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THE SLOWDOWN IN EUROPE AFTER THE WORLD FINANCIAL CRISIS AND THE (KEYNESIAN) CHALLENGES FOR ECONOMIC POLICY

by

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I. Shock and Response

1. The turn of the year has brought a further deterioration in the European economic climate (euro 11 countries). While the impact varies from country to country, the Commission in its spring forecast has revised downwards the expected growth for 1999 for all countries with the exception of Ireland. In this respect, the downturn is evidently a case of the phenomenon called by economists a "symmetrical shock". Moreover, this is clearly a negative demand shock. This is borne out by the origin of the weakening: the growth slowdown that has now set in is clearly the consequence of a sharp drop in exports. From mid-1997 to early 1998, exports by the euro 11 countries had registered growth rates peaking at up to 20 %; in contrast, the rate of change on the year in the last quarter of 1998 was already negative.

2. The present slowdown in the growth rate must be viewed in conjunction with the fact that the acceleration of growth from 1.6 % in 1996 to 2.5 % in the following year was clearly attributable to the enormous gains realised by European economies in their share of the world market. This in turn was primarily the consequence of a massive depreciation of European currencies in real terms in relation to the rest of the world. The real, trade-weighted (effective) exchange rate of the European currency area declined by almost 15 % from mid-1996 to mid-1997. However, by mid-1998 two thirds of this decline had been made good by an upward revaluation. Only in the past few months was the direction again reversed, since the beginning of the year the Euro has lost again 8 % in its trade – weighted value.

3. Notwithstanding the most recent depreciation of the euro, foreign trade cannot be expected to give a boost comparable to that in 1997 in this and the coming year. Many of the economies in transition have already substantially devalued or are continuing to devalue their currencies, the majority of which are not included in traditional calculations of the real exchange rate. For instance, the Czech republic has devalued the koruna since the start of the year by about 7 %, Poland the zloty by about 5 % and Brazil the real by almost 30 % against the euro. Moreover, while gains in market shares may be expected from devaluation in real terms even when markets are shrinking, the increase in exports in absolute terms is likely to remain small.

4. Hence developments in the U.S.A. are of central significance for European exports. If the American boom continues, Europe is again likely to reap large-scale benefits, as the devaluation of the euro against the U.S. dollar in real terms since the start of the year is already in the order of 13 %. But this also embodies one of the major risks to European growth. If the American boom comes to an end with the bursting of the stock market bubble or with an appreciable loss of value of the U.S. dollar on account of growing external imbalances, Europe is likely to experience another severe setback.

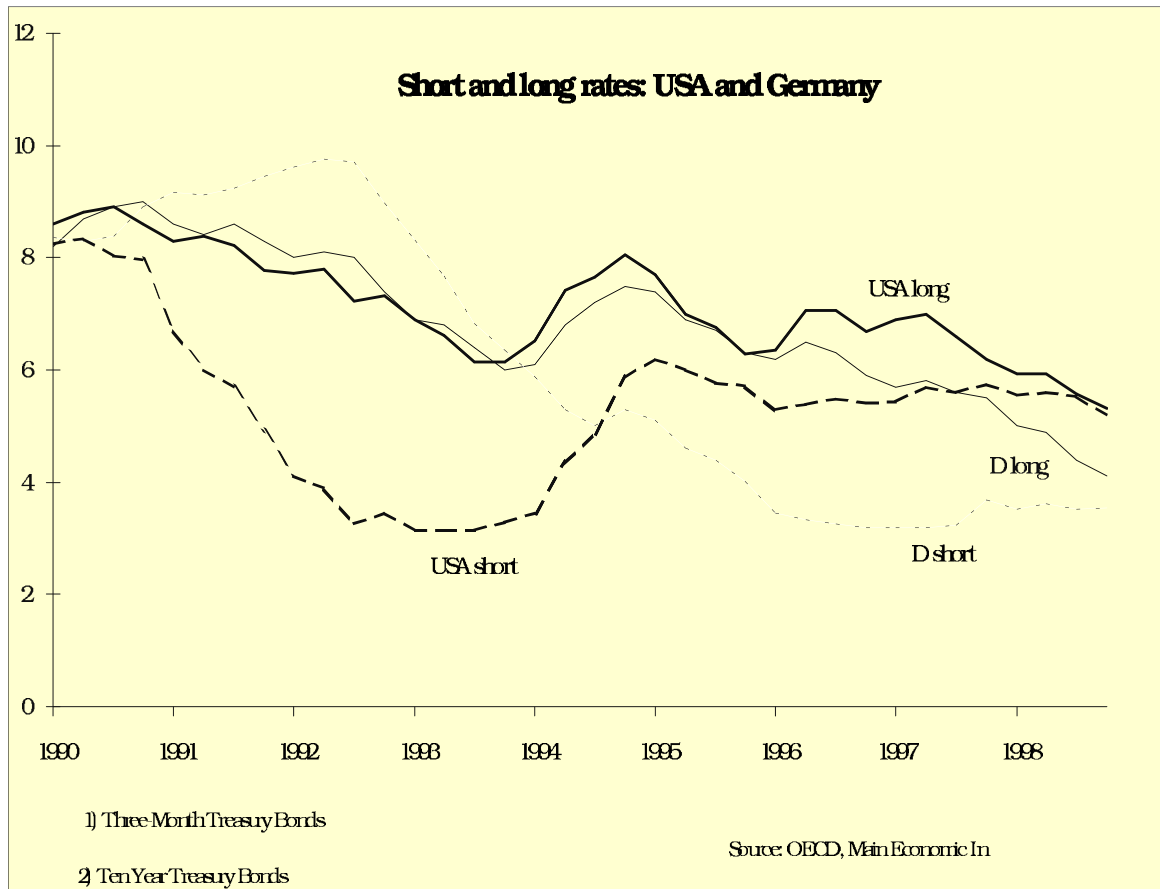
5. This would be supportable only if it were possible to render the European economies much less dependent upon exports, in other words to reinvigorate domestic growth, in a comparatively short period of time. But such revitalisation cannot be expected to come from endogenous sources, from the market alone, as has time and again been implied by the stock image of a "blip" in the growth curve. In the wake of a pronounced negative exogenous shock, only positive exogenous shocks can return the economy to its previous growth path. This is demonstrated particularly effectively by the development of the industrial sector, where fluctuations in the cycle are most marked because it is generally most heavily exposed to the consequences of shocks. The same holds true in the present case: at the close of the past year, industrial output in the euro 11 countries fell short of the preceding year's figure. In the past, this has always been a danger signal.

   After the end of the severe recession of 1981/82, the rate of growth of industrial output in the euro 11 countries registered above 6 % (year-on-year change) only three times and in each case for a very brief phase, namely in the periods 89/90, 94/95 and 97/98. These

were interspersed with four marked downturns, leading in three instances to a minor and in one instance to a major absolute decline in industrial output.

6. The major downturn in 1992/93 may readily be accounted for. In this case it was clearly the framers of monetary policy who in order to prevent the emergence of accelerating inflation in the course of the reunification boom in Germany tightened the monetary reins, hence making inevitable a sharp fall in investment by European business and industry and a pronounced upturn in unemployment. This may be seen both from the exceptionally high level of interest rates at the short end of the market (the real short-term rate registered a peak of 8 %) and from the inverse interest rate structure. The minor downturns in industrial output had differing causes. As in the present case, the 1986/87 downturn was attributable to weak exports (especially in the wake of a marked appreciation of European currencies against the U.S. dollar). In 1995/96 it was primarily the restrictive effect of American monetary policy, causing a phase of weakness in Europe and elsewhere in consequence of a pronounced world-wide rise in long-term interest rates. In the euro 11 area, the real long-term interest level rose from 3 % in early 1994 to 6 % at the close of that year (see graph for Germany and the US).

Whatever the specific causes of these downturns were, they were all ended by clearly identifiable macroeconomic stimuli. In 1987 it was the world-wide easing of monetary policy in the wake of the stockmarket crash, in 1993/94 the decline of interest rates and the return to a normal interest rate structure and in 1997 the aforementioned devaluation of European currencies in real terms. There is at present only the devaluation of the Euro which presents a stimulus to the European economy.



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8. The fact that consumption indicators such as consumer confidence are still on a rather high level is frequently taken as an indication that the endogenous strength of domestic demand could prove sufficient to reverse the trend. There are indeed past examples showing that stepping up the rate of growth of private consumption has been able to offset the tendency of other aggregates to decline. This was the case, for instance, during the "Thatcher boom" in England during the eighties, when the personal savings ratio fell from 6,4 % in 1981 to 2,2 % in 1986 (cf. OECD Economic Outlook, Dec. 1998, p. 216). In the past few years there have been similar trends, among others in Sweden and Denmark. The most recent example is the United States, where the tendency to weakness emanating from the

emerging economies was more than offset by a massive reduction in the personal savings ratio from 2.2 % in 1997 to zero or even into negative figures by the end of last year.

9. Given the lack of stimulus from economic policy and the retarding effects from external sources, a reduction in the personal savings ratio is the only way in which Europe can avoid a lengthy period of persistent weakness. Despite historically low nominal interest rates, investment activity loses momentum because the general climate has clearly deteriorated for investors in comparison with last year, especially for investors in the major European economies. In consequence, the employment situation will at best show no improvement on 1998, so that one cannot at present count on this potential source of more income and hence greater domestic demand in Europe either. However, the personal savings ratio is not suited to use as an "instrument" of economic policy. Even if reducing this ratio as such were feasable, there is still no dependable means of encouraging private households to forfeit a major part of their savings in favour of consumption.

10. Moreover, reducing the personal savings ratio is in principle subject to the same reservations as deficit spending by governments. Those who argue that higher government deficits produce higher long-term interest rates because the state creates extra demand in the capital market in addition to that in the product market and that accordingly a positive aggregate effect is not to be expected must in all consistency also endorse the view that a declining personal savings ratio generates rising interest rates on account of the concomitant reduction in the supply of capital, so that here too the aggregate effect does not have to be positive. A different matter altogether is the fact that a decline in private provision for the future will create additional difficulties in a situation where growing emphasis is being placed on private provision in an attempt to cope with the current and future problems of pension systems.

11. With the weakening of the economy since the autumn of last year the conditions for the introduction of the Euro have fundamentally changed. Whereas the technical introduction was a smooth and simple affair, the economics of the introduction proof to be a protracted and difficult process. Policy makers in Europe never had thought about a start of the Euro in the realms of a world financial crisis and a renewed slowdown of the European economy. But even the new centralbank had to act immediately. The appropriate point at

which to take economic policy action was reached at the same time as the Euro was born. Given the familiar operational time-lag, a waiting game of the central bank would have inevitably resulted in an even more pronounced slow-down in growth and a rise in unemployment. Under heavy political pressure to act the ECB ultimately did cut rates in April from 3 to 2,5 %. The question is whether such a move is sufficient to overcome the current weakness and to regain the growth path of 1996 and 1997.

II. The Policy Options

12. However, the Commission, the ECB and the European Council, in common with many other institutions, expects the probable development to be only a brief, temporary weakening of growth that can be accepted without the need for macroeconomic countermeasures. This view is exceedingly questionable, above all for two reasons. Firstly, even a "temporary" weakening will halt the decline in unemployment that has only just started. By doing so it will buttress unemployment through hysteresis effects, hence making it more difficult for unemployment to be brought down by other means and at a later stage. Second, and more importantly, every slowdown in economic activity bears the seeds of self-reinforcement if no expansive opposing impulse is applied. The downturn in expectations on account of falling demand from abroad will always spread to domestic demand if no compensatory effects arise somewhere else. Playing a waiting game is an exceptionally hazardous strategy, not least in view of global instabilities.

13. It is a widely-held misconception to believe that "automatic stabilisers" could be the source of such a compensatory effect. Given the necessary scope, the stabilisers in monetary and fiscal policy and in private households can do no more than avert imminent destabilisation, i.e. economic collapse. This is clearly demonstrated by the decline in long-term interest rates. This decline naturally weakens the effects of the global reduction in the demand for capital by which it was triggered. But the decline in long-term rates will never be sufficient to lead the economy back to its former equilibrium or to its original growth path. The same holds for the fiscal policy stabilisers or for a decline in the personal-savings ratio.

14. As these interrelations are indisputable, there is a unanimous view in the literature of economics that there should be instruments that can be used to counter such demand-led shocks. The global fall in demand quite clearly constitutes for the euro-11 what is known as a symmetric negative demand shock**.** A common monetary policy can and should react to such shocks - this, too, was the absolutely unanimous opinion among economists in the run-up to the euro. The only controversial issue was whether and in what way one can react to asymmetric shocks under the conditions imposed by monetary union.

15. After the occurance of the symmetric shock most of the observers including the Commission feel that the present policy mix and the prevailing monetary conditions appear to be broadly right if there is convincing evidence that the economic slowdown in 1999 is likely to be only „temporary“ . Such a view is not helpful at all. Given the global situation, the evidence is "uncertain" and anything other than "convincing". Added to this is the fact that setbacks are always temporary: what is important is the duration and the intensity of the setback. Unless it is completely clear from the outset that monetary policy will assume the task of stabilisation and countering the shock, fiscal policy should on no account envisage budgetary tightening. Even trusting simply in the automatic stabilisers would in itself be a very risky strategy.

16. What is asked for by mainstream economic analysis in Europe as an adequate policy response is in no way „keynesian“. A reduction of short term interest rates by the central bank is implicit in any monetarist prescription of medium term reliable monetary targeting. This is true for Friedmanite monetary base growth as well as for approaches following „Taylor-Rules“. Whenever real growth and/or the inflation rate fall short of the rate that had been targeted in one way or the other by the central bank, interest rates have to be cut or fall automatically. Even in the concept the Bundesbank had been following in the last 20 years this in undeniable. The fact that there has never been something like an exogenous money supply didn’t hinder German monetary policy to act „as if“ its intermediate money target, M3, would be an exogenous variable and thus fully under control of the central bank. But if this is an adequate approach an immediate reduction of short rates in case of a symmetric demand side shock is unavoidable. Thus, it is more than surprising that the national as well as the European central bank were extremely hesitant to do what their own concept demands.

17. It is more than questionable whether the "steady hands" policy which – in the „oral“ tradition of the Bundesbank - is proclaimed by the European Central Bank is currently contributing anything at all to counter the shortfall in demand. At all events, the reference to historically low interest rates is misleading. The inflation rate has also reached a historically low level in Europe. Even if one applies only the current CPI-inflation rate as an interest deflator rather than business price expectations or producer prices, the long-term real interest rate is by no means low and at 3 ½ clearly above the real rate of growth. Even more serious is the very marked narrowing in the spread between short and long-term rates**,** both in real and in nominal terms (see graph). The spread (nominal long less short) has narrowed in Europe since mid-1996 from almost 3 percentage points down to 0.5 and has only recovered a bit with the rise of long rates in the States. At all events, this implies that the supply of capital is growing much less than with a "normal" spread, as it is now still a more attractive proposition for many investors to switch from risky, long-term to much less risky short-term investments than at the beginning of the last recovery in 1996. In other words, while long-term interest rates are low in absolute terms, short-term rates would have to be much lower if interest rate patterns were to reflect intertemporal investor preferences adequately.[1] The fact that this is **not** the case is clearly a destabilising element in the present economic situation. Thus monetary policy fails to react to the symmetric demand-led shock in a way that would lead the other policy areas to expect that they in turn could depend solely on automatic stabilisation.

18. The comment often heard in Europe that in the USA the interest rate structure is still less positive than in Europe may be factually correct, but it is of little practical help. After seven years of expansion the USA has achieved full employment and in this situation a demand-led shock from abroad brings a welcome cooling-off of the economy. At any rate, in the USA this prevents monetary policy-makers from pulling in the reins, that is, from raising short-term interest rates again. Consequently, taking into account the respective cyclical positions, the inaction of American monetary policy-makers since last autumn is at least equivalent to an interest rate cut in Europe.

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[1] (Consumption is only forgone today if appropriate compensation is received in the form of higher interest on a long-term investment.)

19. By sticking to a destabilising macroeconomic course while at the same time stressing "structural" factors Europe is continuing the same policies which it pursued over the entire 80s and 90s. Yet, since the beginning of the 80s unemployment in the USA and in Europe has plainly been growing apart. Precisely since the early of the 80s the monetary regime in the two regions has also fundamentally diverged. Whereas in the 70s the interest rate spread in the USA and in Europe was of comparable dimensions, this changed fundamentally at the beginning of the 80s. Between 1980 and 1998 the difference between long-term and short-term interest rates in the USA was on average something like 1.1 percentage points; in the euro 11, on the other hand, it was only 0.4. If one disregards Germany with 0.8[2], the value for the euro 10 drops right down to 0.1.

20. These findings boil down to the fact that on average in the Europe of the last 18 years monetary conditions have not been "normal" in the sense that people's preference for the present was reflected by a reasonable spread between long-term and short-term interest rates. Only the short phases of the normalisation of this relationship both 1987-88 and since 1994 has enabled Europe to return to higher growth rates and a slight reduction in unemployment. But even this is now in jeopardy again due to the deflationary pressure which world capital markets are exerting on long-term interest rates and the inadequate reaction of short-term rates in Europe.

21. It proved impossible to cushion the impact of continued restrictive monetary policies on the labour market in spite of an extremely high degree of flexibility of real wages. Contrary to the situation in the USA, where real wages normally do **not** lag behind productivity even with high unemployment, Europe (the euro 11) has displayed enormous flexibility here. Since the beginning of the 80s, real unit labour costs (that is, growth in real wages minus productivity gains) have fallen by almost 20 **%**, whereas in the USA they have consistently remained constant, even in periods of high unemployment.

22. To sum up: If monetary policy-makers can find no answer to the symmetrical negative demand shock, other policy options for Europe have to be considered. This is not a first best solution. Monetary policy is certainly the superior instrument to respond to a shock

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[2] This is justified because Germany's value, close to the USA's, is accompanied by a jobless rate in West Germany which until 1992 (using the OECD's standardised data) was almost always <u>below</u> that obtained in the USA.

like this[3]. But if it is not used, fiscal measures cannot be ruled out, because the option of doing nothing could turn out to be extremely expensive as it could lead to a deflationary spiral downwards in Europe and in the whole world.

23. If inaction by monetary policy-makers necessitate fiscal measures, it is sometimes feared that this could quickly lead to a rise in the long-term interest rates. Yet, this is groundless. Neither theoretically nor empirically can such a direct connection between long-term interest rates and government deficits can be proved[4]. There is no correlation between budget deficits and long-term interest rates for any of the major industrial powers. Particularly striking are the cases of Japan and the USA, where these two variables clearly display opposite tendencies. It is also remarkable that at present the USA, in spite of a budget surplus of almost 2 % of GDP, has quite a higher long-term interest rate than Europe with budget deficits of more than 2 %. These illustrations, too, show that there is a much closer connection between short-term and long-term interest rates than between budget deficits and long-term interest rates. This is, of course, immediately obvious given the close substitution relations between long-term and short-term interest rates.

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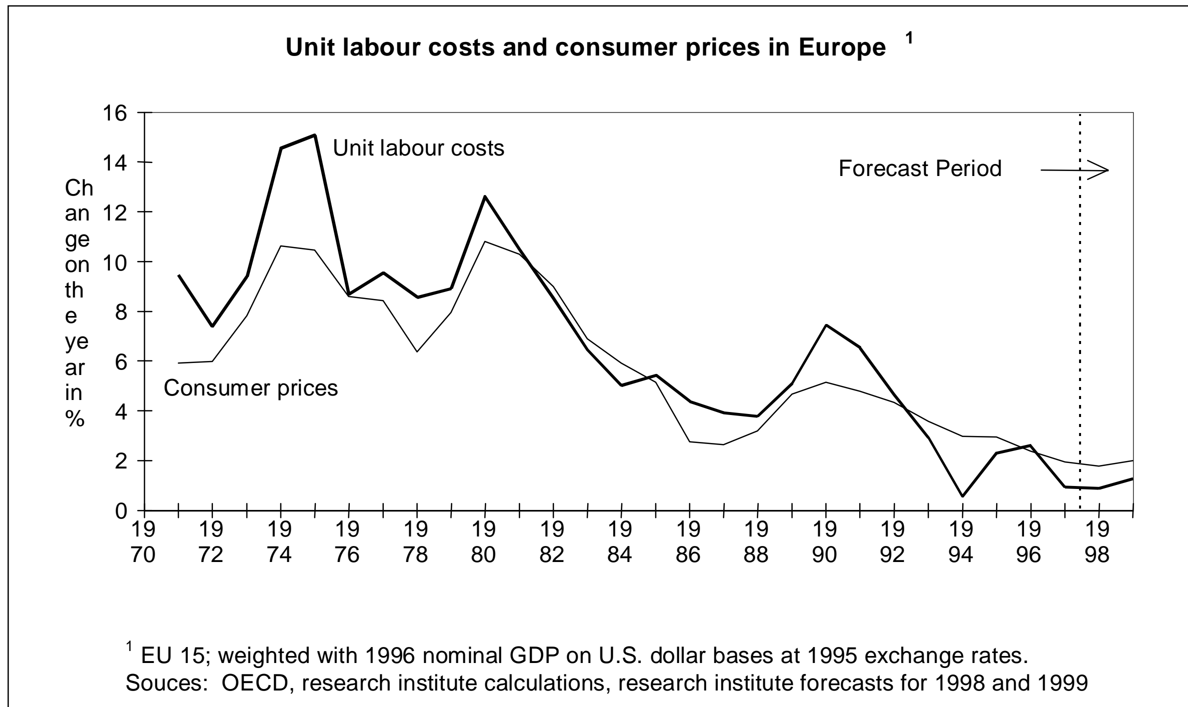
[3] The IMF comes to this conclusion too: "Thus, if the global environment were to continue to deteriorate, it would be a mistake to wait for the effects on euro-area activity to appear in actual data before cutting official interest rates. Similarly, any significant weakening in consumer confidence indicators should be viewed as a sign of a decelerating trend in economic activity that, if not checked at an early stage, could have serious repercussions for economic growth. Moreover, the impact on demand of any tightening of the euro-fiscal stance in 1999 to limit the operation of automatic stabilisers should be taken into account by the ECB in setting interest rates. Some would say that we are adopting a fine-tuning approach to monetary policy, but this is not the case. The seriousness of the downside risk is, under current conditions, not a matter of fine tuning, but one of strategic importance."

[4] This is true in any event leaving aside the trivial comment that a higher government deficit other things being equal entails greater capital demand, while at the same time, however, it also brings greater real activity, so that in the "worst case" the higher long-term interest rate is accompanied by a higher growth rate.



[1] EU 15; weighted with 1996 nominal GDP on U.S. dollar bases at 1995 exchange rates.
Souces: OECD, research institute calculations, research institute forecasts for 1998 and 1999

24. Sometimes it is argued that wage policy could do the job of countering a negative demand shock. But wage policy is not available for the stabilisation of growth. Wages have a crucial influence, via unit labour costs, on the price level (see graph). In order to stabilise the price level, therefore, wages policy must avoid inflationary **and** deflationary cost effects. In the last quarters, however, even the **nominal** unit labour costs in Europe were on the decline thus creating a deflationary effect on producer prices.