

# A macroeconomic survey of Europe

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## Three topics

- The long view. A look at productivity, past, current and future.
- The short view. Prospects for the next year.
- The dollar and the Euro.

A schizophrenic view:

- Medium run prospects: Fundamentals in decent/good shape. Surely much better than common wisdom
- Short run prospects: Lack of confidence. Small margin for policy. Euro appreciation. Prospects worse than common wisdom
- On the Euro. More appreciation to come: Fundamentals of US current account deficit.

## 1. Looking at productivity

- The last 30 years. Productivity growth and productivity levels. Much better than you think.
- The last 10 years. At the end of the 1990s, it appeared that EU-US productivity paths were diverging. Much less obvious today.
- The future. Dynamics of reform: Bruxelles-driven reforms in the goods market, forcing reforms in the labor market. Fits and starts.

(Based on a recent paper, “The Economic Future of Europe”, updated)

## The last 30 years. Basic facts

**Table 1. PPP GDP per person, PPP GDP per hour worked, and Hours worked per person (U.S.=100)**

	GDP per person		GDP per hour		Hours per person	
	1970	2000	1970	2000	1970	2000
US	100	100	100	100	100	100
EU-15	69	70	65	91	101	77
France	73	71	73	105	99	67

First two columns: EU stuck 30% behind the US? Next four columns: Catch up of productivity, decrease in hours worked.

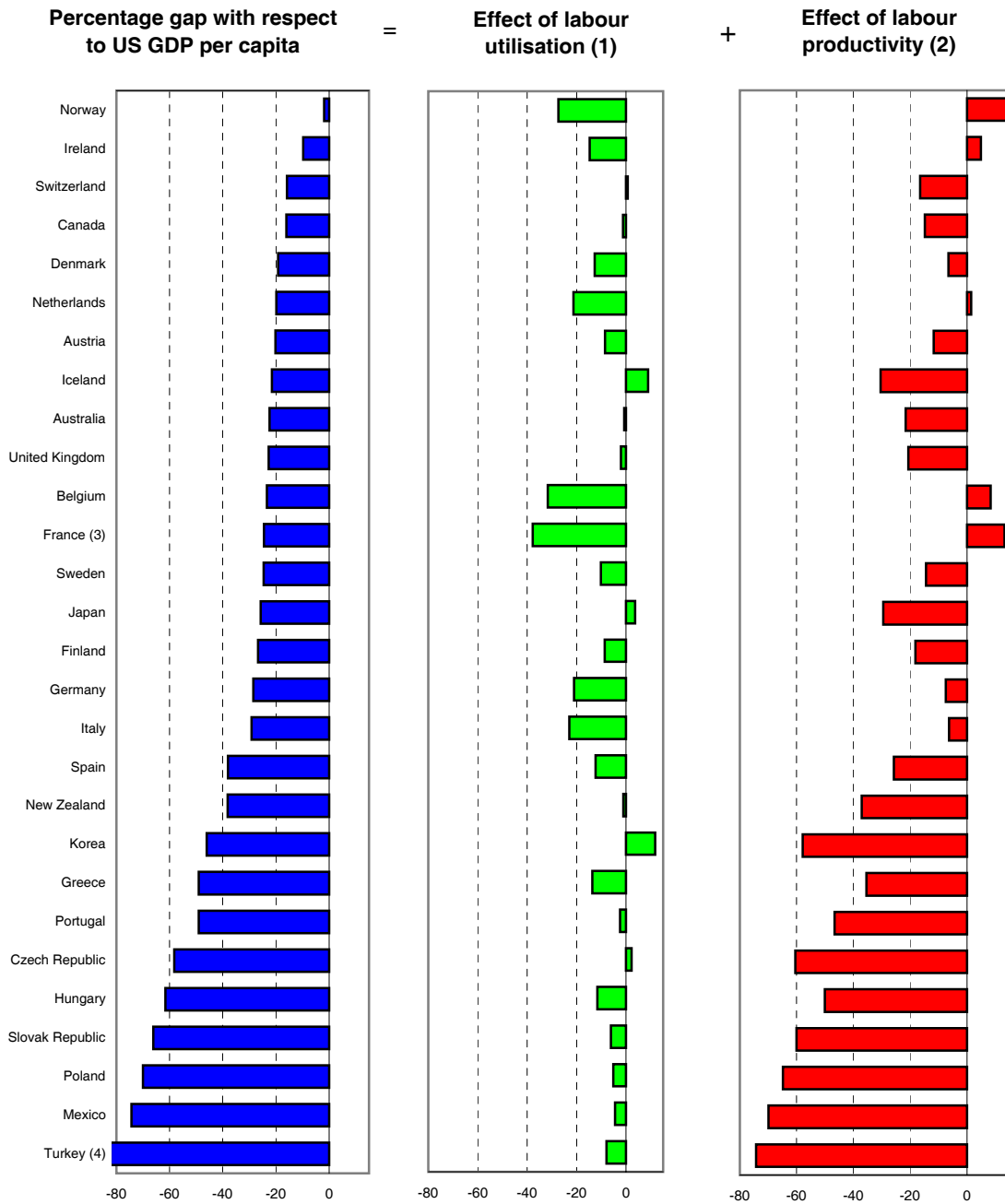
Another way of stating the same underlying facts. From 1970 to 2000:

- **U.S.** GDP per hour : + 38%. Hours per person: +26%.  
GDP per person: +64%
- **France** GDP per hour: + 83%. Hours per person: -23%.  
GDP per person : +60%

Who did better?

## Breakdown of GDP per capita in its components, 2002

Percentage point differences in PPP-based GDP per capita with respect to the United States



1. Based on the total hours worked per capita.
2. Based on GDP per hour worked.
3. Includes overseas departments.
4. GDP for Turkey is based on the SNA 68.

Source : OECD estimates.

## Is productivity really that high?

A recent alternative measure for productivity (GDP per hour worked, OECD September 2004): US=100, France 113.

Two measurement issues:

- The minimum wage, low skill workers, and truncation.  
Rough estimate (upper bound) 7% for France.
- Capital/labor substitution. TFP?  
Capital/output ratios higher in Europe.  
Adjustment (upper bound) 10% for France.

General picture fits well what we know from individual sectoral studies (McKinsey), or about number of European firms in top 500.

## Increased leisure, or increased distortions?

Change in hours per person = Change in:

- Hours worked per worker, ( $H$ ).
- Ratio of employment to labor force (one minus the unemployment rate) ( $1 - u$ )
- Ratio of labor force to working age population ( $L/P_A$ )
- Ratio of working age population to total population ( $P_A/P$ )

A decomposition, from 1970 to 2000:

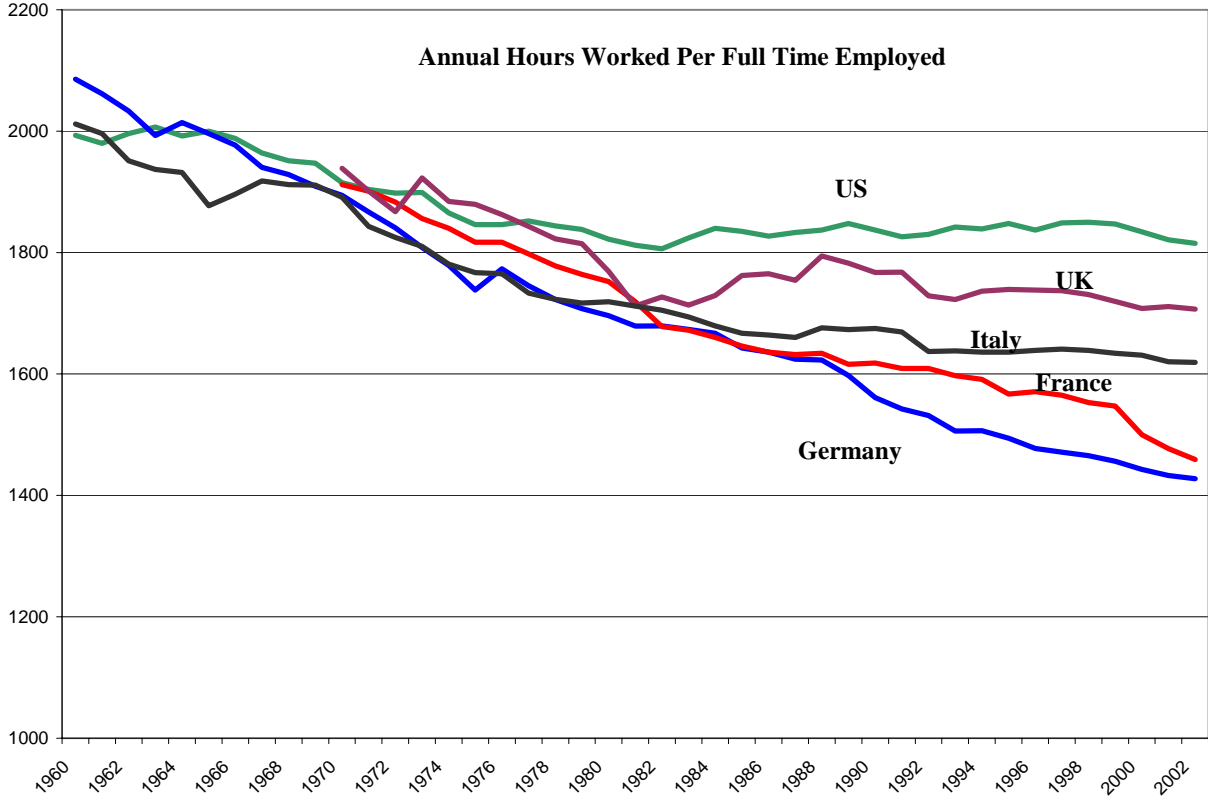
$$\Delta \ln\left(\frac{HN}{P}\right) = \Delta \ln H + \Delta(1 - u) + \Delta \ln\left(\frac{L}{P_A}\right) + \Delta \ln\left(\frac{P_A}{P}\right)$$

France	-21%	=	-23%	-7%	4%	5%
U.S.	+22%	=	-4%	1%	11%	14%
Difference	-43%	=	-19%	-8%	-7%	-9%

- Change in hours: Increase in proportion of part time, or decrease in hours of full time?
- Preference for leisure, or increase in taxation? Evidence on taxes, across income groups, across countries.

**Figure 2**  
**Annual Hours Worked Over Time**

OECD data. Consists of weekly hours worked, annualized and then adjusted for holidays, vacations, sick leave.





**Table 1**  
**Hours Per Person Per Week and Employment Ratios By Country**

E/P, Weeks per Year, Usual Hours use OECD data. Hours per person per week is calculated as the product of E/P\*weeks/52\*usual hours. OECD data on weeks and usual hours provided by the Secretariat and use same sources as OECD Employment Outlook 2004. OECD data on E/P are from <http://www1.oecd.org/scripts/cde>. US data on usual hours and weeks worked are from Luxembourg Income Study. We use usual hours and weeks worked for **\*\*all employed\*\*** including part time. Table 3A uses full time employees.

Country	Weekly Hours Per Person	Employment/ Pop	Weeks per Year (Employed)	Usual Weekly Hours (Employed)
Belgium	17.92	0.643	40.0	36.29
Denmark	20.63	0.761	38.9	36.27
Finland	19.73	0.688	38.5	38.75
France	17.95	0.636	40.5	36.21
Germany	18.68	0.656	40.6	36.48
Greece	20.10	0.576	44.6	40.71
Ireland	20.10	0.659	43.7	36.29
Italy	16.68	0.565	41.0	37.42
Netherlands	17.25	0.734	38.4	31.79
Norway	19.94	0.774	36.0	37.25
Portugal	16.98	0.523	41.8	40.37
Spain	18.14	0.576	42.2	38.85
Sweden	19.06	0.735	35.4	38.10
United Kingdom	21.42	0.721	40.5	38.19
United States	25.13	0.719	46.2	39.39

Source: Alesina et al, mimeo, December 2004

## The recent past

At the end of the 1990s, it appeared that productivity growth was increasing in the United States, decreasing in Europe. (Van Ark numbers we discussed two years ago).

As of the end of 2004, much less obvious. Most recent OECD numbers:

**Table 2. Labor productivity and Multifactor productivity growth in the United States and France, 1990-2003.**

	Labor productivity		Multifactor productivity	
	1990-95	1995-03	1990-95	1995-02
U.S.	2.1	2.2	0.8	1.2
France	2.1	2.0	0.8	1.4

*Source: OECD November 2004, using harmonized IT deflators*

How can this be? (Large differences in employment growth, so in output growth)

## Productivity growth: Cross currents

Reading productivity evolutions in Europe at this juncture is very hard:

- Reforms in goods markets suggest it should be higher.

Tentative explanations. Reluctance to layoff. If output growth picks up, then productivity growth is likely to pick up.

Jobless recovery?

- Some reforms in labor market lead to reemployment of low productivity workers.

The Spanish puzzle: Large decrease in unemployment. But also negative productivity growth.

Composition (growth in low productivity services and construction), low skill workers? Nobody really knows.

# Spain: Unemployment rate and productivity growth

1990:1 2003:1



## The reform process

General line, developed in earlier presentations:

- Reforms in goods markets, largely driven from Bruxelles
- Driving reforms in labor markets, with fits and starts.

An update: On the goods market front:

- Liberalization of services?
- Replacement of Monti by Neelie Kros?
- One potential danger on the horizon:

The European constitution and devolution of some responsibilities for competition policy to the states.

Reform of the state? An important and largely unnoticed development in France: The LOLF (loi d'orientation de la loi de finances), adopted in 2001

- Shift from budget by ministry to budget by function. 48 missions, 170 programs.
- Definition of objectives. Global budget, and full allocation flexibility, except for ceiling on employment. New accounting rules.
- Trial run. 2005 budget. First real run: 2006 budget.

## Reforms in labor markets

- Spring European elections. A setback.
- In France, vote seen as sanction against retirement system reform.  
Government at standstill.  
The Camdessus commission, and Sarkozy.
- In Germany, nothing to lose. Hartz IV (tightening of unemployment benefits, means-testing, workfare)  
The failure of the fall demonstrations
- No visible action in Italy.
- No obvious change of direction in Spain with the change in government. Some discrete reforms. (for example, on employment protection). The SEPI shipyards.

In general, no major reforms before 2006 elections. Small, more discrete reforms.

## 2. The short run

Performance very much what we predicted a year ago (i.e a bit worse than official predictions).

### OECD forecasts, as of November 2004

	Output growth		Unemployment rate	
	2004	2005	2004	2005
Euro area	1.8	1.9	8.8	8.6
France	2.1	2.0	9.8	9.7
Germany	1.2	1.4	9.2	9.3
Italy	1.3	1.7	8.1	7.5
Spain	2.4	3.0	10.9	10.7
UK	2.0	2.8	4.7	4.7

- Weak growth, just sufficient to maintain unemployment.
- Differences across countries. France and Spain feeling better than Germany and Italy. Internal demand stronger in France and Spain
- Most recent numbers: Retail sales down in november, for the fourth month in a row.

## How accurate were the forecasts?

Table: OECD forecasts for the Euro area, as of different dates in the past.

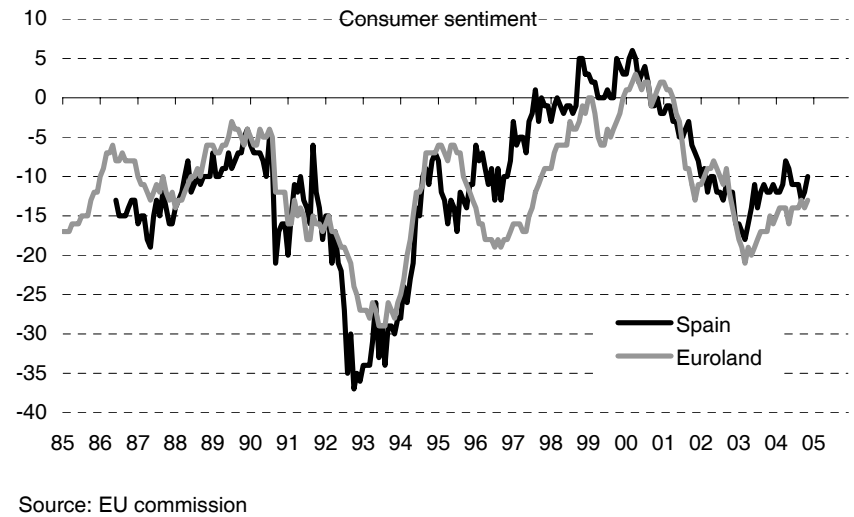
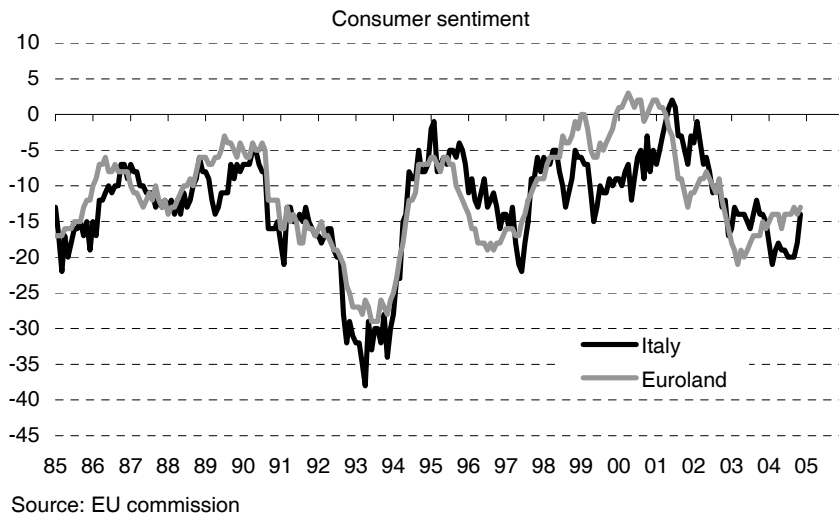
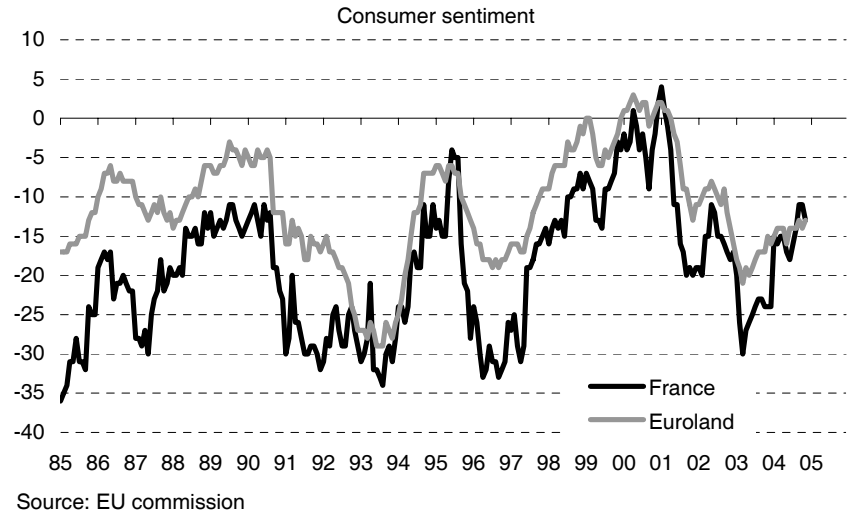
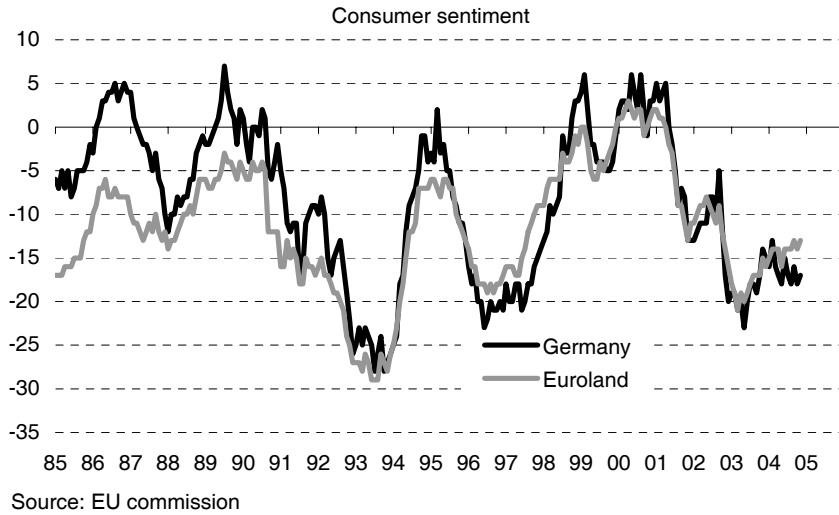
	2002	2003	2004	2005
GDP				
dec 02	0.8	1.8	2.7	
june 03	0.9	1.0	2.4	
dec 03		0.5	1.8	2.5
dec 04			1.8	1.9
Consumption				
dec 02	0.6	1.5	2.5	
june 03	0.7	1.2	2.1	
dec 03		1.4	1.7	2.4
dec 04			1.2	1.6
Investment (non residential)				
dec 02	-2.7	1.3	4.3	
june 03	-2.2	-0.6	3.8	
dec 03	-3.4	-2.1	2.7	5.1
dec 04			2.4	3.7

Source: OECD Economic Outlook, December 2002, June 2003, December 2003, December 2004.

- Overall growth as expected. But lower consumption, and lower investment. (How to reconcile: higher stockbuilding; net exports for Germany, not for others)
- Lack of confidence of consumers. Graph: Consumer sentiment, Euro area: +5 in 2000, -20 in 2003, -12 end 2004.



# Consumer Confidence Euro Area



## Why the lack of confidence?

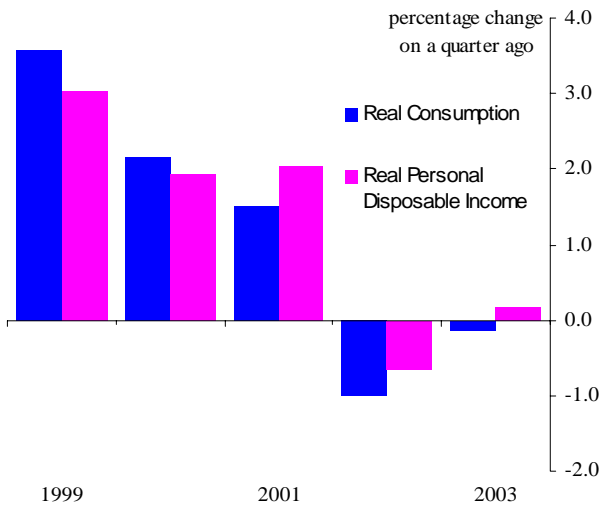
On the part of consumers.

- The fear of outsourcing and globalization (Poland, and China).
- Low real wage growth, and the fear of wage reductions. The VW gambit. (Headline: 30% wage reduction)
- Reforms and confidence: A Catch 22  
Politically helpful to create a sense of crisis if wants retirement or social insurance reform. But also leads to an increase in saving.  
The example of Germany (from a study by Giavazzi).  
Retirement reform, aggregate saving, and saving by age.

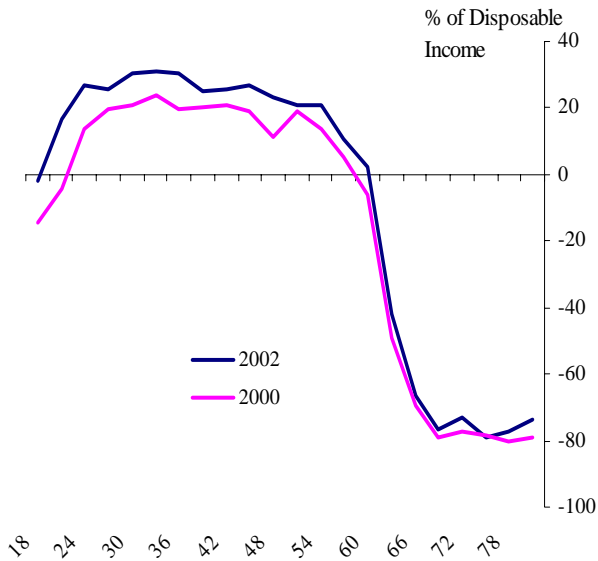
On the part of firms. More optimistic than consumers.

- Profit rates (within Euro area) remain high. Balance sheets improved.
- Why low investment: From econometric French investment equations: No residual.  
The factor behind low investment despite solid profits: low sales.

**Germany: Disposable income, consumption (1999-2003)**



**Germany: Age-saving profile in 2000 and in 2002**



## Monetary and fiscal policy

Fiscal policy in neutral:

	2003	2004	2005 (*)	Debt 2004
France				
actual	-4.1	-3.7	-3.1	46.9
cyclically adjusted	<b>-3.4</b>	<b>-3.1</b>	-2.5	
Germany				
actual	-3.8	-3.9	-3.5	56.2
cyclically adjusted	<b>-2.7</b>	<b>-2.6</b>	-2.3	
Euro area				
actual	-2.8	-2.9	-2.6	53.5
cyclically adjusted	-2.0	-2.1	-1.8	

Source: OECD Economic Outlook, November 2004. \*:forecast. Debt: Net debt. Percent of GDP

- Greece, Poland, Hungary, above 5% in 2004
- The SGP. Likely to become softer. More focus on medium term, and debt level. No shift to capital accounts.

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## Monetary policy unlikely to do much

- Inflation as a single (minded) target.  
How closely is inflation related to activity?  
The labor productivity and wage vicious/virtuous circle.
- But unlikely to move much, except in reaction to Euro.  
(Sterilized) intervention: Likely.  
Cut in rates: maybe later.  
More on this in third part

### 3. The Euro

The depreciation of the dollar: Chronicle of a death foretold.

Start from US account: The main global macroeconomic issue today

- Large and getting larger: -4.8% in 2003, -5.7% in 2004, projected at -6.2% in 2005 (OECD)
- Unprecedented historically. The Reagan deficits peaked at 3.5%.
- Large absolutely. \$670 billion in 2004. Roughly the size of Spain's GDP.

About 12% of non-US gross saving, about 50% of non-US net saving.

(With apologies: Go over some old, some new material)

## **Where does the US CA deficit come from?**

Two lines of explanation.

- The current account side: Faster US growth, lower (private initially, now private and public) saving in the US, leading to the current account deficit
- The capital account side: Increased attractiveness of US assets (liquidity, return), leading to large capital inflows.

Truth in the middle:

- If only the first, depreciation would have started long ago.
- If only the second, the appreciation would have been stronger.

## Can it continue?

Almost surely not at this rate (I discussed the arithmetic in December 2002)

- Requires a steady increase of share of world portfolios in US assets.
- Who has been/is willing to do so?

Equity investors and direct investment in the 1990s.

Bond investors increasingly since 2001.

Central banks for much of 2003/2004.

- Will they be willing to continue in the future?  
Seems increasingly unlikely.
- What current account deficit can we sustain while keeping current proportions. About 1% of US GDP.



## By how much must the dollar decline?

Per 1% reduction of the ratio of current account deficit to GDP: (no stand on required reduction in CA deficit)

- Conservative estimate based on estimated import/elasticities: 1% ca deficit reduction requires 20% depreciation.
- A simulation using a world model, combining fiscal restraint and depreciation:
- Recent Obstfeld Rogoff numbers: 40% real depreciation for reduction in deficit of 5%. Higher than their previous estimates, but lower than general consensus. Assumed elasticities are probably too high.

## Implications for the Euro?

The dollar must depreciate. How much against the euro, the yen, or the yuan?

Answer: Depends mainly on where the money goes. Different scenarios:

- Chinese and Japanese central banks float. Then, mostly yen and yuan.  
(Misconceptions about Chinese policy and the Euro. The current policy is not putting pressure on the Euro).
- Chinese and Japanese change the composition of their reserve portfolio. Then yen and euro.
- Bond holders move away from US T-bills. Probably, mostly euro.
- Equity holders and direct investors move to Asia. Then, mostly yen and yuan.

Most likely: In most scenarios, largely against the euro. More appreciation to come.

## Implications for Europe?

Europe (Japan) needs to offset decrease in external demand by an increase in internal demand. Easier said than done.

Policy tools:

- Intervention by the ECB? Delay tactics at best. Does not work against fundamentals.
- Decrease in nominal interest rate? It should. It may. But can only have limited effect.
- Fiscal policy. Small margin of maneuver: Long run improvements against short-term boosts.

Not without consumer and firm confidence. But how to achieve it?

Final twist. A potential silver lining:

Too much of a euro appreciation kills Europe, but also makes European stocks and FDI less attractive. Enough to prevent/stop further appreciation ?

Judging from the experience with Latin America capital inflows, unlikely.