A STEP IN THE RIGHT DIRECTION

AS THE GLOBAL ECONOMY TWISTS AND TURNS WHAT WILL BE THE OUTCOME FOR THE EURO? **JEREMY PEAT** OF THE ROYAL BANK OF SCOTLAND BELIEVES CAREFUL POLICYMAKING IS THE KEY.

The good news for us economists is that there always seems to be something interesting going on in the global economy – or maybe that is just another demonstration of the old nostrum that little things please little minds. Be that as it may, this is certainly a particularly fascinating time for the euro zone economy. There are serious questions to be addressed on at least four fronts:

- First, are we on the verge of global recovery following a period of prolonged weakness, with positive implications for euro zone growth prospects?
- Second, why has the euro appreciated, and where is it headed next?
- Third, are major changes impending for euro zone macroeconomic 'governance' – specifically regarding the European Central Bank (ECB) and the Stability and Growth Pact (SGP)?
- Finally, there are signs of action on structural reform at the core of Europe. Can we now expect meaningful action on both fiscal consolidation and supply-side flexibility?

HOT TOPICS. Let me take each of these topics in turn and try to wend a way through to some constructive conclusions. Over the past two or three years, the global economy has travelled along an exceptionally slow growth path. This process all really started with the US tumbling into recession, as the IT and telecoms investment bubble burst and that new economy-inspired boom descended to bust.

This cycle has been different from its immediate predecessors. The latter tended – to dramatically over-simplify – to come on the back of rising inflationary pressures, as consumer exuberance got out of hand, leading to monetary tightening, squeezing consumer and inflation alike, until the time was ripe to loosen the grip once more and let the consumer rip. This time around, investment in the new technology sectors inspired and led the upswing, supported by a belief that a new era of ultra-rapid productivity growth had dawned and backed up by consumers, as equities surged and household wealth shot up. The US descent into recession came as investment in the new technology sectors ceased. This followed a realisation that the future earnings of technology firms were likely to fall far short of initial expectations, which had been based on forecasts of unsustainably high rates of productivity and real GDP growth in the US economy.

As a consequence of the form of the collapse, there was substantial international contagion. The cut in investment was global rather than contained to the US. Capacity was reduced sharply, with the euro zone by no means immune. Equities tumbled – again globally – bringing down consumer wealth and confidence, and resulting in a widespread deceleration of consumer expenditure. In sum, contagion to the euro zone from the US recession came via trade, investment, equities, consumer and business confidence and corporate profitability.

The global recovery will also have to be led by the US and will have to incorporate a return to business confidence and investment. There are increasing signs that this process is underway. Certainly, US policymakers have played their part, with huge monetary and fiscal loosening. Now corporate profitability is increasing and activity indicators are becoming more encouraging. That US-led process will feed through to the euro zone via many of the same transmission mechanisms.

EURO MATTERS. In the meantime, there has been limited scope, in much of the euro zone, to generate marked increases in domestic demand to offset the external weakness. This helps to explain why slow growth at the core of Europe has been prolonged (see *Figure 1*). It also serves to underscore the importance of the external revival, which needs to feed through to activity and to boost both the confidence and the finances of businesses and households.

In this context, the euro matters. Recent euro appreciation will have tended to reduce the competitiveness of euro zone producers in a range of traded goods' markets. For several years the euro was remarkably weak against both sterling and the dollar – well below all realistic measures of longer-term equilibrium. Then, suddenly, the dollar fell sharply, with sterling sharing in some of that euro/dollar appreciation (see *Figure 2*). The specific trigger for the realignment is difficult to identify, particularly when the received wisdom is that growth and returns to investment in the euro zone over the next couple of years will be more subdued than in the US. However, the >>

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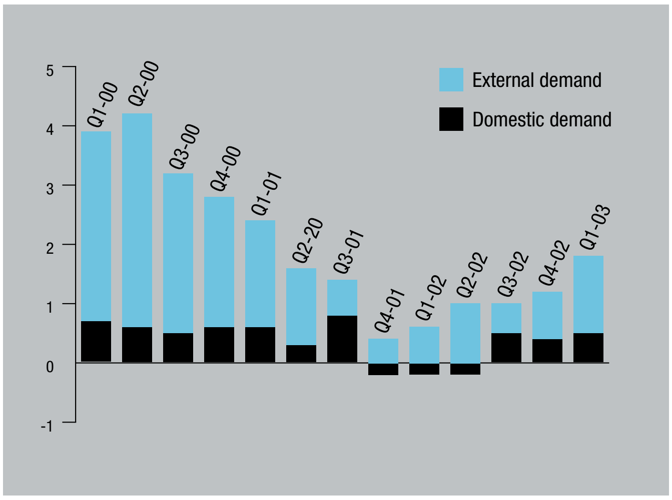
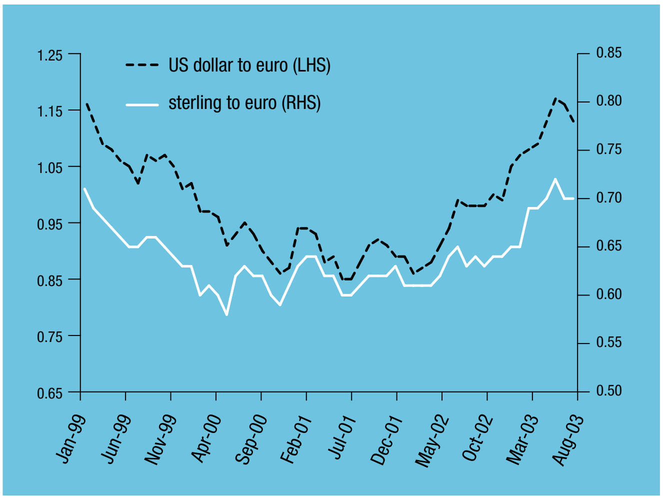
▪ Figure 1
Contributions to euro zone real GDP growth (Year-on-year % change)



▪ Figure 2
Exchange rates



<< movements were certainly back towards purchasing power parities. Perhaps the real surprise was not that the euro eventually gained in value, but how long it took for the markets to drive this inevitable and appropriate movement.

ON THE HORIZON. As ever with exchange rates, it is difficult to say what will happen next. There certainly looks to be scope for some further gentle dollar/euro depreciation. However, the markets will continue to fret about US imbalances – that towering external deficit and its counterparts for the domestic public and household sectors. With a crying need for imbalance correction, and Japan and China respectively resisting yen and renminbi depreciation, there has to be a risk of another sharp dollar/euro descent. This is especially the case as the euro is the dollar's only alternative as a reserve currency – and it is difficult to see where else funds exiting the dollar could head; and there could be a desire in the US to 'talk down' the dollar in the run-up to next year's presidential election.

Policymakers in Europe have no remit to attempt to direct or influence the euro's external value. Nevertheless, their activities are under increasing scrutiny as we await a change at the helm of the ECB and – given the extent of its rules being breached by large member states – further consideration of change to the SGP.

The arrival of Trichet in place of Duisenberg at the ECB should certainly improve communication but may make little difference to the bank's approach or its decisions. My expectation is that rates are close to their floor but likely to remain at their present low level for most of the next 12 to 18 months. The stronger euro helps to minimise any remaining concern about inflation risks, while the spectre of deflation is not to be disregarded.

I must admit to a distinct preference for change in the ECB's policy framework. It would be good to see the monetary pillar demolished or further downplayed, and I would much prefer a truly symmetric inflation target. Enhanced transparency would also be welcomed and the approach to decision-making has to be re-visited before too many new Member States join the euro zone. To be frank, there is much in the approach of the UK's Monetary Policy Committee (MPC) that could, in my opinion, be beneficially transferred to Frankfurt.

There is a conundrum over the SGP. On the one hand, there is a necessity for some arrangement to achieve fiscal policy constraint on member states within a monetary union. Without this constraint the actions of one 'rogue' state could have major implications for the single monetary policy and hence for all members. On the other hand, with a fixed exchange rate and 'one-best-fits-all' monetary policy, fiscal policy becomes an even more important lever for country-by-country adjustment.

The answer is that a pact is needed, but a smarter one. By this, I mean one in which the automatic stabiliser role of fiscal policy is given more leeway, especially for countries with a structurally sound fiscal base. A country with a debt to GDP ratio of 40% should be given more leeway than one with a ratio in triple figures. The key principle of constraint is critical, but more practical guidelines must be developed before the whole approach loses all credibility.

Finally, fiscal and supply-side reform. The former is critical for those Member States struggling to contain government debt and deficits, especially as demographic problems loom. There are signs of steps in the right direction – French pension reform and German healthcare change. But if Member States wish to be allowed fiscal flexibility during times of stress, then they have to show that this is merited by further, even more significant, structural change.

Turning to the supply-side, again enhanced flexibility is highly desirable – particularly to co-exist effectively in a monetary union with limited other scope for adjustment and to help reduce unacceptable levels of unemployment. The ECB, however much reformed, cannot cure all ills. There is a critical role for the micro-economic policies of individual Member States.

The good news is that the global outlook is finally improving. Nevertheless, reform is urgently needed if the euro zone is to benefit fully from the upturn, and to play its part in avoiding such prolonged periods of global economic weakness in future. Reform must cover the monetary and fiscal policies of the euro zone as a whole and the fiscal and supply-side policies of individual Member States. The signs of green shoots should not be used as an excuse for policy prevarication.

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