Press embargo: November 28, 2003, 10:30 a.m. (CET)

EUROFRAME Forecast

EU and Euro Area Economies

November 2003

Press Release

Moderate Recovery Ahead

The Euroframe Network predicts that output in the Euro Area and broader EU economy will grow by 0.3 and 0.5 per cent respectively this year. The EU and Euro Area are expected to grow by 1.7 per cent in 2004 and by just over 2 per cent in 2005. The outlook for price developments in the EU using the Harmonised Index of Consumer Prices (HICP) is for inflation to moderate from 2 per cent in 2003 to around 1.7 per *cent in 2004. In 2005, the HICP inflation rate in the EU is expected to fall to 1.5 per cent.*

Europe falls back

Global economic activity strengthened in 2003, with output expanding more rapidly than anticipated in the US, Japan and in the rest of Asia. However, Europe has failed to keep pace with the rest of the world. A year ago, we were expecting to see a revival in economic activity in Europe, driven by an investment recovery and subdued price pressures, but this revival has yet to materialize. Euro Area investment is expected to have declined for the third consecutive year in 2003, and inflationary pressures have not receded to the extent anticipated, despite the strength of the euro. Notwithstanding the weak performance of European economies, we expect global GDP growth (measured at Purchasing Power Parity exchange rates) to be around 3.4 per cent in 2003, up from 3.0 per cent in 2002 . Global growth is expected to return toward long-term trend levels of just below 4 per cent per annum from 2004. While world trade growth is expected to rise to 4.5 per cent this year, from 3.2 per cent in 2002, much of this revival is confined to intra-Asian and NAFTA trade, while the strong currency has weighed heavily on Euro Area trade. World trade growth is forecast to strengthen further to around 8 per cent per annum from 2004. Rising demand for European goods in the rest of the world is expected to be the driving force behind an anticipated recovery in the Euro Area in 2004 and 2005.

The euro exchange rate is expected to stabilize over the next two years at a bilateral rate of €0.86 per US$. Interest rates in the Euro Area are expected to remain stable throughout 2004, and will start to rise gradually in 2005 as the economy strengthens.

Domestic demand in the Euro Area has been restrained by the persistent weakness of investment. We estimate that private sector investment declined by 0.7 per cent in 2003, following declines of 2.8 per cent in 2002 and 0.3 per cent in 2001. Although we continue to expect a recovery in investment next year, rising long-term interest rates will restrain growth to 2.2 per cent in 2004 and 2.5 per cent in 2005. Private sector consumption is also expected to remain relatively subdued, with growth of 1.3 and 1.5 per cent expected in 2003 and 2004 respectively, before rising to 2.0 per cent in 2005. As inflationary pressures are somewhat higher than anticipated and unemployment has risen, real income growth has moderated, which is holding back consumption growth.

The contribution from the public sector is expected to be more muted than in recent years. Government expenditure is expected to moderate from rises of 2-2¼ per cent per annum between 2000 and 2002 to 1.5 per cent in 2003 and 1.1 per cent in 2004. Further fiscal stimulus is limited by the commitments to the Stability and Growth Pact, given the recent rise in general government deficits across Europe. All EU economies saw a worsening of their budgetary position in 2003, with deficits in France, Germany and Portugal projected to be well above the 3 per cent of GDP ceiling this year.

Despite the weakness of domestic demand, the strength of the euro caused import volume growth to exceed export volume growth this year. Therefore, net trade had a strong negative impact on GDP growth in 2003. The volume of exports was 0.2 per cent lower than in 2002, while import volumes are estimated to have been 2.0 per cent higher. With increased world trade, Euro Area exports are forecast to rise by over 5 per cent in 2004 and 2005. Although import growth will remain somewhat stronger than export growth in 2004, it is expected to be slightly weaker in 2005 as Euro Area domestic demand growth remains significantly weaker than in the other major economies. Net trade should have a small positive impact on GDP growth and external demand will be a driving force behind the anticipated recovery in the Euro Area in 2005. This should lead to a modest improvement in the Balance of Payments current account surplus, which is expected to rise from 0.3 per cent of GDP in 2003 to reach 0.8 per cent of GDP in 2004 and 2005.

Given the persistent weakness of the economy, the unemployment rate in the Euro Area is estimated to average 8.9 per cent in 2003, which is about 0.5 percentage points higher than we anticipated a year ago. However, as growth strengthens next year, we anticipate a modest improvement in labour market conditions, with the unemployment rate due to recede to about 8.8 per cent in 2004 and 8.6 per cent in 2005.