



The Economic Outlook in Europe in 2004-2005

WHAT TYPE OF GROWTH FOR EUROPE?

Summer Report

BFP	- Brussels
CEPREDE	- Madrid
COE	- Paris
CSC	- Rome
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June 2004

About the European Economic Network

The European Economic Network (EUREN), <http://www.euren-network.org>, is a network of seven leading European economic institutes. EUREN was formed in 1999 to facilitate improved analysis of developments and prospects across the European economy, by developing closer links between leading economic research groups. All Euren institutes regularly publish forecasts, both on national economies and on EU and Euro Area as well.

Members of the Euren group have been co-operating in a number of ways over the five last years: meeting regularly to discuss economic developments and prospects; holding annual economic issues conferences, in Paris, to discuss major challenges for the European economic policy, contributing to joint and partner's research reports and economic outlook seminars and conferences (this includes the regular report, *La Tribune d'Euren*, <http://www.coe.ccip.fr/05/tribune.htm>), working together on economic research projects.

This is the fifth joint report on the European economic outlook. In this report Euren intends presenting a broad view on recent economic developments in the Europe as well as offering some special studies aiming to discuss key elements on a more structural basis. Copies of the report can be downloaded from each Institute's web site.

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EXECUTIVE SUMMARY

Since last Autumn, the EUREN partners have become a bit more optimistic – a trait reflected in this report.

The world economy is now moving faster than expected, thanks to a stronger recovery in the USA, continued high growth in China and the more unexpected acceleration of Japan. World trade could grow by 9% on average in 2004.

- The European economic recovery, even if it has been a modest performance so far, is now confirmed; however, this upturn sees the euro area clearly lagging the USA and overall world economy.
- Monetary and fiscal policies has been expansionary in the USA and less in the euro area, in a climate of low inflation, and low interest rates.
- There are early (weak) indications of a possible increase of household expenditure in the euro area, supplementing foreign demand as a growth engine, but these demand expectations have not yet stimulated productive investment; in the UK, consumers are sustaining growth in a more positive way.
- In the new member states of the EU, growth already strong in the second half of 2003, is even accelerating further in early 2004.

Under these new conditions, the EUREN institutes estimate 2004 GDP growth rates at 2.2% for the euro area, 3.1% for the UK, and 5.4% for the new member states.

In recent weeks the threat of new risks has resulted from sudden increases of international prices of oil and raw materials and their headline inflationary impact.

EUREN is not expecting these increases in international prices to have a permanent effect on European inflation rates, and they should not induce any changes in the ECB monetary policy during 2004.

**The euro area
GDP should
grow by 2.2%
in 2004 and by
2.4% in 2005**

Uncertainties increase when the projection is extended to 2005 as both the world economy and world trade may slowdown as a result of more restrictive fiscal and monetary policies in the USA and China to avoid demand overheating. A lower growth of world demand, may rapidly affect the euro area prospects, even if a decline of the \$/€ rate (to an expected 1.15 average for 2005) could help to improve price competitiveness.

But there are new risks on the horizon

EUREN's central 2005 projection for the euro area sets average GDP growth at 2.4%, but the quarterly profile shows a declining trend during the year. The same evolution is expected in the UK with a final average rate of 2.8%. The new members states should remain a growth pole for the EU with an expected GDP rate of 5.1% in 2004.

Table 1.1. Main features of the forecast

	2003	2004	2005
World trade	4.5	9.0	8.0
Oil price (\$/b)	28.9	32.0	28.0
GDP growth			
- United States	3.1	4.5	3.5
- Japan	2.7	4.3	2.3
Euro area			
- GDP growth	0.5	2.2	2.4
- Inflation (HCPI)	2.1	2.1	1.7
- Unemployment rate (%)	8.8	8.8	8.6
UK Economy			
- GDP growth	2.2	3.1	2.8
- Inflation (HCPI)	1.4	1.4	1.6
- Unemployment rate (%)	5.0	4.6	4.4
New EU member states			
- GDP growth	3.7	5.4	5.1
- Inflation (HCPI)	2.1	3.9	3.4
- Unemployment rate (%)	14.8	14.0	13.3

Is it possible the euro area growth model could change? The EUREN institutes believe the credibility of fiscal policy is seriously in danger and that it should become more restrictive in 2005; at the same time the ECB may be inclined to increase interest rates by 50 basic points in 2005. Thus the positive factors might be found in private investment and household consumption.

The first months of 2004 provide some indications of this possible change towards a new growth model in the euro area, but it is too early to provide a correct assessment of this evolution.

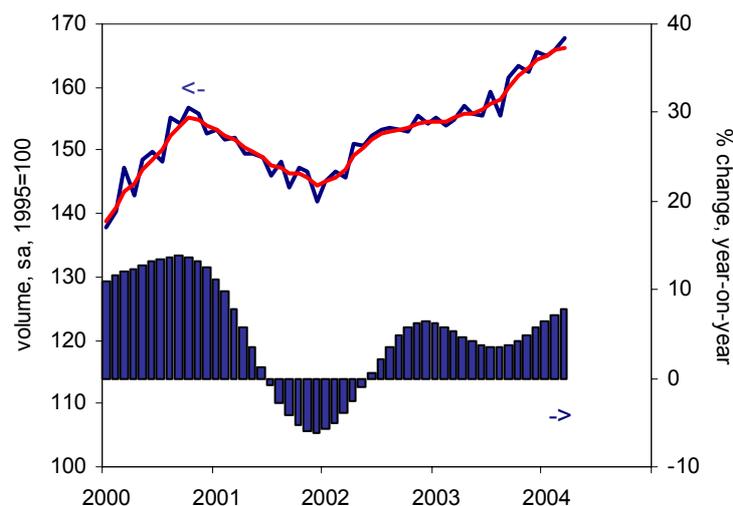
The three Special Studies in this Report deal with subjects of interest to the medium term development of the EU:

**Higher oil prices
could reduce
future growth**

- The analysis of the oil price effect on the world economy, by D. Antonucci and P. Capretta of CONFINDUSTRIA, uses simulations with the OEF econometric model to show the differences of macroeconomic impacts in the USA, EU / EMU and Japan, and points to the conclusion that a permanent increase of 10 \$/bl could reduce GDP world economic growth by as much as 0.4% in the first year.
- The comparison of productivity gains and the contribution of ICT in this regard, prepared by H. Bogaert and C. Kegels of BFP, points to the Key importance of ICT capital accumulation for the productivity and output growth of user sectors, and explains one of the causes of the lower growth in the EU in relation to the USA,
- The analysis of the internationalisation of the euro, by Ch. de Boissieu of COE, establishes clearly the net advantages in terms of benefit and costs for the euro area of such a process of internationalisation, and recommends a less neutral and friendlier attitude of the ECB towards it.

Booming global economy**THE INTERNATIONAL OUTLOOK**

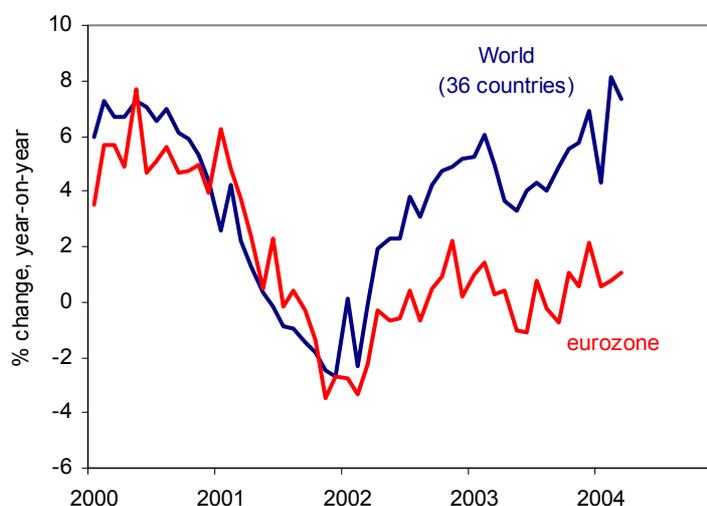
The revival of the global economy that started in mid-2003 has continued in recent months, confirming the signs of firming activity mentioned in the December Euren report. These developments are reflected in the upturn of international trade as well as a rising trend in equity prices on most stock markets. According to the COE indicator, world trade grew 1.8% q/q and 7% on a year earlier in the first quarter of 2004 in volume terms.

Chart 2.1. World Trade COE Index

Source: EUREN

But the dynamism of world economy has not been fully shared by Europe - the growth gap between the euro area and the rest of the world has widened significantly since 2002.

Chart 2.2. Industrial production



Source: EUREN

Table 2.1. Exogenous and international variables

(Percentage changes unless otherwise indicated)

	2002	2003	2004	2005
World trade	3.1	4.5	9.0	7.5
United States				
GDP	2.2	3.1	4.5	3.5
3m interest rates	2.4	1.2	1.6	2.6
10y Gvt bond yield	4.9	4.0	4.6	5.0
Japan				
GDP	-0.3	2.7	4.25	2.25
3m interest rates	0.1	0.1	0.1	0.2
10y Gvt bond yield	1.2	1.0	1.5	1.8
US dollar/euro	0.95	1.13	1.21	1.15
Yen/US dollar	125.2	115.9	110	113
GBP/US dollar	0.66	0.61	0.55	0.57
Oil price, Brent, US\$/barrel	25.0	28.9	32.0	28.0
Percentage changes	2.5	15.6	10.7	-12.5

Sources: IMF, OECD, EUREN forecasts for 2004 and 2003.

The United States has led the way, with high levels of growth since the end of major hostilities in Iraq was called in May 2003. Somewhat more unexpectedly, Japan has also seen an upsurge in activity, driven primarily by sales to China. The Chinese boom has also made a large contribution to a surge in raw material prices, including oil

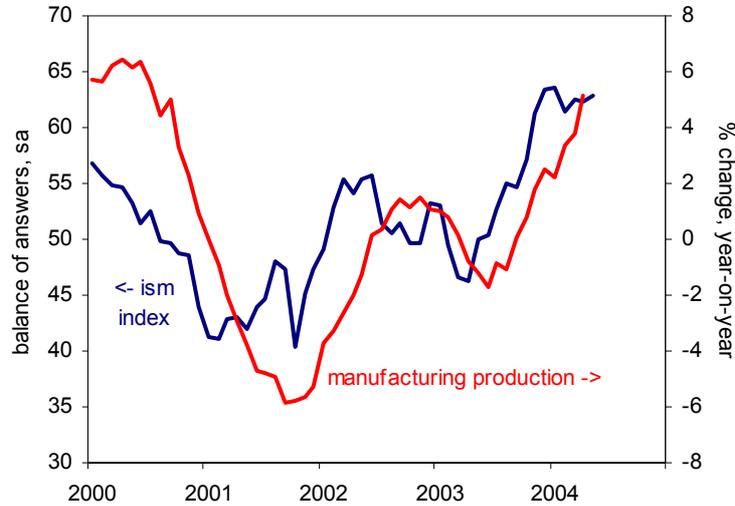
**Sustained
growth in the US
in 2004; towards
a mild slowdown
in 2005**

prices, although geopolitical concerns are arguably more important. Naturally, this recent rise in oil prices illustrates downside risks for the world economy. But the central scenario described in this forecast is a soft landing of global growth in 2005. On the one hand, a somewhat more restrictive stance in economic policy should help cool down the US economy. In the other hand, it is expected that Chinese authorities will prove themselves able to take the suitable measures to limit the various tensions that emerged in the Chinese economy in the last few quarters.

Since the end of the war in Iraq, the United States has seen a phase of sustained growth. Initially driven by a particularly expansionist economic policy, growth has been picking up pace. In the first quarter of 2004, GDP increased at an annual rate of 4.4%, after a solid 4.1% in the fourth quarter of 2003. Productivity gains achieved in the private sector reflected in a boost to profits in 2003 that allowed entrepreneurs to increase capital spending. As a result, investment increased by 9.8% at annual rate in the first quarter of 2004, after 14.9% in the fourth quarter of 2003 and 17.6% in the third quarter. Along with the dynamism of business investment, private consumption has been growing substantially in the last quarters. Additional tax cuts and more jobs creation will help increase household income this year. Even though the stock market has been more volatile in the first half of 2004, US households also benefited from positive wealth effect last year, thanks to the increase in equity prices and sharp rise in the housing market. Thanks to the revival in global economy and previous depreciation of the US dollar, US exports have also risen significantly since mid-2003.

Recent monthly indicators point to solid growth in the second quarter of 2004. The ISM index was above 60 in May in manufacturing industries, well above the 50 threshold that separates the expansion and contraction of activity. This confirms the positive trend in industrial production. And in services, the index also stands at very high level. Moreover, the risk of a jobless recovery has sharply diminished recently. Jobs creation has come back in a positive territory since mid-2003 and has averaged 316,000 per month in March, April and May, a level not seen since 1998. Even the manufacturing sector has created jobs in the last couple of months. The ISM survey jobs component reached its highest level in April since April 1973.

Chart 2.3. United States: manufacturing production



Source: EUREN

Until recently, one of the most interesting features of the US economy in this context of global growth was the absence of inflation, as the oil price rise and other inflationary pressure was more than offset by productivity gains. It is clear that one of the downside risks facing the US economy is the possibility the recent surge in the oil price leads to higher inflation. In April, the consumer price index picked up to 2.3% on a year earlier following a price hike in energy costs. If this trend continues, it would probably impact negatively on the US economy through various channels, including household consumption and input costs. Euren's central scenario assumes that oil market tensions will only be temporary. However, the Federal Reserve will clearly increase its key interest rates soon in order to start the process of returning monetary policy to a more neutral level. The Fed funds could increase by 50 cents before summer and by 100 points more before the end of the year. US long term interest rates are also expected to increase significantly, reaching 5% at the end of this year. Regarding fiscal policy, whatever the results of November elections, the new administration will have to tackle the widening deficit. The result should be a slightly negative stance, which will contrast sharply with the dramatic expansion that has characterised US fiscal policy since 2001. This change in the economic policy stance should lead to a progressive slow down in the US economy in 2005. Moreover, an end to the current period of a weak dollar, one consequence of the change in the monetary policy stance, is likely to

translate into lower export growth next year. Our forecast shows US GDP growing on average by 3.5% in 2005 after 4.5% this year.

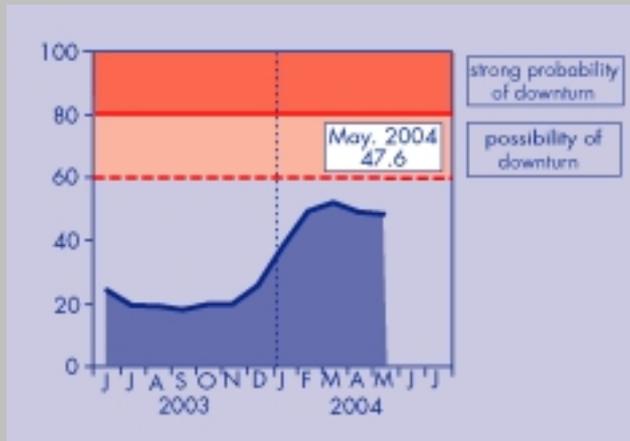
Box 2.1. The COE leading indicator for the United States

The COE leading indicator for the United States is currently used to anticipate the next economic downturn. At the start of the year, the index climbed from 24.9 in December to 51.3 in March, getting closer to the first 60 threshold which would indicate a possible economic slowdown within the next nine months. This was mainly due to the deterioration of the household confidence in line with the lack of jobs creations and the worsening of the situation in Iraq. In addition, there was an accumulation on inventories in the industrial sector. Since then, the indicator is reversing. The probability of a proximate downturn is going down again, thanks to a renewed household confidence and an historical level reached by the interest rate spread. The indicator IARC stood at 47.6 in May, still far away from the first threshold of 60.

Components of the COE leading indicator for the United States

- The Conference Board's Consumer Confidence expectations Index
- The Manufacturing ISM index
- Inventories of manufactured goods
- Privately-owned housing units authorized by building permits
- Standart & Poor's Index
- Interest rate spread

Chart B-2.1.
Growth cycle leading indicator:
 Search of the next peak

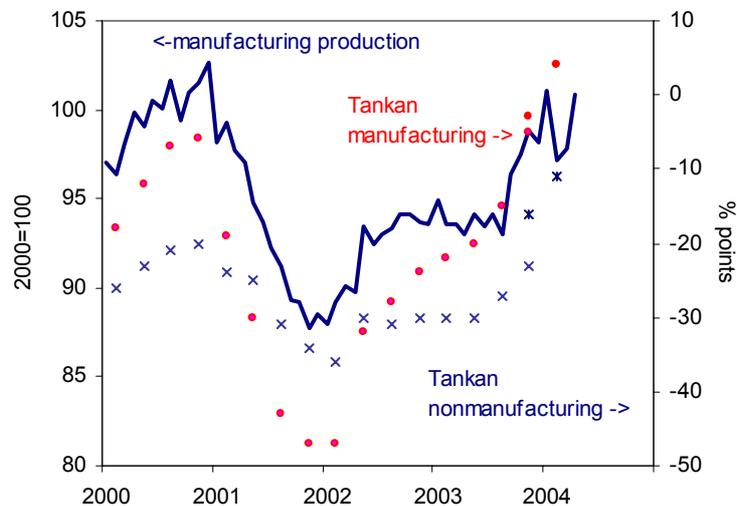


Source: COE

Japan surprises on the upside

In the last six months, Japan economic growth has remained very impressive with an increase in GDP of 1.7% on the quarter in 2003q4 and 1.4% 2004q1, even faster than in the US. Some uncertainty remains around the reliability of national accounts; the increase in volume terms is partly the result of a drop in deflators, especially for private investment. But other hard data, such as industrial production, together with surveys, point to solid growth of the Japanese economy, showing that recent figures are not only a statistical artefact.

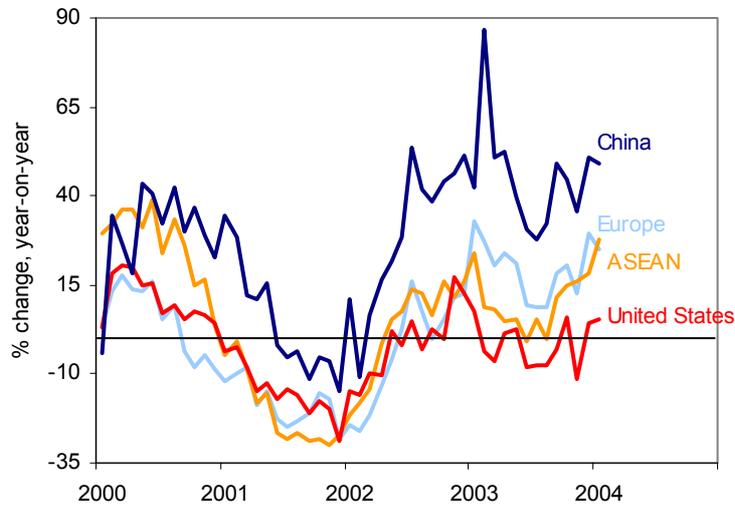
Chart 2.4. Japan: industrial production



Source: EUREN

This impressive Japanese growth is mainly the result of an acceleration in exports. Japan has clearly benefited from the buoyant Chinese demand, a trend which covers both final sales of Japanese products on the Chinese market and exports of intermediate goods to Japan affiliates hosted in China, part of the tendency of companies to move production overseas.

Chart 2.5. Japan: exports by destination



Source: EUREN

But this dynamism in exports coupled with some reform has allowed Japan to get out of the vicious cycle of low activity and structural problems in which it has been stuck for a decade. For instance, the rise in the equity prices that has accompanied the revival of the activity has helped improve the balance sheets of banks, even if all the structural imbalances are far from solved. Thus, contrarily to recent years, this upward trend in the Japanese economy is also the consequence of a rebound in final domestic demand and, particularly, in private investment. Firms' restructuring seems to have been successful and, besides the rise in external demand, this has allowed firms to increase profits, part of which has been fed back into the renewal of capital stocks. Even household consumption has contributed to this economic revival, following an improvement in the labour market. Exports and private investment will remain the two main engines of growth this year. GDP is thus expected to rise by 4¼% this year. This constitutes one of the main revisions from the last Euren forecast in December. Next year, exports are expected to decelerate as the US and Asian demand moderates. The competitiveness of Japanese products is highly dependant on exchange rate movements. The Bank of Japan has until now avoided a significant appreciation of the yen. Moreover, rising US interest rates would favour an appreciation of the US currency against the yen in the second half of 2004. However, the slowdown in exports could lead to a moderation of the business investment expansion. In this context, private consumption would be more subdued as Japanese households will not be able to cut their saving ratio

indefinitely to consume. As a result, the Japanese GDP increase, estimated at 2¼% next year, is likely to fall back closer to potential growth.

China at risk?

Emerging countries have also taken part in the global economic upswing. Recently, better news has been seen from Latin America, with rather strong increases in GDP in 2004q1 in big countries like Brazil and Mexico, while the recovery in Argentina has been confirmed. But emerging Asia has undoubtedly been one of the most dynamic regions since mid-2003. In several countries private consumption has found some support from economic policy, with low interest rates encouraging credit and relaxed fiscal policy before electoral rounds. Exports have also played an important role, stemming from the upswing in the electronics, strong demand in the US and above all in China. Indeed, microeconomic evidence show that Asian exports are redirected from the final markets (USA or Europe) to China, under the form of deliveries of intermediate goods to be assembled in this country. This new segmentation of the production process creates a new trade flows network in Asia, with China as the gravity centre.

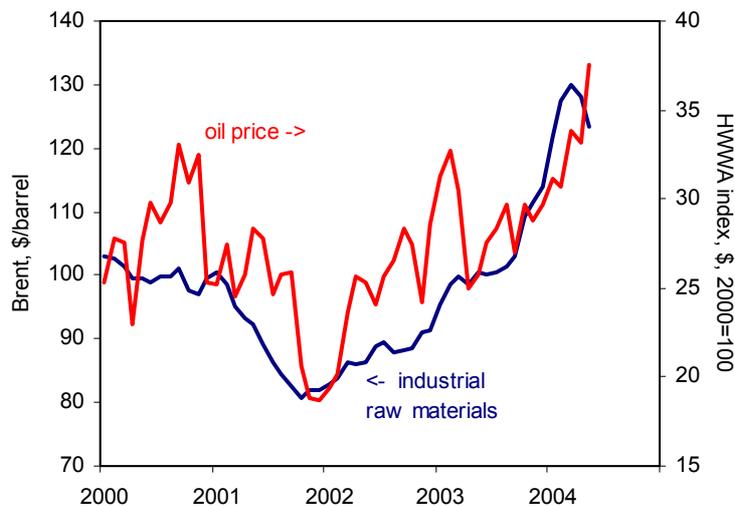
This is one reason making the Chinese economy so buoyant in 2003 and early 2004. In 2003, GDP increased by 9.1% and the first quarter of 2004 showed no signs of slowdown (at 9.8%). This is clearly export-led growth as exports have exploded in 2003 (+36.4% in dollars), and remain quite strong since the beginning of 2004 although at a softer pace. Investment is the second pillar of Chinese growth, but to some extent it also raises the question of the sustainability of recent trends as the share of investment in GDP is close to 50%. Signs of overheating - shortages in raw materials or very rapid credit expansion - have led Chinese authorities to take measures to slow down economic growth gradually. The main aims are to limit the monetary expansion generated by the exchange rate system, to moderate credit growth and to restrain investment in some sectors, including steel and office building. In the context of a strong increase in prices of raw materials, the threat of a pronounced acceleration in inflation has grown. Inflation sped up significantly in the first quarter whilst a year ago deflation was generally mentioned as the main risk. At the moment this upward trend mainly concerns food products, but it is clear that inflationary pressures are developing in the Chinese economy. Other structural measures are heading in the right direction. Improving controls in new investment (for instance office building for which the rate of vacancy is

increasing) and the beginning of banking system reform, needed because of huge amount of bad loans, are positive signs regarding the ability of Chinese authorities to tackle the question of overheating and imbalance growth. Thus, even if reasons to worry have recently increased, we still expect a soft landing of the Chinese economy next year.

The raw material price rise: a sign of overheating

Since August 2003, the HWWA dollar-based raw material price index (excluding energy) has risen 26%. In May 2004, it was about 40% above the slack November 2001 period (more than 50% for industrial raw materials). At the same time, the oil market has not shown any sign of easing up. A surge in oil prices in May and at the beginning of June, saw prices approaching 40 dollars a barrel for Brent crude. Although until recently the euro area has been spared these price increases thanks to the appreciation of the euro at the beginning of this year, this is not the case anymore.

Chart 2.6. Oil and raw materials prices



Source: EUREN

For both non-energy raw material prices, especially for non-ferrous metals, and for oil prices, the current rise is mainly linked to strong demand. China is largely responsible for this upward trend in raw material: China has become in 2003 the second largest consumer of oil after the US. China is also the first consumer country for copper, zinc, steel and cotton. Even if China is also one of the main producers of these commodities, the boom in Chinese demand has led to a period of tension on all these markets. In the case of the oil market, low stocks of gas in the US and record utilisation rate in

refineries have also contributed to push prices upwards. In our central scenario, we expect that a moderation of global growth will contribute to ease tensions on the raw material markets. Inflation pressures, which have recently appeared all over the world should thus be temporary.

But a prolonged period of tension in oil markets cannot totally be excluded. In the short-term, prices include a risk premium linked to the political instability in the Middle East. If new strikes occurred in some producer countries, risk premium could be even higher. In the longer run, world demand of oil will continue to increase strongly especially in emerging countries as rising living standards led consumers to buy cars and other energy intensive products. As the rooms of manoeuvre on the supply side is limited by the availability of natural resources, rising demand could be translated into a higher equilibrium price. So as well as the central scenario of a retreat of oil prices towards a more sustainable level for importing countries, it is thus interesting to study the consequences of an alternative scenario in which oil prices will be definitely higher than in the central forecast (see the special study on what could be the impact of the increase of oil prices on the world economy, on Chapter 4 of this report).

THE OUTLOOK IN EUROPE

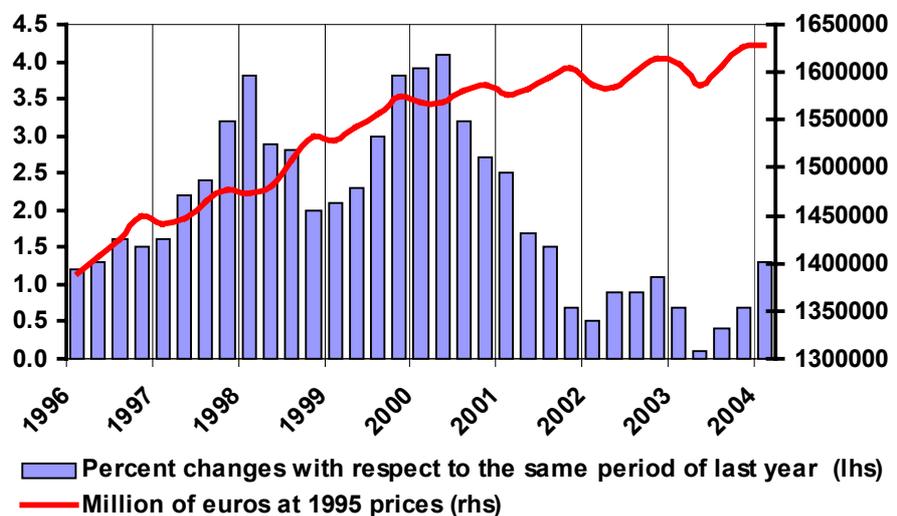
Part I. Recent developments in the euro area economy

Economic activity

The euro area recovery is consolidating, but is still very modest

Last year, the euro area economy grew 0.5%, very slightly higher than estimates made six months ago (0.4%): this is a result of more public expenditure at the end of the year and a smaller decline in gross capital formation than expected. Domestic demand appears to have grown faster (1.2% rather than 0.6% than expected half a year ago) but the impact of the euro's strength has been also slightly higher than expected, with lower export growth and more imports.

Chart 3.1. GDP in the euro area



Source: EUROSTAT

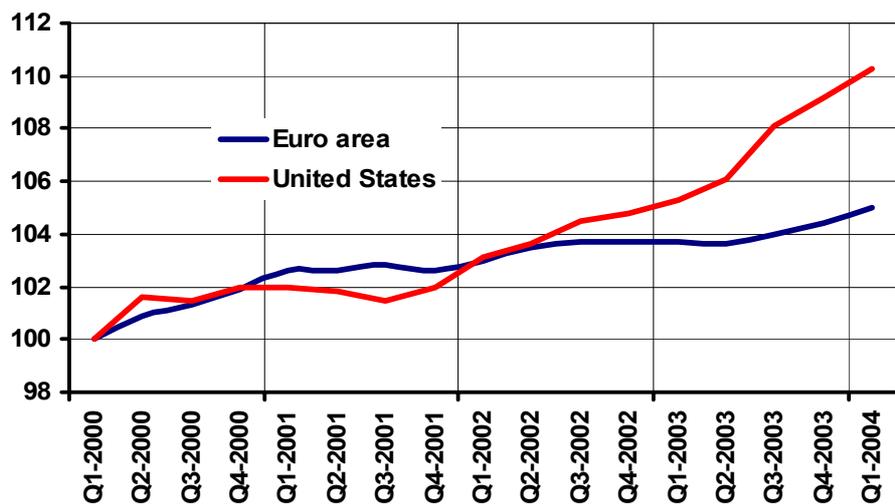
The preliminary estimates for 2004q1 confirm the recovery of economic activity in the euro area, with GDP growing by 1.3% over the same quarter of the previous year. As shown in Chart 3.1, this is the third consecutive quarter where an acceleration of growth is seen,

but it remains well below the medium term potential and the performance observed during 1996-2001.

The EMU economy also lags the USA recovery, a trend already evident already a year ago, during the second quarter of 2003. The upturn was delayed to the last quarter of 2003 in the euro area. And the GDP growth gap with the USA continues to widen (Chart 3.2)

Despite the gloom derived from these comparisons, it should be noted that the first quarter GDP estimates, when analysed in terms of annualised rates, actually show growth at 2.4%, a positive sign at the beginning of the year.

Chart 3.2. US and euro area GDP

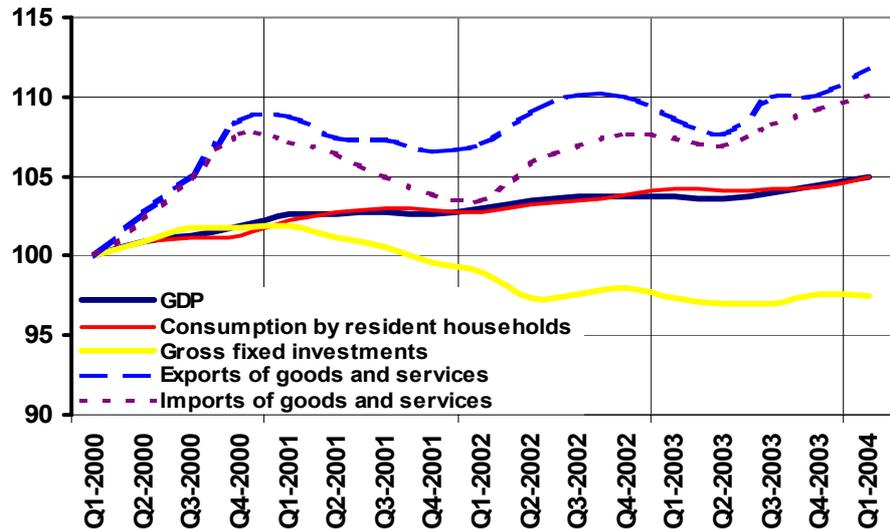


Source: EUROSTAT

Exports are driving the euro area recovery, despite a strong euro

Growth continues to be driven by the positive evolution of exports, stimulated up to now by strong world demand that has dominated the negative, price effects of the euro appreciation (Chart 3.3).

Chart 3.3. GDP and its components in the euro area
(2000Q1 = 100, in terms of contributions)

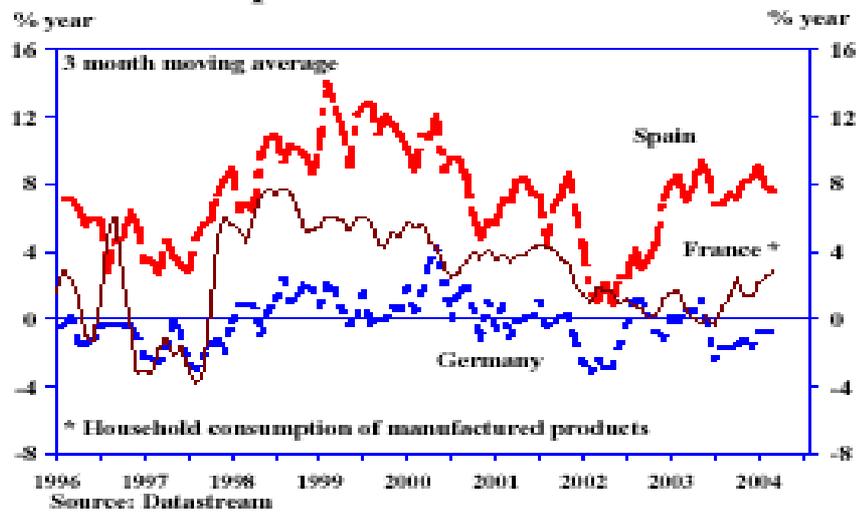


Source: EUROSTAT

But a less expected event was the annualised growth rate of 2.4% in private consumption in the first quarter of 2004, mainly as a result of a strong shift from savings to household expenditure in France. While France seems to be enduring a jobless recovery, households are apparently anticipating further economic improvement, and drawing on their reserves to increase their consumption levels; possibly this surge of consumption has been stimulated by price rebating policies by overstocked suppliers, but retail sales volume have continued to be strong in April.

As there are also positive signs of household expenditure revival in Germany and Italy, and Spain shows robust demand, it seems that domestic spending is becoming a support to the current recovery.

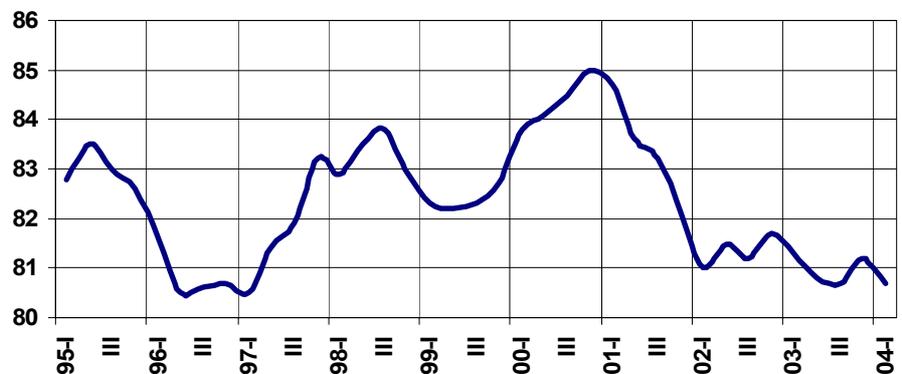
Chart 3.4. Europe: Retail sales volumes



If this evolution was confirmed in the second quarter of 2004, the euro area will in all probability avoid any risk of missing the current world economy recovery, a possibility that was pointed out by the IMF in its latest World Economic Outlook.

The other major component of domestic demand, investment, appears to be stumbling still. The unused production capacity remains high, and the possible impacts of the current strengthening of household consumption induce changes in gross capital formation with adequate time-lags. For the moment, the investment climate remains gloomy, specially in Germany.

Chart 3.5. EMU: Capacity utilization in manufacturing (% of total)



Source: EUROSTAT

Leading indicators point to a further consolidation of the recovery

Meanwhile, the most timely indicators giving an assessment of the economic current situation have also started to improve.

The Belgian leading indicator, based on the Belgian central bank survey of manufacturing, construction and retailing, continued to show gains in recent months. The indicator is highly negative at the depth of a recession and slightly positive at the top of the cycle. The indicator went to 0 at the end of 2003 and has been continuously increasing on the positive side since then, growing from .6 in April to .68 in May 2004.

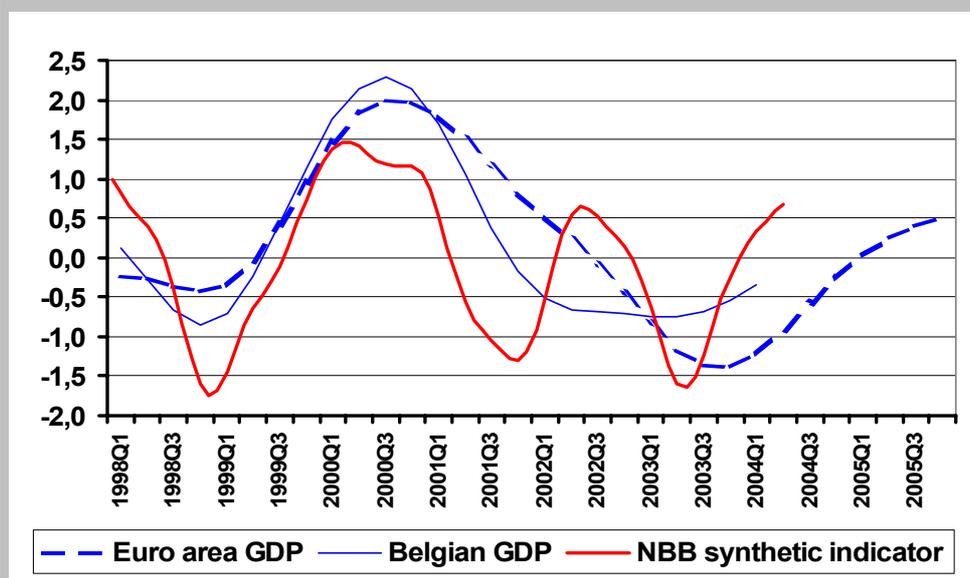
Box 3.1. The NBB business cycle indicator

As was observed during the last decade and as was shown in a previous Euren report¹, the Belgian business cycle and the business survey indicator of the National Bank of Belgium (NBB) can both be considered as leading indicators of the Euroland GDP cycle.

Indeed, after an unusual prolonged period of stagnation, which started in the second quarter of 2002, the bottom of the Belgian cycle was reached in 2003Q2. In the euro area, the cyclical downswing has been more pronounced than in Belgium, but the bottoming out has only taken place during the second half of 2003. Consequently, the upturn of the business cycle started two quarters later in the euro area than in Belgium. The cyclical component of the NBB synthetic indicator reached a trough in the second quarter of 2003 and has since then provided increasing and robust signs of an upswing. The turnaround in the euro area cycle has clearly taken place in the first quarter of the current year. In the current Euren projection for 2004, the strength of the cyclical upturn in the euro area should nevertheless remain moderate. However, despite the projected slowdown of q-o-q growth next year, euro area GDP should continue to increase faster than its trend throughout 2005.

¹ 'The Belgian business cycle as a leading indicator for the euro area', Euren Spring Report 2002, pp. 65-70

Chart B-3.1. Normalised cyclical components of euro area and Belgian GDP, and NBB business survey indicator



Source: EUROSTAT, Belgian Institute of National Accounts, National Bank of Belgium, Euren, Federal Planning Bureau

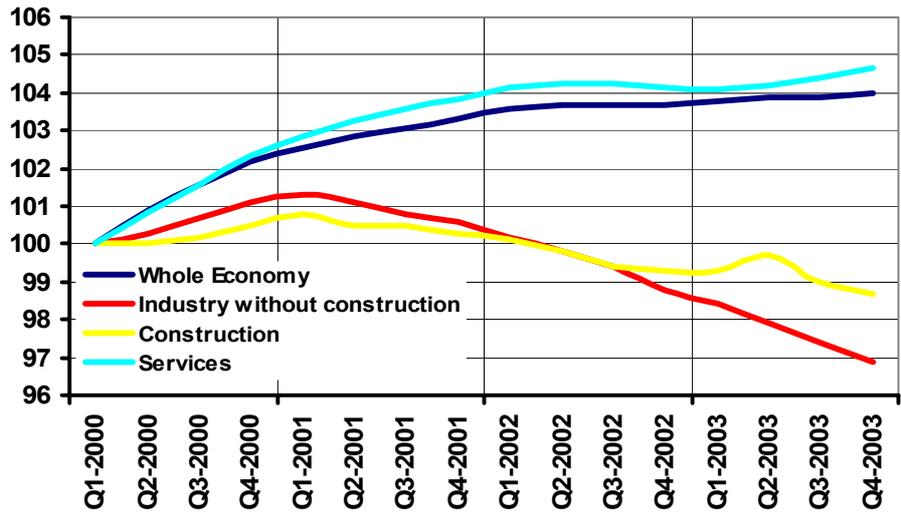
Finally, the OECD composite indicator for the euro area has been rising since April, having reached a level of 123.9 in March 2004 compared with the 115.3 in March 2003. Three successive rises in the indicator are normally considered to signify a turnaround in economic activity. Taken together, all these forward-looking indicators seem, therefore, to confirm that an upturn in activity is underway, driven by improved export performance and business confidence.

Employment, unemployment and labour costs

On the whole, the European labour market continues to be stagnant. Disregarding seasonal factors, total employment growth remained flat in both the third and the fourth quarters of 2003 (Chart 3.6), while the rate of unemployment climbed from 8.9 to 9.0 (Chart 3.7). A closer look at sectoral employment trends show that this is the result of a marked decline in industry as well as in construction. This is compensated by an increase of employment in the services sector, once again leading employment growth as it did before the 2002 economic slow down. This upward swing of services employment

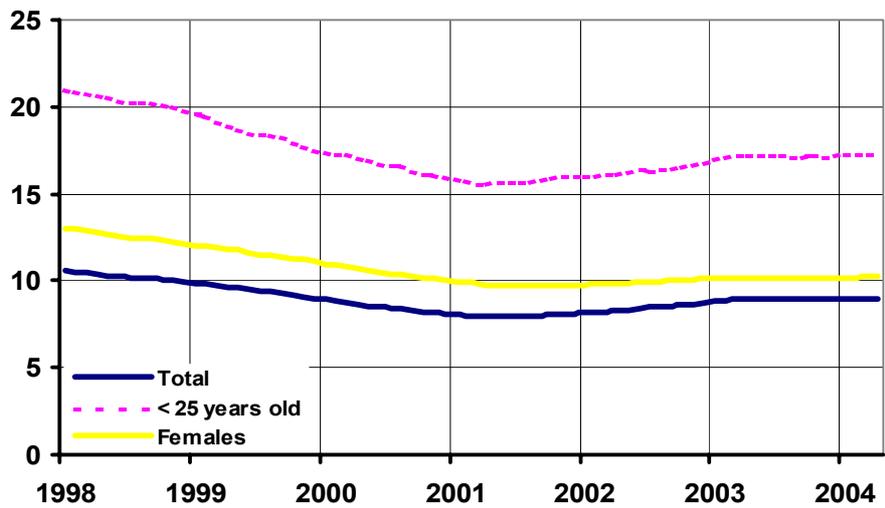
raises the initial positive expectations in the new European recovery process.

Chart 3.6. Employment by economic sector in the euro area
(Quarter on quarter percentage change; indices:Q1-2000=100, s.a.)



Source: ECB

Chart 3.7. Unemployment rate in the euro area



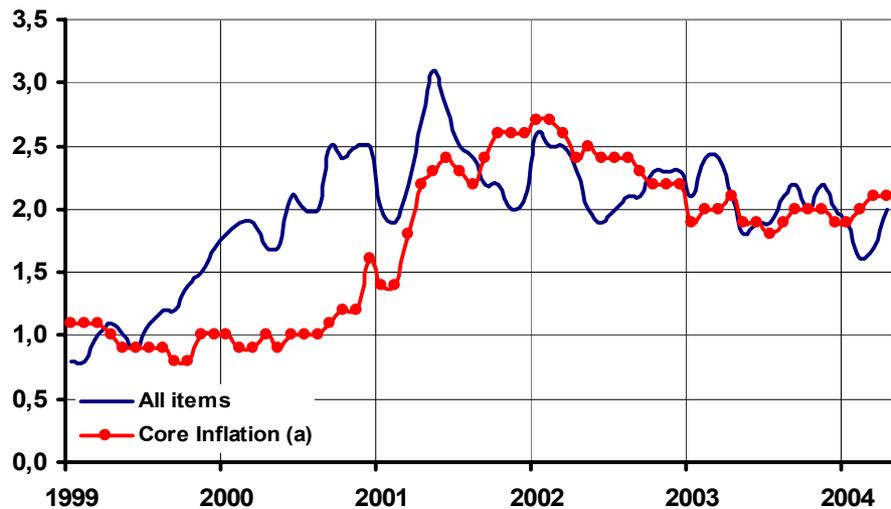
Source: EUROSTAT

Price developments

Since the inflation rate (CPI) peaked at 2.4% at the end of 2003q1, a steady decline has seen the level fall below 2% in 2004Q1. Core inflation has been fluctuating at rates between 2.2% and 1.8% for the past 20 months. The ECB's 2% target ceiling has never been seriously compromised during that period.

Recent events to May 2004 are however likely to modify this picture: mainly thanks to oil price increases the CPI inflation of the euro area has reached 2.5%, although core inflation is still below 2%. This surge in headline inflation is unwelcome as it undermines consumers' purchasing power just when prospects were looking up for household expenditure.

Chart 3.8. Inflation in the euro area
(12-month % changes)



(a) excluding energy and fresh food

Source: EUROSTAT

**Monetary
Policy:
unchanged
interest rates
in 2004**

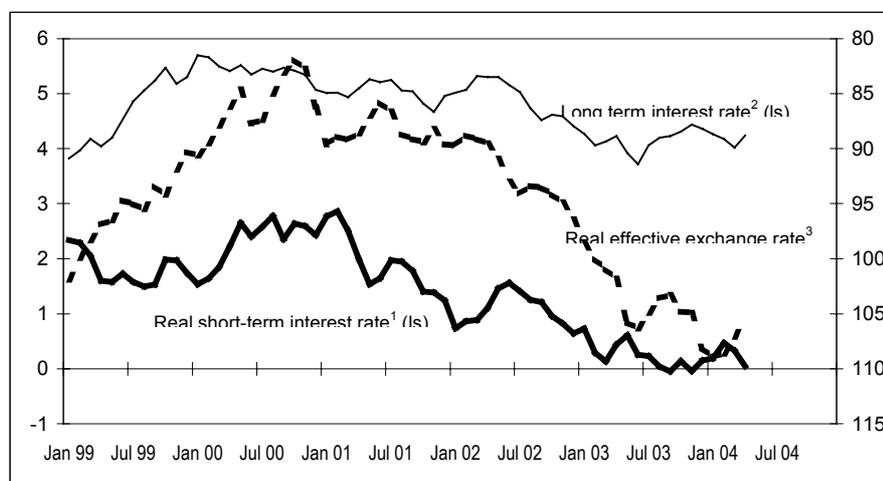
Part II - EUREN forecast for 2004 and 2005

a) Policy assumptions

Since June 2003, the ECB has kept its key interest rate unchanged. On the one hand, inflation has been broadly in line with the ECB's definition of price stability in this period, while on the other hand, M3 continues to grow above its reference value. This is perceived as a possible sign of an increased risk of higher inflation in future. Furthermore, the appreciation of the Euro against the dollar appears to have stalled and even reversed slightly, while economic perspectives brightened, meaning no further cut in interest rates was necessary.

Monetary conditions in the euro area continue to be favourable (chart 3.9): Real short term interest rates are still close to zero, long term rates remained more or less unchanged and the Euro has strengthened again, after the short period of devaluation in the second half of 2003.

Chart 3.9. Monetary conditions in the Euro area

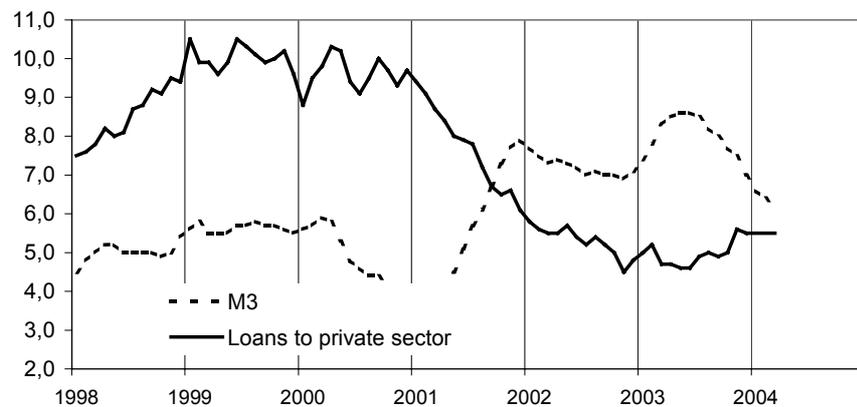


Source: ECB – ¹Deflated with HICP. – ²10 years government bond yields – ³CPI-Deflated, narrow group of countries. Scale inverted

In our forecast, we assume that the ECB will keep its key interest rate unchanged this year. The recent pick up of inflation rates reflects the oil price rise and should not be interpreted as a violation of the inflation target. As there is spare capacity, there is little risk that the energy price hike will translate into higher wages. Furthermore, the expansion of M3 slowed considerably recently, and loans are still rising only at a moderate rate. Thus, price stability seems not to be at

risk in the medium term (chart 3.10). This should help the ECB to keep its current line. Next year, when growth is more solid, the ECB could take first steps to prevent inflationary pressure in the upswing by raising the key interest rate. The EUREN institutes expect a rise of 50 basic points in total. However, the ECB could react earlier and stronger if there are signs that the oil price hike will lead to second-round effects (see Chapter 4, for a special study on oil price effects).

Chart 3.10. Euro Area – M3¹ and loans (yoy percentage change¹)



Source: ECB – ¹M3: three months moving average

Table 3.1. Stability programs: goals and forecasts compared (budget balances as % of GDP¹⁾)

Countries	Data			Stability Programs			EC			IMF			OECD		
				Dec 2003			Apr 2004			Apr 2004			May 2004		
	2002	2003	2004	2004	2005	2005	2004	2004	2005	2004	2004	2005	2004	2004	2005
Austria	-0.2	-1.0	-0.7	-0.7	-1.5	-0.2	-0.6	-0.2	-0.2	-0.9	-1.7	-1.3	-1.7	-1.7	
Belgium	0.1	0.2	0.0	0.0	0.0	-0.4	-0.4	-0.4	-0.4	-0.1	-0.1	-0.2	-0.7	-0.7	
Finland	4.2	2.4	1.7	1.7	2.1	1.7	1.7	1.9	1.9	2.0	2.1	1.6	2.1	2.1	
France	-3.1	-4.2	-3.6	-3.6	-2.9	-3.8	-3.8	-3.6	-3.6	-3.9	-3.2	-3.8	-3.6	-3.6	
Germany	-3.5	-4.2	-3 ¼	-3 ¼	-2 ½	-3.9	-3.9	-3.4	-3.4	-3.5	-3.1	-3.7	-3.1	-3.1	
Greece	-1.2	-1.7	-1.2	-1.2	-0.5	-2.4	-2.4	-2.3	-2.3	-2.7	-2.5	-3.2	-2.9	-2.9	
Ireland	-0.2	-0.9	-1.1	-1.1	-1.4	-1.2	-1.2	-1.1	-1.1	-0.9	-1.0	-0.5	-0.8	-0.8	
Italy	-2.3	-2.6	-2.2	-2.2	-1.5	-2.8	-2.8	-3.5	-3.5	-2.9	-2.8	-3.1	-3.9	-3.9	
Luxembourg	-2.4	-0.6	-1.8	-1.8	-2.3	-2.1	-2.1	-2.5	-2.5	-2.6	-3.1	-1.8	-2.5	-2.5	
Netherlands	-1.6	-2.6	-2.3	-2.3	-1.6	-2.7	-2.7	-2.4	-2.4	-3.0	-2.7	-3.1	-2.9	-2.9	
Portugal	-2.7	-2.9	-2.8	-2.8	-2.2	-3.3	-3.3	-3.9	-3.9	-4.2	-4.0	-3.8	-3.2	-3.2	
Spain	0.1	0.0	0.0	0.0	0.1	0.1	0.1	0.2	0.2	0.4	0.5	0.3	0.5	0.5	
EU-12	-2.2	-2.8				-2.7	-2.7	-2.7	-2.7	-2.8	-2.4	-2.8	-2.7	-2.7	

Source: EUREN

**The
credibility of
fiscal policy
seriously in
danger**

In 2004, it's inevitable that Germany and France will violate the Stability and Growth Pact (SGP) again. Furthermore, Portugal, Greece, Italy and the Netherlands plan deficits close to the 3% threshold and many forecasters assume they will surpass the margin too. In the case of Italy, the European commission asked for an early warning procedure, and it initiated an excessive deficit procedure against the Netherlands. In 2005, the cumulative deficit is expected to be nearly the same as in 2004. Whereas Germany and France will reduce deficits, they are expected to rise in some other countries. Even for Belgium and Spain, where budgets were balanced in 2003, we forecast a slight deficit.

Thus, the credibility of fiscal policy is seriously in danger; economic conditions in the euro area are improving and this time around governments cannot claim that the deficits are rising for business cycle reasons. As the Commission's forecasts show, Germany and France will not reduce the cyclical adjusted deficit to the extent they announced in the stability programmes; whereas this measure is even expected to rise in Italy, Portugal and Greece.

In the past, some countries were quite ambitious to reduce deficits, but their plans were counteracted by slow growth, as was the case in Germany. Other governments made the point that consolidation would be pro-cyclical under the bad business cycle conditions and therefore did not even try to consolidate their budgets. Now, as an upswing has started, fiscal policy must be more ambitious. In our view, to increase credibility, the countries with high deficits should reduce the cyclical adjusted deficit by at least ½ percentage point of GDP.

**Germany:
Fiscal policy
will be less
restrictive**

In Germany, fiscal policy will be less restrictive in 2004 than it was in the years before. On the one hand, subsidies were cut, taxes on tobacco were raised and pensions will not rise. Furthermore, thanks to reforms in the health insurance system, expenditures have been shifted from the state sector into the private household sector. On the other hand, income tax was reduced. All in all, the cyclical adjusted deficit will be reduced by 0.4% in relation to GDP. Even this reduction is at risk, as it is not granted that receipts from the amnesty for tax exiles bringing back their capital to Germany will reach the magnitude underlying this forecast.

For 2005, a couple of measures are already in force that will have an impact. There will be another reduction of subsidies, and the tax base

will be broadened, but also income tax will be reduced once more. In total, this will result in another reduction of the structural balance by 0.3% of GDP. This is less than promised to the European Commission, but it is not very likely that the government will take additional measures

France: The 3% threshold will be hard to reach

The French fiscal situation is still in line with events in Germany. The imbalances of the French public finances increased again in 2003 with a public deficit of 4.1% of GDP against 3.1% in 2002. In this context, with GDP growth slightly below potential this year, it will be impossible for the French government to reach the objective defined with the European authorities, of a deficit under the level of 3% of GDP in 2005.

In 2004, fiscal policy should be slightly restrictive thanks to increases in indirect taxes and decreases in social expenses (especially in the health system), which will be compensated only partially by income tax cuts and an increase in the employment bonus (the so-called prime pour l'emploi). As the cyclical impact on the deficit will not help to reduce the imbalances, the fiscal deficit should stabilise around 4% of GDP in 2004.

The situation will be quite similar in 2005. There will be a modest reduction of the deficit, reflecting a mildly positive cyclical impact. But the cyclically adjusted deficit won't decrease a lot. On the expenditure side, the budget for next year should severely constrain health expenses, unemployment benefits, and the public sector payroll. But it will be difficult to obtain a significant slow down of spending as the government has recently defined new priorities (research, social cohesion, etc.). The deficit also won't be helped by a decrease of some social contributions (for hotels and restaurants). Recently, the government has declared that the initially promised tax cuts may be delayed. Furthermore, the new minister of finance has announced some measures to decrease the deficit (selling the gold of the Banque of France, privatising some public companies). But we don't believe this will have a significant impact on the fiscal deficit. Moreover, it is still unclear if various measures aimed at encouraging a cut in the households saving ratio (fiscal cuts for interests payments) will really stimulate private consumption.

Belgium: Structural deficits ahead

In 2003, the Belgian public balance reached a small surplus of 0.3% of GDP. During the forecasting period, Belgian fiscal policy has a clearly expansionary stance that is leading to a marked deterioration in public accounts. Though the cyclically adjusted budget balance

should remain slightly positive in 2004 (+0.1% of GDP), in effective terms, without corrective measures, the budget is expected to turn in a small deficit of 0.3% of GDP in 2004 and the net financing requirement is anticipated to widen to 1.2% in 2005. Cyclically adjusted, the budget balance deficit is expected to be 1.1% next year.

The reappearance of public deficits mainly reflects new structural measures affecting both public income and expenditure. Those measures are leading to significant increases in social expenditure and income tax rebates between 2003 and 2005.

In the context of the personal income tax reform (decreases in the rates of withholding earned income tax and decreases in social security contributions), and despite an increase in indirect taxes, the total taxes and social security contributions are expected to decrease (all other things being equal) by 0.5% of GDP during the period 2003-2005.

Social policy measures in place consist of adjustments to the welfare system affecting certain benefits: in particular, an increase for older pensioners and people with long-term disabilities and increases and wage indexation of ceilings in disability insurance.

The public primary surplus is expected to fall from 5.8% of GDP in 2003 to 3.6% of GDP in 2005. This decline will not be compensated by the reduction from 5.5% of GDP in 2003 to 4.8% in 2005 of the interest burden on the public debt. The new deficits mainly stem from Entity I (federal government and social security). Entity II (Communities, Regions and local authorities) are expected to continue to report a positive financing capacity throughout the projection period.

**Italy: Deficit
will surpass
3 % of GDP**

Without additional measures, the Stability Program objective of a net financing capacity of 0.3% of GDP in 2007 will not be attained. Nevertheless, the total public debt to GDP ratio is still in decline, projected to fall from 100.7% in 2003 to 88.9% in 2007.

In the Treasury's Quarterly Report (Relazione trimestrale di cassa, April 2004) the government made official new forecasts on public finances, overriding the estimates contained in the update of Italy's Stability programme from December 2003. The assumption on GDP growth was reduced from 1.9 to 1.2% and the deficit to GDP ratio increased from 2.2% to 2.9%. This result assumes the 2004 budget

manoeuvre is completely fulfilled. The 2004 budget measures should improve the public administration account by approximately €12 billion. Revenues are expected to rise by €13.7 billion, thanks, above all, to public real estate sales, an amnesty for past building violations and fiscal settlements. Expenditures are expected to drop by €1.8 billion, reflecting, above all, to a block in labour turnover in the public administration and the effects of the transformation of the Cassa Depositi e Prestiti (a public savings and loans institution) into a private company. Lower revenues are predominantly expected from some tax cuts, and greater expenditures from less burdensome public labour contract renewals. One-off measures also represent a relevant part of budget manoeuvre this year.

Our forecast is that the deficit will be around 3½% of GDP. This assessment is based on the assumption that only the one-off measures will be successful this year. For 2005, our forecast for the general government deficit is based on legislation currently in force (no policy change assumption). Under this assumption the deficit is projected to rise to 4.1%, reflecting the phasing out of all one-off measures.

Until now Italy has maintained its net borrowing requirement below the 3% ceiling (2.4% in 2003), even though some worries seem to be emerging for 2004 and 2005 as outlined above. So, differences between the actual 2003 budget balance and the Italian target, as well as the new forecast of the European Commission, which projected the deficit/GDP ratio around 3.2% in 2004 and 4% in 2005, indicate in the opinion of the European Commission the presence of structural problems in the Italian economy. The Commission has therefore asked Ecofin to send Italy an early warning. After the Italian government declared it would keep the deficit under control, even if it required extraordinary measures, the discussion at Ecofin has been postponed to the 5th of July. Italy is partly counting on its position being viewed favourably given the previous Council recommendation handed down on France and Germany last year, which blocked the excessive deficit procedure for the 2002 financial results.

The attempt to accompany rigor with interventions directed at favouring economic growth characterises the government's stance for 2004; but such as tax amnesties and securitisations but all in all, the current budget package has a neutral impact on the economic cycle.

In 2003, Spain achieved a small fiscal surplus, of 0,5% of GDP, for the first time in the last 30 years. It was made possible by an

**Spain: turn
into a slight
deficit**

increase in tax revenues to GDP of 0.8 percentage points; this increase mainly comes because of higher receipts from indirect taxes and social contributions. The overall picture was also helped by a small decrease in interest payments of 0.5% of GDP.

It is still too early to fully evaluate fiscal policy in 2005, as the new budget will be presented in September. Nevertheless, some announcements made recently by the Minister of Economy and Finance, Mr. Solbes, suggest a deterioration in the fiscal balance this year. These announcements refer to an additional expenditure of about 0.4% of GDP to cover some delayed transfers to regional governments (Andalusia) and other expenditures related to public TV channels cumulative debt, that account for 0.1% of GDP.

Looking ahead to next year's budget, although the specific numbers are still unknown, some trends can be deduced from a quick reading of the Socialist party's electoral programme, announcing additional cuts of direct taxes and higher expenditures for social policy and R&D. This could result in a slight increase of the Spanish fiscal deficit over the next few years.

Anyway, Pedro Solbes, has announced, in his own words, "probably not all this electoral compromises should be included in this first budget", because of his ambition of maintaining fiscal stability across cycle.

b) Forecast summary

In general terms, EUREN has a positive assessment of 2004, as a year of increasingly robust recovery in the euro area, but is more cautious about 2005 expectations.

The main elements considered in the scenario for 2004 are the following and were developed in detail in Chapter 1:

- World trade and world GDP are expected to speed up, stimulated by high economic growth in the USA, China and Japan; the growth rate of world trade volumes should reach some 9% for the year; this growth of world demand implies an important export stimulus for the EU, and will likely push up European industry, specially in sectors characterised by quality and technology rather than by price competition (in our central

The European recovery is strengthening in 2004 but is again at risk in 2005

scenario the \$/€ exchange rate remains at the still relatively high average level of 1.21 for the year).

- The oil price returns to more reasonable market equilibrium levels, closer to 30 US\$ pb, Brent threshold (EUREN estimates the 2004 average price at 32 US\$ pb) and consumer prices grow at 2.1%, only slightly above the ECB target for inflation.

Moving into 2005, the EUREN scenario brings more uncertainties and some factors of restraint:

- Further increases of interest rates will be seen in the US to keep inflation under control and to avoid demand overheating; China should follow the same path and Japan, after its impressive cyclically induced recovery is expected to slow somewhat; as a result world trade and economic growth are expected to decline slightly after the euphoria of 2004.
- A dollar strengthening against the euro (the \$/€ rate is expected to average 1.15 in 2005), and possible ECB interest rate rises, also will put a dampener on both the investment climate and consumer expectations in the euro area.

Table 3.2 portrays the macroeconomic projections associated with the EUREN central forecast for 2004 and 2005.

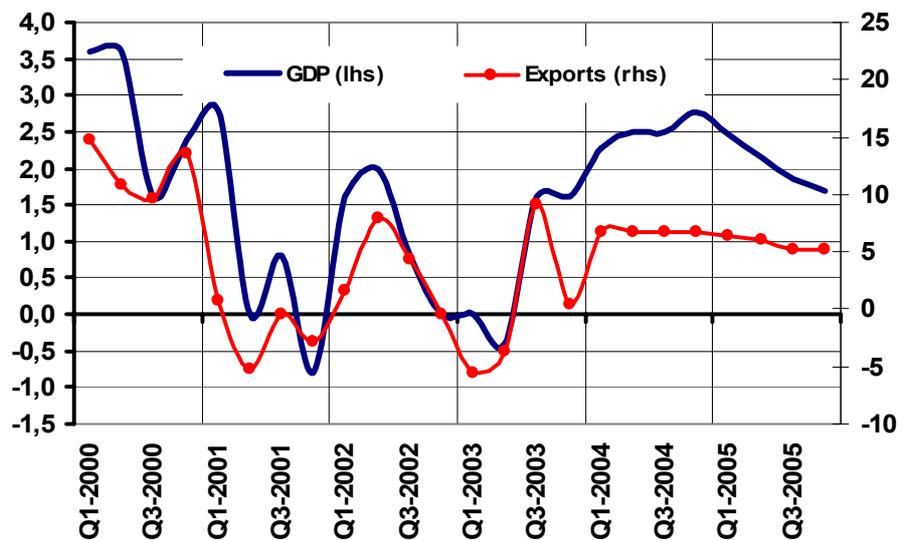
The GDP growth rate jumps from 0.5% in 2003, to 2.2% in 2004 and to 2.4% in 2005. But a look at the quarterly profile helps to better describe the risks associated to the change in conditions assumed in the 2005: the annualised GDP growth rate rises to 2.8% in the last quarter of 2004 and progressively slows down to 1.7% a year later (Chart 3.4). In this context, most probably, the euro area would be again heading for stagnation in the following years, unless there were new developments with boom-like characteristics in the world economy during 2005.

An export driven model for EMU lacks resilience.

What underpins these forecasts and the drop in growth rates a couple of years hence, is a concern about the lack of resilience of the euro area economy. This is a return to the behaviour in 2001-2002; the growth model of the region is heavily dependent on developments in the US and the world economy, and requires very favourable circumstances to be successful. It should be remembered that in 2001, the EU was ready to be a world economic locomotive after achieving a 3.5% GDP growth rate in 2000, an inflation rate below 2%, and budgetary equilibrium. But domestic demand proved insufficient to compensate for the slowdown in world demand and the European

economy returned to less ambitious objectives. Indeed, consumer spending in the euro area seems almost permanently subdued, despite accommodative policy.

Chart 3.11. GDP and exports growth rates (Annualised q/q % change)



Source: EUREN

Box 3.2 COE Leading indicator for the euro area

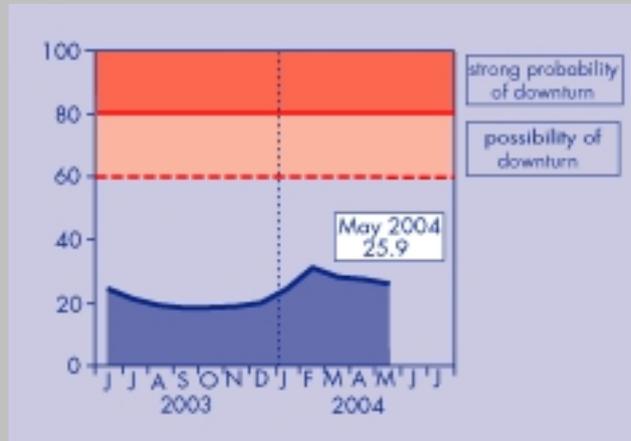
With annualised growth rate of 2.4%, growth in the euro area was back over its trend growth rate (around 2%) in the first quarter of 2004 as predicted by the COE leading indicator since August 2003. The leading indicator is now used to anticipate the next growth cycle peak. Despite a small deterioration in the US leading indicator at the start of the year, the euro area remained in May 2004 (when the reading was 25,9) below the first threshold of 60, which would need to be over-passed to send a signal of possible downturn in the next nine months. Therefore, the COE leading indicator shows a clear confirmation of a future growth persistently above its trend growth rate.

Components of the COE leading indicator for the euro area:

- A synthetic index of the euro-area industrial survey (intermediate goods sector)
- An indicator of the interest rate spread in the euro area
- A weighted aggregate of major stock indices in the euro area
- An indicator of the wholesale price index of the euro-area

Chart B-3.2.

Growth cycle leading indicator:
Search for the next peak



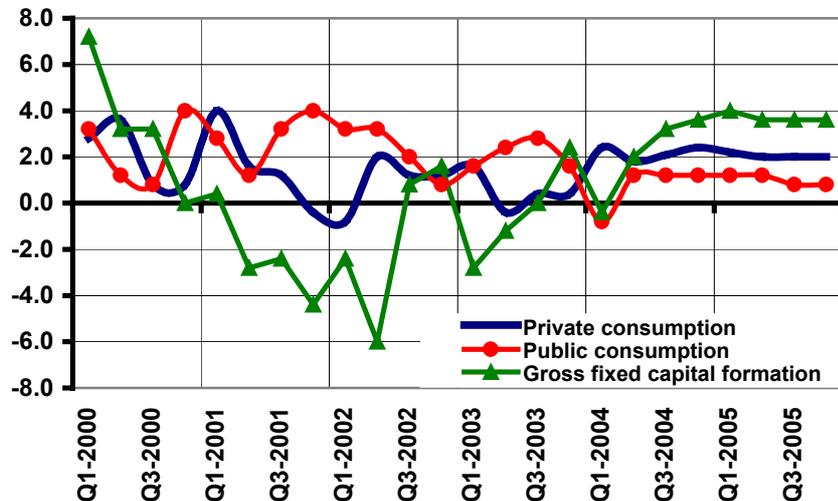
Source: COE

With high oil prices the euro area may totally miss the recovery.

To this (rather) structural factor that keeps down growth expectations for 2005, should be added the reasonable risk associated with oil prices – a factor developed in the special study in Chapter 4 of this report. Should the oil price continue to move upwards, perhaps by 10 \$/bl for 2005 (thus with an average price of 42 \$/bl for 2004 and 38\$/bl for 2005 as in the modified assumptions of EUREN scenarios), the GDP loss in the EMU area could be as high as –0.3% in 2004 (bringing down the EUREN projection to 1.8%) and –0.4% in 2005 (again reducing the projection to 2.3% for the year). In this (hopefully unlikely) context, the current recovery of the world economy would probably go totally unnoticed in the euro area.

For EUREN, the probability of a permanently high oil price is low - world supply could reasonably meet all demand growth contemplated for 2004 and 2005; furthermore, the current risk premium should decrease with greater political stability in Iraq, and this is why the basic scenario adopted is also assumed to be the one with the highest a priori probability.

Chart 3.12. Domestic demand components (Annualised q/q % change)



Source: EUREN

The inspection of table 3.2 and chart 3.12, which outlines EUREN projections, raises some additional issues:

- Public consumption, supported by a Keynesian stimulus during the 2001-2003 slowdown, is now expected to grow well below the GDP rate as a result of increasing budgetary consolidation; while the GDP public deficit of the euro area is still close to the 3% level, some member countries have had to adopt stabilisation measures, and the final outcome is a rather restrictive expenditure policy.
- Gross fixed capital formation was declining in 2001-2003 and is now expected to change sign in 2004 and even to expand above the GDP growth rate in 2005; these positive expectations for gross investment, while still very moderate (they only imply reaching the 2000 real levels by mid-2005) are to be associated with the overall recovery and are anticipated by EUREN to start to be noticed in the second quarter of 2004, following the positive change in consumer spending already observed in the first quarter.
- Exports grow fast, at rates close to 6%, but insufficient to avoid a loss of share in world trade (as the shift towards Asia continues); a decline of the exports growth rate, in line with the world trade scenario, starts to be perceived in 2005q1.
- Imports, which of course are mainly dependent on the evolution of domestic demand, are expected to grow faster than exports in the second half of 2004 and in 2005, and consequently the

The expected euro area growth path offers few surprises.

positive stimulus of foreign trade in 2004, that was a characteristic of the European growth model in the slowdown, disappears with the recovery.

- The unemployment rate is expected to remain constant in 2004 and to improve very slightly in 2005, thus confirming the very mild nature of the expected recovery.
- As to the evolution of prices, as already mentioned, EUREN considers the oil price effects on cost pushed inflation to have a limited time effect, felt only in 2004q2 and 2004q3, with the headline figure for inflation returning below the 2% ECB target soon after. In this view, EUREN is in line with the ECB survey of Professional Forecasters (April 2004) with over 70% of the consulted analysts believing future CPI-EMU averages will be below 2% in 2004, 2005 and even 2008.
- Finally, compensation per employee is not expected to induce any price-wage spiral connected to the oil price effects and is closely associated with the evolution of the recovery, with a slight acceleration in 2005.

The EUREN scenario and its quantified projections (Table 3.2) clearly translate a European economic climate of stability with sound fundamentals and reasonable prosperity.

The EMU trails the rest of the world in terms of growth, but it leads the rest of the world in terms of equilibrium conditions – there are no major imbalances to worry about. The continuous strength of the euro, most probably overvalued in relation to purchasing power parities, supports this argument.

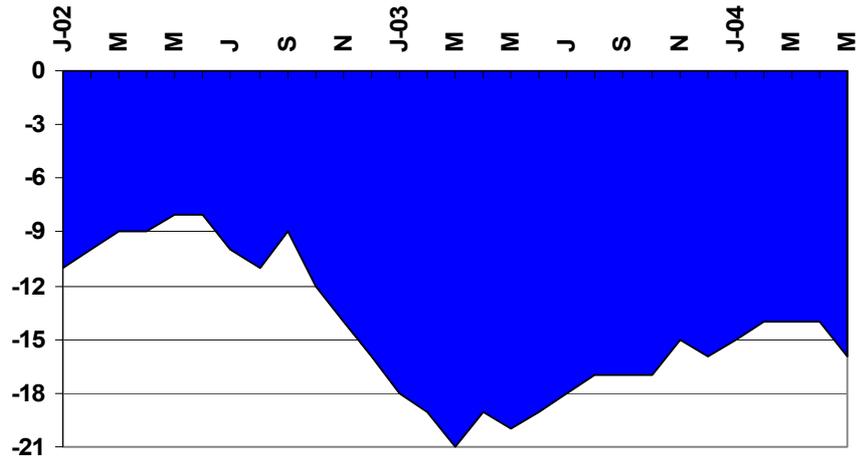
Of course, this stability and lack of risk taking investment is associated with relatively high unemployment levels, but the social framework seems to be able to function adequately in these circumstances. It is however evident that under these conditions the euro area is missing most of the positive aspects of the ongoing world economic recovery.

While the estimates show consolidation in 2004, is there an alternative way of looking at 2005? This question could be reworded in the following way: is there an alternative growth model for the euro area, with an internal growth engine more resilient, more able to resist to changes in the international environment? As the current model is heavily export dependent, is there a way of stimulating the dynamics of domestic demand?

Is there a new growth model in the backyard?.

In the present context, the starting point of this alternative arises from the unanticipated surge of consumer expenditure in early 2004, and the slow but continuous increase of consumer confidence since early 2003, as there is no strong evidence of expanding employment and disposable income, that could give further support to this evolution.

Chart 3.13. EMU: Consumer Confidence Index



Source: EUROSTAT

The increase of household spending, if confirmed during the next months, could correspond to a move towards less conservative behaviour and more risk taking by the households, characteristics that are a necessary feature of any rapid growth process, and are already evident in the case of the British economy (see part III of this same Chapter).

From there on, the steps of a multiplier-accelerator process are well known. Stimulated by consumer market expectations, the need for building new production capacity pushes investment, production, employment and income.

Should the second and third quarter estimates for consumer spending (+1.8% and +1.2% respectively for annualised growth rates) prove to be too conservative, the investment estimates for the third and fourth quarter will also in all probability be too low.

The probability of this alternative scenario is at the moment rather low, but the European economy seems to be moved essentially by “animal spirits” and a sudden change from euro-pessimism to euro-optimism should never be excluded. Analysts should be looking with full

attention to the forthcoming data in consumer expectations and retail sales. There are upside risks to our forecast as well as downside.

Investment seem to play the differentiating role in the current cycle: positive entrepreneurial expectations are considered to be more favorable in the USA, Japan or China, the growth engines, than in the EU even if the enlarged Europe offers new challenging opportunities.

The Autumn of 2004 could offer a very different prospect for industrial investors, should the oil price return to lower levels, confidence be restored in Euro and if there are indications of stronger private expenditures during the summer.

Even a decrease of ECB interest rate, discarded for the moment, could then appear as part of the growth message Europe needs.

Table 3.2. Euro area Forecast

	2001	2002	2003	2004	2005	2004 I	2004 II	2004 III	2004 IV	2005 I	2005 II	2005 III	2005 IV
	q-t-q, saar (unless otherwise indicated)												
Private consumption	1,7	0,5	1,0	1,5	2,1	2,2	1,8	2,1	2,4	2,2	2,0	2,0	2,0
Public consumption	2,5	3,0	2,0	1,0	1,1	-0,9	1,2	1,2	1,2	1,2	1,2	0,8	0,8
Gross fixed capital formation	-0,3	-2,8	-0,8	1,3	3,6	-0,5	2,0	3,2	3,6	4,0	3,6	3,6	3,6
Domestic demand	1,0	0,4	1,2	1,7	2,5	0,8	2,1	2,5	2,8	2,7	2,4	2,2	2,1
Exports	3,4	1,5	0,1	5,3	6,4	6,7	6,7	6,8	6,8	6,4	6,0	5,2	5,2
Imports	1,7	0,3	1,9	4,7	7,1	3,0	6,0	7,2	7,2	7,2	6,8	6,4	6,4
GDP	1,6	0,9	0,5	2,2	2,4	2,3	2,5	2,5	2,8	2,5	2,1	1,8	1,7
Unemployment (% of labour force)	8,0	8,4	8,8	8,8	8,6	8,8	8,8	8,7	8,7	8,6	8,6	8,5	8,5
Compensation per employee ¹ , yoy	2,1	2,7	2,5	2,3	2,5	2,2	2,3	2,4	2,4	2,5	2,5	2,5	2,5
Consumer price (HICP), yoy	2,3	2,2	2,1	2,1	1,7	1,7	2,3	2,4	2,0	1,8	1,6	1,6	1,7
Current account balance (%GDP)	-0,2	0,9	0,4	0,4	0,3	-	-	-	-	-	-	-	-
3m interest rates (% per annum)	4,3	3,3	2,3	2,1	2,5	2,1	2,1	2,1	2,1	2,3	2,3	2,6	2,6
10y Gvt bond yields (% per annum)	5,0	4,9	4,2	4,4	4,8	4,1	4,4	4,5	4,6	4,7	4,7	4,8	4,9

EUREN estimates-¹ Seasonally adjusted

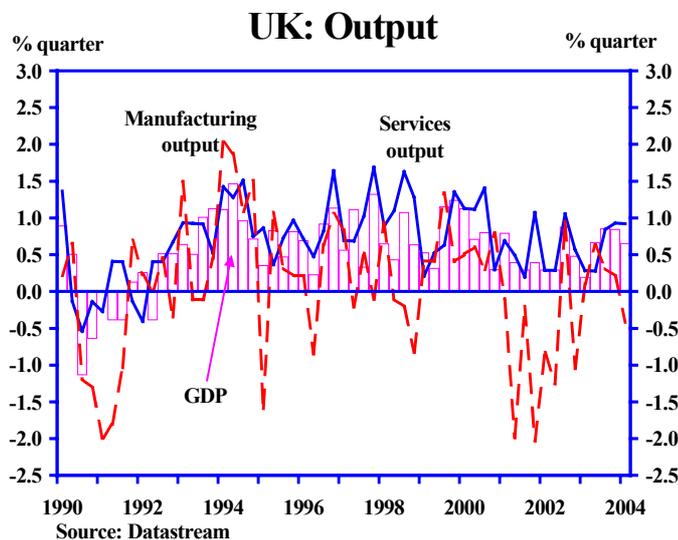
² Annual growth rate for 2004 includes and additional working days effect of 0,2%

Part III. The UK economy

Growth surprisingly subdued in 2004Q1...

Official statistics suggest that UK economic growth was surprisingly subdued in early 2004. GDP is estimated to have risen at an annualised rate of 2.5% in Q1, in line with our estimate of trend growth but down from 3.7% in 2003Q4 and 3.4% in Q3. Nevertheless, interest rates now look set to rise above 5% over the next year, following the Bank of England's May Inflation Report, which projected CPI inflation over 2% in two year's time.

Chart 3.13.



But service sector activity remained strong in Q1, rising 0.9% to a level 2.9% higher than a year earlier, despite a fall in output in the transport and telecommunications sector. Output rose 1.5% in the distribution, hotels and catering sector, as consumer demand remained strong and the number of tourist visits continued to recover, while business service and finance sector output was up 1.3% as a result of strong demand for computing, banking and real estate services. Construction sector output also remained robust, rising 0.8% in Q1 to a level 8.5% up on a year earlier.

...with industry back in recession

In contrast, the industrial sector was in recession again, with production falling 0.6% on top of a 0.1% fall in Q4. In part, this reflected weak energy output, most notably a decline in North Sea gas production. But manufacturing output also dropped 0.5% in Q1 – reversing most of the recovery seen through the second half of last

year – with particularly sharp falls in production of computers, engines & turbines and in the publishing sector.

The falls in manufacturing output so far in 2004 reported by the ONS contrast markedly with the strong signals from business surveys. For example, the purchasing managers' index (PMI) has been well above 50 since last autumn, which is usually taken to indicate that activity is increasing. And the CBI and BCC surveys have also been very positive.

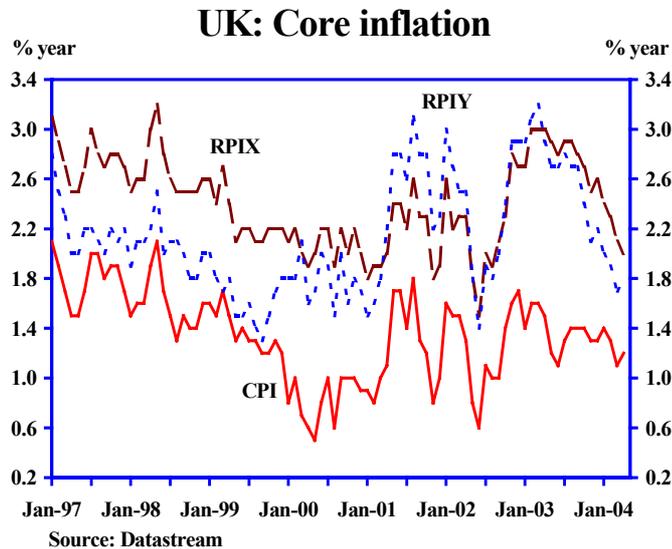
Caution does need to be exercised when interpreting such surveys. For example, while there is a correlation between the PMI and manufacturing output, the relationship is by no means close: the PMI explains only a fifth of the variance in manufacturing output growth, and it 'predicted' a sharp recession in the late 1990s and a boom in early 2002, neither of which transpired. Similarly, the CBI business confidence indicator has given 'false' recession signals in recent years.

Other evidence, however, suggests that the Q1 GDP data are understating the strength of the economy. Domestic demand rose 1% in real terms in Q1, with overall growth pulled down only by a fall of over 2% in exports – very unlikely given the boom in the world economy and most likely the result of recent changes to systems for collecting export data. Moreover, the labour market has remained very buoyant, with employment rising 195,000 (0.7%) in Q1 according to the LFS and unemployment falling almost 50,000 on the ILO definition. And retail sales in the three months to April were 1.6% up on the previous three months and 6.3% up on a year earlier. Our forecast therefore continues to show GDP rising by over 3% in 2004.

Inflation risks exaggerated

It is this strong growth outlook, rather than the recent spike in oil prices, that mainly accounts for the MPC's more pessimistic view about inflation prospects. It expects output to move from a position just below productive potential currently to one where it is somewhat above potential over most of the next two years. Our own view, however, is that the economy has more spare capacity than the Bank estimates, reflected, for example, in the still modest level of private sector pay settlements, which fell to 2.9% in the three months to April according to the IRS survey. Inflation may rise in the short term as petrol prices increase. But we continue to expect policy to be slightly biased, so that the CPI remains below 2% throughout our forecast.

Chart 3.14.



What could go wrong?

OEFC's forecast for the UK economy is very similar to the Chancellor's forecasts published in the Budget, with GDP expected to rise by 3.1% this year and inflation continuing to undershoot its target on the new CPI measure of inflation. But how secure is the situation? There are at least four key risks to the economic outlook.

The UK economy has been very dependent on consumers to sustain growth over the last few years, following the collapse of the high-tech investment boom and subsequent downturn in the global economy. Fortunately, consumers have been very willing to oblige. Indeed, demand has continued to boom over the last year despite the increase in national insurance contributions in April 2003 and rising interest rates. While overall consumption was flat in 2003Q1, it rose at an annualised rate of over 3% in Q2 and around 3½% in both Q3 and Q4.

Strikingly, however, this strong spending was underpinned by rising household disposable incomes – up at an annualised rate of over 7% in 2003Q2 (at the time NICs went up!) and close to 3% in both Q3 and Q4. As a result, the saving ratio actually rose through last year, to 6% in Q4 from 4.8% at the end of 2002.

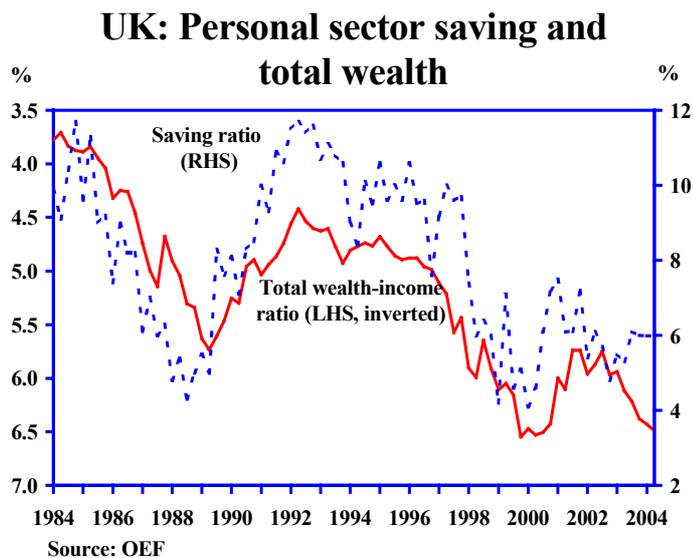
So, the consumer boom continues to be essentially income- rather than debt-financed. Certainly, households are borrowing heavily.

But they are also increasing their savings at the same time, both in property and in financial assets. In part, the recent increase in the saving ratio may be a response to the fall in equity prices since the peak of the dot.com boom in 2000, as households have been seeking to rebuild their financial wealth.

Consumer spending could surge, rather than slow

The chart below shows the relationship between household saving and the wealth-income ratio (which is on an inverted scale). Looking forward, this chart suggests the potential for a marked surge in consumer spending. The strong growth seen in house prices over the last year, coupled with some recovery in equity prices, has pushed the household wealth-income ratio to record levels. On this basis, we might expect the saving ratio to fall sharply over the next year, possibly to 4% or even less.

Chart 3.15.



Such a fall in the saving ratio on top of continued strong income growth – boosted by rising employment and a rebound in bonus payments – would imply overall consumer spending growth of 4-5% over the next year, much stronger than our central forecast of 3-3½%. So, there is a risk that the consumer boom is not coming to an end but is about to intensify!

Part of the caution in our forecast for consumer spending reflects the increase in interest rates we expect over the next year, to 5.25%. Indeed, it is the impact of this monetary tightening on consumption that accounts for the slowdown in GDP growth we are forecasting for

2.8% in 2005. But with the risks to consumer spending looking heavily skewed on the upside, there is also a clear upside risk to interest rates.

How overvalued are house prices?

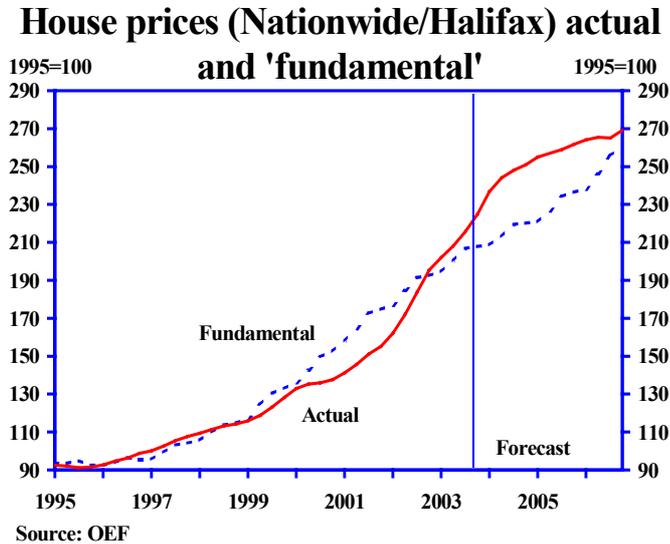
Could house prices crash?

While the risk to consumer spending looks to be upside, there is growing speculation that house prices are on the brink of a major collapse, with some commentators predicting a fall of as much as 30% over the next few years. Certainly, the acceleration in house price inflation in early 2004 does imply that house prices are getting further away from levels justified by economic fundamentals. But just how overvalued are house prices now?

To answer this question, we have compared the actual profile of house prices with the results of a dynamic projection of the OEF Model from 1995. The problem is, however, that the answer depends on which measure of house prices you look at.

Basing the calculation on the ODPM's index suggests that house prices are now about 5% above their 'fundamental' value. But using an index based on the average of the Nationwide and Halifax indices suggests prices may be more like 15% above fundamentals. The difference between the two results partly reflects the different coverage of the house price indices – in particular, the inclusion of more expensive properties in the ODPM measure, whose value has increased relatively modestly over the last year. But it is also a reflection of the genuine uncertainty about the extent to which current developments in the housing market reflect a continuing adjustment to the low inflation/low interest rate era or a bubble.

Chart 3.16.



In either case, though, our forecasts suggest that house prices are unlikely to collapse over the next year. Rather, we expect house prices to remain robust for the rest of the year and to continue to rise in 2005, although at a much slower pace. Our forecast therefore sees house prices returning to 'fair value' basically through a process in which strong economic growth boosts household incomes sufficiently to raise the fundamental level of prices up to the level of actual prices.

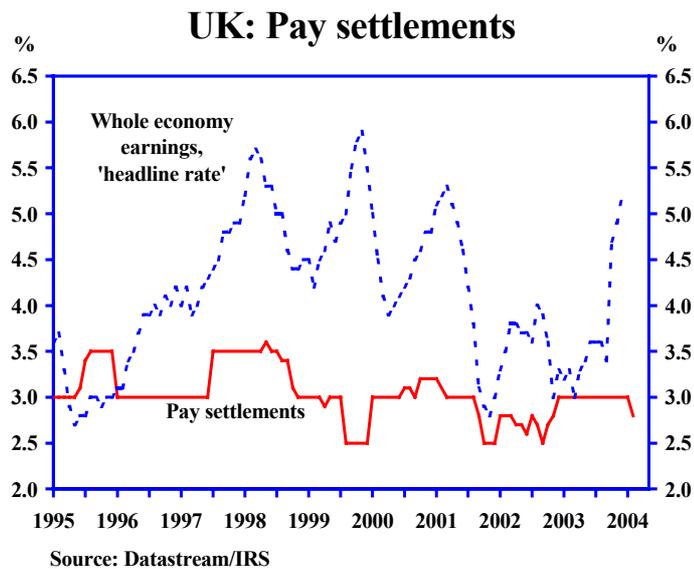
Clearly, with house prices over-valued, there is a danger that a sudden loss of confidence could trigger a market collapse. And this risk will increase the longer house prices rise at double-digit rates. But ultimately it all depends on what happens to interest rates. The risks to house prices are therefore closely tied to the risks to consumer spending described above.

Will the tight labour market fuel inflation?

The jump in whole economy average earnings growth to 5.2% on the headline measure in March from 3.4% in December has raised some concerns about the ability of the labour market to cope with the strong recovery in UK economic growth. With unemployment now below 3% (under 900,000) on the claimant count measure and less than 5% on the LFS measure, and employment rising over 365,000 in 2003 according to the workforce survey, some commentators are worried about potential labour shortages (the row about immigration policy notwithstanding).

The rise in wage inflation in this year should not, however, have been a big surprise. It is almost entirely due to a sharp pick-up in bonus payments, which in turn reflects increased company profits, particularly in the financial services sector. There is no sign yet of a pick-up in underlying pay settlements.

Chart 3.17.



Moreover, the UK labour market is probably not as tight as the headline indicators suggest:

While numbers employed have risen strongly over the last few years, this has been accompanied by a sharp fall in average hours worked. As a result, the total number of hours of labour employed by companies has been broadly flat since 2001. Some of the fall in average hours may reflect structural factors (eg the working time directive). But it may also reflect reduced overtime working and some people having to take part-time work who would prefer a full-time job. So, there is probably scope for average hours to increase to meet some of the likely rise in labour demand.

While overall employment has risen, this has been mainly due to strong growth in self-employment. The number of employees in employment has been fairly stable over the last couple of years, with the number of private employees actually falling sharply while public sector employment has risen. It is possible that many people currently classified as self-employed are simply marking time until a

new job becomes available (eg acting as consultants or handy-men). This would again suggest that the employment data overstate the genuine strength of the labour market.

The number of working days lost to strikes has fallen sharply over the last year, although there have been some large-scale public sector disputes in the last few weeks.

We should expect headline wage inflation to rise further over the next few months as bonus payments continue to recover. However, we do not see pay risks as a major factor likely to push interest rates significantly higher.

Might taxes have to rise?

The Treasury's Red Book suggests that the extra spending announced by the Chancellor in the Budget should be affordable within his 'Golden Rule' – ie that, across the economic cycle, the government will only borrow to finance investment. The current budget deficit is forecast by the government to halve over the next year and return to balance by 2006-07, with increasing surpluses expected thereafter.

In our view, however, the Chancellor's borrowing projections remain over-optimistic, as he continues to expect a very strong rebound in tax revenues – nearly 8% in each of the next two years and well ahead of economic growth in subsequent years. In part, this reflects our slightly more cautious view of prospects for economic growth over the next couple of years and our lower forecast for inflation. But, more importantly, the Chancellor's forecasts imply a higher gearing from growth to tax receipts than suggested by our models.

Our forecasts suggest that overall government revenues will be about £2 billion below Treasury projections in 2004-05, implying public sector net borrowing of £35 billion. And we expect a revenue shortfall of £4 billion compared to Treasury projections in 2005-06, with net borrowing again at £35 billion.

Our bigger concern, however, is with the Chancellor's borrowing projections in subsequent years. Despite its assumption that the level of GDP will have recovered to trend by late 2005 and that growth will be steady at its trend rate thereafter, the Treasury's forecasts show the tax burden – the share of taxes in GDP – continuing to rise, to over 38% by 2008-09, by far its highest since the early 1980s. In contrast, we would expect to see the tax burden

remaining constant in the medium term, implying a potential revenue undershoot of £15 billion by 2008-09.

On this basis, our forecast implies public sector net borrowing is likely to be close to £35 billion a year beyond 2005-06. This in turn implies that the Chancellor will breach his Golden Rule, so that either taxes will have to rise after the general election or the Chancellor will have to rewrite his fiscal strategy.

Indeed, arguably they are already pencilled in the Treasury's fiscal arithmetic, given the continuing increase in the tax burden that is projected for the medium term. The scale of the increase in the tax burden foreseen by the Treasury does pose a significant threat to longer-term growth prospects in the UK. Coupled with business worries about increasing regulation, it implies that incentives for enterprise and investment are being undermined. This should mark the battleground for the debate on the economy in next year's election campaign

Table 3.3. UK Forecast

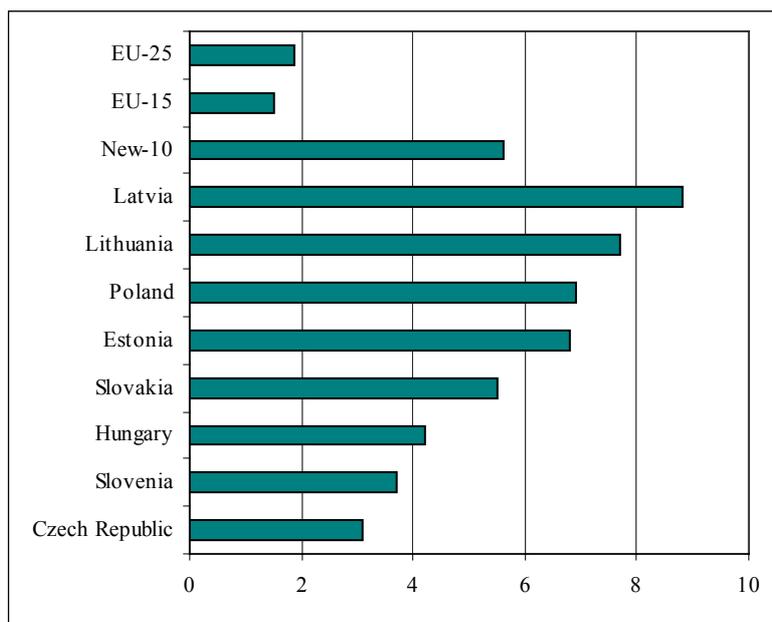
	2001	2002	2003	2004	2005	2004 I	2004 II	2004 III	2004 IV	2005 I	2005 II	2005 III	2005 IV
	q-t-q, saar (unless otherwise indicated)												
Private consumption	3.1	3.4	2.5	3.4	2.6	3.6	3.4	3.1	2.7	2.5	2.2	2.4	2.5
Public consumption	1.7	2.5	1.8	3.3	2.6	2.8	2.8	2.5	2.5	2.5	2.5	2.5	2.5
Gross fixed capital formation	3.6	1.8	2.9	6.0	4.0	4.4	5.0	4.2	4.6	3.8	3.7	3.7	3.6
Domestic demand	2.7	2.8	2.5	3.9	2.9	4.0	2.9	3.5	3.1	2.9	2.8	2.6	2.3
Exports	2.5	-0.4	-0.1	1.5	6.7	-8.1	10.4	6.9	6.6	6.6	6.3	6.2	6.1
Imports	4.5	4.0	0.9	4.2	6.7	-1.8	7.4	7.1	6.9	6.6	6.5	6.3	6.0
GDP	2.1	1.6	2.2	3.1	2.8	2.5	3.4	3.3	2.9	2.8	2.6	2.4	2.2
Unemployment (% of labour force)	5.1	5.2	5.0	4.6	4.4	4.7	4.6	4.5	4.5	4.4	4.4	4.4	4.4
Compensation per employee ¹ , yoy	4.9	3.4	3.3	5.2	4.5	5.2	5.2	5.2	5.0	4.8	4.6	4.4	4.4
Consumer price (HICP), yoy	1.2	1.3	1.4	1.4	1.6	1.3	1.4	1.3	1.5	1.5	1.6	1.6	1.7
Current account balance (%GDP)	-2.4	-1.7	-1.7	-2.6	-2.9	-2.8	-2.5	-2.5	-2.6	-2.7	-2.9	-3.0	-3.1
GGFB/GDP ²	0.8	-1.5	-3.1	-3.0	-2.8	-2.9	-3.1	-3.1	-2.9	-2.5	-2.7	-2.9	-2.9
3m interest rates (% per annum)	5.0	4.0	3.7	4.6	5.1	4.1	4.5	4.7	5.0	5.3	5.3	5.0	5.0
10y Gvt bond yields (% per annum)	4.9	4.9	4.5	4.9	4.9	4.8	5.1	5.0	4.9	4.8	4.8	4.9	4.9
EUREN calculation – ¹ Seasonally adjusted – ² General Government financial balance, excluding UMTS revenues													

Persistent strong growth led by booming exports

Part IV. The new member States

In the new member states of the European Union, the strong economic growth that started in mid-2003 has actually accelerated in the first quarter of 2004. According to preliminary data, real GDP increased by 5.6% which is a new record in the recent economic history of the former transition countries. The main driver of growth is manufacturing exports; in spite of moderate export market growth, new EU members have an outstanding export performance. Among domestic demand components there is a readjustment in favour of business investment, while the rate of increase in private consumption (the engine of growth in 2002-2003) is slowing.

Chart 3.18. Real GDP Growth of the New EU Member States in the First Quarter of 2004 (% change on Q1 2003)



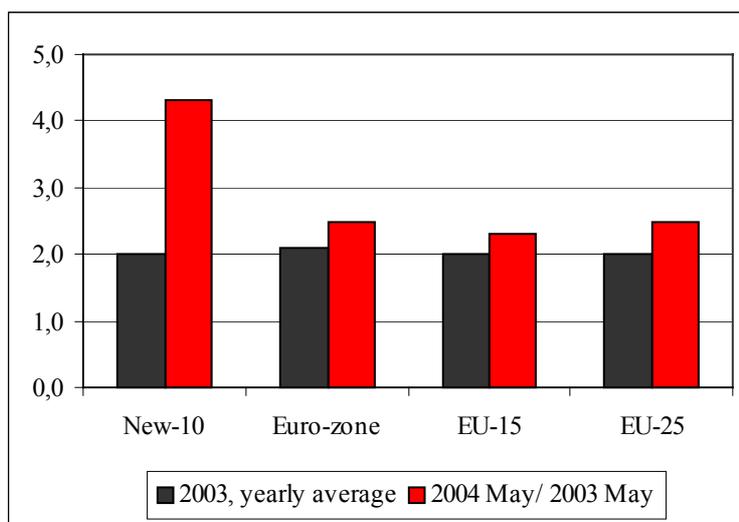
Source: EUREN

In 2003, the per capita GDP of the 10 new members was equal to only 48.5% of the EU-15 average. However, the process of real convergence has been speeding up, especially as growth is fastest in the less developed countries (the Baltic states and Poland). As greenfield investment type FDI inflows as well as corporate profit re-investment has intensified recently, the strong pace of growth is likely to persist in the remaining part of 2004 and in 2005.

**Inflation uptrend
might endanger
smooth
accession to the
EMU**

For the new member states, one of the biggest medium-term challenges is accession to the Economic and Monetary Union, more precisely, the fulfilment of the Maastricht criteria. At the end of 2003, it seemed that the critical issue is the budget deficit, while state debt, exchange rate, interest rate and inflation criteria seemed to be much less problematic. Spring months (especially May) of 2004, however, pointed to the conspicuous fragility of price stability: compared to the 0.3% monthly increase of consumer prices in the Euro-zone, from April to May inflation was 0.9% in the new EU member states. True, this uptrend partly reflects a necessary harmonisation (i.e. substantial increase) of regulated prices (thus partly these developments have a temporary character), but inevitable price *level* convergence and demand pressure fed by strong economic growth might cause serious problems in fulfilling Maastricht inflation criteria.

Chart 3.19. Inflation in the New EU Member States and in the euro area (12-months price increase, %)



Source: EUREN

Besides inflation, Czech Republic, Hungary and Poland have also problems in fulfilling the budget goals: in 2003, general government deficits were 12.9% (without one-off expenditure items 5.8%), 5.9% and 4.1% respectively and current economic policy measures support only a slow fiscal adjustment process in the following years as well. On the other hand, fiscal policy is traditionally tight in the Baltic states and in Slovenia, while the new macroeconomic 'star' of the region, Slovakia recorded a balanced (markedly better than expected) budget in the first four months of 2004. In fact, until now medium-term fiscal policy goals have defined the planned timing and strategy of

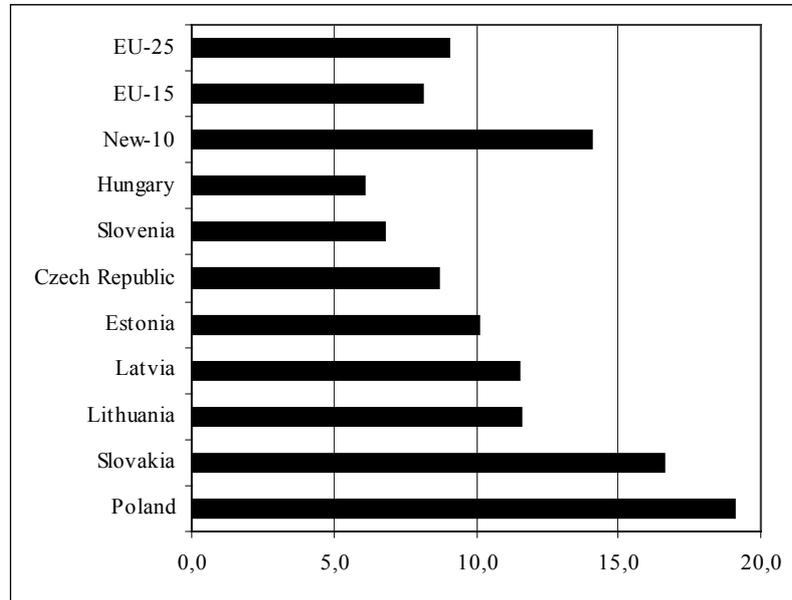
Euro adoption; Estonia and Lithuania have been the most ambitious (with intended entry in 2006-2007), meanwhile Czech Republic, Hungary and Poland preferred a markedly later entry (intended in 2009-2010). The positive growth prospects have a beneficial impact on the viability of Maastricht convergence criterion fulfilment strategy, unless international inflation pressures persist in longer run.

While large fiscal imbalances remain the major concern in the Central-European countries, surging current account deficits are again becoming worrisome in the Baltic states. In the 'Baltic model' the remarkable technological catch-up (especially in Estonia) together with weak autonomous innovation capacities, result in a continuous high import surplus, thus external imbalance is the main limit of real convergence. Not surprisingly, Baltic economic policy decision-makers prefer the 'soonest possible' adoption of the Euro, which would help nullify the constraint that having to watch the current deficit puts on growth.

External imbalances require large FDI inflow to be maintained

External imbalances are less threatening in the new Central-European member states, although until 2003 it was only Slovenia that had a slightly positive current account balance. However, thanks to the economic reforms (praised especially by foreign investors) Slovakia has been able to improve not only the budget position but in the first two months it had a moderate current account *surplus* as well. This is in sharp contrast with the Czech and the Hungarian macroeconomic processes, where fiscal problems (together with deteriorating net household saving positions) have implied an increasing current account deficit. Thus sustainability of growth in the medium term is fundamentally dependent upon FDI inflows; and short-term prospects are rather favourable in this respect. Inter alia, thanks to the EU accession, new members are expected to be natural winners of the global capital reallocation processes.

Chart 3.20. Unemployment Rate in the First Quarter of 2004
(in % of the labour force, ILO Labour Force Survey data)



Source: EUREN

In contrast to positive trends in growth, labour market indicators look much less promising. Unemployment has remained stubbornly high in Poland, is decreasing only slowly (from a very high level) in Slovakia and in Estonia, while it is rising markedly in the Czech Republic. At the same time, the level of employment (as well as part-time employment) is still much lower than in 'old' EU member states, and strong economic growth has only marginally improved the picture.

Our forecast is characterised by a mixed picture. Very positive short-term growth prospects are contrasted by multiple economic policy challenges. Labour market tensions (low activity and/or high unemployment rates) are difficult to ease substantially in the forecast period, and external imbalances can aggravate these matters further. Economic policy-makers typically concentrate on short-term priorities, in most of the countries either 'fair redistribution of growth results' or 'fulfillment of the Maastricht criteria' dominate local economic policy discussions. Even in Slovakia, where economic reforms have brought extremely positive macroeconomic results in a surprisingly short term, persistent social and ethnic tensions and renewing populism can easily undermine the present prosperity deviating the country from its smooth path to EMU accession. The best long-term prospects are in Estonia (however, with notable downside risks because of short-term external deficit problems) and in Slovenia,

where economic policy strategies are formulated in line with the Lisbon strategy goals. On the other hand, there is a marked downside risk in Poland and in the Czech Republic that political factors can seriously damage medium-term growth prospects.

Table 3.4. Main Indicators of New EU Member States

(Percentage changes unless otherwise indicated)				
	2002	2003	2004	2005
GDP real growth	2.5	3.7	5.4	5.1
Czech Republic	2.0	2.9	3.3	3.8
Estonia	6.0	4.9	6.5	6.0
Hungary	3.5	2.9	4.1	4.3
Latvia	6.1	7.5	7.5	6.5
Lithuania	6.8	9.0	7.2	6.2
Poland	1.4	3.7	6.5	5.8
Slovakia	4.4	4.2	5.2	5.5
Slovenia	2.9	2.3	3.6	3.8
Inflation (HICP)	2.7	2.1	3.9	3.4
Czech Republic	1.8	0.1	3.2	2.9
Estonia	3.6	1.3	3.2	2.6
Hungary	5.3	4.7	6.9	4.6
Latvia	1.9	2.9	4.8	3.1
Lithuania	0.3	-1.2	2.4	2.6
Poland	1.9	0.8	2.7	3.2
Slovakia	3.3	8.5	7.7	4.0
Slovenia	7.5	5.6	3.6	3.0
Unemployment rate	14.5	14.8	14.0	13.3
Czech Republic	7.3	7.8	8.4	8.1
Estonia	10.3	10.0	9.7	9.3
Hungary	5.8	5.9	5.9	5.8
Latvia	12.0	10.6	10.4	9.7
Lithuania	13.8	12.3	10.6	10.2
Poland	19.9	19.4	18.8	18.2
Slovakia	18.5	17.4	16.2	15.6
Slovenia	6.4	6.7	6.6	6.4

Sources: National Statistical Offices, Eurostat, EUREN forecasts for 2004 and 2005

SPECIAL STUDIES

(Each study presented in this chapter provides background material to the EUREN report. The views expressed here do not necessarily reflect those of all EUREN institutes)

4.1. What could be the impact of the increase of oil price on the world economy?

Daniele Antonucci and Pasquale Capretta, Cofindustria

4.1.1. Introduction

The price of oil has increased considerably during recent months. Even though it has oscillated around 33-34 dollars per barrel during March-April measured in terms of Brent crude, it has subsequently risen to a peak of 38.9 dollars per barrel in May.

The causes of such increases are very diverse and are related to both economic and extra-economic factors. The recent recovery has certainly played a role, but geopolitical factors continue to drive medium-term price dynamics.

The impact on economic growth is important and has been widely analysed by a number of observers. In particular, most analysts believe that oil price fluctuations have considerable consequences on economic activity. Overall, the *a priori* effect on the world economy is difficult to ascertain, because the net result depends on the different expected impact on both oil importing and oil exporting countries. In fact, while an oil price increase should be considered good news in oil exporting countries, it should be considered bad news in oil importing countries. Conventionally, however, considerable emphasis is placed on the existence of international repercussion mechanisms through the trade channel. Because of the intra-area nature of trade among oil importing industrial economies, a crisis has often exerted detrimental effects on these countries. Moreover, oil exporting countries generally cannot completely compensate for these losses, because they employ only a fraction of the extra income induced by higher oil prices to

increase their own demand for foreign products, due also to the relatively smaller size of their economies.

The transmission mechanisms through which oil prices affect the real economic activity include both supply and demand channels. The supply side effects are related to the fact that crude oil is a basic input in several transformation processes. Therefore, an increase in oil price is often reflected in production costs, thus influencing firms' decisions. Oil price changes also involve demand side effects on both consumption and investment. Consumption is affected because it is highly correlated with disposable income. The magnitude of this effect is in turn stronger the more the shock is perceived to be permanent. Moreover, oil prices have an adverse impact on investment by increasing firms' costs.

In addition to the above-mentioned effects on supply and demand, a proper assessment of the economic consequences of oil price changes should also take into account indirect effects through a number of additional channels. For instance, fluctuations of the price of oil influence inflation, thus in turn exerting a influence on real activity. In addition to the initial impact, as prices of oil and energy-related goods and services increase, second round effects, depending on the response of wages to higher consumer prices, may be extremely important. If a high proportion of wage earners are willing to accept a decline in real wages, only a modest increase in unemployment is likely to occur and inflation is expected to come back to its original level rather quickly. If wage earners demand high nominal wages to compensate for the rise in prices in order to recover their loss in purchasing power, an inflationary spiral may start up, eventually leading to persistent lower growth and higher inflation.

Finally, since some of the discussed effects may involve economic policy reactions, the economic consequences observed after oil price shocks may be generated by a combination of direct impacts of the shocks themselves and the policy responses to them.

4.1.2. Effects of an increase in the price of oil

In order to estimate the impact of an oil price shock on the world economy we have run a “high oil prices” simulation using Oxford Economic Forecasting’s econometric model of the the world economy. Oil prices have been increased by \$10 a barrel with respect to the baseline for three consecutive years (2004-2006) and the results for growth, inflation and current account have been compared to the original scenario. In terms of percentage change in the nominal oil price, the increases correspond to 34% in the first year and to approximately 38% in the following two years. The results change slightly assuming, as we did, that oil prices can also influence other energy prices, such as coal and natural gas. It is likely, in fact, that oil price increases put pressure on the demand for alternative energy sources with further effects on global economic activity.

The results for selected geographical areas are presented in table 1 and show that the impact on the world economy is quite significant and rather immediate. With respect to the baseline, world GDP is 0.2% lower in the first year, 0.5% in the second and 0.7% in the third year. The impact is stronger in the second year and the negative effects of the shock are particularly evident on demand and trade. Eventually, as the economy adjusts to the new situation, GDP comes back to the initial growth path, although the output loss is never recovered. Only the oil exporting countries record an increase in their growth rates especially in the first two years of simulation but, given the size of their economies and the lag before their greater oil revenues are reinvested in the industrialized countries, the increase has only a mildly positive effect on world GDP during the forecast horizon.

Table 4.1. Effects of a USD 10 per barrel increase in oil price
(Percentage differences from the EUREN baseline forecast)

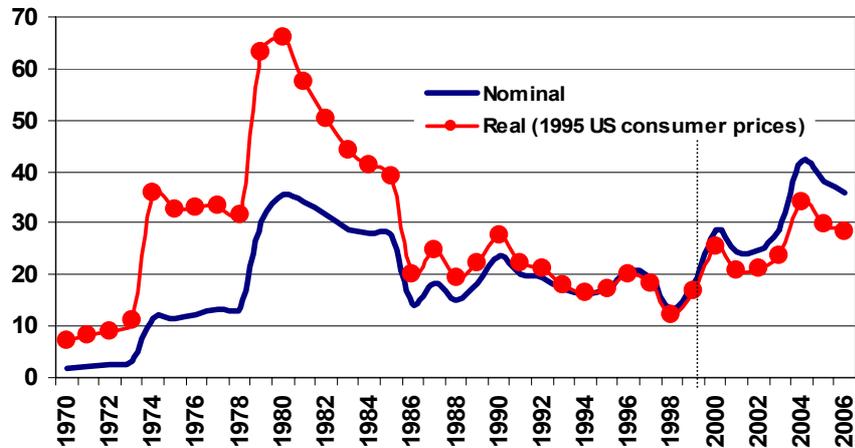
		2004	2005	2006
USA	<i>GDP</i>	-0,2	-0,4	-0,9
	<i>Inflation</i>	0,5	0,9	1,0
	<i>Current Account (as a % of GDP)</i>	-0,4	-0,3	-0,3
EMU	<i>GDP</i>	-0,3	-0,4	-0,4
	<i>Inflation</i>	0,5	0,7	0,7
	<i>Current Account (as a % of GDP)</i>	-0,4	-0,3	-0,3
Japan	<i>GDP</i>	-0,3	-0,8	-1,4
	<i>Inflation</i>	0,7	0,9	0,7
	<i>Current Account (as a % of GDP)</i>	-0,4	-0,3	-0,2

Among the major three economic areas, Japan is the one that suffers the heaviest losses in terms of GDP growth, given its higher dependence on imported energy. Euro area GDP falls more than the US during the first year but less in successive years due, perhaps, to a quicker and stronger ECB response to rising inflation. The ECB, in fact, reacts very rapidly to the price increases and is able to effectively control inflation. After an initial drop, Euro area GDP returns to grow at basically the baseline's rates of growth in the following two years. The Fed action is, instead, much more gradual during the simulation horizon and is, therefore, less effective in controlling inflation: prices and wages rise at a faster pace than in the Euro area and the cost, in terms of output loss, although lower than in the Euro area during the first year of simulation, becomes much higher in the following years.

4.1.3. An historical perspective

A number of previous episodes suggests that the current oil price is not extremely high (Chart 4.1). For instance, in 1974 oil price more than triplicated in nominal terms and jumped by 217% in real terms during a very short time span. Another example is the oil crisis in 1979, when oil price more than doubled both in real and in nominal terms. By comparison, the increases hypothesised in our simulation exercise roughly correspond to one third with respect to the baseline. For this reason, in our scenario the consequences of a rise of the price of oil are a serious concern but do not represent an unmanageable threat to global economic growth.

Chart 4.1. Oil price in \$ per barrel



Source: own calculations.

Furthermore, there is a substantial body of research that emphasizes the non-linear relationship between economic growth and the price of oil. In this view, the consequences of an increase of the latter on economic activity are not proportional to the magnitude of the shock. The higher the current price, the stronger the impact of an increase of the same percentage. Evidently, the economy can adapt quite rapidly to small price variations and rapidly absorb such shocks. As in the past, significant changes in the price of oil may have a seriously disruptive impact.

4.2. ICT, productivity and growth differentials

Henri Bogaert et Chantal Kegels, BfP

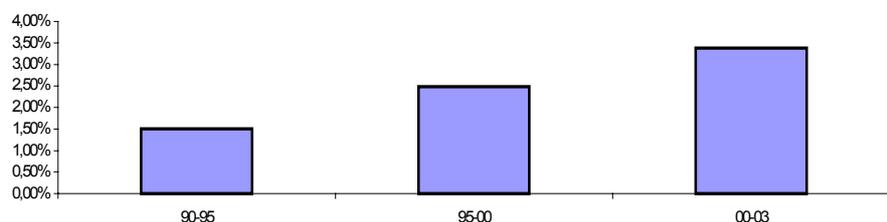
4.2.1. Introduction

American productivity acceleration is confirmed

The recent evolution of the US labour productivity seems to have brought back the consensus among economists on the role played by ICT in economic growth. The rapid and deep stock exchange correction, the decline of ICT investment and the economic slowdown have shed some doubts about the durability of the new economy. At that time, many were sceptical on the sustainability of the American productivity gains. Between 1995 and 2000, the annual average growth rate of the productivity reached 2.5%, which was acceleration from 1.5% recorded during the first half of the nineties. But since the end of the American recession on November 2001, productivity has progressed at a rate close to 5%. Since 2000, productivity has increased at an annual average rate larger than 3%.

Chart 4.2. Productivity, Nonfarm Business Sector

(average annual growth rate)



Source: US Department of Commerce, Website, October 2003

Did ICT play a role in these performances? To answer this question, the determinants of productivity gains have to be identified.

4.2.2. Sources of productivity growth

The three main sources of productivity gains are capital deepening, increasing quality of labor and TFP

Starting from the growth accounting framework, it is possible to identify three main sources of productivity gains.

The first source is the capital deepening: workers become more productive because they have more and better capital for each hour worked. It is the main mechanism of rationalisation, which increases the capital/labour ratio. The second source is the improvement of the quality of labour - by the upgrading of skills for example. The third source is the total factor productivity (TFP), which covers the fact that technical progress in sensu lato, including, among other factors,

improvements of firm organisation, allows companies to produce more with the same quantity of inputs. Under the assumption of perfect statistical information, TFP, calculated as a residual, only includes this technical progress (and no improvements in labour or capital quality), which is rarely the case in available estimations.

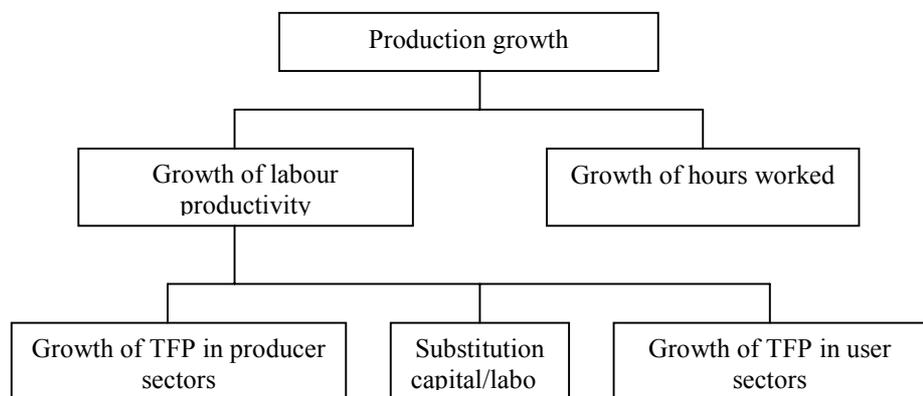
How do the production and the diffusion of ICT influence these sources and lead to productivity growth?

4.2.3. ICT as a source of productivity growth

At this stage, it is useful to distinguish the ICT producer sectors from the rest of the economy. As illustrated by Figure 4.1, this distinction then allows us to identify three channels of transmission of ICT production and diffusion to productivity growth: the growth of TFP in the producer sector, capital deepening and the growth of TFP in user sectors.

ICT sustain productivity gains through their effects on TFP and capital deepening

Figure 4.1. Channels of transmission of ICT effects on growth



The very fast technical progress recorded by ICT production, in particular in semi-conductors, has led to the production of more and better ICT goods with the same quantity of inputs. This progress increases the productivity of producers and thus of the economy as a whole. This progress also has been translated into strong declines of ICT prices, leading other sectors to massively invest in these technologies. These investments have in turn led to an increase in labor productivity.

Moreover, and this has often been controversial, the massive ICT investments have allowed not only a rationalization but also an increase in TFP of the user sectors. However, these productivity gains emerge only progressively and, as documented by many studies, only

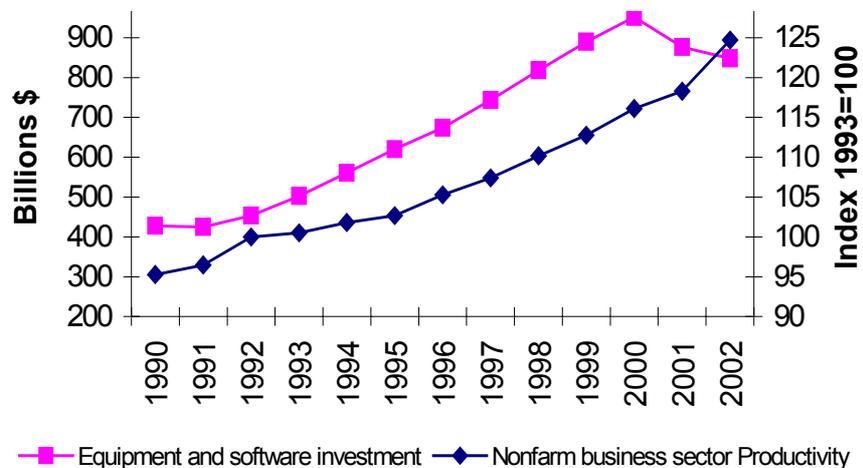
if ICT integration goes in hand with reorganization inside the firm and more generally inside the economy. In other words, ICT investments have to be coupled with intangible investments designed to adapt the workforce to these new technologies and the new organization of work implied.

4.2.4. Lessons of US performances

American performances confirm positive effects of ICT on long term growth

What does the recent American evolution teach us? Mainly two things: On the one hand, labor productivity has increased even during the recession. This behavior is unusual as the productivity evolution generally follows the cycle. Indeed, it normally decreases when the economic activity starts its contraction and when firms have not yet started to fire workers, and inversely when the economy revives. On the other hand, productivity has increased even though investment, and in particular ICT investment, has been declining as illustrated by Chart 4.3.

Chart 4.3. Evolution of productivity and investment



Source: US Department of Commerce, Website, October 2003.

The first evidence leads us to consider the ICT effect on productivity evolution on a structural, rather than a cyclical, basis. Productivity growth has been strong and even accelerating during the different phases of the cycle. New estimations of Oliner and Sichel, quoted by Gordon, go clearly in this direction.

Table 4.2. Contribution of ICT capital to the productivity growth

(Average annual growth rate in %)

	1973-95	1995-99	Change	1995-02	Change
Labour Productivity	1.41	2.36	0.96	2.61	1.20
Capital deepening	0.72	0.98	0.26	1.20	0.49
- ICT	0.42	0.95	0.53	0.93	0.51
- Other	0.30	0.03	-0.26	0.27	-0.02
Quality of labor	0.27	0.30	0.03	0.25	-0.02
TFP	0.42	0.98	0.56	1.15	0.74
- ICT/Semi-conductor	0.30	0.72	0.41	0.70	0.40
- Other	0.11	0.26	0.15	0.45	0.34

Source: Oliner, S., and D. Sichel, Information Technology and Productivity: Where we are now and Where are we going?, Atlanta Federal Reserve Bank Review, 2004.

The total contribution of ICT to the change in productivity growth reached 0.94% during the period 1995-1999 but it was maintained at 0.91% between 1995 and 2002. These estimations not only show a still large increase in TFP of ICT producers (0.70% per year) but also an acceleration of TFP in the other sectors when recent years are taken into account (0.45% instead of 0.26%). This acceleration partly explains the increase in productivity despite the slowdown of investment, particularly those in ICT. This acceleration is also compatible with the assumption, already mentioned, of an adjustment lag needed to enable firms to record productivity gains based on ICT use.

4.2.5. The European and Belgian situation

Compared to US performance, where are Europe and Belgium? Since the mid nineties, the productivity acceleration has been clearly smaller than in the US, and this gap has been increasing during the most recent years as illustrated by Table 4.3.

The problem is mainly a gap in terms of growth rates and not in terms of levels. Levels stay high, especially in Belgium, a country with one of the highest levels of productivity in the world.

In Europe, positive impacts of ICT were smaller

Table 4.3: Average annual growth rate of production
(hours worked and productivity, 1990-2002)

	1990-1995	1995-2000	2000-2002	1995-2002
United States				
- Production	2.38	4.00	1.28	3.22
- Hours	1.24	2.03	-1.24	1.10
- Production per hour	1.14	1.97	2.52	2.13
European Union				
- Production	1.61	2.63	1.28	2.24
- Hours	-0.85	1.21	0.40	0.98
- Production per hour	2.46	1.42	0.89	1.27

Source: Gordon, R, Five Puzzles in the behavior of Productivity, Investment and Innovation, chapter for World economic Forum, Global Competitiveness Report 2003-2004, September 2003.

ICT has sustained productivity growth in Europe and in Belgium but to a lesser extent than visible in the United States, as illustrated by Table 4.3. It has to be underlined that the Belgian statistics are not directly comparable to the American ones. Because of the lack of adjustments for labor and capital quality improvements, these evolutions are included in the Belgian TFP and not in the American TFP for which adjustments have been implemented.

Table 4.4. ICT capital contribution to the growth in Belgium, %

Average annual growth	1991-1995	1995-2001	Acceleration
Real GDP	1.54	2.50	0.96
Hours worked	-0.32	0.87	1.19
Productivity	1.86	1.63	-0.23
- Capital deepening	1.06	0.74	-0.32
Of which ICT*	0.33	0.54	0.21
- TFP	0.80	0.89	0.09

* : excluding software.

Source: Kegels, C., M. van Overbeke and W. Van Zandweghe, ICT contribution to economic performance in Belgium: preliminary evidence, WP 08-02, BfP, 2002.

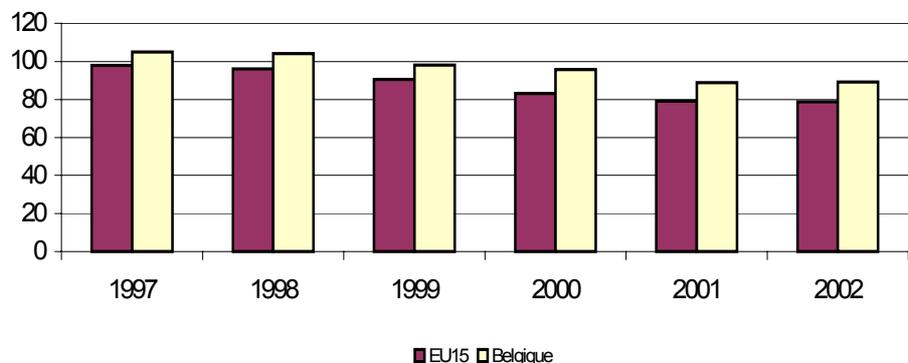
The smaller ICT contribution might be explained by different elements. Firstly, European IT production is generally less developed than in the US. This is particularly true for the semi-conductor industry, which is all but non-existent in Europe. However, TFP gains in the ICT sector have been concentrated in IT manufacturing. Secondly, ICT investments have been realized later than in the US, leading to a smaller stock during the period taken into consideration. This smaller accumulation of ICT capital also leads to a smaller contribution of ICT to capital deepening. This has also been coupled with a slower diffusion of ICT

in the economy, limiting the opportunities of TFP improvements in ICT user sectors. More fundamentally, why have the European and Belgian firms invested less in ICT than their American competitors?

4.2.6. Reasons of the lag in ICT capital accumulation

Partly because the revival of economic activities during the nineties has not been coupled with virtually full-employment as in the United States, making capital deepening not so necessary. In the second half of the nineties, the number of hours worked has been increasing stronger in European firms. Also prices decrease of ICT equipment has not been so fast in Europe than in the US is part of the explanation. Indeed, international comparisons, in particular those conducted by the OECD, show that during most of the nineties, American and Canadian firms purchased ICT goods at prices significantly lower than those faced by the European and Japanese enterprises. Nevertheless, the price differentials have been reduced during the previous decade. In addition to the prices of ICT equipment, the costs for the use of this equipment enter into consideration in the profitability evaluation of such investment. Particularly, the price of telecommunication services, including Internet, varies a lot from country to country. The fact that Belgian telecommunication prices have for a long period been among the highest in Europe might explain part of the lag recorded by the Belgian firms in the modernization of this kind of equipment.

Chart 4.4. Harmonized prices index of communication services
(Base 1996=100)



Source: Eurostat Newcronos database, 2003

However, the analysis conducted by van Ark et al.² on the evolution of sectoral productivity gives a different explanation for the divergences of performances between EU and US. In addition to the difference of development of ICT manufacturing, the gap of productivity growth is mainly due to three services sectors, all main users of ICT: wholesale trade, retail trade and securities brokers. Why have these three sectors recorded faster productivity growth in the US than in Europe? An explanation provided by some authors as McGuckin and van Ark³ is linked to the presence of structural impediments in product and factor markets preventing the efficient implementation of ICT in Europe. They argue that some industry-specific measures would bring clear benefits in terms of effective use of ICT. In the retail industry, for example, extending shop opening hours and harmonizing zoning laws encourage competition and innovative behavior in this intensive ICT-using sector.

Another explanation is given by the survey conducted in four sectors (banks, printing and edition, machines and transport) by the Federal Planning Bureau in Belgium. To the question concerning the main impediment to ICT integration, enterprises put a major part on the qualification of the workforce and the cost of labor skills upgrading. This lack of pertinent qualifications is the result of the lag recorded in Europe to adapt the training and learning system to the new needs for skills. The situation in Belgium is comparable to the European average, which means far behind the United States, which as early as 1994 launched the use of more information technology use in schools. Since the end of the nineties and the multiplication of international and national programs (such as eEurope), a large movement in catch-up is on the way. The Belgian schools, as are the majority of European schools are now on-line, but it is still difficult to pretend that the pedagogy has been revised to fully integrate this new dimension of learning. Indeed, the challenge consists not only in giving everyone a basic ICT knowledge but also and perhaps mainly from the point of view of productivity, in developing scientific training complementary to ICT a sine qua non condition for TFP growth in user sectors. In this field, the current crisis of scientific vocations imposes a challenge to our system of education.

² Van Ark, Bart, Robert Inklaar and Robert H. McGuckin, 2003, ICT and productivity in Europe and the United States, Where do the differences come from?, SOM Conference, January 2003, Groningen.

³ McGuckin Robert H. and Bart van Ark, 2003, Performance 2002: Productivity, Employment and Income in the World's Economies, New York: The Conference Board.

Moreover, European firms do not invest enough in human capital. The average amount spent by enterprises for labor training only reaches 2.3% of the wage bill while the objective fixed at the Lisbon Summit is 5% in 2010⁴. On average, 22% of the EU working population follows a training linked to the job. This average covers extreme situations ranking from 37% in Finland to 12% in Portugal. It is therefore clear that efforts have to be made to increase incentives to enterprises to upgrade skills in the labor force.

4.2.7. Conclusion

It is more and more evident that the production and mainly the diffusion of ICT play an important role in the acceleration of the long-run productivity growth rate. This long-term effect goes through the positive impact of ICT on TFP of user sectors. ICT contributes to an acceleration in the technical progress in sectors using it and therefore improves the productivity of innovation in these sectors. However, the ICT capital accumulation itself is not a sufficient condition to record this positive effect. The ICT integration has to be coupled with a re-organization of the value chain inside firms and with a new combination of production units inside the economy as a whole. In this new information society, human capital is the key factor. Therefore, today as yesterday, the education system remains the key to a successful integration of technical progress, and a welfare improvement.

⁴ Figures quoted by Mr Erkki Liikanen in his speech « Skills matter », Brussel 30 September 2003.

4.3. The International Role of the Euro

Christian de Boissieu⁵, COE, University of Paris I, and President of the Conseil d'Analyse Economique

4.3.1. The facts. Their interpretation

4.3.1.1. The figures

It is crucial to look at the market shares of the major currencies (dollar, euro, yen).

One of the main arguments in favour of EMU and the euro was and still is a less asymmetrical international monetary and financial system. In effect the very notion of the monetary triad (dollar, euro, yen) is not quite appropriate given the huge domination of the dollar and given the fact that the yen is significantly lagging behind the two other reserve currencies (I am talking of the international role of the yen, not referring here to its exchange rate). Henceforth the Japanese currency belongs to the "second league" and this lasting configuration has been somewhat accelerated by the launching of the euro and tougher currency competition.

In table 4.5 I have collected some information about the respective market shares of the dollar, the euro, the yen and wherever possible the deutsche mark in 1998. First we must acknowledge that the available data are piecemeal and difficult to update. For instance the last Triennial Central Bank Survey was conducted by the BIS in April 2001 and we will have to wait until April 2004 in order to get more information concerning the currency composition of foreign exchange transactions, etc. Secondly the data about the world trade invoicing are fragmented and tentative. We could get the relevant information country by country but the difficult phase relates to the aggregation procedure. I would recommend that the competent international organizations (WTO, IMF, OECD...plus the major central banks including the ECB) work in close cooperation in order to fill this information gap.

⁵ This paper is an updated (wherever possible) version of Ch. de Boissieu's Briefing Paper for the European Parliament (November 2003).

Table 4.5. Currency Shares. An Overview

	dollar	euro	yen	DM (1998)	Source and date
- Official reserves (all countries)	64.8	14.6*	4.5	12.2	IMF end 2002
- international trade invoicing	40.0	14.0		12.0	Indirect and conjectural estimate
- international bonds	46.9	38.3	4.3		BIS Year 2002
- international bonds	43.3	44.2	3.0		BIS 2003 Q1
- money market instruments	38.1	36.3	5.1		BIS and ECB 2002 Q1
-spot foreign exchange	42.2	21.5	13.0	21.3	BIS 2001
- swap foreign exchange	48.0	16.8	10.1	10.0	BIS 2001
- total foreign exchange	45.2	18.8	11.3	14.9	BIS 2001
- proportion of notes outside the issuing zone	66.0	8.0**			Fed and ECB (June 2002)

* According to the ECB, this figure underestimates the role of the euro. « ... the share of the euro in global foreign exchange reserves has continued to increase gradually, from 16.4 % in 2001 to 18.7 % in 2002. These data take into account recent statistical revisions made by the IMF ... ». The Review of the International Role of the Euro, ECB, December 2003. Accordingly, the revised share of the dollar was 64.5% at the end of 2002 (instead of 64.8 %).

** This figure has probably increased since June 2002. According to the ECB Review of the International Role of the Euro (December 2003), the shipments of euro banknotes to destinations outside the euro area from December 2001 to June 2003 amounted to 10 % of the total euro currency in circulation.

4.3.1.2. The analysis

For the sake of understanding, we could envisage the effects of the euro and the competition between the dollar and the euro (to a lesser extent the yen) in light of two opposite forces :

- the (positive) aggregation effect. According to this effect, the market share of the euro at the world level is significantly greater than the sum of the euro constituents (measured in 1998 just before the euro). In this configuration, several arguments could explain the "take-off" in some euro's market shares : the size of the euro area, the value of its aggregate GDP, the credibility of the new currency and of the ECB, the extent of positive externalities expected from the effectiveness of the single market, etc.
- the hysteresis effect. According to this effect, it is difficult and it takes much time for a new currency to catch up with the leading reserve currency (the dollar). History reveals that monetary transitions need to be envisaged in the long-run. For instance, the transition from the sterling to the US dollar lasted at least during

The mixed record of the euro deserves some explanation. The combination of two opposite forces (the aggregation effect, the hysteresis effect) is the dominant force.

ten to fifteen years. I am not saying that the euro is going to replace, in the long term, the dollar. What I am saying is that, due to the conjunction of several factors – economies of scale pushing towards currency concentration, inertia in individual behaviours, network (or club) effects beneficial to the leading reserve currency, ...- the structure of currency shares could be pretty rigid.

Let us discard the case of a negative aggregation effect which could be due to specific circumstances. For example, according to the Triennial Central Bank Survey, the share of the euro regarding all foreign exchange transactions was in April 2001 higher than the deutsche mark's share in 1998 but much lower than that of all euro constituents taken together. This quasi mechanical evolution comes from the elimination of trading between the legacy currencies.

Coming back to table 4.5, we could interpret the dynamic since 1999.

- As regards trade invoicing the hysteresis effect dominates for the reasons cited above (behavioural inertia, network effect...). May I add that I am somewhat skeptical about Russia's intention to invoice its oil exports in euros.
- Concerning financial transactions and portfolios the situation is more contrasted five years after the creation of EMU.
 - For the official reserves of central banks the aggregation effect did not take place since the share of the euro is not significantly higher than the share of the DM in the pre-euro period. Moreover the current downward trend in the exchange rate of the dollar could increase the share of the US currency (due to huge interventions by the Bank of Japan, etc.).
 - The aggregation effect has been equally weak regarding the foreign exchange market. Here it is clear that some inertia (hysteretic) has been prevailing.
 - On the contrary a dramatic aggregation effect took place as early as 1999 on the international bonds market. In this compartment of the capital markets the euro and the dollar have been standing side by side (with a 43-44 % market share for each currency according to the last available data).
 - In my 2002 briefing paper for the European Parliament, I have underlined that the proportion of notes outside the issuing zone could be a good proxy for the international status of a reserve currency. Therefore it would be crucial to update table 1 data and to figure out the implications of EU enlargement for

the share of euro denominated notes outside the enlarged EU (and latter the enlarged euro area).

4.3.2. Internationalisation of the euro : The Pros and Cons and the attitude of the ECB

4.3.2.1. The benefits : what to expect ?

The promotion of the euro as a credible reserve currency could generate several positive effects.

The ECB does stick to its neutral attitude vis-à-vis the internationalisation of the euro well summarized in December 2002 : "The ECB does not pursue the internationalisation of the euro as an independent policy goal, which implies that it neither fosters nor hinders this process. Rather it accepts the international role of the euro...as being mainly determined by the decisions of market participants in a context of increasing market integration and liberalisation at the international level" (Review of the International Role of the Euro, December 2002). This global position is less negative than the attitude of the Bundesbank vis-à-vis the internalisation of the DM.

For a country and a central bank, to issue the leading reserve currency means a series of privileges and constraints. In a simplified cost-benefit analysis let us start with the privileges. The rationale for the ECB to give up its neutrality and to actively promote the international use of the euro could be based on several arguments :

- To capture some international seignorage through a redistribution between the dollar and the euro. We must acknowledge that the literature concerning the impact of the seignorage level on economic growth is poor and not conclusive. Moreover the actual allocation of seignorage by the monetary authorities and the governments could as important as the volume of it. Nevertheless the international seignorage like the domestic one generates some rents which could be used to finance imbalances, investment projects, etc.
- To better manage exchange rate risks. The direct conflict between sellers and buyers, between the US and the rest of the world etc. regarding the invoicing of trade flows illustrate the fact that a greater internalisation of the euro would dramatically simplify the management of exchange rate risks for euro area importers and exporters and would also, in more numerous cases, transfer the exchange rate risk to American economic units (e.g, the sales of Airbus planes to US companies if they be denominated in euros). History shows that the US have accepted

to bear the exchange risk only under a big economic or financial pressure (e.g, the Roosa notes denominated in the creditor's currency and issued in the early 1960's).

- To improve the competitiveness of the euro area capital markets and banks. In particular, a greater international role for the euro would increase the degree of liquidity of European capital markets and the creation of truly "deep and resilient" markets.
- To alleviate the very notion of the external constraint when needed. For a long period the US have been financing their external deficits in their currency (the dollar), meaning that the country issuing the reserve currency has the great privilege to face a very "soft" external financing constraint (cf. Jacques Rueff's analyses in the 1960's and 1970's). Nowadays, were the euro the reserve currency, the benefit would be marginal for Europeans since the euro area as a whole is posting a current account surplus (conversely the costs for the US would be enormous...). But external balances are subject to both structural and cyclical adjustments. Who could forecast the external balance of the (enlarged) euro area in five or ten years from now? Therefore we could say that promoting the internationalisation of the euro could give a protection (an insurance) against the implications of a possible deterioration in the euro area balance-of-payments.

We cannot neglect some costs of issuing a reserve currency.

4.3.2.2. The costs

On the other side, a greater international role for the euro would generate some costs and constraints for the ECB. I cite three of them: 1) The euro would be exposed to speculative attacks on a larger scale. 2) As already said, the proportion of the euro notes outside the euro area would increase dramatically, raising some potential controllability problems for the ECB (see the Fed and the very indirect monitoring of notes and coins denominated in dollars outside the US). 3) The international responsibilities of the ECB would (and are going to) increase proportionally to the international role of the euro. We cannot accept the privileges without facing some additional constraints. More specifically, in case of a systemic financial crisis (like the October 1987 crash), the ECB would have to implement lender-of-last resort interventions (with the Fed...).

All in all, I do believe that the benefits of an accelerated internationalisation of the euro exceed the costs significantly in the

short and long run. Therefore I recommend that the ECB departs from its present neutrality and take a more friendly attitude.

4.3.2.3. What to do?

The ECB must pass from neutrality to a more positive attitude.

How to speed up the internationalisation of the euro ? I would underline four aspects.

- The most important quality of a currency is related to the stability of its value. Therefore the main contribution of the ECB is to fulfil its mandate, i.e. price stability.
- Another crucial element concerning currency competition comes from the integration and liquidity of capital markets. Since the causation between the internationalisation of the euro and financial integration in the euro area runs both ways, it is crucial to foster the effectiveness of the single market for banking and financial services. The governments and the European Commission are the competent bodies for such a goal, not the ECB.
- Moreover, given the international role of the City, the entry of the UK into the euro area would be decisive to improve the competitiveness of the euro. No one could reasonably forecast the time-table for such a dramatic change, and the ECB is going to be here a decision-taker rather a decision-maker.
- Given the US experience, a structural external deficit could under certain circumstances be the channel through which the demand for the main reserve currency is satisfied. I am not recommending for the euro area to register a structural current account deficit. I am just acknowledging the fact that the ECB and other policy-makers in the euro area will have to take advantage of the future fluctuations in our balance-of-payments in order to speed up the internationalisation of the euro.