The Economic Situation of the European Union and the Outlook for 2001 -2002

A Report by the EUROFRAME group of Research Institutes for the European Parliament

The Institutes involved are Wifo in Austria, ETLA in Finland, OFCE in France, IfW and DIW in Germany, Prometeia in Italy, and NIESR in the UK

EXECUTIVE SUMMARY

This research in this report and the forecast material contained within it were produced by the EUROFRAME group of European Research Institutes. The results are preliminary and should not be quoted without permission The Report is the result of a co-ordinated programme of work by the Institutes. The views reflect a consensus of those of the Institutes involved, inevitably with compromises. In this and in future reports all members reserve the right to append a minority report if they disagree strongly with the majority.

The forecast numbers have been produced and co-ordinated using the NIESR global model, NiGEM which includes models for all European Union countries. The model is an attempt to represent the economies as they currently stand, and hence account has been taken of developments in labour and product markets that will have changed the way economies can be expected to behave.

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The Prospects for the European Union Economy

Prospects for the European Union and the Euro Area look sound, but there is a risk of a significant slowdown in the US. Central banks in the European Union should stand ready to offset any deflationary impacts from abroad. The appreciation of the euro and lower oil prices should help moderate prospective inflation in the Euro Area.

External environment

- The US is slowing down as equity markets adjust and consumers retrench. The slowdown is expected to be short-lived as monetary conditions are being relaxed, and the dollar has fallen, helping industry recover.
- The world economy seems robust, although we expect output and trade growth to slow from their cyclical peaks. Further monetary easing and some fiscal response in the US should ensure a recession in the world economy is avoided.
- Oil prices have declined from their peak last autumn, easing global cost and price pressures. The economic situation in Japan is still fragile, but does not pose a significant risk for Europe.

Prospects for the Euro Area

- The European economies passed their cyclical peak in the summer. Output growth in 2000 was very strong (3.3-3.4%). Strong exports were the major cause of the acceleration in the Euro Area and the UK. The slowdown in activity we are seeing is not expected to lead to a recession. Growth will be 2.8% in 2001 and 2.7% in 2002.
- Inflation in the Euro Area accelerated to almost 3% at the end 2000 from 1.5% a year earlier. The delayed effects of last year’s tighter monetary policy, lower oil prices and the continuing appreciation of the euro should mean inflation drops back to average 2.2% in 2001 and 1.5% in 2002.
- Recent ECB projections for output and inflation have the centre of their projection with higher growth and similar inflation to ours for 2001. We consider this to be unlikely, and might involve monetary growth in excess of the ECB’s reference value. There is a clear risk that inflation will be higher or growth will be lower.

Risks around the forecast

- The major risk facing the Euro Area is that business confidence and investment in the US will fall sharply. If the US slowdown accelerates sharply the ECB should stand ready to cut interest rates significantly.
- We expect the euro to reach 1.06 against the dollar by the end of 2002. If the euro does not appreciate over the forecast horizon then there is a significant risk that inflation will be noticeably higher than we are forecasting, pushing it above the ECB’s target range.
- The ECB should act rapidly and strongly in cutting rates if the Euro-Area economy were to slow down more than we anticipate or the euro were to appreciate by more than we forecast.

Macroeconomic Policies and Convergence in the European Union

Policy has so far been successful in creating a stable economic environment in the Euro Area and in the European Union.

Current monetary policy

- Short-term interest rates are at a neutral or slightly restrictive level. Overall monetary conditions are probably still accommodating in the Euro Area given the sharp decline of the euro since early 1999.
- We do not see any reason for a further tightening of monetary policy in the Euro Area. Given our forecast for economic growth and inflation in 2001 and 2002, there may now even be some room for monetary easing.

Deficit reduction has been successful in the Euro Area

- The process of fiscal consolidation appears to be at an end. Fiscal policy initiatives in a number of European Union countries appear to be expansionary, and should help offset the slowdown we anticipate this year.
- Plans remain safely within the Stability and Growth Pact guidelines. Deficits should be eliminated by 2004. In the medium term a number of countries have space to cut taxes, or to raise public investment without breaching the fiscal guidelines.

Convergence and divergence of inflation in Europe

- Among the EU countries the convergence process is not complete. Per-capita GDP and prices are likely to grow more rapidly in smaller countries catching up with the rest and we should not worry about this.
- Inflation rates in the biggest four countries are converging. Since the start of the EMU GDP growth rates have become more similar whilst inflation rates have diverged as prices in countries such as Spain, Ireland and Italy adjust toward the Euro Area level.

Wage Policy

- In several major countries like France, Germany and Italy, wage settlements for the next year or more point to a continuation of wage moderation.
- Wage settlements help to preserve price stability if nominal wage increases are equal to the sum of targeted inflation and the trend rate of productivity growth. In this process the initial level of wages and prices should also be taken into account.

Growth and Employment in the Medium Term

Policies to enhance growth, reduce unemployment and raise the level of employment work only slowly over time, and have to be sustained to have an impact.

The reform process must adjust to new challenges such as *the New Economy*, and lessons must be learnt from recent US successes. Information technology can be used to enhance productivity and increase job creation. Institutions in the labour market must evolve to absorb developments. Increasing skills and ensuring higher active participation in the labour force should be central goals of policy.

Fiscal and monetary policy frameworks must be regularly adjusted to improve on outcomes. Fiscal policy should be guided in the interests of the Community, but should remain in national hands. Active fiscal policy to improve infrastructure, to enhance education and to promote innovation should be encouraged. The ECB should be clearer about the nature of its strategy, and wage moderation should be encouraged as part of the macroeconomic framework.

New Economy

- Enhancing technical progress and the adoption of new information based technologies is a key element in the growth prospects of European economies. European development is lagging behind the US.
- Efficient utilisation of new technologies will be easier if there is competition in new markets. More open telecommunications markets have strengthened new technology in the Nordic countries.
- The flexibility of labour markets and improving education have a key role in the structural changes needed to enhance the use of new technology and the creation of jobs in the sector.
- Tax incentives and legislation to strengthen R&D activity should be implemented, but carefully monitored. Enhancing entrepreneurship and the potential for birth of new firms are important. Scientific and academic labour markets should be flexible.

Labour Markets

- Employment strategies have been developed for all European Union countries. Because of differences in national institutions and capabilities, strategies have to remain country specific, and cannot be designed for Europe as a whole.
- Labour market reforms must protect Social Cohesion, and the Commission guidelines should reflect this strongly. The OECD Jobs Strategy and US institutions cannot be used as models without careful amendment and evaluation.
- Long term attachments to jobs, the interaction of the Social Partners and secure employment all help foster process innovations and improvements in products. These have enhanced growth and productivity in Europe for decades. They should be protected and enhanced.
- Reducing unemployment and raising participation in the workforce at the same time requires a re-assessment of all labour market policies. Training programmes for low skilled individuals are important. The activation of the unemployed and non-participant benefit recipients have been successful in the UK and Denmark, for instance, and should be considered elsewhere.

Macro policies in the medium term:

- Alternatives to the Stability and Growth Pact should be discussed. In the medium term it will be worth looking at the role of the public sector in strengthening the prospects for output growth. Borrowing in order to finance some public investment in infrastructure may be a good guideline to ensure growth is enhanced.
- The SGP should not preclude broader initiatives. Monitoring the soundness of both public and private finances is an important part of a framework for economic stability in the medium term.
- Participants at the Macroeconomic Dialogue could recommend a wage path in line with the sum of targeted inflation and the trend rate of productivity growth, and implement an annual monitoring.
- Clear signals should be given about the sustainable growth path as well as targeted inflation. Published forecasts by the ECB can be judged as increasing the transparency of monetary policy and strengthening the credibility of the central bank, as long as they prove consistent with its other analyses.

The future of pensions and taxation

- Governments should stop encouraging early retirement and build stronger institutions to safeguard continuing employment as part of their strategy for ensuring high levels of participation in the workforce.
- All policies should ensure that social cohesion objectives are safeguarded. Any reform should be fair and provide information on how the system will evolve. Any significant cut in public pensions should be accompanied by an almost compulsory system of capitalisation.
- There is widespread support for leaving taxation in national hands. Some harmonisation may nevertheless be needed to prevent more mobile factors, and in particular non-residents' capital and income and also multinational corporations, from escaping taxation.
- Harmonisation of corporate tax should be achieved by a common minimum rate with possibilities of exemptions for small companies and for regions with high unemployment. It would clearly be better if any ecological taxation addressing greenhouse effects were decided jointly.

Part I Policy problems and the current situation

The external environment facing the European Union and the Euro Area has become less favourable over the last six months. There are significant risks, and the US slowdown could cumulate into a severe contraction if confidence collapses and policy does not respond. Avoiding a sharp downturn in the economy is the major task facing the European Union and the Euro Area monetary and fiscal authorities. However, we feel that there is little probability of a recession developing.

We recommend that the ECB and other European Union central banks remain very vigilant, and they should be prepared to respond rapidly and significantly to an emerging crisis. Knowledge that they will do so will help sustain confidence in Europe, and a belief that the Federal Reserve will act to prevent a recession in the US can be expected to stave off the crisis.

World economic activity was at its strongest for more than a decade in 2000. Growth accelerated in all the major geographical areas last year. Activity recovered strongly in many developing countries in Asia, Latin America and Eastern Europe. There was no particular resurgence of global inflation, despite developments in the oil markets, and prospects for continued low inflation remain much better than for some decades.

However there is now clear evidence that global economic growth has begun to slow. Business and consumer confidence in the United States have fallen sharply in recent months. The external environment has clearly deteriorated.

- The European Union appears to have passed its cyclical peak, and the appreciation of the euro in recent months has removed much of the inflationary pressure that may have been developing in the Euro Area in the summer. It has also helped remove some strains in the UK as Sterling has depreciated against the euro.
- We forecast that the euro will appreciate to 1.06 to the dollar by the end of 2002. If it remains significantly below this there is a risk that inflation will above the ECB's target range. If the slowdown in the US causes the euro to rise much more rapidly then deflation becomes a serious risk and the ECB should be prepared to cut rates significantly.
- The stance of fiscal policy has generally changed, and the budgetary consolidation process has temporarily come to a halt. Activity should be supported by fiscal moves over the coming year in a number of countries such as the UK. However, in the medium term vigilance needs to be maintained, and policies to keep budgets within bounds need to be reinforced.
- Monetary policy is no longer restrictive, and the ECB and other central banks may be expected to loosen somewhat in the near term. This should be encouraged as long as there are no strong signs of threats to the overriding objective of sustainable price stability.
- Wage moderation has been important in the process of ensuring convergence within the Euro Area. There are signs that inflation rates and wage growth are converging in the four major economies. Some smaller economies have higher inflation and higher growth as they continue to adjust to membership of the Euro Area and the European Union.

Part II Structural Issues: Growth and Employment in the Medium Term

The level and growth of output in the European Union is strongly dependent on the structure of the economic institutions in place. The availability of capital and labour and the efficiency with which they are used are central to the prospects for growth in Europe. Policies have to be designed to enhance availability and efficiency without significant compromises in other social objectives. The Community Employment Guidelines and the associated National Action plans, the Broad Economic Policy Guidelines for 2000 and the Single Market Programme all stress the need for structural reform.

Our evaluation of the short-term prospects for the European Union and our advice on the setting of policy are influenced by the evolving nature of the European economy. There is little evidence that the recent strong growth in Europe has been underpinned by a significant increase in productive capacity, as in the United States in the last five years.

We need to investigate the ways in which the level of capital available for production can be increased and the methods by which the workforce can be more productively utilised. There are a number of potential changes to the environment in which the economy operates, and we address the four most important for policy makers.

- *New technology* in computers and telecommunications and computer-based knowledge appear to have been major factors behind strong growth in the US. The available empirical evidence suggests that they have caused productivity in the US to rise rapidly in some sectors and have helped to increase overall productivity in all sectors of the economy. In order to evaluate the short-term prospects for Europe we need to assess whether new technology has changed the trend rate of growth in the European Union. This seems not to be the case, and hence we should investigate policies that would enhance the production and use of new technologies
- The wave of *labour* and product *market reforms* that have accompanied increasing European integration over the last 20 years or more have potentially large effects of the level and growth of output in the medium term. These reforms are designed to increase participation and skills in the labour force and increase the efficiency with which factors of production are used. Macro-economic stability and high levels of output are necessary to ensure that the effects of the reforms are fully felt, as the UK example suggests.
- Changes in *taxation* affect the use of resources and the efficiency of production *and pensions* provision by the state may influence the level of saving. Reforms to these systems are clearly important. There are different strategies for both tax and pension reforms and they clearly should be designed to meet individual country needs based on ageing populations and the importance of social cohesion.
- The nature of *macroeconomic policy* affects growth as it can facilitate new developments and also can provide an environment to enhance investment. A policy that is too restrictive may reduce the level of investment at just the stage in the cycle of innovation and product development when increasing the capital stock is central to medium term growth. In addition a more stable macroeconomic framework should reduce the degree of perceived uncertainty about the future and hence encourage investment and innovation.

Policy makers can have a significant effect on the prospects for new technology led growth. However, reforms to promote new technology should proceed with caution in order to ensure social cohesion is maintained. Europe has lagged behind the US in the implementation of computer based tools in workplaces which has helped to hold growth below that in the US. However, this may be inevitable, as the US market system is better designed for periods of product innovation, such as that associated with the current development of new technologies, and European institutions are better adapted to periods of process innovation and development. As we move from the first phase of the new industrial revolution to the second, more developmental, stage, the European economies should once again start to catch up with the US.

Growth in output depends on the growth of knowledge, and education and Research and Development (R&D) enhance skills in the workforce and the knowledge base for production. Only the Nordic countries, and to a lesser extent the UK and Ireland, have levels of R&D in information technologies that match those in the US, and it is these economies in Europe that have seen a comparatively strong increase in productivity growth in the last few years. Others will soon benefit from these developments.

- The Employment Policy Guidelines and the associated National Action Plans all stress, to differing degrees, the importance of education and re-education of the workforce.
- Institutional structures should be developed that ensure that we can provide effective lifetime education.
- Innovation and adaption of new technology depends on the structure of labour markets and the ability of individuals to behave entrepreneurially in the economy.
- Flexibility of response in setting up new firms and developing new ideas is important amongst those with relevant technical skills and amongst the scientific community.
- The adaption of new technology and the enhancement of the rate of growth depends crucially on increasing flexibility and innovativeness throughout the European Union.
- More competitive product markets, and especially a greater market scope for a product, appear essential to encourage innovation,

Labour market reforms under the National Action Plans emphasise the reduction of unemployment through re-skilling and effective assistance. These policies, if successful, will be important in increasing output through a greater availability of factors of production and will also increase welfare. Reductions in the sustainable level of unemployment should not be the only objective of labour market policies. There are a number of countries in the Euro Area where the participation of the population in the workforce remains low as compared to the US, and output and welfare can be improved if these potential workers can become active participants in the workforce. This may involve more effective welfare to work programmes, as in the UK and Denmark. It is also important to see a role for more active job stimulation packages, as in the Netherlands and France.

Participation amongst those over 50 is low in a number of countries. It is important to raise participation in this group because it would raise achievable output in Europe and reduce the potential burden placed, for instance, on state Pay As You Go pension systems. It is also important to raise participation in countries where individuals face more responsibilities for their own pension provision, as this raise their long run level of income. There is far to go in this area, and it is a crucial arena for reform in Europe.

The final plank in a programme for stability and growth in the Euro Area and in the European Union is the framework for monetary and fiscal policy. Monetary policy in the medium term should contribute to the stability of the economy and the incentive for individuals to make long term decisions. This requires that the framework ensures that the volatility of prices and output over the cycle are reduced, and that individual decision-makers are aware of the policy framework that will ensure this. The current Stability and Growth Pact on fiscal policy attempts to put tax and spending in a longer-term framework. A framework in which it was clear that public debt would not rise in an unsustainable way, whilst ensuring that public investment enhanced growth prospects would clearly be preferable. The objectives for fiscal policy should be discussed in the terms of an overall framework for stability and growth, and not just in terms of the generation of debt.