A macroeconomic survey of Europe

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The near future: In short:

- Forecasts for a (mild) recovery.
- Good reasons to be doubtful. The Euro at the top of the list.

Three topics:

- How high can the Euro go?
- Two puzzles: Persistent inflation and low productivity growth. Important implications for the future.
- The SGP row, the EU constitution. How Europe works/does not work.

1. Forecasts from the OECD and private forecasters.

	2003	2004	2005
Private forecasts			
Euro zone	0.5	1.9	
France	0.2	1.9	
Germany	-0.1	1.7	
Italy	0.5	1.7	
Spain	2.4	3.0	
UK	2.0	2.8	
OECD forecast			
Euro zone	0.5	1.8	2.5

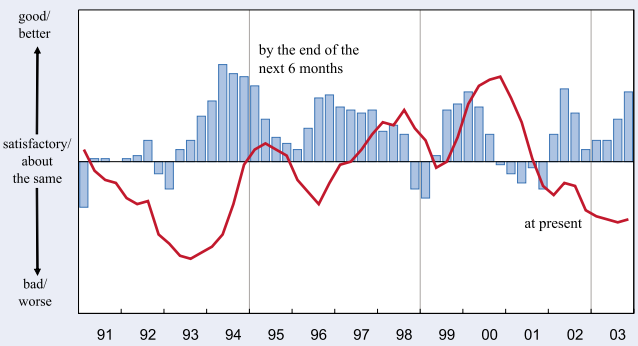
Source: Private forecasts: The Economist, January 2004 (with euro at 1.25) ; OECD forecast: OECD Eco Outlook, as of November 2003 (with euro at 1.15).

All January 2004 private forecasts up by 0.1% over Dec 2003 forecasts (despite Euro appreciation)

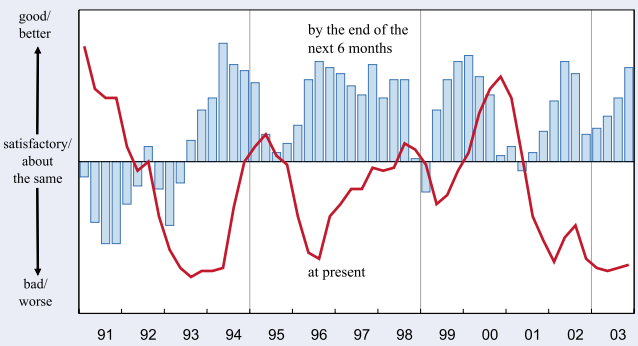
Forecasts consistent with business surveys. For example: IFO business surveys. See attached figure.

- Note the steady deterioration in 2003 in perceptions of actual situation, and the steady improvement in expected situation six months out.
- Note also the pattern for 2002: up (and then back down.)

Figure 3



Source: Ifo World Economic Survey (WES).



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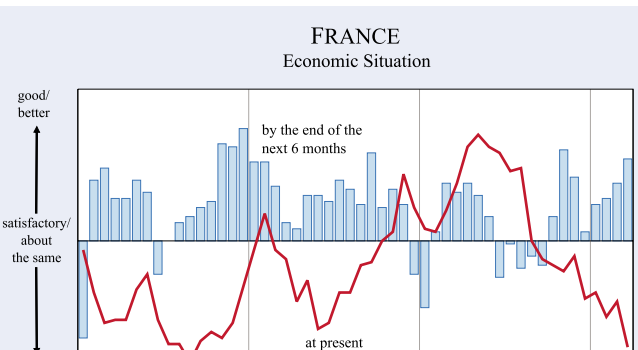

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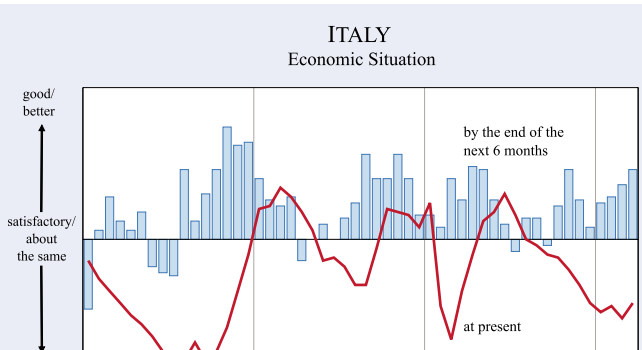

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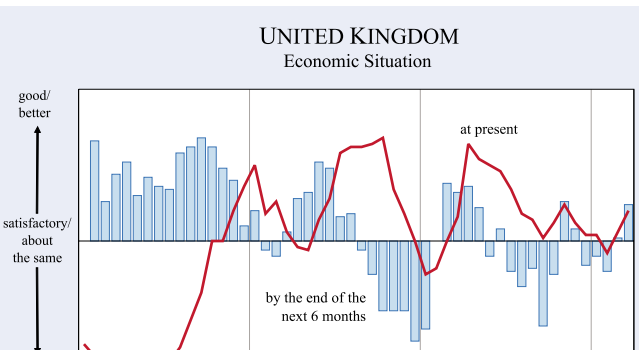

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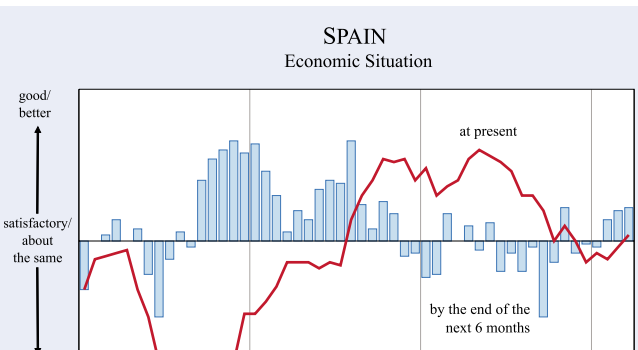


Source: Ifo World Economic Survey (WES).

2. Reasons to be doubtful? Yes.

2.1. Too much optimism? The forecast errors of the recent past.

OECD forecasts for the Euro area, as of different dates in the past.

	2002	2003	2004	2005
GDP				
dec 02	0.8	**1.8**	2.7	
june 03	0.9	**1.0**	2.4	
dec 03		**0.5**	1.8	2.5
Consumption				
dec 02	0.6	1.5	2.5	
june 03	0.7	1.2	2.1	
dec 03		1.4	1.7	2.4
Investment (residential)				
dec 02	-0.6	1.2	1.2	
june 03	-1.5	0.8	1.0	
dec 03		0.1	1.8	1.9
Investment (non residential)				
dec 02	-2.7	1.3	4.3	
june 03	-2.2	-0.6	3.8	
dec 03	-3.4	-2.1	2.7	5.1

Source: OECD Economic Outlook, December 2002, June 2003, December 2003.

Sources of the forecast errors?

Exercise using a Euro–wide model: Role of outside economic environment (world trade, price of oil,commodity prices) in explaining forecast errors? Answer: Small (-0.2 in 2002, -0.6 in 2003)

Exercise by French OFCE (using their macroeconometric model). Large residuals in consumption, and non residential investment:

- Household saving rate has increased in France since 2001. (Same in most EU countries)
- Decrease in debt (after large increase due to mergers) in largest firms: Telecom, Vivendi, Suez.

One step back:

Why do economies turnaround (in rich countries) ?

- More expansionary policies, fiscal or money.
- Natural dynamics of investment/consumption
- Dumb luck: Good shocks.

In the present case, forecasts are based on a combination of the last two (turnaround in investment, and strong world economy). The issue is potential bad luck: the Euro. Take them in turn.

2.2. Fiscal policy.

Despite the heat, and the breakdown of the Stability and Growth Pact, not much action in fiscal policy. Look at the two Pact breakers, and the Euro zone:

	2000	2001	2002	2003	2004 (*)	2005 (*)
France						
actual	-1.4	-1.5	-3.1	-4.0	-3.7	-3.5
cyclically adjusted	-1.6	**-1.7**	**-3.0**	**-2.9**	**-2.5**	-2.4
Germany						
actual	-1.3	-2.8	-3.5	-4.1	-3.7	-3.5
cyclically adjusted	-1.4	**-2.6**	**-2.6**	**-2.3**	**-1.9**	-2.1
Euro zone						
actual	0.1	-1.7	-2.3	-2.7	-2.6	-2.7
cyclically adjusted	-1.0	-1.3	-1.7	-1.7	-1.5	-1.9

*Source: OECD Economic Outlook, December 2003, Tables A28, A29. *:forecast*

Note: Increase in cyclically adjusted deficit in 2002 in France, but tighter in France and Germany in 2003 and (forecast for) 2004.

The income tax cuts in France and Germany in 2003/2004 are more than offset by increases in indirect taxes, and reductions in spending. Not much short run effect.

2.3. Monetary policy.

Typically, a recession leads to lower inflation, which allows the central bank to decrease interest rates.

Not much action this time. The reason: Inflation has not decreased much, if at all. (More on this below).

Euro Inflation using:	2000	2001	2002	2003	2004 (*)
GDP deflator	1.3	2.4	2.4	1.9	1.7
PCE deflator	2.1	2.3	2.3	1.9	1.6
CPI	2.2	2.4	2.3	2.0	1.5

*Source. OECD Economic Outlook, December 2003. *: forecast*

The reaction of the ECB has been muted. And at this stage, despite change of management, no crisis atmosphere.

(Futures markets see the short rate **up** from 2% now to 2.6% at the end of 2004.)

2.4. Natural rebounds in consumption and investment?

In general, a number of potential mechanisms, often weak.

For example, after a period of overinvestment, period of low investment until capital returns to normal, then investment picks up. Same after an episode of excessive consumption.

- As discussed in earlier meetings, much less of an investment or consumption boom in Europe than in the US, and so less of an adjustment since.
  No evidence at this point of much overhang left.

- Why should consumers turn around? Not obvious. Unlikely to be the source of the turnaround.

  [Consumer debt: Not a major issue. EU: Household saving rate, 10%, household debt: 52% (for comparison: US: household saving rate, 3%, household debt: 85%.)]
  [The special case of the UK. Flexible rate mortgages (not the case elsewhere in the EU, except Spain), and ratio of household debt to income: 125%, from 100% in 1998.]

Or the fundamentals become more favorable, leading to higher asset valuations and expectations, and in turn investment and consumption:

Here, no change in basic assessment (see discussion december 2002): Fundamentals are quite good (but have not dramatically improved):

- Profit shares high. Profit rates steady, despite recession. One worry: Low productivity growth (more on this later).

- Reform in goods markets, driven by deregulation and competition policy in Bruxelles, forcing reforms in labor markets. Agenda 2010 in Germany, pension reforms in France, Health care coming in France. Not dramatic, but steady.

In short:

- The increase in internal demand is plausible (Nothing obvious stands in the way, and fundamentals are good)
- But it was equally plausible earlier on (and indeed forecast to happen).
- It is far from assured.

2.5. Dumb luck—or bad luck?

The forecasts are based on a combination of a roughly balanced increase in internal and external demand. (Not much change in trade balance for EU, from 151 b$ in 2002, 144b$ in 2003, to a forecast 162 b$ in 2004).

They are also based on a Euro either at or below current levels. If we thought the Euro was going to further appreciate, the forecast would rapidly look worse.

Two back of the enveloppe numbers to understand the dangers:

- A 10% appreciation of the Euro implies a decrease in Euro zone growth by 0.4/0.6%.
- A 1% higher growth in the US leads to a 0.1/0.3% increase in growth in the Euro zone.

Assuming forecasts were based on a Euro at $1.20, an appreciation to $1.50 would roughly eliminate Euro growth.

Two stupid arguments:

- "One can ignore the appreciation, because there is limited pass through". Low profit margins kill just as much as the high exchange rate.
- "A strong euro will force structural reforms..."

2.6. Is there a risk of deflation?

I believe the risk has increased, and with it the risk of a prolonged deflation–induced recession. Euro appreciation leads to both lower inflation, and lower output.

The ECB does not appear to share this assessment, nor to have contingency plans.

3. The US current account deficit, as seen from Europe

Where can the Euro go? $1.4, 1.6, 2 or more? (Expanding on and updating the December 2002 discussion.)

3.1. Dollar depreciation as a function of the UScurrent account deficit

- Assume US (long run) import elasticity with respect to the real exchange rate of -0.8.
- Asssume US (long run) export elasticity with respect to the real exchange rate of 0.9.
- Assume measures are taken to keep US GDP constant (tighter money, or tighter fiscal policy).

Next figure (lower line) shows what depreciation is required to reduce the deficit from 5% to x%.

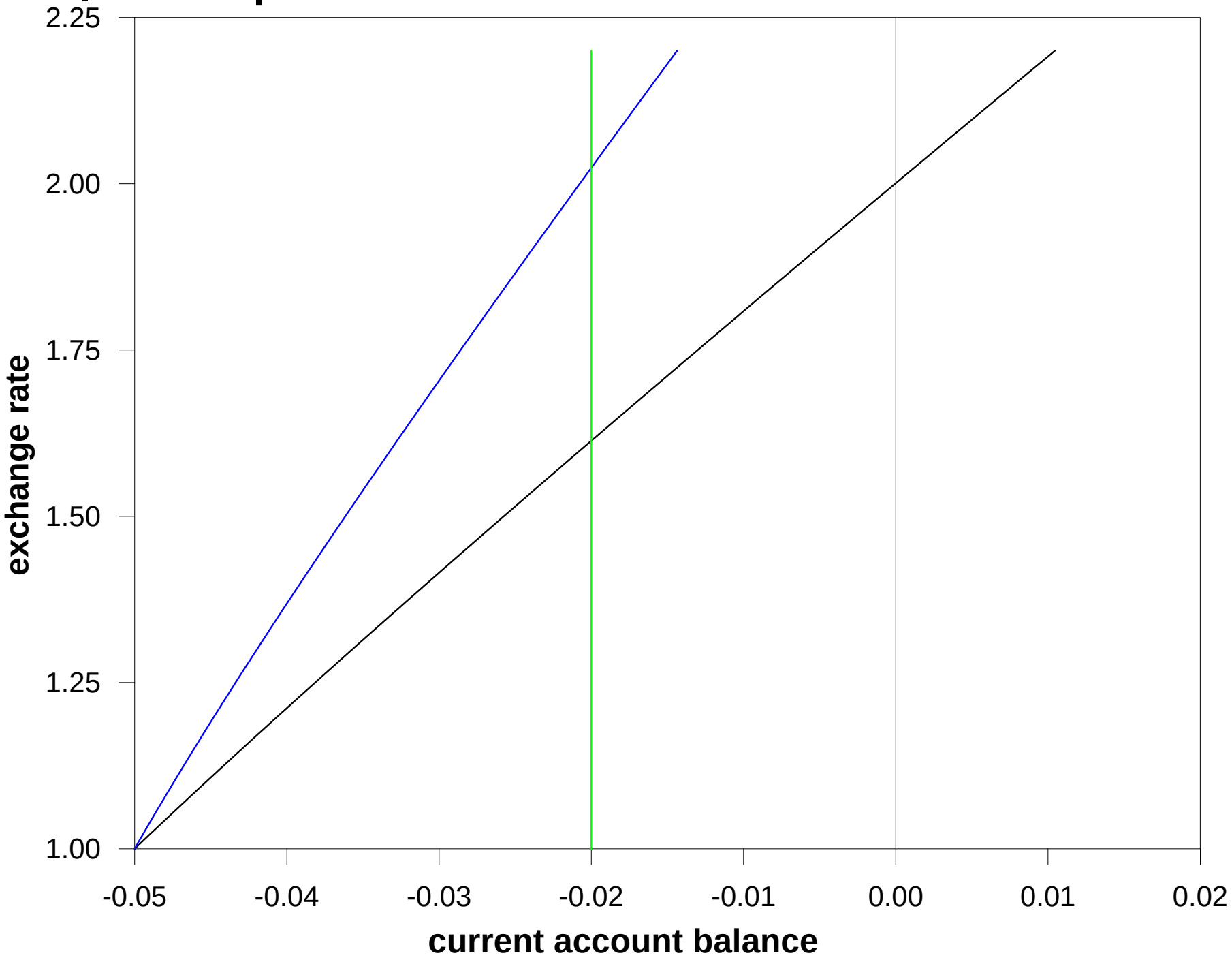
For example, to get to zero deficit, need an increase from 1.00 to 2.00. To reduce the deficit to 2%, need an increase to 1.61.

(Sensitive to elasticities. Upper line corresponds to -0.7, and 0.8 respectively. Then, to reduce it to 2%, need an increase to 2.02.)

If the dollar depreciates against all currencies uniformly, and starting from a 1 to 1 exchange rate, this gives a Euro at 1.6 to 2 dollars.

But no need for the current account to go to zero. This is the next step.

Required depreciation as a function of current account deficit



3.2. What current account deficit can the US sustain?

The wake up call: The sharp decline in equity flows in the second half of 2003. A lot of variability, so a month or a quarter does not mean a lot. But clear decline since 2001. see Figure.

In general, clear change in the composition of flows since 2000. Less FDI, equity, more bonds, largely by foreign central banks.

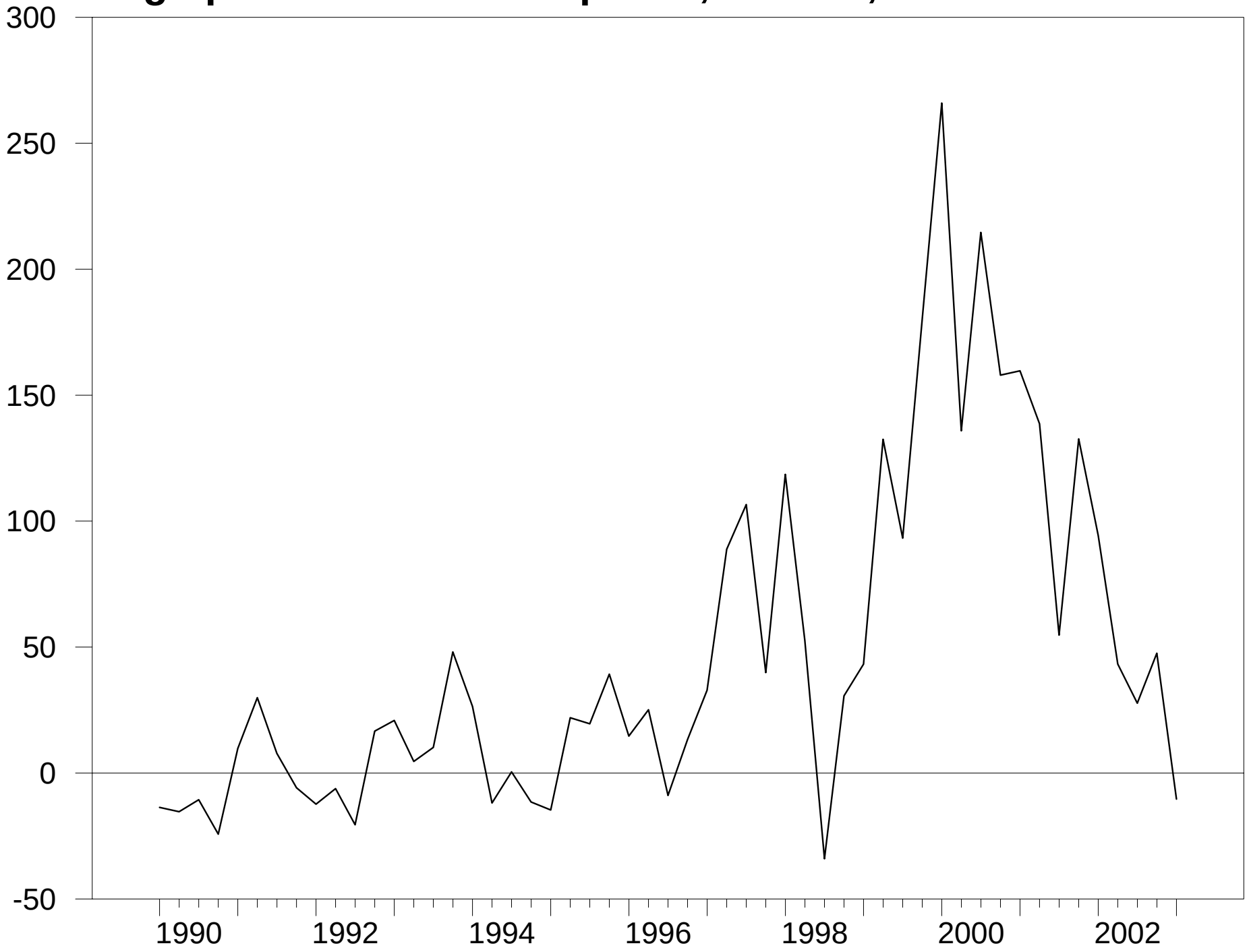
Two main questions:

- How much of the current account deficit is cyclical, and should disappear by itself in the future?
  If and when Europe returns to lower unemployment, this will likely come with a decrease in their current account surplus. But Europe is only one of the US trading partners.
  This effect likely to be small. Back of the enveloppe: less than 1% of US GDP for sure.

- If proportions of US assets in foreign portfolios were to remain stable from now on, how much of a current account deficit can the US finance?
  Short answer: Around 1%.

  (Net US financial liabilities vis a vis the rest of the world (ROW), around 3 trillion. If we assume a 3% growth rate and a constant ratio of US assets in the ROW porfolio, then US can sustain a current account deficit of 3% times 3.0 trillion or about 1% of US GDP.)

Foreign purchases of US equities, billions, 1990:1 to 2003:3



> Are the proportions of US assets in foreign portfolios likely to be stable? Can they increase further? Discussed in December 2002: Unlikely to continue to increase at the rate they have increased in the past.

If we assume a return to 2% current account deficit, then this requires an increase in the exchange rate from 1 to 1.61 (a 48% depreciation).

Any reason for things to be very different from 1985-1987? (By the end of 1987, 54% fall against DM and yen. By the end of 1989, current account deficit was around 1%, down from 3.4% in 1986.)

Tentative answer: No.

3.3. The Euro, the yen and the yuan.

Since the peak of July 2001, depreciation vis a vis the Euro 39%. But vis a vis trading partners: -12%. (Depreciation vis a vis the yen has been only 16%, and 0% against the yuan).

If the dollar must depreciate, how much against the Euro, the yen and the yuan? Two central points:

- The Euro/dollar rate depends fundamentally on where foreigners go when they reduce their US holdings.
  If they went only to Europe, then the Euro would have to do the whole adjustment. (In effect, impossible, given the weight of the Euro zone in US exports/imports, about 19%).
  If they did not go to Europe at all, then the Euro would have to do none of the adjustment.

  [Looking at BoP statistics for the Euro zone and Japan for late 2003, no clear evidence yet of much larger equity inflows.]

- It does not depend on whether central banks in Japan and China decide to intervene or not. (BoJ holdings of US Treasury securities, $525b in november 2003, up from $401b in april)

  When central banks intervene by buying US assets, they in effect replace the investors who are decreasing their US asset positions. A wash (except for composition effects, from stocks to bonds).

  This does not put additional pressure on the Euro vis a vis the

dollar (but an effect on the multilateral Euro exchange rate, as Euro appreciates vis a vis yen and yuan).

So, on the assumption of a neutral shift out of US assets, the previous estimate for the Euro appreciation stands.

3.4. Killing the golden goose?

A further appreciation of the Euro by 20-30% would probably kill Euro zone growth and lead the ECB to lower rates.

Lower interest rates, and lower profit rates are likely to decrease both debt and equity inflows.

This implies a natural limit to the increase, or at least to the speed of appreciation. Were the Euro to appreciate too fast, it might lead to a decrease in capital inflows.

This in turn may put a limit on the Euro appreciation for the time being. (So can additional Parmalat scandals...)

What limit?

4. Two puzzles. Inflation, and productivity

4.1. The persistence of inflation.

Saw the numbers earlier: Despite the slump, not much of a decrease.

Worrisome: suggests that there is little room for expansion without higher inflation.

Proximate causes? Unusual wage growth, or usually low productivity growth? Clearly the second:

Percent change, Compensation per employee, Business sector

	2000	2001	2002	2003	2004 (*)
France	1.9	2.9	2.6	2.7	2.5
Germany	2.2	1.8	1.5	2.5	1.8
Euro zone	2.4	2.5	2.3	2.5	2.1

*Source. OECD Economic Outlook, Table 12, December 2003. *:forecast*

No wage explosion, but wage settlements still based on underlying productivity trend. But productivity growth has been unusually low (even taking into account the slump). So, not much decrease in inflation.

If expansion leads to a large increase in productivity growth, then no danger of increasing inflation. Points to the importance of understanding the origin of low productivity growth.

4.2. Low productivity growth

Percent change, Labor productivity, Business sector.

	2000	2001	2002	2003	2004 (*)
France	1.6	0.1	0.7	0.0	1.7
Germany	1.0	0.4	0.8	1.7	2.3
Spain	0.9	0.6	0.9	1.0	0.9
Italy	1.6	0.0	-0.8	-0.5	0.8
Euro	1.5	0.1	0.5	0.6	1.4

*Source: OECD. Economic Outlook, Dec 2003. *:forecast*

Why? Two hypotheses, with very different implications about the future.

- European firms do not have their act together. As discussed in December 2002, this explanation does not seem right:
  When looking at individual firms, and sectors, plenty of evidence of higher competition, changes in organization, introduction of new technology.
- Reluctance to layoff workers and implement all technological and organizational innovations.
  And perhaps, but harder to assess, employment of low productivity workers has increased, leading to lower measured productivity.

Hard to prove, but strong sense it is the second. (May see, as in the US, a jobless recovery for some time). If so, room for higher growth, without higher inflation (and the ECB should act, but this is a different story).

5. The EU constitution, the SGP row, and how Bruxelles works/does not work.

The key: Instead of division of powers, overlap of powers.[1]

Why? Fear by national governments to delegate or give too much power to "Bruxelles" (The Parliament is in Strasbourg).

Result is one of two outcomes:

- Gridlock (foreign policy, the conflict between the commission and the council on the SGP), or mostly empty rhetoric (The Lisbon agenda), when overlap exercised.
- Strong and substantial action when it is not exercised (Competition policy).

1. This is largely based on a recent paper by Alberto Alesina and Roberto Perotti.

5.1 A brief review of the main institutions

- **The European Council** Composed of heads of state, with a rotating Presidency (6 months).
  Agenda setting, no formal powers.

- **The Council of the European Union (Council for short)** (not the same as the European Council...) Composed of representatives of governments, one per country. (For example, Ecofin, with finance ministers.)
  Shares legislative power with Parliament (depending on the issue).
  Decisions taken either by unanimity (depending on the issue), or qualified majority.

- **The European Parliament** Directly elected.
  Shares legislative authority with Council (depending on the issue).

- **The European Commission.** President appointed by national governments, approved by Parliament. Appoints commissioners. The Commission can be removed by a vote from Parliament.
  proposes all new legislation, then taken up either by Council or Parliament.
  implements legislation, and has regulatory power.

The fuzzy margins: Council versus Commission. Council versus Parliament. States versus Europe, through Council.

5.2. How it works, and does not work.

Gridlock/chaos: Foreign policy.

Three heads:

- The President of the European Council
- The "High Representative for Common Security and Foreign Policy (who is also the Secretary General of the Council) (Solana)
- The Commissioner for external relations (Patten)

The underlying reason: Clearly states have different views, and are not willing to give up control.

Empty rhetoric. The "Lisbon strategy".

The EU Lisbon conference of March 2000 plan to make the European Union "the world's most dynamic and competitive economy within ten years".

The Lisbon agenda: Targets for participation rates, for unemployment, for research. A lot of recommendations, tracking of progress. No teeth, no effect on national policies.

The underlying reason is same as before: States have partly different views and are not willing to give up control over a wide range of policies.

States versus Bruxelles. The SGP.

The rules of the Stability and Growth Pact laid down in the Maastricht Treaty. So, in principle, untouchable.

Council (reflecting the position of France and Germany) decided to suspend the rules.) The Commission has objected, and is taking the case to the EU court of Justice.

The underlying reason: States happy to delegate for a while, but no longer. Takes now the form of a fight between the Council (representing states) and the Commission (representing the supra national position)

Implications for the future. Face saving compromise? Some reform likely. No big economic deal, one way or the other.

When Bruxelles works. Competition policy.

The major source of goods market reforms in Europe. The role of the commissioner (Monti). (Recent rows with France: Alstom, Vivendi, Lagardere)

Why so much power? Two hypotheses.

- A power grab by the Commission?
- Or a way for states to implement reforms with weak political support at home, while deflecting the blame.

The second hypothesis is the right one: States have steadily reinforced the powers of Bruxelles.

For example, tightening of rules on state aid to airline companies in 1994, general rules on rescue plans were tightened in 1999, and so on.

Excluded: Agriculture, or coal. Reflects again the limits put by the states.

The enlargement.

In may 2004, Poland, Hungary, Czech republic, Slovakia, Slovenia, Latvia, Lithuania, Estonia, Malta, Cyprus

Just makes the issues above more obvious:

If commission is going to have commissioners from all 25 governments, then will become too large.

If Presidency of the Council is going to rotate, then even less consistency in direction.

The EU constitution.

Constitutional convention. work from February 2001 to June 2003. Negotiations at an intergovernmental conference have, for the moment, broken down.

Have the President of the Council be nominated for 2.5 years. Would reinforce the Council relative to Commission.

More scope for qualified majority voting, with more transparent rules, relative to unanimity. Would reinforce Europe relative to states.

In the end: If (nearly all) states agree, then Bruxelles can act. If they do not, then largely empty rhetoric. The Constitution will at best change things at the margin.