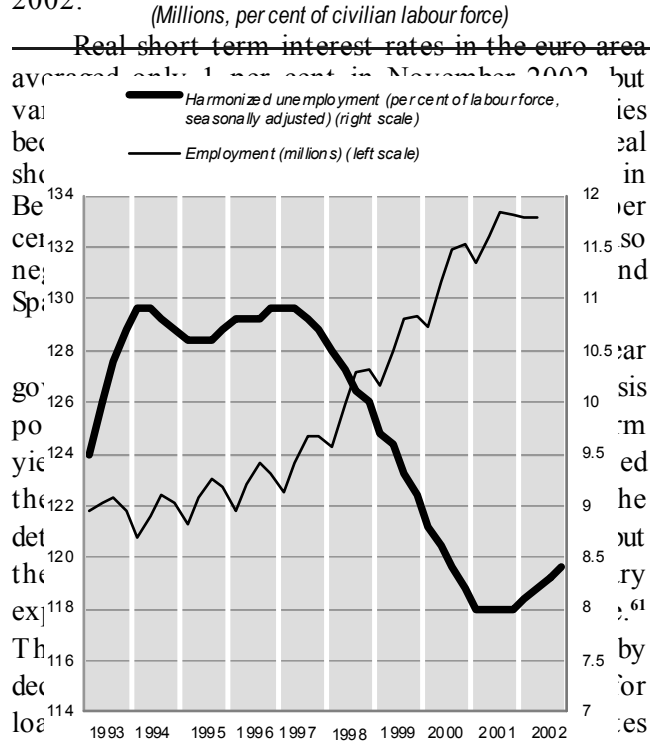
Source: Eurostat, New Cronos Database; European Commission, Business and Consumer Survey Results (Brussels), various issues.

Note: Capacity utilization rates are available only for January, April, July and October of each year. Data shown are approximations of quarterly data calculated as the arithmetic average of January and April data (first quarter), environment and the assumption of market participants that the ECB would raise interest rates in such an event. More generally, money supply developments have not proven to be a reliable indicator of future inflationary pressures, especially in a general context of low inflation. In line with this, money supply growth does not appear to have had a significant impact on the ECB's interest rate decisions since the onset of monetary union. This has weakened the credibility of the second pillar of the ECB's monetary strategy and strengthened the arguments to focus instead on inflation targeting.<sup>60</sup>

In view of the developments in financial markets and the deterioration of economic conditions, short-term interest rates (three-month EURIBOR) tended to fall in the second half of the year, a development that was accentuated by the easing of monetary policy in December 2002 (chart 2.2.7). Average monthly short-term rates

<sup>60</sup> UNECE, *Economic Survey of Europe, 2002 No. 1*, chap. 2, pp. 7–10. The ECB's President announced that the ECB would evaluate its often criticized two-pillar monetary strategy in the course of 2003. "Introductory statement", *ECB Press Conference*, 5 December 2002 [www.ecb.int].

CHART 2.2.4  
Real short term interest rates in the euro area averaged only 1 per cent in November 2002, but fell to 2.94 per cent in December, down by some 50 basis points from their previous peak in May 2002.



Source: Eurostat, New Cronos Database; European Central Bank [www.ecb.int]; UNECE secretariat calculations.

Note: Employment data not seasonally adjusted. Available only until 2002Q1. there was still a slight positive differential.

(c) Fiscal policy

Prolonged cyclical weakness led to a general deterioration of general government financial balances in the euro area in 2002. Most of the targets in the stability programmes for 2002 were not met. This mainly reflected the working of automatic stabilizers although in some countries an expansionary fiscal policy was also a factor. In France, Luxembourg and the Netherlands there were tax cuts in 2002. On average, the general government deficit rose to 2.3 per cent of GDP, up from 1.5 per cent in 2001. The cyclically adjusted ("structural") budget deficit, however, rose only slightly by 0.1 percentage point to 2 per cent of

<sup>61</sup> Long-term inflationary expectations, measured on the basis of index-linked 10-year government bonds, fell to 1.8 per cent in early December 2002, down by 0.4 percentage points from May 2002. ECB, *Monthly Bulletin* (Frankfurt am Main), December 2002, p. 30.

CHART 2.2.5  
**Main components of consumer prices in the euro area,**  
**January 2000–November 2002**  
 (Percentage change over same month of previous year)



**Source:** Eurostat, New Cronos Database; Harmonized Index of Consumer Prices (HICP).

GDP (table 2.2.3). Thus, on average, there was no significant change in fiscal policy in response to the cyclical developments.<sup>62</sup> The aggregate level of gross debt rose to 69.6 per cent of GDP in 2002, up from 69.3 per cent in 2001.

General government financial balances deteriorated in most countries, in some involving a swing from surplus into slight deficit (Belgium, Ireland, the Netherlands). In Germany, the deficit rose to 3.8 per cent of GDP, which is above the 3 per cent ceiling fixed in the Maastricht Treaty; the debt-to-GDP ratio also rose above the 60 per cent threshold. In Portugal, the deficit had already risen above the Maastricht threshold (to 4.1 per cent of GDP) in 2001. Austerity measures by the new government brought the deficit down to 3.4 per cent of GDP in 2002. In France, the budget deficit was close to the 3 per cent threshold in 2002. In Italy, the lack of further progress in

fiscal consolidation partly reversed the decline in the government debt ratio which had been underway since 1998; as in Belgium and Greece, it remains at a very high level of more than 100 per cent of GDP (table 2.2.3).

The deterioration in government financial balances in 2002 led to new tensions regarding the interpretation and implementation of the EU's fiscal policy framework, which essentially comprises the Excessive Deficit Procedure<sup>63</sup> (EDP), augmented by the Stability and Growth Pact (SGP) and the Code of Conduct (COC).<sup>64</sup> The main rationale for the SGP is to protect the ECB from government pressures for inflationary debt bailouts. It also reflects concerns that excessive borrowing by one country may lead to upward pressures on interest rates throughout the euro area.

<sup>62</sup> The cyclical impulse is only somewhat larger, corresponding to 0.3 per cent of GDP, when measured on the basis of the cyclically adjusted primary balance (which excludes interest payments).

<sup>63</sup> This was agreed as part of the EC Treaty, signed in February 1992.

<sup>64</sup> The Code of Conduct on the content and format of Stability and Convergence Programmes was agreed on 12 October 1998, and was subsequently revised by ECOFIN on 27 June 2001. In the Code, member states agreed on a more detailed interpretation of the SGP, which stresses the importance of taking economic cycles into account within the budgetary framework.

CHART 2.2.6

**Unit labour costs and productivity in the whole economy in the euro area, 1999Q1-2002QII**

(Percentage change over same quarter of preceding year, seasonally adjusted)



Source: European Central Bank [www.ecb.int].

The SGP aims to strengthen the framework of fiscal coordination by promoting multilateral surveillance by the Council.<sup>65</sup> It requires member states to achieve and maintain medium-term budgetary positions – measured by the general government financial balance – of “close to balance or in surplus” (CTBOIS). Overall, the fiscal rules are intended to create an appropriate framework for prudent budgetary management, providing ample space for automatic stabilizers to operate fully in response to economic downturns without breaching the reference value for deficits. It also aims to encourage governments to react to population ageing, which represents a future drain on government spending, by running budget surpluses over the coming decades before the problem becomes serious. Finally, the framework should lead to lower interest rates and debt-

<sup>65</sup> It was adopted at the Amsterdam European Council in June 1997 and entered into force in January 1999.

TABLE 2.2.2

**Inflation and unemployment in the developed market economies, 2000-2002**  
(Per cent)

	Consumer prices (percentage change over previous year)			Unemployment (per cent of labour force)		
	2000	2001	2002	2000	2001	2002
France .....	1.9	1.8	1.9	9.3	8.5	8.6
Germany .....	2.0	2.4	1.3	7.8	7.7	8.2
Italy .....	2.6	2.3	2.6	10.4	9.4	9.1
Austria .....	2.0	2.3	1.7	3.7	3.6	4.0
Belgium .....	2.7	2.4	1.6	6.9	6.7	6.8
Finland .....	3.0	2.6	2.0	9.8	9.1	9.3
Greece .....	2.8	3.7	4.0	11.1	10.5	10.3
Ireland .....	5.2	4.0	4.7	4.3	3.9	4.4
Luxembourg .....	3.8	2.4	2.0	2.3	2.0	2.3
Netherlands .....	2.3	5.2	4.0	2.9	2.5	2.6
Portugal .....	2.8	4.4	3.6	4.1	4.1	4.5
Spain .....	3.5	2.8	3.5	11.3	10.6	11.2
<b>Euro area</b> .....	2.4	2.4	2.2	8.5	8.0	8.3
United Kingdom .....	2.1	2.1	2.2	5.4	5.0	5.1
Denmark .....	2.8	2.2	2.4	4.4	4.3	4.5
Sweden .....	1.4	2.7	2.0	5.6	4.9	5.0
<b>European Union</b> .....	2.3	2.5	2.2	7.8	7.4	7.6
Cyprus .....	4.3	2.0	2.8	3.4	3.0	3.3
Iceland .....	5.1	6.4	5.5	2.3	2.3	3.2
Israel .....	1.1	1.1	5.7	8.8	9.2	10.7
Malta .....	2.4	2.9	2.5	5.0	5.1	5.5
Norway .....	3.1	3.0	1.2	3.4	3.6	3.9
Switzerland .....	1.6	1.0	0.6	2.5	2.6	3.1
Turkey .....	54.9	54.4	45.0	6.6	8.5	10.4
<b>Western Europe</b> .....	2.4	2.5	2.0	7.5	7.3	7.7
Canada .....	2.7	2.5	2.1	6.8	7.2	7.7
United States .....	3.4	2.8	1.6	4.0	4.8	5.8
<b>North America</b> .....	3.3	2.8	1.6	4.3	5.0	6.0
Japan .....	-0.7	-0.7	-1.0	4.7	5.0	5.4
<b>Total above</b> .....	2.5	2.3	1.5	5.9	6.1	6.7

Memorandum items:

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2.3 2.2 1.7 8.0 7.5 7.7  
servicing burdens, enabling governments to pursue growth-enhancing reforms.

However, the transition to the CTBOIS requirement has not been achieved by all countries (i.e. France, Germany, Italy and Portugal), largely because of a lack of fiscal consolidation during earlier periods of strong growth and economic developments turning out less favourably than

assumed in government budget plans. These shortcomings reflect not only unexpected adverse shocks but also overly optimistic growth projections.

In any case, the SGP came under pressure in 2002 because of its insistence on procyclical fiscal behaviour during a pronounced cyclical downturn in countries that already had relatively large nominal budget deficits. The pressures for procyclical policies were accentuated by the approach of the agreed deadline – in 2004 – for achieving close-to-balanced budgets.<sup>66</sup>

The SGP has struggled to develop a framework that could handle the idiosyncrasies of the different members of the euro zone. While the targets for budgetary balance are set in nominal terms, it is clear that in the assessment of compliance (especially of the adjustment path to CTBOIS) it is necessary to take into account the effect of the economic cycle on a country's budget position, although the estimation of cyclically adjusted budget balances is admittedly not straightforward.

There also appears to have been a failure of the early warning mechanism, which has not proved effective at critical moments. For example, despite a recommendation from the Commission, the Council declined to issue an "early warning" to Germany and Portugal in early 2002, although both countries are now subject to the excessive deficit procedure.<sup>67</sup> The Council has issued an early warning to France on 21 January 2003.

The collection and assessment of budgetary statistics has also been found wanting. A case in point is Portugal where the government announced in mid-2002 that the general government budget deficit for 2001 was 4.1 per cent of GDP rather than the 2.2 per cent that had previously been reported.

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<sup>66</sup> The economic rationale of the SGP, however, has been widely questioned. UNECE, *Economic Survey of Europe, 2002 No. 1*, for an overview of the criticism of the SGP, in terms of both its rationale and design.

<sup>67</sup> Portugal was deemed to have an excessive deficit by ECOFIN on 5 November 2002 (2,460<sup>th</sup> Council meeting ECOFIN 13490/02 (Presse 333)), and received a recommendation aimed at putting its economy back on track, made public in agreement with the Portuguese Government (Document 13531/2/02 Rev.2, ECOFIN 350 UEM 53). Germany was deemed to have an excessive deficit on 21 January 2003 (2,480<sup>th</sup> Council meeting ECOFIN 5506/03 (Presse 15)).

In view of the deteriorating fiscal balances and the bleak economic outlook, the European Commission proposed in September 2002 to postpone the target year for achieving balanced budgets (or even surpluses) from 2004 to 2006. At the same time, however, governments were expected to commit themselves to reducing the cyclically adjusted deficits by an annual amount equivalent to 0.5 per cent of GDP starting in 2003. Given the favourable budgetary positions of other countries in the euro area, this refers effectively only to France, Germany, Italy and Portugal, although these account for 70 per cent of euro area GDP.

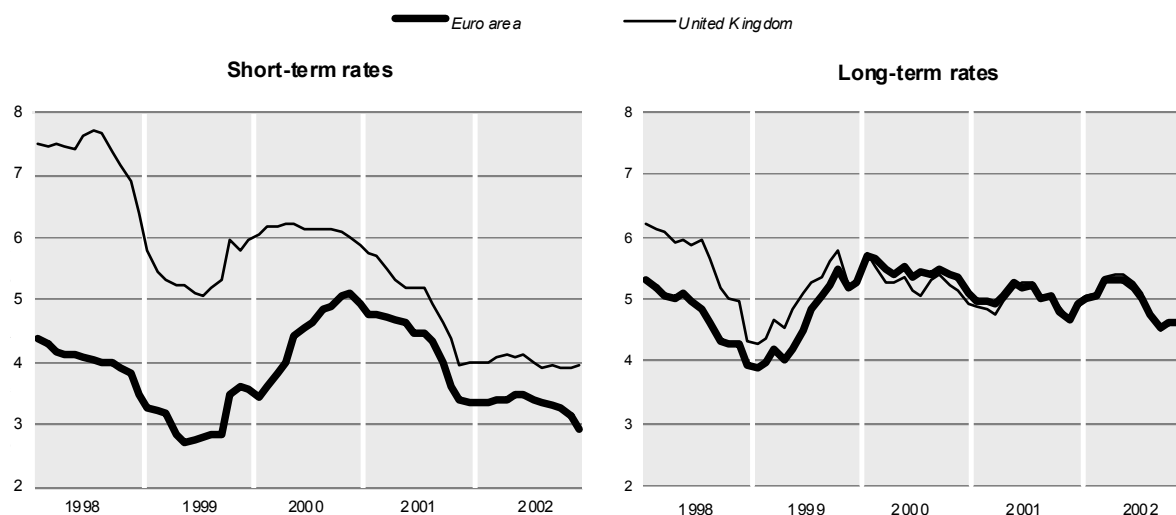
In November 2002, the Commission reviewed the difficulties of implementing the Stability and Growth Pact and made five proposals for improvement.<sup>68</sup> These proposals, which are due to be reviewed at the 2003 Spring European Council, comprise the following:

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<sup>68</sup> European Commission, Communication from the Commission to the Council and the European Parliament, "Strengthening the coordination of budgetary policies" (Brussels), 21 November 2002 (ECFIN 581/02-EN Rev.3).

CHART 2.2.7

Nominal short-term and long-term interest rates in the euro area and the United Kingdom, 1998-2002  
(Per cent per annum)



Source: OECD, *Main Economic Indicators* (Paris); European Central Bank [www.ecb.int].

Note: Short-term rates: three-month EURIBOR and LIBOR, respectively; long-term rates: yields on 10-year government bonds (average monthly values).

- To define the budget target of “close to balance or in surplus” in terms of cyclically adjusted (i.e. structural or underlying) budget balances, which are to be calculated using a common methodology;<sup>69</sup>
- To introduce transitional arrangements for countries that have not yet achieved the (redefined) CTBOIS criterion, namely to improve their structural budget position by at least 0.5 per cent of GDP each year until the target balance is achieved;
- To design mechanisms that prevent countries from pursuing procyclical fiscal policies in periods of “high” growth;
- To allow countries to run (small) structural budget deficits for the financing of structural reforms (e.g. productive investments or tax

reforms) in support of the goals of the Lisbon strategy;<sup>70</sup>

- To raise the importance of compliance with the government debt criterion (i.e. government debt should be below 60 per cent of GDP) in the budgetary surveillance process. In other words, countries with high debt levels would be required to elaborate a medium- or long-term strategy to reduce their debt-ratios in line with the reference value.

These proposals, however, would leave unchanged the reference value of 3 per cent of GDP for the nominal budget deficit established in the Treaty. This reference ratio would have to be observed, as hitherto, at all “normal” times. The shift of focus to structural budget deficits, however, does not solve the policy dilemma of those countries which, in the transitional period, are required to reduce their structural deficits despite weak economic conditions. Also, the allowance of structural deficits for financing “productive public investment” is conditional upon countries having made substantial progress towards the redefined close to balance budget target and on the debt ratio falling below 60 per cent. There is also the more general problem of agreeing on what constitutes

<sup>69</sup> Cyclically adjusted budget deficits cannot be directly measured. Their calculation involves the estimation of deviations of actual from potential output, the so-called output gap. These estimates are typically made using either a production function approach or statistical filter techniques (typically the Hodrick-Prescott filter). The results obtained by these two methods, however, can differ. In July 2002, it was agreed within the European Union that the production function approach would be the reference method starting with the 2002 stability and convergence programmes.

<sup>70</sup> This is the “golden rule” of budget financing, operational in the United Kingdom, which allows deficits for the financing of public investment.

TABLE 2.2.3

**General government financial balances and gross debt, 2001-2002**  
(Percent of GDP)

	Total balances		Cyclically adjusted balances		Gross debt	
	2001	2002	2001	2002	2001	2002
France .....	-1.4	-2.7	-2.0	-2.7	57.3	58.6
Germany .....	-2.8	-3.8	-2.8	-3.3	59.5	60.9
Italy .....	-2.2	-2.4	-2.4	-1.8	109.9	110.3
Austria .....	0.2	-1.8	0.0	-1.6	63.2	63.2
Belgium .....	0.4	-0.1	-0.3	0.2	107.6	105.6
Finland .....	4.9	3.6	3.8	3.7	43.4	42.4
Greece .....	-1.2	-1.3	-2.1	-1.7	107.0	105.8
Ireland .....	1.5	-1.0	0.2	-1.4	36.4	35.3
Luxembourg .....	6.1	0.5	..	..	5.6	4.6
Netherlands .....	0.1	-0.8	-1.2	-0.6	52.8	51.0
Portugal .....	-4.1	-3.4	-4.3	-3.0	55.5	57.4
Spain .....	-0.1	0.0	-0.7	-0.1	57.1	55.0
<b>Euro area</b> .....	<b>-1.5</b>	<b>-2.3</b>	<b>-1.9</b>	<b>-2.0</b>	<b>69.3</b>	<b>69.6</b>
United Kingdom ..	0.7	-1.1	0.7	-0.6	39.1	38.5
Denmark .....	3.1	2.0	2.6	2.1	44.7	44.0
Sweden .....	4.8	1.4	4.2	1.3	56.6	53.8
<b>European Union</b> ..	<b>-0.8</b>	<b>-1.9</b>	<b>-1.2</b>	<b>-1.6</b>	<b>63.0</b>	<b>63.0</b>
Iceland .....	0.5	0.3	-0.9	0.0	47.2	43.7
Norway .....	15.0	12.4	2.1	1.4	25.7	24.7
<b>Western Europe</b> .....	<b>-0.5</b>	<b>-1.5</b>	<b>-0.8</b>	<b>-1.2</b>	<b>60.3</b>	<b>60.7</b>
Canada .....	1.8	0.6	1.8	0.5	83.2	81.2
United States .....	-0.5	-3.1	-0.3	-2.7	59.7	60.7
<b>North America</b> .....	<b>-0.3</b>	<b>-2.9</b>	<b>-0.2</b>	<b>-2.5</b>	<b>61.3</b>	<b>62.1</b>
Japan .....	-7.2	-7.9	-6.8	-7.1	132.6	142.7

“productive investment”.<sup>71</sup> Also, the proposal to make the debt criterion of the excessive deficit procedure operational will require agreement as to what constitutes “a satisfactory pace” of debt reduction towards the 60 per cent of GDP ratio.

**(d) Recent economic developments in individual euro area member states**

Among the three large economies of the euro area, economic activity in *Germany* continued to be very sluggish in 2002. Real GDP rose by only 0.2 per cent compared with the previous modest increase of 0.6 per cent in 2001. Employment fell

by 0.6 per cent and the number of persons unemployed rose above 4 million. The average unemployment rate was 8.2 per cent in 2002, up from 7.7 per cent in 2001.<sup>72</sup> This development partly reflects the impact of the global cyclical slowdown on exports, but the main factor has been the persistent weakness of domestic demand.

Total domestic demand fell by 1.3 per cent in 2002 (table 2.2.1). This reflects declining expenditures on private consumption and fixed investment, which were only partly offset by higher government consumption. Private household consumption was dampened by the impact of falling employment on aggregate income growth. Real disposable incomes fell slightly and, in addition, savings increased against the backdrop of deteriorating conditions in the labour market and declining equity values. Investment in machinery and equipment fell by 8.4 per cent in 2002 – following a decline of nearly 6 per cent in 2001 – in the face of deteriorating sales and prospects for profitability. The crisis in the construction sector continued. Construction investment fell by 6 per cent in 2002, about the same annual rate as in 2001. Public sector investment fell for the third consecutive year. Export growth weakened in 2002, but the fall in domestic demand led to lower imports. The volume of net exports made a strong contribution to GDP growth, as in 2001, partly offsetting the weakness of domestic demand.

The government has announced a package of measures designed to reduce the budget deficit in 2003, aiming to meet its obligation under the revised SGP to curb the structural budget deficit by at least 0.5 per cent of GDP. Current budget plans, however, are still based on an official forecast of GDP growth of 1.5 per cent for 2003, which looks rather optimistic. Meeting the fiscal target would therefore appear to require additional restrictive measures. More generally, the weak growth performance of Germany since about 1995 also

<sup>71</sup> It has been argued by Italy's Finance Minister that government spending on infrastructure, defence, overseas aid and structural economic reform should be excluded from national budget calculations under the SGP. “Tremonti calls for overhaul of EU stability pact”, *Financial Times*, 25 June 2002.

<sup>72</sup> This is the standardized unemployment rate following the ILO definition. Taking hidden unemployment into account, the number of persons unemployed is estimated by the German Council of Economic Advisors (“Sachverständigenrat”) to have reached 5.7 million. Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, *Jahresgutachten 2002/2003, Zwanzig Punkte für Beschäftigung und Wachstum* (Stuttgart, Metzler-Poeschel, 2002), p. 241.

reflects – apart from the absence of a conducive macroeconomic environment – a number of structural factors (box 2.2.1).

In *France*, GDP growth slowed down to 1 per cent in 2002, down from 1.8 per cent in 2001 and the lowest rate in nine years. Nevertheless, it outperformed Germany and Italy, the other large economies of the euro area. The modest growth rate reflects a marked deceleration in the rate of economic expansion in the second half of the year following a marked deterioration of business and consumer expectations about short-term economic prospects. The upturn of industrial production in early 2002 was not sustained in the second half of the year when the output of both intermediate and consumer goods declined.

The overall rise in economic activity was mainly due to resilient private and government consumption. Private household consumption grew by 1.7 per cent in 2002, supported by a rise in real disposable household income (partly the result of tax cuts enacted during the second half of the year) and rising employment, albeit at a more moderate rate than in 2001. The slowdown and stagnation in the second half of the year of employment growth reflected not



## Box 2.2.1

**Germany: why has economic growth been so low?**

In the second half of the 1990s, economic growth in Germany fell significantly below the EU average. Between 1995 and 2002, the average annual growth rate of real GDP was 1.4 per cent, about three quarters of a percentage point less than that of the EU as a whole. Employment growth has also been significantly lower than in most other west European economies, partly as a result of the lower rate of output growth.

The causes of this weak performance have partly to do with the economic developments in eastern Germany, where unification has so far failed to produce a sustained economic recovery. In fact, after a short period of catching up, the region has fallen further behind in terms of GDP per capita in recent years. The sluggish growth of eastern Germany reflects the combined impact of a number of factors, notably the loss of price competitiveness resulting from the money conversion rate in 1990 (tantamount to a massive appreciation), which exacerbated the pressures for rapid wage convergence without regard for the less rapid growth of labour productivity towards west German levels. Given the lack of significant progress in real income convergence, the eastern part of the country is still dependent on large intra-German fiscal transfers, which (on a gross basis) correspond to some 4 per cent of west German GDP. A large part of these transfers are designed to support the social safety net in eastern Germany, which in turn limits the scope for fiscal policy to increase productive investment in infrastructure and reduce the tax burden.

Economic growth in eastern Germany has also been restrained by the aftermath of a boom in the construction sector – partly fuelled by generous subsidies – in the immediate wake of unification. The boom began to fade by the mid-1990s, as markets became saturated and subsidies were reduced. The construction sector was left with large vacancy rates in the market for residential and industrial buildings. The consequent downsizing of capacity has made considerable progress but has not yet run its course. The crisis in the east German construction sector was amplified by the more or less simultaneous weakening of the residential construction boom in western Germany in the mid-1990s, which had been driven by the surge in immigration from eastern Europe and the CIS and by government incentives. As a result, construction investment in Germany in 2002 was 18 per cent below its peak in 1994. According to one study, about one third of the growth gap between Germany and the other core member countries of the EU can be attributed to this lingering crisis in the German construction sector.<sup>1</sup> The slump in construction investment has depressed overall fixed investment. Private consumption, which is the single most important demand factor, was also quite sluggish, held back by weak growth in employment and average disposable incomes, wage increases being partly offset by higher social security contributions and indirect taxes.

To some extent, the sluggish performance of the German economy compared to the rest of the euro area may also reflect the loss of its traditional interest rate advantage in the run-up to European Monetary Union (EMU). With the elimination of exchange rate risk premia, both short-term and long-term interest rates in the other (then prospective) member countries of the euro area converged towards the lower German levels. Lower interest rates in the rest of the euro area, in turn, stimulated economic activity in those countries and may have even diverted capital away from Germany.<sup>2</sup>

On the domestic side, growth is also considered to be restrained by a number of structural rigidities in the German product and labour markets and in the system of social assistance. More generally, these problems, it is alleged, have hampered the ability of the German economy to adjust adequately to exogenous shocks, including reunification and EMU.<sup>3</sup> In the labour markets, the centralized nature of collective wage bargaining together with a lack of opt-out clauses has reinforced the tendency of “insiders” to resist competition from “outsiders”, i.e. from the unemployed. Moreover, the system has proved unable to accommodate a sufficiently differentiated wage structure across skill levels. At the same time, high and rising levels of structural unemployment have led to revenue shortfalls, thereby creating serious problems for the financing of the social security system. The result has been rising social security contributions and tax rates.

The means-tested nature of social assistance to the unemployed, combined with social security contributions and income taxes payable on labour income, imposes marginal effective tax rates of sometimes up to 100 per cent and more on individuals who want to move from social assistance to employment.<sup>4</sup> This system effectively creates a relatively high minimum wage, and thereby prevents a low-wage segment from emerging in the labour market. This is significant given that the sizeable structural component of unemployment consists largely of low-skilled individuals who have been out of the labour force for a long time and have a relatively low productivity. These inefficiencies in the labour market and the systems of social assistance were transplanted to east Germany after reunification. However, in recent years an increasing number of east German firms have decided to leave the employers associations in order to avoid being bound by collective wage bargaining agreements.

Reforming German labour markets and the social security and assistance systems acquires particular urgency in the

## Box 2.2.1 (concluded)

**Germany: why has economic growth been so low?**

The question remaining, however, is how far these reforms can be achieved in a context of low growth or declining GDP and the associated deteriorating situation in the labour markets. Low economic growth will therefore tend to raise resistance to reforms in a similar way as it reduces the scope for achieving the medium-term targets for fiscal adjustment.

<sup>1</sup> European Commission, Directorate General for Economic and Financial Affairs, "Germany's growth performance in the 1990s", *Economic Papers*, No. 170 (Brussels), May 2002 [europa.eu.int/comm/economy\_finance].

<sup>2</sup> H.-W. Sinn, "Die rote Laterne", *ifo Schnelldienst* 23/2002 (Munich), December 2002.

<sup>3</sup> See e.g. Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, *Jahresgutachten 2002/2003, Zwanzig Punkte für mehr Beschäftigung* (Wiesbaden); OECD, *Economic Survey – Germany 2002* (Paris), December 2002.

<sup>4</sup> A. Boss, *Sozialhilfe, Lohnabstand und Leistungsanreize: empirische Analyse für Haushaltstypen und Branchen in West- und Ostdeutschland*, Kieler Studien 318, Institut für Weltwirtschaft Kiel (Berlin-Heidelberg), 2002; H.-W. Sinn et al., "Aktivierende Sozialhilfe – Ein Weg zu mehr Beschäftigung und Wachstum", *ifo Schnelldienst* 9/2002 (Munich), May 2002.

<sup>5</sup> Among these have been new taxes on energy consumption whose receipts are being used to constrain the increase in social security contribution rates and labour market reforms proposed by the so-called Hartz commission, including a reform of the labour offices with the goal of making the matching of unemployed individuals with open jobs more effective, tougher rules specifying under which conditions unemployed individuals may refuse a job offer, and a new, tax-advantaged and less bureaucratic way for unemployed individuals to become self-

only the delayed adjustment of labour to the cyclical downturn but also the fading impact of active labour market policies including the statutory reduction in working time. Fiscal policy turned strongly expansionary in 2002, which together with the working of automatic stabilizers

led to a large increase in the general government budget deficit. Government consumption was the fastest growing component of demand and its contribution to annual GDP growth was only slightly less than that of private consumption. In contrast, fixed investment stagnated on average in 2002 with a decline in the second half of the year. While government investment rose by 0.9 per cent (in line with the rise in total public spending) this was offset by a contraction in private investment. Businesses cut back investment spending on equipment (-1.6 per cent) in response to the weakening economic outlook and rising uncertainty. Construction investment fell by 0.6 per cent. Rather than expanding output, firms met the growth in demand by running down stocks, which for the second consecutive year subtracted some 0.75 percentage points from annual GDP growth.

Growth decelerated sharply in *Italy* in 2002, GDP rising by a mere 0.4 per cent compared with 1.8 per cent in 2001. The marked downturn was due to weak household consumption, fixed investment and exports, all of which subtracted

from GDP growth for the first time in almost a decade. In spite of weak output growth, employment continued to increase and this supported the growth of disposable incomes. But consumer confidence declined sharply throughout the year and households raised their savings rate in

the face of mounting uncertainty about economic prospects. Fixed investment was held back by spare capacity (capacity utilization rates reached their lowest level in six years) combined with weak consumer and external demand. In these circumstances the tax incentives for business investment, enacted in late 2001, were largely ineffective. In fact, real fixed investment fell by over 2 per cent in 2002. Increased government consumption expenditure was not sufficient to compensate for the weakness of the domestic private sector and foreign demand.

Employment rose by 1.5 per cent in 2002, despite sluggish output growth. New job creation resulted mainly from fiscal and labour market measures aimed at reducing non-wage labour costs. Nevertheless, the rising compensation of employees combined with falling labour productivity in a context of decelerating output growth put strong upward pressure on unit labour costs, which rose by 3.5 per cent in 2002.

Contrary to developments in most of the other euro area countries, industrial production did

not recover from the slump of 2001; throughout 2002 it remained virtually unchanged at the level of December 2001. For January–November 2002, total output was 2.3 per cent lower than in the same period of 2001. Activity was particularly depressed in a number of important manufacturing sectors (transport goods, electrical apparatus, textiles, clothing, footwear and leather), output in 2002 being some 8 per cent or more below the levels in 2001.

In the smaller economies in the euro area, economic growth also slowed down in 2002, in some cases significantly influenced by the weakening of economic activity in Germany and other major markets in Europe. As a result of their close trade links, the stagnation of the German economy had negative effects on *Austria, Belgium, the Netherlands* and *Luxembourg*, where growth slowed down to rates of 0.7 per cent or below in 2002 (table 2.2.1). In *Portugal*, economic growth was significantly dampened by the severe austerity package implemented by the new government, but weakening foreign demand also had an impact on the economic performance in 2002. In *Ireland* the slowdown of the ICT sector contributed to a marked deceleration of GDP growth in 2002, although it still remained significantly above the euro area average. Strong growth in private and government consumption was the main support to economic activity. In *Finland*, by contrast, the downturn in the ICT sector had already had a large negative impact on economic growth in 2001. But the recovery strengthened in 2002, based on net exports and strong private and public consumption. In *Greece*, large increases in gross fixed capital formation (spurred by the inflow of EU structural funds and by construction works related to the 2004 Olympic Games) and private consumption (mainly credit-driven) resulted in GDP growth of 3.5 per cent in 2002. This was somewhat less than in 2001, but was still the highest rate in the euro area. The economic slowdown in *Spain* was less pronounced than for the euro area as a whole, and GDP grew by almost 2 per cent, thanks to the strength of domestic demand.

## (ii) Other western Europe

Outside the euro area, real GDP in the *United Kingdom* rose by 1.6 per cent in 2002, down from 2 per cent in 2001. Manufacturing activity remained weak with output gains in the first half of

2002 being reversed in the second half. During the first 11 months, production fell by 3.6 per cent compared with the same period of 2001. In contrast, construction output continued to grow strongly.

A distinctive feature of the United Kingdom economy, in contrast to the euro area, was the strength of both government and private household demand (table 2.2.1). Private consumption rose by 3.5 per cent in 2002, supported by low real interest rates and the continuing surge in house prices, which encouraged households to borrow against the collateral of rising real estate values. House prices rose by more than 20 per cent in 2002, largely offsetting the negative wealth effects of the sharp decline of equity prices. The household debt-income ratio has risen to a historic high. Government spending reflected, *inter alia*, efforts to improve the public infrastructure as well as the health care and education systems. The expansionary stance of fiscal policy, in combination with the working of automatic stabilizers, led to a general government deficit corresponding to 1.1 per cent of GDP in 2002, a marked swing from a surplus of 0.7 per cent of GDP in 2001 (table 2.2.3). In contrast, business capital expenditures fell sharply in 2002; in the manufacturing and service sectors they fell by some 14 and 11 per cent during the first three quarters. Changes in the volume of net exports of goods and services continued to be a drag on overall economic growth in 2002.

Despite the slowdown in output growth, employment continued to rise, and the unemployment rate was more or less stable throughout the year, reaching 5.2 per cent in the three-month period from September to November 2002. Increases in unit wage costs remained moderate, a result of increased productivity growth and a slowdown in the growth rate of wages and salaries.

Annual inflation, retail prices excluding mortgage interest payments (RPIX), remained moderate, averaging some 2.2 per cent in 2002. It rose above the government's target ceiling of 2.5 per cent in November, but this was influenced by statistical base effects on petrol and oil prices. The Monetary Policy Committee has held the base rate at 4 per cent since early November 2001. At its meeting of early January 2003, the Committee considered that given broadly unchanged prospects for economic growth, inflation would be around the government's target in the medium term. But the persistent strength of consumer spending, household borrowing and house price inflation were seen as tilting the balance of risks towards slightly higher inflation.

The merchandise trade deficit in the third quarter reached its highest level since 1967, but this was offset by a larger surplus in services and net income from abroad leading to a narrowing of the current account deficit. For the year as a whole, the current account deficit is estimated to be somewhat less than 2 per cent of GDP, slightly lower than in 2001. In the foreign exchange markets, sterling depreciated against the euro by 3.5 per cent in the 12 months to December 2002, but against the dollar it appreciated by some 10 per cent. On balance, the real effective exchange rate of sterling was broadly unchanged.

In contrast with the downturn in the euro area, GDP growth in the Nordic countries – *Sweden*, *Norway* and *Denmark* – accelerated in 2002, thereby reversing the previous year's slowdown. This was supported by a strengthening of domestic demand – wherein private consumption was underpinned by tight labour markets and low unemployment – and, in the case of Sweden, real exports. In *Iceland*, by contrast, the strong positive impulse of net trade was more than offset by domestic demand, which contracted for the third consecutive year. Consequently, real GDP fell by 0.6 per cent in 2002. In *Switzerland* GDP fell slightly due to the appreciation of the exchange rate and weak foreign demand, which led to large falls in exports and investment that more than offset increases in private and government consumption.

Prevailing pessimism, uncertainty and security concerns in *Israel* led to a fall in private consumption and a steep cutback in fixed investment, which more than offset the large growth in government spending. External demand also subtracted from growth, due mainly to declining ICT exports. GDP fell by 1 per cent in 2002, the second consecutive year of recession, which is unprecedented in the country's history. GDP growth in *Cyprus* slowed down to 1.8 per cent in 2002, but was sustained by the resilient growth of domestic demand. *Malta* in 2002 recovered from the previous year's recession, thanks to the rapid expansion of private and government consumption.