

PROSPECTS FOR THE EUROPEAN ECONOMY – THREATS FROM THE FINANCIAL MARKETS

On 20 and 21 March 2003 the CESifo International Spring Conference took place in Berlin. The two-day event brought together economists from around the world to discuss the prospects of the world's major economies and to unveil the threats to sustained growth. Three major issues were discussed: The regional economic outlook, the impact of the turmoil in the financial markets, and trends in major European manufacturing industries. The start of the Iraq war cast a shadow on the conference and there was a discussion of its impact. There was wide agreement that, with a high probability, it will be a short military conflict and that the political situation in the Middle East will not be destabilised. Under these assumptions, the conclusion was that the economic recovery will be delayed. Global growth will remain weak in 2003. Even though, some risks remain for a global recovery which derive from the financial markets. For the major European manufacturing industries, the speakers presented their views on sectoral developments. They shared the expectation of a recovery in the industries concerned, albeit at a pace that will be low compared with previous cyclical upswings.

The downturn of the world economy in 2001 has not led to a V-shaped recovery as had been expected, in particular for the United States, by most of the forecasters. The global recovery has remained tepid and the margin of uncertainty remains unusually large for this stage of the cycle. With reference to this phenomenon, some speakers discussed patterns of the current business cycle, comparing them to previous cycles since World War II (among them Flemming Larsen, IMF; Claudio Borio, BIS). The results disclose that the recovery showed noteworthy differences. In particular, the growth momentum of the most important indicators has been poor for the United States until recently. At the same time, the productivity miracle seems to have come to an end.

There was general agreement that the financial markets play an outstanding role in the explana-

tion of this currently difficult situation. The combination of a belief in a new paradigm, an unusual strength in the economy, an investment boom and an unusual strong rise in equities has been identified as the ingredients of a bubble economy which embodies the threat of a steep economic decline. A comparison of historic boom-bust-cycles back to the 19th century disclosed that the current state of the cycle shows similarities with periods preceding past phases of a sharp recession. It was suggested that, above all for the United States, such a pessimistic outlook must be considered (Jim O'Neill, Goldman Sachs).

This gloomy outlook for the US economy was heavily discussed, but no final conclusion could be drawn at the conference. The crucial question in this context was the existence of a new paradigm. If there is one, traditional patterns of business cycles can vary and historic comparisons will no longer be appropriate. But there is no clear-cut empirical evidence on the phenomenon of the "new economy", and economists differ in their assessment of the size of the current risks deriving from the financial markets and their potential to harm the global economic recovery.

US monetary policy is easy as is fiscal policy, with stimulating effects on the economy. Both, consumption and investment propensities have remained poor. Uncertainty and gloomy prospects hamper demand. The US savings rate has increased due to private households' efforts to offset, at least in part, the massive losses in the equity markets. A further increase is expected. Capacity utilisation of US industry is at its lowest level since the early 1980s, indicating a further slump in the demand for capital goods.

Slow growth, the Iraq war and the budget policy will result in a high government deficit, even after a couple of years of budget consolidation. The budget deficit coincides with a growing current account deficit. Thus, the US double deficits are back and will bring strain to the foreign exchange markets (Jim O'Neill, Goldman Sachs).

Asia has remained the only region enjoying an appreciable high growth momentum in a worldwide economic slowdown, despite the fact that it has not been able to de-couple fully from the general slow pace of growth and that it suffers from the collapse of the "new economy". The latter affects primarily South East Asia, a region which provides around 40 percent of the global supply of information technology products. But intra-Asian trade has gained in importance over the past decade, contributing to a more stable economic development.

As a consequence of the accession to the WTO, the PR China's economy is booming. Growing public expenditure, high investment of state-owned enterprises and soaring foreign direct investment are the major driving forces, whereas private consumption is not following suit. Although China's accession to the WTO will have positive effects on the overall growth of the economy in the long run, in the short run there are some obstacles. Positive capacity effects will only be realised in the garment and apparel industries. Most other industries face negative capacity effects induced by companies' strategic investment, which leads to excess capacity. Growing unemployment and the burden of comprehensive structural change have to be tackled in the medium term. A slow-down of growth to below the threshold of 5 to 7 percent is deemed critical and could raise serious problems. Seen in perspective, China has to cope with a state deficit of Japanese dimensions but there is the hope that China can grow out of these problems by accumulating sufficient positive assets (Markus Taube, University of Duisburg).

The global slowdown has coincided with more modest growth of the European economy (EU 15). The growth momentum had peaked in 2000 at a rate of 3.5 percent for gross domestic product. In 2001 and 2002 GDP grew by only 1.4 percent and 0.9 percent respectively. Under the assumption of a short Iraq war, a recovery is expected in the second half of 2003, which will not gain much momentum, however. GDP growth will average only 1.1 percent. As compared to the United States, the recovery will be less dynamic, although the distortions from the collapse of the "new economy" are less severe in Europe and pose a minor threat to the recovery. Underlying reasons for the poor European performance are the structural problems in some of the EU Member States, in particular

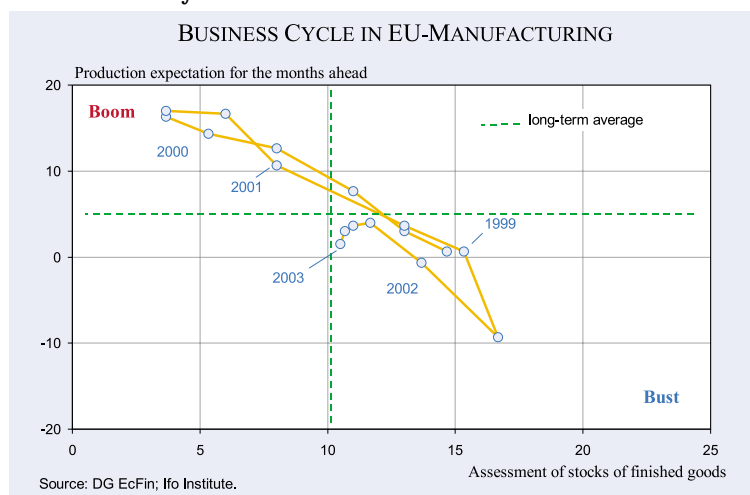
Germany and Italy. Both of these countries are a drag on the EU growth potential. A prerequisite for better prospects for the EU economy are institutional changes in the social welfare systems and the labour markets (Hans-Werner Sinn, Ifo Institute).

The monetary policy of the European Central Bank (ECB) is torn between maintaining price stability with an inflation rate not to exceed 2 percent on average of the euro area and higher money supply growth to stimulate economic growth. The challenge for the ECB lies in big regional differences in inflation, ranging from around 1 percent in Germany to more than 4 percent in Ireland. The benchmark inflation rate of 2 percent for the euro area can turn out to be too low for some of the countries. Germany, in particular, could even experience deflation. An easier monetary policy could support the necessary adjustment processes among different Member States. Germany, for instance, entered the European Monetary Union with a currency that had not yet overcome the appreciation shock of 1992/93 resulting from unification. As nominal devaluation is no longer an option, adjustment may be promoted by fiscal policy (reduction of the tax burden and public expenditure), but eventually a lower inflation rate than for the rest of the euro area may be necessary. A low euro area inflation rate would demand an even lower inflation rate in Germany to restore equilibrium.

In the gloomy global environment, the European manufacturing industries experienced a setback after a rather long growth phase during the second half of the 1990s. Output of EU manufacturing had peaked in 2000 with growth of around 6 percent. In the following year output stagnated and in 2002 it even shrank by around 1 percent. Reasons for this setback were the slowdown of domestic demand and of foreign orders. In particular the intermediate product and the capital goods industries suffered from a breakdown of non-EU demand.

The most recent economic situation of the EU manufacturing industries is characterised by a modest recovery, indicated by moderately growing new order bookings in 2002. Orders received have slowed down once more and at present no more than a stagnation of new orders is expected. The business sentiment has worsened since early 2002. Production expectations have come down to almost zero and indicate stagna-

Figure 1
Ifo Business Survey



tion for the current year. At the same time, companies have adjusted their capacities to the low level of demand and inventories have been markedly reduced since early 2002. A long-term comparison of both of these indicators discloses that the business sentiment is far less gloomy than during the last deep recession of 1992/93. Given the assumption that the Iraq war will be brief and that no further setback in the financial markets will distort the development of the real economy, the EU-manufacturing industries will recover in the second half of 2003. On average production will grow by around 1 percent.

The Iraq war has been identified as one explanation of the present slow growth by the sectoral experts who presented an in-depth analysis of the chemical industry, the steel industry, the capital goods industry, the automotive industry and the data processing and communication industry.

The impact of the Iraq war – whose start coincided with the first day of the conference – on the chemical industry was explicitly analysed. Under the assumption of a short war, there will only be a delay of the recovery and the growth rates of 2003 will be affected, but not those of 2004. In particular, there will be only a short hike in oil prices which will have a limited effect on the global economy. The chemical industry will gain momentum in the course of 2003 (Ralf Gronych, BASF).

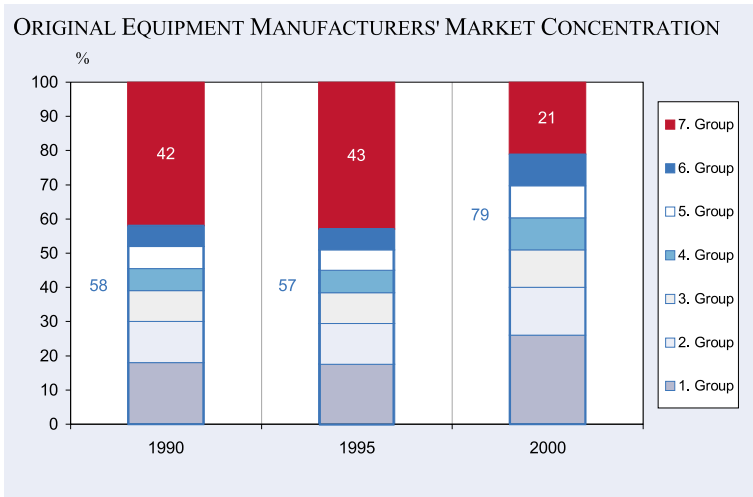
The European steel industry has faced the challenge of low domestic demand, but was able to expand exports during the latter half of the 1990s. The global economic slowdown and the US tariffs

on steel, which became effective just recently, have worsened the economic environment. Mentioned as a major risk for the outlook of the steel industry was a slump of economic activity in the PR China. If this occurs, the global market will come under extreme pressure of excess supply. Currently China absorbs much of the surplus production in other regions like Japan, and in the short term no fundamental change can be expected (Tony Cockerill, University of Durham).

The European capital goods industries play an outstanding role in international markets. They are leading the pace of innovation ahead of the United States and Japan. They strongly benefited from the bright economic environment during the latter half of the 1990s, although domestic demand grew only modestly. The industrialisation of emerging economies has been one of the driving forces nourished above all by foreign direct investment. Since 2000 the boom has faded, with the exception of the PR China. With regard to the low capacity utilisation in many industrialised countries, the growing financing difficulties for big investment projects in emerging countries imply that the short-term outlook cannot be very bright, although the decline of new orders should have levelled out and a recovery is expected for the capital goods industries (Paul van Roon, Orgalime).

The global automotive market is evolving from national to regional oligopolies. While in the beginning of the 1990s the biggest seven suppliers commanded a 60 percent share of the global market, this has changed within a decade. Nowadays their share is around 80 percent and competition has become more intensive. The EU is in a specific situation. The three major suppliers command only a bit more than half the market, whereas in Japan and the United States the share of the major three is around 70 percent. There is intensive competition among suppliers to gain share, which affects the profitability of the European automobile companies. Although there are some constraints on competition via exclusive sales contracts of manufacturers with their distributors and service agencies, profits are lower than in Japan or the United States.

Figure 2
Automotive Industry



Global competition forces the automotive manufacturers to enter emerging markets and to fight for market share in countries with high growth rates. But in terms of volume, the mature markets of the United States, Europe and Japan are of much greater importance, although they do not provide sufficient growth potential. In the emerging markets, massive investment induces tougher competition and in spite of growing demand profits remain under pressure, whereas in mature markets, lacking growth increases price pressure. In this competitive environment the consolidation of the automotive industry will continue and induce structural change, above all in the more scattered European suppliers (Christophe Chabert, Renault).

The information technology (IT) sector has been hit hard by the collapse of the “new economy”. Previous over-investment caused a slump in demand and the adjustment of capacities has not yet come to an end. At the same time, the factors driving the market shifted away from the clients’ need to reduce costs and increase labour productivity. The industry entered a phase of incremental progress and search for a new paradigm. New options for the IT industry are currently emerging. The future driving forces are expected to lie more in the area of strengthening clients’ competitiveness and supporting business expansion. Further opportunities are perceived in a growing supply of IT services, among them the operation of clients’ IT departments etc. Although there are areas of new activities which can be penetrated by IT companies, double-digit growth rates are a thing of the past (Uwe Kühne, IBM).