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# EUROPEAN MARKET COMMENT: EUROPE'S ECONOMY: GROWTH ENGINES STALLED

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**Europe's Economy:**
**Growth Engines Stalled**

Europe's economic recovery is faltering. In recent months, industrial production, investment, and domestic demand have dropped off sharply, while leading indicators in Germany, the Continent's largest economy, point to continued weakness and even contraction. Over the last decade, European growth has become increasingly dependent on exports (particularly to the more dynamic United States) rather than on domestic demand, which has expanded at a relatively modest rate. Now, however, even export growth seems to be stalling, as transatlantic headwinds have intensified.

The classic response to such weakness is fiscal and monetary stimulus. Since authority over the latter had been ceded to the European Central Bank, whose sole mandate is the maintenance of price stability, the only lever available to individual states is fiscal stimulus. Here, however, they are constrained by the straitjacket provisions of the so-called "Stability and Growth Pact (SGP)," which Germany insisted on as a *quid pro quo* for acceptance of the euro, and which is now in danger of becoming the "Contraction and Stagnation Pact."

**Domestic Demand and Net Exports - Running On Empty**

Over the last decade, domestic demand has accounted for 97% to 98% of the Euro Area's economy,[1] though its growth has not been particularly vibrant and has decelerated sharply in recent months. For the year ending in March, domestic demand grew at a 2.4% rate, compared to 6.1% as recently as the year ending June 2001, and growth in each of its components is now falling, especially among inventories (see Table A). While net exports have comprised a small percentage of the EU's total GDP (2% to 3%), over the last decade, their expansion has contributed substantially to growth. For this reason, the slowing U.S. economy is taking its toll on the European economy, with exports declining 2.7% for the year ending in March (see Table B).

**The Stability and Growth Pact**

The SGP, which EMU members signed in 1997, requires that budget deficits fall below 3% of GDP and the ratio of public debt to GDP not exceed 60%. These stipulations were intended to ensure that members maintain fiscal discipline in order not to undermine the EMU, while still allowing a certain degree of government spending to help smooth business cycle fluctuations.

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[1] Euro Area includes all EMU countries plus Greece.

The recent economic slowdown has put the SGP squarely in the crosshairs of public opinion. In recent months, budget deficits have risen significantly, primarily due to falling tax revenues. For 2002, analysts now expect Germany's deficit to fall within a range of 3.4% to 3.7% (up sharply from earlier forecasts of 2.0% to 2.5%); France, 2.7% to 3.1%; Italy, 2.5%+; and Portugal, 4.0%+ (see Table C). This has resulted in a quandary: employ fiscal stimulus to revive economic growth, ignoring the provisions of the SGP and thereby opening the door to future profligacy, effectively undermining the EMU, or stick to the SGP and risk a Continental recession?

**Flexibility vs. Credibility**

On September 24, the European Commission (EC) officially recognized the toll weak growth was taking on government budgets, and announced a two-year delay in the target date for balancing budgets, from 2004 to 2006. This pragmatism should go a long way to reduce growing political pressure to reform, if not scrap outright, the SGP, which is increasingly regarded as politically impractical at a time when many Europeans are expressing increased dissatisfaction with monetary union. On the other hand, the postponement undermines confidence in the willingness of EMU member states to maintain fiscal discipline in the future. Indeed, the EC's recent announcement has prompted financial markets to speculate whether the two-year delay signifies the *de facto* demise of the SGP, if not the whole Maastricht Treaty.

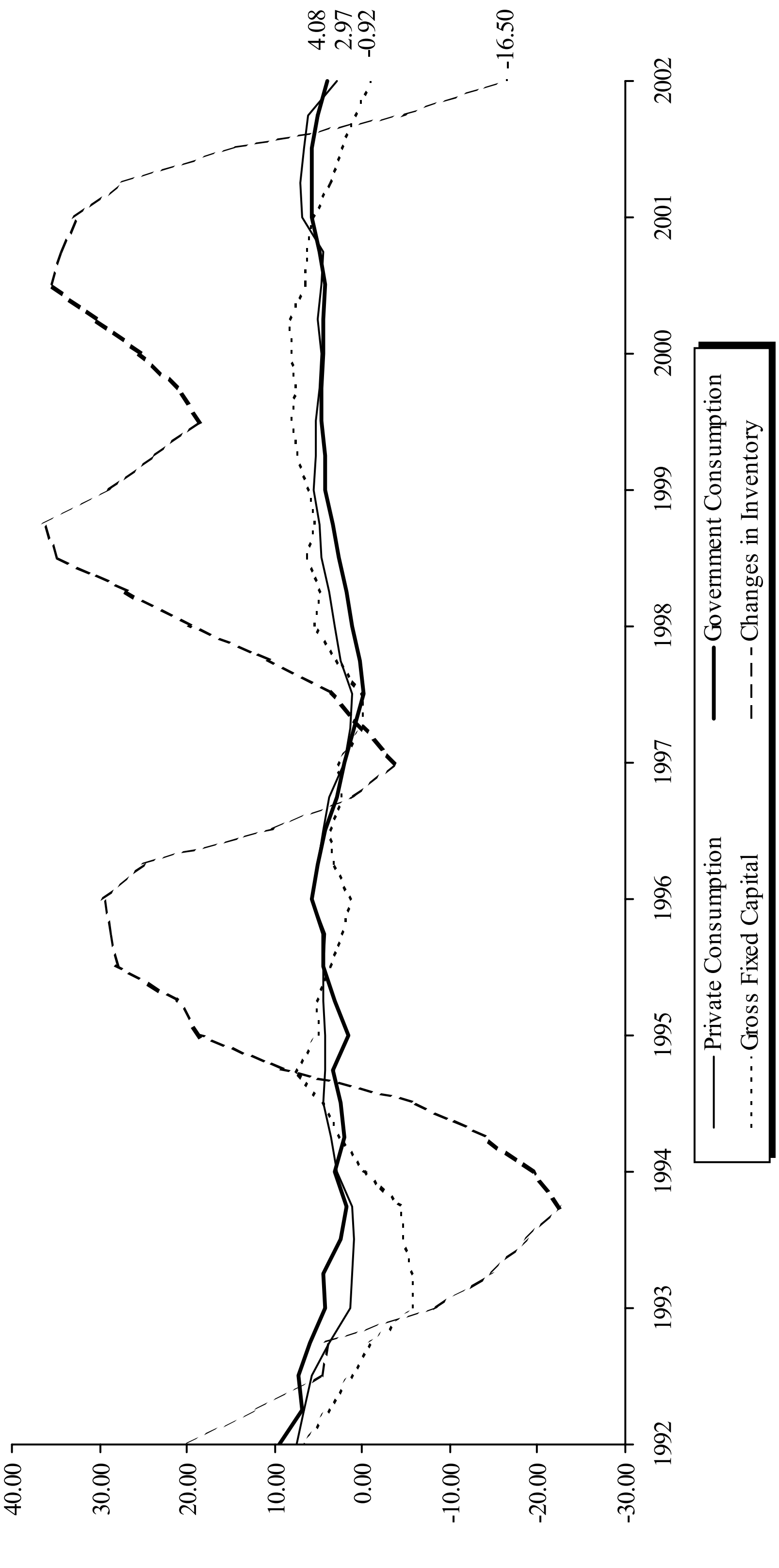
Contrary to popular opinion, however, the SGP is not an iron straitjacket, because it does permit a certain degree of leeway in interpretation. For example, it allows exemptions from the deficit ceiling if the budget shortfall was caused by a severe recession or an event that was beyond the member's control, like Germany's recent flood. A country can qualify for exemption if its GDP falls by over 0.75% per year, and annual exemptions will be automatically granted if GDP tumbles by more than 2% a year. In spite of these built-in safety valves, pundits have recently proposed a variety of other options to impart even more flexibility to the SGP. They include suspending the 3% deficit ceiling until economic growth restarts; refocusing on debt ratios as opposed to budget deficits; and altering the way deficits are officially calculated (France, for example, wants to exempt all defense spending from the calculation, while others have urged the adoption of the "golden rule," currently used in the United Kingdom, which allows public investment to be discounted).

New constraints and old rigidities have hampered the ability of classic growth engines to power the EMU train. The Continent will probably weather the current global slowdown by maintaining the status quo of relying on domestic demand and awaiting the pickup of the U.S. economy, though the cost will be a protracted and weak recovery. If the slowdown intensifies, however, political disaffection will certainly swell, putting the whole remarkable enterprise of monetary union at risk.

**Table A**

**EMU DOMESTIC DEMAND GROWTH**

**January 1, 1992 - March 31, 2002**



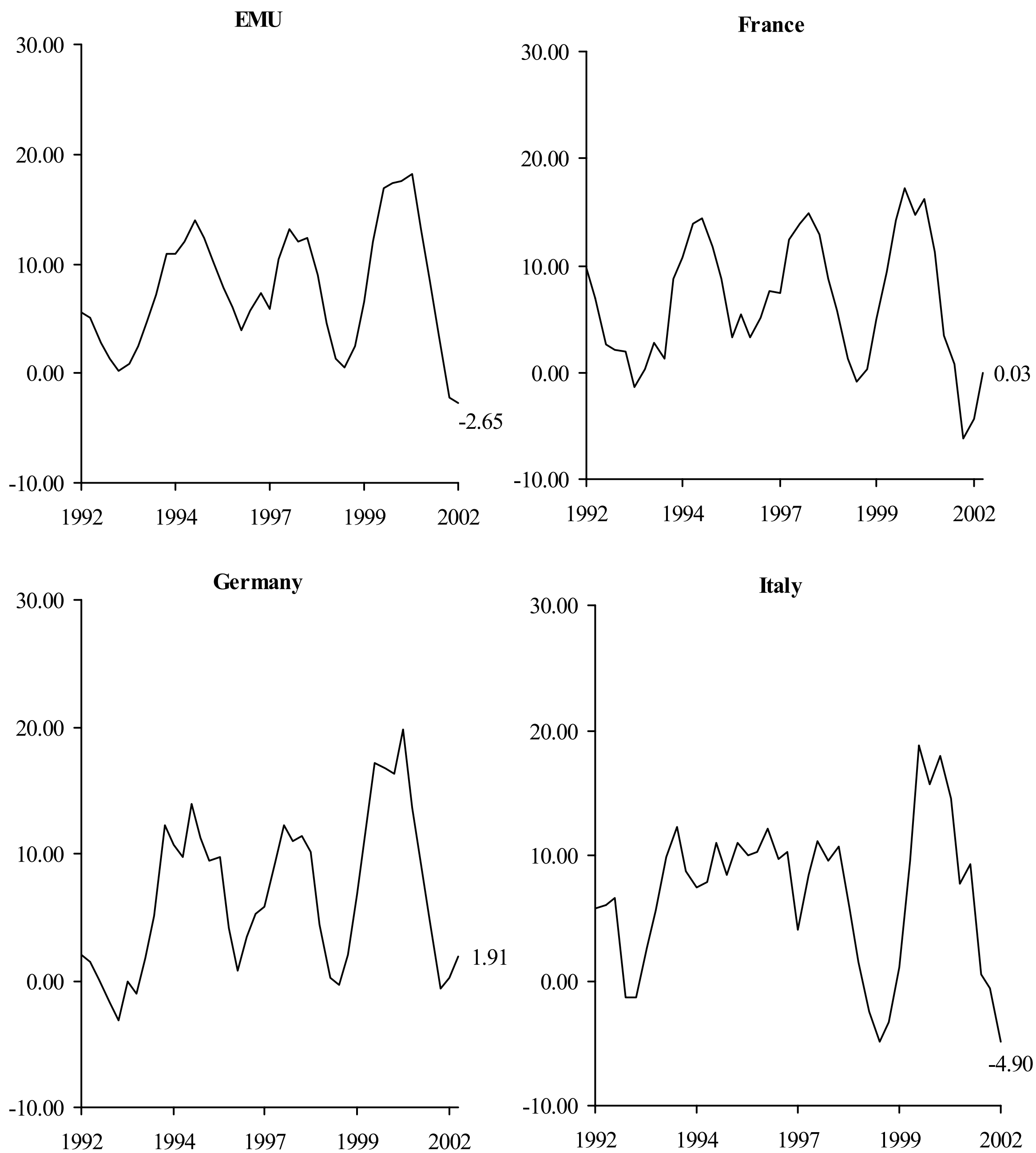

Source: Thomson Datastream.

Note: Data represent year-over-year growth.

## Table B

## EUROPEAN EXPORT GROWTH (%)

### January 1, 1992 - June 30, 2002



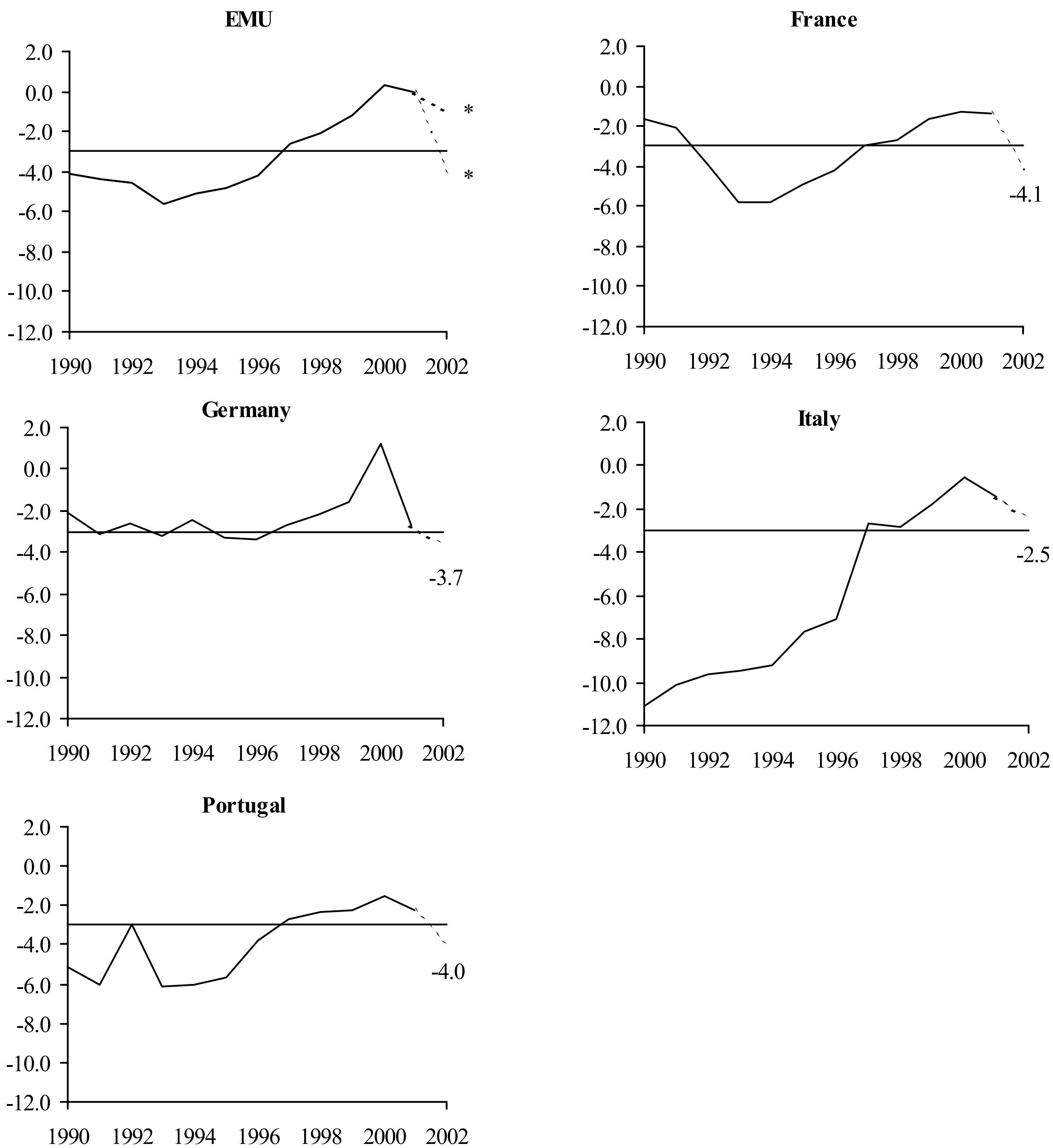

Source: Thomson Datastream.

Notes: Data represent year-over-year growth. EMU and Italy data are through March 31, 2002. According to the Stability and Growth Pact, 3% represents the greatest deficit as a percentage of GDP that any country can have.

## Table C

### EUROPEAN GOVERNMENT DEFICITS AS A PERCENTAGE OF GDP

### 1990-2002




Source: Thomson Datastream.

Notes: EMU data are through December 31, 2000. According to the Stability and Growth Pact, 3% represents the greatest deficit as a percentage of GDP that any country can have. Expectations by private firms represent 2002 data.

* Two scenarios of the downward trend for 2002 of the EMU's government deficit as a percentage of gross domestic product.