The European Economy: Current Situation and Economic Outlook

In 2003 the European economy was close to stagnation. With real GDP growth of only ½ percent, the euro area was the least dynamic region of the industrial world. Despite a further easing of monetary policy, domestic demand remained subdued and exports remained weak reflecting low growth in world trade and the strengthening of the euro. After stagnation in the first half of 2003, output in the euro area increased again in the second half, and business confidence also recovered. In 2004, the European economy is expected to recover with growth in the euro area amounting to 2 percent. This will, however, not be strong enough to reduce unemployment. The forecast is based on the assumption of a continued upturn in the world economy leading to a turnaround in exports and investment. But the upturn remains fragile as it depends to a large extent on external factors. As external imbalances continue to widen – the US current account deficit is expected to increase to more than 5 percent of GDP – there is a risk of a continued weakening of the US dollar and a further appreciation of the euro. Although this would reduce import prices and support real income in the euro area, it could become a major obstacle to an export-led recovery in Europe.

1. The current situation

In 2003, the economic performance in Europe was (once again) disappointing. Output in the euro area increased on average by only ½ percent (after 1.7 percent in 2001 and 0.9 percent in 2002). For the third consecutive year growth remained below the trend rate of around 2 percent, so that the output gap – a measure of the under-utilisation of resources – widened further. As a result, unemployment continued to increase. Output growth in the euro area was about 1 percentage point lower than expected in our report of last year, the main reason being the lower growth in world trade and the significant strengthening of the euro, which restrained exports.[1] Both risks – a weaker recovery of the world economy and a sharper appreciation of the euro – were discussed as risk scenarios in last year's report. Some of the other assumptions in last year's forecast did, however, materialise. In particular the geopolitical situation improved after the war in Iraq and the oil price declined sharply after its peak in March, although it increased again later in the context of rising demand. Furthermore, equity markets stabilised and earlier losses in equity wealth were partially reduced. With rising share prices and lower interest rates (including a lower risk premium on corporate bonds), investment financing became less costly. But as demand conditions deteriorated and profits were squeezed, business investment continued to fall.

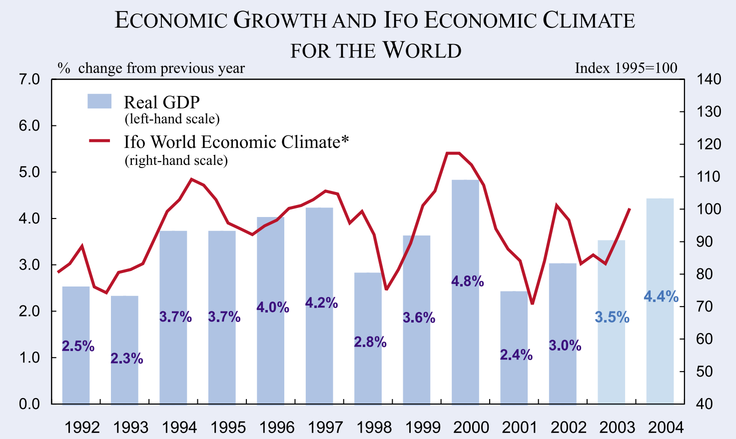
Economic activity was particularly weak in the first half of the year when output in the euro area stagnated. Output increased again in the second half of the year.

After the summer, business expectations in most countries, including those of Western Europe, started to pick up, signalling a bottoming out of the downturn, although in Europe the assessment of the current situation by business remained subdued (Figures 1.1 and 1.2). Towards the end of the year, however, business expectations improved in Germany as well as the assessment of the current situation, according to the Ifo business survey. The combination of both sub-components of the Ifo business climate tends to move in a clockwise manner over the business cycle and the current combination of improved actual conditions and optimistic expectations indicates a recovery of the economy (Figure 1.3). (For further details on business confidence in individual countries and regions see Appendix 1).

In European countries outside the euro area, growth was more robust in the United Kingdom, where it

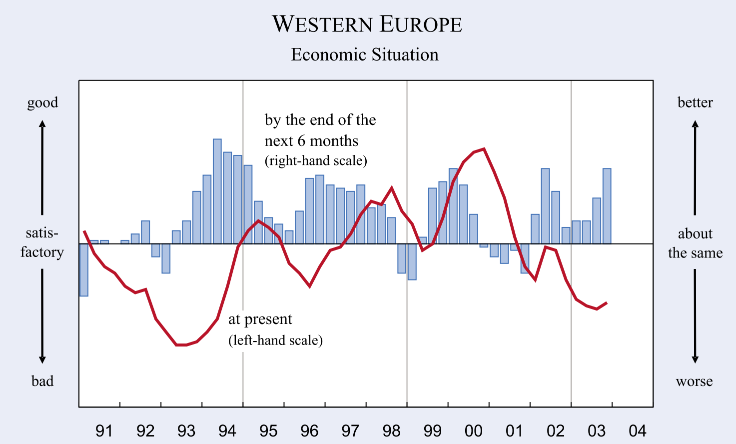
[1] In 2003, world trade increased by only 4 percent, while in last year's forecast an increase of 6 percent had been assumed. In 2003, the euro appreciated against the US dollar by around 20 percent and in effective terms by around 12 percent, which we had not anticipated. The actual export growth of the euro area (1 percent) was much weaker than expected (+ 4.5 percent), and this had also negative effects on investment, employment, and business and consumer confidence.

Figure 1.1



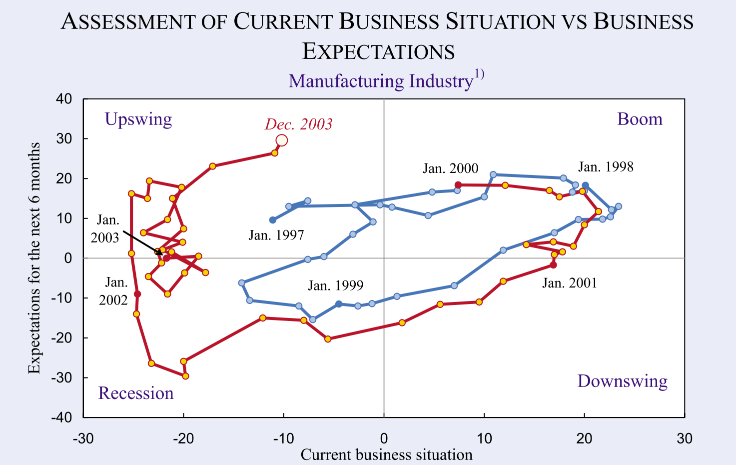
*) Arithmetic mean of judgement of present and expected economic situation.
Sources: IMF, Ifo World Economic Survey (WES); calculations and forecast by the Ifo Institute (Dec. 2003).

Figure 1.2



Source: Ifo World Economic Survey (WES).

Figure 1.3



1) Manufacturing industry excluding food, beverages and tobacco. Balances, seasonally adjusted data.
Source: Ifo Business Survey, West Germany.

was supported by public spending and monetary easing, and in Sweden, while in Switzerland output declined.

1.1 Widening growth gap to the United States

In 2003, the euro area recorded the lowest growth among the major regions of the world and also within the OECD area. Output increased in the United States by 3 percent and in Japan by 2¼ percent. While in the United States this development was broadly in line with our forecast,[2] the rebound of the Japanese economy came as a surprise. In both countries, the recovery was led by domestic demand. In the United States, domestic demand was boosted by a sharp increase in military spending, in particular in the first half of the year in the context of the war in Iraq; the increase in military spending accounted for around one fifth of GDP growth in 2003.[3] Private consumption remained resilient despite the increase in unemployment, as households further reduced their already low savings rate to sustain spending. This was helped by extremely low interest rates.

In Japan, the unexpected rebound of growth during 2003 was led by business investment; at the same time the steady (but moderate) rise in private consumption and the continued strong increase in exports to dynamic countries in Asia, in particular to China, supported demand. It appears that the ongoing restructuring of the business sector and the further easing of financial market conditions by unorthodox measures – with the central bank purchasing bonds and equities to further increase bank liq-

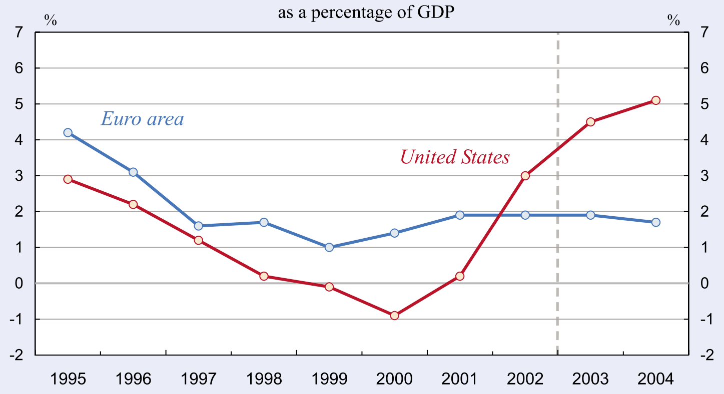
[2] In last year's report we had projected GDP growth of 2.7 percent.
[3] In the first three quarters of 2003, real military spending increased by around 10 percent against the previous year, and as military spending is around 4.5 percent of GDP, its contribution to GDP growth was around ½ percentage point.

uidity and to raise share prices – has created enough liquidity to bail out banks in difficulty and has finally succeeded in turning the economy around. But the recovery is still narrowly based in certain manufacturing industries which benefit from export and investment growth and could be undermined by a further appreciation of the yen and an increase in interest rates. Other sectors still suffer from excessive debt and need further restructuring.

Figure 1.4

GOVERNMENT STRUCTURAL BUDGET DEFICIT IN THE EURO AREA AND THE UNITED STATES

as a percentage of GDP



Sources: OECD, Euro area; 2003 and 2004: Ifo forecast (December 2003).

Similar to last year's assessment, the differences in growth between the United States and Europe can be explained by the more expansionary macro policies in the United States as well as ongoing structural problems in some of the big continental European countries.

1.2 The policy mix

With respect to *fiscal policy*, the difference between Europe and the United States was most pronounced and became even bigger than before. In the euro area, while the (average) actual budget deficit increased from 2.2 percent of GDP in 2002 to 3 percent in 2003, the structural budget deficit remained at 1.9 percent.[4] Whereas a number of countries continued to aim at meeting their consolidation targets as laid out in their stability programmes, France and Germany and – to a lesser extent – Italy deviated significantly from their stability programmes and also from the target to reduce the structural deficit by 1/2 percentage point of GDP a year (until the medium term target of close to balance or in surplus is reached). By contrast, in the United States, fiscal policy continued to boost demand as taxes were cut and public spending, in particular for military purposes, was increased sharply because of the war in Iraq. The structural fiscal deficit (as a percent of GDP) increased by 1 1/2 percentage points (from 3 percent to 4 1/2 percent). Between 2000 and 2003 fiscal policy in the United States provided a historically large stimulus with a deterioration of the structural fiscal balance by 5 1/2 percentage points of GDP and of the actual fiscal balance by 6 1/4 percentage points.

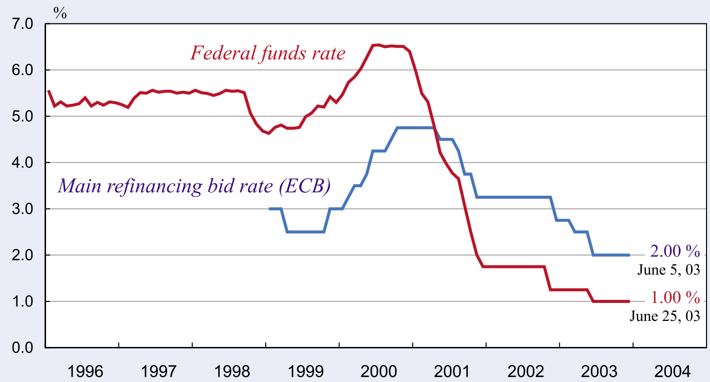
Monetary conditions remained favourable in 2003, both in Europe and in the United States. While nominal short-term interest rates continued to decline to historically low levels, they remained higher in the euro area than in the United States (Figure 1.5).[5]

[4] The breakdown of the government budget into a cyclical and non-cyclical or structural component aims at separating cyclical influences on the budget balances resulting from the divergence between actual and potential output (the output gap) from those which are non-cyclical. Changes in the latter can be seen as a cause rather than an effect of output fluctuations and may be interpreted as a proxy for discretionary policy changes. The structural budget balance is derived by (re-)calculating government revenues and expenditures which would be obtained if output (GDP) were at its potential (or trend) level. We follow here the approach used by the OECD. See also Chapter 2 of last year's report.

[5] The ECB reduced the refinancing rate in March and June by 25 and 50 basis points, respectively, so it is now (December 2003) at 2 percent.

Figure 1.5

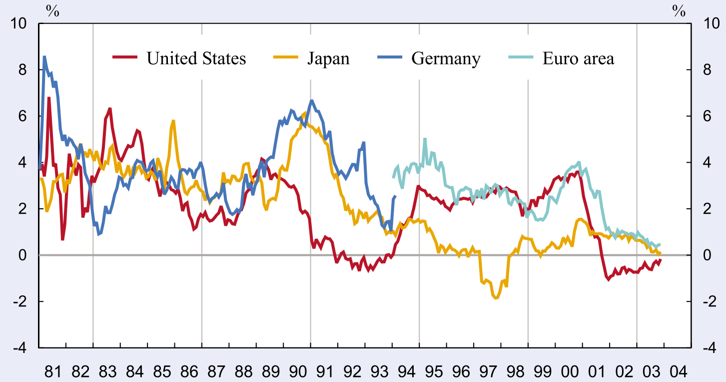
CENTRAL BANK INTEREST RATES



Sources: European Central Bank, Federal Reserve Bank of St. Louis.

Figure 1.6

REAL SHORT-TERM INTEREST RATES [1)]

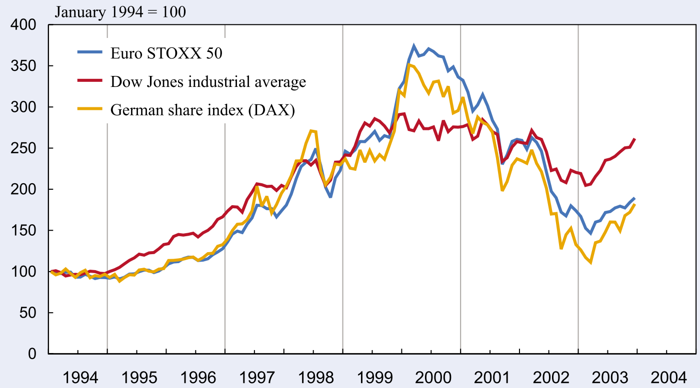


1) 3-month interest rates minus core inflation rate (CPI excluding food and energy).

Sources: Deutsche Bundesbank, European Central Bank, Eurostat, Federal Reserve Bank of St. Louis, Federal Statistical Office, OECD; calculations by the Ifo Institute.

Figure 1.7

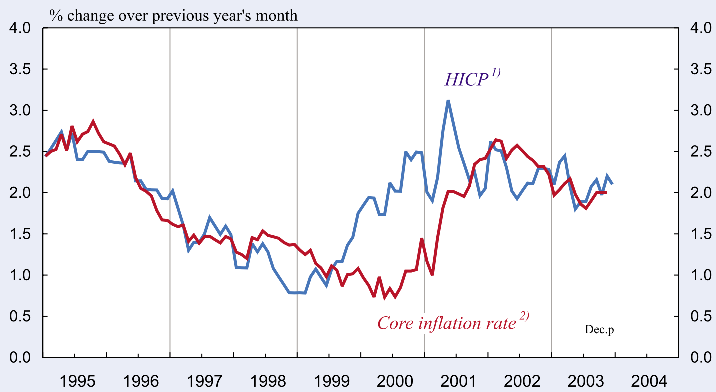
DEVELOPMENTS IN STOCK MARKETS



Sources: Deutsche Bundesbank, Dow Jones & Co., Inc.

Figure 1.8

PRICE DEVELOPMENT IN THE EURO AREA



1) Harmonised Index of Consumer Prices.
2) HICP excluding energy and unprocessed food.

Sources: European Central Bank, Eurostat; calculations by the Ifo Institute.

Real interest rates declined to almost zero in the euro area and became negative in the United States (Figure 1.6).

In the euro area the easing effect of lower real interest rates on monetary conditions was partly offset, however, by the appreciation of the euro, so that overall monetary conditions tightened somewhat during the course of 2003. As a result of diverging exchange rates, monetary conditions became less accommodative than in the United States.

Nominal and real government bond yields also declined further in 2003, but started to edge up again during the course of the year. This may have been caused by the perception of a near-term recovery, notably in the United States, but possibly also by concerns of high and rising fiscal deficits, notably in the United States and Europe.

Furthermore, the turnaround in equity markets and the fall in the risk premium of industrial bonds also contributed to the easing of equity and debt financing of business investment (Figure 1.7). Nevertheless, bank lending to corporations remained low in the euro area, which could reflect both low credit demand but also more cautious lending behaviour by the banks, which were still strained by the earlier stock market decline.

1.3 Cost pressures and demand patterns reflect cyclical and structural weaknesses

It is striking that despite the further weakening of demand – as reflected in the widening output gap – and the strong appreciation of the euro, the inflation rate in the euro area did not significantly fall below the ECB target rate. Reasons for the small decline of the inflation rate include again some special factors like higher oil prices and bad weather conditions as well as increas-

Table 1.1
The development of various measures of wages and wage costs
Average annual changes in per cent

		Nominal wage 1)	Real wage 1)2)	Unit labour cost 3)	Relative unit labour cost 3)4)
Euro area	1996–2000	1.6	-0.3	0.3	-3.6
	2001–2003	2.5	0.3	2.4	6.1
of which:					
Germany	1996–2000	1.2	-0.1	0.6	-1.4
	2001–2003	2.0	0.7	0.5	0.9
France	1996–2000	1.6	0.5	-2.3	-4.0
	2001–2003	2.9	1.1	0.7	0.8
Italy	1996–2000	2.4	-0.3	1.3	2.5
	2001–2003	2.5	-0.5	4.2	5.0
Finland	1996–2000	3.2	1.1	-1.9	-3.7
	2001–2003	4.1	1.2	2.0	2.2
Netherlands	1996–2000	2.9	0.8	0.8	-1.4
	2001–2003	4.6	1.4	2.7	4.0
Ireland	1996–2000	4.5	0.4	-3.1	-5.8
	2001–2003	7.0	0.1	1.7	4.5
Spain	1996–2000	3.6	0.9	2.5	1.2
	2001–2003	4.2	0.9	4.4	4.6
United Kingdom	1996–2000	4.5	2.6	2.2	7.7
	2001–2003	4.5	2.3	1.6	-1.5
Sweden	1996–2000	4.4	3.1	-2.7	-2.3
	2001–2003	4.5	1.9	1.8	-0.4
United States	1996–2000	4.3	2.4	-0.5	3.4
	2001–2003	2.7	0.7	0.2	-1.7

Notes: 1. Business sector
2. Nominal wage deflated by output deflator (*i.e.,* real product wage).
3. Manufacturing sector.
4. Competitiveness-weighted relative unit labour costs in dollar terms.
5. Exports relative to export markets, a positive number indicates gains in market shares and a negative number indicates a loss in market shares.
Source: Calculations by the Ifo Institute.

es in indirect taxes and administered prices in some countries (Figures 1.8 and 1.10).

However, as already mentioned in last year's report, another even more important factor explaining the relatively high inflation rate in the euro area is that unit labour costs continued to increase. Whereas real product wages (nominal wage rates deflated by the output deflator) remained flat, suggesting wage moderation, nominal wage rates increased faster than labour productivity, raising unit labour costs (see Table 1.1). The continued low productivity growth (1/2 percent) was partly cyclical but may also reflect labour hoarding and underlying weakness. At the same time, producer prices (as reflected by the output deflator) were depressed by low demand. Furthermore, the strengthening of the euro increased relative unit labour costs in dollar terms, and as firms did not (fully) pass on higher costs to prices in order to protect their shares in domestic and foreign markets, profit margins were squeezed.[6]

By contrast, in the United States, as a result of the much higher gains in labour productivity (of almost 3 percent), unit labour costs stagnated. This and the depreciation of the dollar helped profit margins of US firms to recover, which stimulated business investment.

The differences in demand patterns between the euro area and the United States are also striking. Although both regions suffered from the low growth of world trade, the negative impact of foreign trade on GDP growth (as reflected in the change in the net foreign balance) was larger in the euro area.[7] The weakening of exports in euro countries reflected the strengthening of the euro, lower world trade growth and the fact that a large part of these exports are within the euro area, the least dynamic region of the world economy. At the same time, domestic demand remained weak. By contrast, in the United States, domestic demand remained robust (with an increase of around 3 percent) as it was boosted by the more expansionary macro policies, including a more aggressive reduction of interest rates, further tax cuts and additional military spending.

In the euro area:

- Real private consumption growth increased to around 1 1/4 percent (from 1/2 percent in 2002), reflecting somewhat higher real income growth. In some euro countries, households increased their savings rate, while in others, households reduced their savings rates.
- Residential construction remained weak; after some increase in the first half of the year, it declined again in the second half.
- Business investment continued to fall, but stabilised by the end of the year (for the contribution of domestic demand to quarterly GDP growth see Figure 1.9).

At the turn of the year 2003/2004, there were clear signs that the European economy will improve, but

[6] A rough proxy for the development of profit margins is the difference between the change in the GDP deflator and the change in unit labour costs.

[7] In the euro area, the contribution of the net foreign balance to GDP growth was – 0.8 percent (after + 0.7 percent in 2002) and in the United States it was – 0.4 percent (after – 0.8 percent in 2002).

there is still considerable uncertainty about how strong and how sustainable the recovery will be. This will to some extent depend on external factors, in particular on the growth of the global economy, the further development of the euro and also on how macro and structural policies are pursued in Europe.

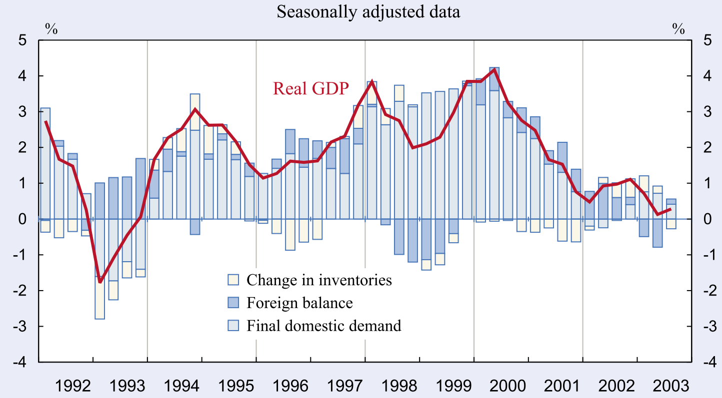
In the United States:

- Public consumption (in particular for security and defence) continued to increase rapidly as a result of the war in Iraq and increases in other security-related spending. Between 2000 and 2003, military spending increased from 3 percent of GDP to 3.8 percent and is projected to increase further to 4½ percent. During the cold war, military spending amounted to around 6 percent of GDP. The absolute level of real military spending will, however, be similar to the peak level reached during the cold war. Thus a good part of the peace dividend from ending the cold war is now spent on the "war on terrorism".
- Private consumption benefited from additional tax reductions, which supported real disposable income. Financial conditions for household spending became more favourable as interest rates were further reduced and equity prices rose again, so that earlier losses in equity wealth were reduced somewhat. The household savings rate declined (after an increase in 2002) despite the drifting up of unemployment. Real private consumption increased by around 3 percent (after a similar increase in 2002), which was much higher than after previous cyclical downturns.
- Residential construction increased by almost 7 percent (after almost 4 percent in 2002), reflecting the sustained willingness of private households to spend; this was supported by the continued increase in house prices and low mortgage rates.
- After sharp declines in 2001 and 2002, business investment started to recover during 2003. Given the low starting position at the beginning of the year, average annual growth remained modest (1½ percent), but investment growth during the year was pronounced, with quarter to quarter (annualised) increases of around 7 percent. A good part of this investment was in ICT equipment, suggesting that the previous overhang has now been largely corrected.

Figure 1.9

CONTRIBUTION TO GDP GROWTH IN THE EURO AREA[1)]

Seasonally adjusted data



1) Annual percentage change, from 2001 including Greece.
Sources: Eurostat, calculations by the Ifo Institute.

2. Economic Outlook 2004: Gradual Recovery in the World Economy and in Europe

2.1 The Global economy

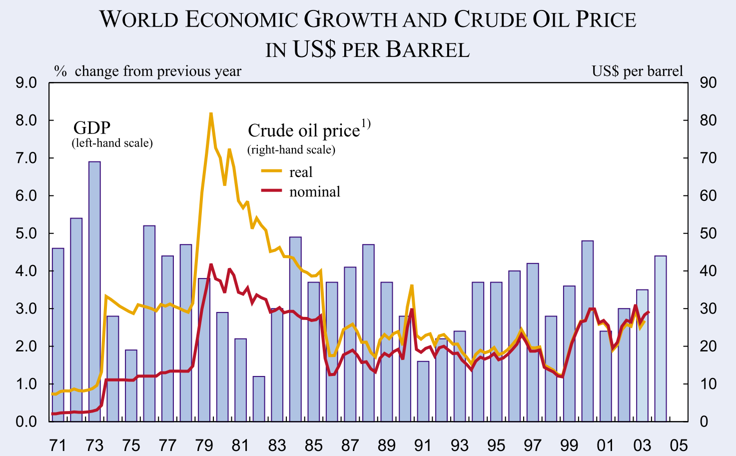
In 2004, we expect the world economy to strengthen because the major obstacles to a recovery are losing in importance. After the war in Iraq, geopolitical risks in the Middle East have diminished despite ongoing instabilities in this region. Business and consumer confidence have improved almost everywhere, also nurtured by supportive macro policies and the rebound of stock markets world-wide The expected strengthening of the world economy is based on the following assumptions:

- In the United States, both fiscal and monetary policies will remain expansionary. The additional tax measures which were implemented in mid-2003 and high government spending will continue to stimulate demand. The structural deficit (as a percentage of GDP) is expected to increase further (by 0.6 percentage points). Whereas interest rates are expected to increase somewhat, overall monetary conditions in the United States will remain supportive. Relatively strong productivity growth will continue to improve corporate profits and real wages. Real income of private households will also be boosted by a gradual improvement in employment. Business investment has already started to improve and is expected to improve further with rising capacity utilisation and profit expectations. Output is assumed to increase by 4.2 percent in 2004 after 3 percent in 2003.

- The continued recovery in the United States will help the world economy to strengthen, although growth will continue to diverge in various parts of the world. The Japanese economy – which was stronger than expected in 2003 despite ongoing deflation – is assumed to grow at a relatively modest pace. Growth will continue to be highest in the emerging economies of East Asia and in China and will also accelerate in other emerging economies including those in Eastern Europe.
- World trade is expected to increase by 8 1/2 percent real terms in 2004, compared to 4 1/4 percent in 2003.
- Oil prices, which fluctuated heavily during 2003, are assumed to remain at around 28 US dollars. While this is a relatively high level in nominal terms, the real oil price (in constant 1995 dollars) is significantly lower than during earlier peaks and should not be a major obstacle to the recovery of the world economy (Figure 1.10).

Although the following forecast for the European economy is based on these relatively favourable assumptions, major downside risks remain with respect to external factors. Firstly, the US current account deficit remains high (at around 5 percent of GDP) so that the foreign indebtedness of the United States will increases unabatedly. This could trigger sharp exchange rate movements with a further sharp dollar depreciation and euro appreciation. This could erode the price competitiveness of European exporters and end an export-led recovery in Europe.

Figure 1.10



1) Average: Dubai, Brent and WTI, deflated with the US GDP deflator.

Sources: HWWA, U.S. Department of Commerce, IMF: World Economic Outlook Database, Sept. 2003; calculations and forecast by the Ifo Institute.

During 2003, both the Japanese and the Chinese central banks intervened heavily in foreign exchange markets to prevent a further fall of the US dollar. Thus, these central banks are to an increasing extent financing the US current account deficit. If, however, Asian countries, which have large current account surpluses with the United States, resist appreciation of their currencies, more pressure will be put on the exchange rate of US dollar vis-à-vis the euro, implying continued appreciation of the euro. Furthermore, there could be mounting political pressure in the United States for import restrictions.

Secondly, given the high indebtedness of private households in the United States, savings could increase more than assumed if households were to consolidate their balance sheets and/or if house prices, which have risen fast, were to start falling again. All of this would dampen consumption and domestic demand.

Thirdly, with capacity utilisation remaining relatively low and the tendency to shift jobs to low wage countries, employment could rise at a lower rate in some countries, enhancing the risk of a jobless recovery which would dampen consumption and domestic demand.

Fourthly, the rise in long-term interest rates could be stronger than assumed in the current forecast. This could result from a relatively rapid closing of the output gap in the United States while at the same time the government's structural deficit increases further. The lack of a clear perspective to reduce the fiscal deficit to a sustainable level increases the risk of higher real interest rates, at least over the medium term.

Finally, new terrorist attacks and/or new major corporate financial frauds could dampen consumer and business confidence (see Box 1.1 on "Enron" can happen in Europe).

If some of these risks should materialise in 2004, European growth could indeed be lower than projected here. On the other hand, there are also upside risks to the forecast: confidence effects and accelerator effects on domestic demand could be larger so that the rebound of the

Box 1.1

"Enron" can happen in Europe!

In the first chapter of the 2003 EEAG report, we asked the question of whether cases similar to the collapse of Enron could happen in Europe. In answering this question with a motivated but resounding "yes", we strongly warned against complacency about European regulatory wisdom. Indeed, at the time of the writing of this report, the collapse of the Italian-based, family-controlled dairy and food giant Parmalat is revealing one of Europe's largest corporate financial frauds. For many years, both auditors and creditors failed to notice any problem in the books of a company with "missing funds" estimated to be between 7 to 10 billion euro. Apparently unsophisticated tricks such as "cut and paste" in documents to produce false bank statements were good enough to trick the system and allow Parmalat to manipulate markets at global level. While at this point the causes and size of the collapse are not entirely clear, Parmalat's collapse exposes unexpected fragility in the Italian and European systems of corporate control and supervision. This is most worrisome at a time when firms may encounter financial problems because of financial and currency volatility, and growth is still quite weak.

European economy could be stronger than expected. Indeed, at cyclical turning points after a downturn the strength of the recovery is frequently underestimated (as is the pace of the downturn after a boom). Overall, it thus appears that the risks for our central forecast are more balanced than they were in last year's report when the downside risks were greater.

2.2 The European economy in 2004

Policy assumptions

Despite the recovery of the world economy and the European economy, the cyclical slack will remain large in the euro area. This and the recent strengthening of the euro will put pressure on the inflation rate. Given these conditions, the ECB is assumed to keep interest rates low during 2004. Nevertheless, in 2004 overall *monetary conditions* will be less accommodative on average than in 2003, as real interest rates will rise somewhat with declining inflation and a strong euro. With continued appreciation of the euro (which is not assumed in our central forecast) monetary conditions could become too tight and an obstacle to the recovery, unless the ECB responded by reducing interest rates and/or intervening in exchange markets.

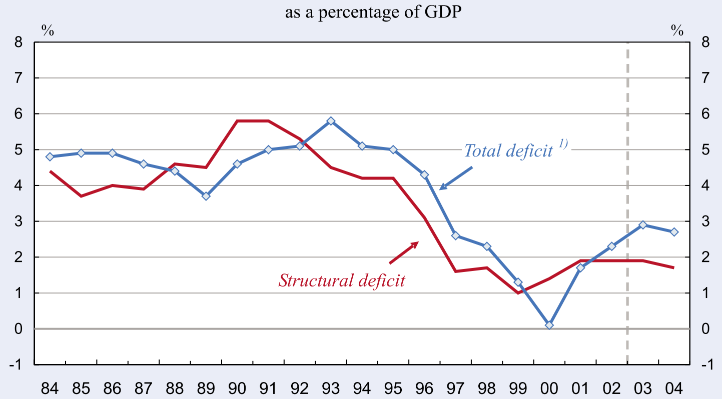
Fiscal policy in the euro area is assumed to remain broadly similar to that of 2003, as countries see no scope for increasing their structural deficits to increase demand but are also reluctant to reduce them in view of high unemployment (Figure 1.11). The degree of already achieved consolidation and of additional efforts differ quite substantially, however, among countries. For example, Finland will continue to run a budget surplus of around 2 percent of GDP and in Belgium and Spain (and outside the euro area also in Sweden) budgets will continue to be broadly balanced. On the other hand, France and Germany will continue (for the third consecutive year) to run deficits above the 3 percent limit of the Maastricht Treaty. In Italy, Portugal and the Netherlands (and outside the euro area also in the United Kingdom), deficits will remain close to or even increase to slightly above 3 percent. In France, Germany, Italy and Portugal, between one third and one half of the deficits are cyclical. In the Netherlands, the cyclical component may amount to three quarters of the total deficit (as cyclical unemployment is rising rapidly), whereas in the United Kingdom, the cyclical component may be only one tenth (as the output gap is relatively low).

Supply-side improvements and risks

The challenge facing the European economy is to reduce the cyclical slack and to improve the growth potential; whereas the former requires a continued easy stance of macro policies, the latter requires additional structural reforms to improve

Figure 1.11

GOVERNMENT BUDGET DEFICIT IN THE EURO AREA
as a percentage of GDP



1) Excluding one-off revenues from the sale of the mobile telephone licenses in 2000.
Sources: OECD, estimates and forecast by the Ifo Institute (December 2003).

Box 1.2

Competitive advantage in business – the Marks & Spencer syndrome

In the last decade, many companies have reported rapid growth in earnings per share due to cost reduction programmes, and this has been translated into increases in productivity in national accounts statistics. These effects have been particularly large in the United States and United Kingdom, but have been increasingly important in other countries.

Many of these cost reductions equate to genuine improvements in efficiency. But others have been obtained by eroding intangible assets of the firm – the principal sources of a firm's competitive advantage – in pursuit of higher earnings. Marks & Spencer, the iconic British retailer, increased margins steadily through the 1990s in search of growth in profits faster than the growth of sales in its relatively mature business. It did so, however, by spending less on stores, by putting increasing pressure on its famous relationships with suppliers, and by pushing at the limit of the value for money to customers, with which it was traditionally associated. In 1998, the company reported the highest margin on sales in its hundred year history. A few months later, it reported a substantial fall in sales, and profits collapsed. The magic of Marks & Spencer's reputation was gone, probably for ever.

conditions for a better utilisation of the labour force. Looking at cyclical conditions, business confidence has recovered. Equity prices have increased and the risk premium of corporate bonds has declined, making investment financing less costly. Furthermore, following a long period of weak business investment, there is mounting pressure to modernise the capital stock. In addition, a number of European countries have implemented – or are in the process of implementing – labour-market reforms which should make labour markets more flexible. It will, however, take some time until the positive effects of these reforms will become visible. At the same time, a number of disincentives to job creation continue to exist (see box on "Labour market reform in Germany" in Chapter 2.).

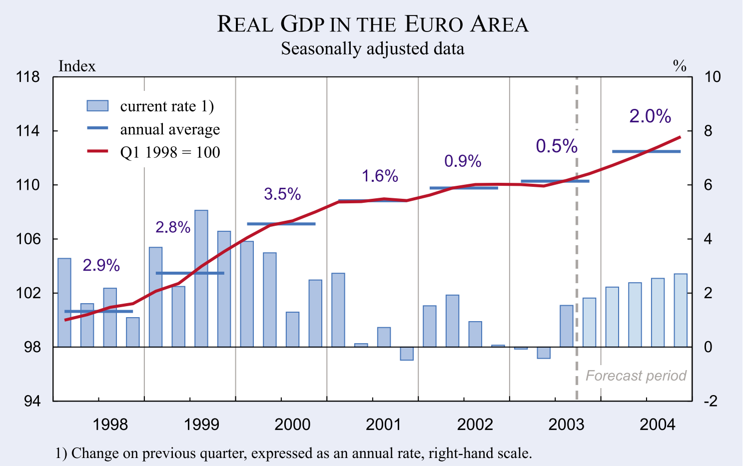
Improved business confidence may to some extent reflect improved profit expectations. However, if actual profits improve less than expected, confidence may falter again. Under conditions of continued cyclical slack there should be relatively strong pressure for wage moderation, so that profit margins could rise leading to an increase in investment and employment. But while this mechanism seems to be operating in the United States, it is not clear whether it will work in Europe where nominal wages are more rigid and productivity growth is lower so that unit labour costs continue to increase. This poses the risk that profit margins will not recover enough to boost investment and job creation. The fierce competition faced by European firms in export and home markets, which is aggravated by the strengthening of the euro, puts additional pressure on profit margins. Experience shows that restoring profit margins by excessive cost-cutting may undermine the long-term survival of firms.

It is also likely that with European enlargement a greater share of total business investment will be shifted to accession countries where labour costs are much lower. Investment in the euro area could therefore remain lower than in previous economic recoveries. Indeed, many of the accession countries are recording high foreign direct investment inflows, a good part of which is from neighbouring western countries. While this should not be a major concern for long-term growth in Western Europe as this investment leads to higher income in accession countries and more demand for imports from western countries, it may well lead to lower growth in sectors, regions and perhaps countries that are less competitive and slow to adjust to new conditions.

Development of demand components in the euro area

In the course of 2004, the gradual recovery of the world economy should support *export growth.* However, a good part of European exports is intra-

Figure 1.12



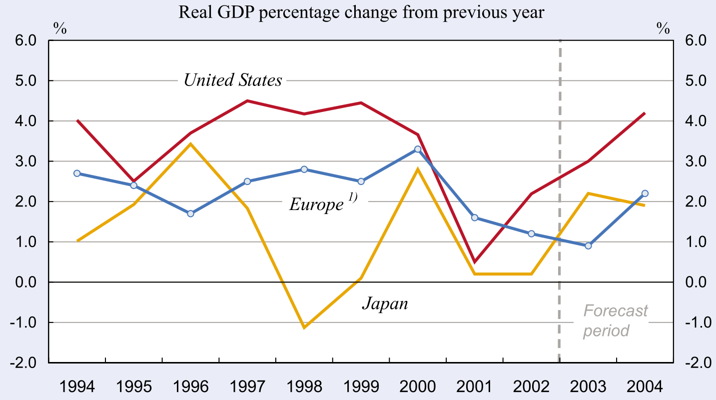
1) Change on previous quarter, expressed as an annual rate, right-hand scale.
Sources: Eurostat; calculations and forecast by the Ifo Institute (December 2003).

European, and as Europe will remain less dynamic than other regions in the world, the export markets of European countries will expand less than world trade. Furthermore, exports of euro area countries to non-euro countries will be restrained by the appreciation of the euro. On average, euro area exports are expected to increase by 5½ percent in 2004, following an increase by only 1 percent in 2003.

Figure 1.13

ECONOMIC GROWTH BY REGION

Real GDP percentage change from previous year



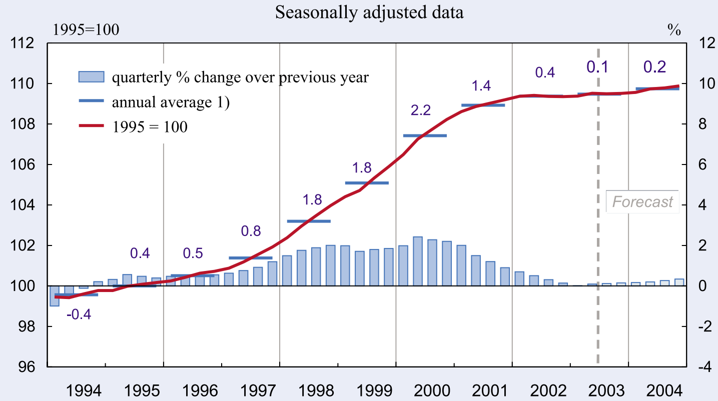
1) Western and Central Europe.

Sources: OECD; Economic Outlook 74/2003, BEA; calculations and forecast by the Ifo Institute (Dec. 2003).

Figure 1.14

EMPLOYMENT IN THE EURO AREA

Seasonally adjusted data



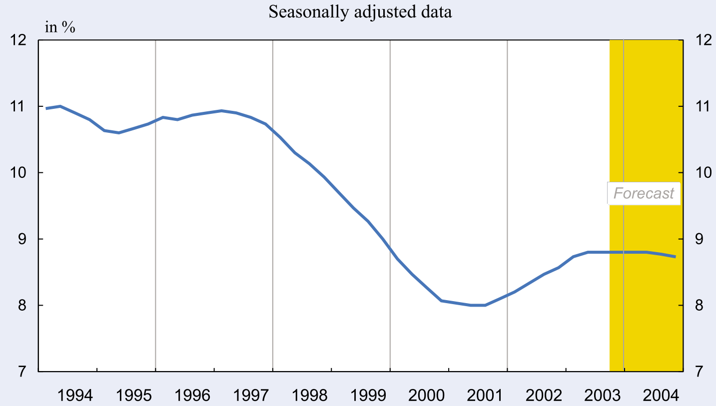
1) Figures: annual % change from previous year.

Sources: Eurostat; calculations and forecast by the Ifo Institute (December 2003).

Figure 1.15

UNEMPLOYMENT RATE IN THE EURO AREA

Seasonally adjusted data



Sources: Eurostat; calculations and forecast by the Ifo Institute (December 2003).

Private consumption is expected to recover as real disposable income is stimulated by a further decline in consumer price inflation and – in some countries – by additional tax reductions. The stabilisation of equity markets should also support consumer confidence. But there are also factors which continue to restrain consumer spending. Fiscal consolidation measures will place additional strains on private households as some transfers are reduced and/or households have to pay higher contributions to social security systems and/or private pension schemes. We, therefore, expect a continued moderate increase in private consumption by 1.6 percent in 2004 after a 1.3 percent increase in 2003.

With the improvement in export markets and the end of the turbulence in equity markets, *investment* is expected to stop declining. Although there is no need to enlarge the capital stock when capacity utilisation is low, investors tend to be forward-looking and anticipate increased future demand. Given weak investment over the past two years, there is also mounting pressure to modernise the capital stock. Furthermore, real long-term interest rates remain relatively low despite some increases and the recovery of the markets has reduced the cost of equity financing. Total investment in the euro area is expected to increase by 2 to 2½ percent in 2004, after a decline by 1 percent in 2003.

Growth, employment and inflation

Forward-looking indicators, such as business confidence and order inflows, point to a recovery in the European economy in the near term. On average, output in the euro area is expected to increase by 2 percent in 2004 after only 0.5 percent in 2003 (Figure 1.12). As mentioned above, growth will remain below trend so that the output gap will not shrink, but will rather continue to widen, and growth in Europe will remain significantly below that in the United States (Figure 1.13).[8]

The recovery in output growth will not lead to a decline in unemployment in the euro area in 2004. This is because output growth remains relatively moderate. Furthermore, during the past downturn, firms typically followed a strategy of labour hoarding which depressed productivity. They can, therefore, produce a good part of the higher output with the existing labour force. Thus, employment will only pick up gradually and unemployment will remain, on average, at the same level as in 2003. Structural reforms of the labour market will be implemented in some countries, like Germany, but are not expected to significantly change labour market conditions in the near term (Figures 1.14 and 1.15).

The inflation rate (as measured by the harmonised consumer price index) will decline marginally from 2.1 percent in 2003 to 1.8 percent in 2004.

2.3 Differences in growth performance within Europe

Despite the general cyclical weakness in the euro area (and in Europe as a whole) in 2003, there were significant differences in the growth performance of individual countries. A few countries (the Netherlands and Portugal and, outside the euro area, also Switzerland) experienced negative growth; in Germany there was no growth and in France growth was just 1/4 percent. In two countries of the euro area (Ireland and Spain), and in the UK, growth was around 2 percent and in Sweden 1 1/2 percent. Greece achieved the highest growth rate, at 4 1/2 percent. Growth in the four major EU accession countries was also uneven, with the highest growth in the Slovak Republic (4 percent), followed by Poland (3 1/4 percent) and the Czech Republic and Hungary (2 to 2.75 percent).

Figure 1.16

Sources: OECD; calculations and forecast by the Ifo Institute.

[8] It should be mentioned, however, that the growth differential between Europe and the United States is smaller with respect to GDP per capita, as population growth in the United States is higher by 3/4 percentage points (almost 1 percent against 1/4 percent in Europe).

The differences in the growth performance of individual European countries reflect a number of factors. Some of the smaller countries inside the euro area, but also the EU accession countries, benefit from relatively favourable supply conditions related to a normal catching-up process (that is a lower starting position of GDP per capita, low wage levels and relatively high capital productivity). But in some of them, emerging wage pressures and obstacles to restructuring have undermined the investment and export performance.

In the more developed European countries, where high and/or rising labour costs were accompanied by an appreciating exchange rate, exports weakened most. In addition, in some countries households have increased their savings rates in response to a deteriorating labour market and losses in equity wealth. This effect was particularly marked in the Netherlands, where the fall in equity prices reduced the wealth of pension funds, which responded by increasing contribution rates. Thus, private households had to allocate a greater share of income to their pension savings accounts, which reduced their propensity to consume. In Portugal, domestic demand was restrained by a tightening of fiscal policy in response to the significant overshooting of the deficit target.

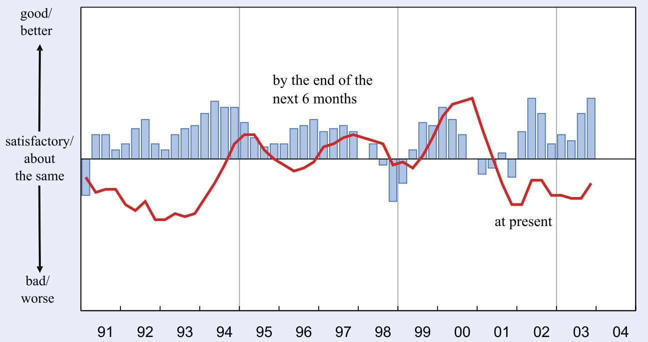
In 2004, growth is expected to be higher in virtually all countries within the euro area but growth differentials will continue to remain significant (Figure 1.16).

(For further details on the forecasts for Germany, France, Italy, the United Kingdom, Sweden, Finland and Spain, see Appendix 2. The key forecast tables of this chapter are presented in Appendix 3).

Appendix 1
Ifo World Economic Survey (WES)

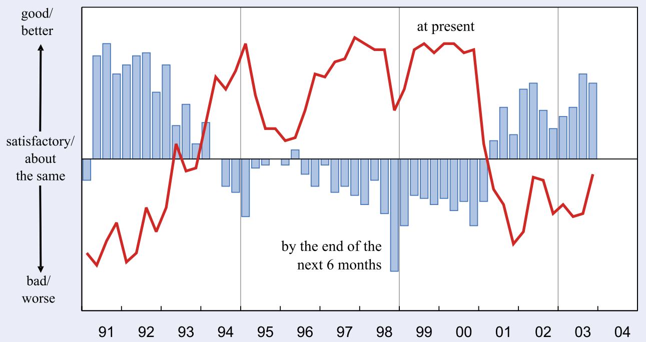
WES is a world-wide survey of the Ifo Institute for Economic Research, questioning – on a quarterly basis – more than 1,000 economists of multinational corporations in 90 countries on the present economic situation of the country of residence and its economic prospects by the end of the next six months.

WORLD ECONOMY
Economic Situation



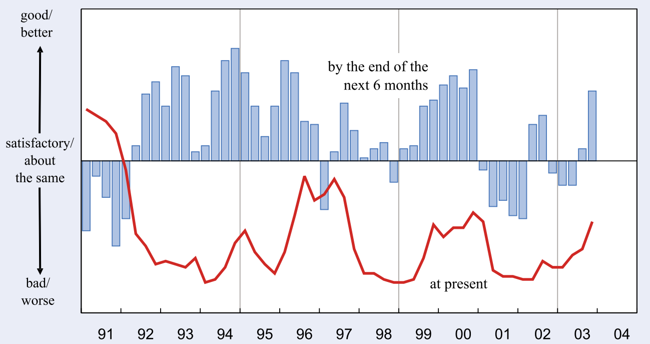
Source: Ifo World Economic Survey (WES).

UNITED STATES
Economic Situation



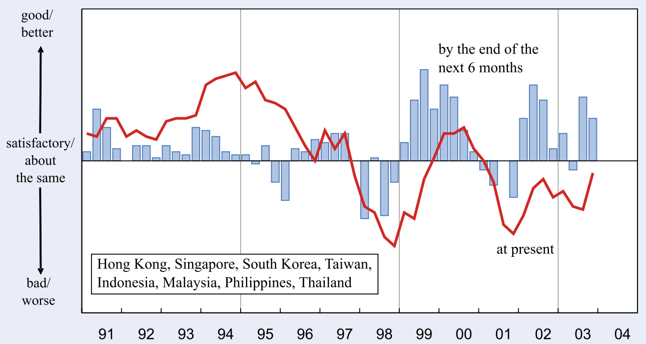
Source: Ifo World Economic Survey (WES).

JAPAN
Economic Situation



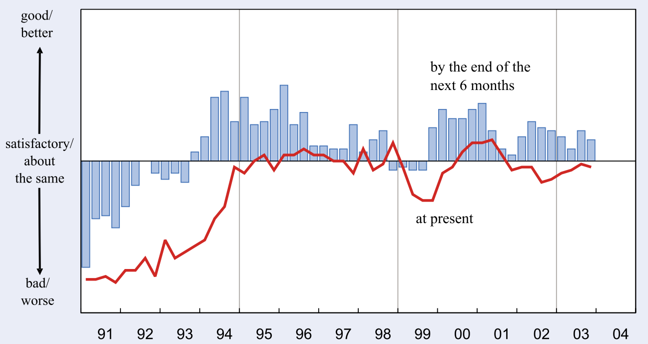
Source: Ifo World Economic Survey (WES).

ASEAN AND EAST ASIAN NICS
Economic Situation



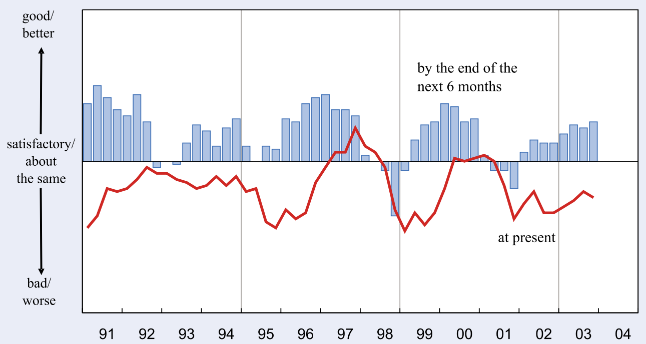
Source: Ifo World Economic Survey (WES).

EASTERN EUROPE
Economic Situation

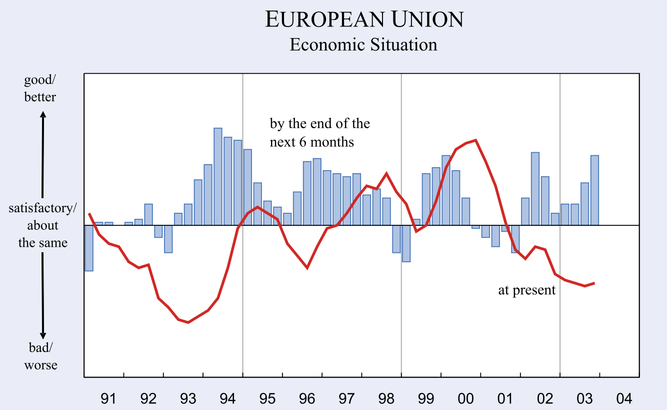


Source: Ifo World Economic Survey (WES).

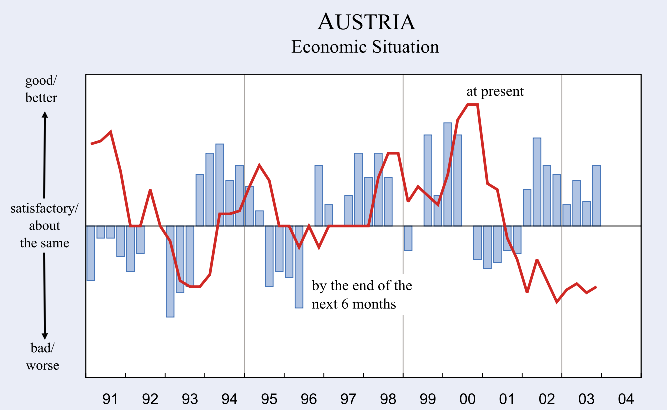
LATIN AMERICA
Economic Situation



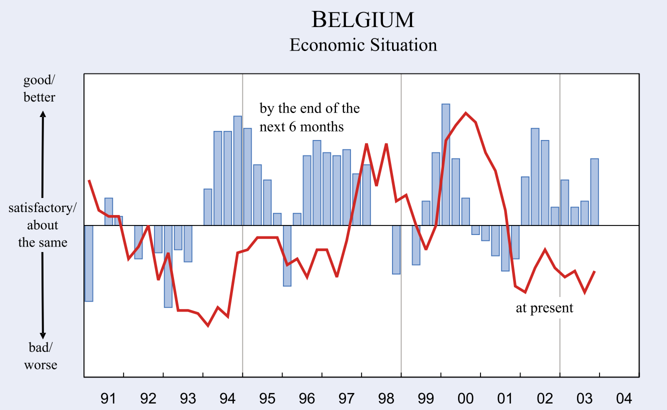
Source: Ifo World Economic Survey (WES).



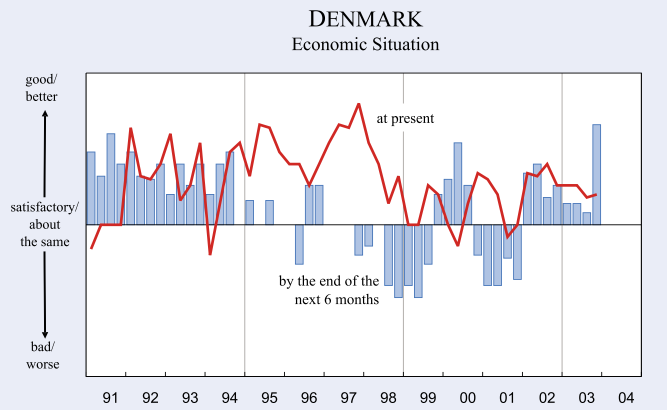
Source: Ifo World Economic Survey (WES).



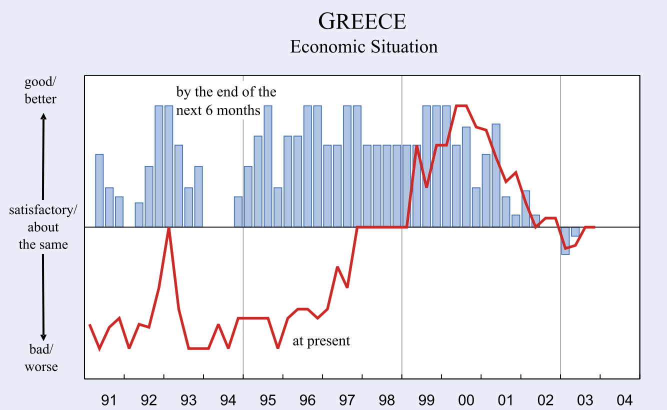
Source: Ifo World Economic Survey (WES).



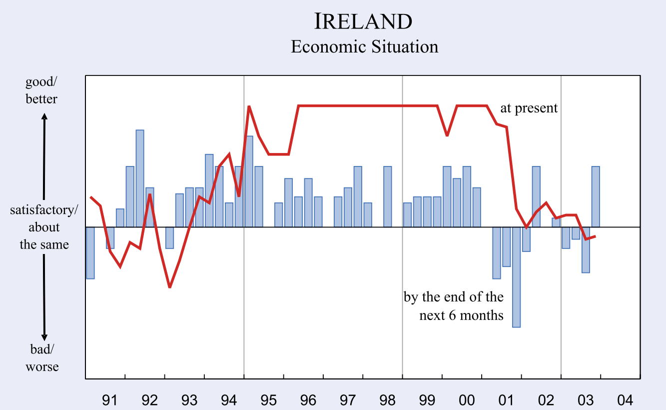
Source: Ifo World Economic Survey (WES).



Source: Ifo World Economic Survey (WES).

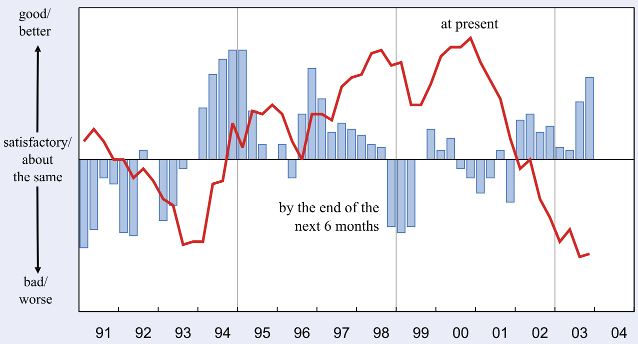


Source: Ifo World Economic Survey (WES).



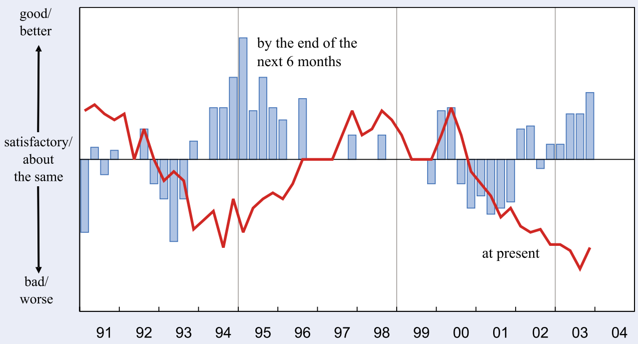
Source: Ifo World Economic Survey (WES).

NETHERLANDS
Economic Situation



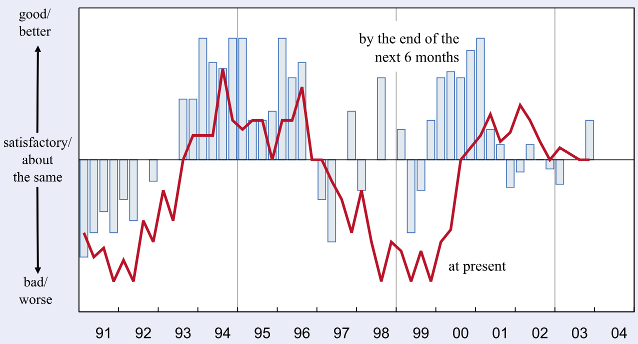
Source: Ifo World Economic Survey (WES).

PORTUGAL
Economic Situation



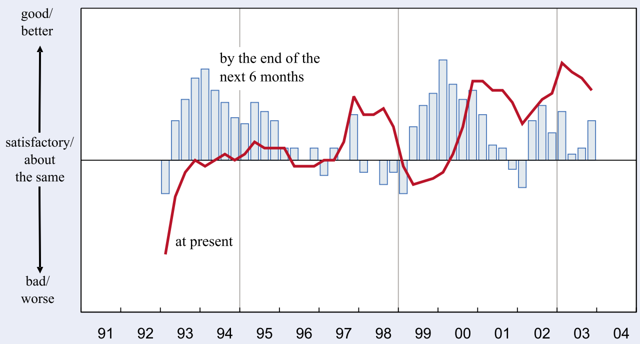
Source: Ifo World Economic Survey (WES).

CZECH REPUBLIC
Economic Situation



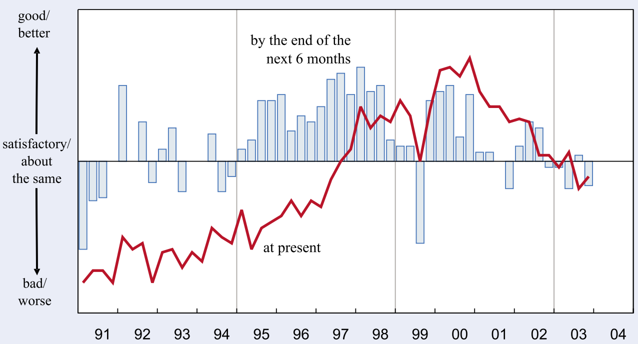
Source: Ifo World Economic Survey (WES).

ESTONIA
Economic Situation



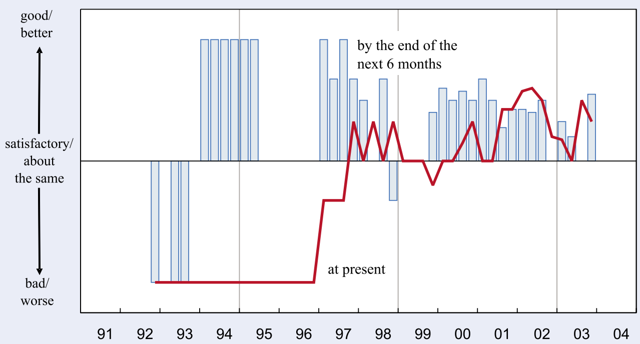
Source: Ifo World Economic Survey (WES).

HUNGARY
Economic Situation

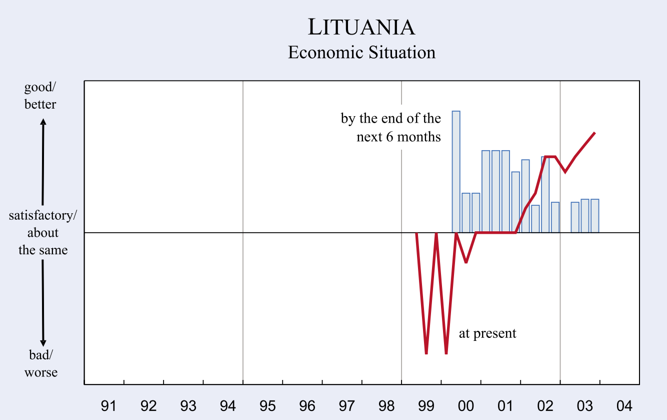


Source: Ifo World Economic Survey (WES).

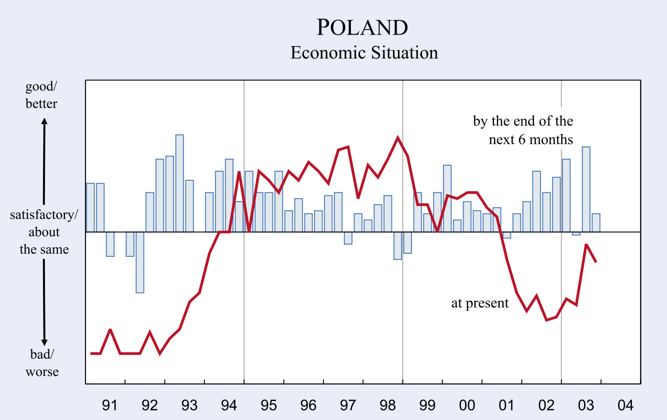
LATVIA
Economic Situation



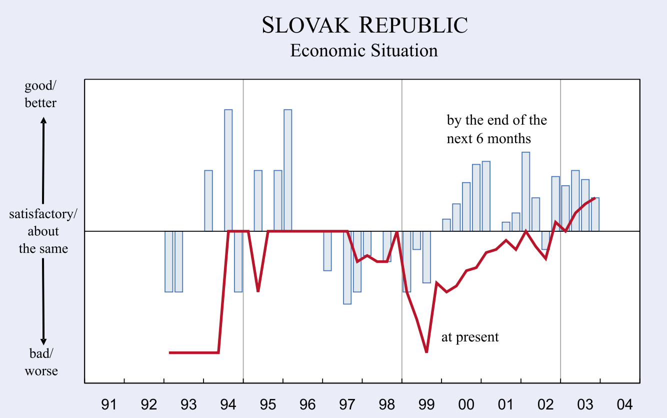
Source: Ifo World Economic Survey (WES).



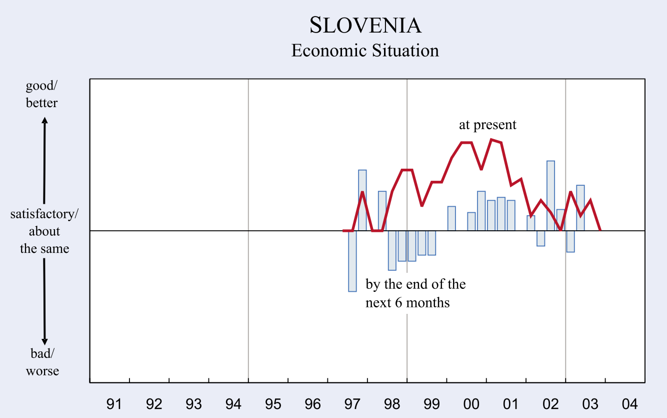
Source: Ifo World Economic Survey (WES).



Source: Ifo World Economic Survey (WES).



Source: Ifo World Economic Survey (WES).



Source: Ifo World Economic Survey (WES).

Appendix 2:
Country Reports

Germany

After three years of stagnation, economic activity has recovered since the summer of 2003. The uncertainty caused by the Iraq conflict, which paralysed the economy (not only in Germany) in the first half of the year, is gone. The monetary policy of the European Central Bank continues to be accommodating. In addition, the financing conditions of business have again become more favourable as a result of consolidation efforts in the banking sector and of stock price gains.

Since mid-year, the Ifo business climate indicator has improved significantly; while this was initially due to improved expectations, more recent assessments of the current situation also improved. Orders received by the manufacturing industry have risen, with the increase coming in equal parts from domestic and foreign orders. All major sectors of industry have experienced this trend. However, industrial output grew only slightly until fall. Accordingly, industrial capacity utilisation increased only slightly, according to the results of the Ifo Business Survey, and, at 83 percent, was not higher than at the beginning of the year.

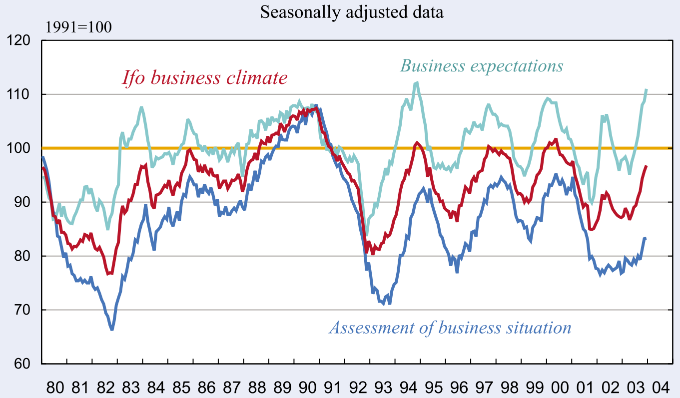
In 2004, real GDP is expected to expand at a moderate but steady pace, following stagnation in 2003. In spite of the appreciation of the euro vis-à-vis the US dollar, growing foreign demand will be a major driving force. Manufacturing will profit from exports, with production expanding by more than 3 percent. Only a small increase (0.5 percent) is expected in construction, but is it the first increase since 1994. In the tertiary sector the situation will be mixed. In the areas of financial services, leasing and business-service providers, expansion will accelerate in line with general economic activity. In contrast, partly because of the cuts in government spending and health reforms, value added of the public- and private-sector service providers will decline slightly. Overall, real GDP is expected to increase by 1.8 percent in 2004.

Of this growth, 0.1 to 0.2 percentage points will stem from the advanced implementation of the third stage of the 2000 tax reform. About 0.5 percentage points will come from the fact that 2004 will have an unusually large number of working days. A more reliable growth figure is therefore the annualised change in total output, which will be approximately 1½ percent.

The state of the labour market remains precarious. Employment declined, on average, by almost half a million persons in 2003 and the number of unemployed increased by more than 300,000. The trough of labour market developments has not yet been reached. In light of the declining number of job vacancies, employment will continue to fall but not as sharply as before. Although labour market policies will boost employment by assisting self-employment (Ich AG), through the creation of Personal Service Agencies and the promotion of mini and midi jobs, an increase in employment is not expected until mid-2004, when the economic recovery will be on firmer ground. For the year as a whole, employment will decline by 170,000 persons (see also the box on "Labour market reform in Germany" in Chapter 2).

Initially, unemployment will not be a mirror image of employment since the labour force will grow, and a considerable part of the people who accept mini jobs will come from the hidden manpower reserves. However, from the beginning of the coming year unemployed persons who are in publicly supported training programmes will not be counted among the registered unemployed but will be booked as "hidden reserves in training measures". With this new definition of unemployment, jobless numbers will

IFO BUSINESS CLIMATE[1)]
Seasonally adjusted data



1) Western Germany; manufacturing industry, construction, wholesale and retail trade.
Source: Ifo Business Survey.

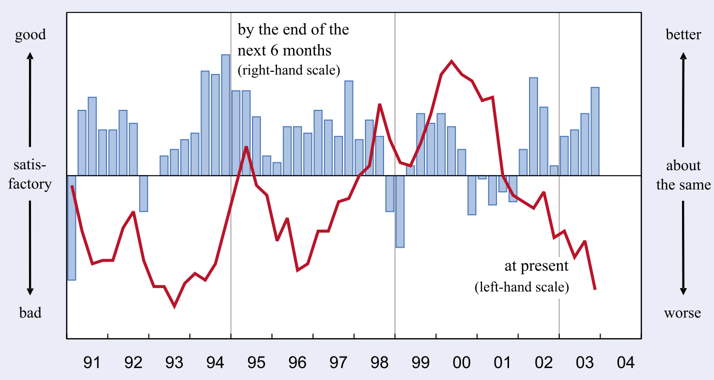
decline by 100,000. The decline in average unemployment of more than 80,000 persons to 4.3 million (or 10.2 percent of the domestic labour force according to national statistics) does not therefore imply an improvement of the state of the labour market.

No lasting improvement of the public finances is in sight. The budget deficit increased to 4 percent of GDP in 2003. The main reason for this increase was the fact that revenues fell significantly below initial expectations while government spending continued to rise. Next year, in spite of the modest economic recovery, the fiscal situation is not expected to improve. Tax revenue will increase by only 1.6 percent. This is mainly due to the partial advancement of the third stage of the tax reform which will lead to revenue shortfalls of 9 billion euro. Government spending will remain largely unchanged, not least because the two biggest cost items of social insurance, retirement pensions and unemployment compensation, will be constrained by consolidation measures. With regard to pensions, in addition to the round of zero increases, the insurance funds will experience some relief from the abolition of the contributions to long-term care insurance (as of April) and from the lowered contribution rates for health insurance; this will almost completely offset the additional costs of the higher number of retirees. With regard to wage replacement payments to the unemployed, the number of beneficiaries will continue to increase but the costs for other labour market transfers, such as benefits for part-time workers and maintenance allowances, will fall. In total, the general government budget deficit will increase to 76 billion euro in 2004, or 3.5 percent of GDP, so that the Stability and Growth Pact will be violated for the third time in a row.

France

In 2003, French economic growth not only failed to regain the fast pace that had been observed since 1998, but real GDP stagnated as in 2002, thus even falling short of the Western European average, with economic policy being almost neutral. It was not until autumn that the economy slowly started to revive. In addition to external shocks, the economy suffered from industrial action and a severe drought. Despite lower interest rates, the recession in investment in machinery and equipment continued throughout the year due to unfavourable business expectations, the frequently poor financial situation of firms and their sluggish adjustment to the changing international environment. There was a small increase in residential construction. Exports of goods and services also performed poorly, causing the contribution of net exports to growth to become negative; the current account remained in surplus, however, also due to the terms of trade improving further. Growth of public consumption lost significant momentum. A lower increase in real household disposable income due to the worsening state of the labour market (unemployment rate of 9 1/2 percent), somewhat higher inflation (HCPI + 2 1/4 percent) and smaller wage increases were only partly compensated by a drop in the savings rate. During recent months, private households' living standards declined and their financial problems rose, further aggravating consumer confidence.

Economic policy is likely to pursue an almost neutral course in 2004. The dampening effects of the euro appreciation should all but disappear at about mid-year, assuming that no further significant appreciation occurs. The monetary policy of the ECB will remain expansionary, albeit to a lesser degree than before. Wage increases are expected to be a bit more moder-



Source: Ifo World Economic Survey (WES).

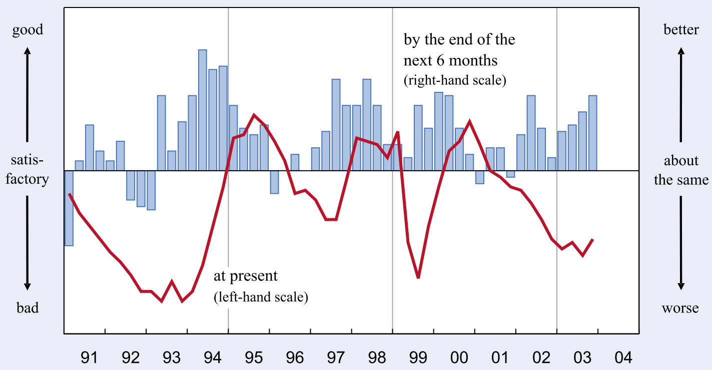
ate, mainly because of the unsatisfactory state of the labour market. Fiscal policy will be somewhat restrictive, assuming that central government expenditure remains constant in real terms. Spending in the public health sector and – despite recent reforms – on social security, remains the crucial point. The general public deficit is likely to drop from 4¼ percent of GDP in 2003 to about 4 percent in 2004.

According to the results of the Ifo World Economic Survey, real GDP is likely to rise by 1¾ percent in 2004 as the result of a moderate acceleration of demand and production after a very weak start at the beginning of the year. Exports will be the main driving force, stimulated by the revival of the world economy. In 2003, shipments to the United States picked up after the slump caused by political reasons. With imports rising more slowly than exports and the terms of trade improving only slightly, the current account should show a surplus in relation to GDP in the same order as in 2003. The rebound of gross fixed investment will be gradual and modest, mainly stimulated by improving profit and sales expectations, low interest rates and higher share prices. Business investment – mainly replacements – will remain hampered by the high indebtedness of many firms and poor balance sheets. In addition, problems with engagements abroad have not yet been solved. Public investment will remain roughly unchanged. Residential investment can be expected to rise further, albeit moderately, despite low mortgage rates. Public consumption will slow down further. Private consumption should gain momentum in the course of the year in accordance with the brightening state of the labour market, although the savings rate is unlikely to decline further. The prices of houses and shares will keep rising, but French households are not very sensitive to asset prices. Real disposable income will only increase moderately, since wage rates will increase more slowly and wage-drift will remain low. Stimulating effects of the additional income tax cuts will be offset by significantly higher taxes on petrol and tobacco – similar to what happened in autumn 2002, when increased local taxes and higher social security contributions offset the effects of the tax cut. Though the state of the labour market is likely to improve in the second half of the year, the unemployment rate will remain as high as in 2003. With import prices contributing little to price stabilisation, but demand increasing moderately, consumer prices (HCPI) are likely to rise by 1¾ percent.

Italy

Economic activity stagnated far into the last year and the pick-up was very gradual; real GDP rose by ½ percent over 2002, with economic policy being about neutral. If there had been no unintentional increase of inventories, the result would have been even worse. The very weak performance was caused by various shocks, including the appreciation of the euro and a severe drought, but also reflected the expiration of temporary fiscal incentives to purchase new cars and investment goods that stimulated domestic demand until the end of 2002. Despite low interest rates, gross fixed investment went through a recession, caused by a significant decline in investment in machinery and equipment following the swift acceleration during the second half of 2002 in response to temporary discretionary measures. Construction, however, continued to grow, albeit at a moderate pace. Residential construction was sustained by low interest rates.. Exports of goods and services underwent a severe recession. Weak economic growth of Italy's main trading partners and the euro appreciation exposed the weakness of the Italian export structure, which is dominated by low-tech goods subject to competition from emerging markets. Because of slow GDP growth, imports remained substantially stable. Despite the euro appreciation, the Italian terms of trade deteriorated: Italian firms offset the appreciation of the exchange rate by lowering their export prices in euro; import prices reflected the sustained dynamics of oil prices in euros. As a result, the current account deficit widened. The increase in public consumption remained almost stable, despite attempts to consolidate the budget. Private consumption picked up considerably compared to 2002. This was due to a declining savings rate and to higher real disposable incomes underpinned by further gains in employment that resulted from various labour market reforms and public measures. Employment growth benefited women and employees with permanent contracts, resulting in a positive effect on the participation rate. The unemployment rate dropped to 8¾ percent. Despite an almost stagnating economy, inflation (HICP 2¾ percent) remained significant amid allegations of consumer associations that the official rate of inflation substantially understates the true price dynamics.

Economic policy is likely to remain fairly neutral in 2004. Fiscal policy should be slightly restrictive, in part because the central government shifted expen-



Source: Ifo World Economic Survey (WES).

ditures from 2004 to 2003 in order to achieve its target budget deficit (2 3/4 percent of GDP) in both years. But the deficit targets could only be achieved by making extensive (and indeed excessive) use of one-off measures like tax amnesties and sales of real estate. The government also took some steps towards addressing structural budget problems like social security. Positive budget effects from these reforms will only be felt in the future, however. ECB monetary policy still has expansionary effects in Italy, although the appreciation of the euro makes overall monetary conditions rather tight. Nominal wages increased at a rate exceeding the government's inflation projection of 1 1/2 percent, but less than actual inflation (and also less than the previous year's rate). This relatively moderate wage dynamic was in part due to delays in the renewal of contracts for some categories of workers. Although unions confirm their commitment to wage moderation, in many sectors, the government's inflation projection is no longer taken as a basis for bargaining (it is replaced by consensus forecasts). Average labour costs grew at 2.5 percent (as in France), but in manufacturing the corresponding rate is as high as 3.8 percent, due to a sizeable drop in productivity and negative effects on profits. This confirms the negative performance already recorded in 2002.

The results of the Ifo World Economic Survey point to an increasing momentum of recovery in 2004, though the effect of comprehensive structural reforms promised by the government in mid-2001 will be hardly felt: until now, only about a tenth of the intended projects were realised. Real GDP might increase by about 1 3/4 percent, which means a rather gradual recovery during the year, the main driving force being exports of goods and services stimulated by the upswing of the world economy, and especially of the European economy. But due to the structure of exports and decreasing price competitiveness, Italy is likely to lose further market shares. With no significant increase in imports, net exports should remain substantially stable despite some improvement to the terms of trade. As a result, the current account deficit will remain at almost 1/2 percent of GDP. More favourable export prospects will induce investment in machinery and equipment but the investment recovery will be very moderate (still reflecting the adjustment to the past effects of temporary measures). The growth in residential construction might lose momentum, partly because of the fast-growing household debt in a country with traditionally very low personal indebtedness. While public consumption will continue to slow down, growth of private consumption will remain almost unchanged, with real wages rising a bit faster, also due to lower inflation (HICP + 2 1/2 percent) and to a slower expansion of employment. The unemployment rate will drop marginally to 8 1/2 percent.

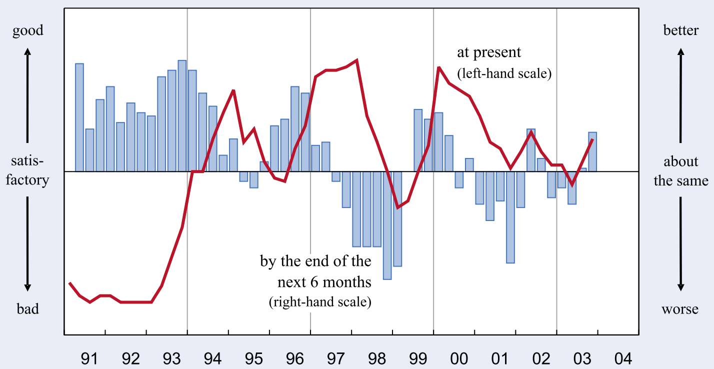
United Kingdom

Despite continued expansionary monetary and fiscal policy, economic growth lost momentum in the first half of 2003 due to external shocks. It subsequently recovered , driven by a rebound in consumer spending. With real GDP growing by about 2 percent in 2003, the economy performed much better than most of the other European economies. The significant acceleration of public consumption continued, based on a medium-term programme to improve the public infrastructure, which meant a strong impetus also for public investment. Residential construction rose markedly, albeit not as strong as in 2002 due to the very high house prices in the metropolitan area and the South East. Investment in machinery and equipment declined further, along with deteriorating confidence in the manufacturing industry. Private consumption lost its role as the main driving force. The slowdown of real disposable income – despite high wage increases in the public sector – was only partly compensated by a drop in the savings ratio. Employment continued to grow very modestly. The unemployment rate remained at about 5 percent. Exports of goods and services continued to decline, reflecting the weakness in world trade and the still overvalued pound sterling. With imports rising steadily and the terms of trade improving only slightly, the current account deficit (2¼ percent of GDP) was well above its long-term average. HICP increased by 1¼ percent – as in 2002.

In 2004, the effect of economic policy on economic growth is about to change. Fiscal policy is likely to stay its expansionary course, running a strongly increasing general government deficit of about 3 percent of GDP, which is well ahead of schedule. In case the government sticks to its mid-term programme for the public infrastructure, the Chancellor of the Exchequer has either to break his "golden rule" or increase taxes or social security contributions. Monetary policy changed its stance in November 2003, increasing the base rate by 0.25 percent to 3.75 percent in order to bring inflation (RPIX) down to the central bank's target, and to deflate the house price bubble, preventing the highly indebted consumers from buying increasingly on credit. Further steps are likely to follow this year. Wage increases will not be curbed in view of the economic upswing and rising inflation.

Economic growth should accelerate well into 2004, still stimulated by economic policy, albeit to a lesser degree than last year. Recent results of the Ifo World Economic Survey confirm this projection. Real GDP can be expected to increase by 2¾ percent. Exports of goods and services will regain their position as the main driving force, but the upswing will be less pronounced than in most European countries because of the persisting overvaluation of the pound sterling against the US dollar and the euro. With imports rising faster and the terms of trade not improving further, the current account deficit will continue to increase. Gross fixed investment – in relation to GDP the lowest of all Western European countries – will pick up thanks to faster growing investment in machinery and equipment due to improving profit and sales expectations and the considerable need for replacement and rationalisation. Residential construction will slow down further, whereas public construction will continue on its strong upward trend. Public consumption is likely to rise somewhat less since wage increases in the public sector will be less generous. Private consumption will also slow down, though real wages will increase as much as last year and employment will rise a little while the unemployment rate will drop to 4¾ percent. Rising interest rates and stagnant or even falling house prices will dampen the inclination of private households to take on mortgages for consumption purposes. Due to higher economic growth and no stabilising effects of import prices, consumer prices (HICP) might rise by 1½ percent.

UNITED KINGDOM
Economic Situation



Source: Ifo World Economic Survey (WES).

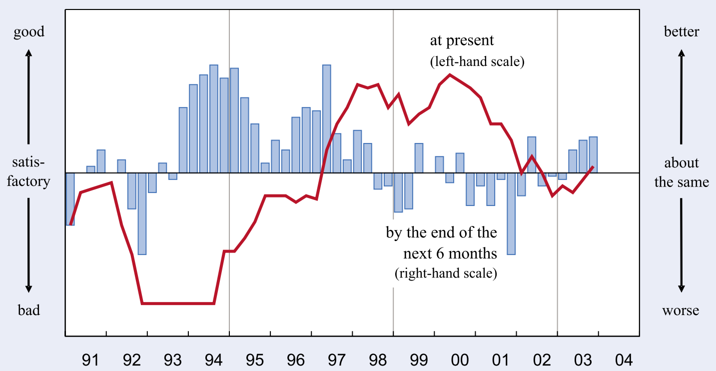
Spain

In 2003, the Spanish economy (real GDP + 2¼ percent) continued to perform better than the Western European average. After a modest deceleration of real GDP during the winter semester 2002/2003, production accelerated again, driven by exports and a slightly expansionary economic policy. Private consumption was fostered by an income tax reduction introduced at the beginning of the year and somewhat faster rising employment, which more than compensated for the slower increase in real wages. In addition, consumer confidence returned to its long-term average as early as mid-year. Public consumption was still very buoyant, albeit less than in 2002. Gross fixed capital formation picked up considerably mainly due to investment in machinery and equipment, restructuring of firms and improving business expectations. The boom in residential construction, propelled by low interest rates, soaring rents and higher real disposable income cooled off slightly. Very much in contrast to the other Western European economies, exports of goods and services picked up considerably. With imports growing even faster and terms of trade improving only little, the current account deficit continued to widen in relation to GDP. Despite rising employment, the unemployment rate (11¼ percent) was slightly higher than in the year before. Inflation (HICP about + 3 percent) slowed down but remained one of the highest in the EU, despite falling import prices.

Economic policy is expected to be more or less neutral in 2004. The general government budget is likely to be roughly balanced once more (including quasi-public institutions there will be a deficit), while monetary policy of the ECB remains expansionary, albeit at a lesser degree than before. Dampening effects of the euro appreciation should almost disappear at about the middle of the year, assuming no further significant appreciation. Since unit labour costs continue to rise much faster than the Western European average, price competitiveness will decline further. In view of a further strengthening of the upswing, wage increases are not likely to moderate significantly.

Real GDP can be expected to grow by 3 percent in 2004 – according to the Ifo World Economic Survey the economic outlook has improved since the second quarter of 2003 – propelled primarily by exports and also by domestic demand. Exports of goods and services, especially tourism, will benefit from the upswing of the world economy in general and of the European economies in particular, though the advantage of entering the euro area with a clearly undervalued peseta has vanished and export performance is beginning to wane in view of the persistently high wage increases. Faster rising imports and relatively stable terms of trade will bring about a further increase in the balance of payment deficit. Given that capacity utilisation is already above its long-term average, interest rates are still low, sales and profit expectations are improving and the need for rationalisation is intensifying, investment in machinery and equipment will keep rising swiftly. The boom in residential construction is slowing down further in response to very high house prices. Public consumption remains a strong driving force of economic growth. Private consumption will expand steadily due to considerable real wage increases, some effects of the 2003 income tax reduction and an improving labour market. Employment can be expected to grow faster resulting in a drop of the unemployment rate to 11 percent. Insufficient competition in the upswing, rising import prices and distinctly rising unit labour costs will cause the HICP to increase by about 2½ percent.

SPAIN
Economic Situation



Source: Ifo World Economic Survey (WES).

Sweden

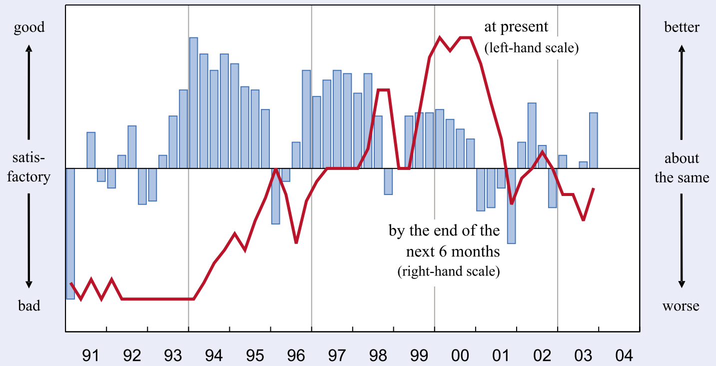
In 2003, economic growth (real GDP + 1½ percent) turned out higher than in Western Europe as a whole, though it continued to be very slow until autumn. In the third quarter, growth picked up driven by external as well as domestic demand. Interest rate cuts stimulated demand, whereas fiscal policy was tightened somewhat. Exports were the main driving force behind demand growth due to the recovery of the world economy in general and the faster rising demand for IT-products in particular. As exports grew faster than imports, the current account surplus increased to 4¾ percent of GDP. The relatively strong expansion in private consumption (around + 2 percent) occurred despite a fall in real disposable income and thus reflected a fall in the savings ratio. On the other hand, public consumption grew rather slowly due to budgetary constraints. Gross fixed capital expenditure declined further since demand and profit prospects of the business sector remained weak far into the year. Inflation picked up considerably in the spring, mainly because of soaring electricity prices, but decreased in the second half of the year (HICP + ¾ percent from December 2002 to December 2003).

Fiscal policy will be tightened a bit in 2004 due to the ongoing consolidation of the state budget and further tax increases by municipalities. A general government financial surplus of 0.4 percent of GDP is forecast for 2004. The significant SKR appreciation, which occurred in 2003, will exert a dampening influence on the economy. The central bank may choose to counteract this through a further interest rate cut. Wage increases are likely to remain moderate (3 to 3½ percent). Although new wage agreements for a large part of the labour market will be negotiated in the spring, the negotiations will take place in a situation of considerable slack in the economy, which will exert a dampening effect. In 2004, inflation is likely to be somewhat below the two percent target of the central bank (HICP + 1.2 to 1.5 percent).

In 2004, economic growth (real GDP + 2¼ percent) will continue to increase well into the year – recent results of the Ifo World Economic Survey point into that direction – again primarily based on exports. The strong export growth depends on the international upswing and an expected increase of demand for IT products. But export growth will be counteracted by higher relative unit labour costs than in the past, associated mainly with the strong krona. Real disposable income is expected to rise by about 2 percent, and consumer confidence may improve. Private consumption growth will gain momentum, whereas public consumption will stay constant. Gross fixed capital formation will pick up significantly, mainly driven by investment in machinery and equipment, since considerable replacements are needed and interest rates remain low. Labour market developments will lag output growth. This implies that the unemployment rate is likely to remain at the 2003 level (5½ to 6 percent), depending on how much the various labour market programmes will be expanded.

SWEDEN

Economic Situation



Source: Ifo World Economic Survey (WES).

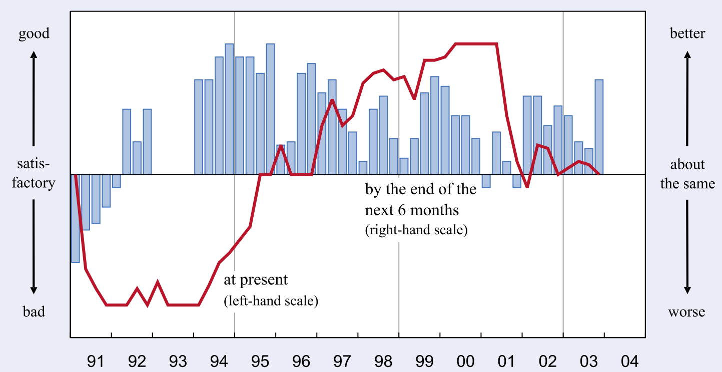
Finland

After a bad start in 2003 due to external shocks, economic growth picked up thanks to recovering exports. But real GDP (+ 1½ percent) was mainly propelled by domestic demand stimulated by the favourable development of real wages and economic policy which strengthened consumer confidence. Given the overall economic situation and the deteriorating state of the labour market (unemployment rate of about 9 percent), private consumption grew surprisingly fast. On the other hand, expansion of public consumption was very sluggish. Gross fixed capital formation remained in recession, although residential construction rose further. Despite low interest rates, investment in machinery and equipment continued to decline across the board with entrepreneurs continuing to be cautious until mid-year according to business surveys, due to unfavourable profit and demand prospects and capacities in the manufacturing industry remaining far below their long-term average. Consequently, business construction also dropped as did public construction because of the fiscal constraints on many municipalities. Induced by the recovering world economy, exports of goods and services rose significantly from the second quarter on, while imports took longer to revive. The surplus on current account remained very high, although it did decline as a result of deteriorating terms of trade. Consumer prices remained almost stable after the increase in the first quarter, bringing the inflation rate (HICP) down to 1¼ percent.

In 2004, economic policy will remain expansionary. There will be considerable cuts of income taxes, as well as taxes on alcoholic beverages, which will lead to a further decline in the general government surplus to 1¾ percent in relation to GDP. Monetary policy will also remain expansionary, albeit to a lessening degree. Dampening effects of the euro appreciation should almost disappear at about mid-year if no other significant revaluation occurs. Wage policy, based on the 2003/04 social contract, is expected to stay its course resulting in a slow-down of nominal wage growth which, in accordance with somewhat lower inflation, will lead to almost steadily rising real wages.

Real GDP can be expected to grow by 2½ percent in 2004 – this projection is underpinned by the latest results of the Ifo World Economic Survey – keeping Finland in the fast lane relative to the Western European average. Exports of goods and services will regain their position as the main driving force, stimulated by the world economic recovery in general and the rising demand for IT-products. With imports growing less buoyantly and the terms of trade improving, the current account surplus will increase. Private consumption expenditure is likely to be a bit higher than in 2003 in view of the favourable development of real disposable income and a brightening economic outlook. But the state of the labour market (unemployment rate 8¾ percent) will not improve until autumn because of still underutilised capacities. For the same reason investment in machinery and equipment will only slowly recover from the recession, which is atypical for upswings in Finland that are normally associated with a sharp turnaround in capital expenditure. Improving confidence of private households, a significant increase in real disposable income and still low interest rates should result in a somewhat faster pace of residential construction. Public construction will remain depressed, however, due to continuing fiscal constraints at the municipality level. Though stabilising effects of import prices are dwindling, inflation should not accelerate before the end of the year; consumer prices (HICP) are likely to rise by about 1 percent.

FINLAND
Economic Situation



Source: Ifo World Economic Survey (WES).

Appendix 3:
Forecasting Tables

Table A1

Real gross domestic product, consumer prices and unemployment rates

	Weighted (GDP) in %	Gross domestic product in %			Consumer prices			Unemployment rate in %		
		2002	2003	2004	2002	2003	2004	2002	2003	2004
EU25	31.0	1.2	0.9	2.2	2.1	2.0	1.8	8.8	9.1	9.0
Switzerland	0.9	0.2	-0.2	1.2	0.6	0.6	0.8	2.6	3.7	3.7
Norway	0.7	0.9	0.2	2.0	1.3	2.2	1.7	3.9	4.6	4.6
Western and Central Europe	32.6	1.1	0.8	2.1	2.0	1.9	1.8	8.8	9.0	8.9
USA	35.9	2.2	3.0	4.2	1.6	2.4	2.3	5.8	6.0	5.6
Japan	13.7	-0.3	2.2	1.9	-0.9	-0.3	-0.3	5.4	5.3	5.4
Canada	2.5	3.3	1.8	2.9	2.2	2.5	1.8	7.6	7.4	5.4
Industrialised countries total	84.6	1.4	2.0	3.0	1.4	1.8	1.7	7.2	7.4	7.2
Newly industrialised countries										
Russia	1.2	4.3	6.2	5.8	15.8	13.9	11.7	8.0	7.4	7.2
East Asia[a)]	4.5	4.8	3.1	5.2	.	.	.	.	.	.
China	4.8	8.0	8.3	8.1	.	.	.	.	.	.
Latin America[b)]	4.9	-0.4	1.0	3.5	.	.	.	.	.	.
Newly industrialised countries total	15.4	4.1	4.3	5.6	.	.	.	.	.	.
Total[c)]	100.0	1.8	2.4	3.4	.	.	.	.	.	.
World trade, volume		3,2	4.2	98,6	.	.	.	.	.	.

[a)] Weighted average of: Korea, Taiwan, Indonesia, Thailand, Malaysia, Singapore, Philippines. Weighted with the gross domestic product of 2002 in US dollars. – [b)] Weighted average of: Brasil, Mexico, Argentina, Columbia, Venezuela, Chile, Peru. Weighted with the gross domestic product of 2002 in US dollars. – [c)] Sum of the listed groups of countries. Weighted with the gross domestic product of 2002 in US dollars.

Sources: EU; OECD; ILO; IMF; National Statistical Offices; 2003 and 2004: calculations by the Ifo Institute.

Table A2

Real gross domestic product, consumer prices and unemployment rates in European countries

	Weighted (GDP) in %	Gross domestic product in			Consumer prices[a)]			Unemployment rate[b)] in %		
		2002	2003	2004	2002	2003	2004	2002	2003	2004
Germany	22.0	0.2	0.0	1.8	1.3	1.1	1.2	8.6	9.3	9.3
France	15.9	1.2	0.2	1.8	1.9	2.2	1.8	8.7	9.4	9.5
Italy	13.1	0.4	0.4	1.8	2.6	2.8	2.5	9.0	8.8	8.5
Spain	7.2	2.0	2.3	3.0	3.6	3.1	2.6	11.3	11.3	11.0
Netherlands	4.6	0.2	-0.7	1.1	3.9	2.2	1.5	2.7	3.8	5.3
Belgium	2.7	0.7	0.9	2.1	1.6	1.4	1.1	7.3	8.0	8.1
Austria	2.3	1.1	0.8	2.0	1.7	1.2	1.1	4.3	4.4	4.4
Finland	1.5	2.2	1.4	2.6	2.0	1.3	1.0	9.1	9.0	8.7
Greece	1.5	3.8	4.6	4.3	3.9	3.5	3.8	10.0	9.5	8.9
Portugal	1.3	0.4	-1.1	1.2	3.7	3.3	2.3	5.1	6.5	7.5
Ireland	1.3	6.9	2.0	3.4	4.7	3.9	2.9	4.4	4.6	4.5
Luxembourg	0.2	1.3	1.1	2.2	2.1	2.6	2.0	2.8	3.7	3.7
Euro area[c)]	73.6	0.9	0.5	2.0	2.3	2.1	1.8	8.4	8.8	8.8
United Kingdom	17.3	1.7	1.9	2.7	1.3	1.3	1.6	5.1	5.0	4.8
Sweden	2.7	1.9	1.4	2.3	2.0	2.4	1.5	4.9	5.7	5.5
Denmark	1.9	2.1	0.1	1.9	2.4	1.9	1.6	4.5	5.7	5.5
European Union[c)]	95.5	1.0	0.8	2.1	2.1	1.9	1.8	7.7	8.0	8.0
Poland	2.0	1.4	3.3	4.1	1.9	0.8	1.9	19.8	19.2	18.4
Czech Republic	0.8	2.0	2.1	2.8	1.4	0.1	2.9	7.3	7.6	7.8
Hungary	0.7	3.3	2.7	3.4	5.2	4.6	6.2	5.6	5.8	5.7
Slovac Republic	0.3	4.4	4.0	4.4	3.3	8.6	8.3	18.6	17.0	15.2
Slowenia	0.2	2.9	2.2	3.3	7.5	5.8	5.3	6.1	6.6	6.2
Lithuania	0.1	6.7	6.5	6.0	0,4	-0.7	1.8	13.6	1.8	10.8
Cyprus	0.1	2.0	1.9	3.2	2.8	4.2	2.7	3.9	4.4	4.2
Latvia	0.1	6.1	5.9	5.7	2.0	3.3	3.5	12.6	10.5	9.5
Estonia	0.1	6.0	4.7	5.5	3.6	1.4	2.4	9.5	10.1	9.8
Malta	0.0	1.2	0.9	2.6	2.2	0.7	1.7	7.4	7.8	7.6
EU Acceding countries	4.5	2.4	3.1	3.8	2.7	2.1	3.4	14.8	14.3	13.7
EU25[c)]	100.0	1.2	0.9	2.2	2.1	2.0	1.8	8.8	9.1	9.0

[a)] Western Europe (except for Switzerland): harmonised consumer price index (HCPI). – [b)]Standardised. – [c)] Sum of the listed countries. Gross domestic product and consumer prices weighted with the gross domestic product of 2002 in US dollars; unemployment rate weighted with the number of employees in 2001.

Sources: EUROSTAT; OECD; ILO; IMF; National Statistical Offices; 2003 and 2004: calculations by the Ifo Institute.

Table A3

Indicators of the public budgets in the euro area

	Gross debt[1]					Financial balance[1]				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
Germany	60.2	59.4	60.8	64.0	65.2	-1.3	-2.8	-3.5	-4.0	-3.5
France	57.2	56.8	59.0	62.4	64.8	-1.4	-1.5	-3.1	-4.2	-3.9
Italy	110.6	109.5	106.7	105.0	104.0	-0.6	-2.6	-2.3	-2.8	-2.8
Spain	60.5	56.8	53.8	51.0	48.2	-0.8	-0.3	0.1	0.2	0.2
Netherlands	55.9	52.9	52.4	54.5	55.3	2.2	0.0	-1.6	-2.9	-3.1
Belgium	109.5	108.7	106.1	103.7	100.5	0.2	0.6	0.1	0.1	-0.1
Austria	67.0	67.1	67.7	66.1	65.9	-1.5	0.3	-0.2	-0.7	-1.3
Finland	44.6	44.0	42.7	44.3	40.0	7.1	5.2	4.2	2.1	1.8
Greece	106.2	106.9	104.7	98.8	94.9	-1.9	-1.5	-1.2	-1.5	-1.8
Portugal	53.3	55.5	58.1	58.2	58.0	-2.8	-4.2	-2.7	-3.1	-3.0
Ireland	38.4	36.1	32.4	33.7	33.7	4.4	0.9	-0.2	-1.5	-1.3
Luxembourg	5.5	5.5	5.7	4.5	4.1	6.4	6.2	2.4	-0.2	-1.5
Euro area[2]	70.2	69.3	69.0	70.3	70.3	0.2	-1.6	-2.2	-2.9	-2.7
United Kingdom	42.1	38.9	38.5	39.5	40.0	3.9	0.7	-1.6	-2.9	-2.9
Sweden	52.8	54.4	52.7	52.1	51.5	3.4	4.5	1.3	0.0	0.4
EU-15	64.1	62.8	62.5	63.6	63.8	1.0	-0.9	-1.9	-2.8	-2.6

[1] As a % of gross domestic product; in accordance with the delimitation according to the Maastricht Treaty. Financial balances without the special revenue gains from the sales of mobile phone licences in 2000–2002. – [2] Sum of the countries: weighted with the gross domestic product of 2002 in euro.

Source: Eurostat; 2003 and 2004: forecasts by the Ifo Institute.

Table A4

Key forecast figures for the euro area

	2002	2003	2004
	Percentage change over previous year		
Real gross domestic product	0.9	0.5	2.0
Private consumption	0.5	1.3	1.6
Government consumption	2.9	1.8	1.4
Gross fixed capital formation	-2.6	-1.0	2.3
Exports[1]	1.7	1.0	5.5
Imports[1]	0.1	2.2	5.4
Consumer prices[2]	2.3	2.1	1.8
	Percentage of nominal gross domestic product		
Current account balance	0.8	0.3	0.5
Government financial balance	-2.2	-2.9	-2.7
	Percentage of employees		
Unemployment rate[3]	8.4	8.8	8.8

[1] Exports and imports contain products and services including the trans-border market within the euro area. - [2] Harmonised consumer price index (HCPI).
[3] Standardised..

Source: Eurostat; 2002 and 2003: forecasts by the Ifo Institute.

Appendix 4:
Past and future of the Stability and Growth Pact

In November 2003, the Ecofin Council[1] voted against the Commission's proposal to give notice to Germany and France to reduce their budget deficits, which would have opened the door to future sanctions if the countries did not comply. The vote has caused a political and institutional crisis within the EU. Many believe that the crisis is a requiem for the common EU fiscal policy framework in the Maastricht Treaty and the Stability and Growth Pact (SGP). But this view neglects that fiscal discipline is a common concern in the euro area and that there is a need for common rules. The current crisis is an opportunity to make the rules more effective in terms of their ultimate goals.

In Chapter 2 of the 2003 EEAG report, we warned against the possibility of a crisis of the SGP in its 1997 formulation (facts have proven us right). We then presented a specific proposal for reforming the fiscal policy framework, which included changes at both the EU and the national level.

The EEAG proposal consists of three elements.

- The first element is to improve the fiscal rules by linking deficit limits to the stock of public debt (lower debt should mean higher permissible deficits). Such a change would acknowledge that a given budget balance should be judged differently depending on the debt situation.
- The second element is to strengthen the enforcement of the excessive deficit procedure by moving decisions on sanctions from the Ecofin Council to the European Court of Justice, as commitments by governments to enforce the rules are not credible.
- The third element is to strengthen the incentives for responsible fiscal policy at the national level. A way to do this is to appoint independent national fiscal policy committees to advise governments on which variations in the budget balance around long-run targets should be allowed for cyclical reasons and to make recommendations on specific tax and expenditure changes to stabilise the business cycle.

The various components of the EEAG proposal have been chosen to reinforce each other. More reasonable and flexible rules will command more legitimacy. This would make it possible to transfer enforcement decisions from the political to the judicial level, which would increase the credibility of the rules. At the same time a strengthening of national institutions for sound fiscal policy reduces the risk of political conflicts between the European and national levels. The recent problems of enforcing the fiscal rules have made the case for reforms along these lines even stronger than before.

The historical evidence on the EU fiscal rules also provides a clear rationale for reform. In the early 1990s, the Maastricht Treaty included limits to debts and deficits as conditions ("convergence criteria") for entering EMU. The same limits were adopted as a binding constraint on the fiscal policy of countries participating in EMU.

A crucial motivation for the inclusion of fiscal criteria in the Maastricht Treaty was widespread concern about the fiscal stance of a few prospective EMU members, namely Italy, Belgium and Greece, which had high and growing public debts. The stability pact reflected the desire to prevent these and other EMU countries from becoming vulnerable to fiscal crises. High debts and deficits are a threat to financial stability: a run on public debt issued by some governments is likely to endanger the payment and financial system of the euro area as a whole. Additional reasons discussed in the making of the Treaty included interest rate spillovers from national saving imbalances due to public sector borrowing, constraints on independent monetary policy by the ECB, and concerns with inter-generational equity. But none of these arguments is as strong as the concern with fiscal sustainability of high-debt countries.

Were the fiscal criteria in the Maastricht Treaty effective? Table 1.1 shows the development of the debt-to-GDP ratios for EU countries. Italy and Greece reduced their debt-to-GDP ratios between 1995 and 2003 (although these ratios are still larger than in 1991 – the currency crises and severe slowdowns in the early 1990s left a mark). Belgium also engineered a remarkable fall in the debt-to-GDP ratio relative to 1991, but its level of debt is still high. For these three countries, debt stabilisation at high debt levels makes the overall fiscal stance vulnerable to shocks.

Ireland and the Netherlands eliminated their debt problems. France and Germany, starting below the

[1] The Council of Ministers of the European Union is termed the Ecofin Council when it is made up of the economics and finance ministers of the member states.

Table 1.1
Gross government debt in EU countries (% of GDP)

	1991	1995	1999	2003	Difference 1999 to 1995	Difference 2003 to 1999
EU-12	58.6	73.0	72.5	70.4	-0.5	-2.1
EU-15	54.9	70.2	67.2	64.1	-3.0	-3.1
Belgium	130.9	134.0	114.9	103.5	-19.1	-11.4
Italy	100.6	123.2	114.5	106.4	-8.7	-8.1
Ireland	102.9	82.7	49.3	33.5	-33.4	-15.8
Greece	82.3	108.7	105.1	100.6	-3.6	-4.5
Netherlands	76.9	77.2	63.1	54.6	-14.1	-8.5
Denmark	62.5	57.0	52.7	42.9	-4.3	-9.8
Portugal	60.7	64.3	54.4	57.7	-9.9	3.3
Austria	57.5	69.2	64.7	66.4	-4.5	1.7
Sweden	51.3	76.2	65.0	51.7	-11.2	-13.3
Germany	40.4	57.0	61.2	63.8	4.2	2.6
Spain	44.3	63.9	63.1	51.3	-0.8	-11.8
France	35.8	54.6	58.5	62.6	3.9	4.1
UK	34.4	51.8	45.1	39.6	-6.7	-5.5
Finland	22.6	54.6	46.8	44.6	-7.8	-2.2
Luxembourg	3.8	5.6	6.0	4.9	0.4	-1.1

Source: European Commission: European Economy No. 6, 2002; European Commission: General Government Data, Autumn 2003.

60 percent ceiling, actually increased their debt-to-GDP ratios between 1995 and 2003.

A striking feature of fiscal consolidation in Europe is that adjustment was mostly concentrated in the period before the introduction of the euro. Table 1.2 shows the cyclically adjusted (or structural) deficit of the EU countries in selected periods and years.

Table 1.2
Cyclically adjusted net borrowing (-) by EU countries (% of GDP)

	1991–95	1999	2003	Difference 1999 to 1991–1995	Difference 2003 to 1999
EU-12	-5.3	1.7	-2.8	7.0	-4.5
EU-15	-5.2	-1.1	-2.2	4.1	-1.1
Belgium	-6.5	-1.1	0.8	5.4	1.9
Italy	-9.8	-1.9	-2.1	7.9	-0.2
Ireland	-1.2	1.0	-1.0	2.2	-2.0
Greece	-11.4	-1.4	-2.2	10.0	-0.8
Netherlands	-3.2	-1.3	-1.3	1.9	0.0
Denmark	-1.2	2.2	1.0	3.4	-1.2
Portugal	-5.2	-3.5	-2.0	1.7	1.5
Austria	-4.1	-2.5	-0.7	1.6	1.8
Sweden	-6.3	0.4	0.4	6.7	0.0
Germany	-3.8	-1.5	-3.5	2.3	-2.0
Spain	-5.6	-1.5	0.1	4.1	1.6
France	-4.8	-2.3	-3.9	2.5	-1.6
UK	-5.2	0.8	-2.4	6.0	-3.2
Finland	-1.2	0.6	2.8	1.8	2.2
Luxembourg	1.0	2.1	-0.5	1.1	-2.6

Notes: Data do not include one-off proceeds from the allocation of mobile phone licenses (UMTS). Countries are listed according to their 1991 debt-to-GDP ratios.
Source: European Commission: European Economy No. 6, 2002; European Commission: Cyclical Adjustment of Budget Balances, Autumn 2003.

Compare 1999 with the 1991–95 average: all countries improved their structural fiscal balances over the period. Belgium, Italy, Greece, Sweden and the United Kingdom showed the largest improvement.

The picture completely changes when we compare 2003 with 1999. Not only does the average structural balance stop improving: it deteriorates for both the EU and the euro area as a whole, with eight countries out of 15 recording a negative difference. The large European countries (Germany, France, Italy, and the United Kingdom) all show signs of fiscal deterioration.

For high-debt countries, the most important factor behind fiscal consolidation in the 1990s was the significant reduction in the interest bill on public debt due to interest rate convergence. Table 1.3 shows this large drop in interest payments for Belgium, Italy, Ireland and Portugal between 1999 and 1995.

Interest payments as a percentage of GDP continued to fall in 1999–2003, although the reduction was smaller than in the 1995–99 period (the reduced interest bills over these periods reflect both lower interest rates and a fall in the stock of debt). The deterioration in overall actual budget balances between 1999 and 2003 is instead explained by lower primary surpluses (the budget balance excluding interest payments) reflecting both the current economic slowdown and in some cases worsened structural balances (see Table 1.2). As shown in Table 1.4, the increase in the primary surplus between 1995 and the launch of the euro in 1999 in EU-12 was 2.5 percent of GDP. Comparing 2003 to 1999, there is instead a reduction of the primary surplus by 2.3 percent. Such a reduction occurred in almost all countries.

Table 1.3

Interest payments in EU countries (% of GDP)

	1991	1995	1999	2003	Difference 1999 to 1995	Difference 2003 to 1999
EU-12	NA	5.6	4.3	3.6	-1.3	-0.7
EU-15	NA	5.4	4.1	3.3	-1.3	-0.8
Belgium	11.3	9.3	7.0	5.6	-2.3	-1.4
Italy	11.9	11.5	6.7	5.3	-4.8	-1.4
Ireland	7.6	5.4	2.4	1.5	-3.0	-0.9
Greece	9.6	12.7	8.3	6.0	-4.4	-2.3
Netherlands	6.1	5.9	4.5	3.0	-1.4	-1.5
Denmark	7.3	6.4	4.7	3.3	-1.7	-1.4
Portugal	8.8	6.3	3.2	2.9	-3.1	-0.3
Austria	4.2	4.3	3.6	3.3	-0.7	-0.3
Sweden	NA	6.6	4.6	2.7	-2.0	-1.9
Germany	2.8	3.7	3.5	3.1	-0.2	-0.4
Spain	NA	5.2	3.5	2.5	-1.7	-1.0
France	3.0	3.8	3.3	3.2	-0.5	-0.1
UK	3.1	3.6	2.9	2.1	-0.7	-0.8
Finland	1.9	4.0	3.1	2.1	-0.9	-1.0
Luxembourg	0.3	0.4	0.3	0.1	-0.1	-0.2

Notes: Interest includes flows on swaps and Forward Rate Agreements. Countries are listed by their 1991 debt to GDP ratio

Source: European Commission: European Economy No. 6, 2002; European Commission: General Government Data, Autumn 2003.

feared sanctions, but these fears were clearly reduced when the countries with the largest political and economic weight ran into fiscal troubles.

It does not take much to understand that the enforcement of the current fiscal rules – or as a matter of fact of any rule – within the EU is subject to political risk: they can be overrun whenever they come into conflict with the interests of the majority of countries. A basic step to reduce such risks is the establishment of procedures that explicitly try to avoid apparent conflicts of interest (such as removing the decisions on the excessive deficit procedure from the Ecofin Council).

The lesson is evident. The fiscal rules were binding before EMU: the sanction of being excluded from EMU was clearly understood and perceived as economically and politically costly. In the 1990s, many countries made an effort to stabilise their debt. After the start of EMU, there was less scope for additional savings in interest payments as no further gains from interest rate convergence could be made. Despite the good overall fiscal performance in the first two years in the life of the euro, deficits started to deteriorate with the current slowdown. Fiscal consolidation in EMU requires deeper structural measures. But the sanctions for violating the rules have become less credible. Some countries may have

But such a step will not be enough. Even the most elaborate procedure can be circumvented. Better procedures are necessary, but not sufficient. It is also necessary to have rules that have a strong legitimacy and the moral support of European citizens.

The fiscal criteria in the Maastricht Treaty were – and perhaps still are – credible as conditions for EMU entry. Even if many observers were not convinced by their economic rationale, the sanction of being excluded from EMU motivated some policy effort to improve fiscal budgets. As a permanent rule in the Union, however, rules can only work if they are felt to have legitimacy and if sanctions are credible.

Table 1.4

Primary surpluses in EU countries (% of GDP)

	1995	1999	2003	Difference 1999 to 1995	Difference 2003 to 1999
EU-12	0.5	3.0	0.7	2.5	-2.3
EU-15	0.2	3.3	0.6	3.1	-2.7
Belgium	4.9	6.6	5.8	1.7	-0.8
Italy	3.9	5.0	2.7	1.1	-2.3
Ireland	3.3	4.7	0.7	1.4	-4.0
Greece	2.6	6.5	4.3	3.9	-2.2
Netherlands	1.7	5.1	0.4	3.4	-4.7
Denmark	0.2	8.0	-1.1	7.8	-9.1
Portugal	0.8	0.4	0.0	-0.4	-0.4
Austria	-0.9	1.3	2.4	2.2	1.1
Sweden	-0.8	6.1	2.8	6.9	-3.3
Germany	0.2	2.0	-1.1	1.8	-3.1
Spain	-1.4	2.4	2.6	3.8	0.2
France	-1.8	1.6	-0.9	3.4	-2.5
UK	-2.2	4.0	-0.7	6.2	-4.7
Finland	0.1	5.3	4.6	5.2	-0.7
Luxembourg	2.4	3.8	-0.4	1.4	-4.2

Source: European Commission: General Government Data, Autumn 2003.

How would our proposal help in this respect? There are a few well-understood shortcomings of the SGP. First, current procedures in case of violation of the pact are not credible once a country is in the euro area: preventing accession to the euro area is now the only effective sanction. Second, the SGP is clearly limiting flexibility beyond what many governments and policy analysts deem reasonable for countries in need of reforms or countries with low income in need of high spending for infrastructure. Third, there is a built-in incentive to pursue pro-cyclical fiscal policy. A country can keep the public deficit below the three percent ceiling by cutting spending and/or raising taxes during recession, while doing the opposite during booms (see Chapter 2 of the 2003 EEAG report for a detailed analysis of these shortcomings).

Linking the deficit ceiling to the stock of debt according to our proposal introduces an important element of flexibility in the SGP. What ultimately matters for solvency and sustainability is the debt level. Countries with a low debt-to-GDP ratio should have more scope for fiscal stabilisation (including tax smoothing in the presence of temporarily high spending), than countries with a high debt level. Low-debt countries should also have more room for deficit financing of public infrastructure – many European countries with low income, including the accession countries, have indeed a low level of public debt.

Consider the procyclicality of deficits. A serious flaw in the existing stability pact has been that there are no immediate rewards for fiscal restraint in booms. Linking deficit ceilings to the debt ratio, as we suggest, would provide governments that reduce public debt in booms with a visible "prize". It would be clear to voters that such a policy has moved the country up a rung to a group with higher "status" allowing more flexibility of future fiscal policy.

Better rules are easier to follow. They would also command more legitimacy. This makes it easier for governments to pre-commit by delegating enforcement to a non-political body. This could be the European Court of Justice as we discussed in the 2003 EEAG report. It could also be another body – say a body of experts at the European level (a supranational fiscal committee). What is relevant here is whether rules have a sense of legitimacy, and there is moral pressure to apply them.

Of course, no rule effectively constraining fiscal policy can be "optimal" in the sense of guaranteeing high flexibility without compromising credibility. We argue that the rules in our proposal are better than alternative proposals.

Some would prefer to define SGP rules in terms of a ceiling on the cyclically adjusted deficit rather than the actual deficit. But this would introduce a large area of discretion: what is structural and what is cyclical in current deficits? The incentive to political bargaining over statistical evidence and economic modelling would be immense.

Another proposal favours the adoption of a "golden rule", allowing deficit spending for public investment. This rule is logically faulty. There is no presumption that the cost of public investment is equal to the present discounted value of current and future improvements in primary surpluses that can be attributed to public capital. Conversely, there are many items in current spending that also contribute to future government revenues: why should they not be subject to the same treatment as public investment? Adopting a "golden rule" would lead mainly to greater accounting creativity: the strongest incentive is for a cosmetic redefinition of budget items.

The failure of the Ecofin Council to adhere to the fiscal rules in the Treaty and in the Stability and Growth Pact has created a dangerous vacuum. There is a blatant discrepancy between the legal rules in force and their application. This discrepancy must be addressed if credibility for fiscal rules at the EU level is to be restored. One should use this opportunity to reformulate the EU fiscal rules and institute a new enforcement procedure.

At the same time, EU member states should take steps to reform their national processes of fiscal policy-making with the aims of both strengthening the incentives for fiscal discipline and improving the possibilities to use fiscal policy for stabilisation purposes. A minimum requirement is to institute a more transparent policy framework with clearly defined medium-term budget targets and stabilisation objectives as well as clear operating guidelines for how fiscal policy is to be used to stabilise the business cycle. As suggested in last year's EEAG report, an ingredient in such institutional reform could be the establishment of an independent, advisory fiscal policy committee at the national level. The committee could be given the task of assessing the cyclical position of the economy and the consistency of the budget balance with medium-term objectives. Its task could also be to make recommendations on the appropriate budget balance and on specific tax and expenditure changes to help stabilise the economy.

One could also go further, and with monetary policy as a model, *delegate* actual fiscal policy decisions of a stabilisation character to an independent fiscal policy committee, as has recently been suggested by, for example, Wyplosz (2002) and Calmfors (2003).

Delegation of decision-making to a technical body would and cannot work on matters such as the structure and level of taxation, the structure of government spending and redistribution policies. Decisions on these matters are inherently political. But delegation of decisions to let budget outcomes vary around medium-term targets set by parliament would be one way of improving the effectiveness of fiscal policy as a stabilisation tool at the same time as the risk of fiscal laxity is reduced. Another option is to delegate the right to vary certain tax rates around long-term levels decided by parliament. The recent blow to the credibility of the fiscal policy framework at the European level strengthens the case for a more radical reform at the national level.

We see a real risk that the recent events in the Ecofin Council will have serious consequences for macroeconomic stability in Europe. These will not materialise in the short run, but the long-run costs can be very severe, as there could be gradual erosion of fiscal discipline. To limit the damage there should be radical reform of both the stability pact and the national decision-making procedures for fiscal policy. There will be strong political incentives to avoid such difficult decisions, but the long-run costs of doing nothing could be large.

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Appendix 5:
The euro and the dollar

Since the spring of 2002 the euro has been appreciating vis-à-vis the dollar and other major currencies. After a long period in which the euro-dollar exchange rate fluctuated around 0.90 dollars per euro, there has been a clearly visible trend toward appreciation. In the fall of 2003, the euro surpassed the rate of 1.26 dollars per euro. Figure 1.1 shows the euro-dollar exchange rate, reflecting the pattern just described.

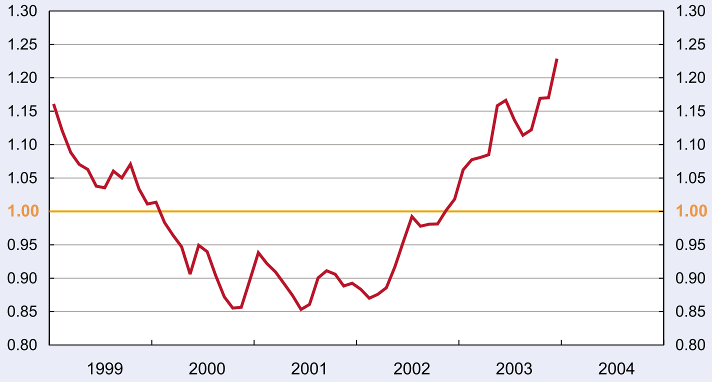
In our first report (EEAG, 2002) we discussed at length possible reasons for the initial weakness of the euro. With reference to different theories of exchange rate determination, the report singled out two factors that are likely to have played a crucial role in driving down the currency. The first factor consisted of expectations of large United States-euro area productivity differentials, driving up US demand for consumption and investment goods relative to Europe. The resulting excess demand in the United States should have worked in the direction of appreciating the dollar in real terms. The second factor stresses portfolio balance effects from the sharp contraction of the demand for D-marks and the euro in association with the introduction of the new currency. As the European Central Bank accommodated this demand contraction at given interest rates with the sale of euro-denominated short-term bonds, a larger supply of these bonds at given euro prices could be absorbed by international portfolios only at a lower exchange rate.

What is the role of these two factors in the new phase of euro appreciation? We reconsider this issue starting from the portfolio effects of the demand for cash. In our 2002 report we pointed out that the uncertainty about the modality of the physical conversion between the national currency and the euro in 2002 made many Eastern Europeans and agents operating in the informal economy or involved in criminal activities increasingly reluctant to hold D-marks and other European currencies starting in 1999/2000. The declining demand for currency was in part responsible for the decline of the value of the euro.

It is striking that the turnaround of the euro vis-à-vis the dollar actually coincided with the turnaround of the demand for money in circulation. Starting in the spring of 2002, previous D-mark money holders apparently switched back their demand for money in circulation in favour of the European currency. The upsurge in demand has contributed to the strong recovery of the euro since spring 2002. Figures 1.1 and 1.2 illustrate this pattern. Both the initial fall, and the recent recovery of the euro coincide with trend changes in the currency in circulation.

Figure 1.1

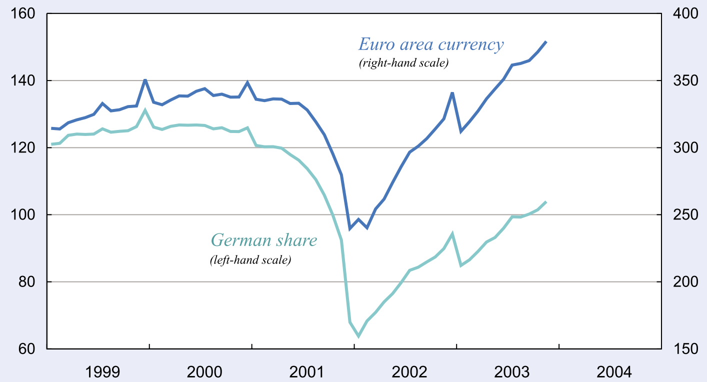
THE EURO/US-DOLLAR EXCHANGE RATE
Monthly data



Source: European Central Bank.

Figure 1.2

CURRENCY IN CIRCULATION IN THE EURO AREA AND GERMANY
Monthly data, in EUR billions



Source: Deutsche Bundesbank.

The argument in our 2002 report was built on estimates by the Bundesbank, according to which approximately 1 in 3 D-marks circulated outside Germany. The set of available data is now much richer and accurate. It includes statistics on the euro notes and coins actually transferred by the ECB to eastern European countries. An ECB report (Padoa-Schioppa 2002) shows that from January through May 2002 at least 18 billion euros were transferred to countries in Eastern Europe, while 13 billion had been deposited in interest bearing euro accounts before the cash changeover. This is comparable to our estimate in the 2002 EEAG report.

What about the effect of productivity growth on the euro-dollar exchange rate? In our 2002 report, we argued that this effect was powerful, and to a large extent euro weakness could be seen as a reflection of dollar strength in anticipation of remarkable productivity growth in the United States. Indeed, for the first two years in the life of the euro, the euro-dollar exchange rate seemed to move quite closely in line with unexpected movements in the differentials between US and EU output forecasts. To the extent that such differentials reflected different forecasts of long-run productivity growth, we claimed that the "productivity factor" played an important role in driving exchange rate dynamics.

Recent work by Corsetti, Dedola, and Leduc (2003) has actually substantiated this claim by providing striking empirical evidence on the effect of productivity growth on the dollar exchange rate. The evidence is based on a vector autoregression (VAR) study of the US economy, which identifies innovations to productivity in manufacturing as shocks that change labour productivity and/or total factor productivity in the long run.

Figure 1.3 is taken from the paper by Corsetti, Dedola, and Leduc (2003). It shows the effects of the technology shocks on the levels of productivity, the real exchange rate (the ratio between price levels of two countries measured in the same currency unit), relative consumption and relative output of the United States vis-à-vis the rest of the OECD countries. What is not shown in the figure is the behaviour of the terms of trade (the relative price of home imports in terms of home exports), which is similar to that of the real exchange rate, and the current account.

According to this figure, following a positive technology shock to manufacturing, US total consumption increased gradually, but permanently, relative to the rest of the world. Most importantly, the real exchange rate and the terms of trade strongly appreciated on impact and remained permanently stronger. Thus, the real exchange rate and the terms of trade have a similar behaviour. In other words, productivity gains in the United States not only appreciate the exchange rate in real terms: they also raise the international price of US output (the terms of trade appreciate). Although not shown in the figure, net exports also fell following the positive productivity shock, consistent with the observed large current account deficit experienced by the United States in recent years.

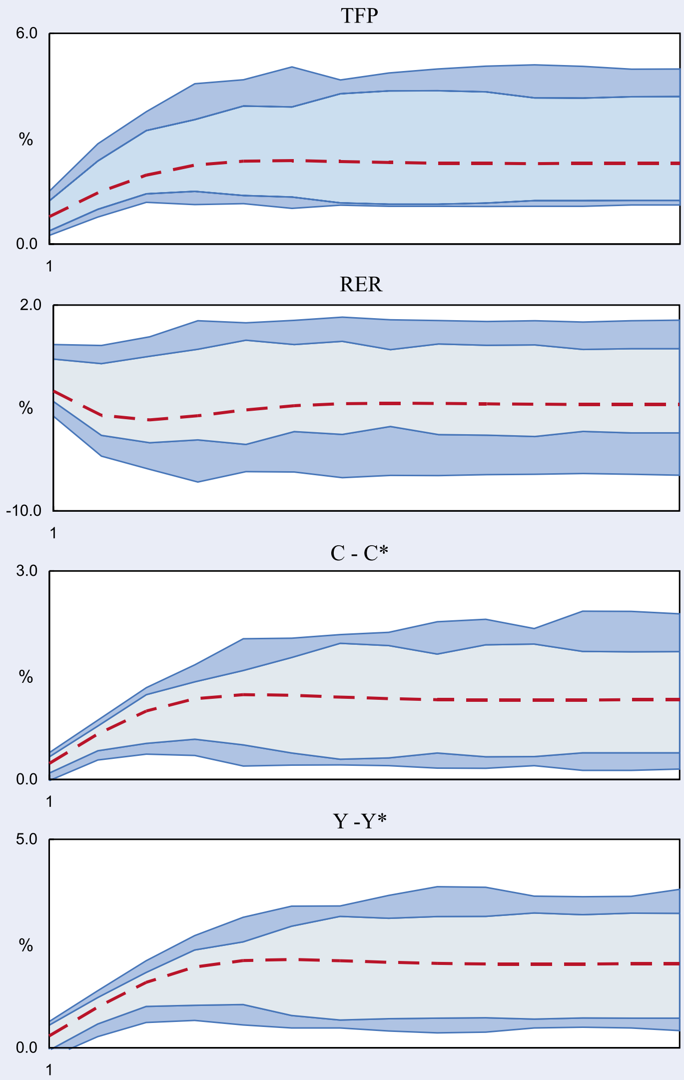
This evidence on the real exchange rate and the terms of trade is somewhat reminiscent of a key prediction of the Mundell-Fleming model: domestic booms that raise demand and output also appreciate the terms of trade, as some of the demand from the rest of the world needs to be "crowded out" to make more room for internal demand. What is striking in the figure is that the origin of the internal boom is not a demand shift, but a productivity shock.

The productivity factor has played a crucial role in explaining the strength of the dollar in the second half of the 1990s. Today its relevance as a determinant of the exchange rate is less pronounced. First, there are doubts about the persistence of a productivity gap in favour of the United States in the future, even if recent data show that productivity keeps growing at surprisingly high rates in the United States. Second, weighing against the dollar is the global imbalance created by the large cumulated external debt of the United States and the persistently large US current account deficit. Dollar depreciation helps address such an imbalance in two related ways. First it restores the competitiveness of US exporters, who can now sell abroad at lower prices. Note that if US exporters decide to lower their prices by less than the rate of dollar depreciation, this translates into higher dollar revenues per good sold abroad. Second, dollar depreciation reduces the international value of dollar-denominated US debt held by foreigners. At the same time, it boosts the dollar value of assets denominated in foreign currencies and held by US residents. These portfolio valuation effects can play an essential part in the adjustment.

What will be the macroeconomic implications of a stronger euro? It will contribute to containing inflation in the euro area, but it will make external

Figure 1.3

IMPULSE RESPONSES TO A TECHNOLOGY SHOCK
IN THE MANUFATURING SECTOR



Note: The figure describes the responses from a 4-variable VAR, using annual data. The variables are total factor productivity (TFP), the real exchange rate (RER), relative consumption (C - C*) and the relative output (Y - Y*). Standard error bands are for the significance levels of 68 percent and 90 percent (corresponding to the darker and lighter shaded areas, respectively).

demand weaker. Past experience and some new evidence tell us that in the initial phase of dollar depreciation European exporters avoid raising dollar prices of their goods and reduce profit margins – that is the degree of the exchange rate pass-through on export prices will be moderate. For some time, European firms will prefer to contract markups rather than running the risk of losing market shares, but this is not a sustainable strategy if the dollar appreciates further and productivity growth remains unchanged at the currently low and unsatisfactory rate. A widespread view is that a key factor underlying low productivity growth in Europe is labour hoarding: during the current slowdown, firms have preferred to keep their workforce rather than incurring both firing costs of dismissing excessive labour, and later on in the next upswing hiring costs of getting new employees. If this view is correct, recovery should be associated with strong gains in observed labour productivity.

The effect of the dollar turnaround on the US current account reversal is unlikely to be visible soon: it may actually take some time before we see a turnaround in the US trade deficit. What could help is a substantial slowdown of the US economy, or, even more, a different exchange rate policy of Asian countries, mainly China, that currently let their exchange rates fluctuate with the dollar against other currencies rather than allowing their currencies to appreciate against the dollar.

In this context, a slow pace of current account adjustment should not come as a surprise. As regards United States-EU relations, we have already discussed the likely pricing strategy of firms in their export markets. European firms will be reluctant to raise their dollar prices, US firms will be reluctant to reduce the euro prices of their goods. Yet it would be wrong to conclude that the dollar depreciation will be ineffective in reducing global imbalances. Even if the pass-through is incomplete, the dollar depreciation will have some expenditure switching effects, redirecting world demand towards US goods. Moreover, as we have argued above, dollar swings have an important impact on the value of US debt and assets abroad, which contributes to addressing the US external imbalance.

How strong will the euro become? This is the hardest question. It is impossible to consider the whole array of factors that can affect exchange rates, and it is well known that exchange rates in the short to medium run are well approximated by a random walk. But history reminds us that, at the current euro parity, the value of the D-mark fluctuated between (approximately) 0.60 and 1.40 dollars. The value of the Japanese yen fluctuated in the range of 80 to 140 yen per dollar. It is not unreasonable to expect similarly wide ranges to be relevant also for the euro-dollar exchange rate.

The strong dollar in the initial phase of the euro's life was arguably good news for Europeans. As noted by many observers, in the 1980s and 1990s some currencies in Europe (for example the Italian lira) would strengthen vis-à-vis the D-mark when the dollar was strong, and weaken otherwise. This view is dubbed "dollar-D-mark polarisation". By reducing the tension in the exchange markets for say, Italian liras, pesetas and escudos, a strong dollar arguably strengthened cohesion in the European currency area before the introduction of the euro. But there is also the other side of the coin to consider.

In a situation of a weakening dollar, different countries experience different pressures. Before the euro, these led to exchange rate pressures. The European currency crisis in September 1992 followed a "dollar crisis" culminating in August of that year. Many of the realignments in the Exchange Rate Mechanism of the European Monetary System were preceded by dollar swings. What would be the reaction within the euro area to a sharp fall of the dollar? In what way will the economic and political process be affected? Have the factors underlying the dollar-D-mark polarisation disappeared with the single currency or are they still active, potentially affecting real and financial markets? If they did not disappear, they are likely to bring about conflicts over the common monetary policy or, most likely, over fiscal policy.

While we will know the answer to this question only after having witnessed the real-life experiment of a falling dollar, there are reasons for concern. The political balance in the EU and in the euro area is already under stress by the accession process and the disagreement on a new constitution. Further tensions from a falling dollar are, unfortunately, to be expected.

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