

EURO AREA: MACROECONOMIC POLICIES UNDER CONSTRAINTS

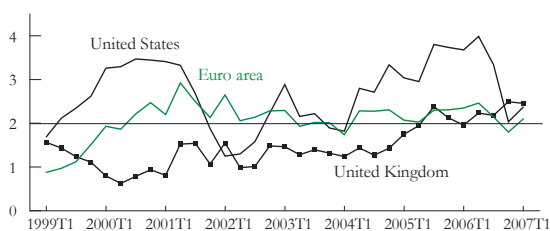
One almost no longer speaks about them. Neither in international forums, where sound economic policies essentially mean structural reforms, enhanced competition, trade integration and financial supervision; nor in the public debate, except to assign them objectives which are mainly out of their scope. Still, monetary and fiscal policies represent important levies of action. Between the ECB's price stability objective and the Stability and Growth Pact, do counter-cyclical policies have a role to play in the euro area?

■ Euro area: the narrow way

Macroeconomic policies in euro area are constrained by the rules of the Maastricht Treaty and of the Stability and Growth Pact (SGP). However, monetary and fiscal authorities still have some room to maneuver.

The European Central Bank (ECB) has for main objective price stability, which it defines as an inflation rate “below and close to 2% in the medium-run”. This principle objective has been remarkably respected since the creation of the euro (see Figure 1). Then, what has been the attitude of the ECB with respect to its secondary objective, which is to encourage growth, both in the long run (encouraging investment by maintaining monetary stability and low real interest rates) as well as over the cycle (reacting to a decline in the activity by cutting interest rates, and conversely when activity accelerate)?

Figure 1 – Inflation rate (year-on-year CPI variation in %)

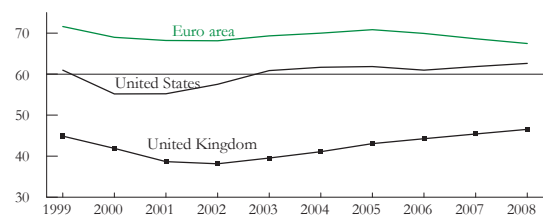


Source: OECD, Economic Perspectives No. 80, 2006.

On their side, the fiscal authorities of each member state aim to provide public goods in compliance with the sustainability rules stated by the SGP. They can also use fiscal policy to stabilize the economic activity over the cycle, in particular when a country is affected by specific shocks that the ECB cannot accommodate. The member states of the euro area inherited an important public debt, but this debt has remained overall stable as a percentage of GDP from 1999 to 2007 (see Figure 2). The question is then to measure how fiscal policy has behaved during the last cycle (strong growth in 1999-2000, downturn in 2001-2003, taken up again from 2004 to 2007).

Counter-cyclical policies are constrained by both the price-stability objective and by the SGP, but which of these two constraints has appeared the least binding for stabilization policies since 1999. The comparison

Figure 2 – Public debt*/GDP in %



* Maastricht definition for the United Kingdom and the euro area.

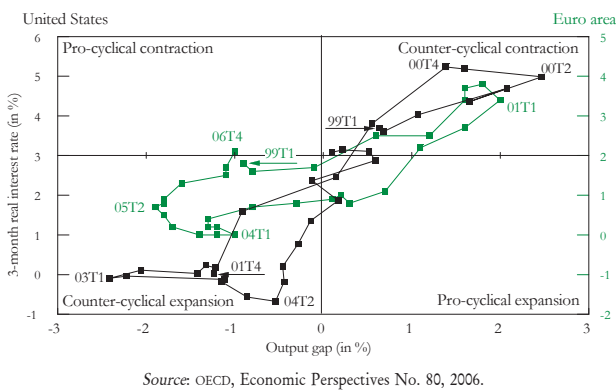
Source: OECD, Economic Perspectives No. 80, 2006.

with the United States is especially telling, since there is no SGP in the United States and the central bank has a different mandate.

Counter-cyclical monetary policy

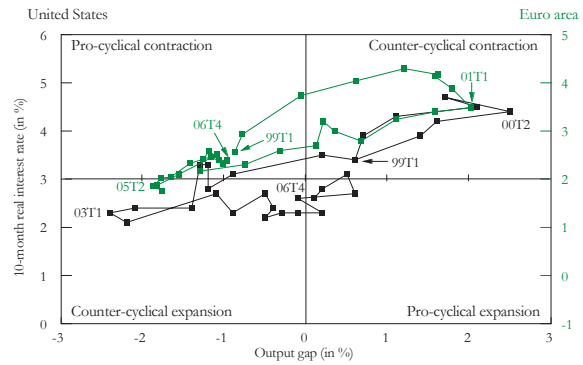
Since 1999, monetary policy has been counter-cyclical, both in the United States and in euro area. Figure 3 shows the real short-term interest rate (difference between the three-month nominal interest rate and core inflation¹) and the output gap, both in the euro area and in the United States, while setting the real rate at 2% and 3% respectively for which the monetary policy can be considered as neutral.² In both cases, monetary policy lies along the first diagonal: monetary policy was restrictive at the time of the cyclical peak of 2000 and early 2001; then, the interest rates decreased with the downturn. During this cycle, the United States nevertheless experienced average real rates that were as low as in the euro area, despite the higher potential growth. This is due to the very sharp drop in the rates starting in 2001. Over the cycle, the Fed appeared to be more reactive than the ECB: for 1 percentage point (p.p. hereafter) fall in the output gap, it lowered the real interest rate by 120 basis points, while the ECB reduced its rate by only 100 basis points.³ In addition, the US cycle recorded greater amplitude, which explains the negative real rates in the United States in 2003-2004.

Figure 3 – Three-month real interest rate and output gap



The transmission of short-term rates to long-term ones however was not mechanical during this period. In the euro area and in the United States, real long-term rates fell little

Figure 4 – Ten-years real interest rate and out gap



Source : OECD, Economic Perspectives No. 80, 2006.

when the economic situation deteriorated (-50 basis points for a one p.p. reduction in the output gap) in particular because they were already low at the peak of the cycle (see Figure 4). After 2003, despite the recovery, long-term rates

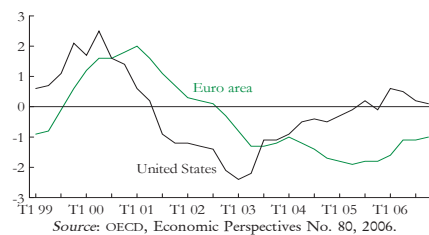
BOX: MEASURING THE POSITION IN THE CYCLE

To measure the position of the economy in the business cycle, one has to estimate, for each date, the level of the “potential output” which represents the level of the production of the economy in the absence of cyclical fluctuations. The output gap (difference between actual output and potential output) traces the economic cycle over time.

Two main methods can be implemented.* The first one, purely statistical, consists in smoothing over time the level of GDP. The second one is to estimate a production function, and then to compute a potential output based on available labor and capital and the productivity trend. Since, in practice, the equilibrium unemployment rate and the productivity trend are estimated by smoothing techniques, the second method is a refinement of the first but none of them can really capture transitory changes in productivity or in labor supply, in particular for the most recent years.

This limits the use of potential output for the conduct of macroeconomic policies, which should not be the same according to whether the downturn is caused by a fall in the output gap or by a temporary or even permanent reduction of potential growth.

The business cycle in the euro area and in the United States, 1999-2006 (Output gap in % of potential GDP)



* “Estimating Potential Output, Output Gaps and Structural Budget Balances”, OECD Economic Department Working Paper, 1995.

1. Inflation excluding price of energy and fresh products.

2. This rate corresponds in theory to the potential growth rate of each of the two economies, that OECD estimates at around 2% and 3% respectively.

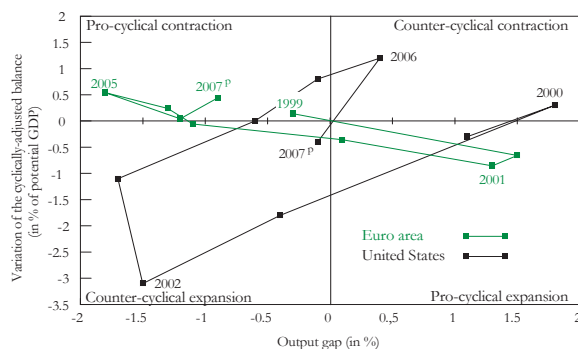
3. The interest-rate sensitivity to the business cycle can be measured in several ways. A first method consists in estimating a Taylor rule which relates the short-term nominal rate to inflation and the output gap. However, as inflation itself depends on the output gap, the estimated coefficient on the output gap cannot take into account the overall effect of the cycle on interest rates. Another method consists in regressing the real interest rate on the output gap. However, since monetary policy impacts economic activity with some delay, the central bank will try to anticipate the cycle, which will induce a downward bias on the estimated coefficient. The method adopted here consists of measuring the amplitude of the interest-rate variation during the cycle relative to the amplitude of the cycle itself.

in the United-States increased only moderately (+ 25 basis points for each output gap p.p.) because of world liquidity abundance (savers around the world were rushing to buy western bonds) and of the disappearance of perceived risk (partly owed to increased monetary credibility). Globalization seems to have weakened the link between the monetary policy and the long-term interest rate, the determinants of which are becoming increasingly worldwide. This means that more reliance on fiscal policy was needed for macroeconomic stabilization.

■ Erratic fiscal policies

While monetary policies were counter-cyclical in both areas, the fiscal stance differed during the last cycle. Excluding automatic stabilizers from the analysis,⁴ aggregated fiscal policy in the euro area appeared largely pro-cyclical between 1999 and 2006. This phenomenon is illustrated in Figure 5 which reports the output gap and the variation of the cyclically-adjusted primary budget balance as a percentage of GDP. The pro-cyclical deterioration of public finance in 2000 and 2001 deprived the euro area countries of necessary room of maneuver when the economic activity slowed down in 2002. Finally, the cyclically-adjusted budget balance deteriorated by 1.3% of GDP over the cycle, and it did so in a pro-cyclical way.

Figure 5 – Pro-cyclical fiscal policy in the euro area, contra-cyclical policy in the United States



Source: OECD, Economic Perspectives No. 80, 2006

During the same period, the US discretionary fiscal policy was clearly counter-cyclical: the fiscal impulse in 2001 and 2002 arrived at the time when the output gap widened. However, the two principal factors of this stimulus were decided either before the downturn (tax cuts), or independently of it (military expenditure): the counter-cyclicality of US fiscal policy was partly fortuitous. Over the cycle, US fiscal policy has not been neutral on average:

the cyclically-adjusted primary budget balance deteriorated by 3.9% of GDP (from a healthy situation at the beginning of period, with a surplus of 0.4% of GDP in 1998, to be compared to a 2.3% deficit in the euro area). The counter-cyclical fiscal policy in the United States thus exhausted a large part of room to maneuver.

The difference between the two discretionary fiscal policies – counter-cyclical in the United States and pro-cyclical in the euro area – needs however to be balanced with the greater importance of the automatic stabilizers in the euro area (the primary balance improved by 0.8% of GDP for each p.p. of output gap between 1999 and 2006), as compared to the United States (only 0.35%).

■ The Pact or the cycle?

The SGP is concerned with the sustainability of fiscal policies rather than with their adequacy to the business cycle. It focuses on member states' fiscal balance and debt. Despite its reform in 2005, it remains unsuited to the guidance of counter-cyclical policies which have to react to the aggregated fluctuations of supply and demand. If production is lower than its potential level, aggregate demand is insufficient which results in a current-account surplus (or a lower deficit). In this case, a suitable fiscal policy consists in increasing the budget deficit. It is the reverse at the time of a cyclical peak when the current account balance falls. Because of the single currency, current-account balances within the euro area are benign since they are financed automatically by monetary flows. They can however deliver useful indications for the conduct of fiscal policies, if one compares them with some current account targets, as this is done for growth with respect to potential growth. The German and Spanish economic situations illustrate this point.

In 2005, the current account balance was a 4% of GDP surplus in Germany and an almost 8% of GDP deficit in Spain; the growth and inflation rates are respectively 1.1% and 1.9% in Germany, and 3.5% and 3.4% in Spain. This situation appears typical of an excess of demand in Spain and a depressed demand in Germany. The appropriate reaction is then a fiscal expansion in Germany and a fiscal contraction in Spain, in contradiction with the SGP. The underlying assumption is that the target current account is close to balance in both countries. But the situation observed in 2005 can be interpreted differently if one considers that potential growth increased in Spain and decreased in Germany, in comparison to the remainder of the euro area. In this case, the current account target

4. Automatic stabilizers represent the mechanical evolution of the budget balance when the position of the economy in the cycle changes: given the level of tax rates, the budget balance improves at the top of the cycle thanks to fiscal windfalls and, symmetrically, worsens during a downturn.

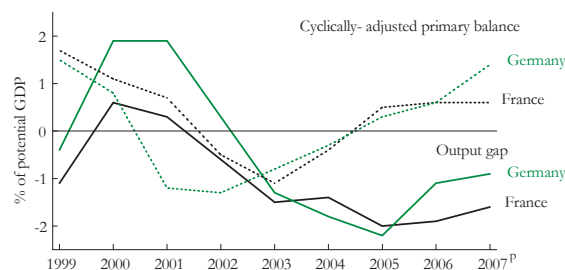
declines in Spain (companies increase their investment while households reduce their saving rate to consume their future incomes in advance) and inflation increases due to the Balassa-Samuelson effect (which can result only in inflation differentials within a monetary union); it is the opposite in Germany. In such circumstances, the appropriate fiscal policy has to be neutral.

The real world probably lies between these two polar interpretations. This brings back to the difficult question of the assessment of potential growth and to the identification of productivity shocks which are crucial for the conduct of fiscal policies and their possible coordination in euro area.⁵

Now let us consider the Franco-German couple. Since 1999, Germany and France have experienced similar business cycle and their cyclically-adjusted budget balance also developed the same way (see Figure 6). Does that mean that without explicit coordination, both economies de facto coordinated their reactions to very largely symmetrical shocks? Actually, behind similar evolutions of the fiscal balance, both countries experienced divergent developments in taxes and expenditures (see Figure 7). In France, government expenditures slightly increased as a share of GDP between 1999 and 2006; in Germany, they decreased by three p.p., reflecting a willingness to reduce the tax burden in order to enhance potential growth. Due to this difference, there is no guarantee that fiscal policy had a similar cyclical effects in Germany as in France, even though fiscal balances developed in a similar way. Several empirical studies⁶ suggest that lowering taxes or increasing transfers of, for example, 1% of GDP has a larger stimulating effect than a rise of public consumption or investment of the same amount. In this case, the German policy consisting in cutting taxes and expenditures simultaneously could have had a positive effect on German GDP, with positive

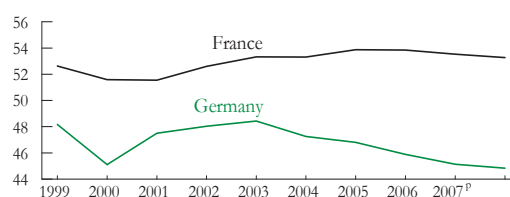
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Figure 6 – Fiscal policy along the business cycle: France and Germany



Source: OECD, Economic Perspectives No. 80, 2006.

Figure 7 – Government expenditures in France and Germany (% of GDP)



Source: OECD, Economic Perspectives No. 80, 2006.

spillovers on its European neighbors, whereas the French policy would have had only a limited impact.

Finally, the coordination of fiscal policies in Europe should not mainly be concerned... with fiscal balances. It should also look at its composition: tax receipts and government expenditures, and follow other indicators such as potential growth, inflation and the current account.

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