Economic Growth in the Euro Area

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How to raise growth in the EU?

1. 1990-2003: an assessment
2 Are macroeconomic policies adequate?
3. Needs for structural reforms?
4. European governance
5. Reforms of the European budget?

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- The ghost of 'Eurosclerosis' is back again in the European Union.
- European Union growth had been satisfactory from 1997 to 2000, but the EU was unable to support economic activity after the fall in new technologies and equity markets.
- Euro area growth prospects are subdued for 2003-2004, contrary to other parts of the world, first of all to the US.
- Why is Europe unable to maintain robust growth durably?

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Two major views on how to raise EU growth

1. Europe needs a more active and coordinated macroeconomic policy. EU must promote competitiveness based on strong social cohesion; on a high level of public spending; on performing education and health systems.

2. Europe needs structural reforms: labour and product markets deregulation; lower public expenditure and taxation; reform of economic institutions; increase research and development and education spending.

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1990-2003: An assessment

- European ambitions have known mitigated success since the beginning of the 1990's.
- The implementation of the Single market and the euro were a success.
- But the Maastricht Treaty was costly in terms of economic activity.
- Economic policy coordination does not generate a strong and coherent strategy
- Lisbon agenda was not really implemented. Cardiff, Cologne and Luxemburg processes did not have an impact in practice.
- The single market did not fulfil its promises to stimulate growth through strengthened markets efficiency.

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Europe as compared to the US

- Since 1975, the EU economies have stopped catching-up with the US in terms of GDP per head. Average per head GDP in the European Union still 70% of the US level only.
- Since 1990, GDP growth has been lower in the European Union than in the US, both in high and low growth periods.

Table 1: GDP Growth

	1990-97	97-00	00-03	90-03
EU	**1.55**	**2.7**	**1.0**	**1.85**
USA	**2.6**	**4.2**	**1.9**	**2.9**

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Europe as compared to the US

- Despite the structural reforms implemented in the 90's, with the Single market and the deregulation processes, labour productivity growth has been decelerating in the European Union when accelerating in the US.

Table 2: Labour Productivity Growth (companies)

	75-85	1986-90	91-95	95-00
EU	**2.4**	**1.9**	**2.1**	**1.1**
USA	**1.2**	**1.0**	**1.3**	**2.25**

Source : OECD.

At the same time, potential labour force has grown more rapidly in the US (1.3% per year versus 0.8%).

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Europe as compared to the US

- Nevertheless, unemployment rates have significantly declined in a large number of Member States in the 1996-2001 period (Spain, Ireland, Finland, Sweden, Netherlands, France).
- In six Member States, employment growth was more rapid than in the US.
- The rise in employment did not stop because of excessive tensions on labour markets. The share of wages remained stable at around 68%. The rate of inflation remained at around 2% in most euro area countries.
- This shows that employment is responsive to demand, and that employment growth is impeded by demand constraints rather than by supply constraints.

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Policy-mix in the euro area and in the US: two different stories since 1990

- In the euro area: monetary policy aiming at lowering inflation, fiscal policy aiming at reducing fiscal deficits.

- In the US: policy-mix should do its best to support growth.

  View not shared by the European authorities: the ECB raises interest rates as soon as output grows more rapidly than the Bank's potential growth estimates (see 1999-2000); at the same time the Commission calls for restrictive fiscal policies.

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Fiscal and monetary policies in the euro area and in the US

	Euro area			US		
	Output gap*	**Fiscal impulse**	**Monetary conditions****	**Output gap***	**Fiscal impulse**	**Monetary conditions****
1991	1.4	– 0.4	– 0.2	– 2.5	– 0.3	– 2.7
1992	0.5	– 0.8	– 5.3	– 1.8	0.9	1.8
1993	– 2.4	– 0.7	– 5.8	– 1.8	– 0.8	1.9
1994	– 2.0	– 0.2	– 1.1	– 0.5	– 0.9	1.5
1995	– 1.5	0.1	– 1.0	– 0.6	– 0.7	– 1.1
1996	– 2.0	– 1.1	– 1.2	0.0	– 0.6	0.2
1997	– 1.7	– 1.0	– 0.3	0.9	– 0.8	0.8
1998	– 1.0	0.2	0.8	1.8	– 0.9	0.1
1999	– 0.4	0.1	1.0	2.4	0.0	0.5
2000	1.1	0.5	0.6	2.2	– 0.6	– 0.6
2001	0.3	0.5	– 0.3	– 1.1	1.5	– 1.1
2002	– 0.9	0.3	– 0.1	– 1.5	3.1	1.8

* According to OECD.
** Output growth less interest rate (a positive sign indicates a relatively low interest rate).
Source: OECD.

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Weaknesses of the existing framework

The framework of fiscal policies coordination in the euro zone is not satisfactory.

- No prevention of negative externalities (too rapid inflation, current account in deficit or in excessive surplus).
- Economic policy co-ordination is not organized, especially in bad times.
- Stability Pact requests objectives without economic justification, like the 3% of GDP reference value or the target of "close to balance or in surplus" budgetary positions in the medium run.

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2001- ?: The Pact in times of slowdowns

- The problem appeared in the slowdown.
- The euro zone was unable to organize a macroeconomic strategy to impulse growth in Europe (contrary to the US or the UK).
- Because the Pact is ill-designed, Commission wastes its energy to persuade Member States to undertake restrictive fiscal policies, to increase slowdowns to fulfil the Stability Pact. In November, it ended in a crisis between the Commission and some Member States.
- It makes no sense to argue on the level of public deficits when the problem is insufficient growth and when the countries pointed out for their deficits do not have any inflation problems.

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2001- : The Pact in times of slowdowns

- Germany and France will run an ‘excessive deficit’ for the third consecutive year in 2004. Italy uses ‘Creative accounting’.
- France and Germany asked by the Commission to make stronger budgetary efforts. For France cut its structural deficit by 1% of GDP in 2004 instead of 0.6 in the draft budget, 0.5 in 2005. For Germany, 0.8% of GDP in 2004, 0.5% in 2005.
- Under the pressure of the Commission and peer countries, Germany and France have agreed to run restrictive fiscal policies in 2004 (0.8% of GDP for France, 0.6% for Germany) and 2005 (0.6% for France, 0.5% for Germany) at a time when growth acceleration is not really sure. It can be a source of future conflicts.

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Budgetary prospects in the euro area

	2002	2003	2004	2005	2002	2003	2004	2005
	Government Balances, % of GDP[1]				Fiscal impulses[2], % of GDP			
Germany	– 3.5	– 4.2	– 3.9	– 3.4	0.1	– 0.2	– 0.3	– 0.3
France	– 3.1	– 4.2	– 3.9	– 3.6	0.9	– 0.1	– 0.6	– 0.3
Italy	– 2.3	– 2.6	– 2.8	– 3.5	– 0.5	0.2	0.5	1.0
Spain	0.1	0.0	0.1	0.2	– 0.8	– 0.1	0.1	0.1
The Netherlands	– 1.6	– 2.6	– 2.7	– 2.4	0.3	– 0.1	– 0.6	– 0.3
Belgium	0.1	0.2	– 0.4	– 0.4	0.1	– 0.3	0.8	0.5
Austria	– 0.2	– 1.0	– 0.6	– 0.2	0.2	0.3	– 0.4	– 0.2
Finland	4.2	2.4	1.7	1.9	1.5	1.2	0.7	– 0.1
Portugal	– 2.7	– 2.9	– 3.3	– 3.9	– 2.3	– 1.2	– 0.1	0.6
Greece	– 1.2	– 1.7	– 2.4	– 2.3	0.3	1.0	1.3	0.0
Ireland	0.0	– 0.9	– 1.2	– 1.1	1.3	– 1.2	– 0.5	– 0.4
Euro Area	– 2.2	– 2.8	– 2.7	– 2.7	0.1	– 0.1	– 0.2	0.1
UK	– 1.5	– 2.8	– 2.7	– 2.4	2.1	1.1	0.0	– 0.1
US	– 3.4	– 5.0	– 5.5	– 5.4	3.0	1.6	0.9	0.0

1. Excluding UMTS receipts.
2. Opposite of the change in the primary structural balance.
Sources: European Commission Autumn 2003 forecasts, OECD, OFCE estimates.

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Ageing Prospects: *ex post* justification for the SGP?

Ageing related costs expected to require a rise in public pension expenditure of about 3% of GDP before 2040.

- Official view: Governments must run a balanced budget with a primary surplus of 3% of GDP to reduce public debts to 0. Reducing interest payments will allow to finance the future pensions costs.
- But: Some countries consider raising the effective retirement age and not to raise pensions expenditure.

There is no certainty that lower interest rates (or lower euro) can compensate for the depressive impact of this strategy. Households need long-term safe public assets to save for retirement

Bringing the public debt from 50% of GDP to 0 will only give a margin of 1% of GDP for pensions expenditures.

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European Growth Initiative (EC, 2003)

The Commission presents an Initiative to boost growth and competitiveness (Lisbon agenda) in Autumn 2003.

- Action plan boost investment in networks (transport, energy) and knowledge from now to 2010. Projects co-financed by public and private sectors (at 60/40%).

Estimated budgetary costs of the programs ready to start rapidly : 0.05% per annum of the Union’s GDP.

- What impact on growth? The small size of the projects and implementation delays imply that they cannot be used to stabilise activity and cannot be a substitute for national fiscal polices, even if this projects may be useful at microeconomic levels.

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Monetary conditions much less favourable in the EA than in the US

- Real interest rates were extremely high during the Maastricht convergence process. Monetary policy stopped being restrictive in the euro area only in 1997-1998.
- Since 1999, the ECB's policy has been slightly more expansionary than indicated by a Taylor rule. But this estimate is conditional on output gap estimates. So the current monetary policy is satisfactory only if the euro area resigns itself to an equilibrium unemployment rate above 8%.
- With similar inflation in the US and in the euro area and stronger growth prospects for 2004 in the US, interest rates are currently much more expansionary in the US.

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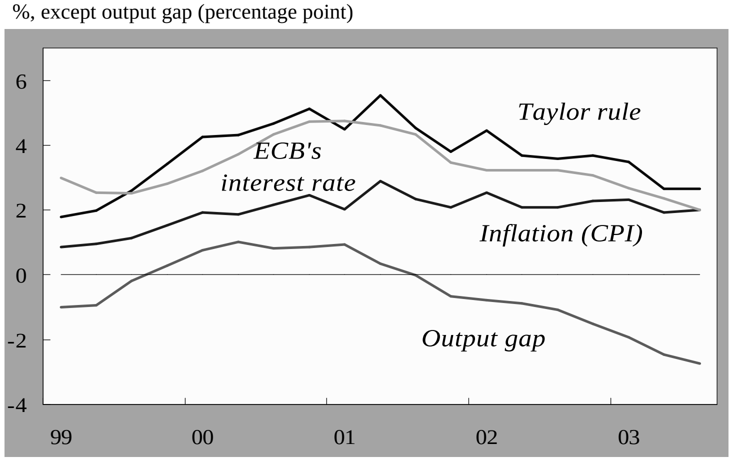
Euro area interest rates according to a Taylor rule*

%, except output gap (percentage point)



* Defined as: , with g: potential output growth, *p*: inflation and : output gap in 2003, according to the OECD.

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Sources: ECB, OECD, own estimates.

Output growth and inflation forecasts, interest rates, November 2003

	Output growth, %	Consumer prices, %	Differential*	Output gap	Taylor rule**
Germany	1.4	1.1	– 0.5	– 3.1	0.5
France	1.4	1.7	– 1.0	– 1.5	3.0
Italy	1.3	2.2	– 1.5	– 3.0	2.5
Spain	2.7	2.8	– 3.5	– 1.2	5.4
Netherlands	0.8	2.2	– 1.0	– 3.8	2.5
Belgium	1.4	1.4	– 0.9	– 3.1	1.6
Austria	1.6	1.4	– 1.0	– 2.9	1.8
Finland	2.4	1.1	– 1.5	– 2.1	2.1
Portugal	1.4	2.4	– 1.8	– 4.0	2.7
Greece	3.9	3.0	– 4.8	1.0	7.5
Ireland	3.6	3.2	– 4.9	2.5	10.6
Euro area	1.5	1.7	– 1.2	– 2.4	2.3
UK	2.5	2.6	– 1.6	– 1.7	4.5
US	4.0	1.8	– 4.8	– 2.0	3.7

* Short-term interest rate (2% in the euro area, 3.5 in the UK, 1 in the US) less 12-month ahead forecasts for consumer price inflation and real output growth.
** Defined as: , with g: potential output growth, *p*: inflation and output gap in 2003, according to the OECD.
Sources: Consensus economics, OECD, own calculations.

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Twelve countries, a single monetary policy

- In the euro area, business cycle positions still differ. Neutral rates start from 0.5% in Germany to 10% for Ireland. The same interest rate does not provide the same monetary stance in all countries.
- It is easier for Spain to run a budget in balance, with strong activity generating fiscal receipts, than for Germany. It would be justified to allow Germany to run budget deficits, as it suffers from a restrictive monetary policy. It would be justified to ask Spain to make budgetary efforts in order to cut inflation.
- This is not the actual policy framework : a country will get no sanctions because of inflation or current deficit. This is in contradiction with the objective of the Stability Pact to avoid negative externalities.

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Euro/dollar issues

- The euro area did not benefit from a strong positive monetary impulse in recent years, contrary to the US. In the first years of existence of the euro, this was compensated by the exchange rate depreciation. But, the real exchange rate started to rise continuously in 2002.
- Since the beginning of 2002, the US economy has benefited from a strong positive monetary impulse and from a depreciation of the real effective exchange rates: two cumulated positive effects, which come on top of a strongly expansionary fiscal policy.
- In the euro area, on the contrary, there has been a small positive impulse from interest rates, short-term interests are close to 0 and the real effective exchange rate has appreciated: a negative effect from monetary conditions, while fiscal policies have had a small negative impulse.

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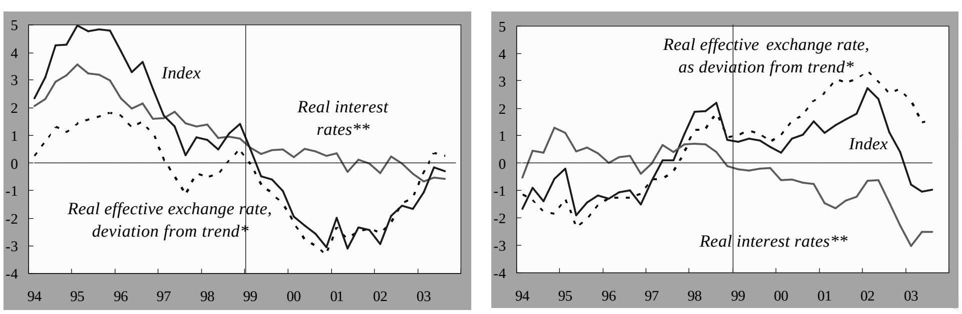
Monetary conditions index

Euro Area US



Notes: The index is calculated as: 1*Interest rate component+ 0.2*Exchange rate component.
*1991-2002 average; component weighted according to its weight in the index (0.2); **Average of long-term and short-term interest rates less annual consumer price inflation less smoothed GDP growth.
Sources: OECD, authors' calculations.

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The comparison of the policy-mix in the euro area and in the US shows clearly two different stories, since the slowdown of 2000:

➢Expansionary policy-mix, both from monetary and fiscal sides in the US

➢Slightly restrictive/neutral policy-mix in the euro area.

➢ Differences in economic growth are not a surprise.

➢The good policy for the euro area would be to maintain a low interest rate. Economic authorities should state clearly that economic growth is their main priority, and that they wish a low level for the euro.

➢In each country of the area, fiscal policies should be allowed to support activity until the Nairu is reached.

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Structural reforms?

➢Official view (Commission, Sapir Report): low growth results from labour markets' functioning and from the excessive weight of social and public expenditure

➢But employment rise again in Europe when demand expands (1998-2001). The growth episode came to a halt because of the burst of the technological and financial bubble. No supply constraints appear.

➢The official view assumes that a fully flexible economy may exist. If wages were flexible enough, the economy would be in equilibrium and no economic policy would be needed. But this is a myth. Capitalist economies go through exuberance and depression times exacerbated by financial market volatility. So, wages and employment rigidities, public transfers are needed to stabilize activity.

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Structural reforms: what should be done?

Since Lisbon Summit, Innovation became a new slogan to replace the old ones (like market integration or deregulation) as a ‘miraculous’ way to impulse growth.

According to the Sapir Report, EU needs to invest more in:

– higher education: 1.4% of GDP in the US, 3% in the EU.

– R&D spending: 2.6 % of GDP in the US, 1.9 in the EU.

We agree but it seems contradictory with the reduction of public spending.

Many proposed reforms may have unfavourable consequences : to reduce public pensions may increase private saving ; to reduce public health expenses can increase total health expenses because private assurances are costly ; to reduce wages to increase firm profitability may decrease demand and activity.

Is it possible to prone more labour flexibility without social organisation to reduce the costs for the workers in terms of income and job insecurity and of social inequalities. So the problem is : What is the social pact that EU can propose to workers ?

EU need also a more active industrial policy, instead of the present competition policy (see the US where military spending contribute to research efforts of big companies).

Must we resign to financial markets’ instability and to an excessive required rate of return ?

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An economic and social European model?

- Must EU try to follow the US model ? Another strategy would be to build a European model based on solidarity, public services and public spending. The European Union is a large closed area. The euro gives significant room to lower the cost of capital. Europe may refuse fiscal and social competition and may introduce harmonised taxation on persons, companies and capital income.

- The Scandinavian example : it is possible to promote competitiveness based on a strong social cohesion ; on a high level of public spending ; on performing public education and health systems. An appropriate management of social security and public services is a source of social efficiency

- At the world level, Europe has a special role, to work towards better global governance, in terms of development, environment, fight against tax evasion, speculation and financial instability.

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European governance

- Recent past has shown once again all the weaknesses of European governance.
- Member states make different political and social choices, which are difficult to reconcile. In many areas, institutions have remained national. Preferences and problems remain country-specific. Yet community authorities wish to raise progressively their fields of competence. This generates conflicts of interest and power between member states and community authorities.
- The increased number of co-ordination processes has brought confusion on the share of responsibilities in economic matters. These processes give a major role to European and national technocracies, which is a retreat of democracy in the EU The respective attributions of national and European decisions, and the way the latter are made have not been settled in a coherent and democratic way.

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European governance

- The need to define clear strategies at the European level would lead to recommend strengthened powers of the Commission. But the Commission is not democratically elected and is not able to play a leading role.
- Stronger fiscal policy co-ordination? But what will a country do when asked by its peers to run a policy it judges against its national interests? (see Ireland, Germany, France).
- Fiscal harmonisation? But it would deprive national parliaments of their power. National institutions remain at that stage too different and harmonisation is source of conflicts.
- Social harmonisation? But will this harmonisation bring social systems closer to the more or to the less developed ones of the Union. How will it fit with national traditions or national agreements reached by social partners?

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European governance

- The Sapir Report suggests that ‘experts’ should be given a stronger role, under the creation of independent agencies, in charge of common policies, especially in higher education and research, and to exert fiscal surveillance. This would increase the lack of democracy in the EU.

- Heterogeneity of preferences and situations will be broadened further with the enlargement. It will become harder and harder for Community bodies to handle the diversity of preferences and situations. Developing democracy in Europe will become harder with the increase in the fragmentation of public opinions.

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Should the EU budget be reformed?

As recently highlighted in the Sapir Report, with 3 proposals:

- Size of the budget kept unchanged (ceiling of 1.27% of EU GDP), refocus 0.6% of spending

- Provide the EU budget with specific resources instead of national contributions (90% of resources): taxation on households’ savings income, environmental taxation, business taxation.

But: this would require strong fiscal harmonisation and a loss of national fiscal autonomy which is opposed to by a majority of member states

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Should the EU budget be reformed?

➢ Refocus spending on three funds:

– growth fund: R&D, education, infrastructure

– convergence fund: for low income countries

– restructuring fund: aid to the agricultural sector and displaced workers

But: With budget size unchanged, countries asked to allocate funding to help agriculture or regions in difficulty: uneasy to implement under current budgetary constraints. Commission wants to left recurrent expenses to Members States to concentrate at its level discretionary and future preparing ones.

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The European Budget

% of EU GDP

	In 2002	Sapir report's proposal
Agriculture	**0,55**	**0,25**
Convergence:		
– Old member states	**0,30**	**0,15**
– New member states	**0,04**	**0,20**
Growth:		
R&D	**0,04**	**0,25**
Education	**0,02**	**0,075**
Infrastructure	**0,02**	**0,125**
Restructuring		**0,05**
Total	**1%**	**1%**

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How to raise economic growth in Europe?

- The Brussels-Frankfort consensus dismisses the idea that a more active macroeconomic management would boost European growth. However, in 2001, European growth did not come to a halt because of supply constraints, which could have been disappeared under the effects of structural reforms.
- The current European economic policy dogmas are ‘sacred’. However, they impede national governments policies, without providing the impulse needed to support activity in slowdowns, or to boost growth durably.
- Active macroeconomic policy would allow for the detection of potential factors constraining supply and for appropriate measures to be taken. It is easier to undertake reforms in times of strong growth than in times of economic stagnation .
- Durable robust growth bringing the economy close to full employment, would allow for higher productivity growth and would lower the equilibrium rate of unemployment.

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