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EUROFRAME Forecast

EU and Euro Area Economies

November 2003

1. Overview of the *Euroframe* Forecast

Global economic activity strengthened in 2003, with output expanding more rapidly than anticipated in the US, Japan and in the rest of Asia. However, Europe has failed to keep pace with the rest of the world. A year ago, we were expecting to see a revival in economic activity in Europe, driven by an investment recovery and subdued price pressures, but this revival has yet to materialize. Euro Area investment is expected to have declined for the third consecutive year in 2003, and inflationary pressures have not receded to the extent anticipated, despite the strength of the euro. Notwithstanding the weak performance of European economies, we expect global GDP growth (measured at Purchasing Power Parity exchange rates) to be around 3.4 per cent in 2003, up from 3.0 per cent in 2002 (see Table 1). Global growth is expected to return toward long-term trend levels of just below 4 per cent per annum from 2004. While world trade growth is expected to rise to 4.5 per cent this year, from 3.2 per cent in 2002, much of this revival is confined to intra-Asian and NAFTA trade, while the strong currency has weighed heavily on Euro Area trade. World trade growth is forecast to strengthen further to around 8 per cent per annum from 2004 (see Table 3). Rising demand for European goods in the rest of the world is expected to be the driving force behind an anticipated recovery in the Euro Area in 2004 and 2005.

Our view is that output in the Euro Area and broader EU economy will grow by 0.3 and 0.5 per cent respectively this year. The EU and Euro Area are expected to grow by 1.7 per cent in 2004 and by just over 2 per cent in 2005. The outlook for price developments in the EU using the Harmonised Index of Consumer Prices (HICP) is for inflation to moderate from 2 per cent in 2003 to around 1.7 per cent in 2004. In 2005, the HICP inflation rate in the EU is expected to fall to 1.5 per cent. Similar rates of inflation are anticipated in the Euro Area. The euro exchange rate is expected to stabilize over the next two years at a bilateral rate of €0.86 per US$ (See Table 5). Interest rates in the Euro Area are expected to remain stable throughout 2004, and will start to rise gradually in 2005 as the economy strengthens.

Domestic demand in the Euro Area has been restrained by the persistent weakness of investment. We estimate that private sector investment declined by 0.7 per cent in 2003, following declines of 2.8 per cent in 2002 and 0.3 per cent in 2001. Although we continue to expect a recovery in investment next year, rising long-term interest rates will restrain growth to 2.2 per cent in 2004 and 2.5 per cent in 2005. Private sector consumption is also expected to remain relatively subdued, with growth of 1.3 and 1.5 per cent expected in 2003 and 2004 respectively, before rising to 2.0 per cent in 2005. As

inflationary pressures are somewhat higher than anticipated and unemployment has risen, real income growth has moderated, which is holding back consumption growth.

The contribution from the public sector is expected to be more muted than in recent years. Government expenditure is expected to moderate from rises of 2-2¼ per cent per annum between 2000 and 2002 to 1.5 per cent in 2003 and 1.1 per cent in 2004. Further fiscal stimulus is limited by the commitments to the Stability and Growth Pact, given the recent rise in general government deficits across Europe. All EU economies saw a worsening of their budgetary position in 2003, with deficits in France, Germany and Portugal projected to be above the 3 per cent of GDP ceiling this year.

Despite the weakness of domestic demand, the strength of the euro caused import volume growth to exceed export volume growth this year. Therefore, net trade had a strong negative impact on GDP growth in 2003. The volume of exports was 0.2 per cent lower than in 2002, while import volumes are estimated to have been 2.0 per cent higher. With increased world trade, Euro Area exports are forecast to rise by over 5 per cent in 2004 and 2005 (see Table 6). Although import growth will remain somewhat stronger than export growth in 2004, it is expected to be slightly weaker in 2005 as Euro Area domestic demand growth remains significantly weaker than in the other major economies. Net trade should have a small positive impact on GDP growth and external demand will be a driving force behind the anticipated recovery in the Euro Area in 2005. This should lead to a modest improvement in the Balance of Payments current account surplus, which is expected to rise from 0.3 per cent of GDP in 2003 to reach 0.8 per cent of GDP in 2004 and 2005.

Given the persistent weakness of the economy, the unemployment rate in the Euro Area is estimated to average 8.9 per cent in 2003, which is about 0.5 percentage points higher than we anticipated a year ago. However, as growth strengthens next year, we anticipate a modest improvement in labour market conditions, with the unemployment rate due to recede to about 8.8 per cent in 2004 and 8.6 per cent in 2005.

2. The International Environment

The outlook for world growth deteriorated in early 2003, due to a sharp contraction in world trade in the first quarter of the year and a failure to sustain the revival in private sector investment seen in the fourth quarter of 2002. However, conditions improved over the second and third quarters in most regions of the world, with the notable exceptions of the Euro Area and Canada, which have both experienced a marked exchange rate appreciation. Following two years of exceptional weakness, Latin American growth has started to revive, although Venezuela is still suffering from the 2 month stoppage in the oil industry earlier this year and Argentina has lost competitiveness due to a strong appreciation against the dollar. China continues to expand rapidly, spurred by the competitiveness impact of the dollar depreciation and infrastructure preparations for the 2008 Olympics. This has helped sustain export growth from the rest of Asia despite the more widespread slowdown in world trade.

Table 1. Forecast Summary: Real GDP in Major Areas

percentage change

	World	OECD	NAFTA	EU	Euro Area
2000	4.8	3.8	4.1	3.6	3.5
2001	2.4	0.8	0.3	1.7	1.6
2002	3.0	1.8	2.4	1.0	0.9
2003	3.4	2.1	2.7	0.5	0.3
2004	3.8	2.6	3.4	1.7	1.7
2005	3.8	2.6	2.9	2.2	2.1

As outlined in Table 1, we forecast world growth of 3.4 per cent this year, and expect the global economy to strengthen further next year, with growth forecast to rise to 3.8 per cent. The recovery will be supported by a revival in world trade, the impact of rising share prices and a broadly stimulative policy stance in most of the major economies. The depreciation of the dollar and the expansionary fiscal stance has already has a positive impact on US growth this year, while the outlook for Japan has strengthened markedly in recent months. We expect the US to grow by 2.9 per cent this year, 3.4 per cent in 2004 and 2.6 per cent in 2005 (see Table 2). Business investment in Japan is estimated to have risen by 6.8 per cent in the first half of 2003 relative to the previous six-month period. While growth rates of this magnitude are unlikely to persist, this surge in investment has imparted a momentum to the Japanese economy that has raised the outlook for growth through to 2005. While we anticipate a marked slowdown of growth in Japan to 0.5 per cent next year, from 2.4 per cent in 2003, we see a more broadly balanced strengthening of the economy in 2005, when it is projected to grow by 1.3 per cent.

Table 2. Forecast Summary: Real GDP in G7 Economies

percentage change

	USA	Japan	Germany	France	Italy	UK	Canada
2000	3.8	2.8	3.1	4.2	3.3	3.8	5.3
2001	0.3	0.4	1.0	2.1	1.7	2.1	1.9
2002	2.4	0.2	0.2	1.2	0.4	1.7	3.3
2003	2.9	2.4	-0.2	0.2	0.3	2.0	1.7
2004	3.4	0.5	1.5	1.5	1.3	2.5	2.3
2005	2.6	1.3	1.6	2.3	1.9	2.7	3.1

Japan has also been supported by external demand, due to its high exposure to Asian markets. Intra-Asian trade has been driven by developments in China, whose exports in US dollar terms rose by 22.5 per cent in 2002 and about 30 per cent in the first two quarters of 2003 relative to a year earlier. China's fixed exchange rate regime has allowed it to gain competitiveness, primarily outside Asia, as the dollar has depreciated. The rise in Chinese domestic demand has raised import demand for goods, especially from neighbouring Asian economies, due to the high level of regional import content of Chinese exports. Most Asian economies export relatively more to China than they import, so the weak dollar has had a positive impact on total trade growth in Asia.

Table 3. World Trade and Prices

percentage change

	World Trade	World prices	
		Manufactures	Oil ($ per barrel)
2000	12.6	-6.0	27.1
2001	0.0	-20.	23.5
2002	3.2	2.6	24.3
2003	4.5	11.6	27.7
2004	7.8	3.8	26.1
2005	7.9	1.8	26.5

As illustrated in Table 4, Monetary policy has been accommodating in the last three years as the world economy slowed and fears of deflation increased. Nominal interest rates have fallen to around 1 per cent in the US and 2 per cent in the Euro Area. This has meant that short-term real interest rates remain at their historically low levels, even entering negative territory. The shorter-term prospects for inflation have been affected by energy prices. Oil prices are somewhat higher than anticipated a year ago and the outlook holds prices in the mid to upper end of the OPEC target range of $22-28 a barrel. The rise in oil prices will have a modest upward impact on world inflation in the short term. A rise in the oil price of this magnitude is unlikely to have a significant impact on world growth, although it will restrain the recovery to some degree. Inflation might on average be 0.1 percentage points higher in the US over the next 2 years as a result, with a smaller impact in the more rigid Euro Area where import costs feed more slowly into domestic prices.

Table 4. Interest Rates

per cent per annum

	Short-term interest rates					Long-term interest rates							
	USA	Canada	Japan	Euro Area	UK	USA	Canada	Japan	Euro Area	Germany	France	Italy	UK
2001	3.7	3.7	0.1	4.3	5.0	5	5.5	1.3	5.0	4.8	4.9	5.2	4.9
2002	1.7	2.7	0.1	3.3	4.0	4.6	5.2	1.2	4.9	4.8	4.9	5.0	4.9
2003	1.2	3.0.	00	2.3	3.6	4.0	4.7	1.0	4.2	4.1	4.2	4.4	4.6
2004	1.7	2.7	0.1	2.1	3.9	4.6	4.6	1.5	4.5	4.5	4.5	4.8	5.2
2005	3.2	3.4	0.2	2.5	4.4	5.1	4.9	1.6	4.8	4.8	4.8	5.1	5.2
2003Q1	1.3	3.2	0.0	2.7	3.7	3.9	5.1	0.8	4.2	4.1	4.1	4.2	4.3
2003Q2	1.2	3.2	0.0	2.4	3.6	3.6	4.4	0.6	4.0	3.9	3.9	4.2	4.3
2003Q3	1.1	2.9	0.1	2.1	3.5	4.2	4.6	1.3	4.1	4.1	4.2	4.4	4.6
2003Q4	1.1	2.6	0.1	2.1	3.7	4.4	4.6	1.5	4.4	4.4	4.4	4.7	5.1
2004Q1	1.1	2.6	0.1	2.1	3.8	4.4	4.6	1.5	4.4	4.4	4.4	4.7	5.1
2004Q2	1.5	2.7	0.1	2.1	3.8	4.5	4.6	1.5	4.4	4.4	4.4	4.8	5.2
2004Q3	1.9	2.8	0.1	2.1	4.0	4.6	4.6	1.5	4.5	4.5	4.5	4.8	5.2
2004Q4	2.2	3.0	0.1	2.1	4.2	4.7	4.7	1.5	4.6	4.6	4.6	4.9	5.2
2005Q1	2.6	3.2	0.1	2.2	4.2	4.9	4.8	1.5	4.7	4.7	4.7	5.0	5.2
2005Q2	3.0	3.3	0.2	2.4	4.3	5	4.9	1.6	4.8	4.8	4.8	5.1	5.2
2005Q3	3.3	3.5	0.2	2.5	4.4	5.1	5.0	1.6	4.9	4.9	4.9	5.2	5.2
2005Q4	3.7	3.7	0.3	2.7	4.5	5.3	5.1	1.8	4.9	4.9	5.0	5.3	5.2

Table 5. Exchange Rates

	Percentage change in effective rate								Bilateral rate per US Dollar			
	USA	Canada	Japan	Euro	Germany	France	Italy	UK	Canadian $	Yen	Euro	Sterling
2001	5.7	-3.2	-8.3	0.3	0.3	0.3	0.2	-1.7	1.55	121.5	1.118	0.695
2002	-0.4	-1.7	-5.0	1.8	0.6	0.6	0.6	0.1	1.57	125.2	1.063	0.667
2003	-8.5	10.4	1.0	10.1	3.9	3.4	3.3	-5.7	1.40	116.1	0.889	0.615
2004	-2.9	4.4	5.1	1.6	0.6	0.6	0.5	-1.7	1.34	108.8	0.86	0.608
2005	0.7	-0.7	2.4	0.7	0.3	0.2	0.2	-1.8	1.34	106.5	0.86	0.619
2003Q1	-3.0	3.4	0.4	4.6	1.8	1.6	1.5	-3.7	1.51	118.9	0.932	0.624
2003Q2	-4.1	7.5	-1.7	3.9	1.6	1.3	1.3	-3.0	1.40	118.5	0.881	0.618
2003Q3	-0.2	1.4	0.7	-0.1	0.0	0.0	0.0	0.1	1.38	117.5	0.888	0.621
2003Q4	-3.4	3.6	5.4	0.6	0.2	0.2	0.3	0.2	1.32	109.6	0.856	0.599
2004Q1	0.4	-0.3	0.4	0.1	0.0	0.0	0.0	-0.4	1.33	109.3	0.858	0.603
2004Q2	0.4	-0.3	0.4	0.1	0.0	0.0	0.0	-0.4	1.33	109.0	0.860	0.607
2004Q3	0.3	-0.3	0.5	0.1	0.0	0.0	0.0	-0.4	1.34	108.6	0.861	0.610
2004Q4	0.2	-0.2	0.5	0.1	0.1	0.0	0.0	-0.5	1.34	108.2	0.862	0.613
2005Q1	0.2	-0.2	0.6	0.2	0.1	0.1	0.1	-0.5	1.34	107.6	0.862	0.616
2005Q2	0.1	-0.1	0.6	0.2	0.1	0.1	0.1	-0.4	1.34	106.9	0.861	0.619
2005Q3	0.1	-0.1	0.7	0.2	0.1	0.1	0.1	-0.4	1.35	106.2	0.860	0.621
2005Q4	0.0	-0.1	0.7	0.2	0.1	0.1	0.1	-0.4	1.35	105.4	0.858	0.622

Long-term interest rates have been rising in all the major economies since the middle of the year. They are about 0.8 percentage points higher in the US, the UK and Japan now than in the second quarter, and 0.5 percentage points higher in the Euro Area.

Following the worldwide collapse in investment in 2001 and 2002, there has been some investment revival in North America and Japan, while investment in the Euro Area remains weak. Investment in housing led the investment recovery in both the US and the UK. Strong house price growth in the US and the UK has also been partly responsible for the continued strength in consumer demand in these countries, despite the collapse in share prices in 2001/2002. While house price growth is expected to moderate over the course of our forecast horizon, consumer demand will gain support from recent developments in equity markets where share prices have risen by 15-20 per cent since the start of the year.

3. Prospects for the Euro Area Economies

In the first half of this year, the Euro Area economies continued to lag behind much of the rest of the world. Output stagnated in the first quarter and contracted by 0.1 per cent in the second quarter, following an average quarterly expansion of 0.3 per cent in 2002. The appreciation of the euro is largely to blame for this development, taking its toll on exports. The weak outcome for the first half of the year, coupled with the appreciation in the nominal effective exchange rate by about 6.9 per cent and weak prospects for private investment, dampens the outlook for the year as a whole. As outlined in Table 6, we expect the Euro Area to expand by just 0.3 per cent in 2003. However, we expect a more pronounced pick-up in growth to around 1.7 and 2.1 per cent in 2004 and 2005 respectively, as domestic and external demand both strengthen.

Table 6. Euro Area

Percentage change

	2000	2001	2002	2003	2004	2005
Consumption	2.7	1.8	0.5	1.3	1.5	2.0
Private investment	5.2	-0.3	-2.8	-0.7	2.2	2.5
Government expenditure	2.2	2.3	1.9	1.5	1.1	1.4
Stockbuilding (as % GDP)	-0.1	-0.5	0.0	0.1	0.0	-0.2
Total domestic demand	2.9	1.0	0.2	1.1	1.6	1.8
Export volumes	12.6	3.3	1.7	-0.2	5.1	5.1
Import volumes	11.2	1.8	0.1	2.0	5.4	4.6
GDP	3.5	1.6	0.9	0.3	1.7	2.1
Average earnings	3.0	4.3	3.5	3.0	2.3	2.3
Harmonised consumer prices	2.1	2.4	2.3	2.1	1.8	1.5
Private consumption deflator	2.2	2.4	2.3	1.9	1.6	1.5
RPDI	2.5	2.5	1.2	1.6	1.4	1.8
Unemployment, %	8.4	8.1	8.4	8.9	8.8	8.6
Govt. balance as % of GDP	0.1	-1.6	-2.2	-2.7	-2.8	-2.4
Govt. debt as % of GDP	69.5	69.1	69.5	71.4	70.8	70.1
BoP Current A/C as % of GDP	-1.0	-0.3	0.8	0.3	0.8	0.8

Economic weakness is widespread throughout Europe. Five Euro Area countries recorded a decline in GDP in the second quarter of this year, including the three largest economies: Germany, France and Italy. Three countries recorded a technical recession of two consecutive quarters of contraction in the first half of 2003: Germany, the Netherlands and Italy. Bright spots in Europe are few and far between, although Spain continues to outpace the other major economies and growth in Greece remains strong, spurred by infrastructural investment in preparation for the Olympic Games.

The nominal Euro Area effective exchange rate strengthened by roughly 10 per cent in 2003. The impact of the appreciation on relative export prices has dampened external demand this year. The level of exports is expected to be slightly lower in 2003 relative to a year earlier. With import demand growing by about 2 per cent, we estimate that net trade will reduce output growth by about 0.7 percentage points this year. Stronger external demand over the next two years, while domestic demand accelerates more slowly than in the rest of the world, will result in a positive impact of net trade on growth of about 0.25-0.50 percentage points in 2004 and 2005.

The inflation outlook in the Euro Area remains relatively benign, as the currency appreciation continues to exert downward pressure on import prices and output remains below full capacity. Nonetheless, the recent rise in oil prices has made further interest rate cuts this year less likely, and inflation expectations implied by index linked bonds have risen by about 0.3 percentage points since June. This may in part reflect a growing realization that the strategy announcement made by the European Central bank (ECB) in May, that it now aims to keep the inflation rate 'close to – but below – 2 per cent', effectively raised the medium term inflation target from around 1.5 per cent to just under 2 per cent, and hence inflation expectations have been revised up. The euro appreciation has led to an implicit tightening of monetary conditions in the Euro Area, partially offsetting the impact of the post-Iraqi war reduction in the ECB's key policy rate to 2 per cent per annum.

Consumer expenditure growth slowed to 0.2 per cent in the second quarter of this year from 0.6 per cent in the first quarter, pointing to continued sluggishness of consumer spending in the second half of this year. Private consumption remains uneven across the Euro Area, with figures ranging from a sharp decline of 1.3 per cent in the Netherlands to a relatively robust increase of 1 per cent in Spain. The latest monthly data for retail sales support our expectation that private expenditure will remain subdued in the short term. Moreover, the weak outlook for employment and concerns about pension reforms are likely to continue to weigh on consumer spending. The sharp drop in equity prices, of around 30 per cent over the course of last year, will further restrain expenditure in the near term, despite the recent recovery in share prices. Overall, we forecast that consumer spending in the Euro Area will grow by 1.3 and 1.5 per cent in 2003 and 2004 respectively, before picking up somewhat to 2.0 per cent in 2005.

Private investment in the Euro Area contracted by about 2.8 per cent in 2002. The available data for the first half of this year reveal that private investment continued to decline in Finland, France and the Netherlands relative to a year earlier. Investment in construction in Germany, the Euro Area's largest economy, also declined over this period. In light of these indicators we expect private investment to record a decline for the third consecutive year in 2003 as a whole, of about 0.7 per cent. We expect to see a recovery in investment growth as economic conditions improve next year, but the recent rise in real long term interest rates will restrain this recovery to some degree. We forecast investment growth of 2.2 and 2.5 per cent in 2004 and 2005 respectively.

Table 7. Real GDP

Percentage change

	2001	2002	2003	2004	2005
Austria	0.7	1.1	0.3	1.5	2.3
Belgium	0.8	0.7	0.6	1.8	2.2
Denmark	1.4	2.1	0.8	2.0	2.0
Finland	1.2	2.2	1.0	2.6	3.0
France	2.1	1.2	0.2	1.5	2.3
Germany	1.0	0.2	-0.2	1.5	1.6
Greece	4.1	4.0	3.6	3.8	4.5
Ireland	6.2	6.9	2.2	3.2	6.0
Italy	1.7	0.4	0.3	1.3	1.9
Netherlands	1.2	0.2	-0.5	0.9	1.5
Portugal	1.7	0.4	-0.3	1.9	2.6
Spain	2.8	2	1.9	2.7	2.8
Sweden	1.4	1.9	1.3	2.2	2.7
UK	2.1	1.7	2.0	2.5	2.7
EU	1.7	1.0	0.5	1.7	2.2
Euro Area	1.6	0.9	0.3	1.7	2.1

Table 8. Harmonised Consumer Price Inflation

Per cent per annum

	2001	2002	2003	2004	2005
Austria	2.3	1.7	1.3	1.0	1.2
Belgium	2.4	1.6	1.5	1.5	1.3
Denmark	2.2	2.4	2.1	1.4	1.8
Finland	2.6	2.0	1.4	0.8	1.4
France	1.8	1.9	2.3	2.2	1.5
Germany	1.9	1.3	1.1	0.9	0.9
Greece	3.7	3.9	3.6	2.2	2.4
Ireland	4.0	4.7	3.6	2.5	2.2
Italy	2.4	2.6	2.8	2.0	1.6
Netherlands	5.1	3.8	2.3	1.6	1.9
Portugal	4.4	3.7	3.4	2.9	2.1
Spain	2.8	3.6	3.0	2.5	2.1
Sweden	2.7	2.0	2.2	1.5	1.8
UK	1.2	1.3	1.3	1.4	1.6
EU	2.2	2.1	2	1.7	1.5
Euro Area	2.4	2.3	2.1	1.8	1.5

Overall, we expect annual inflation to remain just above 2 per cent this year, before receding to about 1.8 and 1.5 per cent in 2004 and 2005, respectively, as seen in Table 8. The outlook remains particularly weak for Germany, where inflation is expected to linger at about 1 per cent per annum through to 2005. We do not currently foresee deflation in our central scenario, but the risks remain substantial.

The standardised unemployment rate for the Euro Area as a whole remained at 8.8 per cent in August for the fifth consecutive month, up from 8.5 per cent a year earlier. The unemployment rate is estimated to have risen in nearly all the Euro Area economies in 2003, with the exceptions of Finland, Greece, the UK and Italy. Portugal and the Netherlands recorded the strongest rises in unemployment, although the unemployment rates in these countries remain well below the Euro Area average. Modest improvements in the labour market are anticipated in most countries next year as the economy strengthens. Table 9 outlines our trajectory for the unemployment rate over our forecast horizon for all the EU countries. We expect the Euro Area unemployment rate to fall from an average of 8.9 per cent in 2003 to 8.8 per cent in 2004 and 8.6 per cent in 2005.

Table 9. Standardised Unemployment Rate

Per cent

	2001	2002	2003	2004	2005
Austria	3.6	4.3	4.5	4.3	4.1
Belgium	6.7	7.3	7.9	7.7	7.7
Denmark	4.4	4.5	5.2	4.9	4.9
Finland	9.1	9.1	9.0	9.2	9.2
France	8.5	8.8	9.4	9.7	9.5
Germany	7.8	8.6	9.3	9.0	9.1
Greece	10.4	9.9	9.4	9.5	9.2
Ireland	3.9	4.4	4.7	5.1	4.7
Italy	9.4	9.0	8.6	8.4	8.2
Netherlands	2.4	2.8	4.1	5.3	5.4
Portugal	4.1	5.0	6.9	7.7	6.9
Spain	10.6	11.3	11.5	10.7	9.8
Sweden	4.9	4.9	5.4	5.4	5.2
UK	5.1	5.1	5.0	5.1	5.3
EU	7.4	7.7	8.1	8.0	7.9
Euro Area	8.1	8.4	8.9	8.8	8.6

Table 10. Fiscal Balance

Per cent of GDP

	2001	2002	2003	2004	2005
Austria	0.3	-0.2	-1.1	-1.5	-1.1
Belgium	0.6	0.1	-0.1	0.2	-0.2
Denmark	3.1	2.1	1.2	1.1	0.9
Finland	5.2	4.2	2.8	1.5	1.4
France	-1.5	-3.1	-3.9	-4.1	-3.7
Germany	-2.8	-3.5	-3.9	-3.6	-3
Greece	-1.5	-1.2	-1.1	-1	-0.4
Ireland	1.1	-0.2	-0.8	-1.3	-1.2
Italy	-2.6	-2.3	-2.7	-3.1	-2.9
Netherlands	0	-1.6	-2.4	-2.8	-2.1
Portugal	-4.2	-2.7	-3.7	-3.9	-2.7
Spain	-0.3	0.1	-0.2	-0.1	0.6
Sweden	4.5	1.3	0.6	1	1.1
UK	0.8	-1.4	-2.8	-3.3	-3.9
EU	-0.9	-1.9	-2.6	-2.7	-2.5
Euro Area	-1.6	-2.2	-2.7	-2.8	-2.4

While government spending will make a positive contribution to growth in the Euro Area this year, public expenditure growth remains well below the historical average, as governments are restricted by their commitments to the Stability and Growth Pact. Fiscal positions have deteriorated significantly in the Euro Area, and four countries are expected to breach the 3 per cent of GDP deficit ceiling in one or more years of our forecast horizon. The Stability and Growth Pact came under significant strain again in September following France's failure to comply with the Pact's deficit rules in 2004. The French government has now been given until 2005 to reduce the deficit to below 3 per cent of GDP, and the Commission has recommended budget cuts worth 1 per cent of GDP in 2004 and 0.5 per cent of GDP in 2005. However, our current projections do not see the French budget deficit falling below 3 per cent of GDP in 2005. Our budget deficit projections for all the EU countries as well as the Euro Area and

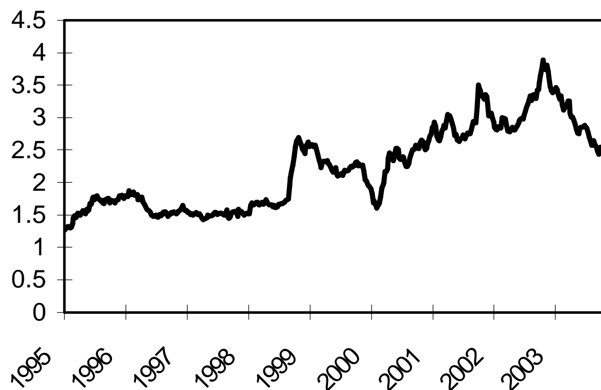
EU as a whole are set out in Table 10. While Germany is introducing measures to reduce its deficit, persistent weakness of domestic demand suggests that the German deficit will also exceed 3 per cent of GDP for the third consecutive year in 2004. The risk is aggravated by the German government's decision, approved by the Bundestag on 17th October, to bring forward to 2004 tax cuts initially planned for 2005, which are unlikely to be fully financed in the first year. We currently estimate that the Portuguese deficit will exceed the 3 per cent ceiling in 2003 and 2004 before coming in below the threshold in 2005 and that the Italian deficit, which has so far been kept consistently below 3 per cent of GDP by using one-off measures, will slightly exceed the deficit ceiling in 2004. Public finances in the Netherlands have also deteriorated sharply recently, but a tightening package of spending cuts and tax increases will keep the deficit within Pact limits. The aggregate Euro Area budget deficit is projected to amount to about 2.7 and 2.8 per cent of GDP in 2003 and 2004 respectively, before recording an improvement of 0.4 percentage points in 2005.

Scenario 1: Stronger Investment in the US

An upside risk to our current forecast is that the US economy will grow faster than currently anticipated. The impact of a rise in US growth will depend crucially on the source of this added strength. For example, the strong outcome for US GDP in the third quarter of 2003, with output rising at an annualised rate of 8.2 per cent, is largely a reflection of stagnating import demand. This allowed net trade to have a strong positive impact on US growth. However, a shift in demand from imported to domestically produced goods does little to raise growth outside the US, and may have a contractionary impact elsewhere. On the other hand, a rise in fixed capital formation would raise import demand for investment goods, raise income and ultimately raise import demand for consumer goods.

Chart 1. US Corporate Bond Spreads

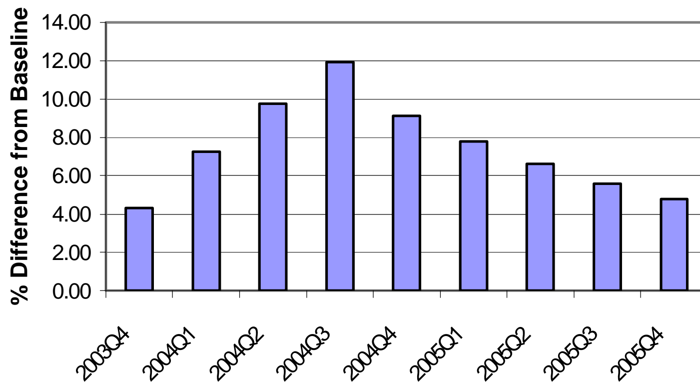
BAA corporate bond-10 year government bond yields



Source: Federal Reserve Board

As can be seen from Chart 1, corporate yield spreads in the US have fallen by 1.5 percentage points since late 2002. Those in Germany have come down by nearly 2 percentage points, to levels last seen in 1996. This may fully or even over compensate for the rise in nominal long rates since the second quarter. This recent easing of financing conditions in the US may offset the impact of higher real interest rates. As a result we may see stronger investment than currently forecast. In order to analyse this we have undertaken a simulation where US investment rises rapidly as a result of low interest rates and declining risk premia in the US private sector. We have induced this by endogenously increasing the demand for capital in the US for 3 to 5 years. This increases the rate of investment growth by around 3 per cent a quarter as compared to our baseline, and after one year investment is around 12 per cent higher than on our baseline, as can be seen from Chart 2.

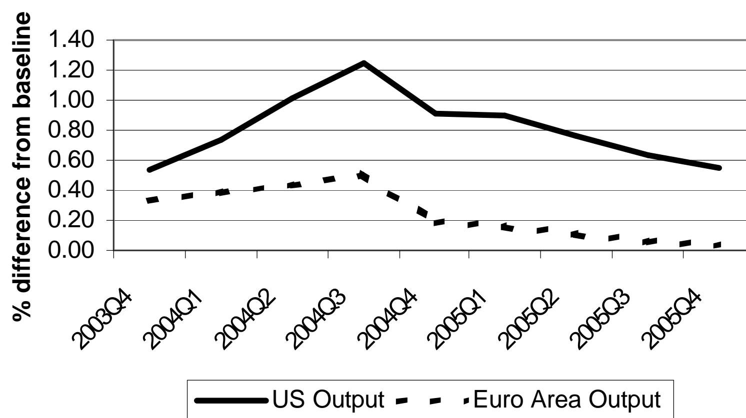
Chart 2. A US Investment Boom



A temporary investment boom of this magnitude, which is about twice that seen in the mid 1990s, is likely to increase US GDP noticeably, as can be seen from Chart 3. US output would grow by 0.9 per cent more in both 2004 and 2005 in this boom scenario. This would spill over into higher world growth, as can be seen from the chart, with Euro Area growth around 0.4 per cent higher than in our base forecast.

Some of the impact of the increased investor sentiment would be offset by the response of the Federal Reserve. Our model interest rate reaction function suggests that they would immediately raise interest rates by 0.5 percentage points and after a year rates would be 1.5 percentage points higher than they otherwise would have been. The US effective exchange rate would be expected to increase in response to this monetary reaction, and in our forward looking model the US effective exchange rate increases by 2.14 per cent immediately, and the euro depreciates against the dollar by 3.3 per cent. This depreciation would increase inflationary pressures in the Euro Area somewhat and our model interest rate reaction function for the ECB would require them to raise rates to offset this, albeit by half of the increase in the US. If the ECB did not respond then the Euro Area would gain more and the US would gain less.

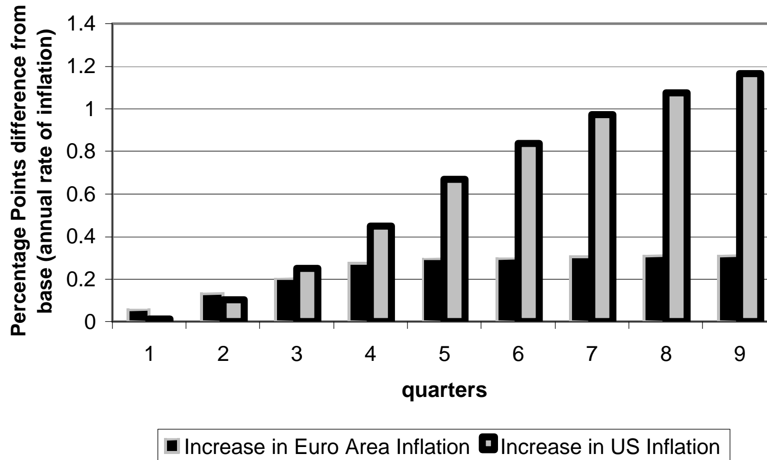
Chart 3. Output Effects of a US Investment Boom



The inflationary impacts of an investment boom in the US would be noticeable even given a relatively robust response by the ECB and the Federal Reserve, as can be seen from Chart 4. World growth would also be increased by just under 0.4 percent in each of 2004 and 2005, and world trade growth would be almost 2 per cent higher in 2004. Much of this effect on the rest of the world would come

from higher US imports. The US current account deficit would worsen by more than 1 per cent of GDP by the end of 2005. However, as we view this as a temporary investment boom we would not perceive the US as entering an unsustainable expansion. If it were to do so, risk premia on US assets might rise or inflation prospects in the US might worsen more than we suggest, and as a result the dollar might weaken significantly. We analyse this possibility below in scenario 2.

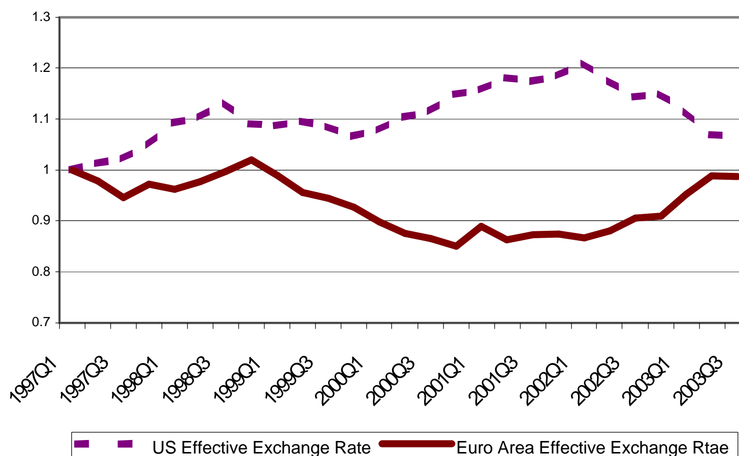
Chart 4. Inflationary Impacts of a US Investment Boom



Scenario 2: Weaker Dollar

The dollar has fallen significantly in the last year, both against the euro and in effective terms. The strength of the euro and the weakness of the dollar seems to have stimulated the US economy and slowed that of the Euro Area. During the technology boom of the late 1990s the dollar was strong. From 1999 the euro weakened as well, as can be seen from the trade weighted exchange rates plotted in the chart below. Since the middle of 2002, the dollar has been weakening, and more recently the euro has strengthened. This may reflect the build up of imbalances in the US economy, with the current account deficit reaching 5 per cent of GDP by early 2003. There remain clear worries that the dollar may not have fallen enough to remove these imbalances leaving the risk that the dollar could weaken further and the euro strengthen somewhat more. We have analysed one possible scenario with the NiGEM model.

Chart 5. Effective Exchange Rates (1997 Q1=1)



There are many reasons why an exchange rate may change, and a 10 per cent shift in the euro/dollar rate can have many causes. The effects of the change will depend upon the causes of the movement, with the two extreme cases being a weakening of the dollar because of a changed perception of inflation risks in the US and a stronger euro for the same reason, but with lower inflation expected in the Euro Area. If the US Federal Reserve announces that it plans to loosen monetary policy sufficiently that inflation will be 1 to 2 per cent higher for 5 years or more then, in a forward looking world, the dollar will fall by 10 per cent immediately and US output and inflation would rise markedly. The impacts on the Euro Area would be limited. If on the other hand the markets perceived that inflation in the Euro Area would be lower than they previously thought, by 1 to 2 per cent a year for 5 years or more, then the euro would strengthen by 10 per cent. If the ECB implemented the policy the markets now expected then the Euro Area economy would slow markedly and inflation would fall. The impact on the US economy would be limited. In both cases the euro/dollar rate would change by 10 per cent, but the impacts on the US and on the Euro Area would be markedly different.
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We have analysed a scenario that is a combination of the two, with a weaker dollar and a stronger euro. We think this is a reasonable description of the realignment that has been happening in the last year or so with the central banks deciding that they were happy to validate this shift, but initially not changing interest rates. A 10 per cent rise in the euro/dollar rate would slow output down in the Euro Area markedly, as we can see from Chart 6, and inflation would fall by around 1 per cent a year for five years as compared to previous expectations. Hence the price level would be 5 per cent below the level otherwise anticipated in the long run. The scene in the US would be the inverse of this with higher inflation and more rapid output growth. In the long run the price level would be around 5 per cent higher. In these circumstances the real exchange rate, the price of European goods relative to US goods in a common currency, would be unchanged.

The short term impacts of such a realignment would be likely to slow the world economy down somewhat, although as we can see, in the long run output is unchanged by the change in exchange rates. The rather inertial European economy would take much of its shock on output, and prices would adjust slowly, whilst the rather more flexible US economy would do the reverse. In the US prices would adjust quickly to their new equilibrium values, and output effects would be smaller. In the medium term the sluggish growth in the slowly adjusting Euro Area economy would hold back the US and the rest of the world economy. Clearly it would be in the interest of all to ensure that the Euro Area had the political space to enact structural reforms that would speed up adjustment to shocks.

Chart 6. The Impact of a 10% change in the euro/dollar exchange rate