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Euroland: recovery is under way

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Euroland: Recovery Is Under Way

by Klaus-Jürgen Gern, Christophe Kamps and Joachim Scheide

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- The economy in the euro area has turned around. While GDP stagnated during the second half of 2001, there are more and more signs that output will increase considerably in the first half of this year. All in all, the slowdown has not been very pronounced. One indication for this is that in 2001, the year of the downturn, unemployment remained more or less constant. The factors which led to the cyclical slowdown have turned around and now stimulate economic activity: Monetary policy has become expansionary, oil prices have dropped substantially, and there is a recovery in the rest of the world.

- Key interest rates in the euro area have remained unchanged since early November 2001. Real short-term interest rates are well below their historical average. Therefore, economic activity is stimulated by monetary policy. Until spring 2003, the ECB will raise key interest rates to the neutral level which should prevail when the output gap is closed and when inflation is at its target; this neutral rate lies between 4 and 4.5 percent.

- Money growth has exceeded the reference value of 4.5 percent for M3 considerably for several months. This increase implies that the velocity of money shows an unusually large deviation from its trend. According to the judgment of the ECB, the demand for M3 has become unstable only in the short run due to special factors. If this judgment is correct, money growth will slow down markedly in the coming months. As a consequence, velocity will return to its trend without an increase in inflation. This implies, however, that the expected slowdown of money growth should not be used as an indication that monetary policy is tight and needs to be loosened because the deceleration of M3 growth is nothing but a normalization.

- Fiscal consolidation has been insufficient in several countries. Governments in Germany, France, Italy and Portugal should begin to pursue a strict consolidation course. Empirical evidence shows that countries that undertook credible consolidation strategies based on expenditure cuts did not experience cyclical downturns. If the governments of these countries were to dampen the increase in government spending, there would be room for a reduction of the tax burden and of budget deficits. This would improve the growth perspectives for the medium term.

- In 2001, wages in the euro area increased somewhat faster than in the previous years largely reflecting the improvement of the labor market situation due to the strong upswing. Also, employees tried to limit the reduction of real wages, which was the consequence of the higher than expected rate of inflation. In our forecast, wage increases will average about 3 percent both this year and next. This implies that there is room for an increase in employment although it is smaller than at the end of the 1990s. Nevertheless, the development of wages does not imply a risk for price level stability.

- The leading indicators suggest that the European economy has reached its trough in the first quarter of 2002 and that the upswing is imminent. From spring on, real GDP will increase at a faster pace than potential output. On average, it will increase by 1.7 percent in 2002. In the course of the coming year, the increase in production will gradually slow down. The upswing in the world economy will probably pass its peak in the first half of next year implying a less dynamic external demand for European products. Domestic demand will also lose some momentum. This is due to the fact that monetary policy will return to a neutral course and that the effects of the preceding easing will gradually fade. We expect real GDP to increase by 3 percent in 2003.
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*Remark:* This report on the economic situation in the euro area was completed on March 15, 2002.
Euroland: Recovery Is Under Way

The economy in Euroland has turned around. While real GDP stagnated during the second half of 2001, there are signs that output will increase during the first half of this year. A number of leading indicators has improved in recent months, especially business confidence. The upturn has already led to an improvement of demand and production in industry, i.e. in that sector which had been most severely hit by the economic downturn. All in all, the slowdown in the euro area had been relatively mild; for example, in 2001, the year of the slowdown, employment even increased and the unemployment rate remained roughly unchanged.

The factors which had led to the downturn have turned in the positive direction in recent months. Monetary policy has become expansionary; the effects of the interest rate cuts until the fall of 2001 will become stronger in the course of this year. Oil prices have declined considerably; this raises disposable income of private households and reduces costs for firms, so that both private consumption and investment receive a boost. Furthermore, the world economy is likely to improve: In the United States, a recovery has already begun, and also the other regions of the world will overcome the recessionary tendencies in the course of this year (Benner et al. 2002).

All in all, conditions are favorable that real GDP will increase faster than potential output in both 2002 and 2003; accordingly, the output gap will be closed again. Therefore, monetary policy should not stay on its expansionary course but should return to a neutral stance. We expect that the European Central Bank (ECB) will raise interest rates to a more neutral level until early next year; this will, however, not be a risk for the recovery. Also, negative effects from labor costs are not likely. Wages will increase only moderately also because the tensions on labor markets which emerged during the previous upswing in 1999/2000 in a few countries have subsided. While oil prices will probably pick up again somewhat in the course of the worldwide recovery, a renewed supply shock is not likely. While short-term prospects are favorable, the conditions for higher economic growth in the medium term have hardly improved. It is particularly worrisome that the progress in terms of fiscal consolidation is slower than announced by the governments; this applies most of all to the large countries in the euro area. As government spending continues to grow considerably, a major reduction of the tax burden cannot be expected; therefore, fiscal policy misses the opportunity to strengthen potential output in the euro area.

1 End of the Downturn

The business cycle in Euroland reached its trough at the end of last year. The leading indicators suggest that economic activity has perceptibly picked up since the beginning of this year. In the fourth quarter of 2001, real GDP shrank at an annual rate of 0.7 percent after having slightly risen in the two preceding quarters (Figure 1). The decline in production was mainly due to weak external demand in the wake of the terrorist attacks in the United States. Real GDP still noticeably increased last year on average because of its high level at the beginning of the year, although its growth rate of 1.5 percent was considerably lower than that of the previous year (3.4 percent).

In our judgment, the European economy was not in recession this winter. This assessment is not based on the fact that real GDP only shrank in a single quarter during this cyclical downturn and not in two successive quarters as is required by the often-used “technical” definition of recessions. This definition is rather rough and can lead to false assessments (Gern et al. 2001: 214). In order to judge the harshness of the latest downturn, a comparison with preceding business cycles is more appropriate. In this respect, the years 1974/75, 1980–82 as well as 1992/93 are especially important since they are generally viewed as recession years for the euro area countries.
Figure 1: Business Cycle Indicators\textsuperscript{a} for Euroland

\textbf{Total Output}\textsuperscript{b,c}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{total_output.png}
\caption{Total Output for Euroland from 1999 to 2002.}
\end{figure}

\textbf{Unemployment Rate}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{unemployment_rate.png}
\caption{Unemployment Rate for Euroland from 1995 to 2002.}
\end{figure}

\textbf{Survey Data}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{survey_data.png}
\caption{Survey Data for Euroland from 1999 to 2002.}
\end{figure}

\textbf{EUROFRAME Indicator and Real GDP}\textsuperscript{f}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{euroframe_indicator.png}
\caption{EUROFRAME Indicator and Real GDP for Euroland from 1999 to 2002.}
\end{figure}

\textbf{External Trade}\textsuperscript{b,d}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{external_trade.png}
\caption{External Trade for Euroland from 1999 to 2002.}
\end{figure}

\textbf{Prices}\textsuperscript{f}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{prices.png}
\caption{Prices for Euroland from 1999 to 2002.}
\end{figure}

\textsuperscript{a}Seasonally adjusted. – \textsuperscript{b}At constant prices. – \textsuperscript{c}Percentage change over previous quarter (annual rate). – \textsuperscript{d}Estimation on basis of the national accounts excluding intra-Euroland trade. – \textsuperscript{e}Partly estimated. – \textsuperscript{f}Percentage change over previous year.

To be able to compare the downturn last year with these recession episodes it is necessary to isolate the cyclical fluctuations of real GDP. A simple comparison of GDP growth rates would be misleading since its trend growth rate has significantly varied in the course of time. Figure 2 shows the cyclical component of GDP (output gap) for the euro area in the years 1970 to 2003 for two alternative measures of the business cycle. The first is the Hodrick-Prescott filter which is a standard tool of business cycle analysis. The second measure is the band pass filter which has become more and more important in the past years because it can be shown that this filter is optimal under certain conditions.\(^1\)

The data used in the estimation of the time series plotted in Figure 2 are taken from two different sources: Eurostat data are available only from 1991 on. These data are chained with those of the Fagan et al. (2001) database for the period 1970–1991. Figure 2 shows that the two filters lead to similar results with respect to the output gap for the sample taken as a whole. The results for the years 1974/75, 1980–82 and 1992/93, in which the output gap fell by at least 4 percentage points, respectively, confirm the judgment that these episodes can be viewed as recessions. In comparison, the latest downturn was significantly milder—with a cumulated decline in capacity utilization by 2 percentage points. It is rather comparable to the downturns in 1986/87 and 1995/96 which generally are not counted as recessions.\(^2\) If the cyclical trough was passed during the first quarter—according to our assessment and as signaled by the leading indicators—then the latest downturn would also not be viewed as a recession for the euro area.

\textit{Figure 2: Output Gap in Euroland, 1970–2003}\(^{a,b}\)

\(^a\)Deviations of real GDP from trend in percent. \(^b\)Forecast starting 2002 I.


\(^1\) The band pass filter is a method of spectral analysis according to which time series can be decomposed in components with different frequencies. The band pass filter used in this application isolates the cyclical component of real GDP—fluctuations with a frequency of 6 to 32 quarters are counted as cyclical. A band pass filter delivers optimal results for infinite samples. In practical applications, approximations of the optimal filter have to be used. Based on simulation results, Christiano and Fitzgerald (1999) show that these approximations provide good results.

\(^2\) In 1987, the output gap was as low as—or according to the Hodrick-Prescott filter even lower than—at the trough of the recessions in 1982 and 1993. However, the decline in the output gap was much less pronounced than during the mentioned recession episodes. Moreover, the downturn did not last for a long time. The German Council of Economic Experts (Sachverständigenrat 1987: 67) reached the conclusion that there was no recession in Germany at that time.
This assessment is supported by the fact that production only shrank in the fourth quarter of last year because of special circumstances. External demand strongly declined in the wake of the terrorist attacks in the United States. Exports to the United States were most strongly affected but also the deliveries to other main trading partners such as the United Kingdom went down due to the loss in confidence that materialized around the world. In the meantime, confidence of consumers and companies has improved. Moreover, there was a significant rise in export orders lately so that a renewed increase in exports can be expected for the first semester of 2002.

The drop in external demand could not be compensated by domestic demand which slightly decreased in the fourth quarter of last year. Gross fixed capital formation shrank for the fourth consecutive quarter. This was due to a renewed worsening of sales and profits expectations after the terrorist attacks and due to the low capacity utilization in the manufacturing sector. Private households hardly expanded their expenditures in the second semester in view of the worsening situation on the labor market. The unemployment rate, which had continuously declined since 1997, stopped its downward trend last spring and has lately risen to 8.4 percent. Moreover, employment expansion probably came to a halt in the fourth quarter of 2001.

Consumer price inflation, which had perceptibly calmed down in the second semester of 2001, accelerated at the beginning of this year. In February, the Harmonized Index of Consumer Prices (HICP) was 2.5 percent higher than one year earlier—last year, the inflation rate had come down from its peak of 3.4 percent in May to 2.1 percent in December. The acceleration of inflation was mainly due to unusually bad weather which led to a strong rise in food prices. According to Eurostat, the introduction of euro coins and notes played only a minor role for the increase in inflation. The core inflation rate (HICP excluding energy, food, alcohol and tobacco) also rose in the past months and continued to be higher than 2 percent—the upper limit of the band that the European Central Bank uses to define price level stability. Probably companies in the euro area are still passing the rise in energy prices that took place until mid-2001 on to consumers. This effect should gradually fade in the coming months. Moreover, the rise in food prices will be transitory. We therefore expect that the inflation rate will fall to around 1.5 percent until the middle of this year.

2 Monetary Policy Will Shift to a Neutral Course

Key interest rates have remained unchanged since November 2001 after the ECB had lowered them by one percentage point in the light of the events of September 11. The minimum bid rate for the main refinancing operations has been 3.25 percent. Money market rates have been around 3.4 percent in recent months (Figure 3). The real short-term rate, calculated on the basis of the core rate of inflation, is close to 1 percent. This implies that monetary policy has a stimulative effect on economic activity.

While long-term interest rates had dropped after September 11, they have increased in recent months. The yield of 10-year government bonds was 5.2 percent at the beginning of March after a short-term low of 4.5 percent at the beginning of November 2001. In real terms, however, it is still below the long-run average. The money stock M3 has risen markedly since the spring of 2001; the three-month centered moving average for the monetary aggregate (for the year-over-year increase), which the ECB refers to in its assessment, has amounted to 8 percent and has thus exceeded the reference value of 4.5 percent more than ever before. However, it is likely that there are special factors at work which may explain this overshooting. At the turn of the year, M3 growth has decelerated, the annual rate of change came down to about 5.5 percent between October and January. The real effective exchange rate of the euro has remained largely unchanged in recent months. All in all, monetary conditions in Euroland are favorable.
Figure 3: Indicators of Monetary Policy in Euroland

Money Stock M1\textsuperscript{a}

Money Stock M3\textsuperscript{a}

Short-Term Interest Rates

Long-Term Interest Rates

Yield Spread\textsuperscript{b}

US Dollar/Euro Exchange Rate\textsuperscript{c}

\textsuperscript{a}Percentage change over previous year. \textsuperscript{b}Long-term interest rate minus short-term interest rate. \textsuperscript{c}Before 1999: exchange rate US dollar/ecu.

Source: ECB (2002), own calculations.
2.1 Key Interest Rates Should not Remain Low for Much Longer

Economic activity is stimulated by the low level of short-run interest rates. In general, the real short rate should be below its natural level if the output gap is negative—if inflation is equal to the inflation target. The combination of the output gap and the inflation gap plays an important role in the Taylor rule. If this rule is interpreted as a norm for monetary policy and if the Taylor interest rate is compared to the actual short-term interest rate, one can judge whether it is higher or lower with respect to the targets of inflation and output stabilization, i.e. whether monetary policy is “too restrictive” or “too expansionary” in this sense. In the macroeconomic literature, there is a large variety of Taylor-type rules. In the following, we use the one originally proposed by Taylor (1993), which appears to be quite successful in a large number of theoretical models regarding the policy targets of stabilizing inflation and output (Taylor 1999). Accordingly, the coefficient for the inflation gap and the output gap is set to 0.5 each. Furthermore, we assume that the real equilibrium interest rate for the euro area is in a range of 2 to 3 percent. The output gap is calculated with a Hodrick-Prescott filter. The inflation target is assumed to be 1.5 percent; this rate is implied by the reference value for M3.

The price index chosen can have a large impact on the level and the change of the Taylor interest rate. The ECB defines price stability in terms of the HICP. This index is, however, very much influenced by erratic fluctuations of prices for food and for energy as could be observed in the past three years. As a consequence, the ECB would have changed interest rates quite substantially if it had followed a Taylor rule and compared actual inflation with the target of 1.5 percent for the HICP. For example, in the second quarter of 2001, when inflation peaked at an average rate of 3.1 percent, an interest rate between 6 and 7 percent would have been appropriate (Figure 4). This surge in the inflation rate was, however, to a large extent due to the sharp rise of food and energy prices. Such transitory effects should not play a role for the stance of monetary policy as they do not reflect the underlying tendency of inflation. If such large price changes occur, the GDP deflator also has a disadvantage as it does not correctly reflect the underlying tendency of inflation: If, for example, oil prices increase sharply, the GDP deflator underestimates the trend of inflation because of the rise of

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3 See the description in Gem et al. (1999: 324).

4 Concerning monetary policy rules such as the Taylor rule, there are two ways of interpretation. First, the Taylor rule may be understood as a reaction function which describes the actual behavior of a central bank in the past to changes in crucial variables; this purely positive analysis does not say anything about the appropriateness of the policy in terms of the targets of stabilizing inflation and output. Second, the rule can be understood as a norm which implies a certain behavior considered optimal for the targets. An “optimal” rule, however, can only be derived in the context of a specific model. In reality, the procedure normally is to assume a specific rule. If actual monetary policy is compared to this rule, we get an indicator which allows us to say whether interest rates are too high or too low with respect to the policy targets. This normative function of the rule is discussed here.

5 The various rules differ in terms of the variables under consideration and the parameter values for the variables. For example, some rules use ex post data whereas others intend to be forward-looking. There is no such thing as “the best rule.” A rule can only be considered “optimal” in the context of a specific theoretical model. Various rules and also their relative performance in different models are discussed in Taylor (1999).

6 The real equilibrium rate of interest cannot be observed. Furthermore, there are a number of theoretical as well as empirical considerations which suggest that this rate is not constant over time. If an average over a longer period is used as an approximation, the value for the euro area is about 3 percent (Kamps and Scheide 2001). More recently, especially after the start of the monetary union, the average real rate has declined somewhat. Given all these uncertainties we think it is appropriate to consider a range of 2 to 3 percent in which the “true” value lies with a high probability. This range is used in the following to calculate the various Taylor interest rates.

7 This is discussed by Kamps and Pierdzioch (2002). The authors show also that the Taylor rates calculated on the basis of different price indices for the United States vary substantially in periods in which oil price shocks occurred. This result implies that a given monetary policy can be described as either extremely expansionary or extremely restrictive depending on the price index that is chosen to calculate the Taylor rate.

8 Accordingly, it can also not be argued that the price increase should be reason for the ECB to loosen its policy only because this negative supply shock dampens economic activity.
Figure 4: Short-term Interest Rates in Euroland: Actual Values and Values According to the Taylor Rule


import prices; as a consequence, the Taylor interest rate would be too low. In recent months, the Taylor rate based on the GDP deflator has increased considerably because oil prices—and therefore import prices—have fallen; this has raised inflation measured in terms of the GDP deflator.

Such problems of interpreting inflation data can largely be avoided if a price index is used which excludes those prices that vary substantially because of special factors. Indeed, the core rate of inflation has shown much less volatility than the HICP. If the core rate is used to calculate the Taylor
interest rate, there is a clear advantage: The central bank can (almost always) reach the target of output stabilization better without a trade-off in terms of price stability.\(^9\) If the Taylor rate calculated on the basis of the core rate of inflation is used as a reference, the policy of the ECB has largely been appropriate. However, the actual interest rate would have almost always been too low if the HICP was used; depending on the assumption about the real equilibrium interest rate, the difference was at times as high as 1.5 to 2.5 percentage points.

If a central bank wants to achieve the policy targets, the behavior of inflation has to play an important role. Therefore, one cannot—as it is often done—judge the stance of monetary policy in terms of the output gap alone; for example, it is not exclusively important whether monetary policy does enough to stimulate economic activity. In the current situation it is often claimed that the interest rate should be as low as it was at the beginning of 1999 when the cyclical situation was about as bad as it is at present. However, this would be a one-sided interpretation of the role of monetary policy as this would imply that the central bank should focus only on the output gap. It is true that the output gap is currently slightly lower than it was three years ago when the economy was hit by the Asian crisis. But the core rate of inflation is much higher today than it was then, namely by about one percentage point. According to the Taylor principle, the real interest rate must therefore also be higher than three years ago.\(^10\) Otherwise, the target of price level stability would be violated which is clearly against the mandate of the ECB.

At present, the money market rate is below the Taylor rate calculated on the basis of core inflation. It is important to note that core inflation is higher than the implied target; for almost one year it has even been above 2 percent, i.e. the upper limit which the ECB accepts as being compatible with price level stability. In the fall of 2001, the ECB deviated from the Taylor rate (Figure 4), the actual money market rate fell below the range calculated for the Taylor rate. At that time, the central bank was facing an admittedly critical situation to limit the risks to the economy which had emerged from the terrorist attacks of September 11. However, these risks do not exist anymore today, because the economy of the euro area is picking up again. Therefore, there is no reason to keep interest rates at the present low level because this would imply that monetary policy is too expansionary, at least if measured in terms of the Taylor rule.

According to our forecast, there are two factors influencing the Taylor rate in the near future: On the one hand, the rate will increase as the output gap increases; on the other hand, the rate will decline as the core rate of inflation will decline. For reasons mentioned above, the HICP inflation (on a year-over-year basis) is not a good guide for monetary policy. This rate will decline markedly until mid-2002 simply because of the base effect; in 2001, inflation surged especially because of the strong rise of food and energy prices.\(^11\)

We expect that the ECB will start to raise interest rates again when the recovery will have gained momentum. According to our forecast, this will be the case in the fall of this year. In the course of the winter 2002/2003, the ECB will lift key interest rates to a neutral level which, according to the Taylor rule, should be reached when both the inflation gap and the output gap are closed. Our estimate for this neutral rate is 4 to 4.5 percent.

\(^9\) This can be derived in the context of a dynamic general equilibrium model (Kamps and Pierdzioch 2002).

\(^10\) This norm for monetary policy is included in practically all macro models today; it is also proposed by economists who consider themselves to be New Keynesians, for example Clarida et al. (1999).

\(^11\) This surge in the price level was to a large extent transitory. As much as the induced acceleration of inflation should not be a reason to tighten monetary policy, the normalization of the price level should not be a reason to lower interest rates.
2.2 On the Implications of High Money Growth in Recent Months

The rapid expansion of M3 implies that the stance of monetary policy is expansionary; money growth by far exceeds the reference value of 4.5 percent. Whether this already is a threat to price level stability depends on the interpretation of the causes. The ECB (2002: 7) mentions a few special factors; among other things, the yield curve was rather flat for some time in 2001, and there was also great uncertainty at financial markets which led to a strong demand for liquid assets. However, the impact of these factors is uncertain, so that it is difficult to estimate the amount of liquidity in the economy which is relevant for aggregate demand and also for the risks to price level stability. In addition, it is possible that money stock figures were distorted at the turn of the year because of the introduction of the euro currency. For example, the currency component fell drastically in December 2001.

The strong increase of M3 implies that the velocity of money shows an unusually large decline (Figure 5). While this variable had been quite stable and moved closely to the estimated linear trend during the first two years of the monetary union, there has been an increasing downward deviation since the spring of 2001. This behavior may mean different things with different implications:

- The low level of velocity may reflect a liquidity overhang. In this case, inflation will sooner or later accelerate.
- It may be a transitory deviation of velocity from trend due to special factors; when these factors disappear, velocity will return to its normal level. Inflation would not be affected.
- It may be a one-time shift in the level of velocity, equivalent to a transitory instability of money demand; this would not affect the trend behavior of velocity in the future or the calculation of the reference value for M3.
- The development may be the beginning of a lasting instability of money demand; in this case, the first pillar of the monetary policy strategy may be questioned or may even have to be given up.

*Figure 5: Velocity of M3 in the Euro Area*

![Graph of Velocity of M3 in the Euro Area](image)

*aLog of nominal GDP divided by M3 (Index Dec.98 =100).
Source: ECB (2002), own calculations.*
At present, it is not possible to make a final judgment on the actual causes—and therefore also the consequences—of the sharp increase of money growth. A structural break in an equation or a permanent instability can only be identified after some time. According to the judgment of the ECB, it is the second one of the possibilities mentioned above: a transitory instability of money demand due to special factors. Actually, a similar observation could be made in the recent past, namely in Germany in 1993/94. At that time, there was also a sharp acceleration of money growth which led to a steep decline of velocity—as can also be seen in Figure 5 for the euro area. After some time, the “build-up of liquidity” (Deutsche Bundesbank 1995: 71) disappeared, money growth decelerated and velocity returned to its normal path. There was no acceleration of inflation as might have been expected from rapid money growth. All in all, the transitory deviation did not imply a lasting instability of money demand.

If the judgment of the ECB is correct and the recent development of M3 can also be interpreted as an outlier, the rate of money growth should come down markedly and also quickly as the special factors do not exist anymore: The yield curve is not flat but is actually steeper than normal, stock prices have risen markedly, and finally also the uncertainty on financial markets has probably disappeared. The growth rates of money should for some time even be smaller than 4.5 percent, i.e. the reference value, because only then the velocity of M3 will return to its normal path; in the case of Germany, M3 actually declined for some time in 1994. This expected low growth of M3 in the euro area cannot be used to justify a loosening of monetary policy because it is nothing but the normalization of M3 growth after the special factors disappear. Therefore, it would be wrong to lower interest rates—just as it would have been wrong in recent months to raise rates just because of high money growth. If one follows the interpretation of the ECB, which stresses transitory factors, this is the only possible conclusion.

The recovery in the euro area will lead to a stronger increase of money demand in the future. In order to avoid a situation in which money growth exceeds the path compatible with price level stability, it is appropriate to raise interest rates. This should be done in due time. Otherwise there would be the risk that interest rates would have to be raised more later when inflation actually accelerates as it was the case, for example, in 2000. All in all: Also this reasoning suggests that the expansionary course of monetary policy needs to be corrected and that interest rates should be raised to the neutral level.

3 Insufficient Consolidation Efforts

The downswing has significantly affected public finances (Table 1). The consolidated budget deficit of the countries in the euro area last year showed a deficit of 1.3 percent in relation to GDP after 0.8 percent in the previous year (excluding receipts from the allocation of UMTS licenses)—the budget deficit increased for the first time since the recession in 1993. Yet, in some countries the deterioration of public finances was not only due to cyclical reasons. Governments in Germany, France and Italy lowered taxes to a considerable extent without proceeding to corresponding expenditure cuts. This resulted in an increase in structural budget deficits and a set-back as regards fiscal consolidation. On the positive side it can be noted that eight out of twelve countries in the euro area record a nearly balanced budget or even a surplus by now—in 1998, this group of countries counted only three members. Against the background of an increased budget deficit the debt-GDP ratio declined only slightly to around 69 percent last year. In 2002, the consolidated budget deficit will probably again be higher than in the previous year in view of a renewed decline in economy-wide capacity utilization this year on average. Next year, fiscal policy is expected to stay on a neutral course; budget deficits in the euro area will decline for cyclical reasons.
Table 1: Indicators of Fiscal Positions in Euroland, 2000–2003

<table>
<thead>
<tr>
<th></th>
<th>Gross public sector debt&lt;sup&gt;a&lt;/sup&gt;</th>
<th>General government balance&lt;sup&gt;a&lt;/sup&gt;</th>
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<tr>
<td>Netherlands</td>
<td>56.1</td>
<td>54.0</td>
</tr>
<tr>
<td>Belgium</td>
<td>109.3</td>
<td>107.6</td>
</tr>
<tr>
<td>Austria</td>
<td>63.6</td>
<td>61.7</td>
</tr>
<tr>
<td>Finland</td>
<td>44.0</td>
<td>43.6</td>
</tr>
<tr>
<td>Greece</td>
<td>102.7</td>
<td>99.0</td>
</tr>
<tr>
<td>Portugal</td>
<td>53.7</td>
<td>53.5</td>
</tr>
<tr>
<td>Ireland</td>
<td>38.6</td>
<td>36.0</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>5.3</td>
<td>4.0</td>
</tr>
</tbody>
</table>

Euroland          | 69.5  | 69.2       | 68.5       | 67.1       | 0.3  | –1.3       | –1.5       | –1.1       |

<sup>a</sup>In percent of nominal GDP. –<sup>b</sup>Partly estimated. –<sup>c</sup>Forecast.

Source: ECB (2002), own calculations and forecasts.

3.1 Stability and Growth Pact in Danger

In accordance with their obligations from the Stability and Growth Pact the countries of the euro area actualized their Stability Programs for the third time at the end of last year. In these programs the member countries present their budgetary plans for a horizon of three to four years. In the Stability and Growth Pact the member countries have committed themselves to strive for a nearly balanced budget or a budget surplus in the medium run. The fulfillment of this goal assures that the reference value for the public deficit (3 percent in relation to GDP) will not be exceeded in a normal cyclical downturn. As can be seen from Table 2 all Stability Programs project a nearly balanced budget or even a surplus for the year 2005 at the latest. The majority of countries already today exhibit budget balances that are in accordance with the goal. Only Germany, France, Italy and Portugal still have high budget deficits—Germany and Portugal are even near the 3-percent limit laid down in the Maastricht Treaty and would probably exceed it if a further deterioration of economic activity occurred.

In view of this risk the European Commission at the beginning of the year suggested to the Council of the European Union (ECOFIN) to give Germany and Portugal an early warning on the basis of Regulation 1466/97 of the Stability and Growth Pact. At the meeting of the Council of Finance Ministers on February 12, 2002, the necessary qualified majority of 62 out of a total of 87 votes could not be obtained. Strikingly, the four countries with high budget deficits together dispose of a blocking minority in the Council of Ministers. It is a design flaw of the Stability and Growth Pact that those governments who come into conflict with its provisions have the right to vote. Whether the Pact is effective when there is an excessive deficit will only be known with certainty once a country exceeds the reference value of 3 percent. One can doubt, however, whether there will be any sanctions in such a case especially since the excessive deficit procedure is very lengthy (Scheide and Solveen 1998: 15 ff.).
### Table 2: Key Figures of the Stability Programs

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP growth</th>
<th>General government budget balance</th>
<th>Gross public debt</th>
<th>Expenditures</th>
<th>Receipts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1998–2001</td>
<td>2002–2005</td>
<td>2001&lt;sup&gt;e&lt;/sup&gt;</td>
<td>2005&lt;sup&gt;e&lt;/sup&gt;</td>
<td>2001&lt;sup&gt;e&lt;/sup&gt;</td>
</tr>
<tr>
<td>Germany</td>
<td>1.8%</td>
<td>2.2%</td>
<td>–2.5%</td>
<td>0.0%</td>
<td>60.0%</td>
</tr>
<tr>
<td>France</td>
<td>3.0%</td>
<td>2.5%</td>
<td>–1.4%</td>
<td>0.0%</td>
<td>57.1%</td>
</tr>
<tr>
<td>Italy</td>
<td>2.0%</td>
<td>2.9%</td>
<td>–1.1%</td>
<td>0.2%</td>
<td>107.5%</td>
</tr>
<tr>
<td>Spain</td>
<td>3.8%</td>
<td>2.9%</td>
<td>0.0%</td>
<td>0.2%</td>
<td>57.5%</td>
</tr>
<tr>
<td>Netherlands&lt;sup&gt;f&lt;/sup&gt;</td>
<td>3.2%</td>
<td>2.2%</td>
<td>1.0%</td>
<td>1.0%</td>
<td>51.8%</td>
</tr>
<tr>
<td>Belgium</td>
<td>2.6%</td>
<td>2.3%</td>
<td>0.0%</td>
<td>0.7%</td>
<td>107.0%</td>
</tr>
<tr>
<td>Austria</td>
<td>2.6%</td>
<td>2.3%</td>
<td>0.0%</td>
<td>0.5%</td>
<td>61.8%</td>
</tr>
<tr>
<td>Finland</td>
<td>3.9%</td>
<td>2.4%</td>
<td>4.7%</td>
<td>2.6%</td>
<td>42.7%</td>
</tr>
<tr>
<td>Greece&lt;sup&gt;f&lt;/sup&gt;</td>
<td>3.9%</td>
<td>3.9%</td>
<td>0.1%</td>
<td>1.2%</td>
<td>99.6%</td>
</tr>
<tr>
<td>Portugal</td>
<td>3.2%</td>
<td>2.6%</td>
<td>–2.2%</td>
<td>0.4%</td>
<td>55.9%</td>
</tr>
<tr>
<td>Ireland&lt;sup&gt;f&lt;/sup&gt;</td>
<td>9.2%</td>
<td>5.0%</td>
<td>1.4%</td>
<td>–0.6%</td>
<td>35.8%</td>
</tr>
<tr>
<td>Luxembourg&lt;sup&gt;f&lt;/sup&gt;</td>
<td>6.1%</td>
<td>5.5%</td>
<td>4.1%</td>
<td>3.4%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Euroland&lt;sup&gt;b&lt;/sup&gt;</td>
<td>2.6%</td>
<td>2.6%</td>
<td>–1.1%</td>
<td>0.2%</td>
<td>68.7%</td>
</tr>
</tbody>
</table>

<sup>a</sup>Some Stability Programs include alternative scenarios concerning GDP growth. This table reflects the basic scenario. – <sup>b</sup>Average annual growth rate. Partly estimated. – <sup>c</sup>In percent of GDP. – <sup>d</sup>Based on figures from the Stability Programs, partly corrected for differences in definitions. – <sup>e</sup>Figures for 2001 are taken from the Stability Programs. Receipts from the allocation of UMTS licenses are not included. – <sup>f</sup>Projection until 2004 only. – <sup>g</sup>Average for the countries above.

**Source:** Stability Programs, own calculations and estimates.

### 3.2 No Reason to Be Afraid of Fiscal Consolidation

Ultimately, the question is why the four mentioned countries were not able to reach a balanced budget position in the three years since the beginning of the monetary union. In 1998, the deficit ratios of these countries were roughly the same as the one for the euro area as a whole (2.2 percent). Probably the governments of these countries were convinced that a budget consolidation of ¼ percentage points in relation to GDP per year would lead to considerable losses in production in the short run. Yet, the recent empirical literature on the cyclical effects of fiscal consolidation shows that such traditional Keynesian effects often are not in accordance with the data.<sup>12</sup> In the past, countries whose governments undertook credible consolidation strategies on the spending side did not experience cyclical downturns—as could be expected according to the traditional theory. Rather the shortfall in public demand was often compensated by additional demand of the private sector, in some cases even over-compensated. The relevance of these so-called non-Keynesian effects of fiscal policy is by now part of the macroeconomic consensus (see, e.g., Blinder 1997).

Figure 6 shows that in the recent past non-Keynesian effects may have played a role in the euro area as well as in Germany which is here referred to as representative of the four stragglers. The figure depicts the output gap as a measure of cyclical conditions and the structural budget balance as a measure of discretionary fiscal policy. According to the traditional theory there should be a negative relationship between these two variables and a causal relationship running from the budget balance to the output gap. It is worthwhile to distinguish two periods in the data analysis: On the one hand the years 1970–1992 and on the other hand the period since 1993, the year in which the fiscal consolidation goal was laid down in the Maastricht Treaty. For the first period, there is a negative correlation between the output gap and the structural budget balance in the case of Germany (correlation

<sup>12</sup> See Alesina and Perotti (1997) as well as Giavazzi et al. (2000), for instance.
coefficient: –0.29). Yet, the null hypothesis of Granger causality tests cannot be rejected, that is, the output gap and the structural budget balance are not causal for each other. For the period 1993–2001, however, a positive correlation coefficient (0.54) and a causal relationship running from the structural budget balance to the output gap can be established. For the euro area as a whole, the same qualitative result obtains (correlation coefficient: 0.77).

Figure 6: Output Gap and Structural Budget Balance

These results are a sign of a change in the cyclical effects of discretionary fiscal policy after the conclusion of the Maastricht Treaty. Admittedly, such a simple analysis does not answer the question whether fiscal policy can use this relationship like a menu. Yet, it makes clear that the claim that budget consolidations inevitably lead to cyclical downturns is unsoundly based. Rather, the works of Alesina and Perotti show that consolidation strategies that build on the government spending side succeed with high probability. Ireland is a spectacular example of such a strategy: Between 1986 and 1989 the structural budget balance was reduced by 6 percentage points altogether. At the same time the output gap increased by 5.5 percentage points. The Irish government cut the government spending ratio by 11.5 percentage points in this period—drastic measures were seen as indispensable by the government against the background of the economic crisis in the preceding years; they were not undertaken in reaction to a beginning upswing. Another example for a successful fiscal consolidation building on the government spending side is the euro area in the years 1993–2000. In this period the structural budget deficit declined by around 4 percentage points, at the same time the output gap increased by 2 percentage points. The improvement in the situation of public finances was exclusively due to a falling expenditure-GDP ratio; public revenues as a share of GDP remained unchanged in this period.

13 No causality can be obtained in the reverse direction. The result of the causality test should not be overvalued, however, because of the short sample period (18 observations).
In view of these considerations the Kiel Institute for World Economics adopted a minority position in the fall report of the six leading German economic research institutes (Arbeitsgemeinschaft Deutscher Wirtschaftswissenschaftlicher Forschungsinstitute 2001). At that time the majority of institutes demanded that the federal government should bring forward the second step of the tax reform and postpone its consolidation efforts until the beginning of the next upswing. The Kiel Institute, on the other hand, held the view that the consolidation course should not be left for several reasons: On the one hand, governments tend to plan consolidation efforts for the future but do not put them into practice when time has come. Especially, governments do often not see the necessity to save during upswings because the actual budget deficit declines due to cyclical reasons. On the other hand, had the tax reform been brought forward without simultaneous expenditure cuts, the credibility of the consolidation strategy would have been endangered. Yet, credibility is a major success factor. If the private sector expects that tax cuts are not permanent because deficit problems are not addressed, it may be that the private sector reduces its demand. Of course, tax cuts are welcome on the grounds of efficiency considerations. Yet, a permanent reduction of the tax burden requires that public activity is diminished by the same amount. Governments in Germany, France, Italy and Portugal should follow the Irish example and begin to pursue a strict consolidation course. If these countries managed to restrain the increase in government spending—especially with regard to social security—or even to cut expenditures, then there would be room for a simultaneous reduction of the tax burden and of budget deficits. This would improve growth perspectives and there would be a chance that economic activity would not be dampened in the short run but rather stimulated.

4 Wage Increases Remain Consistent With Price Level Stability

Wage increases in the euro area picked up slightly in 2001 compared with the previous years that had seen extraordinary wage moderation. Compensation of employees per worker rose by 3 percent, following 2.5 percent in 2000 and somewhat less than 2 percent in 1997–1999. A rate of increase of 3 percent is still consistent with price level stability as defined by the ECB given that trend productivity growth is around 1.5 percent. A stronger acceleration of wage growth, however, would result in a conflict with the monetary policy target of keeping consumer price inflation below 2 percent in the medium term. Against this background, the ECB has once again signalled that it will follow closely the results of the upcoming wage negotiations (ECB 2002: 24).

The acceleration of wages in 2001 was partly due to the increased incidence of labor supply bottlenecks after years of strong employment growth. In addition, workers tried to compensate for some of the real income losses that had resulted from the unexpectedly high consumer price inflation. They have, however, only partly succeeded because, as a consequence of multi-year wage agreements, in some countries (such as Germany, Italy, Finland or Ireland) wage negotiations were not on the agenda last year in a large part of the economy. As a result, the argument that this year’s wage round should “make up” for the previous disappointing real wage development is still around in a number of countries.

However, the cyclical situation has deteriorated significantly over the past year. A worsened outlook for employment and increasing unemployment tend to weaken the position of the trade unions in this year’s wage negotiations. At the same time, reduced profits and declining capacity utilization tend to lower the propensity of enterprises to accept wage increases. Finally, CPI inflation is clearly on a downward trend which will increase the chances that workers accept moderate wage rises.

Against this background, we expect wages in Euroland to increase in 2002 at about the same pace as in 2001, with a moderation in most of the smaller countries going along with a slight acceleration in Germany and France (Table 3). In France, wage settlements per employee had been dampened over
the previous years by the step-wise introduction of the 35-hour working week, an effect which will cease to be of importance this year implying an increased probability of some pick-up in wage rises. Also next year, the pace of wage growth in the euro area will hardly change. While lower inflation will work towards more modest wage demands, the upturn in the economy will work in the opposite direction. With the projected outcome for wages, incentives to increase employment remain there albeit to a smaller degree than at the end of the nineties. At the same time, wage increases do not endanger the stability target of the ECB. On the back of a cyclical productivity improvement the increase in unit labor costs will return to rates below 2 percent (Table 4). Consequently, there will be a beneficial impact on inflation from unit labor costs over the forecast horizon.

Table 3: Wage Increases in Euroland\(^b\) (percent)

<table>
<thead>
<tr>
<th></th>
<th>Weight(^b) in percent</th>
<th>2000</th>
<th>2001(^c)</th>
<th>2002(^d)</th>
<th>2003(^d)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>30.8</td>
<td>1.2</td>
<td>1.9</td>
<td>2.5</td>
<td>2.5</td>
</tr>
<tr>
<td>France</td>
<td>19.0</td>
<td>1.9</td>
<td>2.2</td>
<td>2.5</td>
<td>2.6</td>
</tr>
<tr>
<td>Italy</td>
<td>16.6</td>
<td>2.9</td>
<td>3.2</td>
<td>2.7</td>
<td>2.7</td>
</tr>
<tr>
<td>Spain</td>
<td>11.6</td>
<td>3.4</td>
<td>3.9</td>
<td>3.6</td>
<td>3.0</td>
</tr>
<tr>
<td>Netherlands</td>
<td>5.6</td>
<td>4.6</td>
<td>5.0</td>
<td>4.3</td>
<td>4.0</td>
</tr>
<tr>
<td>Portugal</td>
<td>3.7</td>
<td>6.3</td>
<td>6.4</td>
<td>5.0</td>
<td>4.5</td>
</tr>
<tr>
<td>Austria</td>
<td>3.3</td>
<td>2.1</td>
<td>2.4</td>
<td>2.4</td>
<td>2.5</td>
</tr>
<tr>
<td>Belgium</td>
<td>3.2</td>
<td>3.2</td>
<td>3.2</td>
<td>3.1</td>
<td>2.5</td>
</tr>
<tr>
<td>Greece</td>
<td>3.1</td>
<td>6.1</td>
<td>5.5</td>
<td>5.5</td>
<td>5.0</td>
</tr>
<tr>
<td>Finland</td>
<td>1.9</td>
<td>3.9</td>
<td>4.4</td>
<td>4.1</td>
<td>4.0</td>
</tr>
<tr>
<td>Ireland</td>
<td>1.4</td>
<td>8.7</td>
<td>9.5</td>
<td>7.5</td>
<td>7.0</td>
</tr>
<tr>
<td>Euroland</td>
<td>100.0</td>
<td>2.5</td>
<td>3.0</td>
<td>3.0</td>
<td>2.9</td>
</tr>
</tbody>
</table>

\(^a\)Compensation per employee. \(^b\)Based on the number of employees in 2000. \(^c\)Estimate. \(^d\)Own forecast.


Table 4: Compensation of Employees and Productivity in Euroland (change over previous year in percent)

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001(^a)</th>
<th>2002(^b)</th>
<th>2003(^b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation of</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>employees per worker</td>
<td>2.3</td>
<td>2.5</td>
<td>3.0</td>
<td>3.0</td>
<td>2.9</td>
</tr>
<tr>
<td>Productivity(^c)</td>
<td>0.9</td>
<td>1.4</td>
<td>0.2</td>
<td>1.2</td>
<td>1.9</td>
</tr>
<tr>
<td>Unit labor costs</td>
<td>1.4</td>
<td>1.1</td>
<td>2.8</td>
<td>1.8</td>
<td>1.0</td>
</tr>
</tbody>
</table>

\(^a\)Estimate. \(^b\)Own forecast. \(^c\)Real GDP per worker.


5 Nationally Diversified Wage Setting Processes

In the EU countries there are different wage bargaining systems that have historically developed and vary in different respects. As concerns bargaining levels, wage bargaining on sectoral and company levels can be found in every country (Table 5). This is supplemented by wage bargaining on the central (national) level in five countries, covering either the whole economy (in Finland and Ireland), the private sector (in Belgium and Greece) or the industrial sector (in Denmark). An additional central element exists in a number of countries in the form of minimum wages.\(^{14}\)

\(^{14}\) Minimum wages in various forms exist in Belgium, France, Germany, Greece, Ireland, Luxembourg, the Netherlands, Portugal, Spain and the United Kingdom (see EIRO 2000).
Table 5: Levels of Wage Bargaining in the EU Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Central level</th>
<th>Sectoral level</th>
<th>Company level</th>
<th>Overall assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>xxx</td>
<td>x</td>
<td>x</td>
<td>centralized</td>
</tr>
<tr>
<td>Denmark</td>
<td>xx</td>
<td>xx</td>
<td>x</td>
<td>intermediate</td>
</tr>
<tr>
<td>Germany</td>
<td></td>
<td>xxx</td>
<td>x</td>
<td>intermediate</td>
</tr>
<tr>
<td>Finland</td>
<td>xx</td>
<td>xx</td>
<td>x</td>
<td>centralized</td>
</tr>
<tr>
<td>France</td>
<td></td>
<td></td>
<td></td>
<td>decentralized</td>
</tr>
<tr>
<td>Greece</td>
<td>x</td>
<td>xxx</td>
<td>x</td>
<td>intermediate</td>
</tr>
<tr>
<td>Ireland</td>
<td>xxx</td>
<td>x</td>
<td></td>
<td>centralized</td>
</tr>
<tr>
<td>Italy</td>
<td></td>
<td>xxx</td>
<td>x</td>
<td>intermediate</td>
</tr>
<tr>
<td>Luxembourg</td>
<td></td>
<td>xx</td>
<td>xx</td>
<td>intermediate</td>
</tr>
<tr>
<td>Netherlands</td>
<td>*</td>
<td>xxx</td>
<td>x</td>
<td>centralized</td>
</tr>
<tr>
<td>Austria</td>
<td>*</td>
<td>xxx</td>
<td>x</td>
<td>centralized</td>
</tr>
<tr>
<td>Portugal</td>
<td>xxx</td>
<td>x</td>
<td></td>
<td>intermediate</td>
</tr>
<tr>
<td>Sweden</td>
<td>xxx</td>
<td>x</td>
<td></td>
<td>intermediate</td>
</tr>
<tr>
<td>Spain</td>
<td>xxx</td>
<td>x</td>
<td></td>
<td>intermediate</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>x</td>
<td>xxx</td>
<td></td>
<td>decentralized</td>
</tr>
</tbody>
</table>

x = level of wage bargaining existent, but not important. – xx = level of wage bargaining important, but not dominant.
- xxx = dominant level of wage bargaining. – * = important central coordination.


The central level is the predominant level of wage bargaining in Belgium and Ireland, while the importance of the central level varies in Finland from wage round to wage round and matches the importance of the sectoral level in Denmark. The company level is the predominant level of wage bargaining in France and in the United Kingdom, and is important in Luxembourg also. In the remainder of the EU countries the sectoral level is predominant. At the same time, there are significant differences in the meaning and scope of sectoral wage bargaining across countries. In Ireland and the United Kingdom, sectoral wage bargaining is restricted to a small number of branches; in other countries, such as France, the Netherlands, Portugal and Spain, particularly the small and medium-sized companies are covered by sectoral wage agreements, while large companies tend to have a company agreement. There are also differences with respect to geographical coverage: while in most countries sectoral agreements cover the whole country, coverage is restricted, at least formally, to certain regions in France, Germany and Spain.

Furthermore, there are differences in the relationship between the different wage bargaining levels. In a number of countries sectoral and company levels supplement each other in that agreements on the sectoral level define a minimum wage which may be exceeded by company agreements. By contrast, in Belgium and in Ireland, there is a maximum wage increase agreed upon on the central level which sets the margin for wage negotiations on the sectoral and company levels, respectively.

When categorizing the national wage bargaining systems according to their degree of centralization in the tradition of Calmfors and Driffill (1988), most of the wage bargaining systems have to be grouped as intermediate.15 Central wage bargaining systems prevail in Belgium, Finland and Ireland and also in Austria and the Netherlands, where wage negotiations take place predominantly on the sectoral level but coordination on the central level has a strong influence.

Wage bargaining systems are also characterized by the degree of organization of workers and employers and the share of workers that are covered by negotiated wage contracts. Countries vary considerably also in this respect (Table 6). The Scandinavian countries typically have a high degree of unionization of workers combined with a relatively low share of enterprises organized in employers associations. Coverage of wage agreements is intermediate relative to the other EU countries. The

15 For a slightly different rating see OECD (1997).
Table 6: Organization of Employees and Employers, Coverage of Bargained Wages and Incidence of Mandatory Extension of Bargained Wages in EU Countries

<table>
<thead>
<tr>
<th></th>
<th>Organization degree (percent)</th>
<th>Coverage rate (percent)</th>
<th>Mandatory extension of bargained wages</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>employees^b</td>
<td>employers^c</td>
<td></td>
</tr>
<tr>
<td>Belgium</td>
<td>40</td>
<td>80</td>
<td>82</td>
</tr>
<tr>
<td>Denmark</td>
<td>68</td>
<td>48</td>
<td>52</td>
</tr>
<tr>
<td>Germany</td>
<td>25</td>
<td>76</td>
<td>80</td>
</tr>
<tr>
<td>Finland</td>
<td>65</td>
<td>58</td>
<td>67</td>
</tr>
<tr>
<td>France</td>
<td>&lt; 7</td>
<td>71</td>
<td>75</td>
</tr>
<tr>
<td>Greece</td>
<td>&lt; 15</td>
<td>n.a.</td>
<td>97</td>
</tr>
<tr>
<td>Ireland</td>
<td>37</td>
<td>44</td>
<td>n.a.d</td>
</tr>
<tr>
<td>Italy</td>
<td>32</td>
<td>40</td>
<td>90</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a</td>
</tr>
<tr>
<td>Netherlands</td>
<td>19</td>
<td>80</td>
<td>79</td>
</tr>
<tr>
<td>Austria</td>
<td>37</td>
<td>96</td>
<td>97</td>
</tr>
<tr>
<td>Portugal</td>
<td>&lt; 20</td>
<td>n.a.</td>
<td>80</td>
</tr>
<tr>
<td>Sweden</td>
<td>77</td>
<td>60</td>
<td>72</td>
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<tr>
<td>Spain</td>
<td>&lt; 15</td>
<td>70</td>
<td>67</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>21</td>
<td>57</td>
<td>40</td>
</tr>
</tbody>
</table>

^aMid-nineties. – ^bShare of employees that are members in trade unions. – ^cMeasured as proportion of employees in enterprises that are members of employers associations. – ^dThe coverage in Ireland is very high but figures are not available. – n.a.= not available.


Instrument of mandatory extension of wage agreements to non-organized companies exists only in Finland. The type of wage bargaining system predominant in the European Union, by contrast, consists of a relatively low (and falling) share of workers organized in trade unions and a relatively high share of employers organized in associations, which leads to generally high levels of coverage of bargained wage agreements. The power of trade unions is increased in some countries by the possibility of extending bargained wage agreements to the non-organized part of the economy by law.

Wage policy is coordinated on the macro level by different means. In the United Kingdom and in France setting minimum wages, which can be seen as a form of state-imposed coordination, is the only form of central coordination. Wage indexation mechanisms as in Belgium and in Luxembourg represent a stronger form of government interference. In the other countries there is a coordination of wage policies between the employers associations and the trade unions. This is done explicitly in some countries (Belgium, Finland, Ireland, the Netherlands, Spain) with associations of employers and trade unions setting a target wage increase on the central level. In other countries, including Austria, Denmark, Germany and Sweden, the coordination is implicit with sectoral or regional wage bargaining partners following a leader in some kind of convoy system.

A more recent development is the negotiation of cross-sectoral or national tripartite agreements, so-called social pacts. Such kind of “round table talks” have already been established in 10 EU countries. Design and relevance of these agreements, however, vary strongly across countries, reaching from noncommittal statements of general principles of wage policy (such as with the “Bündnis für Arbeit” in Germany) to legally binding rules for wage setting (as in the case of the Irish consensus programs).

17 Wage increases are generally tied to inflation; in Belgium, however, the development of labor costs in important trading partner countries has played the decisive role in the determination of wages.
All in all, differences in national wage bargaining systems in the European Union are very pronounced. Against this background, it seems inappropriate to think of wage setting in the European Union (or in the euro area) in terms of a single wage bargaining system or even a single wage policy. For institutional reasons it currently seems impossible to obey a certain target path for wages in the euro area as a whole. It has to be recognized that wage increases in the euro area trace back to different national wage developments that can be centrally controlled only to a limited extent.

This means that it is hard (or even impossible) to coordinate macro policies on the European Union level or in the euro area as is sometimes proposed in order to improve the growth performance in Europe. National wage bargaining systems would have to be harmonized and centralized to create the precondition for a single European wage policy. That said, there is no sufficient agreement on how the necessary institutions should look like. Harmonization of wage bargaining systems is regarded as inappropriate for additional fundamental reasons.

The different institutions relevant in the wage bargaining process have developed historically in the individual countries, at least to some extent reflecting different national preferences. It is not clear whether labor market institutions that have produced good results in some country will also work satisfactorily in any other country (Freeman 1988). It is at least doubtful whether centrally designed harmonization of labor market institutions in the European Union can cope with the different national requirements. Consequently we suggest to rely on a process in which superior institutions build and prevail in a process of competition between different alternatives (Hayek 1968).

6 Outlook: Propelling Forces Gain the Upper Hand

The leading indicators suggest that the European economy has passed its trough in the first quarter of 2002 and that the upswing is imminent. The confidence indicators compiled by the European Commission have been rising since last December. Production expectations in the manufacturing sector and expectations of consumers about their future economic situation have strongly improved in the past months. At the same time, the purchasing managers’ index for the euro area has significantly risen; lately, it was only slightly lower than 50 points—index values above 50 signal an expansion of production. Finally, the growth indicator calculated by EUROFRAME points at a strong pickup of economic activity during the first semester.

In the first quarter of this year, economy-wide production has probably increased at a slower pace than potential output (Table 7). Private households have only moderately expanded their consumption expenditures in view of accelerated inflation and of increasing unemployment. Since capacity utilization is low right now, it will take some time before the improved sales and profits expectations result in significantly higher investment increases. Exports have probably only slightly increased during the first quarter. In the coming months, the upswing in the world economy will gather speed and stimulate European exports. In the course of this year, domestic demand will also pick up strongly in view of expansionary monetary policy and of the decline in oil prices in the past months. All in all, we expect real GDP to increase by 1.7 percent this year on average, after 1.5 percent last year (Table 8). The upswing will affect the labor market only in autumn so that we expect the unemployment rate to rise slightly this year on average.

In the course of the coming year, the increase in production will gradually slow down (Figure 7); in the second semester, economy-wide production will increase at roughly the same rate as potential output. The calming down of economic activity is due to the gradual fading of important impulses. The upswing in the world economy will probably pass its peak in the first half of next year implying a less dynamic external demand for European products. The evolution of the real effective exchange rate of the euro will neither dampen nor stimulate European export activity. Domestic demand will also
lose some momentum in the course of 2003 (Figure 8). This is due to the fact that monetary policy will return to a neutral course next winter and that the effects of the preceding easing will gradually fade. Fiscal policy will remain on a more or less neutral course. All in all, we expect real GDP to increase by 3 percent next year on average. In the course of the upswing the situation on the labor market will perceptibly improve; the unemployment rate will probably fall to 8.1 percent in 2003 on average.

The upward trend of prices will weaken until this summer. This is due to the normalization of food prices and to the decline in energy prices in the past months. In the further course of this year, the pressure on prices will remain low in view of a low capacity utilization and of wage increases that are consistent with price level stability. Yet, the high price level at the beginning of this year results in a
relatively high inflation rate this year on average (1.9 percent). In the course of the upswing, the scope for raising prices will gradually increase. The Harmonized Index of Consumer Prices will probably exceed its level in the previous year by 1.8 percent in 2003.

Figure 7: Real GDP\textsuperscript{a} in Euroland

\textsuperscript{a}Seasonally adjusted. \textsuperscript{b}Annualized quarterly rate of change in percent. \textsuperscript{c}Percentage change over previous year. \textsuperscript{d}Forecast starting in 2002 I.


Figure 8: GDP, Domestic Demand and Net Exports in Euroland\textsuperscript{a}

\textsuperscript{a}At constant prices. \textsuperscript{b}Percentage change over previous year. \textsuperscript{c}Change of net exports over previous year in percent of GDP in the same quarter of previous year. \textsuperscript{d}Forecast starting in 2002 I.

References


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