Euro zone recovery teeters

DAVID KERN ASSESSES THE STIFF CHALLENGES FACING THE EURO ZONE ECONOMY.

Last year was a good one for the euro zone. GDP growth almost doubled after a very poor performance in 2005, and the euro has risen to new highs against other major currencies. But recovery is precarious and unlikely to be sustained at its current pace. Lower predicted growth in 2007 reflects global trends, but there are clear risks that policy actions could accelerate the euro zone's slowdown. More seriously, persistent structural impediments, and the absence of effective reforms aimed at removing them, could hinder the euro zone's medium-term growth prospects.

Executive summary

- Growth in the euro zone has improved, but remains disappointing compared with the US, the UK and the other big players.
- Future growth forecasts are uncertain due to persistently rigid labour and product markets, weak domestic demand, high unemployment levels and a reliance on net exports, while the appreciation of the euro could add to the pressure.

UNDERPERFORMANCE The improvement in growth comes after a long period of persistent underperformance. Although the euro zone is a large, rich and stable economy, it lacks dynamism. As *Figure 1* shows, the euro zone's annual GDP growth has been an average of 1% lower than that of the US between 1995 and 2006. The UK has also outperformed the euro zone in that time and even Japan has overtaken it in the past six years. Even more important is the euro zone's very mediocre outlook. It has been at the bottom of the global growth league table in every year since 2003, and most forecasts suggest that the euro zone's relative underperformance will persist in 2007 and 2008 (see *Table 1*).

PROSPECTS Euro zone GDP growth fell sharply in 2005 to a dismal 1.3% – well below the growth in potential output (that is, the maximum growth rate the economy can sustain without stoking inflationary pressures), which is estimated at about 2.1% a year. Between 2001 and 2005, euro zone growth undershot its potential every single year. Given this disappointing background, the recovery in 2006, to an above-trend pace of 2.5%, is very welcome. Unfortunately, the renewal of hope in the euro zone's prospects is premature. The upturn is still on course, but it seems highly likely that 2007 will see euro zone GDP growth slow to 1.8% – reasonable if compared with the pre-2006 record, but still below potential. There could be a modest upturn in 2008, but only to 2%.

The lack of sufficient structural reform is generally seen as a key cause of the sluggish rate of economic growth in the euro zone. More ominously, there are serious risks that potential output is likely to fall over the next few decades, as a result of an ageing population and a declining labour force. Projections from the European Commission suggest that potential euro zone output growth could fall to around 1.25% a year by 2040, if structural reforms to boost productivity and enterprise are not carried out at a more determined pace.

CURRENCY STRENGTH At the end of last year, the US dollar plummeted and the euro and sterling surged to multi-year highs. The sharp currency appreciation entails serious risks for the euro zone, given its reliance on exports and the 2007 slowdown expected in global economic growth. *Figure 2* shows the longer-term context – and demonstrates that the popular impression of a weak currency is wrong, if the relative strength of currencies is examined on an effective, or trade-weighted, basis.

Following a period of initial weakness, after its establishment as a

Figure 1. GDP growth 1995-2000 and 2001-2006

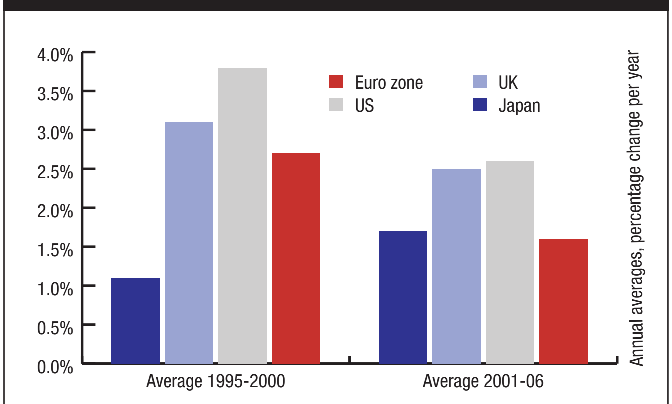

Figure 2. Effective exchange rates

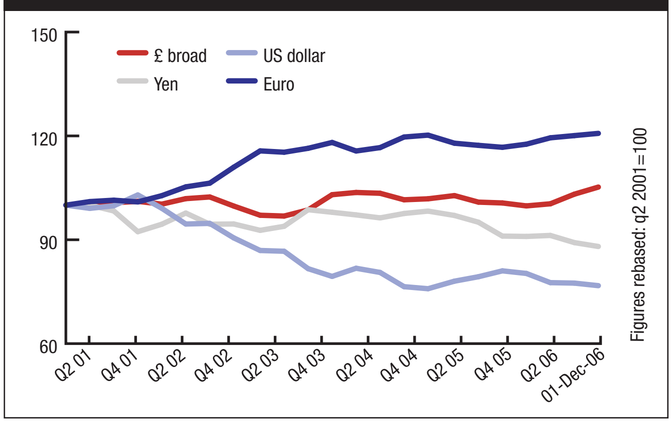

Table 1. GDP growth of the major economies 2003-2008 (annual % change)

	2003	2004	2005	2006 Estimate	2007 Forecast	2008 Forecast
Japan	1.8%	2.3%	2.6%	2.8%	2.2%	2.4%
The UK	2.7%	3.3%	1.9%	2.6%	2.3%	2.4%
The US	2.5%	3.9%	3.2%	3.3%	2.1%	2.7%
Euro zone	0.8%	2.0%	1.3%	2.5%	1.8%	2.0%
China	10.0%	10.1%	10.2%	10.5%	9.5%	9.0%
India	7.2%	8.0%	8.5%	8.5%	7.4%	7.5%

single currency early in 1999, the euro has been strong overall since mid-2001. It is now about 20% above its mid-2001 effective level and there are serious risks that it will appreciate further in the next few months. One key reason is that the euro is set to remain a major recipient of capital flows out of the US dollar, at a time when the major Asian players with huge external surpluses are practising capital controls. Central bank reserve diversification away from the US dollar, and realistic expectations that the European Central Bank (ECB) will raise interest rates further, could put further upward pressure on the euro and seriously damage euro zone economic growth. There are no good objective reasons for the euro to strengthen significantly in 2007, since the euro zone's current account is no longer in surplus but rather in small deficit.

INTEREST RATES The ECB has raised its official interest rate at a brisk pace since December 2005, after keeping it unchanged at 2% for more than two and a half years. There are strong arguments for the ECB to adopt a more relaxed stance, and not raise interest rates above their present level:

- The recent sharp appreciation of the euro effectively tightens euro zone monetary policy;
- Euro zone 2007 growth prospects have worsened; and
- Euro zone inflation is below 2% and falling, in line with oil prices.

The markets still believe on balance that the ECB rate will be raised once more in the next few months to a peak of 3.75%. *Table 2* shows recent trends, and summarises our forecasts, for likely movements in the main official interest rates of the major central banks.

STUMBLING BLOCKS There is widespread agreement that a sustained euro zone recovery still faces major obstacles:

- Poor progress on removing rigidities in its labour and product markets;
- Weak competition and the absence of a thriving enterprise culture;
- Unduly weak domestic demand;
- Unemployment remains excessively high;
- The planned increase in German VAT in 2007;
- Excessive reliance on net exports, particularly given the likelihood that the huge US market is set to slow in 2007;
- The recent strong rise in the euro undermines exports;
- Given the large differences between EU members in terms of growth and employment, the single currency could hinder growth;
- The apparent determination of the ECB to raise rates in 2007 could dampen domestic demand and strengthen the euro.

OBSTACLES It is important not to exaggerate the predicaments, given the euro zone's affluence and weight in the global economy. Though fragile, its current recovery should not be dismissed, although it would be unwise to disregard the serious obstacles it faces, particularly the need to persevere with reforms and move towards a more competitive economy. Europeans do not need to adopt all the features of the more dynamic US economic model, but painful changes cannot be avoided without serious long-term costs.

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Table 2. Official interest rate forecasts for next 24 months

	Actual			Forecast				
	end-04	end-05	07.12.06	3mnth	6mnth	12mnth	18mnth	24mnth
US Fed Funds Rate	1.00%	2.25%	4.00%	4.50%	4.75%	4.75%	4.50%	4.25%
ECB Refi Rate	2.00%	2.00%	2.25%	2.25%	2.50%	2.75%	2.75%	3.00%
Japan Overnight Rate	0.00%	0.00%	0.00%	0.00%	0.25%	0.75%	1.00%	1.00%
UK Repo Rate	3.75%	4.75%	4.50%	4.25%	4.50%	4.75%	4.75%	4.50%
US less ECB Rate	0.25%	2.00%	1.75%	1.50%	1.25%	1.00%	1.00%	1.25%
UK less US Rate	2.50%	0.25%	-0.25%	-0.25%	0.00%	0.25%	0.25%	-0.25%