CHAPTER 3

WESTERN EUROPE AND THE NEW EU-10

3.1 Western Europe

(i) Euro area

Recovery fails to gain momentum

After a very promising start in the first quarter of 2004, the economic recovery progressively lost momentum. Between the second and third quarters, real GDP rose by only 0.3 per cent, equivalent to a seasonally adjusted annual rate of 1.2 per cent and significantly below the trend rate of output growth. Real exports, which had been leading the recovery, slowed markedly in the face of a weakening external economic environment and, possibly, the euro appreciation (table 3.1.1). In contrast, the volume of imports accelerated into the third quarter, so that the impact of real net exports on GDP growth became strongly negative. The strong upturn in exports since the third quarter of 2003 has failed to stimulate final domestic demand, which remained rather sluggish. The weakening of foreign demand occurred in a context where domestic demand had failed to become a source of sustained growth (chart 3.1.1). Higher inventory investments made a significant contribution to growth in the third quarter of 2004, but it is unclear to what extent this was voluntary or due to an unexpected shortfall of demand.

TABLE 3.1.1

Quarterly changes in real GDP and major expenditure items in the euro area, 2003-2004QIII

(Percentage change over previous period, seasonally adjusted)

	2003				2004		
	QI	*QII*	*QIII*	*QIV*	*QI*	*QII*	*QIII*
Private consumption	0.2	–	0.3	–	0.6	0.2	0.2
Final consumption expenditure of general government	-0.1	0.4	0.6	0.5	0.1	0.4	0.8
Gross fixed capital formation	-0.8	-0.2	0.3	1.0	-0.3	0.3	0.6
Total domestic expenditure	0.6	-0.1	–	1.0	0.2	0.3	1.1
Exports of goods and services	-1.7	-0.8	2.6	0.3	1.5	3.1	1.2
Imports of goods and services	-0.4	-0.7	1.3	2.0	0.5	2.8	3.2
GDP	–	-0.2	0.5	0.4	0.7	0.5	0.3

Source: Eurostat, NewCronos Database.

Persistent weakness of demand

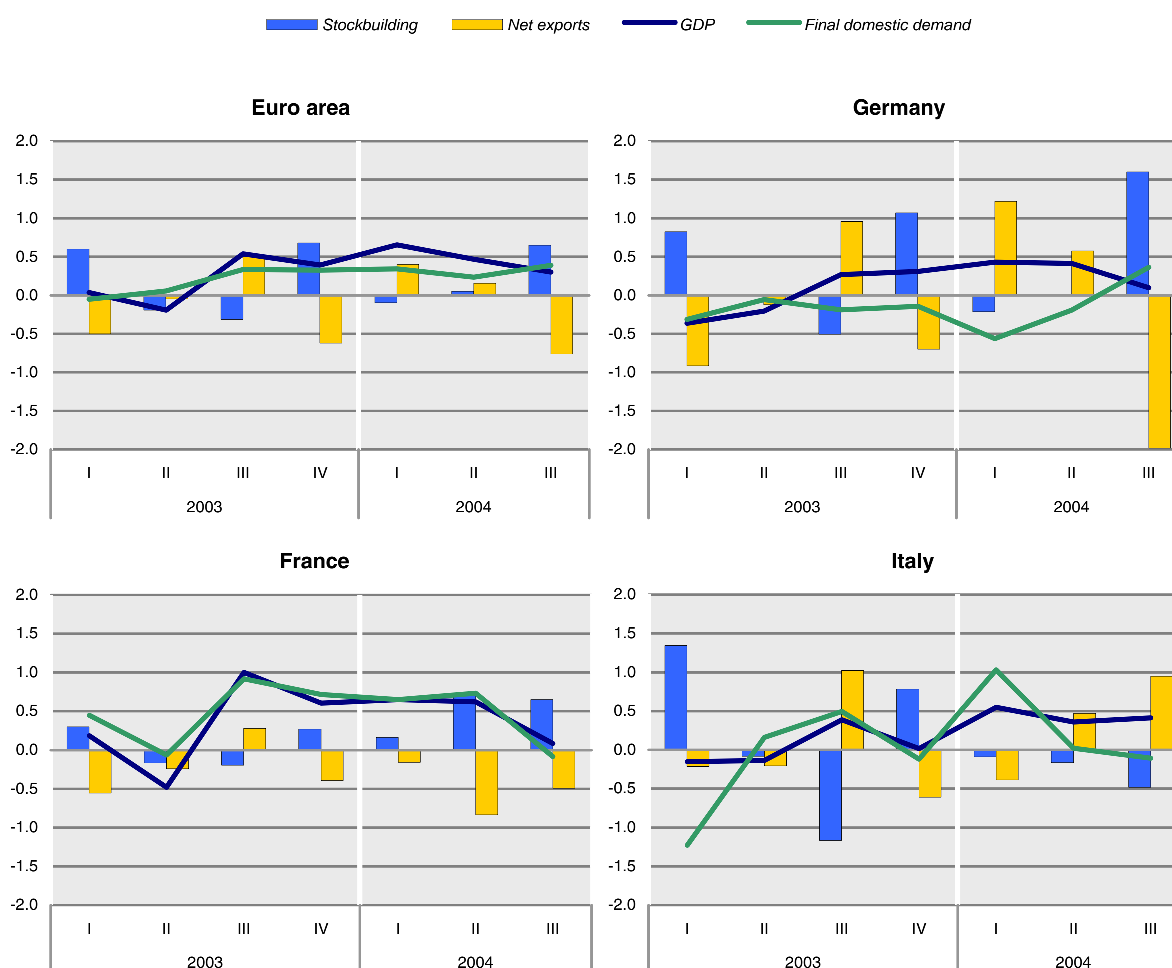
For the year as a whole, real GDP in the euro area is estimated to have increased by 2 per cent, up from an average annual growth rate of 0.5 per cent in 2003. Private household consumption was lacklustre, held back by low consumer confidence, a sluggish employment recovery in most countries, and a dent in real disposable incomes due to rising energy prices. Consumer confidence, having improved somewhat during 2003, stabilized at a subdued level below its long-term average. This partly reflected uncertainties concerning the economic outlook and the medium- and longer-term income effects of ongoing or planned reforms of social security systems in several countries. Following declines in the three preceding years, fixed investment picked up somewhat in 2004, but failed to gather significant momentum. Business fixed investment was held back by uncertainties regarding the medium-term outlook for demand as well as the surge in oil prices. This appears to have offset the potentially better conditions for investment spending due to continued progress in redressing corporate balance sheets, supportive financial conditions, and improved profitability on the back of a cyclical recovery in productivity combined with wage moderation. Capacity utilization in manufacturing, moreover, increased following the rise in output (chart 3.1.2). Influenced by international developments, industrial confidence improved only moderately during 2004. Government spending contributed marginally to economic growth in 2004.

A moderate upturn in labour markets

Labour markets in the euro area remained generally weak throughout 2004. Employment was only 0.5 per cent higher than in 2003. The elasticity of employment with regard to changes in output has fallen in recent years, after being on a rising trend in the second half of the 1990s (chart 3.1.3). The latter increase in the employment elasticity (or the "employment content of growth") may have been a reflection of the labour market reforms that encouraged short-term contracts and part-time work in the second half of the 1990s. Conversely, the recent decline probably reflects the waning impact of these measures as well as the effects of labour hoarding in the cyclical downturn. The steady fall in the unemployment rate since 1997, when it stood at 10.8 per cent, bottomed out at 8 per cent in 2000, the peak of the previous growth cycle. Since then, unemployment edged up to 8.9 per cent in 2004 (chart 3.1.4), mainly reflecting

CHART 3.1.1

The contribution of major expenditure items to quarter-to-quarter changes in real GDP in the euro area, 2003-2004QIII
(Percentage points)



Source: National statistics; Eurostat, NewCronos Database.
Note: Data are seasonally adjusted.

the cyclical downturn but also the fading effects of the labour market reforms that supported the demand for labour in the second half of the 1990s.

Inflation remains moderate

Consumer price inflation has remained moderate, averaging 2.1 per cent, year-on-year, for the first 10 months of 2004. For the year as a whole an increase of 2.2 per cent is expected. Upward pressure on the headline inflation rate from the sharp rise in oil prices was partly offset by lower prices for unprocessed food that were mainly due to a statistical base effect that arose as a result of the long, dry summer in 2003, which had led to large price increases. But higher prices for services (especially administered prices such as those for health care) and increases in tobacco taxes in some countries kept the core inflation close to 2 per cent in 2004 (chart 3.1.5). Higher oil and commodity prices were also reflected in industrial producer prices during 2004, but they only rose by less than 2 per cent, year-on-year, in the first nine months of 2004. Overall, there are no indications of a build-up in medium-term inflationary pressures in the euro area, as wage growth remains moderate in a context of modest real GDP growth and weak labour markets. Due to stronger productivity increases, the growth of unit labour costs moderated significantly in 2004.

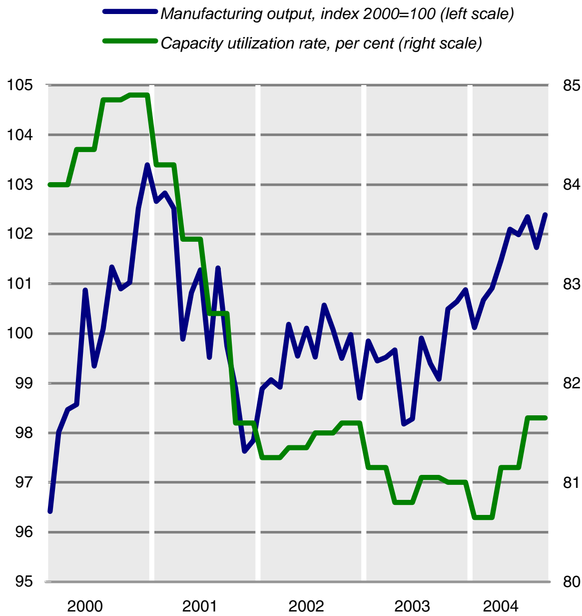
Differences in the inflation rate among the member countries of the euro area, and of western Europe at large, remained considerable in 2004 (chart 3.1.6). It is notable that, with the exception of Finland, the countries with the lowest average rates of inflation in 2004 (January to October) are all non-euro area members, namely, Denmark, Norway, Sweden, Switzerland and the United Kingdom.

Differential sources of growth in the member states of the euro area

Among the three major economies of the euro area, real GDP in Germany grew by 1.7 per cent in 2004, following three years of stagnation. Given their relative

CHART 3.1.2

Manufacturing output and capacity utilization in the euro area, January 2000-September 2004
(Index, percentage)

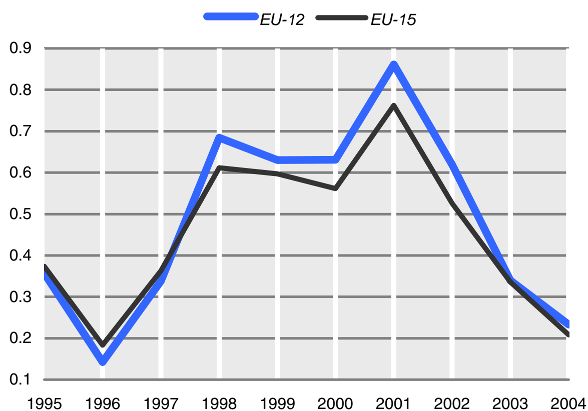


Source: Eurostat, NewCronos Database; European Commission, *Business and Consumer Survey Results* (Brussels), various issues.

Note: Capacity utilization rates are available only for January, April, July and October of each year. Data shown are approximations of quarterly data calculated as the arithmetic average of January and April data (first quarter), April and July (second quarter), etc. All data are seasonally adjusted.

CHART 3.1.3

Elasticity of employment with regard to changes in real GDP in the euro area and the EU-15, 1995-2004
(Percentage points)



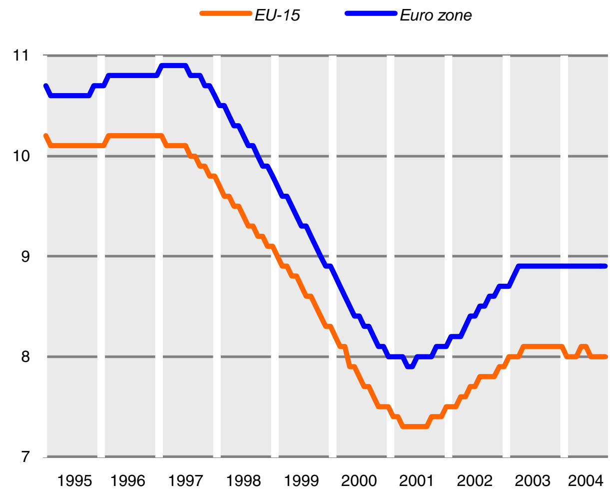
Source: UNECE secretariat calculations.

Note: The elasticity indicates the percentage point change in employment that is associated with a change in real GDP by 1 percentage point. Calculated as the ratio of annual growth rates of employment to annual growth rates of real GDP. Data for 2004 are estimates.

specialization in investment goods, German exporters took advantage of the upswing in the global investment cycle. As a result of the export boom, the current account surplus of Germany almost doubled to an estimated €85 billion in

CHART 3.1.4

Unemployment rate in the euro area and EU-15, January 1995-October 2004
(Per cent of labour force)

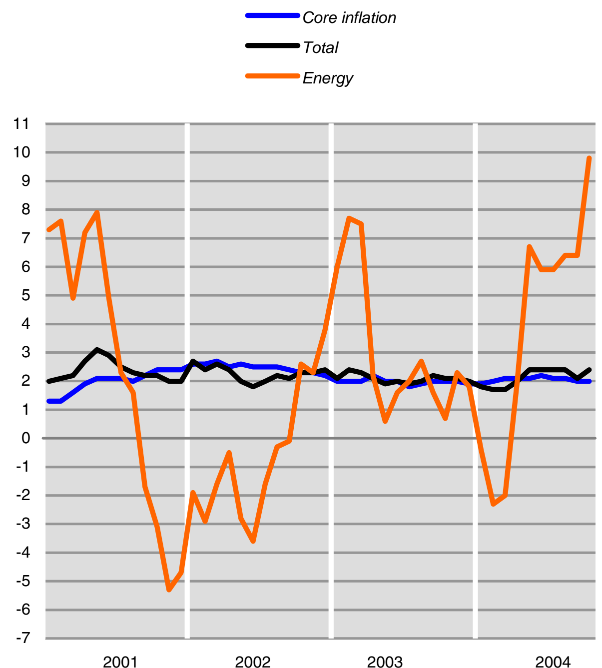


Source: UNECE Statistical Database and Eurostat, NewCronos Database.

Note: Standardized unemployment rate as defined by Eurostat/ILO.

CHART 3.1.5

Consumer prices in the euro area, January 2001-October 2004
(Percentage change over the same month of the previous year)



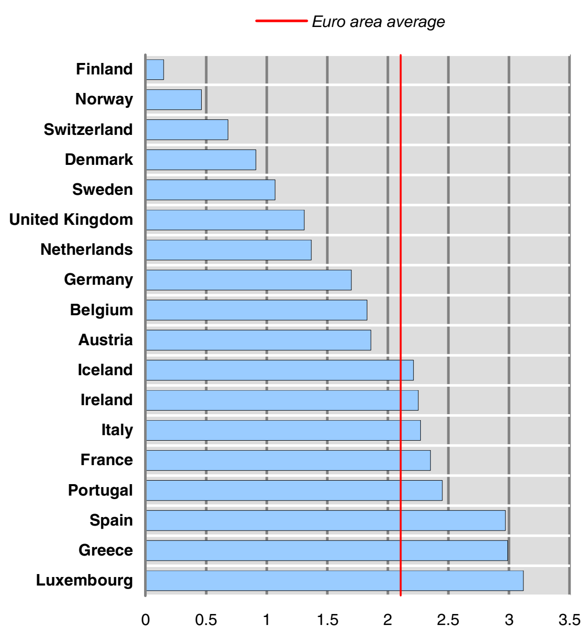
Source: Eurostat, NewCronos Database.

Note: Harmonized Index of Consumer Prices (HICP). Core inflation is defined as the change in total HICP excluding unprocessed food and energy.

2004, corresponding to 3.9 per cent of GDP. Final domestic demand fell marginally, reflecting depressed private consumption and lacklustre fixed investment. Construction investment continued to fall (as has been the case in 9 of the last 10 years), as the hangover from the

CHART 3.1.6

Inflation differentials in western Europe, January 2004-October 2004
(Per cent)



Source: Eurostat, NewCronos Database; national statistics.

Note: Average changes in consumer price indices compared with the same period of 2003. Harmonized consumer price indices for all countries, except Switzerland for which the national consumer price index is used.

post-reunification boom has still not been completely unwound. Further measures of economic reform were adopted – as part of the government's "Agenda 2010" reform programme – designed to create incentives for unemployed persons to seek jobs.

In France, the recovery was more reliant on domestic demand in 2004, in contrast to Germany and Italy. Consumer spending, which was the main factor behind economic activity, was supported by a further reduction in the savings rate, given that employment was stagnant and real disposable incomes rose only marginally. Following two years of decline, fixed investment picked up with the largest increase in four years. To a large extent, this reflected an increase in spending on machinery and equipment, stimulated by increasing profit margins. At the same time, housing construction accelerated strongly. Export growth was relatively weak and changes in net exports subtracted a full percentage point from real GDP growth in 2004. Nevertheless, the average annual growth rate was relatively strong at 2.4 per cent, up from a meagre 0.5 per cent in 2003. This average figure, however, masks a weakening of the cyclical momentum in the second half of 2004.

Activity also picked up in Italy in 2004, following two years of near stagnation. Real GDP rose by 1.2 per cent, the slowest rate among the large west European economies. The Italian economy reacted only belatedly to the more positive international environment, due to its continued loss in competitiveness, which is reflected in the falling shares of Italian products in international markets. This, in turn, is the result of unfavourable specialization patterns and cost developments. (Unit labour costs have been rising continuously above the average of the euro area.) The total number of jobs has continued to grow in recent years in spite of weak economic growth, thanks to the prolonged effects of measures, adopted at various times since the mid-1990s, to promote labour market flexibility (e.g. part-time work).

Growth also strengthened in the other economies of the euro area in 2004, except for Greece, where activity slowed down as the strong impulse of the Olympic Games started to wane. Activity was mainly driven by domestic demand in Belgium, Finland, Luxembourg, Portugal and Spain, while in Austria and Ireland the sources of growth were more balanced. In the Netherlands, the external impulse accounted for the rebound from the previous year's recession, while domestic demand remained depressed.

A mildly supportive fiscal policy

Fiscal policy was slightly expansionary in the euro area in 2004, as indicated by a small decline (corresponding to 0.2 percentage points of potential output) of the surplus on the cyclically adjusted primary balance.[90] The support from fiscal policy to economic activity had been quite modest during the preceding cyclical downturn, a reflection, at least in part, of the rigid constraints imposed by the rules of the Stability and Growth Pact. The actual general government budget deficit averaged 2.9 per cent of GDP in 2004. Budget deficits were significantly above the threshold of 3 per cent in France, Germany and especially Greece. In the latter, revised fiscal statistics show that budget deficits were already significantly above the 3 per cent threshold in 2000-2003.

Against a background of the crisis around the Stability and Growth Pact,[91] which broke in November 2003, the European Commission made proposals in late summer 2004 to increase the flexibility of the fiscal rules. This is to be achieved, *inter alia*, by taking more account of country specific circumstances and putting greater emphasis on levels of public debt in the surveillance process. But a consensus of governments on these proposals may not be easy to achieve.

Monetary policy remains on hold

Against a background of fragile domestic sources of growth and moderate inflationary expectations, the European Central Bank (ECB) has left its key

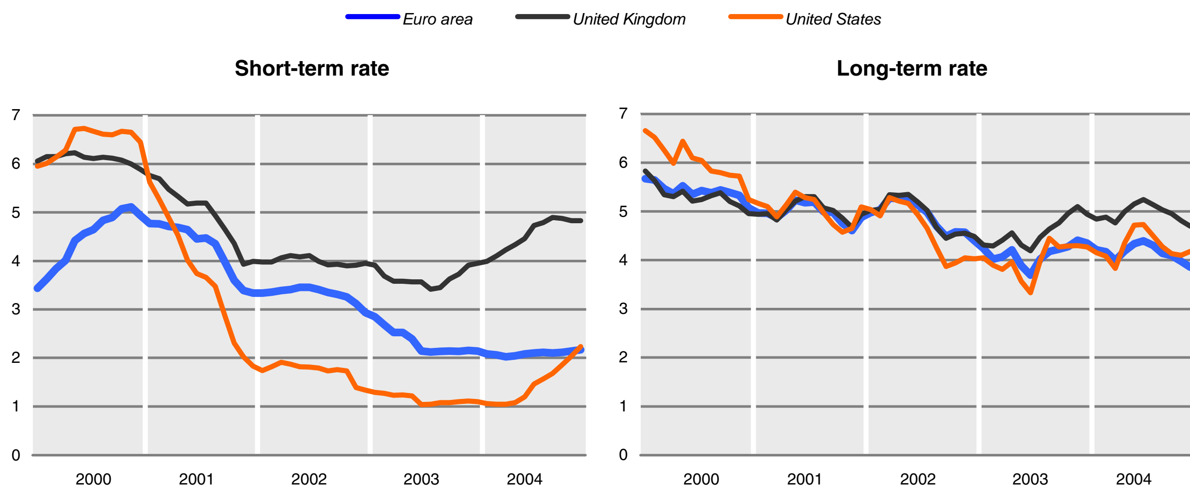
[90] *OECD Economic Outlook No. 76* (Paris), November 2004.

[91] UNECE, *Economic Survey of Europe, 2004 No. 1*, pp. 10-15.

CHART 3.1.7

Nominal short-term and long-term interest rates in the euro area, the United Kingdom and the United States, January 2000-November 2004

(Per cent per annum)



Source: European Central Bank [www.ecb.int]; OECD, *Main Economic Indicators* (Paris).

Note: Average monthly values. Short-term rates are three-month money market rates; long-term rates are yields on 10-year government bonds.

refinancing rate unchanged at 2 per cent since June 2003. In the money market, three-month interest rates (EURIBOR) remained slightly above 2 per cent in the course of 2004. The gradual tightening of monetary policy in the United States led to the positive interest rate differential in favour of euro area short-term interest rates virtually disappearing in November 2004 (chart 3.1.7). Real short-term interest rates in the euro area, based on the Harmonized Index of Consumer Prices (HICP), were close to zero for most of 2004.

Different perspectives on the stance of monetary policy

While the low short-term interest rates suggest an expansionary stance of monetary policy in the euro area, a more coherent framework against which monetary policy can be judged is the Taylor rule. This is an estimated interest rate feedback rule describing how central banks are changing interest rates away from their neutral level in response to deviations of inflation from its desired rate and to emerging output gaps, i.e. to deviations of actual from potential output. The rule is best understood as an approximation to the behaviour of central banks, which are also likely to take other variables besides inflation and output gaps into account in their decision-making process. But it is plausible to assume that central banks will aim to dampen fluctuations of inflation and output gaps.[92] So-called Taylor interest rates have to be taken with a grain of salt, given that key variables such as the neutral interest rate and the output gap cannot be directly observed but have to be estimated. In any case, the estimated Taylor rates (chart 3.1.8) support the view that the monetary policy stance of the ECB continued to be expansionary in 2004, insofar as the actual short-term interest rate has been persistently below the predicted Taylor rate.[93]

While the central bank can control interest rates at the shorter end of the maturity spectrum, the monetary transmission mechanism is also influenced by changes in the real exchange rate, which is outside the direct control of the central bank. The real effective exchange rate of the euro weakened in early 2004, a tendency which bottomed out in April. Since then it has been rising, and at an accelerated pace in late 2004. In November, the real effective exchange rate was 4.1 per cent higher than in April 2004, although only just 0.3 per cent above its level in January 2004.

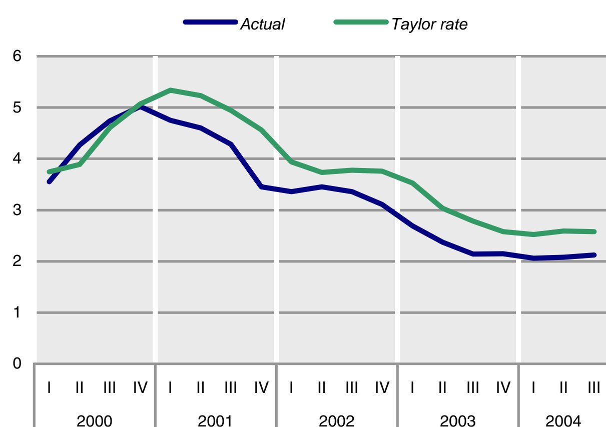
The combined impact of changes in real short-term interest rates and the real effective exchange rate on economic activity can be gauged with a monetary conditions index (chart 3.1.9). This index has been rising since the beginning of 2002, reflecting a tightening of monetary conditions. This was solely due to the real effective appreciation of the euro, in the presence of low and relatively stable real short-term interest rates. This rise in the real effective exchange rate, in turn, is largely due to the depreciation of the dollar. The strengthening of the dollar in early 2004 temporarily reversed this trend, but since May, the depreciation of the dollar resumed and

[92] M. Woodford, "The Taylor rule and optimal monetary policy", *American Economic Review*, Vol. 91, No. 2, May 2001.

[93] In the specification of the estimated equation, the reaction function of the central bank allows for interest rate smoothing, given that central banks typically try to avoid "surprises". D. Gerdesmeier and B. Roffia, *Empirical Estimates of Reaction Functions for the Euro Area*, ECB Working Paper, No. 206 (Frankfurt am Main), January 2003.

CHART 3.1.8

Actual short-term interest rate and the Taylor rate in the euro area, 2000-2004QIII

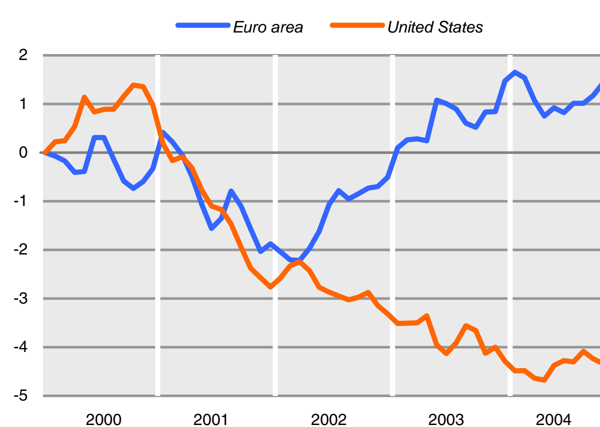


Source: UNECE secretariat calculations.

Note: The short-term interest rate is the nominal three-month EURIBOR. The Taylor rate is computed by fitting the following monetary policy rule with interest rate smoothing: $i_t = (1-\rho)\alpha + (1-\rho)\beta\pi_t + (1-\rho)\gamma(y-\bar{y}) + \rho i_{t-1}$ where *i* is the short-term nominal interest rate, π is the HICP inflation rate, $(y-\bar{y})$ is the output-gap, α is a constant term, β is the coefficient of monetary policy response to inflation, γ is the coefficient of monetary policy response to the output gap, ρ is the smoothing coefficient and *t* is the time index. The output gap has been determined by fitting a linear trend to the seasonally adjusted quarterly GDP data. The values of the coefficients are set as follows: α=1.8, β=1.93, ρ=0.87, γ=0.28. These values are drawn from the empirical estimates reported in D. Gerdesmeier and B. Roffia, *Empirical Estimates of Reaction Functions for the Euro Area*, ECB Working Paper, No. 206 (Frankfurt am Main), January 2003. Alternative sets of numerical values for the coefficients are available from R. Clarida, J. Gal and M. Gertler, "Monetary policy rules in practice – new research in macroeconomics", *European Economic Review*, Vol. 42, Issue 6, June 1998, pp. 1033-1067. These alternative values yield a pattern of the Taylor rate which is not significantly different from the one depicted in the chart.

CHART 3.1.9

Monetary conditions index for the euro area and the United States, January 2000-October 2004



Source: UNECE secretariat calculations.

Note: The monetary conditions index is computed as $MCI = \theta_R(R_t - R_0) + \theta_e(e_t - e_0)$ where *R* is the three-month real short-term interest rate, *e* is the real effective exchange rate (in logs), θ_R and θ_e are weights and *t* is a time index. A fall in the index denotes loosening of monetary conditions. The base period (*t* = 0) is January 2000. Weights are set to θ_R = 0.2 and θ_e = 0.8 for the euro area and θ_R = 0.1 and θ_e = 0.9 for the United States. These are the weights commonly used in the literature and reflect empirically estimated output elasticities. The real short-term interest rate is computed as the nominal rate deflated by the core inflation rate. Core inflation is given by the all-items inflation index minus unprocessed food and energy.

accelerated strongly in November, producing a renewed tightening of monetary conditions in the euro area. The net result, therefore, is that monetary conditions were not supporting economic growth in 2004.

Long-term interest rates remain low

In the bond markets, yields on 10-year government bonds reached a peak of 4.4 per cent in June 2004, but fell thereafter in tandem with bond yields in the United States. In November 2004, 10-year yields averaged 3.9 per cent in the euro area; in the United States, they fell to 4.2 per cent, down from 4.7 per cent in June. A major factor behind the fall in long-term yields were expectations of a more moderate outlook for economic growth in 2005. Contemporaneous real long-term interest rates were only 2 per cent in October 2004, and even lower in the United States at 1 per cent.

The economic recovery in the euro area is expected to continue in 2005

For the euro area as a whole, real GDP is expected to increase by some 2 per cent in 2005, much the same as in 2004. Continuing strong demand from the rest of the world should support exports, which will remain the mainstay of growth. But, as in 2004, changes in real net exports will continue to make only a modest contribution to growth. An important assumption underlying the current forecasts is that domestic demand will strengthen, albeit moderately in 2005. This is due to stronger business fixed investment in response to favourable financing conditions and the pent-up need to replace machinery and equipment, such as ICT products, with relatively short service lives. Private consumption will also strengthen somewhat, supported by a slight improvement in the labour markets. In Germany, the major west European economy, the annual growth rate will only be about 1.5 per cent in 2005, down from 1.7 per cent in 2004. This slowdown, however, partly reflects the smaller number of working days in 2005. Although there has been further progress with economic reforms in Germany, their impact on economic performance is difficult to gauge and, in any case, will take time to materialize.

The situation in the labour markets in the euro area is expected to improve slightly in 2005, reflecting a combination of a further modest increase in employment and a small decline in unemployment. The inflation outlook remains benign with upside risks mainly related to developments in the price of oil.

Against this background, and in the face of continued strong reliance on exports as a main support of

the cyclical upturn, monetary policy should leave interest rates unchanged until the recovery is stronger and supported by a sustained improvement in domestic demand. In fact, a sharp, real effective appreciation of the euro may even necessitate a lowering of interest rates, for which there is sufficient scope. The stance of fiscal policy is expected to be either broadly neutral or possibly even slightly restrictive in 2005.

Given its strong reliance on foreign demand, the recovery in the euro area continues to be very vulnerable to a deterioration in the external environment. Besides adverse trends in the oil markets, downside risks are also related to the risk of a more pronounced than expected weakening of growth in the global economy. A further sharp appreciation of the euro would also weigh on business confidence and risk choking the growth of exports.

(ii) Other western Europe

The United Kingdom business cycle is at a more advanced stage

In the United Kingdom, the growth of real GDP accelerated to 3.2 per cent in 2004, up from 2 per cent in 2003. As in the euro area, the rate of expansion slowed markedly after the second quarter of 2004. But the United Kingdom business cycle is at a much more advanced stage, with strong growth during the past few years having led to tight labour markets and little remaining spare capacity in the economy. Private consumption was again the mainstay of economic growth in 2004, supported by wealth effects originating in the housing market boom. But non-residential private sector fixed investment also rose strongly, following a decline in 2003, as did private housing investment. Inflation remained significantly below the government's target of 2 per cent in 2004, partly because of the strong exchange rate, which led to falling import prices. Fiscal policy was slightly restrictive in 2004, following two consecutive years of strong fiscal stimulus. The fortuitous timing of government spending programmes has been an important factor behind the resistance of the United Kingdom's economy to the global economic downturn after 2000. But the general government budget deficit is likely to have risen above the 3 per cent Maastricht threshold in 2004. The gradual tightening of monetary policy led to a series of increases in the central bank's base rate from 3.5 per cent in November 2003 to 4.75 per cent in August. A major concern of monetary policy is to ensure a gradual correction of the sharp rise in house prices, which have attained levels above their trend values that are generally regarded as unsustainable. But the rise in interest rates since November 2003 does appear to have had a somewhat cooling effect on the housing market, as suggested by the deceleration of house price increases in the second half of the year.

The cyclical momentum is expected to weaken somewhat in 2005 and fall closer in line with the potential growth rate, which is estimated at some 2.5 per cent. The slowdown reflects to a large extent the impact of fading wealth effects in the housing market on private household's spending propensity, which is expected to decline. Apart from adverse changes in the external environment, the downside risks include the possibility of a sudden sharp reversal of the rise in house prices, with consequent negative wealth effects on private household consumption and the overall rate of economic growth.

Favourable growth performance in the other smaller economies

In Denmark and Sweden, economic growth recovered strongly in 2004, with output rising at a rate above its long-term trend. Following a strong performance in 2003, real GDP in Sweden rose by 3.4 per cent in 2004, driven by exports (especially of ICT goods and vehicles) and fixed investment (with large increases in both equipment and housing construction). In Denmark, tax cuts supported consumer spending which, together with strong exports, underpinned economic growth. Economic performance in the west European economies outside the EU (Iceland, Norway and Switzerland) was also quite favourable in 2004. Driven by booming domestic demand, economic growth in Iceland accelerated to 4.3 per cent; economic policy was subsequently tightened to prevent overheating. In Norway strong domestic demand led to a sharp acceleration in GDP growth to an average annual rate of 3.4 per cent. In Switzerland, the economy emerged from the recession of 2003, supported by expansionary monetary and fiscal policies. Real GDP rose by 1.8 per cent. The stance of monetary policy was slightly tightened in response to an increased risk of higher inflation. In all five countries, the recovery is set to continue at a relatively strong rate of expansion in 2005, although perhaps at a somewhat more moderate rate in Switzerland.

3.2 The new EU member states

The growth of GDP in the 10 new member states (EU-10) picked up in 2004, exceeding by a significant margin the average rate in the old member states (EU-15). However, the labour markets in the EU-10 continued to be weak, with low employment and high unemployment rates. The increase in GDP was broadly based in most of the EU-10 economies, and with relatively high levels of confidence and industrial orders, their prospects for output and productivity growth in 2005 are good. Risks to this outlook include a further slowdown of activity in the euro zone, higher than expected energy prices, and a weakening of budgetary discipline. Aside from the need for sustainable fiscal consolidation, the most pressing policy challenge facing the new member states is to create conditions for a strong growth of employment.

(i) The policy agenda

EU membership raises a number of policy challenges. On the structural front, it implies a

commitment to the so-called Lisbon strategy that aims to transform the EU into the world's most competitive knowledge-based economy by 2010. This presupposes catching up with the productivity and employment levels of the United States economy. On the macroeconomic front, the new members are expected to meet the Stability and Growth Pact criteria pertaining to inflation, long-term interest rates, government deficits, public debt and exchange rate stability, and eventually to enter the Economic and Monetary Union (EMU).[94]

The medium-term strategy of the EU-10 is broadly consistent with the official economic policy guidelines for the EU member states.[95] The strategy requires of each member country prudent macroeconomic policies and structural reforms to improve its trend rate of output growth. Similar guidelines were laid down for the formulation of the individual pre-accession strategies of the new members. The implementation of these strategies should enable the 10 economies to achieve sustainable nominal convergence and join the EMU after a transitional period in the European Monetary System, ERM-2.[96]

In recent years, the new member states have been relatively successful in raising per capita income levels while moving towards the EMU nominal convergence targets.[97] Despite the progress achieved to date, a number of major policy challenges continue to face policy makers in the EU-10.

The real convergence challenge: how to overcome the large gaps in per capita income levels?

The average per capita GDP level (at purchasing power parity) in the EU-10 is currently less than one half of the comparable level in the euro zone, reflecting low labour productivity and low employment rates in the former (chart 3.2.1). Productivity levels and employment rates differ significantly across the EU-10 economies, some of them being closer to the characteristic pattern of the EU candidate countries than that of the euro zone or the three mature EU economies remaining outside the EMU. While a strong productivity catch-up has occurred in recent years, the gap in employment rates has not diminished.

CHART 3.2.1

Employment rates and productivity gaps in the new EU member states and candidate countries, 2003

Source: Eurostat.

Note: Labour productivity refers to GDP in purchasing power standards per person employed. Employment rates are ratios of total employment in the 15-64 years age group to the total population of working age (15-64 years).

The real convergence challenge is amplified by shortcomings in the human capital stock. The intensity of R&D spending in the EU-10 is less than one half of the EU-15 average. There is no obvious development strategy that would be able to transform the EU-10 into dynamic knowledge-based economies in the medium term, given the deficiencies of their education systems.[98] Policies to deal with these issues can be classified into two major categories: the "liberal" model (based on the British or Irish experience over the last quarter century) or the "dynamic welfare state" model (based on the Austrian or Scandinavian experience).[99] However, the experience of

[94] Unlike Denmark and the United Kingdom, which were able to negotiate special clauses that allow them to opt out of the euro, the new member states are legally obliged to join the euro zone. The current EMU status of each new entrant is comparable to that of Sweden, i.e. that of a member state with temporary derogation.

[95] These guidelines were approved by the Council of EU member states in June 2003 and updated in April 2004. Commission of the European Communities, *Commission Recommendation on the 2004 Update of the Broad Guidelines of the Economic Policies of the Member States and the Community (for the 2003-2005 period)*, COM (2004) 238 (Brussels), 7 April 2004.

[96] ERM-2 is an exchange rate framework that precludes crawling-peg regimes, pegs to currencies other than the euro as well as floating regimes without a mutually agreed central rate. Only after a country has been a member of ERM-2 for at least two years without major problems, can it apply for full EMU membership.

[97] For the first official assessments of the convergence process in the EU-10 economies, see European Central Bank, *Convergence Report 2004* (Frankfurt am Main), 20 October 2004 and European Commission, *Convergence Report 2004* (Brussels), 20 October 2004.

[98] A number of EU-10 countries participated in the OECD PISA project assessing student performance: in most cases they achieved below-average results and significantly lagged behind the leading countries such as Finland or the Republic of Korea, although performing somewhat better than the United States.

[99] According to a special report on Ireland, published in the *The Economist* on 16 October 2004, policy makers in the eight new EU member states from central and eastern Europe would like to emulate

TABLE 3.2.1

Economic and Monetary Union nominal convergence criteria

Criterion	*Inflation*	*Fiscal criteria*		*Interest rate*
Measure	*HICP [a] annual average (percentage change) Sep. 2003-Aug. 2004*	*Government deficit (per cent of GDP) 2003*	*Public debt (per cent of GDP) 2003*	*Long-term interest rates (annual average, per cent) Sep. 2003-Aug. 2004*
Reference value	*2.4*	*3*	*60*	*6.4*
Cyprus	2.1	***6.4***	***70.9***	5.2
Czech Republic [b]	1.8	***5.3***	37.8	4.7
Estonia	2.0	-3.1	5.3	..
Hungary	***6.5***	***6.2***	59.1	***8.1***
Latvia	***4.9***	1.5	14.4	5.0
Lithuania	-0.2	1.9	21.4	4.7
Malta [b]	***2.6***	***6.5***	***71.1***	4.7
Poland [c]	***2.5***	***5.4***	45.4	***6.9***
Slovakia	***8.4***	***3.7***	42.6	5.1
Slovenia	***4.1***	2.0	29.4	5.2

Source: European Commission and UNECE secretariat estimates.

Note: Numbers in bold italics signify non-compliance.

a Harmonized Index of Consumer Prices.

b Government deficits for the Czech Republic and Malta exclude one-off charges to improve cross-country comparability.

c Government deficit for Poland includes the estimated impact of a reclassification of the defined contribution pension scheme to improve cross-country comparability.

economies that joined the EU in earlier rounds of expansion, and which have been successful in catching up, suggests that neither approach can work without credible fiscal consolidation. A discussion of alternative approaches to real convergence is presented in chapter 7.

Nominal convergence: a multi-speed project

Fiscal consolidation remains a serious problem in most of the new member states, including the relatively large central European economies as well as Cyprus and Malta (table 3.2.1). The majority of the 10 economies have also failed so far to satisfy the EMU inflation criterion, which partly reflects the ongoing process of productivity catch-up.[100] None of the 10 new member states examined in the recent convergence reports of the ECB and the EC fulfil the exchange rate stability and legal requirements necessary for entry into the euro zone. The legal criteria include the independence of the central bank in pursuit of price stability and other legal norms of the EMU.

But it is fiscal consolidation that remains the principal macroeconomic policy challenge in most new member states, including the relatively large central European economies as well as Cyprus and Malta (table 3.2.1). These countries exceeded the 3 per cent threshold for the deficit to GDP ratio in 2003 and 2004; Cyprus, Hungary and Malta in addition exceeded or were close to exceeding the 60 per cent ceiling for the government debt to GDP ratio. But government debt has also been growing rapidly in the Czech Republic and Poland. Fiscal consolidation is particularly urgent in order to set public finances on a sustainable path in the face of rapidly ageing populations, which will put added pressures on public pension and health-care systems in the medium to long term.

To ensure sustainability, the EU fiscal framework also calls for the member states to achieve a medium-term, cyclically adjusted budget position of close to balance or in surplus. However, strict abidance by the EU fiscal framework may impose unnecessary rigidities for some of the new member states. In particular, these economies need to undertake a lasting effort to improve their public infrastructure, which is an essential precondition for a successful catching up to higher productivity and income levels. In turn, this implies the need for maintaining relatively high levels of public infrastructure spending in the medium and longer term. Discussions on the possible reform of the EU's fiscal rules are still underway and the new EU members, now full-fledged participants in this debate, can voice their concerns. Even more than the most developed current members of the EU, the new members would benefit from a possible relaxation of some of the constraints on government borrowing for financing public investment. Relaxing these constraints would help prevent counterproductive fiscal tightening in these economies.[101]

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the impressive economic transformation of Ireland in recent decades and to draw relevant policy lessons. They are also interested in the policies pursued by Finland and other dynamic welfare states. See, for example, the presentation of the Governor of the Czech National Bank, Z. Tuma, "Czech fiscal policy in the light of European fiscal policy lessons", *Forum Populini* (Prague), 23 October 2003 [www.cnb.cz/en/pdf/Tuma_Forum_populini.pdf].

[100] For a comprehensive discussion of the Stability and Growth Pact (Maastricht) criteria, see UNECE, *Economic Survey of Europe, 2004 No. 1*, pp. 10-15.

[101] The available data show that in recent years the level of public investment in most new member countries was indeed higher than the average level in the EU-15 (table 3.2.2). This average reflects significantly lower spending by the most developed current members of

TABLE 3.2.2

Selected fiscal indicators for the new EU member states, 1998-2007
(Per cent of GDP)

	Cyclically adjusted general government deficit, 2003	*Targeted cyclically adjusted general government deficit, 2007*	*Public investment, average 1998-2003*
Cyprus	5.4	1.6	3.1
Czech Republic	5.2[a]	3.6	3.6
Estonia	-2.6	-0.1	4.2
Hungary	6.2	2.7[b]	3.7
Latvia	1.4	2.0	1.4
Lithuania	1.8	1.8	2.6
Malta	5.4[c]	0.2	4.3
Poland	5.0[d]	3.7[d]	3.4
Slovakia	3.7	3.1	2.9
Slovenia	1.5	0.7	2.2
Memorandum item:			
EU-15	1.6	..	2.3

Source: Table 3.2.1; Convergence Programs; European Commission, *General Government Data* (Brussels), Autumn 2004; UNECE secretariat calculations.

a Adjusted for the one-off charge for state guarantees granted for the restructuring of the banking system.

b 2008.

c Adjusted for the one-off charge for restructuring the debt of the shipyards.

d Adjusted for the estimated impact of a reclassification of the defined contribution pension scheme.

For example, the so-called golden rule that allows for public borrowing to finance public investment has been successfully followed by the United Kingdom in conjunction with a self-imposed upper limit on net public debt, without unduly restricting the operation of automatic stabilizers.

In their most recent Convergence Programs, only Estonia and Malta aim to balance their cyclically adjusted deficits by 2007, and Slovenia plans to bring its deficit below 1 per cent in relation to GDP (table 3.2.2).[102] However, most of the other countries target cyclically adjusted deficits that are slightly lower than or close to their ratios of public investment to GDP. Such fiscal targets are in fact consistent with the golden rule mentioned above. This approach would provide for the infrastructure spending necessary for successful convergence, while avoiding a slowdown in economic growth through excessive fiscal restriction. Nevertheless, further fiscal consolidation efforts will be required to reach the golden rule compatible deficits (which seem to have averaged 3.5 per cent of GDP in the larger new member states in recent years) in a sustainable manner.

Overall each new member state has developed its medium-term macroeconomic policy framework on the basis of its own evaluation of the desirability of an early entry into the euro zone.[103] Apparently, the estimated benefits of early entry are judged to exceed the associated costs in the three EU-10 economies (Estonia, Lithuania and Slovenia) that joined ERM-2 in the second month of their EU membership.[104] Estonia and Lithuania have preserved their euro-based currency board, which is effectively a pledge to keep their exchange rates fixed vis-à-vis the euro. The Slovene authorities abandoned managed floating and the tolar is now allowed to fluctuate around its central parity within a relatively large band (±15 per cent). Given their comparatively good fiscal positions and commitment to strong monetary discipline, the adoption of the euro by Estonia, Lithuania and Slovenia may well take place in 2007.

Cyprus, Latvia, Malta and Slovakia also appear to be committed to a relatively early adoption of the euro. In the case of Latvia, ERM-2 entry is expected in 2005, once the authorities implement their plan to replace the SDR-linked currency peg with one based solely on the euro. Both Cyprus and Malta also intend to join ERM-2 in 2005. In Slovakia, the government has made considerable progress in fiscal consolidation and expects to reduce its deficit below the 3 per cent reference value by 2007, while the central bank is aiming to meet the EMU inflation criterion in 2006. The Slovak authorities plan to join ERM-2 in the first half of 2006 and adopt the euro in January 2009.[105] The key question is whether the current medium-term fiscal programme will be adhered to.

The remaining three new EU member states from central Europe (Czech Republic, Hungary and Poland), which account for the bulk of economic activity and population in the EU-10, are unlikely to adopt the euro before 2010. This reflects their weak fiscal positions and the fact that their public expenditure and tax reforms are still at an early stage. Moreover, such reforms could still be subverted by the electoral spending cycle.[106] Until the public finances have been consolidated, entry into the euro zone is unlikely to be pursued by policy makers in these three countries. The ability to devalue a national currency still remains a useful policy option to cope with asymmetric shocks prior to ERM-2 entry.

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the EU, while at the same time, Greece, Portugal and Spain on average spent slightly more on public investment than the four larger new member countries, i.e. the Czech Republic, Hungary, Poland and Slovakia.

[102] Malta's Convergence Program foresees a massive fiscal consolidation equivalent to some 5 per cent of GDP over four years. This target certainly looks ambitious.

[103] For an example of such evaluation, see National Bank of Poland, *A Report on the Costs and Benefits of Poland's Adoption of the Euro* (Warsaw), March 2004.

[104] The only other state with temporary derogation that meets all the nominal convergence criteria is Sweden. However, Swedish voters have repeatedly rejected adoption of the euro in national referenda. Similarly, the citizens of Denmark, the only current ERM-2 member from western Europe, have repeatedly rejected entry into the euro zone.

[105] National Bank of Slovakia, *Specification of the Strategy for Adopting the Euro in the SR* (Bratislava), 2004.

[106] National elections will take place in Poland by September 2005 and in the Czech Republic and Hungary during the first half of 2006.

TABLE 3.2.3

Quarterly real GDP and industrial output in the new EU member states, 2003QIII-2004QIII
(Percentage change over the same period of the preceding year)

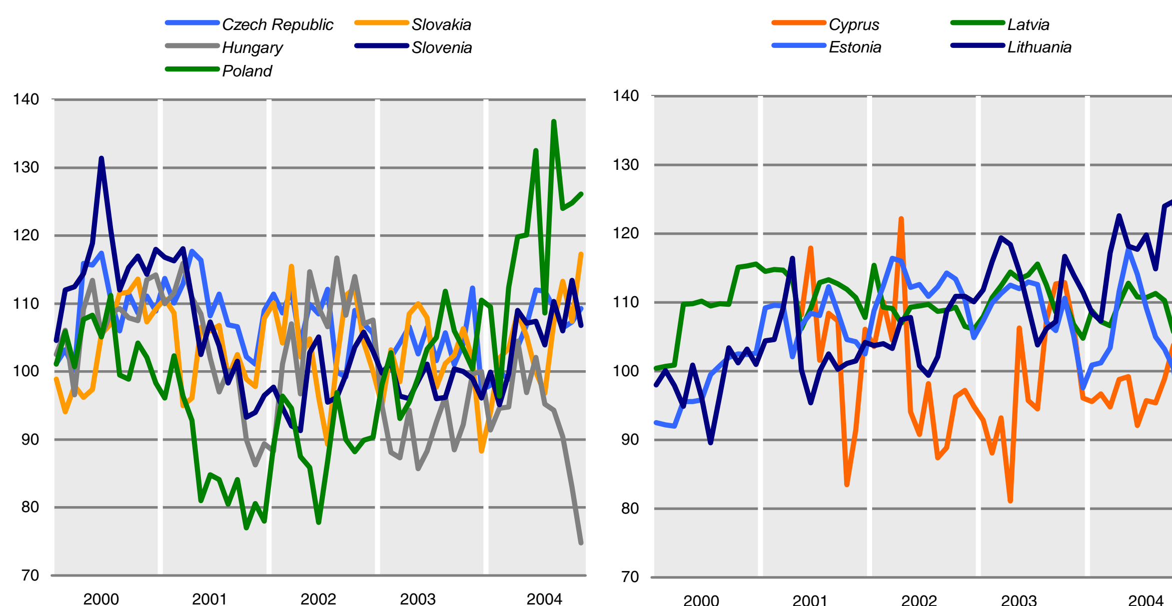
	GDP					*Industrial output*				
	2003QIII	*2003QIV*	*2004QI*	*2004QII*	*2004QIII*	*2003QIII*	*2003QIV*	*2004QI*	*2004QII*	*2004QIII*
Cyprus [a]	1.7	2.8	3.6	4.0	3.5	2.1	2.1	2.5	0.6	-0.7
Czech Republic	4.0	4.0	3.5	3.9	3.6	6.0	6.1	9.0	12.6	8.7
Estonia	5.2	6.2	6.8	5.9	6.2	10.0	9.4	7.4	7.1	7.4
Hungary	3.0	3.8	4.3	4.2	3.7	6.5	10.1	10.4	10.4	6.0
Latvia	7.3	7.5	8.8	7.7	9.1	7.8	4.2	9.2	6.5	3.9
Lithuania	9.3	11.5	7.1	7.3	5.8	20.0	19.3	9.8	17.4	7.3
Malta	-1.6	3.0	2.1	-1.6	1.4	..	..	..	..	..
Poland	4.0	4.7	6.9	6.1	4.8	9.1	11.8	18.9	16.6	9.7
Slovakia	4.5	5.2	5.4	5.5	5.3	2.3	4.2	6.6	5.7	3.8
Slovenia	2.3	2.5	3.8	4.6	4.9	0.2	4.9	4.1	7.4	5.7
Memorandum items:										
Euro area [a]	0.3	0.8	1.9	2.4	1.6	-0.3	1.4	1.0	3.0	2.6
EU-15 [a]	0.5	1.1	2.1	2.4	2.3	-0.1	1.2	1.0	2.8	2.0
EU-25 [a]	0.7	1.2	2.2	2.6	2.3	0.3	1.6	1.6	3.3	2.4

Source: National statistics; Eurostat; OECD; UNECE secretariat estimates.

[a] Industrial output adjusted for the number of working days.

CHART 3.2.2

Economic sentiment indicator in the new EU member states, January 2000-November 2004
(Balance of positive and negative replies, seasonally adjusted)



Source: European Commission, Directorate General for Economic and Financial Affairs.

Note: The economic sentiment indicator is scaled to have a mean of 100 and a standard deviation of 10 over 1990-2003. The weights of the component indicators are as follows: industry – 40 per cent; services – 30 per cent; consumers – 20 per cent; construction – 5 per cent; retail trade – 5 per cent.

(ii) Recent economic developments

Economic growth was strong throughout the EU-10 in 2004 (table 3.2.3). In central Europe, it accelerated and became more broadly based, underpinned by strong private consumption and fixed investment as well as robust external demand. The three Baltic economies continued to grow very rapidly. Economic confidence in the new EU economies is broadly consistent with continued economic dynamism (chart 3.2.2), the economic sentiment indicator in November remaining above its long-term average in the majority of the EU-10.[107]

[107] The economic sentiment indicator and its components are not available for Malta.

TABLE 3.2.4

Components of real final demand in the new EU member states, 2002-2004

(Percentage change over the same period of the preceding year)

	Private consumption expenditure			Government consumption expenditure			Gross fixed capital formation			Exports of goods and services			Imports of goods and services		
	2002	2003	2004 QI-QII	2002	2003	2004 QI-QII	2002	2003	2004 QI-QII	2002	2003	2004 QI-QII	2002	2003	2004 QI-QII
Cyprus	1.5	2.6	6.8	7.5	4.7	11.3	8.1	-2.2	15.5	-5.2	-1.4	4.0	-0.5	-0.4	15.4
Czech Republic	2.8	4.9	3.0	4.5	4.2	-1.1	3.4	4.8	10.0	2.1	7.3	18.4	4.9	7.9	18.8
Estonia	10.3	5.7	6.1	5.9	5.8	4.5	17.2	5.4	6.1	0.9	5.7	18.7	3.7	11.0	16.7
Hungary	10.2	8.0	4.2	5.0	5.4	-0.3	8.0	3.4	13.5	3.7	7.6	18.4	6.2	10.4	18.6
Latvia	7.4	8.6	9.3	2.2	1.9	2.3	13.0	10.9	19.3	5.2	5.0	7.6	4.6	13.0	18.4
Lithuania	6.1	12.4	11.1	1.8	4.0	6.1	11.1	14.0	15.9	19.5	6.9	3.7	17.6	10.2	14.6
Malta	-0.4	1.6	0.4	3.8	1.6	-0.4	-29.6	41.4	-4.1	6.6	-3.8	2.7	-2.4	7.1	0.1
Poland	3.4	3.1	3.8	0.4	0.4	2.0	-5.8	-0.9	3.6	4.8	14.7	13.6	2.6	9.3	9.8
Slovakia	5.5	-0.6	3.0	4.9	2.7	1.2	-0.6	-1.5	2.4	5.6	22.5	16.1	5.5	13.6	14.6
Slovenia	0.3	2.7	3.5	1.7	2.6	0.8	3.1	6.3	7.3	6.7	3.2	11.5	4.9	6.8	12.9

Source: National statistics; Eurostat; OECD; UNECE secretariat estimates.

GDP growth remains vibrant in central Europe…

The available national accounts and industrial production data indicate that economic activity continued to expand briskly throughout central Europe, although slowing somewhat in the third quarter of 2004. Growth was driven by large increases in consumption and investment and by strong external demand. Exports grew rapidly and the central European economies continued to increase their shares of west European markets. The underlying factors include the expanding capacities of export-oriented FDI firms, the one-off effects of full trade liberalization at the time of the EU accession, and rapid labour productivity growth that has preserved their cost competitiveness.

Real consumer spending accelerated in the first half of 2004 in Poland, Slovakia and Slovenia (table 3.2.4). The rapid growth of final consumption slowed somewhat in the Czech Republic and Hungary, reflecting more moderate increases in real wages. Real investment increased throughout central Europe in the first half of 2004. In Hungary, business investment expenditure picked up noticeably in the export-oriented and FDI-dominated manufacturing sector. Investment spending gathered pace in the Czech Republic, growing most rapidly in the government and household sectors but also picking up in the key non-financial business sector where it was driven by improved corporate profitability. Real investment also accelerated in Slovenia. In Poland and Slovakia, fixed capital formation increased after two years of decline. Improved profitability in the non-financial corporate sector underpinned business investment in both countries.

Imports grew rapidly throughout the region, in response to the expansion of both domestic demand and exports. Net trade continued to support GDP growth in Poland and Slovakia in the first half of 2004, while its contribution was negative in the other three central European countries; this pattern most probably continued in the second half of the year.

Macroeconomic policies were broadly supportive of growth. The cyclical upturn in economic activity contributed to relatively favourable budget out-turns in the Czech Republic, Poland, Slovakia and Slovenia. Consequently, the Czech and Polish central banks raised policy rates less aggressively in the face of rising inflationary pressures than would otherwise have been the case with less favourable fiscal outcomes. In Slovakia, the central bank continued to ease monetary conditions with repeated cuts to policy rates, while reducing the upward pressure of strong capital inflows on the exchange rate through sterilization. In Slovenia, the central bank reduced policy rates until June 2004, while allowing the tolar to depreciate slowly against the euro. Following the country's entry into ERM-2, market interest rates and the exchange rate remained stable.

Hungary was an exception to these generally benign developments due to the carryover effects from financial destabilization in late 2003 and early 2004.[108] Inflation had overshot the targeted range since the third quarter of 2003 and only started to subside in the second half of 2004. This, as well as the apparent stabilization of market expectations, allowed the National Bank of Hungary (NBH) to start cautiously reducing its policy rates; however, they have remained at comparatively high levels, reflecting the country's serious twin-deficit problem and the underlying lack of progress with fiscal stabilization. The government's attempt to reduce interest rates more rapidly (and thus the cost of financing the relatively large public debt) through increased political pressure on the central bank is unlikely to succeed and could even backfire through its impact on market expectations.[109]

[108] For details of the financial destabilization, see UNECE, *Economic Survey of Europe, 2004 No. 1*, pp. 51-52, box 3.1.1.

[109] The government attempted to influence monetary policy by pushing through parliament a radical amendment to the Central Bank

…while the Baltic states continue to enjoy the fastest growth rates in the EU…

Rapid GDP growth continued throughout the Baltic region in the first three quarters of 2004. The pace slowed somewhat in Lithuania while picking up in Estonia and Latvia, the latter being the fastest growing EU economy in 2004. The strong growth of output and productivity in the Baltic economies is likely to continue, given the soundness of their underlying competitive positions.[110] Domestic demand remained the principal source of growth throughout the region. Buoyant consumption and rising exports by FDI-firms led to a rapid growth of imports.[111] The contribution of net exports to GDP growth was negative, especially in Latvia and Lithuania. The relatively large current account deficits of the Baltic states appear to be manageable in the short term, given the underlying factors and continuing inflows of FDI (see table 6.1.2).

Both fiscal and monetary policies were supportive of growth and in Estonia and Lithuania there was no change after their entry into ERM-2 in June 2004. The Latvian authorities intend to repeg the lats to the euro in January 2005 and to maintain their unilateral commitment to a narrow (±1 per cent) exchange rate band. Given the strong acceleration of growth and signs of overheating in 2004, the planned entry into ERM-2 in the near future and early adoption of the euro may well require a tightening of fiscal policy to prevent excessive inflation.[112]

…and Cyprus and Malta experience diverging output trends

Following the recent liberalization of all capital account transactions with non-residents, and the uncertainty arising from the failed attempt to unify the country prior to EU accession, the Central Bank of Cyprus tightened monetary policy with a steep rise of its interest rates. Fiscal policy was tightened less resolutely through a gradual withdrawal of fiscal stimulus in 2004 that will be followed by spending restraint in 2005. In the first half of 2004 output growth picked up, driven by robust consumption, increased investment and exports of goods and services. The key tourism sector appears to have recovered from the slump in 2003. It remains unclear whether the pace of economic growth will be sustained when the planned fiscal tightening materializes in 2005.

In Malta, GDP growth appears to have remained sluggish in 2004. The impact of strong investment spending and improving net exports on aggregate output was moderated by subdued final consumption. On the supply side, the deceleration in output growth reflected the poor performance of the manufacturing sector.

TABLE 3.2.5

Consumer prices in the new EU member states, 2002-2004
(Percentage change)

	Consumer prices, total					
	Over preceding year		*2004 (year-on-year)*			*Sept. over previous Dec.*
	2002	*2003*	*QI*	*QII*	*QIII*	*2004*
New EU member states	2.7	2.0	3.1	4.1	4.9	3.6
Cyprus	2.8	4.1	1.4	1.6	3.0	2.4
Czech Republic	1.8	0.2	2.4	2.6	3.3	2.3
Estonia	3.5	1.1	0.7	3.4	4.1	3.9
Hungary	5.4	4.9	6.9	7.4	7.0	5.0
Latvia	1.9	3.0	4.4	5.9	7.5	6.0
Lithuania	0.4	-1.2	-1.3	0.4	2.3	2.5
Malta	2.2	0.7	2.7	2.7	3.0	1.2
Poland	1.9	0.7	1.7	3.3	4.6	3.3
Slovakia	3.3	8.5	8.4	8.1	7.5	6.2
Slovenia	7.6	5.7	3.8	3.8	3.7	2.6
Memorandum item:						
EU-8	2.7	2.0	3.1	4.2	4.9	3.6

Source: UNECE secretariat estimates, based on national statistics.

Disinflation came to a halt

The headline rate of consumer price inflation picked up or remained in high single digits in most of the 10 new member states of the European Union in the first three quarters of 2004 (table 3.2.5). The reversal of the downward trend of the last three years was prompted by a combination of factors. Some of them were expected one-off factors arising from their entry into the EU, such as deregulation of a broad range of prices, and increases in indirect taxes and excise duties. There were other temporary or exogenous factors, such as the rise in food and domestic fuel prices and a surge in imported inflation following the increase of world commodity prices, particularly of oil and natural gas. In some of these economies, the external price pressures were partly offset by the appreciation of their currencies vis-à-vis the dollar and the currencies of other major trading partners; this was particularly the case in Lithuania and Slovakia.

Act. The NBH published a strong objection to the amendment on its website [www.mnb.hu] on 20 October 2004. According to the NBH, the government's attempt to encroach on its independence may "ultimately discredit Hungary as a new member state of the European Union". Although parliament approved the controversial amendment in November, it remains unclear whether it will be implemented.

[110] R. Burgess, S. Fabrizio and Y. Xiao, *Competitiveness in the Baltics in the Run-up to EU Accession*, IMF Country Report No. 03/114 (Washington, D.C.), April 2003.

[111] The importance of foreign-invested firms can be illustrated by the example of Elcoteq Tallin, an Estonian subsidiary of the Finnish-owned Elcoteq Network Corporation. This affiliate has assembled electronic communications products since 1994; its output accounted for 14 per cent of Estonia's exports in 2003. In 2004, it rapidly increased its production and workforce, becoming one of the largest Estonian employers. This expansion was driven by strong global demand for its products and competitive hourly labour costs (€3 in Estonia vs. €20 in Finland). "Finnish-owned Elcoteq to become one of largest employers in Estonia", *Enterprise Estonia News*, 4 November 2004 [www.investinestonia.com/index].

[112] For a brief discussion of ERM-2 and exchange rate issues, see "Aide-Mémoire: IMF Staff Visit to the Republic of Latvia", 13-15 October 2004 [www.imf.org/external/np/ms/2004/101504.htm].

Exchange rates depreciated in nominal effective terms only in Latvia and Poland. Other factors, such as buoyant consumer demand and tighter labour markets, also contributed to the revival of inflationary pressures in some of these economies.

It should also be noted that core inflation, which excludes volatile food and energy price changes and is an indicator of underlying inflationary pressures, was lower than the headline inflation in all these economies in 2004; however, the pace of deceleration was much less than in 2003.

Wage pressures intensified but were offset by surging productivity

The rate of change in industrial producer prices, which is a measure of the overall inflationary pressure originating from the supply side, also accelerated in the first three quarters of 2004 and rose even faster than consumer prices except in Hungary and Slovakia (but in the latter, producer prices rose more than in the same period of 2003).

The moderation of wage inflation came to a halt in 2004 and average gross wages in industry rose faster than the increase in the sector's producer prices. These increased wage pressures, however, were more than offset by surging labour productivity, a reflection of dynamic but jobless output growth. Productivity grew at double-digit rates in the first half of 2004 in all countries except Estonia, Slovakia and Slovenia, while industrial unit labour costs continued to decline in both nominal and real terms. Given strong external and domestic demand, the pricing power of firms rose significantly. This allowed them to increase their operating surpluses in tandem with accelerated wage inflation, particularly in those economies where appreciation of the exchange rate mitigated the pressure of higher import prices on industrial material input costs.

Industrial labour productivity rose significantly in the central European and Baltic economies between the end of 1999 and mid-2004 (chart 3.2.3). In the Czech Republic, Lithuania and Poland, the increase in productivity was greater than the rise in wages. In the other remaining economies, wage inflation in 2000-2004 exceeded the rise in productivity.[113] These wage increases, in excess of labour productivity growth, are recognized by the authorities as a major problem that needs to be addressed in order to achieve and sustain price stability.

Labour markets were generally weak

The relatively strong growth of output in the EU-10 area had only a very slight impact on their labour markets. The average level of employment in the first half of 2004 was only 0.2 per cent higher than in the same period of 2003, while unemployment remained substantially unchanged throughout the first three quarters of the year (table 3.2.6). Employment declined or stagnated in the Czech Republic, Estonia, Hungary, Lithuania and Slovakia. In contrast, there was a modest increase in Poland for the first time in several years, although it continued to fall in the manufacturing sector. Employment growth was comparatively strong in Cyprus and Latvia. The large rise in Slovenia was largely the result of a one-shot increase of employment in the public sector.

Concerns at low employment rates…

The failure of the EU-10 to generate new employment on a significant scale is a cause of major concern, especially since employment rates in these countries remain, with the exception of Cyprus, significantly below the 70 per cent target set in the Lisbon agenda for 2010.[114] Starting from an employment rate of 60 per cent (the current average for the EU-10) in 2005, hitting the Lisbon target by 2010 would require an average employment growth rate of about 1.5 per cent a year, assuming a roughly constant population of working age. With the exception of the Baltic states, none of the EU-10 have been able to sustain this rate of employment growth over the past few years.

Weak employment growth in the EU-10 area results from the combination of two broad sets of factors. On the one hand, rapid labour productivity growth, as achieved in most EU-10 economies in recent years, tends to keep employment growth down in the short run. This is the case over and above the labour-shedding that is associated with restructuring in the enterprise sector. The available empirical evidence, however, suggests that such a trade-off is likely to vanish over the longer term. Continued high rates of economic growth should therefore lead eventually to higher levels of employment. On the other hand, a number of rigidities have created distortions on both the demand side and the supply side of the labour market. The issue appears to be particularly relevant to the central European economies, where the tax-benefit systems have adversely affected the incentives to work and the extent of labour mobility across regions.[115] To overcome these rigidities, reforms to strengthen the incentives to work, job-search facilitation services and programmes to minimize the mismatch of skills are required.[116] Moreover, while the overall degree of

[113] The differential was largest in Slovenia where the gains in productivity were about one third of the rise in wages.

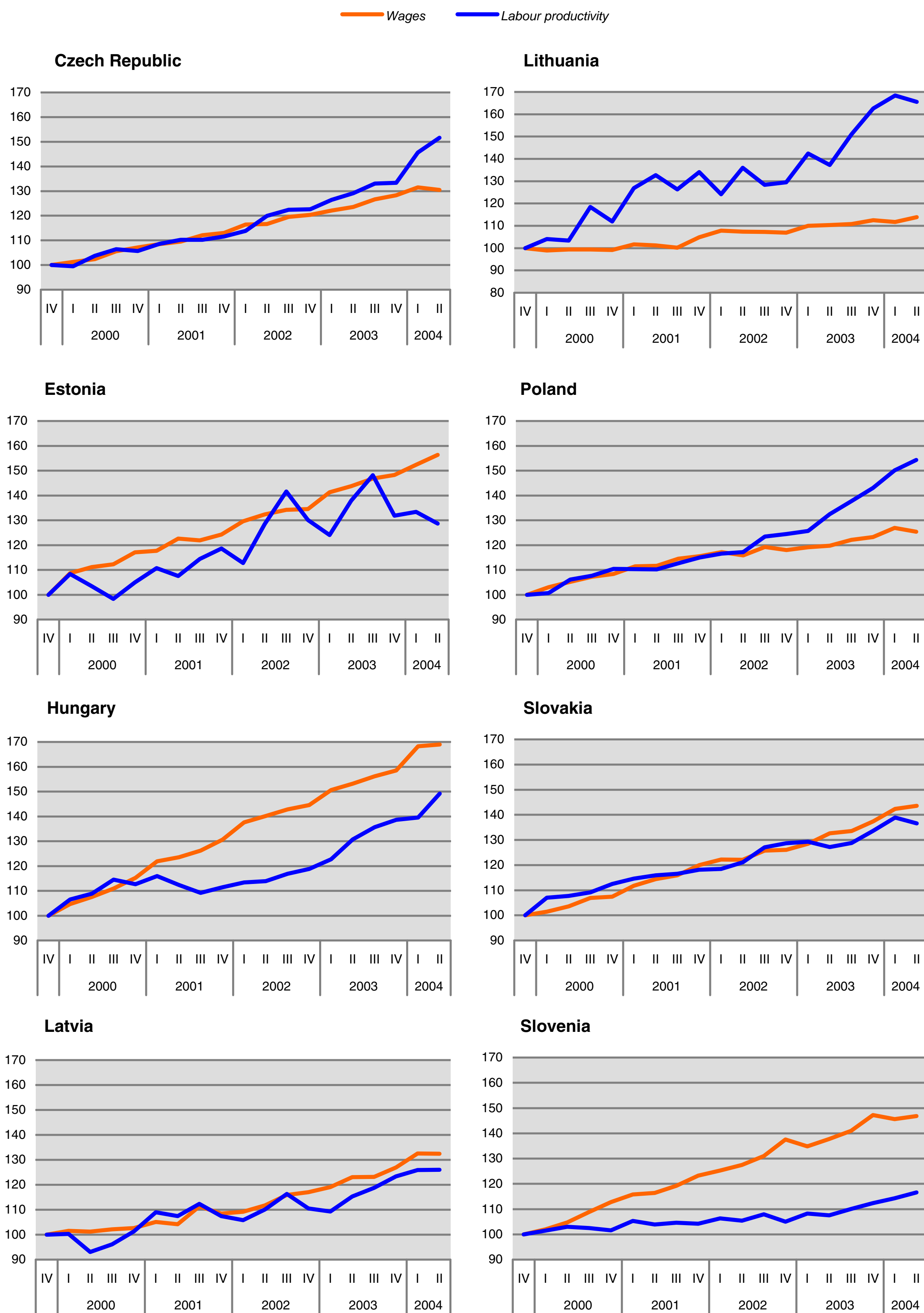
[114] Indeed, it should be pointed out that if the part of Cyprus under Turkish administration was included in the employment statistics, the overall employment rate for Cyprus would likely fall significantly short of its current 69 per cent.

[115] For an elaboration of this point, see UNECE, *Economic Survey of Europe, 2004 No. 2*, chap. 1, pp. 26-27.

[116] In Slovakia, despite recent tax and benefit reforms that have introduced strong work incentives, job creation has stalled. This disappointing result reflects to some extent the lack of specific employment programmes targeted at the large Roma minority. OECD, *Economic Surveys: Slovak Republic* (Paris), March 2004. It may also reflect the uncertainty of firms about the permanence of the recent tax cuts. If these cuts are not reversed following the 2006 election, business investment and job creation in Slovakia could pick up strongly.

CHART 3.2.3

Gross nominal wages and labour productivity in industry in the eight new EU member states, 1999QIV-2004QII
(Indices, 1999QIV=100; seasonally adjusted)



Source: UNECE secretariat estimates, based on national statistics.

TABLE 3.2.6

Rates of unemployment and employment growth in the new EU member states, 2002-2004
(Per cent, percentage change)

	Unemployment (per cent of labour force)			Employment (per cent change over the previous period)		
	2002	2003	2004 [a]	2002	2003	2004 [b]
New EU members states	14.8	14.3	14.2	-0.8	–	0.2
Cyprus	3.9	4.4	4.8	1.3	1.0	2.7
Czech Republic	7.3	7.8	8.4	-0.4	-0.7	-0.8
Estonia	9.5	10.1	9.5	1.4	1.5	0.2
Hungary	5.6	5.8	5.8	0.1	1.3	–
Latvia	12.6	10.5	9.8	2.8	1.8	1.2
Lithuania	13.5	12.7	11.1	4.0	2.3	-0.6
Malta	7.5	8.2	7.4	-0.7	-0.7	-0.1
Poland	19.8	19.2	18.9	-2.2	-0.7	0.5
Slovakia	18.7	17.5	18.2	0.2	1.8	-0.4
Slovenia	6.1	6.5	6.1	0.6	-0.8	4.8
Memorandum items:						
Euro area	8.4	8.9	8.9	0.6	0.2	0.5
EU-15	7.7	8.1	8.1	0.5	0.2	0.5

Source: UNECE Statistical Database; Eurostat; NewCronos Database; European Commission, *European Economy Forecasts* (Brussels), Autumn 2004.

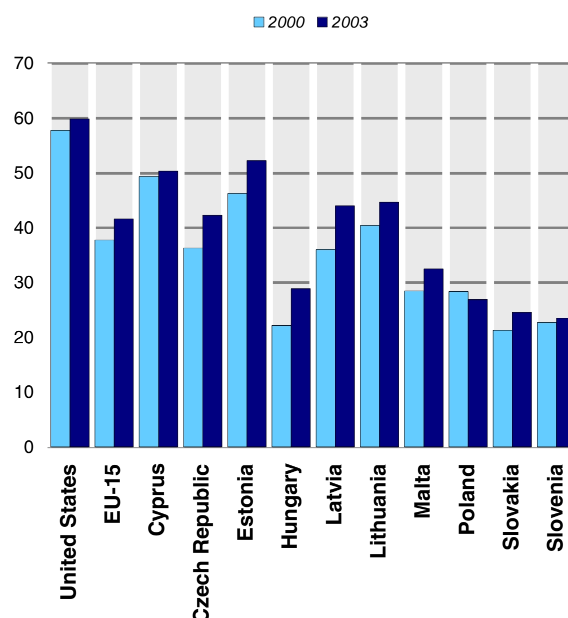
Note: Standardized unemployment rate as defined by Eurostat/ILO.

a Average of the first three quarters of 2004, seasonally adjusted.

b First half of 2004 change over first half of 2003.

CHART 3.2.4

Employment rates of older workers in the new EU member states, 2000 and 2003
(Per cent of population aged 55-64)



Source: UNECE Statistical Database; Eurostat, NewCronos Database; data for the United States are from the OECD, *Employment Outlook* (Paris), 2004.

Note: The employment rate is the proportion of employed persons aged 55 to 64 in the total population in the same age group.

employment protection legislation in central European countries is not particularly high by OECD standards, further flexibility can be achieved through the deregulation of temporary work, especially in Hungary and Poland.[117]

…and to employment of older workers in particular

The overall rate of employment is influenced by developments in the employment of specific demographic groups, such as women, young people and older workers. The significant underemployment of this latter group is a striking feature of several EU-10 economies (chart 3.2.4). Again, the central European economies stand out, as employment rates of older workers, on average, are 16 percentage points below the EU-15 average.

Various factors have reduced the employment rate of older workers.[118] Generous pension benefits have contributed to early retirement in Hungary and Poland; much less so in the Czech Republic and Slovakia, where income replacement ratios are significantly smaller, even by OECD standards. Moreover, on the assumption that jobs freed by older workers would be filled by young workers, several countries in the past have placed high implicit taxes on continued work, either through non-actuarially neutral pension systems or through other social transfer programmes (i.e. unemployment-related and disability benefits). There are also a number of demand-side distortions that are fairly general in this group of countries. One relates to rigid age-wage profiles, which are often due to employment protection legislation. Another has to do with difficulties of older workers in updating their skills in the face of rapid technological progress. This problem is exacerbated by firms' unwillingness to train older workers because of the shorter time horizon of such investment. Taken together these two factors make older workers less attractive to employers. Age discrimination appears to be particularly strong against women in secretarial and clerical jobs in the private sector.

While the incentives for early retirement have been progressively reduced in several countries, thus leading to an overall (albeit still small) increase in the employment rate of older workers between 2000 and 2003, further action is needed to foster labour utilization in this demographic group. A first important step will be the

[117] Empirical analysis of the determinants of unemployment in the central European economies has identified other factors that contribute to weak labour market performance, particularly in Poland and Slovakia. These include the combination of restructuring with tight monetary policy, poor rule of law (which in turn limited FDI inflows) and demographic changes. Some of these factors are cyclical while others appear to be of a more structural nature. If not properly addressed, such problems could then reduce the expected positive impact on employment dynamics of labour market reforms. S. Ederveen and L. Thissen, *Can Labour Market Institutions Explain Unemployment Rates in New EU Member States?*, CPB Document No. 59 (The Hague), April 2004.

[118] See, for instance, R. Duval, *The Retirement Effects of Old-age Pension Systems and Other Social Transfer Programmes in OECD Countries*, OECD Economics Department Working Papers, No. 370 (Paris), November 2003.

reform of the pension system to strengthen its actuarial fairness and at the same time to move away from pay-as-you-go, non-funded mechanisms. Such reforms have already been launched in Hungary, Latvia, Poland and some other new member states.[119] In Poland, however, the still high replacement ratios have probably offset some of the positive effects that the pension reform might have had on the employment rate. A second step is to increase the flexibility of wage growth by age. This can be achieved both within a decentralized wage-setting structure, where wages are more likely to be determined by actual productivity, and a centralized system, where economy-wide considerations are internalized by industry or sector encompassing unions. It is more difficult to achieve this greater flexibility with the intermediate degrees of concentration of wage bargaining that prevail in the EU-10 economies. Additional efforts will also need to be made to reduce age discrimination, especially against minorities, such as the Roma in central Europe and, generally, against women. Finally, retraining programmes to update the skills of older workers need to be strengthened. Some empirical evidence for the OECD countries shows that to be effective training programmes should be designed with a strong on-the-job component and be associated with the provision of efficient job placement services.[120] However, it must be acknowledged that low labour mobility across regions might significantly hinder the effectiveness of such programmes as people receiving training in one region might not be willing or able to move to another region where there are suitable job openings. For this reason, in countries with sharp regional disparities (e.g. Hungary, Poland and Slovakia), it is important to combine training programmes with policies that facilitate labour mobility (for example, housing and rental policies).

(iii) The short-term outlook

Rapid output and productivity growth should continue in 2005…

The prospects for continued strong output growth in the EU-10 in 2005 are relatively good (table 1.1.1) but subject to a number of risks. The pace of expansion may well be only slightly below that of 2004, assuming slow but steady GDP growth in western Europe. Economic sentiment has remained remarkably robust in Poland, the economy that dominates trends in the EU-10. This, together with strong industrial orders in recent months, indicate that activity is likely to remain vigorous in the short term. On the supply side, the capacity-increasing effects of foreign direct investment should continue to play a key role in the growth process. The slowly improving business environment and EU membership have coincided with a noticeable growth of greenfield FDI projects that are likely to improve the quality of the ongoing economic restructuring and to underpin a continued strong performance of exports.[121]

…but prospects for employment growth remain bleak

Strong output growth in the EU-10 area, however, is still unlikely to induce significant employment gains, given the slow progress of labour market reforms and the aggressive industrial restructuring taking place in the dominant economies. The persistent duality of the labour market is apparent in the coexistence of skilled labour bottlenecks with the absence of vacancies for the low-skilled jobseekers that dominate the ranks of the long-term unemployed. The tax-benefit systems still create poverty traps that reduce significantly the work incentives of low-skilled labour. Heavy taxes on labour and excessive regulation limit job creation in the private sector. Moreover, fiscal consolidation in most EU-10 economies precludes employment gains in the government sector.

…and there are considerable risks to the outlook

An important downside risk to the above outlook is the possibility of a sharp slowdown of economic growth in the euro zone and a subsequent weakening of external demand. Another major short-term risk is the possibility of further increases in world commodity prices, particularly of oil and natural gas.[122] This would not only exert direct upward pressure on production costs and prices but could also affect the rates of growth of industrial output and productivity, which were instrumental in offsetting the impact of accelerated wage inflation in 2004. Such developments could result in rising core inflation and a consequent monetary tightening that would eventually reduce the pace of output growth.

Aside from those mentioned above, the most serious risk to the outlook is posed by the fragile nature of fiscal consolidation in central Europe ahead of the upcoming general elections. Traditionally, national elections in the region have been preceded by large increases in public sector wages and social transfers. If this electoral spending pattern is repeated in 2005, it could undermine policy credibility and erode confidence, possibly triggering monetary tightening, lower FDI inflows and reduced competitiveness.

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[119] On pension reforms designed to increase actuarial fairness see A. Lindbeck and M. Persson, "The gains from pension reform", *Journal of Economic Literature*, Vol. 41, No. 1, March 2003.

[120] J. Martin, "What works among active labour market policies: evidence from OECD countries' experiences", OECD, *Economic Studies No. 30* (Paris), 2001/1.

[121] According to a recent report, the number of FDI projects in the first half of 2004 rose much faster in Hungary, Poland and the Czech Republic than in the mature EU economies. Relative to other European economies, Hungary was in the third position with 84 new FDI projects, Poland in fifth place with 69 new projects and the Czech Republic in eighth place with 63 new projects. Slovakia did not rank among the top 10 countries but nevertheless received more new FDI projects than the Netherlands. *Ernst & Young European Investment Monitor,* First Half 2004.

[122] The energy intensity of the EU-10 economies still significantly exceeds that of their west European counterparts. The adverse impact of higher energy prices on economic growth is therefore likely to be stronger in the new EU economies than in the old ones. For a country-specific estimate of this impact, see National Bank of Hungary, *Inflation Report*, August 2004, pp. 75-79.