The European Economy: Current Situation and Economic Outlook

1. The current situation

In 2002 output growth in the euro area increased on average by ¾ percent (after 1.4 percent in 2001).[1] Thus, for the second consecutive year it was significantly below potential (or trend) growth, so that the output gap – a measure of the under-utilisation of resources – widened further. Expectations of a recovery of the European economy were revived in Spring 2002, when business confidence improved significantly and output began to increase after a period of near stagnation. But these hopes were dashed by mid-year when new uncertainties emerged. Growing fears that a war in Iraq could further disrupt an already unsettled world economy, and concerns about profits and financial reporting (see Box 1.2: Could Enron happen in Europe?, p. 23) caused stock markets in the United States and Europe to decline sharply. Business and consumer confidence weakened again in both the United States and Europe, signalling a more fragile recovery than previously expected. All this added to fears of a double-dip recession in the world economy (Figures 1.1 and 1.2) (For further details on business confidence in individual countries and regions see Appendix 1).

[1] This development was slightly weaker than our forecast in last year's report (1.3 percent) and much weaker than official forecasts.

1.1 Past differences in macro-policies between Europe and the United States

Developments in the world economy are not sufficient to explain Europe's particularly weak growth performance in 2002. Although in the first half of 2002 output growth and business confidence in Europe was helped by the recovery of the US economy, growth in Europe remained significantly lower than in the United States.

There are a number of reasons for this disappointing outcome and differences in macro-policies, as

Figure 1.1

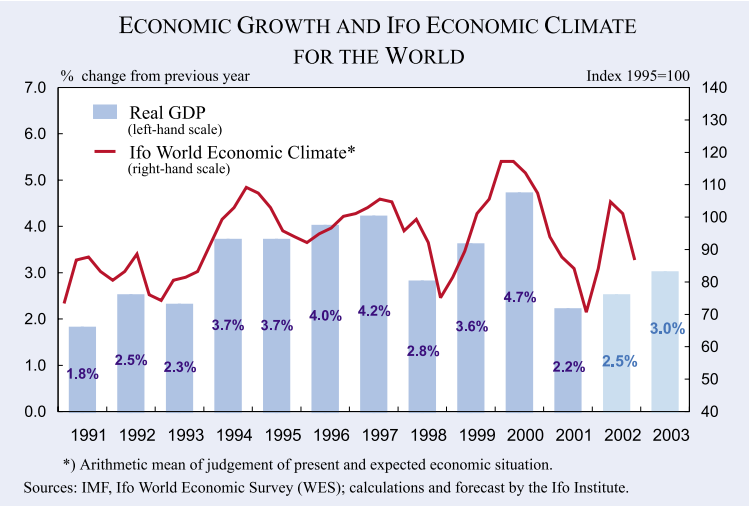
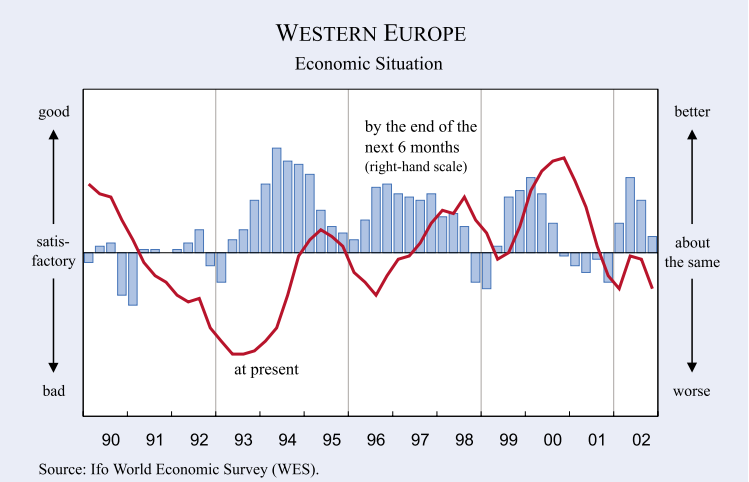


Figure 1.2

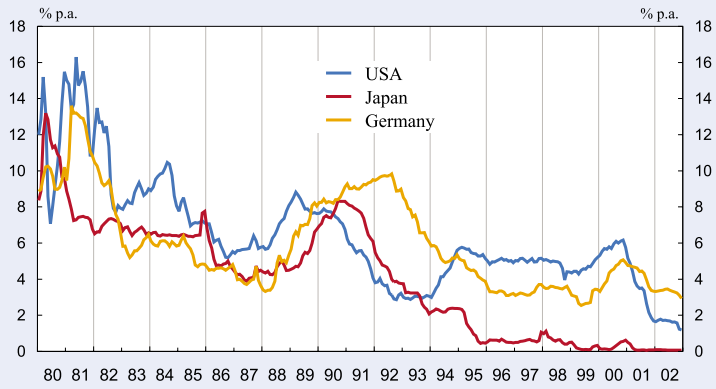


well as ongoing structural problems in the European economy (which were identified in our last report) have been at play.

With respect to *fiscal policies*, the difference between Europe and the United States was most pronounced. In the euro area, countries continued to aim at meeting their consolidation targets as laid out in their stability programmes (albeit not always successfully). The structural budget deficit of the euro area as a whole remained broadly stable at around 1½ percent of GDP.[2] By contrast, in the United States fiscal policy boosted demand as taxes were cut and public spending was increased sharply in the aftermath of the terrorist attacks of 11 September 2001. The structural fiscal deficit increased from ¼ percent of GDP in 2001 to 2¾ percent of GDP in 2002, or by 2½ percentage points; this was the biggest annual fiscal demand stimulus in the United States since the first half of the 1980s.

Figure 1.3

SHORT-TERM INTEREST RATES [1)]



1) 3-month interest rate.

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

Monetary conditions remained generally favourable both in Europe and in the United States but could not prevent the recovery, which began in Spring 2002, from faltering again. Between 2001 and 2002 nominal short-term interest rates in the euro area declined on average by around 1 percentage point (from 4¼ percent to 3¼ percent). In the United States, the decline (from 3¾ percent in 2001 to 1¾ percent) was about twice as much (Figure 1.3). With respect to real interest rates, the difference is smaller as the inflation rate fell more in the United States. If real interest rates are calculated by deducting the increase in the consumer price deflator from the nominal interest rate, the decline in real interest rates in the United States averaged 1¼ percentage points (from 1¾ percent to ½ percent) and in the euro area it averaged ¾ percentage points (from 1¾ percent to about 1 percent).[3]

The easing effect of lower real interest rates on monetary conditions is also reflected in the shortfall from the so-called Taylor rate[4], but it was partly offset by the appreciation of the euro exchange rate, so that the overall monetary condition index for the euro area, which we calculate as a weighted average of the real short-term interest rate and the exchange rate, indicated some tightening (Figures 1.4 and 1.5).[5]

There is, however, a significant uncertainty as to how easy the monetary conditions really are. In Figure 1.4 various Taylor rates were calculated for the recent situation. The base case calculation of the Taylor rate, which is shown by a red line in the Figure, has been

[2] The decomposition of the government budget into a cyclical and non-cyclical or structural component aims at separating cyclical influences on the budget balances resulting from the divergence between actual and potential output (the output gap), from those which are non-cyclical. Changes in the latter can be seen as a cause rather than an effect of output fluctuations and may be interpreted as a proxy for discretionary policy changes. The structural budget balance is derived by (re-)calculating government revenues and expenditure which would be obtained if output (GDP) were at its potential (or trend) level. We follow here the approach used by the OECD. See also Chapter 2.

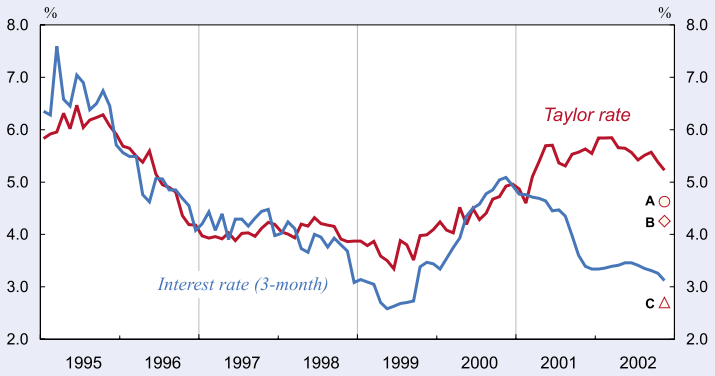
[3] If real interest rates are calculated on the basis of the increase in the GDP deflator, the decline in real short-term interest rates was (again) ¾ percentage points in the euro area but only about ½ percentage point in the United States as the GDP deflator decelerated more.

[4] The Taylor rule interest rate is a benchmark interest rate. The rule is based on the idea that the central bank interest rate is managed in order to ensure price output stability. Any deviation of the inflation rate from its target and of output from its equilibrium (potential) level will prompt the Central Bank to adjust the interest rate. While controlling output has never been an explicit target of the ECB (or the Bundesbank), this indicator assumes that output stabilisation is an implicit target as it also affects actual and/or expected inflation. If the short-term interest rate is above (below) the Taylor interest rate, it indicates that monetary policy is more restrictive (expansionary) than what one would expect with the prevailing inflation rate and output gap. Under the assumption that the Central Bank is equally concerned with price stability and real output, we use an equal weighting of 0.5 for both. Furthermore, the real equilibrium interest rate has to be determined. According to estimates by the Bundesbank, the real equilibrium interest rate in Germany was 2.9% during the period from 1979 to 1998. We assume that this rate also reflects the current real equilibrium interest rate in the euro area as a whole. The Taylor rate therefore is TR = 2.9 + expected inflation rate + 0.5 times output gap + 0.5 times deviation of the inflation rate from the target.

[5] The Monetary Conditions Index (MCI) is a weighted average of the real short-term interest rate i^r and the real effective exchange rate of the euro e^r. The objective is to obtain an estimate of the effect of movements in these two variables on aggregate demand. The weights w^i and w^e which are applied here are 0.9 for the interest rate and 0.1 for the exchange rate. These have been calculated in order to adjust for the difference in volatility of the exchange rate and the interest rate over time. The higher the MCI, the tighter is monetary policy. In the figure, the scale is inverted so that an increase indicates easier monetary conditions.

Figure 1.4

TAYLOR RATE AND ACTUAL INTEREST RATE IN THE EURO AREA



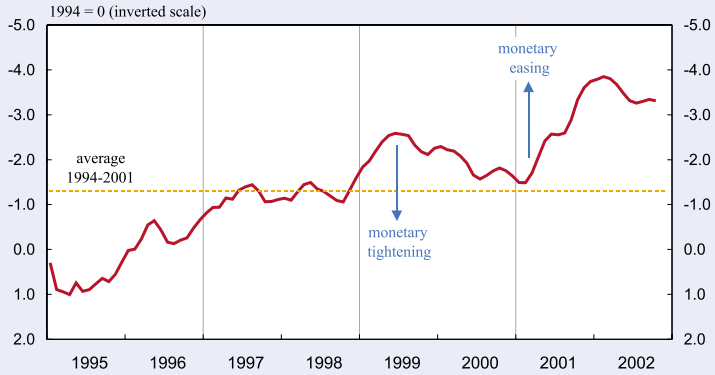
Note: Taylor rate: based on the equilibrium real short-term interest rate (2.9 %), EMU output gap and difference between core inflation (HCPI) and target inflation (1.75 %)
Sources: European Central Bank, Eurostat, calculations by the Ifo Institute.

calculated by assuming that the nominal equilibrium interest rate consists of the equilibrium real rate (which is assumed to be 2.9 percent for the entire period since the mid-1990s) and of inflation expectations, which are proxied by the actual core inflation. The base case calculation further assumes that monetary authorities, when setting interest rates, compare the actual core inflation with the inflation target of below 2 percent (we assume 1¾ percent), and whenever actual core inflation is higher, the interest rate is set at above the nominal equilibrium rate. In addition, monetary authorities also consider cyclical conditions of the economy (as measured by the output gap), and whenever actual output falls below trend the interest rate is set below the nominal equilibrium rate. Under current circumstances, with core inflation overshooting the inflation target and with a negative output gap, these effects almost offset each other so that the Taylor rate in the base case is currently 5.2 percent, which is close to the nominal equilibrium rate of 5.3 percent. If one assumes, however, that the inflation forecast for 2003 (1.9 percent) is a better proxy for inflation expectations and that monetary authorities are forward-looking and, therefore, see currently no reason to fight inflation (as this rate is similar to their target), the Taylor rate is lower as is shown by case A in the Figure. Furthermore, as we argued in last year's report, the ECB should accept a somewhat higher inflation rate for the euro area because of structural effects (the Balassa-Samuelson effect). If, for example, the ECB were to aim at an inflation rate of 2½ percent (rather than below 2 percent) the Taylor rate would be further reduced (case B in the Figure). With these adjustments the Taylor rate is still above the actual interest rate, which suggests that monetary conditions are relatively easy but much less expansionary than suggested by the base case calculations.

For individual countries in the euro area with lower inflation and weaker cyclical conditions than average, monetary conditions are tighter than the Taylor rate for the euro area as a whole suggests, while for those countries with higher inflation and better cyclical conditions monetary conditions are easier. In the case of Germany, for example, where the output gap is relatively large and the inflation rate is lower, the Taylor rate may currently be below the actual interest rate which suggests that interest rates are not particularly low for Germany and that monetary conditions are not as favourable as for the euro area as a whole.[6]

Figure 1.5

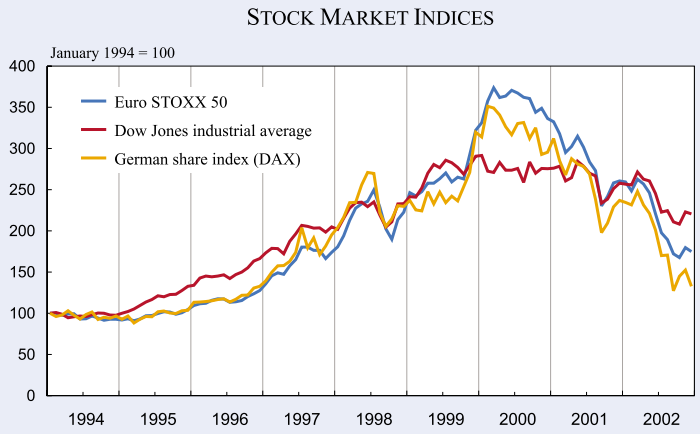
MONETARY CONDITIONS INDEX



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, Eurostat, calculations by the Ifo Institute.

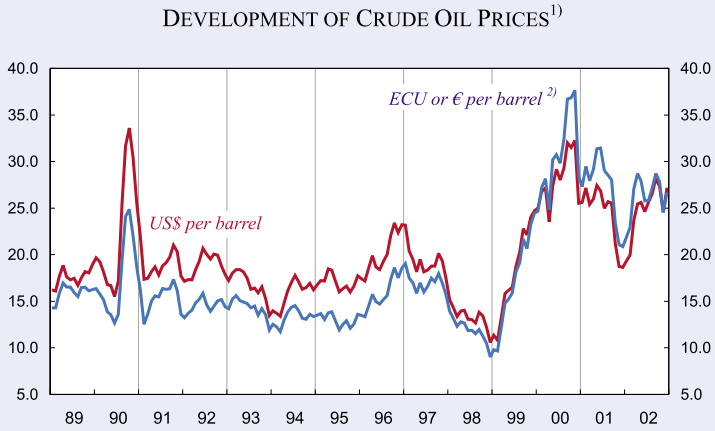
[6] Here we assume inflation expectations of around ¾ percent corresponding to our inflation forecast excluding the effect of indirect tax increases. We assume further that the inflation target for Germany is 1¾ percent and that the German output gap is around ½ percentage point larger than that of the euro area as a whole. We also assume that the real equilibrium interest rate in Germany is 2.9 percent which corresponds to that for the euro area as a whole and the long-term average in Germany. As potential output growth in Germany has declined over past years one can argue that the real equilibrium interest rate is now lower. The Taylor rate would then be lower than shown here.

Figure 1.6



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

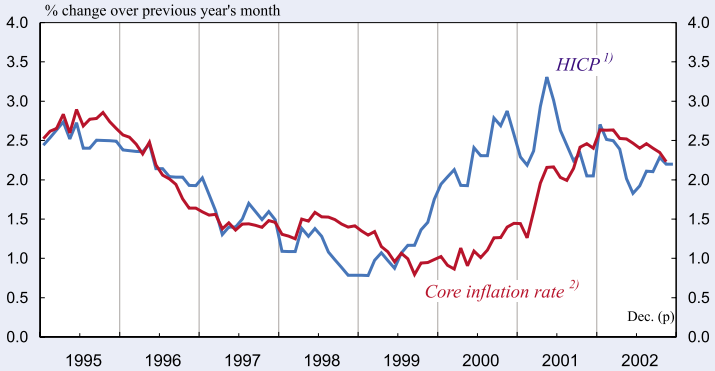
Figure 1.7



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

Sources: HWWA, calculations by the Ifo Institute.

Figure 1.8



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

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

The levels of real government bond yields also remained at historically low rates in both the euro area and the United States (slightly above 3 percent), but were marginally higher than in 2001.

All these monetary indicators may, however, not fully capture the financing conditions recently faced by investors. Despite overall favourable monetary conditions, the financing of business investment has become more costly as the risk premium of industrial bonds increased and stock prices declined sharply, raising the cost of equity financing (Figure 1.6). The weakness of the stock market also reduced the capital base of the banking sector, which may have adversely affected lending behaviour. The fall in share prices also reduced the capital base of the insurance sector, which is generally also an important source of corporate investment finance. This sector was hit in the past by the high cost of insurance losses, in particular the effects of the terrorist attacks of September 11 on re-insurers. Given all these negative effects on the European economy in general, and on the European financial markets in particular, a more aggressive reduction in interest rates by the ECB even before the latest cut would have been helpful.[7]

The resistance of the ECB to lowering interest rates as aggressively as the Fed may be explained by the fact that in the euro area the increase in consumer prices as well as core inflation remained above 2 percent and, therefore, above the rate which the ECB would accept over the medium-term. Reasons for why the inflation rate declined so little, despite the weakness of demand and the appreciation of the euro, frequently include such special factors as higher oil prices, bad weather conditions and animal

[7] On 5 December the ECB reduced interest rates (minimum bid rate on the main refinancing operations) further by 0.5 percentage points from 3.25 percent to 2.75 percent.

diseases as well as increases in indirect taxes in some countries (Figures 1.7 and 1.8).[8]

However, another perhaps even more important factor explaining the relatively high inflation rate in the euro area is that unit labour costs continued to increase unabated (by almost 3 percent), as wage growth did not decline and labour productivity continued to stagnate.[9] This reflects cyclically weak productivity growth and labour hoarding, but it could to some extent also reflect ongoing structural rigidities in European labour markets. By contrast, in the United States the weakening of demand was accompanied by a deceleration of unit labour costs and inflation, which made it easier for the Fed to further reduce interest rates.[10]

1.2 Demand pattern reflects cyclical and structural weaknesses

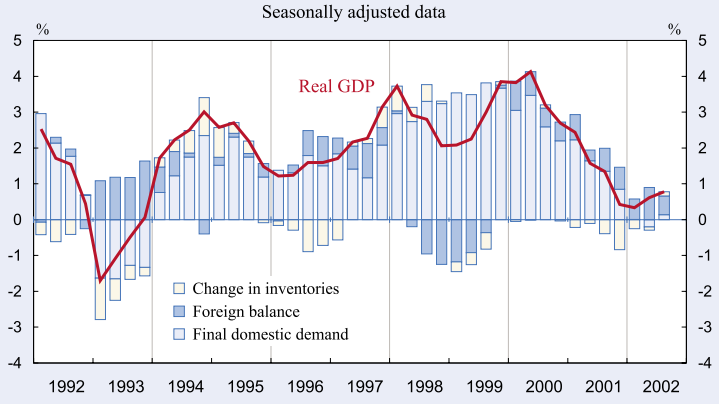
The differences in macro policies and structural problems between Europe and the United States are also reflected in the patterns of demand. While in Europe both consumption and investment remained weak, in the United States consumption was boosted by expansionary macro policies. In addition, domestic demand in the United States benefited from a greater responsiveness of the inflation rate to the cyclical weakening of the economy.

- In the euro area, real private consumption increased by only ½ percent in 2002, which was the weakest growth since the recession of 1993 (when real private consumption in the euro area declined by 0.9 percent). Real disposable household income was weakened by the deterioration of the labour market. Households were also affected by falling stock prices. In the euro area they increased their savings (as a percentage of disposable income), from around 9 percent to around 10 percent. Various factors like rising unemployment, lower equity wealth, general economic uncertainties, including those related to pensions, may have contributed to this, although it is difficult to disentangle the individual effects of these factors on total household savings (see Box 1.1: Macroeconomic effects of declining equity prices).
- In the United States, private consumption benefited from large tax reductions. Furthermore, despite higher oil prices consumer prices decelerated, which also supported real disposable income. Households also responded to higher job insecurity, falling stock prices and the more uncertain economic environment by increasing their savings ratio (from 2¼ to 3¾ percent). Nonetheless, their willingness to spend was sustained until late summer, and real private consumption increased by around 3 percent (after 2½ percent in 2001), which was much higher than in previous cyclical downturns.
- In the United States, public consumption (in particular for security and defence) was boosted in response to the terrorist attacks of September 11; the increase by about 4½ percent in 2002 being the highest since the mid-1980s and more than twice as high as in the euro area (where it increased by around 2 percent).
- Residential construction continued to decline in the euro area (by around 1 percent, following a fall of 2½ percent in 2001). By contrast, in the United States it increased by around 2½ percent, reflecting the sustained willingness of private households to spend, which was stimulated by the continued increase in house prices and low mortgage rates. But the upswing lost some momentum in autumn.

Figure 1.9

CONTRIBUTION TO GDP GROWTH IN THE EURO AREA[1)]

Seasonally adjusted data



1) Annual percentage change, from 2001 including Greece.

Sources: Eurostat, calculations by the Ifo Institute.

[8] Another factor often mentioned to explain the higher inflation rate in the euro area is the effect of the euro cash changeover. Whereas some service prices increased significantly with the introduction of the euro, a significant effect cannot be identified at the aggregate level.

[9] Labour productivity increased by only 0.3 percent after zero growth in 2001.

[10] In the United States, unit labour costs fell by 0.3 percent in 2002 after an increase of 2.4 percent in 2001, and the increase in the GDP deflator declined from 2.4 percent in 2001 to 1.1 percent in 2002. In the euro area, unit labour costs increased by 2.8 percent in 2002 (after 2.9 percent in 2001) and the GDP deflator increased by 2.2 percent (after 2.4 percent in 2001).

Box 1.1

Macroeconomic effects of declining equity prices

The sharp decline in equity prices raises the question of how this affects the European economy. There are various channels through which equity prices affect the real economy. Private households are affected as a decline in equity prices reduces equity wealth (wealth effect). This reduces their means to consume. Households may also interpret the fall in share prices as a warning that future income growth could be lower than expected so far and revise their consumption plans accordingly. The size of the wealth effect depends on the marginal propensity to consume out of wealth and the share of stocks in total wealth. It also depends on the distribution of the various types of assets and of share holdings across income groups. If lower income groups are affected the effect is bigger as those have a high propensity to consume, but if mainly high income groups are affected the effect on consumption is smaller. Regulations in financial markets also play a role as the liquidity of asset markets determines how easily households can realize their losses (or gains), and how they can borrow in order to continue consumption spending. Households that are not liquidity-constrained may continue to spend if they perceive the fall in share prices as temporary but reduce spending if the decline is perceived as permanent. Last, but not least, the confidence effect may also affect spending. The IMF estimates the marginal propensity to consume out of equity wealth at 4 ¼ cents per dollar in the United States and the United Kingdom and 1 cent in the euro area and Japan (See Chapter II of the April 2002 World Economic Outlook). According to these estimates, if the fall in equity prices between end-March 2002 and early September 2002 (around 30 percent in the euro area and around 20 percent in the United States and the United Kingdom) were to be sustained, it would reduce private consumption in the euro area by ¼ percent and in the United States and the United Kingdom by 1 percent. The Fed estimates an adverse wealth effect of 1 to 1½ percent on US private consumption in 2002. But other sources of private wealth should also be considered. For example, in some countries like the United States, the United Kingdom, France and the Netherlands, the increase in house prices in recent years has offset to some extent the effect of declining equity prices. But where house prices are falling, the overall negative wealth effect is larger. According to the IMF, house prices have declined in Germany, but the sources are unclear – there are no official statistics.

A fall in share prices also affects investment by making equity financing of fixed investment more expensive. The size of this effect depends on the share of equity financing in total investment financing, which is currently relatively low in most European countries.

Sharp falls in equity prices may also have a negative impact on credit markets as banks will become more cautious in providing loans to firms with a lower market value. In addition, the decline of stock prices also reduces the capital base of banks. The size of these effects is difficult to estimate, however.

Given all these uncertainties it is difficult to quantify the overall wealth effect on the real economy. Should the link between financial conditions and the real economy have strengthened in recent years, then earlier estimates based on longer-run relationships may underestimate this effect in the current circumstances, in particular, as this shock affects all major regions of the world economy at the same time.

- The reversal of the stock cycle was also less pronounced in the euro area than in the United States, which explains about one-third of the lower output growth.[11]
- Business investment continued to fall in Europe as well as in the United States, although the decline was less pronounced in Europe. In the United States the preceding investment boom, in particular spending on ICT equipment, had led to a larger overhang of capital stock than in Europe so that its unwinding was also sharper (for the contribution of domestic demand to quarterly GDP growth see Figure 1.9).

[11] In 2002 the contribution of stockbuilding to GDP growth was 0.1 percentage points in the euro area and 0.6 percentage points in the United States. Thus about one-third of the growth differential between the euro area and the United States can be attributed to the sharper reversal of the stock cycle.

At the beginning of 2003 there is still much uncertainty as to if and when the European economy will achieve a sustained recovery. This will to some extent depend on external factors, in particular on the growth of the global economy, which in turn also depends on how the geopolitical situation evolves and on how macro-policies and structural policies are pursued in Europe.

2. Economic outlook 2003: Gradual recovery in the world economy and in Europe

2.1 The global economy

In 2003, after spring, we expect the world economy to pick up again, although growth will remain moderate. This is based on the following assumptions:

- The uncertainties with respect to a war in Iraq will decline during the forecasting period. This assumption is in line with a scenario without a war and successful weapons inspections but also with a scenario with a relatively short military attack. With other scenarios, such as a longer war, increased geopolitical instability and possibly continued large-scale terrorist attacks, the outlook for the world economy and for Europe would be weaker than assumed here (see below).
- Oil prices are assumed to remain relatively high until Spring 2003 and then to decline somewhat thereafter as geopolitical conditions improve. (In a more pessimistic scenario with more instability in the Middle East, oil prices will remain higher).
- The recovery in the United States, which became more fragile during 2002 when the fiscal stimulus weakened and uncertainties increased, will continue at a moderate pace. While monetary conditions will continue to stimulate demand, the fiscal stimulus will wane. Relatively strong productivity growth will improve corporate profits and real wages. Real income of private households will be further boosted by a gradual improvement in employment. But part of this increase is expected to be saved as debt levels of households are high, financial wealth has fallen with declining share prices, and expected future occupational pensions have declined. Thus private consumption is likely to increase somewhat less than in 2002. Business investment is expected to recover also as capacity utilisation rises and profit expectations improve. Output growth is assumed to average 2.7 percent in 2003 after 2.3 percent in 2002.[12]
- While the projected recovery in the United States will remain more modest than in earlier upturns, it will nonetheless help world economic recovery. In Japan, output will – after two years of negative growth – increase gradually. The recovery in the United States will help Latin America to get out of recession and will also help emerging economies in East Asia to continue growing at a pace (of 4 to 5 percent) which is higher than in other emerging economies such as those in Eastern Europe which are expected to remain on their current (average) growth trend (of around 3 percent).
- World trade is expected to increase by around 6 percent in real terms in 2003, compared to around 3 percent in 2002.

Although the following forecast for the European economy is based on these relatively favourable assumptions, there remain important downside risks with respect to the world economy. Firstly, the US current account deficit remains high so that the foreign indebtedness of the United States increases unabated. This could trigger sharp exchange rate movements with the dollar depreciating rapidly and the euro and the yen appreciating. The effect would be to erode the price competitiveness of European exporters ending an export-led recovery in Europe. Secondly, given the high indebtedness of private households in the United States, savings could increase more than assumed so that consumption and domestic demand would rise less. Lastly, new terrorist attacks and/or military action in the Middle East could push up the oil price and reduce business and consumer confidence and equity prices. Clearly, on such negative assumptions growth in the United States, in the world economy and in Europe would be lower than projected here. Yet, given the uncertainties surrounding these assumptions we shall not attempt to draw up alternative scenarios, but rather present in the following a forecast based on a gradual recovery of the world economy and a stabilisation of oil prices and equity markets.

2.2 The European economy in 2003

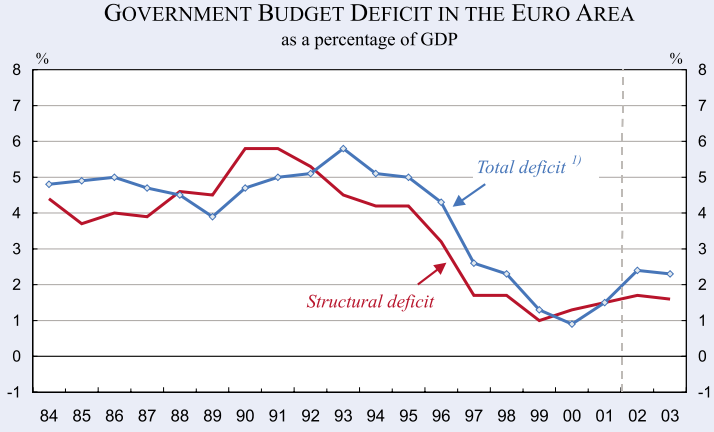
Policy assumptions

Given the continued weakness of demand and some (although small) deceleration in inflation, the ECB is assumed to keep interest rates low during 2003. We also assume no sharp appreciation of the euro against the US dollar so that *monetary conditions* will remain broadly unchanged.[13] Furthermore, we assume that equity markets will stabilise, so that the losses in equity wealth will not

[12] The government has announced a new plan to cut taxes. Part of the program is to speed up tax cuts which were already included in the 2001 tax package but phased in gradually over the next years. The main measures are reducing the top marginal income tax rates from the current 38.6 percent to 35 percent, excluding dividends from taxation at the individual level, increasing child-tax credits, adjusting the tax code so that married couples pay not more income tax than singles living together (with similar income), and broadening the lowest (10 percent) income tax bracket to include more people. Altogether it is estimated that these measures would amount to $ 98 billion or about 1 per cent of GDP in 2003. The forecast assumes that most of the proposed measures will pass Congress but that the effect on real GDP in 2003 will be very limited (not more than 1/4 percentage point).

[13] This should be interpreted as a technical assumption and lies somewhere between two alternatives . The first is that the euro will appreciate sharply, driven by higher demand for currency in circulation and the portfolio effects (which have to some extent explained the weakness of the euro before the cash changeover) and a significant weakening of the dollar as a response to the high US current account deficit. A second, opposite assumption would be that the euro weakens again against the dollar as economic growth in the United States continues to be higher than in Europe. The various effects on the euro exchange rate were examined in detail in Chapter 2 of last year's report.

Figure 1.10



1) Excluding one-off revenues from the sale of the mobile telephone licenses in 2000.
Sources: OECD, estimates and forecast by the Ifo Institute (December 2002).

increase further but will start to diminish during 2003.

The stance of *fiscal policy* in the euro area is assumed to be marginally restrictive as the structural deficit declines by around 0.2 percentage points of GDP (Figure 1.10). Consolidation efforts differ, however, quite substantially among countries. For example, Germany has taken measures to reduce the deficit in order to prevent sanction payments; in 2002 the deficit had exceeded the 3 percent ceiling of the Treaty of Maastricht. In Portugal, where the deficit had already exceeded 4 percent in 2001 and had decreased to 4 percent in 2002, the government is also aiming to reduce it further in order to avoid sanctions. Italy, which also has a relatively high deficit, is also assumed to make efforts to reduce it. But in France, where the deficit was just below the 3 percent ceiling in 2002, it may not decline in 2003 as the government seems to be giving a higher priority to tax reductions. Most other countries in the euro area have reached fiscal positions in line with the "close to balance or in surplus" rule but are also aiming at further improvement.

Supply conditions

Future economic growth is affected by the evolution of supply and demand conditions. If the factors, that are currently restraining demand, dissipate there is a natural tendency for actual output to gradually approach potential output so that actual growth would be higher than potential or (trend) growth until the output gap is eliminated. Some of the factors which currently constrain demand will continue to exist in 2003, although they may become weaker.

In the 1990s, potential output growth in the euro area averaged around 2½ percent per year, but currently it may be only a little over 2 percent. One reason for this decline is slower growth in capital-labour ratios (that is a smaller capital deepening effect).

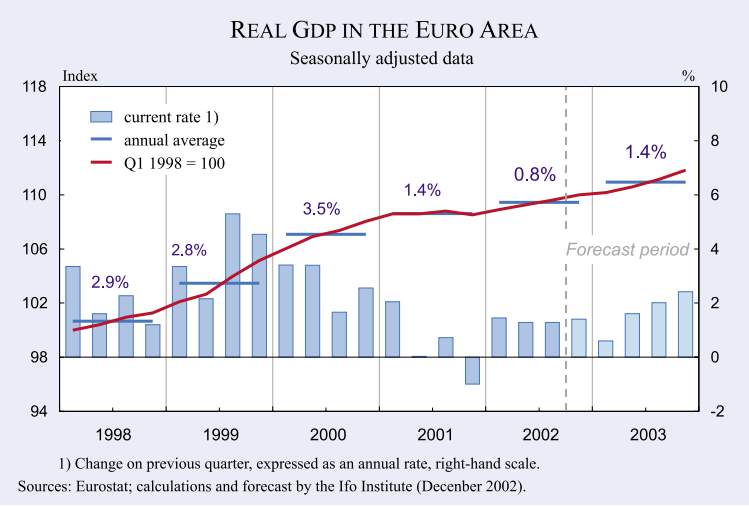
There is great uncertainty about the future growth of labour productivity and multi-factor productivity (MFP) which depend among other things on current and future investment activity as well as on the spread of new technologies. While the relatively low level of real long-term interest rates should support investment, falling share prices have increased the cost of equity financing in general and in the high-tech sector in particular. Furthermore, as the capital base of banks has declined, they may have become more prudent in providing loans to firms. Although some cyclical recovery of investment is expected, it is unlikely that it will suffice to raise the growth of potential output in the near future.

As was shown in last year's report, Europe's lower growth in past years relative to that of the United States can, to a large extent, be attributed to lower labour utilisation in Europe. Hence, another major way to raise the output path would be to increase labour input by reducing structural employment and increasing labour market participation. Reducing obstacles to a fuller use of the potential labour force could raise Europe's output path and thus remains an important policy challenge. While some European countries (inside and outside the euro area) have implemented major reforms in labour and product markets and have managed to increase labour utilisation, others have made less progress. More recently, additional reforms have been undertaken in some countries or will be implemented soon (as for example the so-called Hartz proposals in Germany).[14] We do not, however, expect these reforms to have a significant effect on the medium-term growth path in these countries or in the European economy as a whole

[14] In Germany, the new measures aim mainly to improve job-seeking arrangements and to tighten unemployment benefits for those who are reluctant to accept job offers (see Appendix 2).

because these reforms are incomplete and a number of disincentives to job creation continue to exist. There is even a risk that the pressure to reduce government deficits will lead to further increases in the already high tax burden on labour in some countries, making it even more difficult to raise employment.

Figure 1.11



Given these conditions on the supply side, we do not expect growth of potential output in the euro area to change significantly in the near future. Potential growth may even continue to decline in some countries.

Development of demand components in the euro area

Given the weakness of the world economy, export markets have been depressed. Furthermore, in 2002 the effective nominal exchange rate of the euro appreciated on average by 2¾ percent, reducing the price competitiveness of firms. During the course of 2003 the gradual recovery of the world economy should help *exports* to recover. Trade with Eastern European countries, which has gained in importance in recent years, will intensify further. On average, exports are expected to increase by 4.5 percent in 2003, following near stagnation in 2002 and increases of around 2½ percent and around 12 percent in 2001 and 2000 respectively.

Private consumption is expected to recover. But this will depend very much on our general assumptions that the geopolitical situation will improve and that stock markets will stabilise, boosting consumer confidence. Consumer spending will also be supported by somewhat higher real wage growth and improved labour market expectations. Private consumption will increase on average by 1.5 percent in 2003 after 0.6 percent in 2002.

With the improvement in export markets and the end of stock market turbulence the recent decline in *investment* will come to an end. With low capacity utilisation there is no need to enlarge the capital stock but, given weak investment over the past two years, there is mounting pressure to modernise the capital stock. In some countries (as in Germany) construction will get some temporary stimulus from additional spending to repair the damages caused by the floods of August 2002.[15] Total investment in the euro area is expected to increase by 0.5 percent in 2003, after a decline by more than 2 percent in 2002.

Growth, employment and inflation

Forward-looking indicators, such as business confidence and order inflows, are not pointing to a quick economic recovery of the European economy in the near term. Nonetheless, the assumed improvements in the geopolitical situation during 2003, the recovery in the world economy and the overall favourable monetary conditions should help the European economy to recover gradually. On average, output is expected to increase by 1.4 percent in 2003, following 0.8 percent in 2002 (Figure 1.11). However, growth will remain below trend (which is currently estimated at slightly above 2 percent) for the third consecutive year, the output gap will be larger than in 2002 (Table 1.1), and growth will also remain lower than in the United States (Figure 1.12). However, during the course of the year cyclical conditions will gradually improve.

The recovery in output growth will not prevent a further increase of the unemployment rate in 2003. This is because, during the past downturn, firms in the euro area have typically followed a strategy of labour hoarding which depressed productivity.

[15] It was originally estimated that in Germany repairing the damages would induce additional (public and private) spending of €13.5 billion (or 0.4 percent of GDP) from the second half of 2002 until the end of 2003. This additional spending is expected to increase public construction output by 4–5 percent in 2003, compared to a decline in 2002 and 2001 (by 3½ percent and 6 percent respectively). More recently the estimates of total repair costs have been revised downwards to almost half of the original estimate.

Table 1.1

Output gaps in the euro area

1991	0.5
1992	0.9
1993	– 1.1
1994	– 0.3
1995	0.1
1996	– 0.5
1997	– 0.5
1998	– 0.2
1999	0.1
2000	1.3
2001	0.7
2002[a)]	– 0.3
2003[b)]	– 0.6

[a)] Estimate by the Ifo Institute. – [b)] Forecast by the Ifo Institute.

Source: Eurostat, Calculations by the Ifo Institute.

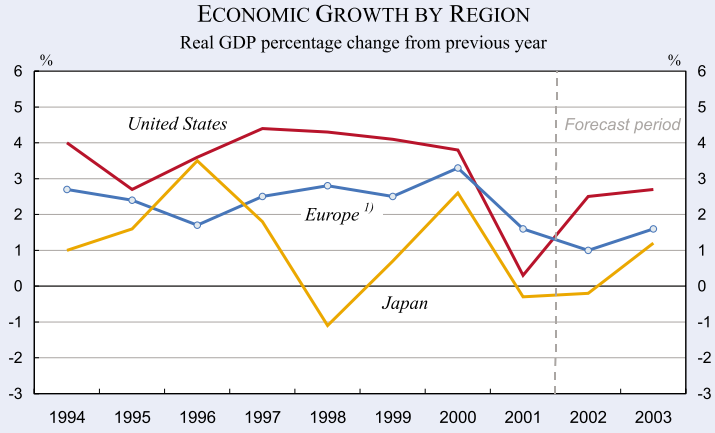
They can, therefore, produce a good part of the higher output with the existing labour force. Thus, employment will start rising gradually in autumn and on average the unemployment rate is likely to increase to 8½ percent. Structural reforms of the labour market will be implemented in some countries, like Germany, but are not expected to significantly change labour market conditions (Figures 1.13 and 1.14).

The inflation rate (as measured by the harmonised consumer price index) will decline from 2.2 percent in 2002 to 1.9 percent in 2003. This is based on the assumption that after spring oil prices will decline again and that wage agreements will be more modest than in 2002 as prices will rise slightly less, and income taxes will be reduced further in some countries.

A more pessimistic scenario

The above forecast takes a relatively sanguine view of the short-term conjuncture. But serious concerns about both the short-term and the medium-term outlook arise from two sources. There is greater uncertainty about the geopolitical situation than at any time since the end of the Cold War, and perhaps longer. The forecast assumes that war with Iraq will be averted, or that if it occurs it will be short in duration and decisive in outcome, and that sentiment will not be substantially affected by the prospect or reality of further major terrorist attacks. Almost all the risks of this scenario are on the downside. The legacy of the long American boom and the resulting stock market bubble have created structural imbalances in the world economy which cannot be sustained over the longer term. As asset prices rose, personal savings in the United States collapsed, and the trade and current account deficits widened. Believing themselves to be much richer in future, Americans borrowed from the rest of the world to finance a boom in both domestic consumption and investment. Higher investment has helped to sustain productivity growth, but investment has recently declined while consumption has re-

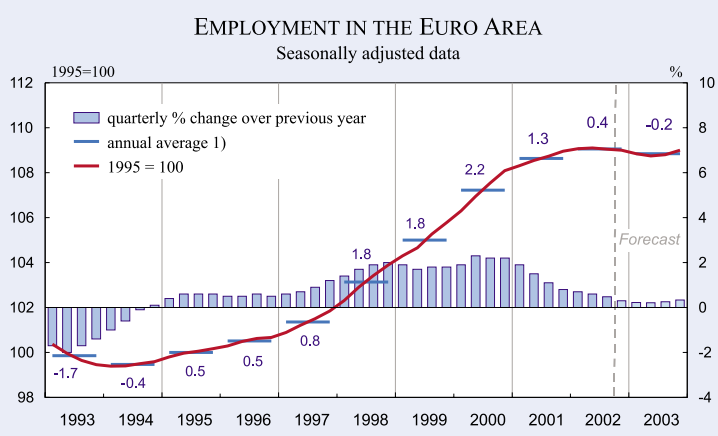
Figure 1.12



1) Western and Central Europe.

Sources: OECD, calculations and forecast by the Ifo Institute (December 2002).

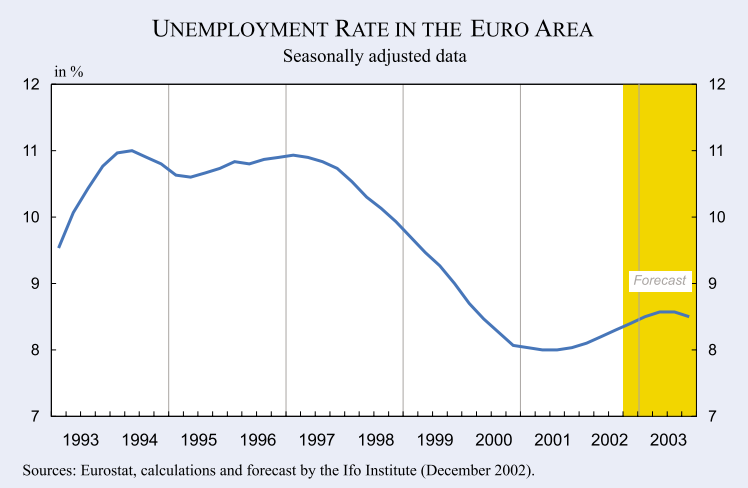
Figure 1.13



1) Figures: annual % change against previous year.

Sources: Eurostat, calculations and forecast by the Ifo Institute (December 2002).

Figure 1.14



Sources: Eurostat, calculations and forecast by the Ifo Institute (December 2002).

Box 1.2

Could Enron happen in Europe?

The collapse of Enron raises the issue of whether similar events could occur in Europe. History does not repeat itself exactly and it is unlikely that identical events will occur even in the United States. Moreover, there are some aspects of the Enron affair – the extreme personal greed of many senior US executives, the acceptance of practices involving strict adherence to the letter but not the substance of accounting standards, and the corruption of some offices of major accounting firms – which are not directly paralleled in Europe.

Still, the events at Credit Lyonnais a decade ago are a reminder that corporate arrogance and overwhelming managerial ambition, combined with disastrous consequences if these are not monitored and controlled, are not only to be found on one side of the Atlantic. And while there are many similarities between these two corporate disasters, the differences are a reminder that European institutional structures are not necessarily better adapted to these problems than those of the United States.

While the problems at Lyonnais emerged only gradually from a process of concealment and cover-up which continues to the present day, the collapse of Enron was immediately followed by judicial and congressional inquiry and action. The transparency of US markets and politics contrasts sharply with European attitudes to similar problems. The costs of the Lyonnais debacle fell almost entirely on French taxpayers, while those resulting from Enron were borne principally by investors (including Enron employees). And the fallout from Enron, including the criminal proceedings which followed, have already had a salutary effect on the behaviour of others. It is more difficult to see equivalent deterrent effects in the European corporate sector, and the rise and fall of Vivendi Universal resembles in many ways a smaller scale version of the earlier experience of other French companies.

The general difference is between informal administrative processes in Europe and judicial and legalistic ones in the United States. This difference has operated to Europe's advantage in the application of accounting standards, but is less effective in handling openly and decisively any emergent issues.

Some European companies have already encountered problems following the bursting of the telecoms and media bubble and it is likely that there is considerably more pain to come in the European financial services sector. It would be wrong to think that Europe has a monopoly of regulatory wisdom, or the United States a monopoly of corporate excess.

mained relatively strong despite the high and rising household debt and the decline in equity prices. Even after recent declines, US stock valuations are still at historically high levels. This strength of consumption, which gives grounds for optimism in the short-term forecast, implies that the required magnitude of these future adjustments will be all the larger. If such adjustments were accompanied by a sharp fall in the dollar exchange rate and a sharp appreciation of the euro, the export-led recovery in Europe, which is predicted here, could come to a sudden end.

Any estimate of the magnitude or timing of these influences is subject to considerable uncertainty. While such adjustment problems may not pose a short-term threat to the European economy, the confidence of business, consumers and financial markets over the next few quarters will depend heavily on how the geopolitical situation in the Middle East evolves. If, for example, because of a war in Iraq, confidence were to fall and oil prices to rise, and growth in the euro area in the first and the second quarters were only half of that predicted here[16] – while growth in the third and fourth quarters were as predicted – then growth in 2003 as a whole would be 1.1 percent rather than 1.4 percent. If, in addition, growth in the third and fourth quarters were also halved (from 2.0 percent to 1.0 percent in the third quarter and from 2.4 percent to 1.2 percent in the fourth quar-

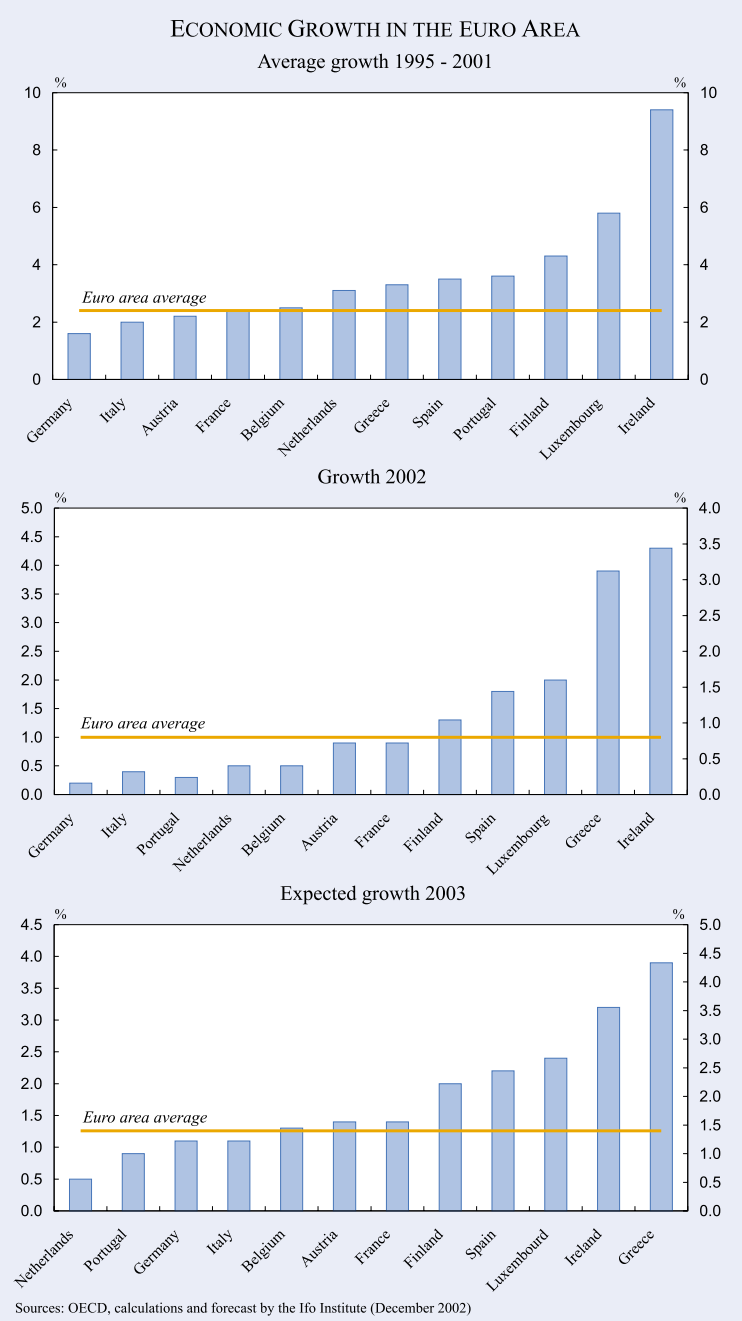
[16] Growth in the first quarter would then be 0.3 percent (annual rate) rather than 0.6 percent and in the second quarter 0.8 percent rather than 1.6 percent.

ter), then growth in 2003 as a whole would only amount to 0.9 percent.

2.3 Development in individual countries of the euro area

The cyclical weakness has reduced growth in all countries in the euro area (and in Europe as a whole), but significant differences in the growth performance continue to exist between countries (Figure 1.15). Many of the countries which had achieved above-average growth between 1995 and 2001 also had, and are expected to have, above-average growth in 2002 and 2003 (Ireland, Luxembourg, Greece, Finland, Spain). But there are a few countries (Netherlands, Belgium, Portugal) which had above-average growth in the past but whose growth declined (or is expected to decline) to below average in 2002 and/or 2003. Two other countries (France and Austria) achieved rates of growth similar to the euro area average both over the medium-term and in 2002, and we expect them to continue to do so in 2003. In two other countries (Germany and Italy), growth performance was below average over the medium-term and in 2002 and is expected to remain below average in 2003.

Figure 1.15



The differences in growth performance between the euro area countries are caused by a number of factors. Some of the countries (such as Ireland and Spain) continue to benefit from relatively favourable supply conditions which are to some extent related to a normal catching-up process (that is a lower starting position of GDP per capita). However, in Ireland and Spain some wage pressure has emerged more recently which could undermine export performance and growth in the medium term. In the case of Ireland domestic demand has been stimulated by a significant easing of fiscal policy.

The Netherlands, Belgium and Portugal, which also recorded above-average growth during recent years, were more affected by the latest cyclical weakening. In these countries the increasing wage pressure has already affected competitiveness and export performance. In addition, households have increased their savings in response to a deteriorating labour market and losses in equity wealth. This effect was particularly marked in the Netherlands,

Table 1.2

Labour costs and productivity in the business sector
Percentage changes

	Compensation per employee			Labour productivity			Unit labour costs		
	Average 1995–2000	2001	2002	Average 1995–2000	2001	2002	Average 1995–2000	2001	2002
Euro area	1.9	2.6	2.9	1.2	– 0.1	0.4	0.7	2.7	2.5
Germany	1.4	1.8	2.1	1.2	0.0	0.8	0.2	1.8	1.3
France	1.4	3.3	3.9	1.2	0.2	1.5	0.2	3.1	2.3
Italy	2.9	2.4	3.0	1.4	0.1	– 1.2	1.5	2.3	4.3
Austria	2.4	4.0	2.2	2.5	0.7	1.5	– 0.1	3.3	0.8
Belgium	2.6	2.8	3.7	2.0	– 1.0	1.3	0.6	3.9	2.3
Finland	3.4	4.9	4.0	2.9	– 0.5	2.3	0.5	5.4	1.7
Greece	8.2	5.2	5.8	2.8	4.9	3.7	5.4	0.2	2.0
Ireland	4.2	7.9	6.5	4.5	3.2	3.1	– 0.3	4.6	3.3
Luxembourg	2.9	5.3	3.2	2.2	– 4.8	– 2.4	0.7	10.6	5.7
Netherlands	2.6	5.0	4.8	1.0	– 0.7	– 0.3	1.6	5.8	5.2
Portugal		6.1	4.0	3.1	0.1	– 0.4	5.6	5.9	4.4
Spain	3.4	4.7	4.1	0.9	0.4	0.6	2.5	4.2	3.5
United States	3.8	2.3	2.5	1.9	0.2	3.8	1.9	2.1	– 1.2

Source: OECD; calculations by the Ifo Institute.

where the fall in share prices reduced the wealth of pension funds which responded by increasing contributions. Thus, private households had to allocate a greater share of income to their savings accounts, which reduced their propensity to consume. In Portugal, domestic demand is currently restrained by a tightening of fiscal policy in response to the significant overshooting of the fiscal deficit target.

The relatively poor growth performance of Germany and Italy since the mid-1990s and during the recent cyclical weakness may be explained both by weaker supply and weaker demand conditions. One reason may be the development of the real effective exchange rate of these countries as compared to the euro area average. The real effective exchange rate (as measured by relative unit labour costs) appreciated significantly in Germany after unification and later declined again, but remained higher than it had been in the early 1990s. In Italy, the real effective exchange rate depreciated significantly in the first half of the 1990s but appreciated in the second half. In the euro area as a whole the real effective exchange rate remained relatively stable in the first half of the 1990s but declined significantly in the second half. Both Germany and Italy lost shares in export markets in the second half of the 1990s. As exporting firms did not fully pass on the higher labour costs in export prices, the losses in export market shares remained limited (Tables 1.2 and 1.3).

Another factor which restrained growth of real income in these countries in recent years were the lower growth in (trend) productivity which was caused by lower capital stock growth (that is less capital deepening) and the low utilization of labour potential. (For a more detailed analysis of structural problems in Germany see Appendix 4, and for further details on the forecasts for the large EU countries Germany, France, Italy and the United Kingdom see Appendix 2 and the forecasting Tables in Appendix 3).

Table 1.3

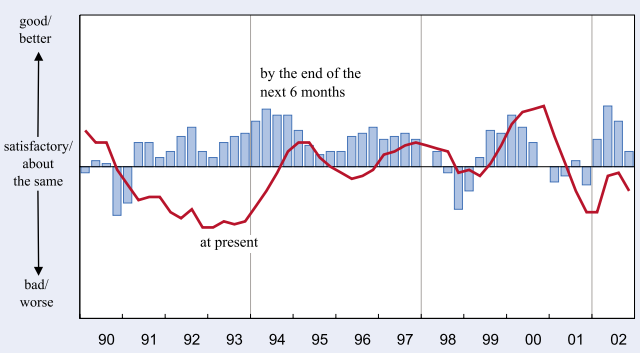
Shares of world exports

	1985	1990	1995	2000	2001
Germany	10.2	12.2	10.5	8.9	9.5
France	5.4	6.3	5.7	4.9	4.9
Italy	4.2	5.0	4.6	3.8	3.9
United Kingdom	5.4	5.4	4.8	4.5	4.5
United States	11.4	11.2	11.0	11.9	11.5
Canada	4.8	3.9	3.9	4.6	4.4
Japan	9.7	8.7	8.9	7.8	6.8
Other OECD countries	19.7	22.3	23.6	23.6	24.3
Total OECD	70.6	75.0	72.9	69.9	69.9
Non-OECD					
Asia	9.9	11.7	16.3	17.7	17.4
Latin America	4.5	3.2	2.9	3.2	3.3
Other non-OECD countries	15.0	10.1	7.9	9.2	9.4
Total of non-OECD countries	29.4	25.0	27.1	30.1	30.1

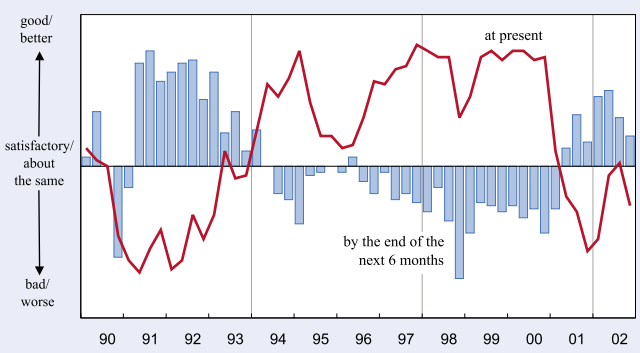
Source: OECD.

Appendix 1:
Ifo World Economic Survey (WES)

WES is a world-wide survey of the Ifo Institute for Economic Research, questioning – on a quarterly basis – more than 1,000 economists of multinational corporations in 90 countries on the present economic situation of the country of residence and its economic prospects by the end of the next six months.



Source: Ifo World Economic Survey (WES).



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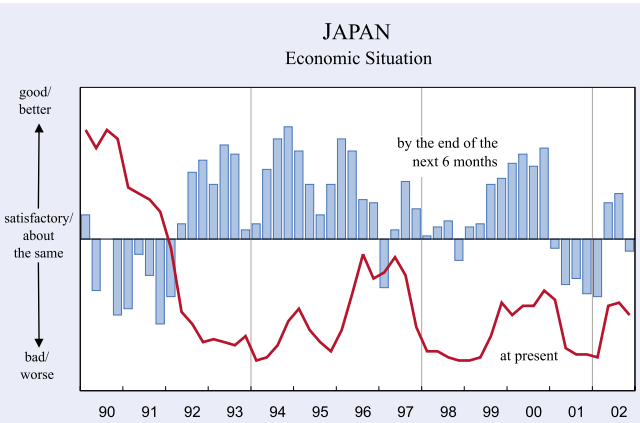

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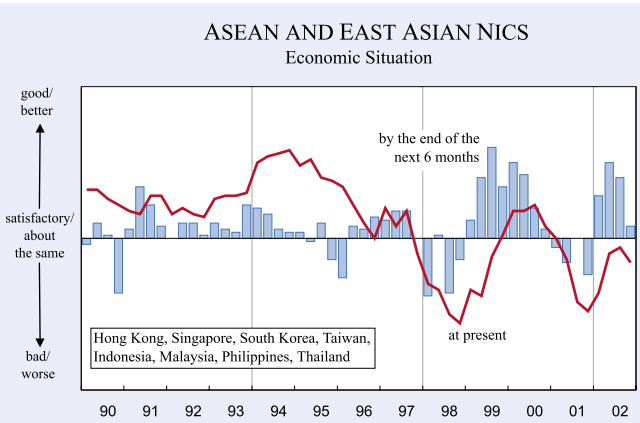

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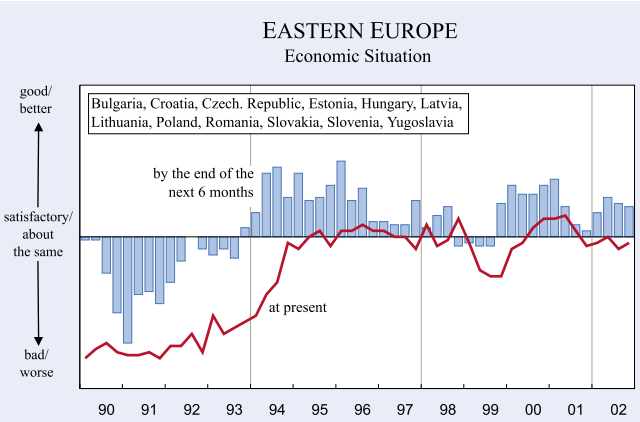

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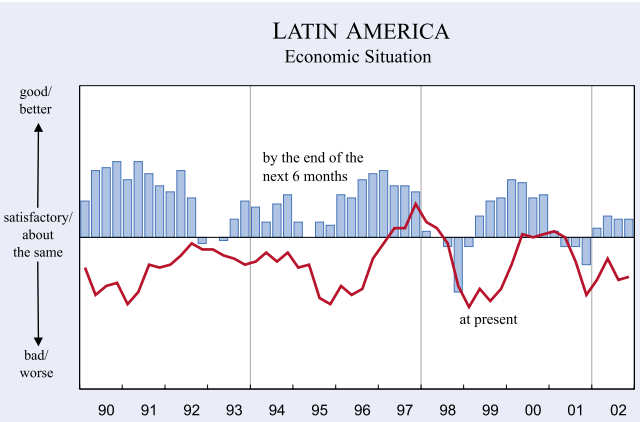

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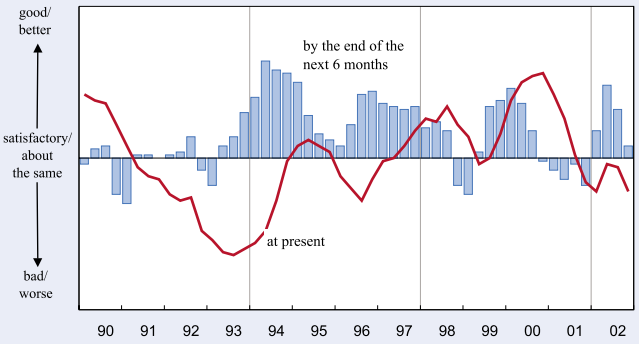
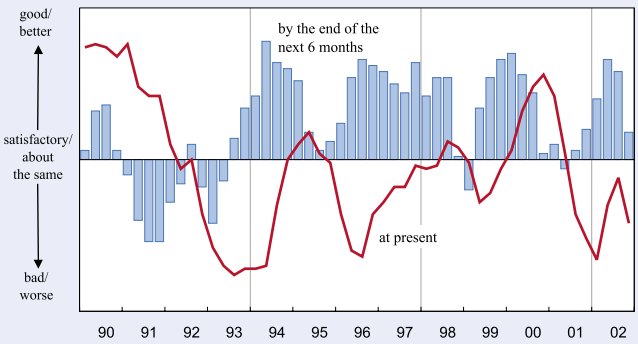
EUROPEAN UNION
Economic Situation



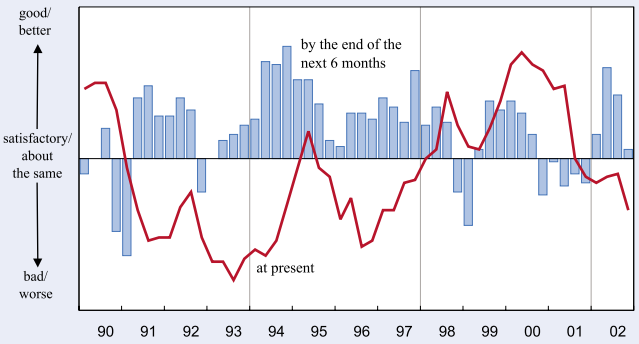
Source: Ifo World Economic Survey (WES).

GERMANY
Economic Situation



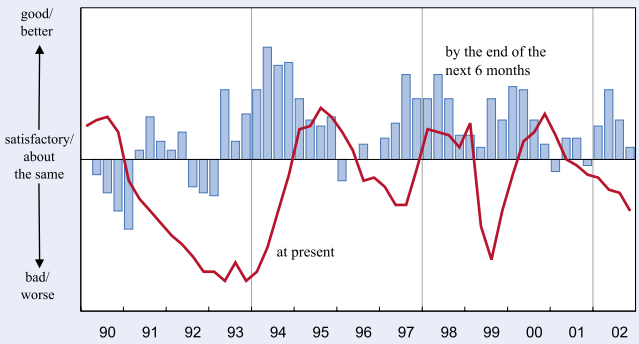
Source: Ifo World Economic Survey (WES).

FRANCE
Economic Situation



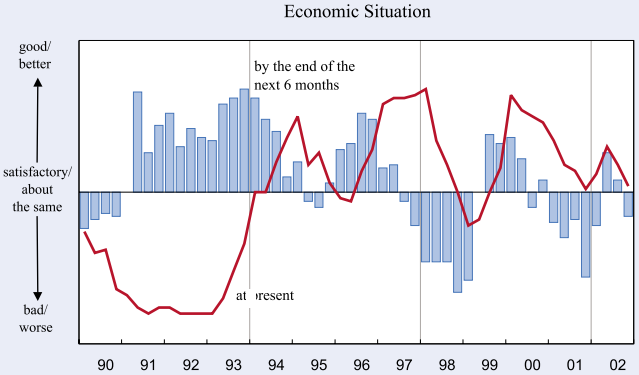
Source: Ifo World Economic Survey (WES).

ITALY
Economic Situation



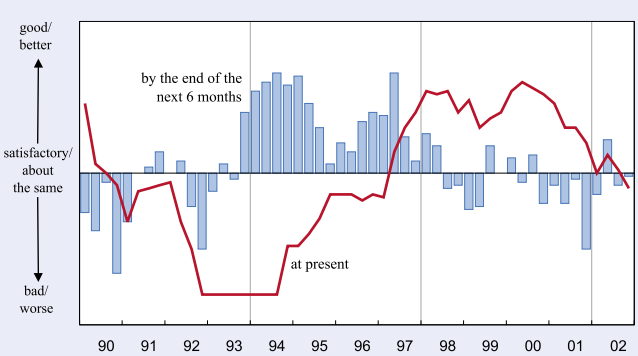
Source: Ifo World Economic Survey (WES).

UNITED KINGDOM
Economic Situation



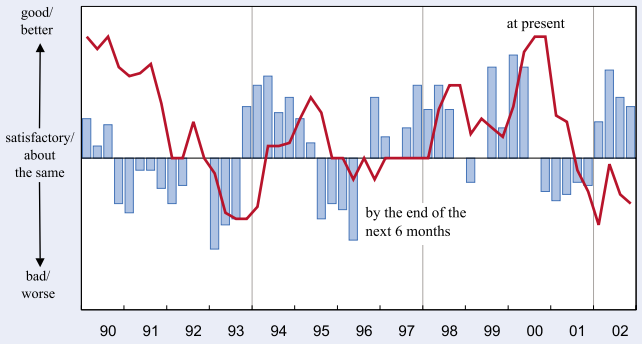
Source: Ifo World Economic Survey (WES).

SPAIN
Economic Situation



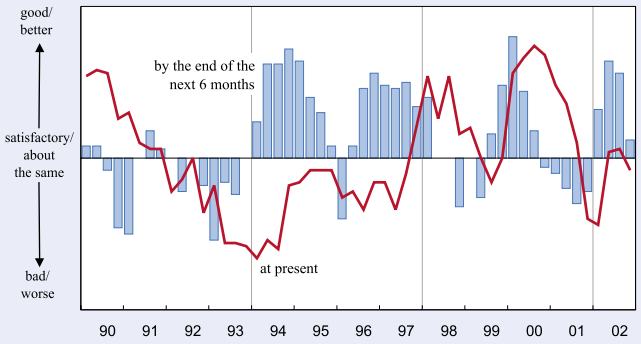
Source: Ifo World Economic Survey (WES).

AUSTRIA
Economic Situation



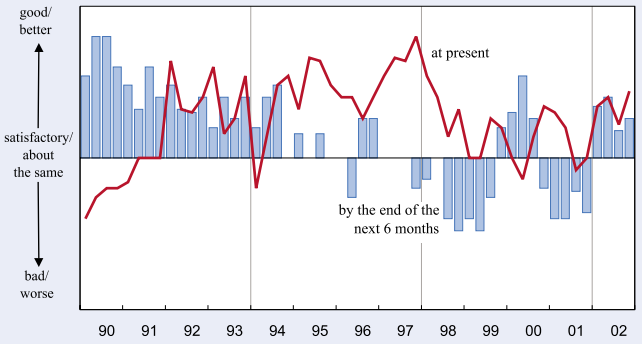
Source: Ifo World Economic Survey (WES).

BELGIUM
Economic Situation



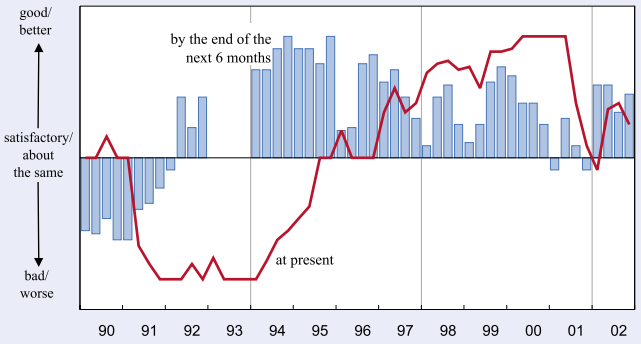
Source: Ifo World Economic Survey (WES).

DENMARK
Economic Situation



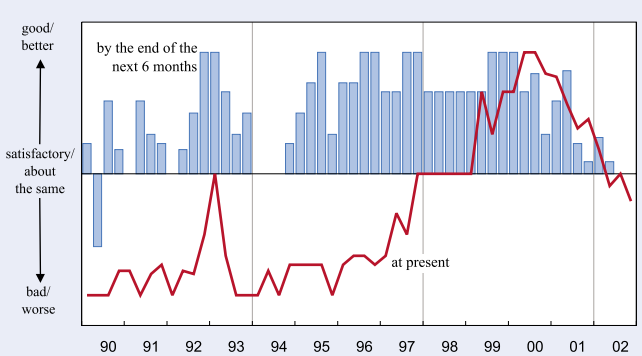
Source: Ifo World Economic Survey (WES).

FINLAND
Economic Situation



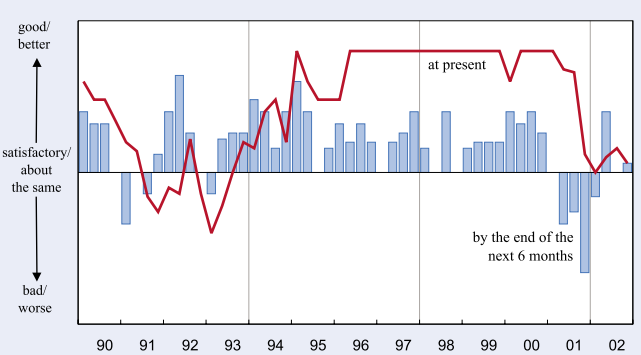
Source: Ifo World Economic Survey (WES).

GREECE
Economic Situation



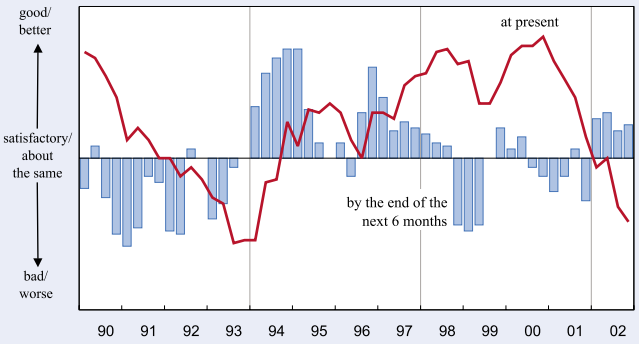
Source: Ifo World Economic Survey (WES).

IRELAND
Economic Situation



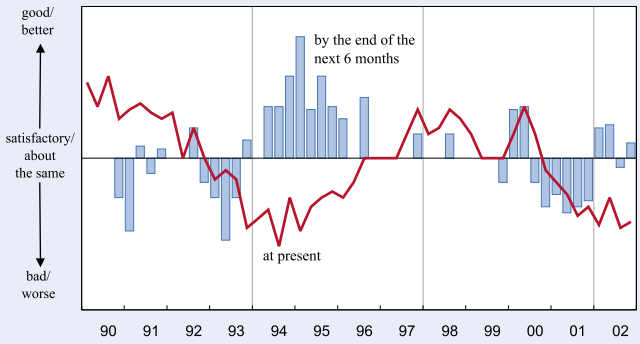
Source: Ifo World Economic Survey (WES).

NETHERLANDS
Economic Situation



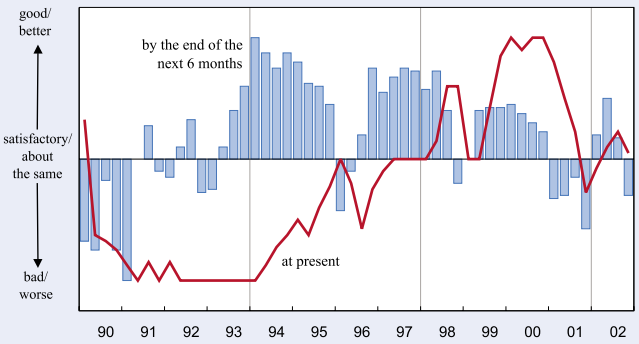
Source: Ifo World Economic Survey (WES).

PORTUGAL
Economic Situation



Source: Ifo World Economic Survey (WES).

SWEDEN
Economic Situation



Source: Ifo World Economic Survey (WES).

Appendix 2:
Country reports

Germany

Economic activity remained relatively weak during 2002. Following the (mild) recession in the second half of 2001, GDP increased again but growth remained significantly below trend, further widening the output gap. The sharp drop in equity prices reduced the financial wealth of households and increased the capital costs of investors. Confidence and economic activity were further reduced by the expectation of a war in Iraq and – related to this – an increase in oil prices. Exports, which had recovered at the beginning of 2002, slowed again as the US economy lost steam and the euro appreciated.

The forecast for 2003 is based on the assumption that wage agreements will – after relatively high wage growth in 2002 – become more moderate again. Fiscal policy will be restrictive as there is much pressure to reduce the deficit. The government is assumed to implement expenditure cuts of about €5 billion, tax increases of €5 billion and to raise social security contributions by €5½ billion (together 0.7 percent of GDP).

The German economy is expected to recover gradually during 2003. The driving forces are exports, which will benefit from the recovery of world trade, although the appreciation of the euro will have a dampening effect. The assumed stabilisation of stock markets and normalisation of the geopolitical situation will also help consumer and business confidence to recover. Under such circumstances the expansionary stance of monetary policy will become more effective than hitherto. On the other hand, fiscal policy will constrain demand. Despite a relatively low increase in consumer prices (+ 1.3 percent), private consumption is expected to increase only moderately (by 0.8 percent) as taxes are increased. Construction investment is supported by the need to repair the flood damages of last August; these costs may amount to €9.2 billion.

GDP is expected to increase by 1.1 percent in 2003 after 0.2 percent in 2002. In the eastern part of Germany GDP growth will be slightly higher (1.3 percent) than in the western part (1.0 percent) because of the repair of the flood damages.

The labour market will deteriorate further, employment will continue to fall and unemployment to rise until summer, but during the second half of the year labour market conditions are expected to improve somewhat as growth accelerates.

The general government budget deficit, which amounted to 3.7 percent in 2002, is expected to decline to 2.8 percent in 2003 as significant consolidation measures are implemented both on the expenditure and on the revenue side.

Germany
Key forecast figures

	2001	2002	2003
	Percentage change over previous year		
Real gross domestic product	0.6	0.2	1.1
Private consumption	1.5	– 0.5	0.8
Government consumption	0.8	1.5	0.6
Gross fixed capital formation	– 5.3	– 6.4	– 0.2
of which equipment	– 4.4	– 6.9	1.8
construction	– 6.0	– 5.9	– 1.8
Exports	5.0	2.9	4.7
Imports	1.0	– 1.3	4.2
Net exports of goods and services[a)]	1.4	1.5	0.4
Consumer prices[b)]	2.4	1.3	1.3
	Percentage of nominal gross domestic product		
Current account balance	0.2	2.0	2.5
Government financial balance[c)]	– 2.8	– 3.7	– 2.8
	Percentage of employees		
Unemployment rate[d)]	7.7	8.2	8.5

[a)] Change over the previous year in % of the real gross domestic product of the previous year. – [b)] Harmonised consumer price index. – [c)] Excluding extra income from sales of mobile phone licences. – [d)] Standardised.

Source: Information of national and international institutions; calculations and estimates of the Ifo Institute; 2002 and 2003: forecast by the Ifo Institute.

Labour market reform in Germany

Following the 2002 elections, the German government has now embarked on a series of reforms in the area of labour market policies. Proposals were made by the so-called "Hartz Commission" representing social partners, chaired by *Volkswagen* human resource manager Peter Hartz (cf. the final report prepared by *Kommission "Moderne Dienstleistungen am Arbeitsmarkt",* 2002). The reforms enacted so far mainly affect the way public employment services are operated but also redefine the fiscal and regulatory framework for some "non-standard" forms of employment. The main elements are:

- *Establishing Job Centres:* Building on a number of international models, all kinds of services for individuals seeking employment (administration of benefits, counselling, job placement) will now be provided by "one-stop" agencies. The new Job Centres aim at a quick re-entry into employment, making use of an early profiling of job seekers and giving them extended access to training programmes. At the same time, requirements regarding active job search, availability for work, and acceptance of working conditions in a new job are tightened.
- *Reforming benefits for job seekers:* All types of benefits open to job seekers are to be integrated in a comprehensive system encompassing insurance benefits (*Arbeitslosengeld* paid for 12 to 32 months, depending on the age of beneficiaries) plus extended welfare benefits with unlimited duration – formerly: unemployment assistance *(Arbeitslosenhilfe)* and social assistance *(Sozialhilfe),* in the future: *Arbeitslosengeld II* – for those whose contributory entitlements have expired. Introducing stricter time limits as well as reducing the level of benefits, in general or over time, has been discussed but in the end was explicitly rejected. Instead, stronger sanctions shall be imposed on those violating work requirements.
- *Stimulating low-pay employment:* Conditions for employment at low pay are modified in two ways. Jobs with wages less than 400 euro a month are subjected to a simplified scheme of raising taxes and social security contributions (with 25 percent of gross wages as the total burden, irrespective of other income earned by the job-holder; 12 percent in cases where private households act as employers). For employees earning between 400 and 800 euro a month as their total income, social security contributions are phased in gradually in order to avoid erratic tax spikes at the 400 euro threshold. Alternatively, former recipients of unemployment benefits or former participants of public employment programmes are entitled to receive subsidies (worth 50 percent of their unemployment pay for the first year, to be reduced to 0 percent over a period of three years) when entering self-employment with low income (less than 25,000 euro a year) and with no employees other than family members. In order to promote self-employment in general, the government is also considering the definition of a favourable tax treatment for all existing small businesses.
- *Reforming temporary work through Staff Leasing Agencies:* Public employment services are to be supported by (non-profit) staff leasing agencies in their attempts to place job seekers in the regular labour market. Accepting to work for these agencies can be made one of the requirements job seekers have to fulfil. Wages paid for these jobs can be subsidised (levels of subsidisation and time limits still to be defined) such that the wage costs for businesses effectively employing these individuals are substantially lower than with regular employment. A recent agreement between government and trade unions states that, unless there is a special collective wage agreement for *all* kinds of staff leasing agencies to be defined in 2003, the (non-subsidised) level of wages in this sector should be equal to current negotiated wages that are relevant for the branch of industry of effective employers. Chances are that this will not only make it difficult, or costly, to use temporary work as a strategy for placing job seekers in the labour market, but may also create an obstacle for the activities of existing (private, profit-oriented) agencies.
- *Improving integration of younger and older workers:* New efforts will be made to integrate young people in the labour market through special training programmes. At the same time, a number of incentives are introduced for firms hiring unemployed individuals aged 52 or older (reductions of social insurance contributions, more flexibility for making temporary contracts). Older workers accepting a new job at lower pay than with earlier positions will be compensated for part of their reduced net wages and pension benefits.

There is broad consensus among economists that the impact of the reforms enacted so far will be limited (cf., for instance, the latest consensus forecast of the leading Economic Research Institutes, or the annual report of the Council of Economic Advisors, *Sachverständigenrat,* 2002). While the introduction of Job Centres and the attempts to re-organise public employment services is generally accepted to be a step in the right direction, most other elements of the "Hartz proposals" are not expected to create incentives for both labour supply and demand suited to reduce the current level of structural unemployment significantly.

References:

Kommission "Moderne Dienstleistungen am Arbeitsmarkt" (Hartz commission, 2002), Moderne Dienstleistungen am Arbeitsmarkt (Final report), mimeo, Berlin; "Die Lage der Weltwirtschaft und der deutschen Wirtschaft im Herbst 2002 (Joint institutes forecast, Fall 2002)", in: ifo Schnelldienst, Vol. 55, Issue 20/2002, pp. 3–50; *Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung* (Council of Economic Advisors, 2002), Jahresgutachten 2002/03: Zwanzig Punkte für Beschäftigung und Wachstum (Annual report 2002/03), mimeo, Wiesbaden.

France

In 2002 the economic start was rather promising. Economic activity accelerated during the first half of the year, stimulated by economic policy and rising exports. Industrial and consumer confidence improved. But after the summer the upturn lost momentum, although fiscal policy remained expansionary. Real GDP increased by roughly 1 percent in 2002 as a whole. Private consumption was the main driving force, stimulated by rising real wages; this was in contrast to the situation in Germany and Italy where private consumption declined. Export expectations, consumer confidence and the business climate in the construction sector continued to deteriorate during the year. Employment started to decline and unemployment increased. The increase in consumer prices (HCPI) remained roughly stable (slightly below 2 percent).

In 2003 economic policy will be somewhat less expansionary than in 2002. The deterioration of the public finances will be brought to a halt in the course of the year if the authorities manage to put a tighter control on expenditures in line with the recovery of the economy. But even in this case the public deficit is likely to rise from 2¾ percent to about 3 percent of GDP. Monetary policy will be less expansionary than in 2002 since the main impact of the December 2002 ECB rate cut will not be felt until Autumn 2003. The appreciation of the euro vis-à-vis the US dollar in 2002 and a further more moderate appreciation during 2003 will dampen exports. Wage increases can be expected to slow down somewhat in nominal terms.

Real GDP is expected to increase by 1½ percent in 2003. The recovery of the world economy in the course of the year will support business confidence, exports and investment. But given the appreciation of the euro and the ongoing consolidation of the balance sheets of highly indebted firms and the low capacity utilisation of manufacturing industry, the recovery of exports and business investment will remain moderate. The increase in public investment as well as residential construction will also remain subdued. Although employment will stagnate at the 2002 level and will only slightly increase towards the end of the year, private consumption will remain relatively buoyant. Real disposable income will be supported by increasing real wages and income tax reductions which were implemented in the last quarter of 2002 and will continue in 2003. Furthermore, the different levels of minimum wages will be harmonised towards the upper bracket of these categories. Public consumption, which increased significantly in 2002, will be dampened by fiscal consolidation measures. The unemployment rate will rise to about 9¼ percent on average also due to intense rationalisation efforts. Inflation will remain moderate with consumer prices (HCPI) increasing by 1½ percent.

France
Key forecast figures

	2000	2001	2002 (1)	2003 (1)
Percentage change over previous year[a]				
Private consumption	2.5	2.6	1.6	1.4
Public consumption	2.7	2.5	3.3	2.3
Gross fixed capital formation	7.7	2.3	0.0	1.1
Domestic demand	4.0	1.7	1.1	1.5
Exports of goods and services	12.7	0.5	0.2	4.1
Imports of goods and services	14.3	0.1	0.3	4.7
Gross domestic product (GDP)	3.8	1.8	0.9	1.4
Unemployment rate[b] (in %)	9.3	8.5	8.9	9.2
Consumer prices[c] (% change on the previous year)	1.8	1.8	1.9	1.6
General government financial balance[d] in % of GDP[e]	– 1.3	– 1.5	– 2.7	– 3.0

(1) Forecast by the Ifo Institute. – [a] At 1995 prices. – [b] Unemployment as a % of labour force (employed and unemployed). – [c] Price index for the cost of living of all private households. – [d] On national accounts definition (ESA 1995). – [e] In 2000 without revenues from the auction of UMTS licenses.

Source: Eurostat, National Statistical Office, calculations by the Ifo Institute.

Italy

From mid-2001 until the end of 2002 the Italian economy was close to stagnation. Real GDP increased by less than 1/2 percent in 2002. The disappointing development of private consumption contributed considerably to this meagre result, declining somewhat against 2001 although real disposable income increased by about 1 percent. Growing uncertainties about the international economy, difficulties of big firms like FIAT and losses of financial wealth by private households who – among others – had bought Argentinian bonds on a large scale, may be some of the explanations. Machinery and equipment investment declined sharply. The investment incentive "Tremonti bis" has not produced remarkable effects so far, whereas a similar programme in the mid-1990s had stimulated investment. Exports also declined. Only public consumption and (involuntary) stockbuilding contributed to aggregate demand growth. Nevertheless, employment continued to increase, mainly as the result of more part-time jobs – and the unemployment rate declined to 9 percent on average. Following a significant hike during the early months of the year, prices remained stable over a couple of months but picked up again in autumn; the CPI (HCPI) exceeded the level of 2001 by 2 1/2 percent.

Economic policy is likely to be neutral or will only marginally stimulate the economy in 2003. The impact of monetary policy remains expansionary. Fiscal policy will be broadly neutral. While the 2003 budget is aiming at consolidation, there are no large cuts in expenditure and a reduction in the income tax, although the scale of this reduction is unclear. The appreciation of the euro will be a dampening factor. Hourly wages are assumed to continue rising by about 3 percent.

Real GDP is expected to increase by somewhat more than 1 percent in 2003. The assumed gradual recovery of the world economy will stimulate exports and investment. Private consumption is assumed to recover. Despite a further spread of part-time jobs, employment is likely to grow only moderately as firms continue to rationalise and the public sector is very hesitant about hiring new staff. The unemployment rate is expected to rise a little to more than 9 percent on average. Consumer prises (HCPI) will rise by about 2 1/2 percent.

Italy
Key forecast figures

	2000	2001	2002 (1)	2003 (1)
Percentage change over previous year[a]				
Private consumption	2.7	1.1	1.0	1.1
Public consumption	1.7	2.2	1.3	1.1
Gross fixed capital formation	6.5	2.4	– 2.3	1.7
Domestic demand	2.1	1.6	0.4	1.2
Exports of goods and services	11.7	0.8	– 1.2	4.5
Imports of goods and services	4.3	1.4	– 0.5	5.0
Gross domestic product (GDP)	2.9	1.8	0.4	1.1
Unemployment rate[b] (in %)	10.4	9.4	9.1	9.2
Consumer prices[c] (% change on the previous year)	2.6	2.3	2.6	2.2
General government financial balance[d] in % of GDP[e]	– 1.7	– 2.2	– 2.7	– 2.8

(1) Forecast by the Ifo Institute. – [a] At 1995 prices. – [b] Unemployment as a % of labour force (employed and unemployed). – [c] Price index for the cost of living of all private households. – [d] On national accounts definition (ESA 1995). – [e] In 2000 without revenues from the auction of UMTS licenses.

Source: Eurostat, National Statistical Office, calculations by the Ifo Institute.

United Kingdom

With real GDP increasing by almost 1½ percent in 2002, the British economy performed better than the average of the Western European countries. Nevertheless, the upswing was very short, losing momentum in the second half of the year. Since 1996, private consumption, the main driving force of economic growth, has continued to rise almost unabated; it was stimulated by rapidly rising real disposable income and house prices which helped to compensate for stock market losses. Employment continued to rise and wage increases remained high while inflation was relatively low. The savings rate continued to decline. Public consumption picked up considerably due to a medium-term programme to improve the public infrastructure. Exports declined somewhat, reflecting the weakness in world trade and the still overvalued pound sterling. While private non-residential investment declined sharply, residential construction recovered impressively, supported by soaring house prices. Employment increased further but at decreasing rates and the unemployment rate increased slightly. Inflation remained moderate with consumer prices (HCPI) rising by only 1 percent on average.

Economic policy will continue to stimulate the economy in 2003. That goes first of all for fiscal policy, as the medium-term public infrastructure programme will continue to support aggregate demand. The Bank of England is in a fairly delicate situation. On the one hand consumer price inflation (RPIX) is at the lower end of the 1.5 to 3.5 percent range of the inflation target, the pound sterling is clearly overvalued and manufacturing production as well as business investment is shrinking further – good reasons for lower interest rates. On the other hand soaring house prices and booming private consumption calls for higher interest rates. It is assumed here that monetary policy will follow the Fed and the ECB with monetary easing once a further cooling-off of the economy becomes evident. It is further assumed that wages will continue to rise relatively fast.

In 2003 economic growth is at risk: The bubble in house prices could burst and reduce housing construction and consumer confidence. However, assuming a soft landing of house prices, the impact on construction and private consumption will be more moderate. The economy is expected to recover during 2003, stimulated by economic policy and external demand. Real GDP is likely to grow by slightly more than 2 percent. Exports will revive, led by the upswing of the world economy. Nevertheless, given the high exchange rate of the pound sterling and rapidly rising unit labour costs, international competitiveness will weaken further so that growth of exports is expected to be considerably lower than that of world trade. Public consumption will continue to grow rapidly and gross fixed investment is expected to recover despite the housing boom cooling off. Investment in public infrastructure will grow strongly and investment in machinery and equipment, mostly driven by the service sector, should overcome the recession due to improving sales and profit prospects and an increasing capacity utilisation in the course of the year. The expansion of private consumption will decelerate despite high wage increases. The slowdown in house price inflation will dampen the inclination to take up consumer credit. The unemployment rate might be somewhat higher on average than in 2002. Also, due to accelerating unit labour costs, consumer prices are expected to rise by 1½ percent (HCPI) which is an acceleration compared with 2002.

United Kingdom
Key forecast figures

	2000	2001	2002 (1)	2003 (1)
Percentage change over previous year[a)]				
Private consumption	5.2	4.1	3.2	2.0
Public consumption	2.1	2.2	3.5	3.2
Gross fixed capital formation	1.9	0.3	– 4.2	2.0
Domestic demand	2.5	2.6	1.8	2.3
Exports of goods and services	10.1	1.2	– 0.3	3.4
Imports of goods and services	11.7	2.8	1.8	4.2
Gross domestic product (GDP)	3.1	2.0	1.4	2.1
Unemployment rate[b)] (in %)	5.4	5.0	5.1	5.4
Consumer prices[c)] (% change on the previous year)	0.8	1.2	1.3	1.4
General government financial balance[d)] in % of GDP[e)]	1.6	0.7	– 1.3	– 1.7

(1) Forecast by the Ifo Institute. – [a)] At 1995 prices. – [b)] Unemployment as a % of labour force (employed and unemployed). – [c)] Price index for the cost of living of all private households. – [d)] On national accounts definition (ESA 1995). – [e)] In 2000 without revenues from the auction of UMTS licenses.

Source: Eurostat, National Statistical Office, calculations by the Ifo Institute.

Appendix 3:
Forecasting Tables

Table A1

Real gross domestic product, consumer prices and unemployment rates in industrialised countries

	Weighted (GDP) in %	Gross domestic product			Consumer prices[a]			Unemployment rate[b] in %		
		Change over the presious year in %								
		2001	2002	2003	2001	2002	2003	2001	2002	2003
Germany	7.9	0.6	0.2	1.1	2.4	1.3	1.3	7.7	8.2	8.5
France	5.6	1.8	0.9	1.4	1.8	1.9	1.6	8.5	8.9	9.2
Italy	4.7	1.8	0.4	1.1	2.3	2.6	2.2	9.4	9.1	9.2
Spain	2.5	2.7	1.8	2.2	2.8	3.6	3.1	10.6	11.3	11.2
Netherlands	1.6	1.3	0.5	0.5	5.1	3.9	3.2	2.4	3.6	3.7
Belgium	1.0	0.8	0.5	1.3	2.4	1.6	1.5	6.6	6.9	7.1
Austria	0.8	0.7	0.9	1.4	2.3	1.7	1.6	3.6	4.1	4.4
Finland	0.5	0.7	1.3	2.0	2.7	2.0	1.9	9.1	9.3	9.0
Greece	0.5	4.1	3.9	3.9	3.7	3.9	3.4	10.5	10.0	9.4
Portugal	0.5	1.6	0.3	0.9	4.4	3.7	3.0	4.1	4.6	5.5
Ireland	0.4	5.7	4.3	3.2	4.0	4.7	3.4	3.8	4.8	5.0
Luxembourg	0.1	1.0	2.0	2.4	2.4	2.1	1.6	2.0	2.4	2.7
Euro area[c]	26.2	1.4	0.8	1.4	2.5	2.1	1.9	8.0	8.3	8.5
United Kingdom	6.1	2.0	1.4	2.1	1.2	1.3	1.4	5.0	5.1	5.4
Sweden	0.9	1.2	1.4	1.8	2.7	2.0	1.9	4.9	5.1	5.3
Denmark	0.7	1.0	1.5	1.4	2.3	2.4	2.0	4.3	4.2	4.3
European Union[c]	33.9	1.5	0.9	1.5	2.3	2.1	1.8	7.3	7.6	7.8
Switzerland	1.1	0.9	0.6	1.0	1.0	0.6	0.6	1.9	2.8	3.7
Norway	0.7	1.4	1.4	1.9	3.0	1.2	1.6	3.6	3.7	3.9
Western Europe[c]	35.7	1.6	0.9	1.5	2.3	2.0	1.8	7.1	7.4	7.6
USA	43.6	0.2	2.5	2.7	2.8	1.4	2.5	4.8	5.9	6.0
Japan	17.8	0.3	– 0.2	1.0	– 0,7	– 0.9	– 0.9	5.0	5.4	5.6
Canada	3.0	1.5	3.4	2.9	2.5	2.1	2.4	7.2	7.6	7.7
Total[d]	100.0	0.7	1.5	2.0	2.0	1.2	1.6	5.9	6.6	6.7

[a] Western Europe (except for Switzerland): harmonised consumer price index. – [b] Standardised. – [c] Sum of the listed countries. Gross domestic product and consumer prices weighted with the gross domestic product of 2001 in US dollars; unemployment rate weighted with the number of employees in 2001. – [d] Sum of the listed countries. Weighted with the shares of German exports in 2001.

Source: Information of national and international institutions; 2002 and 2003: forecasts by the Ifo Institute.

Table A2

Indicators of the public budgets in the euro area

	Gross debt[a]					Financial balance[a]				
	1999	2000	2001	2002	2003	1999	2000	2001	2002	2003
Germany	61.2	60.2	59.5	61.6	63.3	– 1.5	– 1.1	– 2.8	– 3.6	– 2.8
France	58.5	57.3	57.3	58.7	59.8	– 1.6	– 1.3	– 1.4	– 2.7	– 3.0
Italy	114.5	110.5	109.9	110.4	109.0	– 1.8	– 0.5	– 2.2	– 2.7	– 2.8
Spain	63.1	60.5	57.1	56.0	55.0	– 1.1	– 0.6	– 0.1	– 0.8	– 1.2
Netherlands	63.1	55.8	52.8	51.5	51.8	0.7	2.2	0.1	– 1.0	– 1.4
Belgium	114.9	109.2	107.6	106.0	103.0	– 0.5	0.1	0.4	– 0.2	– 0.5
Austria	64.9	63.6	63.2	63.4	63.8	– 2.3	– 1.5	0.2	– 1.8	– 1.7
Finland	46.8	44.0	44.0	42.0	41.7	1.9	7.0	4.9	3.6	2.8
Greece	105.1	106.2	107.0	106.0	103.0	– 1.9	– 1.8	– 1.2	– 1.5	– 1.9
Portugal	54.4	53.3	55.5	58.0	59.0	– 2.4	– 2.9	– 4.1	– 4.0	– 3.5
Ireland	49.7	39.1	36.4	35.5	36.0	2.2	4.4	1.5	– 1.2	– 1.5
Luxembourg	6.0	5.6	5.6	4.8	4.9	3.6	5.6	6.1	0.5	– 2.0
Euro area[b]	72.5	70.1	69.3	70.0	70.7	– 1.3	0.1	– 1.5	– 2.4	– 2.3

[a] As a % of gross domestic product; in accordance with the delimitation according to the Maastricht Treaty. Financial balance without the special revenue gains from the sale of mobile phone licences. – [b] Sum of the countries: weighted with the gross domestic product of 2001 in euro.

Source: Eurostat; 2002 and 2003: forecasts by the Ifo institute.

Table A3

Key forecast figures for the euro area

	2001	2002	2003
	Percentage change over previous year		
Real gross domestic product	1.4	0.8	1.4
Private consumption	1.8	0.6	1.5
Government consumption	1.9	2.0	1.2
Gross fixed capital formation	– 0.7	– 2.0	0.5
Exports[a)]	2.8	0.5	4.5
Imports[a)]	1.4	–0.8	4.2
Consumer prices[b)]	2.5	2.1	1.9
	Percentage of nominal gross domestic product		
Current account balance	0.4	0.9	1.0
Government financial balance[c)]	– 1,5	– 2.4	– 2.3
	Percentage of employees		
Unemployment rate[d)]	8.2	8.3	8.5

[a)] Exports and imports contain products and services including the trans-border market within the euro area. – [b)] Harmonised consumer price index. – [c)] Excluding extra income from sales of mobile phone licences. – [d)] Standardised.

Source: Information of national and international institutions; 2002 and 2003: forecast by the Ifo Institute.

Appendix 4:
The German disease

Currently, Europe's largest economy, Germany, is facing serious economic problems characterized by record levels of unemployment and insolvency rates together with low growth and declining investment. The German banking system has been hit hard by the downturn and is experiencing its most severe crisis in post-war history.

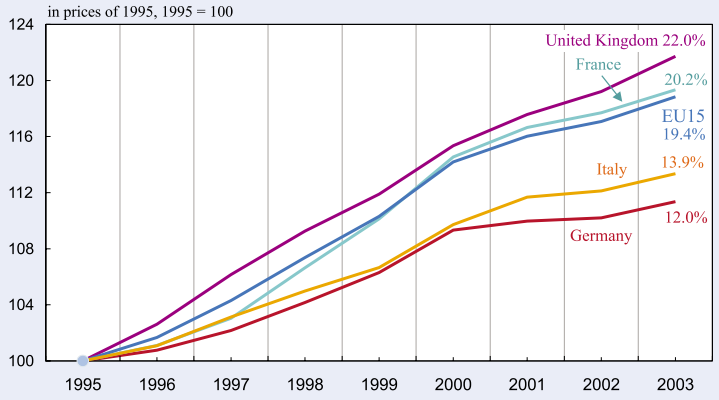
The acute German crisis is only partly due to the bad performance of the world economy. It primarily results from Germany's own idiosyncratic problems. In the past seven years, cumulated German growth has been more than seven percent below the EU average. In fact, Germany has had the lowest growth among all European countries since the middle of the 1990s, and there is no sign for a change. Whichever way the European or world trade cycle develops, it is likely that Germany's growth rate will remain the lowest in Europe for some time to come.

The low German growth relative to other European countries is unlikely to be just an implication of "growth convergence" of countries starting at different levels of development. Germany's GDP per capita used to be one of the highest in Europe thirty years ago. It is now close to the EU average, but Germany's growth rate remains the lowest in Europe. In terms of GDP per capita Germany has been surpassed in recent years by the UK, Finland, The Netherlands, Ireland and Austria. It is possible that the country will fall further back in the years to come.

The most important factor explaining the growth decline in Germany is the relative growth of wage costs.

Figure 1.1

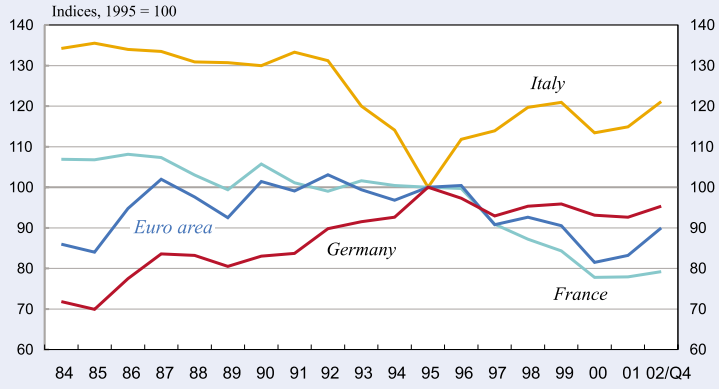
REAL GDP GROWTH IN SELECTED COUNTRIES OF THE EUROPEAN UNION



Sources: Eurostat, calculations and forecast by the Ifo Institute (Dec. 2002).

Figure 1.2

INDICATORS OF COMPETITIVENESS: RELATIVE UNIT LABOUR COSTS



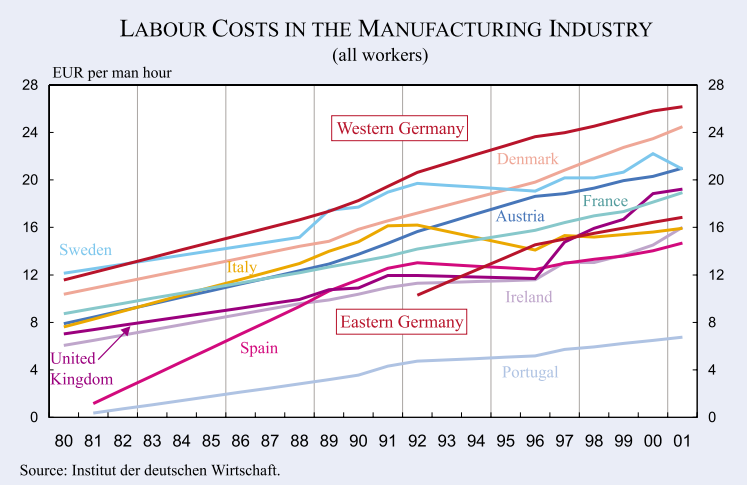
1) Competitiveness-weighted relative unit labour costs in the manufacturing sector.
Sources: OECD.

Figure 1.2 shows a trend-wise increase in unit labour cost[17] of Germany from 1980 to 2002, much of the increase being concentrated in the first half of the 1990s. In this respect Germany compares very unfavourably with the euro area as a whole (although it should be noted that the real increase has been even larger recently for Italy).

Measures of relative unit labour costs are likely to understate the deterioration of international competitiveness, as increases in relative wage costs squeeze out employment. Less productive firms are driven into bankruptcy, and as a result the average productivity of the firms remaining in the market after the wage increase is high-

[17] Competitiveness-weigthed unit labour costs in the manufacturing sector in dollar terms. Competitiveness weights take into account the structure of competition in both export and import markets of the manufacturing sector of 41 countries. For details on the method of calculation see Durand, M., C.Madashi and F. Terribile (1998) "Trends in OECD Countries' International Competitiveness: The Influence of Emerging Market Economies," OECD Economic Department Working Papers, No. 195.

Figure 1.3



er. Moreover, the firms that survive the wage increase are likely to use more capital intensive production techniques, setting workers free and increasing labour productivity. For this reason, it is informative to compare wage costs per unit of time, as is done in figure 1.3 which plots wage costs in manufacturing per hour at going prices and exchange rates. The Figure shows that west Germany is a true outlier in the spectrum of countries, taking a leading position throughout the sample period from 1980 through 2001. Even east Germany has relatively high wages, given its short period of development as a market economy since 1990.

Sometimes it is argued that high wages are beneficial rather than detrimental to employment, alluding to Keynesian demand effects resulting from wage increases. This view is empirically unfounded, as can be demonstrated by comparing the labour market situation during the last 20 years in the US, the Netherlands and west Germany. Figure 1.4 illustrates the growth of real hourly labour costs in manufacturing. In west Germany real labour costs per hour increased by 39 percent between 1982 and 2001, in the Netherlands they increased by 23 percent and in the US they increased by only 3 percent. The employment situation mirrors this development. While the number of employee hours increased in the US by 38 percent between 1982 and 2001 and in the Netherlands by 26 percent, they declined by around 3 percent in west Germany. In the experience of these three countries, in the long run one percentage point wage restraint generated roughly one percentage point more employment.

What is the cause of the large rise in real labour costs in Germany relative to other countries? One problem may be that Germany was locked into EMU perhaps too early after unification. In fact, unification had led to a transitory real appreciation of the deutschmark to accompany the current account and budget deficit generated by the massive resource transfer to east Germany. The creation of the euro fixed the intra-European exchange rate before relative prices and wages could return to their normal level at the ongoing exchange rate. Germany would thus need a devaluation in order to reduce its price misalignment with the other countries in the euro area, but as Germany is member of the European Monetary Union, such an option no longer exists.

Some evidence consistent with this can be found by looking at the trade weighted real exchange rate of Germany. The idea is that the real exchange rate should have increased after unification without having been adjusted in the years that followed. As shown by Figure 1.5 after the break-down of the

Figure 1.4

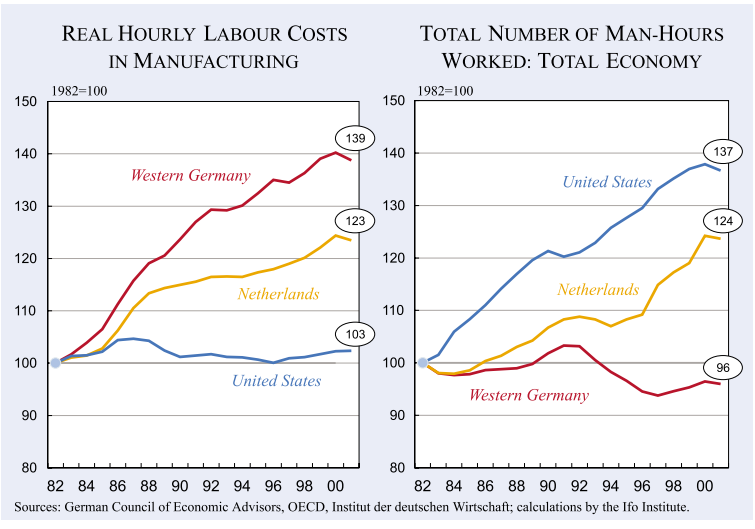
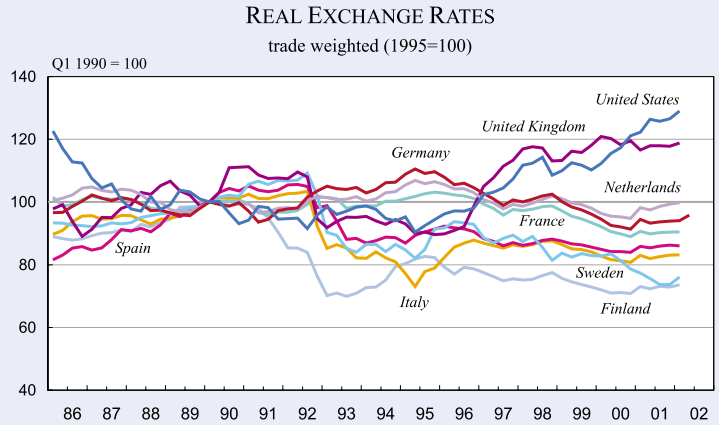


Figure 1.5



1) The curves show the development of the real exchange rates of these countries weighted by their share of trade. The first quarter of 1990 is set at 100. Consumer price indexes were used to eliminate the effects of price inflation.

Source: IMF, calculations by CESifo.

EMS in 1992, there was indeed a period where the currencies of countries such as Spain, Italy, Sweden or Finland depreciated strongly relative to Germany, and this depreciation effect has prevailed to this day. However, there is hardly any real appreciation of Germany relative to France, its most important trading partner, and there is a strong depreciation relative to countries outside Euroland such as the UK or the US, driven by the upward movement of the dollar. Overall, the figure shows no real appreciation in terms of trade between 1990 to 2002. A further appreciation of the euro against the dollar would, however, create a problem insofar as the misalignment within the euro zone would make German exporters a primary victim. Note that Germany did not appreciate relative to the Netherlands: the two curves are fully parallel in the figure. Nevertheless, Figure 1.5 clearly shows that the Netherlands had better employment and growth records. All of this suggests that the competitiveness problem underlying Germany's weakness cannot be assessed by looking at terms of trade only but rather one should concentrate on overvaluation stemming from high wage costs and other idiosyncratic problems, all of which squeeze profits and discourage investment. The reasons will be discussed below.

1. Labour laws

One of the causes of Germany's problems is the legal structure of the labour market in terms of tenure rules and the way wage negotiations are conducted. Germany has relatively extensive labour protection rules which practically amount to lifetime tenure after only a few years of employment. Moreover the country has a system of centralized wage bargaining that generates uniform wages for industry sectors which are only mildly differentiated across regions. This system makes it impossible for a firm that operates on the verge of bankruptcy to settle for lower wages with its employees even if these employees accept such a solution in order to rescue their workplaces. The two elements together give trade unions great power to increase wages for the insiders of the labour market. While there is certainly much nominal wage rigidity in Germany, this power in itself leads to an additional real wage rigidity, against which even a currency devaluation would be useless.

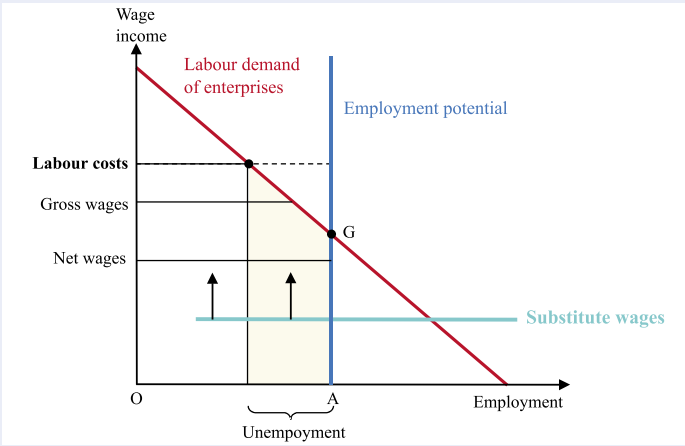
2. Repercussions from high social replacement incomes

Another explanation for Germany's high real wages relates to generous replacement incomes in terms of unemployment benefits, early retirement schemes and social aid. Replacement incomes are paid under the condition that people do not work and earn no income, and they are reduced, in large ranges on a one-to-one basis, if recipients do earn an income. Replacement incomes create high reservation wages (the minimum wages at which workers accept job offers). In many cases, these reservation wages are so high that it does not pay for private firms to create jobs. Unemployment results. Figure 1.6 illustrates this effect by drawing a demand-supply diagram for the labour market. An undisturbed labour market would find a wage cost that equates demand and supply such that no unemployment prevails. The replacement income, however, pushes the net-of-tax wage upward and hence the labour cost of the firms. Jobs are destroyed or they are prevented in the first place. Unemployment results.

Figure 1.7 shows that this is not only a theoretical but also a practical problem for Germany. Even the average-wage incomes often offer little more net income than is available in terms of social aid to every citizen. Given the social replacement incomes, wages simply cannot fall much more with-

Figure 1.6

THE EFFECTS OF SUBSTITUTE WAGES

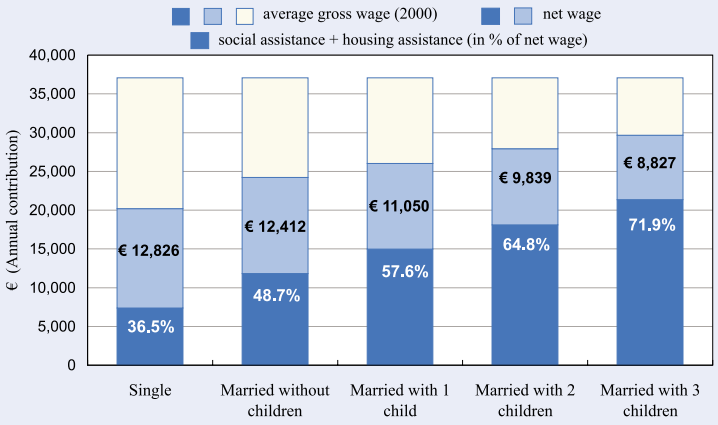


Source: Ifo Institute.

Figure 1.7

WAGE DIFFERENTIAL IN WESTERN GERMANY ACCORDING TO HOUSEHOLD TYPE

Employees in the producing sector, commerce, banking and insurance

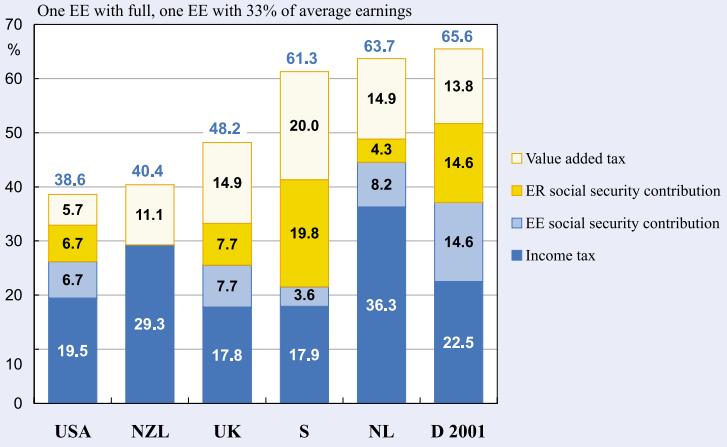


Source: Calculations by the Ifo Institute; status: 2000.

Figure 1.8

MARGINAL TAX BURDEN ON LABOUR (IN PERCENT OF VALUE ADDED)

Family with two wage-earners and two children:
One EE with full, one EE with 33% of average earnings



Sources: Calculations by the Ifo Institute.

out making the jobs available in the market economy unattractive. The picture looks even worse when unemployment benefits are considered. Germany offers unemployment benefits (Arbeitslosenhilfe) until retirement if no job is found, and whether or not a job is found is, in practice, decided by the unemployed themselves. Perhaps the new proposals of the Hartz Commission will change this in the future, but it is too early to make a judgement on how many of these proposals will survive the legislation procedure.

3. High labour tax burden

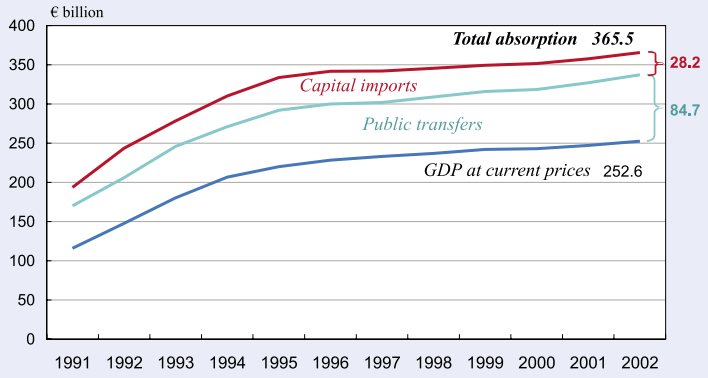
The expansion of the welfare state has contributed considerably to the rise of labour costs by imposing high taxes and social security contributions on this factor. At more than 65 percent, the marginal burden of taxation on value added that an average employee generates from a qualification measure or from an increase in work time is now the highest in the world in west Germany.

4. Expensive unification

German unification has also contributed to the weak growth. For reasons that we explain in Box 2, Chapter 3, “Rethinking Subsidiarity in the EU: Economic Principles”, the economic unification was a failure, involving gigantic resource flows to the east without creating a self-sustained upswing. From 1997 growth in east Germany has been lower than in west Germany, and aggregate productivity per person of working age has

Figure 1.9

ABSORPTION IN EASTERN GERMANY



Sources: Arbeitskreis Volkwirtschaftliche Gesamtrechnung der Länder (2002), Status: September 2002; CES, estimations of the Ifo Institute.

been stuck at a level of less than 60 percent of the west German level.

Figure 1.9 gives an overview of the development of aggregate absorption (consumption of goods and services by households, firms and government) in comparison to own production (GDP). It shows that the excess of absorption over production, the current account deficit, is about 45 percent of GDP. This is large by all standards. Countries like Portugal or Israel, which used to hold the records, have deficits of about 12 percent, and even the Italian Mezzogiorno does not have a current account deficit of more than 13 percent.

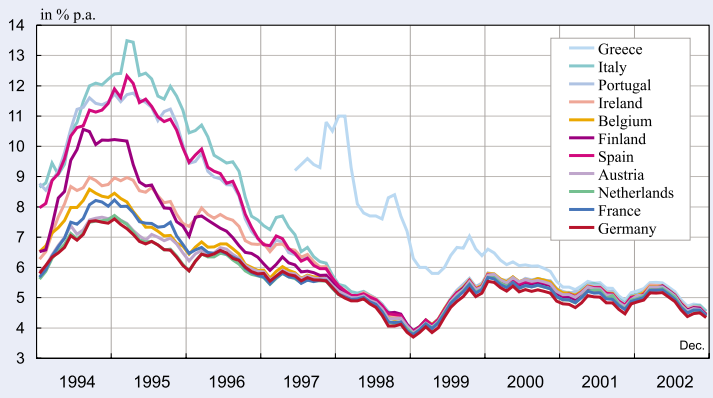
The resource transfers have, of course, beneficial effects in terms of raising the east German living standard. However, they also contribute to exacerbating Germany's problems. On the one hand, they add to the excessively high tax burden on German labour and explain Germany's difficulties in reducing the government share in GDP, which has increased to more than 48 percent. On the other hand, they come primarily in the form of paying replacement incomes, whose detrimental effects on the labour market have been explained above. In fact, the establishment of a welfare state with basically west German standards in an economy that a dozen years ago was still under communist central planning can be seen as the major obstacle to a self-sustained upswing in east Germany.

5. Lost advantage of lower interest rates

Adding to these internal factors is the external factor of the sharpening of competition in Europe, which is due to west European integration, the fall of the iron curtain and, in particular, the levelling of the playing field resulting from the introduction of the euro. The euro has not only sharpened competition in the goods markets. It has also established a European capital market in which the interest rates have converged dramatically. As we pointed out in our first report (EEAG 2002, ch. 4), the interest convergence will boost aggregate European growth as such because it favours investment and capital reallocation in poor countries with high returns such as Spain, Portugal or Greece, over investment in rich countries with low returns such as Germany. As beneficial as this process will be for Europe as a whole, it will contribute to reducing German GDP growth (although not necessarily GNP growth). The German productive system has lost the competitive advantage from low interest rates which the D-mark once provided with segmented capital markets. Note that the convergence in interest rates has occurred in a period where there were no currency alignments, and inflation rates strongly con-

Figure 1.10

TEN-YEAR GOVERNMENT BOND YIELDS IN THE EURO AREA



Source: National Central Banks.

verged. The interest rates have converged in both nominal and real terms.

The remedies

In order to speed up growth again, the market forces must be activated, especially in the labour market. If idle manpower is mobilised, the national product will also grow. Creating employment is the essential tool for creating more growth in Germany.

The reforms should primarily target the welfare state, which creates high reservation wages. The lesser qualified should receive lower replacement incomes and be given wage supplements instead, as was recommended in our first report (EEAG, 2002, ch. 6). This measure would reduce the minimum wage level implied by social welfare payments and would make it easier for the unions to accept lower wages. At lower wages, it will become profitable for entrepreneurs to create additional jobs. If properly designed, the reforms would be cheaper for the state than the present social welfare system, and nevertheless the living standard of those who are currently unemployed will increase.

The reform of the welfare state is particularly urgent in east Germany. A self-sustained growth process will not start unless the government retreats from the policy of paying people for staying absent from the labour market by providing generous schemes for early retirement, paying high unemployment benefits and offering generous social aid payments.

Germany should make active efforts to reduce the excessively high tax burden on labour incomes and to reduce the government share in GDP. The ruling coalition has recently proposed increasing the tax burden by about one percent of GDP to avoid a conflict with the Stability and Growth Pact. This proposal was a step in the wrong direction. It will exacerbate Germany's growth problems.

German labour law and the rules for wage negotiations should be fundamentally reformed. Collective agreements in future should only have the character of wage guidelines, which a company may fail to match if the majority of employees agree. The *favourability principle*, which says that firms can only deviate from union contracts by paying more, should be interpreted such that job preservation by rescuing a dying firm through wage cuts is also included among the "favourable" measures. In addition, legal protection against dismissal could be loosened in order to allow new hiring. Laws that protect workers from dismissals surely safeguard jobs in the short run; in the long term they may cause unemployment and job insecurity.

None of these measures will help improve the situation of the German labour market if wages are not flexible downward. Elsewhere in this report we have argued that, in order to allow for the necessary changes of relative prices in Europe and prevent the countries with mature economies being driven into deflation, the ECB should revise its inflation target and allow a somewhat higher average inflation rate. Such a move would certainly also help Germany. It would enable a real depreciation of commodity prices to the extent it is needed, and it would allow the downward adjustment of the growth trend of real wages that we expect to result from the reforms we recommend.

Appendix 5:
The Japanese disease

Long gone is the era of the Japanese economic miracle. During the past ten years, the Japanese economy, which used to be a model for the West, fell 20 percent below the world-wide growth trend. Whereas the Asian NIEs seem to have recovered from the 1998 crisis, Japan is just bumping along. In 2001, real GDP fell by 1.4 percent, and prices fell for the third year in a row. In 2002, a deflation of 0.2-0.5 percent is still expected, which, given the insufficient inclusion of quality improvements in the price statistics, may in fact amount to more than a 1.5 percent reduction of the price level. This makes Japan the only OECD country to record deflation.

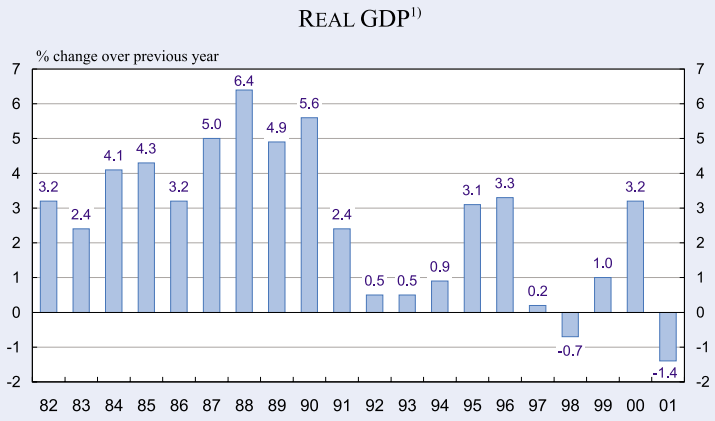
The government of Prime Minister Koizumi hopes to solve the problem with structural reforms. However, as important as these reforms are, deflation is a macroeconomic problem which can only be solved with macroeconomic means. Supply policy is no sufficient cure when demand is lacking.

This does not say that there is no need to reform the banking system. Japanese banks were overly negligent when they handed out loans to investors, and the lack of competition in the Japanese banking system has certainly contributed to continue dubious banking practices. A major reform of the banking system which establishes competition and rids the banks of the loans that have turned non-performing is necessary. However, none of this will help unless the causes of the Japanese problem are understood and appropriate treatment prescribed.

Japan's main problem is an excess of private saving over private investment, which is not absorbed by a current account surplus and the corresponding net foreign investment. Japanese households have an extraordinarily large savings rate and, paradoxically, even Japanese firms have become net savers. Unlike firms in other countries, they are not demanders of the private households' savings to finance their investment, but are themselves providers of savings to the financial markets. According to the IMF, in 2000, the private sector as a whole, that is firms and households together, had savings in excess of investment in the amount of 9.3 percent of Japanese GDP. That is a most unusual relationship. For example, in the EU as an aggregate, the private sector invests more than it saves. Only a small part of Japanese excess savings flow into capital exports, most of it, 8.2 percent of GDP, is absorbed by the government budget deficit.

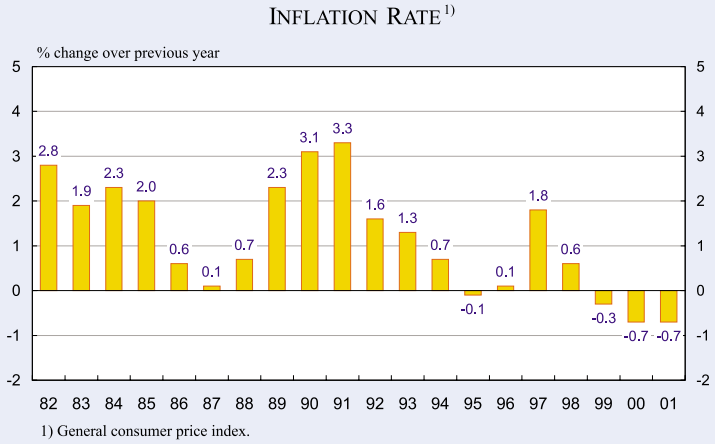
The Japanese economy is apparently in a situation close to what Alvin Hansen called "secular stagnation". Large-scale investment, fed by the high savings of an ageing society making provisions for old age, have created an ample cap-

Figure 1.1



1) The real GDP data refer to the respective fiscal year.
Source: ESRI (December 2002).

Figure 1.2



1) General consumer price index.
Source: Statistics Bureau and Statistics Center.

ital stock and a corresponding low marginal productivity of capital. Thus it becomes increasingly difficult to invest the permanent inflow of new savings productively in the domestic private sector, with the result that the government has either to create the corresponding investment opportunities domestically or accomplish a real exchange rate depreciation that makes it possible to run a larger current account surplus and to invest more abroad. The Japanese savers are accumulating claims against the Japanese taxpayers because domestic private investors and foreign purchasers of Japanese goods refuse to become debtors.

Hansen called the excess of planned saving over planned investment "the deflationary gap", because it implies a lack of aggregate demand. The government can close the gap by incurring more and more debt. But the ability of continuing this policy year after year diminishes as it creates a confidence crisis of the investors with unforeseeable consequences for the state. In 1992, Japanese debt amounted to 60 percent of GDP. Only 10 years later, in 2002, it was about 150 percent, and it still continues to rise. In the whole of Europe there is no single country with a comparable debt-GDP ratio. Even Belgium and Italy with ratios of 102 percent and 105 percent in 2002, respectively, have been superseded by Japan.

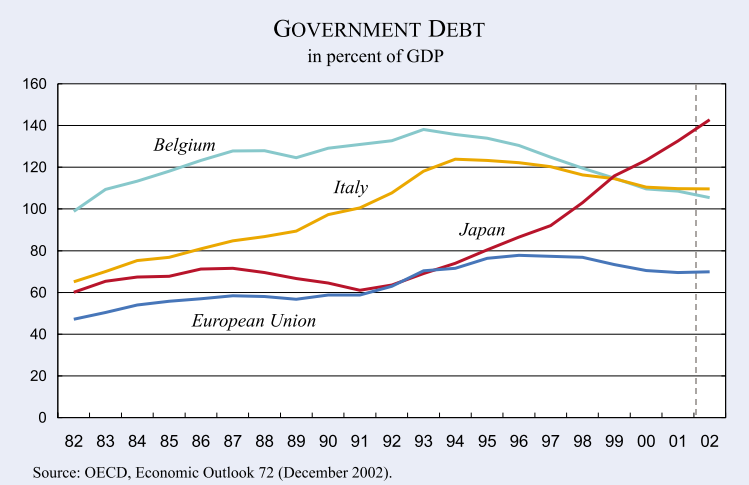
Whenever deficit financing becomes difficult, an expansionary monetary policy is the obvious choice in order to lower interest rates and in this way give an incentive to firms to make the necessary investment. Unfortunately, this road is also blocked with short-term interest rates already close to zero. Japan finds itself in the Keynesian liquidity trap. For decades the liquidity trap described by Keynes remained in the textbooks without having ever been observed anywhere. Today, having been taken out of most textbooks, it shows up in the real world.

An economy in the liquidity trap cannot be revived by monetary policy, because monetary policy would have to cut interest rates; but it is impossible to make nominal interest rates negative. People prefer to hoard their money instead of lending it at negative interest rates.

There is, however, a trick to further lower real interest rates, and this is to engineer inflation. There has to be some inflation before the crisis strikes. With rising prices, monetary policy can lower real interest rates below zero, and perhaps low enough to get the economy in recession moving again. The Japanese would be better off today if they had some inflation. But once an economy finds itself in a liquidity trap, it is impossible to create inflation with interest rate cuts.

The only real option remaining open to Japan is to depreciate its currency. The Bank of Japan can produce a depreciation by printing additional yen and selling them for dollars in the foreign exchange markets. Depreciation increases net foreign demand and thus directly help the economy. The current account surplus increases, and it will be possible to place the excess of savings over investment abroad, avoiding Hansen's deflationary gap. Indirectly it helps by contributing to price rises and thus providing the central bank, during a temporary recession, with the means of a negative real interest rate in order to revive investment.

Figure 1.3



Source: OECD, Economic Outlook 72 (December 2002).

There remains, however, the problem that even under the new government, the Japanese savers have a structural majority in parliament. The Prime Minister represents the Liberal Democrats, and the middle classes backing this party benefit from deflation as it adds to the real value of their monetary wealth. A policy of currency depreciation, which reduces the deflation rate and will even result in inflation, is technically possible, but it is difficult to

find the political support for it. This is true today and will be even more so in the future, as the rapidly ageing population tends to increase the political weight of the savers. Japan is in an economic and political trap from which it may only free itself by radical political change.

The Japanese disease must be taken seriously in Europe, especially in Germany. Germany suffers from insufficient investment and is confronted with the increasing problems of an ageing population. Although in Germany savings are lower due to the generous social security system, Germans more than any other people are still sensitive to the experience of past inflation. Furthermore, if the necessity ever occurred, devaluation of the national currency would no longer be an available policy choice in the EMU.

The Japanese example has shown that it is not only inflation that poses a risk to an economy, but also the pursuit of too rigorous a policy of price stability. The lesson for Europe stresses the importance of balancing both risks – especially in light of our analysis of the current conditions in Germany and elsewhere in the euro-area. The disadvantages of inflation are well-known, but so are the problems resulting from even mild deflation.