

ASSESSMENT AND RECOMMENDATIONS

Key macroeconomic and structural policy challenges

1. Entering its fifth year of existence, the European Economic and Monetary Union (EMU) has met major headwinds. At the advent of the single currency the euro area experienced solid economic growth, with unemployment falling and public finances rapidly improving. However, a number of structural problems were exposed with the cyclical downturn since 2001, from which the area is recovering only hesitantly. The challenges facing policy makers at present are both of a short-run and medium-run nature. Policy makers are currently grappling with sluggish demand. Responding to this challenge, monetary policy has been eased and fiscal policy reacted through the automatic stabilisers. However, the room for manoeuvre was reduced by lingering inflationary pressures and earlier insufficient fiscal adjustment in several member states. Meanwhile the euro exchange rate has appreciated significantly. Over the medium term, the Community has set ambitious targets and a vast programme for enhancing the performance of labour, product and financial markets. This programme needs to be pursued with vigour, thereby raising the odds of large gains in trend growth and jobs while making it easier to achieve sound fiscal positions.

The downturn proved longer than initially expected

2. Growth fell from a 3½ per cent peak in 2000 to 1 per cent in 2002. The bursting of the global stock market bubble, the unsettling of corporate balance sheets and uncertainty about the timing and strength of the recovery inhibited a swift recovery of business investment, while bleaker job prospects and geopolitical uncertainties affected consumer confidence and spending. Macroeconomic policies have provided some offset, as interest rates have been cut in several steps since 2001, with the cuts contingent on falling inflation concerns, while the fiscal stance has been mildly expansionary since 2000. The latter reflected fiscal action by some countries that had achieved sufficient room for manoeuvre, but also by countries that had not yet done so and found themselves in breach of the commitments stemming from the Stability and Growth Pact and the Treaty. While the shocks have been largely global, the euro area has shown less resilience to these shocks than many other parts of the OECD area. This may reflect structural and institutional rigidities, which have inhibited a brisk rebound in domestic demand. While net external trade picked up some of the slack, this favourable influence is now vanishing as the exchange rate has recovered its earlier losses.

Unemployment has risen little so far, while inflation pressure is waning

3. Despite sub-par growth, the unemployment rate has picked up little to date. Since bottoming in 2001, it has risen by ¾ of a percentage point to 8¾ per cent. This could indicate a better labour market performance, but could also mask significant labour hoarding. At the same time real product wages decelerated only little during the downturn, which suggests that wage resistance against adverse price shocks remains an important feature of wage formation

systems in the euro area. However, with slack in product markets growing, profit margins falling and the currency appreciating, inflation has come down to 1.9 per cent in May, after hovering in the 2 to 3 per cent range since mid-2000.

The recovery is set to be muted

4. The recovery is likely to face headwinds for some time. The Gulf conflict weighed heavily on consumer and business sentiment and oil prices have been high and volatile. The euro has appreciated by more than 20 per cent in effective terms from its low in late-2000, and this has eased inflationary pressure. Hence, with the exchange rate assumed to remain strong the OECD assumes the European Central Bank (ECB) to keep its policy rate on hold after the series of cuts in the spring of 2003 until mid-2004. Meanwhile, fiscal policy, which is being constrained by earlier slippage, will provide no further stimulus unless it departs further from the requirements of the Stability and Growth Pact. The OECD's assessment is that activity is likely to remain subdued in 2003, but could accelerate to potential growth of some 2 per cent in 2004. The unemployment rate would peak in 2003, and then fall only slightly to about 8½ per cent in the second half of 2004. With the negative output gap remaining large and temporary factors waning, inflation is expected to decline to 1½ per cent in 2004.

Downside risks predominate

5. Uncertainties around the projection are large. On the positive side, oil prices could fall by more than projected, following the end of the Gulf conflict, thus lowering inflation and boosting household incomes. Another positive factor is that there could be a quicker than projected dissipation of uncertainty, leading to a stronger recovery in confidence and a more rapid unwinding of precautionary savings, thus supporting domestic demand more than anticipated. However, there are also major downside risks, both on the internal and external side, with poor GDP growth in the first quarter of 2003 not boding well in this regard. A possible wave of company restructuring, with a labour shake-out and rising unemployment, could depress consumer confidence further. Fiscal tightening may be stronger than embedded in the OECD projections if several countries take action to respect their Stability and Growth Pact obligations. This would usually be expected to adversely affect demand in the short run. However, meeting the commitments would enhance the credibility of the Stability and Growth Pact and of fiscal policy in general. This may spur confidence among consumers and investors, with positive implications for growth over the medium term and possibly even in the short term. Moreover, fiscal consolidations appear to be more successful if they include spending reforms that sharpen incentives to work and invest. On the external side, the upswing in the US economy may stall. If, moreover, financial markets consider the widening US current account deficit unsustainable in the medium run, a further appreciation of the euro exchange rate *vis-à-vis* the dollar could occur. The euro area economy could perhaps weather one or another of these downside risks, given the scope for monetary policy to respond. However, coping with a combination of several adverse shocks would be very challenging for policy makers.

Temptations to ease fiscal policy in the upswing should have

6. The Stability Programmes presented by the member countries on the eve of the 2001 downturn envisaged balanced budgets to be broadly achieved by 2002, but this goal has been put off by at least four years. Overruns were widespread, but they were particularly large in the three major countries and

been resisted

Portugal. Portugal breached the deficit limit of 3 per cent of GDP enshrined in the Maastricht Treaty already in 2001. Germany and France followed suit in 2002, with Italy also approaching the danger zone. Slippage against the targets was largely rooted in the fiscal easing that was initiated at the peak of the cycle in 2000 with knock-on effects also in 2001 and 2002. These countries failed to comply with the commitments of the Stability and Growth Pact, which required them to move towards and then to stay close to fiscal balance over the medium term. Slippage was possible in part because of the almost exclusive focus on nominal (as opposed to cyclically-adjusted) budget balances which reinforced the asymmetric nature of the Pact, with constraints biting in downswings but not in upswings. But targets were also missed because of an overly optimistic assessment of underlying growth potential. These countries thus failed to take out insurance against a cyclical downturn. This is regrettable for at least two main reasons. First, it means that automatic stabilisers were not allowed to work fully during the upswing. Hence, fiscal policy failed to smooth the cycle. Second, a precious window of opportunity to build up a war chest against the looming ageing challenge was missed.

Corrective action is required alongside with structural reform

7. These difficulties prompted the Commission to propose a series of measures to strengthen the implementation of the Stability and Growth Pact. The spring 2003 European Council meeting subsequently endorsed the following principles:

- The close-to-balance or in surplus rule should apply in cyclically-adjusted terms each year, not just at a medium-term horizon.
- Countries that have yet to comply with this requirement will be committed to consolidate their fiscal position by at least ½ per cent of GDP per year in cyclically-adjusted terms.
- Pro-cyclical budgetary policies should be avoided, especially when growth conditions are favourable.
- The assessment of the conformity of the Stability and Convergence programmes with the close-to-balance or in surplus requirement should take account of the long-term sustainability of public finances, necessary safety margins *vis-à-vis* the 3 per cent threshold and quality of the public finances.
- The pace of decline in public debt plays an important role in the budgetary surveillance, especially in highly indebted countries. In conformity with the Treaty provisions, the excessive deficit procedure should contribute to ensuring a satisfactory pace of debt reduction.

While this refined framework appears to be sensible, it will only work if governments exercise “ownership” over this set of rules. The price of pursuing fiscal tightening before the recovery is fully underway is worth paying to rectify insufficient adjustment in the past and to enhance the credibility of the macroeconomic policy framework. Meanwhile, pursuing a structural reform agenda to boost potential growth would make it considerably easier to achieve sound fiscal positions. Indeed, the fact that most smaller euro area countries –

which grew on average by 3 per cent *per annum* since the advent of the common currency as opposed to 1¾ per cent for the three major countries – easily met the close-to-balance or in surplus rule, provides evidence for this.

The OECD projections assume that interest rates will stay on hold until the recovery firms

8. The challenges facing monetary policy at the current juncture are complex. Policy interest rates were cut by a cumulative 225 basis points since May 2001 to 2½ per cent in March 2003. Stress in financial markets has eased somewhat recently, but the need to restructure corporate balance sheets may slow down the recovery of investment. Buoyant credit to households, associated with the property cycle and spurred by low interest rates, has so far provided some offset, but the persistent overshooting of the price stability objective of keeping inflation below 2 per cent over the medium run has limited the leeway for more aggressive monetary policy easing. However, helped by the appreciation of the euro, moderating oil prices and significant slack in economic activity, inflation pressure has been receding recently, allowing the ECB to lower interest rates by a further 50 basis points in June 2003. Against this backdrop, policy-determined interest rates are likely to remain on hold until there is firm evidence of sustained recovery. If evidence of further weakening of economic activity surfaces, moderating inflationary pressures further, the ECB should stand ready to reduce its key interest rates again. At the same time, the ECB should continue to be vigilant to upside risks.

The monetary policy framework has been clarified

9. Since the adoption of the euro four and a half years ago the framework and *modus operandi* of monetary policy have evolved markedly. The operational definition of price stability, – a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) below 2 per cent over the medium term – has in practice provided room to accommodate temporary price shocks. In the May 2003 review of its policy strategy, the ECB reiterated the definition of price stability, but clarified that in the pursuit of price stability it aims to maintain inflation rates close to 2 per cent over the medium term in line with its past conduct of policy. This clarification has been made to underline the need to provide a sufficient safety margin to guard against the risks of deflation. It also addressed the issue of a possible measurement bias in the HICP and the implications of inflation differentials within the euro area. Moreover, the review clarified the two-pillar framework, emphasising the role of monetary analysis as a means of cross-checking, from a medium to long-term perspective, the indications of risks to price stability in the short to medium-term stemming from economic and financial market developments. These clarifications are welcome because they bolster the resilience of the framework against deflation risks and further underpin market expectations of inflation rates staying close to 2 per cent.

The Lisbon targets now look difficult to achieve

10. Reaching the strategic goal set at the Lisbon summit in 2000 to turn the European economy into “the most competitive and dynamic knowledge-based economy in the world” by 2010 now looks very challenging, and requires that greater progress is made in implementing the structural reform agenda already laid out and attention be given to what additional efforts may be required. The 1993-2000 upswing partly reflected the absorption of the large amount of cyclical slack created in the recession of the early 1990s, while potential output growth picked up only a little, contrary to the United States. Although the implementation of the Single Market Programme had positive

effects, its implementation has been painfully slow in some areas, innovative capacity improved little and labour market performance, while better in recent years, could still be enhanced considerably. The OECD's medium-term scenario suggests that, on unchanged policies, a growth gap between the United States and the euro area will persist. Labour productivity would grow by 1½ per cent per annum over the period 2003-08, as compared with 2¼ per cent for the United States. With structural unemployment declining rather little and remaining, at 7½ per cent, 2½ percentage points above the US rate, trend GDP growth would be 1¾ per cent for the euro area in per capita terms, as compared with 2¼ per cent for the United States. Looking further ahead, with ageing eventually leading to a decline in the working age population, growth can only be sustained by mobilising the participation of those who would otherwise not be employed, by reversing the trend decline in hours worked or by reforms that boost productivity growth. In this context, the potential gains from creating a truly integrated and competitive European market, increasing business dynamism, investing in knowledge and innovation and pushing ahead with labour market reforms could be very large.

Remaining barriers to internal trade should be removed

11. Ten years after it was launched, the single market has partly fulfilled its ambition of fostering European integration; this has been reflected in converging prices of traded goods, heightened competition in manufacturing and surging trade and investment flows. But this process has some way to go. Due partly to regulation and taxation factors, the service sectors are not well integrated and substantial barriers remain. These concern the lack of mutual recognition for business licenses and diplomas in many services and a range of sector specific issues, such as the current system of airport slot allocation, which still hampers entry. Liberalisation moves should be more ambitious, especially in the postal and railway sectors. Moreover, integration of financial markets, while progressing, is very uneven across market segments. Several Directives included in the Financial Services Action Plan still have to be adopted, including the long-overdue Take-over Bid Directive, while further efforts should focus on removing national obstacles that hamper cross-border trade and market entry. Finally, the regulatory framework of the Community has fallen considerably short of the OECD Council's recommendations on improving the quality of government regulation. For instance, a regulatory impact assessment was not mandatory until recently and implementation issues need to be tackled more thoroughly. Steps have been taken to improve the situation. In sum, while the single market programme is advancing, the pace is slow.

Competition policy transcends national interests

12. Vigorous competition in goods and services markets is of particular importance for growth and consumer welfare and is the topic of the special chapter of this *Survey*. Competition ensures that productivity gains are passed through into lower consumer prices and input prices for producers, reduces rents accruing to dominant incumbents and raises the pressure on businesses to allocate and utilise resources in the best way. And it spurs companies to continuously invest in producing new and better products, while also improving production processes. The Community framework for competition policy aims at ensuring a level playing field for competing firms and as such is one of the pillars of the single market. It is one of the key policy areas in the remit of the Community and covers antitrust, liberalisation, state aid and merger control. Also, further trade liberalisation would enhance competition and should be

pursued in the current international trade negotiations to capture the sizeable remaining gains from freeing trade. Further progress needs to be made in improving market access for agricultural commodities in developed countries, in particular for developing countries, while reducing, with a view to phasing out, all forms of export subsidies and other trade distorting subsidies in agriculture.

Keep the instruments of competition policy under review

13. The Community's competition rules, which apply whenever anti-competitive practices have an implication for cross-border trade, are enforced primarily by the Commission's Directorate General for Competition, and complement national competition legislation. Reforms have been adopted recently with the goal of increasing the role of national authorities in the enforcement process. The Directorate General has a wide-ranging toolkit and has reformed it recently, for instance by increasing internal scrutiny and transparency in the handling of individual cases, while strengthening the Commission's investigatory powers. In view of the recent and ongoing reforms, it is suggested to keep the following under review:

- Fines for anti-competitive behaviour are already high, but their deterrent effect should be assessed.
- The leniency programme is already very attractive, but options to make it even more attractive could be explored in the light of the experience with the programme and similar measures taken by member states.
- The effectiveness of the reforms to improve checks and balances in the merger control process should be reviewed.
- Private suits should be encouraged in a well-balanced legal framework that avoids their strategic use by competitors to hamper competition. This could free up resources in the competition authority.

Further, Community action to implement a single market in services should be strengthened and supported by competition policy, especially at the national level. Measures should be taken to facilitate a long-term focus in planning and areas where the biggest gains can be expected should receive priority. The Commission is currently studying this issue. There would also seem to be a potential for large gains from raising competition in public procurement. An important task for the Commission services is to make the broadly spread gains from competition policy more visible, to counter the often fierce opposition of entrenched interests to a greater degree of competition.

Liberalisation of network industries should be stepped up

14. Competition policy is complemented by, and partly overlapping with, the regulation of newly liberalised network industries. Despite the EU's commendable efforts in this area, competition is still undermined by dominant incumbents in some sectors. Price declines stemming from the liberalisation of network industries have become smaller, while new entrants no longer seem to gain market share from the incumbents in some markets. Indeed, in mobile telephony dominant incumbents have been able to consolidate their position. At the same time, the dispersion in prices and the price level differences with other

countries suggest that the full scope for efficiency gains has not yet been fully exploited.

Innovation should be encouraged

15. A raft of indicators shows that innovation activity in the euro area is lagging the most advanced OECD countries. For instance, research and development (R&D) spending, as a share of GDP, is relatively modest and venture capital investment is only a third of the OECD average, while the export share of high-tech products is less than two-thirds of the US level. An effective EU-wide system of protecting intellectual property rights has been long overdue. The recent adoption of a “Community Patent” is a major step forward, but the estimated cost of patenting, though reduced significantly by this initiative, should still be cut by half to match costs in other major OECD economies. Raising R&D spending to the target set by the 2002 Barcelona Council of 3 per cent of GDP would imply a doubling of spending from the current level. However, it would seem to be more urgent to raise the effectiveness of R&D expenditure as opposed to its level. This requires policies that improve the framework conditions, for instance, concerning the venture capital market to encourage risk taking. Moreover, the current set-up has failed to foster research specialisation at the European level, and hence the scope for reaping scale economies remains huge.

Labour markets need to be reformed further

16. Labour markets are in urgent need of reform. Notwithstanding some progress made since the mid-1990s, the structural rate of unemployment was still as high as 8 per cent in 2002 on OECD estimates, leaving it several percentage points above the best performing OECD countries. Meanwhile, skill mismatches have increased and “dual” labour markets have developed, which may provide a stepping stone for certain categories of workers but also risks trapping them in poorly paid or unsteady jobs. While the Community has only limited competence on labour market policies, the 2000 Lisbon European Council and the 2001 Stockholm European Council set ambitious targets for the Union as a whole. These include targets for the overall employment rate (70 per cent in 2010 compared with 64 per cent currently) and the employment rate for older workers (50 per cent compared with 38½ per cent currently). So far, the extent of the reforms in the pursuit of these targets has varied greatly across member states and on current trends and policies the risk is high that targets will not be met. Reform – with priorities depending on specific conditions in different countries – should focus on:

- *Making work pay*, by reducing financial disincentives to work stemming from tax and benefit systems while reducing incentives to retire early.
- *Improving the effectiveness of active labour market policies*, by giving more weight to job matching by the public employment services as opposed to subsidised jobs.
- *Enhancing labour mobility*, to smooth the absorption of “asymmetric shocks” affecting certain regions, sectors or occupations. This requires EU-wide initiatives, concerning, for instance, the mutual recognition of skill certification or the portability of pension rights – all areas where scope for progress is large. Moreover, mobility within

individual euro area countries also needs to be encouraged.

- *Reforming wage setting practices*, allowing local market clearing and the removal of indexation mechanisms to ease real wage resistance against adverse price shocks.
- *Easing employment protection legislation*, to encourage job creation and facilitate flexible adjustment to changing economic conditions, thereby also reducing labour market segmentation.

The potential gains from structural reform are large

17. Simulations with OECD's Interlink model suggest a strong impact of product and labour market reforms on overall economic performance. A reform of product market regulation to make it as competition-friendly as in the United States could boost the level of multi-factor productivity by 2 per cent by the end of this decade. Moreover, based on conservative estimates, the combined effect of labour and product reforms could slash structural unemployment and raise labour market participation, resulting in considerably faster employment growth. Such reforms might boost potential *per capita* growth of the euro area from 1¾ to 2¼ per cent, the same as the US rate. Such a performance would imply much improved fiscal positions allowing a sizeable reduction in the tax burden. At the same time, lower inflation would allow an easier monetary stance.

Summary

18. To sum up, the agenda for high growth and employment adopted at the Lisbon summit in 2000 seems all the more germane now that the euro area has been faced with an unexpected protracted slowdown. While the specific targets set at this summit now look very challenging to realise, a radical shift in attitudes toward structural reform would provide the key to achieving the broader objectives set out. The near-term economic situation remains unsettled. Although the labour market has remained relatively resilient to date, this may not be sustained for long as the recovery is still meeting headwinds and downside risks are present. In the short run, there will be no relief from fiscal policy, which will need to correct earlier insufficient adjustment. However, monetary policy has been significantly eased as inflationary pressures have been receding. If evidence of further weakening of economic activity surfaces, moderating inflationary pressures further, the ECB should stand ready to reduce its key interest rates again. At the same time, the ECB should continue to be vigilant to upside risks. At this juncture it is therefore all the more crucial that the vast structural reform agenda be pursued with vigour. Remaining barriers to fully achieving the internal market should be removed – notably in the service sector – competition and innovation should be encouraged, and the flexibility of labour markets should be enhanced. The Community's regulatory framework should be improved, which would reduce red tape and lead to a better implementation of Community-wide regulations. Further liberalising trade would further enhance competition and lead to sizeable welfare gains. The potential gains from structural reform appear to be very large, and would facilitate the pursuit of a multitude of policy goals, including price stability, sustainable public finances in the face of population ageing, stronger growth and full employment.

