Expect a non-inflationary boom in Europe

A conversation with Jean-Philippe Cotis, chief economist of the Organization for Economic Cooperation and Development (OECD).

By Sciarretta Vincenzo

Investors should be delighted to listen to Jean-Philippe Cotis. He thinks that European economic activity can rise above-average for a couple of years without exacerbating inflation. The Continent is able to stand the fiscal tightening in Germany and Italy, which account for about 50% of the euro area. The US is not entering a recession, but just a mild slowdown while rebalancing its total demand. And as far as the dollar is concerned, the path of least resistance leads to a further depreciation.

Jean-Philippe Cotis is currently Chief Economist and Head of the Economics Department at the OECD in Paris. Previously Director of the Economics Department at the French Ministry of Economy, Finance and Industry since 1997, Mr. Cotis joined the Ministry in 1982 after graduating from the Ecole Supérieure des Sciences Economiques et Commerciales (ESSEC) and the Ecole Nationale d'Administration (ENA). He held the position of Economic Advisor to the Minister in 1993-1994. Mr. Cotis was also an economist at the IMF from 1986 to 1988.

The Euro-zone had been languishing for several years with high unemployment and little growth, but 2006 has shown much greater dynamism. Are you optimistic for the future?

"I believe we are in a period of above-average expansion. It is not a miracle, it was overdue. The weakness was quite persistent. Now, for cyclical reasons, I lean toward a scenario of robust activity and mild inflation. It may last two years or so."

And after that?

"The potential growth for the euro area is currently around 2%. This rate is likely to decline because of the aging of the population and the contraction in the share of working people. Accordingly, structural reforms are needed in order to improve the outlook."

You claimed that on the whole economic activity ought to remain robust for a number of years. Would you qualify it as a deflationary boom?

"I think this is a satisfactory season with well contained inflation. There may be some additional monetary tightening, but of relatively small magnitude and just to make sure that the cost of living remains under control in the long-term. I am not particularly worried as regards price stability. If we have an inflation revival, the causes are likely to be external, as in the case of an oil super-spike engendered by a geopolitical crisis. However, this is not my central scenario."

Do you share the thesis that Eastern Europe keeps on having a disinflationary impact?

"Yes, I do."

Historically, the European cycle has followed the American one by two or three quarters. The United States is experiencing a slowdown right now. Should we expect the same in the Old Continent?

"This is a very interesting question. My answer is *not necessarily*."

Could you elaborate a little bit on that?

"At the beginning of this decade, to balance aggregate demand and supply, US policy had to offset a weak external demand, especially in Europe and Japan, by stronger demand at home. An expansionary fiscal policy and an accommodating monetary stance went hand in hand to produce the recovery in the aftermath of the 2001 recession. Yet, and this is an important point, I believe that aggregate demand and supply broadly match. Therefore the United States needs a rebalancing of demand, not a sharp contraction. In this regard, the greater dynamism in Europe should help. I do not see a recession, we are not in 2000."

As far as Europe is concerned, what are the main dissimilarities between now and 2000?

"First: In 2000, the two sides of the Atlantic shared the same business cycle; by contrast this time we had several years of vigorous growth in America and several years of below-average activity on the Continent. Second: At that time, aggregate demand vastly exceeded potential supply, calling for a noticeable adjustment. Now, In Europe demand needs to catch up with supply and the trend is not over yet. While in the United States the problem is to rebalance total demand rather than lowering it. Thus, is Europe supposed to follow the US cycle? My answer is *not really*. Basically we don't have the same cycle."

The cost of borrowing established by the European Central Bank is currently 3.5%, and the 10-year yield is about 3.9% in Germany. If

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prevailing market expectations are right, short-term rates are heading toward 4% in 2007. In other words, the yield curve may invert. What do you think about?

"I do not attribute any great importance to this eventuality because the risk premium incorporated in long-term rates has fallen decisively over the past few years. In this contest I think that a marginally inverted curve or a flat curve don't carry with them the seeds of the next crisis."

In your opinion, what might be an equilibrium exchange rate between the euro and the dollar?

"Oh, I am not able to give you an answer. To that end, you have to estimate the equilibrium current account deficit for the US. We do not think the US should run a zero current account deficit since it is an attractive economy and people want to buy its assets…"

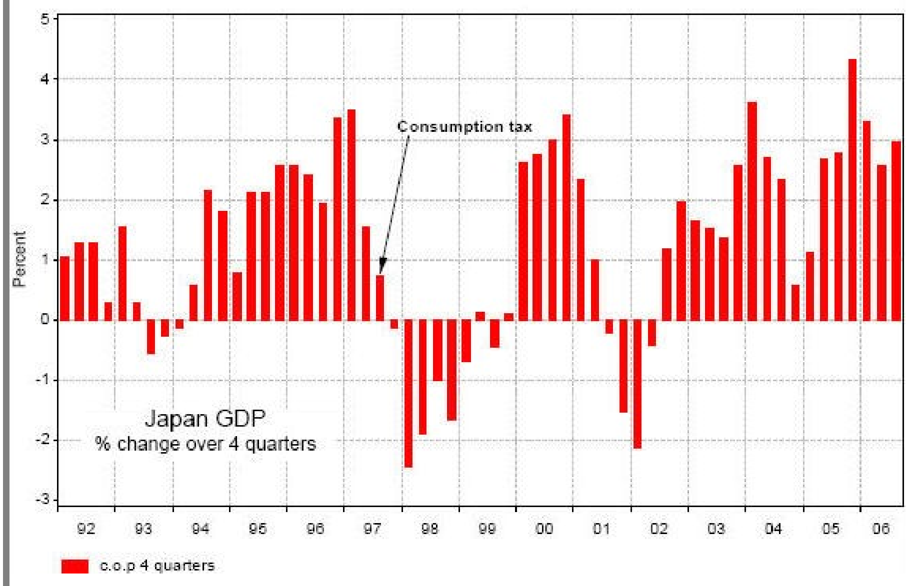
But you sense that the deficit is excessive, don't you?

"Yes, it looks unsustainable; it is my contention that it will eventually go down, although I do not know by how much and accordingly I do not know the size of the dollar depreciation we need."

You are suggesting the dollar is likely to give ground.

"I think so, to some extent."

Germany: Not like Japan in the mid-1990s



Source: *Gavekal Research*

It is worth recalling that Japan in the mid-1990s had a good recovery. Then in July 1997, the government hit consumers with a consumption tax increase and the economy plunged again. But, according to Cotis, Germany can stand the VAT increase, effective on the 1th of January 2007. The environment is different, he says.

Germany is about to increase its value added tax from 16 to 19 percent on January 1. Further Italy has adopted a tightening posture. The two countries account for about 50% of the euro area. Do you expect a severe impact in the short-term?

"It will impact the growth, it will not destroy the recovery. If anything, it may render the recovery a little bit longer. Take Germany, for example: a tightening fiscal policy next year may cool economic activity, but at the same time, by rehabilitating state finances, the government put itself in a position to support the economy if necessary. They are going to recreate the margins. In 1999 and 2000 the opposite was true."

What do you mean?

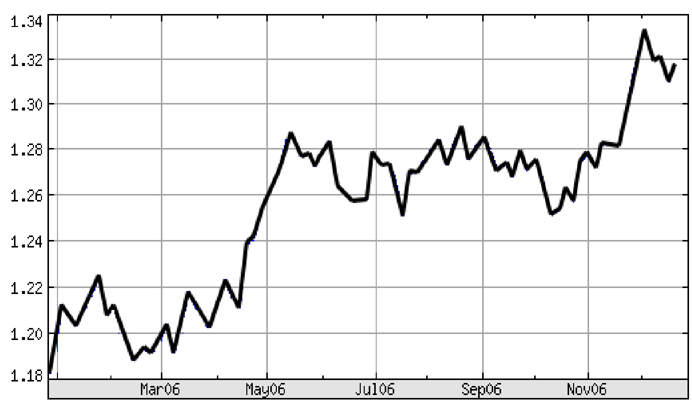
"I mean that in 1999 and 2000, when Europe was at the peak of the cycle, fiscal policy became very loose. And then, as soon as the trend turned down, Germany was forced to engage in budgetary retrenchment. There was a recession. Fiscal policy was not appropriate. If one wants to tighten, it is in the upswing than the chances of success are good. So this is a good moment."

Some argue that there is a noteworthy similarity between the position of Germany now and that of Japan in the second half of the '90s. They recall that Japan in the mid-1990s had a spurt of recovery and was actually the strongest economy in the G7 in 1996. Then, in July 1997, the Government hit consumers with a consumption tax increase and the country suffered a deep recession again.

"You are right, you are right, but the increase coincided with the Asia crisis. The market for Japanese exports deteriorated to the vanishing point. In sum, the environment was bad. Here, the opposite is true, the environment is good."

Mr. Cotis, many thanks for your time.

EUR/USD as of 26 December 2006



"The dollar may give ground"

" I believe that aggregate demand and supply broadly match in the US. The country is not on the verge of a recession."