THE RECOVERY NEEDS TO BE SAVED:

EUROPEAN MACRO ECONOMIC POLICY MAKERS NEED TO ACT NOW!

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Annex 1 – Table demonstrating impact of a 10% appreciation of the euro on growth and inflation

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CHAPTER I

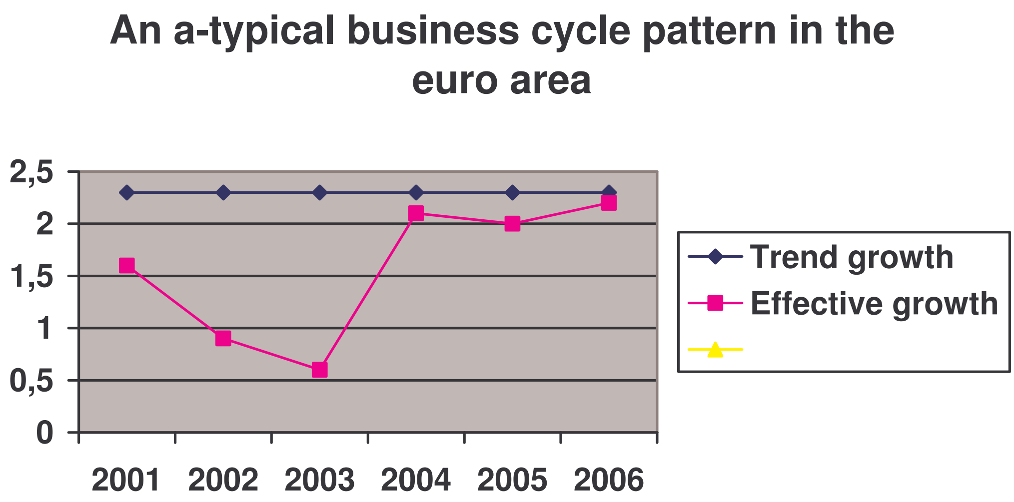
ASSESSING THE ECONOMIC OUTLOOK

Commission's Autumn Forecasts point to disappointing growth prospects for the Euro Area …

For three years in a row, growth in the euro area has been meagre and much below potential. After such a dismal performance, it would be normal to expect a certain 'catching up' effect in the form of a period of higher and above potential growth. Such an effect is indeed highly necessary, not only for short run stabilisation purposes, but also as part of a strategy to raise potential growth. If new investments (which are key to raising future potential growth) are to be triggered, then the underutilisation of productive capacity needs to be eliminated.

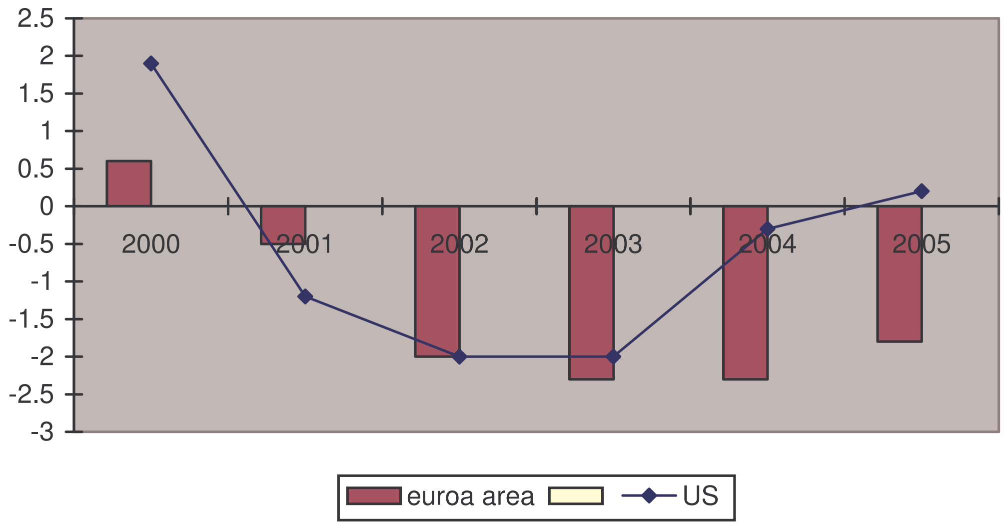
However, a scenario of 'catching up' growth is not emerging from the recent Commission forecasts:

- With growth recovering from 0.6 to 2.1%, the headline 2004 growth statistic does indeed mark an improvement. However, the 2004 figure is very much influenced by pure statistical effects. Extra working days coming from a calendar effect have mathematically pushed 2004 growth up by 0.3%. And the acceleration of growth in the course of 2003 has created a strong base or 'carry-over' effect of the same amount. If these statistical effects (0.6% in total) are taken into account, then the underlying 2004 growth dynamics do not appear to be very strong. In fact, recent quarterly growth rates demonstrate a strong deceleration of growth.
- For 2005 and 2006, growth is to be projected to remain at or slightly above 2%. Even assuming that the potential rate of growth is really that low, it implies that the loss in growth momentum the euro area experienced between 2001 and 2003 will not be recovered. The following graph illustrates this a-typical business cycle pattern. The 'trend' growth rate (2.3%) used here is the average growth over the 1996-2003 period.



Measures of 'economic slack' such as the OECD's output gap also continue to point to this phenomenon. In the euro area, the effective level of output started to fall below the estimated potential from mid-2002. From that moment on, the negative output gap has increased to -2.3% of euro area GDP without showing any sign of closing. The US (and the UK) on the other hand demonstrates a different experience and a more typical business cycle. Slack in the US economy, which was also reaching -2% in 2003, is expected to be overcome in 2005, i.e. after just two years. When looking for explanations for this different pattern of economic recovery, it is hard to dismiss the fact that aggregate demand management has been very flexible and supportive in the US (as well as in other countries), whereas in the euro area both fiscal and monetary policy are constrained by all sorts of rules and procedures when it comes to supporting growth and aggregate demand.

Output gaps in the euro area and the US (source: OECD)



Growth perspective depends on domestic demand…

In the Commission's forecasts, continuation of growth around 2% is highly dependent on a continuing expansion of domestic demand. Export growth on the other hand is decelerating because of the 'soft landing' of US growth and an assumed appreciation of the euro/dollar rate to 1.23. There are however a number of factors casting serious doubts on the likelihood of domestic demand expansion as a driver for the projected 2% growth scenario.

- *Has labour hoarding come to an end so that employment can recover strongly?* Over the last couple of years, employment has been surprisingly resilient in the face of poor economic growth. One of the mechanisms at work here was that many firms have chosen to keep on qualified staff members instead of retrenching them, in expectation of a renewed upturn. This automatically implies that higher economic growth will not translate into higher job growth to the usual extent. Firms will first of all use this hidden reserve of labour as they have during 2004 when, together with 2% economic growth, labour productivity jumped from 0.3 to 1.6%. For 2005 and 2006 however, the Commission seems to assume that this hidden labour reserve has been completely eliminated. Labour productivity growth falls back to 1% while at the same time job growth accelerates to 0.9%. The reason for this assumption of highly job-intensive economic growth is unclear. Taking into account the strength of the labour hoarding effect over the past three years (productivity only grew by an annual 0.3%), it seems more plausible that more growth will be needed for the labour reserves in companies to unwind and before job growth really accelerates again.

- *Will higher job growth lead to a higher disposable income?* Even if job growth were to accelerate to 0.9% in coming years, the impact on household disposable incomes will much depend on which jobs are exactly being created and how much wage income these will generate. In particular, it can be expected that the substantial job recovery that is projected by the Commission in Germany (from 0.1 to 0.8% job growth) will be primarily based on 'mini-jobs' (paying 400 to 700 euros) and 'Ich – AG's' (one-person companies set up with public support by the unemployed). Both sorts of employment generate substantially below-average incomes so that the effect on household consumption may remain muted.

- *Will wage moderation avoid deepening further?* In the Commission's forecasts, the deceleration of nominal wage growth is expected to end in 2004 by reaching a 'floor' of 2.2% in wage increases per worker (from 2.6% in 2003). From 2005 on, nominal wage growth should again increase a little bit, giving room for real wage increases of 0.7%. However, developments since the summer in Germany (a country representing 30% of the euro area) do not confirm that a 'floor' in wage growth deceleration would have been reached and that wages would therefore accelerate again in the next year. Indeed, since summer 2004 deals have been made at several major German enterprises, bringing wages substantially down (e.g. Siemens, Daimler-Chrysler, Volkswagen) in exchange for promises on longer-term job security. In some cases, companies are now using the sectoral agreement pay scales instead of in-house ones. In other cases, elements of holiday pay have been cancelled. This development is producing a negative wage drift in Germany, with effective wage evolution now far below the collectively agreed wage increases: whereas, collective bargained wages have increased by 2% in Germany in 2004, the effective hourly wage increase is zero. Whether 2005 will see a reversal of this trend (as supposed in the Commission forecast) is an open question. Another question is whether developments in Germany will have an impact on neighbouring countries. If so, wage growth in these countries will also be more subdued, making an average real wage growth of 0.7% on the euro area level seem very unlikely in that case.

Collectively bargained wage increases

	2001	2002	2003	2004
Germany	2.1	2.7	2.5	2
France	3.3	3.5	3	2.4
Italy	2.5	2.1	2.2	2.2
Spain	3.5	3.1	3.5	2.9
Euro 4 average	2.7	2.8	2.7	2.3

Source: ETUC questionnaire

Information from the ETUC 2004 collective bargaining overview testifies to the fact that wage growth, in terms of both collectively negotiated wages and effective hourly wages, is indeed coming down. The average effective wage increase per hour in the big four euro area countries (Germany, France, Italy, and Spain, covering 80% of the euro area) has come down from 2.4% in 2003 to 1.8% in 2004. This is far below 2004 inflation. Again, the essential question is whether this process has reached a certain limit (as the Commission supposes) or will this continue instead.

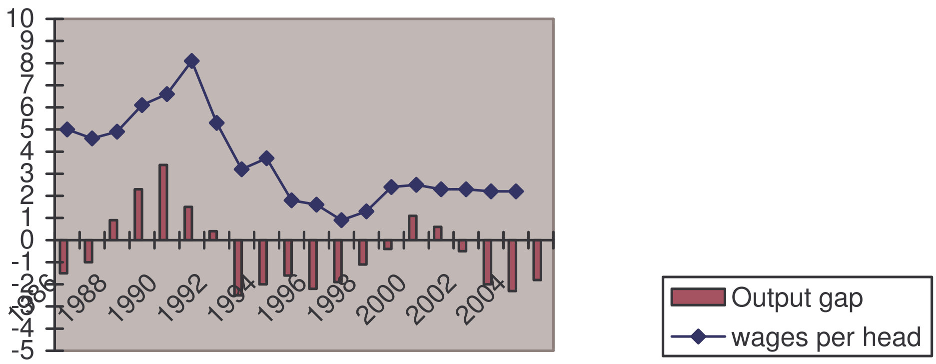
Effective wage increases

	2001	2002	2003	2004
Germany	2.7	2.1	1.2	0.1
France	2.6	2.4	2.4	2.4
Italy*	3.5	2.6	3.2	2.8
Spain	3.8	4.1	4.3	4.1
Euro 4 average	3	2.6	2.4	1.8

Source: ETUC questionnaire
* For Italy, the reply to the ETUC questionnaire indicated wages per head.

The following graph illustrates the link between wage behaviour and underutilization of productive capacities in the past. One can observe that periods in which growth is slowing and periods in which slack in the economy is persisting do indeed put downwards pressure on wage formation. The most important thing to note here is that wage growth per head fell far below 2% to reach 0.9 in the period 1996-1998. In other words, the 2.2% 'floor' in wage increases the Commission is assuming does not necessarily hold, especially not when overcapacity in the economy is persisting. If wages would indeed decelerate further in 2005, then one of the elements for sustaining domestic demand will not be present. In addition, such a scenario would also mean that the nominal anchor that wages are providing against downwards deviations from the price stability target is not there anymore. In turn, this underlines the responsibility from monetary policy makers to avoid disinflationary processes that would drive inflation below the ECB's price stability target

Output gap and wage growth in the euro area



- *Will structural reform continue to keep household savings high?* A wave of programmes of so-called structural reform, as implemented in several Member States, and particularly the largest, Germany, is generating widespread insecurity amongst workers. With the policy message that workers are increasingly on their own to confront unemployment, retirement and health risks, it is not surprising that household savings rates have increased during the downturn instead of falling as they normally do downturns, a reaction by households that helps to stabilise the economy. Not surprisingly, Germany stands out as a country where household savings rates have increased markedly and where the perverse impact of supposed 'structural' reform on growth and demand in an environment of negative output gaps and sluggish demand clearly stands out. As a consequence of the labour market reforms in Germany, regular jobs paying contributions to social security are being 'cannibalized' by employment relations under job schemes where contributions are non-existent or much lower. For example, over 2004 the total employment increased by 55,000 workers. At the same time, some 450,000 mini-jobs have been created, implying that about 400,000 jobs paying regular social security contributions have disappeared. The consequence is rising deficits in social security which in turn cast doubt on financial sustainability of the social security system, thereby further destabilizing confidence.

- *Will investment respond?* In the Commission's forecasts, a revival of investments is also expected to contribute to domestic demand. In particular, growth of investment in equipment is projected to increase from 3% in 2004 to more than 5% in 2005. However, this acceleration of investment growth is to take place essentially in one country. In Germany, investments in equipment are to increase from -0.1% to 6.6%. Again, given the lack of purchasing power, the high uncertainties that are characterising the German economy and the slowdown of export growth due to the euro appreciation, the question is whether investment will indeed take off in Germany.

Acceleration of investment growth on the level of the euro area will also be boosted, in the Commission's view, by rising profit margins, as measured by the difference between the GDP deflator and nominal unit wage costs. This is essentially a statistical effect, however. Whether firms can indeed widen profit margins in a context of overcapacity and increased competition, remains to be seen.

… and do not yet take the falling dollar fully into account

The Commission's forecasts take the falling dollar into account, but only to a minor extent. In fact, with the euro/dollar rate now standing at 1.32, reality has already overtaken the Commission's assumption of a 1.23 rate, implying an additional appreciation of 7.5% vis-à-vis the dollar. With continuing global imbalances (a US current account deficit of almost 6% of GDP!) further adjustment of exchange rates is highly likely. Assuming the euro would further appreciate by 10% and assuming that this would imply an appreciation of the euro effective exchange rate by 5%, this would certainly drive 2004 and 2005 growth further down, by an estimated 0.3% and 0.2% respectively. At the same time, inflation would fall further by 0.1% in 2005 and an additional 0.3% in 2006 (estimates based on table in Annex I). The following table presents the Commission forecasts corrected for the effects of a further slide in the dollar. With inflation falling to 1.7% in 2006, these estimates show that there is room on the inflationary front to react by supporting domestic demand and growth. Furthermore, if the euro appreciation would overshoot further (by 10% for example), then growth and inflation would fall even further (to 1.4% growth in 2004 and only 1.1% inflation in 2005…) Of course, this scenario can be avoided by offsetting policies that strengthen domestic demand. But for this to happen, monetary and fiscal policies need to react.

Impact of further appreciation of the euro

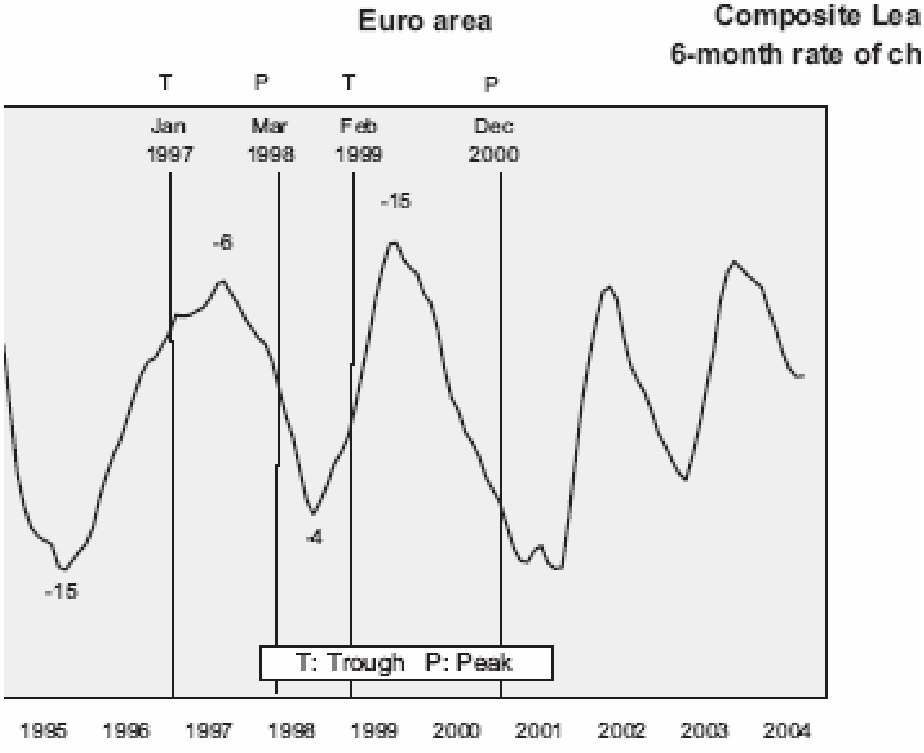
	2005	**2006**
Growth Comm forecast	2	2.2
Growth after 5% further appreciation	1.7	2
Inflation Comm Forecast	1.9	1.7
Inflation after 5% further apppreciation	1.8	1.4

Source : Commission, own calculations

It should also be noted that the 2004 growth figure has to be seen in the context of global economic growth that, at around 5% was the ‘highest for nearly three decades’ (IMF, WEO September 2004). This extremely buoyant external demand has sustained European exports in the face of the severe appreciation of the euro. In view of the serious and still widening current account deficit in the US and the attempts by the Chinese authorities to slow their overheating economy,2005 is another story however. Thus the continued appreciation of the euro will be exacerbated by a slowdown in the rate of growth of the world economy (according to the IMF’s September to 4.3%).

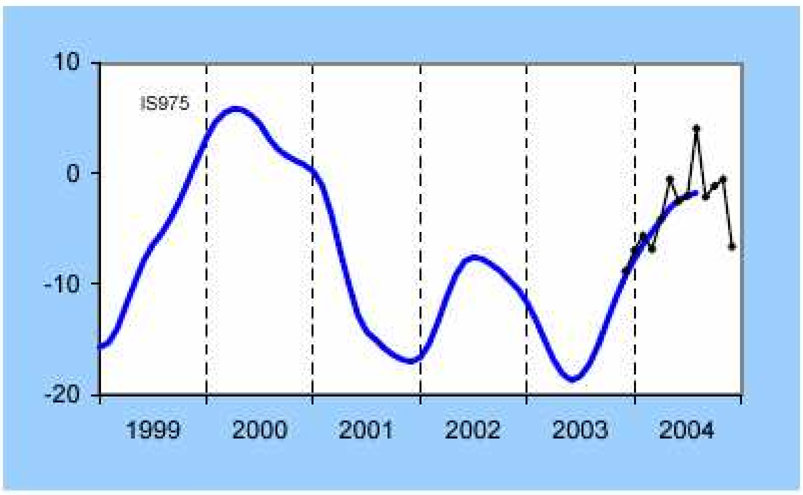
Leading business cycle indicators point to a renewed downturn in the business cycle

The OECD composite leading indicator for industrial production, which foreruns a turning point in industrial production growth some six to nine months ahead has already been falling for several months. On this basis, the recent dismal messages on industrial production and slowing quarterly growth should be no surprise to policymakers and could have been anticipated already from the end of 2003.

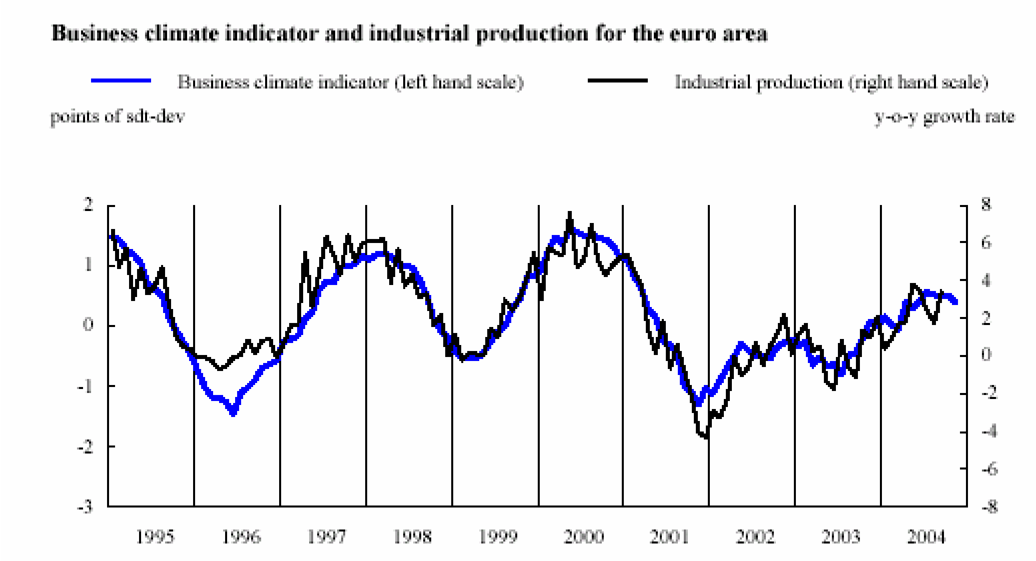


Similarly, the Belgian National Bank's indicator of industrial confidence, which has proven a good measure for coming developments in euro area industrial production, is predicting further bad times ahead.

Manufacturing industry



Business expectations have been declining in Germany also since the start of 2004, according to the Ifo Institute's Konjunktur test indicator. The European Commission's composite business climate indicator continued to rise during the first half of 2004. Since then, however, it has moved sideways and the most recent data – for November, i.e. since the publication of the Autumn forecasts – also point to a renewed weakening of growth. This 'delayed' reaction compared with other leading indicators is consistent, however, with the fact that the Commission indicator, in spite of its name, tends to track, rather than lead, changes in industrial output.



CHAPTER II

ROOM FOR MACRO ECONOMIC POLICIES TO ACT

The present economic outlook is not comforting. Europe has largely missed the recovery that did materialise in the rest of the world and now seems to be already heading for a renewed downturn. Economically Europe simply cannot afford meagre and below potential growth year after year. Politically, another slump in growth in the exact year in which the mid term review and the reinvigoration of the Lisbon strategy is to take place threatens the credibility of the whole Lisbon agenda. After all, why implement structural reform with the aim of raising growth potential if the European economy does not even succeed in realising the growth potential that is already possible?

It is not acceptable to turn a blind eye, point to the supposed 'limits' of macro-economic policies in Europe and switch the discussion to the mantra of 'structural reforms': in the light of the evidence of recent years there must be increasing doubts about their impact even on *potential* output.. Such an approach will further undermine confidence and be counterproductive. Instead, alongside a 'positive' structural reform agenda, dealt with in other proposals, the macro-economic policy mix must be improved in order to support aggregate demand, restore confidence and deliver higher growth. In doing so, the following guidelines should be followed:

- **Act on time.** We cannot afford (another) 'wait and see attitude'. It is much more difficult to <u>restore</u> confidence after another downturn has been allowed to take place than to <u>prevent</u> confidence from sliding down again. Waiting too long without reacting to the renewed loss in growth momentum threatens to put the euro area economy in a situation in which the scope for macro policy making is indeed inadequate. Once the economy has slid into a deep slump, far lower (real) interest rates or far more fiscal stimulus are required to get that same economy out of that slump.

- **Act in a coordinated way.** National policies should be coordinated and generally need to move in the same direction at the same time. In this way, expansionary effects can be maximized. Cross–border effects and trade make an expansionary policy, when pursued by all Member States, more efficient compared to the case where Member States act on their own. (At the same time, if a more general demand boost were to come form monetary policy, there would be a case for some policy tightening in those euro area economies at or above potential.)

- **Act according to economic principles instead of following a bookkeeper's approach.** The necessity of sound fiscal positions cannot be questioned. However, fiscal consolidation by cutting spending alone will not work. Countries also need to 'grow' out of debt and deficits. And for growth to take off, expansionary fiscal policies are necessary in situations where private-sector expectations are depressed.. Once growth has taken off and a self sustaining process of growth and investments has been enacted, then it is time to withdraw the fiscal stimulus and bring deficits and debt back down again.

- **Prefer a pro-active approach.** With the renewed downturn, deficits will increase anyway. It is far more preferable to have deficits that are temporarily higher because of expansionary fiscal policies that put the economy back on the growth track than just simply undergoing the downturn. In the latter case, deficits will increase also but this time with much reduced prospects of subsequent economic recovery.

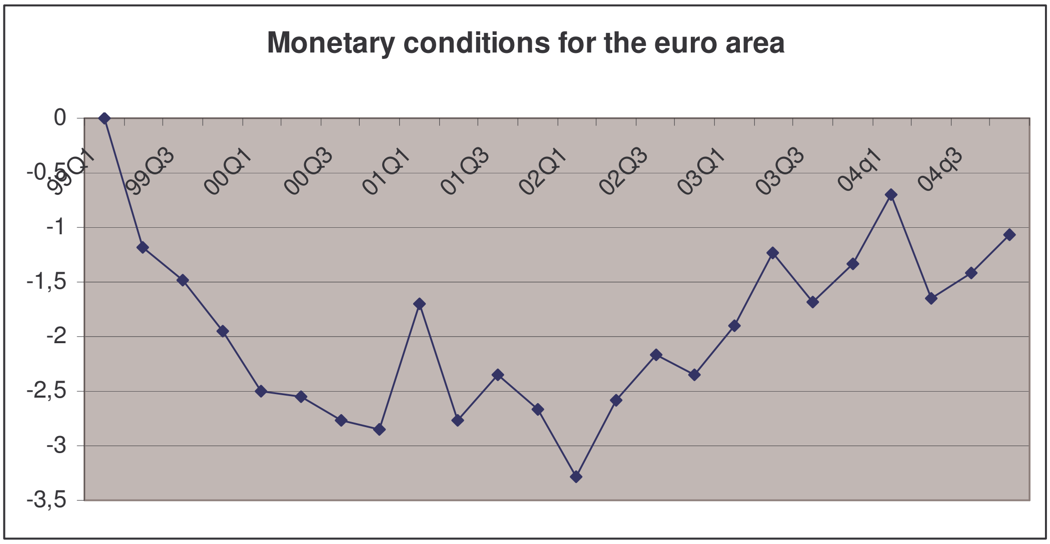
- **Use the advantage of a single currency**. Europe, as the second largest economic zone in the world, is a relatively closed economy in which import demand leakages are limited. Together with the single currency that is eliminating financial disruptive speculation inside the euro area, this implies that Europe, as the US, can be 'master of its own destiny' by pursuing active demand policies.

The ECB and interest rate policy

Interest rates are indeed historically low and, in the face of uncertainty about the recovery, they should at least remain so. Repeating the mistake of 2000, when rates were aggressively raised because of fears about import inflation feeding into domestic prices and wages, should definitely be avoided. Certainly with present downward trends in wage formation, it is extremely unlikely that second round effects coming from a reaction of wages to the oil price hike would occur.

At the same time it should also be pointed out that, given the dismal economic performance, the ECB does still have a margin to cut rates and that such a cut can help to improve growth performance. The Federal Reserve for its part did cut rates in the recent cycle and went as low as 1% in nominal terms, thereby generating negative real interest rates. At present, with 2% nominal interest rate and somewhat above 2% inflation, the ECB's real interest rate is only slightly negative (and only due to inflation that is 'artificially' higher in the short run; in fact it makes more sense to measure real interest rates in terms of core inflation.).

One approach is to study interest rates in relationship to the exchange rate. When combined with an over appreciation of the currency (the euro's effective exchange rate is now 5% higher compared to the start of the euro beginning 1999), low interest rates do not point to a continuing loose monetary policy stance. In such a case, the loss in competitiveness coming from the currency appreciation may require further rate cuts in order to preserve a situation of loose monetary policy. Here, a monetary conditions index in which interest rates and exchange rates are weighed according to their impact on economic growth can provide a useful indication. In the following graph, this indicator is telling us that the monetary loosening that the ECB did provide since 1999 has been substantially rolled back since mid-2002. The appreciation of the euro has to a very large extent offset the stimulus effect that interest rate reductions have had over past years. Overall monetary stimulus has to a large extent been withdrawn over the past two years, thereby most likely contributing to the weak and hesitant recovery we are experiencing. When combined with the exchange rate effect, the overall monetary stimulus cannot be judged as being 'extraordinary' loose. It is clear that the economy, with a hesitating and dissipating recovery, is not yet ready for the ECB's monetary stimulus to be withdrawn. Even in the face of rising interest rates in the US, rates in Europe should not rise until the recovery is on a firm footing.



Source: own calculations

The ECB and exchange rate policy

At the same time, the ECB should also try to 'tame' exchange markets. While, given global imbalances, a certain appreciation of the euro is probably unavoidable; this appreciation should not be so 'brutal' that it chokes European recovery.

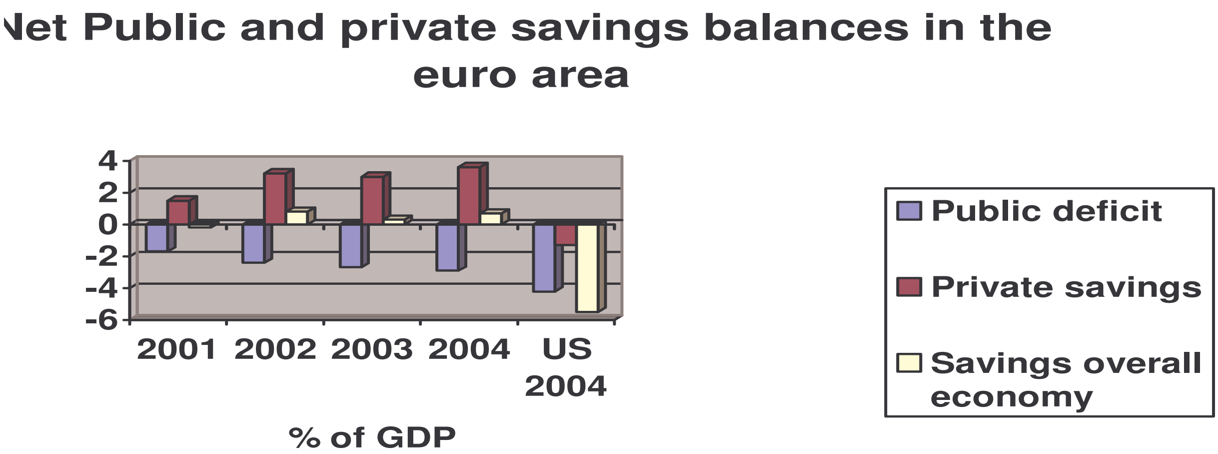
Therefore, the ECB should contemplate action to steer the exchange markets. This can be done by combining:

- Precise comments and declarations about the opposition of the ECB to sudden and overshooting currency movements
- Exchange rate interventions to buy up excess dollars on the market. Here, it should be emphasized that the ECB, as legal emitter of euros is in principle able to buy an unlimited amount of dollars.
- Further cuts in interest rates. These cuts serve a double purpose. On the one hand, they support domestic demand, thereby substituting export for domestic demand. On the one hand, they increase the interest rate differential with the dollar, thus reducing the incentives of investors to move from dollar into euro.
- In the medium term the ECB should also be working with the US Federal Reserve and Asian central banks to ensure an orderly revaluation of the Chinese currency and other Asian currencies, whose dollar peg is contributing to current account imbalances and the threat of a speculative overshooting of the euro.

Putting the fiscal policy house in order

With the average fiscal deficit of the euro area at 2.7%, some commentators are arguing that there is little or no space for fiscal policies to act to stimulate activity. However, it should be remembered that a zero or 3% public deficit is not a goal in itself. Instead, fiscal consolidation is an instrument to increase investments by providing financing room for these investments ('crowding in effect'). However, when it is clear that the expected private-sector investment dynamics are insufficient to use the private and overall savings that are already available, then fiscal consolidation to crowd in investment that will not be there anyway does not make much sense. The euro area is in such a situation. The fiscal authority draw on aggregate savings in order to finance the public deficit, but private savings are so high that they can easily finance private investments, the public deficits <u>and</u> at the same time export capital to the rest of the world. At present, the euro area's private sector savings surplus is almost as high as 4% of GDP and in some countries it is even reaching 8% of GDP! This contrasts markedly with the US where both the public and the private sector savings balances are in the red, thereby sucking in capital from the rest of the world to an amount of 6% of US GDP!

In this situation, increasing the overall savings capacity of the economy by cutting the deficit does not make much sense. What needs to be done first is to address the fact that part of Europe's savings balance is used to finance economic expansion elsewhere instead of being put to better use inside the euro area itself.



Here, it should also be recalled that the US, despite a private savings shortage, did not stop at the arbitrary 3% deficit limit that Europe has imposed itself. Indeed, deficits in the US have swung from a surplus of 1.6 % of GDP in 2000 to a deficit of 4.6% in 2003, amounting to a fiscal policy operation of a stunning 6.2% of GDP. This, along with very expansionary and timely monetary policy loosening, has allowed the US to break out of the slump in a rapid way. In this respect, the euro area, with an average deficit of 2.7%, does still have sizeable room for expansionary fiscal policies if used only a part of the same margins of manoeuvre the US has exploited. A fiscal policy injection of 1% of GDP for Europe would still be modest in comparison to the US and keep the euro area deficit well below the 4.6% the US reached in 2003, all the more so as growth would be higher.

Proposals:

- *Extend the 'Growth Initiative' into an 'Initiative for recovery.'* The upcoming evaluation of the Growth initiative and the Quick Start programme should be seized upon to expand it into a programme that does have a substantial macroeconomic impact. Indeed, the present Quick start programme only represents 0.05%-0.1% of total GDP and is therefore barely noticeable. Member states should be invited to present 'national plans for economic recovery' that increase by 1% of GDP investments in education, research, social housing, and revitalization of inner city areas, clean technologies and renewable energy sources. The point to note is that the 'announcement' effect and the effect of making the investment plans transparent on a European scale will undoubtedly underscore economic sentiment and household confidence. This is also the reason why this 'Recovery Initiative', despite the inherent slowness of the involved fiscal process, may well produce results already in 2005.

- *Pursue the reform of the Stability Pact (SGP).* The recent Commission proposals to make the SGP less rigid are to be welcomed, in particular the proposals to take the position in the business cycle more into account when defining the path of fiscal consolidation and when defining exceptional circumstances as regards to the 3% deficit criterion. It is crucial for confidence that this reform is pursued urgently in order to eliminate uncertainty and the fear of households and investors that fiscal consolidation strategies should be pursued at the wrong time. A further way to improve the SGP is to pay more attention to the euro area average deficit, and only to the fiscal balance of individual countries to the extent individual countries' deficits are a threat for the whole euro area and to the extent individual debt ratios are not under control. National savings and inflation rates are further key indicators.
- *'Lisbonise' the Stability and Growth Pact.* Europe does not have the luxury of waiting another five years or so for deficits to be eliminated before investing massively in innovation, research and development. This dead-lock needs to be broken by reforming the Stability Pact so that investments which are at the heart of the Lisbon priorities are no longer counted in the public deficit, at least for the next few years. In this way, Europe can put its economy back on a path of growth, face the challenge of competitiveness through innovation and reduce deficits and debt in a medium time perspective.

Making the SGP 'bite' in the economic upturn

If fiscal policy is to be made flexible in downturns, the logical consequence is that fiscal consolidation should follow in times of economic upturn. In order to install a mechanism that guarantees the latter, the proposal can be made to introduce a rule in the SGP implying that countries experiencing, for example, more than 2.3% (trend) growth should convert the additional tax proceeds generated into an (interest paying) deposit, managed by the Commission. When the member state later on enters into a downturn, then the deposits can be returned to the country in order to limit the negative impact of the downturn on the government deficit.

In this way, cyclical buffer funds can be created that are not subject to the willingness of the individual Member States but are instead a consequence of clear European rules and agreements. Abuse of cyclical windfalls in the form of pro-cyclical tax cutting operations, as has happened over the recent past, would no longer be possible.

Wage policy: already making its contribution

Finally, wage policy also has a role to play. In avoiding second-round effects from oil prices, in balancing out the profitable prospects of investments with the increase in the purchasing power of wages that is necessary to drive private consumption, wage policy can make an important contribution to a sound and growth supporting macro policy mix. The point however is that wage policy is already doing the former, while it is not possible to maximize the latter in present bargaining conditions. The situation as regards to wage formation has been described in chapter I. Given this, it is up to monetary and fiscal policy to fully exploit the margins for growth that wage policyhas already delivering by containing inflationary pressures.

CHAPTER III

POPULAR MYTHS IN THE EURO AREA

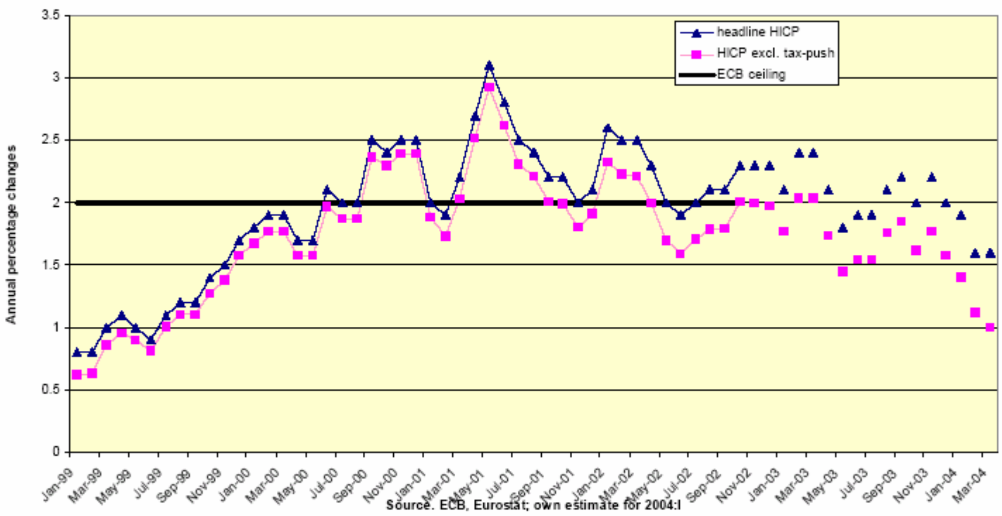
The ECB cannot act because inflation in the euro area is sticky

Inflation, when measured by headline inflation, has been 'stubbornly' higher than the ECB's threshold of 2%. In official policy analysis, this is flashing a red light. An economy where growth decelerates and unemployment is edging up but where inflation does not fall could point to the fact that potential growth is falling as well, alongside effective growth. Otherwise, a slowdown in growth would bring with it a growing imbalance between higher aggregate supply and lower aggregate demand, resulting in the elimination of price (and wage) pressures, hence in falling inflation. The fact that inflation hasn't fallen strongly is then seen as an indication that spare capacity (despite the slump in growth) is limited and so is the room for aggregate demand policies. With spare capacities low, any attempt to get the economic growth motor going through active demand management would almost immediately result in even higher inflation.

Since the ECB is following a monetary policy model that does attempt to stabilise the business cycle by targeting price stability in relation to the position in the business cycle, this issue is of extreme importance.

It is important to recognise that in the euro area headline, and even but core inflation, are not a always good measures for the imbalance between aggregate demand and supply. Inflation figures in the European economy have been systematically distorted by governments raising indirect taxes and/or administrative prices (showing up in services sector inflation). In a single country, an indirect tax hike would be a one–off event, temporarily increasing headline inflation. But in euroland the different governments have instituted a succession of indirect tax hikes. France (tobacco prices), Italy (administered prices in transport) and Germany (higher personal health care contributions) are some examples.

Figure 3. Misses on primary objective in 2002-03 owe to tax-push inflation



Source. ECB, Eurostat; own estimate for 2004:I
Note. Taxes on tobacco products and measure of administered prices within the services sector (aggregate HICP weight of 5.6%) included here most likely underestimate true tax-push inflation.

When correcting inflation for the impact of these indirect tax hikes, it appears that inflation does respond to the unfolding growth slump in Europe. Already from beginning 2002 on, inflation, corrected for government intervention in the form of indirect taxes fell below the ECB's price stability threshold. And since then, it has stayed below 2% with the exception of just two months. Inflation developments, from this point of view, have not been sticky at all and are pointing to spare capacities and oversupply in the economy that provide the ECB increased room for expansionary monetary policy making. Subsequently, headline inflation has, of course, risen above 2%, but this largely reflects higher commodity prices.

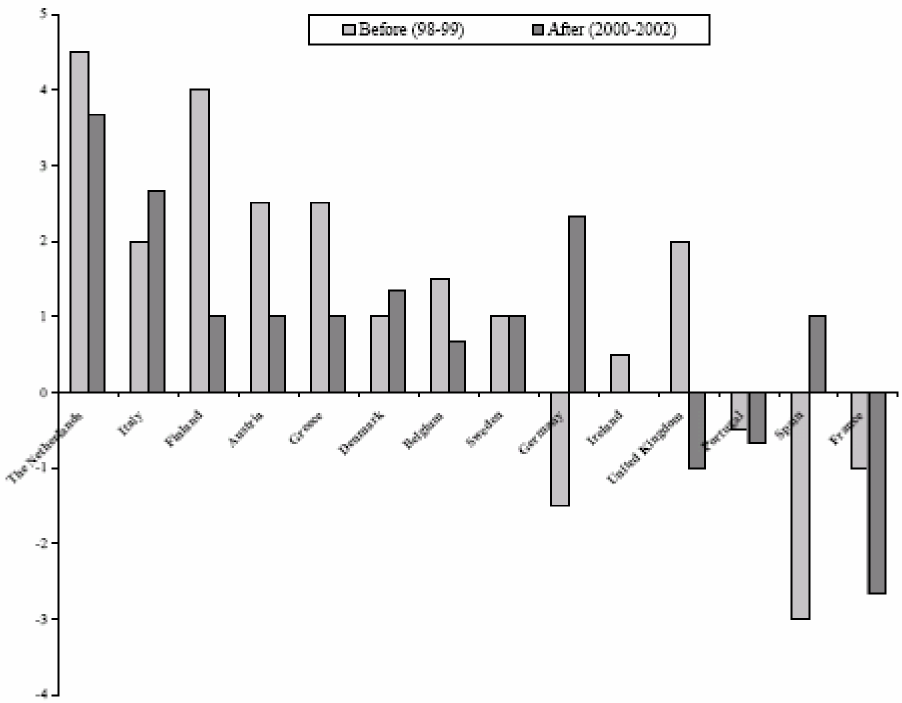
Fiscal and monetary policy makers in the euro area should urgently clarify this point amongst themselves. To the extent that the ECB is indeed basing its contribution to growth-supporting stabilization policies on the basis of signals coming from headline inflation, then indirect tax hikes are highly counterproductive for the macro economic policy mix. In this case, indirect tax policy conveys the mistaken signal to the ECB that there is no or limited need to intervene in order to bring aggregate demand and supply back in line. The consequence is insufficient expansionary monetary policy, which in turn keeps economic growth low, implying high fiscal deficits which fiscal policy makers address with further indirect tax hikes. In that way, the economy finds itself trapped in a vicious cycle of continuing low growth and continuing high inflation. This circle can be broken if the monetary authority provides sufficient room for a strong recovery, thereby bringing deficits down and eliminating the need for further indirect tax hikes. Instead of complaining about the stubbornness and the stickiness of inflation, thereby hinting to a 'rigid' economy, the ECB and fiscal policy makers should urgently communicate on how to handle indirect tax policies and its consequences on inflation. A situation in which the ECB is controlling the upwards risks to price stability and where the downwards risks to price stability are in practice being taken up by fiscal policy makers is not a sound policy mix that is conducive to growth.

Member States are not implementing structural reform

A frequently heard argument is that Lisbon is failing because Member States are not implementing structural reform. The reality however is in contradiction with this line of reasoning. One way to measure structural reform in the area of labour market institutions is provided by the IMF's 2004 review of the euro area economy. In this review, the IMF in turn makes use of the Social Reform database of the De Benedetti Foundation. This database counts the net number of reforms that have been done regarding employment protection legislation, unemployment benefits and pensions. In order to arrive at a net number, reforms that increase flexibility are balanced with reforms that decrease flexibility.

Although the IMF expresses disappointment that only four countries (Denmark, Germany, Italy, and Spain) have accelerated labour market reform after the 2000 Lisbon council, the fact remains that these countries represent 60% of the economic weight of the entire euro area. Other countries, while not accelerating reform after 2000, have also continued to pursue reforms (Netherlands, Austria, Finland, Greece, and Belgium). Only Portugal and France are backtracking on labour market reform as measured by the De Benedetti foundation. **The IMF statistic implies that 80% of the euro area has indeed continued with labour market reforms, as opposed to the popular view that nothing is happening.** In short, it is simply not true that Europe did not deliver on structural reform of the labour market.

Figure 7. Net Number of Flexibility-Enhancing Labor Reforms Per Year: Before Lisbon and After



It is striking to see that there is a also certain correlation between reform and bad economic performance. In those euro area countries that have accelerated reforms, consumer confidence has collapsed and growth has been very meagre. Structural reform as implemented through pure flexibilisation of the labour market, insecurity, high household savings ratios and low growth seem to go hand in hand. At the very least this indicates that the short-run costs of such reforms can be high.

Turning to structural reform on product markets and in general, there also the benefits from structural reform have not been very impressive, to say the least. Consider the long list of reform areas and ‘structural’ changes Europe has engaged in or experienced over the last 20 years:

1. Single Market
2. Competition rules
3. Single currency
4. Freer trade/WTO rounds
5. Privatisation of public enterprises
6. Introduction of ICTs

7. Increased competition in network industries
8. Enlargement
9. Labour market reforms
10. Pension reforms
11. Reduction of state subsidies

Recall that when each of these single structural reform initiatives was proposed, a prediction was made that this particular reform would boost growth, employment and productivity. An identical approach is now taken with the services directive proposal. If the predictions would have been true, then Europe would now be enjoying the highest growth potential and be indeed the most competitive economy of the world! Instead productivity has declined (see below).

Clearly, while a structural policy agenda is important, structural reform as practised the last years is not delivering. The reasons, while complex in detail, are essentially twofold: Firstly, the concept of structural reform that has been pursued has largely focussed deregulation, based on a theoretical conception of the superior of markets that does not hold in real-world conditions. In fact, to give one example, raising labour supply often depends on creating institutions (such as public childcare). Secondly, even where structural reforms have increased growth potential 'on paper', aggregate demand policies have not responded adequately to structural reform measures, so that the supposed benefits can not be reaped. In fact, maintaining buoyant aggregate demand is key not only to sustaining actual, but also to raising potential growth, because of capital-stock and labour market (hysterisis) effects.

Structural reform will make the economy more resilient to downturns

Europe is not so keen on using instruments of aggregate demand management. This has led policy makers to argue that 'structural reform' not only increases aggregate supply and the potential growth rate of the economy, but that it is at the same time strengthens an economy's capacity to withstand adverse economic shocks. In other words, flexible economies are more resilient.

While such an argument evidently comes in handy to justify inaction from the macro policy side, this also raises a number of serious questions:

- If flexible economies are that resilient, how come they are the first ones to make full, in some cases even exaggerated, use of aggressive aggregate demand management? The US and the UK, both considered to be flexible economies, have been champions in fiscal stimulus (US and UK) and monetary stimulus (US) over the last couple of years.
- If flexible economies are resilient to downturns (by for example having more wage moderation) what then about the upturn when a combination of flexible wage formation and good growth will more rapidly lead to wage/inflation acceleration.

Both the OECD and European Commission have been looking into the merits of the argument whether flexible economies are able to recover from recessions more quickly. The 2004 Economic Review of the Commission concludes, on the basis of simulations comparing a more flexible economy with a less flexible one, that '*the difference between the flexible and the rigid scenario is not very pronounced. (…) (This suggests) that structural rigidities are unlikely to be the only explanation of why the latest rebound of the euro are economy was less dynamic than in other industrial economies*' (page 25).

Rigid labour markets block innovation and lower labour productivity growth

The European economy has seen a slowdown in labour productivity growth since the mid–nineties. Before 1995, labour productivity was growing at a rate of 2% a year. The average over the 1996–2004 period is however half that high at 1% a year. Whereas this has indeed meant that more jobs are created for a given growth of output, the US economy has seen over the same period a spectacular increase in labour productivity growth as well as an acceleration of economic growth itself. Again, many observers try to explain this deviating productivity performance between Europe and the US by referring to the more flexible labour markets in the US. Institutions such as employment protection legislation, rigid working hours, or strong trade unions/workers' representation are considered to be standing in the way of the process of innovation and the diffusion of innovative practices throughout the economy.

National account statistics are used to underpin this attack on labour market protection of workers. Following table describes the fall in labour productivity growth in the euro area and the acceleration of productivity growth in the US. The table also splits up the average productivity growth into 'capital deepening' on the one hand and total factor productivity on the other hand, as calculated by the IMF. The driving force behind a decline in the former is that wage moderation will change the relative price between capital and labour. In other words, cheaper labour will result in a less capital intensive production process, leading to higher labour input and consequently to lower labour productivity (growth). There is thus nothing abnormal when labour productivity falls as a consequence of wage moderation leading to a process of substitution of capital by labour and in fact, it is what neo classical economists have been arguing all the time. The other part of overall productivity growth is then labelled as total factor productivity growth. This is calculated as a residual and is seen as an indicator of innovation. High outcomes on total factor productivity growth points to a high degree of technological or organisational innovation.

Referring to the table, it can be observed that the greater part of the deviating productivity growth outcome between the euro area and the US can be explained by different evolutions in the process of capital deepening. In the euro area, wages have been moderating to such an extent that the incentive to replace labour by capital has diminished, while in the US the opposite (high wage growth!) has been happening. The table however also shows that the part of productivity growth that is linked with the capacity to innovate has also been falling in Europe (from 1,6 to 1,2%), while it has almost doubled in the US (from 1to 1,7%). From figures like this, the conclusion is rapidly drawn that Europe's capacity to absorb innovative practice is not adequate and not comparable to the US.

	Labour	**Capital**	**TFP in the**	**Labour**	**Capital**	**TFP in US**

	productivity in the euro area	deepening in euro area	euro area	productivity in US	Deepening in US	
70-80	3,9	1,2	2,7	1,6	0,4	1,2
80-90	2,2	0,6	1,6	1,4	0,2	1,2
90-95	2,6	1	1,6	1,3	0,3	1
95-2000	1,6	0,4	1,2	2,1	0,4	1,7

Source : IMF, based on national accounts

However, a critical look at these figures raises the question that if flexible labour markets are really that good for innovation, then why is it that the US record on total factor productivity growth has been so weak over the whole period between 1970 and 1995, whereas Europe has systematically been scoring better.

Moreover, the IMF's country study on the euro area presents new evidence that throws a completely different light on these statistics. The IMF argues that national accounts are not appropriate to make country comparisons on productivity growth. In particular, national accounts do not take quality changes in ICT equipment or in the quality of labour sufficiently into account. Therefore, the IMF uses another method and bases itself on industry data to recalculate capital deepening and innovation effects on labour productivity growth for the whole economy. The countries in this exercise include, besides the US, Germany, France and the Netherlands (representing slightly over 50% of the euro area). According to IMF statistics, total factor productivity growth accelerated in the US <u>as well as in the euro-3 area</u> in the latter half of the nineties. In the euro-3 area, innovation productivity accelerated from 0,7 a year to 1%. In fact, according to this statistic, innovation processes are delivering higher productivity growth in the euro-3 area compared to the US (1% versus 0,87%).This automatically implies that the deceleration of total labour productivity growth in the euro area can be completely explained by the process of capital deepening. In other words, labour productivity in the euro-3 area has been growing substantially less, not because labour markets are too rigid, but simply because ongoing wage moderation in Europe has stimulated firms to switch over to more labour-intensive production processes. This points to a wage formation process that is flexible and is taking the 'outsiders' into account, not to rigid obstacles that completely protect the insiders. It also means that, logically, policy makers are, in effect pointing the finger at workers because of 'excessive' wage moderation and its impact on lower productivity growth! This is not really serious.

	1990-1995 Euro 3	**1990- 1995 US**	**95-2000 Euro 3**	**95-2000 US**
Labour productivity	1,89	1	1,83	2,17
Capital deepening	1	0,64	0,65	1
Labour quality	0,15	0,23	0,19	0,25
Total factor productivity	0,7	0,1	1	0,87

Source : IMF, based on industry-level data

A further approach to the question as why labour productivity growth has decelerated in the euro area is provided by the Commission's 2003 annual economic review. This study comes to the conclusion that the downturn in productivity growth in the euro area is driven by a very limited number of sectors: hotels, restaurants, utilites and transport. Again, it is hard to see how a supposed general state of labour market rigidity is depressing labour productivity in very specific sectors. Instead, one should look for factors that are specific to these sectors. Here, the fact that these sectors rely much more on lower skilled labour, together with the knowledge that many member states have reduced social contributions for the low skilled/low wage workers provides a more convincing explanation that is again in line with the IMF's analysis of a change in the relative cost of labour and a slowdown in capital deepening. The same study also concludes that the productivity miracle of the US in the 1995-2000 period was also very sector specific. It is retail and finance that very largely explain productivity developments on the other side of the Atlantic. Here, the explanation is that the financial sector was able to record strong productivity gains on the back of the stock market bubble. The retail sector, for its part, made use of booming consumption demand as well as from the fact that in the US 'space' is more readily available. A Mc Kinsey study for example concluded that the acceleration of productivity growth in the US retail sector was almost completely driven by the construction of new stores and outlets outside the city centres. Europe, with its more densely populated regions does not have the same possibilities (or there may be valid social and environmental reasons for rejecting such a strategy).

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Annex 1

Impact of a 10% appreciation of the euro on growth and inflation

	Nigem 1	Nigem 2	Euromon	Euren	Average
Impact on annual growth					
Year 1	-0.8	-0.8	-0.3	-0.3	-0.6
Year 2	-0.6	-0.4	0	-0.6	-0.4
Year 3	-0.4	-0.2		-0.4	-0.3
Year 4	-0.3				-0.1
Impact on inflation					
Year 1		-0.4		-0.1	-0.25
Year 2		-0.5		-0.7	-0.6
Year 3		-0.6		-0.8	-0.7
Year 4		-0.7			

Sources: Nigem 1: National Institute Global Econometric Model, London, as quoted in DNB staff report by Marga Peeters 'Monetary Conditions in Europe', 1998.Nigem 2: National Institute Global Econometric Model, London as quoted by Gustav Horn in 'Exchange rate policy of the euro area', Briefing Paper for the Monetary Committee of the European Parliament, December 2003.Euromon, see source by Nigem 1.Euren: Special study in Euren-Forecasts, June 2003 'How much is Euro Area Competitiveness affected by the Euro appreciation?'.

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