Euro area economic trends 2006 and 2007: gambling with the recovery?

Twice-yearly economic forecast and policy recommendations by the Macroeconomic Policy Institute (IMK) in collaboration with the European Trade Union Institute (ETUI-REHS)
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Global economic imbalances on the increase

Overall, the world economy has been on a robust upward trajectory over the last few years. As a consequence, many economies have since completely recovered from the effects of the global recession that followed the year 2001. This is quite remarkable in light of the burdens imposed on most countries during that period. Specifically, the increases in oil and commodity prices reduced both enterprise profits and the purchasing power of private households in many countries. But some economies also benefited from the price boom. For instance, in the oil- and commodity-producing countries, domestic growth was boosted by higher export earnings, which in some cases rose dramatically. The boom also had indirect positive effects for those economies that benefited from the rise in demand for goods in the oil- and commodity-exporting countries. The recycling of revenue from oil and other commodities thus helped to keep the world economy buoyant. The strongest growth dynamics were once again seen in Asia, in Central and Eastern Europe, and in North America. The euro area continued to lag behind.

The trade deficit in the United States continued to grow, while the trade surpluses in the Asian economies increased perceptibly, in particular as a result of the inadequate, from a global point of view, exchange-rate adjustment. The high external imbalances, whose correction has been postponed year after year and which threaten to cause destabilising adjustment processes, represent a significant risk for the world economy. Seen from a cyclical perspective, there is still no end to the global expansion in sight, even though the United States has tightened its monetary policy stance still further and has thus contributed to a slight interest-rate rise on the capital markets, whose restrictive effects are likely to be felt during the course of the forecast period. U.S. fiscal policy, which substantially reduced the budget deficits on the strength of the economy's robust growth, proceeded in the same direction. This forecast assumes that world growth will weaken slightly, that exchange rates remain stable and the oil price will fall slightly, though still remain high. As regards monetary policy in the euro area, it is assumed that interest rates will not be raised further over the forecast period (Table 1).

Table 1

Assumptions of the forecast			
	2005	2006	2007
Three-month money market rate (%)	2.2	2.6	2.6
Yield on ten-year government bonds (euro area, %)	3.4	3.7	3.8
Yield on ten-year government bonds (USA, %)	4.3	4.7	4.8
Exchange rate (USD /EUR)	1.24	1.20	1.20
Real effective exchange rate (consumer prices, broad group of countries)	103.6	100.7	100.7
Competiveness indicator of the German economy (consumer prices, 49 countries)	97.6	95.7	95.6
Collective agreement index (Bundesbank, per hour)	1.0	1.1	1.2
Oil price (Brent, USD)	54	57	54
Sources: Deutsche Bundesbank, ECB, IEA, Federal Reserve, 2006 and 2007: IMK forecast.			

Slower growth in the United States

The U.S. economy grew by 3.5% in 2005, as in 2004. Labour productivity rose appreciably, but economic growth was strong enough to create around 2 million new jobs, and the unemployment rate fell to under 5%. The inflation rate amounted to an annual average 3.4%, while the core inflation rate (consumer prices, excluding foodstuffs and energy) remained relatively stable at just over 2%. Notwithstanding an increase in the foreign trade deficit to 6.4% of GDP, the U.S. dollar appreciated in nominal terms against the major currencies (by 11% against the euro over the course of last year). The appreciation was mainly due to the higher interest rates in the United States compared to the euro area.

The deficit in the federal budget fell by one percentage point to 2.5% of GDP over the last fiscal year because tax revenue rose at a much faster rate than expenditure, which likewise showed a hefty increase, however. The deficit is likely to rise again this year, largely as a result of a considerable increase in spending on Medicare (partly because of the extension of cost coverage for prescription drugs as of 1 January 2006), the repair of the hurricane damages and the "global war on terror". Fiscal policy will therefore exert an expansionary impulse in 2006. Moderate consolidation appears to be on the cards for 2007. The tightening of the monetary policy reins means that short-term interest rates currently stand at 4.5% and therefore at almost the same level as long-term rates. However, the Federal Reserve Bank is no longer talking about an accommodating monetary policy.

Indeed there is much to suggest that the upswing will continue, even if it is perceptibly curtailed by monetary policy. The leading indicators all point upwards, albeit on a slightly restrained trajectory. Consumer confidence has recovered again since November following the decline induced by the hurricanes.

The main pillar of economic growth in recent years has been private consumption growth. Thus, the crucial question is whether its robust pace of expansion will persist. The linchpin of private consumer spending in the recent upswing (in addition to the rise in employment and earnings) has been positive wealth effects. Experience suggests that these effects are likely to continue to positively influence private consumption for another few quarters. The wealth-income ratio, which indicates how high net wealth is in comparison to the disposable annual income of private households, rose from less than 4 to 5.6 between the third quarter of 2002 and the third quarter of 2005. [1] One half of the wealth effect consists of stock-market profits, while another third is comprised of the increase in net real estate assets. This allowed consumers to maintain their consumption habits even when the rise in energy prices curtailed real income growth – with the result that the savings ratio of private households fell to 0.4% in 2005. The global rise in share prices is not likely to continue uninterrupted, not least because of the higher interest rates. And this is all the more true for the property boom. Interest rates for variable-rate mortgages have already been rising since the beginning of 2004, while those for fixed-rate mortgages have risen to over 6% since autumn 2005. As the savings ratio increases slightly and in view of the weaker capital gains, the pace of private consumption growth is likely to slow over the forecast period. Falling sales and profit expectations will curb the propensity of enterprises to invest. Given a somewhat more moderate trend for exports, but at the same time slightly weaker import growth, the contribution of the external balance to GDP will no longer be quite as negative. On balance, GDP growth is likely to decline to some extent. Growth rates of 3.1% and 2.8% can be expected in 2006 and 2007, respectively. Inflation will decrease as the effects of the oil-price increase wear off and wage growth remains moderate. The inflation rate will amount to an annual average 2.7% in 2006 and is likely to fall to 2.4% in 2007.

Japan on the upswing

The Japanese economy grew by 2.7% last year and thus managed to emerge from stagnation. The decisive factors behind this convincing recovery were a robust increase in investment and, in particular, in private consumption, which had been weak for many years.

Deflation – measured by the consumer price index – has been overcome. In January, the overall index showed an increase (of 0.5%) for the first time in years; the inflation rate excluding fresh foodstuffs – the central bank's standard – has been slightly positive again since November.

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1 *Economic Report of the President*, February 2006, pp. 29f.

Against this more favourable background, fiscal policy will now intensify its consolidation course. The government intends to achieve a surplus in the primary budget (all levels of government) within a few years after 2010. With a view to achieving this goal, this year already overall expenditure is to be pushed below last year's level. According to the proposed budget, the deficit ratio of 6.0% posted in the fiscal year 2005 will be reduced to 5.2%. If the consolidation proceeds at this pace, it will be possible to reduce the debt ratio (currently 160% of GDP) in the coming years.

Monetary policy is still very expansionary and will remain so at least until the autumn, even if the Japanese central bank has announced the conclusion of its policy of "quantitative easing". Thus, the purchases of debt securities, with which the bank stabilised the economy during the deflationary phase, are likely to have come to an end. However, interest rates will remain low over the forecast period.

The prospects that the upswing will continue are favourable. Incoming orders for machinery are on an upward trend, as are the confidence indicators.

If the expansion of the world economy persists, exports will initially continue to grow rapidly. However, the pace of export growth is likely to subside over the course of the year as the positive effects of the yen's depreciation wear off. Domestic demand is also likely to expand significantly – despite the decline in public investments – as profits continue to rise and employment and incomes show moderate increases. However, the contribution of the external balance to GDP growth will decline compared to 2005 as a result of rising imports.

GDP will increase by 2.5% this year. Next year, as the pace of global economic growth abates and the expansionary effect of economic policy wears off almost entirely, it is likely to grow by only 2.0%.

Ongoing robust growth in China and the other Asian emerging economies

The Chinese economy grew by around 10% in 2005 – just as in the previous two years. Exports again provided the strongest impulse, showing a nominal increase of over 28%. The largest customers by far remained the United States and the European Union. Here we see the positive effects for China of the undervalued renminbi.

Bolstered by the rise in employment and the strong income growth, private consumption also increased perceptibly. However, its rate of growth is likely once again to have been somewhat slower than that for the overall economy. As profits growth remained indisputably solid and financing conditions were favourable overall, enterprises increased their real investments by almost 25%. Nominal imports grew by almost 18% last year, so that the current account closed with a positive balance of 4.5% of GDP. The inflation rate amounted to just under 2% again on the most recent figures.

The Chinese central bank loosened the monetary policy reins in spring 2005 in order to counteract speculative capital inflows in the run-up to the planned slight appreciation of the renminbi; the move sterilised the inflows of foreign currency by around half. In addition, the bank curbed the growth of the credit volume by means of administrative measures and by exerting direct influence on the credit decisions of the government-owned commercial banks.

After the capital inflows abated, monetary policy was tightened again to some extent and money market interest rates rose slightly. All in all, however, the monetary parameters are unlikely to have a restrictive effect over the forecast period. And, like last year, fiscal policy will not provide any impulses. Under these conditions, the high rate of economic growth will continue at a slightly weaker pace.

Growth in the remaining Asian emerging economies (Table 2), is likely to remain strong overall this year. South Korea's economy is still on an upswing thanks to the strong growth of private consumption. Despite the appreciation of the currency, exports are continuing to grow, though they will slow to some extent over the course of the forecast period. The inflation rate amounted to just under 3% on recent figures. Economic growth will accelerate to around 5% this year but will lose some momentum next year, falling to just over 4.5%. In Taiwan, too, economic growth accelerated noticeably in the second half of the year with the increase being driven by exports. And similar trends are evident in both Singapore and Hong Kong. These countries are benefiting in particular from the recovery of the IT economy, which began in the second half of 2005. All in all, the economies of these newly industrialising nations are likely to grow at much the same pace in 2006 as in 2005. Next year the reduction in the pace of growth in the United States and in China as well as the slightly more restrictive monetary policy is likely to curb the rates of expansion here, too.

Table 2

Key growth centres of the global economy: Growth, Inflation and Unemployment
% change on previous year

	Weight in % 2006	GDP			Consumer prices			Unemployment rate (%)		
		2005	2006	2007	2005	2006	2007	2005	2006	2007
Euro area	72.2	1.3	1.9	1.6	2.2 [1]	1.8 [1]	2.0 [1]	8.6	8.1	7.9
USA	14.7	3.5	3.1	2.8	3.4	2.7	2.4	5.1	4.8	4.8
South east Asian emerging markets[2]	5.8	5.2	5.1	4.7	2.9	3.3	3.0	-	-	-
China	4.5	9.9	9.3	8.5	1.8	2.5	3.5	-	-	-
Japan	2.8	2.7	2.5	2.0	-0.2	0.3	0.5	4.4	4.1	3.8
Total[3]	100	2.3	2.6	2.3	-	-	-	-	-	-

1) HICP.

2) South Korea, Taiwan, Hong Kong, Singapore, Malaysia, Thailand, Indonesia, Philippines.

3) Regions/countries above weighted with their shares in the goods exports of German companies.

Sources: National and international statistics, IMK forecast.

Upswing in the euro area to remain moderate

Livelier investment activity

Following a brief lull at the beginning of last year, the export sector of the euro area expanded robustly again over the course of the year. Exports of investment goods grew particularly dynamically. Demand from the United States and the new EU member states showed the most substantial growth. In addition to the brisk pace of the world economy, another positive effect on exports was provided by the depreciation of the euro in real effective terms by almost 2% against the annual average for 2004.

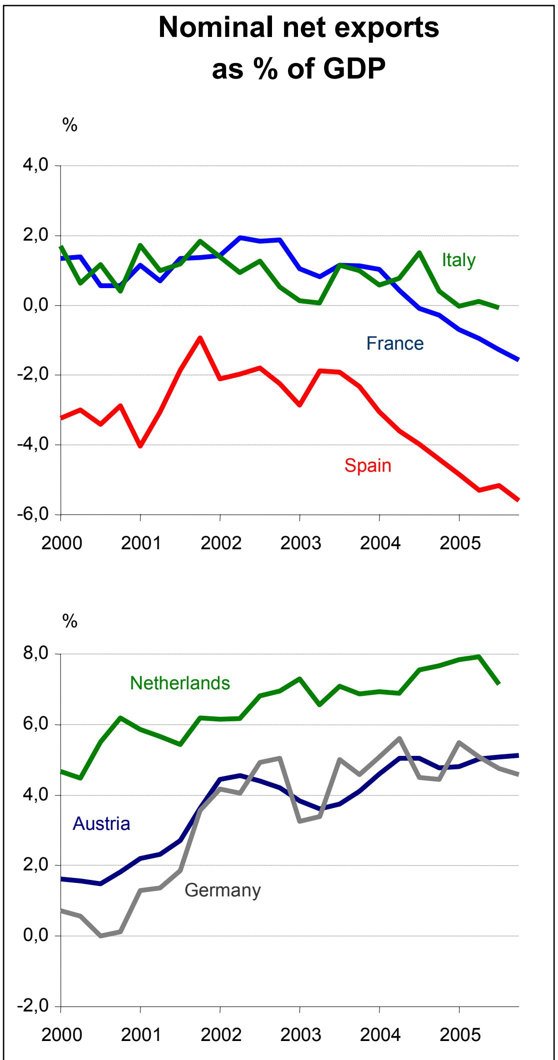
Last year, gross fixed capital formation for the first time significantly exceeded the level reached at the end of the boom year of 2000. Investment has been increasing at annualised rates of around 4% for three quarters now. Machinery investment, in particular, expanded appreciably.

The remaining components of domestic demand remained weak, by contrast. Real private consumer spending rose by only 1.3% on annual average and actually declined in the fourth quarter of 2005. The reason for the feeble rate of consumption growth was the increasingly depressed trend for real disposable income – especially that of workers. The gross wage and salary bill in the euro area was around 2% higher in 2005 than the previous year, but per capita gross wages and salaries rose by only 1.5%. In real terms, therefore, they declined. This weak income trend was compensated only in part, in terms of the impact on consumption, by the increase in profit income and capital gains. Government consumption expenditure rose – at 1.4% – at a slightly stronger rate than the previous year.

Overall, domestic demand expanded by 1.5%. At the same time, the trade imbalances in the countries of the euro area were reinforced. While in Germany and Austria the share of

GDP accounted for by nominal net exports has increased substantially in recent years, France's and Spain's deficits have continued to grow. And Italy's external balance has also recently fallen below zero (Figure 1). Evidently, the diverging trends for unit labour costs in the euro area (Figure 6, below), which since the launch of monetary union can no longer be balanced out by nominal exchange-rate adjustments, are having an impact on the external positions of the EMU countries.[2] Those countries in which wage moderation is being practised are constantly increasing their surpluses at the expense of the other member states.

Figure 1



Sources: Eurostat, IMK calculations.

The number of employed persons rose last year at an estimated 0.6% and thus at a similar rate to the previous year. The unemployment rate continued to decline over the course of the year, then stabilised at the end of the year at 8.3% falling only marginally to 8.2% in February.

The sharp rise in the oil price last year had the effect that the current inflation rate of 2.2% (flash estimate, March) has once again exceeded the medium-term target rate defined by the European Central Bank. Nonetheless, there is currently no inflationary pressure in the euro area. The rise in unit labour costs probably amounted to only around 1% last year. Consequently, the core inflation rate also remained extremely low,[3] amounting to only 1.2% in January and February of 2006. The ECB nonetheless continued to tighten monetary policy and, having already raised base rates in December 2005, raised them again by 25 basis points in February 2006.

No recovery in consumption

The steep rise in incoming orders from abroad towards the end of last year suggests that export growth will remain strong. The depreciation of the euro is also likely to boost growth to some extent in the first half of this year. Thus, exports will temporarily expand at a somewhat accelerated pace. They will then lose some momentum over the further course of the forecast period – not least because of the slight weakening of the U.S. economy and of some Asian economies.

The significant expansion of gross fixed capital investment will continue in the coming quarters. Next year investment is likely to expand at a rather slower pace, however, because of the somewhat weaker export dynamic and the slight dampening effect of monetary policy.

Consumer spending remains the euro area's main problem. In this respect the European economy is substantially influenced by developments in Germany, where the impending V.A.T. increase will generate "pull-forward" effects that will in turn lead to a slight acceleration in growth rates in 2006. However, this trend will come to an end next year when the effects of the V.A.T. increase are actually felt. Private consumer spending will rise in the euro area by an average 1.2% both this year and next year (Table 3).

[2] See G. Horn, B. Müllhaupt, K. Rietzler, "Quo vadis Euroraum? Deutsche Lohnpolitik belastet Währungsunion", *IMK Report* no. 1, August 2005.

[3] Rate of change of the Harmonised Index of Consumer Prices (HICP), not including energy, foodstuffs, alcohol or tobacco.

Table 3

Key forecast figures for the euro area % change on previous year				
	2004	**2005**	**2006**	**2007**
GDP	2.1	1.3	1.9	1.6
Private consumption	1.5	1.3	1.2	1.2
Government consumption	1.1	1.4	1.3	1.0
Gross fixed capital formation	2.3	2.1	3.6	2.9
Net exports[1)]	0.1	-0.2	0.2	0.1
Current account balance[2)]	0.6	-0.4	-0.3	-0.1
Employees	0.7	0.6	0.8	0.6
Unemployment rate[3)]	8.9	8.6	8.1	7.9
Unit labour cost	0.7	1.1	0.8	0.9
Inflation (HICP)	2.1	2.2	1.8	2.0
Budget surplus/deficit[2)]	-2.7	-2.5	-2.4	-2.1
Gross government debt[2)]	70.2	70.6	70.3	70.2

[1)] contribution to growth
[2)] % of nominal GDP
[3)] % of the labour force

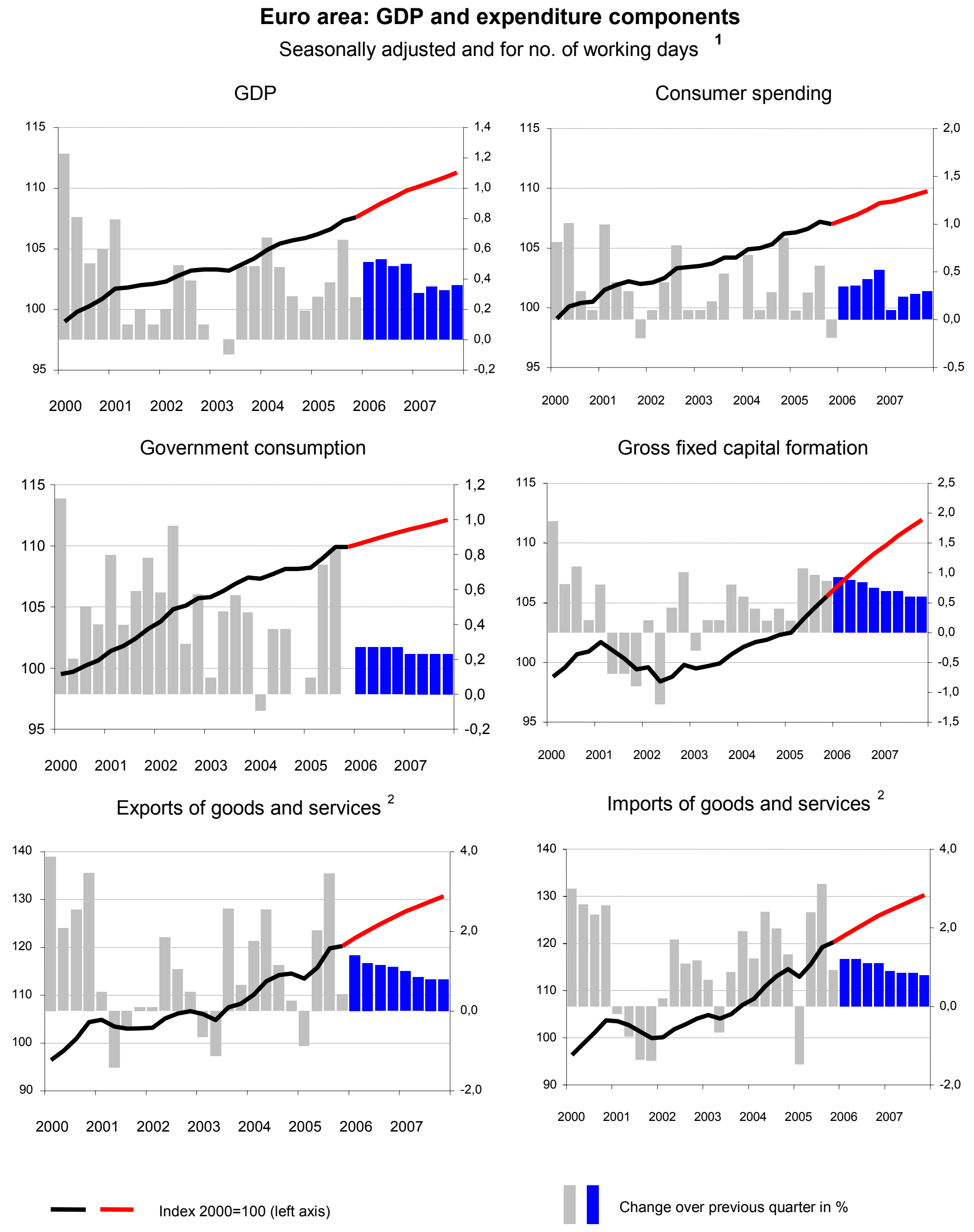
Sources: Eurostat, ECB, 2005: partly estimates by the IMK, 2006 and 2007 IMK forecast.

Government consumption expenditure will also expand only moderately as a result of the ongoing consolidation efforts. The overall fiscal deficit is likely to be further reduced over the forecast period – from 2.5% of GDP in 2005 to 2.4% in 2006 and to 2.1% in 2007. Gross debt as a share of GDP will thus fall over the forecast period to 70.2%.

All in all, domestic demand will grow at a slightly faster pace this year than in 2005. Imports will continue to expand robustly. As a result of the more dynamic export activity, the external balance will provide a positive impulse this year, which will decline significantly over the further course of the forecast period, however (Figure 2). Output will increase by 1.9% this year and by 1.6% next year.

In view of the relatively favourable economic trend, employment growth is likely to proceed at a slightly accelerated pace this year. The unemployment rate will continue to fall. On average this year, 8.1% of the labour force will be without work. Next year the unemployment rate is likely to be slightly lower at 7.9% on annual average, although unemployment will scarcely fall over the course of 2007. As in previous years there will be no inflationary pressure deriving from wages over the forecast period. Nominal unit labour costs will increase by less than 1% in both years and their effect on prices will be accordingly small. After the impact of the oil-price increase on inflation gradually abates, the inflation rate in the euro area will be driven upwards by the sharp increase in the German V.A.T. rate. Euro area inflation will then be around 0.3 percentage points higher than without the V.A.T. increase. The inflation rate in the euro area will amount to 1.8% this year and to 2.0% next year.

Figure 2



1 From 1st quarter 2006, IMK forecast. 2 including cross-border intra-EMU trade.

Source: Eurostat, IMK forecast

Fiscal policy to jeopardise upswing in Germany

Notwithstanding the substantial difficulties created by the massive price increases for oil and other commodities, the German economy showed some signs of growth last year. Once again, foreign trade was the decisive factor behind this trend, although the role played by investment also increased. Investment in machinery, especially, appears to be on a steady upward trend, having expanded for almost two years now, albeit at a relatively moderate pace in comparison to the upswing phases of previous cycles. Building investment also rose perceptibly in the second half of the year. By contrast, private consumption decreased over the course of the year and stagnated on annual average for what is now the fourth year in a row. This was primarily a result of the continued decline in real disposable income. All in all, it proved impossible to resolve the fundamental problem of weak domestic demand. There is as yet no sign of a broad, self-sustaining upswing.

But some early indicators suggest that rather strong export growth can be expected in the initial months of this year. For instance, exports grew again sharply in January (seasonally adjusted figures), and current incoming orders from abroad indicate that this trend will continue. In March, moreover, the ifo business climate index for manufacturing industry rose to its highest level since reunification. Noteworthy here is the fact that the positive assessment regards both expectations and the actual situation.

The global economic environment will remain favourable for Germany over the forecast period. Thus, there is currently no sign of the lively pace of world growth coming to an end, although the tighter monetary policy course adopted in both the United States and the EU and the accompanying higher interest rates on the capital markets will dampen the pace of expansion over the course of the next two years. However, this effect is likely to be largely offset by an ongoing improvement in the price competitiveness of German firms as a result of a further decrease in unit labour costs. Thus, foreign trade can be expected to continue to contribute substantially to overall growth.

The general conditions for the domestic economy will be influenced to an exceptional extent by fiscal policy. The budget deficit will be reduced in both years, and the general impetus exerted by fiscal policy will be restrictive. This effect will be particularly potent in 2007 when both the standard V.A.T. rate and insurance tax are increased by three percentage points. The intention is to use two percentage points of the gain for fiscal consolidation, while the remaining one percentage point will be used to reduce unemployment insurance contribution rates. On top of this substantial tightening of fiscal policy, the monetary parameters have also become slightly less favourable.

Net exports will continue to make a substantial contribution to growth in both years. And investment, especially machinery investment, can also be expected to provide a strong boost, given that financing and tax-depreciation conditions are favourable. By contrast, private consumer spending will not provide any appreciable positive impulse in view of the persisting unfavourable income and employment situation. Only the "pull-forward" effect created by the impending rise in V.A.T. will generate a brief acceleration in 2006, but the decline in 2007 will then, of course, be all the more severe.

All in all, a reasonably strong – at least compared to previous years – GDP increase of 1.7% (1.9% after adjustment for working days) can be expected this year. Next year, as a result of the restrictive fiscal policy, the pace of expansion will be much weaker at 1.1% (1.3% after adjustment for working days). Without the substantially restrictive impulse, growth would amount to over 2%. In other words, an upswing would be possible, but it will be prevented by the policy of budget consolidation.

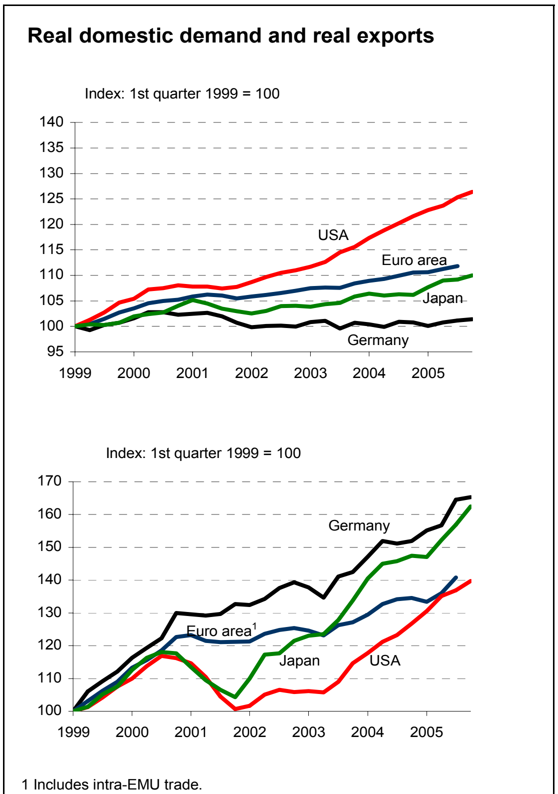
European economic policy: gambling with the recovery

Economic activity in the euro area has begun to pick up. After the setback in 2005, this year growth is moving back towards, without reaching, the level recorded in 2004. Consumer and especially business confidence are high. This will not be enough to bring about more than a marginal improvement in the fiscal position, but still sluggish productivity growth means that there will be a small improvement on the labour market in the euro area as a whole.

Yet the recovery remains weak and fragile. Unlike in the US, policymakers have failed to return the European economy to the growth trajectory of the late 1990s and 2000. Internal demand remains weak and thus the recovery continues to depend on export markets, and this in an already unbalanced and precarious global context. Investment is picking up, but remains desultory compared with previous upturns. Worse, just as the 2004 recovery proved a false dawn, thrown off course by an appreciating euro and higher oil prices, it seems highly likely that even the modest growth achieved this year will prove ephemeral: rising global interest rates, tighter fiscal policy and slowing external demand growth will depress growth once more, all but halting the reduction in unemployment in 2007. And even this depressing forecast relies on technical assumptions – such as no further interest rate hikes in Europe and no sudden unwinding of global imbalances or further oil shocks – that may well fail to be matched by reality. Meanwhile the internal imbalances within the euro area itself remain and in some countries will force painful corrections.

Against this background it is astonishing that the policy discourse in Europe remains dominated by the supposed need to raise Europe's 'competitiveness', indeed, as agreed by heads of state and government in 2000, by the aim to make Europe 'the most competitive' economy in the world by 2010. It is abundantly clear from the figures – notwithstanding the incessant talk about globalisation and China – that Europe's problem does not lie with a failure to compete on world markets: on the contrary, once again Europe is relying on net exports to raise its growth rate, while its domestic demand growth is sluggish; this is true a fortiori of Germany, whereas the recovery in the US has been domestically driven (Figure 3). Europe's problem lies in an inability, or unwillingness, to take the necessary steps to ensure that domestic consumption and investment demand recover from the external shocks that hit the economy in 2001.

Figure 3

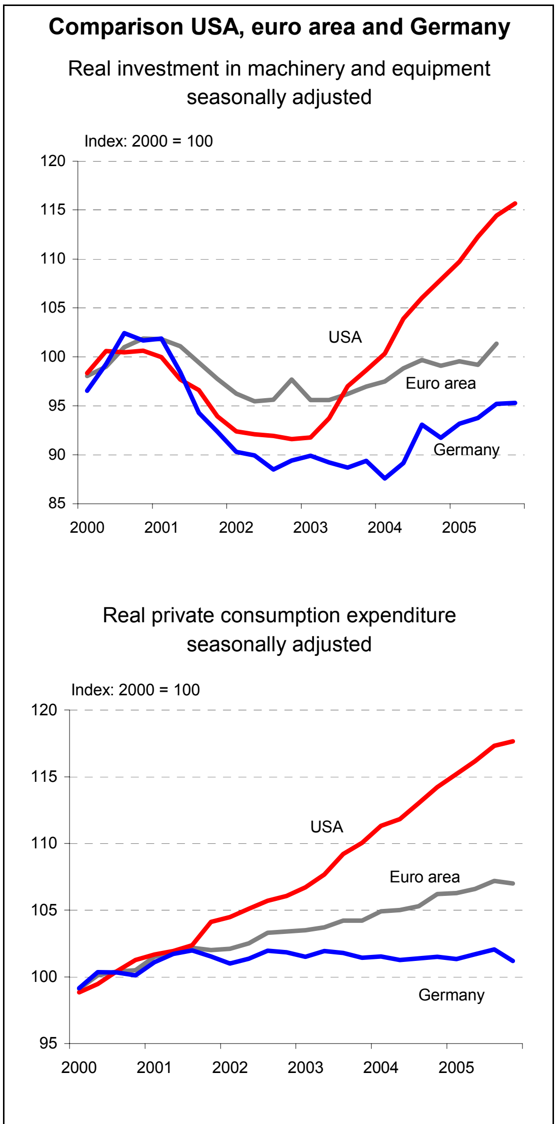


1 Includes intra-EMU trade.

Sources: Eurostat, BEA, ESRI Japan.

Just how important the link between domestic consumption and investment is can be shown by comparing the USA, the euro area and Germany (see Figure 4). The US was hit by a serious demand shock in 2001. But by adopting expansionary monetary and fiscal policies, the authorities were able quickly to stabilise consumption. And in its wake investment, too, accelerated markedly. In Germany real consumption has stagnated year after year, and, despite high profits, investment was much weaker than in the US. It is clear that in large economies – and the trends for the euro area were similar to those in Germany, although less pronounced – the investment dynamic depends in very large measure on the dynamic of domestic demand. Success on export markets alone is insufficient to generate a significant and sustained recovery.

Figure 4



Sources: Federal Statistics Offices, Eurostat; OECD; IMK calculations.

Against this background the question is whether the policy mix in Europe is appropriate, whether, under these conditions, it is capable of inducing a self-sustaining recovery, or whether the economy will enjoy merely a brief bloom. Given the numerous risks and the announced intentions of economic policy-makers, the latter seems more likely.

Given the reliance on net exports, particularly in Germany but also in the euro area as a whole, the global economic risks, in particular, give rise to considerable scepticism. Growing uncertainty surrounding global energy supplies, reflected in highly volatile oil prices constitute a permanent threat to any economic recovery. Yet above all else it is the widening global economic imbalances that give greatest cause for concern. To date they have been criminally neglected by euro area economic policy-makers. It is absolutely clear that the US cannot continue to run growing trade deficits. What is unclear is when the adjustment process will occur and what form it will take. There are scenarios that, from a European perspective, are relatively benign[4]. If the savings rate in the USA rises gradually, or if it falls in the Asian countries that have the largest trade surpluses with the USA, or if those countries were to permit a substantial appreciation of their currencies against the US dollar, the effects on the euro area would be limited. The problem, though, is that the decision whether the necessary adjustment will occur through this relatively benign scenario clearly does not lie in European hands.

In the worst-case scenario – a drastic appreciation of the euro – the euro area would be confronted with the main adjustment burden, although its trade surplus with the USA is relatively small. If this scenario were to unfold, the euro area could see an output loss of almost 2 ½% of GDP (based on Ahearn and von Hagen's calculations for the EU15). A recession would be almost inevitable. Consequently, if the recovery is to continue unhindered, preventive measures are required, or at least a plan of action for the event that the euro area faces such a worst-case scenario.

In the first instance it is monetary policy that is called upon to act. The ECB should make it clear in advance that it is not prepared to accept a dramatic appreciation of the euro. As the guardian of the appreciating currency it is in a position to prevent such a rise either by cutting interest rates or by buying dollars; if necessary the impact of such purchases on the domestic money supply could be offset ('sterilised'). That would be a clear warning to all speculators. If possible such an approach should be done in concert with other central banks, rather than alone, as this would make the announcement even more credible.

Not all the risks to the recovery are linked to relations with the rest of the world. Substantial trade imbalances have also arisen within the euro area itself. What lies behind this is the economic policy strategy of stimulating demand primarily by using wage restraint to lower the real exchange rate, thus boosting net exports. This strategy has been pursued especially by Germany, and to a lesser extent also Austria, and more recently also by the Netherlands. For small countries, such as Austria and the Netherlands, such a policy can work for the country concerned. For a large country such as Germany, however, such a strategy is inappropriate: the weakness of consumer demand as a result of wage moderation in Germany clearly shows this. Even now, with investment gradually picking up, consumption remains weak, and the recovery subdued. From a European perspective such a policy is clearly disastrous. The increase in competitiveness of the countries pursuing the strategy is merely a mirror image of the loss of competitiveness of the other countries. The exports of those countries – Spain, Italy and France should be mentioned in this context – have come under such great pressure that there is a real risk of it impacting negatively on domestic growth. That would put downward pressure on wages. This would lead to a vicious circle of attempted real devaluations that would push the euro area as a whole into the deflationary abyss. This could only be prevented if the ECB were to adopt aggressive expansionary monetary policies. There must be doubts whether they would be willing and – given the low current nominal interest rates – able to do so. The only way to resolve the current account imbalances within the euro area is for Germany to have faster wage growth (with respect to productivity, i.e. unit labour cost growth) than the average of the other countries. There is currently no sign of this whatsoever (see section below on wage policy). If current trends continue the euro area recovery is in great danger. A beggar-thy-neighbour

[4] Cf. A. Ahearn and J. von Hagen (2005), 'Global current account imbalances. How to manage the risks for Europe', Bruegel Policy Brief 2005/02.

policy of competitive real devaluations is incompatible with a stable monetary union[5].

The most immediate cause for concern, though, comes from Germany. The succession of policies that have depressed consumer demand over recent years is set to reach a new climax in 2007. On top of the pressure on real incomes due primarily to the policy of wage moderation and rising oil prices, Germany will raise VAT by 3 percentage points at the start of 2007. The momentum of the steady upturn during the current year will be insufficient to cope with this shock without depressing economic growth. The German government is, at first sight, pursuing the correct strategy, initially stimulating the economy, then consolidating in a more favourable cyclical situation. However, the concept is being poorly implemented. Already in the current year, German fiscal policy is actually restrictive, and so economic and employment growth will be limited. All the more painful will be the consolidation shock in 2007, especially as no support is to be expected from the ECB. This is not only because Germany is only part of, and not the whole, monetary union, making it difficult to coordinate national fiscal consolidation with a supportive monetary policy. The problem is that the ECB perceives indirect tax hikes as a threat to price stability[6]. Germany's VAT hike is calculated to add more than 0.3 percentage points to euro area headline inflation. On past behaviour the ECB must be expected to take this as a signal to raise interest rates, although the impact of the VAT hike will be to lower demand, and thus core inflation, which should be the real guideline for monetary policy. The combination of monetary and fiscal tightening will be to seriously depress growth, which in turn will to a considerable extent offset the positive impact of the tax hike on public finances, threatening the sustainability of fiscal consolidation.

This danger is well illustrated by the case of Portugal, which introduced a tough package of fiscal consolidation measures in 2002, including a 2 p.p. increase in VAT. Initially the deficit was brought down from 4.2 to 2.8% of GDP. However, the accompanying growth slowdown subsequently seriously reduced public revenues, and the deficit rose once more, and is now as a high as 6%.[7]

The only possibility of avoiding a consolidation shock would be if the deficit reduction in 2007 were to lead to increased private spending. It is argued that such so-called 'non-Keynesian effects' occur because private households had been expecting tax hikes: once they actually are implemented, they no longer negatively affect income expectations. The empirical evidence for such effects is extremely weak, however. Consolidation efforts and a fall in deficits and also in public spending as a share of output have not generated non-Keynesian effects on private spending. In cases where private domestic spending has risen, the cause has lain elsewhere (e.g. net exports).[8] Private households base their consumption decisions to a considerable extent on actual income developments, indeed many of them are forced to do so by liquidity constraints. European economic policy cannot be based on such an empirically and theoretically dubious mechanism.

Taking all these factors together it seems highly likely that the currently rather favourable cyclical prospects will quickly cloud over once more, repeating a pattern seen in recent years. The only way to sustain the recovery, barring a global economic upswing that is substantially stronger than already assumed here, is a change in macroeconomic policy. Yet while the chances of achieving the Lisbon employment targets recede ever further, European policymakers continue to repeat the mantra that it is only by implementing the almost exclusively supply-side reforms contained in the Lisbon agenda that the European economy can recover from the slump. In the face of the risks to the global economy and the failure by European policymakers, both in Brussels and national capitals, to recognise that the European economy can and must take on the role of locomotive of the world economy, there are few grounds for optimism.

Premature tightening of monetary policy

The ECB has raised base rates to 2.5% in two steps of 0.25 percentage points – first in

[5] Cf. A Ahearne, J. Pisani-Ferry (2006) 'The euro. Only for the agile', Bruegel Policy Brief 2006/01.

[6] Cf. J. Bibow (2006) 'Refocussing the ECB on output stabilisation and growth through inflation targeting', A. Watt and R. Janssen (eds) *Delivering the Lisbon Goals. The role of macroeconomic policy*, ETUI-REHS:Brussels, p. 78f.

[7] ECB *Monthly Bulletin*, March 2006, p. 72.

[8] Torben M. Andersen (2004) 'Non-Keynesian effects of fiscal policy: theory and evidence', paper presented at the Brussels Economic Forum, Brussels May 2004.

December 2005 and then again at the end of February this year. Three-month rates are still low at 2.7%. Since autumn 2005, short-term rates have risen in real terms by over half a percentage point to 1.5%, while the core inflation rate has fallen slightly.[9]

Long-term rates have risen at a somewhat slower pace than short-term rates in recent months, so that the interest spread has narrowed to some extent. The yield on government bonds with a maturity of ten years has risen in the euro area since autumn 2005 by over a quarter of a percentage point in nominal terms, and by almost half a percentage point in real terms.[10] Lending rates are also somewhat higher than previously. However, the lending conditions of the commercial banks have improved to some extent,[11] and share prices have increased significantly (the broad Euro Stoxx Index has risen by 12% since October 2005), so that financing conditions for enterprises are more favourable.

The euro's exchange rate against the US dollar is currently at the same level as six months ago; between February 2005 and February 2006, however, the euro had depreciated by 8% in nominal terms against the US dollar and by 6% in real effective terms against the currencies of the euro area's most important trading partner. One of the main reasons is likely to have been the increased difference between short-term interest rates between the US and the euro area (Figure 5). The interest-rate differential between the euro area and the United States has amounted to one percentage point for several months now at the long end of the maturity spectrum. The exchange rate is therefore likely to exert a slightly expansionary impulse.

Despite the slight diminution in the real external value of the euro since autumn 2005, the monetary parameters have deteriorated overall since then as a result of the rise in interest rates. Moreover, market participants are expecting a further interest-rate increase on the part of the ECB. It will be argued in the following that the growth of the money supply, of lending and of asset prices is not sufficient to justify an interest-rate rise; the prospects for inflation and for economic growth, on the other hand, suggest that interest-rate increases are not called for. The current course of monetary policy tightening is therefore premature.

As an argument in favour of the most recent interest-rate increases, the ECB cites the strong growth of the money supply and lending. It is true that loans to the private sector, which have been favoured by the ongoing low interest rates, have expanded substantially – most recently at an annual rate of 10.3% (February 2006). Mortgage loans increased at a particularly high rate of 11.8%. But consumer and enterprise loans also showed dynamic growth of 8.2% and 9.5%, respectively (February 2006). All in all, enterprises in the euro zone still have a significant volume of liquidity in view of their high profits and still limited investment activity. The ample liquidity of enterprises, on the one hand, and the strong lending growth, on the other, are among the reasons behind the continued robust expansion of M3, which most recently increased at a rate of 8.0% (February 2006). In its last Monthly Bulletin, the ECB estimated the real money gap at currently almost 6% (adjusted for portfolio restructuring), but there is considerable uncertainty regarding this figure.[12] For instance, it is based on the assumption of a gap of zero at the beginning of monetary union and on a low trend reduction in the velocity of circulation compared to the trend for recent years. It is not possible to verify in the short period since the start of monetary union whether the reduction in the velocity of circulation might possibly have been stronger than assumed by the ECB. If this were the case, however, then one could also come to the conclusion that the expansion of the money supply is appropriate.

In any case, the low level of interest rates is likely to have encouraged a preference for liquid holdings, which are contained in M3, as opposed to longer-term forms of investment. Moreover, cash holdings have been rising perceptibly for some time, which is probably due to no small extent to demand from outside the euro area. Money supply growth in itself should be no cause for concern. This is all the more true given that, in the ECB's own forecasts for the period to the end of 2007, money supply and loan growth do not result either in high GDP growth rates or accelerated inflation.

[9] European Central Bank, *Monthly Bulletin*, March 2006, p. 72.

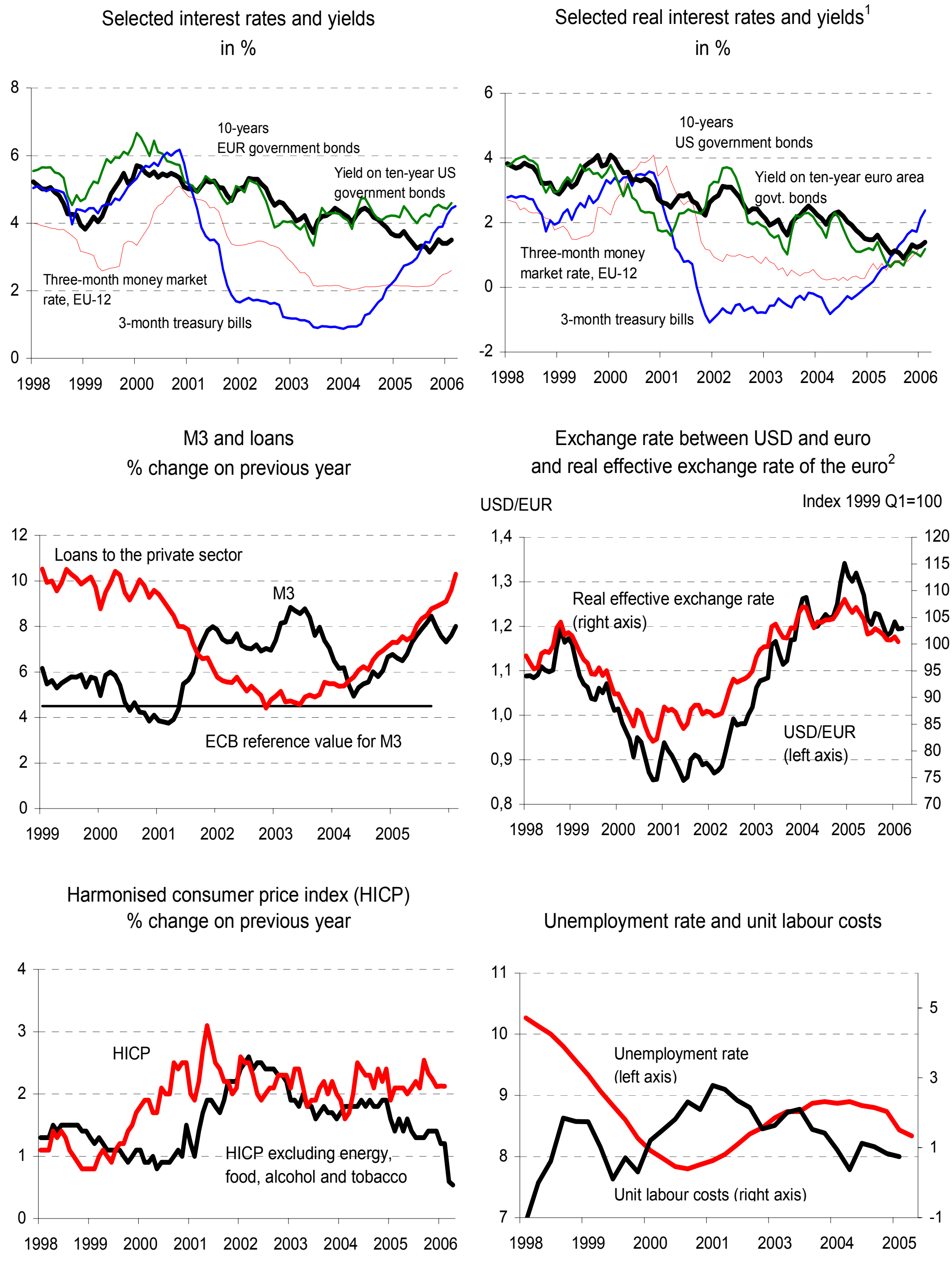
[10] Deflated with the HICP, not including energy, foodstuffs, alcohol or tobacco.

[11] This was demonstrated by the ECB's latest bank lending survey for the euro area; see European Central Bank, *Monthly Bulletin*, February 2006, pp. 18f.

[12] European Central Bank, *Monthly Bulletin*, March 2006, p. 27.

Figure 4

Monetary policy indicators for the euro area



[1)] Short-term interest rate deflated with the consumer price index excl. energy, food, alcohol and tobacco (euro area) and excluding energy and food (USA); long-term interest rates deflated using the centred 12-month average of consumer prices.

[2)] Against a broad group of countries, on the basis of consumer prices.

[3)] Unemployment rate in %; unit labour cost % change on previous year.

Sources: Federal Reserve; Eurostat; ECB; calculations of the IMK.

With respect to lending growth, it must also be emphasised that the ECB assesses the financial situation of enterprises as favourable and the indebtedness of private households as moderate by international standards.[13]

The possible existence of speculative bubbles on the securities or property markets should likewise not constitute an argument in favour of a European interest-rate rise. One reason is that it is practically impossible to identify such bubbles in advance.[14] In addition, the low level of long-term interest rates world wide and the accordingly high prices for securities are to a substantial extent a consequence of low risk premiums, higher demand from pension funds and insurers for long-term securities, and a high global propensity to save, on the one hand, and a low propensity to invest, on the other. The lower risk premiums are probably justified insofar as they reflect the greater degree of macroeconomic stability, also as a consequence of the monetary policy fine-tuning of the Greenspan era. Cases of over-inflated property prices in individual countries in the euro area should not be tackled with monetary policy instruments, but rather should be dealt with by the fiscal policy of the country in question. If monetary policy is already out of its depth when it comes to transregional speculation bubbles, then it will be all the more unable to cope with problems at regional level. As Adam Posen has said, "The monetary tools they have to stop bubbles only work by stopping the economy as a whole, not short of that, and that is never worth it."[15]

Inflation growth in the euro area has been extremely moderate over the last 12 months, notwithstanding an increase in the price of oil of over 30%. The main reason has been the weak growth in the core inflation rate, which on its part reflects the moderate growth in wages. The core inflation rate amounted to only 1.2% in February and has never exceeded 1.4% since June of last year.

A substantial rise in core inflation is not expected during the forecast period. Unit labour costs are likely to rise in the euro area at an annual rate of less than 1%. The ECB likewise does not expect an acceleration in wage growth. It believes that the fact that inflation is still slightly higher than its target rate is due this year to the energy price thrust and will be due next year to the increase in administered prices or indirect taxes. Here, Germany is likely to stand out with its V.A.T. increase, as a result of which the increase in the consumer price index will again substantially exaggerate the underlying inflation dynamic, so that the German inflation rate, despite a substantially lower basic inflation trend, will be only slightly lower than the European rate. Both government interventions and price pushes for energy are to be seen as one-off effects that do not require a monetary policy response as long as they do not generate second-round effects.[16] On the contrary, the low underlying inflation in the euro area suggests that monetary policy has not taken adequate steps against the economic weakness in the area since 2000.

Growth in the euro area is cited as a further reason for tightening the monetary policy reins. The ECB expects GDP in the euro area to grow by 2.1% this year and by 2.0% next year.[17] It must be pointed out that this forecast was made under the technical assumption that monetary policy base rates amount to 2.25% right until the end of the forecast period. Whether growth in the order of 2% would in itself represent grounds for a rise in interest rates, for no change, or for an interest-rate decrease, depends on how severe one believes the danger of inflation to be in a context of this rate of growth. The decision therefore implies an assessment of potential growth and the output gap. An increase of this magnitude in the United State's GDP would lead the Federal Reserve Bank to reduce interest rates, as indeed it has done in the past. Potential growth in the United States is estimated at

[13] European Central Bank, *Monthly Bulletin*, March 2006, pp. 49 and 51.

[14] See A.S. Blinder and R. Reis, "Understanding the Greenspan Standard". Paper presented at the Symposium of the Federal Reserve Bank of Kansas, "The Greenspan Era: Lessons for the Future", Jackson Hole Wyoming, August 2005, pp. 68f.; A. Posen, "The Bartender's Guide to Central Banking and Bubbles", *Boersenzeitung, Schwerpunktthemen und Serien*, guest article, 16 March 2005.

[15] A. Posen (2005), loc. cit.

[16] See J. B. Taylor, "How Should Monetary Policy Respond to Shocks while Maintaining Long-Run Price Stability? – Conceptual Issues". In*: Achieving Price Stability. Symposium Proceedings 1996*. Federal Reserve Bank of Kansas City, pp. 181 ff; L.E.O. Svensson, "Monetary Policy and Real Stabilization". In: *Rethinking Stabilization Policy. Symposium*. Federal Reserve Bank of Kansas City. Jackson Hole 2002, pp. 69ff.

[17] European Central Bank, *Monthly Bulletin*, March 2006, p. 68.

3.2%. By contrast, potential growth in the euro area is currently estimated at 1.8%.[18]

If labour force potential increases annually by almost 1%, then these potential growth estimates imply a rise in labour productivity of less than 1%. It is almost impossible to find a theoretical justification for such a low level of productivity growth in historical comparison, but also in comparison to the United States. Nonetheless, most national and international economic research institutes have recently undertaken substantial downward revisions of their estimates of potential growth in the euro area – and not only their estimates of current potential growth, but also those of past potential growth. Accordingly, the estimation of the output gap has also changed, sometimes fundamentally. Thus, in 2005, the International Monetary Fund retrospectively estimated a positive output gap of 1.8% for the euro area in 2000; in 2001, the estimated output gap was -0.1%.[19] In retrospect, it now looks as though capacities were over-utilised in 2000, notwithstanding an unemployment rate of 8.2%. Accordingly, the current output gap is estimated at only 1.6%.

If, by contrast, one were to take the output gap estimated in 2001 and calculate the current output gap on the basis of the productive capacity growth rate expected at the time and actual GDP growth, then the result would be around 4%. These revisions of estimates of potentials are largely based on purely statistical considerations. The statistical growth trend has declined as a result of the long-running stagnation, but to now interpret this statistical trend as potential growth means cementing it in monetary policy terms, and risking turning it into a self-fulfilling prophecy.

The difficulty of exactly quantifying productive capacity and potential growth makes it near impossible to formulate concrete and reliable numerical values that can be taken as orientation variables for monetary policy or even monetary policy rules.[20] This problem can be shown using the example of the Taylor interest rate, which, as a reference value for the "optimal" short-term interest rate, is a variable often used to assess monetary policy. The Taylor interest rate is calculated as the sum of the equilibrium real interest rate (r^*) and the inflation rate (π), corrected for the weighted output gap (relative deviation of GDP y from potential output y^*) and the weighted inflation gap (deviation of the actual inflation rate π from the central bank's target inflation rate π^*): Taylor interest rate = $r^* + \pi + 0.5\,(y - y^*)/y^* + 0.5\,(\pi - \pi^*)$.

The ECB's target inflation rate is usually taken to be 1.9%, given that the ECB says it is "almost 2%"; the real interest rate is usually equated with potential growth. If one were to now insert the current estimate for potential output into the equation and use the current (March) inflation rate of 2.2%, the Taylor interest rate would turn out to be about 3.5%. This in itself would justify further interest-rate increases. If, by contrast, one were to proceed on the basis of the estimate of the output gap in 2001 and assume a potential growth rate of 2.25%, as has been usual until recently, then the Taylor interest rate would amount to 2.75%. This value is only very slightly higher than the current base rate. In addition, the choice of the inflation indicator is not unproblematic. Although the ECB usually bases its calculations on the change in the Harmonised Index of Consumer Prices, it says – like most other central banks – that it does not react to one-off price shocks. But because the HICP both currently and over the forecast period considerably exaggerates the underlying inflation dynamic – especially as a result of the oil-price shock, but also because of administrated prices and indirect taxes – it would seem more appropriate to use a core inflation rate. This seems an all the more suitable option given that core inflation and unit labour costs indicate a similarly low increase in the underlying inflation dynamic. On this basis, the two calculation procedures above now result in a Taylor interest rate of 1.9% or 1.1%, which would suggest that interest rates should be reduced. One can therefore currently use Taylor interest-rate calculations to justify any monetary policy action at all. In other words, the procedure outlined here does not represent a basis on which monetary policy can be assessed.

The president of the ECB, Jean-Claude Trichet, recently announced that the output gap was not

[18] The International Monetary Fund, for example, calculates this figure on the basis of the output gap; see International Monetary Fund, *World Economic Outlook*, September 2005. Also see *OECD Economic Outlook 78 Database*, which estimates potential growth at 1.9%.

[19] See International Monetary Fund, *World Economic Outlook,* September 2005, p. 15, and October 2001, p. 16. Similar figures can be found in the *OECD Economic Outlook* of the same years.

[20] This also applies to money supply, because potential growth is a component of the reference value for money supply growth.

a component of the bank's monetary policy concept.[21] This is astonishing in that potential growth, on which the output gap is based, is a necessary component of the reference value for money supply growth, and one of the two pillars of the ECB's monetary policy strategy. If, however, the ECB, in view of the uncertainty surrounding estimates of potential treats these with caution, then there is an opportunity to use better indicators to illustrate an underlying inflation dynamic. Econometric studies show that inflation is closely related over the long term with unit labour costs.[22] And this is not surprising because it is impossible to imagine a substantial price dynamic without a corresponding wage dynamic. The ECB should therefore avail of the trend for unit labour costs as a key orientation variable for monetary policy. Observing this variable, it is again not possible to identify an acceleration in inflation over the forecast period. On the contrary, from the wage side, inflation rates will be pushed substantially below the ECB's target rate, which in itself would imply the need for interest-rate reductions. From this point of view there is no justification for raising interest rates, which could bring the upswing to a premature end.

Neither the money supply, loan growth nor asset prices indicate a need for raising interest rates in the euro area. The fact that economic growth is still moderate and is also accompanied by a weak inflation dynamic was already sufficient evidence against a tightening of monetary policy even before the interest-rate increases. Given an unemployment rate of over 8% in the euro area and weak wage growth, what must be done now is to test out the scope for growth. The integration of a substantial share of the unemployed into the labour process during the upswing and the adjustment of the stock of capital to the increased effective supply of labour would enable growth in excess of the potential rate by over one percentage point for several years. Not availing of this opportunity is not only a waste of resources but also implies renouncing a higher standard of living in the euro area. However, the most recent comments by the president of the ECB call for scepticism, especially when he prevails in the Central Bank Council with the following view: "We have no reason to believe as yet that there will be second-round effects, but we must prepare for the eventuality".[23]

This forecast is based on the assumption that base rates in the euro area will now remain unchanged for the remainder of the forecast period. But if the ECB – in accordance with its president's declarations – proceeds along the path of repeated small steps towards higher interest rates, the growth prognosis for 2007 in the euro area would have to be substantially revised downwards. For Germany, which is additionally burdened by its V.A.T. increase, one could not exclude a slide into a recession.

Fiscal policy in the euro area – reform of the SGP does not go far enough

Since the start of the European Monetary Union fiscal policy in the euro area has been dominated by the Stability and Growth Pact (SGP). Quite obviously the SGP has been unsuccessful in fulfilling its goals, fiscal sustainability and supporting economic growth. During the ongoing period of economic stagnation since 2001, more and more countries have exceeded the 3% of GDP limit for the budget deficit, while at the same time macroeconomic performance has been unsatisfactory.

It is hard to escape the conclusion that fiscal policies in the euro area countries contributed substantially to the slow recovery (Table 4). In the face of an average annual fall in the output gap of 0.6% of GDP, euro area fiscal policy was only slightly expansionary, with an average annual increase in the cyclically adjusted budget deficit of 0.1% of GDP. However, almost all of the expansionary, counter-cyclical reaction occurred in 2001, when the fall in the output gap was small. In 2002 the expansion was hardly measurable and since 2003 fiscal policy has even been slightly pro-cyclically restrictive. The cumulated negative fiscal stimulus over the last three years amounted to 0.5% of GDP.

[21] ECB press conference on 2 March 2006 in Frankfurt. Questions and Answers session.

[22] G. Fagan, J. Henry, R. Mestre, 'An area-wide model (AWM) for the euro area', ECB Working Paper No. 42, 2001; M. Duong, C. Logeay, S. Stephan, R. Zwiener with the collaboration of Serhiy Yahnych, "Modelling European Business Cycles (ECB Model)", DIW Berlin, Data Documentation 5, 2005, p. 35.

[23] Interview with Jean-Claude Trichet, President of the European Central Bank, *Süddeutsche Zeitung*, 15 March 2006, p. 21.

For the individual euro area countries the picture is rather diverse. However, there has not been a single country that did not see a pro-cyclically destabilising fiscal policy in at least one year during the recent slowdown. Over the whole period from 2001 to 2005 fiscal policy was strongly expansionary in only two countries: the comparatively high-growth countries Finland and Ireland both increased their average annual cyclically adjusted deficits (CADs) by 0.8% of GDP. Four countries (Italy, Greece, France and Germany) saw a slightly expansionary fiscal policy over the whole period, with CADs increasing by 0.3, 0.2, 0.1 and 0.1% of GDP respectively. In Greece the fiscal expansion turned out to be pro-cyclical, as the output gap improved at the same time. In France fiscal policy initially reacted to counter the fall in the output gap from 2000 to 2003. After 2004 it switched to restriction, and became noticeably pro-cyclical in 2005. In Italy, almost all of the expansion occurred from 2000 to 2001, when the output gap was still slightly improving. From 2002 to 2004, however, when the output gap worsened considerably, fiscal policy was perceptibly pro-cyclical, although it returned to expansion in 2005. In Germany, virtually all of the expansion occurred from 2000 to 2001, with only a minor worsening of the output gap. In 2002 fiscal policy was neutral in the face of a strong fall in the output gap. Since 2003 it has pro-cyclically tightened despite further substantial drops in the output gap. In the five remaining countries, fiscal policy was pro-cyclically restrictive – weakly in Spain, but strongly in Portugal and Austria – over the whole period from 2001 to 2005.

This is in striking contrast to the US, where fiscal policy from 2001 to 2005 was very expansionary with an average annual increase of the cyclically adjusted budget deficit of 0.9% (Table 4). There has not been a single year with a pro-cyclical fiscal policy during the economic downturn. Since 2005, the second year with an improving output gap, US fiscal policy has returned smoothly to careful restriction.

The restrictive and pro-cyclically destabilising fiscal policy reactions to the post-2000 crisis in several countries have without doubt contributed to the ongoing stagnation after 2000 within these countries and in the euro area as a whole. With the exception of Greece and to some extent also France, all the countries with excessive deficit problems stopped their initially expansive fiscal policy and were driven into pro-cyclical, restrictive measures after their deficit had reached the 3% of GDP level. Of course, fiscal policy is only one factor in the explanation of macroeconomic performance. However, with respect to GDP growth it is striking that all of the four countries with below euro area average growth rates (Germany, Italy, the Netherlands and Portugal) suffered from restrictive fiscal policies, while of the three countries with above average growth rates, two (Greece and Finland) had expansionary fiscal policies.

Given the widespread complaints about countries' failure to keep to the 3% limit, it is interesting to speculate what would have happened if countries had done so. A simple back of the envelope calculation for the year 2003 illustrates the probable consequences for the European economy: In 2003 five countries exceeded the 3% limit, the two largest economies France and Germany with 1.2 and 1.0% of GDP respectively. Even if only these two countries had stuck to the SGP, a negative fiscal stimulus of at least 1.8% or 1.5% of GDP would have occurred, taking into account negative macroeconomic repercussions of fiscal restriction on the budget deficit. Given that at the time France was growing only at a rate of 0.8%, whereas Germany was technically already in recession with a rate of -0.2, a fiscal restriction in that order of magnitude would have driven both France and Germany, and soon afterwards probably the whole euro area, from stagnation into a serious recession

In the light of these results, it was high time for a reform of the SGP. The recent reform of the SGP (spring 2005) certainly brought some important changes. Alongside substantial modifications with respect to the medium term objectives, which permit some deviation from the close to balance or in surplus rule depending on national circumstances, the application of the excessive deficit procedure (EDP) has been reformed.

Table4: Indicators for fiscal policy in the euro area countries and the USA, average values, 2001-2005*

	Euro area	USA	Germany	France	Italy	Spain	Austria	Belgium	Finland	Greece	Ireland	Netherlands	Portugal
Budget balance (% of GDP)	-2.6	-3.5	-3.6	-3.2	-3.4	-0.1	-1.0	0.1	3.2	-5.7	0.2	-1.8	-3.8
Budget balance (% of GDP), annual change, percentage points	-0.4	-1.1	-0.5	-0.3	-0.5	0.3	0.0	0.0	-1.0	-0.1	-1.1	-0.6	-0.5
Cyclically adjusted budget balance (% of cyclically adjusted GDP), annual change, percentage points	-0.1	-0.9	-0.1	-0.1	-0.3	0.3	0.4	0.3	-0.8	-0.2	-0.8	0.1	0.1
Output gap, (% of cyclically adjusted GDP), annual change, percentage points	-0.6	-0.3	-0.8	-0.5	-0.5	-0.1	-1.0	-0.5	-0.5	0.4	-0.8	-1.4	-1.4
Number of years with procyclical fiscal policy during an economic slowdown	3 (2003-2005)	0	3 (2003-2005)	1 (2005)	3 (2002-2004)	2 (2002-2003)	3 (2001-2002, 2004)	4 (2001-2003, 2005)	1 (2005)	1 (2005)	2 (2003-2004)	2 (2003, 2005)	3 (2002-2004)
Negative fiscal stimulus in economic slowdown, cumulated (% of potential GDP)	0.5	--	1.1	0.5	0.8	0.9	3.0	1.9	0.5	2.2	2.8	1.2	3.8

Notes: *Forecast values for 2005

Sources: OECD: Economic Outlook, No. 78, December 2005, http://www.oecd.org/document/61/0,2340,en_2649_201185_2483901_1_1_1_1,00.html authors' calculations

In applying the EDP, the Council has specified the 'relevant' factors' to be used in determining whether a country exceeding the 3% limit 'really' has an excessive deficit.

1 The previous exception of a severe economic downturn has been softened to allow for an accumulated loss of output due to protracted very slow growth.
2 Spending on the Lisbon agenda, especially R&D and innovation policies.
3 Debt sustainability – which is to be given greater relevance – and public investment.
4 Financial contributions to international solidarity and European unification.
5 Pension reforms (an allowance being made for up to five years for countries introducing fully funded systems).
6 The deadlines before identifying excessive deficits, taking action following a policy recommendation, and for the deficit to actually be corrected have all been extended.

The reform has addressed some of the most obvious failings of the SGP as originally designed. There is no economic justification for a 3% limit. While that limit has been reiterated, countries facing difficulties in meeting the 3% ceiling or the close to balance medium-term target now have a whole range of possible factors that they can call upon to justify their inability to meet the targets. The additional scope created to invest public money – as required under the Lisbon Strategy – in areas such as infrastructure and education is an important step.

However, as the recent recommendations by the Commission and the decisions by the Council concerning the EDPs against Germany, Italy and Portugal have demonstrated, the practical utility of the reform is very limited: In these cases both the Commission and the Council have taken a rather narrow view and do not seem to have conceded the full leeway offered by the reformed SGP. Despite the fact that economic recovery is only weak and uncertain, a rather ambitious and risky consolidation path has been called for (see 'Economic policy gambling with the recovery' above).

In terms of short-term reform proposals, it would have been preferable to indicate clearly in advance those areas of spending which are considered to be public investment and then to exclude such spending from the deficit calculation. Sluggish growth in recent years plus the need for countries to invest in achieving the Lisbon targets should have led to a coordinated strategy of additional investment in the Lisbon priorities at national level, permitted by temporary derogation from the Pact. Reflecting the original idea of the Pact to avoid some countries putting upward pressure on interest rates to the detriment of others, the national inflation rate should be taken as an important indicator of the scope for countries to pursue expansionary – or the need for restrictive – fiscal policies; the derogation might not be extended to countries where inflation is significantly above the ECB target.

Regarding more longer-term reform proposals for fiscal policy within EMU, the Autumn 2005 IMK/ETUI forecast presented a detailed proposal for a fiscal policy strategy that takes account of cyclical considerations while focusing attention on those variables that are actually under its control, that is the non-cyclical components of public spending (primarily government consumption and public investment). The recommendation is to set a medium run target for these non-cyclical elements of public spending that is below the trend nominal rate of GDP growth. Meanwhile cyclically sensitive components of spending (such as transfer benefits) are allowed to fluctuate over the cycle, acting as automatic stabilisers. Public investment might be excluded for a transition period from the spending cap in countries where it has fallen to sub-optimal levels, or as part of a coordinated strategy to invest in the Lisbon priorities, but in the medium run should be subject to the spending norm. To avoid undermining consolidation on the spending side, any tax cuts must be offset by other sources of revenue (only revenue-neutral tax reforms). Such a strategy would give all actors confidence in longer-run consolidation and debt reduction, while ensuring cyclical stabilisation and permitting the necessary boost to growth and public investment in the shorter run.

In designing fiscal policy rules or guidelines, it is crucial to be aware of the specific context, in this case the overall framework of economic governance in EMU. Concepts derived from national policymaking models may well be inappropriate. In a monetary union national fiscal policy will have to play a much more important role in economic stabilisation. This is firstly because fiscal policy is the only way that national policymakers can react to offset country-specific (asymmetric) demand shocks. Secondly, it may be an important or even – in countries lacking corporatist wage-setting institutions – the only national policy instrument to adjust national competitiveness, should this become necessary within the currency area (Given a common nominal interest rate and fixed nominal exchange rates it is only relative shifts in wages and prices, i.e. changes in the real exchange rate, that can bring about adjustment).

Clearly a basic condition is that national fiscal policies have to be sustainable, but subject to that – and assuming that monetary policy is 'optimal' for the area as a whole' – the prime role of fiscal policy should be to provide stabilisation for the respective national economy. More specifically it should seek to maximise growth and employment opportunities while contributing as far as possible to the goal that the national inflation rate is compatible with the overall area-wide inflation target. Thus a country hit by a specific negative demand shock (with a ceteris paribus disinflationary effect) should adopt a more expansionary fiscal stance. Similarly, a country in which inflation is high relative to the average may need to take corrective action by tightening policy. Depending on the size of the shock and national specifics of the welfare and tax systems, the automatic stabilisers may or may not be sufficient to do this.

An important caveat to the stabilisation role in the context of competitive adjustment is, however, that the impetus for the policy (an excessive or too low inflation rate) results from a shock that needs to be corrected. In some circumstances, the inflation differential may itself be part of an adjustment process and thus desirable, however. A country that, in the past, has lost competitiveness, for instance, needs to have a lower real exchange rate. Up until the point where competitive equilibrium has been re-established, however, fiscal policy should not try to counteract the development. Competitive adjustment is primarily the task of wage policy (although experience has shown that this mechanism works sluggishly, particularly in the larger economies (see next section). Otherwise adjustment will be prevented and the fiscal sustainability condition will ultimately be violated.

The relative disinflation that this implies will, via the higher real interest rate (at a common nominal interest rate), tend to be self-fuelling, however. There is a real danger of overshooting (in both directions). In particular, with a low target inflation rate of 2% for the area as a whole, relative disinflation can quickly turn into national deflation, which must be avoided. An overambitious inflation target, for a monetary union that is still 'immature' and where significant inter-country adjustment processes are likely, can therefore place a huge strain on national fiscal policy.

Responsibility for fiscal policy to ensure stabilisation cannot be left entirely to national actors. As noted earlier, fiscal policy makers (and wage setters) might see an advantage in deliberately undervaluing the real exchange rate (through some combination of a relative tightening of fiscal policy and corporatist wage moderation). Such beggar-thy-neighbour policies via the real exchange rate are damaging at the area-wide level, and appropriate information exchange and coordination mechanisms (Eurogroup, Marcoeconomic Dialogue) should be reinforced to counter such trends. What is important, though, is that the focus here is equally on damaging, excessive fiscal and wage 'discipline' as on profligacy.

Wage policy – no danger to price stability, but to the integrity of the euro area

Nominal wage growth in the euro area will remain moderate during 2006 and 2007. There is no sign of either past rises in import prices and tax hikes nor the hesitant economic recovery generating inflationary wage increases.

Wage trends in the euro area are set to remain below the sum of productivity growth and the price stability target of the central bank – at this 'benchmark' rate there is no shift in the functional income distribution between labour and capital and neither inflationary nor deflationary wage pressure. In both 2006 and 2007 wage increases are forecast to lag 1pp. below the benchmark. Nominal unit labour costs, which serve as a medium-run anchor for domestic price inflation, will be below 1% in both years. The overview of important collective agreements in 2005 and 2006 (which have lagged impacts on actual wage trends) clearly show that organised labour has not sought, or been able to achieve, compensation for higher indirect taxes or energy prices (Table 5). Collectively agreed wages are expected to remain at about the level recorded in 2005 (2.2% for negotiated and 2.5% for hourly wages)

Against this background it is difficult to understand the constant calls by policymakers and many economists for vigilance concerning wage developments and the need for ongoing wage moderation to gain ‘competitiveness’. Such calls have become vocal once more not least in the context of pay rounds, accompanied by strikes, in the German metal and public sectors. Especially the former is often considered to have a pilot function for the entire German economy, and thus for the euro area as a whole. Indeed, the ECB’s two rate hikes can be interpreted as an attempt to fire a warning shot at collective bargainers. It is therefor vital to correctly understand the underlying wage bargaining systems.

Table 5

Pay agreements in the euro area 2005 and 2006

	2005	2006
Spanish national guideline		Below 3%
Netherlands' coordination rule of trade unions	1,25	2
Netherlands - KPN	1,5	1,5
Netherlands-ABN	1,5	2
Belgium's wage ceiling	2,25	2,25
Finland national agreement	2,5	2,1
Austrian banking		3%
Spain, public sector		3%
Italian food	6.3% from May 2005 to March 2007	Amounts to 3.4%
Italian telecom		96 euro (2006-2008 agreement)
Ireland		Discussion on three-year national pact, possible wage increase of 3–4% per year

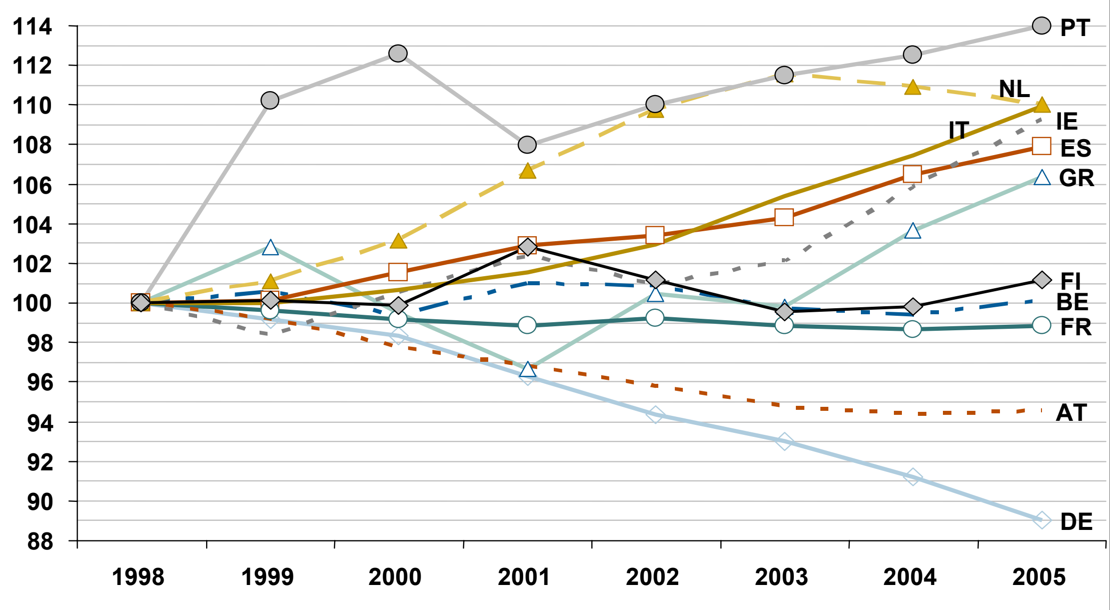
IG Metall’s pay claim of 5% was widely denounced as excessive. Yet before conclusions are drawn from this by other policymakers, it is important to look at the whole picture[24]. Most obviously, the 5% figure is the claim and not the outcome. Actual outcomes are typically considerably lower (e.g. 2004: 4% claim and 2.5% outcome), suggesting a likely outcome in the region of 3%. Secondly, the specific situation of the German metal sector, which has benefited from booming exports and where profits are high, must be taken into account: 2006 settlements in important sectors (chemicals, public sector, construction) are all below 2%. Thirdly, Germany has seen an increasing gap between collectively agreed and actual wages, as opening clauses in regional-sectoral agreements lead to concession bargaining between employers and plant-level trade unions: faced with high unemployment and the threat of relocation, unions and works councils have often agreed to wage increases below the collectively agreed rate and/or to longer working hours without higher pay.

Finally, the relative situation of the different member states of EMU must be taken into account (Figure 6). As noted earlier in this report, Germany (and to a lesser degree Austria) have pursued a strategy of consistent relative wage moderation vis-a-vis the other members of the euro area. Germany has improved its price competitiveness with respect to the EMU average by a massive 10% since the start of monetary union. Meanwhile other countries, particularly in southern Europe, have lost price competitiveness to about the same degree. These trends are unsustainable. They must be reversed (in the Netherlands this process has already begun) if the monetary union is not to come under growing pressures that will lead to protectionism and, ultimately, threaten the very existence of the monetary union. Logically this implies slower unit labour cost and price increases in those countries with widening current account deficits, but also faster wage growth in Germany.

[24] Cf. R. Janssen and A. Watt (2006) ‘Monetary policy tightening in a fragile recovery: are the ECB’s concerns about wage formation justified?’, European Economic and Employment Policy Brief, 1-2006 (http://www.etui-rehs.org/media/files/eeepb/2006/1_2006)

Figure 6

Real effective exchange rates



Source: DG ECFIN AMECO database.

Unfortunately there is little sign of the latter. German nominal unit labour costs are again expected to be negative in 2006 and 2007 (–0.5 and –0.4%), marking a softening but not a reversal of past trends. Collectively bargained wages will scarcely exceed 1%, effective wage increases will be below 1% (wage drift will remain negative, although less pronounced than recently) and real wages will once again fall. This implies severe pressure on wage and price setters in the other countries in the coming years, not merely to reduce the pace of wage and price growth, but actually to cut nominal wages. That would be to embark on a policy of 'competitive stagnation' within the euro area with the risk of spilling over into deflation. It is therefore vital that wage growth in Germany (and Austria) recover to permit the adjustment process to occur smoothly. The ECB must avoid being distracted by spurious signals from money supply figures, energy prices and pay claims in specific sectors from the fact that overall demand in the euro area is inadequate. The focus of monetary policy should be on closing the output gap as quickly as possible. As well as being desirable in itself, this would also permit the inter-country adjustment process to take place without imposing deflation on large areas of the monetary union. Meanwhile, wage coordination mechanisms should be strengthened so as to ensure that national wage developments do not – unless this is necessary to redress previous imbalances – deviate for extended periods from the productivity-plus-price-stability benchmark. This would simultaneously avoid competitive tensions rising within the euro area and provide monetary policy with an effective anchor to inflation expectations, permitting it to test the actual limits of potential output growth in the euro area.

A second basic feature of wage developments in most European countries is the trend towards increasing wage differentials, leading to greater income inequality and an increasing phenomenon of people suffering poverty despite holding a full-time job ('working poor'). This has important impacts for social cohesion – supposedly also a goal, if a subordinate one, of the Lisbon Strategy and European policymaking – but also a number of economic implications: poverty wages exacerbate unemployment and benefit traps (and in turn put downward pressure on benefits protecting the weakest in society). Perhaps more importantly, poverty wages reduce the incentives to innovate and raise productivity. Along with the weakening and decentralisation of collective bargaining referred to above, this would appear, alongside purely cyclical factors, to be an important explanation for the slide in productivity growth in Europe.

An important instrument against the spread of 'working poor' in European countries is the minimum wage. Most European countries have an explicit statutory minimum wage; in others the minimum wage is set by collective agreement. Against the background of growing pressure in the low-wage sector and increasing difficulties in maintaining the coverage of protective collectively agreed minimum wages, an intensive debate has begun in a number of countries, most notably Germany, on the introduction of a statutory minimum wage. Parallel to this, and against the background, in particular, of EU enlargement, the debate about the free movement of workers within the EU and, not least, on the services directive, there has also been growing interest in the idea of a 'European minimum wage'[25].

In standard economic textbook models, in which the labour market is seen as a perfect market, with the real wage as the 'price', unemployment results from a real wage that is above the market-clearing price. On that view minimum wages are widely seen as being a causal factor for unemployment by forcing wages, for certain groups of workers, above productivity, and thus pricing those groups out of the labour market. Such unemployment is 'involuntary' in the sense that workers are not allowed to work at what would be the market-clearing price (real wage). Apart from the (macroeconomic) difficulty that the minimum wage is set nominally, whereas it is the real wage that is important, the traditional approach also encounters major problems once real-world features of modern labour markets are taken into account.

In some more recent literature[26], the fiction of perfect competition is dropped, and the labour market is conceived as a market in which the demanders of labour (employers) have more market power than suppliers (workers). They can thus influence wages. Like the standard neoclassical analysis of monopoly, these monopsonistic labour market models do not assume total control, but rather that, with regard to the competitive situation vis-à-vis other firms, employers set the wage at a level that is optimal from their particular point of view. In such models minimum wages can actually increase the employment of low-paid workers. In the absence of a minimum wage employers pay wages that can be substantially below the competitive wage rate. To the extent that labour supply depends on the wage rate, this will reduce labour supply and thus also employment. A higher minimum wage rate raises labour supply and – provided the minimum wage is not above the competitive rate – also employment. For even at the higher rate firms make profits (although margins are less than before) and thus have an incentive to take on additional labour.

Thus even from a neoclassical perspective the issue is not about artificially raising a wage rate that has been formed on a competitive market (and thus reducing employment). Rather the point is to raise a wage rate that has been set too low on an imperfect market in the direction of the competitive rate. In such a context a minimum wage policy can be seen as a form of competition policy with positive effects on growth and employment.

From a Keynesian perspective in which labour supply does not react elastically, the advantages of minimum wages are even clearer. In a context of inadequate demand there is involuntary unemployment. If labour supply is totally inelastic, the introduction of a minimum wage initially leaves employment unchanged. Employees' incomes rise, however, with the higher wages. This leads indirectly to higher employment as workers' consumption, and thus aggregate demand, rise with the higher income. The impact of such an effect should not be overstated, however, as the increase affects only a segment of the labour market.

Against this theoretical background it is not surprising that many studies, both for individual companies[27] and at the macroeconomic level[28], have shown positive employment effects from minimum wages. All these studies suggest that firms' profits are lower, even if they can to some extent pass on, due to a degree of monopoly power on goods markets, their higher costs to consumers in higher prices.

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[25] T. Schulten, R. Bispinck, C. Schäfer (eds) (2006) *Minimum wages in Europe*, ETUI-REHS: Brussels.

[26] For an overview see J. Dolado et al. (1996) 'The economic impact of minimum wages in Europe', *Economic Policy*, Vol. 23: 319-372, and A. Manning (2003) *Monopsony in motion. Imperfect competition in labour markets*, Princeton University Press.

[27] Particularly noteworthy is the seminal work by D. Card and A. Krueger (1994) 'Minimum wages and employment. A case study of the fast food industry in Pennsylvania', *American Economic Review* Vol. 84(4), pp. 772-793, and (2000) 'Minimum wages and employment. A case study of the fast food industry in Pennsylvania: Reply', *American Economic Review* Vol. 90(5), pp. 1397-1420.

[28] Most recently M. Draca, J. Van Reenen (2006) 'Minimum wages and firm profitability', *CEP Discussion Paper*, No. 71, February 2006.

How minimum wages are best set is a difficult question, the answer to which will depend on the institutional features of the country in question. Strong and effective trade unions may be seen as a 'first-best' solution. Ideally, they balance out competitive relations on different labour market segments in a flexible way, preventing monopsony, but also the risk of politicising wage setting and possibly creating wage pressure in some areas of the labour market that could cost jobs. However, in many countries trade unions lack the organisational resources to perform this function. In others, high unemployment, labour market policies and changing structural features of labour markets and production systems have seriously weakened their ability to do so. In such a context, statutory minimum wages can be seen as a feasible second-best alternative. This matches with the experience in the UK, where a weakened trade union movement shifted its position in favour of a national minimum wage: that introduction is widely seen to have both lifted large numbers of people out of poverty without negative effects on employment. In the specific context of Germany, where an intense debate has opened on the minimum wage, its introduction could help to prevent the downward spiral of wage trends characteristic of recent years, reducing the risks to growth, employment and stability, not only in Germany but also in the euro area as a whole.

Clearly, major differences in terms of income, productivity, price levels, etc. mean that a European minimum wage in the sense of a flat rate figure for all European countries is a non-starter. What would be perfectly feasible, however, would be to have a European-wide benchmark such that the minimum wage in each country should be no less than a specific percentage of the average wage of that country. Under discussion are figures of 50% or 60% of the national average wage. Countries would be free to choose the appropriate institutional mechanisms to meet this requirement. At the national level this would go some way to halting or even reversing trends to greater wage and income inequality. In the European context it would help to resolve some of the social and legal conflicts currently raging in the context of the freedom of movement of workers, the use of posted workers to perform work in other EU countries and the services directive. An ever more integrated European labour market requires a basic set of rules at European level if the benefits of the single market are to be spread widely across the population. A European requirement that employers in each EU country pay a minimum wage appropriate to national conditions could help underpin such a framework, and be a step on the way to a process of upwards convergence of wages and living standards[30].

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[30] For an extended discussion of such issues see the articles in T. Schulten, R. Bispinck, C. Schäfer (eds) (2006) *Minimum wages in Europe*, ETUI-REHS: Brussels.