# Short run prospects in Europe and the United States

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Strong hope in Europe that the US expansion is gaining strength, and will take Europe out of its slump.

- Half right, half wrong:
- Half right: The US expansion is gaining strength.
- Half wrong: Not at all obvious that this will lift Europe out of its slump.

Let me:

- Look at prospects in the US
- Look at prospects in Europe

## 1. The United States

All the stars are aligned:

- The capital overhang is largely digested. And productivity growth continues to be surprisingly high.
- Consumers have been the driver of growth so far, and remain confident.
- First monetary policy, and now fiscal policy, have been at full throttle. The Bush Deficits: Dangerous for later, good for growth now.
- The dollar depreciation reflects the current account deficit position of the US. It will not go away.

## 1.1. The end of the capital overhang, and high productivity growth

What triggered the US recession was excessive capital accumulation, especially but not only IT capital.

Outside the IT producing sector, it is largely gone, and investment is picking up.

The signs:

- Capacity utilization still low. But important to separate IT and non IT sector. (Figure)
- After three dismal years, investment in non IT sector picking up.

And the high productivity growth of the second half of the 1990s is continuing.

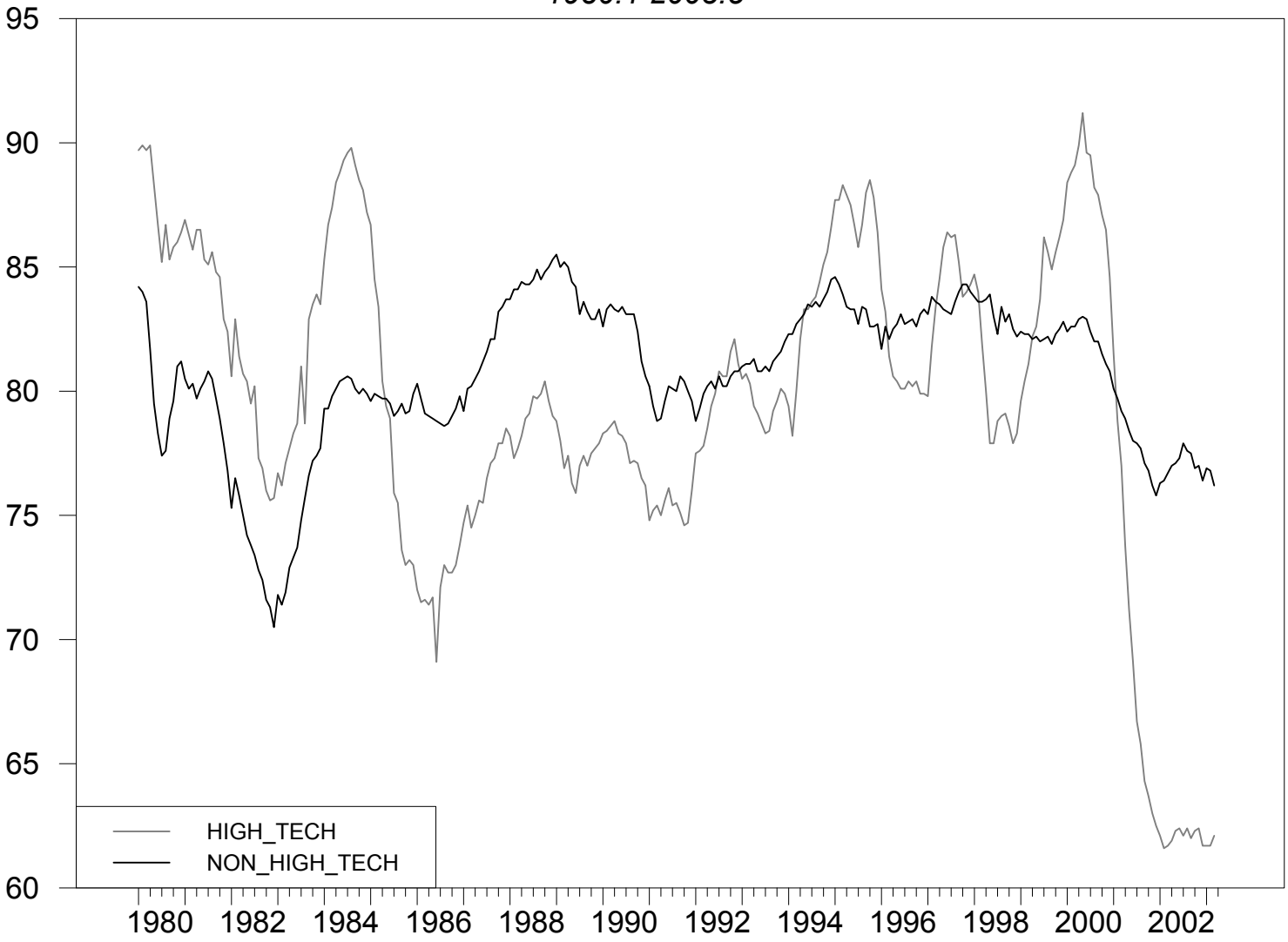
The "jobless" or "job-loss" recovery: Bad news for employment in the short run, but very good news for future growth:

**Growth of output, productivity, and hours. 2001-2003**

| | 2001 | 2002 | 2003-Q1 | 2003-Q2 |
|---|---|---|---|---|
| Business sector: | | | | |
| Output | -0.2 | 2.7 | 1.4 | 3.2 |
| Productivity | 2.0 | 5.3 | 2.7 | 6.1 |
| Hours worked | -2.1 | -2.5 | -1.2 | -2.7 |

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

*1980:1 2003:5*



### 1.2. The resilience of consumers

They have been driving the expansion so far.

Consumer confidence index has recovered from Irak war, now at trend value.

Stock market has done well this year.

### Growth and contributions of different GDP components

| | growth rate 2002 | growth rate 2003 | contribution 2002 | contribution 2003 |
|---|---|---|---|---|
| GDP | 2.4 | 1.9 | 2.4 | **1.9** |
| Consumption | 3.1 | 2.6 | 2.2 | **1.9** |
| Fixed inv | -3.1 | 3.3 | 0.2 | 0.4 |
| Exports | -1.6 | -2.2 | -0.2 | -0.2 |
| Imports | 3.7 | 1.5 | -0.5 | -0.2 |
| Gvt spending | 4.4 | 4.0 | 0.8 | 0.7 |

*2003: First half.*

Reasons to worry? Perhaps.

High personal debt? If combined with sharply higher interest rates, may create problems. But at least a few years away.

## 1.3. Policy at full throttle

- Monetary policy was aggressive early on (as it should have been)
  The behavior of the federal funds rate. Not much room left, but it will not be needed.

- Since 2002, fiscal policy has been reckless, both on the spending side and the tax side.
  Difficult to know exactly how bad it is, as numbers change (increase) nearly every week.

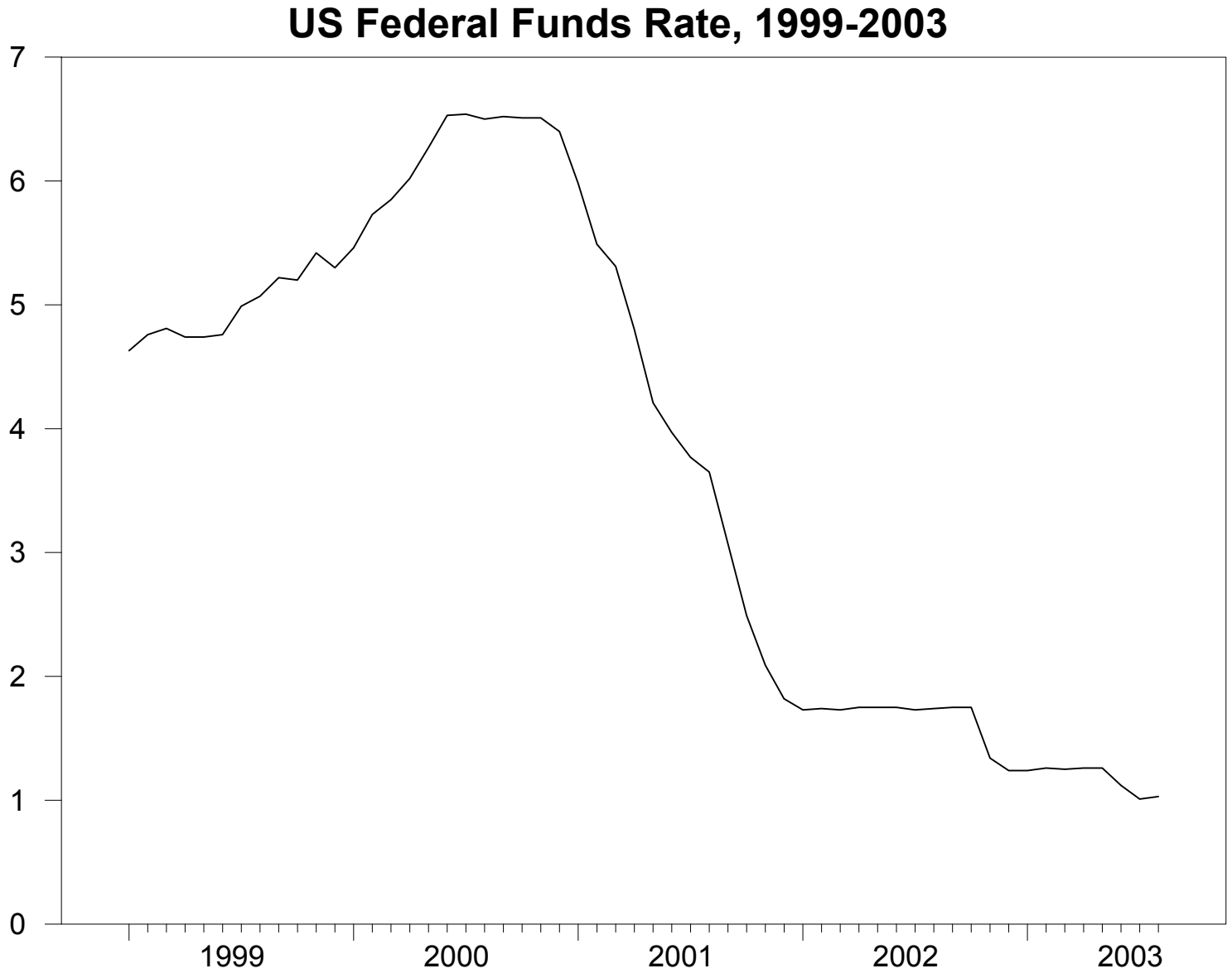
  **The stance of fiscal policy in the US**

| | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|
| Surplus/GDP | 1.4 | -0.5 | -3.4 | -4.6 |
| Cycle adjusted | **0.9** | -0.2 | -2.9 | **-4.0** |

*Source: OECD Eco Outlook. June 2003*

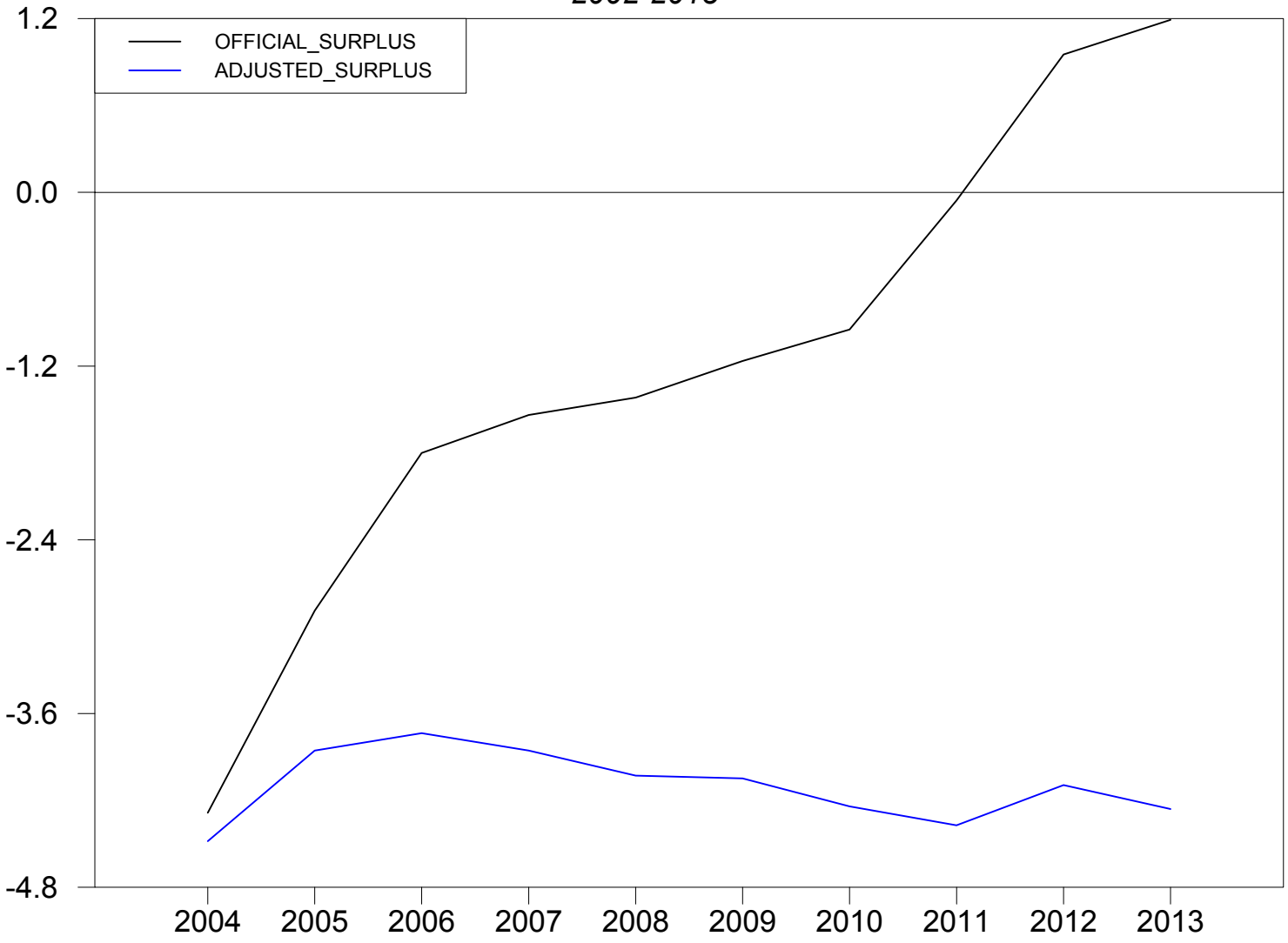
The future looks like more of the same:
Figure (from the Congressional Budget Office, August 2003).
Two lines:
First, deficits according to official projections.
Second, deficits according to more realistic (but still conservative) projections: The deficits are not going away.

Bad for the long run, but good for the current expansion.


US Federal Funds Rate, 1999-2003
7
6
5
4
3
2
1
0
1999
2000
2001
2002
2003

# Deficit projections, CBO

*2002-2013*



### 1.4. The dollar depreciation

Since November 2000, the dollar has depreciated by close to 30% vis a vis the Euro. Why?

The US current account deficit. running at 4-5% of GDP. Large percentage, US is a very large country. $500 billion dollars.

- Can the US continue to finance its current account deficit? Not easily:
- Would require a steady increase in the proportion of dollar assets in foreign portfolios; about 2% a year. This was the case in the 1990s. Unlikely to continue.
- It is the decrease in flows which triggered the depreciation of the last 3 years. Shift from stocks to bonds; recently increase in central bond holdings.

When and how much?

- Expansion and higher interest rates can lead to a reversal. What we have just seen in the last two months.
- Higher productivity growth, higher returns to capital in the US, may also give another reprieve. (Main source of uncertainty at this point)

But eventually, the current account deficit has to be reduced, through a depreciation.

Against whom, by how much, when?

- Yen out, UK Pound irrelevant, China not willing. Leaves the Euro.
- What does this imply? A potentially very large depreciation of the dollar vis a vis the euro. (1 euro=1.5$?)
- When? Nobody knows. Rough waters in the short run.

The great irony. The adjustment to the current account problem of the US is good news for the US, bad news for Europe.

## 2. Europe.

### The current forecasts

From bad to worse:

**Euro Area growth forecasts. OECD June 2003 forecasts (and in parentheses, OECD December 2002)**

| | 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) |

- Note the revisions from 2002 forecasts of 2003. all down
- Already too optimistic. September 2003 OECD interim forecast for 2003: 0.5%

**The September 2003 Economist's poll of forecasters.**

| | 2003 | 2004 |
|---|---|---|
| European Union | 0.3/0.8 | 1.2/2.6 |
| Germany | -0.3/0.3 | 0.7/2.1 |
| France | 0.4/1.1 | 1.3/3.1 |
| Italy | 0.3/0.8 | 0.8/2.5 |

Going through the same list as the US, no reason to be very optimistic:

- Monetary and fiscal policy in a straight jacket.
- Less of an investment boom, and so less of an overhang. But lower productivity growth as well.
- Pessimistic consumers.
- The dollar depreciation is a Euro appreciation. A scary scenario: Deflation?

What about the "locomotive" effects of the US expansion? By themselves, not enough to pull Europe.

## 2.1 Looking beyond the short run: Many reasons for (reasonable) optimism

No justification for a gloom and doom view of Europe:

- Productivity levels often equal or higher than the US.
  GDP per hour, 2002: If US=100, France=105, Italy=104.
- Same productivity growth in EU and the US in the 1990s.
- Unemployment rates. Many success stories. Netherlands. Northern Italy...

Many structural changes in Europe.

- Goods and financial market deregulation, increased competition.
  Clear effects on firms' competitiveness.
  Balance sheets are generally sound. Profit rates sufficient for growth.

- Leading to pressure for labor market reforms.
  Coming slowly, not without pains/political trouble.
  Unemployment insurance reforms, pension reforms,...

So foundations for sustained growth are there. The issue: How to get there?

Back to the short run.

## 2.2. Monetary and fiscal policies in a straightjacket

Here the issues are well understood:

### Monetary policy

Has the ECB been too tough?

- The smaller decrease of the overnight rate than in the United States. But not comparable.
- The need to establish credibility. The resilience of inflation.
- Could it do more? Missing: The cheerleader role.

### Fiscal policy

### The stance of fiscal policy: US versus 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 |
| 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 |

- The SGP constraints. Better to give up on a "stupid" rule than to keep credibility (?) by sticking to it.
- France and Germany now doing the right thing. Larger deficits now, together with reforms to improve fiscal outlook later (pension reforms).
- The right mix: Pushes demand now, and does not scare financial markets. But will it be enough?

### 2.3 Investment and consumption

- Why is fixed non residential investment so anemic? (Look at forecasts and forecast revisions earlier.)

  Only now starting to see signs of higher investment/ M&A activity.

  Apparent puzzle: Less of an IT boom in the second half of the 1990s,so less of a capital overhang. Low interest rates, so low cost of capital.

- Why are consumers so pessimistic? (Figure)

- Back to demand. and so back to policy: No commitment of macro policy to sustained growth.

  Sticks: reforms, often painful; but no carrots.

Consumer confidence
France
5
0
-5
-10
-15
-20
-25
-30
-35
-40
1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003
Germany
10
5
0
-5
-10
-15
-20
-25
-30
1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003
Italy
115
110
105
100
95
90
85
80
1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003

## 2.4. The dollar, the Euro, and deflation

A Euro appreciation vis a vis the Euro is bad in two ways:

- Decreases demand for European goods: How big? A back of the envelope number: 10% appreciation, about 0.6% less growth
  In the current context, another 10% euro appreciation would eliminate growth.
- Decreases inflation. Cheaper foreign goods.
  Back of the envelope again: 10% appreciation 1% less inflation.

  In general, lower inflation is good. But not when the inflation rate is already low, and the appreciation leads to deflation.

### Why and when is deflation so bad?

- By itself, deflation is ok. But it creates one serious problem:
- A floor on real interest rates. The interest rate cannot go below zero.
  If deflation, the interest rate adjusted for inflation becomes positive, and there is nothing the central bank can do about it.
- So, if the economy is doing poorly to start, then vicious cycle (a few months of deflation in the US at this point 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. But still, equally hard to get out of.

## 2.5 Any hope of strong locomotive effects?

In the recent past, rich economies have moved increasingly together. This has led some to conclude that if the US expands, then Europe will as well. This does not follow.

The mechanical effects of a U.S. expansion.

- Increase in US imports, thus in European exports. (for example, higher demand for German machinery)
- Quantitatively small effects. Europe as a whole is a very closed economy.
  According to existing models, roughly 1% more growth in the US leads to 0.1-0.3% more growth in Europe.

Can the effects be larger? Yes: If good news for the US are good news for Europe.

- Increases in US stock prices leads to increase in European consumer wealth.
- Good news on US productivity growth may indicate good news to come for productivity growth for Europe.

Can the effects be smaller? Yes. If good news for the US are bad news for Europe.

- The dollar depreciation: Increases demand in the United States, decreases demand in Europe.

So do not count too much on locomotive effects.

## In summary

### For the United States

- A strong expansion, underway already.
- For how long? A decade? Everything in place.
- The likelihood of much higher interest rates. Watch the term structure.
- Further dollar depreciation. When?

### For Europe

- The medium run looks potentially quite good.
- The hard question is how to get there?
- A best guess: Slow growth, and then higher.
- With the help of fiscal policy, willy-nilly.
- Clear dangers. Timing of dollar depreciation. The danger of deflation not eliminated yet.