

EXECUTIVE SUMMARY

This is the fourth annual report by the European Economic Advisory Group (EEAG) at CESifo. It contains four chapters addressing different topics of policy concern for the European Union and the euro area and also a macroeconomic outlook for the European economy. This executive summary provides a synopsis of the analysis and policy proposals of the report.

Chapter 1 discusses the current situation and economic outlook for 2005 for the European economy. As a main scenario, it is forecasted that GDP in the euro area will grow at about the same rate as in 2004, that is around 1³/₄ percent on average. The recovery remains fragile and depends on continued growth in the world economy. The recent rise of the euro against the dollar and any additional oil price hikes represent significant downside risks to the basic scenario. For economic policy the basic scenario is that interest rates remain at current levels and that the stance of fiscal policy is similar to 2004. An appendix to the chapter reviews the current problems with the Stability and Growth Pact of the EU.

Chapter 2 is devoted to the widely debated topic of outsourcing of production and jobs from the Western EU member countries to the new member countries and also to the rest of the world. This trend is clearly visible in the manufacturing sector in the European Union. Outsourcing is mainly a consequence of the trade integration of ex-communist countries as well as other producers that offer their labour at low cost. While outsourcing can bring benefits from increased international trade and division of labour, these benefits may not materialise fully given the labour market rigidities in many Western EU countries. These rigidities may induce outsourcing to overshoot its optimal level and destroy more jobs than can be created in other parts of the economy.

Chapter 3 reviews working time developments in Western Europe. The main issue is whether recent agreements on longer working time (at unchanged

pay) in Germany represent a reversal of the earlier trend towards shorter working time that could also spread to other Western European countries with low working hours, such as Belgium, France and the Netherlands. The chapter views the agreements on longer working hours in Germany as a response to credible employer threats of outsourcing jobs. Increases in working time will certainly raise output, but they are also likely to increase the number of jobs, especially in the long run.

Chapter 4 is a primer of key economic issues in the reform of pension systems in the EU. The chapter begins with an overview on the strains on European pension systems that loom ahead as a result of the ageing populations in the EU countries. The old-age dependency ratios are forecasted to grow to very high levels, which has major fiscal implications, as the pension system is, to a large extent, a part of the public sector. The chapter discusses principles for reforms of the pension systems that are needed to fix the emerging budget problems and to improve efficiency. The strain can be relieved to some extent by increasing the retirement age and lowering pension benefits, as well as by adopting more general structural policies that enhance economic growth. Our key recommendation is to add a funded pillar to the existing pay-as-you-go systems, to mitigate the missing human capital (due to ageing) by adding incentives for real capital formation. Moreover, the pay-as-you-go pension could be differentiated according to the number of children, provided individually tailored savings plans for the funded pillar are designed to ensure a sufficient level of overall pensions for the childless.

Chapter 5 considers recent developments of house prices in different European countries. There has been widespread worry that house prices might collapse as happened in Japan, the United Kingdom and the Nordic countries in the early 1990s. The country experiences in the last ten years are far from uniform, with rapid price rises in some countries (for example, Ireland, Spain, the Netherlands and the UK) and only small price increases in other countries (for example, France and Germany). A variety of different economic determinants influence the level of house prices.

Houses provide accommodation services, and, being durable assets, investment motives also affect house prices. Analysis of these economic factors suggests that, while current house prices may be overvalued to some extent in some EU countries, there is little evidence of major speculative bubbles in house prices in these countries. In our view, there is no scientific basis for claims that house prices are about to collapse due to a bursting bubble.

The European economy: current situation and economic outlook for 2005 (Chapter 1)

In 2004 the European economy strengthened and output growth 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. In the first half of 2004, growth was stronger than expected, but the expansion lost momentum in the second half as oil prices increased and the world economy slowed.

Boosted by stronger export growth, investment started to increase in the euro area after a decline in the two preceding years, although its pace of recovery remained moderate. Private consumption remained subdued reflecting low real income growth, which was depressed by higher energy prices and poor labour market conditions. Consumer spending developments were, however, not uniform. In a few countries, such as France, Spain and Portugal, consumer spending recovered – partly reflecting a decline in household savings – while in others, in particular Germany, it remained weak.

Economic growth was again higher in the United Kingdom than in the three big euro countries France, Italy and Germany and was also above average in all Nordic countries and in Ireland as well as in Spain. Central and Eastern European economies also achieved higher growth than the EU average – reflecting their catching-up from low income levels – with the highest growth being recorded in the Baltic states, Poland and Slovakia.

During the course of 2005, the ongoing expansion of the world economy should continue to support export growth in Europe, although on average euro area exports are expected to increase somewhat less than in 2004. Private consumption is expected to increase moderately, supported by – after the oil price effect has subsided – a decline in consumer

price inflation and also in some countries by additional tax reductions.

With the continued strength in exports, further improving profit margins and 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.

On average, output in the euro area is expected to grow at about the same rate as in 2004, namely 1³/₄ per cent. The output gap will continue to remain relatively large and improvements in labour markets will be modest as unemployment is forecasted to fall only a little. The growth gap between Europe and the United States will narrow somewhat but only because growth in the United States is forecasted to decelerate more than in Europe.

The recovery in Europe remains fragile and depends on the global upturn remaining intact without any additional oil price hike and on the assumption that the appreciation of the euro will be contained. The forecast also assumes that the European Central Bank will leave interest rates unchanged during 2005 and that the structural fiscal deficit will decline somewhat. With less favourable assumptions about the world economy, oil prices, exchange rates and monetary policies, growth of the European economy would be even weaker.

As to the Stability and Growth Pact, the development is very worrisome. We seem to be witnessing a gradual dismantling of fiscal discipline within the EU through contagion effects, where high deficits in one country are seen as an excuse for high deficits also in others. The on-going discussions on the reform of the pact are likely to result in a further loosening of the rules. The main problem with most reform proposals is that they do not address the key issue of ex post enforcement. Credible enforcement would require either that the decision-making in the excessive deficit procedure is moved to the judicial system, that is to the European Court of Justice, or that sanctions are lowered and made more gradual such that politicians dare use them.

Since a political agreement on credible enforcement of the stability pact is improbable, one had probably better acknowledged that the attempts to impose fiscal

discipline through the EU have largely failed. The lesson is then that the foundations for sound fiscal policy must be built through better institutions at the national level. Such reforms should learn from monetary policy and imply more transparent policy frameworks, including reliance on independent national fiscal policy committees that could either be given a consultative role or be entrusted with some decision-making powers, as suggested in earlier EEAG reports.

Outsourcing (Chapter 2)

Since the fall of the Iron Curtain and the integration of China into the world trading system, international trade in goods and services has increased significantly. This is a consequence of the large differences in factor endowments and hence in relative prices between the earlier OECD countries and the countries that have been opened up to international trade. Trade in intermediary products has developed particularly rapidly due to outsourcing activities of firms that have tried to make use of the huge wage differences between the formerly separated parts of the world. Major improvements in information and communication technologies in the 1990s are a second reason for the increases in outsourcing. The new international production patterns have caused the domestic value added per unit of output, the so-called production depth, to decline in many sectors.

This trend towards a reduction in domestic production depth has been particularly strong in the manufacturing sector, the importance of which has declined significantly in recent years in most western European countries where it now usually accounts for about one quarter of total production and one fifth of aggregate employment. Furthermore, the share of manufacturing value added in GDP has been declining in recent years. A closer look at the input-output tables shows that this trend of deindustrialisation is related to outsourcing activities of domestic firms. Parts of the production process have been moved to low-wage countries. In particular, the new members of the European Union in Eastern Europe are at the receiving end of outsourcing done by Western European firms.

Outsourcing is not limited only to manufacturing. In Germany, for example, it has been shown that these phenomena apply to the export sector as a whole. From 1991 to 2002, an additional unit of real exports induced, on average, a 55 percent increase in intermediate imports. Only 45 percent of the increase in

exports implied additional value added in Germany, a phenomenon that has been caricatured as the “bazaar effect”. Nevertheless, export-induced value added grew relative to GDP, which is a natural implication of increased specialisation.

In principle, outsourcing activities can lead to gains from trade for all countries involved. The low-wage countries of Eastern Europe and Asia find new and profitable employment activities for their large labour forces and are able to increase their wages. And the high-wage countries of the West are able to withdraw part of their endowments of labour and capital from labour-intensive sectors to use them more productively in the service and high-tech sectors where they may have comparative advantages.

Outsourcing is a special form of international trade that can be expected to boost world GDP and world welfare, because it allows countries to specialise on the basis of their comparative advantages. However, for the gains from trade to occur it is essential that the domestic factor markets in the West are flexible enough to allow for the necessary factor migration between shrinking and expanding sectors.

While capital markets in Europe do seem largely to meet this requirement, labour markets are rather rigid. For one thing, national job protection measures prevent workers from moving easily between sectors. For another, collective wage agreements and welfare-state provisions that ensure high replacement payments for the non-employed prevent the necessary wage flexibility. Gains from trade go hand in hand with a tendency towards factor price equalisation. In particular, the specialisation in more capital-intensive production requires lower wages of the less-skilled workers relative to wages of skilled workers in order to prevent unemployment. If wages are rigid, this process cannot take place. The sectors where the West has a comparative disadvantage shrink too quickly, setting more labour free than is useful, and the growing sectors where there is a comparative advantage do not create enough additional jobs. A growing level of unemployment results.

In some European countries we see strong signs for such a deficiency of the adjustment process. Thus, we advocate policies to make the labour market more flexible. The necessary measures are the ones we have recommended in our earlier reports. The measures range from more limited job protection policies via opening clauses for collective wage agreements

towards policies of activating social aid that reduce labour costs and give further incentives to work, thereby changing the role of the welfare state from a competitor to a partner of private enterprises.

Longer working hours – the beginning of a new trend? (Chapter 3)

Both hours worked per capita and hours worked per employee are low in several continental European countries, such as Germany, France, Belgium and the Netherlands, as compared to the United States. This accounts for a large part of the income difference between Western Europe and the United States. The low working hours in Europe reflect to a large extent low standard working hours for full-time employees.

Recent company-level deals in Germany on longer working time may represent a reversal of the earlier trend towards shorter working time that could spread also to other Western European countries with low working hours. It seems that especially the French discussion has been much affected by working time developments in Germany, but also employer demands in Belgium and the Netherlands have been influenced. The agreements in Germany have implied longer working hours without pay compensation. The deals can be seen as cost-cutting measures made necessary by both increased international competition in product markets and credible employer threats to outsource jobs abroad associated with on-going globalisation in general and EU enlargement in particular, as analysed in Chapter 2.

One way of thinking about the deals on longer working time is as a convenient way of reducing hourly wages without reducing the pay per employee. It is natural that such agreements take place at the decentralised level of firms exposed to harsh competitive pressures rather than at more centralised levels of bargaining. The deals on longer working time can also be viewed as a labour supply response in collective bargaining to a reduction in the hourly wage that is required as a response to the forces of globalisation. The desired working time on the part of trade unions may respond differently to a wage change than the desired working time on the part of employees when acting on their own. We argue that it is likely to be in the interest of unions (workers acting collectively) to accept increases in working time when real wages per unit of time have to fall.

When analysing the effects of longer working hours, it is essential to distinguish between the short run and the long run. In the short run, longer working hours at unchanged pay, as in Germany, will by definition prevent job losses in firms where there is an acute risk of outsourcing production because costs are too high. Also in firms where this is not the case, such agreements will have positive employment effects, provided that the longer working time of employees leads to a large enough increase in the utilisation of capital, because the capital stock can be operated for longer hours. Indeed, such an increase in capital utilisation is one of the major advantages of longer working hours. The capital utilisation effect makes an immediate output increase possible without the need to restructure the production process. In other firms where the operating time of capital does not increase with working time (for example, because shift work or overlapping working times of employees have detached the operating time of capital from working time) or where it takes time to restructure the production process, the employment effects are likely to be negative in the short run. Lower wages per hour will, however, make it profitable even for these firms to expand output.

In the long run, the hourly real wage level in an open economy must be such that capital earns the same rate of return as abroad. It follows that the long-run feasible hourly wage depends on the world market rate of return to capital. A critical factor for the long-run employment effects of an economy-wide lengthening of working hours is therefore how wage-setting incentives are affected. If longer working time creates stronger incentives for wage moderation, lower unemployment is needed in equilibrium to discourage wages from rising above the feasible level. Although neither theoretical nor empirical research gives unambiguous conclusions, there is a presumption that longer working hours would contribute to wage moderation. If so, one should expect positive employment effects in the long run from longer working time. This would then add to the positive long-run output effects of an increase in working time that would arise already at an unchanged employment level.

Pensions and children (Chapter 4)

Public pension systems in most countries are currently based on the pay-as-you-go principle, in which current contributions are used to pay the pensions of people in retirement. Under current conditions, most pay-as-you-go pension systems in Europe are not sustainable:

the old-age dependency ratios are forecasted to grow from the current 0.2-0.3 range to as high as 0.4-0.68 pensioners per worker in 2050, which would eventually require a very large increase in tax rates, and/or a reduction in pensions. Reform is required and it should aim not only at fixing the budget problem but also at designing a more efficient pension system.

A general slowdown in the growth of living standards associated with ageing is inevitable. Pension reform that entails a move to a partially funded system (in which workers make savings in personal accounts toward their future pensions) will not prevent the slowdown and cannot benefit all generations. However, such a move may help stimulate national savings and smooth the pension burden across generations. The pension crisis results from a lack of human capital. Partial funding means filling the human capital gap with real capital. It thus helps mitigate the provision crisis to be expected when the baby boomers receive their pensions. Funded pension components may also increase the scope for individual flexibility by allowing people to choose their pension level and retirement age at an actuarially fair rate, and thus alleviate political conflicts associated with ageing.

One should ensure that private pension funds have an appropriate risk structure. That includes limiting exposure to stock market fluctuations and minimising the correlation between the financial risk of pension wealth and labour market risk. Thus portfolios of pension funds should be adequately diversified, with a critical mass of risk-free assets and a very limited exposure to assets in the firm and sector in which the worker is employed. Simple legal rules should be designed to supervise and regulate fund management so as to minimise budget risks and social costs associated with financial instability and moral hazard in financial markets. These rules should also provide strong incentives to contain the managing costs of pension funds. Especially in the initial phase of a reform, these costs may levitate in a privatised system because of aggressive advertising by an excessive number of providers. The introduction of an individually based, privately managed, funded pillar of the pension system would allow for a great deal of individual flexibility, provided it satisfies these requirements. It would be a good idea for those European countries that have not already done so to complement the existing pay-as-you-go system with such a pillar.

A number of other margins of manoeuvre also exist that would contribute to fixing the problem of sus-

tainability of the pension system. To the extent that part of ageing is due to an increase in life expectancy and that people are healthier, it is perfectly natural to raise the retirement age, which has trended downwards for many years in most countries. Pre-retirement schemes that are meant to artificially reduce registered unemployment, while increasing the burden on pensions, should be avoided altogether. Structural reform in the labour market, although desirable in its own right, will also have a positive effect on pension finance by increasing employment, thus increasing the tax base for contributions.

The fiscal system could be amended so as to reduce its distortionary impact on people's decision to have children. Specifically, when deciding on the number of children, people may ignore the fiscal benefits brought by children to society in the form of contributions to pensions and may therefore have fewer children than is socially desirable. One could envisage reforms to address this issue. A partial indexation of pay-as-you-go pension claims on the number of children is one possibility. Additional self-financed mandatory funded pensions for those who have no or only few children could then supplement the pay-as-you-go pension for those with no or only few children. People who do not raise children have on average more funds to save for their old-age pension. Also, personal income taxation can be differentiated according to the number of children and systems of child allowance be used to provide stronger incentives towards having children.

House prices in Europe (Chapter 5)

In the last ten years, home prices have risen in all EU member states, and especially in Ireland, Spain, the Netherlands and the United Kingdom. But the variety of experience demonstrates that Europe is still far from a single housing market, and it raises particular questions for the implementation of a common monetary policy.

There has been growing concern that there is a house price "bubble". There is an important distinction between a bubble – when prices are high because buyers believe prices will rise further and in which prices become entirely divorced from fundamental values – and a period of rapid price increase, or even over-valuation. In this chapter, we look at the fundamental determinants of house prices. We ask whether there is evidence of a bubble in house prices: do present levels

and recent increases take them to levels, which cannot be sustained by a reasonable view of these fundamental determinants?

The housing market is complex because housing is both a consumption good and an asset. We employ both perspectives, asking whether housing consumption now represents an implausibly and unsustainably high proportion of overall household expenditure, and whether house prices are now valued on a basis inconsistent with the valuation basis applied to other assets. Our answer to both questions is negative – current levels of house prices do not make housing unaffordable for typical households, nor do houses seem markedly expensive relative to other assets. Commentators who emphasise the ratio of house prices to incomes, which is historically high in many countries, have not taken sufficient account of the effect of falling real and nominal interest rates on both the price of housing services and the valuation of other assets. In this sense, current house prices are not outside the range of reasonable estimates of fundamental value, and there is no house price bubble.

This does not mean that we believe that house prices will continue to rise at the rate that has recently been experienced. Many speculative asset prices, and the housing market in particular, tend to follow a pattern of positive serial correlation in the short run and negative serial correlation in the long run. This means that a month in which house prices rise is more often than not followed by another month in which house prices rise, but a long period of above-average rises is normally followed by a similarly long period of below-average rises. Thus the longer the present rise continues, the more certain it is that we will see some years of relatively stable or even falling prices. Moreover, future macroeconomic developments can affect house prices. For example, high public deficits in several countries may lead to higher real rates of interest, which in turn can have a negative impact on house prices. It is, however, notoriously difficult to determine when the long run begins or to predict the impact of uncertain macro developments. It is not necessarily the case that houses in any or all EU states are overvalued at current prices.