

Fondo monetario internazionale - Previsioni economiche mondiali Aprile 2005 13.4.2005

Dal Capitolo I - Europa Occidentale: nuove preoccupazioni sul vigore della ripresa

Western Europe: Renewed Concerns About the Strength of the Recovery

The modest recovery that had taken place in the euro area since mid-2003 lost momentum during the second half of 2004. Domestic demand has remained subdued against the backdrop of high and volatile oil prices and longstanding structural weaknesses, while slower global growth and the appreciation of the euro have undercut export growth, which was a key driver of the economy in the first half of 2004. Strong profit growth has yet to feed into a decisive upturn in investment spending as companies continue to focus on restructuring their balance sheets, while slow wage and employment growth and lagging confidence have held back consumption. **As a result, area-wide GDP grew by just 0.2 percent (quarter-on-quarter) in both the third and fourth quarters of 2004. Activity contracted in Germany, Italy, the Netherlands, and Greece in the fourth quarter, but growth accelerated in France and Spain[1] .**

Economic indicators in early 2005 have been very mixed. While industrial production and retail sales in the euro area firmed in January, business and consumer confidence have generally been weak. Against this background, the 2005 growth forecast has been revised down to 1.6 percent (compared with 2.2 percent in the September 2004 *World Economic Outlook*).

Underlying this projection is the assumption that growth will gradually pick up during the course of the year, although at a slower rate than previously expected. The favorable global environment is expected to underpin exports, investment should strengthen as corporate profits remain healthy, and a gradual improvement in the labor market is expected to support a pickup in consumer spending. The risks to this outlook, however, lie predominantly on the downside.

- Growth remains overly reliant on global developments, particularly in Germany, where external demand accounted for three-fourths of growth in 2004. German exports have grown strongly, boosted by the marked decline in unit labor costs and the favorable export structure—a high share of IT-related goods, a high proportion of exports going to China and the United States, and limited exposure to competition in third markets from emerging Asian countries . However, if large global current account imbalances put renewed upward pressure on the euro, or the downturn in the IT sector is more prolonged than expected, export growth will be affected.

- High and volatile oil prices, a drop in business confidence, an increase in household saving in the face of ongoing uncertainties about future pension and healthcare reforms, or a sharp drop in house prices in some countries— notably Ireland and Spain—could hold back domestic demand.

Headline inflation in the euro area continues to hover around 2 percent owing to the effects of oil price increases and hikes in indirect taxes and administered prices. Underlying price pressures, including wage and unit labor costs, however, are well contained—consumer price index (CPI) inflation excluding energy, food, alcohol, and tobacco was 1.4 percent in February 2005, compared with 2 percent in mid-2004—and headline inflation is expected to fall below 2 percent later this year as the impact of one-off factors wane. In these circumstances, monetary policy should remain firmly on hold until a self-sustaining recovery is clearly in place. Indeed, a further cut in interest rates cannot be ruled out if current economic weakness or a further appreciation of the euro were to result in lower-than-expected inflation.

Although fiscal deficits in the euro area are smaller than in the other major currency areas, public debt levels are high, and policy settings remain insufficient to deliver the budgetary adjustments required to cope with the fiscal pressures of population aging. The euro area-wide fiscal deficit is estimated at 2.7 percent of GDP in 2004, with deficits in France, Germany, and Greece all exceeding 3 percent of GDP. Budgets for 2005 envisage varying degrees of fiscal consolidation across the euro area. Although

budgetary adjustments are projected in France and Germany, they rely on one-off measures, and questions remain whether the policies are in place to achieve and sustain the targets, while in Italy the budget deficit is projected to increase substantially. **A faster-than-currently- planned pace of fiscal consolidation is needed in countries with weak budget positions, based on high-quality measures, allowing the automatic fiscal stabilizers to operate around the adjustment paths[2]**

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Reforms to the Stability and Growth Pact (SGP) have recently been agreed in Europe.

The agreement provides governments with significant additional fiscal policy flexibility. It does not, however, strengthen enforcement mechanisms under the pact, which have proved ineffective in the past (France and Germany have been in breach of the deficit limit for three successive years and there has been fiscal misreporting by Greece), nor the incentives to adjust in good times—the Achilles' heel of euro area fiscal policies. A strong fiscal framework clearly remains an essential part of monetary union in Europe, and it is important that the implementation of the reformed SGP restore the credibility of the framework. In the final analysis, this credibility depends on fiscal policies at the national level, particularly in the larger countries. The reformed SGP's encouragement of better domestic governance arrangements is thus welcome.

The establishment of national budgetary councils to publish independent assessments of budgetary policies and the long-term sustainability of public finances could be helpful in fostering transparency and greater public awareness and debate about appropriate fiscal policies.

Structural reforms need to be at the heart of Europe's efforts to improve its growth performance; higher potential growth, in turn, would help strengthen the medium-term fiscal position and facilitate the operation of the SGP. Labor utilization rates need to be raised in the face of stagnating working-age populations, while total factor productivity growth in the euro area has not matched the acceleration seen in recent years in the United States. But, as the High-Level Group headed by Mr. Wim Kok recently concluded, progress with implementing the structural reform agenda in Europe has at best been mixed over the past five years. On the positive side, in centrally led areas, such as the Financial Services Action Plan, important progress has been made, while reforms have also been initiated at the national level, including pension, health care, and labor market reforms in Germany (under Agenda 2010) and in France, and pension reforms—including raising the effective retirement age—in Italy.

Nevertheless, these reforms need to be deepened and prioritized, with a greater focus placed on addressing current distortions in the labor market—particularly overly generous entitlement systems (reducing such entitlement benefits would also have fiscal savings), high tax wedges, and restrictive labor laws—and on promoting greater competition in product markets.

In this regard, the recent rejection of the European Commission proposals to liberalize trade in services in Europe is a setback to reform efforts.

Economic performance in the United Kingdom remains robust. Having slowed gradually through the year, as higher mortgage rates and weaker house price appreciation dampened consumption, GDP growth is estimated at 3.1 percent in 2004 and is projected at 2.6 percent this year. Domestic demand remains the key driver of growth, underpinned by continued robust wage growth and strong corporate profitability.

Relatively high consumer indebtedness and the possibility of a sharp drop in house prices do present risks to this outlook. With the economy operating at or near full capacity, the Bank of England has tightened monetary policy over the past year, and is well positioned to respond to unexpected developments in either direction. Fiscal policy has provided substantial stimulus in recent years, and steps are needed to accelerate the pace of fiscal consolidation—which is very modest in the recent budget—to meet the government's budgetary objectives over the course of the next economic cycle. A recent Interim Report by the Pensions Commission has questioned the adequacy of private saving for retirement, and it will be important to encourage higher saving to ensure that pensioners do not fall back on the state in the future.

Elsewhere in Europe, growth in the Nordic countries accelerated in 2004, owing to exports (Sweden, Denmark), stronger investment (Sweden, Norway—the latter driven by the oil sector) and fiscal expansion (Norway and Sweden). In all three countries, monetary policy settings remain accommodative and will need to tighten as the recovery proceeds, while fiscal consolidation will be required to meet medium-term targets. In Switzerland, growth accelerated to 1.7 percent in 2004 as exports benefited from stronger global demand and expansionary fiscal and monetary policies boosted domestic demand.

Monetary tightening has begun—although interest rates remain low—and measures will be needed to bring the fiscal position back to balance.

Efforts to increase competition in domestic markets are needed to raise potential growth.