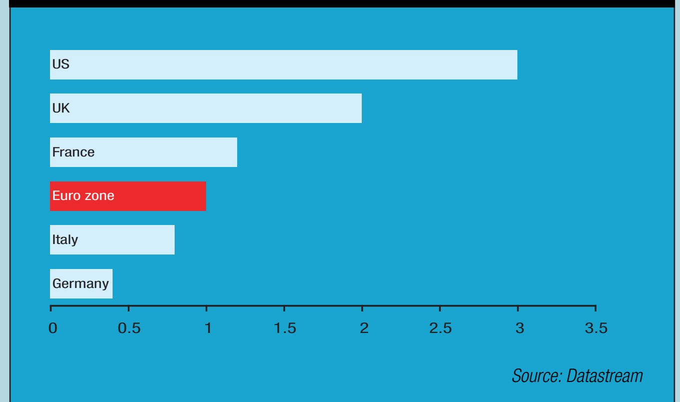
THIS YEAR HAS SEEN A MARKED IMPROVEMENT IN THE GLOBAL ECONOMY, BUT RECOVERY IN THE EURO ZONE HAS BEEN SLOWER, SAYS **JEREMY PEAT** OF THE ROYAL BANK OF SCOTLAND.

A SLOW ROAD TO RECOVERY

The global economy has recovered substantially this year and I am distinctly positive about the outlook for 2005. The euro zone is reviving and can be expected to improve further in the months ahead. A return to trend growth next year is on the cards. At the same time, the euro zone has cleared lagged the global pick-up. Recovery has been driven – particularly in Germany – largely by external rather than domestic demand.

While growth has recovered limply and with a lag, there have also been continuing concerns about euro zone economic governance. The three key economies (Germany, France and Italy) remain in effective breach of the Stability and Growth Pact (SGP), which was set up to enforce budgetary discipline among the 12 countries using the euro in 1997. There is still no clear sign either of how the fiscal position in these countries is to be returned to prudence or how the SGP is to be revised so as to be effective and implementable. We also have to take due account of EU expansion.



THE EURO ZONE LAGS. The gross domestic product (GDP) growth story is summarised in *Figure 1*. Following the 2001 recession, the US recovered markedly – and that recovery has accelerated into 2004 with growth of 4% expected. In the UK, growth at an acceptable pace was maintained in 2001 and 2002, thanks to stimulated public and private sector domestic demand due to lower interest rates and marked fiscal expansion. Again growth has accelerated this year – with GDP in the second quarter estimated to be up as much as 3.7%, year-on-year.

The growth revival is not limited to just the US and the UK. Japan has experienced significant and positive GDP growth in recent quarters and appears to be emerging from deflation. This recovery has been partially due to, and certainly closely linked with, strong growth in China and the rest of Asia. Overall, the global economy is firing on far more cylinders than has been the case since the mid-1990s.

The euro zone and the economies at its core have been the key exception. France (see *page 58*) has marginally out-performed the zone average, but Italy and, especially, Germany (see *page 48*) have proved disappointing.

DIFFERING INTEREST RATE EXPECTATIONS. In the UK and the US, inflation risks have shifted from downside to upside, as growth has accelerated and spare capacity has been utilised. This happened earlier in the UK than in the US, partly because of the emphasis on domestic demand and because of the limited spare capacity – in jargon, the smaller 'output gap' – at least as perceived by the Monetary Policy Committee. As a consequence, the Bank of England started raising UK interest rates in November 2003, while the US Federal Reserve delayed its first hike until July. In both instances further tightening lies ahead – the only questions are how much and how soon?

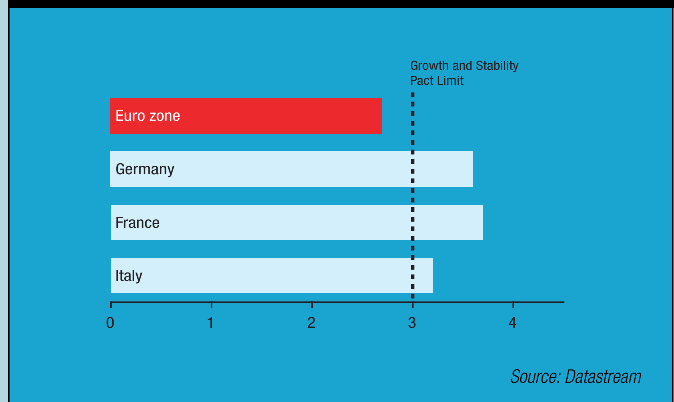
The European Central Bank (ECB) has not yet raised rates. Indeed, if it had not been for the actual and potential impact on inflation of sustained high oil prices, then some further monetary easing should have been seriously contemplated. As it is, expect any monetary tightening is likely to be deferred well into 2005.

Figure 2 reveals the relative contributions to growth in Germany from domestic and external demand and helps explain why growth has been weak and why monetary tightening should be further deferred. Through much of the period since 2001, domestic demand has held back overall growth. The strong external performance is most certainly welcome, and has reflected both the recovery in global demand and the continuing competitiveness of the manufacturing sector in particular. However, with such muted domestic demand, inflation risks are likewise limited and policy can remain loose for longer than in the economies where domestic demand is rising.

DIFFERING FISCAL POLICY POSSIBILITIES. Domestic demand was stimulated in both the UK and the US through a combination of monetary and fiscal loosening. In the UK, the emphasis was on higher public expenditure; in the US it was on tax cuts. But in both instances there was a move from surplus to substantial deficit. Now the challenge is to return to 'normal'.

Figure 2. Germany: Contributions to real GDP Growth (%)

Figure 3. Fiscal deficit predictions for 2004



Fiscal loosening also took place at the core of the euro zone, but there were two key differences. First, policy was subject to particularly rigid rules under the SGP. Second, several of these economies started the downturn of the economic cycle with deficits already at worrying levels. As a consequence, the degree of loosening feasible was insufficient to provide the the desired domestic demand stimulus.

Even then, the degree of loosening led the three major economies – Germany, France and Italy – again to formally or informally breach the SGP (see *Figure 3)*. In Italy, one-off measures may have delayed the inevitable, but given a much higher level of debt to GDP, the breach of SGP limits is even more worrying.

While legal issues rumble on, the SGP has effectively been 'retired'. I have reservations about elements of the pact but accept that in a monetary union, a level of fiscal constraint is essential – hence I reach two conclusions. First, a revised pact is required, with added flexibility and some technical adjustments, but capable of being enforced and imposing appropriate constraints. Second, key member states of the EU must now act to return their fiscal position to balance in short order and take advantage of the stronger growth years. If not – especially as demographic effects with significant public finance implications are starting to flow through – future fiscal flexibility will be as constrained as was the case in this cycle.

NOW FOR THE EXPANSION… The addition of 10 new member states will have important implications for the region. On 1 May 2004, the EU population expanded by almost 20% in one stroke – from around 380 million to 455 million. The increase to the economic scale was much less marked. Most of the new entrants have lower average income levels than existing member states. Average incomes in the new entrants are typically between 20% and 50% of the EU benchmark. Indeed, the expansion added just 6% to the region's GDP – the equivalent of adding another Dutch economy, for example.

But the indirect impact of the region's expansion to the east is likely to be much more dramatic than the headline change in GDP might suggest. The 10 new member states have expanded rapidly over the past decade, with economic growth exceeding the euro zone average by around 1.5 percentage points per annum. The addition of these dynamic and fast-growing economies should provide a welcome boost to the region. The new entrants, and indeed existing EU members, have already benefited from the increase in trade in the run up to full EU membership. But further gains can be expected, as EU accession and increased tightening of currency links with the euro help to unlock the full benefits of the single market. Over time, increasing mobility of workers and investment across the region, as labour and capital markets become increasingly integrated, must confer significant benefits to all concerned.

All the new entrants have undertaken difficult and wide-ranging structural reforms to meet accession treaty requirements. Indeed, in some cases the new entrants now have more flexible product and labour markets than some existing member states. As these economies continue to thrive, there could be a movement towards national governments at the core of the euro zone. Some of these member states have dragged their feet on structural reforms in recent years, especially in tackling labour market rigidities. Low cost, well-educated workforces in these dynamic and ambitious economies will increase competition for new and footloose investment in the region. This will increase the pressure for reform in many existing member countries and signs of this impact are already evident.

The expansion of the EU from 15 to 25 members will also pose significant for governance challenges. The ponderous process of policy and decision-making in the key EU institutions will be further complicated. A new constitution should help to deal with these issues. But so far it is not clear clear whether agreement on a new governance framework can be agreed and implemented. The slow workings of the EU institutions may be accentuated.

Monetary policymaking in the euro zone will not be affected in the near-term, as there is no fixed timetable for the new entrants to adopt the single currency. This will, however, become an issue in time. Unlike the UK and Denmark, none of the new member states have an opt-out of this final stage of monetary union. The ECB is increasingly stressing that there must be real convergence (i.e. in the institutions and structures of the new entrant economies) as well as nominal convergence (i.e. meeting Maastricht convergence criteria for inflation, public finances, etc), before euro participation. Therefore this development is likely to be – and given the diversity of the new entrants – should be a matter of years rather than months.

That is no bad thing, given the challenges already facing new and old members in the years ahead.

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