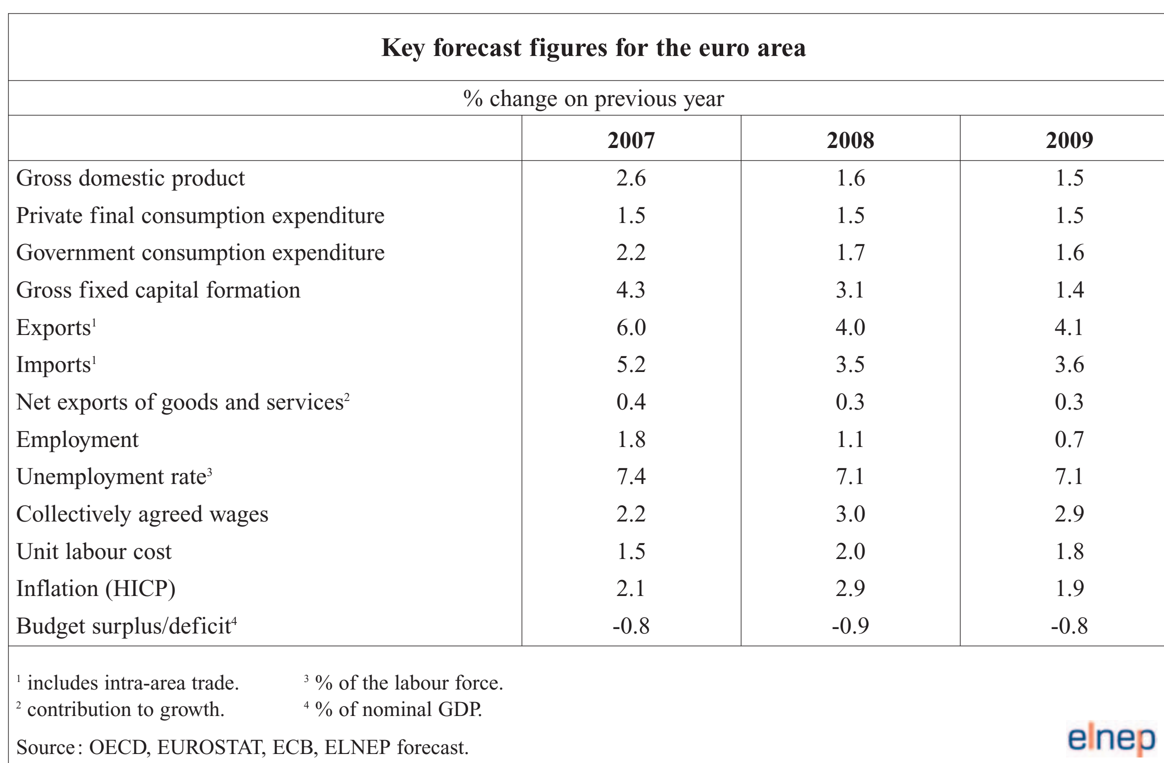
elnep European Labour Network for Economic Policy

http://www.elnep.org

Executive summary

In spring 2008, the outlook for euro area growth is overshadowed by the ongoing financial crisis and the question of how deep the US recession might become. Financial distress worldwide is far from over and the necessary depreciations and write-offs in the banking sector will negatively impact the real economy. Weaker US and global expansion, combined with the appreciation of the euro against the US-dollar, will dampen euro area exports. At the same time, private consumption is impaired by rapid inflation primarily caused by unusually high prices for food and energy. The higher headline inflation rates will make the needed quick counteraction by policymakers, specifically a loosening of ECB monetary policy, less likely.



Key forecast figures for the euro area

% change on previous year

	2007	2008	2009
Gross domestic product	2.6	1.6	1.5
Private final consumption expenditure	1.5	1.5	1.5
Government consumption expenditure	2.2	1.7	1.6
Gross fixed capital formation	4.3	3.1	1.4
Exports[1]	6.0	4.0	4.1
Imports[1]	5.2	3.5	3.6
Net exports of goods and services[2]	0.4	0.3	0.3
Employment	1.8	1.1	0.7
Unemployment rate[3]	7.4	7.1	7.1
Collectively agreed wages	2.2	3.0	2.9
Unit labour cost	1.5	2.0	1.8
Inflation (HICP)	2.1	2.9	1.9
Budget surplus/deficit[4]	-0.8	-0.9	-0.8

[1] includes intra-area trade. [3] % of the labour force.
[2] contribution to growth. [4] % of nominal GDP.

Source: OECD, EUROSTAT, ECB, ELNEP forecast.

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Under these conditions the ELNEP forecasts euro area GDP to fall by a full percentage point to 1.6% in the current year, despite a probably still robust first quarter. Private consumption will stay feeble, hit by higher price increases, and all the other main demand

components will weaken. Growth will not pick up significantly until the end of 2009 at the earliest, and we predict an annual average of just 1.5%. The welcome fall in unemployment will come to a halt at 7.1%.

Currently at rather high rates of 3.6%, inflation is expected to decline during the forecast period, averaging 2.9% this year and returning to the ECB target of 1.9% next year, as the price shocks to energy and food prices drop out of the numbers. Despite the price hikes we expect collectively agreed wages in the euro area to grow by only 3.0% in the current year. Even allowing for slightly faster growth in actual wages, unit labour cost growth – the key metric for domestic price stability – will be 2.0% this and 1.9% next year: wage setting is underpinning medium-run price stability and second-round effects are not expected for the euro area as a whole.

For at least two years, then, the combination of external shocks and the financial crisis will bring an end to the brief period of strong growth that has brought down unemployment and helped to narrow fiscal deficits. Moreover, the downside risks to growth have intensified. ELNEP scenarios indicate that a stronger slowdown in the US and continued financial turbulence that keep inter-bank interest rates at elevated levels would reduce GDP in 2009 by 0.5% and cost 400,000 jobs compared with the forecast.

What should be the response of European policymakers in this situation?

Monetary policy: The ECB should swiftly cut its base rates by 50 basis points (half a percent) to stabilise consumer and business expectations and prevent an unnecessary and potentially drawn-out downturn in growth. ELNEP scenario calculations suggest that such a cut (followed up by the two cuts at the end of the year assumed as part of the forecast) would add 0.3 percent to GDP next year, adding 200,000 jobs and ensuring that unemployment continues to fall, albeit slightly. The cost in terms of higher inflation would be negligible.

Fiscal policy: Provided monetary policy acts to underpin economic activity, fiscal policymakers in most euro area countries need not take explicit counteraction, unless the economic situation takes an unexpected turn for the worse. However, they should allow the built-in stabilisers to work in full, accepting the slight rise in deficits that come automatically through higher spending and reduced tax revenues. Some countries, notably Spain and Ireland, particularly hard hit by the crisis and with strong budgetary positions, should use discretionary fiscal policy to support demand. More generally fiscal policymakers should be seeking to raise public investment in areas that promote longer-run growth.

Wages policy and collective bargaining: The ELNEP encourages wage-setters to stick to the forecast course: the average rate of wage increases is set to accelerate slightly, which will help sustain demand and consumption, but in aggregate remain compatible with

medium-run price stability in the face of temporarily higher inflation. Keeping wage increases to a rate not greater than the sum of labour productivity growth and the central banks inflation target, frees monetary authority to take resolute action to prevent a serious downturn. At the national level the slight wage acceleration in, notably, Germany, and deceleration in countries such as Spain will go some way to correcting the competitive imbalances that have built up within the euro area.

Financial market regulation: Urgent steps need to be taken to ensure that financial market actors behave in ways that promote, rather than endanger, the growth of the real economy. Past liberalisations and the successful efforts of financial market institutions to evade existing regulation have been shown to be highly dangerous. The most important short-term aim is to restore the functioning of financial markets, but the means chosen to achieve this aim should avoid socialising the losses of institutions that in the past successfully privatised their gains. In the medium term effective re-regulation of the financial sector is needed to: ensure transparency, prevent undue risk-taking and risk distribution, ensure adequate safety buffers (capital adequacy) in ways that reduce rather than promote economic instability, provide for European and international coordination and, where appropriate, the centralisation of supervisory authority, to prevent national jurisdictions being played off against each other.

More and better jobs? – Labour market developments in the euro area since 1999 – Executive summary

In a companion report the ELNEP network has analysed in detail the labour market of the euro area since the start of monetary union in 1999. In many important senses the euro area labour market performs better than its widely held reputation would suggest. Most notably, job growth has been strong, especially for women, and unemployment, although still higher than in the US, has fallen markedly. Europe has indeed created 'more jobs'. However, there are a number of serious issues in the area of 'job quality' in the broad sense. More jobs: yes. Better jobs: not really.

Specifically ELNEP finds:

- Progress has been made in raising employment rates, but the Lisbon employment targets will not be met by 2010 because of the mid-decade 'wasted years' of sluggish economic growth.

- Unemployment has come down to levels not seen for a generation. Yet it remains higher than in the US and the non-EMU western European countries.

- In spite of lower unemployment and higher inflation, wage setting remains moderate and consistent with price stability in EMU as a whole. But this also means that national income continues to be shifted from wage to profit income, depressing the wage share.

- At the same time, divergences between countries unit labour cost developments have led to competitive tensions within the currency union.

- The euro area has a productivity problem. Contrary to standard arguments about the productivity-enhancing effects of market-oriented structural reforms, labour productivity growth has been sluggish. While the reasons are complex, we identify the weakening of collective bargaining, which has reduced the pressure on firms to rationalise production, as an important cause.

- Regarding job quality, there are a number of important areas of concern. Involuntary part-time work and the use of fixed-term contracts have increased inexorably. In a number of countries, but not all, wage inequality has increased dramatically. Specifically the share of workers in Germany and the Netherlands earning less than two thirds of the median hourly wage is now almost as high as in the USA.

- A quantitative analysis of job quality in the EU15 using fifteen separate indicators suggests a worrying decline in the areas of non-standard employment contracts and collective interest representation since 2000. Despite the shift to services and political statements of intent, there has been no improvement in 'physical' working conditions or in indicators of 'work-life balance'. Comparing countries on their overall performance, the Scandinavian countries come out top, along with the Netherlands and the UK. The southern European countries perform worse. Worryingly the better-performing countries have improved their scores since 2000, whereas the laggards appear to have fallen further back.

Overall the analysis suggests a link between these developments. Returning to pay trends that are oriented towards medium-run productivity growth, particularly at the bottom end of the labour market, would be an important step towards raising workers' living standards. It would help stop the trend to greater inequality, while serving to stimulate the rate of labour productivity growth on which, ultimately, rising living standards depend.

The data cut-off point for this forecast was 27 April 2008.