

Benner, Joachim; Gern, Klaus-Jürgen; Scheide, Joachim

Working Paper

Euroland: Recovery is slowly gaining momentum

Kiel Economic Policy Papers, No. 3

Provided in Cooperation with:

Kiel Institute for the World Economy – Leibniz Center for Research on Global Economic Challenges

Suggested Citation: Benner, Joachim; Gern, Klaus-Jürgen; Scheide, Joachim (2005) : Euroland: Recovery is slowly gaining momentum, Kiel Economic Policy Papers, No. 3, ISBN 3894562749, Kiel Institute for World Economics (IfW), Kiel

This Version is available at:

<https://hdl.handle.net/10419/3720>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

Euroland: Recovery Is Slowly Gaining Momentum

Joachim Benner, Klaus-Jürgen Gern, and Joachim Scheide

- Economic expansion in the euro area has remained modest in the course of this year. In the first half, real GDP grew at an annual rate of 1 ½ percent. In recent months, there have been signs that economic expansion may be close to its trough. Therefore, we expect that the economy will improve only gradually in the remainder of the year.
- In 2006, the recovery will gain some momentum while the driving forces will shift: Exports will lose some strength given that the expansion of the world economy will slow down somewhat, whereas domestic demand growth will accelerate. The dampening effects from high oil prices will gradually fade, and interest rates will support the recovery as both short-term and long-term rates are at extremely low levels. Real GDP is expected to rise by 1.7 percent in 2006. The unemployment rate will come down moderately to 8.4 percent, and inflation will fall below 2 percent.
- Monetary conditions in the euro area have hardly changed in recent months. The depreciation of the euro has roughly compensated for the modest rise in real short-term rates. The ECB has not given in to demands to cut interest rates in response to the slowdown of economic expansion due to the rise in oil prices. A loosening of monetary policy would not be appropriate because the slowdown resulted from aggregate supply so that the (negative) output gap did not increase. Also, the ECB was correct in not raising rates in response to the pickup of inflation because neither core inflation nor inflationary expectations have increased in recent months.
- Key interest rates will remain low given the slow recovery. However, in the medium term, interest rates will have to be raised because currently they are substantially lower than the estimated neutral rate. If this continued for long, the risks to price level stability would increase. The ECB has warned of such risks also in the light of the ample liquidity in the euro area. We assume that the ECB will start to tighten monetary policy gradually at the end of 2006 after the recovery will have strengthened somewhat.
- The aggregate budget deficit in Euroland will amount to 2.8 percent of GDP this year. But in about half of the member states, the deficit in relation to GDP will exceed 3 percent, including the three largest economies Germany, France and Italy. Next year, the overall deficit will decline only marginally. In general, the consolidation efforts will be modest given the loosening of the Stability and Growth Pact (SGP).
- As the budget deficits in the EMU countries will remain high, the debt-to-GDP ratio will continue to rise in the coming years. This outlook has not been improved by the reform of the SGP. The main reasons are, first, that governments now have more time to correct high and excessive deficits and, second, that the European Commission has no power nor mandate to enforce the new rules of the Pact.
- Although budget deficits have, in general, to be reduced by 0.5 percentage points relative to GDP, this rule applies only to “good times,” defined as a year with a positive output gap. In “bad times,” consolidation efforts may be smaller or deficits do not have to be reduced at all. Given this lax rule, it is unlikely that a balanced budget will be reached at all if the economic performance will be similar to that in recent years. For example, according to OECD estimates concerning potential output in 1998–2006, seven out of nine years would have to be defined as “bad” in France and Germany, in Italy this applies to six years.

Dipl.-Volksw. Joachim Benner

Kiel Institute for World Economics (IfW),
Düsternbrooker Weg 120, 24105 Kiel, Germany.
Tel: ++49-431-8814-273, E-mail: benner@ifw.uni-kiel.de
Website: <http://www.ifw-kiel.de/staff/benner.htm>

Dr. Klaus-Jürgen Gern

Kiel Institute for World Economics (IfW),
Düsternbrooker Weg 120, 24105 Kiel, Germany.
Tel: ++49-431-8814-262, E-mail: gern@ifw-kiel.de
Website: <http://www.ifw-kiel.de/staff/gern.htm>

Prof. Dr. Joachim Scheide

Kiel Institute for World Economics (IfW),
Düsternbrooker Weg 120, 24105 Kiel, Germany.
Tel: ++49-431-8814-264, E-mail: jscheide@ifw.uni-kiel.de
Website: <http://www.ifw-kiel.de/staff/scheide.htm>

KIEL ECONOMIC POLICY PAPERS

Kiel Institute for World Economics, 24100 Kiel, Germany;
Tel: ++49-431-8814-1; Website: <http://www.ifw-kiel.de>

Managing editor:

Prof. Dr. Harmen Lehment, Tel: ++49-431-8814-232,
E-mail: Lehment@ifw-kiel.de

Die Deutsche Bibliothek – CIP-Einheitsaufnahme

A catalogue record for this publication is available from Die Deutsche Bibliothek

<http://www.ddb.de>

ISSN 1860-7322

ISBN 3-89456-274-9

© Institut für Weltwirtschaft an der Universität Kiel 2005.

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means (electronic, mechanical, photocopying, recording or otherwise) without the prior written permission of the Publisher. Printed in Germany

Contents

1	Moderate Increase in Production	3
2	Fiscal Situation Remains Critical	5
3	Targets of the SGP Will Probably Not Be Reached	6
4	Monetary Policy Remains Accommodative	8
5	Wage Inflation Remains Moderate	11
6	Outlook: Domestic Demand Slowly Gains Momentum	12
	References	16

In this report, data up to September 7, 2005, were used.

Euroland: Recovery Is Slowly Gaining Momentum

1 Moderate Increase in Production

The economic recovery in the euro area has weakened since mid-2004. In the second quarter of this year, real GDP increased at an annualized rate of only 1.2 percent, after a slightly stronger increase in the first quarter (Figure 1).¹ Production was particularly dampened by higher oil prices on world markets, amplified by the depreciation of the euro. Overall, the economy-wide capacity utilization declined in the first half of this year. Domestic demand showed a very weak performance. In the first half, private consumption almost stagnated. Given the critical situation of public finances in most of the member countries, public consumption increased only slightly. Corporate investment nearly stagnated; this reflects a worsening of sale and profit expectations mainly due to higher commodity prices. On the other hand, exports increased in the course of the year after they had fallen in the first quarter. It has to be kept in mind that the trade data published by Eurostat include trade flows among the member countries of the euro area. Yet, calculations of the ECB suggest that the deliveries to countries outside the euro area nearly stagnated.

The situation on the labor market has hardly changed. The unemployment rate almost stagnated amounting to 8.7 percent in recent months.² The number of employed persons in the total economy increased moderately; while employment in the industrial sector contracted, employment in the service sector expanded. In August, the Harmonized Index of Consumer Prices

(HICP) was 2.1 percent higher than one year earlier according to preliminary estimates. Hence the inflation rate is still slightly higher than the ECB's target rate. The latest price increase is mainly related to the energy prices; in July, they were 11.8 percent higher than one year ago. On the other hand, the core inflation rate has fallen to 1.3 percent in the course of this year. Mainly the prices for transportation and housing went up considerably; the latter seem to be driven by the boom in some member states' housing market.

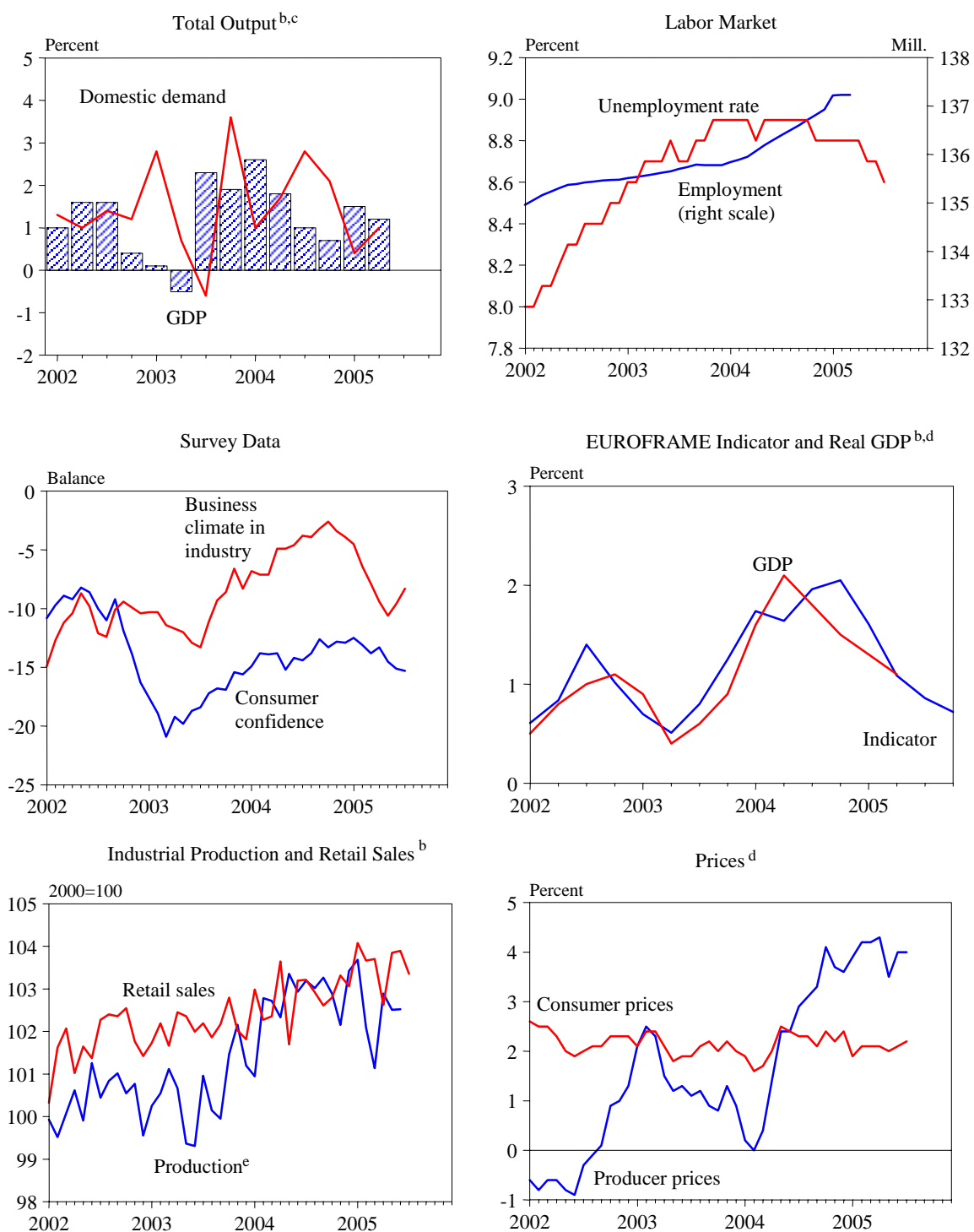
Leading indicators suggest that economic activity increased only moderately this summer. The industrial sentiment indicators compiled by the European Commission slightly improved in the past month. The consumer sentiment remained low, while business sentiment lately picked up. Also the order situation is expected to improve. Overall, the indicators do not show that economic activity has accelerated noticeably this summer. This is compatible with the forecast of our model, which uses sentiment indicators.³ It shows a slight acceleration of economic activity for the third quarter (Figure 2). The confidence interval for this forecast at an error probability of 67 percent (1 standard error) lies between 0.4 and 1.7 percent. Our forecast, which takes into account additional information from other leading indicators and economic considerations, lies roughly in the middle of this confidence interval.

¹Part of the increase in GDP in the first quarter is due to a working-day effect. For the same reason the increase in the last quarter of 2004 is probably understated.

²The harmonized unemployment numbers are not yet final due to changes in the statistics in Germany.

³For a detailed analysis of the model, see Benner et al. (2005a).

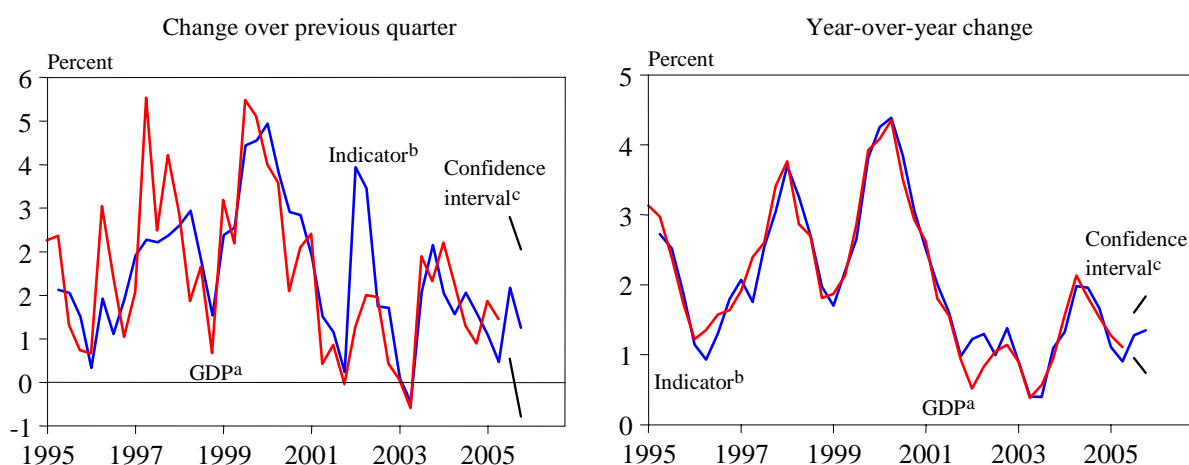
Figure 1:
Business Cycle Indicators^a for Euroland, 2002–2005



^aSeasonally adjusted. — ^bAt constant prices. — ^cAnnualized percentage change over previous quarter. — ^dPercentage change over previous year. — ^eIndustry excluding construction.

Source: EUROFRAME (2005); Eurostat (2005); ECB (2005a).

Figure 2:
Real GDP and Forecasts of the Indicator-Based Model



^aAnnualized percentage change over previous year. — ^b1995 I–2005 II: Ex-post-one-step forecasts based on a recursive model forecast. 2005 III–2005 IV: Ex ante forecasts. — ^c66 % confidence interval (error probability of 33 percent).

Source: Eurostat (2005); own calculations.

2 Fiscal Situation Remains Critical

In 2005, the aggregated budget in the euro area will exhibit a deficit of 2.8 percent in relation to GDP, following 2.7 percent in 2004 (Table 1). Most of the member countries of the euro area will again fail to meet the targets set in their respective Stability Programs. The 3 percent limit for the ratio of the budget deficit will be exceeded in nearly half of the member states, including the three biggest countries Germany, France and Italy. The increase in the budget deficit has mainly been driven by the slowdown of economic activity. Economy-wide capacity utilization will probably decrease by 0.6 percentage points this year. Assuming an elasticity of the budget balance with respect to the output gap of 0.5 percent (OECD 1999: 147), the cyclical

component of the budget deficit amounts to around 0.3 percent in relation to GDP. This implies a reduction of the structural budget deficit of 0.2 percent. However, this reduction is mainly due to special measures in some countries. For example, in France and Germany additional revenues are realized because of one-off payment associated with the capitalization of pension liabilities, which de facto implies an increase in government debt. Therefore, the overall fiscal stance is nearly neutral. Against the background of a somewhat more favorable cyclical development, the aggregated budget deficit will decline modestly next year. Fiscal policy in the euro area will be slightly restrictive. Also because of the reform of the Stability and Growth Pact, the willingness of most governments to consolidate the budget will probably be limited.

Table 1:
Indicators of Fiscal Positions in Euroland, 2003–2006 (percent of nominal GDP)

	Gross public sector debt				General government budget balance			
	2003	2004	2005 ^a	2006 ^a	2003	2004	2005 ^a	2006 ^a
Germany	63.2	64.9	66.7	68.7	-4.0	-3.7	-3.6	-3.4
France	62.8	64.6	67.5	69.0	-4.2	-3.6	-3.3	-3.2
Italy	106.8	106.6	109.0	107.0	-3.2	-3.2	-3.6	-4.0
Spain	49.0	46.6	44.0	41.5	0.3	-0.3	0.0	0.1
Netherlands	54.3	55.7	57.0	58.0	-3.2	-2.5	-2.5	-2.0
Belgium	100.0	95.6	94.0	91.0	0.4	0.1	-0.5	-0.5
Austria	65.4	65.2	65.5	66.0	-1.1	-1.3	-2.0	-2.0
Finland	45.3	45.1	45.5	45.0	2.5	2.1	1.5	2.0
Greece	109.3	110.5	111.5	111.0	-5.2	-6.1	-5.0	-4.0
Portugal	60.1	61.9	67.5	70.5	-2.9	-2.9	-6.5	-4.5
Ireland	32.0	29.9	30.0	30.0	0.2	1.3	-0.9	-0.5
Luxembourg	7.1	7.5	9.0	9.5	0.5	-1.1	-1.0	-0.6
Euroland	70.1	70.6	71.9	72.2	-2.8	-2.7	-2.8	-2.7

^aForecast.

Source: Eurostat (2005); own calculations and forecasts.

3 Targets of the SGP Will Probably Not Be Reached

Budget deficits in the countries of the euro area will remain high in the foreseeable future, and government debt in relation to GDP will rise further. This outlook has not been changed by the reform of the Stability and Growth Pact (SGP), possibly the outlook has even worsened as a consequence. There are two major reasons: First, governments now have more time to correct an excessive deficit, and second, the European Commission has no power or mandate to enforce the rules of the Pact such as the medium-term objective (MTO) of a balanced budget. So it is in the hands of the governments to act in order to achieve the targets they have promised. However, experience shows that this is probably not to be expected. The difficulties in the past concerning the implementation of the Pact had to do with the fact that governments did not comply with their commitments and that, in the end, the ECOFIN Council decided to reject the recommendations which had been prepared by the Commission. It is not very likely that this is going to change very soon. For example, it is a fact that the ratio of the budget deficit in Germany will be higher than 3 percent for five years in

a row (2002–2006), and there is currently no procedure which could contribute to a substantial reduction of the deficit.

In its current version, the SGP allows governments to take more time to consolidate the budgets because the path depends very much on the cyclical situation in the respective countries. It is even possible that the medium-term objective will not be reached at all even if governments follow the new regulations concerning deficit reduction. The general rule says that the ratio of the structural deficit has to be reduced by 0.5 percentage points per year. However, this applies only to good times. “Good times” are defined as years in which there is a positive output gap; in “bad times,” budget consolidation may be less or may not have to take place at all. Apart from the problems of measuring potential output precisely,⁴ this new rule makes it un-

⁴As potential output cannot be observed, budget surveillance which relies on such measures has severe consequences. It is true that the uncertainty concerning potential output pertains to other areas of economic policy as well, for example, for the Taylor rule for monetary policy. But concerning the SGP it is more severe because the estimate of potential output may be used as a basis for decisions concerning sanctions. This shows that the reformed version of the SGP is more complex than the original version, which relied only on the observable budget deficit. Another

likely that the MTO will indeed be achieved.⁵ For example, given the new regulation of the SGP, it can be said that in the period 1998–2006, seven out of nine years were “bad” in both France and Germany, and six years were bad in Italy in terms of the reference of the output gap.⁶ According to this observation, the high structural deficits in a number of countries appear to be “justified” by the new rules of the SGP. Since the reference is defined in terms of the sign of the output gap, the estimate of potential output will be crucial in the future. According to the OECD estimates, the output gap is negative on average. If we assume that this will also be the case in the future, it is unlikely—and according to the SGP it is also not obligatory—that a currently excessive deficit will disappear in a period of a decade.⁷ Against this background, the debt-to-GDP ratio will most likely not decline, as it is intended by the Pact, but it will rather increase.

There is no indication that the governments of the euro area member countries will become more ambitious than in the past. This is especially true against the background of the optimistic GDP forecasts given in the respective

problem is that estimates of potential output vary and may be revised substantially over time. This was also an important point in the discussion on the Pact; for example, a substantial revision of the potential output estimate for Germany by the European Commission in the fall of 2003 led to a new round of discussions on the relevance of the policy recommendations by the Commission.

⁵This objective is not formulated as a general target anymore. Instead, the objective depends on the sustainability of the public finances, i.e. on the debt-to-GDP ratio and on the rate of potential output growth. If these two criteria are applied to the German case, the MTO would have to be that the budget should be balanced or be in surplus because of the relatively low growth rate and the relatively high debt ratio which is not only higher than 60 percent but also rising rapidly.

⁶These figures refer to the estimates of the OECD (2005b), which are similar to those of the European Commission as far as the sign of the output gap is concerned.

⁷Vice President Papademos (2005: 3) of the ECB calls this a “bias towards negative output gaps or ‘bad times’, ..., coupled with the provision that medium-term objectives do not necessarily have to be reached within the horizon of a country’s stability programme.” This bias has increased with the reform of the SGP.

Stability Programs;⁸ in fact, if real GDP growth is lower than expected there, the interpretation will most likely be that times are “bad” in terms of the cycle. In addition, it is unlikely that the European Commission will now try to achieve a “rigorous” (ECB 2005d: 70) implementation of the rules and thus contribute to a faster budget consolidation. Even if the Commission intended to do this, it would be in the hands of the governments to change the procedures just as they did in November 2003 when the ECOFIN Council overruled the Commission’s recommendations.⁹ One can also be pessimistic regarding the time needed for budget consolidation by the fact that, in Germany, the CDU/CSU, which has always criticized the German government because of the increasing debt and which intends to take over the government after the general elections in September, declared that it will try to balance the budget by the year 2013. By then, the SGP will exist already for 15 years.

If the increase in the debt-to-GDP ratios is to be stopped or—as it is intended—to be reversed, governments should become more ambitious in their efforts to consolidate the budgets. This means that structural deficits should be reduced considerably within a limited period of time, and that this course should be independent of the cyclical situation. If countries start with a high budget deficit, it is (almost) unavoidable that the structural deficit must be reduced also in bad times unless tremendous efforts are made in the (rare) good times. Experience shows, however, that this is unrealistic.¹⁰ One advantage of a faster budget consolidation is that there would be enough room for the automatic stabilizers to work.

⁸In fact, the SGP now urges governments to be prudent in their forecasts underlying the Stability Programs.

⁹This decision is commented by Alesina and Perotti (2004: 44): “If anything, this event has proven that, whatever sovereignty large countries are willing to cede to the European Commission in matters of importance like fiscal policy, they will take it back—legally or less legally if convenient.”

¹⁰In the past, there have always been objections to a substantial deficit reduction even in better times, the reasoning being that an ongoing recovery should not be dampened by “tight” fiscal policies.

Critics of the SGP often argue that the target of a balanced budget is not appropriate and that a reference value for the budget deficit is not useful. Even if this is taken for granted, there is a consensus among economists that fiscal policy needs to be sustainable. In general, this implies that the debt-to-GDP ratio should not exceed a certain value and that it should not increase over an extended period of time. In the literature, a level of 60 percent is often mentioned as the upper limit for government debt in relation to GDP.¹¹ However, this reference has been persistently violated in a number of countries; for example, in Germany and in France, the debt-to-GDP ratio is approaching 70 percent, and in Italy it has remained at around 105 percent although it had been planned to reduce it to 60 percent over time.

The main objective of the Pact is to stop or to reverse the tendency of an increasing government debt, which is in line with the consensus view on public finances. This is especially important in the light of the challenges arising in the future. Because of the demographic developments and the implied decline in economic growth (OECD 2005c), there will be a substantial burden for government budgets. In the long run, i.e. up to the year 2050, the additional revenues necessary to finance the liabilities of the governments amount to at least 5 percent, in a few countries to even 10 percent of GDP or more if the present laws and policies remain unchanged (ECB 2005d: 72/73). This means that taxes and/or social contributions will have to be raised dramatically, which would have a negative impact on economic growth and in turn also on public finances. Against this background, it would be wise to take measures today in order to avoid such a culmination of problems. This recommendation is appropriate whether the SGP exists or not. However, the Pact itself will probably not be sufficient to “force” the governments to behave accordingly. Also, experience shows that peer pressure alone will not work to achieve

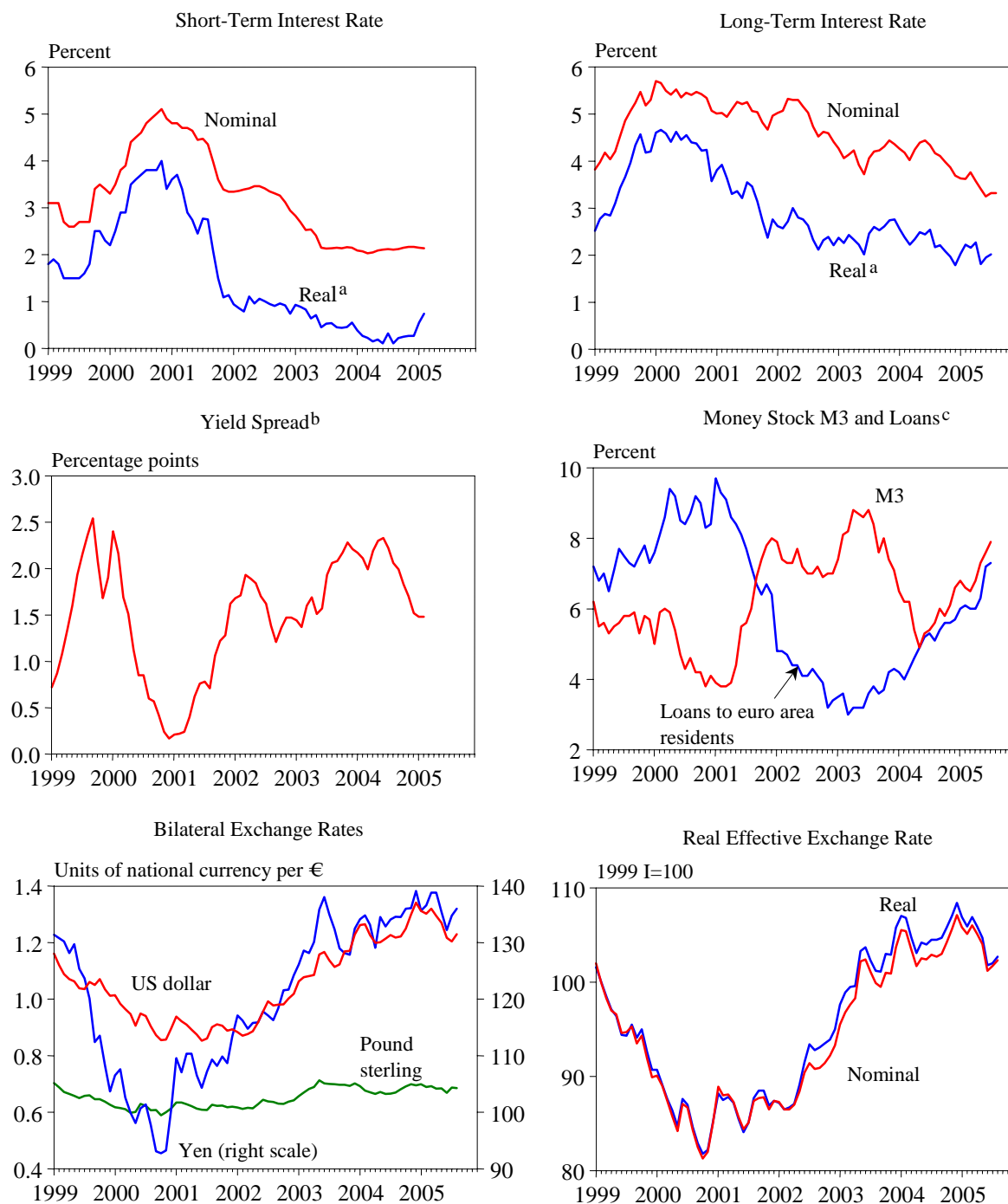
budget consolidation. Finally, the European Commission has neither the mandate nor the power to enforce the rules of the Pact. In this sense, the SGP is not a sufficient condition for budget consolidation. The governments must actually want to pursue a sound policy.

4 Monetary Policy Remains Accommodative

Monetary conditions in the euro area have hardly changed in recent months. The ECB’s key interest rate (the minimum bid rate on the main refinancing operations of the Eurosystem) has remained at 2.0 percent for more than two years. Money market rates (3-month EURIBOR) have only been marginally higher than the rate for overnight deposits; apparently, markets have expected that interest rates will not be raised in the near future. If the stance of monetary policy is measured in terms of the short-term real interest rate, the ECB continues to be on an expansionary course. However, the real rate (nominal rate adjusted for core inflation) has increased somewhat since the beginning of this year and amounted to about ½ percent, after having been close to zero for about one year (Figure 3). Nevertheless, it is still well below its long-term average. Long-term interest rates have continued to decline in recent months. The yields for 10-year government bonds have come down from its record low of 3.3 percent and are about 100 basis points lower than one year ago. In real terms, the long rates are well below their historical average independent of the inflation measure used, be it the core rate of inflation or be it inflationary expectations (approximated by the ten-year breakeven inflation rate for the euro area). There are several reasons for the low level or the decline in long-term interest rates (Benner et al. 2005a). Among them are the high level of worldwide liquidity as well as the weak economic activity in the euro area; in recent months, the forecasts for real GDP growth in 2005 and 2006 have been reduced continuously (ECB 2005b: 67).

¹¹See, for example, Wyplosz (2005). For fiscal policy in Great Britain, the medium-term target is actually 40 percent.

Figure 3:
Indicators of Monetary Policy in Euroland, 1999–2005



^aAdjusted for core inflation. — ^bLong-term minus short-term interest rate. — ^cPercentage change over previous year.

Source: ECB (2005b).

The expansion of monetary aggregates has accelerated considerably; the rate for M3 has reached almost 8 percent in recent months. Also,

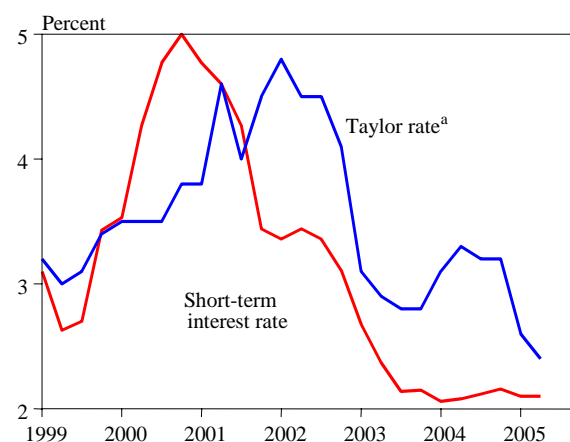
credit growth has strengthened further. This indicates that the transmission of monetary impulses is working even though this does not show

up so much in aggregate demand for goods and thus in consumer prices, but rather for housing and on financial markets. The increase in stock prices implies that financial conditions for firms have improved. In addition, monetary conditions have been positively affected by the depreciation of the euro. Since the spring of 2005, the European currency lost ground against major world currencies, in particular against the US dollar. In real and effective terms, the depreciation amounted to about 5 percent during the past six months. Therefore, the competitiveness of exporters has improved again after having worsened for about three years.

In spite of the recent small increase in the short-term real interest rate, the monetary policy stance must still be considered expansionary. This is supported by the fact that the short-term money market rate has continued to be lower than the rate which is derived from the Taylor rule (Figure 4).¹² In Table 2, three different calculations of the Taylor rate are reported. For the equilibrium real rate of interest we assume, following theoretical considerations, that it is equal to the estimated growth rate of potential output.¹³ The calculated Taylor rate does not differ much, however. According to the rule, the money market rate should have been between 2.2 and 2.6 percent in 2005 on average instead of the estimated actual rate of 2.1 percent (Table 2). In addition, the different assumptions about

potential output growth lead to very similar results concerning the “neutral” rate of interest. According to the Taylor rule, this rate should be reached when the output gap is closed and the inflation rate is on target. According to the various calculations, this rate is between 3.4 and 3.8 percent.

Figure 4:
Short-term Interest Rate and Taylor Rate in Euro-land, 1999–2005



^aThe Taylor rate is calculated for the HICP excluding energy, food, alcohol and tobacco. The calculations are based on the assumption of an inflation target of 1.9 percent and on the assumption of an equilibrium real interest rate equal to potential output estimated with a Hodrick–Prescott filter.

Source: Eurostat (2005); ECB (2005b); own calculations and estimates.

The ECB has not given in demands to cut interest rates in response to the slowdown of economic expansion due to the rise of oil prices. In a similar vein it could be argued that rates should be raised as inflation accelerated because of the surge in oil prices. However, a change in monetary policy in response to higher oil prices alone would not be appropriate as is also discussed in the literature (Clarida et al. 1999). First, the slowdown of economic activity is due to a slowdown of aggregate supply so that the (negative) output gap did not increase. Also, the ECB was correct in not raising rates in response to the pickup of inflation because the inflation perspectives have not deteriorated; neither core inflation nor inflationary expectations have increased in recent months. However, there has

¹²As in our previous reports (Benner et al. 2005a), we use the Taylor rule in its original version (Taylor 1993):

$$(1) \quad i = r + \pi + 0.5(\pi - \pi^*) + 0.5(y - y^*),$$

with i being the nominal interest rate, r the equilibrium real interest rate, π the rate of inflation, π^* the inflation target, y actual real GDP, and y^* potential real GDP. We assume an inflation target of 1.9 percent, which is consistent with the ECB’s target of inflation close to but below 2 percent. The core rate of inflation (HICP excl. processed food and energy) is used as the inflation measure. In Figure 4 we also assume that the equilibrium rate of interest, which is unobservable, is equal to the growth rate of potential output which is estimated with a Hodrick–Prescott filter. The output gap is calculated on the basis of this estimate.

¹³Strictly speaking, one should use the growth rate of GDP per capita. However, population growth in the euro area is very low so that not much would be changed. Furthermore, the equilibrium real rate may also be slightly higher than the rate of potential output growth (Benner et al. 2005b).

Table 2:
Calculation of the Taylor Rate and the Neutral Interest Rate in Euroland for 2005^a

Method	Potential growth (\hat{c} real rate)	Output gap	Taylor rate	Neutral rate
OECD estimate	1.9	-2.1	2.2	3.8
HP filter	1.5	-0.4	2.6	3.4
IfW estimate	1.8	-1.7	2.3	3.7

^aThe inflation target is assumed to be 1.9 percent. The Taylor rate is calculated for the core rate of inflation (HICP excluding energy, food, alcohol and tobacco); we assume the core rate to be 1.5 percent in 2005.

Source: OECD (2005b); own estimates and calculations.

been some reaction by the ECB in the following sense: In the fall of 2004, the central bank had prepared markets for a rate hike which did not take place in the light of the developments on oil markets. Therefore, monetary policy is probably more expansionary today than it would have been otherwise.

We expect that the ECB will keep interest rates constant for some time because the economic expansion will remain modest and the perspectives for inflation will probably not worsen in the near future. All in all, the actual interest rate will be fairly close to the Taylor rate. In our judgment it will be necessary, however, that key interest rates will be raised in the medium term because they are lower than the neutral rate according to all calculations. If rates were kept low, the risks for price level stability would increase; in the view of the ECB, these risks exist already now because of the ample amount of liquidity in the euro area. We expect that the ECB will start to tighten policy at the end of next year.

5 Wage Inflation Remains Moderate

The development of labor costs in the euro area continues to be characterized by wage moderation. That said, the rate of increase in negotiated wages seems to have stopped declining. Wages in the euro area as a whole actually accelerated slightly in the course of last year; in the first

quarter of 2005 they rose by 2.2 percent against the previous year. The increase in the labor cost per hour seems to have bottomed also, although the interpretation of the figures from the new labor cost index launched in June by Eurostat is complicated by strong fluctuations in the rate of increase from quarter to quarter.¹⁴ Compensation per employee, by contrast, slowed down further to a rate of 2 percent in the first months of this year, partly as a result of the continued reduction in average hours worked. Differences in wage increases across countries remain pronounced (Table 3). They are to some extent due to measures in a few countries, including Germany in particular, that lower the employer's burden from social security contributions and have been implemented this year or are planned to take effect in 2006. One measure of significance embedded in the forecast is the reduction of the rate of contribution to the unemployment insurance scheme in Germany by 2 percentage points, which is planned by the CDU/CSU for next year as a first important measure after a change in the government following the upcoming elections. The cut in contributions will, according to the proposal, be financed through an increase in the value added tax by 2 percentage points. While lower social contributions re-

¹⁴This index is calculated according to new rules that aim to improve quality and comparability of the data. The annual growth rate in euro area labor costs is now calculated to be 0.2 percentage points higher on average over the period 2000–2004 than according to the old index (for details see ECB 2005c: 40–41).

Table 3:
Wage Increases^a in Euroland, 2002–2006 (percentage change over previous year)

	2002	2003	2004	2005 ^b	2006 ^b
Germany	1.5	1.6	0.1	0.0	0.2
France	2.4	2.3	3.1	2.8	2.9
Italy	2.5	3.8	2.9	3.0	2.9
Spain	4.3	4.3	4.0	4.0	3.7
Netherlands	6.2	3.9	2.5	0.7	0.0
Portugal	4.4	2.6	3.0	3.1	2.5
Austria	1.7	2.1	2.9	2.5	2.4
Belgium	4.2	2.0	2.5	2.2	2.2
Greece	9.5	4.1	5.8	5.9	5.5
Finland	1.8	2.6	3.6	9.0	3.8
Ireland	5.0	4.7	5.7	5.0	4.7
Luxembourg	3.7	2.1	3.2	3.0	2.5

^aCompensation of employees per worker. — ^bForecast.

Source: European Commission (2005); own forecasts.

duce the compensation per employee, the VAT part of the package does not show up in the compensation figures. The total tax burden on labor does not decline significantly because the VAT is in effect also (mainly) a tax on labor. Consequently, the development of compensation per employee as an indicator of the development of labor costs and their effects on employment may be seriously flawed for the time being in the case of Germany.¹⁵

In a number of countries, there is considerable slack in the labor market, which, in combination with labor market reforms, is an important factor behind the continued wage moderation. Against this background, higher than expected inflation due to the strong rise in energy prices has not led to a meaningful acceleration of wages. Negative surprises from real income developments may, however, be important in explaining the apparent leveling off in the downward trend of wage increases. In any case, given the prospective still modest gains in nominal compensation, there is still considerable support for monetary policy from the wage front in achieving the ECB's stability target. Unit labor costs this year and next will rise by less than 1 percent on aver-

age; the rate of increase per hour will be somewhat higher but still significantly below 2 percent. With an expected cyclical upturn in productivity (Table 4), real unit labor costs will decline in both 2005 and 2006. Even accounting for the fact that actual wage costs, mainly due to the reduction of social contributions in combination with a VAT increase in Germany, will rise somewhat more strongly than indicated by the compensation per employee, wage developments remain modest and continue to have a positive impact on employment.

6 Outlook: Domestic Demand Slowly Gains Momentum

Economic activity will pick up modestly at the turn of 2005/2006 (Figure 5). Domestic demand will continue to expand only moderately (Figure 6). Corporate investment will slightly pick up, stimulated by low interest rates. Private households will increase their consumption at a slow pace in view of their uncertain income situation and the dampening effects of the rise in oil

¹⁵Similar effects may result from the implementation of the health care reform in the Netherlands.

Table 4:

Compensation of Employees, Productivity and Unit Labor Costs in Euroland, 2002–2006 (percentage change over previous year)

	2002	2003	2004	2005 ^a	2006 ^a
Compensation of employees per worker	2.5	2.3	2.1	2.0	1.8
Productivity ^b	0.2	0.4	1.2	0.8	1.3
Unit labor costs	2.2	1.9	0.9	1.2	0.5

^aForecast. — ^bReal GDP per worker.

Source: ECB (2005d); own calculations and forecasts.

Table 5:

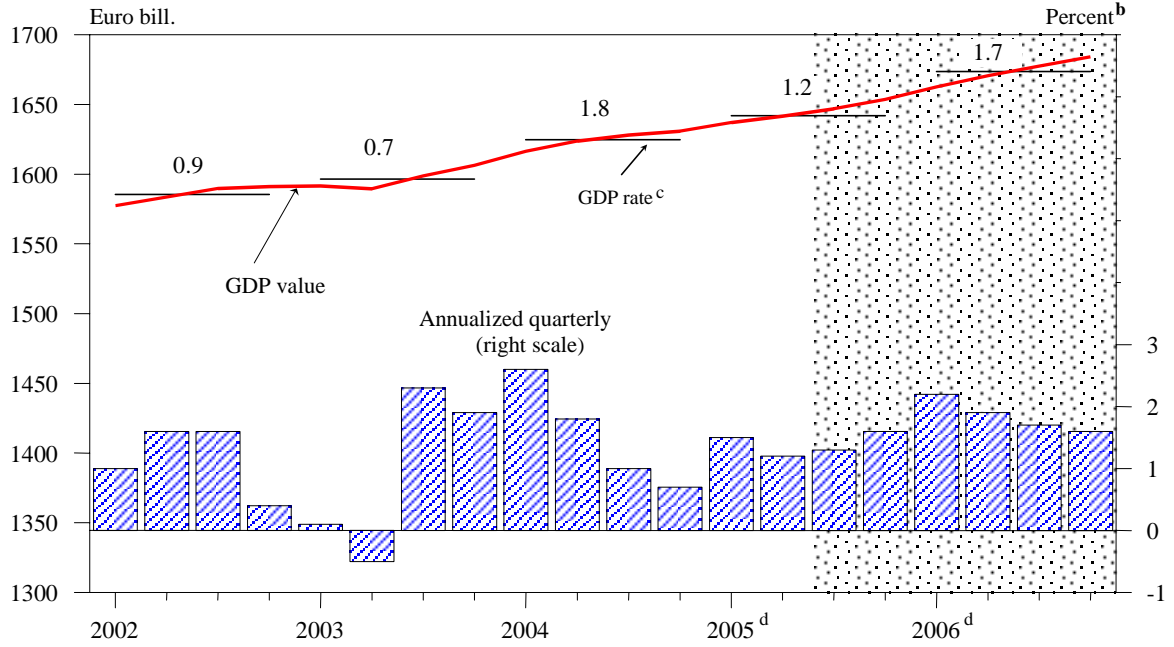
Quarterly Data on the Economic Development in Euroland, 2004–2006

	2004				2005				2006				2004	2005	2006
	I	II	III	IV	I	II	III ^a	IV ^b	I ^b	II ^b	III ^b	IV ^b			
Gross domestic product ^c	2.6	1.8	1.0	0.7	1.5	1.2	1.3	1.6	2.2	1.9	1.7	1.6	2.1	1.2	1.7
Domestic demand ^c	1.0	1.7	2.8	2.1	0.4	1.0	0.8	1.3	1.4	1.5	1.6	1.7	2.0	1.3	1.3
Private consumption ^c	3.0	0.3	0.8	3.3	0.7	-0.3	1.3	1.2	0.8	1.1	1.3	1.5	1.5	1.1	1.0
Public consumption ^c	0.5	1.3	1.6	-1.1	1.9	1.4	0.9	0.8	1.6	1.2	1.2	1.2	1.1	1.0	1.2
Fixed investment ^c	0.7	0.3	2.0	1.6	-0.6	1.0	0.8	2.7	3.6	3.1	2.7	2.6	1.8	0.8	2.7
Change in stocks ^d	-0.9	1.1	1.6	0.1	-0.2	0.7	-0.3	-0.1	-0.1	-0.1	0.0	0.0	0.4	0.3	-0.1
Net exports ^d	1.5	0.2	-1.7	-1.3	1.1	0.2	0.5	0.3	0.8	0.5	0.2	-0.1	0.1	-0.1	0.4
Exports ^{c,e}	6.9	10.5	5.1	2.0	-2.6	8.6	7.2	5.2	5.3	4.8	4.1	3.4	6.5	3.8	5.3
Imports ^{c,e}	3.1	10.8	10.2	5.7	-5.4	8.6	6.3	4.6	3.6	3.9	4.0	3.8	6.6	4.2	4.5
Unemployment rate ^f	8.9	8.9	8.9	8.8	8.8	8.7	8.7	8.6	8.5	8.5	8.3	8.2	8.9	8.7	8.4
Consumer prices (HICP) ^g	1.7	2.3	2.2	2.3	2.0	2.0	2.2	2.1	2.1	1.7	1.5	1.4	2.1	2.1	1.7
Money stock M3 ^c	4.5	5.1	7.8	7.3	6.3	7.4	5.0	5.0	5.0	5.0	5.0	5.0	5.8	6.5	5.1
3-month money market rate	2.1	2.1	2.1	2.2	2.1	2.1	2.2	2.2	2.2	2.2	2.3	2.4	2.1	2.2	2.3
Long-term interest rate	4.1	4.2	4.1	3.8	3.5	3.4	3.5	3.7	3.8	4.0	4.1	4.3	4.1	3.5	4.1
US dollar/euro exchange rate	1.25	1.20	1.22	1.30	1.31	1.27	1.25	1.25	1.25	1.25	1.25	1.25	1.2	1.3	1.3
Real effective exchange rate ^h	106.1	103.7	104.5	107.1	106.5	105.2	104.6	104.6	104.6	104.6	104.6	104.6	105.4	105.2	104.6
Crude oil price ⁱ	31.4	35.2	40.6	44.8	47.8	51.4	63.0	65.0	65.0	65.0	65.0	65.0	38.0	56.8	65.0

^aPartly estimated. — ^bForecast. — ^cAnnualized percentage change over previous quarter. — ^dContribution to change in GDP, in percentage points. — ^eIncluding intra-Euroland trade. — ^fPercent of the labor force, according to the ILO concept. — ^gPercentage change over previous year. — ^hBroad group. Based on the consumer price index. Index 1999 I = 100. — ⁱNorth Sea Brent, US dollar/barrel.

Source: Eurostat (2005); ECB (2005d); OECD (2005b); own calculations and forecasts.

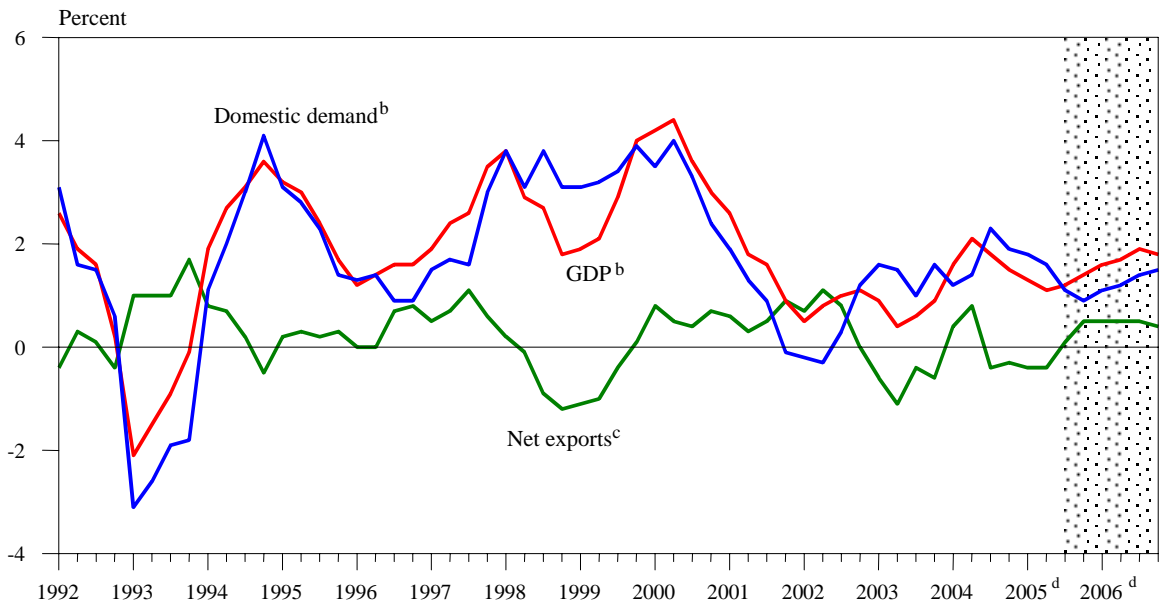
Figure 5:
Real GDP^a in Euroland, 2002–2006



^aSeasonally adjusted. — ^bAnnualized quarterly rate of change in percent. — ^cPercentage change over previous year. — ^dForecast starting in 2005 III.

Source: Eurostat (2005); own forecast.

Figure 6:
GDP, Domestic Demand and Net Exports in Euroland^a, 1992–2006



^aAt constant prices. — ^bPercentage change over previous year. — ^cChange of net exports over previous year in percent of GDP in the corresponding quarter of previous year. — ^dForecast starting in 2005 III.

Source: Eurostat (2005); own forecasts.

Table 6:
Real GDP, Consumer Prices and Unemployment Rate in Euroland, 2003–2006

	Weights ^a	GDP ^b				Consumer prices ^{b,c}				Unemployment rate ^d			
		2003	2004	2005 ^e	2006 ^f	2003	2004	2005 ^e	2006 ^f	2003	2004	2005 ^e	2006 ^f
Germany	28.8	-0.2	1.6	0.7	1.1	1.1	1.7	1.9	1.7	9.1	9.5	9.6	9.4
France	21.5	0.9	2.2	1.6	2.1	2.2	2.3	1.8	1.6	9.5	9.7	9.7	9.4
Italy	17.7	0.4	1.2	0.0	1.2	2.8	2.3	2.1	2.0	8.4	8.1	7.8	7.6
Spain	10.9	2.9	3.1	2.8	3.1	3.2	3.0	3.2	2.7	11.5	10.9	9.7	9.5
Netherlands	6.1	-0.1	1.7	0.8	2.0	2.2	1.4	1.4	-3.5	3.7	4.6	4.8	4.4
Belgium	3.7	1.3	2.9	1.3	2.0	1.5	1.9	2.5	2.1	8.0	7.8	8.0	7.7
Austria	3.1	0.8	2.1	1.7	2.0	1.4	1.9	2.1	1.9	4.3	4.8	5.0	4.7
Finland	2.0	2.5	3.8	1.6	2.6	1.3	0.2	0.7	1.6	9.0	8.9	8.4	8.1
Greece	2.2	4.3	4.1	2.6	3.0	3.4	3.0	3.6	3.3	9.7	10.5	10.0	9.6
Portugal	1.8	-1.1	1.0	0.5	1.6	3.3	2.5	2.2	2.9	6.2	6.7	7.2	6.8
Ireland	1.9	4.4	4.5	4.8	4.5	4.0	2.3	2.2	2.5	4.6	4.5	4.3	4.0
Luxembourg	0.3	2.9	4.5	3.5	4.0	2.6	3.2	3.5	2.5	3.7	4.8	5.0	3.9
Euroland	100.0	0.7	2.1	1.2	1.7	2.1	2.1	2.1	1.7	8.7 ^g	8.9 ^g	8.7 ^g	8.4 ^g

^aBased on nominal GDP of 2004. — ^bPercentage change over previous year. — ^cHarmonized Index of Consumer Prices (HICP). — ^dStandardized unemployment rates according to the ILO concept. — ^ePartly estimated. — ^fForecast. — ^gBased on the number of employees in 2004.

Source: ECB (2005d); OECD (2005a); own calculations and forecasts.

prices (Table 5).¹⁶ However, economic activity will receive impulses from foreign trade. Exports will expand against the background of a robust worldwide economic activity, especially because the euro has depreciated since the beginning of this year. Real GDP in the euro area is expected to increase by 1.2 percent in 2005, and hence to expand at a slower pace than potential output. The situation on the labor market will slightly improve. The unemployment rate will amount to 8.7 percent in 2005 on average (Table 6). Despite the decline in the core inflation rate, HICP inflation will remain at 2.1 percent as in 2004. Hence the inflation rate is again slightly higher than the ECB's target rate, which is, however, mainly due to the surge in oil prices.

In 2006, domestic demand will strengthen somewhat as the dampening effects of the rise in oil price will slowly fade. With improving profitability corporate investment will gain momentum. Private consumption is expected to increase somewhat, reflecting more positive income perspectives. Exports are likely to benefit from a more favorable price competitiveness although they will slow down against the background of a slower pace of foreign economic activity. All in all, real GDP will increase by 1.7 percent in 2006. The unemployment rate will decline gradually in view of the modest expansion of economic activity. Inflation will decline to 1.7 percent in 2006 as there will be no further impact from oil prices.¹⁷ Wage increases will continue to be moderate.

¹⁶We assume that the oil price will remain at a value of US\$65 per barrel North Sea Brent.

¹⁷Because of a new definition of the price index, the HCPI in the Netherlands will decline.

References

- Alesina, A., and R. Perotti (2004). The European Union: A Politically Incorrect View. *Journal of Economic Perspectives* 18 (4): 27–48.
- Benner, J., K.-J. Gern, C.-P. Meier, and J. Scheide (2005a). Konjunktur in Euroland mit wenig Schwung. *Die Weltwirtschaft* (1): 64–92.
- Benner, J., K.-J. Gern, A. Kamps, F. Oskamp, B. Sander, J. Scheide, and R. Schweickert (2005b). Robuste Weltkonjunktur. *Die Weltwirtschaft* (3). Forthcoming.
- Clarida, R., J. Galí, and M. Gertler (1999). The Science of Monetary Policy: A New Keynesian Perspective. *Journal of Economic Literature* 37 (4): 1661–1707.
- ECB (European Central Bank) (2005a). *Monthly Bulletin*. January. Frankfurt am Main.
- ECB (European Central Bank) (2005b). *Monthly Bulletin*. June. Frankfurt am Main.
- ECB (European Central Bank) (2005c). *Monthly Bulletin*. July. Frankfurt am Main.
- ECB (European Central Bank) (2005d). *Monthly Bulletin*. August. Frankfurt am Main.
- EUROFRAME (2005). Euro Growth Indicator. September. Online source (access on August 25, 2005) <<http://www.euro-frame.org/indicator/index.htm>>.
- European Commission (2005). *European Economy – Economic Forecasts Spring 2005*. Brussels.
- Eurostat (2005). *National Accounts*. Luxembourg.
- OECD (Organization for Economic Cooperation and Development) (1999). *Economic Outlook*. December. Paris.
- OECD (Organization for Economic Cooperation and Development) (2005a). *Main Economic Indicators*. August. Paris.
- OECD (Organization for Economic Cooperation and Development) (2005b). *Economic Outlook*. June. Paris.
- OECD (Organization for Economic Cooperation and Development) (2005c). *Economic Survey of the Euro Area, 2005*. July. Paris.
- Papademos, L. (2005). The Political Economy of the Reformed Stability and Growth Pact: Implications for Fiscal and Monetary Policy. Online source (access on August 26, 2005) <http://www.ecb.int/press/key/date/2005/html/sp050603_1.en.html>.
- Taylor, J.B. (1993). Discretion Versus Policy Rules in Practice. *Carnegie-Rochester Conference Series on Public Policy* 39: 195–214.
- Wyplosz, C. (2005). Fiscal Policy Institutions Versus Rules. *National Institute Economic Review* 191 (January): 64–78.8.

KIEL ECONOMIC POLICY PAPERS

1. Monetary Management of Transition in China: Balancing Short-Run Risks and Long-Run Optimality
Markus Diehl, Rainer Schweickert
Kiel, June 2005. €9.
2. Procyclicality in the Financial System: Do We Need a New Macrofinancial Stabilization Framework?
William R. White
Kiel, September 2005. €9.
3. Euroland: Recovery Is Slowly Gaining Momentum
Joachim Benner, Klaus-Jürgen Gern, Joachim Scheide
Kiel, September 2005. €9.

For more information on the Institute's publications see <http://www.ifw-kiel.de/pub/pub.htm>