2. MACROECONOMIC DEVELOPMENTS AND POLICY ISSUES

This chapter opens with an overview of economic developments in the EU, which constitute an important backdrop for developments and policies in other areas covered in this report. Until recently the economic news was largely good, with growth increasing and unemployment coming down to levels not seen in many European countries since the 1970s. We consider how likely it is that this growth will continue in the face of, amongst other things, an appreciating currency and rising inflation.

In the summer of 2007 the European economy was hit by the fall-out from the financial market crisis that had its origins in the US housing sector. A brief description of the way the crisis unfolded is given, and some of the linkages – involving such exotic 'players' as 'collateralised debt obligations' (CDOs) and 'special investment vehicles' (SIVs) – are explained. The vulnerability of the European economy to continued financial-market tensions is emphasised.

More broadly, recent years have seen a debate on the 'financialisation' of the economy. One of the phenomena behind this is the taking over of companies by so-called private equity (PE) firms. Such firms use own resources plus bank debt ('leverage') to purchase companies, often 'taking private' formerly publicly traded companies (and thus delisting them from stock exchanges), in order to restructure and subsequently re-sell them. A number of leading exponents of this model – most notably US-American PE titans such as Stephen Schwarzman (Blackstone) and Henry Kravis (KKR) – have become extremely rich in the process. The PE model is briefly explained and available evidence on the impact of PE activities on jobs and wages in the companies taken over is reviewed.

Themes

2.1. Overview of macroeconomic developments

2.2. Threats to a sustainable upturn: the exchange rate and inflation?

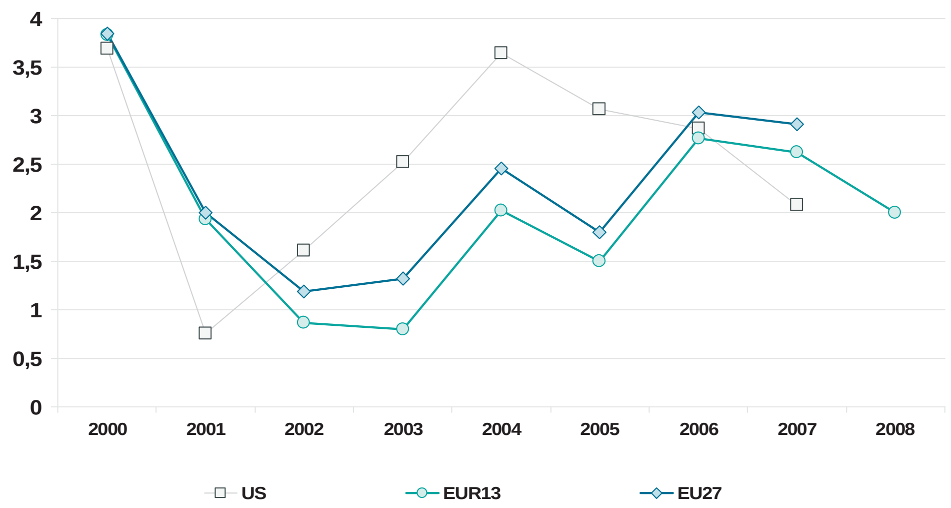
2.3. The financial crisis: causes, effects and remedies

2.4. Private equity: what impact on workers and companies?

2.5. Conclusions

Figure 1

Growth performance in the EU and the US (real GDP, annual change, %)



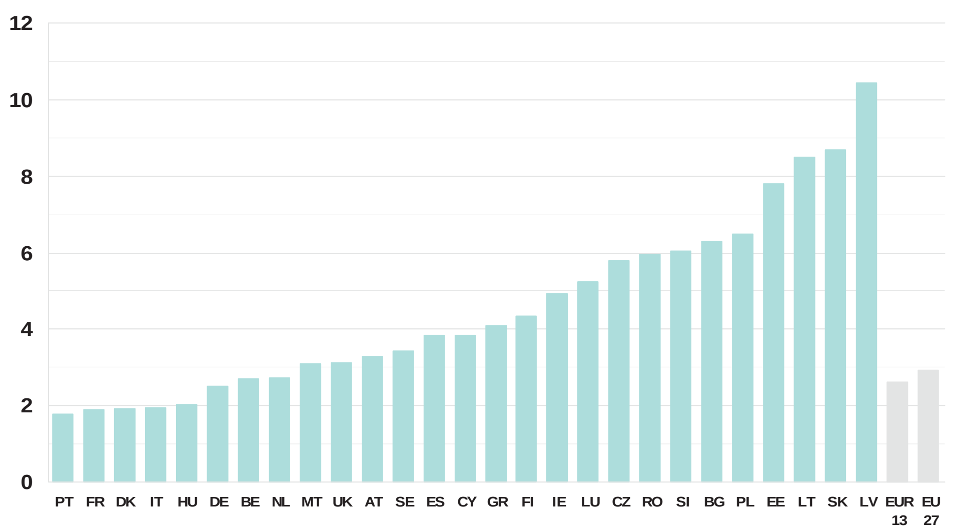
Note: 2008 figure is ELNEP forecast, Oct 2007

Source: Ameco

2006 had seen strong economic growth in Europe, at 3%, with the euro area finally coming out of a long period of economic stagnation after the sudden end of the economic boom in 2000/01. Prospects for a sustained period of growth looked favourable: world trade was booming, unemployment had fallen to lows not seen for decades (for details see next chapter), so domestic demand was strong, while inflation was contained. This picture darkened considerably in the second half of 2007, however. The crisis that began in the US housing sector had knock-on effects on the European financial sector – a process discussed more fully in section 2.3 – depressing growth slightly in 2007, albeit from high levels, but significantly increasing the risks of a more serious slowdown in 2008. The most recent ELNEP forecast (October 2007) was for 2% growth in 2008, but currently conditions are less favourable than the assumptions on which this is based (ELNEP 2007). The US economy has been badly hit by the problems in the housing sector: many families, particularly on low incomes, have run into problems financing their mortgages as interest rates have risen after initial ‘teaser’ periods run out. Meanwhile the value of houses has fallen, in some cases to below that of the mortgage. Repossessions have been on the increase. Coupled with the associated problems of non-performing loans in the banking system and high personal debt levels, the US economy seems set for a serious downturn, if not outright recession. This affects demand for European exports negatively. On top of this, the dollar has depreciated against the euro as the Federal Reserve has cut interest rates to contain the damage to growth and employment, further worsening European export prospects.

Figure 2

Real GDP growth (%, 2007)



Source: Ameco

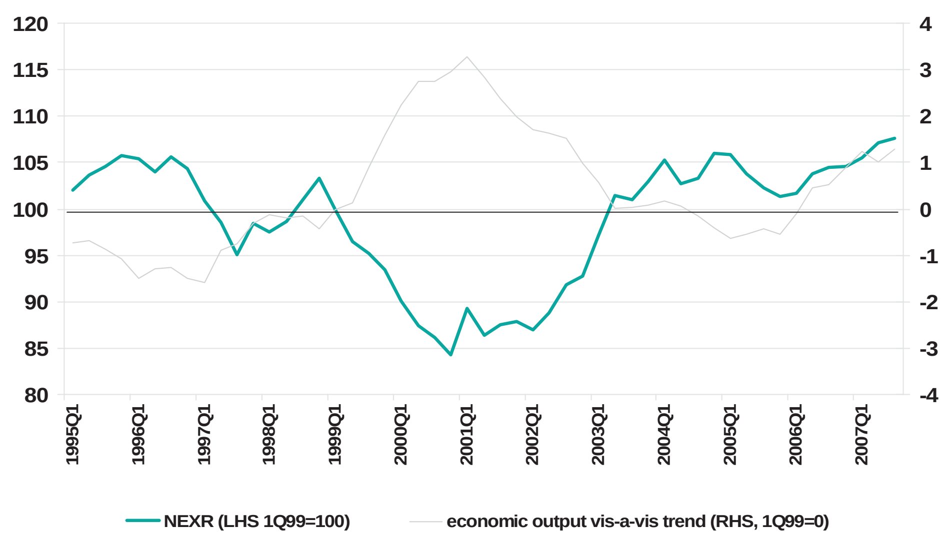
At the same time European economic policy is in a difficult position as higher food and energy prices have pushed up inflation to an uncomfortable 3.1%. The prospects for a continuation of economic growth are discussed in 2.2.

The figures for 2007 (Figure 2), which are annual averages, still show fairly robust growth, albeit a generalised slight decline compared with 2006. Worse, the dynamic going forward is weaker, as the still favourable annual figures are primarily thanks to strong growth before the summer. Looking at individual countries, we see that, once again, growth in the central and east European countries, and especially the Baltic states, is substantially faster than in western Europe. There has been concern about overheating in the Baltic countries, and indeed their growth rates have come down, although not in the fastest-growing country, Latvia. The continuing growth, at rates of 5-6% in eastern Europe (except Hungary, where growth has dropped sharply), marks a continuation of the steady process of European income convergence identified in previous BWE reports. The laggards in European growth terms (PT, IT, F) have maintained or even accelerated their growth in 2007, so that, compared with 2006, the spread between slow and fast-growing economies in Europe has narrowed slightly. The Danish economy has slowed markedly, albeit from high levels and after reaching record low unemployment. Following years of competitiveness-boosting but demand-depressing wage moderation, Germany has continued the 2006 story of a steady improvement in its growth performance, both absolutely and relatively.

A HIGHER EURO THREATENS TO DERAIL GROWTH …

Figure 3

Exchange rate fluctuations and output



Source: ECB, own calculations

Technical note: The NEXR is the value of the euro against a broad basket of other currencies, expressed as an index with the first quarter of 1999 (the start of EMU) = 100. Figures above 100 mean that the euro has appreciated against the currencies of major trading partners. To calculate the growth dynamic, economic output (GDP) in Q1 1999 is set at zero. A trend rate of growth of 0.5% per quarter is then subtracted from the actual GDP figures. If the economy constantly expanded at this trend rate, then the line would remain at zero. Numbers above 0 (a rising curve) indicate that the economy has been growing above trend, while negative numbers (a falling line) describe periods of below-par growth.

The economic outlook for Europe is cloudy. Two immediate causes of concern are the appreciation of the euro and faster inflation. The US-dollar has been in a sustained period of depreciation against the euro since 2001 (briefly interrupted in 2005); the recent slowdown and particularly the resulting cuts in interest rates by the Federal Reserve have accelerated the process. At the start of 2006 the euro bought around USD 1.20 – a level generally seen as being close to an ‘equilibrium’ value. By the end of 2006, the euro had risen further to re-attain its previous record, of around USD 1.35. Even so, during 2007 the euro continued to appreciate, initially steadily. In the wake of the financial crisis and the resulting interest rate cuts in the US, the dollar then went into free fall, flirting with the 1.50 mark, before recovering marginally. This prompted speculation that foreign central banks might dump their vast dollar holdings, causing a run on the currency, which would certainly cause a serious recession in the US, if not provoke a major global crisis.

The question is what impact this will have on the European economy. To help assess this, Figure 3 plots movements in the nominal effective exchange rate (NEXR) of the euro against the growth dynamic in the euro area.

A HIGHER EURO THREATENS TO DERAIL GROWTH ...

The NEXR line shows that the external value of the euro broadly tracked the euro-dollar exchange rate described above. (This reflects the fact that a number of important EU trading partners have currencies that are pegged to the dollar or, like the yen, have tended to follow the dollar rather than the euro.) With an interlude in 1998, the euro depreciated steadily until 2001, only to appreciate steadily since then (again with an interlude, in 1995). By late 2007 the NEXR of the euro was some 7% above its value at the start of EMU and a full 25% above its low point at the start of 2001. Taken by itself, this means that euro area exports were on average that much more expensive, and its imports that much cheaper.

The inverse link between the exchange rate and the growth dynamic over much of the period – usually with slight time lags – is immediately apparent from the graph. Growth rates went above the underlying trend in 1997, a situation that continued until 2001, just at the point that depreciation gave way to a stronger euro. The subsequent very sluggish growth, which lasted into 2005, was mirrored by the steady and substantial appreciation of the euro. The nascent recovery at the end of 2003/start of 2004 appears to have suffered a setback from a negative currency shock. The return to above-trend growth from the end of 2005 came after a stabilisation and then reversal of the appreciation dynamic (the NEXR falling back around 5 percentage points). The approximately 6p.p. appreciation since the start of 2006 already appears to be manifesting itself in a flattening out of the growth trajectory.

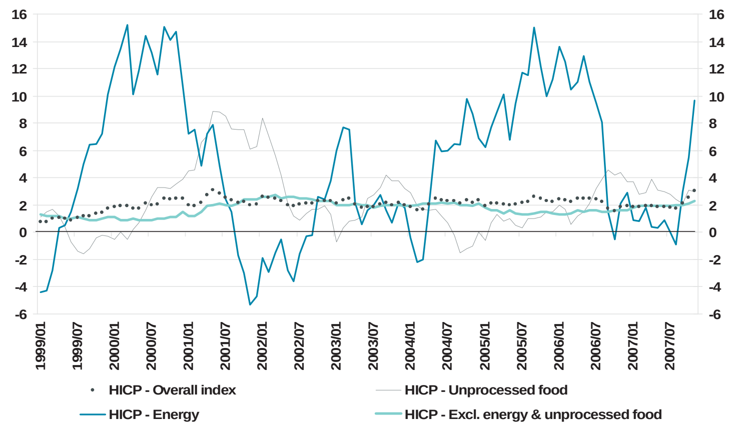
Of course such a graph shows a correlation, albeit a striking one (-0.77), and does not tell us anything definite about causality. (The time lag between exchange rate movements and short-run changes in economic growth and standard economic theory are suggestive of there being a causal relation running from the former to the latter, however.) While the future growth trajectory is uncertain, this evidence suggests that the ECB, in particular, should be particularly sensitive to the likely impact of the exchange rate on output: Europe's exporters are no longer able to absorb a higher exchange rate by compressing profit margins on their foreign sales, and European exports are certain to be affected. To counteract this, the Bank has two main tools at its disposal. It can cut interest rates or it can intervene directly in the foreign exchange markets, selling euros (which it can print 'at will') for dollars.

2.2. Threats to a sustainable upturn – the exchange rate and inflation?

… but does higher inflation tie the ECB's hands?

Figure 4

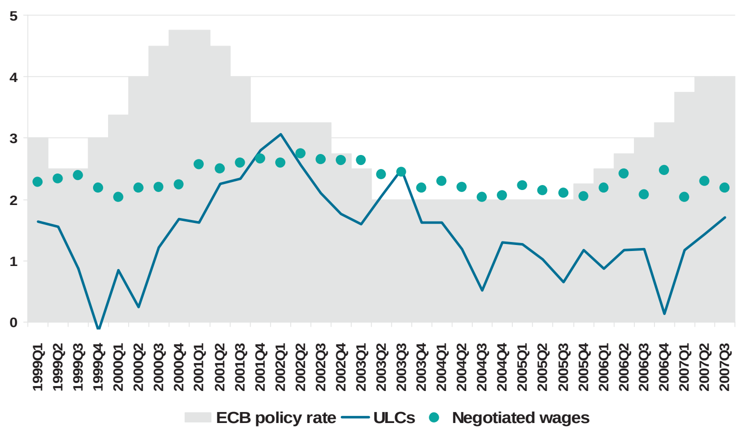
Inflation and its components



Source: ECB

Figure 5

Monetary policy and wage developments



Source: ECB

The ECB may, however, be unwilling to take action to avoid further appreciation of the euro, given that inflation is above target. Last year's BWE looked closely at the inflation numbers, arguing that the above-target inflation rate (then 2.3% on annual average, compared to an ECB target of just below 2%) almost wholly reflected much higher energy prices. Wage growth, by contrast was subdued.

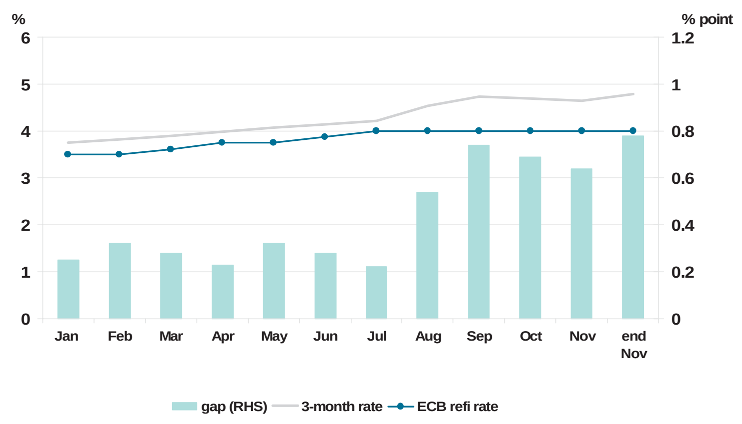
Inflation recently hit 3.1% in the euro area (November 2007). Was last year's analysis incorrect? Have wages pushed up inflation, and thus prevented the ECB from lowering interest rates to shield the recovery? In fact, after falling at the end of 2006, 2007 saw further upward pressure on energy prices (Figure 4). Moreover, increases in food prices pushed prices for staples such as wheat and maize to record levels. As the ECB has itself has acknowledged, it is these factors that have pushed up inflation, as measured by the harmonised Index of Consumer Prices (HICP), to beyond the ECB's 'comfort zone' (e.g. ECB 2007: 6). However, central banks can safely ignore imported inflation provided it is not passed on into higher wage demands. Figure 5 shows clearly that the pace of negotiated wage increases continues to lie between 2 and 2.5%. Unit labour costs (ULC) – the total wage costs to produce one unit of output, and the most important domestic determinant of inflation – have, it is true, accelerated quite sharply in the latter part of 2006 and during 2007. But this is from an extremely low base. The last figure (Q3 2007) is still 0.3p.p. below the 2% inflation target and even that ignores the scope for ULC growth above this figure for a certain period in view of the long period during which ULC growth was below 2%, but inflation above (i.e. in which national income is transferred from wages to profits – see also Chapter 5). Given the uncertain economic outlook it seems unlikely that wage growth will pick up substantially.

The upshot of this analysis is that the ECB was correct to halt its hikes in base rates in the summer (Figure 5). Indeed, for as long as there is no sign of 'second round effects', i.e. higher import prices feeding through to higher wage settlements, the ECB should instead be considering rate cuts to avert an economic slowdown; the inflationary impact of the higher energy and food prices will soon drop out of the statistics and the current inflation rate will come back down to target. The EU's Macroeconomic Dialogue is a potentially useful instrument in this context for the monetary authority to discuss with the social partners, especially trade unions, a cooperative strategy that avoids the need for interest rate hikes while ensuring that wage increases remain, on the one hand, non-inflationary, and, on the other, sufficiently robust to ensure continued stable demand growth and balanced income trends (Watt 2005, 2007).

The financial crisis which hit the US and Europe in the summer had its origins in the US-American housing sector: following years of price rises way above inflation and a construction boom in many areas, prices had reached unsustainable levels, the stock of unsold homes built up and new activity contracted. Meanwhile it emerged that, in their urge to keep the carousel spinning, mortgage companies had increasingly targeted potential homebuyers who would not previously have been considered credit worthy (sub-prime borrowers). Thus people lacking income and even jobs were enticed onto the housing ladder with low 'teaser' interest rates, that re-set after an initial period. Mortgage brokers' incentives to monitor creditworthiness were reduced (to virtually zero) by the practice of selling on packages of mortgages to other financial investors (securitisation via so-called asset-backed securities, ABS), volumes of which shot up exponentially in recent years (OECD 2007c: 32ff.).

Figure 6

Three-month and ECB interest rates (2007)



Source: EUROSTAT (2007a), ECB (refi monthly averages are estimated)

These securities, packaged together in obscure ways, were bought by banks, pension funds and other investors throughout the world seeking higher yields than those available on safe government bonds. The securities received high ratings (including 'triple A', the highest category) from ratings agencies that at the same time were earning commissions from brokers for packaging securities. Banks, seeking to avoid regulations on minimum capital holdings (and in some cases taxation), created off-balance-sheet funds, so-called special investment vehicles (SIVs) and 'conduits', to hold such assets.

When the housing market turned down and defaults and repossessions began to rise, this constellation of financial interlinkages constituted a 'perfect storm'. The price of risky assets rose ('repricing of risk'). A lack of confidence in the ability to determine the 'true' value of the complex structured products effectively meant that the entire ABS market dried up. Fear of lending to institutions sitting on unknown quantities of 'bad paper' and liquidity hoarding by banks facing calls for support from their SIVs meant that banks were reluctant to lend except very short term. Normally the 'spread' (the interest-rate differential) between three-month rates – what the banks charge each other to borrow money for three months – and the central bank refi rate – what the central bank charges commercials banks to borrow money – is very small, typically some 0.2 percentage points. In the summer of 2007 this spread jumped up by more than half a percentage point (Figure 6), implying a substantial and undesirable tightening of monetary policy. Banks in the UK and Germany had to be bailed out. After some initial hesitation, central banks stepped in: the US Fed cut its base rates repeatedly; the ECB suspended planned rate hikes. Both central banks injected billions of dollars/euros into the money markets to reduce spreads. In early December 2007 such action was even coordinated between the central banks of the US, the euro area, the UK, Japan and others; the impact of such measures repeatedly proved only transitory, however. A succession of global banks reported losses of tens of billions of dollars. Estimates of total losses in the global financial sector were continually revised upwards, with figures as high as half a trillion USD mentioned. Bank CEOs were 'let go', albeit with generous compensation packages.

The question is whether what began in the real economy, and then caused havoc in the financial sector, could in turn have an important negative feedback effect on the real economy in the form of output and job losses. Bank lending and conditions of access to credit have clearly tightened. However, this has been against the background of high profitability and a more or less dynamic upturn in much of Europe. At the time of writing the consensus view is that a slight slowdown in Europe (and a more substantial one in the US) is inevitable. The continued lack of information on the full extent of the losses (along with that concerning other risks such as the exchange rate discussed earlier) means, however, that this outlook is very uncertain. What is clear is that the risks of a more serious downturn have increased substantially (ELNEP 2007).

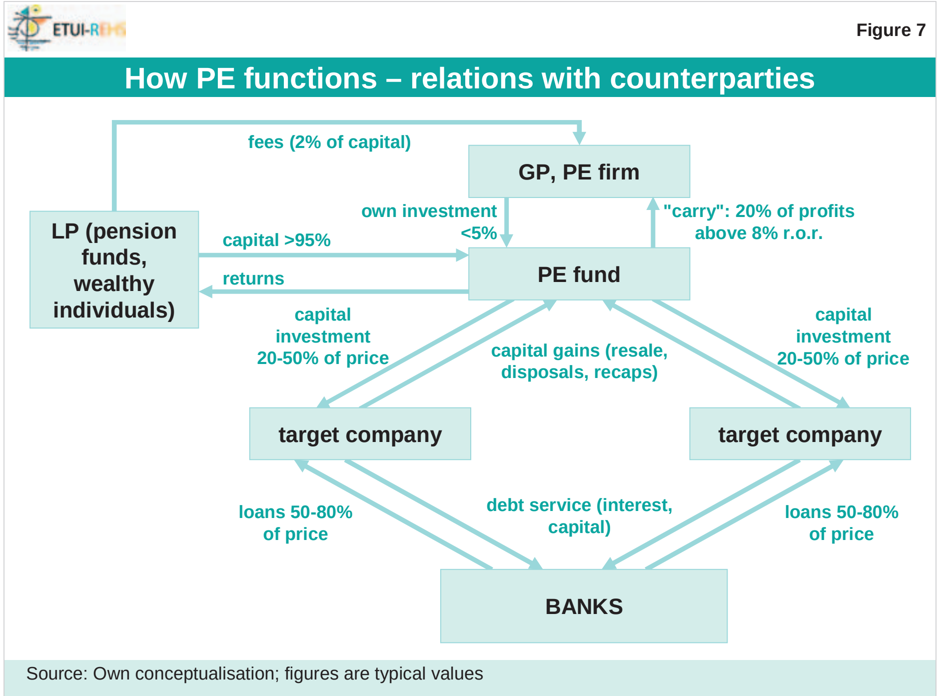
Clearly Europe's financial sector is in need of 'structural reform'. What policy lessons emerge?

- Banks have been bailed out by the public authorities (directly) and central banks (indirectly). The price of such support must be acceptance of and adherence to regulation. Such regulation and enforcement issues need to be urgently re-examined as banks and other financial institutions have increasingly used financial innovation to evade them. In particular the use of off-balance sheet entities must be strictly controlled.

- Tighter regulation and the provision of public information is needed to ensure that the practice of securitisation spreads rather than concentrating risk and that the location of such risks is known to the responsible authorities.

- The role of ratings agencies needs to be examined to resolve issues of conflicts of interest. To the extent that such information is a public good, it should be provided publicly or its provision by private firms must be appropriately regulated.

- Regulatory frameworks need to be seen in a European context. National authorities have incentives to compete to attract capital and wealthy investors by offering the laxest regulations. Cooperation between regulatory authorities and/or European-level solutions are required.

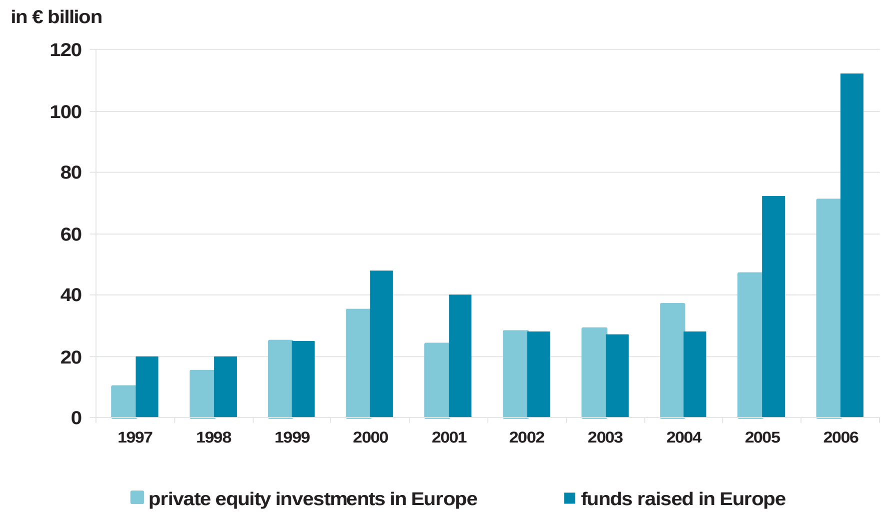


The recent financial turmoil has also focussed attention on a more structural development, the increasing ‘financialisation’ of the economy. This term is used to encompass many different developments, such as the increasing importance of the financial services sector, the growth of capital markets (and the replacement of longer-term relations between companies and banks), speculation by hedge funds on currency and other markets, and the massive increase in the number and complexity of traded financial products (derivatives, options, asset-backed securities, etc.). This section looks at just one aspect of this multi-facetted phenomenon, providing a short introduction to the phenomenon of private equity (PE).

Figure 7 shows how the PE model functions. A general partner (GP) sets up a private equity firm. He convinces investors (wealthy individuals, pension funds, etc.) to put money into a fund promising high returns; such investors are termed limited partners (LP). The fund then purchases target companies using 50%-80% of bank debt (so-called ‘leveraged buy-out’). The target firm is then ‘restructured’ in various ways, usually within a clearly defined time of 3-5 years, before being sold on. The PE firm gets a return from the difference between the purchase and the sales price (capital gain) plus dividends and other fees from the target company, which also has to service the bank debts. These earnings are returned to the LPs minus an annual management fee plus a share of the profits (so-called ‘carry’ or ‘carried interest’: usually 20% of profits above a threshold rate of return, often 8% p.a.) which goes to the GP.

Figure 8

Private equity investments and funds raised in Europe



Source: EVCA/Thomson Financial/PricewaterhouseCoopers

Recent years have seen a phenomenal increase in the number of buy-outs, the amount of capital mobilised by PE firms (Figure 8), and, particularly, the size of the companies taken over. Whereas previously leveraged takeovers were limited to small and medium-sized enterprises, recently a combination of ever more capital seeking higher returns, cheap debt, laxer lending standards by banks, and the pooling of different PE companies in so-called club deals have led to the takeover by PE of household names, such as Boots (UK) or Märklin (DE). This, in turn, has led to increased public scrutiny of the PE model, and a number of campaigns by trade unions. Criticisms of PE relate to four main issues:

- company restructuring practices: high returns to PE investors are at the cost of job losses and cuts in pay and conditions, and weakening of workers' participation and collective bargaining rights.
- taxation: by using more debt (which is tax deductible) PE-owned companies pay less corporation tax, while PE partners pay low rates of tax (on capital gains rather than income) or avoid tax altogether (offshore tax havens).
- leverage: at the micro level PE saddles companies with debts and risks insolvency, at the macro level leverage can provoke financial crises.
- information and transparency: when large publicly owned companies are 'taken private' much less public information is available; PE is secretive more generally.
- Short-termism: the 2-5 year timeframe of PE is inimical to the required long-term investment in fixed capital and workers (lifelong learning) that the European economy needs to remain competitive and productive.

The evidence on these and other issues is patchy, suffers from serious methodological problems and tends to be mixed (for an overview and references to the literature see Watt 2008): case studies of restructured companies range from the highly successful to the disastrous (from the point of view of the workers concerned). Constructing averages from such a range is not necessarily helpful. Overall, the literature suggests that employment losses are likely on average in target companies, especially where management is changed. To some extent, though, the jobs in these firms may not have been sustainable. Restructuring is a necessary process in a changing economy and job losses at firm level may be inevitable, but be offset by higher productivity (and thus earnings potential) and job opportunities elsewhere in the economy. It seems that PE does work with existing structures of worker interest representation, and is of course bound by national laws, but inevitably has the 'whip hand' in cases of takeovers of companies in financial difficulties and can exploit workers in a vulnerable position: 'implicit contracts' with former owners/managers are often no longer adhered to. Workers' rights are inadequately protected under the European takeovers (acquired rights) Directive, as takeovers by investment funds are excluded from coverage.

It has become obvious to governments that the PE model systematically exploits taxation systems and a number of countries (DK, DE, UK) have announced or are considering legislative changes. On both transparency and short-termism the debate is more nuanced. Arguably the problem is that publicly traded companies have to provide too much information (quarterly reporting), and it is they, rather than PE-led companies, that are driven by market pressures to short-termism. At the same time the threat of takeover by PE (or 'activist' hedge funds) may be one element driving the short-termism of listed companies, so that the impact of PE is wider than the circle of target companies and the direct impact becomes hard to measure.

2.5. Conclusions

At the start of 2008 the European economy appeared to be performing tolerably well and has overtaken the USA in terms of growth performance. However, numerous clouds have gathered in the form of higher energy and food prices, an appreciating currency and uncertainty following the financial turmoil of the second half of 2007. The prime task of European policymakers must be to keep the economy on track, limiting the extent of the downturn as much as possible, permitting the welcome reduction in unemployment and fiscal deficits to continue. High inflation does restrict central banks' room for manoeuvre, but provided wages continue to be set appropriately – and there is some scope for further non-inflationary acceleration in many countries – upward price pressure will recede. Therefore the ECB, in particular, should do all it can to support growth either by intervening in currency markets or reducing interest rates. Existing coordination instruments, notably the macro-economic Dialogue, should be used to reach cooperative solutions and maximise the scope for policymakers to support the recovery.

The financial turmoil has revealed the limitations of an economic policy based on the idea that markets and market actors 'know best', and that codes of conduct and ethical statements represent adequate regulation. When pondering areas requiring 'structural reform', policymakers need to take a hard look at the institutional features, interlinkages, and conflicts of interest in the financial system. A growing financial services industry is no bad thing if it is providing useful services to individuals and businesses. To the extent, though, that it is expanding primarily by virtue of its skill in sucking resources out of the other sectors of the economy (producer companies, governments, workers), then appropriate action to tighten regulations needs to be taken.

The future of private equity is also unclear, as stock markets have ceased rising and interest rates are higher, squeezing PE's ability to earn high returns from its business model. A number of high-profile cases have shown major causes for concern for other actors, especially workers and also governments (tax revenue). The discussion still suffers from a lack of comprehensive and reliable data, and further independent studies are required, for the purposes of which the actors concerned should make their data publicly available. A number of national governments have already examined and in some cases legislated on some aspects of the PE model (especially taxation): policymakers should keep PE firmly in their sights in the coming years, and find creative solutions to the difficult problem of preventing excesses while not creating obstacles to needed restructuring process in European companies.