

Box 2

A review of the prospects for the euro area in 1999

Real GDP growth for the euro area proved to be significantly stronger in 1998, at 3.0%, than in the previous year, despite the weakening in the external environment. This reflected a strengthening in domestic demand which more than compensated for the diminished contribution to output growth from net exports. The overall rate of growth recorded in 1998 was the strongest since 1990 and was accompanied by both an increase in employment and – for the first time since 1995 – a decrease in unemployment. Nevertheless, evidence of a slowdown in growth in the euro area was also apparent during the course of 1998, first in industrial production and, towards the end of the year, in total GDP. For the year as a whole, the increase in the HICP slowed to 1.1% from 1.6% in 1997, continuing the downward trend observed in recent years. By the end of 1998, the annual increase in the HICP had reached 0.8%.

The impact of the emerging markets crisis on the euro area has been a source of considerable uncertainty in terms of evaluating the outlook. Forecasts for both real output growth and inflation tended to be revised downwards in the course of 1998, as the negative impact of the external environment was assessed to be both stronger and more prolonged than initially envisaged. The table below summarises the outlook for real GDP growth and inflation in 1999 on the basis of the latest forecasts by international organisations and the private sector. It should be noted that differences between the forecasts are due, in part, to differences in the assumptions underlying the projections, as well as to their different publication dates. In addition, these forecasts have not been able to take into account the consequences of weaker than expected GDP growth in the last quarter of 1998. Nevertheless, they may help to illustrate the general downward revisions to forecasts.

A slowdown in growth generally foreseen for 1999

Generally, real GDP growth in the euro area is expected to continue in 1999, but at a slower pace than that observed in 1998. Although there is some variation in the extent of the anticipated slowdown, most projections place real GDP growth in 1999 within a range of 2-2½%, whereas the most recent forecasts place growth towards the lower end of this range. The forecast of lower output growth in 1999 is generally projected as a result of weaker demand in major overseas markets. Domestic demand is expected to continue to be supported

Inflation and real GDP forecasts for the euro area for 1999¹⁾

	Latest forecast	Inflation		Real GDP	
		forecast (p.c.p.a)	change (in % points) ²⁾	forecast (p.c.p.a)	change (in % points) ²⁾
European Commission	Oct. 1998	1.4	-0.5	2.6	-0.6
IMF	Dec. 1998	1.4	-0.2	2.4	-0.4
NIESR ³⁾⁴⁾	Jan. 1999	1.0	-0.4	2.2	-0.2
OECD	Dec. 1998	1.4	-0.4	2.5	-0.4
Consensus Economics ⁴⁾	Feb. 1999	1.1	-0.1	2.2	0.0

1) Differences in forecasts may be due to differing exogenous assumptions among forecasting institutions.

2) Difference between latest and previous forecast in percentage points; biannual (European Commission and OECD), quarterly (NIESR) and monthly (Consensus Economics); IMF December 1998 update compared with October 1998 forecast.

3) National Institute of Economic and Social Research.

4) Euro area forecasts from NIESR and Consensus Economics exclude Luxembourg.

mainly by private consumption in 1999. One consequence of the lower consumer price increases is that there has been an unanticipated increase in households' real income. This, combined with an upturn in employment growth since early 1997, has accompanied a substantial improvement in consumer confidence and underpins the expectation of continued consumption growth in 1999. In general, investment is also expected to continue to grow, supported by, among other factors, low interest rates.

The risks to output growth remain on the downside. In particular, a decline in profits of the corporate sector, linked to lower demand for area-wide exports, could result in a slowdown in business investment, stronger destocking and weaker employment growth. In addition, a significant reversal in consumer confidence, which had reached unusually high levels around the turn of the year, could constitute a risk to sustained increases in private consumption. The risks arising from the external environment may have become somewhat more balanced, but remain a major source of uncertainty regarding the outlook (see also Section 5).

Labour market conditions expected to improve, but by less than in 1998

In general, labour market conditions in the euro area are expected to continue to improve in 1999, following a decline in unemployment of around 0.8 percentage point in 1998, which brought the rate down to 10.6% in January 1999. However, employment is expected to continue to increase at a slower rate than in 1998. A more sustained decline in unemployment requires much stronger structural reforms in a number of countries.

Slow progress in fiscal consolidation

Fiscal policy for 1999, as reflected in the initial budget plans of most governments, has adopted a broadly neutral stance for the euro area as a whole. In fact, the small envisaged reduction in the euro area weighted average deficit ratio in 1999 is expected to be the result of a similar decline in the ratio of interest payments to GDP. Hence, no significant fiscal consolidation has formed part of countries' budget plans, but rather an easing of the efforts made in 1997, with the exception of those countries that have to compensate in 1998 for the unwinding of temporary effects introduced in the previous year. More recently, in view of the weaker than expected growth in some components of demand, some governments have considered leaving automatic stabilisers to work in an unrestricted manner, at least on the revenue side. This course of action would be compatible with the attainment of the announced budgetary targets, as the impact on public revenue of slower output growth, especially in exports, should not be sizable. In addition, however, the expected slowdown in growth has prompted some requests for a more expansionary fiscal policy stance to counterbalance the effects of the weaker components of demand. However, such discretionary easing of fiscal policies could increase uncertainty about the stance of fiscal policies in the future and the achievement of the objectives enshrined in the Stability and Growth Pact, as it would lead to a rise in structural deficits.

Increases in consumer prices expected to remain subdued

The outlook for consumer price increases in 1999 has also tended to be revised downwards. Part of this reassessment of near-term price developments is due to weaker than expected energy prices. Although inflation rates could increase again in the course of 1999, largely owing to the effect on the overall price index of either more stable or slightly higher energy prices, they can be expected to remain clearly below 2% on average in 1999.

There are no strong upward or downward pressures evident in the outlook for consumer prices at present. There could be a further downward impact on consumer prices in the euro area if world prices turn out, yet again, to be weaker than expected. Moreover, the effects of the Single Market and utilities deregulation on competition may also constitute a downward factor in the development of consumer prices. Upside risks to price stability may be associated with recent wage settlements and exchange rate developments. Overall, the outlook for price stability remains favourable, with consumer price increases expected to remain consistent with the quantitative definition of price stability adopted by the Governing Council of the ECB.