

# **A macroeconomic survey of Europe**

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The themes I want to develop:

**In the medium run: Fundamentally doing well.**

- Steady reforms, although constrained by political speed limits.
- Mediocre numbers on productivity growth in the late 1990s. But the underlying productivity growth is strong.
- Unemployment should come down (already down in many countries). Reforms. Union attitudes.

**In the short run: Fits and starts.**

The boomlet of the late 1990s. (following the boomlet of the late 1980s, the slowdown of the first half of the 1990s) Why?

- Investment overhang? Not much. The role of investment spending, in the expansion and the slowdown.
- Lack of confidence, and (or largely because of) lack of macroeconomic support.

From macroeconomic consolidation, which was needed, to proactive policy, now needed.

**Other issues:**

- The US current account: a problem for Europe?

## THE MEDIUM RUN

### Productivity growth

- **Productivity growth in the 1990s**

*Labor productivity growth in the business sector*

	1991-2000	1997-2000
France	1.4	1.3
Germany	1.7	1.1
Spain	1.5	0.8
Italy	1.7	1.1
UK	1.7	1.3
US	1.8	2.3

*Source. OECD. Output per worker, business sector. Percent per year.*

Over the 1990s, not very different. for the late 1990s, looks bad for Europe.

But low numbers hide a more complex picture.

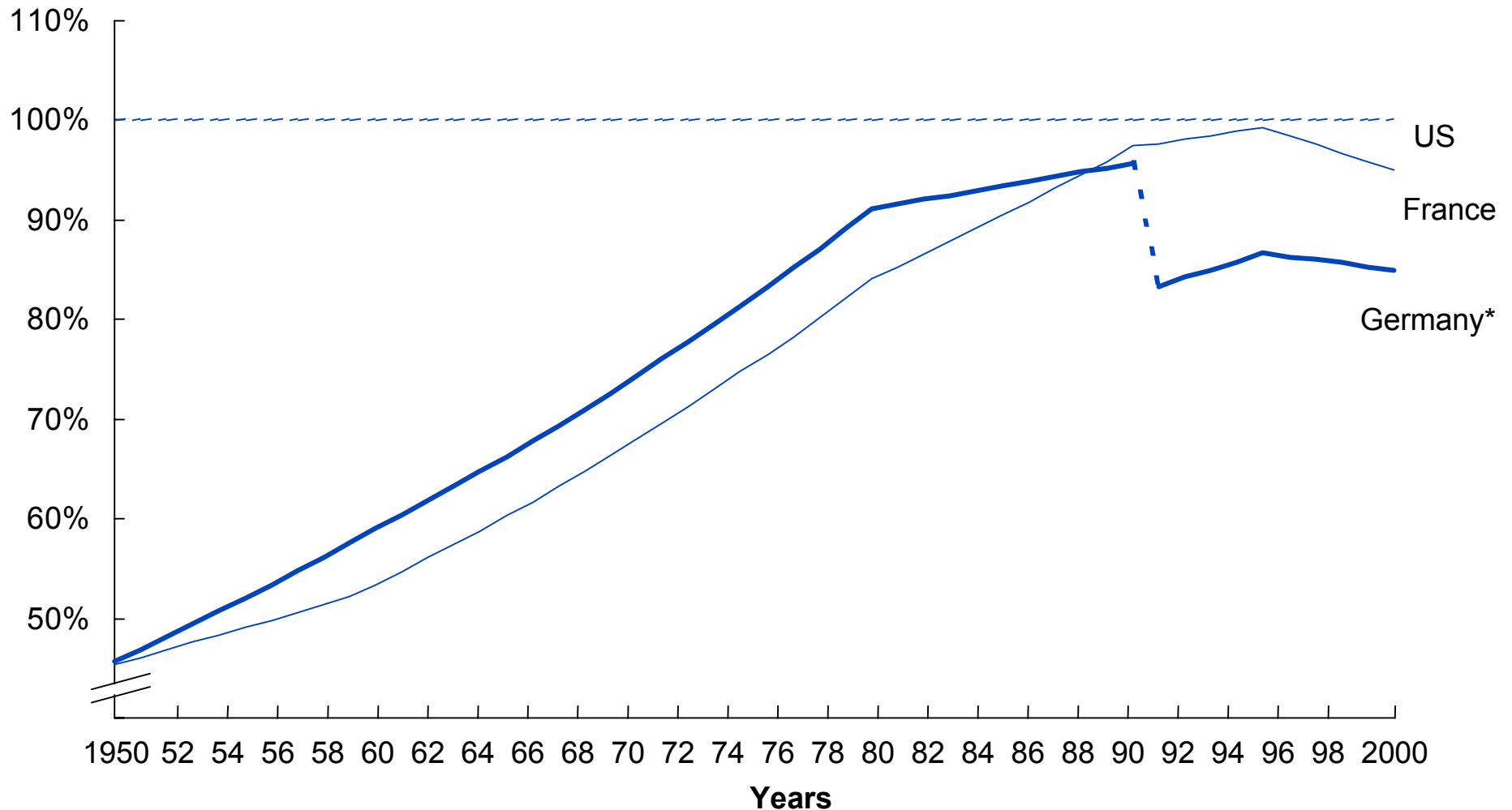
- **The longer view.**

Over 40 years, the catchup of Europe vis a vis the US. (Figure)

Exhibit 0

# PRIVATE SECTOR PRODUCTIVITY FOR COMPARABLE WORKFORCE, 1950 - 2000

Indexed to US



\* West Germany until 1989 and total Germany thereafter

Source: University of Groningen and The Conference Board; GGDC Total Economy Database, 2002,  
<http://www.eco.rug.nl/ggdc>, OECD, BLS, INSEE, MGI analysis

Measured productivity per hour now higher in France than in the US.

(Want to do two corrections. Business. Minimum wage adjustment. In the end close).

Still the case that the last five years have been much less impressive.

- The role of IT? Part but only part of the story.

Distinguish between IT production, IT use.

*Contribution of IT manufacturing to productivity growth, 1995-2000*

	Pty growth	Contribution	IT Share	IT in GDP
France	1.3	0.2		1.3
Germany	1.4	0.2		1.5
US	2.4	0.5		2.3

*Source: U of Groningen, and Conference Board. percent per year, annual rate*

From micro studies, IT use appears very similar.

- Micro evidence: In fact, a lot of action.

Two sectors as examples (from McKinsey study on France, Germany, and the US)

### **Automotive**

*Labor productivity in the automotive industry*

	Growth rate	Level
	1996-1999	1999
France	14.7%	68
Germany	1.5%	71
US	5.3%	100*
Japan	1.8%	95

*Source. McKinsey Global Institute. Growth rate: Percent per year. Level: US=100*

Note the performance of France. Why? The role of quotas on Japanese imports.

Why the remaining gap? (Light SUVs, and smaller overhead and R&D)

## Telecommunications

*Labor productivity in telecommunications (mobile services)*

	Growth rate	Level
	1992-2000	2000
France	27.5%	206
Germany	26.5%	145
US	14.0%	100*

*Source. McKinsey Global Institute. Growth rate: Percent per year. Level: US=100*

Note the performance of France and Germany. Why? More intelligent regulation than in the US.

- So why the mediocre aggregate numbers?

No convincing quantitative answer. An educated guess. Focus on employment creation, not productivity growth, under pressure from governments.

“Employment rich growth” as the motto:

- France, 35 hours

- Spain and elsewhere: reintegration of low productivity workers (increase in the participation rate of young workers).
- The effects of fixed duration contracts.

*Number of hours worked per worker (part time and full time)*

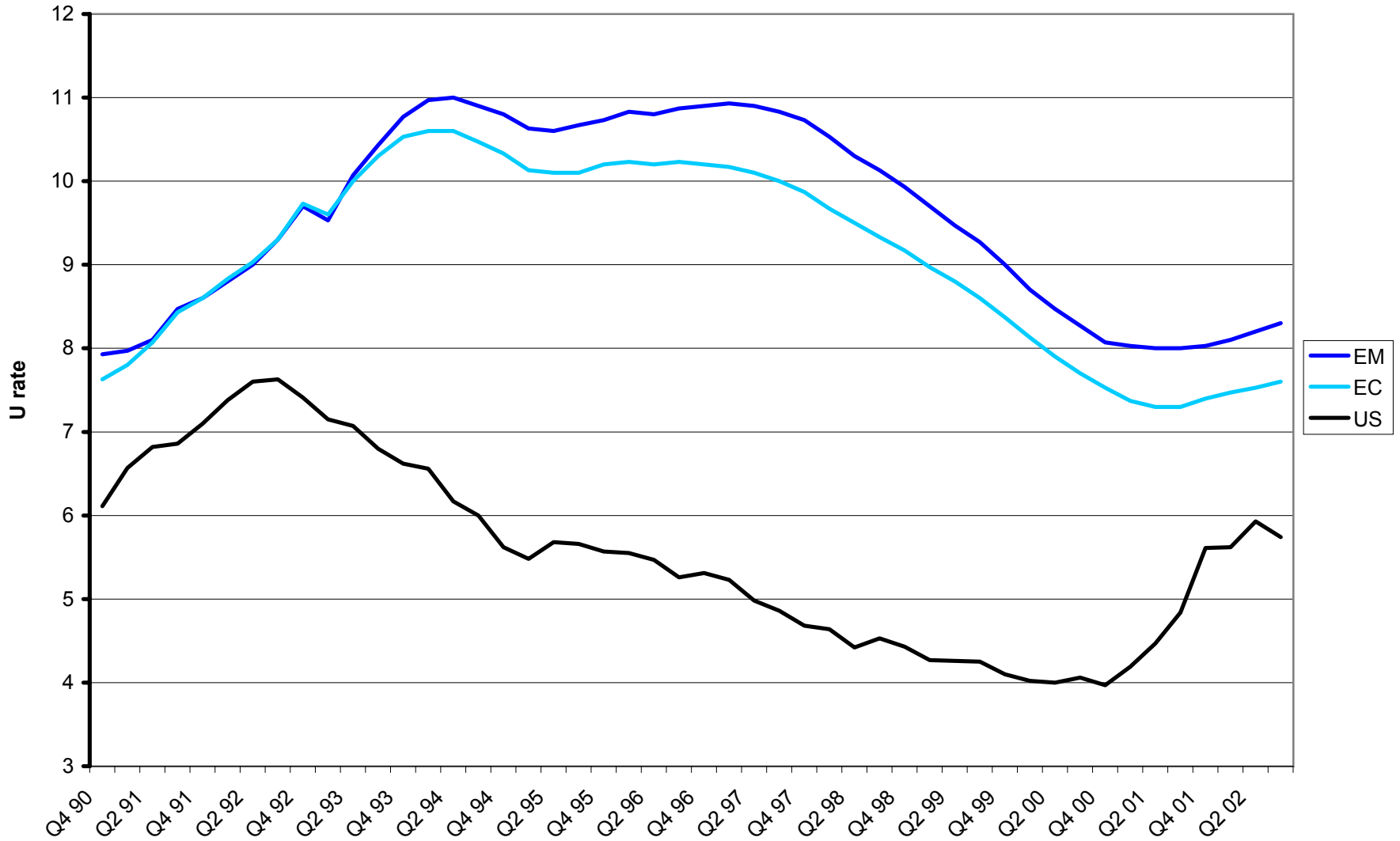
	1990	1997	2001	1997-2001
France	1657	1605	1532	-1.2%
Germany	1560	1513	1467	-0.8%
Italy	1674	1640	1606	-0.5%
US	1838	1849	1821	-0.4%

*Source: OECD Employment Outlook, July 2002. Last column: Annual growth rate, 1997-2002.*

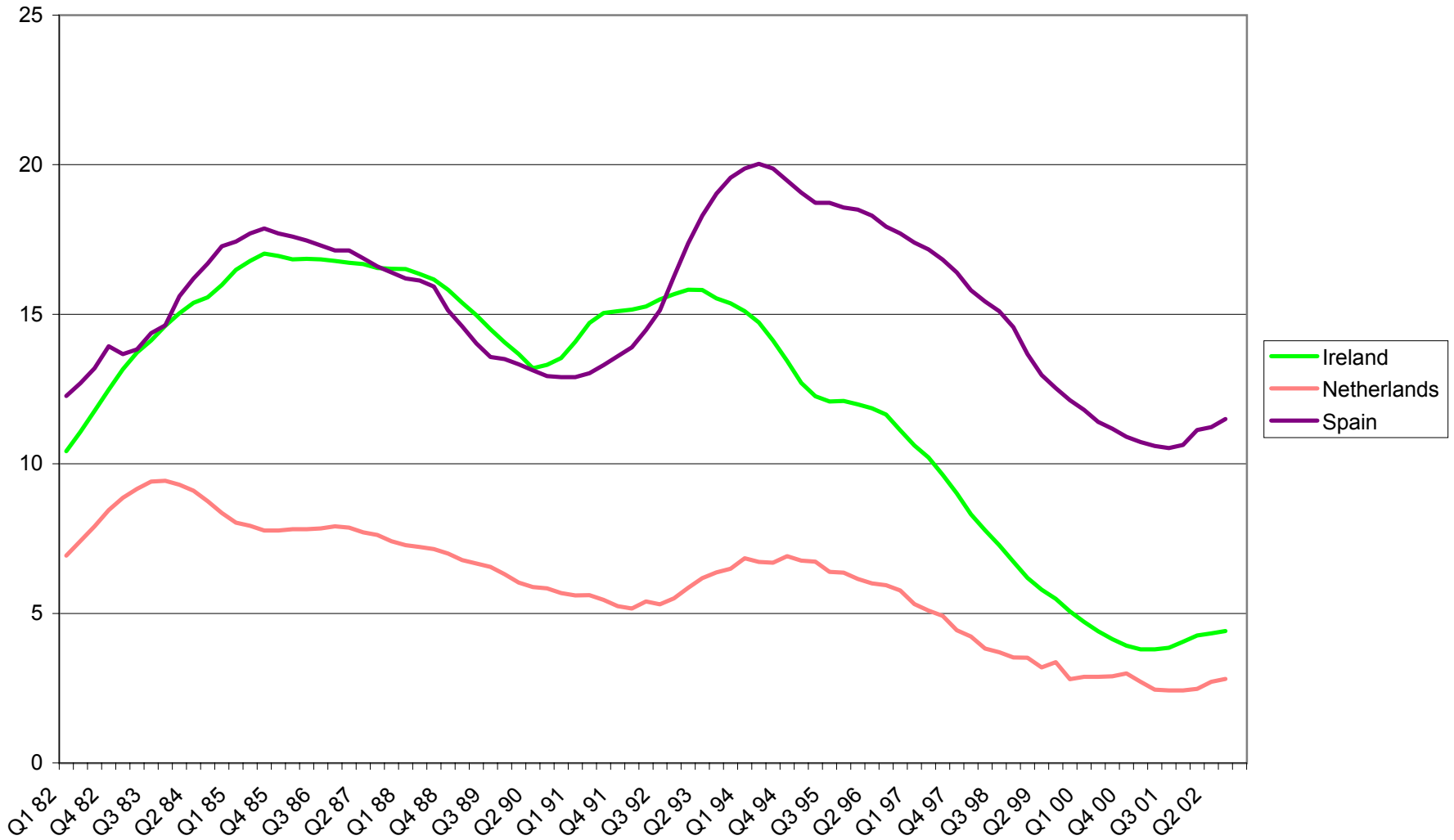
## Unemployment

- Unemployment has been the major story for a long time.  
The high current average level hides large differences across countries. (and within countries. South/North of Italy, Eastern/Western Germany)  
Why did unemployment go down where it did?
- Wage moderation. Unions. Rather than anything else.  
The evolution of labor shares. Another way of stating it: Rate of growth of compensation substantially lower than labor productivity since the mid 1980s.
- Current reforms. A clear movement towards “best business practice”. At different speeds:
  - Unemployment insurance.  
Shift towards tough love. Open ended, but conditional on training, and taking a job if available.  
  
Welfare to work in the UK  
The “Pare” in France.  
The Hartz commission reform in Germany
  - Negative income taxes. Prime a l’emploi in France.  
Will the relative minimum wage decrease?

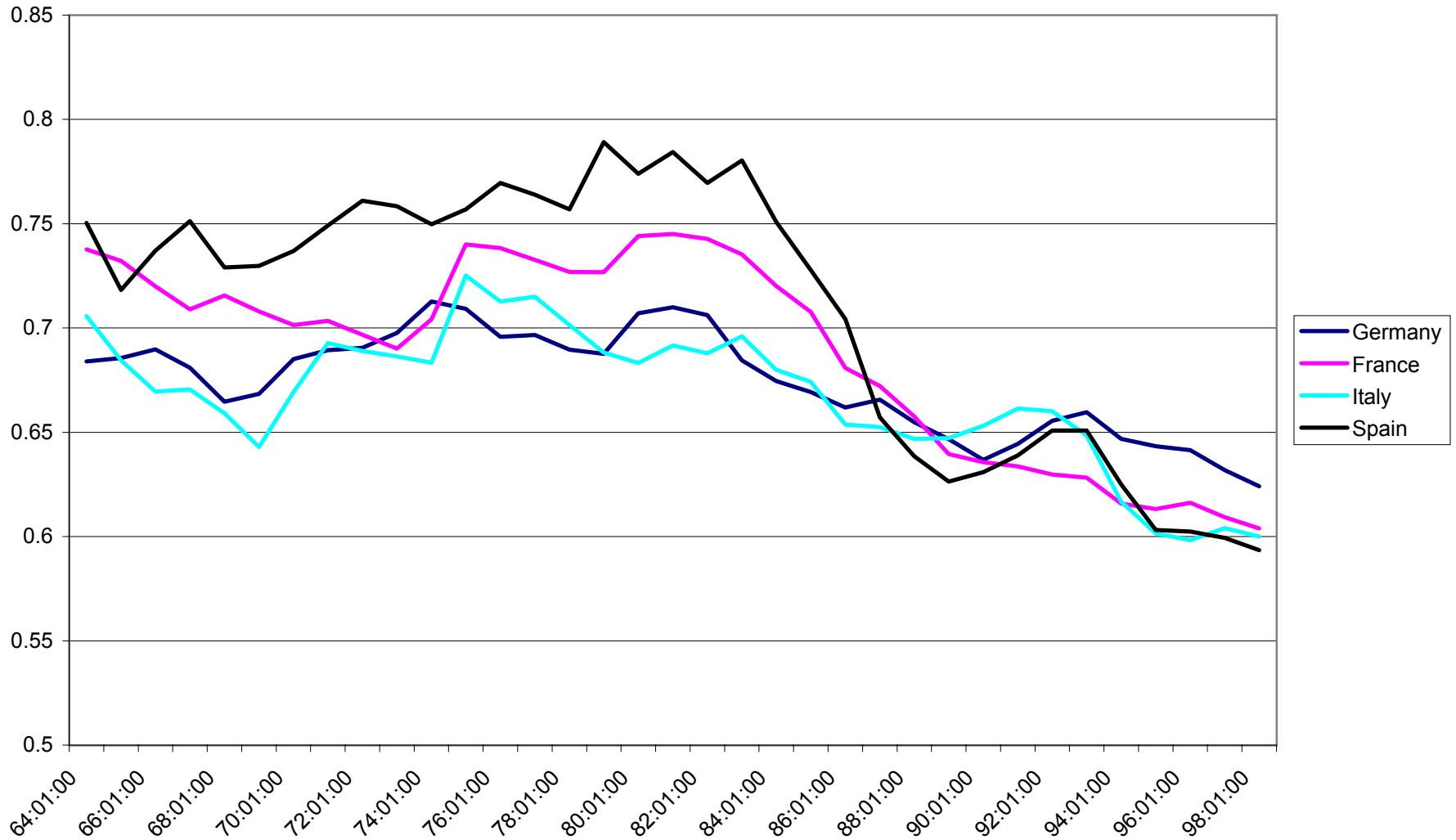
Unemployment rate, 1990-2002  
Euro, EU, and US



Unemployment rates, 1982-2002  
Ireland, Netherlands, Spain



Labor shares, 1970-1998  
Germany, France, Italy, Spain



– Employment protection.

Tougher politically. Progress, but only at the margin (fixed duration contracts), creating two classes of workers.

- Clouds on the horizon? Yes, and visible in Germany, and to some extent, in France.

The wage moderation is starting to grate the wrong way. If labor productivity does not pick up, likely to be an issue in the near term.

*Rate of growth of real wages per worker.*

	1995-2000	2001	2002	2003
Germany	0.2	-0.2	0.7	0.8
France	1.0	1.0	1.2	0.9
Italy	0.2	0.8	0.5	0.6
UK	2.1	4.9	2.6	3.4
US	1.7	0.9	2.0	2.3

*Source. European Union, Statistical Annex, country tables. Compensation deflated using the PCE deflator. Percent per year*

## THE SHORT RUN

### Current growth rates and forecasts

#### *Euro Area*

	2001	2002	2003	2004
GDP	1.5	0.8	1.8	2.7
Consumption	1.8	0.6	1.5	2.5
I resid	-2.7	-0.6	1.2	1.2
I non res	0.0	-2.7	1.3	4.3

*Source: OECD, November 2002. Rates of change in volume (year over year), in percent*

#### Lessons.

- Growth below potential: Unemployment in Euro expected to increase from 8% in 2001 to 8.5% in 2003.
- Investment, residential and non residential, as the weakest component.

France	2001	2002	2003	2004
GDP	1.8	1.0	1.9	2.9
Consumption	2.8	1.5	1.7	2.8
I resid	-0.8	-0.1	0.0	2.0
I non res	3.1	-0.2	0.3	4.1
Exports	1.5	0.2	5.2	7.5

Germany	2001	2002	2003	2004
GDP	0.6	0.4	1.5	2.5
Consumption	1.5	-0.5	1.1	2.2
I resid	<b>-7.1</b>	<b>-3.4</b>	<b>-0.1</b>	<b>-2.1</b>
I non res	<b>-4.5</b>	<b>-5.5</b>	0.9	4.1
Exports	5.0	1.8	5.3	8.0

UK	2001	2002	2003	2004
GDP	2.0	1.5	2.2	2.5
Consumption	4.1	3.6	2.9	2.5
I resid	-4.0	10.5	3.1	2.8
I non res	0.9	-9.3	1.6	3.3
Exports	1.2	-1.1	4.2	7.8

### How much of an investment overhang?

- The evidence from capacity utilization measures.

Clear difference between the US and the Euro zone

At the peak of the cycle: Historically high utilization in Euro Area, low in the US.

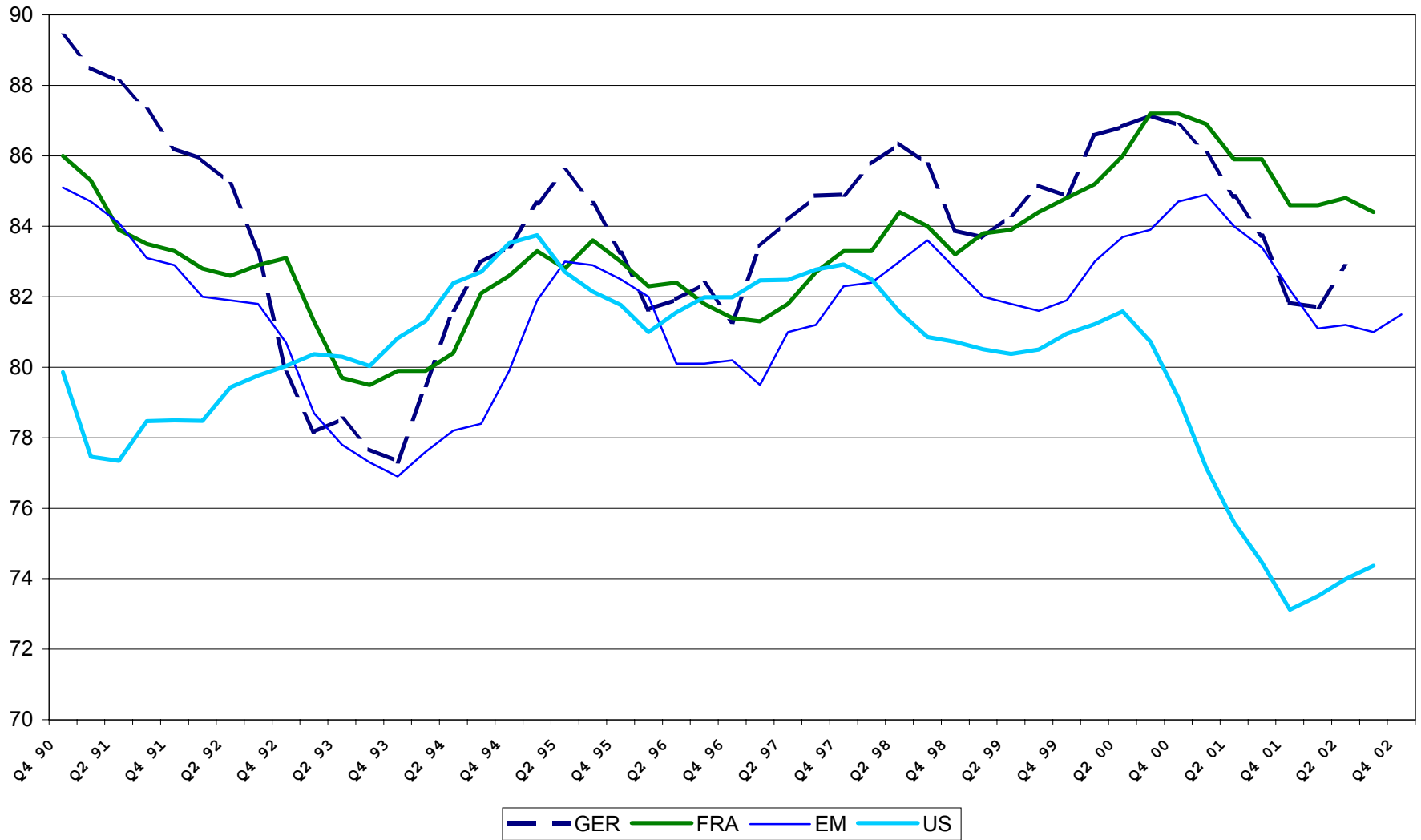
- Looking at it another way.

*Cumulated rates of growth, for non residential, fixed, investment, over the 1990s.*

Investment	1991-2000	1997-2000
France	16.2	24.9
Germany	18.3	18.2
US	78.4	42.8
Output	1991-2000	1997-2000
France	18.2	12.0
Germany	19.5	8.6
US	32.5	16.9

So, for the decade as a whole, no evidence of overinvestment in France or Germany.

**Capacity Utilization, 1990-2002**  
**Germany, France, Euro, United States**



What about 1997-2000? Back of the envelope: Consistent with an increase in the underlying growth rate of about 0.5% (Same capital output ratio requires an increase in the investment rate for some time).

Too aggregated, and evidence of overinvestment in some sectors. But overall, not a major overhang problem.

### **The stock market and consumption**

Larger decrease in Europe than in the US. Effect on consumption?

From estimates in a recent IMF paper: Marginal propensity to consume out of stock market wealth

- US. 0.04 (4 cents on the dollar)
- France. 0.014
- Germany 0.020

Plausible. The effect is likely to depend on:

- The distribution of stock holdings, directly and indirectly  
Percentage of adult population holding shares. 60% in the US, 10% in Germany, 8% in France. same source.
- Relative importance of defined benefit, defined contribution retirement systems.

So, not a major worry. But confidence is.

### **The lack of confidence**

A French poll

*How do you see the risk of the following events over the next few weeks?*

	Likely	Not	Do not know
General social unrest	79	20	1
Major military conflict with France involved	78	20	2
A large ecological catastrophe	76	22	2
A strong economic recession	76	21	3
A deep political crisis	59	38	3

*Source: Harris poll, Liberation, November 19, 2002*

Remember that France is still, for the time being, one of the fastest growing countries in Europe...

Can macro policy be blamed? Yes and no.

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**Monetary policy. Does the ECB know what it is doing?**

- The contrast between the federal funds rate and the ECB refinancing rate since 2000.

- Shouldn't the ECB have followed the Fed and decrease the rate much earlier.

Probably not. Unemployment was high, but mostly structural. No sign of decreasing inflation until recently.

- Is inflation targeting good policy?

Surely the fashion in central banking, but fundamentally a good idea.

The logic is simple:

- There is a natural level of output the economy can achieve without pressure on inflation.

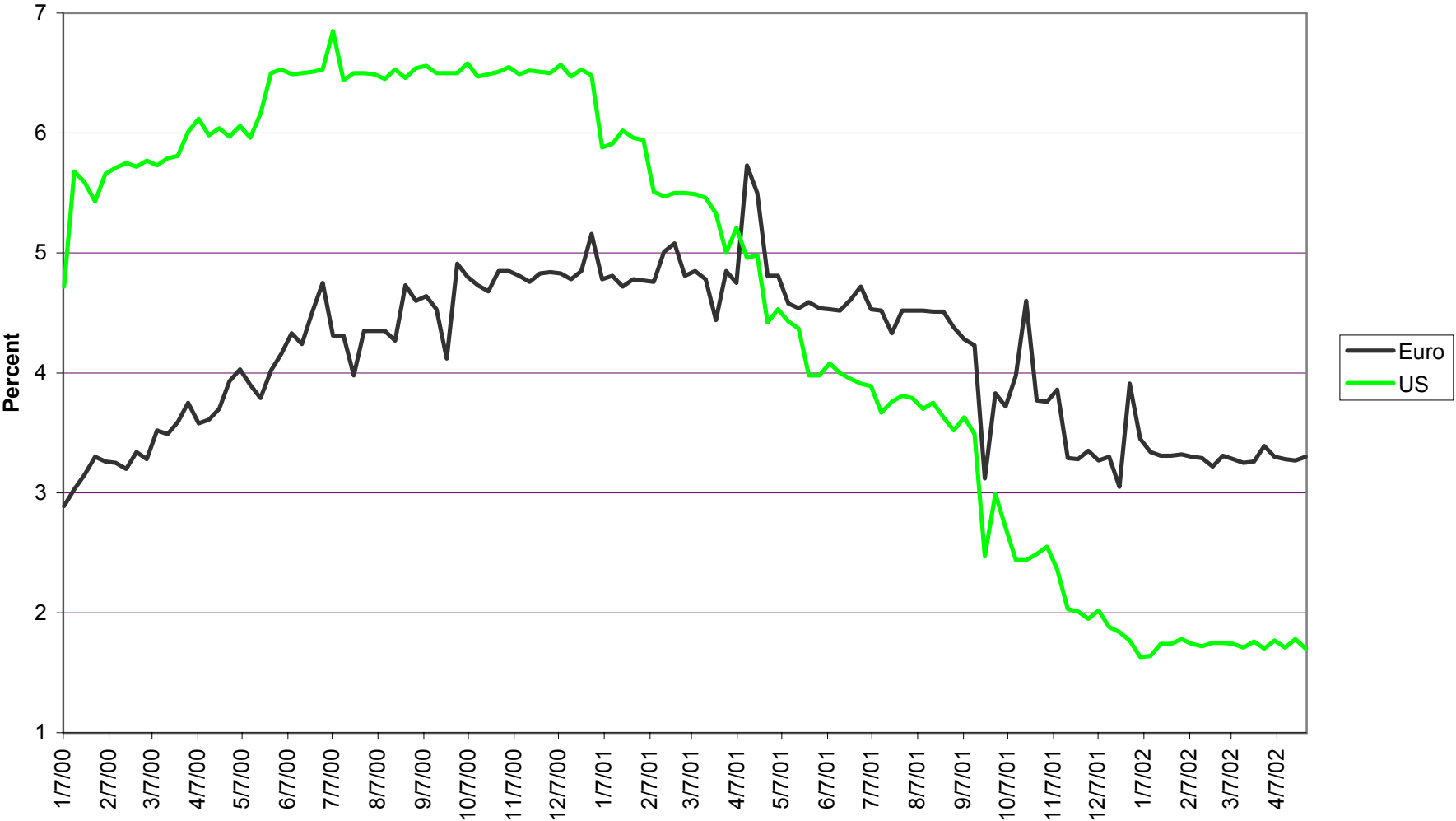
It depends on structural rate of unemployment, on productivity growth.

- If inflation goes up, it means output is above its natural level. Policy should be contractionary.

If inflation goes down, it means output is below its natural level. Policy should be expansionary.

- So inflation targeting is a way of committing to keeping output at its (changing) natural level.

Overnight interest rates, 2000-2002



- Problem: The commitment has to be clear, on both sides (if inflation is too high or too low)

The “too low” part is important. .

- With the right PR, it works. The example of the Bank of England.

The ECB has been much less convincing about the “too low” part.

No confidence of the public that policy will be expansionary if needed.

What about the future? The new team. Papademos, Trichet (?)

**Fiscal Policy: No action beyond the automatic stabilizers**

*General Budget Balance as proportion of GDP. Euro Area*

Euro Area	2001	2002	2003	2004
Budget position	-1.5	-2.2	-2.1	-1.8
Cyclically adjusted	-1.5	-1.6	-1.4	-1.4
United States				
Budget position	-0.5	-3.1	-3.0	-2.7
Cyclically adjusted	-0.3	-2.7	-2.5	-2.4

Enough? Probably not.

- The SGP. OK, if start from zero deficit. Not otherwise.
- Will the SGP be overhauled? Statements by Solbes. At the margin (increased focus on debt/GDP ratio, leeway for public investment). Not very useful for Germany.
- More perhaps later, but not in time for this slowdown.

### Will the Euro have to balance the US current account deficit?

*Current account balances (percent of GDP). OECD Forecasts, November 2002.*

	2002:1	2002:2	2003:1	2003:2	2004:1	2004:2
US	-4.7	-5.1	-5.1	-5.1	-5.2	-5.3
EU	0.8	0.9	0.9	0.9	1.1	1.3
Japan	3.1	3.4	3.6	4.0	4.2	4.3

- Who is financing the US current account deficit? The adding up puzzle. (Japan only half of US GDP)
- Can the capital flows keep coming? The Richard Cooper answer.

World (non US) saving about \$ 5 trillion

400 billion is 8% of world (non US) saving. Can be done

Issues:

- Gross or net saving? (If net saving is 20% of gross, then 40% of world non US saving)
- And requires no such movement from the US to the rest of the world.

- Another approach:
  - US financial wealth: Household assets minus liabilities about 16-20 trillion. US owned assets abroad, at market value, 7.1, or 35-45% of US wealth.
  - World financial wealth? Guess 1.5 times US: 25-30 trillion. Foreign owned US assets, 9.3, or 31-37% of foreign wealth.

If need to finance current account deficit of 400 billion, need to further increase share of US assets in foreign portfolio by 1.5% a year.

This is what we saw in the 1990s. (Share of US assets in portfolios of major equity portfolio managers increased roughly in line with the world portfolio, from 35% in 1995 to 57% in 2001).

Can it be sustained for long? Probably not.

- Which currency will need to appreciate? Not many candidates. The Euro.  
By how much? Estimates: A lot.
- What macroeconomic policy reaction will be needed? Can Europe deliver?