

EFN REPORT ON THE EURO AREA OUTLOOK

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Executive summary

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About the European Forecasting Network

The European Forecasting Network (EFN) is a research group of European institutions, founded in 2001 and co-financed by the European Commission. The objective of the EFN is to provide a critical analysis of the current economic situation in the Euro area, short-term forecasts of the main macroeconomic and financial variables, policy advice, and in-depth study of topics of particular relevance for the working of the European Monetary Union. The EFN publishes two semi-annual reports, in the spring and in the fall. Further information on the EFN can be obtained from our web site, www.efn.uni-bocconi.it or by e-mail at efn@uni-bocconi.it.

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Executive Summary

This Report analyses the current situation in the Euro area economy and discusses a number of policy issues concerned with the effects of fiscal policy and the convergence process in labour markets after the adoption of the common currency. We also look at the dating of business cycle turning points, and consider the consequences for the Euro area of the US current account and examine the extent to which it is structural and unsustainable. We also provide forecasts for key macroeconomic variables for 2002 and 2003 and discuss the nature of the current economic downturn and the light it throws on the conduct of economic policy in a monetary union.

The recovery from the world-wide slowdown during 2001 has proved slightly more sluggish than we expected in the Spring, and we now expect that GDP in the Euro area will grow by only 0.9 % in 2002 compared to 2001. In the Spring Report we believed that the Euro area would grow by 1.2%. However, our forecast for GDP growth in 2003 remains unchanged at 2.2%. Unemployment in the Euro area will continue to rise into 2003 to 8.6%.

The turning point that we identified in our Spring Report has now been passed and the grounds have been laid for a steady, but slow upswing in economic activity in the Euro area. The trough of the economic slowdown in the aftermath of the IT bubble has now been reached and GDP growth in the first and second quarters of 2002 was encouraging. There has not been as sharp a rise in unemployment as in previous downturns as employers anticipating a shallow slowdown, have hoarded labour. However, the absence of a quick economic recovery means that unemployment will continue to rise into 2003.

Events in the US and Europe have confounded the pessimists. Although the NBER in the US marked March 2001 as the date on which the US went into recession, the slowdown has been very shallow. On a quarter by quarter basis GDP fell slightly in the first, second and third quarters of 2001, but resumed growing thereafter, albeit

somewhat erratically. In the Euro area, GDP fell for one quarter only in 2001(q4). Nevertheless, the reasonably benign picture for the Euro area as a whole masks big differences in economic performance between member countries, which is relevant because this is the first economic downturn during which monetary policy has been completely centralised at the ECB. The downturn has been felt much more keenly by Finland, Austria, Germany and Belgium, partly because these countries started in 2000 from a much weaker position. Other countries, such as Spain, Portugal and Greece, by contrast have managed to sustain a reasonable (though lower growth rate) throughout the downturn.

The worst performing economy is Finland with 1st quarter GDP in 2002 1.9% lower than the first quarter of 2001, much of this coming from very weak export performance. Finland's high-tech industries are particularly vulnerable to the world wide IT slowdown. Nevertheless, the downturn in Finland has not been as deep as the recession of the early 1990s, and recently there has been a sharp rise in consumer and business confidence and exports are rising again. There are also faint signs of recovery in the second quarter of 2002 in Germany, Italy and Belgium, with a particularly sharp improvement in France. There is a limit to how much monetary policy can insulate a small economy from a major contraction in export markets, even if monetary policy were not centralised at the ECB. Generally, those economies that have performed worst in the current downturn have been those with the greatest exposure to exports to markets outside of the Euro area. In these circumstances there is little that can be done, especially if fiscal policy under the strictures of the Stability and Growth Pact is more skewed towards medium term balance than short run output stabilisation.

While output continues to recover slowly, the outlook for the inflation rate in the harmonised index of consumer prices remains stubbornly high. The ECB is mandated by the Maastricht Treaty to maintain price stability. So the ECB does

not have strict goal independence but is at liberty to decide what price stability actually means. Price stability has been defined by the Governing Council of the ECB as annual price increases of less than 2%. But it has also been made clear that the objective of price stability should be pursued over the medium term. On this interpretation our forecasts of inflation of 2.1% in 2003 is consistent with this approach. But it makes the 2% objective particularly vulnerable to, for example, a sharp rise in oil prices in the event of military action against Iraq.

We now summarize the contents of the policy papers contained in the Report, starting with the issue of dating the Euro area business cycle.

We need more information about Euro area business cycles as an input to the policymaking process. For example, separating out the cyclical component of fiscal policy from the underlying structural position is essential if under the Stability and Growth Pact the automatic stabilisers are to be allowed to operate while maintaining the medium term commitment to a budget position of close to balance or in surplus. Separating out structural, long term fiscal policies from cyclical variations requires a business cycle chronology. In the United States the NBER's dating committee has established a business chronology over a long period of time which is widely regarded as the authoritative dating of the US cycle. Economists who come up with a new technique for business cycle identification "prove" their technique by comparing their results with the NBER chronology. The NBER's committee comprises economists with expertise in various sectors of the economy and its approach is avowedly a multivariate one: they use information from a variety of sources in order to unambiguously date business cycle turning points. It would be good for Europe to establish a comparably authoritative chronology for its business cycle, perhaps through similar means to the NBER - perhaps through a different one. At risk of stating the obvious, it bears pointing out that the European situation is different in many ways from the one that faces analysts of the American cyclical experience. Not

least, because of the short history of the Euro area economy, country experts might be needed more than sectorial experts. Historical analysis would be complicated by national differences, but all the more necessary for this reason. A complaint that is often made against the NBER procedure is that it can take a long while, in real time, to establish a turning point, partly for reasons to do with data revisions and availability; some of those problems are more acute in the European setting. It could be argued that with techniques at hand today nothing more is really needed than reliable GDP estimates, with the benefit of being robust to revision, to provide reliable dating of the cycle. It would help also if there were a measure of GDP at the monthly frequency for the Euro area. In Part II of this Report we describe and apply some of the methods that are available for creating a business cycle chronology for the Euro area. The finding that most methods generate a very similar chronology, and that this chronology is rather common across Euro area countries, are encouraging.

The pooling of monetary policy in the Euro area has reawakened interest in fiscal policy and in the role that it could play in stimulating economic activity during a cyclical downturn. In the aftermath of September 11th the US not only loosened monetary policy but there was a fiscal relaxation through tax cuts and an increase in military expenditure. Here, in Part III we look, empirically, at the effect of fiscal policy in the four largest economies in the Euro area and separate out the systematic from the non-systematic parts of fiscal policy. The systematic part of fiscal policy in the form of plans for government expenditure and taxes, and the implications that this has for future taxation should have largely been internalised into saving and investment decisions. The systematic component will also contain the automatic stabilisers, or those parts of receipts and expenditures that vary with the business cycle. The non-systematic or unanticipated part of fiscal policy is that which has more relevance to short term

fluctuations and to the discretionary use of fiscal policy at the level of individual countries when monetary policy is centralised in the ECB. We provide a set of stylized facts on the effects of non-systematic fiscal policy in the four largest countries of the Euro area. The stylized facts are then used to shed light on the fiscal policy coordination debate, on the effectiveness of fiscal policy in stabilizing economic activity, and on the interaction of fiscal and monetary policy.

We find that there are relevant differences in the effects of non-systematic fiscal policy across countries, and substantial uncertainty about the size of these effects, which casts doubts on the possibility of a fiscal coordination, or at least complicates its implementation. The presence of spillovers across countries, another justification for a coordinated fiscal policy, is also uncertain, and their size turns out to be small.

Moreover, unanticipated changes in government expenditure are found to be largely ineffective in changing output or reducing its volatility, possibly with the exception of government investment, and, since they are not accompanied by tax increases that balance the budget, they can require deficit financing. There are minor differences between more discretionary policies, such as government consumption, and automatic stabilizers, such as social benefits. Tax shocks also appear to have minor effects on output, and tax cuts could also require deficit financing because of the sluggish reaction of expenditures. These findings suggest focusing more on an accurate specification and implementation of the systematic part of fiscal policy rather than trying to stabilize the economy with fiscal shocks.

The single market programme has helped to liberalise markets and to reduce non-tariff barriers to trade between the nation states of the European Union. However, much of this reform process has been confined to product and capital markets. While this matters a lot for the economic benefits that flow from specialisation, greater consumer choice and lower prices, the reform of labour markets has been much more timid.

Yet the proper functioning of labour markets is a crucial part of the move towards a better functioning currency area. Labour mobility and flexible wages play an important role in adjusting to non-symmetric economic shocks when individual nations do not have independent control over monetary policy, and fiscal policy is constrained. In Part IV of this Report we consider a number of issues that arise in the labour market with a common currency. There are already in place mechanisms for the regular monitoring of product and capital markets through the so-called *Cardiff Process*. However, there is not an equivalent process for labour markets. The Amsterdam Treaty commits the European Union to a high level of employment as an explicit objective and this was reiterated in Lisbon. But it is not clear how this translates into labour market performance and the role that the labour market will play in helping the process of economic and monetary convergence. The convergence of unit labour costs and productivity across the countries in the Euro area is studied in Part IV of this Report. It is found that while there has been convergence in the growth of nominal wages across the Euro area as inflation in prices and wages has converged in the movement towards a single currency, convergence in the levels of productivity has been absent. The danger is that with the transparency that a single currency brings, there will be increased convergence of nominal wages without improvements in productivity that ultimately determine standards of living.

Part V deals with an external development particularly important for the Euro area. In 2001 the US current account deficit reached 4.1% of GDP. The worry is that if the deficit does not move back closer to balance or keeps widening, U.S. external liabilities would represent a growing share of world portfolios. At some point investors could become unwilling to hold dollars. The ensuing large adjustment in the current account and fall in the external value of the dollar could lead to substantial dislocations in the world

economy and disruptions in U.S. and world financial markets.

The central issue is what is a sustainable current account deficit for an economy such as the US whose currency is very widely used for trading purposes. In Part V we examine two approaches. In the first, an intertemporal approach to the balance of payments emphasises both the importance of domestic saving and investment decisions and the role of international portfolio decisions by both domestic residents and foreigners. The question is what deficit is consistent with a number of reasonable assumptions about US growth, changes in the real exchange rate, import penetration and desired portfolio holdings. Calculations suggest that a deficit of 3.5% of GDP is sustainable.

The second approach is more quantitative, and decomposes the deficit into its cyclical and structural components. The results suggest that there is a distinctive cyclical component to the deficit. The current account shows small surpluses during the recessions of the early 1980s and 1990s and large deficits during the peaks of the mid-1980s and late 1990s. By contrast, the structural deficit is that path for the deficit consistent with the average (1980 – 2001) real exchange rate and US growth relative to the rest of the world. On this interpretation the difference between the actual deficit and the structural deficit can be attributed to the faster rate of growth of the US economy relative to the rest of the world.

A real business cycle interpretation of this finding is that the technological shock coming from electronics and IT has been taken up much more quickly during the 1990s by the US compared to elsewhere. Since domestic savings are unlikely to rise, the investment boom domestically has to imply a current account deficit. The question is what the medium term outlook will be. In the standard growth model a technological shock will only affect growth over the

medium term as the capital stock rises. However, once the technology has been fully taken up elsewhere the (comparatively) high growth rate in the US will recede and the current account will move back towards a lower equilibrium. When this will happen depends upon how quickly the rest of the world adopts the productivity enhancing technologies coming from IT as fully as the US.

Highlights for the Euro area Economy

- The Euro area will grow by 0.9% in 2002 and 2.2% in 2003.
- Inflation in the harmonised consumer price index is forecast to average 2.3 % in 2002 and to decline slightly in 2003 to 2.1%.
- Exports will rise by 1.7% in 2002 and on the back of a strong recovery in world trade by 8.7% in 2003.
- Investment remains very weak, falling by 1.7% in 2002 and rising by only 2.3% in 2003.
- Private consumption, after growing by only 1.8% in 2001, rises by only 0.5% in 2002 and 1.4% in 2003.
- The euro is forecast to be 2.0 % higher during 2002 and slightly lower by 0.6 % % in 2003.

Table I.1: Economic Outlook for the Euro area

	1999	2000	2001	2002: 2nd half	2002: annual	2003: annual			
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	2.8	3.5	1.5	1.4	1.1 1.8	0.9	0.7 1.1	2.2	1.7 2.7
Potential Output	2.6	3.2	2.4	2.3	2.0 2.5	2.4	2.1 2.8	1.9	1.3 2.5
Private Consumption	3.5	2.5	1.8	0.5	-0.1 1.1	0.5	0.1 0.8	1.4	0.6 2.2
Government Consumption	1.9	1.9	1.9	1.6	1.3 1.8	1.7	1.6 1.8	1.2	0.9 1.6
Fixed Capital Formation	5.9	4.8	-0.6	-0.7	-2.3 1.0	-1.7	-2.6 -0.9	2.3	0.0 4.5
Inventories / GDP	0.2	0.2	-0.2	0.0	-0.2 0.2	-0.1	-0.2 0.0	0.3	0.0 0.5
Exports	5.3	12.4	2.5	4.8	3.6 6.1	1.7	1.0 2.3	8.7	6.8 10.5
Imports	7.4	11.1	1.1	3.5	1.8 5.3	0.1	-0.8 0.9	8.6	6.3 10.8
Unemployment Rate	9.5	8.5	8.0	8.4	8.3 8.4	8.3	8.2 8.3	8.6	8.4 8.9
NAIRU	9.7	9.1	8.5	8.2	8.1 8.3	8.2	8.2 8.3	8.3	8.0 8.5
World Trade	6.3	12.1	0.5	8.9	7.6 10.2	4.6	3.9 5.2	10.2	8.6 11.8
Euro Nominal Effective Exchange Rate	-5.8	-11.1	1.8	3.2	-0.3 6.4	2.0	0.2 3.6	-0.6	-5.6 4.3
Euro Real Effective Exchange Rate	-5.6	-10.2	2.8	4.3	0.9 7.5	3.3	1.6 4.9	-0.3	-5.3 4.5
Short Term Interest Rate	3.0	4.4	4.3	3.4	3.0 3.7	3.4	3.2 3.6	3.7	3.2 4.4
Long Term Interest Rate	4.7	5.4	5.0	5.2	4.9 5.6	5.2	5.0 5.4	5.2	4.6 5.8
Labour Cost Index	2.3	3.2	3.3	3.4	3.1 3.7	3.6	3.4 3.8	2.6	2.1 3.1
Labour Productivity	1.0	1.1	0.5	0.4	-0.3 1.0	0.4	0.2 0.6	2.3	1.6 2.9
HICP	1.1	2.4	2.5	2.3	1.9 2.7	2.3	2.1 2.5	2.1	1.3 2.9
Deflator Private Consumption	1.7	2.1	2.4	2.3	1.9 2.7	2.4	2.2 2.6	1.9	1.5 2.4
GDP Deflator	1.8	1.3	2.3	2.0	1.5 2.4	2.1	1.9 2.4	1.7	1.2 2.3

Percentage change in the average level compared with the same period a year earlier, except for unemployment rate, NAIRU and interest rates that are expressed in levels. Point forecasts and 80% confidence bounds are taken from EFN forecasting models and based on 2000 stochastic simulations.

Source : *EFN Economic outlook*, Instituts membres du réseau EFN, rapport octobre 2002.