

**‘The world is showing us:
Active macro economic policies
do make a difference’**

ETUC contribution to the Macroeconomic Dialogue
on political level (10th May 2004)

Compiled with the support of the ETUI

'The world is showing us: Active macro economic policies do make a difference'

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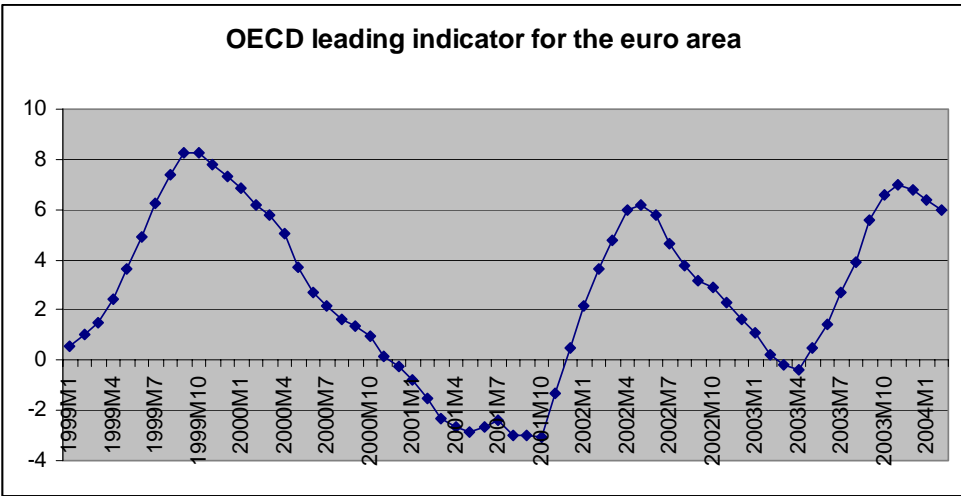
Is the recovery here to stay?

The Commission's forecasts are expecting a return to growth in the coming two years. But even so, the return to growth that is projected is disappointing. Taking into account the leap year effect, growth in 2004 in the euro area would only reach about 1.4%. This is far below the potential growth rate of Europe which different (conservative) estimates place around 2.5%.

Growth in 2005 is expected to strengthen to 2.3%. Although this is close to potential growth, it does confirm the fact that Europe is not experiencing a normal business cycle. After four consecutive years of low and below potential growth, the euro area should be witnessing *above* potential growth for some years in order to pick up existing slack in the economy (see also special box).

On top of this, even the return to these modest growth rates projections is far from certain. The Commission's Spring Forecasts are counting on investments to lead the recovery. But for investments to recover, firms need to have some certainty that they will be able to sell their products. Neither exports nor consumer demand are likely to play that role. Net exports are burdened by the strong euro and are expected to stabilize in 2004 in the Commissions forecast. And with so much policy attention on negative structural reforms and fiscal policy tightening and nominal wage growth moderate, the real disposable income of consumers does not increase very much while at the same time households are keeping a tight lid on their wallets as reflected in high savings rates.

Whereas recent indicators which reflect *current* activity are positive, forward looking indicators point to renewed difficulties for the recovery in coming months. For example, the OECD composite leading indicator for industrial production, which in the past accurately signaled the coming growth crisis in 2001 and the renewed dip in activity in 2002, seems to have reached a turning point. Both in the euro area as in the US, this indicator is coming down again. A continuation of this worrying trend in coming month(s) would raise serious questions about the recovery itself (see graph I). Moreover, the recent downwards revision of growth prospects for 2004 in two important member countries (Germany, France) is further cause for concern.



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Why managing of the business cycle is important

It is often argued that Europe’s problem is low **potential** growth and that this should be tackled by structural reforms that improve the supply side of the economy, not by demand management policies. However, this reasoning fails to recognize that there are circumstances in which aggregate demand policies can make an important contribution in raising both effective *and* potential growth.

One such circumstance arises when the economic growth has been below potential and a negative output gap has arisen. In that case, demand policies can take advantage of the existing slack in the economy and close the output gap by delivering economic growth at a rate that temporarily is higher than potential rates. This can be maintained during several years until the output gap is closed. On top of this ‘static’ growth gain, the potential rate at which the economy can grow without running into inflationary problems also increases. This ‘dynamic’ gain comes about because higher growth or growth above potential provides firms with improved perspectives on future sales, thereby triggering investment. And since investments add to the capital base of the economy, the non – inflationary rate at which demand and growth can proceed annually is in turn increased. Conversely, by limiting the extent of a downturn, active policies can, again beyond the immediate effect, also avoid the more or less permanent exclusion of workers from the labour force (so-called ‘hysteresis effects’) and thus also boost medium-term growth potential. Thus, demand management policies that limit the amplitude of the business cycle in an active way enhance the economy’s growth potential.

At present, there is a range of different estimates concerning output gaps. But all major institutions agree that there is indeed a negative output gap in the euro area, providing demand management policies with the opportunity to act as described above. The Commission’s estimate appears to be in the lower, conservative range. The IMF estimates the negative output gap at -2.4% of GDP, whereas the OECD takes a medium position. In any case, a growth rate above 2.5% for the coming couple of years should not be a problem for the objective of price stability.

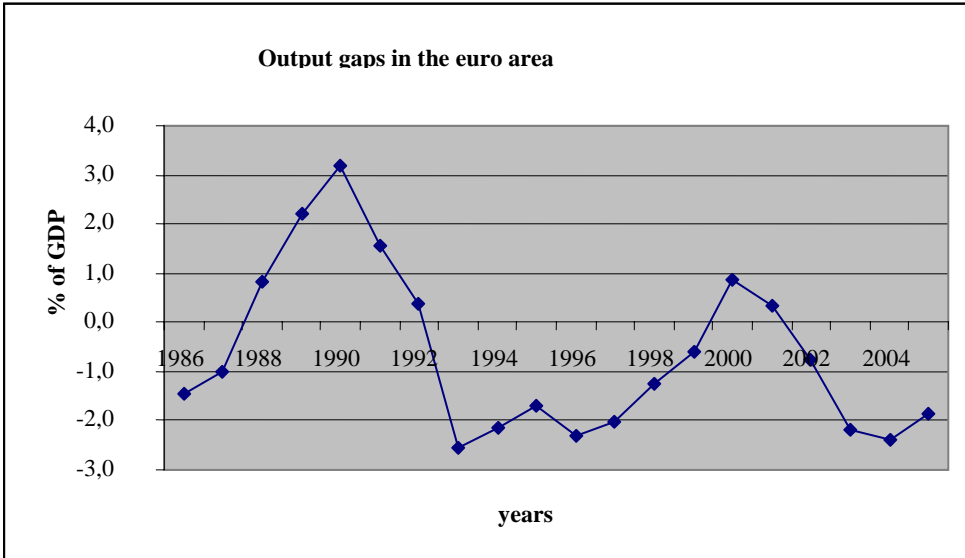
Estimates of the output gap in the euro area, different institutions

	2003	2004	2005
Commission	-1.2	-1.5 (-1.8)	-1.3 (-1.6)
OECD	-1.9	-2.2	-1.7
IMF	-2.1	-2.4	-2.2

(Figures between brackets correct for the leap year effect.)

Graph II shows the trend in euro area output gaps from the mid- eighties (based on the OECD statistics which constitute the middle ground in the different estimates). The striking conclusion is that over a time span of more than a decade, and with the exception of 2000/2001, the euro area’ economy has always operated *below* potential. This has to do with the shift in policy focus that occurred from ‘91 and has transformed ‘stability’ as an overriding objective.

Graph II



Source: OECD

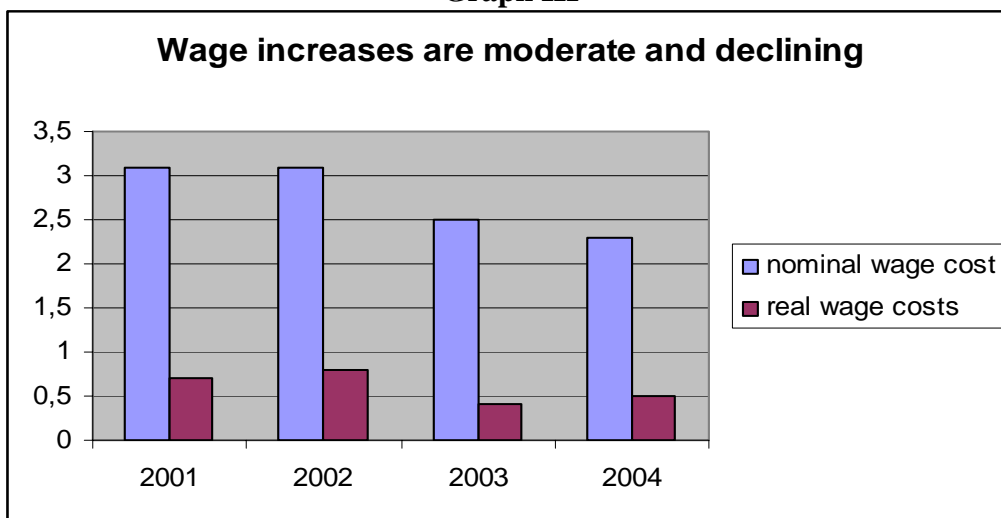
Analysis of the macroeconomic policy-mix

Wage behaviour should trigger a positive response from aggregate demand policies....

Despite the rise in headline inflation from 2000 to 2002, wage outcomes on the level of the euro area have been following a stable path, resulting in very moderate real wage cost increases. And these small real wage cost increases are probably even biased upwards because governments increased non-wage costs.

In doing so, wage formation has avoided the trap of launching a wage/price spiral in response to the oil price shock of 2000. Moreover, even nominal wage outcomes themselves have started to slow down from 3% to about 2.1% at the end of 2003. Most recent wage negotiations outcomes from the beginning of 2004 confirm this trend and fluctuate between 2% (Austria, Germany) and 2.5% (Spain), or even approach the zero line (Netherlands).

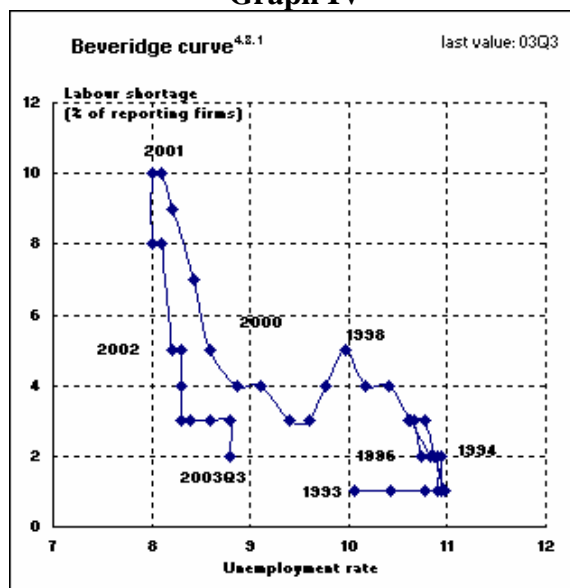
Graph III



Source: Commission

Another indication of continuing wage restraint has to do with the wage drift that normally comes on top of negotiated wage outcomes. This wage drift is expected to be minimal. Whereas in 2001 almost 10% of firms were reporting shortages of skilled labour, this share is now down to 2%, a level last seen in the recession of '93.

Graph IV



Source: Commission

Recent labour market developments have been striking. As the graph shows, the massive drop in the number of firms reporting difficulties in recruiting labour has been accompanied by a very minor increase in unemployment (less than one p.p.). Indeed, according to Eurostat, euro area unemployment has remained constant at 8.8% for more than a year. In the face of very weak output growth, this labour hoarding by firms, in expectation of the repeatedly postponed upturn, has a number of implications. Firstly, it suggests that the associated downturn in labour productivity is largely cyclical in nature, whereas some commentators have suggested it may be structural. This is particularly important because of the implications for estimates of potential growth. Secondly, as output increases only small rises in employment and falls in unemployment are to be expected. This confirms the ETUC view that wage rises will remain moderate. It also suggests, though, that expectations of an imminent boost to domestic demand from rising private consumption – which the Commission has revised upwards by 0.3p.p. for the euro area since the Autumn Forecast 2003 – need to be viewed with caution. In this context it is also noteworthy that the Commission has left its employment-growth forecast unchanged, while forecasting that the unemployment rate will be 0.3 p.p. lower. This confirms fears that some labour market reforms will merely shift people out of the labour market, rather than actually reducing unemployment even as measured by labour force surveys. This makes it all the more important to ensure that employment and employment rate data are made available more frequently and timely than is currently the case.

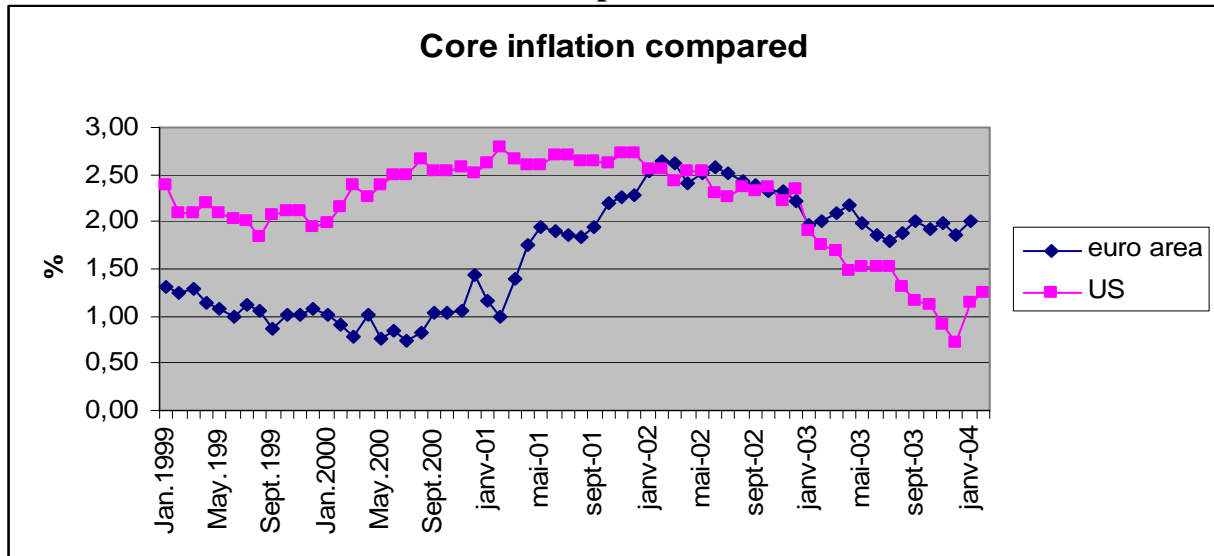
Wages are one determinant of inflation but not the only one. Graph V assesses whether inflation, as a result of more ‘rigid’ markets in the euro area would have been a barrier for the ECB to stimulate the economy. The graph is testing this view by comparing core inflation in the euro area with the US. By using core inflation rates, temporary phenomena such as a hike in energy prices or unprocessed food that blur the more fundamental picture are taken out of the comparison. Note however that exchange rate shocks, second round effects from higher energy prices and direct effects from indirect tax hikes on alcohol and tobacco are still reflected in the core inflation figure.

The figures tell us that, as a result of lagged effects from the earlier euro depreciation and the 2000 oil price hike, core inflation in the euro area were catching up with inflation in the US over 2001. End 2001, both economies had core inflation rates of about 2.5%. Over 2002 and until spring 2003, core inflation and its trend continued to behave surprisingly similar in both economies. Inflation fell continuously to reach 2% by the end of the year. Note that on average over 2002, three month interest rates were at 1.8% in the US compared to 3.3% in the euro area.

In the third period (Spring 2003 until now) core inflation continues to fall in the US but stabilises in the euro area. However, on average, the difference remains limited to 0.5% and much of this difference can be explained by hikes in indirect taxes in several euro area members.

In sum, the graph shows that the argument that (labour) markets in the US are much more flexible, thereby leading more rapidly to disinflation and much more policy space for fiscal and monetary policies should be taken with a big ‘pinch of salt’. Ultimately, the distinction between the US and the euro area is not so much the diverging inflation record but the different preference and inflation targets of monetary policy makers.

Graph V



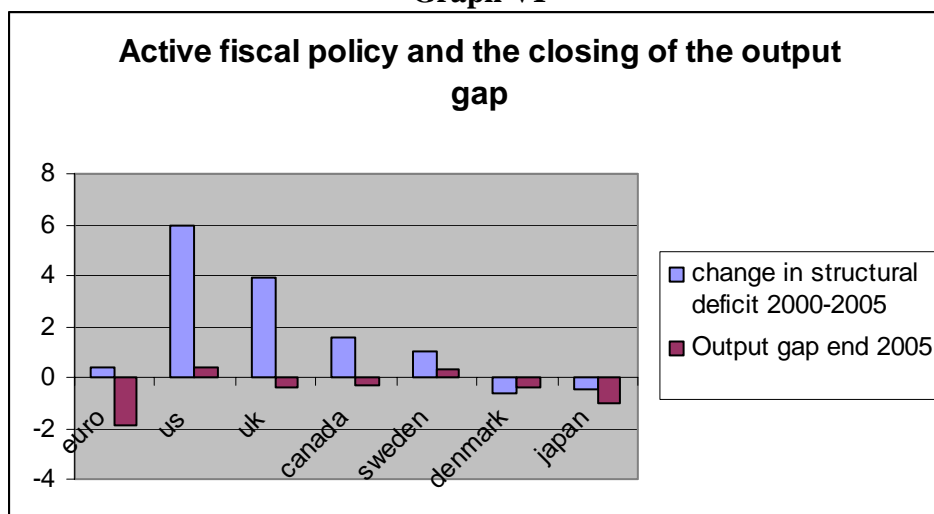
Source: ECB, calculations by DGB

... but fiscal policies are not really delivering...

Aggregate figures on fiscal policies

When comparing different economies over the last few years a clear relation can be observed between the loosening of the fiscal policy stance and the recovery of growth (see graph VI). Whereas the euro area limited itself to letting the deficit reflecting the automatic consequences of the downturn, thereby almost completely abstaining from implementing active fiscal policies, other economies did provide their economy with a fiscal (along side a more substantial monetary) boost. This was the case for the US and the UK in particular and Canada and (to a lesser extent) Sweden. Note that, while the latter group of countries started out from a lower level of deficit or even from a surplus, many of these countries are now running deficits that are higher than the 2.7% of GDP deficit in the euro area. In these countries, this fiscal policy stance (combined with more aggressive reductions in interest rates) was rewarded with higher growth resilience and/or with a more outspoken recovery, resulting in an aggregate output close to potential by 2005. This is not the case in the euro area, where output would still be substantially below potential (-2%!) even five years after the start of the slowdown (see graph VI).

Graph VI



Source: OECD, Outlook December 2003

It is somehow surprising that policymakers are surprised that, after four years of sub-potential growth, the euro area is posting a fiscal deficit. At 2.7% this is low in historical terms and compared with other countries. Moreover, the countries 'responsible' for the deficits above 3% are those with low inflation. This means, on the one hand, that they face higher real interest rates. A looser fiscal policy in those countries makes complete economic sense within the context of a monetary union. Moreover, those same countries are helping to deliver low inflation to the ECB. It is the fiscal 'star pupils', the 'peripheral' countries that benefited most from the fall in risk premiums, that are contributing to inflationary pressure – such as it is – within the EMU.

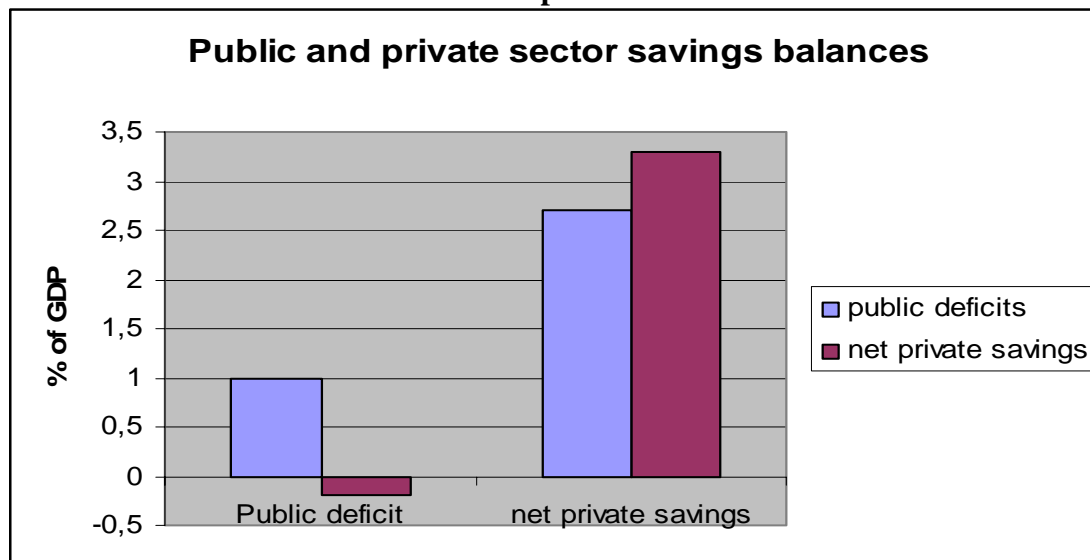
Research by the ECB itself (Working Paper 268, September 2003) suggests the need for active fiscal policy. Examining the reaction of firms and households to interest rate cuts in the US and the euro area, the ECB researchers concluded that the well-known additional sensitivity of demand to interest-rate changes in the US was due almost exclusively to differences in the reaction by consumers. For various reasons – linked notably to differences in the housing markets – interest rate cuts in the euro area, although just as effective as in the US in inducing higher investment, are less effective in stimulating consumer demand, which remains the Achilles Heel of the European economy. So while low interest rates are important, it seems that direct stimulus in the form of high public investment spending or putting more money in the pockets of those who will actually spend it is likely to be more effective in raising consumer spending.

Looking ahead, a weak recovery and an output gap that continues to remain negative raise the question what the effect would be of fiscal tightening in order to respect the Stability Pact. In fact, the national stability plans introduced by the different governments beginning 2004 imply a fiscal tightening of 0.8% of GDP in the coming two years. The present Commission's forecasts do not take these plans into account in the projection of the public deficit. And the question is whether such fiscal consolidation would not further weigh on the recovery that is already below standard.

This does not call into question the long term need to bring (structural) deficits substantially down or even to eliminate them. Debt ratios in several member states do take up policy room for manoeuvre that in due time will be needed to address the challenge of the ageing population. But fiscal consolidation on itself will not be able to bring public debt substantially down. The experience from the nineties (during which deficits were slashed but debts continued to rise because of disappointing growth) vividly testifies to that.

Moreover, when looking at the total savings rate of the economy, no negative impact of the increased deficit of the euro area on the cost of capital or on inflation can be identified. Despite rising public deficits long term interest rates are indeed at an historic low. The reason is the fact that rising public sector deficits are more than compensated by rising savings of the private sector on one hand and falling investment rates on the other hand. These movements cancel out the impact on the overall savings-investment balance of the whole economy. The figures show that in 2000 the low public deficit (1% of GDP when corrected for the UMTS licences) had to be financed by importing capital from the rest of the world (a deficit on the balance on current transactions with the rest of the world of 1.2% of GDP). Because of the scarcity of capital and savings, long-term interest rates were pushed upwards. Now, in 2004, the euro area is running a current account surplus of 0.6% of GDP, implying that the euro area is exporting capital to finance investment in the rest of the world, and this despite a public deficit of 2.7% of GDP. The mirror image of this is of course increased net savings from the private sector. Whereas the difference in investments and savings from the private sector was -0.2% in 2000, the private sector is now saving 3.3% of GDP more than it is investing. In some countries, this excess surplus has even run up to 5 or even 6% of GDP! These figures confirm that there is no scarcity of capital and savings in the euro area and raise the question why fiscal policy should even add more aggregate savings to a savings surplus that is not being used anyway.

Graph VII



Source: Commission, Spring forecasts, own calculations

A look behind the aggregate figures

In addition, one needs to look behind the overall macro economic figures. Behind the limited rise in the structural deficit of the euro area (0.4% of GDP between 2000 and 2003) hide diverging trends concerning taxes on the one hand and public/social expenditures on the other hand. Several governments have indeed cut taxes, which in principle could help support aggregate demand. In practice however this has not been the case and aggregate demand may even have been undermined by these tax cuts. On the one hand, a substantial part of the tax cut operations was financed by expenditure restraint and reform. Because the propensity to save is higher in the first case and lower in the latter, the net effect has not been to support aggregate demand. On the other hand, part of the tax cuts were not financed (as the minor increase in the structural deficit) shows. However, with deficits breaching the 3% limit and policy actors sticking at least in their public pronouncements to a certain rigid reading of the Stability Pact, while abstaining from reforming the Stability Pact in a transparent and sensible way, it should come as no surprise that households are saving instead of consuming their tax cut gains. In sum, even though fiscal policy has loosened slightly in past years, the way in which this has been done has not been conducive for aggregate demand.

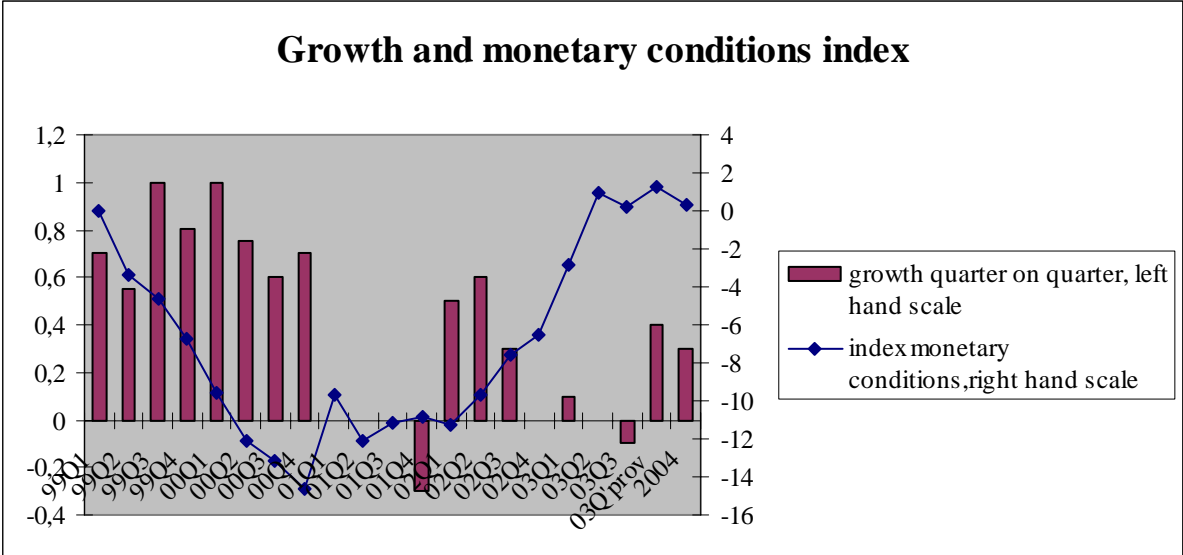
Moreover, there is also the link with indirect taxes. Pushed by the orientations of the Stability Pact, governments are increasing indirect taxes on tobacco, alcohol and energy. Given the existing policy framework, this may also be very counterproductive. These indirect tax hikes directly contribute to inflation, thereby keeping headline inflation above the 2% ECB target or alternatively, preventing inflation from falling below 2%. In either case, wrong signals are given to the ECB. If the ECB is mainly looking at inflation and if governments are keeping inflation artificially 'high' ('high' meaning above or at 2%), then the drive for fiscal consolidation may not result in a looser monetary policy.

... and monetary policies, despite historical low interest rates, need to be extremely watchful over the recovery.

Interest rates are presently indeed historically low. However, the real question is whether, taking other factors into account, they are low *enough*. One such factor concerns the value of the exchange rate. Following graph tracks monetary conditions, calculated by attaching weights in a relationship of 1 to 6 to the nominal effective exchange rate and the real interest rate respectively (based on Commission's methodology). It shows that the monetary loosening that occurred in the first years of EMU and which was being accompanied by dynamic economic growth started to get withdrawn from beginning 2002. The appreciation of the euro overshadowed the interest rate cuts made by the ECB and the reversal in monetary

stimulus is accompanied by a slow economic expansion.. At present, the monetary stimulus enacted over the period '99-2000 has now completely been withdrawn, thereby explaining the slow and suboptimal return to economic growth that Europe may now well be confronted with.

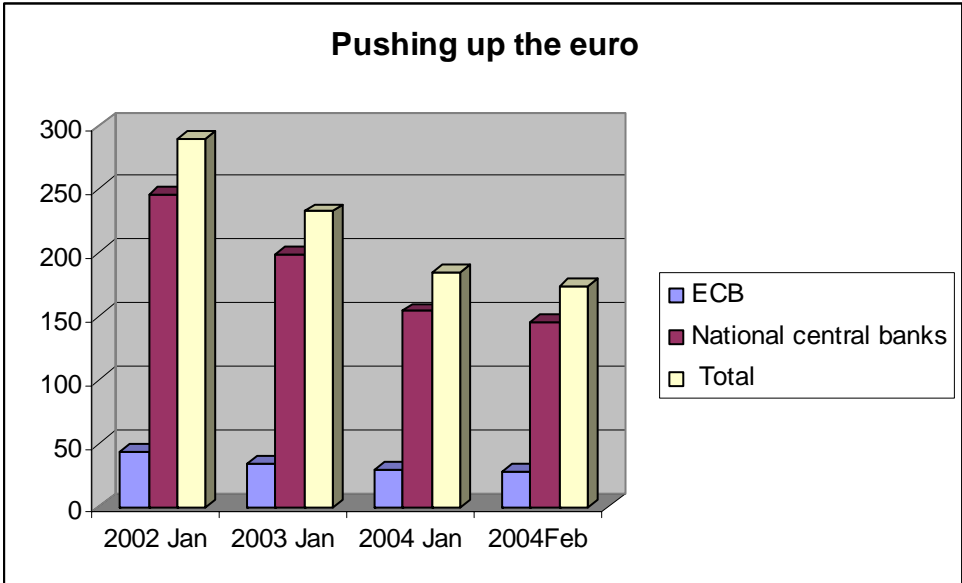
Graph VIII



Source: ECB, own calculations

An additional puzzling aspect of monetary policy decisions is the fact that the ECB and the European system of central banks have been selling a major part of their foreign currency reserves. Graph IX shows the level of foreign currency reserves of the ECB and its system of national central banks (ESCB). Over 2002 and 2003 and continuing in February 2004, the ECB has sold off about 40% of its foreign reserves, thereby adding to the rapid appreciation of the euro. It is not clear how this policy is to be reconciled with the ‘open mouth’ policy of trying to limit the euro’s appreciation.

Graph IX



What should be done: Put growth in the focus of the economic policy guidelines

Confronted with this analysis, the policy message that is essentially coming out of the draft BEPG's is missing the point. Instead of learning the lessons from three to four years of below potential growth, the draft BEPG's carry on as if business is as usual. A call for a narrow implementation of the Stability Pact, with the excessive deficit procedure now being expanded to 6 of the old EU-15 member states, dominates. Providing policy makers with space to support growth does not seem to be on the agenda.

In order to put growth back on the agenda of the BEPG's, Ecfm ministers should:

- Reconfirm their commitment to the growth initiative that was agreed upon in December last year. At present, this growth initiative seems to have been tacitly dropped and, in fact, is unknown to the general public. A European growth initiative that is expanded to investments in renewable energies and social housing could provide a powerful signal of confidence to households and industry. Postponing it by simply 'reporting' on it next year, (as is now decided) will have no impact whatsoever.
- The Stability Pact, as it stands now, is combining the worst of two worlds. Due to the cyclical slowdown, deficits in several major member states are breaching the 3% threshold. At the same time, the efficiency of these automatic stabilizers is greatly reduced because the attention of the public is drawn to systematic calls for a rapid consolidation strategy, irrespective of the state the economy is in. The dead-lock between Commission and the Ecfm council on the reform of the Pact has to be broken in order to get this policy signal correct. A reform of the Pact, leading to consolidation strategies that take account of the business cycle would go a long way to restore confidence in the economy. On the one hand, this would imply designing a fiscal policy framework that provided room to finance the enlarged growth initiative for sustainable development (see above) and more generally public investment which has fallen in Europe, whereas it has risen as a share of GDP in the US. On the other hand, the new fiscal framework should also result in a consolidation strategy that really 'bites' in the economic upturn, thereby forcing member states at that moment to put order in their public finances.
- While the European Treaty consecrates the independence of the ECB, the same Treaty also calls upon the ECB to contribute to its fundamental goals of economic development and employment provided price stability is assured. A reference in the BEPG's to this dual mandate of the ECB and/or to the fact that the ECB needs to be extremely watchful over the recovery, would certainly be useful. Indeed, if the euro exchange rate would start to appreciate again and/or if leading composite indicators would not pick up again and instead continue their fall, new cuts in interest rates should not again be postponed until the very last moment. Instead, the ECB should act quickly, thereby giving a signal of confidence to households and businesses. In doing so the ECB should not be distracted from the impact of rising oil prices on headline inflation. Experience in 2000/2001 (see above) showed that the wage formation systems in the euro area are able to contain the spillover of this effect into wages. It is to be hoped that European policymakers will not repeat the mistakes made in that period when inadequate monetary policies choked off the growth dynamic. This will require a deepening of consultation and cooperation activities, not least in the Macroeconomic Dialogue.