BBVA

EuropaWatch

Economic Research Department

EMU, ready to join the race
ECB, no change until 2006
Europe's policy making, a matter of risk-taking
Turkey, anchored stability

Preface

The publication of EuropaWatch marks the beginning of a new stage in the publications of the Economic Research Department of BBVA, with changes in the formats and contents of existing publications and the edition of new ones, among which EuropaWatch belongs. In this new juncture, the Economic Research Department remains loyal to its vocation to macroeconomic analysis and the follow up of those economies in which BBVA develops its activity.

To this end, the Research Department undertakes the edition of a publication set of quarterly and weekly frequency. The publications of quarterly frequency are classified in three groups. Firstly, those of international focus, which include regional analysis comprising more than one country: EuropaWatch analyzing the euro zone and Latinwatch for Latin America. A second group comprises our set of local quarterly publications. Under the common name of Situación, the examine the economic specifics of Spain, Portugal, Argentina, Chile, Colombia, México, Perú and Venezuela. On the one hand, these publication complement and extend the analysis of the international publications EuropaWatch and Latinwatch. On the other hand, they constitute publications at a national level in which global aspects of financial markets and the world economy are combined with the specific aspects of the economies to which these publications are primarily specifically directed. The third group embraces our publication of sectorial and regional nature. The Situación sectorials contribute to the understanding of the real estate (in Spain, Portugal and México) and the consumer goods (in Spain) sectors. The regional publications take a closer look at the Spanish regions of Cataluña and Canarias.

In addition to EuropaWatch, Latinwatch and the quarterly national Situación, with the aim of dealing with subjects from a more structural point of view, we have designed a second series of publications on a weekly basis called Weekly Situación. These, published for the Group as a whole and in each specific country, are oriented at providing information on markets and economies as it emerges. These publications share the same principles as the quarterly Situaciones: coordinating global tendencies and a deeper understanding of the economic and financial realities of the countries concerned.

Finally, BBVA publishes a series of economic notes, with no frequency and under the heading of "EconomicWatch", examine in an agile and rigorous manner issues relevant for the evolution of economic activity and the financial markets.

All the publications produced by BBVA's Economic Research Department are available at the Group's web page (www.bbva.com).

Contents

This publication has been elaborated by:

Manuel Balmaseda	34 91 374 33 31	m.balmased@grupobbva.com
Gonzalo Cadenas	34 91 537 76 93	santiago.gonzalo@grupobbva.com
Julián Cubero	34 91 537 36 72	jcubero@grupobbva.com
José Félix Izquierdo	34 91 374 42 00	jfelix.izquierd@grupobbva.com
Elena Nieto	34 91 537 37 76	enieto@grupobbva.com

1. Editorial

After several years of frustrated recoveries, the euro economy should join the rest of the world in the ongoing phase of economic expansion. The expansion in the global economy, although moderately loosing steam, will support the newfound dynamism in the euro zone. The ailing domestic demand in the area, which has dragged on economic growth so far, will begin to gather speed, slowly in 2005 and more briskly in 2006, and will become the base for a mild cyclical recovery. Against this backdrop, growth in the euro zone could reach 1.7% in 2005 and 2.4% in 2006.

The global context in which European activity will evolve will remain relatively positive during the next two years. Global growth will decelerate from the maximun levels reached in 2004, but it will remain above its historical average. The US and China will continue to be the drivers of the expansion, to which the euro area should slowly begin to chip in. The asynchronous global expansion of recent years has given rise to economic imbalances, specially within the US economy, which pose a threat to the sustainability of the ongoing expansion. In this context, the perceived difficulties of the US to finance its ever growing current account deficit will continue to strengthen the euro against the dollar, in spite of the dollar already being depreciated relative to its long term equilibrium. This scenario is founded on a relatively optimistic perspective as to the evolution of oil prices. These are expected to come down from the maximum levels reached recently towards US$40 per barrel by the end of 2005 and remain somewhat below those levels in the forecasting horizon.

In a relatively favourable global growth context, the European economy has not been able to contribute to drive economic growth and reduce global imbalances. A number of factors can be put forth as to the reasons for this sluggishness. These range from the well-known structural problems (which limit its growth potential and hamper rapid adjustments following *shocks*) to the way demand policy is managed. In view of the difficulties in implementing structural policies and reflecting a clear aversion to risk, demand policies in the euro zone focus on medium-term objectives, relinquishing more aggressive strategies of cyclical stabilisation. Consequently, in the last few years, while loose demand policies have driven the high degree of dynamism in the US economy, they have been considerably less so in EMU. In fiscal policy, automatic stabilisers have been left to their own devices, but, in a context of a tax rule like the SGP, the absence of consolidation during cyclical expansion has eliminated the scope for implementing a discretionary counter-cyclical policy. The only reaction by European authorities to a rule which does not work sufficiently, has been to "reform" said rule to make it unenforceable.

But beyond these considerations, which affect the scope for economic growth in the medium term, there are factors which point to optimism in regard to a cyclical recovery in the coming years. In 2005, the expansion will rely on the pick up in investment as a result of the low financing costs and the healthy financial situation of firms. Investment growth should lead to employment generation, a confidence boost and the increase in household disposable income. The combination of these, in a context of a healthy financial situation of households, will translate into an increase in consumption. In this context, in the absence of inflationary pressures, the modest pace of growth and the strength of the euro the ECB will remain on hold until 2006. Only then will it slowly begin to bring rates back towards a more neutral stance.

2. EMU, the Recovery Takes Hold

Favourable global environment

2004 was a highly positive year, both, for growth in worldwide activity, which reached 30-year peaks, as well as for international trade. Expansive demand policies and the drive of China's economy, which is gaining ground in international transactions, were the main drivers of international activity. The impact on activity caused by the considerable increase in oil prices registered during the second half of the year turned out to be less than had been feared. Furthermore, BBVA's economic projections for 2005 and 2006 are founded on a relatively optimistic scenario as to the evolution of oil prices. The recent escalade in prices to maximums ($55/b) has largely been due to transitory factors that are expected to slowly dissipate. Hence, projections point to prices sliding back from current maximums to close 2005 at around $40/b and remain at around $37/b in 2006. The price of other raw materials is also likely to drop gradually over the next few years. Against this backdrop, it is not unlikely that, although worldwide activity will slow down in 2005 and 2006 as some of the impulses from previous years subside, the global economy will continue to expand, with growth above the average for the last three decades.

China, with its significant presence both as a consumer of raw materials and financial products, as well as a supplier of low-cost industrial products, will continue to be one of the growth drivers in the global economy. The US, the other driver of global growth, will most likely continue to approach its potential, albeit at a slower rate than in 2004. US growth will continue to be buoyed by investment and by the dynamism of private consumption. Productivity, low capital costs and real interest rates, companies' sound financial position and the recovery of the labour market will be the main foundations for this dynamism. Inflation will remain low. Globalisation, anchored expectations and the flexibility of its domestic market, in a context of gradual correction of fiscal and current account imbalances, will alleviate any price pressures. Nevertheless, at present, the balance of risks on inflation are on the upside.

In this context, the adjustment of interest rates towards more neutral monetary conditions will continue, as before, to be very gradual, in spite of the considerable monetary expansion. This gradual adjustment in interest rates will avoid a significant and abrupt change in the risk premiums of emerging countries, as in previous cycles.

Notwithstanding, the international scenario is not free from uncertainty. In addition to the uncertainties as to the evolution of oil prices, there are a number of other factors at play: possible difficulties the US may have to face in financing its huge and growing current account deficit, the prevalence in international transactions of financial flows, less stable, over direct investment flows - which do not seem to be bouncing back in any definitive way -, and the possibility that the high levels of liquidity have pushed asset prices above fundamentals. These could all undermine future growth. The dollar has been, and will continue, in 2005 and 2006, to be the catalyst of some of these uncertainties, which will remain at relatively depreciated levels with respect to its long-term equilibrium rate. Against the euro, where it has accumulated a significant depreciation since 2002, it will hold at around US$1.32 per € on average in 2005 and US$1.35 in 2006 (see Box: "Will the euro continue to appreciate against the dollar?"). Meanwhile, against some of the currencies from the most dynamic regions of the world, such as Asia where the adjustment has been lower, it could yet have some downside.

Table 2.1. GDP Growth forecasts

	2003	2004	2005	2006
OECD	2.0	3.3	2.7	3.0
US	3.0	4.4	3.6	3.2
EMU	0.5	1.8	1.7	2.4
UK	2.2	3.1	2.5	2.6
Japan	1.4	2.6	1.5	3.0
Non-OECD Countries	6.4	7.2	6.2	5.9
Latam	1.7	6.0	4.4	3.6
WORLD	4.0	5.0	4.2	4.2

Source: IMF and BBVA

Table 2.2. Global Environment

	2003	2004	2005	2006
World trade (import of goods)	6.7	6.1	5.6	5.6
Exchange Rate: $ / €	1.13	1.24	1.32	1.35
Brent in dollars	28	38	43	37
Brent in euros	25	30	33	27

Source: BBVA

Chart 2.1.
US Corporate Spread BAA and EMBI+

■ US BAA (right axis)
■ EMBI +
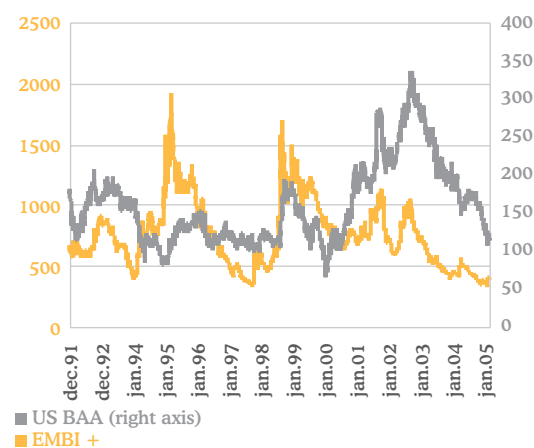
Source: Federal Rererve and JP Morgan

Chart 2.2.
U.S: Current Account Balance and Official Financing
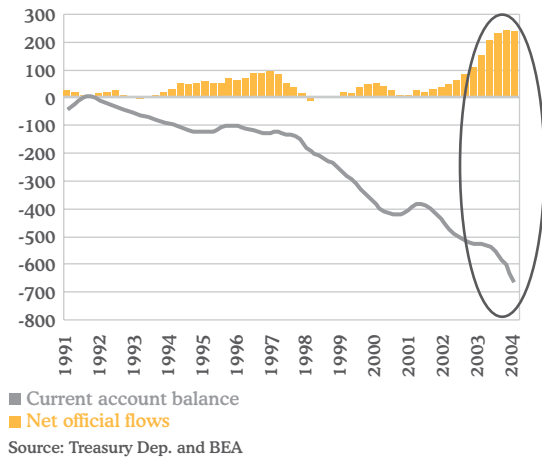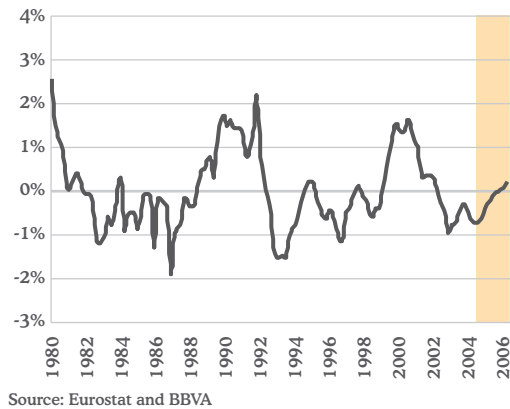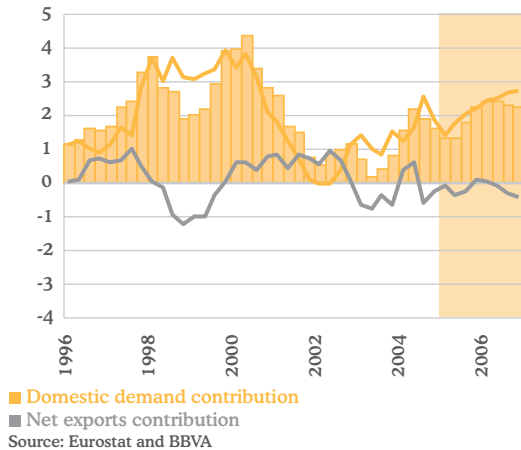In billion dollars. 12 month cumulated

- Current account balance
- Net official flows

Source: Treasury Dep. and BEA

Chart 2.3.
EMU: Output Gap

Source: Eurostat and BBVA

Chart 2.4.
EMU: GDP and contributions to growth

- Domestic demand contribution
- Net exports contribution

Source: Eurostat and BBVA

EMU: having trouble taking off....

In a relatively favourable global growth context, the European economy appears to be having trouble recovering sustained high growth rates. Following strong growth in the first half of 2004, on the back of international expansion, economic activity became sluggish once more in the second half of the year, reigniting the doubts as to the sustainability of a recovery which is well behind other areas of the world.

A number of factors have contributed to the problems the European economy has had in finding its path towards sustained growth. These range from the well-known structural problems (which limit its growth potential and hamper a rapid adjustment following a shock) to the way demand policy is managed. In view of the difficulties in implementing structural policies and reflecting a clear aversion to risk, demand policies in Europe focus on medium-term objectives, relinquishing more aggressive strategies of cyclical stabilisation. Consequently, in the last few years, while loose demand policies have driven the high degree of dynamism in the US economy, they have been considerably less so in EMU (see Article: "Europe's Policy-Making, a Matter of Risk-Taking").

That being said, beyond these considerations, which affect the scope for economic growth in the medium term and the economy's reaction to *shocks*, there are various factors pointing to optimism as far as a cyclical recovery in the coming years is concerned.

....but on the road to cyclical recovery ...

Against this backdrop, growth in the euro zone could reach 1.7% in 2005 and 2.4% in 2006, on the back of expanding internal demand. The cyclical component of GDP would consequently remain negative in 2005 and would only turn positive in 2006. Inflation will remain under control. Projections point to it staying below the 2% target of the European Central Bank, in the region of 1,7%. In this context, the ECB will not begin the process of interest rate normalization until 2006, and even then, at a gradual pace (to 3.25% at year's end).

This economic scenario is reaffirmed in the light of several synthetic indicator models, in the short-term, and medium to long-term structural forecasting models.

Short-term growth indicators, such as the ISA-BBVA synthetic activity indicator, which includes information from indicators of competitiveness, industrial activity, consumption and confidence, point to a moderate growth in the first half of 2005 (0.2-0.4 quarterly in Q1). The recent setback in confidence indicators is the main element of uncertainty at present.

However, more medium-term models such as the BBVA-Aries Bayesian VAR model or a structural multi-equation model[1] , considering factors such as global growth, raw materials prices or international liquidity, suggest that, in a favourable foreign context and one of more sluggish raw materials prices, the conditions are in place for an acceleration in European activity in the second half of 2005 and 2006 (see Box: "Analytical support for European recovery"). This dynamism will hinge upon various factors. Firstly, investment will be the most dynamic component, supported by the strength of the global economy, the buoyant business situation and very favourable financial conditions. Secondly, private consumption, although somewhat later, will benefit from the steady recovery in employment and a good performance by financial wealth. Furthermore, the saving and investment position and the financial situation of the main economic agents and the economy as a whole is quite balanced, especially compared to that of other regions such as the United States. Thirdly, demand policies will remain relatively

---

[1] Similar to the ECB's Area Wide Model.

loose. Following the "dismantling" of the SGP, fiscal policy does not look like representing a restriction in 2005 and 2006. Furthermore, the absence of inflationary pressures, in a context of well-anchored expectations, a relatively appreciated exchange rate and moderation in oil prices, will allow an accommodating monetary policy to continue.

As to net exports, its contribution to growth, in a context of real effective exchange rates at maximum levels[2], will be slightly negative in 2005 and 2006 (-0.2), since the shrinking effect of price-competitiveness on exports will be partly offset by the strength of global growth.

… led by investment

One of the main drivers of the expected European recovery is the favourable situation of the business sector, which could boost investment in both, replenishment, following several flat years, and new equipment. In addition to a positive global environment, this optimism is based mainly on the relatively healthy situation of European companies following the significant adjustments made during the latest slowdown (see Box: "Firms in "good shape").

Secondly, financial conditions are very favourable. Real interest rates on both corporate bonds and bank loans, the main source of financing for European companies, and corporate bonds spreads, remain very low by historical standards[3]. A more qualitative analysis, deriving from the bank lending survey, shows that the criteria for obtaining a loan are becoming increasingly less restrictive and somewhat more relaxed in aggregate terms in the last two quarters. Furthermore, this improvement has extended to small and medium-sized businesses. Even considering that real cost of equity financing, approximated by real dividend yield plus potential economic growth, remains relatively high, a synthetic indicator of the real cost of external financing of European companies shows that this is at a low.

Thirdly, there are signs of an incipient improvement in business margins and an increase in profits. The steady reactivation of the economy has triggered this increment, which, in a context of wage moderation and flat employment, has increased its proportion against total value added. Business margins have widened due to very low unit labour costs deriving from a combination of an increase in productivity (partly cyclical, evidencing a certain amount of labour hoarding) and very moderate

[2] This refers to the real effective exchange rate (export-price deflated), which is at its highest levels since the early nineties.
[3] Although a statistical break in the IMF lending rates at the beginning of 2003 make difficult historical comparisons.
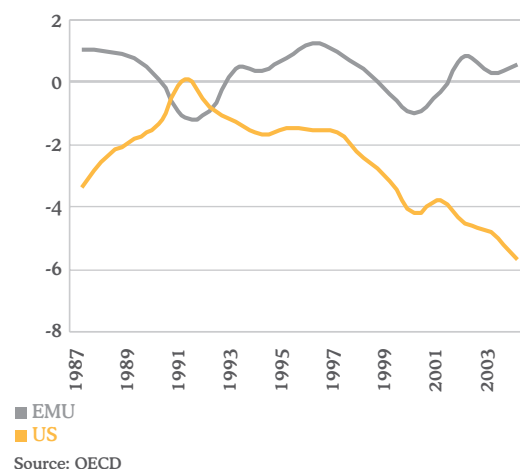
Chart 2.5.
Current Account Balance
(% GDP)

- EMU
- US
Source: OECD

Chart 2.6.
EMU: Changes in Credit Standards applied to the approval of loans or credit lines to enterprises

- Total
- Small Enterpises
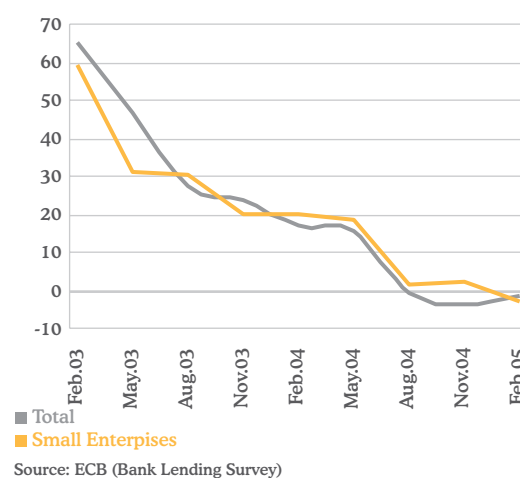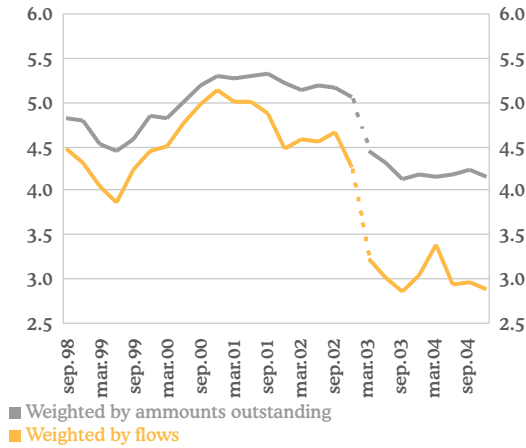Source: ECB (Bank Lending Survey)

Table 2.3. EMU: GDP growth and inflation forecasts

YoY rate	2004				2005							
	1 Q	2 Q	3 Q	4 Q	1Q	2 Q	3 Q	4 Q	2003	2004	2005	2006
Private consumption	1.1	1.0	0.8	1.4	1.0	1.5	1.9	2.0	1.1	1.1	1.6	2.4
Public expenditure	1.8	1.6	1.6	1.4	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Gross fixed capital formation	1.1	2.0	2.0	1.4	2.4	2.8	3.2	3.6	-0.5	1.6	3.0	4.3
Inventories (*)	0.0	0.2	1.1	0.4	0.0	0.0	0.0	0.0	0.4	0.4	0.0	0.0
Domestic demand (*)	**1.2**	**1.6**	**2.4**	**1.8**	**1.4**	**1.8**	**2.1**	**2.2**	**1.2**	**1.7**	**1.8**	**2.6**
Exports	3.4	7.8	6.3	5.9	5.4	5.8	5.8	5.3	0.5	5.8	5.6	5.9
Imports	2.7	6.6	8.0	6.6	6.0	7.2	6.8	5.4	2.3	6.0	6.3	6.8
Net exports (*)	**0.3**	**0.6**	**-0.5**	**-0.1**	**-0.1**	**-0.4**	**-0.3**	**0.1**	**-0.6**	**0.1**	**-0.2**	**-0.2**
GDP	**1.5**	**2.2**	**1.8**	**1.6**	**1.3**	**1.4**	**1.8**	**2.3**	**0.5**	**1.8**	**1.7**	**2.4**
Inflation	**1.7**	**2.3**	**2.2**	**2.3**	**2.0**	**1.8**	**1.5**	**1.5**	**2.1**	**2.1**	**1.7**	**1.5**

*Contributions to growth
Source: BBVA

Chart 2.7.

EMU: Real cost of external financing of euro area non-financial corporations*

- Weighted by ammounts outstanding
- Weighted by flows

*Affected by the statistical break in bank lending rates at the beginning of 2003.
Source: ECB and BBVA

Chart 2.8.

EMU: Profit share*

1995=100

* Ratio of Gross Operating Surplus to Total Value Added
Source: Eurostat and BBVA

Chart 2.9.

EMU: Profit Mark-Up

(as inverse of real Unit Labour Cost)

Source: Eurostat and BBVA

wage cost increments. Furthermore, the relative appreciation of the exchange rate and the moderation of oil prices contribute to containing non-labour costs.

Recent data already reflects some recovery in equipment investment. Furthermore, acceleration in bank lending to businesses, growing already at around 6%, could be a sign that a turnaround point has been reached. Gross fixed capital formation can be expected to grow by 3% in 2005 and by 4.3% in 2006. Once the investment recovery takes hold, the upturn in business activity and the prospects of economic expansion should translate into a pick up in employment.

Consumption, behind schedule

The slowly improvement in household activity will contribute to the dynamism generated by the sound situation of companies. Households have a relatively well balanced financial and saving position. Like companies, they have increased their financing capacity in terms of GDP over recent years. The gross savings rate remains stable, and although indebtedness has increased slightly in line with the increase in the demand for loans by homebuyers, households have also increased their financial assets. Furthermore, their debt/disposable income ratio is still much lower than that of other countries, such as the US or the UK.

Secondly, a steady improvement in employment and in disposable income is likely, based on the performance by both these variables, which has been less negative than in previous slowdowns[4]. In fact, one of the characteristics which distinguishes the latest deceleration from that of previous cycles is the resistance of employment in the EMU as a whole, which has not posted negative growth rates[5]. Not only in Spain, but also in countries such as France and Italy, which have experienced a more unfavourable cyclical performance, job creation has remained relatively sound. This can be attributed to the extension of wage moderation and the reforms implemented over the last few years in the labour market, in spite of their timid nature. In countries like Germany, where there has been job destruction, we are starting to see the effects of the latest reforms[6]. Some of them are very far-reaching and, although they might generate short-term uncertainties for consumers, they allow for some optimism in regard to medium-term prospects.

In line with the relatively good performance of employment in EMU, the moderation of households' real disposable income has been less sharp than in other decelerations. This has led to apathy in consumption, but we have not witnessed a fall in the area wide economy. The consumption slowdown in recent years can be explained by the evolution of its main determinants: disposable income and wealth (see Box: "Nothing "atypical" about consumption"). It is not necessary to resort to arguments about uncertainty, basically associated with the reform of the welfare state, to justify its relative lethargy. The prospects for an increase in financial wealth, in a positive environment for the economy and the stock markets, and the high level of real estate wealth in some countries in the region, constitute the third support for families, and for the prospects of a gradual reactivation of private consumption in the area, which could grow by 1.6% in 2005 and 2.4% in 2006.

[4] Available figures on hours worked suggest that this relatively better performance by employment could be due, in part, to the greater ease in adjusting via hours.
[5] This characteristic has led bodies such as the CEPR Business Cycle Dating Committee to not consider this period as a recession.
[6] The increase in job creation, especially non-listed, and agreements at specific companies to increase work hours in return for greater stability, resulting from the changes in the wage bargaining model and the pressure from outsourcing, are some examples.

No inflation problems

Against a backdrop of gradual cyclical recovery, inflation prospects for the region are looking very good. Inflation in 2005 and 2006 should remain clearly below 2% (at around 1.7%), helped by the almost total absence of demand pressures, the strong euro and the likely moderation in oil prices[7]. This latter factor is the greatest risk to the favourable inflation performance.

During the first few months of 2005, inflation has outperformed expectations mainly due to the deflationary force exercised by the strong euro and the effect of tax increases introduced in early 2004. This is clearly evidenced by core inflation, which dipped from 2.0% to 1.5% in the first two months of the year, while projections point to its holding steady throughout the year. On the other hand, general inflation has not performed so well (inching downwards from 2.4% to 2.1% in the same period). This is due to the unfavourable performance by oil prices. The latter remain as the main risk to the good prospects for future inflation, although its impact is partially mitigated by the strong euro. Projections, however, point to oil prices slowing down throughout the year. In any event, the effects on final consumer prices of increases in oil prices depend on the intensity use of oil in production and on the time frame of increases and their translation throughout the production chain. Thus, a 10% increase in oil prices is estimated to have an impact of 1.3% on import prices. These, in turn, lead to a 0.44% increase in production prices after a ten-month lag. Finally triggering a 0.2% increase in consumer prices in another ten months' time.

Furthermore, the absence of wage pressures and the anchorage of agents' expectations in line with the ECB's "official" target will mitigate possible inflationary tensions deriving from the likely recovery in European demand. Only monetary analysis casts doubts over the future of inflation, although the results are by no means conclusive[8]. The discrepancy in recent years between the growth of core money and core inflation do not necessarily indicate that there is underlying inflation that will eventually surface. The close relationship between these variables may have been broken, either because the monetary aggregate is no longer representative, following the structural changes that EMU supposed, because of the increase in risk-aversion or because the anchoring of inflation expectations is highly effective.

The ECB, in no hurry

The absence of inflationary pressures, in a context of relatively appreciated exchange rate, gives the ECB considerable scope to be "patient" in bringing interest rates into line with "neutrality". Continued downgrades in its growth projections, which have coincided with similar surprises in its inflation projections, will make it want to ensure that the cyclical recovery has truly taken hold before starting interest rates on an upward trend. All of this, in spite of concerns over excess liquidity, credit growth and asset inflation, factors which pose a more obvious risk in a context of a clear economic expansion. In fact, the discrepancy between the performances of these "risk" variables (house prices, credit growth, monetary aggregates) in different countries, compounds the difficulty of managing monetary policy, and favours a position of inaction by a decisively non-active central bank.

Consequently, the ECB will not raise the rate of interest until it has conclusive evidence of the cyclical recovery, which combined with the

[7] Traditional inflation models (Phillips curves, indicator models, etc.) offer very similar predictions, sometimes even lower. In addition to that, Health reform in the Netherlands in 2006 will have a statistical impact on prices which can be estimated to reduce area wide inflation in about 0.2 points.
[8] See: Inflation and core money growth in the euro area. M.J.M. Neuman C. Greiber. Discussion Paper Series 1: Studies of the Economic Research Centre No. 36/2004 Deutsche Bundesbank
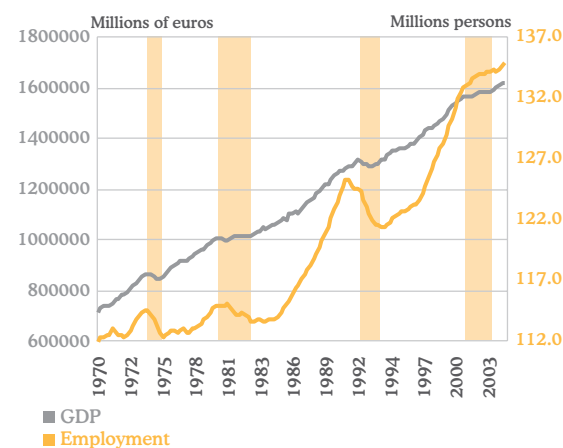
Chart 2.10.
Households Savings Rate
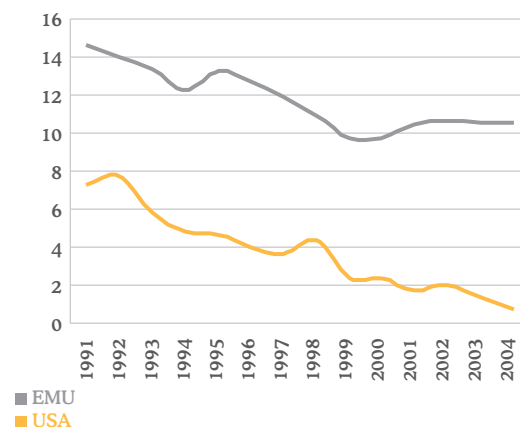
■ EMU
■ USA
Source:OECD

Chart 2.11.
EMU: GDP and Employment
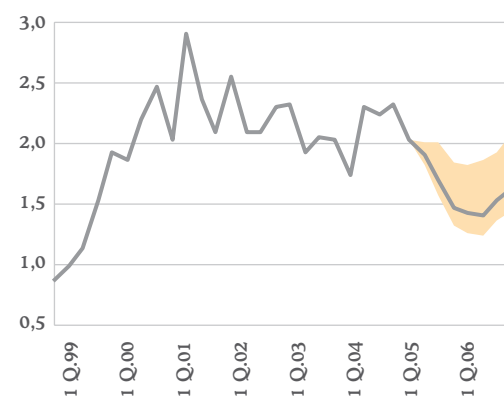

Millions of euros   Millions persons

■ GDP
■ Employment

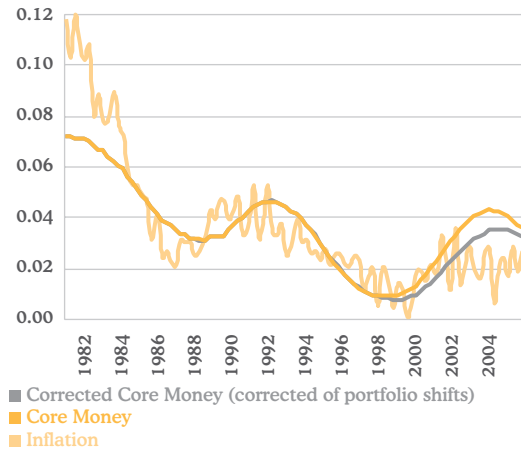* Shaded slowdown phases
Source: Eurostat and BBVA

Chart 2.12.
EMU: CPI and Forecasts*
YoY Growth

* Confidence bands shaded
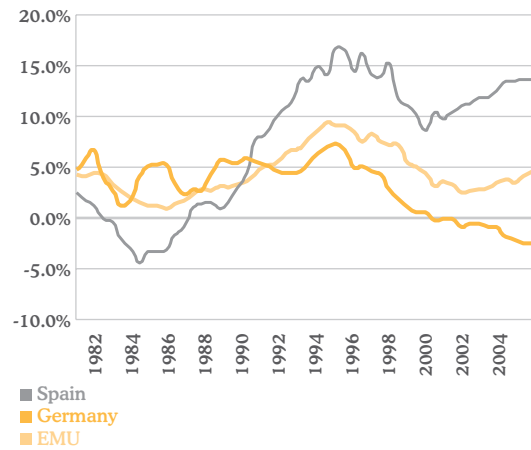Source: Eurostat and BBVA
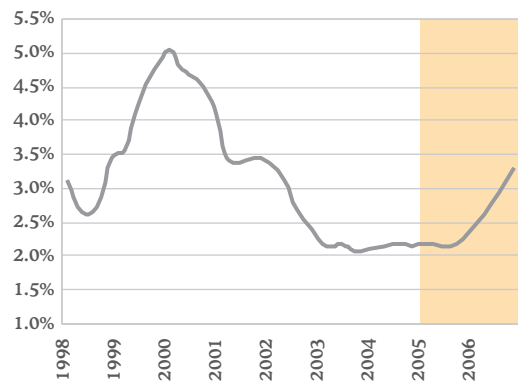
Chart 2.13.

EMU: Core Money and Inflation

Corrected Core Money (corrected of portfolio shifts)
Core Money
Inflation

Source: ECB, Eurostat and BBVA

Chart 2.14.

Bank Loans to Private Sector

YoY in Real Terms

Spain
Germany
EMU

Source: Bundesbank, Banco de España, ECB, Destatis, Eurostat and INE

Chart 2.15.

EMU: 3-Month Interest rate and forecasts according to a Monetary Rule

Source: ECB and BBVA

slow policy making process of the central bank, suggests that monetary tightening will not begin until 2006. It will then return to the discourse on the dangers of excess liquidity and asset inflation. The start of upward interest rate moves, which will bring rates closer to "neutrality", could be kicked off with a 50 bp hike, in light of the delay in getting it started. The process, however, will be gradual, until the official rate of 3.25% is reached by the end of 2006.

Under this scenario, the broadening of the spread in 10-year rates against the US should not be much greater than that already observed. This spread has already gone from levels of 20 base points on average in 2004 to 70 bps. in the first quarter of 2005. On occasion, it has even reached 90 bases points. This is a reflection of the increasing aggressivity expected in hiking rates in the US, linked to the perception that the balance of inflation risks has tilted somewhat to the upside and there have been some positive surprises in the growth of this economy in the first few months of this year. This situation contrasts with the doubts as to start of the tightening of interest rates in EMU. In spite of this, the discounted interest rate hikes for 2006 in forward contracts in the US are quite modest. As these expectations about rate hikes in the US rise, there is still margin for a further widening in the long-term spread between the US and the European bonds– although of a limited magnitude. It is likely that the spread will stabilize around 110-130 basis points levels. Furthermore, any additional delay in the starting of the tightening cycle in Europe would raise the 10-year rate spread against the US to the highs seen in 1999, between 130 and 160 basis points.

Some doubts still remain

The modest European cyclical recovery is not free of risks. On the one hand, an additional appreciation of the exchange rate, which would add to the accumulated appreciation of recent years, and/or the maintenance of oil prices at current levels, would slow the still incipient economic expansion. Furthermore, the abrupt adjustment of the imbalances in the global economy, or, particularly, those of the United States, would also undermine the recovery in activity in Europe. Were this to be the case, and in view of the low level of inflationary tensions, the ECB could hold official interest rates unchanged well beyond the beginning of 2006 and even consider the possibility of further cuts. In contrast, short rates in the US would increase faster and further than in our base scenario, as the financing of the dual deficits becomes increasingly more difficult. In this situation spreads in long-term rates would also widen.

As for the exchange rate, one of the major fears concerns the magnitude and timing of the impact that the accumulated appreciation of the euro could have on the area's external sector, in view of the weakness of the reactivation in internal demand. Both, the nominal exchange rate and the real one, export-price deflated, are at their highs since 1990. Furthermore, the adjustments in relative prices, which had partially compensated the slide in the nominal exchange rate, seem to have slowed since mid-2003. The steady decline in price-competitiveness, however, does not seem to have undermined the performance of European exports, which have maintained a significant dynamism in recent years. This has been possible due to the growth in global demand, to which European exports are relatively highly sensitive[9]. The prevalence in total exports of countries such as Germany, The Netherlands and Belgium, specialised in less price-competitive goods, would explain the relatively low sensitivity of European exports to the exchange rate (see Box: "German exports outside EMU, the demand is what matters"). Consequently, despite the relatively unfavourable

---

[9]The estimated elasticities reveal export growth to be in the very short run three times less sensible to exchange rate appreciations than to weaker market growth.

prospects in terms of the real effective exchange rate, the dynamism of international trade will allow exports to only slow slightly its pace of growth in 2005 and 2006, towards rates of around 5%. However, an additional appreciation in the exchange rate, placing it significantly above expectations for an extended period, would significantly erode the economy's export prospects. This, in turn could halt the recent investment drive by companies and undermine the confidence of economic agents as a whole.

With regards to oil prices, if they remain at current levels or increase further, it would impact on the European economy both directly (boosting production costs and inflation) and indirectly (undermining the dynamism of the world economy). It is true, though, that the appreciation of the euro helps mitigate the impact of oil price increases, and that the current shock is not comparable to that of the 70s and that European economies are now less oil dependent than in the past. Also, the demand nature of recent price hikes also mitigates their impact on global activity. Nevertheless, it is still a risk for the fragile European recovery.

The most important risk for maintaining the cyclical recovery in the euro zone lies in the performance of the global economy. The abrupt correction of imbalances in the US economy, current account and budget deficit, would lead to a sharp correction in the dollar, a loss of confidence in the US economy and sizeable interest rate hikes in order to finance the dual deficits, especially if inflationary tensions also emerge. This would lead to a sudden adjustment in activity in the US and a decline in worldwide growth. In a context of lower global growth, waning confidence and higher exchange rates, the projected cyclical expansion would be aborted. In this scenario, which would be deflationary for Europe, the ECB could even cut interest rates from current levels. In this case, we cannot rule out the prospect that 10-year rates in Europe remain stagnant at current levels, and that the spread vis-à-vis the US reach levels of over 200 base points – levels which have not been seen since the second half of the 80s.

Chart 2.16.
EMU: 10Y and 3M spreads vs US
(in basis points)

■ 10Y spread (right axis)
■ 3M spread
Source: Bloomberg and BBVA
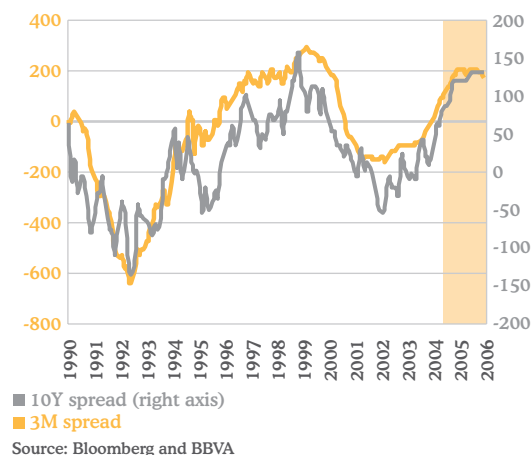
Chart 2.17.
EMU: Real Effective Exchange Rate deflated by export prices

Source: European Commission
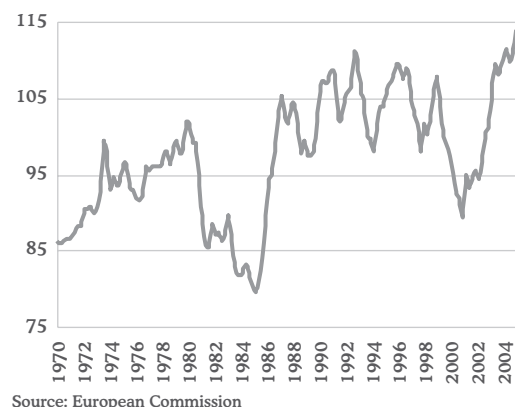
Chart 2.18.
EMU: Contributions to Real Exports Growth
YoY Growth

■ Exports
■ World GDP contribution
■ REER Contribution
Source: BCE and BBVA
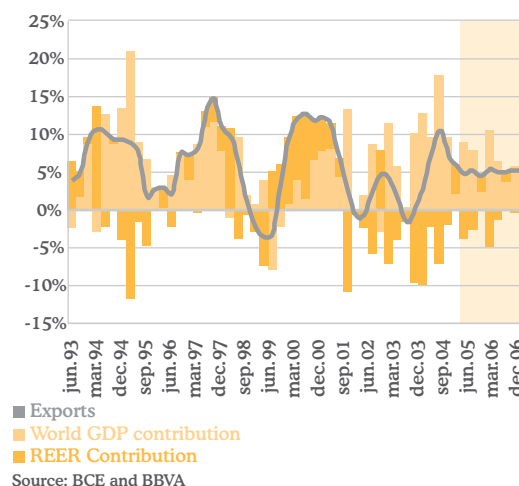
Will the euro continue to appreciate against the dollar?

Since it reached record lows in 2000, the euro has appreciated by almost 50% against the dollar. Although many currencies have gained against the dollar in the last three years, evidencing the uncertainty in regard to the sustainability of the US's historic current account deficit, this appreciation has been clearly asymmetrical: the euro is the currency which has most contributed to the dollar's depreciation in real effective terms. At the same time, growth in the European economy has disappointed in the period, so that the start of the upward cycle in interest rates, which is pending in many economies, is being continuously delayed in Europe. This situation widens spread between long rates in the US and Europe, generating a de-coupling between the two economies. This should take the upside pressure off the euro. In these conditions, the question is whether in the next two years the euro will continue to appreciate against the dollar, or whether it will enter a period of consolidation of the levels reached in recent years, or even whether it might lose ground against the US currency.

Analysis of the dollar-euro exchange rate is no simple task[1]. In fact, in recent years, the economic literature has attempted, using alternative focuses, to explain exchange rate performance. Conventional models are models of error correction which in the long term include a purchasing power parity condition corrected by the productivity spread. The dynamic tends to include, in addition to the lags in variations in long-term variables, other variables which seek to estimate the difference in returns between US and European assets, often calculated based on long term rate spreads. Precisely based on relative net asset return variables, Gourinchas and Rey (2005)[2], on finding evidence that a depreciation in the exchange rate impacts not only on the trade balance but also on the valuation of net foreign assets, conclude that a one standard deviation of the ratio of net exports to net foreign assets predicts an annualized 4% depreciation of the exchange rate over the next quarter. Using daily movements in the dollar-euro exchange rate, many authors have tried to estimate the impact of macroeconomic news or merger and acquisitions data[3].
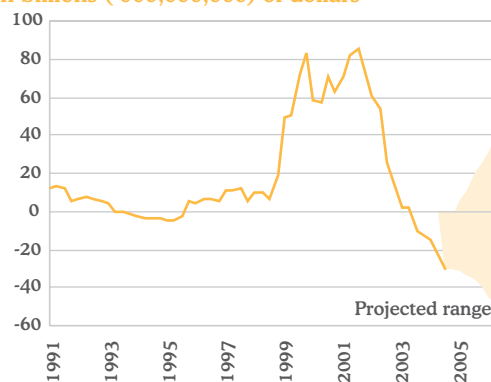
Others[4] have highlighted the non-linear and unstable relationship between fundamentals and the dollar-euro exchange rate, and they therefore propose models of "regime switching" in order to pinpoint which variables impact in each period on the exchange rate and to determine when the regime switch comes. In particular, the dollar's depreciation in the last three years has been explained by the predominance of the "paradigm of disequilibrium" vs. the "paradigm of productivity" which prevailed at the end of the nineties, when the dollar made significant gains.

Precisely in order to capture this changing relationship over time between fundamentals and the dollar-euro exchange rate, a methodology has been established. It combines a set of factors which affect the currency and their weightings, which, by changing these weightings, allows us to detect the prevailing paradigm in exchange rate behaviour. The factors which were identified in the dollar-euro performance have been grouped into three blocks. In fact, it is hard to admit that these three blocks considered are completely orthogonal, an assumption which nevertheless is used in a bid to simplify the analysis. These three blocks of variables are as follows. Firstly, a set of variables which, until the end of the nineties, were able to estimate dollar-euro performance and which are fundamentally price, productivity and interest rate differentials between the USA and EMU. Their relationship with the dollar-euro is established through an error correction model. The methodology allows various scenarios to be envisaged for these variables and for them to be aggregated into a single result using the probabilities of these scenarios.

Secondly, there are a set of variables based on the "paradigm of disequilibrium", which are largely variables relating to the current account deficit and to the way in which this deficit is financed, particularly the quality of the flows of funds between the USA and EMU. In this case, the results of two exercises are aggregated. On the one hand, an estimate is made of the maximum depreciation of the dollar in a context of absence of fiscal adjustment, and, therefore, adjustments to the current account. It is also assumed that this adjustment is passed on completely to the bilateral dollar-euro exchange rate, an assumption which could be relaxed if other currencies, such as the Chinese renmimbi, appreciated against the dollar. The alternative case is that the fiscal deficit be adjusted and that an additional appreciation of the dollar is not necessary on top of the one which has already taken place. Two scenarios are therefore obtained: fiscal adjustment and no fiscal adjustment. On the other hand, the relationship is estimated between the dollar-euro and the investment flows considered to be of higher quality, bilateral mergers and acquisitions between the USA and EMU. This allows projection of the expected performance of the exchange rate in various plausible scenarios for these M&A fund flows: specifically, the scenarios considered range from a bullish one for the dollar, with good quality flows and recovery in net M&A operations from Europe towards the US, to a more bearish one for the greenback in which net M&A fund flows from Europe to the US continue to be negative, although the pace of decumulation of these operations in recent years does slow (see chart 1). Finally, the results of these four scenarios (fiscal adjustment, no fiscal adjustment, good quality flows and poor quality flows) are added based on the probabilities afforded to each one.

---

[1]   In addition to the normal complications in modelling the exchange rate, there is the fact that it is necessary to use a synthetic rate for the euro for years prior to 1999. Similarly, the explanatory variables for EMU must be rebuilt before 1999, by aggregation for all 11 countries which initially joined the monetary area.

[2]   See Gourinchas P. O. and H. Rey (2005): "International financial adjustment", CEPR working paper No. 4923.

[3]   See, for example, Galati G. and C. Ho (2001): "Macroeconomic news and the euro/dollar exchange rate" BIS, working paper no. 105 or Fender I. and G. Galati (2001): "The impact of transatlantic M&A activity on the dollar/euro exchange rate" BIS, quarterly journal.

[4]   See Frömmel, M., R. MacDonald and L. Menkhoff (2003): "Do fundamentals matter for the D-mark-euro/dollar? A regime switching approach", working paper, Hanover University.

Chart 1

Net M&A flows between the USA and EMU

In billions ('000,000,000) of dollars

Source: Thomson Financial Securities and BBVA

Lastly, there is a set of variables which seek to factor in geopolitical risk, an uncertainty which has impacted considerably on the performance of the exchange rate in the first few years of this decade. In f#ıt, greater geopolitical risk has translated into a depreciation of the dollar against the euro. This risk is estimated based on the price of gold and the performance of US equity market. Again, two scenarios are built for geopolitical risk, which is either reduced or maintained at current levels, and they are added based on the estimated probabilities assigned to each one.

How will the dollar's performance in 2005 and 2006 be affected by the performance of each group of variables? The first set of variables, the macroeconomic variables which at the end of the nineties explained the dollar's behaviour, could shore up the US currency for two reasons. Firstly, because the dollar is currently undervalued with respect to its estimated long-term equilibrium level based on parity of purchase power corrected by productivity (this long-term level is at around 1.05, as shown in the chart). Secondly, because the possibility that the US will continue to increase its interest rates appears to be consolidating, at an even faster pace than was projected a few months ago, while there are increasing doubts as to the time when interest rates in the EMU will start their upward cycle. All of this would lead to a dollar-euro at levels of below 1.2 at 2006 year-end.

The second group of variables, current account deficit and its financing, suggest that the dollar will depreciate. The probability of a fiscal adjustment is minimum, and the most likely outcome is therefore that the dollar will continue to depreciate in the coming months. Furthermore, based on the recent performance by M&A fund flows, an increase in these operations in favour of the US looks unlikely. This leads to a scenario in which, with a 60% rate of probability (product of the absence of fiscal adjustment and low quality flows) the dollar would depreciate towards levels of close to 1.5 against the euro at 2006 year-end. There is a 35% of probability that it would depreciate somewhat less, to around 1.44, and just a 5% chance (fiscal adjustment and recovery of flows of good quality) that it would gain to around 1.25 (see table).

Regarding the third group of variables, which account for geopolitical risk, the latest events have increased the probability that this factor of uncertainty will wane. In the scenario of lower geopolitical risk, to which 80% probability is assigned, the dollar would appreciate to levels of 1.25 at 2006 year-end.
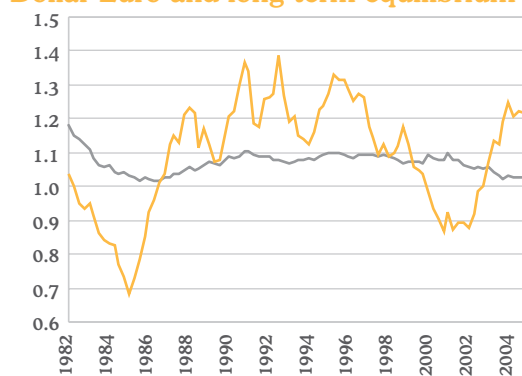
What weightings are given to these three groups of variables to obtain a projection for the coming quarters? In all cases a small weighting will be used for geopolitical risk (10%). The breakdown of probability between the other two groups of variables depends on which of the two, the productivity-price-interest rates trinomial or adjustment to the current account, will be the dominant ones in the coming months. In March 2005, the scales tipped in favour of the former, in view of the increase in the long-term interest rate differential between the USA and EMU. If this performance persists (50% weighting for productivity-prices-interest rates and 40% for the current account adjustment) the dollar-euro would trade at levels of 1.3 until 2006 year-end. However, it seems likely that fears of current account imbalances will reignite (increasing the probability of this variable to 70% at some point), which would lead the dollar to depreciate to 1.4 against the euro. This 1.3-1.4 range will be the projection for the dollar in 2006. This implies an average of 1.35 for the dollar-euro in 2006, not very far from the 1.32 in 2005.

There are two items which could slightly alter this scenario. The first is a revaluation of the Chinese renmimbi which could limit the downward pressure on the euro in the worst scenario for the current account (no fiscal adjustment and poor quality of flows). The second is a deterioration of EMU's economic situation which could lead to a greater weighing for the macroeconomic factors and lend less weighting to the US's unadjusted current account. In both cases the range for the dollar-euro in 2006 would be between 1.25 and 1.35. On average, the currency would post 1.29, not far from the 1.30 average for 2005.

In conclusion, significant further depreciation of the dollar against the euro is not expected for 2006.

Table 1
Dollar-euro forecasts for different drivers

| | | Dollar-euro projections | | | |
	Current	Dec-05	Jun-06	Dec-06	Probability
1. Productivity-prices -interest rates	1.30	1.24	1.19	1.16	
2. Current account balance Fiscal adjustment					
Flow quality: good	1.30	1.30	1.27	1.26	5%
Flow quality: poor		1.41	1.41	1.43	20%
No fiscal adjustment					
Flow quality: good		1.42	1.42	1.44	15%
Flow quality: poor		1.45	1.46	1.49	60%
3. Geopolitical risk					
Lower risk	1.30	1.30	1.27	1.25	80%
Same risk		1.35	1.33	1.33	20%

Source: BBVA

Table 2
Dollar-euro forecasts (weighted drivers)

| Weighting of factors | | | Scenarios for the dollar-euro | | | |
1. Productivity- price- interest rates	2. Current account	3. Geopolitical risk	Current	Dec-05	Jun-06	Dec-06
50%	40%	10%	1.30	1.33	1.31	1.30
35%	55%	10%		1.36	1.35	1.35
20%	70%	10%		1.39	1.39	1.40

Source: BBVA

Chart 2
Dollar-Euro and long-term equilibrium

Long-term equilibrium
Dollar-euro
Source: BBVA

Mayte Ledo
teresa.ledo@grupobbva.com

Analytical support for European recovery

Different types of indicators and structural forecasting models are used to monitor the European economy. These models help to configure a scenario of growth for the zone which is consistent with the outlook of the external variables (more exogenous).

In the short term, the ISA-BBVA[1] indicator is used [2]. Using the normal methodology for synthetic indicators, it considers partial indicators – satisfying certain recommendable features, such as lengh of the sample, economic significance, statistical quality, chronological consistency, monthly frequency or prompt availability of data – and chooses those which show a high degree of contemporary correlation with the growth cycle. The quarterly changes in the selected indicators[3] are standardised and added giving rise to a synthetic indicator whose quarterly changes are directly related to the quarterly changes in GDP.

Generally speaking, these indicators are very useful in the short term, because the swift availability of the information from the partial indicators makes it possible to anticipate changes in activity over the quarter, although the precision of the forecasts deteriorates as the horizon is extended.

The ISA-BBVA indicator suggests that growth in the first half of the year will be modest. Different versions of the indicator provide a range of quarterly growth in the first quarter of the year of (0.2-0.4).

Euro area: GDP Growth and ISA-BBVA forecasts. QoQ rates
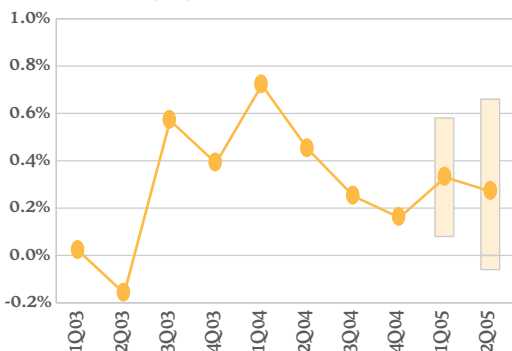
Source: Eurostat and BBVA

For medium term forecast, the BBVA-ARIES[4] model, a quarterly model with eleven variables based on the Bayesian Vector Auto-Regression methodology (BVAR), is used. This type of model, which has proved to be very competitive in forecasting exercises, combines the features of the VAR models (multi-variates which treat all variables as endogenous) with the incorporation of stochastic a priori information to resolve the problem of over-parameterisation. The idea is that the selected variables represent those which influence the economy of the EMU. They are divided into four groups. The external block includes a raw materials price index (CRB), an approximation to non-EMU GDP (OECD plus Argentina and Brazil), and the U.S. three month interest rate, which show, alternatively, shocks to commodity prices, global growth and financing conditions outside the EMU. The second monetary block includes the 3-month and 10-year interest rates in EMU, the exchange rate against the dollar and the M3 monetary aggregate. The third block would be the fiscal one, with a ratio of public deficit to GDP, while the fourth would contain key variables of internal prices and activity such as the GDP of the EMU, CPI and wages. For

purposes of optimisation, the criteria used is to minimize the combined forecasting errors of all variables.

The BBVA-Aries suggests that growth will pick up in the second half of the year, based on a very favourable raw material price profile and maintained dynamism world growth.

Euro area GDP growth and BBVA-Aries forecasts. YoY rates

Source: Eurostat and BBVA

Lastly, to ensure forecasts are consistent, a multi-equation structural model (MESM)[5] is used. It is based on the Area Wide Model (AWM) of the ECB and includes 15 behavioural equations. This model, in spite of its limitations (it is basically backward-looking, does not include credit channels, employs a somewhat doubtful concept of wealth) proves to be extremely useful in evaluating the consistency of forecasts, and in analysing the response to different shocks by means of simulation exercises. The equations may be divided into three blocks: a demand block, a supply block, and a monetary block. In the short term, GDP is shaped by demand, with standard equations for consumption, exports and imports, and investment - which is the result of the process of maximising profits in the supply block. In the long term, GDP is determined by employment, capital and technical progress. In the prices and wages sub-block, the wages are determined by a Phillips curve.

Given our assumptions as the evolution of the exogenous external variables, the MESM model confirms a picking-up of activity on the euro area fuelled by internal demand, particularly investment, with a slightly negative contribution of the external sector.

In short, different analytical instruments confirm the outlook for moderate growth during the first half of the year. Growth that will subsequently become more vigourous.

[5] See Article "Los efectos de una reducción de tipos de interés en la UEM", Situación global BBVA, March 2003

Euro area GDP and MESM*
YoY rates

*MESM: Multiecuational Structural model
Source: Eurostat, ECB and BBVA

---

[1] See box "Un indicador de actividad para la UEM: ISA-BBVA" in Situación Global BBVA, February 2001
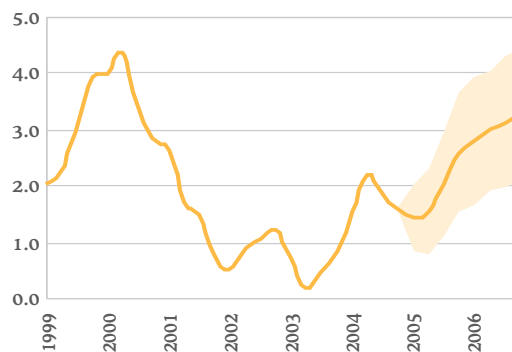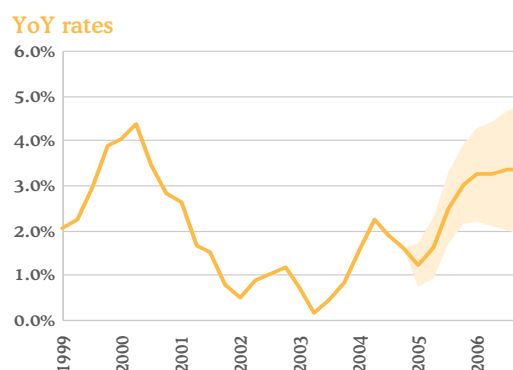[2] Analysis is completed with indicators of certain components of GDP.
[3] In this case, industrial confidence, industrial production and auto sales. An alternative model includes, additionally, the effective exchange rate.
[4] See Ballabriga and Castillo (2000): "Aries: un modelo de previsión y simulación para la economía de la UEM", BBVA working document, no. 1/00

Elena Nieto
enieto@grupobbva.com

Firms in "good shape"

In recent years, European companies have undertaken profound business restructuring, significantly reducing investment and, to a lesser extent, employment, and focusing in debt-restructuring. Therefore, their financial position have significantly improved which puts them in a rather favourable position to invest.
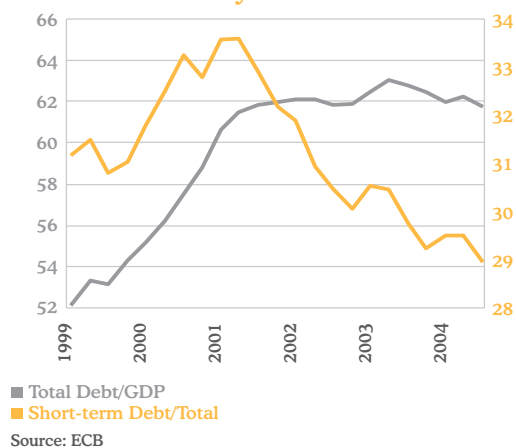
Between 2000 and 2003, in an environment of great uncertainty and a worldwide slowdown, investment in capital goods fell at a cumulative rate of 4.6% in the region as a whole. The adjustment in employment was smaller than during other slowdowns. Job creation was significantly reduced, but there was no job destruction in the region as a whole.

Apart from slower demand, European companies had to face growing difficulties in accessing funding, partly because of the high level of indebtedness they had attained. The correction on the stock markets not only increased companies' cost of capital but also pushed up their debt ratio in relation to their market value, while bank and corporate spreads widened as a result of the increased perception of credit risk. In this context, bank loans to non-financial corporations decelerated to around 3%, from above 10% in 2000, while the issuance of securities, and particularly shares, slowed considerably.

In this scenario, European non-financial companies channelled more resources into restoring their balance sheets (to the detriment of investment) and reduce their exposure to external financing. In this way, in the past few years, they have reduced the net acquisition of financial and non-financial assets, thus also reducing their borrowing requirement and boosting their internal financing ratio .

The process of financial restructuring has stabilized the debt to GDP ratio, which had soared in preceding years. Moreover, the stock market recovery and the increase in revenues have helped to correct the earlier deterioration of other debt measures, such as the debt to equity ratio or the debt to internal funds ratio. In addition, companies have lengthened the average maturity of their liabilities. The ratio of short-term debt to total debt have declined rapidly. The remaining incognita is when companies will put an end to the process

of restructuring their balance sheets and start investing, once the conditions for investing have improved substantially.
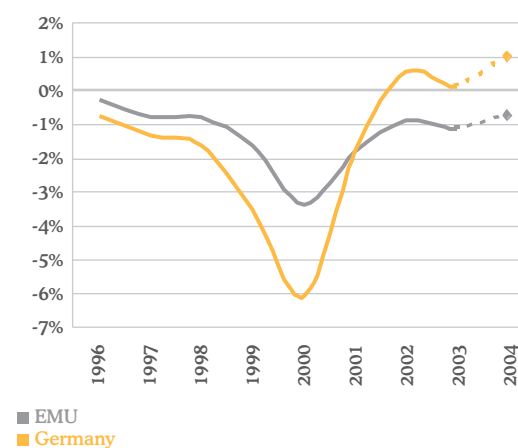
Germany, is the adjustment sufficient?

In Germany, where the cyclical slowdown was more acute, business adjustment was also more pronounced, both in equipment investment (with a cumulative reduction of over 11% between 2000 and 2003) and in employment (net reduction of 1.5% in the number of employed). The problems of access to fund were also greater, partly as a result of the difficulties the banking sector was going through.

In this context, the thorough restructuring of balance sheets effected by German companies in recent years is hardly surprising. This is reflected in the positive net lending position they have presented for two years running (probably three, as forecasts for 2004 shows), which is unusual in the sector of non-financial corporations. Behind this positive balance is net capital formation at its minimum levels since reunification. This, together with the significant moderation in the net acquisition of financial assets, is consistent as well with minimum levels of contracted net financial liabilities.

As in the rest of Europe, German companies' debt ratios have improved and the proportion of long-term debt in the total has increased. Moreover, the debt to GDP ratio has fallen. Although some doubts persist, it seems that the degree of credit restriction has also diminished considerably in Germany[1] , which leaves the reactivation of investment to the expectations of German entrepreneurs.

Non-financial corporations net lending
In % of GDP

EMU
Germany

Source: ECB, Bundesbank and BBVA projections based on European Commission data

Euro area: Non-financial corporations debt level and maturity structure

Total Debt/GDP
Short-term Debt/Total
Source: ECB

---

[1] Bank loans to companies in Germany are falling in real terms, but according to the Bank Lending Survey, this stems more from a problem of demand than from a restriction of supply (See Bundesbank (2005), February monthly bulletin).
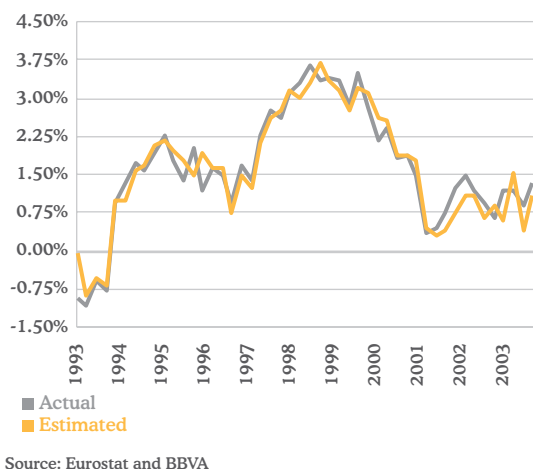
Elena Nieto
enieto@grupobbva.com

Nothing "atypical" about consumption

The weakness of private consumption in the EMU has generated a great amount of concern over the last year, to the extent that it has been a drag on the awaited European recovery. Its growth stood at a mere 1.0% in 2004, which stands in contrast to the increases above 3% reported in the US. The European aggregate, furthermore, hides the different evolution consumption has had within the euro area: from the Spanish, with "US-style" rates, to Germany, with negative increases. What's more, the growing divergence in GDP growth among the various European countries can be largely explained by the differences in private consumption performance.

In the face of this poor consumer performance, it has been postulated that there may be "exceptional" elements which are having a negative impact on consumption in some countries. Specifically, the uncertainty caused by the worsening state of government accounts and the doubts surrounding the sustainability of the public pension and health-care systems. This uncertainty, combined with the already unsteady nature of the recovery, could be causing families to increase their precautionary savings. In Germany, in particular, fear about the impact of the "Agenda 2010" reforms could be behind the increase in the rate of savings among families and their inclination towards low-risk financial assets.

However, we need not turn to theories of uncertainty in order to explain the performance of private consumption in EMU. As opposed to what other organisms have stated[1], its performance seems very much in line with that of its main fundamentals, that is, disposable income and wealth. Estimates from structural consumption functions[2] show no major deviations in recent years between the estimated and observed consumption paths, both for EMU as a whole and for the main countries (Germany, France, Italy and Spain). These tools enable us to assess the causes of the different performance levels of consumption within the area.

EMU: Private Consumption

Source: Eurostat and BBVA

The main determinant of private consumption is real disposable income. Over the last three years, in EMU, it has risen by around 1%, while displaying major differences across countries. In Germany, where private consumption is relatively more dependent on disposable income (it has a greater elasticity), this has been falling in annual rate until very recently – a reflection of the weak labour market. On the other hand, the dynamism of disposable income in Spain has led consumption to grow at rates above GDP.

Germany: Private Consumption and Real Disposable Income
YoY rate

Source: Destatis
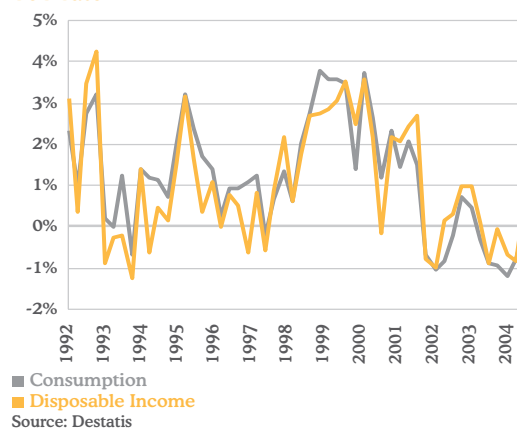
Real estate wealth has also evolved quite differently across the euro zone in recent years. In those countries in which it has performed most favourably (mainly Spain and, more recently, in France), it has sustained increases in overall wealth, driving private consumption. In Germany, where performance has proved unfavourable, real estate wealth would have contributed to the decline of overall wealth, reducing consumption[3].

The performance of financial wealth, on the other hand, has been similar throughout the area, in line with the integration of financial markets. The recovery of stock markets on a global scale, after the bursting of the technology bubble, should push financial wealth higher. As such it will go from being a hindrance to consumption to one of its growth drivers.

To sum up, estimates indicate that the poor performance of consumption in the euro zone in recent years is in line with the evolution of disposable income and wealth. The differing performances of these factors lie behind the different growth of consumption across countries. Fear about the impact of reforms does not seem to have played such a major role in the past. As for the future, the reform process should, in any case, aid the recovery in family spending, which should be propelled by the foreseeable boost in activity. We are already witnessing a rise in family incomes, and the recovery of the financial markets is spurring financial wealth. In Germany, in particular, it is expected that within a framework of gradual recovery, the imbalance in national income distribution that has been seen in recent quarters[4] should be partially corrected.

---

[1] European Commission (2004): "Quarterly Report on Euro area", Volume 3 Nº 1 and Bank of Spain (2004): "El consumo privado en la UEM (Private consumption in the EMU)", Boletín Económico July-August 2004.

[2] Defined in terms of error correction mechanism in which consumption is determined, in the long term, by the real gross disposible income of households and wealth.

[3] Although, in Germany, the coefficient associated with real estate wealth is not significantly different from zero.

[4] Virtually zero increases in employee compensation vs. increases of around 5% of gross operating surplus.

José Félix Izquierdo
jfelix.izquierd@grupobbva.com

# German exports outside EMU, the demand is what matters

German exports, more dependent on demand than on prices

Throughout the year, many voices have been raised to warn of the risk that the appreciation of the euro could involve for German exports and, thus, making the incipient, albeit not yet clear, German economic upturn event more difficult. However, recent export performance, supported by buoyant demand worldwide, raises doubts about whether or not the impact will be so significant.

To support this idea, an error correction model was estimated for Germany's extra-EMU exports[1] . The estimation reveals their positive sensitivity to non-EMU GDP and their negative[2] sensitivity to the real effective exchange rate (REER). The decomposition of export growth, according to the estimated function, shows how the effect of GDP growth has predominated over the effect of the real exchange rate on exports.

In fact, on the basis of the estimated model, a 1% decrease in extra-EMU GDP growth would reduce German exports by 1.7%. Moreover, 1% appreciation of the REER would reduce export growth by -0.6%. However, these exercises are not strictly comparable, since extra-EMU GDP growth and the REER have different volatilities. If they are corrected for volatility, these differences remain (although they are reduced). The impact on exports of 1 standard deviation *shocks* to the GDP and the REER is of -2.8% and -2.0% respectively.

Contributions exports growth
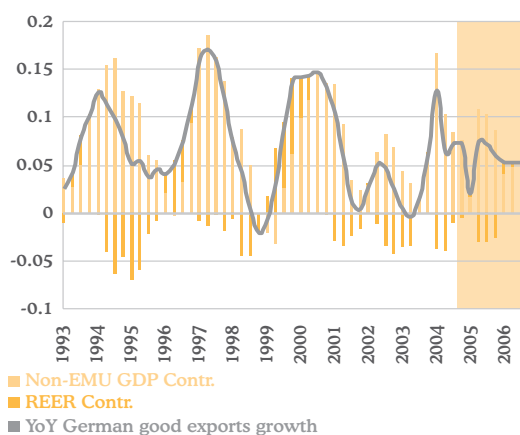
Source: Destatis and BBVA

In the light of these estimates, the concern aroused by the recent appreciation of the euro should be put into perspective, considering the favourable performance of the global environment. As can be observed in the chart, the growth of activity outside the euro zone has amply offset the impact of the appreciation of the exchange rate. This might be explained by the fact that over 60% of German exports consist of goods with a large technological component (motors,

machinery, construction, etc.), with low competition from substitutes and, thus, less susceptible to price competition. The nature of this products could contribute to a reduce the sensitivity of German exports to an exchange rate appreciation, at least when comparing them to the exports of other countries more exposed to price-competition from emerging economies, like Italy for instance.

In addition, the German economy has been making great efforts to become more competitive, as the fall of unit labour costs since 2001 reflects.

Unit Labour Costs
(YoY growth)
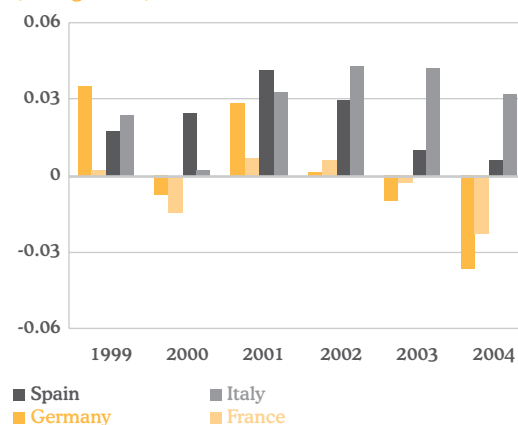
Source: European Commission

Looking forward, the ongoing buoyancy of global demand could be a driver for German exports, offsetting the cumulative deterioration of the exchange rate. Thus, although they will probably increase more slowly than in 2004, German exports outside the EMU are likely to continue being fairly dynamic, with growth rates of 5% in 2005 and 6% in 2006[3] in our central scenario. In more extreme cases, in which Germany's export markets outside EMU grew around 3%[4] on average for the next two years or the REER would experience a very significant appreciation (of over 7% in that period), exports outside EMU would grow by 3.5% and 2.5% respectively in 2005 and 2006.

Germany: Exports, WORLD GDP ex-EMU and REER
Annual growth rates

Year	GDP ex-EMU		REER		Exports		
	Base	Alt 1	Base	Alt 2	Base	Alt 1	Alt 2
2002	3.4%		3.7%		3.3%		
2003	4.5%		7.3%		1.0%		
2004	5.3%		2.2%		8.1%		
2005	4.4%	3.1%	2.1%	7.2%	4.9%	3.0%	2.9%
2006	3.7%	2.4%	1.5%	5.7%	5.8%	3.7%	2.2%

Alt #: alternative scenario
Source: BBVA

---

[1] The entire analysis refers to the export of goods. Export of services have not been considered.

[2] In the long term, the sensitivity of exports to GDP and the REER is 1.53 and -0.52 respectively. These elasticities are similar in the short term.
[3] Which will mean that total exports (including intra-EMU exports) would grow by just over 4.0% in the same period.
[4] Historical average (3.7%).

Gonzalo Cadenas
santiago.gonzalo@grupobbva.com

3. Europe's Policy-Making, a Matter of Risk-Taking

José Luis Escrivá
Elena Nieto

BBVA Economic Research Department

The global economy has experienced a surge of strong dynamism in the last couple of years, leaving behind the recession of 2001-2002. This expansion, however, has not been synchronous across major economies. On the one hand, the US, China and other emerging economies have been the drivers of this newfound drive. On the other hand, Japan seems to be having trouble coming out of their "lost decade". In between these two experiences lies Europe. Europe has alternated spurs of strong growth, such as that experienced in the first half of 2004, with deceptions in sustaining the economic expansion. The asynchronous expansion, combined with the mildness of the last recession, has led to the emergence of some imbalances in the world economy. Nowhere else are these more present than in the US, as its economy keeps expanding at a quite dynamic rate in the presence of a significant public deficit and a seemingly ever-increasing current account deficit, which is mainly financed by emerging economies. However, in spite of the large dual deficits, long-term rates remain modest, so far.

A healthy resolution of these imbalances would require new and maintained dynamism in those economies that, so far, have not contributed to the recent expansion. In particular, strong growth in the European Monetary Union. In this article we will try to convey the view that, unfortunately, this is unlikely to happen. At least to the extent needed for it to become an important factor contributing to the correction of the global imbalances built up over the last few years. Although the European economy may undergo a cyclical recovery, its dynamism will be more a consequence of the sustained expansion of the global economy than the driver of economic activity at the world scale. Additionally, the risks are tilted towards economic activity in Europe remaining sluggish rather than surprising us on the upside.

The reason for this prospect is basically twofold. Firstly, because the problems underlying the poor performance of the euro area are so deep that any measures aiming at overcoming them, were they to be implemented, would only have a significant impact over the medium-to-long term. And secondly, because a distinguishing feature of European policy making is its risk-aversion, as opposed to the characteristic risk-taking of the US. And this risk-aversion leads to both lack of action in addressing structural problems and lack of activism in the conduct of demand policies, both fiscal and monetary.

Structural issues are well-known

The first of these two dimensions, the structural problems of the European economies are well known and widely discussed. There is overwhelming evidence produced by multilateral organisations, the European Commission and various think tanks showing the structural nature underlying the persistently low economic growth in the euro area. Hence, we will touch on this issue only tangentially and we will concentrate on the second dimension, the dilemma of policies aiming to stabilise the business cycle in the euro area. Let us just emphasize that the nature of the structural problems in Europe is not new. The

Chart 3.1.
Euro area GDP

- Annual Growth
- Trend Growth
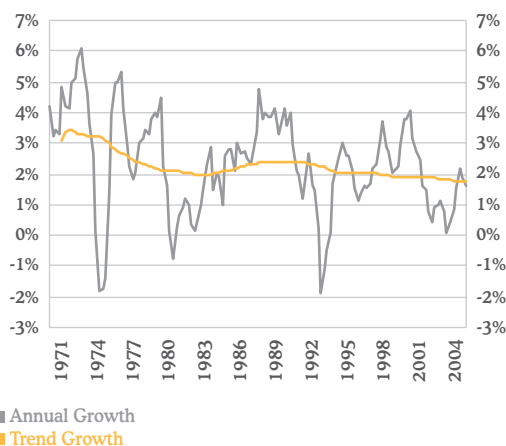
Source: ECB, Eurostat and BBVA

declining growth trend in the euro area economy is a secular one that can be traced back to the seventies. Such a pattern can only result from factors which are deeply rooted into the supply side of the economy. At present, the trend growth in the European Monetary Union (EMU) is not higher than 2%, which implies a gap with the US trend growth level close to one-and-a-half percentage points.

When comparing the US and euro area economies, differences in productivity trends are frequently mentioned. It is true that since the mid-nineties productivity gains have been larger in the US. But when we take some perspective and break down the relative income per capita between the two regions into two factors, the labour productivity and the intensity in the use of labour, the failure of Europe to catch-up with the US level of income can be explained by the ability of the US economy to consistently generate more jobs and work more hours relative to population. Actually, the productivity gap in levels between the two economies is very narrow, while it is substantial, and growing over time, in terms of the intensity in the use of labour. Some authors, namely Olivier Blanchard, have pointed to the Europeans preference for leisure to explain this trend. A different explanation, posited by the Nobel laureate Edward Prescott, points to the differences in the taxation of labour. A third view identify in the rigidities in the European labour, goods and service markets the reason for the discrepancy. Most likely, there is a little of the three explanations behind the differing working habits of Europeans. Although, looking at the high unemployment rates in most European economies, the latter two seem more accurate. In particular, the rigidities and lack of ample competition in the products and factors markets in Europe clearly inhibit both the dynamism of the labour force and the advancements in productivity. The reforms aimed at liberalizing and adding flexibility to the productive structure are still too few and scarcely implemented. For example, fourteen years after the "de iure" creation of the European single market, such a market for many services only exists on paper.

Demand policies in Europe and risk-aversion

While the supply-side dimension of low economic growth seems to be well established, the management of demand policy during this period of insufficient demand may also be responsible for the inability of Europe to sustain a prolonged economic expansion. The existence of insufficient demand of a more transitory nature cannot be ruled out. In fact, euro area economy cyclical indicators, such as output gap estimates, show a rather subdued situation. Five years after the start of the cyclical downturn, we still do not see a confirmation of a pick-up in activity. Ascertaining the cyclical position of any economy is particularly challenging. This all the more so in the case of the euro area, as the degree of insufficient demand varies significantly across countries.

Better that any other single factor, the way of dealing with uncertainty discriminates the risk-taking policy makers, who stand ready to address the worst case scenarios at the expense of incurring certain costs, from the risk averse ones, who may end up as prisoners of a "zero mistake syndrome" as they wait for all the information to become available. In the euro area, in dealing with the uncertainty surrounding the cyclical stance of the economy and the extent of the cyclical downturn, we are unlikely to find strong-minded policies geared towards testing the responsiveness of demand and, therefore, the

Chart 3.2.
GDP per capita euro area vs US (US=100)

■ Productivity contribution ■ Labour intensity*
■ Labour intensity* contribution ■ Productivity per hour

* hours worked per capita
Source: Groningen and BBVA
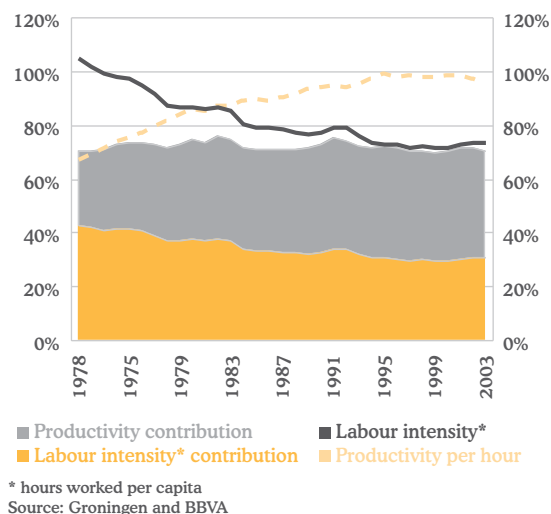
Chart 3.3.
Euro area output gap

Source: Eurostat and BBVA
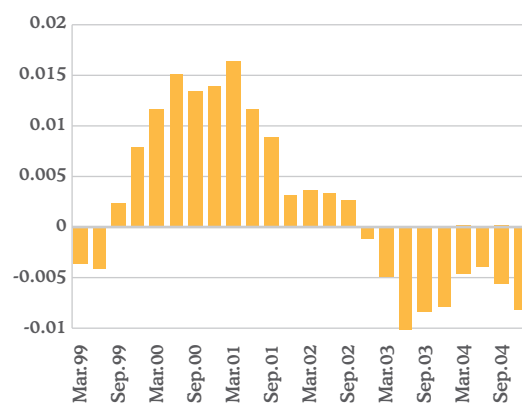
Chart 3.4.
Cyclicality of fiscal policy
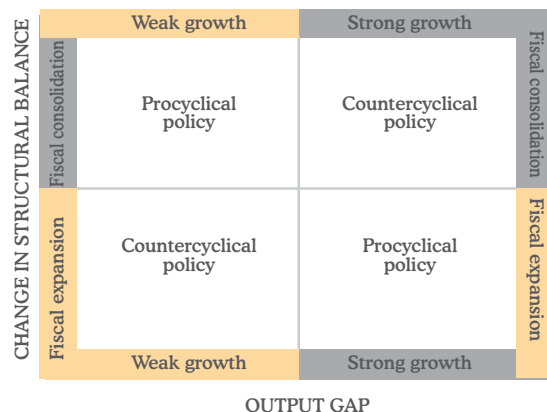
Source: BBVA

Chart 3.5.
Cyclicality of fiscal policy in the US
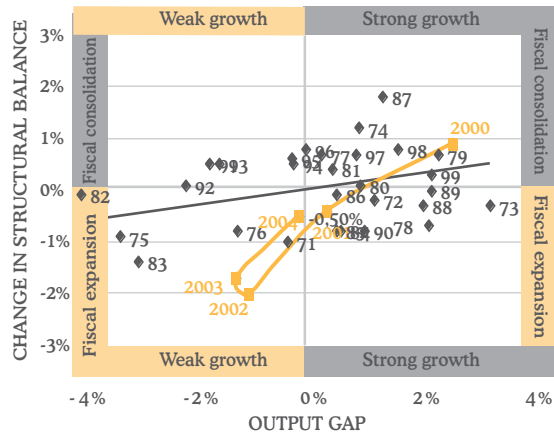
Source: BBVA

Chart 3.6.
Cyclicality of fiscal policy in the EMU
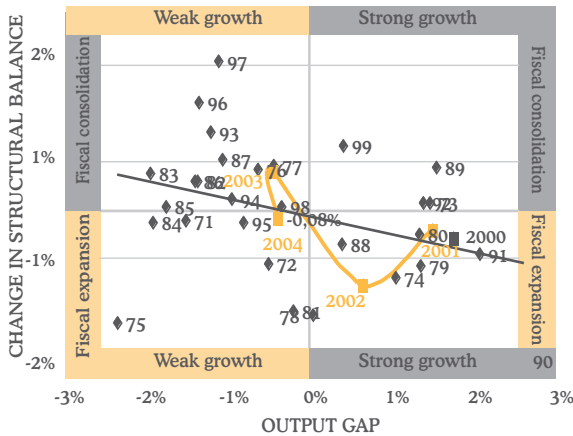
Source: BBVA

Table 3.1.
Decomposition of Public Expenditures

	"Compromised"	Discretionary margin
Germany	86%	14%
France	84%	16%
Spain	82%	18%
US	70%	30%

Source: BBVA on National Sources

limits of growth. It is true that the margin for manoeuvre for looser monetary and fiscal policy is, at present, narrow. But beyond the current juncture, and assessing policy actions over the last few years, risk-aversion has given rise over time to policy frameworks which are ill-designed to operate in a counter-cyclical manner. Additionally, the medium term orientation of demand policy, balancing the budget and the anchorage of inflation expectations, restricts its options, relinquishing more aggressive strategies of cyclical stabilisation.

Let us examine in some more detail the extent to which demand policies respond to business cycle fluctuations. This can be undertaken by representing a measure of the policy instrument, impulses in the structural balance of the budget for fiscal policy and changes in real interest rates for monetary policy, against the output gap. Specifically, in the case of fiscal policy, we plot the output gap against the changes in the structural balance of the budget, as a measure of fiscal stance. Positive values of the output gap are indicative of a strong cyclical growth, while the negative ones show weak growth. Positive changes in the structural balance reflect a tightening of fiscal policy, while negative values show an expansion of fiscal policy. A positive correlation between these two variables would be a signal of counter-cyclical policy: tight in expansions and loose in periods of economic contraction. When this chart is plotted for the US for the last thirty five years - each point representing one year- the picture that emerges is one of counter-cyclical fiscal policy, even more acute in the more recent period (shown by the marked lined in the graph). In the euro zone the picture is quite different. Even some pro-cyclical patterns seems to emerge: in periods of buoyancy the fiscal stance in the euro area tends to be looser than in periods of weak growth. Hence, there is no contribution of the fiscal policy to stabilizing the cycle. In this respect, it is worth noting that the massive breaching of the Stability and Growth Pact over the last few years has not been associated with more discretionary expenditure. It seems to mirror, however, structural fiscal problems. This contrasting pattern between the US and Europe can be explained by the share of total expenditure that can be used by the government for discretionary purposes: while in the US 30% of public expenditure is discretionary and can mobilized for stabilisation purposes, in the euro area only half of that is available. In Europe expenditures tend to become entrenched over time.

With regard to the monetary policy stance, the degree of response to cyclical fluctuations can be illustrated in the same manner. The output gap is plotted against changes in the real interest rate, as a measure of monetary policy. Over the last thirty five years, for the US, there is a clear positive correlation, indicative of a strong counter cyclical monetary policy. When the more recent period is examined specifically, it can be observed that the response of monetary policy to the economic fluctuations has been even more aggressive than in the past. When this exercise is repeated for Europe, response of monetary policy to the business cycle is clearly less aggressive than in the US, particularly in the latter period.

The medium-term orientation of the European Central Bank (ECB) monetary policy is well-known. The ECB has defended its lack of activism relying, *inter alia*, on the long-term nature of the relationship between money and prices. Even if accepting the rationale for that, there are elements in its monetary policy strategy which may unnecessarily constrain the ECB's decision making. An example of

these are the various definitions for price stability which the ECB has been using since it was created in 1999. But there are also institutional elements at work. First, the size of ECB Governing Council and the reliance on consensus-building for policy making creates a bias towards changes in interest rates which tend to be "too little, too late". Second, the ECB is extremely cautious in trying to affect market expectations through a more active communication policy (the expectations channel). And, in doing that, it renounces to the possibility of making a greater impact on the economy through its actions. An third, the available evidence on the monetary policy transmission mechanism in the area shows that, compared to the short term interest rates under the full control of the central bank, the exchange rate and longer-term interest rates are more powerful and rapid channels whereby monetary policy can affect economic developments. Concerning the exchange rate, the comparison between the contribution of exchange rates to growth and the output gap in the US and the euro area show that while in the US exchange rate fluctuations have worked to stabilize the cycle, the opposite is true in Europe, where "benign neglect" does not seem to pay off, as the exchange rate has worked to exacerbate cyclical fluctuations. By refusing to use the communication channel and, consequently, the expectations channel actively the ECB limits the ways in which it can affect the economy.

Conclusions

So far, we have argued that the risk-aversion attitude of the European policy makers is contributing to the sluggishness of the euro economy and its inability to contribute to correcting existing global imbalances. Risk-aversion, however, is not necessarily an undesirable feature. It produces smoother outcomes and generates more certainty about future developments. This notwithstanding, under the current circumstances, Europe needs more risk taking in policy making: more forward-looking attitudes and decisiveness. On structural policies, risk taking is needed to confront the vested interests benefiting from uncompetitive situations which give rise to resistance to reforms. It is also important to explain to people that certain elements of the so-called European social model may prove unsustainable over time. On demand policies, frameworks need to provide for more flexibility. Within a context where inflationary pressures seem to be muted and inflation expectations are well anchored at low levels, embarking on somewhat more active policies to stabilise output fluctuations certainly entails some risks, but these might be worth taking.

Recent developments, however, do not point in this direction. On the structural front, the slow advance in implementing the Lisbon Agenda or the probably successful attempts at watering down the European Directive on services are not exactly examples of decisive actions to push forward badly needed reforms. On monetary policy, the reconsideration of the ECB monetary strategy in 2003 ended up with practically no changes in a framework unduly rigid and *which creates* frequent communication problems. On the exchange rate, the European stance regarding the euro, which is clearly overvalued vis-à-vis the dollar, has been rather lukewarm. The benign neglect stance certainly does not pay off. And finally, on fiscal policy, the reform of the Stability and Growth Pact, after years of being *de facto* inoperative, is clearly disappointing. By learning from an unsuccessful experience, the outcome should have been a set of rules which would combine flexibility and enforceability. Instead, we are confronted with a

Chart 3.7.
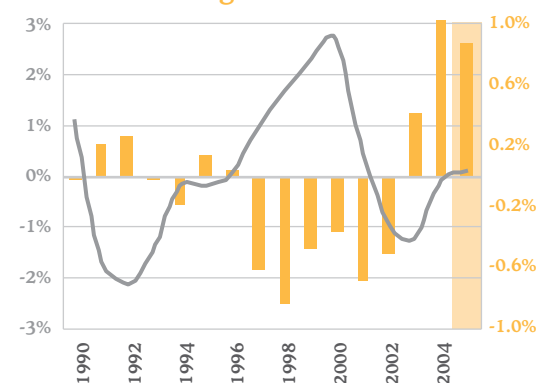**Cyclicality of monetary policy in US**
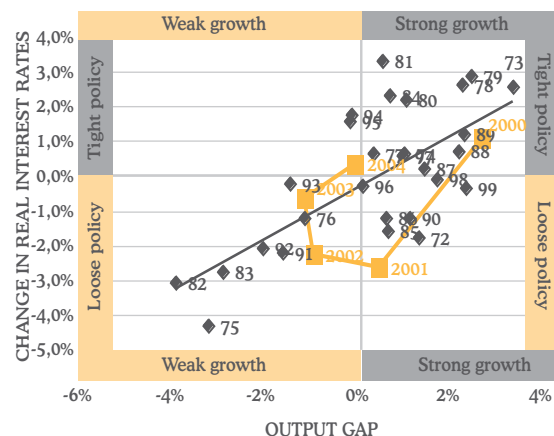
Source: BBVA

Chart 3.8.
**Cyclicality of monetary policy in EMU**
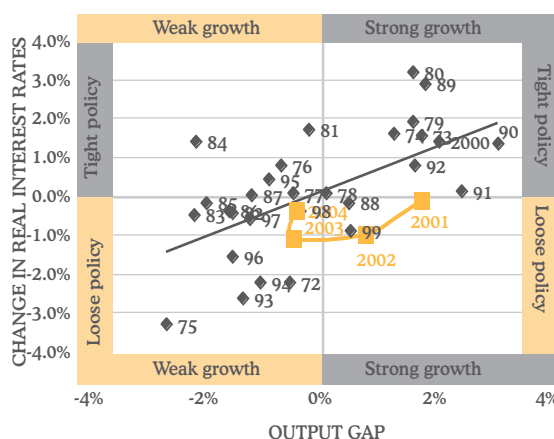
*Core inflation is approximated by a kalman filter estimation
Source: BBVA

Chart 3.9.
US: output-gap and exchange rate contribution to growth

■ Output-gap
■ REER contribution to growth
*REER: Real Effective Exchange Rate
Source: BEA, Federal Reserve and BBVA

Chart 3.10.

Euro area: output-gap and exchange rate contribution to growth

■ Output-gap
■ REER contribution to growth
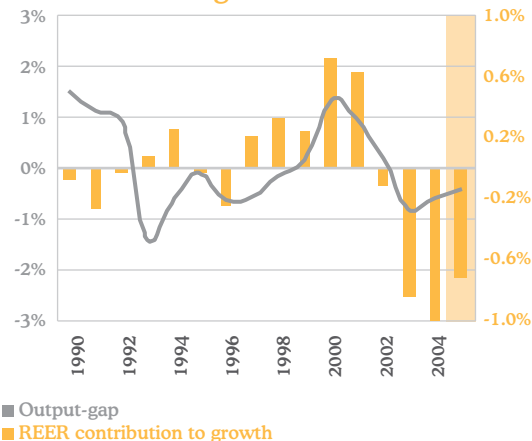
*REER: Real Effective Exchange Rate
Source: BEA, Federal Reserve and BBVA

Table 3.2

	US	EMU	
Structural policies	Medium term policy	Not implemented	→ Lower potenial
Demand policies	Counter-cyclical short-term policy	Predominance of medium term objetives	→
			Less active policies
Policy-making strategies	Risk-taking	Risk-aversion	→

Source: BBVA

framework whose main feature seems to be the use of discretion in tampering with the nature of the Pact itself.

In sum, on the one hand, the institutional restrictions to the implementation of structural reforms limit the growth potential of the European economy. On the other hand, the risk-aversion of policy makers and the medium term orientation of demand policies lead to lower activism in policy making. The combination of these factors translate to a European economy which is unlikely to contribute to correcting existing global imbalances or to experience strong dynamism in a sustainable manner. In spite of all this, there is some room for hope in the long run. In the course of the past twenty years, Europe has shown that it can embark and succeed in large scale projects which have reshaped the continent. Among these, the single market, the making of the monetary union or the enlargement process. These were major risk taking initiatives, although originated primarily in the political field. Let's hope that in twenty years time we can say the same about reforms of a purely economic nature.

4. Turkey: Anchored Stability

Manuel Balmaseda
Miguel Cardoso

Economic Research Department

Last December, the members of the European Union (EU) announced the beginning of negotiations with Turkey (scheduled for next October), geared towards it becoming a full member of the Union. The negotiations come as a reward for the reforms implemented over the last few years which helped the country to achieve the goal it had pursued for a long time: to be considered European, or so they thought. The Turkish road towards full partnership with the EU is still a long one and plenty of obstacles remain ahead (as the country is currently finding out). The fact that we now have a date to begin the discussions does not imply that the goal has been accomplished. In this regard, we can expect a lot of up and downs from here till everything is said and done.

The goal of this article is to give a very brief introduction to the dramatic transformation experienced by the Turkish economy and to underline some of the main economic issues that still have to be addressed. In this sense, the Turkish outlook has changed dramatically: from an economy that used to suffer persistent and recurrent crises, to one that is currently dealing with huge capital inflows, impressive economic growth and enviable future perspectives. Nonetheless, there are some kinks in this knight's armor that could become important in the years to come. Our main conclusion, however, is that as long as EU membership remains likely, the Turks will keep reforming their country and sustaining a process that has brought continuous success and long awaited stability.

A "still" emerging economy ...

There's no denying that Turkey is quite different from the rest of Europe. For example, when we look at GDP per capita figures, Turkish wealth stands at around 30% of the level observed within the EU-25. A person born in eastern Anatolia is likely to live 10 years less than a person in the French Alps and infant mortality is almost eight times more likely in an Istanbul hospital than in a Madrid sanatorium. Moreover, corruption, rule of law, human rights and government regulation are all very sensitive subjects in which the Turkish have a lot to improve upon.

However, although we can say, without a doubt, that standards of living are lower in Turkey than in Western Europe, they are not significantly different from those of the Central and Eastern European countries recently admitted into the union, such as Poland. The same is true for the levels of corruption, rule of law, institutional health, etc. In essence, it cannot be forgotten that we are still talking about an emerging economy, and hence, it is unfair to compare it with the developed economies of Western Europe.

... with a "boom-bust" history

Turkey's economic history resembles a lot what we have observed in other emerging countries: an import substitution strategy during the 1950s and through the 1970s, with a repressed financial system and a great deal of government intervention that yielded high GDP per capita growth rates (3,4% annually), but that consistently generated huge trade deficits and high levels of foreign indebtedness. As a result, the system came to an end with a debt crisis in the late 1970s. After that, throughout the 1980s a reform agenda was implemented aimed at liberalizing trade, privatizing public firms and promoting economic freedom. The success of these policies was particularly remarkable, and was reflected in high GDP growth rates throughout the decade. In particular, from 1984 and until 1993 the economy expanded at an annual rate of 5,3%, which translated to an annual increase of 3,1% in GDP per capita.

Chart 4.1.
GDP per Capita in 2003
(Current USD)
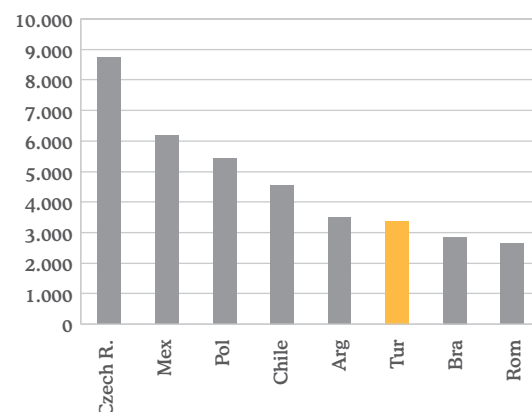
Source: IIF

Chart 4.2.
Infant Mortality in 2000
(per 1.000 births)
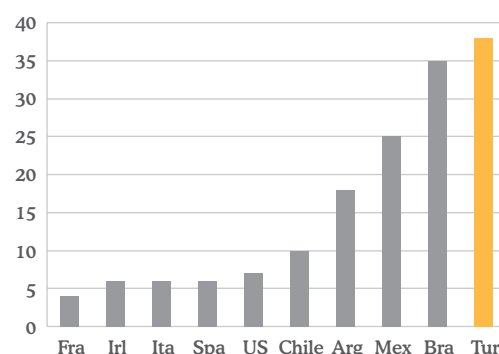
Source: World Bank's World Development

Chart 4.3.
GDP per Capita in Turkey
(1960=100)

Source: AMECO

Chart 4.4.
Inflation rate in Turkey
(annual percentage change in CPI)

Source: Central Bank of Turkey

Chart 4.5.
Real Effective Exchange Rate in Turkey
(1995=100 - Increase=Appreciation)

Source: Central Bank of Turkey

Chart 4.6.
Economic Activity in Turkey
(annual percentage change)

Source: AMECO

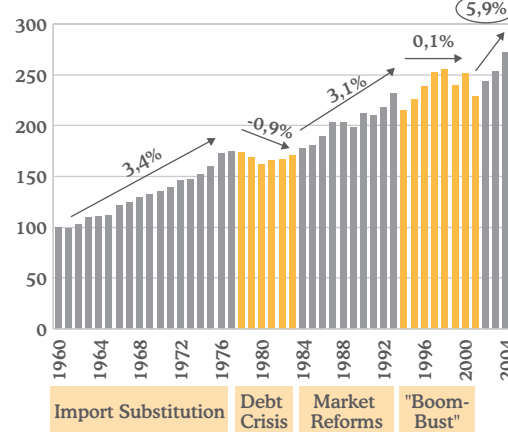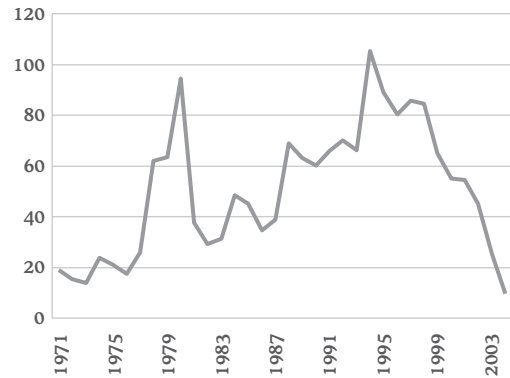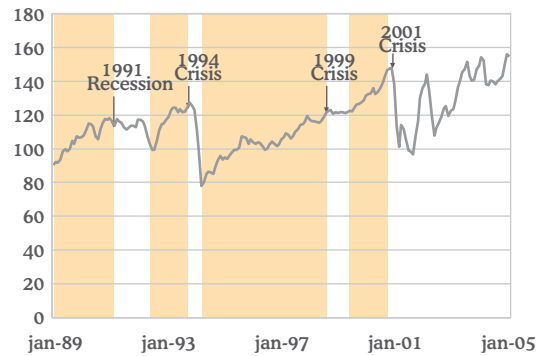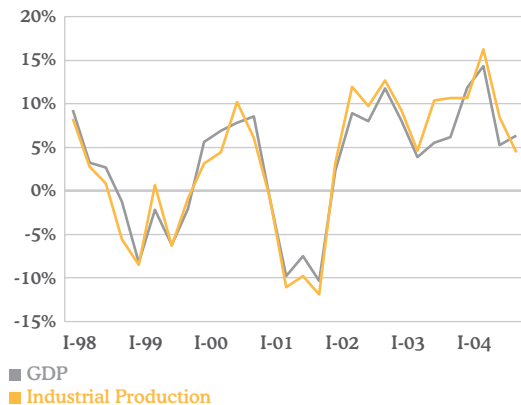Political stability during this period was key in explaining the high growth since it allowed for the implementation of the reform agenda. This is important to mention because in Turkey, government strength and economic success seem to go hand-in-hand. Hence, when political stability came to an end in the late 1980s so did Turkey's economic accomplishments. Specifically, from 1989 and until 2003, there were 12 different government coalitions in power (most of them quite weak), while on average each of these lasted less than a year and a half. This political uncertainty had a tremendous impact on economic activity, but its most visible consequence was the inability to rein in inflation. As governments passed, fiscal and monetary discipline weakened, keeping inflation at levels close to 60% per year. In this context, in order to control the inflationary pressures, Turkish administrators decided to pursue fixed (or close to fixed) exchange rate regimes. The lack of fiscal and monetary discipline, however, led to recurrent episodes of overvaluation of the lira and repeated periods of current account deficits. As a result, high indebtedness and balance of payments crises developed in 1994, 1999 and 2001 as major recessions were experienced (close to a 10% GDP reduction in each of those cases). These "boom-bust" cycles made for the stagnation of Turkish GDP per capita between 1994 and 2001.

This time seems to be for real …

After the 2001 crisis, things appear to have changed quite radically. The 2002 elections brought back political stability, as the Justice and Development Party (AKP) won an absolute majority in parliament. There were some doubts about what to expect from a newly formed movement with suspected ties to the far Islamic right. Nonetheless, the AKP and its leader, a former Istanbul mayor, Recep Tayyip Erdogan, are showing that their inexperience can be compensated by their pragmatism, as they are using their political leverage to begin a process of reform that is still underway. With the newly gained political stability came, once again, economic success. Turkey's performance over the last few years has been impressive: the real percentage increase in GDP was 8,9% in 2004, marking a feat of twelve quarters with positive growth (unseen since the 1980s).

But what has become more important is that the changes this time around seem to be of a structural nature. This has improved the economy's chances of achieving consistently high growth rates, rising potential growth to around 5% per year (see Box on potential growth).

This relatively optimistic view of Turkey's future is founded on the combination of political and economic stability. On the one hand the above mentioned political stability has provided much needed direction to the Turkish economy. In particular, the AKP majority has been able to pass reforms regarding such diverse issues as women's rights, the death penalty, and freedom of the press, speech and association. Since taking over, Mr. Erdogan has placed the goal of European membership at the forefront of the government's agenda and in that regard, the past two years have seen more reforms than the previous 20.

On the other hand, the perspectives for economic stability are anchored, not only on the prospects of political stability, but also on the support of the EU and the US. The goal of EU membership provides the Turkish government with a set of clear guidelines for institutional and economic reforms and with the possibility of making these domestically admissible. The continued integration of the Turkish economy within the EU also provides the country with an "umbrella" which protects it to some extent from market fluctuations. Moreover, if the EU has been the main engine of the Turkish change, one of the most adamant supporters of Turkey's European bid has been the US. The Americans have always recognized the country's geopolitical importance, and few others stand to gain more from the success of a Muslim democracy than the US.

The combined support from the EU and the US has made Turkey one of the key objectives of the IMF scope. The guidelines set by the Fund and its backing have been partly responsible for the Turkish success of recent years. The IMF has helped by providing funds to the country, to the extent that it was Turkey who received the most loans from the IMF during 2003. But more important has been Turkey's following of the Fund's recommendations. For example, in accordance with the IMF, Turkey has maintained a huge primary surplus of around 6% of GDP since the year 2000. This, coupled with the monetary policy implemented by a recently made independent Central Bank has brought down inflation to single digit levels for the first time in 3 decades. Moreover, public debt, one of the major worries after the 2001 crisis, has been reduced considerably from ratios close to 110% of GNP during that year, to around 75% at the end of 2004.

… but it is still a work in progress

Despite of all its accomplishments, the Turkish economy is still a work in progress. There remain some very worrying problems that need to be resolved and that could be a cause for concern in the medium term. The following list is not meant to be exhaustive but includes just the ones that, from our point of view, are the most important.

The fiscal constraint

The fiscal issue will be specially challenging in the months ahead. First of all, as in many countries throughout the world, there is a need for social security reform.[1] During the last two years, the government has had to finance a social security deficit in the range of 4 to 5 percentage points of GDP, while running a primary surplus of 6,5% of GDP. The causes for the heavy burden can be tracked to a "pay as you go" system that included very generous benefits. For example, no minimum retirement age was established and a person that had contributed for only 13,5 years was eligible for a pension. The benefits, on the other hand, were calculated based on wages earned during the last year before retirement and increases were not set to a pre-specified rule, but contingent to political sentiment. It is not surprising then that the social security deficit has kept increasing since the early 1990s.

In 1999, the Turkish government implemented a series of reforms aimed at solving the problem. In particular, the retirement age was increased to 58 years for women and 60 for men, the minimum contribution period was raised to 19,4 years, pensions are now calculated accounting to a person's life earnings and they increase according to a predetermined rule that depends on the rate of inflation.

However, according to IMF estimations, these reforms will only succeed in stabilizing the deficit at around 5% of GDP. Therefore, the Fund has been adamant in its plight for more actions. In fact, the new Stand-By Agreement introduces new reforms that can help lower the future costs of the social security burden.

Given the pressures exerted by the social security deficit and the considerably high primary surplus achieved, fiscal discipline has been attained by a selective reduction of public expenditures and an increase in indirect taxes. These changes have limited the government's ability to implement discretionary fiscal policy and will certainly serve as a constraint in the future. For example, government expenditures on wages currently represent around 21% of total expenditures, as compared to over 40% in 1992. Further cuts seem unlikely given the already big reductions experienced and the political difficulties they would entail. Another illustration of the current fiscal rigidities comes from the fact

---

[1] See, Bajo lupa: Sistemas de Pensiones, Latinwatch Servicio de Estudios Económicos BBVA, March 2005.

Chart 4.7.
Primary Surplus of the Turkish Government
(as a percentage of GDP)
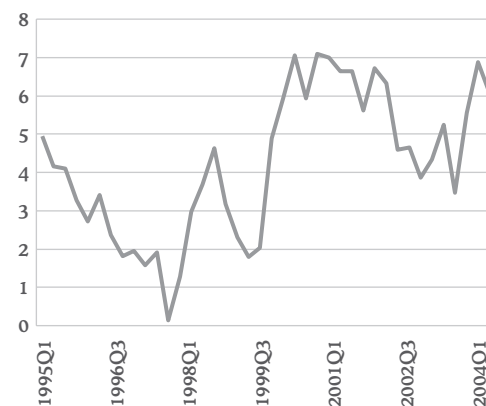
Source: Turkish Treasury

Chart 4.8.
Social Security Deficit in Turkey
(as a percentage of GDP)
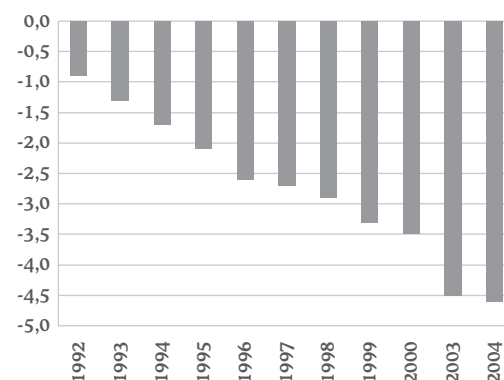
Source: IMF and AKBank

Chart 4.9.
Public Expenditures in Turkey
(as a percentage of the total)

■ Interest Payments
■ Public wages

Source: Turkish Treasury

Chart 4.10.

Turkish Gross Public Debt
(as a percentage of GDP)

■ Domestic currency
■ Foreign Currency

Source: Turkish Treasury

Chart 4.11.

Current Account Deficit in Turkey
(as a percentage of GDP)
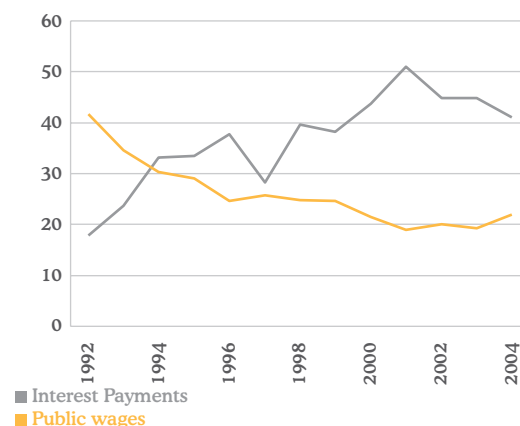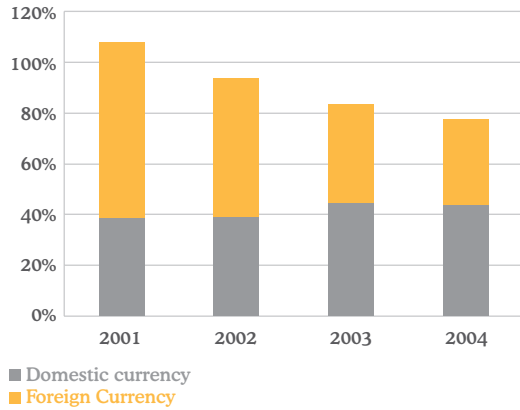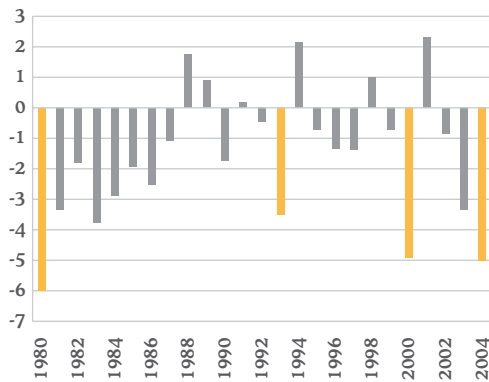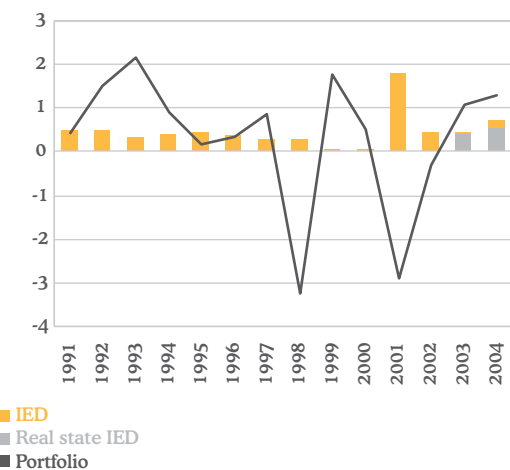

Source: IIF

Chart 4.12.

Portfolio flows and IED (%GDP)
(as a percentage of GDP)

■ IED
■ Real state IED
■ Portfolio

Source: Central Bank of Turkey

that public investment now represents only 5% of the government's total expenditure, while in 1992 it was close to 15%. These already low levels do not only imply that there is a shortage of public infrastructure investment that certainly will have a negative impact on future growth, but also that the room for further reductions is very narrow. Lastly, there is an important question about tax revenue: can we expect improvements that guarantee the sustainability of the public accounts? As with other emerging economies, Turkey has a large informal economy (the World Bank puts it at around 30% of GNP) that limits the government's ability to raise taxes. In an environment of recurrent crises like in the 1990s, these underground sectors flourish and make it more difficult for the government to meet its goals. In this respect, since 1998 income tax revenues as a percentage of total government income have decreased from close to 50% to 30% in 2004. Therefore, the future of the public accounts will depend on whether the government can successfully manage an increasingly rigid flow of expenditures while at the same time, taking on a mammoth effort of improving tax collection.

The debt constraint

The big government primary surpluses haven't had any other objective than to reduce the enormous debt accumulated after the 2001 crisis. Although the strategy has been quite successful, the outstanding debt remains high, and the due terms have stayed relatively short (around a year). However, as we show in an accompanying Box, under pretty conservative assumptions the Turkish public debt seems to be sustainable. Particularly, if we believe that the government will be able to sustain the huge primary surpluses for a few more years (the IMF program calls for three more years) and if there is no major slippage on controlling inflation, Turkey will be on a stable path and public debt should be sustainable.

The current (and capital) account constraint

These days, the Turkish current account deficit stands at around 5% of GDP. These are historically high levels and similar numbers were experienced just before the 1982, 1994 and 2001 crises. At the same time, the real effective exchange rate has appreciated more than 35% since 2001, which rivals similar episodes observed just before the 1994 and 2001 crises. Therefore, at first glance, the red lights should be flashing. However, the situation is now radically different from those other pre-crisis periods. Turkey now has a free floating exchange rate as compared to the fixed or semi-fixed rates, which caused large overvaluations in a high inflationary environment with corresponding "boom-bust" periods.

In the past, high current account deficits implied soaring levels of foreign indebtedness and low domestic saving rates. Since 2001, the total external debt in Turkey has dropped consistently and internal savings have remained constant at around 19% of GNP. Furthermore, while it is true that some of the imbalances in external accounts have been financed with short-term portfolio inflows, Turkey's present experience is similar to that of other EU accession countries in the past. In this sense, economies such as Poland, Hungary, Estonia or Latvia all had current account deficits higher than 4% of GNP when they begun accession negotiations with the EU and have maintained these for quite a while without being in danger of a financial crisis.

However, the composition of the flows that finance these external imbalances remains a worry. For example, foreign direct investment (FDI) has stayed relatively low in Turkey. In particular, the country only receives less than 1% of its GNP in FDI flows even though its growth rate has been on average higher than 6% during the last three years. Additionally, it is not expected that the inflow of funds after the beginning

of accession negotiations will be of a permanent nature. They are more likely to continue being of a short-term nature until the reform agenda gains further credibility and the probability of accession increases. This actually remains, both, a puzzle and a challenge for the Turkish authorities.

Can you die of success?

In dealing with the new capital inflows that are certain to flood the Turkish economy on the eve of its potential EU membership, the monetary authorities will have to face the pressures that these will exert on the foreign exchange. The Central Bank will have to be very careful. On the one hand, there will be voices that will demand a more "competitive" exchange rate. The temptation to depreciate the currency will have to be measured against the loss in credibility and potential increases in inflation.

However, the most important challenges will not come from these pressures, but actually from a possible overzealousness in controlling inflation. The process by which this would materialize goes as follows. Important inflow of foreign capital increases the demand for goods, which puts some pressure on prices. As this happens, the Central Bank decides to increase interest rates to prevent inflationary pressures from emanating. This, in turn, makes the country even more attractive to foreign investors, increasing the inflow of funds. In this sense it is of the utmost importance that the Central Bank succeeds in bringing inflation expectations down and gains so much needed credibility.

Are we there yet?

Obviously, the answer is no. However, there has been a structural change in Turkey during the last few years. New rules, new institutions and most importantly, new attitudes are now in place. Nonetheless, there is no denying that this is a country that has endured 4 major crises in the last 15 years. An economy that it is still riddled with corruption and where the underground economy is still very important. The AKP is only a few years old. Its inexperience has been both an asset and a liability: they are not perceived as corrupt and have made good use of their political leverage to implement the reforms that were needed. At the same time, they have made mistakes, but until now they have been able (and willing) to rectify when necessary, which reflects their pragmatism. They still must show that they can endure the long process towards accession and that the reform fatigue that will appear along the way and the short term costs of reforms they must face will not derail their commitment. In the demand policy front, their biggest challenge is definitely reining in inflation expectations while maintaining the economic dynamism. However, anchored to three solid pillars as the IMF, the US and most importantly, the EU, Turkey has the makings of a potential success story that would rival any of the other so called "growth miracles".

	2000	2005*
Exports/Imports (%)	51	73.8
Current Acc. / GDP (%)	-4.9	-5.0**
Consumption Imports / Imports (%)	13.2	12.5
Exchange Rate Policy	Fixed	Floating
Banks FX Exposure (%)	59%***	46%
Banking Sector	Weak	Strong
FX Reserves (millions of USD)	22,172	37,934

* April 2005
** End 2004
*** 2001
Source: National Sources

Turkey's new dawn: perspectives on future growth

Deconstructing Turkey's growth[1]

Since 1972 the Turkish economy has expanded at a 3,8% real growth rate.[2] This corresponds to a population average growth rate of 2% and a healthy growth rate of output per capita of 1,8%. To evaluate the factors that have contributed to this development we decompose output per capita using the following identity

$$Y/POP \equiv (Y/L)*(L/PE)*(PE/POP)$$

where Y is total output produced, POP stands for population; L is employment while PE represents the economically active population. Note that the identity implies that the growth rate of output per capita can also be written as the product of the increase in labour productivity (Y/L), the growth rate of the employment rate (L/PE) and the change in a demographic factor (PE/POP). Therefore, in order to understand what has driven Turkish growth during the past 30 years, we need to uncouple the dynamics of these three ratios.

First, starting from the last factor, the total dependency ratio (PE/POP) has increased from 54% in 1973 to around 64% in 2003. This reflects the positive demographic change experienced in Turkey by which the 25 to 54 year old population has increased from 30% of the total to 40%. On average, we find that this change can account for around 30% of the Turkish GDP per capita growth.

Next, to study the employment rate (L/PE) we use a second identity that decomposes it into two components: the ratio of the employed to those in the labour force (L/L^s) and the participation rate (L^s/PE)

$$L/PE \equiv (L/L^s)* (L^s/PE)$$

where L^s is the labour force. The contribution of the first term is close to zero. The second one, however, is particularly important for Turkey, since participation rates have decreased considerably from 75% in 1973, to around 50% in 2003. Therefore, the employment ratio (L/PE) has contributed negatively to GDP per capita growth (a decrease of 1,4 pp) and stands as one of the most important potential sources of growth for the future. For example, at 20%, women's participation in the labour market is especially low in Turkey when compared to other developing countries (40% in Mexico or Hungary).

It's the productivity, stupid!

Finally, the most significant contributor to economic growth has been labour productivity (2,6 pp or 144% of total growth). To analyze the evolution of labour productivity we use the modified Solow model of Mankiw, Romer and Weil (1992). With some further assumptions, this model will, additionally, allow us to estimate potential future growth. In particular, it assumes a Cobb-Douglas production function that depends on physical capital (K), human capital (H) and total factor productivity (A). This implies the following

$$Y/L = (K/L)^{\alpha} (A) (H/L)^{\beta} \qquad 0 < \alpha, \beta < 1$$

Hence, the model will yield the evolution of A, as a residual in the estimation of the productivity. The main challenge is to obtain a series that correctly measures the changes experienced in human capital. This obviously depends on how one defines this last term and a discussion in this regard falls outside the scope of the present study. It should be enough to say that we measure human capital using a series of Turkish employees that completed some kind of secondary level education (junior high, high school, etc.), an approach closely resembling the one used in Mankiw, Romer and Weil. Furthermore, following the literature, we assign values for $\alpha = \beta = 0,3$.

The results show that the ratios of physical and human capital to labour can explain each on average around 45% of the labour productivity growth, while the contribution of total factor productivity is relatively small. This outcome, which appears to contradict the related literature, is due to the presence of human capital, which captures most of the improvements in labour productivity.

Potential growth: potential success

As noted, to evaluate Turkey's potential growth we need to make some further assumptions. First, we assume that the economy is at its steady state, with saving and other ratios equal to their historical values. As steady state levels in the model depend on the technology A, we calibrate it to Germany's steady state level. This implies that Turkish output per capita is on a converging path with that of Germany, the leading European economy. Additionally, it is assumed that technology transfers are made without significant costs across borders (so that A is the same everywhere). Finally, the structural change that has taken place in Turkey in the last few years implies that some ratios will have improved, namely the physical and human capital saving rates and the participation rate. With this in mind, the model can be simulated to obtain the growth rate of Turkish output for the next 10 years. The results of this exercise are shown in a table below. Note that the assumptions of the base scenario are not overly optimistic and still output growth reaches 5% on average. Moreover, assuming saving (and participation) rates closer to the ones experienced in other more developed economies significantly improves the growth estimates.

Manuel Balmaseda
m.balmased@grupobbva.com

Miguel Cardoso
miguel.cardoso@grupobbva.com

References:

Mankiw, N. Gregory, David Romer and David Weil, 1992, "A contribution to the empirics of economic growth", *The Quarterly Journal of Economics*, 102 (2): 407-437.

Variable	Historical	Base Scenario	Optimistic
Saving rates			
Physical Capital[1]	22.0%	24.0%	25.0%
Human Capital[2]	2.5%	4.0%	4.5%
Participation Rate	52.0%	58.0%	62.0%
GDP growth rate	3.8%	5.0%	7.1%

[1] Gross fixed capital formation as % of GDP
[2] Expenditure in Education as % of GDP
Source: BBVA and SIS

---

[1] Based on a working paper available upon request.
[2] All series used in this study come from AMECO, except for the human capital series, which comes from the Turkish State Institute for Statistics.

Public debt and fiscal discipline in Turkey

Some standard debt algebra [1]

The sustainability of the public debt is one of the main concerns regarding Turkey's medium term perspectives. To assess this sustainability we use standard methodology. In particular, we assume that the law of motion that determines the evolution of debt from period to period is given by

$$B_t^i = B_{t-1}^i\left(1 + R_t^i\right) - S_t^i, \quad i \in \{d, f\}, \quad (1)$$

where B_t^i is outstanding debt in period t denominated in domestic (whenever $i=d$) or foreign currency (if $i=f$), R_t^i stands for the nominal interest rate on the two types of debt while S_t^i is the part of the government's primary surplus (in domestic or foreign currency) that is used to pay either debt. Letting ε_t be the nominal exchange rate in Turkish Liras per unit of foreign currency, total public debt B_t is given by

$$B_t = B_t^d + \varepsilon_t B_t^f - S_t^d - \varepsilon_t S_t^f$$

Now, using lower case variables for percentages of GDP equation (1) can be rewritten as

$$b_t^d = \frac{1 + R_t^d}{1 + g_t^n} b_{t-1}^d - s_t^d \quad (2)$$

and

$$b_t^f = \frac{\left(1 + R_t^f\right)\left(1 + e_t^n\right)}{1 + g_t^n} b_{t-1}^f - s_t^f \quad (3)$$

where g_t^n is the growth rate of nominal GDP and e_t^n represents the depreciation of the nominal exchange rate. Finally, using the Fisher equation, it is possible to rewrite (2) and (3) as

$$b_t^d = \frac{1 + r_t^d}{1 + g_t} b_{t-1}^d - s_t^d \quad (4)$$

and

$$b_t^f = \frac{\left(1 + r_t^f\right)\left(1 + e_t\right)}{1 + g_t} b_{t-1}^f - s_t^f \quad (5)$$

where r_t^i represents the real interest rate paid on each type of debt and e_t and g_t are the real depreciation of the exchange rate and the growth rate of real GDP respectively.

According to equations (4) and (5) there are two ways in which debt as a percentage of GDP might be reduced at the end of the year. The first one is straightforward and happens whenever the country runs a primary surplus. The second comes if the real interest rate paid on outstanding debt is lower than the real growth rate of output (that is, if the slope of the difference equation is less than one). Therefore, our particular assumption about the behaviour of these variables (r_t^i, e_t and g_t) will be key to determine the future performance of public indebtedness in Turkey. Below, we explain our base scenario and our perspectives regarding public debt in Turkey.

In principle, debt in Turkey is sustainable

In our base scenario we assume that purchasing power parity holds at all times so that $e=0$ and e^n approximately equals the difference between the domestic and foreign inflation rates. With respect to the growth rate of real output, it is set to 7% for

2005 and from then on we assume that the economy reaches its long term growth rate of 5% (see Box on growth). On the other hand, we assume that a primary surplus of 6,5% of GDP for the next three years will be achieved, as done in the last few years and in line with the IMF requirements in the Stand-By Agreement with Turkey. After that, we leave it constant at 2% of GDP.

Finally, during 2004, the average spread on Turkish government debt was 340 bp, which implied an annual real interest rate paid on foreign currency denominated debt of around 3,8%. This rate is particularly low and we assume that, in line with our most probable scenario, the spread paid by the Turkish government will increase. The motivation behind this reasoning is the end of the favourable conditions that have encouraged the emerging market rally of late. Therefore, our base scenario assumes that Turkish government bonds will pay a real interest rate on dollar denominated instruments that will steadily increase during the next few years until reaching 6% in 2006. After that we assume a decrease towards its long-term value of 5%. Regarding the real rate of interest paid on domestic debt, we note that on average it was equal to 17% during 2004. In this respect, we think that the beginning of negotiations towards EU accession, the increased credibility of the Central Bank and the assumed fiscal discipline should bring down the government's cost of borrowing in domestic currency. In particular we let it fall from 11% in 2005 to 5% in 2009.

Under these assumptions, as it can be seen in the graph, debt is sustainable. Although we assume that real interest rates stay relatively high compared to real GDP growth, the primary surpluses that the government would run are so high that Maastricht criteria levels of public debt are reached by 2008.

Lastly, several risk scenarios can be considered. In particular, departures from purchasing power parity (a real depreciation of the Turkish Lira), an increase in country spreads or a lack of reforms that would render a lower growth rate than assumed are all possible scenarios. However, given the huge primary surpluses the government is targeting, there isn't a more dangerous perspective for Turkey than the one associated with fiscal relaxation.

Manuel Balmaseda
m.balmased@grupobbva.com

Miguel Cardoso
miguel.cardoso@grupobbva.com

Turkish Public Debt - Base Scenario
(as a percentage of GDP)

Foreign
Domestic

Source: BBVA and Turkish Treasury

---
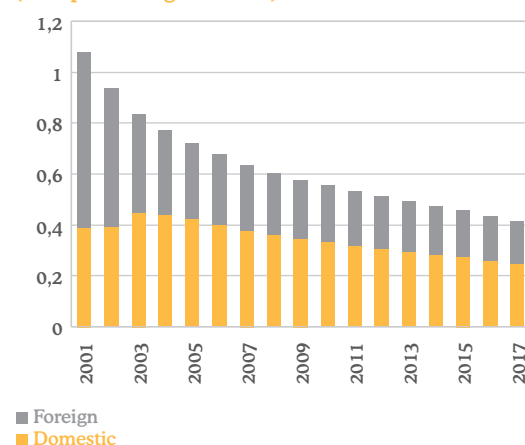
[1] Based on a working paper available upon request.

5. The Stability and Growth Pact and Macroeconomic Stability

David Taguas and Ángel Melguizo

BBVA Economic Research Department

The announcement of the breach of the Stability and Growth Pact (SGP), the EMU's fiscal rule, on the part of the two larger economies of the Economic and Monetary Union (EMU) generated a general sense of expectancy on the rigor with which the procedures of discipline and sanction would be applied. The decision of the ECOFIN to suspend the excessive deficit procedure against Germany and France supposed a loss of credibility that demanded changes in the European mechanisms of fiscal coordination.

The process of reform has been framed within a debate that has had, predominantly, a political character. This nature of the discussions have led to not enough attention been granted to the main objective of the macroeconomic stability of the union. The European economies have continued showing cyclical discrepancies that remark the necessity to establish mechanisms that reinforce the stabilizing character of fiscal policy. Last March, the ministers of Finance of the EMU approved the reform of the SGP. The new SGP should have been made more flexible and enforceable. By contrast, it is more discretionary while weakening the sanction mechanisms, making it, *de facto*, inapplicable. In this context, the re-formulation of the Pact should be more exigent and far-reaching.

This article is intended to contribute to the economic debate, expanding on it, with the consideration of a Macroeconomic Stability Goal which assesses not only the budgetary balance, but the macroeconomic imbalances as a whole: fiscal surplus, inflation and balance of payment on the current account.

The SGP, a mechanism of fiscal policy coordination

The SGP was born from the need to coordinate the fiscal policies of the EMU member states in the belief that these could be carrying out irresponsible fiscal policies which, in a context of common monetary policy, would not be penalized by the markets with a higher cost of debt through government debt interest rate spreads[1]. Against this backdrop, the risk of free-riding emerges. Moreover, the coordination of fiscal policy would facilitate the design and implementation of the monetary policy by the European Central Bank (ECB).

The SGP establishes that each year, each country's public deficit must not exceed 3% of their GDP, which was one of the nominal convergence criteria laid down in Maastricht for integration in EMU. The 3% deficit was sufficient, given the potential 3% growth of European countries, for the public debt to GDP ratio to converge at 60%. Furthermore, the limit established for the public deficit permitted sufficient leeway for automatic stabilizers to act in periods of recession, as shown in the empirical literature (see Chart 5.1.)[2]. Besides, this would allow the implementation of discretionary countercyclical policies, if originally on a structural balance. In this regard, if the SGP established a necessary, simple and economically-sound fiscal rule, why has it not been fulfilled?

Chart 5.1.
Cyclical deficit peak since 1970
(% GDP)
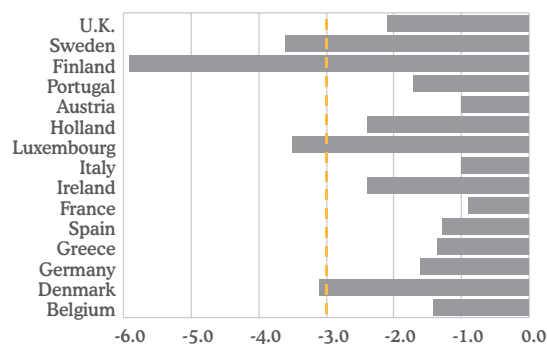
Source: European Commission

---

[1] There are at least four reasons for this: financial markets do not consider credible the no-bail out clause, the majority of countries fail to comply (in the short or long term), there exists excess liquidity and the ECB fails to discriminate between the debt of the different countries when it accepts bonds as collateral in re-financing operations (Joaquim Fels "Eurolands fiscal morass" European Economics Morgan Stanley *Equity Research*, September 2004.

[2] See José E. Boscá, Rafael Doménech and David Taguas, "La Politica Fiscal en la Unión Económica y Monetaria", *Moneda y Crédito*, n.208, pp.267-324, 1999, Since 1970, the cyclical deficit has only exceeded 3% in Finland between 1992 and 1995, in Sweden and in Denmark in 1993 and in Luxembourg in 1996.

From a SGP which has not been applied…

First and foremost, Europe's main economies failed to respect the commitment signed in October 1998 to balance their budgets by 2002. Since 1999, fiscal consolidation has been at a standstill or has deteriorated (see Chart 5.2.). This has been particularly important in the two main economies of the Euro zone: Germany and France. The maintenance of a structural deficit in these two countries, combined with the beginning of an economic recession (the cyclical deficit in both countries peaked in 2003 at 0.7 and 0.3 of GDP, respectively) and the application of expansive fiscal policies (between 2000 and 2001, the fiscal impulse in Germany accounted for 1.4 points of GDP, and 1.3 points in France between 2001 and 2002), led both economies to fail to comply with the limit between 2002 and 2004. This behaviour is unacceptable, since it means a breach of the Pact which was voluntarily subscribed, and which was a prerequisite for entry in the EMU. In second place, this has been encouraged by the complacency of the institutions, and even of the Academy, by an excessively flexible methodology when elaborating public accounts and, judging by the latest reports on Greece and Italy[3], an undue laxness in the control of those public accounts. And, in third place, we cannot ignore certain institutional inadequacies in the implementation of the SGP, particularly in the cession of control and sanction mechanisms to ECOFIN Council , a forum where national interests take precedence over the area-wide ones and which provides little credibility to the no bail-out clauses. The clearest example was the decision taken by the ECOFIN in November 2003 in which it suspended the excessive deficit procedure against France and Germany, and which was later overruled by the European Community Court of Justice.

Nonetheless, admittedly the situation today of the EMU's public accounts is better than it would have been without fiscal rules. In fact, the performance in structural terms is better than that of the US or Japan (Chart 5.3.).

… to an unenforceable Pact

The ongoing failure to comply with the SGP has made a reform necessary. This was approved in the European Council in Brussels. The changes should have made the rule more flexible, while at the same time strengthening its sanction mechanisms. However, the approved Pact is more discretionary, but not more enforceable. This does not mean that the new SGP has no positive elements (see Table 5.1.), particularly in that regarding prevention, namely the obligatory structural adjustments (particularly during economic booms), the increased importance of the Commission's forecasts in macroeconomic scenarios and national budgets and the idea of giving more autonomy and means to Eurostat. In the corrective arm, the considerations about the sustainability of debt and the scope for structural reforms in the pension systems is adequate, In short, it maintains the emphasis on the ambition for macroeconomic stability in EMU economies.

Notwithstanding, on the whole, the SGP reform has, undoubtedly, meant a step backwards. In first place, due to the forms, given that the Pact has been amended at a time of non-compliance by several countries. And, in second place, owing to its contents. With respect to the preventive arm, the new SGP is naive and is based on an erroneous diagnosis of the causes for non-compliance in the past. Despite the economic rhetoric, the proposals provide the Pact with a more political content. Furthermore, it is unduly confident in the "peer pressure" as an incentive for the tax consolidation. Recent experience suggests, on the contrary, the

[3] See, among other, Jürgen Von Hagen and Guntram Wolf "What does deficit tell us about debts? Empirical evidence on creative accounting with fiscal rules in the EU", CEPR *Discussion Papers* n. 4579, November and, Vincent Koen and Paul Van den Noord, "Fiscal gimmicky in Europe; one-off measures and creating accounting", OECD Economics Department *Working Papers* n.417, February 2005.

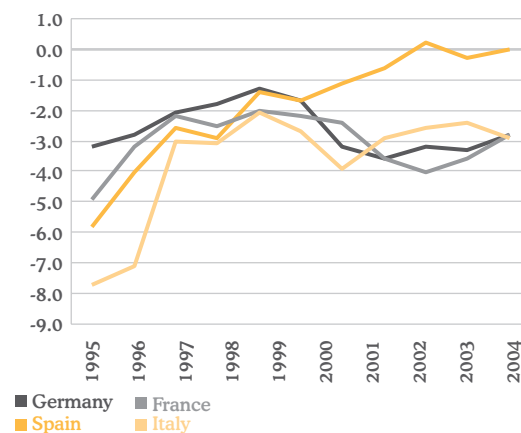Chart 5.2.
Structural budget balance
(% GDP)

■ Germany ■ France
■ Spain ■ Italy
Source: European Commission

Chart 5.3.
Primary structural budget balance
(% potential GDP)

■ EMU
■ U.S.
■ Japan
Source: OECD
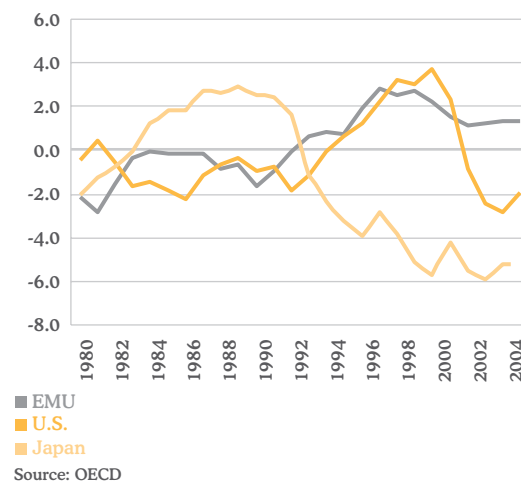
Table 5.1. Main contents of original and reformed SGP

	Original	Current
Annual criteria		
Deficit	3% GDP	3% GDP
Debt	60% GDP	60% GDP
Medium term objective	Balance or surplus	Balance or surplus in indebted -1% GDP in less indebted countries
Prevention	Non-existent	Obligation to consolidate during economic booms
Correction		
Exceptional circumstances	GDP -2%	Fall in GDP or prolonged weak economic growth
Relevant factors	Not defined	Public expenditure, Quality of spending, R+D, Development Aid, European unification costs
Adjustment period		
Effective action	Total period: 10 months	16 months
Correction	Beginning one year	Beginning 2-3 years following non-compliance
Sanction enforcement	Immediate	Subject to political assessment
Other considerations		Structural reforms and Lisbon Agenda Temporary exclusion of pension reform costs

Source: European Council and BBVA

Chart 5.4.
Inflation since 1999
(% observations/total)
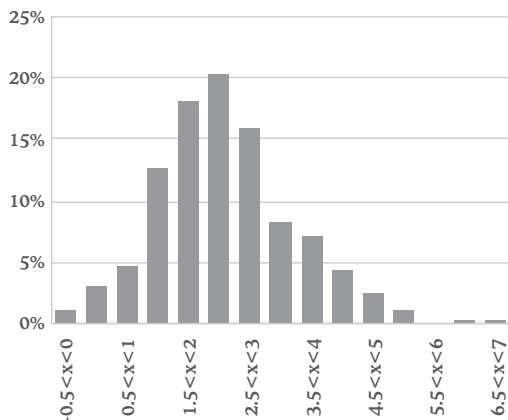
Source: Eurostat

existence of "peer silence" in moments of economic expansion and "peer shielding" in slowdowns. The financial support of companies such as Alstom in France or Parmalat in Italy are clear examples that suggest that the mentioned "pressure" should not be trusted. With respect to slowdown phases, the new SGP is more complex and discretionary, since it further weakens the implementation of the excessive deficit procedure. In first place, the exceptional circumstances are more relaxed, being sufficient to show a negative growth rate or prolonged weak growth period. It is now accepted that several expense items are considered relevant in the evaluation of public accounts (public investment, R&D and innovation, development aid, European unification costs). The period to correct imbalances has been extended (up to three years) and it has eliminated the immediate activation of sanctions. Finally, the medium term balance or surplus objective for those less indebted economies has been eliminated (permitting a deficit of –1%).

The SGP clearly had a problem of application, essentially in that referring to its sanction mechanisms, which has augmented. Instead of achieving a more flexible SGP (depending on the economic cycle position), but more discretionary, the new design has rendered it almost unenforceable. In addition, it fails to explain the analytical instruments used to evaluate the degree of success of the macroeconomic stability by means of public policies.

The Macroeconomic Stability Goal

The overlying goal of all public policy is to increase the well-being of the people and macroeconomic stability is a key factor in achieving this objective. The SGP focused on budgetary discipline in the public sector. However, macroeconomic stability implies more than fiscal policy and involves the private sector, both households and firms.

Any attempt to achieve macroeconomic stability cannot ignore the level of convergence achieved in inflation. The public debate prior to forming the European Monetary Union focused on the existence of the "fiscal free rider" while underestimating the effects of the "monetary free rider" resulting from the lack of convergence in inflation rates. There is a high level of dispersion among the inflation rates in European countries which, given the convergence of nominal interest rates, translates into divergent real interest rates. Using quarterly data for the EMU countries since 1999, the average interannual inflation rate is 2.4%, with a standard deviation of 1.1% (see Chart 5.4.). To the extent that the inflation gaps are not the result of the Balassa-Samuelson effect, but rather are derived from excess demand and are reflected in the different expectations for inflation, the lower *ex-ante* real interest rates contributed to widening the gaps (Table 5.2.). Moreover, inflation has positive effects, at least in the short-term, on public accounts given that tax bases are defined in nominal terms and not all expense items are adjusted *ex-post* for deviations in inflation from the budgeted target.

Achieving macroeconomic stability requires the evaluation of the extent to which the existing deviation from ECB inflation targets are long-lasting in order to be able to apply such corrective measures as may be necessary.[4] This implies that the budget balance should be adjusted not only for economic cycle, but also for the effect of this inflation gap. This would allow for a more precise evaluation of the discretional actions of the public sector without eliminating the leeway of a countercyclical fiscal policy.

---

[4] Structural reforms are medium to long-term, but for the short-term, given the transfer of national monetary policy, the only instrument available is fiscal policy.

Formally, the evaluation of public accounts in structural terms requires the deconstruction of the observed budget surplus into (bs) two non-observable components: one cyclical (bs$_{y-y^*}$) and the other trending (bs*), obtained as the remainder.

$$bs = bs_{y-y^*} + bs^* \qquad (1)$$

Inflation contributes to increasing public surplus so that the structural balance, representing the discretionary action of the public sector, should be obtained as the remainder (bs**) once the public balance has been corrected not only for economic cycle (bs$_{y-y^*}$) but also for the effect of the inflation gap (bs$_{\pi-\pi_*}$), as shown in the following equation (2):

$$bs = bs_{y-y^*} + bs_{\pi-\pi^*} + bs^{**} \qquad (2)$$

Therefore bs*=bs$_{\pi-\pi^*}$ + bs**. Accordingly, an initial formula for the *Macroeconomic Stability Goal (MSG)* could be summarised using equations (3) and (4):

$$bs^*_t = bs^{**}_t + \alpha\,(\pi_t - \pi^*) \qquad (3)$$

$$\overline{bs}^{**} = \Sigma^j_t bs^{**}_t = 0 \qquad (4)$$

Equation (3) reflects the evaluation of the public surplus adjusted for economic cycle (using the estimated output gap) and the effect of inflation (estimated using the deviation from a target value), while equation (4) imposes that this adjusted public balance (bs**) be in balance throughout the economic cycle.

The determination of the coefficient associated to the inflation gap (α), can be estimated using two different methods. Firstly, within a traditional macroeconomic model, a one point increase in inflation would suppose, *ceteris paribus*, a 100 basic point drop in real interest rates. According to the estimates of Doménech et al. (2001)[5] for EMU, this decline in interest rates would have a 0.25 point impact on the output gap. Assuming budget elasticity of 0.8 (due to the lower expenditures for unemployment benefits and, especially, the elasticity of revenues to economic growth)[6], the impact of a one point increase in inflation on the budget balance would be 0.20 points.

Alternatively, the coefficient can be estimated using the quantification of the direct impact of inflation on the budget balance. The budget surplus in terms of GDP can be expressed as:

$$bs = \frac{R(YP, t, \phi) - E(YP, \phi')}{YP} \qquad (5)$$

where public sector revenues (R) depend on the nominal GDP level (YP), of the average tax rate (t) and of other discretional factors (ϕ), while public expenditures (E) depend on nominal GDP and discretional factors (ϕ'). Differentiating said expression with respect to the variation in prices, we would obtain:

Table 5.2.

Source: BBVA

---

[5] Rafael Doménech, Mayte Ledo and David Taguas, "A small forward-looking macroeconomic model for EMU", *Working Paper* n.2/01, BBVA Research Department, September 2001.
[6] This level of budget elasticity is in the upper range of those used by the OECD, the European Commission and the Central Banks given that it considers the impact of the size of the government.
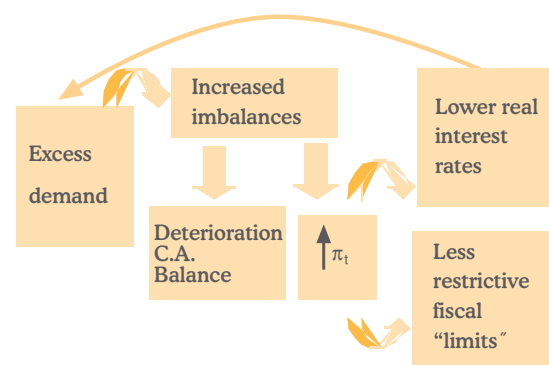
$$dbs = \left[\varepsilon_{R,YP} \frac{R}{YP} - \varepsilon_{E,YP} \frac{E}{YP} \right] \frac{dp}{p} \qquad (6)$$

Lastly, assuming that over the medium-term public revenue will match public expenditures, the expression can be simplified:

$$dbs = \left[\varepsilon_{R,YP} - \varepsilon_{E,YP} \right] \frac{R}{YP} \frac{dp}{p} \qquad (7)$$

So that the variation in the public surplus in response to increases in inflation depend on the elasticity of related public revenues and expenses, as well as on the size of the public sector. Given that the elasticity of the combined public revenue within the EMU is 1.125[7], and expenditures is 0.30, while the ratio of revenue to GDP is 0.46 (simple average of the EMU between 1997 and 2002), each one point rise in inflation would have a positive impact of 0.38 points on the budget balance.

Consequently, the parameter associated to the inflation gap (α in equation (3)), would be between 0.20 and 0.38.

However, the evaluation of macroeconomic stability does not only require the analysis of the public budget, but also the analysis of the behaviour of the private sector. Macroeconomic stability requires that we consider not only the difference between the revenue and expenditures of the public sector, but also the difference between the savings and the investments of all economic agents, in other words, the current account balance. The current account balance with the rest of the world in GDP terms can be expressed as a sum of the budget surplus in GDP terms and the gap between the private sector savings and investment rates:

$$ca_t = bs_t + (s_t^p - i_t^p) \qquad (8)$$

This shows that the current account balance is determined by intertemporal decisions on the consumption-savings and investment by economic agents.[8] Numerous papers demonstrate the countercyclical character of the current account balance in terms of GDP.[9] Given the above equality, this shows the strong countercyclical character in industrial economies $s_t^p - i_t^p$, given the procyclical behaviour of the budget balance. In other words, during recessive phases, private sector savings increase and investment decreases, generally more than compensating for the decrease in the public sector balance. The oft-mentioned "twin deficits" hypothesis used in reference to the behaviour of the economy of the United States of America today and 20 years ago, refers to a situation in which the increase in the budget deficit is not compensated with a wider gap between the savings and investment rates in the private sector, resulting in the deterioration of the current account balance. This is why compliance with macroeconomic stability goals should not focus solely on the behaviour of the public sector, but also on the consumption-savings and investment decisions of the private sector of the economy[10].

---

[7] See Boscá, Doménech and Taguas (1999).

[8] Empirically, modelling of a savings and investment aggregate makes it unnecessary to use imports and exports of goods and services as has normally been used in the dynamic modelling of general balances.

[9] See, for example, David K. Backus, Patrick J. Kehoe and Finn E. Kydland, "Dynamics of the Trade Balance and the Terms of Trade: the J Curve?", *American Economic Review,* v.84, n.1, pp.84-103, 1994, for the industrialized nations, and Rafael Doménech and David Taguas , "Exportaciones e Importaciones de Bienes y Servicios en la Economía Española", *Moneda y Crédito*, n.205, pp.13-44, 1997, for the particular case of the Spanish economy.

[10] Recently, there is a growing discussion on the impact of current account imbalances on economic activity. Those that minimize such impact argue that the low long term interest rates at present reflect a high global savings ratio and that those imbalances are observed in some of the more efficient economies, where investment returns are high and financing mechanisms more sophisticated (See "The Shift away from Thrift", *The Economist*, April 7, 2005). Obviously, evaluating macroeconomic stability should consider, not only the gap between savings and investment rates, but also if it is due to structural changes in the savings rate and/or in productive and residential investment.

In this regard, Germany, on the one hand, and Spain and Portugal, on the other, represent two paradigmatic and opposing examples in Europe. In 2004, Germany again failed to meet the requirements of the SGP with a budget deficit of –3.7% of GDP. However, the gap between the private sector savings and investment rates was 7.5% of GDP, boosting the current account balance to 3.8% of GDP.[11]

Portugal, meanwhile, respected SGP with a budget deficit of 2.9% of GDP. However, this need for financing was joined by a lack of private sector savings (approximately 5.7% of GDP), resulting in a current account deficit of 8.1% of GDP. Spain closed 2004 with a budget deficit of 0.3% of GDP. However, the Spanish economy closed the year with a current account deficit of 5% of GDP, reflecting a private sector savings gap of –4.7% of GDP.

Does it make sense from a macroeconomic stability point of view that the German public sector saves more (or invests less)? Does it make sense for an economy with a strong current account imbalance but with a balanced budget not to make a greater fiscal effort? In other words, given the non-compliance with the Ricardian Equivalence Hypothesis, that households and businesses did not compensate the public sector revenues/expenditures anticipating their savings/investment decisions; does it make any sense for a fiscal rule to recommend that an economy increase an already burgeoning current account surplus?

One possibility is to take into account the current account imbalances in the evaluation of compliance with a macroeconomic stability goal. In those economies with high systematic current account deficits, cyclically and inflation-adjusted budget balances should run a surplus. Specifically, equations 3 and 4 can be rewritten as

$$bs^{*}_{t} = bs^{**}_{t} + \alpha\,(\pi_{t} - \pi^{*}) \qquad (9)$$

$$\overline{bs}^{**} = \beta\,[(s^{p}_{t} - i^{p}_{t}) - (s^{p}_{t} - i^{p}_{t})^{*}] \qquad (10)$$

where equation (9) is identical to equation (3), while equation (10) implies that, over the medium-term, the budget surplus corrected for the impact of economic growth and inflation must also be corrected for the deviations in the gap between private sector savings and investment. In the interest of simplicity, equation (10) can be substituted by

$$\overline{bs}^{**} = \beta\,[ca - ca^{*}] \qquad (10')$$

Specifically, asymmetric evaluation is possible, with it being advisable for economies with a current account deficit that is above the balance level (ca*), to show a positive structural surplus.

An analysis of the current account balances of EMU countries since 1960, shown on Chart 5.5., allows us to establish the maximum reference level for the current account deficit at around –2% of GDP (in only 25% of the cases deficit is higher).

As regards the estimation of the associated coefficient (β), the impact of an additional point in inflation on the current account balance can be estimated by the degree of openness of the economy. Accordingly, expressing the current account balance (*ca*) in national currency and real terms:

---

[11] This wide gap between the savings and investment rates for the private sector could be a signal that the German recession was deeper than shown by those econometric models widely used for estimating economic cycle and output gap.

Chart 5.5.
Current Account Balances since 1960
(% Observations/total)

Source: Eurostat

$$ca = \frac{X\left(Y*, \frac{eP*}{P}\right) - M\left(Y, \frac{eP*}{P}\right)}{Y} \qquad (11)$$

where *Y and Y** represent, respectively, national GDP and that for the rest of the world in real terms; *P and P** are the domestic and external price levels; and *e* is the exchange rate. Differentiating with respect to price variations,

$$dca = -\left[\varepsilon_{X,\frac{eP*}{P}} \frac{X}{Y} - \varepsilon_{M,\frac{eP*}{P}} \frac{M}{Y}\right]\frac{dp}{p} \qquad (12)$$

and assuming that, $\left|\varepsilon_{X,\frac{eP*}{P}}\right| = \left|\varepsilon_{M,\frac{eP*}{P}}\right| = 1$,

$$dca = -\left(\frac{X+M}{Y}\right)\frac{dp}{p} \qquad (13)$$

One additional point in the inflation rate would deteriorate the current account balance in terms of GDP in the coefficient of the openness of the economy. Accordingly, macroeconomic stability would involve the evaluation of the budget surplus adjusted for the effects of the economic cycle, the inflation gap, and the foreign trade imbalance:

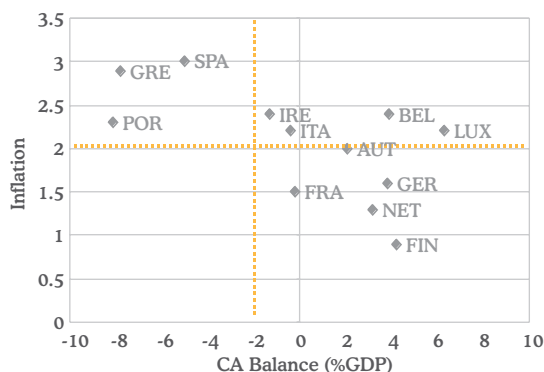$$bs*_t = (bs**_t - \overline{bs**}_t) + \alpha(\pi_t - \pi*) + \beta(ca_t - ca*) \qquad (14)$$

In addition, it should be taken into account that the imbalances in both inflation and the current account are intimately related. While in an economy with a current account surplus the inflation gap contributes to reducing it through the appreciation of real exchange rates, in an economy with a deficit, the inflation spread would only serve to worsen it.

An example for EMU countries in 2004

Coefficients of 0.25 are assumed for inflation and -1/3 for the current account balance[12] and target inflation is 2% and current account of balance –2% of GDP.

$$bs*_t = (bs**_t - \overline{bs**}_t) + 0,25(\pi_t - 0,02) - \frac{1}{3}(ca_t - (-0,02)) \qquad (15)$$

Main results are shown in Table 5.3. In particular, compliance with the objective of Macroeconomic Stability would require Greece to increase its surplus by 1.9 GDP points with respect to structural equilibrium, Portugal by 2 points and Spain by 1 point.

---

[12] It is assumed that $\alpha=0.25$, which, as we have seen, is a low benchmark value. With respect to $\beta=-1/3$, which corresponds approximately to the degree of openness of EMU as an economic area, is the lowest possible value, which undermines the weighting of current account imbalances. Obviously, this figure is lower than the opening degree of each of the countries in the area.

Chart 5.6.

Inflation and current account balance, 2004

Source: European Commission

Table 5.3.

Macroeconomic stability in EMU countries

	2004 Year-end			Correction	
	Struct. balance	Inflation	CA	Inflation	CA
Belgium	0.0	2.4	3.9	-0.2	-1.4
Germany	-3.3	1.6	3.8	-0.1	-1.9
Greece	-7.1	2.9	-7.8	0.2	1.9
Spain	-0.3	3.0	-5.0	0.3	1.0
France	-3.6	1.5	-0.2	-0.1	-0.6
Ireland	1.6	2.4	-1.3	0.1	-0.2
Italy	-2.4	2.2	-0.4	0.1	-0.5
Luxembourg	-0.3	2.2	6.3	0.1	-2.8
Netherlands	-1.2	1.3	3.2	-0.2	-1.7
Austria	-1.1	2.0	2.1	0.0	-1.4
Portugal	-2.1	2.3	-8.1	0.1	2.0
Finland	2.4	0.9	4.2	-0.3	-2.1

Source: European Commission and BBVA

In conclusion, macroeconomic stability is more than budget stability

If EMU is to function smoothly, then not only the public sector's financial stability must be taken into account, but so must that of economic agents, households and firms as well. The reform of the SGP, agreed in March 2005, far from seeking these objectives, has in fact disabled the mechanisms of sanctions, and a loosening of fiscal policy in the euro zone is on the cards for the next few years. Furthermore, their political credibility has been seriously undermined since the "goalposts have been moved halfway through the game".

The debate around the reform process has been predominantly of a political nature. From the economic perspective it has focused mainly on the performance of the public sector. The alternative presented herein considers that macroeconomic stability requires not only sound public sector accounts, but also other indicators of domestic excess demand, namely the inflation rate and the current account balance when not due to supply side factors.

It is necessary to make changes at institutions, to favour greater delegation of competencies in fiscal matters[13]. Depending on their degree, this would imply a strengthening of the independence and influence of the European Commission, the creation of a European Budget Office (similar to the Congressional Budget Office in the USA) or even an independent Fiscal Policy Committee. Opting for the intermediate alternative, among its first tasks would be to estimate the cyclical and structural components of the public surplus, based on macroeconomic scenarios that avoid the bullish stance characteristic of Stability Programmes[14].

Furthermore, attention should focus on diagnosing the causes and nature of the inflation differentials between European economies, especially because, if they respond to surplus demand in some of them, then more stringent fiscal policies would be advisable. This is especially true when these persistent inflation differentials end up significantly undermining the current account balance.

Above all, though, an improvement in fiscal coordination means States considering macroeconomic stability as a national goal. Otherwise, financial markets will eventually wake up[15].

---

[13] For an overview of the proposed reforms to the rules and institutions, both internal and international, see, for example, Lars Jonung and Martin Larch, "Improving fiscal policy in the EU: the case for independent forecasts", European Commission *Economic Papers* n. 210, July 2004.

[14] For an overview of these stances in the case of one of the "top of the class", Spain, see "The process of fiscal consolidation in Spain in the Stability Plans for the period, 1992-2007, *Situación Spain,* BBVA Research Department, May 2004, pp 26-27.

[15] Indeed, Standard & Poor's warned of the possibility of revising sovereign ratings, in the event of implementing a reform such as the one agreed. Standard & Poor's, *Moving the goalposts: how reform of the Stability and Growth Pact could undermine eurozone sovereign ratings,* March 2005.

6. Summary of Forecasts

Germany: GDP growth and inflation forecasts

YoY rate	2003	2004	2005	2006
Private consumption	0.0	-0.8	1.0	2.2
Public expenditure	0.1	0.4	0.5	0.3
Gross fixed capital formation	-2.2	-2.2	1.5	2.5
Equipment	-1.0	0.1	4.8	5.3
Construction	-3.1	-4.1	-1.7	-0.4
Inventories (*)	0.9	0.8	0.0	0.0
Domestic demand (*)	**0.5**	**0.0**	**1.0**	**1.7**
Exports	1.8	7.5	6.7	7.4
Imports	3.9	5.4	7.4	8.2
Net exports (*)	**-0.6**	**1.0**	**0.1**	**0.1**
GDP	**-0.1**	**1.0**	**1.1**	**1.9**
Inflation	**1.0**	**1.7**	**1.3**	**1.0**

(*) Contributions to growth
Source: BBVA

France: GDP growth and inflation forecasts

YoY rate	2003	2004	2005	2006
Private consumption	1.7	2.3	2.2	2.4
Public expenditure	2.6	2.6	2.1	2.1
Gross fixed capital formation	0.3	3.5	3.5	4.2
Inventories (*)	-0.2	0.9	0.0	0.0
Domestic demand (*)	**1.4**	**3.5**	**2.4**	**2.7**
Exports	-2.5	3.3	4.5	5.9
Imports	0.2	7.5	5.9	7.0
Net exports (*)	**-0.8**	**-1.1**	**-0.4**	**-0.4**
GDP	**0.5**	**2.4**	**2.0**	**2.4**
Inflation	**2.1**	**2.1**	**1.5**	**1.3**

(*) Contributions to growth
Source: BBVA

Italy: GDP growth and inflation forecasts

YoY rate	2003	2004	2005	2006
Private consumption	1.4	1.0	0.9	1.7
Public expenditure	2.3	0.7	1.8	2.0
Gross fixed capital formation	-1.8	1.9	1.4	3.7
Inventories (*)	0.4	-0.3	0.0	0.0
Domestic demand (*)	**1.3**	**0.8**	**1.1**	**2.1**
Exports	-1.9	3.2	5.2	5.0
Imports	1.3	2.5	5.8	5.4
Net exports (*)	**-0.9**	**0.2**	**-0.1**	**-0.1**
GDP	**0.4**	**1.0**	**1.0**	**2.1**
Inflation	**2.7**	**2.2**	**1.7**	**1.8**

(*) Contributions to growth
Source: BBVA

Spain: GDP growth and inflation forecasts

YoY rate	2003	2004	2005	2006
Private consumption	2.9	3.5	3.3	3.1
Public expenditure	3.9	4.9	4.8	4.0
Gross fixed capital formation	3.2	4.6	5.9	5.3
Equipment	1.7	4.9	7.5	7.0
Construction	4.3	4.4	4.6	4.0
Inventories (*)	0.1	0.2	0.0	0.0
Domestic demand (*)	**3.3**	**4.4**	**4.4**	**4.0**
Exports	2.6	4.5	6.0	7.0
Imports	4.8	9.0	9.2	9.0
Net exports (*)	**-0.8**	**-1.7**	**-1.5**	**-1.2**
GDP	**2.5**	**2.7**	**3.0**	**2.8**
Inflation	**3.0**	**3.0**	**2.7**	**2.5**

(*) Contributions to growth
Source: BBVA

Summary of forecasts

Euro zone (% change y/y, except when indicated)

	2000	2001	2002	2003	2004	2005	2006
GDP at constant prices	**3.6**	**1.6**	**0.9**	**0.5**	**1.8**	**1.7**	**2.4**
Private consumption	2.8	1.9	0.7	1.1	1.1	1.6	2.4
Public consumption	2.4	2.4	3.1	1.6	1.6	1.6	1.6
Gross Fixed Capital Formation	5.2	-0.2	-2.5	-0.5	1.6	3.0	4.3
Inventories (*)	-0.1	-0.6	-0.1	0.4	0.4	0.0	0.0
Domestic Demand (*)	**3.1**	**0.9**	**0.3**	**1.2**	**1.7**	**1.8**	**2.6**
Exports (goods and services)	12.4	3.5	1.9	0.5	5.8	5.6	5.9
Imports (goods and services)	11.3	1.8	0.5	2.3	6.0	6.3	6.8
External Demand (*)	**0.6**	**0.7**	**0.6**	**-0.6**	**0.1**	**-0.2**	**-0.2**
Prices and costs							
CPI	2.1	2.3	2.3	2.1	2.1	1.7	1.5
Core CPI	1.0	1.9	2.5	2.0	2.1	1.4	1.5
Industrial Prices	5.3	2.0	-0.1	1.4	2.3	3.0	1.4
Labour Market							
Employment	2.2	1.3	0.6	0.2	0.5	0.7	1.1
Unemployment rate (% of labour force)	8.2	7.8	8.2	8.7	8.8	8.7	8.5
Public Sector							
Government balance (% GDP) (**)	0.1	-1.7	-2.4	-2.8	-2.7	-2.6	-2.7
External Sector							
Current Account Balance (% GDP)	-1.2	-0.2	0.8	0.3	0.6	0.6	0.4

*Contribution to growth
**Including UMTS receipts

International environment (% change y/y)

	Real GDP growth (%)					Inflation (%)			
	2003	2004	2005	2006		2003	2004	2005	2006
US	3.0	4.4	3.6	3.2		2.3	2.7	2.7	2.6
UK	2.2	3.1	2.5	2.6		1.4	1.3	1.8	1.6
Japan	1.4	2.7	1.5	3.0		-0.3	0.0	0.0	0.3
Latam (*)	1.7	6.0	4.4	3.6		10.8	6.2	6.7	6.1
China	9.3	9.5	8.5	8.0		1.2	3.9	3.3	3.3

*Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay and Venezuela.

Financial variables (end of period)

	Official rate (%)					Long-term interest rate (%, 10y)			
	15/04/05	Jun-05	Dec-05	Dec-06		15/04/05	Jun-05	Dec-05	Dec-06
Euro zone (*)	2.00	2.00	2.00	3.25		3.5	3.8	4.0	4.7
US	2.75	3.25	4.00	5.00		4.3	4.7	5.2	6.0
Japan	0.10	0.10	0.10	0.10		1.3	2.0	2.0	2.0

* Long-term interest rate refers to German Bund

	Exchange rate (vs euro)					Brent		
	15/04/05	Jun-05	Dec-05	Dec-06		15/04/05	Dec-05	Dec-06
US	1.29	1.30	1.35	1.35	$/b	52	38	36
Japan	134	136	135	135	€/b	40	29	27

BBVA

Economic Research Department:

Chief Economist:
   José Luis Escrivá

Deputy Chief Economist:
   David Taguas

Unit Heads:
   Europe: Manuel Balmaseda

   North America: Jorge Sicilia
   US: Nathaniel Karp
   Mexico: Adolfo Albo

   Latam and Emerging Markets: Javier Santiso
   Argentina: Ernesto Gaba
   Chile: Joaquín Vial
   Colombia: Daniel Castellanos
   Peru: David Tuesta
   Venezuela: Giovanni di Placido

   Sectorial Analysis: Carmen Hernansanz

   Financial Scenarios: Mayte Ledo
   Financial Flows: Sonsoles Castillo

other publications