

European Economic Outlook

Will an upturn + elections = reform?

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IIE Global Economic Prospects

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What Has Gone Wrong In Europe

A weaker Brussels has meant greater statism

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

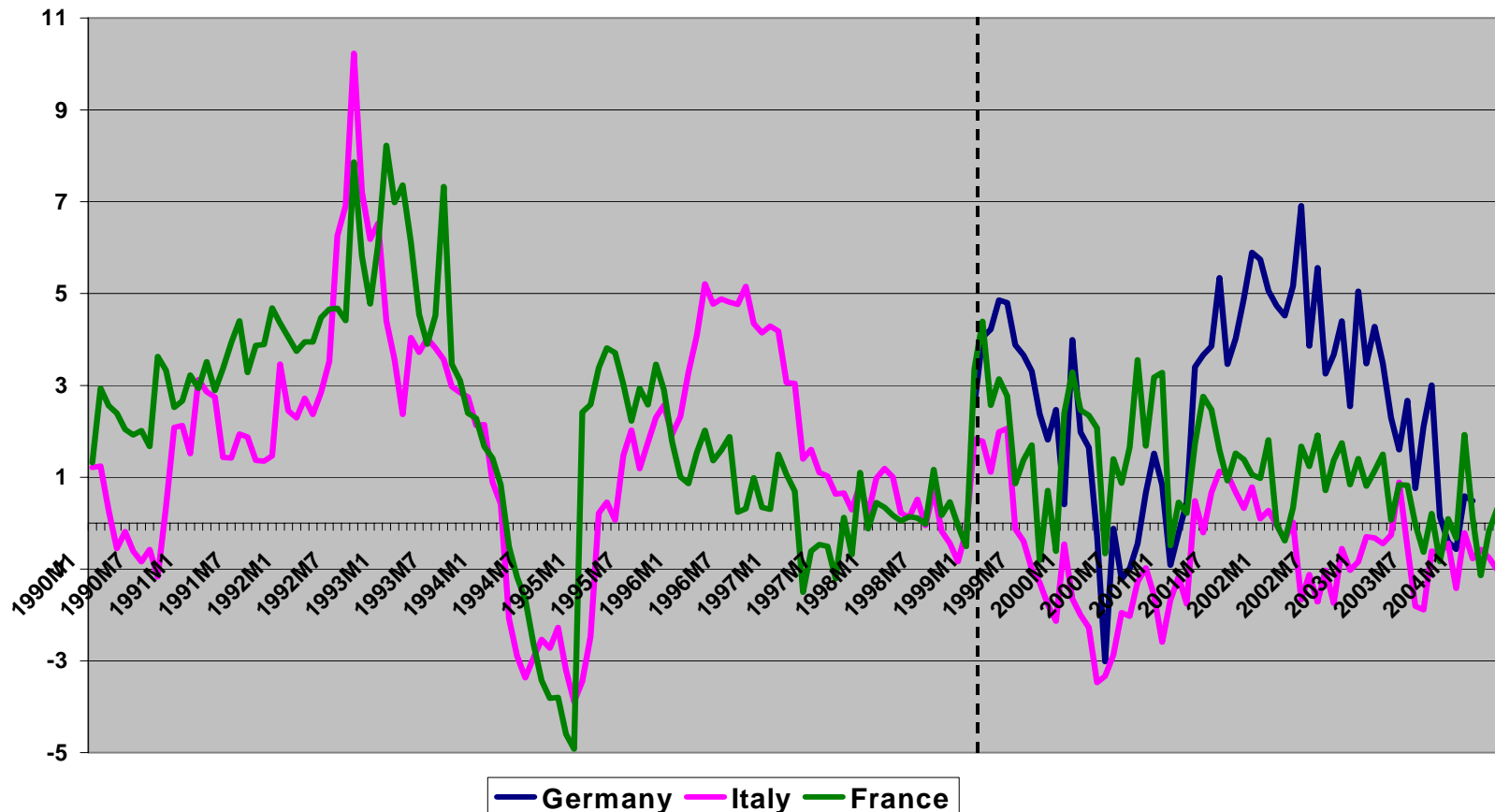
The ECB has been unwilling to reward reform

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

	GDP Growth (constant prices YoY)		
	Mussa 9/05		Factors in outlook
	2005	2006	
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



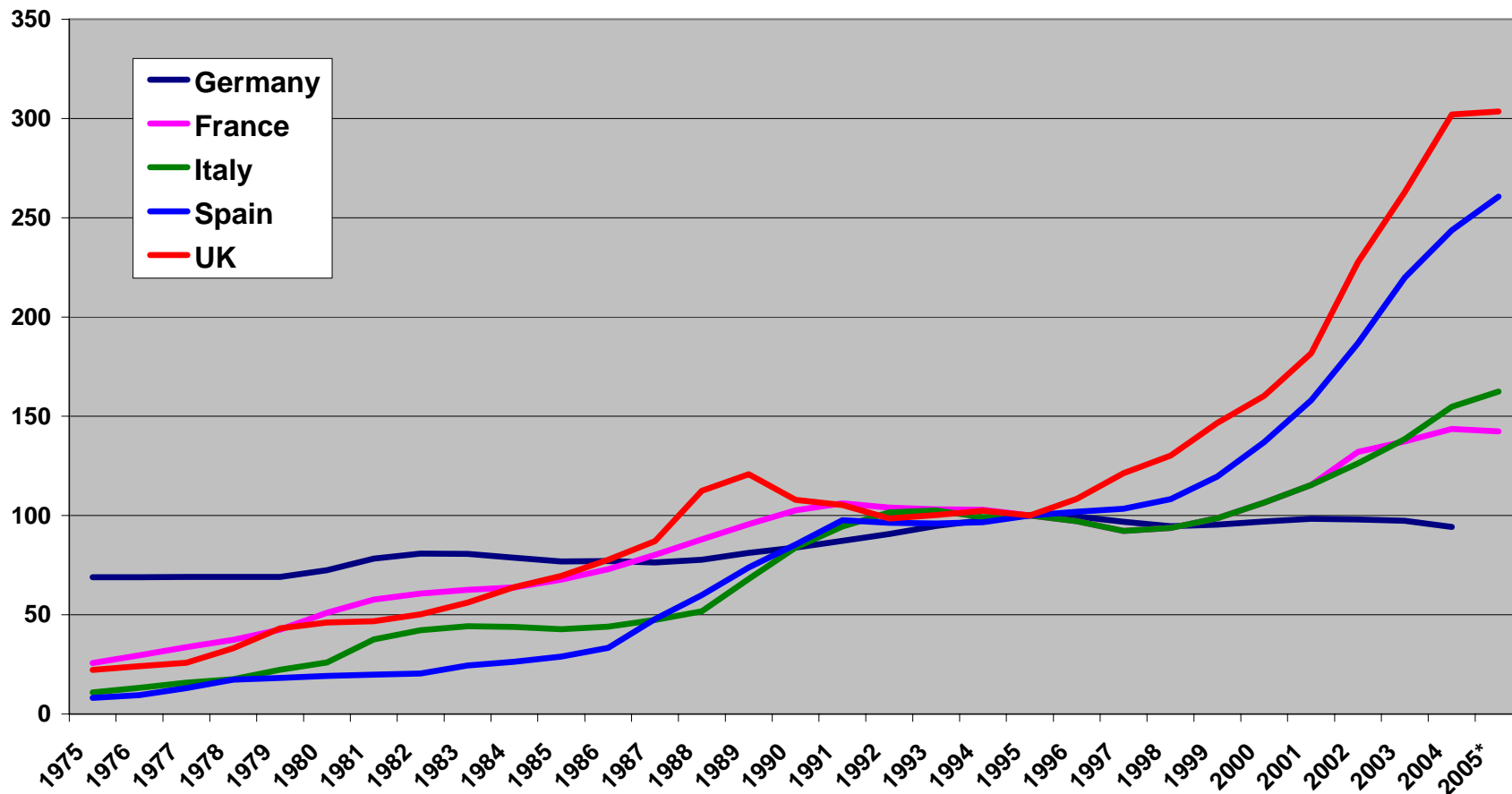
Source: Posen and Popov Gould, “ECB Monetary Policy and Eurozone Stress”, Sept 2005

- 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.

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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

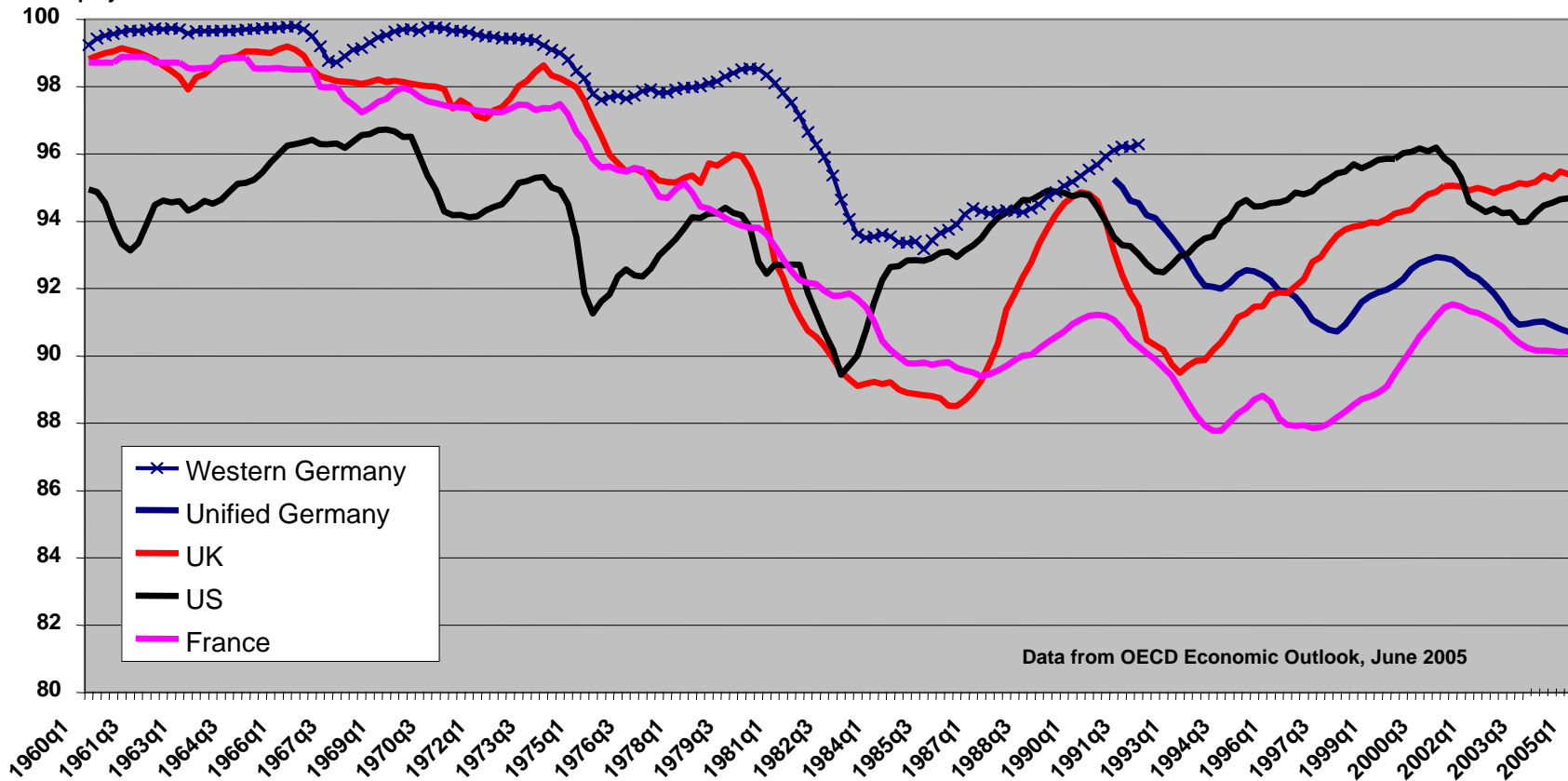
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The ECB's Policy Challenge

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

Employment hysteresis persists on the continent

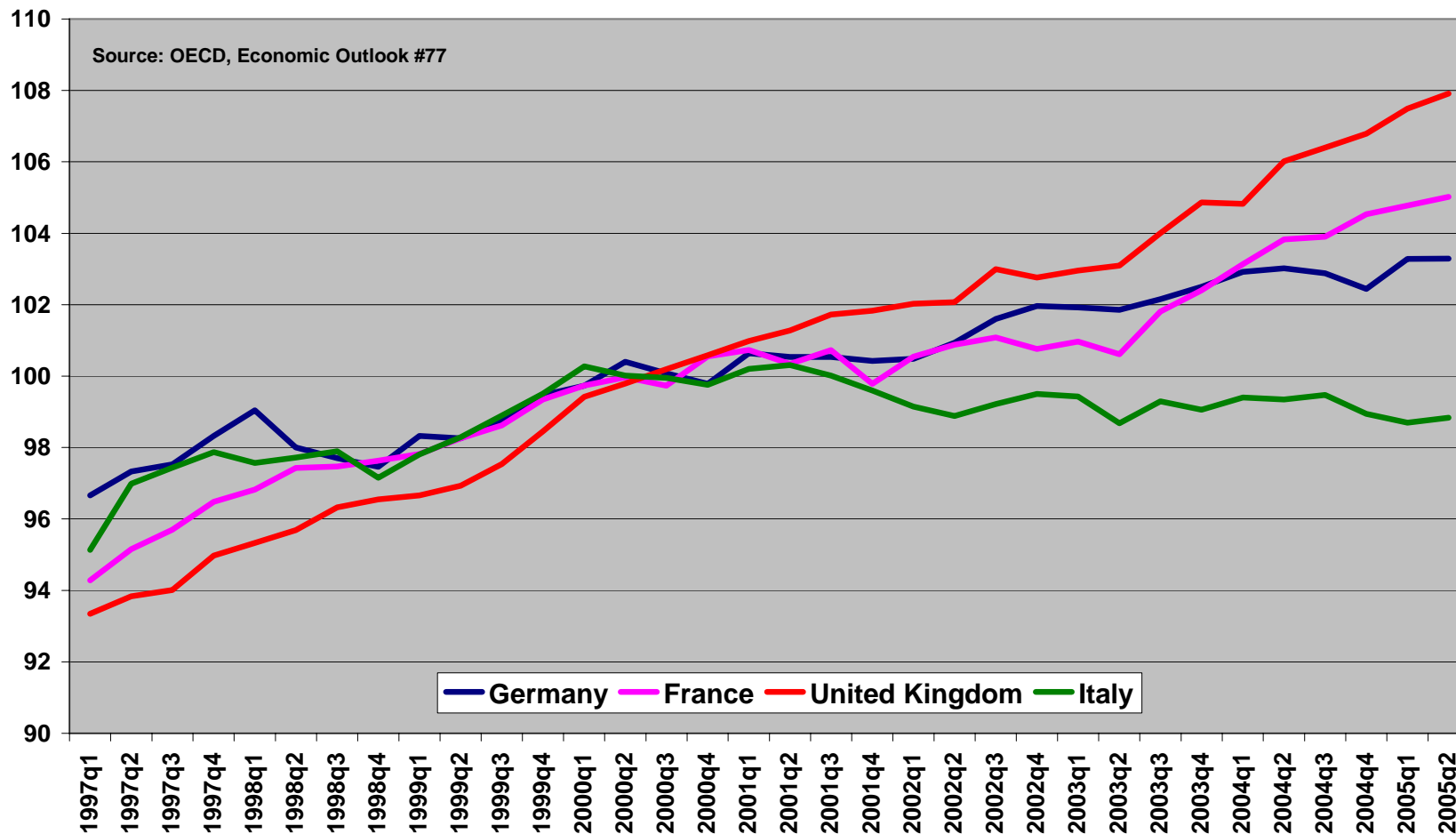
Total Employment/Total Labour Force



Data from OECD Economic Outlook, June 2005

Reducing labor costs is not a substitute for productivity enhancing reform

Productivity Index



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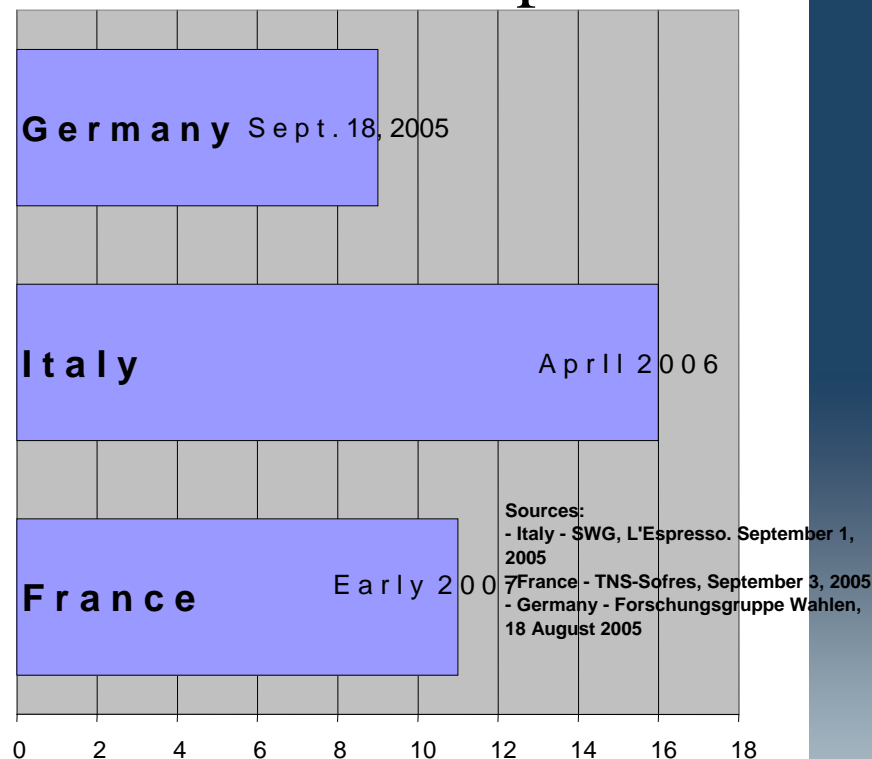
Upcoming Elections

Perhaps a cycle of reform? Or of further stalemate?

Electoral possibilities

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

Share of illiberal parties



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