

# European Economic Outlook

**Will an upturn + elections = reform?**

Adam S. Posen

Institute for International Economics

*IIE Global Economic Prospects*

September 14, 2005

# What Has Gone Wrong In Europe

A weaker Brussels has meant greater statism

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

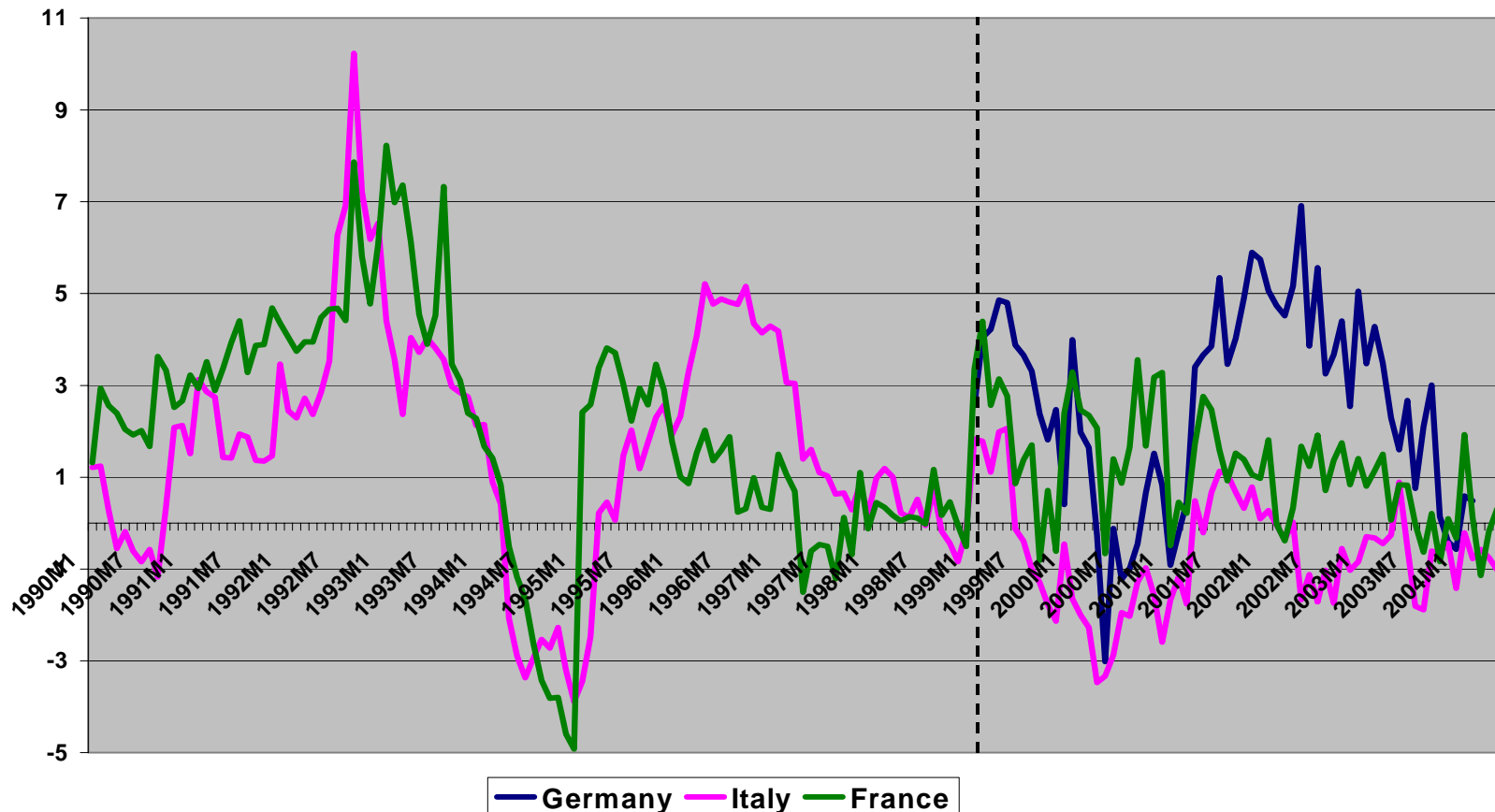
The ECB has been unwilling to reward reform

## Growth will rise in the coming year (but probably not much outside of Germany)

	GDP Growth (constant prices YoY)		
	<b>Mussa 9/05</b>		Factors in outlook
	<b>2005</b>	<b>2006</b>	
France	1.5	1.3	Stealth reforms uncertain
Germany	1.0	1.3	No domestic demand yet
Italy	0.0	0.5	Lower competitiveness
UK	2.0	2.0	Real estate drag coming

## Germany had its own “ERM crisis”, but the worst is over

percentage points



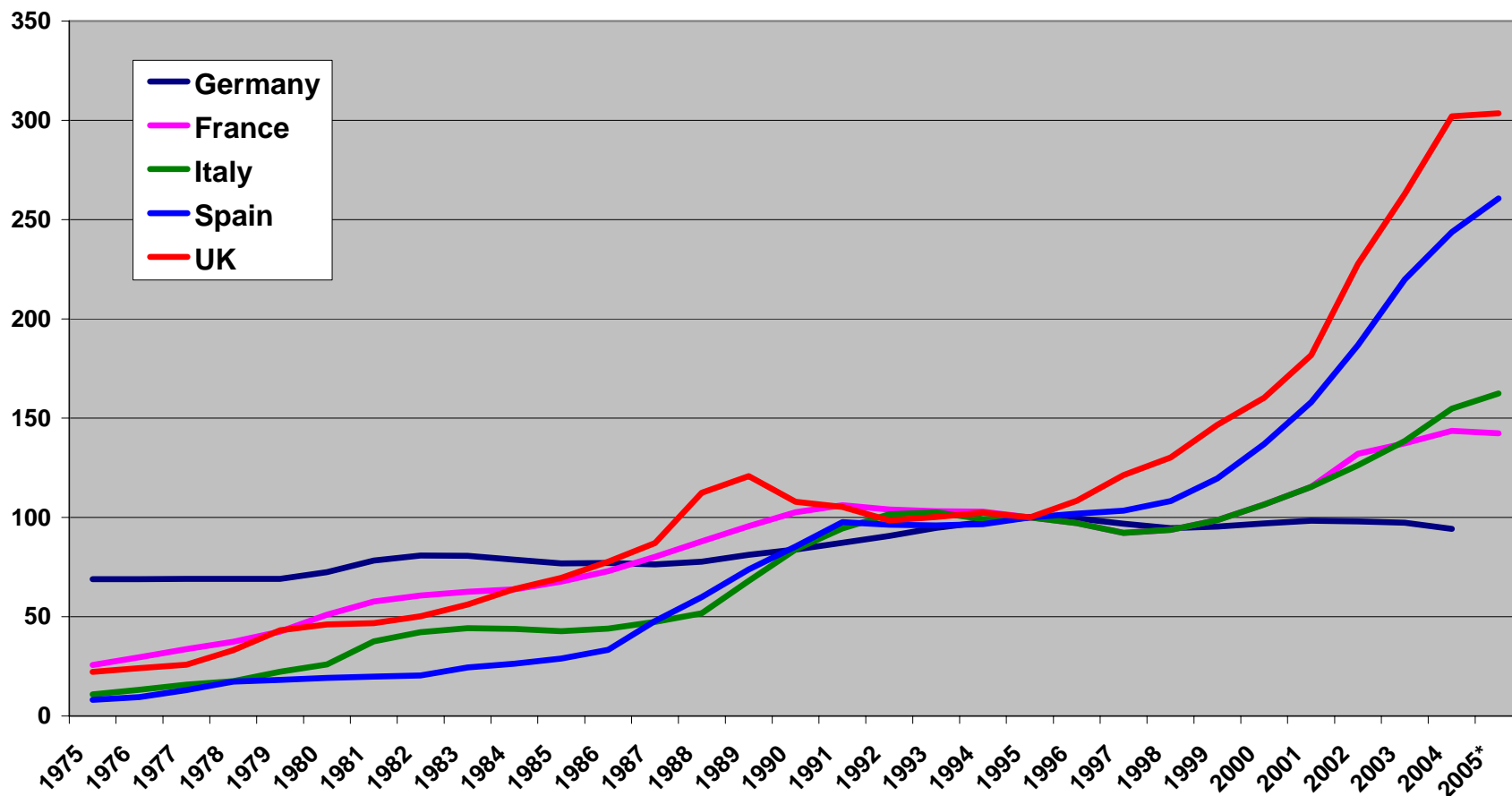
Source: Posen and Popov Gould, “ECB Monetary Policy and Eurozone Stress”, Sept 2005

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

A. Posen, IIE, 09/2005

# The US is not the only housing boom to worry about

Housing Price Indices



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

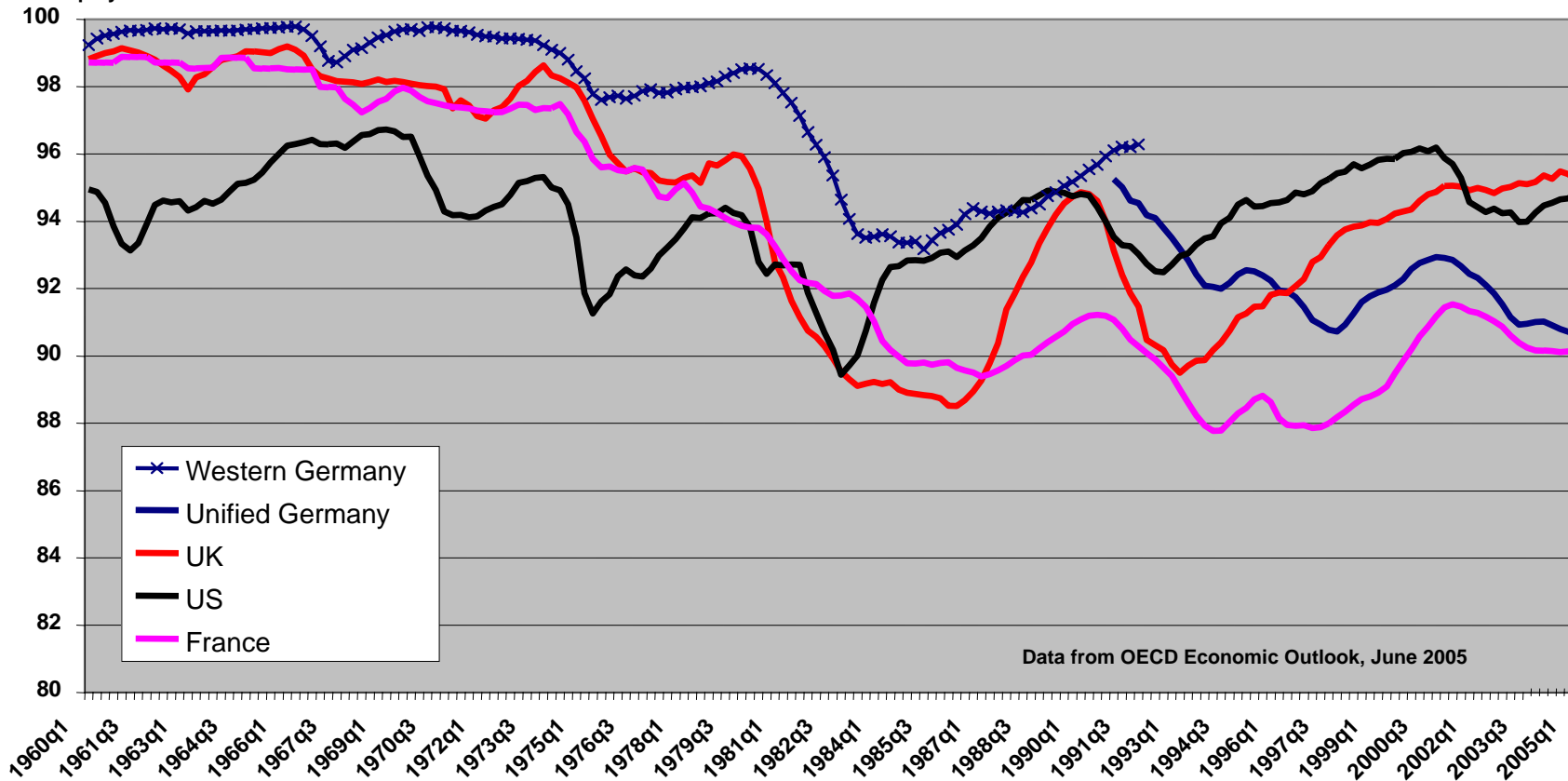
A. Posen, IIE, 09/2005

## The ECB's Policy Challenge

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

# Employment hysteresis persists on the continent

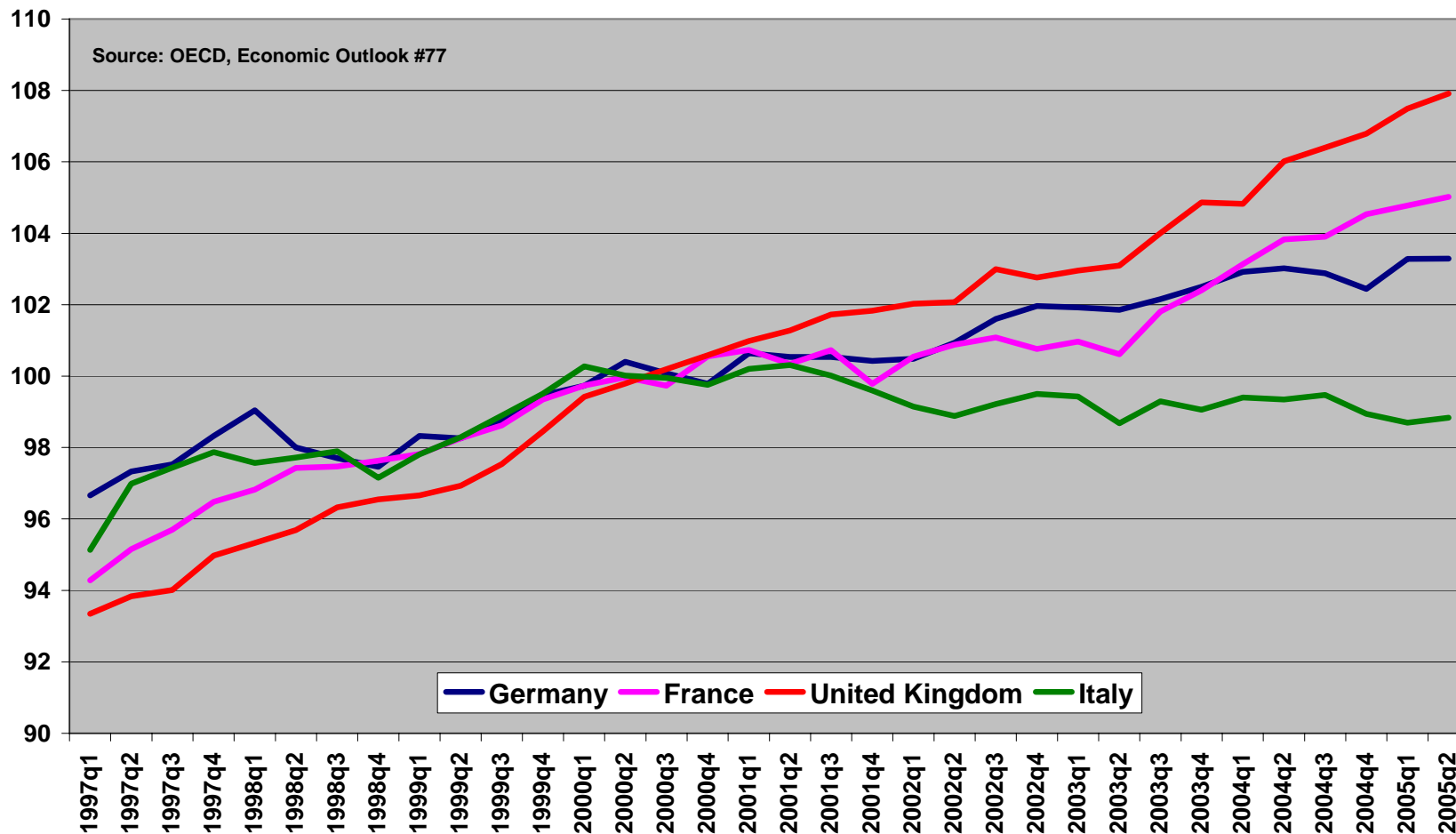
Total Employment/Total Labour Force



Data from OECD Economic Outlook, June 2005

# Reducing labor costs is not a substitute for productivity enhancing reform

Productivity Index



A. Posen, IIE, 09/2005



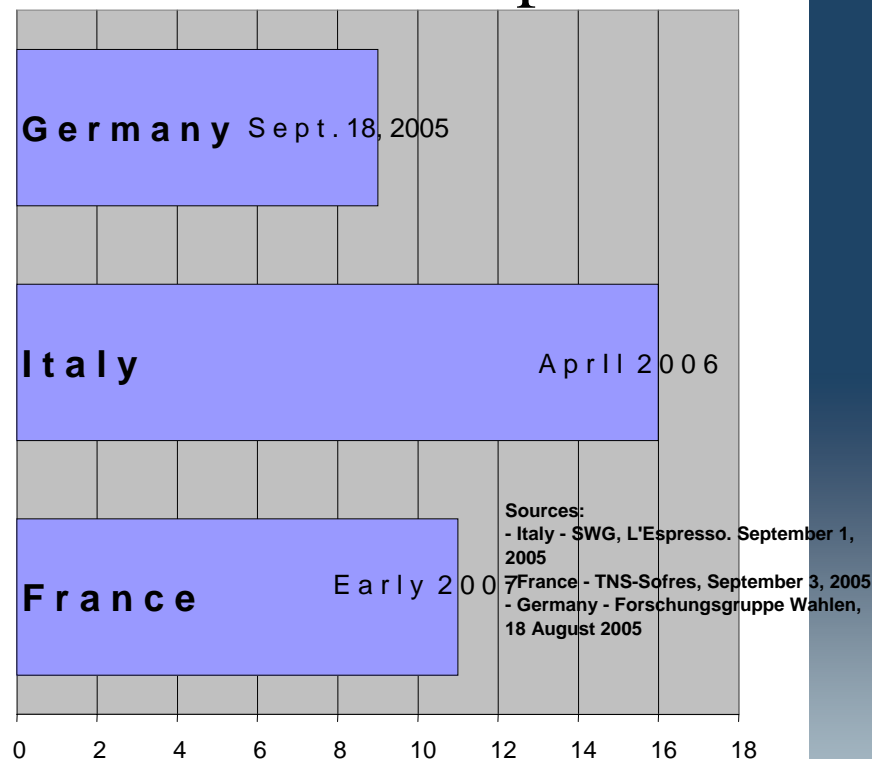
## Upcoming Elections

Perhaps a cycle of reform? Or of further stalemate?

### Electoral possibilities

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

### Share of illiberal parties



## If not now for reform, when?

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

## What might go wrong getting there

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