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# **The Economic Outlook in Europe**

## **In 2005-2006**

### **Summer Report**

BFP	Bruxelles
CEPREDE	Madrid
COE	Paris
CSC	Rome
KOPINT-DATORG	Budapest
OEF	Oxford
RWI	Essen

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## About the European Economic Network

The European Economic Network (EUREN) is a network of seven leading European economic institutes. EUREN was formed in 1999 to facilitate improved analysis of developments and prospects across the European economy, by developing closer links between leading economic research groups. All Euren institutes regularly publish forecasts, both on national economies and on EU and Euro zone as well.

Members of the Euren group have been co-operating in a number of ways over the three last years: meeting regularly to discuss economic developments and prospects; holding annual economic issues conferences, in Paris, to discuss major challenges for the European economic policy, contributing to joint and partner's research reports and economic outlook seminars and conferences (this includes the regular report, *La Tribune d'Euren*, <http://www.coe.ccip.fr/05/tribune.htm>), working together on economic research projects.

This is the seventh joint report on the European economic outlook. In this report Euren intends presenting a broad view on recent economic developments in the Europe as well as offering some special studies aiming to discuss key elements on a more structural basis. Euren intends to produce this report on a semi-annual basis, at mid year and at year end. Copy of the report can be downloaded from each Institute's web site. <http://www.euren-network.org>

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## EXECUTIVE SUMMARY

**World GDP grew at record highs in 2004 but .....**

World GDP grew in 2004 at its highest rate in almost thirty years. The recovery spread throughout the entire globe although wide differences in the rates of growth remained among the various areas and countries. Particularly vulnerable to oil price increases and to an appreciating currency, the euro area economies could only marginally benefit from a buoyant worldwide demand and were generally unable to develop a sustained domestic demand.

**..... global demand is now slowing down**

Following an exceptionally high performance during the first half of 2004, however, the global economy began to slow down as a consequence, in particular, of high oil and commodity prices and the US need to reduce an unsustainable trade imbalance. After increasing by 4.4%, on average, in 2004, the US economy started to decelerate significantly: the GDP annual growth rate fell from 5% in the first quarter of 2004 to 3.7% in the first quarter of 2005. East Asia's emerging and newly industrialized economies are, in particular, being affected by the US slowdown and China's so-far successful effort in cooling off its economy by gradually introducing tougher credit restrictions. Available information seems to rather univocally indicate that world demand has continued to decelerate during this first half of 2005 as well, reflecting, in particular, more moderate growth in the United States and East Asia economies. Thus, the imbalances that have been characterizing the global economy in recent years are bound to remain unsolved over the forecast period.

**Oil prices will moderate but remain high**

Sustained by a still vigorous demand, shrinking production capacity, persisting geopolitical tensions and speculative behaviour, oil prices have remained high and fluctuated at around \$53 per barrel since mid-May. We expect prices to drop only marginally in the course of this year and the

next due to a decelerating global demand and higher spare capacity. They will continue, however, to represent an, albeit limited, threat for both growth and inflation.

**The exchange rate alone won't solve US imbalances**

Our outlook for the dollar/euro exchange rate is a little more positive than in our previous report. We expect the euro to remain strong and stabilize at 1.25 dollars in 2006. While not completely excluding the risk of a further dollar depreciation we feel that a series of factors may play an important role in affecting the dollar/euro rate in the short and medium term. The FED's rather successful effort to lead the American economy towards a more moderate and balanced growth, the interest rate differential between US and euro area assets, higher US growth prospects and, finally, the outcome of the French and Dutch referendums on the EU constitution have all played, and will play, an important role in determining the euro/dollar rate.

As we have demonstrated in past reports, the dollar depreciation alone is not sufficient in correcting current account imbalances especially if the depreciation excludes, even only partially, countries such as Japan, China and other Asian countries which now accounts for a significant share of world trade and have accumulated the greatest trade surpluses with the US. It is necessary that demand picks up in Europe and Japan in order to absorb US exports and that Asian markets become more open to foreign products through both market reforms and exchange rate adjustments. The risk of a global economic downturn with the consequent introduction of protectionist measures by both Europe and the United States cannot be, otherwise, completely excluded.

**The FED's drive towards a "soft landing" will affect US trade partners**

There are now clear signs of a US economic slowdown. The FED successful effort to lead the American economy towards more moderate and balanced growth implies that both investment, which is still a driving force behind the US expansion, and consumer spending will progressively decelerate. The latter will also be affected by the expected slowdown in the house market and an only moderately expanding labour market. The consequent deceleration in American imports will have serious implications for America's trading partners, and in particular for the euro area which has been so far excessively relying on exports. Concerns about the loss of competitiveness and uncertainties regarding global demand, coupled with high oil prices, are the main causes for the deterioration of confidence among European companies which are

becoming more cautious and tend to further postpone their investment plans.

Mainly due to Germany's surprising performance, the euro area economy posted a healthy 0.5% rate of growth in the first quarter of 2005. All leading indicators, however, points to much lower growth in the second quarter. The decline in activity would reflect the delayed effects of the euro appreciation and the oil price increases. With a deteriorating international environment, the area's exports will not be able to trigger a cyclical upturn and their contribution to GDP growth is expected to remain weak or turn altogether negative as the moderate depreciation of the euro will be more than offset by the slowdown in world trade.

**Euro area domestic demand will increase only moderately**

Domestic demand is not expected to pick up decisively: household consumption and investment will grow at stronger rhythms than in 2004 but won't be able to compensate for the deceleration of exports. Consumption will remain rather subdued due to a still weak labour market and concerns over reforms. A possible stimulus to both investment and consumption may come from price developments: inflation is expected to remain quite stable or to even slightly decline. Despite a slightly weaker currency, overall wage moderation and a rather subdued demand will more than offset the upward pressure on consumer prices from recent oil price increases. Thus, although expected to remain unchanged until well into 2006, monetary policy will not provide any further stimulus to either investment or consumption since real interest rates are expected to progressively rise.

**Little stimulus from fiscal policy and the "new" SGP**

Fiscal policy is not expected to provide much stimulus in the medium term. The March reform to the Stability and Growth pact has introduced some flexibility but very few governments, especially in large countries like Germany, France and Italy, can take much advantage from it due to the size of their deficits. It is questionable, in fact, whether running large budget deficit would really be beneficial when confidence among consumers and firms is lacking and the fear that the adjustment that is delayed today will be much harder to undertake in the future. Moreover, tax cuts did not prove too effective in stimulating demand due to the limited extent of the cuts which were also often, at least partially, offset by the introduction of different, although less visible, fiscal burdens and increases in the prices of some public services.

**Is the Euro area potential growth rate still 2%?**

Euro area GDP growth will decelerate to 1.4% in 2005 to, then, rebound to 1.9% in 2006, both years below the EU Commission estimated growth potential (2%). In this regard, the Euren institutes provide three possible explanations for the gap between potential and actual GDP that has lately characterised the euro area economy: a) adverse external shocks (oil prices, exchange rate movements etc.) may have hampered growth; b) economic policy was not able to reduce the gap between potential supply and demand: that is, the ECB was not fully effective; c) finally, it is possible that potential growth in the euro area is not the estimated 2% anymore but less. The institutes conclude that the combination of the three factors can best explain why euro area growth remains below potential. It is, however, important to identify them in order to understand whether demand or supply side measures should be undertaken.

**Table 1.1 - Main features of the forecast**

(Percentage change unless otherwise indicated)				
	2003	2004	2005	2006
World trade volume (% change)	4.9	9.9	6.0	7.5
Oil price (Brent, \$/b)	28.8	38.2	47.8	45.0
<b>GDP growth</b>				
United States	3.0	4.4	3.6	3.0
Japan	1.4	2.7	1.3	1.5
<b>Euro area</b>				
ΔDP growth	0.7	1.7	1.4	1.9
Inflation (HICP)	2.1	2.1	1.9	1.7
Unemployment rate (%)	8.7	8.8	8.9	8.6
<b>United Kingdom</b>				
ΔDP growth	2.2	3.1	2.4	2.5
Inflation (HICP)	1.4	1.3	1.7	1.7
Unemployment rate (%)	3.0	2.7	2.7	2.6
<b>New EU member states</b>				
ΔDP growth	3.8	5.1	3.9	4.2
Inflation (HICP)	2.0	4.1	3.0	2.8
Unemployment rate (%)	13.6	13.5	13.2	12.9



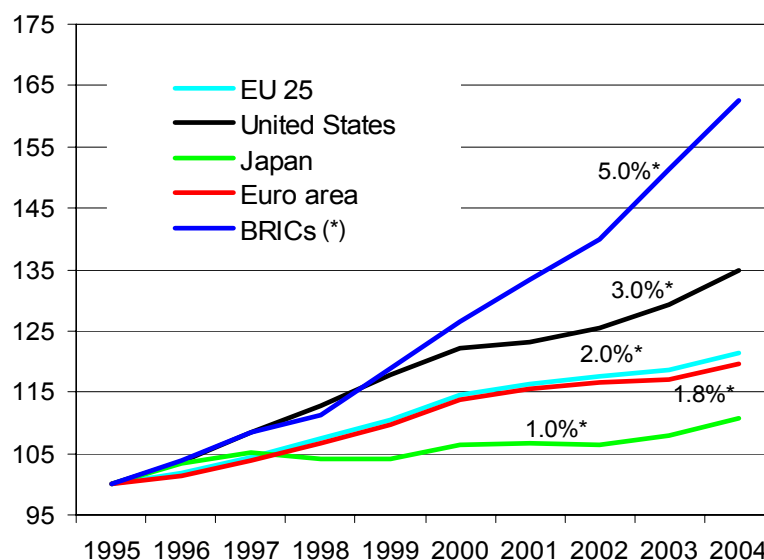
## THE INTERNATIONAL OUTLOOK

### High but uneven growth across countries

World GDP grew in 2004 at its highest rate (5.1%) in almost 30 years. This outcome was, however, the average of exceptionally high growth during the first half of the year and the significant slowdown recorded during the second one. Furthermore, like in previous years, the recovery failed to spread evenly across countries and geographical areas, thus widening the current account imbalances in the industrialized economies (Chart 2.1).

**Chart 2.1 – Growth comparisons**

(Indexes 1995=100, constant prices)



(\*) Brazil, India, China. Average growth rates from 1995 to 2004.

Source: Eurostat.

### Differences in savings rate exacerbate world imbalances

While GDP grew by 4.4% in the United States and 9.5% in China, it increased by only 1.8% in the euro area. The difference in growth rates

between the United States and other most dynamic areas of the globe and the euro area was, therefore, quite striking. At the root of these imbalances there continue to be an excessive saving rate in Japan and Europe as compared to a very low one in the United States. These saving imbalances tend, on the one hand, to support growth in the United States, by providing strong stimulus to domestic demand, but are, on the other hand, also impeding the development of independent and autonomous growth outside the US and China, and in particular in the euro area and Japan. The consequent growth gap in domestic demand between the United States on one side and Europe and Japan on the other is at the heart of the US current account deficit from which the dollar's weakness derives.

Available information on current trends provides a rather uncertain picture. If, on the one hand, there are many signs that tend to confirm that the global slowdown is continuing, persisting tensions on oil markets may indicate that the recovery is still quite strong.

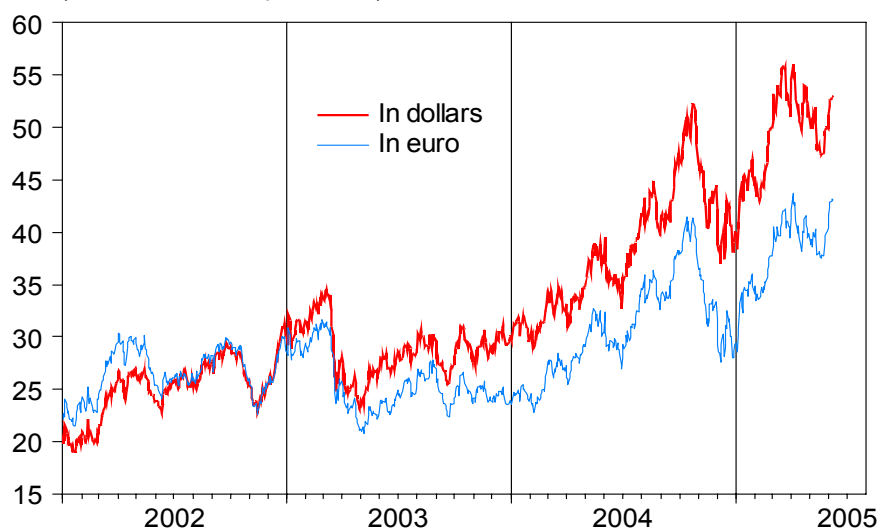
**Oil prices are bound to remain high**

At the peak of a new upward phase begun at the beginning of February, Brent prices touched the new historical record of 56 dollars per barrel at the beginning of April; after moderating somewhat to just above \$47 per barrel during the following month, prices have jumped up again to fluctuate at around 53 dollars since mid-May (Chart 2.2). This was happening in a period, between the last quarter of 2004 and the first quarter of 2005, when all available indicators were showing that the crude oil market was well supplied, with substantial equilibrium between supply and demand. Furthermore, OECD commercial stocks were at satisfactory levels at the end of 2004 and continued to rise both in Europe and in the United States.

Price increases are, therefore, due to a series of factors other than the availability or current shortage of crude: the late winter cold in the northern hemisphere, expectations for a still strong demand for oil products in the medium term, the pressure exerted on price volatility by non-commercial operators such as the hedge funds and, more recently, the pension funds, which have greatly increased their interest in oil market futures. Geopolitical tensions and bottlenecks in the oil industry make the situation worse; there is, in particular, insufficient refinery capacity, which is

expected to last. Availability of crude does not always mean, therefore, availability of refined products. Since demand is expected to remain strong for another year and to be only partly covered by increased non-OPEC production, OPEC decided in mid-April to increase its production quotas by 0.5 million barrels a day, and declared that it was ready to raise it by another 0.5 million in the case that prices would not fall by as much as expected. It should be pointed out, however, that production quotas have already been overshot for many quarters by actual production and OPEC has, moreover, accelerated its plans to expand both its short and long term extraction capacity.

**Chart 2.2 - Oil prices**  
(Dollars and euro per barrel)



Source: Thomson Financial

Prices should, however, remain high, at least in the short and medium term. According to OPEC, spare capacity, which is now at rather low levels, is expected to increase next year also due to worldwide economic slowdown. With higher spare capacity, speculation is also bound to subside. We expect prices to drop by only 4 dollars during the next three months and head for a slow and gradual decline during the entire 2006, settling at 47.8 dollars, on average, in 2005 and at 45.0 dollars in 2006. In our current scenario, we expect prices to be approximately \$5 higher than in our December 2004 forecast.

**US monetary policy aims at a “normal” interest rate**

The Federal Reserve has progressively raised the interest rate on *federal funds* from 1% in mid-2003 to the current 3%. US monetary policy is clearly aimed at gradually normalizing interest rates in order to “cool off” the rhythm of expansion of the economy and keep inflation under control. Since the interest rate on *federal funds* is still well below its long-run real rate (the average rate observed in the last thirty years) the FED move towards what is now called a “normal” rate is expected to lead to a more restrictive monetary policy during the course of this year and the next. We expect, therefore, that the key rate will continue to gradually increase in the months ahead by 25 basis points each quarter to reach 3.75% by the end of this year and 4.5% by the end of 2006.

The long-term rates have so far remained remarkably low. Considering the prolonged period of strong economic expansion it is quite surprising that they have remained so low for so long. The massive buying of government bonds by foreign central banks (China and Japan in particular) certainly contributed to keep long-term rates low as did the corporate scandals which made government bonds much more attractive than corporate bonds. We presume that price expectations, a main determinant of future rates, have also played a major role as it is also probable that the expected productivity gains from massive introduction of ICT technology into the production system may have been largely anticipated by the markets. The effects of higher oil prices on consumer prices and the return to more normal rates of productivity growth are bound to gradually affect long term rates. We expect rates on 10-year government bonds to progressively rise during the forecast horizon to average 4.5% and 5.3% in 2005 and 2006, respectively.

**The €/\$ rate stabilizes but....**

The dollar has recently appreciated with respect to the euro, also as result of the French and Dutch referendums on the EU constitution. It now seems to have stabilized in the range 1.20/1.25 per euro, but its underlying weakness could still lead to further devaluations. In any case, the most significant repercussions of the dollar depreciation in recent years have fallen on the euro.

**Table 2.1 Exogeneous and international variables**

(Percentage changes unless otherwise indicated)

	2003	2004	2005	2006
World trade volume (% change)	4.9	9.9	6.0	7.5
<b>United States</b>				
GDP	3.0	4.4	3.6	3.0
3m interest rates	1.2	1.6	3.3	4.5
10y Gvt bond yield	4.0	4.3	4.5	5.3
<b>Japan</b>				
GDP	1.4	2.7	1.3	1.5
3m interest rates	0.06	0.05	0.10	0.10
10y Gvt bond yield	0.99	1.49	1.33	1.48
<b>US dollar/euro</b>				
US dollar/euro	1.13	1.24	1.29	1.25
<b>Yen/US dollar</b>				
Yen/US dollar	115.9	108.2	106.4	108.0
<b>Oil price (Brent, \$/barrel)</b>				
Oil price (Brent, \$/barrel)	28.8	38.2	47.8	45.0
<b>Percentage changes</b>				
Percentage changes	14.6	32.8	25.1	-5.9

*Source: IMF, OECD, EUREN forecasts for 2005 and 2006.*

Since the beginning of 2002, while depreciating by more than one third vis-à-vis the euro and around one quarter vis-à-vis the British pound, the dollar dropped by much less with respect to several Asian currencies as the comparison between the dollar trade-weighted exchange rate and the euro/dollar rate demonstrates (Chart 2.3). In particular, the exchange rate of the American dollar with respect to the Chinese currency has remained constant. The dollar depreciation would be certainly more effective in correcting US imbalances if the burden of the adjustment is more fairly shared among currencies. Furthermore, we feel that if the exchange rate were to be the only instrument for correcting global trade imbalances, a much stronger devaluation of the dollar than the one seen so far would be needed with the real risk of a sharp recession in both the euro area and

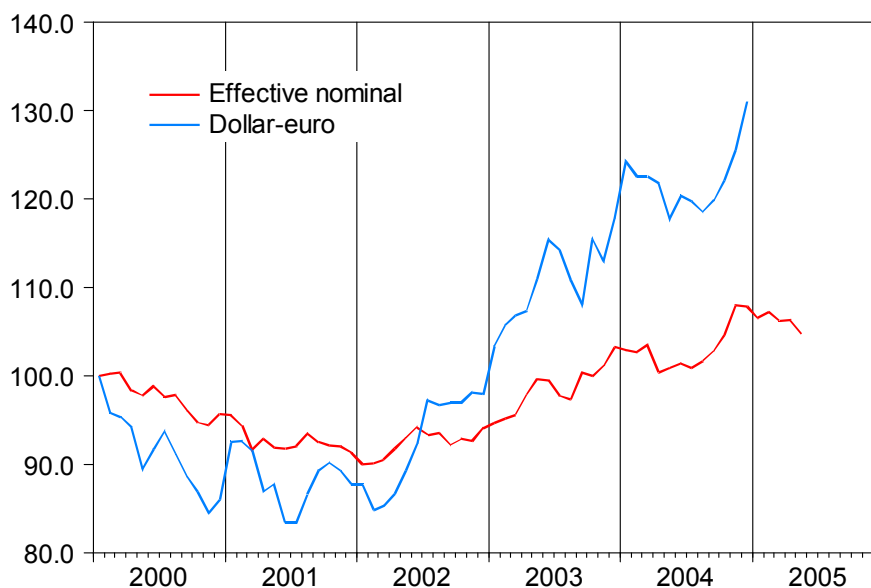
the United States as well; appropriate economic policies aimed at stimulating Europe's and East Asia's domestic demand would, instead, be needed.

..... at a rather high level

In our forecast horizon the dollar would slightly appreciate with respect to the euro to stabilize at 1.25 per euro, on average, in 2006. We believe that while in the long term the most relevant element in the evolution of the dollar/euro exchange rate remains the US trade deficit, which, in our forecast is not expected to significantly improve, other factors, such as interest rate differentials, the economy's growth prospects, improvements in the US budget deficit and the recent uncertainties over European Union political developments will play a greater role in determining the short and medium term trend in the dollar exchange rate.

**Chart 2.3 - Dollar's exchange rates**

(Indexes: January 2000=100)



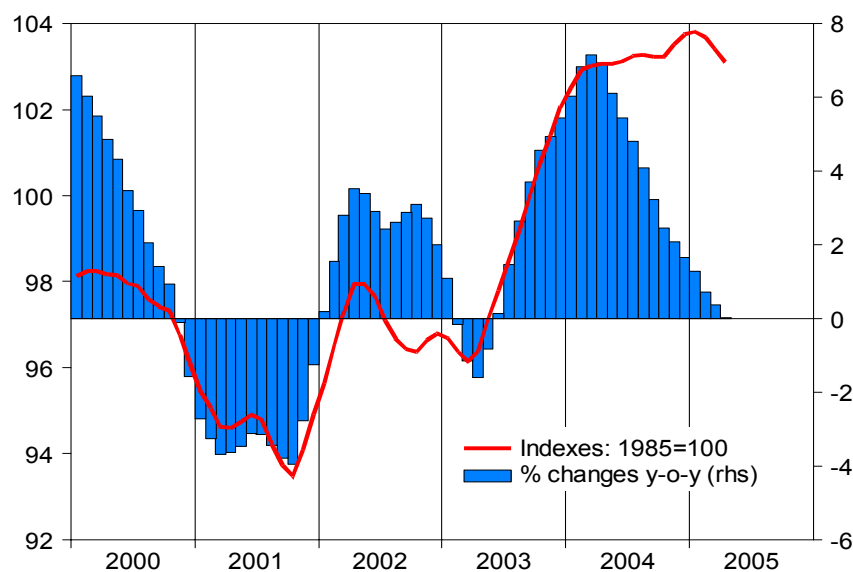
Source: Thomson Financial.

**The OECD indicator reflects the current slowdown**

The OECD composite leading indicator, a good measure of current economic activity in the advanced economies, which had been rapidly rising since April 2003 anticipating the strong recovery that was then recorded in the first half of 2004, began to flatten out at the beginning of

the year and has recently declined for three consecutive months (Chart 2.4). Its annual percentage variations indicate a gradual and steady deceleration since March 2004 suggesting that the peak in the current economic cycle may have well past, indeed.

**Chart 2.4 - OECD composite leading indicator**

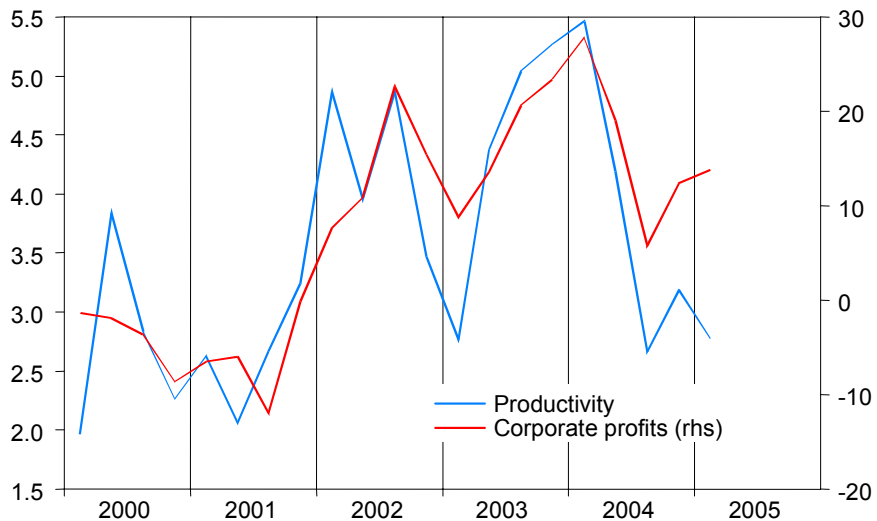


*Source: Thomson Financial*

**Lower but more balanced growth in the US**

In the United States, the slowdown recorded in mid-2004 proved to be only temporary and economic activity began to expand again at a sustained pace. According to national accounts revised preliminary estimates, GDP increased at an annualised rate of 3.7% during the first quarter of 2005. Stimulated by the positive trend in both the stock and real estate markets and by incentives in the auto sector, household consumption continue to provide the main contribution to growth, which is now more balanced among the various demand components. Business investments provided an important contribution, sustained by the good performance of corporate profits and increases in productivity (Chart 2.5). Firms proceeded to replenish their stocks which had been severely depleted during the third quarter of last year, contributing 0.8 percentage points to growth.

**Chart 2.5 - United States: corporate profits and productivity**  
(Y-o-y % changes)



Source : Thomson Financial.

The manufacturing sector starts showing some signs of weakness, probably reflecting both lower domestic and foreign demand. In April, industrial production dropped by 0.2% with respect to the previous month, reflecting, in particular, a rather weak auto sector. The situation in the labour market is improving, albeit at a lower pace than expected. In May, the unemployment rate settled at 5.1%, the lowest level since September 2001, but payroll employment, a much more reliable indicator of labour market conditions, rose only by a disappointing 78,000 units, most of them in services. Employment in the manufacturing sector, however, dropped slightly. This could have influenced the recent trend in consumer confidence. The Conference Board leading indicator declined in April for the fourth consecutive month in a row, suggesting that consumers continue to worry not only about the modest increase in new job opportunities, but also about price hikes due to oil increases.

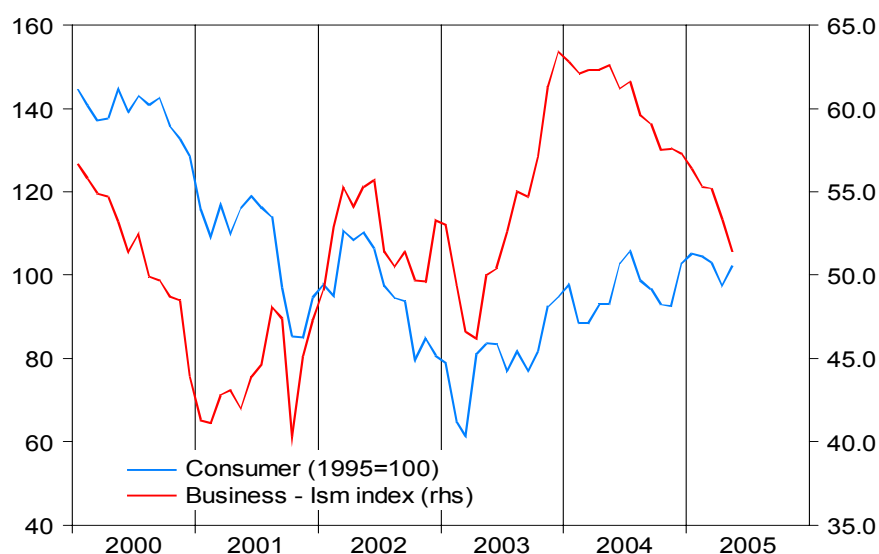
**Business confidence reflects current uncertainties**

Analogous signs of tension originate from the business confidence indicator calculated by the Institute of Supply Management (ISM), which has been declining for almost a year. Although reflecting, above all, greater difficulties due to the rise in interest rates, its trend could simply indicate that the economic activity is returning to rates of growth more



compatible with the economy's fundamentals. In May, the ISM indicator settled at 51.4, still above the threshold that separates the phases of economic expansion from those of recession (50 points) and should remain around these levels during the next months (Chart 2.6).

**Chart 2.6 - United States: business and consumer confidence**



Source: Thomson Financial.

**The trade deficit continues to widen**

Despite the dollar weakness, the American trade deficit continues to widen (it reached 5.7% of GDP in 2004). The slight improvement seen in the latest trade figures may, however, indicate that a partial adjustment of the trade imbalance may be under way. It is possible that prices adjust before quantities because of frictions and delays in re-directing trade flows and that, therefore, the improvement in the foreign accounts will start to take place in coming months. It is evident, nevertheless, that a correction of the trade deficit based only on the dollar exchange rate would require a devaluation of unlikely proportions especially in a situation of relative rigidity of some Asian currencies. An appreciation of the East Asia currencies especially the chinese renminbi, by reducing the pressures on the euro would result in a more equitable sharing of the adjustment burden and is therefore highly desirable. It should be clear, however, that a sustainable correction of the current account imbalances depends ultimately on a greater absorption of US products by other areas of the

globe, which in turn implies higher growth in Europe and greater openness to foreign imports by Asia.

**Domestic demand  
contribution to growth  
still significant**

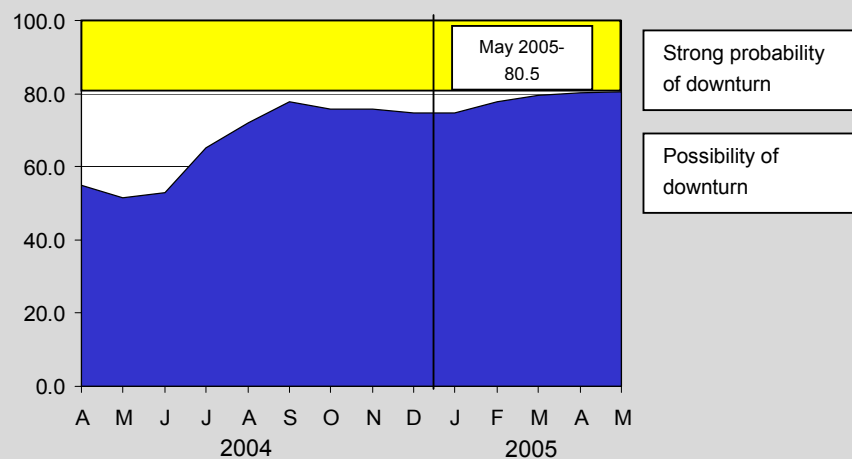
Growth in the United States will continue to depend on domestic demand as the contribution of net exports will remain negative despite the substantial depreciation of the real effective exchange rate of the dollar. The correction of the trade imbalance will also require an increase in the savings rate with the consequent slowdown in domestic demand. By limiting domestic consumer credit, the FED's monetary policy decisions are, indeed, aimed at this objective.

Consumption will continue to provide the main contribution to GDP growth in both 2005 and 2006 but at much lower rates than in the past. Due to a persisting weakness in the labour market, incomes are, in fact, expected to grow only moderately and the effects of oil price and interest rate increases are likely to affect consumer spending. Investment should pick up and expand at rather sustained rates due to still good prospects on profits, improved firms balance sheets and the continuation of a rather accommodative monetary policy.

The outlook outlined above suggests that the United States should grow at more moderate rates during 2005 and 2006, even if significantly above those of the other major advanced economies. GDP should increase by 3.6% this year and 3.0% the following year. The eventuality that an abrupt correction of the imbalances described above would take place, with the risk that investors move away from their dollar assets, is unlikely but cannot be altogether excluded.

### Box 2.1 The COE leading indicator for the United States

The COE leading indicator for the United States is used to anticipate the next downturn. Since April 2005, the index has climbed over the 80 threshold, which indicates a strong probability of an economic downturn within the next three months. It means that the year-on-year growth rate would come back under the trend growth rate estimated at 3% today, probably during the second semester of 2005. Four components have already turned upside down: the Conference Board's Consumer Confidence expectations Index, the Manufacturing ISM index, inventories of manufactured goods and interest rate spread. We have now to focus on the two components, which haven't given a signal yet: the privately-owned housing units authorised by building permits and the Standart & poor's Index. A further good orientation of those two components could asset the theory of a « soft patch ».



### Japan's economic weakness seems over.....

Despite the worsening of the economic picture, Japanese GDP posted a healthy 2.7% increase in 2004, due to the carry-over effect from 2003 and the good performance recorded in the first quarter. According to revised national accounts data, during the first quarter of 2005, Japanese GDP increased by 1.2% with respect to the previous quarter. The result followed the mild increase (0.1%) recorded in the fourth quarter of last year, which had interrupted the technical recession of mid-2004 (Chart 2.7). The economy's weakness of last year seems, therefore, to have ended. Private consumption contributed the most to GDP expansion (0.6%) but private non-residential investment also significantly contributed

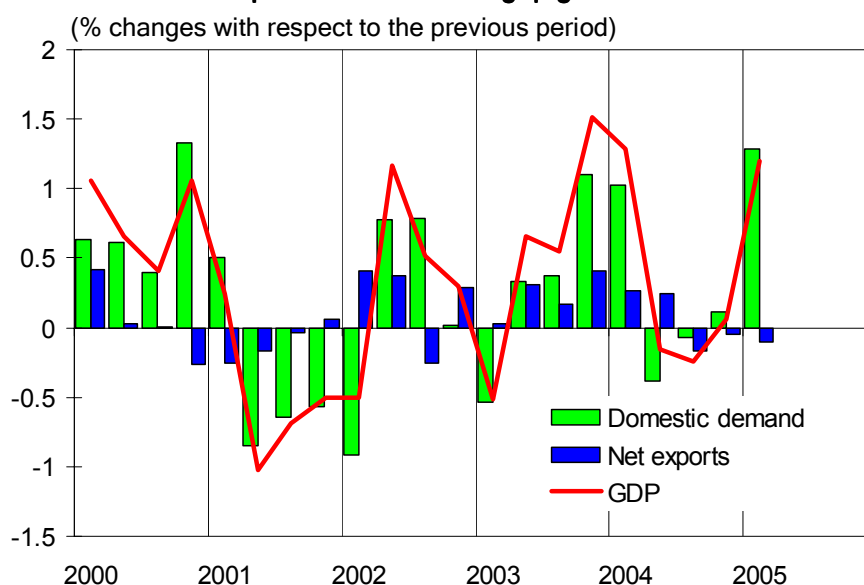
to GDP growth. The foreign sector continued to be a drag on growth and its contribution was negative for the second consecutive quarter (-0.1%).

Confidence among major manufacturing firms collapsed in March (Tankan survey) reflecting the current weakness of the Japanese economy. It should be noted, however, that, in the January-February period, the aggregate index on sales elaborated by the Bank of Japan recorded a notable increase, while, in March, exports started to accelerate again after three consecutive months of decline.

**.....but growth will be moderate**

Although the economy is expected to expand at only moderate rates in the coming quarters, the first quarter result will positively influence the average GDP figure for 2005. We expect GDP to rise modestly, at 1.3% and 1.5% respectively, well below the 2004 rate, both this year and the next. Uncertainty regarding the foreign sector, linked to the evolution of the international economy, should be counterbalanced by the consolidation of the domestic demand. Private consumption should, in fact, continue to mildly rise in the course of the year thanks to improvements in the labour market (full-time employment started to increase again), while private investments will continue to be sustained by the rise in business profits.

**Chart 2.7 - Japan: contribution to gdp growth**



**East Asia economies affected by the slowdown in the US and Europe**

The emerging Asian economies recorded a growth rate of 7.8% in 2004, the highest rhythm of expansion since the 1997-1998 financial crisis. During the second part of last year, however, economic activity in numerous countries of this area slowed down considerably, partly as a result of a physiological comeback toward more sustainable growth. Among the other factors that have influenced this deceleration the following are particularly important: the slowdown in foreign demand or the difficulties of the main commercial partners of the Asian economies (United States and Europe), the increase in oil prices and the slowdown in the semiconductors market. Overall, the economic impact of the tsunami in the south-eastern part of the region has been limited: for one thing, in fact, the weight of the stricken areas on total output is rather modest and, for the other, the opportunities created by the reconstruction activities have offset part of the adverse effects.

**Credit tightening will continue in China**

In China, GDP continued to post very high rates of growth. In terms of demand composition, the slight deceleration in investments has been compensated for by the acceleration in exports. To this point, the manoeuvres aimed at avoiding an excessive “overheating” of the economy don't seem to have had any effect. Even if the rate of consumer price inflation is not worrisome yet, upward pressures can come, above all, from wage increases and excess demand in the energy sector. Given the current phase in the Chinese economic cycle, monetary policy should become even more restrictive during the year, thus contributing to bringing the rate of economic expansion towards more moderate rhythms of growth and facilitating the possible transition toward a more flexible exchange rate regime.

In 2005, the rate of growth of the emerging Asian economies, including China, should slow down to 4%, to, then, return to grow at more sustained rhythms during the following year.

World trade growth averaged 9.9% in 2004, reflecting the buoyancy of East Asia and most other emerging countries' markets and the strong expansion of the United States economy. Approximately one fifth of the 2004 world trade growth was due to higher Chinese imports, increased by 36%, and reflects the positive impact of the country's accession to the

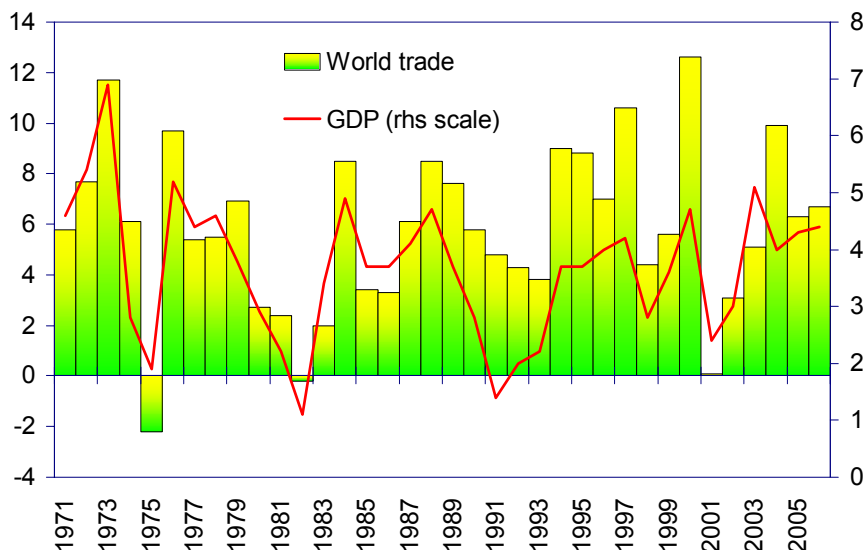
WTO and its rapidly rising consumption and investment demand on global trade.

Reflecting the growth trends in the major economic areas and countries, world trade began to slow down during the second half of 2004 from a 12% annual rate of increase in the second quarter of 2004 to 4% in the last quarter of the year (Chart 2.8). It should have slowed down even further during the first quarter of 2005 due, in particular, to strong decelerations and, sometimes, contractions in European and Japanese growth rates.

**World trade will significantly Slow down**

The expected slowdown in the US and Chinese economies, coupled with more moderate growth in Europe, should be reflected in lower world trade growth in 2005 (+6.0%). Both economies will have to undergo, in fact, heavy external and domestic adjustments which are expected to cool off economic activity. Both the United States and China should, however, continue to provide the greatest contribution to world trade in the following year as well when it will rise by 7.5%.

**Chart 2.8 - GDP and world trade (% changes)**



Source: Thomson Financial, 2005-2006: GDP OECD Economic Outlook; World trade Euren forecasts.

## THE OUTLOOK IN EUROPE

### 3.1 RECENT DEVELOPMENTS IN THE EURO AREA ECONOMY

**Economic growth slowed down in 2004 H2,..**

Economic activity in the euro area picked up around mid-2003, after three quarters of stagnation, and continued to grow at a healthy pace (average qoq growth of 0.5%) in the next 4 quarters. Since mid-2004, however, euro area economic growth slowed down considerably to 0.3% in the third quarter of 2004 and to 0.2% in the fourth quarter, mainly due to a deceleration in export growth (in turn caused by a slowdown in world trade growth, high oil prices and the appreciation of the euro). In 2004 as a whole eurozone GDP grew by 1.7%, with the strongest contributions coming from private consumption (+0.7 percentage points) and government consumption (+0.5 percentage points). Investment contributed only slightly to economic growth (+0.3 percentage points), which was disappointing as investment growth was negative or very weak in the 3 previous years. Finally, both net exports and stocks contributed 0.1 percentage points to economic growth in 2004.

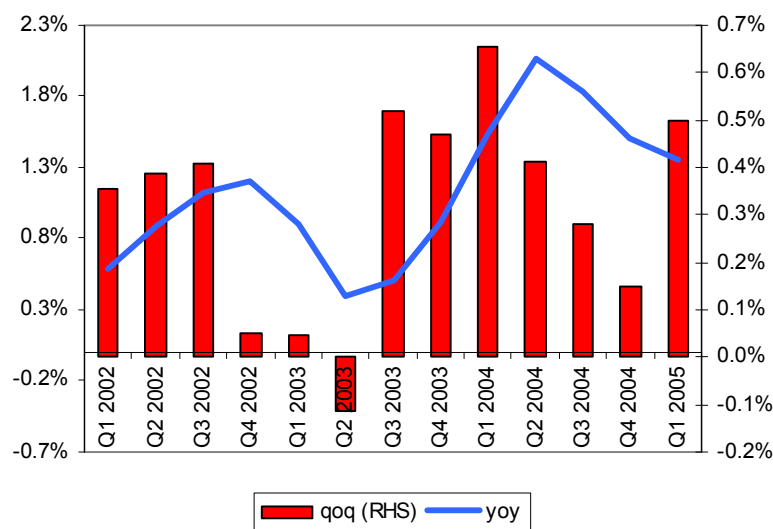
**...accelerated again in Q1 2005, but ...**

In the first quarter of this year, euro area economic growth accelerated again and rose by 0.5% qoq. This figure has to be interpreted with caution as it was due to a surge in German economic growth (+1% qoq), which is exaggerated because it is probably due to an "overcorrection" for calendar effects in the fourth quarter of last year. Moreover the strong quarterly growth rate in Germany is primarily due to a surge in net exports (in fact a sharp drop in import growth), while domestic demand remained very weak. The German figures should hence not be taken as a sign that the German economy is out of the doldrums. In most other euro area countries GDP growth slowed considerably: in the Netherlands and in Italy growth was even negative (see table below). Hence the 0.5% growth in euro area GDP in the first quarter of 2005 has to be put in

perspective, even more so since most indicators point to much weaker growth (0.3%) in the second quarter.

**Chart 3.1.1 - Eurozone GDP**

(Q-o-q and y-o-y)



**Table 3.1.1 - Quarterly GDP growth in the main euro zone economies**

(Percentage)	Q1 04	Q2 04	Q3 04	Q4 04	Q1 05
Euro zone	0.7	0.5	0.3	0.2	0.5
Germany	0.4	0.2	0.0	-0.1	1.0
France	0.6	0.6	0.2	0.7	0.2
Italy	0.5	0.4	0.4	-0.4	-0.5
Spain	0.8	0.5	0.6	0.8	0.9
Netherlands	1.0	-0.1	0.3	0.0	-0.1
Belgium	0.8	0.7	0.9	0.3	0.0

**...indicators point to weak Q2 2005**

The Belgian national bank survey for example, which is considered to be a leading indicator for economic activity in the euro area as a whole has plunged in the last six months and is now at its lowest level since June 2003. This is also seen in the German IFO and the French INSEE



business confidence indicator, which also dropped heavily in the last few months. Finally, the purchasing manager's index (PMI), which measures actual activity rather than confidence, declined to 50<sup>1</sup> in May, while the new orders component is already well below the 50-threshold, which indicates that the manufacturing sector is on the brink of a recession. In fact, in the first quarter of this year, growth of industrial production was already slightly negative. This decline in activity and business confidence is due to the lagged effects of the past euro appreciation (until the end of 2004) and the rise in oil prices. Consumer confidence has also declined somewhat in the last few months, but to a lesser extent than business confidence. Only confidence in the construction sector seems to be holding up well, supported by low real interest rates.

#### **Box 3.1.1 The Belgian business cycle indicator**

In a previous Euren report, it was shown that the Belgian business cycle and the business survey indicator of the National Bank of Belgium (NBB) can both be considered as leading indicators of the euro area GDP cycle, which they lead by respectively one and two quarters on average over the period 1991-2001.<sup>2</sup>

After a prolonged period of bottoming out, both the Belgian business cycle and the NBB business cycle indicator started to recover by the third quarter of 2003. The NBB indicator reached a peak in the third quarter of last year and continued to deteriorate up to mid-2005, mainly as a consequence of growing pessimism among entrepreneurs about the current economic situation. As their judgment on the future situation hardly deteriorated, it is expected that the current downturn of the Belgian business cycle, that started by the first quarter of 2005, will be short-lived.

The upturn in the euro area started in the fourth quarter of 2003, i.e. one quarter later than in Belgium, and has been more subdued so far. As qoq GDP growth slowed down in the second half of last year, the euro area

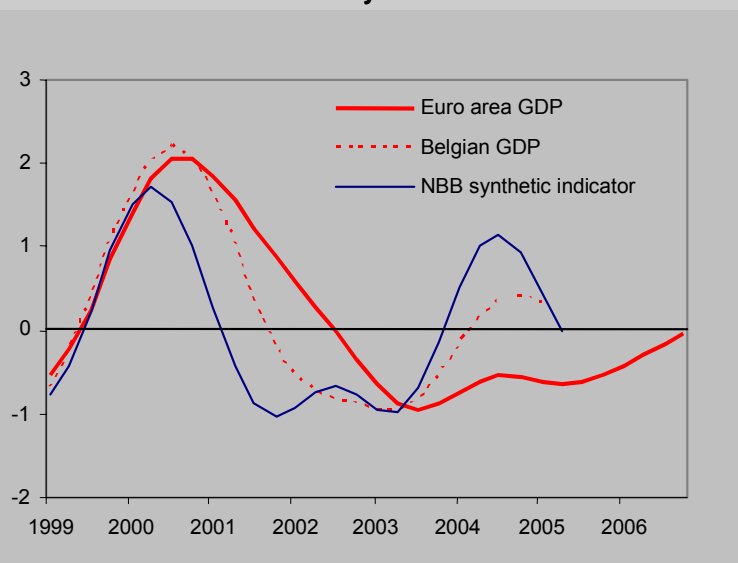
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<sup>1</sup> Levels higher than 50 indicate an expansion of activity, values of less than 50 point to a contraction.

<sup>2</sup> "The Belgian business cycle as a leading indicator for the euro area", Euren Spring Report 2002, pp. 65-70.

business cycle levelled off and even declined somewhat. According to the Euren scenario, GDP growth should accelerate again in the course of this year implying a further rise of the cycle from mid-2005 onwards. The momentum of the recovery should however remain moderate and the trend level of euro area GDP will only be reached by the end of the projection period.

**Chart 3.1.1- Normalised cyclical components of euro area and Belgian GDP and NBB business survey indicator**



Source: Eurostat, Belgian Institute of National Accounts, NBB, Euren, FPB

**Contribution of net exports turned negative in the second half of 2004**

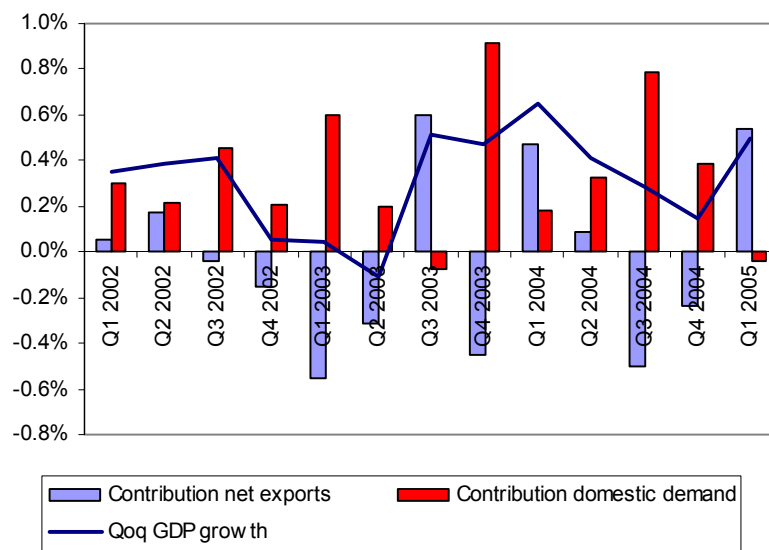
Export growth slowed down considerably from an average quarterly growth of 2.1% in the first half of 2004 to 0.6% in the second half. This was mainly the result of a deceleration in global demand and may also be the result of a technical correction following the very strong export growth in the second quarter of 2004. Furthermore it is becoming clear that the past appreciation of the euro (until the end of 2004) has hit competitiveness, which is increasingly weighing on euro area exports. Indeed, in the last quarter of 2004, the real effective exchange rate of the euro<sup>3</sup> reached its highest level in seven years. Faced with a strong euro and the competition of low-cost manufacturing countries, European companies have been in consolidation mode, reining in capital spending and labour costs.

<sup>3</sup> Calculated using consumer prices

So far this year the euro depreciated considerably vis-à-vis the dollar which will alleviate competitiveness problems somewhat, but it will take time before this feeds through.

In the meantime import growth continued to rise strongly in the second half of 2004, resulting in a significant drag on net exports. While in the first half of the year net exports contributed some 0.3 percentage points to average quarterly growth, it subtracted about 0.4 percentage points from average quarterly growth in the second half of 2004. In the first quarter of this year export growth rose by only 0.2% qoq, but since import growth plunged by more than 1%, net exports contributed 0.5 percentage points to the quarterly growth figure.

**Chart 3.1.2 - Contributions of net exports and domestic demand to qoq gdp growth**



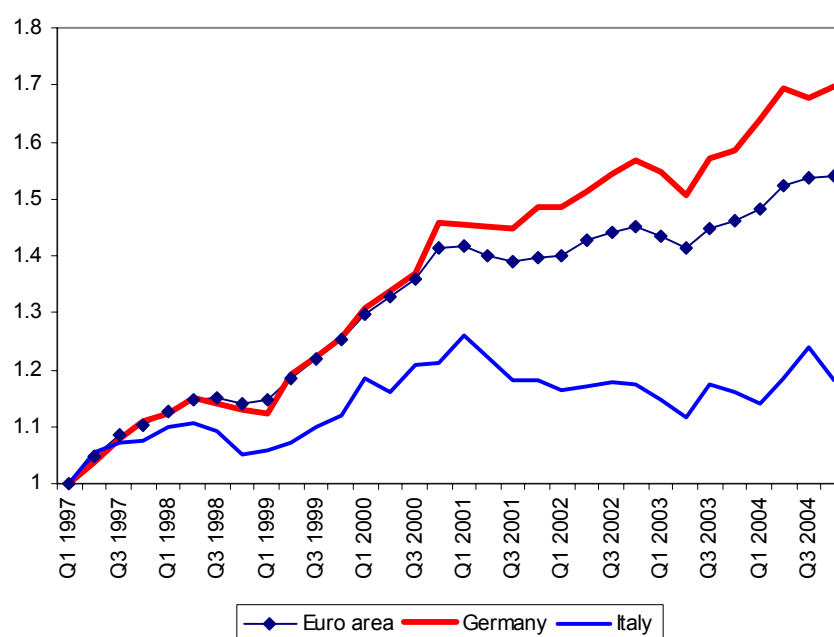
Source: EUROSTAT.

Significant differences in euro area countries' export performances have arisen, but two countries merit a closer look, namely Germany and Italy. Germany has increased its competitiveness hugely over the last few years thanks to wage moderation and structural economic reforms. While that may weigh on short-term economic growth, it has contributed to a

very strong export performance. Italy on the contrary has experienced serious competitiveness losses due to very low productivity growth. This together with the fact that Italian firms' exports are still orientated in traditional manufacturing areas in which competition from Asia is fierce, has resulted in a dismal export performance.

**Chart 3.1.3 - Export evolution in volume terms**

(Indexes: 1997Q1=1)



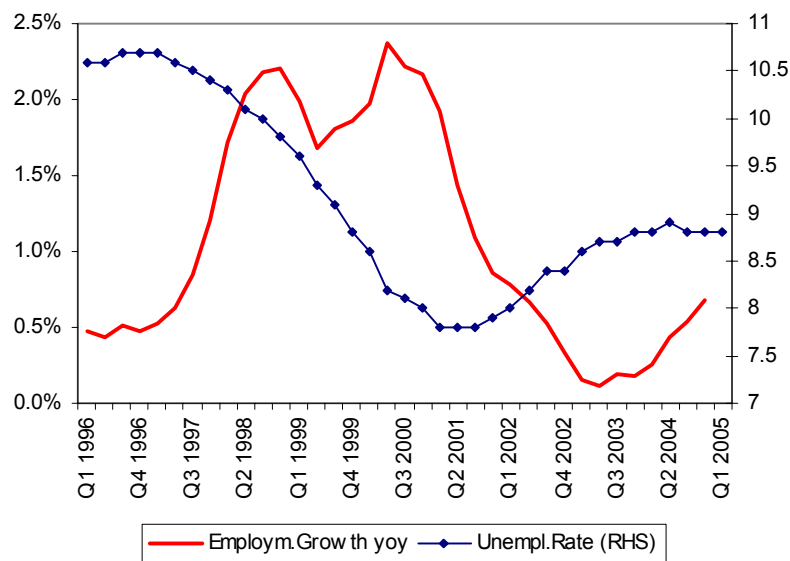
Source: EUROSTAT.

**While domestic demand failed to pick up decisively**

There was a noticeable acceleration (0.6% qoq) in private consumption in the fourth quarter of last year, but this was probably a correction following subdued consumption growth in the previous two quarters. In the first quarter of this year private consumption growth fell back to 0.3% qoq. Overall, hence, private consumption has been lacklustre in the last few quarters. The main reason for this weakness is the situation on the labour market. Despite the economic recovery, decent economic growth in 2004 and strong corporate profit growth, employment growth has been disappointing in the eurozone (compared to previous upturns). This has probably to do with the fact that during the last slowdown (Q3 2001- Q2 2003), companies have shed little staff and in fact employment has not

stopped increasing during the downturn. Now in the first phase of the recovery it appears as if they are drawing on those reserves. This can be clearly observed in the unemployment rate, which has barely budged over the last year and a half.

**Chart 3.1.4 - Employment growth and unemployment rate**



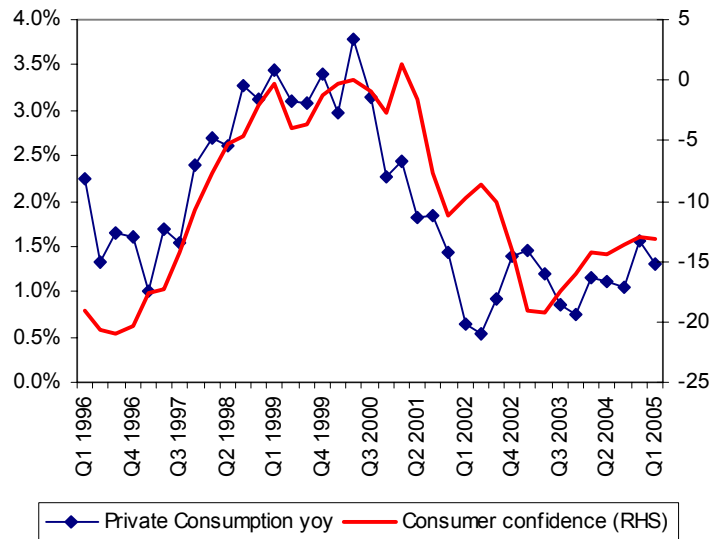
Source: EUROSTAT.

**Consumption was held back by the weak labour market and the rise in oil prices...**

Not at least due to the situation in the labour market wages have grown very moderately over the last year or so. On the one hand, the conditions this improved the conditions for stronger job creation, but on the other it has limited households' disposable income.

The second important reason for weakness in private consumption is the strong rise of oil prices, which also held back disposable income growth. Furthermore, at least in some countries, the implemented or expected structural reforms and the gradual reforms of the social security system might have weighed on consumers' confidence. While this will have a positive influence on the euro area's long-term prospects it is causing short-term pain, in the form of weak consumer demand.

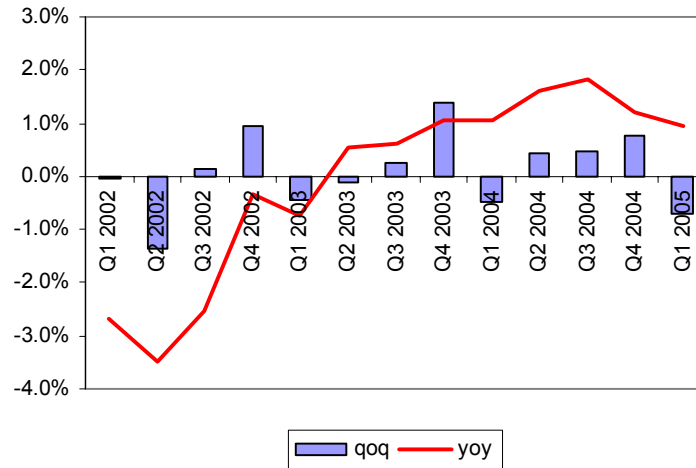
Chart 3.1.5 - Private consumption and consumer confidence



Source: EUROSTAT.

**...and investment by uncertainty over future demand** Investment growth started to rise in the second quarter of last year as the rising rate of capacity utilisation made companies expand their existing capacity. With improved balance sheets, strong profit growth and favourable financing conditions it was expected that investment growth would continue to accelerate, but in the first quarter of this year it surprisingly turned negative again. This has probably to do with the uncertain outlook for the euro area economy (slower economic growth, decline in indicators), which makes companies cautious in expanding capacity too much. Moreover it probably also has to do with an involuntary stock accumulation, caused by lower than expected orders. Finally also the late winter in parts of the euro area might have played a role. In Germany e.g., investment in construction dropped at an annualised rate of about 15%. Investment in housing in general however is holding up nicely thanks to favourable financing conditions for households (interest rates at historically low levels).

**Chart 3.1.6 - Investment growth**

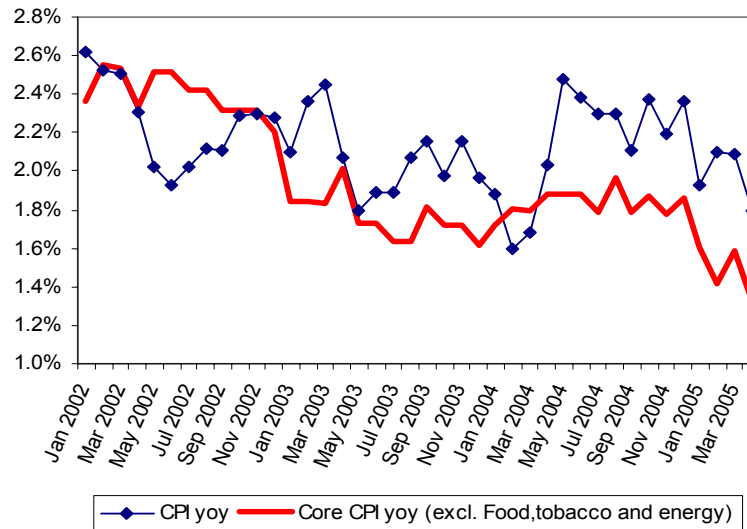


Source: EUROSTAT.

**Inflation declined below 2% in April**

Last year consumer prices accelerated due to a rise in excise duties for tobacco in some countries, by the increase in medical costs for the German households and most of all by the strong rise in energy prices. Considering these factors, the rise of the CPI was very moderate, as the strong rise of the euro limited the impact of the surge in energy prices. Over the last 6 months consumer price inflation has declined significantly from 2.4% in October 2004 to just 1.8% in April. This is due to the fact that the past year's rise of excise duties and medical costs fell out of the yoy comparison. More interestingly also underlying inflationary pressures are very subdued as can be seen in the evolution of core inflation (consumer prices without the volatile food, energy and tobacco components). As regards labour costs, recently released indicators are consistent with an overall picture of moderate wage developments. Unit labour costs have risen somewhat in the fourth quarter of last year, but a growth rate of 1.1% is still very benign. Furthermore it appears that inflation expectations - derived from inflation linked bonds - have declined somewhat in the last 2 months. The main upside risk for inflation is a spike in oil prices in euro terms.

Chart 3.1.7 - Consumer prices



Source: EUROSTAT.

### 3.2 EUREN FORECAST FOR 2005 AND 2006

#### A- Policy assumptions

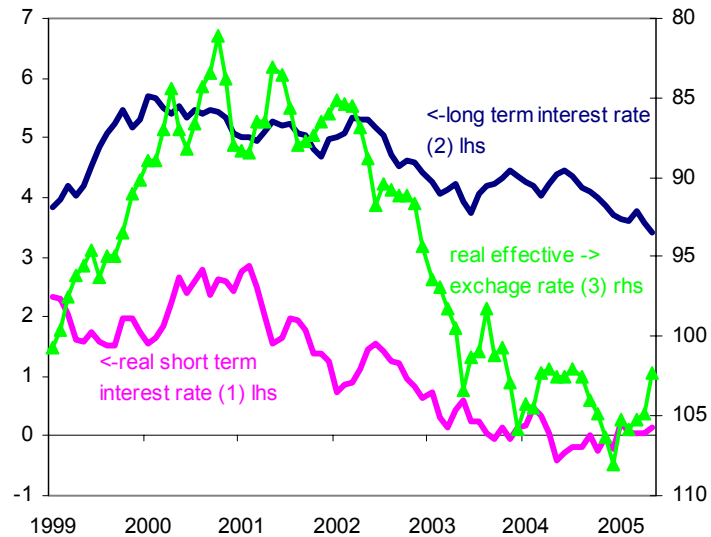
**ECB: a reasonably expansionary monetary policy**

Monetary assumptions in the Eurozone have not been modified since the last EUREN Winter Report and remain therefore reasonably expansionary. Real short term interest rates that have recovered slightly in recent months keep close to zero, while long term rates have continued declining to the lowest levels since the introduction of the EMU.

The expectations of an upward move of interest rates, that were discussed six-months ago, have been postponed, and the ECB is unlikely to consider any raise in basic rates at least up to mid-2006.



**Chart 3.2.1 - Monetary conditions in the euro area (%)**



(1) Deflated with HICP. (2) 10 years government bond yields (3) CPI-deflated, against 23 countries. Scale inverted.

Source: ECB

Since the end of last year the euro has been depreciating, and this move has accelerated in recent months, currently reaching the average levels that were characteristic of the first half of 2004.

As the euro is likely to remain at this lower level, the European economy is expected to improve its international price competitive capacity.

**Can inflationary pressures arise with a weakening euro exchange rate?**

This relative weakness of the euro, that could stimulate exports, may also have a negative impact on inflation rates that had been partly preserved at a lower level by the strong buying power of the European currency. In graph 3.2.2 it can be observed that liquidity is increasing in the eurozone, but this evolution of loans has not reactivated inflation that was cooled down by the strong euro.

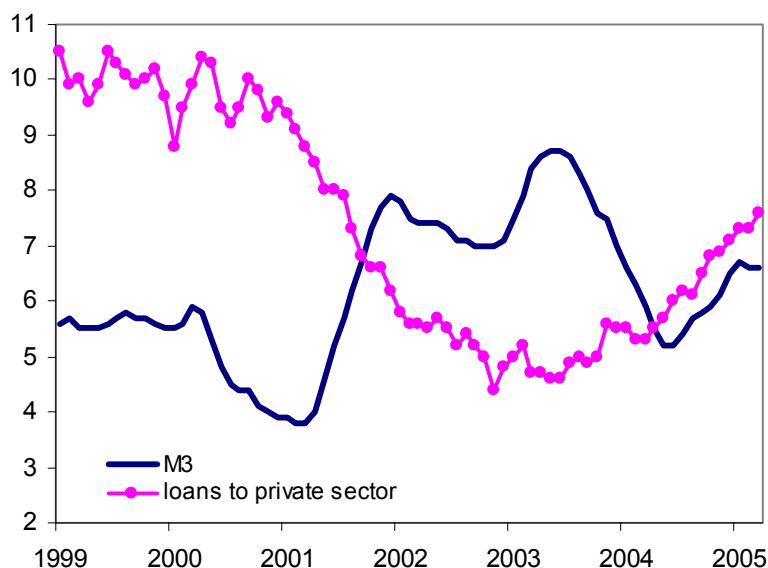
In this sense if the interest rates remain at their present low level, there is no expectation of a slowing-down of liquidity growth, and this is why if the exchange rate of the euro loses ground, one should expect some awakening of inflationary pressures in the coming months, unless

internal supply responds positively to the combined monetary and fiscal stimulus it is now receiving.

As to fiscal policy, the eurozone economies are involved in the complex process of combining fiscal consolidation required by the Stability and Growth Pact and more ambitious growth objectives aiming at an increase of employment.

**Chart 3.2.2 - Euro Area -M3<sup>1</sup> and loans**

(% change, year-on-year)



Source: ECB -<sup>1</sup> M3: three months moving average

In table 3.2.1 are portrayed the projections of the international organizations inferring that in the confrontation between growth and fiscal consolidation, the first objective is receiving more attention. According to the EC estimates, for the current 2005, five of the twelve countries in EMU show deficits above 3% of GDP, and this situation is unlikely to change in 2006 (as only Germany is expected to move below the maximum target of the SGP).

**Table 3.21 Stability programs: goals and forecast compared**  
(Budget balance as % of GDP)

Countries	Data		Stability Programs Dec 2004 <sup>1</sup>		EC		IMF		OECD	
					Apr 2005		Apr 2005		May 2005	
	2003	2004	2005	2006	2005	2006	2005	2006	2005	2006
Austria	-1,3	-1,3	-1,9	-1,7	-2,0	-1,7	-2,0	-1,8	-2,0	-1,9
Belgium	0,3	0,0	0,0	0,0	-0,2	-0,6	-0,4	-1,4	-0,5	-1,2
Finland	2,3	1,9	1,8	2,1	1,7	1,6	1,7	1,9	1,3	1,1
France	-4,2	-3,6	-2,9	-2,7	-3,7	-3,4	-3,1	-3,1	-3,0	-3,0
Germany	-3,8	-3,3	-2,5	-2,0	-3,3	-2,8	-3,5	-3,4	-3,5	-3,2
Greece	-5,2	-6,0	-3,7	-2,9	-4,5	-4,4	-4,1	-4,1	-3,8	-3,5
Ireland	0,2	1,3	-0,8	-0,6	-0,6	-0,6	-0,7	-0,6	-0,7	-0,7
Italy	-3,2	-3,2	-2,7	-2,0	-3,6	-4,6	-3,5	-4,3	-4,4	-5,0
Luxembourg	0,5	-1,1	-1,0	-0,9	-1,5	-1,9	1,6	-1,8	-1,5	-1,5
Netherlands	-3,2	-2,3	-2,6	-2,1	-2,0	-1,6	-2,0	-1,7	-2,2	-1,7
Portugal	-3,0	-3,0	-6,2	-4,8	-4,9	-4,7	-2,8	-2,5	-5,3	-4,8
Spain	0,4	-0,3	0,1	0,2	0,0	0,1	0,3	0,3	0,5	0,6
EU-12	-2,8	-2,0	na	na	-2,6	-2,7	-2,6	-2,6	-1,8	-1,8

Sources: National sources, EC, IMF World Economic Outlook, OECD Economic Outlook

**Germany : New government – new policy ?**

Fiscal deficit in Germany is expected to surpass the 3 % margin of the SGP once again in 2005. According to the latest estimate, tax income will be 5 bn € lower than expected before. On the expenditure side, government's plans to reduce public spending were not very ambitious anyway. Since chancellor Schröder has announced to bring forward the next general elections to September 2005, it is not very plausible that until then any new action will be taken to consolidate the budget. For the same reason there is no clear picture of fiscal policy in 2006. However, a new government will face an enormous pressure to increase consolidation efforts. And the early elections might empower the new government to take actions that previously failed. To enhance growth it would be necessary to put more emphasis on cutting subsidies and to increase public investment, which had to take more than once the burden of reducing deficits and is (in % of GDP) at its historic low.

**French Fiscal Policy: priority to employment in 2006?**

In France, public deficit decreased to 3.6 % of GDP in 2004 after 4,2 % in 2003 but the public debt increased from 62.8 % of GDP to 64.7. In 2005, growth should be again under its potential. So, one cannot expect a decrease of the deficit due to stronger activity. Besides, the structural measures decided to reduce the deficit further should be less important than in 2004. An increase of the social tax, the CSG (2.2 billion euros) is planned, unemployment benefits should decrease due to a previous reform and the health care plan seems to effectively slow down expenses. Nevertheless, some tax cuts are also coming into effect this year like the suppression of the additional tax of 3 % on the business tax (0.4 billion euros) and a new increase of the employment bonus called "prime pour l'emploi" (0.4 billion euro). In fact, in 2005, the public deficit will fall below 3 % of GDP only because of EDF's equalisation payment and the public debt should again increase.

In 2006, the impact of growth on the public deficit would be neutral. According the recent key notes speech of the new Prime Minister, priority will be given to employment in the 2006 budget. Expected tax cuts will thus be frizzed. Moreover 5.5 billions of euros will be devoted to finance to measures for employment. Meanwhile, public employment will be increased via special contracts for certain segments of the workforce. Since the major one-off revenue will vanish (EDF payment), one can expect the public deficit to stay closed to 3 % of GDP. That would mean that the public debt would also get higher in 2006.

**Italian Fiscal Policy influenced by the economy's weakness and next year general elections**

According to Istat and Eurostat new estimates, the Italian fiscal deficit overshot the 3% of GDP threshold in both 2003 and 2004. The deficit is expected to remain well above the 3% ceiling in 2005 as well. Furthermore, Italy's debt-to-GDP ratio has decreased only modestly in recent years and it stands now at around 106-107%. It can be easily asserted that in these years the Italian government's efforts to reduce public spending were neither ambitious nor successful. The government's stance during the recent bargaining over the public employees labour contract renewals, has been, for instance, rather weak. However, when assessing the Italian financial situation the prolonged weakness of the economy must also be taken into account.

Although it is now under great pressure from the EU Commission to increase its consolidation efforts both this year and the next, it is likely that the government will use a rather cautious approach towards this objective. Considering that the economy is in recession and that the general elections are set for the spring of 2006, it is not surprising that the prevailing official opinion seems to be that engaging now in structural fiscal tightening would not be either useful nor advantageous. In this regard, the Italian government is also bound to find support from the new SGP rules which state that if an excessive deficit procedure is initiated, a government is not necessarily required to correct the excessive deficit within the year following the deficit rule violation. For these reasons, we expect the government deficit to rise from 3.2% of GDP in 2004 to between 3.5% and 3.8% in 2005 and 2006.

**Belgium:  
Deficits will appear  
without additional  
measures**

The Belgian general government budget reached an equilibrium in 2004, which implies that government accounts were balanced or in surplus for the fifth consecutive year. During the forecasting period, the net financing requirement should increase to 0.5% of GDP in 2005 and to 1.5% of GDP in 2006. The fall in interest payments (from 4.9% of GDP in 2004 to 4.3% in 2006) is largely outpaced by the drop in the primary surplus (from 4.9% of GDP in 2004 to 2.9% in 2006). In structural terms (i.e. adjusted for the business cycle and one-off measures) a deficit of 0.5% of GDP was recorded in 2004, which is projected to increase to 0.6% in 2005 and to 1.3% in 2006. These figures are based on a 'no-policy change' assumption and include information up to the cut-off date for the forecast (end of April). The Belgian government has planned an additional budget control in June as it intends to keep the 2005 budget in balance.

The reappearance of a deficit in 2005 is mainly due to lower economic growth and the reduced reliance on one-off measures. The additional deterioration in 2006 stems largely from structural policy measures, which reduce the structural primary surplus substantially to 3% of GDP (from 3.9% in 2005). Next year's increased deficit also reflects the absence of one-off measures (which amounted to 0.4% of GDP in 2005).

The structural measures in 2005 and 2006 represent 1.1% of GDP (over the two years, but mostly in 2006). They affect both public income and

expenditures. On the income side the net impact remains modest (-0.3% of GDP), as the budgetary cost of the full implementation of the income tax reform and the additional reductions in social security contributions are partially offset by an increase in taxation on products. The structural net increase in expenditures accounts for a more important 0.8% of GDP. This reflects increased spending on health care and pension benefits, as well as higher outlays in the field of employment policy, public transport, etc.

Despite the smaller primary surplus, the public debt to GDP ratio is expected to decline further (from 95.8% in 2004 to 92.3% in 2006) as the average interest rate on the debt stock continues to decline.

**Spain:  
No immediate  
problems but some  
risks in the long  
run**

In 2004 the public sector deficit amounted to -0.3% of GDP, mainly because of the inclusion of the debt of RENFE (state railways) estimated at 0.7% of GDP.

There are some medium term risks that refer to the financial perspectives of the EU for 2007-2013 and to possible changes in financing models for the Spanish regions.

As to the first risk factor, several institutions envisage a reduction of European funding by 30% to 40% from the present level, and an increase of Spanish contributions to the EU-budget by some 13%. Consequently the net European contribution to Spain could decline from 0.9% of GDP to around 0.1% in 2007, a reduction that will directly affect the budget balance.

As to the second risk factor, it is difficult at the moment to ascertain the fiscal impact of currently discussed changes in the financing schemes of Spanish regions; only the demands of the regions are known. The more likely change will relate to the distribution of functions and responsibilities between the central and regional governments and, in principle, this should not affect the total budgetary balance, but an overall change towards higher levels of expenditures cannot be excluded.

**The 'new' Stability  
and Growth Pact**

The reform of the Stability and Growth Pact (SGP) adopted by the EU finance ministers on 22-23 March 2005 changed the institutional framework for fiscal policy in the Euro Area. On the one hand, the

document underpins that member states still must keep their public deficit under a 3% GDP/deficit ratio and their debts under 60% GDP/debt ratio. On the other hand, the pact's rules have been made more flexible in many aspects, in particular in regard to the Excessive Deficit Procedure (EDP) that can be avoided if negative GDP growth is observed, or if some 'relevant factors' can be put forward.

EUREN Winter Report already commented on the difficulties faced by several countries to meet the SGP targets and was cautious about the risks involved in introducing additional doses of creative accounting and about using structural deficits as yardstick, as this indicator raises many methodological problems of computation and interpretation. In several respects the reform refers to these risks and while an exhaustive list of 'relevant factors' has not been provided, references are made to selected budget items as well as to medium-term budgetary efforts.

Two aspects of the reform deserve special attention: The clarification of the other "relevant factors" that have to be taken into account when assessing an excessive burden and the definition of the medium term objective of fiscal policy and the way to reach it.

Concerning the "relevant factors" for appreciating the economic governance of member states, there are many good arguments for the modifications proposed. In fact, it is definitely rational to take into account the level of public investments (R&D or others) when looking at the deficits. In the original SGP, a country was asked to have a balanced budget on the mid term. The underlying logic was then that a country had to finance public investments with current receipts. But that was not coherent with the fact that future (and not present) generations would get the benefits of these investments and should somehow pay for them.

Furthermore, the "relevant factors" give the opportunity to consider also future expenditures. Due to the ageing society, one cannot consider on the same basis the public finances of a country which has not reformed its pension system and another which already has it. For some countries this could even mean that the room for deficit spending could be smaller than hitherto.

**... raises difficulties of interpretation**

However, as 'all other relevant factors' are addressed in a very general way this new rule could turn out to be a Trojan horse. In the end a good deal of national budget positions can be defined as "contributions to fostering international solidarity and to achieving European policy goals": contributions to the EU-Budget, development aid or even defence expenditure could be interpreted this way. Therefore, additional specification will be required.

**... but stimulates long term thinking**

Another positive point of the 'new' SGP is the definition of a mid-term objective in terms of cyclically-adjusted deficits in despite the already mentioned methodological measurement difficulties of the parameters involved. This objective is to be specific to each country, related to the growth potential of the country, the needs in terms of public investment, the "off balance sheet" expenses due to demographic trends, etc. If a country cannot reach this mid-term objective, it will have to reduce at least its cyclically-adjusted deficit by 0.5 % of GDP a year. The plus is that this new policy objective is now disconnected from the cyclical component of current growth.

However, scepticism is justified against the idea of an asymmetric fiscal policy, i.e. the idea of intensifying consolidation efforts in good times bears the risk that in some countries consolidation will never take place. Many questions arise from the definition of "Good times" which are defined as "periods when output exceeds its potential level". Determining potential output is difficult for methodological reasons. Hence, discussions will arise as to what estimate of potential output has to be chosen and, thus, whether the output gap is closed or not. Furthermore there is a recognition problem: in particular in countries with a low growth trend, potential output in the most recent years is difficult to determine, and we only know ex post whether a year has been a good year or not.

Does this reform solve all the problems? Of course, not, and far from it. The first difficulty will be for the Commission to measure precisely these 'relevant factors'. How to evaluate the cost of the pension reforms? Is spending on education a public investment? Will the member states be disciplined enough to accept the verdict of the Commission?

The new SGP does not offer any incentives to apply more rigorous fiscal policies. Furthermore, the national and European parliaments are not associated closely enough to the process of surveillance of the



implementation of the stability programs. It will still be quite easy for any government to claim that there is a choice to make between national objectives and the European constraints.

**... and will provide new expansionary instrumental policies**

The 'reform' shows in summary a shift of priorities from Stability (an area in which the ECB still keeps a strong position) to Growth. It opens the door to selective expansionary national budget policies at times, like those we expect for 2005-2006, when the European economy faces difficulties in reaching a higher output and employment growth path. At the same time the reform may increase instability risks, and it may bring the ECB into difficulties, how to react to these risks.

## **B. Forecast summary**

The slight acceleration in economic growth in the first quarter of 2005 might be a source of optimism. However, early indications, especially industry surveys, don't support the idea of strong economic activity in the second quarter of this year. Indeed, GDP could increase at a lower rate in 2005Q2 than in 2005Q1. Then, two scenarios can be presented. In the gloomiest case, the current weakness of the euro area economy may translate into a cyclical downturn: firms may adapt their investment and staff (levels) to a lower rate of expansion, triggering a cumulative negative downsizing. Such a black scenario cannot be totally excluded today, but the Euren institutes favour a softer scenario. The current weakness can be interpreted as the consequence of the lack of competitiveness resulting from a strong Euro and the high level of oil prices. It can be noticed that the industrial sector is the most sensitive to those two issues, which can explain why the business climate has deteriorated so markedly in this sector, while the services sector has shown signs of resilience until now. Especially, if the Euro stabilises against the US dollar, it would alleviate the burden of the euro area exporters. Moreover, the purchasing power of households and the energy bill would not be hit anymore by higher energy prices in the coming quarters, as we assume a slight decrease in oil prices from now

on. This will allow the cyclical forces to play a role again after the 2005Q2 soft patch.

**Less competitive pressure but weaker world trade**

External performances have differed quite significantly among the main European countries in 2004, encompassing strong performances of German exporters and rather weak developments of Italian exporters. Besides intra-Euro area cost competitiveness, those differences reflect mainly sectoral specialisation. Even though this can be considered as a structural gap, the Euro area exporters would benefit in the coming quarters from diminishing competitive pressure from other competitors, thanks to the slight depreciation of the Euro against the US dollar. This may translate into a reduction in loss of market shares for the Euro area as a whole. However, world trade developments will be less supportive than in 2004. This may lead to a rather stable increase of the Euro area exports along the horizon forecast, on a cruising speed of around 6% annualised rate.

Exports will not be able to trigger a cyclical upturn of the Euro area economies, even though they will contribute to economic expansion. Will internal demand be the alternative engine of economic growth? Probably not. However, a revival of internal demand may happen, on the basis of cyclical developments.

**An internal demand revival at last?**

After a modest increase in 2005Q1, early indicators as retail sales don't point to a strengthening of private consumption before this summer. However, in the wake of the oil price forecast, a deceleration of inflation can be expected. From mid-2005, consumer price increases would moderate to come back below the 2% threshold. Meanwhile, employment could register a slight increase in 2005, followed by a limited acceleration next year. However, the unemployment rate will decrease only to a limited extent from the end of 2005, after reaching a peak of 8.9% in 2005Q3. All in all, private consumption will only increase by 1.3% in 2005 and accelerate modestly in 2006.

In this context, investment will strengthen a bit in the second half of this year, after a contraction in 2005Q1, which was partly the consequence of bad weather conditions in the construction sector in Germany in March. However, a strong acceleration cannot be expected as the rate of

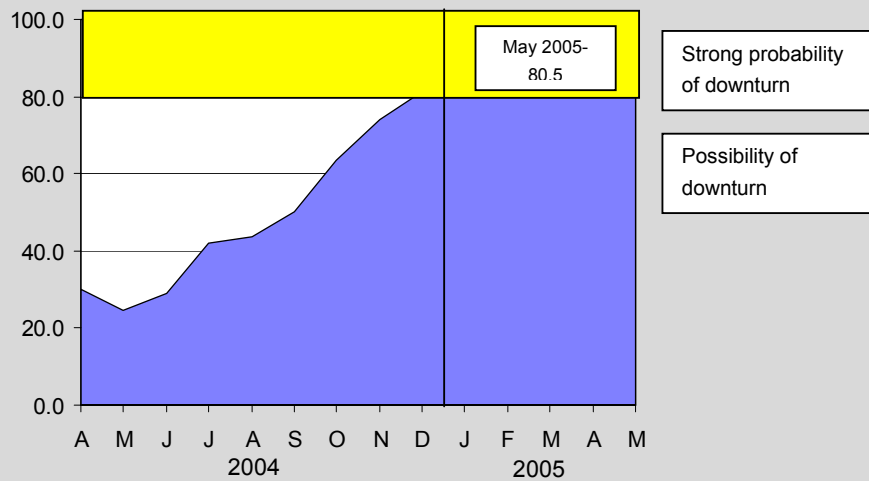
utilisation of the capacity of production has come back below its medium-term average at the beginning of this year.

**A lack of room to manoeuvre**

As a result, GDP growth in the Euro area will increase only by 1.4% in 2005, nearly half a point less than in 2004, using figures corrected for the number of working days. It means that GDP growth in the Euro area will come out below 2% for the fifth consecutive year, which is considered to be the potential growth rate by the European Commission and the ECB. How can we interpret this gap? A first interpretation is that adverse external shocks (oil price, exchange rate movements if those can be considered as exogenous...) have hampered a cyclical recovery in the Euro area after the burst of the Internet bubble at the beginning of the decade, and thus limited the expansion rate. A second interpretation is that economic policy has not fully played its role, which is to limit the gap between potential supply and demand. It could mean that the ECB has not been quick enough to adjust its key rates to a lower level and/or that fiscal policy has not been used properly. Indeed, it is clear that insufficient adjustments of the fiscal deficit in some countries during the time of high economic growth has reduced the room of manoeuvre in the downward phase of the business cycle. A third interpretation is that potential growth in the Euro area is not close to 2% anymore, but is lower. It could be the consequence of demography that will contribute in the future to limit potential growth in the Euro area. It can also be the consequence of past movements in economic growth. Indeed, as a consequence of low economic growth on such a long period of time, capital stock and human capital (because of the high unemployment rate) may be hit. The reality is probably a mix of those three explanations. Identifying more precisely the contribution of those factors to a slow growth rate in the Euro area is also very important for economic policy, as it gives a better idea whether demand side or supply side measures have to be undertaken. In the final chapter of this report, a special focus is made on this latter point, studying recent trends and expectations for productivity, which is a key element of potential growth.

### Box 3.2.1 The COE leading indicator

The leading indicator for the euro area is used to anticipate the next economic slowdown<sup>4</sup>. The indicator climbed over the first threshold of 60 in October 2004 and over the 80 threshold in December, which indicated a strong probability of an economic downturn within the next three months. Thenceforth, the growth rate should drop, in the second quarter of 2005, below the trend growth rate estimated at 1.3%. The GDP estimation from Eurostat for the first quarter already points out a 1.4% year-on-year growth rate. Only the good orientation of stock indices slows down the convergence to 100 of the leading indicator. A « soft patch » in the United States would certainly translate into a « soft patch » in the euro area.



<sup>4</sup> An economic slowdown occurs when the growth rate decreases under the trend growth rate

**Table 3.2.2 - Euro Area Forecast**

	2002	2003	2004	2004 <sup>1</sup>	2005	2006	2005 I	2005 II	2005 III	2005 IV	2006 I	2006 II	2006 III	2006 IV
percentage changes over previous period (not annualised for quarterly data), unless otherwise indicated														
Private consumption	0.9	1.1	1.2	1.3	1.3	1.7	0.3	0.2	0.3	0.4	0.4	0.5	0.6	0.6
Public consumption	2.6	1.3	2.6	1.4	1.4	1.6	-0.2	0.7	0.4	0.4	0.4	0.4	0.4	0.4
Gross fixed capital formation	-2.3	0.4	1.4	1.9	1.1	3.1	-0.7	0.5	0.6	0.7	0.8	0.9	0.9	0.8
Domestic demand	0.3	1.4	1.7	2.0	1.3	2.2	0.0	0.3	0.4	0.5	0.6	0.7	0.7	0.6
Exports	2.1	0.6	5.7	6.1	3.8	6.0	0.2	1.3	1.5	1.5	1.5	1.5	1.4	1.4
Imports	0.5	2.5	5.8	6.3	3.7	7.2	-1.1	1.4	1.6	1.7	1.8	1.9	1.9	1.8
GDP	1.0	0.7	1.7	2.0	1.4	1.9	0.5	0.3	0.4	0.4	0.5	0.5	0.5	0.5
Unemployment (% of labour force)	8.2	8.7	8.8		8.9	8.6	8.8	8.9	8.9	8.8	8.7	8.6	8.5	8.5
Compensation per employee <sup>2</sup> , yoy	2.9	2.7	2.3		2.0	1.9	2.0	2.0	2.0	1.9	1.9	1.9	1.9	1.9
Consumer price (HICP), yoy	2.3	2.1	2.1		1.9	1.7	2.0	2.1	1.9	1.7	1.8	1.6	1.6	1.6
Current account balance (%GDP)	0.9	0.3	0.6		0.6	0.5								
3m interest rates (% per annum)	3.3	2.3	2.1		2.1	2.4	2.1	2.1	2.1	2.1	2.2	2.4	2.4	2.6
10y Gvt bond yields (% per annum)	4.8	4.1	4.1		3.6	4.3	3.7	3.4	3.5	3.6	3.9	4.2	4.4	4.5

<sup>1</sup> Not corrected for working days.

<sup>2</sup> Seasonally adjusted.

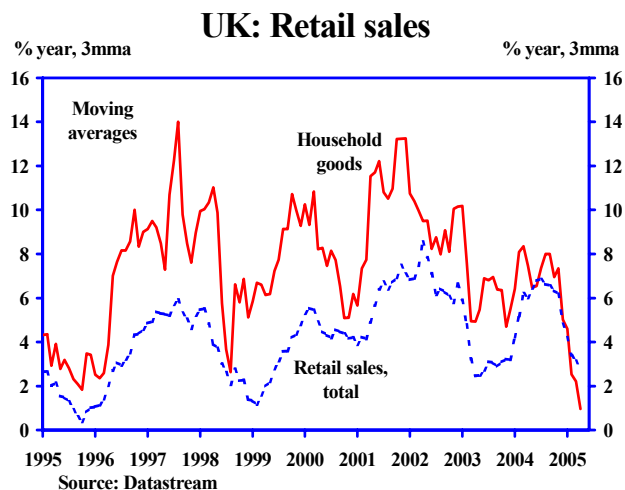
<sup>3</sup> General Government financial balance, excluding UMTS revenues.

### 3.3 THE UK ECONOMY

**Markets now looking for rate cut...**

The next move in UK interest rates is increasingly expected to be downwards. Having worried last summer that interest rates might reach 5.5%, markets now take the view that rates have peaked at 4.75%, with futures implying that three-month interest rates will be down to 4.5% by the end of the year.

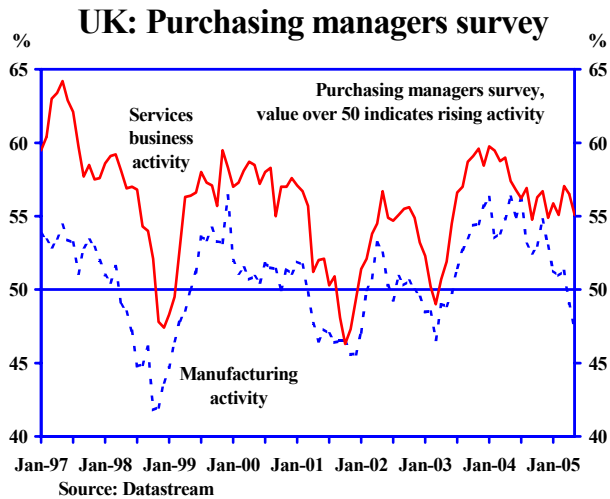
The change in rate sentiment largely reflects the signs that consumer demand has slowed markedly. Having increased by over 3% in real terms in 8 of the last 9 years, consumption rose at an annual rate of just 1.3% in 2005Q1, following growth of just 0.7% in 2004Q4. Similarly, while retail sales rose 0.5% in volume terms in April, sales in the latest three months were only 0.2% higher than in the previous three months and 2.7% higher than a year earlier, having risen over 6% in 2004. Survey evidence from both the CBI and British Retail



Consortium suggest that retail sales remained subdued in May. And car registrations in May were 3.4% lower than a year earlier.

**...as manufacturing faces recession**

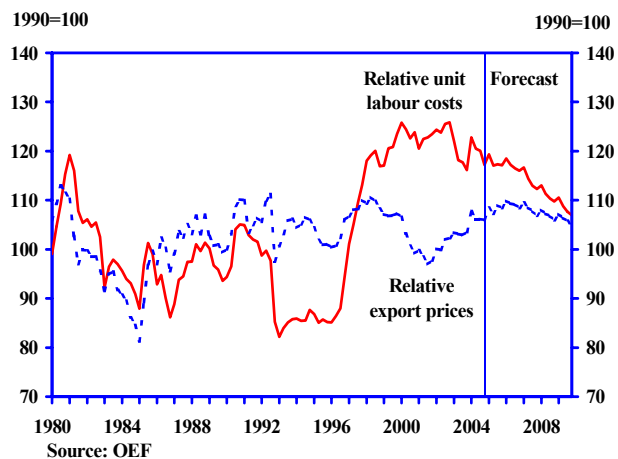
But it is not just the consumer who is suffering. Having shown signs of revival last summer, the manufacturing sector is struggling again. Output rose 0.9% in April, but this followed a fall of 1.6% in March. In the latest three months, production was 1.2% lower than in the previous three months and 1.4% lower than a year earlier. Again the survey evidence points to further weakness recently - for example, the purchasing managers' index has fallen back below 50, indicating that activity is contracting. And the CBI survey of manufacturers' output expectations also turned negative in May.



**Export recovery is stalling...**

The weakness of manufacturing output in turn reflects disappointing trade performance. Having risen 1.6% in Q4, exports of goods and services fell 1.0% in Q1. In part, this reflects the weakness of demand on the continent, which remains the UK's biggest export market. But exports to China, Hong Kong and Japan were particularly weak in Q1, possibly reflecting the impact of the rise in sterling against the dollar over the last year. UK relative unit labour costs remain over 20% higher than their long-run average. And while firms have sought to hold on to market share by accepting lower profit margins, UK manufacturers are clearly struggling to compete with China and other low-cost producers, particularly in sectors such as textiles.

### UK: Competitiveness

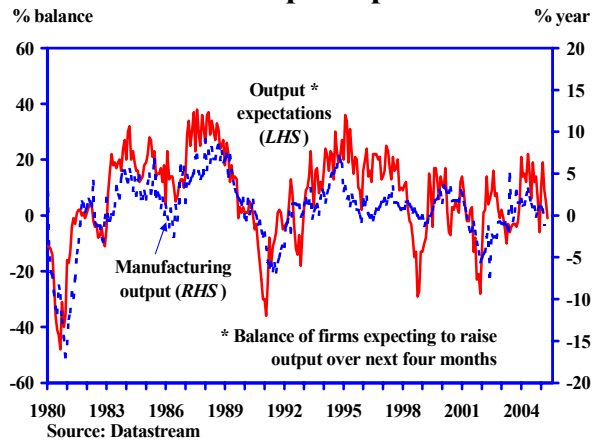


**...under-mining investment recovery**

Disappointingly, these developments also seem to be undermining the recovery in business investment. Business investment rose 6% in the year to 2004Q3. But it rose just 0.2% in Q4 and fell 0.1% in Q1. Similarly, manufacturing investment fell 1.5% in Q1, although it

was still 4.3% higher than a year earlier. While corporate liquidity remains very high, worries about the growth outlook, corporate debts and pension deficits have led companies to be more cautious recently.

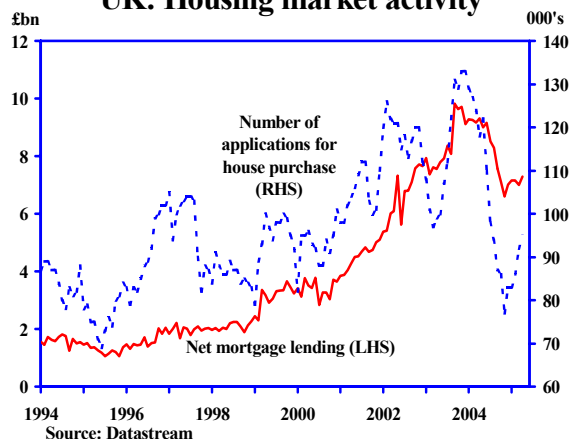
### UK: CBI output expectations



### GDP forecast down to 2.4% for 2005...

Against this background, we have revised our forecast for GDP growth this year down to 2.4% from 2.7% last month. However, this still implies that growth is in line with its long-term historic trend and much healthier than in continental Europe. In part, this reflects continued strong stimulus from government spending. In addition, though, we still consider that the media gloom about consumer prospects has been overdone. Household incomes remain strong as wages rise ahead of inflation and employment expands (up 87,000 in Q1 according to the LFS survey). And confidence is holding up, with encouraging signs that the housing market is indeed achieving a soft-landing - the Nationwide reported that house prices rose 0.3% in May, while applications for new loans for house purchase rose a further 3% in April to a level over 23% higher than their trough last November.

### UK: Housing market activity





**...with rate cut  
now expected  
in August**

Growth should also be supported by monetary policy. We now expect interest rates to fall in August, rather than next spring as previously assumed. And we would not rule out further cuts this year even if we see inflation edge above its target temporarily as a result of high oil prices.

**Table 3.3.1 - UK Forecasts**

	2002	2003	2004	2005	2006	2005 I	2005 II	2005 III	2005 IV	2006 I	2006 II	2006 III	2006 IV
	q-t-q, saar (unless otherwise indicated)												
Private consumption	3.2	2.3	3.3	2.1	2.5	1.3	3.0	2.6	2.3	2.3	2.3	2.5	2.7
Public consumption	3.8	3.2	4.7	3.2	2.7	2.8	2.8	2.8	2.8	2.5	2.5	2.6	2.6
Gross fixed capital formation	2.7	2.3	5.6	3.5	3.4	-0.1	6.1	4.1	3.9	2.8	2.8	2.7	3.0
Domestic demand	2.9	2.4	3.8	2.6	2.6	0.6	2.4	2.8	2.7	2.6	2.6	2.7	2.9
Exports	0.1	0.9	3.0	3.6	5.7	-3.8	10.4	5.1	5.4	5.3	5.3	5.5	5.6
Imports	4.1	1.9	5.2	4.0	6.0	-7.4	10.4	5.8	5.7	5.6	5.5	5.8	5.8
GDP	1.8	2.2	3.1	2.4	2.5	2.0	2.2	2.5	2.5	2.4	2.4	2.5	2.8
Unemployment (% of labour force)	3.1	3.0	2.7	2.7	2.6	2.7	2.7	2.6	2.6	2.6	2.6	2.6	2.6
Compensation per employee <sup>1</sup> , yoy	3.6	3.1	4.2	4.6	4.2	4.6	4.6	4.6	4.5	4.3	4.2	4.2	4.2
Consumer price (HICP), yoy	1.3	1.4	1.3	1.7	1.7	1.7	1.8	1.8	1.6	1.7	1.7	1.8	1.7
Current account balance (%GDP)	-1.7	-1.7	-2.2	-2.2	-2.4	-2.2	-2.2	-2.2	-2.3	-2.3	-2.3	-2.4	-2.4
GGFB/GDP <sup>2</sup>	-1.7	-3.3	-3.4	-2.6	-2.7	-1.3	-2.9	-3.1	-3.1	-2.6	-2.6	-2.7	-2.8
3m interest rates (% per annum)	4.0	3.7	4.6	4.7	4.5	4.9	4.8	4.6	4.5	4.5	4.5	4.5	4.5
10y Gvt bond yields (% per annum)	4.9	4.5	4.9	4.5	4.6	4.7	4.5	4.5	4.5	4.6	4.6	4.6	4.6

EUREN calculation - <sup>1</sup>Seasonally adjusted - <sup>2</sup>General Government financial balance, excluding UMTS revenues.

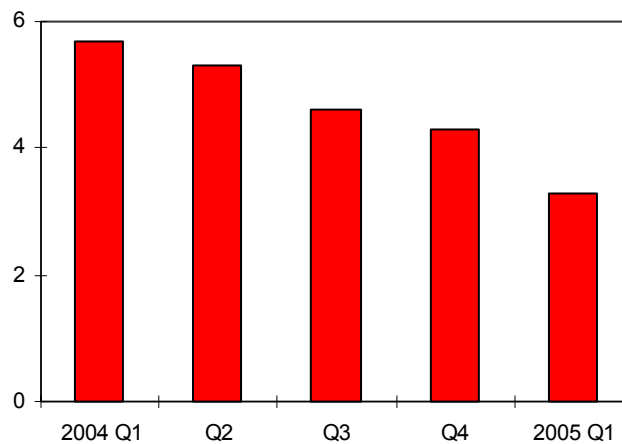
### 3.4 THE NEW MEMBER STATES

**Gdp growth slowed down markedly in q1 2005....**

The new member states' GDP rose by only 3.3% in 2005Q1 (year-on-year), after a record growth rate of 5.1% in 2004. The drop in growth largely reflects the sharp deceleration in previously soaring manufacturing exports. However, output growth in most EU10 countries slowed already in the second half of 2004, and business cycle indicators in 2005Q2 are more promising again.

**Chart 3.4.1 - GDP in new EU members**

% change by quarters, year-on-year

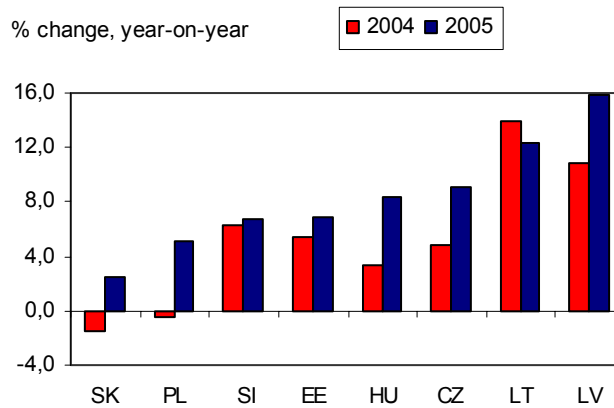


*Source: Eurostat, Kopint-Datorg Database.*

**..But the spring business cycle indicators are promising and investment is robust**

Besides surging transport equipment, computer and office machinery exports, agriculture also had an excellent export performance. However, dependency of growth on Western European (especially German) manufacturing sector has not eased; with the notable exception of Estonia, business services' contribution to growth continues to be weak.

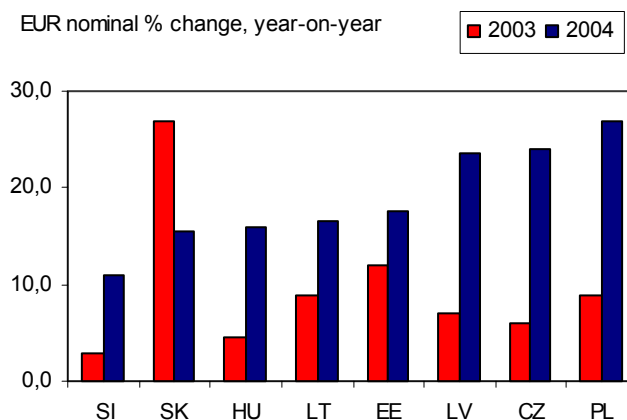
**Chart 3.4.2 - Investment (GFCF) in new EU members**



Source: CSOs.

At the same time, pattern of growth became more balanced. In the Czech Republic and in Hungary, consumption growth slowed somewhat, while gross fixed capital formation became more robust. Investment is lively across the region: infrastructural modernisation needs are feeding construction output, while FDI inflows recovered. The general increase in investment rates is promising regarding the medium-term convergence of the new EU members. In 2004, the investment/GDP ratio was below 20% only in Poland, while in Estonia, following a path of spectacular modernisation, it achieved 28%.

**Chart 3.4.3 - Export growth in new EU members**



Source: CSOs, Kopint-Datorg Database.

**Export difficulties with respect to southern-asian competitors were aggravated by appreciating exchange rates**

Last year witnessed an exceptional export boom across most of the region. Besides evident market gains within the enlarged European Union, the new members had also an excellent export performance in Southern Europe and in CIS countries' markets. The implementation of EU trade rules might have a major role in the soaring intra-EU-8 trade. However, trade balance of the new members keeps deteriorating rapidly against the Southern-Asian countries, particularly against China. Having lost the trade battle in the fields of textile, footwear and leather products, new members' companies may easily loose market share in manufacturing of electrical parts and components against Southern-Asian competitors. The appreciation of local currencies against the euro (coupled with the appreciation of the euro against the US dollar and the related Asian currencies) might aggravate further these unfavourable trends in 2004. However, opposite exchange rate developments in 2005 could support somewhat the price and cost-competitiveness of new members' exporting companies.

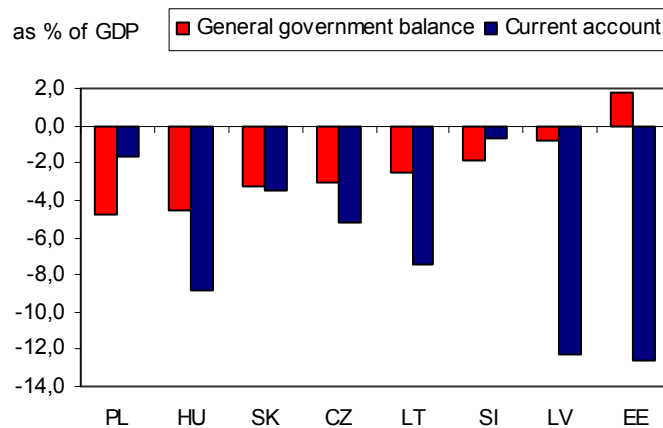
Fiscal policy practices basically remained unchanged in the individual countries: the Baltics and Slovenia maintained the traditional fiscal discipline, while Hungary and Poland were unable to improve markedly their fiscal balance. However, fiscal outcomes were better than expected in Slovakia and especially in the Czech Republic. Structural expenditure cuts as well as higher than expected growth rates also contributed to the positive surprises. These developments might make the introduction of the euro plausible by 2009 in both countries. Nevertheless at present only Slovakia intends to do so; the Czech Republic has not updated its rather unambitious convergence program and the aim of adopting the common currency only by 2010 has remained unchanged. In 2004 high current account deficits persisted in the Baltics and in Hungary, but this year external position is likely to improve markedly across the region.

**After a peak of inflation in mid-2004, disinflation may follow in 2005-2006**

After having jumped in the first half of 2004, consumer prices increases gradually moderated by Spring 2005. Unless a new wave of oil price rises or a further marked appreciation of USD against the EUR causes a shock in imported inflation, the process of disinflation is expected to follow in 2005. As liberalisation of prices and harmonisation of tax rates were completed, additional CPI pressure is moderate. In addition, the remarkable slowdown in food price increase (or even a temporary decrease) is coupled with generally lowering household consumption demand. This projects a slowdown in inflation till end-2005 as well. As a result, this year annual average

inflation rate may decrease by roughly 1 percentage point (3% after 4.1% in 2004).

**Chart 3.4.4 - Fiscal and current account balances**



Source: CSOs, NBs, Kopint-Datorg Database

**Stubborn tensions on the labour market are easing somewhat, disinflation may follow**

Labour market trends were among the positive surprises of the second half of 2004: stubborn tensions, which seemed to remain unchanged for several years, started to ease somewhat. Unemployment rates close to 20% finally decreased in Poland and in Slovakia, meanwhile labour market prospects improved markedly in Estonia and in Lithuania. The two Baltics (the present 'convergence champions') were especially successful in rolling back the unemployment of youth (under age of 25). The first months of 2005 indicate that positive labour market trends across the region may keep going on the whole year, with the notable exception of Hungary.

**Downside risks in Hungary and in Poland, bright short-term prospects elsewhere**

In the short-term, the current path of real convergence is expected to continue in the new members. Excellent growth rates keep supporting the catching-up of the Baltics and Slovakia, while sound macroeconomic fundamentals help the growth prospects of Slovenia. In the Czech Republic, stronger than officially expected growth may offset the more expansionary fiscal stance. However, likely fiscal expansion related to the upcoming Parliamentary elections in 2006 (together with unfoundedly optimistic growth forecasts) means a downside risk in Hungary and in Poland. However, these countries got a significant legal alleviation from the revision of the Stability and Growth Pact: thanks to the respective pension reforms implemented before, they can include private pension fund revenues into the

general government balance. As a consequence, gradual decrease of fiscal deficit might also be viable to achieve Hungarian and Polish EMU accession by 2010.

**Table 3.4 - New member states forecast (Percentage changes unless otherwise indicated)**

	2003	2004	2005	2006
GDP real growth	3.8	5.1	3.9	4.2
Czech Republic	3.2	4.4	4.2	4.0
Estonia	5.1	6.2	6.5	6.0
Hungary	2.9	4.2	3.4	3.8
Latvia	7.5	8.5	7.0	6.2
Lithuania	9.7	6.7	5.2	5.5
Poland	3.8	5.4	3.5	4.0
Slovakia	4.5	5.5	5.2	5.5
Slovenia	2.5	4.6	3.0	3.8
Inflation (HICP)	2.0	4.1	3.0	2.8
Czech Republic	-0.1	2.6	1.8	2.3
Estonia	1.4	3.0	3.4	2.5
Hungary	4.7	6.8	3.5	3.2
Latvia	2.9	6.2	5.8	3.4
Lithuania	-1.1	1.1	2.8	2.8
Poland	0.7	3.6	3.2	2.8
Slovakia	8.5	7.4	2.8	3.0
Slovenia	5.7	3.6	2.7	2.4
Unemployment rate	13.6	13.5	13.2	12.9
Czech Republic	7.8	8.3	8.2	8.0
Estonia	10.0	9.6	8.3	7.8
Hungary	5.9	6.1	7.2	7.5
Latvia	10.6	10.4	9.6	9.3
Lithuania	12.4	11.4	10.0	9.2
Poland	19.4	19.0	18.4	18.0
Slovakia	17.4	18.1	16.5	15.4
Slovenia	6.7	6.3	6.0	5.8

Source: CSOs, Eurostat, EUREN forecasts for 2005 and 2006

## SPECIAL STUDIES

*(The studies in this chapter provide background material to this report. The views expressed here do not necessarily reflect those of all EUREN institutes)*

### Introduction

Growth in the European Union remains sluggish, employment performance is not satisfying, and there is concern that productivity growth is deteriorating. Against this background, the special studies attached to the EUREN report follow a common feature: the determinants of subdued growth in the Euro Area. Focussing on different economies the various contributions, of course, offer different answers to the problem, but they also show that parts of the problem are in common. In Germany, the main contribution to the slowing of growth came from a decline in labour input and a deterioration of productivity growth. In part, shrinking labour input reflects a negative demographic trend, a result that also holds for France. Although the measures taken in this direction differ quite substantially, the reduction of working time also played a role in both countries. Demographic trends would suggest the opposite. The study on Belgium concludes that labour market policies mainly based on wage moderation and reductions in social security contributions, have been successful in increasing the labour intensity of growth, but have been unable to enhance economic growth itself. It therefore recommends increasing R&D expenditure to enhance productivity growth. The last study focuses the role of ICT expenditure for productivity growth in Spain, finding that the country is lagging behind the US in this respect. Therefore there still seems to be considerable room for increasing Spain's effort to take advantage ICT to increase productivity. This recommendation will also hold for many other EU countries.



# 1. Why is growth so sluggish in Germany - A growth accounting approach

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After the re-unification boom at the beginning of the 1990s growth in Germany was disappointingly low on average. Only in 2000, when the international environment was extremely favourable, GDP in Germany grew at a rate above the 1980s' average. Since 2001, problems seem to have aggravated, with growth reaching merely 0.6 % on average. What are the reasons behind this tendency? A growth accounting could offer some insights to answer this question.

Theoretical background of the growth accounting approach is a Cobb-Douglas production function with labour and capital as factor inputs. Labour in this context is defined as hours worked. To achieve comparability for the countries considered and to rely on data for the entire period analysed, a hypothetical capital stock is calculated applying the perpetual inventory method. For that purpose we draw on national accounts figures on gross investment and the depreciation of the capital stock, using an estimate for the initial capital stock in 1980<sup>2</sup>. The contribution of labour and capital to GDP growth is calculated in a rather mechanical way by multiplying factor input growth by the share of the factor in national income. The difference between the contribution of labour growth and capital growth on the one hand and GDP growth on the other is defined as the contribution of multi factor productivity (MFP), which captures improvements in the quality of labour and capital as well as organisational and technological progress. The calculations have been carried out for Germany, the Euro Area and the U.S.

The most prominent feature of Germany's unfavourable growth performance between 1991 and 2004 is the negative contribution of labour input to growth (table 4.1.1). Already in the 1980s labour input

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<sup>1</sup> We wish to thank Torge Middendorf and Torsten Schmidt for their assistance.

<sup>2</sup> This procedure has also been employed by Musso, Westermann (2005), "Assessing Potential Output Growth in the Euro Area". ECB Occasional Paper Series 22. Sichel/Oliner who did similar work on the US calculated productive capital stocks instead. Sichel, Oliner (2000) "The Resurgence of Growth in the Late 1990s: is Information Technology the Story?" Journal of Economic Perspectives 14 (4): 3-22. Compared to the results presented here, capital tends to contribute somewhat more and the MFP somewhat less to growth.

stagnated in Germany and the Euro Area, whereas it has been the main contribution to growth in the US. At the same time growth of MFP fell back. In the 1980s, MFP in the Euro Area as well as in Germany grew faster than it did in the US. In the 1990s yet, its contribution to growth in the US was three times as large as in Germany. On the other hand, the contribution of capital input to growth did not differ much, neither between the regions nor over time. However, the composition of capital input varies between regions. In the US, ICT capital played a more important role compared to most European countries<sup>3</sup>. Furthermore, as it will be shown subsequent, in Germany the contribution of capital declined after 1990.

**Table 4.1.1 De-composition of GDP Growth in Germany, the Euro Area, and the US; 1980-2004**  
(Contribution to growth in %-points)

	Real GDP growth (% annual avg.)	Annual average contribution of		
		Hours worked	Capital	Multi Factor Productivity
1980-1991				
Germany	2.6	0.0	1.0	1.5
Euro Area	2.4	0.0	0.7	1.7
US	2.9	0.9	1.0	1.1
1991-2004				
Germany	1.3	-0.3	1.1	0.5
Euro Area	1.8	0.1	0.8	0.8
US	3.3	0.8	1.0	1.5

*Source: RWI calculations based on figures from the Federal Statistical Office, BEA, ECB, and from the Groningen Growth and Development Centre (www.ggdc.net)*

As labour input seems to be a decisive factor to explain the differences between the regions, it will subsequently be examined in more detail. For that purpose, total hours worked are split into the number of persons employed and the hours worked per person. Furthermore, the number of persons employed can be derived by definition as the share of the labour force in total population (activity rate) multiplied by the share of persons employed in percent of the labour force (employment rate, which is the complement of the unemployment rate).

<sup>3</sup> Inklaar et al. (2003), "Productivity and Competitiveness in the EU and the US". In O'Mahoney, van Aark (eds): "EU productivity and competitiveness: An industry perspective". Enterprise publication, European Commission.

**Table 4.1.2 De-composition of the contribution of labour input to GDP Growth in Germany, the Euro Area, and the US; 1980-2004**  
(Contribution to growth in %-points)

	Contribution of labour input to growth	Annual average contribution of			
		Population	Activity Rate	Employment Rate	Hours Worked per Person Employed
1980-1991					
Germany	0.0	0.2	0.5	-0.1	-0.6
Euro Area	0.0	0.2	0.4	-0.2	-0.4
US	0.9	0.8	0.2	0.0	-0.2
1991-2004					
Germany	-0.3	0.2	0.0	-0.2	-0.3
Euro Area	0.1	0.2	0.2	0.0	-0.2
US	0.8	0.8	0.0	0.1	-0.1

*Source: RWI calculations based on figures from the Federal Statistical Office, BEA, ECB, and from the Groningen Growth and Development Centre ([www.ggdc.net](http://www.ggdc.net))*

Most eye-catching in table 4.1.2 is the population growth rate in Europe on the one hand and in the US on the other. A good deal of the differences between the regions can be explained by just this demographic factor. However, concerning the remaining factors, Germany showed the less favourable figures among these regions in the 1990s. Hours worked per person employed, which had a negative contribution in the 1980s as well as in the 1990s in all regions, declined most sizeable in Germany. The activity rate, which had been growing significant in Germany in the nineties, is now more or less constant. Finally, the surge of unemployment shows up in a negative impact of the employment rate on German growth in the 1980s and 1990s. In the Euro Area, which performed even worse in the 1980s, a turnaround can be observed in the 1990s, and in the US, the influence was slightly positive in both periods.

Table 4.1.3 presents a more detailed look on the situation in Germany after unification. To distinguish more clearly between demographic factors and the decision of individuals to participate in the labour market, the activity rate is split into the dependency rate (working age population in percent of total population) and participation rate (persons employed in percent of working age population). Furthermore, the change in the hours worked is split into two components: The contribution of working hours as they are negotiated between employers and trade unions in the wage agreements on the one hand, a time drift factor that in particular covers the growing importance of part time employment, but also other

sources of deviations from the negotiated working time such as overtime and short time work.

**Table 4.1.3 De-composition of GDP Growth in Germany 1991-2004**  
(Contribution to growth in %-points, annual averages)

	1991-1995	1995-2000	2000-2004
Labour	-0.6	-0.0	-0.3
Population	0,3	0,1	0.1
Dependency Rate	-0.1	-0.1	-0.2
Participation Rate	-0.3	0.3	0.3
Employment Rate	-0.4	0.0	-0.3
Negotiated Working Hours	-0.2	-0.1	0.0
Time Drift	0.0	-0.3	-0.2
Capital	1.4	1.2	0.6
Multi Factor Productivity	0.5	0.7	0.3
GDP Growth	1.3	1.8	0.6

*Source: RWI calculations based on figures from the Federal Statistical Office and of the WSI-Tarifarchiv*

As can be seen from the table, the contribution of the various factors to growth varies over time. In the period 1991 to 1995 the negative contribution of labour input was strongest, but it was markedly influenced by the re-unification: the participation rate as well as employment rate fell significantly in Eastern Germany, which is reflected also in the German total. The aging of the German population appears in a negative impact of the dependency rate which increases over time. On the other hand the participation rate is on the rise since the middle of the 1990s. The decomposition of working time makes clear, that in the beginning of the 1990s mainly negotiated working time reductions played a significant role. Afterwards it was more and more a negative time drift (namely the shift towards part time employment) that dampened the growth of labour input.

It also becomes evident that the slowdown of GDP growth after 2000 cannot solely be attributed to the decline of labour input. In the most recent years the contribution of capital input was cut in half, and also the growth of MFP slowed down significantly. It remains unsettled whether this is a cyclical phenomenon only. However, at least concerning MFP there are some signs that the slowdown is structural. Even between 1995 and 2000, which was a cyclical upswing, the growth of MFP was lower than in the 1980s.

This growth accounting approach is only a descriptive way to divide GDP growth in its components. In particular, the MFP appears, as Romer

rated, as a measure of our lack of knowledge in this concept. Therefore the approach does not really give an explanation why German growth is so weak. But the analysis points at some distinctive features of the German economy: The decline of labour input and the slowing of productivity growth. As far as labour input declines for demographic reasons, this trend cannot be changed in the short run. The more important it is to increase the participation rate as well as the employment rate and to stop the trend towards shorter working time. Labour market policy stimulates the creation of so called minijobs, which are filled by persons that work less than 20 hours a week as a rule. This policy mainly explains the reduction of hours worked in recent years. Because at the same time the attractiveness of taking a job is increased for housewives, pensioners, or students, also the participation rate may rise. But it does not pay off in a higher labour input, in particular if full time employment is displaced by such minijobs.

## 2. Labour productivity in France: fears and hopes

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Output growth is a function of both labour supply and labour productivity<sup>5</sup>. Enhancing labour productivity can thus be considered as one of the main goals of economic policy. On the other hand, when facing high levels of unemployment, governments, particularly in Europe, have tried to implement various policies aimed at increasing the number of jobs created by unit of GDP growth. Naturally, when the latter policies are effective, productivity growth measured as the difference between GDP growth and employment growth is reduced. In other words,

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<sup>4</sup> This text summarises a broader study published as a working paper: "Labour productivity in France: recent trends and expectation", by Carole Deneuve and Alain Henriot, Document de Travail n°68, April 2005 (downloadable in English on [www.coe.ccip.fr](http://www.coe.ccip.fr)). Figures are updated to 2004. They still use 1995 national accounts basis as the repolation doesn't go before 1990 in the new 2000 basis. However, GDP growth is quite similar in average in the 2000 and 1995 basis (2.2% against 2.1% in average from 1978-2004).

<sup>5</sup> (1)  $Y=LxY/L$  and  $dy=dLxd(Y/L)$ , with Y the level of output and L the level of employment.

economic policy can have conflicting consequences on productivity. France is clearly a case that highlights these problems. Since the beginning of the 1990s, successive governments have carried out various measures to increase employment. The main instruments have been a cut in employers' social contributions, targeted to low wage employees, and starting in 1998 a reduction of working time accompanied by new cuts in social contributions. As a consequence, productivity per person employed has continuously declined over the last ten years. In return, the decreasing trend in apparent productivity has led to growing concerns about the ability of the French economy to sustain a high level of economic growth on a long term basis. We review here most recent developments in labour productivity in France, focusing on the different approaches of that concept. Then, we try to identify the factors underlying those developments. Finally, we show the role of labour productivity in explaining potential growth, in a comparison between France and the US.

**A gap between hourly and per person employed productivity trends**

After a period of relative stability in the 1980s, per person employed productivity gains trended downwards between the beginning of the 1990s and 2002, especially in the market services industries. This movement clearly reflects the increase of the job content of GDP growth, which ceased in 2003. The year 2004 saw yet another change, with apparent productivity gains reaching levels which had not been achieved for a decade. This upturn was partly due to the usual productivity-cycle factors whereby, when growth returns, the lapse of time between the build-up of activity and the upturn in recruitment means an increase in per person employed productivity.

Over the period 1990-2004, productivity gains in industry and market services per hour, are not only higher than per person employed, but they are also trending upwards. In construction, when allowance is made for cyclical variations, hourly productivity is relatively stable over the period in question.

**Table 4.2.1 - Productivity Growth<sup>1</sup> Per Person Employed (total and employees only)**

(Annual Average Change, %, Private Sector)

Period	Industry		Market Services		Construction		Total	
	Total	Employees	Total	Employees	Total	Employees	Total	Employees
1980-2004	3.3	3.3	0.7	0.4	0.8	0.7	1.5	1.4
1980-1990	3.1	3.1	1.6	1.4	2.6	2.6	2.4	2.3
1991-1997	3.4	2.9	-0.1	-0.5	-0.5	-0.8	0.9	0.5
1997-2004	3.4	3.4	0.2	0	-0.3	-0.5	1.0	0.8
1998	5.6	5.5	0.2	-0.2	0.0	-0.5	1.7	1.4
1999	3.6	3.6	0.3	-0.1	0.2	-0.2	1.1	0.9
2000	4.2	4.1	0.6	0.2	3.1	2.4	1.6	1.3
2001	1.7	1.6	-0.9	-1.3	-1.4	-1.6	-0.3	-0.6
2002	1.9	2.0	-0.2	-0.4	-1.3	-1.2	0.2	0.1
2003	2.2	2.3	0.3	0.3	-1.9	-1.6	0.6	0.6
2004	5.0	4.8	1.3	1.3	-0.9	-0.6	1.9	2.0

Source: INSEE, authors' calculations. - <sup>1</sup> Value added per employee

**Table 4.2.2 - Hourly Productivity Growth<sup>1</sup> (total and employees only)**

(Annual Average Change, %, Private Sectors)

Period	Industry		Market Services		Construction		Total	
	Total	Employees	Total	Employees	Total	Employees	Total	Employees
1990-2003	4.0	4.0	1.0	0.5	0.2	0.0	1.8	1.5
1990-1997	3.5	3.5	0.7	0.0	-0.3	-0.7	1.4	1.1
1998-2003	4.5	4.6	1.3	1.1	0.7	0.6	2.2	2.0
1998	6.1	6.0	0.9	0.3	0.1	-0.3	2.1	1.9
1999	4.8	4.7	0.8	0.6	1.1	0.5	2.0	1.8
2000	6.5	6.5	3.4	2.9	4.3	4.1	4.2	3.9
2001	3.9	4.0	0.1	0.3	0.4	0.2	1.5	1.3
2002	3.6	3.7	1.2	1.1	0.9	1.6	2.1	1.8
2003	2.7	2.8	1.6	1.1	-0.9	-1.0	1.3	1.4
2004	4.3	4.3	1.5	1.1	-0.8	-0.8	1.9	1.8

Source: INSEE, authors' calculations. - <sup>1</sup> Total value added / employees

This discrepancy between productivity gains per hour and per person is mainly the consequences of economic policy. Indeed, the authorities instigated a number of measures in favour of employment during the 1990s, focusing, essentially, on two key themes - i.e. the reduction of the cost of unskilled and semi-skilled labour in order to encourage job creation, and the reduction in working time. These two approaches sometimes overlapped.

The first measures aimed at reducing labour costs of low income jobs at or near the minimum wage (SMIC) were introduced in early 1990's. From 1 July 2005, the final version of reduction measures will apply. The maximum rate of rebate will then stand at 26% for SMIC-level hourly salaries.

**Cuts in social contributions and reduction of working time were the main factors at the origin of the gap between hourly and per capita productivity growth**

The reduction of working time is the second set of measures which have been undertaken. The encouragement of part-time work was the first mean investigated. As a result, part-time work became much more commonplace starting in 1992, when the first incentive schemes were introduced. The law of 31 December 1992 provided for a flat-rate rebate of 30% (increased to 50% from 1 January 1993) on employers' social-security contributions (sickness, maternity, invalidity and old age). For full-time employees, the length of the working week began to decrease with the implementation of the "de Robien" rebates. In order to boost employment, the law of 11 June 1996 introduced a system of aid for companies which put in place a collective reduction in working time. This law, which paved the way for the 35-hour week, was abrogated by the Aubry law of 1998. It provided for rebates on employers' social-security contributions amounting to 40% in the first year and 30% in the following six years, if the company reduced the working hours of all or part of its workforce by at least 10%. The rebates were set at 50% in the first year and 40% in the following six years if the reduction in working hours reached at least 15%.

These measures explain a good deal of the difference observed in productivity trends. Indeed, the cut in social contribution increased the content of jobs of economic growth, as labour cost was reduced. On the other side, the reduction in working time translated into higher employment growth (although not proportionally): as output was not reduced, mainly because the simultaneous cut in social contributions alleviated total labour cost, hourly productivity increased while productivity per person employed oriented downwards.

However, when we try to explain employment by its traditional determinants (GDP and labour cost), as well as working time, a negative breakdown in the trend of productivity per person employed remains in the 1990's, as it can be seen in the following equation:





employment could continue to increase. Hourly productivity growth in market services was only 1% per year between 1990 and 2003. However, the figure derived from this equation using two trends must be probably consider as too low, as some factors identified as having impacted productivity trends in the 1990's will not influence anymore future developments, especially the increase in part time jobs. A more pragmatic approach consists in assuming that productivity trends in individual sectors will come back to the figures observed in the 1980s, but taking into account that the share of each sector has changed over the past decade. We can then recalculate the potential growth of productivity by combining past productivity trends and current weights in total employment of individual sectors. This estimate leads to an annual growth of 1.9 %. Of course, this figure could be higher if some progress was made in the productivity trends of individual sector, for instance thanks to investments in IT.

**Labour productivity:  
key for potential  
growth**

Previous developments suggest that growth of labour productivity per person employed may range between 1.5 and 2% a year, with both downward and upward risks. What does this mean for potential growth? A historical analysis shows that compared to the US level, which can be considered as a benchmark, the level of hourly labour productivity is already high in France (Table 4.2.3).

Indeed, hourly labour productivity has been the main contributor to French GDP growth since 1970, even if its annual growth rate has been halved between the 1970s and the 1990s.

**Table 4.2.3 - GDP per Capita Breakdown for OECD Countries**  
(USA=100)

	GDP per capita <sup>1</sup>		Hourly productivity <sup>2</sup>		Average hours worked <sup>3</sup>		Employment/ population <sup>4</sup>	
	2002	2003	2002	2003	2002	2003	2002	2003
Austria	80	79	89	88	87	86	95	96
Belgium	80	79	110	109	86	86	83	83
Canada	86	84	88	86	96	96	99	101
Czech Republic	43	43	40	41	110	110	91	91
Denmark	81	79	96	94	81	82	106	105
EU-15	71	70	90	88	88	88	90	91
Finland	76	75	82	82	96	96	94	95
France	74	72	107	105	81	81	87	87
Germany	74	73	95	92	80	81	91	91
Greece	52	52	62	62	107	108	79	81
Hungary	39	39	50	49	98	99	78	80
Ireland	92	91	106	107	93	90	90	91
Italy	71	70	101	99	89	89	77	79
Japan	77	78	74	75	100	101	95	96
Mexico	26	25	31	31	105	104	84	84
Netherlands	76	73	110	106	74	76	104	103
Norway	93	91	119	117	75	75	107	107
Poland	27	28	34	35	109	109	72	72
Portugal	51	50	52	51	94	94	95	94
Slovakia	34	35	38	41	110	101	79	81
South Korea	55	55	42	43	134	133	88	88
Spain	58	58	69	67	101	100	83	85
Sweden	75	75	86	86	88	87	104	104
Switzerland	86	84	86	""	84	""	110	109
United Kingdom	72	72	78	78	94	93	101	102
United States	100	100	100	100	100	100	100	100

Sources: OECD, Cepii-Chelem, authors' calculations. - <sup>1</sup>GDP at purchasing power parity (PPP) prices (Cepii-Chelem database). - <sup>2</sup>Hourly productivity is obtained by dividing GDP at PPP prices by the number of hours worked. The denominator is calculated by multiplying the employment level by the average number of hours worked. - <sup>3</sup>The average number of hours worked is drawn from the OECD Employment Outlook. - <sup>4</sup>The ratio refers to the population aged between 15 and 65 years. It is drawn directly from the OECD Employment Outlook.

Several studies have shown a break in productivity trends in the US in the middle of the 1990s<sup>6</sup>. The table 4.2.4 shows only a slight acceleration in hourly productivity in France, while the acceleration in the US was more pronounced<sup>7</sup>. Regarding other components of GDP growth, one of the most striking features is the marked slowdown of working age population growth, which explains a full point of the growth differential between France and the US between 1990 and 2003. Greatly negative in the 1970s and 1980s, the contribution of the participation rate has been positive since 1990, with a strong increase since 1995. This is clearly a consequence of the measures presented previously. The average number of hours worked has been reduced steadily over the last thirty years. If the reduction in legal working time has only contributed to increase the rate of decline of working time, it does not appear as something new for the French economy.

In a context of weak demographic developments, the contribution of labour force to potential growth will diminish significantly in the coming years. Keeping a potential growth rate around 2 % a year would thus mean orientating economic policy toward three possible ways: enhancing hourly productivity, increasing the participation rate<sup>8</sup> or/and reversing the downward trend of the average number of hours worked. The main task for economic policy will thus be to find the most efficient and socially acceptable combination among those three axes.

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<sup>6</sup> Gordon R.J., (2003) « Exploding Productivity Growth: Context, Causes, and Implications », *Brookings Papers on Economic Activity*, vol. 2.

<sup>7</sup> As the figures in Table 1 refer to total employment, hourly productivity growth differs from the most common series used which is hourly productivity in non farm industries provided by the Bureau of Labor Statistics.

<sup>8</sup> Note that the ratio  $N/POPO_{15-64}$  can also be increased by a reduction of the NAIRU.

**Table 4.2.4 - Contribution of Various Components to the Annual Growth Rate of GDP**

		Contribution of			
	Real GDP growth	Hourly productivity	POP15-64	N/POP15-64	Average number of hours worked
France					
1970-1979	3.5	3.9	0.8	-0.2	-0.9
1980-1989	2.5	3.2	0.9	-0.7	-0.9
1990-2003	1.7	2.0	0.3	0.3	-0.9
1995-2003	2.2	2.1	0.4	0.8	-1.1
USA					
1970-1979	3.7	1.7	1.7	0.6	-0.4
1980-1989	3.3	1.3	0.9	0.9	0.2
1990-2003	3.0	2.0	1.3	-0.2	-0.2
1995-2003	3.3	2.4	1.5	-0.3	-0.3

*Source: OECD database, authors' calculations*

Remark: the US figures refer to total employment based on the Current Population Survey as released by the Bureau of Labor Statistics

### 3. Why is Belgian productivity growth declining?

**Igor Lebrun, Federal Planning Bureau, Belgium**

In its annual review of the EU Economy<sup>9</sup>, the European Commission expressed its concern about the deterioration in the EU's productivity performance. It has been hotly debated in academic and policy-oriented circles whether this phenomenon is temporary or permanent and what its causes are. In this special study we take rather a different approach by analysing long-term productivity growth in Belgium in terms of its main

<sup>9</sup> "The EU Economy: 2004 Review", European Economy, No. 6, October 2004.

macroeconomic determinants. Using a theoretical model based on a production function, we are able to isolate the contributions of real wages, working time and labour efficiency. Within this framework we show that the structural employment shift from manufacturing to the service industry plays a key role in explaining declining labour efficiency gains. These findings are confirmed by applying a shift-share analysis to decompose labour productivity growth into a between- and a within component.

### ***Comparing Belgian and euro area productivity trends***

We will begin by putting recent productivity trends in perspective. The chart 4.3.1 shows Belgian productivity growth per hour and per worker in the private sector since the early seventies up to 2005<sup>10</sup>. Trends are computed using a Hodrick-Prescott filter. First of all, it is noteworthy that declining productivity growth is nothing new, as the phenomenon started after the first oil shock. Secondly, the stronger decrease in productivity gains per hour as compared to gains per head until the mid-nineties is due to the progressive slowdown in working time reduction. Finally, according to the latest data, productivity growth, which has reached historically low rates, seems to have stopped declining.

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<sup>10</sup> The forecasts for 2005 are those published by the FPB in its annual report "Perspectives économiques", April 2005.

**Chart 4.3.1- Belgium: Productivity in the private sector**

(Annual growth in %)

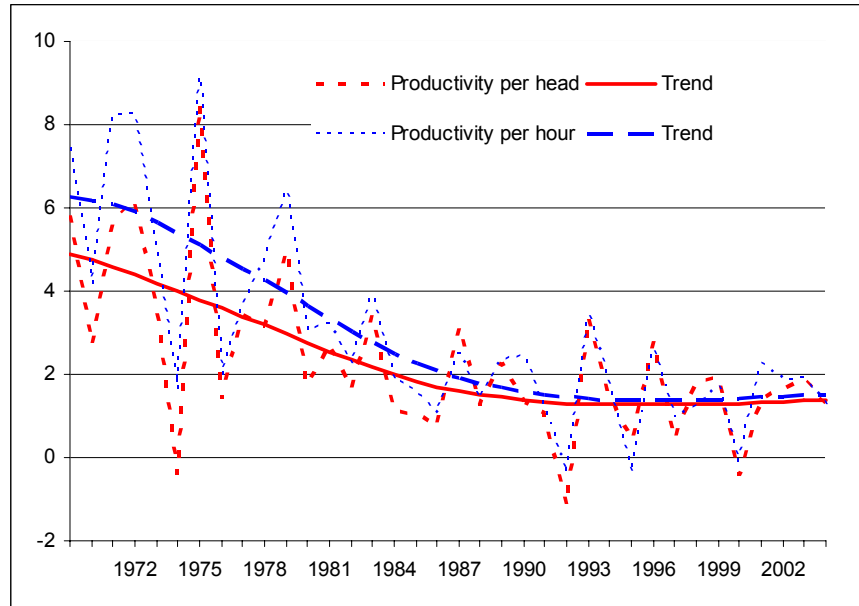


Table 4.3.1 compares average annual value added growth rates in the private sector in Belgium and in the euro area, including a breakdown in its productivity and employment components. A first feature that catches the eye is the higher value added growth rates recorded in Belgium in the seventies. This performance was entirely caused by higher productivity gains. During the two following decades, Belgium showed more similarities with the euro area. While employment failed to contribute to value added growth in the seventies, it was able to do so afterwards, especially during the nineties. Indeed, declining productivity growth has been partly compensated by additional jobs. To some observers - although this is still a controversial issue - this increase in the employment content of growth indicates that labour market reforms have been successful in encouraging the hiring of low-skilled workers.

**Table 4.3.1 - Contributions to value added growth in the private sector**

	Belgium				euro area			
	1971-1980	1981-1990	1991-2000	2001-2005	1971-1980	1981-1990	1991-2000 <sup>a</sup>	2001-2005
Value added growth rate (in %)	3.6	2.2	2.0	1.5	3.3	2.4	2.2	1.2
Contribution of productivity per worker	3.9	1.9	1.4	1.1	3.3	1.9	1.5	0.5
Contribution of employment	-0.3	0.3	0.6	0.3	-0.0	0.5	0.6	0.7

<sup>a</sup>The data have been corrected so as to exclude the effect of the German reunification

In the period 2001-2005, Belgium again outperforms - like in the seventies - the average of the euro area, which saw its productivity growth rate divided by three compared to the nineties.

### ***The macroeconomic determinants of productivity***

Traditionally, macroeconomic productivity gains are analysed by applying a growth accounting method which makes it possible to break down productivity growth into a number of factors such as the quality of factor inputs, capital stock per worker and a residual called total factor productivity. Here we use a slightly different method by going one step backwards and looking at the determinants of factor inputs, namely factor prices and technological progress. Evaluating their respective contributions to productivity growth calls for an econometric approach based on a production function. We follow the methodology proposed by INSEE<sup>11</sup> which states that in a framework of monopolistic competition where firms face a CES production function with labour augmented technological progress, productivity per head is determined by real wages, working time and labour efficiency (see box 4.3.1 for a technical presentation).

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<sup>11</sup> "Le ralentissement de la productivité du travail au cours des années 1990", *Document de travail*, G 2003/07, novembre 2003.



### Box 4.3.1 - The model

Starting from an economy where each firm  $i$  faces monopolistic competition and a CES (constant elasticity of substitution) technology with constant returns to scale:

$$Y_i = [\sigma K_i^{1-\sigma} + (1-\sigma)(E_i H_i L_i)^{1-\sigma}]^{\frac{1}{\sigma}} \quad (0-1)$$

with  $Y$ ,  $K$ ,  $L$  et  $H$  respectively value added, capital stock, employment and working time;  $E$  labour augmented technological progress;  $\sigma$  substitution elasticity between capital and labour and  $\lambda$  a positive parameter smaller than 1;

one can show that profit maximisation leads to an aggregate labour demand function expressed in number of hours equal to:

$$l + h = y - \lambda(w-h-p) - (1-\lambda)e + cst \quad (0)$$

or expressed in number of workers:

$$l = y - (1-\lambda)h - \lambda(w-p) - (1-\lambda)e + cst \quad (1)$$

with lower cases indicating natural logarithms of the variables,  $p$  value added price and  $w$  wage cost per head.

Equation (1) can be rewritten as an equation explaining productivity per head:

$$y - l = (1-\lambda)h + \lambda(w-p) + (1-\lambda)e - cst \quad (2)$$

This expression postulates that labour productivity depends on working time, real wages and labour efficiency. The latter is captured by an exogenous time trend and measures long-term productivity linked to technological progress. From an econometric point of view, the specification of the trend will be determined based on the stationarity of the residuals and the quality of the statistical fit.

Such an approach allows us to test in particular whether the decline in trend productivity growth can be explained by wage evolutions. In other words, it allows to check whether the slowdown in productivity gains (taking into account the number of hours worked) is due to a slowdown in the ongoing substitution process of labour by capital or to other factors considered here as exogenous.

The chart below compares the evolution of hourly productivity and real hourly wage cost for the private sector since the seventies. The first thing to notice is the fairly clear correlation between the series. A second fact to mention is the faster growth of wages compared to productivity during the seventies, while trend wage growth has remained close to or below trend productivity growth since the beginning of the eighties.

**Chart 4.3.2 - Belgium: Productivity and wages in the private sector.**  
(Annual growth in %)

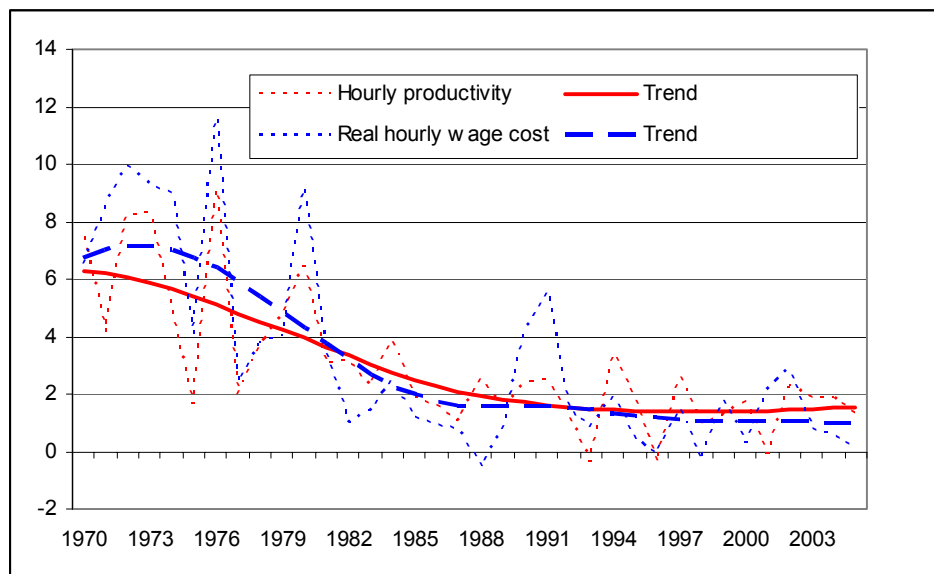


Table 4.3.2 shows a breakdown of productivity growth into its various determinants based on equation (2) presented in box 4.3.1<sup>12</sup>. The second row clearly indicates that the (negative) contribution of working time has been rather small since the eighties. The contribution of real wages also dropped in the eighties, falling from almost two and a half percentage points in the seventies to less than half a percentage point in the following decade. However, it has remained rather stable since then. The slowdown in the substitution process of labour by capital is thus the most important factor behind the decrease in productivity growth during the eighties as compared to the seventies. The last row gives the contribution of the “unexplained” component which is attributed to the improvement in labour efficiency. As this is a measure of long-term labour productivity (in contrast to observed labour productivity), it is worrisome to note that this contribution has decreased significantly in the eighties and nineties. However, this decrease seems to have come to a halt in recent years.

<sup>12</sup> The equation is estimated on the period 1970-2003. For the years 2004-2005, efficiency gains are computed as the residuals of the equation in first differences:  $\Delta(y-l) - (1-l)\Delta h - \Delta(w-p)$ .

**Table 4.3.2 - Belgium - Contributions to productivity growth**

	1971-1980	1981-1990	1991-2000	2001-2005
Productivity growth rate (in %)	3.9	1.9	1.4	1.1
Contribution of working time	-0.8	-0.2	-0.1	-0.2
Contribution of real wage	2.4	0.4	0.5	0.4
Contribution of labour efficiency	2.4	1.7	0.9	0.9

We will now compare the results obtained for Belgium and the euro area. As there is no time series available for hours worked in the euro area as a whole, the trend capturing labour efficiency here includes the effects in working time fluctuations. The difference in productivity growth between the two regions in the seventies is largely due to the much higher real wage contribution recorded in Belgium. Contributions of both components were much closer in the two regions in the eighties and nineties, although efficiency gains declined less in the euro area over the last decade. For the current period, the spectacular drop in productivity growth in the euro area is largely due to the decrease in the labour efficiency contribution, which is now below the one computed for Belgium. Note that the contribution of real wages in the euro area has fallen to almost zero during that same period.

**Table 4.3.3 - Belgium vs. euro area - Contributions to productivity growth**

	Belgium				euro area			
	1971-1980	1981-1990	1992-2000	2001-2005	1971-1980	1981-1990	1992-2000 <sup>a</sup>	2001-2005
Productivity growth rate (in %)	3.9	1.9	1.4	1.1	3.3	1.9	1.6	0.5
Contribution of real wages	2.4	0.4	0.3	0.4	1.1	0.3	0.2	0.0
Contribution of labour efficiency (including working time)	1.6	1.5	1.0	0.7	2.2	1.6	1.4	0.5

<sup>a</sup>The year 1991 has been excluded to avoid the effects caused by German unification

### *An analysis by industry*

We will now examine whether structural changes in the Belgian economy can help explain the declining trend in labour efficiency over the last two

decades. We will therefore conduct a separate analysis for the manufacturing and market service industries. The first row in Table 4 clearly indicates that a dramatic change has taken place as the employment share of the manufacturing industry has fallen by more than 15 percentage points in almost three decades, while the employment share of the service industry has increased by more than 21 percentage points over the same period. The next row shows that productivity growth rates have also been very different. Growth rates in manufacturing industry have declined every decade, but have been stable, albeit at a very low level, for market services since the eighties.

**Table 4.3.4 - Comparing manufacturing and service industry**

	Manufacturing industry				Market service industry			
	1971-1980	1981-1990	1991-2000	2001-2005	1971-1980	1981-1990	1991-2000	2001-2005
Employment (in % of total private sector)	34.0	27.2	21.9	18.6	49.3	59.4	66.1	70.6
Productivity growth (in %)	5.7	4.8	3.5	3.1	2.1	0.7	0.6	0.7
Contribution of working time	-0.6	-0.1	-0.1	-0.2	-0.8	-0.3	0.0	-0.3
Contribution of real wages	4.9	2.5	2.1	2.3	1.6	-0.2	0.2	0.3
Contribution of labour efficiency	1.4	2.3	1.4	1.0	1.4	1.2	0.4	0.8

The breakdown into the various determinants reveals, as it was the case at the aggregate level, that for both industries the contribution of real wages accounts for the decrease in productivity growth rates in the eighties. The contribution of labour efficiency is another story: it increased significantly in the manufacturing industry and declined only marginally in the market service industry during the eighties. In the last decade a decrease in the efficiency contribution was seen in both

industries<sup>13</sup>, but it has been rising again in the market service industry since 2001. These estimates may look somewhat in contradiction with aggregate results presented in Table 4.3.2 where efficiency gains clearly exhibited a downward trend, but this only illustrates the so-called aggregation bias in the economic literature. It is precisely the structural shift in employment from manufacturing (with greater productivity gains) to market service industries (with lower productivity gains) that is responsible for the continuous decreasing trend in labour efficiency observed at the macro level. One implication of this is that, in the context of medium-term projections, relying exclusively on macroeconomic results could lead to biased forecasts. Of course it would be advisable to disaggregate even further than what is done here, particularly in market services where internal shifts between heterogeneous industries could likewise have had an influence on aggregate productivity gains. In the next section we will try to quantify these structural effects.

### ***A shift-share analysis***

As we saw previously, aggregate productivity growth reflects both productivity gains at the sectoral level and the change in the sectoral composition of employment. In other words, employment transfers to sectors with higher or lower productivity levels will have an influence on aggregate productivity growth rates, even without changes in within-sector productivity gains. Shift-share analysis allows decomposing labour productivity growth algebraically into three effects, namely a productivity growth effect, a structural change effect and an interaction effect (see box 4.3.2 for a formal presentation of these effects)<sup>14</sup>.

Table 4.3.5 shows the outcome of the breakdown of productivity growth into these components, based on a disaggregation in eleven industries. The productivity growth effect is, as one could expect from the econometric approach, much lower in the eighties as compared to the

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<sup>13</sup> A possible explanation for the decline in efficiency gains in the nineties is the multiplicity of measures taken aiming at putting some categories of low-productivity workers (low-skilled, long-term unemployed, etc.) back in work. The impact of all those measures is difficult to assess econometrically in labour demand equations due to the lack of accurate time series.

<sup>14</sup> A similar approach has been used by the European Commission to analyse productivity growth in the EU and in the USA, "Employment in Europe 2003. Recent Trends and Prospects", *Employment & social affairs*, 2004.

seventies. More surprisingly, the effect is decreasing further - nevertheless at a much slower pace - in the nineties. Note that this is not entirely due to lower within-industry productivity gains but also to the continuous reallocation of labour in favour of industries with relatively lower productivity gains, which alters the weights (defined by the share of employment), used to compute the productivity growth effect. Calculated on the basis of the labour structure as it was back in 1980, the average productivity growth rate in the nineties would only be 0.1 percentage point lower than in the eighties. In spite of this phenomenon, the productivity growth effect is on the rise again in the period 2001-2005, while total labour productivity growth continues to decline.

#### Box 4.3.2 - Shift-share analysis applied to productivity growth

The aggregate productivity growth rate can be decomposed according to the following identity :

$$\frac{\Delta PROD_t}{PROD_{t-1}} = \sum_{i=1}^n \left[ \left( \frac{\Delta PROD_{it} * PN_{it-1}}{PROD_{t-1}} \right) + \left( \frac{\Delta PN_{it} * PROD_{it-1}}{PROD_{t-1}} \right) + \left( \frac{(\Delta PN_{it} * \Delta PROD_{it})}{PROD_{t-1}} \right) \right] \quad (1)$$

(productivity growth rate = productivity growth effect + structural change effect + interaction effect)

with PROD total labour productivity, PROD<sub>i</sub> labour productivity in industry i and PN<sub>i</sub> the share of employment in industry i.

The first component represents the contribution to labour productivity growth of within-sector productivity gains weighted by an unchanged employment structure.

The second component measures the effect on labour productivity growth of shifting employment from one industry to another industry, given relative productivity levels. A positive (negative) effect means that expanding (contracting) industries are those with a high level of productivity. When this effect is increasing (decreasing) over time, it implies that more and more resources are reallocated to industries with higher productivity levels.

The last component summarizes the interaction effect between changes in structure and within-industry productivity gains. A positive (negative) effect indicates that the industries in expansion are those having the highest (lowest) productivity gains.

**Table 4.3.5 - Productivity per head: growth and structure effects**

	1971-1980	1981-1990	1991-2000	2001-2005
Total labour productivity growth (in %)	3.9	1.9	1.4	1.1
Productivity growth effect	3.4	1.6	1.1	1.4
Structural change effect	0.5	0.4	0.3	-0.3
Interaction effect	-0.0	-0.1	-0.0	-0.0

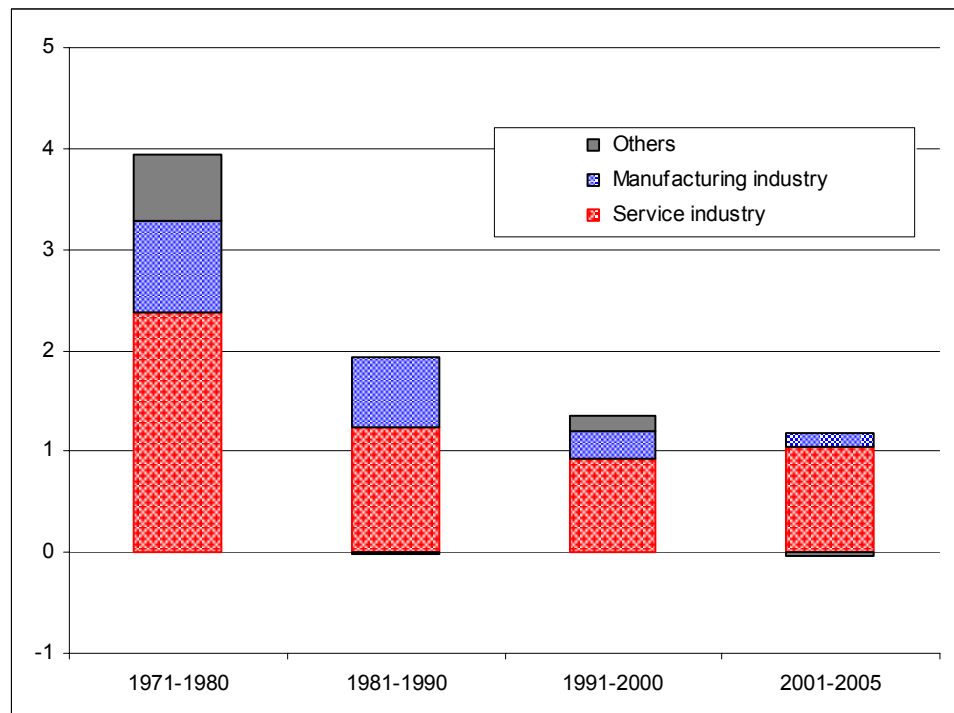
The second row confirms the hypothesis made earlier in the paper that the evolution of productivity growth is negatively affected by structural changes. The effect was positive up to the nineties but decreasing over time, as expanding industries (mainly service industries) are becoming less and less productive<sup>15</sup> in relative terms. For the period 2001-2005, the situation is such that the structural effect becomes even negative. The consequence of all this is that the interaction effect is negative - although rather small - across the whole sample, as expanding industries are precisely those having the lowest productivity gains.

Chart 4.3.3 gives the contributions to productivity by industry. Exception made from the seventies, industries as agriculture, energy and construction, regrouped here under the category 'others', have a negligible impact on macroeconomic productivity. The contribution of the manufacturing industry is more important but rapidly decreasing, as declining productivity effects are combined with negative structural effects due to the employment shift to market services. Notwithstanding its low productivity gains, the service industry is by far the biggest contributor, thanks to largely positive structural effects.

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<sup>15</sup> In 1970, the productivity level of the market service industry stood at 136 (as compared to 100 for the average of the private sector) while in 2000 it was only 90. Conversely, the productivity level for the manufacturing industry stood at 67 in 1970 and 128 in 2000. Clearly, these evolutions in relative levels are caused by the higher productivity gains recorded in the manufacturing industry over the last thirty-five years.

Chart 4.3.3 - Belgium: Productivity growth, Contribution by Industry



### ***Conclusions***

In this paper we have shown that decreasing productivity growth in the private sector is not new, neither in Belgium nor in the euro area as a whole. Luckily, this decrease has not been accompanied by an equivalent slowdown in value added growth, as the decline in productivity gains has been partly compensated by extra job creation.

Using an econometric approach based on a production function, we demonstrate that the decrease in aggregate productivity growth rates in the eighties as compared to the seventies was due to a large extent to a lower contribution of real wages. Similarly, a comparison between the results obtained for Belgium and the euro area indicates that higher productivity in Belgium during the seventies was entirely explained by differences in wage evolutions. More worrisome, however, is the



decrease in labour efficiency gains across the whole sample, both in Belgium and in the euro area.

Using the same approach, but distinguishing this time between manufacturing and market service industries, we end up with what may at first sight look contradictory to the aggregate results, i.e. that no clear decreasing trend in labour efficiency gains is emerging, either in manufacturing or in market services. A possible explanation is the aggregation bias caused by a structural shift in employment from manufacturing to market service industries.

A shift-share analysis based on a further disaggregation in eleven industries seems to confirm this hypothesis. The structural change effect, which measures the effect on aggregate productivity growth rates of shifting employment from one industry to another, is decreasing over time and becomes even negative in the current decade.

Very illustrative of the situation is the comparison between the last two columns of Table 4.3.5: despite higher within-sector productivity gains during the period 2001-2005, macroeconomic productivity growth was higher in the nineties. This means that global productivity growth is somehow caught between, on the one hand, manufacturing industries destroying employment and generating high productivity rates, and, on the other hand, market services creating employment but with low productivity gains. Getting out of this “productivity trap” would imply a complete turnaround, i.e. simultaneously creating productivity gains and employment within one industry.

In this respect, Belgian labour market policies mainly based on wage moderation and reductions in social security contributions, have been successful in increasing the labour intensity of growth, but have been unable to enhance economic growth itself. In its latest recommendation to the Council<sup>16</sup>, the European Commission insists on “the realisation of a knowledge society, based upon human capital, education, research and innovation policies”. Simulations made with the NEMESIS model<sup>17</sup> show that for Belgium, achieving the Barcelona objective of R&D expenditure equivalent to 3% of GDP would have only a limited positive

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<sup>16</sup> CEC, “Integrated Guidelines for Growth and Jobs (2005-2008)”, April 2005

<sup>17</sup> Biatour B., Fiers J., Gilis S., Kegels C. and Thiery F. (2005), “European R&D Strategy : impact and feasibility study for Belgium”, Federal Planning Bureau, *Working Paper*, 3-05, February 2005.

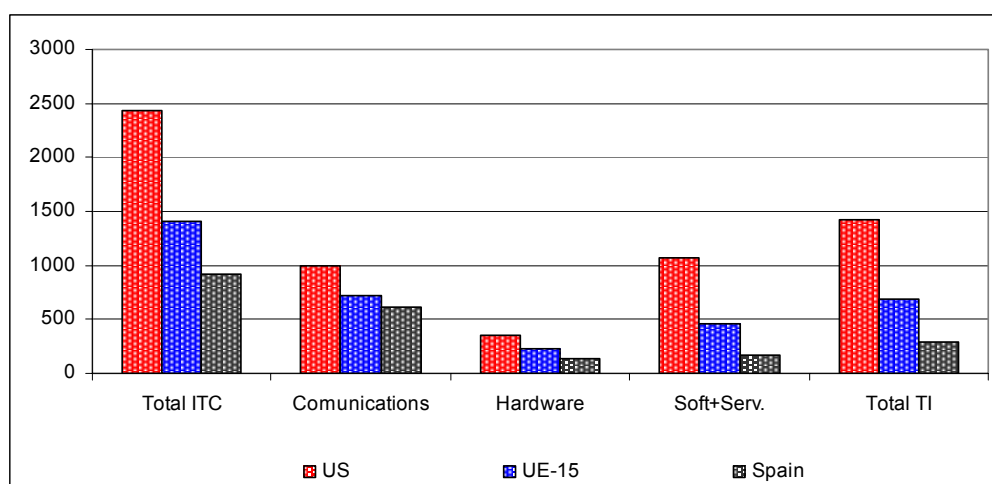
impact on economic growth in 2010, as extra expenditure in R&D only exerts its full effects in the long term.

## 4. The influence of ICT on Spanish productivity

Julian Perez, CEPREDE

Several studies have pointed out the growing importance of ICT as an important factor enhancing productivity growth, and have insisted on the concept of digital divide as accounting for income and wealth differences. In the 2004 report of the European Information Technology Observatory (EITO) total per capita ICT expenditure in Spain was estimated at some 900€, while the EU average was at 1,400€ and the US average at 2,400€

Chart 4.4.1 - Expenditure on ICT, Euro per Capita

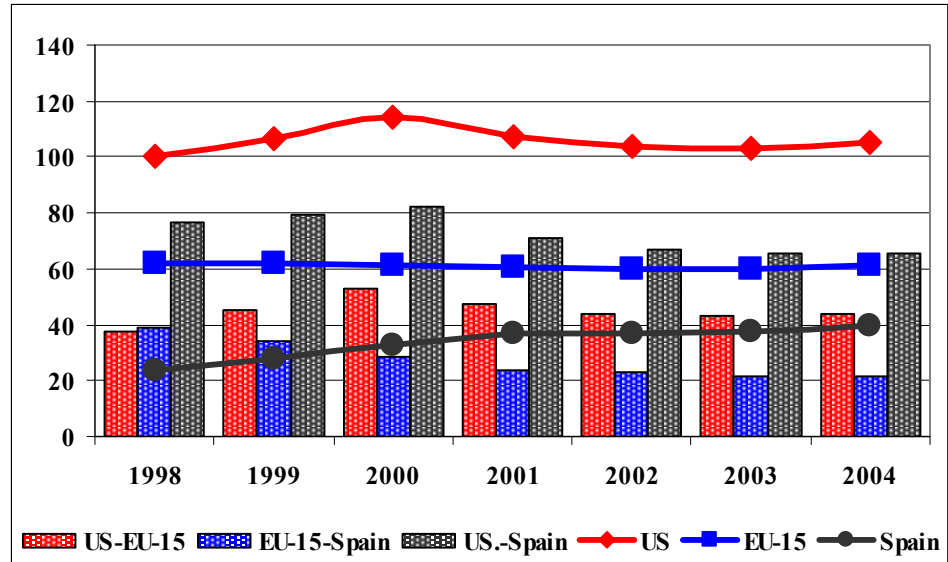


Source: European Information Technology Observatory (EITO)

Inspection of Chart 4.4.1 shows that the overall gap (Spain is at about 65% of the European average) is especially relevant for software and services, and Chart 4.4.2 makes evident that during the past seven years Spain is slowly converging both toward the US and the EU levels.

**Chart 4.4.2 - Expenditure on ICT relative to the US**

(US in 1988 =100)



Source: European Information Technology Observatory (EITO)

There is a positive relation between the development of ICT and productivity gains. The Groeningen Growth and Development Centre (2003) has identified and computed different sources of productivity growth (capital deepening and total factor productivity) and the specific contribution of ICT, for the European countries and the USA during the nineties. As to the contribution of ICT, with the exception of Ireland, all European countries show rates below those of the USA.

These results point out Spain is the only European country in which ICT has not at all contributed to the change in productivity between the first and the second half of the nineties.

If we concentrate on the specific Spanish situation in Table 4.4.2 and we compare the situation here with the USA and the EU using the same set of data and analytical tools, it can be noticed that ICT capital deepening has even declined (due to the decrease observed in software components). Furthermore, the contribution of ICT goods and services, while increasing, is well below European and US rates of change.

**Table 4.4.1: Factors of Change of Productivity.**

(Average 1990-1995 in relation to 1995-2000, Percentage points)

	% g.r	Capital deepening		TFP			Total ICT contribution
		Productivity	ICT	Non ICT	total	ICT	
Spain	-2,07	-0,03	-0,92	-1,12	0,03	-1,15	0,00
Portugal	-1,03	0,02	-0,61	-0,44	0,01	-0,45	0,03
Germany	-1,11	0,04	-0,70	-0,45	0,02	-0,47	0,06
Finland	1,00	0,10	-1,06	1,95	0,01	1,94	0,11
Italy	-1,87	0,09	-0,60	-1,37	0,02	-1,39	0,11
France	-0,03	0,11	-0,78	0,64	0,05	0,59	0,16
Denmark	-0,71	0,16	0,01	-0,89	0,01	-0,90	0,17
EU	-1,02	0,12	-0,65	-0,50	0,05	-0,55	0,17
Austria	1,37	0,16	0,03	1,19	0,02	1,17	0,18
Sweden	0,10	0,25	-0,11	-0,04	-0,05	0,01	0,20
Netherlands	-0,62	0,25	-0,65	-0,22	0,03	-0,25	0,28
UK	-0,89	0,29	-0,26	-0,92	0,11	-1,03	0,40
USA	1,02	0,35	0,06	0,60	0,18	0,42	0,53
Ireland	2,27	0,47	0,50	1,31	1,85	-0,54	2,32

Source: Bart van Ark, Johanna Melka, Nanno Mulder, Marcel Timmer and Gerard Ypma (2003): *ICT Investments and Growth Accounts for the European Union. Research Memorandum GD-56*

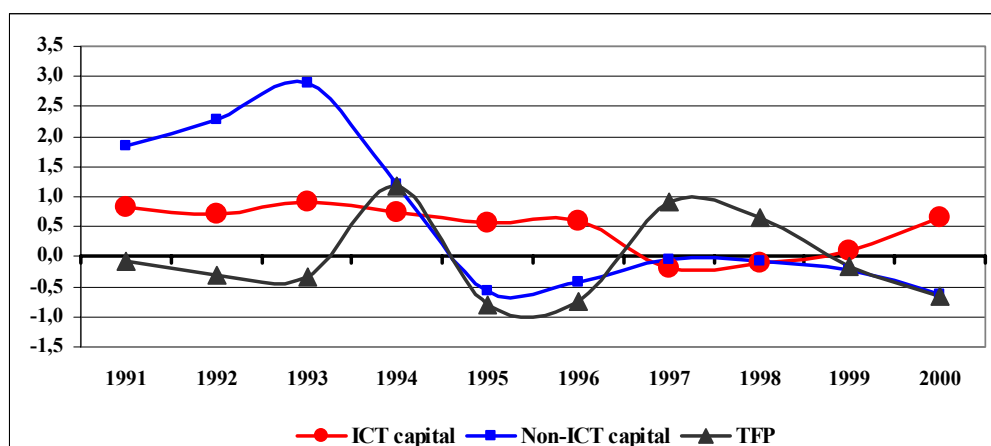
In the same perspective CEPREDE estimated in 2001 the contribution of capital deepening to productivity gains during the period 1991-2000, showing that this contribution had gone down from an average of 0.74 points for the first half of the decade to 0.26 during the second (Chart 4.4.3).

**Table 4.4.2: Factors of productivity change**  
(Percentages)

	1990-1995			1995-2000			Difference 95/90 over 2000/95		
	EU	USA	Spain	EU	USA	Spain	EU	USA	Spain
% Growth Productivity	2,45	1,19	2,29	1,43	2,21	0,22	-1,02	1,02	-2,07
Contributions from:									
Capital deepening	1,34	0,58	1,31	0,80	1,00	0,36	-0,54	0,42	-0,95
ICT Capital	0,28	0,40	0,20	0,40	0,75	0,17	0,12	0,35	-0,03
Office machines	0,13	0,19	0,11	0,22	0,38	0,12	0,09	0,19	0,01
Communications	0,06	0,04	0,02	0,07	0,11	0,04	0,01	0,07	0,02
Software	0,09	0,16	0,07	0,11	0,26	0,02	0,02	0,10	-0,05
Non-ICT Capital	1,05	0,19	1,11	0,40	0,25	0,19	-0,65	0,06	-0,92
Contributions from:									
TFP	1,12	0,61	0,98	0,62	1,21	-0,14	-0,50	0,60	-1,12
ICT Products	0,14	0,23	0,09	0,20	0,40	0,12	0,06	0,17	0,03
Other Products	0,97	0,38	0,89	0,42	0,81	-0,26	-0,55	0,43	-1,15
Total ICT Contributions	0,43	0,62	0,29	0,61	1,15	0,29	0,18	0,53	0,00

Source: Bart van Ark, Johanna Melka, Nanno Mulder, Marcel Timmer and Gerard Ypma (2003): *ICT Investments and Growth Accounts for the European Union. Research Memorandum GD-56*

**Chart 4.4.3 - Decomposition of productivity gains in Spain, annual growth rates**



Source: Pulido, A. y Pérez, J.(2001): "Hacia una valoración del impacto macroeconómico de las TIC". XV REUNIÓN DE ASEPELT-ESPAÑA

These results are apparently negative, and they have to be ascertained by other complementary approaches. In a recent paper I. Hernando and S. Nuñez have used a micro data information base for 1.300 Spanish firms to compute the sources of productivity growth differentials. Their conclusions, while more optimistic, do show a rather similar evolution.

**Table 4.4.3 Factors of productivity Change in Spain**  
(Percent)

	1992-1995	1996-2000	2000-1996/1995-1992
% growth rate of productivity	2,9	1,67	-1,23
Contributions from:			
Capital deepening			
ICT Capital	0,31	0,38	0,07
Software	0,12	0,17	0,05
Hardware	0,19	0,21	0,02
No-ICT Capital	1,36	0,3	-1,06
Contributions from:			
TFP	1,23	0,99	-0,24
ICT Products	0,17	0,19	0,02
Other Products	1,06	0,8	-0,26
Total ICT contributions	0,48	0,57	0,09

*Source: Hernando, I. y S. Nuñez (2003) "The Contribution of ICT to Economic Activity: A Growth Accounting. Exercise with Spanish Firm-Level Data". Investigaciones Económicas . vol. XXVIII (2), 2004, 315-348*

It appears that the Spanish economy has still considerable room for increasing its effort to adopt ICT and to positively take advantage of these technologies to increase productivity gains.