EFN REPORT ON THE EURO AREA OUTLOOK

Executive Summary

AUTUMN 2003

About the European Forecasting Network

The European Forecasting Network (EFN) is a research group of European institutions, founded in 2001 and co-financed by the European Commission. The objective of the EFN is to provide a critical analysis of the current economic situation in the Euro area, short-term forecasts of the main macroeconomic and financial variables, policy advice, and in-depth study of topics of particular relevance for the working of the European Economic and Monetary Union. The EFN publishes two semi-annual reports, in the spring and in the autumn. Further information on the EFN can be obtained from our web site, www.efn.uni-bocconi.it or by e-mail at efn@uni-bocconi.it .

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Executive Summary

Economic performance continues to disappoint

There is a 40% chance of a technical recession in 2003

The economic performance of the Euro area continues to disappoint. This is the Fourth Report of the European Forecasting Network. Once again we have had to revise down our forecast for economic prospects over the next two years. The recovery in economic activity that we have been expecting to appear during 2003 has not materialised. Assailed by a number of negative shocks from high oil prices, an appreciating Euro against the dollar, continuing geopolitical uncertainty, and a slow movement towards the liberalisation of labour and goods markets, economic recovery continues to be sluggish. GDP will only grow by 0.5% in 2003 and just 1.5% in 2004. In both years GDP growth will be reliant upon the strength of the services sector. Indeed, on a quarter on quarter basis Euro area GDP declined by 0.1% in the second quarter. We now believe that the chances of a technical recession of two consecutive falls in GDP in the Euro area during 2003 is as high as forty percent (figure 1).

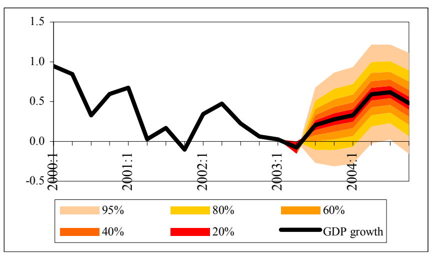


Figure 1: Forecasts for Euro area growth.

Inflation continues to push up against the 2% ceiling though the output gap and the appreciation of the Euro have helped to ease the pressure on costs and we expect that inflation will move below 2% during 2004. There has been recently considerable discussion of the possibility for deflation - actual falls in the price level - in both the United States and Europe. Nevertheless, we think this is unlikely. The inflation fan chart in figure 2, suggests that the probability of deflation in the Euro area is very small.

Fiscal deficit in excess of 3% for three EU-12 countries

The unexpectedly slow economic recovery has also been mirrored in fiscal positions. 3 of the 12 members of the Euro area have been, or are, in excess of the 3% deficit ceiling or close to it. In Portugal the deficit in 2001 reached 4.2% and the excessive deficit procedures of the Stability and Growth Pact (SGP) have been triggered. Some special short term measures have enabled Portugal to bring its deficit below 3% in 2002 but it is forecasted to exceed the limit again in 2003. In 2002 the deficit reached 3.1% in France and 3.5% in Germany. A deficit of around 4% is expected for both countries in 2003. The excessive deficit procedures have been opened against both countries.

Deleted: the EMU

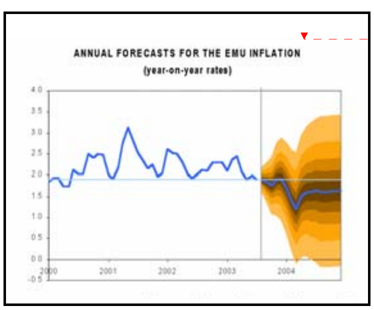


Figure 2: Forecasts for Euro area inflation.

Poor economic performance is also reflected in unemployment, which we now expect to climb steadily over 9% in 2004 as the Euro area continues to operate below full economic capacity.

Some perspective on the current business cycle can be gained from a comparison with the last occasion on which the Euro area experienced a cyclical downturn - at the beginning of the 1990s. Then, of course, monetary policy was not centralised in the ECB, though the Bundesbank in practice played a significant leadership

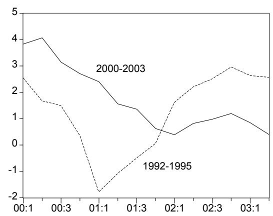


Figure 3: GDP growth in the Euro area.

The economic recovery is more gradual than in the 1990s

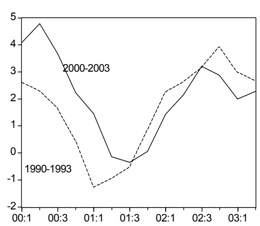


Figure 4: GDP growth in the USA.

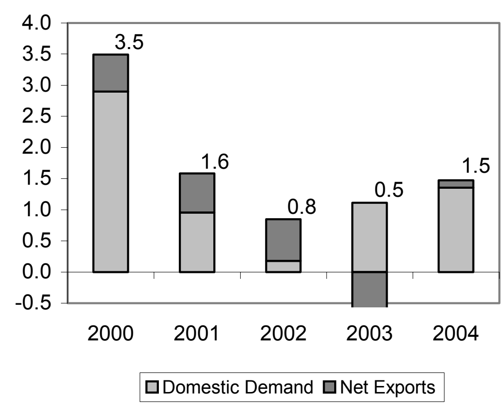
role in the setting of interest rates. In figure 3 we show growth of GDP for the periods from the first quarter of 1992 to the second quarter of 1995 and compare this with the first quarter of 2000 to the second quarter of 2003. From the cyclical peak of 1991, output growth decelerated rapidly and was significantly negative in 1993. Thereafter, the cyclical recovery was rapid with the Euro area returning to trend growth rates by 1994.

The most recent downturn has been much more gradual but the recovery has also been very muted. Indeed after a small acceleration in growth during 2002, output in the Euro area as a whole, as we have already noted, actually fell in the second quarter of this year. By contrast, the economic cycle in the USA at the beginning of the 1990s was very similar to that of the more recent cycle with a very similar decline in output and then recovery (figure 4), though the extent and credibility of the recovery were stronger in the '90s, with larger benefits for the European countries. This feature, combined with an appreciated Euro against the dollar and sterling (the two main trading partners for the Euro area) and the general weakness in world economic activity, means that net exports will make a negative contribution to GDP during 2003, see figure 5, and only a minor one in 2004.

Most of the growth in 2003 and 2004 is due to internal demand, with a stable pattern for consumption but stronger capital formation in 2004.

If now we compare the monetary stance (figure 6), policy was relaxed much more swiftly in the earlier period, reflecting in part that inflation was on a downward trend in the early 1990s compared with the early part of the 21st Century (figure 7). However, if we look at real short term interest rates (figure 8), the relaxation in monetary policy was actually more pronounced in

Negative or small contribution of net exports to growth in 2003 and 2004



Percentage points; figures above the columns indicate overall GDP growth; 2003 and 2004: EFN forecasts.

Figure 5: Contributions to GDP growth.

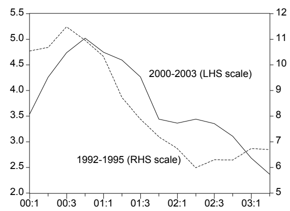


Figure 6: Short term nominal interest rates in the Euro area.

Monetary policy provides a proper background for recovery

Fiscal policy not very useful for the current slowdown

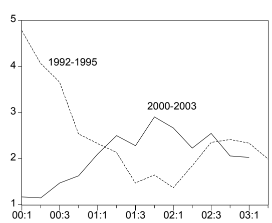


Figure 7: Inflation in the Euro area.

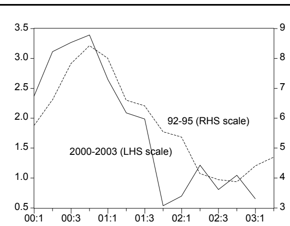


Figure 8: Real short term interest rates in the Euro area.

the later period. Overall, nominal and real interest rates are very low and the monetary conditions appear to be in place to provide the background to a stronger economic recovery, if only world trade could recover more quickly and geopolitical tensions and oil prices ease.

About fiscal policy, in the initial stages of the 1992-3 downturn there was an initial deterioration in the deficit for the Euro area (though starting from a much larger deficit), followed by an improvement. By contrast, in the current downturn the fiscal deficit has continued to deteriorate. The general impression is that the fiscal position is caused by the slowdown rather than causing it. Overall, without structural reforms of the labour market and the welfare system, increased competition in the good and services market, and policies to foster long run growth such as investment in education and R&D, the Euro area growth will continue to be mostly based and dependent on hardly controllable external factors.

Table 1. Economic outlook for the Euro area

	2003: annual		2004: annual	
	Point Forecast	Interval Forecast	Point Forecast	Interv Forec
GDP	0.5	0.3 0.6	1.5	(2
Potential Output	2.2	2.1 2.4	1.9	1 2
Private Consumption	1.1	0.8 1.4	1.3	(1
Fixed Capital Formation	-1.8	-2.5 -1.2	1.2	-(3
Exports	-0.5	-1.1 0.4	4.0	2 5
Imports	1.4	0.6 2.4	3.9	1 6
Unemployment Rate	9.0	8.9 9.0	9.3	9 9
HICP	2.1	1.4 2.6	1.7	(2

Percentage change in the average level compared with the same period a year earlier, except for unemployment rate that is expressed in levels. Point forecasts and 80% confidence bounds are taken from EFN forecasting model and based on 2000 stochastic simulations.

Table 1 provides a summary of our forecasts for the main macroeconomic variables. The rest of this executive summary describes the contents of chapters 2 to 8 of the report. Additional details can be found in a set of Annexes, freely available on the EFN website at www.efn.uni-bocconi.it.

The macroeconomic outlook for the Accession countries is brighter than for current EU members

In the previous Report we drew attention to the importance for the medium term development of the European Union of the accession of 10 more countries. We now therefore include in our report a chapter with the macroeconomic outlook and forecasts for the Accession countries. Despite weaker-than-expected growth in the Euro area, Accession countries fared fairly well in 2002 and early 2003. Private consumption and government spending compensated for weaker export growth. Inflation staged a major decline over the last 18 months and is expected to remain subdued in the nearest future. Following sharp interest rate cuts in 2001 and 2002, monetary authorities are mow more cautious. The state of public finances remains the largest obstacle to nominal convergence with the EU.

The fiscal deficits in Poland, the Czech Republic and Hungary are a serious obstacle to economic integration

In the macroeconomic outlook for the Accession countries we have drawn particular attention to the need for many of the larger Accession countries to sharply reduce budget deficits in the next five years. The build-up in government spending in the larger Accession countries over the last few years has resulted in a public finance position that is not sustainable in the longer term. Furthermore, their fiscal situations may serve to prevent the economies not only from meeting the Maastricht criteria for public finance deficits, but also from reaching their growth potential.

In particular, the fiscal balances of the three Central European candidates for EU membership—Poland, Hungary, and the Czech Republic—have deteriorated considerably over the last two years. The Pre-Accession Economic Programs presented to the European Commission in late August 2003 provide the only official source documents outlining plans for reducing the public sector deficits in the years 2003-2006. With the exception of the Czech government, all three programs appear to be overly optimistic about economic growth and therefore the chances of reducing public finance deficits in the near-term. In addition, they are not binding and provide governments with substantial flexibility in designing each year's budget. Despite announced plans to implement legally binding medium-term spending programs, the governments are likely to make expenditure adjustments based on short-term priorities.

An important issue for understanding the fiscal position among the Accession countries is the dating of the business cycle and the resulting chronology of expansions and recessions. The transition from a centrally planned economy in the 1990s, with a sharp downturn in economic activity followed by a period of sustained growth, makes the phenomenon of the *classical* cycle, in which peaks are succeeded by *absolute* declines in activity, of comparatively little interest with respect to the deviation cycle, in which deviations from the trend level matter.

Rather low cyclical synchronicity between accession countries and the Euro area and wider fluctuations point against an early adoption of the Euro

The analysis of deviation cycles shows that cycles in the Accession countries tend to have a larger amplitude than those for the current EU countries. In terms of convergence, cross-correlation coefficients indicate a high correlation between the Baltic States (as well as between them and the Czech Republic), between the limited set of Euro area countries considered and, as well, between Hungary and Poland separately and the Euro area countries. The comparison of the present situation with previous enlargements shows a lower degree of convergence. Though this provides evidence against the acceptability of a single monetary policy for the Accession countries, further elements such as the extent of trade integration and the gains from enhanced financial stability point in the opposite direction. Therefore the issue deserves a deeper analysis, partly conducted in the next chapter of the report.

Much of the academic debate around Euro area enlargement has focused on the choice of the appropriate monetary regime in Accession countries prior to EU accession and on an analysis of the benefits of joining the Euro compared to the associated costs.

The behaviour of the exchange rates, the type and the size of the economic shocks in the Accession countries and the experience of the German unification also suggest that early membership of the EMU would not be the best choice to foster convergence of the Accession countries

Currently Accession countries use a variety of exchange rate regimes, spanning the whole spectrum from fixed to freely floating exchange rates. In the early 1990s, at the beginning of their transition period, most countries chose some kind of fixed system while others, like Slovenia, opted for more flexible solutions. Since then, there has been a generalised move towards more flexible exchange rates (for example, the Czech Republic and Poland have fully flexible exchange rates), going in the opposite direction to the supposed entry into the Euro, even though the exchange rate volatility against the Euro has not increased and real exchange rates, which matter most for economic performance, are not far away from the real rates that countries such as Italy or Finland faced before adopting the Euro.

The central policy question is how fast should the Accession countries move towards monetary union and the adoption of the Euro. We believe that economic convergence will not be best served by early membership of EMU. There is not only the risk of foreign exchange market turbulence if the currencies of the Accession countries came under sustained speculative attack, but also the lesson of East Germany which was effectively transferred to full monetary union with West Germany overnight and at a completely inappropriate real exchange rate. Finally, the size and type of shocks that hit these countries are rather heterogeneous and different from those of the current Euro area countries.

The sixth enlargement of the European Union raises another important policy question. Although the aggregate economic impact of accession on existing members is small, it is quite large for the Accession countries and there are important issues at the level of regions that need to be addressed. What would the best policies be for the EU to fuel real convergence of the new membersat the national and regional level?

We then analyse the design and implementation of current EU regional policies…

Numerous concerns have been raised about the design and implementation of current EU structural (regional) policies and their ability to achieve stated targets. Excluding Ireland, there is little evidence for significant convergence of the first generation countries at the regional level. Clearly, the quality of local institutions and economic conditions in regions benefiting from European funding has been key to the success or failure of regional policies.

In the light of the lack of evidence concerning the effect of structural funds on long run growth, and the acute political tensions their availability and allocation creates among current members, it could be argued that regional structural funds, within an enlarged EU, should be reformed. This applies, even more so, to the funding of the Common Agricultural Policy. Theory suggests that structural funds are pure income transfers with little long-run effects. They may lead to a suboptimal allocation of regional labour, capital and entrepreneurial resources and to a self-perpetuating system of expectations in which below average income levels are almost "sought" by the regional administrations as a conduit for additional structural funding. Empirical evidence is mixed. Ireland has been an undoubted success story, but the Mezzogiorno of Italy has failed to converge on the northern part of Italy, despite significant inflows of structural funds.

Among the many suggestions contained in the report, the following are the most crucial.

…and conclude that EU regional policies need drastic reforming

- A drastic lowering of the maximum income for admission to funding at the level of 50% of the EU15 average.
- A reduction of the number of objectives to be pursued (as proposed by the Commission in 1998).
- Objective 1, properly rephrased to focus on structural deficiencies (especially large public goods, transportation and communication infrastructures and environmental protection), is the only one that should be retained on a permanent basis. However, in the light of the accession of 10 more countries, it appears that objective 2 (recovery from industrial restructuring) and objective 5 (agriculture structural transformation) should also be maintained during the first budgeting cycle following admission (2007-2013) because of the importance of both industrial and agricultural restructuring for these countries.

To add to the debate concerning the effectiveness of structural funds at the regional level we have also conducted a study of infrastructure investment in Spain. The issue is whether infrastructure investment eventually supported by European funds leads to convergence at the regional level. We provide an analysis of the effects of infrastructure investment on regional economic growth. We assume that the effect on productivity depends on what type of public infrastructure is put in place, so that local infrastructures would enhance economic activity in the area where they are located, whereas transport and communication infrastructure may produce benefits in the area where they are located and spillovers to other regions. These spillovers can be either positive or negative.

The effect of public infrastructure investment in Spanish regions is limited…

We argued above that the macroeconomic conditions in Accession countries are similar in many ways to those of previous entrants such as Spain at the time of its accession. So the experience of Spain can provide guidance as to what may happen to the new entrants. Therefore, our empirical results may throw light on the possible effect of infrastructure on the takeoff of less-developed economies, which are opening and modernising their productive structure as a consequence of their entrance to the EU.

…but it could be positive in Accession countries due to the low initial stock

It turns out that the effects of transport infrastructure is small, declining over time, and with negative spillovers on neighbouring regions. Yet, given the rather modest stock of public capital, there is room to faster growth through public investment in the Accession countries.

In the Accession countries the capital cities pay higher relative wages …

Finally, we evaluate whether accession can modify the economic geography of the Accession countries. In particular, since in centrally planned economies, market forces are not allowed to operate, we might expect to see a concentration of certain sectors and higher relative wages in the region where the capital city is.

When we examine regional wages and employment shares in the Central and Eastern European Countries in their reaction to the increased access to EU markets, three main results emerge.

First, there is a strong effect of the capital city on relative wages. On average, being a capital city produces a 32% higher wage, and doubling the distance from the capital reduces relative wages by 4%.

…and have a larger share of service employment

Second, proximity to the EU seems to give an advantage in terms of relative wages. However, this effect only reflects the wage premium enjoyed by border regions. Workers' wages in those regions are on average 2.8 % higher.

Finally, the share of service employment (in the private as well as in the public sector) is strongly concentrated in capital city regions. The comparison with the current EU countries shows that these concentrations are significantly stronger in the Accession countries than in the long-established member states.

Accession is likely to reverse this pattern in favour of border regions

What can we conclude from this analysis? The extreme centralisation of wages and service sectors in Central European capital cities is likely to erode and give way to a more even distribution of wages and service sector employment driven by market access. Moreover, Accession countries that have regions that border the current EU stand to gain most in terms of relative wages and employment growth in dynamic sectors, confirming the findings in the previous EFN report.