

ADJUSTING TO LEANER TIMES

***5TH ANNUAL REPORT OF THE
CEPS MACROECONOMIC POLICY GROUP***

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This report presents the findings and recommendations of the CEPS Macroeconomic Policy Group (MPG) for the year 2002-03. The MPG is a select body of highly respected economists who have undertaken to carry out independent, in-depth research on current developments in the European economy and to publish their findings in an annual report. CEPS gratefully acknowledges financial support from Deutsche Bank, London and Tudor Investments, New York for the work of the MPG. The views expressed in this report are those of the authors writing in a personal capacity and do not necessarily reflect those of CEPS or any other institution with which the members are associated.

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PREFACE

This is already the fifth annual report issued by the CEPS Macroeconomic Policy Group. As has been our practice for several years now, we have brought together a distinguished group of economists to produce a thorough analysis of the key challenges facing economic policy-makers in the EU.

For the last two years, our reports have emphasised the dismal productivity record as the key reason for the disappointing growth performance (and probably prospects) of Europe. It is no source of satisfaction that this point of view was again so strongly validated during 2002-03. In this year's report we analyse the implications of the productivity slowdown for fiscal policy. Our conclusion is quite simple: Whatever its causes, slower productivity means fewer resources available for redistribution. This applies to governments as well.

True to our mission as 'ECB watchers', we also analyse at length the effectiveness of monetary policy, and in particular the results of the strategic review recently announced by the European Central Bank. We might be less strident in our criticism than some of our colleagues, but this is the outcome of a careful analysis, which finds it hard to fault the ECB on fundamental issues.

The Group is grateful for the comments from participants attending an off-the-record seminar organised by Deutsche Bank in Frankfurt, in particular Lorenzo Bini-Smaghi from the Italian Treasury, Bernd Fitzenberger from the University of Mannheim, Otmar Issing from the ECB and Robert Price from the OECD.

Leonor Coutinho, a Marie Curie Research Fellow at CEPS, provided excellent research assistance and important ideas of her own. All remaining errors are ours.

The work of the CEPS Macroeconomic Policy Group would not have been possible without the continuing support from our main sponsor, Deutsche Bank, London, and, more recently Tudor Investments. I wish to thank them once more for their material and financial contributions.

Daniel Gros
Director

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EXECUTIVE SUMMARY

Macroeconomic Issues

Euroland is currently caught in a slow-growth trap. But, since the fundamental factors restraining growth in Euroland are structural, demand management cannot achieve a lot. This applies, *mutatis mutandis*, to both fiscal and monetary tools policy.

Fiscal policy has to accept the constraints of low growth and ageing. Tax cuts without a credible commitment to restrain future expenditure would be useless. We conclude that:

Governments should concentrate on pension reform and cuts in age-related entitlements. Only after these measures have been achieved should tax cuts be considered. In order to prepare for the pension bomb that will hit Europe starting from about 2010, it makes sense for governments to start aiming now for budgets that are balanced, or in small surplus, over the cycle.

Monetary policy can only aim at allowing the eurozone to achieve its meagre growth potential (1.5-2%) and guard against deflation. The European Central Bank (ECB) seems to accept this challenge, but its strategy could be improved. We conclude that:

The monetary pillar in its old form (comparing M3 growth against a reference value) is useless. The new 'financial stability pillar' should include an analysis of the evolution of financial structures in a broad sense to find out whether disequilibria in balance sheets or indebtedness present a risk to economic stability.

The E(M)U Constitution

Managing the euro. The exchange rate is important for an economy, like that of Euroland, whose exports amount to about 20% of GDP, and the unwelcome deflationary impact of the recent appreciation of the euro underscores the importance of the external value of the euro.

The Intergovernmental Conference that will soon start to finalise the new Constitutional Treaty for the EU should make the President of the Eurogroup a "Mr Euro", who would be empowered to present the official view on the external value of the euro.

Analysis: The basis for our recommendations

A prolonged period of weak investment demand is to be expected after the bursting of a bubble. This is particularly true if the bubble led to excessive capital accumulation, but there is little evidence for this in Euroland. The weak economy is more due to the weakness of consumption demand. Since Euroland's consumers are not really over-indebted, however, this is not easy to explain *a priori*. Nevertheless, this weakness of consumption becomes straightforward to understand if one considers the radical revision of growth expectations that has taken place since the bursting of the 'Lisbon bubble'.

At the special European Council of Lisbon in early 2000, the Heads of State and Government of the EU solemnly promised to make the EU the 'most competitive economy' by 2010, setting *inter alia* precise numerical targets for employment rates. Productivity growth at the time seemed satisfactory so that growth rates in excess of 2.5% seemed within reach. As we now know, however, these expectations were bitterly disappointed: growth has been anaemic, productivity growth has plummeted and expectations of future growth have been revised downwards. We show that revisions to growth prospects, even if they are modest at first sight, can easily explain the observed weakness in consumption demand in Europe.

After reviewing the superficial labour market reforms undertaken so far (Chapter 2), we do not see any reason why the Lisbon employment targets should be reached or why growth should accelerate. What can demand management policy achieve in such a low growth environment?

Fiscal policy

Our analysis in Chapter 3 suggests that fiscal policy has already reached the limit in most member countries with cyclically adjusted deficits in all large member countries close to 3% and in some cases clearly beyond. Our calculations suggest that if Europe is to keep public finances under control despite the rapid ageing of its population, cyclically adjusted deficits need to be kept well below 3%, probably close to the Stability and Growth Pact (SGP) goal of balance.

The fundamental challenge for fiscal-policy makers in Euroland is to accept the constraints from a low-growth environment compounded by an ageing population. The constant hope (or rather illusion) of a rapid return to strong growth has been one key factor in the present difficulties for public finances. Almost invariably budgetary plans rely on assumptions about long-term growth prospects (2.5-3%) that appear unrealistic in the

face of an essential stagnant labour force and productivity growth of only around 1% over the last five years.

Monetary policy

If the current weakness derives from the bursting of a bubble, monetary policy might have a role to play. The bursting of the expectations of the Lisbon bubble might not be, *per se*, a problem for monetary policy. But the exuberance that accompanies a bubble usually leads to the build-up of severe balance sheets problems that must be taken into account by monetary policy, whose main task then becomes to ensure the stability of the financial system (in a wider sense, not just the banking system). In practice, this means that the ECB should be vigilant against the danger of deflation because there exists a pronounced asymmetry. As the experience of Japan shows, even a small dose of deflation can have very high costs whereas the costs of a small dose of controlled inflation are likely to be quite limited (this was recognised by the Chairman of the US Federal Reserve when he underlined the danger of an ‘unwelcome further fall in inflation’ in his May statement). Hence we discuss in Chapter 4 whether there exists a danger of deflation and what can be done about it.

In its strategic review, the ECB has implicitly re-affirmed its determination to fight against deflation (should the danger arise). We fully agree with stance and with other aspects of the revised strategy.

Our main criticism of the new strategy is that it represents an opportunity missed to clarify the nature of the monetary ‘pillar’. It should be clear by now that under the present circumstances it is not useful to just look at M3 growth and conclude that potential inflationary pressures exist because M3 has grown more quickly than a certain reference value (which anyway has – for good reasons – been ignored for some time now). We would argue that the monetary pillar should be interpreted more broadly as a ‘financial stability’ pillar. The pursuit of financial stability requires the analysis of a broad range of issues. For example, the present issue is not primarily how the ECB should react if another financial market price bubble were to arise. Nor is it so much whether the euro-area banking system (or even that of any member country) is on the brink of collapse. Rather, an important issue at present is whether balance sheets of the non-financial sector are overstretched to the point where firms are cutting investment to achieve the lower debt/equity ratios demanded by financial markets in the post-bubble environment (with potentially adverse consequences for price stability). Hence we would argue that the ECB should explain that it will look in the monetary pillar at the evolution of financial structures in a broad sense to find out whether disequilibria in balance sheets or indebtedness present a risk to economic stability.

CHAPTER 1

HOW DID EUROLAND GET CAUGHT IN THE SLOW-GROWTH TRAP?

1.1 Setting the scene: Why is demand so anaemic in Euroland?

2003 is likely to become the third consecutive year of disappointing growth for Euroland. Most current projections of average real growth are on the order of about 1%, after similar results in 2001 and 2002. It is no longer possible to view this dismal performance as a result of external shocks, such as the terrorist attacks of September 11th on the United States or the war in Iraq. Nor can one argue that the weak demand is a result of overly tight monetary and fiscal policy. Real interest rates are not high by historical standards. On the contrary, for the first time ever, real interest rates have actually become slightly negative. Fiscal policy can also be characterised only as expansionary if one looks at the increase in cyclically adjusted deficits. It is thus clear that there must be some more fundamental factors restraining demand in Euroland.

Two different mechanisms seem at work for investment and consumption.

Investment

A prolonged period of weak investment demand is to be expected after the bursting of a bubble. This is true for two inter-related reasons:

i) A bubble usually leads to over-investment. When the bubble bursts, there is likely to be an excess of installed capacity. It is thus natural that there is little need for new investment. This mechanism can explain the persistence of weakness for a decade in the Japanese economy where investment rates were running at over 30% during the 1980s. In the US there was also an investment boom, which led to an increase in the investment-to-GDP ratio of around 5 percentage points during the 1990s. Recent data on capacity utilisation for the US continue to run at historically low levels, indicating that some capital overhang might exist. It seems that this is not the case in Euroland, however. At most, one can speak of a ‘boomlet’ as the investment/GDP ratio rose by about 1 percentage point above the longer-run average of around 21% of GDP. Moreover, the data on capacity utilisation for Euroland do not indicate an unusual amount of excess capacity. The value reported for the first quarter of 2003 was very close to the long-run average.

ii) During a bubble, the corporate sector often takes risks with balance sheets. When an important stock imbalance is built up during the ascending phase, when capital appears cheap, it often takes a long time for firms to get back to more normal ratios. This is usually achieved by cutting back on investment so as to conserve cash flow for a strengthening of the equity base. This effect seems to have operated in Euroland where one can observe that the corporate sector is trying to cut back on debt levels as documented more fully below in Chapter 4.

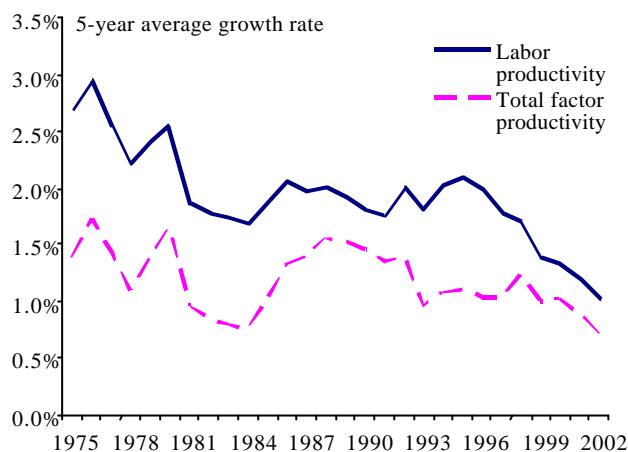
Consumption

The most surprising aspect of the current ‘soft patch’ is the weakness of consumption demand. In Euroland, private consumption demand has grown by only about 1% per annum over the last two years, and might be close to zero during 2003. By contrast, demand in the US has kept growing at close to 3% per annum until recently.

Since Euroland’s households are not really over-indebted, this weakness of consumption is not easy to explain *a priori*.¹ However, this weakness of consumption becomes straightforward to understand if one considers the radical revision of growth expectations that has taken place since the bursting of the ‘Lisbon bubble’. At the special European Council of Lisbon in early 2000, the Heads of State and Government of the EU had solemnly promised to make the EU the ‘most competitive economy’ by 2010, setting *inter alia* precise numerical targets for employment rates.

Productivity growth at the time seemed satisfactory so that growth rates in excess of 2.5% seemed within reach. However, as we now know, these expectations were bitterly disappointed: growth has been anaemic as productivity growth has plummeted (see Figure 1.1).

¹ According to ECB statistics and national sources for in 2001, the ratio of gross household debt outstanding to gross disposable income was 75.7% for the euro area, while for the US and Japan it was considerably higher, at 104% and 109.6%, respectively. The figures for 2002 are not yet available.

Figure 1.1 Productivity slowdown in the euro area

Source: Own calculations based on AMECO data.

As productivity is a slow-moving variable, the drop in recent years implies that the prospects for a quick turnaround must be dim. But what about a horizon beyond the next few years? It is sufficient to look at the expectations for growth over the next 10 years as published by Consensus Forecasts to see that growth is likely to remain low for some time. Between the peak of the bubble in 2000 and today, long-term growth expectations have fallen by 0.5 percentage points for the euro area (from 2.66 to 2.17% p.a.), whereas they have remained roughly constant for the US.

Table 1.1 Long-term growth expectations (%)

	Euro area*	US
2000	2.66	3.27
2003	2.17	3.18

*The euro area refers to the weighted average of its three largest members (Germany, France and Italy).

Source: Deutsche Bank London.

The much better performance of the US in terms of productivity and growth expectations makes it straightforward to explain why consumption has held up much better in the US than in Europe. However, over the last years an additional factor might have been at work, namely

the much stronger impact monetary policy has in the US on consumption via the housing market. The annex at the end of the chapter provides some background to the extraordinary developments in US housing finance, and the potential danger for financial stability that they imply.

As an aside, we note that the deterioration that took place over the 1990s in Euroland relates to the basic concept of output per worker. It is by now well known that there is no great difference between the US and Europe in terms of output per hour, but a large difference in hours worked, which, in turn, explains why US GDP per capita remains (on a PPP basis) about 30% higher than in the EU-15. The decline in the number of hours worked (per worker), however, has not really changed over the last few years so there is no real difference between the evolution of growth in output per worker (the concept we use) and the evolution of growth in output per hour. Moreover, when consumers form their expectations about future incomes, it does not matter much to them whether they revise their estimates of future incomes downwards because they anticipate working less, or because they expect that their productivity (and hence their wages) per hour will be stagnant.

How important is this effect of declining productivity trends and lower growth expectations? In Table 1.2, we provide some illustrative calculations that suggest that even modest revisions of growth rates can have a rather strong impact.

*Table 1.2 Growth rates and permanent income**

Gross rate	Interest rate			
	0.03	0.04	0.05	0.06
0.01	155	139	131	127
0.015	206	166	150	141
0.02	309	208	175	159
0.025	618	277	210	182
0.03		416	263	212

* Permanent income from an income stream starting with one unit and growing at the rate indicated in the first column, in per hundred of today's income. These values would be equivalent to selling an asset whose return increases at this growth rate and then investing the proceeds in a fixed income bond yielding the interest rates indicated in the first column.

Source: Own calculations.

For example, if expected growth rates fall from 2.5% to 2% per annum (as suggested by the Consensus Forecasts expectations shown above and which is much less than the deterioration experienced by the EU during the 1990s) and if this change is expected to be permanent, the permanent income of the average household would be reduced by about 20%. One could thus expect that consumption demand would follow by a similar proportion. If the slowdown is only temporary, the fall in permanent income, and hence consumption, would be smaller, but still substantial. For example, a productivity slowdown of the magnitude used so far that lasted ten years would still reduce permanent income by over 5%. These illustrative calculations show that even small shifts in expectations of future growth rates can potentially have a strong impact on consumption.

1.2 What can policy do under these circumstances?

Structural policy

The steps that need to be taken to revive the long-term growth prospects of Euroland are well known: labour and pension reform, higher investment in human capital, etc. So far, however, little has been done. In particular, as we show in Chapter 2, there has been almost no labour market reform, and the little that has been undertaken has been more in the nature of creating ‘second labour markets’, which also create a lot of uncertainty. Households in Euroland thus had to drastically revise downwards their permanent income expectations. And as most of the (few) new jobs created over the last years were under ‘atypical’ and thus precarious contracts, it is natural to expect that the marginal propensity to consume has been low. It is thus not surprising that household consumption has been rather weak in recent years. The ongoing discussion about the sustainability of pension systems without drastic reforms that would ensure their sustainability also does not exactly encourage spending.

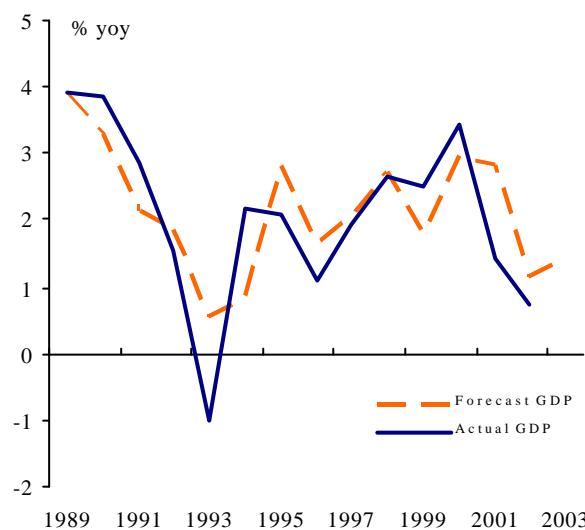
If supply is weak, is there anything that can be done to increase demand? In particular, what could be achieved with monetary and fiscal policy?

Fiscal policy

Our analysis in Chapter 3 suggests that fiscal policy has already reached the limit in most member countries with cyclically adjusted deficits in all large member countries close to 3% and in some cases clearly beyond. Our calculations suggest that if Europe is to keep public finances under control, despite the rapid ageing of its population, cyclically adjusted deficits need to be kept well below 3%, and probably close to the SGP goal of balance.

The fundamental challenge for fiscal policy-makers in Euroland is to accept the constraints from a low-growth environment compounded by an ageing population. The constant hope (or rather illusion) of a rapid return to strong growth has been one key factor in the present difficulties for public finances. Almost invariably budgetary plans rely on assumptions about long-growth prospects (2.5-3%) that appear unrealistic in the face of an essentially stagnant labour force and productivity growth of only around 1% over the last five years. It is true that policy-makers were not the only ones to overestimate growth prospect. As Figure 1.2 below shows, markets have also been overly optimistic on growth prospects since 1999, which corresponds roughly with the onset of the serious slowdown in productivity.

Figure 1.2 EU forecast vs actual GDP



Source: Calculations provided by Deutsche Bank.

The challenges to fiscal policy can be overcome only when policy-makers and the electorate realise that they are living in lean times.

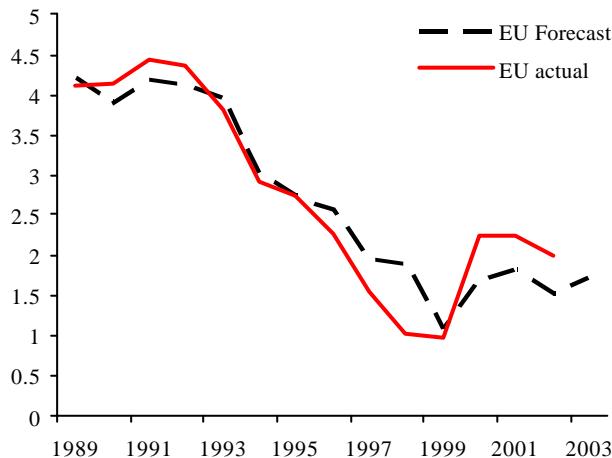
Monetary policy

If the current weakness derives from the bursting of the bubble, monetary policy might have a role to play. Severe balance sheets problems in the corporate sector can be alleviated by monetary policy, whose main task then becomes to ensure the stability of the financial system (in a wider sense, not just the banking system). In practice this means that the ECB

should be vigilant against the danger of deflation because there exists a pronounced asymmetry. As the experience of Japan shows, even a small dose of deflation can have very high costs whereas the costs of a small dose of controlled inflation are likely to be quite limited (this fact was acknowledged by the Chairman of the US Federal Reserve in his May statement when he underlined the danger of an ‘unwelcome further fall in inflation’). Hence we discuss in Chapter 4 whether there exists a danger of deflation and what could be done about it.

Chapter 4 also discusses extensively whether the current stance of the ECB is appropriate. This discussion concentrates inevitably on short-term issues and indicators, such as the monetary conditions index, etc. Nevertheless, it is important to also realise the extent to which the productivity slowdown, which is a longer-run phenomenon, creates an environment in which the ECB must constantly swim against the stream. As Figure 1.3 shows, inflation was overestimated by the markets (as measured by Consensus Forecasts) during the period leading up to EMU, when markets apparently underestimated the political resolve of governments to adapt to the requirements of EMU. We find again, however, a change occurring around 1999, after which time inflation is consistently higher than forecasted. This is exactly what one would expect if a negative productivity shock occurs: growth is lower and inflation higher than expected. In such an environment, monetary policy obviously becomes much more difficult.

Figure 1.3 EU CPI forecast vs actual



Source: Calculations provided by Deutsche Bank.

The ECB has recently confirmed its two-pillar strategy. We provide our evaluation, which is much more positive than most, but also suggest some improvements.

The euro and transatlantic relations

Our analysis of the options for monetary and fiscal policy suggests caution in the use of demand management instruments. This is in contrast to the approach practised in the US, which can only be characterised as ‘full steam ahead on all engines’. In this situation a transatlantic conflict is likely to arise as the US is impatient for the eurozone to become a (if not the) locomotive for world growth now that the US can no longer fulfil this role because its internal dynamism has abated and its external imbalance has become a focal point of financial markets.

How important should the external dimension be for the eurozone? In our view it is often underrated. Indeed the eurozone is far from being a closed economy. The data presented in Table 1.3 below shows that trade in goods and services now accounts for roughly 18% of GDP. This is much more than for the US. Admittedly in the case of the US, there is a large difference between exports – 9% of GDP – and imports – 14% of GDP. In terms of the share of exports of goods and services of GDP, the value of the eurozone is twice as high as for the US, about 20% vs about 9%. For imports the difference is much smaller: 18% vs 14%.

It is interesting to note that the 2002 eurozone ratios are very close to those for France in the early 1990s (then around 19-20% of GDP), or just a bit below the German value for 1992-93 (around 22%).

Table 1.3 The importance of international trade (2002)

	Exports		Imports	
	US	Eurozone	US	Eurozone
Current account transactions, % of GDP	12.2%	24.2%	17.0%	23.4%
Goods trade, % of GDP	6.5%	15.0%	11.2%	13.1%
Goods and services trade, % of GDP	9.3%	19.7%	13.5%	17.6%

Sources: Own calculations based on ECB and Bureau of Economic Analysis data.

What could result from the combination of a weak dollar and the relatively high degree of openness of the eurozone? The first point to note here is that the ‘euro’ is not just the mirror image of the ‘dollar’.

EU-US bilateral trade links are very important in themselves. But the dollar/euro rate is not necessarily the most important single exchange rate for Euroland. For the eurozone, trade with the UK is slightly more important than trade with the US. Likewise, for the United States, trade with Canada alone is more important than trade with Euroland. What matters for Euroland is the ‘euro’ (the effective exchange rate of the euro), not the dollar (i.e. the bilateral rate). Do these two move together in reality? The answer is not straightforward; the ‘dollar’ and the ‘euro’ have a strong tendency to move in a mirror image fashion in the short run, but important deviations from this pattern are possible.

The short-term correlation between the bilateral dollar/euro exchange rate and measures of the effective exchange rate of Euroland has in the past been rather high – at over 80% (the precise value depends on the exact measure of the effective exchange rate chosen). This suggests that the two move almost always in a similar direction. But by how much? In the past, a useful rule of thumb had been that only about one-half of any change in the bilateral dollar/euro rate translated into a change of the effective exchange rate of the euro area (whether in nominal or real terms does not really matter in this context as price levels move much more slowly than do exchange rates).

More recently, however, this relationship seems to have changed. Table 1.4 shows the real effective exchange rates as calculated by the ECB. This table shows that since the start of 2003, the euro has appreciated in effective terms by about 15%, whereas the dollar has depreciated only by about one half as much (7%). This shows that many other currencies (including Sterling and the yen) have moved with the dollar, thus pushing all the adjustment on the eurozone. If one looks at a longer period, this tendency becomes even more apparent: the euro is now, in effective terms, back to the (relatively high) level attained in 1995 by the synthetic euro, but at the same time the dollar is also still much stronger (again in effective terms) than in 1995.

Table 1.4 Real effective exchange rates

	Euro	US\$
June 2003	107.13	118.25
End 2002	92.5	127.26
End 1998	101.3	116.48
End 1995	108.75	92.52

Source: ECB.

The recent pattern (if it persists), in which the currencies of the UK, Asia and emerging markets are effectively pegged to the dollar, has two implications:

- i) Most of the counterpart for the current account adjustment of the US would be forced on the eurozone; and
- ii) A further large move in the bilateral dollar/euro rate will be needed before the dollar can get even close to a level that would produce a sizeable adjustment in the US current account.

These considerations suggest that a further strong appreciation of the euro cannot be ruled out. As argued in Chapter 4, we regard such a development as the main potential source of deflation for the euro area. Given this potential threat from the external side and the increase in the volatility of the euro's exchange rate, it thus become even more important than before to clarify who is responsible for the external value of the euro. As Chapter 5 shows, the present arrangements are not satisfactory in this respect. We discuss ways in which it would be possible to create the position of a 'Mr Euro', i.e. a person who could provide foreign exchange markets with an official view should there be major movements in the exchange rate. The proposals contained in the draft Constitutional Treaty agreed by the Convention on the Future of Europe in July were disappointing in this respect. We hope that the Intergovernmental Conference, which will start in October of this year, will address this issue and find a solution, which could be similar to the one found for the newly created position of Foreign Minister of the EU.

Annex

The Housing Channel of Monetary Policy in the US

Perhaps the only channel of transmission of monetary policy that has worked effectively over the last three years has been the housing channel. Accumulated home equity is not a liquid asset, and its value is uncertain. Selling a house, or getting the house appraised and taking out a home equity loan, converts the illiquid home equity of an uncertain value into liquid funds with a certain value. Home equity extraction thus directly finances household purchases of goods and services by liquefying previously illiquid assets. It also indirectly finances such purchases by facilitating outlays financed by credit cards and other non-mortgage consumer debt. The short-term impact of this channel will thus be greater for liquidity-constrained consumers.

In the US, with the lowest mortgage interest rate in more than three decades and very low refinancing costs, about 10 million home mortgages were refinanced in 2002, which corresponds to about \$1.75 trillion net of cash-outs (an all-time record) or 1/3 of the value of all mortgages outstanding at the beginning of 2002. In this process, the Federal Reserve estimates that households cashed out \$200 billion of home equity, a bit more than in 2001. An even greater support to the economy than cash-outs in 2002 was the extraction of home equity associated with the record sales of existing homes. Estimates point to about \$350 billion of equity extraction through home sales, plus \$130 billion through a net increase in home equity loans. All in all, the total amount of equity extracted in 2002 was about \$700 billion. Estimates of the wealth effect are not conclusive, but the Federal Reserve estimates that up to half of this equity may have been spent in 2002.

The impact of the housing channel is unclear in the EU, because of the lack of data and the different regulations across countries. *A priori*, however, there are three main differences between the US and the EU that suggest that this channel may be more effective in the former.

First, long-term interest rates have declined much more in the US than in the euro area. From their cyclical peak in 2000, the yield on 10-year bonds has declined by 4.4 percentage points in the US compared to only 1.9 percentage points in the euro area. Rough calculations suggest that a fall in mortgage interest rates from 7% to 4% (less than the actual fall) would increase the amount a household could finance under a standard 30-year mortgage by about 30%.

Second, US consumers have, by law, the right to refinance their mortgages at any time. Thus consumers, when taking a mortgage, are also buying a put option against declines in interest rates.

Third, the secondary market for mortgages in the US is very deep and liquid, lowering the cost of mortgages and facilitating the process of refinancing.

Key contributors in this process are two institutions unique to the US, Fannie Mae, and Freddy Mac, which are two ‘government-sponsored entities’ that are the main players of the secondary market in mortgages. By facilitating the securitisation of mortgage risks, they have lowered the cost of mortgage credit and allowed for the development of secured borrowing against home equity as a cost-effective source of credit. Neither one has an explicit government guarantee, but the pricing of their bonds indicate that the market would expect government assistance should they run into liquidity problems.

If one looks at the US as a closed economy, one would expect that refinancing is a zero-sum game between households and financial markets. After all, this channel is possible because the consumer is sold a put option (by somebody else) with its mortgage. Thus the key question is: Who pays for the cost of the option (and pays up once the option is exercised)? There are several possibilities:

- 1) The consumer pays for it *ex ante*, via higher mortgage rates. But the wealth effect is still effective when the refinancing takes place, especially for liquidity-constrained consumers.
- 2) The government, via the implicit government liability inherent in Fannie Mae. In this case, the potential future taxes would not diminish the wealth effect unless they became explicit.
- 3) The banks, via lower profits. This implies a negative wealth effect to consumers through a lower value of their shareholdings. But the share of liquidity-constrained consumers among shareholders is very small, and thus the wealth effect is still effective from a cyclical viewpoint.
- 4) Foreigners, through the sale of mortgage-backed securities to foreigners. In fact, about 25% of these securities were purchased by foreigners over the last two years.

Taking all this together, it seems that the housing channel remains an effective means of providing inter-temporal consumption smoothing during a cyclical downturn, and thus an effective tool of stabilisation policy.

However, while the strength of this monetary transmission channel might have been very convenient for the Federal Reserve during the present situation, it also contains some risks.

First, it is prone to overshooting. Household debt in the US is growing at over 10% per annum, more than twice the growth rate of real disposable income, primarily because of this rampant mortgage-borrowing. Most of this borrowing has been tilted towards adjustable rate mortgages, thus giving more money for current consumption (because variable rates are lower) but raising households' vulnerability to rising interest rates. In addition, households are increasing their leverage to their household wealth, and owner equity as a percent of household real estate is at an all time low of about 50% (compared to about 60% in the early 1990s or 70% in the 1980s). The average home is financed by a mortgage that represents about 75% of the value of the house, and therefore this small equity cushion is vulnerable to a fall in house prices.

Second, Fannie Mae and Freddie Mac, the main counterparts in the secondary mortgage market, face a repayment risk for which there is not a natural hedge. Thus, they cross-hedge this risk in the Treasury bond market through complex derivatives transactions, in a dynamic hedging fashion that tends to push rates down as rates fall, thus encouraging more mortgage refinancing and inducing bubble-type positive auto-correlation in the bond market.

Overall, this channel essentially increases the overall leverage of the economy and its sensitivity to interest-rate increases, and the large size achieved by Freddie Mac and Fannie Mae presents a potential systemic risk to the bond market. These risk factors have to be weighed against the certainly positive effect of developing an extra market.

CHAPTER 2

LABOUR MARKETS AND STRUCTURAL REFORMS

In its 2001 annual report (Gros et al., 2001), the CEPS Macroeconomic Policy Group expressed pessimistic views on the structural situation of labour markets of EU member countries, despite acknowledging some improvements in indicators such as unemployment and employment rates. It was then argued that the reduction of unemployment and the rise of employment were not affecting all population groups equally and that, although there were some reforms aimed at improving the functioning of labour markets, these were done in a piecemeal fashion, targeted at new entrants in the labour market and, hence, did not imply fundamental changes on which to permanently base future improvements. Moreover, in last year's report (Gros et al., 2002a), the Group expressed some concerns about the disappointing performance of labour productivity in most EU countries and called for more aggressive supply-side reforms.

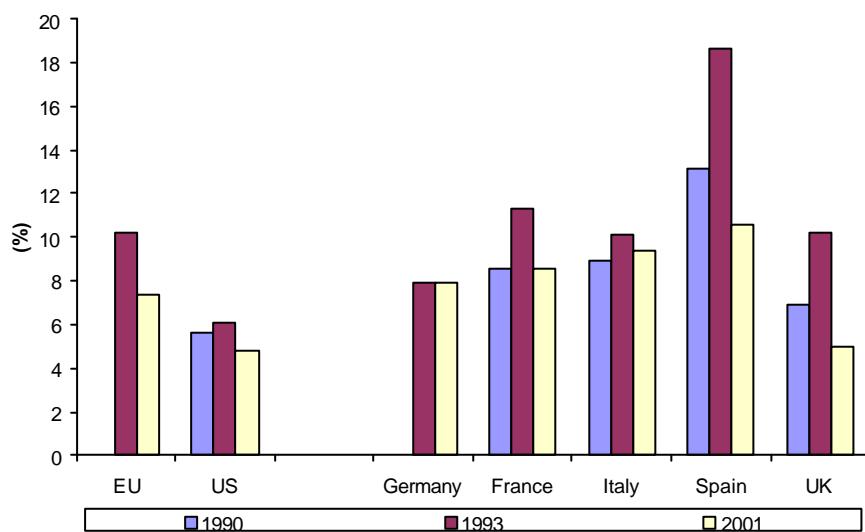
These pessimistic views are usually received with some scepticism. It is often argued that there have been evident structural improvements in EU labour markets during the last five years, with employment growing at an average annual growth rate of 1.5% (1.6% in the euro area) and the unemployment rate falling by 2.6 percentage points (2.8 percentage points in the euro area) during the 1997-2001 period. The fact that this strong employment growth took place without significant inflationary pressures is indicative of a fall in the equilibrium rate of unemployment and suggests that the gains in employment and participation are due to structural factors and, hence, sustainable in the long-run. Moreover, despite the deceleration in growth in 2001-02, the unemployment rate in the EU has 'only' risen to 8.1% (8.8% in the eurozone), according to the latest estimates from EUROSTAT. As for productivity growth, the slowdown is usually perceived as a temporary phenomenon, needed to facilitate the rise of employment through an increase in the 'employment content of growth'.

2.1 A longer perspective and looking into the future...

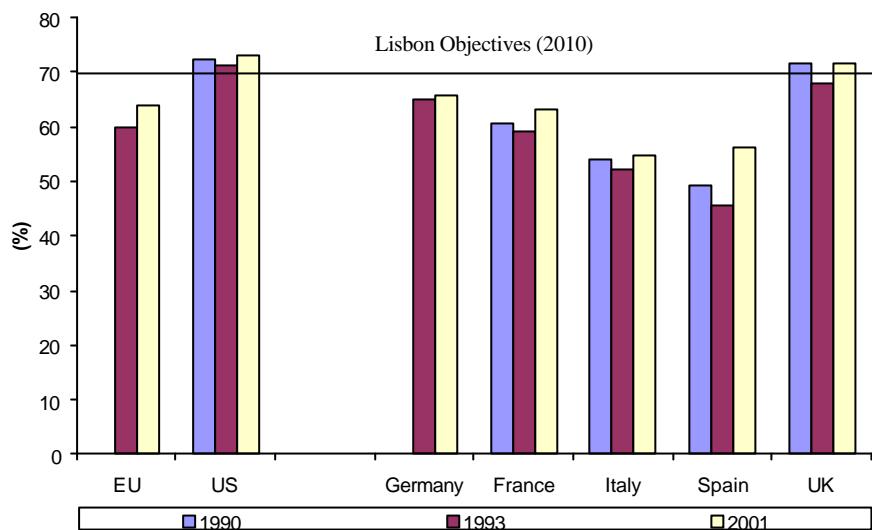
Taking a longer perspective, the evolution of some indicators of the performance of the European labour markets is, however, not very satisfactory. The analysis of the evolution of the indicators of labour market performance in the EU over the last two business cycles is blurred by the lack of availability of statistics for Germany, and, hence for the

whole EU, before unification. For this country, a sufficiently homogeneous statistical series starts in 1993, but the comparison between 1993 and 2001 would be misleading as the former year was in a nadir of the business cycle while the latter was close to the peak. A more illustrative comparison would be between 1990 and 2001, two years at the beginning of the descendent phase of the two more recent cycles. Thus, Figures 2.1a and 2.1b plot the unemployment and employment-population rates for the EU, its five largest member countries, and the US. Regarding unemployment, between 1993 and 2001 the aggregate unemployment rate in the EU fell by 2.8 percentage points while it fell by 1.3 p.p. in the US, and remained at the same level in Germany. But as already mentioned, this has little to do with a structural improvement. A less ‘cyclically contaminated’ comparison (i.e., 1990-2001) shows that the unemployment rate has only significantly fallen in Spain and the UK, but not in France or Italy. This is a bit of good news as previously there had been an upwards trend in the unemployment rate in most EU countries, so that each business cycle started with a higher level than the one reached in the previous cycle.

*Figure 2.1a Unemployment rates, working-age population
(15-64 years old)*



*Figure 2.1b Employment rates, working-age population
(15-64 years old)*



Sources: European Commission, *Employment in Europe 2002*, and OECD, *Employment Outlook*, (several years) (for the US).

With regard to the employment rate, there is also some good news and some bad news. The good news is that throughout the 1990s, there was a clear upward trend in most EU countries, so that it increased by almost 4 p.p. in the whole EU, and by almost 1 p.p. in Germany between 1993 and 2001 vs a rise of 1.3 p.p. in the US in the same period. And in this case, the change seems to be the result of a structural trend: when comparing 1990 and 2001, we also observe a common increase in employment-population ratios in all of the other four largest EU member states (by 2.4 p.p. in France, 0.9 p.p. in Italy, 0.2 p.p. in the UK and 7.1 p.p. in Spain).

There is bad news too, however. First, despite this increase, employment rates in western and southern Europe remain too low in particular, relative to the ambitious objectives established by the European Council in its summit at Lisbon (2000) and subsequently clarified in other summits (Stockholm and Barcelona).² And by looking at the experience

² The Lisbon European Council established the following targets by 2010: the average aggregate employment rate on the EU should be as close as possible to 70%, the average female employment rate on the EU should be higher than 60% for women. The Stockholm European Council in 2001 set intermediary targets of 67% for the aggregate employment rate, and 57% for the female employment

of the last decade there is a serious risk that these goals cannot be achieved, more so when the enlargement of the EU will bring the accession countries which, on average, have lower employment rates than the average employment rate of the EU.

Secondly, almost all the rise in employment rates is explained by the higher participation rates of the adult female population, while high youth unemployment rates and low employment rates among older workers have not shown any sign of improvement. In the case of young workers (see Table 2.1a), there is no significant reduction in unemployment rates in four of the five EU countries considered (the exception is Spain), while youth employment rates are decreasing due to increasing enrolment in higher levels of education. For the prime aged (25-54) male population, employment rates have not shown any significant change between 1990 and 2001, while for the older (55-64) population, they have fallen in Germany, France, and, especially, Italy (see Table 2.1b). While the increases in female participation and female employment are to be welcomed, they cannot be the basis for further and future rises in the overall employment rate, particularly in a demographic scenario in which the weight of the older workers in the labour force is expected to increase noticeably over the coming decades, as shown in Figure 2.2, which shows EUROSTAT's data regarding the latest national population forecasts.³ As can be seen, in the whole EU the share of older persons (55-64) in the working-age population will rise by about 5 percentage points in the next 15 years or so. According to these forecasts, the member states whose working-age population will age more rapidly are Belgium, France, Spain and Finland.

rate by 2005, and introduced a new target of 50% for workers aged 55 to 64 by 2010. In the Barcelona summit the European Council pledged to transform Europe into 'the most dynamic and knowledge-based economy of the world, capable of sustainable economic growth while providing more and better jobs and greater social cohesion'.

³ See EUROSTAT (2001).

Table 2.1a Youth (15-24) employment status in the EU and in the US

	Unemployment rate (%)						Employment rate (%)					
	1990			2001			1990			2001		
	Total	Males	Females	Total	Males	Females	Total	Males	Females	Total	Males	Females
EU*	20.3	19.8	20.8	14.2	14.0	16.0	39.3	42.2	36.3	40.7	44.2	37.1
US	11.2	11.6	10.7	10.6	11.4	9.7	59.8	63.5	56.1	57.8	59.4	56.2
Germany*	8.0	7.8	8.1	9.4	10.3	8.3	51.7	53.7	49.8	46.5	48.6	44.0
France	19.2	15.7	22.9	19.5	17.6	21.8	34.4	38.0	31.0	29.5	33.3	25.7
Italy	28.1	22.4	35.3	28.1	24.9	32.0	29.8	34.0	25.4	26.3	30.4	22.1
Spain	28.1	22.4	35.3	21.5	16.6	27.9	32.0	38.4	25.6	33.1	39.2	26.9
UK	10.4	11.5	9.2	11.9	13.2	10.3	66.4	70.4	62.3	56.9	59.5	54.3

* Data cited for year 1990 are actually drawn from 1993 due to data availability.

Sources: European Commission, *Employment in Europe 2002*, and OECD, *Employment Outlook*, (several years) (for the US).

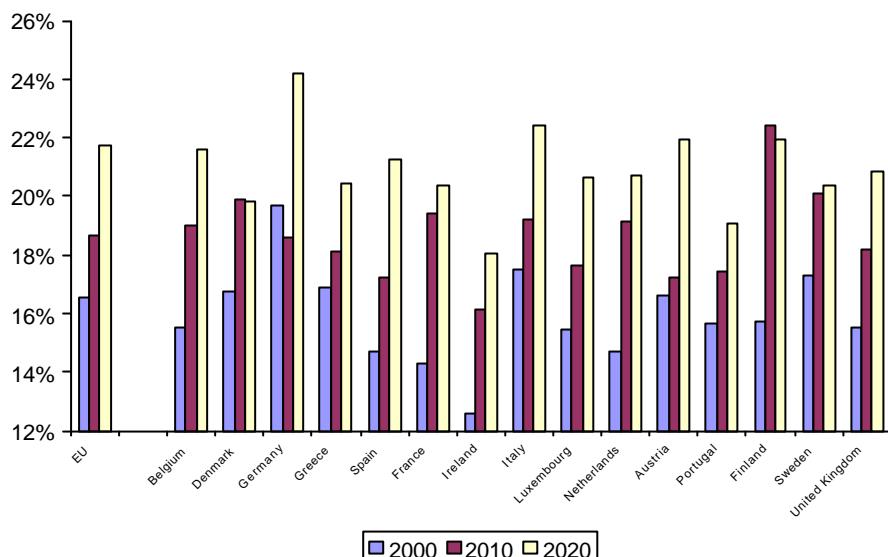
Table 2.1b Employment rates (%) of adult workers in the EU and in the US

	Population aged 25-54				Older workers (55-64)			
	Males		Females		Males		Females	
	1990	2001	1990	2001	1990	2001	1990	2001
EU*	85.8	87.3	60.4	66.8	47.9	48.6	24.2	28.8
US	89.1	87.9	70.6	73.5	65.2	65.8	44.0	51.6
Germany*	87.9	86.7	65.4	71.8	47.8	46.1	24.0	29.5
France	89.9	88.7	65.1	71.2	36.8	35.4	25.0	26.7
Italy*	86.8	85.5	46.6	52.8	48.1	40.4	14.1	16.2
Spain	85.5	85.6	37.2	52.5	57.1	57.4	18.1	21.8
UK	89.1	87.5	68.5	73.5	62.2	61.7	36.7	43.1

* Data cited for year 1990 are actually drawn from 1993 due to data availability.

Sources: European Commission, *Employment in Europe 2002*, and OECD, *Employment Outlook*, (several years) (for the US).

Figure 2.2 Weight of the population aged 55-64 in the working-age population



The changes in the age structure of the population have significant implications for the functioning of the labour market. First, as participation and unemployment rates are age-specific, the aggregate employment, participation and unemployment rates will change even if the age-specific rates remain the same. Secondly, there are some reasons to believe that both the cyclical response of unemployment and the structural unemployment rate may depend on the age composition of the labour force.⁴

Looking into the future, the composition effects of the changing age structure of the population may not be negligible. Table 2.2 reports some calculations of the aggregate employment and unemployment rates that would be observed in 2010 and 2020, under the assumption of constant population group specific employment and unemployment rates.⁵ The

⁴ See Shimer (2001) and Jimeno (2003).

⁵ These calculations are taken from Jimeno (2003) who considers 18 population groups distinguishing gender, age (15-24, 25-54 and 55-64) and three educational levels (low, medium and high). The weights of each group in the

first horizon is relevant since that is the deadline for the fulfilment of the targets set at the Lisbon summit. The second horizon is also relevant since at that time population ageing will start to accelerate even more in many EU countries, thereby putting more stress on pension systems.

Table 2.2 Forecasted unemployment rates and employment rates in EU member states, 2010 and 202

	Unemployment rates			Employment rates		
	2001	2010	2020	2001	2010	2020
EU-15	7.3	7.4	7.4	64.1	63.1	62.7
Belgium	6.7	6.2	6.2	59.9	60.5	60.2
Denmark	4.4	4.3	4.3	76.2	76.0	75.9
Germany	7.8	7.8	8.0	65.4	64.8	63.5
Greece	10.5	10.4	10.3	55.4	56.0	55.2
Spain	10.6	9.9	9.7	57.7	59.3	59.4
France	8.5	8.3	8.3	62.8	60.4	60.3
Ireland	3.9	3.5	3.5	65.7	66.4	66.7
Italy	9.5	9.7	9.6	54.9	54.0	53.2
Luxembourg	2.0	2.0	2.0	62.7	59.0	58.3
Netherlands	2.5	2.1	2.1	74.1	71.9	71.7
Austria	3.6	3.4	3.4	68.4	66.1	64.6
Portugal	4.1	4.0	4.1	68.7	67.7	67.1
Finland	9.1	10.0	9.8	68.2	72.8	73.7
Sweden	4.9	5.2	5.1	74.1	75.7	76.4
UK	5.0	4.9	4.9	71.8	75.0	75.3

Note: Data assume that each population group's specific rates remain constant at the 2001 levels. The number of population groups considered is 18, defined over three dimensions: gender, age (15-24, 25-54, 54-65) and educational attainments (low, medium and high). The educational attainments are coded according to ISCED97 classification: ISCED0_2 (pre-primary): low; ISCED3-4 (upper secondary and post-secondary, non-tertiary education): medium; and ISCED5_6 (Tertiary education): high.

total population are taken from EUROSTAT's data regarding the latest national population forecasts by five-year age groups. The age-gender-education specific employment and unemployment rates are those prevailing in 2001.

For these calculations, there are two relevant demographic trends. First, as the share of youth population in the working-age population decreases, the aggregate employment rate will rise. But at the other extreme of the age distribution, the composition effects have the opposite sign. As the shares of older individuals in the working-age population and in the labour force increase, the aggregate unemployment rate will rise and the aggregate employment rate will fall. In principle, the facts that the educational levels of the younger cohorts of Europeans are higher than those of previous generations and that unemployment (employment) rates are decreasing (increasing) in education may compensate for the rise of the relative weights in the population and in the labour force of the older individuals.

As for the unemployment rate, the calculations show that the changing age composition of the labour force would have a rather minor effect on the aggregate unemployment rate, which would remain at about 7.4% in the EU-15. In some countries, like Spain, where the baby boom took place later than in the other EU-15 member states, this composition effect would produce a negative trend in the aggregate unemployment rate that would fall by about 1 percentage point in both countries between 2000 and 2020. With regard to the aggregate employment rate, the conclusion is more negative. As a result of population ageing, the aggregate employment rate would fall by about 1 percentage point between 2001 and 2010, and 1.4 percentage points between 2001 and 2020. Looking at the longer horizon, Germany, France, Italy, Luxembourg, Austria, the Netherlands and Portugal are the member states where the fall in the employment rate would be higher as a result of the changing composition of the labour supply.

2.2 A structural improvement?

Typically, analyses of the evolution of European labour markets refer to the evolution of the NAIRU and estimates of structural unemployment to argue that there have been significant improvements in the functioning of European labour markets.⁶ This appreciation assessment may, however, be an overstatement for several reasons. First, recent estimates of the NAIRU show an increase during the first half of the 1990s that was reversed in the second half in some countries like France, Spain and the Netherlands, but not in Germany and the whole euro area.⁷ Secondly,

⁶ See, for instance, European Commission (2003).

⁷ Recent estimates of the NAIRU can be found in Pisani-Ferry (2003) for France; Bentolila and Jimeno (2003) for Spain; Franz (2003) and Berthold and Fehn

there are good reasons to believe that the fall in inflation observed since 1994 has a lot to do with the change in the monetary policy regime, but not much with labour market reforms. Finally, even taking for granted that the reduction in the NAIRU observed in several countries is permanent, further improvements need a different policy approach which gives more momentum to effective employment policies.

There are additional signals on the lack of a substantive, fundamental improvement in the functioning of European labour markets. One is the lack of progress in some labour market institutions that are key for maintaining low levels of structural unemployment. It is true that tax reforms have reduced the tax wedge, especially for unskilled workers, and that temporary employment contracts have been liberalised, promoting job creation, especially for young workers, and enhancing labour market flexibility. But it is also true that the cost of supporting private employment through social security contributions and tax incentives may be rather high (for instance, in the case of France, Pisani-Ferry, 2003, places estimates close to 2%), that the employment rates of the low-skilled workers have not significantly risen, that the gap with the employment rate of skilled workers remains too high (see Table 2.3a and 2.3b) and that a higher proportion of temporary employment does not necessarily imply lower structural unemployment.⁸ Moreover, the regulation of collective bargaining, in particular, and the overall legal framework affecting wage-setting, in general, has remained untouched, as has also happened with institutions affecting the demand and supply of labour from older workers, such as the pension systems and some elements of the employment protection legislation that make expelling older workers from the labour force the easiest way to cope with labour force adjustment within firms. As for active labour-market policies, the European Employment Strategy launched around the so-called Luxembourg process has resulted in a rise in the expenditures in active labour market policies, but the effectiveness of these programmes remains a mystery. In very few cases has there been a rigorous evaluation of the impact of these programmes on the employment rates and wages of the participating individuals, while the battery of experimental studies from other countries (e.g. the US) shows that very few programmes pass a cost-benefit test.

(2003) for Germany; and Fabiani and Mestre (2001) for the whole of the euro area.

⁸ For more on this, see the collection of papers from the Symposium on Temporary Employment published in the 2002 volume of *The Economic Journal*.

*Table 2.3a Employment rates (%) by education levels, men
(25-54 years old)*

	isced0_2 Pre-primary		isced3_4 Upper secondary and post-secondary non-tertiary education - levels 3-4 (ISCED 1997)		isced5_6 Tertiary education - levels 5-6 (ISCED 1997)	
	2002,Q2	1999,Q2	2002,Q2	1999,Q2	2002,Q2	1999,Q2
EU-15 ^a	64.5	63	80.6	79.4	88.3	87.4
EU-12 ^b	64.3	62.7	80.3	79.2	88.2:	
Belgium	60.8	62	81	80.4	89.9	90.3
Denmark	69.9	71.8	87	85.7	90.3	90.5
Germany ^a	64.4	62.8	79.8	79.2	89.8	89.1
Greece	65	63.5	70.9	69.5	85.5	85
Spain	62.8	59.1	73.7	71	82	79.5
France ^c	68	66.9	83.3	81.1	87.3:	
Ireland ^d	63.1:		82:		88.7:	
Italy	61.7	59.6	75.9	73.6	85.5	84
Luxembourg ^a	70.9	67.2	82	79.9	88.4	87.4
Netherlands ^d	71	66.9	85.8	84.8	91.3	91.8
Austria ^e	69.5	68.3	84.5	84.6	92.6	91.2
Portugal	80.2	80.8	84.3	83.7	92.4	93.9
Finland	71.9	72.9	80.2	79.1	89.8	88.5
Sweden	74.7	71.4	85.1	82.9	89.2	87.8
UK	55.4	55.5	82.9	82.4	90.4	90.5

^a 2001, Q2.

^b 2001, Q1.

^c 2002, Q1.

^d 2002, Q2.

^e 2001, Q4.

Source: European Labour Force Survey, EUROSTAT.

*Table 2.3b Employment rates (%) by education levels, women
(25-54 years old)*

	isced0_2 Pre-primary	isced3_4 Upper secondary and post- secondary non- tertiary education - levels 3-4 (ISCED 1997)	isced5_6 Tertiary education - levels 5- 6 (ISCED 1997)			
	2002,Q2	1999,Q2	2002,Q2	1999,Q2	2002,Q2	1999,Q2
EU-15 ^a	48.7	47.2	72.3	70.6	83.3	82.2
EU-12 ^b	48.1	46.5	71.8	70.1	83	81.8
Belgium	44.2	45.4	71.4	70.8	86.3	86.5
Denmark	59.4	65.5	83.8	80.2	88.8	87.8
Germany ^a	56.4	54	73.3	71.8	83.6	82.9
Greece	44.4	41.8	53.1	51.3	79.4	78.3
Spain	41.2	36.2	59.4	55.3	75	70.9
France ^c	57.8	56.9	74.7	71.9	83.7	81.5
Ireland ^d	44.7	n.a.	71.3	n.a.	84.6	n.a.
Italy	38.9	35.6	65.3	62.1	80.3	77.3
Luxembourg ^a	55.1	48.7	67.2	63.9	79.9	79.2
Netherlands ^d	57	51.2	77.9	75.2	86.6	87.1
Austria ^e	62.5	60.9	76.7	75.8	87.6	85.2
Portugal	70.4	70.5	81.6	78.8	91.1	92.6
Finland	68.5	68.9	77.2	75.6	87	85.5
Sweden	68.2	65.1	82.9	81.2	89.1	87.8
UK	48.7	49.5	75.9	75.3	87	86.8

^a 2001, Q2.

^b 2001, Q1.

^c 2002, Q1.

^d 2002, Q2.

^e 2001, Q4.

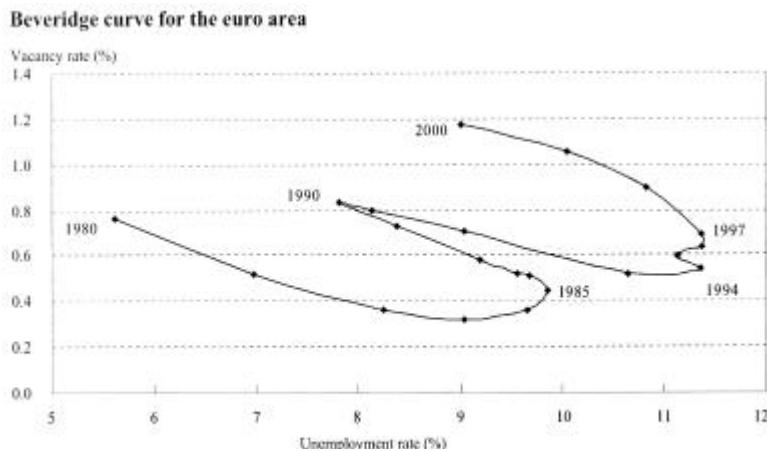
Source: European Labour Force Survey, EUROSTAT.

Yet another clue of the absence of a fundamental improvement in European labour markets comes from the joint analysis of unemployment and vacancy rates, e.g. the Beveridge curve. This instrument provides a useful tool for judging the evolution of labour market imbalances and their sources, whether they are frictions in the labour market, temporary imbalances due to business cycle fluctuations, or structural factors related to the search behaviour of the unemployment and the existence of

regional and occupational imbalances not solved either by wage adjustments or by the reallocation of labour across regions, sectors and occupation by means of workers' and firms' mobility. This analysis is typically burdened by the low quality of data on job vacancies which makes international comparisons in this regard virtually useless. Nevertheless, it provides some indication of the extent of corrections of labour market imbalances across successive business cycles.

In the case of the eurozone, these indications are not particularly optimistic. As the European labour markets tighten between 1997 and 2000, the mismatch between labour supply and labour demand in the sectoral, occupational and regional dimensions remains, at least, to a similar extent as in previous cycles, if not more. Figure 2.3 reproduces the Beveridge curve for the euro area as calculated by the ECB (2002) study on labour market mismatches in euro-area countries (excluding France, Ireland and Italy because of lack of data). As seen in the figure, the Beveridge curve has shifted upwards during the last decade. According to the mentioned study by the ECB, this is mainly due to a worsening of the situation in Germany, and to a lesser degree, in Greece, Belgium, Luxembourg, Austria and Finland, while the Beveridge curve has shifted inwards only in the Netherlands, with no significant change in Portugal or Spain.⁹

Figure 2.3 Beveridge curve for the euro area



The policy conclusion following from this state of affairs is clear. Given the demographic projections for the current decade, the EU must create about 15 million jobs between 2002 and 2010 to achieve the 70% target for the employment rate set in Lisbon. And given the ageing of the labour force, many of these jobs will have to be filled by older workers who currently are leaving employment too early. Thus, more fundamental reforms are needed to improve the functioning of European labour markets. In France and Austria, these reforms are currently dealing with the pension system. In Germany there are positive signs of a political will to proceed with fundamental reforms (see Box 2.1 on Agenda 2010). But as the fierce opposition to these reforms shows, the task will not be easy, particularly when the cyclical situation is not too buoyant. But the reforms are highly needed and delay would make them only more harmful. Moreover, these reforms may enhance growth but only in the long run. This calls for a well designed, gradualist, time-consistent reform programme with a proper timing of the measures to be introduced and coordination with demand policies – exactly what has not been done during the last upswing of the business cycle.

Box 2.1 The German agenda, 2010

German labour market institutions have been singled out as one of the most rigid in advanced countries. Among OECD countries, Germany has a replacement ratio of unemployment benefits close to the average but the duration of unemployment benefits is one of the longest, a rather strict regulation of work availability conditions and of employment protection, about average expenditure on active labour market policies, a very high coverage rate of collective bargaining, despite relatively low union density, with a high degree of coordination, and a relatively high tax wedge, with non-wage costs amounting to more than 40% of gross wages. Since the early 1980s, there have been very few labour market reforms, the most significant being a rise in the duration of unemployment benefits in the mid-1980s, some flexibility of employment protection, together with an increasing trend in the expenditure on active labour market policies.* Now more fundamental reforms aiming at solving German structural problems of high and persistent unemployment and low growth are being pushed forward by Chancellor Gerhard Schroeder.

Among all the proposals in the pipeline, the so-called ‘Agenda 2010’ gets high priority. This is a package of measures aimed at easing labour

⁹ Similar conclusions are obtained from Beveridge curves plotted with OECD data (see OECD, 2001).

legislation and achieving some cutbacks in unemployment and health benefits. Thus, the duration of unemployment benefits would be reduced to 12 months (from 32 months) for unemployed workers aged less than 55, and to 18 months for the unemployed aged over 55. The second pillar of unemployment benefits (*Arbeitslosenhilfe*) and social security benefits would be merged, and the unemployed who reject a job offer would see their benefits cut up to 80%. As for employment protection legislation, small firms (up to 5 employees) could take on temporary workers who would not be fully protected against dismissals, and dismissed workers would have to choose between a severance payment and the right to start legal proceedings against the dismissal. Regarding collective bargaining regulation, there is the proposal of allowing for individual bargains to override collective bargaining agreements. Finally, as for health benefits, the target is to reduce expenditures so that the social security contribution rate for health cover could be reduced from 14.3% to below 13%.

The plans for social reforms in Germany do not end with Agenda 2010. On top of that plan, future pension reforms are envisaged after proposals by the Rürup Commission, and further liberalisation of trading hours and craft industry rules restricting access to some professions are being considered.

As of today, it is not clear to what extent this initiative would represent a significant step forward in the process of adaptation of the German social market economy to the new socio-economic scenario. First there is some uncertainty about the final contents of the legislative package that would receive final approval in the Bundestag. Trade unions and members of the left-wing of SPD are resisting some of the proposed measures, and without left-wingers, the approval of the reform package would require the backing of the CDU/CSU opposition. Secondly, even if Agenda 2010 is successful, further reforms may be needed in the future as the measures envisaged in this initiative may not be sufficient to solve Germany's structural problems. Nevertheless, the fact that labour market reforms have been assigned top priority in the government's agenda is to be welcome.

* For a recent update of indicators of labour-market institutions, see Nickell (2002).

CHAPTER 3

FISCAL POLICY DURING TOUGH TIMES: PREPARE FOR EVEN LEANER YEARS AHEAD OR SPEND YOUR WAY OUT OF A CYCLICAL SLUMP?

Tough economic times expose weakness in economic policy-making. This axiom is being clearly demonstrated in the area of fiscal policy by the collapse of support for the Stability Pact.

The so-called Stability and Growth Pact (SGP) was introduced to ensure that the prohibition of excessive deficits enshrined in the Treaty could actually be enforced in practice. The prohibition of excessive deficits was specially designed to make fiscal policy sustainable, which was clearly needed in view of the rising share of public debt as a proportion of GDP year after year during the 1980s and early-to-mid 1990s. There is little disagreement over the desirability to stabilise debt/GDP ratios at reasonable levels. This is also the reason why the 60% upper limit on debt makes sense (although it is difficult to base on an economic model) and is not really disputed at the political level...except when the implications for current fiscal policy hurt.

However, the central prescription of the SGP – namely that governments should aim, over the cycle, at balanced budgets or small surpluses – has been subject to a lot of criticism. Many have argued that this does not make sense because it implies that debt/GDP ratios should over time go to zero, which would in general not be the appropriate aim for fiscal policy. We will come back to this argument later, but first analyse briefly the nature of the present problems with fiscal policy. We then turn to the implications of a permanent (as opposed to a cyclical) slowdown in growth for fiscal policy. This leads us the next question: What to do when the future threatens to become even more difficult? We find that the predictable effects of ageing provide a surprising rationale for the strictures of the SGP. We then ask whether a one-shot fiscal stimulus might nevertheless be useful in kick-starting the economy. We conclude this chapter with a comparison of reaction of fiscal policy to a post-bubble environment.

3.1 Fiscal policy and growth slowdown

One key assumption of the Maastricht Treaty had been that a deficit of 3% of GDP would be the maximum that member countries could allow

themselves if they wanted to keep debt levels under control. We question this assumption below, but first we want to ask why a number of member countries are breaching the 3% deficit ceiling at present. Governments are claiming that it is not their fault, that their economies are the victims of an unfavourable business cycle. In our view this is an overly optimistic view. As documented above (see also Gros, 2002a for more detail), the potential growth rate of the eurozone is declining, due primarily to the fact that productivity growth has slowed to a snail's pace in Europe (while it has accelerated in the US).

Productivity is a slow-moving variable and the exact numbers are available only after a delay of several years. There can nevertheless be little doubt that productivity growth is now significantly lower than it was 10 years ago, when the Maastricht Treaty was signed. During the 15 years leading up to 1990, labour-productivity growth had been increasing at 2.3% p.a. Over the 1990s, this measure of productivity has decelerated and is now running at around 1.3-1.4%, a decline of almost a full percentage point. Moreover, there is no reason to hope for a quick rebound (as happened in the US over the 1990s).

That potential growth may have declined is not admitted by most policy-makers. They maintain that all one has to do is to wait for growth to get back to its full potential, which they estimate to be growing at over 2.5% p.a., whereas 1.2-1.8% might be a more realistic target, especially for the larger eurozone member countries.

3.2 Implications of lower growth for fiscal policy

The decline in potential growth has two immediate implications for how one judges fiscal policy:

- i) A first implication of lower growth is that current estimates of structural balances are too low. Given that the share of general government in GDP is around 50%, every percentage point of lower potential growth implies an overestimate of structural balances by 0.5% of GDP. If potential growth is in reality 1.5%, or one percentage point lower than the officially assumed figure of 2.5% p.a., then the 'excessive' deficits of Germany in 2002 and 2003 would have to be regarded as almost totally structural and not cyclical, as often assumed. The German example is particularly instructive as this is also the country with the lowest estimates of potential growth. For example, Germany's deficit for 2002 amounted to about 3.7% of GDP. During that year, growth in Germany was only about 0.5%. It is thus not surprising that the estimate of the Commission of the structural deficit of Germany in 2002 was 3.2% of

GDP. The data for 2003 are likely to be even worse. The headline deficit is now expected to go above 4% of GDP, with the structural deficit probably about the same level as in 2002, i.e. around 3.2% of GDP. The excessive deficits of Germany are thus clearly not due to the business cycle, but to a structural weakness of fiscal policy.

- ii) A second implication of lower potential growth pertains to the sustainability of debt levels. If potential growth is as low as 1.5% and if the ECB achieves an average inflation rate of 1.5%, the maximum allowable deficit to keep public debt at 60% of GDP is only 1.8% of GDP (not the 3% as assumed under Maastricht parameters). Again, the German example is instructive in this respect. If Germany were to continue with its structural deficit of close to 3%, its debt-to-GDP ratio would soon start to rise and would eventually stop only at 100% of GDP.

The very low productivity growth in Europe thus imposes some hard constraints on fiscal policy that have not been sufficiently recognised so far. Policy-makers should face up to this problem and stop blaming an anonymous global business cycle.

It is interesting to note that it is mainly the large countries that have a problem with fiscal policy. The three ‘large’ eurozone countries (France, Germany and Italy) are currently violating or close to violating their commitments, whereas most of the small countries (with the notable exception of Portugal) have been able to stick to their commitments. The reason for this is quite clear. The eight ‘virtuous’ small eurozone countries were able to cut expenditure on average by around 1.5% of GDP over the last three years, whereas the three large members and the sinner Portugal were not able to manage even one-third of this. It is thus not surprising that the deficits are under control in the smaller eurozone countries. It seems that the body politic of the smaller countries has been quicker to realise the merit of meeting their obligations under the Stability Pact.

3.3 Even leaner times ahead?

We have so far argued that the lean years (in terms of low productivity growth) are here to stay and that this provides a reason to restrict deficits in order to prevent the debt-to-GDP ratios from increasing. But there are reasons to assume that the environment for fiscal policy will become even more challenging over the next decades.

The basic reason to expect that the environment for fiscal policy will become even more difficult is that the population is ageing all over

Euroland, which implies additional burdens on public expenditure because of an increase in pensions (people live longer) and increases in health expenditure.

Basic economic theory suggests that a sound fiscal policy should set tax rates today not only on the basis of expenditure needs today, but also on those expenditures that can be expected in the future. This is called ‘tax-smoothing’. The standard arguments for tax smoothing suggest that one should prepare for the increase in expenditure from ageing by saving already today (or rather by accumulating less public debt today). This provides another argument why the goal of the SGP, to have public sector balances close to equilibrium, or in surplus, on average, over the cycle, might be appropriate for most Euroland countries for the next few decades. (See box for the essence of the theoretical arguments.)

Box 3.1 The basic formal framework for the tax-smoothing argument

The key assumption is that due to ageing of the EU population, desired public spending will go up in about 20 years. (Supplementary assumption: new steady state starts already in 2020.)

Standard model: Social loss is increasing in tax rate (= tax take as % of GDP), denoted by t , and is increasing in deviation of public expenditure, g (again % of GDP) from target, G .

Time is divided into two periods:

- Period 1 (runs from present to 2020)
- Period 2 (runs from 2020 to infinity, new steady state).

The core is the usual quadratic social welfare loss function:

$$(1) \quad \text{Social loss} = [at_1^2 + (g_1 - G_1)^2] + (1+d)^{-1}[at_2^2 + (g_2 - G_2)^2]$$

Where a denotes the weight of taxes in social loss and d is the inter-temporal discount factor.

The objective for policy-makers is to minimise this social loss subject to the inter-temporal budget constraint:

$$(2) \quad t_2 = g_2 + (1+r)(g_1 - t_1)$$

where r denotes the interest rate on public debt. Minimisation implies:

$$(3) \quad 2at_1 = (1+d)^{-1}[2a(1+r)t_2], \text{ or } t_1 = [(1+r)/(1+d)]t_2$$

$$(3)' \quad (g_1 - G_1) = [(1+r)/(1+d)](g_2 - G_2)$$

This yields the well known result that if the interest rate equals the discount rate (i.e. assuming $d=r$):

$$(4) \quad t_1 = t_2 = t \text{ and } (g_1 - G_1) = (g_2 - G_2)$$

This can be re-written as:

$$(g_1 - t) - (g_2 - t) = G_1 - G_2$$

In other words: it is optimal to keep tax rates constant and it follows that it is also optimal to have in the first period a tighter fiscal policy if target expenditure is higher during the second period. What are the magnitudes?

Recent careful estimates suggest that ageing will lead (*ceteris paribus*) to additional expenditure of 3-5% of GDP, on average, for the eurozone, implying that $(G_2 - G_1)$ should be worth approximately this value.

What should be $(g_2 - t)$? The second period should represent the steady state at which the European economy will settle after 2020. For the reasons explained above, it is difficult to imagine a steady-state deficit even approaching 3% of GDP after 2020 as the old Europe, with a stagnating population, is then unlikely to grow quickly; otherwise, debt ratios would explode.

If one takes the two figures together, the result would be that the optimum scenario would call for having today a surplus of 1-2% of GDP over the next decade to prepare for ageing.

The general argument of the tax-smoothing approach is quite clear: ideally one should keep tax rates as constant as possible and prepare with surpluses today for future increased expenditure. What are the magnitudes? We start from the assumption in the far future when the demographic profile has stabilised that deficits should still be bound by the limit of 3% of GDP.

The next step in estimating how ageing should influence fiscal policy today is to estimate the additional fiscal burden that it engenders. A recent careful analysis has been provided by the 2003 report of the Commission on Public Finances in EMU (European Commission, 2003). The main conclusion of this analysis is that the ageing that one can foresee already today with considerable certainty implies an additional net burden for public finances of around 3-5% of GDP. Taking into account the 3% limit for the future, this leads to a very simple conclusion: If tax rates are to be held roughly constant even as the European population ages dramatically, most member countries should run budgets today that should be between balance and a 2% surplus, which is exactly as foreseen by the Stability and Growth Pact.

This leads us to the following conclusion: It may be difficult to make the argument that a balanced budget over the cycle is always the best choice because this would lead to the public debt level dropping to zero as a percent of GDP. In the specific situation of most eurozone member

countries, however, which have to confront the burden of a rapidly ageing population, it would be advisable to prepare for the future by running today a fiscal policy that allows countries to avoid excessive increases in tax rates. It turns out that estimates of the fiscal cost of ageing imply that the fiscal policy needed today is approximately what is prescribed by the Stability and Growth Pact. Balanced budgets (or actually small surpluses) would in this view be needed ‘only’ during the transition to the new steady state in demographic terms, i.e. according to most projections until around 2020.

Prudent fiscal policy today is not a question of adhering to a rigid rule, but rather ensuring the sustainability of fiscal policy for the future.

3.4 The short-term attractiveness of tax cuts

Fiscal policy thus faces a conundrum at present in Euroland: long-term solvency considerations suggest the need for tightening, whereas the short-term weak state of demand seems to suggest the need for a loosening. A popular approach to this dilemma is to propose immediate tax cuts, which would stimulate the economy both through the demand and the supply side because it is expected that lower taxes stimulate investment and work effort. Could this be a solution?

The basic model presented above can also be used to address this issue. While the model does not contain explicitly the channels by which lower taxes lead to more growth, it contains this idea implicitly in the formulation of the social loss function in which higher taxes lead to lower welfare. The model predicts that a myopic politician has a strong incentive to prefer lower tax rates today even if this implies higher taxes tomorrow.

The morale is intuitively easy to grasp: it is very attractive for politicians to distribute some benefits in the form of tax cuts today even if the cost, which comes in the future if expenditure is kept constant, is much larger than the benefits that can be reaped today. This seems to be happening on a large scale: politicians promise tax cuts today (or the near future), although everybody knows that this implies that taxes will have to be increased in future and that given the ageing population, taxes will have to be increased anyway. Such a policy implies a ‘double whammy’ for future generations, but this is not reflected in election results because future generations do not vote today.

3.5 Could one kick-start the economy anyway?

During times of weak private demand, could one argue that the public sector deficit should be increased even on a cyclically adjusted basis in order to kick-start the economy? This recipe rests on the hypothesis that an increase in deficits leads to more demand because a reduction in taxes or an increase in expenditure ‘puts more money in people’s pockets’. Recent research suggests, however, that the power of discretionary fiscal policy to stabilise the economy in the face of short-term demand shocks is quite limited.

The widely held assumption that higher deficits will support demand is actually based mainly on simulations with large macroeconomic models. There is very little direct empirical evidence of the impact of fiscal policy on output and prices (see Box 3.2).¹⁰ The results from existing large macroeconomic models have to be used with extreme caution because they are based on assumptions concerning some critical parameters.

Box 3.2 Should large-scale econometric models serve as guides to policy-makers?

A first point to note is that economic theory does not even give us the sign of the effects of fiscal policy instruments on the components of GDP with any reasonable confidence. Indeed, Keynesian and neo-classical theories make opposite predictions on the effect of a shock to government purchases on private consumption; and there is some recent evidence that this effect might switch sign, depending on conditions such as the debt/GDP ratio (see e.g. Giavazzi and Pagano, 1989 and Perotti, 1999).

Policy-makers are then often tempted to turn for guidance to the existing large-scale econometric models maintained and used by international organisations. It is not widely appreciated that these models, including that of the European Commission, largely assume the answer. Consider for instance the response of private consumption to an increase in government spending on goods and services. Many modern large-scale econometric models, including the European Commission’s QUEST II and the IMF’s MULTIMOD, specify private consumption as the sum of consumption by two types of agents: unconstrained agents of the ‘Blanchard-Yaari’ type, namely infinitely lived individuals who face a constant probability of death each period, hence effectively discounting

¹⁰ There might be a reason for this state of affairs: Somewhat surprisingly, the data one would need to estimate directly the effectiveness of fiscal policy simply does not exist for many countries. After a long and careful search for data, we were able to perform rigorous statistical tests for four OECD countries (CN, GER, UK and US). These are the only countries for which data are available at the required frequency.

the future at a higher rate than the rate of time preference; and constrained agents, who do not have access to credit markets and are therefore obliged to consume all their disposable income in each period. The ‘Blanchard-Yaari’ assumption effectively shuts off Ricardian Equivalence, and introduces a role for changes in taxes in affecting the consumption even of unconstrained individuals.

For this group of individuals, a permanent increase in government consumption causes a fall in consumption (if they do not discount the future too much), as the future increase in taxation causes their wealth to fall. For constrained individuals, future taxes are irrelevant and an increase in government consumption causes an increase in private consumption. Of course, the overall effect depends on the relative proportion of constrained and unconstrained individuals.

Let us take the models of the IMF and the European Commission as examples. It turns out that a key difference in the specification of the private sector behaviour of MULTIMOD and QUEST II is precisely in the share of constrained agents they assume: QUEST II assumes a very small share, 30% in all countries; MULTIMOD a much larger share, ranging from about 50% in Germany and the UK to 75% in Canada. As a result, an increase in government spending financed by a future increase in taxes causes a fall in private consumption in QUEST II, but an increase in MULTIMOD (see European Commission, 1997 and Masson, Symansky and Meredith, 1990).

While there are other differences in the specification of the consumption function and in the simulation scenarios, the share of constrained individuals most likely plays an important role in these simulation outcomes. Considering that we have so little evidence on this parameter, it would seem rather dangerous to base any policy conclusion on such flimsy foundations.

Recent empirical research of the CEPS MPG on the impact of fiscal policy on demand has shown that the impact of discretionary fiscal policy on GDP since 1980 has been close to zero. This is particularly true for the impact effect. But in those countries where one finds after this essentially zero initial response, that there is evidence that the output response builds up over time, one finds that even the impact is *negative* (Perotti, 2002).

One result common to most countries is that the effect on private GDP is negative. This implies that even if one takes into account that an increase in government expenditure by definition increases the public part of GDP, there cannot be any ‘multiplier’ effect as is often assumed. In fact, in the post-1980 period, the response of private consumption seems to be small and there is evidence of a negative response of private investment.

It would be rash to argue that our results show that fiscal policy has absolutely no impact on demand, or that this impact is always necessarily negative. We would emphasise once more, however, that one cannot discuss the potential use of fiscal policy today without taking into

account the nature of the present slowdown. If it is not only, perhaps not even mainly cyclical, one must be even more careful than usual in the use of fiscal policy as a counter-cyclical tool. Given that the slowdown of potential growth has brought fiscal policy in the large member countries closer to the limit of sustainability, as illustrated above, forward-looking consumers will be even more likely to react negatively to ‘deficits as far as the eye can see’ than if the slowdown were purely cyclical.

Our scepticism concerning the usefulness of the effectiveness of fiscal policy under current circumstances is confirmed by recent polls in Germany in which the following question was asked: Do you believe that anticipating the tax cut by one year will be good for the conjunctural situation? Only 34% of respondents replied ‘yes’; whereas 58% said that they did not think that anticipating the tax cut would improve matters.

3.6 Has the quality of fiscal policy deteriorated?

It is sometimes argued that the quality of fiscal policy, or rather the composition of expenditure, has deteriorated in the sense that under the pressure of the Stability Pact infrastructure spending is cut first. As infrastructure spending is often regarded as ‘better’ or more productive than social transfers, it is often argued that infrastructure spending should not count for the Stability Pact (or for the Treaty limit on deficits of 3%). A similar argument was widespread during the temporary slowdown of 1999 (when it was even argued that the profits of the ECB should be used for EU-wide infrastructure programmes). However, the argument that the Stability Pact has been responsible for cuts in infrastructure spending is not based on the facts. It is true, as has been widely observed, that gross fixed capital formation by the public sector has fallen over the last decades. For the euro-12 it has fallen from close to 4% of GDP in 1970 to around 2.5% of GDP today.¹¹ The decline was already almost complete, however, by the mid-1990s, i.e. before the operation of the Stability Pact. Indeed, the value of 2.5% of GDP for GFCF (gross fixed capital formation) by general government was already reached in 1997, and since then very little has changed.

The data thus do not indicate that the Stability Pact has in any important way led to a reduction of public infrastructure investment. During tough times, however, illusionary projects of relaunching the economy through

¹¹ Since the European system of national accounts has been changed recently, the longer range data are not totally comparable. But for the period for which data are available for both the old and the new system, the difference is minor.

massive investment programmes appear regularly. The latest example is the €70 billion infrastructure programme that the Italian Presidency will make a priority during the second half of 2003. It has not been widely noted that the headline sum (equivalent to less than 1% of the EU-15 GDP) is to be spent over several years – which is unavoidable with these kinds of projects. This implies that this programme cannot really be used to sustain demand now. Its main purpose is to improve supply, i.e. productivity.

But in light of the way in which this initiative has been interpreted in the public, it might be useful to re-visit briefly the golden rule and the case of treating public investment differently from other expenditure. It might be true that during periods of intense budgetary pressures, it is often politically easier to cut capital spending (e.g. on infrastructure) than to reduce transfers that affect powerful voting groups. This is indeed what happened over the last decades with final general government capital expenditure falling as a percentage of GDP, whereas transfers have increased. Since public infrastructure is an essential element of growth, this switch in the composition of expenditure should have a negative impact on supply and growth prospects. How strong could this impact be? This is difficult to say as the growth literature has not yielded any strong results in this respect. Moreover, recent data on overall spending (public plus private) in some key infrastructure sectors suggest that overall spending on infrastructure is higher than often realised and has not been declining in recent years.

Should one nevertheless exclude (public) infrastructure spending from the calculations for deficits? Final capital expenditure by eurozone governments amounts to only 2.4% of GDP, which is approximately equal to the overall deficits in 2002. It thus does not make any sense to argue for a relaxation of the 3%-of-GDP ceiling on deficits on grounds of the so-called ‘golden rule’, which implies that deficits should only be incurred for investment. In practice, applying the golden rule would not amount to a significantly different constraint than the 3% limit in the Maastricht Treaty.

The basic problem with the golden rule is that public spending on capital might have a high social value, but it often does not yield higher revenues for the government that could be used to service its debt. Ireland provides a useful cautionary example in this regard. The Irish government apparently followed the golden rule until about the mid-1970s. The rather high spending on infrastructure led to an accumulation of public debt during the 1960s, when most other countries reduced theirs. Ireland then

had to confront the first oil crisis with a debt-to-GDP ratio of about twice the average of the rest of the EU.

It is sometimes even argued that one should re-interpret Maastricht as saying that public spending on capital investment should entirely be left out of the computations for the deficit. This goes much further than the golden rule mentioned above. Under current circumstances, it would amount to condoning deficits up to 5.4% of GDP (3% plus public capital expenditure of 2.4% of GDP, as mentioned above). Proponents of the idea that public spending on capital is good and therefore should not count under the Maastricht rules for excessive deficits usually do not put it this way because they realise that this would be unacceptable. Nevertheless, it would be the logical implication of such a position.

As an aside, we note that the German Constitution actually contains the golden rule. In Germany, the government is not allowed to borrow more bonds than needed for financing public investment. However, this has not prevented the German government from running up deficits above 4% (justified, *ex post*, by a serious economic disequilibrium). Moreover, as we have argued while the distinction between current and capital account expenditures is an important one, and there is indeed a stronger case for financing capital expenditures through debt, we do not think, at this point, that allowing the Maastricht target to be increased for capital expenditures would be appropriate.

3.7 Fiscal policy in a post-bubble environment

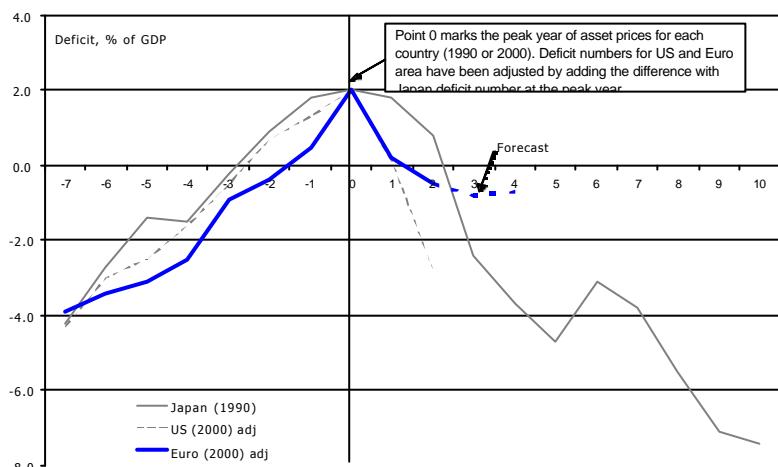
We conclude this brief discussion of options for fiscal policy with a simple observation. It is often suggested that the eurozone and the US face a similar ‘post-bubble’ environment, as Japan did in the early 1990s. It is too early to tell whether this is the case. In any event, however, the experience of Japan over the 1990s provides a stark illustration of the fact that fiscal policy is not the appropriate instrument to deal with the longer-term fall-out from a bubble. There are indeed striking similarities in the path of fiscal policy as illustrated in Figure 3.1. In this figure we report fiscal balances before and after the bubble with the peak of the bubble (as measured by the peak of the relevant stock market indices) marking time zero.¹² There is a striking similarity in the behaviour of fiscal policy among the three economies considered here: Japan, the eurozone and the

¹² Many thanks to Spencer Glendon of Wellington Management, Boston for pointing this out. The vertical axis was also unified to make all three surpluses at the peak comparable.

US. For Japan we now have over 10 years of post-bubble data, which shows a continuing deterioration of the fiscal accounts. The US and Europe have so far spent only a couple of years on the way down. The deterioration of the US fiscal accounts to date has been even stronger than that experienced by Japan in the early 1990s. This might be due to the costs associated with the aftermath of the 9/11 attacks and the war in Iraq. But whatever the reasons, this development does not bode well for the future if the US follows the remainder of the Japanese trajectory.

What has been the result of a decade of increasing fiscal deficits in Japan? There is no visible benefit as growth has not revived, but the accumulated debt is now so large (standing close to 150% of GDP) that it cannot be serviced if growth picks up again and interest rates return to more normal levels. (Public debt in Japan amounts to about 5 times the annual revenues of the Japanese government. This seems to be the more appropriate metric if one takes the current ratio of revenues-to-GDP as indicating the maximum that Japanese taxpayers are willing to sustain. By contrast, public debt in the eurozone is equivalent to ‘only’ 1.5 times annual public sector revenues.)

Figure 3.1 Fiscal policy after the asset bubble



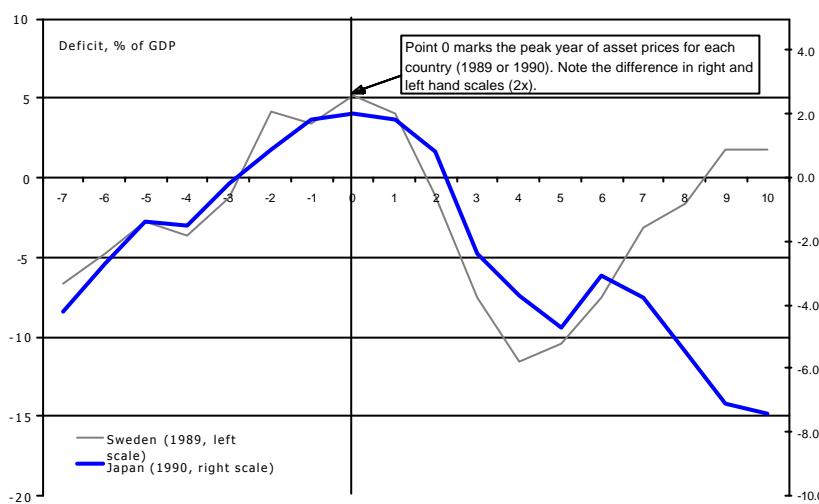
Source: European Commission (2003), *Public Finances in EMU 2003*, May and 2001 international financial statistics of the IMF.

Nevertheless, there are also examples of more successful reactions to bubbles, or financial crises in general. Sweden provides an example. Its fiscal policy also deteriorated sharply after the crash of financial markets

but Sweden operated a sharp correction about five years after the bubble had burst. This shows that it is possible to rein in public finances even in a difficult environment. In Sweden growth started almost immediately after public finances were brought under control. This might have been helped by sharp devaluation. But growth subsequently remained strong even as the exchange rate regained some of the terrain it had lost.

In Sweden, the public sector is about twice as large a percentage of GDP as in Japan. It is thus not surprising that its deficits (and surpluses) have been about twice as large as Japan's. Figure 3.2 shows the evolution of public sector balances in Sweden and the same concept for Japan, but with different scales: the scale for Japan is compressed to one-half that of Sweden. This graph suggests a surprising similarity until about year 6, after the bursting of the bubble when the fiscal adjustment in Sweden turned out to be permanent, whereas Japan's deficits widened again.

Figure 3.2 Japan vs. Sweden: Fiscal policy after the asset bubble



Source: European Commission, General Government Data, Part II: Tables by Series, spring 2001 and 2001 international financial statistics of the IMF.

CHAPTER 4

AN ASSESSMENT OF ECB POLICY

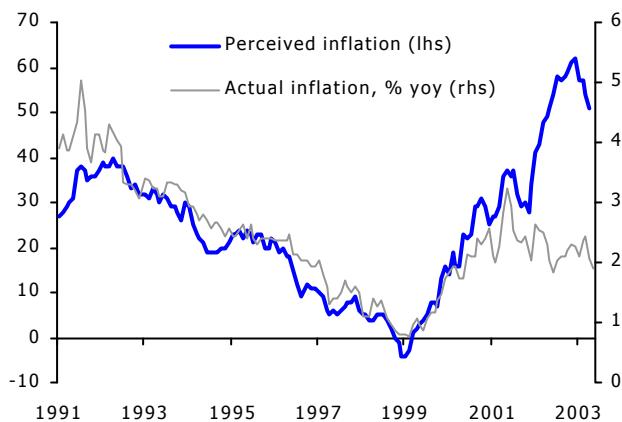
In this chapter we assess monetary policy developments in the euro area. Section 1 briefly reviews the policy decisions since publication of the last MPG Report in June 2002. In section 2, we present new evidence on an ECB interest rate reaction function based on the Taylor rule. Section 3 addresses the widely discussed question whether the eurozone is at risk of falling into deflation, and section 4 concludes the chapter with an evaluation of the ECB's monetary policy strategy.

4.1 Monetary policy decisions

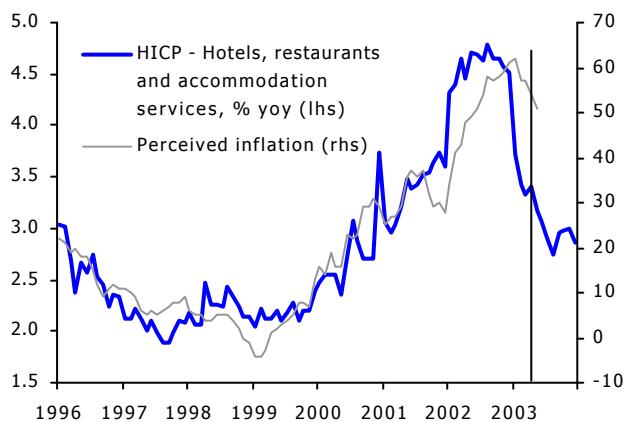
Summer and autumn of 2002

Following high expectations for economic recovery in the first half of 2002 – which had led ECB Council members to signal a bias towards tightening – economic developments were disappointing in the course of summer. Thus, in its September 2002 *Monthly Bulletin*, the ECB acknowledged that “a number of leading indicators and survey data suggest that the recovery is proceeding weaker than expected, although they continue to point to economic expansion”. While markets had begun to speculate about a renewed monetary easing in the run-up to the September Council meeting, the ECB concluded that “the conditions for a stronger recovery in the euro area remain in place”, and left interest rates unchanged. A decline in inflation was expected to raise private consumption while an improvement in the global economy was forecast to support export growth and lift investor confidence.

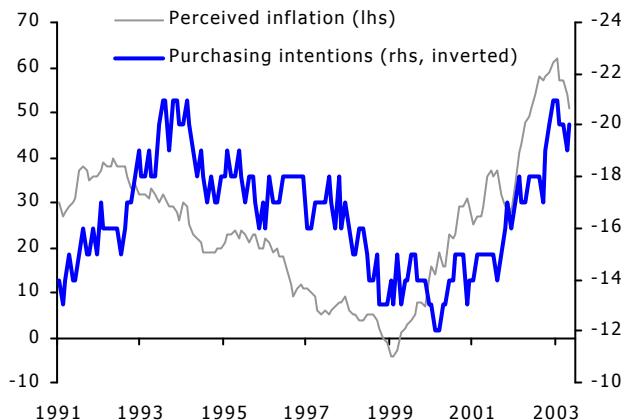
At that time, the ECB in public still maintained its forecasts published in June 2002, which envisaged GDP growth to range between 2.1% and 3.1% in 2003, and inflation to come in between 1.3% and 2.5%. Although the downside risks to this growth forecast were clear, ECB Council members remained concerned about above-target inflation and, in particular, the high level of perceived inflation. The latter was the result of generous ‘upward rounding’ of euro prices especially in the hotel and restaurant sector in the wake of the euro cash introduction at the beginning of 2002. Shocked by the price jumps for these services, consumers believed in the build-up of inflation on a broader basis, and scaled back spending. The accompanying charts (Figures 4.1-4.3) illustrate the misperception of inflation in the wake of the euro cash introduction, the source of this misperception, and its implications for consumers’ purchasing intentions.

Figure 4.1 Actual and perceived inflation

Source: European Commission surveys.

Figure 4.2 Perceived inflation and actual inflation for hotel and restaurant services

Source: European Commission surveys.

Figure 4.3 Perceived inflation and purchasing intentions

Source: European Commission surveys.

As the German government reviewed its fiscal policy outlook after its re-election in September 2002, a debate began across Europe about the merits of the Stability and Growth Pact (SGP). Several government officials from the euro area and the European Commission questioned the usefulness of the pact, and the EU Commission President Romano Prodi called the pact “stupid”. As fiscal deficit estimates in the larger countries rose and fiscal discipline risked being undermined by the criticism of the SGP, the ECB issued an unusual statement on October 24, in which it threw its weight behind the pact. The Council presented four theses:

- 1) The principle of budgetary discipline enshrined in the treaty and the Stability and Growth Pact are indispensable for Economic and Monetary Union (EMU).
- 2) The Stability and Growth Pact has been successful in promoting sound public finances and fiscal convergence.
- 3) The Stability and Growth Pact is in the interest of member states.
- 4) The Stability and Growth Pact supports price stability. In conclusion, it admonished governments, stating that “Respecting the provisions of the treaty and the full implementation of the Stability and Growth Pact remain fundamental to monetary union and to each individual member state. Full compliance with the fiscal framework will also send an important message to accession countries.”

In the event, the German government decided to continue to abide by the pact, and the open criticism ebbed off. Nevertheless, as fiscal policy in the present low-growth environment faces increasing difficulties to squeeze deficits below the 3% GDP limit, the SGP remains under continuous threat.

5 December 2002

Towards the end of 2002, the economy continued to weaken on the back of rising oil prices and declining confidence prior to the Iraq war. After a controversial Council debate on 7 November, the ECB decided to leave rates unchanged, but gave strong hints that a rate cut was in the pipeline. In its *Monthly Bulletin* of November, the bank pointed to rising uncertainty as a major reason for the “hesitant pace of economic expansion and current lacklustre confidence”, and concluded that it was “difficult, at this juncture, to predict the timing and strength of the economic upswing, both in the euro area and globally”. On 5 December, after almost a year of unchanged rates, the Council cut the ECB lending rates by 50 basis points (bp). Such a move had been widely expected, and only the size of the cut had been subject to intense debate. In the event, market participants widely agreed that both the ECB’s preparation of the move as well as the decision itself had been fully appropriate. This was in stark contrast to several episodes in earlier years, when the ECB had been heavily criticised for failing to adequately communicate the motivation and timing of interest rate decisions.

In the run-up to the decision, several ECB Council members had emphasised the role of the economic forecasts issued by the staff of the European System of Central Banks (ESCB) in providing a basis for the move. These forecasts had been available to the Council before its 5 December meeting, and they were subsequently published in the December *Monthly Bulletin*. Compared to the projections published in June, the December forecasts cut expectations for GDP growth in 2003 by one percentage point to 1.1%-2.1%, but left expectations for inflation virtually unchanged. Thus, to the extent that the rate cut was motivated by forecast revisions – as suggested by Council members – it reflected the downgrading of growth expectations. Moreover, it is interesting to note that the 2:1 ratio between the changes in expected GDP growth and policy rates corresponded well with the policy recommendation given by a standard Taylor rule. We will return to this point later.

6 March 2003

Although the ECB had concluded after the December rate cut that “key ECB interest rates [had] now reached a very low level by historical standards”, renewed disappointment about the outlook for economic growth triggered a further cut of 25 basis points in early March. Like the decision before, this move had also been clearly signalled in advance. ECB President Wim Duisenberg, at a press conference held after a G7 meeting on 22 February, indicated that the staff’s growth forecast had been revised down further. Markets again took this as a strong hint for a rate cut on 6 March, which the ECB indeed delivered. In the March *Monthly Bulletin*, concerns about growth were again given as the main reason for the cut: “The decision to lower the key ECB interest rates reflects the Governing Council’s assessment that the outlook for price stability over the medium-term has improved in recent months, owing in particular to the subdued pace of economic growth and the appreciation of the exchange rate of the euro.” When responding to questions at the press conference after the March 6th Council meeting, ECB President Duisenberg indicated that the staff’s internal growth forecast for 2003 had again been revised down by about ½% to around 1%. Press reports published later suggested that the inflation forecast had not changed. Again, the cut of 25 basis points was consistent with the downward revision to growth, in the framework of a simple Taylor rule.

5 June 2003

During the run-up to the Iraq war, the ECB expressed its hope that a swift and successful conclusion of the conflict would reduce uncertainty, restore business and consumer confidence and lay the foundation for recovery in the second half of 2003. Despite the military success of allied forces and the subsequent fall in oil prices, business confidence declined in the aftermath of the war. This may have been related to concerns about the consequences of political disagreements between the US and parts of the EU about the Iraq war; to renewed fears about the external environment triggered by the outbreak of the SARS virus in China; and, to dissatisfaction with domestic economic policies (especially the slow pace of structural reform). Renewed disappointment about the economic performance and concern about the effects of the sharp rise of the euro led markets to expect a further monetary easing in early summer of this year. Continuing pressure to reduce structural budget deficits and the possibility of an even easier monetary policy stance in the US also supported expectations of another rate cut by the ECB.

Markets started to price in another move to ease monetary policy in mid-April. Initially, futures prices for the three-month London Interbank Offered Rate (LIBOR) reflected market expectations of a 25-basis points rate cut, but, as of mid-May, markets began to give a rising probability to a 50 basis points move. Expectations of a sizeable rate cut were fuelled by more dovish comments from several ECB Council members after the meeting of 22 May. Market participants felt that an agreement had been reached at this meeting to announce a cut on 5 June, probably by half a percentage point. In the event, the ECB's move came as no surprise and the market reaction was quite muted.

Duisenberg explained the decision by pointing to a significant improvement of the outlook for price stability over the medium-term and continuing downside risks to growth. This assessment was based on a new ESCB staff forecast, which had been available at the Council meeting and was published in the June *Monthly Bulletin* the following week. The Council still expected an economic recovery during the second half of 2003 and 2004, but Duisenberg made it clear that the level of confidence in this forecast was not very high. He emphasised that the "Governing Council will continue to monitor carefully all factors which are relevant to its assessment". Markets inferred from this statement that rates could still fall further and began to price in another cut by year-end.

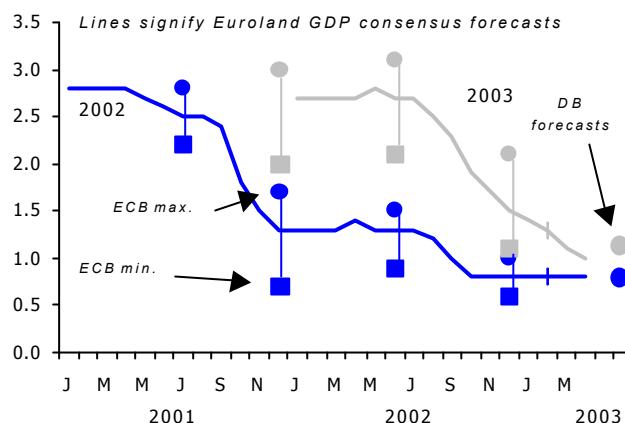
Towards greater transparency and credibility

Two tentative conclusions emerge from the ECB's recent track record: first, the staff forecasts have attained a more prominent role in interest rate decisions. Initially, the ECB reluctantly published these projections and emphasised that they did not reflect the Council's own assessment. Nevertheless, the Council appears to have embraced these forecasts to an increasing degree for its interest rate policy. As one would expect in the case of such an exercise, the ESCB forecast is closely in line with the consensus forecast prevailing at the same time (see Figure 4.4). Through producing and publishing an in-house forecast, the Council may feel more comfortable in using forecasts as a reference point for its interest rate decisions. This clearly strengthens the forward-looking character of monetary policy.

Secondly, communications with market participants and the signalling of policy intentions have improved a lot. After earlier misunderstandings, the ECB seems to have made a deliberate effort to improve its relations with financial markets, and these efforts are now appearing to pay off. Markets have by and large understood interest rate decisions and – with

help from Council members – anticipated them well in advance. Over time, this will enhance the ECB's credibility.

Figure 4.4 The ECB follows consensus views on growth



Sources: Consensus Economics, Inc, ECB and DB Global Markets Research.

4.2 The ECB and the Taylor rule

The anecdotal evidence cited above suggests that the ECB's interest rate policy can be explained by a Taylor rule. Indeed, even though the ECB itself rejects the idea that their policy can be squeezed into such a simple formula, numerous studies have indicated the contrary. As in the case of other central banks, the Taylor rule seems to be a useful approximation of the ECB's true, but unobservable, reaction function. Given data limitations, most economists have used a calibrated Taylor rule to analyse Euroland's short-term interest rates. In the following, we use the data available since the beginning of monetary union to introduce an econometrically estimated version of the Taylor rule. Since the experience of EMU is still short, these estimates can only be tentative. As time progresses, the parameters may change, or the equation may even break down if the ECB alters its character. Nevertheless, the estimated Taylor rule seems superior to the calibrated version.

Normative vs positive Taylor rule

Originally, John Taylor proposed his formula as a normative rule for interest rate policy in the US (Taylor, 1993). In view of the Federal Reserve's mandate to keep inflation under control and promote economic growth, he suggested that the central bank set interest rates as a function

of the cyclically neutral rate, the output gap, and the difference between the actual and targeted inflation rate. A modified version of his original rule is given by:

$$TR = rn + ie + 0.5 \text{ ogap} + 0.5 \text{ igap}$$

where *rn* denotes the real (cyclically) neutral rate, *ie* expected inflation, *ogap* the output gap defined as the percentage difference between actual and potential GDP (in percent of potential GDP), and *igap* the difference between the actual and target inflation.

While Professor Taylor interpreted his formula as a guidepost for monetary policy, other researchers found that it explained the actual behaviour of a number of central banks (such as the US Federal Reserve or the German Bundesbank) quite well (Clarida et al., 1998). More recently, several studies have suggested that it can also serve to explain the interest rate policy of the ECB (see Begg et al., 2002 or Junius et al., 2002).

Central bankers have of course resisted the idea that their behaviour can be described by such a simple formula. They have claimed that their models are much more complex, that they take account of a wide range of data and that they add a good deal of judgement to their policy decisions. The ECB, in particular, has portrayed its two-pillar monetary policy strategy as a framework for the analysis of a vast number of data with a range of economic models. Interest rate decisions are based on this analysis and the judgement of the Council members. At the same time, it may well be possible to find a ‘reduced form’ of the complex model guiding interest rate policy, and to use this ‘reduced form’ to approximate the results of the application of the complex model by decision-makers. It seems that the Taylor rule can serve as such a ‘reduced form’.

While its simplicity makes the Taylor rule so attractive, it also comes with risks. Most importantly, empirically estimated parameters of the formula may not be stable over time. Hence, interest rate forecasts derived from the Taylor rule are subject to two risks. First, there is the risk that forecasts of the output gap and the difference between actual and target inflation required as input into the equation may be wrong. Secondly, it is possible that the parameters linking the explanatory variables to the interest rate may change in the future. As a consequence, interest rate forecasts based on the Taylor formula can only be indicative of likely future developments.

Calibrated vs estimated Taylor formulas

While econometric estimates of the Taylor formula have been made for a number of central banks, the shortage of the observation period so far has largely prevented such estimates for the ECB. Some analysts have constructed EMU aggregates from historical pre-EMU data to arrive at econometric estimates for an ECB Taylor rule, but this approach is flawed. The merger of European national central banks into a common central bank almost certainly resulted in a change of the parameters of the central bank reaction function, even if the theoretical form of the function was maintained. Other analysts have therefore constructed Taylor formulas for the ECB by calibrating the parameters to reasonable values.

We found the latter approach capable of giving a reasonably accurate description of past ECB behaviour. Calibrating the parameters is, of course, a tricky matter. In the absence of reliable historical information, we used theoretical considerations and guesses to arrive at the necessary values. One way to estimate the real neutral rate is to approximate it by the real potential growth rate of the economy.¹³ Thus, if we estimate potential growth at 2% (the annual average rate of GDP growth from 1981 to 2002), we can infer from this a real neutral rate of a similar magnitude. Moreover, since many observers believe that the ECB is aiming at an inflation rate of 1.5% over the medium-term, we may put the nominal neutral rate at 3.5%.¹⁴ To arrive at the appropriate short-term rate for any given point in time, the neutral rate is adjusted by the size of the output gap, which we estimate with the help of a Hodrick-Prescott (HP) filter,¹⁵ and the difference between actual inflation and target inflation,

¹³ Equating the real interest rate to the real growth rate of output can be rationalised with theories of inter-temporal maximisation of utility from consumption and steady-state economic growth. Combining the Ramsey and Solow growth models, Solow has shown that under certain simplifying assumptions, the real equilibrium interest rate can be set equal to the steady state growth rate of output (which is equal to the sum of population growth and the rate of technical progress, see R.M. Solow, 1969). For this equality to hold, however, the economy must grow at its steady state rate, and production and social utility functions must be of a certain form.

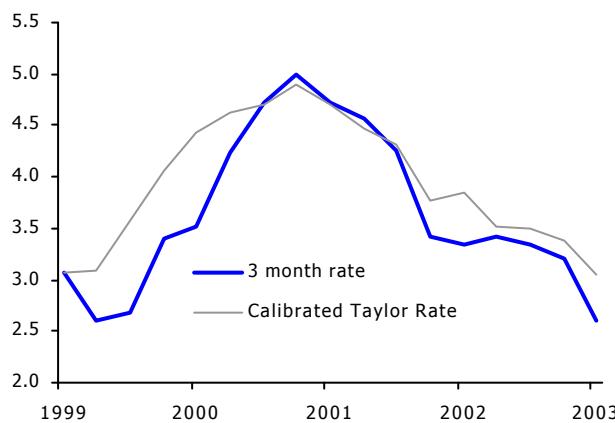
¹⁴ Following the recent clarification of the definition of price stability, the point estimate of the ECB's desired inflation rate is, over the medium-term, likely to shift up to 1.75%. At the same time, after several years of very low growth, the estimate of potential growth may well ease to 1.75%. However, the nominal neutral rate would remain at 3.5% after these adjustments.

¹⁵ Given the well known end-of-period estimation errors of HP filters, we used data estimated with the filter only until the fourth quarter of 2000, and

which we also assume to be 1.5%. For the weights of the output gap and the difference between actual and targeted inflation (inflation gap), we have used 0.6 and 0.4, respectively. These weights have tended to produce a somewhat better fit of the Taylor rates to actual rates than the usual weight of 0.5 for each variable.

Quarterly averages of three-month rates calculated with this formula and actual rates are given in Figure 4.5 below. There are two periods in which there are clear deviations of actual rates from the theoretical ones: the spring of 1999 and the autumn of 2001. In both cases, the deviations can be explained by exceptional events. During the spring of 1999, the ECB (somewhat belatedly) reacted to fears of deflation triggered by the long-term capital management (LTCM) crisis; in the autumn of 2001, the ECB cut rates more aggressively than suggested by economic fundamentals in the wake of the terrorist attacks in the US on September 11. But overall, the chart suggests that we may have set the neutral rate too high.

Figure 4.5 Euroland three-month rate and the calibrated Taylor rate



Source: DB Global Markets Research.

Our earlier discussion of the ECB's performance over the last year concluded that the bank is increasingly using its staff forecasts for monetary policy decisions. This suggests that we should perhaps use the

extrapolated the series for the first quarter of 2001 to the first quarter of 2003. In the fourth quarter of 2000, potential growth was estimated at 2.1%. We kept this estimate for the first and second quarters of 2001, and lowered it to 2.0% for the remainder of the period (i.e. until the first quarter of 2003).

expected output gap and expected deviations of inflation from target instead of actual data. Nevertheless, the data argue against this: interest rate changes seem to be well correlated with contemporaneous output and inflation gap changes. The apparent inconsistency between the expected and actual ECB behaviour can be reconciled by two observations. First, at the time of interest rate decisions, the contemporaneous output gap data were generally not known. Hence, the ECB was making decisions on the basis of forecasts rather than historical data. Secondly, consensus forecasts – which are a close proxy for the ECB's own forecasts – are highly correlated with actual developments at the time the forecasts are made.¹⁶ Hence, the former can be used as a proxy for the latter.

With four years of data now available since the ECB came into operation, it is possible to extend the analysis and introduce an econometrically estimated version of the Taylor formula. We tested two specifications for the latter. To begin with, we assumed instantaneous adjustment (within one quarter) to changes of the output gap and inflation relative to target. Then we assumed partial adjustment to new information, allowing for the possibility that the central bank wants to smooth interest rate developments. Given the ECB's professed aversion to an 'activist' approach to monetary policy, interest-rate smoothing should, in fact, be expected.

Our estimated results are rather encouraging (see the equation and Figure 4.6 below). We found the specification allowing for interest-rate smoothing (modelled by including the lagged endogenous variables on the right-hand side of the equation) to explain 93% of the variance of three-month rates during the period from the first quarter of 1999 to the first quarter of 2003. All explanatory variables are statistically significant at the 1% level of error probability, and the absence of serial correlation of residuals of the equation suggests that no important explanatory variables have been excluded. The coefficient of the lagged endogenous variable indicates that almost 70% of the new information materialising within a quarter enters the interest rate decision, while the coefficients of the output gap and the inflation gap suggest that the ECB gives developments of the real economy and inflation roughly the same weight in its interest rate decisions. In the first round, when adjustment is partial, the coefficients of the output and inflation gaps sum up to 1.0, as postulated by Taylor. Nevertheless, after full adjustment, the sum of the

¹⁶ We found that economists' one-year advance forecasts were highly correlated with present economic conditions during the 1990s (with a correlation coefficient of 0.9 for inflation and 0.8 for GDP growth).

coefficients is 1.5, pointing to a more than proportional influence of these variables on interest rates:

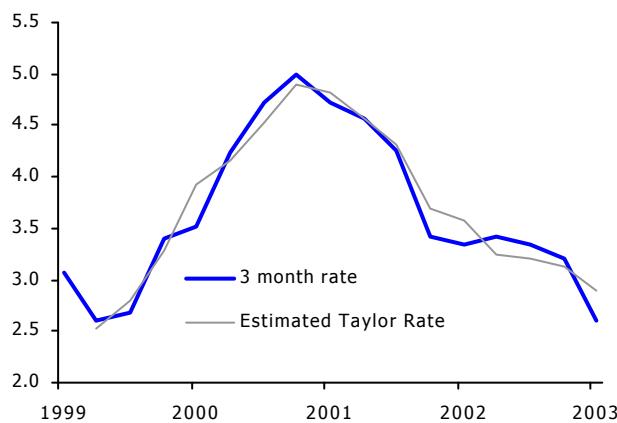
$$i3m = 1.89 + 0.35 i3m(-1) + 0.53 ogap + 0.48 igap$$

(5.35) (3.07) (7.10) (3.50)

$adjR^2 = 0.93$; $AC(1) = 0.07$; for 1999 Q1-2003 Q1

where $i3m$ denotes three-month rates, $ogap$ the output gap, $igap$ the difference between actual and target inflation, $adjR^2$ gives the percentage of variance of $i3m$ explained by the equation, $AC(1)$ is a Chi-square distributed test statistic for first order serial correlation of residuals, and t-values are given in parentheses below the coefficients.¹⁷

Figure 4.6 Euroland three-month rate and the estimated Taylor rate



Source: DB Global Markets Research.

The estimated equation implies a neutral nominal interest rate of 2.9%, considerably below the 3.5% we derived above based on a few theoretical considerations. But the observation period is far too short to allow any inferences on what the ECB implicitly regards as a neutral rate. To arrive at a more reliable estimate, we would need information over several

¹⁷ We also estimated the Taylor equation in first differences, to cross check the level estimates. The results supported the Taylor framework for an interest rate reaction function for the ECB. Specifically, we obtained:

$$di3m = -0.01 + 0.72 dogap + 0.30 digap; adjR^2 = 0.49; DW = 1.57$$

(-0.14) (3.22) (1.04)

economic cycles, which would probably require two decades of data. The difference between the observed neutral rate and a theoretically plausible level implies that our estimated Taylor formula will probably not be stable over time. As we add new data in future years, the parameters are likely to change, with the implied neutral rate likely to increase.

Against this background, any interest rate forecast based on the estimated Taylor equation can only be indicative. At present, based on consensus growth and inflation forecasts (and assuming continuing stability of the equation), our estimated Taylor equation suggest that the refi rate may fall to 1.5% by the end of this year and remain there until the second half of 2004.

Even after four-and-a-half years of operation, the ECB is still occasionally criticised for not communicating clearly enough or for being obsessed with inflation and neglecting ‘growth’. Our review of recent decisions and estimation of an ECB interest rate reaction function suggest that this criticism is wrong. Earlier flaws in communications appear to have been corrected and hick-ups can largely be avoided. In our view, the ECB has made considerable progress in this regard over the last one to two years.

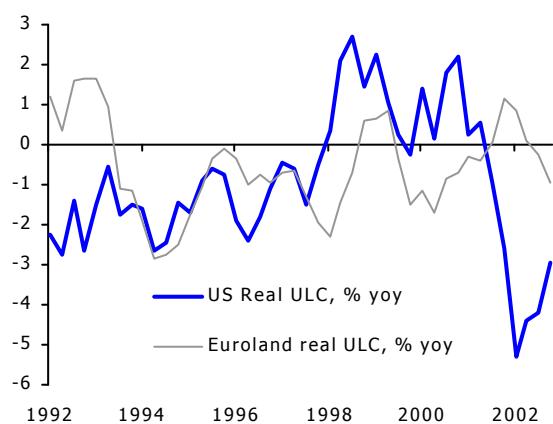
Moreover, our analysis shows that the ECB can be very well explained by using a standard Taylor rule. The Council seems to give equal weight to the output and inflation gaps, and to lean towards interest-rate smoothing. All this is astonishingly similar to the behaviour of other central banks at present and in the past. There is no support for the accusation that the ECB would be an overly zealous inflation-fighter and not responsive to real economic developments. On the contrary, the ECB seems to go almost out of its way to follow a well balanced monetary policy. If there is a risk, then it is that continuous, biased criticism pushes the ECB too far away from the focus on preventing inflation, towards stimulating demand and worrying about deflation. We certainly would not want to claim that the probability of deflation is zero. But as we will explain in more detail later, the risk of deflation in the euro area is fairly small and tends to be overestimated by some financial market participants.

Box 4.1 Proactive Federal Reserve – sclerotic ECB?

A common prejudice is that the US Federal Reserve was more proactive during the recent downturn than the ECB and hence succeeded in stabilising US GDP growth at a relatively high level. By contrast, the reluctance of the ECB to cut interest rates aggressively brought the Euroland economy close to recession. We disagree with this interpretation of recent developments. In reality, inflation eased more quickly in the US thanks to a more flexible economy, allowing the Federal Reserve to cut interest rates more sharply. Sound public finances during the upswing created the room for expansionary fiscal policy during the downswing.

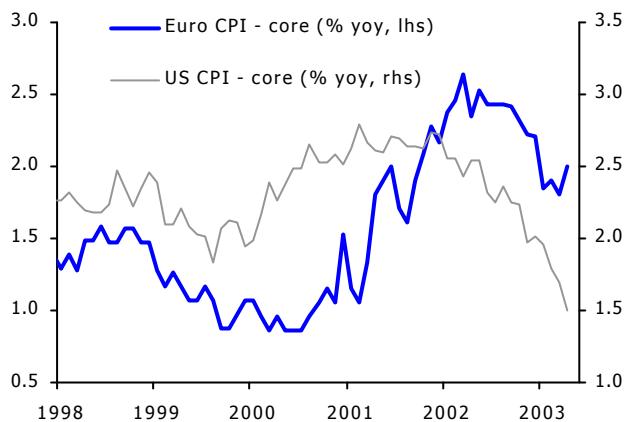
Against that, structural rigidities in Euroland prevented a quick decline in inflation in the wake of economic weakening and forced the ECB to lower interest rates more carefully. Pro-cyclical fiscal policies in major euro area countries during the upswing narrowed the room for expansionary fiscal policy during the downswing. Thus, macroeconomic policy could not make as large a contribution to economic stabilisation in Euroland as it could in the US. These differences are illustrated in Figures 4.7-4.10.

Figure 4.7 Euroland relative unit labour costs (ULCs) rose, despite the economic downturn...



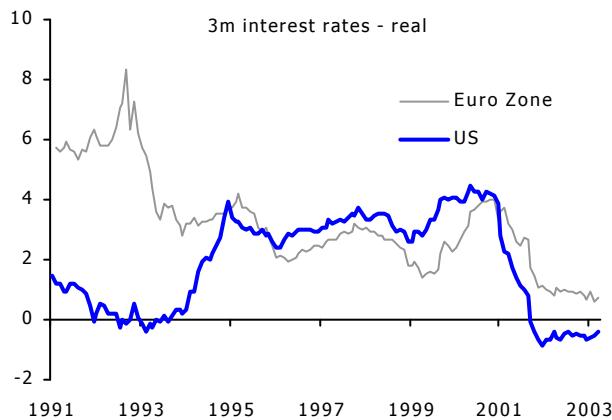
Source: DB Global Markets Research.

Figure 4.8 ... which meant inflation was slow to fall.



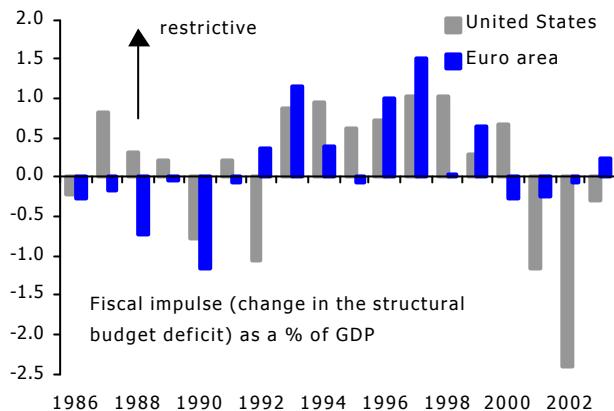
Source: DB Global Markets Research.

Figure 4.9 Because the Federal Reserve could cut rates faster...



Source: DB Global Markets Research.

Figure 4.10 ... the US economy received a big boost from fiscal policy



Source: DB Global Markets Research.

4.3 Deflation in the eurozone?

Despite recent stock price declines and economic weakness, the necessary conditions for deflation are still far from being fulfilled in Euroland. Recent inflation, along with monetary and real economy developments in Euroland do not show any symptoms of deflation. Moreover, risks of deflation emanating from, for example, a plunge in asset prices, a sudden and sharp appreciation of the exchange rate, a fragile banking system or the present weakness of the German economy are limited. Should deflation risks increase, the ECB seems prepared to counter them. Yet, due to past mistakes, fiscal policy would be less effective to stimulate the Euroland economy.

Too much of a good thing?

Until a few years ago, deflation appeared to be an economic illness of the past. The deflation virus had devastated the world economy in the 1930s, but, thanks to the medicine developed by John Maynard Keynes in the wake of this experience, it had ceased to be seen as a serious menace. This perception changed when Japan fell into deflation in the second half of the 1990s and was unable to free itself again from this predicament. Deflation seemed to have made a powerful comeback in our time.

The appearance of deflation in Japan coincided with the demise of inflation in the rest of the world. Hence, what would have probably been welcomed as a final victory over inflation, soon began to appear as a mixed blessing. Could it be that the fight against inflation launched by

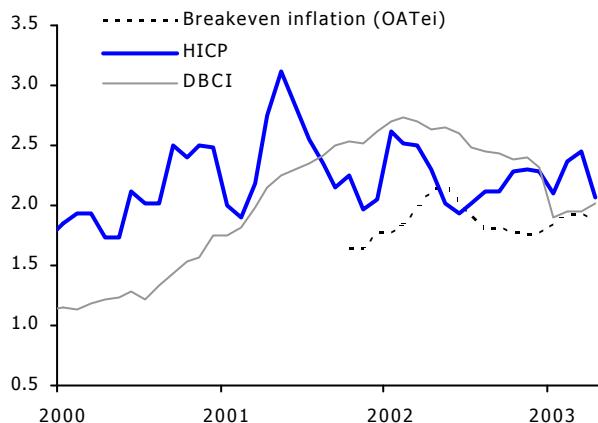
central banks and governments in the early 1980s had ended in a Pyrrhic victory? Concerns began to rise when the Asian and Russian crises in 1997-98 increased financial market instability and the burst of the Internet bubble in 2000 caused stock prices to fall on a worldwide scale. An increasing number of financial market participants now fear that the virus will spread from Japan to the rest of the world. In this section, we discuss whether these fears are warranted. Our main conclusion is that there is little risk of Euroland following Japan into deflation. Deflation is not fate. It is a sequence of serious economic policy mistakes that pushes an economy into deflation and keeps it there. We are quite hopeful that the European economic policy-makers will avoid such a sequence of mistakes.

Before we explain our view in more detail, we need to clearly define the subject of our analysis. We focus on the malign form of deflation (or ‘corrosive deflation’, according to Alan Greenspan), which is characterised by a fall in the general price level and aggregate demand. This is what occurred during the Great Depression, and what has afflicted Japan in recent years. There is also a benign form of deflation, characterised by a falling price level and rising demand. This may occur when technical progress or an improvement in the terms of trade causes a fall in prices that stimulates real demand.

Does benign deflation raise the risk of malign deflation? Not necessarily.¹⁸ In an environment of benign deflation, where productivity growth is high or terms of trade improve, economic growth is robust and real interest rates are positive (see Figure 4.11). Unless the price level falls at a very fast pace – which is unlikely in normal circumstances – positive real interest rates require positive nominal rates. Moreover, government revenues are likely to grow at a healthy rate while cyclical effects dampen spending growth. Hence, both monetary and fiscal policies have room for manoeuvre in case of a negative demand shock. Consumers are accustomed to a falling price level and hence unlikely to suddenly change their behaviour and hoard liquidity when a negative demand shock occurs.¹⁹ All this suggests that there is little reason to worry about benign deflation, and that we may focus on its malign form as follows.

¹⁸ We measure deflation here as the probability of malign deflation.

¹⁹ This could be different if falling prices raised consumer debt in real terms to unsustainable levels. But there are no signs of an excessive consumer debt burden in Euroland.

Figure 4.11 No deflation risk according to index-linkers

Sources: Bloomberg and DB Global Markets Research.

No signs of deflation in Euroland

A recent study by the International Monetary Fund (IMF) provided a comprehensive analysis and historical overview of deflationary developments in the world economy (IMF, 2003). In addition, the IMF assessed the present deflation risks in 35 countries. For this purpose, the authors of the study compiled indices of deflation vulnerability for each of the countries based on a set of economic and financial indicators. The latter included price, excess capacity, asset market, credit and money indicators. But the IMF assessed the deflation risk in Euroland not for the currency union as a whole but country by country. For the euro area, they concluded that deflation risks were: i) minimal in Spain; ii) low in Austria, France, Greece, Ireland, Italy and the Netherlands; iii) moderate in Belgium, Finland and Portugal; and iv) high in Germany. The IMF paper discussed, in more general terms, economic policies to fend off or overcome deflation, but failed to show any implications of its findings for the monetary policy of the ECB.

We are not convinced by the IMF's country-by-country assessment of deflation risks in Euroland. Harmful deflation is caused by a spiral of lower prices causing a fall in aggregate demand. It requires a closed economy, or domestic and foreign demand to move in lock step. The latter is only possible if the world at large also suffers from deflation, or if the domestic market is closed to positive foreign influences from adverse exchange rate movements or very high barriers to trade. None of this applies to any EMU member country.

Long before the beginning of EMU, a fairly well integrated market for tradable goods, services and capital had emerged in the European Union. The project launched in the early 1980s to create a Single Market by 1992 extended trade and capital markets integration with some success into previously uncovered areas, such as financial and professional services.²⁰ The creation of EMU in 1999 and the introduction of euro notes and coins in 2002 have fostered integration further and induced (pre-tax) price conversion of tradable goods and services. Divergence of inflation rates among countries has not disappeared, but it has narrowed, compared to pre-EMU conditions.

In this environment, we would expect prices of tradable goods and services to be largely determined at the Euroland level instead of at the country level. In these circumstances, deviations of inflation rates in a particular country from the common inflation rate would largely reflect changes in prices for non-tradable goods and services. Thus, for a large number of companies, the Euroland market and the Euroland price level are much more important than the national or regional markets and the price levels calculated for these markets. Only companies that exclusively supply to national or regional markets depend entirely on the supply-and-demand conditions that exist there. By the same token, the prices of a large number of consumer goods and services are determined at the Euroland level, and only the prices of locally offered goods and services, notably housing, exclusively reflect supply-and-demand conditions in the regional and national markets.

As long as the common inflation rate for tradable goods and services prices remains positive, low or even negative inflation in an EMU member country would be indicative of a depreciation of the real exchange rate of this particular country within EMU, rather than of macroeconomic deflation. Depreciation would improve the country's competitiveness, allowing it to gain market share and increase production.

Hence, we find Euroland indicators of prices and price expectations, of money and credit growth, and of the real economy as well as the exchange rate more appropriate data for assessing deflation risks in Euroland than national or regional data. National asset price indicators and the health of national financial sectors are important, to the extent that they have a bearing on Euroland inflation and financial conditions. Thus, our approach differs from that of the IMF in that we regard the euro

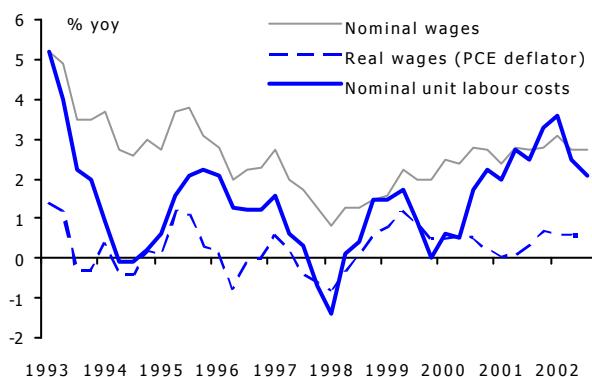
²⁰Thus, in 2002, total Euroland exports (the sum of intra- and extra Euroland exports) amounted to 36% of GDP.

area as the relevant economic entity for the analysis of deflation risk. Recent inflation and monetary and real economy developments in Euroland do not show any symptoms of deflation.

i) Prices and price expectations

Recent price developments and the near-term outlook give little reason to worry about deflation in Euroland. Headline consumer price inflation has come off its peak of almost 3.5% recorded in May 2001 and is presently hovering around 2%. Despite lower oil prices, it is expected to ease only moderately in the near term. Moreover, core inflation, which abstracts from food and energy price developments, has remained close to 2% and is expected to ease only slowly in the course of the next 12 months. One reason for the continuously high level of core inflation is the second-round effects of earlier food and energy price increases, which are presently working their way through the economy. Another reason is last year's acceleration of wage growth, which is still exerting upward pressure on unit labour cost growth (see Figure 4.12). The year-on-year increase in hourly compensation accelerated to 7% in the fourth quarter of last year from 6% in the same period of the preceding year. In view of the sharp slowdown of productivity growth, unit labour cost growth rose to 3.7% in the fourth quarter of 2002 from 3.4% a year ago. Upward pressure from labour cost developments is likely to militate against a more pronounced decline in inflation, owing to weaker economic growth. Finally, higher productivity increases in some countries may be associated with persistently higher inflation there (the so-called Balassa-Samuelson effect).

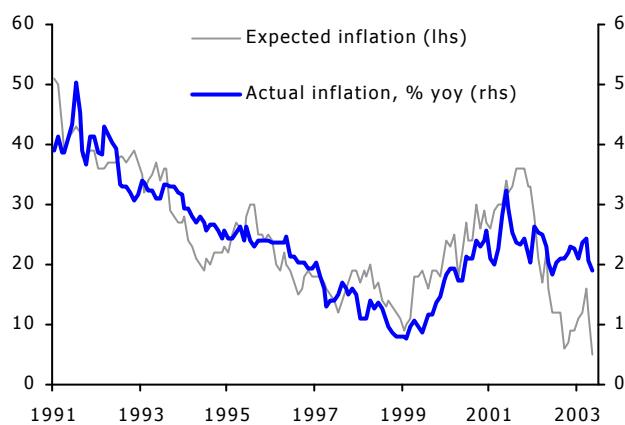
Figure 4.12 Wage growth remains sticky



Sources: Eurostat and DB Global Markets Research.

For deflation to take hold, price expectations may be of even greater importance than recent and likely future actual price developments. If consumers and producers expect prices to fall in the future, they may hold back spending, investment and employment. Towards the end of 2002, inflation expectations in Euroland indeed fell to levels last seen in the winter of 1998 in the wake of the LTCM crisis. Nevertheless, inflation expectations have increased again more recently, as they did in early 1999, when the threat from the LTCM failure faded (see Figure 4.13).

Figure 4.13 Inflation down, expectations down sharply



Sources: Eurostat, European Commission and DB Global Markets Research.

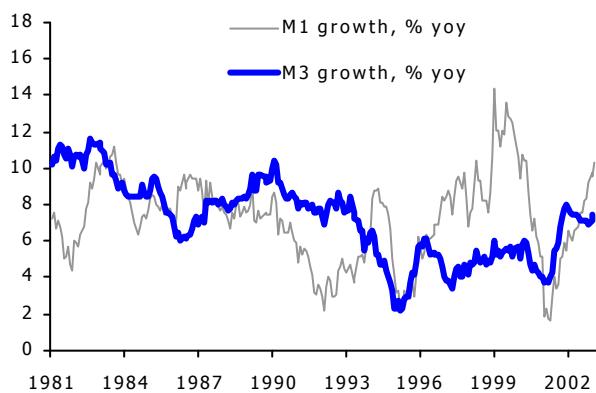
Breakeven rates from French index-linked government bonds suggest that financial market participants presently expect inflation to average a little more than 1.5% over the coming 10 years, compared with more than 2% in early 2002. This is broadly consistent with the recent survey data published by the European Commission. There are presently no signs that either financial market participants, consumers or producers expect the general price level to fall.²¹

²¹ In fact, ‘perceived inflation’ in the wake of the euro cash introduction is still high.

ii) Monetary developments

In a deflationary environment, the demand for liquid balances weakens as the volume and value of transactions shrink. In addition, the growth of broader and narrower monetary aggregates, including the monetary base, converges as demand for liquidity gravitates towards currency or demand deposits.²² Up to now, there are no signs in Euroland that money growth is severely weakening. Given the euro cash changeover at the beginning of 2002, which induced consumers to minimise currency holdings and to park currency in demand deposits, the development of base money is distorted. However, these developments have offset each other within M1. This narrow monetary aggregate showed accelerating growth over the last year, with the latest available year on year rate rising to 11.1% in April from a low of 3.4% in July of 2001. Growth of the broad monetary aggregate M3 has increased to about 8% in recent months, up from less than 6% in 2001.

Figure 4.14 Money growth is strong



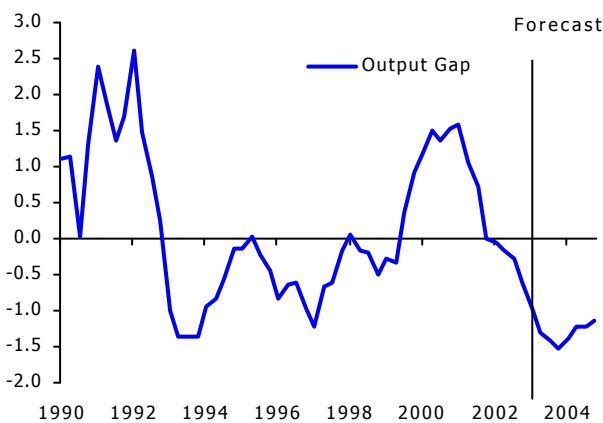
Sources: ECB and DB Global Markets Research.

²² In a recent speech, Marian Bell, member of the Bank of England Monetary Policy Committee, illustrated this point: "In the five years to April 1933, the stock of both the M1 and M2 aggregates fell around 30% (in the US). In Japan, there was a sharp slowdown in the annual growth of broad money (M2 plus CDs) from double-digit rates of growth in 1990 to around zero in 1992" (see Bell, 2002).

iii) Real economy

Both inflation and money growth could of course weaken significantly if the economy turned down suddenly and sharply. The resulting rise in the output gap could exert severe downward pressure on inflation and eventually the price level. What are the chances of this happening? After moderate growth in the first half of 2002, the economy slowed in the second half. It has grown little so far this year. As a result, capacity utilisation is falling and the output gap widening. Nevertheless, both the speed of the decline in economy-wide capacity utilisation and the present and prospective size of the output gap are not out of line with historical experience. Hence, the pace of the slowdown is unlikely to have the power to push the presently positive and rather sticky inflation into negative territory. There are, of course, considerable risks to the present economic outlook, which could change this assessment. We discuss these risks in more detail below.

Figure 4.15 Output gap to widen



Source: DB Global Markets Research.

Limited risk of deflation in the future

The experience of Japan (reviewed above) points to three important sources of deflation risk: i) a plunge in *asset prices*, ii) a sudden and sharp appreciation of the *exchange rate*, and, iii) a *fragile financial and banking system*. Each of these events alone or, more likely, a combination of these events could have the power to push an already weak economy into deflation. Moreover, there have been concerns recently that the German economy, which is particularly weak, could fall into deflation

and drag the rest of Euroland with it. How seriously do we need to consider these risks in Euroland?

i) Asset prices

Consider the development of stock prices first. Since their all time high reached in March 2000, Euroland stock prices (measured by the DJ EURO STOXX index) fell by about 50%. Thus, the performance of the Euroland stock market was even worse than that of the US market, where prices fell by around 40%. However, it seems that the decline in stock prices has had a smaller impact on consumption and investment in Euroland compared to the US.

According to a recent ECB study (see ECB *Monthly Bulletin*, September 2002), the marginal propensity to consume is around 1 cent per euro of equity wealth compared to 3-7 cents per dollar in the US. Thus, a permanent decline in stock prices by 50% would imply a long-term decline in consumption from its counterfactual level by only about 0.3%. There is an even weaker relationship between stock price developments and gross fixed capital formation in Euroland. As the ECB study shows, gross fixed investment rose slowly relative to GDP between 1995 and 2001 while stock prices first surged and then plunged. Hence, the ECB concludes that "...the direct impact of stock market developments on economic activity...can be expected to be rather limited, though discernible" (ECB *Monthly Bulletin*, September 2002, p. 30).

Given widespread home ownership, house price developments may have a stronger influence on consumption than stock price changes. A sharp drop in house prices may not only weaken consumption by making consumers feel less wealthy, but also boost mortgage defaults if it compresses homeowners' cash flow (e.g. through a decline in rents received from let properties) or wipes out their equity capital.²³

According to the ECB, following a period of stability between 1993 and 1997, house prices began to rise in the Euroland average as of 1998. House price inflation peaked at a little more than 7% in 2000, easing back to about 6% in 2002 (see ECB *Monthly Bulletin*, October 2002, p. 26). With consumer price inflation running at around 2%, this translates into a real house price increase of 4%, which is hardly worrisome. Nevertheless, the average rate of house price inflation reflects considerable differences among Euroland countries. Prices have increased more strongly in some

²³ For the relationship between house prices and economic activity, see Girouard and Blöndal (2001).

countries, such as Ireland, the Netherlands, Belgium, Spain and France, but they rose only a little in other countries and, in more recent years, even fell significantly in Germany. Thus, while a house price bubble cannot be detected at the Euroland level, which makes a significant across-the-board price decline unlikely, there may have been some overheating of the housing market at the national or regional level. We discuss below to what extent deflationary developments at the national level pose a risk to the entire eurozone.

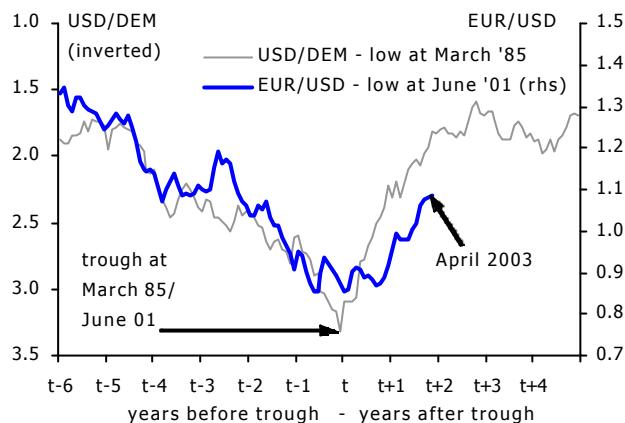
ii) Exchange rate

The most serious deflation risk emanates from the exchange rate. In Japan, the sharp appreciation of the yen in 1995 imparted an additional deflationary shock to an economy already severely weakened by the fall in asset prices. In the wake of the currency appreciation, consumer price inflation turned negative and economic activity contracted. Following unexpected weakness during the first two years of its existence, the euro began to appreciate towards the end of 2000. The pace of appreciation has been consistent with past exchange rate corrections, despite mounting concerns about the sustainability of the US dollar exchange rate, in view of very large and rising current account deficits in the US. At present, the odds favour a continuation of gradual euro appreciation against other major currencies, most notably the US dollar. Economic developments in Euroland are likely to remain relatively weak, amid rising concerns about the course of fiscal and structural policies. At the same time, the US economy and US economic policy-makers have continued to show a remarkable ability to deal with adverse shocks. This is likely to sustain the appetite of international investors for US assets and allow the financing of the current account deficit at an exchange rate that depreciates slowly.

Nevertheless, the risk of a more sudden fall of the US dollar – and corresponding rise of the euro – are significant. This risk could materialise if investor confidence in the US economic outlook suddenly plunged. A possible trigger for such a change in attitudes could be a large deflationary shock to the US economy, for instance in the form of a collapse of the real estate market. Although we do not expect this to happen, a correction in the US housing market cannot be ruled out, given that house prices have increased significantly in recent years. Should this or another presently unforeseeable event disrupt international capital flows and induce sudden exchange rate changes, the Euroland economy would be ill-prepared to digest a sharp appreciation of the euro. With consumption growth still weak, an exchange rate shock would induce a plunge in companies' export and profit expectations. As a result,

investment would fall further and unemployment would rise, exerting more downward pressure on private consumption. Weak total demand coupled with a rising exchange rate could eventually push the economy into deflation. Hence, international capital flows and exchange rates need to be monitored quite closely.

Figure 4.16 Recent developments in line with history



Sources: DB Global Markets Research and Bloomberg.

The above discussion focused on the deflationary risk emanating from a significant nominal exchange rate shock hitting an already weak economy. But is there not a similar risk posed by a gradually appreciating real exchange rate? With the prices of goods exported from some Asian countries stable or falling, while such prices in industrial countries are rising, the real exchange rate of industrial country currencies tends to appreciate. Against this background, an increasing number of market participants and economists are concerned about the ‘deflationary risk’ emanating from large volumes of cheap goods exported from Southeast Asian countries and China.

Nevertheless, we would have to make very strong assumptions to sustain the argument that cheap imports from Southeast Asia could cause deflation in industrial countries. International trade tends to induce specialisation among countries in the production of tradable goods and services. Cheap imports from Asia (or anywhere else) may cause high-cost domestic producers to go out of business. This will free resources that can be employed in other industries. According to the time-tested

theory of comparative advantage, it is extremely unlikely that a low-cost country will compete with a high-cost country across the entire spectrum of tradable goods and services. Even if the low-cost country has an absolute cost advantage across-the-board, it is preferable for that country to concentrate on the production of tradable goods and services where its cost advantage is highest and leave other activities to its trading partners. Hence, international trade may well cause price declines in certain industries, but it is, in most circumstances, unlikely to induce a decline in the general price level. For that to occur, we need to assume that resources freed in the import-competing sector cannot be re-employed elsewhere in the economy. In that case – and assuming the import-competing sector is sufficiently large – job losses in the declining sector will not be compensated by gains in other sectors, causing a general rise in unemployment, which could induce a decline in consumption and investment. Falling domestic and external demand could, in turn, lead to deflation.

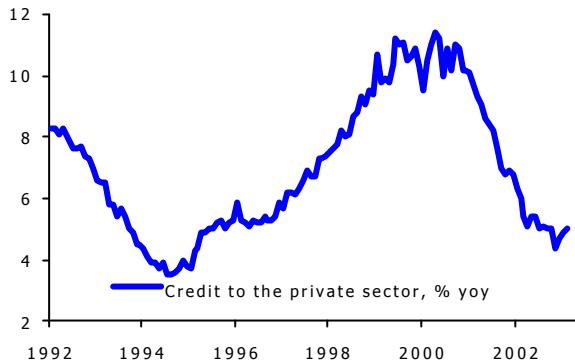
iii) Fragile financial sector

As the Japanese experience showed, falling asset prices can lead to a rise in loan losses and weaken the balance sheets of banks. If a large-scale write-down of assets is required, banks will lack the equity capital base to extend new loans, and some banks may even fail. Credit rationing or a credit crunch could tip the economy into deflation. Since 2000, credit growth in Euroland has slowed sharply. But the slowdown occurred from high levels of around 9% in early 2001 to rates of around 5% in the more recent past. Thus, to a large extent, the decline in credit growth has reflected a normalisation, after very strong growth in the wake of the euro introduction, a weaker economy and a higher corporate debt level. Signs of credit rationing or a credit crunch are presently not visible at the Euroland level.

Yet, developments have differed across countries. While credit growth in most Euroland countries has remained robust, it has weakened sharply in Germany. The six-monthly annualised growth rate of private sector credit slowed from around 8% in the spring of 2000 to -0.5% in the spring of 2002, and it has edged up only marginally since then. The drop in credit growth cannot be entirely explained by the weakening of the economy during this period. Supply-side factors – such as banks' concerns about weak returns to equity, the need to set aside more equity capital for loans to small- and medium-sized companies under the coming Basel capital adequacy agreement and the expiration of government guarantees for the savings banks – also seem to have played a role. Thus, while it may be exaggerated to speak of a credit crunch in Germany, there are certainly

signs of credit rationing. A fragile German banking sector raises the risk for the entire Euroland banking system.

Figure 4.17 Private credit growth down, but largely as a correction



Sources: ECB and DB Global Markets Research.

iv) Germany

After robust growth in 2000, the German economy slowed sharply in 2001 and recorded marginally positive growth in 2002. The outlook for 2003 is not much better. At the same time, inflation has come down to less than 1% while credit growth has slowed sharply. It is widely believed that real interest rates are too high for Germany and the Stability and Growth Pact imposes severe constraints on fiscal policy as an instrument for supporting demand. With the government having difficulties implementing much needed structural reforms, concerns are growing that Germany is locked into economic stagnation, which could turn into outright deflation.

Clearly, in a low-inflation environment, any further drop in oil prices or rise in the euro could induce a temporary decline in the German price level. But would a sinking price level in Germany signal harmful deflation in that country or raise deflation risks for Euroland? First, a decline in the German price level in an environment of positive inflation rates at the Euroland level would not necessarily signal the beginning of a malign deflation spiral. With German prices declining, competitiveness

of German exporters should improve and exports to other Euroland countries should grow. Hence, in contrast to the closed economy case, where falling prices may lead on to falling demand, a possible decline in domestic demand will be countered by a rise in foreign demand due to real exchange rate depreciation.

Secondly, with German GDP accounting for about one-third of Euroland GDP, developments in Germany have a visible impact on those in Euroland. Moreover, problems could arise if difficulties in the German banking system spread to the entire euro area, creating widespread credit rationing or a credit crunch. Hence, developments in Germany must enter an assessment of deflation risks in Euroland. But they must be analysed with regard to their influence on Euroland aggregates, and not in isolation.

Regarding the real economy, German economic activity is weak at present, but the weakness is not so severe that it could pull the entire euro area economy into recession. Moreover, although German private households and companies suffer from a heavy debt burden, the indebtedness is not entirely out of line with that of other euro area countries. According to ECB statistics, total liabilities of German private households amounted to 74.1% of GDP at the end of 2000.²⁴ This was above the 53.2% Euroland average, but below the ratio of the Netherlands (86.0%) and Portugal (79.5%). Liabilities of non-financial corporations amounted to 168.5% of GDP, compared to 306.7% for the euro area on average. Finally, the risk of default by a major bank – which could have systemic consequences – still seems limited. Provided that German banks now step up efforts aimed at cost containment and restructuring, there is a good chance that this risk will decline again over time.

Box 4.2. Where Germany lacks competitiveness

A considerable number of eminent economists blame Germany's dismal economic performance in recent years on a lack of external competitiveness. They claim that the country entered EMU at too high a nominal exchange rate, to which it is now irrevocably locked. The only solution to this predicament, so the argument goes, is a slow and painful 'internal devaluation' of the real exchange rate. This can be achieved when unit labour costs are cut through wage restraint or a reduction of payroll taxes. To this end, social security reform is essential.

²⁴ European Central Bank (2002), Report on financial structures, ECB Frankfurt.

This analysis of Germany's predicament appears convincing and, at first glance, supported by the data. German unit labour costs, measured in common currency, soared after unification relative to those of the country's trading partners. Since the beginning of EMU, unit labour costs have eased only little, and there have even been signs of a renewed deterioration in the recent past. Notably, on this measure, Germany does not seem to have regained any competitiveness against France, its largest trading partner country.

At the same time, however, export data tell an entirely different story. German real exports of goods and services grew at an annual average rate of 6¾% in 1999-2002, significantly stronger than exports in France (5.2%), Italy (2.9%), Spain (5.6%) or the Netherlands (3.9%). According to the OECD, Germany gained considerable market share in its foreign markets in 1999-2002, while France, Italy and Spain lost market shares.

Strong export performance against the odds could be explained by a successful focus on up-market goods and services, characterised by high income and low price elasticities, effective marketing and heavy emphasis on close customer relations. The latter factor is especially important for vertically integrated global companies. During the 1990s, many German companies acquired foreign production facilities, and they are now supplying inputs to these factories from their home base. Clearly, these exports within the same firm are much less price and cost sensitive than exports to outside customers.

Strong export growth accompanied by a high and even appreciating real exchange rate is often a sign of a healthy economy, specialising in the production of technology-intensive and hence less price-sensitive goods and services. Given strong productivity growth, GDP tends to expand at a fast pace, boosting income growth, domestic demand and total employment.

But, the German economy could not differ more greatly from this description. Strong German export performance took place against the background of an overall weak domestic economic environment. German GDP growth averaged only 1.4% in 1999-2002, compared to 2.2% for the entire euro area. Employment growth was sluggish and unemployment moved sharply higher in recent years. Thus, strong export performance went along with weak domestic performance.

Several economists have blamed overly restrictive macroeconomic policies for dampening domestic demand. Yet, fiscal policy was expansionary in 2001 on the back of tax cuts and neutral in 2002, due to strong growth in government spending. At the same time, the ECB lowered interest rates significantly in 2001-2003, without any discernible effect on German domestic demand growth. Hence, recent developments argue against demand-side factors as the main brake on domestic growth.

Failure to explain Germany's economic weakness with either a lack of external competitiveness or restrictive macroeconomic policies points to a lack of 'internal' competitiveness as the main problem. The domestic sector (mainly engaged in the production of non-tradable services) does not have the option to deal with excessive cost increases by moving production to less price- and cost-

sensitive areas, as seems to have happened in the export sector. Higher costs caused by exploding non-wage labour costs will simply raise prices in the domestic sector. This leads to a loss in competitiveness of the formal domestic sector against the informal sector, the so-called shadow economy. With demand shifted from the formal to the informal sector, growth of official GDP and the tax base declines, while officially recorded unemployment increases.

There are indeed signs of rapid growth in Germany's shadow economy. According to Friedrich Schneider, an economics professor at the University of Linz and an expert in estimating the shadow economy, unrecorded German nominal GDP grew at annual average rate of 5.5% in 1995-2003 compared with 2.25% for recorded GDP (see Schneider, 2003). If we add Professor Schneider's estimates of the shadow economy to official GDP and employment, total real GDP and employment grew at annual average rates of 1.7% and 1.1%, respectively, compared with 1.3% and 0.5% for the official counterparts.

If Germany's key economic problem is not a traditional lack of competitiveness that can be cured by ('internal') real exchange rate devaluation, it may take longer for structural reforms to show the expected pay-off. For instance, a reduction in unit labour costs as a result of a cut in payroll taxes that were made feasible by social security reform, may not lead to a quick and meaningful boost in export demand. Rather, lower labour costs may be needed to induce a shift of resources from the shadow to the official economy.

Another implication of our analysis is that the appreciation of the euro may not have the widely expected devastating effect on German exports. Given their past experience, German companies may be more capable of dealing with a deterioration of their price competitiveness than some of their Euroland competitors. Hence, countries that in the past relied more heavily on improved price competitiveness to boost growth and employment, may feel more affected by euro appreciation. If this argument holds, the gap in growth between Germany and France, which benefited from larger gains in cost competitiveness in the past, could narrow in the future.

Are policy-makers taking deflation risks too lightly?

A number of market participants and economists hold the view that economic policy-makers take the risk of deflation in Euroland too lightly. The ECB has lowered rates less aggressively than the Federal Reserve to a level that remains considerably higher than US rates, even though growth is clearly weaker. At the same time, fiscal policy is struggling to contain budget deficits, and hence is likely to be moderately restrictive this year and the next. Long-promised and much-needed structural reforms are slow to materialise. This, so the argument goes, is inappropriate given the risk of deflation.

We take a different view. While structural policies have clearly disappointed expectations, monetary policy seems ready to act when circumstances change. Moreover, the benefits of sticking to sound medium-term fiscal policy objectives and of avoiding a serious conflict with monetary policy are significantly higher than the near-term costs of a moderately restrictive fiscal impulse.

The ECB is on the watch...

An important lesson from the Japanese experience is that central banks should err on the side of monetary easing, if there are serious risks of deflation (Ahearne et al., 2002). The rationale for taking deflation more seriously than inflation is that monetary policy is in a better position to deal with the latter. Hence, a monetary policy error inducing inflation is much easier to correct than an error inducing deflation. It seems that the ECB shares this view.

Since it took up operations, the ECB deviated twice in a significant way from the interest rate suggested by our calibrated Taylor rule.²⁵ The first episode occurred in spring 1999, when the ECB lowered central bank rates by 50 basis points despite a neutral signal from the Taylor rule. The cut came in the wake of the LTCM crisis, when market liquidity had dried up and deflationary risks appeared great. Although the ECB delayed the move (because of political pressure exercised by key Euroland countries), it eventually reacted, not because actual economic developments required lower interest rates but because deflation risks argued in favour of erring on the side of monetary easing. Soon after, it became clear that deflation was unlikely and the move had been an error. Hence, the ECB changed course and tightened monetary policy to rein in inflationary pressures that were unleashed in part by the erroneous rate cut.

The second episode took place in the aftermath of the terrorist attacks on the US, which dealt a severe blow to financial market and business confidence and, at the time, were seen to raise deflation risks. Again, the ECB cut interest rates below levels suggested by the Taylor rule to counter potential deflation. Hence, it seems fair to conclude that monetary policy is conscious of the risks of deflation and prepared to take

²⁵ The econometrically estimated Taylor equation should not, of course, be used as a benchmark to assess the ECB's performance. However, our calibrated Taylor equation is based on economically plausible, rather than econometrically estimated, parameter values. Hence, this equation has a more normative character and may serve as a benchmark to analyse ECB action.

pre-emptive action if such risks appear on the horizon. This view has been reinforced by the ECB's recent clarification of their goal of price stability (see the following section). Moreover, monetary policy still has considerable room to move rates lower. And even when the level of nominal rates approaches zero, a determined central bank may ease monetary policy further by pumping liquidity into the economy.

...but fiscal policy is constrained.

In their analysis of Japan's fall into deflation, Ahearne et al. (2002) point to the failure of fiscal policy to take pre-emptive action. They use scenario analysis to show that deflation could have been avoided had there been a combined monetary and fiscal policy stimulus. The analysis assumes that fiscal policy is an effective instrument for stimulating aggregate demand. This is certainly the case, when fiscal policy acts from a position of strength, which is characterised by low budget deficits and a sustainable public debt burden. But an expansionary fiscal policy may fail to give the desired fiscal stimulus when fiscal policy acts from a position of weakness. In that case, rising budget deficits and debt burdens may undermine investor and consumer confidence in the long-term solvability of the government and stifle the effects of fiscal expansion on demand. Japan's fiscal policy in more recent years is a good example of the loss of power of fiscal policy, as a result of severe weakness in government finances.

Critics of the monetary union have recently focused on the Stability and Growth Pact as a counter-productive constraint for fiscal policy. How can it make sense, they have asked, that fiscal policy is required to rein in deficits in times of economic weakness? It would be far preferable if fiscal policy could at least let the built-in stabilisers operate freely. Nevertheless, this is exactly the policy that the SGP intends to promote. The reason why fiscal policy in some countries presently faces a constraint is not a too-rigid framework set by the SGP, but their failure to let built-in stabilisers work when growth was strong. As a result, their government finances are now weak and, given concerns about long-run government solvability, the effects of fiscal expansion on demand would be highly doubtful. Thus, the SGP simply nudges governments towards a fiscal policy that prudence would have suggested in any case. When operating from a position of fiscal weakness, an expansionary fiscal policy is a weak shield against the risk of deflation.

Bottomline: Deflation is unlikely in Euroland

Despite recent stock price declines and economic weakness, the necessary conditions for deflation are still far from being fulfilled in Euroland. Both inflation and the expectations of inflation remain positive and housing prices continue to edge higher. Appreciation of the euro so far has been in line with historical experience and, despite patches of weakness, the financial system remains basically sound. Monetary policy is on the watch, while fiscal policy is trying to regain the room for manoeuvre lost during the upswing, as a result of insufficient budget consolidation.

4.4 The ECB's strategy review: Realigning theory with practice

In clarifying the definition of price stability as inflation of less than, but close to, 2%, the ECB has effectively established its past monetary policy conduct as the benchmark for the future. Similarly, the rearranging of the two ‘pillars’ of the strategy – with the monetary pillar now taking second place and the emphasis on the reference value for M3 growth reduced – amounts to realigning the theory with the actual practice followed in past years.

The ECB's ‘ugly duckling’

The ECB's monetary policy strategy consists of two basic elements: 1) a quantitative definition of price stability and 2) the organisation of the information and analysis of economic conditions that is used as a basis for monetary policy decisions. The ECB has defined price stability as an increase of the harmonised consumer price index by less than 2% in the medium-term, and it has adopted a two-pillar framework for its analysis. The first pillar gives a prominent role to monetary developments, while the second pillar comprises an analysis of a wide range of other economic and financial variables.

Almost since its presentation, the strategy has been heavily criticised by academics, analysts and market participants for a number of reasons. First, the critics have argued that the definition of price stability ('a year-on-year increase in the Harmonised Index for Consumer Prices [HICP]...of below 2%') is ambiguous. This may have been a linguistically correct criticism, but the real world does not appear bothered about it. There have been no signs that the definition has failed to anchor inflation expectations or induced the ECB to lean towards deflationary policies. Breakeven inflation rates implied by inflation-indexed bonds have ranged between 1.5% and 2%, and the vast majority of respected ECB watchers and watcher groups have concluded that the

ECB has made no major mistakes during the first four years of operations.

Secondly, the critics have argued that the upper limit of ‘less than 2%’ is too low. However, there were numerous exogenous shocks to inflation during the first four years of EMU (oil, food, euro cash introduction, exchange rate changes) that could all be absorbed without much monetary policy stress. Despite the numerous shocks, inflation has averaged close to 2% since the beginning of EMU, and there have been no signs that this average will move higher or lower in coming years.

Much has also been made of the results of the Balassa-Samuelson (B-S) effect in the context of EMU enlargement. However, in a recent study, we put this effect at 1% to 2.5% for the accession countries (Gros et al., 2002b). Taking the average of 1.75% (which is also the estimated B-S effect for Poland) and assuming the share of EMU accession countries at 6% of EMU GDP would imply an increase in EMU inflation by 0.1% due to the B-S effect. That hardly justifies raising the ECB’s inflation target.

Thirdly, the critics have claimed that the first pillar (analysis of monetary and credit aggregates) would be redundant and lead to confusion. We do not share the view that it is redundant. Apart from being able to signal a long-term inflation risk, a close analysis of credit and monetary developments helps to keep an eye on asset price inflation (see below). Historical experience in Japan, and more recent experience in the US and the UK, show that a too-narrow focus on consumer price inflation in a one-to-two-year time horizon, may expose central banks to the risk of missing the emergence of a liquidity-driven asset price bubble. Such a bubble may not have a tangible effect on consumer prices during its expansion phase, but could cause consumer price deflation when it bursts. Hence, to avoid financial instability and deflation, a separate analysis of money and credit developments appears warranted.

Moreover, we do not think the monetary pillar continues to lead to confusion. Markets and analysts have gained a sufficiently good understanding of how the ECB looks at the monetary pillar, so that the release of an M3 growth figure above consensus expectations currently fails to trigger any market reaction. Should monetary developments turn into a risk for price stability in the medium-term, the ECB could easily signal this to the markets and change market reaction to the M3 releases.

A few clarifications

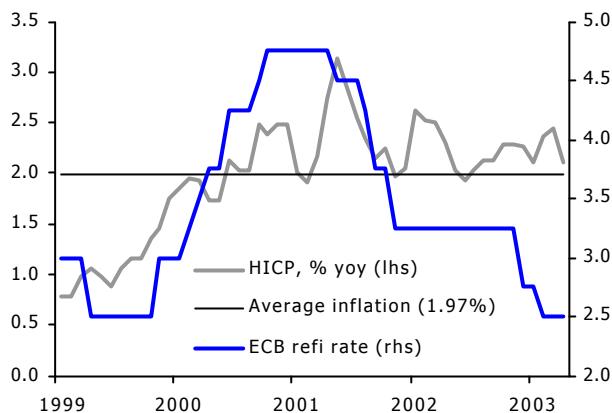
Given that criticism of the strategy is not well founded, it did not come as a surprise that the review brought mostly presentational changes, such as

a reordering of the two pillars and the foregoing of the fixed annual reassessment of the M3 reference value. There was, however, one important clarification. Apart from reconfirming the definition of price stability as “a year-on-year increase in the HICP for the euro area of below 2%”, the Council also agreed “that in the pursuit of price stability it will aim to maintain inflation rates close to 2% over the medium term”.

Some commentators have interpreted this as a ‘relaxation of the inflation goal’. We disagree. The ECB’s clarification essentially establishes the way it pursued its goal of price stability over the last four years as a benchmark for its future conduct. Since 1999, the monthly year-on-year inflation rate averaged 2.0%, close to the ECB’s clarified definition of price stability (see Figure 4.18). During that period, the ECB tended to embark on monetary tightening when inflation trended upward, and it eased when inflation trended downward. The momentum of monetary policy tightening rose the more that inflation exceeded the 2% mark, and easing became more aggressive the further that inflation fell below 2% (in a deliberate attempt to minimise the risks of deflation). In effect, the ECB behaved as if it wanted to see inflation of less than 2%, but not much less. This pragmatic approach to the pursuit of price stability now appears to have been formalised.

The reordering of the two pillars – with the economic analysis now coming first and the monetary analysis second – and the omission of an annual reassessment of the reference value of M3 growth, are further reconciliations of theory with practice. During most of its existence, the ECB has conducted monetary policy on the basis of its economic analyses and forecasts, and used the monetary analysis only as a crosscheck for the longer-term inflation outlook. This approach has now become the new benchmark. It is a little surprising that the Council could not agree to add a reference to the monetary pillar as a gauge for asset price inflation. ECB Chief Economist Ottmar Issing had played with this idea in a number of speeches delivered in the months before the conclusion of the strategy review, but apparently could not convince his colleagues of such a reference. In any case, omission of an explicit reference to the monitoring of asset price developments through money and credit developments will not preclude future use of the monetary pillar in the strategy for this purpose.

Figure 4.18 Price stability: A ‘clarification’, not a ‘change’



Sources: DB Global Markets Research and ECB, Eurostat.

How to leap-frog inflation targeting

Rather than being clipped back to a more narrow inflation targeting, the ECB’s monetary strategy could be developed further, to include financial stability as an intermediate objective for securing price stability over the medium to long term. According to Mr Issing, “Price stability and financial stability both cannot be achieved in a sustainable way one without the other. They tend to mutually reinforce each other in the long run” (Issing, 2002). Yet, as financial instability may also occur at times of low inflation, Issing warns “...that price stability is a necessary but not a sufficient condition for financial stability. This means that if the central bank has a primary objective to maintain price stability over the medium-term, simply pursuing an inflation target strategy according to an inflation forecast of one or two years horizon might not be the optimal policy strategy” (*ibid.*, p. 8).

Based on this view and given its definition of price stability as low inflation over the medium-term, the ECB has room to include financial stability as an intermediate objective in its price stability goal. The latter could be defined as a state of financial market efficiency, where prices appropriately reflect all available information and price changes occur in a timely fashion in response to new information. Thus, a state of financial market efficiency would exclude market conditions, where prices have been inflated beyond fundamentally appropriate values by the irrational behaviour of investors (e.g. in the forms of selective recognition of information and herd behaviour), or have been depressed below these

levels (e.g. by a feeling of a loss of control after the burst of a price bubble). The objective of financial stability would, of course, be qualitative in nature, but its pursuit could be monitored in a quantitative framework.²⁶ The ECB's monetary pillar could be helpful in this regard.

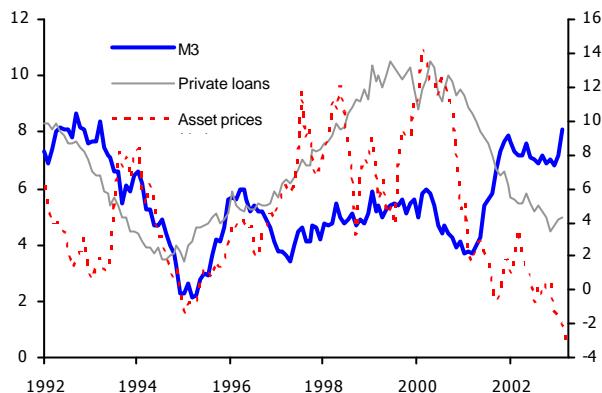
Since the seeds of financial instability can also be sown in an environment of low inflation, it is not enough to simply monitor and control inflation. But the ECB's new second pillar, the analysis of monetary developments, could play a role in the pursuit of financial stability. In a recent paper, Borio and Lowe (2002) present empirical evidence that sustained rapid credit growth combined with large increases in asset prices appear to increase the risk of financial instability. Furthermore, in an earlier paper, Hofmann (2001) argued that there is a dynamic interaction between credit growth and increases in property prices, with higher property prices raising the demand for credit, but also higher credit supply boosting property prices.²⁷

The relationship between credit growth and asset price changes in Euroland is illustrated in Figure 4.19. Asset price changes are calculated as a weighted average of year-on-year changes in the broad EUROSTOXX equity price index and Euroland house price changes, with weights calculated from data on the distribution of private household assets in Germany, France and Italy (provided in Table VI.1 of the *OECD Economic Outlook* of December 2000). As the chart shows, periods of strong asset price increases have tended to be accompanied by periods of strong credit growth and vice-versa (with a correlation coefficient of 0.59). Deviations from the pattern of positive correlation in 1993 and 1998 were due to temporary sharp changes in stock prices, which resulted from hopes for economic recovery in 1993 and the emerging markets crisis in 1998.

²⁶ In this respect, the ECB has already stated its intention to improve statistical coverage of financial indicators, such as the launching of a loan officer survey and the compilation of new indicators of indebtedness.

²⁷ Ireland is an interesting case. The Central Bank of Ireland notes: "Between 1996 and 2000, new house prices rose by 92% and existing house prices by 126%. Nominal year-on-year growth rates for prices of existing houses peaked at over 35% in 1998. It should be noted that overall liquidity in the Irish economy (measured by either money supply growth rates or private credit sector credit) was highly correlated with property price increases" (see G10 Contact Group..., 2002).

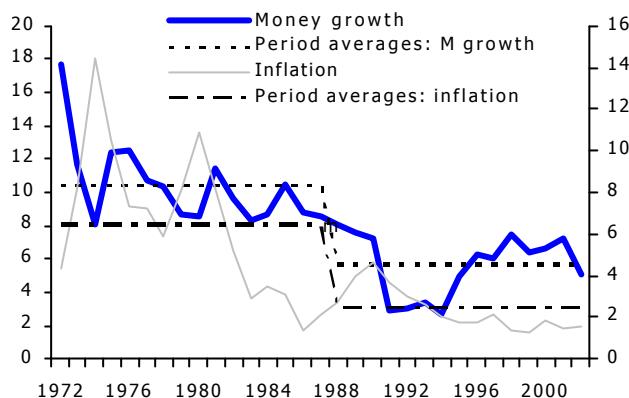
Figure 4.19 Money, private loan growth and asset price inflation in the eurozone



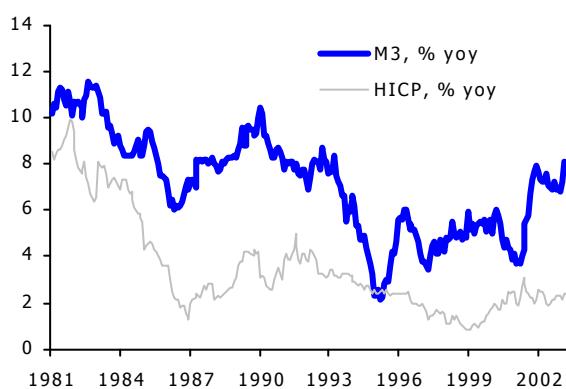
Sources: ECB and DB Global Markets Research.

Nevertheless, there was no discernible positive correlation between money growth and asset price changes (with a correlation coefficient of –0.12). To the contrary, it seems that the drop in stock prices (from 2000 to 2002) induced a rise in money growth as investors preferred low-risk financial assets (included in M3) to equities.

In any case, money growth ought to be monitored as well, as high money growth tends to be associated with high increases in prices of goods and services. This is illustrated in Figure 4.20, showing aggregate money growth and average inflation for the US, Japan, Germany and the UK since the early 1970s. High inflation over the 1970s coincided with strong money growth, while lower inflation thereafter was accompanied by lower money growth (with a correlation coefficient of 0.41 for the entire period). In Euroland, M3 growth has been an even better long-term leading indicator for inflation, with a correlation coefficient of 0.82 between money growth and inflation, one and a half years later (when both series are smoothed by a 12-month moving average (see Figure 4.21 below).

Figure 4.20 Money growth and inflation for G4

Sources: Eurostat, ECB and DB Global Markets Research.

Figure 4.21 Money growth and consumer price inflation in Euroland

Sources: ECB, DB Global Markets Research and NSI's.

Our conclusion from the above discussion is that, with monetary and especially credit developments closely linked to financial stability, a separate monitoring of these variables puts the central bank in a better position to achieve financial and hence long-term price stability.

Development of the ECB's existing strategy in this direction would require greater emphasis on the medium-term character of the price stability definition and a greater role for credit developments in the monetary analysis.

At the same time, the lower emphasis on the numerical reference value for M3 growth makes it clear that this value offers only a broad guidepost for appropriate money growth in the long-run, and hence has little relevance for month-to-month decisions on interest rates. A change of the strategy in this direction implies a move away from a more rule-based monetary policy towards a more discretionary one. This may seem regrettable to some, but is unavoidable in our view. A more discretionary monetary policy should be accompanied by a high degree of transparency in monetary policy decision-making, so as to avoid creating uncertainty as a result of seemingly arbitrary decisions. The ECB has made considerable progress in improving transparency in recent years.

Beyond pure inflation targeting

In Table 4.1 we compare the key features of a revised ECB strategy to those of a stylised inflation targeting strategy. Compared with pure inflation targeting, the revised ECB strategy should make a stronger contribution to ensuring financial stability by bringing this objective directly under the realm of monetary policy. Excessive credit growth, coupled with a broad-based rise in asset prices, would signal the need for monetary tightening, even if the outlook for consumer price inflation remained favourable. By leaning against excessive credit and asset price growth, the ECB could help to prevent asset boom-bust cycles and thus reduce both inflation and deflation risks.

Close cooperation between monetary policy and financial supervision could also help to counter regional asset price bubbles, as they may arise from a common interest rate applied to an area with significant divergence in real economic performance. For instance, a real estate price boom in a Euroland country caused by a common interest rate that is too low for that particular country could be countered by requiring banks to set aside more reserves against loans to borrowers in that country, or by requiring house buyers to raise the equity share in the financing of their purchases.²⁸ Against this, the objective of ensuring financial stability is

²⁸ Taking account of cyclical effects on credit losses is known as dynamic provisioning. Although it could make an important contribution to financial stability in Euroland countries, dynamic provisioning is presently practiced only

largely left to the banking and financial supervisory authorities under pure inflation targeting.²⁹

Table 4.1 Revised ECB strategy vs pure inflation targeting

	Revised ECB strategy	Pure inflation target
1. The goal of price stability		
Definition	Less than 2% inflation over the <i>medium-term</i>	X% inflation over a <i>specific time frame</i> (the next one to two years)
Scope	Broad, including financial stability	Narrower, focusing on consumer price inflation over a clearly defined time horizon
2. Analytical framework		
Control of inflation	Analysis of all variables relevant for price stability, against the background of an economic forecast	Comparison of inflation forecast for the next one to two years with the inflation target
Control of financial stability	a) Analysis of money and credit developments in conjunction with asset price changes and b) Involvement in banking and financial supervision	Cooperation with financial and banking supervisory institutions

Sources: ECB and DB Global Markets Research.

Why development of the strategy is useful

Apart from ensuring continuity amid senior personnel changes, the clarification and further development of the ECB's monetary policy strategy can make an important contribution to strengthening the bank's credibility, with positive consequences for the euro and the bond market. In the past, market participants have tended to criticise the ECB, for a lack of transparency and an arcane monetary policy strategy, reminiscent

in Spain. (The role of micro policies for financial stability is discussed in G10 Contact Group..., 2002).

²⁹ In recognition of the shortcomings of pure inflation targeting, Bernanke and Gertler (1999) have advocated a more flexible approach to inflation targeting, providing a unified framework for achieving both general macroeconomic and financial stability. Thus, it is conceivable that a revised ECB strategy and a more flexible inflation-targeting strategy converge to the same model.

of the Bundesbank's strategy of monetary targeting. Although difficult to show, this criticism may have contributed to a risk premium on Euroland bonds and the euro exchange rate. Over recent years, the ECB has succeeded in quieting some of its critics by significantly improving its communications policy. Nevertheless, the feeling has persisted that the ECB's monetary policy strategy is 'out of date' and hence not quite capable of delivering appropriate monetary policy decisions in a timely way.

Against this background, the clarification and further development of the strategy, with a broadening of the definition of price stability and a new interpretation of the monetary pillar of the strategy, would appear very useful. If the ECB succeeds – as we hope it will – in explaining the advantages of a revised strategy relative to pure inflation targeting, it could establish itself as the most advanced major central bank.

Our main criticism of the new strategy is that it represents a missed opportunity to clarify the nature of the monetary 'pillar'. It should be clear by now that under present circumstances it is not useful to just look at M3 growth and conclude that potential inflationary pressures exist because M3 has grown more quickly than a certain reference value (which in any case has – for good reasons – been ignored for some time now). We would argue that the monetary pillar should be interpreted more broadly as a 'financial stability' pillar. The pursuit of financial stability requires the analysis of a broad range of issues. For example, the primary issue at present is not how the ECB should react if another financial market price bubble were to arise, nor whether the euro area banking system (or even that of any member country) is on the brink of collapse. Rather, an important issue at present is whether the balance sheets of the non-financial sector are overstretched so that firms cut investment to achieve the lower debt/equity ratios demanded by financial markets in the post-bubble environment (with potentially adverse consequences for price stability). Hence we would argue that the ECB should explain that, in the monetary pillar, it will look at the evolution of financial structures in a broad sense, to find out whether disequilibria in balance sheets or indebtedness present a risk to economic stability.

CHAPTER 5

THE REVIVAL OF THE EURO

As discussed in earlier parts of this report, the external value of the euro has the potential to become an important factor in the setting of macroeconomic policy in the euro area. More specifically, it was argued in Chapter 1 that the euro area is sufficiently open in terms of its external trade that movements in the external value of its currency might have a major impact on output and inflation, while in Chapter 4, the main risk of deflation was seen as linked to continuing appreciation.

The past four and a half years of the history of the euro provide illustrations of these points. Simulations with macroeconomic models suggest that Harmonised Index of Consumer Prices (HICP) inflation would hardly have moved above the 2% upper limit throughout 2000-01, if the euro had depreciated by only half of the actually observed rate during the first two years of its existence. Conversely, there would be no discussion of a risk of deflation now, if the euro were seen as likely to stabilise at its present external value. The 15% appreciation in effective rate terms, which has been observed over the past 15 months, can be estimated to have taken the inflation rate down by about one percentage point in each of the two years 2003 and 2004. Given that inflation is now hovering around the ECB's target of 2%, there would not be much inflation left by the end of next year in such a scenario.

In principle, movements in the exchange rate can be offset by movements in interest rates, but that is impossible in practice because of the differences in the transmission channels. Exchange rate movements can have a mechanical impact on inflation and output that can not be fully neutralised. All that a well-designed monetary policy can achieve is to dampen the second-round effects of such movements on wages and prices. This has been accomplished so far. But it might have been easier to keep potential inflationary pressures in check, rather than try to 'reflate' a weak economy. Finally, as to the potential for influencing the exchange rate more directly through monetary policy, there is little basis for any optimism in the long experience of floating exchange rates.

In this brief, final part of our report, we want to return to the challenge that these considerations pose concerning the attribution of responsibilities for exchange rate policy in the euro area. In the CEPS MPG report for the year 2000 (see Gros et al., 2000), we discussed at some length the issue of the external representation of the euro area – obviously then in the context of the weakness of the euro in its early

existence. But it is not only the change of direction in the exchange rate that seems to justify a reconsideration of the issue; two other factors have emerged to make the subject more topical.

One is the re-emerging divergence over the role of macroeconomic policies between the monetary and political authorities in the US on the one hand and in the euro area on the other hand. The other factor is the limited attention given to the issue by the European Convention, which delivered its (in some other respects quite radical) draft Constitutional Treaty to the European Council in June 2003.

We shall deal with these two factors in turn, leading up to the argument that there is indeed a good case for reinforcing the political element in the governance of the euro area and, in particular, in an external role. But first it is necessary to recall the main provisions of the present system.

5.1 How has the present framework for decision-making and external representation worked so far?

The Maastricht Treaty seems to offer a clear answer to the question of who is responsible for the external value of the euro. The formulation of the primary objective of monetary policy as the maintenance of price stability leaves little room for any exchange rate target. The treaty went to considerable lengths to minimise the potential threats to the pursuit of the primary objective arising from public sector deficits and their financing, as well as from exchange rate considerations. But a certain tension persisted in the latter area between this ambition and the traditionally central role of the political authorities in shaping exchange rate policy.

The Treaty of Maastricht determined in Art. 109 (to be slightly modified in the proposed Art. III 223 of the Draft Constitutional Treaty, see Box 5.1) a role for the political authorities to participate in the management of the external value of the euro in two distinct circumstances.

First, the Council of Ministers is empowered to enter into “formal agreements on an exchange-rate system” for the euro vis-à-vis non-EU currencies. But two preconditions will greatly complicate any such decision: it has to be reached unanimously and there has to be prior consultations with the Eurosystem to assure consistency with the objective of price stability. This remains a very unlikely scenario.

Secondly, in the absence of any formal agreements, the Council of Ministers may, by qualified majority “formulate general orientations for exchange-rate policy” – again after assuring that such orientations are “without prejudice to the primary objective of price stability”.

Box 5.1 Rules for determining exchange rate policy for the euro area

1. By way of derogation from [Article III-222 (ex 33)], the Council, acting unanimously on a recommendation from the European Central Bank or from the Commission, following consultation with the European Central Bank with a view to reaching a consensus compatible with the objective of price stability and after consultation with the European Parliament in accordance with the procedure laid down in paragraph 3 for the arrangements there referred to, may conclude formal agreements on a system of exchange rates for the euro in relation to non-Union currencies. The Council may, acting by a qualified majority on a recommendation from the European Central Bank or the Commission and after consulting the European Central Bank in an endeavour to reach a consensus consistent with the objective of price stability, adopt, adjust or abandon the central rates of the euro within the exchange-rate system. The President of the Council shall inform the European Parliament of the adoption, adjustment or abandonment of the central rates of the euro.
2. In the absence of an exchange-rate system in relation to one or more third-country currencies as referred to in paragraph 1, the Council, acting either on a recommendation from the Commission and after consulting the European Central Bank or on a recommendation from the European Central Bank, may formulate general orientations for exchange-rate policy in relation to these currencies. These general orientations shall be without prejudice to the primary objective of the European System of Central Banks, to maintain price stability.
3. By way of derogation from [Article III-222 (ex 33)], where agreements on matters relating to the monetary or exchange-rate system are to be the subject of negotiations between the Union and one or more states or international organisations, the Council shall, acting on a recommendation from the Commission and after consulting the European Central Bank, decide the arrangements for the negotiation and for the conclusion of the agreements. These arrangements shall ensure that the Union expresses a single position. The Commission shall be fully associated with the negotiations.
4. Without prejudice to Union competence and agreements as regards economic and monetary union, Member States may negotiate in international bodies and conclude international agreements.

Source: Draft Treaty establishing a Constitution for Europe (CONV802/03), Article III (International Agreements) revised text of 12 June.

These formulations strongly suggest that the Eurosystem retains the decisive influence over the external aspects of monetary policy and that

the political authorities have a more limited role than their counterparts in the United States (or Japan).

The pre-eminence of the monetary authorities in Euroland is reinforced by the fact that official international reserves in the latter two countries are owned by the respective Treasuries, which are accountable to their political authorities, whereas in the euro area ownership of reserves has been transferred to the Eurosystem (i.e. the ECB). In the transatlantic relationship there is a certain asymmetry between the respective assignments of responsibility, but that has not prevented a joint understanding between the dominant actors that foreign exchange interventions should be used very sparingly while domestic considerations are allowed to dominate in the design of monetary policy.

Developments over the early years of the euro have not made further clarification of the assignment of responsibilities quite as urgent an issue as was expected at the start. During the initial two years of euro depreciation, there was only one publicly known controversy – associated with the suggestion by the then German Finance Minister Oskar Lafontaine, to seek a target zone arrangement for the euro. Although France was not totally unsympathetic to the idea, no effort was made during 1999 nor most of 2000 to formulate ‘general orientations’ for the euro exchange rate. To have done so would have been difficult; while the Eurosystem became increasingly concerned about the inflationary impact of the continuing slide in the euro, several participating governments were not unhappy with the consequent improvements in competitiveness, at a time when there were still perceptions of slack in their economies, even though these perceptions now seem to have been unfounded.

In retrospect, the output gap in the euro area seems to have been eliminated in the course of 2000, as we have argued in the analysis of productivity developments, hence weakening the case for any major stimulus from external demand through a weak euro. But as the euro weakened further in the spring and summer of 2000, there was a convergence of views. The concern over inflation in the Eurosystem coincided in the end with a sense of political embarrassment among governments, over the performance of the euro in the currency markets, creating support for interventions to stem the slide. Such interventions were undertaken jointly with other G7 governments in September – even though it was fully recognised that the normal case for intervention, based on a build-up of short-term positions against a currency, was not observable. The main cause of depreciation was a major and rather steady outflow of long-term funds from the euro area, primarily towards the

United States. The degree of undervaluation of the euro had by then become so clear that authorities outside the euro area saw it as a threat to international monetary stability. The amounts committed were modest – and the support in words and deeds from the United States and the United Kingdom was less than might have been hoped for. Interventions were repeated unilaterally by the Eurosystem during a few days in November and markets were left in no doubt that the official reserves of the euro area were fully adequate to the task of sustaining them; indeed, there had initially been much talk of an overhang of US dollar reserves in the participating central banks.

The brief experience of modest interventions did help to create more two-way uncertainty in the foreign exchange market and to halt the decline in the euro, although a more important factor may have been the long-forecasted deceleration of activity in the United States at a faster pace than in the euro area (which began to be observable towards the end of 2000). Anyway, the adoption of ‘general orientations’ was not put to a real test at the time.

We now move to a discussion of whether it is more likely to arise in the nearer-term future as a result of three factors that distinguish the present from the early years with the euro: significant strength of the euro, policy divergence and conflict with the United States, and new considerations of governance in the euro area in the light of the outcome of the recently concluded European Convention.

5.2 The increasing importance of the external side for the euro area

The appreciating euro and policy assignments in the euro area

The euro has gradually moved back near its starting level vis-à-vis the US dollar, i.e. €=\$1.17. This in itself should not be a source of concern, since most of the available research suggests that this is fairly close to, though probably still below, the longer-term equilibrium for the most important bilateral exchange rate. But as argued previously, in effective rate terms, the euro is back to its strength of 1995. This is due to the close correlation of some other important third-country currencies with movements in the dollar/euro rate, notably the pound sterling, the yen and several East Asian currencies; some of the latter are even pegging to the US dollar. Still it has to be noted that although the pace of appreciation has been swift at times since the spring of 2002, it has been fairly smooth and hence not providing any justification for action on the grounds of correcting disorderly market conditions. Appreciation has, as argued above, helped to reduce inflation. The euro area still has a small surplus

on its current account, whereas the US deficit is continuing to expand and has reached major proportions. A priori, the grounds for any action more specifically designed to stem what has obviously been a desirable contribution to external adjustment in the Atlantic area seem tenuous at best. Yet it seems realistic to predict that a phase of appreciation is not simply a mirror image of the weakening euro experienced in the first two years. Appreciation is occurring at a time of weak activity in the euro area with output growth running at about 1% per year for the 2001-03 period, and (by now) a significant negative output gap, even relative to the slowing rate of growth of potential output.

The sources of the recent strength of the euro are difficult to find in the performance of the euro area itself. Output growth has remained faster in the United States, and structural reforms, which could boost permanent income and hence consumption, are barely starting. In any case, the initial effects of such reforms, until they are clearly perceived to be gaining momentum, are unlikely to be strong. Therefore, there is a strong temptation to look to net exports, the aspect of demand that has performed the best in recent years, as a factor that should not be allowed to weaken rapidly – in short, to react in much the same way as many other trading partners of the United States, by stemming the tendency for the domestic currency to appreciate.

Discussions among financial analysts are turning towards alarming scenarios, in which the euro overshoots by matching the US dollar-ECU bilateral strength against the US dollar of 1995 with a rate of €1=\$1.35 or beyond. If the euro were to overshoot its approximate longer-term equilibrium level of around €1=\$1.20 by as much as it undershot three years ago, that could take it to the \$1.50-\$1.60 range. While it would be naive to rule out such a scenario (which would clearly raise the risk of deflation in the euro area as a whole), it is likely that the political authorities will be more prone to be alarmed by it than the Eurosystem, hence pointing to a potential source of conflict and a risk of efforts to formulate ‘general orientations’ for the euro exchange rate earlier than the monetary authorities would like to see. Anyway, the present scenario calls for better organisation of the formulation of political opinion than has been available so far and, in particular, for a clearer external representation of the euro area in discussions with the US authorities and in the G7 meetings of finance ministers. Otherwise, the risk of conflicting signals from inside the euro area could well arise, as the euro appreciates further.

Divergence of economic performance and the re-emergence of policy conflicts with the United States

The second set of reasons for reconsidering economic governance of the euro area and external representation is the increasingly clear divergence in economic performance of the euro area and the US economies, and the re-emergence of conflicts over the proper role of macroeconomic policies in economic stabilisation. Though linked to the problems in exchange markets, this second set provides stronger arguments for raising the political profile of the euro area. There are three main issues that can be identified.

First, and most closely related to the themes dealt with earlier in this report, is the difference in apparent productivity trends on the two sides of the Atlantic. Whereas the US economy experienced a lift in its productivity from the mid-1990s, which seems to have survived the slowdown since late 2000, the euro area did not; in fact, it even appears to have faced a slowdown relative to earlier performance in the most recent years, whether measured by output per hour or total factor productivity. Hence the performance of the euro area economy has deteriorated relative to that of the United States. The effort to reverse that outcome through the Lisbon Agenda of 2000 has so far met with limited success. Although the projected difference in potential growth per capita, (i.e. after correcting for differences in population developments), is ‘only’ on the order of one-half of a percentage point over the next five years (see OECD, 2003), this is a significant difference from the perspective of future growth in consumption and investment – and the more so the longer it is seen as likely to persist (see Table 1.1 in Chapter 1).

The tasks for structural reforms and the need for cautious fiscal policies through expenditure control and pension reform to make room for lower taxes have been outlined above. But the need to represent this agenda to the outside world is clearly one that strengthens the case for a clear external representation rather than leaving the scene primarily to the Eurosystem (which has no direct responsibility in this area) or to the Commission.

Secondly, the divergence in the approaches to macroeconomic policies on the two sides of the Atlantic has become increasingly evident during the period of modest growth since late 2000. From the pragmatic and discretionary perspective that predominates in US policy-making, the opening up of a negative output gap during a slowdown should quickly trigger a cut in interest rates, while the administration and Congress

should move to sustain consumer and business spending, primarily through tax cuts.

Policy-makers in the euro area are more inclined to regard a slowdown in economic activity as, at least in part, a correction to earlier cyclical strength. In this perspective, the emphasis is more on the medium-term performance, on avoiding periods of overheating and their associated inflationary risks, and on the dangers of excessively encouraging demand when a slowdown occurs. Given the starting point of major stress on public finances in a number of euro area countries and the looming extra burden of ageing-related expenditures in the coming decades, the concept of longer-term sustainability of public finances plays a major role in the European policy debate, providing the justification for the prudent budgetary rules of the Stability and Growth Pact. This concept is nearly absent in the US policy debate.

This contrast in approaches is not new. It showed up dramatically in the 1980s during the period of major fiscal expansion under President Reagan. Most European policy-makers and international financial institutions voiced strong concern at the time, but the conflict in approaches was almost forgotten in the course of the 1990s, when strong growth in the US economy and prudent fiscal policies – possibly because the administration and Congress could not agree on anything else – combined to eliminate the large federal budget deficit. But the seeds of the present divergence date from this period; the Federal Reserve, to its credit, was early in recognising an upward shift in US productivity and acted to exploit the improved short-term trade-off between lower unemployment and inflation that this shift entailed. It was less rapid in recognising that – once households and firms had come to share the view that the upward shift was more than purely cyclical – domestic demand would run ahead of supply and generate a boom that could not be sustained. The strength of the long boom made a sharp slowdown inevitable as the US economy worked off the excess capacity generated during the boom. The aggressive easing of the Federal Reserve since January 2001 has provided the most recent vivid illustration of an absence of the timidity remarkable among central banks.

A major fiscal expansion has been added to this since early 2001, which moved the budget position from a small surplus to a deficit on the order of 4.5% in 2003, with little prospect of correction in the foreseeable future. Both important tax cuts and major increases in expenditures have been enacted and the earlier tight system of expenditure controls has been allowed to lapse. The most recent tax package, though smaller than

initially sought by the administration, will have its major effect in 2003-04, through the advancement of earlier announced tax cuts and will clearly have the effect of bringing demand growth temporarily back above the growth of potential output. Despite the fiscal expansion, not only short-term, but also long-term interest rates remain at historically very low levels, facilitated by the low inflation expectations that have been encouraged through the loud concerns expressed about the risks of deflation and the vigorous way in which the Federal Reserve has announced its intention to deal with that risk. Were this risk to be recognised as exaggerated, interest rates would no doubt move up quite strongly. Combined with the relatively high levels of debt, particularly in the household sector, the prospect of the continuing strength of consumer demand looks precarious.

The contrasting approaches to macroeconomic policies imply a major potential for conflicts across the Atlantic. The US authorities clearly find the euro area unresponsive to the need to restore growth outside the United States, while the euro area authorities are increasingly concerned about the perceived lack of fiscal responsibility in the United States. In the absence of other corrective mechanisms, the adjustment falls squarely on the US current account and depreciation of the US dollar. The drain of demand from the deteriorating external position, as the result of continuing faster growth in the United States, overwhelms the effect of improving US competitiveness through a weaker dollar.

Thirdly, the US current account deficit has become larger than any realistic prospect of financing it smoothly through an inflow of longer-term funds. The US current account is now widely expected to reach about 5% of GDP during the next year. Even with parallel growth in the United States and its trading partners, the US current account has shown a historical tendency to deteriorate, and growth will continue to be faster this year and next. A return to a more neutral stance of monetary policy in the light of the fuller use of resources would add further to the size of the US current deficit and bring it unmistakably into unsustainable territory, which even major depreciation could not correct. This would no doubt be more painful for the euro area economy than for the United States itself, although it could be argued that it has been brought about primarily by US domestic policies. For this reason, the role of reinforced external representation at the political level should not principally be to attribute blame for past events and policies, but to discuss with the US policymakers and others in global macroeconomic fora how the unsustainable position could unfold in a more constructive way.

The central contribution by the euro area would be to demonstrate its readiness to improve Europe's growth prospects, without resorting to shorter-term macroeconomic stimuli that would later have to be reversed.

5.3 Reform of the external representation of the euro area

The work of the Convention on the Future of Europe that has drawn up a draft Constitution (or rather Constitutional Treaty) for the EU has so far delivered surprisingly little in the area discussed here. As mentioned above, the rather stringent conditions of Article 109 of the Maastricht Treaty on exchange rate systems have been substantially confirmed. The only new element in the Draft Constitutional Treaty seems to be the proposed Article 85, which we will briefly discuss below.

The problem of how to organise the external representation of the euro area has been debated for some time now. To date, only two basic models seemed to be available, which follow the existing patterns in other areas.

One would be the upgrading of the member of the European Commission responsible for Economic and Financial Affairs to become a 'Mr Euro'. This would be analogous to the arrangements in areas where explicit authority to act externally has been delegated to the Commission (i.e. trade and competition policy). But this 'Community method' is unlikely to find favour in the absence of vesting similar authority with the Commission in the macroeconomic area, going well beyond the monitoring of individual country performance and policies.

The other model would be the one that has been applied in the area of the Common Foreign and Security Policy, where an eminent person (Javier Solana) was chosen by the European Council to act as the representative of the CSFP. This was a remarkable decision, in view of the occasional major differences between the national positions taken by different EU states in this area, as most recently illustrated during the Iraqi conflict.

Our 2000 report (see Gros et al., 2000), and many other commentators noted some surprise that a similar ambition to strengthen external representation had not become visible in the area of international macroeconomic issues, where the convergence of the interests of the participants is presumably stronger than in the controversial area of the CFSP. The present system where the president of the ECB participates in G7 meetings together with the finance ministers of the four largest European countries and the president of the Eurogroup (if the latter is not already included) is clearly not fully satisfactory and can easily lead to conflicting messages. The six-month rotating presidency of the Eurogroup (with a year of mandate if the president of the Council is from

a non-euro country) is not conducive to continuing dialogue with the main partners of the euro area. Instead, a president elected by colleagues for a longer period, say two and a half years and renewable once (his/her mandate could then coincide with the mandate of the new president of the European Commission, which should be five years according to the Convention), would seem an appealing innovation, no doubt also appreciated by the United States, whose officials sometimes express confusion over the present arrangements.

It could have been expected that the issue of economic governance and external representation would have been addressed at the European Convention and a preference for either the Community or the intergovernmental approach clarified. Surprisingly, this was not the case; the Convention did not modify present arrangements for the euro area in these respects. This is peculiar since the Convention did move away from the rotating presidencies for the ‘informal’ Eurogroup, replacing it with a president elected for a period of the length equal to that suggested above (but without mentioning the possibility of renewal; see the protocol on the Eurogroup, in Annex II of the Draft Constitutional Treaty, [CONV 802/03], 27 June 2003).

It also proposed a modification of the conduct of the CFSP, by unifying the present positions of Mr Solana and Mr Patten, the Commission member with responsibility for External Affairs. The new foreign minister of the EU, ‘Mr CFSP’ would have the unique position of being at the same time an intergovernmental official and a member of the Commission. One might regard this new idea as a third possible model for a ‘Mr Euro’, though at present it seems unlikely that the intergovernmental conference (IGC), to start in October 2003, will revive the idea of such a function. Presiding over the Eurogroup would hardly in itself be a full-time job; hence the logical choice would be one of the current members of the Eurogroup – even though the length of the mandate could create conflicts with national election schedules. Combining the two functions, as for ‘Mr CFSP’, would resolve that problem and would seem to deserve further consideration in the IGC, even though there may be objections as to how one can reconcile the two mandates of an elected president and a member of the Commission. The latter has legitimate grounds for worrying about having such an atypical member in its ranks and about the implications of contiguous areas of responsibility within the Commission.

The European Convention, in the end, proposed only the following new element to the Draft Constitutional Treaty:

Article 3 (Article III-85)

1. In order to secure the euro's place in the international monetary system, Member States which are members of the eurozone shall coordinate their action among themselves and with the Commission with the view to adopting common positions within the competent international financial institutions and conferences. They shall defend and promote those common positions.

Where appropriate, the European Central Bank, without prejudice to its independence, shall be fully associated with that coordination.

2. On the basis of that coordination, the Council, on a proposal from the Commission, may adopt appropriate measures to ensure unified representation within the international financial institutions and conferences.

3. For the measures referred to in this article, only Member States which are part of the eurozone shall vote. A qualified majority shall be defined as the majority of the votes of the representatives of the Member States which are part of the eurozone, representing at least three-fifths of their population. Unanimity of those Member States shall be required for an act requiring unanimity.³⁰

This provision is clearly not satisfactory. All it is likely to achieve is a regularisation of existing ad hoc arrangements. Member states have so far been so strict in defending their participation in international financial institutions and conferences that little progress can be expected, despite the fact that they all realise that their individual influence is close to zero, whereas their combined weight would rival that of the US and could often be decisive.

We propose that concrete consideration should be given to appoint a 'Mr Euro', a sort of 'foreign minister of the eurozone' during the ICG that will start later this year. In the general framework for the economic governance of the EU that is emerging from the work of the Convention, it seems that the best candidate for that job would be the president of the Eurogroup. This person would have the confidence of his/her colleagues because he/she would have been (s)elected by them for a period of two

³⁰ The wording of this article is still under discussion. See modifications in CONV836/03, 27 June 2003.

and a half years. This solution would also make sense in light of the formal recognition of the Eurogroup in the constitution (albeit as an informal forum) and the fact that for some time to come, the countries of the eurozone might constitute a minority within the EU.

5.4 Concluding remarks

In conclusion, it seems clear that the case for a new look at the governance of the euro area and its external representation has strengthened as a result of recent developments. The appreciation of the euro, the divergence of performance and policies relative to the United States and the progress made in streamlining the leadership in the EU in other central policy areas suggest that a decisive step towards a common external representation of the eurozone is overdue.

We propose that the role of the Eurogroup be strengthened in this area and that its president, elected preferably for a period of two and a half years, renewable once, be effectively appointed as ‘Mr Euro’.

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