

The **EEAG** Report on the European Economy

2007



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European Economic
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The **EEAG** Report

on the European Economy

2007

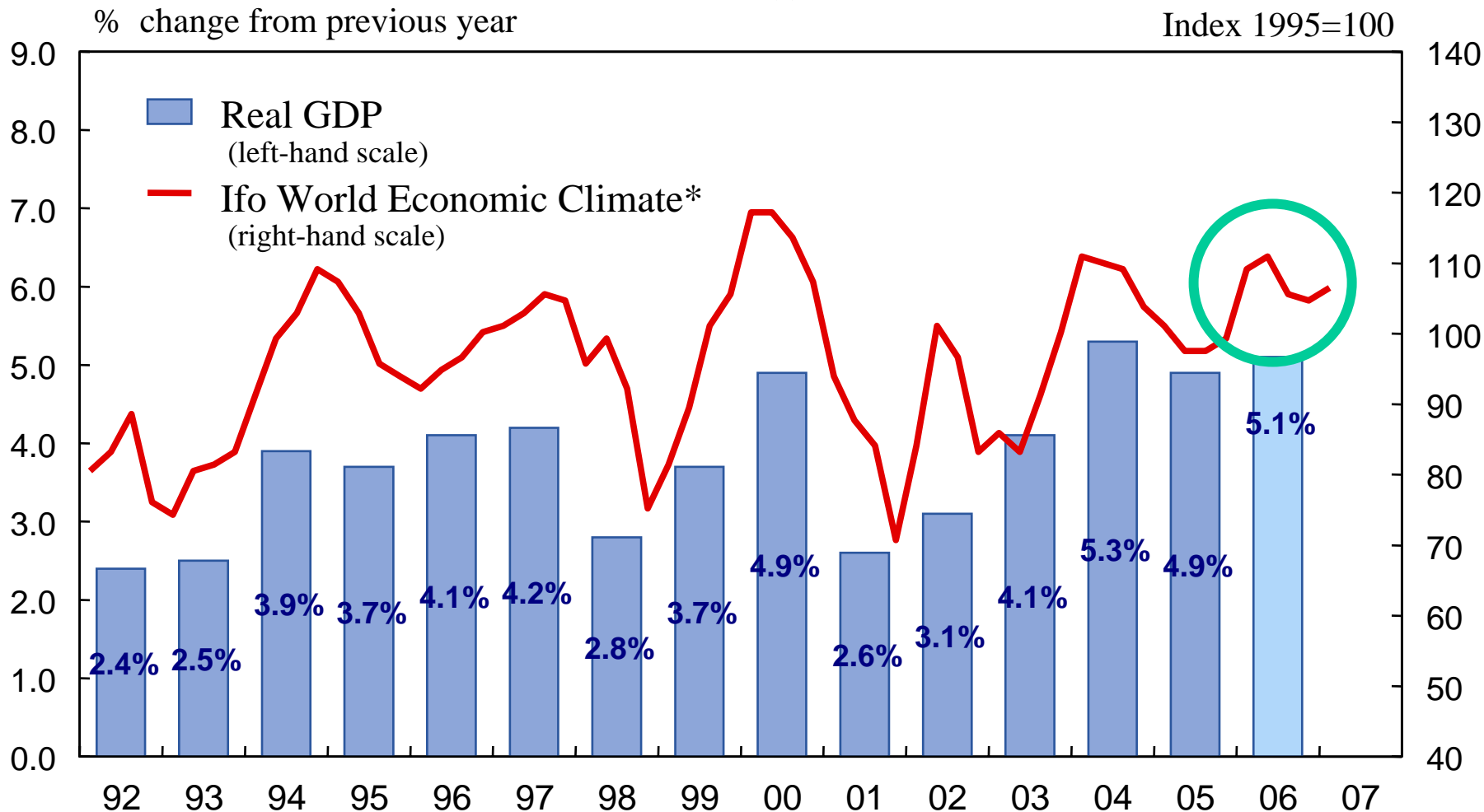


ECONOMIC OUTLOOK
MACRO ADJUSTMENT IN THE EURO AREA
NEW EU MEMBERS
SCANDINAVIAN MODEL
TAX COMPETITION
ECONOMIC NATIONALISM

Macroeconomic outlook and policy

Fig. 1.1

Economic growth and Ifo economic climate for the world

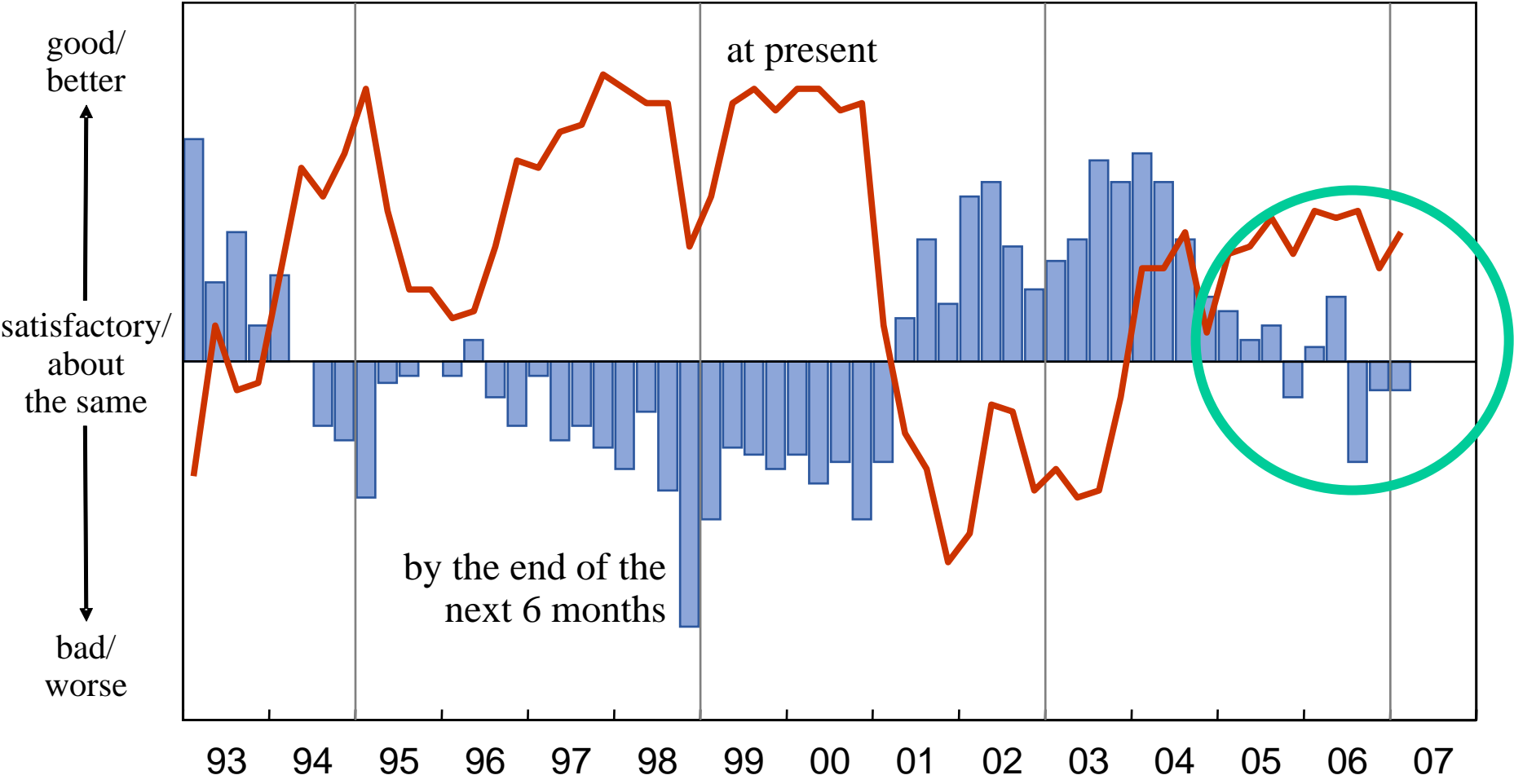


*) Arithmetic mean of judgement of present and expected economic situation.

Sources: IMF, World Economic Outlook Database September 2006;
Ifo World Economic Survey (WES) I/2007.

USA

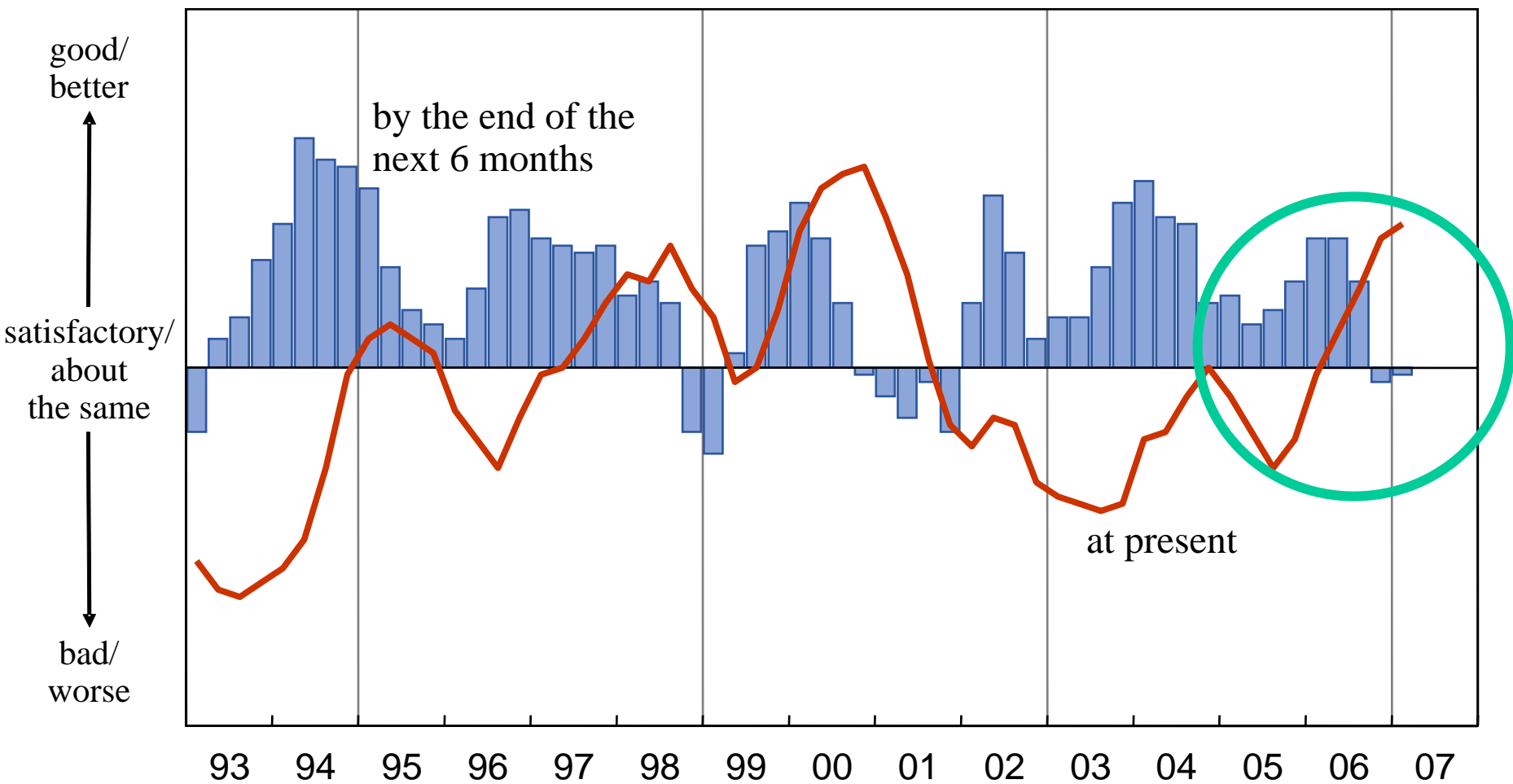
Economic situation



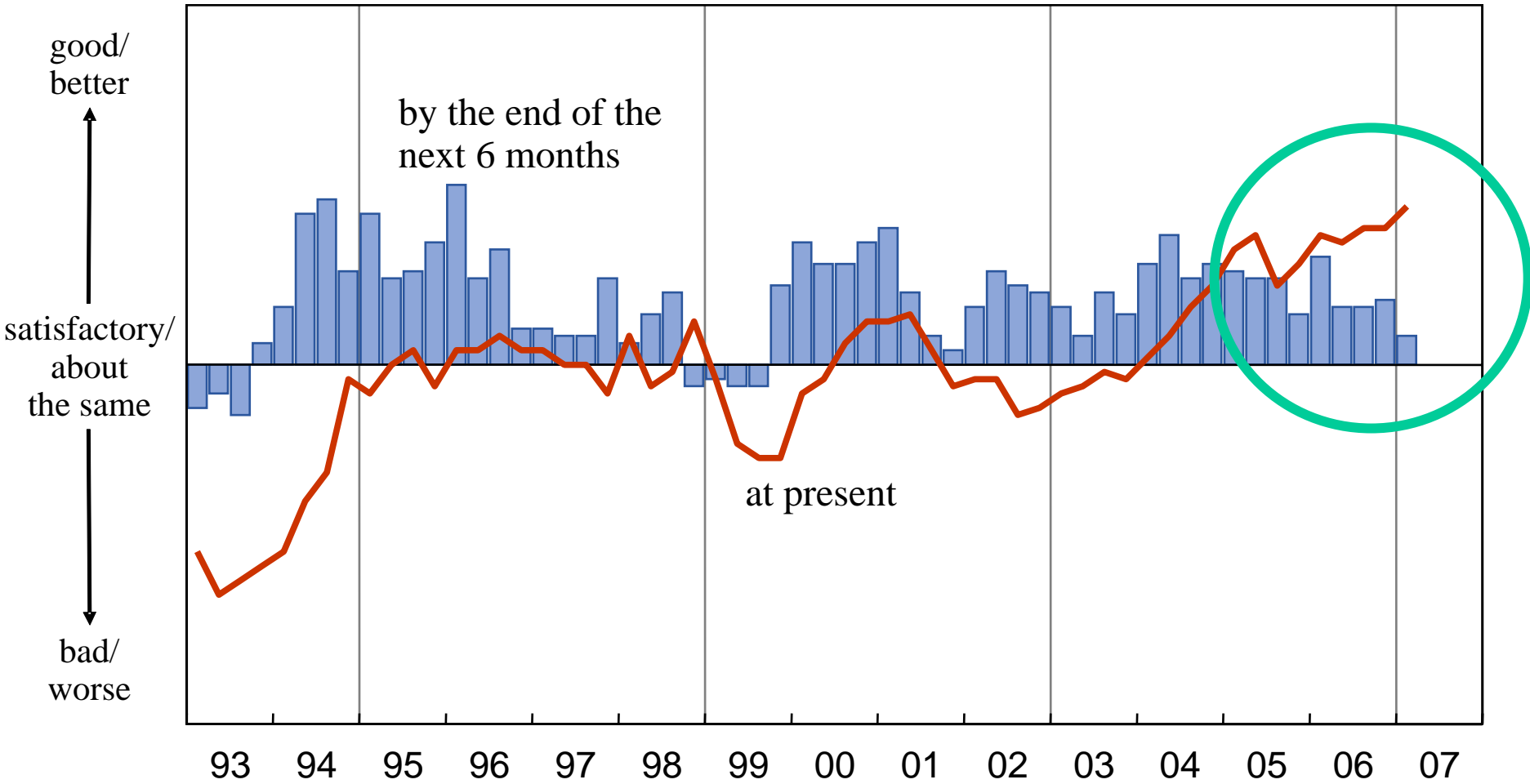
Source: Ifo World Economic Survey (WES) I/2007.

European Union (15)

Economic situation



Eastern Europe Economic situation



France

Economic situation

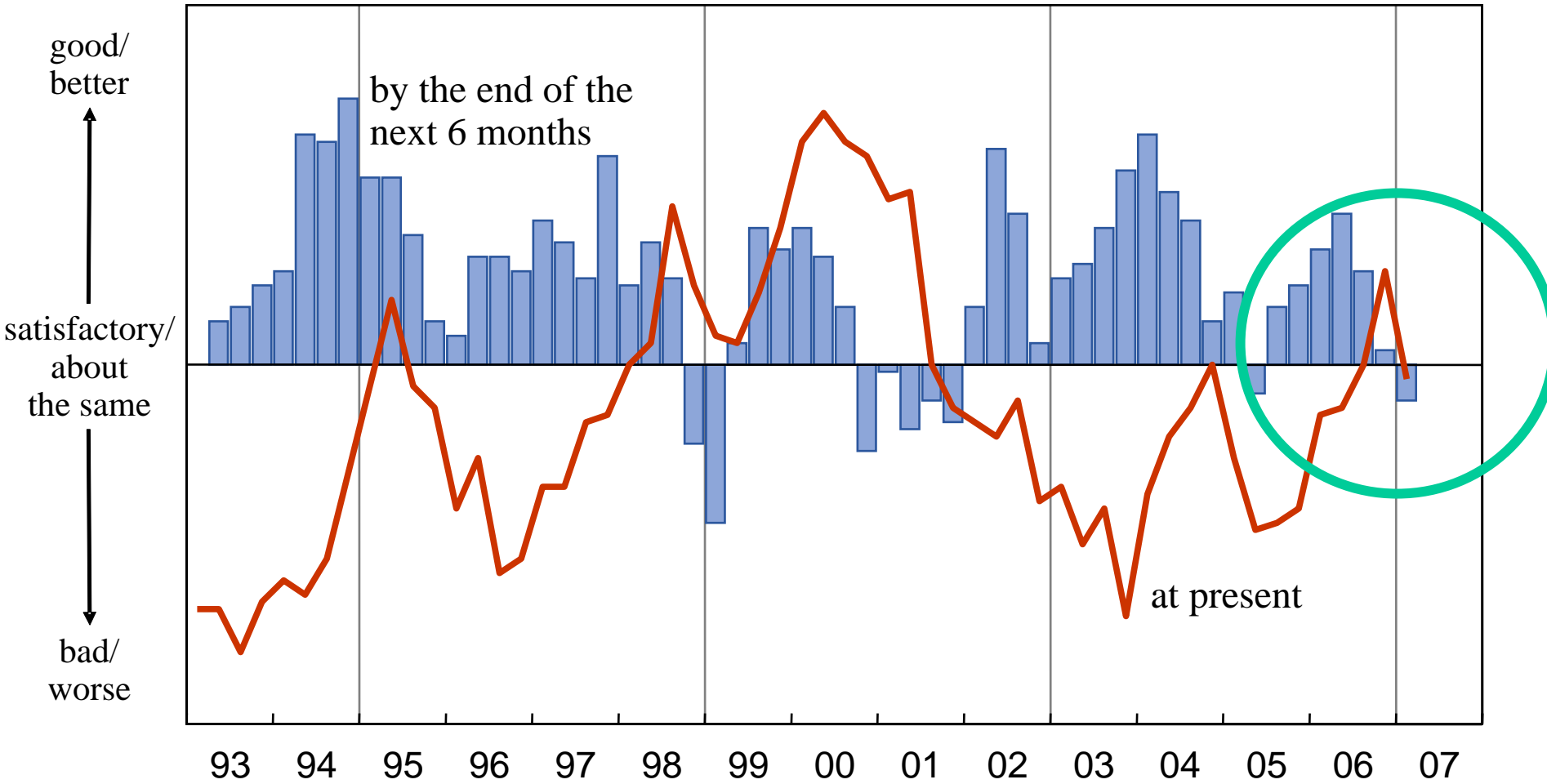
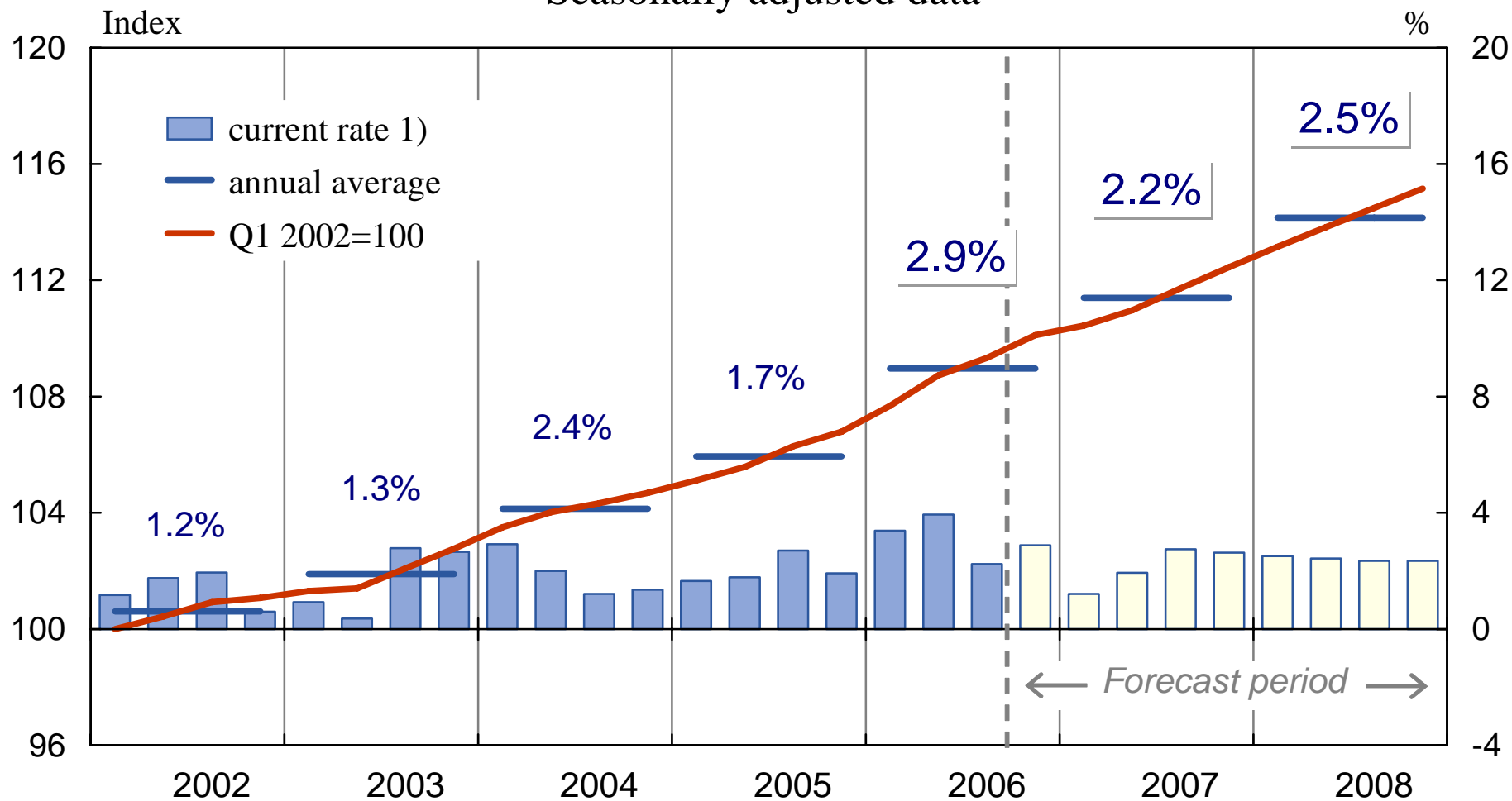


Fig. 1.20

Real GDP in the EU25

Seasonally adjusted data



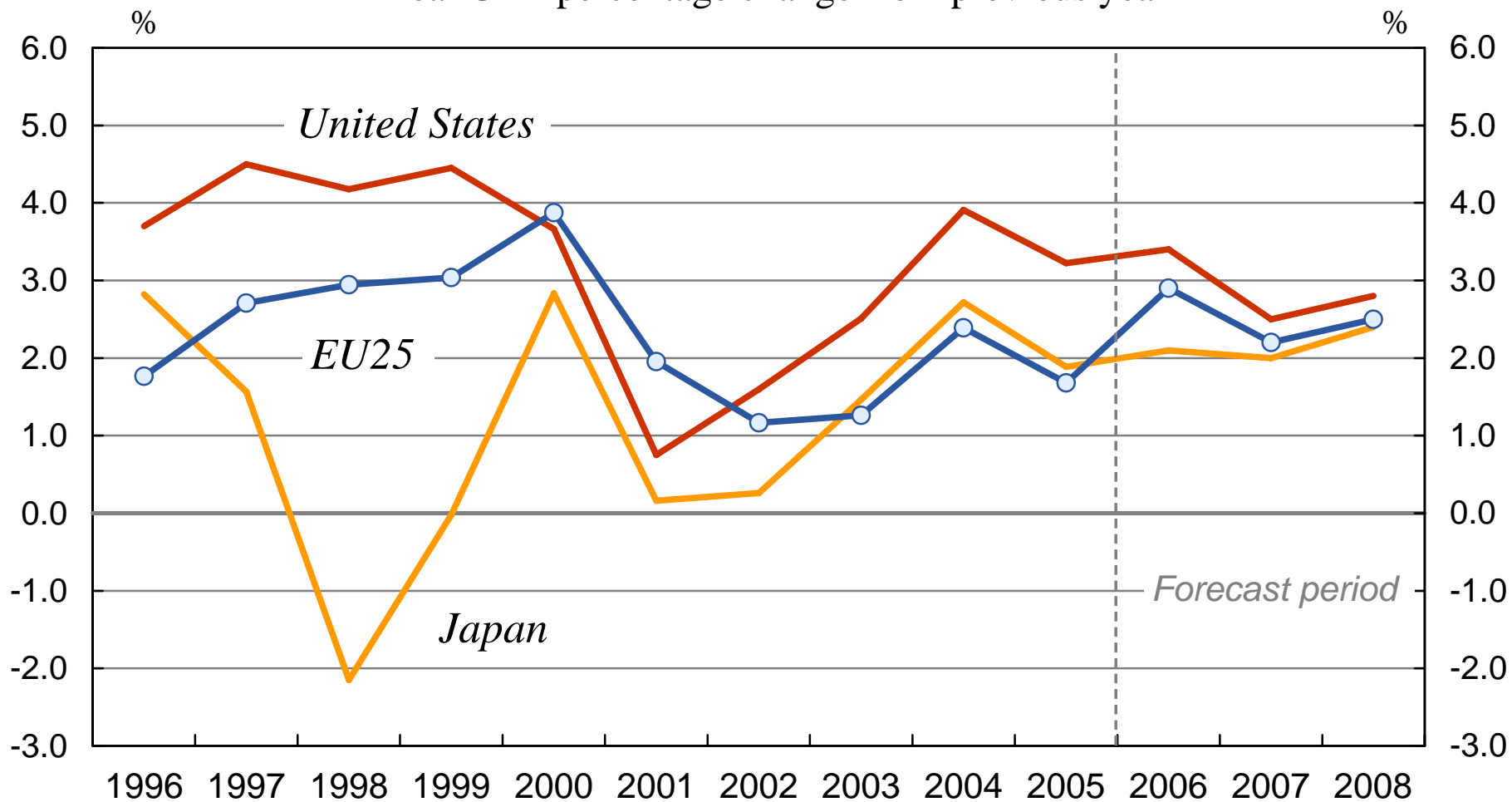
1) Change on previous quarter, expressed as an annual rate, right-hand scale.

Sources: Eurostat; Ifo Institute calculations and forecast.

Fig. 1.21

Economic growth by region

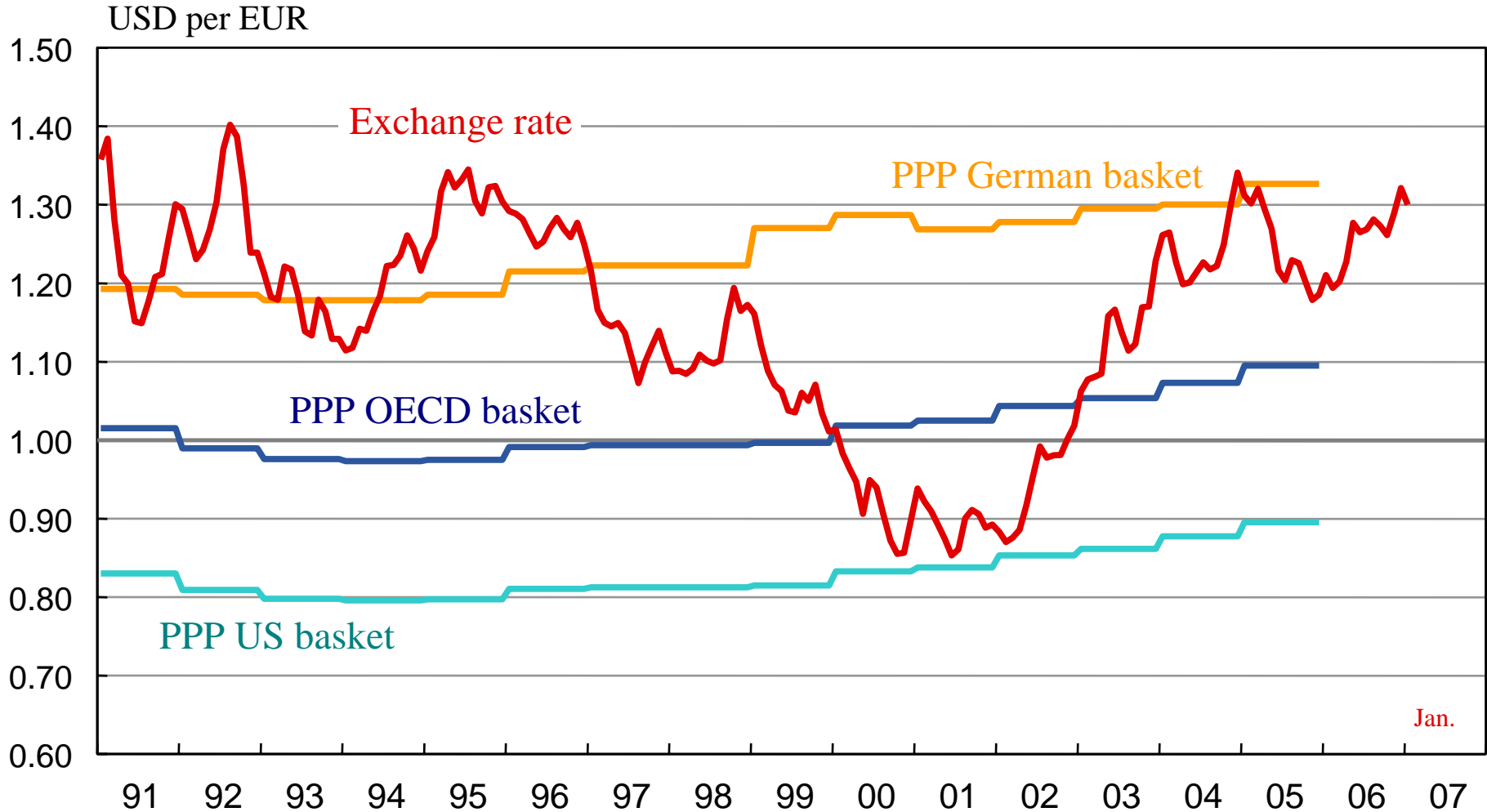
Real GDP percentage change from previous year



Source: Bureau of Economic Analysis; Eurostat; ESRI; 2006, 2007 and 2008: Ifo Institute forecast.

Fig. 1.2

Exchange rates of the euro and PPPs ¹⁾

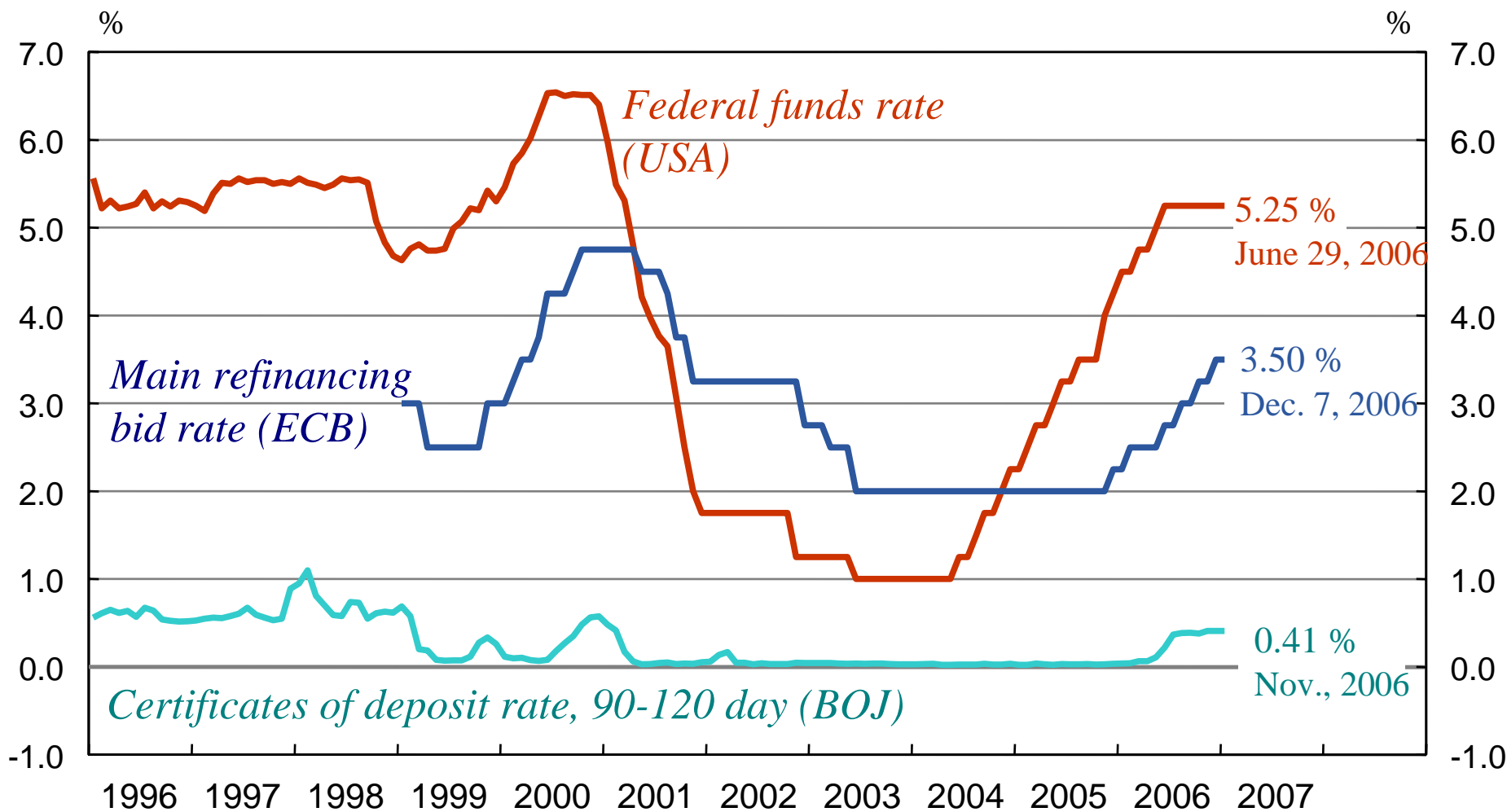


1) Exchange rate are monthly data, while PPPs are given at an annual frequency. Different PPPs are computed with respect to the different consumption baskets in the United States, the OECD and Germany.

Sources: European Central Bank; Federal Statistical Office; OECD; Ifo Institute calculations.

Fig. 1.4

Central bank interest rates



Sources: Bank of Japan; European Central Bank; Federal Reserve Bank of St. Louis.

Table A3**Key forecast figures for the euro area**

	2005	2006	2007	2008
	Percentage change over previous year			
Real gross domestic product	1.4	2.7	2.0	2.3
Private consumption	1.4	1.9	1.6	1.8
Government consumption	1.3	1.9	1.5	1.6
Gross fixed capital formation	2.3	4.8	3.9	4.2
Net exports ^{a)}	-0.2	0.2	-0.1	0.0
Consumer prices ^{b)}	2.1	2.2	2.1	1.8
	Percentage of nominal gross domestic product			
Government financial balance ^{c)}	-2.4	-2.0	-1.5	-1.3
	Percentage of employees			
Unemployment rate ^{d)}	8.6	7.8	7.6	7.4

^{a)} Contributions to changes in real GDP (percentage of real GDP in previous year). – ^{b)} Harmonised consumer price index (HCPI).

^{c)} 2006, 2007 and 2008: forecast of the European Commission. ^{d)} Standardised.

Source: Eurostat; 2006, 2007 and 2008: forecasts by the EEAG.

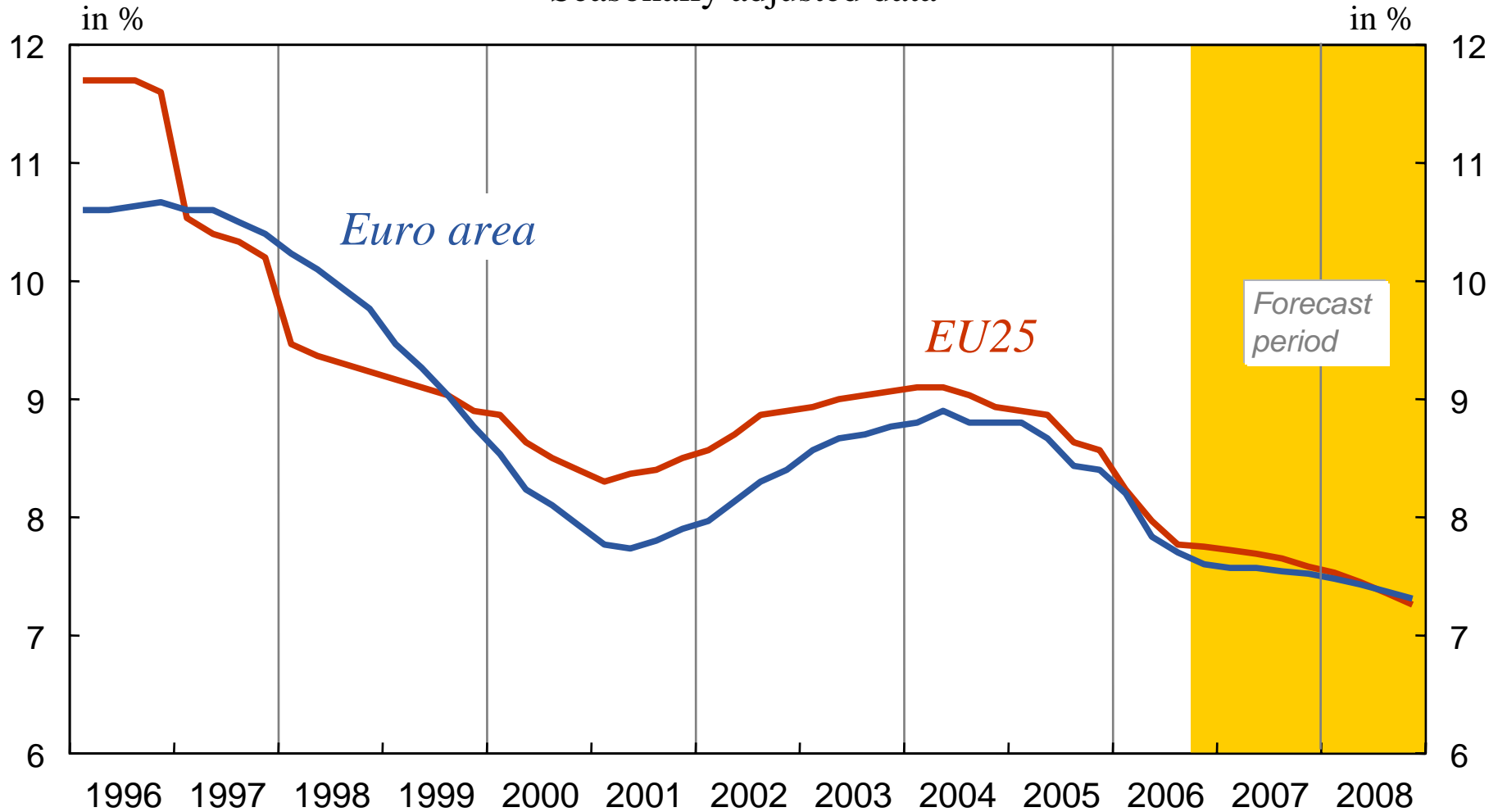
Labour markets

- Higher employment growth in the EU led to a reduction in the unemployment rate to 7.9 percent
- Labour market situation will improve further, albeit at a slower pace

Fig. 1.23

Unemployment rate in the euro area and the EU25

Seasonally adjusted data

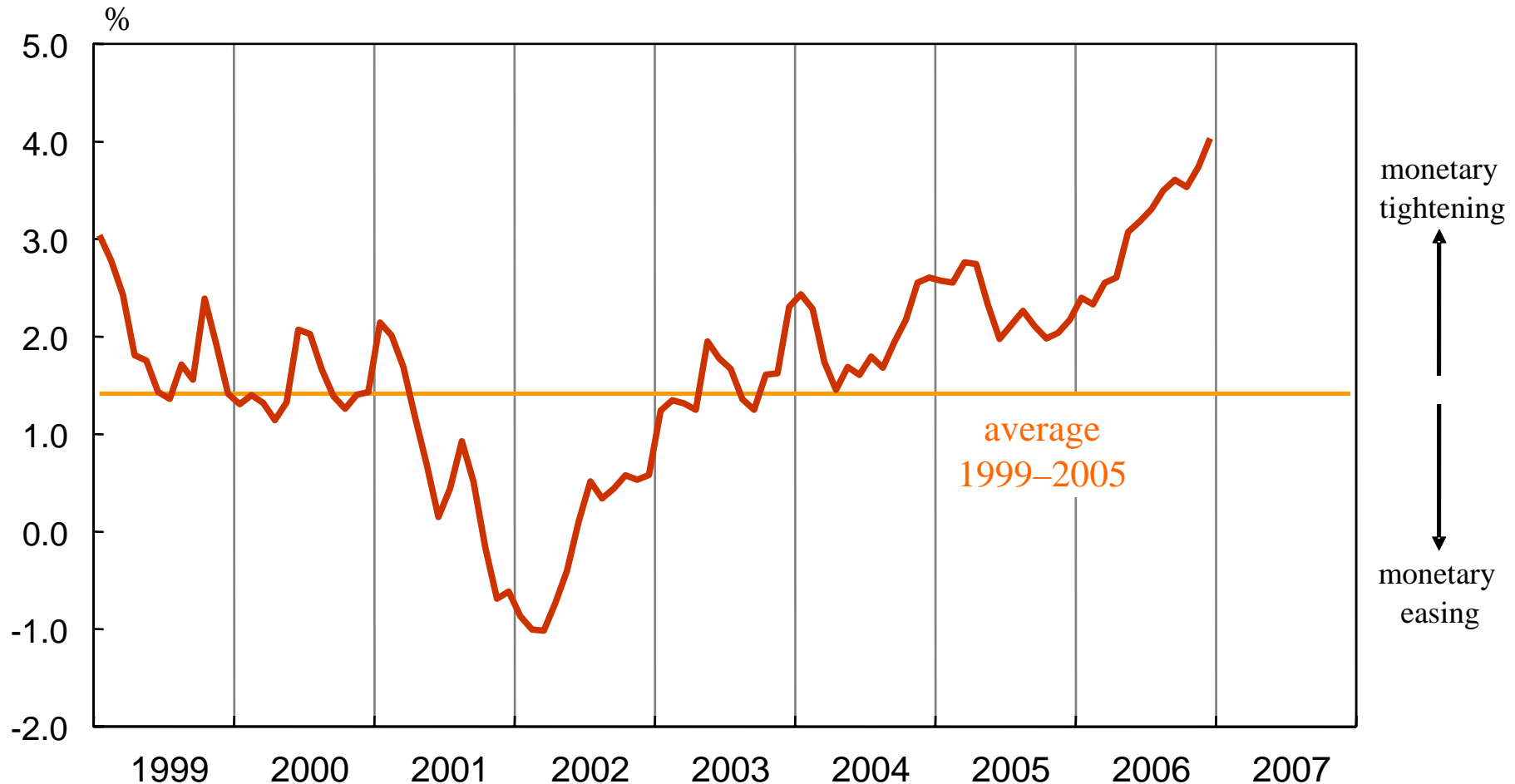


Sources: Eurostat; Ifo Institute calculations and forecast.

A stress test for Europe

Fig. 1.29

Monetary conditions index in the euro area

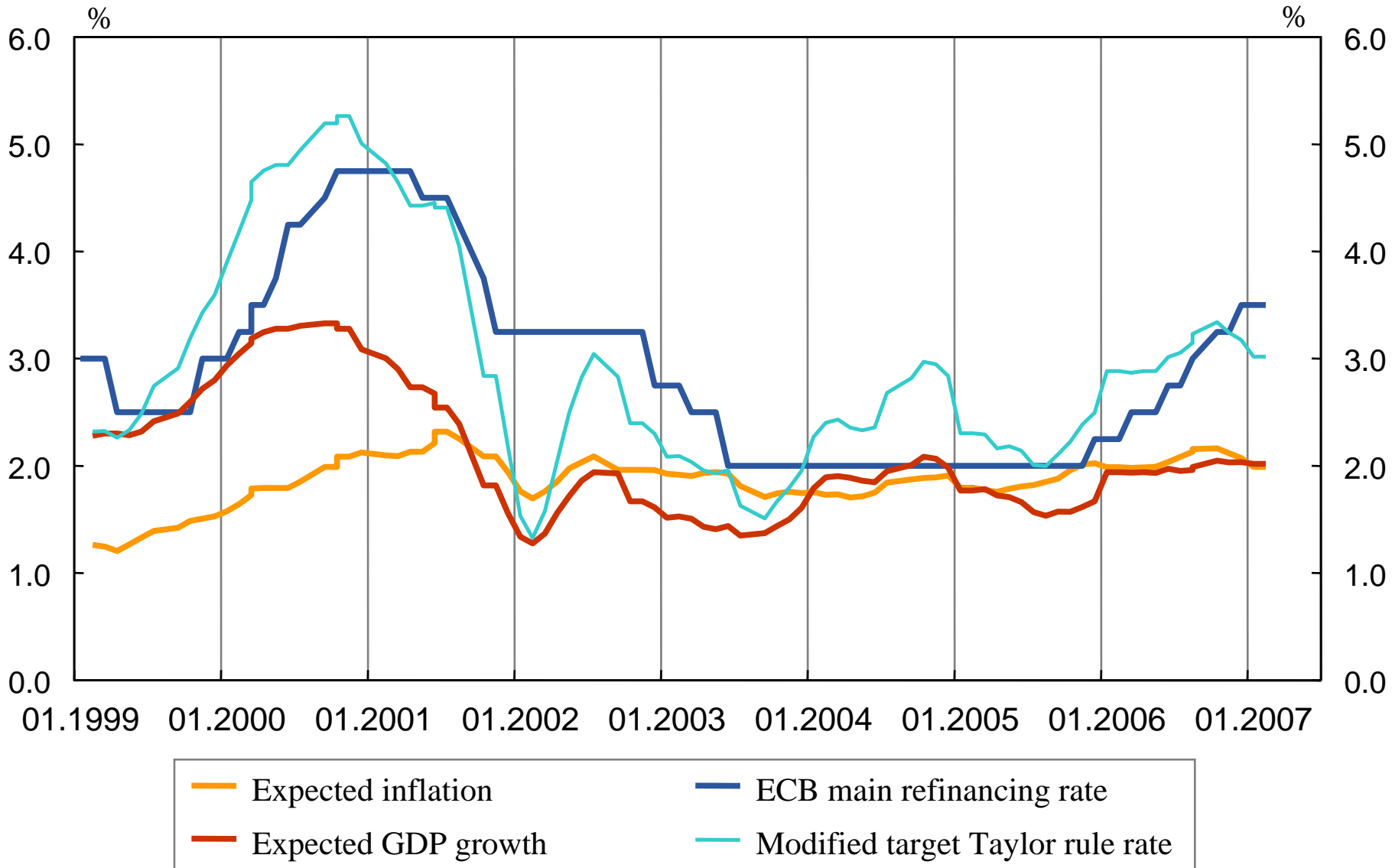


Note: The MCI index is calculated as a weighted average of the real short-term interest rate (nominal rate minus core inflation rate) and the real effective exchange rate of the euro.

Sources: European Central Bank; Ifo Institute calculations.

Fig. 1.30

Interest rates and expectations in the euro area



Sources: European Central Bank; Consensus Economics; calculations by the EEAG.

The stabilisation policy cost of the common monetary policy

- The optimal policy for a country is given by an estimated **Taylor rule** for the ECB but with country-specific inflation and growth expectations instead of euro-area aggregates
- The stabilisation cost of the common currency for a country ("country-specific monetary stress) is computed as the difference between the optimal Taylor rate for the country and the euro area optimal Taylor rate
- On average 1.2 percentage points higher optimal rate in Ireland and 0.4 percentage points lower interest rate in Germany
- Large differences for some countries in various phases of the business cycle
 - Ireland 2000-01: +3.4 percentage points
 - Greece 2003: +2.8 percentage points
 - Netherlands 2001: +2.2 percentage points
 - Netherlands 2004: -1.7 percentage points
 - small differences for Sweden
 - fairly large differences for the UK
- No trend towards better synchronised cycles among euro area countries

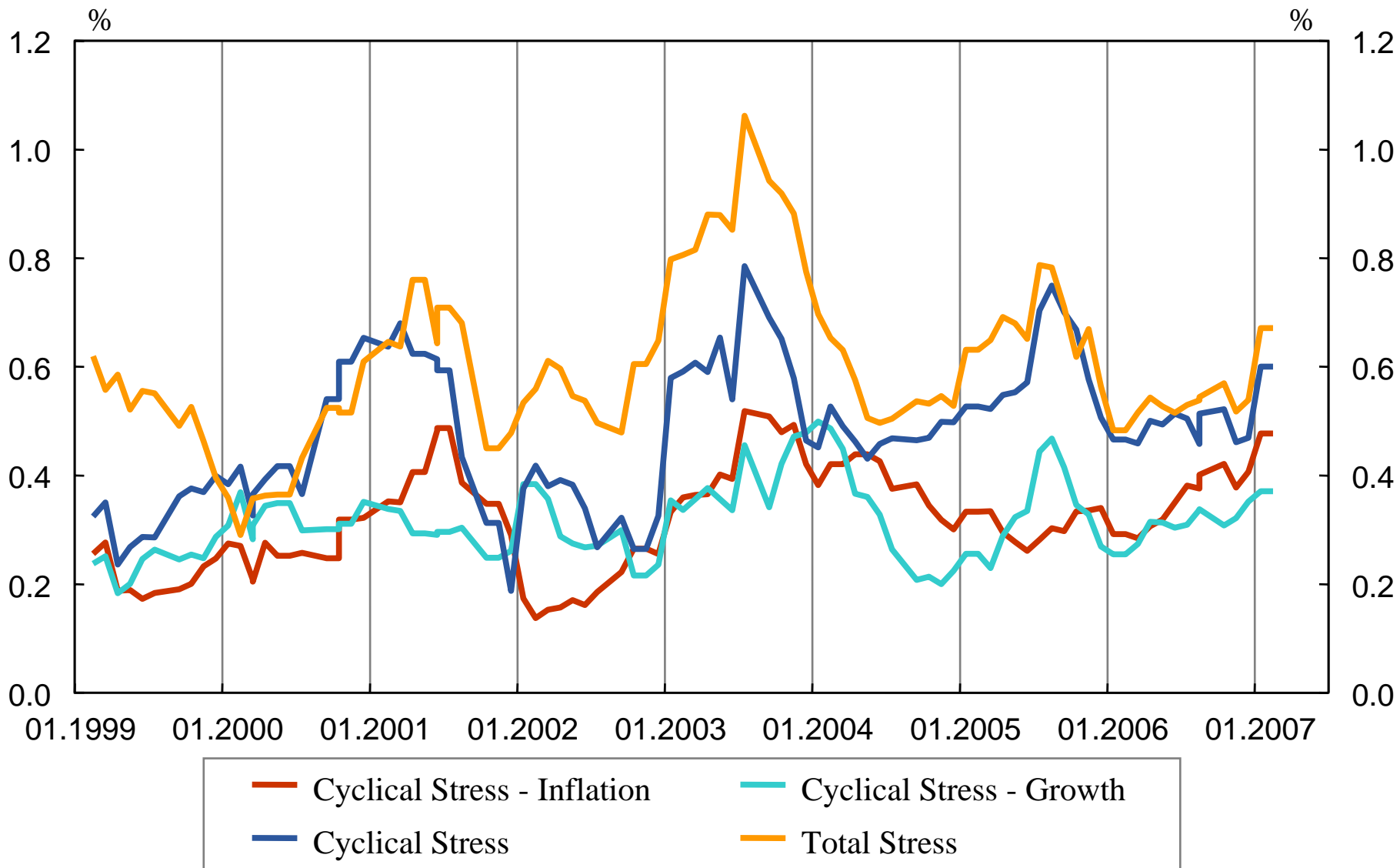
Table 1.3

Decomposition of country stress level

	Structural	Cyclical								RMSE
	99–06	1999	2000	2001	2002	2003	2004	2005	2006	
Austria	0.24	0.42	0.67	0.21	0.20	0.05	0.27	-1.27	-0.48	0.65
Belgium	0.12	0.39	0.18	0.24	0.39	0.57	-0.02	-0.96	-0.63	0.57
Finland	0.19	-0.18	-0.90	-0.83	0.77	0.16	0.96	0.07	0.08	0.72
France	0.36	0.27	0.19	0.60	-0.03	-0.15	-0.52	-0.46	0.12	0.40
Germany	0.37	-0.15	-0.27	-0.13	0.18	0.69	-0.08	0.17	-0.35	0.35
Greece	-1.08	0.52	1.72	0.49	-0.68	-1.70	-0.78	0.06	0.09	1.10
Ireland	-1.20	-1.88	-2.36	-2.07	0.81	0.41	2.74	1.08	1.31	1.88
Italy	-0.16	0.27	0.14	-0.09	-0.41	-0.83	-0.30	0.41	0.72	0.54
Netherlands	-0.29	-0.72	-1.35	-1.92	-0.68	0.83	1.94	1.64	0.27	1.39
Portugal	-0.65	-1.93	-0.21	-0.45	-0.46	-0.12	0.62	0.40	1.80	1.04
Spain	-0.92	0.16	0.95	0.80	0.41	-0.66	-0.04	-0.77	-0.86	0.74
Denmark	-0.19	0.06	0.86	0.96	-0.28	-0.79	0.13	-0.57	-0.43	0.68
Sweden	0.29	1.07	0.08	0.73	-0.55	-0.68	0.21	0.05	-0.75	0.75
United Kingdom	-0.44	1.24	1.08	1.18	-0.25	-1.26	-1.36	-0.62	-0.03	1.10

Fig. 1.31

Decomposition of weighted absolute sum of stress in the euro area



Sources: European Central Bank; Consensus Economics; calculations by the EEAG.

Macroeconomic adjustment in the euro area

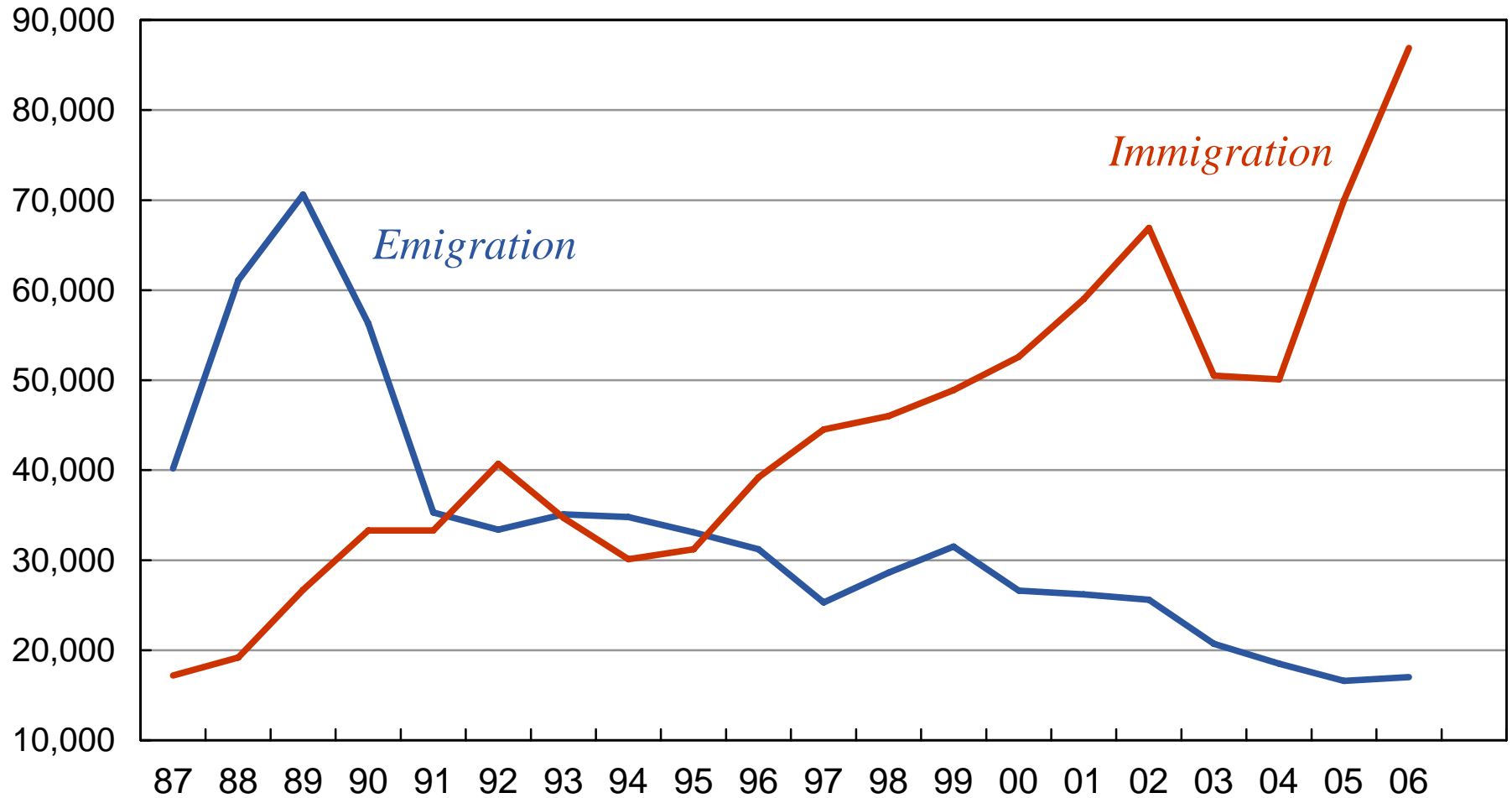
- What have we learnt from actual experiences?
 - Ireland: a booming economy
 - Italy: competition shocks from emerging economies and negative productivity growth

Four lessons

1. Interaction between ordinary wage-price dynamics and housing price dynamics (Ireland)
2. Migration flows contain labour shortages but also add to aggregate demand (Ireland)
3. Adverse productivity developments in combination with persistent wage growth may build up competitiveness problems (Italy)
4. Productivity-enhancing deregulations may be necessary not only for long-term growth but also for short-term adjustment (Italy)

Fig. 2.4

Migration Ireland



Source: Central Statistics Office Ireland (2006).

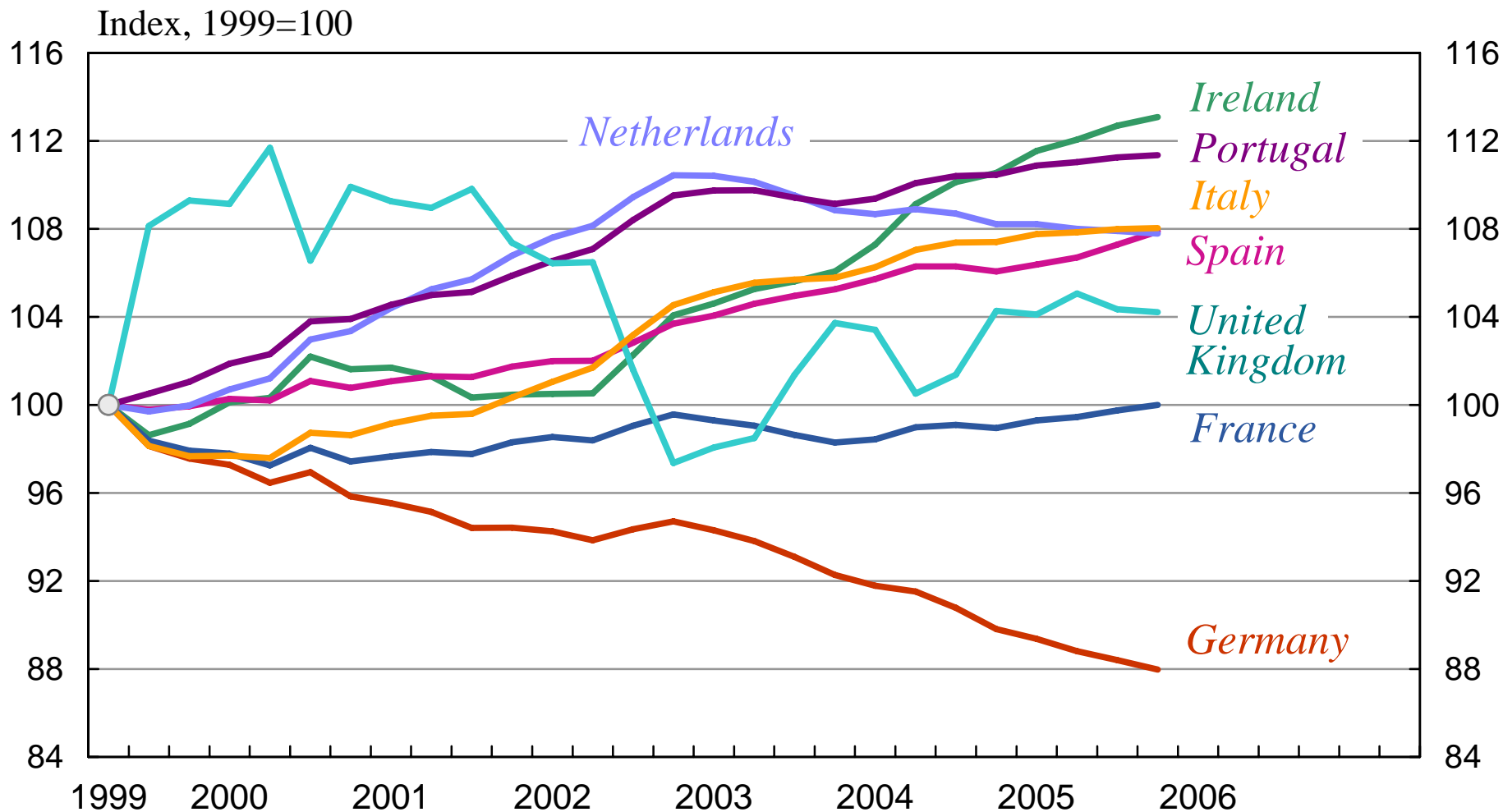
The development of various measures of wages and wage costs
Average annual changes in percent

		Nominal wage	Labour productivity	Unit labour costs	Relative unit labour costs
EURO	2003-05	1.6	0.6	1.3	5.1
	2006	1.9	1.2	0.9	-1.1
IT	2003-05	2.0	-0.3	3.5	4.6
	2006	3.4	0.2	3.7	2.7

Source: OECD Economic Outlook 80 database

Fig. 2.2

Real effective exchange rates versus EU15 members

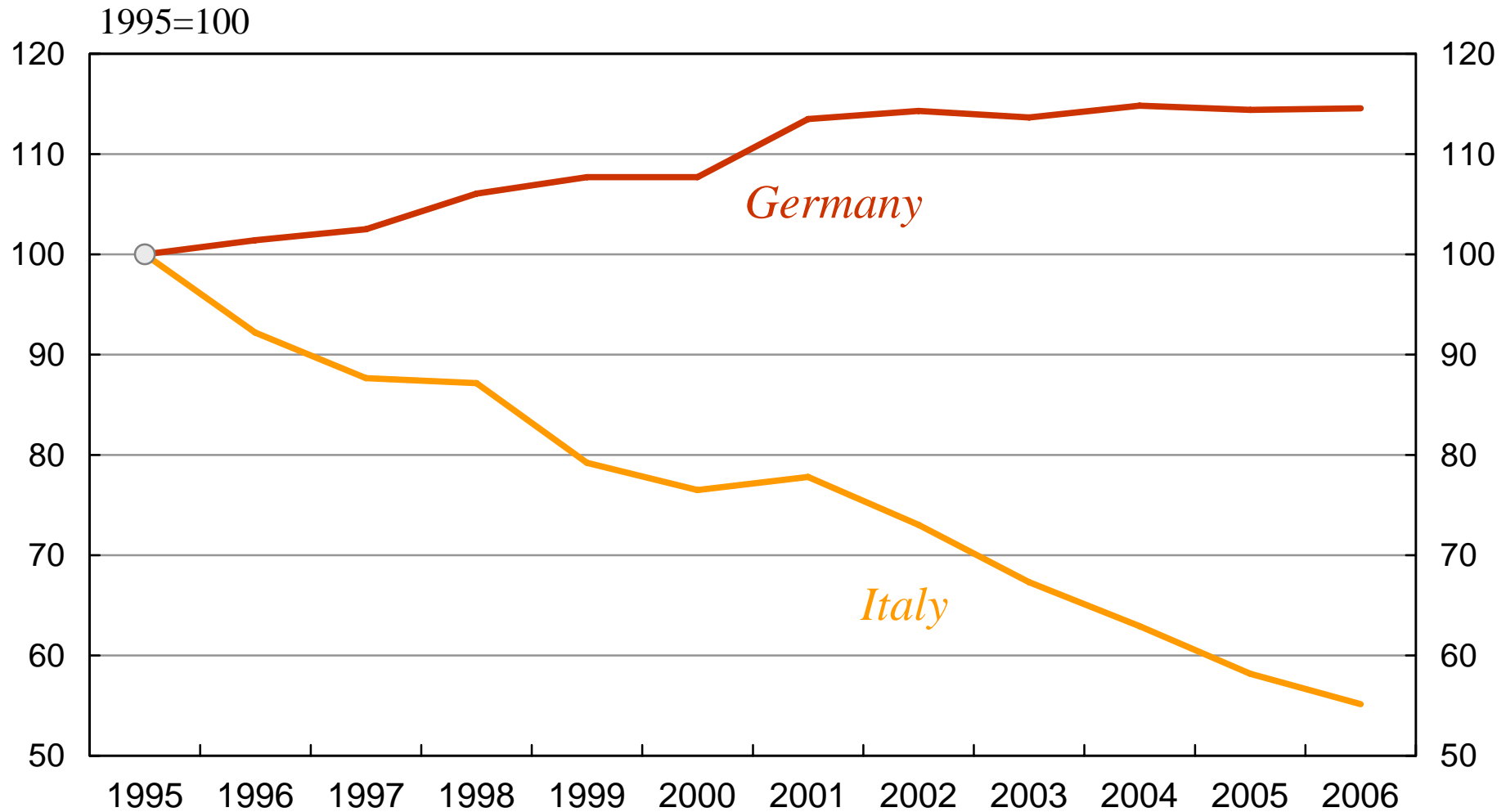


Note: Real effective exchange rate is defined as relative unit labour cost.

Source: Eurostat (2006).

Fig. 2.5

Share in world merchandise exports in volume terms



Source: Banca d'Italia (2006b).

The new EU states

- The inflation criterion should not be used to postpone entry into the EMU for these countries if they fulfil the other criteria
 - potentially vulnerable situation for emerging economies
- This is an issue mainly for the Baltic states
 - star performers with respect to the fiscal criteria
 - fast-growing countries should be given a Balassa-Samuelson (growth) rebate of up to 1 percentage point with respect to the inflation criterion

Is the Scandinavian model a role model for the rest of Europe?

Exaggerated picture of the success of the Scandinavian model

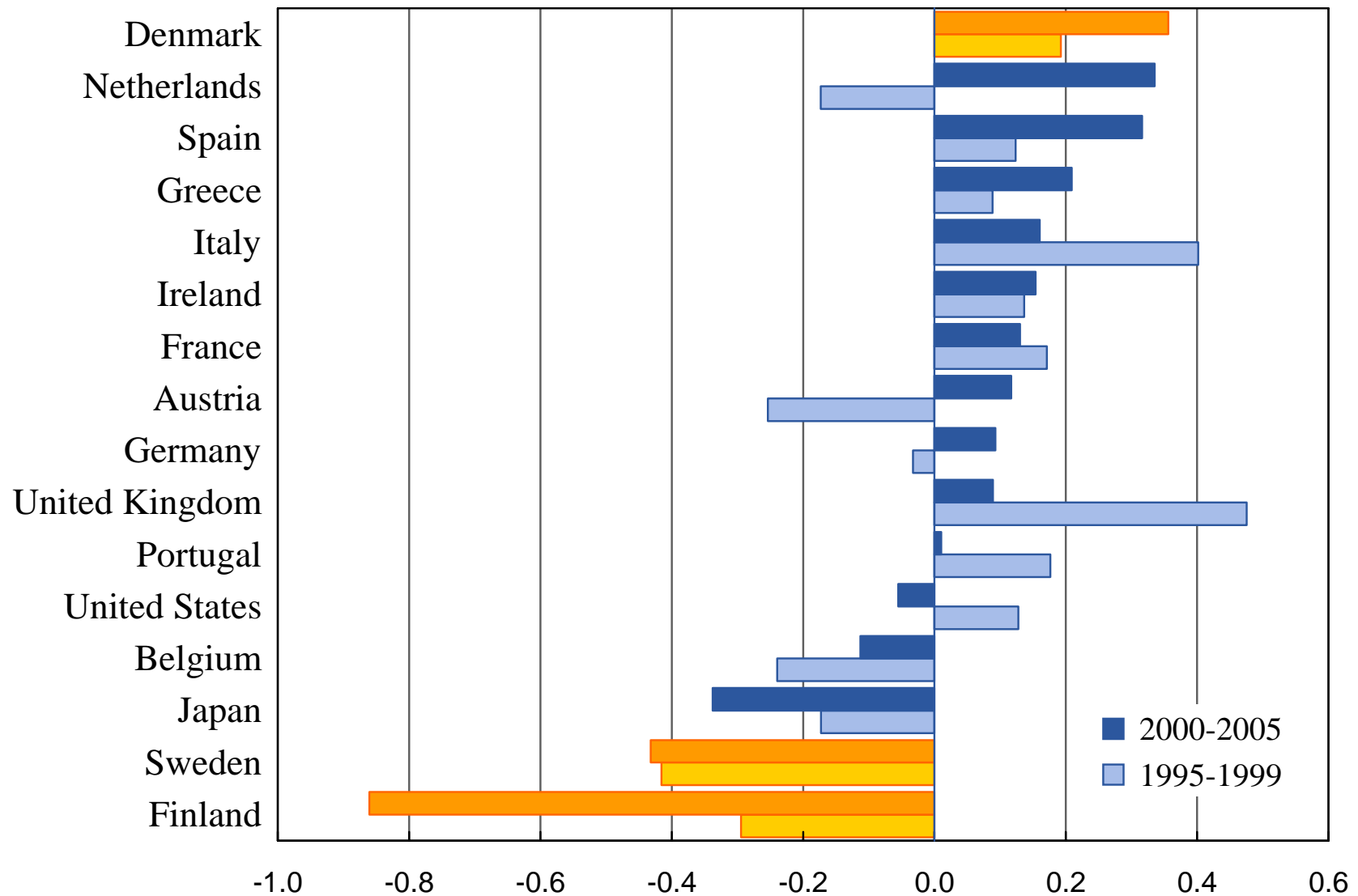
- high output growth in Finland and Sweden (but not in Denmark)
- less impressive income growth in Finland and Sweden with correction for deteriorating terms of trade
- partly a recovery from recession in the first half of the 1990s
- earlier unemployment rises have only partly been recovered
- less success in terms of hours worked than recorded employment in persons

GDP growth per capita (annual averages)			
	1990-94	1995-99	2000-05
Denmark	1.8	2.2	1.0
Finland	-2.5	4.1	2.0
Sweden	-0.8	2.8	1.8
Weighted average Scandinavian countries	-0.5	3.0	1.6
France	0.5	2.1	0.9
Germany	4.7	1.5	0.6
Ireland	2.8	8.3	3.7
Italy	0.8	1.4	0.1
Spain	1.0	3.5	1.6
Weighted average euro area	2.0	2.1	0.9
UK	1.1	2.7	2.0
US	1.1	3.0	1.5

Sources: OECD Economic Outlook and National Accounts Databases

Fig. 4.2

Annual average command GDP per capita adjustment Percentage points, 1995-2005

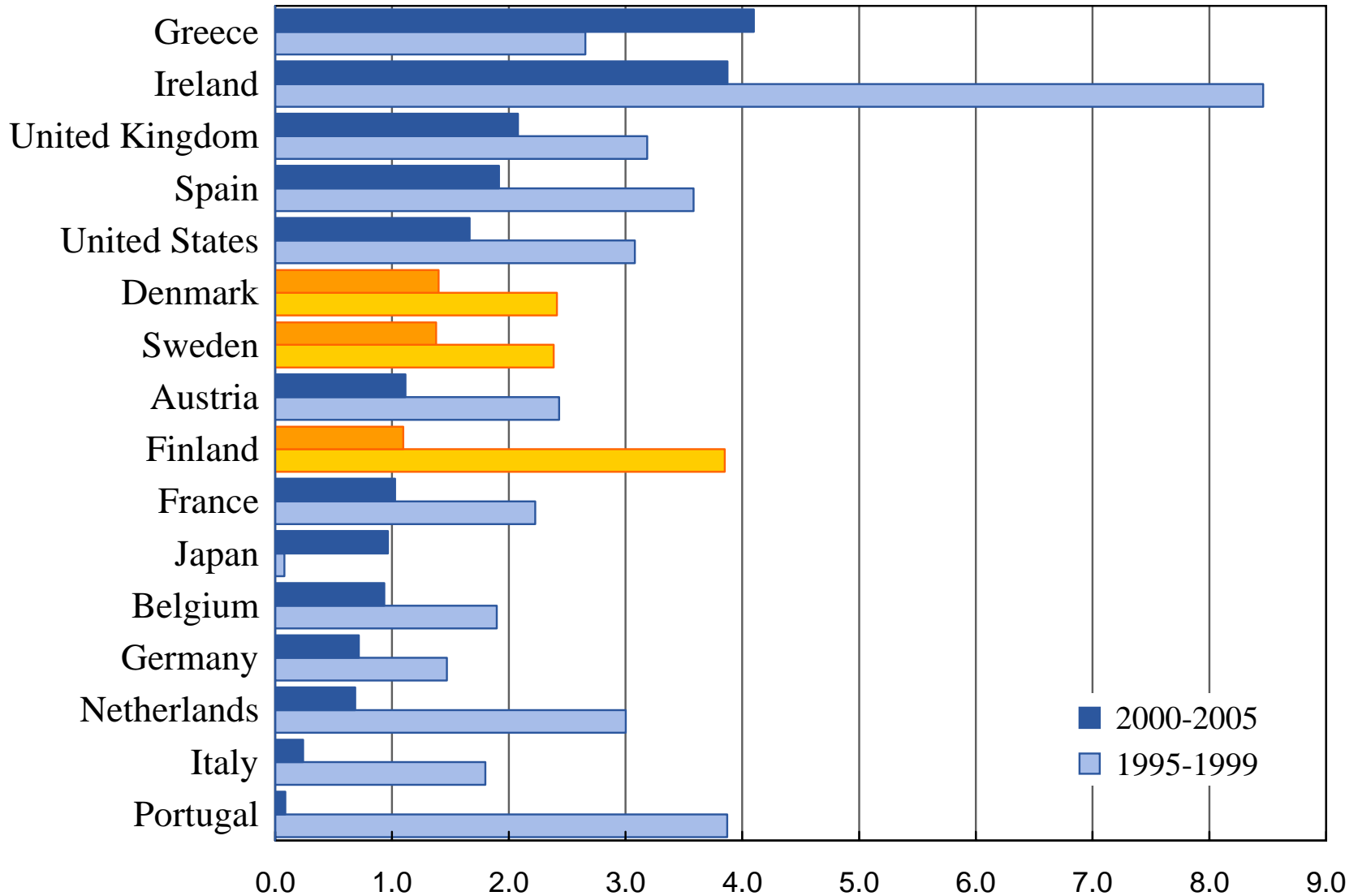


Note: To calculate command GDP, nominal exports are deflated by the import deflator (with the motivation that the purpose of exports is to pay for current or future imports). See OECD (2006a) for details.

Source: OECD Economic Outlook Database; calculations by the EEAG.

Fig. 4.3

Annual average command GDP per capita growth Percent, 1995-2005



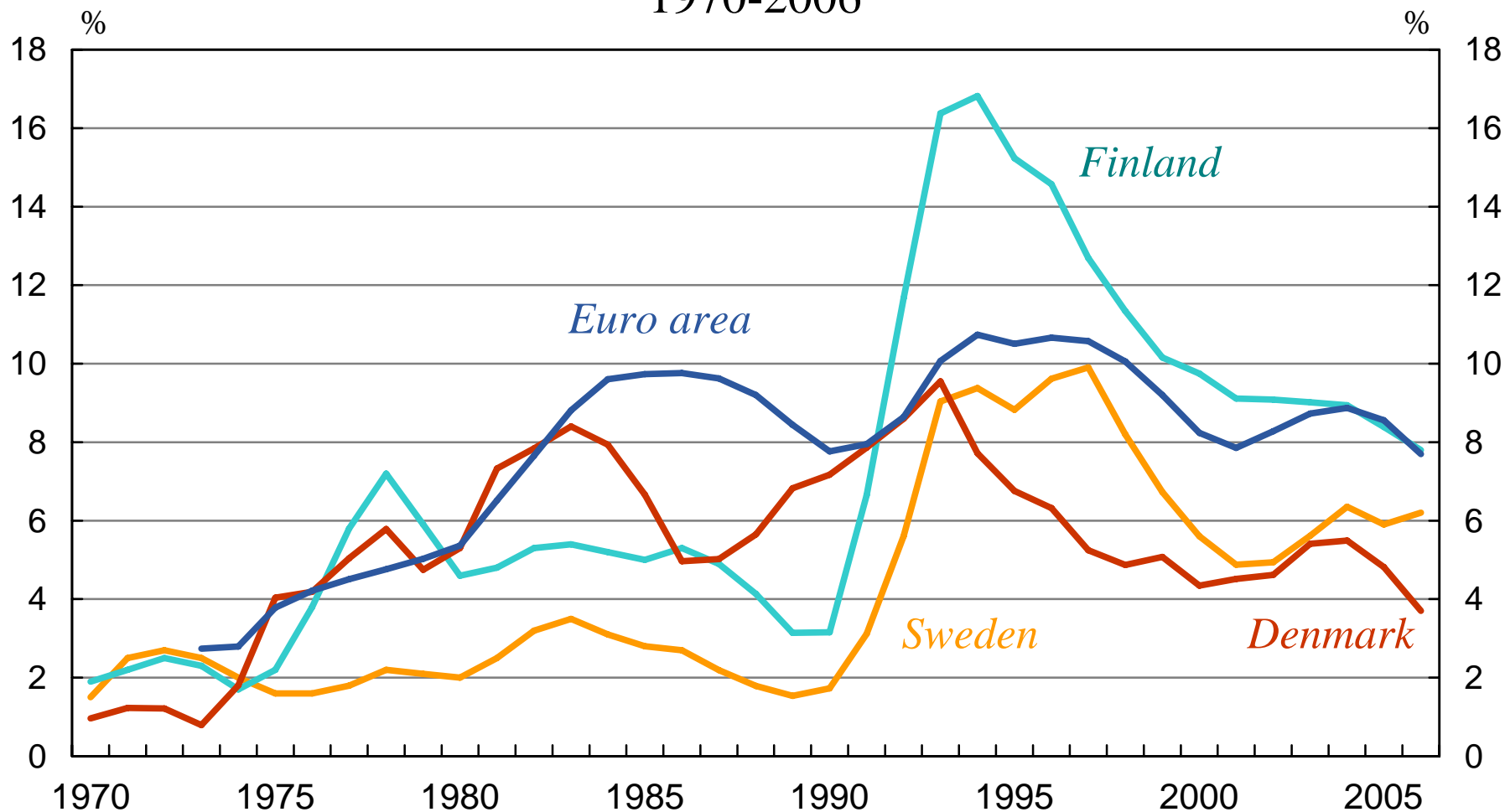
Note: Regarding the definition of command GDP, see Figure 4.2.

Source: OECD Economic Outlook Database; calculations by the EEAG.

Fig. 4.6

Standardised unemployment rates, percentages of labour force

1970-2006



Note: For Denmark and the euro area, standardised unemployment rates for earlier years have been constructed from non-standardised unemployment rates by adjusting these for differences in overlapping five-year averages. The 2006 unemployment figures have been obtained by adjusting non-standardised figures from OECD (2006d), for differences in overlapping five-year average between non-standardised and standardised series.

Sources: OECD Economic Outlook Database, OECD (2006c) and OECD (2006d).

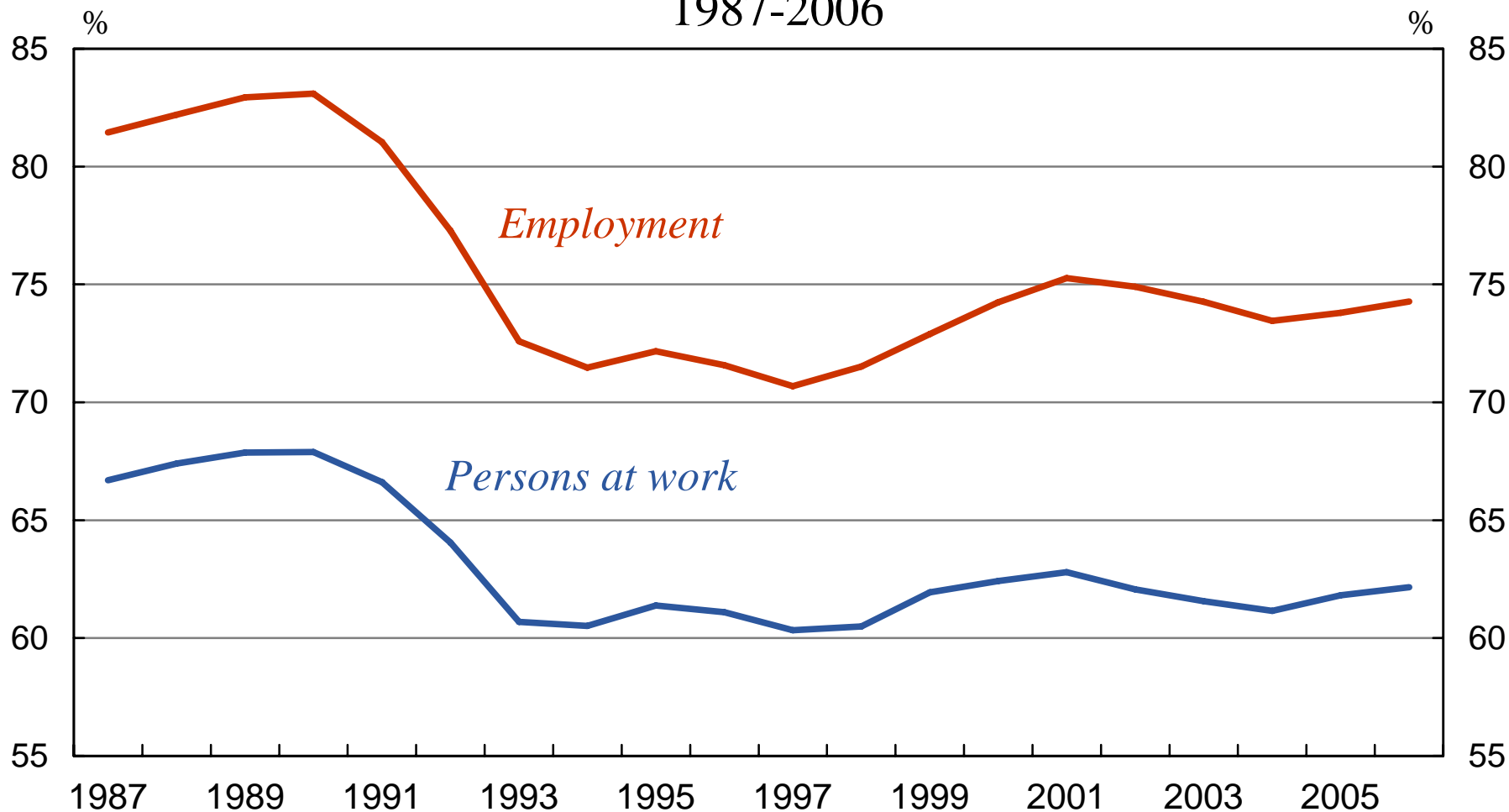
Hours worked

	Average annual hours worked per person of working age, 2005
Denmark	1171
Finland	1133
Sweden	1166
Average Scandinavian countries	1158
France	956
Germany	940
Italy	1030
Netherlands	984
Euro area except Finland	1043
UK	1214
US	1290
Australia	1297
Average Anglo-Saxon countries	1288
Japan	1230

Fig. 4.14

Persons at work and in employment as percentages of working-age population in Sweden

1987-2006



Sources: Konjunkturinstitutet, Stockholm and SCB, Stockholm.

Contributions to differences in total employment rates to the euro area average from differences in employment rates for various gender and age groups, 2005^{a)}

	Total 15-64	Men 15-64	Women 15-64	Total 15-24	Total 25-54	Total 55-64
Denmark	12.1	4.2	7.8	4.1	4.3	3.7
Finland	4.6	-1.2	5.7	0.3	2.4	1.9
Sweden ^{b)}	10.1	1.7	8.3	1.0	3.5	5.6
Average Scandinavian countries	9.2	1.6	7.5	1.7	3.5	4.0
Australia	8.2	3.4	4.9	5.4	1.1	1.8
New Zealand	11.2	4.8	6.6	4.2	3.0	4.1
UK	9.2	3.4	6.0	3.7	2.6	2.9
US	8.1	2.9	5.4	3.4	1.6	3.2
Average Anglo-Saxon countries	8.3	3.0	5.5	3.5	1.8	3.1

Notes: a) Column 2, labeled “Total 15-64” shows how much higher the total employment rate is than the average for the euro area (except Finland). Columns 3 and 4 decompose this difference into contributions in percentage points from male and females, respectively. Columns 5-7 decompose the difference instead in contributions from different age groups. b) 2004.

Source: OECD (2006c)

What explains the Danish employment success?

- Reduction in structural unemployment over the last decade
- High employment on all counts: males and females as well as all age groups
- Standard explanation: **flexicurity**
 - low employment protection and generous unemployment benefits

The flexicurity explanation is wrong

- Weak empirical evidence in general that employment protection is important for employment
- Ample evidence that unemployment benefits are important for employment
- No major changes in employment protection in Denmark
- Major reductions in generosity of unemployment benefits and increases in the requirements on the unemployed (for youth in particular)

Lessons for Europe from the Scandinavian experiences

- **Not** that market-liberal reforms are unnecessary
- Instead that such reforms can be very effective
 - product market reforms in all three Scandinavian countries
 - labour market reforms in Denmark
- Good macroeconomic performance can be achieved with systems very different from the Anglo-Saxon one
 - but steps need to be taken in this direction

Economic nationalism

Selective – and usually discretionary – government interventions in private transactions on the basis of the nationality of the parties

- Blocking cross-border mergers
- Subsidisation of national champions
- Influencing the location of activities
- Political interventions to obtain contracts
- Influencing standards

Costs of economic nationalism

- Less market discipline and poorer corporate governance
- Productive inefficiency
- Distortions in competition
- Coordination failures
 - deregulations may not occur

Possible remedies

- Coordination of liberalisations across countries
- Harmonisation of regulation and regulation at European level
- State ownership in competitive environments – full and partial – should be severely restricted through an EU rule
 - state ownership invites economic nationalism
 - general problems of inefficiency with state ownership

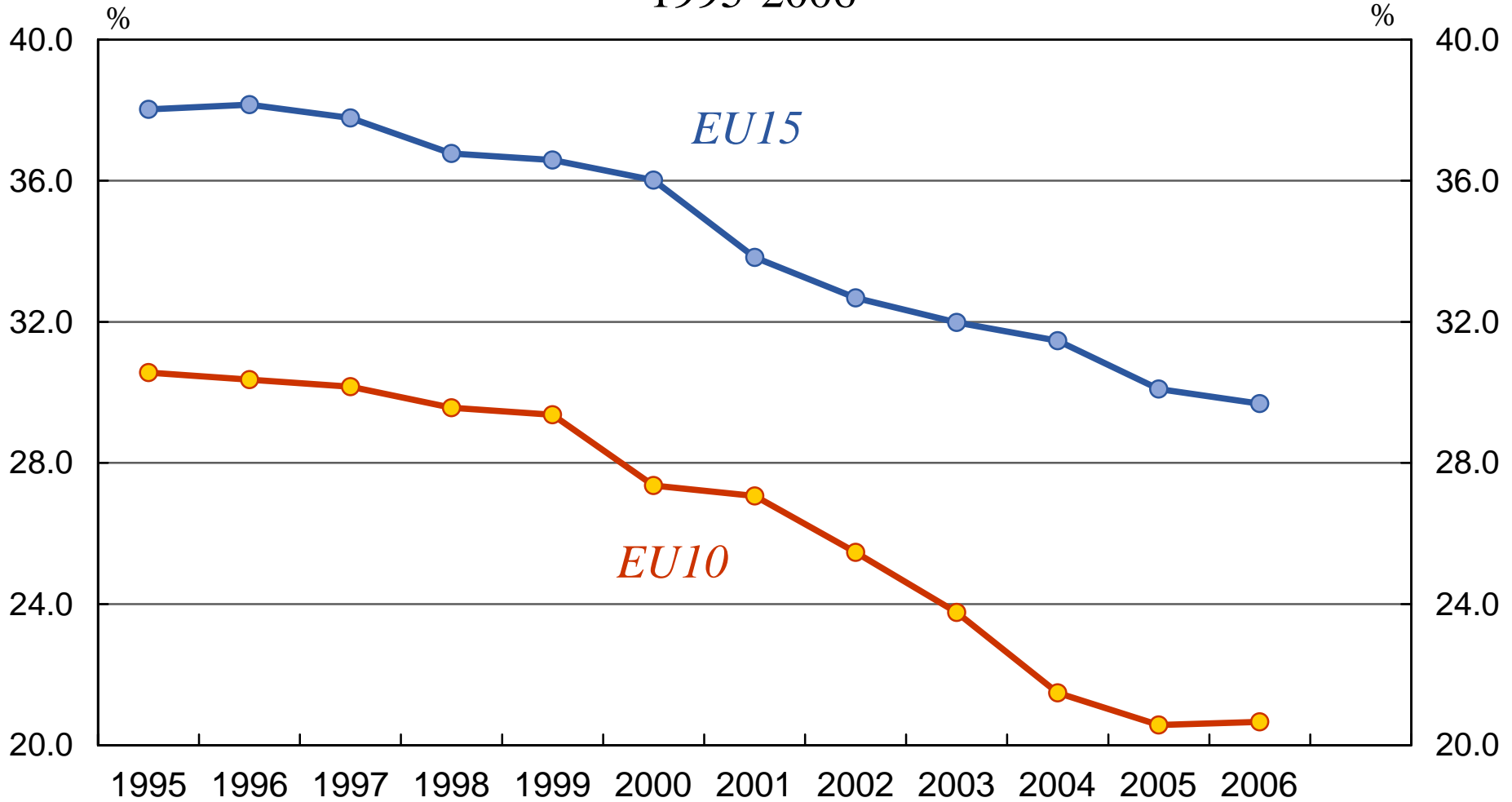
Tax competition

Four questions:

- Does tax competition matter?
- Is it fair?
- Should there be coordination?
- How should governments react?

Fig. 5.1

Statutory corporation tax rates in the European Union 1995-2006



Source: European Commission (2006).

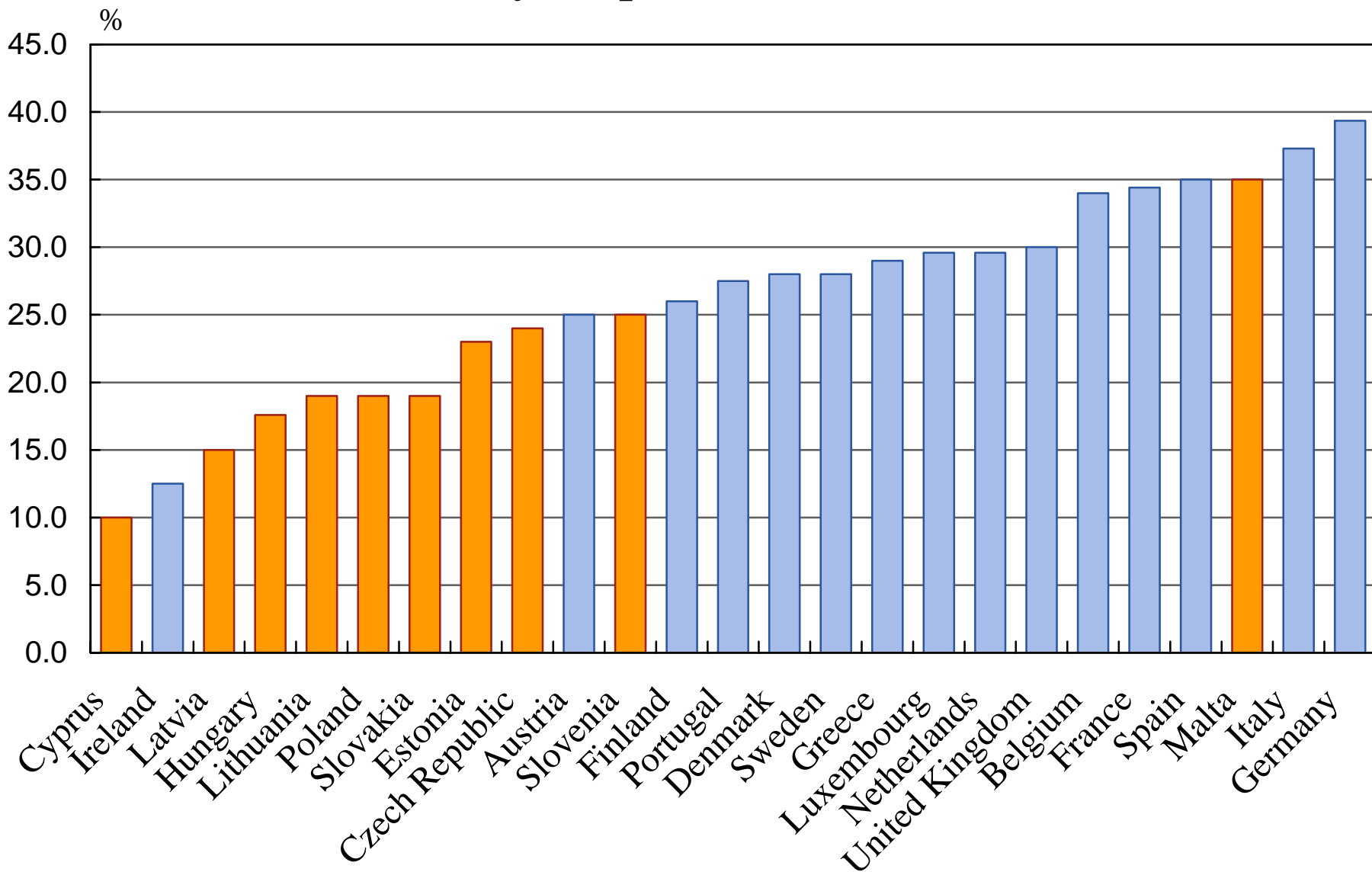
Corporation tax rate reduction in the EU for retained earnings, 2003-06 ^{a)}

	Reduction (percent)	Year of reform
Austria	34 to 25	2005
Belgium	39 to 33	2003
Cyprus	25 to 15 to 10	2003, 2005
Czech Republic	31 to 28 to 26 to 24	2004, 2005, 2006
Denmark	30 to 28	2005
Estonia	26 to 24 to 23	2005, 2006
France	35.4 to 34.9 to 34.4	2005, 2006
Germany	32 to 30.5	2004
Greece	35 to 32 to 29	2005, 2006
Hungary	18 to 16	2004
Italy	36 to 34 to 33	2003, 2004
Latvia	22 to 19 to 15	2003, 2004
Netherlands	34.5 to 31.5 to 29.6	2005, 2006
Poland	28 to 27 to 19	2003, 2004
Portugal	30 to 25	2004
Slovak Republic	25 to 19	2004

a) Reduction shown are for national tax rates only.

Fig. 5.2

Statutory corporation tax rates, 2006



Source: European Commission (2006).

Is tax competition fair?

- Low tax rates and EU grants serve the same end: conversion
- Hence, if one accepts the idea of EU grants to low-wage EU countries, one should also accept that they impose lower corporation taxes

Tax harmonization?

- Overprovision of infrastructure instead

Cash flow taxation

- Avoids economic distortions
- $VAT = \text{Cash flow tax plus labor income tax}$
- Increase in VAT, reduction in tax on labour income

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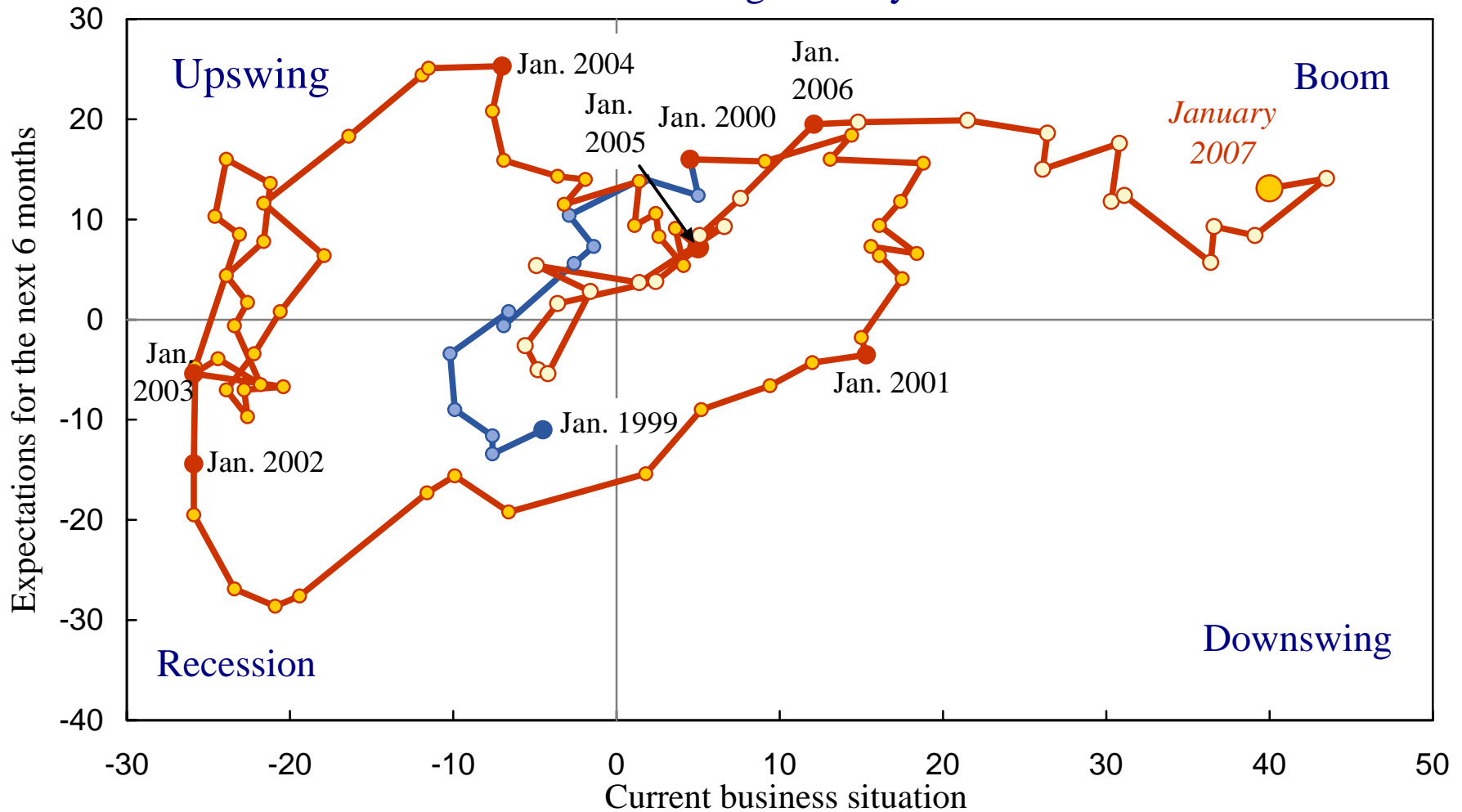
Chapter 1

Appendix 2

Fig. 1.19

Assessment of current business situation vs. business expectations in Germany

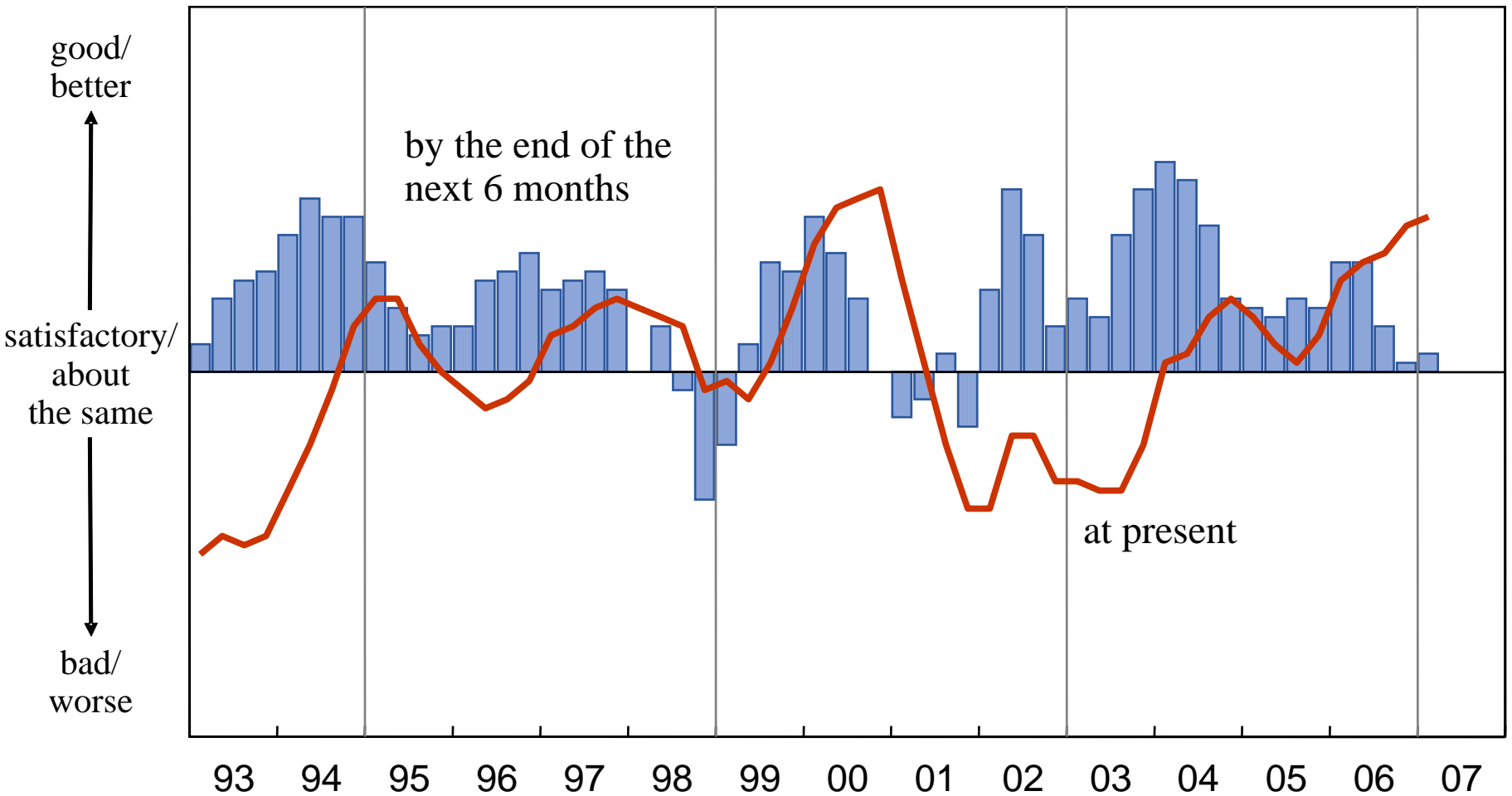
Manufacturing industry¹⁾



1) Manufacturing industry excluding food, beverages and tobacco. Balances, seasonally adjusted data.
Source: Ifo Business Survey, Germany.

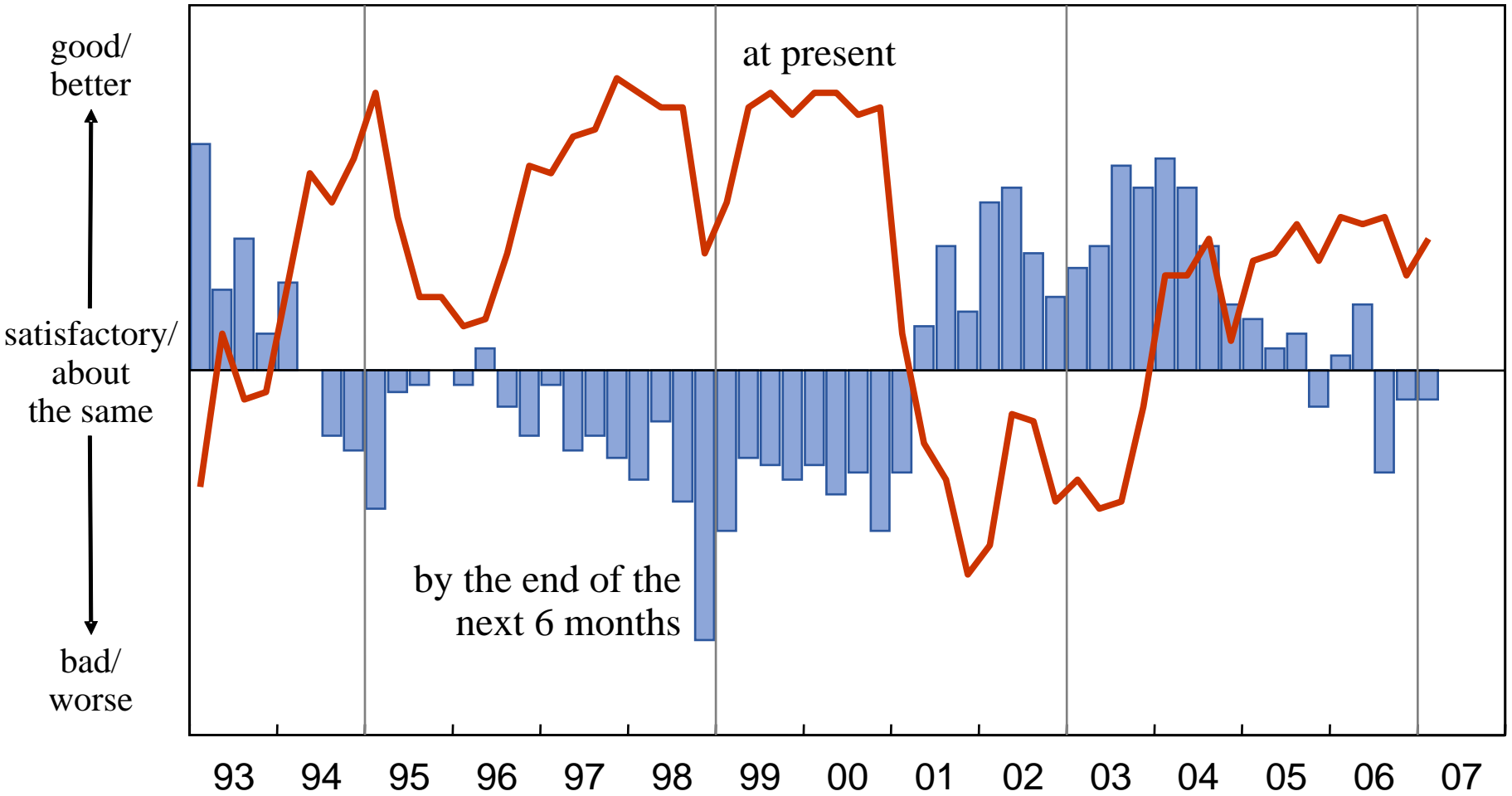
World Economy

Economic situation



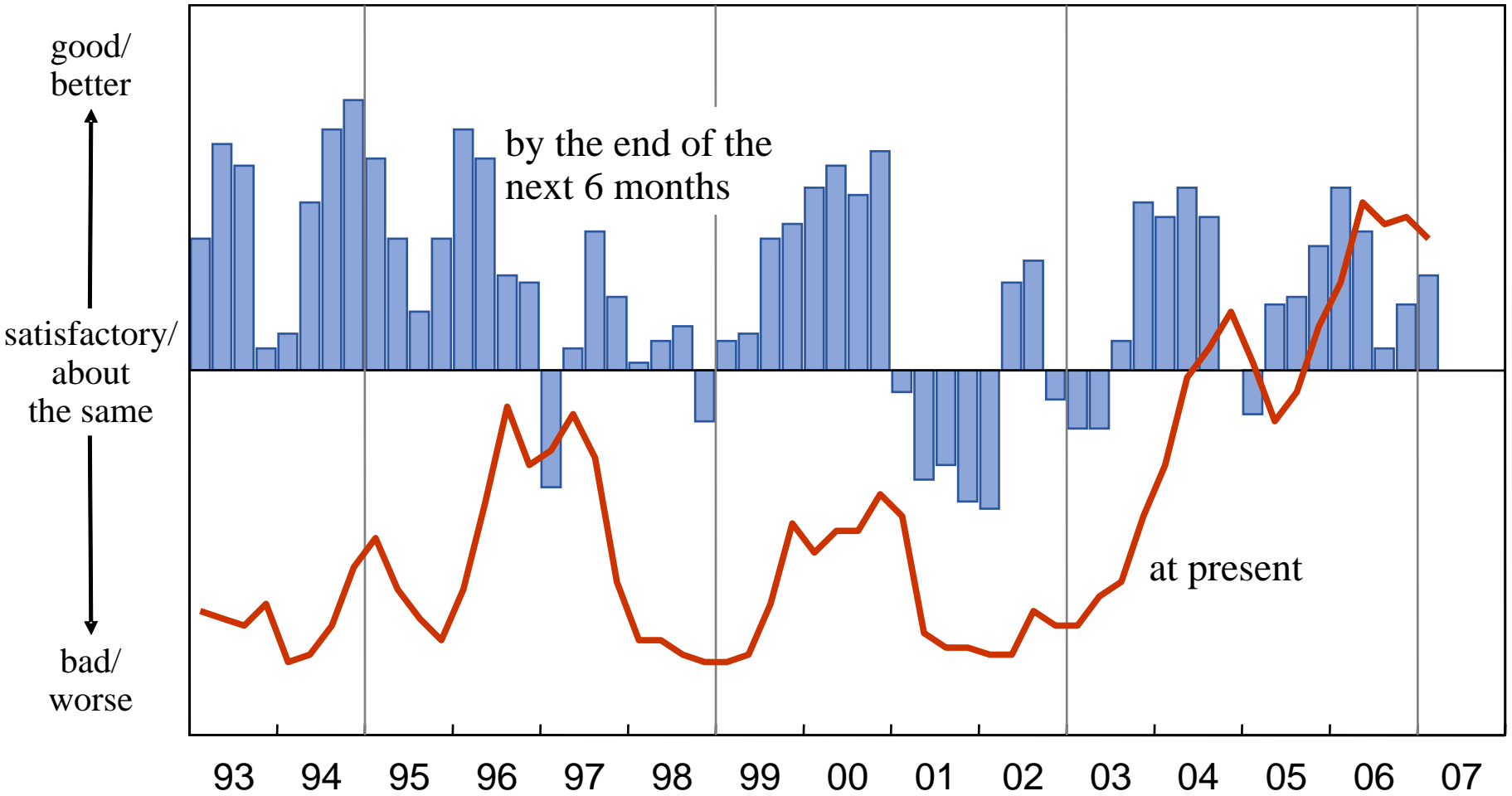
USA

Economic situation



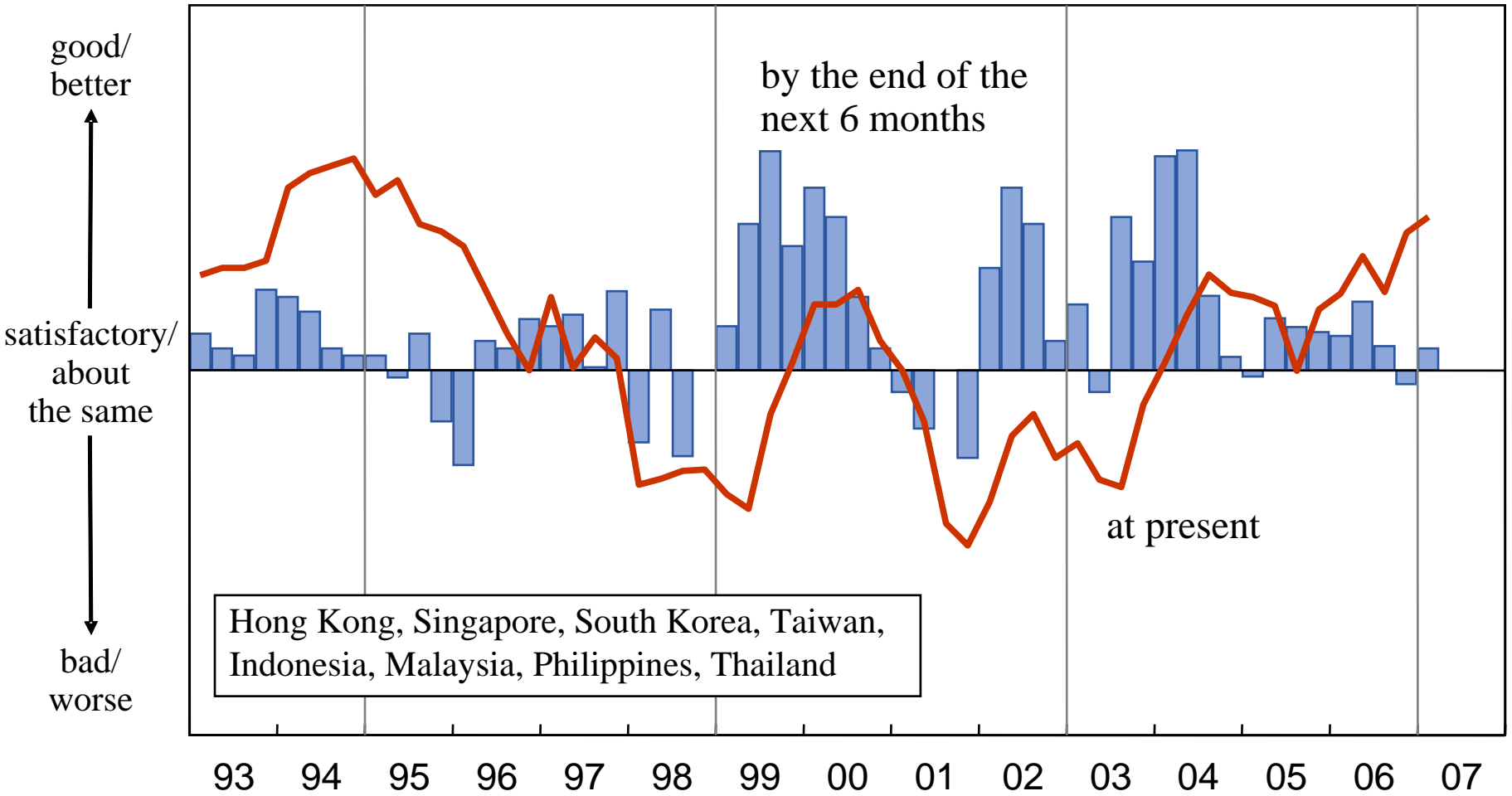
Japan

Economic situation



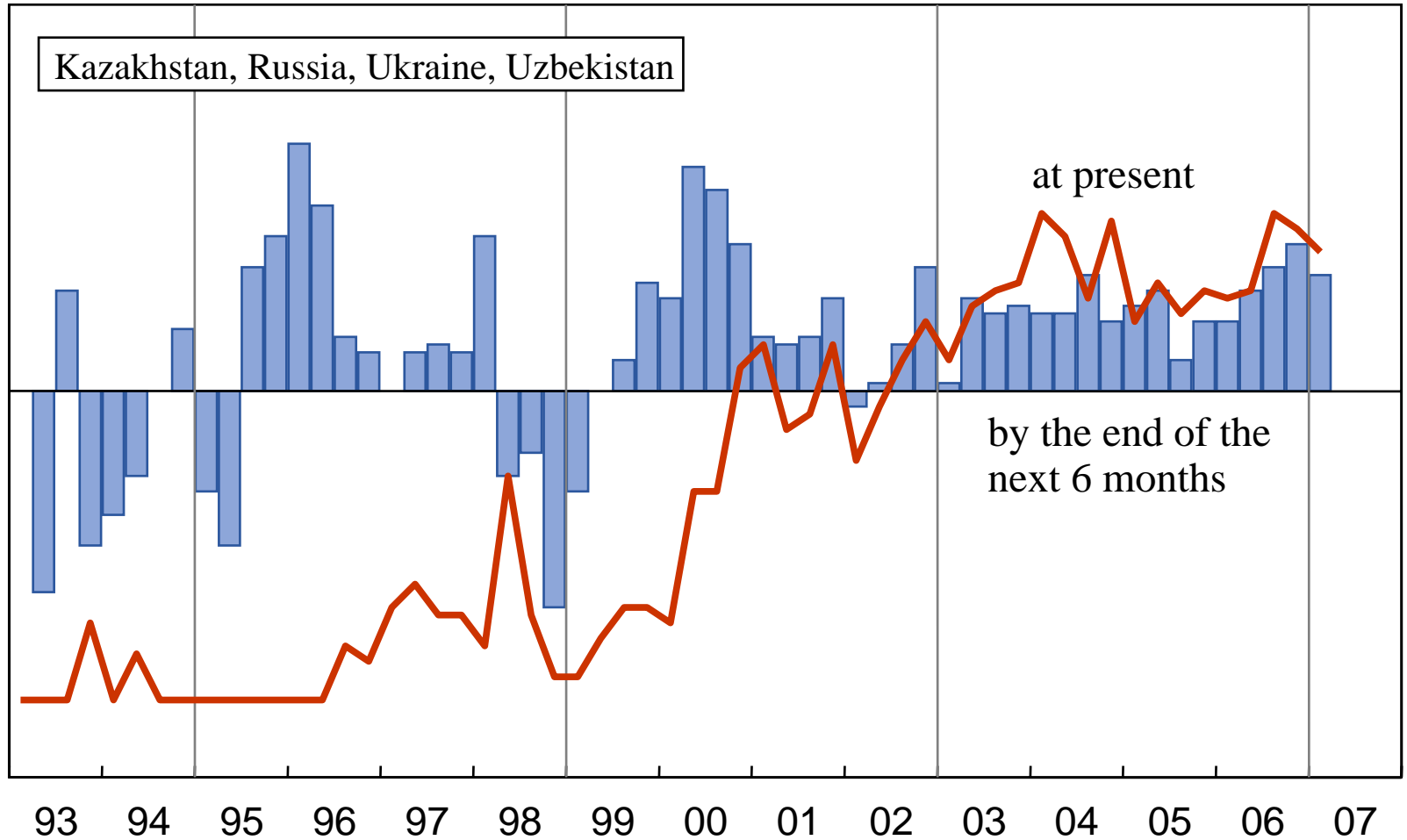
ASEAN and East Asian NICs

Economic situation

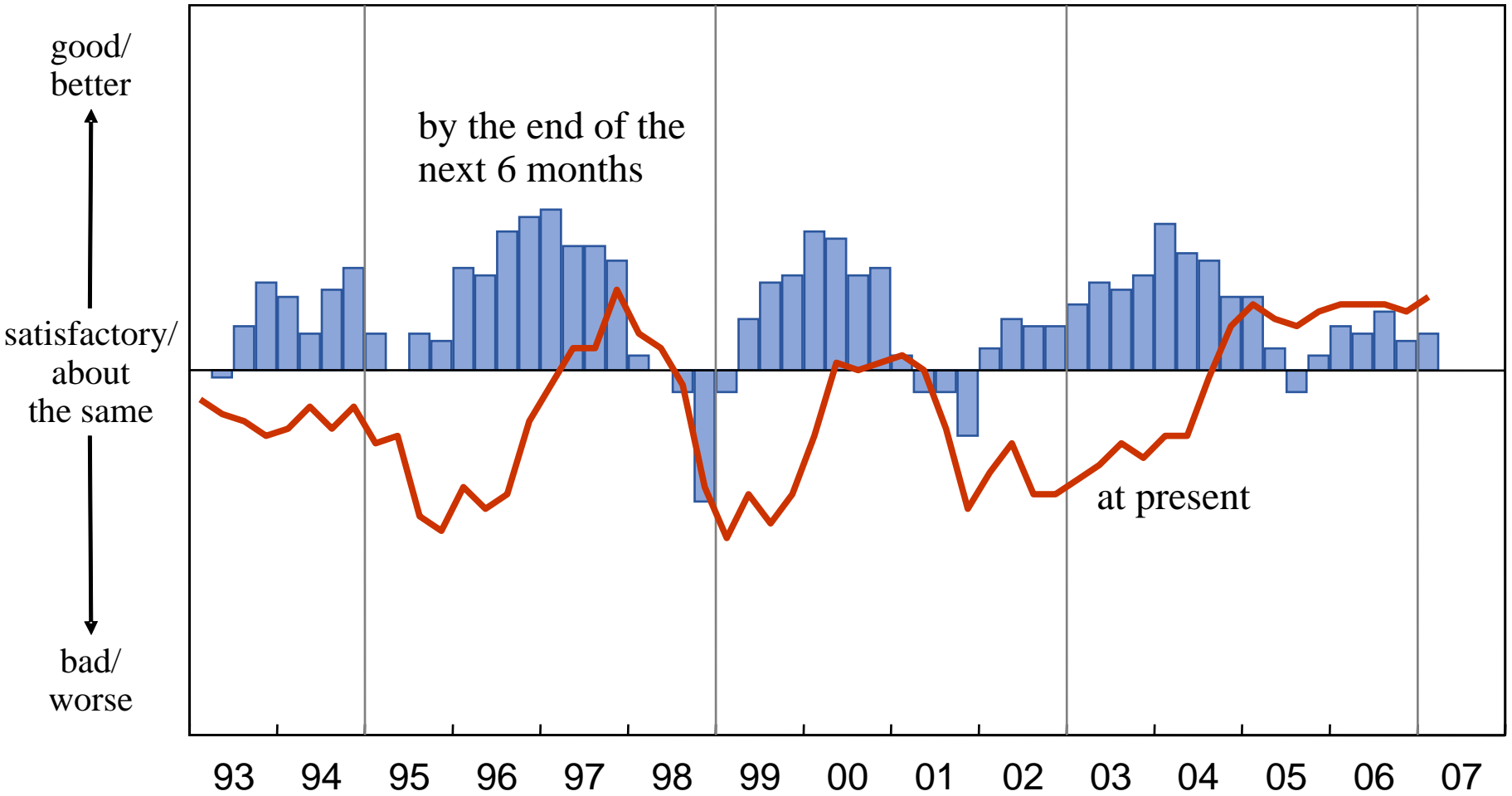


CIS

Economic situation

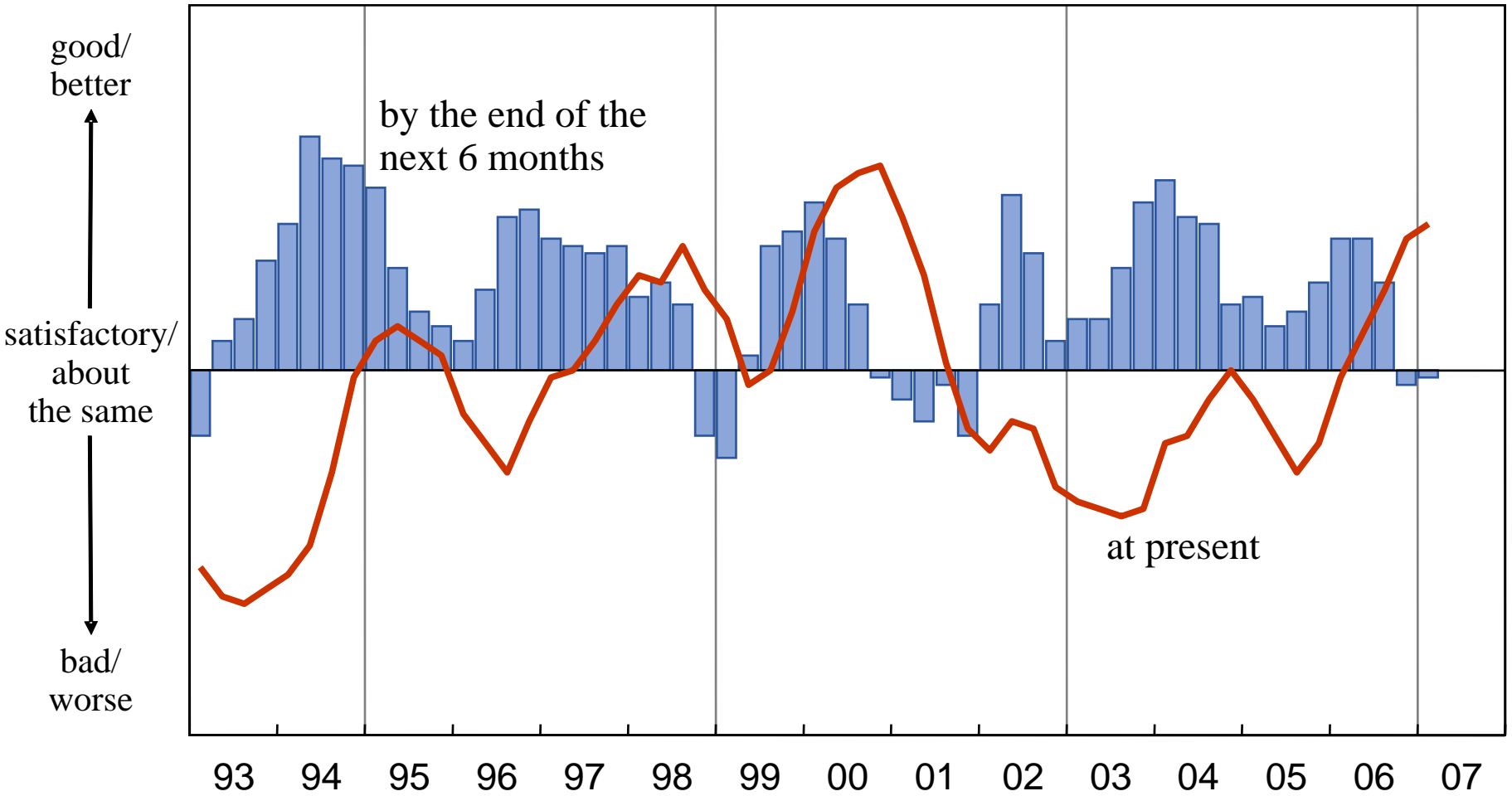


Latin America Economic situation



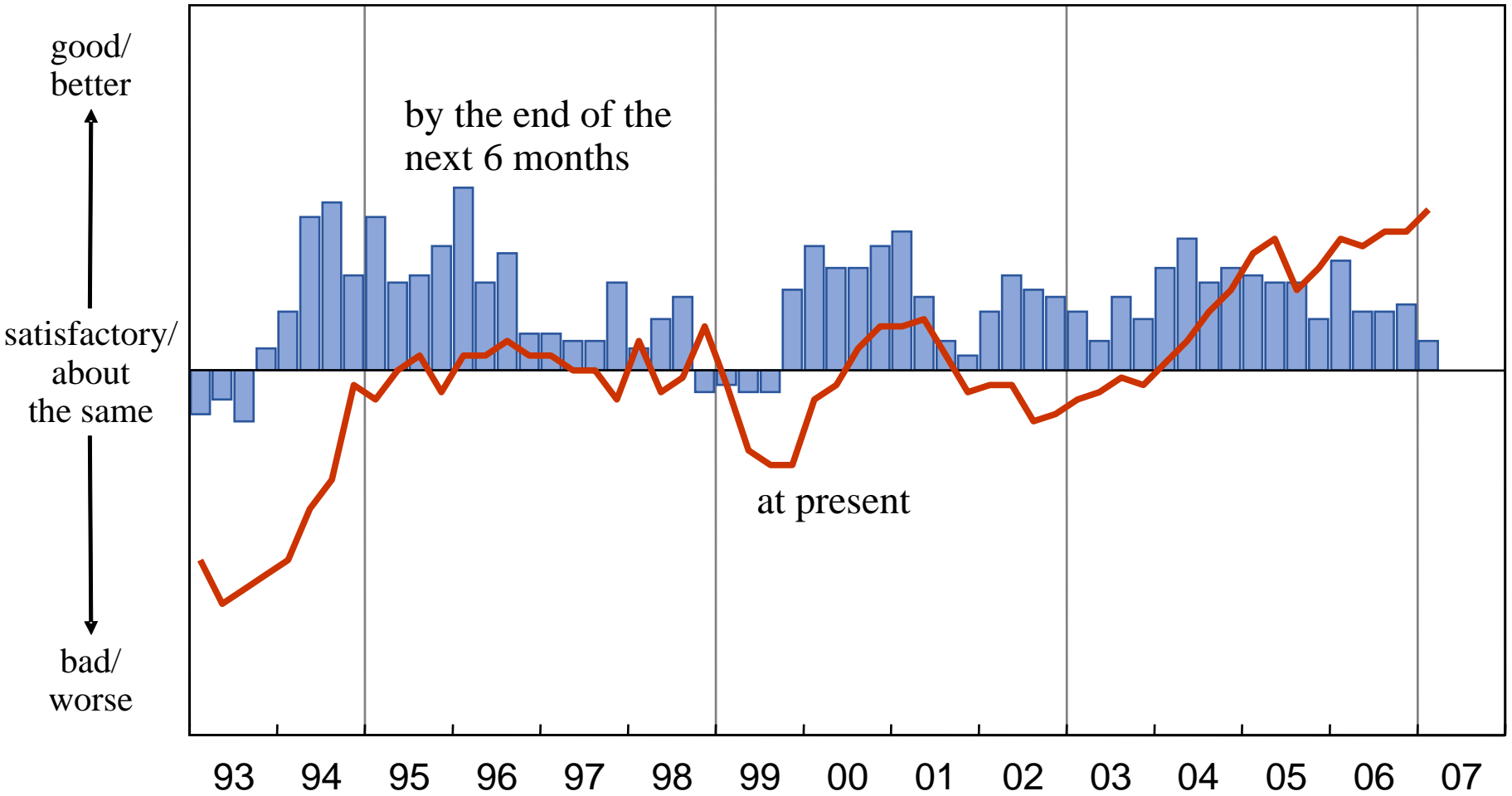
European Union (15)

Economic situation



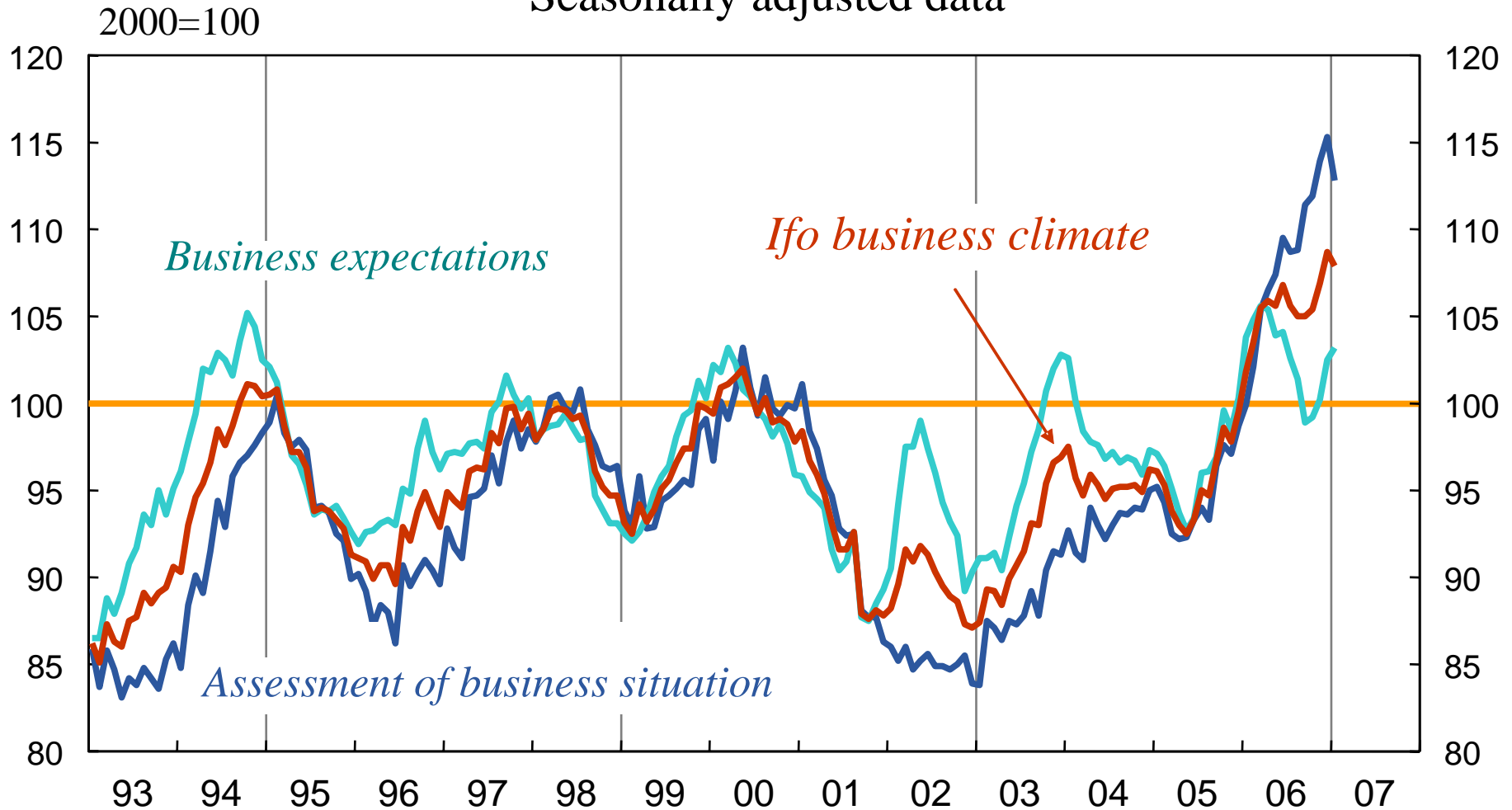
Eastern Europe

Economic situation



Germany: Ifo Business Climate¹⁾

Seasonally adjusted data

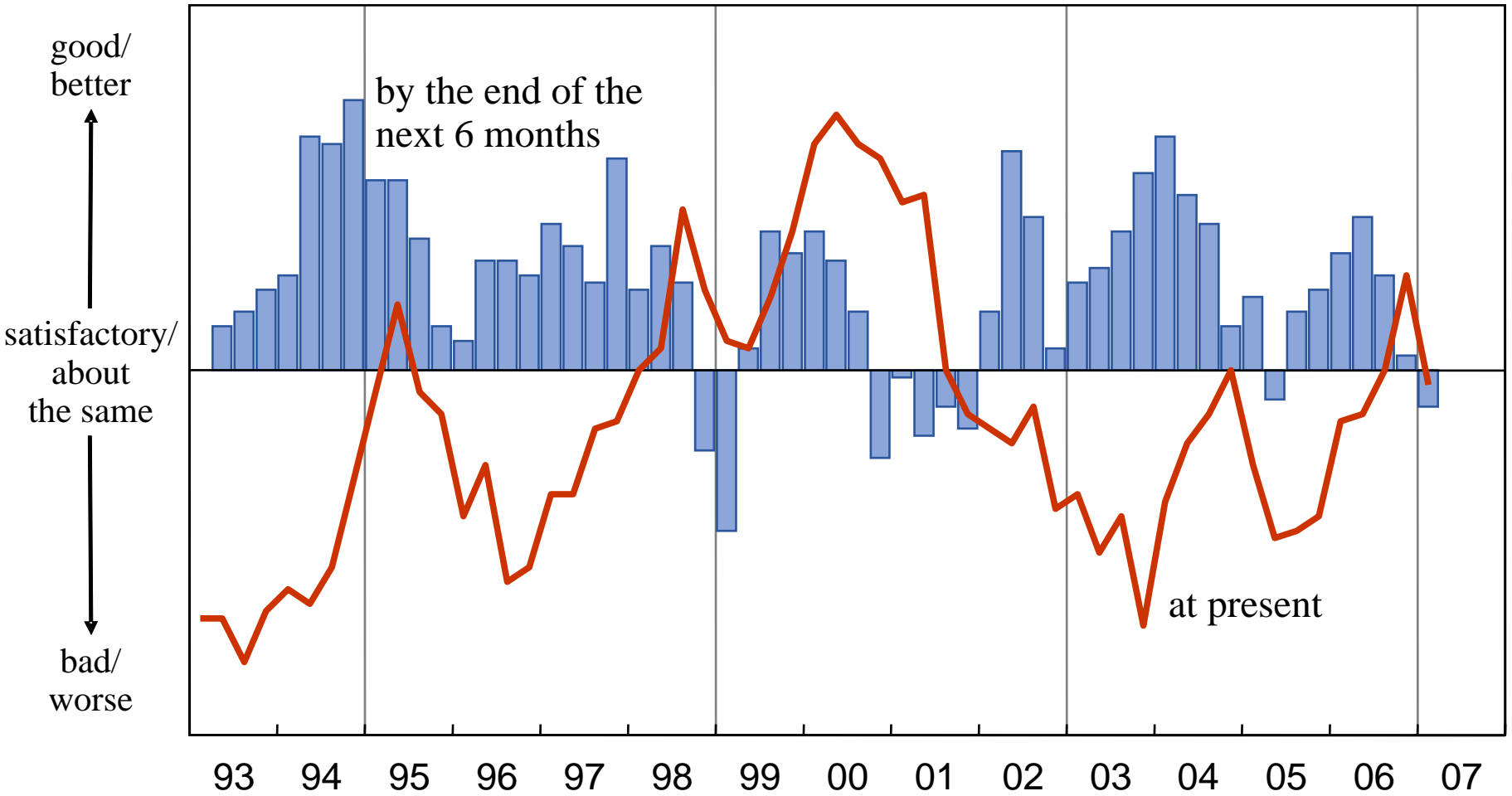


1) Manufacturing industry, construction, wholesale and retail trade.

Source: Ifo Business Survey, January 2007.

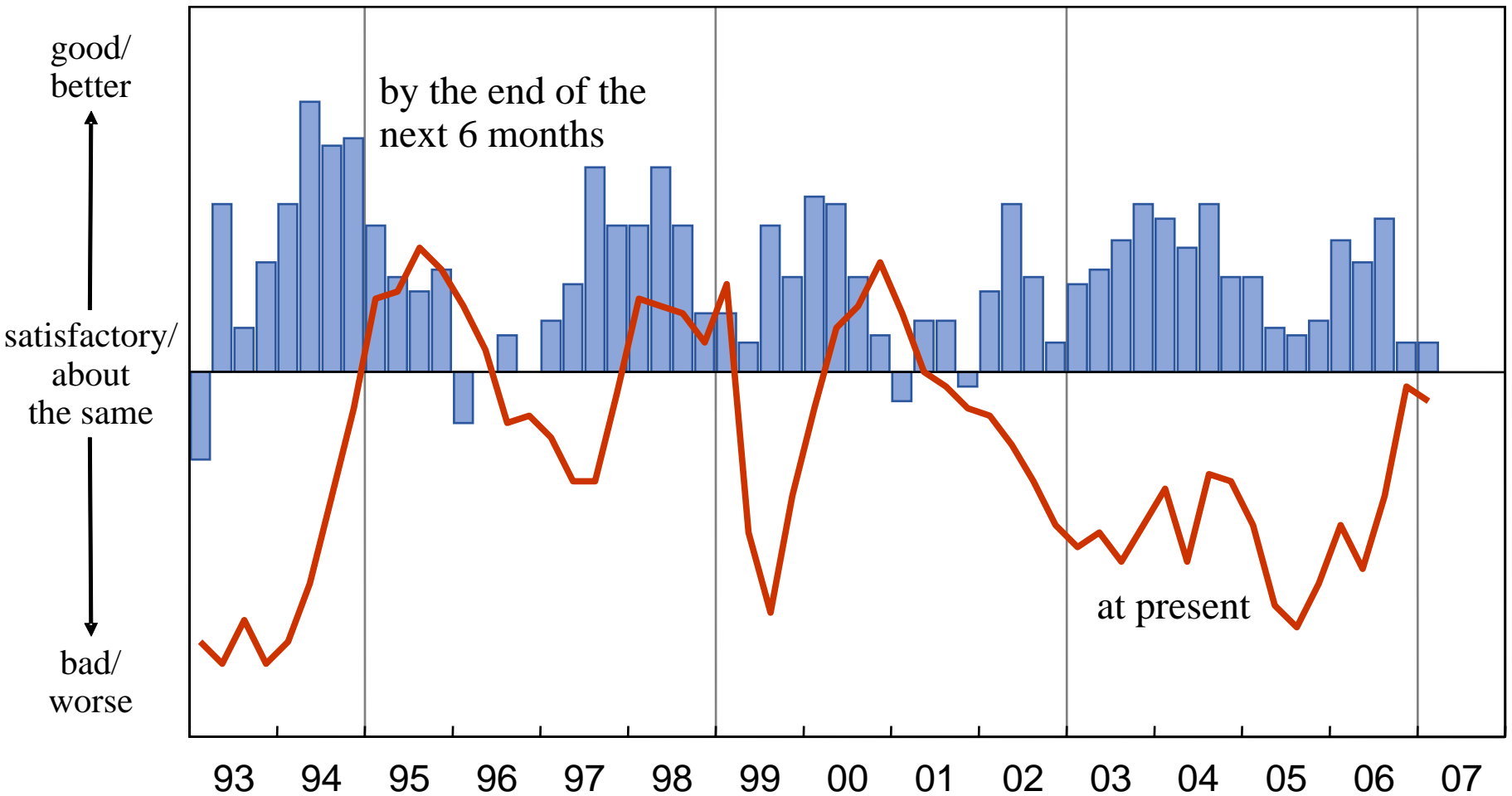
France

Economic situation



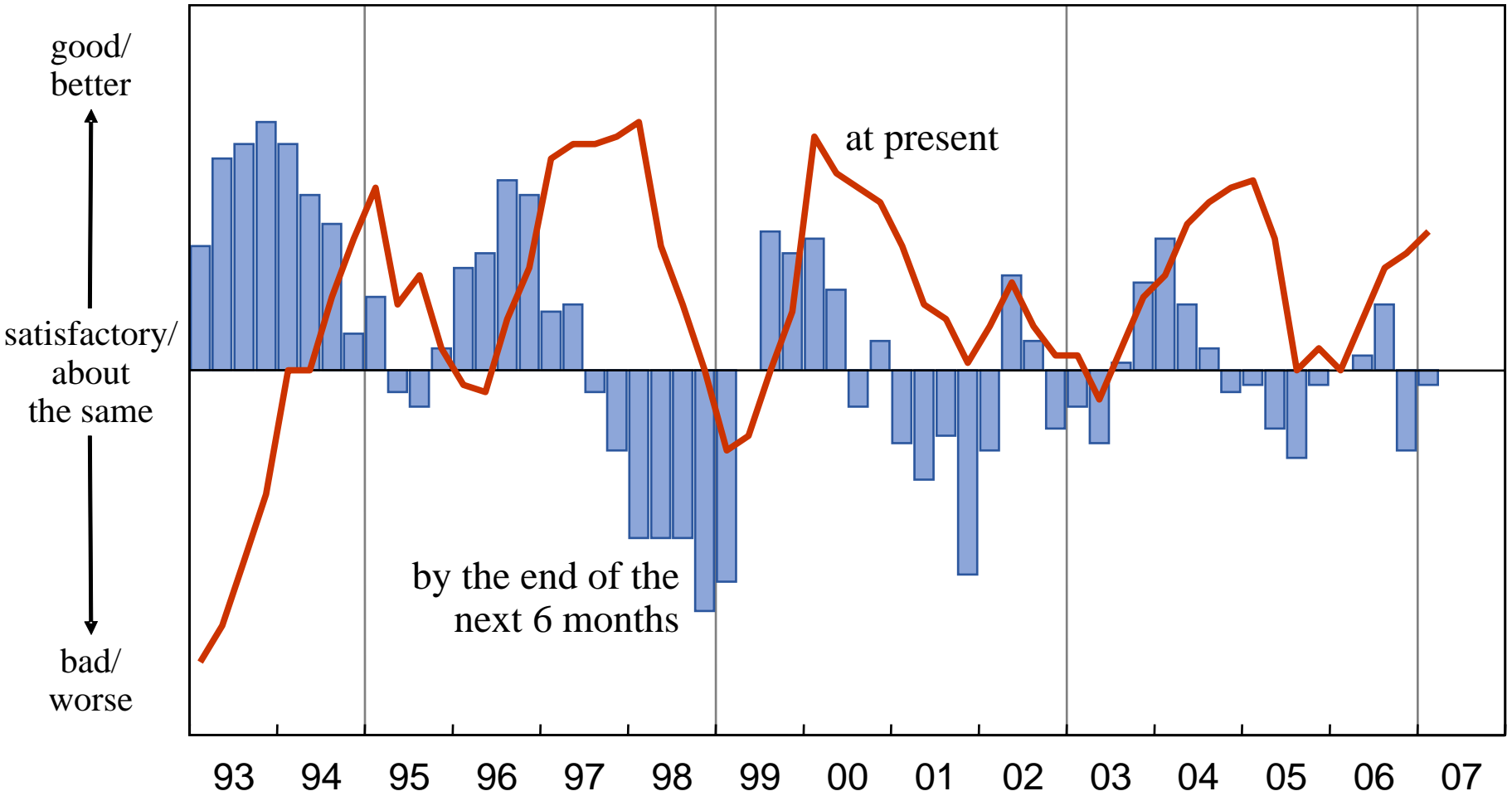
Italy

Economic situation



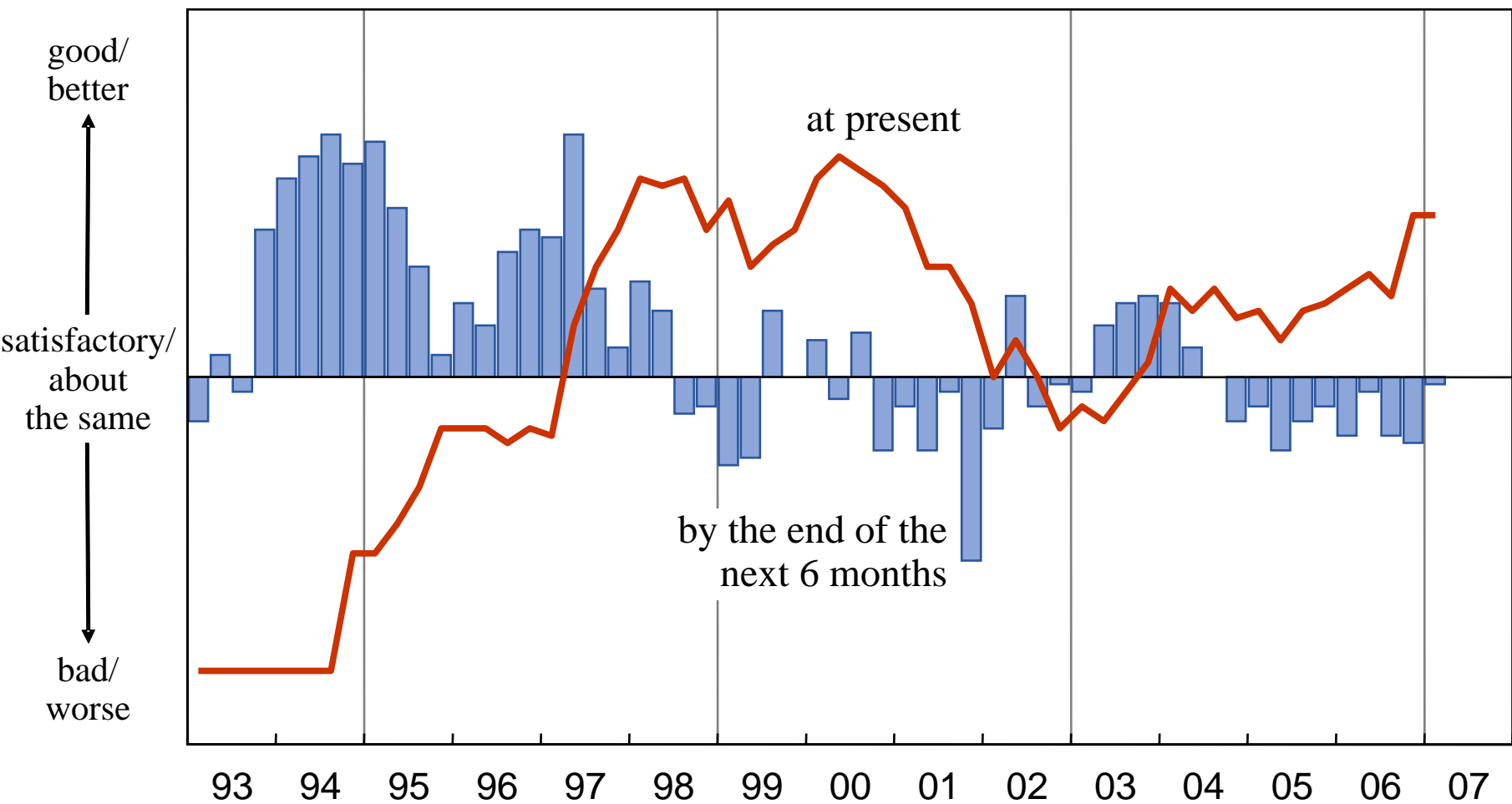
United Kingdom

Economic situation



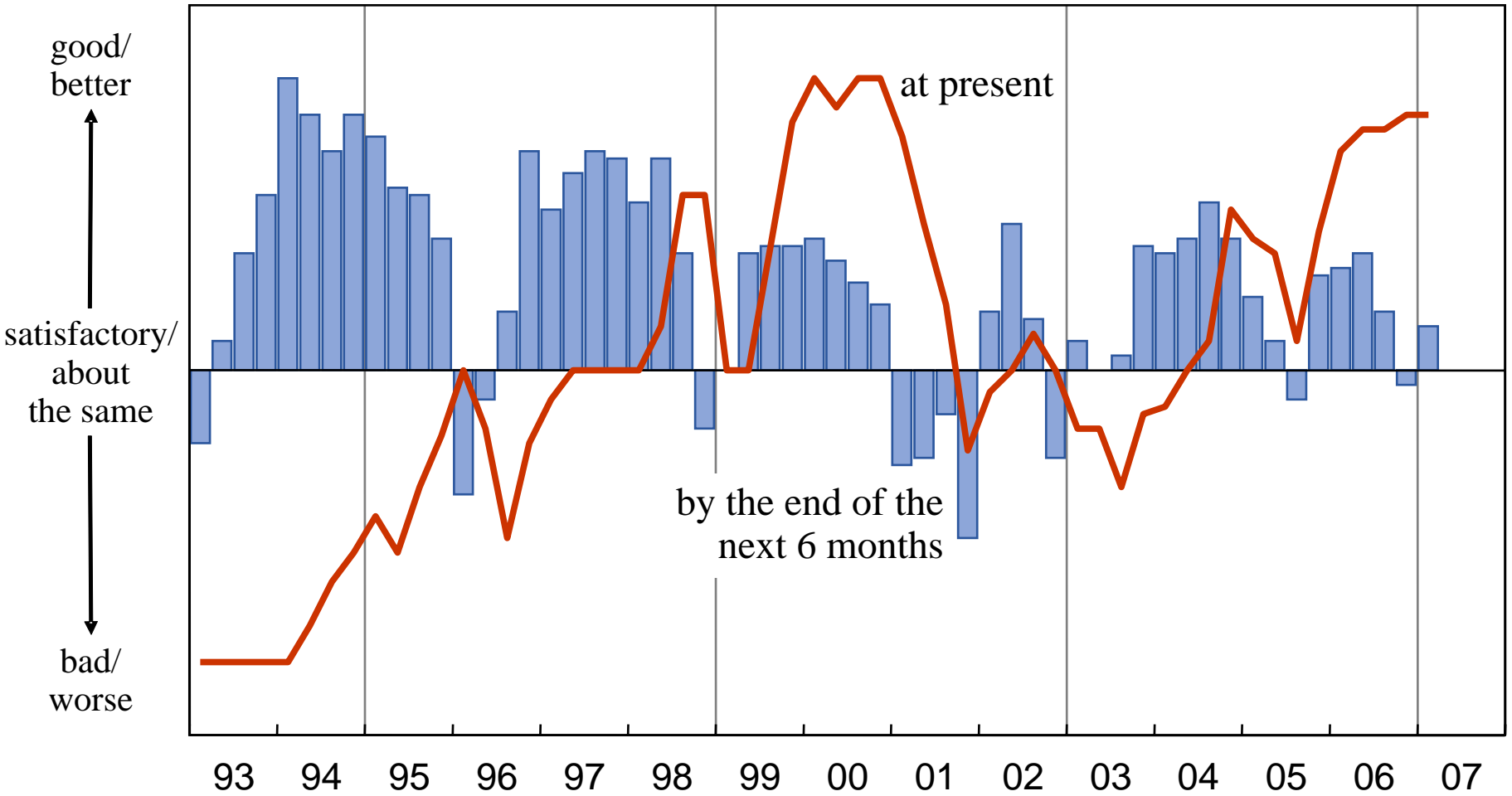
Spain

Economic situation



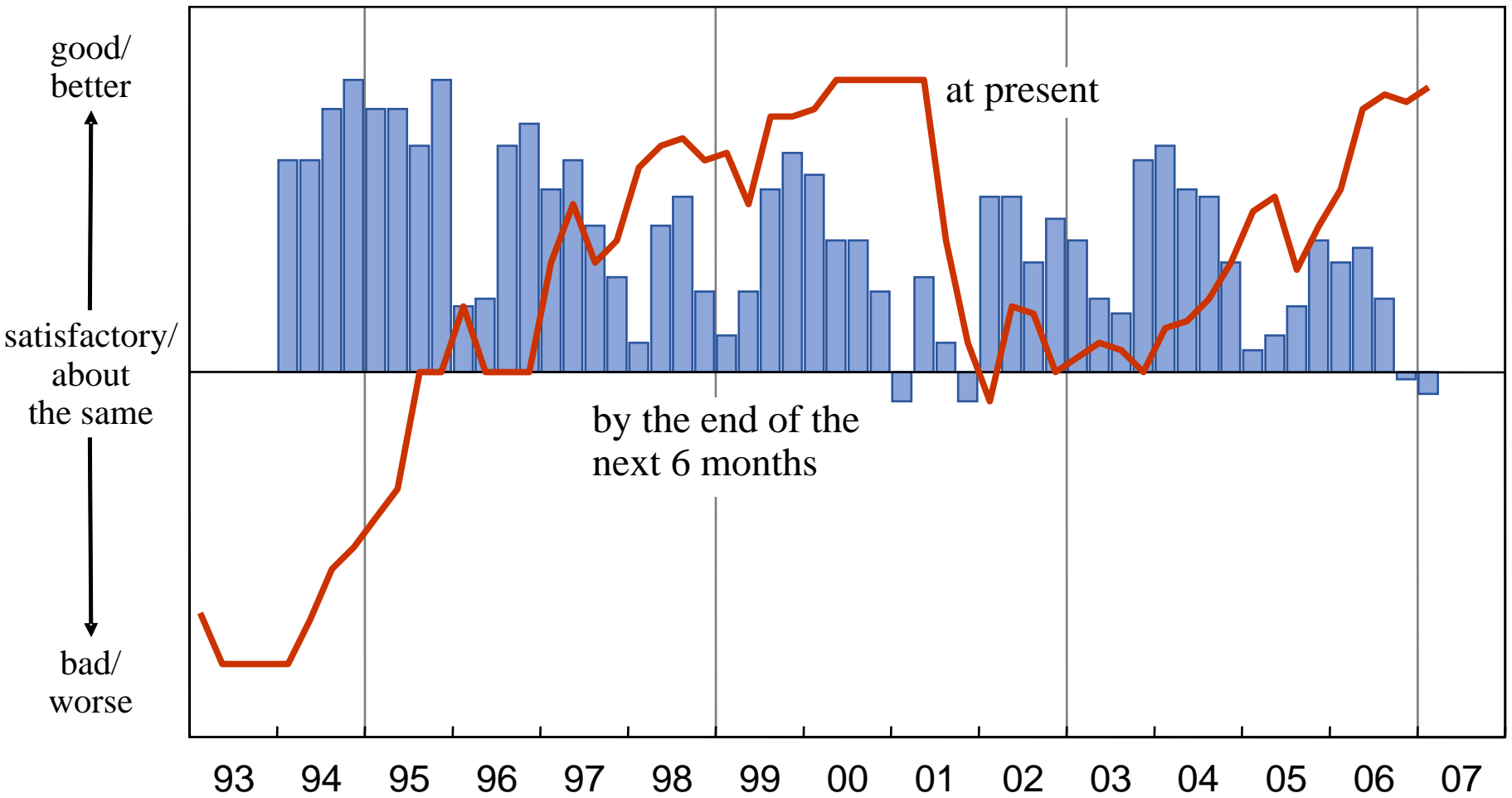
Sweden

Economic situation



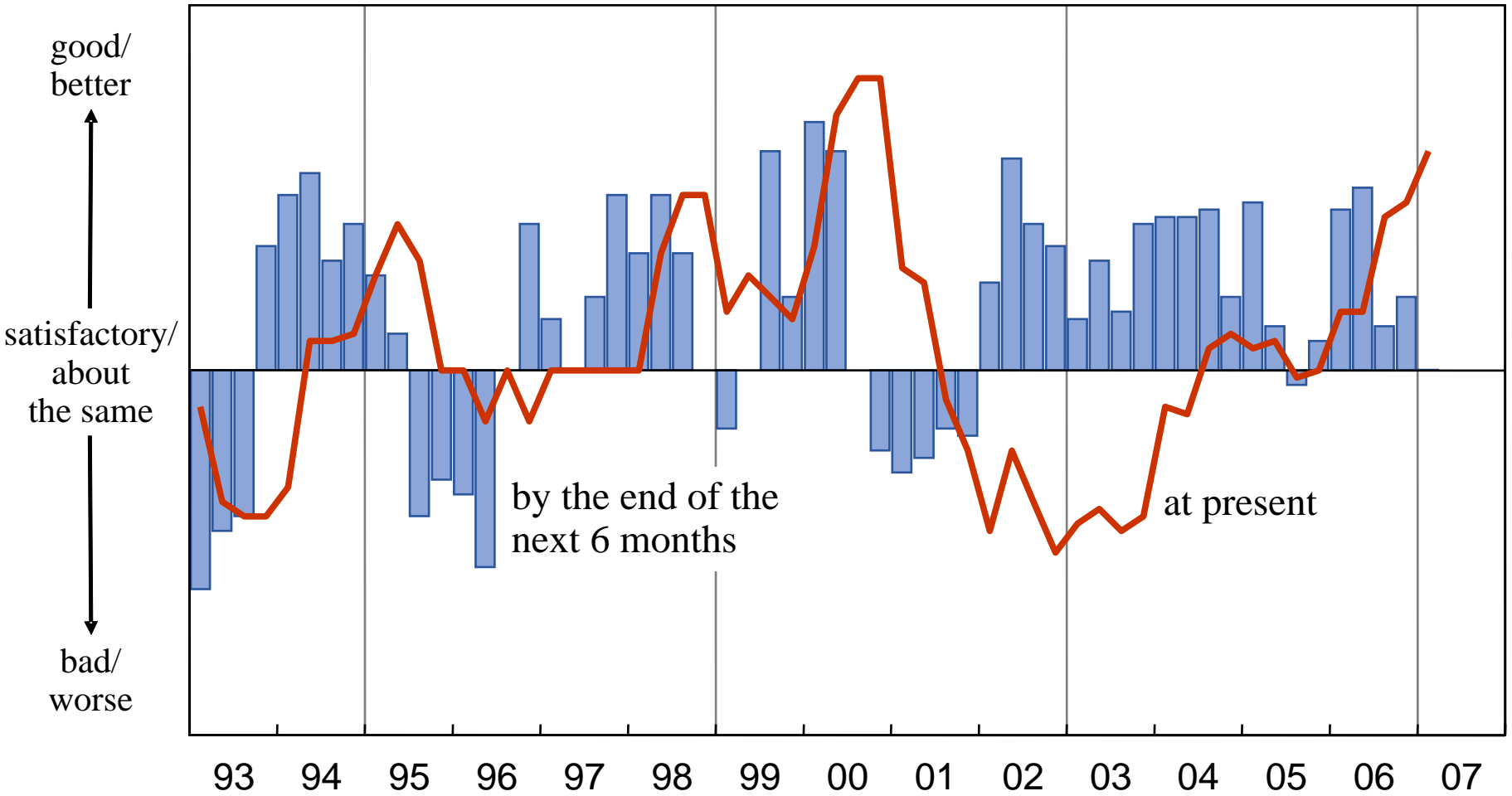
Finland

Economic situation



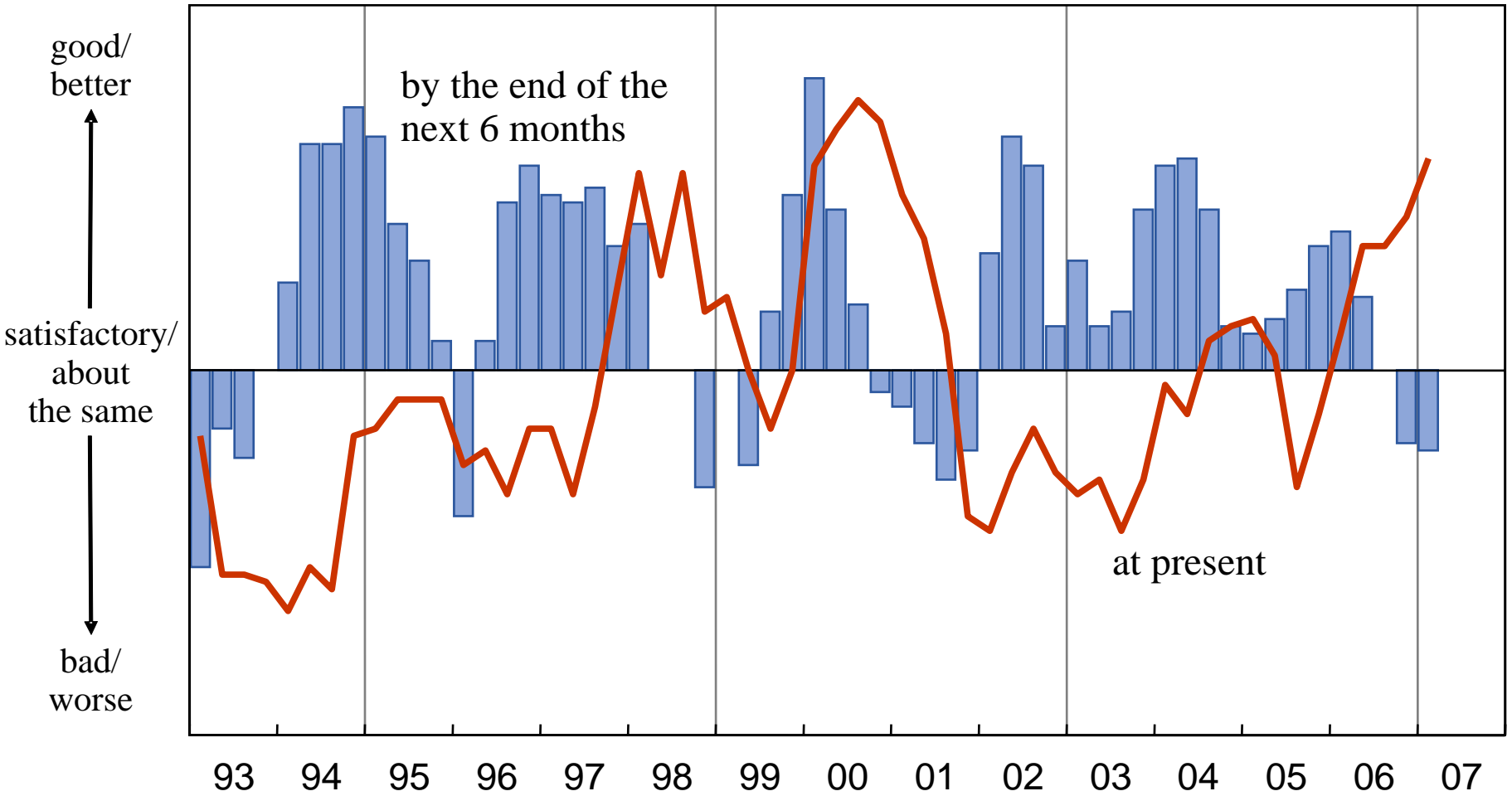
Austria

Economic situation



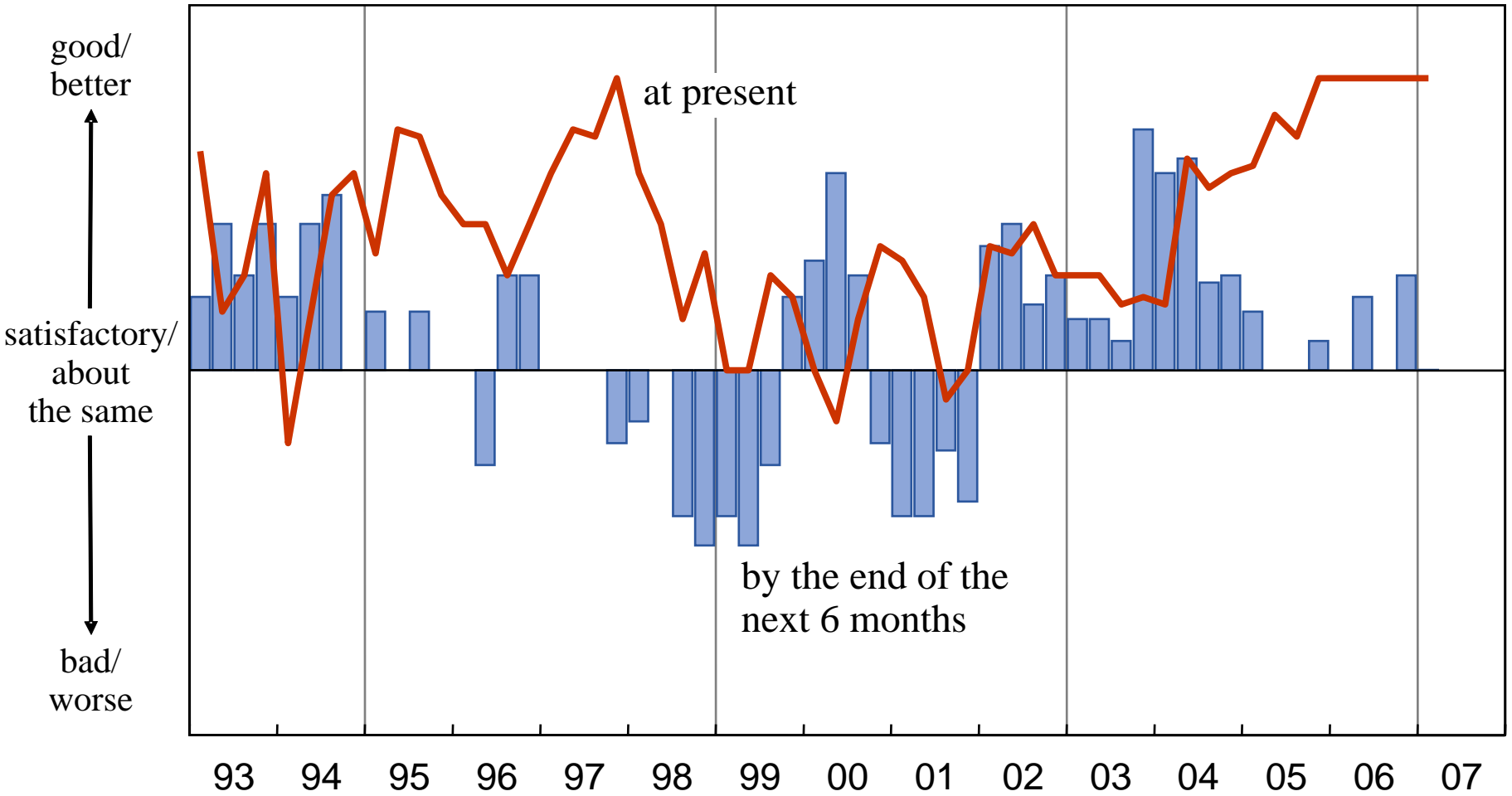
Belgium

Economic situation



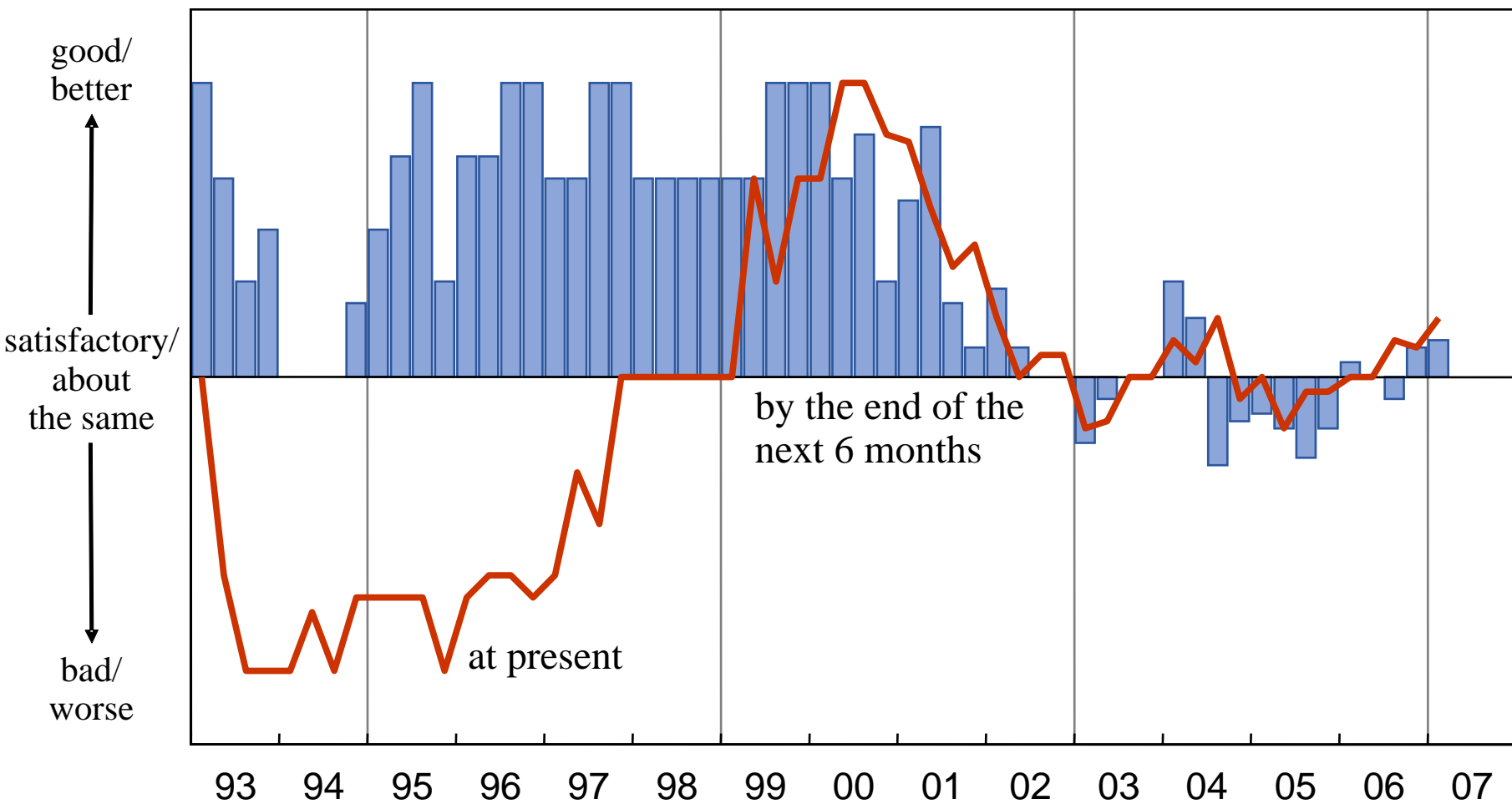
Denmark

Economic situation



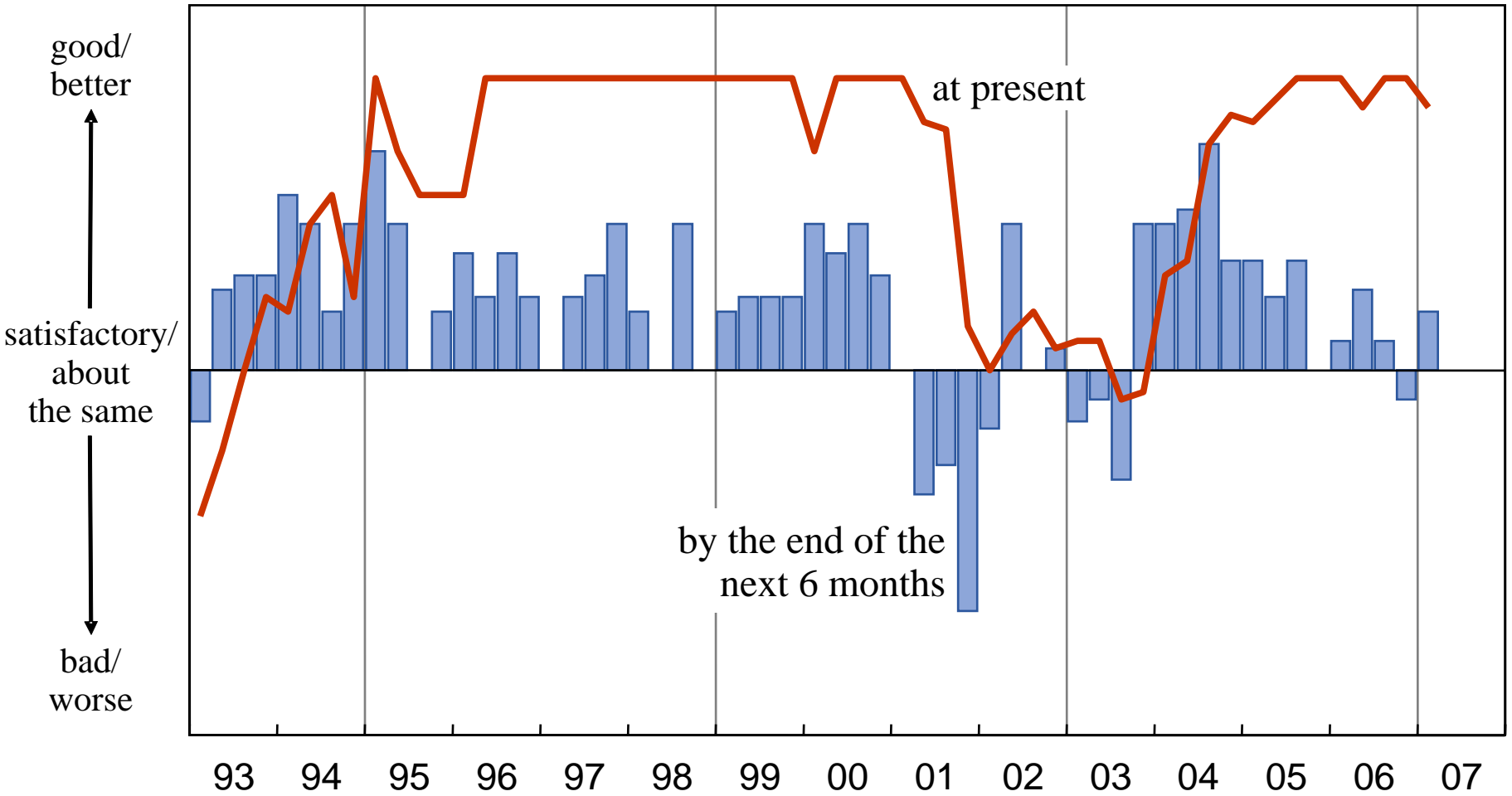
Greece

Economic situation



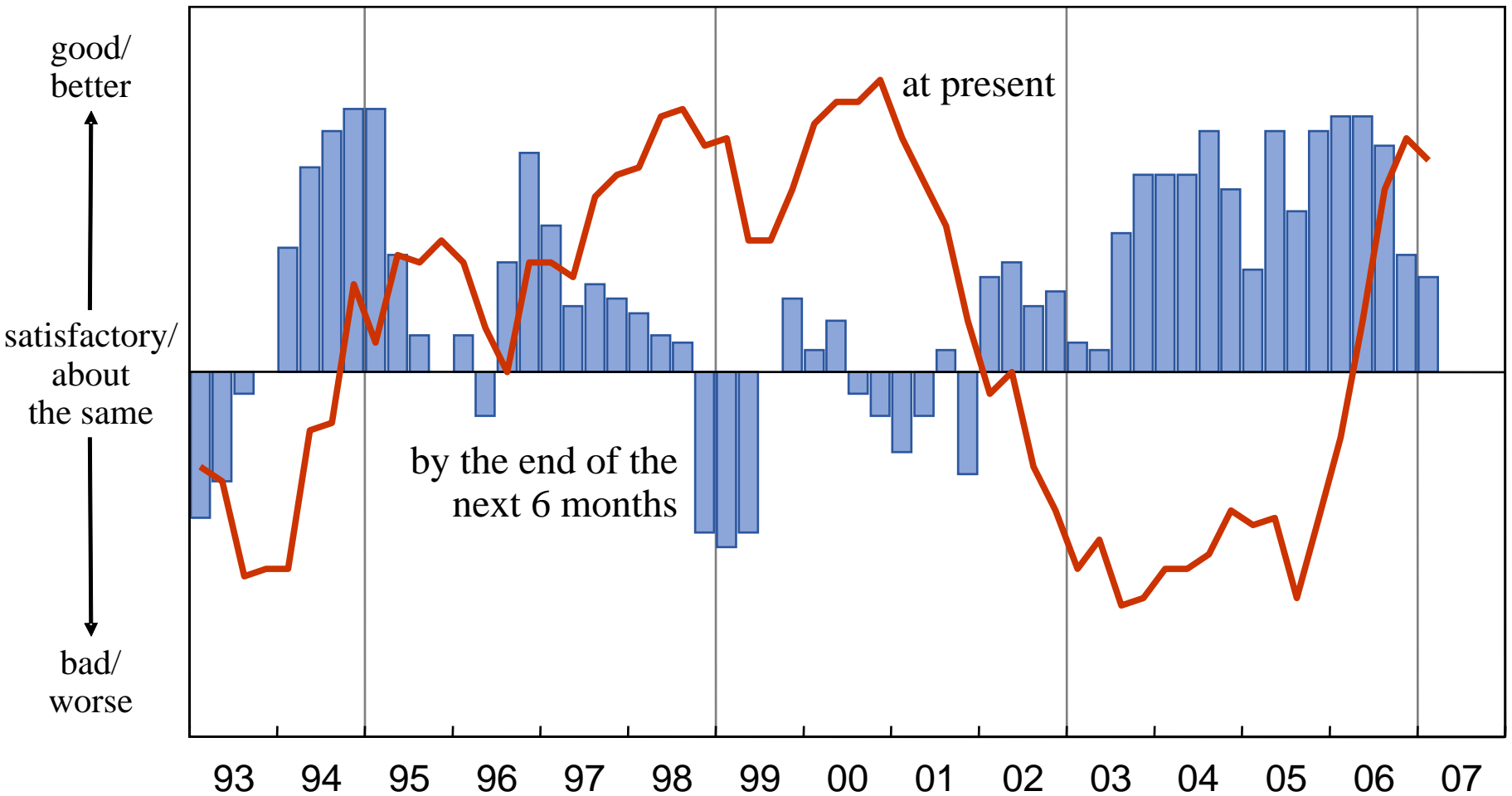
Ireland

Economic situation



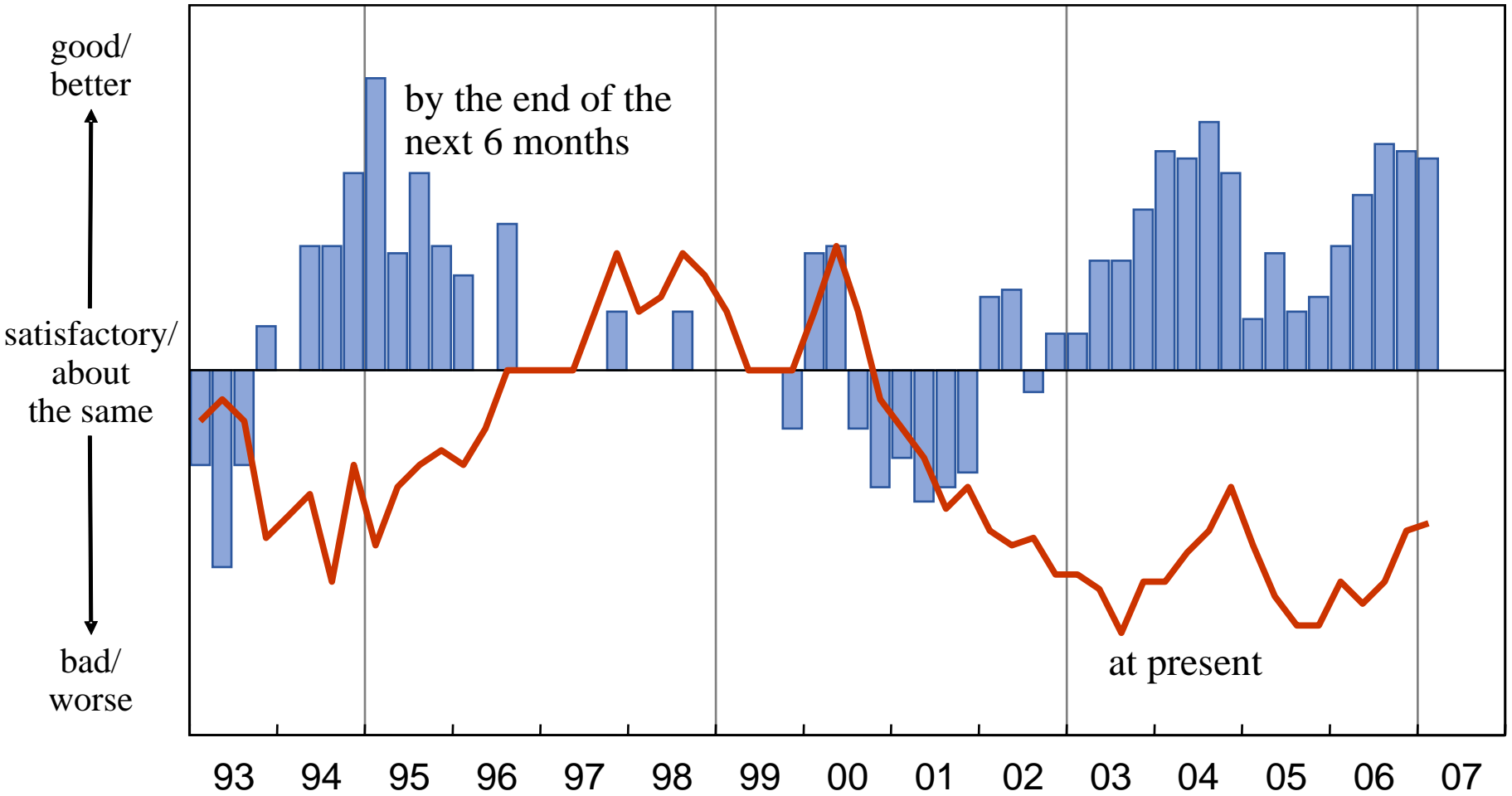
Netherlands

Economic situation



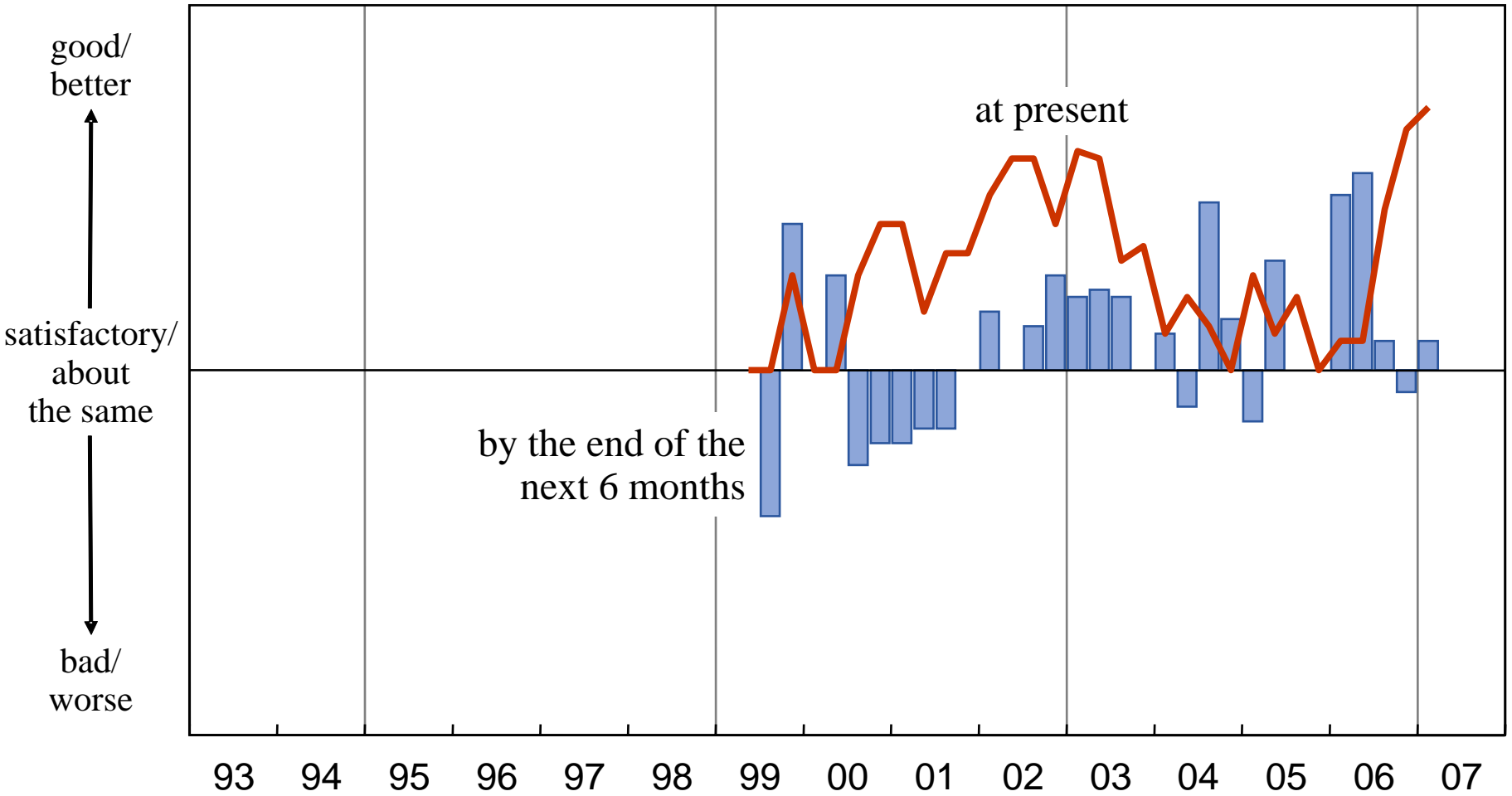
Portugal

Economic situation



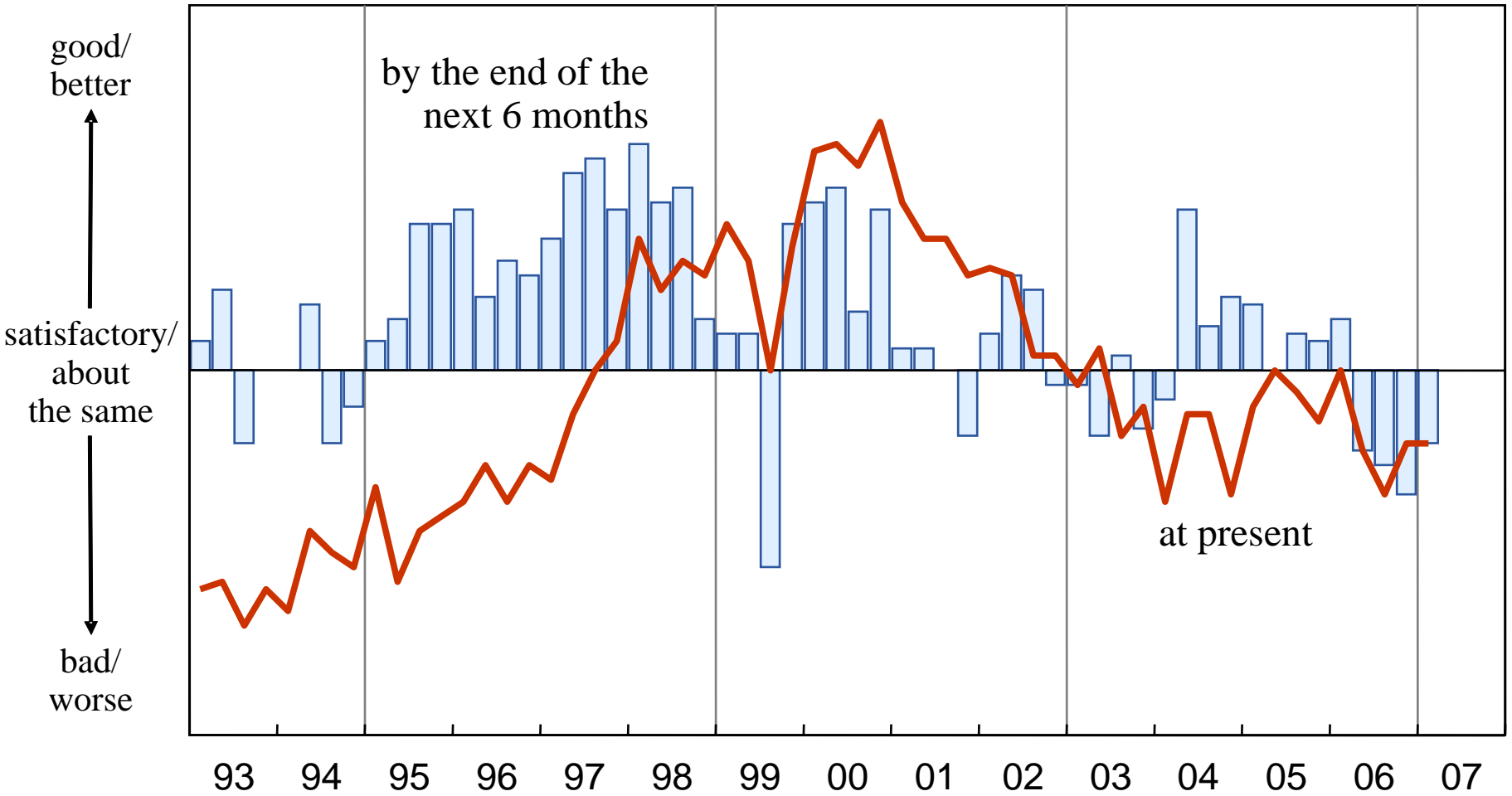
Slovenia

Economic situation



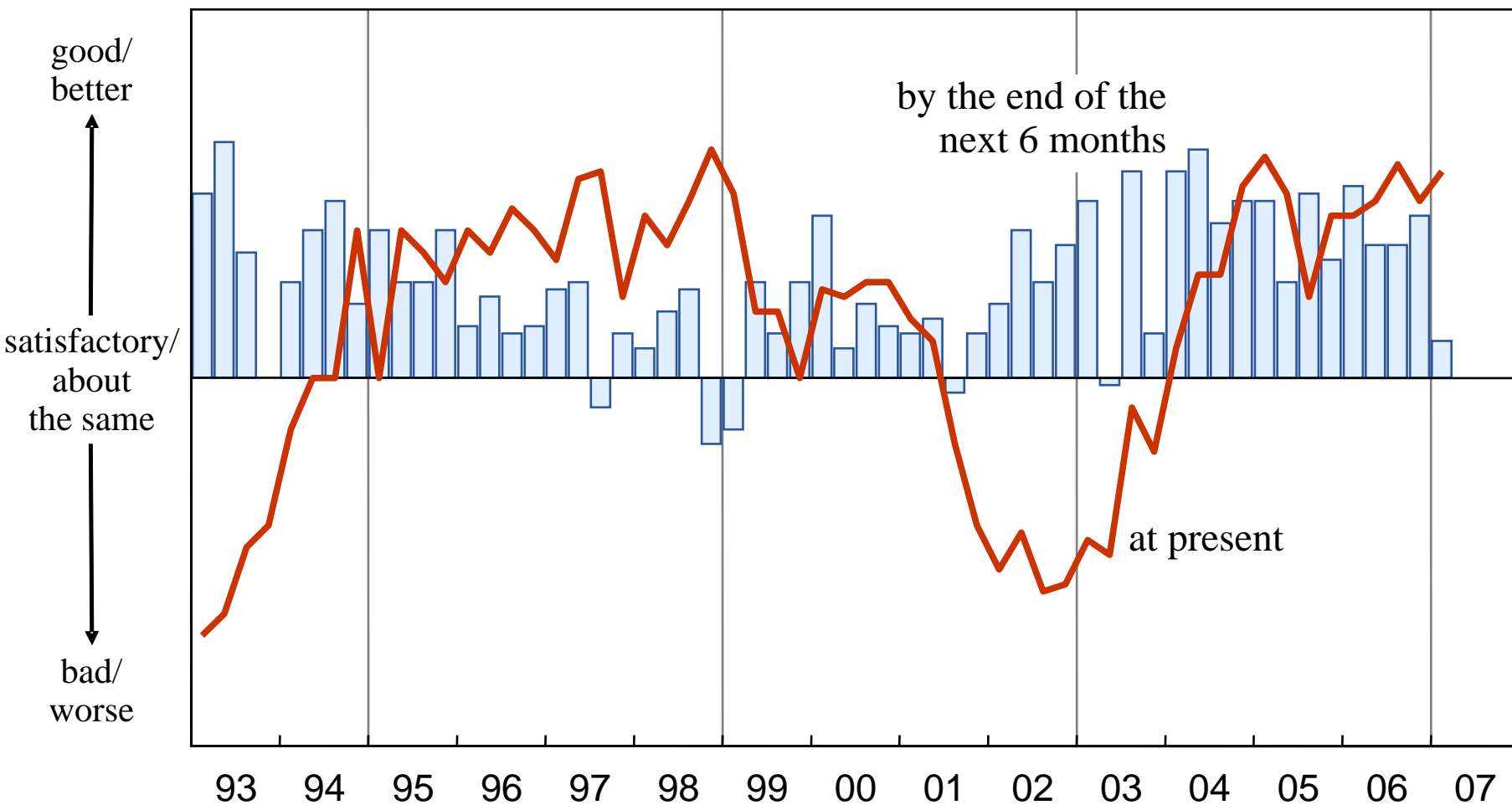
Hungary

Economic situation



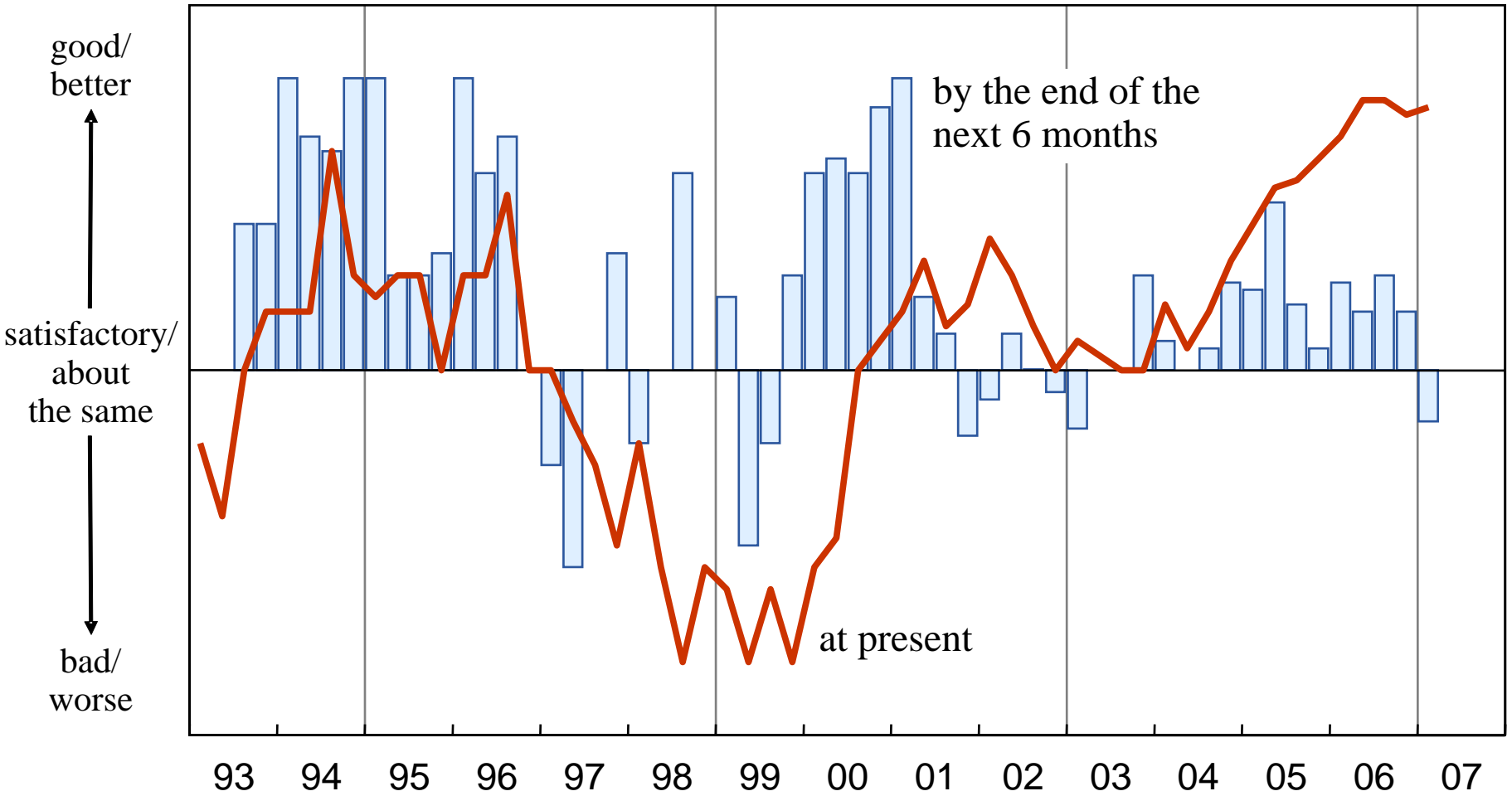
Poland

Economic situation



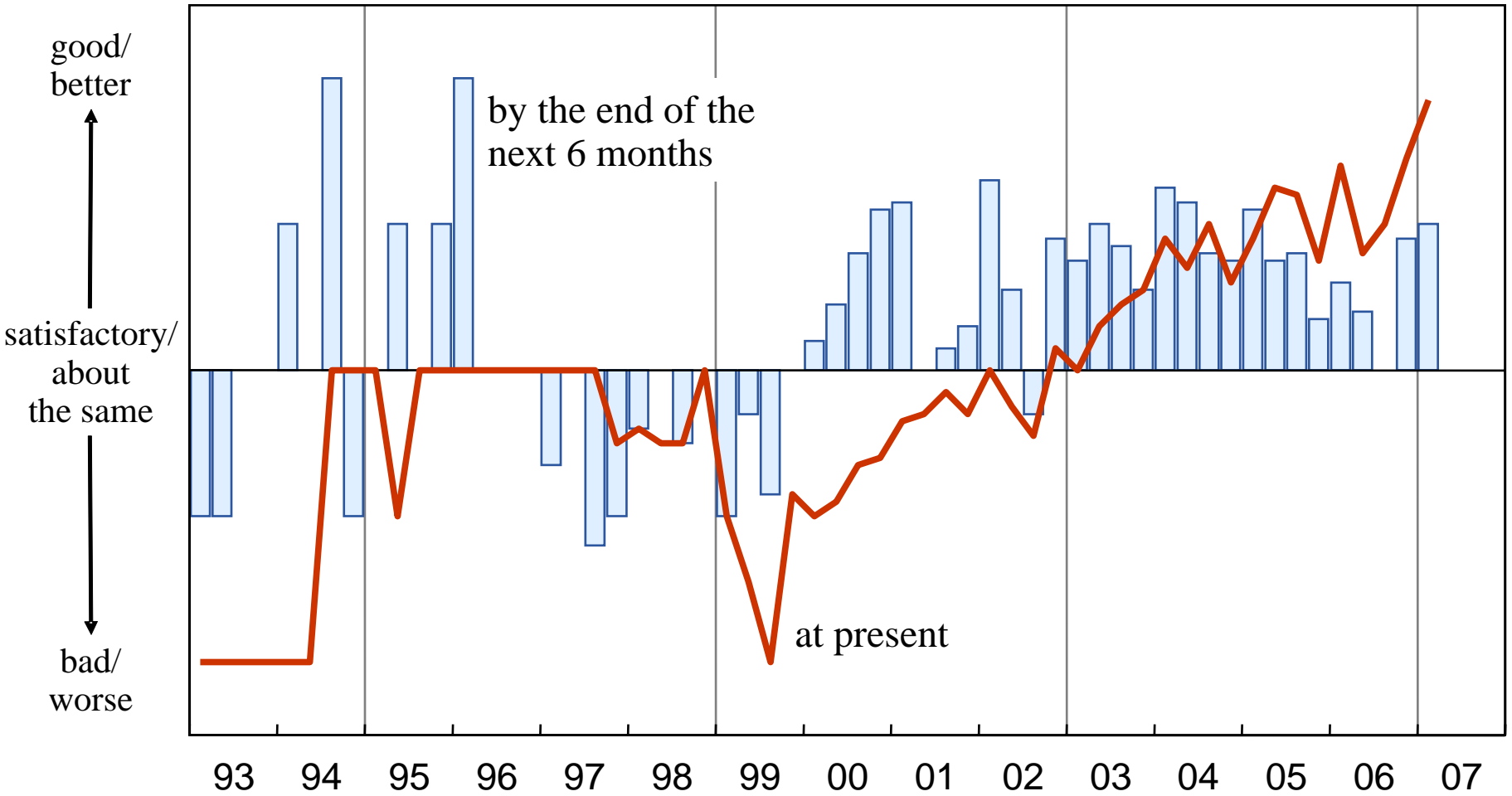
Czech Republic

Economic situation



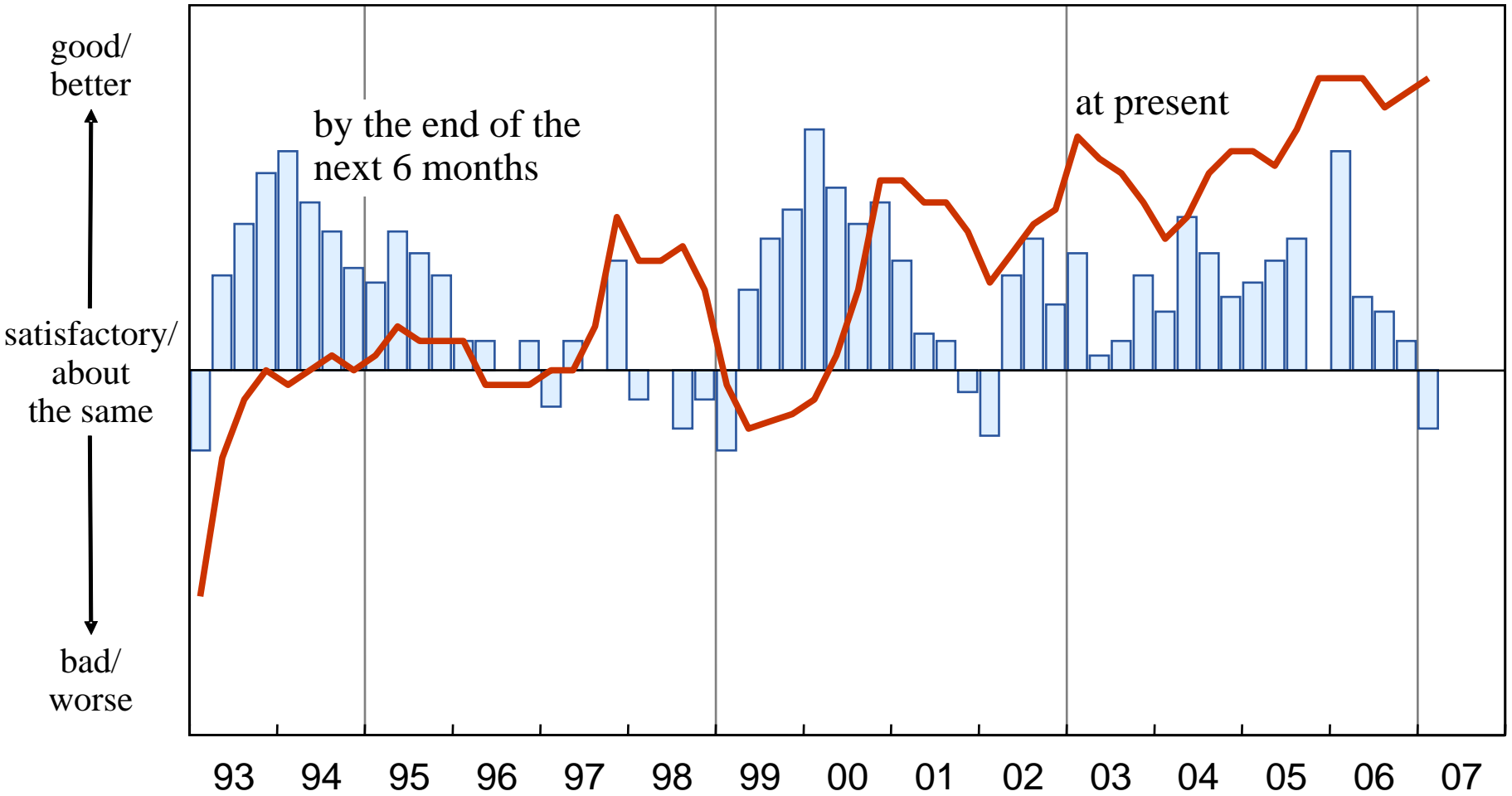
Slovak Republic

Economic situation



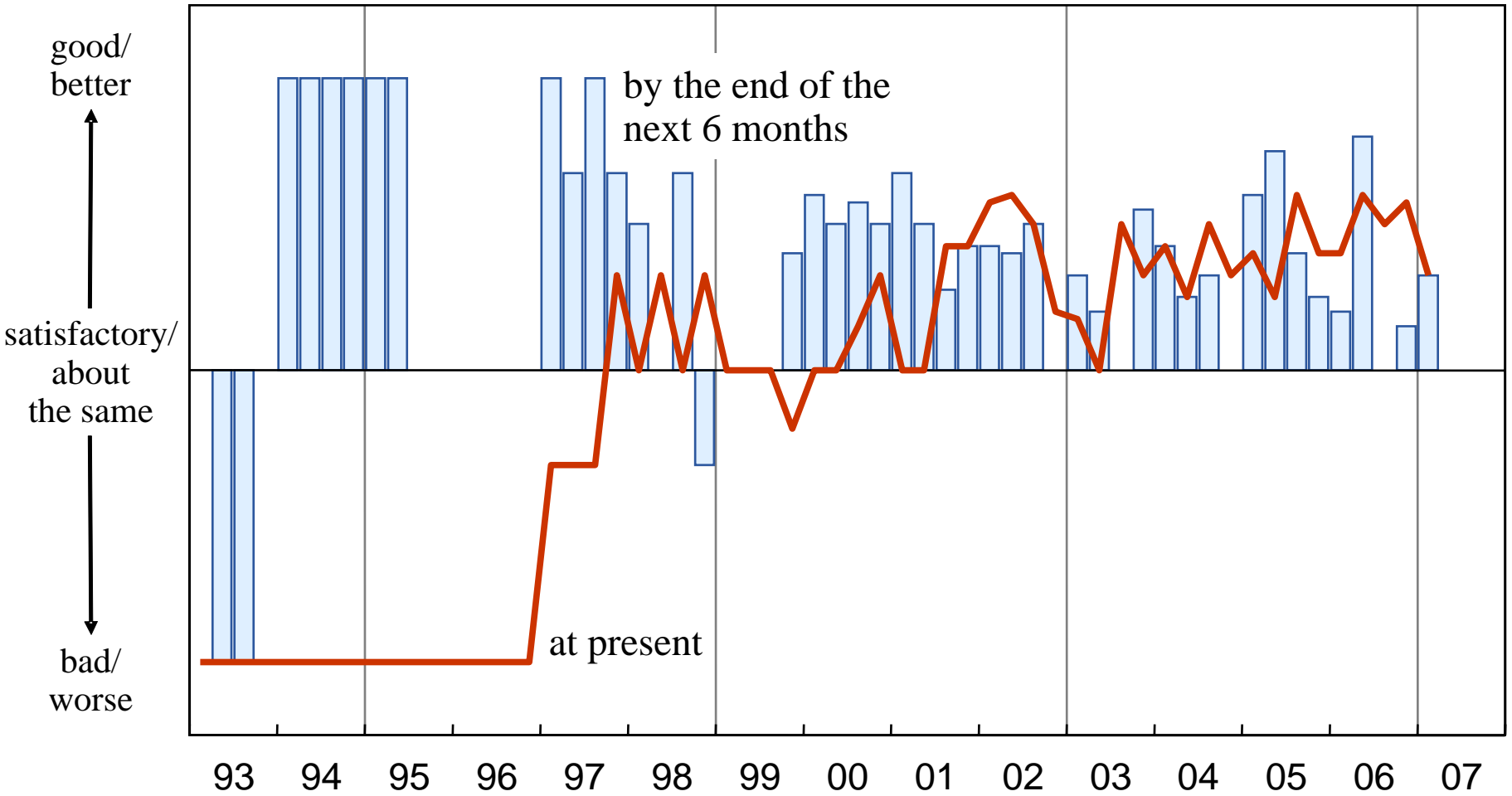
Estonia

Economic situation



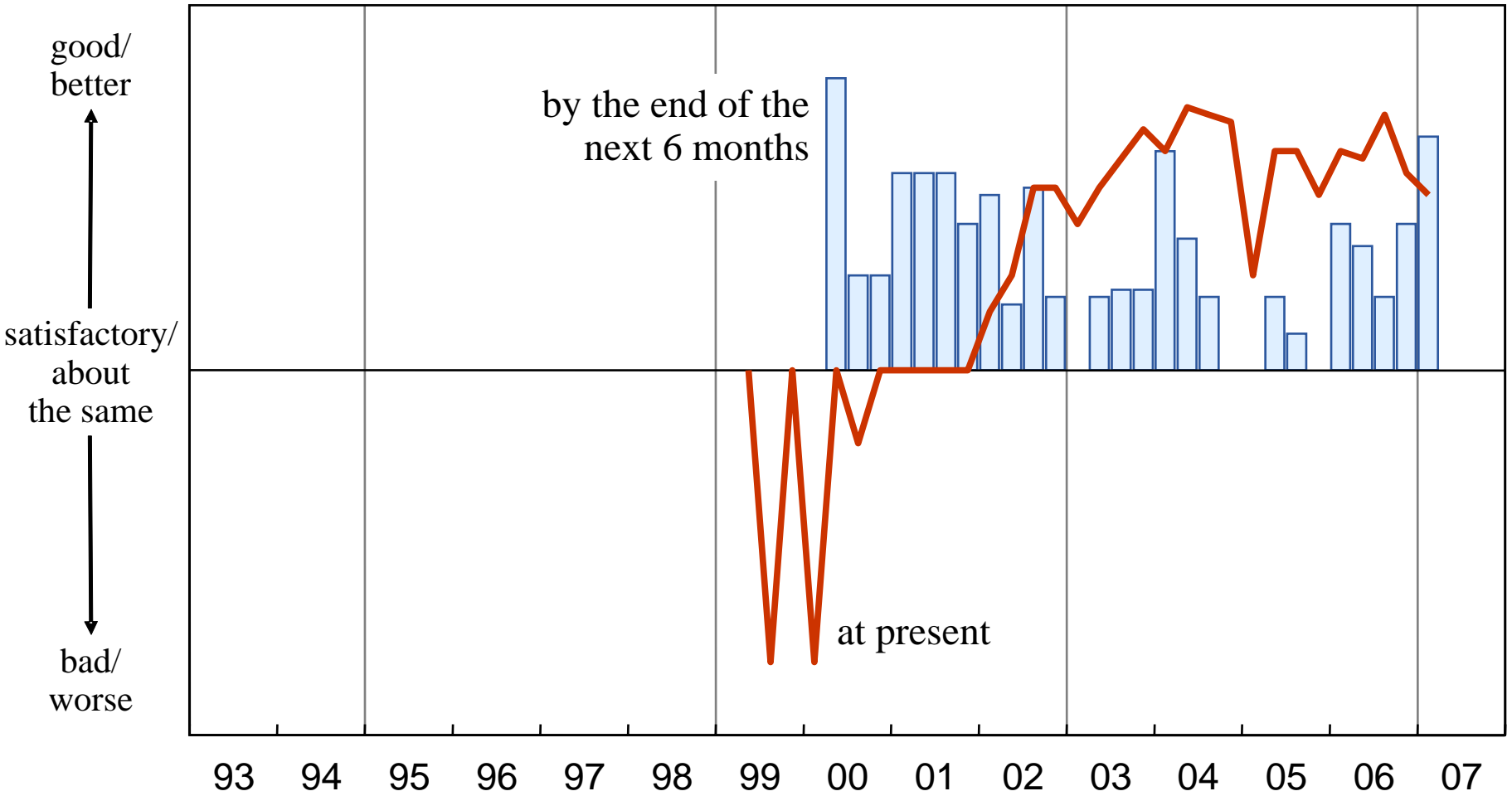
Latvia

Economic situation



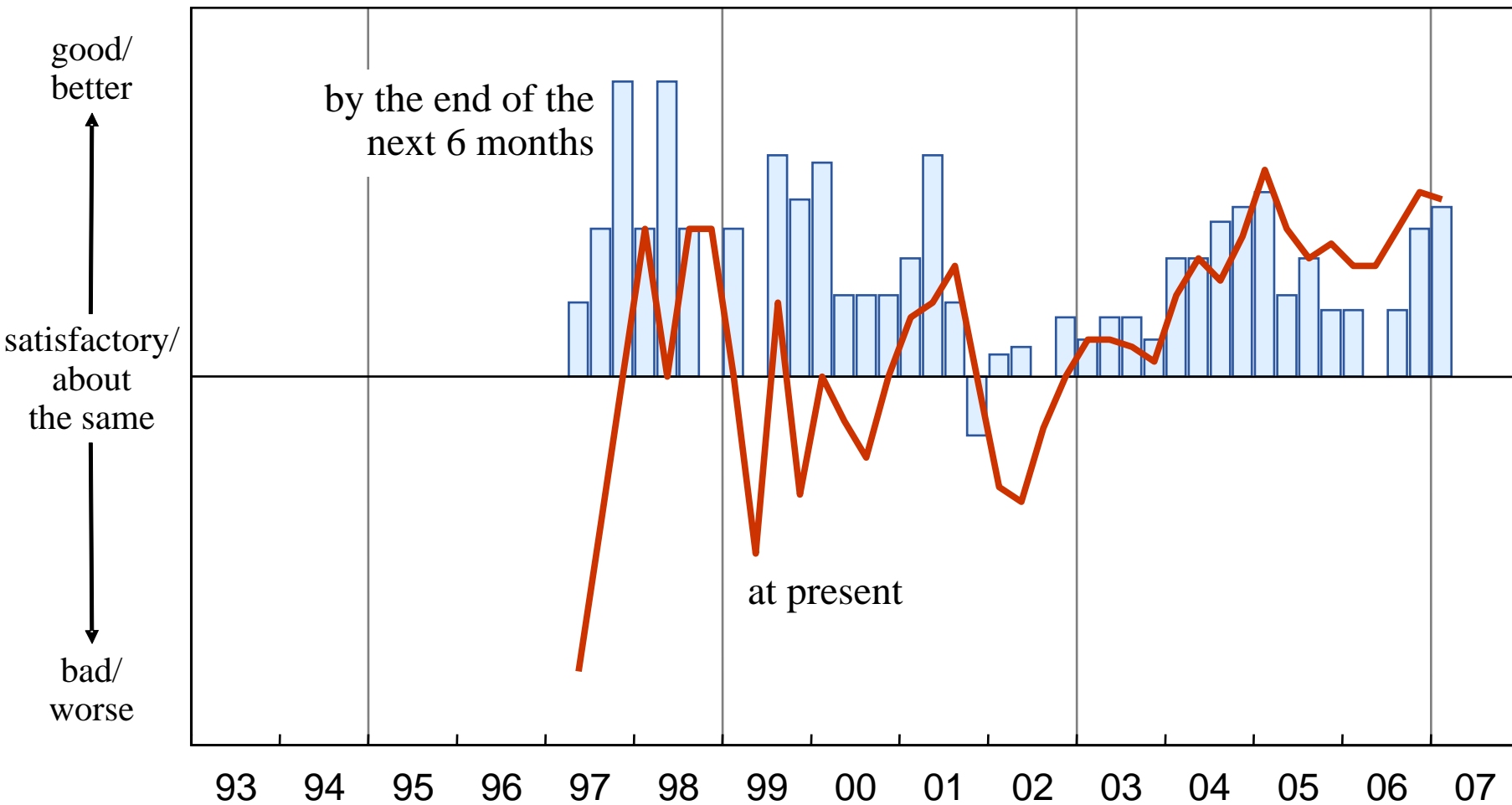
Lithuania

Economic situation



Bulgaria

Economic situation



Romania

Economic situation

