The Forecast for the U.K., Germany and France: Fading Clouds, but Still No Day at the Beach

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THE UNITED KINGDOM, GERMANY, France. These are the three most important economies in Europe – and they've taken three big hits in '95.

First, a slowdown in world growth has hurt export prospects. Second, a decline in consumer confidence has slowed economic expansion. And third, there has been no "locomotive" for European growth – a role generally played by Germany – mainly because that nation's economy has been anemic.

"But," says Gerard Lyons, chief international economist of London-based DKB International, "those negative factors for growth have been partially offset by two positive factors."

First, the interest-rate environment has been far better than most observers expected. German and French rates have continued to fall, while Britain's have been steady after peaking in February at 6.75%, which is low by historical standards. Thursday, the favorable environment was underscored by the latest easing by the German Bundesbank, which cut the discount rate from 4% to 3.5%.

Second, British and French exports have done relatively well, aided by weak currencies and low labor costs, even as the deutschemark's strength has battered sales of German goods abroad.

Cautious Consensus

In Lyons' view, the U.K., Germany and France are likely to experience steady, although not robust, growth throughout the year. "A new consensus is emerging, which is a far more rational view of the situation than before," he comments. "The consensus at the start of the year was wrong. It said that European growth would be strong, that inflation would pick up, and that interest rates would rise. Now the consensus is far more cautious about growth, far more optimistic about inflation – and far more realistic about the persistence of low interest rates."

The economist believes that U.K. interest rates will remain at current levels this year and should decline in '96. In France, he predicts, rates will fall further. In Germany, they'll stay low – and there's an outside chance they could continue to fall.

Inflation in the U.K. has remained low, with the underlying rate running approximately 2.8% on an annual basis.

Comments Lyons: "We have been quite optimistic about the U.K. inflation situation. And we have been proved right. But many observers, including the Bank of England – the British central bank – continue to say that the U.K. economy is growing too strongly, that inflation will pick up, and that interest rates have to rise sharply. But in these respects, what we have actually seen this year in the U.K. is a very similar picture to the U.S."

As in the U.S., the U.K. economy has slowed from an unsustainably strong pace of growth last year to a slower and steadier clip – one that has kept inflation in check.

"What we have seen in the U.K. is almost a dual economy," says Lyons. "Exports have done comparatively well, benefiting from the weak sterling. But on the other side, domestic demand has been relatively sluggish because U.K. consumers still lack confidence. There has been no feel-good factor, as we call it here in the U.K. People have remained concerned about jobs. People have thought twice about spending. And when they have spent they have looked for value for their money."

Consumers are still cautious in the wake of the recession that ended in '92. Homeowners were hit hard as they saw house prices plummet, never to recover to the highs of the 'Eighties. Labor market conditions did improve in 1993 and 1994, but the unemployment rate currently stands at 8.3%.

The U.K. economy also has suffered from rising inventories.

"That points to companies having to reduce their inventory overhang as we move through the second half of the year," says Lyons, "So we could have a few months of weak economic conditions with the indicators remaining poor."

Another reason the U.K. economy has stumbled is that domestic policy has been tight, Lyons observes. "Taxes were raised last year. Interest rates continued to go up until early this year. And it has taken some time for it to be felt by the system. So previous policy tightening has continued to drag the economy down, following tax increases and interest-rate hikes last year."

The economist continues: "Policy makers imposed higher taxes because the budget deficit had deteriorated as a result of the recession and they wanted to bring it back in line. The result is that the deficit has improved, although at the cost of a slowdown in the economy this year. And as strange as it may sound, the government wanted to reduce the deficit in order to be able to cut taxes before the next election." Interest rates, meanwhile, were pushed higher because the Bank of England believed that the economy has been growing too strongly for its own good.

"The Bank of England has followed a very similar policy to the U.S. Federal Reserve," says Lyons. "When the Fed started raising rates last year, they believed that the U.S. economy was growing above trend, and sooner or later that would trigger inflation. The Bank of England has taken a similar view. They raised the base rate from 5¼% early last year to 6¾% by February."

The Bank of England doesn't enjoy the autonomy of the Fed, but instead is under the authority of the Chancellor of the Exchequer, the British counterpart of the U.S. Treasury secretary.

"We have a monthly meeting here in the U.K. between the chancellor and the governor of the Bank of England," Lyons notes. "And for some months now, the governor has continued to argue for higher rates, but the chancellor has overruled him. And the debate is whether the chancellor is right or the governor of the Bank of England is right. I side with the chancellor because I think the economy is on a slow but steady rate of recovery with low inflation – and higher interest rates would only damage growth prospects."

Lyons adds that "this has been an industry-led recovery in the sense that exports have done quite well. By contrast, consumer spending has not been as robust as in previous recoveries, growing only modestly."

Exit the Tories?

Another weak spot: investment. "Industry has not been keen to invest – which is a key disappointment. And they have not been keen to invest partly because they demand very high rates of return. That's due in part to the uncertainty of what is going to happen to interest rates and to demand in the U.K.," Lyons asserts.

Adding to the uncertainty is that a general election has to be called by May '97 at the latest. The Conservatives who are currently in power look like they will lose to the Socialists or to the Labor Party.

"The loss of the Conservatives seems a foregone conclusion," says Lyons. "They have been in power since '79. And that we have had a recession, taxes have gone up, sterling has depreciated – all those factors – have not helped sentiment or confidence."

Lyons predicts that the U.K.'s economy will grow by 2.5%-3% this year, with more of the same going into '96. He sees inflation staying below 2.5% and unemployment continuing at around 8%.

Although the Germans haven't published growth rates since the beginning of this year, Lyons' tracking of Germany's economic indicators places annual growth at 2% or lower. "In the days prior to the Bundesbank's latest easing, there was clear evidence of the economy's difficulties. July's survey of business confidence – conducted by IFO, a prominent private institution – was in negative territory for the first time since May last year," he says. But he believes that economic expansion in Germany should rise to around 2.5% by next year, partly in response to the easing of interest rates and to tax cuts that should boost consumer spending.

German Problems

Investment could make a comeback, too. Historically, Germany has invested heavily in its industries. One danger this time around: The nation's competitiveness problems (a lofty mark, high wages, long vacations, a work ethic that Frederick the Great would find pitiful) could limit the scale of any rebound, as German firms transfer production capacity abroad.

The French economy was in recession in '93 and has been recovering since the start of last year. Despite this, unemployment still remains France's biggest problem, running around 11.5%.

"One problem in France is that it is pegging its interest rates to German interest rates, which has been holding back its growth," Lyons observes. "That's because it's heavily influenced by what the French franc is doing against the D-mark. They have pushed money-market rates lower in recent months because the French franc has performed well. But they have to do more, which they will inevitably realize."

Lyons stresses that France also must pursue a more aggressive fiscal policy. "The government ought to engage in measures to boost demand. But it doesn't want to do this because it's trying to reduce the budget deficit."

The recent elections in France reflected the general malaise among voters. "It was noticeable," comments Lyons, "that in the first round of the recent French elections, four out of 10 people voted for extremist candidates. That's seen by many as a clear sign that French consumers are still disenchanted with how the economy has been run."

But as with the U.K. and Germany, Lyons predicts slow but modest growth of about 2.5%, with inflation continuing to stay under 2%, and with the intervention rate – France's key interest rate – falling from 5% to 3% by year-end. ■