A macroeconomic survey of Europe

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Four themes

- A broad based (both across countries, across consumption, investment and exports) expansion. Not a boom.

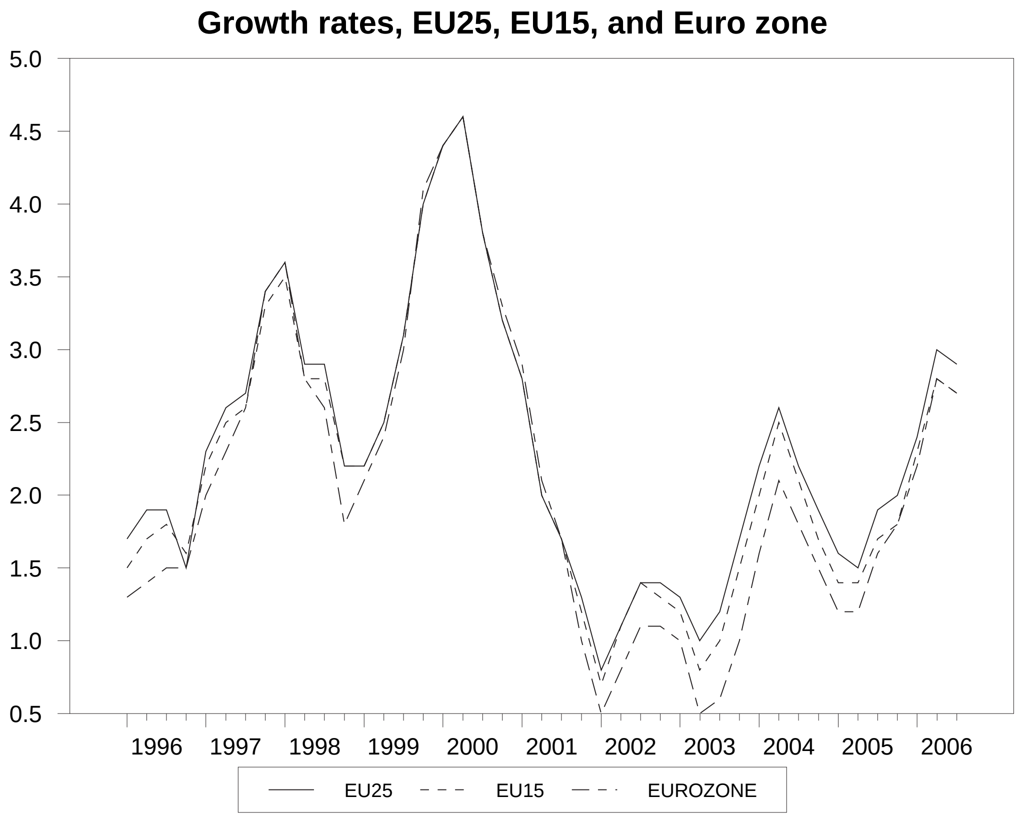
  Fundamentals in place.

  But it can die: Consumer confidence, the Euro/dollar rate.

- Even better news: A decrease in the natural rate of unemployment.
- Perhaps even better news: A pickup in productivity. Time will tell.
- Not everything is fine. The Euro and the rotating slumps. Portugal, Italy. Next? Longer-term implications.

1. A broad based expansion

Good news in 2006 Q2, slightly less in 2006 Q3. But more than just these numbers:



Across countries

	2005	2006 *	2006**	2007 **
Austria	1.8	2.0	2.8	2.3
Belgium	1.3	1.7	2.8	2.1
Denmark	2.0	2.1	3.3	2.3
France	1.4	1.6	2.0	2.0
Germany	0.9	1.1	2.6	1.6
Italy	0.0	0.9	1.8	1.2
Netherlands	0.6	1.6	2.8	2.3
Spain	3.3	2.9	3.6	3.0
Sweden	2.3	2.7	4.6	3.3
U.K.	1.9	2.1	2.6	2.4
Euro area	1.2	1.5	2.8	2.4

**: Forecast as of November 2005. **: Estimate and forecast as of January 2007 (from the Economist)*

Main point: For all countries:
$2006 * * > 2006* > 2005$ (but $2007 < 2006$. Information there?)

Across exports, consumption, investment

	2003	2004	2005	2006	2007
Germany					
Output	-0.2	0.8	1.1	2.6	1.8
Consumption	0.1	-0.3	0.3	0.8	0.3
Investment	-0.7	-1.4	1.0	5.8	4.3
Exports	2.3	8.8	7.1	10.4	6.2
France					
Output	1.1	2.0	1.2	2.1	2.2
Consumption	2.2	2.5	2.1	2.6	2.5
Investment	2.3	2.6	3.7	3.7	3.3
Exports	-1.7	3.3	3.2	7.7	5.7

Source: OECD Economic Outlook December 2006. Growth rates. Investment: non residential fixed. 2006, 2007: forecasts. Average growth rate of exports from 1988 to 2007: Germany: 7.0%. France 5.6%

The story behind the increase?

Nothing stood in the way... Timing?

- The German scenario. Ten years of competitive disinflation/depreciation, with lower than average growth.

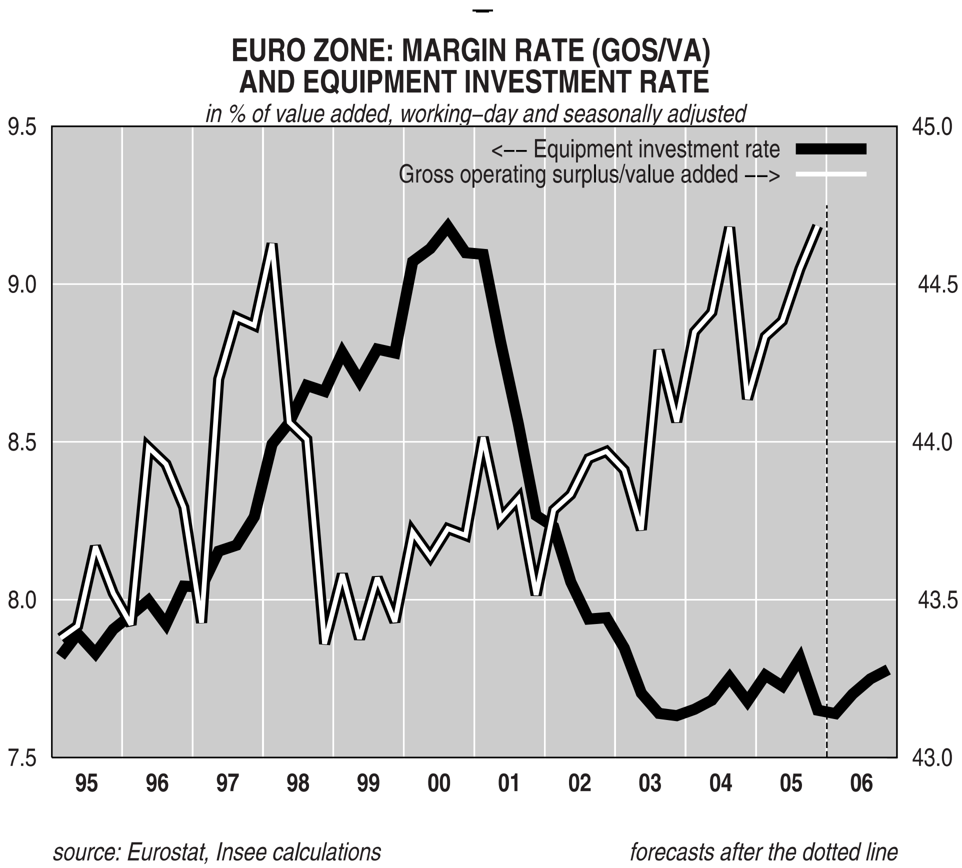
  Improved exports, leading at last to improved investment, and then improved consumption.

  The last step still iffy: The German VAT increase and the decrease in consumer confidence.

- The French scenario. Slow, but steady.

- Why $2007 < 2006$? Not clear. The German VAT increase at the start of 2007.

The remaining investment-profit rate conundrum



The risks are familiar

- The long anticipated dollar depreciation/euro appreciation.

  Implications of the oil price increases:

  - Transfers from US and Europe to oil exporters. Likely to decrease relative demand for both US and Euro assets.
  - Transfers from China and Asia to oil exporters (smaller). Likely to decrease relative demand for both US and Euro assets.
  - So far: some evidence of portfolio and reserve composition shifts. Nothing major.

  Catch 22: Good news below (on natural rate, and more so, on productivity) may make European assets more attractive, and lead to appreciation.

- The price of oil, and the policy of the ECB.

  Policy of the ECB. Yes to first round (direct) effects. No to second round effects.

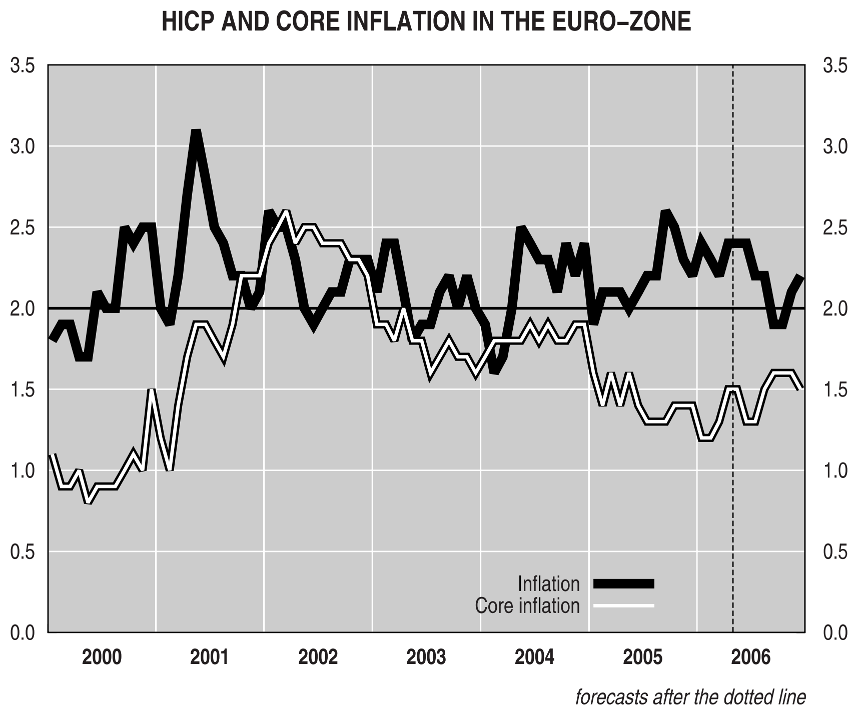
  Equivalently: Force workers to accept the real wage cut in the first round.

  Based on the 1970s: Recipe for disaster. Requires large increase in unemployment. But this time, no such effect. Why?

  Takes us to the next point.

2. Even better news. A decrease in the natural unemployment rate

Despite a decrease in the unemployment rate, and an increase in the price of oil and raw materials, stable CPI inflation:



Behind these numbers, very low wage pressure: Nominal wage growth below CPI inflation, despite productivity gains, and decreasing unemployment.

Inflation rates. Euro area.

	2002	2003	2004	2005	2006	sum
CPI	2.3	2.1	2.2	2.2	1.9	10.7
GDP deflator	2.6	2.0	1.9	1.9	1.8	10.0
Wage	2.4	1.9	1.6	1.0	0.9	7.8
Productivity	0.3	0.3	0.8	0.5	1.2	3.1
Unemployment rate	8.4	8.9	8.9	8.6	7.9	

Source: OECD Economic Outlook, December 2006. Labor productivity is output per worker, business sector. Wage is compensation per worker, business sector.

Why is this good news?

- Higher response of real wages to increases in oil prices, or general weakness? Most likely the second.

- Role of reforms? Perhaps. Unemployment benefit systems: more carrots, and more sticks. Competition from the new members.

- Implication: A decrease in the underlying natural rate. (Differences across countries? No clear outlier.)

- Room for growth above normal. How much? Answer given by Okun's law. Roughly (very roughly):

  1% decrease in unemployment rate allows for 3% more growth for a year.

3. Perhaps even better news, on the productivity front.

(but it is too early to really tell)

Background: The European productivity slowdown.

	1980s	1990-1995	1995-2000	2000-2004
U.S.	0.6	0.5	1.1	1.7
EU-15	1.1	1.2	0.9	0.4

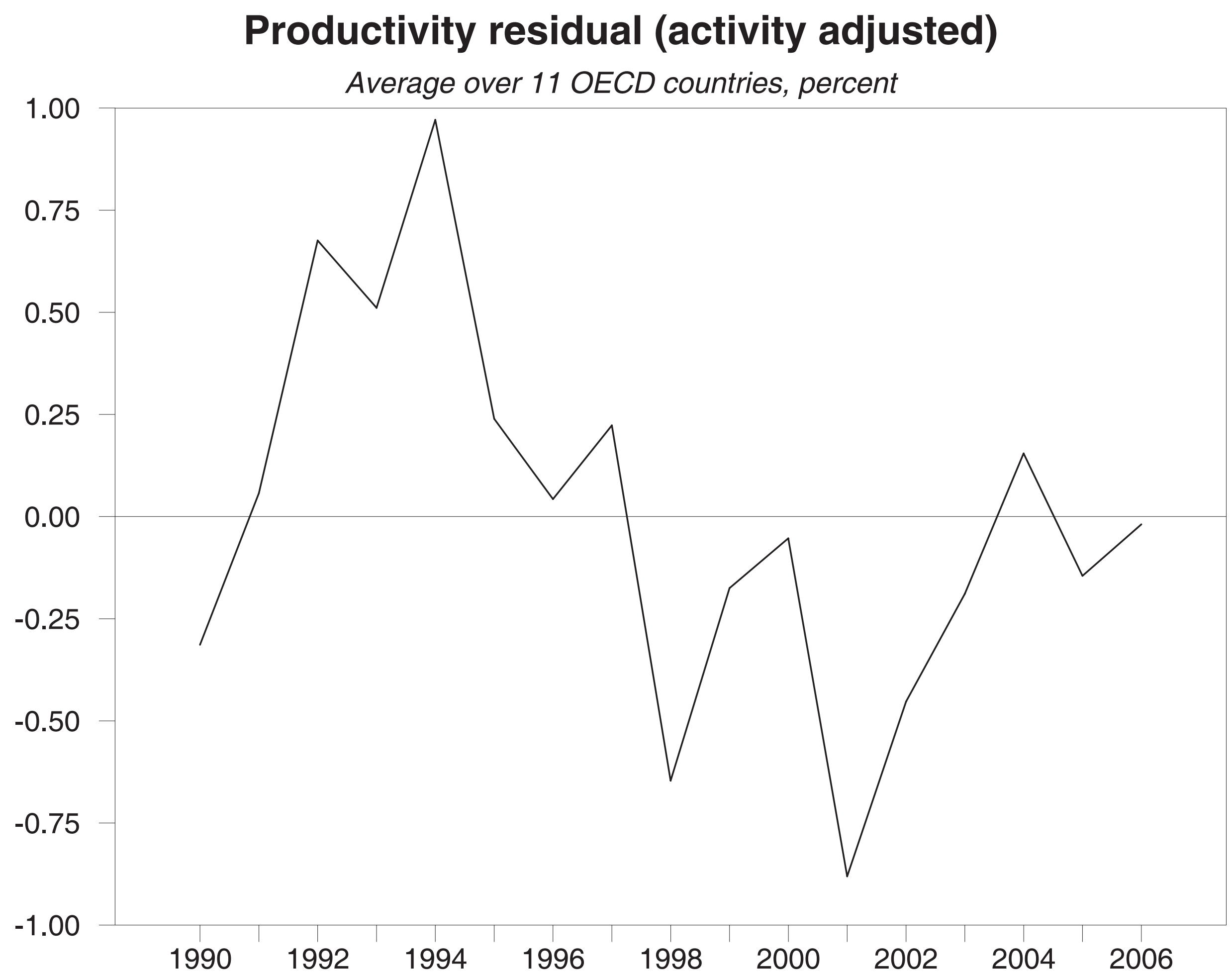
Source: Timmer, Ypma and Van Ark [2003], and GGDC data base.

Why?

- Many hypotheses, discussed before. (Main one: worse IT use)
- An (optimistic) hypothesis: (Some) productivity reservoir. Many improvements in productivity imply a decrease in employment given output. Ready to implement, and easier to implement if growth.
- Some suggestive evidence.

  Not dispositive. Always some labor hoarding/cyclical effect.

  Preliminary evidence: Compute residual from regression of productivity growth on output growth, for each of 11 countries. Next figure plots the average residual for each year.
- If so, then potentially higher growth in Europe, for two reasons (lower natural rate and higher productivity growth).


Productivity residual (activity adjusted)
Average over 11 OECD countries, percent
1.00
0.75
0.50
0.25
0.00
-0.25
-0.50
-0.75
-1.00
1990
1992
1994
1996
1998
2000
2002
2004
2006

4. Not all is well: The rotating slumps under the Euro.

The rotating slumps under the Euro:

- Demand boom driven by internal demand, loss of competitiveness, slow adjustment through high unemployment and lower wage demands. Different incarnations:

- Germany. From the German reunification to today. On the verge of success.

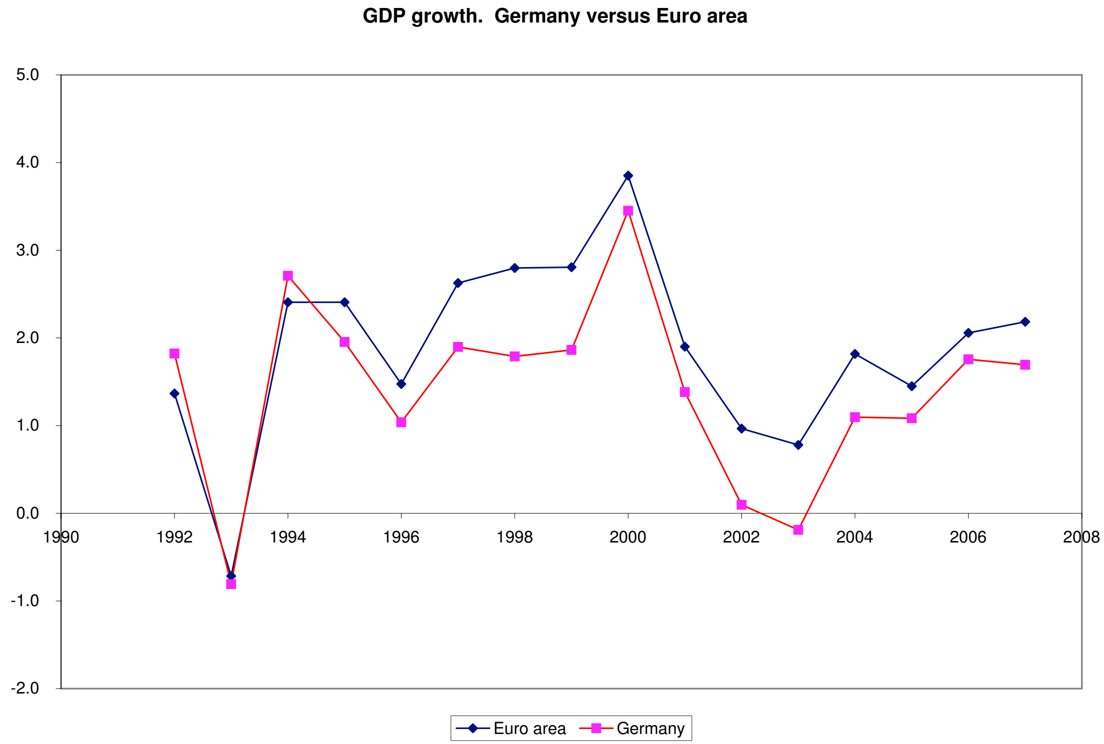
- Portugal. From a Euro boom in the 1990s to low growth and a large current account deficit today.

- Italy. A slow illness. Weak internal and external demand.

- Next? Spain looks like a plausible candidate.

Germany

A long period of low growth, after the reunification boom.



Behind the scene: A long, but (probably) successful competitive disinflation.

- The reunification boom, followed by overvaluation and low internal demand. But since 1995:
- Very low nominal wage growth. Cumulative wage growth since 1995 10% below Euro average.
- Decent productivity growth. Cumulative productivity growth 1.7% above Euro average.
- So steady improvement in competitiveness. Increase in external demand, and improvement in the current account.
- Large profit margins, and investment likely to increase. Consumption picking up. (?)

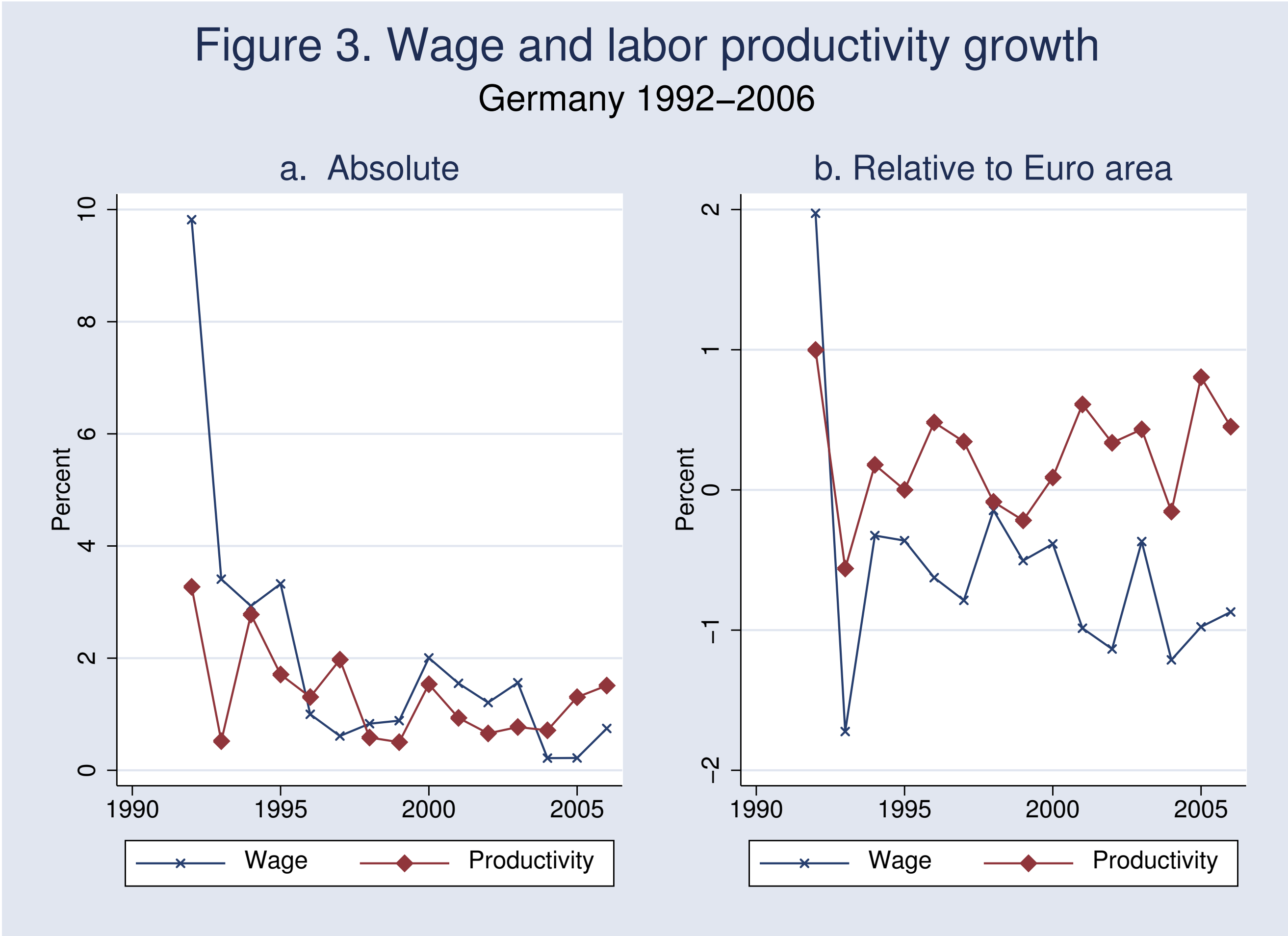
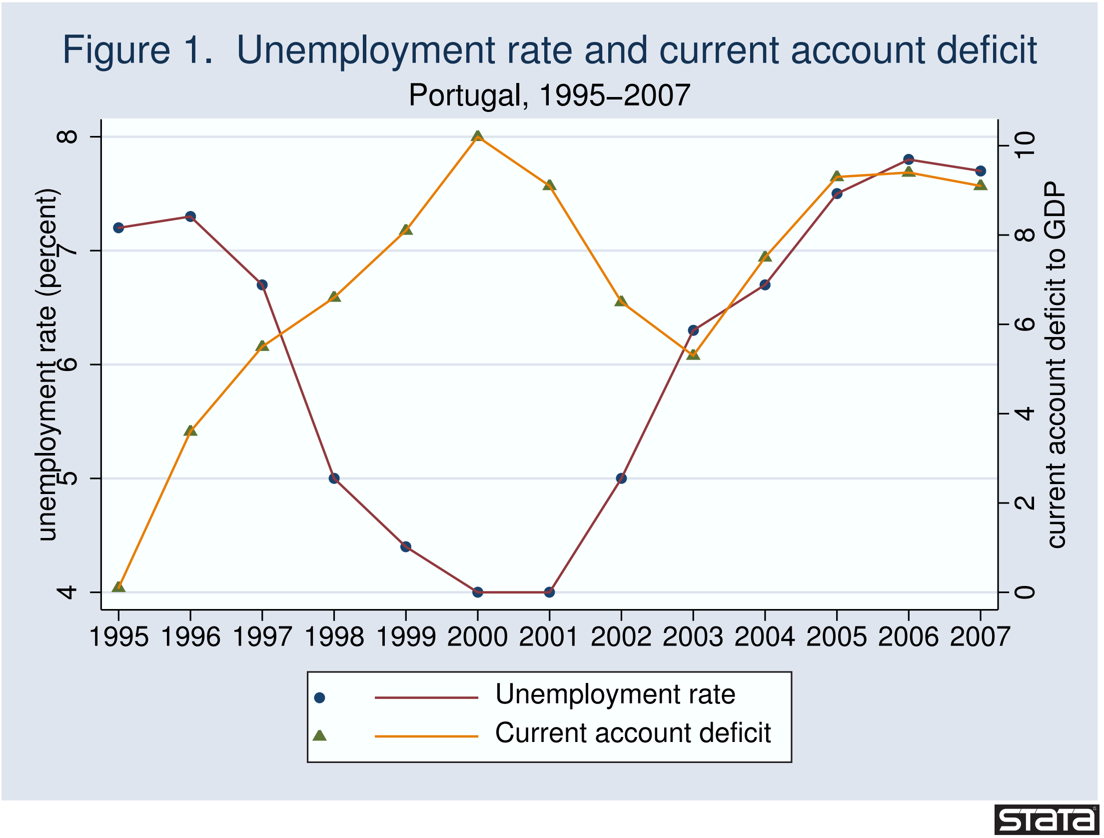


Figure 3. Wage and labor productivity growth
Germany 1992–2006
a. Absolute
b. Relative to Euro area
Percent
0
2
4
6
8
10
–2
–1
1
1990
1995
2000
2005
Wage
Productivity

Portugal. Boom and bust.



The boom

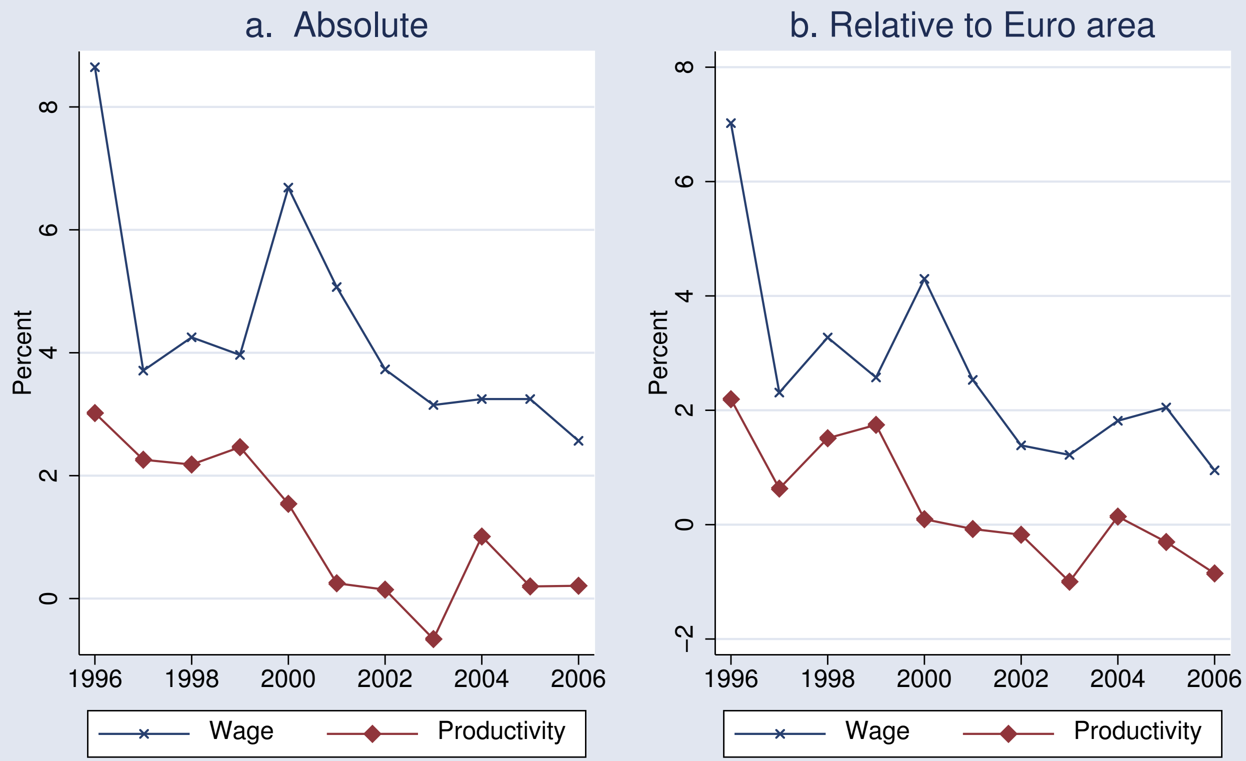
A boom in the second half of the 1990s.

- With prospects of euro entry, reduction in interest rates (real : 6% in 1992 to zero in 2001). Expectations of faster convergence, and higher income.
- Consumption boom. Decrease in unemployment, from 7.2% in 1995 to 4% in 2001.
- Sustained nominal wage growth, despite poor productivity growth. Steady overvaluation vis a vis euro partners: using ULC, by 15% from 1995 to 2001.
- Leading to an increase in the current account deficit from 0% in 1995 to 10% in 2000.

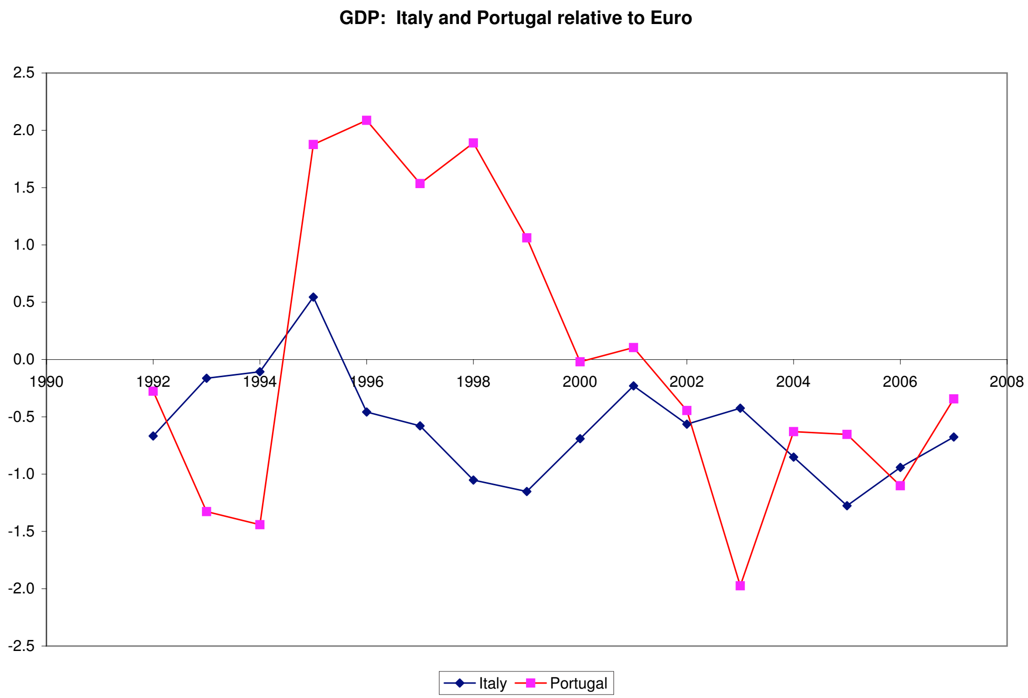
The bust.

- 1.5% cumulative output growth since 2002. Unemployment back at 7.8%.
- Higher productivity growth has not materialized. Just the opposite: 0.7% cumulative productivity growth since 2002.
- Private saving has increased, leading to a decrease in demand.
- Nominal wage growth has decreased a little, but much less than productivity growth.
- The overvaluation has gotten worse. By another 10% relative to euro area since 2002 (using ULC). Current account deficit is still at 9.6% despite the slump. Now associated with a large fiscal deficit, 5% in 2006.
- Prospects: not very good. Higher productivity? Negative wage growth?

Figure 2. Wage and labor productivity growth
Portugal 1996–2006



Italy. A slow deterioration



No boom-bust. Just slow growth.

- On the surface. Not so bad. Decrease in unemployment from 11% in 1995 to 7.7%. Small current account deficit, about 2%.

- But very low growth, and a problem of competitiveness.

- Very low productivity growth. Cumulative 9.3% since 1995. relative to the euro: -3%

- Low, but still higher nominal wage growth. Steady loss of competitiveness. Using ULC: An appreciation of 15% vis a vis Euro area. (The Chaney caveat)

- Loss of competitiveness partly offset by low import growth. So limited deterioration of current account balance.

Ways out?

- Same recommendations as for Portugal (with more balance between external and internal demand).
- Higher productivity growth, especially in non-tradables. The Prodi reforms.
- Lower nominal wage growth (But why has it remained so high relative to productivity?)
- Likely slow and painful.

Parting thoughts

- Next Spain? Why? Demand (housing) boom, overvaluation, and current account deficit: 8.9% in 2006. What happens when internal demand slows down?
- Optimal policy mix? Both ex-ante and ex-post: Wage adjustment and fiscal policy. To maintain internal and external balance.
- Need for much better/explicit labor relations.
- If not, danger of misuse of fiscal policy. Example: Current discussion in Spain: If internal demand slows down, fiscal expansion is not the solution.