A macroeconomic survey of Europe

Olivier Blanchard

November 2005

The continuing (Euro area) Slump.

- Low output growth. Structural factors or insufficient demand? Both:
- Low productivity growth and a high structural rate of unemployment. (Is productivity growth really exogenous?)
- Still clearly some cyclical component. Inflation slowly down since 2001. Low demand, domestic and foreign.

Basic numbers for the Euro area:

	2000	2001	2002	2003	2004	2005
GDP growth	3.7	1.7	0.9	0.6	1.8	1.2
Unemployment rate	8.4	8.0	8.4	8.9	8.9	9.0
Labor productivity growth	1.4	0.1	0.5	0.5	1.1	0.6
GDP deflator	2.8	3.0	2.6	2.2	2.0	1.9
CPI	2.2	2.5	2.3	2.1	2.1	1.8

(Source: OECD. Labor productivity is output per worker, business sector).

The end of the slump?

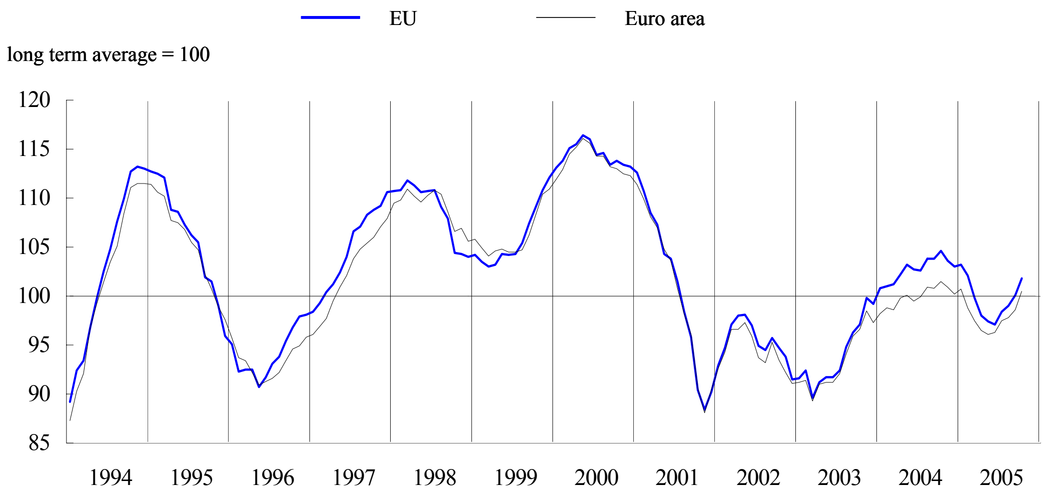
Mild optimism. GDP growth forecasts, as of November 2005 (from the Economist): 2006 > 2005.

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

Euro-wide "Economic sentiment" (weighted average of consumer, service, industrial, and construction confidence indexes). (The role of the euro depreciation?)

An uptick.

GRAPH 1: **Economic sentiment indicator** (s.a.)



Not the first time. The reality check. Recent forecasts and outcomes:

	2002	2003	2004	2005	2006
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	2.5
june 05				1.2	2.0
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	2.4
june 05				1.3	1.7
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	4.9
dec 04				2.3	3.8

Source: OECD Economic Outlooks, December 2002-June 2005.

How will Europe get out of the slump? Three scenarios

- Increase in demand, domestic or foreign, leading to higher productivity growth, and further reforms of labor/goods markets.
- Reforms triggering productivity/employment increases, leading to more optimistic expectations, more demand growth
- Muddling through. Slow reforms or a stop to reforms. A continuing slump.

Four issues. (More questions than answers...)

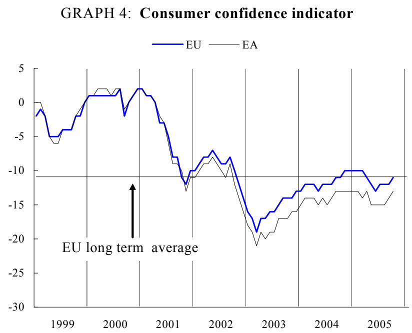
- Consumption, uncertainty, and reforms
- Booming stock markets, high profit shares, and weak investment
- The price of oil and monetary policy.
- Countries in (more) trouble. Italy, Portugal. The non-optimal currency area.

(Left out (but the elephant in the room). The sources of low productivity growth since 2000.)

Conclusions: Which scenario?

Consumers and reforms

Why are consumers not spending more?



- The shift in income distribution, from wages to profits.
- The paradoxical effect of reforms.
  Decrease in employment protection.
  Reforms of the pension systems.
  (Some evidence for Germany, from Giavazzi-McMahon, based on German Socioeconomic Panel, 2002)
- The missing link so far. From reforms to productivity to income growth.

Table: Impact of a one-standard deviation increase in concern about pension reform on the household saving rate, by age.

Age	25	30	35	40	45	50	55	60	65	70
Saving rate	37	38	35	34	32	31	27	6	-50	-68
Impact	-1.8	-1.0	0.3	1.4	3.5	6.3	10.7	17.9	13.8	10.1

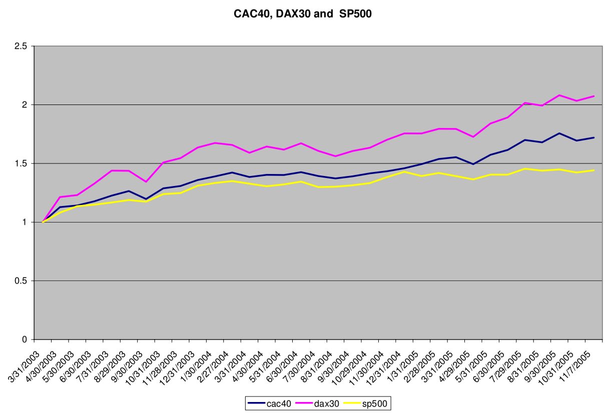
Source: Giavazzi McMahon, Table 7

Profits and investment

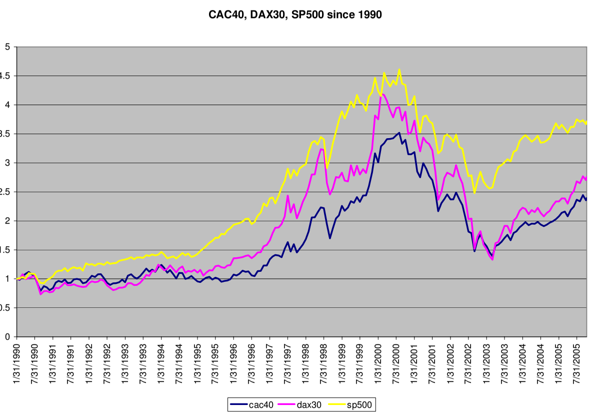
Why are firms not investing more?

- Strong stock markets.
- High capital shares.
- Yet: Low investment to GDP ratios.

Stock price indexes. Germany, France look good relative to the US starting from the trough (2003):



Less so starting from 1990:



Labor shares (Business sector, source Eurostat)

	1981-1990	1991-2000	2003	2005
Euro area	72.3	68.9	67.1	66.2
France	73.6	67.9	66.9	66.0
Germany	69.5	68.1	66.9	65.5
Italy	70.7	66.1	64.2	64.2
Spain	69.8	68.3	65.6	64.9
UK	73.4	73.5	74.2	74.3
USA	68.6	67.4	66.6	66.1

Investment to GDP ratios (percent).

	1981-1990	1991-2000	2003	2005
Euro area	21.7	21.0	19.8	20.3
France	21.7	19.4	19.2	19.9
Germany	20.9	22.4	17.8	17.8
Italy	22.2	19.0	19.2	19.6
Spain	22.7	22.8	25.6	27.6
UK	18.7	16.7	16.3	17.5
USA	18.8	17.9	18.0	19.4

What does it all mean?

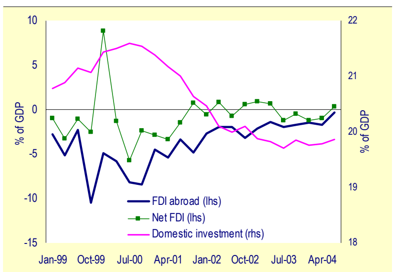
Stock market valuations: Profits from domestic or foreign operations?

Ratio of foreign to total assets for the 42 European firms in the top 100 transnationals: 48%. If high profits reflect profits from foreign operations, then investment abroad.

Magnitude? Basic numbers on FDI: Over 1999-2004, FDI from euro area to outside: 17% of fixed investment But FDI from outside to euro area: 12.5% (half of it M&A)

FDI from euro area and investment have moved in the same directions.

Graph 36: **Investment and FDI** (1)**, euro area**
(1999Q1 to 2004Q2)



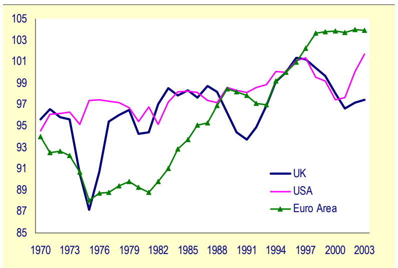
(1) (-) indicates a capital outflow.
Source: ECB, Commission services.

Capital shares: Two factors behind the increase.

Increase in the capital output ratio. Increase in the rate of return. From the mid 1980s to late 1990s, largely the first. Since, mostly the second.

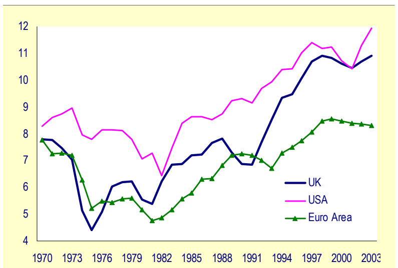
Rates of return (domestic profits over domestic capital). A substantial increase, but less than in the UK or the US.

Graph 16: **Profit mark-up, euro area, UK and USA**
(1970-2003 – index 1995 = 100)



Source: Commission services

Graph 17: **Net return on net capital, euro area, UK, USA** (1970-2003 – In %)



Source: Commission services

Still a puzzle. The "Nike model" ?

Monetary policy and the price of oil

Monetary policy not helping, and may soon hurt. The issue: The likely reaction of monetary policy to the increase in the price of oil.

- The current policy stance. Allow for first round effects, not second round effects.
- Translation: Force workers to accept at once the real wage cut coming from the increase in the price of oil (about 1-1.5% of income).

- Maybe the right policy for the United States.
  Little or no real wage resistance. Weak unions. Large increases in productivity.
- Probably the wrong policy for the Euro area.
  Stronger unions. Low productivity growth. May require a large increase in unemployment to prevent any second round increase in compensation.
  May lead to more of an increase in interest rates than currently in the term structure.

For the time being, limited passthrough, and little wage reaction. Beware of the lags.

The evolution of inflation and compensation growth.

	2002	2003	2004	2005-1	2005-2	2005-3
HCPI	2.3	2.1	2.1	2.0	2.0	2.3
Core CPI (83.8%)	2.5	2.0	2.5	1.6	1.5	1.4
CPI energy (8.6%)				0.3	4.5	5.7
Compensation	2.6	2.3	2.1	1.8	1.6	

Source: Monthly Bulletin, ECB, November 2005

Compare to the US (CPI inflation: 1.2% in September 2005, 4.7% last 12 months, core inflation flat at 2%)

The non optimal currency area. Countries in trouble: Italy and Portugal

Doing poorly: GDP growth.

	2000	2001	2002	2003	2004	2005	Sum
Italy	3.2	1.7	0.4	0.4	1.0	-0.6	6.1
Portugal	3.4	1.7	0.4	-1.1	1.0	0.7	6.1
Euro area	3.7	1.7	0.9	0.6	1.8	1.2	9.9

Why? In part, loss of competitiveness:Productivity growth lower than Euro area, wage growth higher than Euro area.

	2000	2001	2003	2003	2004	2005	Sum
Italy							
Compensation	2.9	3.0	2.4	3.2	3.1	3.2	17.8
Productity	1.5	0.1	-1.0	-0.1	-0.4	0.2	0.3
Portugal							
Compensation	6.9	5.2	3.8	3.5	2.3	2.5	24.2
Productivity	1.3	-0.3	-0.1	-1.0	1.0	0.4	1.3
Euro area							
Compensation	2.3	2.6	2.4	2.2	1.7	1.7	12.9
Productivity	1.4	0.1	0.5	1.1	0.6	1.1	4.8

Things are worse than they look:

- The legacy of excess wage growth. Why?

  In Portugal, a consumption boom associated with entry into the Euro, from 1995 to 2001. Large current account deficit, pressure on non-tradable prices. Pressure on wages.

  In Italy, strong wage growth despite high unemployment. Why?
- More problems to come. The wrong export specializations.
  Exports concentrated in declining world demand sectors.
  And for products close to China's exports (Footwear and textiles account for 20% of Portuguese exports.)

What happens next?

- Long period of higher unemployment and low nominal wage growth, to reestablish competitiveness. A slow process at best.

- Getting out of the Euro? (Northern League). Almost surely not. The cost of unilateral exit is too high.
  Worse than for Argentina. Legal status of government euro bonds held by foreigners/by domestic residents. Legal status of private bonds/ private contracts.

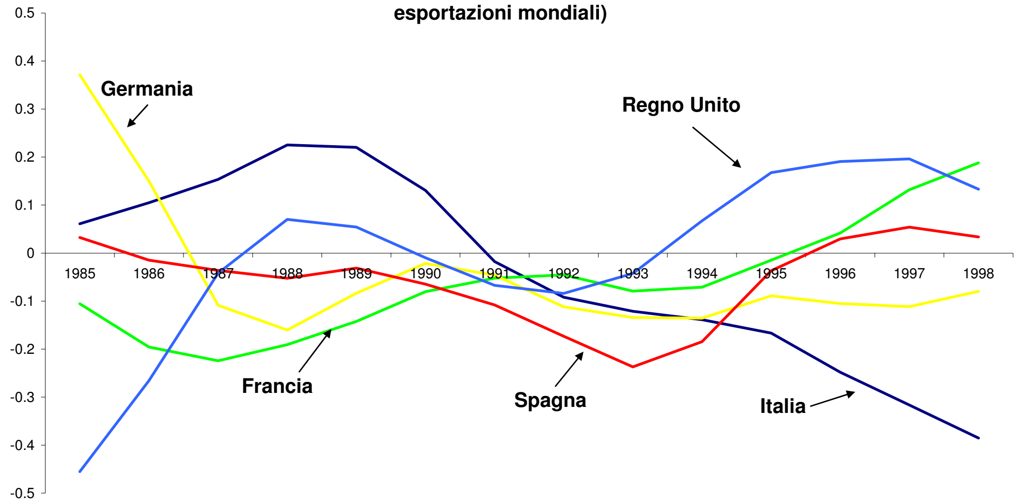
  Anticipation effects, and time to negotiate with Euro partners. Out of Portuguese banks and other financial intermediaries.

- Reforms in labor markets, in service sector?
  Would help a lot with productivity. But unlikely on a major scale.

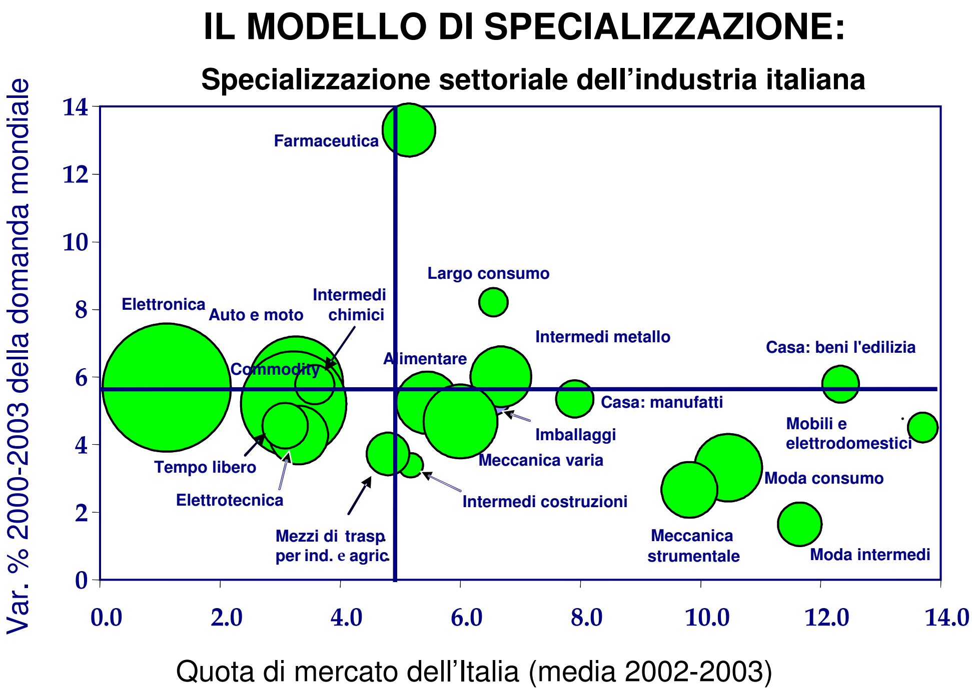
Correlation across sectors between shares of italian exports in total world exports and growth rate of world exports.

Behind the slowdown: exports an increasingly wrong specialization

Fig 11 Un modello di specializzazione obsoleto?
(correlazione fra indici settoriali dei vantaggi comparati e crescita settoriale delle esportazioni mondiali)



A closer look:

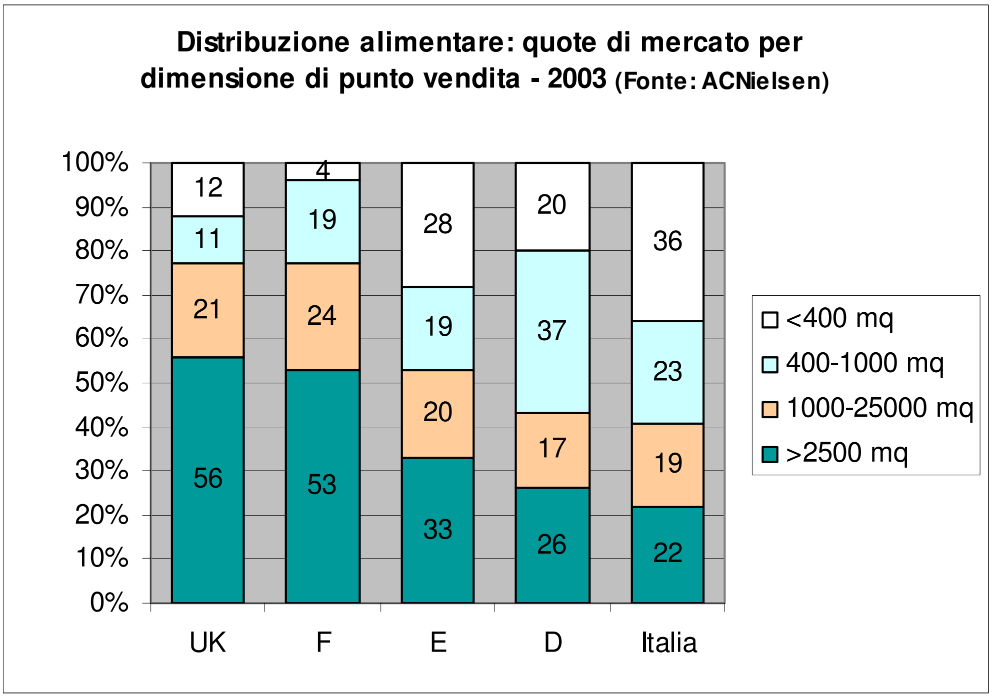


Nota: la dimensione del cerchio indica il peso del settore sul commercio mondiale
Fonte: Banca Intesa - Prometeia.

Best to be on the upper-east and lower-west quadrants.

The scope for productivity growth in the service sector. The example of retail:

The protection of small, inefficient retailers



Conclusions. What happens next?

- Reforms continuing, (too) often by stealth.
  Germany: Hartz IV implementation, increase in retirement age, extension of temporary contracts.
  France: Tougher implementation of the PARE, new temporary contracts for small firms.
  Italy: Repeated extensions of the scope for fixed term contracts. (Now 7% of new contracts permanent and full time).
  Spain: (Limited) decreases in the cost of dismissals.
  A major challenge: Back to a more flexible unique contract. Needed to decrease uncertainty.

- Will reforms lead to higher growth and a Spanish scenario, or will there be a backlash?
  The danger signs. The shift to the left in France. The German elections (a muddled signal). The Portuguese elections.
  How is Spain doing it? The ambiguous miracle: No labor productivity growth, negative TFP growth... But employment and investment growth. And more business and consumer confidence.