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Report on the European Economy 2004

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EEAG Report ISSN 1611-311 X
Publisher and distributor: Ifo Institute for Economic Research
Poschingerstr. 5, D-81679 Munich, Germany
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EEAG Report

FOREWORD

This is the third annual report of the European Economic Advisory Group (EEAG) at CESifo. CESifo is one of the world's prominent research networks of professional economists including more than 350 university professors from 22 countries. Its home base is the Ifo Institute for Economic Research and the Center for Economic Studies (CES) of Ludwig Maximilian's University, Munich, with about 90 researchers in all fields of economics.

The EEAG, which is in toto responsible for this report, consists of a team of eight economists from seven European countries. It is chaired by Giancarlo Corsetti (European University Institute, Florence) and includes Lars Calmfors (University of Stockholm), Seppo Honkapohja (Universities of Helsinki and Cambridge, vice chairman), John Kay (St. John's College, Oxford), Willi Leibfritz (OECD, Paris), Gilles Saint-Paul (University of Toulouse), Xavier Vives (INSEAD, Fontainebleau), and myself. All members participate on a personal basis. They do not represent the views of the organisations they are affiliated with.

The aim of this report is to comment on the state and the prospects of the European economy. With the support of the Ifo Institute it provides a European economic forecast and discusses topical economic issues that are of general interest to policy makers, managers, academics and the European public in general.

I wish to thank the members of the group for investing their time in a challenging project and I also gratefully acknowledge valuable assistance provided by Doina Radulescu and Frank Westermann (assistants to the group); Gebhard Flaig, Wolfgang Nierhaus, Wolfgang Meister and Oscar-Erich Kuntze (economic forecast); Siegfried Schönherr and Martin Werding (comments); Heidi Sherman, Anne Heritage and Paul Kremmel (editing); as well as Elsita Walter (statistics and graphics) and Elisabeth Will (typesetting and layout).

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Munich, 5 February 2004

Executive Summary

This report is the third annual report by the European Advisory Group at CESifo. It includes six chapters, each addressing a set of emerging policy issues in the euro area and in the European Union as a whole. The executive summary provides a brief synopsis of the report and presents the main conclusions of the group as regards both analysis and policy proposals.

While growth in Europe was disappointing in 2003, there are indicators that point to a moderate recovery in 2004. The first chapter of our report presents our forecasts and a discussion of the macroeconomic outlook. In our forecasts, European GDP will grow at a rate as high as 2 percent in 2004, once again lagging significantly behind the United States. The global macroeconomic imbalances imply a risk of further dollar depreciation, undercutting European growth and potentially creating tensions about the appropriate fiscal and monetary policy mix in the euro area. The failure of the Ecofin Council to enforce the fiscal rules in the Treaty and in the Stability and Growth Pact in November 2002 has already created a discrepancy between the legal rules and their application. This implies a dangerous vacuum. In the 2003 EEAG report we presented a proposal aimed at improving the Stability and Growth Pact which links the size of maximum budget deficits to the stock of public debt. The proposal also aims at reducing political conflicts of interest in the enforcement of the new improved rules by moving these decisions to the European Court of Justice. Better fiscal rules can prevent the current institutional crisis from depriving Europe of a much needed common fiscal framework.

Because of political constraints, the margin of manoeuvre for governments to combat unemployment with radical labour market reforms is typically quite narrow. The second chapter identifies a set of policies to reduce unemployment that would encounter much less political opposition. These include liberalising product markets; introducing a simple "firing tax" that would be paid to the worker as severance payment instead of the current system of legal procedures; replacing welfare payments for the poor with in-work benefits such as earned-income tax credits (a proposal was formulated in the 2002 EEAG report); and ensuring that the search activity of the unemployed be tightly monitored, with sanctions in the form of reduced benefits if search is not active.

But, as shown by the United Kingdom, Spain and more recently Germany, a severe crisis and a sense of urgency can help to implement reforms that would otherwise be politically doomed. A critical point has been reached in a number of European countries, not so much because of overall macroeconomic performance (the current slowdown is milder than the previous one), but because of budgetary problems (including the adverse consequences of labour market rigidities for the financing of valuable benefits such as pensions and health care as well as for long-run living standards) and the feeling that "globalisation" is making the burden of labour rigidities unbearable. This is somehow "good news", but also "bad news" in the sense that the expected economic recovery may cause governments to diminish their reform efforts. This would be regrettable, since a recovery would make the immediate costs of reform much easier to bear.

An important dimension of labour market reform concerns pay-setting arrangements, which have significant implications for both macroeconomic performance (by affecting the level of real wages) and economic efficiency (by defining incentives for achieving higher productivity). The third chapter analyses current pay-setting arrangements in Europe as well as the prospect of reform. A main conclusion

is that most Western European countries would benefit from more diversity in relative wages. This applies to small European countries that have achieved real wage moderation at the aggregate level through highly co-ordinated collective bargaining as well as to a country like Germany where wages are determined at the sectoral level. Acceding countries are advised to stick to their current (Anglo-Saxon type) systems of industrial relations, with limited importance for collective bargaining and decentralised bargaining at the level of the individual firm if such collective bargaining does take place. Pay-setting systems are very slow to change: it takes a very long time or extraordinary circumstances to achieve radical changes. Therefore, specific recommendations for individual countries, that are to have an effect in the medium term, must be limited to improvements of the existing bargaining systems, which for historical reasons may differ fundamentally among countries.

In the fourth chapter we review some aspects of the new draft constitution for the European Union. It is, we believe, not the intention of the European Union to give to its courts the policy-making vote that the Supreme Court of the United States has assumed. But the assertion of 'non-discrimination' as a fundamental European value to be written into the constitution invites this very consequence. We fully share the objectives of those who argue for measures against discrimination: the elimination of racism, the advancement of women in public and business life, greater support for disabled people, and the establishment of a true common market in which national origin ceases to be of economic relevance. Yet there is a danger that the necessarily pragmatic pursuit of policies to achieve these objectives will be overtaken by the semantic interpretation of exactly what constitutes discrimination and non-discrimination if non-discrimination were to be included as a general rule in the European constitution. Some forms of "discrimination" are in fact essential in a well-functioning society. For instance, without statistical discrimination for insurance purposes, asymmetric information between economic agents would make many important insurance markets disappear, with possibly high costs in terms of general welfare. Similarly, in our proposal of welfare state reform included in the 2003 EEAG report, we stress that delayed integration of new foreign workers into the national welfare system could prevent an undue scaling back of the welfare state, which would be damaging for both national and foreign workers.

What should European citizens expect from the accession of ten new members in the EU in May 2004? The fifth chapter of the report presents a "primer" on acceding countries, summarising the income and structural differences between the new and the old members of the EU and analysing a number of economic policy issues regarding growth, migration, public finances, trade, foreign direct investment and capital mobility. Our analysis emphasises that convergence of the new countries' income to the EU average will be a very long process with considerable uncertainty about modalities and possible structural and policy problems emerging along the way. This conclusion counters the widespread view that problems in acceding countries are quite minor because convergence will be relatively quick. The few examples of rapid and successful convergence, such as Ireland, are the exception rather than the rule. Large-scale migration, unemployment, financial instability and fiscal imbalances will prevail for some time. Existing studies tend to downplay the importance of the impact of accession on the current EU member states, stressing that the main effects are likely to be felt at the sectoral and/or regional level. But the uncertainty surrounding the economic and policy problems in the post-accession phase is enormous. If anything, the large differences in the rate of return of capital in acceding countries and the rest of the EU suggest that the implications of accession for Western European countries are larger than suggested by the weight of acceding countries' GDP in total EU GDP. Migration and trade can substantially influence the current problems in the labour markets and of the welfare states in most current EU countries. A major problem will be the decline in the wages of low-skilled workers in the current EU countries. Ultimately, this decline is associated with gains from trade in the enlarged EU area: ideally it should result from a smooth and rapid structural adjustment process. But a wage decline cannot easi-

ly be administered with the present pay-setting institutions, especially in countries where the welfare system pays high replacement incomes. We therefore fear that the transition will be unnecessarily difficult for some of the existing EU economies, unless they find effective and socially acceptable ways to reform their institutions, so as to allow for the necessary wage flexibility in the near future (our proposals are discussed in Chapter 2 of this report as well as in the 2002 EEAG report).

How soon should acceding countries enter the EMU? The sixth chapter of the report reconsiders the challenge to macroeconomic stabilisation during the convergence process posed by liberalised capital markets. A number of factors inherently linked to convergence are likely to create financial and currency fragility and lead to dangerously high volatility of capital flows. There is no single strategy that could be recommended to all acceding countries as regards macroeconomic stabilisation on the road to the euro. Countries that are already able to sustain hard pegs (mostly small countries) should be helped to achieve a smooth and fast transition to the euro. Delaying participation in ERM II is instead a realistic option for countries that are currently unable to sustain such hard pegs. Here the policy priority is the reduction of domestic imbalances, achieving a sustainable fiscal stance and stabilising inflation at the correct relative prices. For both groups of countries, the convergence criteria in terms of inflation, interest rates, debt and deficits provide desirable targets to guide policy and should not be relaxed. Once countries enter ERM II, the risk of crisis is somewhat reduced, but not eliminated, by letting acceding countries make full use of the 15 percent bilateral exchange rate bands.

The findings by chapter

The *first chapter* discusses the current economic situation and the future outlook for Europe stressing the cause and implications of a strong euro as well as the need for a common fiscal framework through an improvement of the Stability and Growth Pact.

The *second chapter* discusses the political constraints that prevent governments from implementing labour market reforms and identifies factors and conditions that, in the current situations could soften political opposition. In addition, it analyses alternative policies that are effective in reducing unemployment, while encountering much less opposition than labour market reforms.

The *third chapter* analyses current pay-setting arrangements in Europe as well as the prospect of reform. It reviews the positive experience of many small European countries that have achieved real wage moderation through co-ordinated collective bargaining as well as the experience of countries where the achievements of collective bargaining are arguably much less positive. In either case, European countries would benefit from more diversity in relative wages.

The *fourth chapter* reviews some aspects of the new draft constitution for the European Union, pointing to possible undesirable consequences from including non-discrimination as a general rule in the European constitution.

The *fifth chapter* presents a "primer" on the ten new members of the EU starting in May 2004. It summarises the income and structural differences between them and the old members of the EU and analyses a number of economic policy issues regarding growth, migration, public finances, trade, foreign direct investment and capital mobility.

The *sixth chapter* discusses the challenge to macroeconomic stabilisation in the ten new members of the EU during the convergence process posed by liberalised capital markets. The focus is on financial and currency fragility created by dangerously high volatility of capital flows and possible policies to reduce macroeconomic vulnerability to a crisis.

The European economy: Current situation and economic outlook (Chapter 1)

In 2003, the European economy was close to stagnation. With real GDP growth of only 1/2 percent, the euro area was the least dynamic region of the industrial world. Despite further easing of monetary policy, domestic demand remained weak and exports declined, 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. This forecast is built 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 above 5 percent of GDP – there is a risk of a continued weakening of the US dollar and a further appreciation of the euro. While this would reduce import prices and support real incomes in the euro area, it could become a major obstacle to an export-led recovery in Europe.

How weak will the dollar become in the next few months? There is no sensible answer to this question, as it is well known that exchange rates in the short to medium term 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 per euro. The value of the Japanese yen fluctuated in the range of 80-140 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 was arguably good news for EMU. 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 tensions in the exchange markets for say, the Italian lira, the Spanish peseta, and the Portuguese escudo, a strong dollar arguably strengthened cohesion in the EU 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 problems. Before the introduction of the euro, these led to exchange rate pressures. The European currency crisis in September 1992 followed a "dollar crisis" culminating in August 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 further sharp fall of the dollar? 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 have not disappeared, they are likely to bring about conflicts over the common monetary policy and over fiscal policy in the various euro-area countries.

There could soon be a need for further interest rate cuts or a need to keep interest rates at the current level, even if (as widely anticipated) the US Fed alters its stance in 2004. In the past, the ECB has been much less active than the Fed in changing rates. In this respect, the conclusions from the ECB's assessment of its own monetary policy strategy in 2003 does not point to any substantial change in behaviour in the future. A monetary relaxation relative to the United States is unlikely to happen before there is a significant appreciation of the euro. Different regions in the euro area may respond quite differently to interest rate and exchange rate stimuli. In some regions, cuts in interest rates per se may bring little relief, unless they substantially affect the exchange rate.

Conflicts over fiscal policy are a major concern in the present situation. The failure of the Ecofin Council to enforce the fiscal rules in the Treaty and in the Stability and Growth Pact in November 2002 has created a dangerous vacuum. There is a blatant discrepancy between the legal rules in force and their application – a discrepancy that undermines the credibility of fiscal rules at the EU level and in the long run threatens to undermine fiscal discipline.

In the 2003 EEAG report we presented a proposal aimed at improving the Stability and Growth Pact. A key ingredient of our proposal is to link the size of maximum deficits to the stock of public debt. The proposal also aims at reducing political conflicts of interest in the enforcement of the rules by transferring the decisions on sanctions in the excessive deficit procedure from the political level of the Ecofin Council to the judicial level of the European Court of Justice.

At the same time we proposed that the EU member states should take steps to reform their national procedures for fiscal policy-making with the aim 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 guide-

lines for how fiscal policy is to be used to smooth cyclical fluctuations. As suggested in last year's EEAG report, one ingredient in such an 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. The committee's task would be to make recommendations on the appropriate budget balance and on specific tax and expenditure changes to help stabilise the economy. If there were to be a virtual breakdown of the common EU fiscal framework, even more thorough-going reforms of national fiscal policy institutions might become desirable: one radical reform would be to delegate the actual decision-making regarding variations of actual budget deficits or specific taxes around levels determined by the parliament to an independent Fiscal Policy Committee.

Labour market reform in Europe (Chapter 2)

Because of political constraints, the margin of manoeuvre for governments to combat unemployment with institutional reforms is typically quite narrow. In this chapter we first identify alternatives to labour market reform that can reduce unemployment perhaps less efficiently but would encounter less opposition. Second, we argue that present circumstances in Europe could make more radical reforms possible in the near future, pointing out several reasons why governments have become more ambitious in this area.

An important alternative to labour market reform is product market liberalisation. Increasing competition in product markets can have a strong beneficial effect on the equilibrium rate of unemployment. This is because more competition raises firms' productivity and imposes discipline on pay setting, since it reduces monopoly rents that are available to workers. In Sweden, for example, aggressive product market deregulation in the 1990s may have contributed to the large fall in unemployment.

A second approach consists in eliminating inefficiencies in the welfare system without radical changes in its basic structure. Relevant measures include the following.

- Dismissal costs can be made more efficient in many countries by replacing the current system of legal procedures with a simple "firing tax" which would be paid to the worker as severance payment.
- Incentives to work could be increased by replacing means-tested welfare payments with in-work benefits such as earned-income tax credits (a proposal was presented in the 2002 EEAG report).
- Search activity of the unemployed should be tightly monitored, with sanctions in the form of reduced benefits if search is not active. However, an open issue in this respect is how to make sure that the unemployment insurance administration engages in effective monitoring and applies sanctions.

Third, there are specific institutions or reforms that may enhance convergence of the interests of employees (who do not profit from many reforms) and firms (who gain from reforms). An important example is provided by "profit sharing" and the promotion of stock ownership among workers. These can make policies of wage moderation, which boost profitability and job creation, more acceptable to workers. If adopted on a large scale, they can be an efficient means of reducing equilibrium unemployment. A second example is provided by recent reforms liberalising temporary employment contracts, which have increased labour market flexibility in many European countries. These reforms have met with much criticism. For instance, it has been pointed out that the reforms may increase the protection of permanent workers. Yet, there has been substantial mobility from temporary to permanent contracts in many countries, and firms value temporary contracts as a way to test the quality of new workers.

The experiences of the United Kingdom and, to a lesser extent, Spain suggest that in situations perceived as "crisis", government can be more ambitious in pushing reforms directly targeted at the labour market. In principle, a critical point has also been reached in a number of European countries, not so much because of overall macroeconomic performance (the current slowdown is milder than the previous one), but because of budgetary problems and the feeling that "globalisation" is making the burden of labour rigidities unbearable. What are the main factors that could promote, or delay, reforms in the next few years?

First, paradoxically, the very efforts made by governments to combat unemployment tend to make it a bigger problem, as they tend to increase social spending per unemployed worker. Active labour

market policies in France and Sweden require considerable spending per recipient. But in France they have failed to produce a reduction in unemployment, and in Sweden their efficiency has been question (one view is that they may have succeeded in reducing registered unemployment, but at the cost of lowering regular employment). Similarly, when high persistent unemployment is erroneously fought using fiscal and monetary policies, this leads to excess deficits and/or inflation, which in the end creates the need for more drastic structural reforms.

Second, financial problems in other politically sensitive areas, such as pensions and health care, raise the social value of high employment rates. The recent drive for labour market reform in Germany stems from a more general crisis of the welfare state with the recognition that the pre-reform state commitments in this area are unsustainable. Opposition to the removal of labour market rigidities weakened as it became clear that failing to reform the labour market would increase the need for reductions in pension and health insurance benefits that are more valuable than the gains from existing rigidities.

Third, changes in the international economic environment may raise the cost of labour market rigidities. Increasing openness reduces producers' ability to transfer changes in their labour costs to prices. Since a faster pace of technical progress raises the need for labour turnover, it penalises those societies that impose a tax on turnover in the form of employment protection provisions. New technologies may increase the demand for skilled workers and reduce the demand for unskilled workers, thus reducing the real wages and/or employment of the latter.

The reform package called "Agenda 2010" recently adopted in Germany is a good illustration of these effects. The reform was pushed forward because it had become clear to the political elite of the country that Germany's welfare state was no longer affordable and proved incompatible with the degree of wage flexibility required by globalisation. In addition to a large number of minor reforms, the package abolishes the second-tier unemployment benefit system, which used to pay roughly 60 percent of the worker's last net wage until retirement age. While Agenda 2010 falls short of reforming the welfare system and the system of wage bargaining, where major reasons for the inflexibility of the German labour market can be sought, it goes much further than seemed possible only a year ago. The German example is therefore a good illustration of how a severe crisis and a sense of urgency enhance reform possibilities and help to implement fundamental changes that are otherwise politically doomed.

Pay-setting systems in Europe (Chapter 3)

Macroeconomic performance is also intimately associated with the functioning of pay setting. It has become commonplace to relate the rise in western European unemployment in the 1970s and 1980s to aggregate real wage rigidities. The reduction in unemployment in many of the smaller EU countries throughout the 1990s was associated with real wage moderation. But in some countries a badly functioning pay-setting system has contributed to persistent unemployment: in Germany, for instance, a crucial problem has been the compression of pay differentials between eastern and western Germany. Another important aspect of pay setting relates to the use of pay as an incentive to promote effort and labour productivity. Increased international competition and new forms of work organisation have substantially increased the importance of this last aspect of pay setting.

A key feature of pay-setting arrangements that is common to most western European countries is the high coverage of collective agreements, usually above 60 percent of employees. The main exception is the United Kingdom, where in 2001 the overall coverage rate was estimated to be as low as 36 percent. In most western European countries the main bargaining level is the sectoral one. But the general trend is toward enlarging the scope of local bargaining. Somewhat paradoxically, in some countries this development has occurred simultaneously with social pacts between top level labour market organisations, sometimes also involving governments, that have set norms for pay increases at the national level. In some EMU countries, such co-ordination efforts have been a means to restrain wage increases. The most far-reaching examples are Finland, Ireland and the Netherlands, but less ambitious schemes have also been adopted in Belgium, Greece and Spain.

Most of the new EU member states in Eastern and Central Europe find themselves in an entirely different situation from that of the present EU states. In most of the acceding countries collective bargaining is of much less importance than in Western Europe.

When collective bargaining does take place, the main level is the enterprise one. Estonia, the Czech Republic, Hungary, Latvia, Lithuania and Poland are all characterised by decentralised pay bargaining at the level of the enterprise and low unionisation and coverage of collective agreements.

The forces behind the decentralisation of pay bargaining in the past decades are likely to keep operating also in the future: one should expect further decentralisation in western Europe. There are three possible scenarios.

The first scenario is massive decentralisation, deunionisation and reduction in the importance of collective bargaining, as has happened in the United Kingdom, New Zealand and Australia. In these countries, single-employer bargaining has almost completely replaced multi-employer bargaining. The Anglo-Saxon model of pay setting has its advantages. The combination of enterprise-level bargaining and low unionisation/coverage of collective agreements is likely to produce aggregate real wage restraint. At the same time, it promotes relative-wage flexibility and the use of incentive pay. But the radical change in pay-setting practices in the United Kingdom, New Zealand and Australia have only occurred following fundamental changes in the legal system. Without sweeping legal reforms, a development in this direction in continental western European countries is unlikely.

The second scenario is a slow and disorgansed process of decentralisation, leading to a reduction in the importance of collective bargaining in Western Europe. This has occured in eastern Germany, where many firms have left the employers' associations or violated sectoral collective agreements in order to reduce wage levels. However, because of the inertia of wage-bargaining institutions, a process of spontaneous, disorganised decentralisation is likely to be slow. In principle, decentralisation could promote real wage restraint, although the effects might not be large. But it is also possible that a move to single-employer bargaining weakens the incentives for wage restraint. This risk is actually great if coverage of collective agreements and unionisation remain high.

A third scenario is organised decentralisation, according to which higher-level union confederations and employers' associations choose voluntarily to leave more scope for local bargaining. This could involve larger freedom at the enterprise level to determine the margin for wage increases and its distribution among individual employees.

Which pay-setting system should the EU countries opt for? While there is no general answer to this question, there are a few basic guidelines for reform. We summarise them as follows:

- Pay-setting systems are very slow to change: it takes a long time or extraordinary circumstances to achieve fundamental changes. Therefore specific recommendations for individual countries would have to take into account the existing bargaining systems, which for historical reasons may differ considerably among countries.
- There are good reasons for keeping existing bargaining systems in those current EU member states that have achieved wage restraint through formal or informal co-ordination of bargaining at the multi-sector level. Such arrangements have worked well especially among smaller countries. But aggregate real wage moderation should be combined with relative wage flexibility. One way to achieve this could be to publicise a "corridor" for wage increases, rather than a single figure, when wage norms are formulated. Alternatively, a co-ordinated agreement on a "normal wage increase" could be reached with the understanding that "above-normal" wage raises should only be granted in areas with labour shortages.
- The recommendation of allowing more relative wage flexibility applies in particular to Germany, where wage bargaining mostly takes place at the sectoral level. In Germany, there is a strong need for diversity in wages between the western and the eastern regions, as well as for greater opportunities to set wages at the enterprise level that are lower than the norms agreed upon at the sectoral level. If Germany's stagnation problem is to be solved, labour market reform must be extended to pay-setting practices as well, which so far has not taken place.
- The acceding countries, with industrial relations are of an Anglo-Saxon type (low unionisation, low coverage of collective agreements, and collective bargaining at the level of the enterprise when bargaining takes place) should keep their present systems. These countries are likely to face strong pressures from Western European trade unions, and possibly also from EU institutions, to change their industrial relations systems so as to conform better to "EU standards". Such pressures should

be resisted. The existing combination of enterprise-level bargaining and limited importance of collective agreements is likely to produce better macroeconomic outcomes than a move to sectoral bargaining of the Western European (German) type.

What will be the outcome of the present trend towards greater importance of local-level pay setting in Western European countries? For political and economic reasons, it may turn out to be impossible to combine aggregate real wage restraint with relative-wage flexibility within the current bargaining systems. If this is the case, one cannot, in the long run, rule out a development towards an Anglo-Saxon system in which a move to single-employer collective bargaining is accompanied by massive de-unionisation and a decline in the importance of collective bargaining in general. But such a development would probably occur only as a consequence of a long period of deep economic crisis, followed by radical reform of basic labour legislation. This point is underlined by the failure to include even modest changes of the pay-setting system in the recently adopted labour market reforms in Germany.

The economics of discrimination (Chapter 4)

The draft of the European constitution asserts the principle of non-discrimination as a fundamental European value, to be explicitly written into the constitution along with such values as pluralism, tolerance, justice and solidarity. We fully share the objectives of those who argue for measures against discrimination: the elimination of racism, the advancement of women in public and business life, greater support of disabled people and the establishment of a true common market in which national origin ceases to be of economic relevance. But we are concerned with the danger that the necessarily pragmatic pursuit of policies to achieve these objectives will be overtaken by the semantic interpretation of exactly what constitutes discrimination and non-discrimination, if non-discrimination were to be included as a general rule in the European constitution.

The reality of this danger is illustrated by the experience of German reunification. In this case, the political and constitutional imperatives of non-discrimination between the residents of the former eastern and the residents of the former western provinces required a common benefit system and common labour regulation across areas at very different stages of economic development. This both imposed costly burdens and held back development in the eastern *states*.

In this chapter, we examine the application of non-discrimination rules in three broad areas of European policy: gender discrimination in goods and services (essentially in the insurance market); disability discrimination and discrimination on grounds of nationality. In each of these areas, policy effectiveness can be much better achieved by careful analysis of costs and benefits, and different policy trade-offs in relation to objectives than by the legal application of general principles which sound rhetorically attractive but whose precise meaning and practical consequences are often unclear and must necessarily be the subject of future judicial determination.

In these and other areas covered by the proposed anti-discrimination provisions we suggest that in general the European constitution should contain non-binding statements of objectives and give the Commission and member states the responsibility of introducing specific measures of implementation. The confused and repetitive provisions of the draft constitution dealing with non-discrimination, which conflate a variety of policy issues into a single heading, should be replaced by a declaratory statement of the European Union's objectives in these areas. Such a statement would include a commitment to combat racism, to promote the advancement of women in business and public life, to give greater opportunities to disabled people and to promote the free movement of goods, services and people within the EU. Where there are trade-offs to be made between competing objectives or between different means of achieving the same objectives – which is true in all these cases – these trade-offs should be made through the ordinary political processes rather than by the courts, whose central but limited role in policy should be the defence of the union's fundamental values and ensuring the propriety of its processes.

EU enlargement (Chapter 5)

EU enlargement in 2004 will most likely yield major benefits to the new member countries in the long run. Acceding countries are likely to reap vast gains from trade in goods and services and from a contin-

ued inflow of financial and real capital. Capital inflows to these countries are already substantial, as suggested by current account deficits in the order of 4 to 6 percent for the major ones. Most of these capital flows are in the form of direct investment from present EU member countries. To a large extent these flows respond to profit opportunities created by the currently very low wages in acceding countries. While firms in the current EU member states have already outsourced labour-intensive parts of their product chains to Eastern Europe in the pre-accession stage, outsourcing is likely to gain further momentum after accession in 2004.

Without doubt, these processes will significantly speed up economic growth in Eastern Europe. However, even under optimistic assumptions, catching-up with the EU-15 countries will be a time-consuming process that will take at least several decades. The crucial issue is the degree to which EU membership will enhance economic growth in the accession countries. Attracting private FDI will be a key element of fast economic growth: preconditions for further large FDI flows are well-functioning goods and financial markets, an improved infrastructure and a high quality of public services.

The existing EU member countries will also participate in the gains from trade in the long run. However, the internal adjustment processes caused by enlargement may involve significant costs and frictions in the short and medium term. In particular, trade with acceding countries will increase downward pressures on the wages of low-skilled workers. Cuts in pre-tax real wages for this group may become necessary to prevent a further increase in unemployment rates and an excessive dismantling of labour-intensive production, yet such cuts will be difficult to implement. In chapters 2 and 3 of this report, we discuss reforms of labour market institutions that would enhance wage flexibility. As regards pay-setting practices, for instance, such reforms should entail measures to promote relative-wage flexibility among sectors, regions, and occupations. But policy priority should also be given to specific measures to combine wage flexibility with socially acceptable standards of living for low-wage employees. The first EEAG report (EEAG 2002) suggested a system of social assistance according to which low-wage incomes from employment could be topped up with employment tax credits that would generate the necessary pre-tax wage differentials while preventing socially undesirable declines in the living standards of low-skilled workers.

The economic consequences of EU enlargement will also depend on the policies pursued by the new members. Acceding countries currently have fairly delicate macroeconomic situations. Many of them have significant public sector deficits. Even if the stocks of public debt are low or moderate, sustainability of public finances can become a major policy concern.

There are a number of potentially positive fiscal effects from EU membership, including significant transfers from the EU and indirect gains from interest rate convergence and higher growth rates. These effects notwithstanding, the new EU members are likely to face pressures on public spending after accession: the countries will have to co-finance EU-funded projects, and the implementation of EU regulations will entail fiscal costs. Improvement of the infrastructure as well as social insurance reform and education,will be additional major items in public spending.

In many accession countries, high unemployment rates imply that there is significant underutilisation of resources. At best, these resources can provide further impetus for rapid economic growth, but they could also feed major labour migration to the EU-15 countries. Migratory pressure is likely to be felt most strongly in Germany and Austria, countries that are geographically close to the new members.

EU membership and fully open borders will gradually lead to industrial changes as well. The decline of manufacturing in the Baltic and Central and Eastern European accession countries throughout the 1990s has been reversed in recent years. Some manufacturing sectors have recovered and are likely to keep expanding in the future. Significant parts of the relatively low-skill manufacturing industry and services may gradually shift from EU-15 to the new member countries.

Agricultural productivity is quite low in the acceding countries and there is significant potential for improvement. Agricultural and food production are likely to increase in some of these countries, though food safety and other regulations could contain the rate of expansion. An important role in shaping the future of the agriculture and food processing indus-

try in Europe will be played by international WTO negotiations.

The road to the euro (Chapter 6)

The ten EU accession countries are supposed to join EMU in the next few years – the third and last phase of accession. Participation in EMU is conditional on satisfying the convergence criteria established in the Maastricht Treaty. When should these countries adopt the new currency? What are the challenges to policymakers in the period between EU accession and the adoption of the euro?

There are clear benefits from participating in EMU. The traditional argument is the credibility of low inflation, which applies to acceding countries as it did to southern European countries in the 1990s. A common currency eliminates currency risk and therefore drastically reduces interest rate differentials. In addition, a common currency is likely to increase trade with other EU countries. In this respect, adopting the euro is equivalent to a drop in transaction costs in cross-border exchanges of goods and services within the EU economic area. Also, by reducing the stock of external debt denominated in foreign currency, adopting the euro will substantially reduce vulnerability to currency and financial instability (although in principle EMU countries could still issue large stocks of dollar-denominated debt). The main and well-known disadvantage of participation in a monetary union is the loss of national monetary policy as an instrument of macroeconomic stabilisation and of the exchange rate as an adjustment mechanism. Whether and under what circumstances the adoption of the euro is a net economic benefit is the subject of an ongoing academic debate and political discussion in present EU countries that are not members of EMU. However, from a political point of view it appears certain that the accession countries will ultimately join EMU, so the relevant policy issue is one of timing.

The road to EMU may be quite difficult. Policy choices on the timing of EMU participation directly impinge on the acceding countries' ability to use monetary policy to stabilise their economies in the next few years and to build an economic environment that favours high rates of investment and growth, economic integration and financial stability.

Fiscal and monetary authorities in the acceding countries now operate in a regime of high capital mobility. This is the result of a relatively rapid process of liberalisation and deregulation implemented in the last few years. But it is too early to say whether or not the financial and legal systems of these countries can weather volatile capital movements. However, it would be naïve to hope for the better and envision years without large (global or region-specific) shocks.

Our last chapter points at the intrinsic financial and currency fragility of fast-growing emerging markets in a world of liberalised capital flows. Based on the experience of the 1990s, emerging markets may be exposed to highly volatile capital flows, which can be a formidable challenge to macroeconomic stability. In boom periods, large inflows of short-term capital lead to domestic overheating and high rates of domestic credit expansion, causing excessive risk taking. Since debt is usually denominated in foreign currency, these inflows also expose domestic institutions and individuals to severe currency risk. In bust periods, currency devaluation worsens the balance sheets of banks and production firms.

EU accession is likely to increase short-term speculative capital inflows into the acceding countries. These flows may also respond to moral hazard distortions at both domestic and euro-area levels. Vulnerability to crises and contagion emphasises the need for building well-established mechanisms at the EU level to deal with such contingencies.

As discussed in Chapter 5, structural imbalances in the acceding economies may cause acute problems. Deteriorating fiscal conditions could constrain the use of budget policies for stabilisation purposes. Stabilisation is likely to fall disproportionately on monetary and financial authorities, both from a macro perspective and from a financial stability perspective. In such an environment, mandatory adoption of a regime of limited exchange rate flexibility (ERM II) for two years before entering EMU is controversial.

Overall, there is no single strategy that may be recommended to all acceding countries as regards macroeconomic stabilisation on the road to the euro. Arguments in favour of adopting the euro as early as possible includes smaller financial risk due to the elimination of currency mismatch in the balance sheets of banks and firms (which implies the risk of a

self-fulfilling run on the country's debt); interest rate convergence (with the associated gains in terms of the interest bill for the government as well as investment financing by firms); and overall gains in monetary credibility. Arguments for a slower pace to the euro include the need to remove financial distortions creating moral hazard and therefore raising the country's default risk; easier relative-price adjustment without the need of costly nominal wage and price adjustments; and the need to make fiscal and financial policy sustainable and compatible with a fixed exchange rate before participation in the EMU.

The following recommendations may be made, however:

- Countries that are already able to sustain hard pegs should be helped to achieve a smooth and fast transition to the euro. In this set of countries, mainly small ones, priority should be given to institutional reforms and building a policy framework consistent with participation in the euro area without suffering from major macroeconomic imbalance.
- Delaying participation in ERM II is a realistic option for countries that are currently unable to sustain hard pegs and have large domestic imbalances. Here the policy priority is achieving a sustainable fiscal stance and stabilising inflation at the correct relative prices. This task requires both institutional and policy reform.
- For both groups of countries, the convergence criteria in terms of inflation, interest rates, debt and deficits provide desirable targets to guide policy and should not be relaxed. Though they are not first-best targets, these convergence criteria should be judged relative to existing distortions that could derail the stabilisation efforts.
- ERM II allows for large fluctuation bands around the exchange rate parity. Once in the ERM, a country should be able to use the exchange rate flexibility implied by such an arrangement: exchange rate stability should not be mechanically assessed with reference to much narrower bands. Fluctuations in the exchange rate in response to domestic and foreign shocks are not necessarily an indicator of tension in the foreign exchange market, but can be part of an efficient adjustment process. If the dollar suffers further depreciation, it would be reasonable to expect exchange rate fluctuations within ERM II. Declaring that acceding countries will be accepted in the euro area only if they can peg to the euro within narrow bands may raise the possibility of speculative attacks driven by self-fulfilling prophecies. During the transition to the euro, strict domestic stabilisation with some exchange rate flexibility is better than exchange-rate based stabilisation with very limited flexibility.

The European Economy: Current Situation and Economic Outlook

In 2003 the European economy was close to stagnation. With real GDP growth of only 1/2 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 1/2 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

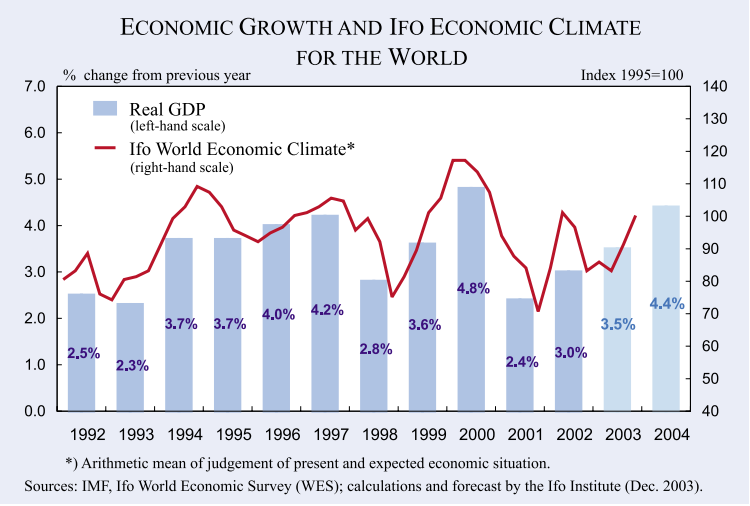


Figure 1.2

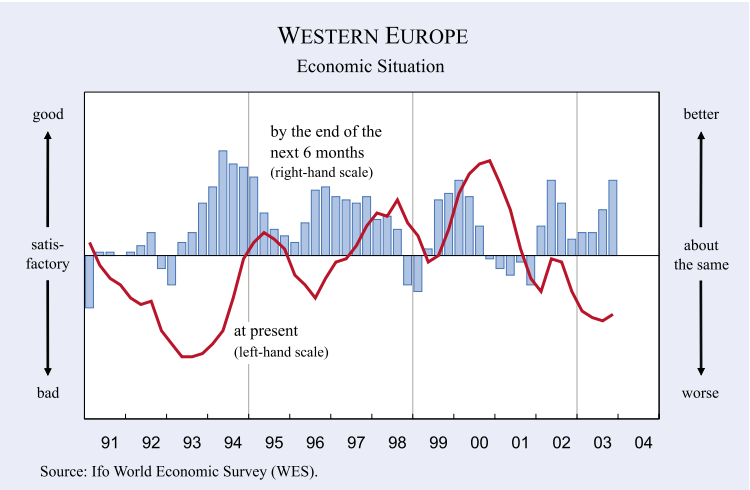
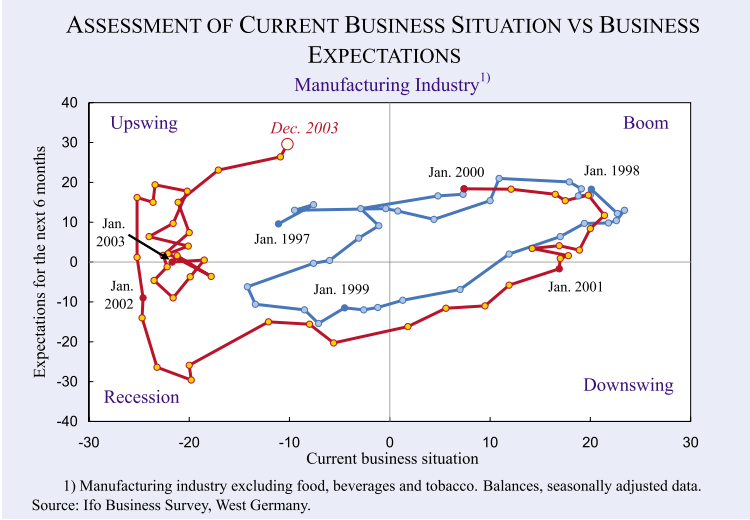


Figure 1.3



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-

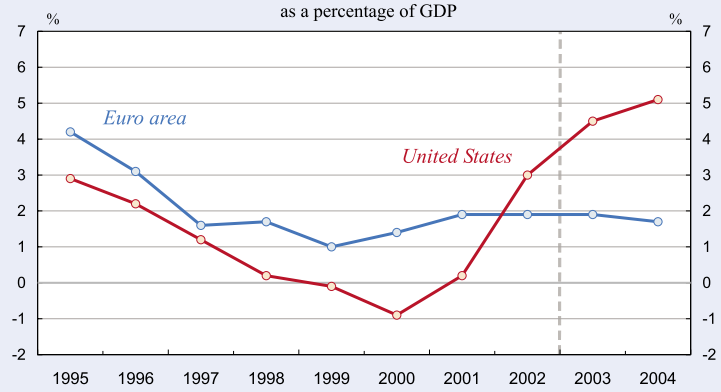
[2] In last year's report we had projected GDP growth of 2.7 percent.
[3] In the first three quarters of 2003, real military spending increased by around 10 percent against the previous year, and as military spending is around 4.5 percent of GDP, its contribution to GDP growth was around ½ percentage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

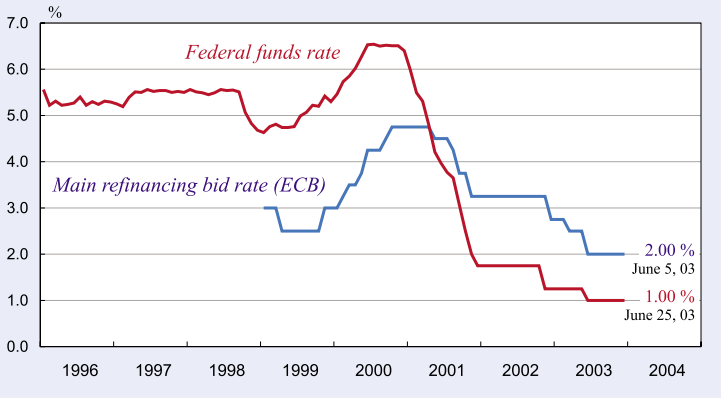
Monetary conditions remained favourable in 2003, both in Europe and in the United States. While nominal short-term interest rates continued to decline to historically low levels, they remained higher in the euro area than in the United States (Figure 1.5).[5]

[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.

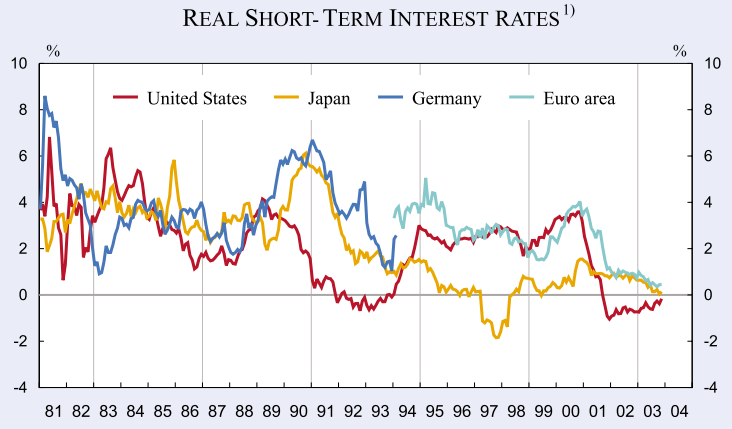
Figure 1.5

CENTRAL BANK INTEREST RATES



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

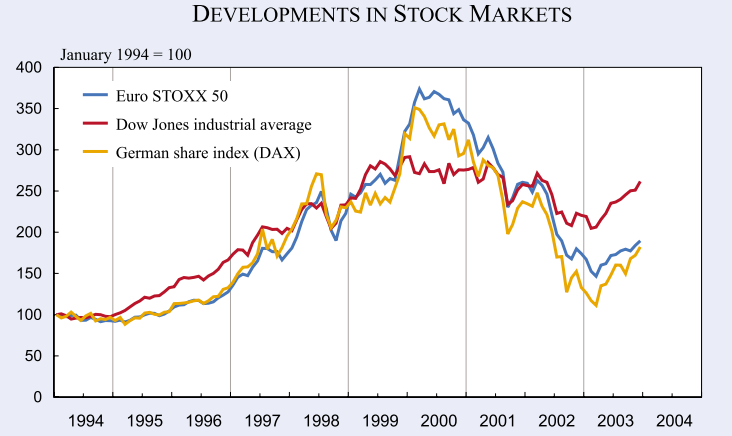
Figure 1.6



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

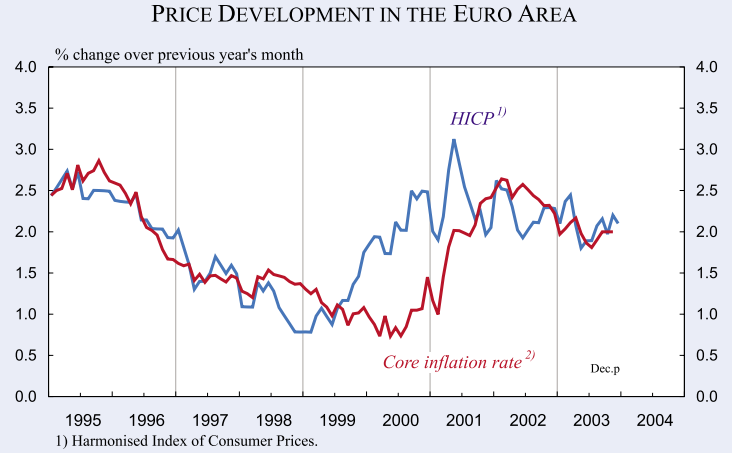
Sources: Deutsche Bundesbank, European Central Bank, Eurostat, Federal Reserve Bank of St. Louis, Federal Statistical Office, OECD; calculations by the Ifo Institute.

Figure 1.7



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

Figure 1.8



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.

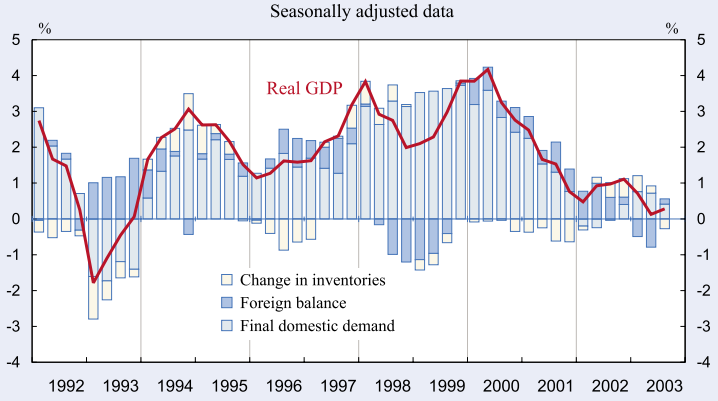
[7] In the euro area, the contribution of the net foreign balance to GDP growth was – 0.8 percent (after + 0.7 percent in 2002) and in the United States it was – 0.4 percent (after – 0.8 percent in 2002).

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.

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.

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.

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

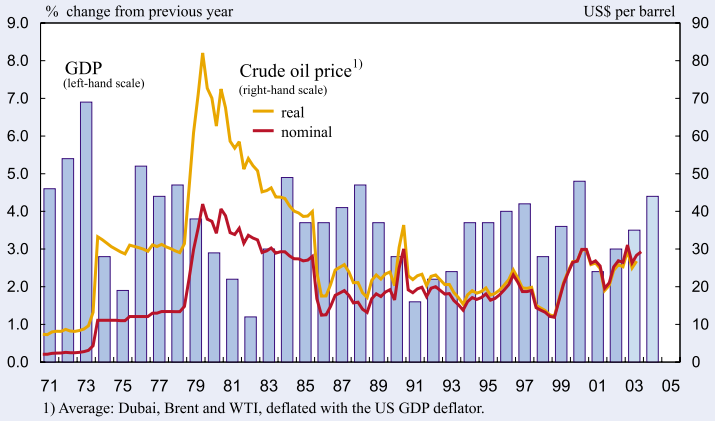
rising capacity utilisation and profit expectations. Output is assumed to increase by 4.2 percent in 2004 after 3 percent in 2003.

- 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 8½ percent real terms in 2004, compared to 4¼ 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

WORLD ECONOMIC GROWTH AND CRUDE OIL PRICE IN US$ PER BARREL



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.

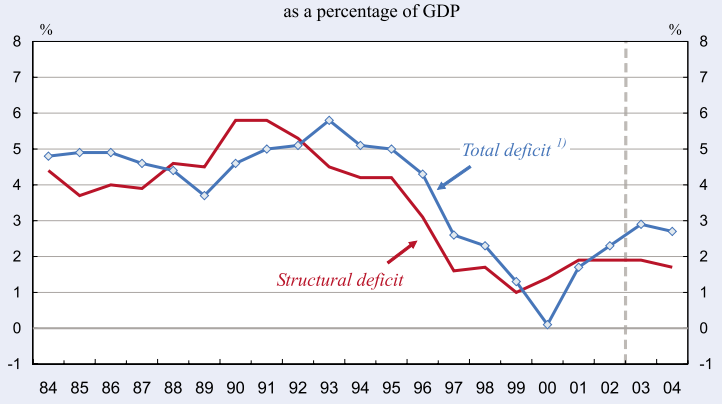
Fiscal policy in the euro area is assumed to remain broadly similar to that of 2003, as countries see no scope for increasing their structural deficits to increase demand but are also reluctant to reduce them in view of high unemployment (Figure 1.11). The degree of already achieved consolidation and 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.).

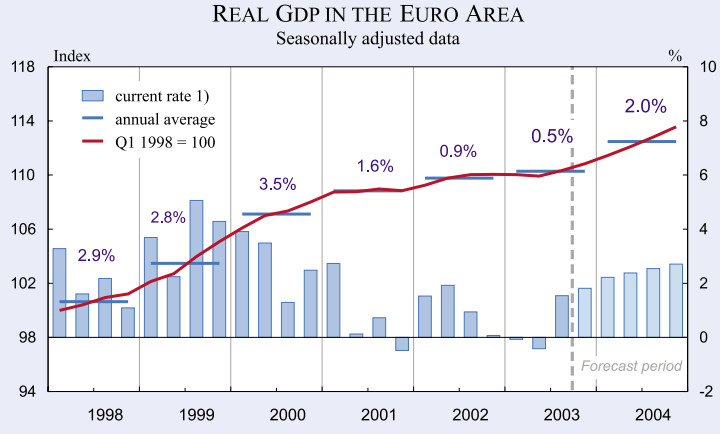
Improved business confidence may to some extent reflect improved profit expectations. However, if actual profits improve less than expected, confidence may falter again. Under conditions of continued cyclical slack there should be relatively strong pressure for wage moderation, so that profit margins 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

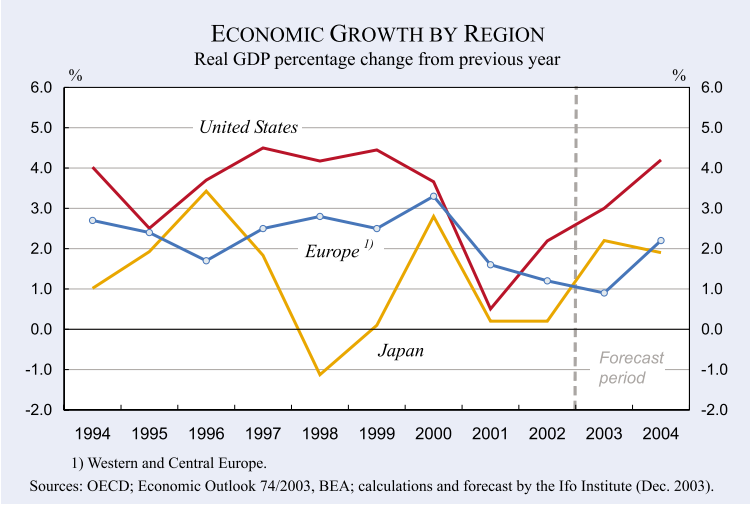
In the course of 2004, the gradual recovery of the world economy should support *export growth.* However, a good part of European exports is intra-

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).

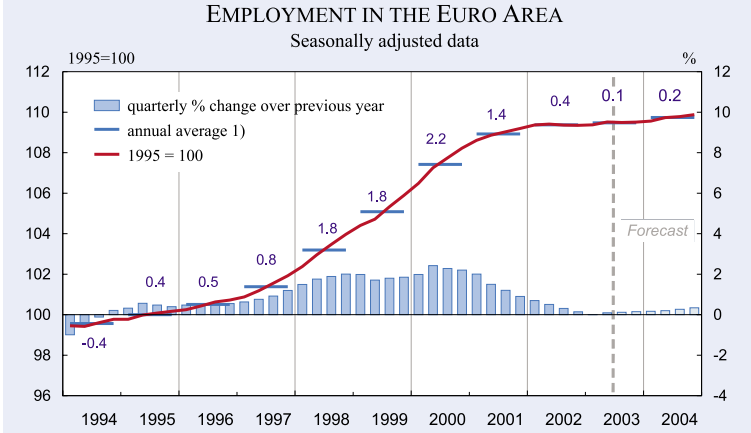
Figure 1.13



1) Western and Central Europe.

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

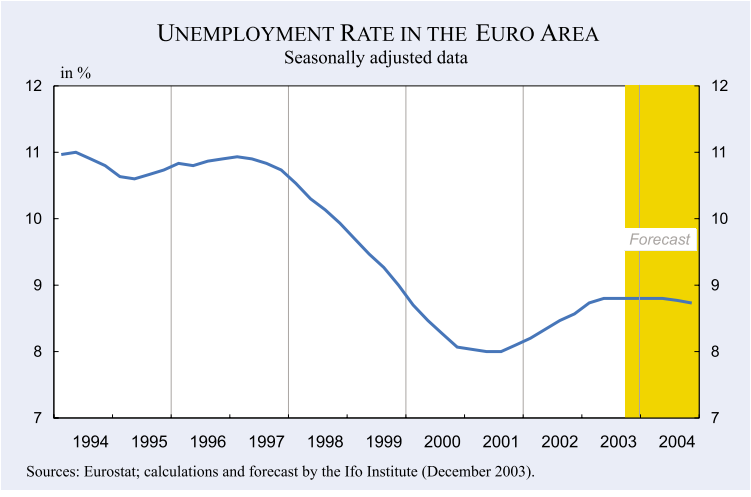
Figure 1.14



1) Figures: annual % change from previous year.

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

Figure 1.15



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.

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]

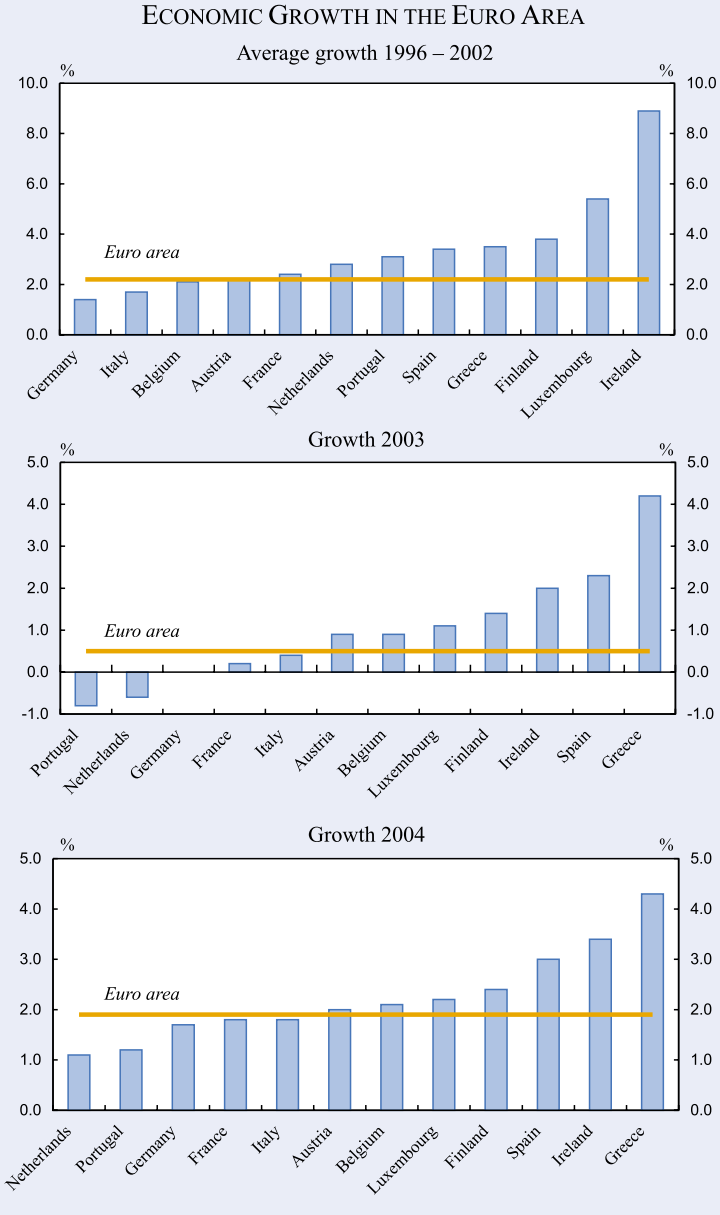
The recovery in output growth will not lead to a decline in unemployment in the euro area in 2004. This is because output growth remains relatively moderate. Furthermore, during the past downturn, firms typically followed a strategy of labour hoarding which depressed productivity. They can, therefore, 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.

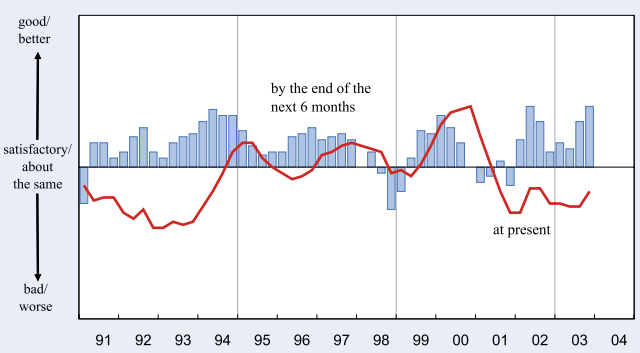
In the more developed European countries, where high and/or rising labour costs were accompanied by an appreciating exchange rate, exports weakened most. In addition, in some countries households have increased their savings rates in response to a deteriorating labour market and losses in equity wealth. 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).

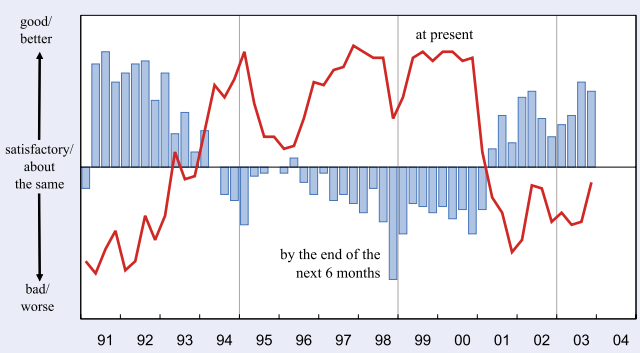
(For further details on the forecasts for Germany, France, Italy, the United Kingdom, Sweden, Finland and Spain, see Appendix 2. The key forecast tables of this chapter are presented in Appendix 3).

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.



Source: Ifo World Economic Survey (WES).



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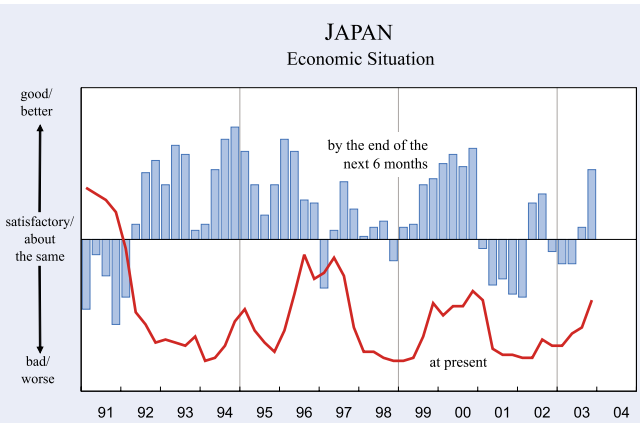

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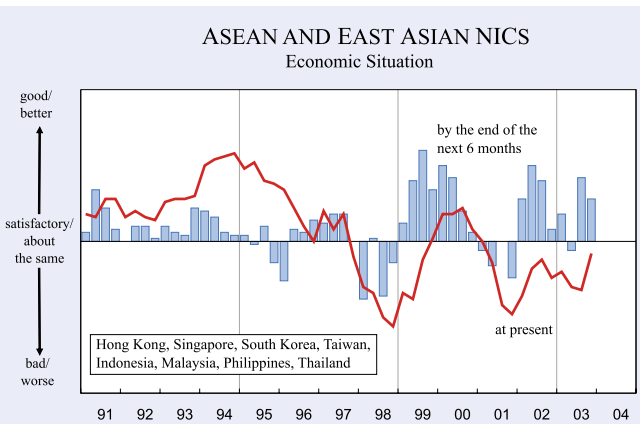

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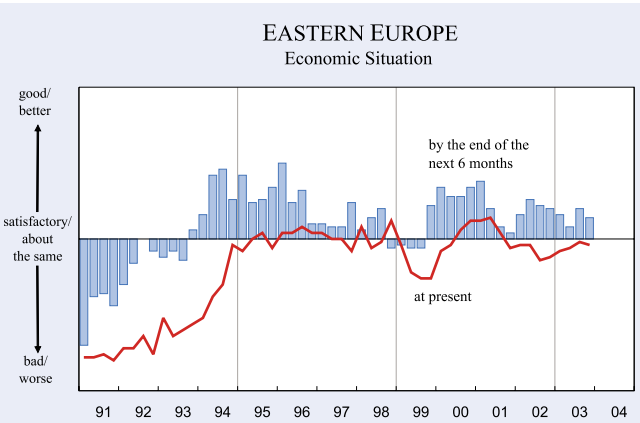

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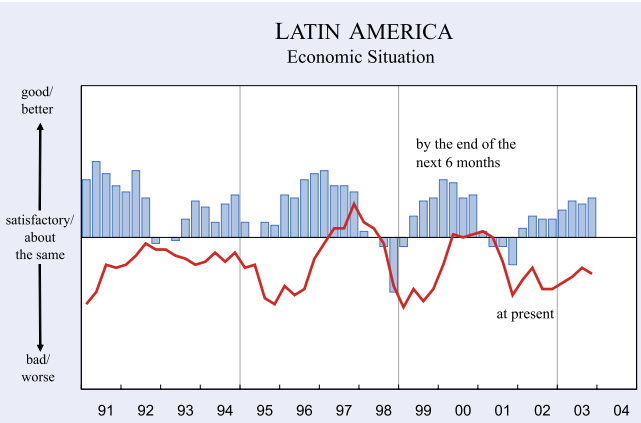
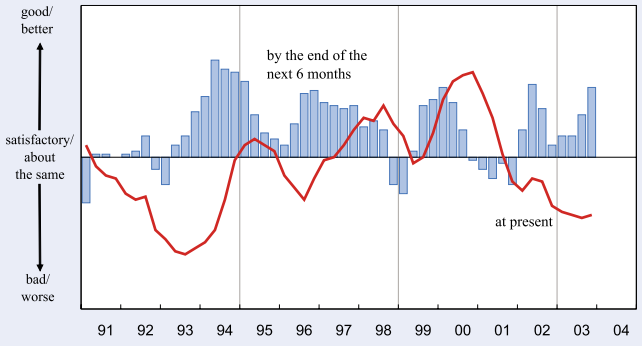


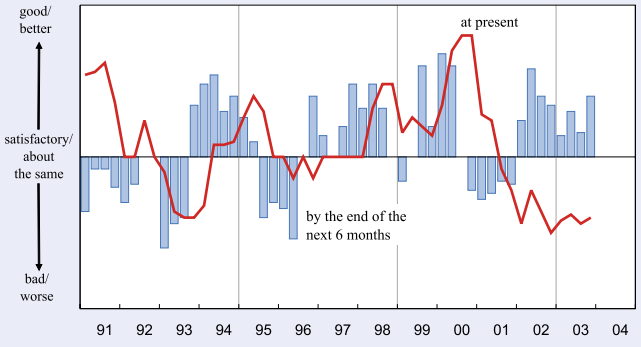
Source: Ifo World Economic Survey (WES).

EUROPEAN UNION
Economic Situation



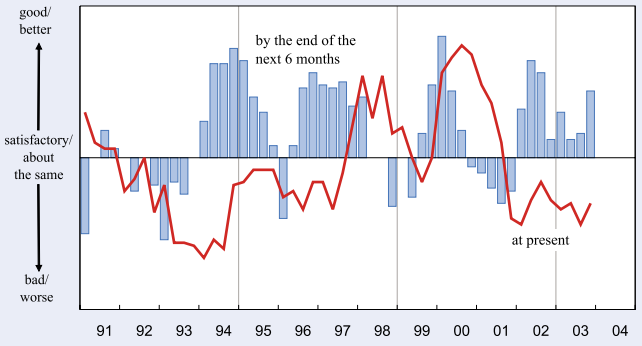
Source: Ifo World Economic Survey (WES).

AUSTRIA
Economic Situation



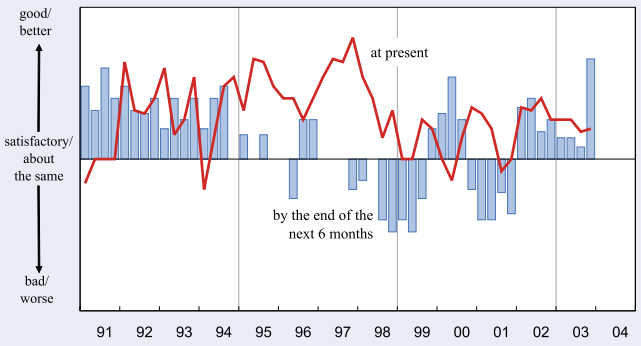
Source: Ifo World Economic Survey (WES).

BELGIUM
Economic Situation



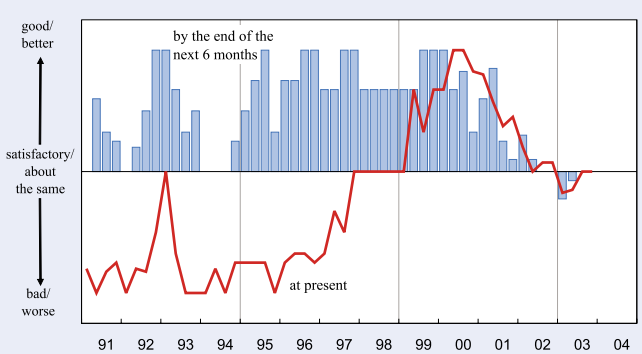
Source: Ifo World Economic Survey (WES).

DENMARK
Economic Situation



Source: Ifo World Economic Survey (WES).

GREECE
Economic Situation



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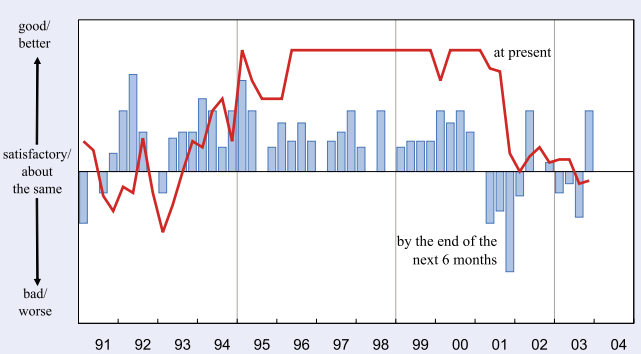
IRELAND
Economic Situation



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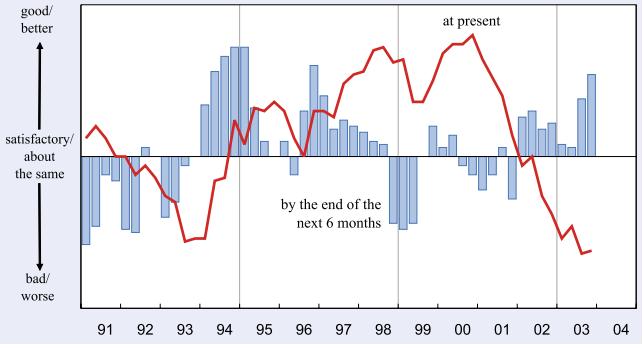
NETHERLANDS
Economic Situation



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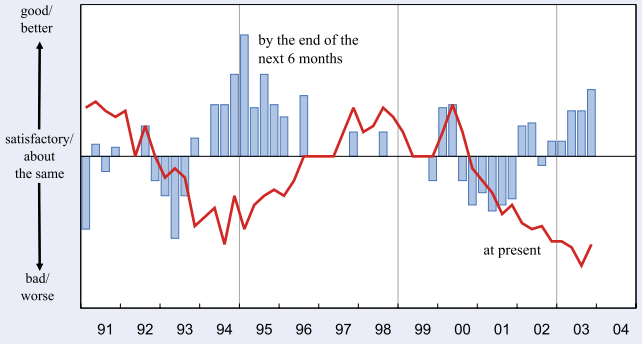
PORTUGAL
Economic Situation



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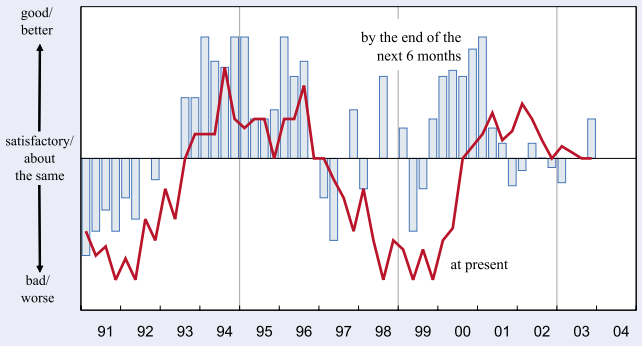
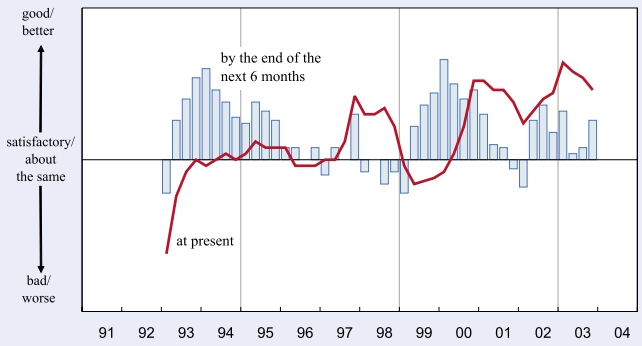
CZECH REPUBLIC
Economic Situation



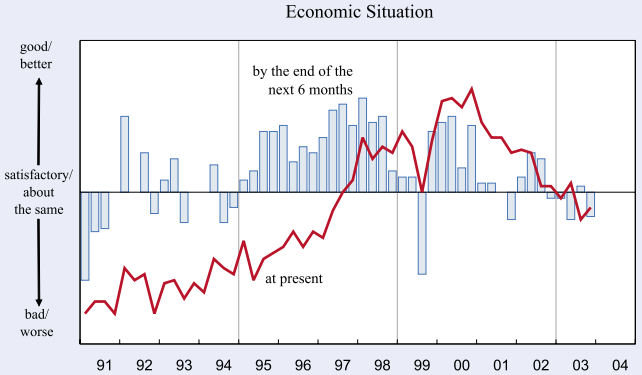
Source: Ifo World Economic Survey (WES).

ESTONIA
Economic Situation



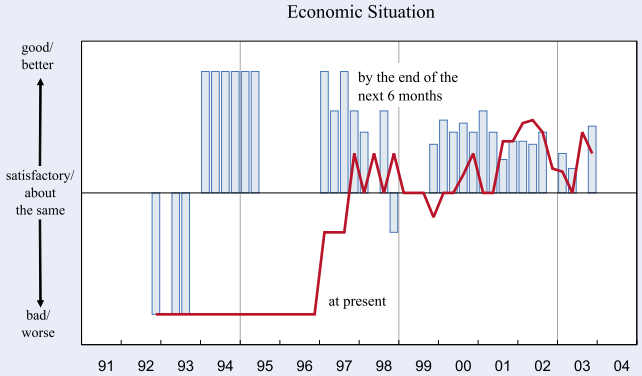
Source: Ifo World Economic Survey (WES).

HUNGARY
Economic Situation



Source: Ifo World Economic Survey (WES).

LATVIA
Economic Situation



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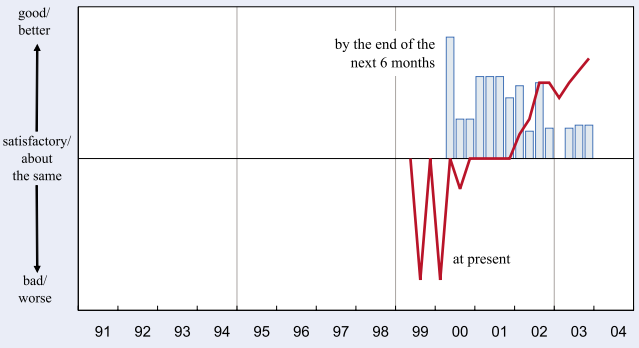
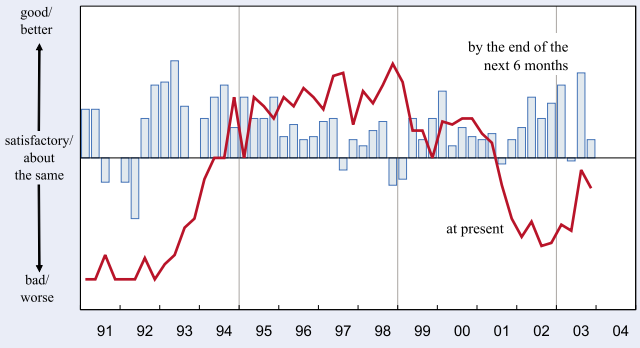
LITUANIA
Economic Situation



Source: Ifo World Economic Survey (WES).

POLAND
Economic Situation



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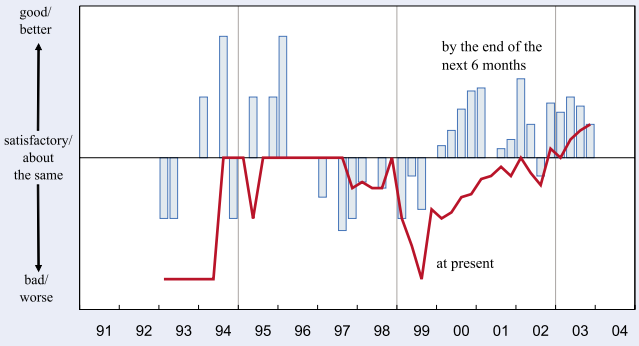
SLOVAK REPUBLIC
Economic Situation



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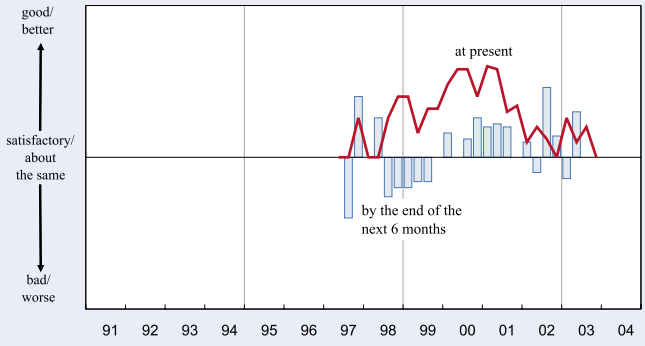
SLOVENIA
Economic Situation



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.

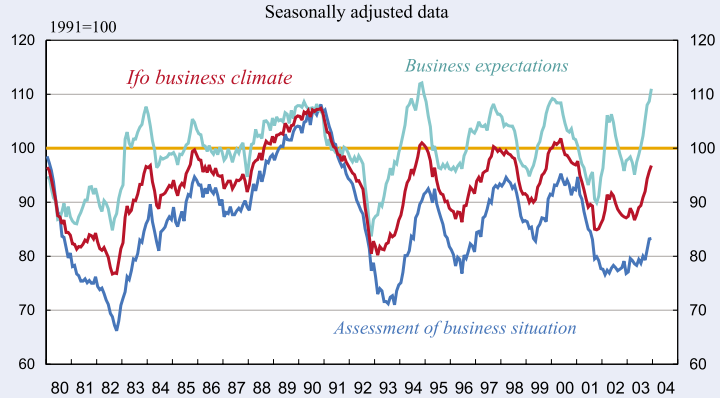
Since mid-year, the Ifo business climate indicator has improved significantly; while this was initially due to improved expectations, more recent assessments of the current situation also improved. Orders received by the manufacturing industry have risen, with the increase coming in equal parts from 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.

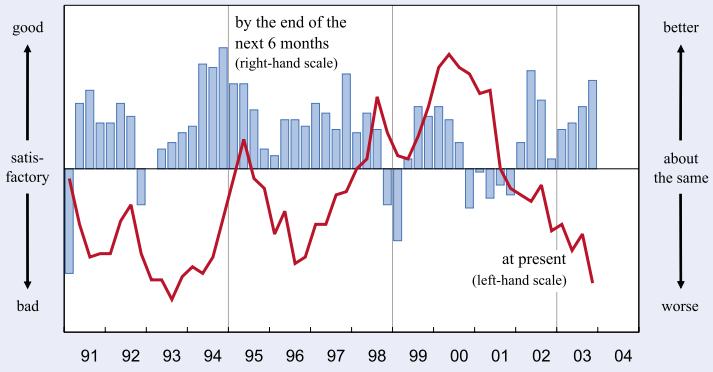
No lasting improvement of the public finances is in sight. The budget deficit increased to 4 percent of GDP in 2003. The main reason for this increase was the fact that revenues fell significantly below initial expectations while government spending continued to rise. Next year, in spite of the modest 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-

FRANCE
Economic Situation



Source: Ifo World Economic Survey (WES).

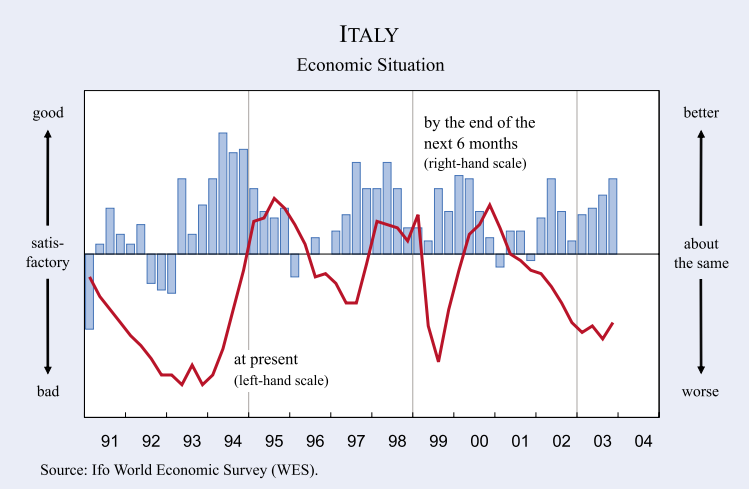
ate, mainly because of the unsatisfactory state of the labour market. Fiscal policy will be somewhat restrictive, assuming that central government expenditure remains constant in real terms. Spending in the public health sector and – despite recent reforms – on social security, remains the crucial point. The general public deficit is likely to drop from 4 1/4 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 1 3/4 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 1 3/4 percent.

Italy

Economic activity stagnated far into the last year and the pick-up was very gradual; real GDP rose by 1/2 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 8 3/4 percent. Despite an almost stagnating economy, inflation (HICP 2 3/4 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 (2¾ 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 1½ 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 1¾ 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 ½ 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 + 2½ percent) and to a slower expansion of employment. The unemployment rate will drop marginally to 8½ percent.

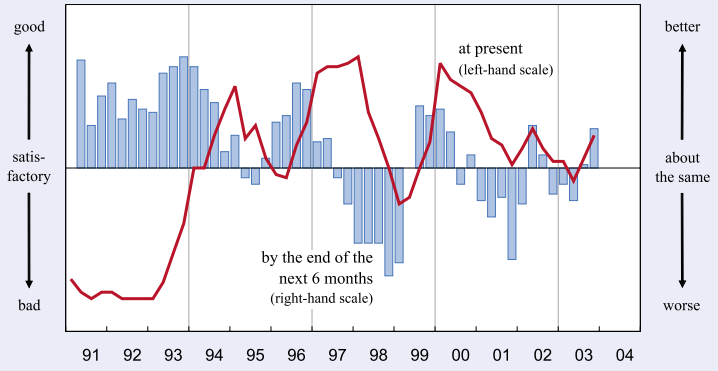
United Kingdom

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



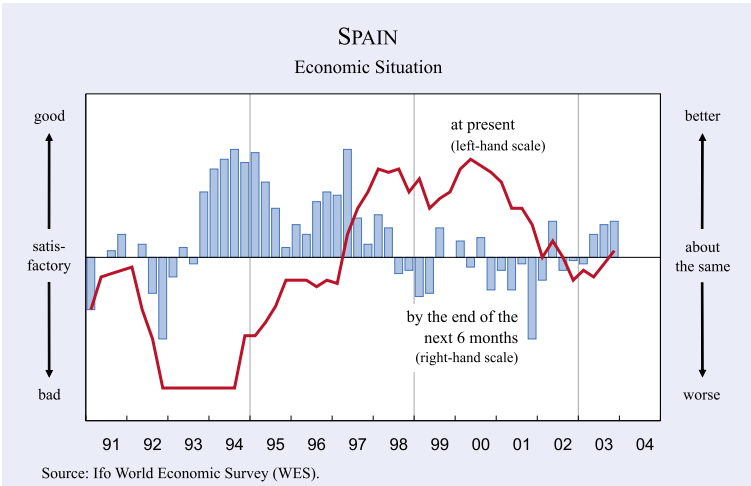
Source: Ifo World Economic Survey (WES).

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.



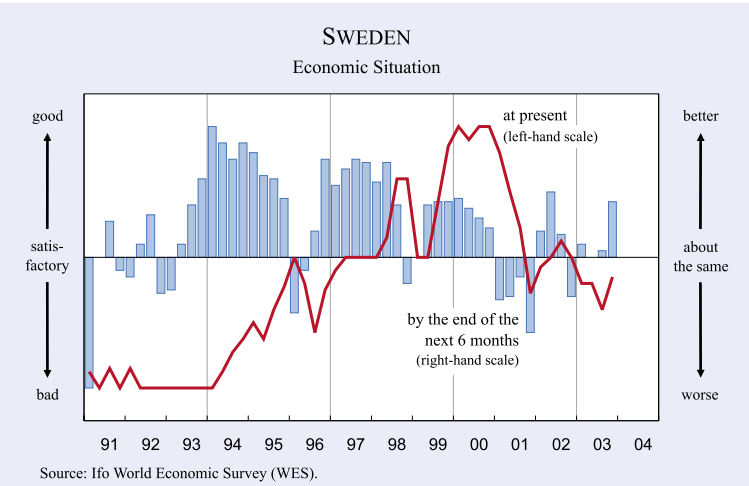
Source: Ifo World Economic Survey (WES).

Sweden

In 2003, economic growth (real GDP + 1 1/2 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 4 3/4 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 + 3/4 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 3 1/2 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 + 2 1/4 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 (5 1/2 to 6 percent), depending on how much the various labour market programmes will be expanded.



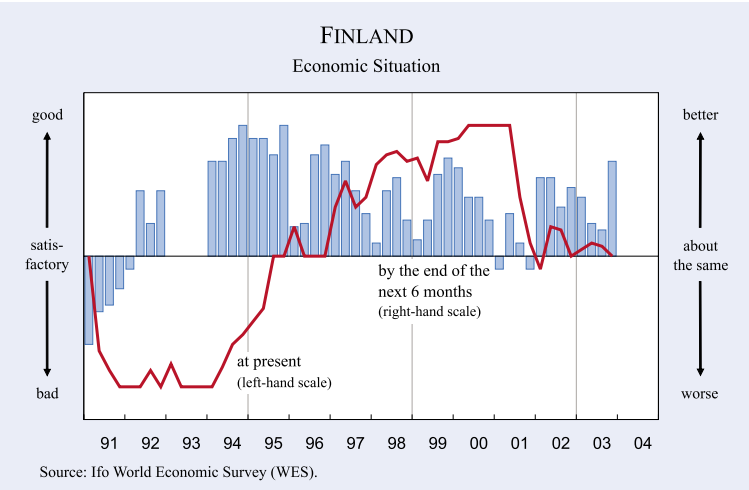
Source: Ifo World Economic Survey (WES).

Finland

After a bad start in 2003 due to external shocks, economic growth picked up thanks to recovering exports. But real GDP (+ 1 1/2 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 1 1/4 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 1 3/4 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 2 1/2 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 8 3/4 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.



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 in %			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)] in			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.

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 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). 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

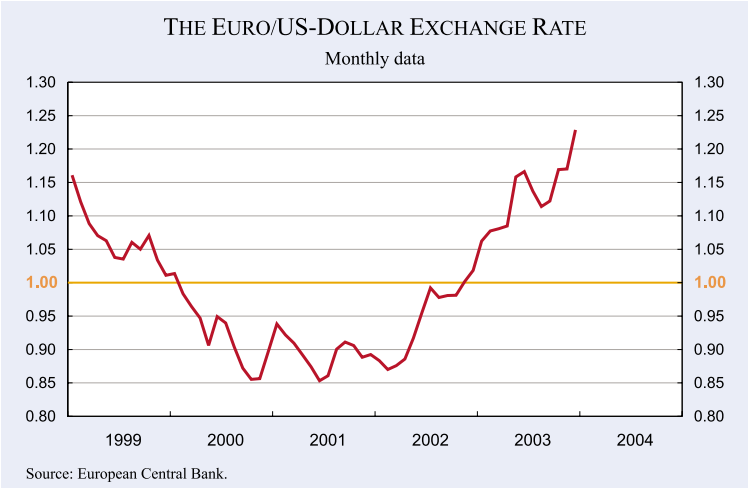
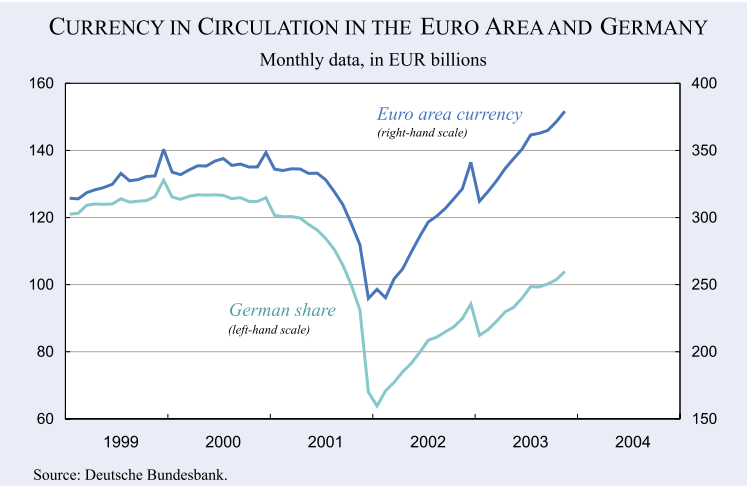


Figure 1.2



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.

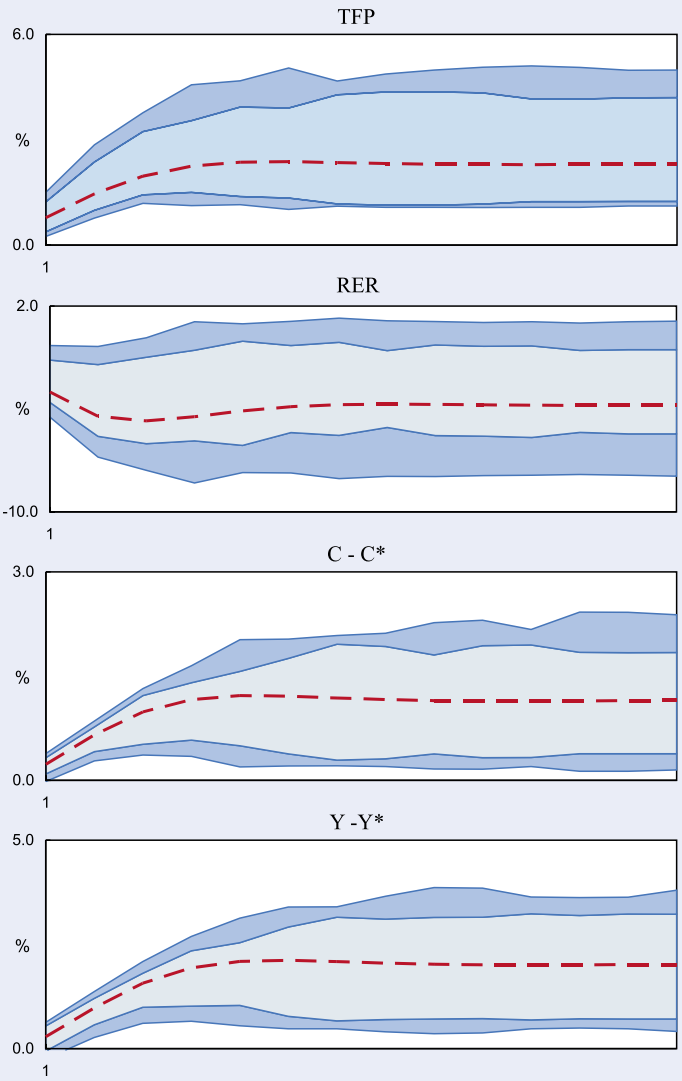
According to this figure, following a positive technology shock to manufacturing, US total consumption increased gradually, but permanently, relative to the rest of the world. Most importantly, the real exchange rate and the terms of trade strongly appreciated on impact and remained permanently stronger. 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



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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Labour Market Reform in Europe

1. Introduction

In order to solve the European unemployment problem, economists have usually advocated reforms that reduce labour market rigidities, which to increase the cost of labour: such reforms include less generous unemployment benefits, reductions in minimum wages and more flexible employment protection provisions. These recommendations are based on a cornerstone of modern economic theory: the notion of an "equilibrium rate of unemployment" to which the labour market converges in the absence of shocks, once all prices and wages have adjusted. This view holds that the equilibrium rate is entirely determined by real frictions at the microeconomic level, such as the workers' bargaining power, information and incentive problems at the firm level, the efficiency of job search, etc. While these parameters themselves depend on the above-mentioned institutions, they do not depend on short-run fiscal and monetary policies, which only have a transitory effect on employment.

However, in many countries structural reforms have typically been difficult if not impossible; they have suffered delays and have often not been designed in an optimal way from the point of view of economic efficiency. Hence, reducing the minimum wage for youths in France in 1994 encountered such violent opposition that the proposal was eventually withdrawn.

Reducing firing costs in Spain in the 1980s was only possible by liberalising the use of temporary contracts for newly hired workers, while leaving employment protection unchanged for permanent workers. This created a dual labour market, which has been much criticized for a number of reasons: the inequality it creates in working conditions between workers with identical jobs; the burden it imposes on the unemployment benefit system by increasing the inflow of eligible unemployed workers; and the potential wage inflation it has induced by creating a cushion of temporary workers who shelter permanent ones from job loss. Nevertheless, in Italy, France and Portugal, reductions in employment protection have taken the same form, and across-the-board reductions in employment protection are rarely seen.

More recently, in France, a reform of the unemployment benefit system was implemented. It was originally intended to follow the recommendations of many economists, by making sure that the payment of benefits would be conditional on the workers actively seeking a job. In order to get the benefits, the worker now has to regularly report his job search activities to the administration. However, in the process of being negotiated between employers' associations, unions and the government, the reform has been considerably watered down. Sanctions and tight monitoring have been replaced by a *bona fide* pledge of active job search on the part of the worker. Worse, as a compensation for the unions, the previous negative dependence of benefits on unemployment duration was abolished. As a result, it is far from clear that the unemployed search more actively because of the reform, especially given that monitoring rests on social workers who traditionally consider the unemployed as their customers.

Similarly, there are a number of examples of active labour market policies, which most economists consider superior substitutes for passive unemployment compensation, that are ill-designed in the sense that they fail to boost the participants' prospects for a regular job. For example, in 1997, France implemented the "emploi jeunes" programme, which directed young unemployed workers, who often had an appreciable educational background, to exclusively public jobs with a low skill content. Such a programme is unlikely to enhance the employability of participants in the medium term. Swedish labour market policies are also famous and many authors claim that they have played a key role in maintaining a low unemployment rate there. However, the huge empirical literature that has tried to evaluate them is generally cautious or negative. A recent survey by Calmfors et al. (2001), for example, concludes that

Box 2.1

The equilibrium rate of unemployment

According to standard macroeconomic theory, the unemployment rate converges to an "equilibrium rate" in the absence of structural reform. This equilibrium rate is the one which makes workers' wage-setting behaviour compatible with firms' labour demand and price-setting behaviour. The former depends on factors such as unions' bargaining power, employees´ wage aspirations and labour market institutions, such as minimum wages, unemployment benefits and employment protection. The latter depends on productivity, taxes imposed on firms, and the degree of competition among them. An increase in unemployment has a moderating effect on wages by exerting discipline on workers' wage demands, while at the same time increasing the wages that firms are able to pay. This is because at lower employment levels, everything else equal, productivity is higher, as the least productive jobs are shed first.

Therefore, if initially the unemployment rate is lower than the equilibrium rate, workers will tend to demand wages that are higher than what firms are willing to pay for labour. Firms will stop hiring and start firing, and unemployment will tend to rise until it is again equal to the equilibrium rate.

Economists usually summarise the determinants of equilibrium unemployment as in Figure 2.1 (see, for example, Nickell and Layard 1999 or Calmfors and Holmlund 2000 for a more detailed account). The WS curve shows how wage demands increase with employment. The LD curve represents the wage that firms can pay workers, which depends on technology (which determines productivity), as well as the degree of competition in product markets. For simplicity, we have only drawn the LD curve for the long run when the capital stock is adjustable, implying that the feasible wage does not depend on unemployment. In the long run, LD is horizontal, as depicted in the Figure. In the medium term, however, productivity falls when employment goes up, as it takes time for the capital stock to adjust upwards; consequently, the wage that firms are willing to pay is a declining function of employment. The medium-run LD curve (not drawn here) would be downward sloping.

The equilibrium level of unemployment is the one which makes wage aspirations compatible with the wages firms are willing to pay, that is it is determined by the intersection of the two curves.

According to the equilibrium rate theory, only structural reforms which change the long-run determinants of firms' and workers' behaviour can have a lasting effect on unemployment. A reduction in unemployment benefits, for example, reduces wage demands by lowering workers' incomes outside employment. Thus, as illustrated in Figure 2.2, the WS curve shifts down, and (once the capital stock has adjusted to the new increased profitability of the firms) equilibrium is restored at a new, lower rate of unemployment. Note that wages do not decline, because in the long run they are pinned down by the behaviour of the firms. However, they would have to fall in the short run, until enough capital is accumulated to absorb the increase in employment.

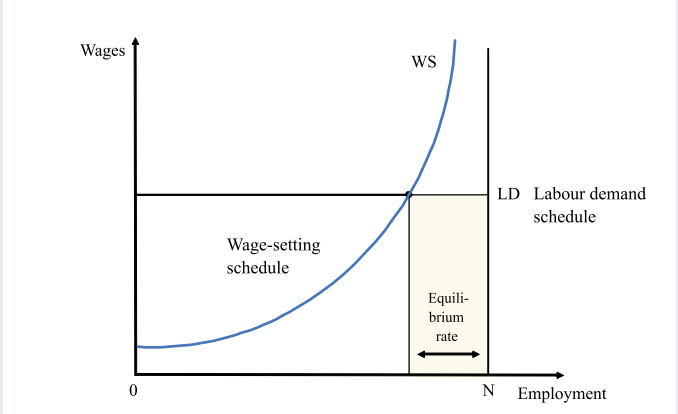
Also, everything else equal, a reform that increases the wages that firms are willing to pay at any level of unemployment (for example because productivity has risen) will reduce the equilibrium rate of unemployment. This is because less discipline needs to be imposed on workers, who can now be paid more (the LD curve shifts up in this case).

Other policies only have a transitory effect on unemployment, because they do not change the equilibrium rate. This is particularly true for fiscal and monetary policy, which stimulate the economy in the short run but not in the long run. While a macroeconomic expansion may speed recovery if unemployment is initially higher than the equilibrium rate, it would fail to reduce it permanently below the equilibrium rate. Such an attempt would simply result in greater inflationary pressure and/or mounting public debt.

This view does not commend a total consensus, though, because there are mechanisms such that the transitory effects of fiscal and monetary policy can have persistent effects by changing the equilibrium rate of unemployment in the future (the so-called "hysteresis" effect pointed out by Blanchard and Summers1986). This will happen, for example, if workers lose skills during spells of unemployment (see Pissarides 1992); a temporary contraction will then have long-lasting effects on equilibrium unemployment by reducing workers' productivity. However, most specialists agree that while these mechanisms make the effects of macroeconomic policies more persistent, they are not strong enough to affect the equilibrium rate in a distant enough future (see Layard et al. 1990).

Figure 2.1

THE EQUILIBRIUM RATE OF UNEMPLOYMENT



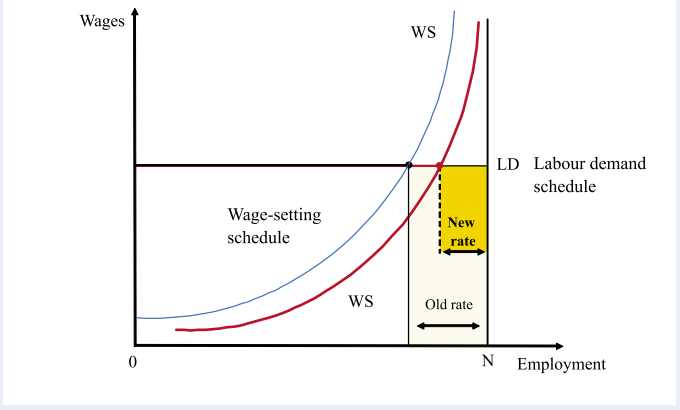
Source: EEAG.

active labour market policies in Sweden have "probably reduced open unemployment, but also reduced regular employment" and that they are not an efficient means of employment promotion when used on a large scale. Again, an important issue is that neither politicians nor bureaucrats have a strong incentive to design and manage them so as to improve the long-run efficiency of the labour market.

Finally, more systematic evidence based on synthetic indica-

Figure 2.2

EFFECTS OF STRUCTURAL REFORMS ON UNEMPLOYMENT



Source: EEAG.

tors suggests that overall, European labour markets have been substantially more rigid since the mid-1970s than before, while there was a divergence in the late 1980s and 1990s between those countries that deregulated their labour markets to some extent and apparently enjoyed some benefits in the form of lower unemployment rates, and those where rigidity continued to increase or remained high, where unemployment did not fall. The latter group includes the three largest continental European countries: Germany, France and Italy. Thus, according to Nickell (2003), relative to the 1980s, unemployment benefit replacement ratios had gone up in Austria, Finland, Italy, Norway, the Netherlands, Portugal, Sweden and Switzerland. They remained roughly constant in France, Germany and Denmark, and fell in Belgium, Ireland, Spain and the United Kingdom.

Employment protection indices have decreased in many countries, with the exception of France, but not by much, a fact that should be taken with caution, given the qualitative nature of these indices. It is also known that such a fall is mostly due to marginal liberalisations, such as more scope for using temporary contracts. In any case, employment protection in continental European countries remains much stricter than in Anglo-Saxon ones.

Finally, labour taxes remain high or have gone up in most countries. From the early 1980s to the late 1990s, the total average tax rate on labour, which is computed by adding VAT, income taxes and payroll taxes, has increased from 58 percent to 66 percent in Austria, from 46 percent to 51 percent in Belgium, from 65 percent to 68 percent in France, from 56 percent to 64 percent in Italy, and from 40 percent to 45 percent in Spain. Elsewhere in Europe, the total average tax rate has remained high and roughly constant, with four exceptions where it has fallen: Ireland (from 37 percent to 33 percent), the Netherlands (from 55 percent to 43 percent), Norway (from 65 percent to 60 percent) and the United Kingdom (from 51 percent to 44 percent).[1] Interestingly, in Ireland, the Netherlands and the United Kingdom, unemployment declined a lot during that period.

That same analysis implies that, when comparing the evolution of employment in a panel of countries and relating it to changes in labour market institutions, the traditional "neo-classical" reform strategies based on reducing labour costs do work, although it is not straightforward to disentangle which aspects are more important. The Dutch reforms, which have been successful in reducing unemployment, illustrate this point: they have been quite comprehensive[2], encompassing nation-wide agreements on wage moderation (see also Chapter 3) and reductions in firing costs, unemployment benefits and minimum wages as well as cuts in welfare spending and better monitoring of the unemployed. Therefore, while we do not know exactly what works and what does not, we are confident enough to say that comprehensive reforms do work. However, they have not been pursued, except in Anglo-Saxon and a few small countries.

The overall picture suggests that

1. Those countries that managed to reduce unemployment all liberalised their labour markets along at least some dimensions;
2. None of those who did not liberalise (France, Germany, Italy) managed to reduce unemployment.
3. Small countries have less of a hard time reforming than large ones.
4. Many policies are put into place to fight unemployment, but a lot of them are ineffective, misguided or counter-productive.

One implication of the last point is that reforms often encounter fierce political opposition, despite

[1] Source: Nickell (2003).
[2] See for example Barrell and Genre (1999).

the claim by many economists that they are worthwhile in order to reduce unemployment. Furthermore, those policies that actually are implemented in order to fight unemployment are so heavily shaped by political constraints that they are often counterproductive.

2. Political constraints faced by reformers

So, why is it that labour market reforms have been inadequate and/or rare in light of standard recommendations by economists?

2.1 Resistance by interest groups

A typical explanation is that labour market rigidities benefit powerful interest groups because they create and protect rents for their members and that these groups are likely to oppose reforms or at least to distort them so as to protect themselves (see Saint-Paul 1993, 1996 and 2000).

If the total gains from reform in terms of extra output and employment are large enough, one should in principle buy the support of workers whose rents are eliminated by the reform, by promising to transfer a share of the total gains to them. In practice, however, such a possibility rarely enters the political debate and sounds remotely abstract. This is true for a variety of reasons, from the difficulty to clearly identify the losers from a broad reform – thus generating incentives for everyone to claim being a loser – to constitutional provisions about equal treatment.

2.2 The role of ideology

Resistance by interest groups is enhanced by ideological views that question the idea that only painful structural reforms may effectively reduce the long-run unemployment rate. Indeed, many analysts and journalists dispute that notion and hold the traditional Keynesian view that a fiscal and monetary expansion could bring unemployment back to its level of the 1960s. Consequently, they ascribe Europe's high unemployment rate to macroeconomic mismanagement in the 1970s and 1980s and advocate more expansionary fiscal and monetary policies.

This is compounded by the observation that in the United States the unemployment rate, while substantially lower than in Europe, is still not negligible (some 5 percent versus 8 percent in the EU and goes up quite rapidly in recessions. Thus, one may ask what is the use of harming some of the most disadvantaged workers and risking severe social disruptions to obtain a labour market which does not look that desirable after all?

One factor that has been overlooked in the debate about European labour market reform is the role of ideologies and statements about the functioning of the economy in shaping our beliefs about what should be done. In particular, while in the United States there is a well-defined "mainstream" in economics, with other approaches still existing but being marginalised, in Europe one still typically is of the opinion that there are many competing schools that are equally worth considering. The combination of a given policymaker's preferred "school" and some emotional discourse about "helping people" may lead to erroneous policies which will not cure unemployment. However, these policies are not uniformly erroneous and often benefit some interest groups. These interest groups then have an interest in promoting the underlying "school" or ideology regardless of whether or not it is correct. Some examples may illustrate our point.

The view that all unemployment is Keynesian and there is no such thing as a long-run equilibrium rate of unemployment, or that such rate is zero or very low, implies that the bulk of unemployment would eventually be eliminated by traditional fiscal and monetary tools, and this underlines much of the short-run Keynesian stimulation policies. Instead of recognising the failure of such policies, the advocates of such ideologies argue that macroeconomic stimulus has not gone far enough. One should note that similar ideas have been vindicated within the mainstream of economics by the "hysteresis" view (see Box 2.1).

The idea that an increase in wages will help reduce unemployment because it stimulates consumption is popular among union leaders, who often advocate wage increases in order to lift the economy out of a slump. While such an effect may exist, any positive effect on employment is bound to be short-lived, while the long-term effects are likely to be negative. In the long run the logic of equilibrium unemployment prevails, and unemployment depends on whether and to which extent wage aspirations are compatible with productivity, as discussed in Box 2.1. Higher wage pressure makes it necessary for unemployment to increase in order to bring actual wages back to what productivity levels allow. In the short run, an increase in wages *may* indeed increase employment: if workers consume more than capitalists,

total aggregate demand may go up. But even that is not guaranteed: investment will fall because higher wages reduce profitability, and so will exports, as higher wages reduce the country's competitiveness vis-à-vis the rest of the world. Despite this, trade union leaders tend to overemphasize the view that higher wages promote employment, because increasing wages benefits incumbent employees, provided their jobs are protected enough, regardless of the effect on demand and employment.

The "lump-of-labour" fallacy, which states that the total amount of work is fixed and can only be shared among those who want to work, has led to many misguided policies, such as early retirement to "make room" for the young, or working time reduction. Both theory and evidence run counter to the "lump-of-labour" view. The long-run equilibrium rate of unemployment does not depend on the size of the labour force. The reason is that the size of the labour force does not affect the link between the unemployment rate and wage aspirations, nor does it affect the wages firms are willing to pay in the long run.

A reduction in the labour force decreases unemployment initially. However, this leads to more wage pressure. Higher wages then lead to fewer hirings and also less investment, as profitability goes down. That contributes to bringing employment back to the equilibrium rate, which is what happens in the long run. Thus, a 10 percent decrease in the workforce eventually leads to a 10 percent decrease in employment and an unchanged unemployment rate. Working-time reduction (WTR) is less straightforward to analyse, but there are good reasons to believe that it may lead to increases in wages per hour that offset any tendencies of the equilibrium unemployment rate to decrease. One mechanism is that a reduction in working time tends to reduce the total wage income of each employee: this creates strong incentives for unions to push up wages per hour, which will in turn reduce the total number of hours worked. Also, the tendency for total wage income to fall when working time is reduced makes work less attractive relative to non-work. That reduced attractiveness is another factor working in the direction of increasing wage pressure when working time is reduced (see, for example, Calmfors 1985 for a more detailed analysis).

As far as evidence is concerned, one may simply point out that since the mid 1980s, thanks to their flexible labour market, the United States has been able to create millions of jobs so as to absorb a large number of immigrants. And recent empirical studies of working time reductions conclude that they have had an adverse impact on employment (Hunt 1999, Crépon and Kramarz 2002). Nevertheless, we may see such policies being advocated, and even implemented, because they again benefit some groups of workers by sheltering them from competition, although this remains to be further investigated.[3]

Another ideology is the general scepticism, among many analysts and policymakers, about the allocative role of prices in general, and wages in particular. Dismissing the common sense view that less labour is demanded when its price goes up amounts to dismissing all policies that would lead to reductions in wages, or in the total cost of labour, in order to create jobs. Such a view may be supported by the difficulties one encounters when estimating such effects, especially with aggregate data: careful empirical work, however, has made a rather convincing case that increases in labour costs reduce employment (Laroque and Salanié 2000, 2002). The view that it does not, however, remains popular in some places, and again it benefits workers who are already employed and whose labour is a substitute for the jobs that would be created by such reductions in labour costs.

Finally, reforms may also be blocked by "analytical myopia": the general public tends to be more confident about the *direct* effects of policies than about their *indirect* ones, which shapes beliefs in a way rarely friendly to employment-enhancing reforms.[4] Thus, the direct effect of a reduction in the minimum wage is to reduce the income of minimum wage earners; subsequent job creation only comes later. The direct effect of reducing employment protection is that some workers will lose their jobs; the benefits in terms of job creation come later and hinge on the firms' rational calculations taking into account the reduced cost of having to dismiss a worker in the future. Reductions in the generosity of unemployment benefits impose "hardship" on the unemployed, but their beneficial effects on employment involve the complex process of wage bargaining and so on.

2.3 Labour market reform under political constraints: what does it look like?

Following the preceding discussion, one may even ask why governments would want to implement a

[3] See Marimon and Zilibotti (2000), for a model where "insiders" may prefer to take welfare gains in the form of reduced working time rather than higher wages.
[4] See Gersbach and Schniewind (2001) for an analysis.

reform of the labour market at all. Most of the pressure for implementing structural labour market reforms comes from employers, who want lower labour costs and more freedom in managing the workforce, and from the financial unsustainability of the welfare system when unemployment gets too high. The actual policy being followed results from a complex game where these factors interact with the objectives of unions and representatives of incumbent workers to protect their rents and with the government's need to satisfy its electorate while demonstrating its competence. This process results in a number of outcomes, none of which is fully satisfactory from the point of view of economic efficiency. The political economy approach to designing labour market reforms helps to understand the characteristics of the economic environment and of reform design that make reform more likely to be politically viable. Saint-Paul (2000) has discussed how it may be rational for groups that would otherwise block labour market deregulation to actually support structural reforms if properly designed. Such rational design sometimes resembles reforms that are actually undertaken. For example:

- Political support for reform is more likely in times of "crisis" when incumbent employees are more exposed to the risk of job loss. Indeed, Saint-Paul (1996) has found that most reduction in employment protection provisions have taken place at times of rising unemployment.
- Reform is more viable if it is designed in a two-tier fashion, leaving existing provisions unchanged for incumbent workers, but applying new rules to labour contracts signed after the reform.
- Reform is more viable if there is a lag between the date it is decided and the date it is implemented. This increases the probability that a voter who is in the group of losers at the time of the decision (say, employed in a high-wage, protected job) may have moved to a group that is benefiting from the reform at the time it is implemented (say, employed in a precarious job, or unemployed).

In other words, postponing reform induces people to vote as if under a veil of ignorance, taking into account the interests of groups to which they do not belong, because they might belong to them at the time reform is implemented. However, other policies may be difficult to rationalize and be driven by short-termism or concerns about politicians' public image. In any case, none of the approaches undertaken so far are fully satisfactory; and, after almost 30 years of high unemployment, we are seeing their limits.

3. Some reform strategies: advantages, draw-backs, and political problems

The preceding discussion highlights the difficulty, but not the impossibility, of implementing "orthodox" labour market reforms. Thus it is natural to analyse alternative ways of reducing unemployment, that might perhaps be less effective but would encounter less political opposition.

3.1 Trying alternatives to labour market reforms

Product market liberalisation

On paper, and this may sound surprising to people who are not professional economists, deregulating product markets may have positive employment effects almost as large as labour market deregulation. This is because the equilibrium rate of unemployment is the one which makes workers' wage aspirations compatible with the wages that firms are willing to pay, which in turn depend on productivity and on the degree of competition among firms.

By increasing productivity and competition among firms, product market deregulation increases the wages that firms can pay to workers, thus allowing for a "tighter" labour market, that is lower unemployment, according to the mechanisms described in Box 2.1.

Furthermore, product market liberalisation may have positive side-effects on wage formation, which yields extra dividends in terms of job creation. As discussed by, for example, Blanchard and Philippon (2003), greater competition in product markets reduces the monopoly rents that are appropriable by workers and makes labour demand more sensitive to wages, since it is more difficult for firms to pass higher wages on to their customers in the form of higher prices. This tends to impose greater discipline on workers in their wage demands, thus building in wage moderation and leading to additional reductions in the equilibrium rate of unemployment.

One may thus conclude that instead of deregulating the labour market, which faces fierce opposition, one may achieve equivalent results by deregulating the product market. The experience of the Scandinavian

Box 2.2

Sweden's deregulation in the 1990s

Sweden is one of the countries that went farthest during the 1990s in deregulating their product markets, substantially increasing competition and the number of companies in a number of sectors. In particular:

- The number of companies owned by the state declined by more than 50 percent. Employment in state-owned enterprises also declined.
- Privately managed social services have grown substantially.
- The public monopoly on telecommunications was abolished, and the market opened to international players. The market share of the former state monopoly has been falling rapidly.
- Similarly, the state monopoly on postal services was abolished.
- Airlines have been deregulated to an extent similar to other EU countries.
- Private operators have been allowed in railways.
- Electric power has also been deregulated to a large extent, with the standard outcome of a state-owned monopoly for operating the network and a number of competing suppliers.

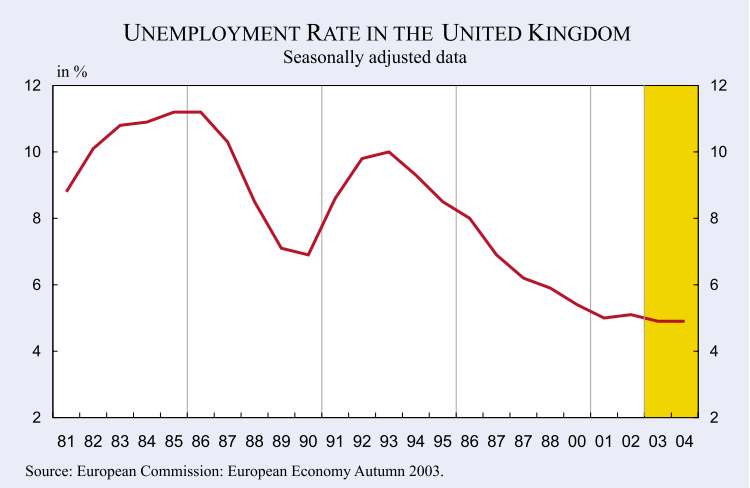
Source: CEEP, 2000.

Box 2.3

Lags in the effects of British labour market reforms

In the United Kingdom, major reforms took place in the 1980s, in particular reductions in the power of trade unions (which are discussed in greater detail in Chapter 3), and in the generosity of unemployment benefits. As described by Blanchflower and Freeman (1993), these reforms have been broad: "industrial relations laws that weakened union power; measures to enhance self-employment; privatisation of government-run or owned businesses; reduction in the value of unemployment benefits and other social receipts relative to wages; new training initiatives; tax breaks to increase use of private pensions; lower marginal taxes on individuals; and elimination of wage councils that set minimum wages." However, it took a long time for theses changes to translate into durable reductions in equilibrium unemployment. As Figure 2.3 suggests, unemployment was still around 10 percent in 1994.

Figure 2.3



Source: European Commission: European Economy Autumn 2003.

countries suggests that this could be partly true: in Sweden, for example, product market deregulation was quite aggressive in the 1990s (see Box 2.2), and during that period, unemployment fell quite rapidly after the large increase at the beginning of the decade. However, we do not believe such a conclusion to be warranted. First, one can also observe political opposition to deregulation from the employees of regulated firms. Second, it is not totally clear whether the effects on employment are large enough, especially given that only a fraction of the economy is affected by deregulation and privatisation. Even if a large fraction is regulated, each sector has its specific regulations, and it takes time to change all of them.

Keynesian policies

A number of continental European countries have resorted to short-run Keynesian economic stimulus rather than structural reform. As we argued in Box 2.1, such policies cannot have long-lasting effects on unemployment. Indeed, while public debt increased in France in the 1990s, the unemployment rate has typically remained at 9 percent, while in the United States, which pursued structural reforms in the 1980s, it has fallen to about 5 percent, in accordance with the equilibrium rate theory. If they do not work, why do governments pursue such policies? Because they work well over the short-run, and the electoral cycle imposes a short horizon on politicians; and because their costs are diffuse and remote in the future, while structural reforms are politically painful, as discussed above. Furthermore, as the UK experience suggests (Box 2.3), the gains from structural reforms only show up after several years, a decade in the case of that country, which is beyond a government's electoral horizon. Finally, it is also true that such policies benefit from uncertainties about the "true model" of the economy, which leaves room for ideology, as discussed below.

We do not want to imply that such policies should be abandoned altogether. They can be quite efficient, since unemployment can be above the equilibrium rate for fairly long periods as a result of a recession

or a fall in the equilibrium rate. This is illustrated by the Fed's policy in the 1990s: the Fed deliberately allowed unemployment to stay below the earlier estimated equilibrium rate, an estimate which proved *ex post* to have been too high. However, when one observes high and persistent unemployment for a decade or more, that is a sign that the equilibrium rate is itself high, and Keynesian policies are bound to fail.

Active labour market policies

Active labour market policies have been popular in many countries as a tool to reduce unemployment. They are appealing to politicians because one has a sense of directly tackling the problem by acting upon the unemployed individuals. They also directly impact on unemployment statistics for sheer accounting reasons. Finally, in a world where social insurance is provided to the unemployed, relief jobs or training periods seem a more productive way of using the unemployed workers' time and monitoring them than passive compensation. However, things may go wrong with active labour market policies, which may explain why they are so costly. Specifically, economic analysis shows that they can reduce the equilibrium rate of unemployment if they increase the search intensity of the long-term unemployed. However, it is precisely that sort of competitive pressure that unions and dominant interest groups want to combat when they resist orthodox reforms. If they have a say in the design of active labour market policies, they may well have an interest in designing them so as to prevent active search of a regular private sector job by programme participants (Saint-Paul 1998). A telling example is the above-mentioned French "emploi jeunes" programme, which was a programme of relief jobs aimed essentially at young workers who just finished their studies, consisting exclusively of jobs in public administrations or non-profit businesses. Clearly, this removes a good deal of competition for private sector jobs.

Such perverse incentives may explain why active labour market policy has failed to reduce unemployment in some countries, despite its substantial costs.

3.2 Eliminating inefficiencies in the welfare system

Another approach is to try to eliminate inefficiencies in the welfare system without questioning its basic construct. In principle, that opens the door for changes that are not radical, but would face little opposition as most workers would benefit.

Simplifying employment protection legislation

One case in point is employment protection. In most countries, especially southern European ones, it is extremely difficult to shed labour without offering workers high compensation for dismissal. The reason is that most of the costs are in the form of highly uncertain legal procedures, which have even led, in some cases, to some layoffs being reversed years later, jeopardizing the firm's financial soundness and the job stability of all current employees. The existence of these legal procedures often lead to generous settlements, but this is by no means systematic, and such an outcome depends on the outcome of bargaining between firms and workers.

Such a costly and inequitable system is in part due to misunderstandings about the role of employment protection. Employment termination is a normal component of a market economy, just like any other contract termination, and should not be criminalized. In addition, promoting an employment protection policy on the ground that it will reduce unemployment is misguided. The implied reduction in job destructions is offset by a reduction in job creation, and countries with the lowest unemployment rates (the United States and the United Kingdom) have little job protection. The role of employment protection legislation should be to give the right incentives to firms and to compensate workers for the cost of job loss. In that respect, we advocate the elimination of the current system of legal procedures in many countries, especially the southern European ones, and its replacement by a simple "firing tax" which would be paid to the worker as severance payment.

Monitoring the search activity of the unemployed

In principle, monitoring the search activity of the unemployed and imposing sanctions on them in the form of reduced benefits if search is not active enough may be a productive way to reconcile a high degree of social insurance with an efficient labour market. And this philosophy seems to work well in both Sweden and the Netherlands, which have achieved low unemployment rates. However, the recent French experience with a reform called PARE (Plan d'Aide au Retour à l'Emploi) highlights a number of difficulties with this approach. In particular, there is an agency problem in that the social workers in charge of moni-

toring the unemployed may well treat them, rather than the taxpayers, as their customers, and fail to report misdemeanour. In the French case, as compensation for the supposed monitoring of the unemployed, the duration and level of benefits was increased. If the monitoring turns out to exist only on paper, the reform will have been counterproductive.

In-work benefits

Replacing means-tested welfare payments to the poor by in-work benefits such as earned-income tax credits or the French "prime à l'emploi" is also a non-controversial proposal on which a large majority of economists would agree. Indeed, this (as proposed in the 2002 EEAG report) is likely to have sizeable effects on employment by increasing work incentives. It is not clear to us whether or not there should be a smaller constituency to oppose such policies, relative to, say, reductions in employment protection or the extent of collective bargaining. After all, in all cases, competition between outsiders and insiders is enhanced. However, in-work benefits surely are less vulnerable to opposition based on cognitive issues than those discussed in Section 2.2. It seems harder, for example, to argue that they would "reduce demand"; and their impact effects are more favourable than for the traditional prescriptions, so that they are less vulnerable to "analytical myopia".

3.3 Establishing convergence of interests between insiders and outsiders

Finally, one may enhance the viability of labour market reforms by increasing convergence of interests between the incumbent, protected employees, who do not profit from many reforms and the unemployed or the firms who gain from many reforms. This can be built into the design of a specific reform, or one may develop institutions (such as stock ownership) that are not *per se* a labour market reforms but may help enhance their viability in the future.

Two-tier systems

Some continental European countries have also adopted the two-tier reform strategy, as outlined above. This has been especially true with respect to reducing employment protection legislation, which in Spain, but also in France, Italy and Portugal has taken the form of a liberalisation of the use of temporary contracts. This strategy has come under much criticism for various reasons. It has been accused of maintaining a dual labour market, with haves and have-nots, thus fuelling social tensions. Another argument has been that, by allowing firms to use temporary workers as a buffer against labour demand fluctuations, the strategy has increased the protection of permanent workers, thus creating excess wage pressure and eventually reducing employment (Bentolila and Dolado 1994). Finally, by increasing turnover and at the same time the fraction of workers who are eligible for unemployment benefits, the two-tier strategy has put pressure on the financing of the unemployment insurance system. In our view, these criticisms are exaggerated, to say the least, because no other way of increasing labour market flexibility in continental Europe has been found. The idea that a two-tier system of employment protection leads to a segregated labour market, for example, is overstated. There is substantial mobility from temporary to permanent contracts, and firms value temporary contracts as a way to test the quality of newly hired workers. Furthermore, the two-tier system has generated political dynamics that are favourable for reform. In Spain, for example, the government has been able to trade reductions in the employment protection provisions associated with permanent contracts against further restrictions in the use of temporary contracts.

Profit sharing

The political economy approach suggests that the virtues of policies such as profit sharing or the promotion of stock ownership have been underestimated. These policies generated a lot of interest in the 1980s, following work by Martin Weitzman (1984), who argued that profit sharing enhances a country's macroeconomic stability over the business cycle. Profit sharing also creates convergence between the interests of workers and those of capitalists by making each worker a little bit of a capitalist. Our discussion in Section 2 implies that such schemes would make policies of wage moderation, which boost profitability and job creation, more acceptable to incumbent workers. Profit sharing should therefore be seen as a way of reducing the rate of equilibrium unemployment.

4. The current situation: An opportunity for reform?

The preceding discussion implies that the margin of manoeuvre for governments to combat unemployment with institutional reforms is typically quite nar-

row. However, past experiences like that of the United Kingdom (or, to a lesser extent, that of Spain in the 1980s) suggest that in situations perceived as a "crisis", one can be substantially more ambitious. To some extent, such a point has been reached in a number of European countries, not so much because of overall macroeconomic performance (the current slowdown is milder than the previous one), but because of budgetary problems and the feeling that "globalisation" is making the burden of labour rigidities unbearable.

For one thing, paradoxically, the very efforts made by governments to combat unemployment tend to make it a bigger problem. Beyond their sheer psychological effect of making them a political test, these efforts tend to increase social spending per unemployed worker, making unemployment more of a financial problem. Hence, active labour market policies in France and Sweden represent considerable spending per recipient and, in the former case, have failed to bring unemployment back to its level of the 1960s. In the case of Sweden, the efficiency of the large-scale measures undertaken has been questioned (Calmfors et al. 2001). Similarly, when high persistent unemployment is erroneously fought using fiscal and monetary policies, this leads to excess deficits and/or inflation, which in the end create the need for more drastic structural reforms.

Second, financial problems in other areas, such as pensions and health care, which are even more sensitive, make it more valuable to increase employment. The recent drive for labour market reforms in Germany comes from a more general crisis of the welfare state and a recognition that the commitments of the government are unsustainable. Labour market rigidities can be tackled because it is clear that the alternative is reducing benefits that are more valuable than these rigidities, such as pensions or health insurance benefits.

Thus, Germany has recently started an ambitious and comprehensive reform package called "Agenda 2010". It is too early at this stage to assess whether it is going to be implemented fully or only partly. But it includes a number of measures that are described in Box 2.4.

The programme does little to reduce the rents of incumbent employees, as predicted by the political economy approach. For example, as will be discussed in more detail in Chapter 3, the reforms do not encompass the system of pay bargaining. On the other hand, the programme is more ambitious about reducing unemployment benefits and tightening eligibility requirements as well as enhancing measures to bring the long-term unemployed back to work. These measures are clearly more likely to be acceptable to incumbent employees than changes in the pay-setting system, which might reduce their rents. Furthermore, the design of the reforms confirms to some extent the principles discussed above in that there is a sense in which they affect marginal, non-core groups of workers more than others (reducing unemployment benefit duration for elderly people exerts less downward pressure on wages than reducing it for core workers, as the elderly unemployed compete less intensively with insiders). Their political viability is also enhanced by some delay in implementation (for example, the gradual phasing out of the previous system of non-contributory benefits avoids political opposition from those whose benefits would otherwise immediately fall, leading more workers to consider the reform under some "veil of ignorance"). However, similar changes have been opposed or neutralized by unions in other circumstances. The German example is therefore illustrative of how a severe crisis enhances reform possibilities.

Third, changes in the international economic environment may increase the cost of labour market rigidities. Increased openness to international markets makes producers more sensitive to increases in labour costs. A greater pace of technical progress increases the need for labour turnover and penalizes those societies that impose a tax on turnover in the form of employment protection provisions. New technologies may increase the demand for skilled workers and reduce the demand for unskilled workers, thus reducing the real wages and/or employment of the latter. These arguments illustrate how a feeling of urgency helps to implement reforms that are otherwise politically doomed. In other words, crises and severe recessions are more conducive to reform than booms. This is somewhat unfortunate and paradoxical, as most economists tend to agree that the adverse effects of reforms on job destruction are more bearable in booms. However, the record suggests that political incentives to implement structural reforms in booms are quite weak. This is probably because governments' popularity surges in booms and they do not want to jeopardize it with risky reforms.

Box 2.4

Labour Market Reform in Germany

In the course of 2003, a first round of reforms of German labour market policy became effective that had been enacted in December 2002 (see EEAG, 2003, box on p. 31). Further amendments of labour market regulation were passed in the summer of 2003. In December 2003, decisions were taken regarding a second round of reforms, following intense negotiations between the two houses of parliament in which the *Bundesrat* opposition took an active role in pushing through more stringent measures than those planned by the Federal government. Core elements of recent changes are as follows.

Unemployment benefits: The time limit for entitlement to unemployment insurance benefits (*Arbeitslosengeld*) for workers aged 55 and over will now be reduced from 32 to 18 months, while the standard limit of 12 months for other beneficiaries is left unchanged. The dual system of non-contributory benefits with unlimited duration – unemployment assistance (*Arbeitslosenhilfe*) and social assistance (*Sozialhilfe*) – is now integrated in one comprehensive scheme (*Arbeitslosengeld II*) that is basically modelled on the less generous scheme of the former social assistance. However, those whose contributory benefits have expired will be moved only gradually, over a period of two years in each individual case, to the lower level of benefits. Also, incentives to take up a new job are still limited by high transfer rates (that even exceed 100 per cent over a certain range of incomes in the case of family households). On the other hand, job offers now have to be accepted without any binding minimum level of wages, thus creating some leeway for expanding the low-wage sector, which might now offer job opportunities for the large number of unemployed people with low skills.

Job Centres: Building on the 2002 reform, all kinds of services for individuals seeking employment (administration of benefits, counselling, job placement) are to be provided in Job Centres operated by the Federal Employment Services and act as "one-stop" agencies. In the future, Job Centres will also be responsible for job seekers who are currently on social assistance. Alternatively, municipalities, some of which have been rather successful in the past in re-integrating this particular sub-group of individuals in the labour market, can opt for becoming responsible for all the long-term unemployed (12 months or longer, *i.e.*, living on *Arbeitslosengeld II*). In any case, municipalities are still responsible for welfare recipients who are not classified as being job seekers. As the new assignment of responsibilities has some inconsistencies and as the administrative changes associated with the introduction of Job Centres are still under way, it is as yet unclear whether the discontinuities involved in the re-organisation will harm the attempts to fight long-term unemployment.

Protection against dismissal: Up until now, the strict rules regarding protection against dismissal that are in place in Germany are applicable to all firms with five or more employees. This threshold is now raised to ten or more employees, while the rules themselves remain unchanged. In addition, only new employees in firms that stay within the "5-to-10 employees" category will no longer be subject to these rules. As the existence of this threshold is usually considered an obstacle to further expansion of small-sized enterprises, extending it could lead to some job growth in firms that end up employing less than 10 individuals.

The 2002 reform package was primarily meant to have an impact on the way public employment services are operated. Specifically, rules regarding active job search and availability of work for those receiving unemployment benefits were tightened. So far, the major effect appears to be that, over the year, unemployment growth related to the business cycle was lower than expected because some registered as unemployed decided to withdraw from the labour force rather than re-enter the labour market, while others were channelled into new "non-standard" forms of employment (in particular, a subsidised form of self-employment for individuals formerly unemployed or employment with non-profit temp work agencies). Apart from a surge in so-called "mini jobs" (with less than 400 Euro of monthly pay, effectively a domain of second earners or individuals seeking a second source of income, not of people otherwise unemployed), employment continued to decrease over the year of 2003. Measures taken in the new 2003 package are potentially much more important for moving the unemployed back into work. Yet, when compared to a number of proposals made by leading German economists (see for instance, German Council of Economic Experts, 2002, No. 472–476, Joint Forecast of the Economic Research Institutes, Fall 2003, pp. 38–40, or Sinn et al. 2003), the changes introduced so far may still be insufficient to substantially reduce the current level of structural unemployment.

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Pay-setting Systems in Europe: On-going Developments and Possible Reforms

During the last twenty years, Western Europe has been characterised by both high unemployment and low growth as compared to the United States. However, in the last decade, experiences have been diverse among European countries. Several smaller countries have managed to reduce unemployment substantially, whereas the large EU countries (France, Germany, Italy and Spain) have been less successful (see Chapters 1 and 2). As discussed at length in last year's EEAG report (EEAG 2003), Germany is the EU country that has suffered the worst stagnation.

Macroeconomic performance is intimately associated with the functioning of pay setting. It influences output and employment in a number of ways:

- Aggregate real wage moderation, as was achieved in, for example, the Netherlands in the 1980s and the first half of the 1990s, is a precondition for high equilibrium levels of output and employment, that is for high average output and employment over the business cycle.
- Aggregate wage flexibility contributes to output and employment stabilisation in the case of macroeconomic shocks. Such flexibility has become even more important than before with the common currency, as changes in relative wage costs represent the only way of changing real exchange rates among countries in the euro area.
- Relative-wage flexibility is required to reduce labour market imbalances at sectoral, occupational, and regional levels that otherwise raise equilibrium unemployment. Vivid illustrations of the importance of this factor are provided by eastern Germany and southern Italy, where a compression of the wage differentials to the other parts of the countries is a major cause of high unemployment.
- Pay differentials according to skills determine the returns to investment in education and training and thus the pace of human capital accumulation, which is a fundamental determinant of the rate of long-run growth.
- The extent to which pay is linked to individual or group performance at the level of the enterprise and the workplace has an important influence on labour productivity.

As discussed in Chapter 2, pay setting and macroeconomic performance are affected by a number of basic "institutional" factors: the generosity of unemployment insurance, the scope and design of active labour market policy, the degree of employment protection, the extent of competition in product markets, and tax levels (see also Nickell and Layard 1999 and Calmfors and Holmlund 2000). The way pay bargaining is conducted is also a fundamental determinant of macroeconomic performance. This chapter assesses the on-going developments of pay-setting systems in the European countries, including the new EU member states, and gives recommendations on appropriate reforms.

The chapter is structured in the following way. Section 1 reviews the present pay-setting practices in the European countries. Section 2 analyses the advantages and disadvantages of various systems. Section 3 discusses possible future developments. Section 4 offers some normative conclusions as to what pay-setting systems to strive for.

1. A review of pay-setting systems in Europe

The most striking observation on pay-setting systems in Europe is probably their diversity and the number of country-specific features. There is no such thing as a uniform European model of wage setting. Still most countries show many similarities. To characterise pay setting, we focus below on two key aspects. The first is the importance of collective bargaining and trade unions. The second aspect concerns the level at which collective bargaining occurs (the degree of centralisation) and the extent of co-ordination among various bargaining units.

1.1 Unionisation and the coverage of collective agreements

A key common feature in most western European countries is the importance of collective agreements. As shown in Table 3.1, collective agreements cover over 60 percent of all employees in most of the current EU countries, and in some of them (Austria, Belgium, Denmark, Finland, France, the Netherlands, Spain, and Sweden) coverage is even above 75 percent. In most cases, coverage is higher in the total economy than in the market sector. This reflects the fact that collective agreements usually cover a larger fraction of the labour force in the public than in the private sector.

The coverage rates of collective agreements are much more similar among the current EU countries than unionisation rates. The latter vary from only 10 to 15 percent in France and Spain to 70 to 90 percent in Belgium and the Scandinavian countries. The similarity of coverage rates, despite the large differences in union density, can be explained by various extension mechanisms: in some countries employers choose voluntarily to extend collective agreements to all employees. In others they are legally required to do so. Most present EU countries – though not the Scandinavian ones – also have legal provisions for extending sectoral collective agreements to non-unionised firms in the sector (Ebbinghaus and Visser 2000; Calmfors et al. 2001).

Table 3.1

Coverage of collective agreements and unionisation[a)]

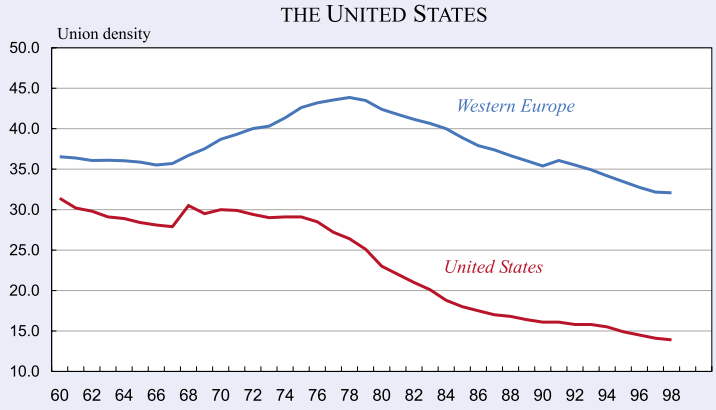
	Total economy (2001)		Market sector (mid 1990s)	
Country	Coverage	Unionisation	Coverage	Unionisation
Old EU member states				
Austria	98	40	97	34
Belgium	100	69	82	44
Denmark	85	88	52	68
Finland	90	79	67	65
France	90	9	75	< 4
Germany	67	30	80	25
Greece		32		
Ireland				43
Italy		35		36
Luxemburg	60	50		
Netherlands	78	27	79	19
Portugal	62	30	80	< 20
Spain	81	15	67	< 15
Sweden	94	79	72	77
UK[b)]	36	29	35	19
New EU member states				
Cyprus	65-70	70		
Czech Republic	25-30	30		
Estonia	29	15		
Hungary	34	20		
Latvia	< 20	30		
Lithuania	10-15	15		
Malta	60-70	65		
Poland	40	15		
Slovakia	48	40		
Slovenia	100	41		
Other countries				
Australia	22 (23)[c)]	23		
Canada	32	30[g)]		
Japan	21	22[h)]	21	24
New Zealand	45[d)]	22		
Norway	70-77[e)]	55[h)]	62	44
Switzerland	53[f)]	23[h)]	50	22
US	15	14[h)]	13	10

Notes: [a)] Coverage refers to the percentage of employees covered by collective agreements and unionisation to the percentage of employees with union membership; [b)] Figures do not include Northern Ireland; [c)] The parenthesis refers to the coverage of wage awards (see Section 1.1) and to 2000; [d)] 1997; [e)] 2000–01; [f)] 1994; [g)] 2000; [h)] 1996–98.

Sources: *Industrial Relations in the EU Member States and Candidate Countries* (2002) for the total economy and Ebbinghaus and Visser (2000) for the market sector in most cases. The sources for the total-economy coverage data are *Aus-tralian Workplace* (2003) for Australia, http://www.gov.nf.ca/labour/unionization_rates (2002) for Canada, *Industrial Rela-tions in the EU, Japan and the US* (2002) for Japan and the US, Bray and Walsh (1998) for New Zealand, http://www.eiro.eurofound.ie/2002/12/study/tn0212102s for Norway, and Ochel (2001) for Switzerland. The sources for total-economy unionisation data are Ebbinghaus and Visser (2000) for Japan, Norway, and the US, OECD for Canada and Switzerland, and ERA (2003) for New Zealand. Differences among countries should be taken only as broadly indicative, as data are not always exactly comparable.

The main outlier in Western Europe in terms of coverage of collective agreements is the United Kingdom, where the overall coverage rate in 2001 was estimated at 36 percent. This reflects a process where coverage has fallen pari passu with unionisation over the last twenty years. According to Brown et al. (2000), around half of all employees and around 2/3 of employees in the private sector now have their wages set unilaterally by employers in the United Kingdom. The development in New Zealand, and also in Australia, has been similar to that in the United Kingdom: both coverage of collective agreements and unionisation have fallen dramatically, although the development in these countries occurred mainly in the 1990s. For New Zealand, Bray and Walsh (1998) reported that in the mid-1990s around 50 percent of all employment contracts were between an individual employee and an employer. The developments in the United King-

Figure 3.1



Note: Union density (union membership relative to employment) for Western Europe is a weighted average of Austria, Belgium, Denmark, Finland, France, western Germany, Ireland, Italy, the Netherlands, Norway, Sweden, Switzerland and the United Kingdom.

Source: Ebbinghaus and Visser (2000).

dom, New Zealand and Australia imply that the industrial relations systems there have approached the US system. In most Western European countries, except the United Kingdom, coverage rates have remained quite stable, even though there have been significant reductions in unionisation rates in most of them over the last two decades (the exceptions are the Scandinavian countries and Belgium; see Ebbinghaus and Visser 2000, Calmfors et al. 2001, and Ochel 2001). A summary picture of these reductions is given in Figure 3.1, which shows how average union density in Western Europe declined from 44 percent in 1979 to 32 percent in 1998.

It is evident from Table 3.1 that the new EU member states are very different from the present ones in terms of both coverage of collective agreements and unionisation. With the exception of Slovenia (with almost 100 percent coverage), Cyprus and Malta, coverage is much lower than in Western Europe. Unionisation rates are also very low in some of the new member states. In Estonia, Lithuania, Poland and Hungary union density is around 20 percent or lower. This reflects to a large extent the difficulties of the old trade unions in these countries, which did not play a wage-bargaining role under communism, to adapt and obtain legitimacy with employees as well as the difficulties of building up new unions (Flanagan 1998).

1.2 Bargaining levels

Table 3.2 gives a summary picture of how collective bargaining is conducted in different countries. Again there are large differences among countries, to a large extent along the same lines as the differences in the coverage of collective agreements. In the present EU countries, the most important bargaining level is usually the sectoral one. This applies to Austria, Denmark, Germany, Greece, Italy, the Netherlands, Portugal, Spain and Sweden. In several of these countries (primarily Austria, Denmark, Germany and Sweden), there is a strong element of pattern bargaining, with the engineering sector usually acting as a wage leader, setting the pace for the whole economy.

The standard situation in the present EU member states is one of multi-level (or at least two-tier) collective bargaining, where multi-employer bargaining at the sectoral level is complemented to a smaller or larger extent by bargaining at the enterprise level on the implementation of the sectoral agreements. The general trend over the last twenty years has been that the scope for local bargaining has increased (Traxler et al. 2001; Calmfors et al. 2001; Traxler 2003). This picture is confirmed by the development of various measures of bargaining co-ordination that seek to measure the importance of the different bargaining levels (see also Section 2.1). According to Visser (2000), co-ordination decreased from the mid-1970s to the mid-1990s in ten out of thirteen EU countries examined.[1] A similar picture is given by Ochel (2000), who found that co-ordination decreased in eight out of thirteen EU countries between 1975–79 and 1995–99.[2]

However, the only current EU country where single-employer bargaining at the local level has become completely dominating is the United Kingdom, where multi-employer bargaining at the sectoral level has almost ceased to exist (Brown et al. 2000; Nickell and

[1] The ten countries are Austria, Belgium, Denmark, Finland, France, Germany, Italy, Spain, Sweden and the United Kingdom. According to Visser, co-ordination increased in Ireland, the Netherlands and Portugal. Outside the EU, co-ordination was found to have decreased in Switzerland but to have remained stable in Norway.

[2] Concerning the EU countries, the difference between Visser and Ochel is that the latter found bargaining co-ordination to have decreased in Portugal, increased in Finland and Italy and remained unchanged in Germany. As to countries outside the EU, Ochel reports a decrease in co-ordination in Australia, Canada, New Zealand, Norway and Switzerland and unchanged co-ordination in Japan and the United States.

Table 3.2

Bargaining levels

Country	National guidelines	Inter-sectoral level	Sectoral level	Enterprise level
Old EU member states				
Austria	Pattern bargaining		XXX	X
Belgium	Centrally agreed guidelines for wage increases with the government 2003–04	XXX	X	X
Denmark	Pattern bargaining	XX	XX	X
Finland	Tripartite national pay agreement 2003–04	XXX	XX	X
France			X	XX
Germany	Pattern bargaining		XXX	X
Greece	National general collective agreement 2002–03	XX	XXX	X
Ireland	Tripartite national pay agreement 2003–04	XXX	X	X
Italy	Social pacts with government 1993 and 1998 setting guidelines for the wage-bargaining process		XX	X
Luxemburg			XX	XX
Netherlands	Centrally agreed ceiling for wage increases with government 2003; tripartite national wage freeze 2004–05	XX	XXX	X
Portugal			XXX	X
Spain	Centrally agreed guidelines for wage increases 2003	XX	XXX	X
Sweden	Intersectoral agreements setting guidelines for the wage-bargaining process; pattern bargaining		XXX	XX
UK			X	XXX
New EU member states				
Cyprus			XXX	X
Czech Republic	Tripartite national agreements on minimum wages		X	XXX
Estonia	Tripartite national agreements on minimum wages		X	XXX
Hungary	National guidelines for wage increases agreed with government and tripartite national agreements on minimum wages	X	XX	XXX
Latvia	Tripartite national agreements on minimum wages	X	X	XXX
Lithuania			X	XXX
Malta				XXX
Poland	National guidelines for wage increases agreed with government and tripartite national agreements on minimum wages		X	XXX
Slovakia	Tripartite national agreements on minimum wages		XX	X
Slovenia	Tripartite national pay bargains	XXX	XX	X
Other countries				
Australia	National wage awards for minimum wages	X	XX	XXX
Japan	Pattern bargaining			XXX
New Zealand			X	XXX
Norway	Pattern bargaining; tripartite agreement on guidelines for wage increases 2003	XX	XXX	X
Switzerland			X	XX
US				XXX

Notes: XXX = dominating level
XX = important, but not dominating, level
X = existing level

Sources: *Industrial Relations in the EU Member States and Candidate Countries (2002), Collective Bargaining Coverage and Extension Procedures* (2002), individual Eiroline country reports. For New Zealand: Bray and Walsh (1998).

Quintini 2002). Again, similar developments have occurred in New Zealand and Australia, where the earlier systems of letting government tribunals determine sector, and occupation-based national wage awards were replaced in the 1990s by a system of basically single-employer bargaining (Honeybone 1997; Bray and Walsh 1998). France is also a country where the enterprise is the most important bargaining level (in recent years stimulated by government financial incentives for firms to conclude local collective agreements on working time reductions), although bargaining at the enterprise level coexists with bargaining at the sectoral level (Jefferys 2000; Dufour 2003; Eironline France 2003).

The enterprise is the dominating bargaining level in most of the new EU member states (the Czech Republic, Estonia, Hungary, Malta, Poland, Latvia and Lithuania). The sectoral level is dominating in Cyprus and of substantial importance in the Slovak Republic and Slovenia. One important explanation of the limited role of sectoral bargaining in the former communist countries is that it has proved difficult to organise employers' associations in a situation of rapid structural change, where many old (state) firms have been closed down or privatised and many new firms have been started (Flanagan 1998).

Perhaps somewhat surprisingly, the trend towards greater importance of the local bargaining level has in many of the current EU countries occurred at the same time as there have been *social pacts* between the peak-level labour market organisations, some-

times also involving the government as a third actor, setting national norms for pay increases to be negotiated at the sectoral level. Indeed, such agreements became more frequent in the pre-EMU period in the 1990s as a means to promote real wage restraint without resorting to inflation and exchange rate depreciations. Such income policies have also been used frequently in some EMU countries after 1999 as a means to restrain wage increases.[3] Table 3.2 also gives an overview of the extent to which such attempts at co-ordination of wage increases have been made recently.

The most comprehensive central agreements in force are probably those in Finland and Ireland, where the peak-level labour market organisations agreed low wage increases with the government for 2003–04 in exchange for tax cuts (Finland) or other changes in government policies (Ireland). Tripartite bargaining has also taken place in the Netherlands. For 2003, the peak-level labour market organisations agreed on a ceiling for wage increases in exchange for cuts in taxes and social insurance contributions (Eironline Netherlands 2002) and for 2004–05 they accepted a pay freeze in exchange for a government commitment to refrain from reductions of certain expenditures. Another recent example of tripartite bargaining is Belgium, where a central "indicative norm" on wage increases was negotiated for 2003–04, at the same time as the government undertook to implement certain employment measures.[4] National central agreements on wage increases have also been negotiated between peak-level employer organisations and union confederations in Greece and Spain. Italy and Sweden provide examples of weaker co-ordination efforts, where earlier social accords (Italy) or inter-sectoral agreements (Sweden) established guiding principles for wage setting and bargaining procedures.[5] Germany provides an exception to the pattern described, as the attempts there of achieving co-ordinated wage restraint through social pacts (Bündnis für Arbeit) have been largely unsuccessful.

Social pacts have also played a much smaller role in the new EU countries than in the old ones. Slovenia is the only new member country where tripartite national pay bargains have a dominating influence, whereas national guidelines agreed centrally with the government play some role in Hungary and Poland. In the other ex-socialist countries joining the EU, tripartite bargaining at the national level applies only to minimum wages.

2. Advantages and disadvantages of various pay-setting systems

There is a large literature on the advantages and disadvantages of various pay-setting systems. This literature has emphasised the effects on:

- the aggregate (equilibrium) wage and employment levels
- the flexibility of the aggregate wage level
- relative wages and wage dispersion
- incentives for effort and productivity

2.1 The aggregate wage and employment levels

Much of the literature on pay-setting systems has focused on the determination of the aggregate wage level. This literature has usually tried to distinguish between, on the one hand, the effects of collective bargaining and unionisation *per se,* and, on the other hand, the effects of different degrees of co-ordination/centralisation of the collective bargaining that takes place.

Theoretical modelling of trade union behaviour usually assumes that unions strive for real wages that trade off the benefits of a wage increase for employed members against the income (and utility) loss of those members who may become unemployed because of the wage rise. The bargaining process between unions and employers is modelled as providing a negotiated wage that balances unions' wage objectives against employers' interests in high profits (see, for example, Nickell and Layard 1999 or Calmfors and Holmlund 2000). A well-known argument based on such an analytical framework is that a high degree of co-ordination of collective wage bargaining (which may come about either because

[3] See, for example, Crouch (2000a, b), Calmfors et al. (2001), and Calmfors (2001) for more detailed discussions.
[4] The Competition Act of 1996 stipulates formally that wage bargaining must be based on a pay norm set by the Central Economic Council (an advisory body to the government) according to which wages should not rise any faster than in Belgium's three main neighbouring countries (France, German and the Netherlands) (Calmfors et al. 2001; Eironline Belgium 2003).
[5] In Italy, social accords of 1993 and 1998 established a two-tier wage-bargaining process, according to which wage increases at the sectoral level should be linked to forecast inflation, whereas bargaining at the enterprise level should be based on productivity increases (Baccaro et al. 2002; Bertola and Garibaldi 2003). In Sweden, an agreement between a number of industry unions and employers' associations in 1997 (the Industrial Agreement) has sought to establish a bargaining framework conducive to industrial peace and wage moderation with the aim of strengthening the role of the manufacturing sector as wage leader (Elvander 1999). Similar agreements on the bargaining framework have later been concluded in the public sector.

bargaining is formally conducted at a high level, such as the national one, or because separate bargaining units co-ordinate their actions at that level) promotes real wage restraint because it allows negative externalities of high wage levels for individual bargaining areas to be internalised. Wage setters will take into account that high wages for one group may have a negative impact on other groups. This could occur for several reasons (Calmfors, 1993):

- because the aggregate consumer price level is pushed up;
- because the prices of inputs to other production sectors are increased;
- because high wages in one sector cause job losses there that reduce employment opportunities for everyone in the economy;
- because such job losses raise costs of unemployment benefits and reduce the tax base; or
- because high wages for one group can give rise to pure envy effects.

For these reasons, one should expect collective bargaining at the sectoral level to result in higher real wage levels, and thus also higher unemployment, than co-ordinated multi-sector bargaining, as negative externalities will be internalised to a lesser extent. This hypothesis receives strong empirical support from attempts to relate unemployment differences among countries to differences in labour-market institutions, as is illustrated in Table 3.3 (see also Calmfors et al. 2001 and Calmfors 2001).[6]

It has been more difficult to show in time series wage equations for individual countries that periods with highly co-ordinated collective bargaining have been associated with wage moderation (see, for example, Hartog 1999 on the Netherlands or Walsh 2002 on Ireland), although Koskela and Uusitalo (2003) – after controlling for other factors – report significantly lower wage increases in Finland in years with centralised wage agreements than in years when the main locus of bargaining has been the sectoral level.

It is less clear, both theoretically and empirically, how decentralised single-employer collective bargaining at the enterprise level compares with multi-employer bargaining at the sectoral level. If various degrees of internalisation of negative externalities were the whole story, then enterprise-level bargaining would imply an even higher aggregate wage level than sector-level bargaining, since the degree of

[6] Some of the earlier studies in the table exploit only cross-section variation among countries, but later studies use panel data, thus exploiting also time-series variation.

Table 3.3
Unemployment rates under various bargaining regimes (ceteris–paribus differences to decentralised systems) in various studies[a)]

A: Studies finding a hump-shaped relationship between bargaining co-ordination and unemployment

	Study	Intermediate co-ordination	High co-ordination	Measure of bargaining structure[b)]
1	Zetterberg (1995)[c)]	2.6	- 1.5	Centralisation
2	Bleaney (1996)[d)]	3.5	- 2.1	Centralisation/ co-ordination
3	Scarpetta (1996)[e)]	0.9	- 12.0	Centralisation
4	Elmeskov et al. (1998)[f)]	1.3	- 2.4	Centralisation
5	Elmeskov et al. (1998)[g)]	1.2	- 4.4	Centralisation/ co-ordination
6	Elmeskov et al. (1998)[h)]	6.9	- 4.6	Co-ordination
7	Cukierman & Lippi (1999)[i)]	5.8	3.2	Centralisation
8	Daveri & Tabellini (2000)[j)]	5.8	- 7.2	Geographical[k)]
9	Nicoletti *et al.* (2001)[l)]	3.6	- 2.2	Centralisation/ co-ordination
	Average	**3.5**	**- 3.9**	

B: Studies finding a monotonic relationship between bargaining co-ordination and unemployment

	Study	Intermediate co-ordination	High co-ordination	Measure of bargaining structure[b)]
1	Layard et al. (1991)	- 4.7	- 10.4	Co-ordination
2	Zetterberg (1995)[m)]	- 0.4	- 2.4	Centralisation
3	Scarpetta (1996)[n)]	- 6.2	- 12.3	Co-ordination
4	Bleaney (1996)[o)]	- 2.0	- 3.9	Co-ordination
5	Elmeskov et al. (1998)[p)]	- 0.8	- 5.7	Co-ordination
6	Hall & Franzese (1998)[q)]	- 2.6	- 5.1	Co-ordination
7	Iversen (1998)[r)]	- 3.3	- 4.1	Centralisation
8	Nickell & Layard (1999)[s)]	- 4.6	- 6.0	Co-ordination
9	Blanchard & Wolfers (2000)[t)]	- 4.4	- 8.9	Centralisation
10	Belot & van Ours (2001)[u)]	- 2.6 (0)	- 5.2 (0)	Co-ordination
11	Belot & van Ours (2001)[v)]	- 1.9	- 1.9	Co-ordination
12	Nickell et al. (2003)[x)]	- 7.2	- 14.4	Co-ordination
	Average	**- 3.4**	**- 6.7**	

Notes:
[a] The table shows how the unemployment rates under intermediate and high co-ordination/centralisation differ from that under decentralisation/low co-ordination when other factors are controlled for. High co-ordination can be interpreted as bargaining/co-ordination at the national level, intermediate co-ordination as bargaining/co-ordination at the sectoral level and low co-ordination/decentralisation as uncoordinated bargaining at the enterprise level.
[b] Measures of centralisation capture the level at which actual bargaining takes place. Measures of co-ordination try to capture informal co-ordination among formally independent bargaining units as well.
[c] Equation (5) in Table 4.14. We have classified the countries ranked 1–3 and 7–9 as centralised, the countries ranked 13–17 as intermediately centralised and the countries ranked 4–6 and 10–12 as decentralised.
[d] Equation (4) in Table 5. Bleaney distinguishes between highly centralised systems, highly decentralised systems, moderately centralised systems with a high degree of corporatism and moderately centralised systems with a low degree of corporatism. In the table, the last two categories have been amalgamated to one.
[e] Equation (8) in Table 1. The entry for intermediate centralisation refers to the country ranked 14 and the entry for co-ordination to the country ranked 1. The comparison is with the country ranked 17.
[f] Equation (2) in Table 2.
[g] Equation (4) in Table 2.
[h] Equation (4) in Table 4. In the equation, taxes and bargaining co-ordination are interacted. The effects are evaluated at the average tax ratio for the sample period 1983–95.
[i] Equation 4.5 in Table 4.2. In the regression, centralisation is interacted with central bank independence. The effect in the table is evaluated at the sample average for the central bank independence variable. At high levels of central bank independence the hump-shaped relationship between centralisation and unemployment turns into a positive (!) monotonic one (that is with higher centralisation being associated with higher unemployment).
[j] Equation (5) in Table 9. In the equation, taxes and bargaining co-ordination are interacted. The effects are evaluated at the average tax ratio for 1983–95.
[k] This study associates the Scandinavian countries with high co-ordination, the European continental countries with intermediate co-ordination, and the Anglo-Saxon countries with low co-ordination/decentralisation.
[l] The dependent variable is non-employment and not unemployment. The study has not been included when computing the averages.
[m] Equation (3) in Table 4.14. The countries ranked 1–5 are classified as highly co-ordinated, the countries ranked 6–10 as intermediately co-ordinated, and the countries ranked 11–17 as uncoordinated/decentralised.
[n] Equation (2) in Table 1.
[o] Equation (1) in Table 5.
[p] Equation (1) in Table 2.
[q] Decade equation in Table 2. Countries have been assigned co-ordination values from 0 (lowest co-ordination) to 1 (highest co-ordination). In our calculation, high co-ordination is 0.875, intermediate co-ordination is 0.5, and low co-ordination 0.125. In the regression the co-ordination variable is interacted with a central bank independence variable ranging from 0 to 1. In the calculation in the table the central bank independence variable has been assigned the value 0.5.
[r] Full model in Table 2. High co-ordination refers to the average score for the three countries with the highest co-ordination, low co-ordination to the three countries with the lowest co-ordination, and intermediate co-ordination to the halfway distance between the two groups. In the regression the co-ordination variable is interacted with a central bank independence variable ranging from 0 to 1. In the calculation in the table the central bank independence variable has been assigned the value 0.5. Note that the monotonic relationship does not hold at high degrees of central bank independence. Then the relationship is instead u-shaped.
[s] The equation explains the log of the unemployment rate. In the calculation of the effect on the unemployment rate, it has been assumed that unemployment under decentralisation is equal to the average rate of unemployment among the countries studied during the estimation period.
[t] Equation (1) in Table 1. In the equation, macroeconomic shocks and bargaining co-ordination are interacted. The entries show the differences in the increase of unemployment between the 1960–65 period and the post-1995 period.
[u] Equation (1) in Table 3a. The equation has been estimated without fixed country and time effects. With such effects, there are no significant unemployment differences among various bargaining regimes as indicated by the zeros in the parentheses.
[v] Equation (2) in Table 3b. This equation interacts various labour market institutions with each other (for example employment protection and co-ordination as well as union density and co-ordination). The effects in the table are evaluated at the average values of employment protection and union density in 1960–94. The equation has been estimated with fixed country and time effects.
[x] Equation (1) in Table 5. This equation interacts various institutional variables with each other (for example union density and co-ordination as well as the employment tax rate and co-ordination); the effects in the table are evaluated at the average sample values of union density and tax rates. The effects in the table are steady-state effects.

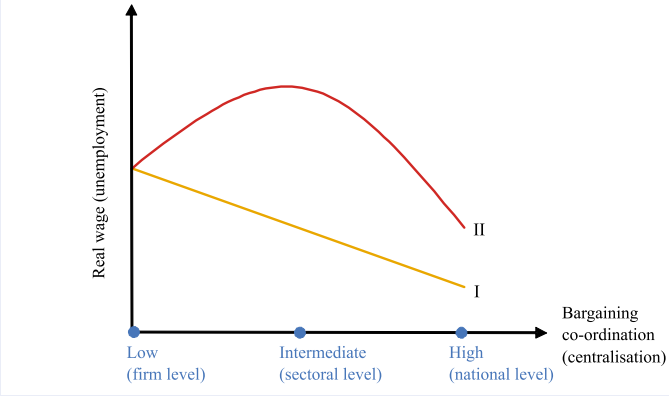
Source: Calculations by the EEAG.

internalisation is lower. In this case there is thus a monotonic negative relationship between, on the one hand, the degree of co-ordination and, on the other hand, the real wage and unemployment (curve I in Figure 3.2). But enterprise-level bargaining may also have a wage-restraining effect because it increases competitive pressures to restrain wages. These pressures may be weak in sectoral bargaining, since all domestic competitors in a sector are then exposed to similar wage increases, which makes it easy to shift them on to prices. If the competition effect due to loss of market power outweighs the reduction in the internalisation of negative externalities, enterprise bargaining leads to lower wage levels than sectoral bargaining. In that case, there is a hump-shaped relationship between, on the one hand, the degree of co-ordination of collective bargaining and, on the other hand, the levels of real wages and unemployment (curve II in Figure 3.2).[7] The height of the hump depends on the extent of competition from abroad. Because sectoral bargaining only reduces competitive pressures from other domestic producers, the hump will be less pronounced the larger is the degree of competition from abroad (Danthine and Hunt 1994; Calmfors et al. 2001).

[7] This hypothesis was originally formulated by Calmfors and Driffill (1988). Note that the hump-shaped relationship presupposes that the degree of bargaining co-ordination is changed along the dimension firm-sector-nation. Changes in the degree of co-ordination along the dimension of various types of labour would have other effects. For example, decentralising collective bargaining so that different types of labour in each firm negotiate separately would raise the aggregate wage level if a wage increase for one group reduces labour demand for other groups (that is, if the various types of labour are complements in labour demand), since this negative externality cannot then be taken into account.

Figure 3.2

THE RELATIONSHIP BETWEEN BARGAINING CO-ORDINATION (CENTRALISATION) OF COLLETIVE BARGAINING AND THE REAL WAGE (UNEMPLOYMENT)



The empirical research on the determination of aggregate unemployment in Table 3.3 does not give a clear verdict on how collective bargaining at the enterprise level compares with sectoral bargaining. Almost half the studies indicate that decentralisation to the enterprise level results in lower unemployment than sectoral bargaining, whereas the other half gives the reverse result. As can be seen, there is a tendency in the studies to find more support for the hump-shape hypothesis with "centralisation measures", focusing on the actual level of bargaining, than with "co-ordination measures", attempting to capture also informal co-ordination among separate bargaining units. But the studies finding a hump-shaped relationship also agree that bargaining under high centralisation/co-ordination (at the multi-sector or national level) is associated with lower unemployment than bargaining under decentralisation/low co-ordination (at the enterprise level).

There is, however, a consensus in the empirical literature that less importance of collective bargaining and unions *per se* – given the degree of co-ordination of the collective bargaining that takes place – is associated with lower wages or factors likely to be correlated with lower wages. Table 3.4 reports estimates of the effects on unemployment from cross-section and panel data sets of countries. There is also a large body of microeconomic evidence indicating that higher unionisation and coverage of collective agreements lead to higher wages and lower profitability of firms (see, for example, Addison and Hirsch 1989, Belman et al. 1997, Kleiner 2001 or Askildsen and Nilsen 2002). This is, of course, to be expected, since the main raison d'être of trade unions is to push up wages and various employee benefits above the levels that would otherwise prevail.

An important conclusion is that the chances that decentralisation of collective bargaining is associated with wage restraint increase if such a development is associated with a reduction in unionisation and the coverage of collective agreements. This is all the more so, as there is some evidence that low unionisation has a larger unemployment-reducing effect under decentralised bargaining than under intermediate or high centralisation/co-ordination: for example, Belot and van Ours (2001) find that

Table 3.4
Unemployment rates under various rates of union density and coverage of collective agreements (*ceteris– paribus* differences to 15% union density or coverage) in different studies[a)]

	Study	45%	75%	Explanatory variable
1	Layard et al. (1991)	2.5	4.9	Coverage
2	Scarpetta (1996)[b)]	1.8	3.6	Union density
3	Elmeskov *et al.* (1998)	0	0	Union density
4	Hall & Franzese (1998)	0	0	Union density
5	Iversen (1998)	0	0	Union density
6	Nickell & Layard (1999)[c)]	2.8	6.5	Coverage
		3.7	9.0	Union density
		6.5[d)]	15.5[d)]	Total
7	Nickell & Layard (1999)[e)]	2.4	4.8	Union density
8	Nicoletti et al. (2001)[e)]	2.1	4.2	Union density
9	Belot & van Ours (2001)[f)]	1.8 (0)	3.6 (0)	Union density
10	Belot & van Ours (2001)[g)]	4.7	9.4	Union density
11	Nickell et al. (2003)[h)]	0 (2.1)	0 (4.2)	Union density

Notes:
[a)] The table shows how much higher the unemployment rate is at 45% and 75% density or coverage rates compared to 15% density or coverage rates when other factors are controlled for.
[b)] Equation (2) in Table 2.
[c)] The equation explains the log of the unemployment rate. In the calculation of the effect on the unemployment rate, we have assumed that unemployment at 15% density and coverage rates is equal to the average rate of unemployment among the countries studied during the estimation period.
[d)] The sum of coverage/density effects.
[e)] The dependent variable is non-employment and not unemployment.
[f)] See footnote (u) to Table 3.
[g)] Equation (2) in Table 3B. The equation interacts various labour market institutions with each other (for example union density and co-ordination). The entries in the table refer to the effects of changes in union density under decentralisation. At higher levels of co-ordination there are no significant effects.
[h)] Equation (1) in Table 5. The figures not in parenthesis are long-run effects. The figures in parenthesis are impact effects. The regression equation interacts union density and co-ordination. The effects in the table are evaluated at the sample average of co-ordination.
Source: Calculations by the EEAG.

variations in unionisation only affect unemployment under decentralised bargaining.

EMU and different bargaining structures

An issue that has received much interest in the recent research literature on bargaining co-ordination is how monetary unification in Europe affects wage outcomes.

One strand of literature has focused on the interaction between the central bank and wage setters in an economy with monetary policy autonomy, that is a flexible-exchange rate economy outside the EMU (Coricelli et al. 2000, Soskice and Iversen 2000). The starting point is that, provided there is some co-ordination of collective bargaining, wage setters could be expected to act strategically and take into account the anticipated responses of the central bank to wage settlements. More precisely, central bank behaviour can act as a *deterrent* to high wages, because wage setters realise that wage increases that threaten the price stability goal of the central bank will trigger an interest rate rise that raises the cost of high wage increases in terms of employment losses (the effective elasticity of labour demand). For a country outside EMU, with a flexible exchange rate and an inflation-targeting central bank, like Sweden, an extra incentive for wage restraint is thus added under these conditions. But this incentive does not work for the EMU countries, as national wage setters will always be too small relative to the ECB to be able to trigger any monetary policy reaction.

So, one could argue that monetary unification weakens the incentives for wage restraint when there is some co-ordination of collective bargaining. The argument has been made that the effect is larger with only intermediate co-ordination (bargaining at the sectoral level) than with high co-ordination. The reason is that in the latter case the incentives for wage moderation may be very strong anyway because of various internalisation effects, so the potential deterrence role of monetary policy may then not matter much anyway (Soskice and Iversen 2000; Holden 2001).[8] But with weaker internalisation effects in the case of intermediate co-ordination, the loss of a deterring national monetary policy in EMU is more serious. This might be one explanation of why it may be difficult for Germany – with its heavy reliance on sectoral bargaining – to achieve sufficient real wage moderation (see also Soskice and Iversen 1998 and Hall and Franzese 1998).

2.2 Aggregate wage flexibility

Another aspect of pay setting concerns the degree of aggregate nominal wage flexibility as an adjustment mechanism in the case of macroeconomic shocks. This aspect has become more important than before in the euro zone, as there is no longer any nominal exchange rate channel for changing real exchange rates among the member countries.

An old argument already dates back to Keynes (1936), who argued that the concern of employees over relative wages would make them oppose money wage reductions, unless all wages were cut simultaneously so as to preserve existing wage relativities. A more modern version of this co-ordination failure argument is that because of product demand interrelationships, the benefit of changing wages (and thus also prices) in individual firms depends on whether or not other firms do the same (Ball and Romer 1991). With small demand shocks, adjustment costs may make it unprofitable for each firm to change the wage independently of what happens in other firms. With very large shocks, it will always pay to adjust the wage, even if others do not. But for shocks of intermediate size, the individual wage setter may gain from adjusting only if others do the same. This could give rise to *multiple equilibria:* which one materialises will then depend on the expectations of what other wage setters will do. Co-ordination of pay setting is a way of removing such indeterminacy and ensuring that the economy ends up in a good equilibrium in which wages adjust.

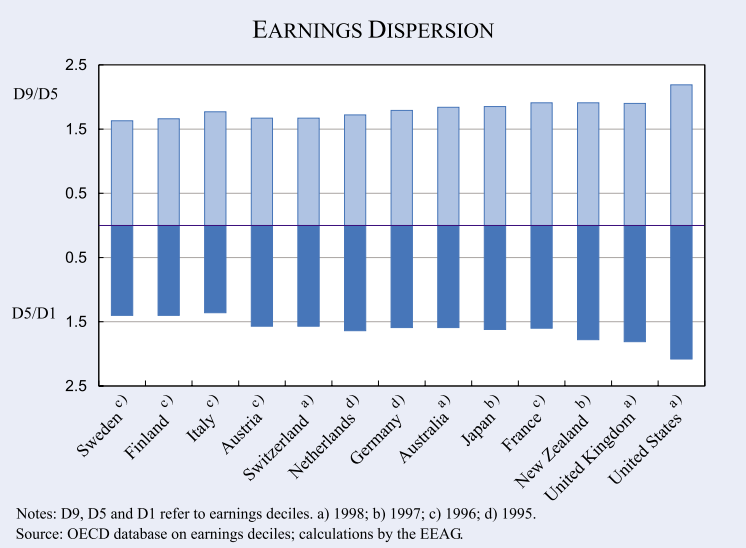
A similar argument can be made with respect to the length of wage contracts, which is an important determinant of nominal wage flexibility. In systems with decentralised and unsynchronised wage setting, contract length may be chosen in a socially inefficient way (Ball 1987). Most notably, there is an aggregate-demand externality: wage setters in an individual bargaining area do not take into account that a long-term wage contract on their part may contribute to aggregate demand fluctuations in the economy. The reason is that money wage stickiness in a part of the economy means lower flexibility of the aggregate price level in the case of nominal

[8] Iversen (1998) did indeed find empirical support for the hypothesis that a more non-accommodating central bank has a larger unemployment-reducing effect at intermediate levels of co-ordination than at high or low levels. But Hall and Franzese (1998) and Cukierman and Lippi (1999) found only partial empirical support for the theoretical predictions.

shocks. With co-ordination of wage setting, wage setters have an incentive to internalise this externality. This effect works towards shorter wage contracts and thus more nominal wage flexibility, when there is more co-ordination.[9]

At the same time, it should be recognised that decentralised wage setting is easier to combine with various systems of performance-related pay (see Section 2.4), including profit-sharing arrangements, which increase aggregate pay flexibility. Also, lower unionisation and less importance of collective agreements are likely to make labour markets conform more closely to the textbook competitive model, with demand and supply factors exerting a more direct influence. Overall, however, there has been little empirical research on the importance of various bargaining systems for nominal wage flexibility.

Figure 3.3



Notes: D9, D5 and D1 refer to earnings deciles. a) 1998; b) 1997; c) 1996; d) 1995.
Source: OECD database on earnings deciles; calculations by the EEAG.

2.3 Relative wages and wage dispersion

The determination of relative wages is an equally important aspect of wage setting as the determination of the aggregate wage level. Aggregate real wage restraint is not enough for achieving low unemployment if there are large demand and supply imbalances between regions, sectors, occupations and skills.

Trade unions typically regard a "fair distribution of wages" as a central goal. Sometimes the objective is formulated as "equal pay for equal work", but many times the objective is the even more far-reaching one of general pay compression. This latter objective has been particularly important in the Scandinavian countries and Italy.[10] Reducing pay compression is a rational objective for a trade union if the utility gain for an employer member is seen as larger the lower is the initial wage. Then a union will be more inclined to trade off wage increases against employment losses for low-wage than for high-wage members. Another factor working in the same direction is that the income loss in case the wage rise makes a member unemployed (the wage when employed minus unemployment compensation) is smaller the lower the initial wage is (provided that unemployment compensation is fixed and thus independent of the wage).

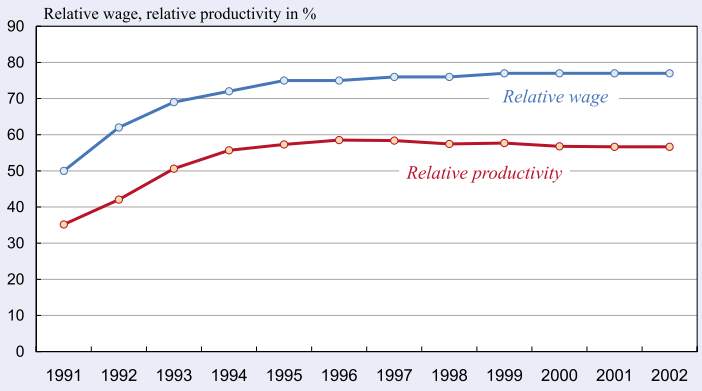
There exists overwhelming evidence that high degrees of unionisation and coverage of collective agreements compress the wage structure in all dimensions. It is also well-known that higher degrees of centralisation of collective bargaining reduce wage dispersion (see, for example, Rowthorn 1992 or Wallerstein 1999). This is illustrated in Figure 3.3, which shows that earnings dispersion is higher in New Zealand, the United Kingdom and the United States, where multi-employer bargaining is rare and rates of unionisation and coverage of collective agreements are lower than in other countries.

Reductions in wage dispersion in centralised collective agreements seem to come about mainly through higher wages at the lower end of the wage distribution. For example, Blau and Kahn (1996) found that centralisation of bargaining reduces wage dispersion by narrowing the wage differential between the 50th and 10th percentile, but has no significant effect on the differential between the 90th and 50th percentile. It is also striking how the large increases in wage dispersion in the United Kingdom over the last twenty years and in New Zealand over the last ten

[9] But, as analysed by Ball (1987), there is also an externality working in the opposite direction. It arises because wage setters in an individual bargaining area will not, under decentralisation, take into account that an increase in contract length there, and the consequent reduction in nominal wage variability, will reduce real wage variability in other bargaining areas.
[10] For example, the Trade Union Congress in Sweden sees "the possibility of achieving the basic elements of solidaristic wage policy with special wage increases for low-wage groups in order to attain equitable wage differentials" as a main advantage of co-ordinated bargaining (*Riktlinjer för samordnade förhandlingar* 2003, 19).

Figure 3.4

RELATIVE WAGE PER EMPLOYEE AND RELATIVE PRODUCTIVITY PER EMPLOYEE IN EASTERN VERSUS WESTERN GERMANY



Source: Federal Statistical Office, Germany.

years have coincided in time with de-unionisation, reduced coverage of collective agreements in general and virtual disappearance of multi-employer bargaining.

A clear-cut example in Europe of how wage policies aimed at compressing wage differentials across regions can contribute to high unemployment is Germany. As has been reported by the German Council of Economic Experts (2002), the lowest union wages in west German industry rose much more than average wages over the period from 1970 through 1999. This was a direct implication of the unions' policy of negotiating for lump sum rather than proportional wage increases. While the unemployment rates among people with high and average skills have not risen much in Germany, the unemployment rate of those who have neither vocational training nor a university degree rose from about 6 to 22 percent in the period from 1975 to 2001.[11]

The most adverse consequences of wage compression in Germany have occurred in eastern Germany. Wages per hour increased from 7 percent of wages in western Germany in 1989, before unification, to about 72 percent in 2002 (Sinn 2003). The relative wage per employee in 2002 amounted to 77 percent, while aggregate productivity (GDP per employee) had only reached a level of 57 percent of the level in western Germany (see Figure 3.4). This is a major cause of the high unemployment in eastern Germany (currently around 18 percent, see Figure 3.5).

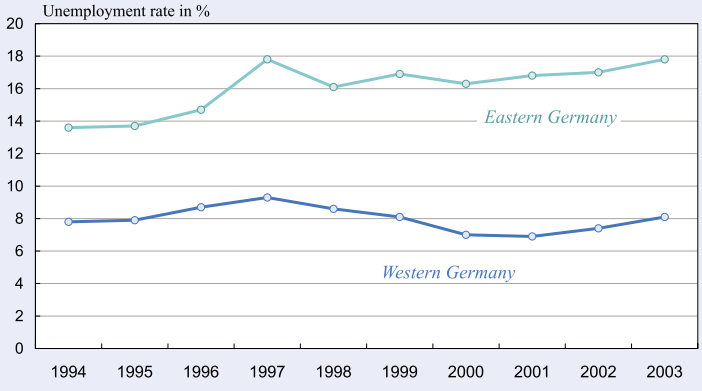
2.4 Performance-related pay

During the last two decades, it has been a general trend in most countries for firms to increasingly use pay systems to stimulate both individual and group effort of employees. This trend towards more incentive pay conflicts with traditional union policies of pay compression, as described in Section 2.3. In most Western European countries, union policies have had a large influence on the possibilities of differentiating pay both among and within firms. Sectoral wage bargaining has limited the possibilities of differentiating pay depending on individual company performance. This has been quite a binding constraint, especially in countries like Germany and Austria, where local bargaining about the implementation of sectoral agreements has played only a limited role. Within firms, collective agreements traditionally set standard pay rates for broadly defined groups or tasks based more on formal criteria than on individual performance.

An important objective for each firm is to align the incentives of the employees with those of the firm to stimulate high performance. Profit maximisation

Figure 3.5

UNEMPLOYMENT RATES IN EASTERN AND WESTERN GERMANY



Source: Federal Employment Services, Germany.

[11] IAB (2002a).

requires that this is done in as cost-efficient a way as possible. One method is close monitoring of employees combined with threats of dismissal or missed career opportunities. But monitoring is efficient as an incentive device only if the probability of discovering "shirking" is high (Nalbantian and Schotter 1997) and may therefore be costly. It will be the more so the more complex the relationship is between employee work and firm performance. Performance-related pay is therefore likely to be part of any optimal incentive package.

The optimal mix of individual pay incentives and group incentives, such as profit-related pay or employee stock ownership plans, depends on the character of production. The advantages for the employer of incentive pay linked to group rather than individual performance are greater when (i) capital intensity is high and the risks of misuse of capital equipment is large; (ii) when labour inputs are strongly complementary, so that the pay-off from encouraging co-operation among employees is high and the potential disruptive costs from conflicts over the use of differentiated pay are large; and (iii) when it is difficult to measure individual output (which explains why profit sharing and employee stock ownership plans are common in sectors with complex employee tasks and rapidly changing technology; Kruse 1996). Another advantage of profit-related pay is that it introduces more flexibility of the average pay level in the firm, as discussed in Section 2.2. One should therefore expect profit sharing to be common in firms with a high variability of performance and in new firms with uncertain prospects, which is an empirical prediction that seems to be borne out by the data (Kruse 1996).

The benefits of incentive pay seem increasingly to have been realised by employers over the last twenty years. So called *Human Resource Management* practices have been adopted by a large number of firms (Lazear 1999). These practices have been described as aiming to substitute co-operative employer-employee relationships, focused on "managing the contribution and commitment of individual employees", for more collectivist and adversarial industrial relations (see, for example, Godard and Delaney 2000 or Roche 2001). Flexible work assignment, cross training, teamwork and formal employee participation are typical elements of human resource management policies. Performance-based pay is also seen as a key ingredient (see, for example Lazear 1999, Ichniowski et al. 1996, Godard and Delaney 2000 or Rayton 2003).

Not very surprisingly, performance-based pay has been found to be associated with superior economic performance in empirical studies. For example, the profit-sharing literature has found significant links between firm performance and profit-related pay (Kruse 1993). A widely quoted study by Ichniowski et al. (1997) of productivity in steel finishing lines concluded that "innovative work practices" (incentive pay, team structures and flexible job assignments) lead to higher performance than "traditional work practices" (narrow job specifications, close supervision, hourly pay and strict work rules). A very recent study by Rayton (2003) of US firms finds that average employee compensation is significantly positively related to firm performance (in terms of stock returns and bond ratings) in high-performance firms, whereas there is no significant relationship between average employment compensation and performance in low-performance firms.

Decentralisation of pay setting to the level of the individual firm makes it easier in general to design incentive pay systems that are appropriate for the specific activities performed. Also average employee compensation can more easily be linked to firm performance in this way, because benefits in the form of profit sharing or employee stock ownership plans can best be traded off against standard wages at the local level. Indeed, profit sharing arrangements and employee stock ownership plans have often been adopted by firms in distress as an explicit part of concession bargaining at the firm level (see, for example, Bell and Neumark 1993).[12]

The standard view has been that unions are opposed to incentive pay systems because they are likely to increase wage dispersion. But it has also been claimed that higher unionisation may not necessarily make such pay systems less likely and that the key determinant of the probability that such systems are adopted is the general industrial-relations climate (Heywood et al. 1998). Interestingly, a recent study using panel data for US firms found that, although unionised firms were less likely than non-unionised firms to have profit sharing and employee stock ownership plans in 1975, they were equally likely to have adopted them subsequently (often as part of concessionary bargaining; Kruse 1996).

[12] There are, however, also many examples of such systems being adopted because firms want to raise employee compensation in periods of good performance without taking on an obligation to pay higher wages also in the future (Kruse 1996).

3. Alternative ways of decentralising pay setting

The development towards more decentralised pay setting in the current EU countries over the last two decades, which was described in Section 1.2, has taken place on the initiative of employers. Several driving factors have been pointed out:

- Standardised tasks and hierarchical Tayloristic organisation within firms seem increasingly to have been replaced by more flexible tasks and flatter hierarchies, allowing greater decentralisation of decision-making. This makes an increased use of performance-related pay systems, which have to be decided on at the enterprise/workplace level, profitable for employers (Lindbeck and Snower 2000; 2001). This development can be seen as part of a more intensive search for efficiency-enhancing measures at the level of the firm driven by increased competition (due to product market deregulations and "globalisation").
- If most of the competition for a firm comes from other domestic producers, it may regard uniform wages across a sector as an advantage because they provide a "level playing field". But increasing international competition renders this consideration less relevant. Instead, it becomes more important for each firm to be able to adjust its wage level to that of foreign competitors, which requires greater scope for wage bargaining at the level of the firm (Crouch 2000a,b; Calmfors et al. 2001).
- A desire to reduce the political power of unions by limiting their role as a national actor in general may be a third factor (Elvander 1999; Calmfors et al. 2001).

The development towards more decentralisation of pay bargaining can also be seen as an outcome of "meta bargaining" between unions and employers about the level at which wage negotiations should take place. To the extent that the relative bargaining strength of employers has increased, they may have been able to shift the locus of bargaining in their preferred direction. One possible explanation of such a shift in bargaining power is the increasing degree of international capital mobility, which gives the employer side a better "fall-back" position in the case of disagreement with unions.

Another explanation of the shift in bargaining power in favour of employers is the fall in unionisation rates that has taken place in many western European countries (see Figure 3.1 in Section 1.1). This development has been attributed to a number of structural changes in the economy (Ebbinghaus and Visser 2000; Calmfors et al. 2001). One such change is the shift in employment from the traditionally heavily unionised manufacturing sector to the private service sector with many small establishments that are costly for unions to organise. At the same time, employment in the public sector, where unionisation is in most countries higher than in the private sector (presumably because politicians for election reasons are more favourable to unions than private-sector management) has stagnated. Increased relative importance of part-time and temporary employment is usually also held as an important explanation of the trend towards lower unionisation, since employees on such contracts are likely to see smaller benefits of being unionised than permanently employed full-time employees.

The forces behind a decentralisation of pay bargaining are likely to operate also in the future. Thus, one should expect further decentralisation to occur in continental, Western European countries. But this process can take place in different ways, which may have quite different implications. We shall distinguish between three possible scenarios:

1. Massive decentralisation and de-unionisation of the Anglo-Saxon type
2. Disorganised and gradual decentralisation/de-unionisation
3. Organised decentralisation where higher-level collective agreements allow more scope for local wage setting.

3.1 Massive decentralisation and de-unionisation

The first scenario is *massive decentralisation/de-unionisation* of the type that has taken place primarily in the United Kingdom and New Zealand, but also in Australia. As discussed in Section 1, developments in these countries have not only meant a large reduction in unionisation, but also a dramatic reduction in the coverage of collective agreements and a radical shift from multi-employer to single-employer bargaining.

From a theoretical point of view, the Anglo-Saxon model has its benefits. It allows an increased use of incentive pay and more relative wage flexibility. As we discussed in Section 2.1, it is an open question to which extent collective bargaining at the enterprise

level in a system with high unionisation and high coverage of collective agreements creates incentives for aggregate wage moderation as compared with higher-level bargaining. But de-unionisation and low coverage of collective agreements represent strong wage-moderating forces.

In both the United Kingdom and New Zealand, there has been much talk of trying to achieve larger 'individual variation' in employment contracts. It is, however, not clear to what extent this has happened in practice. A weaker role for collective agreements appears to have led to more legal regulation of 'minimum employment conditions' (Bray and Walsh 1998; Brown et al. 2000). Employers also often seem to have stuck to standardised employment contracts independently of the degree of trade union presence because of the cost savings implied (Bacon and Storey 2000).

A development of the Anglo-Saxon type appears very unlikely in most western European countries in the near future. Existing bargaining institutions in these countries seem to be changing only at a slow pace. One should not expect radical changes in the bargaining institutions unless there are massive reforms in the legal regulations. Indeed, it was such reforms that triggered off the dramatic changes in pay-setting systems in the United Kingdom, New Zealand and Australia.

In the United Kingdom, there was a sustained series of legal changes during the 1980s, which gradually restricted union powers. These legal reforms involved: legislation on election of union officials and secret ballots before strikes; outlawing of secondary action; making unions liable for fines and civil damages if legal rules on industrial action were not observed; *de facto* abolition of closed shops; legal recognition of the right not to belong to a union; and rules making it more difficult for unions to be recognised by employers (Gregory 1998). Even despite these radical changes, the reduction in the importance of collective bargaining has been only a gradual process. The main explanation of the decreased scope of collective bargaining has been the difficulties of unions to get recognition at new workplaces rather than de-recognition at already existing ones (Machin 2000). The legal reforms seem to have led to a situation where traditional union wage premiums have largely disappeared, and where unionisation no longer appears to cause negative productivity effects (Addison and Belfield 2001; Forth et al. 2002).

In New Zealand, the changes in wage-setting institutions were triggered by the Employment Contracts Act of 1991, which introduced completely new labour legislation. Here, unlike in the United Kingdom, no attempts were made to regulate the internal structure of unions. Instead, the guiding principle behind the new legislation was to view the employee and the employer as the primary parties to the bargaining process. Each employee must choose between bargaining on his/her own or being represented by a "bargaining agent", who could be another person or an organisation. A trade union can be such an organisation, but it cannot bargain on behalf of an employee (not even a union member) unless he/she has given it explicit bargaining authority. Legislation allows explicitly for two types of employment contracts: individual and collective ones. Single-employer bargaining is encouraged, for example, by explicit provisions prohibiting industrial action to force an employer to become a party to a multi-employer collective agreement (Honeybone 1997; Bray and Walsh 1998).

Changes in the legal regulations in Australia have been later and less radical. But the Workplace Relations Act of 1997 clearly favours collective agreements at the enterprise level and restricts the earlier use of compulsory arbitration (with "wage awards" now being confined mainly to minimum wages). The legislation also allows for individual employment contracts, although, unlike in New Zealand, these have not become the norm, but instead require an active "opt-out" (Bray and Walsh 1998).

The upshot is that dramatic changes in wage-setting systems of the type that have occurred in Anglo-Saxon countries would seem to require massive legal interventions, abolishing, for example, legal restrictions on individual employment contracts that stipulate lower wages or other less favourable employment conditions than in collective agreements. Such *favourability clauses* exist, for example, in Germany, the Netherlands and France. In the United Kingdom and New Zealand, the fundamental changes in pay-setting institutions were made politically possible because of deep economic crises and widespread dissatisfaction with the workings of the traditional systems. But it is difficult to see that the political preconditions for such radical reforms exist in Western European countries today. This point is underlined by the failure to include even very modest changes of the pay-setting system in the recently adopted

labour market reforms in Germany. It appears that political resistance to reforms of pay-setting practices is often much harder than to other types of labour market reform. The main reason is that changes in the pay-setting regime have a large, direct impact on employed insiders, as discussed in Chapter 2. Also, union officials, who see their role challenged, have strong incentives to try to organise political opposition to such reforms.

3.2 Disorganised decentralisation

An alternative scenario is that decentralisation and de-unionisation proceed in a spontaneous way without legal changes and with opposition from the union side. Such a *disorganised decentralisation* process seems to have been going on in Germany. It has, to a large extent, been concentrated in eastern Germany, where many firms have left the employers' associations in order to conclude enterprise agreements outside the sectoral collective agreements, and others have, in violation of existing legislation, paid wages below the minimum levels stipulated in the sectoral agreements.

In eastern Germany, western German unions and employers' organisations stepped in immediately after unification in 1990 to carry out wage negotiations. Before the privatisation programmes could begin, long-term wage contracts were concluded that foresaw full wage equalisation with western Germany in only five years. After privatisation, many east German entrepreneurs tried to negotiate new contracts, but they only managed to postpone the time of wage equalisation by one year. As a consequence, many employers broke the union contracts with the silent consent of the unions, whereas others left the employers' organisations. In 2002, no more than 20 percent of all firms with 43 percent of the work force were covered by sectoral agreements in eastern Germany, whereas the corresponding shares were 44 percent and 63 percent, respectively, in western Germany (see Table 3.5).

Unions in eastern Germany have been much weakened by this development. When the metalworkers' union (IG Metall) called for a strike in the spring of 2003 to reduce the working week in eastern Germany to 35 hours, the weakness of unions there was clearly exposed. The strike was unpopular among employees who feared that the union demands would further undermine the competitiveness of their companies. After only a few weeks, the union had to give in without having achieved any of its goals.

Spontaneous and disorganised decentralisation has also occurred in the public sector in Germany. The earlier joint bargaining association *("Tarifgemeinschaft")* for public sector employers, encompassing the federal government, the states and the municipal employers, collapsed in 2003 because bargaining goals turned out to be too diverse. To a large extent, this was related to tensions between western and eastern states (Eironline Germany 2003a).[13]

However, one would expect spontaneous decentralisation and de-unionisation processes to be slow, unless they occur in such extreme economic situations as in eastern Germany. As pointed out in Section 3.1, it does appear that, in the absence of fundamental changes in the legal framework, bargaining institutions are very persistent. A possible explanation is that the design of labour market institutions to a large extent reflects deep-rooted social attitudes. For example, Black (2001) finds that differences in the degree of centralisation of wage bargaining among countries depends on differences in societal values relating to such basic factors as "power distance" (the

Table 3.5
The coverage of collective agreements in eastern and western Germany, 2002

	Percentage of firms		Percentage of employment	
	Western Germany	Eastern Germany	Western Germany	Eastern Germany
Sectoral collective wage agreement	44	20	63	43
"Orientation" towards sectoral collective wage agreement	22	34	16	23
Enterprise collective wage agreement	2	4	7	12
No collective wage agreement	32	42	14	22

Note: "Orientation" towards sectoral collective agreement means that firms/workers are not formally encompassed by such agreements, but that wage conditions have been "influenced" by them.
Source: WSI Tarifarchiv 2003: Tarifbindung (IAB Betriebspanel).

[13] Similarly, in Austria, the earlier centralisation of the (informal) bargaining in the public sector was abandoned in 2002 because of diversity in bargaining objectives (Eironline Austria 2002). Similar developments occurred much earlier in Sweden.

degree of inequality of power in organisations and institutions that the population considers normal), general attitudes towards "individualisation", the cultural values attached to "masculinity" and attitudes towards risk.

Another factor that counteracts tendencies toward spontaneous moves to single-employer bargaining is the demand for insurance on the part of employers against the costs of labour market conflicts. An important function of employers' associations in some countries, such as the Scandinavian ones and Germany, is to provide this type of insurance through joint conflict funds. Indeed, in Sweden, for example, multi-employer bargaining initially emerged on the initiative of employers who sought to protect themselves against union action against individual firms through such co-operation (Skogh 1984). The operation of such a system of insurance creates incentives for hierarchical control in the employers' associations to address moral hazard problems, so that individual employers do not choose too aggressive a stand against unions leading to an excessive number of labour market conflicts.

Spontaneous moves to single-employer bargaining are not likely to proceed at a fast pace in most western European countries. Nor are unionisation and the coverage of collective agreements likely to fall rapidly. The structural changes working in this direction, which we discussed in the introduction to Section 3, occur only slowly over time, and trade unions may, to some extent, develop strategies to cope with them (Calmfors et al. 2001). Experiences from the United States and Canada seem also to imply that negative management attitudes to unionisation may matter much less for union recognition and the existence of collective agreements than the legal framework (Kleiner 2001).

The available empirical research surveyed in Section 2.1 does not permit clear-cut conclusions on the macroeconomic effects of moving from a system of sectoral collective bargaining, such as in Germany, to a system of collective bargaining at the enterprise level. If the hump-shape hypothesis (see Section 2.1) is correct, such decentralisation will promote aggregate real wage restraint, although the effects may not be very large. But there is also the possibility that the incentives for wage restraint are weakened. This risk is most apparent if a move to single-employer bargaining would occur at the same time as coverage of collective agreements and unionisation remain fairly high.

3.3 Organised decentralisation

A third possibility is *organised decentralisation* (a term coined by Traxler 1995), according to which higher-level union confederations and employers' associations choose voluntarily to leave more scope for local bargaining. At least theoretically, this scenario would seem to offer the greatest possibilities of combining the benefits of co-ordination in terms of internalisation of various effects of wage increases with the benefits of larger relative-wage flexibility. Several models exist for such organised decentralisation.

Local determination of the distribution of wage increases

One possibility is to retain the determination of the total margin for wage increases (the average wage increase in each firm/workplace) at the higher (usually sectoral) level, but increase the freedom of local bargainers to determine how this margin should be distributed among the individual employees in the firm/workplace. In many countries there has been a general trend towards such *separation* of the decisions at the sectoral level on the total margin applicable to each firm and the decisions at the enterprise level on how the agreed wage increase should be distributed among individuals. But the development does not seem to have gone very far in countries like Austria, Belgium, Germany and Italy. The development has gone much further in the Netherlands and the Scandinavian countries. In the Netherlands, sector-wide agreements have been interpreted as "increasingly adopting the character of framework agreements, which then need to be developed in detail at company level" (Eironline Netherlands 2002a). This can occur through negotiations between the employer and the local works council.

Table 3.6 gives an overview of the differences in the designs of existing collective agreements in Sweden in 2002. According to the table, collective agreements with standard wage increases at the sectoral level that applied to *all* employees (category 7) existed only in the private sector and did not encompass more than ten percent of the employees there. All other collective agreements left some scope for local bargaining about the distribution of wage increases among individual employees. Usually local bargain-

Table 3.6

Types of collective agreement in Sweden, 2002

	Percentage of employees in each sector		
	Private sector	Central government	Local government
1. Local bargaining without nationally determined margin for wage increase	7	32	28
2. Local bargaining with nationally determined margin for wage increase if the local parties cannot agree	5		
3. Local bargaining with a nationally determined margin for wage increase if the local parties cannot agree and some type of binding individual guarantee	8	68	
4. Local bargaining on the distribution of nationally determined margin for wage increase without any type of individual guarantee	7		24
5. Local bargaining on the distribution of nationally determined margin for wage increase with a binding individual guarantee or an individual guarantee if the local parties cannot agree	45		48
6. Nationally agreed general wage increase plus local bargaining on the distribution of additional nationally determined margin	18		
7. Nationally agreed general wage increase	7		

Note: Local government refers to regional authorities and municipalities.
Source: *Avtalsrörelsen och lönebildningen* (2002).

ing about the distribution of wage increases was conducted under the constraint of a minimum guaranteed wage increase for everyone (sometimes only as a guarantee when the collective agreement was evaluated *ex post*) or a fall-back clause stipulating that such a guarantee would apply if the local parties could not agree (categories 3, 5 and 6).

Delegating the decisions on the distribution of wage increases among individuals to the local level makes it possible to use pay increases as an individual incentive mechanism. It is instructive to study how this has influenced wage setting in hospital care in Sweden, where employers (the regional authorities) have tried (in fact much more consistently than in large parts of the private sector) to introduce pay policies that aim explicitly at stimulating effort and on-the-job training (Calmfors and Richardson 2003). This has been achieved for registered nurses (*sjuksköterskor* in Swedish), where, since 1995, the union side has accepted that the distribution of nationally agreed pay increases are a subject for local negotiations only, without any influence from higher bargaining levels. Such a pay system has not been accepted by the trade union organising less educated assistant nurses (*undersköterskor* in Swedish), for whom collective agreements have contained guarantees of pay rises for the individual (more or less amounting to the standard pay increases negotiated centrally). As can be seen from Table 3.7, wage dispersion has increased substantially for registered nurses (in the upper half of the wage distribution), whereas it has stayed more or less constant for assistant nurses.

Local determination of the total margin for wage increases

Table 3.6 also shows that a substantial share of employees in Sweden is subject to higher-level, multi-year agreements that do not specify any figures for wage increases at all, but leave the determination of both, the total margin for wage increase (the average wage increase) and its distribution

Table 3.7

Wage dispersion in Swedish hospital care run by regional authorities

	1988			1994			2002		
	90/10	90/50	50/10	90/10	90/50	50/10	90/10	90/50	50/10
Registered nurses (*sjuksköterskor*)	1.18	1.05	1.12	1.19	1.07	1.11	1.29	1.15	1.12
Assistant nurses (*undersköterskor*)	1.12	1.02	1.10	1.08	1.03	1.04	1.13	1.06	1.07

Note: 90/10 is the wage ratio between the 90th and the 10th percentiles etc.
Source: Calmfors and Richardson (2003).

among individual employees in each firm/workplace, entirely to annual local bargaining (category 1). Such contracts apply to seven percent of the employees in the private sector and to as much as 32 and 28 percent in central government and local government (municipalities and regional authorities), respectively. These contracts apply mainly to white-collar employees with higher education. This represents another form of organised decentralisation, where higher-level collective agreements delegate also the determination of "total" wage increases to bargaining at the local level. The local bargaining is then conducted under a "peace obligation", ruling out the use of industrial action. With such delegation of bargaining rights, higher organisational levels retain some co-ordination capacities through their influence on local negotiators as well as the capacity to "recall" the delegation in future collective agreements. This "recall capacity" can be seen as a constraint on the behaviour of local parties, at the same time as the delegation increases the scope for adjusting wage developments to local conditions. So far, collective agreements leaving the determination of the total margin for wage increases to the local level have mainly been used as a means to raise relative wages for groups with a favourable labour market position. But such agreements could also allow downward wage flexibility in situations of unfavourable labour market developments.

Local incentive pay schemes

The possibilities of using incentive pay mechanisms at the level of the individual firm/workplace can be enhanced by sectoral agreements on the design of performance-related pay systems. For example, the Confederation of Danish Industries and the Central Organisation of Industrial Employees in Denmark concluded a framework agreement on a new pay system (Plus Pay) in 2002, outlining the general principles for how basic pay (80 percent of the total wage) and qualification-motivated supplements should be combined with task-related bonuses and performance-related pay elements, with the specific design in each firm to be negotiated in local bargaining (Eironline Denmark 2002). A similar framework agreement on more decentralised pay was also concluded in the public sector in Denmark in 2002 (Eironline Denmark 2003). Another example is the 2002 agreement in the German banking sector on variable pay, allowing variations of annual earnings of up to eight percent) based on performance appraisals and achievements of agreed targets (Eironline Germany 2003b).

We are not, however, aware of any sectoral or other higher-level collective agreements in EU countries on guiding principles for how local bargaining parties could trade off employee benefits in the form of profit sharing or employee stock ownership arrangements against standard pay rates in individual firms. In Finland, for example, unions have tried to negotiate such framework agreements, but employers have not been willing to do so (Eironline Finland 2003). On the other hand, unions have often been opposed to such compensation schemes, because they are likely to increase pay dispersion. However, in a system where the main locus of pay bargaining is the sectoral level, such framework agreements may be necessary for a more widespread introduction of profit-related pay.

Opening clauses

A final possibility of increasing the flexibility of company pay levels in a system with sectorally negotiated pay increases is to widen the scope also for downward deviations from them. In Germany, for example, these possibilities are very restricted. The so-called *favourability* principle in the federal Collective Agreements Act (§ 4) states that "sites which are subject to collective agreements can only approve regulations which depart from the collective agreement if the changes are in the employees' favour" (Bispinck 2003). Downward adjustments of the pay level to save jobs are not allowed under this stipulation, unless an explicit opening clause has been negotiated in the sectoral agreement. Such clauses are, however, usually quite restrictive and allow only limited and temporary deviations from the sectorally determined pay levels (Lange et al. 2001). A possible reform, proposed, for example, by the German Council of Economic Experts (2002) would be to amend the statutory regulations to establish a legal framework for decentralised pay bargaining. Each employer and local works council could be given complete freedom to deviate both upwards and downwards from the sectoral agreements if they agree on that. Alternatively, such a deviation could be allowed if a certain proportion of the employees agree to it. Introducing such "symmetric" flexibility at the local level would allow both, greater wage dispersion among firms in general and greater possibilities to adjust wages locally to adverse shocks. One would not, however, expect

such a reform to radically affect wage outcomes, as the sectoral wage agreement would serve as a fall-back option in local bargaining in the case the parties cannot agree. Still, it did not prove possible to include such limited changes of the pay-setting system in the recent labour market reforms in Germany (see Chapter 2).

4. Conclusions

Each system of pay setting has its advantages and disadvantages. There is ample research evidence that highly co-ordinated collective bargaining at the multi-sector or national level, such as in many smaller European countries, promotes aggregate real wage restraint and low unemployment. Controlling for other factors, unemployment appears to be systematically lower with high co-ordination of collective bargaining than with intermediate co-ordination (where the locus of bargaining is the sectoral level). There are reasons to believe that EMU membership could increase the benefits of high co-ordination. The explanation is that monetary policy in EMU cannot react to wage hikes in individual countries, which weakens its disciplining force. Under such circumstances, there may be a greater pay-off from wage-setting arrangements that in themselves foster wage moderation than if national monetary policy could be used as a direct means to influence domestic wage setting. However, pay compression and inflexibility of relative wages seem always to be serious disadvantages of centralised wage bargaining.

Decentralisation of collective bargaining to the level of the firm facilitates the adjustment of wages to the labour market situation of different skill categories, occupations, regions and sectors. Such single-employer bargaining also facilitates the use of performance-related pay to boost labour effort and productivity. It appears, however, that decentralised collective bargaining is less conducive to aggregate real wage restraint and low unemployment than highly co-ordinated bargaining. But it is less clear how decentralised collective bargaining compares with intermediate centralisation (sectoral bargaining) in this respect. According to some empirical studies, decentralised collective bargaining leads, other things equal, to lower unemployment than sectoral bargaining. According to others it leads to higher unemployment. What is clear, however, is that low unionisation and low coverage of collective agreements promote real wage restraint and high employment. Therefore, the chances that single-employer bargaining results in wage moderation increase if a development in this direction goes hand in hand with a reduced importance of collective bargaining.

As to the flexibility of the aggregate pay level, there are conflicting tendencies. On the one hand, an increased use of profit-related pay under single-employer collective bargaining can help raise aggregate pay flexibility. But, on the other hand, it can become more difficult to change wages in response to macroeconomic disturbances if bargaining is decentralised and unsynchronised, because the incentives for wage adjustments for a particular bargaining area may be weak unless other bargaining areas also adjust their wages.

Against this background, which pay-setting systems should the EU countries opt for? One cannot give a generally valid answer to this question. A characteristic feature of pay-setting systems is their high degree of inertia: it usually takes a very long time or very special circumstances to achieve fundamental changes. So, the answer is likely to depend on the starting point, which for historical reasons differs a lot among countries.

Several of the current EU member states, especially many of the smaller states (for example Belgium, Finland, Ireland and the Netherlands) have been able to achieve wage moderation through formal or informal co-ordination of bargaining at the multi-sector level, involving peak-level labour market organisations and sometimes also governments. Through such social pacts it has often been possible to establish generally accepted *norms* for wage increases, serving as benchmarks for subsequent negotiations at lower bargaining levels. In countries where such arrangements have worked, there is little reason to abandon them now. But there are good reasons for treating central wage norms only as indicative, and not binding, in order to give more room for relative wage changes. The trick is to avoid such recommendations being regarded as "floors" for wage increases. It is important to get an understanding that a functioning market economy means that wage increases across firms, sectors, occupations and regions must deviate from the average, depending on the situation in the specific labour market. One way of signalling the need for this could be to publicise a corridor for wage increases rather than a single figure when guidelines are formulated. Alternatively, one might define a "normal" wage

increase, which lies below the desired average, with the understanding that "above-normal" wage increases should only be granted in bargaining areas with labour shortages.

Both in countries with a social-pact tradition and in countries with more traditional bargaining at the sectoral level, such as Austria and Germany, one could also conceive of other reforms within the existing pay-setting system in order to increase relative pay flexibility among both firms and individuals. Such *organised decentralisation* could encompass reforms of the following type:

- The distribution among individual employees of agreed "aggregate" wage increases at higher bargaining levels should be determined at the local level to a much larger extent than is currently the case. Higher-level agreements should therefore by and large abstain from providing individual guarantees of wage increases.
- The scope for opening clauses that give local wage bargainers also the right to deviate downwards from higher-level collective agreements should be increased. Such flexibility would, for example, be very helpful for adjusting wages in eastern Germany and southern Italy to the prevailing unemployment situations.
- Where there is bargaining at the sectoral level, framework agreements would facilitate the introduction of variable performance-related pay systems at the level of the individual firm. Such framework agreements should allow the possibility of wage adjustments at the company level in connection with the introduction of profit-sharing systems or employee stock ownership plans.
- One could also conceive of higher-level collective agreements that delegate the determination of the total margin for wage increases (the average wage increase in each firm/workplace) to the local level, but where the local negotiations are conducted under a "peace obligation", ruling out industrial action, and the higher level retains the organisational capacity to "recall" the delegation in future collective agreements. Such "discretionary delegation" increases the flexibility of relative wages at the same time as the higher-level collective agreements serve as a "stand-by option" if co-ordinated wage adjustments are needed in a macroeconomic crisis.

How should one expect wage bargaining systems in continental Western European countries to develop? We have surveyed the tendencies to decentralisation that have taken place and concluded that this development is likely to continue. How should one evaluate this? Obviously, the conclusion depends on the starting point from which decentralisation occurs.

For the countries with social pact co-ordination, the key question is whether or not it is possible to have both general wage norms determined in a co-ordinated way and relative wage changes that are decided in a decentralised manner. In our view the jury is still out. An optimistic scenario is that the process of organised decentralisation proceeds in the manner we have described so as to make greater diversity of wages compatible with continued aggregate real wage moderation. A pessimistic scenario is that disorganised decentralisation, increasing the number of independent pay-setting actors, ultimately makes co-ordinated wage restraint unfeasible.

For a country such as Germany, where the main locus of collective bargaining is the sectoral level and the extent of co-ordination of collective bargaining is lower than in many of the smaller EU countries, the prospects are different. It is possible that a disorganised decentralisation process could lead to more aggregate wage restraint. But the difference to current outcomes may be small. And it is also possible that more single-employer collective bargaining could weaken the incentives for such wage restraint. A key requirement for overcoming the present stagnation in Germany seems to be that labour market reforms are extended to pay-setting practices in such a way that greater diversity of wages is allowed.

If it turns out to be impossible to combine aggregate real wage restraint with relative-wage flexibility in the continental western European economies, one could not in the long term rule out an Anglo-Saxon development, where decentralisation of collective bargaining is accompanied by massive de-unionisation and reduction in coverage of collective agreements. But such a development would probably only occur as the consequence of radical political reform of basic labour legislation after a deep economic crisis. An important reason why this scenario may not materialise is that trade unions may find it in their self-interest to acquiesce in both wage restraint and organised decentralisation precisely because they want to avoid such a development.

Most of the new EU member states in Eastern and Central Europe find themselves in an entirely differ-

ent situation from the present EU states in Western Europe. Estonia, the Czech Republic, Hungary, Latvia, Lithuania and Poland are all characterised by decentralised pay bargaining at the level of the enterprise and low unionisation and coverage of collective agreements. These countries are likely to face strong pressures from Western European trade unions, and possibly also from EU institutions, to change their industrial relations systems so as to conform better to "EU standards". Such pressures should be resisted. The existing "Anglo-Saxon" combination of enterprise-level bargaining and limited importance of collective agreements in these countries is likely to produce better macroeconomic outcomes than a move to collective bargaining at the sectoral level of the Western European type.

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The Economics of Discrimination: Equity, Equality and Diversity in the New European Constitution

1. Introduction

The proposed Constitution of the European Union serves a number of purposes. It should describe the mechanics of the governance of the Union. It should provide a concise statement of the purposes and objectives of the Union. Ideally, it should do so in language which gives inspiration to the citizens of the Union. The US Constitution, which achieves all of these, is one of the most important and influential documents in world history.

The US constitution has enduring influence because it was the product, not just of shrewed bargaining between interest groups – although that was important – but also the result of profound debate about the nature of the republic, the values of American society and the functions of a modern state. The development of a European constitution ought to be the result of similar insight and discussion over the description of European culture and European values. The collapse of political negotiations about appropriate governance arrangements may provide an opportunity to begin that wider intellectual debate. This chapter is written in the hope of provoking such discussion in an area in which the draft constitution contains some poorly conceived provisions – that of discrimination and non-discrimination.

A fundamental purpose of a constitution is to distinguish between strategic and tactical issues of policy formation in a democratic society. Strategic issues describe broad objectives; tactical issues concern the means by which these objectives are to be achieved. A constitution which is difficult but not impossible to amend limits the ability of government or legislature to compromise long-term objectives for short-term advantage. It is a mechanism of social and economic pre-commitment (Holmes 1991, 1996).

In this way modern constitutions typically enshrine freedom of speech and prohibit imprisonment without due process. These are not absolute rights and may be overridden in extreme circumstances. But the effect of establishing them as constitutional rights is to ensure that they are not lightly overturned. Restricting such rights requires time, careful consideration, and a wide political consensus. Making judges the defenders of constitutional principles gives them the role of defending broad social goals against pragmatic political pressures. This is one element in the checks and balances characteristic of a society which is both democratic and free.

This is, however, a more limited role than the judicial activism – the positive development of new social and economic policies – which has sometimes, and controversially, been undertaken by the Supreme Court of the United States. It is not a European tradition to follow this approach, and there is little inclination to adopt it: the development of policy is instead the function of democratic political institutions. The assertion of non-discrimination as a principle comparable to freedom of speech and due process is a fundamental mistake, because non discrimination is a value of a quite different kind, and one which requires subjective interpretation. The likely outcome of the process which will follow will not necessarily advance the worthy objectives of those who have advocated measures against discrimination. Their legitimate concerns relate to a disparate group of issues – the elimination of racism, the advancement of women in business and politics, the provision of social support for disabled people, and the creation of a true common market within the European Union. These issues have little in common with each other, save that each is most effectively handled by carefully tailored social and economic policies which are specific to time and place.

If the constitution's reiterated references to "non-discrimination" had purely declaratory force, they would matter little. The potential problem is that they may exclude precisely the specific and pragmatic approaches which are required to meet the underlying objectives. The potential consequence is that

policy is not determined by a political process or a rational assessment of costs and benefits, but emerges from judicial interpretation of the language of a constitutional provision.

Our fear that a principle of non-discrimination will not help and may hinder the search for policies that promote the substantive objectives of the European Union is not a purely theoretical concern. Practical experience of the reunification of Germany provides a clear example and warning. In that country, the political and constitutional imperative of non-discrimination between residents of the former eastern and western provinces has in practice worked against the interests of economic assimilation of the eastern zone. Extending to the east labour legislation and benefits designed for the much richer west put back long-term development goals in the east and imposed substantial economic burdens on the west. The danger is that this specific problem will be replicated in dealings between the existing EU members and the accession states, and that this example will be repeated in many other areas where a legal requirement not to discriminate conflicts with the achievement of widely held social and economic goals.

2. Non-discrimination in the draft constitution

The draft Constitution makes frequent and casual use of the phrase non-discrimination. Article 2 of the draft Constitution – the Union's values – declares that

> The Union is founded on the values of respect for human dignity, liberty, democracy, equality, the rule of law and respect for human rights. These values are common to the Member States in a society of pluralism, tolerance, justice, solidarity and non-discrimination.

Article 3 reiterates that "the Union shall combat social exclusion and discrimination".

But non-discrimination is not a value of the same kind as pluralism, tolerance, justice and solidarity. In fact, discrimination is essential to modern economic life. We discriminate in the students we admit, the friends we choose, the workers we employ, the contractors we hire. We discriminate between people who are guilty of crimes and those who are not. "The word to 'discriminate', once divested of its emotional connotation, simply means to distinguish or draw a line" (Fisk 1976, p.109). What is objectionable is not discrimination as such, but inappropriate discrimination – arbitrary discrimination, invidious discrimination. (Karst [1969], defines and distinguishes these latter terms).

But the question of whether a particular form of discrimination is appropriate or inappropriate is inherently subjective and relative, and it is both proper and inevitable that the forms of discrimination we think appropriate and inappropriate change over time. The forms of discrimination that typically cause most concern – discrimination on grounds of race, gender and sexual orientation – cause such concern precisely because changing social values have led to changes in views of appropriate and inappropriate grounds of discrimination. The distinguishing characteristic of areas of potential discrimination such as race, gender and sexual orientation is that they are ones which have been the subject of recent contention – a century ago, such discrimination was a widely accepted social practice.

We do nothing about discrimination on grounds that most people would think inappropriate but few people have ever engaged in (e.g. discrimination on grounds of star sign or height, or the use of handwriting tests in selecting personnel) or about discrimination on grounds that most people would consider appropriate (e.g. discrimination on the basis of experience or educational qualifications).

A generalised non-discrimination requirement raises some fundamental issues to which answers are not at all obvious. What are the criteria by which appropriate and inappropriate grounds of discrimination are identified? In what circumstances should inappropriate discrimination – by public or private agents – be prohibited? What mechanisms should be put in place to limit inappropriate discrimination? These questions are considered further below.

Discrimination, whether appropriate or inappropriate, may be observed in several ways. The most straightforward is the blatantly discriminatory practice – the sign that says blacks will not be served, the job advertisement that excludes women. Discrimination may be inferred from the difference between the actual composition of a workforce or customer base and the composition of the potential workforce or customer base. Extreme cases are easy to identify, but in many instances the inference of discrimination may be difficult to draw or refute.

Most discrimination cases today are individual cases, in which a single person claims that a particular decision – to dismiss, to not promote, to refuse to serve – was made on inappropriate grounds. The existence of discrimination is not in dispute: it is the basis of discrimination which is at issue. Such cases are inevitably difficult to resolve because the court or other adjudicating body must infer motive from the circumstances of the decision. This is a powerful reason for limiting legal prohibition of discrimination to areas of policy in which urgent social or economic issues arise.

After the very general statement of Article 2, Article II-21 narrows the ground:

1. Any discrimination based on any ground such as sex, race, colour, ethnic or social origin, genetic features, language, religion or belief, political or any other opinion, membership of a national minority, property, birth, disability, age or sexual orientation shall be prohibited.
2. Within the scope of application of the Constitution and without prejudice to any of its specific provisions, any discrimination on grounds of nationality shall be prohibited.

The phrase "any ground such as" clearly envisages that the list is not exhaustive, but does not explain the criteria by which other grounds of impermissible discrimination might appropriately be added.

There is a striking contrast between the wide scope and definitive prohibition of Article II-21 and the weak reiteration of similar sentiments in Article III/8:

1. Without prejudice to the other provisions of the Constitution and within the limits of the power conferred by it upon the Union, a European law or framework law of the Council of Ministers may establish the measures needed to combat discrimination based on sex, racial or ethnic origin, religion or belief, disability, age or sexual orientation. The Council of Ministers shall act unanimously after obtaining the consent of the European Parliament.
2. Any discrimination based on nationality between workers of the Member States as regards employment, remuneration and other conditions of work and employment shall be prohibited.

Articles II-21 and III-8 give a clear indication of the intended scope of the declaration made in Article 2 and the objective – to combat discrimination – announced for the Union in Article 3. To understand their economic effects, it is necessary to consider why individuals, businesses and public organisations engage in discrimination.

3. The economics of discrimination

The principal literature on the law and economics of discrimination is found in the United States and inevitably reflects the legal framework there. The central constitutional provision is the Fourteenth Amendment, passed in the immediate aftermath of the Civil War, which declares that no State of the Union may "deny to any person within its jurisdiction the equal protection of the laws". This requirement is limited in extent and relates to government rather than private action: it superseded the notorious Supreme Court's *Dred Scott* judgement of 1857, which upheld slavery in the southern states and was, almost a century later, the basis for the 1954 decision in *Brown vs. Board of Education,* which declared separate school facilities for blacks and whites illegal and began the process of racial desegregation in the United States. The main anti-discrimination provisions of US law, however, are the Civil Rights Acts of 1964 and 1968, which attack discrimination by race and by gender, and the Disability Rights Act of 1990, which follows a similar model.

The economics of discrimination begins by asking why people engage in discrimination and what costs such discrimination imposes – on the person who discriminates, the person discriminated against and on society as a whole. It is conventional to distinguish two broad types of discrimination. Individuals may have what Becker (1957) calls "a taste for discrimination": they are motivated by animosity – dislike of a particular group or of the characteristics of that group. And individuals and organisations may practice statistical discrimination (Phelps 1972, Arrow 1973): selection on the basis of generalisations from the average characteristics of a group that are valid or believed to be valid – such as the use of test scores in student admissions.

These forms of discrimination are often conflated, both by those who practice discrimination and by those who oppose it. Animosity towards a group may be fuelled by (true or false) beliefs about the characteristics of the group, and decisions purportedly based on statistical generalisation may in reality be

dictated by animosity. But many people display animosity without any statistical basis for their prejudices, and many people practice statistical discrimination without any animosity towards those they discriminate against.

This distinction is mirrored in an analysis of the costs and consequences of discrimination. Animosity leads to inappropriate selection criteria – as when the considerations that enter hiring decisions are not those which "fit" the proper purpose of finding the best employees for the job. Such criteria are both over and under inclusive (Tussman and ten Broek 1949) – leading to the appointment of unsuitable members of the favoured group and to the rejection of suitable members of the disfavoured group. Discrimination based on animosity is costly because of this irrationality (in the ordinary sense of the word irrational, rather than in the economists' sense, which normally relates to the maintenance of consistent preferences.)

The costs of such discrimination depend on the competitiveness of the market in which discrimination is practiced (Becker 1957). An individual trader (not based in Canada) who dislikes Canadians and refuses to deal with them imposes modest costs on his or her own business (by diverting a class of potential customers to competitors) and a very small cost on Canadians (who can obtain service or employment elsewhere). And because animosity imposes costs on the person who displays such animosity, it will tend not to survive or grow in competitive markets. The costs of discrimination become substantial only if a systematic pattern of animosity is displayed by many traders in the same market – if, in effect, there is a discriminatory cartel.

As with all cartels, the more effective the cartel the greater the benefits from cheating on it. If animosity towards a particular group is widespread, then traders who do not display such animosity can derive substantial competitive benefits from this behaviour. The practice of discrimination is therefore likely to continue only if other social and commercial pressures are brought to bear against those who deviate from the cartel behaviour. This was indeed the mechanism by which racial segregation in commercial life continued in the United States for many decades (Sunstein 2002, 158) and it also underpinned religious discrimination in many parts of Europe for decades, if not centuries.

Discrimination based on animosity will therefore have significant economic consequences in competitive markets if, and only if, it is associated with deeply and widely held patterns of animosity in society. While there can be little dispute that this was once true of both racial and religious animosity, it is more difficult to argue that such discrimination is common today. As with all economic cartels, once significant numbers of traders defect from the cartel – in this case, no longer feel either desire to discriminate or social pressure to do so – the arrangement rapidly unwinds, as the costs of continued adherence to the discriminatory practice outweigh the benefits.

Discrimination based on animosity is, properly, a particular concern in the public sector, which often holds a monopoly of access to particular functions. And it also raises problems in private sector monopolies also. European competition law recognises the link between the adverse consequences of discrimination and the existence of monopoly and cartels. Case law under Article 82 establishes that dominant firms have a "special responsibility" which means they may not discriminate between customers or refuse to supply without "objective justification": non-dominant firms are free to engage in price discrimination and to supply (and refuse to supply) as they choose (Bellamy and Child 2001).

Statistical discrimination finds such objective justification in data on group characteristics. It would not be possible to conduct business without statistical discrimination. Most decisions about hiring, about promotion, about the choice of suppliers rely at least to some degree on knowledge and experience of general properties of groups rather than specific knowledge of the future performance of the individual or business selected. It cannot be otherwise.

Thus while the reduction of discrimination resulting from animosity yields economic benefits, the elimination of statistical discrimination imposes economic costs. (Norman 2003). Such costs will not arise if the assumptions on which statistical discrimination is based are false. But if discrimination is based on misinformation rather than animosity it can be expected that the provision of valid information will quickly reduce it: legal and constitutional provisions should not be necessary.

Yet the acceptability of statistical discrimination does not hinge solely on the quality of the statistics which underpin it. In the nineteenth century, many – perhaps most – well educated, liberal people genuinely believed that the intelligence of blacks and

females was lower than that of white men, and on the limited evidence before them it was not unreasonable for them to believe this. It is because we know now that these beliefs were false that we are particularly sensitive today to race and gender based discrimination. But no research on the relative intelligences of different groups, whatever its results – and there is persuasive evidence of difference in the nature if not the quantity of male and female intelligences, (see, for example, Baron-Cohen 2003) – would today render racial or gender discrimination admissible. Our concern is that the widespread practice of rational statistical discrimination will lead to the creation, or continuation, of disadvantaged groups.

Statistical discrimination is normally what is at issue in complaints about age and gender discrimination since animosity towards old people or women is rare (in contrast to discrimination on grounds of race or sexual orientation, where animosity was historically widespread). Older people may, on average, be less well equipped to perform certain tasks, but that is not necessarily true of any particular individual. Such an argument does not differ in any fundamental way, however, from the argument that although, on average, doctors may have greater medical knowledge than laymen, this is not necessarily true in any particular case. It is hard to believe, however, that many people would regard provisions which demand medical qualifications from those who perform certain tasks as representing inappropriate statistical discrimination.

Legislative attacks on statistical discrimination must therefore balance the economic costs of its prohibition against the social benefits of anti-subordination (Fisk 1976) provisions which protect the interests of potentially disadvantaged groups. That is why we are untroubled by discrimination against unqualified medical practitioners. The costs of ignoring the statistics and allowing them to practice are potentially large – the costs of the stigma suffered by those excluded seems relatively minor. In other cases, however, the balancing of costs and benefits is more problematic.

Racial profiling exemplifies the issue. In the US racial profiling is sometimes described as the "driving while black" offence (Strauss 2003): it is rational for police confronted with statistics showing that young black men are on average more likely to be involved in crime to question a disproportionate number of young black drivers. Such racial profiling might be motivated by animosity, but this need not be the case – such a policy might well be implemented by black police officers.

The consequences of racial profiling, however, may be to increase the sense of exclusion which leads to the observation that gives rise to it. In general, law enforcement agencies feel required to issue (barely credible) denials that such profiling takes place. In *United States v. Martinez-Fuerte* (1976) the Supreme Court held that the immigration service did not act illegally when officers looking for illegal immigrants from Mexico interned disproportionate numbers of persons of "apparent Mexican ancestry". It is hard to see how the Court could sensibly have reached any other decision. But the consequences of racial profiling are such that it can never be an acceptable public policy.

These are issues with which honest and well-meaning people struggle and on which there are inevitable differences in the balances that are arrived at. And that is why a generalised principle of non-discrimination cannot and should not be, as the draft Constitution asserts, a fundamental European value. Discrimination of many kinds is an indispensable aspect of social and economic life which could not be eradicated even if it were desirable to do so. We should seek to eliminate inappropriate discrimination, but in itself that statement has no content beyond an exhortation to do the right thing. To give it meaning requires a careful, and pragmatic, analysis of the social costs and economic consequences of particular policies. The examples discussed below illustrate both how important, and how difficult, that task is.

4. Areas of non-discrimination

Article III-8 identifies the areas in which the European Union should combat discrimination: sex, racial or ethnic origin, religion or belief, disability, age or sexual orientation, and Article III-18 adds nationality. Article II-21 includes property ownership but this is not reproduced in Article III-18. Political opinion also included in III-18, is perhaps reproduced as "belief" in Article III-18.

There is a certain irony in this list, because the convention which framed the constitution was selected with a view to maintaining a careful balance between

groups on almost all the criteria which the constitution deems as impermissible grounds of discrimination. The tension here is that between two senses of anti-discrimination: anti-discrimination may be defined as blindness to inappropriate distinguishing criteria such as race; or anti-discrimination may be represented as an anti-subordination principle in which society seeks to prevent the emergence of systematic patterns of disadvantage. The classic article by Fisk (1976) elaborates this distinction. The requirements of these two objectives are not the same, and may directly conflict: most clearly in the case of affirmative action (which would appear to be prohibited by the draft constitution, except in the case of gender, for which there is a specific provision in Article II-23). This tension has been a constant source of difficulty in the United States, most recently in the Supreme Court's inconclusive ruling in the case against the University of Michigan.

The inclusion of property in Article II-21, although not III-18, seems to be a mistake. It is hard to imagine that the architects of Article II-21 intended to prohibit residential mortgages, although Article II-21 might appear to have that effect. Property ownership is used extensively by financial institutions as a means of statistical discrimination, for example in credit scoring, and presumably it is not intended that the Article II-21 prohibition should exclude this.

But what then did this provision of Article II-21 intend to prohibit? This illustrates the difficulty of legislating through declaratory principles of this kind. The prohibition is probably aimed at practices such as imposing property ownership qualifications on voting rights, which were once widespread but are no longer. But if it is thought necessary to prohibit discrimination of that kind, it would be better to do so directly. Anti-discrimination provisions are aimed at "inappropriate" discrimination. But outside areas where the motivation for discrimination is animosity – race, and sometimes ethnicity and religion – discrimination rarely takes place unless there are some reasonable grounds for believing such discrimination is appropriate. The rationale for a prohibition must therefore rely on one or the other of two grounds. One is that the criteria employed to discriminate, although *prima facie* relevant, are in fact irrelevant. Statistical discrimination is engaged in, but mistaken. This is a difficult argument to develop where discrimination is a matter of commercial judgment and the trader concerned will suffer financial loss by his mistake. The alternative, and more powerful rationale for anti-discrimination rules is that the criteria of discrimination, although relevant to the provider, have adverse social consequences. That is the issue posed by racial profiling.

Discrimination related to property and property ownership illustrates these problems clearly. Lenders have commercial incentives to make their credit scoring procedures as refined as possible. Their practices are not generally irrational or driven by animosity. But such practices may have adverse social consequences, as in the practice of "red-lining" by mortgage lenders: people in disadvantaged areas find it difficult or impossible to obtain mortgages or other forms of credit. These policies may provoke a spiral of further decline and decay in the areas concerned.

The courts are not equipped to assess the quality of credit scoring procedures, still less to propose strategies of urban regeneration. And the practical consequence of prohibiting red-lining is likely to be a reluctance on the part of major financial institutions to engage in low quality lending at all, rather than the adoption of a policy of indiscriminate lending in such areas.

Credit assessment is an example of an area where policy developed in conjunction with financial institutions with a deliberate objective of tackling anti-subordination offers some prospect of achieving desirable social goals, while a policy of prohibiting statistical discrimination is likely to have opposite effects. The nature of markets characterised by statistical discrimination requires subtle analysis. Gender discrimination in insurance, which is discussed in the next section, illustrates the issue well.

5. Gender discrimination in goods and services

The Commission has recently put forward proposals (IP/03/1501, memo/03 216, November 2003) for a directive prohibiting discrimination by gender in the supply of goods and services. In practice, this directive is about insurance. Other examples cited of markets in which complaints about gender discrimination in the supply of goods and services have been received are trivial. With the exception of insurance, there are proposals for specific exemption of the small group of industries which routinely practice gender discrimination, such as hairdressers, beauty salons, swimming pools and gentlemen's clubs.

Female mortality is lower at all ages than male mortality and in consequence life insurance and annuity rates are lower for women. Some forms of health insurance, particularly permanent health insurance, are more expensive for women, but motor insurance is generally cheaper. This differentiation is particularly marked in the UK, where competition in insurance markets has led to particularly sophisticated risk-based pricing.

Risk-based pricing in insurance markets exemplifies statistical discrimination. The insurer determines premiums using a range of variables correlated with claims experience. The effect of these variables may be causal, but often is not. It is unlikely that gender as such affects the probability of involvement in a motor accident: gender here acts as a proxy for other variables, such as attitude to risk, which insurers cannot measure directly. It is probable that gender does have a direct effect on mortality: however the observed relationship is confounded by the influence of other variables, such as occupation and stress, which are correlated with gender but not directly caused by it. Statistical discrimination is fundamental to insurance: if there were complete knowledge of the determinants of risk, the pooling and sharing of uncertainties, which is intrinsic to the concept of insurance, would be impossible.

The suppression of statistical discrimination leads to the problems famously analysed by Akerlof (1970). A situation where information is known to both parties, but may not be used by one of them, is analytically identical to the situation described in his "market for lemons", where information is available to only one party to the transaction. There is a cumulative problem of adverse selection. People for whom the product is underpriced tend to buy it, and those for whom it is overpriced do not. As a result, the population served is not representative of the market as a whole. This leads to a rise in prices, followed by further adverse selection, driving the better risks out of the market. The overall effect is to reduce demand for the product and in extreme cases the market may disappear altogether.

The degree to which the disallowance of gender as a variable in risk assessment will raise average prices will depend on the extent of adverse selection and the ability of insurers to work around the prohibition by finding alternative proxy variables that achieve the same effect. The effect will be least significant for third party motor insurance, where purchase is compulsory, and the impact of adverse selection correspondingly reduced. It will be larger for products where demand elasticities are relatively high – such as term life insurance (life insurance without a savings component) – or where the insured product can be effectively substituted by non-insurance products, such as uninsured retirement savings. When insurers are not allowed to differentiate premiums between men and women, men will be driven out of the annuity market because they will find the rates that are needed to reflect the greater longevity of women unattractive.

One method of avoiding adverse selection effects is the provision of goods and services to groups rather than to individuals – as when an employer buys coverage for the whole workforce. If group membership is effectively compulsory, the characteristics of the insured population will be closer to the characteristics of the population as a whole. Such group purchasing is common in health insurance, with the consequence that rates for group insurance are substantially lower than the rates for similar cover sought by individuals: in the UK, annuity rates for tax-exempt pension savings (which require the purchase of annuities) are, for similar reasons, higher than general annuity rates (for which adverse selection is a problem). Thus the restriction of statistical discrimination in insurance creates two distinct kinds of market distortion. Insured products become less attractive relative to individual arrangements which can be used to achieve similar outcomes. Among insured products, collective provision is favoured over individual purchase.

The Commission's proposal exemplifies declaratory non-discrimination. It fails to provide any statement of benefits in terms other than the rhetorical. The proposals do not appear to be necessary or useful in tackling either of the general groups of problems which anti-discrimination provisions seek to address – the process irrationality of discrimination driven by animosity or the subordination of disadvantaged groups. And the Commission's assessment of its planned directive contains no substantive discussion of the consequential effects on prices and the demand for affected services.

The attempt to prohibit particular forms of statistical discrimination in insurance raises a broader issue. It is very likely that in coming decades there will be rapid increases in the ability to predict health and life expectancy through the use of genetic informa-

tion. At present, many countries discourage insurers from using the relatively small number of genetic markers – such as those for Huntington's Chorea and breast cancer – which have been identified. Insurers do, however, use other variables for purposes of statistical discrimination – hypertension, which is mainly genetic in origin, is a key variable in life insurance rating.

Existing redistribution from the healthy to the unhealthy and young to old within the insurance systems of member states may therefore be progressively undermined by the increased sophistication of statistical discrimination. Prohibition of statistical discrimination based on genetic factors seems a possible solution – and indeed Article II-21 might be interpreted as having this intention or effect. However, in order to avoid the problem of adverse selection as explained above it is necessary that no one, not even the insurees themselves, can obtain the genetic information. Just preventing one side of the market from using the information would not lead to viable outcomes.

These are difficult problems. It is impossible, however, not to observe the contrast between the subtlety and complexity of issues raised by statistical discrimination in the insurance market and the poor quality of analysis and argument presented in the Commission's proposals on gender discrimination in the provision of goods and services. If Europe is to make good policies in these areas, it needs to be better served.

6. Disability discrimination

Most EU states have for some time had legal provisions to assist disabled people, in the form of measures of social support and assistance in obtaining employment. The widespread use of the term discrimination in this context and the assertion of disability "rights" are relatively recent developments. It appears to result from a belief by lobbyists, initially in the United States, that processes of the kind which had been used against racial and gender discrimination might be used with advantage on behalf of disabled people. The Disability Rights Act, passed in 1990, was consciously modelled on the Civil Rights Act, which had tackled race and gender discrimination.

There is a hierarchy of four levels of disability discrimination:

(i) The most basic is a form of prejudice or animosity, as when employers refuse work to disabled people who are in all relevant respects qualified for the job because they attach stigma to disability in general, or to particular forms of disability.

(ii) The next level is statistical discrimination against disabled people. People with disabilities may, on average, be less effective in a particular role than others, but this is not necessarily true of any particular disabled person: however disability is used as a characteristic to screen applicants.
Discrimination of type (i) or type (ii) results in the unjust exclusion of disabled people from activities for which they are fully qualified. More expansive interpretations of discrimination concern activities for which disability is a genuine handicap.

(iii) It is not enough for disabled peolple to be given the same opportunities if they are not in practice able to take advantage of them. The disadvantages which result may be described as discrimination. This concept of discrimination implies that a form of affirmative action is required to permit equality of outcome. The most familiar example is the provision of wheelchair access to buildings and transport.

(iv) Yet another concept of discrimination demands blindness to disability even when its consequences are objectively relevant. Such a concept of discrimination would prevent the exclusion of physically disabled people from the armed forces, psychologically disturbed persons from positions of responsibility or the learning disabled from advanced education.

This is the ultimate logic of a position which implies that disability is an inappropriate basis for discrimination (and not merely an inappropriate basis) when, as in (i) and (ii), it is objectively irrelevant.

While (iv) represents an extreme position, there is increasing willingness to interpret disability discrimination in this way: the broad idea is that individuals should not suffer disadvantage from actions or events that are not their fault and may therefore be interpreted as disability. UK cases have included examples of successful claims of disability discrimination against a police authority which refused employment to a person suffering from manic depression and by an individual sacked for employment-related misconduct while a psychiatric inpatient (Sayle 2003). Implicit in this approach is that

individuals should not be accountable for their actions if these are the product of an illness, rather than something for which they are culpable.

Measures to combat discrimination of types (i) and (ii) are relatively uncontroversial. While there are costs to the prohibition of any form of statistical discrimination, the cost of expecting an employer to enguire into the specific characteristics of a disabled person seem modest relative to the potential benefits of such a policy in terms of anti-subordination arguments.

Discrimination is not a helpful concept in dealing with issues of type (iv). The distinction between what is culpable and what is not culpable is hard to make, and the underlying rationale would seem to be that misfortune, which is not culpable, should, at least in part, be a shared social concern. But this is an issue of solidarity, not discrimination. By treating it as thelatter, the costs are transferred to the other party of an economic transaction (generally the employer) and in a manner which is likely to arouse resentment rather than reinforce solidarity. There are no evident arguments of equity or efficiency for doing this and the practical consequence is to raise the costs of engaging in any such exchange. As in the other cases cited above, the liability creates a strong incentive to avoid situations which might potentially give rise to such claims – to screen out potentially difficult cases, on objectively defensible grounds, from the beginning.

Complex issues in disability discrimination mainly arise under (iii). In practice, expenditure motivated by this concern seems to have been very substantially directed towards wheelchair users. It is not apparent why this should have priority over assistance to victims of other common forms of disability, particularly deafness and blindness. But the objective of access for wheelchair users is relatively easy to define and monitor, while equality of outcome for those with hearing or visual impairments is incapable of achievement. Priority in expenditure appears to depend on the ease with which a charge of discrimination can be levied.

Thus in this area policy is also shaped by rhetoric and semantics rather than by assessment of the costs and benefits of alternative policies. The Commission's recent report on disability discrimination (European Commission 2003) is remarkable, not only for the absence of information on costs and benefits, but for its lack of concern about this dearth of information. We do not know how many non-institutionalised wheelchair users there are in the EU or in most of its member states. While the costs of providing disabled access in new public buildings is generally relatively small, the cost of providing it in existing buildings may be large, but there is little information on the magnitude of these costs or on how it is divided between public and private sectors. While it is important that some taxis everywhere should be wheelchair accessible, a requirement that all taxis be wheelchair accessible may not be a cost effective means of meeting the needs of disabled people. Ronald Dworkin's (1984) famous phrase describes "rights as trumps", identifying the nature of a right as a claim that is not commensurable with other claims: so the creation of rights precludes discussion of the cost effectiveness of implementing these rights. The exclusion of cost benefit analysis of provisions to assist disabled people is not generally in the interests of disabled people themselves.

Policies on disability are properly the province of solidarity, not discrimination. The claim to rights has force only if there is concomitant willingness to assume obligations and extravagant assertions of such rights, such as those under (iv) above, ultimately undermine the solidarity, which is the real basis of social support for disabled people. A balanced approach to such issues would also recognise differences between member states in willingness and capacity to provide that support. This is not a problem that has an important Community dimension, and provision for disabled people is an issue properly covered by the principle of subsidiarity. In other areas of welfare provision, however, EU level policies are essential: most particularly in relation to welfare provision and the free movement of labour.

7. On grounds of nationality

Economic integration is central to the objectives of the European Union. The accession of ten new states, whose income levels are substantially below the average of existing members, creates significant problems of integration. The goals are clear: the promotion of growth, which will allow the accession countries to converge towards the productivity and living standards that have already been achieved by the EU's other members, and the establishment of the four economic freedoms, including the free movement of labour, defined by the Treaty of Rome.

The best means of achieving these goals, however, require carefully calculated policies. Substantive, rather than rhetorical, non-discrimination requires that economic life in these accession countries is similar to that in the rest of the Union – something which is far from the case at present. This outcome may not be best accomplished by imposing a requirement of non-discrimination on the process of assimilation.

Political and constitutional imperatives imposed a range of non-discrimination requirements in the reunification of Germany. In particular, migration was freely permitted, labour market regulation and social benefits were aligned, and substantial wage convergence was imposed. The effect of these measures taken as a whole was the virtual collapse of tradable goods production in the east combined with a large and prospectively indefinite burden of transfer payments from the west; see Sinn (2002) and EEAG Report (2003, Chapter 3).

The provision by New York City in the late 1960s of a range of benefits on terms more generous than elsewhere in the United States led to an influx of poor people from other parts of the United States. In the early 1970s, the City became technically bankrupt, and these policies were scaled back. The cases of west Germany and New York, taken together, illustrate the incompatibility of the distinct objectives of non-discrimination, subsidiarity, and the economic development of poorer areas.

Non-discrimination provisions of the Constitution relevant to nationality are found in two areas. First, discrimination in conditions of employment by reference to nationality is explicitly prohibited. Second a migrant worker who is an EU citizen may receive benefits in any member state as if he or she were a national of that state.

The impact of migration flows depends on the size of the differentials in income and social benefits across the Union and on the scale of these flows (which is itself a function of these income differentials). The transitional provisions for accession countries allow existing member states to restrict immigration for employment from accession countries for up to seven years and Germany – the largest likely recipient – will impose such restrictions, although the UK will not. (See chapter 5 for details of these provisions.) There will be no restrictions on migration for residence.

As discussed in Chapter 5, cost estimates suggest that the scale of economic migration will be modest (Boeri and Brücker 2000; Home Office 2003). However, there is little comparable historic basis for extrapolation. Heavy reliance is placed on the experience of the Southern accession countries – Portugal, Spain and Greece. But these states were relatively much richer at accession than those that will join in 2004. And while Spain, Portugal and Greece had encouraged outward migration prior to their EU membership, the former Communist regimes had prohibited it. Thus there may be an untapped reservoir of potential migration in Eastern Europe that never existed in Southern Europe. We do not suggest that Western Europe will be swamped by immigrants from the accession states. We do believe that there is simply no way of knowing what the impact of free movement of labour on the economies of either existing or accession members is likely to be, and in these circumstances there should be as much scope as possible for flexible and adaptive policies.

The wages of economic migrants tend to lie between the wages of employees in their home country and employees in their host country (Olson 1996). This outcome is not mainly, or necessarily at all, the outcome of discrimination based on animosity. Some of it arises because of inefficient allocation of workers to jobs in a labour market with which they are unfamiliar. But there are also reasons why such discriminatory outcomes are consistent with an efficient labour market. And workers from accession states have, on average, less developed modern labour market skills and experience than residents of existing member states. More broadly, nationality is a strong proxy for variables such as mother tongue and cultural experience, which are relevant to labour market performance. These correlations are a basis for statistical discrimination by employers. There is likely to be evidence of inferred discrimination when employers use discriminating factors that are not themselves nationality but are correlated with nationality as a basis for selection.

These are not significant issues within the existing EU. To date, income differentials across member states have not been sufficiently large to make it attractive to recruit groups of migrant workers from other states on any substantial scale. After accession, the Union will experience an income dispersion wide enough to create many opportunities of this kind. And hitherto, concern over nationality-based dis-

crimination has largely been confined to explicit policies. But the attack on racial and gender discrimination has moved on from blatant discrimination to inferred discrimination. The same must be expected to happen in relation to statistical discrimination related to nationality if substantial observed differences between the wages of home and foreign EU national workers emerge within individual member states, as they inevitably will.

Economic migration which offers workers from accession states better paid jobs in other parts of the EU imposes costs but also offers significant benefits. Migration stimulated by social benefits available in other states is economically damaging to the state that receives migrants and socially damaging to the state from which they come. The attractions of such migration will be much greater in the enlarged EU than before. Purely social migration in search of benefits is restricted under existing EU legislation by the requirement that the claimant be connected to the labour force, but this is not a overly demanding requirement.

Discrimination by nationality would be a powerful means of restricting social migration if, at least for a period, some of the tax-financed benefits were related to those which would be received in the home state rather than the host state (Sinn 2000). Social migration on any scale will undermine the legitimacy of free movement of persons as a fundamental EU goal and may, as in the New York case, make the maintenance of differing levels of social benefits in different EU states – reflecting both the principle of subsidiarity and the wide range of earnings level across the EU – increasingly difficult to sustain (see Chapter 3 of EEAG Report 2003).

8. Conclusions

We have examined the application of non-discrimination rules in three broad areas of European policy. In each of them, policy will be better if it is made by the careful analysis of costs and benefits in relation to objectives than by the legal application of general principles that sound rhetorically attractive but whose precise meaning and practical consequences are often unclear and must necessarily be the subject of future judicial determination.

We advocate this approach in all the areas in which the draft Constitution asserts the principle of non-discrimination. If it is thought desirable to – for example – abolish mandatory retirement ages or to prevent employers excluding groups of potential workers automatically on the grounds of age; such policies would be better implemented by specific measures than by assertion of a general principle of age discrimination. In the other areas covered by the proposed anti-discrimination provisions we suggest that in general the Constitution should contain non-binding statements of objectives and give the Commission and member states the responsibility of introducing specific measures of implementation. We tentatively suggest that the relevant provisions of the Constitution should be as follows:

- it is an objective of the European Union to combat racism and to promote the development of employment opportunities for women and their access to positions of influence in politics, business and other areas of public life.
- freedom of expression, of religion, of political opinion, and of sexual orientation are fundamental values of the European Union.
- no citizen of the Union shall suffer economic disadvantage through exercising these freedoms, in areas unrelated to the practice or profession of such beliefs (this is an area where some discrimination is clearly appropriate.
- the member states of the Union shall promote economic and social opportunities for disabled people.

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The 2004 Enlargement: Key Economic Issues

1. Introduction

At their meeting in Copenhagen in December 2002 the EU heads of state decided to accept ten new countries as members of the European Union (EU) in May 2004. This enlargement is a very significant event in the history of the EU. The number of accession countries is large, as ten new members will join (the Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia). The earlier enlargements in 1995 and in 1981–86 involved only three countries each. The 2004 enlargement will raise the EU population to about 480 million people from the current 375 million in the EU-15 countries.

The 2004 enlargement will have major economic implications, and this chapter aims to provide a primer on key economic issues, including economic growth, the public sector, labour markets and social policies, as well as factor mobility and sectoral changes. Our discussion will review what different studies say about economic consequences of the enlargement.

The expansion of the EU has created, on the one hand, high hopes for fast economic growth and rising living standards among the new members and, on the other, has led to worries about the loss of jobs and higher unemployment in the EU-15 countries. Two simple indicators about differences in living standards and labour costs between EU-15 and new member states serve to illustrate the emerging economic pressures. These differences imply major challenges to economic policies.

Data on PPP-adjusted GDP per capita as a measure of living standards in Table 5.1 indicate that many of the new member countries are poor in comparison to the existing members. Latvia has currently the lowest GDP per capita among the accession countries (the ratio to the EMU average is 32.3 percent) while Cyprus has the highest GDP per capita (the ratio to the EMU average is 88.5 percent). The big differences in living standards can, for example, trigger significant migration from new members to EU-15 countries. Speeding up economic growth in the accession countries is obviously a major policy objective.

Table 5.1
GDP per capita, PPP 2001
(in thousands of current international $)

Latvia	7.73
Lithuania	8.47
Poland	9.45
Estonia	10.17
Slovak Republic	11.96
Hungary	12.34
Malta	13.16
Czech Republic	14.72
Slovenia	17.13
Cyprus	21.19
EMU	23.94

Note: PPP GDP is gross domestic product converted to international dollars using purchasing power parity rates. An international dollar has the same purchasing power over GDP as the US dollar has in the United States.

Source: WDI, World Bank.

As a second indicator of economic policy issues we briefly look at labour costs among the accession and present EU countries, measured at going exchange rates. Table 5.2 shows that hourly labour costs in the new member countries are only a small fraction of the corresponding costs in the present EU countries.[1] The wage gap is particularly large for those present EU countries that happen to neighbour on the accession countries, such as Austria, Finland, Sweden and, in particular, Germany. In West Germany, the hourly labour cost was about 26 euro in 2000,[2] which is nearly six times the Polish wage.

[1] Data on Malta is not available.
[2] IdW, "Deutschland in Zahlen", 2002.

Table 5.2
Hourly costs in the EU and in the accession countries (in EUR), 2000

Czech Republic	3.90
Cyprus	10.47
Estonia	3.03
Hungary	3.83
Latvia	2.42
Lithuania	2.71
Poland	4.48
Slovak Republic	3.06
Slovenia	8.98
EU-14	21.19

Note: EU-14 includes all present EU members except Belgium.
Source: Eurostat (2003a).

The wide gap in labour costs suggests that there are incentives for western firms to move the labour intensive parts of their production activities to the new member states, and in fact, there has already been a significant movement of western firms to the east. While the 1980s and 1990s have shown significant outsourcing activities of big European companies to east Asia, at present an increasing outsourcing activity of middle-sized and even smaller firms to Eastern Europe can be observed. For example, in a survey carried out by the Cologne Institute for Business Research, about 60 percent of the German firms with less than 5,000 employees had already established plants outside the EU, most of them in Eastern Europe.[3]

Besides growth, labour markets, and sectoral changes, the accession to the EU will have major implications for the public sector of the new member states. On the one hand, the new member countries will receive significant transfers from the EU budget. On the other hand, they will need to co-finance project-based transfers and pay their membership dues to the EU from the beginning. Moreover, compliance with the EU regulations, the *Acquis Communitaire,* will lead to additional public expenditure. The levels of public debt in the new member countries are currently low, but many of these countries have sizeable public deficits.

2. Economic growth

Following the difficult early 1990s, many of the new member countries have achieved relatively fast growth in recent years (see Table 5.3). For most accession countries, growth rates reached high levels as early as the second half of 1990s, but in the Czech Republic the difficulties with transition from a socialist system appear to have lasted longer, as growth became significantly positive only after 1999.[4] Most recently, as a result of the recession in the Western world, there has been a little bit of a slowdown in growth in some accession countries, whereas economic growth has continued at a largely unchanged pace in others.[5]

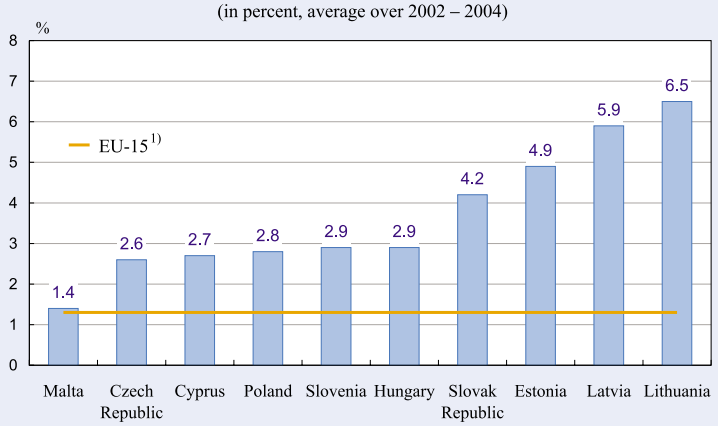
On the whole, the new member countries have been growing faster than most of the EU-15 countries. The relatively high growth rates in Figure 5.1 suggest that these countries have already been reaping some gains from closer integration with Western Europe. EU Eastern enlargement will trigger some further changes in growth and welfare in the accession countries and also small growth effects in the EU-15 countries, though these changes have already partly been taking place in recent years in the pre-accession process.

[3] IdW, *IW-Trends,* Dokumentation 4, 2002.

[4] It should be kept in mind that GDP per capita in the former socialist countries fell significantly in the early years of transition from socialism, so that for several countries the level of real GDP in 2001 was still lower than in 1989.
[5] Table A.1 in the Appendix gives key economic indicators for the new member countries.

Figure 5.1

ECONOMIC GROWTH IN ACCESSION COUNTRIES
(in percent, average over 2002 – 2004)



1) EU-15: 1.3 %. Gross domestic product weighted with members gross domestic product of 2002 in US dollars.
Sources: Eurostat, OECD, IMF, National Statistics Offices; 2003 and 2004: calculations by the Ifo Institute

There are two basic mechanisms whereby full EU membership contributes to improved economic growth in the accession countries. First, traditional trade effects of economic integration will occur through trade creation and trade diversion, of which the former is beneficial and the latter is harmful. Trade creation refers to increased trade generating new economic activity, whereas trade diversion refers to the redirection of existing trade as a result of changes in tariffs and other barriers due to the regional customs union.

Increased international trade will, in principle, also benefit current member countries, but this effect is much less certain, at least in the short and medium term, since it relies on the ability of the current member countries to react quickly to the changes in relative goods and factor prices that come with opening trade. (Moreover, the effect on the EU-15 will be small, given that the combined GDP of the entrants is only a small fraction of EU-15 GDP.) As Eastern Europe is capital-poor but labour-abundant, trade will require the relative prices of labour-intensive goods along with real wages to decline in the West and labour to move out of these sectors to more capital-intensive ones. If unions or social replacement incomes offered by the welfare state impede the necessary wage adjustments, unemployment may result instead of gains from trade. Among the current members, those bordering the entering countries will potentially receive the largest benefits in the long run, but they may also incur the largest adjustment costs in the short run.

Second, economic growth in the new member countries can receive a boost through movements of factors of production and other dynamic effects such as capital accumulation, technology transfer, increased competition and possible economies of scale. Movements of factors of production can lead diverse effects on growth, as they depend on the nature and direction of the factor movements. These movements have already been taking place in recent years, for example in the form of increased foreign direct investment in the new member countries.

Next, we shall discuss the effects on trade and growth more closely, after which scenarios for growth and convergence of the new member countries toward EU-15 average levels of GDP will be presented. We note that fiscal transfers to new member countries can also alter the picture of pure growth effects as they represent a benefit to entrants. The fiscal transfers are to a significant degree a consequence of full membership, though some transfers have taken place even before membership as pre-accession aid.

2.1 Growth and trade

Changes in international trade between countries are a major part of the effects of economic integration on GDP and welfare; see Frankel and Romer (1999) and references therein. The fall of the Iron Curtain led to major changes in trade. EU imports from the Central Eastern European countries doubled within the first five years of the transition from socialism. The EU-15 countries are by far the largest trading partner of the accession countries. For example, in 2001 about 61 percent of exports of the new member countries went to the EU (see Table A.1 in the Appendix). In contrast, the share of imports from the accession countries in total imports of the EU-15 is still relatively low, approximately 10 percent in 2001.

The trade effects of EU enlargement are likely to be different from those in the 1990s because significant reductions in trade barriers have already taken place before actual enlargement. The effects of the abolition of tariffs and the reduction in trade costs between EU-15 countries and the new member states are likely to be small for the EU-15, amounting perhaps to 0.05-0.1 percentage points cumulative changes in levels of GDP in a five-year period, according to Breuss (2001). This is because the entering countries are economically small in relation to the current EU-15.

For the accession countries, the trade effects are likely to be much bigger than for the EU-15, amounting perhaps to 1.2 to 4.3 percentage points of changes in GDP; see e.g. Breuss (2001) for a study using the OEF world macroeconomic model and for references to other studies.[6] The asymmetry is explained by the fact that, as noted above, the current EU countries are the largest trading partner of the new member countries, whereas the new member countries are a small trading partner for EU-15.

[6] Some estimates of the effects from trade diversion have also been made. Overall, the effects of Eastern enlargement on the rest of the world are small, but the effects from trade diversion can be significant in specific sectors, notably in textiles and agriculture; see Francois and Rombout (2001) for further discussion.

2.2 Estimated growth effects

Full membership is expected to accelerate economic growth via increased foreign direct investment (FDI), new trade within the enlarged EU, the aid from the EU budget, and other channels. However, it is not straightforward to disentangle the effects of full membership from the effects of increased integration that has already taken place at the pre-membership stage.

The empirical studies considering full integration of the accession countries into the Single Market of the EU employ either global computational general equilibrium models or global macroeconomic models for computing the growth effects; see e.g. Baldwin et al. (1997), Breuss (2001), Lejour et al. (2001), Fidrmuc et al. (2002) and the references therein. These studies suggest that the level of GDP in the accession countries will be significantly raised by the 2004 enlargement. For example, simulation results from a world macroeconomic model reported in Breuss (2001) suggest an up to 8 or 9 percent higher GDP over a ten-year period for some accession countries, with lower estimates for other entering countries. These estimates of GDP effects on the entrants translate into an increase in their growth rates by nearly one percent per year.

Even higher estimates of the effect of EU enlargement on growth in the Central Eastern European countries have been suggested in studies using the methodology of growth accounting. The growth effect might be as high as 1 to 2 percent per year; see European Commission (2001a) and Doyle et al. (2001).[7] Possible membership of the accession countries in EMU in the longer term could stimulate GDP per capita further through improved opportunities for trade and capital movements as a result of reduced exchange rate risks, increased competition and lower transaction costs.[8]

The effect on the GDP of current members is, at best, of the order of one tenth of the corresponding effect on the accession countries. Moreover, there are likely to be differences among the current member countries. The largest benefits will be received by countries having geographic proximity to and extensive trade links with the new members. Germany and Austria are examples of higher than average impacts.[9] However, as mentioned above, it is unclear when such benefits will occur. The available empirical results are based on general equilibrium models with instantaneous market clearing and flexible wages that are unable to capture the particular difficulties facing economies whose labour markets are restricted by large welfare states and powerful unions. By their very nature these models are unable to foresee the transitional difficulties such economies might have before they are able to reap textbook gains from trade.

More generally, the growth benefits from joining the Single Market will not be uniform across countries and regions. There will probably be significant differences between countries, with the Central Eastern European countries having possibly the largest growth benefits. In addition, experiences from the transition period, during which there has already been significant partial integration of Eastern European countries into the Western world, suggest that close-to-border regions and regions around national capitals are likely to be the greatest beneficiaries in the process of further integration. Not only geography but also foreign direct investment and a high level of education are apparently the keys to regional and country success; see Tondl and Vuksic (2003).

2.3 Growth scenarios for new member countries

The slowness of the growth and catching-up processes is an important point that is often forgotten in popular discussions of the benefits from the 2004 enlargement. We illustrate the long period of time needed in the catching-up towards the EU-15 average by two simple simulations of per capita GDP levels and labour costs of the new member countries.[10]

The computations assume that the income per capita difference between the EU-15 and the respective acceding country will shrink by two percent every year. This is in accordance with the estimates in Chapters 11 and 12 of Barro and Sala-i-Martin (1995), although the actual convergence rate was

[7] More generally, panel-structured growth accounting estimates suggest that membership in the EU has positive effects on economic growth through closer integration and possibly institutional change; see Crespo-Cuaresma et al (2002) for estimates and discussion.
[8] The estimates of the growth effects of a common currency are subject to disagreements due to different measurement methodologies; see for example Persson (2001), Rose (2000, 2001) and Micco et al. (2003).
[9] Keuschnigg et al. (2001) point out that Germany is likely to have gains from the enlargement even after accounting for the increased budgetary costs via contributions to the EU budget. See Fidrmuc et al. (2002) for results on Austria.
[10] See for example Sarajevs (2001) and European Commission (2003b) for other scenarios.

even lower in the period 1963 to 2000, which was only 1.1 percent; see Sinn and Ochel (2003).

Table 5.3 gives the relative levels of per capita income and labour cost for the years 2010, 2020 and 2030. We emphasize that the quantitative results must be viewed with extreme caution since they are based on strong assumptions and a mechanistic projection. Despite their limitations, the scenarios convey the important lesson that catching up with EU-15 will take several decades for most accession countries even under the optimistic assumption that EU membership is consistent with a two percent annual convergence rate, which is above the rate so far observed.

Cyprus and Slovenia have the shortest catching-up periods, but even for them it will take, respectively, 10 and 30 years to reach 90 percent of the EU-15 level of per capita GDP. Under the more realistic present convergence rate, it would take even longer. At the other extreme, several countries, including Poland, and the Baltic countries, will need 10 to 20 years to reach even 50 percent of the EU per capita income level. Achievement of fast economic growth must therefore be a major item on the economic policy agendas of the new member countries.

Table 5.3 a

Convergence in per capita income (PPP)

	2001	2010	2020	2030
Latvia	32.2	43.5	53.8	62.3
Lithuania	35.3	46.1	55.9	64.0
Poland	39.4	49.5	58.7	66.3
Estonia	42.4	52.0	60.8	67.9
Slovak Republic	49.9	58.2	65.9	72.1
Hungary	51.5	59.6	66.9	73.0
Malta	54.9	62.4	69.3	74.9
Czech Republic	61.4	67.8	73.7	78.5
Slovenia	71.5	76.2	80.6	84.1
Cyprus	88.5	90.4	92.1	93.6
EMU	100	100	100	100

Table 5.3 b

Convergence in labour cost (% of EU average)

	2001	2010	2020	2030
Latvia	10.9	25.7	39.3	50.4
Lithuania	12.2	26.8	40.2	51.1
Estonia	13.6	28.0	41.1	51.9
Slovak Republic	13.7	28.1	41.2	52.0
Hungary	17.2	31.0	43.6	53.9
Czech Republic	17.5	31.2	43.8	54.1
Poland	20.1	33.4	45.6	55.5
Slovenia	40.4	50.3	59.4	66.8
Cyprus	48.4	56.9	64.8	71.2
EU	100	100	100	100

Note: The assumption underlying these simulations is that the difference in the levels of per capita income and labour cost will shrink by two percent every year.

Source: World Bank, WDI, Cologne Institute for Business Research and own calculations.

3. Fiscal aspects of enlargement

3.1 Sustainability of public finances

We start by considering the public finances in the accession countries. Figures 5.2 and 5.3 show the development of public sector deficits and debt for the period 2001–2003.

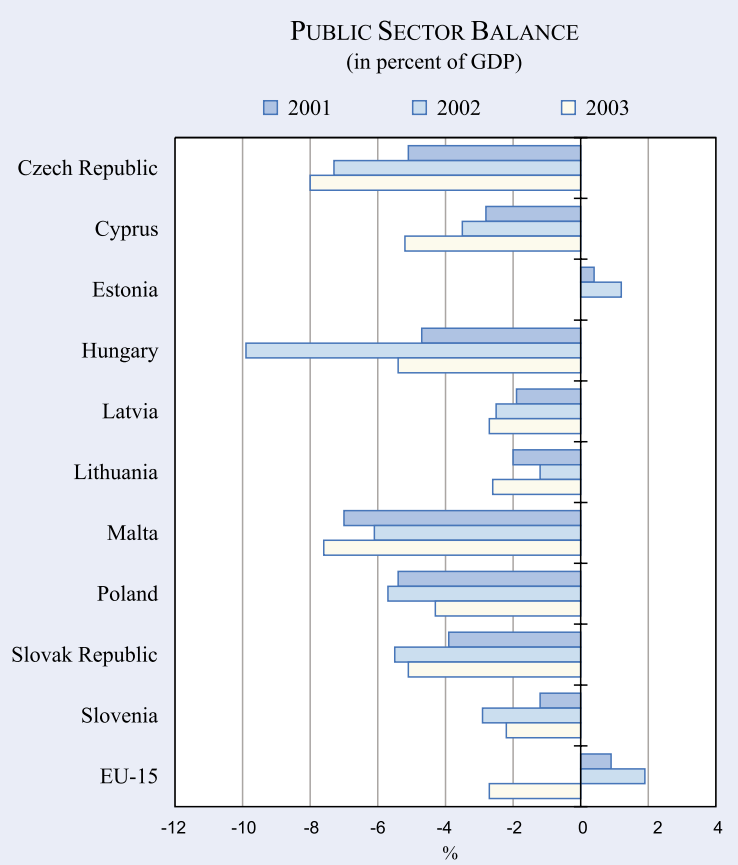
Table 5.4 indicates that interest rates for long-term bonds have been relatively high for most entering countries.

It is evident that public finances are fairly delicate for many of the entering countries. It is anticipated that problems of fiscal balance will continue in the future; see for instance European Commission (2003b) for such forecasts. The new member countries are in quite different situations with respect to current public sector balances. Some countries face severe problems, while public deficits are moderate for other countries, with Estonia even running a surplus.

The levels of public debt are relatively low (Figures 5.2 and 5.3). In terms of the level of public indebtedness, the entering countries are generally in better shape than most of the EU-15 countries.[11] Only Cyprus and Malta are above the Maastricht limit of 60 percent and even

[11] See also Chapter 2 of the 2003 EEAG report for data and discussion of public debts and deficits of the EU-15 countries as well as of the accession countries.

Figure 5.2



Sources: European Commission, European Economy, Autumn 2003.

their debts are not very far above the limit. The currently low levels of public debt are, however, not that convincing as several entering countries are running large public sector deficits, though there are also countries with a much better fiscal situation (Figures 5.2 and 5.3). The highest forecasted figures for 2003 are 8.0 and 7.6 percent deficits in the Czech Republic and Malta, respectively. Moreover, the entering countries will greatly need to increase their public spending, e.g. to improve their public infrastructure.

On the whole, the accession countries have not been successful in improving their public finances. In the period 2000 to 2002 the deficit levels have been constant or slightly increasing for many of the entrants as a result of the economic slowdown, though a few countries, notably the Baltic countries, have succeeded in improving their public sector balances despite the slowdown. The European Commission (2003b) forecasts that public sector deficits will continue to be a problem in coming years for several of the new member countries. Unless public sector deficits are brought under control, the sustainability of public debt can become a major problem for some of the new member states in the longer term.

3.2 Enlargement and the EU budget

The EU-15 member countries have to finance the additional expenditures in the EU budget that are not covered by the contributions of the new members. The latter contributions will, however, be small in the aggregate, though not so small in terms of the GDPs of the entrants, which is of the order of 1.2 percent of their GDP; see Backe (2002) and Richter (2003b).

The burden of the enlargement on the EU budget for the EU-15 members has been estimated to be small, perhaps of the order of 0.2 percent of GDP, though for the southern European countries the costs (relative to GDP) are likely to be higher due to a reformulation of the structural funds programme; see Breuss (2001).

After enlargement, over 14 percent of the EU budget will go to the ten accession countries.. Table A.2

Table 5.4

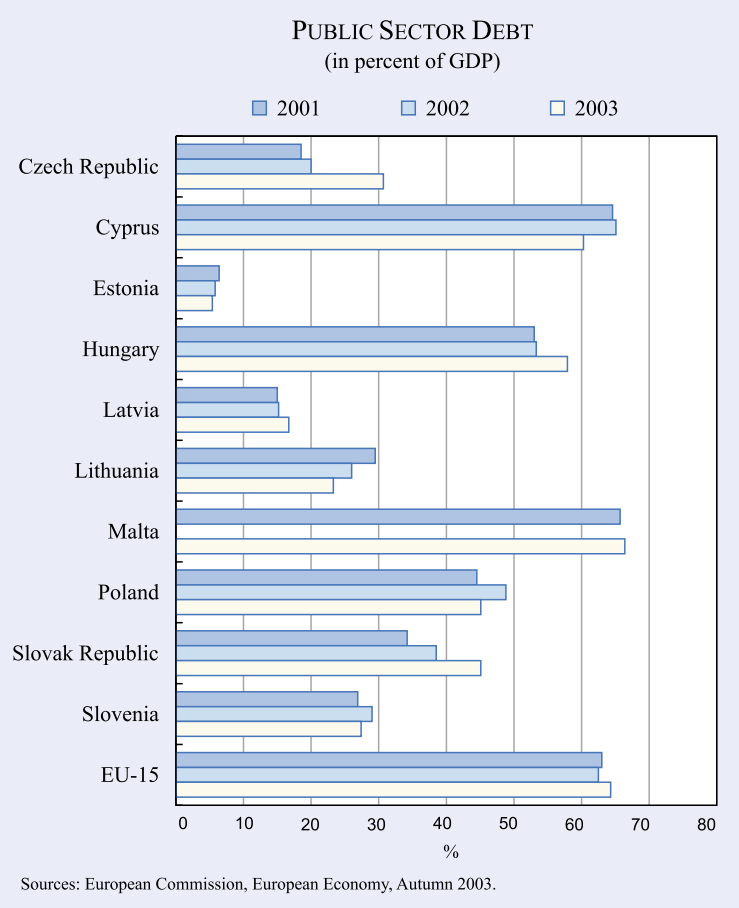
Long-term interest rates in percent

	2000	2001	2002
Czech Republic	6.9	6.3	4.6
Cyprus	7.6	7.7	5.4
Estonia	3.8	4.0	2.7
Hungary	8.6	7.9	7.1
Latvia	7.8	7.5	5.3
Lithuania	11.5	7.3	6.0
Malta	5.8	6.1	5.7
Poland	11.8	10.7	7.3
Slovak Republic	8.3	8.1	6.9
Slovenia	4.7	4.6	3.4
Euro area	5.4	5.0	4.9

Note: long-term or medium-term government bonds. Estonia: Commercial bank deposit rates; EU: weighted average using GDP; Euro area: From January 1999, weighted by the nominal stock of government bonds.

Source: Eurostat,"Money, Finance and the Euro," European Commission, Luxembourg.

Figure 5.3



Sources: European Commission, European Economy, Autumn 2003.

in the Appendix provides the data on the amounts of the EU budget that are appropriated to the new member countries for the years 2004 to 2006. (In EU jargon "appropriations for commitments" refer to maximal allocations in the EU budget. The *ex post* amounts will usually be smaller than the appropriations since, for example, some of the items require a project.) The appropriated amounts for the new member countries range from 6.9 to 1.7 percent of the GDP of each recipient country. Table A.3 shows the appropriations to the new members as part of the EU budget, expressed as fractions of the total EU budget.

3.3 Effects on the new member countries

The new members will be recipients of significant funds from the EU budget, as indicated by Table A.2 in the Appendix. Total receipts as a percentage of the GDP of recipient countries vary inversely with the level of GDP. Structural assistance to public infrastructure, transport, the business sector and education are a major item in the EU support, with, for example, Latvia receiving 4.4 percent of its GDP as support for structural actions. Agriculture is another major item of support from the EU budget to the new member countries: entering countries will receive from 1.7 percent (Lithuania) to 0.3 percent (Cyprus and Malta) of their GDP as support for agriculture. We will discuss agriculture further in Section 5.

Several further considerations are pertinent in assessing the data in Tables A.2 and A.3. First, a significant part of the appropriations will be project-related, and it is probable that some projects will not go through. Thus, in reality net transfers are going to be smaller than the appropriations, though precise estimates are not easy to obtain. By making specific assumptions about "success rates," Richter (2003b) estimates that the actual transfers might be around 60 percent of the appropriations. He suggests that the net transfers from the EU to the new member states might be just a little over one third of the gross figures in Tables A.2 and A.3.

Second, the entering countries will have to co-finance the EU-funded structural operations to a significant extent. This will be a burden on government budgets in these countries unless there is substitution between the co-financing and existing national public spending. On the other hand, the additional infrastructure investments are likely to stimulate growth in the entering countries. Estimates of these two effects vary a great deal. Moreover, differences in opinion exist about the adequacy of public infrastructure in terms of both quantity and quality (see Funck 2002 and Backe 2002 for further discussions).

The reform of public administration and *acquis* implementation is another source of costs and benefits to the government budgets in the entering countries.[12] In particular, the costs of environmental pro-

[12] Funck (2002) provides a detailed discussion and estimates of costs and benefits. Young and Wallace (2000) assess the enlargement and the politics of EU regulatory policies.

tection have been viewed as a major expenditure item. The European Commission (2001b) provides information on the relevant aspects of environmental financing and the state of the environmental infrastructure in the accession countries. A variety of estimates have been made of the budgetary implications in adopting EU environmental regulations, with the initial high estimates becoming more moderate in recent times. In individual cases the costs of regulatory compliance can be high. An example is Estonia, for which the annual compliance costs have been estimated to be of the order of 4 to 5 percent of GDP, mostly resulting from meeting environmental regulations. This estimate for Estonia is in marked contrast to general estimates that are in the range of 0.5 to 1.9 percent; see Backe (2002). Transport is another item of public infrastructure,[13] for which the compliance costs are likely to be significant; see Kopits and Szekely (2002) and Funck (2002).

The recent Comprehensive Monitoring Report by the European Commission (2003c) points out numerous difficulties in the progress towards implementing EU regulations in the new member countries. The failures of fulfilment can even risk reductions in EU aid to some entering countries. Another concern is the continued existence of corruption in several entering countries even if progress has been made in reducing it; see European Commission (2003c) for further discussion.

Additional budgetary costs or savings to the entering countries arise from realignment of customs duties, tax harmonization and phasing out of production subsidies. Most entering countries have higher customs duties than EU-15 members and the loss in this revenue item can be up to 0.5 percent of GDP for some entering countries. However, for Estonia there is an estimated revenue increase of the order of 0.2 percent of GDP, since customs duties there will have to be raised after EU entry. With respect to tax harmonization it is estimated that there will be a small positive revenue effect, perhaps 0.5 percent of GDP of the new member states. Similarly, the elimination of production subsidies will have a positive budgetary effect, as they will be phased out gradually. A case in point is the banking sector. Some of the accession countries are still struggling with reducing the subsidies to the banking system that are a legacy of the banking crises in the early years of transition (see Backe 2002, Römisch 2003, Funck 2002, and Kopits and Szekely 2002 for further discussion).

[13] For example, road improvement for heavy trucks will need to be done.

3.4 Further indirect effects

The 2004 enlargement will induce indirect effects on the economies of the entering countries, which will in turn have implications for the government budgets. As discussed in Section 2, full EU membership is likely to stimulate economic growth in the entering countries. The projected increases in growth will lead to some improvements in the government budgetary balances of these countries. The magnitude of these budget effects depends on the size of the positive growth effect. The budgetary improvement could be significant, of the order of 0.4 percent of GDP; see Backe (2002).

In addition to growth effects, structural reforms as a result of EU membership can yield some improvements in government budgetary balances, but these effects are difficult to separate from the growth effects. EU membership will also bring benefits in the form of reduced interest rate risk premia and increased FDI, though these have to some extent been anticipated before the entry itself. Finally, with EU membership, the entering ten countries will face some tax competition, for example in the taxation of capital. This can, in principle, exert a negative effect on their government budgets. However, since the relevant effective taxes in the entering countries are usually lower than in the current EU-15 members, the downward pressure on the tax rates of the entrants is likely to be small if not non-existent.

The following table summarizes the estimated medium-term fiscal effects of EU membership on the entering countries; the estimates are from Backe (2002).

Table 5.5 suggests that the fiscal effects from EU membership are likely to be somewhat positive in the medium term. In the short run, there will most likely be fiscal strains on the entering countries, as the positive indirect effects will emerge only gradually. Moreover, the magnitude of the indirect effects will depend on the size of the positive growth effects of EU membership.

3.5 Other pressures in the public sector

Recent data on the new member countries indicate that, on the whole, the countries have not cut their public expenditures. In addition to expenditure needs that arise from joining the EU, the new member states will need to reform the structure of their

Table 5.5

Fiscal effects of EU membership
(medium-term annual effects on the fiscal balance of entering countries)

	% of GDP
Direct effects	
Contributions to EU budget	-1.0 to –1.2
EU structural operations	-0.9 to +1.3
Infrastructure expenditure	?
Admin. reform and *acquis* implementation	+/- 0
Realignment of customs duties	+0.2 to -0.5
Tax harmonization	+0.5
Phase-out of production subsidies	+0.2 to 2
Indirect effects	
Positive growth effects	0 to +1
Structural reforms	+ (minor)
Tax competition	- (minor)
Reduced risk premia	+ (anticipated)

Source: Backe (2002).

public finances to achieve rapid growth. In comparison to the EU-15 countries, the entering countries have relatively high rates of consumption taxes, similar levels of labour taxation and relatively low taxes on capital and corporations; see Römisch (2003) for a description and estimates of statutory and average effective rates.

Pension reforms have been undertaken in some but not all of these countries. In particular, the Czech Republic, the Slovak Republic and Slovenia have not undertaken major reforms and are facing sustainability pressures, whereas concerns about the sustainability of the pension system are gradually subsiding in other countries (Estonia, Latvia, Hungary and Poland); see Funck (2002, 71–83) for a detailed discussion.

A more universal issue is the need for reform of the education systems in the accession countries. School age populations and to some extent school enrolment in the accession countries (excluding Cyprus and Malta) have fallen and are projected to fall further. Performance in terms of recent international comparisons does not seem to be very good. For example, the PISA results for some accession countries were below the OECD average in 2000 and there is some evidence of a fall in the test scores over time; see Funck (2002, 37–39) for a discussion of the indicators. Improving the ability of the education system to match the changing structure of skill needs is a central element in the challenge of economic growth in the future; Landesmann (2003) provides some evidence on changing skills.

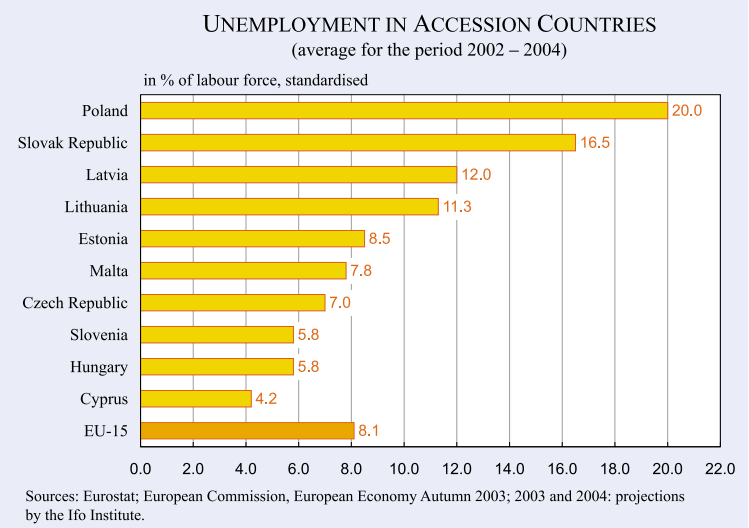
Some other areas of public spending also face major needs for reorientation and restructuring. Transport industries, for example railways and utilities, are such areas. Cost-benefit analyses of transport infrastructure investments would be important, as there can be a tendency to favour new big projects such as new motorways at the expense of road maintenance and improvement that may in fact yield higher rates of return. Improvement also appears possible in the social services sector, which appears to have too much manpower. Here improvements in the productivity and efficiency of health care are a significant issue given that health care is a major item of social spending. The modernization of social services and education can also lead to demands for increased wages, which can create another pressure on public finances unless reductions in manpower are carried out in conjunction with reforms in these sectors.

4. Labour markets and social policies

4.1 Employment and unemployment

Figure 5.4 indicates that there are wide disparities in the unemployment rates among the entrants. For

Figure 5.4



Sources: Eurostat; European Commission, European Economy Autumn 2003; 2003 and 2004: projections by the Ifo Institute.

Table 5.6
Employment rate in accession countries
(employment in percent of population, 15 to 65 years)

Age limits 15 to 65	
Czech Republic	71.4
Cyprus	69.7
Estonia	70.8
Hungary	60.2
Latvia	67.6
Lithuania	71.0
Malta	n.a.
Poland	65.8
Slovak Republic	69.7
Slovenia	68.0
EU	63.2

Source: Eurostat (2003d), German Statistical Office (2003).

some countries unemployment is, in fact, lower than the EU-15 average, whereas other entering countries have quite high unemployment. The 2003 unemployment rates range from the high 20 percent for Poland to the low figure of 4.2 percent in Cyprus.

The relatively high unemployment rates indicate that there is potential for higher output in the accession countries. Employment rates in the accession countries are relatively high, though there is quite a lot of variation among countries. Growth of employment in the new member countries has been fluctuating and it has not been very high on average. Hungary and Slovenia are to some extent exceptions.

Labour markets in both the entering and the EU-15 countries are likely to face major challenges as a result of the 2004 EU enlargement even if transition periods will make the effects more gradual than would an immediate liberalization. Box 5.1 outlines the transition agreements.

The movement of labour and capital among countries can enhance economic efficiency when it corresponds to comparative advantages of the different economies. These efficiency gains may not be realized if the functioning of labour and product markets in EU-15 and entering countries is not sufficiently smooth.[14] In any case, the efficiency gains will take a long time to realise and different sectors may well experience different patterns and speeds of adjustment. Some results suggest that convergence takes place mostly in services whereas traditional manufacturing will experience only very slow change; see Stehrer et al. (1999). If possible gains do not accrue equally to different parts of the labour force, political and social opposition to these impacts of the 2004 enlargement can be induced.

[14] The establishment of NAFTA, especially the increased prosperity of the US-Mexican border areas, indicates that increased integration need not lead to unemployment and other adverse effects when the labour markets are flexible; see e.g. Hanson (2001).

Box 5.1
Transition periods in labour mobility and social policies

The enlargement treaties give individual countries a possibility to introduce transition periods during which mobility of people from the new member countries to Western EU countries can be limited. Each country can decide whether it adopts the transition arrangements. The general rules for transition periods are:

Free movement of people
The following measures apply to all acceding countries except Cyprus and Malta.

- During a period of two years, national policies will be applied by current members to new member states; they may result in full labour market access depending on how liberal the measures are.
- Before the end of the second year after accession an automatic review by the Commission will be held and upon request by a new member state a further one. The decision whether to apply the *acquis* is left to the current member state.
- After five years the transitional arrangement should in principle end; nevertheless it may be extended by two more years in the member states in case of serious labour market disruptions.
- Up to the end of the seventh year safeguards may be applied by member states.

Austria and Germany are allowed to apply specific national measures in certain critical service sectors. There is also a safeguard clause for Malta.

EU-15 countries are currently deciding on the application of the transition periods. Austria, Finland, France and Germany have decided to adopt them, while Sweden has not yet made a decision. Some other countries, including the UK, that are not bordering the entrants, have decided against transition periods.

Further information: European Commission: Report on the results of negotiations on the accession of Cyprus, Malta, Hungary, Poland, the Slovak Republic, Latvia, Estonia, Lithuania, the Czech Republic and Slovenia to the European Union.
http://europa.eu.int/comm/enlargement/negotiations/pdf/negotiations_report_to_ep.pdf

The wage determination process is also likely to change with tighter product market integration, leading to some wage moderation in the current EU countries and possibly higher average levels of employment.

The 2004 enlargement will affect the structure of labour demand as well as industrial location in both current and new member countries. Low-skilled manufacturing jobs and industry will probably relocate to some extent to the accession countries. In addition, there will be both low and high-skill labour migration from the accession countries to the current members.

Table 5.7

Gini coefficients for EU and acceding countries

Country	Survey year	Gini coefficient
Czech Republic	1996	24
Cyprus	1997	29
Estonia	2000	36
Hungary	1998[a,b]	24.4
Latvia	1999	31
Lithuania	1999	31
Malta	2000	30
Poland	1999	28
Slovak Republic	1992[c,d]	19.5
Slovenia	1999	22
EU-15[e]	1999	29
EU range		23-34

Notes: a. Refers to expenditure shares by percentiles of population, b. Ranked by per capita expenditure, c. Refers to income shares by percentiles of population, d. Ranked by per capita income, e: The EU average is calculated as a weighted average of national results (where each country receives a weight that equals its total population).

Source: World Bank: World *Development Indicators 2002*; Eurostat (2003b) and (2003c).

Both developments will incur substantial difficulties for a number of the existing EU countries, and they will challenge the flexibility of their political systems. Currently, the wages of low-skilled workers are rather high in the West, as they are supported, among other things, by high replacement incomes provided by the welfare state. If these replacement incomes remain as high as they are, the speed at which manufacturing industries in the West will have to give way may be excessive, and the risk that too few jobs in the service sectors will be created will be substantial. Unemployment could increase. To prevent such a development, it is desirable that the West European welfare states overhaul their welfare systems to allow for the necessary flexibility of wages for low-skilled workers.[15]

4.2 Income inequality

Table 5.7 presents data on income inequality (measured by the Gini coefficient).[16] Two characteristics stand out. First, overall the degree of income inequality in the entering countries is similar to that in the EU-15 countries. Second, there is significant variation in inequality among countries. Among the new member states, the Slovak Republic and Slovenia have the most egalitarian income distributions.

Following the well-known Kuznetz Curve hypothesis, it is often suggested that over time income inequality follows a hump-shaped curve, so that it initially tends to increase and then decrease as countries grow rich.[17] If this hypothesis is true, some increase in income inequality in the new member states is likely to occur. This is all the more probable in the Eastern European and Baltic countries, as trade unions there are weak and collective bargaining is of limited importance and takes place at the firm level if it occurs. However, at this stage of development this increase in income inequality may be beneficial for employment growth in these countries.

4.3 Migration of labour to EU-15 countries

It has been estimated that opening of borders as a result of the enlargement will lead to increased migration of labour from the new member states to the EU-15 countries. This migration process is likely to have very differential impacts on different EU-15 countries, with countries close to new member states, like Austria and Germany receiving the biggest impacts. Belgium, Denmark, Finland, Greece and Sweden may also be affected to a significant degree. It is anticipated that the time pattern of the migration of labour will be hump-shaped with increasing magnitudes in the early years due to learning effects and tapering off late in the current decade.

[15] In our first report, EEAG (2002), we designed a system of employment tax credits as activating social aid that provides for such flexibility and that allows the western countries to capture the potential gains from trade in an enlarged Europe.

[16] See for example Deaton and Muellbauer (1980, 232–237) for a definition and discussion of the Gini coefficient and other related measures of inequality.

[17] See Aghion and Williamson (1998) for a discussion and critique of the Kuznetz curve hypothesis.

According to the estimates provided by the European Commission (2001a), the cumulative migration potential in the five-year period 2005 to 2009 could amount to 1.2 percent of the population in the acceding countries and 0.35 percent of the working population in the EU-15 countries. These estimates are based on the study by Boeri and Brücker (2000), but that study filters out the cross country information on economic migration stimuli and infers its long-run migration estimates from observing migrants' previous responses to business cycle variations.[18] Another study by Sinn et al. (2001) comes up with higher estimates for the migration potential in the order of 4 to 5 percent of the population in the acceding countries over a period of 15 years, which corresponds to a migration of roughly 1.5 to 2 percent of the population of the acceding countries within the first five years.[19] Whatever the true migration potential, actual migration will, in all likelihood, be smaller than these estimates of migration potentials simply because the EU has already envisaged administrative constraints on the possible number of migrants (see Box 5.1). There is no study we know of that dares to predict the volume of migration under these constraints.

The structure of migration is an additional issue even if it is difficult to obtain quantitative estimates of it. A first distinction is between short-term and permanent migration. It is anticipated that there will be significant temporary migration – even commuting – into EU-15 countries bordering some of the new member states. Cross-border provision of services is likely to increase as a result of free mobility of labour once any transition restrictions are abolished.

A second distinction concerns the skill level of the migrants. The old impression that migrants move from relatively high positions may be true, but in many cases the jobs taken in the receiving countries will have a lower qualification level than the jobs the migrants left behind. Using different studies, the European Commission (2001a) quotes the estimate that 12 to 14 percent of westbound migration after 1989 has been highly skilled, comprising managers, scientists and students. If these estimates are of any guidance about the future, it seems that the new member countries will face some brain drain.[20]

[18] See Sinn and Werding (2001).
[19] Sinn et al. (2001).
[20] According to the EEAG (2003, Ch. 5), the issue of a brain drain from Western Europe to North America is currently a concern. A similar brain drain to Western Europe can become a concern for the new member states.

The migration scenarios just discussed can perhaps be summarized as indicating that the 2004 enlargement will induce a non-trivial amount of labour migration, which will lead to downward pressures and possible unemployment of blue-collar manufacturing workers and of unskilled labour in services in the EU-15 countries. Moreover, it is likely that a relatively high proportion of the migration from the new member countries will go to Germany and some other countries that are geographically close to the entrants. Thus far, two thirds of east European migrants into the EU have moved to Germany, and one third has spread over all other EU countries.[21] Unemployment in the latter countries can increase as a result of the migration, which will put pressure on their welfare systems.

Referring to experiences from the 1980s' EU Southern enlargement, which did not lead to very large migration flows, Boeri et al. (2002) suggest that, while migration after the 2004 enlargement will be significant, the impact on the labour markets of the EU-15 countries will nevertheless be fairly moderate. One should note, however, that Eastern enlargement differs substantially from Southern enlargement. First, while Portuguese and Spanish wages averaged about one half of west German wages at the time of accession, the average wage of the Eastern countries is about one sixth of German wages, both measured at going exchange rates. Second, while the Iron Curtain and subsequent legal migration constraints by Western EU countries have prevented mass migration before accession, the Iberian countries had experienced mass emigration before accession. From 1960 to 1974, the time when the Iberian dictatorships ended, and EU membership was applied for (1975), net cumulated emigration from Portugal and Spain had been 5.5 percent of the joint population of these countries despite a simultaneous re-migration from overseas territories. This crucial difference should not be overlooked when forecasts about migration from Eastern Europe are made.

4.4 Social policies towards labour

As was already noted, the functioning of the EU-15 labour markets is a key issue in dealing with the labour market impacts of the 2004 enlargement. It is often argued that, in the EU-15 countries, labour markets are relatively rigid due to fairly high levels

[21] See Ochel (2001).

of employment protection. Measures to increase labour mobility and wage flexibility would facilitate the adjustments that are needed in EU-15 countries in response to the 2004 enlargement. The major policy objective will be the enhancement of labour mobility between different sectors and types of jobs in the economy.

The challenges will be partly different for the new member states. They are in general likely to benefit from enhanced economic opportunities and faster economic growth. However, the question of labour mobility is also a concern for the new member states since their economies are likely to face major structural change as a result of EU membership. The current high unemployment in several accession countries suggests that labour markets in these countries are not functioning well even though wages are determined in a decentralized manner.

Labour market policies that increase employment protection reduce labour mobility; see Chapters 2 and 3 and also Chapter 6 in EEAG (2002). Similarly, mobility can be decreased by social replacement income schemes. Such schemes play a valuable role in providing insurance against adversity, in particular the incidence of unemployment, but the design of these schemes implies a trade-off between the insurance rationale and the negative effects on labour mobility. The EU-15 and the accession countries face very different pressures as regards these labour market policies. The former will need to restructure employment protection arrangements. In contrast, the latter countries will probably face pressures to introduce some policies of employment protection, at least when these countries grow richer and begin to build up their welfare states. Premature introduction of labour market policies can be dangerous for the accession countries as it can slow down the required labour mobility and structural change.[22]

Different measures of labour market regulation for income protection are to an extent substitutable: a lower level of employment protection could be compensated by more generous temporary unemployment insurance and in-work benefits. Retraining schemes and better incentives for life-long learning to educate people in the middle of their working life are another set of measures that improve labour mobility. These kinds of measures will be important in the current EU-15 countries since the low-skilled workers are likely to be hit hardest by the 2004 enlargement even if transition periods will smoothen the effect of labour competition from the entering countries. Chapters 2 and 3 in this report provide more complete discussions of appropriate policies to enhance the functioning of EU labour markets.

Other social policies to mitigate labour market and regional effects of enlargement will rely on more general transfers and other measures. These will be politically important since the impacts of the 2004 enlargement on different sectors and regions will differ a great deal. On the one hand, some regions and sectors in EU-15 will receive aid to combat economic decline. On the other hand, there will be pressures to provide aid to the poorest regions in the entering countries. Redistribution schemes between regions and countries are going to be the subject of debate as a result of the enlargement.[23] Building up social safety nets will probably be a policy concern in the new member countries. An important consideration for safety nets is the creation of a system of "welfare to work" in order to increase employment in the entering countries (see Chapter 6 of EEAG 2002 for a further discussion of welfare to work). The proposal relies on a system of employment tax credits to enhance work incentives.

It is often suggested that the EU structural funds play an important role in facilitating the growth and convergence processes that were discussed in Section 3 above. The efficiency of the EU structural programme has been questioned in a number of studies; see the discussion in Boeri et al. (2002). The empirical findings have given rise to a fair amount of controversy, which suggests that the structural funding programme must be implemented with great care.[24] Some measures are likely to be beneficial, while the effect of others is more questionable. Education is perhaps the clearest example of where EU-level aid can be helpful in promoting growth and thereby in mitigating social problems. Other items such as infrastructure investment can also be useful at least in cases where the region or country has deficiencies in its infrastructures.

[22] See Sinn and Ochel (2003).

[23] See Ingham et al. (2002) for an overview of regional policies and further discussion.

[24] The empirical assessment of such programmes is subject to a number of econometric issues that have not been fully solved; see de la Fuente (2000).

5. Capital mobility and selected sector issues

Data on the current accounts of the new member countries are presented in Figure 5.5. Evidently, current accounts are in deficit in the new member countries. This is not surprising, given that these countries are amidst a catching-up process with Western Europe. Domestic savings have not been sufficient to finance the relatively high levels of investment required for rapid economic growth. The saving-investment gap has necessitated the financing of investment by foreign funds and, as will be discussed below, there has already been quite significant FDI into the entering countries during the transition process in the 1990s.

Current account deficits in the accession countries are a symptom of both large financing needs for enhancing economic growth as well as possible problems in domestic financial intermediation. Current account deficits can be sustainable if economic growth takes place at a rapid rate. However, if growth starts to slow, then deficit countries become vulnerable to capital inflows, which could trigger exchange rate instabilities and macroeconomic fluctuations. This is discussed at length in Chapter 6. Countering such instabilities would require flexibility in macroeconomic policies, and countries with large public deficits would need to rely on monetary and exchange rate policies.

5.1 Capital movements

Besides international trade, capital movements are another major element of the benefits from European integration. Capital movements are a potentially important source of growth for new member countries. In general, the 2004 enlargement is likely to reduce industry risk premia for FDI into the entering countries, which is likely to promote FDI. Direct investment in Eastern Europe has already taken place on a large scale.[25] As was mentioned above, firms from the old member countries have already moved labour intensive parts of their intermediate product chains to Eastern Europe. The process is particularly pronounced in west Germany where even many the small and medium-sized firms have sought to preserve their competitiveness by shifting activities to Eastern Europe and other parts of the world.

Table 5.8
Foreign direct investments in accession countries (in percent of GDP – 1998 to 2002 average)

	1998 to 2002
Czech Republic	9.2
Cyprus	6.2
Estonia	8.1
Hungary	3.7
Latvia	4.9
Lithuania	5.1
Malta	14.0
Poland	4.0
Slovak Republic	8.0
Slovenia	3.3

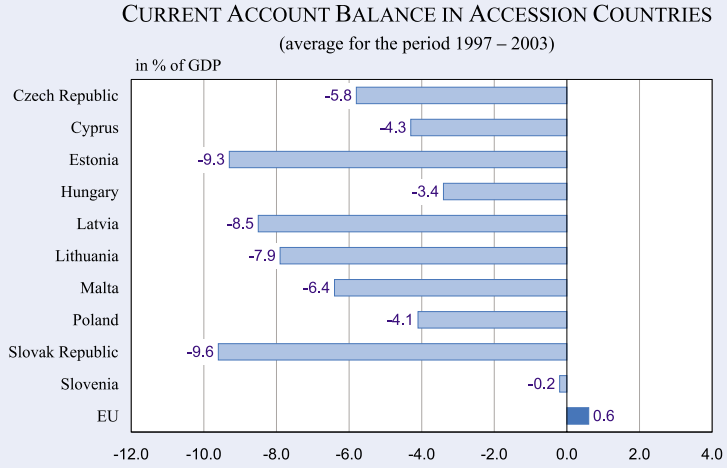
Notes: For Malta the average is calculated for the period until 2001; figures used for 2002 (also 2001 for the Slovak Republic and 2002 and 2001 for Cyprus) are provisional.

Source: Regular Reports 2002 and 2003; http://europa.eu/enlargement/report2002/; http://europa.eu/enlargement/report2003/;

FDI involves the establishment of new plants as well as acquisitions of existing firms in the entering countries.[26] Data on FDI into the new member countries are presented in Table 5.8.

A notable feature of capital flows is that they, at least for Central Eastern European and Baltic countries, predominantly take the form of private FDI. In the early years of transition, the privatisation activities were

Figure 5.5



Sources: EBRD Transition Report 2003; European Commission, European Economy Autumn 2003; own calculations.

[25] See Sinn (2003).
[26] The studies in Alessandrini (2000) provide further details on FDI from EU-15 into Central and Eastern Europe.

apparently a key factor behind the FDI flows. However, the connection between privatization and FDI has become much less pronounced in recent years, which suggests that mergers and acquisitions might be playing an increasing role in FDI inflows; see European Bank for Reconstruction and Development (2003) for further discussion. Capital outflows from the accession countries are currently very limited, but there is some potential for increase, which might be of some importance to those EU-15 countries that border on the new member countries.

With the exception of Slovenia, the entering countries have largely liberalized their capital movements in advance of integration into the EU. There have been significant differences among the entrants in the timing of the liberalization; see Buch (1999). For example, Estonia liberalized capital account transactions as early as 1994. In general, it is difficult to separate the impact of EU membership from the effects of "announcements" and from liberalization measures that have been taking place ahead of actual membership.

Buch (1999) considers the correlation between national savings and investment and finds that, in the period 1991 to 1997, the degree of capital mobility for several of the Central Eastern European countries is of a similar order of magnitude to those of Southern European countries (Greece, Portugal and Spain).[27] Moreover, looking at time series, it appears that EU membership of the Southern European countries had differing effects on capital mobility. There were significant positive effects on capital inflows to Portugal and Spain, whereas the change in capital inflows to Greece was much less pronounced (with even a decline relative to GDP). Breuss (2001) estimated that, with full EU membership, FDI into Central Eastern European countries could increase by up to 1.5 percentage points of GDP per year.

5.2 Industrial change

After the downfall of socialism in the early 1990s, Central Eastern European countries came increasingly to operate under the practices and rules of market economies. In the latter, industrial structures and their changes are largely the outcome patterns of relative competitiveness among different sectors in a country and, for sectors with tradable goods, also of the relative competitiveness of each sector in different countries. The performance of the "open" sectors, whose products are tradable internationally, depends critically on relative cost and price structures among countries. The cost and price structures are in turn determined by aspects of both comparative advantage in international trade as well as by possible scale economies and firm linkages.

Midelfart-Knarvik et al. (2000) suggest that reductions in trade costs with deepening EU integration have the potential of explaining industry location and industry structures in the EU. When the new members join the EU Single Market, the forces of comparative advantage, scale economies and firm linkages will also become increasingly important for them. Using a global computable general equilibrium model with trade costs and scale economies, Forslid et al. (2002) suggest that many industrial sectors with scale economies will be relatively concentrated in specific areas when international integration lowers trade costs. The agglomeration effects would seem to work in favour of both the present EU countries and the entering Central Eastern European countries. However, Forslid et al. (2002) also find that the relationship between trade costs and industrial concentration is not monotonic and forces of comparative advantage become relatively more important when other trade costs approach zero. Effects of comparative advantage in international trade do not favour any particular country or region, and the agglomeration effects are weakened as a high degree of integration with small trade costs is attained. The more symmetrical effects of comparative advantage would, in relative terms, favour countries in northern and southern parts of the enlarged EU. In total, it is difficult to make unambiguous predictions about future developments here.[28]

The transition away from socialism led to major structural changes in industries of the Central and Eastern European countries. Many of these countries inherited, in terms of relative employment, very big industrial sectors, which were pronouncedly biased towards heavy base industry. The early years of transition led to both absolute and relative declines of manufacturing in these countries. In some of these countries, the second half of the 1990s saw a partial recovery as a result of restructuring,

[27] The correlation of national saving and investment as a measure of lack of capital mobility was initially suggested by Feldstein and Horioka (1980).

[28] The structure of the Forslid et al. (2002) model does not yield very specific predictions for industries and welfare in the new member states and incumbent countries after the enlargement.

privatization and FDI. Table 5.9 shows, within each country, changes in productivity among different industrial sectors for the period 1995 to 2001 in the entering Central Eastern European countries. It can be seen that different countries have experienced somewhat different changes in relative productivity

Table 5.9

Relative productivity gains, winner and loser industries 1995-2001

(average annual change in % for total manufacturing (D) and relative gains DA to DN, in percentage points)[1]

		Czech Republic	Estonia[2]	Hungary	Latvia	Lithuania[2]	Poland	Slovak Republic	Slovenia
D	Manufacturing total	7.2	10.6	12.7	7.5	6.4	9.6	8.2	3.6
DA	Food products; beverages and tobacco	-3.9	-7.2	-8.8	-4.8	-4.3	-3.6	-4.1	-0.6
DB	Textiles and textile products	-4.9	2.8	-6.5	0.5	-2.3	-1.4	-8.6	0.2
DC	Leather and leather products	-16.1	3.7	-9.1	-2.1	9.8	-2.6	0.3	-6.0
DD	Wood and wood products	-1.8	15.4	-8.0	-2.0	0.1	-1.7	-2.9	-8.6
DE	Pulp, paper & paper products; publishing and printing	-1.7	0.8	-0.8	-0.6	-5.2	-1.2	3.6	-7.0
DF	Coal, refined petroleum products & nuclear fuel	-2.6		-7.9		-12.2	-4.7	-4.0	
DG	Chemicals, chemical products and man-made fibres	0.4	4.8	-9.5	-4.2	11.2	-0.8	-2.2	2.3
DH	Rubber and plastic products	1.4	-2.6	-7.4	10.2	0.0	-0.2	-2.9	-2.0
DI	Other non-metallic mineral products	-0.4	4.6	-5.0	11.2	1.3	1.0	-2.4	1.6
DJ	Basic metals and fabricated metal products	-6.8	4.1	-6.1	3.3	-3.2	-1.7	-6.7	-2.1
DK	Machinery and equipment	5.4	3.7	-6.9	-5.3	-2.7	0.7	-0.2	-1.5
DL	Electrical and optical equipment	13.3	7.0	18.7	18.1	24.0	4.4	2.7	3.3
DM	Transport equipment	2.8	5.6	6.7	-0.2	13.3	6.3	18.8	6.5
DN	Manufacuring n.e.c.	1.2	1.2	-5.3	1.0	-4.2	-0.6	0.8	3.1

Notes: 1: Calculations of relative gains DA (1995-2001)- D(1995-2001)= relative gain DA.
2: 1995-2000

Sources: Richter ed. (2003a, 25); WIIW estimates based on national statistics.

Table 5.10

Relative changes in unit labour costs, 1995 to 2001

(average annual change in % for total manufacturing (D) and relative gains DA to DN, in percentage points)[1]

		Czech Republic	Estonia[2]	Hungary	Latvia	Lithuania[3]	Poland	Slovak Republic	**Slovenia**
D	**Manufacturing total**	**3.3**	**2.4**	**-7.8**	**6.0**	**13.8**	**3.0**	**1.5**	**3.6**
DA	Food products; beverages and tobacco	4.0	2.9	7.1	0.7	2.6	3.5	3.9	0.3
DB	Textiles and textile products	4.1	-3.3	5.8	0.8	-0.3	0.5	8.5	-2.8
DC	Leather and leather products	14.9	-4.6	9.8	2.0	-11.5	0.4	-1.1	5.7
DD	Wood and wood products	1.0	-10.0	6.5	2.4	-5.3	2.3	-0.4	6.2
DE	Pulp, paper & paper products; publishing and printing	2.9	3.8	-0.2	4.9	6.5	1.7	-1.0	9.3
DF	Coal, refined petroleum products & nuclear fuel	5.1		11.1			2.1	2.1	
DG	Chemicals, chemical products and man-made fibres	1.9		11.7	4.0	-9.7	2.9	1.6	1.9
DH	Rubber and plastic products	-1.3	0.1	9.5	-13.2	9.2	-1.7	2.2	0.0
DI	Other non-metallic mineral products	0.4	1.3	6.8	-5.4	-3.7	0.4	3.3	-0.4
DJ	Basic metals and fabricated metal products	4.6	-2.4	4.5	0.8	-0.6	-0.7	5.4	-0.4
DK	Machinery and equipment	-4.4	-1.7	5.8	6.1	5.2	-1.0	-0.8	2.4
DL	Electrical and optical equipment	-10.8	-1.7	-13.1	-10.2	-5.9	-3.5	-2.2	-4.7
DM	Transport equipment	-2.6	-4.8	-9.4	2.1	-10.7	-4.8	-14.4	-5.5
DN	Manufacuring n.e.c.	-1.6	n.a.	4.9	-1.9	4.7	-1.1	-1.9	-1.0

Notes: 1: Calculations of relative gains DA (1995-2001)- D(1995-2001)= relative change DA. Positive values indicate weaker, negative values better competitive (cost) performance than total manufacturing (D.)
2: Data for individual industries only available from 1995 onwards. However, average annual change for total manufacturing is available for the period 1995-2000 (6.8%)
3: 1996-2001.

Sources: Richter ed. (2003a, 25); WIIW estimates based on national statistics.

changes.[29] The electrical and optical equipment industry has been a big gainer in several countries, notably in the Czech Republic, Hungary, Latvia and Lithuania. The transport equipment industry has been another industry that is becoming more competitive in terms of productivity. In Estonia productivity improvement in the wood industry also stands out. On the other hand, food products, textiles and leather industries have been relative losers in terms of productivity, though there are some variations between countries. Productivity changes are one key factor behind changes in competitiveness. In addition, changes in labour costs are important.

Table 5.10 shows the relative changes in unit labour costs among different domestic sectors for the Central Eastern European entering countries. Certain specific industries, such as electrical and optical equipment and transport equipment, have made gains in cost competitiveness in the entering countries (excluding Cyprus and Malta).

Relative competitiveness in domestic terms is not the only determinant of the overall competitiveness of sectors with tradable products. Changes in overall competitiveness vis-à-vis other changes are not straightforward to measure, though indicators such as sector trade balances for different countries can be used to suggest patterns of competitiveness. Examining sector trade balances, Havlik (2003) suggests that the gains in competitiveness vary a good deal among the entering countries. It appears that textiles, wood and wood products and other (non-classified) manufacturing have fairly generally been gainers in competitiveness in the period 1995 to 2001. For individual countries and sectors some clear results also emerge: Big gainers are (i) the electrical and optical equipment industry in Hungary and Estonia, (ii) transport equipment in the Czech Republic and Hungary, and (iii) coal, refined chemicals and nuclear fuel in Hungary and the Baltic countries.

The results from the indicators suggest that there will be significant diversity in the patterns of industries and their catching-up and growth processes in the entering Central and Eastern European countries. This conclusion broadly accords with studies that consider sector dynamics using models of catching-up in terms of productivity and product quality; see e.g. Stehrer et al. (1999) and Landesmann (2003). The diversity is likely to translate into fairly persistent differences in wages and living standards among countries and among regions within countries.

[29] See Havlik (2003) for an overview of industrial change in Central Eastern European countries.

5.3 Agriculture

In order to assess the effects of the Common Agricultural Policy (CAP) on the new member states, we start with some basic facts about their agricultural systems. These are summarised in the following table:

In terms of total cultivated area, Poland is the most important country, followed by Hungary and the Czech Republic. If measured in terms of civilians employed in agriculture, Poland is also the country with the highest agricultural share, but by this measure agriculture is also quite important for Latvia and Lithuania. The agricultural sector contributes about 2 to 4 percent of GDP. The GDP shares of agriculture are much lower than its employment shares, which suggest that labour productivity in agriculture is quite low and there is scope for significant improvement. Agricultural and food trade between EU-15 and the entering countries increased significantly already during the transition process in the 1990s.[30] All of the entering Eastern European

[30] See Lukas and Pöschl (2003) for a more detailed discussion.

Table 5.11

Key agricultural data for accession countries – 2001

	Employment in agriculture. in % of total civilian employment	Share of agriculture in GDP (%)	External trade balance in food and agricultural products (million EUR)
CC-10	13.2	3.1	- 2,281
Czech Republic	4.9	1.7	-709
Estonia	7.1	3.2	-347
Cyprus	4.9	3.9	-556
Latvia	15.1	3.0	-361
Lithuania	16.5	3.1	-56
Hungary	6.1	3.8	1,486
Malta	2.1	2.2	-265
Poland	19.2	3.1	-604
Slovenia	9.9	2.0	-363
Slovak Republic	6.3	1.9	-506

Source: European Commission, Eurostat and Directorate General for Agriculture, **Agricultural statistics;** http://europa.eu.int/comm/agriculture/agrista/2002/table_en/2012.pdf

countries except Hungary exhibit trade deficits in food and agricultural products.

The data show that agriculture is of major political and social concern to the entering countries. Reforming their agricultural sectors as well as the integration into the EU Common Agricultural Policy will be an important task for the years to come. Agriculture is also an important policy concern as it is a huge item in the EU budget (see Section 3 above).

Considering the economic aspects, it can be noted that for the EU-15 economies and also for EU-25 as a whole the effects of the enlargement stemming from agriculture on the aggregate economies will be fairly limited. This is because the role of agriculture in GDP is relatively small even if agriculture is an important policy concern. Interestingly, the role of agriculture in the Southern European countries was of similar magnitude upon their entry in the EU in the 1980's. The southern countries provide a point of comparison for developments in agriculture: The share of agriculture in GDP and employment decreased gradually after the entry of the southern countries into the EU.

What are the likely effects of the 2004 enlargement for agriculture and food industries in the entering countries? The abolishment of tariffs and other protective measures will no doubt lead to increased trade between EU-15 and the entering countries that have major agricultural and food processing sectors.[31] This should increase agricultural production in several new member countries. There are, however, some factors that will limit this tendency. Quota restrictions will limit increases in agricultural output and EU regulations on food quality and safety also have a restrictive effect. The latter are imposed on the new member countries from the beginning of EU membership. The tight regulations will make some of the food industry firms in the entering countries non-competitive, but the regulations are also likely to lead to improvements in food quality in the longer term. More generally, the future of agriculture and the food industry in the entering countries will significantly depend on how CAP develops in the coming years. Future changes in CAP are in turn heavily dependent on what happens to agriculture in the WTO global trade negotiations.

[31] Currently, the accession countries (excluding Cyprus and Malta) tend to have high import tariffs for agriculture and food processing but hardly any export tariffs. In contrast, EU-15 has both tariffs; see Lejour et al. (2001).

There will be some transition periods in the adoption of CAP by the new member countries. These imply a gradual percentage increase in the EU support in the form of direct payments and other schemes. The development of productivity in agriculture and food processing is clearly an important issue for agriculture. There appears to be much scope for narrowing the productivity gap in agriculture between the EU-15 and the entering countries. For example, small farms still dominate agriculture in Poland. For the record, it can be noted that the agricultural productivity gap between the southern European countries and the other EU countries did not close very rapidly; see European Commission (2001a).

The structural changes in agriculture in the entering countries imply a significant movement of labour from agriculture to other sectors and possibly also to other countries. This movement was already in progress in the 1990s, as employment in agriculture was falling; see European Commission (2001a) and Ingham and Ingham (2002b) for details. The movement of labour away from agriculture can be a major source of immigrants from the accession countries to EU-15 member states. It appears, however, that the across-the-border migration flows due to the structural change in agriculture are likely to be limited since much of the "released" labour will be relatively aged and low-skilled. Thus this movement is more likely to be towards other domestic sectors and retirement.

6. Conclusions

The 2004 EU enlargement will most likely yield major benefits to the new member countries in the long run. The new members will be able to capture gains from trade in goods and services and will moreover benefit from a continued inflow of financial and real capital. In fact, the capital inflow is already very substantial as revealed by the current account deficits in the order of 4 to 6 percent for the major countries. Most of the capital flows are in the form of direct investment by present EU member countries, largely driven by the attempt to profit from currently very low wages. Many firms in the existing member countries outsourced labour-intensive parts of their intermediate product chain to Eastern Europe already in the pre-accession stage and this development is likely to gain further momentum after the formal accession. Without doubt, these processes will significantly

accelerate the economic growth of Eastern Europe. However, even under optimistic assumptions, catching-up with the EU-15 countries will be a time-consuming process that will take several decades in most cases.

In principle, the existing EU member countries will also participate in the gains from trade. However, the internal adjustment processes necessary for such an outcome may involve significant costs and frictions. In particular, it will be difficult to administer the wage cuts for the low-skilled that are necessary to prevent a further increase in unemployment and an excessive dismantling of labour intensive production. EEAG (2002) suggested a system of employment tax credits as a way of activating social assistance that would generate the necessary wage flexibility without reducing the living standards of the poor. Moreover, in Chapters 2 and 3 of this report, we point to reforms of labour market institutions that would also enhance wage flexibility. As regards pay-setting practices, such reforms should entail measures to promote relative-wage flexibility among sectors, regions and occupations.

The economic consequences of EU entry will also depend on the policies adopted by the new member countries themselves. The entering countries currently have fairly fragile macroeconomic situations. Many of them have significant public sector deficits even if the levels of public debt are low or moderate. Sustainability of public finances can become a major policy concern for several of the new member countries.

Significant transfers from the EU notwithstanding, the new members will face pressures on public spending after enlargement. The countries will have to co-finance EU-funded projects, and implementation of EU regulations will entail fiscal costs. Improvement of the infrastructure, including reforms of the social sector and education, will be another major item in the public spending of several new member countries. Some other fiscal costs and savings coming from EU membership contributions and alignment with EU customs and taxes will also have to be met. In total, the fiscal effects are not straightforward and there can be small gains or losses for the different new members.

Many of the accession countries have high unemployment, so that there are significant underutilized resources. At best this can provide further impetus for rapid economic growth. The same characteristics represent major labour migration potential from the new members to EU-15 countries. This pressure will be particularly strongly felt in countries such as Germany and Austria that are geographically close to the new members.

EU membership and fully open borders will gradually lead to changes in industrial structure as well. The 1990s decline of manufacturing in the Baltic and Central European accession countries has been reversed in most recent years. Some manufacturing sectors have seen a recovery, and it is probable that this will continue in the future. Significant amounts of fairly low-skill manufacturing industry and services may gradually shift from EU-15 to new member countries.

Agricultural productivity is evidently quite low in the new member states with significant potential for improvement. This can lead to increased agricultural and food production in some of these countries, though food safety and CAP regulations imply limitations in this respect. The future of international WTO negotiations will also play an important role for the development of agriculture and the food processing industry in the new member countries.

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Table A.1

Key economic indicators of EU 15 and accession countries (A10) in the year 2001

	EU 15	A 10	Poland	Czech Republic	Hungary	Slovak Republic	Slovenia	Lithuania	Cyprus	Latvia	Estonia	Malta
Area[2)]	3191.1	738.5	312.7	78.9	93.0	49.0	20.3	65.2	9.3	64.6	45.2	0.3
Population	377.1	74.8	38.6	10.3	10.2	5.4	2.0	3.5	0.8	2.3	1.3	0.4
GDP (bill.)	8843.1	411.7	204.1	63.3	57.8	23.3	20.9	13.4	10.2	8.5	6.2	4.0
GDP per capita (PPP)[1)]	100.0	47.7	40.5	59.0	52.8	48.2	69.8	39.6	74.0	33.4	39.8	55.0
Share of agriculture in gross value added (in %)	2.1	4.1	3.8	4.2	4.3	4.6	3.1	7.1	4.0	4.7	5.8	2.4
Export share in GDP (in %)	35.9	48.5	28.1	71.3	74.3	75.9	57.8	50.9	46.8	44.4	89.4	87.4
Import share in GDP (in %)	34.7	52.4	31.8	75.8	75.8	84.6	58.2	56.4	51.5	55.6	93.1	92.2
Unemployment rate (in %)[2)]	7.7	14.4	19.9	7.3	5.6	18.6	6.0	13.1	3.9	12.8	9.1	7.4
Share of exports[3)] of EU 15 to (in %)	-	11.3	3.6	2.8	2.4	0.8	0.7	0.3	0.1	0.2	0.3	0.1
Share of imports[3)] of EU 15 from (in %)	-	10.3	2.5	2.4	2.4	0.8	0.9	0.3	0.3	0.2	0.3	0.2
Share of exports[4)] to EU 15 from (in %)	-	61.2	69.2	68.9	74.3	59.8	62.2	50.2	52.3	61.2	69.5	44.6
Share of imports[4)] from EU 15 to (in %)	-	56.6	61.4	61.8	57.8	49.7	67.6	44.4	50.8	52.6	56.5	63.0

Notes: 1) In purchasing power parities (as a percent of EU average)
2) 2002
3) Share of exports to (imports from9 accession countries (A10) in total exports (imports) of EU 15 in the definition of foreign trade statistics.
4) Share of exports to (imports from) EU 15 in total exports (imports) of accession countries (A 10) in the definition of foreign trade statistics.

Source: Ifo Institute (2003).

Table A.2

Financial framework for enlargement 2004-2006
Indicative allocation of Commitment appropriations - in % of the respective country's GDP for 2003

	Cyprus	Czech Republic	Estonia	Hungary	Lithuania	Latvia	Poland	Slovenia	Slovak Republic	Malta[1]
1. Agriculture	0.3	0.5	1.3	0.8	1.7	1.6	0.9	0.6	0.8	0.3
1a Common Agricultural Policy	0.1	0.3	0.6	0.5	0.6	0.4	0.4	0.2	0.3	0.03
1b Rural development	0.2	0.2	0.7	0.3	1.1	1.2	0.5	0.4	0.5	0.27
2. Structural Actions after capping	0.3	1.2	3.2	1.6	3.3	4.4	2.3	0.6	2.1	0.7
3. Internal Policies	0.1	0.2	0,8	0.3	1.3	0.8	0.4	0.4	0.5	0.2
10. Compensations	1.0	0.4	0.7	0.1	0.1	0.1	0.3	0.4	0.1	2.1
Total Appropriations for Commitments (Heading 1,2 and 3)	1.7	2.3	5.3	2.8	6.5	6.9	3.9	2.0	3.5	3.3

Note: The calculations for Malta are per GDP of 2002

Source: EU: http://europa.eu.int/comm/budget/pdf/financialfrwk/copenhagen_package/webtablesEN.pdf.;
EBRD Transition Report update 2003; own calculations.

Table A.3

Financial framework for enlargement 2004-2006
Indicative allocation of Commitment appropriations
in % of total Commission budget for 2004

	Total 10 Acc. Countr.	EU-15	EU-25
1. Agriculture	3.3	38.3	41.6
2. Structural Actions	7.5	26.8	34.3
3. Internal Policies	1.5	5.9	7.4
4. External Actions		4.2	4.2
5. Administration	0.6	4.5	5.1
6. Reserves		0.4	0.4
7. Pre-Accession Aid		2.8	2.8
8. Compensation	1.2		1.2
Total Appropriations for Commitments (Heading 1, 2 and 3)	14.1	82.9	97

Source: EU.
http://europa.eu.int/comm/budget/pdf/financialfrwk/perspfin/tbl20002006eur15_en.pdf.
http://europa.eu.int/comm/budget/pdf/financialfrwk/ip03217/ip03217_en.pdf.
http://europa.eu.int/comm/budget/pdf/financialfrwk/copenhagen_package/webtablesEN.pdf.
http://www.europarl.eu.int/committees/budg/budg2003/preparation_inter_en.htm
Calculations by the EEAG.

Acceding Countries: The Road to the Euro

1. Introduction

The ten acceding countries are expected to join the euro area at some point in the next few years. Their participation in the monetary union is seen as the end point of their process of integration in the EU. In the "pre-accession phase", the acceding countries have fulfilled the *acquis communautaire* in the area of EMU: they have implemented reforms to make their institutions compatible with joining the European Union (for example, they have made their central banks independent) and liberalised capital flows. At the start of the "accession phase", they are expected to pursue policies aimed at fulfilling the nominal convergence criteria established by the Maastricht Treaty and qualify for joining the euro area. The third and final phase will start with the formal replacement of domestic currencies with the European currency.

The EU treaties do not contemplate the possibility that acceding countries opt out of the euro: joining the EU automatically requires these countries to take the necessary steps to enter the EMU. The Maastricht Treaty lays out the conditions and procedures to become a member of the euro area, which are the same for both old and new members of the EU. Technically, acceding countries will join the European Union with "a derogation". Thus, the *only* policy decision by acceding countries is whether to try to join EMU at an early or a late stage after accession.

In principle, a country could choose to delay participation in EMU indefinitely. In this respect, it is useful to recall that, contrary to the United Kingdom and Denmark, Sweden is staying outside EMU without having negotiated any "opt-out clause". But the perspective of postponing EMU participation does not seem to be appealing to current governments in acceding countries: all of them have declared their willingness to adopt the euro as soon as possible.

The traditional argument in favour of EMU participation is credibility of low inflation, which applies to the newly acceding countries as it did to the Southern European countries in the 1990s. A common currency eliminates currency risk and reduces interest rate differentials. Such credibility gains are an advantage from

Box 6.1

The nominal convergence criteria

- Deficit of the general government must be below three percent of GDP. Gross debt of the general government must be below 60 percent of GDP, or declining toward 60 percent of GDP at a satisfactory rate.
- Inflation rate must not exceed the average rate in the three EU countries with the lowest inflation rate by more than 1.5 percentage points.
- Long-term interest rates must not exceed the average rate in the three EU countries with the lowest inflation rate by more than two percentage points.
- Two years of participation in the Exchange Rate Mechanism II (ERM II) without major tensions in the foreign exchange market.

ERM II replaced the ERM of the European Monetary System created in 1979. ERM II was established in 1997 with a resolution of the European Council in order to link the currencies of EU member states outside the euro area and the euro. Like ERM I, ERM II is also a multilateral exchange rate arrangement with a fixed, but adjustable, central parity and a fluctuation band around it. Countries participating in ERM II peg their exchange rates to the euro, allowing for fluctuations within a symmetric band of 15 percent on each side of the central parity. Interventions at the margin are automatic, unless they conflict with the primary objective of price stability in the euro area.
Decisions concerning central parity adjustment, or fluctuation within margins narrower than 15 percent, are taken by mutual agreement. Any member (including the ECB) can initiate a confidential procedure to reconsider central rates.
As established by the Ecofin Council in 2000, currency boards are compatible with ERM II participation. The following regimes are incompatible with ERM II: floating, crawling peg, peg against a currency different from the euro, and unilateral euroisation (Ecofin Council 8/11/2000).
Participation in ERM II is voluntary, but acceding countries are expected to join as a precondition to adopting the euro. The procedure to join ERM II can be initiated at any time by a EU member state. There are no formal criteria for joining ERM II.
Whether a country satisfies the convergence criterion of exchange rate stability will be judged by looking at a range of indicators. As discussed below in the text, a country is expected to keep its exchange rate close to the central parity in ERM II or experience a currency appreciation. The assessment will also take into account short-term interest rate differentials and the frequency and intensity of foreign exchange market interventions.

the point of view of macroeconomic stabilisation that should be set against the loss of national monetary policy as a stabilisation instrument and of exchange rate flexibility as an adjustment mechanism.[1]

Recent literature has stressed a number of effects of joining EMU which are not analysed in the traditional debate. First, a common currency is likely to increase trade within the EU. In this respect, adopting the euro is equivalent to a drop in transaction costs in cross-border exchanges of goods and services within the EU economic area. Second, by reducing the stock of external debt denominated in a foreign currency, adopting the euro will substantially reduce vulnerability to currency and financial instability (although in principle EMU countries could still issue large stocks of dollar-denominated debt). We will discuss this point at length below.

Taking it as a political fact that the accession countries will ultimately join EMU, the question of the optimal timing of such a move becomes crucial. The timing directly impinges on the acceding countries' ability to stabilise their economies in the next few years and build an economic environment that favours high rates of investment and growth, economic integration and financial stability.

Fiscal and monetary authorities in acceding countries now operate in a regime of high capital mobility. This is the result of a relatively rapid process of liberalisation and deregulation implemented in the last few years. But their domestic institutions and markets have only recently started to operate in a fully liberalised and deregulated system. Whether or not the financial and legal systems of these countries can weather volatile capital movements is perhaps too early to say, but it would be naïve to hope for the better and envision years without large (global or region-specific) shocks.

As discussed in Chapter 5, structural imbalances in these economies may cause acute problems. Deteriorating fiscal conditions could constrain the use of budget policies for stabilisation purposes. Stabilisation is likely to fall disproportionately on monetary and fiscal authorities, both from a macro perspective and from a financial stability perspective. In such an environment, mandatory adoption of a regime of limited exchange rate flexibility (the ERM) for two years before entering EMU is quite controversial and has stirred a considerable debate in both policy and academic circles (see Buiter and Grafe 2002, Begg et al. 2003 and ECB 2003 among others).

In this chapter, we will reconsider the main issues related to the choice among alternative paths of transition to the euro. Independently of the exchange rate regime, a high degree of capital mobility in the transition to the euro will entail high financial risk. The choice of inappropriate exchange rate regimes can, however, magnify this risk greatly. The experiences from recent crises and financial turmoil in emerging markets show that wrong decisions can be extremely painful – the punishment for apparently small mistakes can be enormous. Based on this experience, we will try to single out the policy that could reduce vulnerability to currency and financial instability.

We will devote a large part of our discussion to the debate on the costs and benefits of participating in "ERM II", which is the Exchange Rate Mechanism with large fluctuation bands. However, the exchange rate regime is only one dimension of the policy framework. What is ultimately important for acceding countries is pursuing the right stabilisation policies, strengthening their fiscal, financial and monetary institutions, making their economies flexible and choosing a consistent level of social protection. For the EU, policy priority should be given to strengthening its financial architecture, along the lines extensively discussed in Chapter 4 of the 2003 EEAG report.

2. Exchange rate regimes with liberalised financial markets: the current policy framework of acceding countries

In Chapter 5 of this report, we have seen that the acceding countries are rapidly integrating their markets for goods and services in the world and the EU

[1] The traditional theory of optimal currency areas (OCA) suggests a set of criteria to judge the costs of giving up exchange rate flexibility. These include the degree of price and wage flexibility, the extent of factor (labour) mobility, insurance via fiscal transfers or fiscal integration in general, and correlation of macroeconomic non-financial shocks. This last item can be attributed to several structural features of the macro economy: openness and economic size, degree of goods market integration, composition of production and trade specialization. Note that, per se, correlation of business cycles is not an OCA criterion, as a high correlation may not result from symmetric shocks but from symmetric policy responses to asymmetric shocks. Actually, national business cycles in Europe may well become more correlated after the creation of EMU, without implying that the cost of giving up exchange rate flexibility has fallen at all (see Corsetti and Pesenti 2002). The literature applying these criteria to judge whether acceding countries are ready for EMU is extremely vast, but its results are quite inconclusive (at least as inconclusive as the results of the literature on the same subject applied to EMU creation). The specific problem with the OCA approach applied to acceding countries is how to account for structural changes currently under way in the convergence process. We believe that these changes are exceedingly difficult to assess, and therefore provide shaky ground for empirical exercises.

economies. Acceding countries are highly open – the average degree of openness (exports plus imports as a share of GDP) is around 100 percent of GDP, compared with 70 percent of the present EU countries (Poland and Cyprus are significantly below average, however). Approximately 60 percent of the acceding countries' imports and exports is with EU countries. A significant share of EU trade with the acceding countries is intra-industry, clearly reflecting cumulated foreign direct investment (FDI) by EU countries. Openness is destined to increase after accession. Thus, these countries will be highly exposed to terms of trade shocks and international demand spillovers from both within and outside the EU area.

Acceding countries have removed most restrictions on capital mobility, with the exception of restrictions on the purchase of land by foreigners. Slovenia also keeps some controls on short-term capital and direct investment. Financial integration with the EU is already quite high. Over the last few years, two thirds of capital inflows to acceding countries consisted of FDI flows: approximately 80 percent of these flows originated in the EU.

Some indicators show that the financial systems of the acceding countries are moving towards the EU performance standard (see European Commission 2003). In Cyprus and Malta the size of the financial sector is close to the EU average. But compared to the rest of the EU, the domestic financial sector in the acceding countries in Eastern Europe is still underdeveloped. Banks dominate the financial sector. In the last few years, most banks were privatised – only in Poland and Slovenia do the governments still retain ownership of some large financial institutions. The privatisation process has coincided with a change in ownership from domestic to foreign.

In 2000, domestic credit amounted to 60 percent of GDP in the acceding countries, against an average of 140 percent in the euro area. Gross debt of individuals was quite low: the average for the acceding countries was seven percent of disposable income, against an average of 50 percent for the euro area. Stock market capitalisation was also low. Several indicators show lack of funding for small and medium-sized firms, especially in the initial stages of their life (European Commission 2003).

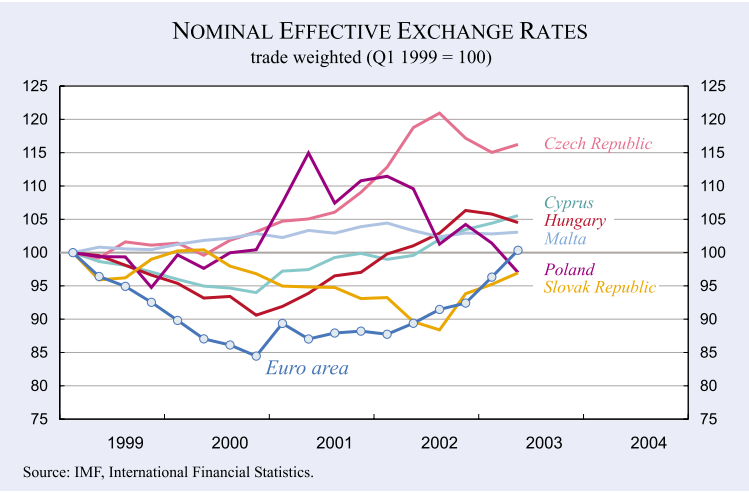
The room for financial deepening in the Eastern European acceding countries is large. In the next few years, credit to both households and corporations, stock market capitalisation as well as activities by financial intermediaries will probably experience very rapid growth. Financial deepening can be extremely beneficial: it can relax credit constraints, provide a sufficiently diversified supply of funds to finance projects with different risk profiles, and create opportunities for risk diversification and the reallocation of consumption over time. Yet, a high speed of expansion can also cause a deterioration of allocative efficiency if it leads to excessive risk-taking, potentially undermining the contribution to welfare of financial market development.

Country size, capital mobility and exchange rate regimes

Figure 6.1 plots the exchange rates of the acceding countries, while Table 6.1 reports the exchange rate regime adopted in 2003 as well as changes that have occurred since the beginning of the 1990s. Exchange rate regimes are classified according to the official IMF classification allowing for some suggestions by various researchers (see von Hagen and Zhou 2002 among others).

There are two striking features in Table 6.1, already noted by many commentators. The first is a positive correlation between country size and the flexibility of the exchange rate regime. Looking at 2003, smaller countries like Estonia and Lithuania have currency boards (arrangements that constrain monetary

Figure 6.1



Source: IMF, International Financial Statistics.

Table 6.1

The evolution of exchange rate regimes in acceding countries

	1990	1995	2000	2003
Cyprus				Peg to the euro (±15% band, de facto ±1-2% band)
Czech Republic	Peg	Peg	Managed float	Free float, inflation targeting
Estonia		Currency board	Currency board	Currency board with peg to the euro
Latvia		Peg	Peg	Peg to SDR (euro weight is 29%; ±1% band)
Lituania	Peg	Currency board	Currency board	Currency board with peg to the euro
Hungary	Peg	Crawling bands	Crawling bands	Peg to the euro (±15% band), inflation targeting
Malta				Peg to currency basket (±0.25% band)
Poland	Peg	Crawling bands	Crawling bands	Free float, inflation targeting
Slovakia	Peg	Peg	Managed float	Managed float
Slovenia		Managed float	Managed float	Managed float

Note: IT stands for inflation targeting

Source: Von Hagen and Zhou (2002); Begg et al. (2003).

authorities to expand domestic money supply in line with international reserves), Latvia pegs its currency to a basket of international currencies within very narrow bands. Malta pegs to a basket of currencies with a 70 percent euro share, also within very narrow bands. Cyprus pegs to the euro, officially adopting large bands of fluctuation, but de facto pegging within extremely narrow bands.

Conversely, larger countries adopt more flexible regimes. The Czech Republic and Poland have opted for a free float – central banks in these countries have adopted inflation targeting as their monetary strategy. The Slovak Republic and Slovenia pursue some form of managed exchange rate float. Hungary has adopted a regime with somewhat limited exchange rate flexibility combined with inflation targeting.

Fixed exchange rate regimes provide a nominal anchor to pin down the price level in the economy. For the peg to be viable, domestic prices cannot move too far from international prices, because real exchange rate changes would have destabilising effects on aggregate demand. The choice of a more flexible exchange rate regime, instead, raises the issue of choosing a nominal anchor to guide private sector expectations of inflation. The largest acceding countries have opted for some form of inflation targeting – requiring monetary authorities to set explicit, yet contingent, goals in terms of rates of increase of the consumer price index (CPI).

The second feature of Table 6.1 is a tendency of governments to move away from intermediate regimes of limited exchange rate flexibility after capital market liberalisation. Indeed, most of the acceding countries had adopted some form of soft peg at the beginning of the 1990s. After liberalisation of capital flows during the 1990s, they have moved either to flexible exchange rate regimes, or to hard pegs/currency boards that in principle exclude any realignment. In 2003, five countries have a currency board or a hard peg, whereas five have a free float or some form of flexible regime.

Free capital mobility and fixed exchange rates: inconsistent policy regimes?

According to a view that has gained more and more supporters after the global turmoil of the 1990s, free capital mobility is inconsistent with any form of limited exchange rate flexibility. The reason is as follows. Rates of return from short positions in currencies that fall by 10, 20 or 30 percentage points in a short time-span are extremely high. With high capital mobility, taking a speculative position against a currency has low costs: investors will miss no opportunity to test the resolve of governments in maintaining their exchange rate target. As long as market participants think that the government can "realign" the exchange rate (that is, devalue the currency), the targeted parity will not be completely credible. Investors know that, depending on the circumstances, policy makers will prefer to modify the

exchange rate rather than to sustain the enormous costs of extreme defence. These costs possibly involve protracted periods of sky-high interest rates, with devastating effects on the health of the banking and financial system, and therefore on investment, growth and employment.

Many factors determine the circumstances that may force governments to devalue. Some of them have a domestic origin, but very often the shock-triggering waves of speculative attacks originate in the global economy. Recurrent examples include monetary shocks in the OECD countries (higher US interest rates), as well as turmoil/crises in other countries or markets.

What makes the problem worse is that speculative attacks may be driven by self-fulfilling beliefs. If investors consider an exchange rate policy credible, they will have no reason to speculate against the currency, and the current level of the exchange rate will be viable. Otherwise, they will launch speculative attacks that will undermine the stability of the peg. The ensuing currency and financial collapses validate ex post the initial expectations of turmoil.

Different factors and events determine the ability of domestic policymakers to guarantee stability of their domestic markets and financial institutions, but the country's vulnerability to them ultimately depends on its fundamentals. Sound domestic policies and strong institutions can eliminate the possibility of self-fulfilling crises. Low credibility of stabilisation policies and weak institutions cannot.

3. Vulnerability to crises: lessons from emerging markets

As extensively documented in Chapter 5 of this report, the acceding countries are emerging markets: their income levels are considerably lower than in the rest of Europe, and their economies are growing rapidly. What lessons can we learn from the recent experience with macroeconomic stabilisation and exchange rate regimes of other emerging markets? The 1990s are rich in cautionary tales. During this decade, several factors contributed to the rapid growth of markets for emerging market assets, including low interest rates in the industrialised countries as well as the growth of financial instruments and the diversification of financial institutions. But, as is well known, severe financial turmoil hit Mexico, Thailand, Indonesia, Korea, Russia, Brazil, Ecuador, Turkey, Argentina and Uruguay, to name the main ones. Before a crisis, these countries had all liberalised their capital accounts (although to different degrees) and adopted policies of low inflation and macroeconomic stabilisation. In addition, all of them had struggled to reduce their high country-risk premia charged in international capital markets.

In all these episodes, a common pattern emerges. Capital mobility is associated with high volatility of capital flows. After capital account liberalisation, emerging markets pursuing macro stabilisation programs typically experience a very large upsurge of capital inflows. Such inflows are driven not only by high rates of return in economies with relative scarcity of capital, but also and to a large extent by the attractiveness of short-term profit opportunities from speculative positions. This is because, just after capital account liberalisation, country-risk and/or inflation tend to keep domestic interest rates high relative to international rates. Gains in the credibility of domestic policies drive the process of "convergence" of domestic to international interest rate levels over time, but usually at a slow pace. Large capital inflows into the country can just as easily and suddenly stop, opening up enormous financing gaps (see Calvo 2003).

Convergence can create vulnerability

When a country commits to a peg, its exchange rate, riding the wave of the "convergence process" is very attractive from the point of view of international fund managers and investors. These invest in short-term debt issued by the country at high interest rates, expecting stable or appreciating exchange rates. When debt is denominated in foreign currency, the interest rate typically includes a substantial country-premium over international rates. Speculative positions are invariably short-term, since investors prefer to be able to withdraw quickly from the country if there is any sign of trouble (i.e., rumours about devaluation or default.

What we have described above is labelled "convergence play" in the literature on currency and financial crises. It has been common in most episodes of exchange rate-based stabilisation in emerging markets as well as in advanced economies. The "convergence play" became notorious in Europe during the period preceding the currency crises of 1992–93, when fund managers massively bought high interest-

rate assets denominated in, say, Italian lira, sometimes pretending to cover their positions by selling short assets denominated in D-marks (see Buiter, Corsetti and Pesenti 1998).

In emerging markets, large inflows driven by the "convergence play" are problematic in many dimensions. First, by feeding spending on both consumption and investment goods, they usually lead to an overheating of the economy. Second, by expanding the demand for short-term assets denominated in domestic currency at a rate several times higher than the growth rate of the economy, they provide a strong incentive for financial intermediaries to expand their activities without paying sufficient attention to prudential standards. To the extent that newly available funds drive up housing and land prices, the rising value of collateral assets further magnifies the incentive to create credit. Excessive credit creation exacerbates the fragility of the financial system (see Corsetti, Pesenti and Roubini 1999). In addition, with abundant capital inflows, policymakers perceive a softening of credit constraints. Not only does this create an incentive to borrow too much: abundant liquidity may also make governments more willing to extend public guarantees on private projects. Liberalisation and privatisation magnify the distortions due to public guarantees and "connected lending" (where credit is obtained through political links). This, too, contributes to excessive risk taking. Finally, and most importantly, since most debt is short-term and denominated in a foreign currency, the country is highly illiquid and exposed to destructive debt runs.

Are acceding countries likely to experience a "convergence play"? One may argue that these countries have already experienced large inflows of capital, most of which in the form of foreign direct investment (FDI). Moreover, interest rates in acceding countries are not far above the international rate. Why should the composition of capital flows change in the future?

The problem is that participating in the EU will change the international assessment of risk in these countries. The EU "seal of approval" and the macroeconomic stabilisation programmes that accompany accession are likely to induce a new wave of capital inflows, this time with a stronger portfolio component. In other words, stabilisation and convergence policies are very likely to attract portfolio managers chasing short-term and medium-term profit opportunities. Even if the external debt of acceding countries now reflects to a significant extent the cumulated stock of FDI, the composition of external debt may change rapidly in the next few years.[2]

Is foreign direct investment a solution?

Suppose, however, that capital will still flow into these countries mostly in the form of FDI. Would this mean that these countries are sheltered from crises and/or their adverse consequences? Indeed, FDI flows have two major advantages over foreign debt as regards financial and currency stability. First, they are driven by real investment opportunities and therefore tend to be long-term. The data show that they are much more stable than portfolio flows. Second, the return on FDI depends on the profitability of real investment and is therefore pro-cyclical and ultimately contingent on the performance of the economy. In the presence of currency and financial turmoil, FDI investors typically suffer capital losses: the international value of the country's liabilities drops in a crisis. Consider instead external debt denominated in foreign currency. Payments on debt are not contingent. In a crisis associated with a drop in output and devaluation, the burden of foreign debt increases: the larger the rate of devaluation, the sharper the revaluation of the country's external liabilities.

These two advantages of FDI over foreign debt clearly reduce the vulnerability to financial turmoil of countries with a large share of FDI in total capital inflows. However, the argument in favour of FDI is sometimes taken one step further. It is argued that, since FDI investors lose from a currency collapse, they will be unwilling to speculate against the country in which they have relatively illiquid assets (or perhaps that they will even be willing to take long positions in domestic currency in episodes of turmoil!). If this argument were true, large FDI investments could in principle shield a country almost completely against currency crises. Unfortunately, this argument is wrong. The point is that, once rumours of devaluation spread, investors who own domestic capital have the strongest incentive to hedge against capital losses due to the drop in the international value of their assets in the country. They will therefore take a short position against the

[2] The recent default crisis in Argentina affected investors' attitude towards lending to sovereign states and private firms in emerging markets. To the extent that investors will be reluctant to engage in "convergence play", the crisis in Argentina may turn out to have some beneficial implications for acceding countries.

currency and/or the stock market index in the country. So, while FDI flows have indeed many properties that strengthen financial stability, FDI investors can also cause massive volatility in short-term capital flows as a result of hedging strategies by firms with capital in the country at the onset of a crisis! To put it simply, it is largely a myth that FDI can eliminate speculation in the currency and asset markets (see Guimaraes and Morris 2003).[3]

Currency and maturity mismatch

When most flows from abroad are short-term and are directed towards assets denominated in international currencies, the maturity structure and currency denomination of the country's external debt create a strong imbalance for the financial system as a whole. Unless firms, households and banks hedge their positions (the evidence is that they hardly do so), fluctuations in exchange rates and asset prices have strong effects on the balance sheets of domestic agents and institutions. Currency crises may turn into widespread bankruptcy in both the banking and the real sector.

These problems are quite compelling in acceding countries, since their financial systems are already operating to a large extent in a foreign currency.

[3] Aside from the volatility aspect, there are also doubts that FDI is the most efficient way to channel capital to emerging economies, as with FDI the benefits from financial liberalisation accrue only to very few firms, mostly (but not exclusively) in the tradable sector. Conversely, bank flows – intermediated by the domestic banking system – are in practice the only source of external financing for firms in the non-tradable sector and/or small firms. Heavy reliance on stable FDI flows can easily lead to bottlenecks and strongly imbalanced growth. Moreover, in many cases FDI is mainly motivated by tax-saving schemes adopted by multinationals.

Table 6.2

Outstanding euro-denominated bank-deposits

	As % of total deposits
Slovenia	37.9
Estonia	19.2
Turkey	15.6
Bulgaria	15.3
Latvia	11.6
Hungary	11.2
Romania	9.3
Slovakia	8.5
Czech Republic	7.6
Malta	6.6
Poland	5.3
Cyprus	5
Lithuania	1.9

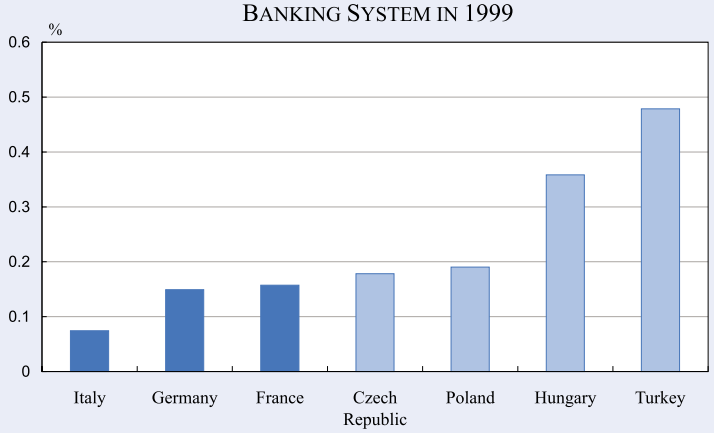
Source: "Review of the International Role of the Euro", ECB December 2002.

Thus, liabilities and financial assets are already to a large extent euroised, and the degree of euroisation may be expected to increase in the future. Table 6.2 and Figure 6.2 provide some evidence on the extent to which liabilities in selected acceding countries are denominated in a foreign currency.

Could banks in acceding countries insure against these balance sheet effects by lending domestically in foreign currency? In this case there would be no currency mismatch in the balance sheet of the banking system, since both assets and liabilities would be denominated in foreign currency. The problem, however, is that many domestic firms borrowing in foreign currency obtain a large share of their revenues from sales in the domestic market. To the extent that domestic prices do not adjust one to one with the exchange rate, nominal devaluation would worsen these firms' balance sheets: given the value of their cash flow in domestic currency, the local-currency value of their debt would increase with a drop in the exchange rate. A high rate of bankruptcies of borrowing firms would directly and indirectly affect the health of financial intermediaries. In other words, euroisation of both assets and liabilities of the banking sector in the acceding countries does not solve the problem:

Figure 6.2

SHARE OF FOREIGN CURRENCY LIABILITIES IN THE BANKING SYSTEM IN 1999



Source: OECD, Database on Bank profitability, financial statements of banks, 1999.

exchange rate risk is simply translated into default risk for the banks.

Does foreign ownership of banks shield against crisis?

Another often heard argument is that financial stability in acceding countries is not a concern since the financial sector in these countries is dominated by banks, and a large number of banks are owned by EU-based financial institutions, responsible to their home country's supervisors and regulators. Thus, EU standards in supervision and regulation apply to a large part of the financial sector in acceding countries. This point is well taken, but the argument misses an important element.

Good supervision and regulation may constrain excessive risk taking but cannot eliminate balance sheet problems and/or liquidity runs. Bank headquarters abroad cannot be expected to intervene and provide the necessary funds to their branches in the country should these experience difficulties or are hit by liquidity runs.

The argument that the role of central banks as lenders of last resort is less crucial when financial intermediaries are owned by foreign institutions (weak on logical grounds) has been definitely proved wrong by the recent experience of Argentina. To put it simply, foreign bank owners do not guarantee any liquidity provision or capital injection. Most crises fall into the grey area between liquidity and solvency, so that it is difficult to assess whether additional funds will save a specific bank or simply be lost in a bankruptcy. But even when crises are close to those of illiquidity, systemic nation-wide contagion creates a coordination problem among liquidity providers. Either all foreign financial intermediaries provide liquidity and the crisis is prevented or no individual intermediary has an incentive by itself to bring more funds into the country, as its own contribution will be insufficient to avoid systemic financial collapse and will therefore be lost in the speculative run.

The pattern of strong capital inflows, driven by "convergence plays", is present in the experience of many countries, whether or not their governments commit to peg the exchange rate, and independent of the specific features of the exchange rate regime. However, commitment to a peg may exacerbate the intensity and the consequences of "convergence plays" and strengthen the expectations of public sector involvement in bailing out both financial and non-financial private enterprises.

Stabilising an economy on a fast convergence track: challenges to monetary policy

In a boom with large capital inflows, monetary authorities have a hard time stabilising the economy. If they raise interest rates to reduce domestic overheating, they may exacerbate the "convergence play". If they try to sterilise the capital inflow, reserve accumulation can become excessive by any standard. Nominal and real appreciation of the exchange rate, while reducing overheating, can harm exports and create the premise for currency and financial crises in the future. Regulatory institutions and supervisors have a hard time enforcing prudential standards, as price signals (for example, a high value of collateral) may create a misperception of risk.

What is particularly disturbing for policymakers is that any policy aimed at slowing down an overheating economy may not be easily communicated to the public, since accession to the EU has created very optimistic expectations of fast convergence. How can one distinguish between an overheating economy and an economy that is simply on a fast convergence track? Efforts of policymakers to avoid overheating could be interpreted as misguided policy.

In Chapter 5, we have shown that convergence of Eastern Europe will realistically take about 20 to 25 years in the best-case scenario for the most advanced countries. More likely it will take 50 to 100 years in most countries. What is not clear is whether cyclical stabilisation can be well defined and understood by the public in a country that is far away from its steady state growth rate.

4. Reducing vulnerability

Recent experience with stabilisation and crises in emerging markets (including Eastern European countries) suggests two important considerations in designing stabilisation policies in acceding countries.

Financial frictions and the size of the business cycle

First, business cycles in acceding countries are likely to be more pronounced than in the EU and perhaps comparable to boom-bust-cycle episodes recently

experienced in emerging markets. An important reason for cyclical variability is the currency denomination of external debt. To the extent that debt is denominated in foreign currency, in periods of real exchange rate appreciation the value of liabilities in the banking system will fall, allowing banks to lend more. In periods of sudden reversal and depreciation, banks will be experiencing stress and/or crisis. Both cyclical upswings and downturns are likely to be more pronounced than in the current EU member countries (see Tornell and Westermann 2002). Early adoption of the euro can in principle eliminate this magnification mechanism of the business cycle amplitude. Yet, even after euroisation, there could be other financial market imperfections that would still contribute to large fluctuations in economic activity.

Crises are not necessarily bad news for long-run growth

Second, while convergence by the acceding countries is likely to be "bumpy" (that is, characterised by occasional episodes of financial turmoil and crisis), this is not necessarily bad for long-run growth. The main issue is whether, on average, a country could be better off by avoiding instability altogether, even if this happens at the cost of slowing down the process of deregulation/liberalisation of goods and financial markets and full economic integration in the European and world markets. Theory and evidence in this respect are not conclusive. For instance, on the one hand, risky balance sheets may lead to fragility and crisis; on the other hand, if economic agents are credit constrained, risky balance sheets are an (admittedly imperfect) way to overcome credit constraints during the boom phase of the cycle.

Looking at the experience of emerging economies over the last 20 years, Tornell, Westermann and Martinez (2003) point out that, despite episodes of major crisis, Chile, Thailand and Korea are among the fastest growing economies in the developing world. In these cases, financial fragility notwithstanding, financial market liberalisation appears to be good for growth in the long run.

This is not to say that crises are necessarily good for growth and that countries should disregard financial fragility in pursuing their growth process. But the experience of the last decade also makes it clear that there is no easy solution to the problem of reducing a country's vulnerability to financial shocks. The following lessons apply.

A sustainable fiscal stance

First, there is no monetary and exchange rate stability without a strong fiscal stance. One of the key factors underlying the crisis of Argentina's currency board was the deterioration of fiscal conditions implied by a deep conflict between the central and the provincial governments. Such conflict undermined any expectation of fiscal discipline in the near and less near future. Even if current fiscal imbalances were still small at the time of the crisis, international investors and institutions came to realise that the path of Argentina's public finances would not be consistent with exchange rate stability.

In other words, current public deficits and the outstanding stock of public debt provide a partial picture of a country's fiscal stance. Fiscal sustainability crucially depends on the market assessment of future and contingent liabilities. In many instances, this gives rise to the possibility of self-fulfilling crises. In anticipation of large deficits caused by a crisis, a speculative attack on a country's assets can create macroeconomic imbalances that cause a crisis and thus validate ex-post the initial forecasts of fiscal troubles.

Implicit and contingent fiscal liabilities are a crucial determinant of currency and financial fragility. These are magnified by inconsistent fiscal policy that feeds expectations of public bailout of firms in trouble and creates incentives for the private sector to take excessive risk.

Well-functioning financial markets

Second, there is no currency and financial stability without well-functioning financial markets. The main problem is that capital account liberalisation and deregulation magnifies the economic distortions associated with inconsistent financial policy. In practice, excessive risk taking means that, when undertaking projects, firms, households and banks believe that under some circumstances they will be able to avoid the bill if things go wrong – a bill involving both monetary and non-monetary costs.

Reducing vulnerability does require strong financial regulation and supervision, which in turn involves the development of strong and efficient institutions. It also requires a process of privatisation of the economy accompanied by a clear definition of rules, laws and policies concerning risk management. In princi-

ple, this can be achieved in different ways, not necessarily through strict external regulation and supervision of financial firms but also through self-regulating bodies set up at industry level. But simply asserting the unwillingness by EU governments to bail out private financial and non-financial firms would not be effective, as such announcements lack credibility: investors know that the political pressure to intervene in crisis situations is very strong.

In Chapter 4 of last year's report we analysed the incentives for EU governments to intervene excessively at the national level. These incentives will become even stronger once the acceding countries are in the EU and even more so once they are in EMU. The tension between many national regulators and one monetary policy will be aggravated by the entry of new members with weaker institutional structures.

An exit strategy from a fixed exchange rate regime

Third, fixed exchange rate regimes suffer from an "escape clause" or "exit strategy" problem. Suppose a government adopts a hard peg as a means to reduce inflation. To be successful, the government needs to commit to keeping the current parity indefinitely. However, to the extent that the strategy is not immediately credible and/or there are contracts in the economy that predetermine inflation in the near future, the economy will suffer from increasing relative price imbalances during the first years of the strategy. High rates of inflation relative to the international rate will translate into a deterioration of competitiveness. By the same token, to the extent that low credibility translates into high risk premia in the asset markets, the stock of public debt will rise rapidly, whereas the capital stock will not (as investment will be relatively costly). At a given exchange rate, the correction of these imbalances requires the government to reduce domestic inflation below the international rate for some time, adding to the cost of disinflation and therefore raising the attractiveness of a nominal realignment of the exchange rate. But this possibility undermines the credibility of the policy strategy in the first place. Expectations of devaluation raise the costs of exchange-rate based stabilisation and can eventually become self-fulfilling.

Either the exchange rate is kept fixed no matter what, or a fixed exchange rate policy becomes a recipe for crises. The longer the attempt lasts to resist devaluation, the greater is the magnitude of cumulated economic imbalances. As the recent experience of Argentina shows, the bill of delaying the exit from unsustainable policies can become so large as to cause a collapse of prices, incomes and production.

A high degree of wage and price flexibility

Fourth, systems of inflexible exchange rates require some degree of price and wage flexibility. Those emerging market economies that weathered well the global shocks of the 1990s (such as Chile) experienced swings in the real exchange rate on the order of 20 to 30 percent over a business cycle. In these cases, nominal exchange rate flexibility has arguably provided the country with an extra degree of freedom to adjust to shocks. Countries pegging their currency also experience large swings in the real exchange rate, but without this extra degree of freedom to adjust to shocks. As the Argentinean government pegged the peso to the dollar, Argentinean exporters were exposed to large destabilising fluctuations in the peso value of the euro, as well as to fluctuations in the peso value of other Latin American currencies (mainly the Brazilian currency). The same can be said for the Asian countries that were pegging to the dollar or to a basket of currencies, in which the dollar had a substantial weight, at the onset of the crisis of 1997–98. The appreciation of the US currency in that case translated into a loss of competitiveness vis-à-vis Japan and other countries in Asia and Europe.

The current dollar depreciation vis-à-vis the euro is likely to raise similar problems for acceding countries by inducing sizeable changes in their terms of trade.

A consistent international financial architecture

Fifth, vulnerability has a strong systemic dimension. The risk connected with maturity and currency mismatches in the external debt of emerging markets are understood by international investors, who are nonetheless willing to lend. Both domestic and international guarantees (in the form of international liquidity provision) induce creditors' moral hazard: lenders have a weak incentive to differentiate among debtors of different quality if they believe that a combination of international bailouts and market timing (early withdrawal) can shield them against losses.

The current debate on the reform of the international financial architecture has clarified the policy

trade-offs in the bailout of countries. Large bailout packages can substantially reduce or eliminate altogether the large economic costs of capital outflows, costs falling disproportionately on workers and the weakest sector of the economy. A reduction of the costs associated with default, however, does induce moral hazard distortions. Debtors may be less ready to insure against crises: they may hold an insufficient level of international reserves; and most importantly, they may postpone important reforms or avoid the implementation of good policies when these entail political costs. This is "debtor moral hazard". As mentioned above, international investors may lend while paying insufficient attention to country risk, as they expect bailout packages from international institutions to help rescue the country. This is "creditor moral hazard".

As a result of past FDI, EU-based corporations own a large number of financial intermediaries and firms in acceding countries. With financial deepening in these countries, households in other EU countries may be expected to include significant holdings of acceding countries' liabilities in their portfolios. In the event of a default crisis, this implies that some non-trivial part of its cost will fall on households and firms in other EU countries. Political-economy considerations will strongly influence the balance between "bailouts" and "bailins" (that is, how much international investors will lose) in the event of a crisis within the EU. In the 2003 report (Chapter 4) we presented evidence of the fiscal costs of debt crises in OECD economies. Past experience shows that these costs can be substantial: the risks for financial stability and the presence of euro-area-wide spillovers are likely to play a key role in the decision process.

Box 6.2

Financial fragility and the sustainability of hard pegs

Gale and Vives (2002) provide a formal analysis of the costs and benefits of adopting hard currency boards (or unilateral euroisation) from a financial stability perspective. Three features characterise countries that stand to gain from a hard currency board and therefore from giving up their monetary policy altogether: these are countries that have (a) a weak institutional structure (including lacking truly independent central banks), (b) serious but not extreme moral hazard problems in the private sector, and (c) moderate liquidation costs of business projects. For these countries, the cost of operating without a lender of last resort (LOLR) is smaller than the benefits from the commitment to fight inflation. Note that low moral hazard implies that risk-taking is not that excessive (the number of firms that would default in the event of macro or sectoral shocks is therefore smaller than otherwise). In the case of default, economic and social costs are contained. A national monetary policy is better for countries with a stronger institutional structure. In their paper, Gale and Vives present an analysis of a sample of countries including Turkey. The authors conclude that Turkey is a candidate for euroisation despite important liquidation costs. Note that concerns about the stability of the banking system are a reason to diversify the choice of roads to EMU across acceding countries.

5. Are acceding countries different from other emerging markets?

Recent studies on currency and financial crises pointed out a set of crucial institutional and economic features that characterise emerging markets. A consensus list (as in Mishkin 2003) includes

1. weak fiscal institutions
2. weak financial institutions
3. low credibility of monetary institutions
4. dollarisation/euroisation of liabilities
5. overall, greater exposure to a sudden end of capital inflows and to liquidity crises.

To what extent are acceding countries different from typical emerging markets? There are at least two notable differences: the ultimate goal of full integration into the EU as well as into the euro area and participation in a multilateral exchange rate agreement/international monetary system.

The ultimate goal of full integration into the EU and into the euro area

First, the stabilisation efforts of acceding countries are clearly driven and motivated by the ultimate goal of full integration into both the EU and the euro area. Not only does this endpoint constraint create a strong incentive for governments to pursue reforms – in terms of expected benefits of closer ties to Europe. It also provides a clearly defined agenda of institutional and policy reforms, influencing private sector expectations. In the accession process, fiscal, monetary and financial matters are subject to multilateral surveillance. Integration into the European financial markets could, in principle, reduce the exposure of these countries to liquidity crises. A similarly clear end-point constraint cannot be found – at least in an equally strong form – in the experience of other emerging markets.

Participation in a multilateral exchange rate arrangement

Second, governments of the acceding countries expect to play some role in the decision-making process of the ECB and other EU institutions. The extent to which this translates into an effective influence is uncertain.

But no other emerging market in Latin America and Asia has any formal link with, say, the US Federal Reserve or the Bank of Japan.

Specifically, participating in ERM II is different from unilaterally pegging a currency to the euro. Multilateral surveillance and integration into the European institutions strengthen the credibility of domestic monetary authorities. There are explicit mechanisms regulating liquidity provision in case of need. Yet, it is clear that liquidity support from the ECB will not be boundless but will be subordinated to maintaining price stability in the euro area.

The two differences above may mitigate the credibility problem stemming from weak fiscal and financial institutions as well as the credibility problem of monetary authorities (points 1, 2 and 3 in the list above).

These differences however do not shield acceding countries from financial turmoil

It is, however, unclear how institutions and markets in acceding countries will deal with financial stress if and when it comes. Possible shocks can take the form of higher interest rates with demand growth expansion in Europe, reversal of capital flows driven by domestic or foreign events and strong fluctuations in the terms of trade and commodity prices – think of the implications of strong dollar depreciation. Some imbalances and shocks are likely to originate domestically, during the process of convergence, as relative price and structural adjustments may produce changes in the production structure.

As argued above, EU accession is not likely to mitigate the problems raised by currency mismatch in foreign liabilities. If anything, one may expect capital inflows to intensify after EU accession that provides these countries with a "seal of approval." Note that in the political debate, the issuance of euro-denominated liabilities could even be welcomed as a positive step towards full integration into the euro area.

Stronger institutional ties with Europe could reinforce expectations of bailouts in the event of a crisis, leading to excessive risk-taking by both local and institutional investors. In our 2003 report (Chapter 4), we stressed that the presently ill-defined procedures for dealing with financial crises within the EU create considerable uncertainty about policy responses to a crisis, well beyond what could be desirable in terms of "constructive ambiguity". EU enlargement strengthens the case for a reform of the EU financial architecture.

An often heard argument is that financial crises in any of the acceding countries are not a concern because each of them is economically very small relative to the EU. Thus, the argument goes, the risk of EU contagion is limited, and the EU can easily "afford" the costs of a regional crisis. This argument is not convincing. Even if the effects of a crisis in the richer regions of the EU can be contained, there could be "horizontal" contagion among new members. Acceding countries may be small in terms of GDP but not in terms of population. Financial contagion can create widespread harm, generating political sentiments against European integration. Second, EU countries may have different and possibly conflicting views about the appropriate EU policy in the event of a crisis. This may make the EU response slow, uncoordinated and eventually ineffective (even if large), with adverse effects on the magnitude of the crisis. Eventually, the costs of a crisis for EU firms and institutions may be significant, and their distribution across EU member states is bound to create political conflicts.

6. Preparing for the euro

Acceding countries are expected to spend at least two years in ERM II prior to entering EMU. In light of the considerations above, two or more years in ERM II after accession could expose these countries to major currency and financial instabilities.

Acceding countries' intended strategies

In view of the risks associated with regimes of limited exchange rate flexibility, all acceding countries have stated their intention to participate in ERM II for as short a time as possible, that is, no more than the two-year requirement, before entering EMU. They see ERM II as a "waiting room", with no recognisable merit or contribution to the convergence process.

Strategies, however, differ across countries as regards the timing of EMU entry. One group of countries aims at joining ERM II as early as possible after accession. These are the countries that already have hard pegs or currency boards, including Cyprus, Estonia, Latvia and Lithuania. Currency boards and

hard pegs to the euro as the reference currency have been declared compatible with participation in ERM II and therefore qualify a country for EMU membership (Governing Council of the ECB, April 13, 2000). Thus, these countries will not change their exchange rate regimes between EU accession and the adoption of the euro – some of them however have to revise the currency basket to which they peg, as to make the euro the only reference currency.

For the group of countries that is instead pursuing some form of inflation targeting with flexible exchange rates, participation in ERM II is a clear change to an intermediate regime with only limited exchange rate flexibility before adopting the euro. They will therefore need to undertake a double regime switch, from the current regime to ERM II, and then from this to EMU.

In some cases (the Czech Republic, the Slovak Republic and Poland) policymakers have expressed a preference for delaying ERM II participation for some time. This will give them time to achieve some progress in financial development, and, most importantly, to put their fiscal house in order. A relatively slow pace on the road to the euro could be appropriate for countries with mild fiscal problems – to the extent that mild fiscal problems are not priced in too harshly by international investors (i.e., to the extent that country and currency risk premia are not too high in international markets). However, countries with relatively bad fiscal fundamentals may also have a strong incentive to target EMU entry as early as possible, to achieve fast interest rate convergence with the euro area and in this way reduce the government's interest bill. These countries are primarily worried about being exposed to fluctuations in risk and currency premia. This seems to be the reasoning underlying the strategy of Hungary, a country that is targeting early ERM participation despite apparent fiscal imbalances.

The ECB view

In accordance with the spirit and the letter of the Treaty of Maastricht, the ECB sees ERM II as a means to achieve nominal convergence and macroeconomic stability, and ultimately to foster real convergence and growth. More precisely, the ECB sees ERM II as a catalyst, enhancing the discipline of stabilisation policies and domestic policy institutions (ECB 2003). Consistent with this view, there is no reason to limit participation in ERM II to two years only. The risks that we have discussed in this chapter are not inherent in the system: rather, they are inherent in premature participation in ERM II. The modalities to join should be decided on a case-by-case basis, looking at the progress of a country in implementing structural reforms, achieving policy credibility, and implementing stabilisation policies.

Moreover, the ECB points out that real convergence may be associated with changes in the equilibrium real exchange rate, which are easier (less costly) to achieve via nominal realignment than domestic price adjustment. Once in ERM II or EMU, the adjustment will necessarily fall on prices. Joining ERM II and EMU at a later stage, after a country will have sufficiently advanced in the process of real convergence, may help reduce macroeconomic costs.

The rationale of these different views of nominal convergence has been the focus of an intense debate. Specifically, there are strong concerns about three dimensions of nominal convergence: the ERM as a regime of intermediate exchange rate flexibility, the consistency of inflation and interest rate stability, and the extent of fiscal flexibility.

Exchange rate stability

As regards "exchange rate stability" as a criterion to qualify for EMU membership, an important issue is whether large exchange rate fluctuations within the official bilateral 15 percent band around central parity would be considered an indicator of "tension" in the exchange market, disqualifying a country from EMU participation. Will the criterion be applied with reference to a much narrower band, say 2.25 percent, the size of the band in the pre-1993 ERM? According to the ECB (2003), "the assessment of exchange rate stability against the euro will focus on the exchange rate being close to the central rate". This issue may be a minor concern for the set of countries adopting currency boards and hard pegs. It is, however, crucial for countries currently using some form of inflation targeting and therefore in need of undertaking a regime switch prior to entering the euro area.

In light of the recent financial history summarized in this chapter, the ERM with narrow bands is the kind of intermediate fixed exchange rate regime that invites speculation and makes countries vulnerable to severe liquidity shocks. If the convergence criterion requires countries *de facto* adopting narrow

bands, acceding countries will be forced to take unnecessary and useless risks.

Several documents of EU institutions and the Eurosystem seem to define "exchange rate stability" as an asymmetric criterion, that is, compatible with appreciation but not with depreciation. But acceding countries are recommended to set their initial parity in ERM II according to their best guess of the currency's fundamental value, based on a broad range of indicators, including market prices, rather than "playing games" with an eye on the final euro conversion rate. It is apparent that such a recommendation is not consistent with an asymmetric definition of exchange rate stability. Clearly, such a definition provides a strong incentive for acceding countries to choose a relatively weak central parity at the beginning of their participation in ERM II and let their currency appreciate over time. It is not surprising to see acceding countries' governments strongly arguing that their currencies are overvalued (while perhaps intervening heavily to prevent appreciation).

We should note here that uncertainty about the final euro conversion rate could actually damage the country as well as the stability of ERM II by creating a coordination problem among market participants: with which final conversion rate would markets coordinate their expectations?[4] The benefits from a clear endpoint exit from exchange-rate based stabilisation would in part be eroded.

The (unfeasible) option of immediate euroisation

Immediate euroisation, even in the form of unilateral adoption of the euro, would eliminate exchange rate risk and solve the problems raised by currency mismatches in the country balance sheets when external debt is denominated in a foreign currency. It would therefore close an important channel through which self-fulfilling prophecies in the exchange market and exchange rate crises can have devastating effects on the economy.

Among the policy trade-offs of immediate euroisation, an important one concerns relative prices. An excessively appreciated (or depreciated) initial conversion rate between the domestic currency and the euro could create large and protracted real costs in terms of employment, investment and growth. But supporters of euroisation see the exchange rate as a potentially destabilising price (in the event of a crisis).

A crucial dimension of this trade-off is the extent to which the elimination of exchange rate risk raises the default risk in the economy. With weak financial institutions and markets, immediate euroisation will possibly exacerbate moral hazard problems leading to excessive risk taking. An ill-defined financial architecture for the euro area as a whole may magnify the the distortion, offsetting the benefits of sheltering balance-sheets from valuation shocks due to exchange rate movements.

Moreover, in the political economy of EU accession, participating in EMU is a well-understood ultimate goal that can motivate reforms and good policy making in the third phase of the accession process. Immediate euroisation will substantially reduce the leverage of current EU members on acceding countries, as well as of domestic governments on domestic and international interest groups. As discussed in Chapter 1 of this report (Appendix 4 on the Past and Future of the Stability and Growth Pact), the goal of entering EMU can motivate large fiscal consolidation efforts, but common fiscal rules become much less binding once a country is in EMU.

The European Council in Nice, however, excluded euroisation from the set of relevant policy options open to acceding countries on the ground that it would be inconsistent with the view underlying EMU as the endpoint of a convergence process, adopted by the Treaty of Maastricht (Council of the European Union Press Release No. 13055/00; see also European Central Bank 2003). Euroisation is seen as a way to circumvent the convergence process.

Currency boards

Would an early adoption of a currency board provide a good substitute for early euroisation to address the issue raised by the currency denomination of foreign debt and the escape clauses implicit in intermediate regimes of fixed exchange rates? There are strong reasons to be sceptical. First, markets may still attach some positive probability to devaluation. Second, (as in the case of unilateral euroisation) the ECB will not be required to act as *de facto* lender of last resort (although it may choose to do so if there is no danger for its price stability objective). Third, we have seen that many countries are suffering a

[4] ERM realignments raise a number of well-known policy issues as regards their timing, size and guidance of market expectations (see Buiter, Corsetti and Pesenti 1998 for a discussion).

deterioration of their fiscal state. Large deficits are not compatible with adopting a currency board. As experience shows, a currency board is not per se effective in forcing convergence of the country risk premium: interest rates may not fall at all if markets are not absolutely convinced about the sustainability of the fiscal and financial systems.

These are among the reasons why a successful currency board requires a country to meet strict fiscal and macroeconomic conditions. If readiness for the euro is to be judged in terms of a country's ability to sustain a currency board, the accession to the euro will be a longer and more risky process than most acceding countries would hope for.

Inflation versus exchange rate stability

The second dimension of the convergence process under scrutiny concerns inflation. Given that acceding countries are growing at fast rates, and the price level tends to increase with income, is there a conflict between exchange rate stability and price stability? Many observers trace a possible conflict between exchange rate and price stability to the Balassa-Samuelson theory. The well-known argument is as follows. Fixing the exchange rate pins down the price of tradables in domestic currency. As gains in productivity in the tradable sector cannot translate into lower prices, they translate into higher wages that, with sufficient labour mobility, will spread across industries in the non-tradable sector. But these sectors experience much lower productivity growth: higher wages can only be paid if the price of non-tradable output goes up. A high rate of price increase for non-tradable goods (which is an equilibrium relative price adjustment) may raise observed CPI inflation above the convergence criterion. Suppose the Balassa-Samuelson effect was indeed the main determinant of inflation and real exchange rate appreciation in acceding countries. If monetary policy targets some low inflation rate, such policy would result in some moderate appreciation of the exchange rate. According to the Balassa-Samuelson theory, an appreciating exchange rate would translate into a fall in the domestic price of tradables relative to non-tradables, a fall that is completely offset by gains in productivity. Thus, choosing an inflation target would not violate the exchange rate stability criterion (as the exchange rate would appreciate) and at the same time would produce a fall in the price of tradables in domestic currency (not to be confused with deflation).

Conversely, if a country pegs the exchange rate, there would be some inflation differentials during the income convergence process. Available empirical studies produce a wide array of estimates of the size of inflation differentials attributable to Balassa-Samuelson effects. While most studies predict small differentials, unlikely to cause violation of the Maastricht inflation criterion, there are also much higher estimates. Critics of the convergence criteria point out that, in the presence of nominal rigidities in the economy, a binding inflation criterion would only produce unnecessary harm, as it would confuse equilibrium adjustment of relative prices with a general increase in the price level.[5] Thus, according to these critics, the inflation criteria should be made more flexible for countries that choose hard pegs or currency boards.

To sum up: during real convergence, sticking to a low inflation target would imply a moderate rate of exchange rate appreciation (which has been declared consistent with the exchange rate convergence criterion); adopting a hard peg would imply a rate of inflation which could violate the inflation convergence criterion. In principle, this criterion should be relaxed. Are there specific reasons to prefer one regime over the other?

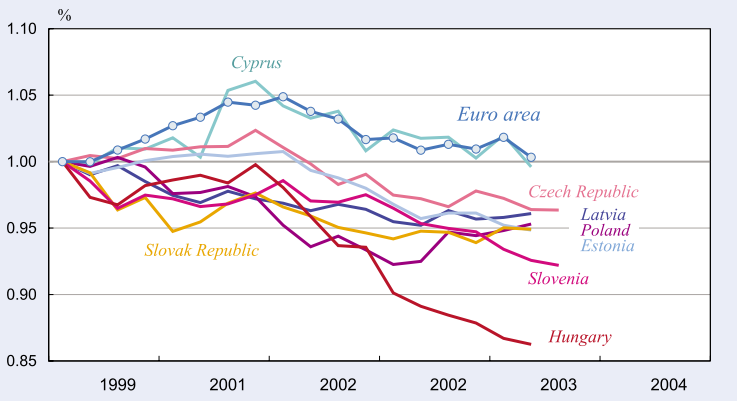
Inflation differentials depend on much more than Balassa-Samuelson effects

Even in the case that, at some stage of the convergence process, inflation differentials could be entirely attributed to desirable relative price adjustment, relaxing the inflation convergence criterion is risky. This is because high inflation rates could feed agents' expectations of further price dynamics. The potential problems raised by such expectations include overvaluation of the real exchange rate and short-term excessive demand expansion.

This argument stresses that in reality inflation and real appreciation during the convergence process reflect much more than the Balassa-Samuelson effect. There are also (a) changes in the terms of trade; (b) changes in the size of deviations from the law of one price for tradable goods; and (c) measurement errors that may be sizeable in acceding countries due to rapidly changing baskets of consumption goods and the structure of production. In

[5] The problem could be mitigated by calculating the reference value for inflation using the euro area inflation rate, rather than an average for three countries with the lowest inflation in the EU.

Figure 6.3



1) The figure shows the ratio between producer price index (PPP) and the consumer price index (CPI).
Source: IMF, International Financial Statistics.

addition there could be (d) inflationary effects of domestic over-heating caused by capital inflows and private sector expectations. There is insufficient understanding of the relative importance of these elements in practice.

Figure 6.3 plots the ratio between the producer price index (PPP) and the consumer price index (CPI) in the different accession countries. It is reasonable to expect that the PPI includes a larger share of tradable goods than the CPI, as services have a larger share in the latter. In that case, a strong Balassa-Samuelson effect would imply a fall in the PPP relative to the CPI, since a relative increase in the price of non-tradables would raisethe CPI more than the PPI. The figure shows that a pattern consistent with the Balassa-Samuelson hypothesis can be detected for a few, but not all acceding countries. There are large differences in real exchange rate patterns.

Overall, these considerations suggest caution in relaxing the inflation criterion as a precondition to participation in EMU. Overall, a regime of (some degree of) exchange rate flexibility coupled with low inflation dynamics seem to provide a safer path to joining EMU.

The need for fiscal discipline and the Stability and Growth Pact

As regards the final concern with convergence criteria, some observers claim that the Stability and Growth Pact (SGP) is likely to become a straitjacket for fast growing countries at low levels of income, in need of building their own infrastructure and implementing many reforms that could require temporary government spending. Given the political and institutional crisis concerning the SGP, critical views are likely to gain strength over time.

It is quite obvious that fast-growing countries are in need of large public investment, and that there are reasons why it is neither optimal not equitable to finance infrastructure with current taxes. By the same token, institutional and structural reforms may create temporary spending or revenue shortfalls, which would be optimally financed by borrowing. Yet one needs to be aware of the fact that local governments have a strong incentive to use fiscal flexibility for other purposes than the accommodion of a high rate of public investment or the facilitation of reforms (see the box on the SGP in Chapter 1 of this report). At times when governments are making an effort to consolidate their budgets and find viable fiscal paths, a relaxation of the fiscal rules may compromise the consolidation process, with negative effects on expectations affecting interest rates on the public debt. Our proposal for an improved Stability and Growth Pact (summarised in Chapter 1 of this report and extensively discussed in Chapter 2 of the 2003 EEAG report) can, however, suggest ways to grant some degree of flexibility in the design of fiscal policies.

The enlarged euro area

Many of the problems discussed in this chapter will still persist at the end of the third phase of EU accession, when the euro area will consist of at least 22 countries. Enlargement obviously exacerbates issues regarding efficient monetary policy decision-making in the euro area: a very large decision-making body cannot work well. These issues will call for a much needed structural reform, which we do not see as a major issue, however. After all, monetary policy in the euro area is not a weighted average of national policies.

Yet, enlargement raises new policy issues. In an enlarged euro area, the acceding countries will be small in terms of economic weight but not in terms of population.

A small economic size means that acceding countries will not have much weight in the design of stabilisation policies. Even if inflation were tending to be higher in the new countries than in the current euro area, their influence on interest rate setting by the ECB would be negligible. First, their weight in the euro area Harmonized Index of Consumer Prices is very small. Second, a significant part of any inflation differentials is likely to be attributed to desirable relative price adjustments.

A large population share in the EU, however, implies that the importance of acceding countries may become much larger in the event of financial turmoil and crises. Markets may expect political considerations to guide EU crisis management and resolution. Even if the ECB were to be able to pursue a consistent monetary policy through periods of turmoil, crises would be formidable challenges to national fiscal authorities and financial supervisors/regulators. As argued in chapter 4 of last year's report (EEAG 2003), defining procedures and intervention policies in the event of crisis at the euro area level may be extremely helpful in this respect.

7. Summary

Overall, there is no single strategy that could be recommended to all acceding countries as regards macroeconomic stabilisation on the road to the euro. Arguments in favour of adopting the euro as early as possible include smaller financial risk due to the elimination of currency mismatch in the balance sheet of banks and firms (which implies the risk of a self-fulfilling run on the country debt); interest rate convergence (with the associated gains in terms of the interest bill for the government as well as investment financing by firms); and overall gains in monetary credibility. Arguments for a slower pace toward the euro stress the need to remove financial distortions creating moral hazard and therefore undermining the stability of the domestic financial sector and raising the country's default risk; the advantage of relative price adjustments without the need of costly nominal wage and price adjustments; and the need to make fiscal and financial policy sustainable and compatible with a fixed exchange rate before participation in the EMU.

At the end of 2003, some countries reiterated their willingness to enter ERM II on or shortly after accession: Hungary, Estonia, Cyprus, Lithuania in 2004, and Latvia and Slovenia in 2005. In this group of countries, Hungary has the most fragile fiscal situation. The other countries have chosen to delay their entry into ERM II, perhaps waiting to see whether the interpretation of the convergence criteria will be adapted in light of their arguments against the merits of ERM II.

Countries that are already able to sustain hard pegs should be helped to achieve a smooth and fast transition to the euro. In this set of countries, mainly small ones, priority should be given to institutional reforms and to building a policy framework consistent with participation in the euro area without suffering from major macroeconomic imbalance.

Delaying participation in ERM II is a realistic option for countries that are currently unable to sustain hard pegs and have large domestic imbalances. The magnitude of domestic imbalances varies considerably across countries, so that ERM entry may be desirable at different times. Yet in all cases, the policy priority is achieving a sustainable fiscal situation and stabilising inflation at the correct relative prices, a task that requires both institutional and policy reforms.

For both groups of countries, the convergence criteria in terms of inflation, interest rates, debt and deficit provide desirable targets to guide policy and should not be relaxed. Though they are not first-best targets, these convergence criteria should be judged relative to existing distortions that could derail the stabilisation efforts.

The evidence reviewed in the previous chapter shows that on average acceding countries are doing well as regards the two criteria of inflation and long-term interest rates. Once in the EU, it is even possible that the three countries with the lowest inflation rates will include acceding countries. The main issue is fiscal convergence (which of course may undermine the sustainability of the inflation and interest rate performance).

As regards exchange rate stability, ERM II allows for large fluctuation bands around exchange rate parity. Once in ERM, a country should be able to use the exchange rate flexibility implied by such an arrangement, in the sense that exchange rate stability should not be mechanically assessed with reference to much narrower bands. Fluctuations in the exchange rate in response to domestic and foreign

shocks are not necessarily indicators of tension in the exchange market but can be part of an efficient adjustment process. If the dollar continues to depreciate, it may be reasonable to expect exchange rate fluctuations within ERM II. Declaring that acceding countries will be accepted in the euro area only if they can peg to the euro within narrow bands may raise the possibility of speculative attacks driven by self-fulfilling prophecies. During the transition to the euro, strict domestic stabilisation with some exchange rate flexibility is better than exchange-rate-based stabilisation with very limited flexibility.

In practice, however, exchange rate flexibility will not be enough to shelter a country from financial turmoil. The risk of crisis is somewhat reduced, but not eliminated, by delaying participation in ERM II, or by making full use of the 15 percent bilateral bands once a country is part of the ERM system. "Convergence play" and currency mismatches can still characterise the transition to the euro.

A dangerous possibility during the transition is that markets do not learn to appreciate countries' specific features and assess country risk based on domestic policy and real fundamentals. It would be extremely frustrating if the policy effort of one country were to be discounted in episodes of turmoil, whereas markets extend to all acceding countries the adverse assessment of a subset of them. The 1992–93 experience of the ERM as a multilateral system clearly shows that financial contagion is possible even in advanced countries (see Buiter, Corsetti and Pesenti 1998). The weakness of the old ERM are present, in magnified form, in ERM II. The experience with the ERM also points out that there is no stability without a consistent currency and financial policy framework for Europe as a whole.

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John Flemming†

John Flemming, the first chairman of CESifo's European Economic Advisory Group, died on August 5 2003, aged 62.

John was one of Europe's leading economists. His activities spanned both academic and public life. In Oxford University, he began his career teaching at Oriel College, and moved to a research position at Nuffield College. He finally returned to Oxford as Warden of Wadham College in 1993 after a ten year interlude at the Bank of England and as chief economist of the newly established European Bank for Reconstruction and Development.

Like all John's colleagues, we in the EEAG constantly marvelled at the range and depth of his intelligence. In a world of increasing specialism, John Flemming stood out for his ability to perceive rapidly the essentials of a diverse range of economic problems, and to offer new approaches and fresh insights to every question, including questions we had foolishly not yet thought to ask ourselves.

We in the EEAG will miss not only those professional attributes, but also a personal friend: John was not only a distinguished scholar but an engaging and exhilarating companion. He continued to participate actively in our deliberations despite the pain of his final illness. We extend our sympathy to his devoted wife Jean, who often joined him at the meetings of the group.

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Gilles Saint-Paul John Kay Xavier Vives Giancarlo Corsetti John Flemming†

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Preliminary Programme

Thursday, 18 March 2004

11:00 **Press conference**

12:00 **Cold buffet lunch**

12:45 **Welcome and Introduction**
Hans-Werner Sinn, President, Ifo Institute, Munich

13:00 **Global Economic Outlook**
John Llewellyn, Lehman Brothers, New York

13:30 **The United States' Deficits and Exchange Rates**
Jim O'Neill, Goldman Sachs, New York

14.00 **The European Economy**
Hans-Werner Sinn, Ifo Institute, Munich

14.30 **Discussion**

15.30 **Coffee break**

16:00 **Global Trends in Foreign Direct Investment Regional and Sectoral Scope**
Torbjörn Fredrikson, UNCTAD, Geneva

16:30 **Central and Eastern Europe Patterns of Investment and FDI**
Willem Buiter, EBRD, London

17:00 **PR China Inward Investment and Chinese Financial Markets, Impact on Asia**
Sonja Opper, Universität Tübingen

17:30 **General discussion**

19.00 **Dinner at the British Embassy**
Jean-Paul Mingasson, European Commission, Director-General for Enterprise (invited)

Friday, 19 March 2004

9:00 **Welcome and Introduction**
Hans-Günther Vieweg
Ifo Institute, Munich

9:15 **Rating in Continental Europe – Opportunities and Challenges**
Karl Cordewener, BIS, Basel
Jochen Flach, Federal Reserve, Frankfurt
Dieter Glüder, KfW, Berlin

10:00 **Discussion**

10:30 **Coffee break**

Major Branches of European Manufacturing Industries

10:45 **Overview**
Simon Hallamon, Cambridge Econometrics, Cambridge, UK

11:15 **Chemical Industry**
Alain Perroy, cefic, Brussels (invited)

11:35 **Mechanical Engineering**
Ralph Wiechers, VDMA, Frankfurt

11:55 **Automotive Industry**
Paul Nieuwenhuis, Center for Automotive Industry Research, Cardiff

12:15 **Summary**
Hans-Günther Vieweg, Ifo Institute, Munich

12:30 **General discussion**

13:00 **End of the session**

Hot buffet lunch

14:30 End of conference

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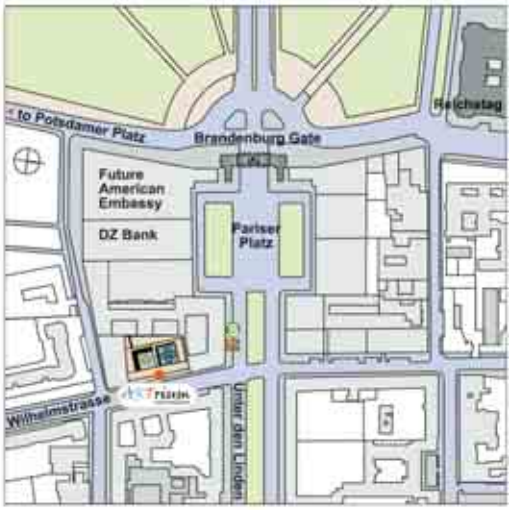

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Formerly *ifo Studien*

Vol. 49, No. 4/2003

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