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Press Release

Europe's economy on the mend but the weak recovery poses major risks

Impact of fiscal austerity planned or under way risks a renewed economic downturn

Geneva, 18 January 2011 – The gross domestic product (GDP) of the European Union (EU-15) grew at a rate of 1.7 per cent in 2010 and is expected to slow to 1.5 per cent in 2011, only to pick up slightly in 2012, to 1.9 per cent, says a United Nations report, *World Economic Situation and Prospects 2011 (WESP)*. The recovery among new EU members remains fragile, while the recovery among the economies in transition of South-Eastern Europe remains very weak.

Uneven recovery in the EU-15 and rest of Western Europe

The report released today demonstrates that Europe's economic discord has resulted in uneven economic performances, with some countries registering positive growth while others remain in recession with the prospect of near-term minimal recovery. Fiscal austerity measures dominate the region's economic landscape.

WESP says that economic activity in Western Europe picked up greatly during the first half of 2010, as a result of an export-driven industrial rebound, various fiscal support measures and inventory restocking. However, in the second half of 2010, output growth slowed, as the rebound in global trade weakened, the inventory cycle turned, and fiscal stimuli were being phased out or, as was the case in some countries, replaced by austerity measures.

While growth has recovered, the report says, it is not robust and masks a number of important weaknesses. Industrial production, for example, remains 12 per cent below its April 2008 peak, indicating that renewal is far from complete. Unemployment rates remain high in many countries and dramatically high in some, like Spain. The recovery is taking place at different speeds. At one end of the spectrum are the countries, led by Germany, with a relatively strong rebound, showing a 3.4 per cent expansion in 2010 economic activity. These were able to take full advantage of the improvement in global trade. At the other end are countries entrenched in fiscal crises, such as Greece, Ireland, Portugal and Spain, which will either remain in recession or see minimal recovery at best.

WESP predicts in its outlook that consumption expenditure is expected to improve gradually for the majority of Western European countries, but without much vigour. The situation is far worse in countries with severe fiscal consolidation programmes. In Greece, for example, consumption expenditure is expected to continue to decline through 2012.

The precipitous decline in equipment and housing investments was a major driver of the recession. Evidence for a turnaround is sparse, with the first positive investment growth for the euro area since the recession registered in the second quarter of 2010. With the exception of countries undergoing severe fiscal consolidation programmes, investment is expected to pick up gradually, registering positive, but low, growth rates in 2011 and 2012.

Europe: Rates of growth of real GDP, 2007-2012[a]

Annual percentage change

	2007	2008	2009	2010[b]	2011[c]	2012[c]
Western Europe	**3.0**	**0.5**	**-4.1**	**1.7**	**1.6**	**2.0**
European Union	3.0	0.5	-4.2	1.7	1.6	2.0
Austria	3.7	2.2	-3.9	1.8	2.0	2.1
Belgium	2.9	1.0	-2.8	2.0	1.0	1.6
Bulgaria	6.4	6.2	-4.9	0.4	3.4	5.5
Cyprus	5.1	3.6	-1.7	1.0	1.5	1.5
Czech Republic	6.1	2.5	-4.1	2.0	2.0	3.0
Denmark	1.7	-0.9	-4.7	1.4	1.8	2.0
Estonia	6.9	-5.1	-13.9	1.5	3.0	3.0
Finland	5.3	0.9	-8.0	2.6	3.0	2.5
France	2.4	0.2	-2.6	1.6	1.2	1.3
Germany	2.7	1.0	-4.7	3.4	2.2	2.5
Greece	4.5	2.0	-2.0	-4.8	-3.6	0.1
Hungary	1.0	0.6	-6.3	0.8	2.5	3.5
Ireland	5.6	-3.5	-7.6	-1.0	-0.9	1.5
Italy	1.5	-1.3	-5.0	1.3	1.1	1.2
Latvia	10.0	-4.2	-18.0	-0.8	3.0	3.8
Lithuania	9.8	2.9	-14.7	-0.6	2.7	3.5
Luxembourg	6.6	1.4	-3.7	3.2	2.0	2.6
Malta	3.7	2.6	-2.1	1.5	2.0	1.5
Netherlands	3.9	1.9	-3.9	1.8	1.5	2.4
Poland	6.8	5.1	1.7	3.6	4.2	5.5
Portugal	2.4	0.0	-2.6	0.8	-0.9	0.2
Romania	6.3	7.3	-7.1	-1.5	2.5	4.0
Slovakia	10.6	6.2	-4.7	3.8	3.5	4.0
Slovenia	6.9	3.7	-8.1	0.6	2.4	3.1
Spain	3.6	0.9	-3.7	-0.7	0.4	1.0
Sweden	3.3	-0.4	-5.1	4.3	3.4	3.0
United Kingdom	2.7	-0.1	-5.0	1.8	2.1	2.6
EU-15	2.8	0.3	-4.3	1.7	1.5	1.9
New EU member States	6.2	4.0	-3.6	1.9	3.2	4.3
Euro area[d]	2.8	0.5	-4.1	1.6	1.3	1.7
Other Western Europe	3.3	1.4	-1.8	1.3	2.1	2.2
Iceland	6.0	1.0	-6.8	-3.4	0.5	0.5
Norway	2.7	0.8	-1.4	1.0	2.4	2.2
Switzerland	3.6	1.9	-1.9	1.8	1.9	2.2
South-Eastern Europe	**6.1**	**4.3**	**-3.7**	**0.1**	**2.5**	**3.4**
Albania	5.9	7.7	3.3	2.5	3.0	3.5
Bosnia and Herzegovina	6.2	5.7	-2.9	1.0	2.5	3.0
Croatia	5.5	2.4	-5.8	-1.7	1.6	2.7
Montenegro	10.6	7.0	-5.7	0.8	3.0	4.0
Serbia	6.9	5.5	-3.1	1.5	3.5	4.5
The former Yugoslav Republic of Macedonia	5.9	4.9	-0.7	1.5	3.0	4.0

Source: United Nations, *World Economic Situation and Prospects 2011*.

a Regional averages are calculated as a weighted average of individual country growth rates of gross domestic product (GDP), where weights are based on GDP in 2005 prices and exchange rates.

b Partly estimated.

c Forecasts, based in part on Project LINK.

d Based on membership as of December 2010.

Unemployment will remain high in coming years

The rate of unemployment in the euro area drifted up from 7.2 per cent in March 2008 to 10.1 per cent in September 2010. Most of the increase took place during 2009, with the unemployment rate rising by only 0.3 percentage points since. The picture differs widely across countries, with unemployment rates reaching 20.0 per cent in Spain, 14.1 per cent in Ireland and 10.0 per cent in France, while unemployment in Germany has been largely contained and is currently 6.7 per cent of the workforce. The modest job growth in 2010 could indicate that labour markets are approaching a turning point. Germany has turned the corner already, as the unemployment rate has fallen by a full percentage point since its 2009 peak, and other countries in the region have seen some improvement as well. For the countries affected by the sovereign debt crisis, however, unemployment rates either continue to increase or have stalled at extremely high levels. *WESP* predicts very little improvement for these countries, due to continuing recession or weak growth, exacerbated by severe fiscal austerity programmes.

The UN report says it will take years for employment to rebound significantly in the region, as the growth outlook is not sufficiently strong and, in some cases, structural problems will be a hindrance. In Spain, for instance, much of the increase in unemployment was caused by the collapse of the construction sector after a long real estate boom. These jobs will not return in the near term, and employment prospects will be hindered by a mismatch between existing skills and new jobs created. Italy is another case where skills mismatches, coupled with a weak growth outlook, are expected to lead to increasing rates of unemployment.

From stimulus to austerity

Fiscal policy and the workings of automatic stabilizers played a major role in softening the impact of the global downturn on most European economies. It has come, however, at the cost of large increases in fiscal deficits and public debt. The budget deficit in the euro area rose from 2.0 per cent of GDP in 2008 to 6.2 per cent in 2009, while the debt-to-GDP ratio rose from 69.3 per cent to 78.7 per cent. Both ratios are estimated to have increased further in 2010, says *WESP*.

The UN report says that concerns remain over the capacity of Greece to bring down its public debt, while Ireland and Portugal continue to suffer imminent debt distress, spurring calls for an international bailout. Ireland was recently granted €85 billion in emergency finance to deal with the huge increase in its deficit. Others may follow that route in 2011.

Sovereign bond spreads for Ireland, Greece, Portugal and Spain continue to be elevated, and there is evidence of further contagion—spreads for Italy and Belgium have increased since the onset of this phase of the crisis. Pressure for fiscal consolidation remains high. More generally, all members of the euro area, with the exception of Finland and Luxembourg, are required to consolidate their budgets, as their deficits exceed the 3 per cent of GDP limit enshrined in the Stability and Growth Pact (SGP). Fiscal retrenchment in most countries is scheduled to start in 2011, and it will take from two to four years to bring deficits to below the ceiling. The countries facing deeper fiscal crises, however, were already forced into drastic fiscal austerity in 2010, and the degree of retrenchment ahead is considerable. The Greek government, for example, aims to have reduced its deficit by more than 10 percentage points of GDP by 2014, says *WESP*.

In the early stage of the crisis, central banks aggressively cut their main policy rates. The European Central Bank (ECB) cut its main policy interest rate from 4.25 per cent in July 2008 to 1.00 per cent in May 2009, and has maintained that rate since. The Bank of England, as well as all other central banks in Europe, also brought rates down drastically.

Since then monetary policy has relied on unconventional measures. The ECB targeted mostly money markets. It modified and extended its refinancing operations providing unlimited liquidity at a fixed interest rate, extending the set of lending maturities up to one year. It also loosened its collateral requirements. The Bank of England adopted quantitative easing through the Asset Purchase Facility, allowing it to purchase securities (gilts) issued by the British Government in the secondary market as well as high-quality private sector assets, including commercial paper and corporate bonds. The ECB subsequently added quantitative easing to its policies, purchasing sovereign bonds of the constituent economies of the euro area. Some of these measures have already been phased out, but others will only be withdrawn gradually during 2011-2012. WESP expects that policy interest rates will be kept low during 2011, with very gradual tightening beginning in 2012.

Downside risks remain

Risks to the forecast are slanted to the downside. The impact of the fiscal austerity underway or planned, while unemployment rates are still up, could risk a renewed economic downturn. Without a concerted EU response, it could affect confidence in the euro, as the affected economies are part of the common currency area. There is a risk for further appreciation of the euro and other regional currencies, given the forces in play that are weakening the United States dollar. Exchange-rate appreciation would erode export competitiveness and thus weaken a key driver of growth in the region.

WESP warns that if remaining financial fragility is not addressed, bank lending could remain constrained, hampering the rebound in investment, while consumption spending would falter if labour market conditions are too slow to improve. On the upside, export growth may strengthen if growth in emerging market economies remains robust, and investment expenditure could be stronger if bank lending conditions were to ease sooner than expected.

A cautious, export-led recovery of the economies of the new EU members

Following the sharp economic downturn of 2009, the new EU members in Eastern Europe saw a modest recovery in 2010. The recovery was mainly driven by rebounding exports, supported by stronger external demand. *WESP* warns, however, that the recovery remains fragile in most economies. Only Poland and Slovakia exhibited solid economic performance in 2010, with output increasing at more than 3.5 per cent. Elsewhere, the upturn was feeble, while in Latvia, Lithuania and Romania, economic contraction continued. On average, the GDP of the new EU member States increased by 1.9 per cent in 2010, having shrunk by 3.6 per cent in 2009.

The space for stronger counter-cyclical measures which could speed up recovery is limited. Budget deficits are large, especially in the economies most affected by the global crisis. In Latvia and Lithuania, fiscal deficits exceeded 8 per cent of GDP in 2010. All governments of the new EU members will be engaging in drastic fiscal retrenchment over the next three or four years in an attempt to bring deficits below the ceiling of 3 per cent of GDP set for the euro zone. Estonia, which recently joined the euro zone, already reached that target but aims to balance its budget in the medium term.

Growth is expected to strengthen to 3.2 per cent in 2011. Yet, it will take some time before pre-crisis growth rates will be achieved again and the fiscal austerity likely will not be of immediate help in that sense. WESP recommends that deeper structural reforms should be undertaken to underpin more sustained long-term growth. Better utilization of available EU funds could support such reforms.

Unemployment rates remain relatively high in most new EU members, although there has been improvement in some cases. In Latvia, for instance, the unemployment rate had declined to 15 per cent in August 2010, down from 19.7 per cent in 2009. In all countries, the unemployed tend to go longer without a job, however. This is all the more worrisome as fiscal stimulus measures that supported job creation are being phased out and fiscal austerity measures are threatening to shed public employees. This is expected to hold back further improvements in labour markets during 2011.

Weak recovery in South-eastern Europe

Economies in transition of the Commonwealth of Independent States (CIS) and those in South-eastern Europe recovered visibly from the steep downturn caused by the global crisis. The UN report attributes the recovery primarily to more favourable external conditions. The CIS economies in particular benefited from higher commodity prices (*see CIS press release*). The performance of the transition economies in South-eastern Europe, by contrast, remained lacklustre as weak domestic demand stifled most of the impetus from export growth. The GDP of the region expanded by a mere 0.1 per cent in 2010. Export growth was the main driving force behind an otherwise weak recovery in Bosnia and Herzegovina, Montenegro, Serbia and the former Yugoslav Republic of Macedonia during 2010. Croatia, however, failed to climb out of the recession as continued declines in consumption and investment outweighed export growth.

In the outlook, GDP growth in South-eastern Europe is expected to remain subdued at 2.5 per cent in 2011, but may accelerate to 3.4 per cent in 2012.

Unemployment increased in the region in 2010, with the exception of Albania. It is particularly high in Bosnia and Herzegovina and the former Yugoslav Republic of Macedonia. As the economic recovery is expected to gain some speed in 2011, job creation in the private sector is also expected to improve. Large numbers of workers have now been without a job for a longer period of time. *WESP* predicts that this problem is likely to persist in the absence of targeted measures to encourage retraining and hiring in the formal sector.

In addition to weakening global demand conditions (*see global press release*), downward risks include the high degree of euroization of bank loans, particularly in Serbia, which given prevailing currency mismatches, could lead to large numbers of non-performing loans in the case of any exchange rate devaluation. The banking sector of the countries in the region will likely also be affected directly by any serious further deterioration in the financial situation in Greece.

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http://www.un.org/esa/policy/wesss/wesp.html

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