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

TIME TO ACT TOGETHER!

Resolution adopted by the ETUC Executive Committee in their meeting held in Brussels on 24-25 June 2008

I. ACTION TO STABILISE THE ECONOMY AND SUPPORT GROWTH HAS BECOME NECESSARY

1. **A series of shocks is squeezing European growth.** Since mid 2007, the European economy has been hit by a number of negative shocks. Major losses on sub-prime and related collateralised debt obligations have weakened bank's balance sheets while increasing their aversion to risk. As a result, credit conditions have been tightened and credit has become more expensive. The euro exchange rate has appreciated substantially, thereby eroding past efforts to moderate wages. Inflation, driven by oil, commodities and food prices, is transferring income to the rest of the world and erasing the purchasing power of modest nominal wage increases. World economic growth, which until now has been offering dynamic export markets for Europe, is set to slow down with the US economy no longer able to play the demander of last resort for the world economy.

   Meanwhile, monetary policy decisions inside Europe are adding to these negative shocks. Over the past two years, the European Central Bank (ECB) and other central banks in Europe have been engaging in a series of interest rate hikes. The effects are starting to show now, severely hitting those euro area countries where past growth performance had been based on a housing boom and mortgage lending on the basis of variable interest rates.

   As a result, growth in Europe is expected to decelerate sharply from over 3% in 2006 to 1.8% in 2009. The euro area in particular would see growth in 2009 slow down to 1.5% (Commission forecast) or even only 1.2% (IMF forecast).

2. **…. and their full impact is yet to come.** Despite this accumulation of negative shocks, there is a certain perception amongst policy makers that the effects on growth and jobs would be manageable since, thanks to past structural reforms, the euro area has now become more 'resilient'. This, however, fails to take into account that many of these shocks take some time to work their way through the economy. Interest rate hikes, currency appreciation and tightening credit conditions are all characterised by time lags running up to 4 or 6 quarters. Moreover, some of the structural reforms implemented (cuts in unemployment benefits, cuts in job protection, higher incidence of low-paid, precarious jobs) would deepen the impact of an initial shock and would therefore actually work to

destabilise the economy. Hence, basing policy action , or rather the lack of it, on most recent growth performance is deceptive[1].

3. **The danger of the 2008 slowdown turning itself into a prolonged slump.** If left unchecked, negative shocks tend to amplify themselves[2] , ultimately triggering a vicious circle of low growth, loss of confidence, depressed spending and, hence, low growth. This was the case for example for the euro area between 2001 and 2005. During this period, the economy underperformed substantially because confidence was destroyed. Both households and investors, thinking that the European economy was 'doomed', restrained from spending, thereby effectively producing depressed growth outcomes. To prevent negative growth expectations from becoming entrenched in households' and investors' psychology and to avoid that another slump in growth would take over the next years, timely and convincing demand side action to stabilise the economy is necessary.

II. ECONOMIC POLICY IS NOT PROVIDING AN ADEQUATE ANSWER

4. **Monetary policy concerns over stagflation.** Monetary policy is considered to be the first line of defence. However, the European Central Bank in particular is now turning a blind eye to the need to stabilise the economy. Worried over 'stagflation', interest rates are kept at high levels while workers get lectured to continue to deliver wage moderation.

   This policy response is inadequate. It fails to see that higher inflation is not in any way related to an overheating of the domestic economy but is coming entirely from the external side. External price developments are driving a wedge between price stability on the one hand and the need to stabilise economic activity on the other hand. These developments are beyond the control of a central bank. If a central bank does try to offset the impact of more expensive oil on average inflation by generating deflation on the domestic price front, monetary policy itself risks becoming a major source of economic volatility and instability[3].

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[1] Recent and much better than expected growth performance is the issue at stake here. The euro area registered a 0,5% q-on-q growth in the first quarter of 2008, growth in Germany even going as high as 1,5% growth. However, the following should be taken into account: Mild winter conditions, additional working days from the leap-year as well as a major build up of stocks, worth 1% of German GDP, are inflating first quarter growth figures in an artificial way. Moreover, the fact that inventory build up has contributed 1% to GDP growth is actually quite disturbing. A build up in stocks implies that demand does not meet production and that production will be adjusted downwards in coming quarters in order to return to a more normal level of stocks.

[2] This works through different channels such as demand multipliers, investment accelerators and financial accelerators.

[3] This is particularly the case for the euro area. In the euro area, collectively bargained wage growth has stayed very close to a rate of 2% over the past fifteen years. This 2% growth rate may well constitute a floor below which workers and trade unions do not want to accept pay deals (because, for example, inflationary expectations are well anchored around this 2% figure and workers are highly reluctant to accept a cut in real wages). If this is the case, then depressing domestic price inflation requires to create

Moreover, nor the monetary overkill, nor the excessive wage moderation that will result from it, are a structural solution. In fact, simply pressing workers to 'accommodate' the oil price shock and to accept a transfer of purchasing power to oil producing countries may well work as an open invitation for oil markets to push up prices even further. An adequate policy response is to correct for the overdependence on oil of European economies instead (see further below).

5. **'Capital chasing assets': The new alibi to forget about 'stabilisation'?** In circles of central bankers, the idea is being put forward that monetary policy should not only aim for (consumer) price stability but should also prevent asset price bubbles from developing. According to this view, the provision of cheap and abundant liquidity has been at the basis of both the housing price boom as well as the sub prime mortgage bust. By using the argument that loosening monetary policy would only result in new asset price speculation elsewhere in the economy followed by another bust further down the line, have created the problems in the first place', monetary policy gets completely paralysed.

   This is a dangerous approach. By focussing monetary policy on price stability as well as asset price stability, it risks sweeping the objective of stabilising economic activity completely under the rug. It will tie the hands of central bankers when it comes to bringing economic activity back in line with potential output. Instability on the 'real' side of the economy will increase and the economy will remain below its potential level of activity over prolonged periods of time[4].

   Meanwhile, avoiding financial market speculation and 'booms and busts' driven by asset price speculation remain a valid concern. However, instead of giving up on the real economy by abstaining from expansionary monetary policy, a more intelligent approach is instead to cut interest rates and inject liquidity while at the same time ensuring that there's an adequate regulatory framework in place to prevent liquidity from spilling over into speculation and 'piramid' games.

   The US sub prime crisis provides a good illustration. The wave of sub prime mortgages in the US did not emerge when interest rates were at a historically low. Sub prime only started to take off when the activity of semi-public institutions[5] issuing mortgage collateralised debt was put to a stand still while regulation on sub prime private lenders was loosened at the same time. As a result, and despite <u>rising</u> interest rates and rising defaults (!), light or unregulated sub prime mortgage finance only started to boom in the US from 2005 on.

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a substantial amount of slack in the economy so as to convince workers to accept real wage cuts anyway .

[4] For example, to address a real property bubble of 15%, central banks would need to raise interest rates to such an extent that economic activity would be depressed by 5%. This represents a massive loss in output. Gerlach S and Assenmacher-Wesche,K <u>Can monetary policy really be used to stabilise asset prices?</u> March 2008 at www.voxeu.org

[5] FreddieMae and FreddieMac

6. **Fiscal policy: European demand side coordination is missing.** The European economy is highly integrated and this has certainly boosted productivity. However, the bias against expansionary fiscal policy is the Achilles heel of the European internal market: Since expansionary fiscal policy tends to disappear partly through import leakages to other European members, the responsibility of reviving the economy is left to all others and becomes the concern of no one. Even worse, in the absence of a European framework to correct for this bias against demand side policy, individual member states will be tempted to put their own economy in order by resorting to 'beggar-thy-neighbour' policies such as competitive wage moderation or downwards tax competition on mobile income sources. However, weakened demand and weakened public budgets for Europe as a whole will be the outcome of such 'free rider behaviour'.

7. Governments are already responding to the 2008 growth crisis on their own and without much attention for spill over effects on other member states. Some try to improve an already favourable competitive position by cutting employer social security contributions. Others waste existing leeway for demand side policies by promoting longer working hours and/or reducing taxes for the rich. Some think of engaging in implicit devaluations by raising indirect taxes. In this way, it will not take long before several member states hit the 3% excessive deficit again and will feel constrained to backtrack and start fiscal consolidation in the midst of the downturn.

III. MAKING THE MANAGEMENT OF DEMAND A MATTER OF COMMON CONCERN

8. Balancing price stability with stabilisation of economic activity. In the face of the slowdown that is unfolding, economic policy needs to balance the objective of price stability with the need to stabilise economic activity. Demand side management must be made a 'matter of common concern'. The ETUC calls for:

- **A forward looking monetary policy regime**. The focus of monetary policy makers needs to shift from headline inflation to underlying inflationary pressures and from a backward looking to a forward looking approach focussing on where the economy is heading over the coming year(s). The ECB in particular is now significantly running behind the economic cycle and should embark on a path of interest rate cuts without any further delay.

- **A temporary moratorium on contractionary fiscal consolidation.** This is not the time to engage in pro-cyclical fiscal policy tightening. Instead, the automatic stabilizers should be allowed to operate to the fullest extent. In countries where deficits are now below 3% of GDP, deficits should be allowed to increase in line with the economic slowdown. Other countries, if trying to keep the deficit close to 3%, should combine tax and expenditures measures in such a way that net impact on aggregate demand is neutral. This implies reviewing tax cuts for the rich while improving the purchasing power of those who are economically weak.

- **A European Smart Growth initiative.** Letting automatic fiscal stabilisers work is necessary to absorb negative demand shocks and prevent a worst case outcome. However, this may not be sufficient and discretionary action may be needed to turn the economy back around. To be prepared for such a situation, the ETUC suggests to discus the launch of a new European wide growth initiative, based on the principles that governments act together at the same time and in the same direction.

  If all member states do so, the weakness of the internal market becomes its strongest point since a joint fiscal expansion will have an effect on internal European demand that is twice as large[6].

  Moreover, this should not be about any form of fiscal expansion. The focus should be the need to reduce the overdependence of our economies on oil. In this way, demand side policy becomes structural policy.

  This European wide smart growth initiative should be coordinated and facilitated from the European level. This can be done by:

  - Putting the reformed Stability and Growth Pact to good use. The Commission and the Council should define those types of investment promoting 'smart' growth in order to take them (temporarily) out of the excessive deficit procedure.
  - Issuing an international bond of the European Investment Bank to finance the European Smart Growth Initiative. By balancing the high demand for euro denominated assets coming from the rest of the world with corresponding investment opportunities inside the euro area, such international bonds issuance would provide a response to the structural trend for euro appreciation[7].
  - Establishing national and pan-European will to crackdown on tax avoidance and evasion by the very wealthy and by corporations, thereby generating significant revenue to be used to invest in smart growth benefiting all members of society..
  - Organising European economic solidarity so that those member states having low deficits and high current account surpluses are turned into an engine for growth for the rest of the European economy.

- **A stop to thinking of wages as the adaptor of first and only resort.** Wages tend to be seen by policy makers in Europe as the single buffer against all sorts of shocks. Regardless whether the issue is globalisation, demand shocks, price stability shocks or boosting profits, the policy answer always tends to be more wage moderation, more wage flexibility. As a result, the share of wages in GDP has been falling almost continuously, while employment results have been mixed.

  This can not continue any longer. For Europe to become its own engine of growth, real wages need to catch up and evolve back in line with overall productivity growth. This implies stronger collective bargaining. It also implies stronger coordination to prevent workers from different member

[6] Compared to a situation where member states engage in fiscal expansion on their own.

[7] See background note attached

states undercutting each other while at the same time avoiding inflationary second round effects.

- **Put financial markets at the service of productive investment.** At present, the efficiency of financial markets to channel savings into productive investment can be seriously questioned. Financial markets have become instead a major source of instability, speculation and inequality. To reassert the role of financial markets in transforming savings into investments, financial market regulation needs to be improved substantially. Issues such as the lack of transparency, failing ratings agencies, excessive leverage, herd behaviour and speculative bubbles need to be addressed. This will involve a 'hands on' policy to ensure that necessary regulation keeps pace with financial market innovation.

9. Finally, the ETUC calls upon the incoming French government to put the twin concerns of preventing the economy from getting trapped in another long slump and of having financial markets function at the service of the real economy high on the agenda of the French presidency. Amongst other things, the existing Macro Economic Dialogue (Cologne process) should be strengthened and used as a way to discuss these policy challenges in close cooperation with European social partners.

Attachment: Background note

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ANNEX 1

GLOBAL FINANCE CAPITAL ON THE MOVE: TURNING A THREAT TO JOBS INTO AN OPPORTUNITY FOR SUSTAINABLE GROWTH

I. The euro's rise will take its toll on wages and euro area growth…

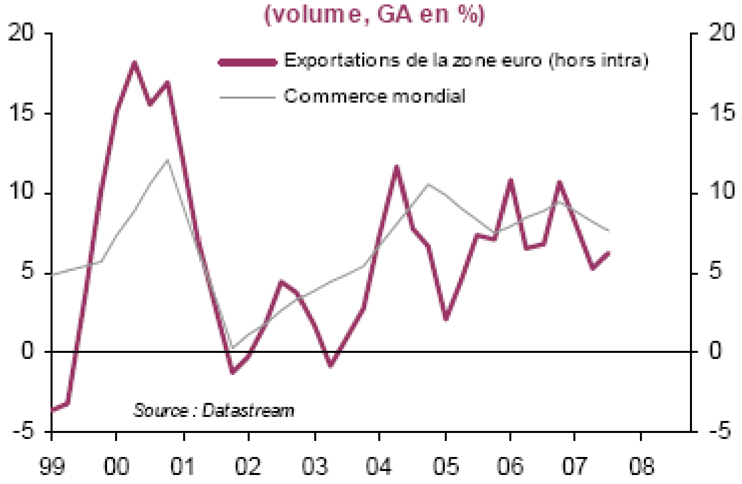
Over 2007, the euro exchange rate has appreciated steadily. Mainly driven by appreciation against major currencies such as the US dollar and the yen, the effective nominal exchange rate of the euro had risen by 6.2% in November 2007 compared to the same month one year ago. More recently, the British pound has also joined the basket of currencies losing value against the euro.

This trend of an appreciating euro comes on top of a list of other developments threatening demand and growth dynamics. The sub prime induced credit squeeze, the tightened monetary policy stance of the ECB triggering a turnaround in those European economies which until now had been acting as a locomotive for average European growth (Spain in particular), the fall-out from a possible recession in the US, the rise in oil and commodity prices transferring purchasing power outside of Europe all work in the same direction and the total result may very well be to push growth and job creation substantially back down.

Indeed, it can be seen from historical experience that euro area export performance is negatively correlated with the exchange rate. When the euro exchange rate goes up, euro area exporters lose market shares and export growth remains behind world trade growth and vice versa. On top of this 'mechanical' effect comes the fact that European exporters try to maintain their competitive position by lowering their product prices. To maintain profit margins at the same time, European producers exert massive pressure on workers and trade unions to cut wages and displace investments and outsource jobs outside the euro area. This does prevent some jobs in the export sector from disappearing but it also depresses wages and jobs in the non-export sector with overall lower growth as a result.

One illustration is the 2002-2003 period. Over this period, the appreciation of the effective exchange rate of the euro by some 20% coincided with export growth lagging behind world trade growth and with wage growth lagging behind productivity growth. A new wave of 'concession bargaining' was set in motion, with longer working hours without corresponding pay and cutbacks in holiday and bonus pay (see two graphs below).

Graphique 4a
Exportations et commerce mondial
(volume, GA en %)



Graphique 7
Zone euro : coût salarial unitaire (GA en %)

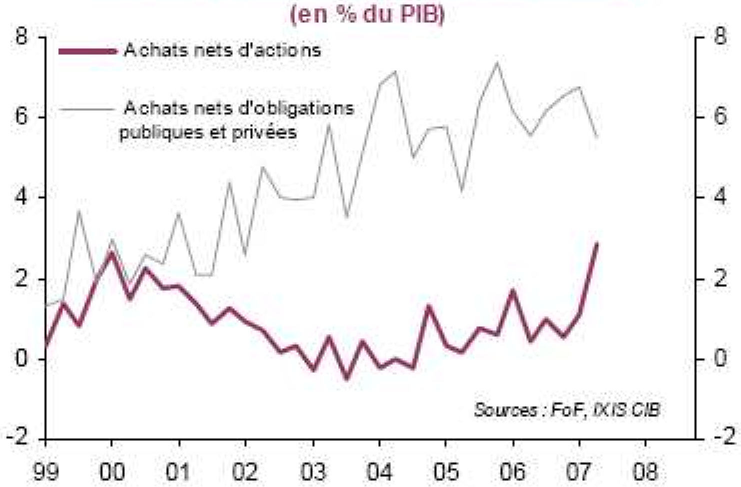
II. What is behind the steady rise of the euro

The reasons for the trend appreciation of the euro are to be found in the financial and not in the 'real world' sphere of the economy. They have to do with a structural mismatch between demand and supply for euro denominated assets.

A. Rising demand for euros …

Analysis of the euro area's capital account shows that a sizeable demand for euro denominated assets from the rest of the world has been developing itself from 2002 on. In particular, foreign demand for euro denominated bonds is very high, running up to 6 or even 8% of euro area GDP and resulting in a net total capital inflow.

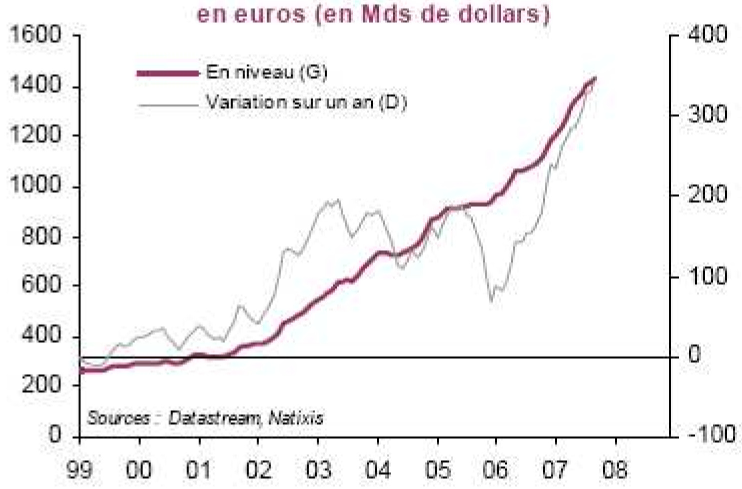
Graphique 9
Zone euro : achats nets par les non-résidents
(en % du PIB)



This appetite for euro labelled securities from the rest of the world is driven by several factors:

- The euro is gradually becoming an international reserve currency, as can be seen from the fact that central banks all over the world are shifting their currency reserves from dollars to euros. Whereas central banks had 20% of total foreign currency reserves in euros in 2002, this share has now gone up to 25,6%.In absolute terms, global currency reserves in euros have more than tripled from 400 billion in 2002 to 1.400 billion in 2007.

Graphique 10
Réserves de change mondiales investies
en euros (en Mds de dollars)



- Until the end of 2005, Asian countries like China acted as an 'absorber of last resort' by mopping up all dollars coming from their huge trade surplus with the US, thereby keeping their currency pegged to the US dollar. However, since end 2005, China has let go of its 'fixed-peg' currency regime, thus providing less support for the dollar. The excess of dollars in the world financial market being no longer absorbed by the Chinese central bank is now contributing to the collapse of the dollar in relation to other currencies, including the dollar–euro exchange rate.

- The huge US external current account deficit (about 6% of GDP) has until recently also been financed by the rest of the world by investing in US enterprise bonds. However, with two thirds of US company bonds in the form of 'asset backed securities' (ABS) and with the collapse of the ABS-market after the subprime turmoil, the dollar has lost this factor of support as well.

- Finally, there's the cyclical factor. With the Federal Reserve reacting to the unfolding slowdown in a clear pre-emptive way while the ECB stubbornly is refusing to take action, financial markets' perceptions of interest rate differentials change and capital flows get redirected towards the euro.

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B…is not matched by supply of euros.

There is, however, no corresponding supply of euros to match the appetite of the rest of the world. Indeed, with a current account close or even slightly above equilibrium, the euro area does not need additional import of capital and savings from the rest of the world. Euro area macro–economic savings are already sufficient to cover the present level of euro area investments.

This mismatch between high demand for euros (coming from capital flowing into the euro area) and lack of corresponding supply of euros (coming from the slight surplus on the euro area's current account, reflected in the lack of sufficient new debt emissions) is at the heart of the trend for the euro to appreciate. It implies that, if this mismatch is not addressed, the appreciation of the euro will continue.

Even worse, there is the possible danger that the euro appreciation trend may even intensify in coming months. It appears that the central bank of China seems to have recently signalled another shift in exchange rate policy, allowing the yuan to appreciate faster so as to contain inflationary risks in China[8]. However, if the appreciation of the 'yuan' is limited to the bilateral exchange rate with the dollar, then this would imply less dollars being bought up by the Chinese central bank and more dollar flows directed into other currencies, pushing up the bilateral exchange rate of the euro vis-à-vis the dollar.

III. Speculation driving oil, commodity and food inflation

Global capital is not only moving more into euro denominated assets. More recently, since mid 2007, financial investors are also looking to invest in oil, commodities and basic food stuff. With the collapse of investor confidence in subprime, mortgages and asset, attention of financial markets has shifted to the structural boom in oil and commodities which is driven by rising demand from emerging economies in a globalising world. Using 'futures' instrument, financial markets are now buying oil and commodities, hoping to cash in on higher prices in future. So, for example, the City of London has seen in the first half of 2007 the set-up of a whole branch of hedge funds specifically targeting commodity markets. Banks are openly advising their clients to invest in commodities' related funds because high returns seem to be guaranteed in this 'world of scarcity'. And the price increase of oil at the beginning of 2008 is conspicuously coinciding with the fact that investment flows are once again released after the closure of end of the year financial accounts.

However, in doing so, financial markets are once again in the business of conducting a self-fulfilling prophecy. It is basically the same 'Ponzi-type' of mechanism that has been observed in the past when financial markets were pouring in liquidity in ICT-related equity and housing markets, thereby effectively realising the asset price gains they were speculating upon without this asset price increase having much to do with a corresponding rise in the intrinsic value of the underlying asset. In the present case of commodities, this implies that financial markets are 'overshooting' and are pushing up the price of oil and commodities faster and higher than warranted by the mere 'physical' situation of the market in question.

This new type of 'overshooting' by financial markets can be illustrated, both in the case of oil market as in the case of corn markets. How to explain for example oil prices shooting up from 57 dollar a barrel beginning 2007 to almost 100 dollar a barrel end 2007 <u>when the rate of growth of world demand for oil has been limited to 2% in this same year and when the margin of oil capacity production over world demand has actually increased ? (see two graphs).</u>

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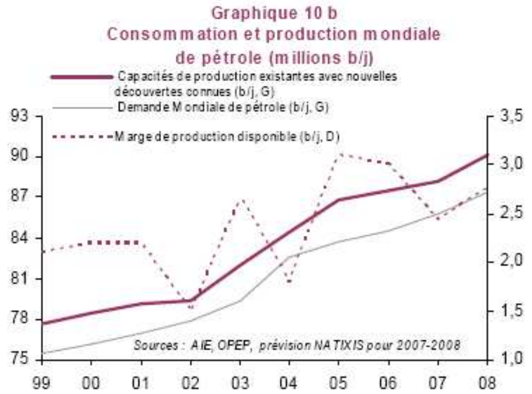
[8] The Star « China signals policy shift, yuan to appreciate faster », December 28, 2007 at www.thestar.com



Similarly, the rapid increase of corn prices from mid 2007 on is also difficult to explain, given the fact that world demand has been rather stable since 2004 (and even falling slightly in 2006), and given a world stock worth about 20% of annual consumption.

What does this mean for euro area growth? Higher oil and commodity prices invoke the spectre of 'stagflation'. Higher oil prices erode the purchasing power of the euro area, transferring it to oil producing countries and hedge fund owners, while at the same time pushing inflation higher. All the ingredients are there to produce a cocktail dangerous to jobs and growth: The transfer of purchasing power already depresses domestic demand and overall growth. And if the ECB were to react to the (temporary) rise in inflation by raising interest rates or failing to produce a warranted cut in interest rates, then the initial slowdown in growth is amplified further.

The previous also illustrates that demands for wages to simply 'absorb' the rise in oil process and absorb the loss in purchasing power are not very convincing. It partly boils down to saying that wage earners should indeed reward the excesses of financial markets speculating on commodities and oil. Another policy response is necessary.

IV. From threat to opportunity: Combining a European Growth Initiative with the challenge of sustainable development.

Global finance capital on the move endangers jobs and growth in the euro area by triggering a too expensive euro as well as by pushing oil and commodity prices up What can policy makers do to manage these capital flows in a better way?

A. Cutting interest rates and/or exchange rate management: Possible but unlikely

To address the mismatch on the euro exchange market, one possibility is to reduce the demand for euro denominated assets from the rest of the world by cutting euro interest rates and/or by having the ECB stabilise the dollar by accumulating dollar currency reserves.

However, whereas cuts in interest rates are possible and necessary (given the downward direction into which the economy is moving), the ECB is not likely to move on this and when it does move it will be too late to avoid negative growth expectations from getting entrenched.

It is also unlikely that the ECB would start up exchange rate interventions (although it did successfully do so when there was the opposite problem of the collapse of the euro exchange rate). However, in contrast to monetary policy, exchange rate management is a shared responsibility of the ECB and the Council. Provided the Commission puts forward a proposal, the Council can indeed provide the ECB with guidelines and orientations concerning (bilateral) exchange rates which the ECB is forced to implement provided the objective of price stability is respected. Also note that the ECB can intervene on its own since the problem is to stabilise the dollar and since this can be done by simply buying up dollars and accumulate dollar reserves in return for emitting euros (for which it has the right and possibility to do so). However, the initiative for exchange rate management lies wit the Commission which is not keen either to act in this matter. Besides this a qualified majority would be necessary in the Ecfin council which is not easily assured either.

B. An alternative proposal: Absorb capital flows in an intelligent way

An alternative way is to absorb the capital flowing into the euro area by increasing the supply of euros in an intelligent way. If the rest of the world is willing to invest in the euro currency, then this is an opportunity that euro area policy makers should grasp. Instead of leaving global capital flows to their own devices and letting them push up the value of the euro and destroy competitiveness and jobs, the euro area should move to a higher level of domestic demand and in that way meet (partially) the demand for euros and stabilise the exchange rate and/or offset the negative impact of the stronger euro on jobs and competitiveness. However, the strict condition is that this additional demand and the debt that corresponds with it needs to be an 'intelligent' demand, generating adequate benefits.

A practical proposal is to organise European finance for a sustainable growth initiative. The European Investment Bank (EIB) should mobilise capital from the rest of the world by writing out euro denominated loans amounting to 1% of European GDP. The EIB should then re-lend this capital to those governments investing in <u>additional</u> sustainable development priorities, with possible areas of investment and criteria defined by the Council upon a proposal from the Commission. Sustainable development priorities can cover renewable energy, energy savings programs, a switch to clean technologies. And support could be provided in the form of subsidies or, additionally, in the form of tax incentives for sustainable investments. The latter will certainly be welcomed by European business, given the new generation of European environmental directives in the pipeline.

Obviously, this initiative would require temporarily higher public deficits. However, given the fact that the euro area deficit has almost disappeared, there is room to do so, at least in those countries where the deficit is close to zero <u>and</u> where there is a danger that economic activity would fall below potential activity. The choice is between two scenario's. Either Europe does not act and watches how the collapse in economic confidence and growth will push up deficits anyway.

Or Europe pro-actively increases public deficits (in a temporary way), thereby allowing to stabilise economic confidence and preventing a long economic slump while at the same time adressing the challenge of sustainable development and defending European's purchasing power and standard of living by allowing savings on energy and commodities. The choice is ours.