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**The EU Economy: 2004 Review
- Summary and main conclusions -**

1. INTRODUCTION

The enlargement of the Union on the 1st of May 2004 marks a historic achievement. While the process of economic integration in the new Member States began during the pre-accession phase, it has been reinforced by their entry into the EU. It will imply challenges, but above all opportunities, both for the old EU-15 and for the new EU-25.

Enlargement and the mid-term review of the Lisbon Strategy put the spotlight on key economic issues of the Lisbon Agenda

At the Spring 2004 European Council, a high level group chaired by Wim Kok was asked to carry out an independent review to contribute to the forthcoming mid-term review of the Lisbon Strategy. This will first and foremost be an opportunity to draw lessons from the experience gained so far, and to reinforce the policy strategy and the instruments to achieve the strategic ambition for this decade agreed by the European Council in Lisbon in March 2000. The upcoming mid-term review has also been a defining factor in the conception of the 2004 edition of the EU Economy Review. The Review starts with a chapter on recent macroeconomic and policy developments in the euro area and then goes on to analyse four specific topics that have been chosen because of their central importance to the Lisbon Agenda: convergence, employment, productivity and the environment. The final chapter discusses topical issues in economic surveillance.

2. ECONOMIC DEVELOPMENTS: BELATED RECOVERY RAISES QUESTIONS OF RESILIENCE

Following three years of weak growth, the euro area economy is now recovering

In 2004, economic prospects brightened against the background of a favourable international economic environment. Growth was mainly driven by strong exports, while domestic demand in the euro area gained pace slowly but steadily. However, the contribution to growth of private consumption and investment, which are the two main components of domestic demand, remained too unsteady to speak of a truly secure recovery. There is little evidence to support the argument that the weak domestic demand in recent years can be attributed to macroeconomic policies. The monetary conditions remained accommodative, with historically low short- and long-term interest rates, and fiscal policy was marked by the cushioning impact of the automatic stabilisers. The policy mix thereby provided a sound macroeconomic environment conducive to a resumption of domestic demand.

Belated and sluggish recovery puts the spotlight on the area's economic resilience

The rebound of the EU economy has been relatively belated and sluggish compared with other major economies. This has prompted questions about the euro area's economic resilience and more specifically about whether the euro area is more sensitive than other regions to adverse economic shocks, or whether its economic structures

are less favourable to economic resurgence. Analysis shows that, although adverse economic events have impacted on economic confidence indicators, their effects on industrial production were short-lived and not particularly deep. Rather, it would appear that structural rigidities have been a more significant factor in the late and sluggish cyclical adjustment in the euro area. Simulations suggest that structural rigidities impact mainly on investment activity. Thus, the speed of the return to potential output will be determined by how much these rigidities continue to weigh on investment once the cyclical impact of a lack of demand on the one hand and financial constraints that held back investment growth on the other is worn out. Wage rigidities and imperfect competition, in particular in the service economy, are among the main reasons for sticky prices in the euro area. Relative prices do not adjust quickly in the euro area, implying the need for costlier quantity adjustments in the form of scaling down production and hence employment. It may also be that the lack of resolve in addressing budgetary consolidation, structural reforms and pension reforms has increased uncertainty and thereby adversely affected consumer confidence and spending. Forceful resolution of these outstanding policy issues could potentially support consumption during the upswing.

3. THE ECONOMIC UNDERPINNINGS OF THE LISBON STRATEGY

A closer look at the economics of convergence, labour market performance, productivity, and the environment

At the Lisbon European Council in March 2000, the Heads of State or Government stated their ambition of making Europe “the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion.” As a contribution to preparing the upcoming mid-term review of the Lisbon Strategy, the EU Economy 2004 review focuses on the Strategy’s economic underpinnings in four areas. Firstly, with regard to cohesion, an analysis is made of the prospects for catch-up growth and convergence in the new Member States. Secondly, the economics of labour market performance are reviewed in detail. The analysis in last year’s review of productivity developments is extended, with particular reference to the role played by Information and Communication Technologies (ICT) and product market reform. A fourth chapter looks at the nexus between the environment and economic growth, and the final chapter reviews selected topics in economic surveillance.

3.1. Catch-up growth and convergence in the new Member States

Enlargement has brought the cohesion issue to the fore

Since the new Member States have income levels significantly below the EU average, it seems pertinent here to identify the main policy levers to foster a sustained process of catching-up. However, the EU’s

past experience suggests that income convergence is not necessarily a rapid, continuous or automatic process. Furthermore, in the early stages of catching-up, growth tends to strengthen first in urban rather than rural areas, so that regional income inequalities may initially increase as the national growth rate accelerates.

Growth in new Member States driven by investment and productivity growth

The new Member States started the long catching-up process well before their accession, in the transition phase of the early 1990s – albeit at only a moderate pace in most cases. This process of economic convergence has so far been entirely driven by investment and total factor productivity (TFP). The challenge will be to broaden this process by drawing in underutilised labour resources, thus increasing the fairly low employment rates in most of the new Member States, and by progressively mobilising higher domestic savings to complement foreign direct investment, which has played a major role so far.

Comprehensive policy approach required to foster catching-up

An important question is how policy can help foster stronger and more broadly based growth. Trade liberalisation has already contributed significantly to growth since the early 1990s. A key priority will be to further entrench macroeconomic stability, with public deficits still too high in most cases and inflation remaining somewhat high and variable in some Member States. Institutional reform is also important in sustaining convergence, and now that the prospect of EU accession can no longer act as an external anchor, helping to catalyse political support for change, the challenge is now to keep up the momentum and support for further domestic reforms.

EU cohesion policy can have a substantial impact if several conditions are met

Structural Funds also have a role to play in fostering convergence effectively, but to do so three conditions must be met: stronger spatial concentration on the regions and Member States most in need, improved thematic concentration, and a more effective use of funds in pursuit of the Lisbon objectives. The contribution of EU cohesion policy to real convergence will depend primarily on the commitment of policy-makers to coherent national and regional policies, ensuring that the environment in which Structural Funds are utilised is characterised by macroeconomic stability, continuing structural reforms, and good governance.

3.2. The labour market in the EU: an economic analysis of recent performance and prospects

Lisbon employment target looks challenging and is probably out of reach

Halfway through the first decade of the Lisbon strategy, it is difficult to see how the employment targets can still be achieved by 2010, partly because of the economic slowdown, but more importantly because progress on structural reforms has been slow and insufficient. On the positive side, however, there is evidence that much of the improvement in labour market performance over the 1990s was structural, and that

significant progress has continued in some areas, such as improving female employment.

The strategy is clear but much remains to be done

Furthermore, the main determinants of labour market performance and the kind of measures Member States need to take in order to pursue the Lisbon goal of more and better jobs are well known, and fully reflected in the comprehensive approach of the European Employment Strategy. These include, for instance, reforms to allow for wage differentiation in line with productivity developments and local labour market conditions, tax and benefit reforms in conjunction with well-targeted active labour market policies, labour market regulations that are conducive to job creation and policies to improve education and training especially for low-skilled and older workers. Detailed reform strategies must be country-specific, looking at the mix of labour market and social protection institutions. However, a comparison of country-specific priorities as identified in the EU Employment Recommendations and the Broad Economic Policy Guidelines with progress made in the last few years points to areas for urgent action at the Member State level.

While higher employment may temporarily dampen productivity growth, this effect is estimated to be small

Some have voiced doubt about whether the Lisbon goals to raise employment and productivity at the same time are compatible. However, analysis suggests that only a small share of the observed deceleration in labour productivity growth since the mid-1990s can be attributed to rising employment. Indeed, there are few reasons to think that a higher employment rate has any negative implications for longer-term productivity growth, which is what really matters for the competitiveness and dynamism of the EU economy.

3.3. Productivity, the impact of new technologies and product market reforms

Productivity growth fundamental to realising the Lisbon strategic goal

The EU economy must not only achieve a higher labour input, but also enhance productivity growth. Macro as well as sector-specific analysis suggests that a large part of the productivity slowdown since 1995 is structural, reflecting the combined effect of low productivity growth in a large proportion of mid-tech EU industries, the relatively small size of the EU's ICT production industry and problems of TFP growth in ICT-using sectors. Also, the higher returns which can be earned outside Europe with globalisation and increased international capital mobility may exert pressure on capital productivity. These developments could be part of the explanation as to why capital-labour substitution and hence labour productivity growth have declined.

Knowledge production and absorption are mutually supportive elements of any

TFP is mainly determined by the efficiency with which advances in the competences of workers are harnessed to the organisation and the technological level of capital equipment. The knowledge-based economy is not yet fully entrenched in the EU. A considerable gap

***successful long-run
productivity strategy***

exists between the EU and the USA in terms of both the amount of resources allocated to research and the efficiency of research. The US's superior innovation system has substantially shifted the US economy towards new, high-productivity growth industries, most notably the ICT-producing manufacturing sectors and the ICT-using service sectors. As a result, it is in a much more robust position following the acceleration in globalisation-induced, competitive and technological pressures since the mid-1980s. Reforms which would allow new, innovative firms to become established and grow are particularly needed. This underlines the importance of increased investments in human capital to help further improvements of knowledge production and diffusion. Investment in education, training and lifelong learning are essential to the Union's international competitiveness in knowledge-intensive, innovation sectors, and to sustainable growth and employment. It is equally important to improve the "leverage" of additional R&D investments into productivity growth and to pursue with determination the target of increasing expenditures on R&D to 3% of GDP. This will mean getting the framework conditions right and further improving the interface between research and industry.

***Product market
reforms play a central
role in the Lisbon
strategy as they
improve the
framework conditions
in which business
operates***

Another dimension of the endeavour to raise productivity growth is product market reforms. The way in which product markets are regulated has a significant impact on the degree of competition in the market and the scope and size of the market, and hence on the size and structure of economic activity. The direct effects of the decrease in costs of doing business and the removal of barriers to new markets on productivity tend to be small. Empirical studies suggest that a large part of the impact on productivity is through indirect effects, namely a reduction in mark-ups and a reallocation of scarce resources (allocative efficiency); an improvement in the utilisation of the production factors by firms (productive efficiency); and an incentive for firms to innovate and to move to the modern technology frontier (dynamic efficiency). In particular, product market reforms that ease entry, reduce tariff rates, diminish regulatory barriers to trade, remove price controls and reduce public involvement in production reduce the average level of economic rents in the economy. In high-tech sectors where productivity gains are most important, it is the new firms that make the most significant contribution to productivity growth. Competition seems to deliver its full effects on dynamic efficiency with long lags and the literature underlines the fact that innovation has differential effects on productivity growth depending on the distance to the technological frontier.

Further reforms should mainly aim at promoting entry of new companies and pursuing internal integration

The EU has already engaged upon thoroughgoing reforms, in particular with the creation of the Internal Market. The EU is open to international competition and its network industries are liberalised to a degree that equals, if not exceeds, the USA. However, it seems to be lagging behind when it comes to measures that promote the entry and exit of firms. There is still scope to increase the degree of internal trade integration in the EU. The costs of complying with regulation also appear to be higher than in the USA, which suggests that much remains to be done in the EU on this account.

3.4. Environmental protection: drag on growth or growth-enhancing structural adjustment?

A certain reduction in the pollution intensity of growth in Europe has been achieved over recent decades without crowding out industries

While environmental sustainability is an integral part of the Lisbon strategy, protection of the environment and economic growth are often seen as competing aims. The controversy is focused on water, soil and air pollution and global commons such as the climate and the ozone layer. While these are all more or less renewable natural resources, their scarcity (or overuse) has risen dramatically over the last few decades. The absence of enforceable property rights has not helped counter this tendency. Environmental policy aims to put these resources under a common-property regime with enforceable rules. The main policy instruments are various forms of restriction on activity, which is hazardous or damaging to the environment.

Environmental policies must be cost-effective, gradual and predictable in their design if they are to stimulate welfare-enhancing structural adjustments

Demand for environmental protection has risen along with economic growth, and public action and market forces have triggered a reduction in the pollution intensity of economic activity in the EU. This has also been helped by the dynamic growth and growing share of the services sector. There is no evidence to support assertions that this decoupling of pollution levels from levels of economic activity has been achieved by exporting pollution through large scale delocalisation, although the increased spending on environmental protection has made production of regulated industries in some cases more expensive. On the other hand, the long-term strengthening of credible environmental standards and ambitions is contributing to the establishment of new markets for environmental technologies and to the emergence of specialised industries and potential for jobs.

In order to stimulate a welfare-enhancing adjustment of economic structures environmental policies must be cost-effective in their design

Environmental policies cause an adjustment of economic structures, mainly by adapting the property-rights regimes for natural resources to take account of their increased scarcity and new scientific insights. In this way, the price of using environmental resources and of exposing the public to health risks should be brought closer in line with the social costs. This leads to a better working of the market, thus to a more efficient allocation of resources and associated welfare gains. Therefore, welfare-enhancing environmental policies must be cost-effective, and they should take into account the frictions involved in

the adjustment, the dynamic character of adjustment needs, and the uncertainties of cost and benefit estimations in the absence of well-functioning markets.

3.5 Ongoing issues in economic surveillance

Economic surveillance requires identification of topics that will become important in the future

Amongst the issues which are currently coming to the fore, this year's Review addresses include the Draft Treaty Establishing a Constitution for Europe, which strengthens economic governance in the EU in a number of respects. A second issue is education, which is expected to have a changing but significant impact on economic growth in the coming decades, as the educational profile of the workforce evolves. Finally, structural indicators and statistics in the EU are critical for the effectiveness and transparency of economic surveillance.