A macroeconomic survey of Europe

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1. Common forces at play in the US and Europe.

- Oil prices down–not as much as hoped for before the war.

  Figure: The price of oil (Brent crude), 1998-1 to 2003-5

  (A useful number: 10% increase in price leads to .25% decrease in growth, and .5% increase in inflation).

- Uncertainty down, risk appetite up.

  Figure: Baa spread over the 10 year T-bond, 1998:1 2003:5

- The winding down of the investment overhang.
  Capacity utilization in the US. Still low, but important to separate high tech from the rest. Interpretation: Outside of high tech: Overhang, or recession?

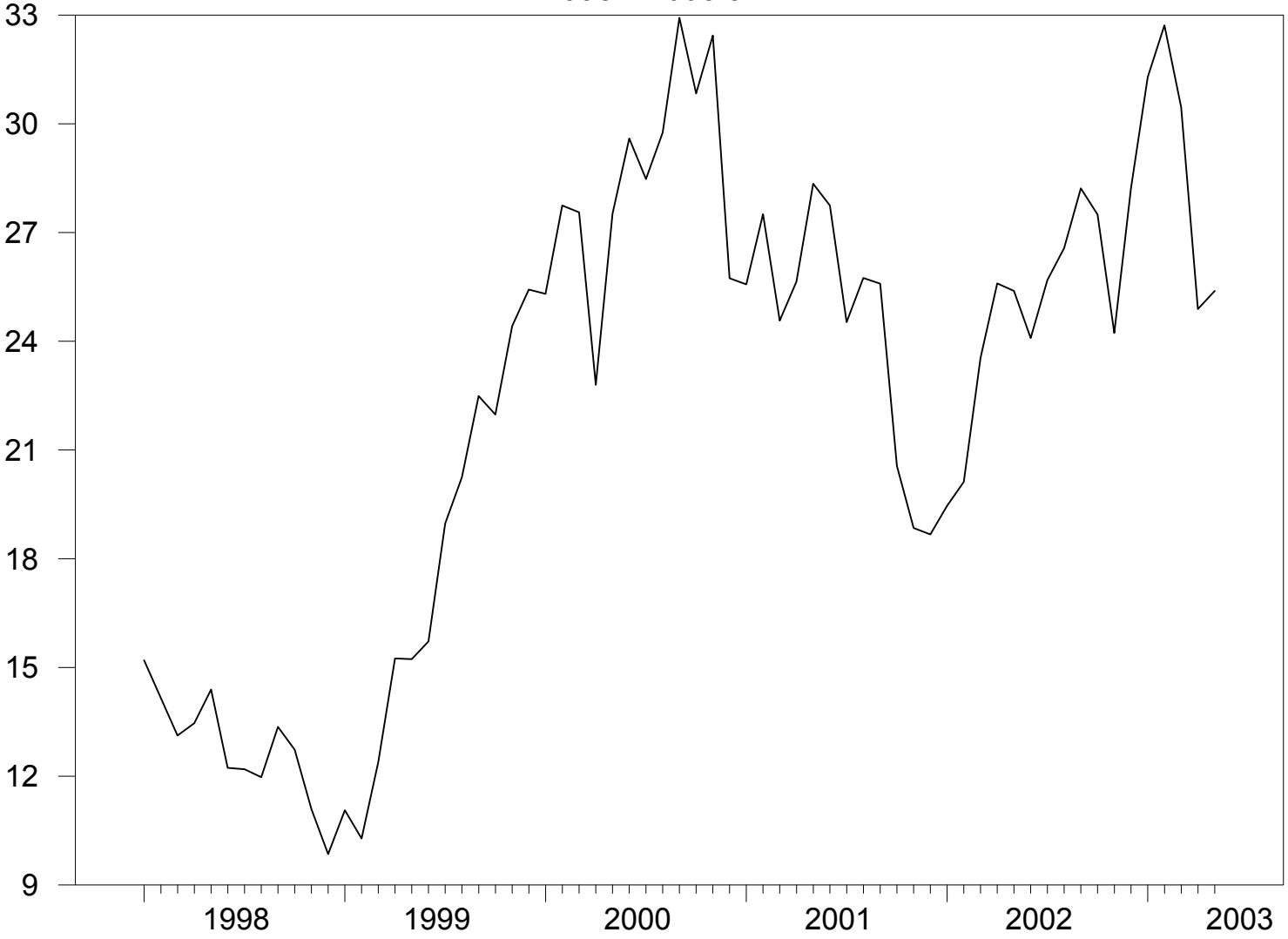
  Figure: Cap utilization, US, high tech and non high tech.

  Cap utilization in Europe. (Have less of an IT sector, had less of an IT boom). No evidence of overhang.

  Figure: Capacity utilization, France, Germany, Spain, and Italy.

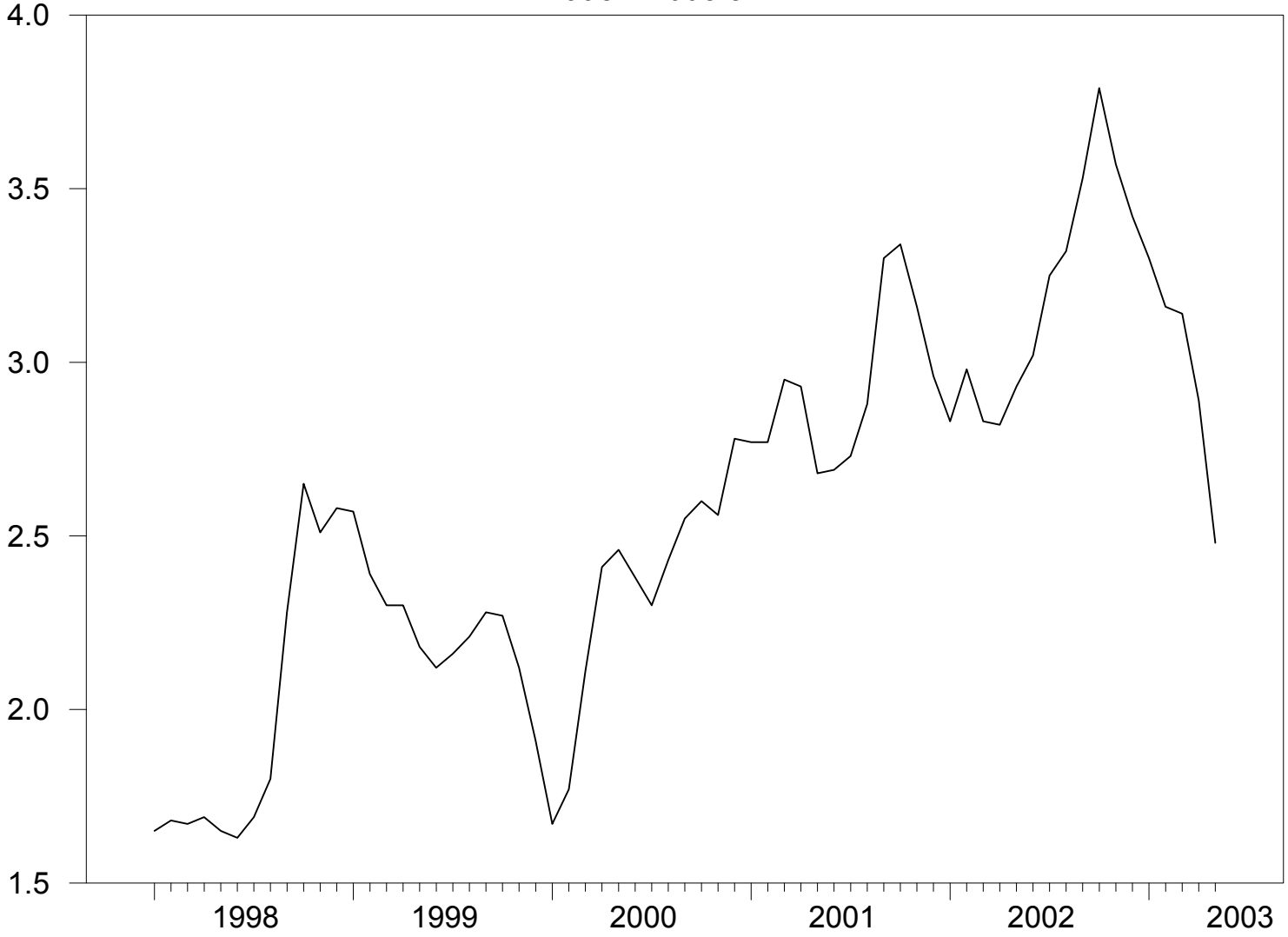
Price of oil (Brent crude)

1998:1 2003:5



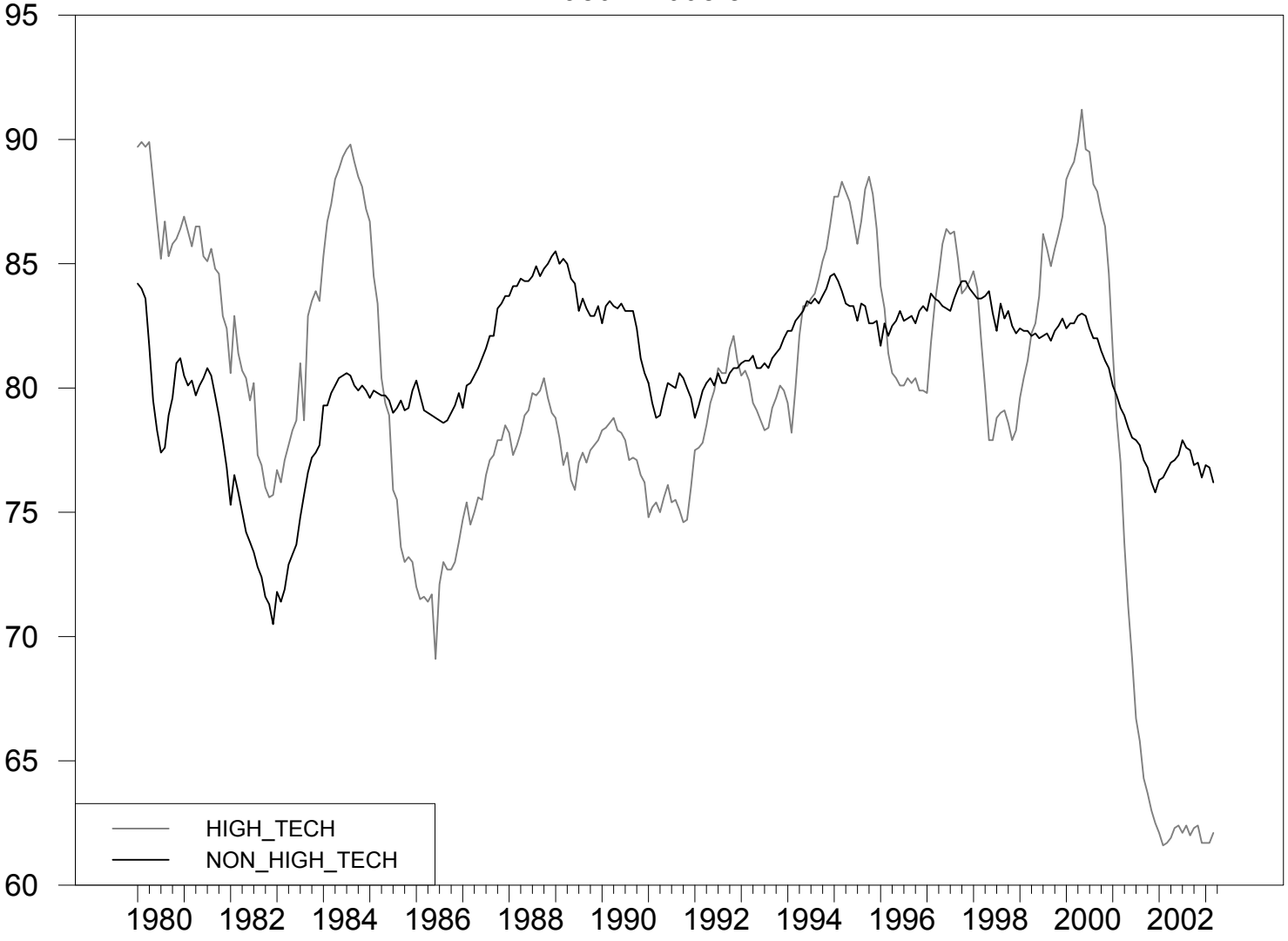
Baa spread over 10-year T-bond

1998:1 2003:5



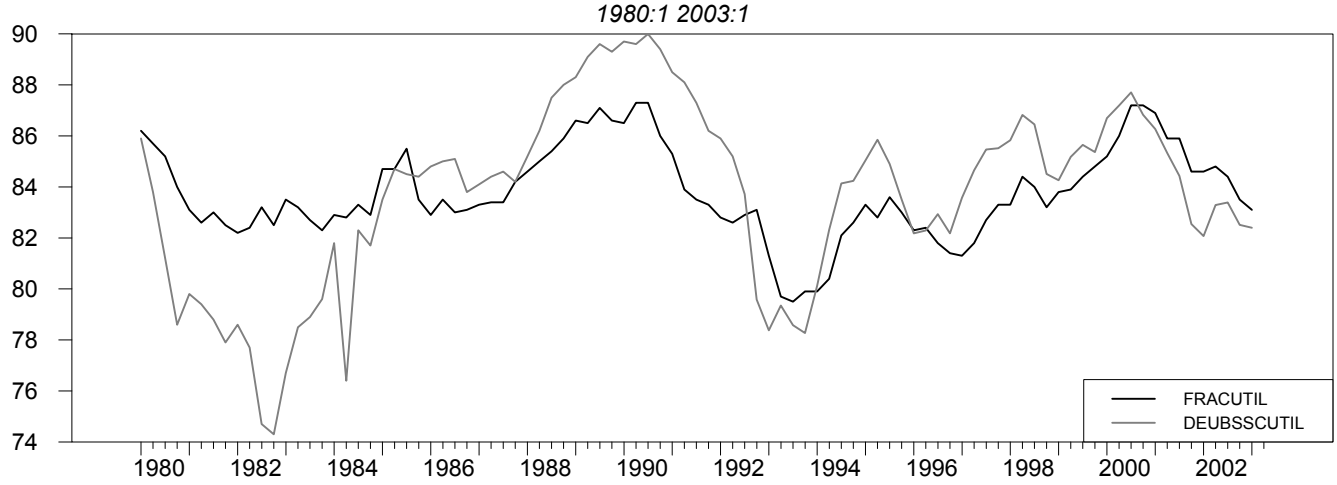
Capacity utilization, US: High Tech, and Non High Tech

1980:1 2003:5



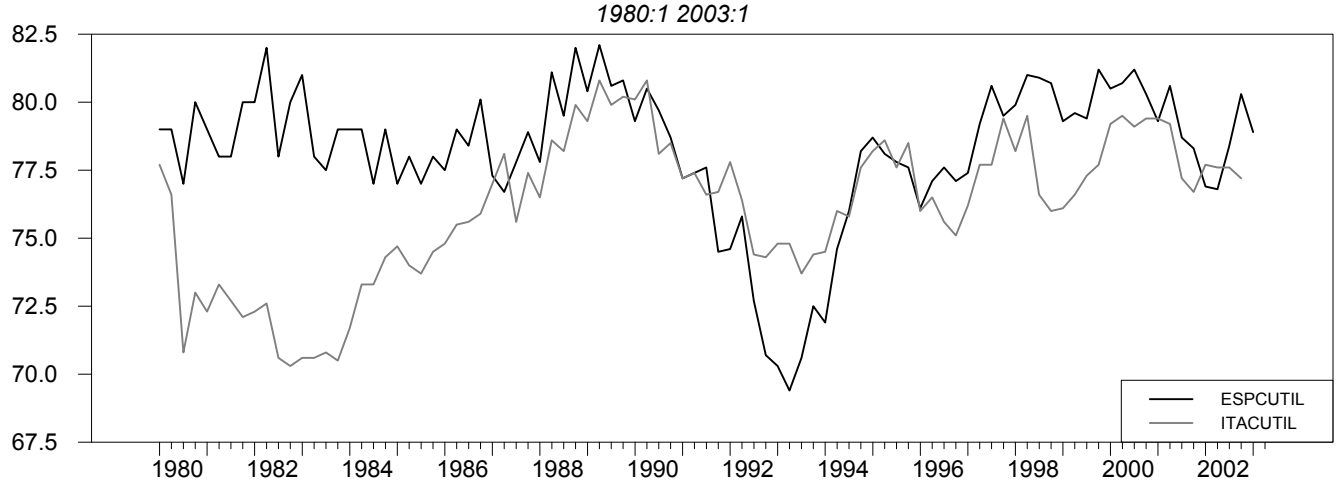
Capacity utilization, France, Germany

1980:1 2003:1



Capacity utilization, Spain, Italy

1980:1 2003:1



2. Divergent forces: I. Sharply different macro policies.

- US: Strong monetary expansion/ then major fiscal expansion. Spending and revenues.
- Europe: Fiscally neutral/Monetary careful

The stance of fiscal policy in the US and the Euro area

	2000	2001	2002	2003	2004
Gvt balance					
US	1.4	-0.5	-3.4	-4.6	-4.2
Euro	0.1	-1.6	-2.3	-2.5	-2.4
Germany	-1.9	-2.8	-3.0	-2.5	-2.2
France	-1.9	-2.0	-3.1	-3.0	-2.9
UK	1.3	0.9	-0.8	-1.2	-1.5
Cyc adj balance					
US	**0.9**	-0.2	-2.9	**-4.0**	-3.9
Euro	**-1.5**	-1.8	-1.9	**-1.6**	-1.6

Source: OECD Eco Outlook. June 2003

3. Divergent forces. II. The dollar depreciation/the Euro appreciation.

- The long predicted dollar depreciation.
- Unlikely to be reversed any time soon, for reasons discussed last time. (small role of low short US rates, of low US growth. The current account is the issue)

  (Inflows: shift from shares (194 b$ in 2000 to 54 b$ in 2002) to govt securities (50 in 2000 to 225 in 2002)
- The great irony. The adjustment to the current account problem of the US is good news for the US, bad news for Europe. (Japan will be on the side lines).
- Substantial macro effects:

  Expansion and inflation in the US.

  Contraction and potential deflation in Europe.

  (A useful number. A 10% Euro appreciation reduces Euro GDP by 0.6%, and increases US GDP by 0.3%)

So:

- An expansion coming in the US. (I disagree with the wisdom embodied in the current term structure).
- Higher risks in Europe.

Next:

- A look at the changes in the forecasts
- The risks of deflation in Europe.
- The likely path of fiscal and monetary policy.

4. Looking at changes in the forecasts for Europe over the last six months.

Looking at OECD forecasts for 2002-2004, as of December 2002 and June 2003, for Euro, and France, Germany, UK.

Euro Area growth forecasts

	2002	2003	2004
GDP	0.9 (0.8)	1.0 (1.8)	2.4 (2.7)
Consumption	0.7 (0.6)	1.2 (1.5)	2.1 (2.5)
I resid	-1.5 (-0.6)	0.8 (1.2)	1.0 (1.2)
I non res	-2.2 (-2.7)	**-0.6 (1.3)**	3.8 (4.3)

Source OECD. June 2003 forecasts. December 2002 forecasts in parentheses.

The main culprit:

Non residential investment? Still overhang? Probably not. Waiting for uncertainty to decrease?

France.

	2002	2003	2004
GDP	1.2 (1.0)	1.2 (1.9)	2.6 (2.9)
Consumption	1.8 (1.5)	1.6 (1.7)	2.2 (2.8)
I resid	0.2 (-0.1)	-0.1 (0.0)	1.8 (2.0)
I non res	-1.1 (-0.2)	**-2.0 (0.3)**	2.8 (4.1)
Exports	1.5 (0.2)	2.6 (5.2)	5.2 (7.5)

Germany.

	2002	2003	2004
GDP	0.2 (0.4)	0.3 (1.5)	1.7 (2.5)
Consumption	1.5 (-0.5)	0.8 (1.1)	0.4 (2.2)
I resid	-5.9 (-3.4)	-0.1 (-0.1)	-1.4 (-2.1)
I non res	-7.3 (-5.5)	**-1.1 (0.9)**	4.2 (4.1)
Exports	2.6 (1.8)	3.2 (5.3)	6.0 (8.0)

UK

	2002	2003	2004
GDP	1.8 (1.5)	2.1 (2.2)	2.6 (2.5)
Consumption	3.8 (3.6)	2.2 (2.9)	2.3 (2.5)
I resid	12.2 (10.5)	3.2 (3.1)	2.1 (2.8)
I non res	-8.0 (-9.3)	0.5 (1.6)	6.4 (3.3)
Exports	-1.0(-1.1)	2.1 (4.2)	8.4 (7.8)

5. The risk of deflation in Europe.

Why is deflation so bad?

- By itself, deflation is fine. But it creates two serious problems:
- A floor on real interest rates.
- (If unanticipated), transfers of wealth from creditors to debtors if nominal claims.
- So, if the economy is doing poorly to start, then vicious cycle (a few months of deflation in the US would be irrelevant for example)

Old versus modern forms of deflation

- Great Depression: Sharp falls in the price level, very high real rates
- Japan. Slow fall (more wage/price inertia). High, but not very high real rates.

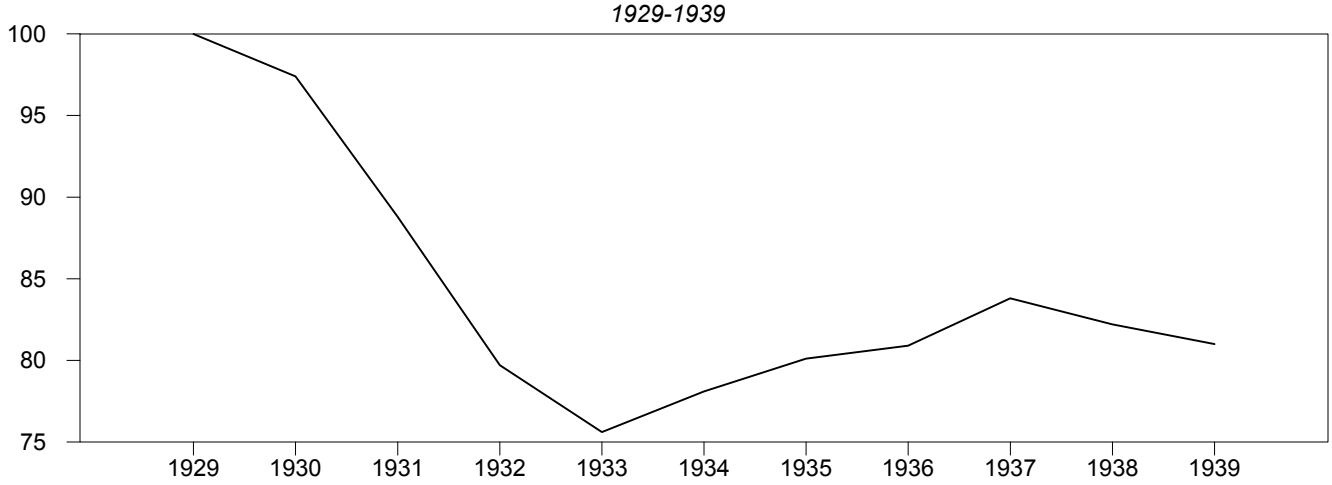
Figures. Price levels and Real interest rates (nominal minus last year's inflation) during Great Depression and Japanese slump

The dangers of the Euro appreciation for Europe: Recession and deflation:

10% appreciation, about 0.6% less growth, and 1% less inflation (through both direct effect and higher unemployment).

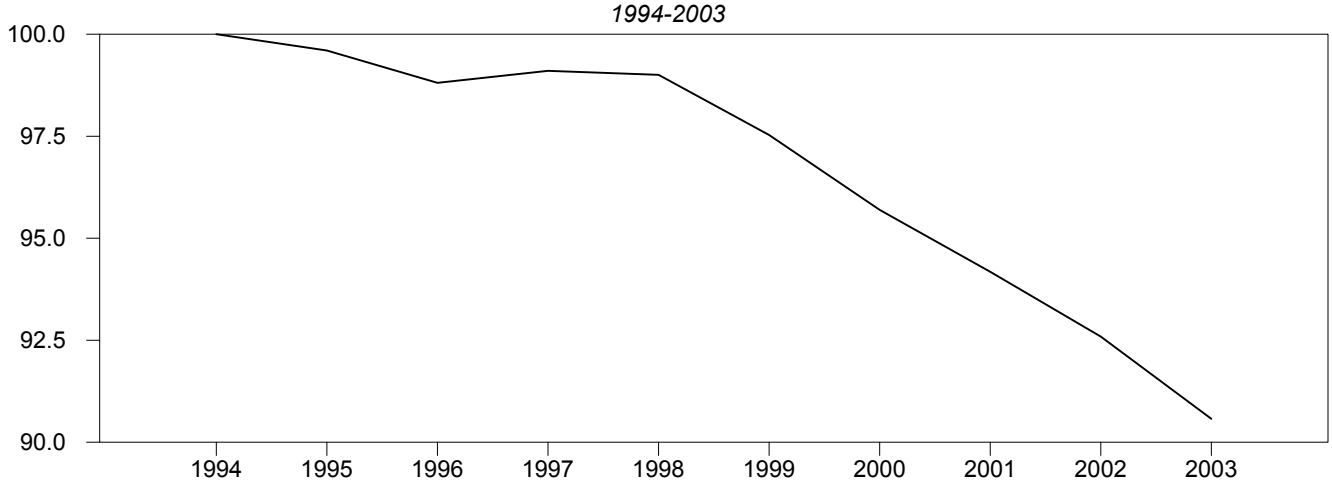
US Price level (CPI)

1929-1939



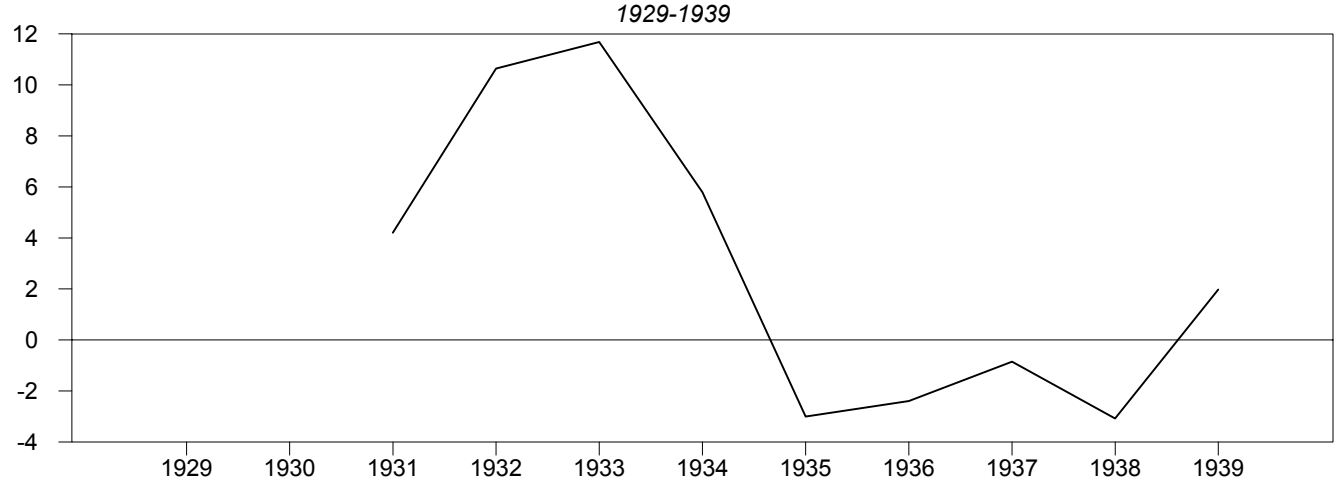
Japanese Price level (GDP deflator)

1994-2003



US real interest rate

1929-1939



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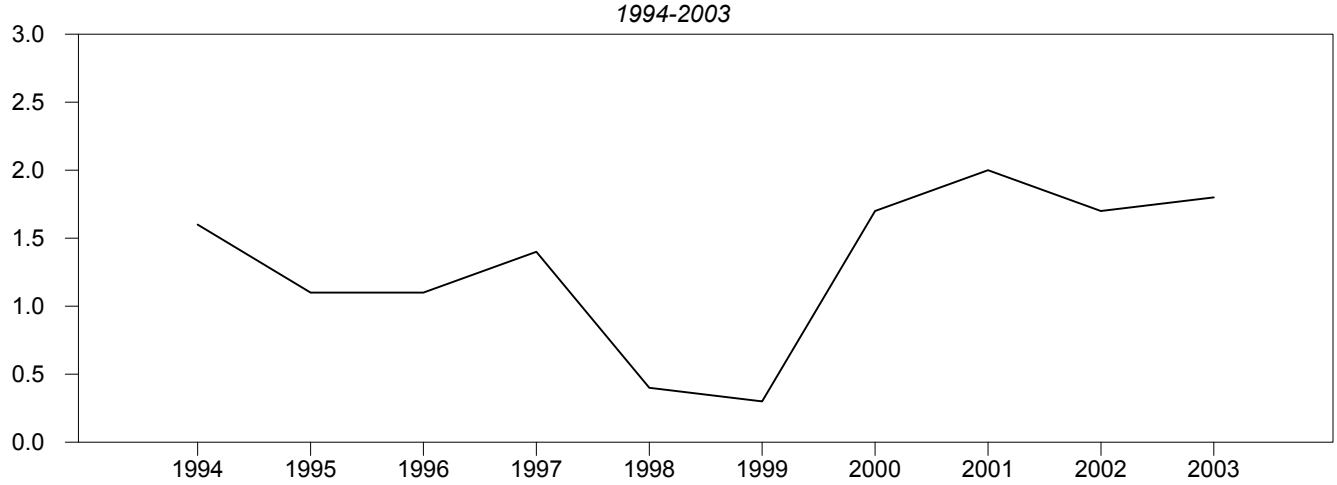

6. Will macro policy be used if and when needed?

The ECB will do what it needs to, if a bit late. Still worried about credibility (and, incorrectly, "keeping its powder dry"). But not much margin.

The action has to come from fiscal policy.

- The constraints of the SGP. (60% debt, 3% deficit).
- "Excessive deficit procedure" activated for Germany, Portugal, and France.
- What would be needed?

  Higher deficits in the short run, with reforms improving the long run outlook (more on this below).

  Exclude net investment from the deficit (have separate current and capital accounts.)
- Will it happen? Not in time. EU commission diddling at the margin. (The last recommendations from Ecofin: exclude transnational investment from limit.)

What if the reaction comes too late? Lessons from Japan. Very hard to get out.

- Expansionary monetary policy even at zero interest rate, to affect inflation expectations and decrease real interest rates.
- Depreciation: Stand ready to exchange the euro at 80 centimes to the dollar? Option open to Japan, not to Europe: Too large.

6. The medium run. Current reforms.

- Action on two main fronts: Pension reforms and labor market reforms. First are essential for fiscal credibility, second for sustained growth.(I shall focus on pension reforms here).
- (Product and financial market reforms continue in the background, largely from Brussels)

Basic facts on the ageing of population. The demographic evolutions.

	Fertility rate (2000)	Immigration rate (2000)	65+/20-64		80+/65+	
			2000	2050	2000	2050
France	1.73	0.08	27	50	22	38
Germany	1.40	0.36	25	53	22	39
Italy	1.22	0.09	27	66	22	39
Spain	1.19	0.08	27	65	22	33
UK	1.72	0.15	28	45	25	37
USA	2.05	0.33	22	38	26	36

Source: OECD Economic Outlook, 2001-1. Fertility rate: Children per woman. Immigration rate: percent of pop. Next columns: Ratios of individuals 65 and older to individuals between 20 and 64. Ratios of individuals 80 and older to individuals 65 and older

Note the difference in fertility rates

Note the difference in the old age dependency ratios between Continental Europe and the UK/US.

The budgetary implications. Increase in old age pension expenditures, as a percentage of GDP.

	2000	2050	Change	due to demographics	due to policies
France	12.1	15.9	3.8	7.1	-3.2
Germany	11.8	16.8	5.0	5.7	-0.7
Italy	14.2	13.4	-0.3	6.9	-7.2
Spain	9.4	17.4	8.0	6.0	2.0
UK	4.3	3.6	-0.7	1.6	-2.4
USA	4.4	6.2	1.8	2.3	-0.5

Source: Dang et al. 2001. The projections take into account legislated changes for the future, as of 2001.

Note the similarity of changes due to demographics in Continental Europe, and the contrast with the UK/US.

Note the different policy responses. The strong policy response in Italy, the weaker responses in France, Germany, and Spain.

The set of current pension reforms: Largely common trends:

- Keep pay as you go. Solve the financing problem primarily by increasing the retirement age. (In general, 2 years more goes most of the way)
- Increase flexibility for early or late retirement.
- And encourage development for additional funded schemes.

A partial country–by–country survey:

- France is the laggard. No substantial reform until now.

  This reform, introduced in May 2003 solves the financing problem through an increase in retirement age:

  Aligns numbers of years of contribution for private and public sector (from 37.5 years to 40 years in public).

  Political stumbling block until now. (Some regimes (SNCF for example) left out)

  Then, slowly increase number of years to 41 in 2012, 42 in 2020.

  More flexibility to retire earlier or later.

- Germany. On the 2010 Schröder SPD agenda.
  Increase in retirement age. 65 to 67 after 2011

- UK.
  "Green paper," introduced at the end of 1992 and now under discussion.
  Allows for work beyond 65, ends compulsory retirement

- Italy.
  Ahead of most other countries. A series of reforms by Amato (1992), Dini (1994), Prodi (1997), now Berlusconi again.
  This time: Intent is to limit early retirements for those who started contributed early.

- Austria.
  Report in december 2002. Tripartite talks May 2003.

  Cutbacks in invalidity pensions reduction of early retirement program

  Benefits computed over whole work life, not the last 15 or 18 years Reduction in the pension rate from 80 to 68

7. How to interpret the strikes, the tensions, the political evolutions.

Strikes in France, in Austria, in Italy earlier. Opposition to Schröder within the SPD.

Two keys to interpreting events:

- Privatization, product and financial market reforms are (stealthily) driving the rest. Privatizations decided at the national level. The rest largely in Brussels.

  Increased competition, smaller rents. Steady pressure on labor market institutions. Will continue.

- The realignment of the right and of the left in Continental Europe.

  Traditionally, left Marxist, right more nationalist than pro-market.

  Right has endorsed markets, and is increasingly defined this way.

  Left faces a difficult choice: in effect, Marx versus Blair:

  Keep traditional positions. Reinforce constituency on the left, but hard time when in power.

  Accept market economy, and work within it. Lose much of its constituency on the left, but cover more of the center.

Seeing this in the positions of leaders, parties, and unions in a number of European countries:

Schröder has decided to endorse, at least for the time being. (challenged within the SPD)

The Socialists in France have decided to return to traditional positions, at least for the time being.

In France, one union, CFDT has decided to accept and work within market rules. The communist union, CGT, has not. The strikes are largely to mobilize the troops.

The current strikes have a lot to do with this positioning game. The tensions, and the flows largely to be there for some time.

(Among the issues not discussed:

Labor costs, and other woes, in Germany.

The UK and the Euro.)