European Economic Outlook

Will an upturn + elections = reform?

Adam S. Posen
Institute for International Economics
*IIE Global Economic Prospects*
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What Has Gone Wrong In Europe

A weaker Brussels has meant greater statism

- Low lying fruit for new EU initiatives is gone
  - And there is no Plan B now that Lisbon Agenda has failed
- Franco-German logrolling has replaced German use of Brussels to strongly encourage liberalization
- Spain and Italy are unwilling to graduate into donors
- The UK presidency has done nothing so far

The ECB has been unwilling to reward reform

A. Posen, IIE, 09/2005
Growth will rise in the coming year (but probably not much outside of Germany)

<table>
<thead>
<tr>
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<th>GDP Growth (constant prices YoY)</th>
<th>Factors in outlook</th>
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<tbody>
<tr>
<td></td>
<td>Mussa 9/05</td>
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<tr>
<td></td>
<td>2005</td>
<td>2006</td>
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<tr>
<td>France</td>
<td>1.5</td>
<td>1.3</td>
</tr>
<tr>
<td>Germany</td>
<td>1.0</td>
<td>1.3</td>
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<tr>
<td>Italy</td>
<td>0.0</td>
<td>0.5</td>
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<tr>
<td>UK</td>
<td>2.0</td>
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Germany had its own “ERM crisis”, but the worst is over

- Indicators are the difference between national (1990-98) and European (1999-2004) interest rates and rates implied by the Bundesbank/ECB reaction functions using national data on output gaps and inflation. A positive value implies an excessively high de facto interest rate. Indicators extend to 2004m6 only due to forward-looking reaction function models used in estimations.

A. Posen, IIE, 09/2005
The US is not the only housing boom to worry about

Housing Price Indices

- Germany
- France
- Italy
- Spain
- UK

NOTES: Sources: BIS, HVB Group, Bulwien, Bloomberg, European Mortgages Federation
Series for the UK and Spain is up to 2005Q2. Series for Italy is for 2005Q3, France 2005Q1

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The ECB’s Policy Challenge

- Must handle a negative supply shock as in US
- Energy vulnerability less than in US
- Housing price vulnerability only slightly less
  - Fewer adjustable rate mortgages, no cash-out refi’s
  - As high or higher wealth effect on consumption
  - Less securitization of mortgages by banking systems
- Inflation target is headline not core inflation

A. Posen, IIE, 09/2005
Employment hysteresis persists on the continent

Total Employment/Total Labour Force

Data from OECD Economic Outlook, June 2005

A. Posen, IIE, 09/2005
Reducing labor costs is not a substitute for productivity enhancing reform

Productivity Index

Source: OECD, Economic Outlook #77

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Upcoming Elections
Perhaps a cycle of reform? Or of further stalemate?

Electoral possibilities

- Germany - Sunday
  - Sept 18, 2005
- Italy - April 2006
- France - Spring 2007
  - Could be earlier...

Share of illiberal parties

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If not now for reform, when?

- The German, Italian, and French elections present an opportunity for governments to use a cyclical upswing to push reforms through
- There is an absence of credible alternatives to reform
- Germany might surprise on the upside if confidence responds and previous reforms show their benefits
- Demonstration effects might be repackaged as the rebirth of the Lisbon Agenda to unify EU
What might go wrong getting there

• CDU/Merkel will win in Germany, but perhaps a Grand Coalition will reinstate the *Reformstau*
  • Federalism in Germany breeds vetoes rather than experiments, and is already putting Merkel on defensive
• In Italy, Berlusconi will run against “Prodi’s Europe”
• In France, resistance to reform divides all the parties, and protectionism is getting stronger
• Dutch and Swedish exemplars are slowing down
• The Services Directive rallies opposition

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