Could Europe Take the Slack Caused by a Slowdown in US Growth?

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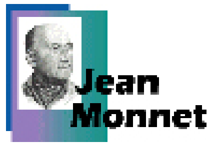

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These topics form part of the pressing agenda of the EU and represent the multifaceted and complex nature of the European integration process. These short papers also seek to highlight the internal and external dynamics which influence the workings of the EU and its relationship with the rest the world.

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Could Europe Take Up the Slack Caused by a Slowdown in US Growth?

According to the International Monetary Fund "World Economic Outlook" published September 6, 2006 the world will enjoy a fifth year of consecutive growth with an economy on track growing at 5.1 per cent.[1] In the European Union, Joaquin Almunia, European Union Monetary Affairs Commissioner, has raised the EU growth forecast from 2.1per cent to 2.5 per cent for 2006. According to the "Macroeconomic and Financial Situation in the European Union"[2] report, presented in Madrid last September, Almunia gave the most upbeat assessment of the eurozone economy for years, claiming that the economic recovery was robust and that structural reform in the labor, financial, and product markets were paying off. He explicitly reported that "economic growth this year is set to be the best we have had since 2000,"[3] and even expressed confidence in a further economic growth update for 2007 since he believes that the economic reforms will continue. The latest unemployment rate for the eurozone- 8.3 per cent in August- together with an accelerating growth driven by a boost in domestic demand and investment are nothing but good news for Almunia for whom the inflation rate, at 2.3 per cent, is under control.

However, according to the aforementioned IMF report, this economic boom is predicted to finish in 2007, and, while the IMF agrees with Almunia´s in an unprecedented economic growth for 2006, it forecasts a "soft landing" for the world economy for 2007, due to a slowdown in the US economy. "Risk to the global outlook is clearly tilted to the downside, there is one-in-six chance of growth falling below 3.25 per cent in 2007"[4], a significant decline compared with the 5.1 per cent growth confirmed for 2006. While for Almunia, structural changes, employment, and domestic growth, are the reason for a continuous economic boom, for the IMF the burst will come by a slowdown in the US housing market and the actual surge in inflationary expectations that are forcing central banks to raise interest rates.

This clash in points of view over future economic performance is not new. Economists have been constantly discussing factors and indicators that can trigger shifts in demand and supply that affect economies' performance. In fact, for the past year there seems to be a new "economic indicator" to measure economic activity: crane's count. Never before in the history of economic modeling and forecasting, has counting the cranes at construction sites become of any interest to predict the strength or weakness of economic recovery. In fact, in the past recent years, we have been hearing about the "construction bubble" and its theory. Buoyancy of the building industry highlights the broadening of a given economy recovery based on domestic demand, since building site activity has been lately considered as a good sign of economic

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[1] Internacional Monetary Fund. ¨World Economic Outlook.¨ http://www.imf.org/external/pubs/ft/weo/2006/02/pdf/exesum.pdf

[2] Almunia, Joaquin. ¨Macroeconomic and Financial Situation in the European Union.¨ http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/06/484&format=HTML&aged=0&language=EN&guiLanguage=en

[3] Parker, George. ¨Almunia raises EU Growth Forecasts¨, Financial Times Thursday September 7, 2006

[4] Blas, J., and Daneshkhu, S., ¨IMF Sees Risk of Global Slowdown¨ Financial Times Wednesday Septermber 6, 2006.

activity. This "new" economic indicator seems to be backed up by the European Construction Industry Federation since its president has recently stated that "overall, we've really pleased with the situation. My forecast is that the positive trend will continue but with noticeable differences between individual countries".[5]

Despite these divergences among economic forecasting for growth in 2007, what is a real fact is that the US economy seems to be in trouble, and many economists are wondering if Europe could take up the slack caused byits slowdown. According to many economists, the US has entered a period of economic slowdown that means the end of the economic expansion that, according to the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER), began on July 17, 2003.[6] The NBER is the most recognized authority to signal any changes in the business cycle which does not define a recession in terms of two consecutive quarters of decline in real GDP but a significant decline in activity spread across the economy lasting more than a few months. This decline must be visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. The table below shows the evolution of the macroeconomic data:

2006 US DATA	January	February	March	April	May	June	July	Aug
Unemployment Rate	4.7per cent	4.8per cent	4.7per cent	4.7per cent	4.6per cent	4.6per cent	4.8per cent	4.7per cent
Industrial Production		0.004per cent	0.005per cent	0.009per cent	0.001per cent	0.009per cent	0.004per cent	
Real GDP	2.5per cent	3.9per cent	3.2per cent	3.3per cent	4.2per cent	1.8per cent	5.6per cent	2.9per cent
Real Personal Income	0	5.678per cent	5.078per cent	-0.77per cent	1.012per cent	2.21per cent	2.377per cent	1.794per cent

Data: www.economagic.com.

Therefore, is the recent slowdown in the US economy guiding the world economy towards a recession period? According to the data collected and presented in the schedule above, unemployment rate is the only indicator that is sustained while the industrial production and real GDP are following an uneven path together with real personal income. This situation clearly indicates that the US economy is in dire straits, and changes will soon be implemented by the Fed to correct the situation. However, whether the eurozone economy could substitute the US or find the US recession more painful would depend on: (1) how some EU members manage their exports to the US; (2) how the monetary policy is directed by the European Central Bank; (3) how the Stability and Growth Pact is imposed to counterbalance the US recession; and (4) how labor markets and productivity react in taking the leading role.

For a start, the eurozone recovery is based on export-led growth, since countries such as Germany and Italy depend on their export to US to obtain a surplus balance in their net export account within the GDP. However, the euro is enjoying a sweet moment as a very strong currency against the US dollar, and according to forecasts the euro is expected to strengthen even

[5] Atkins, R., Dangers Ahead Cast Clouds Over Recovery. Financial Times Thursday September 7, 2006
[6] National Bureau of Economic Research, http://www.nber.org/cycles/cyclesmain.html

further in the future. This forecast of a further strengthening of the euro is because the US needs a “cheap” currency to be able increase exports in order to obtain a surplus in its net export account to improve its GDP and reduce its tremendous current account deficit. If the US is successful at maintaining the US dollar’s low profile and lets the euro play the role of the strong currency, European exports will become more expensive and more difficult to sell abroad. Hence, if the euro’s exchange rate overshoots against the dollar for the above reason, the eurozone’s export industries would suffer, and the present economic recovery based on exports would go into reverse.

Second, the Eurozone should not be counting on the monetary policy. The European Central Bank hiked the EU interests rates last August to 3 per cent in order to fight an inflation rate that if not properly controlled will go off hand. For instance, in countries like Spain the inflation rate in July 2006 reached 4 per cent, and for the past two years have been moving between 3 per cent and 4 per cent. The US Federal Reserve hiked interest rates by another quarter point to 5.25 per cent on June 29 despite signs of a slowdown in the pace of activity in the economy. Even though it is believed that the Fed will continue to raise rates – this has been the seventeenth increase since June 2004 - to keep the economy growing at or below its current trend, in early July, Fed Vice Chairman, Donald Kohn, noted that policymakers were “well aware” of the risk of raising interest rates too far, but stated that “there were greater risks of not raising” rates, since an increase in inflation would be “even more disruptive”.[7] However, the financial world believes this will be the last hike and that it will mark the peak for the current cycle, with the Fed trimming interest rates in 2007 as the economy slows and inflation moderates.[8] In fact, the Fed[9] left the interest rate unchanged at 5.25 per cent despite that many economists were betting that the Fed would raise the rate to 5.50 per cent. Even the committee judges that some inflation risks remains although the housing market is slowing sharply and oil price pressures are undercutting some price pressure. In fact, the Fed stated on September 20 that there is evidence of a sharp slow down in activity and that “a moderation in economic growth appears to be continuing”.[10] Furthermore, the latest Industrial Production (IP) and Capacity Utilization (CU) reported by Federal Reserve Statistics[11] on September 15, 2006, show that IP declined 0.1 per cent in August after an increase of 0.4 per cent in July. Manufacturing output was unchanged in August but it advanced an upward-revised 0.4 per cent in July. Capacity utilization, which measures the operating capacity of the resources in the economy and shows how much slack there is in the economy, for total industry fell to 82.4 per cent in August. Even so, the utilization rate was more than two percentage points above its level in August 2005 and 1.4 percentage points above its 1972-2005 average. Basically, according to the Federal Reserve Board of Governors, capacity rates of 85 per cent (or higher) are seen as inflationary and measures to control inflation are taken; furthermore, sector readings above 100per cent are indicative of working at excess capacity. Basically, industries are forced to work near full

[7] Federal Reserve Board. ¨Monetary Policy and Economic Outlook. Monetary Policy Report submitted to the Congress on July 19, 2006, pursuant to section 2B of the Federal Reserve Act¨http://www.federalreserve.gov/boarddocs/hh/2006/july/ReportSection1.htm

[8] Shellock, Dave. ¨Data and Oil Price Make Fed Rate Rise less likely.¨ Financial Times, September 16/Septermber 17 2006.

[9] Beales, Richard. ¨Fed Leaves Rates Unchanged at 5.25%¨ Financial Times, Thursday September 21, 2006

[10] Ibid.

[11] Federal Reserve Statistics. ¨Industrial Production and Capaticy Utilization.¨ http://www.federalreserve.gov/releases/G17/Current/

capacity only when there is significant demand for output and this is why we see capacity utilization rates rising during economic expansions and falling in recessions.

In third place, if the eurozone contracted the role of the Stability and Growth Pact (SGP) it will once again will be in jeopardy since a slowdown in the economy will push governments in the eurozone to run public sector deficits at more than the permitted 3 per cent of GDP to provide some insurance against a possible economic depression in the form of automatic stabilizers.[12] By running deficits, governments will most probably use Keynesian remedies that although effective will have devastating long-term effects on eurozone economies.

Finally, while it is true that most countries in the eurozone have undertaken major economic reforms specially focused on improving cost competitiveness, the results shows that those might have to be accompanied by measures to enhance flexibility, not only the financial market and the service industries as Almunia defends, but more specifically the labor market. Economic inflexibility means that shocks in the eurozone will tend to persist for much longer, and this lack of flexibility is the reason why, according to the NBER,[13] it took the US economy only eight months to recover form the 2001 recession and took the eurozone five years to return to the pre-recession economic levels. Furthermore, most economists are criticizing that all recent reform programs focus primarily on labor competitiveness, such as the Lisbon Agenda, and not enough attention is paid to productivity.

Therefore, with US economy data anticipating a more abrupt slowdown than the Fed was predicting, and the eurozone economy in the middle of fundamental economic reforms, I believe that the eurozone could hardly be able to play a leading economic role since the US slowdown is arriving too soon for the European economies. In fact, the eurozone will suffer with the US slowdown because the US still maintains world economic hegemony, and its slowdown continues to be bad news not only for the eurozone but for the world.

[12] Munchau, Wolfgang. ¨… and Europe Hill not be able to give it life.¨ Financial Times, Monday August 14, 2006.

[13] National Bureau of Economic Research. ¨ Business Cycle Dating Committee, National Bureau of Economic Research¨ http://www.nber.org/cycles/recessions.html