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Markus Marterbauer, Ewald Walterskirchen

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E-mail addresses: Markus.Marterbauer@wifo.ac.at, Ewald.Walterskirchen@wifo.ac.at
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Neglecting Demand and Cycle in the Euro Area

Markus Marterbauer, Ewald Walterskirchen

Abstract:

The stagnation of the economy in the Euro area since 2000 is closely connected to the dominance of purely long-run supply-side oriented policies in the Euro area. While exports and profits soared, domestic demand has been weak. The neglect of cyclical and demand factors appears to be the major deficiency of the EU policy guidelines, the Lisbon strategy and the Brussels/Paris (European Commission-OECD) consensus on growth policy.

Monetary policy in the Euro area is only slightly expansionary, fiscal policy is at the best on a neutral stance and social reforms are deterring consumers. Cyclical and demand considerations are not only denied in the short term, but also in the medium term. In fact, growth differentials in the period 1995 and 2005 can largely be explained by rising house prices as well as by the adoption of anti-cyclical policies in Anglosaxon and Scandinavian countries rather than by "structural reforms". In the long run, there prevails an interaction between supply and demand factors as well. Higher expenditure on R&D and education (input factors) are important to improve potential economic growth, this will however only materialise if effective demand is sufficiently high.

1. Disregarding the business cycle

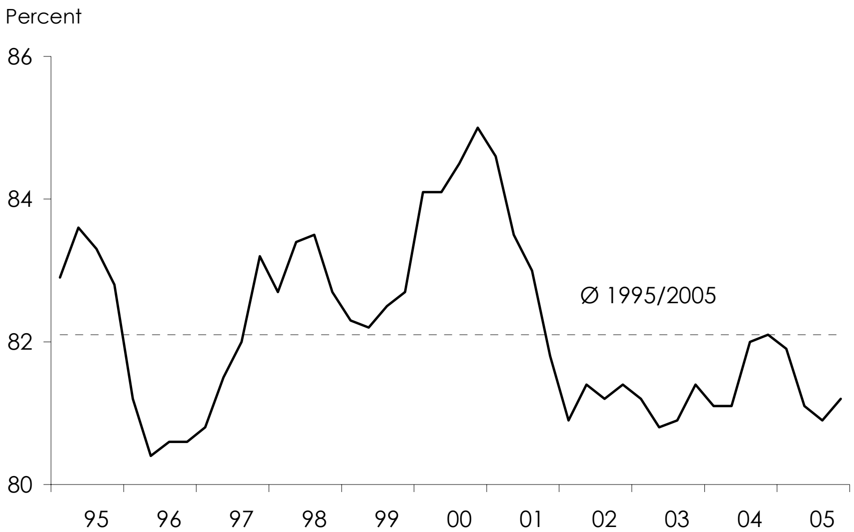
The economy of the Euro area has been in a poor situation since 2000, with the lowest growth rate of the industrialised world. In contrast to the United States, economic policy in the Euro area was not able to initiate a self-sustaining economic upswing. Given unchanged policy guidelines, no lasting improvement can be expected.

Mainstream economists explain the weak economic performance of the EU by "structural problems". The growth rates of potential output are low due to a lack of reforms on the supply side of the economy. Labour markets are not flexible enough, deregulation and privatisation are lagging behind and the cut in state expenditures especially concerning the welfare state is taking on too slowly. However, potential output commonly is measured as the trend output of the recent past. This completely overlooks cyclical and demand factors, in particular the effect of supply-side policies on demand.

It is always the study of cyclical problems that sheds light on the importance of effective demand. Cycle and trend cannot be separated mechanically by time-series analyses, they are interacting. Following Kalecki, the long run is just a series of cycles. "In fact, the long run trend is but a slowly changing component of a chain of short-period situations: it has no independent entity" (*Kalecki,* 1968).

In the Euro area capacity utilisation in 2005 had been below average for the fifth year in a row. This is an important impediment to investment. Despite a sharp rise of profits, investment remains stagnant. Entrepreneurs prefer to repay debt, in some European countries the business sector has become a creditor - for the first time in history.

Figure 1: Capacity utilisation in the Euro area

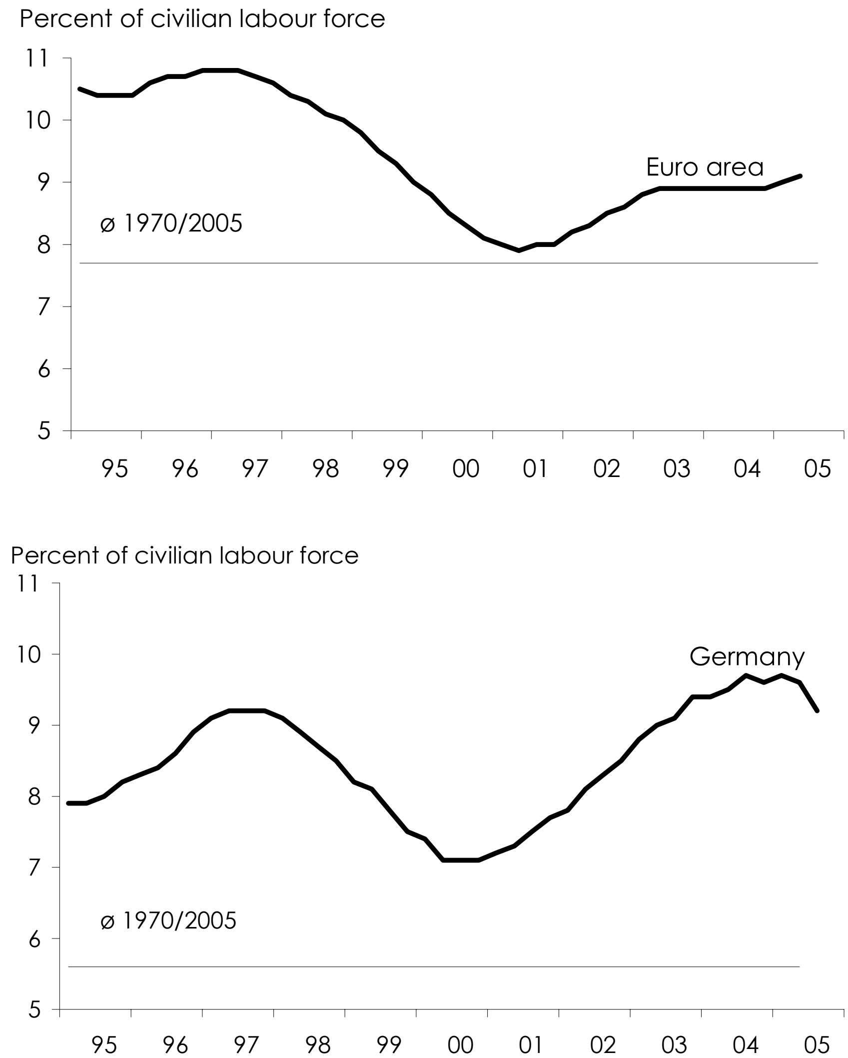


Source: European Commission.

The transmission from export-led growth to domestic demand is blocked. This is mainly due to the wide-spread uncertainty among consumers as a consequence of structural and labour market reforms at the wrong time. In Germany (*Horn,* 2005), savings rates of private households have been rising even in a stagnation period (precautionary savings).

The underutilisation of labour is even more evident than that of machinery. Unemployment rates are at a historical peak, clearly above the long-term average and far away from full employment. Since more and more unemployed are discouraged to look for work, the true labour market situation is even worse than one might expect from statistical evidence. In the EU surveys many inactive people state that they would like to work if there were job opportunities available. It is quite strange that some economists in this situation call for an increase of labour supply and working hours.

Figure 2: Unemployment rate in the Euro area and Germany



Source: OECD.

The underutilisation of capital and labour in the Euro area is determined by short, medium and long term influences. In the short term a lack of anti-cyclical economic policy is predominant. In the medium term the effects of house prices and refinancing on consumption and investment as well as the dilemma of improving competitiveness while dampening disposable income are determining economic growth. In the long term a successful growth policy of stimulating innovation, technology and education has to be accompanied by an increase in effective demand.

2. Anti-cyclical policy missing in the Euro area

2.1 No active fiscal policy in the Euro area

The Pact for Stability and Growth which aims to coordinate national fiscal policy in EMU was harmful to macroeconomic growth and employment in recent years as it did not adequately take into account cyclical factors. Even after the reform of 2005 the SGP is an impediment to an active anti-cyclical policy. Countries with budget deficits higher than 3 percent of GDP – like Germany and Italy – are urged by the Commission to reduce their deficits even in a period of stagnation. The best way to overcome a recession is to increase spending on public investment. But the main instrument applied by EU countries to reach the Maastricht criteria has been to cut public investment. In Germany, the share of public investment in GDP declined between 1999 and 2005 from 1.8 percent to 1.3 percent of GDP.

There are considerable differences in fiscal developments between the USA and the Euro area. In the United States, the fiscal deficit is primarily the result of an active anti-cyclical policy, which can be measured in terms of increasing structural deficits in the recession. The fiscal balance shifted from +1 percent of GDP in 1999 to –4 percent in 2005, this was almost exclusively the outcome of active measures. There can be no doubt that this policy was successful. Fiscal policy could have been even more effective if tax cuts had been directed towards the low income groups rather than the high income groups and expenditures had been improving infrastructure and education rather than the military. Anyway, the US economy is running close to full capacity, the unemployment rate has been declining considerably, and fiscal deficits become smaller than expected due to high growth rates of GDP. The relatively high fiscal deficit (about 4 percent of GDP) poses a risk to the US economy, but there is the possibility that the US budget will be out of the red again at the end of the policy-induced boom.

A similar story can be told about the United Kingdom and Sweden. In these countries, structural deficits have been increasing considerably. Anti-cyclical policy measures have contributed to the solid growth performance of the United Kingdom and Sweden since 2001.

In the UK the structural budget deficit increased by 3.7 percent of GDP between 1999 and 2005. Investment in road and railroad infrastructure was raised by 10 percent per year. Public investment as a percentage of GDP rose from 1.3 in the year 2000 to 2.0 in 2005. Public expenditures (especially for the National Health Service) increased and tax subsidies for low income households (Working Families Tax Credit) have been extended.

In Sweden the structural budget deficit increased by 2.2 percent of GDP between 2000 and 2005. Tax cuts came into effect when the international business cycle turned down. Public expenditures for the health system, infrastructure, education and families have been extended. This helped to stabilise private consumption especially in the years 2002 and 2003.

The budget deficits in the Euro area, on the other hand, are not the outcome of active measures. They have been suffered by low economic growth (*Walterskirchen,* 2005A). The fiscal balance in the Euro area shifted from a deficit of 1.5 percent of GDP to a deficit of 2.8 in 2005. This shift was caused primarily by cyclical factors, the structural deficit was kept nearly constant – in line with the Maastricht concept.

There is, however, a relation between structural and fiscal deficits which is often neglected: Tight fiscal policy in a period of stagnation leads to an accumulation of cyclical deficits, whereas expansionary policy reduces the cyclical component. Since there is no business upswing in sight, fiscal deficits will remain high in the Euro area – in contrast to the USA.

The sharp fiscal consolidation in Germany, especially the increases in indirect taxes, envisaged by the new government for 2007 will probably dampen growth expectations and hence will not be very successful. The reduction of the "structural" deficit may be counteracted by a higher cyclical deficit.

Table 1: Structural and cyclical deficits in the USA and the EU

	Public deficit	Structural 1999/2005 Change in percentage points	Cyclical	GDP growth Ø 1999/2005 Annual change in %
USA	– 4.9	– 4.7	– 0.2	+ 2.9
United Kingdom	– 4.0	– 3.7	– 0.3	+ 2.7
Sweden	– 1.7	– 2.2	+ 0.4	+ 2.5
Euro area	– 1.3	– 0.4	– 0.9	+ 1.8

Source: European Commission, OECD.

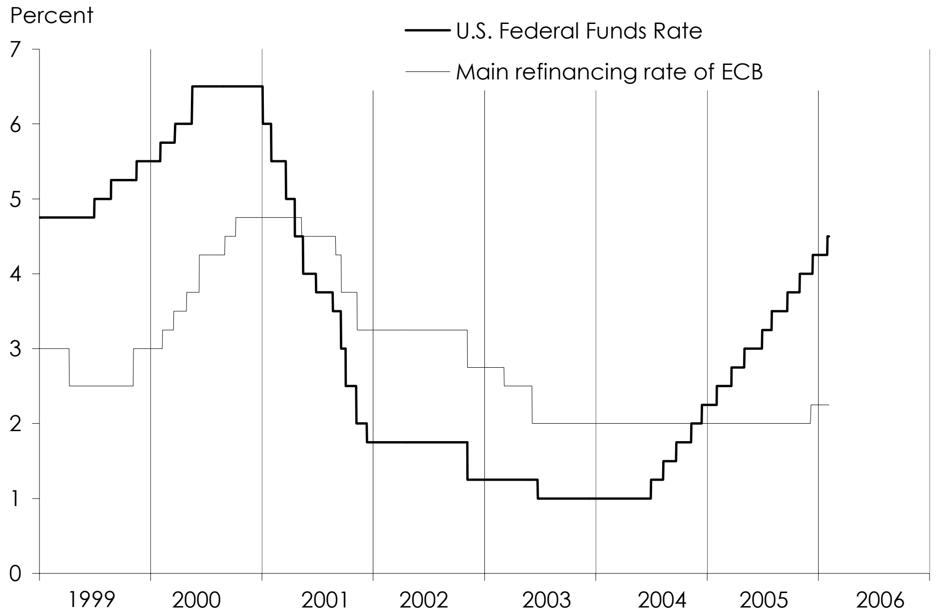
2.2 Monetary policy too hesitant

The ECB strategy is one-sided, too much oriented towards price stability. This explains the late and timid reaction to the recession in 2001. During the year 2001, the Fed lowered interest rates by as much as 4¾ percentage points, the ECB only by 1½ percentage points.

The effect of interest rates on residential building and consumption is much higher in the USA than in the Euro area. Refinancing of debt is much easier in the Anglosaxon countries, in the Euro area it is blocked by high transaction costs. This implies that an interest rate reduction in the Euro area needs to be larger than in the USA to result in the same expansionary effect.

Thus, the effect of the modest reduction of interest rates in the Euro area was very limited and not sufficient to stimulate housing and consumer credits. This is particularly true for low-inflation countries as Germany. Since the introduction of a single interest rate in the Euro area, these countries have faced relatively high real interest rates dampening expenditures on construction and durable consumption goods.

Figure 3: Monetary Policy in the USA and the Euro area



Source: ECB, Federal Reserve Board.

Macroeconomic policy in the EU is characterized by a restrictive bias. It prefers price stability and budget consolidation to economic growth and full employment. In the Broad Economic Policy Guidelines of the EU this is called "sound" macroeconomic policy. Josef Steindl called this strategy a "deliberate policy of stagnation" (*Steindl,* 1979). It is rather the political attitude that has changed in the Euro area than objective circumstances. The Maastricht treaty and the shift in economic power from labour to capital in the aftermath of globalisation undermined full employment policies.

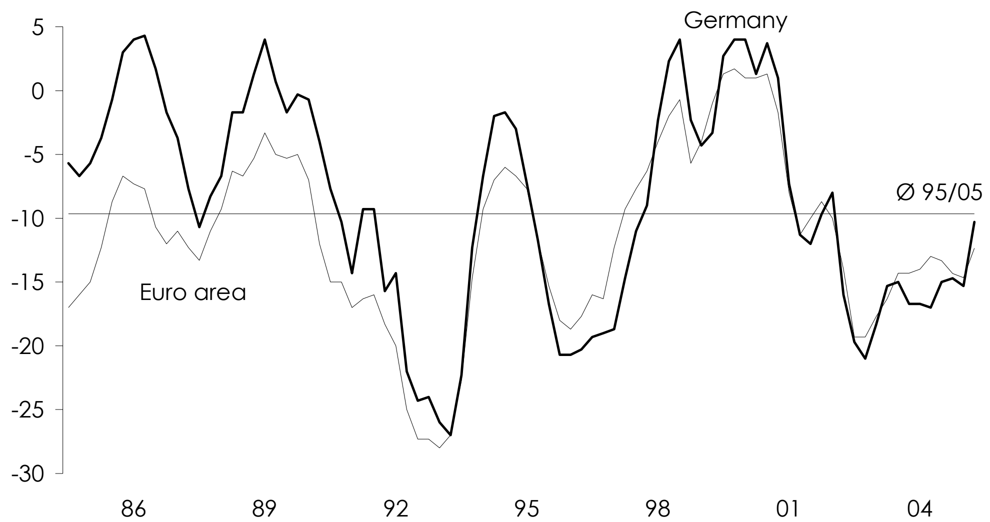
2.3 Structural policies raise uncertainty of consumers

One of the most important factors to overcome stagnation is to reduce uncertainty of consumers and investors. The stabilisation of expectations has to be a major target of policy. EU surveys show that consumer confidence has been below the medium-term average for four years. This is not only the consequence of job insecurity, but also of extensive labour market and social reforms at the wrong time. Policy makers often create an atmosphere of crisis to enforce the "necessary structural reforms". They postulate a lack of competitiveness in the globalised economy, financial problems of old age pension and the health systems and the need to cut unemployment benefits. It is, however, not adequately taken into consideration that this atmosphere of crisis and the resulting structural reforms are leading towards an increase in insecurity, a rise in savings and a reduction of consumption expenditures even in a stagnation period (*Tichy,* 2005).

In the Anglo-Saxon and Scandinavian countries, the reduction of the savings rate of private household – fuelled by refinancing debt and higher house prices – was a major impetus to economic growth. In Germany, on the other hand, the savings rate increased due to a lack of confidence. A reduction of the savings rate of private households – e.g. driven by refinancing, house and share prices or income redistribution – raises private consumption and leads to a rise in growth rates as well as to a reduction of public deficits.

Mainstream economists and policy makers in the Euro area, however, do not care about the problems of uncertainty and precautionary savings as they neglect the importance of cyclical and demand factors in general.

Figure 4: Consumer Confidence in the Euro area and Germany
Differences between the percentages of correspondents giving positive and negative replies (s.a.)



Source: European Commission.

3. Neglecting demand in the medium-term

Why do economic growth rates differ between EU countries in the medium-term? The answer that we get from most economists today is: GDP growth is higher in countries with "successful structural reforms" and it is lower in countries with a lack of neoliberal reforms to improve competitiveness by deregulation, tax cuts (for enterprises) and, above all, reforms of the labour market and the welfare system. This tautological statement has a strong ideological bias and a weak empirical foundation. Just as in the short term, the importance of demand factors is denied by mainstream economists also in the medium term.

We would like to draw the attention to two important medium-term facts: the effect of house prices and refinancing of debt on consumption and GDP growth in the Anglosaxon and

Scandinavian countries, and the improvement of the international competitiveness of the business sector in the Euro area at the expense of disposable income. The economic success of the Anglosaxon and Scandinavian countries since 1995 is largely due to soaring house prices and refinancing, not to neoliberal reforms. Evidently, the success of the Scandinavian countries is consistent with a strong welfare state. Moreover, the economic performance since the recession 2001 has been bolstered by anti-cyclical policies in the United States, the United Kingdom and Sweden.

3.1 The effect of house prices and refinancing on consumption and residential investment

The development of demand components in the period 1995-2003 differs considerably between countries. Faster growing economies are primarily characterised by higher growth rates of residential investment and consumption – not so much higher exports and business investment. We may argue that exports and business investment are mainly related to international competitiveness, residential building and consumption are closely related to domestic demand.

Private consumption and housing has been boosted by soaring house prices and refinancing in the Anglosaxon and Scandinavian countries. House prices rose by 9 percent p.a. in these countries, in the core of the Euro area only by 1 percent p.a. Above all, market-based countries react much faster to changes in house prices than bank-based countries (i.e. the core of the Euro area). According to IMF calculations, the long-run reaction of private consumption to a 1 percent increase in house prices is +0.040 in market-based countries and +0.015 in bank-based countries.

Cross-country regressions show that, in the period 1995-2003, the effect of house prices on growth differentials was even more important than that of investment in machinery and equipment (*Marterbauer – Walterskirchen,* 2005). In the very long run, however, there is no significant effect of house prices on GDP growth, as periods of booming prices are normally followed by sharp price falls. A decline in house prices dampens consumption expenditures and housing investment.

Above all, in the long period of falling interest rates refinancing of debt gave a strong impetus to growth of private consumption (and partly also residential building) in Anglosaxon and Scandinavian countries. However, in most countries of the Euro area refinancing of debt has been blocked by high transaction costs and non renewable loans of building societies.

The theoretical axiom that medium-term growth rates are exclusively supply-determined and effective demand causes only short-run fluctuations (that should be denied) is not valid empirically. The duration of the cycle in construction and residential building is about 15 years.

Table 2: Demand components of GDP growth

	GDP	Private consumption	Residential investment	Exports	Investment in equipment
			Ø 1995/2003 Annual percentage change, volume		
Finland	+ 3.6	+ 3.2	+ 5.9	+ 7.3	+ 1.9
United Kingdom	+ 2.8	+ 3.6	+ 2.8	+ 4.5	+ 4.3
Sweden	+ 2.6	+ 2.5	+ 3.7	+ 6.4	+ 3.6
Netherlands	+ 2.5	+ 2.7	+ 0.9	+ 4.9	+ 2.9
France	+ 2.1	+ 2.2	+ 2.3	+ 5.1	+ 4.7
Denmark	+ 2.1	+ 1.1	+ 4.0	+ 5.8	+ 6.8
Austria	+ 2.0	+ 2.1	– 3.0	+ 7.6	+ 3.6
Italy	+ 1.5	+ 1.9	+ 1.3	+ 1.7	+ 3.3
Switzerland	+ 1.4	+ 1.5	– 3.4	+ 4.6	+ 2.9
Germany	+ 1.2	+ 1.3	– 2.0	+ 6.7	+ 1.9

Source: Eurostat, OECD, own calculations. – Ranking according to GDP growth.

Table 3: House prices and domestic demand

	House prices	Private consumption	Residential investment	GDP
		Ø 1995/2003 Annual percentage change, volume		
Ireland	+ 13.2	+ 6.1	+ 10.9	+ 8.1
UnitedKingdom	+ 11.1	+ 3.6	+ 2.8	+ 2.8
Netherlands	+ 10.2	+ 2.7	+ 0.9	+ 2.5
Spain	+ 9.3	+ 3.4	+ 6.3	+ 3.4
Denmark	+ 7.1	+ 1.1	+ 4.0	+ 2.1
Sweden	+ 6.9	+ 2.5	+ 3.7	+ 2.6
Finland	+ 6.6	+ 3.2	+ 5.9	+ 3.6
USA	+ 6.2	+ 3.9	+ 4.7	+ 3.3
France	+ 4.7	+ 2.2	+ 2.3	+ 2.1
Italy	+ 4.0	+ 1.9	+ 1.3	+ 1.5
Switzerland	+ 0.1	+ 1.5	+ 3.4	+ 1.4
Germany	± 0.0	+ 1.3	– 2.0	+ 1.2
Austria	– 1.1	+ 2.1	– 3.0	+ 2.0
Japan	– 2.6	+ 1.0	– 3.8	+ 1.2

Source: Bank for International Settlements, Eurostat, OECD, WIFO-calculations. – Ranking according to House prices.

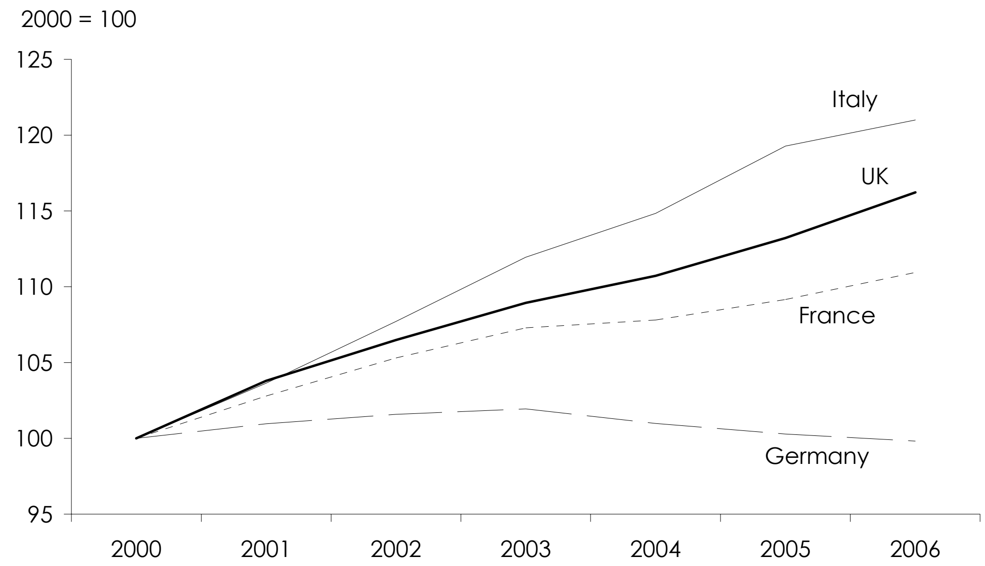
3.2 Improved competitiveness at the cost of disposable income

Another striking fact characterises the economic development of Germany and other continental European countries: Price competitiveness has been improving substantially due to wage restraint and sacking workers. The decline in relative unit labour costs has been boosting exports. Domestic demand, however, has been falling behind for exactly the same reasons: moderate wage increases, labour-saving and, in addition, a shift of tax pressure from enterprises to consumers.

Neoclassical economists can hardly explain why the shift in distribution from wages to profits did not induce higher investment and why the marked wage restraint had no positive effects on the labour market. In Germany, real wage increases remained behind productivity increases. As a result, between 1999 and 2005 unit labour costs decreased by 10.9 percent vis-à-vis the trading partners. At the same time, however, the unemployment rate rose from 7.9 percent to 9.5 percent. The improvement in international competitiveness was counteracted by the stagnation of domestic demand.

This had negative effects on the labour market since the effects of domestic demand on employment are substantially higher than those of exports. Direct effects of an increase in exports on employment are small due to high productivity increases in export industries. Indirect effects depend on a rise in investment and real wages as an effect of higher exports. An increase in domestic demand, however, leads directly towards higher employment, especially in the service sector.

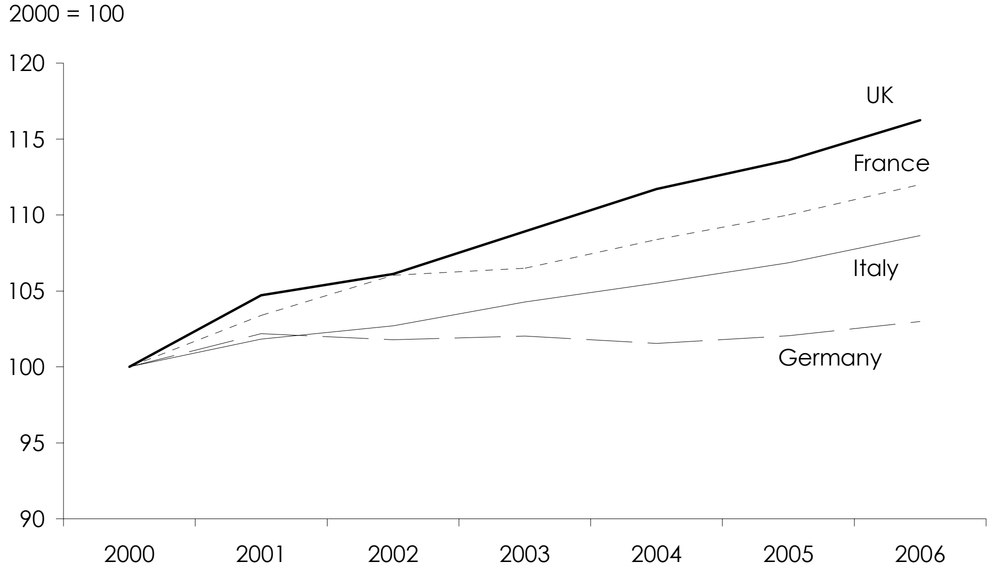
Figure 5: Unit labour costs in major EU countries



Source: OECD. 2005, 2006: Forecast.

Economic development in the UK has been quite different: Relative unit labour costs increased between 1999 and 2005, but so did real disposable income. In total, the outcome in terms of GDP was quite favourable – assisted by rising house prices. The development in France was somewhere in between the experiences of Germany and the UK: Relative unit labour costs and real disposable income increased moderately. Italy was in a rather bad situation: Relative unit labour costs rose dramatically, but net real disposable income increased only slightly due to fiscal tightening (to reach the Maastricht criteria). In effect, neither exports nor domestic demand were able to pick up substantially.

Figure 6: Net real disposable income of private households in major European countries



Source: OEC. 2005, 2006: Forecast.

4. Trend and cycle – the long run

The EU Lisbon strategy is an important step in the right direction. Technology and education policy is the proper way to increase welfare in the long run, and the combination of economic, social and environmental factors as main pillars of the Lisbon strategy gives us hope for the future. But the Lisbon strategy is confined to the improvement of competitiveness; it does not even mention the contribution of domestic demand to growth.

Investment, the driving force behind long-run output, is primarily influenced by three factors: innovations, internal accumulation and capacity utilisation. In the long run, there is an interaction between supply and demand factors – not just a supply-driven trend. Higher expenditure on R&D and education (input factors) will end up in higher economic growth rates only if capacity utilisation (demand) is sufficient to induce investment (*Steindl,* 1981). Without investment in machinery and labour, the increase of input factors will hardly affect output. Without adequate effective demand there is no growth in investment. Germany gives a good example: The R&D ratio is one of the highest in Europe, but investment to use the new prototypes is dampened by low utilisation of existing capacities.

Thus, growth policy implies the stimulation of innovation, technology and education plus anti-cyclical policy measures to raise capacity utilisation. Innovation and education policy should focus on the technologies of the information society (electronics, genetics, etc.) to become more effective (*Walterskirchen,* 2005B). Moreover a stabilisation of the wage share, better tax coordination in the EU and lower net savings of private households could stimulate growth.

Table 4: Differences in growth strategies

Steindl-Kaleckian growth policy	***Current mainstream on growth policy***
Full employment As main political concern	Price stability and budget consolidation As main political concerns
Demand as growth driver	Supply as growth driver
Higher effective demand to raise employment	Higher labour market flexibility to raise economic growth
Technology and educational policy	Deregulation and privatisation
Lower household savings	Higher savings (for investment)
Stable or rising wage share	Falling wage share (real unit labour costs)
Anti-cyclical policy (cycle and trend have the same determinants)	No active anti-cyclical policy (irrelevant for growth path)
Rise of public sector promotes growth (through effective demand)	Decline and restructuring of the public sector (efficiency)
Tax coordination	International tax competition
International cooperation	International competition (location)

Source: *Guger – Marterbauer – Walterskirchen* (2004).

5. Summary

The economy of the Euro area has not been able to take part in the strong upswing of the world economy in recent years. Exports and profits soared, but domestic demand fell behind. The stagnation of the economy since 2000 is closely connected to the dominance of purely long-run supply-side oriented policies in the Euro area. In contrast to the United States, the UK and Sweden, anti-cyclical demand-oriented policies are largely denied in the Euro area. This neglect of cyclical and demand factors appears to be the major deficiency of the EU policy guidelines, the Lisbon strategy and the Brussels/Paris (European Commission-OECD) consensus on growth policy.

It is not surprising that the Euro area has been unable to overcome the stagnation period despite excellent conditions of the world economy: Monetary policy in the Euro area is only slightly expansionary, fiscal policy is at the best on a neutral stance, structural policies are deterring consumers and competition policies are favouring large enterprises at the cost of consumers. Without a change in policy guidelines, a business upswing in the Euro area may only come about as a result of positive exogenous shocks.

Cyclical and demand considerations are not only denied in the short term, but also in the medium term. Mainstream economists explain growth differentials between EU countries mainly by neoliberal reforms, but do not provide the necessary empirical proof. In fact, growth differentials in the period 1995 and 2005 may largely be explained by rising house prices and refinancing in Anglosaxon and Scandinavian countries as well as by the adoption of anti-cyclical policies in these countries. Soaring house prices and refinancing of debt strongly stimulated private consumption and residential building.

In the long run, there is also an interaction between supply and demand factors. Higher expenditure on R&D and education will lead to higher economic growth only if capacity utilisation is sufficient to induce additional investment.

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