The European Economic Advisory Group at CESifo was born out of the need to look at policy issues from a European rather than a national perspective. Europe is growing, and growing together, integration is accelerating, Eastern expansion is imminent. The establishment of a European central bank and the introduction of a common currency have joined the Continental countries with one monetary policy and the common need to establish the internal and external stability of the euro. At the same time, national fiscal policies must operate within the boundaries of the Stability Pact. Many problems in Europe are shared problems like unemployment and overburdened social systems, others are more idiosyncratic. Solutions are needed in all cases, and they may emerge from theoretical analyses, practical experiments and international institutional comparisons. The European Economic Advisory Group discusses the options and reports on the experience in the member countries and elsewhere. The Group also comments on economic activity in the European countries.

The European Economic Advisory Group was set up in 2001 by CESifo, a joint initiative of the Ifo Institute for Economic Research and the Center for Economic Studies (CES) of the University of Munich. CESifo's international network of 350 academic economists provides a valuable source of information behind the report, Ifo's macroeconomic department makes the basic forecasts, Ifo's Data Base for Institutional Comparisons in Europe (DICE) serves as a useful tool for policy evaluation, and Ifo's quarterly World Economic Climate (WEC) indicators, based on polls in 80 countries, ensure an up-to-date overview of the state of the business cycle in different parts of the world.

This is the Group's first report. It was prepared by a team of seven economists from six European countries, chaired by John Flemming, Warden of Waldam College, Oxford and former Executive Director of the Bank of England. The group also includes Giancarlo Corsetti (University of Rome III), Seppo Honkapohja (University of Helsinki), Willi Leibfritz (OECD), Gilles Saint-Paul (University of Toulouse), Xavier Vives (INSEAD) and Hans-Werner Sinn (Ifo Institute for Economic Research). The group plans to deliver similar reports on an annual basis, assuming as a group responsibility for the content.

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 Wolfgang Ochel, Frank Westermann, Wolfgang Nierhaus, and Wolfgang Meister (content), Heidemarie C. Sherman and Paul Kremmel (editing), Sascha O. Becker (secretariat) as well as Elsita Walter (statistics and graphics) and Elisabeth Will (typesetting and layout).

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Munich, 5 February 2002

Executive Summary

This is the first annual report by the European Economic Advisory group at CESifo that brings together economists from different European countries with the goal of contributing analyses and proposals to the process of policy making and reform. Each year, the report presents a selection of emerging policy issues.

This report is in seven sections, each focused on a key policy issue in the euro area. After assessing the growth prospects for the current year, the 2002 report discusses the external value of the euro, the appropriate fiscal and monetary policy mix, price and inflation divergences across member states, factors enhancing or hampering European growth in the long run, an employment-friendly reform of welfare, and a reform of the Common Agricultural Policy.

The first section is an assessment of the economic situation of Europe, with some concentration on those countries which have adopted the euro in 2001 and 2002 drawing on a wide variety of sources including Ifo survey data.

At 1.6% in 2001 and 1.3% in 2002, these GDP growth rates are both, lower than earlier forecasts as a result of information since September 11, 2001 and lower than most forecasts by national governments (which may be biased upwards to present projections of imminent fiscal stabilisation) and one percentage point lower than the growth of potential output. Prospective European growth exceeds that of the United States in 2001 and, like in the United States, recovery starts in the course of 2002. Unlike the United States, Europe as a whole is not expected to experience any decline in quarterly GDP, although some member countries are already in recession.

Slow growth is reflected in unemployment rising by 0.25 percentage points between 2001 and 2002 (from a low point in 2001), while inflation falls by 0.75 percentage points in the Euro area.

The second section addresses the weakness of the euro against the US dollar and the yen since its launch in 1999. The report stresses the effects on the euro of a dramatic decline in the demand for base money which probably reflected a flight of black money from within the euro countries as well as of deutschmarks returning from Eastern Europe and other parts of the world. As the ECB absorbed the fall in the demand for base money at given interest rates by changing the composition of its broad money aggregate M3, without changing its size, the effect on the exchange rate was very similar to a sterilised intervention of the same size. Measured against the trend, the decline in the demand for base money was in the order of €90 billion over the last few years until October 2001, enough to fully explain the euro weakness in quantitative terms.

Apart from these changes in the demand for currency, macroeconomic factors have also contributed to the weakness of the euro, which may be seen as a reflection of dollar strength in the late 1990s. Dollar appreciation was initially driven by high consumption and investment demand due to expectations of a strong US advantage in growth and productivity. After doubts about the persistence of this advantage towards the end of 2000, the euro stopped depreciating, but remained weak, perhaps reflecting market pessimism about Europe's ability to sustain its own growth independently of the United States. It was precisely in this period that the movements in currency demand mentioned above may have become stronger.

Chapter 3 considers the monetary and fiscal policies appropriate to Europe under the circumstances of an adverse international cycle and a weak euro. Typically, governments have medium-term plans for fiscal consolidation, "stabilisation plans", calling for a falling trend in budget deficits. The European Commission has called for this trend to be sustained and argued that the ECB should provide the necessary value-stimulus by cutting interest rates further. On the other hand Euro area interest rates are already lower than

would be expected on the basis of the evolution of prices and output, and an indicator based on interest and exchange rates also indicates considerable easing of monetary conditions throughout 2001. There is thus a danger that neither party will be willing to act.

The growth and stability pact underlying national fiscal stabilisation plans has a number of presentational weaknesses. In particular, although paths for deficit reduction are typically presented alongside GDP projections, they are not explicitly conditional on them. If GDP turns out lower than expected, deficits will be higher than planned which may induce the fiscal authorities to take steps that have the effect of aggravating the downturn. There may also be a tendency for them to have published unrealistic GDP projections in order to show falling budget deficits despite their failure to take real steps towards consolidation.

We would like to see stabilisation plans made more explicitly conditional and the projections made more realistic. Against this background one would be able, with much greater confidence, to allow the built-in stabilisers to operate and also to take parallel self-reversing measures (such as accelerating previously planned tax cuts).

While we cannot wait for such reforms to take place, and the recession should not be used as an excuse to postpone necessary reforms of the state sector, it would be appropriate for deficits to rise throughout Europe during the current cyclical downturn except where stabilisation efforts have been weakest, and debt income ratios are also highest, and even there they should not decline. We also believe that (especially as compared to the US Fed) the ECB has room to cut interest rates further – a measure which should be adopted sooner rather than later.

It may also be appropriate to consider/propose a contingency plan for a more radical and co-ordinated policy throughout Europe. This might either be modelled on the discretionary fiscal regulations in the German Stability and Growth Act of 1967 (and a UK law of that era) and/or be designed to provide structurally improved incentives, e.g. for investment or for larger families.

Chapter 4 addresses questions about the effect of the introduction of the euro on price differentials across the Union and also on the cost of capital in its member countries which may account for capital flows from the slow growing centre to the more buoyant peripheral states.

Although price differentials have narrowed, and should be expected to remain narrow as productivity and labour costs converge throughout the Euro area, they should not be expected to disappear completely. According to some evidence, ten years ago price dispersion in Europe was about three times that in the United States – it had already been halved at the end of the 1990s.

Nominal interest rates on government securities have converged virtually completely with the announcement and introduction of the euro indicating that risk premia resulting from uncertain exchange rates and other causes have disappeared. As these premia are generally believed to have been higher in the peripheral states, these should now be benefiting from a reallocation of capital in their favour. As a result, labour productivity and prices of goods that are not traded internationally can be expected to rise faster than would have been the case without the euro. A sizeable inflation differential among the Euro countries is a natural aspect of the real convergence process that has been brought about by European integration in general and by the euro in particular.

Differences in cyclical development within the Euro area in the last few years have raised an issue in the desirability of national inflation differentials as a mechanism reducing the risk of overheating in the countries or regions with the fastest growth rates. By raising the relative price of domestic products, in fact, national inflation differentials discourage external demand.

The problem with this idea is that only a few cyclical shocks require a permanent appreciation of the real exchange rate. So, while high inflation at time of booms in domestic demand may be a useful way to contain domestic imbalances, prices and wages then need to come down after the boom is over. Downward nominal rigidities preventing a fast adjustment can create quite a bit of unemployment.

Provided that they are not excessive, inflation differentials need not be reversed in the presence of persistent differences in productivity growth in the

tradable sector of the economy, or in the presence of international taste shocks (an upsurge of demand for Italian pasta or French wine …). Even in these cases, however, overshooting of equilibrium inflation is a real risk. Inflation differentials need to be reversed in other cases, including domestic demand booms due, for instance, to export dynamics fuelled by a weak euro. The adoption of policies promoting wage and price flexibility is a key step in the future of the Euro area.

Chapter 5 compares growth in Europe and the United States in recent decades. Although Europe was, as one would expect, catching up in the 1950s and 1960s, this virtually ceased in the 1970s, and the United States has pulled further ahead in the 1980s and 1990s – and at a particularly remarkable rate in the second half of the last decade. The chapter examines the effects of general factor endowments and their accumulation with special emphasis on the role of information technology. Here the Scandinavian countries share a number of characteristics with the United States rather than the core European countries. The analysis highlights the effects of both industrial and labour market regulations in Europe as well as shortcomings in education and access to the Internet in much of the Continent. This last effect is attributed to inadequate openness of the sector to effective competition.

Chapter 6 argues that traditional social programmes of the modern welfare state have concentrated on replacing the earnings which are not enjoyed by those without jobs. This offers an incentive to those capable of earning only very low wages to qualify for (higher) benefits by declining jobs which, as a result, are also not offered. An alternative is developed, already implemented in varying degrees in a number of countries, in which tax credits are used to supplement the wages available to low productivity workers – whose benefits when not in work may also be reduced after a period of joblessness. Traditional social insurance schemes used also to offer higher benefits for limited periods and this feature, too, should be reemphasised.

A fairly detailed proposal is put forward on a basis which should allow the living standards of both the working and most of the non-working poor to rise at no net cost to governments while raising employment output and growth. In essence, it implies requiring government work in exchange for existing welfare benefits, cutting welfare benefits for those who do not work although they are classified as being able to, and paying a wage subsidy to those who take low-paid jobs in the private sector.

Finally, Chapter 7 re-examines the case for reforming the Common Agricultural Policy. The health and environmental aspects of modern agriculture have been highlighted by British experience with BSE and FMD. Historically, agricultural support has been rationalised by reference to security of supply, income maintenance, or, increasingly, environmental concerns. It is argued that production price supports, the scale of which is set out, act as incentives to intensification which is environmentally damaging and poses threats to animal welfare and human health. Hormone beef and GMOs are no more threatening to the health of Europeans than of Americans and therefore should not be an issue in transatlantic trade although regulation of their use in production may be in order. Trade with developing countries is also affected by the CAP to their disadvantage on average – a problem that might be aggravated by EU enlargement to include countries such as Poland and Hungary with large agricultural sectors.

The EU allows member states to enforce standards of animal welfare in excess of Union-wide minima. It is argued that doing this merely diverts production to less demanding regimes. It would be better to define different standards and to acquire appropriate labelling (as also of hormone use, GMOs etc).

Farm support should be switched much faster from price support (with the environmentally damaging side effects) to explicitly environmentally friendly programmes (possibly rationally administered within an EU framework) compatible with a more liberal trading regime.