CHAPTER 2

THE GLOBAL CONTEXT AND WESTERN EUROPE

2.1 The global context

(i) The broad picture

A global recovery is underway...

There is increasing evidence that a global recovery finally took hold in the second half of 2003. The recovery is being led by the United States, where economic activity accelerated markedly in the second and third quarters, supported by a very expansionary stance of economic policy. Additional support for the global recovery has come from the cyclical upturn in Japan. In the United Kingdom, moreover, economic growth has regained strong momentum and continues to be more closely aligned with the United States growth cycle rather than with that in continental Europe. In contrast, the forces for a recovery still look fragile in the euro area, where domestic demand has remained weak and the impact of the sharp appreciation of the euro on exports has been offsetting the stimulus from an easing of monetary policy. Growth has been particularly sluggish in France, Germany and Italy, the three major economies of the euro area. Support for economic activity from fiscal policy has been limited because of the constraints imposed by the rules of the Stability and Growth Pact. In the major seven (G-7) economies combined, real GDP rose by slightly more than 1 per cent in the third quarter of 2003 compared with 0.5 per cent in the second (table 2.1.1). This acceleration largely reflects the sharp increase in real GDP in the United States which, at 2 per cent, was the strongest quarterly growth rate in 20 years.

Outside the major developed market economies, global economic activity was mainly supported by the continued strong growth in Asia, notably China and India. The strength of Asian growth reflects more intensive intraregional trade links and expansionary policies but also spillovers from the strong domestic demand in the United States. In eastern Europe, the aggregate growth rate of the eight countries that are going to join the European Union at the beginning of May 2004 was significantly above the EU average in 2003, a trend that has now been prevalent for several years. But growth has varied across countries, with more moderate rates in central Europe contrasting with continued buoyancy in the Baltic states. Growth has also been robust in most of the other east European countries. In the CIS, growth rates maintained considerable momentum in 2003, with Russia continuing to be a major support.

TABLE 2.1.1

Quarterly changes in real GDP in the major seven economies, 2002QI-2003QIII

(Percentage change over previous period)

	2002				2003		
	QI	*QII*	*QIII*	*QIV*	*QI*	*QII*	*QIII*
France	0.7	0.7	0.2	-0.3	–	-0.4	0.4
Germany	0.2	0.2	0.1	–	-0.2	-0.2	0.2
Italy	–	0.3	0.2	0.4	-0.2	-0.1	0.5
United Kingdom	0.3	0.5	0.7	0.5	0.2	0.6	0.7
Canada	1.4	0.9	0.7	0.4	0.5	-0.2	0.3
United States	1.2	0.3	1.0	0.3	0.4	0.8	2.0
Japan	-0.5	1.0	0.9	0.4	0.4	0.6	0.3
Total above	0.7	0.5	0.7	0.3	0.2	0.5	1.2
Memorandum items:							
Euro area	0.4	0.5	0.2	–	–	-0.1	0.4
European Union	0.4	0.5	0.3	0.1	–	–	0.4
Western Europe [a]	0.3	0.5	0.3	0.1	–	–	0.4
Total industrialized countries [b]	0.6	0.5	0.7	0.2	0.2	0.4	1.1

Source: National statistics; Eurostat, NewCronos Database.

Note: Data are seasonally adjusted.

a Western Europe: European Union plus Norway and Switzerland.

b Western Europe, North America and Japan.

The more optimistic outlook for global economic prospects is mirrored in a significant rise of prices in international equity markets in 2003. In many countries, business fixed capital formation has picked up, although large margins of excess capacity remain in the manufacturing sector. The collapse of the demand for ICT products, which started in 2000, appears to have bottomed out and there are tentative indications of a strengthening of global demand. There was also a resumption of international mergers and acquisitions in the second half of 2003. The corporate sector in the United States and other major economies have made progress in consolidating balance sheets, which had deteriorated significantly in the second half of the 1990s. This adjustment was facilitated by the progressive easing of monetary policy since 2001. The recovery of equity markets and the fall of spreads on corporate bonds have also been helpful in this respect.

....but downside risks remain important

Although the risks to the global economic outlook are now more balanced than in the last few years, there remain major concerns about the sustainability of the global imbalances, largely because of the huge United States current account deficit, which is projected to widen in 2004. The significant depreciation of the dollar since early 2002 is part and parcel of the inevitable adjustment process that has to take place in order to reverse these imbalances, but an accelerated, disorderly depreciation of the dollar combined with a sudden reversal of capital flows needed to finance the external deficit could act as a brake on global recovery in 2004. There are major concerns about the uneven distribution of the adjustment burden, which has so far fallen disproportionately on western Europe, while countries in Asia have stemmed the appreciation of their currencies against the dollar by heavy intervention in foreign exchange markets. Concerns about exchange rate overshooting and excessive short-term adjustment pressures associated with high exchange rate volatility have moved once again to the centre stage.

The economic situation in emerging markets has been improving

Emerging markets in 2003 benefited from a more favourable international environment, particularly during the second half when international trade intensified and international capital inflows accelerated. Net private capital flows to emerging market economies rose to $187 billion in 2003, thus recovering from the slump of the previous two years (which had resulted in net outflows) and reaching a level close to the average of the last 10 years.[67] The increase consisted of portfolio investment, bonds and bank lending, while direct investment fell. All regions received larger inflows of private capital in 2003, most of it going to emerging Asia. Risk premia on emerging market bonds have fallen to very low levels as international investors have sought higher yields and become less risk averse.

Asia suppporting global growth

Developing Asia grew by some 7 per cent in 2003 and thus remained the fastest growing region of the world. The expansion was led by China, which grew by some 9 per cent and is emerging as a major source of demand for foreign goods and services (box 2.1.1). In India, the second largest economy in the region, growth strengthened to 6 per cent as it took advantage of both the better external environment and favourable weather conditions. Growth in developing Asia was resilient despite the outbreak of SARS (severe acute respiratory syndrome) during the second quarter. Economic activity was underpinned by robust domestic demand, fuelled in most countries by expansionary economic policies, and in east and south-east Asia by intraregional trade, which is being strengthened by the deeper regional integration of production networks. During the second half of the year, additional support came from the pick-up in world economic activity and global trade. The current account surpluses and heavy intervention in the foreign exchange markets have led to a massive accumulation of reserves, most notably in China, Hong Kong, Republic of Korea, Singapore and Taiwan Province of China. The counterpart to this has been a rapid expansion of money supply and bank loans.

Economic conditions improve in Latin America

Latin America in 2003 started to recover from the recession of the previous year: it benefited from the more favourable international environment, which led to lower external financing spreads, higher commodity prices, increased revenues from tourism and growing non-oil exports to the United States. While maintaining competitive exchange rates, most countries in the region succeeded in strengthening their macroeconomic management. The basis of recovery was provided by exports, including those of primary commodities, of which shipments to China rose strongly. As merchandise exports increased to a record level, the region’s current account moved into surplus for the first time in 50 years. Yet economic performance remained relatively weak**,** with regional GDP growing by just 1.5 per cent in 2003.[68] This average includes stagnation in Brazil, due to restrictive macroeconomic policies, and a marked improvement in Argentina, where GDP grew by more than 7 per cent in 2003 compared with a slump of 11 per cent in the previous year.

Rising global demand leads to rising raw material prices

Non-energy commodity prices in 2003 rose on average by 14 per cent, the largest increase in 10 years (on the basis of current dollar prices). In December 2003, they had increased by almost one fifth year-on-year, thus regaining their levels of early 1996. These movements were largely driven by industrial raw materials (i.e. non-ferrous metals, agricultural raw materials and iron and scrap); prices of food commodities (including tropical beverages and sugar) rose more moderately, after their sharp rise due to temporary supply disruptions during the second half of 2002 (chart 2.1.3).[69]

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[67] Institute of International Finance (IIF), *Capital Flows to Emerging Market Economies* (New York), 15 January 2004 [www.iif.com].

[68] ECLAC, *Preliminary Overview of the Economies of Latin America and the Caribbean* (Santiago), December 2003 [www.eclac.org].

[69] For consumers in the euro area, higher dollar prices were more than offset by currency appreciation. In euros, the prices of non-energy commodities in 2003 were on average 5 per cent lower than in 2002; this was the third consecutive annual fall in the euro price of these commodities.

BOX 2.1.1

China in the world economy

Macroeconomic performance

China's economic performance over the past two decades has been extraordinary. Between 1980 and 2003, real GDP grew at an average annual rate of 9.4 per cent. On the basis of purchasing power parities (PPPs), China today accounts for about 13 per cent of world output, compared with less than 3.5 per cent in the early 1980s. The level of real GDP in 2003 was more than double that in 1995. In fact, current trends are in line with the objective of the Chinese government to quadruple real GDP by 2020. Most of this expansion has translated into growth of real per capita income, since population growth has moderated. Real GDP per capita (on a PPP basis) in 2003 was some 14 per cent of the United States level compared with only 3.6 per cent in 1980. The extent of catch-up is also impressive when real income is evaluated at market exchange rates (table 2.1.2). China has also gained a pivotal role in world trade, both as a supplier and as a buyer. Export and import values rose (in dollars) by a cumulative 65 and 70 per cent, respectively, in 2002 and 2003. As a result, China's share of world merchandise exports rose to some 6 per cent in 2003, and of imports to some 5.5 per cent. China is now estimated to have displaced Japan as the third largest trading nation (behind the United States and Germany). As a result of this surge in economic activity, Chinese demand has become a major determinant of international commodity prices, notably for raw industrial materials.[1]

China's rapid growth over the past two decades or so is associated with two main factors. First, the market-oriented economic reforms launched in 1978 boosted labour productivity by encouraging the formation of rural enterprises and private business, by introducing the profit incentive, and by relaxing state control over various aspects of economic activity. The reforms also facilitated the integration of China into the world economy by progressively liberalizing trade – China officially acceded to WTO in December 2001 – and by creating an attractive environment for foreign direct investment. China has become a major attraction for FDI, which reached record levels of $52.7 billion and $56 billion in 2002 and 2003, when the country overtook the United States as the world's largest recipient of FDI. Second, a sustained and very high rate of domestic capital accumulation – gross fixed investment rose from about 27 per cent of GDP in the early 1980s to more than 40 per cent in 2003 – provided the economy with a rapidly growing stock of physical capital (i.e. new machinery and factories, and more infrastructure). This investment is estimated to have accounted for more than two thirds of total potential output growth since 1990.[2]

China in the global production chain

In association with robust export and import growth (table 2.1.2), China's shares of foreign markets have also increased significantly (chart 2.1.1). This holds not just for Japan, other Asia, the United States and the European Union, but also for the CIS and, to a lesser extent, eastern Europe. Trade liberalization has also spurred Chinese imports, increasing the country's importance as a market for goods and services. China's merchandise trade balance is in comfortable surplus and so is its balance on the current account. China runs a trade surplus with both the EU and United States (chart 2.1.2), but a deficit with most of its Asian partners.

Within this overall pattern of international trade, China is also gaining a central role in global production chains. Thanks to the low cost of labour (which is estimated to be less than 4 per cent of that in the United States), China is becoming a world manufacturing hub for labour-intensive goods. Raw materials and capital-intensive goods are imported to China, mainly from Asian and western trade partners; goods are then processed, often in foreign-financed firms, and then re-exported to the industrial countries. Indeed, export processing zones (EPZs) now account for more than 50 per cent of total Chinese exports and for slightly less than 40 per cent of total imports; in 1990 the corresponding shares were some 17 per cent and 16 per cent, respectively. High-tech exports account currently for some 20 per cent of total exports but most of them are produced by foreign-owned companies, with little local value added. The government, however, is making considerable efforts to promote research and development (the Chinese space programme is an example) that will eventually make the country competitive as a high-tech manufacturer.

The currency regime

Since 1997, the Chinese authorities have pegged the national currency, the renminbi, to the dollar at a rate of 8.28 renminbi per dollar. Indicators of internal and external disequilibrium, however, suggest that the renminbi is significantly undervalued and that a revaluation may be desirable. A major concern in this context is the risk of cyclical overheating. Investment in real estate rose by some 30 per cent in 2003, and both the money supply and domestic credit expanded considerably, reflecting the rapid accumulation of foreign reserves, mainly of dollar-denominated government bonds. (China's stock of foreign reserves is now the second largest in the world.) Against this background, some recent analysis suggests a 15 to 25 per cent revaluation is needed to bring the nominal exchange rate in line with its fundamental long-term equilibrium value.[3] A revaluation and a more flexible currency regime are also recommended in order to allow the Chinese economy to better absorb shocks and cope with the adverse fiscal implications of future structural reforms.[4]

Prospects and challenges ahead

The large gap in real per capita incomes between the industrial countries and China suggests that the latter still has a considerable potential for long-run growth. At the same time, the large supply of labour suggests that the competitive edge resulting from low

BOX 2.1.1 (concluded)

China in the world economy

labour costs is likely to last for a long time. Yet, to maintain its rapid rate of growth, China needs to implement further economic reforms in order to improve efficiency and total factor productivity.[5] A key area requiring intervention is the banking sector, which is faced with a large volume of bad debts, amounting to some 30-40 per cent of all outstanding loans. This reflects the political direction of loans to the large state-owned sector for the financing of investment projects and is a negative aspect of the very high investment-output ratio. Another set of important reforms relates to state-owned firms. Corporate governance needs to be strengthened and budget constraints hardened, also with the aim of reducing the flow of non-performing loans. Restructuring such enterprises will lead to productivity gains and hence contribute to the growth process. Additional investment in education will also be critical both to tackle growing income disparities and to form the human capital required to sustain long-run growth. Finally, the government will face growing pressure in the labour market, especially as the reform of state-owned firms will continue to increase the pool of the unemployed. In this respect, the restrictions on internal migration are elements of rigidity that result in an inefficient allocation of labour across sectors and regions, thereby adding to income inequalities.

On current trends, the emergence of China will have an increasingly profound influence on the world economy in the medium and longer term. This constitutes a major challenge both for China and the rest of the world to adapt to the consequent changes in global patterns of production and specialization.

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1 K. Morris, "China holds the key to prices and demand", *Financial Times*, 3 January 2004.

2 P. Heytens and H. Zebreges, "How fast can China grow?", in W. Tseng and M. Rodlauer (eds.), *China: Competing in the Global Economy* (Washington, D.C., IMF, 2003).

3 J. Williamson, "The renminbi exchange rate and the global monetary system", lecture delivered to Central University of Finance and Economics, (Beijing), 29 October 2003.

4 IMF, "IMF concludes 2003 Article IV consultation with the People's Republic of China", *Public Information Notice*, No. 03/136 (Washington, D.C.), 18 November 2003.

5 T. Feyzioglu and T. Wang, "China's dynamic economy needs structural reforms to sustain its rapid growth", *IMF Survey*, December 2003.

TABLE 2.1.2

Selected macroeconomic indicators for China, 1980-2003

	Unit	*1980-1990* [a]	*1990-2000* [a]	*2000*	*2001*	*2002*	*2003*
Real GDP	Annual percentage change	9.8	9.7	8.0	7.5	8.0	9.0
Consumer prices	Annual percentage change	7.5	7.8	0.4	0.7	-0.8	0.8
Fiscal balance [b]	As a per cent of GDP	-0.8	-2.2	-3.1	-4.5	-3.0	-3.2
Current account balance	As a per cent of GDP	-0.5	1.8	1.9	1.5	2.8	1.4
World output share							
GDP valued at PPP	Per cent	4.6	8.8	11.5	12.1	12.7	13.1
GDP valued at current exchange rates	Per cent	2.3	2.5	3.4	3.8	3.9	3.9
GDP per capita (United States=100)							
At PPP	Per cent	2.5	8.3	13.1	14.7	15.8	17.2
At current exchange rates	Per cent	4.8	8.9	11.8	12.7	13.4	14.1
Merchandise trade (dollar values)							
Exports	Annual percentage change	12.9	14.3	27.8	7.0	22.1	34.6
Imports	Annual percentage change	14.8	11.5	35.8	8.2	21.2	39.9
Share in world trade							
Exports	Per cent	1.4	2.7	3.9	4.3	5.1	6.0*
Imports	Per cent	1.5	2.4	3.4	3.8	4.4	5.5*
FDI Inflows	Billion dollars	15.1	28.5	40.8	46.8	52.7	57.0

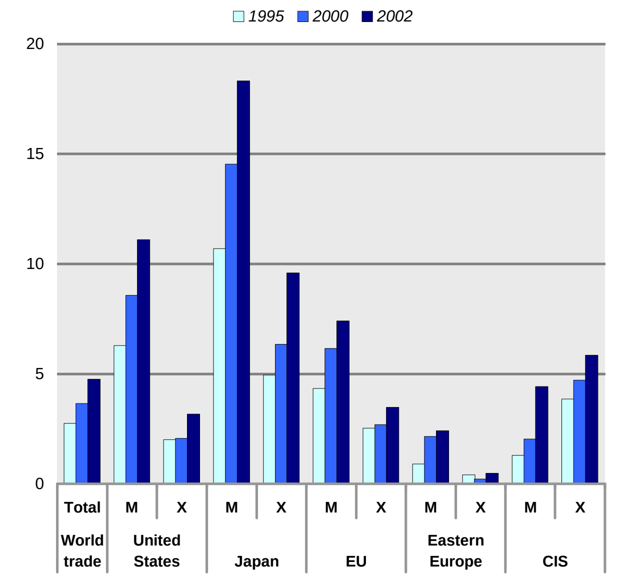
Source: IMF, *World Economic Outlook 2003* (Washington, D.C.), October 2003; *International Financial Statistics 2003* (Washington, D.C.), 2003. Data for 2003 estimates: direct communications from UNCTAD.

a For real GDP growth, growth of exports and growth of imports, the average annual per cent change is reported; for other variables, the average annual level is reported.

b Financial balance of central government; - signifies a deficit.

CHART 2.1.1

China's role in international trade, 1995-2002
(Percentage shares)

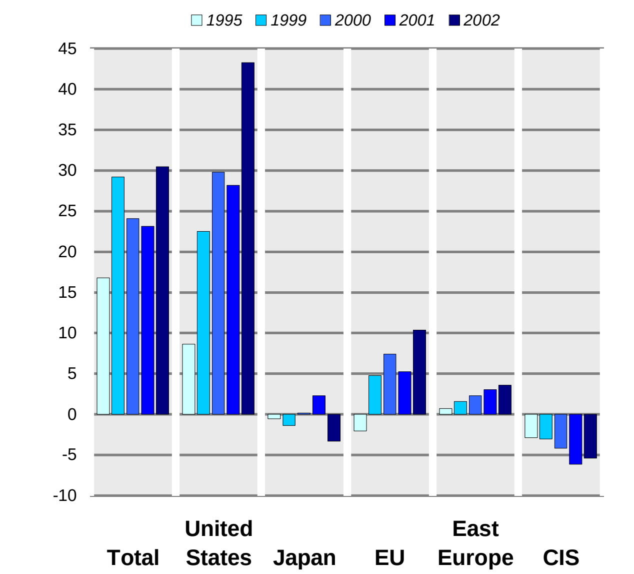


Source: IMF, *Direction of Trade Statistics 2003* (Washington, D.C.); WTO, *International Trade Statistics 2003* (Geneva).

Note: M = imports of countries/regions from China as per cent of total imports; X = exports of countries/regions to China as per cent of total exports.

CHART 2.1.2

Merchandise trade balances of China, 1995-2002
(Billion dollars)



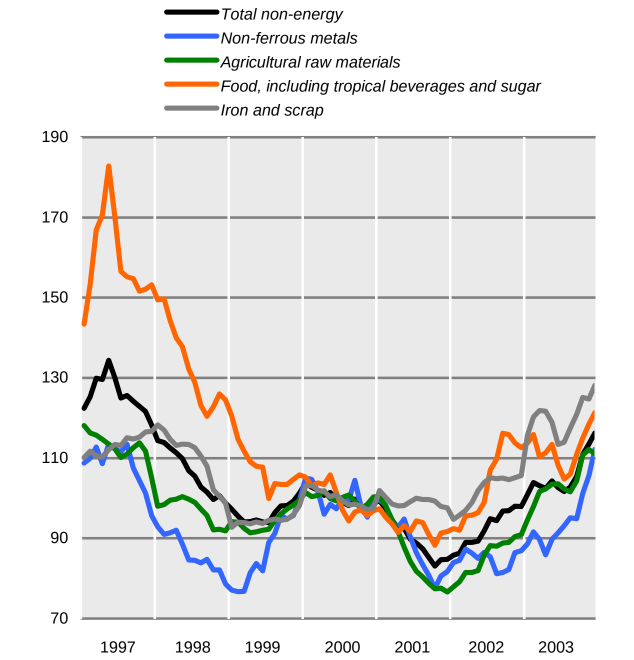
Source: IMF, *Direction of Trade Statistics 2003* (Washington, D.C.); WTO, *International Trade Statistics 2003* (Geneva).

Note: Exports: f.o.b.; imports: c.i.f.

Since early 2002, the rise in the prices of industrial raw materials has been determined by the expected and actual recovery in world economic activity and, consequently, by the pick-up in global industrial

CHART 2.1.3

Non-energy commodity prices, 1997-2003
(Indices, 2000=100)



Source: Hamburg Institute of International Economics (HWWA).

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

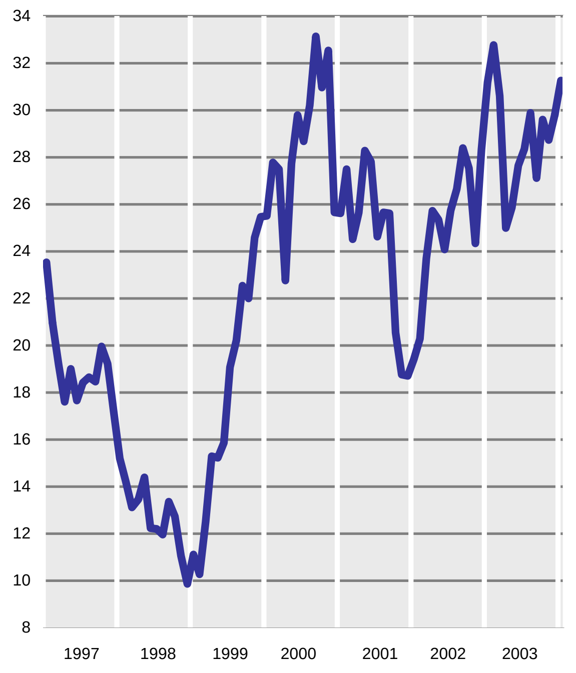
production. This pattern conforms to previous commodity price cycles. A specific feature of the present cyclical upturn, however, is the particularly strong impact of China as a consumer of commodities. Given the pattern of its development (especially its material intensity, the rapid rate of growth and the size of its economy – see box 2.1.1), the country has become a major importer of several commodities, accounting for a large share of the increase in world demand and pushing up prices, particularly those of some industrial raw materials. This process is also being accompanied by a rapid expansion of energy consumption. Since the country is a net crude petroleum importer, China has also started to have a strong impact on the oil market, where it is expected to account for one third of the rise in world demand in 2003 and 2004.

Crude oil prices remain high

Oil prices remained relatively high in 2003: they averaged around $29/barrel (spot price of Brent crude), some 16 per cent above the previous year and their highest level since 2000 (chart 2.1.4). Prices in 2003 were somewhat above the higher bound of OPEC's target range of $22-$28/barrel. Geopolitical troubles and uncertainties (e.g. the war in Iraq, worldwide terrorist activities and fears thereof, as well as specific national problems) all helped to sustain prices at these levels. Supply disruptions (e.g. in Indonesia, Iraq, Nigeria and Venezuela) and a rise in demand for precautionary stocks

CHART 2.1.4

Crude petroleum prices, January 1997-January 2004
(Dollars/barrel)

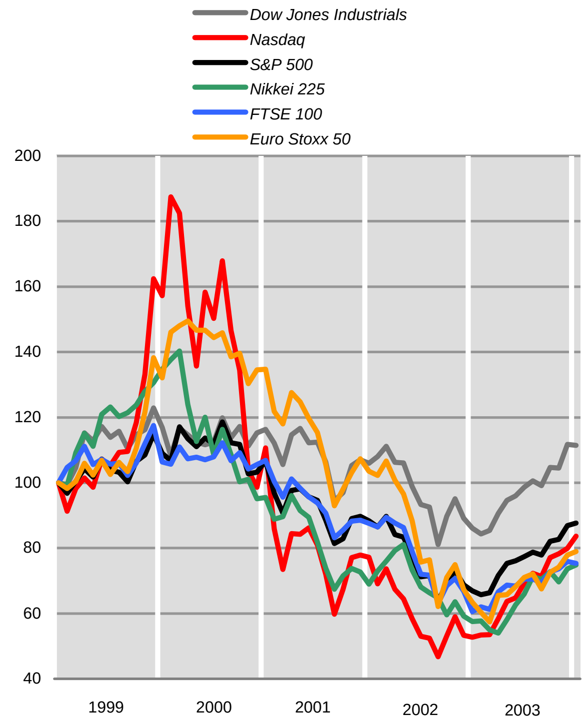


Source: United States Department of Energy, *Weekly Petroleum Status Report* (Washington, D.C.), various issues [www.eia.doe.gov].

Note: Brent spot price, monthly averages.

CHART 2.1.5

International share prices, January 1999-January 2004
(Indices, January 1999=100)



Source: Internet websites [finance.yahoo.com] and [www.Stoxx.com].

Note: End of month data, except for January 2004 (13 January 2004 data).

prevented prices from stabilizing at a lower level. In this environment OPEC countries (excluding Iraq) were able to raise petroleum output close to capacity levels (countries producing less than their quota being offset by others producing above-quota) and non-OPEC producers also increased supplies. World oil demand, driven by the recovery in global economic activity, expanded by 1.9 per cent in 2003, the largest increase in four years.[70]

Global oil demand in 2004 is expected to rise by some 1.5 per cent as the world economic recovery continues to strengthen. Supply is projected to increase by more than that, thanks to non-OPEC capacity coming on-stream. Oil prices are expected to be lower than in 2003, although continuing geopolitical tensions could work in the opposite direction.

A good year for global stock markets

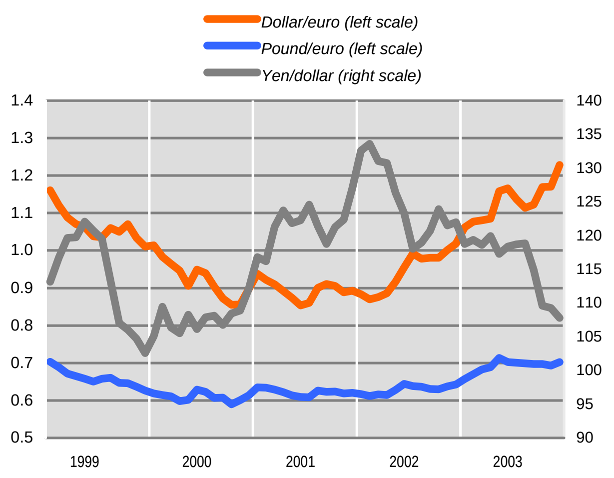
After a stagnant first quarter attributed to war-related risks, 2003 proved to be a good year for global stock markets (chart 2.1.5). The improving international economic outlook and favourable corporate earnings reports boosted global equity markets in the second half of the year. In the United States, the blue-chip Dow Jones Industrial Average closed the year some 21.5 per cent higher than its opening levels in January 2003, while the broader S&P 500 index rose more than 22 per cent. The best-performing stocks were the cyclically-oriented ones, especially those in high-tech sectors: the Nasdaq Composite (of companies in the high-tech sector) rose by 44 per cent, reaching its highest level since July 2001. The surge in the stock market has again raised concerns that, based on historical price-earnings ratios, United States equities appear to be rather expensive, thus pointing to the risk of a major reverse should the expected improvement in corporate profits fail to materialize.

Stock markets in the euro area were more hesitant, reflecting the more modest prospects for economic growth and profits, which in turn were partly related to the appreciation of the euro. At the end of 2003, pan-European benchmarks (Euro Stoxx 50 and Stoxx 50, covering the euro area and the European Union, respectively) were some 9.5 and 6 per cent higher than their opening levels in January 2003, despite sharp losses in the second quarter. The German DAX was among Europe's best performing national index, rising some 28 per cent during 2003. This partly reflected a recovery from the large losses in 2002. In Japan, the Nikkei finished the year around 23 per cent higher than its opening value in January 2003. This was the first annual rise since 2000.

[70] International Energy Agency, *Monthly Oil Market Report* (Paris), 16 January 2004 [omrpublic.iea.org].

CHART 2.1.6

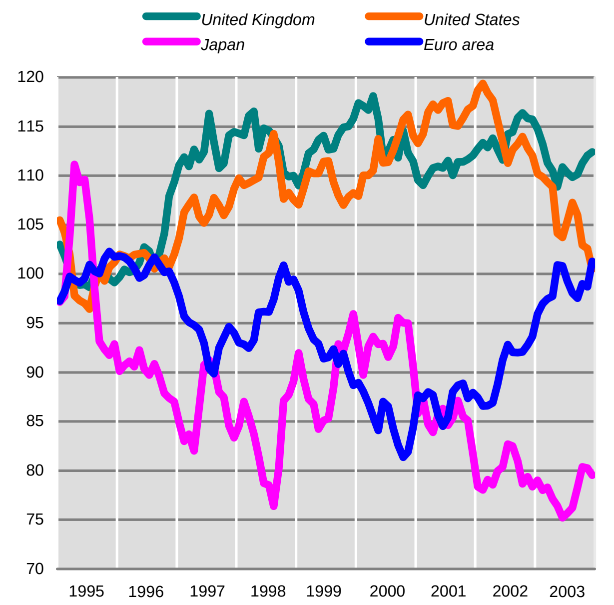
Bilateral exchange rates between major currencies, 1999-2003



Source: Eurostat, NewCronos Database.
Note: Average monthly values.

CHART 2.1.7

Real effective exchange rates of major currencies, 1995-2003
(Indices, 1995=100)



Source: Eurostat, NewCronos Database.
Note: Deflated by consumer price indices.

The dollar continues to decline

Since early 2002, the main development in the international currency markets has been the steady fall of the United States dollar: this continued throughout 2003 but gained considerable momentum in December 2003. The large United States current account deficit is seen as the major factor behind the financial markets lowering their estimate of a sustainable dollar exchange rate. In bilateral terms, the average monthly exchange rate of the dollar depreciated by 29 per cent against the euro between February 2002 and December 2003. This corresponds to a euro appreciation of 41 per cent. The dollar depreciated against the yen and the pound by around 19 per cent over the same period. Since its low in October 2000, the euro has appreciated by almost 44 per cent against the dollar and 43 per cent against the yen (chart 2.1.6).

The real effective exchange rate of the dollar fell some 12 per cent between its previous average monthly peak in February 2002 and December 2003, but it was still slightly above its previous low in July 1995. Over the same period, the real effective exchange rate of the euro rose by 22 per cent, while the yen appreciated by only some 8 per cent (chart 2.1.7).

(ii) North America

United States: the recovery gains momentum…

In the *United States*, the marked acceleration in economic activity in the third quarter of 2003 was largely due to the rapid expansion of private consumption expenditures, which were bolstered by income tax cuts, the favourable wealth effects from higher equity prices, the sustained rise in house prices and the continuation of mortgage refinancing at low interest rates (table 2.1.3). The personal savings ratio remained low, averaging some 2¼ per cent of disposable income in the first three quarters of 2003. Low interest rates also contributed to a surge in residential and business investment. The latter, which was especially strong in ICT products, was also supported by the recovery of corporate profits in the last two years. Exports rose markedly in the third quarter 2003, more than offsetting their cumulative decline in the three preceding quarters. In contrast, import growth slowed down to near stagnation, which is surprising in view of the strong growth of domestic demand and the depreciation of the dollar, and most likely reflects temporary special factors. In sum, the changes in the volume of net exports made a small positive contribution to economic growth in the third quarter (chart 2.1.8).

The available indicators suggest that economic conditions continued to improve in the final quarter of 2003. Manufacturing output continued to rise and capacity utilization rates started to edge upward, although they are still considerably below their long-term average (chart 2.1.9). The Purchasing Managers' Index (PMI) of manufacturing activity reached its highest level in 20 years in December 2003 signalling a further marked improvement in business conditions. This contrasts, however, with business surveys that point to a moderate slowdown in the rate of expansion in the services sector (chart 2.1.10). Against the background of accelerating economic growth, business and consumer confidence strengthened in the second half of 2003 (chart 2.1.11), but

TABLE 2.1.3

Changes in real GDP and main expenditure items in the United States, 2002QIV-2003QIII

(Percentage change over previous quarter, seasonally adjusted)

	2002	2003		
	QIV	QI	QII	QIII
Private consumption	0.4	0.5	0.9	1.6
Final consumption expenditure of general government	1.4	0.2	2.1	-0.1
Gross fixed capital formation	0.9	-0.1	1.7	3.7
Stockbuilding [a]	0.1	-0.2	-0.2	–
Total domestic expenditure	0.7	0.1	1.1	1.8
Exports of goods and services	-1.5	-0.3	-0.2	2.6
Imports of goods and services	1.8	-1.6	2.1	0.4
Net exports [a]	-0.4	0.2	-0.3	0.2
GDP	0.3	0.4	0.8	2.0

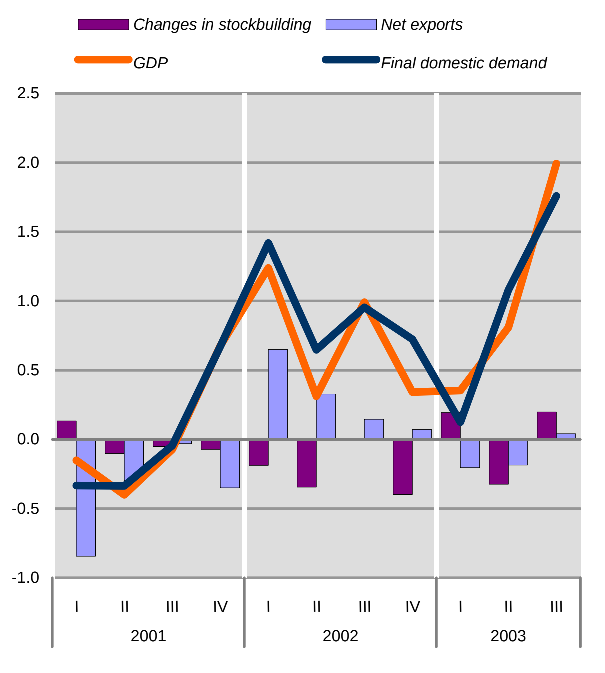
Source: United States Department of Commerce, Bureau of Economic Analysis.

a Percentage point contribution to real GDP growth over the previous quarter, seasonally adjusted.

CHART 2.1.8

Quarterly changes in real GDP and major expenditure items in the United States, 2001QI-2003QIII

(GDP and final domestic demand: percentage change over previous quarter, seasonally adjusted)



Source: United States Department of Commerce.

Note: Real net exports and changes in stockbuilding: percentage point contributions to real GDP growth.

consumer confidence continues to be held back by the lack of significant improvement in the labour market.

....but has still to reach the labour market

The present United States recovery has been even slower to reach the labour market than the previous economic recovery in 1991-1992.[71] Although the sharp fall in employment since 2000 bottomed out in mid-2003, this was followed by only moderate increases in the following months, which petered out into virtual stagnation in December. Unemployment has fallen significantly from its recent peak of 6.3 per cent in June 2003 and stood at 5.7 per cent at year end (chart 2.1.12). The decline was, however, mainly due to withdrawals from the labour force, notably by teenagers who, given their poor job prospects, opted to stay in school longer.

Productivity growth remains robust

The mirror image of the "jobless" recovery has been very strong productivity growth. In 2001 and 2002, productivity growth exceeded output growth by a significant margin, which was associated with a marked fall in hours worked. This tendency continued in the first two quarters of 2003. The buoyant (and unsustainable) rate of output growth in the third quarter (a seasonally adjusted annual rate of more than 10 per cent) was almost entirely due to the acceleration in the growth of labour productivity: consequently, there was only a modest increase in labour utilization (table 2.1.4). The productivity increase held unit labour costs in check and so helped to keep inflation down. Although the headline inflation rate increased to 2.3 per cent in 2003 (up from 1.6 per cent in 2002), mainly because of higher prices for energy, core inflation (which excludes food and energy prices) continued its downward trend and averaged 1.5 per cent in 2003, down from 2.3 per cent in 2002.

The current account deficit continues to rise and is now associated with a government budget deficit

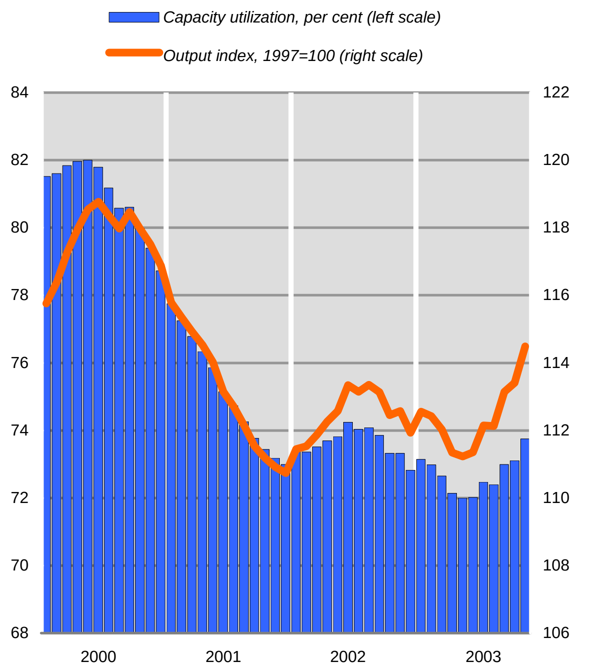
The current account deficit widened to some $500 billion in 2003, corresponding to 5 per cent of GDP. In 2002, the annual current account deficit was $480.7 billion, or 4.6 per cent of GDP. At the peak of the previous cycle in 2000, the current account deficit corresponded to 4.2 per cent of GDP. At that time, the general government budget was in surplus, i.e. the external imbalance fully reflected the excess of private investment over private savings.[72] In fact, it was the rapidly deteriorating financial balance of the

[71] In January 2004, the present recovery had been underway for about 25 months based on the National Bureau of Economic Research's (NBER) business cycle dating [www.nber.org/cycles/july2003.html]. In the 1991-1992 recovery, employment began to grow vigorously about 18 months after the cyclical trough. This was in sharp contrast to earlier post-war recoveries, when the return to economic growth was followed closely by significant increases of employment. E. Goshen and S. Potter, "Has structural change contributed to a jobless recovery?", Federal Reserve Bank of New York, *Current Issues in Economics and Finance*, Vol. 9, No. 8, 2003, and E. Rissman, "Can sectoral labor reallocation explain the jobless recovery?", Federal Reserve Bank of Chicago, *Chicago Fed Letter*, No. 197, December 2003.

[72] In the framework of national accounts, the current account balance is *by definition* equal to the sum of the private sector financial balance (savings less investment) and the government financial balance. For a given private sector financial balance, any change in the government financial balance will be matched by a corresponding change in the balance on the current account. The same holds *mutatis mutandis* for a given government financial balance or a given current account balance.

CHART 2.1.9

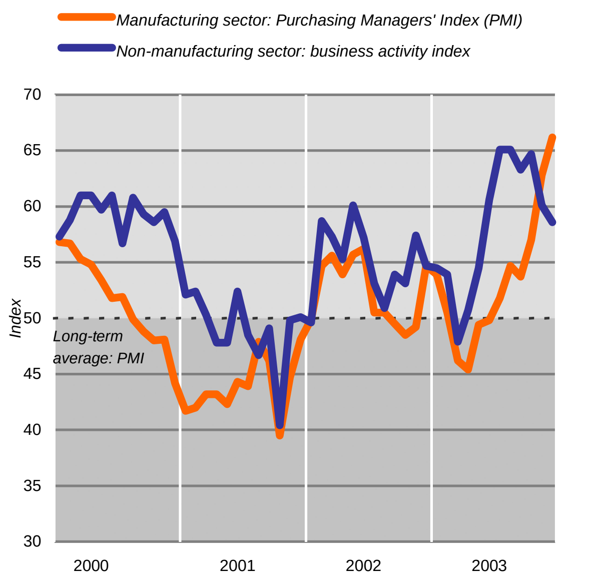
Monthly output and capacity utilization in manufacturing industry in the United States, January 2000-November 2003
(Index, per cent)



Source: Federal Reserve Board [www.federalreserve.gov].
Note: Data are seasonally adjusted.

CHART 2.1.10

Surveys of business activity in the United States, 2000-2003
(Per cent)



Source: Institute for Supply Management (Arizona) [www.ism.ws].
Note: An index value above (below) 50 indicates that the sector is generally expanding (contracting). Long-term average of PMI for 1990-2002.

private sector that was the counterpart to the rise in the current account deficit from 1.4 per cent of GDP in 1995 to 4.2 per cent in 2002. Over the same period, the government financial balance swung from a deficit corresponding to 3.1 per cent of GDP in 1995 to a surplus in 1998, which gradually increased until 2000 (chart 2.1.13). The situation reversed during the recent cyclical downturn, when a strongly expansionary fiscal policy was used to support private domestic consumption, while the private sector reconstructed its balance sheets, following the sharp rise in debt during the boom years of the second half of the 1990s. Thus, as the current account deficit widened to 5 per cent of GDP between 2000 and 2003, there was a drastic change in the domestic counterpart to the external imbalance, with financial consolidation in the private (mainly corporate) sector being more than offset by a structural deterioration in the general government's financial position.

Viewed from a different perspective, the rise in the current account deficit in the second half of the 1990s was financed largely by private foreign capital inflows attracted by the higher expected rates of return in the United States economy. That pattern has changed more recently: the capital inflows required to finance the external deficit now consist primarily of foreign purchases (mainly by central banks) of United States government bonds, notably treasury bills.

United States fiscal policy is very expansionary

Fiscal policy remained strongly expansionary in 2003. The cyclically adjusted budget deficit rose to 4.5 per cent of GDP in 2003, 1.5 percentage points higher than in 2002. The general government fiscal deficit is estimated at 4.9 per cent of GDP in 2003, up from 3.4 per cent a year earlier. In other words, virtually all of the deficit is structural, i.e. it will not be reversed automatically during the cyclical recovery. In 2000, there was still a structural budget surplus corresponding to 0.9 per cent of potential GDP.[73] The cumulative fiscal policy impulse (as measured by the change in the cyclically adjusted government financial balance) corresponds to 5.4 per cent of potential GDP between 2000 and 2003. This massive shift mainly reflects the effects of income tax cuts (in 2001 and 2003) and increased spending on defence and homeland security, as well as discretionary increases in spending on entitlements. It is generally acknowledged that while these measures have contributed to pulling the economy out of recession, fiscal policy is currently on an unsustainable path, especially given the fiscal implications of the projected trends for public health care expenditures and pensions which, *inter alia*, reflect demographic developments.

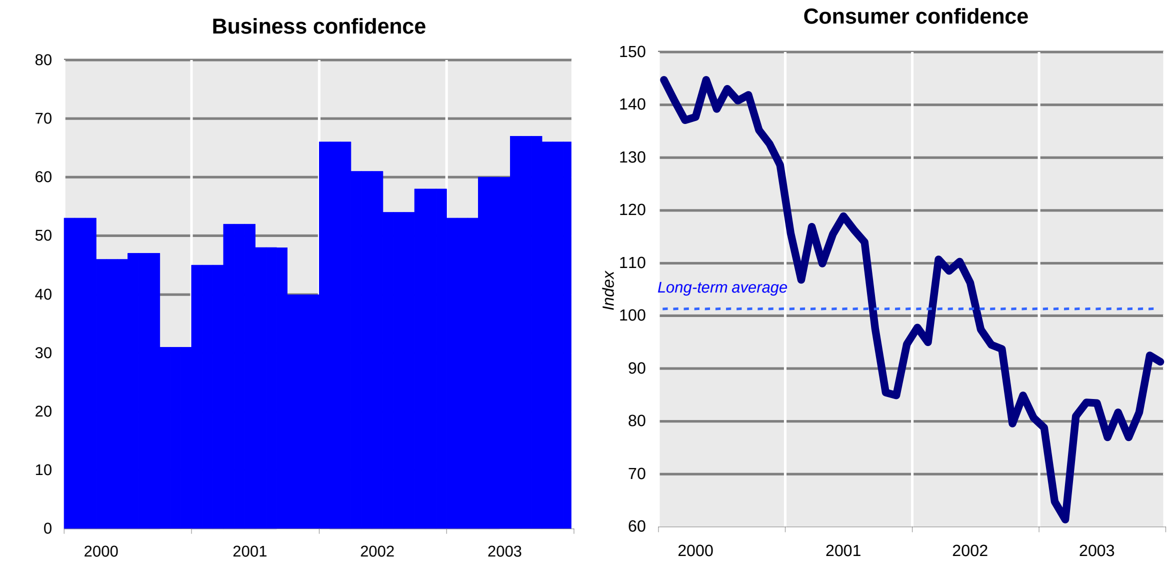
Monetary conditions are easing further…

The Federal Reserve has left monetary policy unchanged since late June 2003, when the target for the

[73] *OECD Economic Outlook No. 74* (Paris), December 2003, annex tables 28 and 29.

CHART 2.1.11

Business and consumer confidence in the United States, 2000-2003
(Business confidence, balances; consumer confidence, index 1985=100)

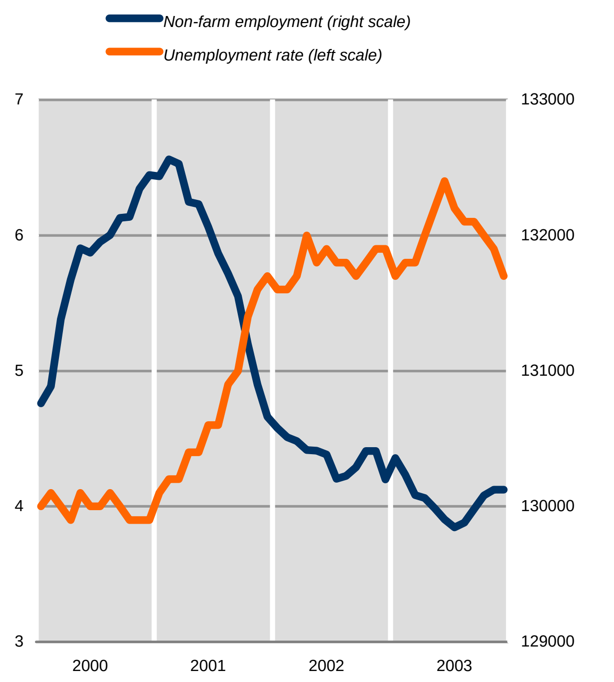


Source: The Conference Board [www.conference-board.org].

Note: For business confidence a value above 50 indicates more positive than negative responses (quarterly values). Long-term average value of consumer confidence for 1990-2002.

CHART 2.1.12

Employment and unemployment in the United States, 2000-2003
(Thousands, per cent)



Source: United States Department of Labor, Bureau of Labor Statistics [www.bls.gov].

Note: Unemployment is measured as a per cent of the civilian labour force aged 16 and above; non-farm employment is payroll employment (establishment data).

federal funds rate was reduced by 25 basis points to 1 per cent. (In 2000, at the peak of the previous cycle, the target rate was 6.5 per cent.) This move was prompted by concerns about risks of deflation, which diminished in the course of the second half of the year when the recovery gathered momentum. In view of the prevailing low inflation rate, the considerable margins of spare capacity and the judgment that the sustainability of the recovery was not yet ensured, the FOMC announced that the accommodative stance of monetary policy “can be maintained for a considerable period”[74] thereby also influencing the expectations of investors in bond markets about future long-term interest rates and so avoiding an unwelcome steepening of the yield curve at this stage of the recovery.

....and long-term bond yields have risen

In reaction to the monetary policy decisions, nominal short-term interest rates (three-month rates) have fallen since late June 2003 to some 1 per cent (chart 2.1.14). Real short-term rates were negative throughout 2003. This very accommodative stance of monetary policy has been amplified by the sharp depreciation of the dollar in real effective terms, which amounted to some 9 per cent in the 12 months to January 2004. In the capital market, yields on 10-year treasury bonds averaged 4.3 per cent in December 2003, up from 3.4 per cent in June

[74] The Federal Reserve Board, Press Release, 9 December 2003 [www.federalreserve.gov]

TABLE 2.1.4

Output, hours worked and labour productivity in the non-farm business sector in the United States, 2000-2003
(Percentage changes from previous period, quarterly changes at annualized rates)

	2000	2001	2002	2003 QI	2003 QII	2003 QIII
Output	4.0	-0.1	2.7	1.4	4.6	10.3
Hours worked	1.0	-2.0	-2.5	-0.7	-2.2	0.8
Labour productivity	2.9	1.9	5.4	2.1	7.0	9.4

Source: United States Department of Labor, Bureau of Labor Statistics [www.bls.gov].

Note: Labour productivity is output per hour worked.

2003. The yield in June was the lowest since mid-1958.[75] The subsequent sharp rise in long-term bond yields in the following weeks reflected a major sell-off in global bond markets in reaction to the decision of the FOMC to lower interest rates by only 25 basis points, rather than the 50 basis points that investors in the bond markets had been led to expect. The smaller than expected cut was interpreted as being inconsistent with signals from the Federal Reserve that suggested it was prepared to use unconventional policy measures (such as direct purchases of government bonds) to avert deflation. This suggestion had led to a strong rise in demand for treasury bonds in the preceding weeks, which reduced yields to near historic lows. But the subsequent rise in yields also partly reflected bond investors' improved expectations about short-term global growth prospects.[76]

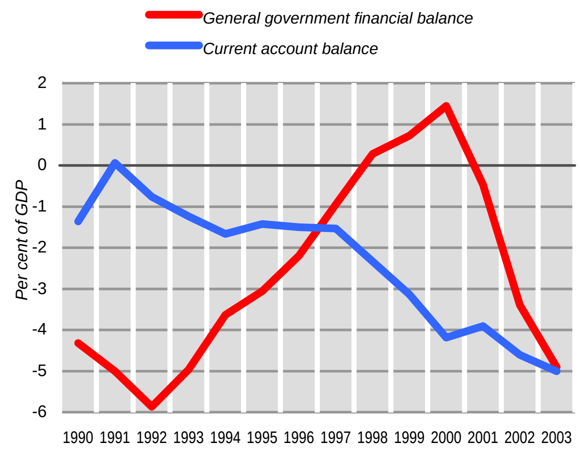
The Canadian economy copes with adverse shocks

In *Canada*, the marked slowdown in the rate of economic growth during 2002 continued into the first half of 2003. But the cyclical downturn appears to have reached its trough in the second quarter, when GDP declined slightly (table 2.1.1). A moderate recovery started in the third quarter supported by the continued strength of private consumption expenditures and a rebound in gross fixed investment. The decline of exports in the first two quarters was succeeded by a small increase, and the change in real net exports made a slightly positive contribution to economic growth. This followed three consecutive quarters in which real net exports had been a substantial drag on economic growth. In the event, real GDP increased by 1.8 per cent in 2003, a marked slowdown from a growth of 3.3 per cent in the preceding year.

Economic activity in Canada in 2003 was adversely affected by the spreading of SARS and bovine spongiform encephalopathy ("mad cow disease"); moreover, the large appreciation of the Canadian dollar against the United States dollar depressed exports. The labour market improved in the second half of the year and at the end of 2003 employment was 1.7 per cent higher than a year earlier. The unemployment rate, however, was unchanged at 7.4 per cent. A high rate of inflation prompted the Bank of Canada to raise its key policy rate in early 2003, but this was reversed in September, when inflation had fallen back into the Bank's target range (1-3 per cent). In January 2004, the monetary authorities lowered interest rates again to 2.5 per cent, in response to the subdued inflation outlook and the contractionary effects of the appreciating exchange

CHART 2.1.13

United States current account balance and general government financial balance, 1990-2003
(Per cent of GDP, (+) surplus / (-) deficit)

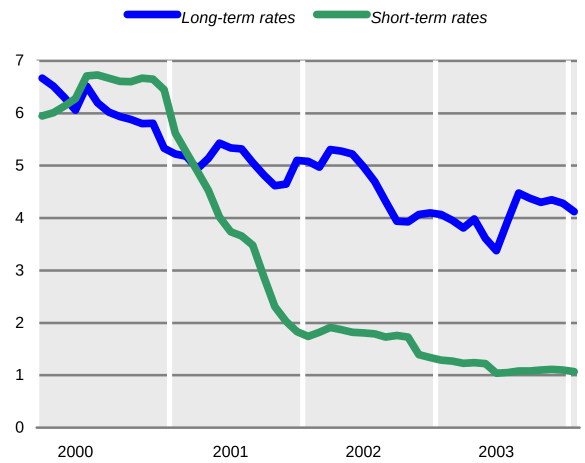


Source: *OECD Economic Outlook No. 74* (Paris), December 2003.

Note: Projected values for 2003.

CHART 2.1.14

Nominal short-term and long-term interest rates in the United States, January 2000-January 2004
(Per cent per annum)



Source: Federal Reserve Board [www.federalreserve.gov].

Note: Average monthly values. Short-term rates: three-month interbank rates. Long-term rates: yields on 10-year government bonds.

[75] The lowest rate since 1953 was the monthly average of 2.29 per cent in April 1954.

[76] For a detailed analysis see BIS, *Quarterly Review*, September 2003, pp. 1-9.

rate. Although the automatic stabilizers were allowed to operate, fiscal policy was relatively tight in 2003 as the cyclically adjusted budget surplus increased by about half a percentage point to 1.1 per cent of GDP. The actual general government financial balance, which has been in surplus since 1997, corresponded to 1 per cent of GDP in 2003, slightly higher than in the preceding year.

(iii) Japan

Japan on the road to sustained recovery?

In *Japan*, the improvement in economic activity, which started in 2002, continued in 2003. Although the estimate of economic growth in the third quarter of 2003 was revised downwards to 0.3 per cent, this was nevertheless the seventh consecutive quarter of expansion. For the year as a whole, real GDP is estimated to have increased by 2¼ per cent. The recovery has been driven mostly by net exports, benefiting from strong demand from the United States and Asia, most notably China. The other main support to economic growth was business fixed investment, sustained by rising corporate profits and a better outlook for sales and profits. The current account surplus is estimated at some 3 per cent of GDP in 2003, slightly higher than in 2002. Consumer price deflation came to a virtual halt in the final quarter of 2003.

Both fiscal and monetary policy remained expansionary. The cyclically adjusted budget deficit rose to 6.9 per cent of GDP in 2003, mainly reflecting the impact of corporate tax cuts. The overall deficit rose by 0.3 percentage points to 7.4 per cent of GDP.[77] The Bank of Japan kept short-term interest rates close to zero and repeatedly raised the target for the current account balances (mandatory cash reserves) held by commercial banks at the central bank. Concerns about export price competitiveness and the sustainability of the export-led recovery prompted the authorities to intervene in the foreign exchange markets to the extent of some 20 trillion yen ($150 billion) in order to check the appreciation of the yen against the dollar and, indirectly, against the Chinese renminbi, which is pegged to the dollar.

2.2 Western Europe

An upturn in the growth of exports in the third quarter of 2003 began to pull western Europe out of a protracted economic stagnation, which had started in the third quarter of 2002. For the year as a whole, real GDP rose by only 0.9 per cent. There was only moderate growth of private consumption which, nevertheless, was the mainstay of activity. Fixed investment fell slightly and the change in real net exports was a drag on economic growth. This was the worst annual economic performance since 1993, when real GDP stagnated, and mainly reflected weak growth in France, Germany and Italy, the three largest economies of the euro area.[78] This contrasts with the continuing strong economic performance of the United Kingdom outside the euro area. Outside the EU, the most remarkable developments were the continued strong growth in Turkey and the recovery from recession in Israel and Iceland.

(i) Euro area

(a) Main macroeconomic trends

An export-led recovery leads to improving business expectations

After a pronounced weakness during the first two quarters of 2003, a cyclical recovery appears to have started in the third quarter, when real GDP rose by 0.4 per cent (chart 2.2.1).[79] Although domestic expenditure declined for the first time in two years, due to a combination of stagnant final demand and massive destocking, this was more than offset by the strong growth of net exports. In spite of the exchange rate appreciation, euro area exporters benefited from the strong recovery of international trade, which accelerated during the second half of the year (table 2.2.1).[80] The available short-term indicators suggest that the recovery continued in the fourth quarter, when GDP increased between 0.3 per cent and 0.7 per cent, according to the European Commission.[81] Expectations improved throughout the second half of 2003. Consumer confidence recovered somewhat from its low levels of the first quarter of 2003, but at the end of the year it was still below its long-term average, being kept down by the soft state of the domestic economy. Industrial confidence, in contrast, tends to react more promptly to changes in the international environment: it rebounded strongly during the second half and closed the year close to its long-term average (chart 2.2.2).

Domestic demand remains weak

For the year as a whole, aggregate real GDP in the euro area increased by only 0.5 per cent in 2003, the smallest increase since the recession of 1993. On the demand side, the outcome reflects the weakness of domestic

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[77] OECD, op. cit. However, government spending did not contribute to economic growth in 2003, as public consumption remained flat and public investment actually declined.

[78] Technically, Germany and Italy (as well as the Netherlands) were in recession during the first half of 2003.

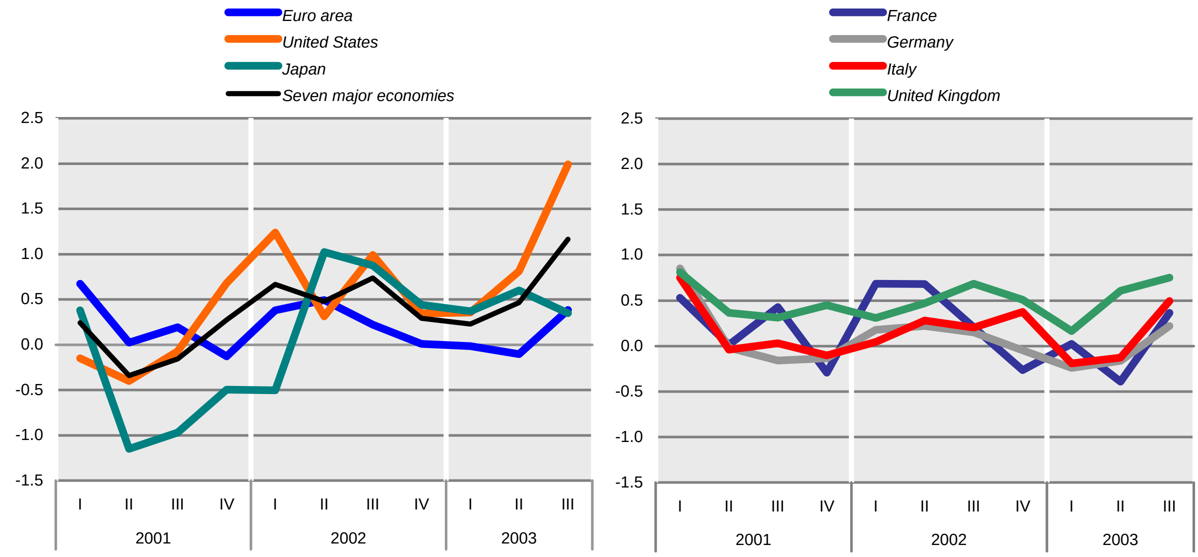
[79] Compared with the same quarter of 2002, the increase in euro area GDP was a meagre 0.3 per cent.

[80] During the third quarter, euro area merchandise exports rose (in nominal terms) in all major partners, namely central and eastern Europe, eastern Asia, the United Kingdom and the United States. This reversed the pattern of the previous three or four quarters when sales to these markets had fallen.

[81] Internet website [europa.eu.int/comm/economy_finance/indicators/euroareagdp/2004/ gdp150104en.pdf].

CHART 2.2.1

Quarterly changes in real GDP in the developed market economies, 2001QI-2003QIII
(Percentage change over previous quarter, seasonally adjusted)



Source: National statistics; Eurostat, NewCronos Database.
Note: Seven major economies: Canada, France, Germany, Italy, Japan, United Kingdom and United States.

TABLE 2.2.1

Quarterly changes in real GDP and major expenditure items in the euro area, 2002QI-2003QIII
(Seasonally adjusted)

	Percentage change over previous quarter							*Growth contribution (percentage points)*						
	2002				*2003*			*2002*				*2003*		
	QI	*QII*	*QIII*	*QIV*	*QI*	*QII*	*QIII*	*QI*	*QII*	*QIII*	*QIV*	*QI*	*QII*	*QIII*
GDP	0.4	0.5	0.2	–	–	-0.1	0.4	0.4	0.5	0.2	–	–	-0.1	0.4
Total domestic demand	–	0.4	0.2	0.3	0.4	0.1	-0.4	–	0.4	0.2	0.3	0.4	0.1	-0.4
Private consumption	-0.4	0.4	0.3	0.3	0.5	0.1	0.1	-0.2	0.2	0.2	0.2	0.3	–	0.1
Government consumption	0.7	0.8	0.6	0.2	0.4	0.5	0.5	0.1	0.2	0.1	–	0.1	0.1	0.1
Gross fixed capital formation	-0.7	-1.5	0.1	0.3	-1.2	-0.6	-0.3	-0.2	-0.3	–	0.1	-0.2	-0.1	-0.1
Changes in stockbuilding								0.2	0.3	-0.1	–	0.2	0.1	-0.5
Net exports								0.4	0.1	–	-0.3	-0.4	-0.2	0.8
Exports	0.2	2.6	1.4	-0.2	-1.4	-0.9	2.0	0.1	1.0	0.5	-0.1	-0.5	-0.4	0.8
Imports	-0.9	2.5	1.6	0.6	-0.5	-0.3	-0.1	0.3	-0.9	-0.6	-0.2	0.2	0.1	–

Source: Eurostat, NewCronos Database.

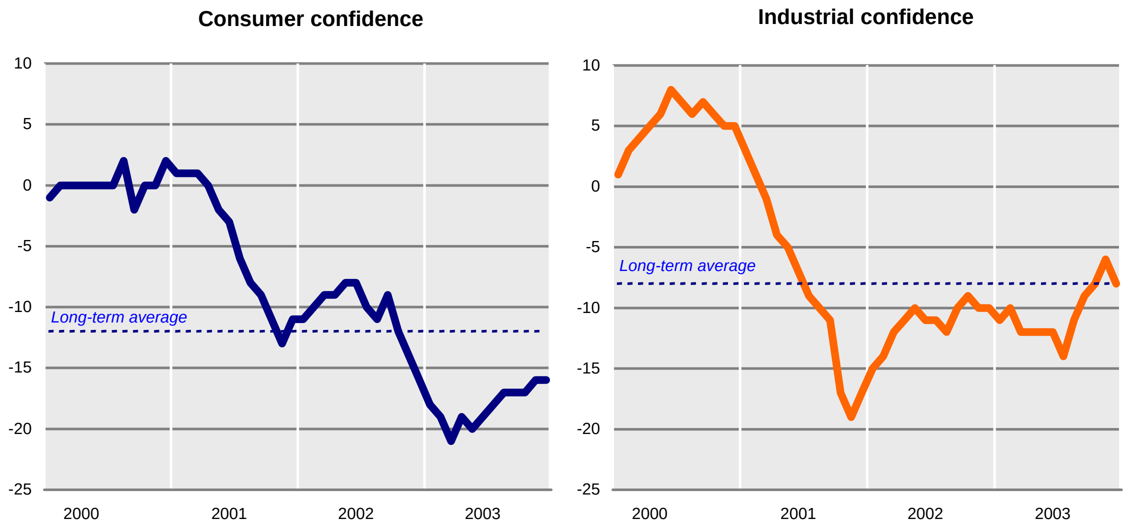
spending. Personal consumption growth (at 1.3 per cent) grew in line with the increase in real household disposable income, as the savings rate remained constant. Consumer spending was held back by rising unemployment and increased uncertainty arising from the international environment (particularly during the first half of the year), but also from a number of reforms in welfare systems being enacted or discussed in several countries, which raised doubts about the security of future disposable incomes. Fixed investment declined for the third consecutive year. Business fixed investment was held back by economic and political uncertainties, the sluggishness of domestic demand, the continuing restructuring of corporate balance sheets, and large margins of spare capacity in industry.[82] Public investment rose marginally.[83] Government consumption supported GDP growth, although to a lesser degree than in the previous two years as much of the focus of fiscal policy

[82] Fixed investment in equipment (which is mostly undertaken by the private sector) declined more than total investment and the fall occurred in most countries of the euro area.

[83] Public investment is more concentrated on construction. It is likely that public spending on this item was offset by falling private investment in construction, since overall construction (public and private) fell in the euro area in 2003, but by less than total fixed investment. Contrary to equipment investment, the cutback in construction was not widespread: it was mostly due to the contraction in Germany, where this type of fixed investment declined for the fourth consecutive year.

CHART 2.2.2

Consumer and industrial confidence in the euro area, 2000-2003
(Balances)



Source: European Commission, *Business and Consumer Survey Results* (Brussels), various issues [europa.eu.int/comm/economy_finance].

Note: Balances are the differences between the percentage of respondents giving positive and negative replies to specific questions. Long-term averages are for the period 1990-2002.

was on budget consolidation. Changes in real net exports subtracted approximately half a percentage point from annual growth in 2003, as real exports stagnated and imports rose, influenced by currency appreciation. This is in contrast to the previous three years, when foreign demand had contributed positively to growth and attenuated the impact of the cyclical downturn.

In terms of supply, industrial output (as defined in national accounts) increased during the third quarter of 2003, having contracted or stagnated during the previous three quarters. In the January-October period manufacturing output was virtually unchanged from its level of a year earlier, but between July and October it recovered somewhat from the slump of the first half of the year, mainly because of increased production of capital and intermediate goods. This recovery led to a marginal rise in the level of capacity utilization in industry, but nevertheless this remains well below its previous peak (chart 2.2.3). Other indicators point to a stronger pick-up in activity towards the end of the year. The euro area manufacturer's PMI rose throughout the second half and since September has indicated an expansion of activity. The output of services (according to national accounts data) also grew during the third quarter, having stagnated during the first two quarters of the year. Similarly, the monthly survey of service sector activity rose from the second quarter and between July and December indicated expanding activity (chart 2.2.4).

Inflation remains moderate

Consumer price inflation in the euro area averaged 2.1 per cent in 2003, slightly less than in the preceding year and marginally higher than the ECB's definition of price stability. Price developments in the course of 2003 were influenced by the fall in oil prices after the first quarter of 2003, which brought about a significant fall in overall energy price inflation. In the second half of the year, the inflation rate moved around the 2 per cent mark and closed at 2 per cent in December (chart 2.2.5). Service price inflation was relatively stable at some 2.5 per cent in the second half of the year. The relative stickiness of the headline inflation rate was due more to volatile components, such as processed and unprocessed foods, which climbed steadily throughout the year due to the hot, dry summer, and by the rise in tobacco taxes implemented by the French government in October 2003.

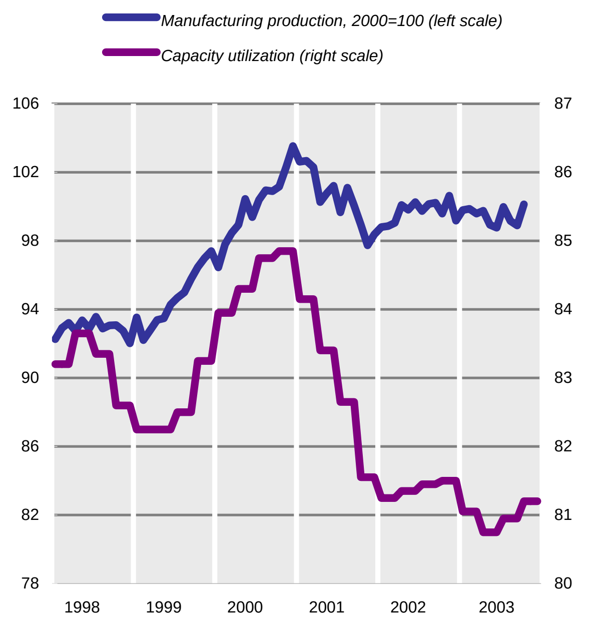
Cyclical weakness means sluggish labour markets

The economic downturn has continued to take its toll, albeit modestly, on the euro area's labour markets. Employment fell slightly in 2003 and the unemployment rate, which was 8 per cent in the last quarter of 2001 (a 10-year low) edged up to 8.8 per cent in March 2003 and remained there for the rest of the year (chart 2.2.6).[84] Total economy labour productivity increased very modestly in 2003, reflecting the combination of moderate gains in output and relatively stable levels of employment. (This is partly a cyclical phenomenon reflecting the lagged adjustment of labour input to changes in output.) Labour productivity rose by only half a percentage point in 2003, the same as in 2002. Unit labour costs increased by

[84] The latest month for which data are available at the time of writing is November 2003.

CHART 2.2.3

Manufacturing output and capacity utilization in the euro area, 1998-2003
(Indices, percentages)

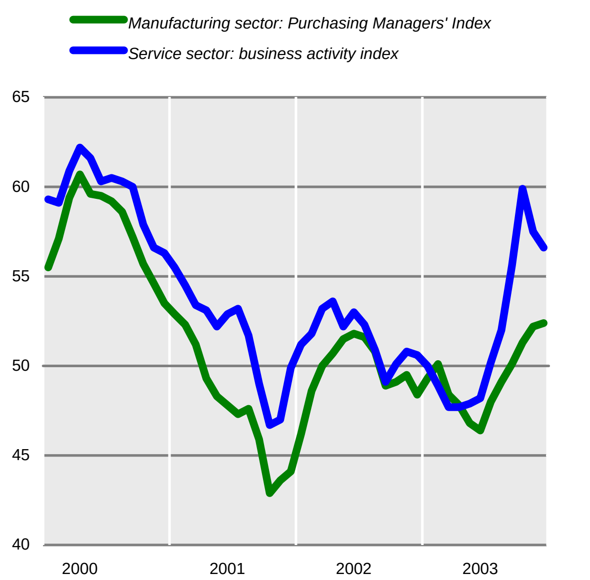


Source: Eurostat, NewCronos Database; European Commission, *Business and Consumer Survey Results* (Brussels), various issues.

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), April and July (second quarter), etc.

CHART 2.2.4

Surveys of business activity in the euro area, 2000-2003
(Indices)

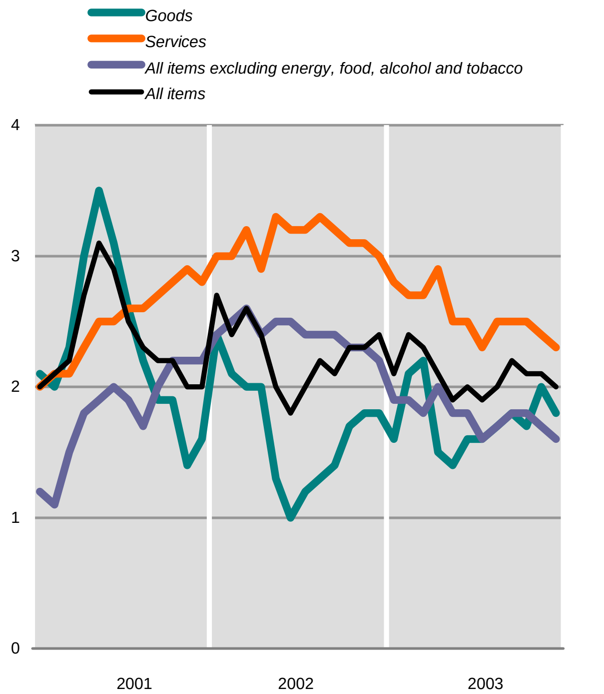


Source: Dow Jones Reuters Business Interactive (Factiva) [www.factiva.com].

Note: An index value above (below) 50 indicates that the sector is generally expanding (contracting).

CHART 2.2.5

Consumer prices in the euro area, 2001-2003
(Percentage change over same month of previous year, HICP index, main components)



Source: Eurostat, NewCronos Database.

somewhat more than 2 per cent, again broadly the same as in the preceding year (chart 2.2.7). As the recovery takes hold, however, productivity growth should lead to smaller increases in unit labour costs.

(b) Monetary policy

Cyclical downside risks lead to a further easing of monetary policy...

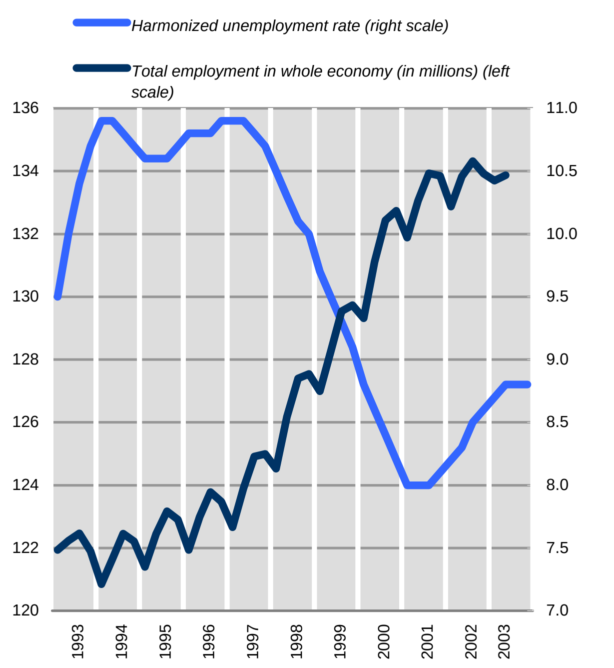
The ECB reacted to concerns at the downside risks to economic growth by reducing its main refinancing rate, first by 0.25 percentage points in March 2003 and then by a further half a percentage point to 2 per cent in June 2003. Since then the stance of monetary policy has remained unchanged. Inflation is forecast by the ECB to fall below the 2 per cent threshold later on in 2004. Money supply continues to grow at rates significantly above the Bank's reference value of 4.5 per cent since mid-2001, reflecting a combination of portfolio shifts into money, precautionary savings and low levels of interest rates.

In the money market, three-month interest rates have been slightly above 2 per cent since June 2003. Real short-term rates (calculated by subtracting the rate of consumer price inflation from the nominal rate) have been close to zero since June 2003. At the longer end of the maturity spectrum, yields on 10-year government bonds

CHART 2.2.6

Employment and unemployment in the euro area, 1993QI-2003QIII

(Millions, per cent of civilian labour force)



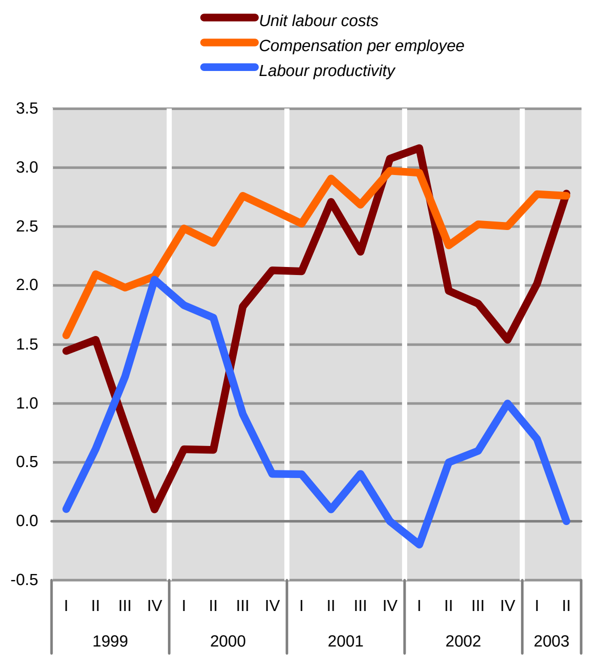
Source: Eurostat, NewCronos Database.

Note: Unemployment data are seasonally adjusted. Employment data (available until 2003 QII) are not seasonally adjusted.

CHART 2.2.7

Unit labour costs and their main components in the euro area, 1999QI-2003QII

(Percentage change over same quarter of preceding year)



Source: European Central Bank; UNECE secretariat calculations.

Note: Data are seasonally adjusted and pertain to the whole economy.

rose from a monthly low of 3.7 per cent in June to 4.4 per cent in November (a smaller rise than in the United States), but fell back thereafter (chart 2.2.8). In mid-January 2004, nominal 10-year bond yields were around 4.2 per cent in the euro area, but the contemporaneous real long-term interest rate was still only some 2 per cent.

...but exchange rate appreciation leads to tighter monetary conditions

Compared with the beginning of 2002, the ECB's main refinancing rate has fallen by 1.25 percentage points to its current 2 per cent. Historically, nominal short-term and long-term interest rates (bond yields) are now quite low, i.e. for the period since 1950, using German interest rates as a benchmark.[85] It is estimated that a 1 percentage point decline in short-term interest rates will raise real GDP in the euro area by about half a percentage point after two years.[86] In other words, the progressive monetary stimulus of the past two years can be expected to lead, *ceteris paribus*, to a rise in real GDP by somewhat more than 0.6 percentage points. But the marked appreciation of the euro's real effective exchange rate by nearly 20 per cent since early 2002 has tended to offset this monetary stimulus. Overall monetary conditions can be gauged with a monetary conditions index (MCI), which is a weighted average of changes in real short-term interest rates and the real effective exchange rate.[87] Monetary conditions in the euro area have been quite volatile since 1999, but there has been a clear downward trend of the MCI since 2002, indicating a tightening of monetary conditions (chart 2.2.9). (It should be noted that a fall in the index corresponds to a loosening of monetary conditions; but the scale of the chart has been reversed so that *downward movements represent tighter monetary conditions.*) Much of this change occurred between March 2002 and May 2003. The further easing of monetary policy in June 2003 partly reversed this trend, but in the final quarter of 2003 there was again a tightening of monetary conditions driven by the euro exchange rate. The net result is that the decline of real short-term interest rates by some 90 basis points in December 2003 compared with early 2002 has only partially offset the real exchange rate appreciation over the same period. This suggests that the ECB should have reduced interest rates by more than it actually did in order to stimulate economic activity.

The ECB reviews its monetary policy strategy…

In early May 2003, the ECB Governing Council announced the outcome of its review of the ECB's

[85] ECB, *Monthly Report* (Frankfurt am Main), September 2003, pp. 25-28, box 3.

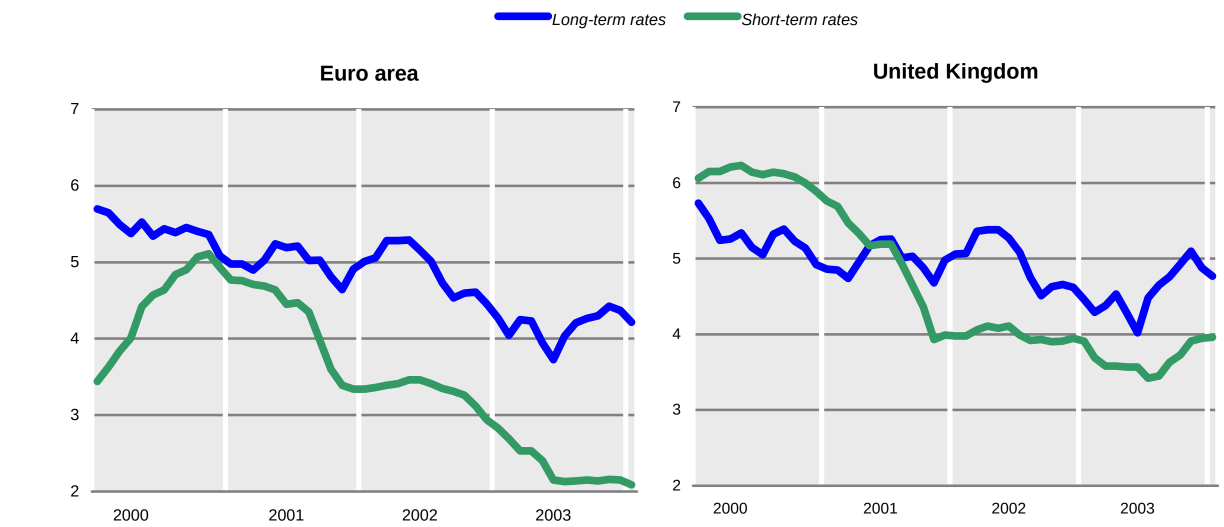
[86] ECB, *Monthly Report* (Frankfurt am Main), October 2002, p. 45, table 1. The figure quoted is the arithmetic average of the output response to changes in interest rates from three different econometric models.

[87] This builds on the empirical findings that monetary policy is transmitted primarily through the interest rate and exchange rate channels.

CHART 2.2.8

Nominal short-term and long-term interest rates in the euro area and the United Kingdom, January 2000-January 2004

(Per cent per annum)

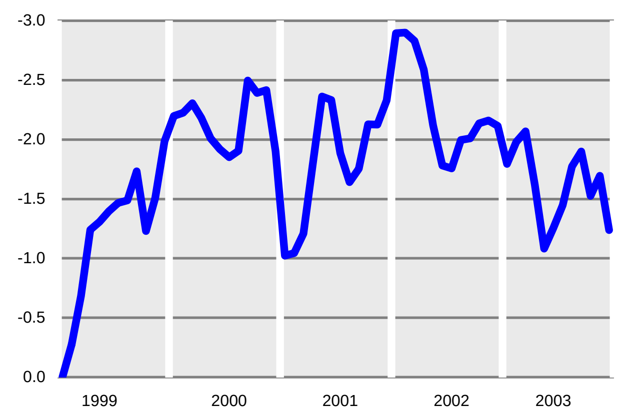


Source: European Central Bank [www.ecb.int]; OECD, *Main Economic Indicators* (Paris).

Note: Average monthly values. Short-term rates: three-month interbank rates. Long-term rates: yields on 10-year government bonds.

CHART 2.2.9

Monetary conditions index for the euro area, 1999-2003



Source: UNECE secretariat calculations.

Note: The monetary condition index is computed as: $MCI = \theta_R(R_t - R_0) + \theta_e(e_t - e_0)$, where *R* is the three-month interest rate (EURIBOR), *e* is the real effective exchange rate (in logs), θ_R and θ_e are weights and *t* is the time index. The base period (*t* = 0) is January 1999. The weights are computed from estimated output elasticities. They are θ_R = 0.875 and θ_e = 0.125 and hence correspond to relative weights of 7:1, interest rate to exchange rate. This compares with relative weights of 6:1 employed by the European Commission.

monetary policy strategy.[88] The strategy, which was agreed in October 1998, consists – in addition to a definition of price stability – of two pillars: first, a prominent role for money, which is reflected in a reference value for the growth rate of a broad monetary aggregate (M3) and second, an assessment of the inflation outlook, based on a wide range of factors that influence price developments in the short term.[89]

The Council confirmed its definition of price stability as a year-on-year increase in consumer price inflation below 2 per cent to be maintained over the medium term. This asymmetric inflation target has been criticized because there is no explicitly defined lower bound, except for the fact that a decline in the Harmonized Index of Consumer Prices (HICP) is excluded. This definition reduces the transparency of monetary policy and increases uncertainty about the monetary policy reaction function, because it is a matter of guesswork as to how low the ECB's preferred inflation rate actually was. The absence of an explicit lower bound to the inflation target was especially criticized in early 2003 against a background of lingering deflationary pressures in Germany. The obvious way to avoid this uncertainty would have been to define a symmetric (point) inflation target, where undershooting and overshooting can be expected to lead to monetary policy reactions. Instead, the ECB has now clarified its inflation target by stating that it will aim to keep the inflation rate at "close to 2 per cent over the medium term". The motivation is to provide a safety margin against the risks of deflation taking into account the (upward) measurement bias in consumer price indices and the inflation differentials in the euro area.

[88] European Central Bank, "The ECB's monetary policy strategy", *ECB Press Release*, 8 May 2003 and *ECB Monthly Bulletin* (Frankfurt am Main), June 2003, pp. 79-92.

[89] ECB, *The Monetary Policy of the ECB* (Frankfurt am Main), 2001.

As regards the first pillar of the ECB's monetary policy strategy – the "prominent role of money" – the experience during the first four years of EMU – not surprisingly – has been that the demand for money has tended to be very unstable in the short run. Monetary growth has been very volatile and above the reference value (4.5 per cent per annum) for most of the period since 1999, leading to erratic signals for monetary policy. The conclusion from this experience is that changes in M3 are not a good guide for monetary policy in the short run and that it only has a useful role in the design and implementation of monetary policy in a medium- and longer-term context.[90]

Against this background, the ECB Governing Council has decided to discontinue its annual review of the reference value (undertaken in December of each year) for the growth of broad money supply (M3) in the year ahead. This is in order to emphasize the longer-term nature of the link between growth in the money supply and inflation. This decision has been accompanied by a restructuring of the monthly statement on monetary policy by the ECB President, which now starts with an "economic analysis" of all non-monetary variables that can have an impact on inflation in the short and medium term. These include, *inter alia*, exchange rates, labour costs, indicators of output, employment and productivity, fiscal policy, etc. This assessment will be complemented by a "monetary analysis" of changes in the main components of money supply and their counterparts, such as bank lending to the private sector. But the role of monetary analysis is now mainly to serve as a cross-check, in a medium- and longer-term perspective, on the conclusions from the aforementioned "economic analysis."

Although the ECB has decided to formally maintain its two-pillar monetary policy strategy (which it judged to have worked "satisfactorily"), the role of the monetary pillar in the policy-making process has been substantially reduced. Actually, de facto the ECB has been pursuing a policy of inflation targeting since 1999, although it never published an inflation forecast, which is the usual intermediate target in such a policy strategy. (In the case of monetary targeting, the intermediate target is a broad monetary aggregate such as M3.) It may be argued that it would have been more appropriate to integrate the monetary analysis into the second pillar, i.e. the economic analysis of leading indicators of inflation, and set an explicit inflation target.[91] In practice, however, the differences between monetary targeting and inflation targeting are small. Another important issue is the maintenance of the 2 per cent ceiling for the definition of price stability. Such a low inflation rate will be associated with low nominal interest rates, and this could create problems in the event of adverse economic shocks because the zero lower bound of nominal rates limits the scope for an expansionary monetary policy. It also complicates the adjustment of countries to an asymmetric shock that would require a decline in real wages. The 2 per cent ceiling, moreover, may turn out to be rather low in view of the future enlargement of the euro area as countries from eastern Europe will tend to have a higher structural rate of inflation associated with the real convergence process (the Balassa-Samuelson effect).

....and prepares for future euro area enlargement

From the time they join the EU, the economic policies of the 10 new member states will be part of the multilateral surveillance mechanisms within the EU policy framework. The new members will join with a derogation, i.e. they will not have to adopt the euro as their national currency immediately, but they are committed to work towards meeting the Maastricht convergence criteria, which will open the door to EMU. From the onset of accession to the EU until the adoption of the euro, the new members will have to treat their exchange rate policy as a matter of common interest, meaning essentially that competitive devaluations will not be permitted. The process towards adopting the euro involves an eventual participation in the ERM-2, the exchange rate mechanism established in 1997, which links the currencies of EU member states that are outside the EMU to the euro.[92] Most of the new member states have stated their intention to participate in the exchange rate mechanism as soon as possible, but the timing of entry into ERM-2 will be largely determined by their progress in meeting the Maastricht convergence criteria.

It is expected that new member states will have to stay in the ERM-2 and respect the normal fluctuation margins around the central parity (+/-15 per cent) of the exchange rate mechanism without severe tensions for at least two years before an assessment can be made of their progress in meeting the convergence criteria. This assessment must precede the adoption of the euro. Past experience with the ERM shows that it will not be easy to avoid such tensions (see also chapter 3, box 3.1.1, on the recent experience with an exchange rate band in Hungary).

Euro area enlargement constitutes a major challenge for monetary policy because of the associated increase in

[90] UNECE, "The two pillars of the ECB monetary strategy", *Economic Survey of Europe, 2002 No. 1*, chap. 2.3, p. 37.

[91] Ibid.

[92] Membership in ERM-2 may create problems because of a potential conflict between the EMU targets of exchange rate stability and inflation on account of the real exchange appreciation that goes along with the catch-up process in real incomes. UNECE, "Economic transformation and real exchange rates in the 2000s: the Balassa-Samuelson connection", *Economic Survey of Europe, 2001 No. 1*, chap. 6 and "Alternative policies for approaching EMU accession by central and east European countries", *Economic Survey of Europe, 2002 No. 1*, chap. 5.

the heterogeneity of the participating countries, both in terms of their levels of economic development and their relative economic performance, notably inflation. But enlargement will also have implications for the established institutional framework designed to ensure an efficient monetary policy decision-making process and will also require a reform of the voting system in the ECB Governing Council (box 2.2.1).

(c) Fiscal policy

The euro area's fiscal policy has not supported economic activity

The protracted economic slowdown and the associated impact of automatic stabilizers left their mark on government budgets in 2003. In general there was a rise in budget deficits or a fall in surpluses, which in some countries also reflected budgetary slippages (table 2.2.3). In France and Germany deficits were significantly above the threshold of 3 per cent fixed in the Stability and Growth Pact. Given the absence of special factors, which allow for a temporary "excessive deficit", this was the second consecutive year in which the rules of the EU's fiscal framework were broken. Against the recommendation of the European Commission, the Council of Ministers of Economics and Finance (ECOFIN) decided on 25 November 2003 to place the excessive deficit procedure in abeyance. This was seen as a major blow to the EU's fiscal policy framework, which had been frequently criticized for its rigidity and now, in all probability, will have to be radically reformed if it is to survive (see section 1.3(i)). The European Commission has, in the meantime, announced it will mount a legal challenge to the ECOFIN decision at the European Court of Justice.

For the euro area as a whole, the weighted average budget deficit rose to 2.7 per cent of GDP in 2003, up from 2.3 per cent in 2002. Changes in cyclically adjusted budget deficits suggest that fiscal policy, on average, was slightly restrictive in 2003 (table 2.2.3). A significant fiscal impulse (corresponding to half a percentage point or more of GDP) was provided only in Austria, Greece and Finland. The restrictive – and procyclical – fiscal policy stance in the euro area in 2003 is projected to continue in 2004, when the output gap will continue to widen (table 2.2.4). This would then be the third consecutive year in which fiscal policy, despite a negative output gap, has not supported economic activity. Ironically, fiscal policy did support economic growth in 2000 and 2001 when actual output was already above its potential.[93]

The level of general government gross debt in the euro area rose to more than 70 per cent of GDP in 2003, up from 69 per cent in 2002. Debt levels are below the 60 per cent Maastricht ceiling in only 5 of the 12 euro area member states (Finland, Ireland, Luxembourg, the Netherlands and Spain). In Belgium, Greece and Italy, the debt ratios have been declining in recent years, but they are still more than 100 per cent of GDP.

(d) Developments in individual countries

Following two years of moderate growth, real GDP in *Germany* declined by 0.1 per cent in 2003. This was the first annual fall in aggregate output since 1993. In contrast to 2001 and 2002, when the sluggishness of economic activity was due primarily to weak domestic demand, the outcome in 2003 was due to a decline in real exports, which more than offset a modest rise in domestic demand. Among the main expenditure items, both private consumption and gross fixed capital formation declined. In contrast, government consumption continued to support economic activity. The sluggish output growth left its mark on the labour market: the level of employment fell and the (standardized) unemployment rate rose by 0.6 percentage points to an average 8.7 per cent. The average annual rate of consumer price inflation fell to 1.1 per cent, the smallest increase since 1999.

Economic performance for the year as a whole, however, conceals the fact that economic activity edged up in the second half of the year, led by stronger exports as demand outside the euro area gained momentum. Most business surveys were trending upwards, and both domestic and export orders increased substantially. The Ifo Business Climate Index (for western Germany) rose in December 2003 for the seventh consecutive month.

A major area of concern was the development of the public finances in 2003, with the general government budget deficit rising to 4 per cent of GDP, thereby breaching the EU's fiscal rule for the second consecutive year. The stance of fiscal policy is estimated by the OECD[94] to have been slightly contractionary in 2003, but other estimates[95] point to a moderate expansion despite the measures taken by the government to reduce the structural deficit.

In December 2003, the Bundestag passed a package of fiscal measures that are estimated to result in a net fiscal stimulus of about 0.4 per cent of GDP in 2004. The measures include the bringing forward to January 2004 the reduction of personal income tax rates and the increase in the tax-free income threshold originally planned for 2005. These moves will be partly financed by reductions in public expenditure and an increase in the tobacco tax. More far-reaching tax reforms are under discussion for 2004. Given the overall focus of fiscal policy on deficit reduction, however, the overall fiscal impulse is likely to be negative in 2004.[96]

[93] In the United States, fiscal policy was restrictive in 1999 and 2000, when output was significantly above potential. The cyclical downswing then led to a pronounced fiscal loosening in 2001-2003, which will moderate in 2004 when the output gap is forecast to narrow considerably.

[94] OECD, op. cit., annex table 29.

[95] European Commission, *Autumn 2003 Economic Forecasts* (Brussels), October 2003, p. 135, table 41.

[96] DIW, *Wochenbericht 102/2004* (Berlin), 8 January 2004, p. 26.

Box 2.2.1

Reforming the voting system in an enlarged ECB Governing Council

Status quo

The statute of the ECB establishes that monetary policy decisions in the euro area are made by the Governing Council (henceforth the Council). The Council comprises the six members of the Executive Board (appointed by member states through the Community institutions) and the (currently 12) governors of the national central banks of the euro area member states. Decisions are formally made by a simple majority rule under the principle of "one person one vote"; in the case of ties, the President of the Executive Board (the ECB President) has the casting vote. Some of the implications of this structure can be immediately highlighted. First, the large number of Council members may increase the costs and reduce the efficiency of decision-making. The councils of the central banks of the industrial countries are all smaller than the Council of the ECB. Second, given that the number of votes assigned to the Board is smaller than that assigned to the pool of governors, there is a risk that decentralized national concerns may dominate the wider interests of the euro area. While in principle governors should not act as national representatives, there is empirical evidence that in established federal central bank systems council members do tend on occasion to adopt a region-specific perspective.[1] The hypothesis that governors will cast their votes on the basis of national economic interests (rather than euro area-wide considerations) cannot therefore be ruled out. Third, the allocation of votes on the basis of the "one person one vote" principle is clearly biased in favour of economically smaller countries (chart 2.2.10).

Effects of enlargement

In the foreseeable future, up to 15 new countries could adopt the euro. (These comprise the 10 accession countries and the candidate countries Bulgaria and Romania, as well as the three EU member states that are currently outside the euro area.) This would raise the size of the Council from the current 18 members to 33 members, with the consequence of an even greater numerical dominance of national governors over the Board than is currently the case. Without a reform of the voting system, the decision-making process could therefore become very lengthy and less efficient, particularly if governors were to promote national interests. To see why, consider that under the status quo with 18 voters, a policy proposal by the Executive Board can achieve the majority threshold with support from only three national governors. Since the proposals of the Board tend to be weighted averages of national preferred policies, they will tend to be close to the median policy (i.e. a policy on which the preferences of individual council members can realistically be expected to converge) and hence will have a high probability of obtaining the required support from at least three governors. In the enlarged Council, however, the higher number of voters and the greater economic heterogeneity of member states imply that the Board's proposals may no longer come close to the median policy. Consensus will be more likely to arise around proposals that reflect coalitions of national interests, especially those of the smaller, faster-growing countries. Formal analysis suggests that relative to a benchmark where a euro area wide utility function is maximized, the monetary policy decided by the enlarged Council could result in higher rates of inflation and suboptimal policy responses to shocks.[2]

Possible reforms

An efficient decision-making process requires a reform of voting procedures to give the Board a more strategic role and to realign the voting system with the economic weight of the member countries. Several proposals have been advanced to achieve those objectives.[3]

Centralization of decision-making power in the Board. This would ensure in principle that policies are decided within the interests of the euro area as a whole. The main drawback of this solution is its political unfeasibility: it would in fact deprive countries of the right to contribute to monetary policy formation as is currently the case under the Maastricht Treaty.

Weighted voting system. If countries' votes were proportional to their economic size (as measured, for example, by their share of total euro area GDP), then voting rights and economic weight would be more balanced. Weighted voting however clashes with the principle of "one person one vote" embedded into the ECB statute. Moreover, as the debate on the voting system in the EU Council of Ministers has shown, the allocation of weights and the definition of majority thresholds is a complex and highly controversial task.

Representative voting system. Countries would be organized in groups, with a representative for each group casting its vote in the Council and the Board maintaining its current voting rights. Such a system would require criteria for the preliminary identification of groups (an example could be nine groups of three countries each based on economic size). There would also be the problem of how to design the delegation mechanism.

Rotation system. In this system, the right to vote is given to only a limited number of governors on the basis of a rotation scheme. The formula is used by the United States Federal Reserve Bank, where at any time only 5 of the 12 regional central banks are allowed to vote. The New York Federal Reserve is allocated a permanent seat, while the other 4 rotate among the other 11 regional federal reserve banks.

The proposal of the ECB

The Governing Council of the ECB has made a proposal to adjust voting modalities.[4] This proposal, which combines elements of the rotation and of the representative voting systems, rests on five pillars. First, the principle of "one person one vote" must be retained, at least for members exerting a voting right. Second, all members of the Council should participate in the policy discussion, even if they are not voting, and they should do so in a personal and independent capacity. Third, the voting procedures should be such that at any point in time the group of governors with voting rights should be representative of the euro area economy. Fourth, the new mechanism must be robust and automatically adapt to the accession of new members. Fifth, the mechanism must be based on clear and transparent rules.

Box 2.2.1 (concluded)

Reforming the voting system in an enlarged ECB Governing Council

The details of the proposal can be summarized as follows. While Executive Board members retain permanent voting rights, 15 votes are allocated to governors on a rotating basis, so that the majority threshold is 11 votes. To ensure representativeness, voting rights are allocated to governors with different frequencies. For this purpose, governors are partitioned into groups, which are defined on the basis of a ranking of member states according to their economic and financial size. Economic size refers to a country's share of total euro area GDP and financial size refers to a country's share in the aggregate balance sheet of the monetary financial institutions of euro members.

The ranking is obtained by taking the average of the two indicators, with a weight of 5/6 assigned to economic size and 1/6 to financial size. Three groups are then identified. The top five countries in the ranking are placed in the first group and share four voting rights. The second group includes half of all governors, selected from the subsequent positions in the ranking, with eight voting rights. The remaining governors are in the third group and share three voting rights. However, all governors (with and without voting rights) will preserve the right to participate in the discussion and to express their views about monetary policy decisions. This system will come into force as soon as the total number of member states reaches 22. A transitory arrangement, based on only two groups, will be established for as long as the number of member states varies between 16 and 21 (table 2.2.2). An adjustment of groups will be made whenever changes in economic and financial size lead to a change in the ranking of countries. The mechanism for rotation within each group and other procedural details for the adoption of the system will have to be specified outside the statute.

It can be questioned whether the proposed system is effectively in line with the principle of "one person one vote". It certainly limits the loss of voting power of the Executive Board that would occur in the absence of such a reform. At the same time, rotation based on economic and financial size permits a more balanced allocation of voting rights than under an unreformed system (chart 2.2.11). Nevertheless, 21 voting rights may still be too many to ensure smooth and fast decision-making.

The debate in the EU institutions

The proposal of the ECB was formally presented to the EU Council of Ministers on 3 February 2003. On 19 February 2003, the European Commission gave a positive overall evaluation of the proposal, suggesting, however, a few amendments: (i) that the number of governors with voting rights should be reduced; and (ii) that in addition to economic and financial size, population should also be used in compiling the ranking of countries. On 13 March 2003, the European Parliament rejected the ECB proposal mainly on the grounds that the envisaged rotation scheme is too complex. The Parliament suggested maintaining the status quo, with all members of the Council entitled to one vote and decisions taken by simple majority. However, it also proposed a broader reform to be undertaken within the context of the Convention for a European Constitution. In the view of the Parliament, operational decisions should be made by the Executive Board, while strategic policy decisions should be made by the Council with a double majority system of the type proposed in the Nice Convention for the EU Council of Ministers. Despite these objections and alternative proposals, the EU Council adopted the ECB proposal on 21 March 2003. It will now have to be ratified by the member states of the EU.

[1] E. Meade and D. Sheets, *Regional Influences on US Monetary Policy: Some Implications for Europe*, Board of Governors of the Federal Reserve System, International Finance Discussion Papers, No. 721 (Washington, D.C.), February 2002.

[2] P. De Grauwe, "The euro at stake? The Monetary Union in an enlarged Europe", *CESifo Economic Studies*, Vol. 49 (Munich), pp. 103-121; H. Berger, *The ECB and Euro Area Enlargement*, IMF Working Paper, No. 02/175 (Washington, D.C.), October 2002.

[3] H. Berger, op. cit.

[4] European Central Bank, "The adjustment of voting modalities in the Governing Council", *ECB Monthly Bulletin* (Frankfurt am Main), May 2003.

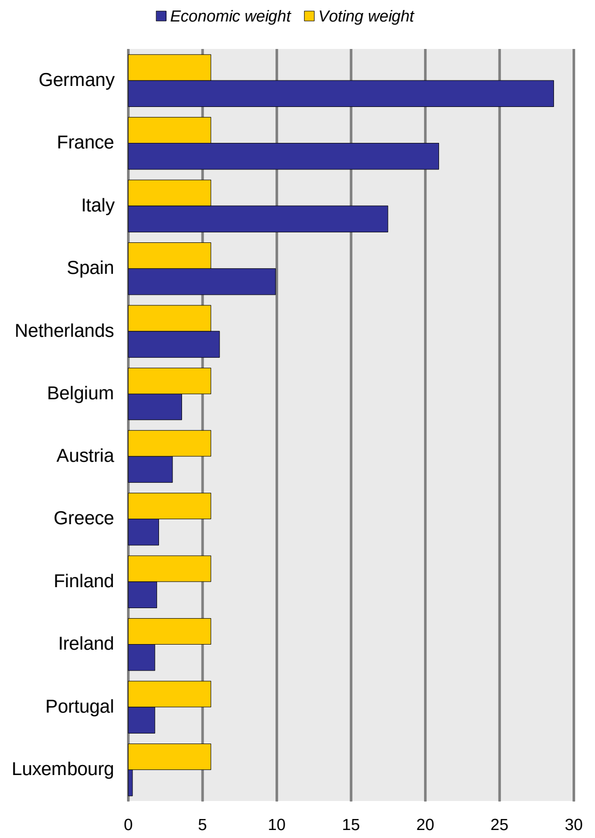
The parliament, moreover, has passed a series of labour market and social security reforms, which originated from the government's "Agenda 2010". Major elements include measures to strengthen the incentives of employers to create jobs, to strengthen individual incentives to seek work, and to reduce the wedge between labour costs and take-home pay.[97] More generally, these reforms are intended to raise the growth potential of the economy and also to facilitate the process of fiscal consolidation.

In *France* the economy also stagnated in 2003, the worst outcome since the recession of 1993. While domestic demand grew at the same moderate pace as during the preceding year (1 per cent), this was mostly offset by the negative contribution of net exports. Moderate domestic demand growth was supported in equal proportions by private and government consumption. Although real household disposable income rose moderately, private consumption was dampened by rising unemployment, as well as economic uncertainty and the discussion about reform of the pension system, both of which depressed consumer sentiment. Fixed investment, discouraged by lower profit margins, weak domestic demand and low levels of

[97] Also included is a health care reform designed to stem the rapid increase in costs and hence health insurance premiums.

CHART 2.2.10

Economic weight and voting weight in EMU
(Percentages)



Source: National statistics; European Central Bank.

Note: Economic weight is defined as the percentage share of a country's GDP in total euro area GDP. Voting weight is defined as the percentage share of a country's central bank governor's vote in the ECB Council.

capacity utilization, fell for the second consecutive year. In the external sector, real exports contracted at the same rate as real imports rose, driven by the sharp appreciation of the euro. While employment had continued to expand even during the downturn of recent years, this came to a halt in 2003 when the economy shed jobs for the first time in 10 years. Nevertheless, the unemployment rate rose only slightly to an average 9.6 per cent compared with 9 per cent in 2002. In terms of fiscal policy, the strong deceleration in growth brought about a shortfall in government revenues. A small rise in VAT and fuel tax income failed to compensate for the drop in corporate tax takings and for the lower income tax yield resulting from the government's tax cuts. Consequently, the budget deficit rose to 4.2 per cent of GDP in 2003, from 3.1 per cent in 2002. After stagnating or falling between mid-2002 and mid-2003, economic activity recovered during the second half of 2003 in the wake of stronger foreign demand. Industrial confidence recovered following the sharp improvement in the outlook for export orders and there was a moderate recovery of manufacturing output during the second half of the year. Consumer sentiment also improved from the second quarter onwards, although from a much lower base and considerably more slowly than industrial confidence.

In *Italy*, real GDP rose by only 0.5 per cent in 2003, significantly below trend output. As a result there was a substantial widening of the output gap, which rose to 1.8 per cent of potential GDP. The weak performance in 2003 mainly reflects a decline in fixed investment and exports that was offset, however, by increases in domestic consumption and the rebuilding of inventories. Core inflation averaged 2.8 per cent in 2003, about 1 percentage point higher than the euro area average, signalling a further loss of price competitiveness against the country's major trading partners in the euro area. The inflation differential appears to stem from the convergence of price levels in the monetary union. Furthermore, because centralized wage setting in Italy is largely based on the economic conditions prevailing in the north of the country, wage inflation tends to remain high even in areas where there are high rates of unemployment, thus aggravating the aggregate inflation rate and sharpening regional disparities. Inflation inertia, due to the slow adjustment of backward looking expectations, has also played a role. On the fiscal side, there was a slight increase in Italy's general government deficit to 2.7 per cent of GDP in 2003, but the cyclically adjusted (structural) budget deficit fell by 0.3 percentage

TABLE 2.2.2

The rotation system proposed by the ECB Governing Council

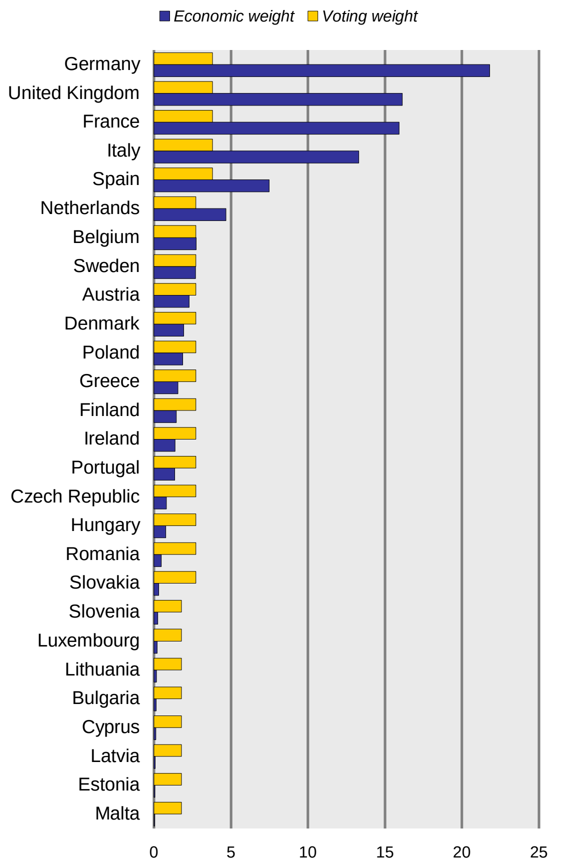
Number of governors:	*16*	*17*	*18*	*19*	*20*	*21*	*22*	*23*	*24*	*25*	*26*	*27*
Group 1	5/5	5/5	5/5	4/5	4/5	4/5	4/5	4/5	4/5	4/5	4/5	4/5
Frequency (per cent)	100	100	100	80	80	80	80	80	80	80	80	80
Group 2	10/11	10/12	10/13	11/14	11/15	11/16	8/11	8/12	8/12	8/13	8/13	8/13
Frequency (per cent)	91	83	77	79	73	69	73	67	67	62	62	62
Group 3	..	..	..	..	..	..	3/6	3/6	3/7	3/7	3/8	3/8
Frequency (per cent)	..	..	..	..	..	..	50	50	43	43	38	38

Source: European Central Bank, *Monthly Bulletin*, May 2003.

Note: Each column indicates the number of voting rights and total number of members in each group for a given total number of national central bank governors. Group 3 is only formed when the number of EMU member states reaches 22. For each group, the table also gives the frequency (in per cent) with which each individual member participates in the voting process.

CHART 2.2.11

Economic weight and voting weight in an enlarged EMU-27
(Percentages)



Source: National statistics; European Central Bank.

Note: Economic weight is defined as the percentage share of a country's GDP in the total enlarged euro area GDP. Voting weight is determined for each country as the voting frequency associated with its group times 1/21 (the weight of each voter in the Council). Groups are defined according to a ranking constructed as specified in the ECB proposal (see text).

points to 1.8 per cent. The latter, however, was mainly due to falling interest payments. Moreover, if one-off measures (such as sales of assets and tax amnesties) are excluded, the structural deficit increases to around 3 per cent of GDP. Despite weak output growth, employment continued to increase. This reflected progress in increasing labour market flexibility (through the liberalization of part-time and fixed-term contracts), tax incentives and some degree of wage moderation.

Apart from cyclical factors, economic performance in Italy continues to be restrained by structural supply-side weaknesses. This points to the need to reduce the tax burden and the large tax wedge on labour as well as developing infrastructures, especially in poorer regions, and designing policies to raise labour productivity. Achieving fiscal consolidation will require greater efforts to curtail the growth of the public sector wage bill and to enforce hard budget constraints on local authorities in the context of fiscal decentralization. A crucial element of

TABLE 2.2.3

General government financial balances in the euro area, 2002-2004
(Per cent of GDP; (+) surplus; (-) deficit)

	Actual balance			*Cyclically adjusted balance*		
	2002	*2003*	*2004*	*2002*	*2003*	*2004*
France	-3.1	-4.0	-3.7	-3.0	-2.9	-2.5
Germany	-3.5	-4.1	-3.7	-2.6	-2.3	-1.7
Italy	-2.5	-2.7	-2.9	-2.1	-1.8	-2.1
Austria	-0.4	-1.3	-1.2	-0.3	-0.9	-0.6
Belgium	–	0.2	–	0.5	1.4	1.3
Finland	4.2	2.6	1.9	4.8	4.2	2.9
Greece	-1.5	-1.6	-1.6	-1.5	-2.0	-2.1
Ireland	-0.2	-1.0	-1.3	-2.4	-1.9	-1.7
Luxembourg	2.4	-0.3	-1.8	..	..	..
Netherlands	-1.6	-2.4	-2.5	-1.8	-1.2	-0.5
Portugal	-2.7	-2.9	-3.0	-2.3	-1.6	-1.7
Spain	0.1	0.1	0.2	0.2	0.5	0.4
Euro area	-2.3	-2.7	-2.6	-1.9	-1.7	-1.5
Memorandum items:						
Denmark	2.0	0.8	1.0	1.6	1.7	1.7
Sweden	1.1	0.2	0.5	0.8	0.6	0.8
United Kingdom	-1.5	-2.9	-2.9	-1.3	-2.3	-2.5
EU	-2.0	-2.7	-2.6	-1.7	-1.7	-1.5

Source: *OECD Economic Outlook No. 74* (Paris), December 2003.

TABLE 2.2.4

Fiscal policy stance and cyclical conditions in the euro area and the United States, 1999-2004

	Euro area		*United States*	
	Output gaps	*Fiscal stance*	*Output gaps*	*Fiscal stance*
1999	-0.6	0.7	2.5	0.3
2000	0.9	-0.4	2.2	0.8
2001	0.3	-0.5	-1.0	-1.1
2002	-0.8	–	-1.3	-2.8
2003	-2.2	0.2	-1.5	-1.5
2004	-2.4	0.2	-0.3	-0.6

Source: *OECD Economic Outlook No. 74* (Paris), December 2003.

Note: Output gaps are measured as the difference between actual and potential output, expressed as a per cent of potential output. A negative figure indicates that output is below potential. Fiscal policy stance is measured by the change in the cyclically adjusted general government budget deficit. A positive (negative) figure indicates a fiscal contraction (loosening).

fiscal consolidation is the further reform of the pension system to curb age-related expenditures. New proposals were put forward by the government in October 2003 with the objective of raising the minimum contributory period from 35 to 40 years, increasing the effective age of retirement and introducing supplementary saving schemes to counteract the projected fall in replacement rates.

Among the other economies of the euro area, the worst outcomes in 2003 were in *Portugal* and the *Netherlands* where GDP shrank at rates of close to 1 per cent. The former is still struggling with the fiscal austerity programme introduced in 2002. All the components of final domestic demand contracted in 2003, and there was only a partial offset from net exports. The Netherlands is still suffering from a loss of international competitiveness and rising unit labour costs, caused by tight labour markets in recent years, to which the economy is adjusting only slowly. Both weaker domestic and foreign demand contributed to bring about the recession of 2003. Among the smaller economies of the euro area, *Austria*, *Belgium* and *Luxembourg*, all grew at above average rates due to the resilience of their domestic demand. In *Finland* and *Ireland* economic activity was supported by the upturn in the ICT industry. Yet in both countries there was a slowdown in economic growth from 2002. This was particularly marked in the case of Ireland, which appears to have entered a phase of slower growth after the boom of the 1990s. The highest growth rates in the euro area were in *Greece* and *Spain*. In both countries this strong performance was underpinned by large increases in private consumption brought about by employment growth, a rise in household disposable incomes and negative real interest rates. GDP growth in Greece of over 4 per cent in 2003 was also helped by the strong rise in fixed investment (mostly related to construction projects undertaken for the Olympic Games).

(ii) Other western Europe

In the *United Kingdom*, the economy picked up in the second quarter of 2003 and gained momentum in the second half of the year. In the final quarter of 2003, real GDP rose by 0.9 per cent (over the preceding quarter), the fastest quarterly rate of growth since early 2000 and above its long-term trend rate, which is estimated at 0.6-0.7 per cent per quarter or a seasonally adjusted annual rate of some 2.6 per cent. For the year as a whole, real GDP increased by 2.1 per cent.

Private consumption and government spending remained the principal sources of economic growth in 2003. Private consumption continued to be supported by favourable developments in the labour market and low interest rates. The continuing surge in house prices, moreover, continued to facilitate access to consumer credit (mortgage equity withdrawals). House prices rose on average by some 16 per cent, compared with 25 per cent in 2002. The annual increase in consumer spending in 2003 slowed to 2.3 per cent, about 1 percentage point less than in 2002.

Government consumption expenditures rose strongly, by some 10 per cent (about the same as in 2002), reflecting increases in public sector employment, especially in the health and education sectors. There was, moreover, a considerable increase in public investment of about 25 per cent, compared with 13.9 per cent in 2002. In contrast, business fixed investment continued to fall, mainly due to reduced capital spending in the manufacturing sector. Changes in real net exports have continued to pull down GDP growth in 2003 by around 0.6 per cent, although to a lesser extent than in 2002 (around 1.4 per cent). The current account deficit in 2003 is estimated at 2.7 per cent of GDP, up from 1.8 per cent in the previous year. This increase partly reflects the more advanced stage of the cyclical recovery in the United Kingdom relative to continental Europe. The overall situation in the labour market remained relatively tight; further gains in employment were concentrated in public administration, education and health, as well as in construction and in financial and business services. The standardized unemployment rate (from the labour force survey) was 4.9 per cent at the end of 2003, its lowest level since records began in 1984.

In early December 2003, the United Kingdom Chancellor changed the inflation target to be met by the Bank of England from one based on the Retail Price Index excluding mortgage interest payments (RPIX) to one based on the EU's HICP. The new target is to keep HICP inflation to 2 per cent.[98] Inflation has been well below this new target for the last four years: it fell to 1.3 per cent in December 2003 and averaged only 1.4 per cent in 2003.

The Monetary Policy Committee raised the base rate to 3.75 per cent in November 2003, in response to projections showing that the economy was growing slightly above trend and that inflation would be above target over the forecast horizon (due to the world economic recovery and the continued strong growth of domestic demand). This fully reversed the reduction of interest rates in July 2003, when the strength of the recovery was still uncertain.

Fiscal policy remained strongly expansionary in 2003, with the cyclically adjusted government financial deficit increasing by 1 percentage point to 2.3 per cent of GDP. The stance of fiscal policy has been progressively loosened since 2000, when there was still a structural budget surplus corresponding to 0.9 per cent of GDP; since then there has been a large, cumulative fiscal impulse equivalent to 3¼ percentage points of potential GDP. The actual (nominal) government budget deficit in 2003 is estimated at 2.9 per cent of GDP, up from 1.5 per cent in 2002.[99] The government expects that in fiscal year 2003-2004, which ends in March 2004, the budget deficit will exceed somewhat the 3 per cent ceiling fixed in the Maastricht Treaty.[100]

[98] Under the old inflation measure, the inflation target was 2.5 per cent. The main differences between the two indices are: (i) the HICP excludes house prices and council tax; and (ii) the formula used for calculating average prices of most items is not the same. These discrepancies result in RPIX inflation being systematically higher than inflation measured by the HICP.

[99] OECD, op. cit.

[100] *Financial Times*, 22 January 2004.

The main policy challenges ahead centre around the risk of the boom in the housing market suddenly going into reverse with adverse consequences for consumption and overall growth. The continuing weakness of the dollar on activity in the euro area and thus on external demand for UK output also remains a key uncertainty. Doubts have been increasingly expressed, by independent researchers and by the European Commission, about the sustainability of the public finances over the longer-term (i.e. the next three years or so) and the risk of a breach in the Finance Minister's "golden rule" to borrow only for public investment. If revenues fail to rise in line with the government's forecast, adherence to the "golden rule" will imply a cut in expenditure and/or a rise in tax rates.

Among the other EU countries that have not adopted the euro, growth in *Sweden* moderated to 1.6 per cent, while in Denmark strong growth turned into near stagnation. There was a softening of private and public consumption, a weaker contribution of real net exports and falls in fixed investment in both countries in 2003.

Among the non-EU west European countries, there was a 0.5 per cent fall in GDP in *Switzerland*, a decline in fixed and inventory investment more than offsetting a moderate rise in the other components of domestic demand and a positive contribution from net exports. The latter were helped by a very loose monetary policy, which achieved its goal of a depreciation of the exchange rate. Although averting a recession, GDP in *Norway* in 2003 grew by just 0.4 per cent, the lowest rate in 15 years. Economic performance has been compromised since 2001 by the strong exchange rate and high interest rates, which have led to higher levels of unemployment and bankruptcies. In *Iceland* in 2003 there was a recovery from the slight contraction of the previous year, which had been a consequence of policies to counter overheating in the early 2000s. The pick-up in economic activity was led by fixed investment in power generation. In *Israel* there was also a turn-round in the economy, with GDP growing by a modest 1 per cent following two years of recession. Against a bleak domestic outlook, domestic demand contracted (mainly because of falling investment) and the recovery was based on a strong growth of exports (helped by the incipient recovery of international trade in high-tech products), coupled with declining imports. The economies of the Mediterranean EU acceding countries – *Cyprus* and *Malta* – are strongly influenced by tourism receipts, which in 2003 moved in opposite directions in the two countries. They fell slightly in Cyprus, but the economy remained remarkably resilient. Consumer sentiment was mostly positive and household consumption was the main source of the 2 per cent growth in GDP. In Malta, by contrast, despite rising exports (including receipts from tourism), net exports subtracted from GDP growth, which was less than 1 per cent and sustained mainly by government fixed investment.