Economic slowdown in euro zone

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As recently as March, European Central Bank president Wim Duisenberg was insisting that the economic outlook in the euro zone was "robust" and there was no sign that the slowdown in the US economy was having "significant and lasting spillover effects".

Two weeks ago, the ECB president was only slightly less upbeat in claiming that reduced growth in the US economy would have only a "limited impact" on Europe.

Figures released this week, however, reveal that a slowdown is developing in Europe at a rate much faster than had been anticipated.

The most significant data came from Germany, which plays the key role in the euro zone economy. First quarter growth was only 0.4 percent, bringing annual growth down to 2 percent, from the rate of 2.6 percent in the previous quarter. The main factors at work were a steep decline in investment for machinery and equipment and what was described in one report as "anaemic growth in exports and private consumption".

At the same time, preliminary figures for the consumer price index showed a rise in the inflation rate to 3.5 percent—the highest level since December 1993. Food prices were reported to be up by between 5.7 percent and 9.9 percent, household energy prices increased by more than 15 percent and fuel prices rose by up to 17 percent.

While the lower German growth rate has been apparent for some months, the figures from France came as something of a surprise. These showed that the French economy expanded by only 0.5 percent in the first quarter of this year, down from the 0.8 percent expansion in the final quarter of last year and well below expectations.

The same tendencies are being reflected in other parts of the euro zone economy. As a report in the *New York Times* noted: "The Netherlands, among Europe's growth leaders for much of the last decade, reported a few days ago that its economy virtually stopped expanding in the first quarter, and in neighbouring Belgium, where business sentiment often presages developments in the euro zone as a whole, confidence fell to its lowest level in two years."

In London, an editorial in the *Financial Times* entitled "A chill wind over Europe" drew attention to the combination of slower growth and rising inflation.

"This unhappy combination," it noted, "is only a shadow of the 'stagflation' of the 1970s, when rising oil prices pushed European inflation to a peak of more than 13 percent while growth stalled. But the parallel is uncomfortable. With more than 8 percent of the euro zone labour force still unemployed, there ought to be ample room for non-inflationary growth. But in spite of a welcome pick-up in France since 1998, the economic performance of the zone has been disappointing, a fact reflected in the continued weakness of the euro."

The coincidence of falling growth and rising prices in this week's data had an immediate impact on currency markets sending the euro down to its lowest level this year—US85.03 cents—compared to a high of US95.95 cents in January.

The reaction in currency markets is dictated by the contradictory implications for monetary policy contained in the growth and inflation data. On the one hand, declining growth rates point to the need for a cut in interest rates. On the other hand, confronted with the prospect of rising inflation, the ECB will leave rates where they are, or even increase them.

The fall in European growth rates has implications for the world economy as a whole. It means that three major areas—the United States, Europe and Japan—are all experiencing significantly lower growth rates and even the prospect of recession.

The global slowdown is reflected in forecasts issued by the World Trade Organisation this week. World

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trade, it predicted, would expand by only 7 percent this year compared to 12.5 percent last year.

"The prospects for world trade in 2001 have become more clouded in recent months," the WTO said. "The deceleration of global trade growth which set in in the final months of 2000 is expected to continue for most of 2001."

As a result of the slowdown in the American economy, the WTO said the risks were highest for 20 major exporting countries which sent more than one-third of their exports to the US.

And no quick turnaround can be anticipated in the US economy, despite the rapid cuts in interest rates by the Federal Reserve Board.

Delivering a major speech to the Economic Club of New York on Thursday night, Fed chairman Alan Greenspan claimed the US was only experiencing a "pause" in economic expansion and the wider applications of innovative technologies "should again strengthen demand for capital equipment and restore solid economic growth".

Even as he put forward this scenario, Greenspan warned that the US economy may decline further. "The period of sub-par economic growth is not yet over," he said, "and we are not free of the risk that economic weakness will be greater than currently anticipated, requiring further policy response."

Some economic commentators have cast doubt on the ability of such a "policy response"—the cutting of interest rates—to bring about a renewed expansion, pointing out that as the slowdown has not been caused by Fed monetary policy, so it will not be cured by it.

In the post-war period, these observers note, contractions have been set off by the tightening of monetary policy. In this case, however, the slowdown is the result of excess capacity due to the unprecedented level of investment in high-tech equipment and infrastructure.

In an article entitled "The impotence of monetary policy" published in the *Financial Times* on Thursday, Zurich Financial Services global economist David Hale provided figures which showed how rapidly this investment grew in the late 1990s and its role in boosting US economic growth.

The capital spending boom of the late 1990s, he wrote, resulted from "an unprecedented flow of money into the technology sector from a variety of different channels". The most spectacular increase was in venture capital funding—used to finance new business undertakings. This increased from $4.4 billion in 1995 to $114.6 billion in 2000.

"Venture capital funding in 1999-2000 was equal to 70 percent of venture capital funding during the past two decades. The value of equity in initial public offerings for the technology sector surged to $37.5 billion in 2000, from levels of $2-3 billion a year during the early 1990s. The junk bond market provided $200 billion of funding for new telecommunications service providers between 1997 and 2000."

Overall, business spending on new technology emerged as "the principal growth engine during the late 1990s". From 1995 information technology spending in constant dollar terms rose from $227.5 billion to $713 billion, representing almost 25 percent of the growth in gross domestic product in that period.

No amount of interest rate cuts by the Fed is going to bring about a return of these conditions because the problem is not the high cost of capital but excess productive capacity, leading to pressure on profit rates, cuts in investment and reduced economic growth.

Such is the interconnected character of the world economy that these pressures are now being felt beyond the US, as the latest figures from Europe indicate.

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