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Euroland: Strong upswing, risks to price level stability

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Euroland: Strong Upswing, Risks to Price Level Stability

by Christophe Kamps, Carsten-Patrick Meier and
Joachim Scheide

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● The Euroland economy is in a strong upswing. Last year, real GDP increased at a rate roughly equal to that of potential output in spite of the export losses in the wake of the crises in various countries of the world. There have been considerable impulses from monetary policy. Because of the strength of the economy, the ECB has started to tighten its policy. Nevertheless, monetary conditions in the euro area are still favorable. In 2000, real GDP is likely to increase by 3.2 percent; this is the highest rate in the past ten years.

● After a weak start, the economy gained considerable momentum in the course of 1999. While the strong export performance was responsible for the turnaround, domestic demand growth also accelerated somewhat. In the second half of 1999, real GDP increased at an annual rate of 3.5 percent, and capacity utilization should have reached its normal level by now. Inflation picked up in the course of 1999 with rates between 1.5 and 2.0 percent, thus coming close to the upper limit of the target range tolerated by the ECB. The driving force so far were higher import prices.

● Since November, the ECB has raised key interest rates by 100 basis points to 3.50 percent. This is the first tightening of monetary policy since the fall of 1997. The expansion of M3, however, indicates that monetary policy continues to be expansionary. Last year, the reference value for money growth was exceeded considerably. The interest rate hikes must be seen against this background. They were the logical consequence in the concept which is based on money growth. In the present situation, rules for monetary policy also suggest a tightening. The McCallum Rule pertains to the growth rate of the money stock M3 that is compatible with the inflation target and the trend changes in output and velocity. Since early 1999, money growth has been higher than the rate implied by the rule. If this tendency continued, inflation would exceed 2 percent. In order to avoid this, interest rates have to go up. Similarly, the Taylor Rule suggests that interest rates need to be higher because capacity utilization is at its normal level and will rise further.

● The countries in the euro area have come closer to the target of the Stability and Growth Pact as budget deficits have declined. Next year, fiscal policy will be characterized by tax cuts in a number of countries. The strongest impulse will come from the tax reform in Germany. For Euroland as a whole, the stance of fiscal policy will thus become expansionary. In general, there appears to be a shift in the strategy of fiscal policy: While deficits were reduced on the road to EMU also by increases in taxes and contributions, the revenue/GDP ratio will decline in the coming three years according to the plans of governments. Spending is supposed to decline even more so that deficits will shrink. Such a strategy can be highly recommended. According to empirical estimates, fiscal policy has contributed to the decline in the potential growth rate in the past 30 years by expanding the share of government spending in GDP.

● While leading indicators point to a strong expansion of economic activity in the near future, several factors will lead to a moderate slowdown of the upswing later this year and in 2001. The recovery in the world economy will lose some momentum and the effect of the weaker euro will gradually fade. Furthermore, the ECB will raise interest rates again. An impulse for the upswing, however, will result from the turnaround of fiscal policy. All in all, real GDP growth will amount to 3.2 percent this year and will go down to 2.8 percent in 2001. The unemployment rate will continue to fall; next year, it will drop to below 9 percent for the first time since 1992. Consumer prices will rise a lot faster than in 1999. Although the inflation rate will decline somewhat in the course of this year because import prices will moderate, the core rate of inflation will go up due to the marked rise in capacity utilization. The Harmonized Index of Consumer Prices will increase by 1.9 percent this year and by 1.8 percent next year.

● The weakness of the euro has a stimulating effect on output in the euro area which is equivalent to roughly half a percentage point of GDP. If the trade links of the individual EMU countries with the dollar area are taken into account, it can be shown that the effects are spread more or less symmetrically across the economies.

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Euroland: Strong Upswing, Risks to Price Level Stability

The economy of Euroland is in a strong upswing. Last year, real GDP increased at a rate roughly equal to the growth rate of potential output in spite of the export losses in the wake of the crises in various countries of the world. This suggests that the impulses from monetary policy have been substantial. The European Central Bank has started to tighten its policy somewhat. Nevertheless, monetary conditions in the euro area are still favorable and push the economy. In 2000, real GDP growth in the euro area will reach its highest rate in the past ten years.

In 1999, the rate of inflation accelerated considerably. To a large extent, this was due to higher import prices. However, since money growth has been strong for some time and capacity utilization is increasing, there is the risk that the target of the ECB will be violated. To reduce this risk, the ECB will raise interest rates further and move towards a more or less neutral course. This way, the impulses from monetary policy will decline slightly in the near future. Also, export growth will lose some momentum as the expansion in the world economy will slow down somewhat and the stimulus from the weak euro will gradually fade. This will dampen the upswing next year. However, a turnaround in fiscal policy is in the cards: While on the road to EMU budget deficits were reduced also by increases in taxes and contributions, more and more governments are likely to reduce taxes in the time to come and will also limit spending growth. If this tendency continues, potential output in Euroland will expand faster than in recent years.

1. With Vigor into the New Millennium

After a sluggish start, economic activity in Euroland gained momentum in the course of 1999. This was mainly due to a turnaround of exports. Furthermore, domestic demand growth accelerated slightly at the end of the year. In the second half of 1999 real GDP increased at an annual rate of around 3.5 percent (Figure 1), thus outpacing potential growth. Leading indicators point at a continuation of the rapid output expansion in the first quarter of 2000; capacity utilization in the economy should have reached its normal level by now. The results of the European Commission Business and Consumer Survey reveal that capacity utilization in manufacturing was already above its long-term average in January.

Exports have recovered sharply pushed by the pickup of economic activity in the emerging markets and by the depreciating euro. The euro's real effective exchange rate declined by 12.8 percent in the course of 1999, implying a marked gain in competitiveness for euro area companies. Moreover, exports received impulses from the faster expansion of industrial production in the most important sales markets. Particularly strong was the rise in demand from Southeast Asia, but also the deliveries to the Central and Eastern European reform countries and to the United States showed an acceleration. Germany and Italy benefited most from the export recovery; consequently, the cyclical divergency between euro area countries was noticeably reduced in the second half of 1999.

Domestic demand in Euroland proved robust last year in view of strong monetary impulses. Especially the weakness of economic activity in the first months of 1999 did obviously not lead to a downward revision of investment plans. Stimulated by low interest rates, gross fixed capital formation increased by 4.5 percent, a rate far above the average rate experienced in the 1990s. Private households raised their consumption expenditures almost as fast as in the preceding year; real disposable income expansion remained strong in view of an only marginal slowdown in employment growth and higher wage settlements. In contrast, inventories rose at a lower pace than before, partly reflecting the unexpectedly strong increase in final demand in the second half of 1999.

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Figure 1: Business Cycle Indicators[a] for Euroland

Total Output[b,c]

Unemployment

Survey Data

Industrial Production

External Trade[b,d]
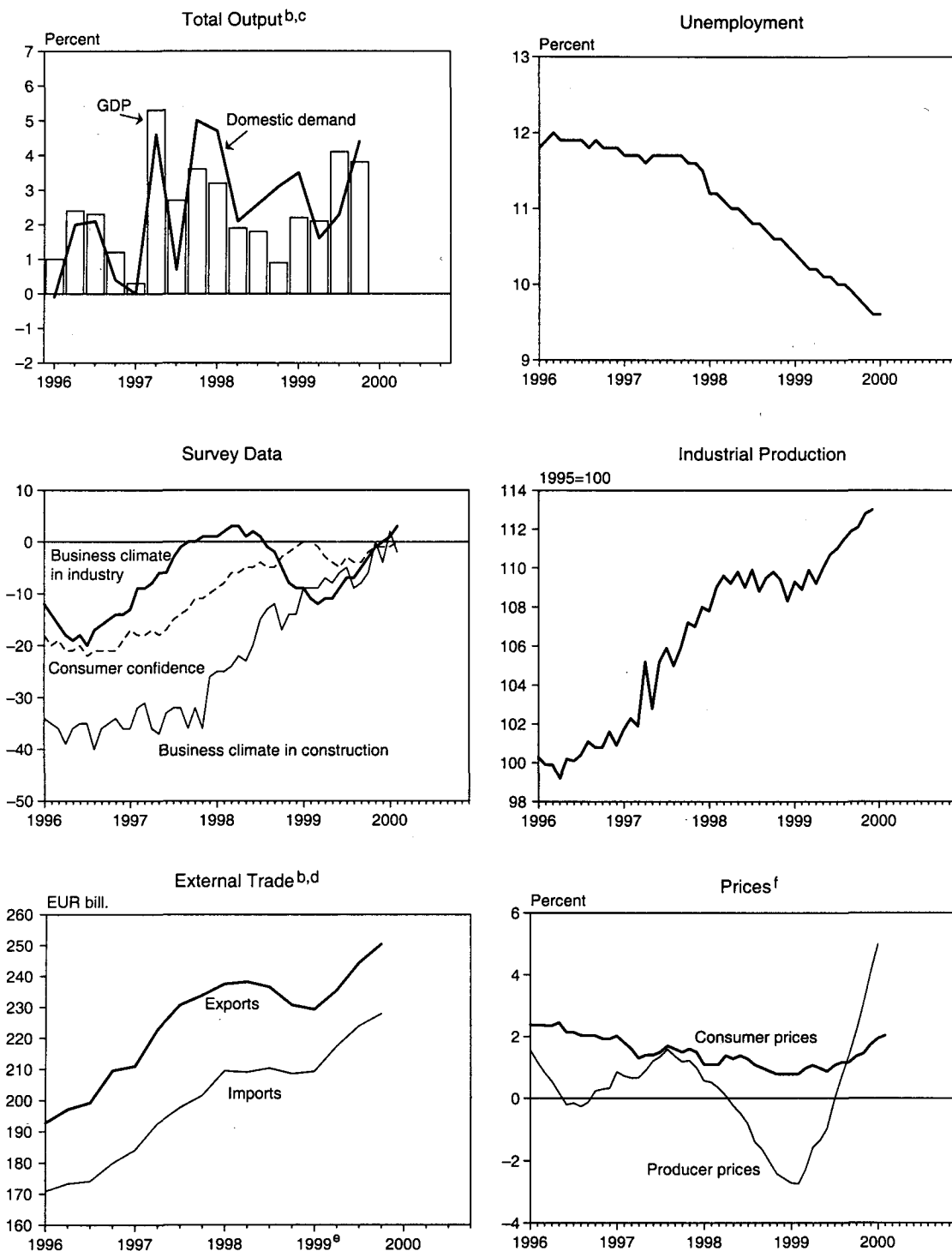
Prices[f]

[a]Seasonally adjusted. — [b]At constant prices. — [c]Percentage change over previous quarter (annual rate). — [d]Estimated on the basis of the national accounts excluding intra-Euroland trade. — [e]Partly estimated. — [f]Percentage change over previous year.

The evolution on the labor market in Euroland was remarkable. In spite of the economic slowdown at the beginning of the year, the number of employees expanded by 1.4 percent in 1999, thus only a little slower than in the year before (ECB 2000: 43). Nonetheless, there were considerable differences between countries: Whereas employment went down for most of the year in Germany and Italy, it increased strongly in all other countries. This discrepancy was probably due to the fact that capacity utilization fell in Germany and Italy in the first half of the year, whereas it stayed constant or even rose in the other countries. Employment growth was surprisingly high in France, with an annual rate of change of about 2 percent; the unemployment rate fell to 11 percent. Here the strategy of reducing charges in the low-wage sector followed since 1993 seems to pay off (IMF 1999b: 18). However, it is doubtful whether the compulsory 35-hour workweek introduced in February 2000 will lead to additional employment. Admittedly, the corresponding law provides for more flexibility in working time, but it has to be expected that the labor cost increase will cause a slowdown in employment growth. Without further labor market reforms, France will probably not succeed in reducing structural unemployment markedly.[1]

Consumer price inflation accelerated considerably in the course of last year; the driving force behind this evolution was the surge in energy commodity quotations. Since spring 1999, the quarterly rates of change in the seasonally adjusted Harmonized Index of Consumer Prices (HICP) have been between 1.5 and 2 percent, thus reaching the upper bound that the ECB is willing to tolerate in the medium term. However, the core inflation rate that excludes energy prices remained subdued; it amounted to 1.1 percent in December. In the service sector, price increases further slowed down mainly due to the deregulation of telecommunication markets. Producer prices rose markedly, however, after imported goods had become much more expensive partly owing to the depreciation of the euro. In view of the good economic situation, the increase in producer prices should translate into higher consumer prices in the course of this year. In consequence, we expect a rise in the core inflation rate.

2.   Correction of Monetary Policy

Since the fall of last year, the European Central Bank has raised its key interest rates in three steps by 100 basis points. Monetary policy in the countries of the euro area has thus been tightened for the first time since the fall of 1997. The interest rate on the main refinancing operations now stands at 3.50 percent, the rates on the marginal lending facility and the deposit facility amount to 4.50 percent and 2.50 percent, respectively. The 3-month money market rate has gone up by about 90 basis points since September 1999.[2] Long-term interest rates have increased as well but not as fast as until the fall of last year (Figure 2).

The development of interest rates per se suggests that monetary conditions have deteriorated since the fall of 1999. To be sure, the increase in short-term rates was accompanied by a roughly equal rise in inflation, but this was mainly due to the temporary acceleration of import prices which does not have an impact on inflationary expectations; as a consequence, the real rate of interest has increased. This does not mean, however, that monetary policy has become restrictive. Real short-term interest rates calculated on the basis of the core rate of inflation amount to about 2.5 percent, which is lower

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[1]   The French labor market belongs to the most regulated ones among industrial countries (OECD 1999a: 156 ff.). The rate of structural unemployment is estimated to be around 10 percent by the OECD (1999b: 56).

[2]   The 3-month money market rate recently stood at 3.7 percent and was thus only slightly higher than right before the first rate hike by the ECB in November 1999; however, its level at that time was affected by the strong demand due to the uncertainty related to the millennium change.

Figure 2: Indicators of Monetary Policy in Euroland

Money Stock M1[a]

Percent

Money Stock M3[a]

Percent

Short-Term Interest Rates

Percent

Long-Term Interest Rates

Percent

Yield Spread[b]

Percentage points

US Dollar/Euro Exchange Rate[c]
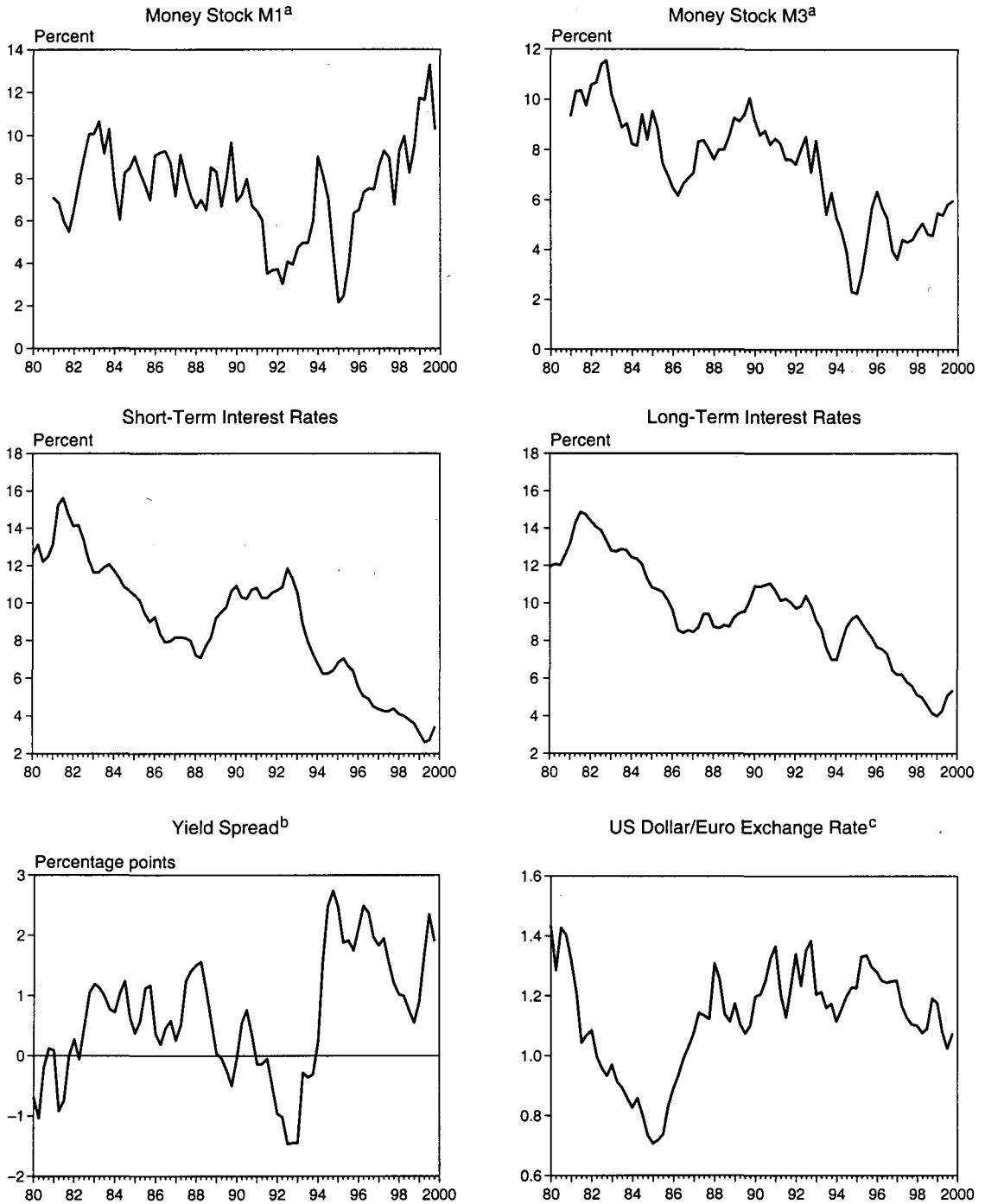
[a]Percentage change over previous year. — [b]Long-term interest rate minus short-term interest rate. — [c]Before 1999: US dollar/ecu exchange rate.

than the long-term average. Real long-term interest rates, which currently stand at 4.5 percent, are slightly higher than in the past.[3]

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3   As a reference, the averages for Germany are used. In many other European countries, real interest rates were much higher in the past.

The rate of money growth indicates that the stance of monetary policy is still expansionary. After the acceleration in the first half of 1999, the expansion of M3 came down somewhat, the annual rate of change amounted to slightly less than 5 percent in recent months. For the year as a whole, however, the reference value of 4.5 percent was exceeded considerably. Credit growth, too, continued to expand at a high rate.

The renewed weakness of the euro has contributed to an improvement of monetary conditions. The European currency devalued not only against the US dollar but also against the British pound and the Japanese yen. The real effective exchange rate of the euro has declined by 13 percent since the beginning of 1999, in February 2000 it was about 7 percent lower than half a year ago.

All in all, monetary conditions in Euroland continue to stimulate economic activity. As capacity utilization will increase even further, the risks to price level stability would rise if the current stance of monetary policy were to continue. We assume, therefore, that the ECB will raise interest rates again.

2.1   On the Reference Value for the Current Year

Early December last year, the ECB determined the reference value for the year 2000; the money stock M3 is supposed to rise by 4.5 percent, the same rate that had been envisaged for 1999. The ECB justified this decision by stating that the underlying estimates for potential output growth in the euro area (2 to 2.5 percent) and the decline in trend velocity (0.5 to 1 percent) have remained unchanged compared to last year (ECB 1999b: 10 f.). Thus, it did not follow the suggestion made by several observers to raise the value somewhat, namely to 5 percent. This proposal was based on an estimate which revealed that the decline in trend velocity was 1 to 1.5 percent instead (Arbeitsgemeinschaft 1999: 36). The period for which a trend has to be estimated is, of course, somewhat ambiguous. For the period 1992–1999 used by the ECB, the decline in velocity is indeed smaller (ECB 1999b: 11). Therefore, the decision by the ECB can be justified, and it does not change the underlying norm for the inflation rate. Furthermore, there are no indications of an instability of money demand in the transition phase; therefore, there was no reason for the central bank to change its view.[4]

Nevertheless, other motives for not raising the reference value are possible. Maybe the ECB expected that such a move would have been misunderstood as a relaxation of monetary policy. However, this could have been avoided by a well-founded explanation. Possibly, the more important reason was the fact that the reference value for 1999 had been exceeded considerably, namely by 1.5 percentage points. According to the medium-term concept of monetary targeting, this overshooting should be corrected.[5] It would have been necessary, therefore, to reduce the reference value relative to the optimal path. The ECB did not do this; it was only mentioned that "the generous liquidity situation in 1999 will have to be borne in mind when assessing the information content of monetary developments in the future" (ECB 1999b: 11). The ECB should — if there are no changes in the underlying estimates — avoid a renewed overshooting of the target.

The recent interest rate hikes have to be seen against this background. Because of the strong upswing and the pickup of inflation, a stronger increase in money demand is likely. Should this not

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[4]   Even if there were a larger decline in trend velocity, the ECB could still stick to the reference value of 4.5 percent. This would be equivalent to reducing the norm for the inflation rate from the current 1.5 percent to 1 percent. Given that the ECB obviously tries to keep inflation in a range between 0 and 2 percent, such a move would indeed make sense because 1 percent would be the middle of the range. However, it would have been necessary to explain such a shift to the public.

[5]   In its description and also in its derivation of the reference value, the ECB follows the concept of orienting money growth at the potential output which the Deutsche Bundesbank pursued in previous years. The idea of this strategy is to stabilize price level expectations. This target can be achieved only if the money stock is kept on the target path; under these circumstances, the price level is trend-stationary. If corrections are not made ("base drift"), the price level becomes nonstationary, i.e., it includes a random walk component. As a result, inflationary expectations would not be stable as is intended by the strategy. This means that the reference path for this year should actually start at the targeted and not at the actual level of M3 at the end of 1999.

lead to an acceleration of monetary expansion, interest rates had to be raised. This is the logic of the concept based on money growth. Critics of the recent interest rate increases obviously want to criticize this strategy as such. Even though the ECB does not use this concept "mechanically," the rate hikes were justified. However, this has not been clarified enough by the statements of the ECB.

This year will bring an important test for the first pillar of the ECB's strategy, i.e., the reference value for M3. The ECB should not allow another overshooting of the reference value because this would reduce its credibility. The ECB has stated over and over again that inflation is a monetary phenomenon (ECB 1999a: 39). The basis for its concept, namely the stability of money demand in the euro area, is still intact (Coenen and Vega 1999) and it has not been discredited by recent developments (ECB 1999b). This implies that also the second pillar, i.e., the perspectives for inflation, is affected because the money stock is an important variable for predicting inflation. Against the background of the strong upswing and higher inflation, we expect the ECB to raise key interest rates by another 25 basis points until the summer of this year. The money market rates will rise accordingly.

2.2   Rules for Monetary Policy Call for Further Action

According to the first pillar of the ECB's strategy, money growth has to be checked so that there is no excess liquidity. This strategy can be translated, for example, into the rule for the money stock suggested by Bennett McCallum. According to this rule, the growth rate of the money stock M3 is calculated so that it is compatible with the target for inflation, which is assumed here to be 1.5 percent, and the trend changes in output and velocity. [6]

At the beginning of the 1990s, M3 expanded faster than was compatible with the (hypothetical) inflation target (Figure 3). Actually, inflation was above 1.5 percent for a few years and came down only after money growth had decelerated. Neglecting short-run fluctuations, M3 growth came down so that at the beginning of the monetary union inflation was also low. Since early last year, however, monetary expansion has accelerated beyond the stability-oriented path; this is true even though the rate according to the rule has also gone up slightly.

In the past, there have been deviations from the optimal path time and again, but this has not necessarily led to deviations from the target of price level stability. However, it is important that the path is not exceeded over a longer period. If, for example, expansion of M3 continued at the rate observed last year, the McCallum Rule would suggest that inflation would be higher than 2 percent. As it is likely that money demand will rise substantially in the course of this year because of the strong upswing, there is the risk that money growth will be too high if interest rates remain constant. Thus the concept of monetary targeting — whether on the basis of the McCallum Rule or in the strategy of the ECB — implies that key interest rates will have to be raised. After these rate increases, we expect the liquidity overhang to decline gradually.[7]

In the present situation, interest rate hikes can also be justified on the basis of the rule proposed by John Taylor.[8] Here, the short-term interest rate controlled by the central bank (e.g., the 3-month money market rate) is determined by the cyclical situation and the inflation rate relative to its target.[9]

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[6]   For the calculations, see Gern et al. (1999: 324). In the rule by McCallum (e.g. 1999), the trends are calculated by taking the averages over the past four years. This rule is remarkable in the sense that, contrary to the often-heard notion, monetary targeting can be pursued even if the money demand function is not stable. The resulting instability of velocity is captured by the averaging procedure.

[7]   There is a problem of interpreting the published M3 figures: The ECB adjusts the original data to account for, among other things, exchange rate variations (ECB 2000: 14*) without giving an explicit explanation. Without these corrections, money growth would be higher. For example, the year-over-year increase in December 1999 actually was 7.6 percent instead of the "corrected" 6.4 percent.

[8]   For the calculations, see Gern et al. (1999: 324).

[9]   For the period up to the beginning of the monetary union it is not possible to calculate an average interest rate for the euro area which could sensibly be used as a gauge for monetary policy. In Figure 4, the actual interest rate is the one observed in Germany, while the Taylor rate is calculated on the basis of data for Euroland; thus, there is an unusually

Figure 3: Expansion of M3 in Euroland: Actual Values and Values According to the McCallum Rule[a]
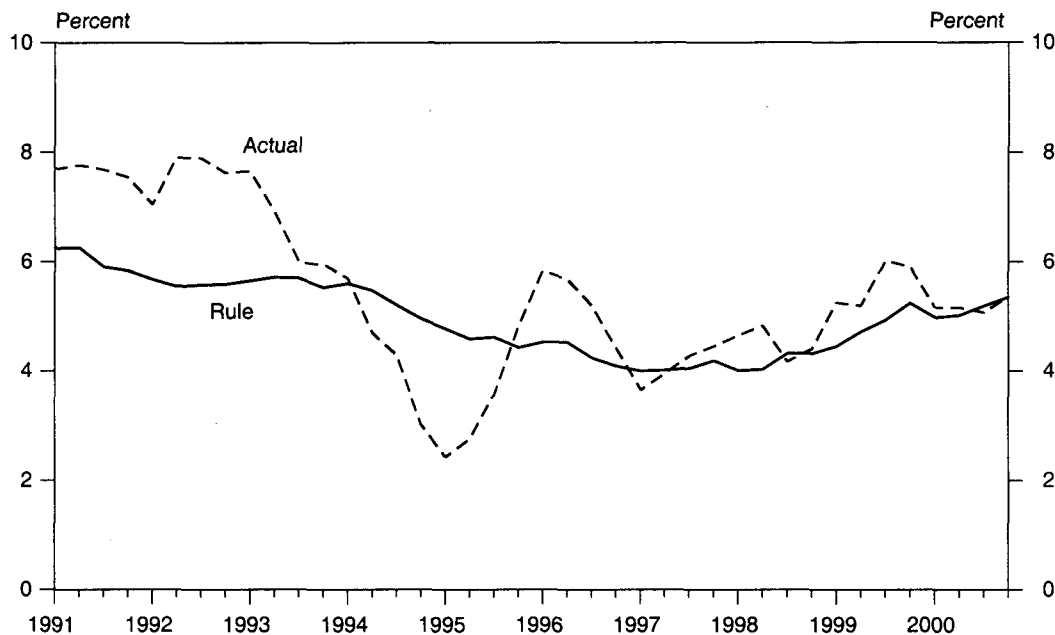
[a]Year-over-year increase of M3. Forecast starting in 2000 I.

According to this rule, the cut of interest rates in April 1999 was not justified (Figure 4). In fact, the Taylor rate increased in the course of last year as the upswing gained momentum and inflation picked up. At the beginning of 2000, the interest rate according to the Taylor Rule is about 4.5 percent. This is the value which is based on an assumed equilibrium real short-term interest rate of 3 percent[10] and on the observation that capacity utilization is near its normal level[11] and inflation near the target of 1.5 percent. The actual 3-month money market rate is about 80 basis points lower than the Taylor rate. One could, however, argue that the Taylor rate is actually lower — and, equivalently, the present stance of monetary policy is less expansionary —, if the core rate of inflation (which excludes energy prices) is used instead of the actual inflation rate. But even under this assumption, the interest rate according to the Taylor Rule would increase in the course of this year as capacity utilization will go up further and the core rate will accelerate, too.

2.3 Should the ECB Be Concerned about the Euro?

The comments of the ECB on the role of the exchange rate have not always been clear-cut. This may have led to irritations also on financial markets. Although it had been stated several times that the exchange rate was not a reason for the ECB to act, monetary policy decisions were influenced by the weakness of the euro. In an interview (*Süddeutsche Zeitung* 2000), the president of the ECB stated that the interest rate increase by 0.25 percentage points, "which would have come in any case, was made already at the beginning of February because of the weakness of the euro in the second half of

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large difference between the rates. For a criticism of the Taylor Rule, see, for example, Deutsche Bundesbank (1999) and Scheide (1998).

[10] This value of 3 percent is somewhat lower than the long-term average for Germany. The calculation of the equilibrium rate is subject to many problems, see Scheide (1998:10).

[11] The calculations of potential output are based on the data published by the OECD (1999b). The estimates of the output gap were corrected according to recent figures of actual GDP. Quarterly figures were produced by interpolation of the annual OECD data. Due to the strong increase in real GDP in the second half of 1999, the output gap was reduced substantially. A similar judgment on the size of the present output gap can be made if the Hodrick-Prescott filter is used.

Figure 4: Short-Term Interest Rates in Euroland: Actual Values and Values According to the Taylor Rule[a]
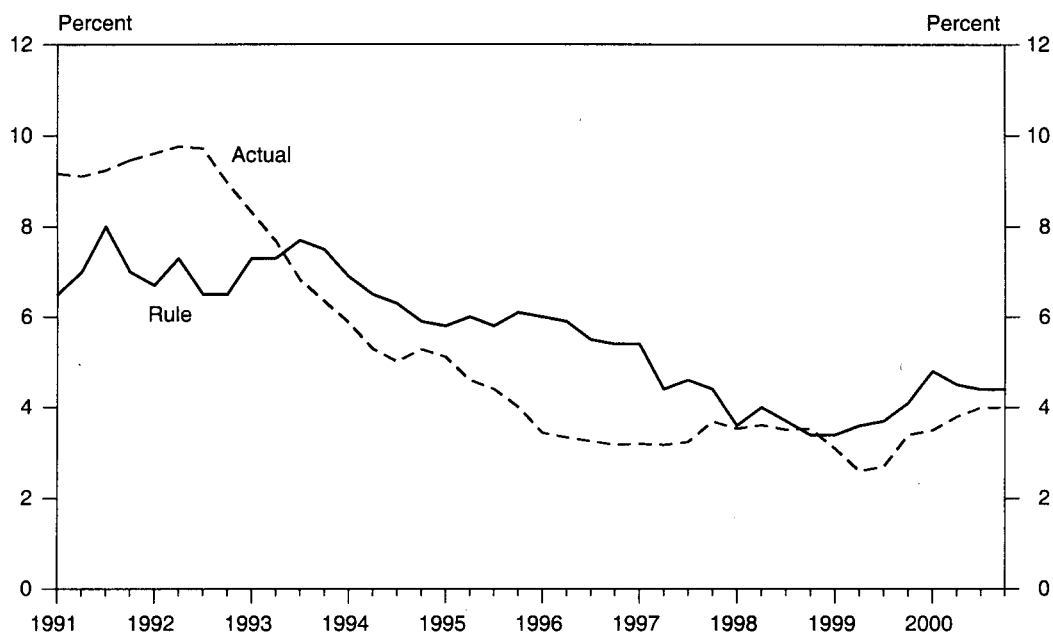
[a]3-month money market rate. Forecast starting in 2000 I.

January" (own translation). Obviously, exchange rate movements can influence at least the timing of decisions on key interest rates.

The exchange rate is affected by a large number of factors. Monetary policy at home and abroad play an important role. Furthermore, other measures of economic policy, the economic outlook and possibly political factors can have an impact. Whether the central bank should react to changes in the exchange rate depends crucially on the causes of those movements. The strategy of the ECB rests on two pillars, and these alone should serve as the basis for decisions. The concept of monetary orientation is not directly affected by the exchange rate. But it matters for the second pillar, namely the perspectives for inflation; however, here the exchange rate is only one of the many indicators which the ECB is looking at when making an inflation forecast. And above all, it has to be kept in mind that onetime changes in the exchange rate do not have a lasting effect on the inflation rate or on inflationary expectations but may only lead to onetime changes in the price level.

There are possibly several reasons for such changes in the exchange rate. For example, the euro may be weak because markets do not expect that the structural reforms in the euro area are pursued to a sufficient degree. The low value of the euro would then be the result of the outlook for economic growth which is assumed to be less favorable for Europe than for the United States. This would imply a permanently lower value for the euro, and there is no reason for the ECB to adjust its policy. Furthermore, it would not make sense if the ECB raised interest rates only because of political uncertainty in individual countries or because the markets did not trust the political situation. The exchange rate may weaken for some time because of such perceptions, but there is no reason for the ECB to dampen economic activity in the euro area just for that reason.

However, the exchange rate may signal that there is indeed a need to act in that it points to a too expansionary monetary policy which would jeopardize the target of price level stability. But the need to correct the policy stance does not stem from the exchange rate devaluation as such but rather from the fact that monetary policy has been too loose; the exchange rate is just an indicator for this policy mistake. The size of this effect on the value of the euro can probably not be determined. But this does not matter for the reaction because the ECB has measures which define how monetary policy should

be pursued in order to achieve price level stability. In the strategy of the ECB, the money stock M3 has a prominent role, and the ECB has repeatedly stressed the importance of the reference value. This means that monetary expansion has to be lower than in 1999. Against the background of the current and the expected path of output and prices in the euro area, interest rate increases are necessary to reach the reference path announced for this year.

In general, the ECB would be well advised to make the decisions on interest rates independently of market expectations or public debate. The central bank has to determine the course, and it should not be influenced by speculations on financial or foreign exchange markets. If the ECB decides that an interest rate increase is necessary — either because monetary expansion is too high (first pillar) or inflation is likely to increase (second pillar) —, it should simply raise rates. The freedom to act according to its strategy cannot be limited by considerations whether speculations on markets are met or whether they are disappointed. Furthermore, its actions should be independent of actions by other central banks: It does not matter whether the ECB raises interest rates at the same time as the Fed does, or whether it is earlier or later. Only domestic considerations are essential for monetary policy. The ECB can strengthen its reputation only if it follows its strategy with the necessary determination.

3. Tax Cuts Stimulate Economic Activity and Growth

In 1999, Euroland further approached the medium-term target of a balanced budget laid down in the Stability and Growth Pact. The general government budget deficit amounted to 1.2 percent in relation to GDP compared to 2 percent in 1998. In view of a decreasing capacity utilization, the fall in the structural deficit was even more pronounced (Figure 5). Nevertheless, fiscal policy seems to have been far less restrictive than is implied by the mere numbers. Due to special effects tax revenues increased strongly in Germany and Italy — differently from what would have been expected on the basis of the fall in capacity utilization in these countries.[12] Moreover, interest payments (in relation to GDP) which cannot be influenced by governments in the short run went down further in Euroland. Consequently, the cyclically adjusted primary balance (structural budget balance less interest payments) showed no noticeable improvement (ECB 1999b: 49). All in all, the stance of fiscal policy seems to have been roughly neutral in 1999.

Figure 5: Indicators of General Government Fiscal Position in Euroland[a]
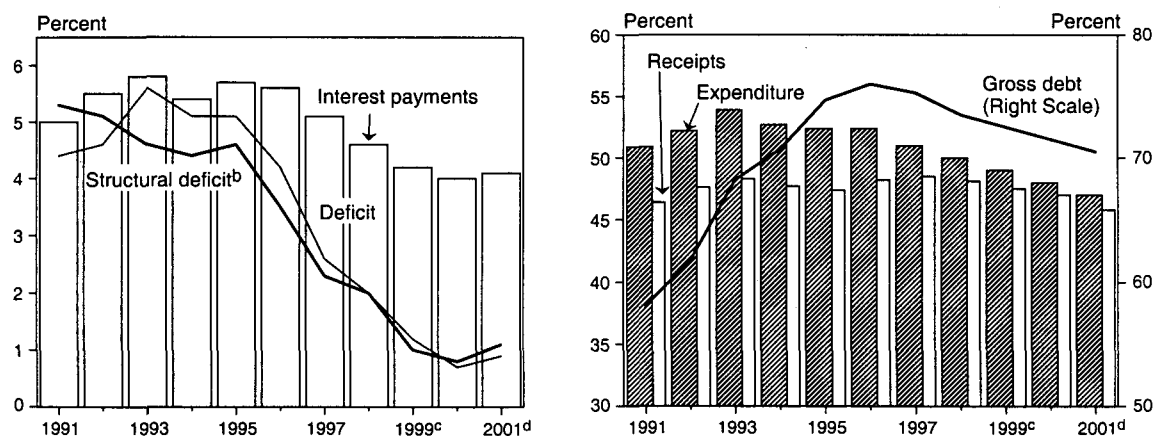
[a]In percent of nominal GDP. — [b]Based on potential output estimated with a Hodrick-Prescott filter. For details on the methodology, see Döpke et al. (1998: 281 f.). — [c]Estimation. — [d]2000 and 2001: Forecast.

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[12] In Germany, assessed taxes surged because of taxes for profits that had been made in prior years. Italy partly succeeded in its effort to check tax evasion.

For the year 2000, we expect a further decline of the budget deficit in Euroland to 0.7 percent in relation to GDP. This will be mainly due to the good economic situation. The structural deficit will be only slightly lower than in 1999; its decrease will mainly rest on the further fall in interest payments (in relation to GDP). Fiscal policy will by and large have neutral effects on economic activity.

In 2001, however, fiscal policy will alter its course and turn expansionary due to tax cuts in most euro area countries. The big countries above all plan substantial reductions in income and company taxes. The German tax reform will provide by far the greatest relief; since the German government will not cut expenditures equivalently, the stimulus for economic activity will be considerable. In Euroland as a whole, the budget deficit will rise to 0.9 percent in relation to GDP. Since the economy will still expand faster than potential output, the structural deficit will increase by more indicating an expansionary stance of fiscal policy.

4. Ambitious Fiscal Plans for the Medium Term

In the past few months, EMU member countries have presented the updated versions of their Stability and Growth Programs to the ECOFIN Council and to the European Commission.[13] In these programs the governments report on the actual budget situation and on fiscal plans until the year 2003. According to the Stability and Growth Pact, the core of the programs is the documentation of the measures planned in order to reach a balanced budget in the medium run. In its "Broad Guidelines of the Economic Policies of the Member States and the Community," adopted in 1999, the European Council has urged governments to pursue this goal more vigorously. Above all, they should take full advantage of the good economic situation and "front-load the budgetary adjustment efforts envisaged in their programs as of the year 2000." It should be clear that a fast achievement of the balanced budget goal does not only serve the observance of the 3 percent ceiling laid down in the Stability and Growth Pact. Rather Euroland needs to take actions in order to be prepared for the financial burden that will arise in the next decades from the aging of its society. In addition, the European Council called upon euro area countries to reduce the tax burden — in line with the provisions of the Stability Pact — and to further liberalize protected sectors.

The Stability and Growth Programs presented recently have to be judged against this background (Table 1). First, it has to be recorded that Finland, Ireland and Luxembourg — as well as the non-member states Denmark and United Kingdom — exhibit budgetary surpluses and moreover a public debt-to-GDP ratio of less than 60 percent. To this extent there is no urgent need for action in these countries. All other Euroland countries with the exception of the Netherlands showed budget deficits in 1999, which in some cases were too close to the reference value of the Maastricht Treaty. These countries plan further progress regarding budgetary consolidation. However, only Spain and Belgium strive for a balanced budget until the year 2003. Although the speed of consolidation will thus remain slow, there has been a noticeable development: Whereas deficits were brought down through revenue increases in the run-up to monetary union, European governments are now planning to considerably reduce public revenues in relation to GDP. The ratio of expenditures is supposed to shrink even more so that the budget deficit in Euroland will probably decline further.

These intentions of the European governments are to be welcomed. According to empirical investigations the decline in the industrial countries' potential growth rate in the past 30 years is partly due to the strong expansion of the public sector's share in the economy.[14] This expenditure growth

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[13] At the time of publishing this report, the Stability and Growth Programs of Austria and Portugal were not yet available.

[14] In a cross-section analysis comprising 87 countries for the period 1965–1985, Barro and Sala-i-Martin (1999: 434) find that an increase in the public spending/GDP ratio by one percentage point led to a decline in the potential output growth rate by approximately 0.1 percentage points. Heitger (1998: 113) reaches a similar conclusion in a study encompassing

Table 1: Key Figures of the Stability and Growth Programs[a]

	GDP growth[b]		General government budget balance[c]		Gross public debt[c]		Expenditure[c,d]		Receipts[c,d]	
	1996–1999	2000–2003	1999[e]	2003	1999[e]	2003	1999[e]	2003	1999[e]	2003
Germany	1.5	2.5	–1.2	–0.5	61.0	58.5	48.5	45.0	47.3	44.5
France	2.3	2.6	–2.1	–0.3	60.3	57.2	53.9	51.1	51.8	50.8
Italy	1.3	2.6	–2.0	–0.1	114.7	100.0	48.7	45.0	46.7	44.9
Spain	3.5	3.4	–1.3	0.2	63.5	55.8	41.3	39.5	40.1	39.8
Netherlands[f,g]	3.5	2.8	–0.6	–0.3	64.3	59.8	40.1	38.7	39.2	37.3
Belgium	2.3	2.4	–1.1	0.4	114.9	101.2	47.4	44.8	46.4	45.2
Finland	5.9	3.0	3.1	4.7	46.6	35.2	50.5	47.1	51.2	49.3
Ireland[f]	9.0	6.5	3.2	2.9	52.0	36.0	32.3	29.0	35.5	33.6
Luxembourg	4.8	5.1	2.3	3.1	4.3	.	44.1	39.3	46.4	42.4
Euroland[h]	2.1	2.7	–1.4	–0.1	73.1	66.9	48.4	45.3	47.0	45.2

[a]Some Stability and Growth Programs include alternative scenarios concerning GDP growth. This table reflects the basic scenario. — [b]Average annual growth rate. — [c]In percent of GDP. — [d]Based on figures from the Stability and Growth Programs, partly corrected for differences in definitions. — [e]Figures for 1999 are taken from the Stability and Growth Programs. — [f]Projection until 2002 only. — [g]Central government. — [h]Average for the mentioned countries.

Source: OECD (1999b), Stability and Growth Programs, own calculations and estimates.

had to be financed by substantial tax increases and rising budget deficits. Against this background, the strategy of a simultaneous charge and deficit reduction is appropriate for Euroland. Nonetheless, Germany, France, Italy and Austria should take additional measures and further restrain public expenditure.[15] Otherwise these countries could be pushed beyond the 3 percent deficit value in the case of an adverse shock (Dalsgaard and de Serres 1999). Therefore, governments should take additional consolidation measures in view of the currently favorable economic conditions in order to avoid an evolution comparable to that in the 1990s. At that time, budget deficits were not brought down rigorously enough in upswing periods. In the following downturns, excessive deficits could only be avoided by opposing automatic stabilizers. Thus, fiscal policy followed a procyclical course for most of the past decade (OECD 1999b: 142).

5.   Outlook: Slight Cooling Down in 2001

Leading indicators point at a continued vigorous expansion of economic activity in the next months. Industrial confidence has risen until recently — in particular the improved assessment of order books points at a vivid increase in production. At the same time consumer confidence has stabilized at a very high level. The bright picture is also expressed by the composite indicator of economic sentiment which at the beginning of 2000 was at its highest level since the boom in the wake of German unification.

We expect a slight weakening of propellant forces for the further course of this year and for the year 2001 (Table 2). The pace of expansion will come close to potential output growth at the end of the

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the OECD countries. One should keep in mind that the public sector's share in the economy has risen by roughly 20 percentage points in most euro area countries since the 1960s.

[15] Alesina and Perotti (1997) indicate that in the past, budgetary consolidation yielded persistent successes when the implemented measures concerned the expenditure side of the budget. Particularly, government consumption should be scaled down and not — as was often experienced in the run-up to European Monetary Union — public investment.

Table 2: Quarterly Data on the Economic Development in Euroland, 1999–2001

	1999				2000				2001			
	1.Q.	2.Q.	3.Q.	4.Q.	1.Q.[a]	2.Q.[a]	3.Q.[a]	4.Q.[a]	1.Q.[a]	2.Q.[a]	3.Q.[a]	4.Q.[a]
Gross domestic product[b]	2.2	2.1	4.1	3.8	3.3	2.8	2.7	2.7	3.0	2.8	2.5	2.4
Domestic demand[b]	3.5	1.6	2.3	4.4	3.2	2.7	2.7	2.8	3.2	3.2	2.9	2.8
Private consumption[b]	3.0	1.2	3.0	3.2	2.8	2.7	2.7	2.8	3.2	3.2	2.8	2.8
Public consumption[b]	3.4	–0.3	1.0	1.2	2.4	1.2	1.3	1.2	1.4	1.6	1.2	1.0
Fixed investment[b]	6.7	2.9	7.0	2.0	5.9	4.8	4.9	4.6	4.4	4.4	4.4	4.4
Change in stocks[c]	–0.3	0.4	–1.0	1.8	–0.1	–0.1	–0.2	–0.1	0.1	0.1	0.0	0.0
Net exports[c]	–1.2	0.5	1.8	–0.4	0.1	0.1	0.1	0.0	–0.1	–0.4	–0.3	–0.3
Exports[b,d]	1.7	9.8	13.9	5.7	8.9	8.9	7.9	7.2	6.6	5.8	5.5	5.2
Imports[b,d]	5.6	8.5	8.7	7.3	9.1	9.1	8.1	7.7	7.4	7.2	6.5	6.3
Unemployment rate[e]	10.3	10.1	10.0	9.7	9.4	9.2	9.0	8.8	8.6	8.5	8.4	8.3
Consumer prices (HICP)[f]	0.7	2.0	1.5	2.0	2.3	1.8	1.7	1.8	1.8	1.8	1.7	1.7
Money stock M3[b]	8.2	5.5	5.9	4.7	4.9	5.5	5.5	5.5	5.2	5.0	5.0	5.0
3-month money market	3.1	2.6	2.7	3.4	3.5	3.8	4.0	4.0	4.0	4.0	4.0	4.0
Long-term interest rate	1.1	1.1	1.1	1.0	5.6	5.7	5.8	5.8	5.8	5.8	5.7	5.5
Exchange rate vis-à-vis US dollar[g]	1.12	1.06	1.05	1.04	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Real effective exchange rate[h]	100.0	96.0	94.7	92.2	89.7	89.7	89.7	89.7	89.7	89.7	89.7	89.7

[a]Forecast. — [b]Annualized quarterly rate of change in percent. — [c]Contribution to change in GDP. — [d]Including intra-Euroland trade. — [e]In percent of the labor force, harmonized according to the ILO concept. — [f]Change over previous year in percent. — [g]US \$/euro. — [h]Index 1999 I = 100.

Source: Eurostat (2000), EZB (2000b), OECD (2000), own calculations and estimates.

forecast horizon (Figure 6). We assume that the oil price will decline somewhat because oil producers will raise oil production (Gern et al. 2000).

The slowdown will be mainly due to external influences (Figure 7). We expect that the demand increase from the most important export markets — particularly from the United States — will decline markedly. Furthermore, the impulses stemming from the depreciation of the euro will gradually fade. After the dynamic development during the past winter, exports will grow at a noticeably slower pace. Imports will expand at an only slightly slower rate in view of a buoyant domestic demand so that net exports should decline next year.

In contrast, domestic demand will continue to expand rapidly. Although monetary conditions will not be as favorable as until recently, a strong impulse will come from fiscal policy next year. Increasing capacity utilization in the overall economy should result in a continuously brisk investment activity. If wage settlements turn out to be moderate — as we assume in this forecast —, vigorous employment growth can be expected. Then the unemployment rate will go down further; next year it will fall below 9 percent for the first time since 1992. In view of this labor market development, consumer confidence will further improve and private consumption should rise rapidly in the forecast horizon — not least because of the tax cuts. After a growth rate of 3.2 percent in this year we expect an increase in real GDP of 2.8 percent for the year 2001 (Table 3).

Consumer price inflation will turn out markedly higher than in 1999, with a rate of almost 2 percent in both years of the forecast period. In spring of 2000, the inflation rate in Euroland should even exceed 2 percent due to basis effects. After mid-year, though, the effects of the rapid rise in oil prices will gradually fade. Dynamic activity will augment companies' scope for price increases so that core inflation should go up considerably.

Figure 6: Real GDP[a] in Euroland

[a]Seasonally adjusted. — [b]Annualized quarterly rate of change in percent. — [c]Percentage change over previous year. — [d]Calculated using a Hodrick-Prescott filter. — [e]Forecast.
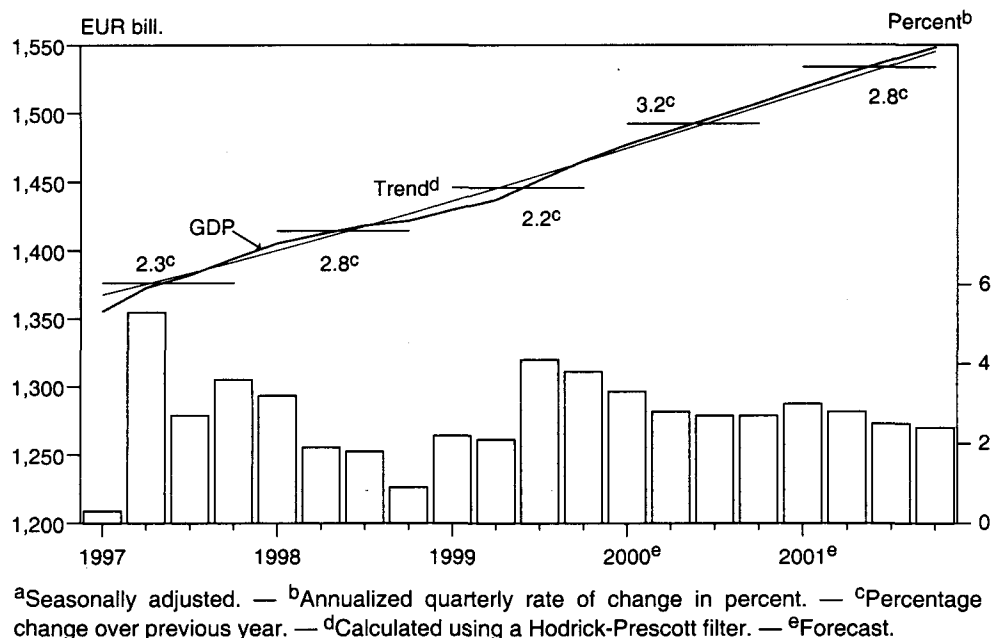
Figure 7: GDP, Domestic Demand and Net Exports in Euroland[a]

[a]At constant prices. — [b]Percentage change over previous year. — [c]Change of net exports over previous year in percent of GDP in the dame quarer of previous year. — [d]Forecast.
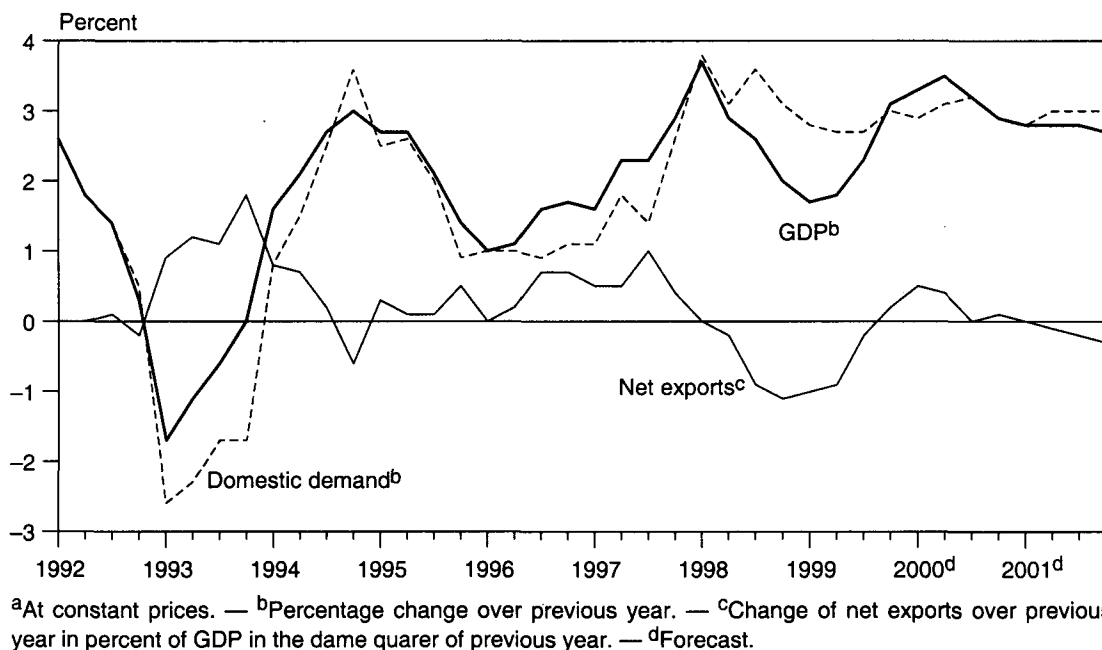
The greatest risk to economic development in the near future lies in a recession in the United States. If a hard landing of the US economy occurred, the euro area countries would also be affected.[16] Then export dynamics would suffer a serious set-back — not least because of a massive depreciation of the US dollar.

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[16] For an extensive discussion of this scenario see, Gern et al. (2000).

Table 3

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Table 3: Real GDP, Consumer Prices and Unemployment Rate in Euroland, 1998-2001

	Weights in total[a]	Real GDP[b]				Consumer prices[b,c]				Unemployment rate[d]			
		1998	1999	2000[e]	2001[e]	1998	1999	2000[e]	2001[e]	1998	1999	2000[e]	2001[e]
Germany	33.0	2.2	1.5	2.7	2.6	0.6	0.7	1.4	1.4	9.4	9.1	8.4	7.6
France	22.2	3.4	2.7	3.4	3.0	1.4	1.5	1.6	1.5	11.7	11.0	9.4	8.9
Italy	18.1	1.3	1.4	2.5	2.3	2.0	1.6	2.1	1.8	11.9	11.3	10.7	10.3
Spain	8.6	4.0	3.7	4.0	3.4	1.8	2.2	2.6	2.5	18.8	15.8	14.3	13.2
Netherlands	5.8	3.7	3.5	3.7	3.2	1.9	2.0	2.1	3.0	4.0	3.1	2.8	3.0
Belgium	3.9	2.7	2.3	3.1	2.8	0.9	1.2	2.0	1.8	9.5	9.0	8.2	7.7
Austria	3.3	2.9	2.2	3.3	2.7	0.8	0.5	1.9	1.7	4.7	4.3	4.1	4.2
Finland	1.9	5.0	3.5	4.0	3.6	1.4	1.5	2.0	2.3	11.4	10.3	9.2	8.6
Portugal	1.6	3.5	3.0	4.0	3.5	2.2	2.2	2.1	2.5	5.1	4.5	4.2	4.4
Ireland	1.3	8.1	7.3	7.5	6.5	2.2	2.5	4.0	3.0	7.7	6.5	5.6	5.0
Luxembourg	0.3	5.0	4.9	5.0	4.0	0.9	1.1	2.2	1.9	2.8	2.8	2.6	2.8
Euroland	100.0	2.8	2.2	3.2	2.8	1.1	1.1	1.9	1.8	10.9[f]	10.0[f]	9.1[f]	8.5[f]

[a]Based on GDP in current prices and exchange rates of 1998. — [b]Percentage change over previous year. — [c]Harmonized Index of Consumer Prices (HICP). — [d]Standardized unemployment rates according to OECD. — [e]Forecast. — [f]Based on the number of employees in 1997.

Source: ECB (2000b), OECD (2000), own calculations and estimates.

6.   Asymmetric GDP Effects of the Euro's Weakness ?

In light of the weakness of the euro against the US dollar, the question arises whether this will change GDP of the countries in the euro area in a homogeneous way. This is important because it would affect the forecast for the individual countries. It also relates to the recent literature on the asymmetric transmission of monetary policy impulses in the common currency area (e.g. Dornbusch et al. 1998), as the exchange rate — like interest rates and bank credit allocation — represents an important transmission channel for monetary policy.

The impact of changes of the euro/dollar exchange rate on an EMU country's foreign trade depends, among other things, on the share of imports from the United States in total imports of that country; on the export side, the impact could analogously be measured by the share of exports to the United States in total exports. However, the latter measure pertains to the direct price competition of the exporters from the EMU country with producers of the United States but not to the competition of Euroland exporters with US exporters on third-country markets. This is measured by so-called augmented export weights, which are used by the Deutsche Bundesbank in the calculation of the effective external value of the D-mark. The Deutsche Bundesbank (1998) has calculated these weights for 38 of Germany's most important trading partner countries. Since the latter (plus Germany) probably also include the most important trading partners of the other EMU countries, their augmented export weights can also be calculated on the basis of the Bundesbank data.

Augmented export weights and import shares of the United States are shown in Table 4 for each EMU country. According to the (unweighted) mean over all EMU countries, the United States compete on average with 9.3 percent of EMU exports, their share in EMU imports averages 7.1 percent; the standard deviation is 1.7 percentage points for exports and 3.9 percentage points for imports. However, if one is interested specifically in the effects of exchange rate changes, account has to be taken of the fact that a number of countries in Southeast Asia used to hold their currencies within a fixed parity vis-à-vis the US dollar and will probably attempt to do so in future. The impact of changes in the euro/dollar exchange rate is therefore more precisely measured by the sum of the import shares and the augmented export weights, respectively, of the United States and those Asian countries. According to Table 4, this does not only raise the measured significance of the US dollar for the EMU countries' foreign trade, it also increases the dispersion of the effects across countries, since trade with Asian countries is more unevenly distributed across the euro area than trade with the United States. For Germany, for instance, the calculation shows that roughly 23 percent of exports compete directly or indirectly with products from the dollar area. This figure, like that for Ireland, is significantly above the EMU average while figures for Austria and Portugal are well below the average.

Finally, to assess the impact of foreign trade changes on output, these figures are multiplied by the share of exports and imports, respectively, in GDP (degree of openness). The average "GDP weight" across all EMU countries is 6.2 for exports and 4.7 for imports. From this, the effect of a change in the euro/dollar exchange rate on output can be estimated by assuming that foreign trade is in balance for each country (that is, that the level of exports matches exactly the level of imports) and that the absolute value of the elasticities of export demand and import demand with respect to the exchange rate are uniformly 0.5 across countries.[17] In this case, a devaluation of the euro against the dollar by 10 percent[18] will cause an increase in exports to the dollar area and a fall of imports from that area by

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[17] This is roughly the exchange rate elasticity of German exports (Boss et al. 2000). Lapp et al. (1995) find elasticities of 0.4 and 0.9 for France and Italy, respectively; Strauß (1998) estimates an exchange rate elasticity of Euroland's exports of 0.6.

[18] In February, the euro/dollar exchange rate was 13 below its level one year ago. While exchange rate changes of this magnitude have not been uncommon in the past, long-term averages are somewhat lower. The mean absolute annual rate of change of the D-mark against the US dollar was 7.4 percent between 1973 and 1998, and 6.2 percent between 1988 and 1998.

Table 4: Effects of a Change in the US Dollar/Euro Exchange Rate on the GDP of EMU Countries[a]

	United States (1)	South East Asia[b] (2)	(1)+(2)	Degree of openness[c]	United States (3)	South East Asia[b] (4)	(3)+(4)	GDP effect[d]
	Export weight				*GDP weight*[e]			
Belgium and Luxembourg	8.3	7.6	15.9	71.1	5.9	5.4	11.3	0.9
Germany	11.4	11.1	22.5	25.2	2.9	2.8	5.7	0.4
Finland	10.4	8.9	19.3	33.4	3.5	3.0	6.4	0.5
France	10.0	8.0	18.0	21.0	2.1	1.7	3.8	0.3
Ireland	11.6	6.6	18.2	75.8	8.8	5.0	13.8	1.4
Italy	11.1	8.0	19.1	20.7	2.3	1.7	3.9	0.3
Netherlands	7.6	6.4	14.0	53.1	4.0	3.4	7.4	0.8
Austria	6.6	5.8	12.4	29.5	1.9	1.7	3.7	0.3
Portugal	8.0	5.4	13.4	22.6	1.8	1.2	3.0	0.3
Spain	8.4	6.3	14.7	19.7	1.7	1.2	2.9	0.3
Mean	9.3	7.4	16.8		3.5	2.7	6.2	0.5
Standard deviation	1.7	1.6	3.0		2.2	1.4	3.5	0.4
Mean[f]								0.3
Standard deviation[f]								0.1
	Import share				*GDP weight*[e]			
Belgium and Luxembourg	5.6	3.5	9.1	64.9	3.6	2.3	5.9	
Germany	6.6	8.0	14.6	21.9	1.4	1.8	3.2	
Finland	7.2	5.4	12.6	25.1	1.8	1.4	3.2	
France	7.8	6.0	13.8	19.7	1.5	1.2	2.7	
Ireland	17.7	10.4	28.1	52.4	9.3	5.5	14.7	
Italy	4.8	5.3	10.1	18.4	0.9	1.0	1.9	
Netherlands	8.4	7.6	16.0	49.5	4.2	3.8	7.9	
Austria	3.1	2.6	5.7	32.1	1.0	0.8	1.8	
Portugal	3.3	3.7	7.0	34.5	1.1	1.3	2.4	
Spain	6.5	6.0	12.5	24.0	1.6	1.4	3.0	
Mean	7.1	5.9	13.0		2.6	2.0	4.7	
Standard deviation	3.9	2.2	5.9		2.4	1.4	3.8	

[a]In percent. — [b]China, Hong Kong, Taiwan, India, Indonesia, South Korea, Malaysia, Singapore, Thailand. — [c]Exports and imports, respectively, in relation to GDP in 1998. — [d]Percentage increase in real GDP due to a 10 percent depreciation of the euro against the US dollar under the assumption of identical national exchange rate elasticities of export demand and import demand of 0.5 and −0.5, respectively, without multiplier effects. — [e]Export weight and import share, respectively, multiplied by the degree of openness. — [f]Without Belgium and Luxembourg, Netherlands and Ireland.

Source: Deutsche Bundesbank (1998), OECD (1998), IMF (1999a), own calculations.

5 percent. The effect on GDP in an EMU country is estimated by multiplying this rate by the sum of the dollar-area GDP weights for exports and imports. On average across all EMU countries, output will increase directly (that is, without multiplier effects) of $(6.2 + 4.7) \cdot 0.05 = 0.55$ percent. For Germany, the result will be an increase of 0.4 percent, for France it will be 0.3 percent. The effects will be much more pronounced in Ireland (1.4) as well as in Belgium/Luxembourg (0.9) and in the Netherlands (0.8). The standard deviation is ±0.4 percentage points, that is, on average the effects of the assumed euro devaluation on output growth will normally deviate by 0.8 percentage points between all countries in the euro area. Given that trend GDP growth is 2 to 2.5 percent in Euroland, this is a considerable magnitude.

However, the export weights and import shares of Belgium and the Netherlands may overstate their true degree of openness because foreign trade of these countries comprises transit shipments from other countries that are delivered through Belgian and Dutch ports. If one excludes these two countries

and Ireland — which is an outlier that distorts the average due to the small size of the country — from the calculation of the averages, the picture becomes much more homogeneous. The standard deviation of the effects on GDP growth falls to only ±0.08 percentage points. Effects of this magnitude should not be economically relevant. Overall, the conclusion is that changes in the euro/dollar exchange rate have only limited asymmetric effects on EMU countries' output.

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