ETUI-REHS

The broad economic policy guidelines 2005 – 2007: A basis for European economic revival?

European Economic and Employment Policy Brief

No. 2 - 2005

Ronald Janssen

The broad economic policy guidelines 2005 – 2007: A basis for European economic revival?

Executive Summary

- Although the economic recovery in the euro area is once again dwindling before our very eyes, the draft Broad Economic Policy Guidelines (BEPG's) continue to ignore demand side policies. Instead, the central assumption seems to be that 'stability-oriented' policies and structural reform policies will create their own demand.
- A closer look at so-called 'expansionary' fiscal contractions reveals fiscal tightening was either done *after* the economy had already taken off, or was accompanied by other policies to compensate for the loss in aggregate demand (currency devaluation, interest rate cuts, the EMU-boom of shrinking long term rate differentials).In all other cases, fiscal contraction delivered the standard 'Keynesian' – effect of depressing growth and thereby pushing the public debt ratio even higher.
- Similarly, not much evidence exists that would show that 'business friendly' structural reforms would increase resilience against business cycle downturns. On the contrary, it may be expected that excessive wage moderation and increased institutional uncertainty would depress aggregate demand even further. Here also, the message is that 'reforms' need to be accompanied by active demand side policies.
- The ECB should be the 'first line of defence' in providing such active demand management. While the ECB urgently needs to come through on the recent OECD call to cut interest rates, the fact is that only relatively limited interest rate margins at the ECB's disposal. The ammunition that is still left (and which should be used!) might prove to be no match against a policy that, on top of already weak confidence and a possible collapse of the dollar, depresses aggregate demand further. In such a case, the BEPG recommendations, if implemented to the letter, boil down to digging an even deeper hole for ourselves and might introduce the spectre of outright deflation in Europe.
- This underlines the urgency of the ETUC-demand of relaunching the Lisbon agenda by drawing up a coordinated European Growth Initiative, thereby using the margins the new Stability Pact is offering while being supported by a growth-friendly monetary policy from the part of the ECB.

Ronald Janssen (rjanssen@etuc.org)

The views expressed in the EEEPB are those of the respective authors and do not necessarily reflect the views of the ETUI-REHS or ETUC.

For more information, please contact the coordinator Andrew Watt, e-mail: awatt@etuc.org.

I. The central claim of the draft BEPG's: Stability and structural reform policies create their own demand

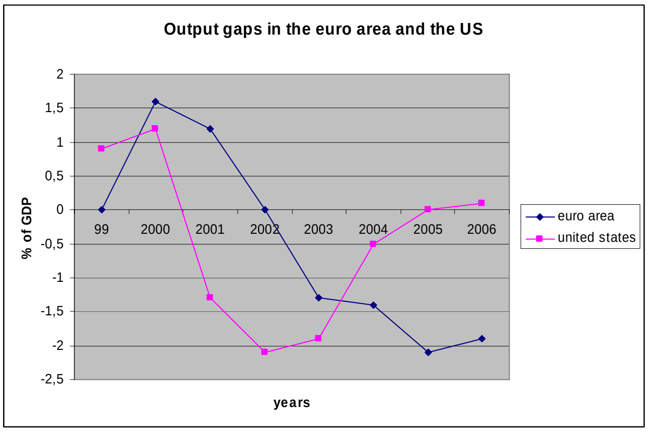
On 12 April, the Commission proposed a draft of the new broad economic policy guidelines 2005-2007. While the form of these guidelines is certainly new (integrated guidelines, focus on implementation at the national level), the *contents* of the proposed policy package sounds strikingly familiar. Essentially, the draft BEPG's boil down to:

- Increasing *potential* growth in the medium run. The BEPG's seek to do this by calling for structural reforms that improve the supply side of the economy and increase competitive pressures on product and labour markets.
- Safeguarding *short-term economic stability*. Here, the recommendation is to take the necessary fiscal consolidation measures in order to respect the Stability Pact.

However, the European economy, or more precisely the euro area, also has a problem with *short-term (or actual) growth*. In contrast to the rest of the world, the euro area has experienced a very shallow recovery. Moreover, the recovery has already begun to falter and, according to leading indicators, is now set to weaken further. It is as if the euro area is caught in a vicious circle. Because business and consumer confidence remain low, domestic demand and thus growth itself continue to be weak. In turn this confirms the pessimistic outlook. With exports to the rest of the world limited to 15% of overall euro area GDP, foreign demand has proven to be too weak a channel to substitute for the lack of dynamic domestic demand.

The result is that in spring 2005, after four years of growth slowdown, the euro area's effective output is still seriously below existing productive capacity. Different international organisations (IMF, Commission, OECD) estimate that, on average, significant slack exists in the euro area's economy. In the OECD's recent Outlook, the output gap even amounts to -2% of GDP in 2005 while showing no sign of improvement in 2006. It means that Europe finds itself (more than) five years in a row in a situation of underutilisation of full productive capacity! Also note how, in contrast to Europe, the US swiftly recovers from its slowdown by closing the output gap.

Output gaps (OECD)



Source: OECD (2005)

What have the draft BEPG's to say about policies to strengthen domestic demand and to 'kick-start' a convincing recovery? How do they intend to bridge the gap between the medium-term benefits of 'structural reform' and the short term problem of sizeable economic slack? After all, it is difficult to imagine how the economy would suddenly perform substantially better in 4 or 5 years time if this pattern of low confidence and sluggish growth were to continue in the next couple of years. In such a scenario, the potential impact of, for example, labour market reforms on potential growth would simply be counterbalanced by the failure of firms to build up the economy's capital stock because of lack of demand prospects. Put differently, upgrading work force skills without providing these workers with the machinery and capital goods that are needed to establish new job places will in the end not improve the economy's growth potential.

A close reading of the draft BEPG's reveals that they do recognise the important role domestic demand has to play in making structural reform and stability policies deliver real results. However, the draft BEPG's philosophy is that *solving the issue of lack of sufficient domestic demand does not require explicit demand-side policies. In the BEPG's view, pursuing (vigorously of course) stability and reform policies will by itself guarantee a revival of domestic demand.* To get to this intellectual outcome, the BEPG's invoke a revival of consumer and investor confidence as well as increased 'resilience' against business cycle slowdowns.

Here, we find a modern version of the famous 'law' of Jean-Baptiste Say who claimed that 'supply creates it own demand'. The similarities between the BEPG philosophy and this economic theory dating from the nineteenth century are rather striking and can be illustrated by the following quote (taken from Keynes' General Theory):

> 'What constitutes the means of payment for commodities is simply commodities. Each person's means of paying for the productions of other people consist of those which he himself possesses. All sellers are inevitably, and by the meaning of the word, buyers. Could we suddenly double the productive powers of the country, we should double the supply of commodities in every market; but we should, by the same stroke, double the purchasing power. Everybody would bring a double demand as well as supply; everybody would be able to buy twice as much, because every one would have twice as much to offer in exchange. [John-Stuart Mill *Principles of Political Economy*, Book III, Chap. xiv. § 2.]'

This note addresses the question to which extent there are indications that support the BEPG's case of 'stability and reform creating their own demand'. It also considers the consequences for the European economy if stability/structural reform policies fail to revive domestic demand on their own while explicit policies to strengthen domestic demand continue to be ignored.

II. On expansionary fiscal contractions

A. The BEPG theory

Here, the BEPG argument is based on the sustainability of public finances as reflected in public debt ratios. High debt ratios are thought to undermine overall confidence. Households and firms, discounting the possibility of future tax increases and/or public expenditure cuts, depress consumption and increase their savings ratio. In that case, the net impact of fiscal contractions on aggregate demand might be positive. By driving the deficit down, contractionary fiscal policy may restore the general public's confidence in the sustainability of public finance: these effects are termed 'non-Keynesian'. The 'income' effect of a fiscal contraction (less overall purchasing power available) may then be compensated by the 'confidence' effect (reduced savings ratios).

Again, note the resemblance of this argument with another classical theory, the theory of Ricardian equivalence which states that tax cuts will not trigger increased demand because households will immediately take future tax increases into account.

B. Expansionary contractions: Not very likely to happen

For confidence effects to result in a *net* increase in aggregate demand, these effects have to be strong enough to compensate for the reduction in available purchasing power and to add a demand effect on top of that. In other words, we are not talking of the 'Ricardian equivalence theorem' but of a Super Ricardo theory.

Such a 'Super Ricardian effect' could perhaps be expected to manifest itself if public debt ratios are extremely high. Is this the case in the euro area?

A first comparison concerns the US. The US is interesting because it conducted from 2000 on a very aggressive fiscal loosening policy, which has effectively supported aggregate demand and has helped to pull the US out of the slowdown. It appears that the average debt level in the euro area is indeed somewhat higher compared to the US. However, it should be noted that individual country situations within Europe diverge quite a lot. Germany's debt level for example is quite close to the US one, so the argument that Germany would be in a situation of 'non-Keynesian' confidence effects because of higher debt levels compared to the US is not valid. It should also be noted that US debt levels have been accelerating since 2000 by 7 percentage points of GDP, whereas the increase in the public debt ratio in the euro area has remained limited.

Table I: Comparing debt ratios: General government gross financial liabilities (OECD concept) in % of GDP

	2000	2005
US	58	65
Japan	134	170
Euro Area	77	79
Germany	60.9	68.6
France	66	76
Italy	124	119

Events in the Japanese economy around 1997 constitute a second point of comparison. In 1997, with a debt ratio as high as 100% of GDP, Japan cut the structural primary deficit by 1.2% of GDP. This was immediately accompanied by a substantial slowdown in growth. In 1996, the Japanese economy was growing at 3.4%. In 1997 however growth collapsed to 1.9% and even -1.1% in 1998. The collapse of Japanese growth from 1997 on even contributed to the overall Asian financial crisis of 1998. The Japanese experience shows that even with debt levels of around 100% of GDP, straightforward 'Keynesian' effects (fiscal contraction driving down aggregate demand) still operating.

Moreover, one should not only look at present debt levels but also at the indicators that determine future debt dynamics (initial debt, potential growth, structural primary balance). Here, the euro area is not in a bad position compared to the US or Japan. Potential growth may be lower in the euro area (2% against 3% in the US), but so are long term interest rates (compared to the US) while structural primary balances are substantially higher (compared to both the US and Japan). The combination of all these figures results in a small but structural downward trend movement of the euro area's debt ratio, whereas both Japanese as US debt are moving structurally upwards (see table). Again, the question is whether it is reasonable to expect 'non-Keynesian' effects from fiscal consolidation in Europe when such effects do not manifest themselves in other regions of the world where the structural situation of fiscal sustainability is in fact worse.

Table II: Determinants of fiscal sustainability

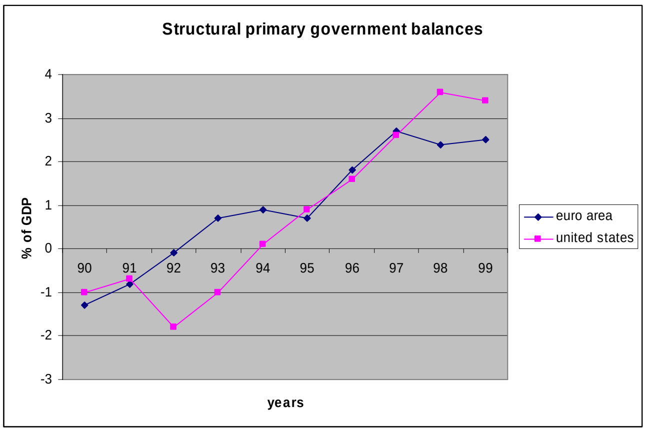
	Euro area	US	Japan
Potential growth (Nominal growth: + 2% inflation for the US and Europe, 1% for Japan)	2 (2.5)	3	1.5
Long term interest rates (average of rates between 2000 peak and 2004 trough)	4.5	5.2	1.6
Structural primary balance	0.8	-2.5	-4.8
Structural annual change in debt level	-0.4% of GDP (-0.8% of GDP)	+2.7% of GDP	+3.3%

Source: OECD, Commission, own calculations

An overview of international experiences with fiscal consolidation policies over the nineties and their impact on public debt levels casts further doubt on the likelihood of 'non-Keynesian effects 'of fiscal contraction. From the overview provided by Bibow (2004) we highlight the following experiences:

- With the US debt ratio declining by 10 pp over the course of the 1990's, the US has been the only large economy in the world that has successfully consolidated public finances. Here, the striking fact is that fiscal policy was conducted in a counter-cyclical way, with consolidation policy starting in 1993, *after* the economy had already bounced back from the crisis. Much cooperation also came from the Federal Reserve which decided not to abort the long upturn of the nineties. US - deficit and debt fell against a background of stable nominal GDP growth around 6% over a prolonged period of time. In the US, growth was not ignited by fiscal policy 'thrift' but by timely and adapted fiscal and monetary policies.

- Despite the fact the euro area's fiscal contraction was comparable to the US, the euro area added 20 pp of GDP to its initial debt from the beginning to the mid-nineties. How to explain this? One important difference with the US is the timing of fiscal contraction. In contrast with the US, the euro area already started consolidation in 1991 and continued with it through the deep recession of 92-93.In this case, fiscal 'thrift' caused growth to collapse and public debts to rise. The other important difference with the US is that interest rates in Europe (German unification!) were held artificially high by monetary policy makers, thereby depressing growth *and* even reinforcing debt dynamics.
- In the latter half of the nineties, the euro area turned the corner. Debt first stabilised and then fell back by 5 pp of GDP. In this period, fiscal consolidation was indeed accompanied with improved growth performance. However, this period is also characterised by other important policy shifts that were growth-supporting (appreciation of the dollar, gradual ending of Bundesbank policy of choking the German economy and the EMU bonus of falling long term interest rate because of substantially reduced rate differentials with the DM).



- At the level of individual European countries, Bibow describes an identical story. Fiscal retrenchment, if undertaken in a low growth environment and/or without growth supporting measures from other macroeconomic policies, results in a substantial slowdown of growth. The picture is completely different if fiscal consolidation follows growth-enhancing measures such as a currency devaluation or interest rate convergence in the run up to EMU. Table, based on Bibow (2004) summarizes these different country experiences.

	Fiscal contraction without demand compensating macroeconomic policies, resulting in slow growth and rising debt ratios	Fiscal contraction with compensating policies (devaluation, interest rate convergence), or preceded by a fiscal boost and resulting in falling debt ratios
Ireland	88-90	86-87 and from 94 on
Italy	89-93	95-97
Finland		From 93 on
Portugal	91-93	
Germany	92-95	
UK	90-91	From 91 on
Denmark		From 96 on

The basic messages from this overview are that:

- Pro-cyclical fiscal consolidation in itself does not work. It depresses growth and, in doing so, even ends up in pushing debt ratios higher.
- Other macro economic policies that compensate and inverse the depressing impact of consolidation on aggregate domestic demand are indispensable if these perverse effects of pro-cyclical tightening are to be avoided. Whether the BEPG's 'expansionary fiscal contractions' will materialise depends whether the ECB can and will implement such accompanying demand policies (see also further below).

III. Increasing economic resilience through structural reforms?

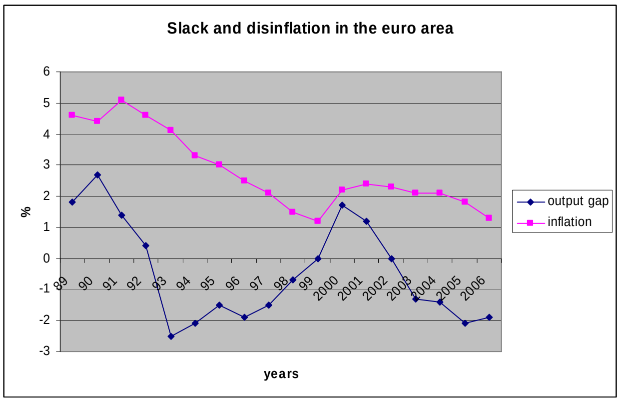
From structural reform to resilience against a downturn in aggregate demand: The Supply-side theory

The draft BEPG's make the argument that 'reforms support the macro-economic framework by increasing flexibility and adjustment capacity in response to cyclical changes'. The Commission's document does not elaborate further on this issue, but the link running from structural reform to the demand side stabilisation may be thought of in the following way (see also OECD2004):

- Structural reforms such as dismantling job protection and unemployment insurance weaken the bargaining position of workers and contribute to lower wage increases (or even wage cuts) and higher profit margins. Firms are then supposed to react to this by increasing investment and pulling the economy out of the cyclical slump. Related to this is the argument that lower price pressure coming from wage moderation will also cause disinflation, hence opening up the possibility for the central bank to cut interest rates and thereby stimulating aggregate demand. Firms expecting both higher profit margins and positive demand prospects may then almost certainly be expected to increase investment.
- A second theory linking structural reform and cyclical rebound is again the 'confidence' channel (based on the German 'Sachverständigenrat').Their concept is one of 'super rational expectations' : Supply side reforms can be thought of as unlocking dynamic economic forces by improving the market equilibrium. Households and firms, observing the this new market and business friendly framework that governments are creating are then expected to experience a rise in confidence, bringing down savings rates and thus increasing aggregate demand. For example, in this 'classical' theory, households are expected to equate a dismantlement of unemployment benefits as abolishing 'traps' that keep unemployed out of work and depress overall spending power. Households, 'freed' from this 'benefit trap', would start expecting future increases in income and start consuming. Firms would plan for an immediate increase in household spending and react by raising investments. In other words, this theory is based on the assumption that (labour) market reforms work because people and business *expect* them to work and anticipate the future benefits of these reforms.

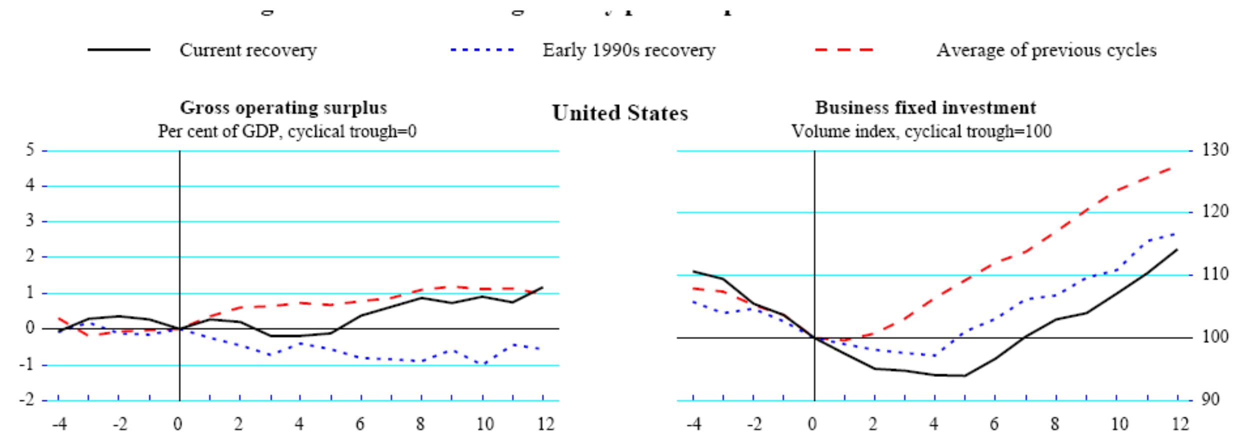
Structural reforms, cyclical responsiveness of wage bargaining and profitability

To be sure, the claim that the euro area's institutional labour market framework makes the economy non-responsive to cyclical setbacks by blocking trends of disinflation and profit recovery is not confirmed by the facts. Comparing wage evolution and inflation on the one hand with cyclical slack on the other hand (see graph) illustrates clearly that every time a negative output gap opens, wages and inflation start to slow down. This pattern is very clear over the nineties when a continuing negative output gap squeezed inflation down to an historical low. In the slowdown of the recent years, a disinflation trend can also be recognised, although it is blurred somewhat by different one-off price shocks (oil price, depreciation of the euro) and by systematic hikes in indirect taxes. For example, when correcting for these indirect taxes, inflation would have been limited to 1.5% over 2004. Underlying inflation excluding energy and food at this moment (April 2005) is only 1.4%, much below the ECB's 2% inflation threshold.

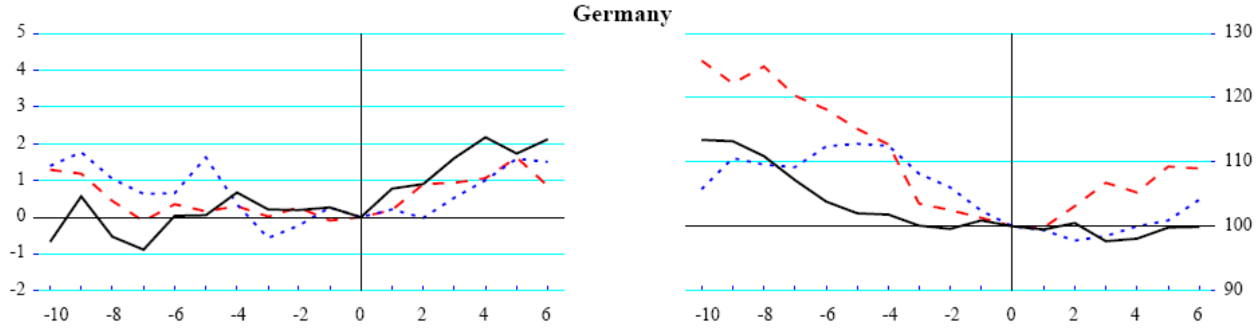


Source: OECD (2005)

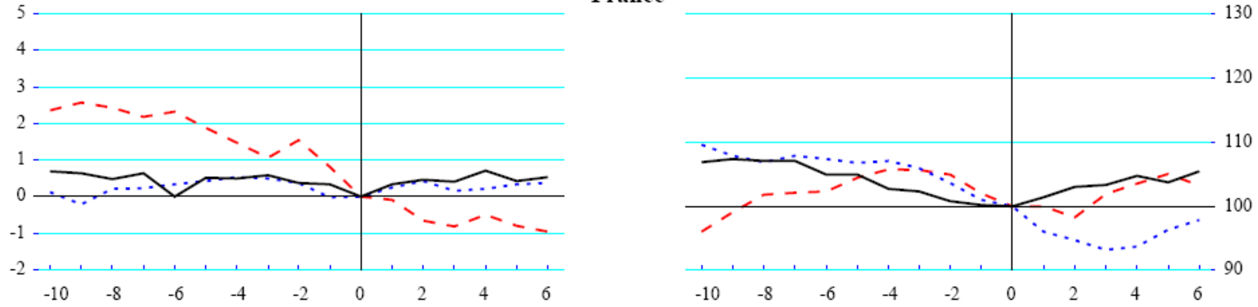
However, the BEPG argument is that reform of wage bargaining systems could probably make the euro area deliver even faster disinflation and ensure an even more profound profit recovery. Here, the fundamental flaw in the logic is that higher profits do not translate automatically into higher investment dynamics. Profitability is indeed one of the determinants of investments but demand perspectives remain fundamental. The ECB (Monthly Bulletin 2003) for example confirms the determining importance of demand perspectives over interest rates and profitability in explaining investment behaviour. Illuminating are also the OECD statistics on the profile of profit recovery over the recent cycle. The increase in profitability over the recent cycle has been more outspoken in Germany than in the US or France. Nevertheless, and because German profit recovery has come at the expense of wages and domestic demand, the recovery of investment has been outspoken in the US, noticeable in France but almost completely absent in Germany ….



Germany



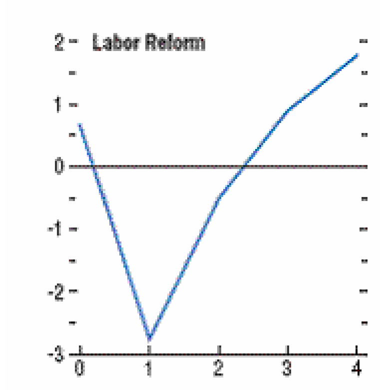
France



In any case, demand prospects will certainly not be promoted if excessive wage moderation ends up in falling purchasing power. Here, the danger is real that wage policy turns out to be a second source of pro-cyclical tightening. A vicious circle would then not only run from fiscal policy contraction but also from wage cuts to depressed domestic demand.

Even the IMF, which cannot be accused of being an enemy of 'market and business' friendly structural reforms, comes to the conclusion that these structural reforms, in particular labour market reforms, are not a recipe for immediate success. In the 2004 World Economic Outlook, the IMF estimates that labour market reforms initially even worsen economic performance. According to the IMF, it may take 3 years before GDP per capita has recovered and even longer before any net-gain could be observed.

Impact on GDP per capita to a one standard deviation increase in reform indicators



Source: IMF (2004

But even this IMF outcome needs to be read in a cautious way. In simulations like this (see also OECD 2004), the implicit assumption is that there is a policy actor that breaks the vicious circle of pro-cyclical policies and prevents the economy from sliding from slow growth to depression and even deflation. It is the central bank that is expected to intervene by cutting interest rates, thus injecting new demand momentum in the economy and providing firms the demand prospects they need in order to turn increased profits into higher investments. This requires, however, a central bank that is sensitive to negative output gaps and prepared to cut rates swiftly. We return to this issue below.

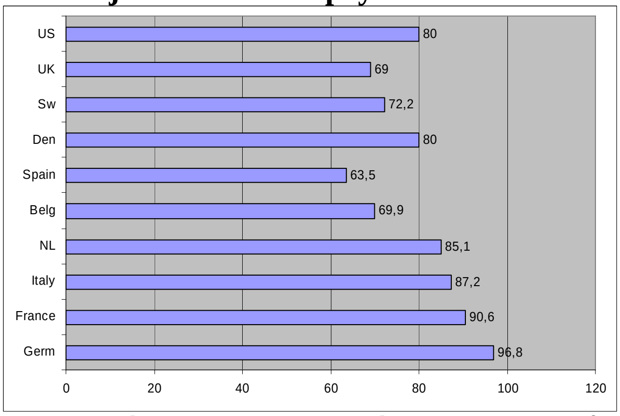
Structural reforms promoting or undermining confidence?

One peculiarity of the sluggish growth performance in the euro area is the a-typical behaviour of household savings rates. During the recent slowdown savings rates have increased or have not fallen to the same extent compared to previous slowdowns. But explaining this phenomenon by a lack of 'market-friendly' reform is taking too fast a step.

Why are households in major euro area economies so uncertain? Why do they lack confidence?

A recent enquiry is revealing in this regard. The percentage of workers who, if fired, think they will experience major difficulties in finding a job with comparable wages/conditions as their present job is stunning. In Germany for example, almost *all* workers (93%!) express that kind of fear, followed by 90 % and 87% of workers in France and Italy. This is probably related to the phenomena of globalisation and outsourcing of jobs, phenomena which are actually relatively limited in importance but which have been systematically overstated by employers and politicians hoping to scare workers into accepting cutbacks on wages, working conditions and dismantlement of the social security system.

Share of workers thinking an average worker, if laid, will face many difficulties in finding another job with similar pay



Source: Right Management Consultants, Career Confidence Index, May 2005

If people indeed worry that much about decent/similar job alternatives, then it is extremely unlikely that 'business friendly' structural reforms can ease these fears. Indeed, all of these reforms take the 'low road':

- Questioning employment protection legislation, when people worry about finding alternative jobs with similar wages being available, will only increase workers' uncertainty.
- Questioning duration and level of unemployment benefits will reduce the 'reservation' wage, thereby pushing people into accepting any kind of job.
- Questioning minimum wage legislation and sectoral bargaining systems removes another wage floor in the labour market.
- Questioning the whole system of social security boils down to telling people they are on their own to prepare themselves for major risks such as sickness, old age, unemployment. With no help from a social security system (which spreads risks over the entire population), the normal reaction will be to increase savings.

In short, the type of 'business friendly' reforms being proposed only confirms and even reinforces existing workers' perception and fears that, in future, they may very well loose the level of wages they presently enjoy. With expectations on reduced future income flows, it is quite logical for workers to increase (precautionary) savings.

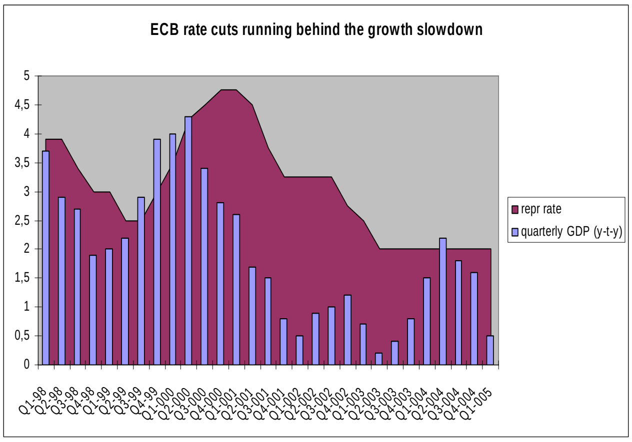
The fact that stressing the mantra of 'market friendly reforms' only makes things worse for aggregate demand is also confirmed when identifying the two countries where domestic demand has been suffering most : Italy and Germany are indeed the two countries that have implemented major reforms of their labour market (Hartz IV in Germany, Biaggi laws in Italy) As a result, uncertainty and insecurity have shot up and so have savings rates and unemployment. Also notice these are the two countries where many workers are not at all feeling confident in finding, if fired, a job paid at a comparable level (see above).

IV. Monetary policy: Europe's white knight?

Pro-cyclical fiscal tightening, pro-cyclical and excessively flexible wage policies as well as confidence eroding 'structural reforms' need a central bank to step in and 'bail the economy out' of a vicious circle of depressed aggregate demand. Is the ECB up to such a job ?

Is the ECB willing to play the role of manager of aggregate demand?

The track record of the ECB on output stabilisation is not impressive, to say the least. Over the course of the recent slowdown, the ECB has adopted a 'wait and see' attitude. Also taking into account the time lags which monetary policy needs to impact on the economy, this passive policy attitude implies that monetary stimulus was provided much too late. Meanwhile, the slowdown was allowed to develop itself further, eroding deeply overall economic confidence and resulting in 2005 in a negative output gap of 2% of GDP. The graph below illustrates how the ECB's rate cuts have systematically lagged behind dismal developments in economic growth (for a lively description of the ECB's policy discussion over this period, see Bibow). From mid-2004 on we are witnessing this drama develop itself further. While leading indicators have been pointing already since mid 2004 to a renewed slowdown, the ECB has been pointing from end 2004 on to 'excess liquidity' and speculative bubbles, thereby actually preparing the markets for a rise in interest rates! Even now, when the slowdown can clearly be seen in the quarterly growth figures and *leading indicators continue to go down*, the ECB flatly rules out a cut in interest rates and continues to talk about the fact that the next move in interest rates is upwards.



Source: ECB

Why would we expect a change in this attitude from the part of the ECB? Why would the ECB be suddenly very pro-active in accompanying *new* structural reforms with timely demand side measures when it ignores the *already existing* opportunities to increase GDP by raising potential demand to the level of potential output? One can easily imagine the ECB arguing that the exact impact of these structural reforms on inflation and growth is not exactly known and that the 'credibility' of the ECB warrants a very cautious approach.

*Can the ECB still deliver **sufficient** demand stimulus?*

Assuming that the ECB would indeed overcome its reluctance to support growth and come through with interest rate cuts, what would then be the situation?

While it is beyond any shadow of a doubt that the economy is in urgent need of further interest rate cuts (and indeed the OECD's recent call on the ECB to cut rates by 0.5% underlines this !), the fact is that there is not much room to cut rates further. And the question needs to be raised whether the positive growth effects that can be expected to come from a 2% cut in rates (the maximum that is still possible) is sufficient to counter the negative demand shocks that might be in store for the economy.

On the one hand and on the basis of the Nigem model and the ECB's 'Area Wide Model', it can be estimated that reducing nominal rates to zero would support annual growth by 0.5 – 0.8%.

Impact of 2% rate cut on growth	Year 1	Year 2	Year 3	Year 4
Nigem	0.2	0.5	0.4	0.3
AWM	0.7	0.7	0	-

Source: ECB

However, the euro area is already confronted with economic slack amounting to a negative output gap of -2% of GDP in 2005 and the extent of this slack is estimated to remain so in 2006 (OECD). In order to correct for this situation, the economy is already in need of substantial (monetary) stimulus. Closing this output gap by lifting the level of GDP by 1.5/2% over a two/three year's time horizon would imply a radical cut in rates, bringing nominal rates down from 2% to zero.

Since nominal interest rates cannot be turned into zero, this leaves no room for further cuts. In other words, the monetary policy ammunition that is still available is already spoken for to tackle the existing aggregate demand problem that results from the five year slump. Monetary policy room to address *new* aggregate demand shocks in coming years is not available.

To illustrate his point we use the recent OECD work simulating a 30% fall in the dollar resulting in a 7% increase in the effective exchange rate of the euro. This OECD scenario refers to the unsustainable character of imbalances in the world economy, in particular the high and rising US external deficit. In its exercise the OECD assumes that the ECB will react (immediately) by cutting interest rates by 2%, in other words driving nominal rates down to zero. What happens is absolute disaster. Real growth collapses again in the first year (0.2% growth), remaining extremely weak in 2006, while inflation falls dangerously towards the zero level in 2006. Meanwhile, slack in the economy rises to 3.5% of GDP. In other words, in 2006 aggregate supply would exceed aggregate demand by 3.5% of GDP, a size that has not been seen over the past two decades.

OECD simulation of a dollar collapse with 2% interest rate cut	2005	2006	2007
Real GDP growth	0.2	0.5	
Output gap	-3.1	-3.4	
Inflation	1.5	0.6	1

Source: OECD (2005)

Of course, this is 'just' a scenario and things may not come that far. However, the point is that the euro area economy presently has a very limited line of defence in terms of monetary policy demand stimulus. With interest rates already at 2%, we are extremely vulnerable and almost powerless in the face of new adverse demand shocks. In such a situation, it is extremely risky to engage in experiments with so-called 'expansionary' fiscal tightening, wage cuts and confidence eroding structural reforms. The evidence described in this paper points to the high probability that such actions will indeed constitute additional negative demand shocks. Engaging in such policy action when knowing that the policy actor that is expected to bail the economy out has insufficient room to act is not a wise thing to do. In addition, with inflation already very low (1.3% in 2006 according to the OECD's baseline scenario), such policy line also risks tipping the economy into deflation, thereby re-introducing positive real interest rates and making matters even worse. With both nominal rates and inflation at record-low levels, this is not the time for 'Chicago school'type of experiments.

V. Conclusion: Europe needs a real European growth initiative

Implementing the two basic pillars of the BEPG's 2005-2008 is like playing with fire. The economy is already struggling with excess supply and does not seem able to stage a decent recovery. With global imbalances endangering the stability of the euro's exchange rate, further challenges already lie ahead. Injecting additional negative demand shocks on top of all of this is the last thing the European economy needs. The only policy actor that could come to the rescue in this situation is extremely reluctant to do so and is in need to devote all of its remaining policy margins to address the economic slack that is already there. This makes the danger of having the European economy tip over from a situation of low growth/very low inflation into an economic implosion with an outright Japanese style deflation very real.

If European policy makers want to set the economy back on track to reach the Lisbon targets, then a major overhaul in policy approach is necessary. On the macro – economic front, Europe needs to revive a growth initiative, build around the principle of national but European-wide coordinated recovery plans, injecting new demand of 1% of GDP into the economy. On the front of structural reforms of labour markets, European economic policy makers need to abandon their campaign of scaring people by systematically promoting 'business friendly' reforms that go at the expense of workers' employment conditions and their social security systems. Instead, it should be made clear that structural reform measures should be about *investing* in good labour market institutions that strengthen workers' rights on a decent reinsertion in labour markets (skills upgrading, active labour market policies, right on information and consultation in restructuring) instead of *abolishing* and *flexibilising* labour market institutions. Only in this way may structural (positive!) reform indeed rebuild confidence and function in an expansionary way for macro-economic demand.

*****

References

Bibow (2004) "Assessing the ECB's Performance since the Global Slowdown", Levy Economics Working paper no 409.

Bibow (2004) "Fiscal consolidation Contrasting strategies and lessons from international experiences", Levy Institute Working Paper no 400

ECB Monthly Bulletin, September 2003 and other issues

IMF (2004) *Spring World Economic Outlook*

OECD (2004) *Autumn Economic Outlook*

OECD (2005) *Spring Economic Outlook*