Annual economic report 1999

2000/2046(COS) - 24/11/1999 - Non-legislative basic document

PURPOSE : To present the 1999 report on the EU economy providing a comprehensive picture of recent and prospective economic development, as well as a study of specific economic topics that are of particular importance for economic policy. CONTENT : The report details the events of the year which began with the launch of the euro in January. The key point of the report is that the downturn in the first part of the year has improved as a result of strong domestic demand and the right policy mix. The economy is on the verge of a sustained recovery, with improving employment figures and manageable inflation. The main points to come out of the report are as follows : 1) The Euro was launched on strong foundations but amid cyclical weakening. The successful launch of the single currency was due to great strides in economic convergence achieved by euro area countries. The last decade was also, however, characterised by lacklustre economic growth and poor employment performance in the EU. In the wake of the 1997-1998 financial crisis, there was sluggish demand in the EU's export markets. The annual rate of real GDP growth slowed to about 1.5% from about 3% in the first par of 1998. Exports decelerated, as did investment in equipment. The size of the downturn was mitigated by several factors. Amongst these were the adequate adjustment of the policy mix, moderate wage developments and robustness of economic activity in the sheltered sectors. Clear signs of renewed recovery have emerged since early summer. The initial impetus came from exports which surged following the depreciation of the euro in the first half of the year. Overall, economic growth has strengthened from about 1.5% in the first quarter to an expected 2.75% in the fourth quarter of 1999. For the year as a whole, the Commission expects real GDP growth of 2.1% in both the EU and the euro area. This will accelerate to 3% in both 2000 and 2001 (2.9% for the euro area). Domestic demand will continue to drive the expansion, boosted by low inflation, relatively low interest rates and improving confidence. Export growth will accelerate driven by growth in export markets and the competitive value of the euro. 2) Risks and uncertainties · external uncertainties include the prospective developments of the US economy. An abrupt deceleration could trigger a rise in interest rates and provoke a slide in the dollar. The EU economy will not remain unscathed. The impact of a surge in crude oil prices is another uncertainty. On the internal side, uncertainties relate to the rise in long-term interest rates and future wage trends. On the upside, the expected rebound in the EU could also prove stronger than anticipated, fed by budgetary consolidation, employment-friendly wage developments and a more rapid introduction of new technologies. 3) Differences in growth pattern are likely to narrow. Growth differences reflect the impact of three factors: - Vulnerability to decline in external demand, which affected countries differently. The impact was, for example, considerable in Germany and Italy, which have relatively large trade exposure to emerging market economies and more moderate in France and Spain. - the adjustment to macro-economic policies leading to EMU - Disparities in potential growth rates. This reflects differences in the stage of economic development, in demographic features and the functioning of markets. These differences will become less prominent with a single monetary policy. 4) Unemployment is declining but remains the key policy challenge. Total employment is expected to increase by 1.2% in 1999, equivalent to 2.1 million additional jobs. The outlook is for growth of 1.25% over the next two years. This is due to a number of structural factors, including the gradual shift to the more labour-intensive service sectors, initiatives to enhance working skills, and more flexible forms of employment. Yet, the employment rate in the EU is low both inhistorical and international comparative terms. The report dismisses one-dimensional views focussing either exclusively on adverse macroeconomic shocks or on rigidities in the labour market. The current majority view attributes the EU's dismal labour performance to the interaction of a series of adverse aggregate supply and demand shocks with labour market institutions and product market regulations proving insufficiently capable to adjust swiftly to changes in economic conditions. To reduce unemployment, sound macroeconomic policies are needed. In addition, structural reforms are indispensable and probably the most important element to improve labour market performance. 5) Inflation outlook remains benign · On a year-average basis, inflation is expected to remain at 1.2% in 1999 in the EU. The outlook is for a modest increase to 1.5% in both 2000 and 2001. Next year, the effect of higher oil prices will subside, but the slight increase is due to

the relatively vigorous recovery. Inflation differentials are set to narrow from about 1.8% in 1999 to about 1.6% in 2001. This is partly due to the fact that inflation will increase in countries where it is lowest (Germany, France, Austria) and decrease where it is highest (Spain, Ireland, Portugal). A certain degree of inflation dispersion will persist in the Euro area and is normal in monetary unions. In some cases, it can lead to the emergence of competitive imbalances or signal an undesirably large variation in cyclical conditions. Monetary policy is not the appropriate tool to deal with this. Other economic policy responses in terms of structural or budgetary policies could be required. 6) Macroeconomic policy monetary conditions are consistent with price stability and adequately supportive of growth, notwithstanding the ECB's decision to raise its key interest rates in early November. The depreciation of the euro against most major currencies is mainly attributable to cyclical factors, notably the weakness of the euro-economy relative to the US in the first half of 1999. The euro's prospective appreciation should also be seen against the background of a reversal in relative cyclical positions, when the US economy slows. 7) Budgetary adjustment · budget targets for 1999 and 2000 are likely to be met and in some cases exceeded. For the EU the budget deficit is projected to fall by 1.25% of GDP to 0.5%of GDP while for the euro area a decline of about 1.5 of GDP to 0.75 GDP is expected. Countries could take the opportunity to progress more quickly to medium-term objectives or prepare for increased expenditure due to an ageing population. 8) The Euro contributes to more integrated and efficient financial markets Changes in investor behaviour are well underway. There has been a rapid development of the corporate bond market. Equity markets have shifted to pan-euro area or pan-European positions. The Commission has produced a communication and an action plan to deal with the important obstacles that remain.