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Article

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Intereconomics

Economic Downturn in Western Europe Bottoming Out

In recent months, the recession in Western Europe has shown signs of coming to an end. The climate in industry for example, having drastically cooled down in the second half of 1992, has at least recorded no further deterioration since the beginning of this year. Nor has real gross domestic product in Western Europe declined further from the first to the second quarter, although in the first six months of 1993 it was almost 1% lower than in the same period last year. These developments have been attended by a persistent decline in the utilization of capacity and employment. Unemployment has thus continued to rise; at $10^1/_2$% of the labour force in Western Europe in mid-1993, it was almost a third up on the figure at the beginning of the economic downswing three years ago. Only in the UK has there been a discernible upward trend, where demand and production have increased slightly since mid-1992.

The continued slowdown in Western Europe is largely the result of interest rates, which are still high. Monetary policy in most countries has so far been only gradually relaxed, mainly due to the situation in Germany. The disincentive effect of high interest rates has made itself particularly strongly felt in business, where comparatively high attractiveness of financial assets and the gloomy sales and earnings prospects have persistently inhibited the propensity to invest. Another significant impediment to business investment reaching into the current year has been the aftermath of the turmoil on the foreign exchange markets which began in September 1992. Private consumption also dropped at the beginning of the year because income growth slackened off and the decline in expectations led to reticence with regard to purchases. The decline in domestic demand has only been partially offset by the plus in foreign transactions, although individual countries differed markedly from one another primarily due to shifts in competitiveness caused by the changes in exchange rate relations since September 1992.

The lower utilization of capacity and employment has tangibly held back price and cost rises in Western Europe. Standard hourly wages in industry, which had gone up on average by 6% in 1992, were some $4^1/_2$% up in the first six months of 1993 compared to the same period in 1992. The slowdown in those branches less affected by the slump than industry has, however, been less pronounced. Wages have continued to rise faster than consumer prices, which have on average in Western Europe risen little over 3% since the beginning of the year as compared with last year. The latest inflation figures for Denmark, Great Britain, France, the Netherlands, Norway and Finland range between 1 and 2%; in Germany, Italy, Sweden and Spain, in contrast, the rate is between 4 and $4^1/_2$%. In the latter three countries, a price upswell induced by depreciation has counteracted a trend toward lower inflation.

The foreign exchange grid in the European Monetary System (EMS) has de facto been suspended since the beginning of August following a renewed massive wave of speculation, especially aimed at the French franc and the Danish krone. The subsequent shifts in rates have, however, kept within narrow bounds. Since the onset of the turbulence on the foreign exchange markets a year ago, which were not confined to the EMS, the currency relations in Europe have shifted markedly. Taking into account the depreciation against the dollar and the yen, in August the trade-weighted exchange rate of the currencies in Italy, Spain and Sweden was 20 to 22% lower than in the first six months of 1992. The effective depreciation in Finland was slightly lower; in the UK it amounted to 11%. At the same time, the external value in France, Belgium and Denmark changed little, while in Austria, the Netherlands, Germany and Switzerland it went up by 3 to 5%. These changes have caused large shifts in competitiveness, especially as the lower foreign exchange rates have so far had hardly any impact on wages and prices due to low utilization of capacity and employment.

Irrespective of the institutional foreign exchange pegging, most Western European countries were evidently concerned to keep the depreciation process within narrow limits to avoid the attendant risks to stability. Under these circumstances, the hesitant loosening of the monetary reins in Germany remained the prime yardstick for other countries. Only in Switzerland and the UK are money market rates noticeably lower than in Germany, whereas above all in Italy, Spain and Belgium – the latter having to cope with acute devaluation expectations – they are a good deal higher. On the other hand, the consistent stability course of the central banks has been conducive to a drop in the capital market rates; even in real terms, they have gone down noticeably in most countries. The almost ubiquitous inverse interest rate structure – "money" is more expensive than "capital" – attests to the relatively strict monetary policy so far.

Government finances in the Western European countries have deteriorated tangibly again this year, major contributory factors being revenue losses and increased spending due to the economic downturn. The growth of aggregate government debt in 1993 in Sweden and the UK will be well in excess of such effects, whereas in some others – Germany, Italy and Spain, for example – it should keep comfortably within them thanks to consolidation measures. Altogether, given a rise in aggregate national debt of over one percentage point to some 6½% of gross domestic product, the so-called automatic stabilizers for Western Europe taken together should more or less take full effect. For 1994, there are signs of increased efforts by governments to curb the largely structural core of the deficit as part of medium-term consolidation efforts. Short-term income support from government deficit spending will thus be curtailed, but this will be counterpoised by the stimulus of lower interest rates which will result from the prospects of a return to a sounder fiscal policy.

The bottoming out of the recession in Western Europe since the spring has certainly been expedited by the fact that the uncertainties caused by the currency turmoil in autumn 1992 have gradually faded during the current year, helped no doubt by the virtual suspension of the intervention obligations in the EMS in early August. It may thus be expected that most Western European countries will follow the anticipated lowering of interest rates by the Bundesbank and be able to approach the lower rates in Germany to differing degrees. As the capital market rates are likely to diminish further, we can anticipate a progressive improvement in the overall monetary conditions for economic growth in Western Europe. At the same time, the depreciation of the Western European currencies against the dollar and in particular the yen has enhanced competitiveness as compared with the most important non-European rivals. Since growth is also likely to recover somewhat in the rest of the world in 1994, there are prospects of some modest stimulus from foreign trade.

Along with inventory cycle factors, the gradual monetary relaxation that begun about a year ago has been a major contributory factor to slowing down the recession in Western Europe, but apart from the UK there is currently no sign of a recovery. With the expected further lowering of interest rates, demand impulses will gain noticeable strength in the course of 1994. Thus, while financial investment continues to become less attractive, business investment will improve, despite low utilization of capacity. Low interest rates will also give a boost to residential building and they ought also to give an impetus to the propensity to consume. Disposable income will receive relatively little stimulus at first as above all to begin with the productivity of labour will increase, but employment will hardly rise at all. Private consumption will thus revive only slowly. The upswing in aggregate demand and production will under these circumstances only gain little momentum at first. Western European real gross domestic product, which in 1993 will be somewhat below that of the previous year, ought to rise by 1 to 1½% in 1994. Consumer prices in both years will probably rise by some 3%, with differences between countries diminishing considerably.

Compiled by the Department of World Business Trends of the Hamburg Institute for Economic Research (HWWA).

HWWA Index of World Market Prices of Raw Materials[1]
(1975 = 100)

Raw Materials and Groups of Materials	1992		1993					
	AA[2]	August	May	June	July	August	3. 9.	17. 9.
Total index	160.1	165.9	151.8	147.3	141.1	141.7	140.3	138.2
Total, excl. energy raw materials	132.1	136.4	119.5	117.9	119.3	118.5	118.1	118.5
Food, tropical beverages	88.6	85.2	89.9	87.6	92.1	91.3	91.2	93.6
Industrial raw materials	165.2	175.3	142.1	141.0	140.1	139.2	138.6	137.4
Agricultural raw materials	169.8	178.8	144.0	140.6	137.5	136.0	135.3	137.6
Non-ferrous metals	172.3	186.2	142.2	143.8	145.7	144.9	143.0	134.0
Energy raw materials	176.5	183.1	170.6	164.4	153.8	155.2	153.2	149.7

[1] On dollar basis. [2] Annual Average.