European Trade Union Confederation (ETUC)
Confédération européenne des syndicats (CES)

TIME TO ACT!

EURO AREA ECONOMIC POLICY MAKING AND THE SLOWDOWN

A report from the ETUC

I. The IMF forecasts on Euro area growth : Grim but relevant

At the beginning of April, the IMF surprised economic policy makers worldwide by publishing gloomy growth forecasts. In doing so, the IMF broke with the unwritten tradition for economic forecasters to underestimate the extent of economic slowdowns in order to avoid a self fulfilling prophecy. According to these IMF forecasts, the US economy, which has been acting as a demander of last resort for the rest of the world during the past decade, would slow down to a meagre 0.5% growth in 2008 as well as in 2009. Growth in the Euro area is also expected to decelerate sharply, from 2.6% in 2007 to 1.2% in 2009, with unemployment no longer falling but remaining stuck at a level of 7.4%.

Table: IMF growth forecasts compared with most recent national updates

Growth 2008	IMF forecast	Most recent national forecast
Germany	1.4	1.6 (German Institutes)
Spain	1.8	2 (Banking association)
Italy	0.3	0.6 (Italian central bank)
France	1.4	2
Euro area	1.4	-

Is the IMF acting like a doomsday prophet? There are two reasons not to think so and regard the IMF's forecasts as being highly relevant.

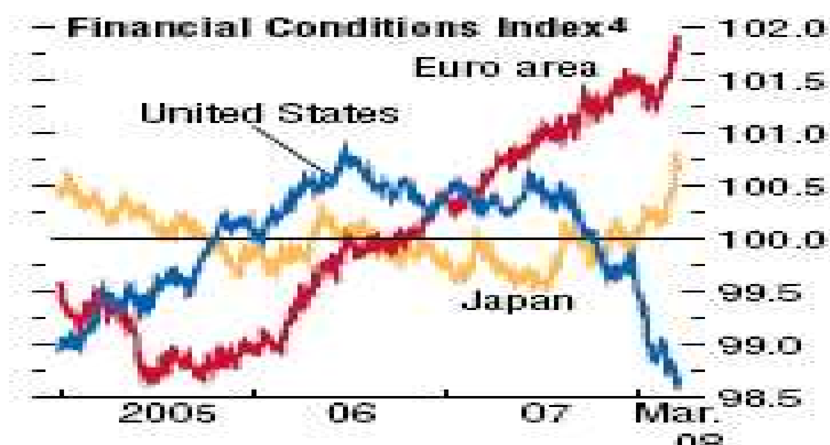
First of all, most recent national forecasts have already moved closely to the IMF forecasts (see second column in table). Taking into account the fact stated above that growth tends to be overestimated when the slowdown is in the process of unfolding, the IMF's gloomy forecasts do not seem to be that exotic anymore.

Secondly, the euro area economy is being hit, not by one but by a combination of several negative and major shocks at the same time:

- Monetary policy in euro land has been consistently tightened over the past year. Given the usual time lags with which monetary policy operates, this implies that further negative impact on economic activity is still in the pipeline.
- Subprime turmoil has made the cost of credit more expensive. Three month Libor interest rates, which are a benchmark for many credit instruments, have risen and have stayed at a level of around 70 base points above the ECB's repo rate, implying that interest rates have actually been hiked by some 50 points since the financial crisis broke out in summer 2007.
- Subprime turmoil is also causing banks to tighten credit conditions. Two effects are at work here. One is that there is now a widespread and strong aversion to risk. Moreover, billions of losses in securitised subprime debt instruments are destroying bank's capital values, thereby restraining their ability to provide new credit and loans.
- With the US no longer functioning as the demander of last resort for the world economy, global growth and euro area export markets are set to slow down.
- On top of this, the continuing appreciation of the euro exchange rate is delivering serious blows to the competitiveness of the euro area.
- Finally, energy and food product inflation, which in turn is partly triggered by speculative capital moving out from subprime related CDO's into commodities, is eroding the purchasing power of euro area wages and transferring this purchasing power to OPEC countries and emerging economies that are exporting these commodities.

It needs to be stressed that at least part of the unfolding slowdown is 'home made' under the responsibility of the ECB. The ECB has not only hiked interest rates, it has also done so against the

background of an appreciating exchange rate. This approach is usually very effective in dragging down both domestic demand as well as net exports at the same time. The extent to which monetary policy is turning more restrictive by hiking interest rates at a time when the exchange rate is also getting more expensive can be traced by an index of monetary conditions. In the graph below, such an index is shown for the euro area, the US and Japan. As can be seen, the monetary contraction implemented by the ECB over the recent period is substantial and contrasts with the US loosening its monetary conditions.



Source: IMF World Economic Outlook

II. The danger of the euro area getting trapped again in a long slump

Growth forecasts are never to be taken literally but should instead be used to identify trend breaks and major implications for macro economic policy making.

Forecasts, such as those from the IMF, focus policy makers' attention in particular on the fact that, if left unattended, a slowdown in activity tends to multiply and spread itself throughout the economy. This process of 'contamination' works in different ways:

- Job losses triggered by an initial slowdown drag down disposable income and aggregate demand which in turn depresses activity further ('Demand multiplier').
- Faced with disappointing demand, firms cancel or reduce investment, thereby destroying jobs and, once again depressing income and demand ('Investment accelerator).
- Faced with a higher risk environment as well as rising defaults on loans and losses in capital, banks tighten credit conditions, thereby delivering an additional blow to investment dynamics ('Financial accelerator').
- Deficits rise as a consequence of the slowdown and if governments react to this by tightening fiscal policy, the slowdown gets amplified again.

Ultimately, if the slowdown is allowed to unfold, negative expectations and low confidence get entrenched and the economy finds itself trapped in a low growth/low confidence trap from which it is difficult to escape.

This is why active macro economic policies matter. By stabilising demand, macro economic policies prevent temporary shocks from transforming into a structural and long lasting slump in growth.

At the present juncture, the risk of the euro area economy undergoing these downwards spirals and tumbling into a slump is aggravated further by two additional factors:

- The economy is now getting squeezed from two sides. From the side of the real economy, hikes in interest rates and in the euro exchange rate are depressing activity. From the financial

side of the economy, ongoing tightening of credit conditions will have a similar effect. The risk is that a particularly virulent downwards spiral will be enacted if these two processes get entangled and start feeding off each other. If the economic slowdown starts increasing defaults and intensifying the already ongoing destruction of equity and bank assets' value, the 'financial' accelerator gets another twist: Bank capital collapses further, leading to a further tightening of credit standards, a further loss in activity, additional defaults and destruction of investment value..

- Moreover, there is a structural break in the model of economic growth. Until now, US growth dynamics have been driven by debt and asset price bubbles. By taking out more debt, American households have systematically driven up asset prices (house prices until 2007, equity prices until 2001). The ensuing construction boom and wealth effects have then boosted demand and economic growth. In doing so, the US consumer was not only able to 'stabilise' the US economy itself, he/she also acted as the 'demander of last resort' for the rest of the world. In turn, this enabled the rest of the world, including the euro area and Germany in particular to try and pursue a strategy of 'export led growth' strategies.

  "Subprime" has lead to the total breakdown of this growth model. And instead of being the 'demander of last resort', the US is now itself becoming a 'free rider' and seeking to enjoy export led growth itself by devaluing its currency. In other words, the trend for the dollar to depreciate is here to stay. For the euro area, this implies that growth will continue to be dragged down by the euro getting even stronger. This exacerbates the risk on a structural slump.

III. Monetary policy: The first line of defense is missing in action.

A. 'Missing in action'

It is widely accepted that monetary policy should be the first to react to a downturn and the risk of this downturn deepening itself.

Indeed, cuts in interest rates do not carry costs with them, whereas a fiscal expansion raises deficits and public debt. And while monetary policy is characterised by long time lags (it takes 4 to 6 and 8 quarters before a rate cut impacts on economic activity), the decision to cut interest rates is not subject to a drawn out process of making up a public budget but can be taken immediately. So, provided monetary policy is forward looking and acting well in advance, it is a very useful instrument to keep the economy from tumbling into a slump.

Unfortunately, it is for all to see that this approach is not working right now. Faced with an unfolding slowdown and major shocks to the twin paradigms of financial market securitisation and export led growth, the ECB has not budged one inch on interest rate policy and some are even unsettling financial markets and the wider economy by spreading the rumour that it is discussing a further rise in interest rates. In fact, a closer look at monetary policy reveals that broad monetary conditions have actually been substantially tightened since the beginning of the turmoil. Whereas policy interest rates have been put on hold, three-month inter bank interest rates (and it is this which determines actual lending rates on a number of types of loans) have increased by 60 to 70 base points. Eight months after sub prime hit, the spread between three-monthly rates and the ECB's repurchase rate has not come back down.

Moreover, the euro exchange rate has continued to appreciate sharply since summer 2007, thereby adding strain by weakening the contribution that net exports make to overall growth (see point I and graph on monetary conditions index).

So, it appears that, even if monetary policy has been put formally on hold, the ECB has let others (banks, exchange rate markets) to do the job of injecting a dose of monetary restriction in its place.

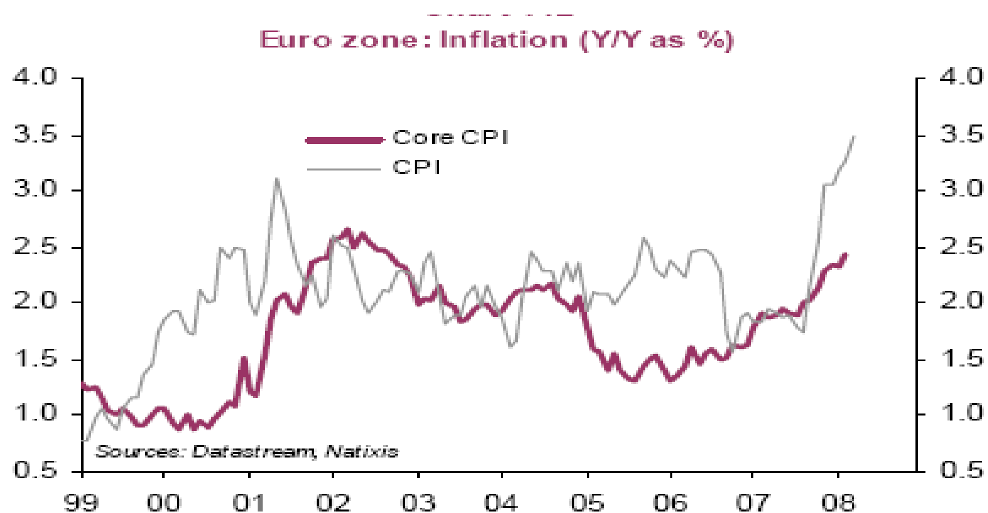
B. The euro area's disinflation potential is huge

Formally, the ECB defends this pro-cyclical policy by pointing to the high inflation rates being recorded at present. Furthermore, the ECB fears that remaining automatic wage indexation schemes would trigger inflationary wage-price spirals, similar to what happened in the seventies.

Are the ECB's fears warranted? Does there now exist a trade-off between growth and price stability which policy can not avoid?

The key flaw in the ECB's analysis is that it is a partial and backward looking analysis. The ECB is only looking at one side of the equation, at the dangers for inflation and not at the forces working to produce disinflation. If the ECB were to do a full analysis and take a forward looking attitude, it would have to take into account that the euro area's potential for disinflation is actually quite huge:

- Inflation is not a monetary phenomenon right now. High present inflation rates are not related to demand side factors or domestic factors such as labour market bottlenecks. Instead, inflation is originating from the external environment and is driven by oil, food and commodity prices on international markets. Core inflation, which can be thought of as a rough indicator of domestic inflationary pressures, is still much lower than core inflation (see graph).

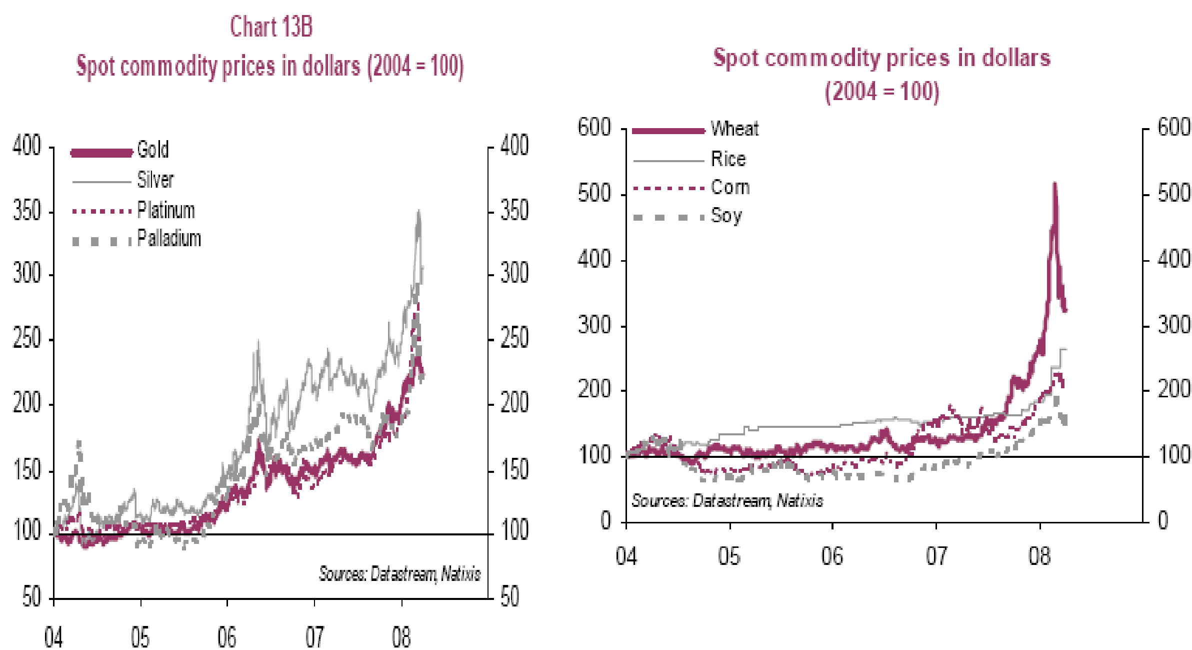


However, if euro area inflation rates are driven to such a high extent by oil and commodity prices, a mere stabilisation, let alone a sharp reversal of these prices, will have the automatic effect of cutting overall inflation rates sharply.

A reversal of oil and commodity prices is indeed rather likely. The reason is that oil and commodity markets have been the latest victim of financial speculation. After the subprime crisis

erupted, financial markets have massively shifted their speculative activities and capital out of collaterised securities and into commodity markets, thereby pushing prices on these markets through the roof. Financial markets' herd behaviour is, once again, producing the illusion of a self fulfilling prophecy and is pushing prices on specific markets far above normal. However, just as previous asset bubbles such as the ICT bubble and the housing bubble were burst, this commodity price bubble will also deflate. In fact, there are already signs of 'stress' to be seen: and prices of some commodities have recently been falling again (wheat, silver, see graphs). When the financial herd discovers another type of asset and stops victimising oil and commodity markets, headline inflation in the euro area will fall back to levels substantially below the ECB's price stability target.

To illustrate the latter, consider the case of basic food. This item, representing around 15% in the HICP basket and moving at a rate of 5% price increases over 2007, is contributing some 0.75% to overall inflation. If the price of this component of the HICP were to stabilise, this would bring inflation immediately back down within the range of the 2% price stability target.



- The euro will continue to deliver further disinflation. The appreciation of the euro does not come out of the blue but can be explained by the interaction and a serious mismatch between the demand and the supply of the euro currency (see below point V).

  The mismatch of the supply and demand of euro currency and the factors behind it is structural and will not disappear overnight or in the near future. As a consequence, the euro exchange rate will remain vulnerable to further appreciation. This allows a further lowering of imported inflation, thereby adding to the future disinflation potential of the euro area.

- Wages are not inflationary but disinflationary. On wages, a process of 'mystification' is going on. The comparison with of the seventies might sound convincing, in reality however, we are very far away from inflationary price/wage spirals. The ECB is once again missing the point that there's a trend break in wage formation behaviour dating back to the mid nineties (see graph). From '94-'95 on, collectively bargained wages have been increasing at a regular but extremely modest rate of 2 to 2.5%, accelerating somewhat in good times but decelerating to 2% in bad times. This trend of extreme wage moderation even seems to have intensified itself since collectively agreed wages in the final quarter of 2007, in other words at the peak of this business cycle, are still down to a rate of increase of 2%.

Source: ECB

Even if more recent agreements, in particular in Germany, Austria and the Netherlands, signal the desire of trade unions to depart from this road of excessive wage moderation), the

initial starting base of 2% is so low that it is highly unlikely that these agreements would lead to wage hikes over 3% for the euro area as a whole! Wage dynamics will therefore still lie below the sum of the ECB's price stability target (1.9%) and trend productivity (1.5%). This rules out an inflationary influence of wages in 2008. This recovery in wage bargaining will instead simply prevent already high profits shares from increasing even further. It is also extremely welcome to support domestic demand and start tackling imbalances inside monetary union!

However, there is more. From past experience, we know that a business cycle downturn does not leave wage bargaining unaffected. Deteriorating economic prospects weigh on the bargaining position of workers and trade unions. This is in fact already noticeable in the recent agreements in which the robust wage increase for 2008 is combined with a return to a much lower wage increase for 2009. Moreover, wage bargaining will be put to the test especially in countries where the economy has been hit by the unwinding of the housing boom. Finally, opening clauses at enterprise level strengthen the employer's possibilities to play out the safeguarding of jobs against the inroads into existing collective agreements.

C. Automatic wage indexation and inflationary spirals: Not the ECB's nightmare but a fairy tale

The ECB seems to think that automatic wage indexation systems are still important in the euro area. They still exist in five countries (Spain, Belgium, Luxemburg, Malta, Cyprus, Slovenia) and apply to 16% of the euro area work force. The impact of indexation schemes on total wage formation would be significantly enhanced by the fact that in particular public sector wages are automatically adjusted to inflation, in combination with the 'demonstration' role public sector wages are thought to have.

What is the reality?

- If automatic wage indexation systems in some (mostly small) countries have survived the deregulatory onslaught of such systems after the seventies', they have not done so without scars. In several countries, automatic wage indexation is not full but partial, and this was done exactly to avoid generating inflationary spirals. Belgian wage indexation for example does

not take into account the increase in prices of car fuel, tobacco, cigarettes and alcohol (the so called ‘health index’). In Spain, wage indexation is also limited and only guarantees to maintain the purchasing power of the initial wage and does not include a guarantee to preserve the real wage that was agreed upon in the collective agreement. On average, if a Spanish worker is covered by an automatic indexation clause, he or she gets only gets 40% of the difference between the actual inflation rate and the inflation rate that had been used in the initial collective bargaining agreement.

- The effective impact of wage indexation schemes also tends to be limited in terms of workers. In Spain for example, one third of workers are not covered by it since these revision clauses tend to be negotiated at firm level.
- Another type of reform of was to anchor the indexation mechanism into a system of overall coordination of wage bargaining. In Belgium, this was done by the ‘law on competitiveness’, through which social partners each year assess whether wage growth in Belgium stays in line with wage growth of the main competitors. In return for maintaining indexation, Belgian trade unions were willing to cooperate in this scheme of overall wage coordination. In Spain, the ‘inflation revision’ clause is also to be seen as a counterpart for trade unions allowing opening clauses in sector agreements. Given the integration of indexation schemes into coordinated wage bargaining systems, an attack on wage indexation schemes may actually produce the opposite result, of unwinding worker support for bargaining systems where overall wage bargaining, through social dialogue, is streamlined in accordance with the macro economic needs of the economy. This is for example reflected in the fact that Spanish employers support the inflation revision clause, knowing that without the clause worker militancy and wage increases actually would be promoted….
- The idea that it would be mostly public sector workers enjoying the benefits of indexation mechanisms does not seem to be based on reality. More importantly, it is not accurate to think of the public sector as systematically having ‘demonstration’ effects on other sectors. The table below, based on information from the annual ETUC collective bargaining survey, shows that public sector wages in Germany and Spain have tended to lag behind private sector wages over the past 4 years. So, the public sector’s role at

this moment is not so much about 'leading' but about trying to 'catch up' with past private sector wage developments.

%		2004		2005		2006		2007
	Private	Public	Private	Public	Private	Public	Private	public
Germany	2.1	1.8	1.7	0.9	1.6	0.4	2.7	0.7
Spain	3.6	2.9	4	3.1	3.6	3.1		2.7
Italy	2.7	3.9	3.4	0.7	2.6	4.4	2	1.3

Source: ETUI

All of this is not to say that this trend of a return to wage moderation would be desirable. On the contrary, it is a problem because it will pull household demand out of the economy. The key point is that, economic mechanisms being what they are, a return to lower rates of growth of nominal wages, with wage formation delivering disinflation once again is actually rather probable.

IV. Fiscal policy: The second line of defense is in chaos

With the 'first line of defense' not acting to halt the slowdown, it is up to fiscal policy to do the job of stabilising the economy.

This is especially so given the fact that the room for fiscal policy to act is not to be underestimated. Certainly at the level of the euro area, the deficit has now been brought back below 1%. Some important member states have even more room to manoeuvre. This concerns in particular Germany (deficit below 1%) and Spain (surplus above 1% of GDP), two countries that are suffering respectively from the expensive euro and the unwinding of the housing boom.

What sort of fiscal policy are member states actually pursuing for the moment?

- The 2008 German budget mainly focuses on improving even further a competitive cost position that is already very

pronounced. Social security contributions for the unemployment risk will be lowered and the federal profit tax rate will slashed from 25 to 15%. Each measure costs around 0.3% of GDP. Recently, public finances have been worsening somewhat because of the government bailing out several banks hit by the sub prime turmoil. As a result, there seems to be an intention to take additional measures in order to keep the budget 'on track'. This approach is reminiscent of a typical pro-cyclical policy, having the effect of deepening a given downturn.

- Whereas the German budget forecasts a deficit of 0.5% of GDP, the French official budget has postponed the target to reach budget equilibrium to 2012. At the same time, France is looking to promote internal demand by reducing taxes on overtime and by giving tax advantages on mortgage interest payments (0.6% of GDP).. However, France has recently announced that it will control public expenditure and cut public employment so that the net effect on domestic demand is much reduced. There's also the idea of pursuing a competitiveness strategy by increasing taxes on added value to reduce labour costs (a competitive strategy with the associated risk of keeping inflation artificially high).
- Italy is also providing some relief of internal demand by channelling extra fiscal resources to public sector wages (0.14% of GDP), to stronger social benefits (0.08% of GDP) and to the housing sector (0.15% of GDP). However, the new government could shift this policy and already seems to be thinking of promoting overtime by cutting taxes on it.
- Spain (where public debt is now limited to 38% of GDP!) is pursuing a "double" dividend strategy. It is investing heavily in productivity related domains with expenditures in R and D and education projected to increase by 16% in 2008. At the same time, this investment, together with a cut in personal taxes and increased social benefits, constitutes a package of 0.3% of GDP. In addition, since it has become clear that the unwinding housing boom is producing a sharp overall slowdown for the Spanish economy, the new government has taken additional measures with particular relevance for the situation at hand. Tax cuts have taken the form of lump sum payments, mostly benefiting lower incomes, investment in public infrastructure works and social housing are being increased to offset somewhat the crisis in residential construction, and retraining programs intended to service

several thousands of unemployed construction workers are being set up.

From this overview, it is clear that fiscal policy is anything but coordinated. In fact, it is quite the opposite and the situation can be described as simply chaotic! Some governments are still playing the old game of 'beggar-thy-neighbour', trying to hijack activity from other member states. Others even seem to be thinking about applying pro-cyclical fiscal policies. And in those cases where measures are taken to support aggregate demand, the actual impact on demand can be expected to be minimal, given the nature of the measures that have been chosen. Tax cuts on overtime for example are benefiting those who already have an income and a job and are likely to end up in higher household savings rather than additional demand.

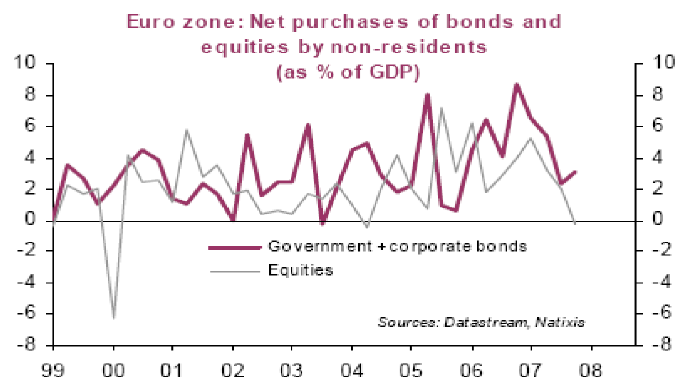
For an economic entity as integrated as the euro area, this fiscal policy 'chaos' is an important missed opportunity. With member states adressing the slowdown on their own and in isolation from each other (not to mention resorting to non-cooperative measures, trying to shift the problem to their peers!), the fiscal expansion effort will get seriously diluted. Import leakages will spill over into the rest of the euro area. If, instead, fiscal action were taken at the same moment and went in the same direction, then import leakages would become export opportunities and individual country weakness would become European strength. Moreover, such a jointly coordinated fiscal policy action would have the additional advantage of being extremely visible for the European public, therefore scoring maximum effect on confidence and positive expectations.

The key conclusion is that the euro area urgently needs a real system of economic governance. Simple rules on deficits are not enough and are, if applied in a rigid way, at present even counterproductive. Economic governance in the euro area should be substantially beefed up.

V. The super strong euro: Harmful neglect of the euro exchange rate

The appreciation of the euro does not come out of the blue but has to do with the interplay between supply and demand for euros.

On the hand, there is high demand for euros in the form of euro denominated assets from the rest of the world (see graph below).



This high demand for euro denominated assets is linked to the following factors:

- Central banks are gradually shifting international currency reserves from dollars into euros (see table below).
- After the US sub prime debacle, aversion to invest in the US and dollar denominated securities is high and international capital is looking for other places and currencies to invest in than the US dollar.
- China is allowing its currency to appreciate and is therefore no longer absorbing the excess flow of dollars originating in the huge US current account deficit.
- The US, being hit by an unwinding of the construction boom, does not think it has much choice but to shift from a model where growth is driven by debt and asset price bubbles towards a model of 'export led growth'. The US is doing so by slashing interest rates in order to move international capital flows away from the dollar, thereby weakening its currency and making US exports more attractive.

Breakdown by currency of official reserves (as %)

Breakdown by currency of official reserves (as %)

	USD	GBP	JPY	CHF	EUR	c
2002 Q1	71.57	2.68	4.39	0.34	19.70	
2002 Q2	69.06	2.73	4.73	0.33	21.58	
2002 Q3	68.02	2.80	4.57	0.34	22.60	
2002 Q4	67.04	2.82	4.36	0.41	23.82	
2003 Q1	66.97	2.53	3.90	0.24	24.69	
2003 Q2	66.74	2.53	3.60	0.21	25.13	
2003 Q3	67.13	2.43	3.84	0.23	24.60	
2003 Q4	65.90	2.77	3.95	0.23	25.18	
2004 Q1	67.50	2.70	4.00	0.23	23.61	
2004 Q2	67.81	2.73	3.86	0.24	23.48	
2004 Q3	67.30	3.07	3.60	0.17	23.94	
2004 Q4	65.81	3.38	3.85	0.17	24.91	
2005 Q1	65.43	3.56	3.90	0.17	25.13	
2005 Q2	66.12	3.48	3.77	0.13	24.79	
2005 Q3	66.35	3.60	3.79	0.14	24.35	
2005 Q4	66.84	3.60	3.59	0.15	24.10	
2006 Q1	66.43	3.96	3.32	0.16	24.58	
2006 Q2	66.06	4.19	3.12	0.15	24.79	
2006 Q3	66.36	4.23	3.02	0.16	24.54	
2006 Q4	65.35	4.39	3.10	0.17	25.19	
2007 Q1	64.89	4.48	2.98	0.17	25.51	
2007 Q2	64.78	4.66	2.81	0.16	25.62	
2007 Q3	63.80	4.73	2.93	0.17	26.40	
2007 Q4	63.70	4.73	2.93	0.17	26.50	

Sources: IMF, Natixis

On the other hand, this demand for euro currency is not matched by a corresponding supply. With its current account slightly above equilibrium (and this despite major oil price shocks transferring income to oil producing and some emerging economies!), the euro area has objectively no need to import capital from the rest of the world. The lack of a current account deficit, combined capital flows from the rest of the world into the euro area, is at the heart of the pressure for the euro to continue to appreciate.

How are policy makers dealing with this? The ECB is giving contradictory messages. Using coded language it has, occasionally, condemned 'excessive volatility' of the euro exchange rate. However, this has been a totally unconvincing signal since at the same time the ECB, by refusing to cut interest rates, has allowed the interest rate differential with the US dollar to increase. It does not take a super intelligent economist to realise that with euro

interest rates double the US ones, investors will shun the dollar and come flooding into euros.

Even worse, it appears that some of the hawks at the ECB are using the euro exchange rate to bypass the ECB's governing council. Some ECB'ers, seeking to obtain an interest rate hike but unable to not get it through the ECB governing board because of its unanimity rule seem to resort to techniques of market manipulation. Simply spreading the message in the media that the ECB is discussing an interest rate hike is then sufficient to influence financial markets' expectations. And markets, thinking that the US- euro interest rate differential will widen further and therefore anticipating a further appreciation of the euro then start pushing up the euro exchange rate.

Ecofin ministers, who according to the Treaty have a joint responsibility with the ECB to manage the euro area's exchange rate, are not offering much of a solution either. Until now, their action has been limited to making visits to China, pleading with the Chinese central bank not to invest their international currency reserves in euros and let the Chinese yuan appreciate vis-à-vis the euro as well. As could be predicted from the start, their pleas are falling into deaf ears. From the point of view of Chinese central bankers, this is entirely logical. Indeed, why would one invest currency reserves in dollars delivering a 2% interest yield when an investment in euros would give a return of 4% to 5%, plus the prospect of an increase in the value of the investment because of the continuing appreciation of the euro? If European finance ministers want their visits to China to be of any use, then they need to make sure that their words on avoiding a super strong euro are backed up by actions in the form of lower euro area interest rates.

How is this process to continue further? As described above, at the heart of this pressure for the euro to appreciate is this mismatch between, on the one hand, excess demand for euro denominated assets from the rest of the world and, on the other hand, the lack of a current account deficit that would supply the rest of the world with euro currency. The ECB can address this mismatch by printing additional euros and exchanging these dollars, thereby building up a giant dollar currency reserve. It can also alleviate the mismatch by reducing interest rates, thereby reducing as well the international appetite to invest in euros.

However, given the fact that the ECB is reluctant to intervene in case of euro appreciation (it did however intervene back in 2000

when the euro was falling against the dollar!), the other possibility to address the euro currency mismatch is to run a current account deficit which is high enough to provide the rest of the world with the euro's they need to invest in euro denominated assets.

Here, euro area policy makers have a choice:

- Either they allow the euro to appreciate so strongly that a current account deficit is run corresponding to the excess demand for euros in the capital market. This however would imply a massive deterioration of competitiveness, wiping out substantial parts of the euro area's industrial base. Moreover, additional policy loops worsening the initial situation are to be feared in this scenario. Indeed, with models of stability and export led growth firmly anchored in the minds of many European policy makers, it is highly likely that the creation of any current account deficit will be resisted. Wage moderation will be the most likely course of action. However, if wage moderation is indeed implemented, the current account deficit will not materialise and the pressure for euro appreciation coming from capital market demand will not be offset. The upshot is then another round of appreciation of the euro. Wage moderation and euro area appreciation would then reinforce each other, dragging down both domestic as well as external demand.

- However, the other possibility is that policy makers identify this strong international demand for euros as an important opportunity. If the rest of the world is so keen to invest in the euro area's assets, why not accept this and put this situation to good use by moving to a higher level of investment and demand in the euro area? In that way, jobs and incomes will be created and part of this income will flow into the current account deficit, thereby eliminating the euro mismatch by putting euro currency at the disposal of the rest of the world. In this scenario, the euro exchange rate appreciation would be less pronounced than otherwise would have been the case. Moreover, new other jobs will be available to replace the ones lost by deteriorating cost competitiveness. Of course, it is of the utmost importance to channel this additional demand and activity into 'intelligent' investment, and not 'let go' of consumption. To do so, it would make more sense to focus this additional demand on the challenges of climate change and sustainable development, thereby strengthening our competitiveness by moving our economy and industry into the

areas where future demand is likely to be the strongest and the most dynamic (see also below, point VI).

VI. Conclusions: Monetary union's policy makers urgently need to put their house in order.

Summing up, the assessment of the macro economic policies pursued in the euro area at this moment is rather shocking. Monetary policy is looking backwards not forwards. Fiscal policy of member states is going in all sorts of directions. A policy response to the continuing appreciation of the euro is totally lacking. And this chaotic policy mix is operated in the face of major challenges such as an economic slowdown, sub prime and financial market turmoil and the US turning from a 'demander of last resort for the rest of the world' into a 'beggar-thy-neighbour' entity.

Euro area policy makers need to get their act together and deploy macro economic policies in order to stabilise the economy:

- Interest rate cuts are long overdue. The ECB should enact them, explaining clearly to markets that price stability is not at risk if a forward looking approach is taken.
- Economic governance should be substantially strengthened and certainly so if monetary policy action remains absent. Member states' fiscal policy should be closely coordinated in order to:
    - Avoid making matters worse by sticking to rigid deficit objectives. The automatic stabilizers should be allowed to work to the fullest extent possible.
    - Improve the efficiency of the automatic stabilizers by giving prioirity to those expenditure or tax measures with the highest positive impact on aggregate demand. This implies measures for the economically weak instead of further tax cuts for the rich.
    - Turn those Member States with low deficits and/or high current account surpluses into an engine of growth for the rest of the European economy.
- The idea of launching a new European Smart Growth Initiative should be discussed. This Smart Growth Initiative would focus on public investments in sustainable development. It would be

backed up by issuing European bonds on international markets, thereby making good use of the high demand for euro denominated assets. The European Smart Growth Initiative would on the one hand compensate the loss in activity from the appreciation of the euro. At the same time, it will also ease the trend for the euro to appreciate by supplying more euro currency to international markets through the euro area's current account.

Finally, to set up such economic governance of fiscal policy and to discuss the European Smart Growth Initiative, a special ECOFIN Council should be organised before summer 2008. European social partners should be invited to take part.

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