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Europe and the Lisbon Goals

Introduction

Christian Ude
Jürgen Chrobog
Hans-Werner Sinn

Keynote Addresses:
Edmund Stoiber
Wim Kok

Speeding up European Reform: A Master Plan for the Lisbon Process

Panel 1

Jean Pisani-Ferry
Otmar Issing
Edward G. Krubasik
János Kóka
Arend Oetker
Ernst Schwanhold

Dinner Speech:
Günther Beckstein

Keynote Address:
Vaira Viķe Freiberga

European and National Champions: Burden or Blessing?

Panel 2

Paul Seabright
Wolfgang Ziebart
Lars Pettersson
Eric LeBoucher
Rainer Frank Elsässer

Conclusion

Closing Remarks
Hans-Werner Sinn

Statistics Update

Trends

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Volume 6, Number 2 Summer 2005

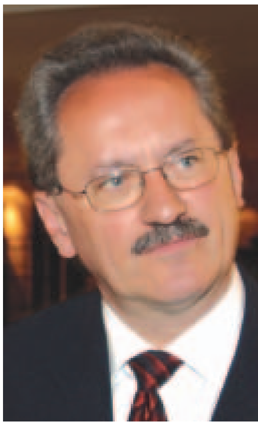
EUROPE AND THE LISBON GOALS: ARE WE HALFWAY THERE?

Europe and the Lisbon Goals: Are We Halfway There?

Munich Economic Summit 9 and 10 June 2005

Luncheon Speech by

Christian Ude,
Lord Mayor of the City of Munich



Ladies and Gentlemen,

I feel very honoured to welcome you to Munich on the occasion of the 4th Munich Economic Summit.

The main theme of the Lisbon Goals also addresses in particular such central economic areas like Munich. May I therefore touch upon the subject as it presents itself from a local perspective.

With the strategy passed in Lisbon in 2000, Europe was to be reformed by the year 2010 and turned into the most competitive economic area of the world.

The intermediate report of a high-ranking group of experts of last December, headed by the former Dutch prime minister Wim Kok – who will participate in the discussion panel on the revival of the Lisbon Strategy this afternoon – revealed the following:

- The employment rate in the European Union is stagnant, in the field of research Europe is losing ground all over the world.
- It is true, however, that at the beginning of this millennium, Europe was able to catch up with the United States in productivity, but at present, we are falling behind again.
- No doubt, unemployment, one of the biggest social challenges of our time, remains on an unacceptably high level.

The heads of state of the European Union have therefore reached the conclusion in their half-year report at this year's Spring Summit, that we are still some distance away from reaching the ambitious goals.

Further efforts are required to stimulate employment and prevent the social systems from going down the drain. A number of measures to be made by the public sector lie in the competence area of national and federal states. But even the cities are called upon here, because economic activities, purchasing power and the population are concentrated in the cities.

Munich, the capital of Bavaria, makes great efforts to support the European economic and social model on the local level.

Let me just mention some key features:

The Munich school system, which has a model function on the European level, makes an important contribution in the field of education.

Today, a solid professional training is more important than ever, representing an essential prerequisite for future prosperity.

The Munich office in support of start-up enterprises, a joint organisation of the City and the International Chamber of Commerce for Munich and Upper Bavaria, offers a first-class guidance service on the road to establishing new businesses. This helps to stimulate the implementation of new ideas and business models, as we are rejuvenating our economic structure at the same time.

The Municipal Department of Labour and Economic Development promotes and engages in many regional networks which form the backbone of the science-based economy.

No doubt, successful implementation of structural reforms in the transformation into a knowledge-based economy will largely be shaping the future position of the EU and its cities.

With the Munich Technological Centre planned for 2008, the city will make a significant contribution to provide optimal growth conditions for dynamic companies of expanding sectors.

For successful market orientation we are offering these companies consultation services, supporting them, with inclusion in regional networks and enabling them through the providion of very flexible space, to rent office space tailored to their market success.

In combination with a number of other activities, Munich is providing active support to improve productivity and promote innovations, especially in small and medium-size enterprises, which are the heart of the local economy.

The promotion of fields like biotechnology and information and communication technology, which are strategic key sectors in the framework of municipal development, makes sure that Munich will maintain its role as economic steam engine.

With the specialised site made available on the grounds of the former Munich airport we have created conditions for Munich high-tech enterprises with extra space for expansion to respond to growth opportunities.

We are supporting the field of life sciences in a similar way. In the new industrial estate near Martinsried, one of the leading clusters of biotechnology in Germany, we are providing exclusive sites for companies of this sector.

Apart from the promotion of firms and sectors, we also try to care for the interests of the workforce. For example, by providing child-care facilities we contribute to the compatibility of family life and professional career.

The time-sharing model introduced in the Municipality of Munich is very popular, the more so as it enables parents to combine security with flexibility in bringing up their children.

Through our consistent equal-opportunity policy we were able to gradually increase the share of women working in their municipality.

With the Munich Programme for Employment and Qualification we are providing additional support for the integration of disadvantaged groups in the job market.

With all these measures, which have often a pilot function, for the private economy even, we were able to contribute towards more employment in recent years and towards a child-friendly and therefore sustainable society, even under economic aspects.

These examples realised in the City of Munich show that Europe's cities are playing an important role in the successful implementation of the revised version of the Lisbon Strategy for more employment and economic growth.

But Munich's experiences also show that, apart from economic aspects, it is also important to consider the cohesion of the urban society along with aspects of environmental protection. Social balance and a sound environment are considerable advantages in the global competition of economic locations. Positive soft location factors in Munich are an asset which speak for our city on the international level.

In conclusion let me add:

It will require concerted efforts involving all actors in the European Union to safeguard our social model securing the achieved level of prosperity and environmental standards. It would be short-sighted indeed to sacrifice these accomplishments for global competition.

However, not only the European Union and their Member States are called upon in this respect. The cities of Europe, in particular, can make valuable contributions here.

To be able to meet this role it is indispensable to secure the necessary revenue base for local governments and to make sure that the room for manoeuvre of the cities is preserved.

Only municipalities with a high performance level can help to preserve and maintain our society and its economic model.

Through my work in the Association of German Mayors I will undertake great efforts to do just that.

I hope to have provided you with some ideas for your conference which should inspire you to also include Europe's cities in the further development of the Lisbon strategy.

On the other hand, I expect from your conference to receive some suggestions as to how the public sector can contribute towards the success of the reformed strategy.

Thank you.

Welcome by

JÜRGEN CHROBOG,

State Secretary, Foreign Office, Chairman Designate of the BMW Foundation Herbert Quandt,

Dear President Vike-Freiberga,
Dear Minister-President Stoiber,
Dear Minister Kóka,
Dear Minister of State Kok,
Your Excellencies,
Ladies and gentlemen,

as designated Chairman of the Board of Directors of the BMW Foundation Herbert Quandt, I am delighted to welcome you as participants of the fourth Munich Economic Summit in the Bavarian state capital. These conferences have gained international repute as expert forums to discuss key issues of Europe's future. As State Secretary in the Foreign Office until mid-year, I am in a position to note this with great satisfaction, since politics also benefits from the results of forums like this one, which assemble a wide range of expertise. It is enormously important and forward-looking that for the fourth consecutive year, a dialogue has been initiated between top-level representatives from business and academia, politics and media here in Munich. This dialogue truly deserves to be called a European dialogue: The approximately 150 participants of this year's Summit represent almost all 25 EU Member States as well as countries striving for EU membership.

The national parliaments of the EU States are also represented to a hitherto unprecedented degree – we have counted parliamentary representatives from 10 European countries. No doubt, this is because the topic of this conference is of fundamental importance for all Member States, in all realms of society: Europe's ability to reform or, as we formulated it in the conference title with a big question mark, "Europe and the Lisbon Goals: Are We Halfway There?"

Five years after the reform agenda was announced in the Portuguese capital, we are unfortunately far from being able to say that the European Union is halfway to achieving its goal of becoming "the most dynamic and competitive knowledge-based economy in the world." This was made evident in the half-term assessment undertaken by the heads of state and government at the Spring Summit in Brussels.

And yet, the goal of systematically furthering the reform process in Europe has not lost its validity. Increased efforts are needed to implement the catalogue of reforms to foster growth, employment, scientific research and environmental protection in the EU countries. Only if Europe succeeds in joining the rank of top nations in these fields can the citizens' loss of faith in the European institutions be restored. This is the lesson that should be learned from the French and Dutch referenda on the Constitution.

The questions we confront today and tomorrow are: How can we reinvigorate the stagnant European reform process? And how can the citizens of Europe be made to understand that the unification process is in their interest? Finally, what are the economic, political and social prospects of an enlarged Europe? All these questions will be the focus of today's and tomorrow's intense and knowledgeable discussions – not in spite of, but because of the outcome of the referenda.

I wish all of you an interesting and inspiring conference and would now like to officially open the fourth Munich Economic Summit together with the President of the CESifo Group, Professor Sinn. Professor Sinn, the floor is yours!

Introduction by

HANS-WERNER SINN
Professor of Economics and Public Finance, University of Munich
President of the Ifo Institute for Economic Research an CESifo, Inc.

Dear President Vike-Freiberga,
Dear Minister-President Stoiber
Excellencies, ladies and gentlemen,

On behalf of the CESifo Group it is my pleasure to welcome all of you. This fourth Munich Economic Summit provides a great opportunity to discuss the important challenges that confront us these days. Currently, everyone is concerned about Europe after the rejection of the Constitution in two founding member countries of the European Union. Obviously, the birth and progress of Europe has been a painful process, much more difficult than had been expected some years ago. The Constitution, as it is, will not come into effect as we all might have anticipated. It is impossible to offer the same document to the French and Dutch voters once again, so there will have to be major revisions.

That is good news, for the goal to create an Economic, Monetary *and* Social Union for Europe, which is implicitly drafted in the Constitution, is too demanding. Especially we in Germany know what a social union really means. We have learned under great pains that a social union with a less developed region like the eastern German states in the early 1990s is very expensive and is bound to create serious problems – particularly in those regions that one wants to help. Like a lot of Germans in the eastern and the western parts of the country, Europeans in the old member countries are disappointed about the process they are seeing. They wanted to become rich and now they are afraid to become poor because they will have to share their wages or the benefits of the welfare states with the new accession countries.

They may not completely understand the mechanisms at work, but, I am afraid, their feeling is not completely wrong. As we economists know there is a tendency towards factor price equalisation if you allow for the free mobility of capital and goods and, to some extent, also the free mobility of labour. Factor mobility, like trade, leads to factor price equalisation. This is good news for those, whose factor prices are low, but not for those whose factor prices are high. In addition, there is the issue we discussed at last year's Summit: The potential migration of people into the western welfare states might lead to an erosion of social standards. There are, of course, gains from trade that economists and the European Commission are eager to stress. But, after all, this is a very theoretical economic concept. It does not state that everybody gains but only that the winners of this process gain more than the losers lose. This is no trivial qualification as the losers might encompass a major part of the working population. If I, as an economist, tell them *"don't worry, there are winners – the capitalists – they will win even more than you lose"*, that is no help for them at all. On the contrary, I am afraid they might find this even worse than a situation where everyone loses proportionally. It is against this background that we shall discuss the theme of this years Summit **"Europe and the Lisbon goals – are we halfway there?"**.

The main message of the 2000 Lisbon Summit was that *Europe shall become the most dynamic and competitive knowledge-based economy in the world, capable of sustainable economic growth, with more and better jobs, greater social cohesion and respect for the environment.* The aim was to create a knowledge-based economy, enhance competitiveness and innovation, complete the internal market, modernise the European social model and combat social exclusion and, last but not least, apply an appropriate macro-economic policy mix. These are the basic, potentially contradictory, goals that were defined and that we identify with the so- called Lisbon Strategy.

Following the Lisbon Summit, the Commission and the Member States agreed on a large set of main goals, sub-goals and indicators to monitor progress made on the road to Lisbon. If you take a look at all the relevant documents, it is very hard to understand what all this really means. There are currently 28 main goals and 120 sub-goals, so we are talking about 148 identified goals, followed by no less than 117 indicators on which to make a judgement. It seems to me as if, through these goals, some people and groups of society had hoped to get some additional funds for particular things via the EU budget. I doubt whether these goals really help to become more competitive. On the contrary, in my view, this is a nightmare.

In addition, some of the goals violate the principle of subsidiarity. Let me give you an example: One of the goals is to achieve a female employment rate of 60 percent by 2010. Why is that a European goal? First of all, women should decide for themselves whether they want to work or not, and if there are faults in the legal and regulatory systems that artificially impede women's preferences, then each country should decide for itself whether and how to correct them. Defining a European goal on this only reveals *paternalistic or merit good* preferences, as we call them in economics. Some European body believes it knows better what is good for the European countries than the countries and their citizens themselves.

There are, of course, some sensible goals. For example, the goal to increase domestic expenditure on research and development to 3 percent of GDP, which was defined in Barcelona in 2002 as part of the Lisbon process, is in my view a good objective. It is genuinely economic, because we know that there are a lot of spill-over effects between the countries and we cannot expect that a single country has the appropriate incentives to carry out enough research. Unfortunately, only two countries in Europe – Finland and Sweden – satisfy this goal. Most of the countries are far away from it, at an EU average of 2 percent. Thus, we are missing the goal by a full percentage point. This is one of the points to discuss at this year's Summit – what can be done to get closer to such a target.

The EU Commission measures the progress of the Lisbon Strategy by many indicators: GDP per capita in purchasing power parity, labour productivity per person employed, the total employment rate, the total employment rate of older people, gross domestic expenditure on research and development, youth education attainment, comparative price levels, business investment, the poverty rate, the dispersion of regional employment rates, the total long-term unemployment rate, total greenhouse gas emissions, the energy intensity of the economy, the volume of freight traffic relative to GDP and so on. It is very difficult to see how these items can usefully be combined into one sensible indicator. It is also totally unclear how they contribute to our main goal of becoming more competitive. Again, this leads nowhere. This is by far too complicated and is too arbitrary in terms of selective criteria on which to concentrate.

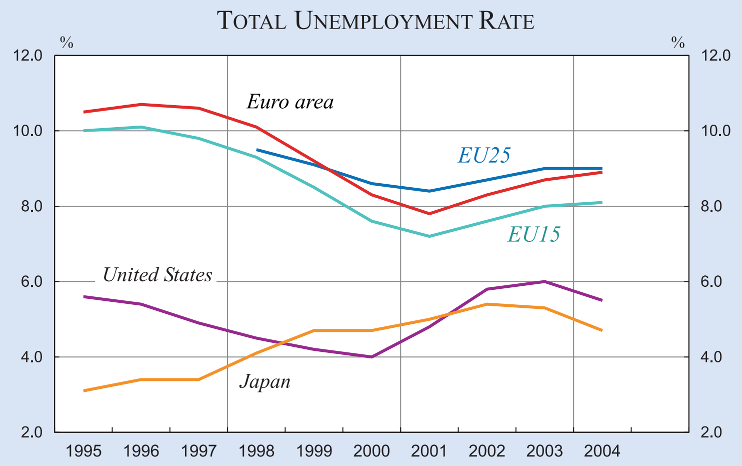
Thus I am glad that the new Commission is trying to focuses on the overall economic performance as measured by jobs and growth. Let us look at these two criteria: The employment rate, which was defined in the Lisbon Council of 2000, had the target of 70 percent of people between 15 and 64. And then, while that target was defined for 2010, it was slightly reduced for 2005 at the Stockholm Summit. Figure 1 shows the reality in most of the Member States.

The EU25 is not yet there, but is close. The same holds true for the EU15: Germany is very close and some other countries like the UK, Sweden, the Netherlands and Denmark, are above the target.

Figure 1

* United States 2003
Source: Eurostat, Structural Indicators database.

Figure 2



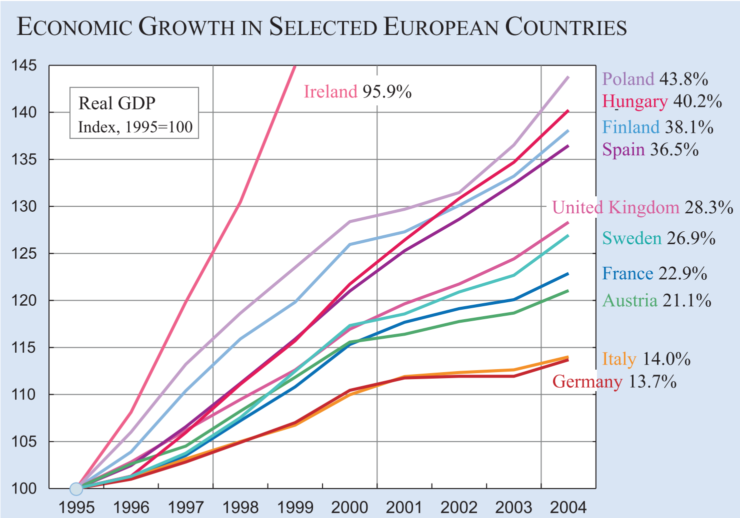
Source: Eurostat, Structural Indicators database.

They have somehow found ways to mobilise their population. Still, there is the persistent unemployment problem in the European Union, which is shown in Figure 2.

The unemployment rate is much higher in the EU15 countries and even higher in the euro-area countries than in the United States or Japan. The enlargement does not really change that picture because the average unemployment rate in Eastern Europe is about the same as in the euro-area countries. Unemployment is still one of Europe's main problems.

The second really important indicator is growth. Figure 3 shows the growth performance of the European countries from 1995 to the present. Ireland leads with 95.9 percent growth in nine years. Irish GDP nearly doubled. Poland achieved a remarkable

Figure 3



Sources: Eurostat, calculations by the Ifo Institute.

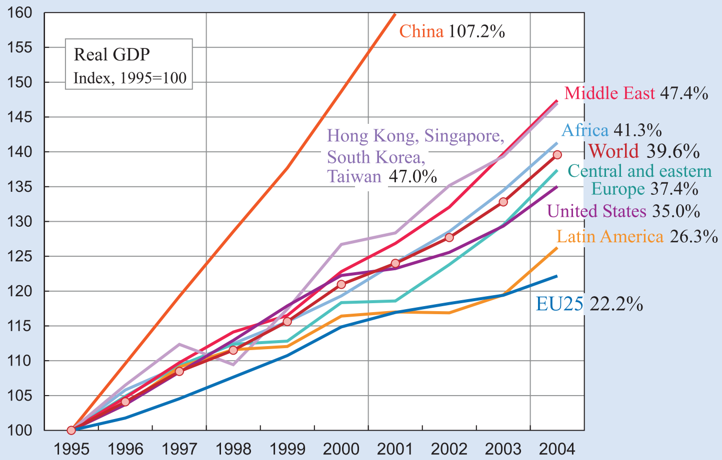
43.8 percent. Poland and the other new Member States should grow faster than others because they are starting from a low level. Hungary grew by 40 percent, Finland by 38 percent, which is a very good performance for a country that is already that well developed. Spain stood at 36 percent, the UK at 28 percent, Sweden at 27 percent and France at 23 percent. At the bottom you can find the back benchers: Austria grew by 21 percent, Italy and Germany only by roughly 14 percent.

Germany is the bottom country with respect to growth and Ireland the top. Is that good? Is that a healthy process? If Ireland were on a low level and Germany on a very high GDP level, this would be an encouraging development, since it would imply convergence of the EU countries. But I am afraid this is not the case. There is no convergence in Europe. Comparing the per capita incomes of Germany and Ireland, one can see that Ireland has overtaken Germany in absolute terms and is still growing rapidly. So there is more going on than mere convergence. And the same thing would be true by looking at quite a number of other countries.

Since Europe wants to become the most competitive knowledge-based society in the world, I would also like to compare Europe with the rest of the world (Fig. 4). The entire world grew by 40 percent in real terms from 1995 to 2004. How have the non-European regions performed? China has even grown faster than Ireland. But it is a similar order of magnitude, if, of which I am not sure, one can believe Chinese statistics. The Middle East grew by 47 percent in nine years, Asia by 47 percent and Africa, surprisingly, by 41 percent, starting of course from a very, very low level. Central and Eastern Europe grew by 36 percent, the United States by 35 percent and Latin America by 26 percent. At the very bottom is the EU25 at only 22.2 percent.

Figure 4

ECONOMIC GROWTH IN SELECTED REGIONS AND COUNTRIES



Source: International Monetary Fund, World Economic Outlook Database, April 2005; EU25: Eurostat.

The Summit's title is "Europe and the Lisbon Goals: Are we halfway there?" I do not think we are. Europe – at present and during the last ten years – has been the laggard of the world. That is the bitter truth. Obviously, the Lisbon Process is hope, not reality. To some extent this may explain the frustration of the Europeans with this enterprise.

We must face the challenge. What needs to be done to really become better? This is the core question of this fourth Munich Economic Summit.

Thank you very much for your attention.

Keynote Address by

EDMUND STOIBER,
Minister President of the Free State of Bavaria

Ladies and Gentlemen,

I am happy to see so many outstanding individuals meeting here in the State Capital of Bavaria. You, Ladies and Gentlemen, are all leading executives and opinion leaders in the process of Europeanisation and globalisation. I hope that you feel at home in Munich and that you will take home with you a good impression of our Bavarian hospitality.

While our subject today is “Striking a Half-Time Balance of Europe’s Lisbon Strategy and its future up to the year 2010”, this Conference also stands under the immediate impression and impact of the vote against the European Constitution taken in both France and the Netherlands.

The response of all friends of Europe to that vote against the Constitution must be clear and unequivocal: “We understand!”

In other words, simply continuing along the old lines would be both wrong and inappropriate. For the referenda in France and the Netherlands have clearly shown that Europe has taken on too much, particularly with the perspectives opened up for Turkey but rejected by citizens in both France and the Netherlands, as well as by many people in Germany.

Europe has also taken on too much in terms of its agenda. Come what may, we must make sure that what we have achieved in Europe is not destroyed. We must see the current crisis as an opportunity. And precisely this is why we make specific demands:

First: We must show all our determination in overcoming the lack of democracy in the EU. In future we must debate EU legislation to a greater extent also in the German Bundestag. Europe must, at long last, become an issue of domestic interest.

Second: Following the enlargement of the EU to the east, we now need a period of consolidation. The admission of new members to the EU must follow the strict fulfilment of all admission criteria and must take the capacity of the EU for accepting new members into account. Under a German Government led by the Christian Union parties, our focus on Turkey would change. In the event of negotiations, we would strive from the start towards a re-orientation of the EU’s policy towards Turkey, looking at a status of privileged partnership.

Third: Not every problem in Europe is also a problem for Europe. The sheer number of tasks taken on by the EU must be cut back to what is really necessary and affordable. Following the referenda in France and the Netherlands, it is fair to assume that the Constitution Treaty in its current form will not come into force. However, we should endeavour to save the positive elements and features of the Treaty.

This applies particularly to the institutional rules and regulations set forth in the Constitution Treaty serving to make Europe more active and democratic. It also applies to the provisions dividing competences between the EU and the Member States.

I therefore hope very much that, in its session on 16/17 June, the EU Council will find a way to agree on this objective. Indeed, the entire integration of the EU, the position of Europe in the world, and the quest for democratisation and close civic relations in Europe would suffer significantly if the EU of 25 Member States were required to continue working on the basis of the institutional provisions established and set forth in Nice. This we can no longer afford also in economic terms in the day and age of globalisation.

A great German statesman once said: *“It would be a grave mistake to forget that industrialisation is making significant progress also in countries outside of Europe rich in raw materials, progress we would never have envisaged in the past.”* – This statement was made by Gustav Stresemann on 16 April 1925 (at the Hamburg Overseas Conference).

I wonder whether today, 80 years later, we still believe in the hubris and misconception of European superiority that Stresemann warned us of at the time.

Five years ago, the Heads of State and Government agreed to make the European Union the most competitive, dynamic and knowledge-based economic region in the world by the year 2010. Those were too many superlatives.

At this year's Spring Summit of Heads of State and Government on 22 and 23 March, this objective was abandoned, being replaced by the almost equally ambitious targets to create more than 6 million new jobs by the year 2010 and to increase the European gross domestic product by an average of 3 percent each year, again up to the year 2010.

We are still far away from these ambitious targets. Rather, since 2000 Europe has continued to fall behind the United States in terms of both growth and productivity.

Airbus, Galileo, Ariane – these are examples of European competitiveness. But in economic terms Europe continues to play second fiddle behind the United States: Economic growth in America is twice that of the EU, the increase in labour productivity is 2$^1/_2$ times greater.

The latest figures again confirm the ongoing structural weakness of growth in Europe, with the EU Commission reducing their growth forecast for this year from 2.0 to 1.6 percent, miles away from the objectives we have set ourselves.

A further point is the employment rate, which was to be 67 percent within the EU by the year 2005. In reality it is just 64.4 percent at the moment.

Only five countries currently fulfil the Lisbon objective of implementing 98.5 percent of the Internal Market directives. Particularly Belgium, France, and Germany are not fulfilling their duties. Germany is lagging behind!

The announcement made in Lisbon was that the Europeans would be "landing on the moon in 2010". But even after five years there is no rocket in sight to boost European growth. Indeed, so far we have not even agreed on its blueprints.

I naturally realise that external shocks such as worldwide terrorist attacks or the collapse of the new economy were not exactly helpful in achieving the targets set forth in Lisbon. But the European Commission is quite right in stating that the main reason for Europe's disappointing performance in implementing the set targets lies in a lack of reform on the part of the EU Member States.

Germany in particular lags behind in the structural reform of its economic, employment, social and fiscal policies. From 1995 to 2004 Germany was the slowest growing country throughout Central and Western Europe!

While Germany is No 1 in terms of exports, value added in these exported products is moving increasingly to regions outside of Germany. For example, 85 percent of the production of some German cars now takes place abroad. This clearly shows that Europe's high-wage countries in their entirety have no choice but to move foreward and open up new perspectives: We must quite simply be better, more innovative and faster than our cheaper competitors.

Helmut Schmidt, the former German Chancellor, was quite right in stating that "everything we are complaining about comes from within – it is all of our own making!" (20 June 2004, speech on the occasion of Rainer Barzel's 80th birthday).

Turning this statement around, it means, quite simply, that everything else is nothing but a poor excuse!

One of the things Germany needs most is simple and competitive tax legislation. In a comparative study, the World Economic Forum examined the efficiency of fiscal systems in no less than 104 countries. And they found that Germany ranked last, No 104 out of 104.

While we might live with last place in the European Song Contest, we must be really worried about coming last on such an essential criterion in the competition among countries. I am confident that we Germans can do better than that!

We must focus on Germany's strengths and push these strong points to a higher standard. I am convinced, for example, that the Social Market Economy and the stability it establishes within society give us a particular benefit also in global competition.

Without social peace there can be no economic success – and vice versa. So it is wrong and inappropriate to pitch social policy and market policy against one another.

But if egalitarianism is the only goal regarded as desirable, if egalitarianism is interpreted as "comforting" and "secure", maintaining existing values and vested interests, and if at the same time we hear polemic criticism of a more competitive spirit, greater freedom and self-responsibility, if reforms seeking to maintain the social state are wrongly claimed to constitute "social harshness" – then that has nothing to do with the Social Market Economy as a concept for success also in this day and age of globalisation.

Activating the individual is required, not a levelling off. Politicians must offer incentives for performance that can truly be felt in one's wallet. This is the only way to really help those who need and depend on solidarity. Trying to make everybody equal, will just make everybody equally poor.

The fact remains, however, that the implementation of Europe's Lisbon strategy so far is one of the reasons for the generally disappointing performance we still see today. Increasingly overburdening the Lisbon strategy over the years by adding on new targets, indicators, projects and programmes has proven to be extremely counterproductive: If everything has priority, nothing has priority!

A very positive point, therefore, is that this year's Spring Summit has set out to re-orient the Lisbon strategy of the European Union. Indeed, Commission President Barroso wishes to make this a core feature of his policy.

What we need is

- greater deregulation of EU law,
- more investment in research and development,
- strict observance of the stability and growth pact.

Europe needs further deregulation and internationally competitive conditions for companies

In the meantime, the European Commission, too, has redirected its policy, realising that we will only be able to afford our social and environmental standards in future through more employment and greater growth.

An important step towards more growth is the Deregulation Initiative proclaimed at the 2004 Spring Summit. However, the Deregulation Initiative should cover not only provisions, rules and regulations imposing burdens on companies, but also provisions regarding our administrative system and its various tasks, since this is highly relevant to the public sector share and, accordingly, the competitive position of our economy. First and foremost, we must seek to improve general conditions for companies on an international level and *not* pursue an active industrial policy simply inhibiting and slowing down competition and innovation.

In particular, a policy of promoting individual companies as "national champions" does not improve competitiveness, but rather serves solely to move funds in the wrong direction.

We must make it worthwhile for investors to invest globally mobile capital in Europe. Indeed, this is the simple basic rule of globalisation helping to generate more growth and jobs. And in this context the "National Action Plan" proposed by the Commission and to be developed under the responsibility of the Member States may indeed become the compass for further reforms, particularly in Germany.

Europe needs a major effort for research and development

For decades, Europe was the role model and driving force behind progress. Looking back at the history of the Nobel Prize, for example, you see the dominating position particularly of German scientists. But today Europe has a hard time keeping up with the United States and Asia.

Let me state very clearly that the PISA Education Survey is not only a test examining our schools and educational systems, but also an overall evaluation of European societies and their priorities.

Almost 50 years ago, the Sputnik shock (1957) gave great momentum to our Western societies in fuelling more education, research and development. All of a sudden, the West had the power to make great efforts in this contest among systems.

Today the losers of the global education ranking have no choice but to give maximum priority to education, research, and the transfer of knowledge between science and the economy.

Education and top-flight research are the best investments in the future. We must find new opportunities to replace and make up for the classical industrial production currently being drained out of Europe. New ideas, patents and skills are the most important sources in developing an edge among competitive systems. The know-how which goes into a computer chip is tens of thousands of times more valuable than the silicon it is made of. Natural raw materials are losing significance compared to the raw material "intellect".

This is precisely why the highest social dividend is provided by innovation! The best guarantee for social security is to rank right at the top in terms of progress. This applies both to the individual and – particularly in the age of globalisation – to all highly developed countries.

Bavaria, incidentally, has already reached the EU's target of investing 3 percent of its gross domestic product in research and development. Munich is the home of the European Patent Office with no less than 3,200 employees. Only last week the President of the European Patent Office stated that more patents were registered per inhabitant in Bavaria than, say, in the United States (Süddeutsche Zeitung, 2 June 2005).

However, he also added that about one-quarter of all patents registered worldwide came from the United States, with Germany – that is the good news – following in second place at 18 percent, ahead of Japan at 17 percent. In all, however, we Europeans must catch up, since the competition of regions and locations these days first and foremost means competition in terms of innovation.

We must therefore focus primarily on the promotion of European high technology. To be really effective, such promotion must not be confused with or linked to a policy of cohesion. Pursuing the promotion of research activities within the EU primarily under the perspective of cohesion, we would do nothing but harm Europe in its global competitiveness. Remember that anybody who seeks to make everybody equal ultimately makes everybody equally mediocre.

Money can be redistributed up to a certain limit. Knowledge and education cannot.

Instead of *"knowledge is power"*, the philosophy of the 21st century is that *"knowledge is prosperity"*.

Europe needs a fundamental turnaround leading away from consumption today towards investment for tomorrow

What we need in Europe in the current situation is *not* the reinstatement of old and old-fashioned Keynesian principles and economic programmes financed by debt. That will not solve structural problems – on the contrary. All it would do at the very best is light a short fire. We must not seek on a European level to solve the challenges of tomorrow by pursuing policies of yesterday.

As early as in 1982, Helmut Schmidt addressed his party with a most dismal statement: "Either we continue to increase the national debt – and that is something *I* will not do – or we make cutbacks in our social system – and that is something *you* will not do."

It is no secret that state intervention and a democracy of prosperity have been leading into a growing crisis throughout Europe ever since the 1970s. And it is likewise no secret that many – to a certain extent also *social-democratic* – national governments have already responded to the general pressure for reform.

Making painful reforms in their state and social spending, these courageous governments have initiated a process of lasting success. This all started in Great Britain in 1979 – where Blair continued and did not reverse the reforms introduced by Margaret Thatcher –, in Sweden in 1991, in Italy in 1994, in the Netherlands, and not least in Germany as of 1982 with the success achieved by the Federal Government led at the time by the Christian Union parties.

All long-term international comparisons confirm that a high level of state indebtedness weakens a country in its power of action. The payment of interest in the German federal budget alone amounts to € 40 billion.

The result is not only an all-time low in our rate of investment of just 8.8 percent, but also a higher tax burden channelling investment and purchasing power out of the economy.

Given this experience, the one and only choice, obviously, is for Europe and all Member States of the EU to strictly follow the process of budget consolidation while at the same time reshuffling the budget structure, moving the focus away from current consumption within social security systems towards future-oriented investment in infrastructure, research, development, and education.

Looking at the EU budget for the years from 2007 to 2013, we must therefore restrict the scope of the budget preferably to one percent of the EU's gross national income, which is precisely the demand made by Germany and five other EU Member States.

Another fact is that all efforts made for greater growth will inevitably fail if the Stability and Growth Pact does not, de facto, develop a stronger effect. Otherwise we would fail to achieve the consistent, ongoing growth so essential to Europe.

The Stability and Growth Pact helps to secure a stable currency worthy of confidence and thus sets the basis for a low level of interest rates also in the long term.

Any softening of the Pact would lead to an increase in interest rates – which, in turn, would be thoroughly detrimental to greater investment and more growth. So it is completely irresponsible of the German Federal Government to lead the way in softening the Pact by taking a very misguided initiative.

Millions of Europeans – and millions of unemployed Germans and their families – are looking into the future full of concern and even fear, asking "what can the state and politicians do?"

Many also wonder whether they will receive any help at all from politics. Many think that politicians have already been disarmed by the global business players with their dominating economic position and have already been caught in the "globalisation trap" (H.-M. Peter and H. Schumann, *Die Globalisierungsfalle,* Rowohlt 1998).

Our politicians, they claim, have long ago given up the global race among locations for investment and centres of industry with the lowest level of taxes and the lowest standards in social and environmental matters.

Seen from this perspective, politicians and the state are often regarded as nothing but poorly functioning repair operations serving to heal the wounds struck by the allegedly inhuman market and allegedly cold competition.

I do *not* share this opinion.

On the contrary – the state can do something to create the right conditions and environment for growth, work, and, as a result, social prosperity. Here in Bavaria we show this, for example, by companies such as Sandoz or General Electric moving to our region. There is no such thing as a powerless, helpless *state*. The only thing that is powerless and helpless is the wrong *policy*.

In the Middle Ages, the Europeans lagged behind the large Asian countries in most fields of learning, decisive initiatives in science and technology coming to our part of the world from the Far East. But around 1900, Europe became the most progressive continent in the world and people spoke of the "European miracle".

The decisive driving force for progress and prosperity in Europe was constant, ongoing competition among relatively small units – competition taking place *decreasingly* in military and *increasingly* in economic and scientific terms. And in the process the decentralised decisions taken by merchants, industrialists and researchers always remained open for correction. We competed against one another, but in particular we learnt from one another – then seeking to do the job even better than before.

For two centuries, Europe was the first address for industrialists, researchers and engineers. It was the European pioneering spirit which gave bread and work to millions, and prosperity to our entire continent. Today we find this spirit of breaking through to new frontiers in parts of Eastern Europe, in China, India, Brazil, and in the United States.

The new world order of the 21st century with its new power centres will not wait for the antiquated structures we still find in the industrial countries of Europe. And at the same time we still see a lack of competitive spirit here in Europe. However, everybody must realise that only he who is willing to conquer the future will actually win the future! So let us open up the window to the years and decades that lie ahead!

Every generation has its task. The task of our generation in a society that is growing older is to overcome exaggerated bureaucracy, to ensure competitive work structures, social prosperity and strong financial conditions. We don't wish to leave our children and grandchildren mountains of debt and interest payments, but rather opportunities and perspectives for their future.

The value of every generation lies not in what it reaps, but rather in what it sows. Precisely this is why we Europeans have a common objective: To make investments and ensure innovation, to generate profits for employers, wages and bread for employees, and, as a result, social prosperity in Europe both today and tomorrow. Everything that creates jobs is social. So we should discuss the right way to reach this objective.

I now look forward to the discussion and I wish the Conference the best of success.

Keynote Address by

WIM KOK,
Minister of State and former Prime Minister of the Netherlands;
Chairman of the High-Level Group on the Lisbon Strategy

Mr. Chairman, ladies and gentlemen,

First of all I would like to thank the organisers of this economic summit for their invitation to be with you today and for the kind words of welcome that were addressed to me.

It is a pleasure indeed for me to make a few introductory remarks at this opening session about the competitiveness of the European Union in a globalising and challenging world and the future perspectives for the European economy: the central theme of the so called Lisbon Strategy that was adopted by the governments of the EU member states five years ago.

The goal of this Lisbon Strategy was to make the European Union stronger, both in terms of economic performance and in terms of social cohesion and sustainability.

Its targets included, just to mention a few examples:

– increasing average labour participation to 70 percent,
– reducing the school drop-out rate by half and
– raising public and private spending on innovation to 3 percent of GDP, all by the year 2010.

All together, the strategy contained over one hundred targets, sub-targets and indicators, really a kind of "Christmas tree".

The strategy agreed for achieving these targets was to use the Community Method – the traditional European legislative process – combined with setting common goals and comparing national performance, including best practices. The latter is known as the Open Method of Coordination.

As you all know, the results since 2000 have been mixed. Some countries have managed and are still managing very well, whereas most others are lagging behind.

Because this has been a matter of growing concern, a high level group – which I chaired – was set up last year by the European Commission and the European Council in order to prepare a mid-term review of the Lisbon Strategy. This mid-term review was on the agenda of the European Spring Council in March this year.

The conclusions of this high level group were – briefly stated – the following:

We prefer Europe to be economically strong and competitive, but also responsible and sustainable – in terms of social cohesion, environmental protection and economic policies. In other words, the Lisbon three-pillar strategy has not lost its validity. If we want, however, to do our utmost to sustain our model of social cohesion and environmental sustainability, we must focus much more strongly on Europe's growth and employment performance – and therefore improve Europe's competitiveness. National and European politicians, entrepreneurs and all other stakeholders must urgently revitalise the Lisbon process. Focussed and comprehensive national and European policy actions are required to improve our overall performance.

To ensure a better performance by member states, the Lisbon process needs to be improved, too. In order to make the common European strategy more effective, the national component – "ownership" – must be made more visible and has to be strengthened. The process must better engage and involve citizens, social partners and parliaments.

Above all, however, common political will and determination are strongly required.

Both strong global competition and radical demographic changes are main causes why action must be taken now. Frankly speaking, not with the unrealistic ambition of becoming the world's number one economy by 2010 because that will prove to be absolutely impossible. No, urgent action is first of all required to maintain (and possibly strengthen) our position in the economic league we are currently in.

Let's not be afraid to look squarely at how things now stand. Over the last several decades, Europe has not succeeded in closing the economic gap with the U.S. – a gap which, since the 1970s, has remained at about 30 percent of GDP per capita.

An even greater cause for concern is the fact that, since the mid-1990s, annual labour productivity growth in the U.S. has outstripped that of the European Union.

International competition is intensifying, and Europe is facing a twin challenge from Asia and the U.S. Of course: the potential rapid growth of the Chinese economy will create not only a new competitor to Europe, but also a vast and growing market. For Europe to take advantage of that opportunity, it needs to have an appropriate economic base, recognising that over the decades ahead competition in manufacturing goods at home and abroad, especially those with a high wage content and stable technologies, is going to be formidable.

Indeed China, industrialising with a large and growing stock of foreign direct investment together with its own scientific base, has begun to compete not only in low-value, but also in high value-added goods.

Although Chinese wages are a fraction of those in Europe, it is clear that the difference in duality of a growing number of products and goods produced in China or the EU is already small or non-existent.

India's challenge is no less real – notably in the service sector where it is the single biggest beneficiary of the "offshoring" or "outsourcing" of service sector functions with an enormous pool of educated, cheap, English speaking workers.

In short, Asia's collective presence in the world trading system is going to be much more marked.

Europe, therefore, has to develop its own area of specialisation, excellence and comparative advantage which inevitably must lie in a commitment to the knowledge economy in its widest sense – but here it is confronted by the dominance of the U.S. The U.S. accounts for 74 percent of the top 300 IT companies and 46 percent of the top 300 firms ranked by R&D spending.

The EU's world share of exports of high-tech products is lower than that of the U.S.; the share of high-tech manufacturing in total value added and numbers employed in high-tech manufacturing are also lower.

In a global economy, Europe has no option but radically to improve its knowledge economy and its underlying economic performance if it is to respond adequately to the challenges of Asia and the U.S.

Europe must also face a second challenge – the problems arising from its ageing population. Two forces – declining birth rates and rising life expectancies – are interacting to produce a dramatic change in the size and age structure of Europe's population. These are two separate but interconnected problems.

The total population size in the European Union is projected to fall by 2020. By 2050, the working-age population (15 to 64 years) is projected to be 18 percent smaller than at present and the numbers of those aged over 65 years will have increased by 60 percent.

As a result, the average ratio of persons in retirement compared with those of the present working age in Europe will double from 24 percent today to almost 50 percent in 2050.

This development is already at work, and by 2015 the EU average dependency ratio will have increased already to 30 percent. The impact is then compounded by the low employment rate of older workers.

All this will have serious repercussions on public finances. Ageing will raise the demand for pensions and healthcare assistance at the same time as it reduces the number of people of working age, to produce the necessary wealth.

In case the present utilisation of the labour potential would remain unchanged, European Commission projections estimate that the pure impact of ageing populations will be to reduce the potential growth rate of the EU from the present rate of 2 to 2.25 percent to around 1.5 percent from 2015.

A conclusion we must draw from all this is the following. If we want our social systems, including our pension systems, to be financially sustainable, a better utilisation of labour is desperately needed, both by increasing employment and by working more hours on a life-time basis. In other words, people will inevitably have to work longer before they retire.

In order to enable people to do so, they will have to be provided with up-to-date skills which are in demand. A modern, properly functioning education system. including life-long learning, must ensure that this is possible.

Europe must pay attention to these two challenges – all the more so because it has just seen its biggest enlargement since the creation of the European Community.

It must be said – while this enlargement in itself is most important and welcome of course – that this has not made reaching the Lisbon targets any easier. Enlargement has made inequality and the problems of EU cohesion more pronounced. The new Member States are characterised by strong regional disparities with wealth only concentrated in a small number of regions.

Equally, quite understandably, the EU-25 will find some of the Lisbon targets even more challenging than the EU-15.

The positive aspect of enlargement is that it offers the prospect of the new Member States achieving rapid rates of growth in GDP and productivity as they catch up with the European average, so creating an area of economic dynamism in Central and Eastern Europe.

There is already evidence that this is happening. Output and productivity growth in most new Member States have been above that of the U.S. over the last five years. As they replace redundant ageing technology with state-of-the-art processes they will jump a generation in terms of their technological capacity. There is every prospect of their growth in output and productivity continuing.

Nonetheless, their relatively low tax and wage rates attracting inward investment from the rest of the EU are likely to be a source of continuing friction. The present restrictions within the EU on free labour movement from new Member States as well as sensitivities in "old Europe" related to the current debate on the Services Directive clearly illustrate this. Unless there is some prospect of convergence, these tensions will probably not disappear.

In this respect meeting the Lisbon goals to promote growth and employment in all parts of the European Union is vital for its future internal cohesion.

Ladies and gentlemen,

Europe needs to face these three challenges – with much greater political will and resolve than we have seen up to now.

If Europe wishes to uphold its distinctive choices in respect of its social model, if Europe wishes to increase its living standards, it needs to accelerate employment and productivity growth via a wide range of reform policies, including a better utilisation of labour both by increasing employment and by working more hours on a life-time basis, and via a set of interconnected initiatives and structural changes releasing Europe's potential.

This demands priority action across five policy areas:

- **The knowledge economy**
  Making Europe much more attractive to researchers and scientists by competing for the best brains in the world; at the same time, making R&D and innovation top priorities; strengthening Europe's industrial basis and promoting the use of information and communication technologies (ICTs), including the recommendation on adopting a Community patent at short notice.

- **The internal market**
  Completing the internal market for the free movement of goods and capital and urgent action to create a single market in services, including financial services (EU Member States can simply not afford the luxury of not making the best possible use of the benefits of the single market for services, eventually with some exemptions and/or transitional periods). Reaping the full benefits of a single market by appropriate and timely implementation of agreed EU legislation by member states.

- **The business climate**
  Enacting measures to reduce the administrative burden; improving the quality of legislation; improving the availability of and access to risk capital; facilitating the rapid start-up of new

enterprises; creating an environment which is more business-friendly and finally less and better regulation at all levels.

- **The labour market**
  Increasing the adaptability of workers and enterprises; creating an inclusive labour market by striking the right balance between flexibility and security and by moving away from job-security to employment- security; developing strategies for life-long learning and active ageing through more effective investment in human capital; the participation rate of female and older workers is essential to Europe's labour markets.

- **Environmental sustainability**
  Spreading eco-innovations and building leadership in eco-industry; pursuing policies which lead to long-term, sustained improvements in productivity through eco-efficiency; special attention is needed in order to avoid the risk that the competitive position of European industries is endangered by the application of unilateral EU environmental regulation; instead, synergies must be developed between a strong economic performance and sustainability.

Last but not least however, a wider macroeconomic framework is required which is, as much as possible, supportive of growth, demand and employment.

For that reason, the high level group supported the moderate reform proposals for the Stability and Growth Pact that were presented by the European Commission in September last year.

Under the reformed Stability and Growth Pact, however, that was agreed recently, governments seem to be allowed to run budget deficits of more than 3 percent of GDP for several years as long as they are of the opinion that relevant factors are justifying this. It all depends upon the wisdom of respective governments, but this potential lack of sufficient checks and balances at EU level worries me seriously.

So far my brief remarks, ladies and gentlemen, on the five priority areas on which the high level group recommended comprehensive actions. Each of these areas was already part of the original Lisbon Strategy, but implementing the recommendations now is even more urgent than it was five years ago. Time is running out.

Europe formulated the right strategy in 2000, but now words need to be followed by action. To that purpose we made a number of additional suggestions on how to improve the process and thus improve the performance of the EU.

The essence of these proposals is more coherence and consistency between policies and participants; improving the process for delivery by involving national parliaments and social partners; and clearer communication on objectives and achievements, because the necessity of structural social and economic reforms in order to raise productivity, economic growth and employment is to a large extent a communication project.

It is clear that until now the progress of the Lisbon strategy has suffered from lack of ownership and from lack of coherence and consistency, both between participants and between policies.

Policies pulling in contradictory directions must be realigned so that they become mutually reinforcing, including the European budget.

Whatever decisions are finally reached about the absolute level of the budget, the High Level Group believes that the structure of the European budget must reflect the Lisbon priorities of growth and employment – as should national budgets.

On top of that also a clear alignment between participants is needed.

Member States play a crucial role in creating the right conditions for more growth and employment. Up until now national parliaments and citizens have not been sufficiently associated with the process. The same applies to social partners and other stakeholders.

Therefore, the High Level Group proposed – and the European Council followed that proposal – that from now on each member state will formulate its national action programme.

In order to ensure coherence between the national and European levels, these national programmes need to have a clear link with the Broad Economic Policy Guidelines and Employment Guidelines, but also with the legislative process in the member states.

In addition, the Open Method of Co-ordination can be improved. It has fallen far short of expectations.

The central elements of this method – peer pressure and benchmarking – are clear incentives for the Member States to deliver on their commitments by measuring and comparing their respective performances and facilitating the exchange of best practice.

And finally, a stronger focus on a limited number of top priorities is absolutely necessary.

Ladies and gentlemen, let me now turn to my concluding remarks.

The challenges facing Europe – why policies are developing as they are and the importance of acting together – need to be understood much better by the European public.

Understanding this requires clear and vigorous communication. All involved, including European and national politicians, and especially the European Commission, have an important role to play in delivering the message. Europe's leaders need to instil the hope that tomorrow will be better than today.

Europe has considerable economic and social strengths. The programme of reform outlined in our report is eminently deliverable and will bring improvement. It needs to be clearly explained, understood and delivered.

Citizens are not always sufficiently aware of the urgency and scale of the challenges we are facing. Citizens are not always sufficiently aware of the high price they or their children will have to pay if the Lisbon Strategy is not going to succeed.

In the present circumstances, the clear message must be: if we want to preserve and strengthen our social model we have to act and adapt.

In any event the status quo is not an option.

The High Level Group did not call for indiscriminate action; reform packages should, of course, be balanced, well thought through and properly designed. Equally, there should be a strengthening and modernisation of the distinctive European approach to organising the economy and society, so embedding core European values that all Europeans care about. Social partners should be fully involved at all levels.

The issue is delivering on the promises and undertakings that have been made, and that will entail significant change.

As I said earlier: at the end of the day, achieving higher growth and increased employment depends highly on the political will and determination of Europe's leaders.

The outcome of the European Spring Council meeting in March this year was not very encouraging, I must say. My general impression is that the meeting was too much dominated by the controversy on the Stability and Growth Pact and the bitter dispute on the Services Directive.

Certainly, reading the conclusions of the meeting I do recognise a large number of analytical remarks and recommendations the High Level Group put forward.

But in my view the European Council missed to seize the momentum, to express a real sense of urgency, to send a clear signal to governments, parliaments, stakeholders and citizens in Europe that in order to revive the European economy a narrow focus on growth, employment and competitiveness is urgently needed.

Only a few weeks ago a majority of the French and the Dutch electorate rejected the constitutional treaty.

I fully recognise that this is not the most appropriate occasion for me to try and analyse the main reasons for this. The European Council will meet one week from now to discuss the current situation and possibly to decide about the future roadmap.

Potentially Europe is running the risk now of entering a period of stagnation and standstill. Of course, solutions will have to be found in order to overcome the present institutional and political deadlock. But we cannot afford to become an inward looking continent. The world will not be waiting for us. External and internal realities cannot be ignored.

A new constitutional treaty or not, a considerable recovery of our European competitive performance is absolutely indispensable in order to raise current employment levels as well as our living standards and to sustain Europe's social model – in whatever form. Therefore Europe has to act now.

Thank you for your attention.

Panel 1

Speeding up European Reform: A Master Plan for the Lisbon Process

Jean Pisani-Ferry

Bruegel and Université Paris-Dauphine[1]

What's wrong with Lisbon?

In a democracy, a policy institution acquires and retains legitimacy either through the quality of its decision procedures or because it is able to deliver what the citizens expect. In the recent referenda, the French and Dutch citizens were asked to vote on a new set of rules and procedures. But rather than to give their opinion on the machinery, they chose to express their dissatisfaction with the output.

Together with peace, prosperity remains the Union's premier public good. From the Single Market to the euro, many ambitious projects have been undertaken in the name of it. Expectations have been created, only to be disappointed a few years later – a sure recipe for frustration.

The referenda thus emphasise that Europe's poor economic performance deeply undermines the very legitimacy of the EU – a point rightly emphasised by Prime Minister Tony Blair in a speech to the European Parliament on the eve of the 2005 British presidency.

The need for a growth agenda is thus more pressing than ever. This Spring, the EU announced a revamped version of its growth programme, the so-called Lisbon strategy. Initially launched in 2000, when Europe started to realise that in spite of a favourable environment it had been losing ground vis-à-vis the U.S. for a decade, the Lisbon agenda has not delivered. If anything, the EU's comparative growth performance has weakened since it was adopted five years ago.

The European institutions cannot be accused of ignoring the evidence. The Kok report commissioned by the European Council and the Commission's own assessment of the economic performance of Europe are unusually frank. President Barroso's intention to give growth an overriding priority is unmistakable. The question, however, is whether the revamped Lisbon strategy is likely to work better than the original one. Lisbon mark 2 essentially boils down to a renewed emphasis on integration, a smaller set of objectives, and a streamlining of the coordination procedures that already exist: "less, but the same", as observed by Collignon (2005). Hardly a revolution.

There is wide agreement that five years after the beginning of the economic slowdown, the EU and especially the Eurozone cannot afford to remain on a sub-par growth track. The question is why the initial strategy has been unsuccessful and why it should now be expected to deliver what it has not delivered in its first five years. On this account, the conventional explanations, which basically put emphasis on the complexity of the initial set of objectives and indicators, are unconvincing. Complexity may account for implementation failures here and there, not for an overall lack of action.

There is thus a need for a deeper investigation into the shortcomings of the Lisbon strategy. What this paper argues is that the reason for those shortcomings is a lack of incentives to coordinate reforms within the EU. It makes the point that the very rationale for undertaking reforms jointly is in fact weak for the EU as a whole while it is stronger *within the Eurozone.*

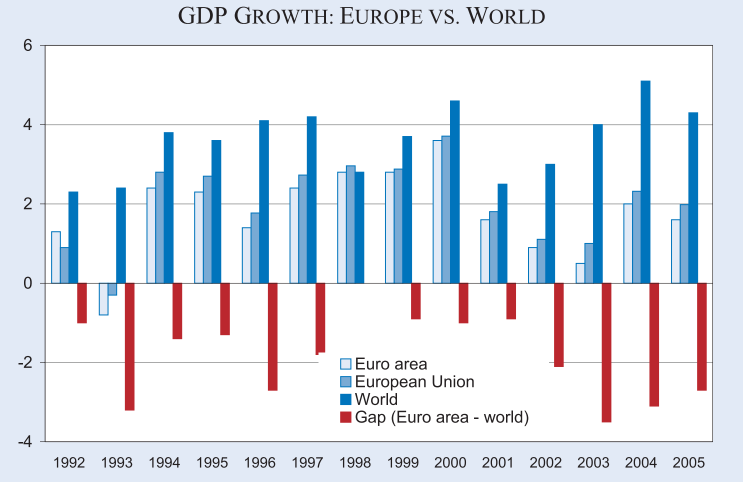
If this analysis is correct, the conclusion is that the EU must give thoughts to improving the incentive they face, especially within the Eurozone. It must also make better use of its own instruments – the EU legislation, the budget, monetary policy and the Stability pact.

This paper starts with a short assessment of the economic situation in the Union and the degree to

[1] jpf@bruegel.org. This is a revised version of a paper initially prepared for the "Munich Economic Summit", June 2005. Opinions expressed in this paper are those of the author. They do not represent in any way those of the members or the board of Bruegel.

which it explains the result of the referenda. Part 2 is devoted to an evaluation of the Lisbon strategy. Part 3 discusses why this strategy did not deliver. Recommendations for improving it are made in part 4. Part 5 concludes.[2]

Figure 1



Source: International Monetary Fund, World Economic Outlook Database, April 2005; EU25: Eurostat.

Europe's economic and political woes

In a recent paper, Olivier Blanchard (2004) challenged the view that Europe is sick, and claimed instead that its relatively low income per head reflects a preference for leisure. This was already a controversial reading of the 1980s and the early 1990s. Turning to the late 1990s and the early 2000s, it can at best be regarded as paradoxical.

Two basic facts illustrate the point. First, the EU's economic performance has consistently disappointed expectations since 2000. The last five years have been characterised by a persistent lack of economic momentum in the Eurozone and Europe at large and by a widening gap between world and European GDP growth. In comparison, Europe's relative performance was markedly superior in the early 1990s in spite of the aftershock of German unification (Fig. 1).

Second, the growth gap between the U.S. and Europe can no longer be ascribed to an inferior mobilisation of labour resources. In the early 1990s, the EU could still be described as a high productivity-low employment economy and it was routinely compared to the low productivity-high employment US economy. But since the mid-1990s, Europe has started to catch up on employment while it has been lagging behind as regards productivity growth. Although the level of labour utilisation remains inferior to that in the U.S., the main factors behind the widening of the income gap are now demographics and productivity (see Table).

Instead of moving towards the frontier by improving its performance on both employment and productivity, the EU thus only seems to be able to trade-off productivity for employment while remaining at a GDP per capita level markedly inferior to that of the U.S. (Sapir et al., 2004). The two macroeconomic goals of Lisbon – employment and productivity – look as being substitutes rather than complements (CEPS, 2003).

It is in the three main economies of the Eurozone – Germany, Italy and France – that those woes are especially apparent. In France, they weighed very significantly in the voters' decision to reject the draft constitutional treaty: all exit polls indicated that the deteriorated economic and social situation had been the main motive for the no vote, over and above other factors such as the judgement on the constitution itself, disagreement with the prospective enlargement to Turkey or domestic political concerns (Fig. 2).[3] The voters' intention was apparently to sanction the EU for a failure to deliver economic prosperity.[4] In the Netherlands, the main declared

[2] This paper partially draws on joint work with Philippe Aghion and Elie Cohen (2005).
[3] This result consistently emerges from the exit polls of CSA, IPSOS and SOFRES, in spite of varying formulation of the question and of varying alternative answers. It can therefore be considered robust.

[4] Although more detailed analyses indicate that opposition to the treaty among public-sector employees was a significant factor behind the victory of the no, they also confirm that social polarisation among the voters was exceptionally high (Goux and Maurin, 2005).

Table

Relative US/EU15 performance
(EU performance level as a percentage of corresponding US performance)

	1995	2003
Income per head	72.1	70.9
Hourly labour productivity	93.6	88.0
Empolyment rate	82.9	90.4

Source: Eurostat, structural indicators database.

motives were that the country "pays too much to the EU" and that it would risk having "less control over its own affairs".[5] While the difference with French motivation is noticeable, those results can also be regarded as indicating that the EU does not deliver [economic] value for [budgetary] money. Again domestic concerns and Turkey seem to have played a minor role.

One of the messages from the referenda is therefore that citizens are reluctant to approve the rules and procedures of a Union that does not deliver prosperity.

An assessment of the Lisbon strategy

Is Lisbon the remedy? A prerequisite to an answer is to define what Lisbon really means. Putting aside an unfortunate initial hype, it can be summarised in a three-pillars programme[6]:

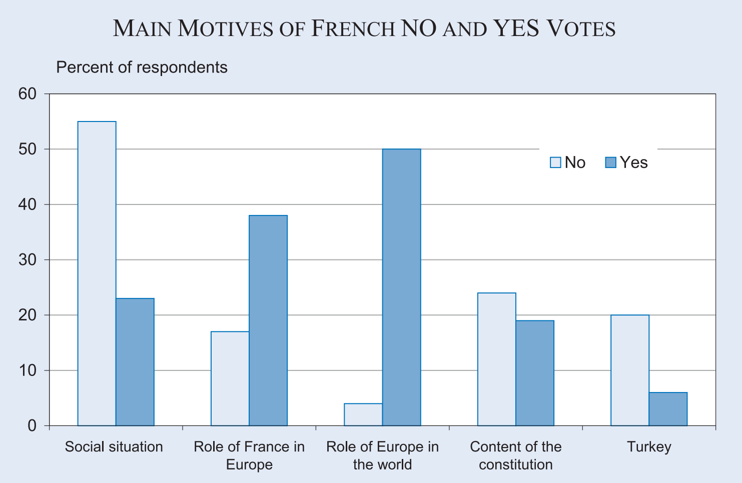
- *Economic integration.* This is the traditional EU agenda and the one on which its growth strategy rested in the 1980s and the 1990s. Lisbon was a recognition that economic integration was not likely to be sufficient as an engine for growth, but it remains a key component of the approach. Integration today obviously no longer means dismantling border controls, but reforming domestic regulations that obstruct freedom of establishment, hinder cross-border mergers and acquisitions and stifle competition. This requires to combine EU and national policies, albeit in a field where the EU generally has precedence.
- *A soft coordination of domestic labour markets and pension reforms.* This pillar was added in 2000 thanks to the adoption of the "open method of coordination", a non-binding commitment to reciprocal consultation and benchmarking (Rodrigues, 2002). The goal was to complement the traditional agenda with policies aiming at increasing labour supply and tackling long-term unemployment. However, no legislation could be proposed, as the EU has almost no competence for labour markets, taxation and social security: those areas primarily belong to the remit of the member states. Common targets were set instead, together with supporting league tables and a benchmarking of policies. It was expected that this non-binding coordination would encourage the adoption of best practices. To that end, the Commission had to draw up scoreboards on the basis of commonly agreed targets and indicators.
- *A restructuring of public spending* in the direction of R&D and higher education. Here again, most of the means are in the hands of the member states, but the setting up of common objectives was expected to foster additional efforts.

Although in this area the EU is either the player (for Eurozone monetary policy) or can rest on explicit coordination powers (for budgetary policies), macroeconomic policy is not part of the strategy, as it focuses on the structural conditions for growth. Macroeconomic stability, i.e. budgetary discipline and price stability, is regarded as a complement to it.

This is the programme. What are the achievements?

On the integration front, little has changed in recent years. The one advance that can be noted is the implementation of the Lamfalussy programme for financial services. For other policies, no major push has been recorded. Aggregate evidence based on price convergence or trade intensity suggests that after the completion of the Single Market in 1992, integration has somewhat stalled (Fig. 3). Compared to other regional groupings, trade within the EU-25 evidently lacks

Figure 2

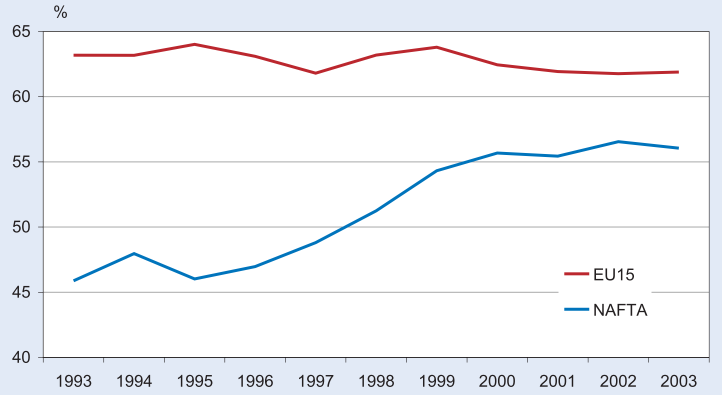


Source: CSA Exit Poll.

[5] NOS/NSS polls.
[6] The Sapir report (2004) and the Kok report (2004) provide a more comprehensive overview of the Lisbon strategy. The revised version of the Lisbon strategy is presented in a Commission (2005) communication to the Council and the Parliament as well as in the Integrated Guidelines first adopted in 2005.

Figure 3

SHARE OF INTRA-TRADE WITHIN THE EU AND NAFTA



Source: WTO.

momentum. Furthermore, more detailed research (Mayer and Zignago, 2005) indicates that in spite of a much more complete legislative and regulatory apparatus, EU-induced intra-European trade is markedly less important than NAFTA-induced North-American trade. More than ten years after the removal of all border obstacles, the EU is still very far from being an integrated economy.

Another piece of evidence on integration is provided by the OECD (Conway et al., 2005) index of product market regulation (Fig. 4). In spite of the Single Market, there is roughly as much variance in the degree of product market regulation within the EU-15[7] as among the non-EU OECD countries. Furthermore, the trend towards deregulation is similar in the two groups of countries. In short, there is no prima facie evidence that membership in the EU makes a difference as regards the nature or degree of product market regulation.

Turning to labour markets and tax or welfare reforms, the evidence does not suggest tight coordination either. Again, the OECD indicators (Brandt, Burniaux and Duval 2005) can be used to assess the degree to which the regulatory and tax regimes of labour markets have effectively converged within the EU and whether a common European approach emerges from the data.

Only examples can be given here. The most striking regards the degree of employment protection for permanent workers, for which the dispersion among EU-15 members is as wide as within the OECD and remains at the same level as ten years before. Although the issue of employment protection is central in a strategy that intends to equip workers for a transforming economy, there is no evidence whatsoever of European convergence towards a common approach. Some more convergence can be observed

[7] The new member states of Central and Eastern Europe have been excluded from the sample because their recent transition to the market economy could have affected comparisons over a 10-year period.

Figure 4

PRODUCT MARKET REGULATION, 1998 AND 2003

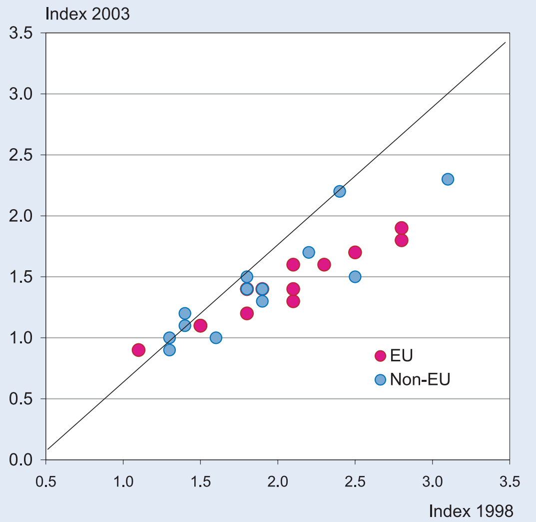


Figure 5

EMPLOYMENT PROTECTION FOR PERMANENT WORKERS, 1993 AND 2003

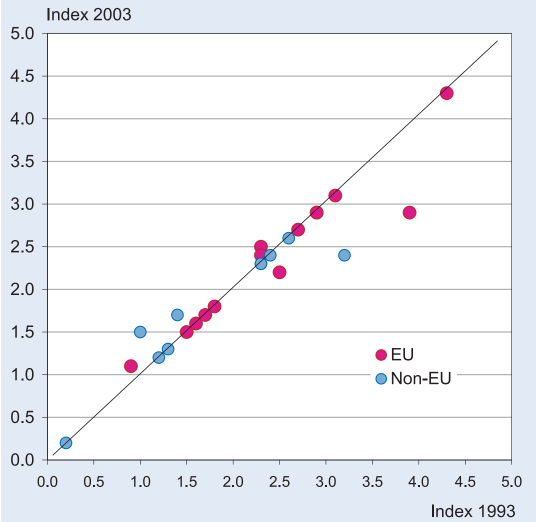
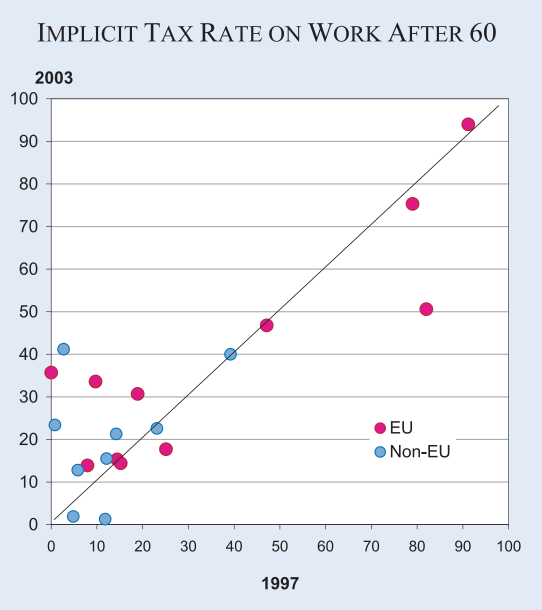


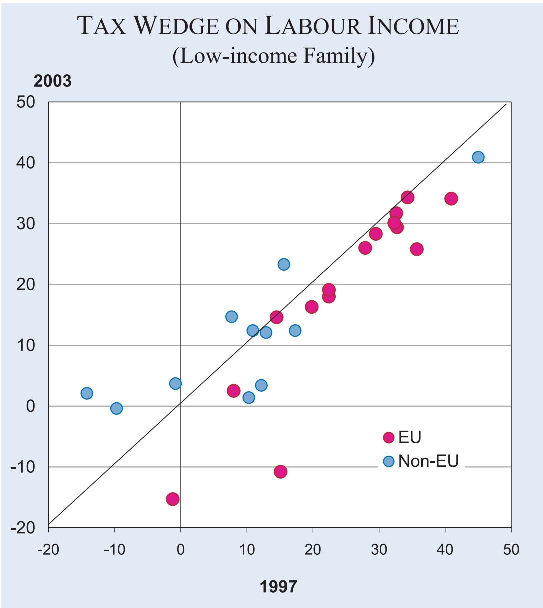
Figure 6



in the protection of temporary workers, as many countries have relaxed provisions regarding temporary workers, but in that case the dispersion regards the frequency with which companies rely on such contracts.

A second, equally striking example is given by the implicit taxation on work after 60. A major objective of the Lisbon programme is to increase the labour force participation and employment rates of persons between 60 and 65 years old. A major obstacle in higher senior participation comes from provisions in the pension and tax regimes that effectively discourage work after 55 or 60, frequently because additional pension contributions do not increase the future benefits. Reducing this implicit taxation of work should thus be a common objective of the EU member states. Yet the dispersion of implicit taxation rates remains wider within the EU than among non-EU OECD countries.

Figure 7



Finally, I look at the tax wedge on labour income at the bottom end of the wage distribution (data are again from the OECD). A number of European countries have recently introduced targeted cuts of social security contributions in order to "price in" unskilled labour. Figure 7 does confirm that there is an observable tendency toward a lower tax wedge among EU members. However it has taken place at a very uneven pace and the dispersion has in fact increased rather than decreased over the 1997 to 2003 period.

Although the evidence presented remains somewhat sketchy, it tends to confirm that the Lisbon coordination of labour market policies has not strongly affected national policies.

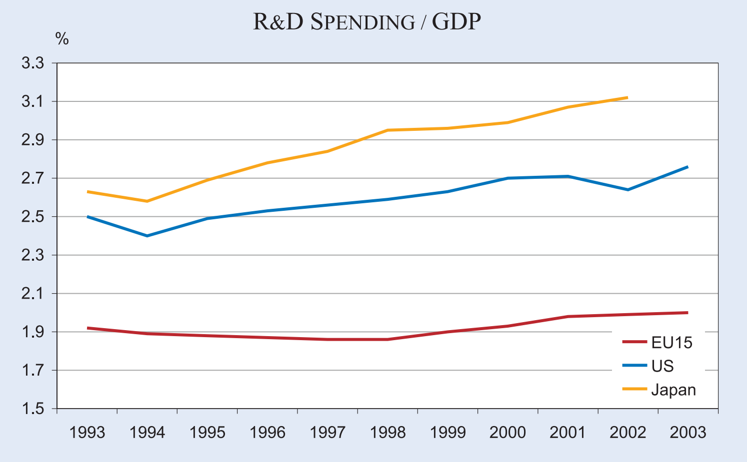
Finally, the restructuring of public spending is not taking place, at least it has not yet occurred. Aggregate figures indicate that the share of R&D in GDP has increased in Japan and the U.S., but not in Europe (Fig. 8). The commitment to increase this spending to 3 percent of GDP has failed to materialise.

Evidence thus supports the view that Lisbon has not fulfilled its promises. The question is, first, why it has not delivered, second, what can be done to make it effective.

Why is Lisbon not effective?

It is hard to challenge the Lisbon goals. In fact, they command virtually universal support. Governments are committed to them. The European parliament supports them quasi-unanimously. Both the employers federation, UNICE, and the European Trade Unions Congress, ETUC, strongly endorse them. But action does not follow words. So why is the EU unable to deliver on such a seemingly uncontroversial reform agenda? Why have integration and reform stalled? Why, finally, is Lisbon the least effective in the large Eurozone countries, where reform is the most pressing?

Figure 8



Source: Eurostat.

Conventional wisdom puts the blame on complexity, i.e. on the multiplication of detailed targets, objectives and reporting procedures. Yet the argument places much to much faith in the Lisbon process. Beyond the technicalities, the gist of the Lisbon agenda is clear and simple – as previously emphasised. To claim that its failure stems from the complexity of the procedures amounts to assuming that governments have behaved in an excessively myopic way.

The deeper issue is of a different nature. Rather than with complexity, the problem has to do with the lack of incentives to behave in accordance with the prescriptions of the Lisbon strategy.

Lisbon rests on the belief that member countries have a common interest in coordinating structural reform policies. The underlying rationale draws on two series of arguments. First, it is assumed that countries may gain from undertaking reforms jointly. Second, it is expected that they may learn from the experience of each-other and that the EU may help in providing an assessment of what works and what does not.

The first argument rests on the existence of positive cross-border externalities from supply-side policies. As always in the presence of such externalities, coordination should help internalising the benefits of reform policies and thereby lead governments to move away from an inefficient no-reform equilibrium to an efficiency-enhancing reform equilibrium. The problem, however, is that externalities arising from supply-side policies are less evident than those from demand-side policies. Absent labour mobility, a country that lowers its structural unemployment rate does not significantly impact its neighbours. Its success fundamentally benefits its own citizens. Similarly, a country which succeeds in improving its productivity performance essentially boosts its own growth. Its neighbours may benefit from resulting price cuts and corresponding purchasing power increases, but this effect normally results from the move to a new price equilibrium and, absent market failures, there is no reason to suspect that this cross-border spill-over reduces the incentive to improve productivity. In other words, externalities are pecuniary ones and are normally dealt with by the market (Tabellini and Wyplosz, 2004).

There are obviously exceptions, as some policies such as spending on research and higher education, which involve non-pecuniary externalities, gain from being coordinated. There are also counter-arguments[8], but on the whole, a fair assumption is that the case for coordinating supply-side policies must be assessed on a case-by-case basis.

The second argument is based on the so-called theory of "yardstick competition", initially developed in a regulatory context (Shleifer, 1985) and later extended to analyse the behaviour of decentralised governments (Besley and Smart, 2001). By providing an independent assessment, the EU could help governments to sort good from bad policies and voters to sort good from bad governments. In this way, the "open method of coordination" should trigger competition and foster reform.

The problem with this argument is that, in the European context, yardstick competition is a rather weak force. Voters may compare the overall performance of the respective EU countries – for example their relative unemployment rates – but comparing policies and reforms is much less straightforward, as the impact of any given reform depends on a host of other factors, from existing institutions to complementary policies and the macroeconomic context. A recurring theme of the literature on economic

[8] See Pisani-Ferry (2004) for a discussion of Tabellini and Wyplosz.

reforms is that, in the presence of policy complementarity, their effectiveness heavily depends on these context factors. Furthermore, voters face difficulties in appreciating the trade-offs involved (for example between efficiency and equity or employment and job security), as, again, this requires more information than the mere observation of economic results.

Lisbon may be regarded as a supporting device to make yardstick competition more effective. The provision of harmonised data and comparative assessments may trigger a kind of performance transparency and help determining what works best – without infringing on the member states' policy autonomy.

However, anecdotal evidence suggests that the adoption of the Lisbon programme has not significantly affected the reform debate in the larger member states such as Germany (where the discussion on Agenda 2010 was mostly conducted without reference to it) or France (where politicians routinely warn against the devilish character of the Anglo-Saxon model). The paradox of Lisbon is thus that it tends to be a reference in smaller, more open and reform-minded economies – exactly where it is hardly needed.

Furthermore, the Commission is visibly in an uncomfortable position vis-à-vis the member states. It has no power to enforce the Lisbon agenda and hesitates between the role of a schoolmaster and that of a coach. The Barroso Commission recently took some distance with the former role, indicating that its intention was not to designate good and bad pupils, but rather to support the efforts of all of them.

Against this background, the decision by the European Council of March 2005 to base the monitoring on "national reform programmes" geared to the member states' "own needs and specific situations" (and whose preparation is the responsibility of the member states) risks watering down the whole exercise and may weaken even further the incentive to conform to the commonly agreed agenda.

There is, however, another potential motive for coordinating reforms, this time within the Eurozone. In a monetary union, countries that reform and, as a result, lower their structural unemployment rate or increase their trend productivity growth rate exert a medium-term externality on their neighbours. Think, for example, of a monetary union composed of two countries, A that reforms and B that does not. Both obviously share the same nominal interest rate. Suppose that as a consequence of reforms in A, the aggregate structural unemployment rate goes down while aggregate productivity goes up – in both cases lowering inflation until a new steady-state equilibrium has been reached. The central bank can thus lower interest rates, thereby boosting domestic demand in both A and B. However, for A the interest rate reduction is less than it would have been with currency autonomy, while for B it entirely results from the partner's policies (and can therefore result in inflationary pressures). The key here is that the externality is entirely attributable to the fact that the two countries share the same currency.

Assume now that governments face a political economy constraint and therefore hesitate to undertake reforms. Structural reforms, which increase potential output in the medium term, frequently cause output losses in the short term because they involve adjustment costs, create uncertainty and affect consumer behaviour (as illustrated by the current situation in Germany).[9] A recent IMF (2004) study suggests that this kind of inter-temporal distribution may in fact characterise a wide array of labour market and product market reforms (Fig. 9). In such situations, the inter-temporal gain from introducing a reform can be low or even negative if governments have a strong preference for the present.

More generally, reforms frequently amount to trading short-term (economic and political) costs for long-term (economic) gains. For that reason, politically motivated governments may hesitate to undertake welfare-improving reforms. This is where macroeconomic policy comes in. What it can do is to change the inter-temporal distribution of costs and benefits through speeding up convergence to the new, higher equilibrium. By taking advantage of the structural improvement before spontaneous convergence has taken place, it can make reforms less costly in the short term and thus more attractive for politicians. In other words, macroeconomic accommodation can be an incentive to structural reform.

In a monetary union, however, monetary policy can only support the reform efforts of any given government to the extent it contributes to improving the

[9] Reforming employment protection can, for example, imply more unemployment in the short term (as firms dispose of redundant workers) but less in the long term (as flows increase and the market for labour becomes more fluid).

Figure 9

INTERNATIONAL EFFECTS OF STRUCTURAL REFORMS

Response of real GPD per capita to a one-standard-deviation increase in reform indicators

(Percent cumulative effects; x-axis time units represent three-year periods)

Source: IMF; World Economic Outlook, April 2004.

aggregate performance. For a government acting in isolation, the incentive to overcome political economy constraints is reduced accordingly. Absent a coordination of structural reform efforts, this may result in a reform deadlock in which no government undertakes the necessary reforms.[10]

This reasoning has relevance in the Eurozone. Reform-minded governments can only rely on fiscal policy to the extent this does not conflict with the Stability and Growth Pact. They can only rely on monetary policy to the extent their reforms result in lowering the aggregate inflation rate. On both accounts, the macroeconomic framework does not help to overcome the reform deadlock.

Summing up, the problem with structural reform coordination at the EU level it that the rationale for it is relatively weak and that the incentive to coordinate hardly exists. The problem with coordinating structural reforms among Eurozone members is that they face a collective action problem that the macroeconomic framework does not help to overcome.

This Eurozone dimension was until very recently not taken into account in the EU policy framework, as the Lisbon agenda entirely focuses on reform coordination among the 25 and completely overlooks the Eurozone dimension, while the Stability Pact ignored the issue of structural reform until its recent reformulation and monetary policy was not geared to supporting structural reform.

What can be done?

To return on a higher growth path, the EU first needs to concentrate efforts and political energy where they can be expected to deliver growth dividends. Second, it needs to remedy the lack of incentives in the Lisbon programme. Third, the Eurozone needs to better combine structural and macroeconomic policies in a way that builds on their complementarities.

Economic integration within the EU should be pushed further, but as a growth-enhancing programme rather than as an end in itself. In an environment characterised by rising reluctance to governance from Brussels and a tendency to revert to the nation-state as the ultimate shelter against the pressures from globalisation, it is important not to confuse means and ends. Recent reactions to the outcome of the referenda indicate that the two major achievements of the last decades, the Single Market and the euro, can be openly challenged by senior mainstream politicians. The mere preservation of what has been achieved can therefore not be taken for granted.

Against this background, the EU should neither promote further market integration in an indiscriminate way nor stop pushing for it. It should consciously devise a strategy to rebuild legitimacy through concrete achievements. This implies to focus on areas where integration has the potential of decisively con-

[10] Other Eurozone-specific externalities exist. Another important one regards pensions. The case for coordinating pension reforms within the EU as a whole is not a very strong one, but it is much more compelling within the Eurozone because of their impact on public finance. Long-term sustainability essentially depends on the implicit liabilities created by the pay-as-you-go systems and for that reason, budgetary surveillance necessarily encompasses the issue of pension reform.

tributing to aggregate growth and better take into account the balance between political costs and economic benefits.

In other words, the EU should primarily focus on "making the Single Market more dynamic" as proposed by the Sapir report (2004). This means less insistence on liberalisation across the board and stronger priority on areas such as competition, the long-awaited community patent, the completion of the single market for financial services or the free cross-border provision of high-productivity services. This also means lifting the bottlenecks that prevent the effective integration of the new member states, which has the potential of contributing to a renewal of European growth and competitiveness.

Reform coordination should not be abandoned, but efforts should focus on areas where it is justified by cross-border externalities. The European Commission should continue to provide an uncompromising comparative assessment of performance and efforts that can be used in domestic policy debates and thereby trigger an informed discussion on what works and what does not. But it should focus its positive coordination efforts in areas where significant externalities exist, such as migration or research and higher education. In those areas, policy effectiveness requires joint action and EU intervention is more than legitimate.

However, reform coordination cannot only take the form of exhortations or encouragements. To ensure effective coordination, words need to be substantiated with deeds. This is why the Sapir report (2004) had proposed to use the EU budget as an incentive device to support national efforts in areas of common interest and encourage member states to undertake them (A good testing ground could be higher education, where member states share a common interest in upgrading their research universities to retain students and professors and make them contribute to the development of a knowledge-based economy: EU money could be used to elicit national efforts). The initial Commission proposal for the 2007 to 2013 financial perspectives had partially taken this proposal on board, but further negotiations in the run-up to the June European Council led to reverting to a more traditional approach. An unambitious budget that neither restructured spending nor increased it in a significant way would have deprived the EU of a potentially powerful device to trigger coordination and increase incentives to pursue growth-enhancing policies. The debate over the financial perspectives that has started creates an opportunity for discussing options.

Finally, the Eurozone should take into account complementarity between structural and macroeconomic policies and adapt its policy framework accordingly. The principles governing macroeconomic policy in EMU are certainly not compatible with the explicit "two-handed approach" advocated two decades ago by economists (Blanchard and al., 1985). However, more can be done within the current framework to help overcoming the political economy obstacle to growth and reform.

First, overall stabilisation can significantly be improved. Over the last cycle, the Eurozone has been characterised by a lack of responsiveness of monetary policy (combined with comparatively weak transmission mechanisms) and an inappropriate stance of aggregate fiscal policy in the upswing. Improving stabilisation through better responsiveness would benefit in the short run and might even improve long-term growth (Aghion, Cohen and Pisani-Ferry 2005). Some progress, albeit without much result so far, has been made in this direction through the redefinition of the ECB target and the reform of the Stability Pact.

Second, the fiscal policy framework must encourage reforms that are conducive to growth and may improve the intertemporal budget balance. The agreement of March 2005 on reforming the Stability and Growth Pact includes a commitment to take structural reforms into account "when defining the adjustment path to the medium-term objective for countries that have not yet reached this objective and in allowing a temporary deviation from this objective for countries that have already reached it". The devil, however, is in implementation, especially as the reformed Stability and Growth Pact has moved away from rules to rely more on discretion (Pisani-Ferry 2004b, 2005). Furthermore, the countries in the most urgent need for reform are also those in which the budgetary margins allowed by the Stability Pact are exhausted.

Third, the ECB should explicitly let it be known that, without prejudice to price stability, it stands ready to back reforms that lower structural unemployment and put the Eurozone on a higher growth path. It has already recognised the existence of complementarities between macroeconomic policies and structural reforms and hinted at the additional room for manoeuvre that the latter would create for the single monetary policy (Papademos, 2004). Time has come to go further and more unequivocally recognise that, provided the governments act, monetary policy would support their action. Such a commitment would certainly involve taking a risk. The question, however, is whether it is preferable to take the alternative risk of remaining in a deadlock that would ultimately undermine the sustainability of monetary union.

Conclusions

Two decades of sub-par performance and four years of near-stagnation have resulted in a situation where the very legitimacy of the European Union is at stake. Failure to deliver growth and prosperity has already undermined support for the common institutions. It could tomorrow trigger a backlash against economic integration and the very achievements of the last twenty years, the Single Market and the euro. It could turn the potentially highly beneficial integration of the new member states into a zero-sum game and spark off a range of intra-EU controversies.

This paper has argued that the Lisbon programme has not delivered on its promises and that Lisbon mark 2, its revamped version, is unlikely to succeed either, because it fails to recognise the shortcomings of its predecessor. What the EU needs is to focus integration efforts, to use the EU budget to support reform efforts with effective incentives rather than just words, and to make the macroeconomic framework more conducive to reforms.

A more effective growth programme has for a long time already been an economic imperative. After the referenda, it has also become an even more pressing political imperative.

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OTMAR ISSING
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The implementation of the Lisbon Agenda: A political priority

The inability of European countries to take decisive action towards increasing the flexibility of their national economies stands in sharp contrast with the success of the EMU project that culminated in introduction of a single currency for 12 European countries and the start of a common monetary policy in 1999. In the euro area, the lack of sufficient flexibility has hampered the dynamism of the economy. Consequently, both firms and households could not fully reap the benefits of the stable macroeconomic framework ensured by EMU. Over the recent decade we experienced a decline in trend labour productivity growth. For example, GDP per hour worked in the euro area averaged about 1.3 percent over the period 1996 to 2003 from around 2 percent over the period 1980 to 1995.

Furthermore, despite declining on average since 1996, the unemployment rate in the euro area remains close to 9 percent, which is not, by any measure, a tolerable level for a developed economy like the euro area. Some European citizens, like women and people closer to retirement age, remain structurally at the margin of the labour market. Even more dramatic is the youth unemployment rate in the euro area, which in 2004 stood at close to 18 percent, because that keeps out of the production process the most productive and dynamic part of the euro area labour force.

In light of the empirical evidence showing that the lack of dynamism in the euro area economy is rooted in its microstructure, the ECB has consistently advocated, through its diverse means of communicating to the public, the implementation of structural reforms that would improve the functioning of product and factor markets in the euro area.

Such assessment is shared by the European Council as shown by the Presidency Conclusions of the European Council held in March 2005. On that occasion, in line with the recommendations of both the High Level Group chaired by Wim Kok and the Commission Spring Report, the Council concluded, that European national governments should relaunch the Lisbon strategy without delay and refocus priorities on growth and employment. Such reforms, as the Conclusions recalled, need to be supported by sound macroeconomic conditions, which imply both a price-stability oriented monetary policy and national fiscal policies that are consistent with this objective.

EMU: A unique historical event

Monetary Union in Europe started on 1 January 1999 with one more country joining on 1 January 2001. The uniqueness of this event is the transfer of national monetary policy decision-making powers to a supranational entity, which is the ECB. With the decision to share the same currency, the 12 participating countries relinquished part of their sovereignty. This regime shift reflects the political will, explicitly expressed in the Maastricht Treaty "to mark a new stage in the process of European integration undertaken with the establishment of the European Communities".

EMU is unique in history. It is one of the great success stories in the long standing process of European integration that started immediately after the end of World War II.

EMU and the Lisbon Agenda: Completing the institutional framework of an integrated Europe

The decision of European countries to delegate monetary policy to a supranational entity whose responsibility is to maintain price stability in the whole area originated a debate in the 1990s that still continues today. In particular, some observers have argued against the feasibility of a single monetary policy which would set interest rates for many countries characterised by significant structural differences. Following the core results of the well-known economic literature on Optimal Currency Areas, EMU critics have argued that European countries would not reap the advantages of a common currency because their national economies are too dissimilar and rigid.[1] Furthermore, the very limited labour mobility across euro area countries, especially when compared to other monetary unions, like the U.S., was stressed. Finally, EMU critics argued that the lack of a single fiscal policy did not allow the necessary redistribution mechanism to work within the euro area in case real economic developments diverged strongly across member countries. Following on from the above, according to this critical view, EMU was bound to deliver more costs than benefits to its participants. Euro area countries were likely to need different monetary policy responses at the same moment of time and thus could not afford relinquishing their sovereignty over monetary policy and the nominal exchange rate as one important tool to adjust relative prices.

In contrast to the gloomy picture of these critics, a fair assessment of the first six years and a half of the euro's existence is extremely positive. The introduction of the single currency can certainly be considered a great success along many dimensions. The most relevant aspect has been, of course, the macroeconomic stability enjoyed by the euro area with average inflation only slightly above 2 percent and long-term inflation expectations always centred on the ECB's objective. Furthermore, in the last six years and a half, long-term forward interest rates in the euro area have never drifted away from the low level to which they had converged by end-1998. Moreover, both inflation and unemployment volatility have significantly declined since the ECB started to operate a single monetary policy. Finally, some preliminary evidence shows that the convergence process in the 1990s, in combination with the credible monetary policy of the ECB since 1999 have contributed to reduce the persistence of the inflation process, presumably through the anchoring of price and wage setting behaviour.[2] There is also some preliminary evidence that the single monetary policy has helped to consolidate the harmonisation of the monetary transmission mechanism and to reduce inflation persistence, whose dispersion across European countries had increased significantly after the ERM crisis in 1992.

The success of EMU suggests that the concerns about the fitness of European countries to share a single currency and run a common monetary policy were largely misplaced. In the last six years and a half, more and more evidence has accumulated showing that national economic institutions have endogenously adapted to the single monetary policy thus furthering the harmonisation and integration of euro area countries. National business cycles are more synchronised and financial markets more integrated than they were in 1999. Furthermore, the Stability and Growth Pact, now in its revised form, has to be implemented strictly. It is crucial that the aggregate results of national fiscal policies are consistent with the single monetary policy aiming at price stability in the euro area. National fiscal policies must continue to aim at achieving and maintaining sound public finance also within the framework provided by the recently revised Stability and Growth Pact.

At the current stage, EMU represents a successful achievement, but cannot be considered the endpoint of the European integration process. Six years and a half of history have demonstrated that a successful stability-oriented macroeconomic policy framework alone is a necessary but not a sufficient condition for euro area citizens to reap all the benefits arising from the single currency. EMU needs to be complemented with economic institutions at the micro level, which do not hinder the dynamism and the flexibility of the economy. This is even more necessary in the euro area than it is in other monetary unions because fiscal policy is a matter of national competence, and is likely to remain so for the foreseeable future. The decentralised character of fiscal policy in the euro area implies that there is no extended cross-border transfer mechanism that helps to smooth out business cycle divergences. Such fiscal transfers will not be a realistic option for a long time because the impact on national public finances would go far beyond the levels which are accepted by the public. Furthermore, cross-border movements of people will likely remain very limited within the euro area. Against this background, structural reforms will not only be beneficial because they raise

[1] The probably gloomiest picture was painted by Martin Feldstein who in 1997 predicted that *"instead of increasing intra-European harmony and global peace, the shift to EMU and the political integration that would follow it would be more likely to lead to increased conflicts within Europe and between Europe and the United States"* and that, as a consequence, *"war within Europe itself would be abhorrent but not impossible"* (Feldstein, 1997). And still one year after the successful introduction of the euro, Feldstein (2000) predicted that *"the euro is likely to have adverse medium-term and long-term effects on employment and inflation, and is likely to be the source of political conflicts within Europe and between Europe and the United States"*. Similar critical views were also expressed by Bayoumi and Eichengreen (1993a, 1993b) and Blanchard and Katz (1992), among others.

[2] Masuch, K. (2005).

factor productivity, open up additional employment opportunities and increase the potential growth rate of GDP. Increasing the flexibility of product and labour markets will allow national economies to better cope with economic shocks, in particular with those impacting asymmetrically on the euro area countries. Moreover, enhanced flexibility of wages and better conditions for creating new firms and jobs will imply that negative supply shocks are absorbed with a smaller short-term increase in unemployment. Finally, it would also contribute to dampen second round effects arising from one-off inflationary shocks (e.g. those arising from increases in oil prices or indirect taxes) and thus allow monetary policy to react less strongly. Such an environment will not only make it easier for monetary policy to maintain price stability, but it will also help to keep the volatility of inflation and output lower thus making the stabilising effects of the single monetary policy more visible.

A stability oriented macroeconomic framework is supportive of the Lisbon agenda

The ECB actively helps to support the Lisbon goals by maintaining price stability and safeguarding financial stability. In such a stable macroeconomic environment, structural reforms will be easier to implement for a number of reasons. Price stability

- preserves and bolsters consumers' purchasing power, thus supporting consumption;
- enhances the efficiency of the market system in allocating resources, by making it easier for people to recognise changes in relative prices;
- avoids additional menu costs, i.e. production costs occurring when printed prices have to be changed;
- is associated with lower uncertainty and risk premia in financial markets, facilitating financial transactions and ultimately implying lower medium and long-term interest rates, fostering investment;
- provides markets with an indispensable nominal anchor for adjusting changes in wages in a forward-looking manner thus avoiding harmful indexation to past inflation;
- prevents the considerable and arbitrary redistribution of wealth and income that arises in inflationary as well as in deflationary environments.

In this regard, price stability is a vital element of fostering non-inflationary sustainable growth and of supporting employment and social cohesion, thus ultimately helping the Lisbon process to achieve its objectives. Moreover, as price stability helps to guide economic agents in their decisions to move production factors towards more efficient uses, it should help structural reforms to exploit their welfare-enhancing benefits. As an additional aspect, in an environment of stable prices, a decline in relative prices in some sectors, resulting from competition and productivity enhancing structural reforms, would become more visible, supporting acceptance of such reforms. Credibly maintaining stable prices is thus the most important contribution of monetary policy to the Lisbon process. Moreover, credible monetary policy aimed at price stability can contribute over time to improving the supply side of the economy.[3] With a more credible monetary policy, wage and price setters are less likely to index wages and prices to past inflation. This tends to reduce the persistence of wage and price inflation.

Empirical estimations show that even rather low rates of inflation can lead to welfare losses that might be larger than expected. A study for the United States, for example, indicates that a permanent increase in the inflation rate from 0 percent to 4 percent can lead to output losses ranging from 0.4 to 1.1 percent per year.[4] There are, however, several arguments that support basing a definition of price stability on positive but low inflation rates. The ECB has thus provided a quantitative definition of price stability, namely a year-on-year increase in the HICP for the euro area as a whole of below 2 percent to be maintained over the medium term. Looking back over the past six and a half years, despite significant exogenous shocks, the ECB's stability-oriented monetary policy following this definition has resulted in low and stable inflation. And it has ensured that medium and long-run inflation expectations have been well anchored. Monetary policy has thus delivered its necessary contribution to a stable macroeconomic environment supporting the implementation of structural reforms.

The ECB's and the ESCB's contribution to macroeconomic stability by promoting financial stability is perhaps less well-known but also important. This task is crucial as a well-developed and stable financial system improves the efficiency of financing decisions, favours a better allocation of investment in and among economies and thus supports economic

[3] See Bayoumi and Sgherri (2004a, 2004b).
[4] Dotsey, M. and P. Ireland (1996).

growth. This was also recognised by the Lisbon Council when it called for accelerating the completion of the internal market for financial services and to “exploit the potential of the euro” in achieving this aim. The tasks of the ESCB in this regard consist of systematically monitoring financial stability conditions in the euro area countries. This monitoring particularly aims at identifying potential sources of vulnerability in the financial system of the euro area and the EU and to assess its resilience to shocks.

To sum up, maintaining price stability is a vital contribution to foster non-inflationary sustainable growth and, together with financial stability, supports a stable macroeconomic environment, within which structural reforms can fully exploit their welfare enhancing effects. Maintaining price stability and promoting financial stability is thus the assistance that monetary policy can render to the Lisbon agenda’s reform efforts.

Conclusion

After six and a half years since the introduction of the euro, EMU has lived up to the more optimistic expectations. The euro area institutional framework, centred on the single monetary policy, has significantly contributed to the stability of the euro area economy.

However, recent years have also shown that a stability oriented macroeconomic framework alone cannot ensure the necessary degree of economic dynamism and flexibility. The lacklustre performance of productivity growth and the still unacceptably high unemployment in the euro area may undermine the perception of the benefits that EMU has brought to Europe. Paradoxically, EMU has been criticised as the cause of low growth and employment creation. It is now, more than before, of the utmost importance that the Lisbon process is revitalised and that the national governments implement well-designed policies that remedy the root causes of their particular problems in labour, product and financial markets.

First, on purely economic terms, European policymakers cannot be lenient towards the growth and employment performance of the past few years. The euro area must grow much faster and create many more jobs in order to ensure the living standard of the people. The severe economic and fiscal pressures, associated with demographic developments, make structural reforms even more urgent.

Second, the lack of structural reforms and the continuous sluggish performance of the euro area economy may risk, even in the immediate future, eroding the social cohesion that has been a fundamental force supporting the European integration process since the end of WWII. This process has recently entered into one of its most challenging and exciting phases, cumulating in a historic enlargement of the EU with ten countries in central and eastern Europe and the Mediterranean. The euro area, and the EU at large must be able to adapt the social and economic institutions in order to keep this process going without creating wasteful tensions.

Last, but not least, structural reforms will help the euro area to contribute to growth and stability of the world economy. More flexible labour, product and capital markets will increase the euro area’s growth potential and also improve its ability to adjust to external shocks. Higher potential growth will induce higher imports from other countries. In addition, higher potential growth will increase the relative real return of the capital invested in the euro area thus attracting a larger share of global savings. Hence, a more flexible euro area economy will help to re-equilibrate the current global imbalances that originate, at least in part, from the United States being the only fast growing country among the major developed world economies.[5]

The Lisbon agenda has been crucial for raising Europe’s attention to the need for further structural reforms. It is now time to actively pursue and implement those reforms. In the euro area, the single monetary policy will continue to support these efforts by maintaining price stability and by safeguarding financial stability.

[5] See Issing (2004a).

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Edward G. Krubasik
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Innovation, Entrepreneurship, Competitiveness – Agenda for Growth and Employment in Europe

The EU's growth strategy is the right agenda

The Lisbon Agenda is the right strategy for improving Europe's ability to grow, innovate and compete, in order to be successful in a globalised world. It would be wrong to abandon the EU's original goal of becoming the most dynamic and competitive knowledge-based region in the world because of delays in the implementation of the Lisbon Agenda. Global competition does not permit that. The two other big economic regions, Asia and America, are pursuing this goal without hesitation. We should accept the challenge of competition and implement the agenda, which is focussed on growth and jobs, even more consistently now. International investors also count on this largest homogenous market in the world with 450 million consumers, and we should make use of this economic strength. The European Monetary Union is considered a success in the entire world, supporting the integration of this market. Europe should take a leading position in global competition in the areas of innovation, entrepreneurship, infrastructure, excellence of education, skills, labour mobility and investment.

The global challenge for Europe

The need to act is obvious: There are clear signals that the European manufacturing industry is adapting to the strong growth in Asia, the United States and Eastern Europe and to the slow growth in our home countries, with corresponding effects on employment that is shifting to the growth regions. These changes were accelerated during the past decade by the fact that countries, which adopted the market economy only 15 years ago, are attracting enormous investment due to their big need for development: Eastern Europe, China, Russia and India. These countries must build their infrastructure and their industries. In the past, European companies have always participated in the build-up of growing world regions, establishing production and maintaining the competitiveness of mature technologies by shifting them to low-cost countries. The value-added lost could always be offset by the creation of new growth by introducing new technologies in the lead market Europe. Conclusion: The creation of value-added is moving to where growth is.

European companies and politicians must therefore accept the challenge of replacing the creation of value-added that is moving abroad. We can generate new growth and prosperity by innovation, by developing and above all by applying new technologies in Germany and Europe. Our motto must be to create lead markets for new technologies here first and later also to export these products and systems. Exports will only be possible for products and services that have their lead market here. We cannot rely on exports of mature products or on exports of technologies that are primarily used abroad. We must rely on new technology applications and create a new base for the prosperity of our countries here. Although the first installation of a magnetic levitation train in China should be regarded a considerable success for Europeans, it means at the same time that jobs and R&D will be relocated to China if we in Europe fail to catch up with applications quickly. Recognisable growth areas are: IT applications, intelligent traffic solutions, energy, health, education, safety, environmental protection, new technologies like sensorics, nanotechnology, optronics, new materials, molecular imaging, biotechnology, genetic engineering.

This means "yes" to more growth and innovation and at the same time "yes" to restructuring and cost reduction. Restructuring and growth measures must be complementary.

A significant increase in productivity and the simultaneous reduction of labour costs in Germany and Europe are necessary, but will only partially restore our international competitiveness. More flexible and longer annual and lifetime working times and a reduction of non-wage costs to keep the rise in labour costs moderate are useful approaches toward this end. We have to attract innovative talents and risk taking entrepreneurs and investors to Europe. For that we have to offer opportunities. High-Tech and innovation have made us successful for quite a long time, also the active engagement of intenational companies and the openness of our people and markets. But it is a mistake to limit the reform agenda to the labour market, pensions, and health costs. We have to add an explicit growth agenda to the cost reduction agenda.

Prime measures for growth and employment in Europe

1. The fastest and most cost-efficient road to growth is to create a political and market environment in our countries that generate entrepreneurship and attractive conditions for investment. We should insist that the EU Commission and the national governments implement all items on the growth and jobs agenda to improve the economic conditions. We need simpler and better regulation for our industry:
   - Less ideology and detail directives, clear priorities for business and market mechanisms
   - A reduction of administrative requirements, especially for SMEs and new companies (but also for all others)
   - A much simpler, more cost-effective and faster EU patent is indispensable as well as the EU-wide harmonisation of the patentability of computer-implemented inventions.
   - A reduction of business taxes in order to allow the buildup of a sufficient equity base for SMEs. Abolition of the inheritance tax if the firm is continued (corresponding to the British model).
   - Instead of issuing detail directives, the EU Commission and the EU Parliament should complete the free, integrated European internal market in the areas of infrastructure markets, financial services and all those markets that are not yet open to competition.
   - Livelier financial markets, including venture capital and private equity, would help start-ups and create new growth in company segments by making them available to strategically better suited new owners.

2. An unused short-term source of growth is the modernisation of our European infrastructure. Applying new technologies can create new lead markets, especially here in Europe. Many of these infrastructure projects will mobilise the entire value chain from small supplier to general contractor. Infrastructure and consumer markets are connected in many cases, i.e. in digital broadcasting and telematics.
   - Application of information technology (broadband, Internet, e-business, e-government, e-health, e-schools), fast digitalisation of radio and television, traffic telematics and railroad automation, upgrading our health infrastructure by full IT networking are essential.
   - We must refocus our public responsibilities: Less consumption, more investment, i.e. mobilising private investment and transferring the upgrading of the infrastructure to the private sector. Attractive investment conditions for public-private-partnerships will make for success, not the demonisation of private or foreign investors.

3. In the medium term, we can quickly develop close-to-application technology markets through the closest possible co-operation of industry and university research.
   - In order to advance quickly and support new technology markets like sensors, nanotechnology, mechatronics, MEMS, new materials, optical and optronic technologies, biotechnology, genetic engineering, fuel cells, and software technologies, private business needs closer co-operation with research institutions. Regional clusters should be fostered.
   - The German Electrical and Electronic Manufacturers' Association (ZVEI) has suggested to offer a research co-operation reward for our public R&D institutes: for each euro that an institute receives from industry, another 25 cents would be added by the institutional support fund. This will foster competition for private funds, industry will help technologies to market faster, and governmental project evaluation bureaucracy will be replaced by a simple mechanism.

4. Although only effective in the medium term, excellent education is one of our most important growth drivers or could become a growth handicap.
   - Today, education is already one of the biggest differences regarding unemployment: 3.9 per-

cent of university graduates, 5.4 percent of people with secondary education, 18 percent of those with less education.
- Excellence of educational institutions cannot be ordered by the government. But higher effectiveness in the education sector can be achieved by the competition for funds, the best professors and talented students.

5. The labour market also plays a key role in innovation: Innovation means to establish new businesses and product segments, and to phase out the old. The necessary restructuring can only work if our labour market becomes more flexible and labour becomes more mobile. Global cost competition, however, also means a reduction of labour costs wherever possible.
   - We must help businesses and individuals to change to new technologies, business sectors, locations, firms and countries. Laws and regulation, which cement old jobs and prevent restructuring, are counterproductive. Instead, restructuring and retraining must be promoted. We must inspire our employees to try new things, to change to new technologies and we must reward mobility.
   - The collective bargaining law needs greater differentiation in order to do justice to the high share of development, especially software development, services and project business in our value added.
   - The advantage of highly automated manufacturing must be supported by internationally competitive labour regulations that permit maximum utilisation of the German capital stock.

Decisive will be how we communicate to our people and employees that the restructuring phase will create new chances for all of them, that it is worthwhile to invest in the future today, and that the social safety net will not disappear.

- If a government invests more into the future, into universities and infrastructure, there will not be enough funds in the budget for all of today's social spending. Some tasks will have to be delegated to the individual and the private sector.
- People will have to be convinced that education and taking individual initiative are decisive for success, that everyone will get the chance for a better education and for improving life and prosperity on this basis.
- They will have to be convinced that it is worthwhile to seize the initiative and that new regulations will make it ever easier to determine one's future oneself; and that with more self-responsibility for social security, education, old-age provision, etc. we will be able to create this new future much faster.

We need this general call for cooperation, for creating a new and bigger pie, rather than fighting over consuming a shrinking old pie. In order to do that, we must show all concerned that we are acting responsibly for our country.

JÁNOS KÓKA
Minister of Economy and Transport,
Republic of Hungary

Ladies and gentlemen,

In his keynote address, Wim Kok made a very convincing statement. The Lisbon Agenda needs much greater commitment by the Member States and needs to be co-ordinated and enforced by the European Commission. These are the essential shortcomings that led to a halt of this demanding Agenda. In practice, Europe is no longer acting.

I would like to take this opportunity to ask how the accession countries and Hungary in particular can contribute to the success of the Lisbon Process. From my point of view, the current European situation is rather interesting. Traditional Western European democracies tend to be rather anxious about the fact that there are so many changes in their countries and that these changes tend to happen very fast. In Hungary the situation is quite the opposite. In Hungary, many people feel that change is too modest and comes too slowly. In Hungary, a generation is growing up that says: "We don't have time to wait for twenty, thirty years to close the gap between the Western and Eastern states. We want to gain momentum." At least in some areas our people not only want to be integrated, but want to surpass the rest of the European Union.

Responding to these ideas I would like to stress that we were already able to build a new economy and to create a new culture of entrepreneurship in Hungary within a period of approximately ten years. We were able to achieve such a high level of a market economy that other, more established European countries, were unable to reach in such a short period of time. Actually, we have never before seen a success story of this magnitude in Hungary, and, I would like to proudly add, this in a very short time span without bloodshed but in peace. However, Hungarians are still not satisfied. 70 of 100 citizens and companies believe that we are moving too slowly. They are not happy with the 3.5 percent growth rate, with the 6 to 7 percent unemployment rate, with the strongly flourishing stock market. They want to speed things up. Last year a total of 3.5 billion euros were invested in the country and the amount of FDI is expected to increase further this year. What is more important, these investments seem to be flowing increasingly into so-called intelligence sectors. But still some Hungarian companies are eager to move faster. Hungarians and all accession countries' citizens are hungry for success. They want to achieve something. For this they are willing to learn and acquire new skills, to work hard, to start new businesses and to be courageous when it comes to taking risks.

However, the question is, what do we Hungarians want to achieve and how shall we contribute to the EU Lisbon Process? I believe that we know exactly what we want. We want to increase our competitiveness. From 2007 onwards, accession countries will receive a lot of funds from the EU. We need to use them better than we have used them to date. Moreover, there is also an obligation towards the EU to use these funds appropriately.

I would like to draw your attention to the three most important projects with which we are planning to improve our competitiveness. Firstly, we would like to transform the Hungarian economy to a freer and more transparent economy. Secondly, we are trying to redefine the role of the state by attempting to leave at least some parts of state services to the market. In addition we would also like to make the remaining state services cheaper and more efficient. And thirdly, we will continue to dedicate massive investment efforts to infrastructure development. Surveys clearly show that there is a significant correlation between economic freedom and growth. In 2004, a total of 123 countries were ranked according to the level of economic freedom, and we jumped thirteen places on that ranking. Although we are very proud of this position, many people in Hungary consider the level of economic freedom as still too low.

Personally, I totally agree with the need for more economic freedom in order to increase competitiveness. However, besides these three main points, there are a number of other conditions that need to be established, if greater economic and entrepreneurial freedom is to be achieved. For instance, we need to conduct an intelligent tax reform, we need affordable loans and, in addition, a predictable, organized and transparent economic environment. Whether we like it or not, tax competition is one the more obvious instruments to broaden economic freedom and to improve the country's competitive advantage over other countries. Naturally, there are other aspects that might prove to be vital in attracting foreign investors. These include improving productivity, modernising the sphere of public administration, demolishing barriers, erasing red tape and so on. But currently tax reduction is fashionable. It has recently become very popular in Eastern Europe. By the way, it is not us but Ireland that is responsible for bringing this type of tax reduction into motion in 2001. The country opted to reduce general tax levels from 35 percent to 25 percent as well as its corporate tax rates from 40 percent to 24 percent. Estonia was the first European country to introduce a flat tax system, and Lithuania, Russia and Ukraine, the Czech Republic and Slovakia followed in Estonia's footsteps. And even against considerable political fire from the left, the German Chancellor Schröder still managed to reduce tax levels as well. Last but not least, talks about reducing tax rates have currently also begun in France. Tax reform and deregulation is a must for all of us and the Hungarian government is keen to introduce these reforms. We have also other challenges such as meeting the Maastricht Criteria in the light of the need to close the infrastructural gap between Hungary and the developed Western European nations.

Another thing I want to mention is that the future will bring a new large free trade zone called Europe. I believe, this process is unstoppable. Perhaps the process can be delayed to a certain extent, but I do not think it is possible to bring it to a complete halt. Goods and capital are already moving freely in this zone. The free flow of labour and services are yet to be achieved. There are strong forces, especially in the old Member States, to prevent this from happening, but I believe these walls are going to tumble sooner than many would expect. But still, I have the impression that something went wrong. The current situation, after the rejection of the constitution in France and the Netherlands, is in my view very similar to a large multinational company that bought a small and smart company with higher growth potential and greater flexibility. But rather than using the newly acquired company as a source of growth, it moves the new company to its own low level of performance. Are these countries really afraid of the newcomers? Fear seems to be the basic reason for the rejection of the constitution. Of course, we politicians have to blame ourselves as well. We Europeans were not smart enough to explain that the real challenges come from the United States and from Southern Asia and not from Eastern Europe. We can be a contributor to success and we can be a chance for all of the old EU states. Intensive business activity in Central and Eastern Europe, this is proven, can generate jobs in the western part of Europe. This was the case with several German and other investments in Hungary.

In this light, in order to increase competitiveness we need to redefine the role of the state. We need to make significant changes to reduce bureaucracy that is by far too large and too expensive. Here I am referring to the tendency of the states to squander funds and to exist in total disarray. This is not a Hungarian specialty, however. Most state bureaucracies tend to be just as excessive in their spending.

As we see, there is not a single problem for Hungarian society, there is not a single big secret. There is not a single key that can open the door to success, there is not a single reform that is missing, but there are rather many, many steps to take. 'There are a hundred steps' like an Hungarian proverb states. That is the reason why the Hungarian government is adopting a programme called the "Hundred Steps Programme", which tends to solve smaller and larger problems step by step from the health care and welfare systems to the labour market and education. Why doesn't the EU itself work out its own "One Hundred Steps Programme"?

Ladies and Gentlemen, for decades states have been occupied with the following question: How can we interfere with people's lives skilfully and effectively? Now, I think the right question today is, how can we remove ourselves, that is politicians and the state, from people's lives in a wise and fair manner? This is one of the most difficult questions politicians are facing today. All of Europe is looking for answers to this question. It seems, whenever we are making our new development plans, we need to listen more carefully to industry. We need to listen to the business people. We need to create appropriate macro-economic and micro-economic environments and then let the firms do their jobs, because only they are generally able to address the relevant questions about competitiveness. How did Ireland become a superpower or how was a company, specialising in paper and rubber boot production, able to end-up as today's Nokia? These questions need to be answered. In Hungary we now know that intelligent questions merit intelligent answers and both are needed. I would like to stop with an African proverb, to express my gratitude for your attention here today: "Every morning in Africa, a gazelle wakes up. It knows it must run faster than the fastest lion or it will be killed. Every morning, a lion wakes up. It knows it must outrun the slowest gazelle or it will starve to death. What does that mean? It doesn't matter whether you are a lion or a gazelle, when the sun comes up you better start running."

Thank you!

ARΕND OETKER
Managing Director,
Dr. Arend Oetker Holding GmbH & Co. KG, Berlin

In March 2005, the European Council confirmed the Commission's critical assessment of the current status of the Lisbon Strategy. From now on, Member States were required to commit themselves to national action plans.

Let me be frank: The conclusions of the March European Council concerning the Lisbon Strategy were disappointing. In spite of the rhetoric for growth, competitiveness and employment, the strategy is still not sufficiently focussed.

Clearly, Member States must engage in structural reforms. But the Commission must also refrain from new proposals that are a burden on companies. We welcome the focus on research and development. But once again, environmental goals, consumer protection and the social agenda gained ground.

The decision to make an early commitment on post-Kyoto emission targets is a case in point. We hope the Commission will refrain from action especially in the field of the environment that leads to disproportionate burdens on companies.

Of course, sustainability and social security are important objectives. But they can only be realised if the EU is economically successful and can assert itself in international competition. The credibility of the entire process stands or falls with the willingness of governments to make a more determined effort to tackle the causes of weak economic growth and high unemployment in the European Union.

The report of the High Level Group published in November 2004 ("Kok-Report") gives an accurate picture of the considerable deficits in the implementation of the Lisbon strategy.

The results so far are disappointing. Europe has not managed to catch up, especially with the United States. On the contrary, per capita GDP in most EU countries is markedly lower than the level in the U.S. In addition, productivity continues to improve more slowly than in the U.S. At the same time, new competitors have gained strength. The economic dynamism of China, India and other emerging countries in the region offers opportunities but also poses new requirements for structural changes in Europe.

What needs to happen now? I see five top priorities:

- The real challenge for policy-makers and businesses is an increase in European competitiveness. Growth and employment must be at the heart of the strategy. Competition – and not redistribution – must be the guiding principle for European policies. The European Union should now take another look at the original objectives of the Lisbon Strategy. Without better priority-setting with the aim of consistent economic renewal, the Union will fall farther behind in global competition.
- Innovation and knowledge must be at the top of the list of objectives for European policies and budget plans. Global competition between industrialised countries is competition in innovation to a great extent. Research and innovation are the keys to tackling economic, ecological and social problems. The share of forward-looking investments in public spending, including promotion of private investments in education, research and development, must be increased and the efficiency of innovation systems enhanced.
- The trend towards over-regulation at the European level must be reversed. European legislation needs an impact assessment to ensure that proper account is taken of the objective of the competitiveness of our companies. In recent years, the Commission, claiming to act under the Internal Market competence, has increased its output of legislative proposals which pursue other objectives, for instance in the area of environment or consumer protection. These measures have contributed to a worrying level of over-regulation, often to the detriment of industry. A topical example is the unwieldy legislative proposal for chemicals (REACH) which is currently under dis-

cussion in the institutions. In future, every legislative proposal in the European Union must be subjected to a proper impact assessment, designed to measure the consequences of the planned measures for the competitiveness of companies. More measures are needed to simplify legislation on the European Level.

- Market opening must be pushed forward, especially in network industries. Past liberalisation successes must be consolidated and completion of the Internal Market must be pursued with even greater resolve. Less state, less tax and more budget discipline are pre-requisites for stability and a reduced burden on companies and consumers.
- A stable European currency is not an obstacle to but a requirement for the success of the Lisbon Strategy.

The obligations associated with the Lisbon Strategy should not give governments an excuse for delaying their consolidation efforts. An internationally competitive interest rate and stable financial markets are a condition for more growth and employment in Europe.

In all Member States, the objectives of the Lisbon Strategy must be embedded in a solid and predictable economic policy that places greater value on competition and individual responsibility, and targets a reduction in the burden on companies.

As the largest economy in the EU, responsibility lies not least with Germany. While labour market reforms have been initiated, these must be followed by further steps with the aim of even more effective flexibility.

The Lisbon Master Plan won’t work without economic reforms in the EU Member States. The Strategy can still be saved, but only if governments and the European institutions set priorities. Competitive companies and more wealth creation in Europe are determinants of all the other objectives of the Lisbon Strategy.

All of us are disappointed about the failure of the referenda in France and the Netherlands. I am sure that, in the long run, there will be no chance to convince the people in Europe without economic success for more growth and more jobs.

ERNST SCHWANHOLD
President, Competence Centre Environment, Safety and Energy, BASF AG, Ludwigshafen; Former Minister of Economic Affairs, Energy and Transport, North-Rhine Westphalia*

Ladies and gentlemen,

thank you very much for the opportunity to contribute to the panel discussion today as a representative of the chemical industry. To reach the ambitious target of becoming the world's most dynamic and competitive economy by 2010, it is necessary for all the driving forces of the European economy to work together.

Nearly all the aspects of the Lisbon process have already been addressed so I won't stress them again.

As I am representing the chemical industry, I will touch on some issues of importance to us.

Growth is shifting to Asia

Should we be concerned about our industry's competitiveness in Europe?

Today, our industry faces intense competition from Asia in commodity products and from countries with a low-cost feedstock base. This has recently been confirmed by the European Chemical Industry Council's study "Horizon 2015: Perspectives for the European Chemical Industry". According to this 2004 study, Asia-Pacific countries, and China in particular, will be accounting for an increasing share of global chemicals production: The region's rate of industrial production growth exceeds much of that of the rest of the world. Another factor is the dynamic development on the electronics, textile, construction, leather and plastics markets, which are very important end-users of chemicals. The emerging countries are making great efforts to become global leaders in these sectors.

In view of this, we are calling for an international competitive framework within which industry can flourish. The European chemical industry needs to be able to compete on a level playing field, both inside and outside the EU.

Better Regulation is needed in Europe

For the chemical industry in Europe, one of the factors most relevant to its future competitiveness is the regulatory environment. Here I can say that the EU has already made progress regarding the number of regulations.

Particularly when it comes to social policy and environmental protection, Europe is "world class": In the past ten years more than 500 EU environmental legislative acts have been adopted. Companies often have the impression that they will never be able to keep up with the constant flow of new rules.

An excellent opportunity to achieve better regulation is the proposed new chemical policy REACH (Registration, Evaluation and Authorisation of CHemicals).

REACH, as it stands now, will have far-reaching implications for the European chemical industry and downstream users and their ability to innovate. EU chemical legislation is already the most stringent in the world. Regulatory compliance costs and bureaucracy will result in higher production costs.

In particular, downstream users are unlikely to be able to pass on higher production costs to their customers, as existing WTO rules allow imports of cheaper products and articles manufactured outside the EU. This uneven playing field reduces the competitiveness of European companies, and they are likely to be forced to relocate certain production lines outside the EU.

SME's will be hardest hit, especially the several thousand companies in the fine and specialty chemicals sector, a factor confirmed by a KPMG study in May 2005.

* Not present in person.

Stifling innovation by threatening to impose bureaucratic legislation such as REACH is not the way to inspire confidence in Europe's future business.

Sustainability is mandatory in decision making

Since the first industrial revolution, the chemical industry – especially in Europe – has always played a key role in economic and social development: It underpins a high standard of living and quality of life for an increasing number of people and is the key to sustainable development. In my opinion, European policy too often favours environmental and consumer protection at the expense of industrial policy! But sustainability, ladies and gentlemen, has three pillars; it is not just about ecology. Sustainability is also a matter of generating wealth and providing employment for the people in Europe. I would like to point out that I am not questioning the importance of environmental and consumer protection. These are matters everyone in our industry takes very seriously. We are committed to *Responsible Care* and *Sustainable Development.* But at the same time we are also aware that social cohesion and environmental ambitions are only possible in a growing economy.

I would like to end by summing up:

1. A new European industrial policy is needed, creating a favorable framework for the global competitiveness of the manufacturing industry.
2. We call for a new understanding of regulation: supporting companies in turning innovation into profitable products.
3. We also need European legislative processes, ensuring a proper balance between the three pillars of sustainability.

Thank you for your attention.

GÜNTHER BECKSTEIN
Bavarian State Minister of the Interior

Ladies and gentlemen,

I should like to welcome you warmly to this reception an behalf of the Bavarian State Government. The Bavarian Minister-President has already had the opportunity to address you today in his keynote speech.

Jean Monnet, one of the founding fathers of the European Community, once said in reference to the unification process in Europe:

"We are not unifying nations, but people."

This succinct statement summarises the aim of the EU concisely: The EU is there to serve the wellbeing of its citizens. It is not some theoretical construct, but rather a vital community of citizens. That is why the EU can only be filled with life if it is supported by its citizens, if people commit themselves to the EU and identify with it.

The new constitution would certainly help the EU in this matter. Its Charter of Fundamental Rights delineates a common set of values for all citizens of the EU. With this unifying bond, the EU could continue developing its identity, could find greater internal resolve, while at the same time maintaining the sovereignty of each individual nation.

And so the results of the referenda in France and Holland should indeed give us pause for thought. The ballots cast by these citizens are a serious warning shot. lt is not an accidental result. The votes show that the fundamental trust of many citizens in EU policies has been shaken. This cannot go on.

At the present time, the citizens have a conflicting rapport with the EU. We are quite willing to accept the advantages the EU offers. Surely everyone appreciates crossing EU borders without needing a passport and being subjected to complex formalities. Surely everyone appreciates the many years of peace and stability that we have in, and because of, the EU. All this seems almost natural, so we easily forget the difficult road that led to these advantages. They are the outcome of extraordinary work that went into the process of unification. Without the EU, we would probably not enjoy these benefits.

Yet the image of "Brussels" is anything but good. "Brussels" has the reputation of wastinq money and being obsessed with regulations. When it comes to the subject of "Europe", only a minimal percentage of people seem to show enthusiasm.

One of the EU's most important tasks now and in the future is to bolster the confidence of citizens in the EU.

- To do this, as many decisions as possible must be made as close to the citizens as possible. The principle of subsidiarity must be enacted consistently.
- Europe must concentrate on its core tasks. That is: common foreign, security and defense policies. We especially need closer cooperation amongst the Member States with regard to internal security.
- Europe also needs borders, and these are not in Asia or Africa. We must all realize that a great community like Europe can also break up due to excessive demands and overstretching.

An old wisdom of government states: "Non multa, sed multum" – one shouldn't do lots, but rather less, and that with great vigor and commitment.

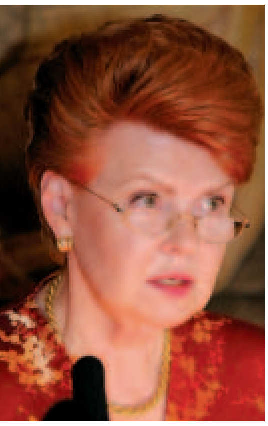
At its Spring Summit on the Lisbon process last year, the European Council did a great deal of work in this spirit. lt clearly reasserted the original core goals of the Lisbon process: sustainable growth and more employment through increased competitiveness. First and foremost, the individual countries are called to task here. They must undertake the necessary reforms.

When growth begins to increase again, when employment figures start rising, then so will the trust the citizens have in the EU. The emotional ties of each citizen to the EU will then be closer and stronger. That is exactly what the EU needs if it intends to remain on the path of success.

Ladies and gentlemen,

The birth of the EU is a lengthy and very dynamic process. This process must be evaluated and controlled at all times. Need for change must be identified as quickly as possible. The conference today is an important forum for this.

I hope that this meeting can generate ideas for the continuing Lisbon process and I wish you inspiring exchanges of ideas.



VAIRA VIĶE-FREIBERGA,
President of Latvia

Dr. Beckstein,
Professor Sinn,
Excellencies,
Ladies and gentlemen,

I am pleased and honoured to address this distinguished audience of academics and decision-makers at the Fourth Munich Economic Summit. Five years ago, in 2000, the leaders of the European Union met in Lisbon and launched an ambitious set of reforms, which were designed to turn the European Union into the most dynamic knowledge-based economy in the world by the year 2010. These reforms were designed to make the European Union capable of sustainable economic growth; to generate the conditions for more and better jobs, as well as greater social cohesion and increasing respect for the environment.

Now, in 2005, we are halfway through the time frame that was assigned for reaching these goals, but are we really halfway there in practice? Apparently, we are not. The implementation of reforms in many of the EU's member states has been rather tentative, and the overall results, at best, are mixed.

During these past five years, the EU has seen an unprecedented increase in its membership, and is set to expand even further during the coming years. Just over a month ago, on May 1st, Latvia and nine other European countries celebrated the first anniversary of their accession to the EU. Both politically and economically, this landmark event spelled the end of an historical injustice that had artificially split Europe into two opposing camps. For fifty long years, Europe had been divided between the free and the oppressed, between the haves and the have-nots. Now we truly have the chance to turn Europe into one of the most dynamic areas of economic activity in the world. In that sense the latest expansion of the EU is not just a happy ending to a complicated accession process, but a significant new beginning with unprecedented perspectives for continuing growth.

The EU's older Member States already enjoy the highest standards of living in the world and have consolidated a unique, participative social model. Their educational systems are highly advanced and their science base is well developed. They are home to dynamic and innovative companies with extraordinary competitive strengths. With the vast single market offered by an EU of 25 and with the euro as a single currency, there is every opportunity to consolidate the EU's economic stability and deepen its potential of economic integration.

The EU's tremendous success over the decades was one of the reasons that induced Latvia and nine other countries to join it last year. I will add that Latvia also plans to accede both to the euro zone and to the Schengen common visa space within the next three years.

However, we must now come to terms with the paradox that the EU's notable achievements have made Europeans the victims of their own success. The Union's older Member States have established generous social support systems that are extremely costly to maintain and that will be untenable in the long term, particularly if Europe continues to experience low – and in some cases, even negative population growth – and if the proportion of pensioners continues to increase as it is now doing.

Meanwhile, competition from outside of the Union is becoming increasingly fierce. The exceptionally high wages that trade unions have managed to obtain for workers in Western Europe are compelling manufacturers to transfer their production facilities to China, India, Brazil and other countries, where wages are much lower. Insufficiently flexible labour markets, along with a complex regulatory environment and taxes that are too high, are also driving companies out of the EU's older Member States.

The result is high unemployment, stifled economic growth, strained social support and health care systems, and rising dissatisfaction among the EU's citizens. Some countries, such as Italy, are now experiencing a full-scale recession. That is why the EU's Member States will have to display a greater degree of commitment in the implementation of a whole series of urgently needed reforms, and that is why the Lisbon Strategy is so important for us all.

I believe that this general sense of malaise and dissatisfaction is what also swayed many voters in France and in the Netherlands to reject the EU's new constitution. They feel that Europe is not delivering the goods it is supposed to. The EU has, in effect, reached a state of crisis, which as we all know, can be interpreted in two ways. One interpretation is "danger," while the other is "opportunity." I believe that we require a considered debate about what the EU is and what it really stands for, so that we can all move forward together and turn this crisis into an opportunity.

I also believe that the EU's ten new Member States can provide the stimulus that Europe needs to regain its competitive edge. During the past few years, my own country of Latvia has been experiencing one of the fastest GDP growth rates in the entire European Union. Last year's growth rate was 8.5 percent, and annual growth rates that exceed 7 percent are expected to continue during the next few years.

I am firmly convinced that in the medium term Latvia will be able to increase its per capita income level, which currently is still below 50 percent of the EU average. We are determined to catch up with our more developed neighbours, and to catch up fast. We are anxious to reach the stage where we become net contributors to the EU budget as quickly as possible.

Latvia is experiencing rapid growth because it believes in a free market under conditions of open competition. We believe in the free movement of goods, people and services; and we believe in free and flexible labour markets. The removal of obstacles to the free movement of labour would assure that the principle of equality is truly observed within the Union. We believe in lightening the administrative burden on companies and in creating a business-friendly environment for all enterprises, and most particularly for small and medium enterprises, which account for 99 percent of all firms and two-thirds of total employment in Europe.

What's more, services account for around 70 percent of value added in the European economy. Therefore it is in the EU's interest to conclude an agreement on a Service Directive that would facilitate the development of a dynamic service sector and promote an increase in European competitiveness.

Regarding the harmonisation of taxes, I have serious doubts about whether the imposition of a uniform company tax would add to the competitiveness of the Union. First of all, I don't believe that it would be fair to deprive the new Member States of an important stimulus for promoting their economic growth. Secondly, if we raise the tax, then Latvia and the EU as a whole will lose investments which will flow elsewhere. Does the EU need that, and would this raise our overall competitiveness? Let us talk about tax harmonisation once all the Member States of the EU are equally strong and developed, and when the per capita income is no longer so different between the richer and the poorer EU nations.

Excellencies,
Ladies and gentlemen,

One of our common goals, and that of the Lisbon Strategy, is sustainable development. It is also to ensure continued growth, and to provide businesses with the conditions to create more and better jobs. It is to create a knowledge society. In order to do this, we must ensure that Europe is a more attractive place to invest and work in. Clearly, such a strategy cannot be based either on natural resources or on cheap labour.

Instead, Europe must develop its knowledge and innovation-based activities. Therefore it is essential to increase and effectively allocate investment into research and development (R&D), both by the public sector and by private business. In order to ensure the production of high value-added products, Europe must also facilitate innovation and the uptake of new technologies. It must invest in education to increase Europeans' knowledge and skills. During the past few years, the productivity of Europe's competitors has grown faster and they have invested more in R & D than we have.

Two other prerequisites for a competitive EU are modern transport and energy infrastructures. These would not only foster the free movement of goods, services and labour. They would also help to reduce existing disparities among the EU Member States. Since no Member State alone possesses the capacity to launch large-scale infrastructure projects, we must reach an agreement on the EU financial perspective and ensure adequate funding for the EU's cohesion policies.

I believe that several other things are also required if we are to create a genuine knowledge society and to raise Europe's global competitiveness. One is the assignment of a pre-determined minimum of GDP by each of Europe's national governments to science and research, along with the pooling of the resources of the EU's Member States for research projects on a broader, European scale. Latvia has recently adopted a law that foresees an annual increase in budget financing for science in Latvia. This is an important step for us and a contribution to the overall development of research in Europe.

Another fundamental pillar of a knowledge society is education. Educational programs and training are necessary to provide skilled professionals who can meet the labour market's needs. Currently we do not invest enough in education. Educational budgets represent around 2 percent of GDP in the EU, versus 3 percent in the U.S. Furthermore, many researchers trained in Europe then choose to work in the U.S. The brain drain of Europe thus remains a very important issue.

Excellencies,
Ladies and gentlemen,

We, the people of Europe, cannot be complacent. Europe's Lisbon Strategy requires immediate and concerted action. Our activities will require more focus, with an emphasis on productivity and on employment. Furthermore, the Lisbon Strategy will have to be simplified. Currently the reporting system for 25 Member States requires no fewer than 300 annual reports. Nobody can possibly read all of them, nor is this of real help in ensuring better compliance with the Lisbon agenda.

And finally, we must mobilise public support for change. We failed to mobilise sufficient support for Europe's constitution among voters in France and the Netherlands, partly because this important document was widely perceived to be long-winded and confusing, partly because it was perceived to have been drawn up by unelected bureaucrats who cater to big corporations rather than to the average citizen, and for numerous other reasons.

However, I am convinced that the people of France and of the Netherlands, and of Europe as a whole, have not rejected the European ideals that form the basis of the European Union. They have not rejected pluralism, tolerance, fairness, solidarity, non-discrimination and gender equality. They have not rejected the vision of sustainable development, balanced economic growth, price stability, full employment and respect for the environment, which was cited in the European Constitution, and which forms part of the Lisbon Strategy. They have not rejected freedom, democracy, the respect for human rights and the rule of law, as well as fair and free market competition.

It is time to forge a new consensus, as difficult as this may be, and to make the EU closer and more understandable to its citizens. For the first time in their history, Europeans have acquired the opportunity to create a united continent, not on the basis of force and armed conquest, as during centuries past, but of their own free will. I am confident that with the required effort and commitment, we shall all be up to this important task.

I will go even further in saying that the EU must not be a closed and exclusive club, and that it must remain open to all countries in Europe that abide by, and are committed to, the democratic values that we all share. I believe that the EU should spare no effort in furthering its European Neighbourhood Policy. In so doing, the EU will support the strengthening of civil societies, independent media, NGOs and human rights defenders in such neighbouring countries as Ukraine, Georgia, and Belarus, which, sadly, remains the last authoritarian dictatorship in Europe. I also believe that we must maintain and strengthen our transatlantic partnership with the United States, regardless of any disputes that may arise over trade, the environment, or military intervention in third countries. This is in our common interests, particularly if we wish to successfully deal with such urgent issues as international terrorism, organised crime, the spread of weapons of mass destruction and the diffusion of regional conflicts. We need to actively promote the virtues of freedom, democracy, the rule of law and good governance worldwide and this is why I believe that this coming fall, when the United Nations meets during its September session, we all need to push forward with the UN reforms that have been proposed by Mr. Kofi Annan, the Secretary General of the United Nations. That institution was founded 60 years ago, after the Second World War, in a world that was entirely different from the world we are living in now. Now is the moment of opportunity, when it is possible to go forth with these reforms, and

I do hope that we will be able to reach a consensus on the majority of those points that have been put forth by the Secretary General, even if we all realise that the reform of the Security Council is going to be very hard indeed.

The values that have been mentioned and that seem as clichés to us who live them daily – these values are still but a dream in a great many countries. This is why we must never forget how precious they are, how important they are, and how dearly they have been bought by all the wars and conflicts and suffering in the history of various countries of Europe.

We know what our values are. They have been developing over the centuries and over several millennia. We have taken the best out of our history, we have put it together brick by brick, like a medieval cathedral that has been erected. It is the cathedral of our ideas, hopes and ideals. I hope that we are up to ensuring that it does not crack, that it remains standing, that we continue to appreciate what it means, that we maintain it in such a way that it is not taken for granted, and that the light that we enjoy is spread further and further into those lands where it is still a dream. I hope that our dream will remain a reality, and that the people of Europe can be a beacon of hope for those in many other lands.

Thank you.

Panel 2

National and European Champions – Burden or Blessing?

Paul Seabright
University of Toulouse

Introduction

The recent commercial and developmental success of Airbus Industrie has led many observers (particularly but not only in France) to suggest that the time has come to apply the Airbus model of industrial policy more widely across industries that could be important for the future economic success of the European Union. Could the lessons of Airbus be fruitfully applied in other sectors, creating champions that might be not only national but, in appropriate cases, pan-European? Does the Airbus case show that the pendulum of received opinion has swung too far in recent years, and that active industrial policy has more to be said for it than skeptics have acknowledged? Or might future European projects turn out to be more like Concorde than like Airbus? Or like Bull, Credit Lyonnais, or MG Rover? In other words, what makes the difference between successful industrial policy and prestige projects that appeal to politicians but are quite unable to pay their way?

In this short contribution I propose to do two things. First, I assess the Airbus experience and ask whether it does indeed constitute an example that could usefully be followed by European leaders seeking to apply industrial policy. I conclude that Airbus has been a rather special case whose applicability to other projects and sectors is fairly limited. Secondly, I ask more broadly what we have learned in the last couple of decades about how markets and political processes differ in their ability to select and promote innovative and productive investment projects. Surprisingly, perhaps, for the skeptics, I conclude that there is no evidence that politicians are any less good than private markets at "picking winners". But markets appear to be *much* better than politicians at terminating projects that turn out to be unsuccessful. And the real discovery of recent years, about which we now know much more thanks to the availability of high quality panel data on firms, is that terminating failed projects is a very important part of the process of productivity growth, though more so in some sectors than in others.

The Airbus experience

I turn first to the Airbus experience. Has this been worth it? Reliable accounting and other economic data to answer this rigorously are unfortunately not available. Nevertheless, in a simulation study I published ten years ago with Damien Neven [14] we estimated that Airbus was likely to make a comfortable rate of return on the public investments that had been made to launch it. This study was not contested at the time, and events since then appear to have confirmed the assessment. However, we also estimated that these benefits would come mostly at the expense of forgone profits for Boeing; gains to consumers, though positive, would be fairly modest. The reason for this assessment was that gains from competition would be offset by lost economies of scale, and the weakening and/or exit of McDonnell-Douglas. Though there is some controversy about whether McDonnell-Douglas could have survived in the industry even without the advent of Airbus, it seems unlikely that the US Justice Department would have accepted its exit through takeover by Boeing had there been no Airbus to provide countervailing competition.

It is hard not to conclude, therefore, that even if this kind of "subsidy war" makes sense from the perspective of Europe, it is collectively self-defeating when applied at a world level. This conclusion can only be reinforced by the consideration that Airbus has many sub-contractors in the United States and Boeing has many in Europe, so that in terms of value-added there may be much less to choose between the projects from the perspective of the European economy than its political sponsors may realize. Competition policy to restrict subsidies to industry, whether under the EU's state aid legislation or under the subsidy rules at the WTO, is based on the idea that such subsidy wars may be collectively self-defeating, and the Airbus experience provides no reason to ignore this very sensible presumption.

Even ignoring such adverse international spillovers, we may well ask whether it is just luck that Airbus has not had the fate of Concorde. (It may even be premature to conclude that Airbus will avoid the fate of Concorde in the future – recent Franco-German wrangling over the nationality of the chief executive does not inspire confidence in the corporate governance of the company). It is true that Concorde had some bad luck (notably in facing regulatory obstacles in the United States). But the aircraft was also poorly designed for passenger comfort, and the project as a whole was much more engineer-driven than customer-driven. Airbus certainly seems to have learned from these particular mistakes, but its success is not just a matter of inspired innovation. The aerospace sector has some particular characteristics (see in particular the work of John Sutton [17]) that make it a suitable setting for publicly-sponsored innovative projects, and which by the same token suggest caution before launching such projects in other sectors where these characteristics do not occur.

What are these particular characteristics of aerospace? The three crucial technological characteristics are:

- High fixed costs of production
- Variable costs of production that fall significantly with scale
- The products are somewhat less differentiated than in other comparably high-technology sectors such as motor vehicles and precision instruments.

The consequence of these characteristics is that successful market entry into aerospace requires principally focus and commitment, rather than such virtues as flexibility, responsiveness to customer preferences throughout the development process, and openness to the unexpected. In this respect, as Sutton points out, it is quite different from precision instruments (the fact that these are both "hi-tech" sectors is neither here nor there). Indeed, the reason why Airbus has been able to meet customer requirements reasonably effectively is in large part that customer requirements can be summed up rather more simply than in many other industries. Designing new aircraft is largely a matter of throwing money at the challenge of carrying a given number of passengers for a given distance at reasonable speed and safety and at minimum fuel cost. Paradoxically, this is one of those industries where an open cheque-book (what economists in their jargon call a "soft budget constraint") may actually be a recipe for success. One sign of this is that successful aerospace firms tend to be large and rather stable over time. In this they are quite unlike firms in many other sectors, such as cars, biotechnology, consumer goods, most kinds of software, precision instruments, venture capital and computer hardware. It is worth recalling that the US motor vehicle industry had 300 independent manufacturers in the year 1900, 297 of which did not survive long into the twentieth century. Overall, few industries outside aerospace look as though they would be suited to the Airbus model.

Picking winners: politicians versus markets

What do we know about the biases of politicians (and more broadly, of public officials) in selecting investment projects for public support? Some characteristics of such projects are reasonably obvious: they tend to be large, they tend to produce products that are highly visible in the press and media (affording many photo-opportunities for the politicians concerned), and they tend to be comparatively insulated from competition – both because this makes them less risky to finance and because it avoids awkward questions about their comparative performance with similar projects that do not receive public support. In addition, such projects tend to face a number of other less obvious biases, which recent studies have helped to document:

- One common bias is that politicians and public officials tend to favour projects in relatively high-technology sectors, whether or not these are suitable for the comparative advantage of the location in question. A recent study by Midelfart-Knarvik and Overman [12] showed that both national state aids and EU regional aid often failed to attract targeted industries to a significant degree because they did not take comparative advantage into account (like whether there was enough skilled labour in the workforce). They therefore often failed to benefit from agglomeration economies.
- A second bias is that politicians frequently ignore the impact of one project on others. A recent study by Algan et.al. [2] showed that such impacts can be large – public employment can reduce pri-

vate employment through general equilibrium effects. The last biennial report of the German Monopolkommission [13] also discusses these harmful inter-project effects at some length. And the study by Midelfart-Knarvik and Overman just referred to suggests one route by which this could occur – subsidized projects could bid up the price of a scarce resource like skilled labour, making it less available to other firms.

Does this mean that private firms do not have equivalent biases? Not at all! Recent years have seen no shortage of examples in which the executives of private firms have displayed all the vanity, short-sightedness and obsession with technology and visibility that can characterize public projects at their worst: names such as Vivendi Universal, Enron and WorldCom spring irresistibly to mind. In fact, it would be hard to show convincingly that executives of private firms are any better than public officials in their selections of projects to support (they may be, but there is no rigorous evidence that I know of, and anecdotal evidence can be used to show anything in this domain).

Nevertheless, there remain two important respects in which public and private sponsorship of industrial projects differ systematically from each other:

- The first is that private projects can come from anywhere – not necessarily the politically well-connected, nor even necessarily from firms that already exist. Recent evidence has shown that this openness to new sources of innovation has been crucial to growth in Western economies in recent decades. For instance, Hobijn and Jovanovic [11] have shown that the US stock market recovery of the 1980s and 1990s was driven almost entirely by new firms, and that incumbent firms of the early 1970s that did not take over or merge with new firms had still not recovered their market value relative to US GDP even by the end of the 1990s. If investment projects had had to depend significantly on public support for their funding, who can doubt that incumbents would have got their hands on a very substantial proportion of that support?
- The second is that politicians and private markets typically react very differently when projects fail – politicians, responding to well-understood electoral and lobbying pressures, are reluctant to close projects down unless their failure becomes spectacular. Of course, private financiers can sometimes be too hasty in withdrawing their support from projects that do not yield profits early enough, and the fact that public projects are hard to close down is sometimes a strength (as, arguably, in an aerospace firm like Airbus seeking to establish a credible market entry). But recent research has shown that allowing projects to fail and disappear is a very important part of innovation and productivity growth in a modern industrial economy.

Indeed, work by a number of authors using panel data on individual firms (usually at the plant rather than the firm level) has established the major role that selection plays in productivity growth. For instance, an important study by Disney, Haskel and Heden [10] showed that:

- Half the growth of labour productivity in UK manufacturing 1980-92 was *not* due to internal growth of plants. It was due instead to selection (the replacement of low-productivity plants by high-productivity plants)
- 80 to 90 percent of *total* factor productivity growth was due to selection
- Much of the selection effect was due to multi-plant firms opening good plants and closing bad ones. This suggests that multi-plant firms operate an internal capital market that can be – and on average, is – somewhat more efficient than external capital markets.
- However, the ability of multi-plant firm to do this depended on their facing significant competitive pressure. Without this they tended to stagnate.

In some sense, therefore, we can say that the process of productivity growth is more Darwinian and less Lamarckian than previous research (lacking detailed panel data) had supposed.

A number of other studies can be cited concerning the conditions under which productivity growth is fostered in a modern economy:

- First, several studies have established the importance of some degree of competition (what has been termed "a minimum of rivalry") as an incentive for productivity growth: [3], [4], [6], [7], [15], [16].
- Secondly, and distinctly, there needs to be a relatively stable competitive environment in which productive projects have a significantly higher probability of survival than unproductive ones. In a study I conducted with Wendy Carlin and Jonathan Haskel [8] on firm restructuring in tran-

sition economies, we found that for many inefficient firms in the former Soviet Union, the problem was not that they were resistant to change. It was that change didn't help them – the environment was too turbulent. Firms doing a lot of restructuring were no better off, on average, than firms doing very little. By contrast, in stable environments there *is* a relation between the degree of change and the growth of productivity. This encourages firms to gamble on innovation and change. But such stable environments cannot be provided by firms themselves – their provision is a central responsibility of government.

- Thirdly, there is an important role for the state in supplying high-quality public goods such as infrastructure, education and public support for innovation: [5], [9]. There is very clear evidence that foreign direct investment is attracted not just by low wages (otherwise sub-Saharan Africa would be the magnet for FDI), but more importantly by education and infrastructure, as the recent success of the Irish economy has made clear. There is no reason to think that domestic productivity growth depends any less on these conditions.

Conclusions

My main conclusions are as follows. In modern economies growth comes mainly from innovation. Innovation is a gamble – it will often fail. But that is a normal part of the process of economic change. Indeed, an economic climate that fosters innovation is one that allows for failure. But this needs to take place in an overall climate of stability, so that success or failure is a good discriminator of the fundamental quality of investment projects.

Most actual or prospective national (or indeed European) champions do not fit this description. On the contrary, most of them are or would be "too big to fail" – perhaps "too prestigious to fail". Private firms, on the contrary, are not usually too big to fail, sometimes to the surprise and discomfiture of their executives (banks are something of a special case, due to considerations of systemic risk). Indeed many private companies, though very large indeed, have had to restructure and adapt radically to their environment in order to avoid failure. IBM is a case in point – since the sale of its last assembly plant to a Chinese buyer in 2004, it no longer even manufacturers computers – can we imagine an Airbus that no longer made aircraft?

It is hard to escape the conclusion that if the computer industry had been dominated in the 1970s by national champions (as opposed to containing a few national champions in a landscape dominated by private firms), we would all still be using mainframes.

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DR. WOLFGANG ZIEBART
President and Chief Executive Officer,
Infineon Technologies AG, Munich

Good morning Ladies and Gentlemen,

When we talk about national champions in Europe, I am reminded of Airbus Industries, competing so successfully with Boeing. A question that then comes to mind is whether the case of Airbus could be a precedent for other capital-intensive industries such as semiconductors, for example. We have already seen a major merger in Europe with one Italian and one French semiconductor company merging into STMicroelectronics, which is now the fifth- or sixth-largest semiconductor manufacturer in the world. So the question is whether a merger on an even greater scale is desirable, or necessary. Do we need a European champion in the semiconductor industry?

Two Main Issues

I have two main views on the question of European or national champions. In my opinion, we do not need national or European champions in the semiconductor industry. What we need is a world champion here in Europe. By that, I mean a semiconductor enterprise that is based in Europe and able to compete internationally on worldwide markets.

To achieve that goal--the second issue I would like to address--we need important lead markets here in Europe. Furthermore, we need a favourable environment for the semiconductor industry in Europe, including innovative high-tech clusters, infrastructure, and a competitive tax system.

To give you the full picture, let me first talk about the characteristics of the semiconductor industry. Then I would like to give you some background on our decision-making processes regarding future investments. Finally, I would share some recommendations with you on what can be done for a lasting and successful development of the European semiconductor industry.

Characteristics of the semiconductor industry

First of all, I think that the semiconductor industry is by far the most globalised industry. Here's a good example: A wafer weights 100g and costs about $1,000. If you ship this product around the world ten times, that would only add 1 percent to its costs. In addition, there are no duties on semiconductors, since all members of the WTO have agreed on avoiding duties and tariffs on these products. This means that basically all production sites in the world compete with each other. We have world-wide competition and everybody is competing with each other, but without having any particular advantage. This is in contrast to heavy-goods producers, which might have a local advantage if they were close to their main markets, and so on. In our case, we do not have those kinds of advantages. In my industry, we sometimes even have some of the production steps done on one continent, while other processes such as back-end operations including testing and packaging, are done somewhere else. During a manufacturing process consisting of 400 steps, our products are shipped around the world.

In Europe, the semiconductor industry is the manufacturing branch that requires the most research and development, with more than 15 percent of sales spent on R&D. The semiconductor industry is an enabling industry of strategic importance for Europe. Semiconductors provide the foundation for many other industries in Europe; they are the driving forces for technical progress, for example in the car industry and in industrial electronics. Semiconductor progress is a prerequisite for progress in many other industries, as semiconductors are tied to specific applications. When you think about electronics, which certainly have made a lot of progress, you have to dig a little bit deeper to see that it is not the electronics that made the progress. Rather, it was the semiconductors with new designs, greater capacities, and new efficiencies that made progress, facilitating the introduction of totally different and new devices. Both the semiconductor industry and the application industry are closely linked.

This linkage has two implications. First, many industry branches need a strong semiconductor industry. Every industry that depends on semiconductors needs to have direct access to the semiconductor industry.

Second, the semiconductor industry only thrives if it has close links to applications. I think it is almost impossible to succeed in a business activity if your lead market is somewhere else, for example in Asia, if you are trying to run your business from Europe.

To sum up the characteristics of the semiconductor industry, it is on the one hand very internationalized and globalised, but on the other hand strongly linked to the main drivers and the lead markets for certain applications.

Aspects of future decision making

Now, what determines the decision by a semiconductor manufacturer as to where to invest in the future, be it in terms of products and in terms of production sites? These questions relate to production and to research and development as well, for central research and for design or engineering centers.

Recently we have been blamed for moving production facilities to Asia, and we have even been insulted for not being loyal to our home location. But that is beside the point.

Our decision is mainly driven by three factors. Probably the most important one is the location of the lead markets. This is essential for us when it comes to deciding where to build our application engineering or the center of a certain activity. For instance, when you realize that mobile phone production is moving to Asia, then either you also move the center of your mobile phone activity to Asia, or sooner or later you will be driven out of this market. For instance, it is also impossible to get a foothold in consumer electronics without being in Japan. Japan is the lead market. So either you have the center of your activity in Japan, or it is very unlikely that you will be successful in the market for consumer electronics.

The second most important factor is infrastructure. Where are the best people, the universities, the suppliers and so on? I am convinced that the EU still has a very favourable environment, but other countries and regions are rapidly catching up, especially with regard to education. For instance, we have quite close ties to one of the four universities in Xian, Western China. This university pours out as many electronic engineers as Germany as a whole. So here, I think, even if the current situation in China might still be inferior, China is catching up very fast.

The third factor is costs. We often hear that due to the huge investment to be made in semiconductor production with depreciation of about 50 percent, labour costs do not play an important role in decision making. This is not correct. In Europe, labour costs in the semiconductor industry are roughly between 15 and 30 percent of the total price of products. But if you go to Asia, labour costs amount to something like 5 percent. This gives you a considerable difference in margin. Since we are fighting for 1 to 2 percent in return on sales, having an advantage of 10 or 20 percentage points in labour costs cannot be overlooked by any means. Interestingly, we have a severe problem of labour costs even in this high-tech area, where everybody would think investment and automation dominate the game.

Recommendations for the future of the European semiconductor industry

What should and could be done for a lasting and successful development of the European semiconductor industry? Here are two major recommendations that I think we should put on the agenda.

First, let us create lead markets. For example, we have done very well in GSM, i.e. mobile communication here in Europe. Europe was the first mass market for mobile communication, and actually took the lead in mobile phones, GSM and digital mobile phones. This lead then created a lot of follow-up industries such as mobile hand sets and wireless infrastructure, with some services and service providers expanding later in other areas of the world. For some years, this was a promising development. Unfortunately, we lost ground here. There is currently a tendency for this market to move to Asia, along with the upcoming applications industry. When Europeans go to Korea, for instance, and see what the Koreans can use their mobile phones for, Europeans are often amazed. People in Korea are paying for subway tickets with mobile phones, or reading bar codes with the cameras in their phones. A lot of applications that are totally new for us are already quite common in Korea.

As a semiconductor manufacturer, we have no choice. Either we are where these applications come up first, or we have no chance of staying in this particular market in the future.

So we must create lead markets. By this I mean that we need to be open to new technologies, new applications, and new business models. We need to seize the opportunities when they come up.

I would just like to mention some of these opportunities such as Radio Frequency IDentification (RFID). This will be a very big market in the future, and instead of discussing possible hazards and problems, we should move forward and make it possible for Europe to take over the lead in this technology.

Another opportunity is health cards, which are being introduced in India. Unless we move quickly, we will again miss this opportunity. It is very important for us to consider technological progress as a chance for success, not as a threat. If customers here are not prepared to adapt to innovations fast enough, if we are conservative and hesitant, then we will not have any lead markets in Europe.

Second, we need high-tech clusters, with a combination of companies, universities, and related businesses that complement each other to form an area of competence. We have Silicon Valley in the U.S. as an example, but we had to learn that this is very hard to copy. Even the U.S. has not been able to copy Silicon Valley to another location within the United States.

I think we have done very well in forming a semiconductor cluster in Dresden/Germany, with the strong support of the government, local authorities, and especially the local politicians. Today, we have a major semiconductor industry in Dresden, where supporting industry suppliers and universities and so on are available. This is a very good example – but we need many, many more of them.

Conclusion

To sum up, the past has shown that Europe has a proven track record of bringing forward a number of world-class companies in different industries, in different markets, and of different sizes. When we talk about champions, we shouldn't just focus on Europe, or a single nation, we should focus on the entire world, and on being the home for a world champion in semiconductors. A world champion here in Europe would be a viable, innovative, and competitive semiconductor enterprise with entry to, and large market shares in the most important lead markets in the world. A world champion would combine the competitive and comparative advantages of different sites all over the world.

Such a world champion in Europe needs an encouraging and stimulating framework for doing high-tech business here. We must provide a favourable environment in Europe to create European-based world champions.

Thank you.

LARS PETTERSSON
President and Chief Executive Officer,
AB Sandvik, Sandviken

Good morning, Ladies and Gentlemen,

I would like to connect our current discussion with the book "In Search of Excellence" which was written about 20 years ago by Tom Peters. That book dealt with the issues that were confronting the US economy at the time. In many ways, these are the issues Europe is confronted with today. The issue today of national champions is in my view an issue of global champions, since national boundaries have lost their significance. For a national champion to become a global champion, is of course a great opportunity, but demands that we have an understanding of the global market and are at the same time able to operate on a local level. What we have learned from this concept is that a global champion or a national champion drives growth and competence in their respective region. We have also learned that, with a few exceptions, the situation does not diminish over time, but it rather self-propels and accelerates, if it's not overregulated by governments. We have also learned that it inspires suppliers, it inspires competition, it inspires education and it inspires the overall society surrounding them to develop positively. So the question for Europe is, how do we continue to develop the centres of excellence that we already have? And how do we make sure that we develop new ones, because, as I will show later on, that is also possible.

If we look at the centres of excellence that exist today, we will find that they are rather much the same as those that were identified by Peters in 1988. Take, for example, the high-performance car industry in the southern part of Germany. If we look at the stock prices, at the growth performance, at the profitability of these companies, they far outpace the companies that have tried to produce conventional cars for the general population. No one, I think, would disagree with the fact that the discrepancy between the producers of high performance cars and the producers of normal cars has rather accelerated than diminished over the years. This has happened because there is strong local competition between these companies in southern Germany. But also because there is a consumer base and a regulatory system that has permitted this development to take place. Another example is the telecom industry in the Nordic countries, which was not one of Peter's identified centres of excellence. The telecom industry is something that actually came out of the co-operation between the government of Sweden and the national air force to create a world-class communication and fire control system for the Swedish air force. This was the foundation of the GSM system which the Finnish Nokia Company very quickly picked up, and then it stopped to produce rubber boots, tyres and television sets. And again, these two small countries in the northern part of Europe still hold a very strong position, both on the systems side and through Nokia of course on the mobile phone side. The same holds true for the Toyota cities, which we already had around that time as centres of excellence for small cars. They again have created a very strong supply base in that part of the world, and have driven the idea of how to manufacture in a competitive world to an excellence that all of us in the western world are trying to copy and to implement in our own cultures and environments. And finally there is Silicon Valley – it existed then, it exists today. The firms there have transformed, they have changed, but they still operate as a formidable force in the area of software and hardware development.

So the lessons we can learn from this is that we should build on existing strengths. It is much easier and much less risky. But at the same time we have also learned that we can develop new things. We have learned that by focussing, by being prepared to take risks, we can develop new centres of excellence. I think that there is currently a chance in medical technology, which is one of the fastest growing areas in the world today. It will benefit tremendously from the development we are seeing in India, in China and in eastern Europe as well. Medical technology is an area where European industry has already shown that it has an ability to create centres of excellence. We have to build on this in the future.

We then need to discuss the issue of state support. I have to say that, as an industrialist, my general attitude towards this is very negative. But there are exceptions like Airbus. I think that Paul Seabright made a very good argument in his introduction, why Airbus it is an exception, why state support worked in this specific area and why it could work in certain other areas. But in the long run it must also be recognised that it inherently inhibits creativity, productivity, and further growth due to the fact that it also reduces the competitive pressure that is essential for further development. Only competitive pressure generates value and a high standard of living for the global population. The unclear financial gain in state supported industries will prohibit other new actors from stepping in and creating further competition. And in the end it drives a negative spiral: Less competitiveness leads to further protectionism and subsidies which can only result in higher costs to the consumers, a higher tax burden for the population and in the end a lower market potential for the products. So it is my conviction that in the long run this does not result in winners.

So if we look at Europe as a team, what are the things we can build on? First of all I think it is important to remember that companies have shown that we can work, not only on a European, but also on a global basis as one team. But there are also a number of issues which need to be resolved. First of all education and research has already been described yesterday as a cornerstone and a prerequisite for success. However, sometimes I think that we should caution ourselves against just looking upon this in quantitative terms. I think the quality of both, our education and research, is what is going to make the difference. There are no silver medals. Only world class education, only world class research matters and will yield the desired results in the global arena. Adding to what was said here earlier about the education of electronics engineers, I think that we should all recognise that in China alone over 140,000 Masters of Science engineers are educated every year. In numbers, India is closing up and will actually surpass China in 2015. The challenge is formidable, but there are also opportunities. For us in Europe, the issue can become very painful and a challenge for our education systems. We may have to question some of our sacred cows of the past. We had tremendous success and a good history of independent research and education in Europe and a favourable business and political environment. Going forward I think we need to question this model. We need a discussion about what part of it should be independent and how we should interact with business in the future to make sure that the investment that our taxpayers and students are making in education and research pays off, for the individuals, for the populations and for our nations. We need to strengthen the connection between research and business. This does not mean that business will dictate what to do and where to do it, but the connection should make sure that research is linked to business, that these spheres interact, and that active frames of opportunities and networks are created that benefit Europe as a whole in the long term. We have to strengthen the manufacturing industry through research. This case I make differs from those who claim that Europe as a manufacturing base has come to an end. Certainly, for many products the game is over. We must recognise that manufacturing with high labour content can only be made in areas of the world where wages are significantly lower. And we should not forget that we are not only dealing with direct labour costs, such as wages. We are also dealing with taxation, we are dealing with environmental costs, we are dealing with transportation costs and many other costs that the governments are levying on business. We need to strengthen the manufacturing industry, because in the end the service economy cannot exist without it. With no manufacturing production there is no product related service industry.

An issue, which we are also forced to recognise, is that the national boundaries are becoming less significant. Language barriers are diminishing and we have to recognise that one of the key issues for future development is going to be the capability to communicate and interact with each other. Much has been said about how we build networks from the technical side. Less has been said about teaching languages. Like it or not, our European mother tongue is and will continue to be English. It does not mean that we are giving up French, Swedish or Spanish, but young people and our employees in companies, in the governments and in the education system must become much more fluent in English. Otherwise we will not be able to communicate, we will not be able to use the capabilities that IT and the communications systems are providing for us. It is going to be an investment which we are not harvesting to the fullest extent without English.

So what does this mean for education and research then? Well again, I think that Europe must look upon itself and identify its strengths and its centres of excellence. The idea that you go to one university or one educational institute to take your education is becoming less and less significant. I think that we need to create pan-European education programmes, in which students can go from one centre of excellence in education to another to do the same kind of research. This is not to say that one thing should be done in only one place. But students should be able to subject universities and educational institutions to competitive pressures, to force these institutions to compete for the interests and to focus on the needs of specific students. It would create a new quality of European managers and people who are able to develop society with a true pan-European perspective and cultural understanding. We must continue to reduce the fragmentation in the European education and research institutions. We spend too much on too many places. Again we need to look at the qualitative aspects of education and research and not necessarily only on the quantitative issues. Unless we make sure that we are world class in every one of these institutions, they will gradually lose relevance on the global scale. We have shown that we can do this. We have shown it with CERN in Geneva where I work myself. We have shown it with Airbus as a company. Again it might be an exception, but we have shown that we are able to work together to build a centre of excellence. We must create a balance between basic and applied research and we have to make sure that we continue to adapt the curriculum of the educational institutions to the present and the future needs of society and industry. Competence is going to be the primary competitive advantage.

So with this in mind let me stress that we in Europe have the institutions, we have the capabilities, we have the technologies, we have the brand names and we have the capital. We have to grasp the opportunities when they present themselves to us.

Thank you.

Eric Le Boucher
International Editor and Economic Columnist,
Le Monde, France

It has always been difficult to discuss industrial policy and national or European champions in Germany, a country in which classical economic thought has always been widely predominant. Exactly the opposite prevails in France, in which Keynesian thought is part of a natural political culture.

Yet it seems that both countries have – in part – agreed on a joint criticism of Brussels' policy of competition, although they immediately diverged on the Alstom-Siemens case. This conference is a very useful opportunity for France and Germany, and more broadly for European countries, to have a closer look at things.

In Germany, Mario Monti's policy provoked heavy criticism for not taking into account the German industrial model. The Chancellor himself intervened to explain that the Brussels vision of competition should take into account the fact that German domestic production still depends on industry to a greater extent than elsewhere. Such a German specificity should be supported, not fought against.

In France, what triggered the debate was the takeover of Pechiney by Alcan. A French champion, nationalised first, then privatized in poor financial conditions, was disappearing. The question was raised about the other champions: are they fragile? Are they in jeopardy of being taken over as well? What had the State done to protect Pechiney? What could it have done? What should it have done?

The concept of "industrial policy" was banned from the 1990s vocabulary after what was considered the failures of Mitterrand's left, although an exact inventory has yet to be undertaken. It was taken for granted that the State should privatise and limit its role to the improvement of the economic, social and judicial environment of firms and let the market act.

This "hands-off" policy has indeed been that of Francis Mer, the Minister for the Economy, who, although he had been warned by Jean Pierre Rodier, Pechiney's chairman and CEO, did nothing to prevent the takeover by Alcan. The political classes reacted only after the fact, under the pressure brought to bear upon them by trade unions, political parties and the media.

The arguments brought forth to define a "new industrial policy" and a "defense of French champions" came under three headings.

The first argument is the importance of these groups to our national economy. Renault or PSA, Saint-Gobain or LVMH all have their headquarters in Paris, which implies high-level internal as well as external jobs for auditors, lawyers, and service companies of all kinds. This is an argument of the «pole» type: a firm exists in an environment and vice versa. As for the internal jobs, the news which went round after the takeover, concerning the departure of French executives and the moving of service providers to Canada strengthened the idea that the nationality of a firm still existed in the days of international pension funds. Furthermore, champions pay taxes which, even reduced through shrewd action by fiscal advisers, still represent essential assets for municipalities, regions and the State. Finally, the presence of champions warrants that the most advanced research laboratories are maintained in the country.

The second type of argument brought forth to defend a "new industrial policy" in France was that championed by Jean Louis Beffa, Saint-Gobain's chairman and CEO. It says that the American model of such companies as Apple and Microsoft, which were created out of nothing in backyard garages, has never succeeded in taking root in France or even in Continental Europe. What rather seems to work is the Japanese model which rests upon big groups whose research is co-financed by the State. Japan and Europe would thus belong to the same tradition: it should be pursued and not given up through useless dreams of Silicon Valley.

The third argument rests precisely on what is being done abroad: Europe is "naïve" not to support its champions when the American Department of Defense is handing out billions of dollars to its leading industries and when President Bush himself phones the Chinese President and others when it comes down to selling Boeings.

How can one sort through these arguments? As for me, I believe they can't be swept aside without thinking pragmatically. Siemens, Airbus or Fiat are heavyweights in the European economy. Better to have many champions than few. Governments and the Union's authorities must take their defense unblushingly, including when they go through dire straits as Alstom has. Provided, of course, that they need not be put on artificial life-support systems.

But there is one condition: that in return, these firms should bring economic and social benefits. This is a problematic aspect since we know very well that the most promising markets are in America or Asia and that these champions are naturally tempted to transfer their jobs, laboratories, and even, it is bound to come, their headquarters. So, industrial policy has to be on a give-and-take basis. Without economic and social returns, it would be better for member states to let champions go, let them survive as they can, and bet on venture capital, a European Small Business Act and that sort of Schumpeterian policy.

RAINER FRANK ELSÄSSER
Former member of the management board,
E.ON Energie AG, Munich

European or national champions are certainly more a blessing than a burden if customers do have a choice between at least two or – preferably more – champions. The definition of the term 'champion' depends very much on the nature of the business. In highly capital-intensive industries employing technologies with large economies of scale, members of the Champions League need to be quite sizable.

In my statement I shall deal with today's subject from the perspective of an energy manager.

When the European Union designed the Lisbon Strategy, the goal was to become the world's most competitive and dynamic economy by 2010. A drastic change process had already started in the European energy sector. It was in 1998 when the liberalisation of the electricity and gas markets constituted a new legal framework for energy suppliers.

Before 1998, there was hardly any competition in the energy market: utilities were active within clearly defined supply areas and customers did not have the possibility to choose their energy supplier. I admit that this was a rather convenient situation for the whole energy industry.

In Germany, the market was not opened step by step. The right for customers to choose their supplier came "overnight", and the energy companies were forced to reflect upon their strategy and to define new entrepreneurial goals. The first objectice was to increase competitiveness.

This process very often led to a reorganization of the company structure. When, in 2000, the former companies VEBA and VIAG merged, each of them was a broad conglomerate, active in different branches of industry. It became clear that concentrating on one core business would be the key to future success. Thus E.ON was born.

During the last five years, the E.ON group sharpened its profile and, step by step, became a member of the international "Champions League" in the energy industry. Today E.ON is the world's largest private energy supplier with a clear focus on electricity and gas.

Its subsidiary, E.ON Energie, representing the largest of five market units within the E.ON group, is responsible for the entire electricity and the downstream gas business in Central Europe.

E.ON Energie

Let me now focus on E.ON Energie:

The opening of the European energy markets meant to us a unique chance for transformation and growth. What did we do to reach this ambitious goal? How did E.ON Energie develop from a national to a European player?

In Germany, further acquisitions are rather limited for us due to cartel restrictions. Seven strong regional suppliers belong to our group as well as a number of shareholdings in German municipalities.

Concerning our international activities, the political changes in Eastern Europe opened the door for growth. Step by step, E.ON Energie increased its radius of extension. Today, we are active, besides Germany, in the Benelux countries, Switzerland, Austria, and in most of the EU accession states in Eastern Europe. Our latest acquisition took place in Bulgaria, and we also expect Romania to become a new regional member of our European family. After almost ten years of engagement in East European countries, we are proud to be the leading energy supplier there.

Our philosophy follows an integrated business model. In the electricity sector, we want to be present along the entire value chain, including generation, transmission, distribution, trading, and supply. In addition, we try to exercise power and gas convergence in the downstream sector.

This business model means stability of revenues as well as risk minimization, following the principle: "Don't put all your eggs in one basket."

Despite our growth in Central Europe, E.ON Energie is still regionally bound.

Energy supply cannot be compared to other industries due to its special characteristics. Electricity has to be produced where it is needed, i. e. we are conducting a local business. Being part of a strong group and benefiting from economies of scale enables us to offer premium products and services to our customers.

The energy industry in Europe

The introduction of competition in the European energy markets had one major goal: It was to improve Europe's competitiveness. However, the European Commission is looking with distrust at the development of energy markets and market players in Europe. Especially the big players are being observed suspiciously.

The Commission's distrust is mirrored by major regulating interferences such as the infrastructure package in autumn 2003, by the Commission's benchmarking reports and by its most recent decision to carry out a sector inquiry of the energy market.

I do not share the Commission's scepticism. I am convinced that first of all, liberalisation of the energy markets in principle has been a success story, and, secondly, that we need big, financially sound market players for the challenges the electricity industry is facing.

Liberalisation in principle has been a success story

Large parts of the electricity markets in the European Union today are open for competition, the lacking parts will be opened up by July 1, 2007. The Commission itself, in its fourth Benchmarking Report, has recognised the results achieved concerning growth of productivity and price reduction.

Yet the German market in particular is still under criticism. But if we look at the facts, we see that concentration in generation and distribution is comparably low. We have a considerable share of foreign competitors (with Vattenfall and EDF up front) and the leading power exchange (EEX) in Continental Europe. The interconnection capacity between Germany and its neighbours, i.e. the relationship between import capacity and peak load, is as high as 20 percent. Access to the grid is open to all market players and non-discriminatory and will soon be controlled additionally by a regulation authority.

The competitive market has led to an overall decline in electricity prices – even though the heated debate on recent price hikes may indicate something different. In fact, industry prices in Germany have fallen up to 30 percent between 1998 and 2004 (for households the figure is 16 percent) – without even taking account of inflation.

However, most of the liberalisation dividend has meanwhile been consumed by the sharp rise in state-inflicted costs. Households thus pay about the same today as in 1998, industry "only" 18 percent less.

The message is clear: It is not a malfunctioning of the market that is prohibiting lower energy prices, but the distortion of the market by numerous and often contradicting political aims. To safeguard the competitiveness of European industry, these distortions have to be reduced considerably.

This leads me to my second point.

We need big, financially sound market players

Not only European industry in general needs to be competitive, but also the European electricity industry. Even more so if we consider the big challenges ahead: According to Eurelectric, 520 GW of new capacity will have to be installed by 2030 in the EU-15 Member States, costing more than € 600 billion. Additionally, a major modernisation and extensions of the grid will have to be accomplished.

These giant investments cannot be undertaken by administrative guidelines and regulations. The investments we are facing need to be undertaken by market participants at least cost.

"Small is beautiful", the slogan of the environmentalist movement of the 1970s against modern industrial technologies and mass production, can still be found today in the ideas of policy makers. However, reality has shown that it is more than doubtful whether all big business is bad and whether small is all that beautiful.

In fact, the electricity industry continues to be dominated by economies of scale. This is why big private utilities come into play: In Germany as well as in the rest of Europe, there are many with a strong capital base. It is they who have the engineering know-how and experience as well as the financial background to face the challenges of developing, building and operating modern, efficient and environmentally sound power plants and grid systems.

European and national politicians should take this into account when regulating energy markets in Europe. They should focus on the implementation of current legislation, on guaranteeing a stable and reliable market framework, and on preventing the use of dominant positions. If they do so, a competitive power industry will continue to provide secure energy supply at competitive prices.

Conclusion

Let me finally draw a comparison with the oil industry in which we find a number of global champions:

All oil majors operate the entire value chain from exploration to the filling station. In addition to that, we find a large number of smaller oil companies, e.g. in the transport, trading or retail business. But nobody expects from these companies the exploration of new oil fields in Alaska, off-shore or in Siberia, which is, however, indispensable for the security of oil supply.

Thank you.

HANS-WERNER SINN
President, Ifo Institute for Economic Research and CESifo

Closing remarks

I would like first and foremost to express my gratitude to all participants of this year's Munich Economic Summit. We had a great conference with stimulating presentations and good interventions. On behalf of the BMW Foundation Herbert Quandt and CESifo I thank all speakers on the podium and on the floor for their participation. This was the fourth Munich Economic Summit and we can look forward to more such conferences in the future.

Europe and the Lisbon goals, where do we stand today? We all agreed that the Lisbon programme has not delivered on its promises, that it and its revamped version have too many shortcomings. What can be done? Edmund Stoiber, in his keynote address, gave us his answer from a politician's point of view: greater deregulation of EU law, more investment in research and development, and strict observance of the Stability and Growth Pact. Jean Pisani-Ferry, in his introduction to the first panel, focused on the need to make the Single Market more dynamic, to ensure effective coordination by using the EU budget as an incentive device for national efforts of common interest, and to make the Eurozone adapt its policy framework to take into account the complementarity between structural and macroeconomic policies. The second panel discussed the pros and cons of national champions. The topic was introduced by Paul Seabright and discussed by representatives of industry. Paul Seabright pointed out that while the success of Airbus has revived the idea of national champions, aerospace is a special case: large firms, hi-tech, low variety, large-scale economies, dependent on commitment. Politicians like big projects, love hi-tech, prefer products that are visible in the press/media and are insulated from competition. Private firms are very similar in picking winners, but there are much better in terminating the losers. The conclusion was clear: Europe does not need state supported national champions outside aerospace.

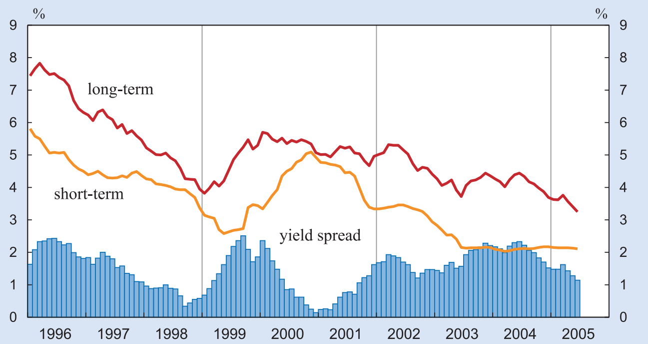
It was an interesting conference, on the macroeconomic as well as the microeconomic level.

In closing, I would like to thank Jürgen Chrobog and Kai Schellhorn from the BMW Foundation Herbert Quandt for the good cooperation of the Foundation and its team. And I want to single out Thomas Leeb from the Foundation and Christian Kelders from CESifo for their excellent work. This also goes for all the others behind the scene, whose efforts helped to make this conference a success. They deserve a big hand of applause.

Ladies and gentlemen, this concludes the fourth Munich Economic Summit.

Financial Conditions in the Euro Area

NOMINAL INTEREST RATES a)

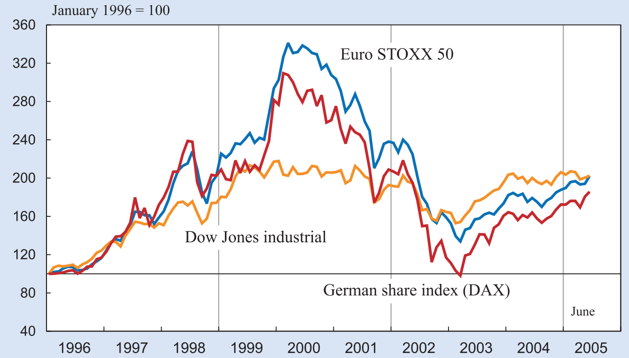


a) Weighted averages (GDP weights).

Sources: European Central Bank.

At its meeting on 2 June 2005, the European Central Bank Council decided to leave its key interest rate unchanged at 2%. This is reflected in the 3-month money market rate that has averaged 2.14% since January. Bond yields have continued to decline and averaged 3.25% in May 2005. The yield spread consequently shrank to 1.14%.

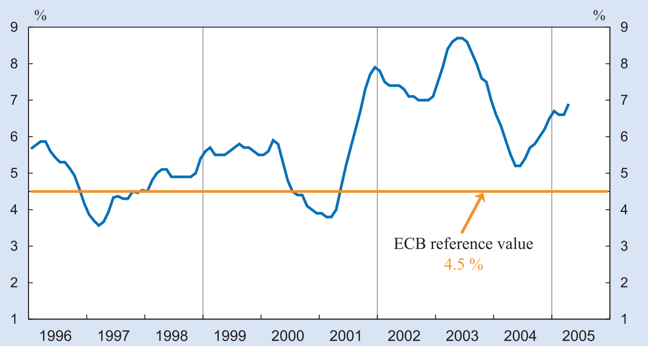
STOCK MARKET INDICES



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

All three indices continued on a broadly rising trend. The Euro STOXX rose to 3151.7 in June from 3032.5 in May; the Dow Jones Industrial recovered to 10586.7 in June from its last high of 10723.8 in February; and the German DAX averaged a new high of 4586.3 in June.

CHANGE IN M3 a)

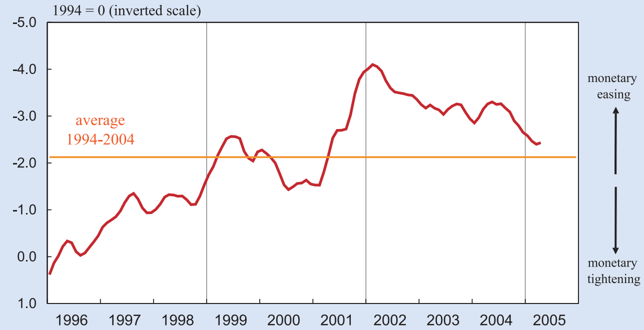


a) Annual percentage change (3-month moving average).

Sources: European Central Bank.

The annual growth rate of M3 increased to 7.3% in May 2005, from 6.8% in April. The three-month moving average of the annual M3 growth rates over the period from March to May 2005 rose to 6.9% from 6.6% in the previous three-month period. The annual rate of growth of M1, one of the main components of M3, increased to 10.1% in May 2005 from 9.3% in April.

MONETARY CONDITIONS INDEX

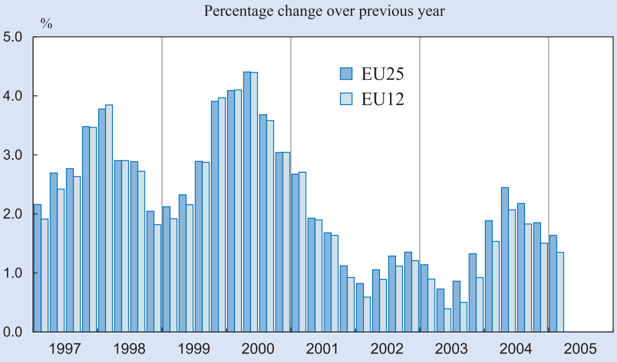


Note: MCI index is calculated as a (smoothed) weighted average of real short-term interest rates (nominal rate minus core inflation rate HCPI) and the real effective exchange rate of the euro.

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

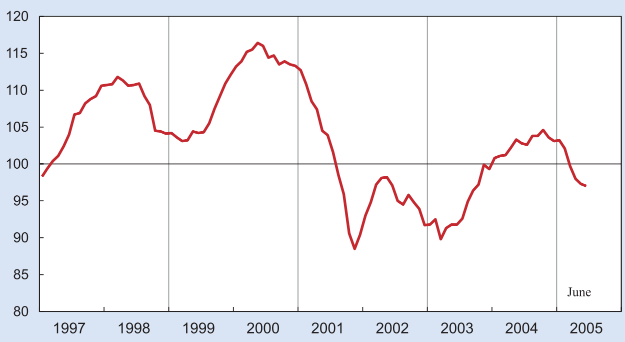
Between March and April 2005, the monetary conditions index rose marginally following a declining trend (tighter monetary conditions) since May 2004. Real short-term interest rates all but constant in April whereas the real effective exchange rate of the euro declined.

EU Survey Results



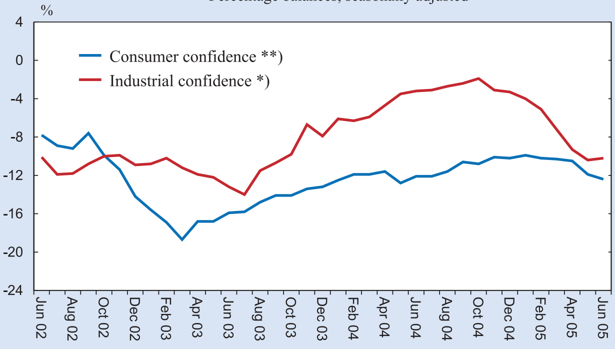
Source: Eurostat.

In the first quarter of 2005, real gross domestic product of EU25 (as well as the eurozone) increased by 0.5% on the previous quarter. Compared to the first quarter of 2004, GDP of EU25 rose by 1,6%, that of the eurozone by 1.3%.



Source: European Commission.

In June, the EU Economic Sentiment Indicator slightly declined by 0.3 points, indicating a slowdown of the decline that had started in November 2004. The consumer confidence continued to be fairly stable and the decline in industrial confidence came to a halt after a continuous fall since the end of last year. Confidence in other business sectors (services. Retail trade and construction) registered small declines. There has been a strong fall of economic sentiment in the UK for the fourth consecutive month to 94.8 in June (February: 113.5).



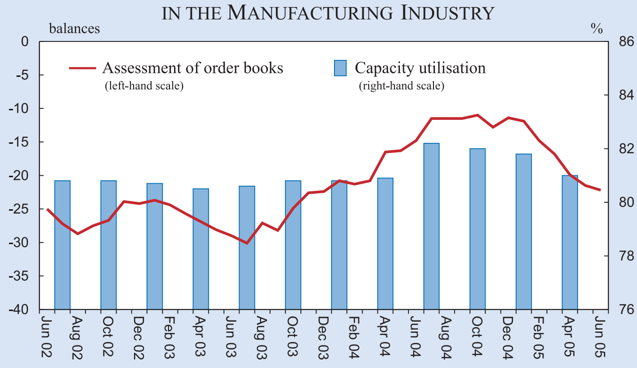
Source: European Commission.

* The industrial confidence indicator is an average of responses (balances) to the questions on production expectations, order-books and stocks (the latter with inverted sign).

** New consumer confidence indicators, calculated as an arithmetic average of the following questions: financial and general economic situation (over the next 12 months), unemployment expectations (over the next 12 months) and savings (over the next 12 months). Seasonally adjusted data.

The industrial confidence indicator rose marginally in the EU. The coming months will show whether this is the beginning of a turnaround or merely an interruption of a continuing downward trend.

There was hardly any change in the consumer confidence indicator in June. Since the beginning of last year, the indicator has been fluctuating within a small corridor of – 10 and – 13. this stability is also reflected in the development of the underlying factors. Only unemployment expectations worsened slightly, while consumer expectations regarding their own financial situation, the general economic situation and their savings remained unchanged.

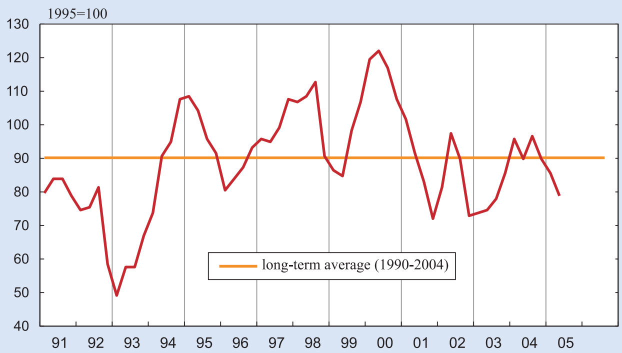


Source: European Commission.

The slight increase of EU industrial confidence in June was caused by a small improvement in production expectations, while the assessment of order books worsened from – 21.5 to – 22.2. Capacity utilisation in the second quarter of 2005 declined to 81.0% from 81.8% in the first quarter.

Euro Area Indicators

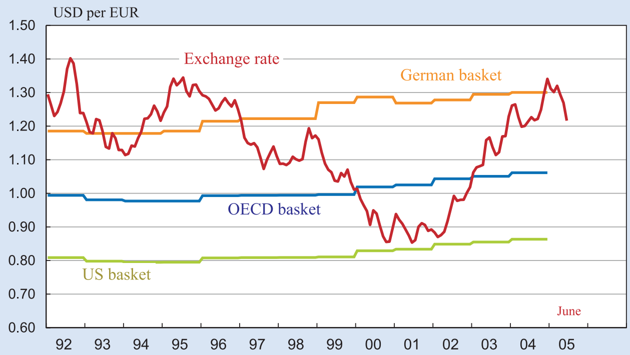
Ifo Economic Climate for the Euro Area



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

The Ifo World Economic Survey for the Euro area showed a further deterioration of the economic climate in the second quarter of 2005 to 78.8 from 85.6 in the first quarter. Both expectations for the next six months as well as assessments of the current economic situation declined. This indicates that the economic weakening in the euro area will persist.

Exchange Rate of the Euro and PPPs

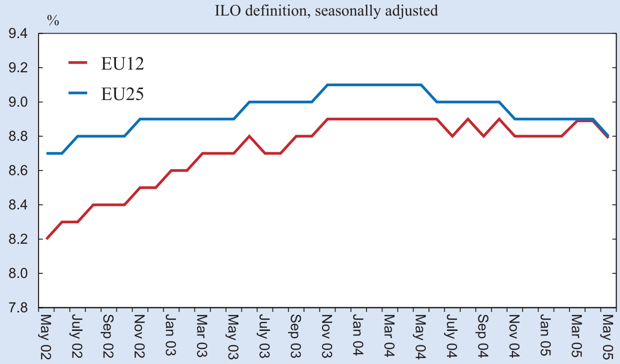


Sources: European Central Bank, Federal Statistical Office, OECD and calculations by the Ifo Institute.

The exchange rate of the euro against the US dollar continued to decline in June when it dropped to an average rate of $1.22. It had reached a high of $1.34 in December 2004. I has thus bounced back from its purchasing power parity ($1.30) with the dollar based on the German goods basket.

Unemployment Rate

ILO definition, seasonally adjusted

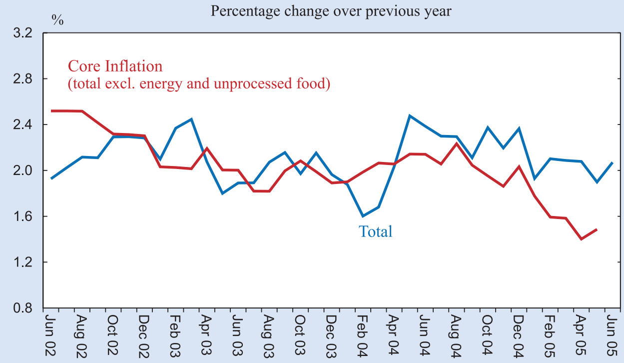


Source: Eurostat.

Euro-area unemployment (seasonally adjusted), like that in EU 25, stood at 8.8% in May 2005, down from 8.9% in April. The lowest rates were again registered in Ireland (4.2%), the UK (4.6% in March), Austria (4.6%) Luxembourg (4.7% and Denmark(4.9% in April). Unemployment rates were highest in Poland (17.8%), Slovakia (15.5%), Greece (10.2%), Spain (9.9%) and France (9.8%).

Inflation Rate (HICP)

Percentage change over previous year



Source: Eurostat.

The annual inflation rate of the euro-zone (HICP) rose from 1.9% in May 2005 to an estimated 2.1% in June. It has remained rather stable at about 2% during the year to date, despite the rise in oil prices. The lowest inflation rates were registered in Finland (0.6%) and the Netherlands (1.1%), the highest in Luxembourg (3.7%). Core inflation (excluding energy and unprocessed foods) which had followed a steeply declining trend, showed a slight increase in May.

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