IMK

Euro area economic trends 2006 and 2007: The upswing - will it last?

Twice-yearly economic forecast and policy recommendations by the Macroeconomic Policy Institute (IMK) in collaboration with the European Trade Union Institute (ETUI-REHS)
October 2006

ETUI-REHS

Executive Summary

The boom in the world economy has at last reached the euro area, which has now left the extended period of sluggish growth behind it. For the first time in six years the countries of the monetary union are experiencing a strong upswing. The buoyant external demand has translated into a rapid expansion of investment, as capacity utilisation increased further. The euro area has a real chance of turning the dynamic expansion of the recent months into a self-sustained upturn. Employment is already picking up. This should have a positive effect on household incomes and, consequently, also on private final consumption expenditure, which has been the euro area's weak point in recent years. A sustained upswing in the euro area is a necessary condition for it to solve its persistent problems on the labour market and consolidate public finances.

However, it cannot be expected that economic activity in 2007 will be as strong as in 2006. The first reason is that the world economy is losing steam. In particular the US will show a marked dampening of economic activity. The repeated hikes in interest rates by the US Federal Reserve will take their toll. The real estate boom will come to an abrupt end and investment and consumption activity will weaken. This will impact negatively on euro area export performance. Furthermore the restrictive fiscal policy stance adopted by some euro area countries will also dampen economic activity. In particular Germany and Italy will be hard hit by these measures. Furthermore, trade imbalances among euro area member states will persist and may negatively affect some economies like Spain that already have severe current account deficits. Last but not least, the ECB has left its accommodative course and raised interest rates significantly, and that will also be felt next year.

The most serious economic policy problem in the euro area is still high unemployment. Hence it would be appropriate if economic policy would address this issue first. To do this especially an expansionary monetary policy is necessary as long, and is possible as no indication of wage inflation can be seen. That is, according to the ECB's own analyses, the case. Recent ECB rate rises have been premature. In the current situation the ECB should refrain from further rate hikes until the recovery is well established and core inflation has begun to rise. Secondly, fiscal policy should reap the fruits of the economic upturn by using the additional tax revenues to reduce debt, particularly in fast-growing countries with above-average inflation. Thirdly, wage policy is still moderate overall and is dampening domestic demand: a slight acceleration in particular in Germany and Austria would be appropriate. The main target of economic policy should be to sustain the unfolding economic upturn.

IMK/ETUI-REHS Policy Recommendations

Central task: keep the unfolding economic upturn alive. This can be achieved by:

- a monetary policy that stops further tightening until there are signs of higher core inflation
- a fiscal policy that stick to a predetermined expenditure path and lets the automatic stabilizers work
- a moderate acceleration of wages increases, at the area-wide level, by ¾ of a percentage point to follow a productivity-oriented track. However, this should not be done homogenously done across member states, but in each country taking account of deviations from national trend productivity and the ECB inflation target.

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Fastest growth in six years

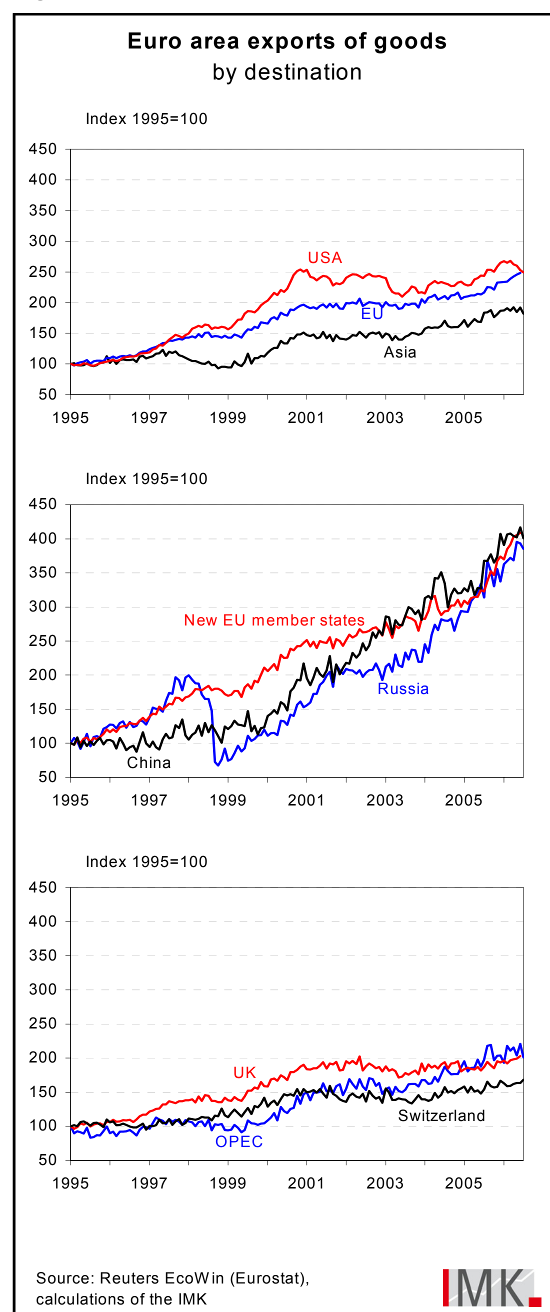
The economic expansion in the euro area picked up momentum in the first half of 2006. With an annualised growth rate of 3.7% in the second quarter the euro area recorded its fastest pace of economic activity in six years after an already strong first quarter.

In the second quarter of 2006 the main driving force of the euro area economy was domestic demand, particularly gross fixed capital formation, which rose by 2.1% compared to the first quarter and thus contributed 0.4 percentage points to the quarterly GDP growth of 0.9%. Growth was almost equally strong both for machinery and equipment and construction. However, construction activity in the euro area was heavily influenced by Germany, where two effects were at play. Due to the long and severe winter, much building work was postponed to the second quarter. In addition, the anticipation of some construction projects due to the increase of the VAT rate by 3 percentage points planned for the beginning of next year may also have played a role. Thus, construction investment surged by 4.6% in Germany and accounted for more than half of the increase in the euro area. Due to the favourable external environment, as well as supportive monetary conditions, investment in machinery and equipment has continued to record substantial growth rates, albeit still significantly below those of the boom of 1999/2000.

Private final consumption expenditure increased by 0.9% in the first half of 2006 and thus continued to lag significantly behind GDP growth. As real wages virtually stagnated, it was increases in employment and profits that were the main driving forces for consumption spending.

Developments in the individual countries have remained rather heterogeneous. While private consumption expenditure has contributed significantly to growth in France and Spain, it has once again had a retarding effect on economic activity in Germany and the Netherlands.

Figure 1



Government consumption in the euro area has been rather volatile, increasing by an average of 1.3% during the first half of 2006.

Net exports of goods and services, which contributed more than half of the quarterly GDP growth in the first quarter, slowed somewhat in the second, parallel to the weakened growth in the US. Goods exports to the new EU member states, China and Russia, which have quadrupled since 1995, continued to expand rapidly (Figure1). Whereas in the case of Russia oil and gas revenues are largely "recycled" as euro area exports, the picture is not so clear for the OPEC countries. Exports to these countries increased by a mere 1.9% and 1.8% in real terms in the first and second quarters, respectively, after a sharp decline at the end of 2005. In value terms they stayed significantly behind the euro area's imports.

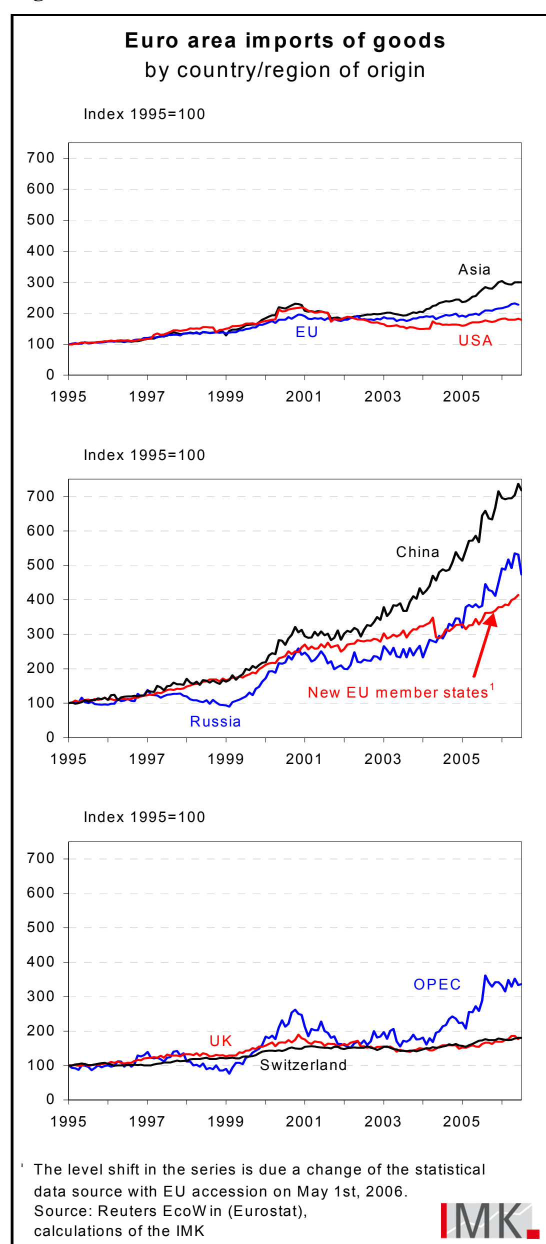
Imports of goods and services slowed along with exports in the second quarter (Figure 2). They rose by only 1.2% after 2.7% in the first quarter. Imports from Asia have levelled off, whereas imports from the new EU member states show a clear upward trend.

The increase of total employment accelerated slightly in the second quarter in line with the higher growth rate: the number of employed and self-employed persons was 1.3% higher than in the previous year. The positive employment dynamics are reflected in a downward trend of the unemployment rate over recent months. In August 2006 7.9% of the euro area's labour force were out of work, compared to 8.5% in August 2005.

Taking into account past oil price hikes, inflation has been rather contained in recent months. The sharp fall of oil prices in September has led to a rapid decline of the headline inflation rate in the euro area.

At 1.8% the Flash estimate of euro area inflation in September is comfortably below the ECB's target rate. Neither core inflation, which amounted to 1.3% in August 2006, nor unit labour costs, which – due to very moderate wage increases and high productivity gains – rose by just about 0.6% in the year to the second quarter 2006, indicate any inflationary pressure. Unlike headline inflation, these indicators of medium-run price pressure have been depressed for an extended period, suggesting continued economic slack in the euro area as a whole.

Figure 2



Euro area imports of goods
by country/region of origin

¹ The level shift in the series is due a change of the statistical data source with EU accession on May 1st, 2006.
Source: Reuters EcoWin (Eurostat), calculations of the IMK

Slower pace in 2007

Several leading indicators suggest that the cycle is already near its turning point. The OECD's composite leading indicator peaked in June 2006, suggesting a slow-down from around the end of 2006. According to the Euro Growth Indicator growth rates should start declining in the fourth quarter. At the same time the indices of new orders – both domestic and external – show a clear upward trend. Data from the European Commission provide a mixed picture. Whereas the Economic Sentiment Indicator points to a sustained expansion, the Business Climate component turned down in mid-year. Moreover, the Commission's quarterly growth projections derived from a dynamic factor model[1] already show a slowdown for the third quarter, which is to continue in the subsequent two quarters. On balance these indicators suggest a less optimistic outlook for the near future.

This is not surprising, as there are signs that the conditions for a sustained upswing in the euro area are becoming less favourable. The ECB has raised its key interest rates by 25 basis points five times since December, thus moving from an accommodative monetary stance to a more neutral one. The IMK and ETUI-REHS expect an additional interest rate hike in December 2006. The effects of the monetary tightening in the euro area will largely be felt in 2007, when they will be exacerbated by substantial discretionary budget consolidation measures in Germany and Italy, which together account for roughly half of the euro area GDP.

In addition the external prospects of the euro area are dimming. The effects of the effective exchange rate appreciation since the beginning of 2006 – around 5% in both nominal and real terms – will continue to be felt during the second half of the current year and into 2007. At the same time the outlook for the world economy is deteriorating slightly. Economic activity in the USA, where monetary policy has aggressively raised interest rates to counter inflation risks, is already losing some steam.

Table 1

Assumptions of the forecast			
	2005	**2006**	**2007**
Three-month money market rate (%)	2.2	3.1	3.6
Yield on ten-year government bonds (euro area,%)	3.4	3.9	4.1
Yield on ten-year government bonds (USA,%)	4.3	4.9	5.0
Exchange rate (USD /EUR)	1.24	1.25	1.27
Real effective exchange rate (consumer prices, broad group of countries)	103.5	103.2	104.2
Oil price (Brent, USD)	54	68	65
Source: Deutsche Bundesbank, ECB, IEA, Federal Reserve, 2006 and 2007: IMK forecast			

[1] See Grenouilleau, D. (2004.

Export growth will still be robust during the forecast period, but it will slow significantly as a result of the slowing world economy. Demand from the new member states, of the EU, Russia and China should remain on a clear upward trend, but this will not compensate the losses – incurred particularly in the North American market. Exports of goods and services are thus expected to increase by only 5.0% in 2007, after 8.5% in this year

Table 2

Key growth centres of the global economy: Growth, Inflation and Unemployment
% change on previous year

	GDP			Consumer prices			Unemployment rate (%)		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
Euro area	1.4	2.6	2.0	2.2	2.3	2.1	8.6	7.9	7.7
USA	3.2	3.4	2.3	3.4	3.7	3.0	5.1	4.8	5.1
South east Asian emerging markets[1)]	5.7	4.3	4.8	3.5	4.3	4.0	k.A.	k.A.	k.A.
China	10.2	10.3	9.5	1.8	1.5	2.0	k.A.	k.A.	k.A.
Japan	2.6	2.7	2.2	-0.3	0.2	0.5	4.4	4.1	4.0
Total	1.4	2.6	2.0	2.2	2.3	2.1	8.6	7.9	7.7

1) South Korea, Taiwan, Hong Kong, Singapore, Malaysia, Thailand, Indonesia, Philippines.

Source: National and international statistics, 2006 and 2007: IMK forecast.

Gross fixed capital formation in the euro area is expected to weaken significantly, as domestic and external sales expectations worsen and financing conditions become less favourable. Construction investment in particular will be sluggish in the coming quarters. At the same time the striking regional discrepancies will persist. In Spain construction investment will continue to expand much faster than the euro area average, whereas in Germany it will be close to stagnation again next year – not least because of the effects of the VAT hike.

The tax increases in Germany and Italy will also weigh heavily on private consumption expenditure in 2007. In addition, slow wage growth will continue to limit the purchasing power of households. A positive impact will result from (assumed) lower oil prices and continuing net job creation. Private final consumption is forecast to grow by 1.8% in 2006 and just 1.5% in 2007.

Due to the fiscal consolidation efforts undertaken by, in particular, Germany and Italy, the growth rates of government consumption are expected to decrease significantly. In 2006 and 2007 they will amount to 2.3% and 1.6%, respectively.

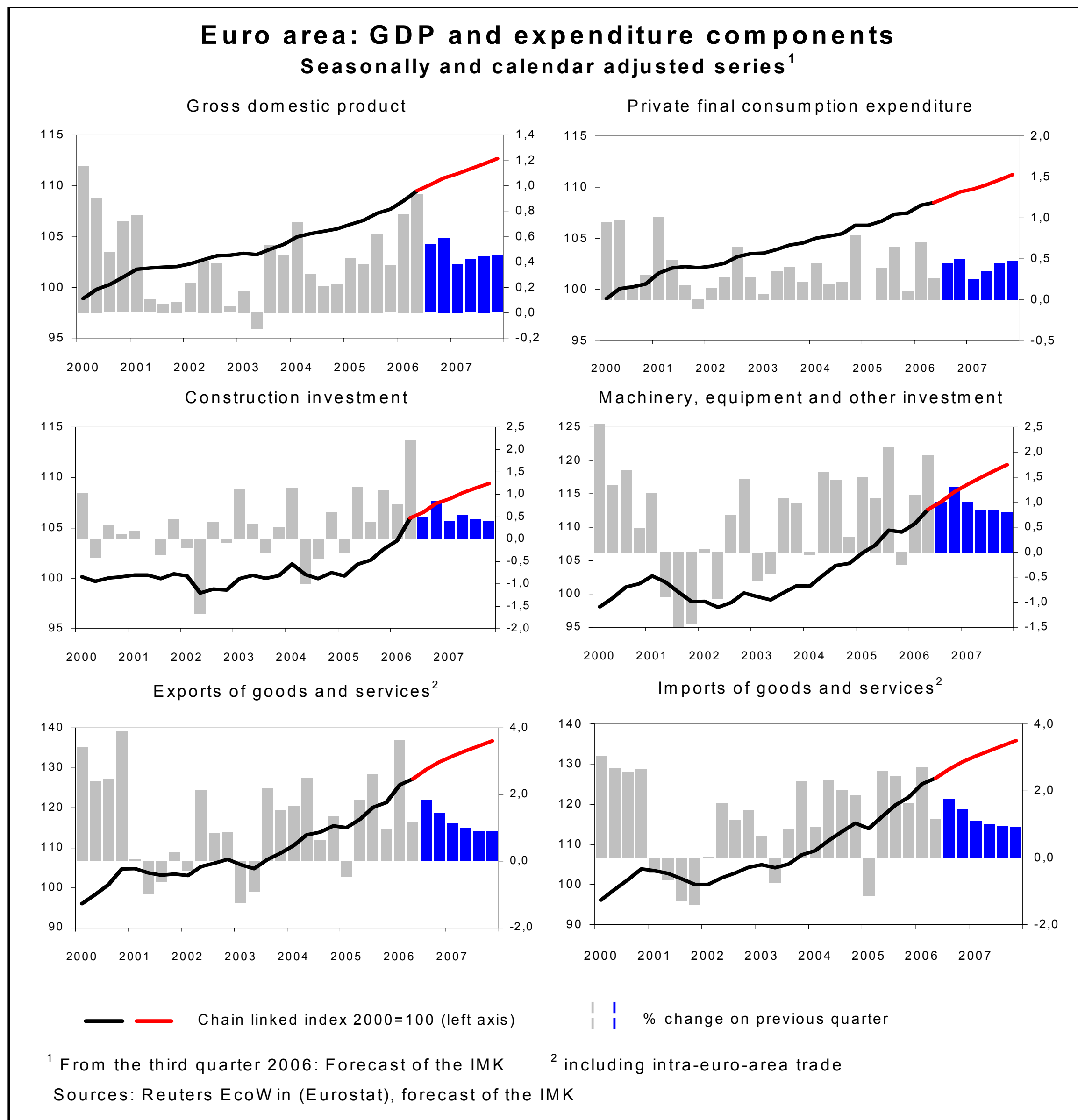
Affected by the slowdown in export activity, imports of goods and services are projected to expand by only 4.9% next year, after 8.1% this year. Net exports will thus rise further and contribute 0.3% to GDP growth both this year and next year.

The decline in the unemployment rate should continue at a slower pace in 2006 but will come to a halt already in 2007. On average 7.9% of the labour force will be unemployed in 2006. At 7.7% the unemployment rate will be only slightly lower in 2007. Thus once again the process of reducing unemployment will come to a halt, at least temporarily, at a rate no lower

than that achieved in the last upswing 1997-2000. Even more disappointingly, continued employment growth at sluggish rates of economic growth is only possible because productivity growth remains depressed compared to recent averages.

Wage increases will remain subdued during the forecast period, since a number of collective agreements with low pay rises signed recently extend well into 2007. The analysis of these agreements shows that wages rarely rise by more than 3% on an annual basis. Often the increase is below two percent[2] Collective agreements in Germany – the largest euro area economy – envisage pay rises of 1.6% on average in 2006 according to the IMK's forecast on the basis of the Bundesbank's Tarifindex and the collective agreements signed so far. The IMK expects an average rise of just 1.7% for 2007[3].

Figure 3



[2] See the final section of this report.

[3] IMK, 2006b.

For the euro area as a whole, wage increases of about 2.5% can be expected for next year. This will mean that unit labour costs – a key determinant of changes of the price level – will expand by just 1.2% - way below the ECB's inflation target of below but close to two percent.

With oil prices assumed to stabilise, headline inflation should exceed the ECB's inflation target only slightly next year – despite the indirect tax hike in Germany. The combined effect of an increase of the VAT and insurance tax by 3 percentage points and a net lowering of social security contributions by slightly more than half a percentage point (employer's share) should add almost 1% to the German price level, which translates into 0.3% for the euro area as a whole. Euro area HICP inflation will thus be 2.1% in 2007, after 2.3 in 2006. Core inflation will remain substantially below the ECB target.

All in all, economic activity will remain relatively strong in 2006. At 2.6% the euro area is expected to record the highest growth rate since 2000. In the coming year, however, the euro area economy will be less dynamic and GDP will only increase by 2.0%. Due to the carry-over into 2007, the average annual growth rate exaggerates the actual dynamics over the course of the year, which amount to a mere 1.7%.

Table 3

Key forecast figures for the euro area% change on previous year

	2004	2005	2006	2007
GDP	1.9	1.4	2.6	2.0
Private consumption	1.5	1.3	1.8	1.5
Government consumption	1.2	1.4	2.3	1.6
Gross fixed capital formation	2.1	2.6	4.4	3.4
– Construction	0.9	0.9	4.3	2.6
– Machinery and equipment	3.5	4.6	4.6	4.3
Net exports[1)]	0.2	-0.3	0.3	0.2
Exports[2)]	6.8	4.2	8.5	5.0
Imports[2)]	6.7	5.3	8.1	4.9
Current account balance[3)]	0.6	-0.3	-0.4	-0.2
Employees	0.7	0.9	0.9	0.9
Unemployment rate[4)]	8.9	8.6	7.9	7.7
Unit labour cost	0.9	1.0	0.6	1.2
Inflation (HICP)	2.1	2.2	2.3	2.1
Budget surplus/deficit[3)]	-2.8	-2.4	-2.0	-1.6
Gross government debt[3)]	69.8	70.8	69.6	68.5

1) contribution to growth
2) Includes intra-area trade
3) % of nominal GDP
4) % of the labour force

Sources: Reuters EcoWin, Eurostat, ECB, 2005: partly estimates by the IMK, 2006 and 2007: IMK forecast.

It should be emphasised that the assumptions underlying this forecast are rather benign (Table 1). For the forecast period the IMK and ETUI-REHS assume neither a recession in the USA nor a sharp devaluation of the US-dollar or a renewed surge of oil prices. Further, the two institutes do not assume that the ECB's key interest rates are raised beyond 3.5%. There is clearly a downside risk to all of these assumptions. Only on this basis will the slowdown in 2007 avoid becoming a severe downturn. Even then, the economy will enter 2008 at a rather slow pace and there is a risk of sluggish growth in the longer term. This would endanger the sustainability of budgetary consolidation and, more importantly, scupper the – limited – progress made to achieving the EU's Lisbon goals, which depends decisively on a sustained increase in employment rates and a reduction in unemployment. The risk would be even higher, if the ECB were to further tighten monetary policy in the coming year.

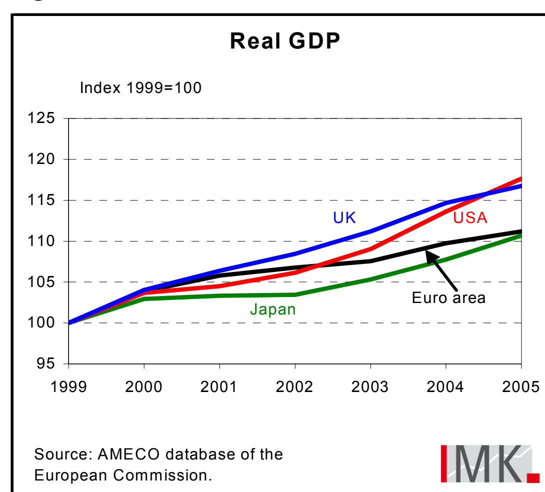
Benchmarking the euro area

This new section of the study is dedicated to an international comparison of the developments in the euro area on the one hand and country-specific trends within the euro area on the other hand. The objective is to assess recent developments in comparison with similar economies and draw conclusions for economic policy. The chapter focuses on aggregates of national accounts as well as data on employment, wages and prices. 1999 the year, when the euro was launched and the ECB took over the full responsibility for monetary policy in the euro area, serves as a starting point. This also makes sense given that in 1999 all the analysed economies were in an upswing after the Asian crisis and the cyclical positions can therefore be considered similar.

Slow growth, high unemployment

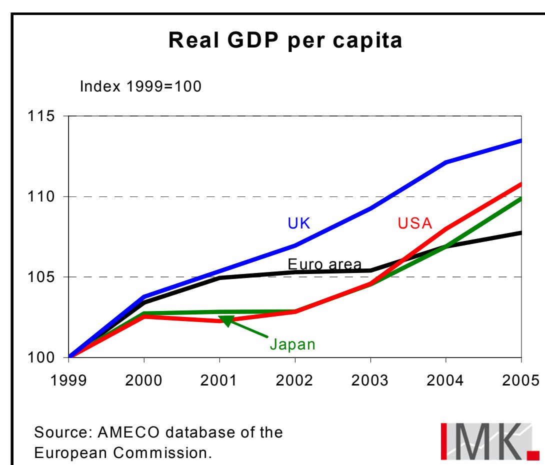
Since 1999 growth in the euro area has been much more sluggish than in the USA or the United Kingdom. Economic activity in the euro area has expanded only slightly faster than the deflation-ridden Japanese economy.

Figure 4



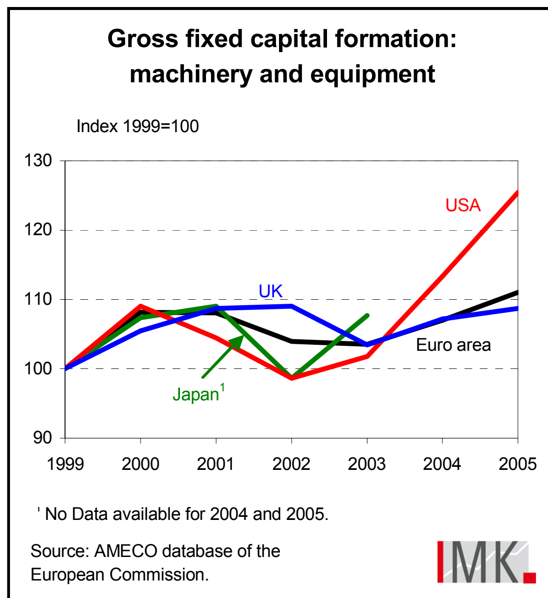
The most striking fact is that although the US economy was hit much harder by the downturn at the beginning of the millennium than the euro area economy, it managed to overcome the economic weakness much faster thanks to an aggressively expansionary monetary policy and a substantial fiscal stimulus. Per capita the difference between the USA and the euro area narrows to some extent reflecting substantially faster population growth (natural and net immigration) than in Europe.

Figure 5



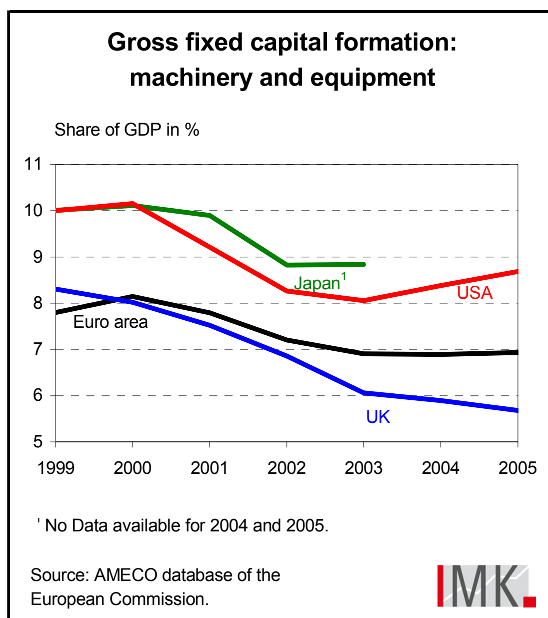
Supported by a growth-oriented economic policy, investment in machinery and equipment in the USA quickly returned to very high growth rates after the trough in 2002. By contrast investment activity in the euro area remained weak.

Figure 6



This is reflected in a steadily declining share in GDP of investment in machinery and equipment.

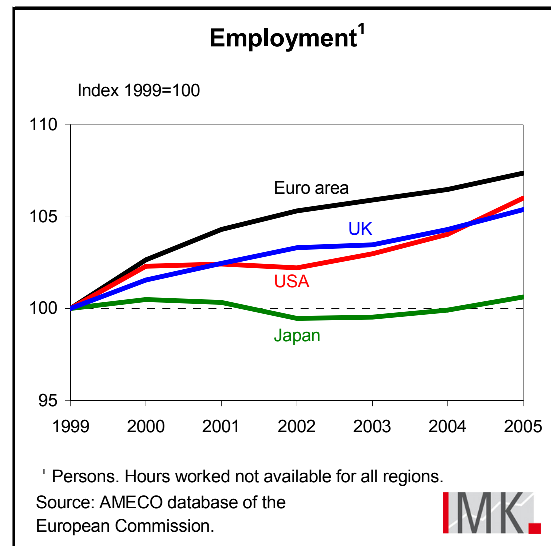
Figure 7



The slower investment growth has a retarding effect on the capital stock and thus dampens longer-term growth prospects.

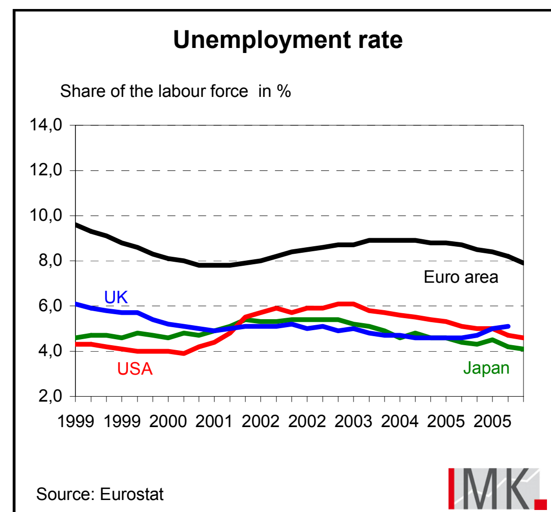
The fast increase of employment in the euro area, which even exceeds that of the USA and the UK seems a striking contrast to the findings above – but only at first sight.

Figure 8



One reason is that – as hours worked are not available for all regions/countries – employment figures used here are based on persons and thus suffer from distortions brought about by such effects as the rapid rise of small scale employment ('geringfügig entlohnte Beschäftigung') in Germany as well differing trends for part-time employment. Another reason is that the shake-out of workers in the downswing of 2001-3. was more pronounced in the US. This has had consequences for labour productivity however (see below).

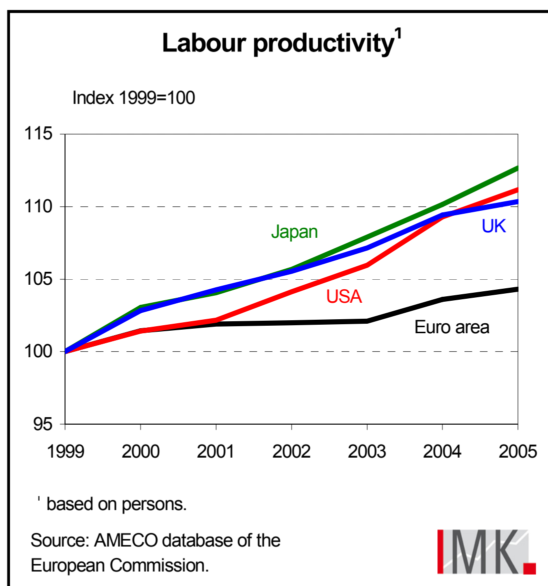
Figure 9



Unemployment in the euro area is still about twice as high as in the USA, though on a declining trend since 2004. In the UK and Japan unemployment has remained low during the whole period since 1999 and cyclical fluctuations have been much less pronounced than in the USA or the euro area.

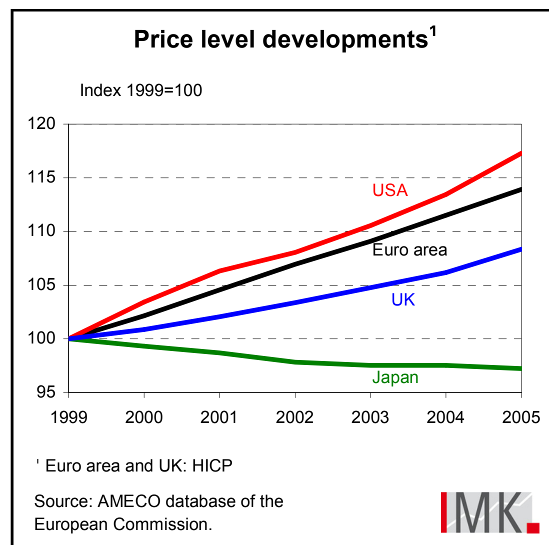
Labour productivity, which is also based on persons, suffers from similar drawbacks to the employment data. Most probably the productivity increase in the euro area is understated by the data. Nevertheless, it has stayed significantly behind that in the USA.

Figure 10



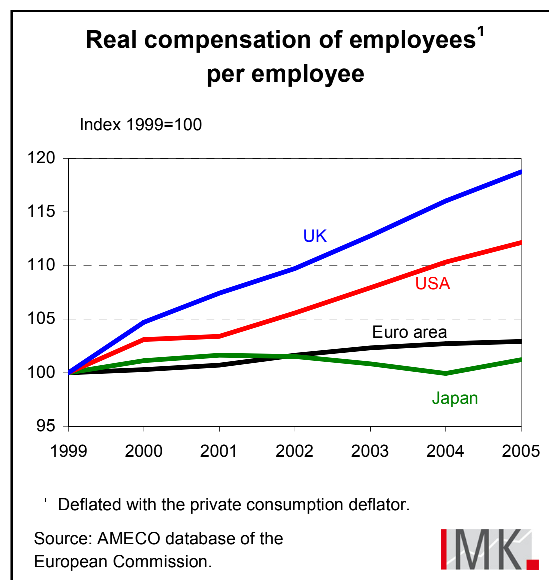
Of all countries/regions Japan shows the fastest productivity growth. Wage dynamics were very heterogeneous. Whereas compensation per employee rose very rapidly in the USA and in the UK, it actually declined in Japan. The increase in the euro area is probably understated for the reasons mentioned above. Nevertheless, it is likely to have remained significantly below that of the USA and the UK. With the exception of the United Kingdom the heterogeneous wage developments largely translate into the price trends.

Figure 11



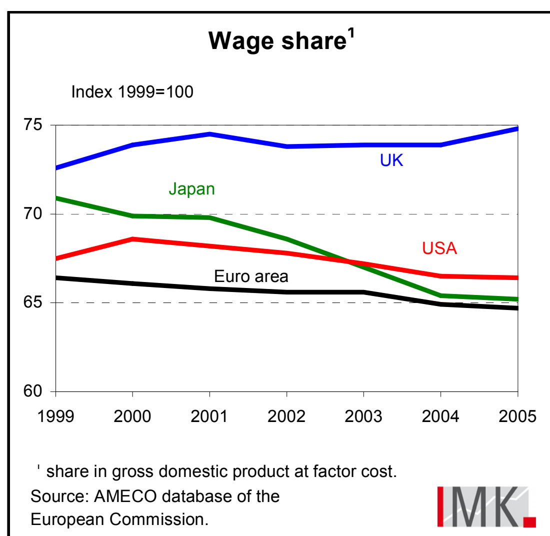
As a result the UK shows the fastest increase in real compensation per employee, whereas real wage dynamics in the euro area and in Japan have been rather subdued.

Figure 12



The functional income distribution has deteriorated for workers (and improved for recipients of income from property) in all regions/countries, except in the United Kingdom, where the wage share was highest and on an upward trend since 2004. Japan experienced the steepest decline of the wage share due to rapidly falling nominal wages.

Figure 13



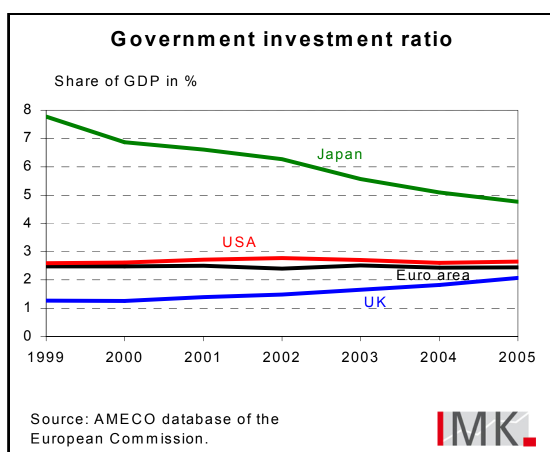
Slow growth, extensive tax reforms to reduce the tax burden for business as well as a falling wage share contributed to the deterioration of public finances in the euro area since 2000. From a slight surplus, the budget balance turned into a substantial deficit. With the improved economic performance it has recently been reduced again. It has to be noted, however, that the fiscal deficits in the euro area as a whole are still small by international standards. US fiscal policy led to deficits of far beyond the 3%-limit required by the Stability and Growth Pact in Europe. The UK also resorted to significant budget deficits to finance a boost in spending on education, health and infrastructure. In Japan, deflation had a devastating effect on public finances leading not just to persistently high budget deficits, but also to a massive increase in the debt ratio.

Table 4

Government Budget							
	1999	2000	2001	2002	2003	2004	2005
	Budget balance in% of GDP						
USA	0.9	1.6	-0.4	-3.8	-5.0	-4.7	-3.8
Japan	-7.5	-7.7	-6.4	-8.2	-8.0	-6.3	-6.5
UK	1.1	3.7	0.7	-1.6	-3.3	-3.3	-3.5
Euro area	-1.3	0.1	-1.8	-2.5	-3.0	-2.8	-2.4
	Government debt ratio in% of GDP						
USA	64.5	58.5	58.4	60.6	64.2	64.8	65.0
Japan	128.8	136.8	145.0	152.0	156.3	157.3	158.9
UK	44.9	41.9	38.7	38.2	39.7	41.5	43.5
Euro area	71.7	69.2	68.3	68.2	69.4	69.9	70.9

Source: AMECO database of the European Commission

Figure 14

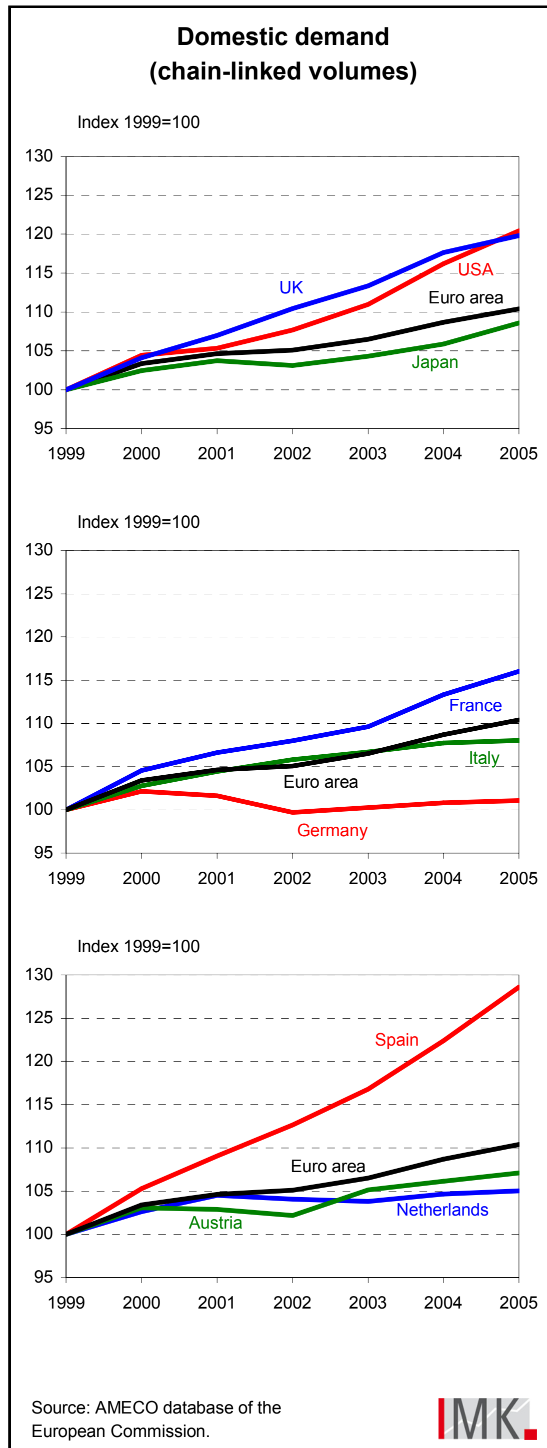


The consequence has been a sharp decline in the government investment ratio. Nevertheless – as a% of GDP – Japan's government investment still exceeds that of the USA, the euro area and the UK by far. The UK, which exhibits the lowest share, has raised public investment spending significantly during recent years.

Exports, competitiveness and domestic demand

For the countries analysed there is a clear link between wage dynamics, export performance and domestic demand. Most of the high-growth countries, such as the USA and Spain, have also shown a rapid expansion of domestic demand.

Figure 15



At the same time their labour costs rose much faster than productivity. This is equivalent to a surge in unit labour cost and a loss of competitiveness. As the graphs show there is a close link between export performance and unit labour cost developments – even for countries outside the euro area, where exchange rate movements can still offset the effect of domestic wage-cost changes on competitiveness.

Figure 16

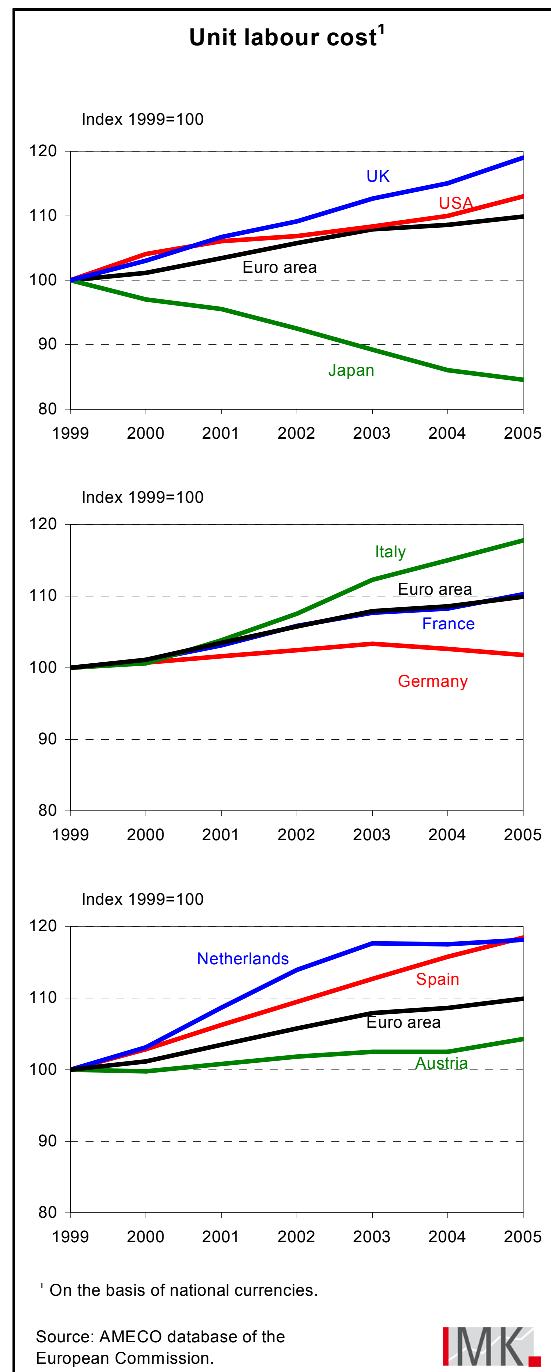


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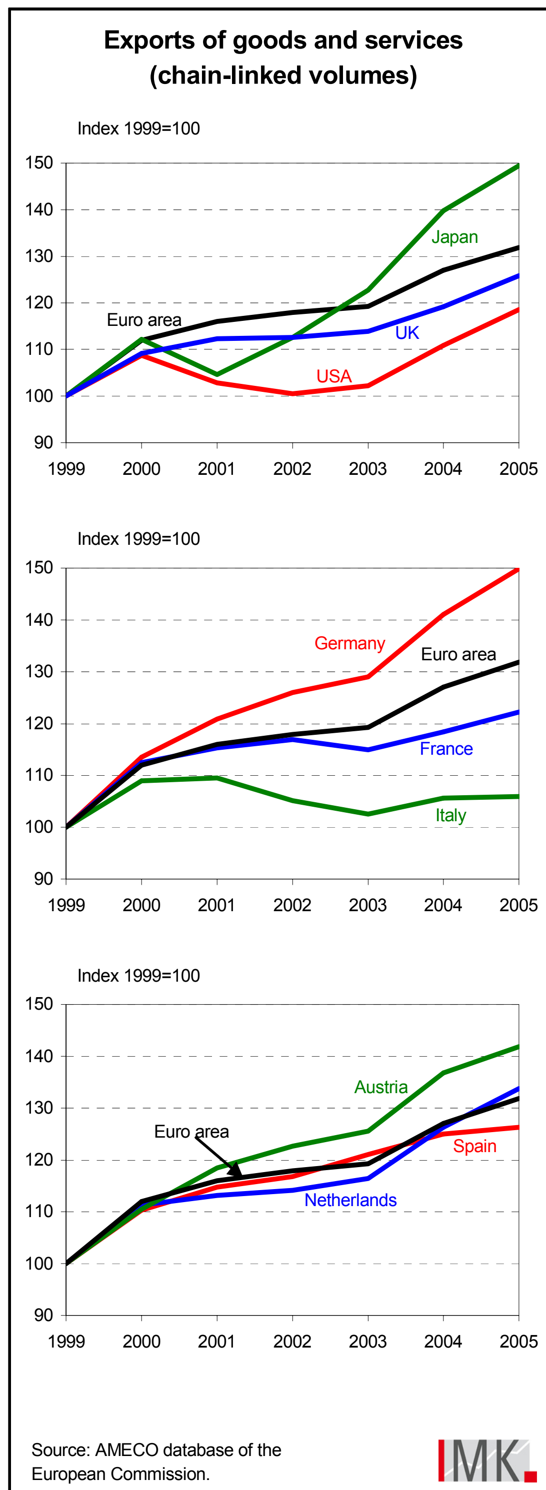
Figure 17



Within the euro area this adjustment mechanism was removed with the establishment of the monetary union. Thus, when wage and price trends get out of line, losses of competitiveness can accumulate over the years with a negative effect on export performance, without the possibility of recourse to exchange rate adjustment. Among the larger euro area economies Italy and Spain are examples of such a development. Their unit labour cost rose by almost 20% since 1999. Their export performance remains significantly below the euro area average and both countries show a negative trade balance. Austria and Germany represent the other extreme. Both countries have practised wage restraint for some time and thus caused unit labour cost to stay behind that of their competitors. In Germany –as the only country in the euro area – unit labour costs have actually declined since 2003. As a consequence Germany's exports increased by 50% since 1999, Austria's by more than 40%. Since the beginning of the monetary union the imbalances have widened rapidly. The absolute decline of German unit labour cost means a deflationary impulse. If other countries follow such a strategy – and competitive pressures will push them in this direction – the euro area could lapse into deflation. Austria and, more recently, the Netherlands already seem to be on such a path, despite substantial trade surpluses.

Economic policy for the euro area: learning from past failed recoveries

The European economy has seen a number of false dawns since the sharp downturn that followed the last period of sustained economic growth and falling unemployment in 1999/2000. Each time the hopes placed in positive soft data – leading indicators, business surveys – were dashed. Actual recoveries of net exports and investment

proved weak and were easily derailed by a worsening in the external situation, on which the euro area economy has been overly reliant: this was notably the case in 2004. This year, for the first time in six years the euro area economy has now actually enjoyed several quarters of relatively strong economic growth. At the same time headline inflation has been slightly above the ECB target.

This has led some commentators to draw parallels with the year 2000 and to call for a tightening of policy. To what extent is the situation in 2006 really comparable with 2000? And what, if any, lessons should be drawn from that period?

The first thing to note is that, not only was real GDP growth in 2000 (3.8%) much stronger than currently forecast for this year, but it came on top of three previous years (1997-1999) in which growth had been above 2%. By contrast, in 2004 growth only just reached the 2% threshold to be followed by a disappointing 2005. Moreover, all forecasters are agreed that, on current expected policies, growth will already fall back next year, in our estimate to 2%. Thus the comparison with the 1999/2000 period is severely flawed. And what about policy?

The mini boom at the turn of the millennium succumbed to a combination of tighter monetary policies and the severe deterioration in the external environment (stock market crash, terrorist attacks etc.).

At the very least in retrospect, it is clear that policymakers in Europe over-braked the economy in 2000 and 2001. Economic growth plunged and unemployment was driven up. Why were the brakes slammed on too hard? For two interrelated reasons. Policymakers underestimated the restrictive knock-on effects of the US-led downturn on the European economy: they overestimated its resilience to shocks. Policymakers were still convinced that – in line with the Lisbon strategy – Europe was on the cusp of a sustained information-economy-driven expansion, such as the US had experienced in the 'roaring nineties'. At the same time they, especially the ECB, were overly concerned about the impact of higher import prices feeding into wages, in a situation when the euro was depreciating against the US-Dollar. This concern proved unfounded at the level of the euro area as a whole.

All this suggests that in the current situation the key task for European policymakers is to nuture the still fragile recovery. It is not the strong growth of 2006 that is the key parallel to the 2000 period, but the risk of a repeat of the sharp downturn of 2001, which if, it is what happens starting in 2007, would follow a much shorter and weaker expansion.

Growth is reasonably strong this year albeit much weaker than in 2000, and the euro is appreciating against the US-Dollar rather than depreciating. With the expected policy stances, a weakening of economic activity is already 'programmed' for 2007. Especially in view of the lags before policies affect aggregate demand, it is vital that policymakers co-ordinate their policy stance and, by doing so, send confidence-building signals to investors and consumers that, this time, the growth process will be supported by policy until it has convincingly become self-sustaining. This is also the best contribution that Europe can make to mitigating the dangers posed by global economic disequilibria. At the same time policymakers must show that they are 'vigilant' that there will be no sustained increase in the underlying rate of inflation that would feed into expectations about future inflation.

The following sections look at the three main policy areas – monetary and fiscal policy and wage setting or 'incomes

policy' – and consider the different contributions they can and should make to this end. It is evident that, at both European and national levels, policymakers will only be able to realise these aims if they are willing and able to take each others' actions into account. Thus, while considering the policy areas separately for analytical reasons, the IMK and ETUI insist on the need to strengthen the existing mechanisms of policy coordination – notably the eurogroup and the Macroeconomic Dialogue – at the European level.

Monetary policy: avoiding premature tightening

The European Central Bank recently raised base rates by 0.25% in June, August and October of this year. Since 11 October the main refinance rate has been 3.25%. The three-month rate currently stands at 3.4%, or 1 ¼ percentage points higher than a year ago. Real short-term rates (deflated by the core inflation rate, which is approximated as the rate of change of the Harmonised Index of Consumer Prices excluding energy, food, alcohol and tobacco) rose just as sharply, and – at over 2% – roughly correspond to the rate of growth forecast for the euro area.

Long-term rates have shown little change in recent months in either nominal or real terms and the interest spread has thus narrowed again (Figure 18). Lending rates have risen slightly, while the lending conditions of the commercial banks for enterprise loans have remained largely unchanged.[4] The euro's exchange rate against the US dollar appreciated by 3 ¾% over both the last six and the last twelve months and by almost 2% in both cases in real effective terms against the currencies of the euro area's most important trading partners. The appreciation was probably largely a consequence of the narrower differential now existing between short-term rates in the euro area and the United States and of the wider inflation differential to the disadvantage of the latter; for some time now the interest-rate differential between the euro area and the United States has amounted to one percentage point at the long end of the maturity spectrum. The exchange rate is exerting a slightly restrictive impulse so that overall the monetary conditions have deteriorated. Moreover, market participants expect to see more interest-rate increases on the part of the ECB.

This monetary policy tightening is premature because neither money supply and lending growth nor the prospects for inflation indicate a need for interest-rate increases, whereas – in view of the cooling down of the world economy and the weakening of domestic demand caused by fiscal tightening in Germany and Italy next year – the slowly emerging recovery in the euro area will continue to require a monetary policy tailwind.

One of the ECB's justifications for the most recent interest-rate increases is the robust growth of the money supply and of lending. It is true that loans to the private sector have expanded substantially (most recently – August 2006 – at an annual rate of 11.3%), with enterprise loans showing particularly strong growth of 12%. And consumer and mortgage loans also rose sharply at rates of 8.3% and 11.1%, respectively (August 2006). However, the sharp increase is due in part to overheating in some regions – Spain, for example, where loans to the private sector rose at a rate of 25% in the second quarter of the year (Banco de España 2006). In Germany, the largest member state of the euro area, the growth of loans to enterprises and private individuals remained low at 1.7% (August 2006).

[4] This is also demonstrated by the ECB's most recent bank lending survey for the euro area; see European Central Bank (2006a: pp. 20ff.).

The robust lending growth in the euro area is one reason for the continued sharp expansion of the M3 money supply, which increased at a rate of 8.2% on the most recent figures (August 2006). The ECB currently estimates the real money gap at around 7% (money gap adjusted for portfolio restructuring; European Central Bank 2006b: p. 22), but there is considerable uncertainty regarding the accuracy of this figure. For example, it is based on the assumption that the gap was zero at the beginning of monetary union. Moreover, the ECB is also proceeding on the assumption that the trend decrease in the velocity of circulation of money has been minimal compared to recent years. If the decline in the velocity of circulation was actually stronger than assumed,[5] then the real money gap would be accordingly narrower. In addition, influences from outside the euro area also seem to play a role, especially external demand for cash, which probably explains to some extent why it has been expanding so rapidly. All in all, money supply growth is currently overstating the growth of demand-effective liquidity.[6] Thus, the robust expansion of the money supply and of loans does not lead to high GDP growth rates or accelerated inflation in the forecasts published by the ECB. The uncertainty of the ECB's own interpretation of the monetary situation in the euro area is demonstrated, for example, by the fact that in December 2002 it defined liquidity in the euro area as "ample". (European Central Bank 2002, p. 5) Viewed from today's perspective, however, at that time the real money gap – adjusted for portfolio restructuring – had already been close to zero for two years. (European Central Bank 2006b, p. 22)

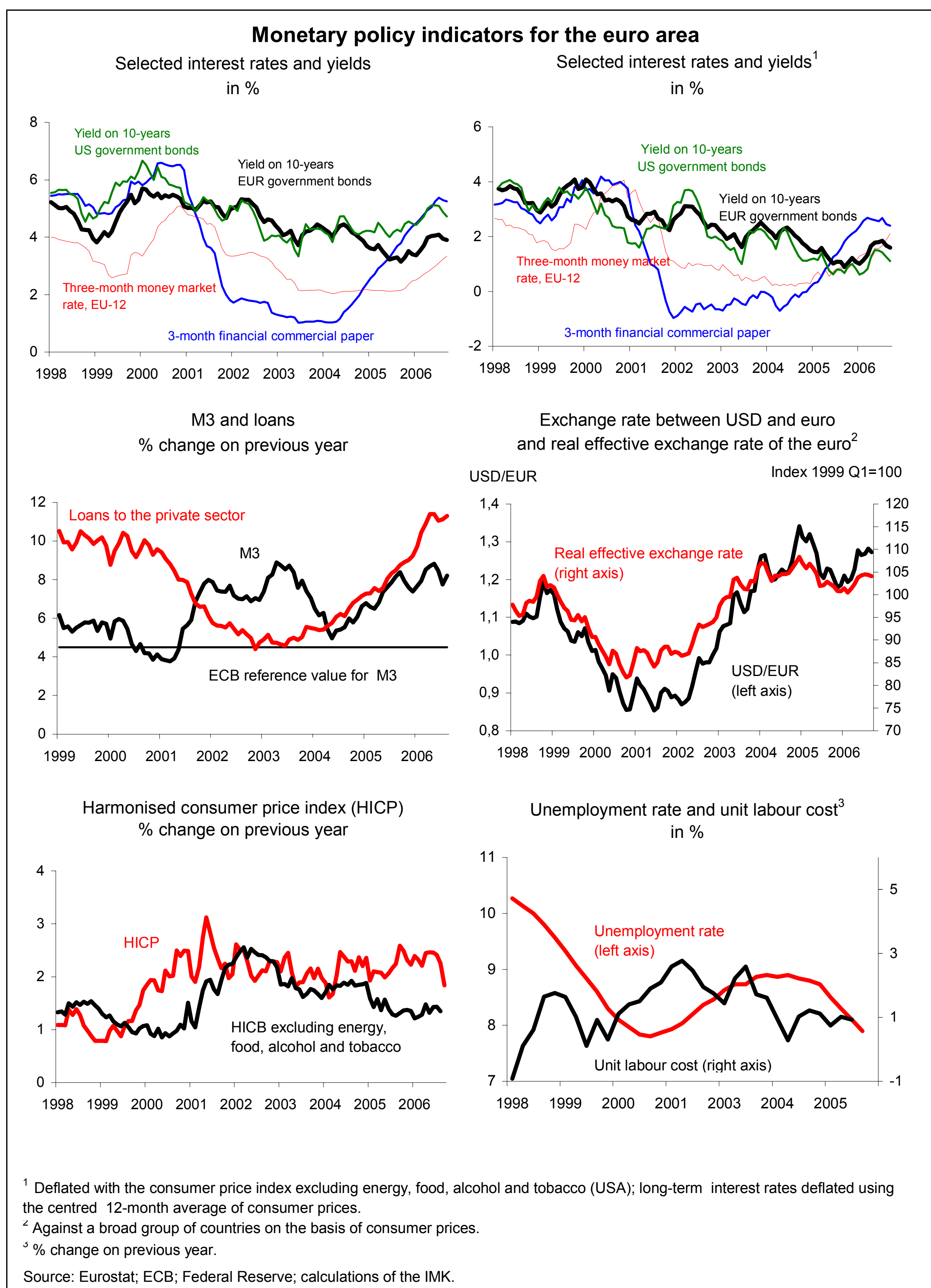
Seen in the light of an increase in the (euro) price of oil of almost 70% between January 2005 and August 2006 (and of almost 10% in the preceding twelve months), inflation growth in the euro area is very moderate; since then the price of oil has fallen perceptibly. The main reason is the weak core inflation rate, which in turn largely reflects moderate wage growth. Core inflation amounted to 1.3% in August and, notwithstanding moderate productivity growth, on the most recent figures (second quarter of 2006) unit labour costs rose at a rate of 0.6%, is below to the average growth rate since the second quarter of 2004. A substantial increase in the core inflation rate is not to be expected up to the end of the forecast period. Unit labour costs are likely to continue to rise in the euro area at an annual rate of around 1%. The inflationary expectations for the euro area are in line with these figures: The forecasters surveyed by both the ECB and *The Economist* magazine expect consumer prices to grow by 2.1% in 2007, despite the VAT increase in Germany. (European Central Bank 2006a: p. 39).

Against the background of the low growth in unit labour costs, claims that the core inflation rate is understated due to cheap imports do not hold up. Such claims would only be valid in any case if import prices – excluding crude oil – were increasing at a much slower pace, and this is not the case. For example, Germany's import prices without crude oil and mineral oil products showed a year-on-year increase of an average 3.7%. Moreover, the strong growth in the countries in which cheap imports originate, especially China, significantly contributed to the dramatic increase in commodity prices in recent years. The major effect of globalisation is increased competition. The correspondingly lower price and wage increases increase the scope for inflation-free growth and allow the Central Bank to pursue a monetary policy course that is more favourable to growth.

[5] In their Joint Forecast the six leading German economic research institutes (DIW Berlin et al. 2000) estimate the decline in the velocity of circulation of money to be half a percentage point stronger per annum.

[6] Dreger / Wolters (2006) come to the same conclusion on the basis of their econometric study – that the current robust pace of money supply growth will not accelerate inflation.

Figure 18



[1] Deflated with the consumer price index excluding energy, food, alcohol and tobacco (USA); long-term interest rates deflated using the centred 12-month average of consumer prices.
[2] Against a broad group of countries on the basis of consumer prices.
[3] % change on previous year.
Source: Eurostat; ECB; Federal Reserve; calculations of the IMK.

This is also true for the insight in many countries of the euro area that in the interests of macroeconomic stability wage negotiations should be based on the ECB's target inflation rate and not the actual inflation rate, which is currently exaggerated by price shocks.

The ECB also does not expect wage growth to accelerate. It believes that the fact that

inflation is still slightly higher than its target rate is due this year to the recent energy price thrust and will be due next year to the increase in administered prices or indirect taxes. Both government intervention and energy price hikes are to be seen as one-off effects that do not require a monetary policy response as long as they do not generate second-round effects. The low underlying inflation in the euro area in fact suggests that monetary policy has not taken adequate steps against the economic weakness pervading the region since the year 2000.

At 2.5% and 2.1%, respectively, the ECB's projection for GDP growth in the euro area deviates only minimally from the forecast presented here.[7] Which short-term interest rate is appropriate in the case of growth of 2% depends on how the risk of inflation is assessed to be given this level of growth. This implies making a judgement about potential growth and the output gap. International organisations currently estimate potential growth in the euro area at 2.0% or 1.9% (OECD 2006a, International Monetary Fund 2006). Given an annual increase in labour force potential of just under ¾% (OECD 2006a), this implies an unrealistically low rise in labour productivity of around 1 ¼ %. The decisive factor for the low estimation of potential growth in the euro area is the weak growth of actual GDP – an average 1.4% – over the last five years. In view of the methods used to estimate potential, a sharp downward correction becomes inevitable: At the beginning of this lull, in other words in 2001, the International Monetary Fund (2001), for example, had estimated the annual increase in productive capacity retrospectively until 1996 at 2.4%. The new statistical trend is to a great extent based on recent years – when the European economy was faced with numerous shocks to which economic policymakers sometimes responded inadequately. Thus, the euro area did not cope as well with the oil-price shock, the stock-market crash and the geopolitical uncertainty as the United States with its very expansionary monetary and fiscal policy. If the ECB now interprets this weaker growth as the maximum limit of inflation-free growth, if it defines the substantial output gap out of existence and sets its monetary policy accordingly, then there is a danger that the euro area really will remain stuck on this low growth path. Low growth potential becomes a self-fulfilling prophecy (Janssen/Watt 2005).

The difficulty of precisely quantifying productive capacity and potential growth make it practically impossible to formulate concrete and reliable numerical values that can be taken as orientation variables for monetary policy or even monetary policy rules. As explained in the Spring forecast, in the current situation different Taylor interest rates can be formulated that would suggest raising interest rates, lowering interest rates or making no monetary policy intervention at all (IMK/ETUI-REHS 2006, p. 17). What is decisive is whether one bases the calculations on the overall consumer price index or a core inflation rate, and how one calculates the output gap. The ECB declaredly does not use simple monetary policy rules, rather comes to a view of the future inflation trend by analysing numerous indicators. Unit labour costs (supplemented by wage costs) lend themselves as an excellent indicator because they are closely related to the underlying inflation trend and thus offer guidance when headline inflation is distorted by price shocks (Fagan et al. 2001, Duong et al. 2005: 35). In addition, the ECB could then specifically indicate undesirable developments in individual countries; a reinforced Macroeconomic

[7] The ECB has recently begun to base its forecasts on the assumption that short-term rates will change in accordance with market expectations. It therefore currently forecasts a three-month rate of 3.9% for 2007. The forecast is also based on the assumption of an exchange rate of 1.28 USD/EUR and an oil price of 77.6 USD per barrel in 2007; European Central Bank (2006b: pp. 62ff.).

Dialogue could be used to coordinate course corrections. While the ECB should also call attention to regional signs of overheating – because these can lead in the future to adjustment processes that represent a burden for the entire monetary union – it would be asking too much of the ECB to combat a regional property boom such as that currently taking place in Spain; more specifically the only way it could combat such a development would be to stifle the recovery in the euro area as a whole. In a monetary union, negative developments at the regional level should therefore be primarily corrected by fiscal policy and wages policy.

The fact that economic growth is still moderate alongside a weak inflation dynamic suggests that the restrained wage trends should be accompanied by "monetary policy restraint". Given an unemployment rate of 7.9% in the euro area (August 2006) and muted wage growth, what is needed is to strengthen and prolong the nascent upturn. The integration of a sizable share of the unemployed into employment in the course of an upswing and the adjustment of the stock of capital to the increased effective labour supply would enable robust growth for several years. In the course of this process, productive capacity would also increase. In addition, the OECD (2006b, p. 49) has pointed out that an enduring upswing tends to go hand in hand with a rising labour force participation rate, which in turn increases the supply of labour and productive capacity. Failing to avail of this opportunity would amount to wasting resources and renouncing a higher standard of living in the euro area. A stable, inflation-free upswing in the euro area could also help to reduce the current-account disequilibria worldwide and create an additional engine for the world economy. Both of these developments would also be welcome in view of the economic slowdown that can be expected in the United States.

Fiscal policy – no sign of an end to pro-cylical national fiscal policies

In 2006 and 2007 euro area fiscal policy as a whole will continue the process of fiscal consolidation that started in 2004 (see Table 5). The area-wide deficit will fall to 2% in the current and 1.6% of GDP in the coming year. Given the currently rather strong upswing the pace of consolidation in 2006 – a forecast reduction in the euro area budget deficit by 0.4 percent – is moderate. The forecast reduction by the same amount in 2007, on the other hand, must be seen against the background of growth slowing down in that year to a rate that is almost certainly below potential. Even so, outstanding government debt will decline as a share of GDP by one percentage point to 68.5% in 2007.

This picture, however, changes if one takes a closer look at the developments at the level of individual euro area countries (see Table 5). The reductions in the budget deficits are by no means equally distributed over the individual countries. In 2006 large reductions will occur in Greece, Portugal and Germany – 1.5%, 1.5% and 0.9% of GDP respectively – whereas the reductions in the other countries are rather small. Spain can even be expected to decrease its financial balance by a small amount. In 2007 the disparities become even stronger. Germany, Italy and Portugal are the countries with large reductions between 0.6% and 0.9% of GDP. In France, Greece and the Netherlands the reductions will be small with values between 0.1% and 0.3% of GDP. However, five countries, namely Finland, Spain, Ireland, Austria and Belgium can be expected to see deficits rise (or surpluses fall) by between 0.5% and 0.1% of GDP.

Table 5

Fiscal Balances in the Euro area.% of GDP. 2001-2007							
	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Austria	0.1	-0.5	-1.5	-1.1	-1.5	-1.0	-1.2
Belgium	0.6	0.0	0.1	0.0	0.1	0.2	0.1
Finland	5.2	4.1	2.5	2.3	2.6	3.0	2.5
France	-1.6	-3.2	-4.2	-3.7	-2.9	-2.8	-2.6
Germany	-2.9	-3.7	-4.0	-3.7	-3.3	-2.4	-1.5
Greece	-6.1	-4.9	-5.8	-6.9	-4.5	-3.0	-2.9
Ireland	0.8	-0.4	0.2	1.5	1.0	1.2	1.0
Italy	-3.2	-2.9	-3.4	-3.4	-4.1	-4.0	-3.2
Luxemburg	6.1	2.0	0.2	-1.1	-1.9	-1.0	-0.5
Netherlands	-0.2	-2.0	-3.1	-1.9	-0.3	0.0	0.1
Portugal	-4.2	-2.9	-2.9	-3.2	-6.0	-4.5	-3.9
Spain	-0.5	-0.3	0.0	-0.1	1.1	1.0	0.7
Euro area	**-1.9**	**-2.5**	**-3.0**	**-2.8**	**-2.4**	**-2.0**	**-1.6**
Source: Eurostat; 2006 and 2007 IMK forecast.							

These differences in the individual countries' fiscal policy orientation would be justified and unproblematic if they constituted an appropriate response to differences in the individual countries' economic situation. As will be shown below, however, this is not the case. It turns out that the serious economic problems for some, slow-growth euro area countries, that are being exacerbated by the constraints of the Stability and Growth Pact, will continue to exist over the next years, as will the Pact's inability to curb procyclical budgetary expansions in faster-growing economies.

As has been treated in depth in the IMK-ETUI-REHS spring 2006 forecast and policy recommendations, the SGP has been unsuccessful in fulfilling its goals of fiscal sustainability and supporting economic growth. During the ongoing period of economic stagnation since 2001, more and more countries have exceeded the 3% of GDP limit for the budget deficit, while at the same time macroeconomic performance has been unsatisfactory.

The restrictive and pro-cyclically destabilising fiscal policy reactions to the post-2000 crisis in several countries have without doubt contributed to the ongoing stagnation after 2000 within these countries and in the euro area as a whole. With the exception of Greece and to some extent also France, all the countries with excessive deficit problems reversed their initially expansive fiscal policy and were driven into pro-cyclical, restrictive measures after their deficit had reached the 3% of GDP level. Of course, fiscal policy is only one factor in the explanation of macroeconomic performance. However, with respect to GDP growth it is striking that all of the four countries with growth rates below the euro area average (Germany, Italy, the Netherlands and Portugal) suffered from restrictive fiscal policies in recent years, while all of the three countries with above-average growth rates, (Finland, Ireland and Greece) had expansionary fiscal policies. (The remaining countries were close to the respective averages.) Therefore, fiscal policy under the SGP turned out to have increased rather than decreased the

growth disparities between the individual euro area countries.

It was also argued in the spring forecast that the Spring 2005 reform of the SGP, although conceptually a step forwards, was unlikely to be very effective in practice, as the subsequent recommendations by the Commission and the decisions by the Council concerning the EDPs against Germany, Italy and Portugal had demonstrated. In those cases both the Commission and the Council had taken a rather narrow view and did not seem to concede the full leeway offered by the reformed SGP. Despite the fact that economic recovery in these economies then was only weak and uncertain, a rather ambitious and risky consolidation path had been called for.

Table 6

Average growth rates 2001-2005 in%	
Austria	1.5
Belgium	1.5
Finland	2.3
France	1.6
Germany	0.7
Greece	4.3
Ireland	5.2
Italy	0.6
Luxemburg	3.3
Netherlands	0.8
Portugal	0.6
Spain	3.1

Source: Reuters EcoWin (Eurostat)

The deficit forecasts presented in Table 5 tend to confirm that view.: Especially in 2007, all of the countries in which net government borrowing is increasing belong to the group of high growth countries (Finland, Spain and Ireland) or medium growth countries (Austria and Belgium) identified for the period from 2001 to 2005 (Table 6). What is more, with the possible exception of Austria, the fiscal expansion does not seem to reflect an economic slowdown, i.e. reflect the operation of the automatic stabilisers. Rather it is due to the fact that the countries' fiscal positions are in surplus or close to balance, so that under the SGP the incentive for further consolidation efforts is small and pro-cyclical policies are promoted. On the other hand all of the countries with substantial deficit reductions belong to the group of slow-growth countries: there fiscal policy is acting as a drag on already sluggish economic growth.

This suggests that, also in its modified form, the SGP will continue to promote pro-cyclical fiscal policies and increase growth disparities in the euro area.

It is not in principle wrong that countries start consolidating their budgets during the recovery. However, in countries experiencing slow (below-potential) growth the consolidation should occur via the automatic stabilisers. Relying on more ambitious discretionary consolidation efforts is gambling with the recovery. This is particularly so given that their economies cannot at the same time be stimulated by national monetary policy. A centralised monetary policy makes it vitally important that member countries of a monetary union retain scope to keep their economies close to potential growth by means of fiscal policy. Against this background the IMK/ETUI therefore renew their reform proposals for fiscal policymaking in EMU.

In terms of short-term reform proposals, it would have been preferable to indicate clearly in advance those areas of spending which are considered to be public investment and then to exclude such spending from the deficit calculation under the SGP. Sluggish growth in recent years plus the need for countries to invest in achieving the Lisbon targets should have led to a coordinated strategy of additional investment in the Lisbon priorities at national level, permitted by temporary derogation from the Pact.

Reflecting the original idea of the Pact to avoid some countries putting upward pressure on interest rates to the detriment of others, the national inflation rate should be taken as a key indicator of the scope for countries to pursue expansionary – or the need for restrictive – fiscal policies; the derogation should not be extended to countries where inflation is significantly above the ECB target.

This would help to make fiscal policy in EMU more symmetrical and would reduce both growth and inflation differentials within the currency area. Such differentials cause problems for monetary policy and also, given the low overall inflation target, risk individual countries experiencing deflationary conditions for extended periods.

Regarding more medium-term reform proposals for fiscal policy within EMU, the Autumn 2005 IMK/ETUI forecast presented a detailed proposal for a fiscal policy strategy that generates medium-run fiscal consolidation, but takes account of cyclical considerations while focusing attention on those variables that are actually under government control, that is the noncyclical components of public spending (primarily government consumption and public investment). The recommendation is to set a medium-run target for these non-cyclical elements of public spending that is below the trend nominal rate of GDP growth. Meanwhile cyclically sensitive components of spending (such as transfer benefits) are allowed to fluctuate over the cycle, acting as automatic stabilisers.

Public investment might be excluded for a transition period from the spending cap in countries where it has fallen to sub-optimal levels, or as part of a coordinated strategy to invest in the Lisbon priorities, but in the medium run should be subject to the spending norm.

To avoid undermining consolidation on the spending side, any tax cuts must be offset by other sources of revenue (only revenue-neutral tax reforms). Such a strategy would give all actors confidence in longer-run consolidation and debt reduction, while ensuring cyclical stabilisation and permitting the necessary boost to growth and public investment in the shorter run.

Responsibility for fiscal policy to ensure stabilisation clearly cannot be left entirely to national actors. Appropriate information exchange and coordination mechanisms (Eurogroup, Marcoeconomic Dialogue) should be reinforced to coordinate both individual countries' fiscal policies as well as euro area fiscal policy and monetary and wage policy.

Coordination of the monetary-fiscal link is vital not least because, both in the past and according to fiscal plans for 2007, fiscal consolidation frequently takes the form of hikes in indirect taxes. Against the background of relatively low inflation (and a low inflation target) such tax hikes adding 0.7pp to inflation risk having an additional restrictive effect on the economy if they are read as inflation by the monetary authority and also by wage and price setters.

Wage policy: still no sign of area-wide wage pressure but worrying national divergence

Nominal wages are decisive variables in determining inflation in the medium run, and thus a key parameter for the monetary authority. If nominal wages grow at a rate equal to the sum of productivity growth and the target inflation rate of the central bank, inflation will, in the medium run, home in on that target rate. At the same time, real wages will increase in line with productivity and the functional distribution of national income between labour and capital will remain roughly unchanged.

Within a monetary union, furthermore, if national wage trends follow the rule with respect to national productivity trends, there will be no lasting changes in intra-area competitiveness.

As described earlier in this report, at the level of the euro area as a whole, nominal wages have performed this anchor function in a context of rising headline inflation due to repeated cost-push shocks (indirect taxes, oil). This is the key reason for the substantial differential between headline and core inflation. The IMK/ETUI-REHS expect area-wide nominal unit labour cost growth of just 0.6% in the current year, rising to a still very moderate 1.2% in 2007. Reflecting this, according to the European Commission (AMECO database) by 2007 the adjusted wage share will have fallen by almost two-and-a-half percentage points of GDP since the start of EMU in 1999.

The following tables based on data from the WSI and the ETUC show, respectively, collective agreements signed for Germany and other euro area countries with impacts into 2007.

Table 7

Recent collective agreements in Germany covering 2006 and 2007				
	Concluded percentage	Number of months	Ending in…	Annual rate of wage increases
Metal	3% (1)	13	March 2007	2.8%
Steel	3.7% (1)	17	January 2008	2.6%
Banks	4.5%	25	June 2008	2.2%
Deutsche Telekom	3%	16	July 2007	2.25%
Deutsche Post	5.5%	24	April 2008	2.75%
Wood,plastics	2.5%	12	April 2007	2.5%
Retail	1%	13	July 2007	0.9%
Paper	3.5%	24	March 2008	1.5%
Hotels	2.9%	24	March 2008	1.5%
Textiles	4.5%	22		2.5%
Energy	2.7%	13	March 2007	2.5%
Construction	1%			Negative since 40 hour week re-introduced
Public services (federal and community level)	One off payments, in January 2008 2,9% structural increase		July 2008	
Public services (regions)	2.2-2.7%			Working week from 38.5 to 38.7-39.35 hours

(1): plus one-off payment. Not included in annual rate.

Source: WSI (2006).

Table 8

2006 bargaining in the rest of the euro area			
	2005	**2006**	**2007**
Netherlands coordination rule	0.7	1.3	2.5 (maximum wage increase)
Netherlands-metal	1.1	1.1	
Spain	4	3.2	
Outcome in Spain first quarter 2006		3	
Belgium	2.4	2.4	
Finish national agreement	2.5	1.7	
Austrian metal and banking	2.5 (metal)	3	
Italy	2.1	2.5	
Italian metal		2.4%	
France	3.3	3.2	
Ireland		10% over 27 months (4.5% annual basis)	
Portugal	2.7	2.8	

Source: ETUC collective bargaining questionnaire 2006

These figures confirm the expectation of continued wage moderation in the euro area. Nowhere is there any sign of wage pressure raising core inflation. Importantly, in Germany where the scheduled VAT hike at the start of 2007 has given rise to concerns that this will feed into higher wage demands, in most important sectors wage agreements have already been reached that run well into 2007 and indeed 2008, locking in pay increases that do not raise concerns with respect to the ECB's inflation target.

Given an implicit ECB target of 1.9% and trend labour productivity growth of 1.5%, the non-inflationary average wage growth ceiling is at a first approximation 3.5%. Given the expected cyclical pick-up in productivity a certain period with nominal wages increasing at a rate of 4% would pose no threat to aggregate euro area inflation: currently and for the foreseeable future euro area wage setters are far from achieving such rates.

What explains the muted response of wages to higher headline inflation? Alongside still substantial economic slack and high unemployment in much of the euro area, the increased potential for relocating production within wider Europe and overseas, coupled with, in some sectors, heightened import competition, has reduced workers' bargaining power. In some sectors migration from the new member states is exerting downward wage pressure in euro area countries (while, partly as a consequence of outward migration, real wages are now rising very rapidly in the NMS). More specifically it is important to recognise that those euro area countries that in the past employed wage indexation mechanisms that tended to feed higher price rises into nominal wages, risking inflationary wage-price spirals, have

abolished or substantially reformed these mechanisms (for details see ETUC 2006).

- In Italy the scala mobile was abolished in 1993 and replaced by a system that recognises the price stability objective. Ex post compensation for past inflation is partial and has led to collectively agreed wage increases that have been only slightly higher than inflation (annual average 2002-2007: 2.2% (inflation) and 2.4% (collectively agreed wages) [5]
- Spain has retained a system of revision clauses for inflation above 2%, but in the period 2000-2005 this led to compe-nstion of just 40% of this differential. Still, unit labour cost growth has exceeded the area average, contributing to the deterioration of Spain's external balances.
- For some time in Belgium and more recently in Luxembourg, wage indexation has been based on a so-called 'health' index that excludes alcohol, tobacco and petrol prices.

Paralleling the discussion of fiscal policy above, while aggregate wage developments have recently contributed, and will continue to contribute, to macroeconomic stability in the euro area, developments at national level continue to give cause for concern. The trend towards widening real exchange rate differences within the euro area, reflecting diverging nominal unit labour costs, identified in the two previous IMK/ETUI forecasts is expected to continue this year and next (Figure 16 in Benchmarking section).

Germany has improved its competitiveness with respect to the euro area average – of which it itself represents almost one third – by more than 10 percent since 1999. With nominal unit labour costs expected to fall by 1.1% in 2006 and by 0.3% in 2007, Germany will further increase that competitive advantage in the two years under consideration. This will exacerbate the competitive pressure on the other – and especially the so-called club Med – countries.

It is vital that, in the course of a sustained economic recovery, German (and also Austrian) wages, in particular, return to growth in line with productivity plus the ECB's target inflation rate. Apart from being a prime cause of chronically weak domestic demand, a policy of 'exporting unemployment' to the rest of the euro area is clearly dysfunctional from a European perspective. Moreover it poses substantial economic and, ultimately, political risks to the sustainability of the currency union. For this to happen policymakers in these countries should avoid policies – such as cutting wage compensation benefits – that further weaken the position of wage earners in wage negotiations. More generally – especially in view of the decision to raise VAT by three percentage points – measures that restrict domestic demand should also be avoided.

At the same time countries with sustained high inflation – to the extent that this does not represent a desirable upward adjustment of national price levels towards the area average – will need to take appropriate measures, if they are to avoid a sudden adjustment in reaction to an accumulated loss of competitiveness and unsustainable current account deficits. This will certainly involve wage setting in line with the above-mentioned benchmark, and possibly below, but, depending on the national context, may also involve targeted fiscal measures and steps to reduce the extent of monopolistic price setting (e.g. in the professions). To the extent that a housing boom is fuelled by pro-cyclical mortgage lending, specific measures in this area should be considered. Of course,

[5] Italy has lost competitiveness in recent years (see below) but this has primarily reflected low and even negative productivity growth and monopolistic structures that have encouraged firms to pass on higher input costs (energy).

the best way to improve competitiveness for the countries concerned is to raise their rate of productivity growth at unchanged wage growth. This is a particularly pressing concern in Italy, which has actually recorded negative productivity growth in recent years.

In the medium run trade unions at the European level should pursue the various (national, sectoral) existing efforts at coordinating wage policy so as to achieve desirable nominal wage outcomes both in the aggregate and at national level.

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