Economic and monetary conditions in the euro area: crossing the Atlantic Ocean

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Briefing paper

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Outlook

With respects to my last briefing paper (november 2000), the economic outlook for the euro zone has evolved, but in a direction and in extent which remain uncertain. The fashionable world is "resilient". Most forecasting institutes expect the euro area to be relatively resilient, with growth slowing only slightly this year to stay well above 3%. Hence basically they are forecasting the continuation for 2001 of the present growth cycle. But the term "resilient" is supposed to captures the uncertainty surrounding the forecast : "despite the slowing down of world growth, the euro area will not be much affected".

Why this rather obscure, or even negative way, of designing the prospects? There is a deep reason for that. Economic thinking continues to be dominated by a crude version of the (keynesian) locomotive theory according to which the essential international transmission mechanism is the trade effect. Because the economic slowdown in the United States seems more significant than previously expected, and because the recovery in Japan is still delayed, external demand addressed to the euro area is likely to weaken.

But growth in the euro area is not so much driven by external demand. If it where how can one explains the long periods of slow growth which have characterised Europe between 1991 and 1997, or between 1982 and 1986? Both periods correspond to strong growth in the United States. Apparently in crossing the Atlantic Ocean, the beneficial trade effect had vanished or even reversed. Hence others transmission mechanism which may overcome the trade effect are at work (cf. Fitoussi and Phelps: *The slump in Europe: reconstructing open macroeconomic theory*, Basil Blackwell, 1988). Without entering the details of the theoretical reasoning, it is worthwhile to try to understand these effects.

The present situation in the euro area is one of a relatively strong internal demand, rather massive job creation, and an historically high level of consumer confidence. The slight decrease in the european rate of growth during the second half of the year 2000 was obviously not due to the weakening of the american economy but to the surge of the price of oil magnified by the depreciation of the euro.

What then would be the effect on such an economic situation of a slowing down of growth in other parts of the world? For sure european exports should slow down, but in an extent which will be all the more moderate that the euro area is a rather closed economy. Hence the trade effect should not be that strong. But three other effects are at work, the exchange rate effect, the (long term) interest rate effect and the primary good effect. In a nutshell, the expected appreciation of the euro, the weakening of the pressure on the allocation of world saving and thus the likely decrease of long term interest rates, and last the decrease with respect to trend of the price of primary goods, will have both beneficial supply and demand effects well above the weak negative trade effect. The combination of these three effects is analogous to a positive supply shock, as it entails a decrease in costs, but also because the reduced long term interest rate has a significant effect on asset valuation, and thus on mark-up. The decreasing rate of inflation has besides a positive effect on purchasing power and thus on demand.

All that lead to expect a re-acceleration of growth in the first semester of 2001.

Monetary conditions in the euro area

Against this background, how to evaluate the course of monetary policy?

First, it is not that astonishing that the Governing Council of the ECB did not decrease interest rates in its last three meetings. If the preceding reasoning contains some true, the case to follow the decisions of the Fed is not so well established. That the ECB is the only major central bank not to have cut rates this year is just reflecting the fact that the economic situation in Europe is different from what it is in the US or elsewhere. In the last quarter of the year 2000, many observers were forecasting that the rate of interest would be increased by a quarter of a point at the beginning of the year 2001. This did not happen. The phase of tightening of monetary policy has come to an end before expected.

Taking a broader view of the course of monetary policy during the year 2000, one may even assess that monetary policy has been and still is rather accommodative. An index of monetary conditions which combines changes in exchange rates and interest rates show a rather continuing easing in monetary conditions since january 1999. And it appears that such an index is broadly linked with GDP growth. Recent appreciation of the euro, and the expected continuation of this appreciation -- most institutes are forecasting that the euro will come at least to parity with the dollar in the year 2001— together with the likely decrease of the inflation rate, seem to indicate that monetary conditions will become tighter throughout this year, without reaching the point of being restrictive. The substantive fiscal easing in the euro area may thus lead to a progressive inversion of the policy mix. It is why many observers are expecting stable official interest rates throughout the year as the most likely outcome. But one factor remains difficult to assess, namely the effect of increased competition in the euro area; the degree of competition will increase for two reasons : the coming into being of the euro (but this should not be overstated), but more surely the increased competitiveness of foreign (to the euro area) firms, due to the appreciation of the euro. Such an appreciation leads not only to a mechanical decrease of the price of imported goods, but also to a decrease in the mark-up of "national" firms to cope with increased competition from abroad. Hence the desinflation of the year 2001 may be more pronounced than expected.

Should then the ECB reverse the course of monetary policy? What are the pro and cons as we find them in the last monthly bulletin of the ECB?

Looking at monetary aggregate – the first pillar – is not really informative for reasons which were spelled out in preceding papers. There is some deceleration in M3, but argues the ECB, its rate of increase is still higher than the target. "Overall, while some caution still needs to be exercised, following the recent slowdown in monetary growth, the risks to price stability from the monetary side have become increasingly balanced." (ECB, Monthly Bulletin, february 2001).

Price developments show a decrease of headline inflation from 2.9 in November to 2.6 in December. This deceleration is expected to continue throughout the year 2001, for reasons emphasized above. The December figure incorporates a sizable increase of the prices of unprocessed food, partly explained by "the current health concerns associated with beef consumption". Admittedly, we cant infer from such a volatile component of the HICP index lessons for the future. But there is more to the point. Because this increase is linked to health concerns, and to the need to ameliorate the security of consumption, there is obviously a measurement problem. If prices increase *pari passu* with quality improvement, there is no inflation, and the growth of the index is overstated. In view of the fact that the "mad cow" problem is a serious one, and taken seriously by european governments, there is no doubt that decisions which have been already taken and decisions which will be taken in the future will lead to a much needed quality improvement. The price index in the future should be revised accordingly to avoid an overestimation of the inflation rate.

But what about core inflation? The annual rate of increase in the HICP excluding unprocessed food and energy was unchanged in december as compared to november at 1.5%. But the ECB is fearing that second round effects associated with past increases of headline inflation may still show up. For the moment, looking at labour costs, there is no clear sign of the presence of a catch up effect. (The ECB rightly recognizes that the growth of hourly labour costs is overestimated because of measurements problems, mainly related to the reduction working days in some economies.) And For the future, there are some indications of a deceleration of producer prices and manufacturing input prices.

All that means that risks to price stability if they existed are progressively, if not rapidly, vanishing.

But it is uncomfortable to assess medium term inflation prospects from the informations contained in the monthly bulletin, not only because it does not include a model or a framework allowing to forecast inflation, given monetary policy, but also because it does not include even estimation of most recent developments: in a bulletin published the 28th of february, it is odd not to find an estimation of the rate of growth of the forth quarter 2000, nor an estimate of the rate of inflation for january 2001.

To sum up, it seems to me that 1) there is nothing wrong in the recent (non) decisions of the ECB, 2) that the case can be done for a decrease of the official interest rate in a not too distant future, and that 3) the course of monetary policy in the euro area will be better understood if the reasoning behind it is made more explicit.