Euro area economic trends 2006: Time for a new economic policy approach

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World economy: on an upward but narrow path

Despite the various pressures on it, the world economy continues to expand virtually unabated. The regional divergences remain, however. Whereas in North America and eastern Europe output growth has remained almost as strong as previously, and this is expected to continue, the economic dynamic in the European Union, and particularly the euro area, remains weak. Importantly, Japan has emerged from its long crisis and entered a moderate but stable growth path, while in China restrictive government policies have reduced the danger of overheating and a subsequent hard landing. In the other Asian countries, too, growth continues at a rapid pace (cf. Table 1).

Table 1

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

	GDP			Consumer prices			Unemployment rate (%)		
	2004	2005 1)	2006 1)	2004	2005 1)	2006 1)	2004	2005 1)	2006 1)
Euro area	2,1	1,2	1,5	2,1	2,2	2,1	8,9	8,7	8,5
USA	4,2	3,6	3,4	2,7	3,0	2,7	5,5	5,2	5,0
South east Asian emerging markets 2)	5,7	4,3	4,8	3,5	4,3	4,0	k.A.	k.A.	k.A.
China	9,5	9,2	9,0	3,9	2,0	3,0	k.A.	k.A.	k.A.
Japan	2,7	1,8	2,1	0,0	-0,1	0,1	4,7	4,3	4,0
Total 3)	2,9	2,1	2,4	-	-	-	-	-	-

1) IMK forecast

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.

Source: National and international statistics, IMK forecast.

The global economic upswing can currently be described as self-sustaining, in the sense that economic policy is now only providing limited stimulus, if any. In almost all regions fiscal policy has tended to reduce public deficits, so that fiscal policy measures no longer provide a stimulus. More importantly, monetary policy in the USA has steadily tightened its policy stance, pushing up short-term interest rates substantially above their low points. At the same time, long-term interest rates in the USA, and world-wide, remain unchanged at a low level. This is an indication of low inflation expectations, but also of a limited propensity to invest in real capital relative to the liquidity available.

However, under the seemingly favourable surface of dynamic world economic growth, worrying developments have emerged that raise doubts about the sustainability of the global upturn. Two main factors seem to be behind this. The first is a scarcity of natural resources and the second is regional imbalances.

Raw materials and energy appear to constitute a new bottleneck for global output. Massive price increases for energy and other raw materials have been caused by two factors: the integration into the world economy of large countries, such as India and China that, because they are growing so fast, have substantially raised their energy consumption, and capacity constraints in refining petroleum and a lack of competition in energy supply. Although these price hikes are, on the face of it, merely shifts in relative prices, given the macroeconomic importance of energy, which is required for the production of virtually every good and service, energy price increases have knock-on effects in other sectors, pushing up the overall rate of inflation. As long as this is not passed on in the form of higher wages – and this does not currently appear to be happening– there is no serious risk of inflation. On the other hand, this puts all the more pressure on real incomes and – where higher costs cannot be passed on fully in higher prices – on profits. Both have negative implications for economic activity and thus pose a threat to the sustainability of the recovery.

The second factor is the regional imbalances. The unevenness of the global economic recovery has already led to a very substantial current account deficit in the USA, one that is not expected to narrow during the forecast period. At the moment the USA is not encountering problems in financing the deficit, because the high levels of global liquidity, combined with the strength of economic growth in the USA, have clearly induced investors to put their money on the US. The question is for how long they will continue to do so as America’s foreign indebtedness rises. This cannot be forecast and therefore a change in behaviour is not assumed to occur during the forecasting period (2005-06). Even so, this forecast does clearly point to a continued cyclical divergence between the USA and the euro area. Consequently, the risk of a reaction by international investors continues to grow. If such a reaction occurs, the dollar would decline in value dramatically and both inflation and interest rates in the US would rise appreciably. There is a risk of a recession in the US, primarily on the back of a collapse in private consumption. This would deprive the global economy of its main locomotive, and the impact would be dramatic, especially for the euro area. The hopes for a recovery would be dashed once more.

In contrast to earlier recoveries, and especially to earlier oil-price shocks, inflation is not a prime concern. In the past, excessive wage claims following long periods of robust economic growth were the main cause of inflation. In an increasingly globalised economy it is evident that the scarcity of labour has been substantially reduced. Competitive pressure on labour markets has risen world-wide, so that even in countries such as the USA, where unemployment has been at low levels for a long time, inflationary wage pressure has not had a chance to develop. This is all the more true of regions such as the euro area, where employment growth has been far less dynamic. This is also what is behind the low inflation expectations throughout the world. In other words, although the recovery is now self-sustaining, the global economy has not yet reached the limits of its productive potential. The change in global competitive conditions, to the disadvantage of workers as a result of globalisation is making its effects felt. The problem is that economic policymakers have not yet taken sufficient account of this, for their decisions ought to be based on a higher assumed growth of potential output. Consequently, the basic stance of economic policy ought to be more expansionary.

Table 2

Assumptions of the forecast			
	2004	**2005**	**2006**
Three-month money market rate (%)	2,1	2,1	2,2
Yield on ten-year government securities (euro area, %)	4,1	3,4	3,7
Yield on ten-year government securities (USA, %)	4,3	4,3	4,8
Exchange rate (USD /EUR)	1,24	1,26	1,23
Real effective exchange rate (consumer prices, broad group of countries)	105,4	103,8	101,7
Competiveness indicator of the German economy (consumer prices, 49 countries)	98,8	97,5	95,6
Collective agreement index (Bundesbank, per hour)	1,2	1,2	1,3
Oil price (Brent, USD)	38	56	61
Source: Deutsche Bundesbank, ECB, IEA, Federal Reserve, 2005 und 2006: IMK forecast			

The euro area lacking in dynamism

Cyclical developments in the euro area since the start of this year have been disappointing. Not only has the widely expected upturn not materialised, the pace of economic activity has actually slowed somewhat. The main reason is almost certainly the negative impact of the oil-price shock. However, there is a second reason that is linked to the first. Increasingly, the downward pressure on wages coming from, in particular, Germany is making its effects felt in other countries of the euro area. Spain and Italy remain as exceptions to this rule. Wage moderation at the euro area level has far-reaching consequences.

In order to evaluate the impact of the downward wage pressure emanating from Germany, it is important to recall two important factors. First, the euro area is an internal market that is there is a direct competition, not mitigated by exchange rates, between all the suppliers from the member states for the custom of all those demanding goods and services on all euro area markets. Second, economic developments in the euro area depend only to a minor degree on global economic developments. Just as in the USA, it is the domestic economy that is decisive.

One remarkable fact is that the very substantial energy price rises of recent years have led to only a slight acceleration of inflation. Over the forecast period inflation is expected to be only slightly higher than 2%, and thus almost in line with the ECB's medium-run inflation target, despite the dramatically higher energy prices in both years. This was also what happened during the oil price shock at the start of this decade. This is in complete contrast to previous oil-price shocks which led to, in some cases dramatic, rises in the rate of inflation.

Even so, the energy price rises themselves will have raised the cost pressure on firms. However, to a very substantial degree this was offset by the extremely moderate wage trends, enabling firms to bear the increase in costs without suffering a severe decline in profits. This is an indication of the impact of the wage pressure emanating from Germany which, via declining competitiveness, forces the other euro area countries to follow suit. The upshot of this is that real wages in the euro area have stagnated and, indeed, on most recent figures, have probably even declined, while unit labour costs have risen only slightly. Thus wage developments are not inflationary, in spite of the oil-price shock. In fact, on the contrary, labour costs, in spite of the fact that productivity growth has been depressed for cyclical reasons, would, taken by themselves, lead to inflation rates that are substantially below the ECB target.

In spite of the weakening of economic activity, economic policy has not given an additional impulse to the business cycle. Monetary policy has remained unchanged – albeit at an expansionary stance – despite increasing wage moderation and declining growth rates. Fiscal policy-makers have continued their attempts to consolidate public finances, albeit without much to show for it. In terms of the business cycle fiscal policy was more or less neutral.

Against such a background it was inevitable that consumption has remained weak. This also had knock-on effects on investment, whose rate of expansion has slowed to a very modest pace.

It is domestic trends that are driving the overall economic results. Given the size of the internal market, the impulses from foreign trade are minor, all the more so given that during the forecast period exports and imports will grow more or less in parallel. As a result the growth prospects for the euro area during the forecast period remain bleak. This year GDP growth will be 1.2%, with 1.5% forecast for next year (cf. Table 3). This is considerably below the potential growth rate: as such, the period of cyclical weakness in the euro area continues. The growth path on which the euro area economy found itself as recently as 2000 will not be achieved for the foreseeable future, even if growth is expected to pick up slightly next year.

Table 3

Key forecast figures[1] for the euro area
% change on previous year

	2003	2004	2005	2006
GDP	0,7	2,1	1,2	1,5
Private consumption	1,0	1,5	0,9	0,9
Government consumption	1,5	1,1	0,9	0,8
Gross fixed capital formation	0,8	1,8	1,0	2,6
- Construction	1,1	0,8	-0,3	1,8
- Machinery, equipment, other products	0,4	2,9	2,3	3,3
Net exports[2]	-0,7	0,1	0,0	0,2
Current account balance[3]	0,3	0,6	0,2	0,2
Employees	0,2	0,6	0,5	0,5
Unemployment rate[4]	8,7	8,9	8,7	8,5
Unit labour cost	1,8	0,9	1,3	0,7
Inflation (HICP)	2,1	2,1	2,2	2,1
Budget surplus/deficit[3]	-3,0	-2,7	-2,7	-2,5
Gross government debt	70,4	70,8	71,7	71,8

[1] at constant prices

[2] contribution to growth

[3] % of nominal GDP

[4] % of the labour force

Sources: Eurostat, ECB, calculations of the IMK, 2005 and 2006 IMK forecast.

Private consumption stagnating

Overall the euro area economy expanded only slightly faster in the first half of 2005 than in the second half of 2004. Moreover, the growth rate in the second quarter was actually slightly lower than in the first (0.3% compared with 0.4%).

Private consumption was flat at the start of the year and actually declined during the second quarter. The renewed sharp rise in oil prices was not the only factor impinging on private households: the very depressed wage growth also contributed to the only marginal rise in real earned incomes. Public consumption, on the other hand, did expand somewhat faster during the first half of 2005.

The conditions for foreign trade remained favourable in the first half of the year. Euro area competitiveness improved significantly following the depreciation of the euro against the dollar. At the same time the economic dynamic in both Asia and the USA eased back only slightly. During the first two quarters of 2005 net exports accounted for 0.2 percentage points - and thus around half - of GDP growth on average, although this primarily reflected a drop in real imports.

Given such sluggish demand growth it is hardly surprising that investment in equipment expanded only slowly, while investment in construction contracted once again. Although corporate profits have grown strongly and the stock markets have risen substantially since the start of the year, this largely reflects success in cost-cutting, rather than rising capacity utilisation.

In spite of the weak cyclical dynamic, employment rose slightly at the start of the year, and unemployment has fallen to 8.6%. Wages, on the 'compensation per employee' measure, expanded only very slowly: in the first quarter they were up 2.2% on the same quarter the previous year. Thus for the euro area as a whole wages lagged significantly behind the norm (the 'scope for distribution') of the sum of the target inflation rate of the ECB and medium-run productivity growth. However, this average masks significant differences between the countries. Whereas wage trends in Spain and Italy were significantly above the norm, in Germany, Austria and the Netherlands they were considerably below.

The core inflation rate, excluding energy, food, alcohol and tobacco, which is a better guide to medium-run inflation than the headline harmonised index of consumer prices (HICP), was just 1.3% in August 2005; this is largely explained by the sluggish growth of unit labour costs. On the other hand the drastic rise in oil prices has helped cause a sharp acceleration of overall consumer prices in recent months. According to Eurostat's flash estimate, the rate of HICP inflation in September was 2.5%[1]. Given an inflation rate at about this level and wage growth of just 2.0%[2], real wages have actually been falling.

[1] Besides rising energy prices, the rise in inflation is due to a considerable extent to higher administered prices. The International Monetary Fund (IMF) estimates their influence on the inflation rate at 0.7% in 2004 and 0.4% in 2005. Cf. IMF, Euro area policies, Washington July 2005, p. 8.

[2] Gross hourly wages and salaries (2nd quarter 2005), ECB Monthly bulletin, October 2005, p. S43.

No sign of a sustained improvement

A number of indicators point to a marginally faster rate of growth in the third quarter. The euroCOIN indicator (Centre for Economic Policy Research) has started to rise once more; the OECD leading indicator is, at least, not suggesting a further slowdown. Both the IMK and the European Commission[3] expect a GDP growth rate of 0.4% in the third quarter.

For the time being private consumption will remain the brake on faster economic growth. The second half of 2005 will see virtually no increase in consumer spending. Although a number of countries have announced measures to bolster economic activity, such as subsidies for heating costs, these will not nearly be large enough to offset the restrictive impact of the oil-price hike. As the oil price stabilises around the turn of the year, the pressure on private consumption is expected to ease gradually. In annual-average terms, though, private household consumption will not grow any faster next year than this (0.9%) (Table 3) Public consumption is also expected to rise at about a similar rate, and thus not to make any notable contribution to economic growth.

This year the government deficit of the euro area as a whole is expected to remain unchanged at 2.7% of GDP, falling slightly next year to 2.5%. As a result government debt will increase further to 71.7% of GDP this year and 71.8% next. In other words no progress will be made during the forecast period towards consolidating public finances.

Given that we assume no further depreciation of the euro and the rate of global economic growth will ease back slightly, net exports are no longer expected to make a positive contribution to economic growth this year; next year the growth contribution will be a modest 0.2 percentage points. The weakness of overall export growth masks considerable differences between countries. Whereas, for instance, Germany and the Netherlands will derive the greater part of their economic growth from their export surpluses, trade deficits in France, Italy and especially Spain will have the effect of dampening growth; indeed in Spain the negative growth contribution of net exports, at 2 percentage points will even be somewhat higher than last year.

Investment in equipment is forecast to pick up slowly during the prognosis period, parallel to the slightly improved consumption trend, expanding by 2.3% in the current and 3.3% in the coming year. In those countries in which net exports make the largest contribution to growth, the expansion of investment is likely to be considerably higher than this average figure. In the case of construction investment, the gradual stabilisation of the situation in Germany is beginning to exert a positive effect on the euro areas as a whole. Following a decline of 0.3% in the current year, an expansion of almost 2% is expected next year.

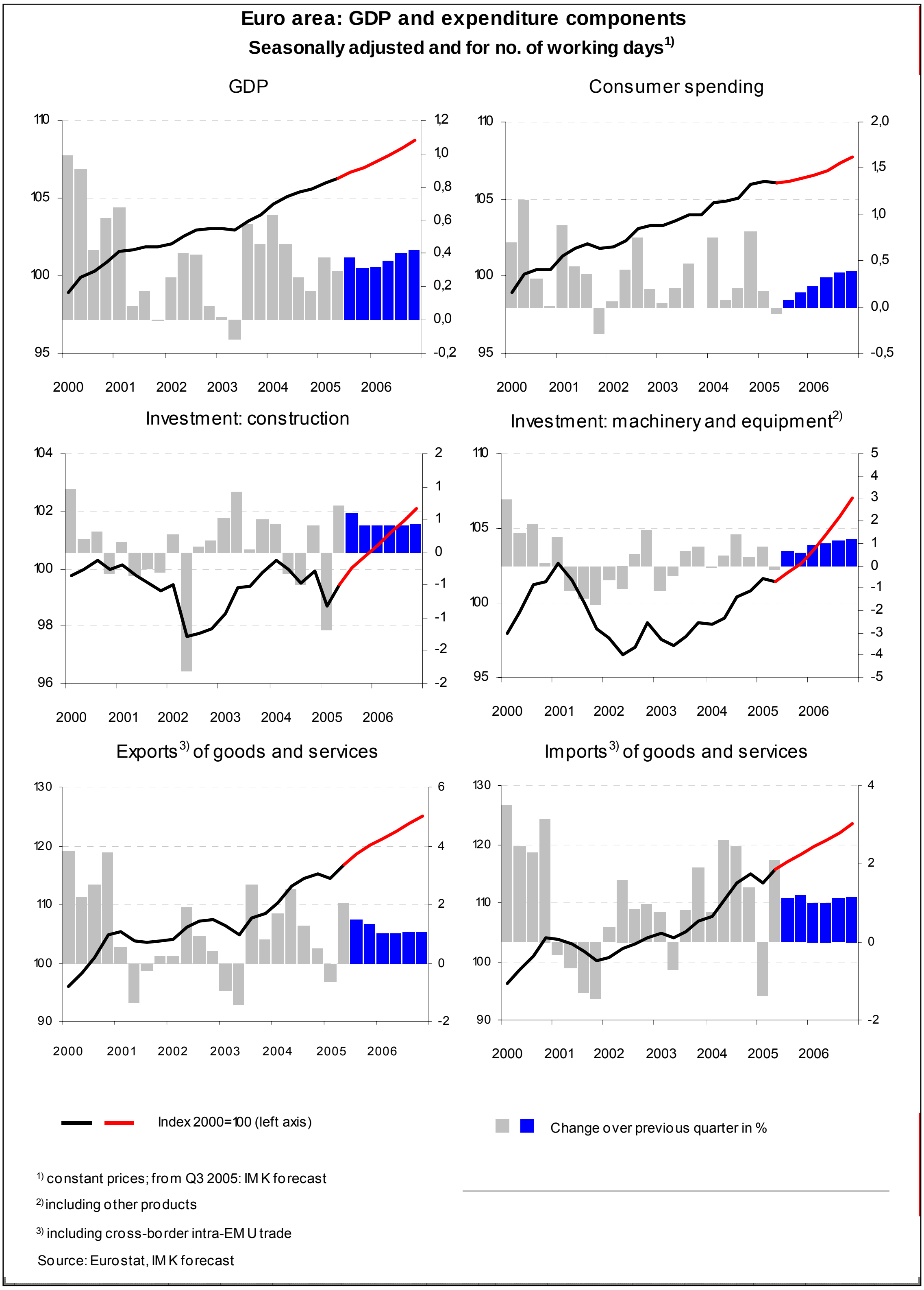
Overall, GDP is expected to grow by 1.2% this year and 1.5% in 2006. There will be no substantial acceleration going forward, though (Figure 1). The upturn is not yet self-sustaining, nor are additional positive impulses expected from either the global economy or economic policy.

Employment is forecast to expand somewhat more slowly during the prognosis period than last year. This implies a slight acceleration of productivity growth going forward. At rates of 1.3% this year and just 0.7% next year, unit labour cost growth will continue to be very low. This means that wage trends in the euro area will continue to exert downward pressure on inflation during the forecast period.

Inflation will continue to be driven primarily by the course of energy prices, which will continue to rise in the coming months. As a result, inflation, at 2.2% this year and 2.1% next, will temporarily lie above the target inflation rate of the ECB. At the end of the coming year, however, it will have returned once again to below 2%.

[3] Cf. European Commission, Key indicators for the euro area (6 September 2005), p. 2. In this case the figure is the midpoint between a forecast range of 0.2-0.6%.

Figure 1


Euro area: GDP and expenditure components
Seasonally adjusted and for no. of working days1)
GDP
Consumer spending
Investment: construction
Investment: machinery and equipment2)
Exports3) of goods and services
Imports3) of goods and services
2000 2001 2002 2003 2004 2005 2006
Index 2000=100 (left axis)
Change over previous quarter in %
1) constant prices; from Q3 2005: IMK forecast
2) including other products
3) including cross-border intra-EMU trade
Source: Eurostat, IMK forecast

Lopsided growth persists in Germany

Macroeconomic growth in Germany was extremely unbalanced in the first half of the year. After a decidedly spirited upturn in the spring, the economy almost came to a standstill in the second quarter of the year[4]. While the positive external balance seen in the first quarter still comfortably offset the decline in domestic expenditure, a sharper rise in imports subsequently dampened growth. Domestic demand growth was based exclusively on stock-building, while private consumer spending, in particular, decreased once again. The latter decline was probably not least a consequence of reduced purchasing power due to higher energy prices following the oil-price rises. The trend for investment in machinery and equipment remained positive.

A range of leading indicators suggest that a perceptible increase in economic activity can be expected in the second half of the year: Industrial output, for example, has risen sharply over the last few months, while incoming orders, in particular those from abroad, have also risen at an extraordinary pace. Moreover, the business climate has also recently improved once again. Despite all these signs, foreign trade will initially continue to make the most decisive contribution to the expansion, although export growth is likely to weaken to some extent over the forecast period, as world economic growth declines slightly. Exports will nonetheless remain the cornerstone of economic growth in Germany, mainly because German competitiveness on international markets, which is already strong, will improve still further as unit labour costs fall.

Germany's weak point remains its domestic economy. The decisive factors in this respect are the ongoing low rate of real wage growth and the volume of employment, which will continue to fall this year and will increase only slightly in 2006. The hope held by some that the loss of aggregate demand caused by wage moderation would be compensated by rising employment is still not being fulfilled, as weak income growth curbs the sales expectations of enterprises. The situation is being aggravated by the acceleration in inflation induced by the oil-price rises, which will reduce the real disposable income of private households both this year and next year. The consumption crisis, which is significantly curtailing economic growth, persists relentlessly. Thus, private consumer spending will once again fail to provide a positive impetus for the duration of the forecast period. There is a glimmer of hope for domestic demand in the form of machinery and equipment investment, which will be substantially expanded as profitability remains high and export sales continue to grow robustly. All in all, domestic demand is once again unlikely to contribute to GDP growth in 2005; next year, however, a contribution of half a percentage point can be expected. The share of growth accounted for by foreign trade will amount to around one percentage point per annum over the forecast period and therefore constitute the only source of growth this year and the strongest source by far next year. All in all, GDP is likely to rise by 1% this year and by 1.4% next year (cf. Figure 2 and Table 4).

[4] Because the procedure used for the calendar adjustment takes insufficient account of the sharp fluctuations in the number of working days, the figures are probably understated for the final quarter of 2004, overstated for the first quarter of 2005, and slightly understated again for the second quarter of 2005. Thus, the changes in the underlying rhythm are probably somewhat more moderate.

The lop-sided development of the German economy will therefore persist over the forecast period: On the one hand, the extraordinarily good performance of the export economy (also in comparison to other countries) and, on the other, the deep-seated weakness of domestic demand. One thing has changed, however, compared to previous years. While in recent years Germany has frequently demonstrated by far the lowest rates of growth in the euro zone, over the forecast period its performance in this respect is likely to be just below average. The reason will not be so much a sharp acceleration in German growth, but a weakening of the economies of the other EMU countries. Wages are now rising at a much slower pace in many countries – in reaction to the export problems that have gradually evolved as a consequence of the decline in their competitiveness compared to Germany. As a result, domestic demand (and especially private consumption) is also struggling in these countries. The imbalance in the German economy appears to be increasingly spreading to the rest of the euro zone.

Table 4

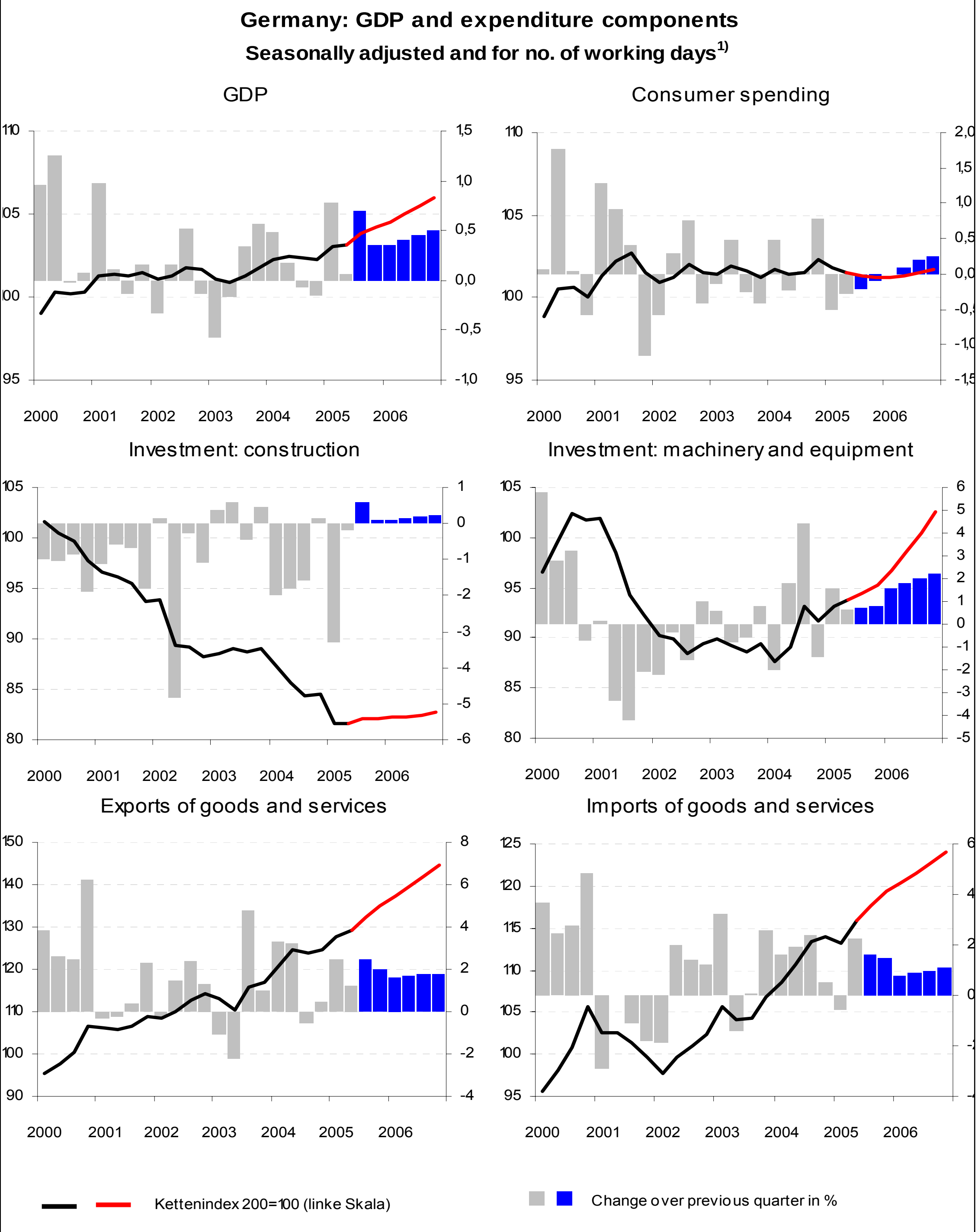
Key forecast figures[1] for Germany
% change on previous year

	2003	2004	2005	2006
GDP	-0,2	1,6	1,0	1,4
Private consumption	0,1	0,6	-0,5	-0,2
Government consumption	0,1	-1,6	-0,5	-0,5
Gross fixed capital formation	-0,8	-0,2	-0,8	2,7
- Construction	-2,3	-1,6	-4,7	0,3
- Machinery and equipment	-0,2	2,6	3,8	5,3
- other products	3,3	1,8	1,8	2,5
Net exports[2]	-0,8	1,1	1,0	0,9
Current account balance[3]	2,1	3,8	4,0	4,1
Employment	-1,0	0,4	0,2	0,6
Unemployment rate[4]	10,2	10,1	11,1	10,6
Unit labour cost	0,7	-1,1	-0,6	-0,4
Inflation (HICP)	1,0	1,8	2,0	1,5
Budget surplus/deficit[3]	4,0	3,7	3,5	3,1

[1] at constant prices
[2] contribution to growth
[3] % of nominal GDP
[4] % of the labour force

Source: Statistisches Bundesamt, calculations of the IMK, 2005 and 2006 IMK forecast.

Figure 2



1) constant prices; from Q3 2005: IMK forecast

Source: Statistisches Bundesamt; IMK forecast

High oil prices: their causes …

The price of oil in US dollars has more than trebled since the beginning of 2002. In Germany, for instance, the price of heating oil has increased by 50% over the last 12 months alone, while petrol prices have risen by over 25%.

The standard gauge for the prices of the different mineral oil products is the price of crude oil, which is determined by the prices charged on the international oil markets[5]. The next-to-expire futures contract determines the spot price for the actual amount of oil traded. The volume of futures contracts has expanded enormously since 2003 as institutional investors, including hedge funds, have begun to participate in the futures market. The transactions carried out in futures currently amount to around a hundred times actual output. This is why the price of oil may not always reflect the real situation on the market and is often over- or understated. A decisive factor are the market expectations of investors. These are primarily of a short-term and possibly also speculative nature, but are ultimately guided by developments on the real markets.

Crude oil output has regularly exceeded demand for the last two years. According to the forecasts produced by the International Energy Agency (IEA) and OPEC, this will also remain the case this year and next year. However, the expectations of the market participants are likely to be influenced to a greater extent by the following developments:

Since autumn 2003, as the economy has picked up, global demand for oil has increased more rapidly than previously. The additional demand has come from the Pacific area, especially China[6]. Forecasters were surprised by the rise in demand, as a comparison of the actual trend and the preceding prognosis indicates[7]. At the same time, the OECD countries increased their stocks substantially.

Most of the additional demand was met by OPEC, which sharply increased its output[8]. This had two consequences:

1. The importance of oil production increased substantially in the so-called crisis countries (Indonesia, Iraq, Nigeria and Venezuela, and also Iran), which account for almost 40% of OPEC’s output.
2. OPEC’s reserve capacity[9], which has a stopgap function on the global oil market, shrank to around 2 million barrels per day (mbd)[10].

Taken together, the relatively small reserve capacity and the relatively high share of production accounted for by ‘crisis countries’ led the futures markets to react very sensitively to politically or climatically determined disturbances to production.

This situation is exacerbated by a lack of refinery capacity, especially in the USA, where imports of mineral oil products increased by over 45% between 2002 and the second quarter of 2005. Not only the expansion, but also the modernisation of the refineries has been neglected, with the result that only a limited amount of heavy and sulphurous crude oil can be processed. The latest proposal by OPEC

[5] The oil markets were established in the early 1980s with a view to giving oil producers, traders and consumers a means to protect themselves against the risk of price alterations. “Paper barrels” are traded on the NYMEX, IPE and SIMEX futures markets. Only a small share of futures trading leads to actual delivery of “wet barrels”.

[6] Demand from China increased by around 1.5 mbd (million barrels per day) to 6 mbd between 2002 and 2004.

[7] One of the reasons it is difficult to forecast oil demand is that in some countries the elasticity of demand for oil can evidence sharp short-term fluctuations with respect to economic growth. This was the case in China. At 1.2 and 1.6 in 2003 and 2004, respectively, elasticity in China significantly exceeded 1. The IEA expects elasticity to fall below 1 both this year and next year (IEA, Oil Market Report, August 2005). The uncertainty of the forecasts, along with recent experiences, are likely to have made the oil markets even more attractive for speculators and to have encouraged them to expect rising prices.

[8] From over 25 mbd in 2003 to over 29 mbd on recent figures.

[9] The reserve capacity is defined as the additional output that can be achieved within 30 days and can be sustained for at least 90 days.

[10] Only less than 1 mb of this capacity is held by Saudi Arabia, which is considered relatively secure.

(which mainly delivers crude oil of this quality) to increase its output to 2 mbd and therefore exploit its total production capacity, thus had very little impact on the markets. The release of some of the stocks held in the USA and in Europe in reaction to the supply shortfalls caused by the Katrina and Rita hurricanes has not yet lead to a sustained decrease in the price of oil.

The high oil price serves to bring about a balance between supply and demand. The demand for oil is being curtailed by the decline in global economic growth and by the increase in energy efficiency. On the supply side, however, neither production nor refining capacities have been expanded. At least the market has not yet noticed any credible developments in this sense. At the end of September, Saudi Arabia’s oil minister announced an increase in production capacity from 10.5 mbd today to 12.5 mbd by 2009, but this has had practically no impact to date. And the large mineral oil companies, which may have suffered high losses in the first half of the 1980s, but have been operating at a profit since 1996 and achieved peak results last year[11], have been investing less in exploration and instead have secured previously developed oil fields by buying companies and company shares[12].

As long as there are no convincing indications of significant increases in both production and refining capacities that correspond to expected potential demand and enable an increase in reserve holdings, then crude oil prices are likely to remain high for some time.

… and their macroeconomic impact

The sharp rise in oil prices increases consumer spending in related areas. An assessment by the German Federal Statistical Office estimated that private households in Germany had additional direct oil and gas costs of 6.8 billion euro this year. ‘In mathematical terms, this means that each private household had to spend 176 euro more this year than last year’[13]. This corresponds to over 0.5% of private consumption. On top of this, the industrial sector’s rising energy costs in transportation and production will raise prices for the final consumer. The macroeconomic effects are more complex, however, and are difficult to quantify. Given that the higher prices for crude oil have increased the profits of oil companies in Germany, the fall in private consumption could theoretically be partially offset by higher spending on the part of these companies, but there is little sign of this actually happening. In addition, Germany’s trading partners are also affected by the rise in energy prices. Their additional energy costs are leading in turn to reduced purchases of goods and services. This decline is being counterbalanced by increased imports on the part of the oil-producing countries. However, the trend during the last oil-price hikes as well as today’s trend show that increased income from oil sales is never entirely ‘recycled’ in the short term. Consequently, the current account surpluses of the oil-producing countries are rising[14]. And so the oil-price rises can be expected to dampen growth at a worldwide level, too. The losses in real income in the oil-importing countries will only be partially offset by rising exports to the oil-producing countries.

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[11] On the record results achieved by the mineral-oil processing industry in Germany, cf. MWV (Association of the German Petroleum Industry), Annual Report 2004, p. 5.

[12] At the beginning of September, a company funded by the Ludwig Bölkow Foundation published an evaluation of the expenditure of the three oil giants, ExxonMobil, BP and Shell. According to this assessment, investment in exploration of new fields fell by 39% between 1998 and 2004, while spending on maintenance and expansion of existing production (including purchases of firms and shares) rose by 21%. Clearly, the interpretation goes, it was cheaper for the oil giants to increase output by buying other firms than by discovering new fields (Fossile News Gazette, Vol. 6, September 2005, pp. 4f., www.energiekrise.de/news/haupt/html).

[13] Federal Statistical Office Press Release of 19.9.2005.

[14] Cf. UNCTAD 2005: Trade and Development Report, p. 21, Fig. 1.3.

[15] Also cf. Sachverständigenrat (German Council of Economic Experts) zur Begutachtung der gesamtwirtschaftlichen Entwicklung 2004: *Erfolge im Ausland – Herausforderungen im Inland*, p. 165, Table 29, which indicates an average decline of 0.06 percentage points per annum.

In addition to oil-price rises, second-round effects can also have a macroeconomic impact. The reactions of wage setters and monetary policy play an important role in this respect. The oil crises of recent decades brought significant wage and price increases world wide in reaction to the oil-price rises, to which the central banks reacted by raising interest rates. This conflict between wages and monetary policy led to a substantial slowdown in economic growth. The oil-price increases since 2000 have not yet been accompanied by a conflict of this kind. And so deductions must be made to the results of the econometric models applied to date. According to a traditional rule of thumb, a prolonged oil-price rise of 10% reduces GDP growth in the euro zone by around 0.3% within 3 years, which would correspond to a weakening of the annual growth rates by 0.1 percentage points[15]. According to current estimates, the euro zone would have suffered losses in GDP of a magnitude of 3% to 5% since the beginning of 2002. Further dampening effects can be expected next year as a consequence of the drastic increase in 2005, even if it is assumed that the oil price will now remain more or less stable. The actual losses in growth are currently probably lower than in the past because there is as yet no sign of a conflict between wages and monetary policy, and because energy efficiency has increased substantially in recent decades. However, it remains the case that economic growth is currently being significantly curtailed by the oil-price increases.

The need for a new economic policy approach

The fundamental economic problem in the euro area, and especially in Germany, is to be found at the macroeconomic level: there is something wrong with the overall framework. To some extent this has institutional causes. Apart from monetary policy there is no real European macroeconomic policy, and in most countries fiscal policy, constrained by the Stability and Growth Pact (SGP), is focussed exclusively on consolidation. Yet a coordination of macroeconomic policy in the euro area is necessary, because a large internal market – which is what the euro area now is – also requires a policymaking structure at the level of the macro-economy in order to be able to avoid economic crises.

In addition to the institutional weaknesses there is also a serious problem of content. Particularly in Germany, but to some extent also in Europe as a whole, the role played by demand in economic development is vastly underrated. The economic problems of the euro area, and especially Germany, are conceived solely as supply-side problems. This is astounding if it is recalled what an economy suffering from supply-side problems ought, in theory, to look like at the macro level. It would be characterised by rapid rates of growth of labour costs, both in absolute terms and with respect to the rate of productivity growth (unit labour costs). It would be suffering from inflationary tendencies and a lack of international competitiveness. The rapid wage or benefit increases would lead, at least in the short term, to buoyant consumer demand, whereas investment would be weak due to poor profitability expectations. Above all else, exports would be weak, due to the lack of international competitiveness, and the external balances would be in deficit. Examples of economies that were suffering from supply-side problems and exhibited precisely such phenomena include Great Britain and the Netherlands at the end of the 1970s and start of the 1980s, and eastern Germany in the wake of unification.

In today's Germany, the largest economy in the euro area, none of these manifestations of supply-side problems is to be seen. On the contrary, for years labour cost increases have been extremely moderate, its international competitiveness has steadily increased and, if anything, deflationary trends are to be observed. It is therefore hardly surprising that consumer demand is particularly weak, investment in equipment is expanding only weakly, while exports are particularly strong and the trade balance and current account are posting huge surpluses. All this points to the very opposite of an economy suffering from supply side problems: the problem is the lack of demand. Although Germany is the most prominent case within Europe, the same phenomena and diagnosis apply – in somewhat milder form – to the euro area as a whole. This reflects not only the large weight of Germany – one third – within the euro area economy: the path of competitive disinflation taken by Germany is increasingly squeezing demand throughout the currency area. In small open economies 'structural reforms' that depress domestic demand can, via the real exchange rate, boost output through the trade channel. When pursued by a country as large as Germany, both the negative effects on internal demand and the knock-on effects on the rest of the currency area are much greater (see 'Wages and labour costs' below).

This diagnosis is not an argument against reforms. It is correct that global competition has substantially increased the need for flexibility on the part of firms and workers. This implies that reforms are needed wherever institutions prevent a sufficient degree of flexibility being achieved. There is no reason why the necessary reforms should always be targeted at workers and private households, though. Educational reform, steps to reduce bureaucracy and cuts in subsidies to firms are all examples of areas that are at least as important. Whatever reforms are implemented, one thing is crucial: to the extent that the measures taken impinge negatively on demand, they must be supported by an expansionary macroeconomic policy. The failure to do so has been a major reason for the poor performance of the large euro area economies in recent years.

Years pursuing an economic policy that has been focussed on the wrong side of the market have left indelible marks on the economy in Germany and much of Continental Europe. The redistribution of income away from labour, due to wage moderation and social security reforms, has put severe pressure on private consumption. Moreover, the huge amount of uncertainty has encouraged saving at the expense of consumption. It will not be easy to overcome this deep-seated economic weakness. The following sections contain proposals for ways in which, in these difficult circumstances, demand can be stimulated without leading to a deterioration in supply-side conditions.

Lack of policy coordination in the euro area

The fundamental problem for macroeconomic policy coordination in the euro area is that the institutional preconditions are very different in the various policy areas. Whereas monetary policy is centralised and thus conducted for the area as a whole, fiscal policy remains the responsibility of national authorities, while in the area of wage policy coordination occurs, at best, at the national level, and in some cases not at all.

Successful coordination also has to address issues relating to the current orientations of monetary policy and decentralised fiscal and wage policies. Although the EC treaty sets the monetary authority a clear hierarchy of goals, and allows support for the general goals of economic policy only to the extent that this is without prejudice to the primary goal of price stability, it does offer scope for the monetary authority to play a role in stabilising the real economy. However, to date the ECB has tended to see its contribution to ensuring higher employment and economic growth as being limited to ensuring price stability[16]. The need for coordination with other policy actors was rejected with reference to the need for a clear assignment of policy-making responsibilities.

Coordination of national fiscal policies within the framework of the Stability and Growth Pact (SGP) suffers from the fact that the target policy variable, the current

[16] See for example Issing, O. (2000) 'On macroeconomic policy co-ordination in the EMU', Journal of Common Market Studies, vol 40, pp. 345-358.

deficit as a share of GDP, is not one that is under direct policy control. The SGP has functioned asymmetrically, has led to a tendency for fiscal policy to act pro-cyclically and thus undermined the stabilising role of fiscal policy. Moreover, the requirement to consolidate public finances has been damaging to public investment. The reform of the way the SGP is applied that the European Council agreed in the spring of 2005 has not called into question the targets for current government deficits (deficit ceiling of 3% of GDP, close to balance or surplus position over the medium term) nor for government debt (maximum of 60% of GDP). However, it has introduced greater scope in interpreting situations where the targets are missed and providing longer adjustment periods within which the targets have to be met. Under the excessive deficit procedure greater attention is to be given to factors such as the economic situation, the level of government debt and the growth orientation of public spending (as originnally intended in the Maastricht Treaty)[17].
Coordination of national wage policies within the EMU with the aim of achieving nominal wage growth equal to the sum of the long-run rate of national productivity growth and the target inflation rate of the ECB still faces the problem that national wage bargaining systems remain very different and exhibit different degrees of coordination at national level[18]. Moreover, the longer-run tendency for more decentralised wage bargaining and towards labour market deregulation poses obstacles to the ability to coordinate at both the national and international level. Thirdly, in a number of countries wage policy, at least at times, has been tied into social pacts in order to improve the international competitiveness of the domestic economy via wage moderation.

It is true that a suitable forum exists for the coordination of monetary, fiscal and wage policy, in the Macroeconomic Dialogue, which brings together the ECB, the European Commission, the member States via the ECOFIN and Labour and Social Affairs Councils, the European Trade Union Confederation and the European-level employers' federations. And, in principle, the Broad Economic Policy Guidelines constitute a suitable coordination instrument. However, an effective Macroeconomic Dialogue requires macro-level actors that are both willing and able to coordinate and that are aware of the interdependence of the instruments they use and their joint responsibility for employment, growth and price stability. Yet the existing economic policy programme of the EMU and EU, as set out, for instance, in the Broad Economic Policy Guidelines, the Lisbon Strategy and, more recently, in the Integrated Growth and Employment Guidelines[19], continues to be oriented primarily towards structural reforms, particularly of labour markets and social insurance systems, in order, by these means, to raise potential output and reduce the rate of unemployment compatible with stable prices (the NAIRU). The role of macroeconomic policy is one-sidedly reduced to that of ensuring price stability (for monetary policy) and consolidating public finances on the spending side (for fiscal policy).

Improvements in the growth and employment situation on the EMU require a reorientation of macroeconomic policy. In the short term that means, in particular, to take seriously the need to stabilise a real economy that is in stagnation and with no threat of domestic inflation. Under such conditions monetary policy should take action. But fiscal policy too, especially in those countries with below average growth and inflation rates, should make use of the scope created by the reform of the application of the SGP for more expansionary policies. On the other hand, those countries in which the economic trend is more dynamic should be aiming for fiscal surpluses.

In the longer term, steps must be taken to improve coordination, both within the areas of fiscal and wage policy, and between monetary, fiscal and wage policy.

[17] European Council, Presidency Conclusions, 22 and 23 March 2005. The text (Annex II) can be downloaded from http://europa.eu.int/european _council/conclusions/index_en.htm.

[18] Cf., for instance, Hancke, R., Soskice D. (2003) Wage setting and inflation targets in EMU, Oxford Review of Economic Policy, Vol. 19 (1), pp. 149-160.

[19] European Commission (2005), 'Integrated guidelines for growth and employment', COM (2005) 141 final.

In the case of fiscal policy this means that the SGP should be reformed in a more far-reaching way, so as to enable the automatic stabilisers to function without hindrance, and to enable public investment to be deficit financed in order to stabilise the growth of demand and improve growth potential. Within the framework of a substantially reformed SGP, each country should present expenditure trajectories for those components of spending unaffected by the cycle, and these should be coordinated as a consistent package. On the one hand, this allows the automatic fiscal stabilisers to work; on the other, the expenditure path can be applied such that the public debt-to-GDP ratio is reduced in the long-run. Given that this would imply a slightly restrictive impulse from fiscal policy across the cycle, the EMU-wide coordination of the spending trajectories must ensure that in sum they do not impart an overly restrictive impulse on the euro areas as a whole.

In terms of wage policy, the European trade unions need to intensify their coordination efforts in order to ensure that in the EMU member countries nominal wage growth is in line with the sum of long-run national productivity and the target inflation rate of the ECB. The aim is not, not even in the long run, to have centralised wage bargaining for the euro areas as a whole, but rather to network between and coordinate national wage determination systems with a view to the above-mentioned rule[20]. The large member states (Germany, France and Italy) should form the nucleus of such a system. This is because, on the one hand, they ultimately have little to gain in employment terms from excessive wage moderation and a beggar-thy-neighbour approach and, on the other, excessive wage growth in these countries, because of their importance for inflation trends in the euro area as a whole, would inevitably be sanctioned by the central bank. Yet a coordination of wage policy also requires support from economic policy, because it requires trade unions and employers' federations that can bargain strategically, orientate wage settlements to macroeconomic requirements and ensure that they are implemented. Decentralisation of wage bargaining, as called for in the Employment Guidelines, the Broad Economic Policy Guidelines and the Integrated Guidelines for Growth and Employment run counter to this requirement, as does further deregulation of European labour markets.

Crucially, coordination of macroeconomic policies oriented towards growth and employment depends on the central bank participating and taking up its responsibility for growth and employment. By the same token, macroeconomic co-ordination increases the scope for a growth-oriented monetary policy. A significant change of course by the ECB is therefore required, all the more so given that the long-term output effects of monetary policy tend to be larger in Europe than in the USA[21]. This implies, in particular, timely and significant cuts in interest rates when growth drops and more cautious reactions when the unemployment rate falls and approaches the rate where the NAIRU is supposed to lie.

[20] Cf., e.g. Traxler, F., E. Mermet (2003) 'Coordination of collective bargaining: the case of Europe', Transfer, vol. 9 (2), p. 229-246.

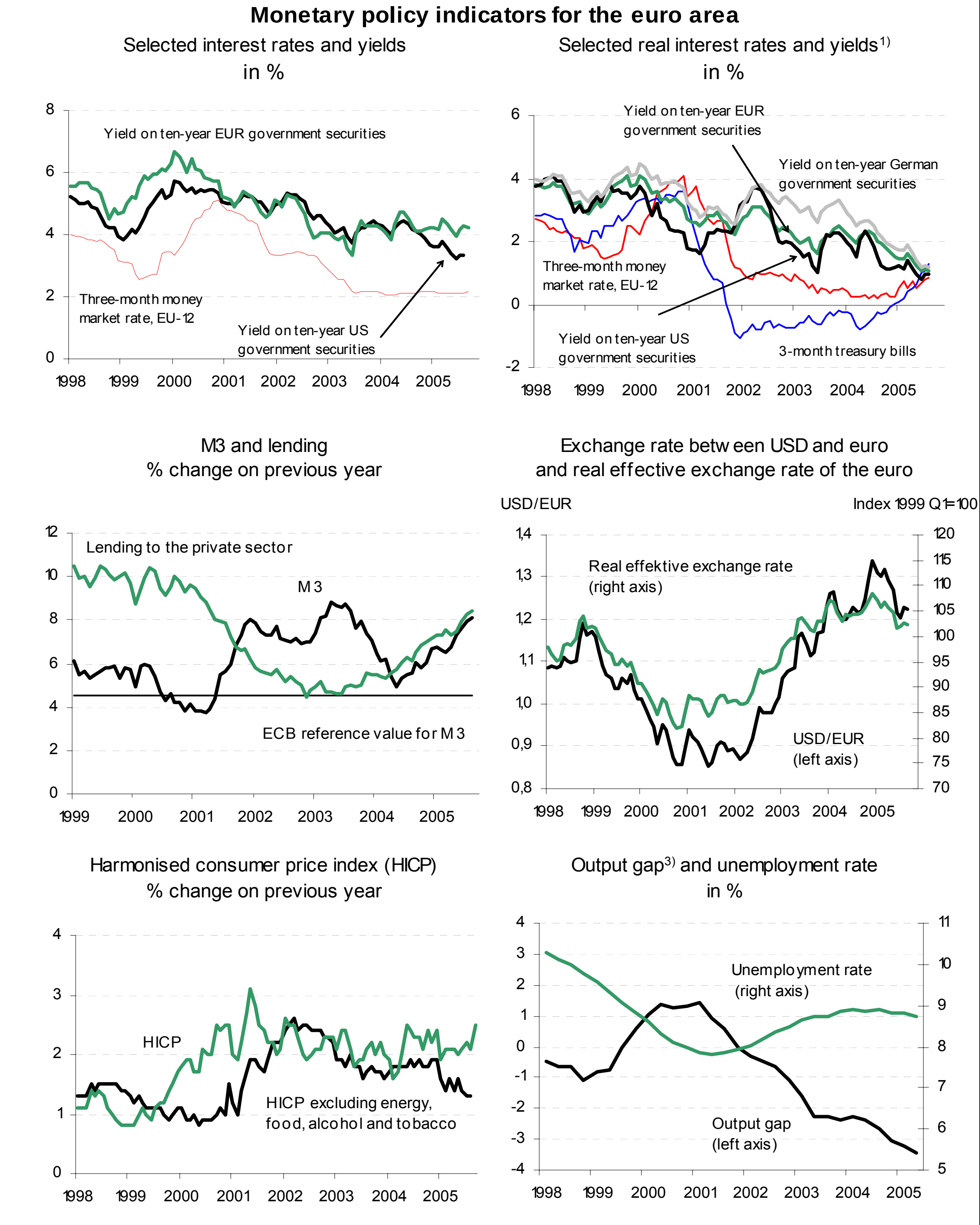
[21] CF. De Grauwe, P., C. Costa Storti (2004), 'The effects of monetary policy: a meta-analysis', CESIFO Working Paper, no. 1224.

Monetary policy stimulus required

The ECB has kept its main base rate constant at 2% since June 2003. Nevertheless, the monetary conditions have changed substantially during the past two years. This is due primarily to changes in the exchange rate of the euro, but also to the conditions for financing investment in the euro area. In the course of this year the monetary conditions have, overall, improved slightly.

The main reason for this is that the euro-dollar exchange rate, which had risen by 51% between the start of the long appreciation phase in April 2002 and December 2004, has since fallen by around 9% (Figure 3). The key factor behind this shift is the widening gap between short-term interest rates in the two currency areas. Accordingly, the long-term interest-rate differential between the euro area and the USA has increased to almost one percentage point. In real effective terms, too, the external value of the euro has fallen substantially (5%), having previously risen by 25%. The euro-dollar exchange rate is currently around the level of a year ago, while the real effective exchange rate is just under 2% below its level a year ago. This means that, for the first time since spring 2002, the exchange rate has no longer been exerting a restrictive effect on the euro area economy.

Figure 3



[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 12-month average of consumer prices.

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

[3] The calculation of the output gap is based on the assumption that the gap was closed in the IV quarter of 2001 and annual potential output growth equals 2.25 %.

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

Long-term interest rates have also declined in recent months. Since the spring the yield on ten-year government bonds in the euro area has fallen by a quarter of a percentage point in nominal terms, and somewhat more in real terms[22]. Interest rates on bank loans have also fallen somewhat. In addition banks' lending conditions have improved and share prices have risen markedly.

On the other hand, real short-term interest rates have risen, only slightly since the spring but by more than half a point compared with a year ago. The (nominal) interest-rate differential has narrowed: at just under 1 ¼ percentage points it is approximately at a level that can be considered neutral.

Stimulated by low interest rates, lending to the private sector has expanded substantially. This is particularly true of mortgage lending, but consumer credit and business loans, at 7.0% and 6.7% respectively (figures for August) have risen substantially. Moreover, firms are highly liquid, as profits are up while investment activity remains muted. Corporate liquidity and rapid credit growth are the main factors behind the continued rapid growth of M3, which recently (August) posted a growth rate of 8.1%. Besides these drivers, low interest rates will have encouraged investors to hold liquid funds, which form part of M3, rather than longer-term assets. Furthermore, cash balances have also been rising for some time now, which probably reflects to a not insignificant extent demand outside the euro area, largely to finance unregistered economic activities. Taken by themselves, money supply trends cannot be a cause for concern. Although the ECB estimates that the real money gap is now 4% (adjusted for portfolio shifts)[23], the size of this variable is highly uncertain. For instance, it is based on the assumption that the gap was zero at the start of monetary union and on an estimate of the trend decline in the velocity of circulation that is lower that the actual decline in recent years. In the short run it is not possible unambiguously to determine whether or not the velocity of circulation has declined faster than the ECB estimates. If this were to be the case, then it would be equally possible to conclude from econometric calculations that the money supply has grown too slowly. The real money gap would be virtually closed if it were calculated using the reference rate for money supply growth proposed by the leading German economics research institutes and which, because of a higher estimate for the rate of decline of the velocity of circulation, is 0.5 percentage points higher than that of the ECB.

Current prospects for inflation and economic activity indicate that the risks are more to be seen on the side of weak growth. Inflationary trends in the euro area are extremely moderate given the doubling of oil prices since the start of 2004 and a rise of almost 50% during the last 12 months. This is clearly shown by the low rate of core inflation, which in turn reflects the degree of wage moderation. The HICP consumer index excluding energy, food, alcohol and tobacco is currently increasing at just 1.3% and the rate has never been above 1.6% during the entire year. This is despite the fact that the energy price hikes of recent years also find their way into this index, for instance in the category 'transport', which since the start of the year has posted average growth rates of 4 ½%. In Germany, the largest euro area economy, the core inflation rate has recently been just 0.4%. The low rate of underlying inflation in the euro area indicates that the monetary authority has done too little to counteract the economic weakness of the euro area since 2000.

[22] The calculation of real long-term interest rates is based on a 12-month moving average of the HICP inflation rate; for short-term real interest rates HICP inflation excluding food, energy, alcohol and tobacco was used.
[23] ECB Monthly Bulletin, September 2005, p. 24.

An additional guide for evaluating monetary policy is the Taylor rule[24]. The Taylor rate is calculated as the sum of the equilibrium real interest rate and the inflation rate, corrected for the weighted relative deviation of actual output from potential output (the output gap), on the one hand, and of the actual rate of inflation from the target inflation rate of the central bank (inflation gap) on the other. Here, two variants of the Taylor rate are calculated (Figure 4). In the first, both the output and the inflation gaps are given a weighting of 0.5, as originally proposed by Taylor. In the second the output gap is given a weight of 1 and the inflation rate one of 0.5[25]. This allows for a greater degree of output stabilisation combined with only a slightly higher degree of inflation variability. The calculations are based on an equilibrium real interest rate and a rate of potential output growth of 2 ¼% each[26]. The target inflation rate of the ECB is set here at 1.9%. Given that the ECB, as with most other central banks, has indicated its intention not to react to one-off price shocks, the inflation rate used is the HICP excluding energy, food, alcohol and tobacco[27]. Whereas the original Taylor rule was calculated with respect to the current inflation and output gaps, here the figures for these variables 12 months ahead are used, in order to take account of the time lags before monetary policy affects the economy.

[24] The interest rate derived from a Taylor rule is not to be understood in a mechanical way as the 'right' rate; monetary policy decisions are too complex to be reduced to a few numerical values. Moreover, it is not possible unambiguously to determine the value of its various components. This is true in particular of the equilibrium real interest rate and also the output gap, but also of the choice of a suitable time series for core inflation.

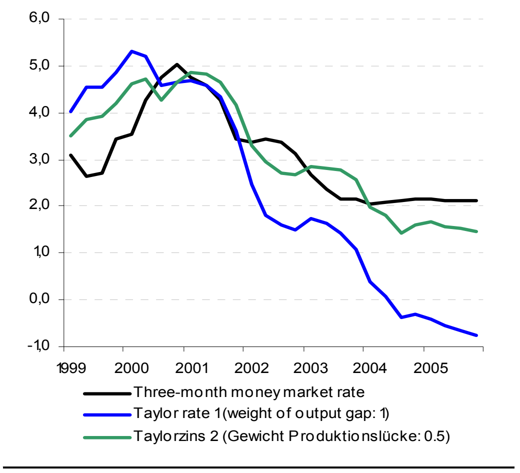
[25] Cf. Lawrence Ball, 'Policy rules in open economies', in John Taylor (ed) Monetary policy rules, London 1999; John Taylor 'A historical analysis of monetary policy rules', in John Taylor (ed) op cit.

[26] This means that the assumed real interest rate for the euro area is higher than the rate often assumed for the US economy with its much faster growth rate. Cf. for instance A.S. Blinder and R. Reis (2005) '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, p. 18. Most of the national and international economics research institutes have revised down their estimates for the productive potential of the euro area economy. We do not follow this trend, which is largely based on purely statistical considerations. It is true that the trend rate of growth, as measured statistically, has fallen due to the persistent economic stagnation. However, to interpret this as a decline in productive potential would imply locking it in to monetary policy , with the risk of turning it into a self-fulfilling prophecy.

[27] For 2006 this rate is 1.6%. this accords with a forecast increase in the HICP as a whole of 2.1%.

Figure 4

Three-month money market rate and taylor rates for the euro area, 1999 to 2005



The calculation of the output gap is based on the assumption that the gap was closed in the IV quarter of 2001. This assumption is supported by OECD and IMF calculations of the output gap. Annual potential output growth is assumed – in accordance with ECB estimates – to be 2.25%. The same figure is assumed for the equilibrium real interest rate. In both interest rates the inflation gap is given a weighting of 0.5. The inflation rate used is the core inflation rate (HICP excluding energy, food, alcohol and tobacco). The inflation and output gaps used are those 4 quarters preceding the date indicated; the values for the second half of 2005 and for 2006 are the values forecast by the IMK.

According to these calculations, the short-term interest rate is half a point above the Taylor rate if the inflation and output gaps are each given a weight of 0.5. If the output gap is accorded a weight of 1, the Taylor rate is actually in negative territory. This leads to the conclusion that the interest rate cuts have been, at best, barely adequate and have almost certainly been insufficient.

Against the background of continued economic weakness in the euro area and moderate wage developments, the ECB should swiftly cut interest rates by at least half a percentage point. The risks inherent in allowing the euro area economy to remain locked in sluggish growth are substantial, especially given the high unemployment in the euro area and also global economic imbalances. The less robust economic growth in the European economy is, the less it is able to cope with possible shocks, such as further appreciation of the euro, further rises in the price of oil or an increase in long-term interest rates. This is also an important reason for the central bank to cut rates.

The possible existence of speculative bubbles on asset markets cannot constitute an argument against a cut in interest rates. Firstly, it is very difficult to identify speculative bubbles before the event[28]. Secondly, the causes of such a bubble – if it does indeed exist – are not to be found in the euro area. Although the low level of long-term interest rates globally, and the correspondingly high values of securities, are partly due to the low international level of short-term interest rates, to a considerable degree they also reflect low risk premiums and a high propensity to save, coupled with a low propensity to invest at the global level. Low risk premiums are probably justified to the extent that they are a reflection of the increased macroeconomic stability due, partly, to Greenspan's fine tuning of the economy. The possibly excessive price increases of real estate in some euro area countries should not be addressed by monetary, but rather by fiscal policy. By cutting interest rates, the ECB would help to reduce global imbalances. Higher investment and output in the euro area would ease the pressure on the US current account, both directly and via third markets, and thus reduce the danger of drastic exchange rate fluctuations.

[28] Blinder/Reis (2005), op. cit., p. 68.

Fiscal policy – a drag on the upturn

In the EMU, with monetary policy oriented towards the situation in the currency area as a whole, fiscal policy is the only macroeconomic instrument available to the national authorities in slow-growth economies with which to promote growth and employment. At the same time, fiscal policy must also attend to the sustainability of public finances. It must take care not to endanger its own ability to act in the longer run by allowing government debt levels – and thus also interest payments – to rise inexorably. This means that a fiscal policy oriented towards promoting economic growth must always be combined with a consolidation strategy that ensures that a given debt level is not exceeded in the medium run. In the absence of an objective yardstick for such a level, the figure of 60% of GDP set out in the Stability and Growth Pact is used here.

Against this background, it is clear that in recent years fiscal policy has been oriented in a very one-sided way, with a clear focus on budgetary consolidation, a strategy that at the end of the day has been unsuccessful. Specifically, governments sought to stick to the deficit ceiling of 3% of GDP set out in the SGP, in spite of the weakness of economic growth. The fact that economic growth has repeatedly lagged behind the economic forecasts since 2001 has led to a dramatic loss of government revenue. At the same time, rising unemployment has led to cyclically induced higher social spending.

The question facing fiscal policy in the euro area – and especially in those countries where deficits are currently above the 3% limit – is whether policymakers should continue to pursue a strategy of consolidation oriented towards the current deficit ratio, attempting via additional cutbacks to force the deficit under the limit, while undermining demand and the prospects for economic recovery. Or should they take advantage of the new scope created by the revision of the SGP and adopt a more medium-term approach to consolidation, one that takes greater account of the economic cycle?

The IMK calls for a consolidation strategy that takes account of the needs of the macro-economy while not losing sight of the goal of reducing the debt ratio in the medium run. Budgetary consolidation should only occur in phases of rapid economic growth and rising capacity utilisation, in which private demand is strong and stable. But then it should be pursued with vigour. In phases of weak economic growth, on the other hand, higher deficits, and thus also a rise in the debt ratio, should be tolerated as a means of stabilising the economy. Moreover, government should concentrate its efforts on those variables that are actually under its control. These are the nominal growth rates of the non-cyclical components of public spending (primarily government consumption and public investment). Cyclically dependent variables such as the deficit ratio or the tax share, in contrast, are not under the control of government, as they are determined endogenously by the economic process as a whole. A growth path should be set for the non-cyclical components of public spending such that consolidation of public finances is achieved in the medium run. This means that it must be set somewhere below the trend nominal rate of GDP growth. Currently this would imply a rate of around 2% in Germany, with a somewhat higher figure in other countries needing fiscal consolidation (reflecting either higher trend real growth or more rapid inflation). Cyclically sensitive components of spending are then allowed to vary across the cycle around this growth trajectory, acting as automatic stabilisers. This avoids excessive restrict-tion on spending during cyclically weak periods, while ensuring that consolidation is achieved in the medium run.

In those countries in which public investment has been particularly squeezed by past vain attempts at consolidation – here again Germany is the prime example – it should be excluded from this policy for a transition period, during which public investment should be steadily increased to around the euro area average of 2-3% of GDP. Once this is achieved, public investment should be put on the same annual spending path. In order to avoid the limit on the growth of spending being offset by tax cuts, endangering the consolidation process – as has happened in a number of euro area countries – any taxation reforms during the consolidation process must be neutral in terms of revenue generated.

Initially, the proposed consolidation strategy leads – particularly due to higher public investment spending where this is below the current EMU average – to an increase in the deficit ratio, by around one percentage point of GDP compared with what would otherwise occur. This means that a number of countries would once again be above the 3% limit of the SGP, certainly in 2006 and possibly the year after. From an economic point of view, all the arguments are in favour of temporarily accepting this. The 3% limit makes no economic sense and the modification of the conditions for implementing the SGP have increased the political *marge de manoeuvre*. The low-growth, low-inflation countries of the euro area –most prominently Germany, but also France and to some extent Italy – need an expansionary impulse from fiscal policy. This is economically and politically feasible given, respectively, that the spending path target ensures a consolidation in the medium run and the combined weight of these countries in the euro area. If the political will is nevertheless lacking to finance the transition to the spending trajectory via temporarily higher deficits and higher public investment, then it would be possible to offset the higher spending by higher taxes or cuts in subsidies. In such a case those taxes must be raised and those subsidies cut that have only a limited impact on demand. Offsetting tax increases would weaken the expansionary impulse that is currently required, but would not offset them entirely, because the multiplier for government revenue is normally considerably smaller than that for public spending. In order further to reduce the negative cyclical impact of any tax increases, they should be targeted as far as possible at high-income households whose savings-to-income ratio is high and propensity to consume low. This would also have positive distributive effects.

Wages and labour costs

Wages and non-wage labour costs in the euro area continue to rise at moderate rates. This is remarkable given the sustained and substantial increase in energy prices, which has hit private households hard and put a serious squeeze on real incomes. In previous decades this repeatedly led to compensatory wage increases, giving rise to, in some cases drastic, hikes in labour costs and setting off a wage-price spiral that ultimately led to a major loss of price stability. As a result, central banks stepped on the brake, pushing economies into a stabilisation recession. This, in turn, led to a rise in unemployment, again often of a dramatic nature, which, via reduced wage pressure, subsequently enabled a return to price stability.

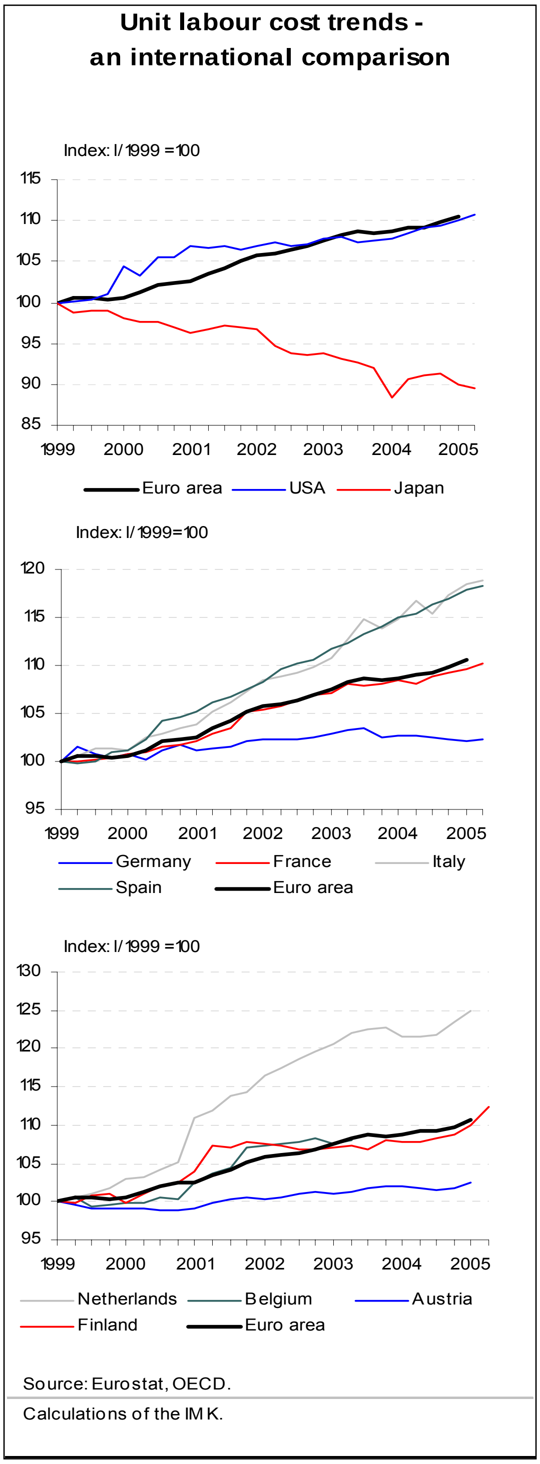
In most countries lessons have since been learnt from this course of events, with its negative impact on the economy as a whole and particularly on workers. Not only were steps taken to reduce dependence on energy imports, trade unions in the euro area as a whole reacted to the last oil shock, in 2000, by refraining from making compensatory wage claims. Even so, the ECB raised interest rates substantially – partly because the economic outlook at the time was decidedly rosy – which was a major contributory factor in the subsequent economic downturn. This time, with the economic outlook far less favourable, the ECB has so far refrained from such a course of action.

What is also striking is the composition of labour-cost trends in the euro area. While collective wage increases are running at about 2%, social insurance contributions have been growing at between 3 and 4%. Overall, hourly labour costs are 3% higher than a year ago[29]. Thus, despite the strong growth of non-wage labour costs, overall labour costs, once productivity is allowed for, are not causing any inflationary pressure whatsoever, and there is no reason for the ECB to tighten policy. Subtracting inflation from the increase in

[29] ECB Monthly Bulletin, September 2005.

labour costs, it is evident that, in real terms, too, they are hardly increasing. Consequently, wages can hardly be seen as an obstacle to an expansion of employment in labour-demand terms.

Figure 5



Unit labour cost trends - an international comparison

Source: Eurostat, OECD.
Calculations of the IMK.

However, recent trends in this area do give rise to two problems: firstly, differentials within the euro area and, secondly, negative demand-side effects.

The first problem has its origins in Germany. In no other euro area country, with the exception of Austria, has the rise in unit labour costs since the start of EMU been lower than in Germany (cf. Figure 5). This has an immediate impact on price competitiveness, which has developed very favourably for Germany in recent years with respect to the rest of the euro area[30]. This impacts on export trends, positively for Germany – as seen in this economic forecast – and negatively for the rest of the euro area. This puts downward pressure on demand in the euro area as a whole. For the competitive pressure emanating from German wage trends is gradually exerting downward pressure on wage trends in all the euro area countries. There is clear evidence of this in countries like the Netherlands, which have close trading relations with Germany and whose growth depends heavily on foreign trade and external developments. If this downward pressure spreads to other countries – which is to be expected – economic developments in the euro area as a whole will be destabilised, as has already happened in Germany. Weak domestic demand, particularly of private consumption, will then spread to the currency union as a whole. This is far more dangerous for the euro area, because at that level domestic demand is even more important than for Germany, so that a destabilisation trend could develop, leading to competitive real currency depreciation and, ultimately, deflation.

The core of the problem, a fact often overlooked in economic policy debates, is that wages are not just a cost factor, they also create demand. It is vital that wage and labour cost developments maintain the balance between these two characteristics. This is the case when nominal wage increases are equal to the sum of country-specific productivity growth and the target inflation rate of the central bank. In such a case both demand and supply-side conditions remain unchanged.

If wage trends fail to follow this guideline over an extended period – and given the

[30] On this see also IMK Report no. 1, August 2005.

heterogeneity of wage determination processes in the euro area, this can be expected – it is the task of economic policy to intervene. Given that, in this case, it is only monetary policy that has the required tools at its disposal for the euro area as a whole, it must act. In the case of excessive wage increases it is generally accepted that the central bank must raise interest rates and reduce growth. What is not so clearly understood is that, if wage settlements are below this norm, the central bank must cut interest rates in order to stimulate demand, which will otherwise be depressed. Otherwise there is a risk that the euro area will drift into deflation. The argument often put forward that the European labour market is too inflexible for such a compensatory monetary policy is not convincing. Precisely the nominal wage moderation and the depressed real wage increases in the wake of the oil price hock show that this is not the case. If the labour market were rigid, inflation would have increased. We can conclude that, with a view to the European labour market, too, a stronger role for macroeconomic policy is needed.

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