THE EUROPEAN ECONOMY: CURRENT SITUATION AND ECONOMIC OUTLOOK FOR 2005*

In 2004, the European economy strengthened and output growth of 1¾ percent in the euro area was close to its trend, although the output gap remained large and unemployment increased further. The recovery was export-led with spending shifting only gradually to domestic demand. After a weakening in the second half of 2004, mainly because of higher oil prices and lower growth in world trade, the economic expansion is expected to continue at a moderate pace during 2005 with growth in the euro area averaging again only 1¾ percent. This will once more be insufficient to reduce the output gap and unemployment will remain high. The recovery in Europe remains fragile, depending on the global upturn remaining intact without major exchange-rate turmoil and on oil prices not rising further. Despite some narrowing of growth between Europe, the United States and Asia, external imbalances between the regions remain large and could trigger a further fall of the US dollar and a strengthening of the euro. Under such circumstances growth of the European economy could be even weaker.

1. The current situation

In 2004, the European economy strengthened and output in the euro area increased on average by 1.8 percent (after only around ½ percent in 2003). Growth was close to the trend rate (of 2 percent), so that the output gap – a measure of the underutilisation of resources – did not shrink. This development was only slightly weaker than our forecast in last year's report (we had forecast growth of 2 percent). Indeed, most of our assumptions in the report did materialise. In particular, the global recovery strengthened and nominal and real interest rates remained at historically low levels. However, oil prices increased more than expected.[1]

*The forecast is based on data available until 10th of February 2005.

The sharp appreciation of the euro in 2003 (by around 12 percent against the currencies of major trading partners) came to a halt in 2004, although towards the end of the year the euro began to strengthen again.

In the first half of 2004, growth was stronger than expected, but the expansion lost momentum in the second half and business expectations weakened again and more recently the assessment of the present situation also declined slightly (Figure 1.1). In Germany, where the combination of both components of the Ifo business climate indicator (assessment of actual conditions and expectations) tends to move in a clockwise manner over the business cycle, the current level neither points to a downturn of the economy nor to a strong upturn that would help lift growth in Europe as a whole (Figure 1.2). (For further details on business confidence in individual countries and regions see Appendix 2.)

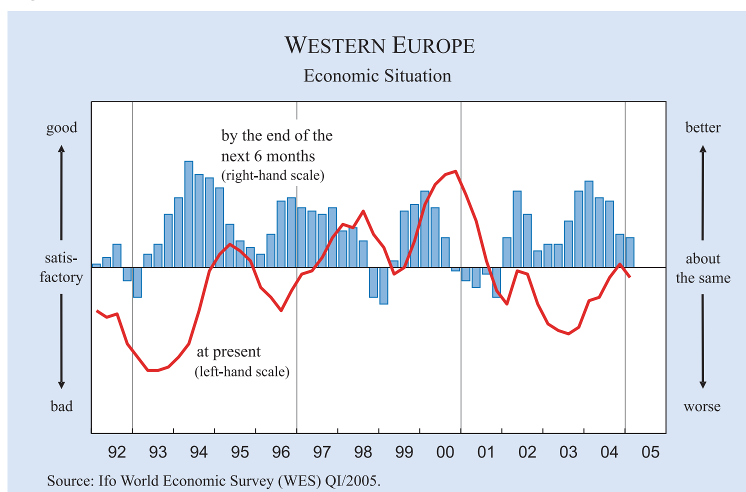
Boosted by stronger export growth, investment in the euro area started to increase after a decline in the two preceding years, albeit at a moderate pace. Private consumption remained subdued reflecting low real income growth, which was depressed by higher energy prices and poor labour market conditions. Consumer spending, however, was not uniform and in a few countries such as France, Spain and Portugal it recovered – partly reflecting a decline in household savings – while in others, in particular Germany, it remained weak. (For the contribution of domestic demand to quarterly eurozone GDP growth see Figure 1.3.)

Economic growth continued to be higher in the United Kingdom than in the three big euro countries France, Italy, and Germany and was also above average in all the Nordic countries and in Ireland as well as in Spain.

Central and Eastern European economies also achieved higher growth than the EU average – reflect-

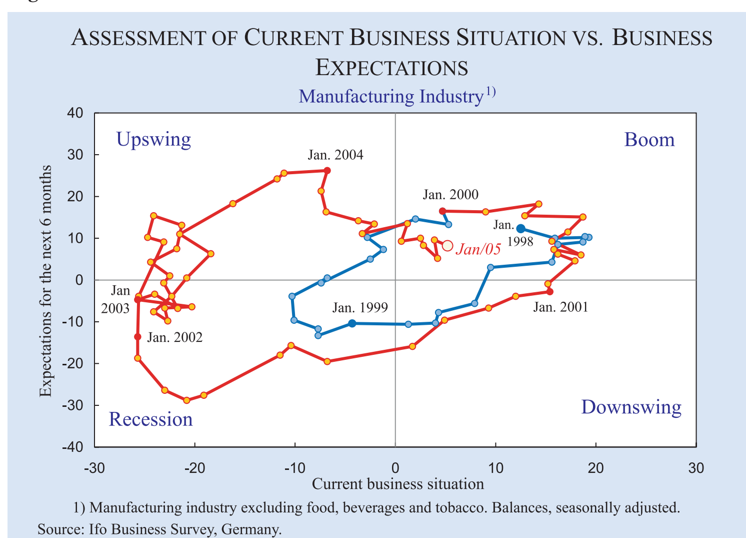
[1] Growth was stronger in the first half and weaker in the second half of 2004 than projected, being related to the unexpected increase in oil prices. During the year, the oil price (Brent) increased to between 45 and 50 US dollars per barrel, while last year's forecast assumed that it would remain at around 28 US dollars.

Figure 1.1



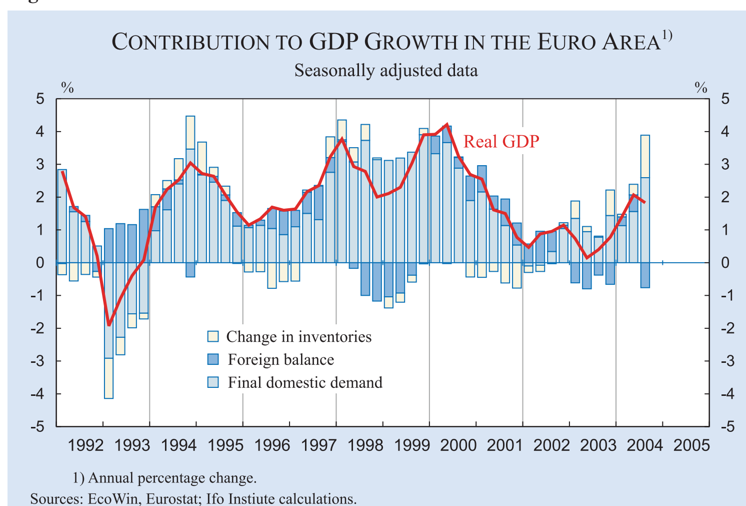
Source: Ifo World Economic Survey (WES) QI/2005.

Figure 1.2



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

Figure 1.3



1) Annual percentage change.
Sources: EcoWin, Eurostat; Ifo Instiute calculations.

ing their catching-up from low income levels – with the highest growth being recorded in the Baltic states, Poland, and the Slovak Republic.

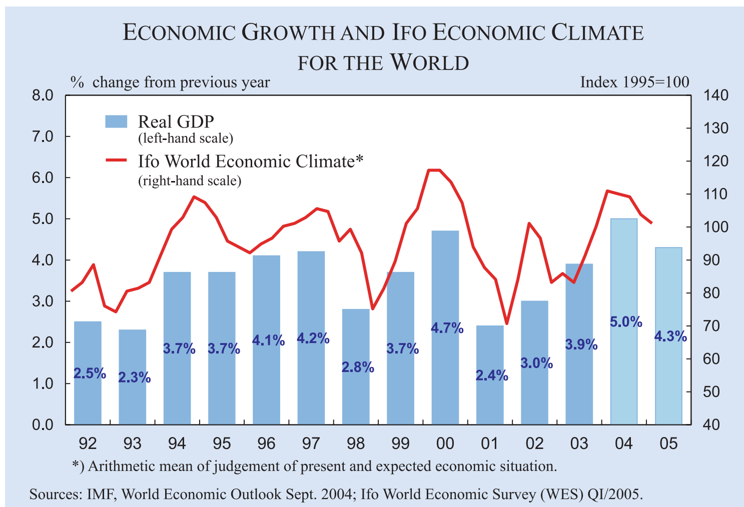
1.1 The United States and Asia as engines for European growth

In 2004, European growth depended – once more – on the strength of the world economy. World output increased by 5 percent (after almost 4 percent in 2003) and the strengths of the US and Asian economies were again the main forces behind the global expansion. Growth of the world economy was stronger than expected in our last year's report.[2] But the sharp rise in oil prices has raised concerns about the sustainability of the global recovery.

In the *United States*, despite some deceleration during the course of the year, GDP growth in 2004 is expected to have reached 4.4 percent (after 3 percent in 2003). Growth was supported by all major demand components. Business investment remained strong throughout the year boosted by low interest rates, higher profits and rising capacity utilisation. Housing investment also remained buoyant, supported by low interest rates. Private consumption benefited from additional tax cuts, rising real wages, higher employment, low interest rates, and further rising house prices. A huge public sector deficit continued to add to aggregate demand. Exports were driven by higher global demand and the depreciation of the US dollar, but as imports increased again faster than exports, the contribution of net exports to output growth remained negative and the current account deficit reached a new record high of 5¾ percent of GDP (after 4¾ percent in 2003). This also re-

[2] In last year's report we projected GDP growth of 3.4 percent for the world economy, 4.2 percent for the United States, 1.9 percent for Japan, and 8.1 percent for China. In all three regions, growth turned out to be higher (4.4, 2.9, and 9 percent, respectively).

Figure 1.4



Sources: IMF, World Economic Outlook Sept. 2004; Ifo World Economic Survey (WES) QI/2005.

flects the growing gap between domestic savings and investment. While investment continues to rise, domestic savings remain low. The low savings rate is caused by both low savings of private households, declining to around 1 percent of disposable income, and high negative government savings. Compared with earlier upswings, job creation remained sluggish, raising concerns about jobless growth, but employment improved later in the year.

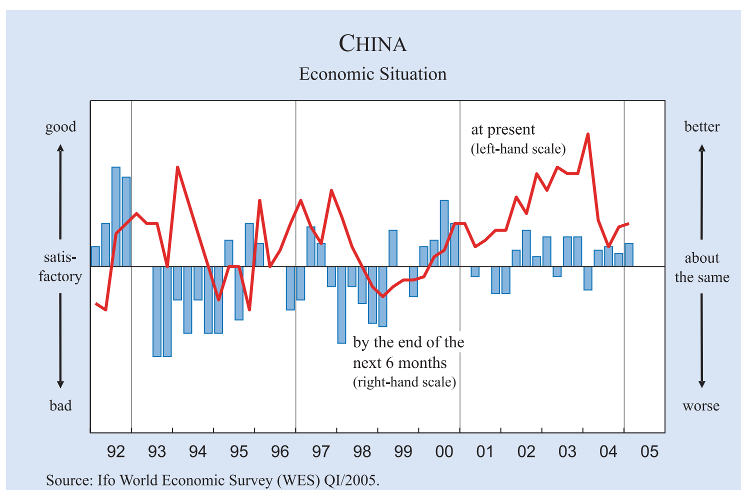
In *Japan*, the economic expansion, which had started in 2003, strengthened further. Output growth reached a record 5.2 percent annual rate in the first quarter of 2004, but stagnated in the second and third quarters. It may have reached almost 3 percent for the year as a whole (after 2.5 percent in 2003). In contrast to previous short-lived recoveries, the expansion was not driven by additional fiscal stimulus.[3] The major driving forces of output growth were exports, in particular to China, and business investment, which was stimulated by higher profits resulting from exports and from ongoing corporate restructuring. Private consumption also recovered and was supported by a decline in household savings and a moderate increase in employment. Nominal and real wage rates, however, continued to decline. Despite higher annual growth and higher oil prices, deflation has not yet come to an end. While the decline of consumer prices has almost stopped, the decline of the GDP deflator has not.[4] The fall in land prices continued for the thirteenth consecutive year, although rising land prices in some metropolitan areas may be signalling the end of land price deflation. As bank loans are often backed by real estate as collateral, land price deflation continued to have a negative impact on banks' balance sheets. At the same time, banks reduced the amount of non-performing loans. While the fall in bank lending continued in its six consecutive year, it was no obstacle to the recovery of business investment as this was mainly financed by retained profits.

During recent years, *China* has become an important engine of growth for the global economy as its rising demand for imports has been fuelling the export-led recoveries in other countries. China's share in world trade doubled over the past ten years and is now above five percent; China's increase in trade currently accounts for around one quarter of world trade

[3] The structural deficit declined slightly by around 0.5 percentage points of GDP and public investment declined by 14 percent. Japan's fiscal deficit remained very high, however (almost 7 percent of GDP after 7¾ percent in 2003). Japan's gross government debt increased from 65 percent of GDP in 1991 to more than 160 percent in 2004 and is now the highest in the OECD. During the same period, government net debt increased from 13 percent of GDP to 85 percent. Given the historically low interest rates on government bonds, government net interest payments, however, only increased from 1.1 to 1.8 percent of GDP during this period. But debt interest could become a significant burden in the future.

[4] The continued fall in the GDP deflator (by around 1 percentage point) can be explained by the decline in unit labour costs (as wages fall while productivity increases). However, after the recent introduction of chain-linked indices, the decline in the GDP deflator was lower (and growth in real GDP was also lower) than previously measured.

Figure 1.5



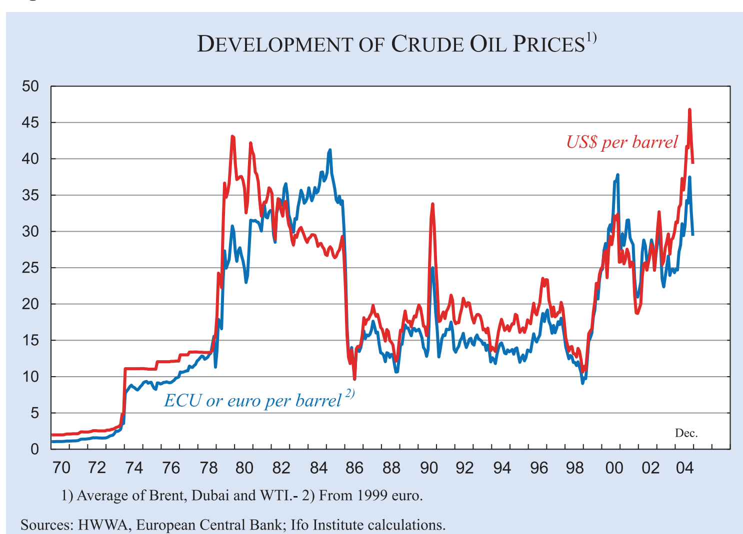
Source: Ifo World Economic Survey (WES) QI/2005.

growth. While aggregate demand in neighbouring countries such as Japan and South Korea profits most from trade with China, aggregate demand in other countries and regions, including Europe, also benefits.[5] As China's imports increased again more than its exports, its current account surplus declined from around 3.1 percent of GDP in 2003 to around 1.1 percent in 2004. Given the mounting inflationary pressures, credit conditions were tightened to reduce growth. This together with the increase in oil prices have had some effect and business confidence weakened and showed only a moderate improvement in recent months (Figure 1.5). Nevertheless, annual growth remained at around 9 percent. China's growth was again driven by booming business investment, reflecting high domestic saving and a large influx of foreign direct investment, and by booming exports, reflecting low labour costs.

1.2 The latest oil price hike

The strong recovery of the world economy has increased demand for raw materials and in particular crude oil. The rising demand for oil, in particular by China and the United States, met with supply disruptions in Iraq and uncertainties over the fate of Russia's top producer Yukos. In addition, speculative purchases and, perhaps, the response of oil producers to the decline in the dollar exchange rate, pushed oil prices to record levels of around 50 US dollars per barrel in October (Figure 1.6). The hike in oil prices has raised fears that the recovery of the world economy may slow. Indeed, the inflationary pressures stemming from the increase in energy prices brought the process of disinflation to a halt (Figure 1.7) and dampened real spending in a number of countries. More recently, oil prices have declined again and, assuming that the increase in oil prices will be contained, energy prices will only have a transitional impact on inflation and growth. However, if oil demand should continue to rise more than supply, oil prices will rise again and the impact on inflation and growth could become more significant than assumed in our projection.

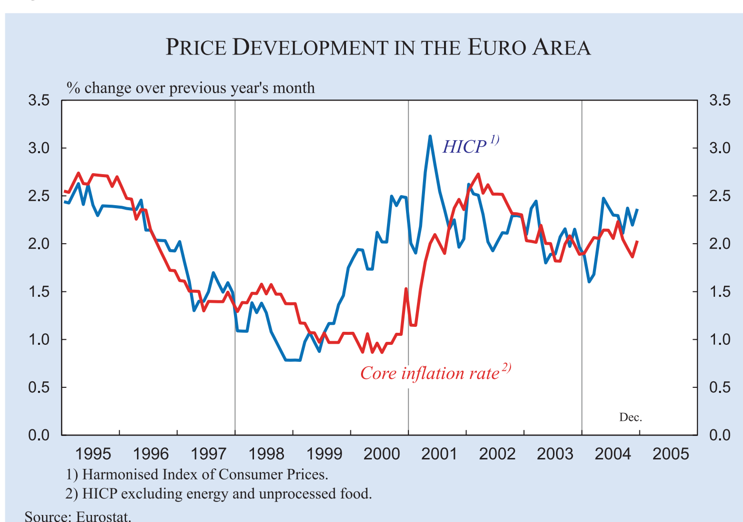
Figure 1.6



1) Average of Brent, Dubai and WTI.- 2) From 1999 euro.

Sources: HWWA, European Central Bank; Ifo Institute calculations.

Figure 1.7



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

Source: Eurostat.

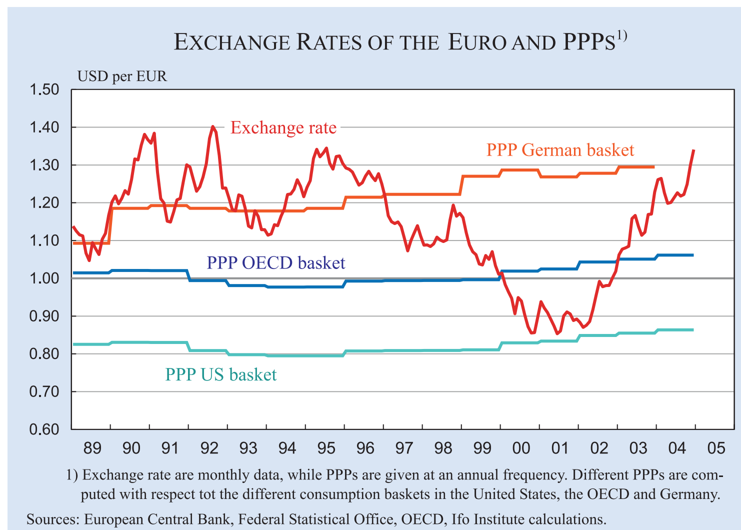
1.3 The international policy mix

In the industrial countries, the stance of macro policies continued to be accommodative, even more so in the United States and Japan than in Europe. With respect to fiscal policy, the difference between structural deficits remained large. In the euro area, the (average) structural and actual deficits remained broadly constant (at around 2 percent of

[5] During 2003 and 2004, exports to China accounted for about a third of the rise in total Japanese exports and over 40 percent of the rise of South Korean exports, but less than 10 percent of the rise in total German exports and less than 5 percent of the rise in total French exports. The main reason is that in Japan and Korea the share of exports to China is much higher than in Europe. While Japanese and South Korean exports to China amount to around a quarter of their total exports, exports of the euro area to China only amount to around 3 percent of total exports (excluding intra-area trade).

GDP for the structural and around $2\frac{3}{4}$ percent for the actual deficit), reflecting a rather neutral stance of fiscal policy.[6] Countries with better fiscal positions tended to provide a larger fiscal stimulus than countries where deficits were already above the Maastricht ceiling. An exception, however, was Greece where the surge in spending for the Olympic Games led to an increase in the actual deficit from around $4\frac{1}{2}$ to $5\frac{1}{2}$ percent of GDP and of the cyclically-adjusted deficit from $5\frac{1}{4}$ to $5\frac{3}{4}$ percent of GDP (see Appendix 3 on the Stability Pact).[7] In 2005 the structural deficit in the euro area will decline by about $\frac{1}{2}$ percentage point to $1\frac{1}{2}$ percent of GDP. In the *United States,* the structural deficit remained at $4\frac{1}{4}$ percent of GDP providing no additional boost to domestic demand, although between 2000 and 2003/2004 US fiscal policy had provided a historically large stimulus with a deterioration of the structural fiscal balance by $5\frac{1}{2}$ percentage points of GDP and of the actual fiscal balance by around 6 percentage points. *Japan* continued to run the largest structural fiscal deficit, which is clearly unsustainable; in 2004, the structural deficit amounted to $6\frac{1}{4}$ percent of GDP and the actual deficit to $6\frac{1}{2}$ percent of GDP

Figure 1.9



1) Exchange rate are monthly data, while PPPs are given at an annual frequency. Different PPPs are computed with respect tot the different consumption baskets in the United States, the OECD and Germany.

Sources: European Central Bank, Federal Statistical Office, OECD, Ifo Institute calculations.

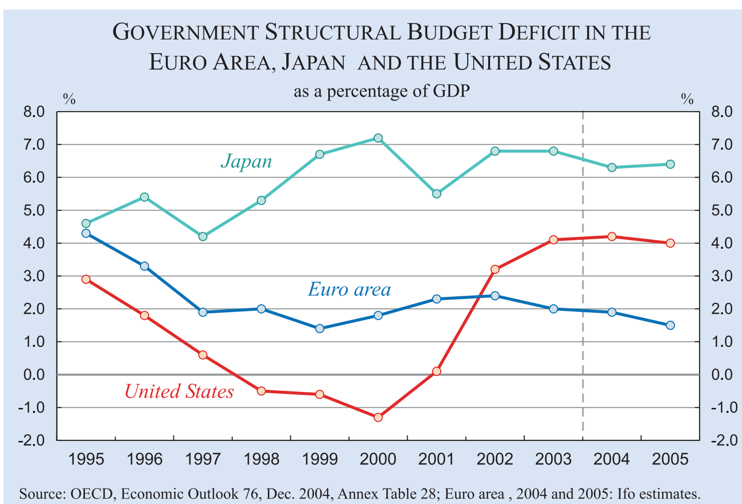
Monetary conditions remained favourable everywhere in 2004 but – given the lower real interest rates and the depreciation of the US dollar against the euro – continued to be more accommodative in the United States than in the euro area. Towards the end of 2004, the euro further strengthened against the dollar, reaching very high levels. Only after German unification was the respective deutschemark exchange rate (expressed in ECU) higher. Figure 1.9 shows the value of the euro in terms of dollars as well as the purchasing power parity (PPP) of the euro for alternative commodity baskets.[8] As a rule, a country's commodity basket contains many of those goods that are cheap there. The exchange rate of another country's currency must

[6] The decomposition 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 our 2003 report.

[7] Greece has significantly revised its deficit and debt-to-GDP ratios. The deficit ratio has been raised from around $1\frac{1}{2}$ percent on average between 2000 and 2003 to 4 percent, which is above the Maastricht ceiling and – had it been known at the time – would not have allowed Greece to enter the euro area. The debt ratio has been revised upwards from an average of around 105 percent of GDP to around 113 percent for the same period.

[8] Note that the series do not represent an index that is normalized at any point in time. The reported values are computed for a standard basket of goods consumed in the respective countries with city prices in the capitals of the countries normalized to one. A value of 1.30 in 2004 therefore means that a resident of Berlin would pay 1.3 times the price of the basket consumed at home if he moved to the United States and purchased the same basket of goods in Washington DC. The calculations are based on prices of identical goods weighted by their share in a typical consumption bundle in the respective country.

Figure 1.8

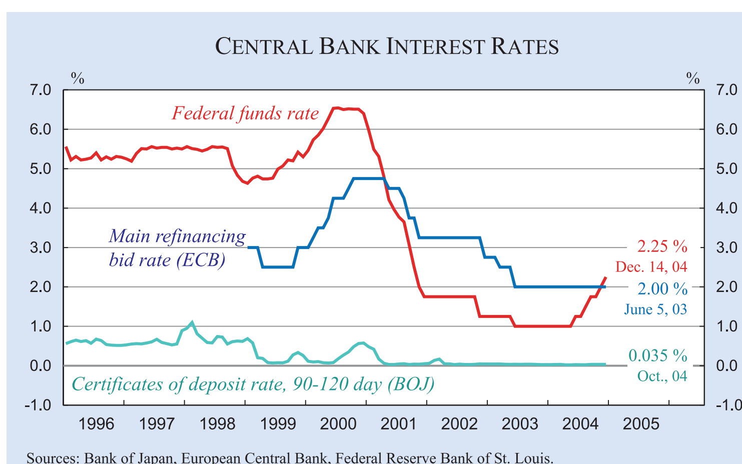


Source: OECD, Economic Outlook 76, Dec. 2004, Annex Table 28; Euro area , 2004 and 2005: Ifo estimates.

be low if that country's commodity basket is to be as expensive as the home country's. Thus, the PPP value of the euro is low when the American basket is chosen and high when the German basket is chosen. The lower and upper PPP lines in the figure reflect this. In addition, the figure contains an intermediate PPP line that refers to a standardised international basket as defined by the OECD. In 2004, the PPP value of the euro was 1.06 according to the OECD basket and 0.86 according to the US basket. As the figure shows, the euro exchange rate is now much higher than the OECD basket PPP and even higher than the German basket PPP. Hence, at the current exchange rate, it is relatively cheap for Europeans to spend their money in the United States rather then at home or to import goods and services, while exporting becomes more difficult (Figure 1.9).

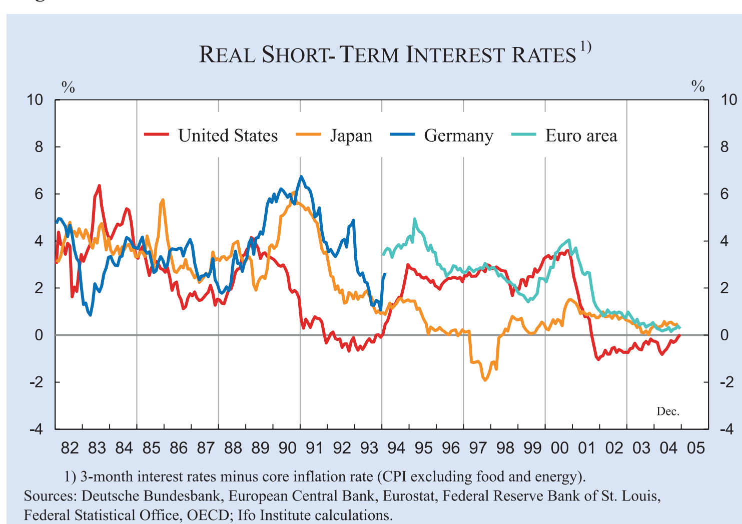
While the European Central Bank left its target interest rate unchanged at 2 percent and the Bank of Japan continued its zero interest rate policy, the US Federal Reserve began, in the summer of 2004, to reduce the monetary stimulus by raising the Federal funds rate in consecutive steps (Figure 1.10). In the United Kingdom, where economic growth has remained stronger than in continental Europe, the central bank also gradually raised interest rates in an attempt to cool activity and, in particular, to dampen the boom in the housing market (see Chapter 5 of this report). In most countries, real short-term interest rates continue much below their equilibrium levels, currently being close to zero in the euro area, Japan, and the United States (Figure 1.11).

Figure 1.10



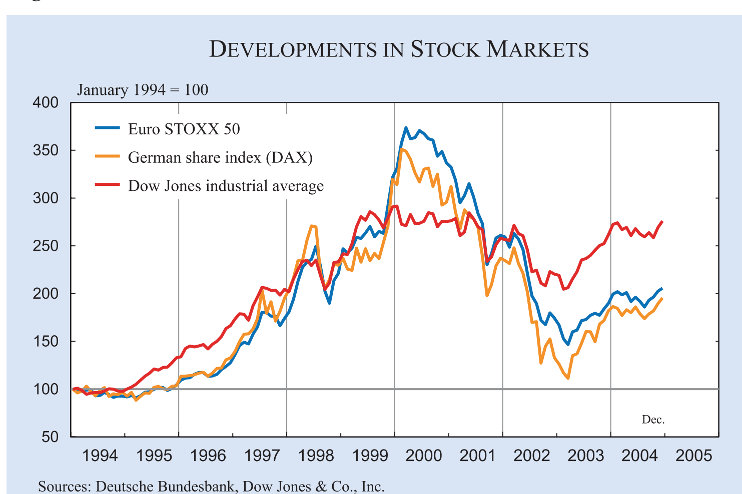
Sources: Bank of Japan, European Central Bank, Federal Reserve Bank of St. Louis.

Figure 1.11



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; Ifo Institute calculations.

Figure 1.12



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

The increase in oil prices has raised the issue whether monetary authorities should raise interest rates to fight inflation or keep rates low to support growth. The fact that in the United States the rate hikes have

been relatively modest and that the ECB and the Bank of Japan have not yet raised rates at all suggests that central banks are generally interpreting the oil price hike as temporary and not affecting long-term inflation expectations, in particular as the recent weakening of growth has slowed down the closing of output gaps. In our view this is a realistic assumption.

Nominal and real government bond yields edged up temporarily in 2004, but this development was reversed later in the year. In the euro area nominal long-term rates remained on average at 4¹/₄ percent and real rates at 2¹/₂ percent. At the same time, the risk premium of industrial bonds remained low. Although the increase in share prices came to a halt at the beginning of 2004, overall financing conditions remained favourable (Figure 1.12). Nevertheless, bank lending to corporations remained low in the euro area. This could reflect low credit demand as investment could be financed by retained profits. It could also reflect more cautious lending behaviour by banks, which were still strained by earlier stock market declines.

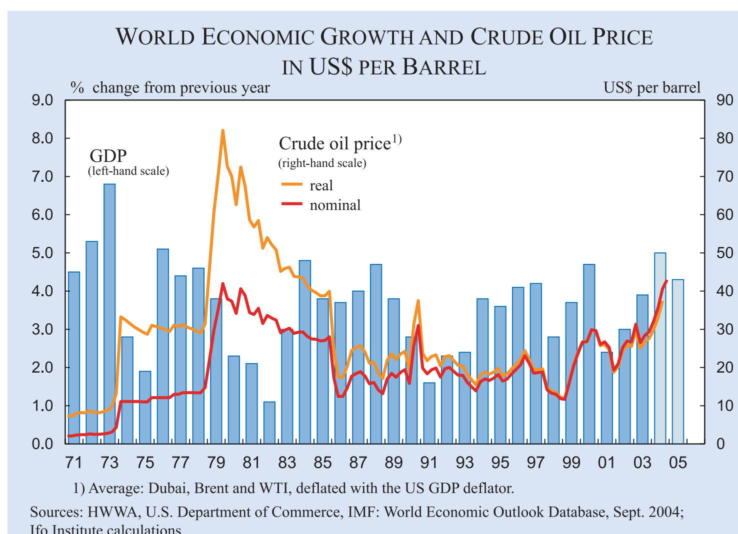
2. Economic outlook 2005: Recovery in the world economy and in Europe continues

2.1 The global economy

In 2005, we expect the expansion of the world economy to continue at a moderate pace. This is based on the following assumptions:

- In the United States, the Federal Reserve is assumed to increase interest rates further, but real short-term interest rates will remain below the so-called neutral rate[9] so that monetary conditions will continue to support an increase in demand. The structural fiscal deficit is expected to decline only marginally (by ¹/₄ percentage points of GDP), implying only a modest fiscal tightening. Relatively strong productivity growth will continue to raise corporate profits and also boost real wages. Household income will also be supported by a further rise in employment. Business investment will remain strong as capacity utilisation and profit expectations increase further, but growth in housing investment is expected to decline significantly. Output is assumed to increase by 3 percent in 2005, after 4.4 percent in 2004, but this will still not fully close the output gap in 2005.
- Growth in the Asian economies, in particular in Japan and in China, will also decelerate – from 2.9 percent to 1.2 percent in Japan and from 9 percent to 8 percent in China – but there will be no “hard landing” of these economies.
- The continued recovery in the United States, Asia and Europe will help the world economy to continue its expansion albeit at a somewhat lower rate than in 2004. World trade is expected to increase by around 7¹/₂ percent in 2005, after around 10 percent in 2004.
- Oil prices (composite index) are assumed to remain on average at a similar level as in 2004 (37 US dollars in 2005 after 38 dollars in 2004). In nominal terms the oil price would be still similar to the levels which triggered recessions in many countries in the early 1980s, but the real oil price (in constant 1995 dollars) is significantly lower than during earlier peaks and the appreciation of the euro against the dollar has also dampened the increase in the euro oil price (Figure 1.13). The importance of oil to the economies, as measured by the oil import bill as a percentage of GDP, has been reduced significantly

Figure 1.13



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. 2004; Ifo Institute calculations.

[9] In the United States, in the past, a real short-term interest rate of around 3 percent was commonly thought to reflect the neutral rate at which monetary policy is neither expansionary nor restrictive. According to more recent estimates, however, the neutral rate has fallen below 2¹/₂ percent. See Thomas Laubach and John C. Williams, “Measuring the natural rate of interest,” *The Review of Economics and Statistics,* November 2003, 85(4): 1063–1070; *OECD Economic Outlook* No. 76, November 2004, Box 1.4.

over the past decades, in many countries by more than half. Furthermore, oil producing countries are assumed to spend a good part of their additional revenues on imports from industrial countries so that the net effect on world output growth will be muted (see Appendix 4).
- The euro exchange rate is assumed to remain on average below 1.35 dollars in 2005 after averaging 1.24 dollars in 2004.

Risks and uncertainties

The following forecast for the European economy is based on relatively favourable external assumptions, but major downside risks remain. Oil prices could start to rise again and this could hurt business confidence and reduce global growth. In addition, the existing external imbalances with the high US current account deficit (at around 6 percent of GDP) could trigger sharp exchange rate movements with a further dollar depreciation and euro appreciation. This could erode the price competitiveness of European exporters and bring the export-led recovery in Europe to a sudden end. Job creation in industrial countries may also remain lower and households may increase savings, so that consumption remains weaker than assumed. Furthermore, in countries that are currently experiencing a boom in the housing market housing investment could slump. Finally, China's economy could face a hard landing rather than the assumed soft slowdown. This would also reduce growth in the global economy.

Should some of these risks materialise, European growth would be lower than projected below. While there are also upside risks to the forecast – confidence effects and accelerator effects on domestic demand might be larger, so that the rebound of the European economy could be stronger than expected as is often the case during early recovery periods – we believe the downside risks currently to be somewhat higher than the upside risks.

2.2 The European economy in 2005

Policy assumptions

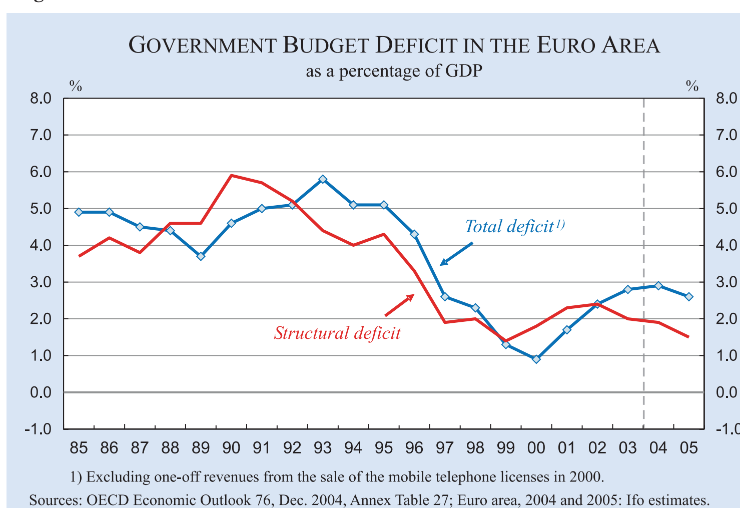
Despite the continued recovery of the eurozone, the cyclical slack will remain large and put downward pressure on the inflation rate. Under these conditions, the ECB is assumed to keep interest rates unchanged during 2005.

The stance of *fiscal policy* in the euro area is assumed to remain broadly similar to that of 2004 with only a modest tightening. Countries seem to be reluctant to reduce structural deficits significantly in view of high unemployment, and the fiscal rules in the Stability and Growth Pact are in effect becoming less firm (see Appendix 3) (Figure 1.14). The degree of already achieved consolidation and of additional efforts differ quite substantially among countries, however. For example, Finland is continuing to run a budget surplus and in Spain and Ireland government budgets will be broadly balanced. On the other hand, Greece, France, Germany, Italy and Portugal will continue to run deficits at or above the three-percent limit of the Maastricht Treaty (Table A3). Outside the euro area, government budgets in some countries (Sweden and Denmark) will remain in surplus, while the United Kingdom will continue to record a deficit of above three percent. The new EU member states also tend to run relatively high fiscal deficits and six of them have deficits in excess of three percent of GDP. As the output gap has been closed in the United Kingdom, its entire deficit is structural, while in France, Germany, Italy and Portugal, where output gaps prevail – according to OECD estimates – between one fifth and one half of the deficits are cyclical.

Supply-side improvements and risks

The challenge facing the European economy is to continue reducing the cyclical slack, and to improve the growth potential. Whereas the former requires a continued accommodative stance of macro policies, in particular easy monetary conditions, the latter

Figure 1.14



1) Excluding one-off revenues from the sale of the mobile telephone licenses in 2000.
Sources: OECD Economic Outlook 76, Dec. 2004, Annex Table 27; Euro area, 2004 and 2005: Ifo estimates.

Box 1.1

Labour Market Reform in Germany

Starting from January 2005, a number of changes in labour market institutions that were enacted in 2003 and 2004 will now become effective (see EEAG 2003, Box on p. 31 and EEAG 2004, Box 2.4). The most important of these changes is a fundamental reform of the benefit system for the long-term unemployed and other non-employed individuals living on general welfare benefits. According to official estimates, between 3 and 3.5 million individuals, or about 7 to 8 percent of the total labour force, will be affected by this reform (*IAB* 2004).

Starting from 2005, the maximum duration of unemployment insurance benefits *(Arbeitslosengeld I)* for older workers is reduced from up to 32 months to 18 months; the period of benefit payments for younger workers remains at 12 months. More importantly, unemployment assistance is integrated with social assistance to form one comprehensive scheme *(Arbeitslosengeld II)* that is basically modelled on the less generous scheme of former social assistance and covers all non-employed individuals of working age except those with unemployment insurance entitlements and those unfit for work or engaged in a number of specific home responsibilities. For former recipients of social assistance who did not work, the level of benefits remains largely unchanged. For former recipients of unemployment assistance, which is now abolished, there can be substantial reductions of benefits. Unemployment assistance was based on earlier net wages and amounted to 53–57 percent of these, depending on whether beneficiaries had children or not. By contrast, the new benefit is defined by the subsistence level of income of a given household. For the average unemployment assistance recipient, the reduction of benefits is about 8 percentage points. Benefit withdrawal rates are also slightly reduced (from between 85 and 100 percent to between 70 to 80 percent) over a certain range of low incomes, but withdrawal rates are unchanged for higher incomes. In certain income ranges they may now even exceed 100 percent for family households. Because of the reduction of withdrawal rates, former recipients of social assistance who worked may now receive higher benefits.

In addition to changes in benefit entitlements, requirements to search for a job and to accept jobs proposed by case managers are being tightened: benefit sanctions in cases of non-compliance are higher and shall be applied more strictly under the new framework than according to past practices. For the jobs offered to be acceptable, the new law specifies no limits regarding qualifications demanded (compared to the job searcher's formal skills or actual job experience), wages paid (compared to wages earned in previous jobs, wage levels defined in collective agreements, etc.), or the number of working hours regularly covered (in full-time, part-time, or even "mini" jobs).

Public protests against the reforms that were vigorous in the Summer of 2004 have now largely subsided. As the latest reform steps that become effective now are unprecedented, assessing their consequences is difficult. In our view, they mark an important step in the right direction, whereas earlier, less fundamental changes enacted since 2002 have largely proven to be ineffective in reducing unemployment and promoting job creation (*see* Council of Economic Advisors 2004 and 2004 Joint Forecast of the Institutes).

An immediate consequence of the current changes could be that officially recorded unemployment rises by about 300,000 to 400,000, or by 0.7 to 0.9 percentage points, in January 2005 because individuals of working age who formerly received social assistance, but did not register as being unemployed are now included in the statistics. As some of these individuals will find a job during the course of the year, registered unemployment will fall again, but the annual average may be higher than in 2004 by about 100,000 to 150,000. Hence by eliminating hidden unemployment of the social assistance system, the reform would have reduced effective unemployment by 200,000 to 250,000, or by about half a percentage point. However, benefit levels in the new scheme are still relatively generous, and withdrawal rates still very high, so that beneficiaries may not accept jobs at low wages. It may therefore be necessary to further reduce benefit rates and withdrawal rates to stimulate both labour supply and demand in an expanding low-wage sector of the labour market, as has been suggested by, for example, the Council of Economic Advisors (2002), the Advisory Board of the Federal Ministry of Economics (2002) and Sinn et al. (2002).

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requires structural reforms, in particular improved conditions for a better utilisation of the labour force. Looking at cyclical conditions, aggregate demand and capacity utilisation are still relatively low, but profit margins are improving and overall conditions for investment financing are favourable. 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 that should make labour markets more flexible. Although past reforms have already shown positive results in some countries, the new measures require time to have their full effects (see Box 1.1). With the current cyclical weakness, labour demand is relatively low, which makes it more difficult to quickly absorb a reform-induced increase in labour supply. This also creates political headwinds

against such reforms and risks that reform efforts will wane. Nevertheless, such reforms are urgent in order to raise employment rates over the medium-term, in particular as the employment targets for 2010 set in Lisbon in 2000 seem currently out of reach.[10]

Under conditions of continued cyclical slack, pressure for wage moderation will continue and this could be reinforced by recent tendencies in some countries (in particular Germany) to lengthen working hours (see Chapter 3 of this report). As a result, unit labour costs will be restrained and profit margins should widen further, leading to an increase in investment and employment. Given low inflation expectations and high unemployment, the increase in oil prices is unlikely to trigger higher wage claims that would squeeze profits, even if such a risk cannot fully be excluded.

There is also a tendency that with European enlargement a greater share of total business investment will be shifted to the accession countries where labour costs are much lower than in the old EU states. Investment in the euro area could therefore remain lower than in previous economic recoveries and concerns about outsourcing have been raised. Indeed, many of the accession countries are recording high foreign direct investment inflows, a good part of which are from neighbouring western countries. As already mentioned in last year's report, such mobility of capital should not be a major concern for long-term growth of Europe as a whole, since it results in an improved allocation of capital, incorporating those regions of the continent that previously had been artificially excluded from international investment flows by the Iron Curtain. Mobility of capital also helps maintain the competitiveness of western companies that succeed in keeping their wage bills under control and withstand competition from other parts of the world by outsourcing labour intensive parts of their production to Eastern Europe. However, flexible labour markets in Western Europe are a prerequisite for the reallocation of capital not to result in unemployment in the West and to boost economic growth in the EU aggregate. Chapter 2 will discuss this in more detail.

The development of demand components in the euro area

During the course of 2005, the ongoing expansion of the world economy will probably continue to support *export growth.* On average, euro area exports are likely to increase somewhat less than in 2004.

Private consumption is expected to be supported by an improvement in labour market conditions and – after the oil price effect has subsided – a decline in consumer price inflation and in some countries also by additional tax reductions. But there are also factors which continue to restrain consumer spending. In particular, fiscal consolidation measures will continue to place strains on private households by reducing transfers and raising contributions to social security systems or to private pension and health care schemes. Hence, we expect a continued moderate increase in private consumption.

With the continued strength in exports and further improving profit margins as well as favourable financing conditions, the recovery in *investment* that began in 2004 is expected to strengthen in 2005. Capacity utilisation in the export sector has increased and in domestically oriented sectors, where capacity utilisation is still low, there is mounting pressure to modernise the capital stock.

Growth, employment and inflation

On average, output in the euro area is expected to grow at a similar rate as in 2004 (1 3/4 percent)[11] (Figure 1.15). The growth gap between Europe and the United States will narrow somewhat, but only because growth in the United States will decelerate more than in Europe (Figure 1.16).[12]

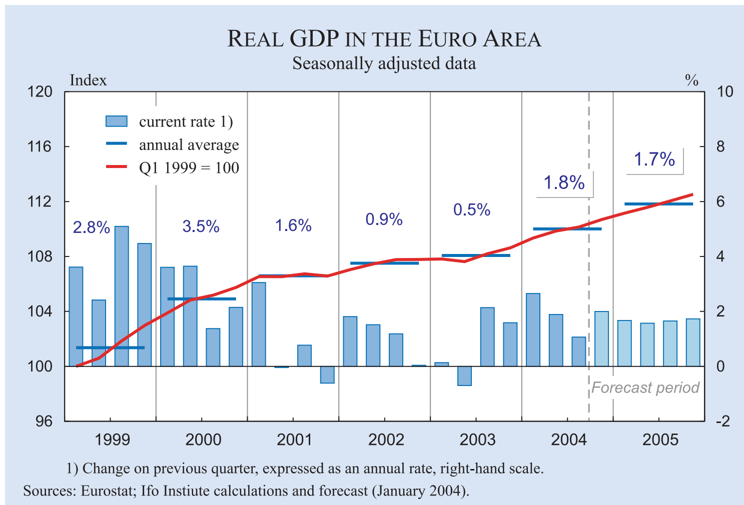
Output growth will remain too weak to significantly improve labour markets and in the euro area employment growth will continue to remain very small. Unemployment will continue to remain high and is expected to decline only marginally towards the end of the year (Figures 1.17 and 1.18). Structural reforms of the labour market, which have been implemented in some countries, like Germany, should help to

[10] In March 2000, the EU member countries fixed numerical employment targets. The total employment rate (of those aged 15 to 64) was targeted to increase on average by 6 1/2 percentage points to 70 percent between 2000 and 2010, the employment rate of women by around six percentage points to 60 percent, and the employment rate of older workers (55 and older) by 12 percentage points to 50 percent. However, the employment rate in EU-15 increased only by less than 1 1/2 percentage points over the past four years and is unlikely to increase by another five percentage points over the next five years.

[11] The precise numbers are 1.7 percent for 2005 and 1.8 percent in 2004 but this small difference lies well within the uncertainty range of forecasting.

[12] It should be noted that the growth differential between Europe and the United States is smaller with respect to GDP per capita than GDP, as population growth in the United States is higher by 3/4 percentage points (almost 1 percent against 1/4 percent in Europe). Thus in 2005, GDP per capita will increase by 1 1/2 percent in Europe compared with around 2 1/4 percent in the United States, implying a further widening of the income gap between Europe and the United States.

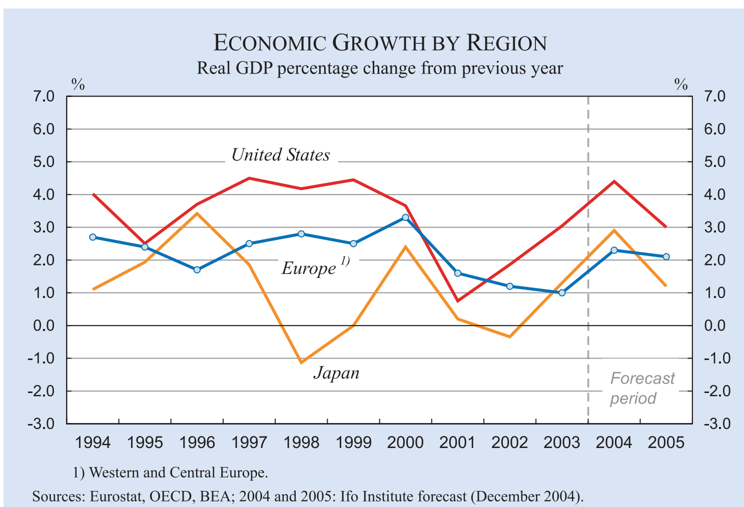
Figure 1.15



REAL GDP IN THE EURO AREA
Seasonally adjusted data

1) Change on previous quarter, expressed as an annual rate, right-hand scale.
Sources: Eurostat; Ifo Institute calculations and forecast (January 2004).

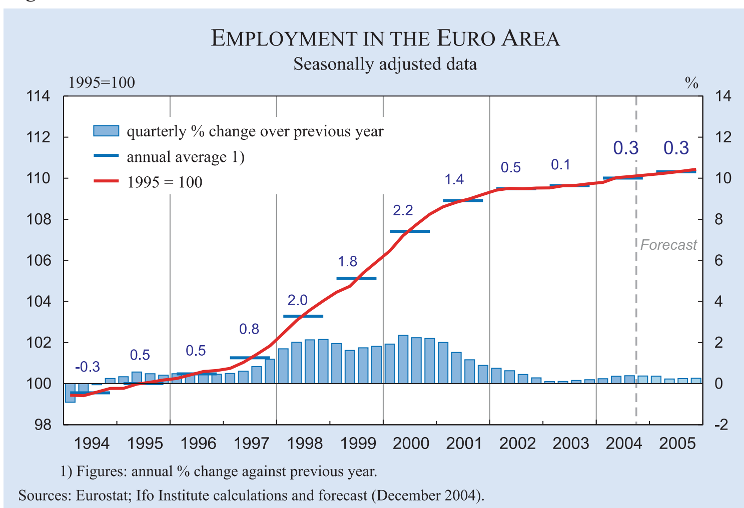
Figure 1.16



ECONOMIC GROWTH BY REGION
Real GDP percentage change from previous year

1) Western and Central Europe.
Sources: Eurostat, OECD, BEA; 2004 and 2005: Ifo Institute forecast (December 2004).

Figure 1.17



EMPLOYMENT IN THE EURO AREA
Seasonally adjusted data

1) Figures: annual % change against previous year.
Sources: Eurostat; Ifo Institute calculations and forecast (December 2004).

reduce unemployment over the medium-term, although their short-term impact may be small and at the beginning of the year the reform in Germany has increased unemployment as more of the formerly hidden unemployed are now registered as unemployed (see Box 1.1 on labour market reform in Germany).

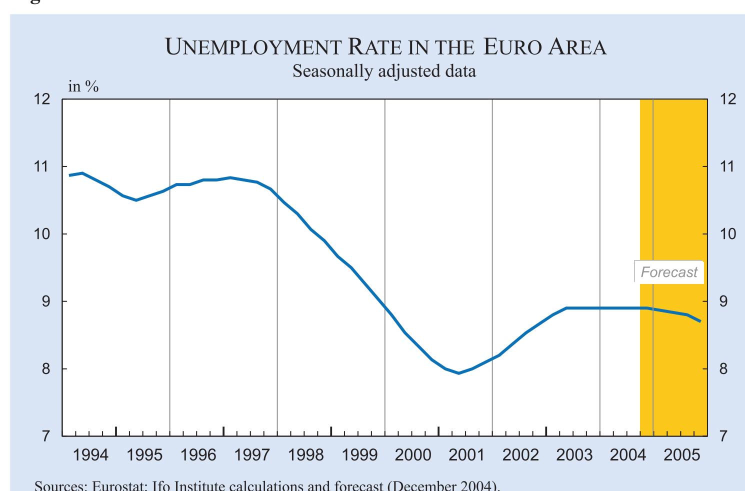
2.3 Differences in output growth within Europe

Despite the general recovery in the euro area (and in Europe as a whole) in 2004, there were significant differences in the output growth of individual countries. Among the countries with below-average growth in 2003, a few (Germany and France) achieved almost average or above-average growth in 2004, while in others (Portugal, Italy and the Netherlands) growth remained below average. In three countries of the euro area (Greece, Ireland and Spain) and in the UK, growth was above 2 1/2 percent, with Greece achieving the highest growth rate, at 3 3/4 percent (boosted by the Olympic games). Growth in the four major new EU member countries was also uneven, with the highest growth in Poland (at around 5 1/2 percent), followed by the Slovak Republic (at around 5 percent), and Hungary and the Czech Republic (at almost 4 percent). Growth was even higher in the Baltic States, at between 5 3/4 and 7 percent.

The differences in the growth performance of individual European countries reflect a number of factors, including statistical differences as the number of working days in 2004 increased more in some countries than in others.[13] The new EU member countries benefit from relatively favourable supply conditions related to a

[13] This calendar effect was particularly marked in Germany where it amounted to 0.5 percent in 2004. As in some countries GDP is adjusted for the number of working days, growth rates are not fully comparable.

Figure 1.18



Sources: Eurostat; Ifo Institute calculations and forecast (December 2004).

normal catching-up process (i.e. lower initial levels of GDP per capita, low wage levels and relatively high capital productivity).

Wage moderation, as measured by the development of nominal and real wages, continued in the euro area in 2004. With moderate nominal wage growth and higher productivity growth, the increase in unit labour costs was lower than in 2003, although this was not a uniform pattern across countries (Table 1.1). In countries like Italy and Spain, increases in unit labour costs remained above-average, reflecting higher nominal wage increases and low productivity growth. Outside the euro area, the increase in wage costs was also relatively high in the United Kingdom despite higher productivity growth. Among the new EU member countries, the increase in wage costs was high in Hungary but low in Poland. Unit labour costs measured in a common currency, relative to those of trading partners (an indicator often used as a proxy for the real effective exchange rate) continued to increase in the euro area as a result of the strengthening of the euro in contrast to the United States where they declined. As a result, European countries lost shares in their export markets although these losses differed substantially across countries. Due to wage

Table 1.1.

The development of various measures of wages and wage costs

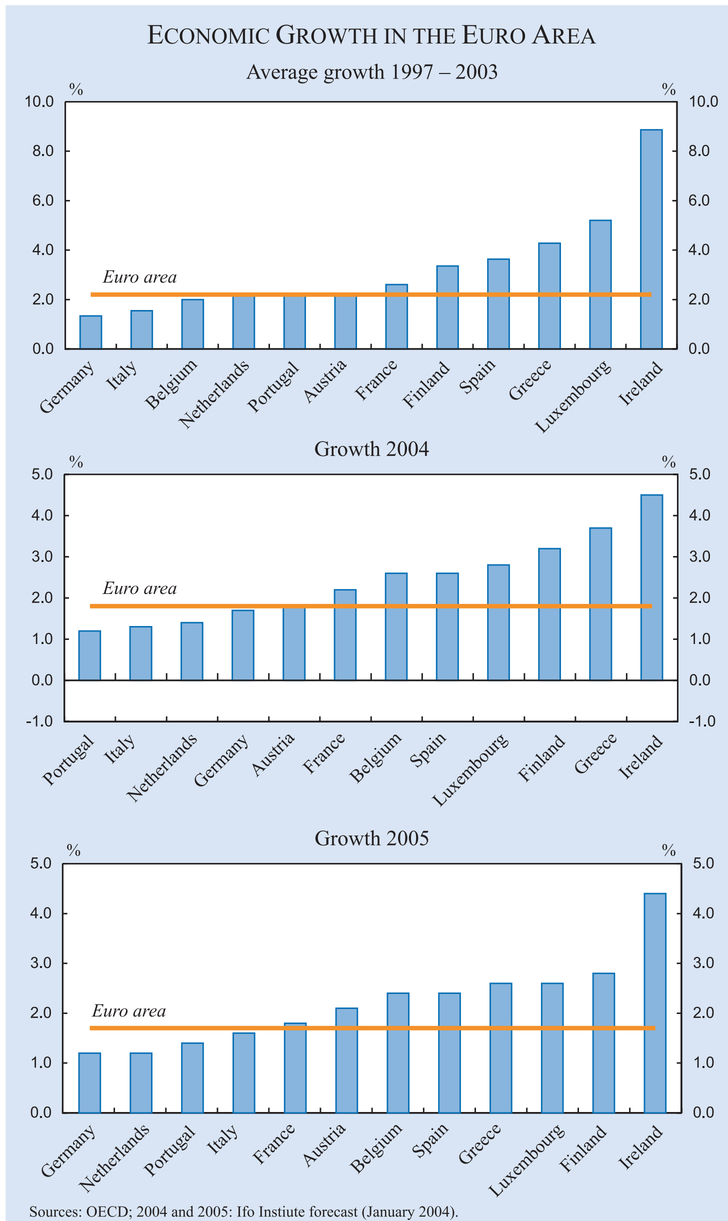
Annual average changes in per cent

		Nominal wage[1]	Real wage [1,2]	Labour productivity [1]	Unit labour costs[1]	Relative unit labour costs[3]	Export performance[4]
Euro area	2001-2003	2.4	0.1	0.4	2.0	6.4	
	2004	1.9	0.0	1.2	0.7	5.1	
of which:							
Germany	2001-2003	1.6	0.3	0.6	1.0	1.6	1.0
	2004	1.0	0.1	1.0	0.0	1.8	-0.5
France	2001-2003	2.5	0.7	0.5	2.0	0.9	-2.2
	2004	2.7	0.8	2.8	0.1	-1.1	-3.9
Italy	2001-2003	2.9	0.0	-0.4	3.3	5.5	-4.7
	2004	2.5	-0.3	0.3	2.2	4.6	-4.0
Finland	2001-2003	3.2	1.9	1.3	1.9	2.4	-1.8
	2004	3.1	2.3	3.8	-0.7	1.3	-6.7
Netherlands	2001-2003	4.5	0.7	-0.4	4.9	6.2	-1.3
	2004	1.8	1.0	2.6	-0.8	0.7	-0.7
Ireland	2001-2003	3.6	-0.3	3.4	0.2	0.2	2.1
	2004	5.2	1.6	3.5	1.6	2.4	-0.9
Spain	2001-2003	4.6	0.4	0.7	3.9	3.2	0.7
	2004	4.5	1.4	0.7	3.8	4.4	-2.1
United Kingdom	2001-2003	4.3	1.5	2.7	1.6	-0.9	-1.3
	2004	5.6	3.4	3.7	1.8	4.8	-5.3
Sweden	2001-2003	2.9	1.0	1.3	1.6	-1.3	-0.5
	2004	2.8	1.7	4.5	-1.6	3.1	2.4
Poland	2001-2003	3.8	1.9	4.8	-1.0	-8.6	3.2
	2004	2.8	-1.1	5.4	-2.5	-10.9	3.5
Hungary	2001-2003	11.2	2.6	3.3	7.7	9.4	3.2
	2004	9.3	4.1	3.0	6.1	4.1	5.9
United States	2001-2003	3.1	1.1	2.7	0.4	-2.0	-3.7
	2004	4.1	2.1	3.7	0.4	-5.8	-0.8
Japan	2001-2003	-1.4	0.3	1.5	-2.9	-5.8	0.6
	2004	-0.3	2.0	4.0	-4.3	-1.1	2.8

Notes: 1. Business sector.
2. Nominal wage deflated by GDP deflator (as a measure of the real product wage).
3. Competitiveness-weighted relative unit labour costs in dollar terms.
4. Export performance is the ratio between export volumes and (trade-weighted) export markets for goods and services.

Source: OECD, estimate for 2004, calculations by the Ifo Institute.

Figure 1.19



Sources: OECD; 2004 and 2005: Ifo Instiute forecast (January 2004).

moderation and a favourable commodity structure, Germany's export growth was only marginally lower than the growth of its export markets, while Italy, Finland, and the United Kingdom experienced larger losses in export market shares. The new EU member countries achieved further gains in market shares, although (as in Hungary) the real exchange rate of some countries appreciated.

Domestic demand remained relatively weak in many countries of the euro area. This was especially the case in Germany and the Netherlands, where real income growth was particularly low and households continued to increase their savings rates (in response to a deteriorating labour market, policy uncertainties, reforms of social security systems, and earlier losses in equity wealth). In some other countries, such as France and Spain, domestic demand was stronger. While in Spain private consumption benefited from buoyant income growth, in France consumption was supported by a decline in household savings.

In 2005, growth differentials will continue to remain significant (Figure 1.19).

Appendix 1:
Forecasting Tables

Table A1

Real gross domestic product, consumer prices and unemployment rates

	Weighted (GDP) in %	Gross domestic product			Consumer prices			Unemployment rate in %		
		in %								
		2003	2004	2005	2003	2004	2005	2003	2004	2005
EU25	33.7	1.0	2.3	2.1	2.0	2.0	2.0	9.1	9.0	8.9
Switzerland	0.9	-0.4	1.7	1.7	0.6	0.8	1.1	3.7	3.9	3.8
Norway	0.7	0.4	3.2	2.8	2.0	0.8	1.5	4.5	4.4	4.2
Western and Central Europe	35.3	1.0	2.3	2.1	1.9	1.9	2.0	8.9	8.8	8.7
USA	33.6	3.0	4.4	3.0	2.3	2.6	2.6	6.0	5.5	5.6
Japan	13.2	1.3	2.9	1.2	-0.3	-0.2	-0.1	5.3	4.7	4.5
Canada	2.7	2.0	3.0	2.7	2.8	1.8	1.9	7.6	7.3	7.1
Industrialised countries total	84.7	1.9	3.2	2.3	1.8	1.9	1.9	7.6	7.1	7.0
Newly industrialised countries										
Russia	1.3	7.3	6.8	5.3	13.6	11.0	10.6	8.7	7.8	7.0
East Asia[a)]	4.6	3.7	6.2	5.4	.	.	.	.	.	.
China	4.8	9.1	9.1	8.2	.	.	.	.	.	.
Latin America[b)]	4.6	1.7	5.1	3.9	.	.	.	.	.	.
Newly industrialised countries total	15.3	5.1	6.8	5.8	.	.	.	.	.	.
Total[c)]	100.0	2.3	3.8	2.9	.	.	.	.	.	.
World trade, volume		4.2	10.0	7.5	.	.	.	.	.	.

[a)] Weighted average of: Korea, Taiwan, Indonesia, Thailand, Malaysia, Singapore, Philippines. Weighted with the gross domestic product of 2003 in US dollars. – [b)] Weighted average of: Brasil, Mexico, Argentina, Columbia, Venezuela, Chile, Peru. Weighted with the gross domestic product of 2003 in US dollars. – [c)] Sum of the listed groups of countries. Weighted with the gross domestic product of 2003 in US dollars.

Sources: EU; OECD; ILO; IMF; National Statistical Offices; 2004 and 2005: 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			Consumer prices[a)]			Unemployment rate[b)] in %		
		in								
		2003	2004	2005	2003	2004	2005	2003	2004	2005
Germany	21.9	-0.1	1.7	1.2	1.0	1.6	1.4	9.6	9.7	9.8
France	15..9	0.5	2.2	1.8	2.2	2.3	1.9	9.4	9.6	9.5
Italy	13..4	0.3	1.3	1.6	2.8	2.3	2.2	8.6	8.3	7.9
Spain	7.6	2.5	2.6	2.4	3.1	3.1	3.0	11.3	10.8	10.5
Netherlands	4.7	-0.9	1.4	1.2	2.2	1.5	1.4	3.8	4.6	4.5
Belgium	2.8	1.3	2.6	2.4	1.5	1.9	1.7	8.0	7.8	7.6
Austria	2.3	0.8	1.8	2.1	1.3	1.9	1.7	4.3	4.5	4.3
Greece	1.6	4.5	3.7	2.6	3.4	3.1	3.4	9.3	8.9	8.9
Finland	1.5	2.0	3.2	2.8	1.3	0.1	1.6	9.0	8.9	8.8
Ireland	1.4	3. 7	4.5	4.4	4.0	2.3	2.8	4.6	4.5	4.3
Portugal	1.3	-1.2	1.2	1.4	3.3	2.5	2.3	6.3	6.5	6.5
Luxembourg	0.2	2.9	2.8	2.6	2.5	3.3	2.9	3.7	4.3	4.1
Euro area[c)]	74.5	0.5	1.8	1.7	2.1	2.1	1.9	8.9	8.8	8.7
United Kingdom	16.3	2.2	3.2	2.7	1.4	1.3	1.6	5.0	4.6	4.7
Sweden	2.7	1.5	3.5	3.0	2.3	1.2	1.6	5.6	6.3	6.1
Denmark	1.9	0.4	2.3	2.3	2.0	0.9	1.7	5.6	5.4	5.1
European Union[c)]	95.5	0.8	2.2	2.0	1.9	1.9	1.9	8.1	8.0	7.9
Poland	1.9	3.8	5.4	4.4	0.7	3.5	3.1	19.2	18.8	18.5
Czech Republic	0.8	3.7	3.8	3.3	-0.1	2.6	2.7	7.8	8.4	8.4
Hungary	0.8	3.0	3.9	3.5	4.7	6.8	5.3	5.8	5.8	5.7
Slovakia	0.3	4.0	4.9	4.6	8.5	7.5	4.1	17.5	18.0	17.5
Slowenia	0.2	2.5	3.8	3.5	5.7	3.8	3.3	6.5	6.0	5.7
Lithuania	0.2	9.7	7.0	6.6	-1,1	1.0	2.5	12.7	10.8	10.2
Cyprus	0.1	1.9.	3.6	3.8	4.0	2.1	2.5	3.9	4.4	4.2
Latvia	0.1	7.5	6.5	5.9	2.9	6.2	5.5	10.5	9.8	9.4
Estonia	0.1	5.1	5.7	5.4	1.4	2.9	3.1	10..1	9.2	8.4
Malta	0.0	-0.3	0.9	1.1	1.9	2.9	2.7	8.2	7.3	6.9
EU Acceding countries	4.5	3.7	4.7	4.1	2.7	2.1	3.4	14.4	14.1	13.8
EU25[c)]	100.0	1.0	2.3	2.1	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 2003 in US dollars; unemployment rate weighted with the number of employees in 2003.

Sources: EUROSTAT; OECD; ILO; IMF; National Statistical Offices; 2004 and 2005: calculations by the Ifo Institute.

Table A3

Indicators of the public budgets in the euro area

	Gross debt[1]					Financial Balance[1]				
	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005
Germany	59.4	60.9	64.2	65.6	66.5	-2.8	-3.7	-3.8	-3.9	-3.1
France	56.5	58.8	63.7	65.0	65.7	-1.5	-3.2	-4.1	-3.7	-3.0
Italy	110.6	107.9	106.2	106.1	105.5	-2.6	-2.3	-2.4	-3.0	-3.5
Spain	57.5	54.4	50.7	48.6	45.9	-0.4	-0.1	0.4	-0.9	-0.5
Netherlands	52.9	52.6	54.1	56.0	58.1	-0.1	-1.9	-3.2	-3.0	-2.3
Belgium	108.1	105.8	100.7	95.5	94.2	0.6	0.1	0.4	-0.1	-0.2
Austria	67.1	66.6	65.1	64.2	63.8	0.3	-0.2	-1.1	-1.3	-2.0
Greece	114.7	112.5	109.9	112.5	110.5	-3.7	-3.7	-4.6	-5.5	-4.4
Finland	43.8	42.6	45.6	44.1	43.5	5.2	4.3	2..3	2.1	2.1
Ireland	35.9	32.7	32.1	30.4	29.6	0.9	-0.2	0.1	-0.3	-0.6
Portugal	55.8	58.4	60.3	60.7	61.7	-4.4	-2.7	-2.8	-2.9	-3.4
Luxembourg	5.5	5.7	5.4	5.0	5.1	6.4	2.8	0.8	-0.9	-1.8
Euro area[2]	69.5	69.4	70.7	71.3	71.3	-1.7	-2.4	-2.7	-2.7	-2.6
United Kingdom	38.8	38.3	39.8	40.5	41.1	0.7	-1.6	-3.3	-2.9	-2.7
Sweden	54.4	52.6	52.	51.1	49.5	2.8	0.0	0.3	0.5	0.6
EU-15	63.3	62.7	64.3	64.8	64.8	-1.1	-2.1	-2.7	-2.6	-2.4

[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 2003 in euro.

Source: Eurostat; 2004 and 2005: forecasts by the Ifo Institute.

Table A4

Key forecast figures for the euro area

	2003	2004	2005
	Percentage change over previous year		
Real gross domestic product	0.5	1.8	1.7
Private consumption	1.0	1.2	1.4
Government consumption	1.7	1.6	1.1
Gross fixed capital formation	-0.6	1.8	2.6
Exports[1]	0.9	5.7	5.1
Imports[1]	2.1	5.6	4.9
Consumer prices[2]	2.1	2.1	1.9
	Percentage of nominal gross domestic product		
Current account balance	0.4	0.3	0.4
Government financial balance	-2.7	-2.7	-2.6
	Percentage of employees		
Unemployment rate[3]	8.9	8.8	8.7

[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; 2004 and 2005: forecasts by the Ifo institute

Appendix 2:
The Ifo World Economic Survey (WES)[14]

In January 2005 the World Economic Climate slightly deteriorated for the fourth time in succession since April 2004. Both components of the economic climate index – current economic situation and expectations for the coming six moths – have been downgraded somewhat. However, the climate indicator, at 101.1 (after 103.8 in October; 1995=100), is still higher than its long-term average (1990–2004: 93.0). In the following we summarize the results of the latest survey. The two components of the climate indicator, the assessment of the current situation and the expectations for the next six months, are depicted in the figures below.

World economy is losing steam

According to the latest WES results, growth is expected to slow down further in the coming months. Although assessments of the current economic situation as well as economic expectations for the first half of 2005 have been slightly downgraded by experts surveyed in January, the change is not expected to result in a strong downturn. Most determinants of the short-term prospects remain positive. However, further downward pressures remain: possible disruption in oil supplies as result of terrorism or other military actions in the Near East. Nevertheless, a soft-landing of the economic climate index is seen by surveyed experts to be the most likely scenario for 2005.

Western Europe: Economic performance remains sluggish

The overall economic climate indicator slipped in January for the second time in succession. The assessments of the present economic situation have fallen slightly below the satisfactory mark, on average for all Western European countries. Also the economic expectations for the coming six months have been slightly downgraded but remained generally positive. This pattern also holds true for the majority of countries of the euro area. However, in *Belgium, Finland, Spain* and *Greece*, surveyed experts assessed the present economic state somewhat better than in the October survey. The best marks for the current economic performance in the euro area were again given by experts surveyed in *Ireland* and *Finland*. The lowest marks for the present economic situation were given by experts in *Portugal, Italy* and *the Netherlands.* Though, *Germany's* economy experienced an upturn in 2004 thanks to strong exports and the world economic recovery, its present economic situation is assessed once again as below satisfactory. An important aspect for the lagging economy in the euro zone is the euro's 50 percent appreciation against the dollar over the past three years, as the cheaper dollar makes European goods more expensive in global export markets. For 2005 experts in the euro zone are expecting the export sector to develop less dynamically than in 2004. But the exchange rate is not the only dampening factor. Unemployment and weak private consumption are the other problem areas. However, surveyed experts see an improvement in both aspects for the first half of 2005.

The economic climate in the Nordic countries outside the euro area *(Denmark, Sweden, Norway* and *Iceland)* remained very favourable. The assessments of the present economic situation continued to improve in *Denmark* and *Norway* and have been slightly downgraded in *Sweden*, though remaining far above the satisfactory level. Also, the *United Kingdom's* economy has begun 2005 on course to continue its period of growth, with low inflation and interest rates, and the government continuing to meet its fiscal goals. The current economic situation in the UK has been assessed as highly satisfactory by WES experts. The economic expectations for the next six months point to further stabilization. Also in *Switzerland*, the economic recovery continues to gain momentum, according to the January survey.

North America: Still the driving force in the world economy

According to the latest survey results, the economic climate indicator in North America has improved in

[14] The World Economic Survey (WES) assesses worldwide economic trends by polling transnational as well as national organizations worldwide on current economic developments in their respective countries. This allows for a rapid up-to-date assessment of the economic situation prevailing around the world. In January 2005 some 1,130 economic experts in 90 countries were polled. The survey questionnaire focuses on qualitative information: assessments of a country's general economic situation and expectations regarding important economic indicators. It has proved to be a useful tool in that it reveals economic changes earlier than traditional business statistics. The individual replies are combined for each country without weighting. The grading procedure consists in giving a grade of 9 to positive replies (+), a grade of 5 to indifferent replies (=) and a grade of 1 to negative (-) replies. Overall grades within the range of 5 to 9 indicate that positive answers prevail or that a majority expects trends to increase, whereas grades within the range of 1 to 5 reveal predominantly negative replies or expectations of decreasing trends. The survey results are published as aggregated data. The aggregation procedure is based on country classifications. Within each country group or region, the country results are weighted according to the share of the specific country's exports and imports in total world trade.

January, due to higher marks for the present economic situation in the *US*. The country's economy is still fairly strong despite the slippage in business sentiments in the preceding October poll. However, the economic expectations for the coming six moths have been downgraded again, reflecting that business confidence remains weakened though no sharp downturn is expected. Concerns persist that the rising interest rates and oil prices combined with federal budget deficits and fears of expanded military activity in the Near East may slow the US economy in 2005.

In *Canada* both components of the economic climate index have deteriorated. However, the assessments of the current economic situation remain favourable. Economic expectations, though slightly downgraded, are still generally positive.

Eastern Europe: Further economic stabilization

The sluggish Western European economic performance has evidently had no far-reaching effect on its neighbours, particularly in Central and Eastern Europe. According to the January survey, the overall economic climate index followed its positive trend, with the assessments of the current economic situation continuing to improve and economic expectations for the coming six months pointing upward. The general present economic conditions as well as business sentiments are regarded as positive, on average, for Eastern Europe.

As already in the October survey, the assessments of the present economic situation in almost all new EU countries – *Czech Republic, Cyprus, Estonia, Latvia, Lithuania, Poland, Slovenia* and *Slovakia* – were above the satisfactory level in January. The present economic performance has considerably improved also in *Hungary*, though the satisfactory level has not yet been reached, according to WES experts. The forecasts for the coming six months remain positive throughout. The strongest economies in the region, according to WES experts, are *Estonia, Poland, the Czech Republic* and *Slovenia*. The surveyed economists remained optimistic about the near-term future. Particularly capital expenditures and exports are expected to boost the overall economic expansion in the coming six months.

Also in Eastern European countries outside the EU, economic trends observed in January are generally positive. The economic climate is particularly favourable, according to WES experts, in *Bulgaria* and *Croatia*. In *Romania, Albania, Bosnia Herzegovina* and *Serbia-Montenegro* the present economic performance is also rated "satisfactory" or above. The outlook for the next six months points to a continuation of the economic revival.

CIS: Moderate economic slowdown expected

According to preliminary official figures *Russia's* economy grew at about 7 percent in 2004, benefiting from the rising prices for oil, gas and metals. In the beginning of 2005 the economic climate in *Russia* deteriorated somewhat, according to the recent WES results. The present economic situation is judged less favourably than in the preceding October survey. Also the economic expectations, though remaining positive, have been slightly downgraded. Economic growth is expected to slow in 2005, partly due to constraints on oil export capacity. This implies that for achieving sustainable growth, Russia's economy needs restructuring away from its dependence on energy resources. At present, investors are still suspicious about the country's corporate governance and President Vladimir Putin's commitment to reforms.

Less positive signals than in the October survey have also been reported from the Ukraine. The present economic situation has been described by WES experts as slightly below satisfactory, but the prospects for the coming six month have been upgraded here and are now displaying optimism. Yushchenko, the new President, wants EU membership talks to start in 2007 and thus there is more confidence among panelists that *Ukraine* is now on course towards becoming a full-fledged democracy and market economy.

Very positive marks for the present economic performance were given by experts in *Kazakhstan*. The economy grew at about 9 percent in 2004, making the Central Asian country one of the fastest growing economies in the CIS. The current situation is judged at a highly favourable level and is expected to improve further in the course of the next six months. Similarly to *Russia*, much of the growth has been fuelled by oil production. The extraction of natural resources remains the most attractive sector for investors and the main driving force for exports. However, other sectors are also emerging, and the favourable general economic outlook includes higher corporate activity outside the oil sector as well as growth in private consumption.

Asia: Economic soft-landing

Asia was the most rapidly growing economic region in 2004, largely driven by China's and India's economic expansions, making the Western economies increasingly dependent on their Southeast Asian counterparts. In January, the economic climate index in Asia deteriorated slightly for the third time in succession. The assessments of the current economic situation have deteriorated somewhat, on average, for the Asian countries surveyed by WES, mostly reflecting an economic cooling-down in *Japan*. However, economic expectations for the first half of 2005 point to an only moderate slowdown of economic growth. The December 26 earthquake and the giant tsunami that shattered coastal regions in 11 Asian countries, killing some 250,000 people and leaving millions homeless, has caused no major damage to the economic infrastructure of the affected countries, while the costs in human life remain, of course, appalling by any measure.

The economic recovery in *Japan*, the world's second largest economy, appears to be losing momentum, according to WES experts. A further appreciation of the yen against the dollar poses a downside risk, making it difficult to keep Japanese exports attractive on the global market. The *Chinese* economy was also expected to achieve a soft-landing in 2005. But as it seems, there has been no landing at all, as the assessments of WES experts polled in the country in January are more positive than in the October survey, reflecting that optimism has the upper hand. But economic near-term expectations remain subdued, signalling concerns that slowing global growth may reduce demand for goods made in *China*. Nevertheless, *China's* long-term prospects remain very promising. Particularly consumer spending is expected to continue benefiting from the country's economic growth. Closely related to the economic growth of the Chinese mainland are the business sentiments in *Hong Kong,* where private consumption and investment in fixed assets gave momentum to economic growth last year and are predicted to remain strong, though to a slightly lesser degree than in 2004. Also *India* will again record healthy economic performance this year, according to WES experts. The overall economic situation was assessed considerably above satisfactory. The outlook for the coming six months is generally positive and implies further growth of corporate activity and private consumption.

In *Malaysia, Singapore* and *Taiwan* the assessments of the present economic situation, though slightly deteriorated, remained far above the satisfactory level. In *Thailand* major tourist areas were severely affected by the tsunami. However, the assessments of the present economic situation here even improved somewhat from an already favourable level of the October survey. From an economic point of view, the impact of the tsunami on *Indonesia* is also limited, since the Aceh province contributes only 2.1 percent of *Indonesia's* GDP, and its oil and gas production industries have not been affected. But the country's tourism industry has been strongly hit again, though experts expect that the region's tourism will recover faster than after the Bali bombings in 2002 and the SARS outbreak in 2003. Production and international trade flows were not affected in these countries, as manufacturing production facilities and major ports weren't damaged and economic expectations for the first half of 2005 remain generally positive.

Latin America: Economic rebound continues

According to the latest WES results, the assessments of the present economic situation continue to improve in all surveyed countries of the region without exception. Economic expectations are pointing to further stabilisation in 2005. Further strengthening in imports and exports is expected to support economic growth in Latin America. Private consumption and capital expenditures are also forecast to boost further in the coming six months.

Except for *Costa Rica* and *Paraguay*, where the assessments of the present economic situation have not yet reached the satisfactory level, all countries have contributed to the improvement of the economic climate in the region. *Chile* again topped the list of expanding economies. The present economic situation is regarded as highly satisfactory and experts are confident that the country's economy will grow further in the coming months. In the three major regional economies, *Brazil, Argentina* and *Mexico*, WES experts also reported an improvement of the current economic situation. Economic expectations for the coming six months, though slightly downgraded, point to further stabilization. Particularly, *Brazil's* economic performance is surpassing economists' forecasts, as President Lula da Silva has implemented enormous structural reforms since coming to power in January, 2003. But also *Argentina's* economy is making considerable progress, according to surveyed economists. *Venezuela's* economic performance has also become noticeably better, with assessments of the

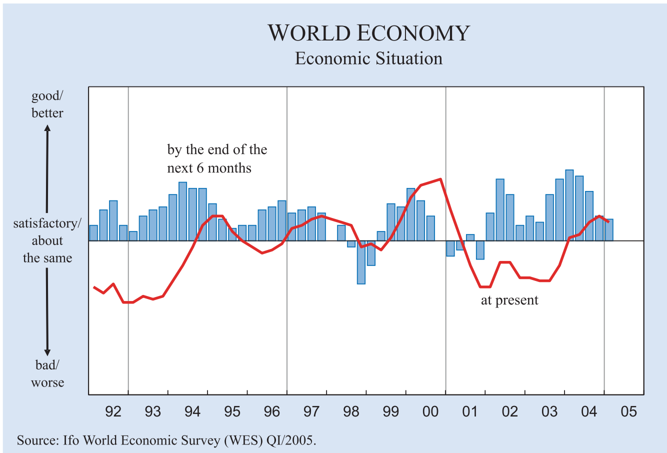
present economic situation approaching the satisfactory level and economic expectations for the first half of 2005 being, except for the export sector, generally optimistic. For the coming six months experts forecast a decrease in exports. One reason may be that *Venezuela*, the world's fifth-largest producer of oil and a major supplier to the United States, is planning to reduce its dependence on the United States as the main consumer of its oil.

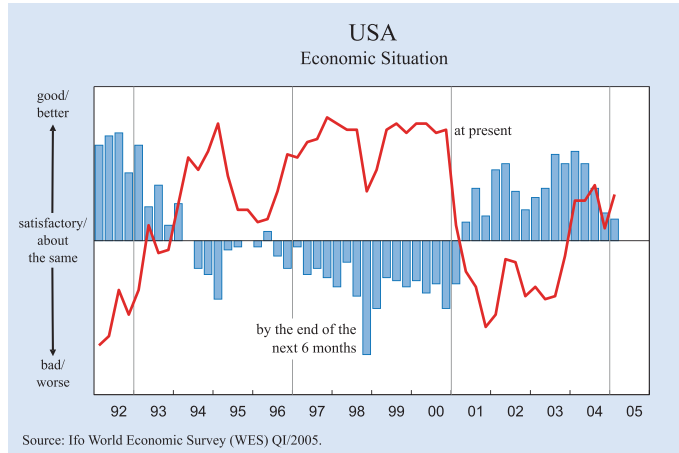
Near East: Economic situation remains favourable

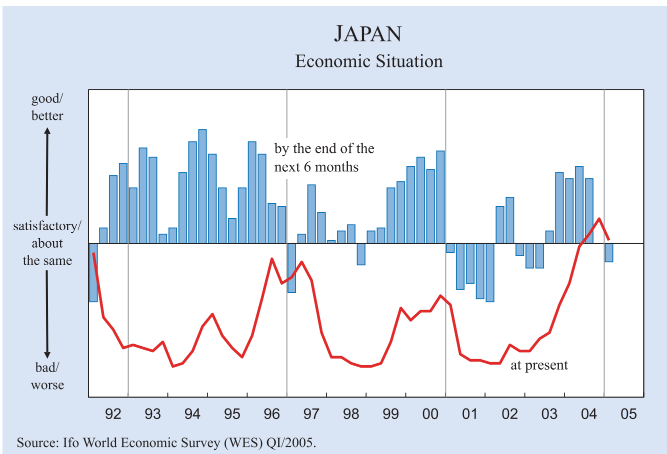
The economic situation in the Near East region has further improved and continues to be highly favourable in all countries covered by WES. However, the near-term prospects for the first half of 2005 have been slightly downgraded resulting in a lower value of the economic climate index.

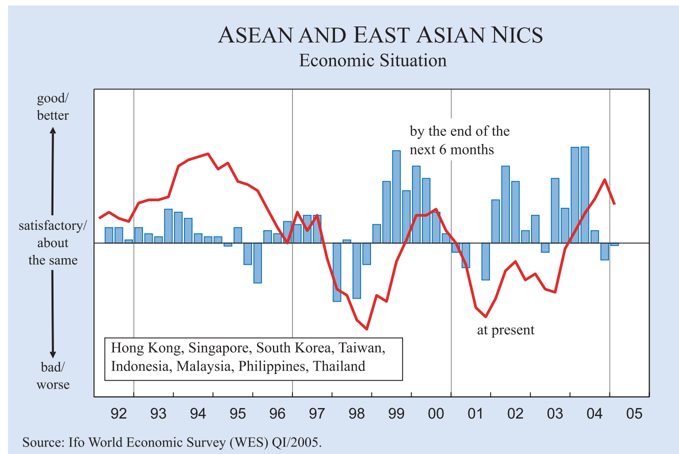
The highest marks of business confidence were again given by experts surveyed in the *United Arab Emirates, Saudi Arabia, Bahrain* and *Kuwait*, followed by *Lebanon, Iran* and *Jordan*. The prospects for further economic stabilisation are, except in *Iran*, very bright. According to the January WES results, the economic climate in *Israel* further improved. Both components of the climate index – present economic situation as well as economic expectations for the next six months – received very positive marks. *Turkey's* GDP expanded by about 10 percent in 2004, making it's economy one of the world's fastest-growing. Much of the GDP growth is due to rising productivity and corporate investment that are expected to strengthen further. In 2005 the country's economy will remain on the strong stabilization course that it set in 2002, according to WES experts polled in January.

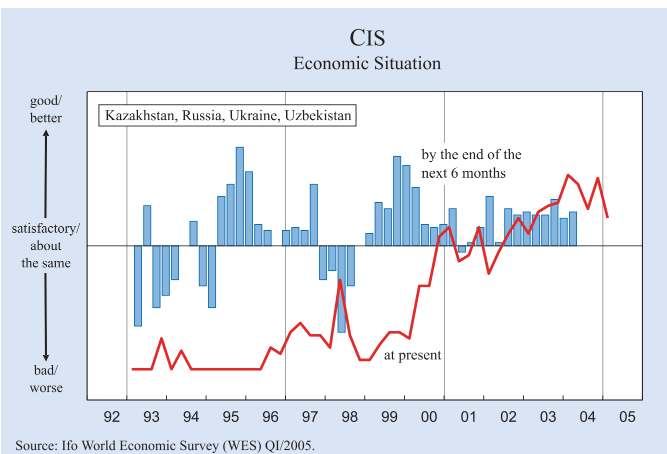
Ifo World Economic Survey (WES)

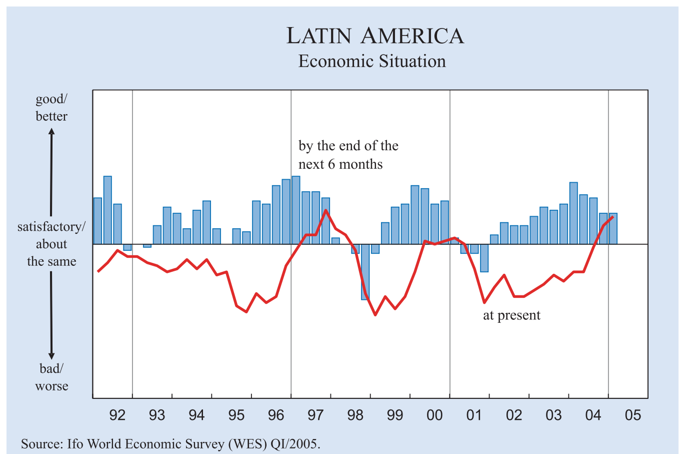


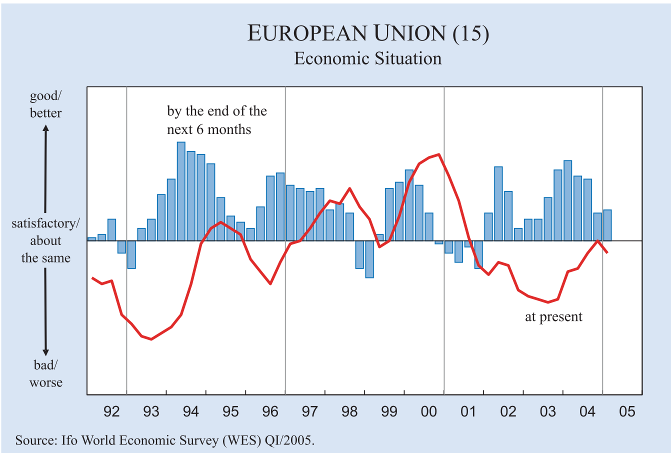












EUROPEAN UNION (15)
Economic Situation

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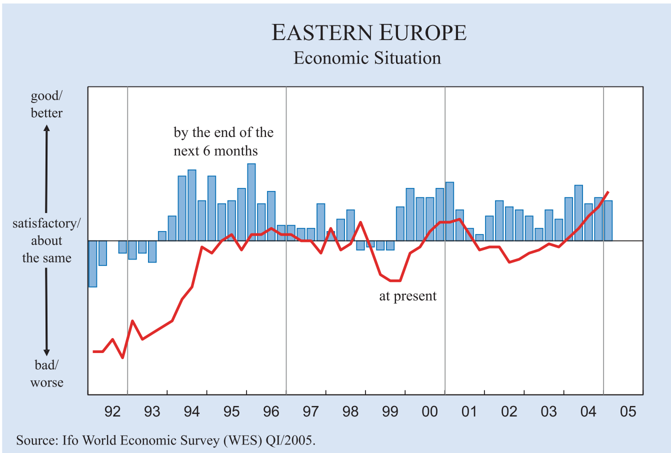

EASTERN EUROPE
Economic Situation

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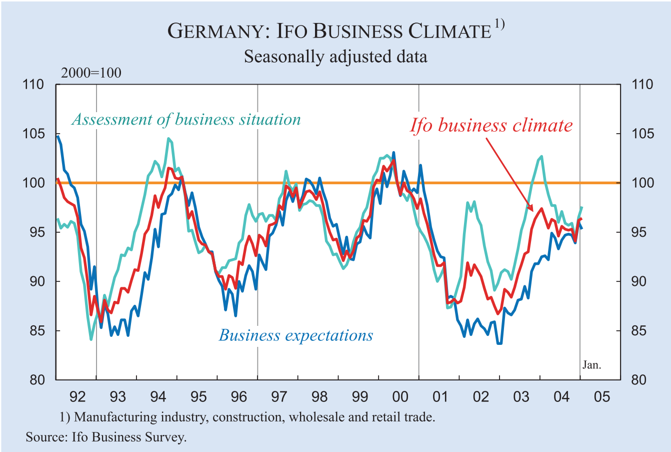
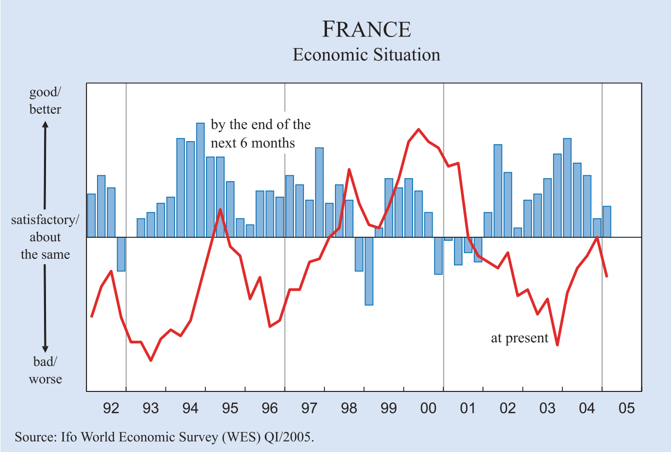


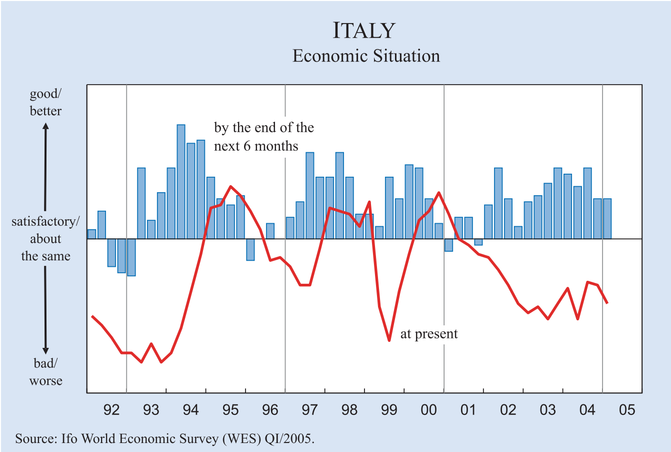
GERMANY: IFO BUSINESS CLIMATE [1)]
Seasonally adjusted data

1) Manufacturing industry, construction, wholesale and retail trade.
Source: Ifo Business Survey.



FRANCE
Economic Situation

Source: Ifo World Economic Survey (WES) QI/2005.



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Economic Situation

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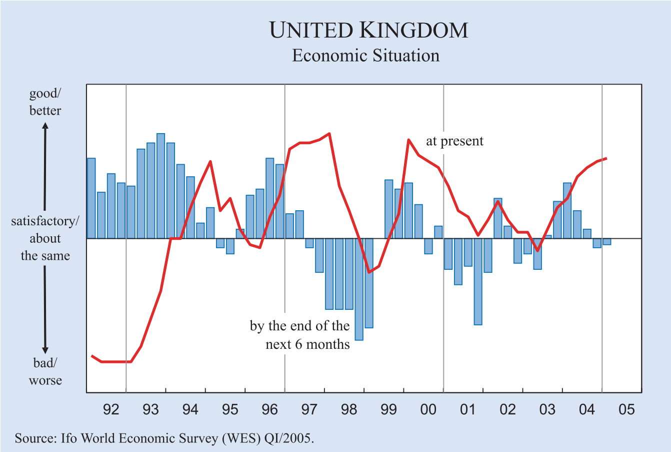

UNITED KINGDOM
Economic Situation

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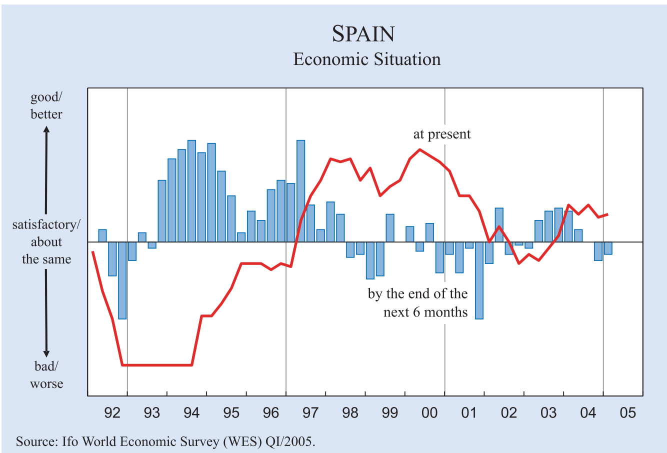

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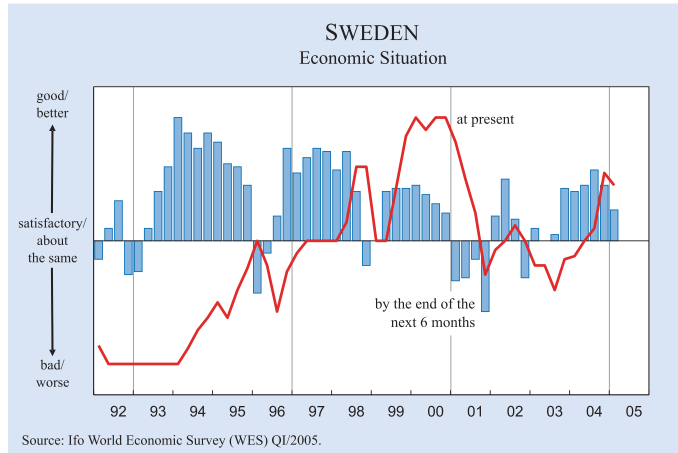

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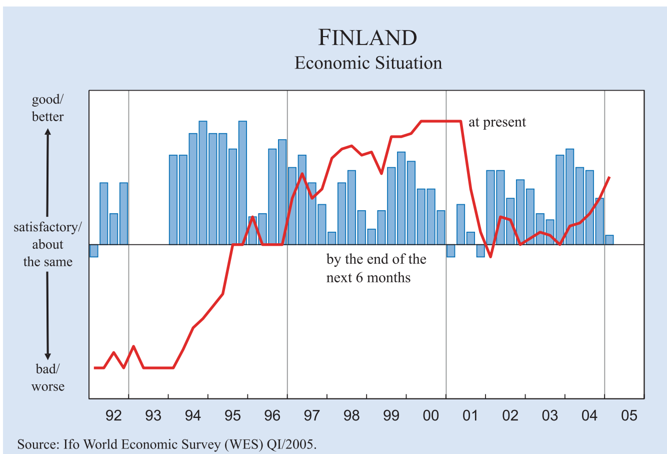

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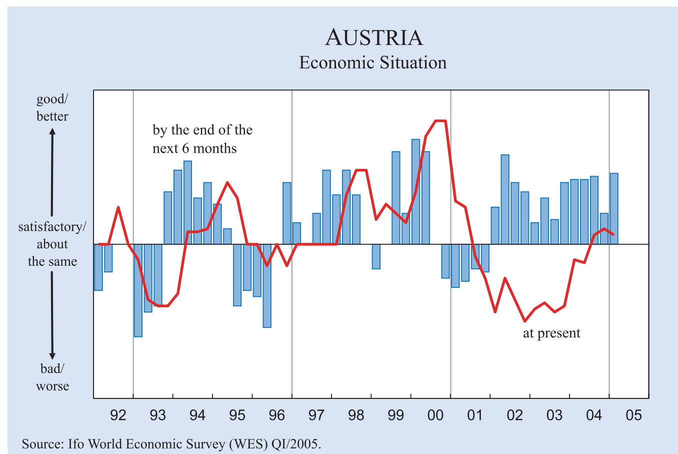

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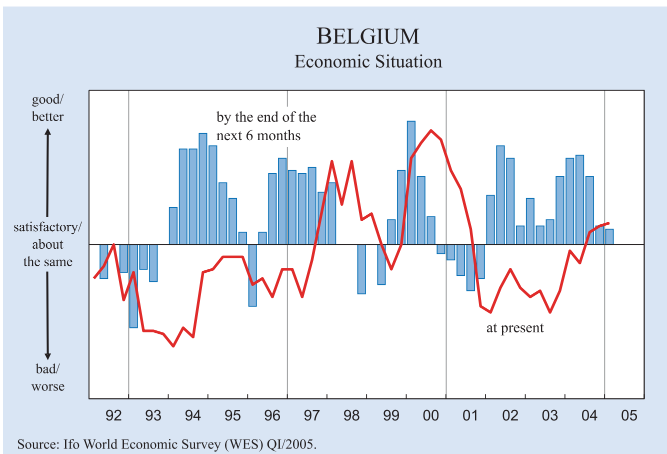

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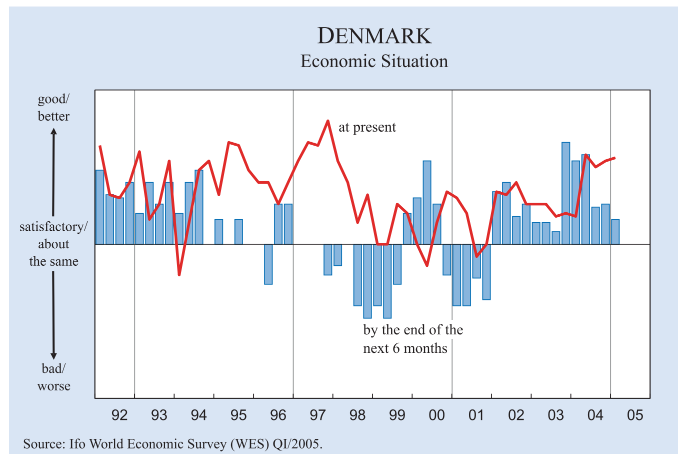

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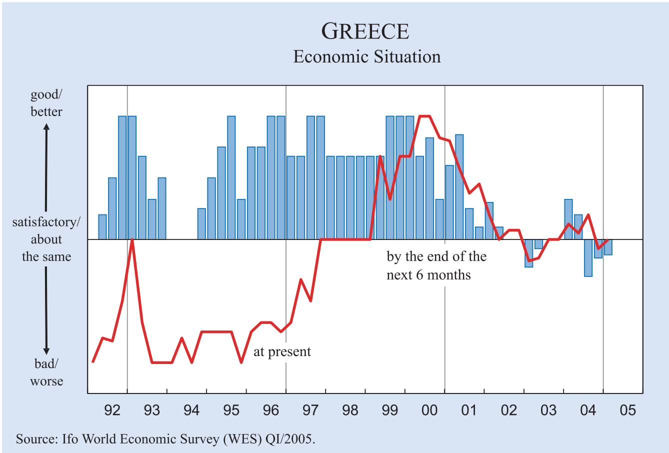

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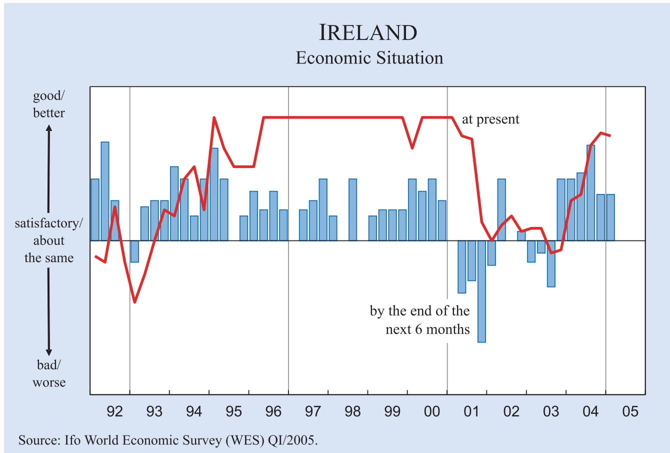

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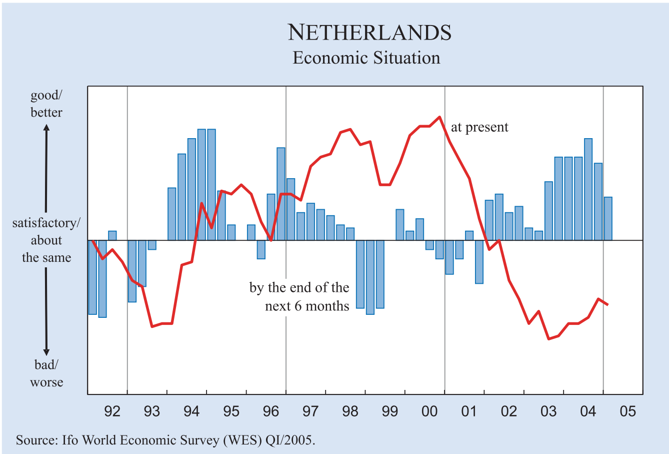

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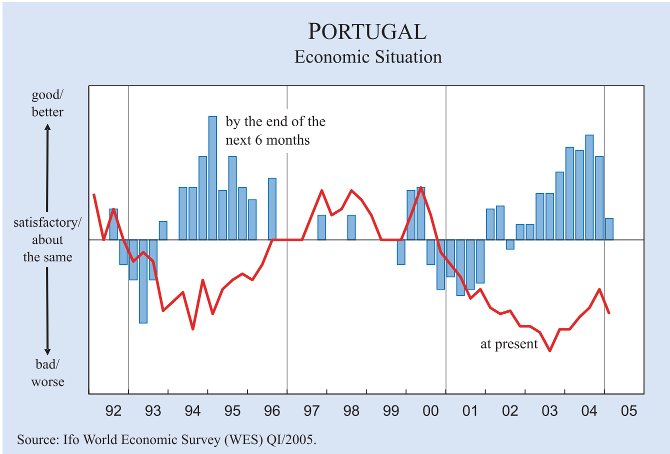

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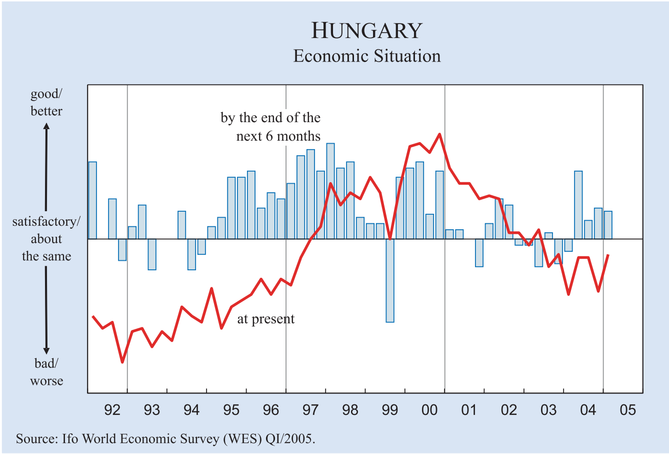

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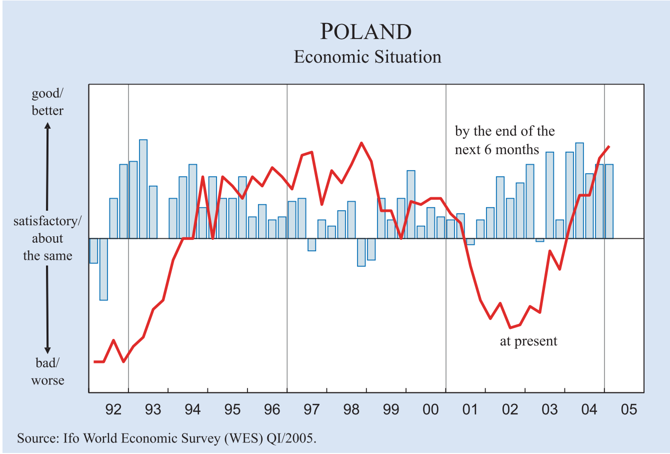

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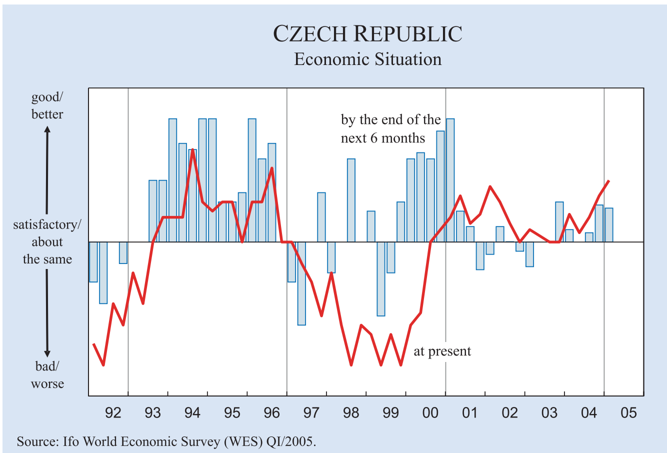
CZECH REPUBLIC
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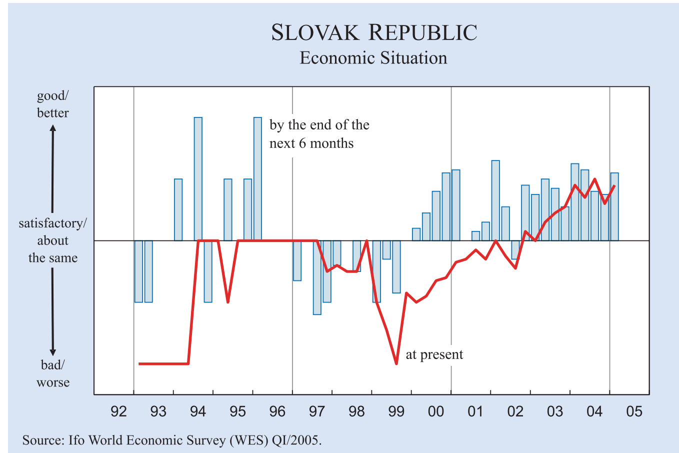
Source: Ifo World Economic Survey (WES) QI/2005.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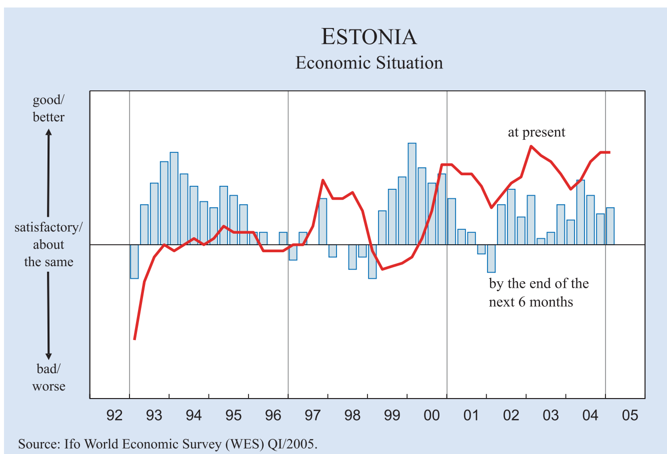
Source: Ifo World Economic Survey (WES) QI/2005.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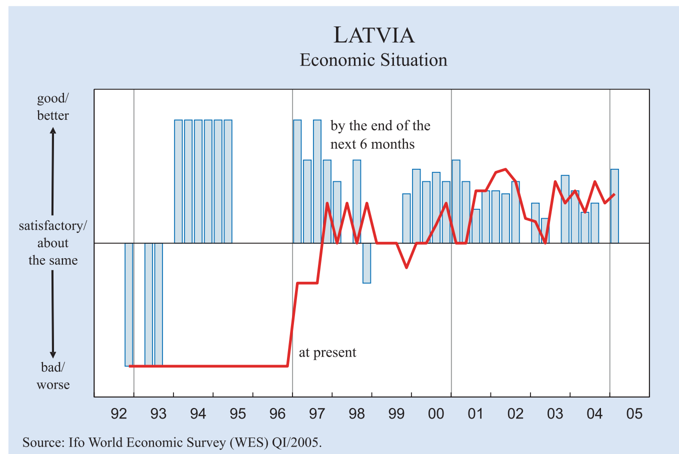
Source: Ifo World Economic Survey (WES) QI/2005.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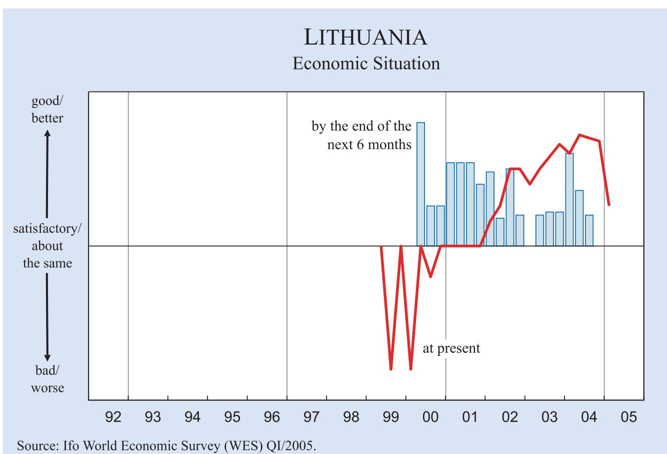
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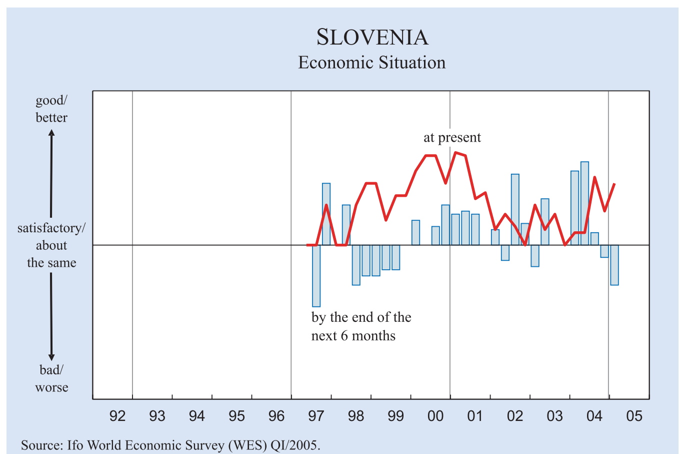
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Source: Ifo World Economic Survey (WES) QI/2005.

Appendix 3:
Is the Stability and Growth Pact dead?

The EU fiscal policy framework, encompassed in the Maastricht Treaty and the Stability and Growth Pact, is in crisis. In 2004, France and Germany ran budget deficits in excess of the three-percent-of-GDP deficit ceiling for the third consecutive year and they are likely to do so in 2005 as well. The two countries are also violating the stipulation that if government debt is above 60 percent of GDP it must be decreased. Yet, the excessive deficit procedures against these countries were put on hold in late 2003, when the Ecofin Council (the EU ministers of finance) did not heed the recommendation of the Commission to give notice to these countries to reduce their deficits in 2005. In a ruling in the summer of 2004, the European Court of Justice did in principle accept the right of the Ecofin Council to take such a political decision.

Several other EU countries have serious budgetary problems as well. Greece, Portugal, and possibly Italy, will also exceed the three-percent-of-GDP limit in 2005. Debt ratios in both Greece and Portugal have been increasing, even though they are already above 60 percent of GDP. Greece has been underreporting its deficits, which have in effect been above three percent of GDP, for several years. There remain a number of question marks regarding the fiscal accounting of other EU countries, for example Italy, too. In addition, six of the new EU member states (Cyprus, the Czech Republic, Hungary, Malta, Poland, and Slovakia) had budget deficits in excess of the three-percent limit in 2004 and are likely to continue them in 2005 as well.

The EU fiscal rules were established as a counterweight to the excessive accumulation of government debt in most European countries in the 1980s and early 1990s. There were also fears that the common currency would aggravate this deficit bias. Current fiscal developments seem to represent a gradual dismantling of fiscal discipline through contagion effects, where higher deficits in one country are seen as an excuse for higher deficits in others. This process is further fuelled by the lax attitude towards the even larger deficits in the United States.

There seems to have emerged a consensus that the Stability Pact needs to be reformed. Many proposals have been put forward and some of them are currently being discussed among the EU finance ministers. There could be a revision of the Stability Pact early this year.

When evaluating reform ideas, it is helpful to distinguish between three aspects:

1. The economic contents of the rules.
2. *Ex-ante* measures to prevent violations of the rules.
3. *Ex-post* enforcement once the rules have been violated.

Clearly, the main problem with the stability pact is the lack of *ex-post* enforcement. Yet, most reform proposals have focused on the two other aspects.

The economic contents of the rules

The European Commission has come up with a number of proposals to modify the economic contents of the rules (European Commission 2004a). These include a larger emphasis on the debt level: a clarification of what the requirement means that debt must be "decreasing at a satisfactory pace" when it is above 60 percent of GDP; to make the budget target over the cycle dependent on the debt situation and more refined assessments of the long-run sustainability of public finances; and to give countries with low debt and sustainable finances longer time to correct excessive deficits.

There is a case for changes in the direction proposed by the Commission. But changes in the rules must be transparent. Modifying the rules in such a way that they are left open to interpretation would in effect mean that case-by-case decision-making is substituted for a rules-based system. That would, for example, happen if "country-specific circumstances" were taken into account when evaluating fiscal performance and deciding how fast excessive deficits must be corrected. There should instead be a clear rule linking the maximum permitted deficit to the amount of debt, as suggested by EEAG (2003) and Calmfors and Corsetti (2003). Discretionary decision-making works well for monetary policy, which has been delegated to independent central banks. It does not work for fiscal-policy decisions by politicians, who could then always find excuses for lax policies.

The Commission has also proposed a revision of the so-called "exceptional circumstances clause" so that it

would allow countries to exceed the three-percent limit not only in the case of negative growth but also in the case of sluggish growth in a protracted slowdown. Such a change could be motivated by the increased diversity of the EU after enlargement. A deep downturn in the new fast-growing EU states might very well be associated only with a large drop in the growth rate, but not with negative growth. However, such a rule must again be clearly formulated. It should allow exceptions only when there is a large *temporary* decline in GDP growth. A *sustained* decline in growth is not an argument for permitting larger deficits, as a given deficit-to-GDP ratio implies a higher long-run debt ratio the lower is the trend rate of growth.

It would be very unwise at this stage to start exempting various types of government spending from the calculation of deficits. As shown by the ongoing discussion, the list of suggested exemptions is endless: real capital investment, military spending, expenditure on innovation and R&D, expenditure on education, net transfers to the EU budget, costs related to the reform of social security and the tax systems, and "specific burdens borne by the member states" (such as the costs of unification in the case of Germany). In fact, the introduction of any such exemption would just trigger demands for additional exemptions. The end result would be that the rules become entirely toothless.

It is often argued that softer budgetary requirements would command more legitimacy and therefore be easier to enforce. However, a softening of the budgetary requirements in the current situation would be perceived as an endogenous response to the violations that have occurred and would further undermine the credibility of any fiscal rules at the EU level. The proper way of preventing violations of the rules designed to promote fiscal discipline cannot be to relax them to such an extent that no one violates them any more.

Ex-ante prevention

There appears to be a consensus on the desirability of strengthening budgetary surveillance in the Stability Pact with the aim of enhancing peer pressure to avoid that excessive deficits arise in the first place. For example, the European Commission has proposed firmer commitments to pursue restrictive fiscal policy in upswings, greater interaction between the EU and national levels in preparing the budgets in the member states, and increasing the visibility of Commission assessments of the budgetary situations in member states by using the European Parliament as a forum for presentations. In addition, the provision in the proposed EU constitution that the Commission alone could issue so-called early warnings would serve to increase *ex-ante* pressure to avoid violations of the fiscal rules.

The underreporting of fiscal deficits in Greece has highlighted the need for common rules ensuring that national fiscal statistics are produced by independent and reliable authorities, as well as the need to give the European Commission and Eurostat large enough resources to monitor the accuracy of national reporting more effectively. There appears also to be a need for clear rules specifying which sanctions should apply against countries that provide false data to disguise budgetary problems.

Stronger *ex-ante* measures to prevent excessive deficits from emerging would be welcome. But a key problem is the "disconnect" between the political processes at the national and the EU levels. One could try better to connect the two processes by organising the "physical" presentations of Commission evaluations and Council opinions in the national arena and by commitments of national parliaments to hold public hearings in the case of a formal critique from EU bodies. However, no *ex-ante* preventive measures are likely to make much difference in the absence of credible *ex-post* enforcement once violations have occurred.

Ex-post enforcement

If the stability pact is to remain an important disciplinary force, reforms must also address *ex-post* enforcement. The root of the current problems is that the excessive deficit procedure in the stability pact suffers from an inherent contradiction: it is in essence a judicial process administered by politicians (see also Lindbeck and Niepelt 2004). The legalistic approach is revealed by the terminology used: unless "corrective action" against excessive deficits is taken, "sanctions" in the form of "fines" should ultimately apply and so on.

In principle, there are two ways of addressing the enforcement problem. The first is to be consistent about the judicial character of the process. In that case one ought to move all decisions on sanctions from the EU finance ministers to the European Court of Justice. Such a proposal was put forward in EEAG (2003).

The second option is to keep political decision-making as it is, but acknowledge that the ultimate sanctions are now so harsh (an "atomic bomb") that politicians dare not employ them. A lowering of the fines as compared to the present situation, in which they could in principle amount to as much as 0.5 percent of GDP, would make their use more credible. Lower fines should also apply at an earlier stage than is presently envisaged in the Stability Pact.

In addition, the rules should be re-interpreted so that the "fines" are instead regarded as "fees", designed as a *disincentive* to undesirable fiscal behaviour rather than as a "punishment for crimes". This would contribute to flexibility. It would clarify that a country may exceed the three-percent-of-GDP deficit limit in a downturn, but that this can be done only at a cost.

One idea that has been raised in the debate is that deficits above three percent of GDP should not be regarded as excessive if they can be "explained" by forecast errors (made by the Commission). In our view, there is no need for such exceptions, as the procedures that already exist (in theory) give ample time for reducing deficits due to expectational errors. Rather, we see a considerable risk that such exception possibilities would increase the risks of biased forecasts. An illustration of this risk is provided by the Commission's judgement in December 2004 that France and Germany are "on track to correct their excessive deficits in 2005", which seems designed to avoid further political conflict on how the ongoing excessive deficit procedures against these countries should be handled (European Commission 2004b).

An issue that ought to be addressed is the tendency of violators of the budgetary rules to "collude": as recent experiences have shown, countries with excessive deficits are likely to oppose sanctions against other member states with excessive deficits in exchange for getting a lenient treatment themselves. This problem could be solved if countries that have been formally declared to have excessive deficits were not allowed to vote in the excessive deficit procedure for other countries.[15]

[15] As of now, the formal decision on whether a larger deficit than three percent of GDP should be regarded as *excessive* is taken by the Ecofin Council with a qualified majority after a *recommendation* by the Commission. According to the proposed constitution, the Ecofin Council decision on whether a country has an excessive deficit should instead be based on a proposal from the Commission, which can only be voted down if there is unanimity in the Council.

Is there a future for the Stability Pact?

The first-best solution would be a package solution involving some modifications of the budgetary requirements as well as reforms strengthening *ex-post* enforcement. Such a package deal needs to be accompanied by a resumption of the excessive deficit procedures against France and Germany, as long as these countries violate the rules, and a proper handling of the Greek violations.

Unfortunately, political agreement among the EU countries on credible enforcement is highly improbable. Such an agreement may presuppose that decisions are taken under a *veil of ignorance* of which countries are likely to be exposed to enforcement measures, which is not the current situation. Reforms to make enforcement credible would probably also require changes in the EU treaty (constitution), which are not now politically realistic. The most likely outcomes are either a softening of the budgetary requirements or that no formal changes are made at all, leaving a wide discrepancy between stipulations and implementation. In that case the Stability Pact may remain as a benchmark, but the disciplinary impact will be slight.

Without credible enforcement we had better acknowledge that the attempts to impose fiscal discipline through the EU have largely failed. This interpretation gains support from recent political demands by, for example, the German Chancellor to limit "intervention of European institutions in the budgetary sovereignty of national parliaments" (Schröder 2005). The lesson would be that the foundations for sound fiscal policy must be built through better institutions at the national level. As discussed in EEAG (2003) and Calmfors (2003), one can think of several more or less radical reforms of national fiscal policy making inspired by monetary policy making:

- A more transparent fiscal policy framework involving the adoption of clear long-run national fiscal policy objectives as well as guidelines for the use of fiscal policy as a stabilisation tool. Such a framework could also specify appropriate procedures when governments violate their own commitments, such as requirements to give a formal explanation to the parliament, stipulations that the parliament must arrange public hearings with the finance minister and outside experts etc.
- An obligation on the part of governments and parliaments to base budget decisions on economic forecasts made by an independent forecasting

authority (see also Jonung and Larch 2004). Such forecasts could be published in regular stabilisation reports of a similar type as the inflation reports of many central banks.

- An obligation on the part of government to consult with an independent economic advisory council before presenting budget proposals. Such a council should work on the basis of economic policy objectives defined by the parliament. The government could be required to respond formally to the recommendations of the council. The recommendations could be given more "bite" by stipulating that the government should deviate from them only in exceptional circumstances. If this happens, the parliament could commit to holding public hearings.
- Formal delegation of parts of fiscal policy making to an independent fiscal policy committee that would be given a well-defined mandate by parliament. The fiscal policy committee could be given sole responsibility for the use of fiscal policy for stabilisation purposes. Such a mandate could imply the right to vary some tax rate(s) within a pre-specified band in order to smooth the business cycle. The government would retain responsibility for fiscal policy decisions designed to affect the size of government consumption, income distribution, and social efficiency, but should commit in advance to a rule for the long-run development of government debt (with well-specified procedures in case this commitment is not upheld, as discussed above).

Even if budgetary discipline must build mainly on the insight that it is in the national interest, the EU can make an important contribution by trying to promote the adoption of best-practice solutions. But this role will be much more limited than originally envisaged in the Maastricht Treaty and the Stability Pact. However, a process where countries gradually learn from "good examples" may be the best we can hope for. Unfortunately, experience suggests that radical reforms of national fiscal policy institutions come only after serious crises. That is why fiscal discipline in the EU countries may have to deteriorate further before it can improve.

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Appendix 4:
VAR analysis of the effects of an increase in the oil price and an appreciation on the euro zone

This appendix analyses the effects of an increase in the oil price and a real effective appreciation on gross domestic product and the inflation rate in the euro zone using a Vector Autoregression (VAR). In reduced form a VAR model has the following representation:

$$Y_t = A(L)\, Y_{t-1} + B(L)\, X_t + \varepsilon_t$$

where Y_t is the vector of endogenous variables and X_t is a vector of exogenous variables. The vector of endogenous variables contains the Brent oil price in US dollars (OIL), real gross domestic product (GDP), the harmonised index of consumer prices (HICP), the nominal 3-month interest rate (EURIBOR) and the real effective exchange rate of the euro against 42 countries (REER).The vector of exogenous variables only consists of a constant and a linear trend. The data, which is at a quarterly frequency, is taken from Eurostat, the European Central Bank and the OECD database. The VAR was estimated in levels using OLS over the period I/1980 – III/2004. By doing the analysis in levels we allow for implicit cointegrating relationships in the data. With the exception of the interest rate, which is in percent, the data are expressed in logarithms and are seasonally adjusted. A likelihood ratio test and the Akaike information criterion were used to determine the lag order of the VAR which turns out to be of order five. The residuals of the OLS estimation were free of autocorrelation which was tested using a correlogram and the related Ljung-Box Q-statistic.

The effects of an unexpected increase in the oil price and a real appreciation of the euro are investigated by means of impulse response functions of the estimated VAR. In order to identify these structural shocks from the reduced-form residuals of the estimated VAR (ε_t), we use a standard recursive identification scheme with the endogenous variables ordered as described above.

The impulse responses, which are shown in Figure 1.1, give the effect of a 20 percent increase in the oil price (left column) and a 10 percent real effective appreciation of the euro in period 0 on the remaining variables of the model, together with the 10 and 90 percent percentiles obtained through a standard bootstrapping procedure with 100 draws. Thus, the true impulse response function lies within the confidence band (which is bounded by the two blue lines) with a probability of 80 percent, and the red line is computed as the median of the confidence band. The horizontal axis depicts the quarters following the shocks. Since GDP, HICP, OIL and REER enter the model in log-levels, deviations of these variables from the zero line can be interpreted as a percentage deviation from an

Figure 1.1

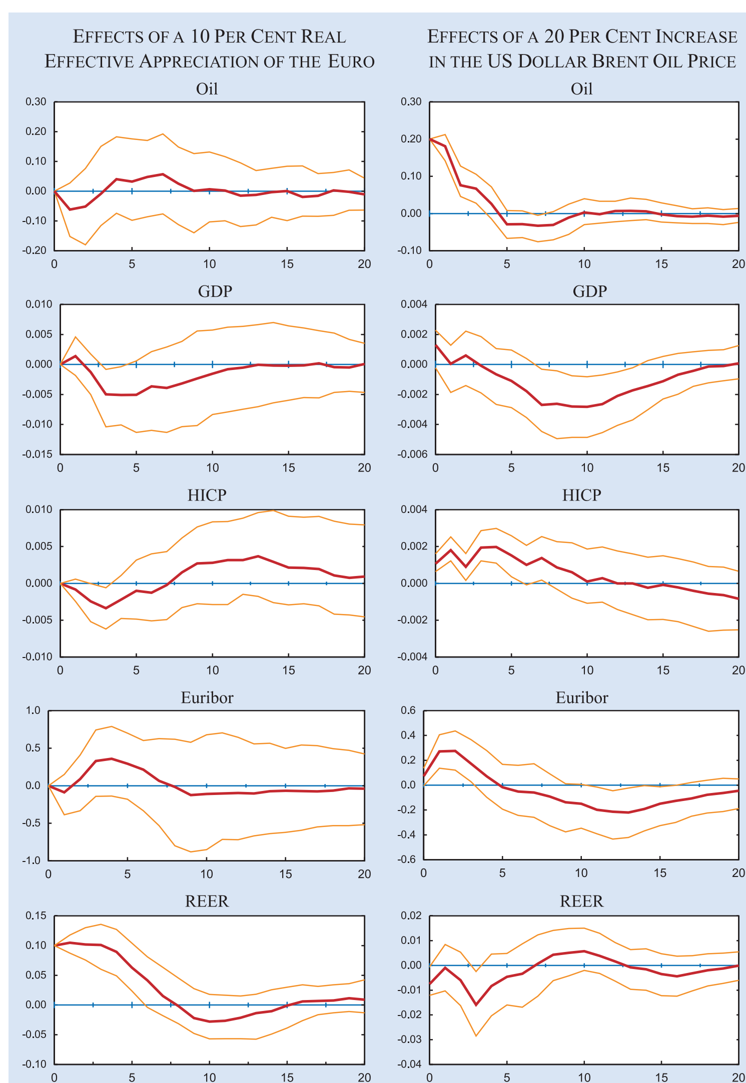

Table 1.1

Effects of a 10 per cent real effective appreciation of the euro

	OIL[1)]	GDP growth[2)]	HICP inflation[2)]	EURIBOR[3)]	REER[1)]
1st year	-3.1	-0.12*	-0.17*	0.08	10.2*
2nd year	4.4	-0.32	0.05	0.23	5.2*
3rd year	0.9	0.25	0.37	-0.09	-2.0

Notes: * significant at the chosen significance level (see text).
1) average deviation from a long-run trend in per cent.
2) average deviation of the year-on-year changes from the long-run trend growth rates in percentage points.
3) average deviation from the neutral nominal interest rate in percentage points.

Source: Ifo Institute.

implicit long-run trend. The EURIBOR, by contrast, enters the model in percent, so that its deviations from the zero line indicate a deviation from the neutral nominal interest rate in percentage points.

The impulse responses show that, following a real effective appreciation of the euro by 10 percent, GDP and HICP fall below their long-run trends (see Figure 1.1). The effect reaches its maximum after about three quarters and becomes insignificant thereafter. In terms of average annual growth rates (see Table 1.1), GDP growth and HICP inflation fall by about 0.12 and 0.17 percentage points, respectively, below their long-run growth rates in the year following the unexpected appreciation. As the reaction of the EURIBOR to the exchange rate shock is insignificant, we conclude that the European Central Bank (and the average monetary policy of its predecessors) did not react to exchange rate shocks.

Following an increase in the US dollar Brent oil price, GDP falls and HICP increases. The effects on GDP only become significant in the second year after the shock when they also reach their maximum. HICP, by contrast, immediately reacts to the increase in the oil price and becomes insignificant after three years. The maximum deviation of HICP from its long-run trend is reached after four quarters. In terms of average annual growth rates (see Table 1.2), GDP growth falls by 0.20 percentage points in the second year after the shock and by 0.12 percentage points in the third year compared to its long-run growth rate. HICP inflation accelerates by 0.06 percentage points in the first year. Concerning the reaction of monetary policy, the VAR analysis shows that in the past the central banks of today's euro zone (whose average interest rate policy is depicted for the period I/1980 – IV/1998) and the ECB followed a more restrictive stance after an increase in the oil price and raised interest rates by 0.20 percentage points in the first year. The fact that we did not observe any change in the monetary policy stance of the ECB in the course of 2004 despite the surge in oil prices can be explained by the one-dimensional view of our estimation method. VARs only describe the effects of an isolated shock, i.e. a shock that occurs independently of any other shock, and the shock hits the economy in a situation in which all the variables are on their long-run path. Thus, a possible explanation of the ECB's interest rate policy in 2004 is that the euro zone had already been hit by an adverse shock before the oil price started to rise, which induced the ECB to lower nominal interest rates to the current two percent level, and hence a level which is clearly below the neutral level.

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Table 1.2

Effects of a 20 per cent increase in the US dollar Brent oil price

	OIL[1)]	GDP growth[2)]	HICP inflation[2)]	EURIBOR[3)]	REER[1)]
1st year	13.1*	-0.05	0.06*	0.20*	-0.8
2nd year	-1.6	-0.20*	0.00	-0.01	-0.4
3rd year	-1.0	-0.12*	-0.10	-0.14	0.5

Notes: * significant at the chosen significance level (see text).
1) average deviation from a long-run trend in per cent.
2) average deviation of the year-on-year changes from the long-run trend growth rates in percentage points.
3) average deviation from the neutral nominal interest rate in percentage points.

Source: Ifo Institute