A macroeconomic survey of Europe

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September 2006
Four themes

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

• 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?
1. A broad based expansion

Good news in 2006 Q2. But more than just these numbers:
Across countries

<table>
<thead>
<tr>
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<th>2005</th>
<th>2006 *</th>
<th>2006**</th>
<th>2007 **</th>
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</table>

*: Forecast as of November 2005. **: Forecast as of August 2006 (from the Economist)

Main point: For all countries:
Across exports, consumption, investment

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
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<td>1.1</td>
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<td>0.2</td>
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<td>0.6</td>
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<td>Output</td>
<td>0.9</td>
<td>2.1</td>
<td>1.4</td>
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<td>Consumption</td>
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<td>3.2</td>
<td>6.7</td>
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</table>

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: ZEW August survey.
- The French scenario. Slow, but steady.
The remaining investment-profit rate conundrum

EURO ZONE: MARGIN RATE (GOS/VA) AND EQUIPMENT INVESTMENT RATE

in % of value added, working-day and seasonally adjusted

source: Eurostat, Insee calculations

forecasts after the dotted line
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.
• 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.**

<table>
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<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
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<td>8.9</td>
<td>8.9</td>
<td>8.6</td>
<td>8.2</td>
<td></td>
</tr>
</tbody>
</table>

*Source: OECD Economic Outlook, June 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.

<table>
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<tbody>
<tr>
<td>U.S.</td>
<td>0.6</td>
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<td>EU-15</td>
<td>1.1</td>
<td>1.2</td>
<td>0.9</td>
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</tbody>
</table>

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.
- If so, then potentially higher growth in Europe, for two reasons (lower natural rate and higher productivity growth).
- But one year (partly using forecasts...) does not prove much.
Change in productivity growth versus change in output growth, from 2005 to 2006.
4. Not all is well: The rotating slumps under the Euro.

The rotating slumps under the Euro:

- Demand boom, 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. (?)
Portugal. Boom and bust.

Figure 1. Unemployment rate and current account deficit
Portugal, 1995–2007

Unemployment rate
Current account deficit

Nr. 20
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.


- 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?
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.

• 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


- Future of the Euro?

- Too costly for individual, rational, governments to want to exit. (Legal complexities).

- Financial markets may however force it (The scope for disintermediation.)

- Not yet. (Spreads on Euro bonds. 27 basis points for Italy and Greece, 17 for Portugal, 0 for Spain).