

# EUROFRAME - European Forecasting Network



## **Economic Assessment of the Euro Area: Forecasts and Policy Analysis**

Spring Report 2005

Special Policy Issue:

*When Jobs Disappear and Workers Do Not.  
International Relocation of Production  
and the European Economy*

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# EXECUTIVE SUMMARY

*Modest growth ahead  
– but still behind on  
Lisbon Agenda*

**EUROFRAME - European Forecasting Network** predicts that the Euro Area economy will experience a modest rate of output growth in 2005 with a gradual pick-up in activity by the second half of the year and into 2006. Our forecast for output growth in real GDP terms is 1.5 per cent in 2005 followed by a rise to 2.0 per cent in 2006. The Euro Area is experiencing a faltering recovery back towards rates that are more in line with its estimated potential after almost a half-decade of underachievement. The performance of the Euro Area continues to lag behind that predicted for US economic growth over the next two years. The ambition, retained within the refocused Lisbon Agenda, to make the European Union the most dynamic and competitive economy in the world remains a formidable challenge, though a clearer emphasis upon economic growth is an important restarting point.

## Summary of Key Forecast Indicators for Euro Area

|                                   | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|-----------------------------------|------|------|------|------|------|------|
| Output Growth Rate                | 1.6  | 0.9  | 0.5  | 1.8  | 1.5  | 2.0  |
| Inflation Rate                    | 2.4  | 2.3  | 2.1  | 2.1  | 2.0  | 1.8  |
| Unemployment Rate                 | 8.0  | 8.4  | 8.9  | 8.9  | 9.0  | 8.8  |
| Government Balance<br>as % of GDP | -1.7 | -2.4 | -2.7 | -2.7 | -2.6 | -2.5 |

*Risk from a further  
appreciation of the  
euro...*

World economic growth over 2005-2006 is expected to be at its strongest level in a generation with rates of the order of 4.5 per cent providing a favourable trading background for a resumption of strong Euro Area activity growth. However, given that the Euro Area's weak growth performance in recent years has been primarily due to the competitiveness losses arising from the strength of the currency, European fortunes will be inextricably linked to exchange rate movements. The main threat for sharp effective exchange rate movement depends on how global macroeconomic imbalances are played out over the coming few years.

*...due to  
unsustainable  
developments in the  
US and China*

In this context it is not clear-cut that the dollar/euro exchange rate has much further to fall even if the effective exchange rate would fall to ensure sustainability of the US current account. However, if the Chinese renminbi and other Asian currencies are not re-valued, the euro exchange rate may come under greater pressure as demand for euro-based assets could easily rise as they are the main alternatives to assets denominated in the US dollars.

*Correction through  
higher US savings...*

The correction of global imbalances has to occur mainly through higher US private savings required to restore balance to its triple deficits – trade, government and households. This may reduce world demand and dampen Euro Area growth through decreases in export demand and deterioration in

*... with a modest  
impact on euro's  
value*

price competitiveness. The full impact would depend upon the nature of the shock and the response of the monetary authorities. For example, if a 10 per cent US housing and equity price decline triggered the balancing, the Euro Area output would be around 0.3 per cent below the base line in the first year and would only recover slowly thereafter. The exchange rate changes implied by the simulation are rather modest.

*Oil price most likely  
not a threat to the  
recovery ...*

The nature of the oil price shock resulting from increased demand in developing countries, and especially in China, impacts negatively on the Euro Area in terms of both output and inflation. It is estimated that the losses for the Euro Area are not that significant, with the main impact coming through a change in the terms of trade. The overall long-run effect will depend on oil intensity, trade patterns and policy flexibility. If we assume that the oil price will rise permanently by US\$5 above the baseline, Euro Area GDP growth would decrease only 0.1 percentage points in the first two years. To a significant extent there would be a recycling of the oil revenue through increased imports by oil producers. High world economic growth reveals that oil prices are not a major threat to recovery.

*... weak spot  
remains domestic  
demand in the Euro  
Area*

While the external environment is important, explanations for the weak growth performance of the Euro Area must also focus upon domestic demand deficiencies. The appreciation of the euro can definitely not explain poor domestic demand. Monetary policy has not been restrictive, and interest rates in real inflation-adjusted terms are low, yet consumption growth remains weak with some modest investment recovery underway. The influence of discretionary fiscal policy has been close to neutral at the aggregate level in 2004 but still has made only a limited contribution to domestic demand in recent years.

*Policy-mix tightening  
ahead but inflation  
under control...*

The policy-mix forecast for this year and next is for the European Central Bank to tighten interest rates by 0.75 percentage points, while fiscal policy is expected to be broadly neutral this year and slightly restrictive next year. Interest rates in nominal terms are rather low if we use a standard Taylor Rule and inputs from our model based forecast. Therefore, much uncertainty is attached to estimates of output gaps, and on estimates like those from of the OECD and the European Commission, forecast interest rates may be appropriate and in line with the target inflation rate. Our forecast for price inflation is for a rate of 2 per cent in 2005 and 1.8 per cent in 2006.

*... while fiscal policy  
has been neutral in  
recent years...*

The three largest economies of the Euro Area are expected to exceed the 3 per cent deficit of the SGP, with the overall Euro Area public deficits averaging around 2.5 per cent both this year and next. The influence of discretionary fiscal policy was close to neutral in recent years in the Euro Area, such that the increase in fiscal deficits was due to poor economic performance. Discretionary fiscal policy in the Euro Area did not contribute to domestic demand in recent years, which was in sharp contrast to the US and the UK.

Two views are expressed within EUROFRAME-EFN institutes on the Council's agreement reached on 22 March 2005 on the implementation of the Stability and Growth Pact. Some of us are worried that the agreement will be detrimental to budgetary discipline and will lead to higher government deficits and insufficient budgetary consolidation. Some of us regret that criteria such as the 3 per cent of GDP threshold remain: they would like the policy framework to prevent negative externalities to occur (excessive inflation, current account deficits) and domestic fiscal autonomy to be reaffirmed.

*... but high  
unemployment rates  
persisting*

The host of deficiencies across the Euro Area economies point to the need to address specific policy measures at solving seemingly intractable problems such as the high rates of unemployment. Our forecasts for unemployment rates in the Euro Area are 9 per cent this year and 8.8 per cent next year.

*Relocation: where do  
we stand? ...*

Visible disadvantages and much less visible gains characterise the impact of international relocation of production on the EU economy. This Report's special topic shows that relocation requires sectoral restructuring, causes job losses, affects the position of low-skilled workers, and may intensify tax competition. However, these disadvantages should be seen in perspective. Trade with and direct investment in low-wage countries are rising fast, but still take up a relatively small part of the total. Most of EU countries' trade and capital flows take place with the US or other European countries. Hence, job losses due to relocation are relatively small. Also, relocation only to a limited extent weakens the position of low-skilled workers, which manifests itself in unemployment or growing wage differentials with high-skilled workers. Technological change is more important for the disparity between low-skilled and high-skilled workers. Moreover, a part of relocation is not motivated by low-cost competition, but by access to foreign markets or foreign suppliers.

Gains from relocation countervail the disadvantages. Larger international trade and capital flows reduce import prices, create opportunities for productive companies, expand product variety and foster international learning. Relocation also enables companies to increase their productivity. More productive companies reduce their prices or pay higher wages, thus benefiting customers and workers. These advantages spread out across the economy and are less visible than direct disadvantages.

*...policies should  
respond*

Visibility of losses and gains from relocation is also relevant for policy makers. Policy makers need to take both sides of the coin into account when they want to make informed decisions and when they participate in the public debate. Policy makers can facilitate sectoral shifts and skill upgrading to enhance Europe's comparative advantage in high-skilled activities. R&D warrants special attention because relocation of R&D entails the risk of a loss of associated knowledge spillovers. To prevent tax competition, policy co-ordination on corporate taxes seems desirable. Last and somewhat least from the perspective of relocation, but certainly not least from the perspective of technological change: in their design of social security provisions, policy makers face an awkward dilemma between greater income inequality and higher unemployment of low-skilled workers.





# 1. OUTLOOK FOR THE EURO AREA

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## 1.1 Overview

Global economic activity has weakened somewhat in recent months after accelerating considerably in the first half of 2004. The primary cause of this slowdown lies in high and volatile oil prices, while for the Euro Area the depreciation of the US dollar also plays a role. We anticipate a rebound in activity in the second half of 2005 and in 2006, predicated on the unwinding of growth in oil prices. Overall, we expect global GDP growth to be around 4.5 per cent this year before moderating slightly to 4.3 per cent in 2006. These forecasts are consistent with the world economy operating at around potential. In line with this slowdown in international growth, world trade growth is likely to decelerate from around 9 per cent in 2004 to 7.3 per cent in 2005 and 5 per cent in 2006. Oil prices are expected to decline moderately from mid-2005 with average prices forecast to be around \$41 per barrel in 2005 and \$39 per barrel in 2006.

Despite a modest rebound in Euro Area activity last year, growth continues to lag behind that of the world's major economies. The recovery lost momentum as the year progressed and real GDP increased by a disappointing 0.2 per cent in the fourth quarter of 2004 compared to the previous quarter. However, we anticipate this slowdown to be temporary, and that a recovery will be underway by the second quarter of 2005. Our view is that the Euro Area will grow by a modest 1.5 per cent this year and when the recovery takes hold in 2006 growth of 2.0 per cent is expected. This is broadly in line with potential, but insufficient to reduce the current output gap. Domestic demand is expected to make a stronger contribution to growth, while the continued appreciation of the euro will result in a smaller contribution to growth from the external sector.

The outlook for prices in the Euro Area is for inflation to moderate. We project inflation to be 2.0 per cent this year before moderating further to 1.8 per cent in 2006. We anticipate limited second-round effects of recent oil price increases. Limited monetary tightening is anticipated to begin in the second half of 2005, with interest rates expected to rise gradually as the economy strengthens. The larger Euro Area economies, that currently have a deficit above the 3 per cent GDP limit of the Maastricht Treaty, are forecast to make modest progress in fiscal consolidation over the next two years. This will result in the overall general government deficit declining slightly to 2.6 per cent in 2005 and 2.5 per cent in 2006.

**Table 1.1: Euro Area Forecast of Key Indicators**

|   | 2001                             | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|----------------------------------|------|------|------|------|------|
|   | <b>Annual percentage changes</b> |      |      |      |      |      |
| GDP                                       | 1.6                              | 0.9  | 0.5  | 1.8  | 1.5  | 2.0  |
| Harmonised Consumer Prices                | 2.4                              | 2.3  | 2.1  | 2.1  | 2.0  | 1.8  |
|   | <b>Levels</b>                    |      |      |      |      |      |
| Standardised unemployment <sup>a</sup>    | 8.0                              | 8.4  | 8.9  | 8.9  | 9.0  | 8.8  |
| Government financial balance <sup>b</sup> | -1.7                             | -2.4 | -2.7 | -2.7 | -2.6 | -2.5 |

<sup>a</sup> As percentage of total labour force

<sup>b</sup> As a percentage of GDP

Despite improving growth prospects for the Euro Area, several downside risks pose a threat to our forecast. These are mainly externally driven and include increasing volatility in oil prices (see box in Section 1.3) and the impact of persistent and increasing global imbalances on the Euro Area (see Section 1.2). On the upside, current inflation and interest rates in the Euro Area have yielded very low real interest rates, which could help increase business investment.

## 1.2 Short Term Economic Outlook

### DEVELOPMENTS AND OUTLOOK OUTSIDE THE EURO AREA

Growth in the world's main economies has remained relatively robust despite some deceleration in recent months. In the last quarter of 2004, strong growth in the US and China helped to overcome the negative contribution from Japan to global growth. Inflationary pressures are beginning to mount, particularly in the US, with OECD inflation forecast to increase from 2.0 per cent in 2004 by 0.3 percentage points both this year and next. We will see some monetary tightening in the world's major economies over the forecast horizon. Oil prices are expected to decline moderately from mid-2005. The robust world growth forecast in the near term, albeit at a more moderate rate than last year, will ensure Euro Area foreign demand remains relatively strong.

#### UNITED STATES

Fuelled by burgeoning domestic demand, US GDP growth remained robust last year. However, growth decelerated slightly to 3.9 per cent per annum in the final quarter of 2004. There are few signs that economic activity in the US will shift away from consumer and government spending and investment and towards exports this year, as monetary policy remains accommodative and there is little indication of fiscal prudence in the current federal budget negotiations between the White House and Congress. As a result, we expect US GDP growth to be 3.6 per cent this year and slightly less in 2006, with the economy operating near full capacity.

As the dollar continues on its downward trajectory we forecast the annual rate of inflation in the US to be somewhat higher than in the recent past, averaging over 3.0 per cent in 2006. Given strong asset prices and the weak exchange rate then interest rates may have been set to produce a more expansionary monetary policy in the US in February of this year than in the previous May just before tightening began. In spite of this, there are few indications that the US monetary authorities are prepared to raise the federal funds rate at anything other than "the measured pace" – we forecast short-term US interest rates to reach only 3.25 per cent by the end of this year, rising further to just over 4.0 per cent in 2006, a level which hardly qualifies as neutral. This, in combination with a weaker dollar, suggests that annual inflation in the US will grow somewhat faster than in the recent past. Supply-

side indicators also point to a pick-up in inflation rate in the US over the near term. The deceleration in productivity is well underway – non-farm labour productivity grew by 2.5 per cent on an annual basis in the last quarter of 2004 as compared to the annual growth rate of 5.5 per cent during the first half of last year. As a direct consequence, labour costs per unit of output have begun to increase, adding further impetus to inflation resulting in a more rapid increase this year than in 2004.

The US imbalances – external, government and household – continue unabated. In the final quarter of last year, the US current account deficit, driven by a massive trade deficit, widened to over 6 per cent of the country's GDP for the first time. Preliminary data for the first few months of this year indicate that the US trade deficit continues to widen, as import growth outpaced that of exports. However, it should be noted that the ongoing dollar depreciation against major currencies – with the notable exception of China – is beginning to have an impact on the external imbalance, as trade deficits with key trading partners such as Canada and Europe are beginning to narrow. In this context, it is not clear-cut that the dollar/euro exchange rate has much further to fall even if the effective exchange rate falls to ensure sustainability of the US current account. However, if the Chinese renminbi is not re-valued, the euro exchange rate may come under greater pressure as demand for euro-based assets could easily rise as they are the main alternatives to US dollar denominated assets.

## JAPAN

Official revisions show that the recovery in economic activity in Japan was less robust than originally estimated. The latest revisions to the newly applied chain-linked Japanese national accounts data showed that economic growth not only softened from the second quarter of 2004 but that the economy was in fact in a technical recession as it contracted by 0.3 per cent in both the second and third quarters of last year. While the economic contraction did not extend to the fourth quarter, the economy only grew by a weak 0.1 per cent in the last quarter of 2004. These data reinforce our view that the Japanese recovery remains fragile despite the significant structural improvements in the corporate and banking sector. In particular, consumer and business confidence in the economy appears to be easily quelled by temporary external shocks such as the global inventory adjustment in specific IT-related sectors in 2004.

From the disappointing national accounts data, one would never have concluded that the Japanese corporate sector is actually at its healthiest in the post-bubble era. Balance sheet restructuring and non-performing loans disposal have more or less been completed, while double digit corporate profit growth since the end of 2003 have resulted in high levels of free cash flow. These would usually translate into higher labour compensation and, in turn, higher consumption as well as high investment as capacity expansion activities pick up. However, in the current continuing deflationary environment, both the corporate and household sectors remain extremely cautious and real recovery may be delayed into 2006. The current investment recovery has been patchy with year-on-year private sector investment growth falling from 8.6 per cent in the last quarter of 2003 to 1.6 per cent in the fourth quarter of 2004. Although signs of a rebound in the economy have emerged in the last few months as various coincidental and leading indicators improved, we forecast growth to remain weak in 2005 as a whole with the economy expanding by 0.8 per cent as the corporate and household sectors rebuild their confidence.

## REST OF ASIA

Despite the sustained increase in oil prices in 2004, growth in Asia excluding Japan remained resilient last year. Most importantly, economic fundamentals within the region continued to improve as economies slowly shifted their reliance on export led growth to internally generated Asian demand growth. Much of the growth in the rest of Asia comes from China which has become the engine of growth for the region, while domestic demand in individual economies is also benefiting from low real interest rates.

Prospects for the region in the coming two years remain bright as China has successfully achieved a soft landing. With Chinese exports showing renewed signs of strength in the latest data releases, assisted by the weak US dollar, we expect growth in China to remain strong in 2005 before decelerating in 2006. Growth in the region will in turn remain robust. Nonetheless, key risks remain, especially that of overheating in China because asset inflation remains high. Preventing an asset bubble is likely to be the key challenge for the Chinese authorities in the coming year as pressure for the renminbi to appreciate continues.

## UK

The UK expanded strongly in 2004, with GDP growth of 3.1 per cent per annum. Growth is expected to moderate this year and next, but to remain slightly above the rate for trend GDP. Growth this year and next is forecast to be more balanced than in previous years. Slowing household consumption expenditure growth is expected to be compensated for by growth in business investment and exports. We expect the trade balance to begin to provide a positive contribution to growth. Weaker than expected world demand remains a risk to the economy but, more particularly, weak growth in domestic demand in the European Union remains a downside risk to UK exports, and consequently UK growth.

## OTHER EUROPEAN COUNTRIES

According to the first published estimates, GDP growth accelerated in almost all of the ten new member states in 2004. The weighted average growth rate for the ten countries was 5.0 per cent. Domestic demand grew substantially in all countries. However, the emphasis has now shifted: private consumption growth declined due to the inflation upturn, whereas investment outlays showed strong dynamics based on continued foreign investment inflow and public infrastructure projects. Foreign trade contributed negatively to growth in most countries (excluding Poland, Hungary and Estonia), however, the negative contributions decreased in some countries compared with the previous year owing to dynamic world demand and EU accession.

On average, GDP growth will slow down in 2005 and remain broadly on that level in 2006 (with rates of 4.2 per cent and 4.3 per cent respectively forecast), mainly as a result of reduced world demand and the currency appreciation recorded during 2004. Additionally, some one-off measures (opening of EU markets and implementation of EU rules to third countries, accumulation of reserves in the economy) will not take place in the upcoming years.

Last year the Scandinavian economies of Sweden and Denmark expanded at or above the average rate of GDP growth for the Euro Area as a whole with considerably lower rates of inflation. In Norway a domestic demand recovery is gaining momentum. It has been driven largely by increased oil investment that has coincided with the recent rise in crude oil prices.

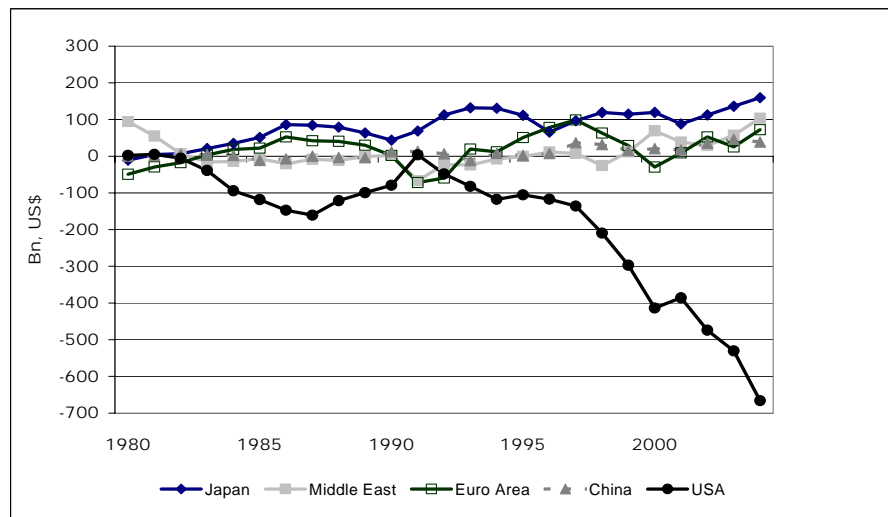
Russia continues to rely on oil exports as the principal engine of economic growth and the latest economic data corroborate this view. Russia's GDP

growth rate is expected to continue in high single digits this year and next, as oil prices have shown few signs of receding during the first quarter of this year.

### WORLD CURRENT ACCOUNT IMBALANCES A KEY RISK TO THE FORECAST

Current-account balances are at present very unevenly distributed across the world economy. The US current-account deficit is especially large, and reached \$666 billion, i.e. 5.7 per cent of GDP, in 2004. Summers (2004) has already noted that the US deficit represents two-thirds of the surpluses of other countries. According to Debelles and Galati (2005), most of the thresholds, beyond which adjustment in the current-account balance typically occurs, have been passed. However, in our baseline forecast we assume that the external debt stock can be kept in check, in part, because the US dollar is a key currency. Most US liabilities are expressed in dollars while many assets are priced in foreign currencies. In contrast to other industrialised countries, a possible depreciation would reduce the US's sizeable foreign net debt, which would ease the short-run negative effect of depreciation.

**Chart 1.1 Current Account in Selected Countries and Groups**



A closer look at the US saving-investment balance, which is behind the current-account deficit, shows that the current situation differs from the “twin deficits” period of the late 1980s; today’s case is more one of triple deficits than twin deficits. In addition to deficits in the current account and general government finances, the financial balance of households is also deeply in deficit. On the other hand, the business sector has implemented measures to bring its financial balance into considerable surplus in recent times (see e.g., de Carvalho and Suni (2003)). The large stock of debt accumulated by the external, government and household sectors makes the US economy very vulnerable to shocks, and thus represents one of the key risks to the forecast (see more in the article released on the EFN web site).

In the literature examining the adjustment of the US current account deficit, e.g., Blanchard *et al.*, (2005) and Obstfeld and Rogoff (2004), limited emphasis is placed on the importance of adjustment in the domestic saving-investment imbalance, a channel of adjustment that is treated in more detail in the NiGEM model. However, these studies show that a substantial adjustment is very probable and would be associated with large exchange rate changes.

## EFFECTS OF BALANCING GREATLY DEPEND ON THE SOURCE OF THE SHOCK AND ON THE POLICY REACTIONS

The current account balance is only a reflection of economic processes in the global economy. The balancing of world current accounts calls for a rise in domestic saving in the US relative to saving elsewhere. We analyse the balancing using the NiGEM model and extend the analysis of Al-Eyd, Barrell and Pomerantz (2005). They argue that an exchange rate shock alone or, more generally, a monetary shock would have sizeable short-term effects, but would not significantly improve the imbalances over the longer term. Shocks to the US such as tax increases, a decrease in housing prices or a sustained rise in the risk premium have permanent effects by changing behaviour. Naturally, a strong recovery in the Japanese and Euro Area economies would also balance the global situation in a favourable way.<sup>1</sup>

According to Al-Eyd *et al.*, fiscal contraction in the US would reduce output growth and improve the current account. An autonomous rise in US saving would also reduce US output growth and have negative spill-over effects on the Euro Area. Monetary loosening in the US and a temporary rise in the risk premium on US assets would generate a fall in the exchange rate, with an immediate worsening of the trade balance due to the J curve effect, and the US current account would improve only temporarily. In the former case the Euro Area might experience an increase in growth, whilst in the latter the negative impacts of the appreciation of the euro would be offset by a fall in real interest rates.

## THE EFFECTS OF CHANGES IN DOMESTIC SAVINGS

We have argued above that savings imbalances in the US are a major part of the imbalances problem, and thus we focus on changing the level of private sector saving in the US. Using NiGEM, we analyse the implications of a 10 per cent fall in house prices, and then a 10 per cent fall in both housing and equity prices. Finally, we simulate the effects of a rise in consumption in Japan and Europe.

In all three cases the US current account improves, but in the first two Euro Area output falls below its baseline trajectory because world demand is lower. The size of these effects depends on changes in (long-term real) interest rates and their impact on investment, which partly offsets the fall in consumption.

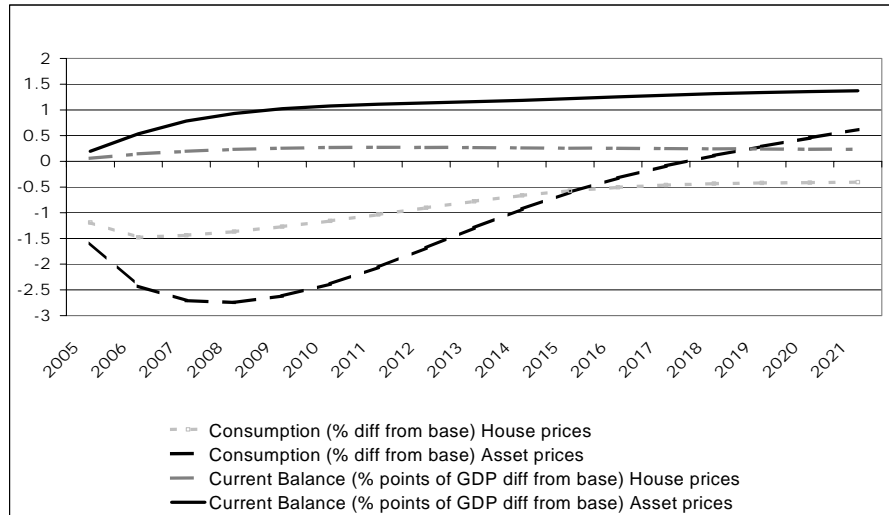
The most important part of the model for the transmission of saving shocks is clearly consumption, especially in the US, as shown in Barrell and Davis (2004). Changes in house prices feed into tangible wealth, and have five times the impact of a change in equity prices in the short run, but the same effect in the long run. A one per cent fall in real house prices reduces consumption by 0.15 per cent in the short run and by more in the long run even before the feed through effects on the rest of the economy are taken into account.

During the last five years real house prices in the US have risen by 25 per cent and household debt has expanded substantially by around 40 per cent in real terms. Both have reached levels which could lead to correction. We analyse a simulated fall in house prices of 10 per cent at the beginning of 2005. A decline of this magnitude would reduce consumption by more than 1 per cent

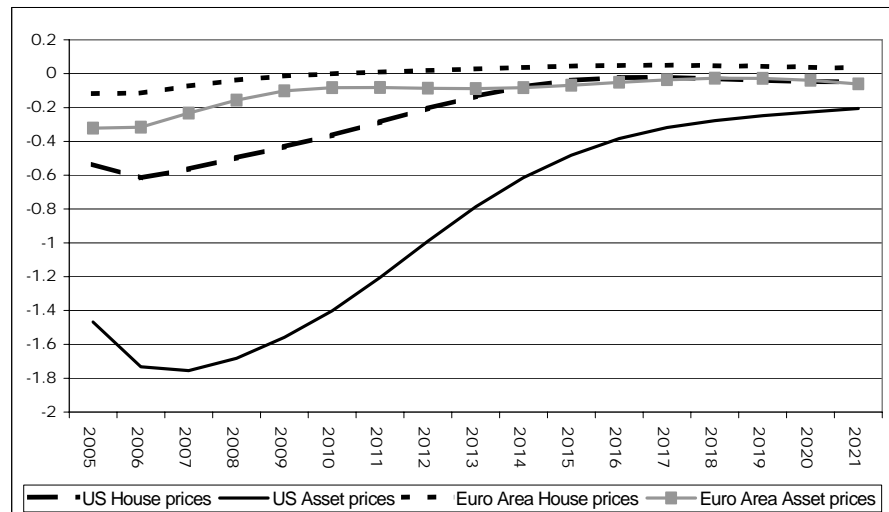
<sup>1</sup> It should be emphasised that the exchange rate is an endogenous variable (both in the model and the real world). It is not possible to give a simple answer to the question – what are the effects of a fall in the dollar? Effects will depend on the reasons for the fall. For instance, it is possible that a monetary expansion in the US will cause the dollar to fall, but will expand world demand so much that Euro Area output could even rise. On the other hand, a fall in the dollar associated with weak US demand would be accompanied with a decline in output growth in the Euro Area.

in the first year and slow growth markedly, as can be seen from Chart 1.3. If it were accompanied by a similar fall in equity prices, the impacts on the US economy would be much larger, as can be seen from the Chart 1.3. A fall in equity prices reduces both real financial wealth and the ability of firms to raise finance and hence would rapidly reduce investment.<sup>2</sup>

**Chart 1.2 Impact of Asset Price Falls on Consumption**



**Chart 1.3 Impact of US Asset Price Falls on GDP ( per cent diff from base)\***



\*The Asset price shock is a combined 10 per cent fall in US housing and equity prices.

A fall in saving in the Euro Area and Japan would have an expansionary impact on these economies, which in turn would reduce the current account imbalances between these areas and the US. The simulation is done by changing the intercept in the consumption equation for each Euro Area country. In the first year the saving rate falls by one percentage point. Falling saving rates lead to a reduction in wealth accumulation, which impacts the

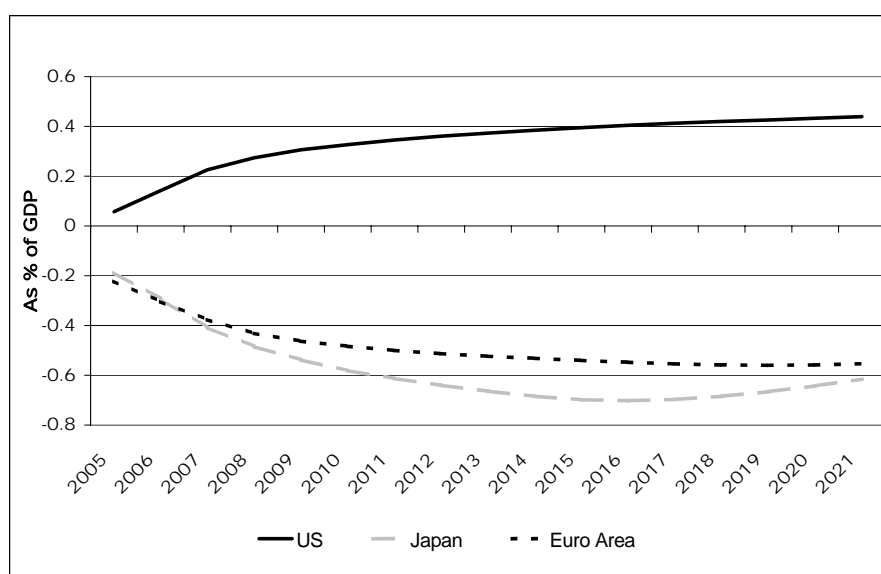
<sup>2</sup> Equity prices are a forward looking variable in our model, and we engineer a 10 per cent fall by raising the equity premium, and hence the discount rate on future profits.

future path of consumption. Higher demand induces a rise in interest rates which would put upward pressure on exchange rates, and higher long rates would reduce wealth. These factors would help offset the initial expansionary effects on consumption and demand. Output growth would rise markedly in the Euro Area and Japan, but a stronger dollar and higher interest rates would weaken growth in the US. Chart 1.4 plots the impacts of these increases in consumption on the US current account.

**Table 1.2 Effects of higher consumption in Japan and the Euro Area, ( per cent difference from base)**

| Output | Japan | Euro Area | US   |
|--------|-------|-----------|------|
| 2005   | 0.9   | 0.3       | -0.1 |
| 2006   | 0.6   | 0.4       | -0.2 |

**Chart 1.4 Increased Consumption in Japan and the Euro Area: Impact on Current Balances**



### 1.3 Developments and Outlook of the Euro Area

#### OVERVIEW AND DETAIL OF FORECAST

Recent economic developments have been disappointing in the Euro Area. Economic growth weakened significantly in the second half of the year, after a rather unimpressive performance in the first half. In the fourth quarter, real GDP increased by a meagre 0.2 per cent quarter-on-quarter unchanged from the previous quarter and compared with average growth of 0.7 per cent in the first half of 2004. It is likely that statistical working day adjustments help to explain some of the poor fourth quarter performance as there were approximately four extra working days in 2004 compared with 2003 and the numbers given are calendar adjusted. The impact of this on the annual growth rate is substantial- real GDP in 2004 is estimated to have increased at an annual rate of 2.0 per cent on a non-working day adjusted basis although on an adjusted basis it is estimated to have increased by 1.8 per cent.<sup>3</sup>

Overall Euro Area growth in 2004 was not broadly based and was characterised by strong export growth and weak domestic demand. However, in the last quarter of 2004, the contribution of domestic demand to quarterly

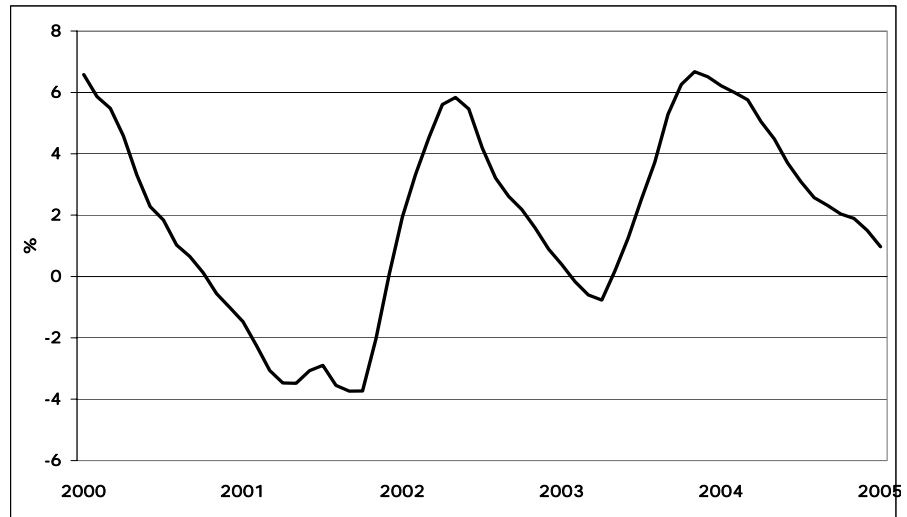
<sup>3</sup> All GDP data and forecasts discussed in the text and described in the tables are adjusted for working-day variation.



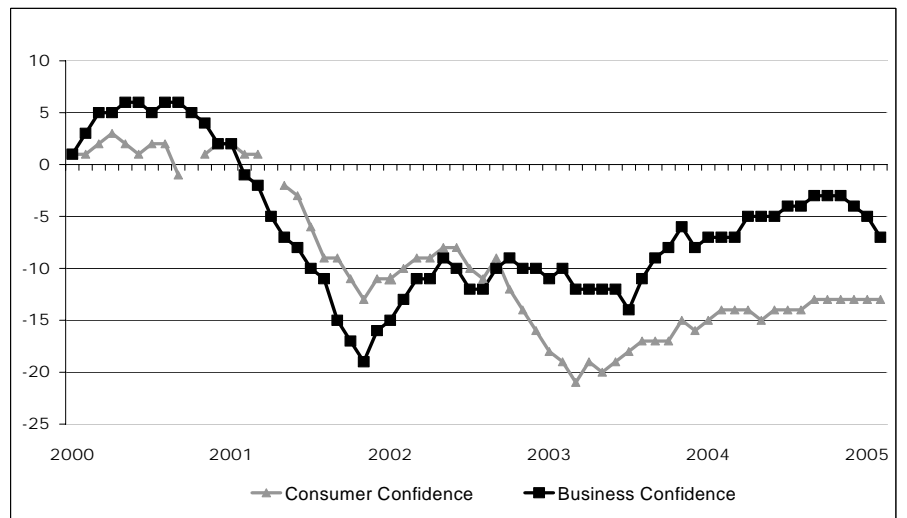
growth strengthened due to a rebound in consumer expenditure coupled with continued buoyant investment growth. The Euro Area was hit by the strong appreciation of the euro in the final quarter of 2004. This has served to dampen export growth by adversely affecting the competitiveness of the Euro Area.

**Chart 1.5: Euro Area, forward-looking indicators**

**OECD Composite Leading Indicator for the Euro Area**



**OECD Consumer and Business Confidence**



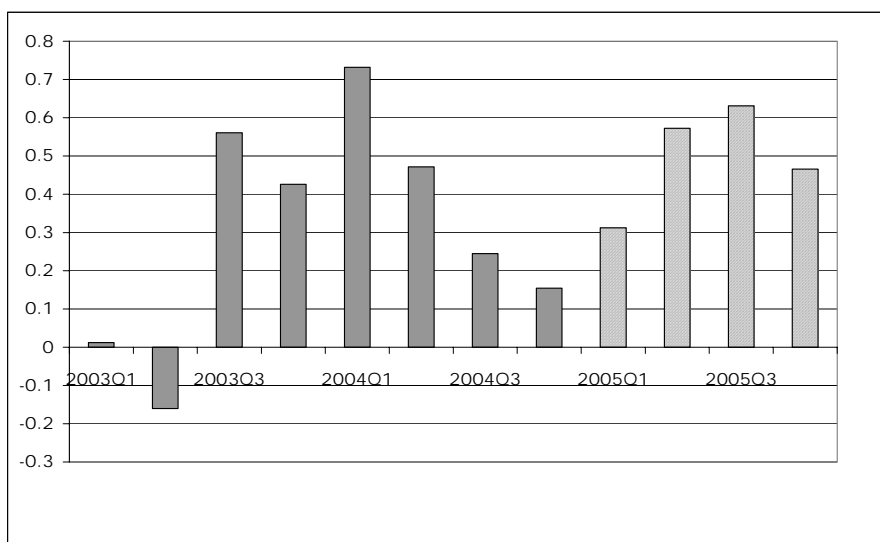
We feel that the Euro Area is currently experiencing a temporary lull in growth due to high and volatile oil prices and the strong appreciation of the euro and that it will return to a more favourable trajectory, after a slow start in 2005. Leading indicators of activity show that a pick-up in activity in the very near term is unlikely. The leading quarterly indicators produced by OFCE and NIESR suggest that growth in the first quarter of 2005 could be as low as 0.2 per cent compared to the previous quarter.<sup>4</sup> The EUROFRAME Euro Growth Indicator also shows a deceleration in the growth rate in the near term.<sup>5</sup> The

<sup>4</sup> See Charpin F., “OFCE quarterly GDP indicators” and Weale M., “Monthly GDP for the US and the Euro Area”. These papers are available at [www.euroframe.org/efn](http://www.euroframe.org/efn).

<sup>5</sup> The EUROFRAME Euro Growth Indicator is updated every month and is available at [www.euro-frame.org/indicator/index.php](http://www.euro-frame.org/indicator/index.php).

first quarter is forecast to be stronger than these indicators suggest, in part because of a carryover to demand of high levels of (working day unadjusted) incomes in the fourth quarter. We anticipate that growth will gather momentum in the second half of this year (see Chart 1.6) but that the Euro Area will expand only moderately over the next two years. For 2005 as a whole, real GDP is projected to increase by 1.5 per cent before strengthening to rise by 2 per cent next year.

**Chart 1.6: Euro Area Output Growth**



**Table 1.3 Euro Area Forecast**

|   | 2001                     | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|--------------------------|------|------|------|------|------|
|   | <b>Annual percentage</b> |      |      |      |      |      |
| <b>Volume</b>                             |                          |      |      |      |      |      |
| Consumption                               | 1.9                      | 0.7  | 1.0  | 1.1  | 1.4  | 1.5  |
| Private investment                        | -0.4                     | -3.4 | -1.0 | 1.3  | 2.7  | 3.1  |
| Government expenditure                    | 2.3                      | 2.8  | 1.5  | 1.7  | 1.2  | 1.4  |
| Stockbuilding <sup>a</sup>                | -0.6                     | -0.1 | 0.4  | 0.5  | 0.1  | -0.1 |
| Total domestic demand                     | 1.0                      | 0.3  | 1.2  | 1.8  | 1.6  | 1.7  |
| Export volumes                            | 3.5                      | 1.9  | 0.2  | 5.6  | 5.7  | 4.9  |
| Import volumes                            | 1.8                      | 0.5  | 2.0  | 5.9  | 6.1  | 4.4  |
| GDP                                       | 1.6                      | 0.9  | 0.5  | 1.8  | 1.5  | 2.0  |
| Average earnings                          | 3.6                      | 3.3  | 2.8  | 2.9  | 2.0  | 2.4  |
| Harmonised consumer prices                | 2.4                      | 2.3  | 2.1  | 2.1  | 2.0  | 1.8  |
| Private consumption deflator              | 2.4                      | 2.2  | 2.0  | 2.0  | 1.9  | 1.7  |
| Real personal disposable income           | 2.6                      | 1.2  | 0.9  | 1.6  | 1.6  | 1.3  |
|   | <b>Levels</b>            |      |      |      |      |      |
| Standardised unemployment <sup>b</sup>    | 8.0                      | 8.4  | 8.9  | 8.9  | 9.0  | 8.8  |
| Government financial balance <sup>c</sup> | -1.7                     | -2.4 | -2.7 | -2.7 | -2.6 | -2.5 |
| Government debt <sup>c</sup>              | 69.5                     | 69.4 | 70.7 | 73.6 | 73.6 | 72.8 |
| Current account                           | -0.2                     | 0.8  | 0.3  | 0.6  | 0.8  | 0.8  |

<sup>a</sup> Change as percentage of GDP.

<sup>b</sup> As percentage of total labour force.

<sup>c</sup> As a percentage of GDP.

The forecast sluggish recovery will continue to be dominated by strong export growth but will become slightly more broad-based. A weak investment recovery appears to be underway, encouraged by low real interest rates. Private

consumption will experience modest growth supported by real personal disposable income growth. Growth in government expenditure is likely to be more muted than in recent years, mainly due to the need in some of the Euro Area's larger countries to rein in expenditure to comply with the rules of the Stability and Growth Pact.

The forecast is based on the following assumptions:

The oil price is projected to increase moderately this year and to decline over the course of next year. Average prices are forecast to be around \$41 per barrel in 2005 and \$39 per barrel in 2006.

The exchange rate between the US-Dollar and the Euro is assumed to remain relatively stable over the forecast horizon at \$1.31 (\$/€) in 2005 and \$1.32 (\$/€) in 2006.

The short-term interest rate in the Euro Area is projected to be 2.3 per cent at the end of 2005 and 2.7 at the end of 2006.

The forecasts are based on data available up to 14<sup>th</sup> of March 2005.

In 2004, core inflation in the Euro Area remained marginally above the ECB's target of "close to but below 2.0 per cent" against a background of poor economic growth. The inflation outlook in the Euro Area remains relatively benign, as the currency appreciation continues to exert downward pressure on import prices and output remains below full capacity. Nonetheless, the recent rise in oil prices has made the possibility of a cut in interest rates unlikely in the immediate future. To date there has been an absence of second-round effects from developments in the oil market to wages and prices in the Euro Area.

The forecast for inflation shows a downwards trend over the next two years. Average inflation, as measured by the Harmonised Index of Consumer Prices (HICP), is expected to be 1.9 per cent this year before decreasing to 1.7 per cent in 2006. This fall in inflation is being triggered by weak output growth in early 2005, the feed-through of the stronger currency and continuing moderate wage increases. The tighter prevailing monetary conditions due to the strengthening of the euro coupled with the dampening effect on inflation of the current lull in growth mean the ECB are likely to keep interest rates unchanged in the first half of 2005. Thereafter monetary policy is expected to be tightened in order to bring rates more in line with a neutral rate implied by a Taylor rule.

Fiscal balances in the Euro Area remain a contentious issue among Member States and our projections show some progress in fiscal consolidation over the short term horizon. The overall Euro Area deficit stood at -2.7 per cent in 2004, unchanged from the previous year with France, Germany, Greece and Italy breaching the 3 per cent of GDP ceiling. The deficits for Germany, France and Greece are expected to be reduced both this year and next, although they will continue to remain outside the SGP deficit limits, while the Italian deficit is forecast to deteriorate further. Subdued growth prospects in Italy will contribute to an increase in its budget deficit this year before declining to 3.2 per cent of GDP in 2006. Although the economic situation may warrant it, the fiscal stance in the Euro Area does not appear to be expansionary.

Euro Area unemployment averaged a stubbornly high rate of 8.9 per cent of the labour force in 2004. An unemployment rate of this magnitude is related to the accumulation of weak growth in the Euro Area over recent years, and the slower growth forecast for this year may cause the high unemployment rate to become further entrenched. Particularly high rates of unemployment of about 10 per cent prevail in the larger economies of Germany, France, Spain,

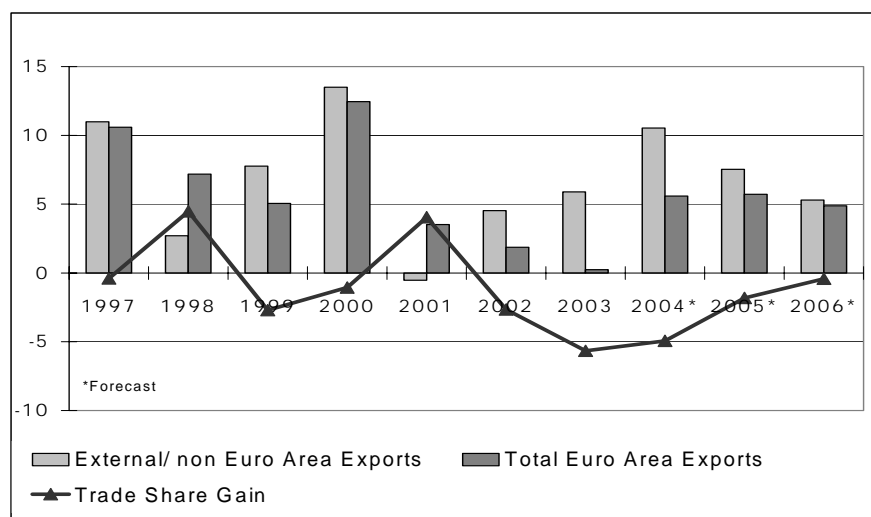
as well as in Greece. The impact of the recent merger of the welfare system and the unemployment system under the Hartz IV labour market reforms in Germany may move German unemployment rates higher initially, although they should result in the level of unemployment falling as active labour market interventions help boost employment over time. The standardised Euro Area unemployment rate is expected to reach 9.0 per cent this year before declining moderately to average 8.8 per cent in 2006.

The current account surplus has remained small and is by no means the major counterpart to the large and increasing US deficit. This surplus is projected to increase slightly in 2005 and 2006 to 0.8 per cent of GDP, up from 0.6 per cent of GDP in 2004. This rise will be driven by strong export demand growth and relatively moderate import growth.

### EXTERNAL DEMAND AND GROWTH

Economic activity in the Euro Area remains heavily dependent upon external conditions leaving it vulnerable to changes in global growth and exchange rates. However, despite the strengthening of the euro and a moderation in external demand, Euro Area exports grew at an impressive rate in 2004 in comparison to growth in previous years and growth is expected to hold up well over the short run. Export price competitiveness, fostered through low rates of inflation and subdued unit labour costs, has permitted some Euro Area countries to maintain export market shares despite the rising euro. Intra European trade, notably with the fast growing economies of Eastern Europe, and trade exposure with oil exporting nations have also provided support to overall Euro Area exports. Looking ahead, slowing global trade and risks arising from a further strengthening of the euro will leave net trade in the Euro Area making a negative contribution to economic growth. Strong growth in import volumes continues to outpace gains made through exports and therefore not all countries will see a boost to their output.

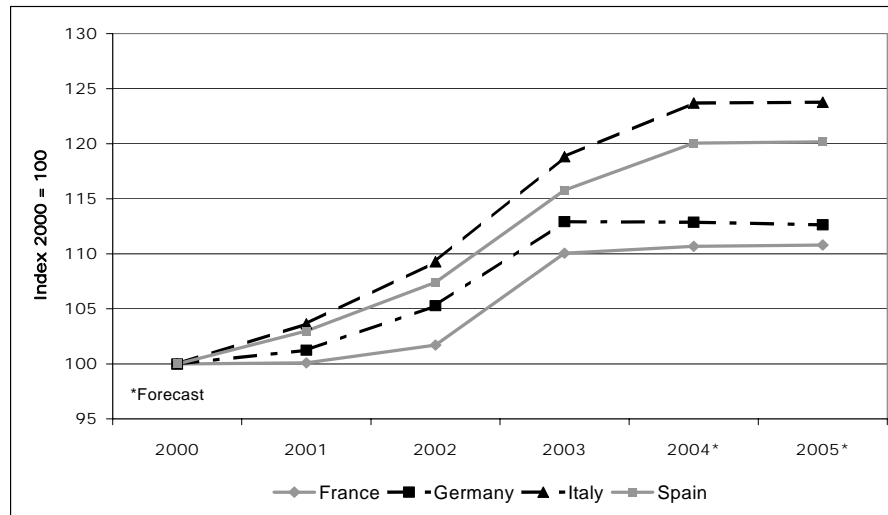
**Chart 1.7: Non Euro Area exports, Total Euro Area exports and trade shares**



As Chart 1.7 illustrates, external trade grew by 10.6 per cent in 2004 up from 5.9 per cent in the previous year, while growth in Euro Area exports increased by 5.6 per cent during this same period. This robust growth in exports is attributable to some Euro Area countries maintaining competitiveness and strong growth in global imports. The high price of oil has facilitated strong import growth in oil exporting countries that have historically been quick to recycle their oil revenues. European exporters are increasingly

exposed to these countries and to other fast growing and emerging economies such as China, which registered over 20 per cent growth in import volumes in 2004. Chart 1.7 also shows that the rise in Euro Area export growth coincides with a reduction in global trade share losses suffered by member country exporters. This trend began in 2003 and, although the Euro Area as a whole is expected to continue to suffer from trade share losses in the very near term, these losses will diminish over time as competitiveness gains achieved by individual countries, notably in Germany and France, move to sustain export market shares. These developments will support Euro Area exports in the near term despite a projected slowing of external trade growth.

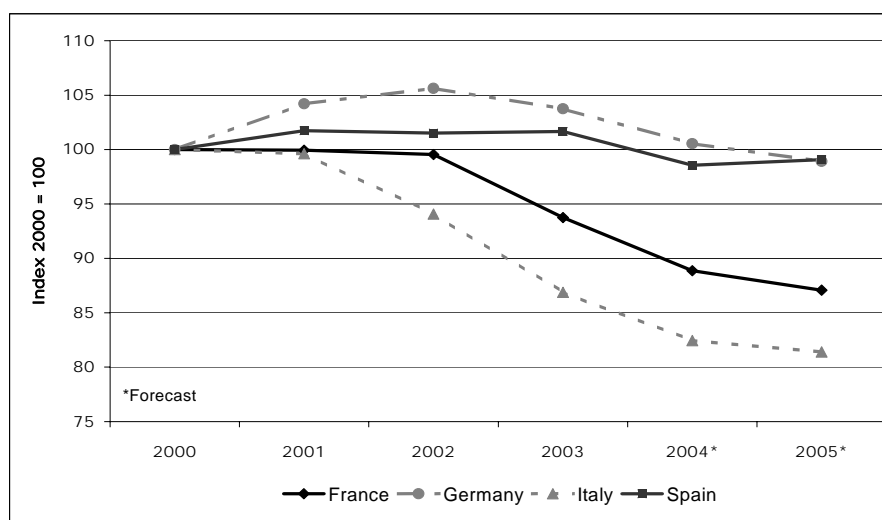
**Chart 1.8: Export Price Competitiveness**



Low inflation amongst Euro Area countries and subdued cost push pressures in some of the major economies have helped to keep overall exports competitive despite the strength of the euro. A closer look at export price competitiveness in Chart 1.8 reveals that both Germany and France have remained substantially more competitive than either Italy or Spain.<sup>6</sup> Relatively low inflation and subdued unit labour costs in Germany means that it has appreciated less in real effective terms than the rise in the euro might suggest. In Italy, however, rising unit labour costs have contributed to a loss in competitiveness and a recent deterioration in its trade balance. Remaining competitive externally does not necessarily imply a greater market share of exports. Falling labour costs and productivity gains in France have helped it to be more competitive externally, but this has not translated into a greater share of the export market, as Chart 1.9 indicates.<sup>7</sup> Germany and Spain, however, have managed to maintain their respective market shares over the recent past, but the strength of the euro could impact on them in our forecast period. As the Euro Area trade share indicates (see Chart 1.7), member countries are expected to stop losing export market shares and this is likely to be underpinned with low inflation and continued favourable financing costs. Moreover, the appreciation of the euro, while having the potential to weigh negatively on competitiveness, reduces the cost of commodities, such as oil, and manufacturing equipment, which are priced in US dollars, further easing costs to manufacturers.

<sup>6</sup> Export price competitiveness in a country is defined as the ratio of the price of non-commodity exports of goods and services to the price of its competitor's exports.

<sup>7</sup> A constant market share is defined as maintaining a constant share of imports into world markets.

**Chart 1.9: Export market share**

Recent gains in external price competitiveness do not appear to have come at the cost of thinning profit margins, which would point to increasing future export prices and the possibility of losses in export market shares. More precisely, corporate restructuring efforts, notably in Germany, and subdued wage pressures throughout most of the Euro Area have helped firms to build profit margins. Therefore, profits have grown but firms have not had to absorb much of the cost of the rise in the euro since competitiveness has, for the most part been maintained. Taken in conjunction with other national reform processes and the low cost of capital, the employment situation in the Euro Area is set to improve providing, a boost to consumption and total domestic demand.

The impact of trade share gains achieved through competitiveness effects is expected to feed through to domestic absorption as consumption and investment gain traction in the near term. This process will be supported by low financing costs, low inflation, and rising levels of tangible and financial wealth. Government expenditures will, however, remain restrained leaving only a modest pace of domestic expansion. However, the resulting combination of domestic and external demand will provide a more balanced path for economic growth in the near term.

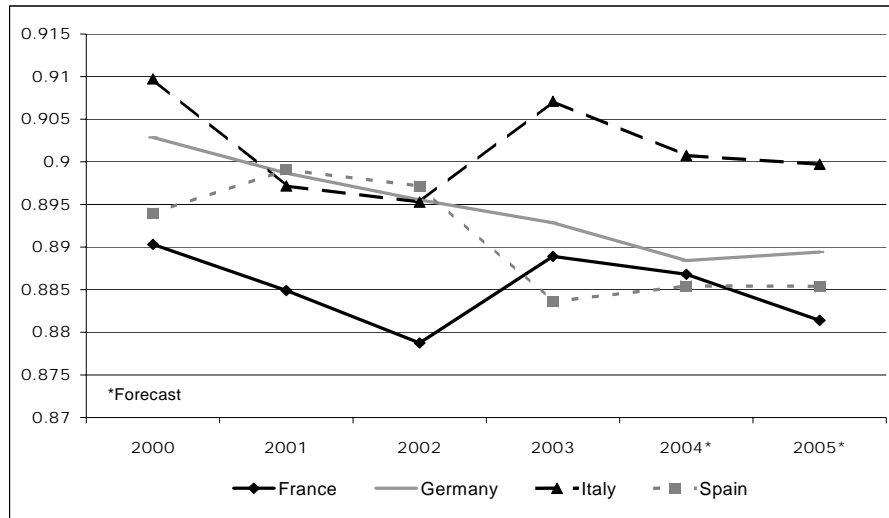
### **DOMESTIC DEMAND AND GROWTH: WHY IS THE EURO AREA GROWING SO SLOWLY?**

Part of the recent deficiency in domestic demand, and consumption in particular, can be attributed to the economic uncertainties generated by national reform processes, such as the Hartz IV reforms in Germany. It is likely that the ambitious nature of the Lisbon agenda, as well as external developments, have imparted a degree of uncertainty regarding the impact of these reforms on social systems as well as in relation to corporate sector restructuring. In turn, Euro Area savings rates are high and private consumption remains stagnant. This dynamic is most apparent in Germany where the implementation of the first part of the Hartz IV reforms and continued corporate restructuring have been accompanied by high savings rates and anaemic growth in consumption.

Looking at Chart 1.10 it is clear that German consumption as a proportion of personal income has been falling for some time and this trend has only recently been reversed. Both French and Italian ratios appear to have oscillated around the same point, while in Spain consumption has fallen well below previous levels. Stronger consumption growth in the Euro Area needs the

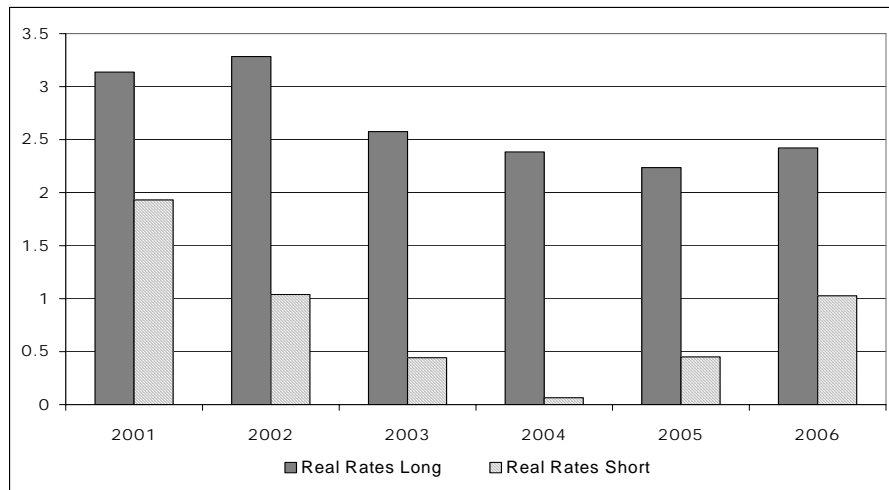
support of rising employment growth. This will move to broaden the basis of economic growth and help to restore confidence as contributions from net trade begin to moderate.

**Chart 1.10: Real consumption to personal disposable income**



Interest and exchange rate developments, at least in part, also explain the lacklustre performance of the Euro Area economy in recent times. Monetary policy has not been particularly restrictive, and real interest rates are low (see Chart 1.11). However at the same time, the exchange rate has been very strong with the Euro Area nominal effective exchange rate appreciating by 13.8 per cent in 2003 and a further 5.4 per cent increase in 2004. This has served to reduce the export market shares of the Euro Area economies and external demand.

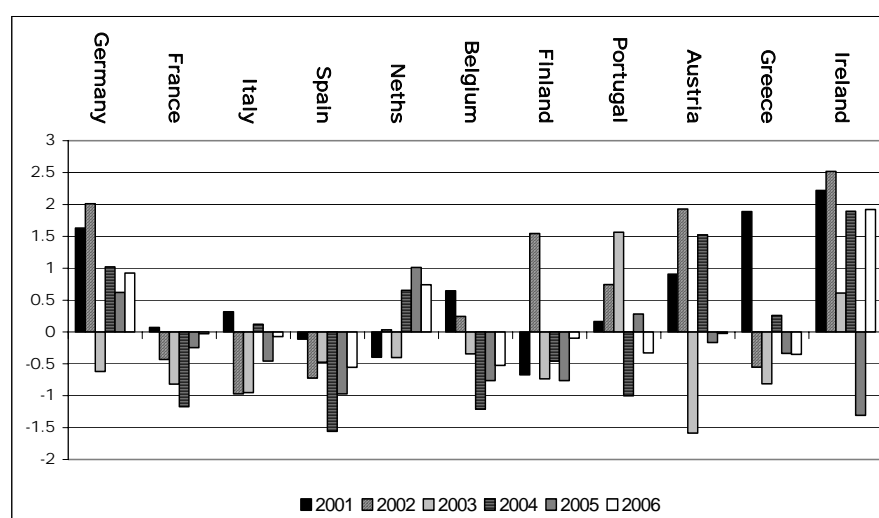
**Chart 1.11: Real Interest Rates in the Euro Area**



## MAIN DIFFERENCES BETWEEN THE LARGER EURO AREA ECONOMIES

Output growth differences between Euro Area countries have diminished in 2004 and this trend is set to continue over the near term.<sup>8</sup> Although growth differences have diminished, they have remained distinct and there are clear differences in the sources of growth. French and Spanish economic performance strengthened in the fourth quarter of 2004. GDP rose by approximately 0.8 per cent in both countries. This convergence of quarterly growth rates may mask the fact that the French and the Spanish economies have been following different paths in 2004. The strong growth in France followed an exceptionally weak third quarter. It does not constitute an acceleration of economic activity, but rather a return to the trend observed since the third quarter of 2003. Between that quarter and the first half of 2004, French output has been growing at an average quarterly rate of 0.8 per cent, which is very close to the growth rate posted in the fourth quarter. Spanish growth, on the contrary, has been accelerating steadily since the second quarter of 2003, from 0.6 per cent in that quarter to 0.8 per cent in the fourth quarter of 2004. The Atocha bombing in March 2004 had a very strong impact on GDP growth, which decelerated from 0.8 per cent in the first quarter of 2004 to 0.5 in the second quarter. However, exports of services were the only component of GDP affected by this event, and recovered quickly in the following quarters of the year. In contrast to the strengthening performance of the French and Spanish economies Germany's economy contracted by 0.2 per cent in the final quarter of last year with the negative impetus coming from company investment and consumer spending.

**Chart 1.12: The Contribution of the External Sector to Growth**



The external sector should make a negative contribution to growth in the major Euro Area countries, with the notable exception of Germany (see Chart 1.12). The appreciation of the euro hampered export performance and boosted imports. Although French and Spanish exports accelerated in the fourth quarter of 2004, export volumes in France and Spain have closed the year 2004 3.2 and 4.5 per cent above the levels reached in 2003, respectively. Imports have increased by 7.4 per cent in France and 9 per cent in Spain. Preliminary data from the Italian central bank indicate that import volumes rose by 3.2 per

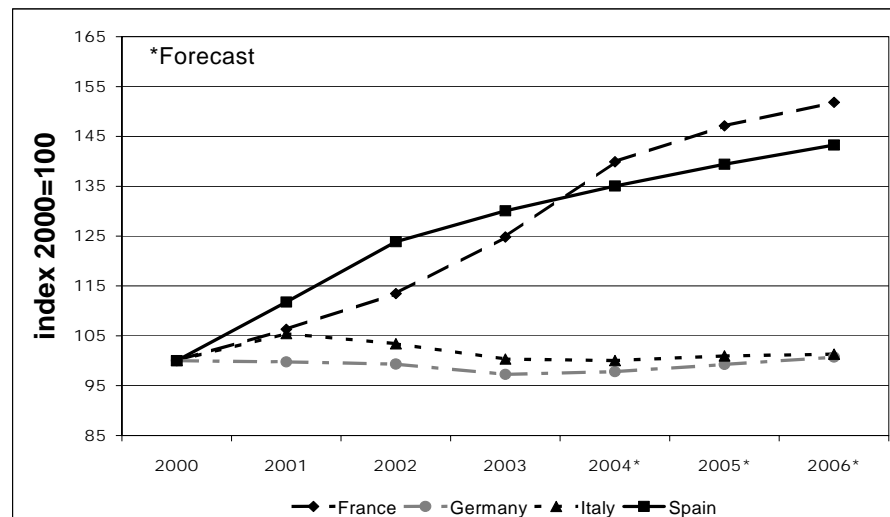
<sup>8</sup> Based on the standard deviation of unweighted growth rates of the Euro Area countries excluding Luxembourg.



cent in 2004, and Italian exports by 2.5 per cent. Finally, as we show in Chart 1.9 France, Italy and Spain have been losing export market. As a result, a positive contribution of the external sector in these three countries over the forecast horizon is very unlikely. German export volumes picked up markedly in 2004, rising at 7.5 per cent above their 2003 levels, in spite of suffering from the appreciation of the euro. German exporters have been particularly successful in the Chinese market and have benefited from strong import growth in that country.

The development and deregulation of financial markets in Europe has eased the liquidity constraints faced by consumers enabling them to draw upon both private wealth and current income to smooth their spending decisions over time. Evidence increasingly points to a positive relation between housing wealth (or the real value of the housing stock) and private consumption (see Al-Eyd and Barrell (2004) for an investigation and evidence). Chart 1.13 below shows that the real price of housing in both France and Spain has increased substantially in recent times, while those of Germany and Italy have remained relatively flat. Strong house price growth has clearly supported consumption in France, and to a lesser extent in Spain, whilst weak house prices have held back consumption in Germany, but have had little impact in Italy.

**Chart 1.13: Real House Price Growth\***



\* House price data comes from the Bank of International Settlements

Looking at fiscal matters, in both France and Germany, government expenditure is expected to remain restrained by their respective governments' commitment to achieving medium-term fiscal balance. Both countries have been in breach of the Maastricht treaty for three consecutive years and are now required to adjust public spending. The French government adopted stringent measures in the 2005 Budget to bring the budget deficit below 3 per cent of GDP. We thus anticipate annual government expenditure will grow at an average of 1.5 per cent over the forecast horizon. The budget deficit should revert to 3 per cent of GDP in 2005, and remain around this level in 2006. The reduction of the fiscal deficit to the Maastricht threshold in 2005 (from 3.7% to 3.1%) will be mainly due to the exceptional revenue generated by the transfer of management of EDF (Electricité de France) and GDF (Gaz de France) pensions to the state pension regime. The two state-owned firms will financially compensate the government with a transfer of €7.7 billion, representing 0.45 per cent of GDP. We do not forecast a substantial improvement in Germany's fiscal position, although the budget deficit will be reduced from 3.7 per cent of GDP in 2004 to 3.5 per cent of GDP in 2005, with the help of a one-off measure amounting to 0.4 per cent of GDP, and to

3.3 per cent of GDP in 2006, with the help of a one-off measure amounting to 0.2 per cent of GDP.

The Italian budget deficit is expected to reach around 3.5 per cent in both years. In the past two years, the Italian government has been relying on one-off measures to keep its deficit within the confines of the Maastricht Treaty.

## RISKS AND UNCERTAINTIES

Oil price developments continue to be characterised by significant volatility and they remain a major downward risk to the forecast. For this reason, we consider the impact on output in the Euro Area of a permanent \$5 rise in the price of oil. This is not meant as a forecast but rather to highlight the Euro Area's exposure to oil prices.

The euro could strengthen further, undermining future Euro Area growth. Issues relating to global imbalances persist. The US current account deficit has risen to more than 5 per cent of GDP, an all-time record high, and may increase further over the next two years with possible harmful consequences for Euro Area growth.

### Box: Oil Markets and China: Impact for European Economies

Since 2001, oil and other commodity prices have risen strongly and have displayed considerable volatility. In addition to supply problems, the main reasons for this have been strong energy-intensive growth in China as well the upturn in the rest of the world. In 2004 supply rose faster than demand, but inventory accumulation kept prices on an upward path. In 2005-6, oil markets will remain tight, although demand growth especially in China, will slow down from exceptionally high rates. The lack of free capacity continues to be the main problem making markets vulnerable in the long run as oil demand is expected to remain strong.

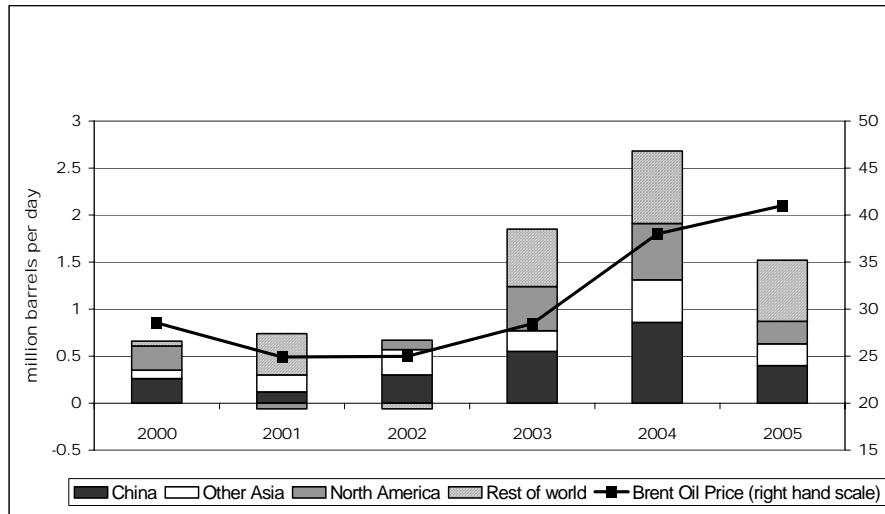
With less than a 5 per cent share of global oil output, China does not produce enough oil to meet its own demand. In 2004, China surpassed Japan as the second largest petroleum consumer in the world after the USA. The strong rise in energy demand will continue.

A sustained rise in oil demand from developing countries, and especially from China, will raise the equilibrium oil price permanently. Rising oil prices increases the costs of firms and reduces the purchasing power of consumers. The impact of a permanent \$5 increase in the price of oil is to only slightly depress the Euro Area in the short term. The impact on the Euro Area will be less than for the USA because the Euro Area's oil intensity of output is lower. In regions like the Euro Area where demand is not strong the impact of higher oil prices is the same as the terms of trade change against that region, reducing output and raising prices.

### Impact of a permanent \$5 increase in the price of oil on GDP

|                                      | Euro Area | Germany | France | Italy | USA  |
|--------------------------------------|-----------|---------|--------|-------|------|
| <b>per cent difference from base</b> |           |         |        |       |      |
| 2005                                 | -0.1      | -0.1    | -0.1   | -0.1  | -0.1 |
| 2006                                 | -0.2      | -0.2    | -0.2   | -0.1  | -0.3 |

**Chart 1.14: World Oil Demand Growth 2000-2005, Estimated by IEA and Euroframe Oil Price Forecast**



**CONCLUSIONS**

The Euro Area is experiencing a temporary lull in growth caused, in part, by high and volatile oil prices and the strong appreciation of the effective exchange rate. However, weak growth in recent years has also been due to structural problems in Germany, which will take time to resolve. Our forecast for the Euro Area economy is that it will experience a modest rate of output growth in 2005 with a gradual pick-up in activity by the second half of the year and into 2006. Our forecast for output growth in real GDP terms is 1.5 per cent in 2005 followed by a rise to 2.0 per cent in 2006. Domestic demand is expected to make a stronger contribution to growth than in the recent past while the continued appreciation of the euro will result in a smaller contribution to growth from the external sector. The potential impact of increasing global imbalances, most noticeably the US current account deficit, remains a threat to Euro Area growth. It is difficult to see how the issue of the strong euro will be addressed without US policy changes.

## Forecast Tables

**Annex Table 1: Real GDP in Major Economies<sup>a</sup>**

|                                  | World | OECD | NAFTA | Euro Area |     |       |         |        |       |     |     |
|----------------------------------|-------|------|-------|-----------|-----|-------|---------|--------|-------|-----|-----|
|                                  |       |      |       | EU-25     | USA | Japan | Germany | France | Italy | UK  |     |
| <b>Annual percentage changes</b> |       |      |       |           |     |       |         |        |       |     |     |
| 2002                             | 3.1   | 1.7  | 1.9   | 1.1       | 0.9 | 1.9   | -0.3    | 0.1    | 1.1   | 0.4 | 1.8 |
| 2003                             | 3.9   | 2.2  | 2.8   | 0.9       | 0.5 | 3.0   | 1.4     | -0.1   | 0.5   | 0.4 | 2.2 |
| 2004                             | 4.6   | 3.2  | 4.3   | 2.2       | 1.8 | 4.4   | 2.6     | 1.0    | 2.3   | 1.1 | 3.1 |
| 2005                             | 4.5   | 2.7  | 3.6   | 2.0       | 1.5 | 3.6   | 0.8     | 0.8    | 2.1   | 1.0 | 2.8 |
| 2006                             | 4.3   | 2.9  | 3.3   | 2.3       | 2.0 | 3.3   | 2.1     | 1.6    | 2.2   | 1.5 | 3.0 |
| 1995-2001                        | 3.6   | 2.9  | 3.4   | 2.6       | 2.4 | 3.4   | 1.2     | 1.7    | 2.6   | 2.0 | 3.0 |

<sup>a</sup> GDP data shown in the tables are adjusted for working-day variation. Extra working days in 2004 add around a quarter percentage point to GDP growth in 2004 for the Euro Area, while it reduces growth marginally in 2005. The impact of working-day variation is most pronounced for Germany.

**Annex Table 2: Private Consumption Deflator in Major Economies**

|                                  | OECD | NAFTA | EU-15 | Euro Area | USA | Japan | Germany | France | Italy | UK  |
|----------------------------------|------|-------|-------|-----------|-----|-------|---------|--------|-------|-----|
| <b>Annual percentage changes</b> |      |       |       |           |     |       |         |        |       |     |
| 2002                             | 1.7  | 2.0   | 2.1   | 2.2       | 1.4 | -1.2  | 1.2     | 1.7    | 3.1   | 1.6 |
| 2003                             | 1.9  | 2.3   | 2.0   | 2.0       | 1.9 | -0.7  | 1.0     | 1.8    | 2.5   | 1.9 |
| 2004                             | 2.0  | 2.5   | 1.9   | 2.0       | 2.2 | -0.5  | 1.6     | 1.5    | 2.1   | 1.3 |
| 2005                             | 2.3  | 3.2   | 1.9   | 1.9       | 2.8 | 0.3   | 1.6     | 1.9    | 2.0   | 1.7 |
| 2006                             | 2.6  | 3.4   | 1.9   | 1.7       | 3.3 | 0.7   | 1.0     | 1.9    | 2.2   | 2.5 |
| 1995-2001                        | 3.0  | 3.3   | 2.1   | 2.2       | 1.9 | -0.2  | 1.4     | 1.2    | 3.2   | 2.4 |

**Annex Table 3: World Trade Volume and Prices**

|           | World trade volume               | World export prices in \$ | Oil price (\$ per barrel) <sup>a</sup> |
|-----------|----------------------------------|---------------------------|--|
|           | <b>Annual percentage changes</b> |                           |  |
| 2002      | 3.6                              | 0.5                       | 24.4                                   |
| 2003      | 4.8                              | 9.4                       | 27.8                                   |
| 2004      | 9.0                              | 7.9                       | 35.9                                   |
| 2005      | 7.3                              | 5.4                       | 41.4                                   |
| 2006      | 5.0                              | 4.2                       | 38.6                                   |
| 1995-2001 | 7.3                              | -1.5                      | 19.3                                   |

<sup>a</sup> Based on the unweighted average of the Brent, WTI (West Texas Intermediate) and Dubai oil prices.

**Annex Table 4: Interest Rates**

|        | Short-term interest rates |       |           |     | Long-term interest rates |       |           |     |
|--------|---------------------------|-------|-----------|-----|--------------------------|-------|-----------|-----|
|        | USA                       | Japan | Euro Area | UK  | USA                      | Japan | Euro Area | UK  |
| 2002   | 1.7                       | 0.1   | 3.3       | 4.0 | 4.6                      | 1.2   | 4.9       | 4.9 |
| 2003   | 1.2                       | 0.0   | 2.3       | 3.7 | 4.0                      | 1.1   | 4.2       | 4.5 |
| 2004   | 1.6                       | 0.0   | 2.1       | 4.6 | 4.3                      | 1.5   | 4.2       | 4.9 |
| 2005   | 3.3                       | 0.1   | 2.3       | 4.9 | 4.3                      | 1.5   | 4.2       | 4.9 |
| 2006   | 4.1                       | 0.3   | 2.7       | 5.0 | 4.6                      | 1.8   | 4.3       | 5.0 |
| 2007   | 4.4                       | 0.5   | 3.2       | 5.0 | 4.7                      | 2.0   | 4.5       | 5.0 |
| 2004Q1 | 1.0                       | 0.0   | 2.1       | 4.1 | 4.0                      | 1.4   | 4.2       | 4.8 |
| 2004Q2 | 1.3                       | 0.0   | 2.1       | 4.5 | 4.6                      | 1.8   | 4.4       | 5.1 |
| 2004Q3 | 1.7                       | 0.0   | 2.1       | 4.8 | 4.3                      | 1.4   | 4.2       | 5.0 |
| 2004Q4 | 2.3                       | 0.0   | 2.2       | 4.8 | 4.2                      | 1.4   | 3.8       | 4.7 |
| 2005Q1 | 2.7                       | 0.0   | 2.1       | 4.8 | 4.2                      | 1.5   | 3.9       | 4.7 |
| 2005Q2 | 3.2                       | 0.0   | 2.2       | 4.9 | 4.3                      | 1.5   | 4.0       | 4.8 |
| 2005Q3 | 3.5                       | 0.1   | 2.3       | 5.0 | 4.4                      | 1.5   | 4.1       | 4.9 |
| 2005Q4 | 3.7                       | 0.2   | 2.4       | 5.0 | 4.4                      | 1.6   | 4.1       | 5.0 |
| 2006Q1 | 3.9                       | 0.2   | 2.5       | 5.0 | 4.5                      | 1.6   | 4.2       | 5.0 |
| 2006Q2 | 4.0                       | 0.3   | 2.7       | 5.0 | 4.5                      | 1.7   | 4.3       | 5.0 |
| 2006Q3 | 4.1                       | 0.3   | 2.8       | 5.0 | 4.6                      | 1.8   | 4.3       | 5.0 |
| 2006Q4 | 4.3                       | 0.4   | 2.9       | 5.0 | 4.6                      | 1.9   | 4.4       | 5.0 |

**Annex Table 5a: Effective Exchange Rates**

|        | USA                       | Japan | Euro Area | Germany | France | Italy | UK   |
|--------|---------------------------|-------|-----------|---------|--------|-------|------|
|        | Annual percentage changes |       |           |         |        |       |      |
| 2002   | 3.0                       | -0.4  | 7.5       | 2.9     | 3.4    | 4.8   | 2.5  |
| 2003   | -6.0                      | 3.9   | 13.8      | 6.6     | 6.4    | 7.1   | -2.7 |
| 2004   | -4.7                      | 4.2   | 5.4       | 2.3     | 2.3    | 2.7   | 5.3  |
| 2005   | -3.7                      | 1.7   | 2.1       | 0.7     | 1.2    | 1.1   | -1.0 |
| 2006   | -0.1                      | 2.9   | 0.8       | 0.5     | 0.5    | 0.5   | -1.5 |
| 2004Q1 | -1.9                      | 0.4   | 3.4       | 1.5     | 1.3    | 1.7   | 4.6  |
| 2004Q2 | 2.2                       | -1.7  | -2.7      | -1.4    | -1.3   | -1.4  | 0.4  |
| 2004Q3 | -0.8                      | 0.0   | 1.1       | 0.4     | 0.5    | 0.5   | -0.1 |
| 2004Q4 | -3.7                      | 2.0   | 3.1       | 1.3     | 1.6    | 1.6   | -1.6 |
| 2005Q1 | -1.0                      | 0.5   | -0.1      | -0.1    | 0.1    | 0.0   | 0.1  |
| 2005Q2 | 0.0                       | -0.1  | -0.1      | 0.0     | 0.0    | 0.0   | 0.1  |
| 2005Q3 | 0.0                       | 0.0   | 0.0       | 0.0     | 0.0    | 0.0   | -0.6 |
| 2005Q4 | 0.0                       | 0.8   | 0.2       | 0.2     | 0.1    | 0.2   | -0.6 |
| 2006Q1 | 0.0                       | 0.9   | 0.3       | 0.2     | 0.2    | 0.2   | -0.5 |
| 2006Q2 | 0.0                       | 0.9   | 0.3       | 0.2     | 0.1    | 0.2   | -0.4 |
| 2006Q3 | 0.0                       | 0.9   | 0.2       | 0.2     | 0.1    | 0.1   | -0.4 |
| 2006Q4 | 0.0                       | 0.9   | 0.2       | 0.2     | 0.1    | 0.1   | -0.4 |



**Annex Table 7: Real GDP in the European Union<sup>a</sup>**

|                | 2002                             | 2003 | 2004 | 2005 | 2006 |
|----------------|----------------------------------|------|------|------|------|
|                | <b>Annual percentage changes</b> |      |      |      |      |
| Austria        | 1.4                              | 0.7  | 2.1  | 2.3  | 2.3  |
| Belgium        | 0.9                              | 1.3  | 2.7  | 2.2  | 2.3  |
| Denmark        | 1.0                              | 0.4  | 2.0  | 2.7  | 2.6  |
| Finland        | 2.2                              | 2.5  | 3.4  | 2.9  | 3.1  |
| France         | 1.1                              | 0.5  | 2.3  | 2.1  | 2.2  |
| Germany        | 0.1                              | -0.1 | 1.0  | 0.8  | 1.6  |
| Greece         | 3.9                              | 4.3  | 4.8  | 3.0  | 3.2  |
| Ireland        | 6.1                              | 3.6  | 4.3  | 5.4  | 5.4  |
| Italy          | 0.4                              | 0.4  | 1.1  | 1.0  | 1.5  |
| Netherlands    | 0.6                              | -0.9 | 1.3  | 1.0  | 2.3  |
| Portugal       | 0.4                              | -1.2 | 0.8  | 1.8  | 2.3  |
| Spain          | 2.2                              | 2.5  | 2.7  | 2.6  | 2.3  |
| Sweden         | 2.0                              | 1.6  | 3.4  | 3.1  | 2.6  |
| United Kingdom | 1.8                              | 2.2  | 3.1  | 2.8  | 3.0  |
| Euro Area      | 0.9                              | 0.5  | 1.8  | 1.5  | 2.0  |
| EU-15          | 1.0                              | 0.8  | 2.0  | 1.8  | 2.2  |
| Accession-10   | 2.4                              | 3.7  | 5.0  | 4.2  | 4.3  |
| EU-25          | 1.1                              | 0.9  | 2.2  | 2.0  | 2.3  |

<sup>a</sup> GDP data shown in the tables are adjusted for working-day variation. Extra working days in 2004 add around a quarter percentage point to GDP growth in 2004 for the Euro Area, while it reduces growth marginally in 2005. The impact of working-day variation is most pronounced for Germany.

**Annex Table 8: Inflation in the European Union**

|                | 2002                             | 2003 | 2004 | 2005 | 2006 |
|----------------|----------------------------------|------|------|------|------|
|                | <b>Annual percentage changes</b> |      |      |      |      |
| Austria        | 1.7                              | 1.3  | 2.0  | 2.1  | 1.8  |
| Belgium        | 1.6                              | 1.5  | 1.8  | 2.1  | 2.0  |
| Denmark        | 2.4                              | 2.0  | 1.0  | 1.7  | 2.1  |
| Finland        | 2.0                              | 1.3  | 0.2  | 1.3  | 1.5  |
| France         | 1.9                              | 2.2  | 2.3  | 2.0  | 1.9  |
| Germany        | 1.3                              | 1.1  | 1.7  | 1.5  | 1.0  |
| Greece         | 3.9                              | 3.4  | 3.0  | 3.6  | 2.9  |
| Ireland        | 4.7                              | 4.0  | 2.3  | 1.5  | 2.3  |
| Italy          | 2.6                              | 2.8  | 2.3  | 2.1  | 2.2  |
| Netherlands    | 3.8                              | 2.2  | 1.4  | 1.1  | 1.3  |
| Portugal       | 3.7                              | 3.3  | 2.5  | 2.2  | 2.5  |
| Spain          | 3.6                              | 3.1  | 3.1  | 3.0  | 2.3  |
| Sweden         | 2.0                              | 2.3  | 1.0  | 1.9  | 2.1  |
| United Kingdom | 1.3                              | 1.4  | 1.3  | 1.7  | 2.2  |
| Euro Area      | 2.3                              | 2.1  | 2.1  | 2.0  | 1.8  |
| EU-15          | 2.1                              | 2.0  | 2.0  | 1.9  | 1.8  |
| Accession-10   | 2.7                              | 1.9  | 4.1  | 3.0  | 2.8  |
| EU-25          | 2.2                              | 2.0  | 2.2  | 2.0  | 1.9  |

**Annex Table 9: Fiscal Balances in the European Union**

|                | 2002  | 2003 | 2004 | 2005 | 2006 |
|----------------|-------|------|------|------|------|
|                | % GDP |      |      |      |      |
| Austria        | -0.2  | -1.0 | -1.0 | -1.7 | -1.8 |
| Belgium        | 0.1   | 0.3  | -0.1 | 0.0  | -0.4 |
| Denmark        | 1.6   | 1.2  | 0.9  | 0.9  | 1.1  |
| Finland        | 4.3   | 2.1  | 2.4  | 2.2  | 2.3  |
| France         | -3.3  | -4.1 | -3.7 | -3.1 | -3.0 |
| Germany        | -3.7  | -3.8 | -3.7 | -3.5 | -3.3 |
| Greece         | -3.7  | -4.6 | -5.0 | -4.2 | -3.3 |
| Ireland        | -0.2  | 0.2  | 0.5  | 0.0  | -0.7 |
| Italy          | -2.4  | -2.5 | -2.9 | -3.5 | -3.6 |
| Netherlands    | -1.9  | -3.2 | -2.6 | -2.1 | -1.9 |
| Portugal       | -2.7  | -2.8 | -2.6 | -2.7 | -2.0 |
| Spain          | -0.1  | 0.4  | 0.0  | -0.2 | -0.5 |
| Sweden         | -0.3  | 0.1  | 0.4  | 0.3  | 0.2  |
| United Kingdom | -1.6  | -3.3 | -3.0 | -3.6 | -4.0 |
| Euro Area      | -2.4  | -2.7 | -2.7 | -2.6 | -2.5 |

**Annex Table 10: Standardised Unemployment Rate in the EU-15**

|                | 2002                 | 2003 | 2004 | 2005 | 2006 |
|----------------|----------------------|------|------|------|------|
|                | % Total labour force |      |      |      |      |
| Austria        | 4.1                  | 4.3  | 4.5  | 4.9  | 5.1  |
| Belgium        | 7.3                  | 7.9  | 7.8  | 7.3  | 7.7  |
| Denmark        | 4.6                  | 5.5  | 5.4  | 4.9  | 5.1  |
| Finland        | 9.1                  | 9.0  | 8.9  | 8.8  | 8.6  |
| France         | 8.9                  | 9.4  | 9.6  | 10.0 | 9.6  |
| Germany        | 8.7                  | 9.6  | 9.8  | 10.1 | 9.7  |
| Greece         | 10.3                 | 9.7  | 10.1 | 9.9  | 9.7  |
| Ireland        | 4.4                  | 4.6  | 4.5  | 4.6  | 4.5  |
| Italy          | 8.6                  | 8.4  | 7.8  | 7.6  | 7.9  |
| Netherlands    | 2.8                  | 3.8  | 4.6  | 5.0  | 5.2  |
| Portugal       | 5.0                  | 6.3  | 6.6  | 6.9  | 6.4  |
| Spain          | 11.3                 | 11.3 | 10.8 | 10.3 | 10.4 |
| Sweden         | 4.9                  | 5.6  | 6.3  | 7.2  | 7.5  |
| United Kingdom | 5.2                  | 5.0  | 4.7  | 4.6  | 4.5  |
| Euro Area      | 8.4                  | 8.9  | 8.9  | 9.0  | 8.8  |



## 2. EUROPEAN POLICY MONITORING

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### 2.1 Monetary Policy in the Euro Area

Monetary policy has been quite accommodative in the recent past. Since June 2003, the minimum bid rate on the main refinancing operations of the Eurosystem has been 2.0 percent. Money market rates (3-month EURIBOR) were only slightly higher in early March this year. Apparently, markets expect that interest rates will not be raised very soon. If nominal rates are adjusted for core inflation, the real short-term interest rate is close to zero, i.e. well below the long-term average of 2 to 2 ½ percent for the Euro Area. Long-term rates are extremely low as well. The yields for 10-year government bonds have come down by some 50 basis points since the spring of last year and were near the historical lows they had previously reached in early 1999 and early 2003. In part, the decline reflects the expectation of a moderation of economic growth in the Euro Area and elsewhere as this has been a general tendency on world bond markets. In real terms, long-term interest rates are also very low by historical standards, whether the adjustment is made with the current rate of core inflation (total HICP excluding energy and unprocessed food) or the measure of inflationary expectations which is commonly approximated by the ten-year break-even inflation rate for the Euro Area; this measure has stayed slightly above 2 percent for more than a year now. Credit growth has accelerated in the wake of the economic recovery, and also the growth rates of monetary aggregates, which play a role in the monetary policy strategy of the ECB, picked up in the course of 2004. All these indicators suggest that monetary conditions in the Euro Area are favourable and stimulate economic activity.

The only major dampening factor stems from the exchange rate. The euro has gained ground against major world currencies, in particular against the US-dollar. However, the rapid appreciation of the euro, which could be observed up to the end of 2004, did not continue in the first months of this year. All in all, the euro has appreciated against the US currency by roughly 5 percent in the past 12 months. At the same time, the appreciation in real effective terms amounted to only 2 percent; this implies that the competitiveness has not been strongly affected and that the impact of the recent exchange rate change on real GDP growth and inflation in the Euro Area will be quite limited. It has to be kept in mind, however, that this appreciation comes on top of the previous sharp rise amounting to some 20 percent in real effective terms between late 2001 and early 2004.

Monetary policy is clearly on a course that is broadly supportive of the economic recovery at the Euro Area level. Key interest rates are low also if they are compared to the Taylor rule which may be used as a gauge of the monetary policy stance. If calculations of this rule are based on the standard formula<sup>1</sup>, current interest rates in the Euro Area are lower than their “neutral

<sup>1</sup> In the original version, the coefficients for the reaction to both the inflation gap and the output gap are 0.5. Following this assumption and assuming further that the core rate of

level” according to the rule, the difference being about 100 basis points. This is due to the fact that currently, (core) inflation is somewhat higher than the target of the ECB and that the negative output gap is – according to our estimate – relatively small, amounting to about -0.5 percent in 2004.<sup>2</sup>

This judgement is also important for the future course of monetary policy. The neutral nominal interest rate, which would be appropriate if overall capacity utilization in the economy is normal and if inflation is at the target, is probably between 3.5 and 4 percent.<sup>3</sup> Such an estimate would follow from the Taylor rule and other rules for monetary policy. With the recovery continuing, the ECB is likely to move in that direction, which is also appropriate given its mandate to maintain price stability.

Against this background, further reductions of key rates are unlikely. Also, it has to be remembered that the ECB has reduced interest rates to the current low levels because of previous negative shocks and unusual uncertainties concerning the economic outlook. For example, about two years ago, the risk of deflation was publicly discussed not only in the United States but also in the Euro Area. But these risks are much less relevant today. Although the recovery in the Euro Area has so far been relatively sluggish, it has firmed enough so that it would not be credible to state that the unusual circumstances, which led to very low interest rates, persist. In other words, the economy does not need a further stimulus from monetary policy under the present and foreseeable circumstances.

However, the timing of interest rate hikes is also crucial and should depend on the outlook for inflation. Given our forecast, we do not see that the neutral rate should be targeted at in the near future. As far as demand conditions are concerned, we expect that the recovery will continue at a moderate pace. In addition, inflation will probably not accelerate so that interest rates do not have to be raised very quickly. In our view, rates will be raised moderately later this year and in 2006 so that short-term interest rates should be 2.9 percent at the end of 2006.

When evaluating the future monetary policy, it has to be kept in mind that there appears to be ample liquidity not only in the Euro Area but also worldwide. The ECB has acknowledged this on various occasions.<sup>4</sup> This is not only revealed in rapid growth of monetary aggregates in major economies but also in bond yields which are historically low in real terms; the latter fact is especially surprising given the strength of the upswing in the world economy. Also against this background, the ECB has repeatedly warned of “upside risks for price stability”. While our central forecast does not imply that the high level of liquidity will translate into a surge of nominal demand and therefore pose a major inflationary risk, a central bank with a commitment towards low inflation

inflation is a better guide for policy than the “headline” rate, the rule for period  $t$  can be interpreted as follows:

(1)  $i = r + \pi + 0.5 (\pi - \pi^*) + 0.5 (y - y^*)$ , with  $i$  being the nominal interest rate,  $r$  the equilibrium real interest rate,  $\pi$  the (core) rate of inflation,  $\pi^*$  the inflation target,  $y$  actual real GDP, and  $y^*$  potential real GDP.

<sup>2</sup> The calculations also require an estimate for the so-called equilibrium real interest rate. This is far from trivial. In general, estimates for the Euro Area are between close to 2 per cent, which is roughly in line with estimates for the growth rate of potential output. As it is well known, estimates vary here, too, and consequently the estimates for the output gap are affected as well. But according to most estimates – including that of our model – of the output gap and the equilibrium real interest rate, the current money market rate is lower than the one following from a Taylor rule.

<sup>3</sup> i.e. the sum of the real equilibrium interest rate (about 2 percent) and the target for inflation (slightly less than 2 percent). Needless, to say, such calculations of equilibrium real interest rates are highly uncertain. The modern literature on macroeconomics suggests also that this rate may fluctuate even in the short run.

<sup>4</sup> “... there remains significantly more liquidity in the euro area than is required to finance non-inflationary growth.” European Central Bank, Monthly Bulletin, January 2005: 5.

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## 2.2 Fiscal Policy in the Euro Area

has to closely monitor such developments of liquidity as well. Currently, we do not see that such a risk is emerging as the growth rate of nominal GDP is rather low. A scenario in which the ECB may have to consider an opposite move of interest rates concerns a possible sharp appreciation of the euro. (Such a scenario was considered in Chapter 1 and is discussed in detail in an Appendix to this report.) In order to prevent a strong deterioration of monetary conditions, the ECB would most likely lower key interest rates.

This section provides a brief assessment of the short-term budgetary prospects in the euro area. It focuses on the fiscal stance expected in the euro area in comparison with the latest updates of the stability programmes (SP) released at the end of 2004. It addresses successively: GDP growth scenarios, deficits targets and the fiscal stance of the euro area and summaries of two views of EUROFRAME-EFN institutes views on the agreement reached on the Stability and Growth Pact by the European Council of 22<sup>nd</sup> to 23<sup>rd</sup> March 2005.

### GROWTH PROSPECTS

The EUROFRAME-EFN Spring 2005 forecast expects the euro area GDP to grow by 1.5 per cent this year and 2.0 in 2006, well below the figures forecast in the SPs where euro area GDP is expected to grow by 2.3 per cent this year and 2.4 next (see Table 2.1). The SPs may well turn out again to be optimistic at the euro area level, as has been the case each year since 2001; in other words since the economic slowdown began in 2000.

Over our forecast horizon, we expect GDP to grow less rapidly than announced in the SPs, mainly in Germany this year (0.8 as compared to 1.75 in the SP, with growth expected to come closer to the SP figure next year: 1.6 as compared to 1.75), in Italy (around 1.0 this year and 1.5 next year instead of 2.5), and Greece (around 3 instead of more than 46). We expect French GDP to grow slightly less rapidly than in the SP (around 2.1 in 2005 and 2006 instead of 2.5 per cent). The macroeconomic scenarios of the SPs are judged broadly realistic for the other euro area countries.

### DEFICIT TARGETS

We do not expect the deficit targets announced in the SPs to be met in 2005 and 2006 at the euro area level (EUROFRAME-EFN forecast of around 2.6 per cent each year instead of the 2.3 per cent and 1.8 per cent announced in the SP). The deficit targets announced in the SPs are not expected to be met in 2005 in the three biggest countries: France, Germany and Italy. But the other euro area countries will probably meet their deficit targets. The same is likely to occur also in 2006.

The targets announced by Germany, France and Italy will not be met, partly because the assumptions on economic growth are too optimistic - GDP growth is expected to remain weak especially in Germany and Italy - partly because contractionary measures will not be as strong as announced. One-off measures are expected to cut the deficit by around 0.5 per cent of GDP in each of the three countries in 2005 and by 0.2 per cent of GDP in Germany in 2006. Additional restrictive measures would be needed for the three countries to meet their targets. In particular, Italy has to phase-out the one-off measures used extensively in recent years and to replace them with more structural measures. But at the same time the Italian government faces two important

<sup>5</sup> The Italian government has already announced it will revise downwards its forecasts for 2005.

<sup>6</sup> Figures available in early March, before the submission by the Greek government of a revised SP update due for March 21.

elections, which may make it unrealistic that additional measures will be implemented to tighten the fiscal stance.

The forecasts for GDP growth and fiscal balances suggest that the three biggest countries will be able to bring their deficits below 3 per cent of GDP in 2005 and 2006 only if they implement more restrictive fiscal policies than announced, unless they decide to use creative accounting again.

**Table 2.1. Euro area GDP growth and general government balances according to the stability programmes**

|    | GDP growth assumptions (per cent) |     |     |     |     |     |     | General government balance (per cent of GDP) |                      |      |      |      |      |      |        |       |
|----|-----------------------------------|-----|-----|-----|-----|-----|-----|--|----------------------|------|------|------|------|------|--------|-------|
|    | Stability Programmes              |     |     |     |     |     |     | Actual                                       | Stability Programmes |      |      |      |      |      | Actual |       |
|    | J99                               | J00 | J01 | J02 | J03 | J04 | J05 |  | J99                  | J00  | J01  | J02  | J03  | J04  |        | J05   |
| 98 | 2.8                               |     |     |     |     |     |     | 2.9  | -2.1                 | -1.9 |      |      |      |      |        | -2.3  |
| 99 | 2.5                               | 2.2 |     |     |     |     |     | 2.8  | -1.7                 | -1.4 | -1.2 |      |      |      |        | -1.3  |
| 00 | 2.6                               | 2.8 | 3.3 |     |     |     |     | 3.5  | -1.5                 | -1.1 | -0.7 | -0.8 |      |      |        | -1.0  |
| 01 | 2.6                               | 2.5 | 3.1 | 1.7 | 1.5 |     |     | 1.6  | -1.0                 | -0.8 | -0.6 | -1.2 | -1.6 |      |        | -1.7  |
| 02 |                                   | 2.5 | 2.9 | 1.9 | 1.0 |     |     | 0.9  |                      | -0.6 | -0.3 | -0.9 | -2.2 |      |        | -2.4  |
| 03 |                                   | 2.5 | 2.8 | 2.6 | 2.1 | 0.6 |     | 0.5  |                      | -0.2 | 0.0  | -0.5 | -1.8 | -2.7 |        | -2.8  |
| 04 |                                   |     | 2.8 | 2.6 | 2.6 | 1.9 | 2.0 | 1.8  |                      |      | 0.4  | 0.1  | -1.1 | -2.4 | -2.7   | -2.7  |
| 05 |                                   |     |     | 2.6 | 2.6 | 2.5 | 2.3 | 1.51   |                      |      |      | 0.3  | -0.6 | -1.8 | -2.3   | -2.61 |
| 06 |                                   |     |     |     | 2.6 | 2.5 | 2.4 | 2.01   |                      |      |      |      | -0.2 | -1.3 | -1.8   | -2.51 |
| 07 |                                   |     |     |     |     | 2.5 | 2.4 | -  |                      |      |      |      |      | -0.9 | -1.3   | -     |
| 08 |                                   |     |     |     |     |     | 2.4 | -  |                      |      |      |      |      |      | -1.0   | -     |

1. EUROFRAME-EFN, Spring Forecast 2005.

Sources: EUROFRAME-EFN, Stability programmes, Eurostat, own calculations.

### EXPECTED FISCAL STANCE

We expect euro area GDP to grow by 1.5 per cent and government deficits to remain almost unchanged this year at around 2.6 per cent of GDP. Deficits excluding one-off measures will, however, be close to 3 per cent this year like last year (with one-off measures expected to amount to 0.35 per cent of GDP in 2005 after 0.2 in 2004). On this basis, the fiscal stance in the euro area will be slightly restrictive this year. If it were assumed that potential output grows by almost 2.2 per cent, as in the SPs, the fiscal stance would appear to be marginally less restrictive this year at the euro area level (see Table 2.2b) than announced in the SP's (see Table 2.2a). However, the uncertainties in estimating the output gap and how potential output growth impacts on the fiscal stance are well known. Hence the fiscal stance would be more restrictive under higher potential growth estimates and would be better characterised as neutral with potential output growing at around 1.6 per cent.

In 2006, we expect GDP growth to accelerate at around 2.0 per cent and deficits to decrease to around 2.5 per cent of GDP, i.e. 2.6 excluding with one-off measures. This implies a restrictive fiscal stance of around -0.4 per cent of GDP against -0.7 per cent in the SPs.

Up to 2006, the fiscal stance is expected to be neutral or restrictive in almost all euro area countries according to the SP, with some exceptions: Belgium, Finland and Austria. Fiscal policy will probably have a dampening effect on economic growth at the euro area level in 2005 and 2006.

**Table 2.2a. GDP growth, fiscal balances and fiscal impulses in the updates of the stability programmes, end 2004**

|  | 2003 | 2004  | 2005 | 2006 | 2007 | 2008  |
|--|------|-------|------|------|------|-------|
| <b>Real GDP growth, per cent</b>                   |      |       |      |      |      |       |
| Germany  | -0.1 | 1.8   | 1.7  | 1.75 | 2.0  | 2.0   |
| France   | 0.5  | 2.5   | 2.5  | 2.5  | 2.5  | 2.5   |
| Italy  | 0.3  | 1.2   | 2.1  | 2.2  | 2.3  | 2.3   |
| Spain  | 2.5  | 2.6   | 2.9  | 3.0  | 3.0  | 3.0   |
| The Netherlands                                    | -0.9 | 1.25  | 1.5  | 2.5  | 2.5  | 2.5*  |
| Belgium  | 1.3  | 2.4   | 2.5  | 2.5  | 2.1  | 2.0   |
| Austria  | 0.8  | 1.9   | 2.5  | 2.5  | 2.4  | 2.4   |
| Finland  | 2.0  | 3.2   | 2.8  | 2.4  | 2.2  | 2.0   |
| Portugal   | -1.2 | 1.0   | 2.4  | 2.7  | 2.8  | 2.8*  |
| Greece   | 4.5  | 3.7   | 3.9  | 4.0  | 4.2  | 4.2*  |
| Ireland  | 3.7  | 5.3   | 5.1  | 5.2  | 5.4  | 5.4*  |
| Luxembourg   | 2.9  | 4.4   | 3.8  | 3.3  | 4.3  | 4.3*  |
| Euro area  | 0.6  | 2.0   | 2.3  | 2.4  | 2.4  | 2.4   |
| <b>General government balance, per cent of GDP</b> |      |       |      |      |      |       |
| Germany  | -3.8 | -3.75 | -2.9 | -2.5 | -2.0 | -1.5  |
| France   | -4.1 | -3.6  | -2.9 | -2.2 | -1.6 | -0.9  |
| Italy  | -2.4 | -2.9  | -2.7 | -2.0 | -1.4 | -0.9  |
| Spain  | 0.4  | -0.8  | 0.1  | 0.2  | 0.4  | 0.4   |
| The Netherlands                                    | -3.2 | -3.0  | -2.6 | -2.1 | -1.9 | -1.9* |
| Belgium  | 0.4  | 0.0   | 0.0  | 0.0  | 0.3  | 0.6   |
| Austria  | -1.1 | -1.3  | -1.9 | -1.7 | -0.8 | 0.0   |
| Finland  | 2.1  | 2.0   | 1.8  | 2.1  | 2.2  | 2.0   |
| Portugal   | -2.8 | -2.9  | -2.8 | -2.5 | -1.8 | -1.4* |
| Greece   | -4.6 | -5.3  | -2.8 | -2.6 | -2.5 | -1.9* |
| Ireland  | 0.1  | 0.9   | -0.8 | -0.6 | -0.6 | -0.6* |
| Luxemburg  | 0.8  | -1.4  | -1.0 | -0.9 | -1.0 | -1.0* |
| Euro area  | -2.7 | -2.7  | -2.3 | -1.8 | -1.3 | -0.9  |
| <b>Fiscal impulse, per cent of GDP (1)</b>         |      |       |      |      |      |       |
| Germany  | -0.8 | 0.1   | -0.5 | -0.7 | -0.6 | -0.4  |
| France   | 0.0  | -0.4  | 0.0  | -1.1 | -0.6 | -0.6  |
| Italy  | 0.3  | -0.6  | -0.4 | -1.2 | -0.4 | 0.0   |
| Spain  | -0.5 | 0.2   | 0.0  | 0.0  | -0.2 | 0.1   |
| The Netherlands                                    | -0.2 | -0.7  | -0.8 | -0.4 | -0.1 | 0.1*  |
| Belgium  | 0.4  | 1.2   | 0.6  | 0.5  | -0.3 | -0.4  |
| Austria  | 0.3  | 0.1   | 1.0  | 0.1  | -0.8 | -0.7  |
| Finland  | 1.9  | 0.6   | 0.4  | -0.2 | -0.2 | 0.2   |
| Portugal   | -0.2 | -0.9  | -0.5 | -0.6 | -0.6 | -0.2* |
| Greece   | 1.9  | 1.1   | -2.2 | -0.4 | 0.3  | -0.2* |
| Ireland  | -1.9 | -0.8  | 0.3  | -0.3 | 0.3  | 0.1*  |
| Luxemburg  | 1.3  | 2.3   | -0.6 | -0.6 | 0.2  | 0.0*  |
| Euro area  | -0.2 | -0.1  | -0.3 | -0.7 | -0.4 | -0.3  |

(1) Excluding one-off measures, as estimated by EUROFRAME-EFN (see Table 2b). The fiscal impulse is the opposite of the change in the cyclically-adjusted primary balance, as estimated by the SP and excluding one-off measures.

\*Own assumptions.

Source: Stability programmes, Sixth updates, end 2004, own assumptions.

**Table 2.2b. GDP growth, fiscal balances in the EUROFRAME-EFN forecast and fiscal impulses**

|  | 2003 | 2004 | 2005 | 2006 |
|--|------|------|------|------|
| <b>Real GDP growth, per cent</b>                   |      |      |      |      |
| Germany  | -0.1 | 1.0  | 0.8  | 1.6  |
| France   | 0.5  | 2.3  | 2.1  | 2.2  |
| Italy  | 0.4  | 1.1  | 1.0  | 1.5  |
| Spain  | 2.5  | 2.7  | 2.6  | 2.3  |
| The Netherlands                                    | -0.9 | 1.3  | 1.0  | 2.3  |
| Belgium  | 1.3  | 2.7  | 2.2  | 2.3  |
| Austria  | 0.7  | 2.1  | 2.3  | 2.3  |
| Finland  | 2.5  | 3.4  | 2.9  | 3.0  |
| Portugal   | -1.2 | 0.8  | 1.8  | 2.3  |
| Greece   | 4.3  | 4.8  | 3.0  | 3.2  |
| Ireland  | 3.6  | 4.3  | 5.4  | 5.4  |
| Euro area-10 (1)                                   | 0.5  | 1.8  | 1.5  | 2.0  |
| <b>General government balance, per cent of GDP</b> |      |      |      |      |
| Germany  | -3.8 | -3.7 | -3.5 | -3.3 |
| France   | -4.2 | -3.7 | -3.1 | -3.0 |
| Italy  | -2.9 | -3.0 | -3.5 | -3.6 |
| Spain  | 0.3  | -0.3 | -0.2 | -0.5 |
| The Netherlands                                    | -3.2 | -2.6 | -2.1 | -1.9 |
| Belgium  | 0.4  | -0.1 | 0.0  | -0.4 |
| Austria  | -1.0 | -1.0 | -1.7 | -1.8 |
| Finland  | 2.5  | 2.1  | 2.0  | 2.0  |
| Portugal   | -2.9 | -2.9 | -2.7 | -2.0 |
| Greece   | -5.2 | -6.1 | -4.2 | -3.3 |
| Ireland  | 0.2  | 1.3  | 0.0  | -0.7 |
| Euro area-10                                       | -2.8 | -2.7 | -2.6 | -2.5 |
| <b>One-off measures, per cent of GDP</b>           |      |      |      |      |
| Germany  | 0.0  | 0.1  | 0.4  | 0.2  |
| France   | 0.0  | 0.0  | 0.5  | 0.0  |
| Italy  | 2.0  | 1.0  | 0.5  | 0.0  |
| Spain  | 0.0  | -0.8 | 0.0  | 0.0  |
| The Netherlands                                    | 0.0  | 0.0  | 0.0  | 0.0  |
| Belgium  | 0.0  | 0.0  | 0.0  | 0.0  |
| Austria  | 0.0  | 0.0  | 0.0  | 0.0  |
| Finland  | 0.0  | 0.0  | 0.0  | 0.0  |
| Portugal   | 2.5  | 2.0  | 1.4  | 0.7  |
| Greece   | 0.0  | 0.0  | 0.0  | 0.0  |
| Ireland  | 0.0  | 0.5  | -0.4 | -0.2 |
| Euro area-10                                       | 0.4  | 0.2  | 0.3  | 0.1  |
| <b>Fiscal impulse, per cent of GDP (2)</b>         |      |      |      |      |
| Germany  | -0.8 | -0.3 | -0.4 | -0.5 |
| France   | 0.1  | -0.4 | -0.2 | -0.6 |
| Italy  | 0.6  | -1.1 | -0.3 | -0.8 |
| Spain  | -0.5 | -0.4 | 0.6  | 0.1  |
| The Netherlands                                    | -0.2 | -1.0 | -1.1 | -0.2 |
| Belgium  | -0.1 | 1.4  | 0.3  | 0.8  |
| Austria  | 0.4  | 0.0  | 1.0  | 0.3  |
| Finland  | 1.8  | 1.0  | 0.3  | 0.4  |
| Portugal   | -0.1 | -1.1 | -0.9 | -1.2 |
| Greece   | 1.9  | 1.3  | -1.0 | -1.5 |
| Ireland  | -2.1 | -0.8 | -0.7 | 0.7  |
| Euro area-10                                       | -0.1 | -0.4 | -0.2 | -0.4 |

(1) Excluding Luxembourg. (2) Excluding one-off measures. Fiscal impulse is the opposite of the change in the cyclically-adjusted primary balance, derived from EUROFRAME-EFN Spring forecasts for GDP growth, fiscal balances and one-off measures, with potential output growth as in the stability programmes.

Sources: EUROFRAME-EFN Spring forecast Stability programmes, sixth updates, end 2004, Eurostat, own assumptions.

## IMPROVING THE IMPLEMENTATION OF THE STABILITY AND GROWTH PACT<sup>7</sup>

The Ecofin Council of 20<sup>th</sup> March 2005 reached an agreement on the implementation of the Pact and that agreement was endorsed by the European Council of 22 March. The agreement on increased flexibility has been seen by most observers as a victory for the countries currently breaching the rules (Germany, France and Italy). Some observers, like the ECB, see the agreement as threatening euro area stability, while others welcome it as a step towards a Pact based more on economic logic.

The Council reaffirms that the reference values of 3 per cent of GDP for the deficit ratio and 60 per cent for the debt ratio continue to be the centrepiece of multilateral surveillance, but also states that the economic rationale of the budgetary rules must be enhanced and that heterogeneity must be taken in consideration in a European Union of 25 countries.

### THE AGREEMENT

The agreement has three parts.

*Part 1, 'Improving governance'*, lists a set of responsibilities: the Commission and the Council respect 'Member States' responsibility to implement the policies of their choice within the limits set by the Treaty'; the Commission is the guardian of the Treaty; the Council exercises its margin of discretion; the Member States, the Council and the Commission implement the Treaty and the Pact. Item 1.3 addresses the issue of complementary European and domestic fiscal rules, and, without precision, inadequacies between the concept of public deficit in national accounts and the objectives of mutual surveillance. Item 1.4. invites new elected governments to show continuity with the budgetary targets of the former government. Item 1.7. stresses the need for reliable statistics.

*Part 2, 'Strengthening the preventive arm'*, aims to define medium term objectives (MTO) for borrowing differentiated for each Member State: they will vary from -1 per cent of GDP for low debt/high potential growth countries to achieving balance or surplus for high debt/low potential growth countries. The implicit liabilities from ageing populations will be estimated and taken into account. The MTO will be reviewed every four year. Member States should make a fiscal effort of 0.5 per cent of GDP per year (in cyclically and one-offs adjusted terms) until they reach their MTO. The effort should be higher in positive output gap periods, smaller in bad times. Member States could deviate from this trajectory by explaining the reasons for it in their stability programmes. Structural reforms (in particular pension reforms introducing a mandatory, fully funded pillar) will be taken into account if they raise potential growth and induce long-term savings. The Commission will have the right to send early warnings.

*Part 3* is entitled '**Improving of the excessive deficit procedure**'. The Commission will always prepare a report if the deficit exceeds 3 per cent. A limited and temporary excess over the reference value will be allowed if it results from a negative growth rate or a strong negative output gap. The Commission report will take account of 'all other relevant factors': policies implemented in the framework of the Lisbon agenda, R&D expenditures, public investments, economic situation, debt sustainability. Member States will be able to put forward other factors such as budgetary efforts for international solidarity or for European goals or for the unification of Europe. The cost of the introduction of a compulsory, fully funded pillar for pensions would also

<sup>7</sup> 'Improving the implementation of the Stability and Growth Pact', Council report to the European Council, 7423/05, 21 March 2005.

be taken in account. If an excessive deficit occurred in year  $n$  it would have to be corrected in year  $n+2$  ( $n+3$  in some specific cases), the effort having to be at least 0.5 per cent of GDP per year.

The agreement brings the crisis that erupted at the Council of 25<sup>th</sup> November 2003 to an end, but it will probably have no impact on current fiscal policies in euro area countries. The agreement does not introduce fiscal policy coordination targeting growth. At the same time, it allows the countries that have breached the 3 per cent limit (like France, Germany and probably Italy) to give reasons for the breach and it will thus possibly allow these countries not to take strong corrective measures. The easing of the medium-term objective will also have a very limited impact, since that objective was not really taken into account in the fiscal policies of most Members States.

### VIEWS OF EUROFRAME-EFN INSTITUTES

The summaries of two views of EUROFRAME-EFN institutes on the agreement reached on the Stability and Growth Pact by the Council of 22-23 March 2005 are given below. The views can be found in Appendix 1.

According to Joachim Scheide, Klaus-Jurgen Gern (IfW), Malgorzata Markiewicz (CASE) and Wim Suyker (CPB), the statement that the reference values of the SGP – a 3 per cent deficit ratio and a 60 per cent debt ratio – remain unchanged is welcome. But, there are now several modifications which raise doubts whether “... the need to reduce government debt to below 60 per cent of GDP at a satisfactory pace ...” (Council Report: 16) can be met in reality. The risk that budget deficits will be higher and that fiscal policy will become less sustainable in the future has increased. The target of a balanced budget can only be achieved if the structural budget deficits are reduced considerably every year in a pre-announced way, and that this course should not be made dependent on the state of the business cycle. The budgets should be balanced in the near future according to the rules of the SGP. Budget deficits above 3 per cent in relation to GDP should automatically be qualified as excessive; no “other relevant factors” should be considered. The failure of the SGP to produce the desired sound fiscal policy was not due to wrong targets but rather due to the fact that several governments have not pursued a strict course of budget consolidation.

According to Ulrich Fritsche, Alfred Steinherr (DIW), Catherine Mathieu, Henri Sterdyniak (OFCE), Markus Marterbauer, Ewald Walterskirchen (WIFO), the lessons of the past have not been fully drawn. The reform still lacks economic rationale: there is no reflection on the objective of fiscal policy or on the measurement of the output gap; the softening of the MTO is too limited; the 3 per cent of GDP threshold for deficits, the medium run balance objective, the requested annual 0.5 per cent decrease in structural deficits to GDP ratios remain. No reduction in the structural deficit should be required in bad time. Fiscal policies in Europe must be implemented at three levels. Each Member State must keep the responsibility of its fiscal policy. European authorities should intervene only to prevent the emergence of negative externalities (excessive inflation, too large current account deficit, unsustainable public debt). Economic co-operation would be useful within the Eurogroup with the ECB agreeing to dialogue; it should not focus on public finance criteria, but should target the 3 per cent economic growth of the Lisbon strategy.

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## 2.3 Progress on the Lisbon Agenda

In March 2000 the EU-15 leaders made a commitment to a series of reforms and goals that collectively became known as the Lisbon Agenda. The explicit aim of this programme was to make the European Union the most dynamic and competitive economy in the world by 2010. Unlike the Single European Market programme, which had an intellectual basis in the Cecchini Report, and



the creation of a monetary union, which relied on the *One Market One Money* report, the Lisbon Agenda was launched without a coherent intellectual basis. However, in 2004, the Sapir Report set out the economic logic behind the Agenda.

In order to achieve its aims, the Lisbon Agenda set out a number of targets that should be met by 2010. In November 2004, Wim Kok, the former prime minister of the Netherlands, presented a report to the European Council reviewing the progress made on the aims of the Agenda thus far. Kok cited external events since 2000 as the main contributor to the lack of progress made, as well as a lack of urgency on behalf of the Member States in adopting the proposals. He suggested that the Lisbon Agenda lacked specificity in that while it outlined desirable aims, it neglected to highlight the means of achieving them. Kok concluded that the Agenda was not overambitious and that the 2010 target date should remain.

José Manuel Barroso, the new president of the European Commission, announced a new strategy to revitalise the Agenda in February of this year. The new revitalised plan proposes an updating of the Lisbon Agenda, with the main focus now on delivering sustainable growth and better jobs. Success in these two key areas will enable achievement of other economic goals such as progress on social and environmental issues. It involves a streamlining of the original proposals, with an outlining of clearer objectives across ten key policy areas.<sup>8</sup>

However, the recent European Council ended without any significant additional commitment by governments to furthering the Lisbon Agenda. As many of the spheres in which progress is needed are properly the remit of national governments it is not clear that there is going to be any greater urgency shown to the underperformance in this area of policy.

In the light of the revised Strategy, we now consider a few significant examples of recent policy innovations that have either contributed to or have detracted from the objectives encapsulated in the Lisbon Agenda. The issues on the macro-economic policy framework are dealt with elsewhere in this report. Here we focus on progress in four key policy areas:

## THE LABOUR MARKET

The Sapir Report, among many others, has highlighted the need for labour market reform in the EU. Such reforms are seen as vital if the EU is to raise its employment rate and if the waste of resources represented by unemployment is to be effectively tackled. However, this area of policy is generally the remit of national governments. Each Member State has different labour market institutions and, as a result, very different policy measures may be needed in each State.

Over the period between 1999 and 2003, beginning from a low base, the biggest improvement in the employment rate occurred in Spain and Italy (Table 2.3). These two countries also saw a significant fall in long-term unemployment. Even though the employment rate was already high in Sweden and the Netherlands, these two countries also saw some increase over the same period.

Over the last year a number of policy innovations have been established in major EU Member States. In the case of Germany the Hartz IV reforms should have some impact on the German labour market over the coming years (Boss and Elendner, 2005). While initially the numbers registered as unemployed have risen as a result of the reforms, this is due to the way such administrative data are collected. The effect of the reforms should be to

<sup>8</sup> The key policy areas highlighted cover the internal market, competition, regulation, infrastructure, research and development, ICT, the European industrial base, employment, labour markets, and educational attainment

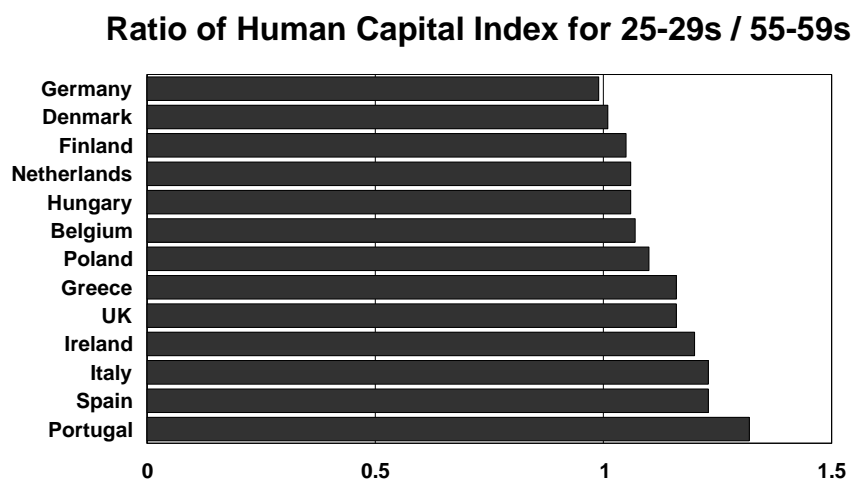
encourage more of those currently unemployed to seek employment. The attractiveness of paid employment relative to unemployment benefit payments will increase marginally. This is because the level and the eligibility criteria of unemployment benefits payable unconditionally to the long-term unemployed, has been tightened and the duration of short-term pay related unemployment benefits will be gradually reduced starting from next year. Therefore, over time, the reforms should, in combination with improvements in the administrative procedures in the labour office, help reduce the numbers unemployed using a standardised measure (the ILO definition of unemployment).

### EDUCATIONAL ATTAINMENT

As shown in Table 2.3, a number of the new Member States score significantly better than the average for the EU 15 in the area of the educational attainment of those aged 20 to 24 years (Kok, 2004). In the case of the EU 15 there is evidence of a significant increase in investment in human capital over the period between 1999 and 2003, especially in Portugal, Belgium, Ireland and Italy.

Looking over a much longer time frame, Figure 3.1 measures investment in human capital for a selection of EU states. It shows the ratio of the human capital index for 25-29 year olds relative to that for 55-59 year olds. An increase in the ratio indicates an upgrading in the human capital of the population over a 30-year period.<sup>9</sup> The Figure suggests major improvements in some countries, including Portugal, Spain, Italy and Ireland. However, a number of these countries were coming from a very low base and the level of human capital in Portugal, for example, still remains significantly below the EU average.

**Figure 2.1: Investment in Human Capital**



The Sapir report points to the problems faced by unskilled labour in the EU economy, with very high unemployment rates. While measures are certainly needed to enhance employability and the demand for unskilled labour, consideration also needs to be given to reducing the supply, through raising retention rates in the educational system. While a long-term project, such a programme of investing in the human capital of those who would otherwise remain unskilled could produce a high long-term economic and social pay-off for the EU.

<sup>9</sup> The human capital indices are derived by weighting the returns (in terms of wage rates) to different levels of education by the numbers in those educational categories. Four levels of education are used: third level; those who have completed upper secondary; those who have completed lower secondary; and those with no qualifications.

## RESEARCH AND DEVELOPMENT (R&D)

In Table 2.3 we show the performance of EU Members States on some key indicators, two of which relate to R&D. Sweden and Finland already devote a significant share of national output to research and development. Sweden in particular has further increased its national allocation of resources to R&D over the period 1999-2003. A number of other smaller EU States, such as Belgium and Denmark have also increased resources on R&D. In the case of the 10 accession states, the share of resources allocated to R&D is well below the EU 15 average, with Slovenia and the Czech Republic being the leaders. However, an allocation of funds to R&D does not guarantee that they will be used productively and there is much less evidence on the efficacy of the expenditure across the EU.

In 2005, some countries like Italy or France are in the process of introducing or raising fiscal incentives for firms undertaking R&D. The French budget contains a number of measures designed to improve the attractiveness of some French areas ('competitiveness poles'). The idea is to give fiscal incentives to companies investing in high technology production in specific geographic areas. These "poles" must bring about collaborative work between Universities or training centres, public or private research centres, and small and big firms, to introduce innovative production processes. France has created a new 'Agence pour la recherche' to fund applied research conducted by private or public centres. Italy has undertaken similar measures.

Looking to the future it will not be sufficient just to raise expenditure on R&D. Attention will need to be given to how increased resources can be best used. The shortfall in investment in R&D is not just a problem for EU governments. A significant part of the problem lies with underinvestment by firms. It will be important for the EU as a whole to learn from the models in some member states that are already working, encouraging increased links between firms and the broader research community.

## COMPETITIVENESS AND THE ENVIRONMENT

The signing of the Kyoto protocol was a major achievement for the EU. The single most important instrument so far implemented to limit emissions is the Emissions Trading Scheme that came into effect in January 2005. This scheme has the potential to ensure that the necessary reduction in emissions is achieved at least cost to the EU economy. However, the details of its implementation over the period 2005-2007 mean that it will be unnecessarily damaging to the competitiveness of the EU, while also being less effective than it should be in limiting emissions.<sup>10</sup>

Over the coming year, in reviewing how this scheme will operate between 2008-2012 governments should reconsider their approach. A move to increase the share of permits that are auctioned in the period 2008-2012 offers the best opportunity to remove the distortions in the present scheme. The revenue from the auctions would permit governments to reduce taxes elsewhere in their economies. Such a reform would reduce the overall cost to the EU economy of complying with the Kyoto protocol, resulting in improved competitiveness and an increase in sustainable employment.

<sup>10</sup> The reasons for this are twofold: Firstly, the lack of an emissions permit auction system will increase the cost of emissions trading (Goulder *et al.*, 1999, Congressional Budget Office, 2000). Secondly, the second round allocation of free permits for the 2008-2012 period means that many of the bigger polluting firms that are covered by the scheme and have market power (e.g. electricity generation) are incentivised to remain in business to receive a further free allocation of permits for the next round, further raising the costs of compliance with Kyoto for the EU (Fitz Gerald, 2004).

**Table 2.3: Change in Performance of Member States on Structural Indicators, 1999-2003**

|             | <b>Employment<br/>Rate %</b> | <b>Long-term<br/>Unemployment<br/>Rate %</b> | <b>R&amp;D<br/>Expenditure, %<br/>of GDP</b> | <b>Educational<br/>Attainment (20-<br/>24) %</b> |
|-------------|------------------------------|--|--|--|
| Austria     | 0.2 (69.2)                   | 0.0 (1.1)                                    | 0.07 (2.2)                                   | -0.2 (83.8)                                      |
| Belgium     | 0.1 (59.6)                   | -0.3 (3.7)                                   | 0.11 (2.2)                                   | 1.3 (81.3)                                       |
| Germany     | -0.1 (65.0)                  | 0.1 (4.6)                                    | 0.02 (2.5)                                   | -0.5 (72.5)                                      |
| Denmark     | -0.2 (75.1)                  | 0.0 (1.1)                                    | 0.14 (2.5)                                   | 0.3 (74.4)                                       |
| Spain       | 1.5 (59.7)                   | -0.5 (3.9)                                   | 0.05 (1.0)                                   | -0.4 (63.4)                                      |
| Finland     | 0.3 (67.7)                   | -0.2 (2.3)                                   | 0.05 (3.4)                                   | -0.4 (85.2)                                      |
| France      | 0.6 (63.2)                   | -0.2 (3.5)                                   | 0.00 (2.2)                                   | 0.2 (80.9)                                       |
| Greece      | 0.6 (57.8)                   | -0.3 (5.1)                                   | -0.02 (0.6)                                  | 0.6 (81.7)                                       |
| Ireland     | 0.5 (65.4)                   | -0.2 (1.5)                                   | -0.02 (1.2)                                  | 0.9 (85.7)                                       |
| Italy       | 0.9 (56.1)                   | -0.5 (4.9)                                   | 0.04 (1.1)                                   | 0.9 (69.9)                                       |
| Luxembourg  | 0.3 (62.7)                   | 0.1 (0.9)                                    | -  | -0.4 (69.8)                                      |
| Netherlands | 0.4 (73.5)                   | -0.1 (1.0)                                   | -0.07 (1.9)                                  | 0.3 (73.3)                                       |
| Portugal    | -0.1 (67.2)                  | 0.1 (2.2)                                    | 0.05 (0.9)                                   | 1.9 (47.7)                                       |
| Sweden      | 0.3 (72.9)                   | -0.2 (1.0)                                   | 0.31 (4.3)                                   | -0.2 (85.6)                                      |
| UK          | 0.2 (71.8)                   | -0.2 (1.1)                                   | 0.01 (1.9)                                   | 0.7 (78.2)                                       |
| EU-25       | 0.3 (62.9)                   | 0.0 (4.0)                                    | 0.03 (1.9)                                   | 0.5 (76.7)                                       |
| EU-15       | 0.5 (64.4)                   | -0.2 (3.3)                                   | 0.02 (2.0)                                   | 0.3 (73.8)                                       |
| US          | -0.7 (71.2)                  | -  | 0.03 (2.8)                                   | -  |

*Note:* The levels of the indicators of the EU 15 in 2003 are given in parenthesis

*Source:* Kok, 2004.

# SPECIAL POLICY TOPIC:

**When Jobs Disappear and Workers Do Not...  
International Relocation of Production and the  
European Economy**



# 3. WHEN JOBS DISAPPEAR AND WORKERS DO NOT... INTERNATIONAL RELOCATION OF PRODUCTION AND THE EUROPEAN ECONOMY

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## 3.1 Introduction

‘By damming up a source of supply of some commodity, we may increase the employment available for workers in a particular occupation, but we cannot directly increase the employment available for workers as a whole.’ One may guess this is a quote from an economist. One is not likely to guess, however that this quote is nearly a century old. The concern that jobs disappear abroad (and do not reappear) is not characteristic for our time, but seems for all time. Pigou (1913) wrote a book on unemployment for the general public in which he explained that the worries about international trade, the plea for shorter working hours and the anxiety about prison-labour were based on the same idea: the amount of work is fixed. The anxiety about prison-labour is outdated and pleas for shorter working hours are nowadays far from popular, but the worries about international trade are still common.

Worries about outsourcing and relocation of economic activities seem of all time, and of all places. On both sides of the Atlantic politicians address these worries among the general public. In the last election campaign the Democratic presidential candidate, John Kerry, criticised companies which relocated production abroad. He also criticised the Bush administration for not doing enough to stem the loss of American jobs to other countries. To counter this, he proposed changes to US corporate taxes. Even so the Republican President George W. Bush was hardly a staunch advocate of free trade. During his first administration, tariffs were introduced to protect the US steel industry from foreign competition.

The interest in outsourcing is not confined to America but is also alive in Europe. Recently, the German engineering firm Siemens has been able to secure an extension of the working week at the same rates of pay by threatening to shift production to Hungary. Also, the French branch of the German manufacturer Bosch has used the threat of relocation to persuade workers to put in more hours without extra pay. The response of European leaders has strong similarities with that of American politicians. The German chancellor Schröder labelled offshoring unpatriotic. The French Prime Minister Raffarin announced "competitiveness zones" in which companies would be offered reduced corporate tax rates and social charges in exchange for

commitments not to take jobs overseas (See Mathieu and Sterdyniak (2005) for an overview of the French debate).

The concern about relocation is of all time and of all places but the cause for such concern seems now greater than in the past. The impact of relocation is growing: over time, trade and investment flows have increased much more rapidly than production. This is part of the internationalisation process. Different economies are becoming more intertwined because barriers to foreign trade and investment are disappearing (to some extent at least). One of the consequences is that the country of origin is difficult to determine for some products. The World Trade Organisation (WTO, 1998) gives the example of a car sold by one of the major US car manufacturers. At least nine countries are involved in the production of this car. Only 37 per cent of its value can be attributed to activities in the United States. The rest of its value is linked to activities in South Korea (30 per cent), Japan (17.5 per cent), Germany (7.5 per cent), Singapore (4 per cent) and Taiwan (4 per cent), among others.

These days, the international division of labour is no longer restricted to manufacturing industry, but also extends to services. The breakthroughs in communication technologies have made some services tradable, since producers and consumers no longer need to be in the same place. This applies in particular to administrative services (e.g. payroll administration or transaction processing), call centres and some IT services (e.g. development and testing of computer programs). According to the United Nations Conference on Trade and Development (UNCTAD, 2004), 12 per cent of all cross-border investment projects concern these types of services. This is attracting attention because a proportion of the tradable services has moved to Asia and Central and Eastern Europe, and because these services require skilled workers.

In the economic literature the possibility that a country loses from relocation is extensively studied (a recent example is Samuelson, 2004), but many economists expect the gains to exceed the losses. The chairman of the Council of Economic Advisers Gregory Mankiw saw in the relocation of production 'just a new way to international trade' and called it 'a good thing'. For that assessment he was lambasted by both Democrats and Republicans. One can conclude from this that the economists' message of free trade, and of the relocation of activities as part of its application, does not convince everyone. One reason for this is that the disadvantages of relocation are clearly visible, while the advantages are difficult to observe directly.<sup>1</sup> When a company transfers activities abroad, this sometimes leads to immediate job losses. This disadvantage is clearly visible. It is not included in the story that the redundant workers subsequently find other jobs at other companies. What is more, the advantage of relocation either becomes evident only later, when the company reports higher profits, or does not become evident at all, when the profits fall to the company's various customers in the form of lower prices.

The aim of this chapter is to supplement the debate about the direct effects of relocation with a clear exposition of the indirect effects. Therefore, it not only presents the arguments *pro* and *contra* relocation, but also reviews empirical evidence on the extent of relocation and the impact of relocation on the economy of the country of origin. In that way it assesses who may gain and who may lose from relocation. In addition, it analyses the implications for policy by asking two questions. First, if relocation leads to policy competition, what could be done about that? Second, how can public policy enhance the gains from relocation and soften the impact on those who lose.

<sup>1</sup> Kets and Tang (2004) offer several other reasons why the benefits of free trade as advocated by economists do not always convince non-economists. For a start, the dynamic benefits of liberalisation are highly uncertain.



## Definitions

A number of terms are used in the context of relocation, such as ‘offshoring’, ‘outsourcing’, ‘foreign direct investment’ etc. This can lead to some confusion. To avoid this in this chapter, Table 3.1 gives the various terms a place. It distinguishes between two dimensions of economic activities: geographic location and legal ownership. The term ‘offshoring’ refers to relocation of activities across the geographical border, whereas outsourcing refers to relocation across the firm’s boundaries (widely used comparable terms have been put in parentheses).

Not much attention is given in this chapter to the dimension of ownership, despite a recent literature in which ownership, productivity and relocation are linked. Successful companies – those with popular products or low production costs – exploit this success by entering foreign markets. The most successful companies do this by relocating activities and setting up plants outside their own country. Indeed, according to Helpman, Melitz and Yeaple (2004) in the United States exporting companies are 39 per cent more productive than domestically oriented companies, and multinational concerns 54 per cent more so. One reason to ignore the dimension of ownership is the limitation of space. The other, more important reason is that the dimension of geography is central to the commotion about relocation.

**Table 3.1: Relocation of Activities According to Geographic and Judicial Boundaries**

|               | Within a country                      | Between countries                                    |
|---------------|---------------------------------------|--|
| Between firms | Outsourcing<br>(National Outsourcing) | Outsourced offshoring<br>(International Outsourcing) |
| Within a firm | Insourcing<br>(Domestic Investment)   | Inhouse offshoring<br>(Foreign Direct investment)    |

Section 3.2 discusses the reasons why companies may outsource or relocate activities abroad. Section 3.3 attempts to indicate the extent of relocation. Section 3.4 examines the consequences for the economy as a whole as well as for certain groups within the economy. Section 3.5 considers arguments for government intervention and Section 3.6 concludes.

## 3.2 Outsourcing: why, where?

More than in the past, companies may choose where they locate parts of the production process. They relocate activities to countries with low wages, low environmental standards and/or flexible working conditions. They also relocate activities to countries where the state of economic development is comparable to Europe. Indeed, Europe itself attracts activities and thus benefits considerably from inward relocation.

Companies have different motivations for relocating to ‘dissimilar and ‘similar’ countries. In the case of relocation to a ‘dissimilar’ country, wage costs are likely to be the dominant factor. This motivation plays a role in the production of toys in China, for instance, but also in programming work in India. But other differences, such as in tax regimes and environmental standards, also play a role. Foreign trade and investment thus puts companies in a position to exploit *cost differences* between countries.

In the case of relocation to a ‘similar’ country, the presence of key suppliers, customers or workers is decisive. For example, the US market is attractive to many companies because of its size, now and in the future. Furthermore, the easier access of knowledge workers to the European labour market or a larger supply of science students may help to keep certain knowledge-intensive activities in Europe. The key issue here is *market access*.

In practice, both motivations for foreign trade and investment, cost differences and market access, play a role in companies' decisions to relocate. But internationalisation will shift the relative significance of both motivations.

### 3.2.1 RELOCATION TO EXPLOIT COST DIFFERENCES

There are cost differences between countries. These differences may stem from natural conditions (fertile land, rivers, ports), but also from the availability of productive factors (labour versus capital, low-skilled versus high-skilled labour). Government policies, as reflected in environmental standards for instance, may also play a role. These cost differences are exploited through international trade and investment. The aim is to sell one good at a high price (export) and to buy another good at a low price (import). The result is international specialisation.<sup>2</sup> A country exports one good in which it has a comparative cost advantage, and imports another for which the production costs are relatively high. What this boils down to is that the country outsources some of the possible economic activities and concentrates on others.

Competition, where the gain for one is a loss for the other, does not adequately characterise the commercial relations between countries. International specialisation is *not* a zero-sum game. Instead, it brings benefits in total, so that each participant may gain.

Nevertheless, concerns remain. Some are concerned that the European economy cannot 'compete' with low-wage countries. Others have the concern that part of the European economy will disappear: they fear deindustrialization. Let us address these two related concerns briefly.

#### Can Europe compete?

As workers produce more, they can be paid more. The relationship between pay rates and labour productivity is therefore important. If these are in balance, then unit labour costs in, say, Germany and China will be the same, so that cost will not be a reason for a shift in demand for German or Chinese products. At the same time, the levels of wages and productivity can diverge sharply between the two countries. Or to put it differently, high productivity permits high wages.

Productivity and wages do not always move in tandem. Let us assume that productivity growth unexpectedly lags behind wage increases over a certain period. This means that unit labour costs will rise, so that companies will become less competitive in domestic and foreign markets. Lower sales mean less demand for labour and rising unemployment. This drives down the wage level, until it rises again in line with the productivity level and unemployment has returned to its structural rate.

The structural unemployment rate is strongly related to the institutional characteristics of the labour market: the level and duration of unemployment benefit, the tax wedge between gross labour costs and net wage income, and so on. However, in combination with domestic institutions, foreign competition can lead to structurally higher unemployment. Firstly, international specialisation puts the position of low-skilled workers under pressure. Through foreign trade and investment low-skilled workers in Europe compete with low-skilled workers elsewhere. Secondly, relocation means additional job destruction and job creation, which may lead in the short run to 'frictional unemployment' (i.e. between-jobs unemployment). This will be examined in more detail and more specifically in Section 3.4.2.

<sup>2</sup> The notion that cost differences determine the international patterns of foreign trade and investment has a long history in economics. Its main protagonists are Ricardo, Heckscher, Ohlin and Samuelson.

### Does trade with low-wage countries lead to deindustrialisation?

Over the years, employment in manufacturing industry has declined in relative terms in industrial countries. The combination of globalisation and fast growth in low-wage countries leads to falling relative prices for (certain) manufacturing goods. In other words, increasing competition from low-wage countries forces industrial producers in Europe to outsource or even to close down. Low-wage countries will concentrate especially on simple production processes requiring much manual labour.

However, domestic developments also bring about deindustrialization. Relatively high productivity growth in industry – in line with Baumol's law – leads to falling relative prices of manufacturing goods and induces a sectoral restructuring towards services. Similarly, with higher income the demand for services becomes relatively higher. Indeed, rich countries are spending ever more on tourism and health care, for instance. This contributes to the reduction in industrial employment as well.

Whether external or internal developments are more important for deindustrialization is an empirical matter.<sup>3</sup> Rowthorn and Ramaswamy (1999) estimate an equation for the share of manufacturing in output and employment. They find that 'North-South trade explains less than one-fifth of the deindustrialization in the advanced economies' in the period 1963-1994. The share in total employment has fallen but labour productivity has increased, with the result that the share in output has been roughly stable.

#### 3.2.2. RELOCATION TO GAIN MARKET ACCESS

Trade and investment flows do not arise from cost differences alone. Production is often located near important customers and/or close to main suppliers. Indeed, a firm may want to 'conquer a market' or may consider establishing ties with local producers. Access to output and input markets is one of the most important factors behind location decisions. It is a crucial determinant of trade and investment patterns.

The analysis of market access as a factor of location starts with a tension between trade costs and scale economies. Trade costs include transport costs, import duties, communication problems between people with different languages and cultural backgrounds, differences in legislation etc. Scale economies are lower unit labour costs at higher output levels. These advantages arise, for instance, by spreading fixed costs such as overheads across a larger turnover. There is a trade-off between the two variables. When production is being spread, companies miss out on scale economies, while concentration of production pushes up trade costs. This tension can be overcome in part by choosing a location in proximity to a large market.

Not all companies will opt for the same location. At an attractive location, competition on the local market will eventually be fierce and/or wages will eventually reach high levels. Consequently new companies will choose a different location, or existing companies will look for another location. Production of comparable goods and services will thus spread to different locations, within a country and across countries. This explains the intensive trade between countries of the same size and with the same productivity level.

But a firm does not have to opt for a single location from which to supply both the home market and export markets. There is also a choice between

<sup>3</sup> International trade may magnify the consequences of domestic developments. Not all sectors will be able to improve their production process or renew their products sufficiently to keep up with average labour productivity growth. These sectors can only compete on the labour market and pay the going wage rate if the prices of their products rise. Manufacturing sectors with lagging labour productivity growth, however, face international competition and cannot afford higher prices. Production in those sectors will become structurally loss-making and will disappear over time, making room for more productive activities.

export and local production. By opening plants close to suppliers and buyers, companies can circumvent the trade costs.<sup>4</sup> The higher these costs, the greater the incentive to produce locally. This argument is particularly relevant for some services, which cannot be relocated across distances and require physical proximity of producers and consumers (such as bank branches and accounting firms, but also cleaning work). Foreign direct investment between similar countries thus has a character of its own. It is not vertical, where companies slice up the value chain and spread it geographically, but horizontal, because they duplicate parts of the production process in different locations. The probability of horizontal foreign direct investment is greater when countries do not differ that much in sectoral labour productivity and in size (see Markusen, 2002).<sup>5</sup>

### 3.2.3 HORIZONTAL VERSUS VERTICAL SPECIALISATION

Two broadly defined motivations inform location choices by companies and are behind patterns of international specialisation. Firstly, international trade and investment exploit cost differences between countries. These cost differences may arise from differences in the availability of productive factors, but also from differences in natural conditions. They lead to vertical specialisation, in which the various links in the production chain end up in different locations. Trade costs, broadly defined, are an obstacle to the exploitation of cost differences. Secondly, access to markets explains trade and investment patterns. Thus companies want to be near major customers and suppliers, or be close to specialised workers. The latter argument is relevant for R&D activities, for instance. This leads to horizontal specialisation, in which the same links in the production chain are found in different locations. Trade costs pose an obstacle to the trade in similar products. Local production is a means of avoiding some of these trade costs, however, since scale diseconomies may arise, this is not always profitable.<sup>6</sup>

The above motivations are not mutually exclusive.<sup>7</sup> For example, investment in China is informed not only by the relatively low wages in that country, but also by the growth expectations for the Chinese market. Table 3.2 shows the advantages and disadvantages for both forms of international specialisation.

**Table 3.2 Considerations with regard to vertical and horizontal specialisation**

|                      | Vertical specialisation | Horizontal specialisation |
|----------------------|-------------------------|---------------------------|
| <b>Advantages</b>    | Lower production costs  | Better market access      |
| <b>Disadvantages</b> | Higher trade costs      | Scale diseconomies        |

<sup>4</sup> Here the focus is on product markets. A similar argument applies to labour markets. A company can opt to conduct its R&D activities at a central location and recruit foreign workers, or it can opt for several locations. The costs of migration are a factor in this choice.

<sup>5</sup> Markusen (2002) shows that, in addition to high trade costs and a plant's low fixed costs, the fixed costs at company level are decisive for horizontal investment. A parent company provides services for subsidiaries. In many cases these services are associated with knowledge capital (e.g. expertise in production technologies, a brand name, a marketing strategy), which has the character of a public good within the company. In those cases scale economies arise at company level. As the scale economies at company level become more important in relation to the scale economies of a production unit, the opening of several plants will become more attractive.

<sup>6</sup> Markusen and Venables (2005) extend the notions of horizontal and vertical specialisation in the literature on FDI to international trade.

<sup>7</sup> Helpman and Krugman (1985) were the first to integrate the 'new' and the traditional trade theory.

### Globalisation: more vertical and less horizontal specialisation?

Trade costs have opposite effects on vertical and horizontal investment. A fall in trade costs makes it easier for companies to supply various markets from a particular base. In that way, it reduces the need for horizontal investment. But a fall in trade costs also enhances the opportunities for companies to exploit cost differences between countries, leading to more vertical investment. One may conclude from this that globalisation should trigger a shift in investment flows, away from flows between rich countries and towards flows between rich and poor countries. This is certainly true to some extent. Yet, more than half of the foreign direct investment by the European Union remain within the Union. More spectacular was the overall expansion of investment flows in the 1990s (see Section 3.3). These additional investments broadly followed the old pattern, that is, they were made in other rich countries.

There are various reasons why the share of horizontal investment is not falling. Firstly, integration is often not so much global as it is regional. The deepening of the European Union (through the harmonisation or mutual recognition of standards, for instance) will stimulate investment flows within Europe. Secondly, lower trade costs constitute only one aspect of globalisation. Globalisation may also reduce institutional differences between countries, which is likely to stimulate horizontal investment.

### 3.3 Relocation: facts and figures

With globalisation the cross-border flows of goods, services and capital are expanding faster than their production. The stock of direct investment by and in the four largest European countries – France, Germany, Italy and the United Kingdom – has on average more than trebled in the period 1989-2001. Export and imports have not kept pace with foreign direct investment but have nevertheless grown at a fast rate. They have roughly doubled in that period. From these numbers it is clear that relocation must have increased.

**Table 3.3: Foreign direct Investment of the four largest EU member states,<sup>a</sup> 1989-2001**

|                                      | 1989-1995   |        | 1996-2001   |        |
|--------------------------------------|---|--------|---|--------|
|                                      | By home-companies<br>in other countries<br>% of total |        | By foreign companies<br>in home countries<br>% of total |        |
| European Union 15                    | 46.3  | 48.8   | 45.7  | 54.6   |
| United States                        | 27.1  | 27.0   | 30.1  | 27.9   |
| Eastern Europe                       | 0.4   | 1.8    | 0.1   | 0.1    |
| ASEAN countries (Japan not included) | 3.6   | 3.5    | 0.6   | 0.6    |
| China                                | 0.1   | 0.5    | -   | -      |
| India                                | 0.2   | 0.2    | -   | -      |
| Singapore and Hongkong               | 2.2   | 1.9    | 0.2   | 0.3    |
| Rest of the world                    | 22.7  | 18.9   | 23.5  | 16.9   |
| Total                                | 100.0   | 100.0  | 100.0   | 100.0  |
| EUR billions                         | 623.4   | 2367.5 | 457.3   | 1498.0 |

Source: OECD (2005), adapted by CPB.

a) France, Germany, Italy and the United Kingdom. No table could be derived for foreign direct investment from and to the EU-15 as a whole, since not every country reports.

- : Negligible amount

#### 3.3.1 GEOGRAPHICAL PATTERNS

Even though the popular perception is that jobs disappear in developed economies to China and India, trade and investment flows go predominantly to and from the rich countries. Table 3.3 shows the stock of direct investment for the four largest European countries according to destination (outward) and origin (inward). Table 3.3 shows that the majority of the outward investment is made in the EU-15 (48.8 per cent in the period 1996-2001) and in the United

States (27.0 per cent). The flow of investment to Asian low-wage countries is modest and their share in the total is rising only slightly. China's share is growing more quickly, at the expense of Hong Kong and Singapore.

Eastern Europe's share is larger than China's and is rising even more rapidly. Especially nearby Germany has invested at a large scale in the new member states of the European Union. Its stock of outward investment has quadrupled in the period 1989-2001, and the share of capital in Eastern Europe has also quadrupled. The presence of Italian firms has sharply increased in the last ten years, but this does not show up in FDI statistics. These firms in traditional manufacturing are often small and medium sized and choose for 'light relocation', i.e. choose for keeping parts of the production process at arm's length.

**Table 3.4: EU-15 goods exports and imports, 1995-2003, average annual percentage growth and percentage share of the total<sup>a</sup>**

|                   | Exports        |       | Imports |                |       |       |
|-------------------|----------------|-------|---------|----------------|-------|-------|
|                   | average growth | share | share   | average growth | share | share |
|                   | 1995-2003      | 1995  | 2003    | 1995-2003      | 1995  | 2003  |
| EU-15             | 5.4            | 62.3  | 59.7    | 5.1            | 61.8  | 57.0  |
| United States     | 9.9            | 6.6   | 8.9     | 4.7            | 7.4   | 6.6   |
| Eastern Europe    | 13.1           | 2.9   | 4.9     | 14.9           | 2.6   | 4.8   |
| Asia (excl Japan) | 5.3            | 10.2  | 9.7     | 10.2           | 9.5   | 12.8  |
| China             | 13.2           | 1.0   | 1.6     | 18.9           | 1.7   | 4.2   |
| India             | 5.1            | 0.6   | 0.6     | 7.0            | 0.5   | 0.6   |
| Rest of the world | 5.2            | 18.0  | 16.9    | 6.3            | 18.7  | 18.8  |
| Total             | 6.0            | 100.0 | 100.0   | 6.2            | 100.0 | 100.0 |
| EUR billions      |                | 1542  | 2457    |                | 1469  | 2376  |

<sup>a</sup> *Source*: ITC/WTO database

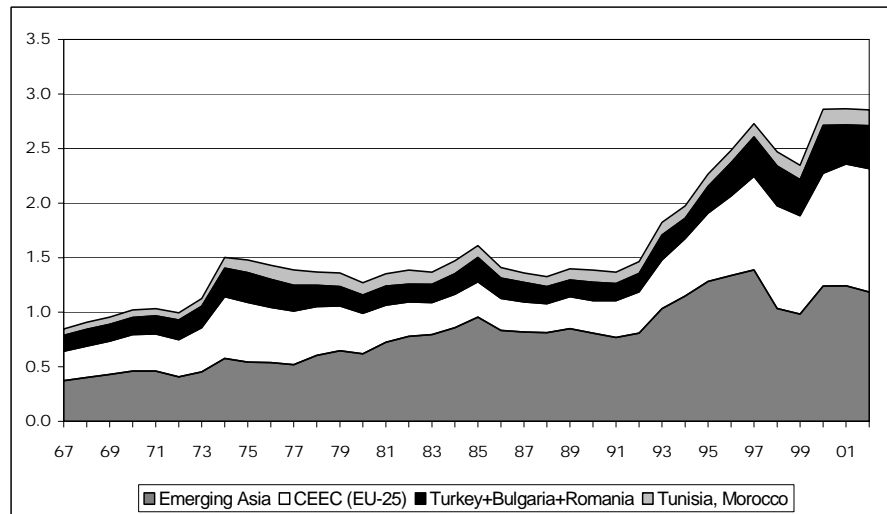
Overall, the investment figures show that relocation to low-wage or accession countries does not occur on a large scale. Table 3.4 presents trade flows from and to the European Union of 15, and a familiar pattern arises. Intra-EU trade is more than half of the total. Also, the trade shares of Eastern Europe and China are rising fast, but are still modest. Over a longer time span this is also illustrated by Figure 3.1 and 3.2 for EU-15 manufacturing.<sup>8</sup>

The fact that the origins and destinations of direct investment follow similar patterns is also remarkable. Investment in one country is balanced by a proportionately similar amount of investment from that country. For instance, nearly a quarter of all foreign direct investment by the four EU countries goes to the United States while US companies account for around a quarter of the direct investment in these four countries. Also import and export shares are strongly alike: the ranking of exporters and importers is broadly similar.

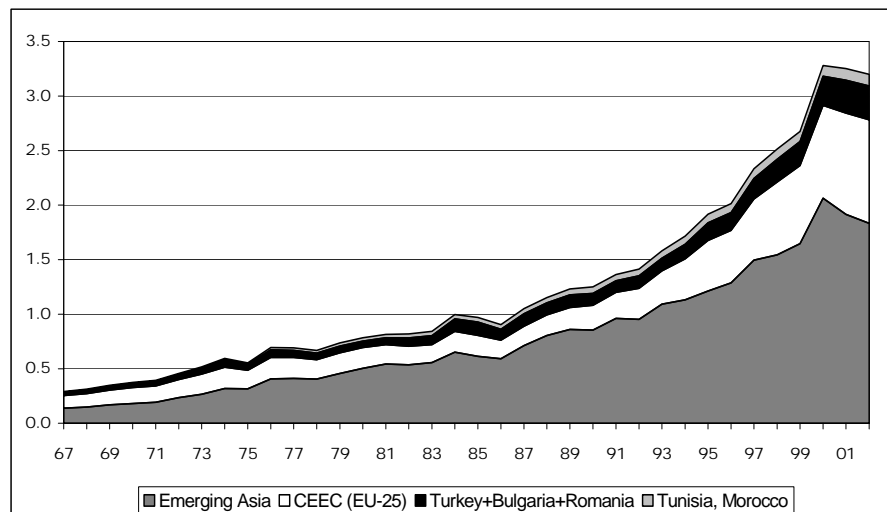
Comparing Tables 3.3 and 3.4 makes clear that the geographic patterns for trade and investment are broadly similar. Whereas at the firm level investment may substitute for trade, the similarity in patterns suggests that at national level trade and investment go hand in hand. Indeed, Barrell and Dees (2005), for example, conclude that for various OECD countries imports and inward FDI are strongly, positively related. Furthermore, Holland and Pomerantz (2005) find for four accession countries the empirical result that inward FDI not only affects imports but also has a positive impact on exports.

<sup>8</sup> Over the same horizon Daudin and Levasseur (2005) show the substantial increase in French trade with emerging countries over 1967-2002. Yet, at the end of the period trade with these countries does not exceed 2.5 per cent of GDP.

**Figure 3.1: Manufactured Exports to Emerging Industrial Countries ( per cent of EU-15 GDP)**



**Figure 3.2: Manufactured Imports from Emerging Industrial Countries (as per cent of EU-15 GDP)**



The data on trade and investment patterns make clear that the flows among the rich countries are dominant. The flows to and from developing and transition countries grow, sometimes fast, but are only small fractions of the total. The data do not support the popular notions that distance is dead and that relocation towards low-wage or accession countries occur at a large scale.

The upshot is that through international trade and investment European workers compete more with each other than with workers in low-wage countries. Also within Europe, geographical distance and economic size matter. The results from empirical work underline this. Using German firm-level data, Buch *et al.* (2005) show that as distance increases the average size of affiliates increases but the number of foreign affiliates declines. Blomstrom *et al.* (1997) find from firm-level data that workers of Swedish multinationals and their counterparts in low-wage countries do not compete directly. A study by Konings and Murphy (2001) into labour demand by multinationals comes to an analogous conclusion. They find statistically relevant substitution between plants in the European Union and not between plants in 'old' and 'new' Europe. Becker *et al.* (2005) find instead for German and Swedish multinationals a statistically significant result: a wage decrease of one per cent in Central and Eastern Europe has a negative effect on employment in

Germany and Sweden. This effect is statistically significant but is roughly one-third of the effect on employment that results from a similar wage decrease in Western Europe.

Trade and investment statistics may not give an entirely accurate picture of relocation. For example, investment in China may arise from the wish to serve the Chinese market, and have little or no consequences for activities in Europe. The other way around, locally financed foreign expansion does not appear in the statistics on FDI but may come at the expense of European exports.

Surveys among firms are a different source of information. They have their own problems but complement trade and investment statistics. An Italian survey finds that 13 per cent of the firms have plans for moving parts of the production abroad whereas 5 per cent consider shifting the entire production across the Italian border (Fondazione Nord-Est, 2004). A Dutch survey comes up with similar figures (Berenschot, 2004). It shows that 84 per cent of the companies have not performed any relocation activities in the last ten years and does not plan to relocate within the next twelve months. Relocation affected 1.5 to 3.4 per cent of employment over the three year period before the survey (2004). Relocation to a large extent takes place within Europe: 52 per cent of the firms relocated to Middle and East Europe, 42 per cent to West and South Europe, 16 per cent to China, and 11 per cent to India.<sup>9</sup> Finnish enterprise surveys tell that firms intend to expand faster in Russia, Eastern Central Europe and China than in Western Europe and the USA (Pajarinen and Ylä-Anttila, 2004).

According to the surveys both savings on costs and market access are important motives for relocation. In the Dutch survey cost savings stand out: 62 per cent of the relocating firms mention costs as a decisive reason. The Finnish survey indicates that the main motives for expansion in Western Europe and in the USA are market factors and firm specific know-how (Pajarinen and Ylä-Anttila, 2004). In China as well as in Eastern Europe and Russia, the main motives are market growth and cost factors (*ibid.*; Alho, Kaitila and Kotilainen, 2004). In the case of Russia and the Baltic states also the near geographical location is an important factor for different forms of foreign business operations (Kotilainen et al, 2003). In a survey by the German chamber of commerce firms consider relocation because of high taxes (38 per cent), high labour costs (45 per cent), exchange rate risk (7 per cent) or excessive bureaucracy (5 per cent) (Buch *et al.*, 2005). However, when asked directly, for most of these firms the cost saving motive does not dominate. More important motives are improving access to fast growing foreign markets or providing distribution services to foreign markets.

The costs motive is even more important for banks; a survey among European banks finds that for 90 per cent cost reduction is the main reason for outsourcing (see Pujals, 2005). Since operations of banks are still very much vertically integrated, the scope for outsourcing seems large (for example, software development and financial administration). However, only 25 per cent of the banks in the sample think of outsourcing to offshore locations. All in all, the different surveys are broadly in line with the trade and investment statistics.

### 3.3.2 SECTORAL PATTERNS

Since in low-wage countries like China and India unskilled labour is abundant, they are expected to specialise in production that requires manual labour and involves simple production processes. From this one could derive that Europe will see growing imports of textiles and toys from these countries. However, imports of other, more advanced products have grown even faster.

<sup>9</sup> Figures do not add to 100 per cent because companies could indicate several relocation destinations.



In Table 3.5 total EU-15 imports are divided into low-tech, medium-tech and high-tech goods. Almost half of low-tech imports consist of foodstuffs and live animals, around one-third of iron, non-ferrous metals and paper. Major medium-tech goods are fuels and chemicals, which account for around one-third of the total. The high-tech category consists of office equipment (34 per cent) transport equipment and parts (20 per cent), telecom equipment (13 per cent) and electronic components (13 per cent).

Most of the EU-15 imports consist of medium-tech and high-tech goods. Their share is growing whereas the share of low-tech goods is limited and falling. One explanation is that transport costs and other trade barriers do not fall for low-tech goods as fast as for the other goods. Another explanation is that demand in the European economies shifts away from the low-tech goods.

Table 3.5 also gives a break-down of imports to origin. More than half of the imports originates in the EU-15 members itself. The EU-15 share of total imports has declined somewhat in favour of Asia and Eastern Europe between 1995 and 2002. Imports from China have increased by nearly 19 per cent per year.

**Table 3.5: Geographical distribution of EU-15 imports by technological level, 1995-2003, percentage share of the total and average annual percentage growth<sup>a</sup>**

|                    | Shares in 2003 |          |          |           | Average growth in 1995-2003 |          |          |           |
|--------------------|----------------|----------|----------|-----------|-----------------------------|----------|----------|-----------|
|                    | Total          | Low-Tech | Med-Tech | High-Tech | Total                       | Low-Tech | Med-Tech | High-Tech |
| EU - 15            | 57.0           | 12.6     | 23.1     | 21.3      | 5.1                         | 2.3      | 6.4      | 5.8       |
| United States      | 6.6            | 0.5      | 3.0      | 3.1       | 4.7                         | -1.0     | 7.3      | 3.7       |
| Eastern Europe     | 4.8            | 0.8      | 1.7      | 2.3       | 14.9                        | 6.4      | 11.2     | 25.5      |
| Asia (excl. Japan) | 12.8           | 1.5      | 6.1      | 5.2       | 10.2                        | 6.5      | 8.9      | 13.5      |
| China              | 4.2            | 0.3      | 2.1      | 1.8       | 18.9                        | 12.8     | 15.2     | 27.8      |
| India              | 0.6            | 0.2      | 0.3      | 0.1       | 7.0                         | 5.4      | 7.2      | 12.6      |
| Rest of the world  | 18.8           | 3.8      | 10.2     | 4.8       | 6.3                         | 3.1      | 8.0      | 5.7       |
| Total              | 100.0          | 19.2     | 44.0     | 36.7      | 6.2                         | 2.8      | 7.3      | 7.1       |

Source: ICT/WTO database

<sup>a</sup> SITC classification, see <http://unstats.un.org/unsd/cr/registry> (bottom left corner of the page) Low-tech consists of classes of goods 0, 1, 24, 25 and 63-68. Medium-Tech consist of classes of goods of 21-23, 26-29, 3, 4, 5, 61-62, 69, 8 and 9. SITC category 7 is defined as High-tech.

Strikingly imports of high-tech goods are growing faster than imports in other categories from China, India and Eastern European countries. A priori, one would not expect these countries to have a comparative advantage in high-tech goods. Nevertheless, the principle of comparative advantage may still explain this pattern of international trade. Asian and Eastern European are likely to specialise in those parts of high-tech production, that do not necessarily require highly skilled, highly specialised workers and that concern fairly standardised products. Related to that, foreign direct investment from the richest countries may actually have been essential for the production of 'high-tech' goods in developing and transition countries. The richest countries export know-how and technology, and import (components of) high-tech goods. Indeed, lower transport costs and other trade barriers have promoted vertical specialization; especially the production chain for high-tech goods has become fragmented. The European Union may benefit less from the new, better possibilities to outsource production than the United States. One reason is that the Union is specialised in medium-tech goods (for example chemicals), for which the possibilities for outsourcing do not seem to expand as fast as for high-tech goods.

A parallel trend occurs in the trade of services. As with goods, there are major differences in tradability among the services. Most services still require physical proximity of consumers and producers, but with the emergence of information and communication technology, some standardised services have become tradable, such as software development, payroll administration, transaction processing and technical support. While total cross-border trade in

goods and services has expanded more or less in line between 1992 and 2001, shifts have occurred in services trade during this period. Table 3.6 shows that the share of computer and information services in total services trade has more or less doubled, from 1.4 per cent in 1992 to 2.7 per cent in 2001. In particular computer services seem responsible for this increase; the share of computer services has risen between 1998 and 2002 from 1.7 per cent to 2.3 per cent. The table also shows that trade in services such as administration has grown relatively rapidly. UNCTAD (2004, p. 147) examines the relocation of services in detail, but also warns that ‘although recent media attention may suggest otherwise, to date, the magnitude ... is relatively small, albeit growing fast’.

**Table 3.6: Import of selected services, 1992, 1997 and 2002, share as a per cent of total import in services**

|  | 1992 | 1997 | 2002 |
|--|------|------|------|
| Computer and information services                                      | 1.4  | 1.8  | 2.7  |
| Business services  | 28.6 | 30.0 | 36.2 |
| Legal, accounting, management consulting and public relations services | 1.8  | 2.6  | 3.7  |
| Research and development   | 2.3  | 2.4  | 2.7  |
| Other business services  | 20.2 | 22.1 | 26.6 |
| Services between related enterprises, n.i.e.                           | 4.3  | 3.0  | 3.2  |

*Source:* OECD Trade in Services (2003).

### 3.3.3 CONCLUSION

The choice of location is largely informed by its characteristics. Different links in the production chain can move to different countries (vertical specialisation). The motivation behind this are cost differences between countries, arising from differences in the availability of factors of production, for instance. The same link in the production chain can be duplicated in different countries (horizontal specialisation). The motivation behind this is market access.

Some surveys may paint a sombre picture of relocation. But largely surveys are in line with the trade and investment statistics. Most of Europe’s inward and outward direct investment takes place with the United States or remains within Europe. Investment in low-wage countries is not only very small in absolute terms, it is not rising very fast either. Trade flows present a slightly different picture. The United States is Europe’s largest trade partner by far. In addition, individual European countries largely trade with other European countries. However, the share of imports from Eastern Europe and Asia is growing fast.

Trade in goods and services is expanding rapidly as a result of internationalisation, but there are considerable differences between products. A striking feature is the rapid growth in high-tech imports. The same is true for the imports of some services, such as software and administration.

## 3.4 Consequences of relocation

### 3.4.1 GAINS AND LOSSES

Falling costs of international transactions provide new opportunities to organise production and trade, implying efficiency gains for the global economy. The participating countries may share these gains in various ways. The traditional argument is that countries gain by importing at a lower price and by exporting at a better price. But in the economic literature many other arguments have been put forward. Among other things, better opportunities for international trade and investment are considered to:

- lower mark-ups and allow a better exploitation of scale economies (see e.g. Smith and Venables, 1998);

- offer a greater scope for the most productive companies, boosting average productivity (see e.g. Melitz, 2003, and Baldwin and Forslid, 2004);
- expand the range of available product varieties (see e.g. Romer, 1994);
- foster the international exchange of ideas and technologies (see e.g. Coe and Helpman, 1995).

For Europe there is scattered direct evidence for the idea that relocation to foreign location contributes to productivity of domestic firms. For example, Barba Navaretti and Castellani (2004) find that for Italian firms investment abroad is associated with higher productivity and not with lower employment. Furthermore, Egger, Pfaffermayer and Wolfmayr (2001) arrive at the result that for Austrian sectors outsourcing is related to (total factor) productivity.

Even when better opportunities for international trade in goods, services and capital imply a global gain in welfare, individual countries may not benefit. In the economic literature at least two possibilities appear. First, lower barriers to trade and investment may lead to adverse changes in a country's terms-of-trade. Second, changes in trade and production patterns may magnify distortions in a country's economy. Of particular interest is the possibility that a country sees a cluster of economic activities dissolve and that it can no longer enjoy the benefits from this cluster. These two possibilities are discussed in somewhat more detail below.

### **Terms-of-trade losses**

A country may see its welfare decline when opportunities to trade and invest expand or growth elsewhere accelerates. These concerns are far from new. Bhagwati *et al.* (2004) recall that in the 1950s the brisk growth of the American economy raised concerns about the level of economic welfare in Europe and that in the 1970s fast economic development in Japan led to similar concerns in the United States. These concerns are addressed in the economic literature. Bhagwati *et al.* point to old work by Johnson (1954 and 1955) that shows how growth in one country – through terms-of-trade effects – lead to income changes in other countries. Samuelson (2004) reiterates this result. But also in recent work the economic interaction through the term-of-trade changes is central. Acemoglu and Ventura (2000) present an empirical analysis showing that a country's growth (through capital accumulation and technology convergence) is accompanied with terms-of-trade losses and spills over to other countries. In other words, growth brings these other countries a gain and not a loss. Growing possibilities for outsourcing may imply losses for some countries, suited for integrated production. Markusen and Venables (2005) stress this simulation result.

Yet, the trade and investment flows between poor and rich countries are small fractions of the total. Large changes in small flows are not likely to bring about important terms-of-trade changes. More important for Europe is perhaps the accession of Central and Eastern European countries to the European Union. The enlargement may bring a gain to the Union as a whole, but the question is whether each EU member shares it. Baldwin *et al.* (1997) and Lejour *et al.* (2004) have studied the effects of the enlargement. The benefits for the accession countries are clear, although the two studies disagree on the size: an increase in gross domestic production with 1.5 per cent versus 7.8 per cent. Both studies also predict an increase in GDP for the EU-15 member states of 0.2 percentage points. This increase is modest but it is clearly not a decrease.

Countries are more likely to avoid the possibility of losses and to share the global gains from better trade and investment opportunities, the better their economy adjusts to changes in world markets. To minimise the loss of falling world market prices in some sectors, the sectoral structure must adapt. It will be easier to bring about a sectoral shift if the labour force is better skilled for

two reasons. First, higher and broader educated workers are more employable, they more easily become productive in new activities. Second, comparative advantage for Europe lies in high-productive sectors with a high skill intensity. Skill upgrading of the labour force facilitates the shift towards these sectors.

### External effects of agglomerations

Separate location decisions can reinforce each other. There are advantages to agglomeration, which often have the character of external effects. For one thing, not only does a company's new plant benefit from the proximity of its suppliers and customers, these suppliers and customers also benefit from the proximity of the new plant. And for another, companies can contribute to the local knowledge stock, from which other companies can benefit in turn. When clustering of (certain) activities have positive external effects, relocation may imply potentially important losses for a country. Krugman and Venables (1995) stress this possibility. In a theoretical model they show that falling trade barriers can induce important changes in agglomeration patterns. When a country sees capital and firms leave, it may not only lose these firms but also associated clusters of activity.<sup>10</sup>

However, the possibility of important changes in economic geography is somewhat theoretical, for at least three reasons. First, core-periphery patterns are quite stable. Location decisions reinforce each other, so that firms are unlikely to reconsider them quickly. Up to a certain threshold, the core-periphery patterns are immune to differences in wage costs or government policies to strengthen competitiveness. The fast economic development of India and China may not have a strong effect on the European centre of activities but rather have an impact at the periphery of the world economy. Second, there are also disadvantages to agglomeration, ranging from high land and house prices to congestion of public infrastructure. These disadvantages sometimes also have the character of an external effect. The most telling example is road congestion. Consequently, it is not clear a priori whether the separate and uncoordinated location decisions lead, from the perspective of society, to not enough or too much agglomeration. Third, the core-periphery patterns are particularly strong at a regional level. For instance, the differences between city and countryside are stark. Brakman *et al.* (2005) estimate that within the European Union broadly two-thirds of the variation between output per square kilometre – a measure of the extent to which a location would function as a core – can be found at subprovincial level. They also estimate that the geographical reach of agglomeration advantages is limited to only several tens of kilometres. The new economic geography thus seems particularly relevant at the regional level within a country.

The three reasons do not deny positive externalities from clustering on an economy altogether. R&D is a good counterexample. A striking feature of R&D activities, and possibly of other ways of knowledge production as well, is that they generate clearly identifiable external effects. Spending by one firm will benefit other firms in the sector, but also other sectors at home and abroad. The extent of the benefit depends on the links with the innovating firm, which arise from economic transactions but are also determined by physical proximity. Researchers can learn from each other. Despite the internet and e-mail, personal contact is still the most appropriate means of exchanging knowledge. An international airport is therefore important, but the physical proximity of other researchers is even more important. Indeed, the external

<sup>10</sup> On local distortions related to agglomeration external effects see also Gaffard and Qu  r   (2005)

effects diminish sharply as the distance increases.<sup>11</sup> These external effects may therefore constitute a reason for formulating government policy.<sup>12</sup>

**Box 1: Agglomeration of ICT production or use: Can relocation of ICT activities prove unfavourable?**

Production and application of information and communication technology can have external effects on the rest of the economy and prompt an agglomeration of companies. Information on these external effects is limited, however, and the various studies that have been undertaken have yielded conflicting findings.

Agglomeration of companies is frequent in the case of ICT production. The best-known example is Silicon Valley in California. Minne and Van der Wiel (2004) offer another example. They point to the Eindhoven region, where a wide range of ICT companies appeared around Philips and the Technical University of Eindhoven.

It is unclear whether and to what extent the production of ICT goods and services and their agglomeration have external effects on the rest of the economy. Daveri and Silva (2004) convincingly argue that Nokia has contributed directly to Finnish productivity growth, but that the indirect, external effect on that growth has been limited. One of the reasons is that Nokia and the associated service companies do not have strong ties with other industries.

The application of information and communication technology can have external effects on productivity. For instance, Van Leeuwen and Van der Wiel (2003) show for the Netherlands that investments in one company have a substantial effect on the productivity of another company in the same sector. This fits in with Mun and Nadiri (2002), who find a similar effect in a study of 42 US industries. This suggests that the departure of ICT-intensive companies can harm an economy. However, an empirical study by Stiroh (2002) finds no evidence of external effects.

In short, the picture from the economic literature is unclear. Both the production and application of information and communication technology can have external effects, but the evidence is far from overwhelming.

### 3.4.2 LOSERS: (LOW-SKILLED) WORKERS

Workers may lose their jobs as a result of the relocation of business activities. They will then have to look for other jobs. Low-skilled workers in particular will not find that easy. Their position in the labour market is relatively unfavourable, and relocation does not make it any better, because they are competing indirectly with other low-skilled workers elsewhere in the world.

The implications of relocation for the labour market position of the low-skilled and for transitional unemployment are sometimes a cause for concern. That is understandable. But how relevant is this concern? The existing economic literature gives an impression: relocation offers little cause for concern about the position of the low-skilled workers and for the concern about transitional unemployment. This section will explain this.

**Is the unfavourable labour market position of low-skilled workers due to relocation?**

Wage inequality between high- and low-skilled workers has been widening over the last few decades. In the United Kingdom and the United States the wages

<sup>11</sup> See e.g. Keller, 2001.

<sup>12</sup> Agglomeration of researchers is not accompanied by clearly identifiable negative external effects (such as congestion).

of low-skilled workers are actually falling in real terms, while those of high-skilled workers are rising steadily. This trend in wage differentials is less pronounced on the European continent, but evident enough. Moreover, it is unfolding against a background of deindustrialisation and is accompanied by relatively high unemployment among low-skilled workers. Because of the social security provisions, the wages of low-skilled workers cannot fall sufficiently, and therefore unemployment among them is rising.

It is tempting to point an accusing finger at international specialisation. And with some justification, because international specialisation drags down the prices of goods whose production requires relatively low-skilled work, putting the remuneration of low-skilled workers under pressure.

We should not jump to conclusions, though. As mentioned, the lion's share of trade and investment takes place between similar countries. The reason is not comparative advantage. The relocation to dissimilar countries is simply too small to explain the widening wage inequality in full (Krugman, 1995). Moreover, prices are rising precisely in those industries most exposed to competition from low-wage countries. One explanation for widening wage inequality is therefore what has been called 'skill-biased technological change', that is, technological developments which have a relatively favourable effect on the productivity and wages of high-skilled workers. The ICT revolution springs to mind here.

Ultimately the question whether widening wage inequality is due to international specialisation or technological change is an empirical one. The relevant literature is extensive and diverse, and a clear answer does not readily offer itself. Nevertheless, there is a consensus among economists that the role of international specialisation is subordinate. Most economists conclude that international specialisation has no significant effect on pay inequality. Even Feenstra and Hanson (2001), who champion the role of international specialisation, find that on the basis of macrodata only 10-35 per cent of the growth in income inequality can be attributed to international specialisation.

The knowledge that international specialisation is probably not the main culprit, is certainly relevant for policymakers. Firstly, it means that countering wage inequality by frustrating international specialisation with trade barriers and the like will not be very effective. At most it will prevent firms taking advantage of the opportunities offered by globalisation. Secondly, regardless of the cause, the widening inequality between high- and low-skilled workers implies that the return on education is increasing. Barriers in the way of education and training (such as high drop-out rates) which leave the labour force's potential untapped, will thus become more expensive. What is more, if the labour force is better educated and trained, it is easier to realise shifts within and between sectors.

### **Does relocation lead to unemployment over the short term?**

International specialisation is accompanied by restructuring, both within and between sectors. This inevitably leads to job destruction and job creation, which may lead to frictional unemployment. The move from one job to the next may take time and for some job seekers, this interval between jobs may be considerable, especially if they lose skills and become less attractive to employers. Frictional unemployment is of course not uniquely linked to international specialisation. Job destruction and job creation is a normal part of the economic process. A rough calculation shows that substantial relocation does not contribute significantly to the normal flows on the national labour market. A study by Forrester (2004) projects job losses of 220,000 per year due to relocation, which again pales into insignificance compared to the dynamism of the US labour market, where between 15 and 25 million jobs disappear every year. According to Kierkegaard (2004), this is not surprising. He points out that 'overseas location' was the direct cause of only 1 per cent of all mass redundancies in the United States in 2003. From a survey of studies for France

Daudin and Levasseur (2005) conclude that until the early 1990s trade with developing countries accounts for a total of 150,000 to 300,000 jobs lost, compared to total employment of roughly 2.2 million. Their review 'suggests that most French employment developments were not related to international trade but had domestic causes'. In a study on the United Kingdom, Amiti and Wei (2004) find no link between the extent of outsourcing and employment in 78 sectors. Where outsourcing leads to job losses, this is offset by comparable job creation in the same sector. They do not make a distinction between the outsource location.

It is interesting that for 7 EU countries outsourcing to low-wage countries has a negative effect on employment whereas outsourcing to other (high-wage) countries does not have a clear, positive or negative effect. According to Falk and Wolfmayer (2005) this effect has contributed to the employment decrease in manufacturing. Over the period 1995-2000 the annual decrease was on average at least 0.25 percentage points.

At the national level the job losses due to relocation are thus relatively small. However, at a regional level the impact of relocation can sometimes be considerable. International specialisation could thus be responsible for major regional employers going under. Little or nothing is known about the regional effects of relocation. Regional variations in unemployment point to imperfections in European labour markets. Ideally, job seekers from a region with relatively high unemployment should look for jobs in regions with relatively low unemployment. But apparently, interregional mobility is limited.

### **3.4.3 LOSERS: THE PUBLIC SECTOR?**

Often governments can only change the characteristics of their countries slowly and indirectly. The education and training of the labour force and the production methods of companies spring to mind here. However, there are policy variables which seem to have a direct impact on the location of activities: corporation taxes, environmental standards and employment conditions. Hence one question is how important these policy variables are in relation to countries' macro-economic characteristics. Another, related question is whether actual or threatened relocation induces competition between governments. There is a concern that governments may pursue beggar-thy-neighbour policies in this respect. Policy may be rational from the perspective of an individual government, but collectively it may be inefficient. This can throw a different light on the desirability or otherwise of relocation.

In this section we will examine two areas of influence: taxes on firms and environmental standards. We focus on two prominent examples rather than examine all policy options.

#### **Policy competition: corporate taxes**

Governments try to attract and retain investment in several ways. One of them is to offer favourable corporate tax rates or energy tax rates. This can lead to competition among governments, resulting in low tax rates on firms. This has become more likely with the enlargement of the European Union, because the new member states have lower corporate tax rates than the original 15 members. Some analysts believe that competing on tax rates will make it ever more difficult for governments to carry out their core public tasks while others see it as a brake on the otherwise unbridled expansion of the public sectors.

What is the effect of corporate taxes on inward foreign investment? Comparing the outcomes of many empirical studies, Ederveen and de Mooij (2003) conclude that a 1 percentage point reduction in the tax rate (from 34.5 per cent to 33.5 per cent, say) eventually raises the stock of total foreign investment by 3.3 per cent: a demonstrable effect. But it still leaves open the question whether this effect is large or small or whether this is worthwhile. And perhaps more importantly, it leaves open the question whether

governments consider this effect large or small, a question that marks the difference between a race and no race to cut corporate tax rates.

So does tax competition exist? At first glance governments do not seem to be competing, or only to a very limited extent. In West European countries corporate and energy tax revenues (as a proportion of output) have not fallen over time. It seems that when governments set tax rates for firms, they are not guided by the effect on foreign investment, although these investments have become more important.<sup>13</sup>

Yet, there are signs of tax competition. Energy tax rates are lower for firms than they are for households. And while corporate tax revenues have remained stable, the various statutory tax rates have fallen over time, indeed a fact that is evidence of tax competition (see also Griffith and Klemm (2004) for an overview of empirical work on tax competition). Multinational concerns try to account for profits in countries where the tax rates are lowest. Since deductible items, which determine the tax liability for an individual company, are generally linked to real capital, the applicable tax rates are relevant for the location of paper profits. Multinationals can ensure that these are accounted for in low-tax countries through ‘transfer pricing’, i.e. by manipulating purchasing and selling prices within the concern. Much more mobile than production plants are the profits generated by them, which can be channelled from one subsidiary to another, a process which probably exerts pressure on tax rates. The effect of those rates on foreign investment seems less important.

### **Environmental standards**

A company’s location choice may also be influenced by differences in environmental standards. The concern here is that companies will gather at locations with relatively low standards (so called ‘pollution havens’). These locations are to be found in developing countries, for instance, where poverty acts as a constraint on environmental concerns and standards are not very high. Relocation towards such locations may undermine the strict environmental policies of developed countries or undermine the wellbeing of local populations.

There is empirical literature on the influence of environmental standards on location choice. An overview by Bollen *et al.* (2002) on this matter shows that this influence is rather limited. And in a study of foreign investment in some US states between 1977 and 1994, Keller and Levinson (1999) find a small effect for polluting industries, but no clear and significant effect on investment flows to states, which is striking. After all, US states compete fiercely with each other (certainly more than countries) in attracting foreign investors. Environmental standards could therefore play a role in location choice, but it turns out that they are often not decisive. Factors other than environmental standards play a role, and these evidently weigh more heavily. This does not exclude the possibility that policy competition may sometimes be of importance. It is noteworthy, for instance, that energy taxes for businesses are appreciably lower than those for households.

### **Summary**

The macro-economic characteristics of countries largely determine the location of business activities. Often governments can only change these characteristics

<sup>13</sup> Baldwin and Krugman (2004) distinguish between the core and periphery in Europe. Core countries – the Benelux, France, Germany and Italy – offer companies a relatively favourable geographical location, not least because many major customers and suppliers are based in the core. According to Baldwin and Krugman, these countries can cream off this advantage (‘rent’) without companies leaving. In short, countries in the European core can afford to levy relatively high tax rates. The countries on the periphery – Greece, Ireland, Portugal and Spain – have to accept lower tax rates.



indirectly and slowly. That is why the geographical patterns of foreign trade and foreign direct investment do not show abrupt shocks.

However, governments can exert a direct influence on location choices, in particular regarding corporate tax rates. In this respect governments seem to be involved in mutual competition. This may generate inefficiencies when companies are taxed at different rates. The corporate tax will weigh less on multinational companies than on domestically oriented companies.

Even so, differences in corporation tax rates do not have a disastrous effect on foreign direct investment. Other policy variables only have a limited influence. This applies at least for environmental standards, but probably also for employment protection legislation, administrative burdens and other policy variables which are important for the investment climate. The reason is that apart from policy variables, there are many other factors which determine companies' location decisions.

### 3.4.4 CONCLUSION

All in all, relocation offers several advantages, while the potential disadvantages are limited. Relocation is an integral part of commercial relations between countries. Europe gains a number of advantages from the free flow of goods, services and capital. Consumers and companies benefit from low import prices. Commercial relations between countries also give greater scope to productive companies, access to a wider range of specialised products, the potential for scale economies, and the potential to learn from other companies. Some disadvantages also relate to the free flow of goods, services and capital, however. Firstly, international competition could force a number of European companies to reduce their export prices. Hence, adjustments in the economic sector structure are a necessary condition for not losing out in the free flow of goods, services and capital. Secondly, the growing opportunities for international trade and investment may influence the income distribution. High-skilled workers and owners of knowledge capital will benefit, while low-skilled workers may lose out. However, the effects on low-skilled wages and unemployment seem to be limited. Because the disadvantages can be avoided and/or are limited, Europe on balance benefits from the free flow of goods, services and capital, and thus also from relocation.

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## 3.5 Government policy

There are many views on relocation. Some analysts believe that it offers new opportunities for Europe whereas others are worried about job losses and lower wages. These views yield different perspectives on the role of government. Below we will concentrate on the role of government from the perspective of the analysis in the earlier sections.

### **A case for further economic integration**

The important role of distance in international economic relations suggests that the gains from international trade are far from exhausted. Indeed, the European Union is in the position to create further gains by broadening and deepening the internal market and by pushing for multilateral trade liberalisation.

### **The need for sectoral restructuring**

European countries can benefit from international trade and investment. Among other things, they allow companies to purchase more cheaply abroad (rather than produce themselves) and sell at a better price abroad (rather than sell in the home market).

A precondition, however, is that the sector structure adjusts to changes on the world market. Not least owing to the rapid growth of China and the new

EU member states, some sectors will face more competition and lower profit margins. Investment and jobs in those sectors will have to contract. Of course, for some European firms exports to these countries are new sources of profit. (By exporting know-how they fuel the economic growth in these countries.) Even so, it is important that investment and jobs shift to other sectors. This helps to secure the net benefits from international specialisation. Hence it is the task of government to facilitate sectoral shifts in the economic structure.

Yet, the adjustments in sectoral structure should be seen in perspective. The extent of relocation seems limited, contrary to what the media sometimes suggest. Statistics show that trade and investment tend to flow between 'similar' countries. It is true that the share of developing and transition countries is growing rapidly, but it is still small.

### **Special attention for research and development**

The location choices of individual companies are sometimes interconnected. Agglomeration may generate external effects. In principle, these external effects are an excellent reason for government action.

- Agglomeration of suppliers and customers: This plays at the regional level in particular, and is of only limited significance for national economic growth. Moreover, not all external effects are positive; some are negative. Thus it is unclear whether there is not enough or too much agglomeration of economic activities.
- Agglomeration of researchers: The external effects of European research and development are substantial, and what is more, they largely accrue to European countries. However, agglomeration patterns are difficult to change. Attracting 'new' activities will be more successful than attracting 'existing' activities. Moreover, market failure should not be replaced by government failure, for instance when governments err in picking winners.

### **Improving the functioning of European labour markets**

Relocation to low-wage countries raises a concern that it will push wage levels downwards and unemployment upwards in developing countries.

- Low-skilled workers in Europe compete with low-skilled workers elsewhere through product markets. Booming economies in some developing and transition countries as well as internationalisation mean that competition is intensifying. This may put the wages of low-skilled workers under pressure. Insofar as social security provisions (unemployment benefit, minimum wage etc) put a floor under their wages, this can lead to structurally higher *unemployment among low-skilled workers*. The government then faces the awkward choice of lowering this floor and accepting greater income inequality between low- and high-skilled workers, or maintaining the floor and accepting higher unemployment among the low-skilled. This choice lies with our politicians. They may take some inequality for granted, reform social security and enhance labour market flexibility. Or they may opt for more outlays on support of low-skilled people, if they highly value equity and the position of the low-skilled. However, the dominant view in the economic literature is that international competition between low-skilled workers is limited. Trade and investment flows between rich and poor countries are relatively modest. The deteriorating position of low-skilled workers is often primarily attributed to technological change, which of course does not make the political choice less awkward.

- International specialisation is accompanied by job destruction and job creation. In this way it contributes to *frictional unemployment*. It is not very clear how large this contribution is exactly, but the labour market is very dynamic in any case. The government can try to make the transition from one job to another easier. This may be part of a general policy aimed at encouraging participation in the labour market.

### **Policy coordination is sometimes useful**

Governments try to influence location choices through policies. If there is no coordination between countries, this may be an argument for an individual country to react. However, there are several reasons for a cautious stance in this respect.

- The external effects of the activities to be attracted are often small or unclear. Exceptions may be R&D activities (see above).
- The influence of government policy on location choice is often limited. This seems to apply for environmental standards but also for other policy options. Corporate taxation is an exception. Tax competition takes place above all because paper profits are highly mobile, and coordination at a European level in some form seems desirable. If such coordination does not arise, countries may feel the need to lower the tax burden on firms (for example through an across-the-board reduction of corporate tax rates or by introducing competitiveness zones.)

### **What is the role of education and knowledge?**

At various points in this article, two arguments come to the fore which call for a climate in which education and training improve the labour force's potential effectively and in which business investment in knowledge can thrive. First, in some countries there is a trend towards growing inequality between low- and high-skilled workers, and international specialisation may force shifts within and between sectors. Therefore, any barriers which thwart education and training will become more expensive. Moreover, it is easier to realise shifts within and between sectors if workers are more employable through better education and training.

Second, without making a deliberate choice, Europe can attract or start 'new' activities by offering a climate in which investment in those activities is profitable. Knowledge (not only of new technologies but also of ideas, for instance) will be central to these 'new' activities.<sup>14</sup> From this perspective, an effective knowledge infrastructure is required.

### **What are the impacts on relocation of supporting specific sectors or firms?**

Now and then proposals are put forward to support sectors or firms. Typically, the support is directed to those sectors and firms that have proven to be successful (national or European champions) and/or that are involved in developing and applying new technologies. These proposals may have the specific aim of stopping the process of deindustrialisation or raising the rate of economic growth. The general background is, however, that European sectors and firms are thought to need support to withstand foreign competition. Mathieu and Sterdyniak (2005) provide an overview of the different proposals that have been floated up to now.

Whether specific support is an effective and efficient way to achieve the specific aim of reversing deindustrialisation or boosting growth, does not

<sup>14</sup> See Widgren (2005) for an empirical analysis of comparative advantage and human capital.

concern us here. Instead, the question is what the impacts on relocation are. Crucial in the different proposals is that support does not go directly to activities that require relatively little skills or know-how and in which emerging economies have a comparative advantage. So, the different proposals may make some sectors or firms more competitive, but they do not seem to stop the ongoing relocation of these activities. In fact, the champions are as a rule exactly those firms that operate in more than one country and that are able to shift activities across borders. Specific support to successful firms or sectors may thus even increase the scale of relocation towards emerging economies.

### **Beyond relocation**

All in all an economic analysis of relocation offers only a limited number of motives for government policy. However, the government may still need to play this role from a different perspective. For example, attracting or retaining economic activities may not be a decisive or even a good reason for efforts to improve the investment climate for foreign companies. Such efforts are, however, appropriate if they primarily stimulate domestic investment.

### **Relocation in the future**

The empirical evidence is clear: relocation towards Asian countries or towards East European countries has not had a large impact on labour markets in the West and South Europe up to now. This will not change overnight. The growth in international trade and investment has been and will be a gradual process. But may the impact of relocation change in the more distant future? The data show, for example, that the share of China in trade and investment flows is small but growing fast (see Section 3.3). More generally, the process of internationalisation will continue. In a globalisation scenario for the European economy openness is projected to increase 29 per cent in 2000 to 43 per cent in 2040.<sup>15</sup> In a scenario like this new government policies may become relevant.

When considering the more distant future, one should not overlook several developments that make a simple extrapolation of current trends invalid. First, the pace of internationalisation depends on trade agreements. Indeed, this globalisation scenario assumes among other things a successful Doha round. Second, further integration within the European Union may make trade and investment flows with Asia less important. This explains that in the last decades the share of intra-EU trade has been relatively stable. Third, economic growth will lead to higher wages in emerging economies. Indeed, some firms already experience problems with turnover of high skilled staff in regional labour markets of emerging countries.

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## **3.6 Conclusion**

Free flows of goods, services and capital bring the European Union important gains. They also imply that production facilities and jobs are sometimes relocated elsewhere. Trade and capital flows to and from low-wage countries, that are driven by cost differences, are rising relatively rapidly but still take up a relatively small share of the total. By consequence, the impact of competition from low-wage countries on the European labour markets is small.

One 'problem' is that the advantages are not eye-catching. Relocation will make companies more productive. Under the pressure of competition, owners of companies (shareholders) cannot appropriate the gains of higher productivity through higher profits. They have to share the gains with customers and workers, in the form of lower prices and higher wages. In this way the advantages of relocation are spread across the economy, and consequently they are often not directly visible. At the same time the

<sup>15</sup> Openness is measured by imports as a percentage of production. The numbers apply to the EU-15 and are derived from one of the CPB scenario's (de Mooij and Tang, 2003).

disadvantages are all too clear. In many cases the relocation of business activities involves job losses. If redundant workers do not find a new job or only do so after a long time, they will experience some of these disadvantages. Even so, regular headlines about relocation should not create the impression that many jobs are lost in this way.

The difference between clearly visible disadvantages of relocation and advantages that are difficult to observe is relevant for policy makers. Policy makers need to take both sides of the coin into account when they want to make informed decisions and when they participate in the public debate. In addition, several more specific policy conclusions follow from this analysis:

- By promoting trade liberalisation and a more integrated internal market policy may reap further gains from trade.
- Policy can facilitate sectoral shifts in Europe to adapt to emerging economies.
- Research and development warrant special attention because in their location decisions private actors do not take benefits from agglomeration and knowledge spillovers into account.
- Within social Europe, the policy dilemma intensifies between higher income inequality and higher unemployment of low-skilled workers. However, only to a limited extent this dilemma results from competition by low-skilled workers outside Europe and from relocation. Technological change is more important.
- Primarily to prevent tax competition, policy coordination on corporate taxes seems desirable.
- Investments in education and training enhance employability and specialisation in knowledge-intensive activities. That supports shifts in specialisation patterns towards a more knowledge-intensive European economy.

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# APPENDIX 1: ON THE REFORM OF THE STABILITY AND GROWTH PACT

In the middle of March, the European governments and the European Commission discussed changes of the Stability and Growth Pact (SGP). Apparently, the SGP has not worked as desired in recent years. Not only were budget deficits high, often reaching some 3 percent relative to GDP even when adjusted for the cycle; also, the corrective mechanisms could not lead to better outcomes in terms of the targets of the SGP. In the Council Report to the European Council “Improving the implementation of the Stability and Growth Pact” (in the following: Council Report), these changes of the SGP are described. They are controversial not only in the public debate but also among economists. The EUROFRAME Institutes therefore present two different views on the debate.

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## A1.1 Higher risk of unsustainable fiscal policies

**JOACHIM SCHEIDE, KLAUS-JURGEN GERN (IFW),  
MALGORZATA MARKIEWICZ (CASE), WIM SUYKER (CPB)**

The Council Report makes clear that the reference values of the SGP – a 3 per cent deficit ratio and a 60 per cent debt ratio – remain unchanged. We welcome this statement. However, there are now several modifications which raise doubts whether “... the need to reduce government debt to below 60 per cent of GDP at a satisfactory pace ...” (Council Report: 16) can be met in reality.

According to the Council Report, budget consolidation efforts shall take account of cyclical conditions. The structural budget deficits should be more strongly reduced in good times, whereas they may remain unchanged or may be reduced only slightly in bad times. In the Council Report, “good times” are defined as “periods where output exceeds its potential level” (Council Report: 11), i.e. when there is a positive output gap<sup>1</sup>. Therefore, the periods in which a reduction of the structural deficit is seen as appropriate are very limited. For example, the countries with excessive deficits can claim that actual output in the years 2001 to 2004 was lower than potential output, so that budget consolidation should not have taken place; the same will apply to 2005 and probably to 2006. This seems to justify ex post the actual increase of structural budget deficits in recent years. Even in the mentioned “good times”, the deficit should be reduced by only 0.5 per cent of GDP, which is given as a benchmark in the Council Report. Against the background that structural deficits in a few Member States are close to – or even above – 3 per cent of GDP, this implies that the (still valid) medium-term objective of budgets close

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<sup>1</sup> Our criticism applies – although to a lesser extent – to the case when “good times” are defined as periods in which actual GDP growth is higher than the growth rate of output potential, i.e. when the negative output gap declines.

to balance or in surplus will not be reached in the foreseeable future as this would require up to 6 years of consolidation. The target of a balanced budget can, in our view, only be achieved if the structural budget deficits are reduced considerably every year in a pre-announced way, and that this course should not be made dependent on the state of the business cycle. Instead, the budgets should be balanced in the near future according to the rules of the SGP.

There are also other reasons why the cycle-oriented strategy proposed in the Council Report may not lead to the desired outcome. For example, it requires that fiscal policy is sufficiently flexible. However, the legislative process can be very time consuming so that a quick response to a “good year” in terms of the business cycle may not be possible. This is also one of the reasons why many economists are not in favour of “fine tuning” by fiscal policy. In addition, experience shows that such a strategy of rapid consolidation in good times has not worked in the past although it was agreed upon by the Member States. For example, many governments did not reduce the structural deficits in the boom year 2000.

Another modification in the Council Report implies that each country can claim that special expenditures are necessary so that budget deficit above 3 per cent in relation to GDP would not automatically be qualified as excessive. In the context of the so-called “other relevant factors” (Council Report: 15), “special consideration” will be given to efforts related to “fostering international solidarity ... the unification of Europe ...” and so on. This rule is not transparent as these factors are not clearly defined and can therefore be subject to different interpretations. According to the German government, these factors include the costs of German unification. However, these costs are not at all the reason why the German budget deficit has exceeded 3 per cent of GDP in recent years. The effect of this change of the SGP is most likely that budget deficits will be higher than they would otherwise be.

The same consequence follows from the change in the initial deadline for correcting the excessive deficit (Council Report: 18). In “case of special circumstances”, the deadline for correcting an excessive deficit can be set one year later. Sanctions are therefore even less likely than under the old rules. In effect, the deficits are allowed to be higher than under the old rules of the SGP.

To conclude: The risk that budget deficits will be higher and that fiscal policy will become less sustainable in the future has increased. The recent modifications of the SGP allow budget deficits to be higher than originally intended or to remain high for a longer period of time. Therefore, it is likely that the debt-to-GDP ratio which in 2004 was already higher than 70 per cent for the Euro Area as a whole will not come down sufficiently in the coming years. In particular, large economies like France and Germany have experienced rapidly rising debt ratios in recent years – approaching values close to 70 per cent of GDP in 2006 – as a consequence of persistent high budget deficits; in Italy, the high debt ratio has hardly declined in recent years contrary to the rules of the SGP. The medium-term objective for budgets to be in balance or in surplus as well as the target for the debt-to-GDP ratio of 60 per cent require that high deficits should be reduced quickly and not only in “good times”.

This risk of persistently high debt-to-GDP ratios is even more relevant now that the medium-term growth performance in the Euro Area has weakened, in particular in a few large Member States. The growth rate of potential nominal GDP in the Euro Area has declined according to most estimates and is probably only 4 per cent or even less, and not the assumed 5 per cent as underlying the reference values of the SGP. This implies that the debt-to-GDP ratio is likely to increase in several countries if budget deficits are higher than 2.5 per cent of GDP. Therefore, it is even more problematic that deficits in excess of 3 per cent of GDP are not to be corrected as fast as under the old rules of the SGP.

All in all, we recognize the problem of enforcing rules which is a common problem for economic policy and which is intensively discussed in the economic literature. The experience with the SGP in recent years is a demonstration of this problem. In our view, the failure of the SGP to produce the desired sound fiscal policy was not due to wrong targets but rather due to the fact that several governments have not pursued a strict course of budget consolidation – contrary to their repeated statements in various documents. Now that the rules have become softer, it is uncertain whether governments are more willing to stick to their commitments.

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**A1.2  
Implementation  
of the Stability  
and Growth  
Pact: still an  
Effort to be  
made...**

**ULRICH FRITSCHÉ, ALFRED STEINHERR (DIW), CATHERINE MATHIEU, HENRI STERDYNIÁK (OFCE), MARKUS MARTERBAUER, EWALD WALTERSKIRCHEN (WIFO)**

The reform of the Stability and Growth Pact decided at the European Council of 22-23 March 2005 has been seen by most observers as a victory of the countries currently breaching the rules (Germany, France and Italy) and as an increased flexibility of the Pact. Some, like the ECB, see the agreement as threatening euro area stability, some others welcome it as a step towards a more economically based Pact. We will argue in this text that the lessons of the past have not been fully drawn and that economic pitfalls remain. We will make some suggestions for further reform.

*The agreement on the implementation of the SGP<sup>2</sup>*

The Council reaffirms that the SGP is essential in the EMU macroeconomic framework, without commenting on why the Pact did not work. The Council states that the economic rationale of the budgetary rules must be enhanced but also that the 3 per cent of GDP value for the deficit ratio and the 60 per cent value for the debt ratio remain the centrepiece of multilateral surveillance. It has however been widely shown in the literature that the 3 per cent of GDP threshold for deficits has no economic rationale. Looking at the debt ratio makes sense, although it raises a number of issues we will address below.

Part I of the agreement, ‘Improving governance’, is a set of responsibilities: the Commission and the Council respect ‘Member States’ responsibility to implement the policies of their choice within the limits set by the Treaty’; the Commission is the guardian of the Treaty; the Council exercises its margin of discretion; the Member States, the Council and the Commission implement the Treaty and the Pact. **But Member States do not say why they have not been able to fulfil the requirements of the Pact (inappropriate domestic fiscal policies or inappropriate fiscal rules?).** Item 1.4 invites new governments to show continuity with the budgetary targets decided by the former government. **We do not think this constraint is consistent with democratic rules and that newly elected governments will commit themselves to the former government’s objectives.** Item 1.3 addresses, with no precision, the inadequacy between the concept of public deficit in national accounts and the objectives of mutual surveillance. **We agree that there is a need for a new concept of public deficit, without one-off measures, but also without debt depreciation or public investment as long as there is a significant social rate of return. But why not open widely this Pandora’s box?**

Part II, ‘Strengthening the preventive arm’, accepts to define medium term objectives (MTO) differentiated for each Member State. **But the range goes only from -1 per cent of GDP for low debt/high potential growth**

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<sup>2</sup> See ‘Improving the implementation of the Stability and Growth Pact’, ECOFIN Council report to the European Council, 21 March 2005.

countries to balance or surplus for high debt/low potential growth countries. These limits have no economic rationale. Why not consider the golden rule for public finance, or a deficit stabilising the public debt ratio at a reasonable level (i.e. an objective for the structural deficit of around 2 per cent for a country with a nominal growth of 4 per cent and a target of 50 per cent for the debt ratio; of around 3 per cent for a country with a nominal growth of 7.5 per cent and a target of 40 per cent for the debt ratio)?

The implicit liabilities from ageing populations will be taken into account. **But why not take into account the social contributions that people will pay to have a satisfying level of pension and health insurance? Countries with generous public pensions systems may well have a higher tax burden than countries where employees need to save on an individual basis in view of retirement or health spending. There is no certainty that countries (like the UK) projecting very low levels of public pensions, hence having a very small implicit debt, will be able to let a significant and growing part of their population living in poverty. How will the Commission address this social risk?**

Member states having not reached their MTO should make a budgetary effort of 0.5 per cent of GDP per year (in cyclically adjusted and excluding one-off measures balances). The effort should be higher in positive output gap periods, smaller in bad times. **But potential output and the economic cycle are difficult to assess. Most methods are based on the assumption that the economy fluctuates around equilibrium at typical business cycle frequencies. Therefore extraordinary stagnation periods are from a methodological point of view difficult to grasp – as well as astonishingly long boom periods. The Commission’s current estimates point to small output gaps. Even if the unemployment rate is high, a short period of growth will lead output to stand above its potential level. However if the estimated potential growth rate is given for granted and forms the base of fiscal policy, this method implies that past slow growth is necessarily reproduced in the future. The experience has shown that Member States will not undertake restrictive fiscal policies in bad times and will not use all their room for manoeuvre to pursue an arbitrary ‘close to balance or in surplus’ medium term objective. It would be reasonable to require no reduction in the structural deficit in bad times.**

Structural reforms, in particular pension reforms introducing a mandatory, fully funded pillar, will be taken into account if they raise potential growth and induce long-term savings in the long run. **The design of the Social Security system is a national choice and there is no justification for a European rule to provide incentives for a fully funded system.**

Part III is entitled ‘Improving the implementation of the excessive deficit procedure’. The Commission will prepare a report if the deficit exceeds 3 per cent. A small and temporary breaching of the rule will be allowed if it is due to negative growth or a strong negative output gap. The proposal made by France, Germany and Italy to automatically withdraw certain categories of expenditure from the deficit has not been accepted. But the Commission report will take account of “all other relevant factors”: policies implemented in the framework of the Lisbon agenda, R&D spending, public investments, economic situation or debt sustainability. Member States will be able to put forward other factors like budgetary efforts for international solidarity or for European goals or for the unification of Europe. The cost of the introduction of a compulsory, fully funded pension pillar would also be taken in account. These elements may prevent to launch the EDP if the excess is limited and temporary. They could also allow for longer adjustment paths to bringing deficits below 3 per cent.

**On the one hand, the Commission keeps the right to prepare a report for each country breaching the ceiling and will be entitled to send**



**directly an early warning. On the other and, the state concerned will be entitled to justify its fiscal policy by output gap, public investment, contribution to the EU budget or defence spending, or by the cost of Unification (for Germany) or other reasons... So the implementation of the EDP will not be automatic. It will require a specific judgement on the economic context and policy choices of the state concerned. How can peer countries condemn the policy run by an elected government, if this policy does not generate negative externalities for them?**

This agreement may be interpreted in two ways. It may be viewed as a death of the pact: rules are no more rigid; Member States sovereignty on domestic fiscal policy has been reaffirmed; the medium-term target of budgetary position in balance becomes less binding. A country breaching the 3 per cent of GDP threshold for deficits will be entitled to justify it with economic conditions, specific spending measures or undergoing reforms. But one may also consider that the reform still lacks economic rationale: there is no reflection on the objective of fiscal policy or on the measurement of the output gap; the softening of the MTO is very limited; the requested annual 0.5 per cent decrease in structural deficits to GDP ratios, remains. The 60 per cent threshold, long-term sustainability, the 0.5 per cent of GDP requested budgetary efforts and more restrictive fiscal policies in good times mean that governments will have to justify in permanence domestic fiscal developments before the Commission and peer countries. The Pact would remain a factor of permanent tensions in Europe.

#### *About the ECB's Reaction*

The ECB has expressed strong worries about the SGP reform, fearing that the reform will undermine price stability in the Union. But there is no direct link between public deficits or debts and inflation, as shown by Germany or Belgium. Public deficits do not have inflationary consequences if private domestic demand is subdued.

#### *Towards a new Pact...*

According to us, fiscal policies in Europe must be implemented at three levels. Each Member State must keep the responsibility of its domestic fiscal policy and decide on issues like the amount of public expenditure, the quality of public finances, intergenerational equity. Fiscal choices need to reflect the votes from the people. National autonomy in fiscal policy must be reaffirmed. In order to facilitate the visibility of fiscal policy, each government could announce its fiscal rules and commitments, i.e. the way in which it intends to ensure public finance sustainability. Governments could present a structural expenditure path, where public expenses grow generally at a rate consistent with nominal trend growth, and structural taxation rules, consistent with debt sustainability, so that automatic stabilisers and discretionary policies could play. Governments could have the objective of stabilising the debt level at a satisfactory level (50 per cent of GDP for instance, which would authorize an average structural deficit of 2 per cent of the GDP in a country growing at a nominal rate of 4 per cent) or to limit the average level of structural deficit to public investment (**the golden rule for public finance** would ensure sustainability since public debt would be equal to public capital stock). These objectives could be revised according to macroeconomic developments in the medium term. In the short run, automatic stabilisers and discretionary policies should be allowed to run freely. In order to facilitate the visibility of fiscal policy, national governments could announce clearly which measures are transitory and discretionary.

In the current level of European integration, European authorities should intervene only to prevent the emergence of negative externalities. The European authorities should ask for tighter fiscal polices only in countries

where inflation is too high, the current account deficit too large or where public debt becomes unsustainable. The decision must be based on a precise macroeconomic analysis, non on arbitrary criteria.

Besides, we think economic co-operation would be useful within the Eurogroup with the ECB agreeing to dialogue. The Eurogroup and ECB could discuss the European economic situation, agree on the impulses needed at the European level, discuss how the impulses may be shared between monetary policy and domestic fiscal policies. This co-operation should not focus on public finance criteria, but should target the 3 per cent economic growth of the Lisbon strategy.

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