A macroeconomic survey of Europe

Olivier Blanchard

May 2008
Forecasts: A very mild case of stagflation

OECD forecasts for the Euro area:

<table>
<thead>
<tr>
<th></th>
<th>20005</th>
<th>2006</th>
<th>2007</th>
<th>2008*</th>
<th>2009*</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP Growth</td>
<td>1.6</td>
<td>2.9</td>
<td>2.6</td>
<td>1.9</td>
<td>2.0</td>
</tr>
<tr>
<td>Inflation (CPI)</td>
<td>2.2</td>
<td>2.2</td>
<td>2.1</td>
<td>2.5</td>
<td>2.0</td>
</tr>
</tbody>
</table>

Most recent forecasts a bit less optimistic: Consensus forecast from The Economist:

GDP growth for 2008, 1.5%. CPI inflation for 2008: 3.0%
Reasons to worry?

• Always...
  Price of oil to $200? Probably not.
  Failure of a major financial institution. Given Central Bank policies, probably not either.

• Focus on three issues:

• The Euro. More appreciation to come?

• The price of oil, inflation, and the ECB bet.

• Divergences across Euro countries. Spain?
1. The rise of the Euro. More to come?
• More to come?
• Need to take one step back: “Global imbalances”
• Asia (China), and Oil producers, versus US. Europe on the sidelines.
Current account balances

Note the position of Europe. “No dog in that fight”?  

Nr. 6
Why the imbalances?

- **China.** High saving, higher than investment. Better put it abroad, especially in the United States.

  Another way of thinking about it. Keep the exchange rate low to favor exports, attract foreign direct investment, and boost productivity growth.

- **Oil producers.** High saving, few investment opportunities. Better put it, especially in the United States abroad.

Perfectly reasonable behavior, but will not last forever.
• Strong political pressure to increase internal demand relative to exports in China.

• Oil producer net saving will slowly come down

• Current account deficit of the US will decrease. Current account surplus of Asia and oil producers will decrease.

• When this happens, two evolutions:
  The euro will appreciate vis a vis the dollar
  The euro will depreciate vis a vis the yuan, and Opec currencies (if no longer linked to the dollar).
  (Dollar down, Euro stable, Yuan/yen up)

• So: Euro real exchange rate should remain about the same.
• Seen some of the adjustment already. RMB real appreciation against dollar (inflation and nominal appreciation) about 17% since January 2007.

Current account deficit of the US decreasing, despite oil prices. Very slow.

• Much of the action however has come from elsewhere: Portfolio shifts
  Movement away from (many) US assets. By central banks. By private investors. To Euro assets

• Thus, the euro appreciation (both bilaterally with dollar, and multilaterally. Increase in real exchange rate.)
The tough question: Implications and forecast?


- To the extent they do, the Euro will depreciate vis a vis the dollar. May be relevant over the next year or two.

- But the adjustment of global imbalances still need to take place (slowly). This implies an eventual appreciation of the euro vis a vis the dollar, and a depreciation vis a vis the RMB/yen.
2. The price of oil and the ECB

Price of oil in euros and in dollars

![Graph showing the price of oil in euros and dollars over time.](image)

- Price in dollars
- Price in euros

Nr. 11
The price of oil and stagflation

- An increase in the price of oil increases the CPI directly. ("first round effect")

  Workers ask for higher nominal wages
  The increase in nominal wages leads to an increase in the price of all goods. ("second round effects")

- To contain inflation, the central bank must allow unemployment to increase.


- The 1970s. High inflation and high unemployment.
The "ECB bet": Yes to first round effects, no to second round effects.

- A dangerous bet.

- Another way of stating it: Force workers (consumers) to accept the real wage cut right away. Increase in the CPI, no increase in the nominal wage.

- In light of the 1970s, would look like a very risky bet. May have to force unemployment up a lot.

- So far: The bet has worked.
  Both in the US and in Europe, nominal wage growth has not adjusted to higher CPI growth.
The basic numbers for the Euro area.

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflation (CPI)</td>
<td>2.2</td>
<td>2.2</td>
<td><strong>2.1</strong></td>
<td><strong>2.5</strong></td>
</tr>
<tr>
<td>Wage growth</td>
<td>1.2</td>
<td>1.8</td>
<td>2.4</td>
<td>2.8</td>
</tr>
<tr>
<td>Productivity growth</td>
<td>0.5</td>
<td>1.2</td>
<td>1.0</td>
<td>0.9</td>
</tr>
<tr>
<td>Wage minus pty growth</td>
<td>0.7</td>
<td>0.6</td>
<td><strong>1.4</strong></td>
<td><strong>1.9</strong></td>
</tr>
</tbody>
</table>

The basic numbers for Germany.

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflation (CPI)</td>
<td>1.9</td>
<td>1.8</td>
<td><strong>2.2</strong></td>
<td><strong>2.3</strong></td>
</tr>
<tr>
<td>Wage growth</td>
<td>-0.1</td>
<td>1.3</td>
<td>1.3</td>
<td>2.3</td>
</tr>
<tr>
<td>Productivity growth</td>
<td>1.1</td>
<td>2.4</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Wage minus pty growth</td>
<td>-1.2</td>
<td>-1.1</td>
<td><strong>0.3</strong></td>
<td><strong>1.3</strong></td>
</tr>
</tbody>
</table>
Will the bet (continue to) succeed?

- Wage negotiations in Germany. Lessons?
- Are workers that weak in bargaining? If so, why is structural unemployment still so high?
- What if the price of oil increases further? (and so does the price of food). Is there a pent-up reaction?
- A major political and economic issue: Perceived versus actual inflation.
5. Comparaison entre l’inflation réelle et l’inflation perçue

Solde de réponses (moyenne mobile centrée d’ordre 3), en %

Source : INSEE, Datastream, repris de CAS (2006a).
3. Divergences across Euro countries

A very old issue. What if there are country-specific shocks in a common currency area?

- For a while after 2001, not a major issue. In the more recent past, it has become very relevant.

- Portugal. Boom, then bust. How long will it take to recover?

- Spain. Boom, then?
Portugal. Boom and bust

Portugal. Unemployment rate and current account deficit

<table>
<thead>
<tr>
<th>Year</th>
<th>CA deficit to GDP</th>
<th>Unemployment rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>-2</td>
<td>3.5</td>
</tr>
<tr>
<td>1997</td>
<td>0</td>
<td>4.0</td>
</tr>
<tr>
<td>1999</td>
<td>2</td>
<td>4.5</td>
</tr>
<tr>
<td>2001</td>
<td>4</td>
<td>5.0</td>
</tr>
<tr>
<td>2003</td>
<td>6</td>
<td>5.5</td>
</tr>
<tr>
<td>2005</td>
<td>8</td>
<td>6.0</td>
</tr>
<tr>
<td>2007</td>
<td>7.5</td>
<td>7.0</td>
</tr>
<tr>
<td>2009</td>
<td>7.0</td>
<td>7.5</td>
</tr>
</tbody>
</table>

Nr. 19
Portugal: The story behind the scene


- Steady decrease in unemployment. Steady increase in wages, and decrease in competitiveness. Large current account deficits


  Low wage growth but low productivity growth. Very slow adjustment.
Spain. Boom and ?

Spain. Unemployment rate and current account deficit

Unemployment rate
CA deficit to GDP

-2 0 2 4 6 8 10 12 6 8 10 12 14 16 18 20

Nr. 21
Can Spain avoid a long bust?


• 2007-? Decrease in internal demand (housing). How long will it take to reestablish competitiveness?

• Fiscal policy? Useful for a while, but stands in the way of adjustment.

• Wage flexibility? Higher than in Portugal? Probably. But higher than in Germany (10 years of adjustment after 1995, and the reunification shock)?
Conclusions

- The Euro. Two major forces at work. A likely decrease in the real exchange rate, but less so vis a vis the dollar.

- The price of oil. A risky bet by the ECB, which so far has paid off—but remains risky.

- The legacy of housing booms and large current account deficits. No easy way out for Spain.