EUROFRAME - European Forecasting Network

Economic Assessment of the Euro Area: Forecasts and Policy Analysis

Autumn Report 2007

Special Policy Issue:

European Social Model(s) and Social Europe

September 2007

www.euroframe.org

CONTENTS

EXECUTIVE SUMMARY

This report has been prepared against a background of considerable uncertainty in global financial markets which arose from the difficulties in the US subprime mortgage market. It is unclear at the time of writing how long this uncertainty will persist and what its impacts might ultimately be on the real economy. Hence, our forecasts need to be read in this broader context and the associated downside risks understood.

Before looking at the forecasts, we assess the most recent outturns. Global economic growth decelerated slightly in the first half of 2007, but has remained buoyant. This was partly due to the ongoing integration of the emerging economies in the world economy. The Euro Area's performance was also favourable, but the economic upturn lost some momentum in the first half of 2007. Quarterly real GDP growth in the Euro Area slowed to 0.3 per cent in the second quarter of 2007, down from a stronger than expected 0.5 per cent in the first quarter.

There is an impression that actual economic developments in the second quarter could have been somewhat stronger than is implied by recent national account statistics. While the observation of a slowdown in real GDP growth in the second quarter is based on "hard" data currently available for output and demand, it is clearly at odds with business and consumer surveys which have been reliable gauges of economic activity in the past and which indicate much stronger growth.

A continued strong expansion of economic activity in the Euro Area is also suggested by the strong performance in the labour market. Employment grew by another 0.5 per cent in the second quarter, bringing annual growth to 1.7 per cent. Unemployment continued to decline steadily and fell to 6.9 per cent, down from 7.1 per cent in March and 7.5 per cent in December last year.

Wage growth remains moderate at the aggregate Euro Area level. Despite the substantial decline in unemployment, average earnings can be expected to rise by just 2.8 per cent this year. Annual inflation in the Euro Area continued to be below the 2 per cent threshold for 12 consecutive months, coming in at 1.7 per cent in August. Inflation has remained modest despite the substantial impact of the VAT increase in Germany that lifted the price level in the Euro Area by close to 0.3 per cent.

The generally high level of confidence and a high backlog of orders, along with first indicators from the production side, suggest a rebound of economic growth in the third quarter. Looking further ahead, and as mentioned at the outset of this Summary, the outlook is obviously clouded by the recent events in financial markets and the uncertainty about their impact on the real economy. It is difficult to assess at the current juncture to what extent and for how long financing conditions for firms and household will be negatively affected and what impact the current developments will have on business sentiment and consumer confidence.

With the major caveat of high uncertainty about the evolution of the situation in financial markets, we forecast the economic expansion in the Euro Area to remain strong in the second half of 2007 bringing growth for the full year to 2.7 per cent and we expect it to slow moderately in 2008 and 2009 to around 2 ¼ per cent, a level of growth which is close to the growth of potential output.

Table 1.1: Summary of Key Forecast Indicators for the Euro Area

	2003	2004	2005	2006	2007	2008	2009
Output Growth Rate	0.8	1.8	1.6	2.9	2.7	2.3	2.1
Inflation Rate (Harmonised)	2.1	2.2	2.2	2.2	1.9	2.1	2.0
Unemployment Rate	8.7	8.8	8.6	7.9	7.0	6.5	6.2
Govt. balance as % of GDP	-3.0	-2.8	-2.4	-1.5	-0.9	-1.0	-0.9

Growth in private consumption is expected to accelerate markedly in 2008 to 2.5 per cent, up from 1.7 per cent this year. Growth in private investment is projected to lose momentum with the slowdown concentrated in residential investment as a consequence of less buoyant housing markets in a number of countries. Exports should continue to rise but at a decelerating pace as a consequence of more moderate growth in world output and slower domestic demand growth in the US in particular. With import growth slowing less, we expect no significant contribution to overall growth from net exports this year and next. More moderate economic growth will be reflected in slower employment growth, and the unemployment rate is expected to decline less rapidly to a level of 6.5 per cent this year and 6.2 per cent in 2009. Inflation should remain benign with the HICP continuing to rise by around 2 per cent.

As regards individual countries within the Euro Area, real GDP in Germany is projected to increase by 2.2 per cent next year, followed by 2 per cent growth in 2009. Unemployment will continue to fall and could drop below 6 per cent in 2009. Consumer prices are expected to rise by 2 per cent this year. Despite the impact of higher VAT (estimated at more than 1 percentage point) disappearing, inflation will moderate only slightly over the next two years as a result of a significant pick-up in unit labour costs and higher food prices.

We forecast French GDP to grow by 1.9 per cent in 2007. Domestic demand will remain the major engine for growth, rising by 2.3 per cent. Both household's consumption and government expenditure will rise by around 2.3 per cent, while private investment growth will stay close to 4 per cent. Net external trade will remain the main factor dampening GDP growth, for the fifth year in a row, reducing GDP growth by 0.3 percentage point this year as in 2006.

For Italy, the changed international context will reduce growth prospects for next year to 1.4 per cent and so Italy is likely to grow at a rate below the Euro Area average again. Much of the slowdown will be due to household consumption expenditure for the following reasons: the ending of the effects of consumption-related incentives, consumer spending that is likely to be affected by worsening consumer confidence and by the somewhat tighter credit condition.

The forecasts are based on the following set of assumptions. Oil prices will average US$66.6 per barrel in 2007, US$70.9 in 2008 and US$70.0 in 2009. The dollar/euro exchange rate will average 1.39 in 2008 and 1.40 in 2009. The assumptions for commodity prices, exchange rates and interest rates used in the forecast were constructed by consensus, as the average projections of the 10 member Institutes. These are broadly consistent with current financial market expectations and forward markets, as the majority of Institutes use this information in constructing their own forecasts.

We expect the US economy to grow by 1.9 per cent this year and by 2 per cent in 2008, both forecasts having been revised downwards since our Spring report. Our growth projection for Japan has also been revised downwards. We now expect growth of 2 per cent this year and 1.7 per cent in 2008.

Major risks to the forecast relate to the impact on the real economy of the current turmoil in the financial markets, although the usual suspects (high and volatile oil prices, current account deficit in the US) are still present. It is clear that some pension funds, insurance companies, banks and other investors have experienced severe losses. Investors in general have become more risk averse and this is likely to persist for some time. This will negatively affect investment and consumption and thus economic growth and employment. Falling consumer and producer confidence may also dampen short-term demand in the advanced economies. The size of the negative impact on the real economy is highly uncertain, but it seems clear that the US housing market will be hit very hard.

The report contains analyses of a number of additional issues. We look at some of the factors behind developments in the level of house building in a selection of euro-area countries. We also identify which regions face the highest risk of succumbing to a similar house-building downturn as that seen in the US. Focusing on our findings with regard to Spain, we expect the housing investment ratio, which has been supported by speculative activity, to revert towards historical norms over the coming years. While we project a soft landing of the housing market in our baseline forecast, this could be associated with a sharp correction in the housing market in some Euro Area economies, as experienced in the US.

The Spanish housing market is looked at again, in a section on house prices and banking crises. If banks and other lenders were to become concerned about lending to house builders in Spain then the spread between their borrowing rates and market rates, the quality spread, could rise. We undertake a simulation in which house prices in Euopre fall by 5 per cent and Spain experiences a rise in the quality spread that is sufficient to slow output growth to zero in each quarter of 2008. The results suggest that private sector investment growth drops to an annual rate of -15 per cent in Spain by the last quarter of 2008.

In the general context of uncertainty in international financial markets, we consider the potential recessionary impacts of a banking crisis. Our hope and expectation is that the current crisis is a short-term blip in the liquidity of the banking sector. Our simulations suggest that the effects of such a "blip" on the potential output of the Euro Area would be quite limited. Hence we have not made major changes to our forecast for 2008. However, if a full-blown banking crisis were to develop, then we could see several years of stagnation. There would be the danger that even if such a crisis were to originate in the US, contagion would see it spread immediately to Europe. It is the task of the Fed,

the ECB and the other European central banks to ensure that such a crisis does not happen.

On monetary policy, we assume that the ECB will raise rates by 25 basis points before the end of the year. That said, the ECB will certainly watch developments in the economy closely and will also take account of moves in the exchange rate. There is a relatively large chance that the ECB will drop another rate hike from the agenda in the event that the economic environment should look less reassuring than projected here, especially in the event that the Fed cuts interest rates aggressively.

On fiscal policy, with GDP growth decelerating from 2.7 per cent in 2007 to 2.1 per cent in 2009 and a close to neutral fiscal stance, the Euro Area deficit should remain at around –1 per cent of GDP. This would mean that the objective of 0 per cent of GDP deficits in 2010 would be difficult to reach at the Euro Area level. Within the Euro Area, the most striking development as compared to recent history would perhaps be the decoupling of government balances developments between Germany, which is running small government surpluses over the forecast horizon, and France, which is at risk of breaching the 3 per cent of GDP limit for deficits.

In the Special Topic of this report, an analysis of the European Social Model(s) (ESM) is undertaken. Three different views are presented on the future of the ESM. The first stresses the importance of guaranteeing social cohesion in the Member States, by reducing income inequalities and ensuring a high level of social protection, in particular for people who cannot work, because of their age, their handicap, their family situation or the economic situation. The disincentive effect of social protection is judged to be of second order and it is considered that rich countries can accept it. The second expresses the importance of restoring work incentives, by accepting initially some increase in income inequalities. Making work pay will increase production and will give more resources to the social security system, ensuring its financial sustainability. The third suggests a new architecture of welfare states in Europe, inspired by the Scandinavian model, so that the impact of social protection as a productive factor increases.

1. OUTLOOK FOR THE EURO AREA

1.1 Overview

Global economic growth decelerated slightly in the first half of 2007, but has remained buoyant. This was partly due to the ongoing integration of the emerging economies in the world economy. The Euro Area's performance was also favourable, with unemployment falling to its lowest rate in more than a quarter of a century. Despite the unusually long global upswing and record high oil prices, inflation is still relatively moderate.

However, the outlook is obviously clouded by the recent events in financial markets. The uncertainty about their impact on the real economy constitutes a major risk to our forecast. In July, news of substantial losses on US subprime mortgages led to worldwide turbulence in financial markets. Inter-bank loans dried up as it was unclear how much counterparts had lost on the US mortgage market through new financial products like CDOs. Moreover, declining interest of investors in asset-backed commercial paper required central banks to inject liquidity in the money markets. The credit crisis has certainly made investors more risk averse. The turmoil in credit markets initially led to a fall in share prices, but not at an alarming rate and since mid-August some of the lost ground has been recovered. The Fed lowered its benchmark interest rate by 50 basis points on September 18, while the ECB refrained from increasing the refi-rate, contrary to earlier expectations. The Fed is expected to loosen monetary policy further in the near future, but the ECB may stick to its objective of inflation control. The US economy will probably be affected most by the financial problems, particularly through the housing market. As a consequence, the short-term outlook for GDP growth in the United States has been lowered to approximately 2 per cent in 2007 and 2008, but growth in the US should accelerate in 2009.

Table 1.1: Summary of Key Forecast Indicators for the Euro Area

	2003	2004	2005	2006	2007	2008	2009
Output Growth Rate	0.8	1.8	1.6	2.9	2.7	2.3	2.1
Inflation Rate (Harmonised)	2.1	2.2	2.2	2.2	1.9	2.1	2.0
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Govt. balance as % of GDP	-3.0	-2.8	-2.4	-1.5	-0.9	-1.0	-0.9

GDP in the Euro Area increased by 2.7 per cent at an annual rate in the first half of 2007 compared to the second half of last year. This was substantially above its potential growth rate, but less than the growth rate over the course of last year. The slight deceleration was mostly due to the German VAT hike adversely impacting German consumption. The continuing above-trend growth led to a further drop in unemployment, to its lowest level in more than

a quarter of a century. GDP growth in the Euro Area is forecast to fall back from 2.7 per cent in 2007 to 2.3 per cent in 2008 and 2.1 per cent in the year after. Euro Area unemployment is expected to fall further from 7.0 per cent in 2007 to 6.2 per cent of the labour force in 2009. Inflation is expected to remain contained over the forecast horizon at around 2 per cent and net government borrowing is anticipated to stabilize at 1 per cent of GDP.

Table 1.2: GDP Growth Forecasts in Autumn 2007 and Spring 2007

	World		Japan		US		Euro Area		China	
	Spring	Autumn	Spring	Autumn	Spring	Autumn	Spring	Autumn	Spring	Autumn
2007	4.8	5.1	2.3	2.0	2.4	1.9	2.5	2.7	9.8	10.9
2008	4.5	4.8	2.1	1.7	2.3	2.0	2.2	2.3	9.1	9.8

Table 1.2 compares the current EUROFRAME-EFN forecast for GDP growth in major regions with the Spring forecast. Growth projections for the Euro Area have hardly changed, but growth in the US and Japan is now forecast to be lower in 2007 and 2008. On the other hand, production in the emerging markets, particularly in China, is increasing more rapidly, pushing up growth forecasts for the world, in spite of the problems in the financial markets.

Major risks to the forecast relate to the impact on the real economy of the current turmoil in the financial markets, although the usual suspects (high and volatile oil prices, current account deficit in the US) are still present. It is clear that some pension funds, insurance companies, banks and other investors have experienced severe losses. Investors in general have become more risk averse and this is likely to persist for some time. This will negatively affect investment and consumption and thus economic growth and employment. Falling consumer and producer confidence may also dampen short-term demand in the advanced economies. The size of the negative impact on the real economy is highly uncertain, but it seems clear that the US housing market will be hit very hard. Therefore, the impact on the US economy is likely to be (much) bigger than on the European economy. Possible effects of a more severe financial crisis are analyzed in more detail in Section 1.4.

1.2 Global Outlook

1.2.1 KEY DEVELOPMENTS

Below we discuss the key developments in commodity and financial markets underlying the current forecasts.

OIL PRICES

Growing demand for oil in a strongly expanding world economy and tight supply conditions sent oil prices up again over the course of the year. In January, the Brent crude spot price declined to $54 per barrel and in response OPEC lowered its official output by 1.7 mbd. In addition Nigerian output fell by 0.5 mbd because of internal political turmoil. Consequently oil prices shot up to almost $75 per barrel for Brent in the third quarter of this year, setting new nominal records.

Most of the extra demand originated in the Emerging Economies, particularly in China. The projected modest slowdown of unusually strong growth in the

world economy is insufficient to stop the rising trend in oil demand, although high prices are likely to have a tempering effect. Oil supply in non-OPEC countries will only rise marginally in the short run. Although OPEC remains cautious about increasing supply, it recently announced a production increase of 0.5 mbd from November. OPEC mentioned the emphasis on bio-fuels in the high-income countries as one reason for keeping up-stream investments in check. We expect oil prices[1] to remain high over the forecast horizon at approximately $70 per barrel.

INTEREST RATES

The turmoil in financial markets, originating from defaults on American subprime mortgage loans, is having a noticeable effect on interest rates in the US and also in Europe. Yields on short-term paper have soared as inter-bank loans have dried up. Central Banks attempt to counteract the problem by providing ample liquidity, but tensions are likely to remain as long as the extent of the damage is unknown. The Fed lowered its rate by 50 basis points on September 18 whereas, contrary to expectations, the ECB did not increase the refi-rate in September. The outlook for interest rates critically depends on how the problems in the financial markets evolve. We assume a gradual return to normal spreads between official rates and 3-months paper in the fourth quarter of this year. Moreover, we expect the Fed to lower its rate between now and early next year by another 50 basis points. We still believe that a rate increase of 25 basis points by the ECB is likely in December, but a more aggressive policy change by the Fed may put pressure on the ECB to refrain from a further rise or even open the way to some decline of the refi-rate.

Government bonds rallied substantially in recent weeks as they were obviously seen as a safe haven. The yield for 10-year government bonds fell by more than 50 basis points in the United States and Europe alike. As the financial markets calm down, long-term interest rates will probably go up again to approximately 4¾ per cent in the US and 4½ per cent in the Euro Area.

Refinancing conditions in the corporate sector deteriorated as a consequence of declining equity prices, higher risk premia on corporate bonds and credit rationing. This situation may persist for some time, negatively affecting investments.

EXCHANGE RATES

The euro continued its upward trend against the US dollar and the Japanese yen over the course of this year. Against the dollar, the euro rose to over 1.40. This partly reflected (anticipated) interest rate reductions in the United States, but the slowdown of the US economy and the ongoing large deficit on the current account probably contributed as well. We do not foresee a strengthening of the dollar or a further decline, although the risks are on the downside. Very recently the yen has appreciated somewhat as carry trade unwound on the back of increasing uncertainty in financial markets. We assume a very gradual recovery of the yen versus the euro over the forecast horizon. The British pound has recently weakened against the dollar and the euro, but is expected to hold its ground over the forecast horizon.

EQUITY MARKETS

Equity prices fell in July amidst increasing uncertainty in the financial markets, but have recovered somewhat since mid-August. Surprisingly, US shares have

[1] Based on the average of Brent, WTI (Western Texas Intermediate) and Dubai oil prices.

held up reasonably well, whereas markets in Japan, France and Italy showed more significant drops, but even here the drop did not wipe out more than had been gained since the beginning of the year. Moreover, much of the decline was concentrated in financials, leaving other sectors relatively untouched. We assume a very gradual recovery of equity prices over the forecast period.

1.2.2 EXTERNAL ENVIRONMENT

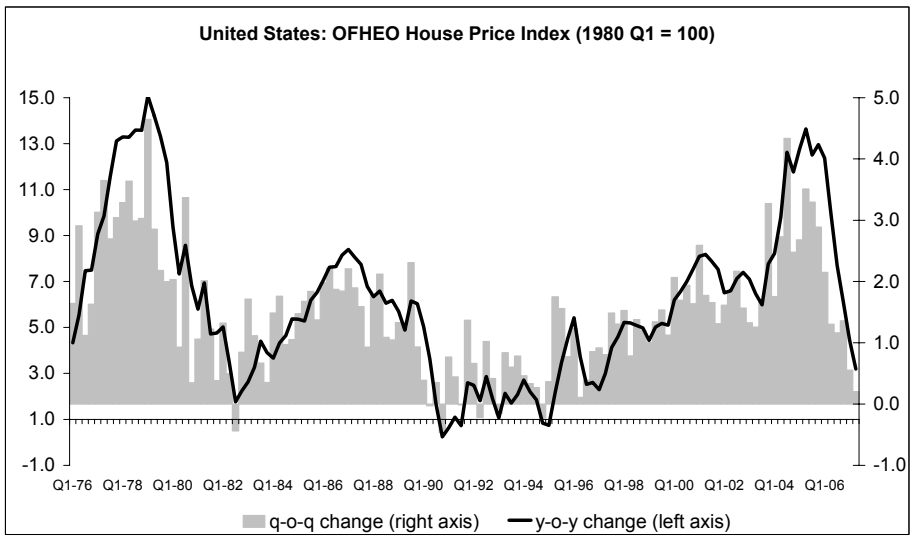
North America

In the US, the turmoil in the financial markets occurred in an environment characterised by decelerating private consumption growth, falling housing investment and upward pressure on the price level. Expectations suddenly shifted from the risk of inflation to the risk of a sharp slowdown in economic growth. Notwithstanding the fact that the subprime market is only around 10 per cent of the overall mortgage market (21 per cent including (sub prime) mortgages rated alt-A), the miss-pricing of both part of the subprimes as well as some of the financial instruments developed to diversify the risk linked to subprime mortgages, contributed to the turmoil. As the delinquency in subprime mortgages grew, global financial markets became more volatile and increasingly risk-averse (see Box 1 on the US Mortgage Market). Increasing demand for liquidity by the banking system could not be met and the spreads on Treasury bond yields dramatically widened. The Federal Reserve intervened and tried to restore liquidity and orderly conditions in financial markets in many ways. It provided the banking system with a huge amount of liquidity, on August 17th it reduced the discount rate by 50 basis points and accepted asset-backed commercial paper as collateral for discount window borrowing as well as allowing short term financing up to 30 days. On September 18th, it reduced both the federal fund target rate and the discount rate by 50 basis points. At the same time, nevertheless, it was signalled that monetary policy would not be used to shield investors from losses so as to back moral hazard.

The expected adjustment effects of the financial markets on the whole economy are not only through the deterioration of confidence, but may also lead to tighter financing conditions for households and firms. This will certainly be a temporary process, but it exacerbates the problems in the housing market and represents an important downside risk to our forecast (see Section 1.4). We are projecting lower US GDP growth (1.9 and 2 per cent, respectively in 2007 and 2008) due to expected weaker housing investment and lower house prices. GDP growth is forecast to be 2.4 per cent in 2009. The projected soft landing of the US economy will see the economy returning to its potential growth rate in the second part of 2009.

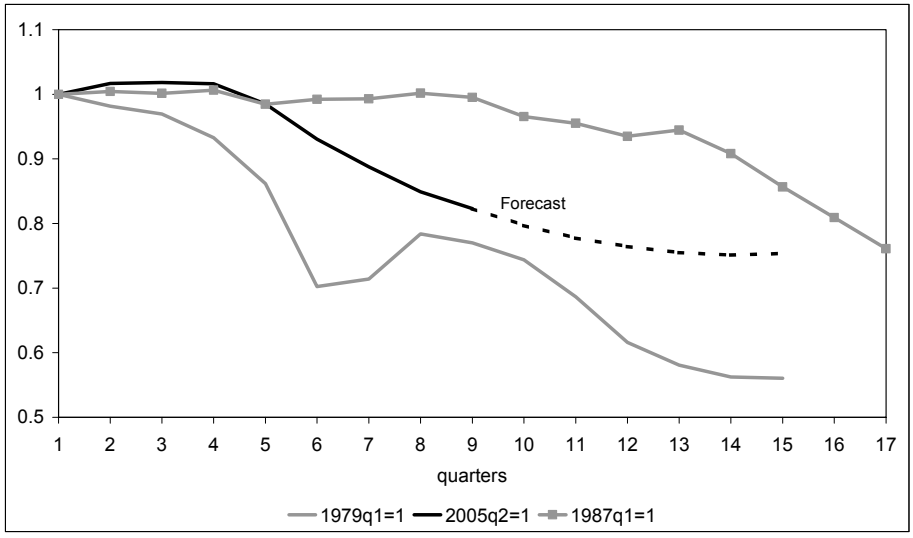
In the first half of 2007 GDP growth in q-o-q terms was very volatile. Growth rebounded in the second quarter (1 per cent q-o-q), with net exports, fixed non-residential investment and government spending all making positive contributions to growth, after an unexpectedly strong deceleration of growth in the first three months of the year (0.2 per cent q-o-q). At the same time, private consumption growth continued to decelerate and housing investment dropped further. On the whole GDP growth in the first six months of 2007 was weaker when compared with the second semester of 2006 (1.7 per cent and 2.5 per cent in y-o-y terms respectively) mainly due to the dramatic drop in housing investment (-16.5 per cent y-o-y, -10.6 per cent in the second part of 2006). With respect to the housing market, prices stagnated on a q-o-q basis in the second quarter of the 2007, according to the Office of Federal Housing Enterprise Oversight (see Figure 1.2.1).

Figure 1.2.1 US House Prices



The financial market turmoil is likely to intensify the downturn in housing by reducing the availability of credit and leading to the tightening of lending standards. In addition, housing starts and permits are trending down whereas inventories of new homes remain at very high levels. We expect house prices to decline in the second half of 2007 and in 2008. Housing investment is also expected to decline further over the next 9-12 months, with an annual average decline of 6.9 per cent expected in 2008. Since the peak in 2005 the volume of housing investment is forecast to decline by a cumulative 26 per cent by mid 2008, that is a correction in line with that which occurred in the second part of the eighties (24 percentage points), but less than that at the end of seventies and the early part of the eighties (44 percentage points) (see Figure 1.2.2). Beyond the direct impact of housing investment on GDP growth, a significant negative effect is likely to occur on private consumption. The drop in house prices will reduce nominal housing wealth and hence total wealth which will negatively affect consumption expenditure. This effect could be intensified by a simultaneous decline in employment. In July and August total employment fell in q-o-q terms due to falls in the construction and manufacturing sectors, and payroll employment also fell in August.

Figure 1.2.2. US Housing Investment



With respect to inflation, the most recent data show some improvement in underlying pressures. In the second quarter of 2007, core inflation, based on PCE excluding food and energy, was under 2 per cent (1.8 per cent) after 3 consecutives quarters above 2 per cent (the implicit target of the Fed). On the other hand, the expected persistence of high energy prices due to relatively strong demand, matched with tight supply conditions, will lead to growth in the consumption deflator of around 2.5 per cent in 2008 before easing in 2009.

The expected deceleration in domestic demand growth, especially in private consumption, will reduce import growth and net exports are expected to make a positive contribution to GDP growth in 2007-2009, having made a negative contribution to growth from 2000 to 2005. Despite a deterioration in the terms of trade, due to the depreciation of the dollar, this allows the current account deficit to improve by around one percentage point of GDP by 2009.

For North America as whole the second quarter of 2007 proved to be strong: the Mexican GDP growth rate accelerated (1.3 per cent q-o-q), whereas Canada continued to experience more steady growth with GDP growing by around 1 per cent (q-o-q). For the whole region, GDP grew 1.8 per cent y-o-y in the first semester, following growth of 3 per cent in 2006. The July inflation release showed signs of stabilisation in the area, after upside pressures in the first part of the year. In Canada the permanence of inflation above the central bank target rate prompted a 25 basis points rise in the refinancing interest rates in July. The expected deceleration of US economic growth driven by domestic demand will negatively affect the whole region through weaker demand for Canadian and Mexican goods. We are projecting GDP growth rates of 2.1 per cent, 2.3 per cent and 2.6 per cent, respectively for 2007, 2008 and 2009.

BOX 1: The US Mortgage Market

In July, problems in the US market for subprime mortgages triggered worldwide turbulence in financial markets(a). Subprime mortgages are residential loans to borrowers with a poor credit history, and provided without a full income documentation. The debt service-to-income ratio of these mortgages is above 55 per cent, while the mortgage loan-to-value ratio is over 85 per cent(b). In recent years, the market for subprime mortgages has seen extremely rapid growth. This has contributed to a rise in homeownership from 65 per cent of US households in 1995 to 68 per cent in the second quarter of 2007. Subprime mortgages were 20 per cent of all mortgages originating in 2006, compared with a share of 36 per cent of prime mortgages, 15 per cent of jumbo mortgages and 25 per cent of Alt-A mortgages. Subprime mortgages were 10 per cent of the outstanding mortgages at the end of 2006. At the same time, only 2 per cent of the total outstanding mortgages were government guaranteed, down from 9 per cent in 1996.

Most subprime mortgages which originated in 2005 and 2006 have an adjustable rate, with a below-market rate in the first two years ('teaser rate'). As a consequence, debt servicing costs can rise by 50 per cent after two years, even if market interest rates do not rise. Mostly due to a relaxation of lending standards, adjustable-rate subprime mortgages have shown a very rapid rise in delinquency. In July, serious delinquencies on those mortgages were up to almost 15 per cent, more than double the rate in mid-2005. This delinquency rate is much higher than the rate of 5.5 per cent on fixed-rate subprime

mortgages in July, 3 per cent on Alt-A mortgages (up from 1 per cent mid-2005) and 1 per cent on prime and jumbo mortgages(c). Subprime lending amounted to around 1200 billion dollar in 2005 and 2006. Assuming a default rate of 20 per cent on those mortgages and a recovery rate of 60 per cent, the losses for the financial sector on those mortgages alone could be around 100 billion dollars. Apart from causing heavy losses for the financial sector, defaults by distressed borrowers is deepening the housing market crisis.

In recent years, most mortgages are not held by the originating enterprise but are securitised as mortgage-backed bonds. The privately owned government-sponsored enterprises Freddie Mac and Fanny Mae are responsible for most securitisation, but only take care of prime mortgages. Currently 56 per cent of US home mortgages are securitised, up from 10 per cent in 1980 and less than 1 per cent in 1970. Securitisation is extended by collateralised debt obligations (CDOs)(d). By spreading the risk and facilitating the trading of risks, securitisation has raised the supply of mortgages and therefore home ownership. Unfortunately, it has also weakened incentives to underwrite carefully and has contributed to the relaxation of loan standards. This can be characterised as a classical principal-agent problem. Furthermore, it probably placed risks in the hands of investors who are ill-equipped to handle it.

As a consequence of increased risk aversion, almost no subprime mortgages were issued in July and August. Issuance of securities backed by non-prime mortgages has fallen sharply as it is very hard for investors to know who will experience credit losses. Furthermore, interest of investors in mortgage backed commercial paper dropped dramatically. This has forced "special purpose vehicles" or "conduits" normally financed by asset-backed commercial paper to draw on back-up liquidity facilities of affiliated banks.

(a) In early February, there was already substantial turbulence after a major bank announced that more funds would have to be set aside to cover bad debts in its subprime lending portfolio.

(b) The traditional prime mortgage is provided to borrowers with a good credit history and requires proof-of-income documentation. The debt service-to-income ratio is less than 55 per cent, while the mortgage loan-to-value ratio is less than 85 per cent. Prime mortgages are capped at 417,000 dollar. Jumbo mortgages have the same characteristics as prime mortgages but are bigger than 417,000 dollar. Alt-A mortgages are between prime and subprime mortgages and are not based on full income documentation of the borrower. See J. Kiff and P Mills, Money for Nothing and Checks for Free: Recent Developments in U.S. Subprime Mortgage Markets, IMF Working Paper wp/07/188, 2007.

(c)Based on F.S. Mishkin, Outlook and risks for the U.S. Economy, speech to the Money Marketeers of the New York University, 10 September 2007.

(d) CDOs are certificates that entitles the bearer to draw the interest and principal payments from a pool of mortgages bonds.

Asia

In the first part of 2007, economic growth in Asian countries, excluding Japan, was very good due to both strong consumption and investment while exports showed a mixed picture in terms of growth, even though they grew at a good pace in annual terms. China and India reached new records in GDP growth rates. China continues to try to cool down the economy mainly using monetary instruments but without much success. In contrast, Japanese GDP contracted in the second quarter (-0.3 per cent over the previous quarter), mainly because of a sharp decrease in all categories of investments: public and private both in housing and in machinery and equipment, and also due to the poor performance of exports. The picture for inflation is a little more worrying for different reasons: in Japan prices represent a problem because of the persistence of zero or negative inflation, however on the other hand, prices of consumption goods are growing in China, while in India inflation remains stable at high levels.

In Japan the quarterly path of GDP continues to be quite variable with negative and positive increases following each other within a few quarters. The most recent data seem to point towards a further slowdown in the economy, as suggested by the decrease in industrial production, the sharp contraction of sales and orders in addition to the difficulties experienced by exporters in the European and US markets (while export growth in Asia continues to be in double digits). Political turmoil following the result of recent elections, which were very negative for the ruling party and for the premier, and his resignation, add some uncertainty to the coming quarters. Small positive signals coming from the labour market (declining unemployment in a rising labour force) are partly offset by a flat income situation due to firm's policy of labour cost restraint and a wave of substitution of retiring high-wage baby-boomers with low-wage new graduates.

We don't expect a rapid recovery for the Japanese economy because of a number of negative signals ranging from domestic demand to the global economic environment; in a framework where both fiscal and monetary policy are having difficulty finding instruments to revive growth given the constraints they are facing. As far as monetary policy is concerned, the Bank of Japan will give up the interest rate hike desired within the year: the slowdown in economic activity goes side by side with the inflation rate around zero (but the core is below zero). Moreover the yen has appreciated somewhat since June, on the wave of a partial unwinding of carry trade triggered by lower interest rates in the US. A deceleration in sales growth, in the context of weaker domestic demand (and falling household confidence) and a lower level of imports of trade partners could slacken investment growth in the short term.

The Chinese economy has been continuing to grow at a very fast pace, around 11.9 per cent in annual terms in the second quarter (y-o-y). All the components of the economy appear to be contributing with investment playing the main role (it was still accelerating in July) together with consumption and very buoyant exports. The central bank is trying to cool down both economic growth and the speculation in the stock market. Many measures have been taken to increase the cost of investment (five consecutive rate hikes this year), to constrain bank credit (increasing the reserve ratio seven times this year to 12.5 per cent) and to boost deposits against stock investing (by lowering taxes on current account deposit returns and by allowing larger investment abroad for the private sector). Also the government is trying to curb investment, delaying approval of some local projects particularly in its fastest growing regions (with investment in the first seven months of the year up by almost 50 per cent). A rising problem for China is inflation which is currently running at

6.5 per cent in annual terms (highest in 10 years) due mainly to food prices. This level is not excessive in absolute terms for a country that is catching-up, that has GDP growth of over 11 per cent and given the low starting price level. In addition, it is perhaps not completely unwelcome because of its positive effect on farmers incomes. To date, popular anger about rising inflation and the possibility of a further spillover to the other prices is being avoided (in order to do this the government recently froze the state-controlled prices). It should be noted that high inflation also contributes to real negative returns on deposit accounts favouring an alternative investment in more speculative instruments and assets.

The Chinese economy is forecast to grow at fast pace for the next two years, with some deceleration mainly due to the increasingly restrictive stance of monetary policy and foreign trade. Given the current growth, interest rates and money supply appear to be still accommodative but the mood of the government and central bank is well explained by the unprecedented number of restrictive interventions in the recent months, both with monetary policy and administrative measures (these are mainly due to the still poor transmission mechanisms in the monetary system). As for the foreign sector, the (small) appreciation of the yuan and the slowing down of partner's demand (United States in particular) could dent export performance, even though the improving trade with Asian partners could partly offset the lower demand. Domestic demand appears very difficult to endogenously slow; interest rates hikes and other measures are likely to be repeatedly used in the next quarters to curb investments and to stop the inflationary rally in consumer prices. Other measures are expected to make use of the large amount of international reserves (withdrawing them from the money supply) and to tackle speculation in the stock market which may be producing a price bubble.

Non Euro Area European Economies

The robust pace of UK GDP growth has continued into the first half of this year. On an annual basis economic growth has accelerated from 1.6 per cent in the second quarter of 2005 to just over 3 per cent in the first half of this year. Looking ahead we expect the economy to moderate, with a slowdown in the rate of growth of consumer spending. Household consumption expenditure has been the prop to the UK economic growth, contributing around ¾ of economic growth since 1997. A slowing housing market and increased propensity to save are expected to be behind more modest consumer spending growth. We expect GDP growth to slow to around 2.2 per cent next year.

The annual rate of inflation in the UK, as measured by the HICP, was at its highest level for over a decade in the first quarter of this year, at one point moving more than one percentage point above the target rate of 2 per cent per annum. But despite the accelerating rate of inflation and a relatively tight labour market, average earnings over the first half of this year have been weaker than in much of 2006. Since then HICP inflation has moved back towards target, even dipping below target in August and September of this year. Our projection is for inflation to hover around the Bank of England's target of 2 per cent over the next few years. However, there remain upside risks to the inflation outlook, in particular if the recent rise in oil prices were to be sustained, although the weakness of the dollar-sterling exchange rate will help to mitigate some of the impact from oil.

The credit crunch has taken an interesting turn in the UK financial system. Through turmoil in the money markets Northern Rock, the fifth largest mortgage lending bank in the UK economy, experienced a liquidity problem

such that it had to call on the Bank of England in its capacity as 'lender of last resort'. A significant amount of the funding of Northern Rock's loan book was through borrowing on the money markets in comparison to other UK banks. Consequently, when liquidity dried up, the otherwise solvent Northern Rock required funding from the Bank of England, at a punitive rate, in order for it to keep trading. From a macroeconomic perspective, the major impact of this crisis will most probably be a greater slowdown in the housing market than had been envisaged previously as households react to the increased uncertainty. The Northern Rock crisis has been exacerbated by widening spreads in money markets, and the Bank of England has recently stated that it will allow borrowing against a wider range of assets in order to "alleviate the strains in longer-maturity money markets". If such spreads prove to be more sustained than we anticipate, the Bank of England may have to react in order to avoid growth in demand slowing more dramatically, and anticipated interest rate rises may not materialise.

Employment demand in the UK economy has proved to be relatively robust, but has failed to keep pace with the growing labour force. Increases in the unemployment rate have stalled at around 5½ per cent, but we expect the upward trend in the unemployment rate to continue after next year in line with slower growth. Our forecast is for the unemployment rate to reach almost 6 per cent by 2009.

After the Chancellor's exuberance of recent years, the position of the public finances appears to be improving. Revisions to data suggest that the government's financial balance improved from -3.4 per cent of GDP in 2005 to -2.8 per cent in 2006. Due to a planned decline in the government's share of the economy we expect the financial balance to move onto a more sustainable footing, and to improve towards 2 per cent of GDP in 2009.

Swedish economic growth increased to 4.5 per cent in 2006 supported by rapid investment. This strong growth is expected to slow in 2007-9 as higher interest rates and weakening export market growth dampen the domestic demand growth. However, growth is expected to continue above the Euro Area average. Danish economic growth is already showing signs of slowing from the relatively high level of activity. Total output declined in the second quarter and growth is expected to be well below the Euro Area average in the forecasting period due to e.g. labour shortages and decreasing price competitiveness of Danish products. Both Sweden and Denmark remain well-balanced economies in terms of current account and general government surpluses in 2007-9.

Growth in the NMS accelerated in 2006 and good economic performance continued in the first half of 2007. Again, internal demand proved to be the most important contributor to growth. Growth was especially strong in the Baltic countries and in Slovakia (at near 10 per cent y-o-y); in Poland and most other NMS countries it was more moderate (5-6 per cent y-o-y), whereas it was quite weak in Hungary, mostly due to the restrictive fiscal policy. Due to a noticeable increase in employment and real wages, private consumption expanded strongly. One of the reasons for the strong expansion of investment in several countries was the inflow of financial means from the EU funds. However, the strong financial situation of companies – for example in Poland - played an important role as well.

Due to the improved economic situation in the Euro Area, many of the NMS countries experienced a stronger expansion in exports. However, external trade developments were quite different: in the Baltic countries, in Poland and Bulgaria robust imports were translating into big negative net exports; in the

other countries there was a positive or marginally negative contribution to GDP from net exports.

The situation in the labour market improved, with the unemployment rate falling almost everywhere. Part of this is explained by job emigration to Western Europe which lowers the labour force.

Since late 2006 HICP inflation has been rising steadily in NMS thus widening the gap vis-à-vis the Euro Area. In the period January-July 2007 the average rate of inflation in NMS reached 3.6 per cent y-o-y which was 1.7 percentage points above the rate registered in the Euro Area. This was primarily due to price acceleration in Poland (food, fuel), the Czech Republic and the Baltic countries (food, tobacco). Most central banks across the region have reacted to higher inflation by raising their interest rates, even if interest rates have on average increased a little less than in the Euro Area. The positive inflation differential with the Euro Area is in line with the 'catching-up' of the region as manifested in the higher inflation in services (in particular those related to utilities and networks), upward adjustments of indirect taxes (e.g. excise on tobacco), increasing reputation of goods produced domestically and increasing quality of goods and services.

All in all, economic activity during the forecast period will remain strong. We anticipate that most of the NMS will continue to experience strong wage growth as a result of continued outward migration but also due to productivity increases. Therefore consumption will remain an important source of demand growth. EU funds from 2007-2013 will be lower so budget investments may slow down a little. By contrast, private investment should accelerate. The slow down in the world economy may imply some worsening in the foreign trade situation in some of the NMS. The GDP growth rate will decrease only slightly, from around 6.0 per cent this year to about 5.3 per cent in 2008 and 4.9 per cent in 2009. Unemployment will continue to fall reaching a rate of just above 7 per cent in 2009.

Russia continues to show dynamic development supported by the high commodity prices. The economy grew by 6.7 per cent last year. The main driving force behind growth was internal demand which accelerated further in the first half of 2007. Given high investment needs and increasing profits, investment in equipment grew by about 14 per cent (y-o-y). At the same time, the rapid increase in wages in 2006 led to a strong expansion of private consumption (around 9 per cent). This led to a smaller surplus in the current account.

Inflation, measured by the increase of consumer prices, has slowed down. The inflation rate, which is expected to be around 8 ½ per cent this year, will almost meet the targets of the Central Bank (6.5 – 8 percent). Wage growth is strong, but productivity is rising rapidly, too, and the appreciation of the rouble in effective terms is contributing to slower inflation. The accumulation of reserves in the new Stabilization Fund (see below) is also having a stabilising effect on inflation.

Economic activity will continue to be supported by high world market prices for oil and other raw materials over the forecast horizon. Real GDP growth will remain strong although the y-o-y growth rate will decline slightly in 2008 to about 6.3 per cent. The sustained growth will be supported by private consumption due to the higher wage sum as well as by a strong momentum of investment in equipment. The situation in the labour market will improve further; the unemployment rate is expected to fall from 8.4 per cent this year to 7.4 per cent in 2008.

An important new feature of the Russian economy is the Stabilization Fund which was founded in 2004 and should in the medium and long term contribute to stabilizing economic growth. It is financed through the export tolls and mineral resources extraction tax that is imposed upon the surplus revenues of the oil extracting companies. These surplus revenues are due to a difference between the actual (Urals) oil price and a lower cut-off price, which is currently 27 US Dollars. The size of the Stabilization Fund is quite impressive: in September 2007 it achieved almost 133 billion US Dollars, which represents around 12 per cent of Russian GDP for the current year. The use of the accumulated resources is, however, confined to paying off the foreign debt and absorbing the excess liquidity in the economy. There are many discussions in Russian society about the possibility of using these resources for investment and welfare purposes. However, the government refuses to do it, saying that it would only destabilize the economy. Nevertheless, in the beginning of 2006, a so called Investment Fund was created, which is accumulated through a difference between the revenues of the Stabilization Fund at the cut-off price and the revenues at cut-off price minus 1 US Dollar. In comparison to the Stabilization Fund, the Investment Fund is quite small: about 14 billion US Dollars, or 0.3 per cent of Russian GDP in 2007. It is a first move at government level which aims to use the windfall gains generated by favourable oil price developments for investments to modernize the Russian economy. The Investment Fund can be used directly for public infrastructure investment or to stimulate private investment in infrastructure.

1.3 Euro Area Detail

EURO AREA FORECAST

The economic upturn in the Euro Area has lost some momentum in the first half of 2007. This moderation had been expected by EUROFRAME-EFN as a consequence of the VAT-rate increase in Germany and the assessment that the strong acceleration of growth towards the end of last year in Italy had been partly due to special factors. Nonetheless, there were some surprises with regard to the quarterly pattern of growth as well as to the composition of demand.

Quarterly real GDP growth in the Euro Area slowed to 0.3 per cent in the second quarter of 2007, down from a stronger than expected 0.5 per cent in the first quarter. This result was significantly below expectations. Stronger growth had been anticipated given the remarkably high level of business climate indicators and consumer sentiment. Growth was particularly weak in most of the larger countries, including Germany, France, Italy and the Netherlands. Part of the explanation lies in a return of residential investment to normal levels after the strong rise in the first quarter that was to a large extent due to unseasonally warm weather and was a major factor behind the surprising resilience of growth in the first three months. In addition, the recovery of private consumption in Germany from its tax-induced dive in the first quarter proved to be more modest than expected, leading to a slower-than-expected growth rate of 0.5 per cent in the second quarter, following stagnation in the beginning of the year. The upturn in corporate investment, on the other hand, seems to have remained on track reflecting high utilization rates, especially in the industrial sector, high profitability and optimistic business expectations. Exports continued to increase, although at lower rates than in the second half of last year when export figures in Germany were

inflated for statistical reasons.[2] Imports at the same time grew at a slightly slower rate which led to a positive contribution of net exports to GDP growth in both quarters.

There is an impression that actual economic developments in the second quarter could have been somewhat stronger than is implied by recent national account statistics. While the slowdown in real GDP growth in the second quarter is consistent with "hard" data currently available for output and demand, such as industrial production and retail sales, it is clearly at odds with business and consumer surveys which used to be reliable gauges of economic activity in the past and indicate much stronger growth.

A continued strong expansion of economic activity in the Euro Area is also suggested by the strong performance in the labour market. Employment grew by another 0.5 per cent in the second quarter, bringing annual growth to 1.7 per cent. Employment growth remained particularly strong in Spain, Finland, Austria and Slovenia, and also in Germany after accounting for the weather-related developments in the construction sector. On the other hand, employment rose at a more moderate pace in France, Belgium and also in Italy, despite a visible pick-up registered here in the second quarter.

Unemployment continued on its steady decline and fell to 6.9 per cent, down from 7.1 per cent in March and 7.5 per cent in December last year. The reduction in unemployment since the start of the year was substantial in many countries, including Finland, France and Germany although German unemployment declined at a slower rate after having fallen like a stone in the first months of the year. In other countries the decline in unemployment was less pronounced, partly due to the already very low level of unemployment (Netherlands, Austria, Slovenia), and to a strong inflow of labour (Spain, Austria). In Portugal, unemployment stagnated reflecting sluggish growth in the economy, and in Ireland unemployment even rose in recent months as a consequence of decreasing activity in residential construction.

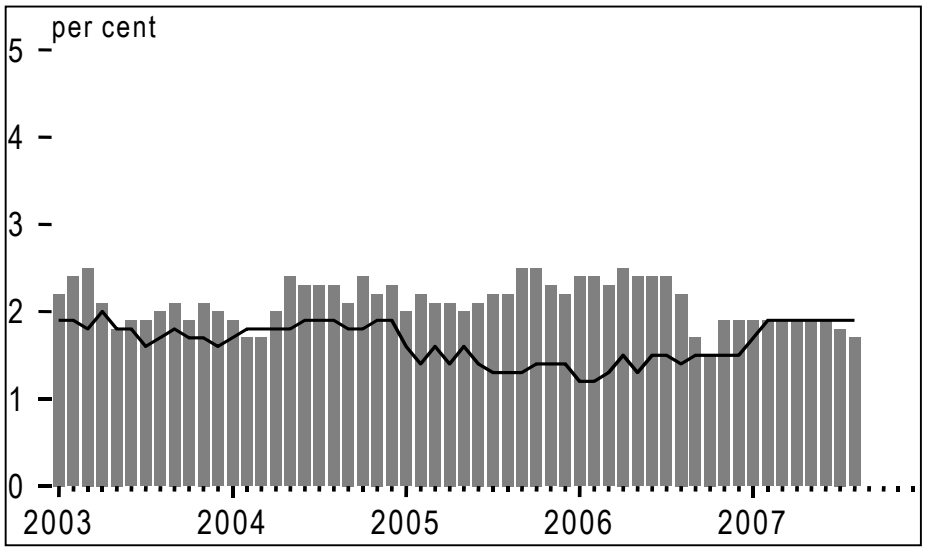
Wage growth remains moderate at the aggregate Euro Area level. Despite the substantial decline in unemployment, average earnings can be expected to rise by just 2.8 per cent this year, translating into unit labour cost growth consistent with the ECB target of an inflation rate of below but close to 2 per cent. We expect a modest acceleration of wage growth next year and in 2009, reflecting increasing tensions in some pockets of the labour market. Most of the increase, however, stems from a further pick-up in German wages that can be regarded as a return to normality in German wage growth after a period of extremely low – or even negative – growth in 2004–5 which had been triggered by restructuring in the corporate sector and labour market reforms. An acceleration in German wage growth has been underway since last year and is expected to continue into 2009. In this process, the gap between wage growth in the Euro Area and Germany, respectively, will disappear ending the sustained period of real devaluation of the German economy vis-à-vis the rest of the Euro Area. With average earnings growth in the total Euro Area projected at below 3.5 per cent, risks to price stability from wage cost developments will remain limited over the forecast horizon.

Annual inflation in the Euro Area continued to be below the 2 per cent threshold for 12 consecutive months, coming in at 1.7 per cent in August. Inflation remained modest despite the substantial impact of the VAT increase

[2] The German statistical office recorded exports into the national accounts for the third and fourth quarters that had actually taken place in the first half of the year but were notified late by firms.

in Germany that lifted the price level in the Euro Area by close to 0.3 per cent. Another factor putting upward pressure on consumer prices was the upward movement of some food prices, with large increases in recent months reflecting drastically higher world market prices especially for cereals and dairy products. On the other hand, energy prices were below the previous year's level or only slightly above, following a number of years with strong rises in this component. The core rate of HICP inflation (excluding energy and unprocessed food) which had been on an upward trend in 2006, partly due to the effect of the higher VAT in Germany being rolled over into consumer prices, stopped rising in spring 2007. It has remained stable since then at slightly below 2 per cent.

Figure 1.3.1 CPI Inflation in the Euro Area 2003-2007[a,b]



[a]Change over previous year. [b]Solid line: Core inflation,bar chart: headline inflation. Source: Thomson Financial Datastream.

The outlook for production in the near term is still benign, although business sentiment has fallen slightly in recent months. The generally high level of confidence and a high backlog of orders, along with first indicators from the production side, suggest a rebound of economic growth in the third quarter. Looking further ahead, the outlook is obviously clouded by the recent events in financial markets and the uncertainty about their impact on the real economy. It is difficult to assess at the current juncture to what extent and for how long financing conditions for firms and household will be negatively affected and what impact the current developments will have on business sentiment and consumer confidence. In our baseline scenario, we expect financial market turmoil to calm down in the course of the coming weeks. In this event the negative impact on investment and household consumption should be limited. Monetary policy, under this assumption, is expected to remain tight with a final rise in the ECB main refinancing rate to 4.25 per cent projected for December (see monetary policy section). We do, however, discuss alternative scenarios in this report that would lead to a more severe reduction in economic momentum and a different path for short term interest rates (see Section 1.4). Fiscal policy is expected to be close to neutral next year, following a period of substantial reduction in the aggregate deficit in the Euro Area. A major stimulus from the fiscal side is projected for France while the fiscal impulse in most other countries is small (see fiscal policy section).

With the major caveat of high uncertainty about the evolution of the situation in financial markets, we forecast economic expansion in the Euro Area to

remain strong in the second half of 2007 bringing growth for the full year to 2.7 per cent and we expect it to slow moderately in 2008 and 2009 to around 2¼ per cent, a level of growth which is close to the growth of potential output. Growth in private consumption is expected to accelerate markedly in 2008 to 2.5 per cent, up from 1.7 per cent this year. This will be driven by a recovery in consumption in Germany following the VAT-induced stagnation seen this year and robust household demand in France as a result of the positive impact of tax cuts on real disposable income. Growth in private investment is projected to lose momentum with the slowdown concentrated in residential investment as a consequence of less buoyant housing markets in a number of countries. In addition, monetary tightening and frontloading of corporate investment in Germany into 2007 to escape the deterioration of depreciation rules will weigh on investment next year. Exports should continue to rise and at a decelerating pace as a consequence of more moderate growth in world output in general and slower domestic demand growth in the US in particular. With import growth slowing less, we expect no significant contribution to overall growth from net exports this year and next. More moderate economic growth will be reflected in slower employment growth, and the unemployment rate is expected to decline less rapidly to a level of 6.5 per cent this year and 6.2 per cent in 2009. Inflation should remain benign with the HICP continuing to rise by around 2 per cent.

Table 1.3.1 Euro Area Forecast[a]

	2003	2004	2005	2006	2007	2008	2009
Consumption	1.2	1.5	1.5	1.9	1.7	2.4	2.2
Private investment	1.8	3.1	2.8	6.0	4.8	3.3	2.5
Government expenditure	1.8	1.0	1.4	2.1	2.1	2.0	2.0
Stockbuilding[(b)]	0.2	0.4	0.2	0.0	0.0	-0.1	0.0
Total domestic demand	1.7	2.1	1.9	2.7	2.3	2.4	2.2
Export volumes	1.1	6.5	4.6	8.2	5.8	4.2	3.7
Import volumes	3.2	6.3	5.3	7.8	5.1	4.7	4.0
GDP	0.8	1.8	1.6	2.9	2.7	2.3	2.1
Average earnings	3.0	2.3	2.3	2.9	2.8	3.4	3.4
Harmonised consumer prices	2.1	2.2	2.2	2.2	1.9	2.1	2.0
Private consumption deflator	2.2	2.1	2.0	2.1	1.9	2.2	2.0
Real personal disposable income	0.8	1.6	1.1	1.7	1.8	2.4	2.3
Standardised Unemployment, %	8.7	8.8	8.6	7.9	7.0	6.5	6.2
Govt. balance as % of GDP	-3.0	-2.8	-2.4	-1.5	-0.9	-1.0	-0.9
Govt. debt as % of GDP	69.3	69.8	70.8	68.9	66.6	64.4	62.7
Current account as % of GDP	0.4	0.7	-0.1	-0.2	-0.5	-0.6	-0.6

a GDP data shown in table are adjusted for working-day variation.
b change as a per cent of GDP.

The forecast is based on the following assumptions:

Oil prices will average US$66.6 per barrel in 2007, US$70.9 in 2008 and US$70.0 in 2009. Our forecast refers to an unweighted average of Brent, WTI (Western Texas Intermediate) and Dubai oil prices.

The dollar/euro exchange rate will average 1.39 in 2008 and 1.40 in 2009.

Forecasts are based on data available up to mid-September 2007.

The assumptions for commodity prices, exchange rates and interest rates used in the forecast were constructed by consensus, as the average projections of the 10 member Institutes. These are broadly consistent with current financial market expectations and forward markets, as the majority of Institutes use this information in constructing their own forecasts.

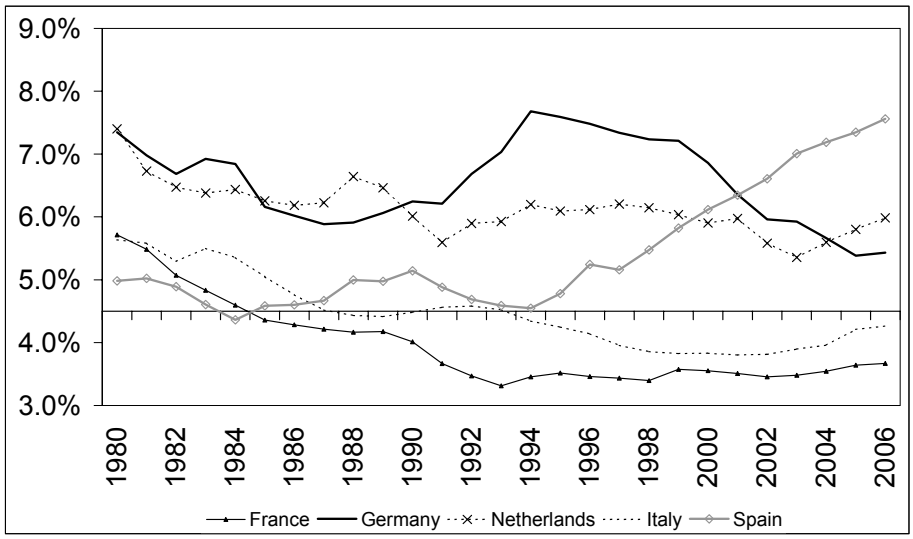
EURO AREA HOUSING INVESTMENT IN LIGHT OF ITS FUNDAMENTALS

In light of the recent sharp recession in the US housing market and against the backdrop of falling house prices and with construction activity in a number of Euro Area countries rising at least as fast as in the US over recent years, housing markets could be regarded an obvious risk factor for the Euro Area outlook. In Ireland, a smaller Euro Area economy that has experienced extremely strong rises in house prices and housing construction in recent years, house prices have already peaked and residential investment has started to recede. House prices in the larger Euro Area economies have been increasing rapidly in Spain, the Netherlands and France. In the following, we look at some of the factors behind the housing market developments in these countries. We also identify which regions face the highest risk of succumbing to a similar housing market downturn as that seen in the US.

The downturn in the US housing market can be viewed as a correction to the housing investment to GDP ratio, which inched up from an average of 4½ per cent in the 1980s and 1990s to reach 5.6 per cent in volume terms in the third quarter of 2005, the highest level since the 1970s. The recent downturn brought this ratio back to 4.3 per cent in the second quarter of 2007, and we expect it to deteriorate further before reverting to the historical average of 4½ per cent over the longer term.

Figure 1.3.2 shows that housing investment to GDP ratios have been differing across countries since 1980. While the level of housing investment relative to GDP in the 1980s averaged between 4½-5 per cent in Spain, France and Italy, comparable to that in the US, housing investment to GDP ratios have been consistently higher than that in Germany and the Netherlands. In the 1990s these ratios started to diverge across countries, with the average ratio in France falling to about 3½ per cent of GDP and in Italy to 4 per cent. The Spanish ratio by contrast rose to 5.5 per cent by 1999. Since then the Spanish housing investment to GDP ratio has continued to rise sharply, dwarfing the recent rise observed in the US. While we have seen a slight rise in the housing investment ratios in France and Italy in recent years, they remain well below the 4½ per cent average of the 1980s. In Germany the already high housing investment to GDP ratio rose sharply in the early 1990s following unification before starting a long-lasting decline. Nevertheless housing investment relative to GDP is still relatively high by international standards, which is also true in the case of the Netherlands.

Figure 1.3.2 Housing Investment/GDP (volumes)



There are a number of reasons why we might expect housing investment to GDP ratios to differ across countries and over time. Preference may differ and evolve. Demographics may differ and evolve, and these can affect preferences. Interest rate volatility can also affect the evolution over time, as it affects investor risk.

Table 1.3.2 reports some key housing market indicators for the 5 countries charted above. The number of inhabitants per dwelling is an indication of the relative living standards, in terms of housing, across countries. We might expect housing investment to GDP ratios to be higher in regions with a relatively high housing density, to allow convergence in living standards. Housing density in Italy and the Netherlands is high relative to the other countries in our sample and indeed the Netherlands has exhibited a relatively high housing investment ratio over the last 25 years, although Italy did not.3

Table 1.3.2. Key Housing Indicators for large Euro Area Economies

	Population density (2005)	Housing density (2001)	Dwelling size (2001)	interest rate volatility[(a)]		
	(persons per sq km)	(inhabitants per dwelling)	average m^2 per capita	1980s	1990s	2000-2006
France	108.4	2.0	43.9	1.2	1.0	0.3
Germany	231.0	2.1	42.1	0.9	1.0	0.3
Italy	194.5	2.7(b)	35.0(b)	2.0	1.7	0.3
Netherlands	391.5	2.4	41.2	1.0	0.9	0.3
Spain	85.8	2.0	47.6	2.6	1.8	0.3

(a) Standard deviation of 3-month money market rates, after removing a common trend.
(b) 1998

Housing density reflects the number of inhabitants per dwelling, but does not give any insight into the relative quality or size of housing across countries. Average dwelling size per capita is another indication of living standards in terms of housing. By this measure, living standards in Europe are generally

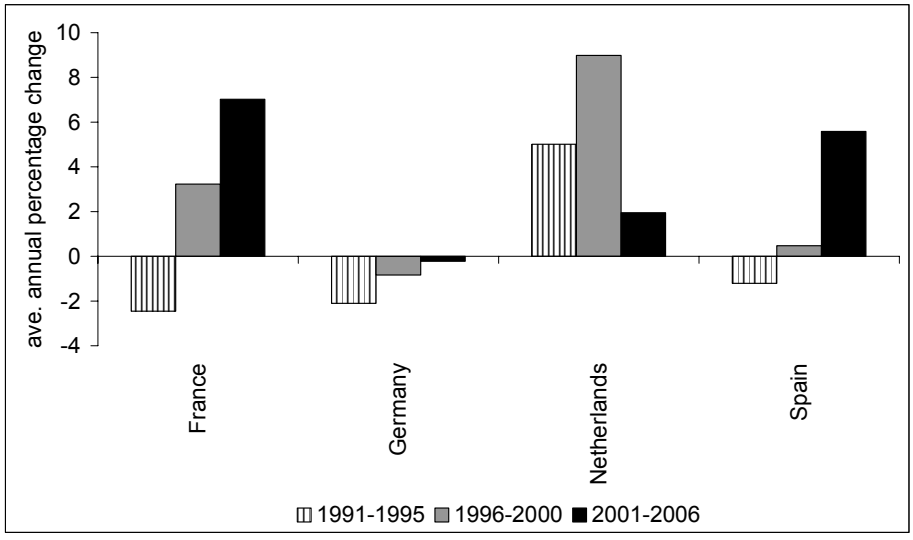
[3] Analysis based on a larger sample of countries (Holland 2007) suggests that Italy is an exception in this regard.

relatively low compared to other industrial countries such as Australia, the US and Canada. Clearly population density must play a role in this, as the opportunity cost of an extra square metre of dwelling space is lower in countries with large stocks of undeveloped land. Among European countries, average dwelling size per capita is lowest in Italy, followed by the Netherlands and is relatively high in Spain. As there is no obvious correlation between housing investment ratios and average dwelling size per capita and assuming that consumer preferences across the board demand more living space per capita, this suggests that supply does not react significantly to rising demand pressures in Italy, which could be associated with strong house price growth.

Spain has a relatively low housing density and a high average dwelling size. Population density is fairly low by European standards, which is consistent with a higher dwelling size, but the figures reported in Table 1.3.2 do little to explain the recent surge in Spanish housing investment. One factor that may raise housing demand in Spain is the recent rise in population growth, which is partly attributable to a surge in immigration. However, housing investment has outstripped population growth by a considerable margin, pointing to additional factors at work. One such factor could be the decline in interest rate volatility experienced in recent years in Spain, although there is not a strong correlation between interest rate volatility and housing investment ratios across countries. Another important element distinguishing the Spanish housing market from those in the other countries discussed here is the large share of holiday homes in the stock of housing. Adjusting housing density for holiday homes will yield a significantly different picture, as inhabitants per dwelling in residential homes is much higher than in holiday homes.

If we think of housing as an investment good, the level of investment should be related to the expected return on housing, or the expected sale value of a house relative to its construction cost. This can be viewed as an approximation of Tobin's Q ratio for housing. Higher growth in the ratio of the average annual growth of house prices relative to housing investment deflators can be expected to be associated with a rise in the housing investment ratio. This type of speculative investment is not necessarily related to demand pressures, and can lead to a sharp turnaround as we have recently observed in the US.

Figure 1.3.3 Housing prices/housing investment deflators



France has seen a very strong rise in the return to housing investment in the last 5-10 years. Nonetheless, its housing investment to GDP ratios has

remained low and stable. This suggests that housing investment may be restrained by domestic regulation. Price rises appear to be driven by a shortage of supply, and we should not expect a sharp drop in housing investment in France. In the Netherlands, the return on housing investment rose sharply in the second half of the 1990s, but growth has slowed in recent years. Over this period, housing investment to GDP has been very stable, but remains at a high level relative to most other economies. The Netherlands is constrained by a high population density, so while average dwelling size is on the low side we expect the housing investment ratio to recede somewhat over our forecast horizon. However, this process is expected to be affected gradually, without a sharp contraction in housing investment.

The return on housing investment in Germany has been declining over the last 15 years, and this has been associated with a decline in the housing investment ratio from nearly 8 per cent at the end of 1994 to 5.5 per cent at the end of 2006. Nonetheless, this remains high relative to most of the other major economies, and cannot be explained by demographic developments, as total population is expected to stagnate or decline for the next several years. Average dwelling size is slightly on the low side, but the fundamentals do not support strong housing investment growth over the coming years. Housing investment in Germany expanded by 4½ per cent last year, after 10 years of weakness and 5 consecutive years of decline. This was, however, probably mainly due to the abolition of housing allowances (Eigenheimzulage) for buildings permitted after January 1st, 2006. Since building has to be started within two years after permission, this legislation led to a sharp but temporary increase in housing starts in 2006. Over a longer horizon we expect housing investment to grow more slowly than GDP and cannot rule out further declines in the short to medium term.

Spain has seen a significant rise in the return on housing investment in the last few years. Combined with a reduction in interest rate volatility and a surge in population growth, this has been associated with a sharp rise in the housing investment ratio. Population growth is expected to moderate over the next few years and housing density in Spain is already at relatively low levels. We expect the housing investment ratio, which has been supported by speculative activity, to revert towards historical norms over the coming years. While we project a soft landing of the housing market in our baseline forecast, this could be associated with a sharp correction in the housing market in some Euro Area economies, as experienced in the US. In Section 1.4.2 we discuss the potential impact of a collapse in Spanish housing investment on the Spanish and Euro Area economies.

GERMANY

The cyclical upswing in Germany has lost momentum in the first half of 2007. This was in line with expectations, since domestic demand was dampened by restrictive fiscal policy measures, in particular the increase of the main VAT rate by 3 percentage points to 19 percent at the start of the year. Private consumption was especially affected and fell at an annualized rate of 2.1 per cent, both as a result of the loss in real incomes that came with the higher VAT as well as the response to the advanced purchases in 2006. In addition, exports grew markedly slower than in 2006, following reduced momentum in industrial production growth abroad. The quarterly pattern of growth, however, was somewhat surprising. While q-o-q real GDP growth remained astonishingly high, at 0.5 per cent in the first quarter, output expanded by a slower than expected 0.3 per cent in the second quarter when aggregate capacity utilisation fell for the first time in four quarters. A major factor behind

this was residential construction, which benefited from advanced purchases and exceptionally mild weather in the first quarter but fell drastically in the second quarter. However, industrial production also lost momentum despite an extremely positive assessment of current economic conditions by firms, strong order inflows and a historically very high backlog of orders.

The situation on the labour market continued to improve, although employment grew more slowly in the second quarter than in the first quarter and unemployment did not decline as strongly as in the first quarter. In July, the rate of unemployment (Eurostat definition) was at 6.4 per cent, more than 1 percentage point lower than at the start of the year, but only 0.2 percentage points down from April. With the VAT hike now nearly fully rolled over into consumer prices, inflationary pressures were somewhat lower in recent months, despite rising food and energy prices. In August, consumer prices exceeded their level one year ago by 2.0 per cent.

The slowdown in activity in the first half of the year does not, in our view, imply that the upswing has come to a standstill. Business investment continued to grow and firms continued to expand regular employment. Despite some decline in recent months, the ifo business climate index is still at a very high level by historical standards, as are firms' assessments of orders at hand. We therefore expect the cyclical momentum to be markedly higher in the second half of 2007 than in the first half, although growth rates are likely to remain below those seen last year. Most importantly, domestic demand growth will accelerate as the dampening effects from the VAT hike fade out. Private consumption growth is expected to be stimulated by the improvement in the labour market and a normalisation of the savings rate. This has risen by a remarkable half a percentage point in the first half of 2007. Corporate investment growth will remain high driven by the firms wishing to expand capacities. In addition, we expect investment from next year to be brought forward into 2007 as a reduction in depreciation allowances will become effective next year. In addition, export growth will pick up as industrial production in the Euro Area should re-accelerate. Overall, real GDP in 2007 should register growth of 2.7 per cent. Consumer prices are likely to rise by 2 per cent.

Next year aggregate production will increase at a more moderate pace. Domestic demand, however, will remain robust, driven primarily by private consumption. With employment rising and wage growth accelerating, household real disposable income will grow faster and this will spur consumption growth. Investment, by contrast, will slow down due to higher financing costs and as a result of the advanced purchases in 2007. Export growth should be rather moderate reflecting reduced momentum in the world economy. Real GDP is projected to increase by 2.2 per cent next year, followed by 2 per cent growth in 2009. Unemployment will continue to fall and could drop below 6 per cent in 2009. Consumer prices are expected to rise by 2 per cent this year. Despite the impact of higher VAT (estimated at more than 1 percentage point) disappearing, inflation will moderate only slightly over the next two years as a result of a significant pick-up in unit labour costs and higher food prices.

The forecast assumes fiscal policies that are almost neutral in 2008 and 2009, with no significant change in the structural general government budget balance after two years of substantial fiscal restraint. Government expenditures will accelerate somewhat but continue to rise at a slower pace than potential GDP. At the same time, corporate tax reform and a lower rate of contribution to the social security schemes will reduce the tax burden. With output continuing to rise somewhat faster than potential a small surplus in the general government

finances can be expected for 2008, after a balancing of the budget being achieved this year.

We do not expect the current turmoil on financial markets to cause a credit crunch in Germany over the next months, although it is not clear at the current juncture to what extent the problems in the banking system will affect interest rates for bank loans or credit conditions. These banking problems have hit Germany with two mid-sized government-controlled banks having had to be rescued,. Unexpectedly tight credit is a major risk to the short-term outlook in Germany.

FRANCE

According to the last release of quarterly national accounts, French GDP grew by 0.5 per cent in the first quarter of 2007 and by only 0.3 per cent in the second quarter. This brings GDP growth to only 1.3 per cent in the second quarter as compared to the same quarter of 2006, well below the average area performance of 2.5 per cent. Although the low French GDP growth in recent quarters partly reflects weak industrial production growth, it seems low in the context of business survey results. For instance, OFCE's quarterly GDP growth rate indicator based on business survey data suggested a GDP growth of around 0.7 in the first quarter and 0.6 in the second quarter. The divergences between survey data and hard data have increased since 2005 in France like in other Euro Area countries. For France, the divergence between hard and soft data may perhaps be interpreted as an indication of a future upward revision in GDP growth for the first half of the year (as was recently the case for annual GDP growth in 2005, now being estimated at 1.7 per cent instead of 1.2 per cent a few months ago).

We expect GDP to grow more in line with business survey data in the second half of 2007, with quarterly growth rates expected at close to 0.7 per cent, slightly below OFCE's quarterly growth indicator. As far as the third quarter is concerned, both survey data available up to July and the industrial production index suggest an acceleration of growth, although one has to be cautious because we have at this stage mainly information on the first month of the quarter and this was before the turmoil in financial markets. The industrial production index has risen by 1.3 per cent in July as compared to June mainly because of a sharp rebound in the automobile industry (+4.7 per cent). Industrial production growth remains fragile, however, with a 0.7 per cent increase in the three months up to July 2007 as compared to the same months a year earlier.

We forecast French GDP to grow by 1.9 per cent in 2007. Domestic demand will remain the major engine for growth, rising by 2.3 per cent. Both household's consumption and government expenditure will rise by around 2.3 per cent, while private investment growth will stay close to 4 per cent. Net external trade will remain the main factor dampening GDP growth, for the fifth year in a row, reducing GDP growth by 0.3 percentage point this year as in 2006. The corresponding figure, on annual average basis, for 2003 to 2005 was 0.8 percentage points. French exporters seem to have stopped losing market shares since 2006. But import growth remains more rapid than export growth due to a relatively robust domestic demand as compared to France's major trading partners.

It is too early to assess whether the past trend in French exporters' market share is over. French export market shares have been more affected than other countries, and especially Germany, by the appreciation of the euro from 2002

to 2005. The recent rise in the euro and our forecasts for a further appreciation lead us to expect a further decline of French exporter's markets shares in 2008 and 2009. Net external trade will reduce GDP growth by an annual 0.5 percentage point up to 2009, under our forecast of rather robust domestic demand. Domestic demand growth will accelerate to 2.9 per cent in 2008 and will slowdown slightly to 2.6 per cent in 2009. This will be due to households' consumption (rising by more than 3 per cent) being supported by the introduction of significant tax cuts (see fiscal policy section).

French inflation has been among the lowest in the Euro Area over the last few months. The harmonised consumer price index rose by an annual 1.2 per cent in July in France and by 1.8 per cent in the Euro Area. French inflation is expected to come closer to 2 per cent at the end of this year under the effect of past rises in energy prices. However, apart from the energy and some food components, there are hardly any signs of inflationary pressures. We expect HICP inflation to remain close to 1.7 per cent in 2008 and 2009, below the 2 per cent area average. Under our GDP growth forecast the unemployment rate will continue to decline. In terms of the EUROSTAT standardised measure, it will decrease from 8.1 per cent in 2007 to 7.7 per cent in 2009. France will remain one of the Euro Area countries with the highest unemployment rates.

In terms of fiscal policy, French prospects seem likely to be at odds with developments in neighbouring countries. The government in office since the Presidential and Parliamentary elections of last Spring has announced a number of fiscal measures, mainly tax cuts benefiting households and amounting to 0.7 per cent of GDP. At the time of preparing the forecast, detailed budget plans were not available (they will be released on September 26). Our forecast embeds the new measures announced in terms of revenues. On the expenditure side, we have more limited information and we have assumed that government spending growth will rise at rates close to the recent trend. Under these assumptions, fiscal policy will be clearly expansionary in 2008, with a fiscal impulse amounting to 0.5 percentage point of GDP, whereas the objectives announced in the latest update of the Stability Programme at the end of 2006 where of a 0.7 percentage point of GDP fiscal tightening. Under our GDP growth forecast and fiscal assumptions, the government deficit is at risk of breaching the 3 per cent of GDP limit of the Stability and Growth Pact in 2008 and remaining at close to 3 per cent of GDP in 2009.

ITALY

The Italian economy's slowdown in the second quarter (0.1 per cent q-o-q) was expected and correctly incorporated in our forecasts. The new data does not necessitate a revision to our forecast for 2007, but the worsened international context will reduce GDP growth to 1.5 per cent in 2008.

In the first six months of this year the pace of GDP growth slowed to 0.2 per cent q-o-q from 0.7 per cent q-o-q in the second part of 2006. This mirrored the slowdown in industrial production which, after an 18 month recovery, fell in the first part of 2007 (-0.8 per cent q-o-q in q1and -0.2 per cent q-o-q in q2). Over the same period, increases were recorded in both Germany (2.7 per cent) and France (1.3 per cent).

The slowdown is driven by investment (in particular construction) while demand for consumer goods is accelerating. This recovery in consumption is taking place despite two years of very low growth in household disposable income. As consumption growth was driven by durable goods, it appears that the fiscal incentives for the purchase of some durable goods are working. Net

exports made a negative contribution to GDP growth and exports continue to fall (-1 per cent q-o-q in q2 and -0.1 per cent q-o-q in q1). Notwithstanding the disappointing performance of exports, in the first six months of the 2007 the trade deficit improved relative to the same period of 2006 (from -14 billions of euro to -7.3) and in June, after ten months in deficit, it returned positive.

During the summer, according to survey evidence, economic growth would have improved slightly but several elements of uncertainty are still present. Although the outlooks for investments and exports are more favourable, the outlook for consumption is weaker, as signalled by the fall in the index of household confidence in August.

For this year we expect GDP to increase by 1.8 per cent while the changed international context will reduce growth prospects for next year to 1.5 per cent. Much of the slowdown will be due to household consumption expenditure and for the following reasons: the ending of the effects of consumption-related incentives, worsening consumer confidence and tighter credit conditions. Residential investment will also contribute less to GDP growth, in spite of fiscal incentives (VAT tax on house restorations was reduced from the 20 to 10 per cent and a fiscal saving of 55 per cent was introduced for energy saving measures). We expect this to continue into 2008.

Inflation is in line with our forecast. The slowdown in headline inflation (1.7 y-o-y basis in August) has been mainly due to a favourable base effect. However, this may already have disappeared in September, when inflation is expected to reach 1.8 per cent and then to rise further in the following months. Looking ahead, wage growth is likely to accelerate towards 3 per cent, as next year will bring about the negotiation of several wage contracts, both in the public and in the manufacturing sector. Moreover, crude oil prices will remain high. On the other hand, some improvement in labour productivity growth and the strength of the euro should help to keep inflation in check at slightly above 2 per cent.

The public finances appear to be as strong as was expected. Tax revenues and the transfer of Tfr to Inps funds reduced the public borrowing requirement in the first eight months of 2007 by 11 billion euros relative to the same period of 2006. According to our estimates, revenue growth will continue to be larger than expected in the coming months. However, taking into account the spending passed in July and the willingness of the government to take advantage of this favourable situation by bringing forward as much as possible spending that was due in 2008, we expect that the budget deficit will not be lower than the target of 2.5 per cent of GDP. However, we cannot exclude a revision to the target in the coming Update of the Planning Document, due at the end of September. The deficit is estimated to be 2.5 per cent of GDP in 2008 as well, only slightly above the government target (2.2 per cent), and is likely to fall only in 2009.

1.4 Additional topics

References have been made above to financial uncertainty, its possible consequences for the banking system and the reactions of central banks to the situation. Given the importance of these issues, it is appropriate to analyse them further. In the following three sub-sections, we present such analyses.

1.4.1 A BERNANKE PUT?

Federal Reserve Board chairman Ben Bernanke has made it clear that he will stand by the markets and try to ensure that the recent turmoil that has resulted from lending to home buyers that was not fully secured will not cause a major downturn. The US faces two major problems, in that the banking sector is distressed and the housing market appears to be turning down sharply. The

former could result in a crisis, whilst the latter will reduce the level of economic activity rapidly. It has been made clear that the Federal Reserve will both support the markets through the discount window and also that it would cut interest rates to support demand. We consider that this is a clear message that monetary policy will be looser than it would have been and the markets hence must react. The message form other Central Banks has been less clearly expansionary in its implications, and hence the dollar has weakened in anticipation of the loosening.

We can simulate the effects of a decline in the dollar generated in this way by shifting the target for US inflation, and we scale it so that the dollar falls by around 2 1/2 per cent in effective terms, much as it did between early August and the middle of September 2007. In the simulation, interest rates in the US fall by 50 basis points in the fourth quarter of 2007 and by a further 25 basis points in the first quarter of 2008. We add on to this a relative appreciation of the yen induced by a fall in its relative risk premium. This, we believe, has been generated by the belief that the Japanese banking system is not at risk in the same way as elsewhere. The combination of these two shocks shift the yen from around 123 to the dollar in July to around 114.6, whilst the euro rises from 1.355 to 1.400 to the dollar.

Table 1.4.1 plots the effects of these shifts on a baseline where they would have been absent. US growth and inflation are noticeably higher than they would have been, whilst the increase in US demand largely offsets the output effects of appreciations elsewhere. These results would lead us to think that the Bernanke put is wise and effective. However, bailing out a banking system that is unsound builds up risks for the future that we cannot model. These in turn could lead to a more severe banking crisis in future.

Table 1.4.1 Impacts of a loosening of monetary policy in the US

	Output (per cent difference from base)			Inflation (per cent difference from base)		
	Euro Area	Japan	US	Euro Area	Japan	US
2007	0.0	0.0	0.0	0.0	0.0	0.0
2008	-0.1	0.0	0.4	-0.1	-0.2	0.5
2009	-0.1	-0.1	0.5	0.0	-0.2	1.1
2010	-0.1	-0.1	0.4	0.0	-0.2	1.0
2011	-0.1	0.0	0.2	0.0	-0.1	0.7
2012	-0.1	0.0	0.0	0.0	-0.1	0.5

NiGEM simulation. Forward looking financial and foreign exchange markets Forward looking wages, myopic consumers. Lower risk premium in Japan.

1.4.2 HOUSE PRICES IN A BANKING CRISIS

House prices in Europe have generally risen strongly in the last few years, supported by low interest rates and financial deregulation. A rise in credit spreads facing consumers could impact rapidly on housing markets in a number of countries, and this would affect the level of demand, both through its impact on investment and through its effects on consumption. The impact of house prices on consumption varies across the European economies, depending on the nature of the housing market and the degree of financial deregulation. Al Eyd et al (2006) looks at the evidence on the role of house prices on consumption in Europe, and concludes that in countries such as Spain and the UK a fall in house prices has an immediate effect whereas in

countries such as France the effects are delayed. There is little evidence that changes in house prices impact on Italy. The impact of house prices on investment is not at all clear, but if there has been a lot of speculative investment with large inventories, then falling house prices are liable to impact strongly on housing investment. Holland (2007) suggests that Spain is the only European country where this might be a problem.

Table 1.4.2 The Impact of a 5 per cent fall in House Prices

	Output (per cent difference from base)			
	Euro Area	France	Spain	UK
2007	-0.01	-0.01	-0.06	0.00
2008	-0.08	-0.07	-0.24	-0.28
2009	-0.08	-0.13	-0.21	-0.25

NiGEM simulation. Forward looking financial and foreign exchange markets
Forward looking wages, myopic consumers

We have undertaken two simulations to evaluate the potential impact of financial market turmoil on the European economies. In the first we reduced house prices by 5 per cent in all countries from the fourth quarter of 2007. Output growth slows as we can see from Table 1.4.2, but the effects on the Euro Area are not large, and market interest rates would only fall by 10 basis points initially. In the UK the effects are larger, and interest rates would be cut by between 25 and 50 basis points.

Because of the high rate of investment in housing in Spain (discussed in Section 1.3) we have considered an additional scenario involving that country. If banks and other lenders were to become concerned about lending to house builders in Spain then the spread between their borrowing rates and market rates, the quality spread, could rise. The simulation presented in Table 1.4.3 overlays the fall in European house prices with a rise in the quality spread in Spain that is sufficient to slow output growth to zero in each quarter of 2008. Private sector investment growth drops to an annual rate of -15 per cent in Spain by the last quarter of 2008. If the ECB follows our policy rule it would cut the interest rate by at least 25 basis points by the end of 2008 to help absorb the shock to the Euro Area as a whole, but it would not respond to events in Spain in any specific way. As a consequence of the slowdown in demand in Spain the current account would improve by 2 ½ per cent of GDP in 2008. Inflation would take time to respond, but it would be one per cent a year lower in Spain for 2 years. Euro Area inflation would not initially fall because the deflation in Spain would be offset by the impacts of a weaker currency that the policy response would induce.

Table 1.4.3 Impacts of an Investment Crisis in Spain after a 5 per cent fall in House Prices

	Output (per cent difference from base)				Inflation (per cent difference from base)	
	Euro Area	France	Spain	UK	Euro Area	Spain
2007	0.0	0.0	-0.1	0.0	0.0	0.0
2008	-0.3	-0.1	-2.0	-0.3	0.0	-0.2
2009	-0.5	-0.2	-3.9	-0.4	-0.1	-0.9
2010	-0.5	-0.2	-3.6	-0.2	-0.2	-1.1
2011	-0.3	-0.2	-2.0	0.1	-0.1	-0.6
2012	-0.1	-0.1	-0.9	0.2	0.0	0.1

NiGEM simulation. Forward looking financial and foreign exchange markets Forward looking wages, myopic consumers.

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Al Eyd, A. Barrell, R, Davis, E.P., and Pomerantz, O., (2005) 'The Resilience of Consumption in the Euro Area' submitted December 7th 2005. Forthcoming as an European Commission *European Economy Working Paper*

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1.4.3 BANKING CRISES AND THE RISKS OF RECESSION

Turmoil in the financial markets between June and September 2007 has led to the possibility that we may see a wave of banking crises. A full blown banking crisis leads to a destruction of financial assets and to a loss of confidence in banks, changing people's behaviour and the equilibrium of the economy. There are few ways to deal with them, and a fiscal intervention is almost inevitable. The state normally takes the assets and liabilities of the failed banks and covers most liabilities and attempts to realize value from the assets. The Norwegian and Swedish banking crises involved an initial increase in government debt of 8 per cent and 4 per cent of GDP respectively. Finland had a larger scale problem and the initial cost of the banking crisis involved an 11 per cent of GDP increase in government debt, but many of the assets had a realized value in excess of their initial book amount, and hence the overall cost to the fiscal authorities was probably 3.8 per cent of 2005 GDP. In each of these recent European cases the output loss was severe, as can be seen from Figure 1.4.1. Banking crises have not been uncommon, as we can see from the 'agreed' list of crises that is commonly used in studies of their causes and impacts.[4]

[4] The table is abstracted from Barrell, Davis and Pomerantz (2006) which survey studies on the impact of crises on GDP and investment and undertakes the fist study of their direct impact on consumption. The list does not include obvious problems in the banking system such as those in the UK or France in the early 1990s as no bank went bankrupt in either case. In both cases the banking sector turmoil constrained consumption and reduced growth for a period. Hence the literature probably underemphasises the impact of banking sector problems on the real economy.

Figure 1.4.1: GDP Growth and the 1991 Banking Crisis

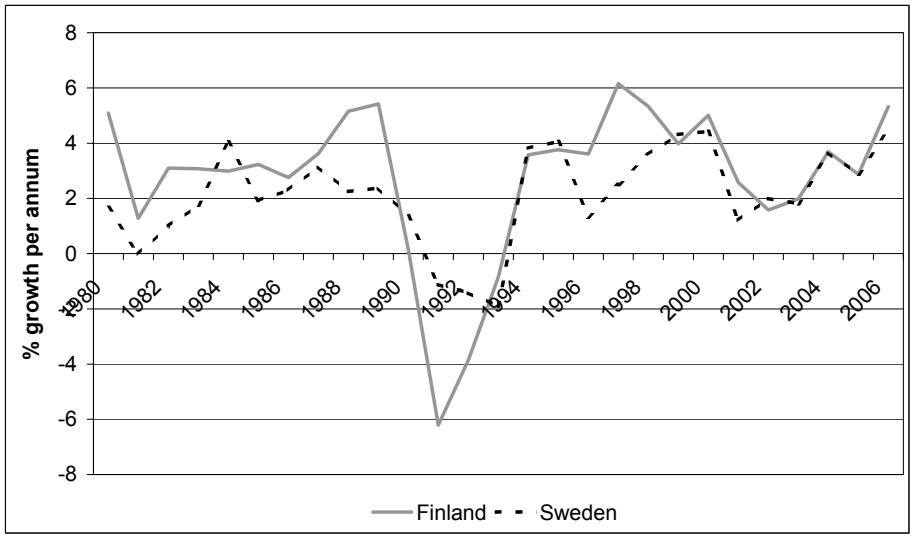


Table 1.4.4: List of Crises

	Start date for banking crises
US	1984
UK	1974
Germany	1977
Japan	**1992**
France	1994
Sweden	**1991**
Italy	1990
Canada	1983
Spain	1977
Finland	**1991**
Denmark	1987
Australia	1989
S Korea	**1998**
Norway	**1987**
Total	***14***
1960s	***0***
1970s	***3***
1980s	***5***
1990s	***6***

Source: Barrell, Davis and Pomerantz (2007) based on Caprio and Klingebiel (2003), Bordo and Eichengreen (2002); systemic banking crises shown in bold.

Banking crises are very hard to predict, but they have a tendency to follow on from periods of financial deregulation and excessive optimism in asset markets. Inadequacies in regulation may also raise the possibility of a crisis, and concerns have been expressed about the regulatory architecture in Europe[5]. The Commission has generated a European Economic Area wide financial system[6] with cross border banks and interlocking deposits and loans.[7] However, this multi-country market is regulated by the individual country Financial Stability authorities, and it is difficult for any of them to have enough

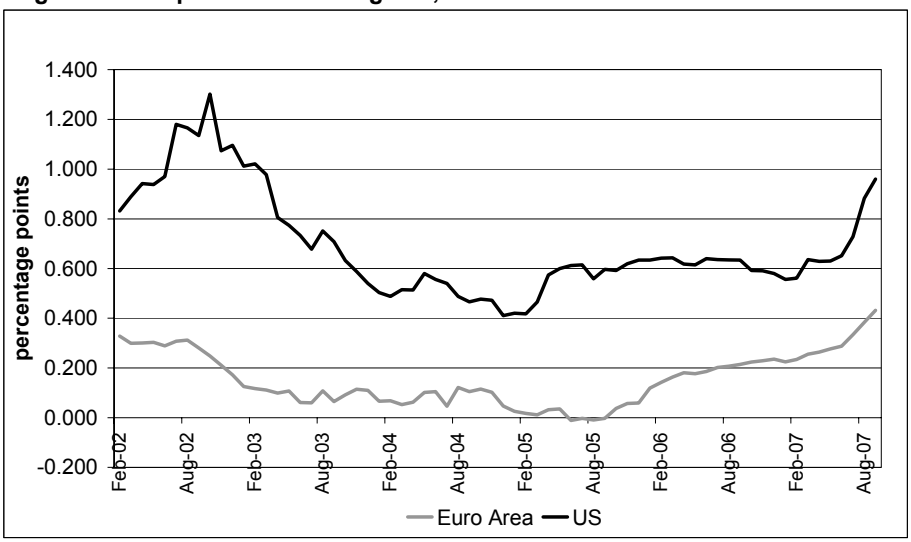
[5] Barrell and Davis (2005) describe financial regulation as the missing pillar in the European policy architecture, and they draw attention to the risks of crises.

[6] The Area includes non-EU members such as Norway and Switzerland, as they are covered by the banking directives and by most of the Single Market Programme for financial services.

[7] The timely paper by Nicolas Veron (2007) looks at the growth of cross border banking in Europe.

information to fully understand the balance sheets of international banks. Coordination takes place, but it is inevitably clumsy. If deregulated banks lend on the strength of bubble backed asset prices, either in the housing or equity markets, then a burst in the bubble can leave banks very exposed. Banks can also come under pressure when they have mispriced risk, and cut the spread between borrowing and lending rates. This can result from unwise competition combined with inadequate supervision, much as we have seen in Europe in the last decade. A low spread may leave little room for defaults, and spreads have been low in the US and the Euro Area over the last three years, as we can see from Figure 1.4.2.

Figure 1.4.2: Spreads at the long end, Government-AAA



Recent turmoil has involved an increase in the inter bank rates spread over the central bank rate because lending banks are uncertain about the solvency of borrowing banks. This uncertainty has stemmed, at least initially, from the scale of defaults in the US subprime mortgage market. As the assets associated with these mortgages have been stripped and split it is not always clear to outsiders who is liable to make losses. The rise in inter-bank rates can cause short-term liquidity problems, as banks cannot easily borrow to cover the fluctuations in their assets and liabilities flows. If the scale of such borrowing by a bank becomes large then the availability of funds might dry up as risk would be seen to be high. It is at this point that the central bank can step in to provide liquidity and ease the situation, and the ECB announced large-scale intervention in late August, and the Bank of England intervened in September.

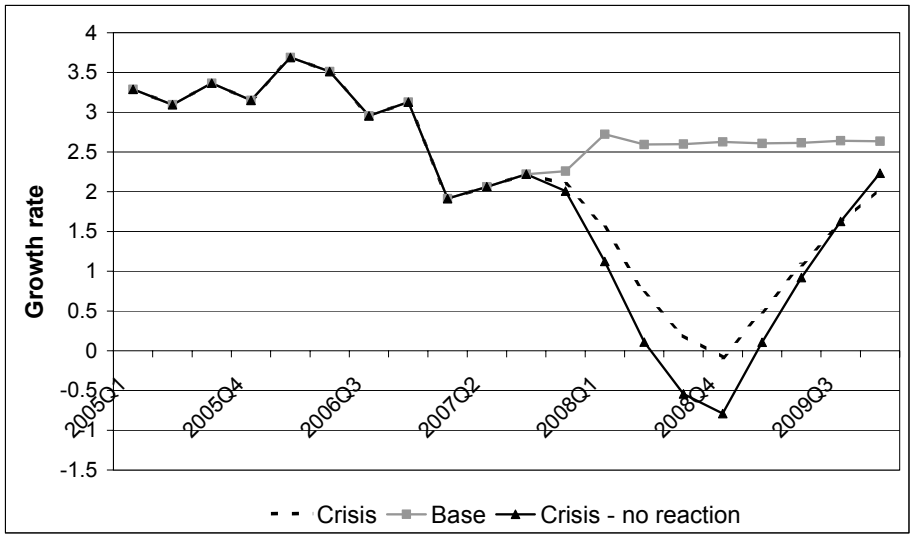
Views differ on how this intervention should take place, but it would appear to be unwise for the lending to take place at a subsidized rate, and a penalty rate would impose a cost on bank equity holders and reduce the hazard of the banks repeating foolish book structures based on central bank bail outs. The Bank of England imposed a penal rate on its lending to the Northern Rock, a basically sound lender, but unfortunately induced a bank run. The run resulted from the public nature in which support was announced, and this made it clear that transparency in Central Bank operations is not always best practice. A run on the bank induced by the publicity could in turn have led to a liquidity crisis turning into a bankruptcy, but this was prevented. Subsequent lending to banks by the Bank of England has been less transparent, even though it has been at penal rates. ECB lending has also been less transparent than the Northern Rock case, but it is not at all clear that it has always been at a penal rate.

Liquidity crises can go away in a few months as exposures become clear, and our baseline case involves this assumption. We recognize that risk may have been underpriced and as a result the spread between risk free and risky assets will increase permanently. This increase in the cost of borrowing will slow investment and reduce sustainable output, but we would anticipate that the effects would be distributed over a number of years. Barrell, Holland, Liadze and Pomerantz (2007) suggest that a one per cent increase in the quality premium would raise the cost of capital by ½ to 1 percentage points and hence reduce equilibrium output in the Euro Area by between 0.4 and 1 per cent in the long run. Model simulations suggest that this could mean that growth would be reduced on average by 0.1 to 0.2 per cent a year for five years. Such a change is not a recession. However, a full scale banking crisis would have a much larger impact, and we present the potential impacts of such events as alternative scenarios to our main forecast.

The core problem for the world financial system appears to originate in the US, although the major fall out appears to have been in Europe to date. The housing market has weakened in the US, but if as a result of the credit crisis the margin between borrowing and lending rates were to rise further house prices could fall by more than we anticipate. In our scenarios we assume that house prices drop by 10 per cent over the next year, and stay that low for 3 more years. The rise in spreads and the increase in risk that we anticipate in this scenario could raise the premium in the equity market, reducing the current value of future profits, and hence in order to simulate this we reduce the equity by 10 per cent in the fourth quarter of 2007, although we assume it begins to return to fundamentals after three years. If the 'credit crunch' turns into a banking crisis then the cost of firms borrowing from banks would rise sharply and credit would be rationed in relation to the quality of the borrower. We can simulate this by raising the investment premium, which increases the user cost of capital (essentially one for one) by 8 percentage points. We can see this as an increase in the shadow price of borrowing, as credit would be quantitatively rationed as well. Such a large rise would slow investment down markedly, and output growth would slow to zero, as we can see in Figure 1.4.3.

We utilize the full forty countries on the NiGEM model, and we assume that the banking crisis takes place within the OECD, as the risky lending appears to be from Europeans and Americans to each other. We assume that financial markets for equities, long rates and the exchange rate are all rational and forward looking, and hence prices and exchange rates can jump when there is news of a change in belief. We also assume that firms are forward looking in their investment decisions and workers in their wage bargaining. If these last two assumptions were dropped then the effects on output would be greater. We do not assume consumers are forward looking as they may find them selves constrained in a banking crisis. If they were, then they would absorb almost half of the shock as they would respond to lower market interest rates and consume more now.

Figure 1.4.3: US Output



It is of course possible for the Federal Reserve to react, and we have our default policy feedback for the Fed in place. Interest rates would be quickly cut by 400 basis points as compared to our baseline, and this would absorb much of the shock. However, in the unlikely event that it took the Fed two years to react, then the US would be in a full recession for a year, even though long rates and exchange rates would fall in the knowledge that the Fed would eventually step in.8 Conversely if the reaction were to be more vigorous the output effects may be less.

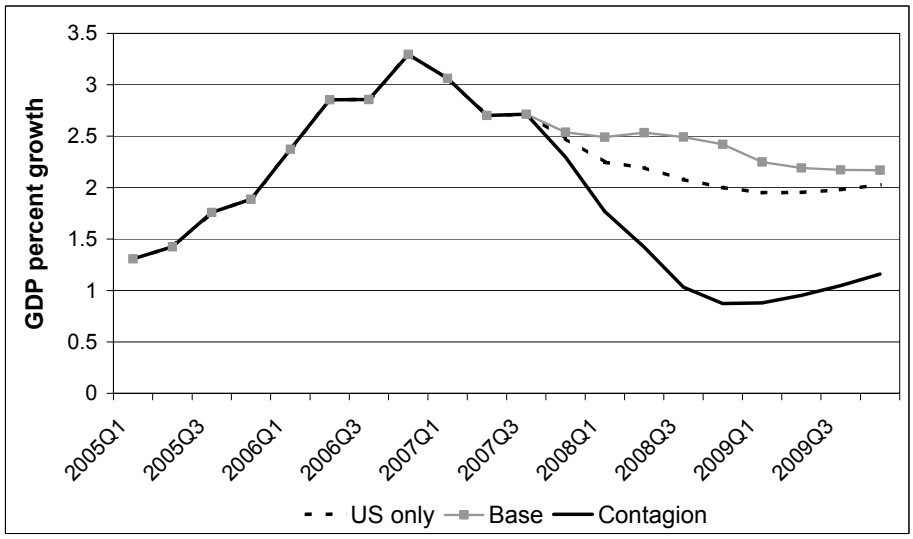
If the US slowed down so markedly, and interest rates fell sharply, the dollar would fall, and the Euro Area would lose competitiveness. It would also suffer a direct reduction in export demand, and as a result the growth rate might slow by up to ½ a percentage point, even if the ECB were to cut rates by 50 basis points as our policy rule suggests. Figure A.4 plots the effects of the US crisis alone on Euro Area output.

The evidence that we have so far seen suggests that the crisis will not be restricted to US financial markets. Equity markets have become much more linked in the last three decades, and Barrell and Davis (2007) show that on average 60 per cent of a shock to US equities spills over to Europe. In addition the existence of international banks and portfolios will have spread the US risks to others, especially in Europe. Hence we can expect that the rise in the quality premium would be the same in Europe as in the US, and that equity markets would also decline. We have undertaken a second scenario where contagion takes place, and equity prices fall as much in the rest of the OECD world as they do in the US, and the investment premium, that reflects constraints on lending as well as higher risk, rises by a similar amount elsewhere. However, we do not assume that there is an autonomous collapse in the housing market elsewhere. Figure 1.4.4 contains the resulting profile for Euro Area growth, which would slow to 1 per cent. Much of this would be domestically generated, as we can see, and the increase in spare capacity would reduce inflation to around half a per cent in 2009, 2010 and 2011 despite the depreciation of the euro against other currencies that would follow from monetary policy differences. Of course the ECB could cut rates more than our rule suggests, as they fall slowly to around 1.5 per cent at the end of 2010. If it

[8] This was what happened after the great crash in 1929 when the Fed did not react in the way we would expect today. However, central banks have learned from this experience.

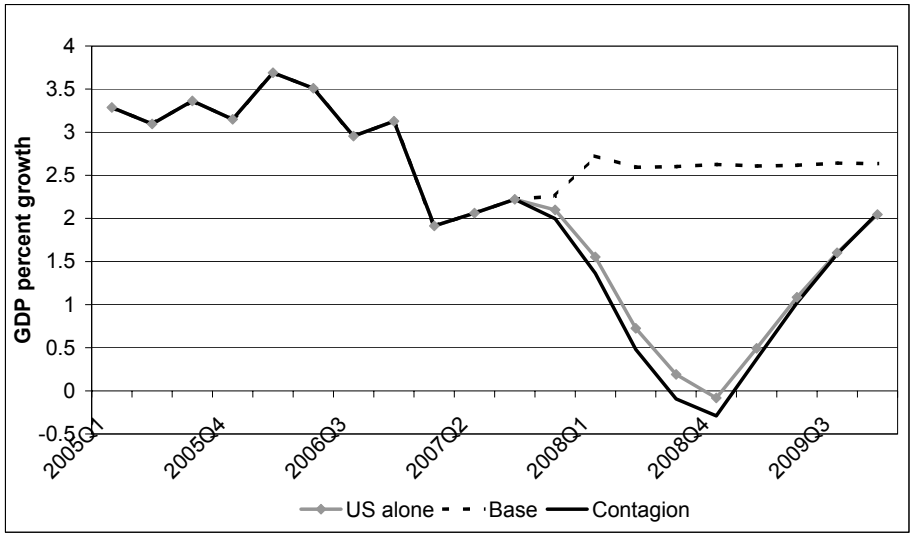
were to do so it would absorb some of the shock, and shift some back onto other countries.

Figure 1.4.4: Output Growth in the Euro Area



We do not assume contagion to Japan, in part because we have not seen it, and in part because Barrell and Davis (2007) find less evidence for it. In addition we do not shock the quality premium in emerging markets because the spread does not seem to have risen there. The impacts on the Euro Area are less than on the US, in part because we do not assume that housing markets will collapse in the same way, but also because equities play a smaller role in determining consumption in Europe than they do in the US.

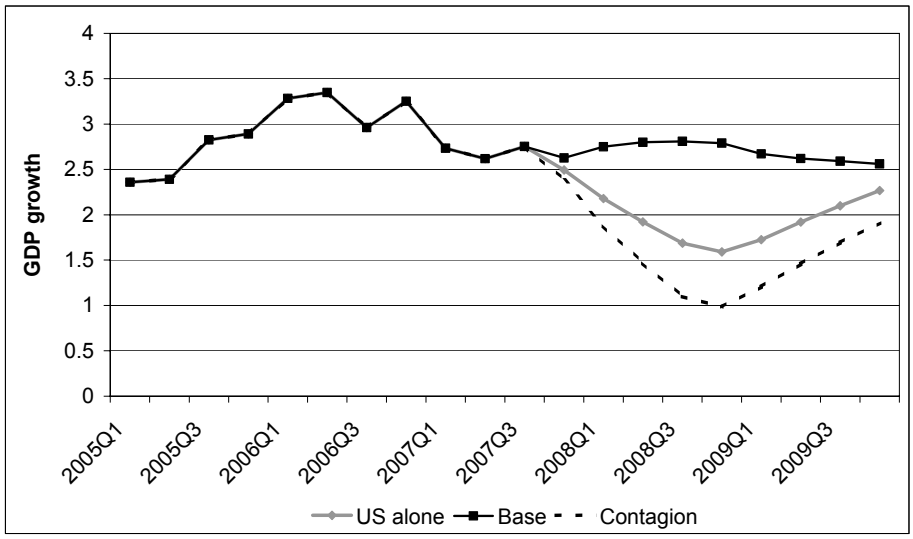
Figure 1.4.5: US Output in Crisis



The contagion to the Euro Area would feed back into the US and other countries, as we can see from Figures 1.4.5 and 1.4.6. Even if the Fed were to react the US would enter a full recession, and US interest rates would, following our feedback rule at least, be cut to zero for a full year after the crisis had had some time to develop. The Federal Reserve would find itself in the same position as the Bank of Japan through much of the 1990s. The liquidity trap would reduce the efficiency of its actions, and would make it hard to stimulate demand. Of course, it could cut rates more quickly than our policy

rule suggests, and it could keep them low for longer. Inflation is currently high, but in our contagion scenario it falls to around 0.25 in 2009 and 2010.

Figure 1.4.6: OECD Output in Crisis



Of course, we would hope and expect that the current crisis we are seeing is a short-term blip in the liquidity of the banking sector. This is the assumption underlying our forecast. Our simulations suggest that the effects of such a "blip" on the potential output of the Euro Area would be quite limited. Hence we have not made major changes to our forecast for 2008. However, if a full-blown banking crisis were to develop, then we could see several years of stagnation. There would be the danger that even if such a crisis were to originate in the US, contagion would see it spread immediately to Europe. It is the task of the Fed, the ECB and the other European central banks to ensure that such a crisis does not happen.

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FORECAST TABLES

Annex Table 1: Summary of Key Forecast Indicators for Euro Area[a]

	2003	2004	2005	2006	2007	2008	2009
Output Growth Rate	0.8	1.8	1.6	2.9	2.7	2.3	2.1
Inflation Rate	2.1	2.2	2.2	2.2	1.9	2.1	2.0
Unemployment Rate	8.7	8.8	8.6	7.9	7.0	6.5	6.2
Gov. Balance as % GDP	-3.0	-2.8	-2.4	-1.5	-0.9	-1.0	-0.9

a GDP data shown in the tables are adjusted for working-day variation.

Annex Table 2: Real GDP in Major Economies

	World	OECD	NAFTA	China	EU-27	Euro Area	USA	Japan	Germany	France	Italy	UK
	Annual percentage changes											
1997-2003	3.6	2.6	3.2	8.6	2.4	2.3	3.1	0.6	1.5	2.4	1.6	2.9
2004	5.3	3.3	3.6	10.1	2.3	1.8	3.6	2.7	0.6	2.3	1.0	3.3
2005	4.9	2.7	3.0	10.4	1.9	1.6	3.1	1.9	1.0	1.7	0.2	1.8
2006	5.4	3.2	3.0	10.7	3.1	2.9	2.9	2.2	3.1	2.2	1.9	2.8
2007	5.1	2.7	2.1	10.9	2.9	2.7	1.9	2.0	2.7	1.9	1.8	2.9
2008	4.8	2.5	2.3	9.8	2.4	2.3	2.0	1.7	2.2	2.3	1.5	2.2
2009	4.7	2.6	2.6	9.3	2.4	2.1	2.4	1.7	2.0	2.1	1.7	2.5

Annex Table 3: Private Consumption Deflator in Major Economies

	OECD	NAFTA	China	EU	Euro Area	USA	Japan	Germany	France	Italy	UK
	Annual percentage changes										
1997-2003	1.9	2.3	0.6	1.9	1.9	1.7	-0.5	1.1	1.1	2.5	2.0
2004	2.1	2.7	3.0	1.9	2.1	2.6	-0.6	1.6	1.5	2.6	1.7
2005	2.1	2.9	2.8	2.1	2.0	2.9	-0.8	1.5	1.4	2.4	2.5
2006	2.1	2.7	1.4	2.1	2.1	2.8	-0.3	1.4	1.4	2.7	2.4
2007	2.0	2.5	4.1	2.0	1.9	2.5	-0.3	1.8	1.1	2.1	2.6
2008	2.4	2.7	3.2	2.2	2.2	2.5	0.8	1.8	1.9	2.5	2.3
2009	2.3	2.6	2.8	2.0	2.0	2.2	1.4	1.9	1.6	2.0	2.1

Annex Table 4: World Trade Volume and Prices

	World trade volume	World export prices in $	Oil price ($ per barrel)[a]
	Annual percentage changes		
1997-2003	6.2	-1.0	21.6
2004	10.3	8.6	35.9
2005	7.2	3.4	51.8
2006	8.4	2.4	63.4
2007	7.0	7.3	66.6
2008	7.3	5.1	70.9
2009	6.4	3.0	70.0

[a] Based on the unweighted average of the Brent, WTI (West Texas Intermediate) and Dubai oil prices.

Annex Table 5: Interest Rates

	Short-term interest rates				Long-term interest rates			
	USA	Japan	Euro Area	UK	USA	Japan	Euro Area	UK
2004	1.6	0.0	2.1	4.6	4.3	1.5	4.1	4.9
2005	3.5	0.0	2.2	4.7	4.3	1.3	3.4	4.4
2006	5.2	0.2	3.1	4.8	4.8	1.8	3.9	4.5
2007	5.3	0.6	4.2	6.0	4.7	1.7	4.4	5.1
2008	4.4	0.8	4.3	6.0	4.7	1.8	4.5	5.3
2009	4.3	1.0	4.2	5.5	4.7	2.0	4.5	5.3
2007Q1	5.3	0.5	3.8	5.5	4.7	1.7	4.0	4.9
2007Q2	5.3	0.6	4.1	5.7	4.8	1.9	4.7	5.2
2007Q3	5.5	0.6	4.5	6.4	4.7	1.7	4.4	5.3
2007Q4	5.0	0.7	4.3	6.3	4.7	1.7	4.4	5.3
2008Q1	4.7	0.7	4.3	6.2	4.7	1.8	4.4	5.3
2008Q2	4.3	0.8	4.3	6.2	4.8	1.8	4.4	5.3
2008Q3	4.3	0.8	4.3	6.0	4.7	1.9	4.5	5.3
2008Q4	4.3	0.8	4.3	5.7	4.7	1.9	4.5	5.3
2009Q1	4.3	0.9	4.2	5.5	4.7	2.0	4.5	5.3
2009Q2	4.3	1.0	4.2	5.5	4.7	2.0	4.5	5.3
2009Q3	4.3	1.1	4.2	5.5	4.7	2.0	4.5	5.3
2009Q4	4.3	1.1	4.2	5.5	4.7	2.1	4.6	5.3

Annex Table 6: Effective Exchange Rates

	USA	Japan	Euro Area	Germany	France	Italy	UK
	Annual percentage changes						
2004	-4.3	3.7	5.2	2.3	2.2	2.5	5.2
2005	-2.6	-3.6	-1.0	-0.8	-0.3	-0.7	-1.4
2006	-1.3	-6.2	0.2	0.0	0.1	0.1	0.8
2007	-3.6	-4.3	3.4	1.5	1.7	1.7	3.1
2008	-1.3	2.9	2.2	1.0	1.0	1.1	-0.6
2009	0.1	1.1	1.2	0.5	0.5	0.6	-1.5
2007Q1	-0.4	-0.9	0.6	0.3	0.3	0.3	0.8
2007Q2	-2.6	-5.5	1.4	0.7	0.7	0.6	-0.4
2007Q3	-1.0	2.9	0.5	0.2	0.2	0.2	0.7
2007Q4	-0.1	3.0	0.9	0.4	0.4	0.5	-0.2
2008Q1	0.0	0.2	0.5	0.3	0.2	0.3	-0.3
2008Q2	0.0	0.3	0.2	0.1	0.1	0.1	-0.1
2008Q3	0.0	0.3	0.4	0.2	0.2	0.2	-0.6
2008Q4	0.0	0.3	0.3	0.1	0.2	0.2	-0.5
2009Q1	0.0	0.3	0.5	0.2	0.2	0.2	-0.5
2009Q2	0.1	0.3	0.1	0.1	0.1	0.1	-0.2
2009Q3	0.1	0.3	0.1	0.0	0.1	0.1	-0.2
2009Q4	0.1	0.3	0.1	0.0	0.1	0.1	-0.2

Annex Table 7: Euro Area, Main Features of Forecast[a]

	2003	2004	2005	2006	2007	2008	2009
	Annual percentage changes						
Volumes							
Consumption	1.2	1.5	1.5	1.9	1.7	2.4	2.2
Private investment	1.8	3.1	2.8	6.0	4.8	3.3	2.5
Government expenditure	1.8	1.0	1.4	2.1	2.1	2.0	2.0
Stockbuilding[b]	0.2	0.4	0.2	0.0	0.0	-0.1	0.0
Total domestic demand	1.7	2.1	1.9	2.7	2.3	2.4	2.2
Export volumes	1.1	6.5	4.6	8.2	5.8	4.2	3.7
Import volumes	3.2	6.3	5.3	7.8	5.1	4.7	4.0
GDP	**0.8**	**1.8**	**1.6**	**2.9**	**2.7**	**2.3**	**2.1**
Average earnings	3.0	2.3	2.3	2.9	2.8	3.4	3.4
Harmonised consumer prices	2.1	2.2	2.2	2.2	1.9	2.1	2.0
Private consumption deflator	2.2	2.1	2.0	2.1	1.9	2.2	2.0
Real personal disposable income	0.8	1.6	1.1	1.7	1.8	2.4	2.3
				Levels			
Standardised unemployment %	8.7	8.8	8.6	7.9	7.0	6.5	6.2
Government financial balance[c]	-3.0	-2.8	-2.4	-1.5	-0.9	-1.0	-0.9
Government debt[c]	69.3	69.8	70.8	68.9	66.6	64.4	62.7
Current account[c]	0.4	0.7	-0.1	-0.2	-0.5	-0.6	-0.6

[a] See footnote a of Annex table 1.

[b] Change as percentage of GDP.

[c] As a percentage of GDP.

Annex Table 8: Real GDP in the European Union [a]

	2004	2005	2006	2007	2008	2009
	Annual percentage changes					
Austria	2.2	2.4	3.1	3.5	2.4	2.0
Belgium	2.8	1.4	3.0	2.6	2.1	2.1
Denmark	2.1	3.1	3.5	1.5	1.6	1.7
Finland	3.7	2.9	4.9	4.8	3.2	2.9
France	2.3	1.7	2.2	1.9	2.3	2.1
Germany	0.6	1.0	3.1	2.7	2.2	2.0
Greece	4.7	3.7	4.3	4.0	3.1	2.9
Ireland	4.3	5.9	5.7	4.5	2.8	3.4
Italy	1.0	0.2	1.9	1.8	1.5	1.7
Netherlands	2.2	1.5	3.0	2.6	2.3	2.3
Portugal	1.3	0.5	1.3	2.3	2.2	1.8
Spain	3.3	3.6	3.9	3.9	3.2	2.7
Sweden	3.7	2.9	4.5	3.3	3.0	3.0
United Kingdom	3.3	1.8	2.8	2.9	2.2	2.5
Poland	5.2	3.6	6.1	6.4	5.5	5.3
Hungary	4.8	4.1	3.9	2.2	3.5	3.5
Czech Republic	4.6	6.5	6.4	5.6	4.5	4.1
Estonia	8.1	10.5	11.4	8.8	6.9	5.0
Latvia	8.2	11.2	12.0	9.8	7.5	6.7
Lithuania	7.3	7.6	7.5	8.0	7.1	6.0
Slovak Republic	5.4	6.0	8.3	9.1	7.3	6.1
Slovenia	4.0	4.3	5.5	5.0	4.3	3.9
Romania	8.5	4.2	7.7	5.7	5.4	4.9
Bulgaria	6.6	6.2	6.1	5.9	6.1	4.6
Euro Area	1.8	1.6	2.9	2.7	2.3	2.1
EU-15	2.1	1.7	2.9	2.7	2.3	2.2
NMS-12	5.4	4.9	6.3	6.0	5.3	4.9
EU-27	2.3	1.9	3.1	2.9	2.4	2.4

[a] GDP data shown in the tables are adjusted for working-day variation.

Annex Table 9: Harmonised Inflation in the European Union

	2004	2005	2006	2007	2008	2009
	Annual percentage changes					
Austria	1.9	2.1	1.7	1.9	1.7	1.5
Belgium	1.9	2.5	2.3	1.5	1.6	1.5
Denmark	0.9	1.7	1.8	1.5	2.0	2.0
Finland	0.1	0.8	1.3	1.5	2.3	2.3
France	2.3	1.9	1.9	1.4	1.8	1.6
Germany	1.8	1.9	1.8	2.0	1.8	1.9
Greece	3.0	3.5	3.3	2.6	2.6	2.5
Ireland	2.3	2.2	2.7	2.8	2.9	2.8
Italy	2.3	2.2	2.2	1.9	2.2	2.0
Netherlands	1.4	1.5	1.6	1.6	2.4	2.2
Portugal	2.5	2.1	3.0	2.3	2.3	2.1
Spain	3.1	3.4	3.6	2.4	2.6	2.6
Sweden	1.0	0.8	1.5	1.7	2.3	2.1
United Kingdom	1.3	2.1	2.3	2.3	2.0	2.0
Poland	3.6	2.2	1.3	2.1	2.7	3.0
Hungary	6.8	3.5	4.0	7.7	4.4	3.6
Czech Republic	2.6	1.6	2.1	2.5	3.4	3.7
Estonia	3.0	4.1	4.4	5.8	5.8	6.3
Latvia	6.2	6.9	6.6	8.2	7.0	7.0
Lithuania	1.2	2.7	3.8	4.8	5.0	4.9
Slovakia	7.4	2.8	4.3	1.9	2.3	2.6
Slovenia	3.7	2.5	2.5	3.1	2.7	2.6
Romania	11.9	9.1	6.6	4.0	4.3	3.4
Bulgaria	6.1	6.0	7.4	5.6	5.4	5.5
Euro Area	2.2	2.2	2.2	1.9	2.1	2.0
EU-15	2.0	2.1	2.2	1.9	2.1	2.0
NMS-12	5.0	3.5	3.2	3.6	3.6	3.6
EU-27	2.3	2.3	2.3	2.1	2.2	2.1

Annex Table 10: Fiscal Balances in the EU-15

	2004	2005	2006	2007	2008	2009
			% GDP			
Austria	-1.3	-1.7	-1.2	-0.5	-0.6	-0.5
Belgium	-0.1	0.0	0.1	-0.4	-0.8	-0.8
Denmark	2.0	4.7	4.2	3.9	2.5	2.5
Finland	2.3	2.7	3.9	4.2	3.8	3.6
France	-3.6	-3.0	-2.5	-2.7	-3.1	-3.0
Germany	-3.7	-3.4	-1.6	0.2	0.2	0.3
Greece	-6.2	-4.5	-2.3	-2.4	-2.4	-2.4
Ireland	1.5	1.0	2.9	0.8	0.2	0.6
Italy	-3.5	-4.2	-4.4	-2.5	-2.5	-2.3
Netherlands	-1.8	-0.3	0.5	-0.3	0.5	1.1
Portugal	-3.3	-5.9	-3.9	-3.6	-3.1	-3.1
Spain	-0.2	1.1	1.8	1.2	0.6	0.5
Sweden	0.8	2.1	2.2	2.3	2.1	1.8
United Kingdom	-3.4	-3.4	-2.8	-2.8	-2.4	-2.1
Euro Area	-2.8	-2.4	-1.5	-0.9	-1.0	-0.9
Eu-15	-2.6	-2.3	-1.5	-1.0	-1.1	-0.9

Fiscal deficits of NMS are not included due to incomparability of available data. Some countries have taken the opportunity to temporarily present the surplus in the second pillar pension funds as part of general government sector balance. In spite of the fact that the transitional period has passed in March 2007, the most recent convergence reports available for NMS are dated prior to the deadline so do not yet include the harmonized fiscal statistics.

Annex Table 11: Standardised Unemployment Rate in the European Union

	2004	2005	2006	2007	2008	2009
			% Total labour force			
Austria	4.8	5.2	4.7	4.3	4.2	4.0
Belgium	8.4	8.5	8.3	7.5	7.1	7.0
Denmark	5.5	4.9	3.9	3.5	3.4	3.9
Finland	8.9	8.3	7.7	6.8	6.2	6.2
France	9.6	9.7	9.0	8.1	7.9	7.7
Germany	9.5	9.4	8.4	6.7	6.1	6.0
Greece	10.5	9.9	8.9	8.3	8.2	8.5
Ireland	4.5	4.3	4.4	4.6	5.3	5.2
Italy	8.0	7.7	6.8	6.1	6.0	5.6
Netherlands	4.5	4.7	3.9	3.3	3.0	3.1
Portugal	6.6	7.6	7.6	8.2	7.6	7.6
Spain	10.6	9.1	8.5	8.0	7.2	6.4
Sweden	6.3	7.3	7.0	5.7	5.2	4.8
United Kingdom	4.8	4.9	5.4	5.4	5.6	5.9
Poland	18.9	17.7	13.8	10.0	9.0	8.5
Hungary	6.1	7.2	7.5	7.6	7.2	7.1
Czech Republic	8.3	7.9	7.1	5.7	5.7	5.8
Estonia	9.7	7.8	5.9	5.1	4.2	3.7
Latvia	10.4	8.9	6.8	5.8	5.3	5.0
Lithuania	11.4	8.2	5.6	4.8	4.5	4.6
Slovakia	18.2	16.2	13.4	10.8	10.2	10.1
Slovenia	6.3	6.5	6.0	5.2	4.9	5.1
Romania	8.1	7.1	7.3	6.8	6.2	5.2
Bulgaria	12.0	10.1	8.9	7.0	6.3	6.5
Euro Area	8.8	8.6	7.9	7.0	6.5	6.2
EU-15	8.0	7.9	7.4	6.6	6.3	6.2
NMS-12	13.5	12.5	10.3	8.1	7.5	7.1
EU-27	9.0	8.7	7.9	6.9	6.5	6.4

2. EUROPEAN POLICY MONITORING

2.1 Monetary Policy in the Euro Area

Recent turbulences on financial markets, have – just like in other countries – significantly affected the level of interest rates also in the Euro Area. Money market rates that had continued to increase at moderate pace until the beginning of August, reflecting the gradual tightening campaign of the ECB, jumped to substantially higher levels in the following weeks. By mid September 2007, the 3-month EURIBOR has gone up to almost 4.8 per cent. While the level of 4.2 per cent that prevailed in July has been in line with expectations of market participants that the ECB would raise key interest rates in early September by another 25 basis points, the strong increase in the recent past cannot be explained by movements in the expected refi-rate. It rather reflects the shortfall of the credit supply as a reaction to uncertainties about credit risks linked to the US sub-prime mortgage market that have spread out through highly leveraged derivatives and structured instruments. Facing an immeasurable uncertainty about underlying credit quality and counterparty risks, a general lack of confidence against other market participants developed and investors started to reduce risk in an indiscriminate fashion, almost stopping to lend to each other. In response, the ECB provided ample liquidity so that the market for overnight money soon calmed down and rates returned to their normal level. However, rates for longer maturities, e.g. 3-month money, remained at elevated levels and even continued to increase, although at a slower pace, even though the ECB provided liquidity for this part of the money market, too.

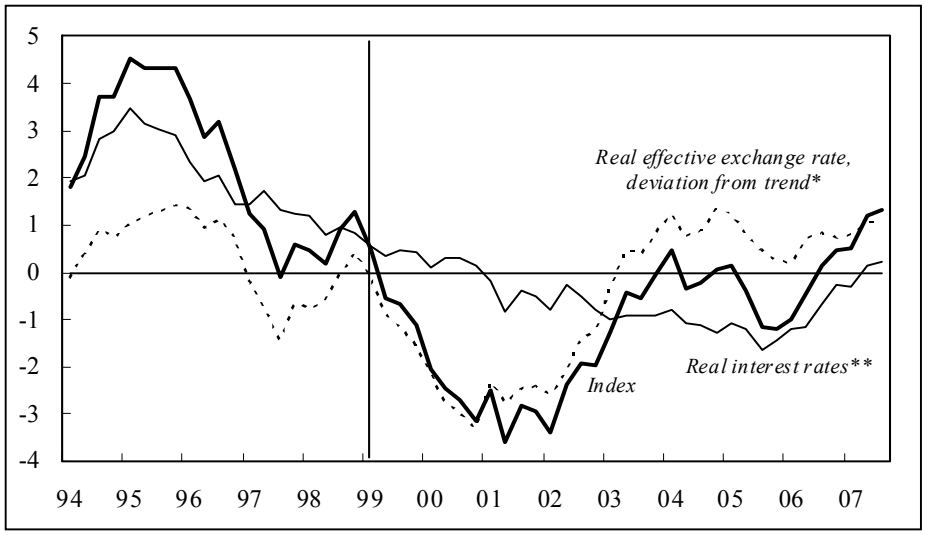
With investors shying away from the money market, government securities rallied substantially in recent weeks as they were obviously seen as a safe haven. The yield for 10-year government bonds fell to 4.2 per cent in mid-September, after having gradually increased to almost 4.5 per cent in the first half of the 2007.

All in all, monetary conditions have deteriorated considerably as a consequence of the turbulences. The real short-term interest rate, calculated as the difference between the nominal rate and core inflation, rose to approximately 2 ¾ per cent which is considerably higher than a few months ago when it was about 2 per cent and close to what generally is regarded as a "neutral" level. The conditions of refinancing for the corporate sector also deteriorated as a consequence of lower stock prices and higher risk premia on corporate bonds. The impact of the recent turmoil in the money markets on credit availability is currently still unclear. While there is some indication that banks have tightened credit standards somewhat there is still no evidence of an outright credit crunch developing. During the drastic changes of interest rate sand asset prices, the US-dollar initially gained some strength against major currencies, but lost ground in recent weeks with the euro marking a new all-time high against the dollar. As far as the international competitiveness is concerned, the effects are, however limited so far. The euro has appreciated only very little in real effective exchange terms since the beginning of this year.

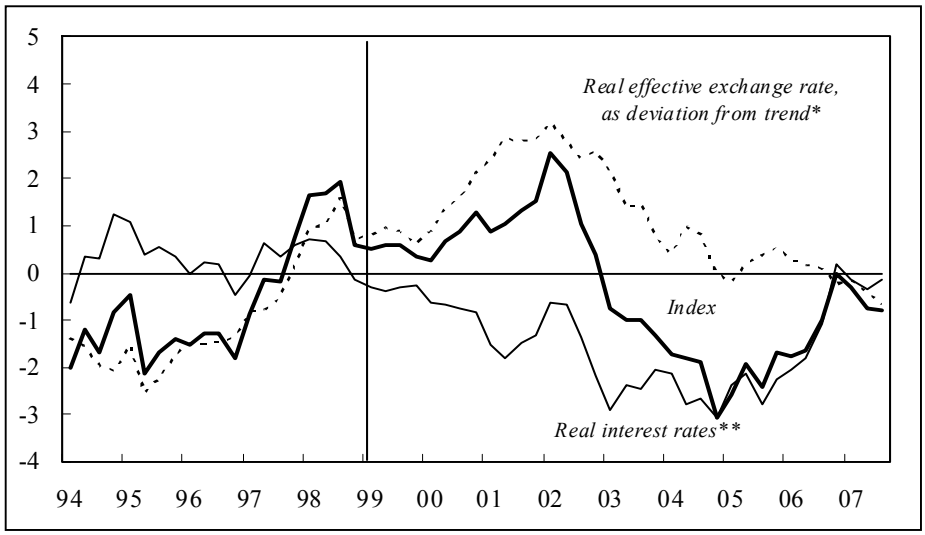
The deterioration of monetary conditions is also confirmed by our monetary conditions index (MCI) The MCI is a combination of real interest rates adjusted for trend growth of real GDP and the detrended real effective exchange rate (Figure 2.1.1). As far as the Euro Area is concerned, the real interest rate moved up as a result of higher nominal rates and lower inflation, and the exchange rate also contributed to the deterioration as the euro appreciated slightly in real terms. By comparison, the index for the US shows a slight improvement because inflation went up at roughly constant nominal interest rates and the real effective exchange rate came down slightly.

Figure 2.1.1*:* Monetary Conditions for the Euro Area and the US

Monetary conditions for the Euro Area



Monetary conditions for the US



Notes: The index is calculated as: 1*Interest rate component+ 0.2*Exchange rate component.

*1991–2006 average; component weighted according to its weight in the index (0.2); **Average of long-term and short-term interest rates less annual consumer price inflation less smoothed GDP growth. The MCI's methodology is based on "Disparités de croissance et de politiques économiques en Europe", Catherine Mathieu and Olivier Passet, Revue de l'OFCE no. 64, janvier 1998.

Sources: OECD, national sources, own estimates.

The outlook for interest rates crucially depends on how the problems in the financial market play out. The EUROFRAME-Institutes assume that the uncertainty in financial markets about the level of potential losses from investments in US mortgage backed securities and where they will finally accrue will fade relatively soon. As a large part of these paper is financed short-term and has to be refinanced in the coming weeks, potential problems should become more and more disclosed, and this should facilitate a return to normality in the money market. We expect that 3-month money market rates will decline gradually over the coming months, again reflecting mainly the expected interest rate policy by the ECB by year end; the 3-month EURIBOR is assumed to be back to 4.3 per cent in December. In this scenario the effects of temporarily higher interest rates on the real economy should be quite limited.

On September 6, the ECB kept its key interest rate (the minimum bid rate in the Eurosystem's main refinancing operations) constant at 4 per cent. This was a deviation from the previous course of gradual raising interest rates that the ECB had indicated it would continue for the time being in previous announcements. It was however, already widely expected after more recent comments on the developments in the financial markets. Apparently, the ECB wants to accumulate further evidence on the impact of the freeze in the money markets on the outlook for the real economy and finally prices.

In the comments on the interest rate decision, the ECB stressed that it has two prime responsibilities. The first is to ensure price stability over the medium term, the second is to ensure a smooth functioning of the money market. In meeting the latter responsibility, the ECB will be quick to address any signs of a significant and undesired tightening in credit conditions by supplying additional liquidity. In line with this assessment, the ECB council decided to launch another additional longer-term refinancing operation in its most recent meeting. On the other hand, we would not expect central bank interest rates to be lowered to counter stress in the financial markets unless the outlook for inflation was significantly affected. Such a stance is consistent with the century-old conventional wisdom that central banks in periods of financial market turmoil should lend freely in order to ensure liquidity, but at high interest rates in order to reduce the problem of moral hazard.

Concerning first responsibility, maintaining price stability, the ECB still sees risks for inflation tilted to the upside, a judgement that is based on both the monetary and the economic analysis. One reason for this assessment is the rapid growth of monetary and credit aggregates. In fact, M3 growth even accelerated in recent months reaching more than 11 per cent y-o-y. Loans to the private sector have continued to increase at double-digit rates although there has been some moderation mainly as a result of less dynamic lending for consumer credit and lending for households. In the economic analysis the outlook has not changed materially since June. The staff projections for real GDP growth have been reduced only slightly to 2.5 per cent this year and were kept unchanged at 2.3 per cent for next year (see Table). With growth at such a level, capacity utilization in the Euro Area should remain high or rise even further. The outlook for inflation was unchanged at 2.0 per cent in both years. In the baseline scenario adopted for this EUROFRAME report, with money markets calming relatively soon and the fallout in the real economy limited, these projections should not be revised substantially soon, and the ECB is expected to perform in December the rise in interest rates by 25 basis points that was originally scheduled for September. That said, the ECB will certainly closely watch developments in the economy, also taking account of moves in the exchange rate. There is a relatively large chance that the ECB drops another rate hike from the agenda in the event that the economic environment

should look less reassuring than projected here, especially in the event that the Fed cuts interest rates aggressively. Even rate cuts would be a likely response should one of the larger risks discussed in the report materialize.

In any case, the ECB is not expected to raise key rates any further than to 4.25 per cent over the forecast horizon. This projection is supported by our estimate of a forward looking Taylor rule.1 According to our forecast, overall capacity utilization in the Euro Area will increase only slightly, and according to the Professional Forecasters, the inflation rate will be near 2 per cent. Assuming that the ECB will behave in the same fashion as in the past, the key interest rate will most likely remain at 4.25 per cent.

Table 2.1 Eurosystem Staff Macroeconomic Projections for the Euro Areaa

Date	Real GDP growth 2007	Real GDP growth 2008	HICP inflation 2007	HICP inflation 2008
September 2006	2.1	..	2.4	..
December 2006	2.2	2.3	2.0	1.9
March 2007	2.5	2.4	1.8	2.0
June 2007	2.6	2.3	2.0	2.0
September 2007	2.5	2.3	2.0	2.0

[a]Middle of the respective confidence bands (percentage change over previous year).

Source: ECB, Monthly Bulletin, various issues.

2.2 Fiscal Policy in the Euro Area

In 2006, budgetary positions have improved much more rapidly than expected in the Euro Area, especially in Germany. This was also the case for Italy although it does not show in terms of the global deficit because of the impact of exceptional measures. This year again, budgetary positions are likely to improve more rapidly than expected in the Euro Area. A major surprise will be again on the German side, with government deficit now forecast to turn into a slight surplus instead of 0.5 percentage point deficit in our Spring forecast at unchanged GDP prospects. Budgetary positions have also improved more rapidly than expected in several other countries, among them the Netherlands and Ireland, which we will address below. In general, the larger than expected improvement in budgetary positions this year does not result from higher growth and results only partly from discretionary measures. Other elements have play a role, first of all higher than usual revenues to GDP elasticity.

The fiscal stance has been contractionary at the Euro Area level over the last years, mainly in countries running deficits. We expect the fiscal stance to remain slightly contractionary in 2007 and come close to neutral in the two coming years at the Euro Area level. In two of the four remaining countries currently running close to 3 per cent of GDP deficits - Greece and Portugal - the fiscal stance will remain contractionary. However, the fiscal effort is forecast to be less restrictive than announced in the updates of the Stability Programmes (SPs) at the turn of 2005-2006 and below the 0.5 percentage point of GDP requested by the rules of the Stability and Growth Pact (SGP). France will probably be major exception, at least in view of government

[1] See Box 2.1 in the Autumn 2006 Report.

measures announced at the time of our forecast, with a positive fiscal impulse possibly bringing the deficit slightly above 3 per cent of GDP in 2008.2 In most countries running close to balance positions or surpluses, fiscal policies are expected to be close to neutral, at the noticeable exception of the Netherlands where the fiscal stance will be contractionary both in 2008 and 2009.

With GDP growth decelerating from 2.7 per cent in 2007 at 2.1 per cent in 2009 and a close to neutral fiscal stance, the Euro Area deficit would remain at around -1 per cent of GDP. This would mean that the objective of 0 per cent of GDP deficits in 2010 would be difficult to reach at the Euro Area level. However a 1 per cent of GDP Euro Area government deficit is low from a historical perspective and as compared to deficits elsewhere in the industrial world.

2.2.1 GROWTH PROSPECTS

We expect Euro Area GDP to grow by 2.7 per cent this year before decelerating to 2.3 per cent next year and 2.1 in 2009. We have hardly revised our GDP growth prospects for 2007 since our Spring forecasts, both at the area and country level. The main revision has been for France, where the figures of national accounts up to the second quarter of 2007 lead us to revise our forecast downwards from 2.2 per cent to 1.9 per cent.

In 2006, Euro Area GDP grew more rapidly than announced in the SP's (2.9 per cent instead of 2.5 per cent, see Table 2.2). This now seems to have been also the case in 2005, accounting for GDP data revisions GDP growth had already been underestimated in the course of the recovery of the early 1990's, although the recovery was then stronger than now. We forecast the peak of growth to be already behind us and GDP to grow up to 2009 at around 2.2 per cent per annum, i.e. very close the SPs assumptions.

[2] Exhaustive information on the forthcoming budget was however not available for France at the time we were producing our forecast. The French government will announce its budget plans for 2008 and 2009 on September 26th. The situation is similar for Italy, where budget plans will be announced at the end of September.

Table 2.2: Euro Area GDP growth and general government balances according to the stability programmes

	GDP growth assumptions (per cent)										General government balance (per cent of GDP)									
	Stability Programmes									Actua	Stability Programmes									Actual
	J99	J00	J01	J02	J03	J04	J05	J06	J07		J99	J00	J01	J02	J03	J04	J05	J06	J07	
98	2.8									2.7	-2.1	-1.9								-2.3
99	2.5	2.2								2.9	-1.7	-1.4	-1.2							-1.4
00	2.6	2.8	3.3							4.0	-1.5	-1.1	-0.7	-0.8						-1.0
01	2.6	2.5	3.1	1.7	1.5					1.9	-1.0	-0.8	-0.6	-1.2	-1.6					-1.8
02		2.5	2.9	1.9	1.0					0.9		-0.6	-0.3	-0.9	-2.2					-2.5
03		2.5	2.8	2.6	2.1	0.6				0.8		-0.2	0.0	-0.5	-1.8	-2.7				-3.1
04			2.8	2.6	2.6	1.9	2.0			1.8			0.4	0.1	-1.1	-2.4	-2.7			-2.8
05				2.6	2.6	2.5	2.3	1.4	1.3	1.6				0.3	-0.6	-1.8	-2.3	-2.6	-2.4	-2.4
06					2.6	2.5	2.4	2.1	2.5	2.9[1]					-0.2	-1.3	-1.8	-2.4	-2.0	-1.5[1]
07						2.5	2.4	2.0	2.1	2.7[1]						-0.9	-1.3	-1.9	-1.4	-0.9[1]
08							2.4	2.2	2.2	2.3[1]							-1.0	-1.4	-1.1	-1.0[1]
09								2.2	2.2	2.1[1]								-0.9	-0.6	-0.9[1]
10									2.2	–									-0.1	–

1. EUROFRAME-EFN, Autumn 2007 Forecast.
Sources: EUROFRAME-EFN, Stability programmes, Eurostat, own calculations.

2.2.2 GOVERNMENT BALANCES

GDP grew by 2.9 per cent in 2006, instead of 2.5 expected in the SP's, while deficits decreased from 2.4 per cent of GDP in 2005 to 1.5 in 2006, instead of 2 per cent in the SPs. The reduction in the Euro Area government deficit can be explained partly by stronger than expected growth: 0.2 percentage point under usual unitary elasticity of revenues to GDP. Another 0.2 percentage point would thus be explained by non cyclical factors. However, the improvement in government balances has been more rapid than usually, not only because of more tightening discretionary measures but also of higher than usual revenues to GDP elasticity. On the latter element, we will focus below on recent developments in Germany, Italy, the Netherlands and Ireland.

UNEXPECTED REVENUES GROWTH IN RECENT PAST: THE EXPERIENCE FROM FOUR COUNTRIES

GERMANY

Tax revenues will rise much stronger than nominal GDP in 2007 as was already the case in 2006. The increase of tax revenues will amount to 10.7 per cent (cash basis, not in terms of NIPA) (Graph 2.2.1), while GDP will probably increase by 4.2 per cent. The tax ratio which had declined in the early 2000's rose by 1.3 percentage points (2006: 21 per cent; cash basis). It reached the level which had been "normal" in the 1990's.

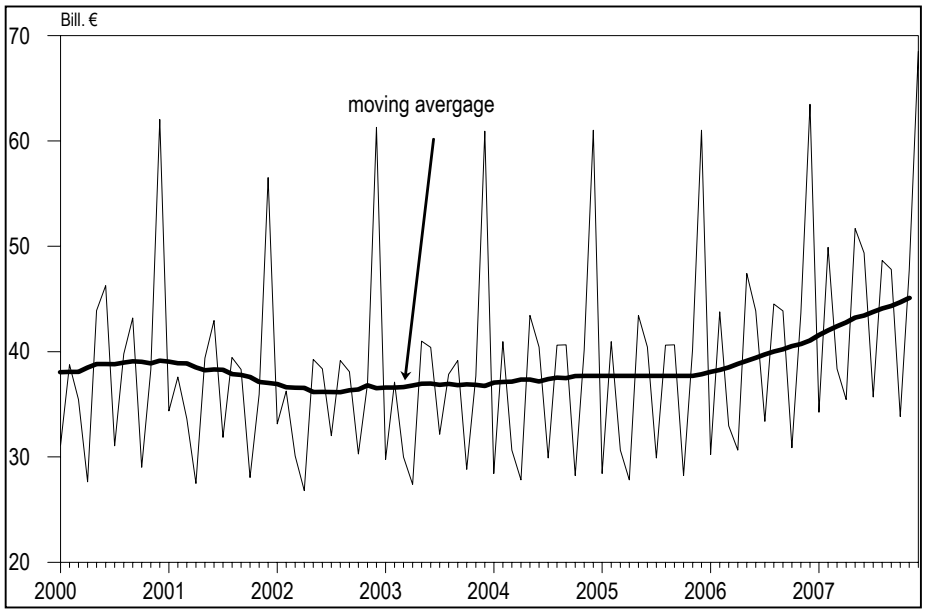
The increase in taxes on capital income (corporate income tax, assessed income tax, withholding tax on dividends and interest income) will be very high in 2007 (Graph 2.2.2), at an expected 14.5 per cent. Besides, the revenues of the Gewerbesteuer (tax on profits and on parts of interest paid by firms) will increase by 20 per cent in 2007. VAT revenues have continued to rise more rapidly than private consumption, their most important determinant (Graph 2.2.3).

It is not yet clear why tax revenues surged in 2006 and 2007. There are only some elements of an explanation:

1. Taxable incomes and taxable profits were higher than expected due to an underestimation of the effects of tax base broadening measures (e.g. restrictions to carrying losses forward) which had been decided upon in recent years.
2. Due to the lag structure of assessed taxes, there was a reaction on the poor development of assessed tax revenues in the period 2002–2004.
3. As a result of the upswing, the number of insolvent firms went down. In addition, the fight against tax fraud seems to be successful to some extent. Thus, losses of VAT revenues probably were much smaller than in the previous years.

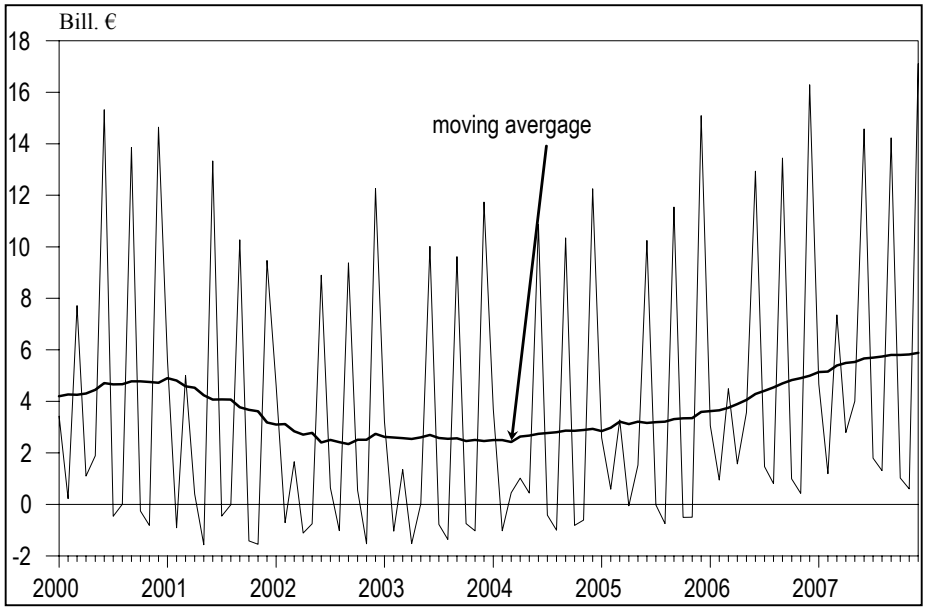
Overall, tax revenues developments in 2006 and 2007 may have been a kind of reaction on the poor development in the period 2002–2005. We do not expect a further strong increase of tax revenues in 2008 and 2009. In addition, the reform of business taxation will lead to a loss of revenues in the range of 6.5 billion euros in 2008 and somewhat less in 2009.

Figure 2.2.1*:* Tax Revenues in Germany 2000-2007



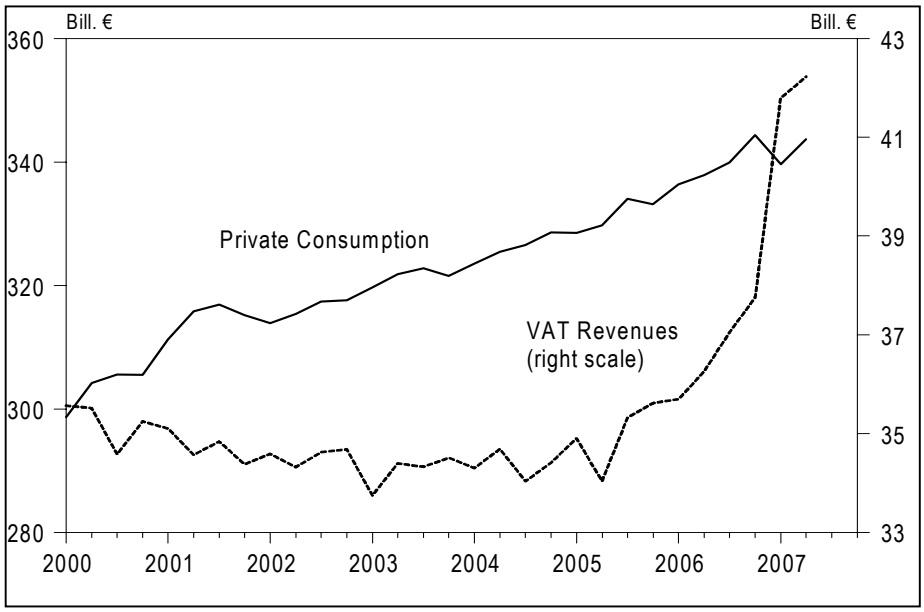
Source: Federal Ministry of Finance.

Figure 2.2.2 Capital Income Tax Revenues in Germany 2000–2007



Source: Federal Ministry of Finance.

Figure 2.2.3 Private Consumption[a] and VAT Revenues[a] in Germany 2000–2007



[a]Seasonally adjusted.

Source: Deutsche Bundesbank.

ITALY

The improvement in general government net borrowing in 2006 was unexpectedly large, from 4.1 to 2.4 pp of GDP (excluding the extraordinary burden related to the judgment of ECG concerning VAT, 1.2 pp, and the decision to cancel the State's claims on TAV Spa, 0.8 pp), while the government estimate published in the Stability Programme update in December 2006 was by 3.6 per cent. The decrease of deficit reflected the increase of fiscal burden by 1.7 pp of GDP, from 40.6 to 42.3 per cent, with a contribution of the tax components near to 1.6 points.

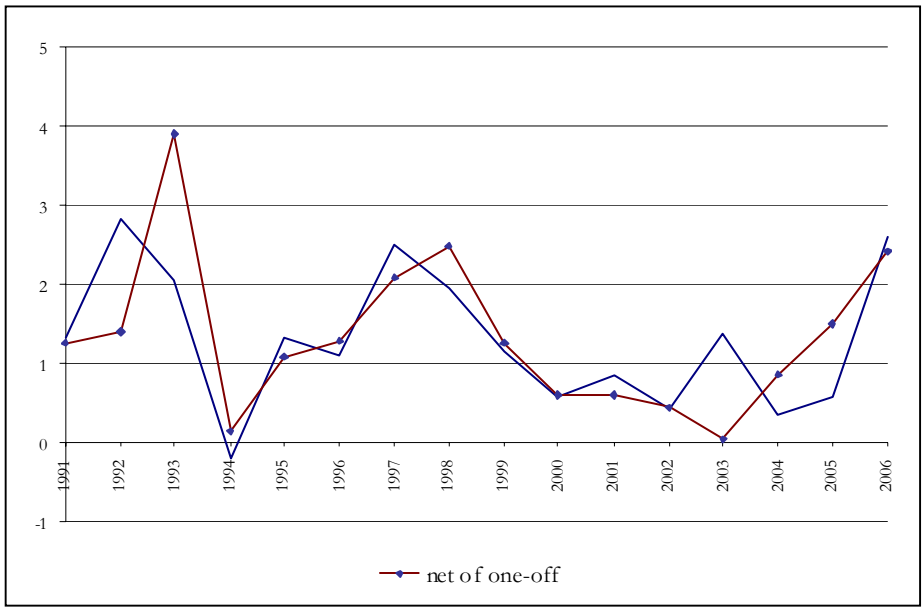
The divergence with respect to the forecasts in SP updates is only partly due to a more favourable economic growth (1.9 versus 1.6). The increase in tax revenues was larger than forecasted and larger than would have been consistent with the changes in the corresponding bases. The infra annual information on tax receipts has determinate several upward revisions in the forecasts of tax revenues growth, as the table below shows:

Table 2.3: General government – taxes (rate of growth)

Forecasting and Planning Report - October 2005	2.6
Quarterly report on the Borrowing Requirement - April 2006	4.2
Economic and Financial Planning Document - July 2006	5.9
Forecasting and Planning Report - October 2006	6.8
Outturn, ISTAT March 2007	10.0

In general, the growth of tax receipts in 2006 is evidence for the sharp increase of elasticity of revenues with respect to GDP. Taxes increased by 9.5 per cent, 8.9 per cent net of one-off, while nominal GDP increased by 3.7 per cent.

Figure 2.2.4: Elasticity of Revenue with respect to GDP



The elasticity in 2006 is close to the values of 1992-1993 and 1997-1998, when budgetary consolidation was intensified and structural changes in taxes were enacted primarily with the aim of increasing revenues (the revisions of VAT and personal income rates and the curbs on the correction of fiscal drag in 1992-93; the tax system reform in 1998). On the contrary, in 2006 the measures enacted did not involve changes in tax rates.

More in detail, according to our estimation the growth of tax revenues in 2006 can be attributed to several factors, which we can group in four categories:

Table 2.4 Composition of additional tax revenues, in % of GDP

Macroeconomic growth	0.9%
Discretionary measures	0.6%
One-off and extraordinary items	0.6%
Other items	0.5%
Total	2.6%

At first, we take into account the effects of macroeconomic recovery, which explains a 30 per cent of the total growth in fiscal receipts. A 23 per cent of the growth can be attributed to the measures of Budget Law and other discretionary fiscal measures implemented by government in 2006. A further class includes extraordinary and temporary factors. In this group we can set direct tax receipts paid by public employees on back payment in the first part of the year, tax on insurance companies' mathematical provisions, increase of the taxes on capital income due to the large increase in redemptions of post office savings and the effects of the increase in the prices of oil and other energy products on VAT.

The latter group corresponds to the un-explicated fraction of major receipts. Trying to give reasons for this residual increase of revenues, we made some exercises with Prometeia's macroeconomic model. If we run the budgetary equations of the model with the tax basis and other economic variables at their historical values, we can test for the presence of a structural break of the budgetary equations. All in all, this analysis seems coherent to an increase of taxpayers' compliance due to the intensifications of the measures to fight tax evasion and avoidance. This is particularly noticeable in the growth of VAT and personal income taxes.

More in detail, for direct taxes the total error which came from the model was about 70 per cent larger in 2006 estimation than in the previous five years. If we do not include the one off revenues, the error decreases, but it remains 35 per cent larger than in the previous years anyway.

Among direct taxes, personal income taxes grew by 6.3 per cent, while salaries and pensions grew by 3.7 per cent. The observed elasticity from 1 per cent calculated in the last two years is by 1.9 per cent in 2006. This effect seems to confirm an increase in the reactivity of tax receipt to personal income (fiscal drag was estimated about 2 billion of euros) caused by previous reforms and measures aimed to broaden the taxable base of self-employed.

Also receipts of the taxes on capital income grew sharply, by 36.4 per cento, 28.3 per cent net of one-off factors (redemptions of post office savings), but in this case the rise is consistent with the growth in the tax base.

For indirect taxes we have a similar outcome. In 2006 estimation, the equations error is by 50 per cent larger than in the previous five years, 32 per cent if we do not consider one-off revenues.

The increase of VAT was particularly large, 9.2 per cent, while the related consumptions in national account data increased by 3.2 per cent. The observed elasticity of VAT revenues with respect to the tax base grew from the average of 1.5 of the previous two years to 3. This increase could reflect in part the shift in the composition of household spending towards durable goods, which are subject to higher VAT rate, and the role of large-scale retailing, which reduces the possibility of evading VAT. In the model equations, the observed increase of elasticity of VAT can explain about of 80 per cent of the increase in error on indirect taxes estimation.

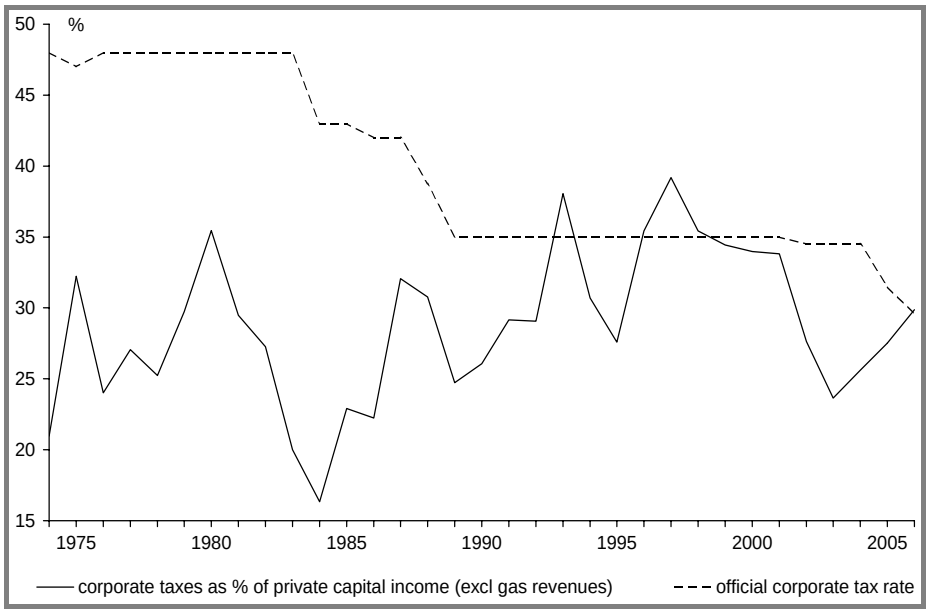
NETHERLANDS: CORPORATE TAXES IN HISTORICAL PERSPECTIVE

Forecasting corporate tax returns proves to be a wearisome exercise and errors in forecasting government revenues often relate to corporate taxes. The windfall in profit taxes in the Netherlands in 2005 and 2006, which helped to reduce the government deficit beyond the budget proposals, is a clear example.

Figure 2.2.5 shows the statutory corporate tax rate and actual corporate tax returns on a cash basis as a per cent of private capital income in the Netherlands over the period 1975-2006. Two striking features emerge. Firstly, in spite of the decline of the statutory rate actual tax return are on a slightly upward sloping trend, implying a broadening of the tax base. Secondly, actual tax returns as a percentage of private capital income show extreme annual fluctuations, from 16 per cent to 39 per cent.

Numerous changes in the laws affecting the tax base were carried through over the reference period. The impact of these measures on actual returns is often difficult to gauge, reducing the reliability of revenue projections. However, the single most important factor explaining the large fluctuations of actual tax returns is the asymmetric treatment of profits and losses. Profits are followed by a positive assessment, but losses do not result in a negative assessment, but opens up the possibility of clearing with profits in other years. Macro-economic profits, which are hard to forecast anyway, are the balance of profits and losses and can result from high profits and high losses or of low profits and low losses, with completely different implications for tax returns. The timing of the clearing of losses constitutes also a considerable element of uncertainty. Moreover, we often lack reliable data on recent corporate tax returns, negatively affecting the projection base.

Figure 2.2.5: Corporate Tax Rate and Returns as a % of Private Capital Income



IRELAND: THE EFFECT OF THE HOUSING MARKET

Figure 2.2.6 illustrates the extent to which tax revenue in Ireland has diverged from the targets outlined in the Budget. In the earlier part of this decade there was substantial undershooting of tax revenue, while in more recent years tax revenue has overshoot forecasts. In 2006 the overshoot in revenue was particularly strong at 9.3 per cent.

Figure 2.2.6: Tax Revenue in Ireland: Difference Between Outturn and Budget Target

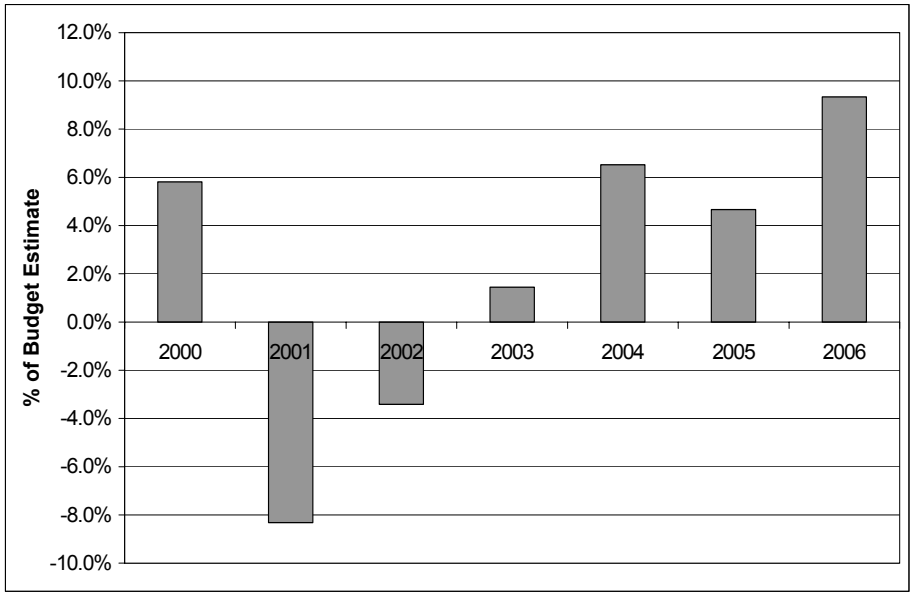


Table 1 shows the overshoot by individual tax heads for 2006. The table shows that the largest tax heads experienced the smallest forecast error, while the overshoot on stamp duty and capital gains tax was considerable. Much of this error can be attributed to the exceptional growth in the Irish housing market[3] which has made the forecasting of housing related tax revenue very difficult.

Table 2.5: Overshoot in Revenues in 2006 by Tax Head

	Share of Total Outturn	Overshoot (as a % of Budget Estimate)
Income Tax	27%	4.9%
VAT	30%	2.7%
Corporation Tax	15%	10.8%
Excise Duties	12%	1.8%
Stamp Duty	8%	38.4%
Capital Gains Tax	7%	52.3%
Capital Acquisitions Tax	1%	35.8%
Customs	1%	7.1%

Figure 2.2.7 plots the annual aggregate tax revenue to GDP elasticity from 1990 to 2006. Over the period the average elasticity is 1.04, however it is clear from the graph that it can deviate significantly from this average in individual years, and indeed for periods of years. From the graph, we can see that between 1996 and 2003 the actual elasticity was below the average, while in

[3] Between 2000 and 2005 house prices have increased by around 63 per cent, while housing completions were 93.4 thousand in 2006 (around half of the UK level).

more recent years it has been above the average, with an elasticity close to 2 in 2006.

Figure 2.2.7: Aggregate Tax to GDP Elasticity

2.2.3 BUDGETARY POSITIONS AND EXPECTED FISCAL STANCE

Euro Area countries can be split into four groups in terms of recent budgetary positions and developments:

- Countries having improved their budgetary positions and now expected to run close-to-balance budgetary positions or even surpluses in 2007: Germany, Austria.
- Countries keeping a close to balance position: Belgium, the Netherlands.
- Countries keeping fiscal surpluses: Finland, Ireland, Spain
- Countries keeping deficits: France, Italy, Portugal, Greece

The fiscal stance has been contractionary at the Euro Area level in recent years, mainly in countries running deficits. The estimate of the fiscal stance is based among other things on unitary revenues to GDP elasticity, and we have seen above that these have been higher than expected in recent years in some countries and for some revenues. The estimate also depends on potential output growth. Table 2.6 shows two estimates of the expected fiscal stance in the Euro Area, based on our forecasts for GDP and government deficits. The first measure uses potential output growth taken from the SP's, leading to a potential growth close to 2 per cent for the Euro Area as whole. The second measure uses NiGEM estimates that suggest Euro Area trend output has been accelerating in recent years from 1.7 to 2.2 per cent, mainly under the effect of a more rapid German trend output. At the country level, Germany has been in recent year a major case for uncertainty in terms of potential output growth. The recent German economic acceleration of growth has led to upwards revisions of German potential output growth, now often assumed to be closer to 2 per cent than 1.5 per cent a few years ago and in the latest update of the SP.

Table 2. 6: GDP growth, fiscal balances and fiscal impulses according to two estimates

	2005	2006	2007	2008	2009
Real GDP growth, per cent					
Germany [1]	0,9	2,9	2,6	2,5	2,0
France	1,7	2,2	1,9	2,3	2,1
Italy	0,2	1,9	1,8	1,5	1,7
Spain	3,6	3,9	3,9	3,2	2,7
The Netherlands	1,5	3,0	2,6	2,3	2,3
Belgium	1,4	3,0	2,6	2,1	2,1
Austria	2,4	3,1	3,5	2,4	2,0
Finland	2,9	4,9	4,8	3,2	2,9
Portugal	0,5	1,3	2,3	2,2	1,8
Greece	3,7	4,3	4,0	3,1	2,9
Ireland	5,9	5,7	4,5	2,8	3,4
Euro Area-11 [2]	**1,5**	**2,8**	**2,6**	**2,3**	**2,1**
General government balance, per cent of GDP					
Germany	-3,4	-1,6	0,2	0,2	0,3
France	-3,0	-2,5	-2,7	-3,1	-3,0
Italy	-4,2	-4,4	-2,5	-2,5	-2,3
Spain	1,1	1,8	1,2	0,6	0,5
The Netherlands	-0,3	0,5	-0,3	0,5	1,1
Belgium	0,0	0,1	-0,4	-0,8	-0,8
Austria	-1,7	-1,2	-0,5	-0,6	-0,5
Finland	2,7	3,9	4,2	3,8	3,6
Portugal	-5,9	-3,9	-3,6	-3,1	-3,1
Greece	-4,5	-2,3	-2,4	-2,4	-2,4
Ireland	1,0	2,9	0,8	0,2	0,6
Euro Area-11	**-2,5**	**-1,6**	**-0,9**	**-1,0**	**-0,9**
One-off measures, per cent of GDP					
Germany	0	0	0	0	0
France	0.5	0.0	0	0	0
Italy	0.5	-1.2	0.1	0.1	0.1
Spain	0	0	0	0	0
The Netherlands	0	0	0	0	0
Belgium	0.4	0.6	0	0	0
Austria	0	0	0	0	0
Finland	0.4	0.3	0	0	0
Portugal	0.2	0	0	0	0
Greece	0.0	0.6	0	0	0
Ireland	-0.4	-0.2	0	0	0
Euro Area-11	**0.2**	**0.2**	**-0.2**	**0.0**	**0.0**
Fiscal impulse, under SP potential output growth assumptions, per cent of GDP [3]					
Germany	-0,5	-1,1	-1,3	0,5	0,2
France	-0,4	-0,9	0,0	0,5	-0,2
Italy	-0,4	-1,2	-0,6	0,0	-0,1
Spain	-0,4	-0,3	0,9	0,5	-0,3
The Netherlands	-1,6	-0,2	1,1	-0,7	-0,4
Belgium	-0,1	1,2	0,3	0,4	0,1
Austria	0,6	0,2	0,2	0,3	-0,2
Finland	-0,5	-0,1	0,5	0,3	0,4
Portugal	-0,2	-2,7	-0,2	-0,3	-0,1
Greece	-1,7	-1,4	-0,3	-0,2	-0,6
Ireland	-0,5	-1,9	1,7	-0,5	-1,0
Euro Area-11	**-0,5**	**-0,8**	**-0,3**	**0,3**	**-0,1**
Fiscal impulse, under NiGEM trend output growth assumptions, per cent of GDP [4]					

Germany	-0,5	-1,2	-1,5	0,2	-0,2
France	-0,2	-0,8	0,2	0,6	-0,1
Italy	-0,1	-1,1	-0,7	-0,2	-0,3
Spain	-0,4	-0,4	0,9	0,6	0,0
The Netherlands	-1,5	-0,1	1,0	-0,8	-0,8
Belgium	0,0	1,2	0,3	0,4	0,0
Austria	0,5	-0,1	-0,1	0,1	-0,3
Finland	-0,5	-0,5	0,1	-0,2	-0,1
Portugal	0,3	-2,3	0,0	-0,3	-0,1
Greece	-1,6	-1,3	-0,2	0,3	0,0
Ireland	0,0	-1,0	2,3	0,4	-0,3
Euro Area-11	**-0,3**	**-0,8**	**-0,3**	**0,2**	**-0,2**

(1) Not working day adjusted. (2) Excluding Luxembourg. (3) Excluding one-off measures. Fiscal impulse is the opposite of the change in the cyclically-adjusted primary balance, derived from EUROFRAME-EFN forecasts for GDP growth, fiscal balances and one-off measures, with potential output growth as in the stability programmes. (4) Excluding one-off measures. Fiscal impulse here is the opposite of the change in the cyclically-adjusted primary balance, derived from EUROFRAME-EFN forecasts for GDP growth, fiscal balances and one-off measures, with trend output growth as in NiGEM
Sources: EUROFRAME-EFN Autumn 2007 forecast, *Stability programmes*, seventh *updates*, end 2006, Eurostat, own assumptions.

The fiscal impulses associated with the two measures give some bounds for the fiscal stance. Both measures suggest that countries will reduce their budgetary efforts in 2008 and 2009, and be below the 0.5 percentage point effort announced in the SPs at the area level. Both measures are in general very similar at country level, with the exception of Germany and Ireland due to differences in potential output estimates.

We expect the fiscal stance to remain slightly contractionary in 2007, become slightly expansionary in 2008 and slightly contractionary in 2009 at the Euro Area level. In most countries running close to balance positions or surpluses, fiscal policies are expected to be close to neutral, at the noticeable exception of the Netherlands where the fiscal stance will be contractionary both in 2008 and 2009.

In Germany, we expect the government balance to remain close to 0 per cent of GDP, possibly with a slight positive fiscal impulse in 2008, reflecting the introduction of the corporate tax reform. German fiscal policy would become close to neutral after years of budgetary efforts

In two of the four remaining countries currently running close to 3 per cent of GDP deficits - Portugal and Greece - the fiscal stance will remain contractionary. However, the fiscal effort is forecast to be less restrictive than announced in the SPs and below the 0.5 percentage point of GDP requested by the requirements of the SGP. In Italy, although there is a possibility that revenues growth remains in the short future stronger than expected, we expect a deficit at 2.5 per cent of GDP in 2008, above the 2.2 per cent target of the SPs, and at 2.5 per cent too in 2009 (versus 1.5 per cent in the SPs). In other words, we expect the fiscal stance to be close to neutral rather than strongly contractionary.

France seems likely to be at odds with neighbouring countries in terms of fiscal developments. The government in office since the Presidential and Parliamentary elections of last Spring has announced a number of fiscal measures, mainly tax cuts benefiting households and amounting to 0.7 per cent of GDP in 2008 (see Table 2.7). At the time of preparing the forecast, detailed budget plans were not available. Our forecast embeds the new measures announced in terms of revenues. On the expenditure side, we have more limited information. Some measures reducing spending growth have been

announced but they are small (see Table 2.8). We have assumed that government spending will rise at rates close to the recent trend. Under these assumptions, fiscal policy will be expansionary in 2008, with a fiscal impulse amounting to 0.5 percentage point of GDP, whereas the objectives announced in the latest update of the Stability Programme at the end of 2006 where a 0.7 percentage point of GDP fiscal tightening. Under our GDP growth forecast and fiscal assumptions, the government deficit is at risk of breaching the 3 per cent of GDP limit of the Stability and Growth Pact in 2008.

Table 2.7. France: Impact of measures decided in August 2007

	2007	2008	2009	Full year
Income tax exemption on students earnings	-	0.3	0.3	0.3
Income tax cuts on interest payments	-	0.7	1.4	2.8
Inheritance taxes	1.2	3.5	3.5	3.5
'Bouclier fiscal' and ISF		2.0	2.4	2.4
Extra-hours worked	1.1	4.9	6.0	6.0
Research tax credit		2.0	2.4	2.4
Total (billion euros)	2.3	12.4	15.6	17.0
% of GDP		0.7	1.0	1.1

Table 2.8. Impact of lower expenditure announced

	2007	2008	2009
Civil service employees		0.3	0.7
Health expenditure	0.2	1.2	2.0
Special pensions regimes		0.1	0.3
Total (billion euros)	0.2	1.6	3.0

Table 2.9 shows French fiscal prospects under our central assumption. The government will perhaps announce in its forthcoming budget substantial expenditure cuts in order to offset the tax cuts impacts on the deficit from 2008. Accounting for the fiscal package announced, the stabilisation of the government deficit at the 2007 level would require that expenditure growth decelerates significantly down from its recent trend.

Table 2.9 France: Government balance prospects under a central assumption

	2006	2007	2008	2009
GDP growth, %	2.2	1.8	2.3	2.1
Tax to GDP ratio, before fiscal package, % of GDP	44.0	44.0	43.8	43.8
Fiscal package, % of GDP		-0.1	-0.7	-0.9
Expenditure, % of GDP	53.5	53.5	53.1	52.8
Expenditure growth, %	1.8	1.8	1.5	1.5
Government deficit, % of GDP	2.6	2.7	3.1	3.0

CONCLUSION

With GDP growth decelerating from 2.7 per cent in 2006 at 2.1 per cent in 2009 and a close to neutral fiscal stance, the Euro Area deficit would remain at around -1 per cent of GDP. This would mean that the objective of 0 per cent of GDP deficits in 2010 would be difficult to reach at the Euro Area level, albeit with different situations within the area, countries running close to -3 per cent of GDP deficits and other more than 3 per cent of GDP surpluses. A 1 per cent of GDP Euro Area government deficit is low from a historical perspective and as compared to deficits elsewhere in the industrial world.

Inside the Euro Area, the most striking development as compared to recent history would perhaps be the decoupling of government balances developments between Germany, running small government surpluses at the forecasting horizon and France at risk of breaching the 3 per cent of GDP limit for deficits.

SPECIAL POLICY TOPIC:

EUROPEAN SOCIAL MODEL(S) AND SOCIAL EUROPE

This report was prepared by a EUROFRAME-EFN team led by OFCE, with contributions from WIFO, CASE, CPB, DIW, ETLA and PROMETEIA. CPB takes responsibility only for its contributions.

CONTENTS

Introduction

The Report aims at providing an analysis of the European Social Model – or European Social Models(s) – and to draw future prospects for Social Europe. European societies are based on a compromise between on the one hand capitalism, private ownership and market strengths, and on the other hand, socialism, redistribution and public production. A substantial part of households' consumption is public (education, health); some risks are collectively insured (unemployment, healthcare, old-age, family, poverty); income redistribution is substantial through taxation and social protection. Labour legislation sets the framework of employment relations in the workplace, wage settings and dismissal procedures. There seems to be a broad consensus among EU (political or social) leaders that there is a European Social Model (ESM), typical of European societies and that this model should be protected and developed. But the ESM is an ambiguous notion (see Jepsen, 2005): is it a simple description of the actual state of European societies (which are diverse and evolving) or a political objective (but what is its precise content)?

'Social Europe' is also an ambiguous expression. It may refer to the current actions of European Institutions in social areas, which are limited by the subsidiarity principle and by European Treaties, where social issues remain mainly at the National level. It may also refer to a political project: increasing gradually the level of Europe's intervention, so that there will be a social Europe tomorrow like there is a monetary Europe today. But this project may try to 'modernise social protection', i.e. to reduce its field and costs to bring it more in line with the norms of a global world economy, or on the contrary to progressively implement common social norms in all Member States in order to reach a high and similar social protection level.

In its "Golden Age" after World War II, Europe was an economic and social success story: Europe had substantially narrowed the gap in living standards vis-à-vis the United States; European welfare states combined strong growth, low unemployment and a solid social safety net in these years. Since the mid-1990s, Europe has performed rather poorly: Economic growth and productivity growth were lower than in the past and lower than in the US. Unemployment has been persistently high. In fact, economic performance was diverse: while both liberal market economies with a low level of state interference and the Scandinavian countries with high taxation and large welfare states performed well, large continental European economies fell behind in the last decade.

Some economists claim that the inferior performance is the consequence of restrictive macroeconomic policies, blaming both monetary policy (first the Bundesbank and later the ECB) and fiscal policy due to the Maastricht criteria and the Stability and Growth Pact as well as insufficient wage increases. Most blame high welfare costs and low market flexibility for the disappointing growth. The European model with its emphasis on social protection is perceived as barrier to competitiveness in a global world.

In a complex reality, no straightforward explanation is apt to shed light on the question of Europe's lacklustre economic performance. The world has changed since the "Golden Age": On the one hand, international competition has intensified through globalisation, a development that in Europe was reinforced by European integration and the fall of the iron curtain. These factors have strengthened the potential for growth, but at the same time more adjustments were required in goods and labour markets. On the other hand, welfare state institutions have come under pressure by demographic ageing, rising unemployment, flexibility requirements and individualisation. In each country, globalisation gives rise to winners and losers and reduces national solidarity.

The objectives of social protection systems should be precisely redefined. In the Golden years, the target was to socialise (i.e. to leave out of the Market)

a substantial part of households spending and incomes. Unemployment, old-age, incapacity benefits ensured a satisfactory living standard for the individuals who cannot work. This automatically reduces the financial incentive to work for some categories of the population and reduces labour supply. Over the last decade, national and European authorities have stressed that social protection should not be a disincentive to work: "work must pay". But can the system provide a greater incentive to work without questioning the basis of the social protection system and without reducing the incomes of unemployed, retired people, or of poor families? The concept of 'ESM modernisation' is particularly ambiguous. One cannot avoid a trade-off between work incentives in one hand and social equality and income guarantees in the other. But is this choice the same everywhere and for every social category in Europe?

The notion of the ESM may hide diverging interests between social categories. In many Member States, the social protection system is linked to trade unions, either through a joint management by employers and employees' trade unions (Bismarkian model), or because trade unions have imposed it at the political level (Scandinavian model). Can the management of social protection be handled at the European level, without threatning to break this link?

Can the ESM survive in a global world? The answer will be positive only if social protection is not a handicap but also a factor of higher productivity and competitiveness. Social cohesion arising from the reduction of incomes inequalities, from public education and health should raise productivity, by avoiding the alienation of a large part of the population, thereby ensuring that they do not become a financial weight for society. Job stability must be an incentive for companies to invest in workers and for workers to invest in their company. However social protection, basically implemented in a national framework is necessarily questioned by globalisation and by European construction. The wealthiest, the managers and companies can find a way to escape the cost of social protection. How can MS and EU institutions prevent this?

This report investigates what kind of welfare state architecture is required in Europe in the face of intensified competition due to globalisation and European integration, higher flexibility requirements and demographic ageing to fulfil the ambitious Lisbon agenda; i.e. to achieve a virtuous triangle : social cohesion, full employment and dynamic economic growth. It discusses features of a reformed European social model, which would not be a barrier to growth but a comparative advantage for international competitiveness.

Section 1 provides an assessment of 'the European Social Model'. This model has different patterns among EU-15 countries[1]. The generally adopted classification (Esping-Andersen, 1990) sets out four social models in Europe: liberal, continental, Scandinavian and Mediterranean. However, each country has its own specificities, each risk is specific. National systems have changed quite substantially over the last 25 years. There has been, however, no convergence, each country keeping their specificities. This raises two types of questions:

- Are the four models variants of a single ESM, or does each model have its own specificities that cannot be abolished? For instance, is the liberal model an ESM?
- What are the assessments of these models in terms of economic performances and social cohesion? What features of these models should be generalised in Europe or, on the contrary, abolished? Can we invent a European model that would pick out the best elements in all

[1] The report discusses mainly Social protection issues in the old member states. NMS issues are discussed in the two annexes: Ruzik (2007) and Sowa (2007).

models or is it a utopia? Should European Institutions protect the national specificities or should they try to make the existing models converge?

Section 2 compares the economic and social performances of the different groups of EU countries, using economic (output growth, unemployment) and social indicators (poverty rates, income inequality). According to a widespread view, the continental model can be held responsible for the poor performances of the Euro area and needs to evolve towards the liberal or the Scandinavian model (see Sapir, 2005). When social indicators are taken into account, the position of continental countries looks more positive, although remaining clearly below the performance of Scandinavian countries. What specificities of the continental model need to be corrected? Can the Scandinavian model be implemented in all larger, open, heterogeneous countries and those with high unemployment?

Section 3 discusses the need to adapt to new economic and social challenges: the ageing of populations, the rising trend in health spending, the change in family structures, the rising trend in social exclusion, the persistence of mass unemployment in some countries, of low fertility rates in some others. In the face of rising trends in spending, should European models become more liberal, target social protection on the poor or should they remain universal, even if this would require some rise in contribution rates?How to combine social cohesion (hence low inequalities) and work incentives? How to raise female, older workers and socially excluded employment rates without increasing poverty among the unemployed? Should the financing of social protection be reformed in a way that it weighs less on labour? And if so how? The section provides a discussion, risk by risk, of the economic and social reforms needed.

What could be the respective roles of national and European institutions in the evolution of the ESM (or ESMs). The single market makes it more and more difficult for national protection systems to coexist: the EU has until now only organised the coexistence through systems coordination. There are three incentives for moving beyond this: the functioning of the single market would be facilitated, European citizenship would be strengthened, the risk of social competition would be reduced. But how can the move from systems based on domestic foundations to a European system be achieved? Are European citizens ready for a European solidarity? The current European strategy to influence the evolution of the national socials systems - the social Agenda and the Open method of coordination (OMC) – is based on two non-binding pillars: the definition of common objectives and the exchange of good practices. But these procedures remain disconnected from national debates and reforms. Can they become more democratic and more powerful?

In conclusion, three different views are presented on the future of the ESM: the first stresses the importance of guaranteeing social cohesion in the Member States, by reducing income inequalities and ensuring a high level of social protection, in particular for people who cannot work, because of their age, their handicap, their family situation or the economic situation. The disincentive effect of social protection is judged of second order and it is considered that rich countries can accept it. The second expresses the importance of restoring work incentives, by accepting initially some increase in income inequalities. Making work pay will increase production and will give more resources to the Social security system, ensuring its financial sustainability. The third suggests a new architecture of welfare states in Europe, inspired by the Scandinavian model, so that the impact of social protection as a productive factor increases.

1. From One to Four Models

The basic principle of the ESM is that society has to provide each individual with some basic goods and services (education, health) and that it should ensure everyone has a minimum vital income, that everyone is protected against some risks (sickness, unemployment, old-age), that some redistribution must be done in favour of some categories of the population (families, disabled people), that everyone can earn their living through a paid job, with decent working conditions and some degree of job protection. Labour Law and social dialogues regulate wage setting, relations in the workplace and lay-off procedures. By supporting social cohesion, by ensuring that important parts of the population are not durably excluded from the productive life, by ensuring a minimal level of education and health, by supporting compatibility between work and childcare, social protection is a productive factor. But, it necessarily weakens incentives to work and thus the size of the system is a delicate trade-off between fairness, social efficiency and individual incentives.

Should this trade-off change over time? According to a first view point, rising living standards should translate into lower work dependence; social protection should rise over time; productivity gains should pave the way for more leisure time and therefore economic inactivity. A rising share of economic inactivity should be financed through social protection: disabled people, old-age pensioners, child care. This trend took place until the early 1980's and has since then been reversed. Today's mainstream view is that work should pay and that people have both rights and responsibilities, that benefit entitlement needs to be conditional on duties towards the Society. Liberal ideas and globalisation constraints plead for reducing the weight of taxation. A major objective of the reform of social systems is to give people incentives to work and to work longer. This raises the question of the link between labour and social protection. Should social protection aim at ensuring that everyone has decent incomes or make sure that everyone is able to get decent earnings form their work? The issue is all the more delicate since most continental European countries still have a high level of unemployment.

Social protection was originally highly connected with trade unions, and more progressively toward a universal coverage, more satisfactory in terms of social cohesion. Workers financially support the economically inactive, while at the same time the system provides insurance for active people (sickness, family, unemployment, pensions). The solidarity function was included in the social insurance system. But this system is fragile: workers may refuse to pay for the inactive and may prefer occupational systems.

Until the early 1980's, the ESM had also the objective of supporting economic growth and maintaining full-employment through fiscal and monetary policies. This ambition weakened in the 1980's when the reduction of inflation and macroeconomic stability became priority objectives in Europe, rather than full-employment that seemed impossible to maintain.

Social protection systems are extremely heterogeneous in the EU, which reflect different histories and different organisations of social relations. Each country manages risks in its own way. In the tradition of Esping-Andersen (1990), four models are generally considered:

1. The Scandinavian (or social-democratic) model is the most comprehensive one, with a high degree of emphasis on redistribution, social inclusion and universality. A uniform and relatively high level of social protection is afforded to all citizens, meaning that dependence of the individual on the market and on his work is lowest. They are complemented by occupational benefits agreed by social partners and covering almost all the labour force. A generous infrastructure of social services is designed to be both affordable and of high quality. High replacement rates of unemployment benefits and the health system are financed through the tax system. Taxation is very progressive while business taxes are rather low. Job protection is

rather low but unemployment allowances are high with an active policy of reintegration in employment. Trade unions are strongly involved in the administration of unemployment insurance and training. The Scandinavian countries have been successful in generating high employment rates, especially for female and older workers and at reducing gender inequalities in the labour market especially for female and older workers. A strong social dialogue and close cooperation of the social partners with the government characterise the countries that can be subsumed under this ideal-type (Denmark, Finland and Sweden).

- The liberal (or Anglo-Saxon) model emphasises the responsibility of individuals for themselves. A minimal social protection is afforded to the poor and is complemented by company or private insurance. Social transfers are smaller than in the other models, more targeted and "means tested". Accordingly, social policies usually cater to a clientele consisting of low-income groups. The state encourages market actors to co-provide services, and leaves recipients with the choice to opt between public and private providers. Private insurance and savings schemes are frequently supported by complementary state policies (e.g., tax credits, tax shelters). The labour market is not regulated; labour relations are decentralised and bargaining takes place primarily at the firm level. Unemployment allowances are low and only slightly over the subsistence minimum. Employment rates are high. Taxation is relatively low. The Anglo-Saxon model is typified in Europe by the United Kingdom and Ireland.
- The Continental European model of social insurance: social protection is organised on an occupational basis and aims at guaranteeing wage incomes. Accordingly, transfers are financed through employers' and employees' contributions. The redistributive efforts of the fiscal system are less pronounced than in Scandinavian countries. Social partners play an important role in industrial relations and wage bargaining is centralised. The model includes strong job protection and generous unemployment allowances. The employment rate is relatively low. The tax-to-GDP ratio is high. This is the model in Germany, France, Belgium, the Netherlands and Austria.
- In the Mediterranean model, the low level of social transfers is partly counterbalanced by the strong supportive role of family networks. Families still play a significant role in the provision of security and shelter; these countries maintain some aspects of a paternalistic society, especially pronounced gender inequalities. If old-age benefits are high, family and anti-poverty benefits are low. Female employment rates are very low and the total employment rate is low. Job protection is very high but unemployment allowances are low. The Mediterranean group of countries includes Spain, Italy, Portugal and Greece.

This breakdown into four models is not so clear-cut when one looks in more detail at country level. Some countries have characteristics of both continental and Scandinavian countries (the Netherlands, Austria). Domestic specificities are very strong: for instance the Finnish pension system is very different from the Swedish one, although the two countries are generally considered as Scandinavian ones. France and Germany are continental countries, but they run different policies in many fields like family benefits or industrial policy. The UK health system is not typical of a liberal model.

The distinction needs to be refined according to the risk: relatively relevant for old age, much less relevant for family and health benefits. Systems have changed over time: health and family allowances have become universal in

almost all countries; minimum incomes have been introduced in most continental countries.

Globally the differences between the four models remain (see Table 1.1). Social protection public spending amounts to 33% of GDP in Scandinavian countries, 30% in continental countries, 26% in Mediterranean countries and 23% in liberal countries. Some countries can be singled out: the Netherlands is the only country where the share of social protection spending has been significantly reduced. On the contrary, Portugal has converged towards continental countries and the share of social protection spending has risen in the UK.

Table 1.1: Social Protection Public Expenditures

	As a Percentage of GDP			
	1980	1990	1998	2006
Austria	26.9	28.2	30.0	29.5
Belgium	30.0	28.0	28.9	29.6
France	27.3	29.3	32.0	33.2
Germany	25.6	23.5	29.7	29.7
Netherlands	30.6	29.7	23.6	26.2
Average[(1)]	*27.0*	*26.2*	*29.8*	*30.5*
Greece	..	19.4	23.7	23.9
Spain	..	23.8 [(2)]	22.4	23.0
Italy	..	27.0	27.3	29.0
Portugal	13.4	17.3	21.8	27.5
Average[(1)]	..	..	*24.9*	*26.3*
Denmark	33.9	33.5	34.8	33.2
Finland	22.5	28.6	31.6	30.1
Sweden		42.5 [(3)]	37.6	35.9
Average[(1)]			*35.2*	*33.6*
Ireland	..	21.1	18.2	18.6
UK	22.6	21.7	24.3	26.4
Average[(1)]		*21.7*	*23.9*	*25.8*

(1) Weighted averages. (2) In 1995. (3) In 1993.
Source: Eurostat.

An analysis of expenditure per function reveals divergences both between models and within models (see Table 1.2):

- Anglo-Saxon countries spend little on old-age pensions, continental countries quite a lot. The picture is more contrasted for other models. Italy spends quite a lot on pensions, Spain very little. Swedish spending on pensions differs widely from the Finnish one.
- Health spending is low in Mediterranean and Anglo-Saxon countries; high in continental countries.
- Incapacity benefits are high in the Scandinavian model, also in the Netherlands and to a lesser extent in Portugal and the UK. On the contrary, this category of expenditure is low in Mediterranean countries, in Ireland and in France..
- Family allowances are high in Scandinavian countries; this is also the case for continental countries (except for the Netherlands). By contrast, spending is low in Mediterranean countries.
- Unemployment allowances are high in the Scandinavian countries (despite low unemployment rates). This is the opposite in Mediterranean countries.
- Poverty benefits vary quite substantially within the models.

From 1992 to 2003 the rise in social protection expenditure (by 1.7 percentage point of GDP) was due mainly to higher old-age spending (1.1 percentage point), health (0.5) and family (0.3) while the weight of unemployment spending, was diminishing (0.5) (see Table 1.3).

- Old-age spending rose in almost all countries and especially rapidly in Portugal, in a catching-up process. It remained stable in the Netherlands while it hardly rose in Spain and decreased in Ireland, two high growth countries.
- Health spending rose rapidly in France, despite a rather high initial level, to a smaller extent in the UK and in catching-up countries (Greece, Portugal).
- Scandinavian countries and the Netherlands have reduced significantly the level of incapacity spending.
- Family spending rose in Germany and Italy whereas it was being reduced in Scandinavian countries.
- Unemployment spending declined in line with unemployment in Scandinavian countries, the Netherlands, Spain and the UK.
- Spending targeted at reducing poverty and social exclusion fell in Sweden but rose in France, the Netherlands, Greece.

All in all, some elements of convergence emerged at the level of the risks, although domestic specificities remain.

Table 1.2: Social Protection Expenditures in 2003

	As a Percentage of GDP						
	Total	**Old-age**	**Health**	**Incapacity**	**Family**	**Unempl.**	**Exclusion**
Austria	29.5	14.2	7.3	2.5	3.2	1.8	0.5
Belgium	29.7	13.2	8.0	2.0	2.3	3.7	0.5
France	30.9	13.4	9.4	1.5	2.8	2.4	1.4
Germany	30.2	13.0	8.4	2.4	3.2	2.6	0.8
Netherlands	28.1	11.3	8.8	3.1	1.4	1.7	1.7
Average[(1)]	*30.2*	*13.0*	*8.7*	*2.4*	*2.9*	*2.5*	*0.9*
Greece	26.3	13.4	7.0	1.3	2.0	1.5	1.2
Spain	19.7	8.5	6.0	1.5	0.6	2.6	0.3
Italy	26.4	16.3	6.8	1.7	1.1	0.5	0.1
Portugal	24.3	11.2	7.0	2.8	1.6	1.3	0.4
Average[(1)]	*23.8*	*12.9*	*6.5*	*1.7*	*1.0*	*1.4*	*0.3*
Denmark	30.9	11.5	6.3	4.2	4.1	3.0	1.8
Finland	26.9	10.0	6.8	3.6	3.1	2.7	0.9
Sweden	33.5	13.4	8.8	4.8	3.2	2.0	1.1
Average[(1)]	*31.1*	*12.0*	*7.6*	*4.3*	*3.4*	*2.5*	*1.2*
Ireland	16.5	3.8	4.2	0.8	2.6	1.4	0.9
UK	26.7	12.0	7.9	2.5	1.8	0.4	1.7
Average[(1)]	*25.9*	*11.3*	*7.6*	*2.4*	*1.9*	*0.5*	*1.6*
EU-15	**28.3**	**12.9**	**8.0**	**2.2**	**2.3**	**1.9**	**1.0**

(1) Weighted averages
Source: Eurostat.

Table 1.3: Social Protection Expenditures in 1992

	As a Percentage of GDP						
	Total	**Old-age**	**Health**	**Incapacity**	**Family**	**Unempl.**	**Exclusion**
Austria	27.0	12.9	7,5	1.8	2.9	1,4	0.5
Belgium	26.5	11.0	7.4	1.8	2.3	3.4	0.6
France	27.8	12.0	7.9	1.7	2.7	2.5	1.1
Germany	26.6	11.0	8.5	1.7	2.2	2.6	0.7
Netherlands	30.3	11.3	8.9	4.9	1.5	2.6	1.1
Average[(1)]	27.4	11.5	8.2	2.1	2.3	2.6	0.9
Greece	20.3	10.8	5.3	1.2	1.7	0.9	0.7
Spain	21.8	8.9	6.4	1.6	0.4	4.3	0.2
Italy	25.1	15.1	6.6	1.7	0.8	0.7	0.0
Portugal	16.5	6.7	5.6	2.4	1.0	0.7	0.1
Average[(1)]	23.0	12.0	6.4	1.7	0.7	2.0	0.1
Denmark	29.5	10.4	5.8	2.9	3.5	4.9	2.0
Finland	32.6	10.5	7.6	4.9	4.2	4.3	1.1
Sweden	37.7	13.8	8.6	4.0	4.5	4.3	2.4
Average[(1)]	34.3	12.0	7.3	3.9	4.1	4.5	1.9
Ireland	19.4	5.5	6.6	0.9	2.2	3.2	1.0
UK	26.7	11.5	6.6	2.5	2.3	1.9	1.8
Average[(1)]	26.1	11.0	6.6	2.4	2.3	2.0	1.7
EU-15	**26.6**	**11.8**	**7.5**	**2.1**	**2.0**	**2.4**	**0.9**

(1) Weighted averages
Source: Eurostat.

Box 1: The Difficulties of International Comparisons

The differences in social protection systems make international comparisons difficult:

- Incapacity benefits are very widespread in some countries where they play the role of unemployment or early retirement allowances.
- Families can be supported through social benefits or tax allowances
- Childcare can be facilitated though social benefits or collective services (nurseries, pre-primary schools).
- In some countries (like in the UK) employees can chose to opt out of public insurance if their employers provide a higher benefit

Models also differ in terms of degree of market regulation. From 1998 to 2003, product markets' regulation decreased in all countries, so that the ranking of countries in terms of regulation remained unchanged from liberal, Scandinavian, continental to Mediterranean countries (Table 1.4). The same ranking can be found in terms of labour regulation, with a less clear convergence. Unemployment allowances are more generous in continental and Scandinavian countries than in liberal countries and less generous in Mediterranean countries.

Table 1.4: Product and Labour Market Regulation

	Product Market Regulation		Employment Protection Legislation			Unemployment Net Replacement Rate
	1998	2003	1990	1998	2003	2004
Austria	1.8	1.3	2.2	2.4	2.2	73
Belgium	1.9	1.4	3.2	2.5	2.5	66
France	2.4	1.6	2.7	2.8	2.9	71
Germany	1.8	1.3	3.2	2.6	2.5	75
Netherlands	1.8	1.4	2.7	2.3	2.3	79
Average[(1)]	2.0	1.4	2.9	2.6	2.6	73
Italy	2.7	1.8	3.6	3.1	2.4	6
Greece	2.7	1.7	3.6	3.5	2.9	33
Portugal	2.2	1.7	4.1	3.7	3.5	72
Spain	2.1	1.5	3.8	3.0	3.1	52
Average[(1)]	2.4	1.7	3.7	3.1	2.8	29
Denmark	1.4	1.1	2.3	1.8	1.8	77
Finland	2.1	1.3	2.3	2.2	2.1	75
Sweden	1.8	1.1	3.5	2.6	2.6	77
Average[(1)]	1.8	1.2	2.9	2.3	2.2	76
Ireland	1.4	1.0	0.9	1.2	1.3	71
UK	1.1	0.9	0.6	1.1	1.1	66
Average[(1)]	1.1	0.9	0.6	1.1	1.1	66
US	1.3	1.0	0.2	0.7	0.7	29

(1) Weighted averages
Source: OECD.

Social models differ also in terms of tax structure (see Table 1.5). Direct taxation is low in liberal countries, high in continental countries, slightly less high in Mediterranean countries, where indirect taxation is more substantial; households' taxation is higher in Scandinavian countries, while company taxation is relatively low.

Table 1.5: Maximal Tax Rates in 2006

	Income Tax	Corporate Tax
Austria	50	25
Belgium	50	35.5
France	48.1	34.4
Germany	44.3	39,3
Netherlands	52	31.5
Average[(1)]	*47.0*	*36.3*
Italy	43	37.25
Greece	40	32
Portugal	42	22.5
Spain	45	35
Average[(1)]	*43.4*	*35.1*
Denmark	59.8	28
Finland	56.75	26
Sweden	56.5	28
Average[(1)]	*57.3*	*27.5*
Ireland	42	12.5
UK	40	30
Average[(1)]	*40.2*	*28.6*

(1) Weighted averages
Source: European Commission.

Table 1.6 shows another typology, where social protection systems are broken down into: social insurance systems (benefits depend on contributions paid although there is also some redistribution), universal systems (entitlement to all citizens) and assistance systems (targeting the poor, income-tested). Besides public systems are complemented with more or less compulsory

occupational systems, benefiting from tax incentives and relying more or less on public decisions and on private individual insurance systems (that benefit often from tax incentives). Each country is characterised by specific choices on each insured risk.

Table 1.6: Social Benefits: A Typology

	Assistance	Universal System	Social Insurance	Occupational Insurances	Private Insurance
Pensions, long-term care, incapacity	Minimum pension	Flat pension Incapacity benefits	Pays-as-you-go systems	Company funds	Individual insurance
Family, Housing	Housing benefits, Minimum income	Universal benefits	Family tax credit or allowance		
Health	Free health care for the poor	Universal public system	Health insurance	Mutual insurance funds	Private insurance
Unemployment, Exclusion	Minimum income		Unemployment benefit		

By nature, the liberal model favours assistance systems complemented by private insurance systems. This raises the question of the level of assistance benefits and does not ensure social cohesion. The lower middle-class may turn out to be the looser, because it is not covered by social protection and pays relatively high tax and premiums. The continental model favours social insurance systems for pensions and unemployment, but these systems are complemented with assistance systems and universal systems (family, sickness, poverty). The Scandinavian model is based on universal systems complemented in practice by more or less universal occupational systems (for pensions). Disincentives to work are corrected by social control and activation policies in Scandinavian countries. The two models require the acceptance of a high level of taxation (which is easier in a homogeneous society, like in Scandinavian countries). The disparities between models make it difficult to define 'the' ESM.

2. Economic and Social Performance of Social Models in Europe

2.1 ECONOMIC PERFORMANCES

European economic performance has deteriorated since the beginning of the nineties, compared with the past as well with the United States. Growth has been disappointingly low compared with the expectations raised by the European integration and the enlargement project. Many authors blame the high level of taxes and government expenditures, the degree of regulation, and the costs of welfare in Europe as main reasons for Europe's economic underperformance. Other authors emphasise the role of "growth drivers", macroeconomic policies and the housing cycle.

In the long run (1970-2006) there are rather small differences between social models in Europe: the best performers were countries with initial low level of GDP par capita (Greece, Portugal; Spain, Ireland) rather than countries which belong to a particular model. During the 1986-1996 period, Continental model countries obtained the best results and Scandinavian ones the worst. The situation had changed since 1996 (see Table 2.1). In the last decade, GDP per capita and real GDP growth was high in liberal and Scandinavian countries and rather low in Continental and Mediterranean countries. Is it an effect of the inadequacy of these models with globalization or a temporary failure?

Table 2.1: Economic Performance

	Real GDP Growth (Per Cent p.a.)			
	1970/2006	**1970/1986**	**1986/1996**	**1996/2006**
Continental Model	*+2.3*	*+2.7*	*+2.6*	*+1.9*
Germany	+2.2	+2.4	+2.7	+1.5
France	+2.4	+2.9	+2.1	+2.2
Belgium	+2.4	+2.5	+2.3	+2.2
The Netherlands	+2.5	+2.4	+2.8	+2.4
Austria	+2.6	+2.9	+2.7	+2.3
Mediterranean Model	*+2.6*	*+3.0*	*+2.4*	*+2.3*
Greece	+2.8	+2.9	+1.5	+4.1
Italy	+2.3	+3.1	+2.0	+1.4
Portugal	+3.1	+3.5	+3.9	+2.1
Spain	+3.2	+2.7	+3.0	+3.8
Scandinavian Model	*+2.3*	*+2.5*	*+1.5*	*+2.9*
Denmark	+2.0	+2.6	+1.7	+2.1
Finland	+2.9	+3.4	+1.5	+3.7
Sweden	+2.1	+1.9	+1.5	+3.0
Liberal Model	*+2.5*	*+2.2*	*+2.5*	*+3.1*
Ireland	+5.2	+3.8	+5.1	+7.1
United Kingdom	+2.3	+2.1	+2.3	+2.8
EU-15	**+2.4**	**+2.7**	**+2.4**	**+2.3**
United States	+3.1	+3.2	+2.9	+3.2

It is not surprising that the catching-up process results in higher long-run growth for countries with a low initial level of GDP per head (e.g., Southern Europe, Ireland). Therefore we ran a regression of GDP growth on GDP level per head and calculated the per capita growth rate which could be expected for each country given its initial level of GDP per head in PPS (i.e., the convergence process). The difference between the actual and the 'hypothetical' growth rate per capita gives us an indicator of relative economic performance. According to this indicator, economic performance since 1970 has been the highest in Ireland, Austria and Finland. Greece, Portugal, France, Germany, Italy and Spain were under-performing.

Table 2.2: Economic Performance

	Real GDP Growth Per Capita (Per Cent p.a.)		Actual Minus Hypothetical Real GDP Growth Per Capita (Per Cent. points p.a.)	
	1970/2006	**1990/2006**	**1970/2006[1]**	**1990/2006[2]**
Continental Model	*+1.8*	*+1.3*	*-0.1*	*+0.0*
Germany	+1.8	+1.3	-0.1	-0.1
France	+1.8	+1.3	-0.2	-0.2
Belgium	+2.1	+1.6	+0.2	+0.3
The Netherlands	+1.8	+1.8	+0.1	+0.4
Austria	+2.3	+1.8	+0.4	+0.7
Mediterranean Model	*+2.2*	*+1.5*	*-0.1*	*-0.5*
Greece	+2.2	+2.5	-0.4	-0.7
Italy	+2.2	+1.1	-0.1	-0.4
Portugal	+2.6	+1.7	-0.3	-1.5
Spain	+2.4	+2.2	-0.1	-0.5
Scandinavian Model	*+2.1*	*+2.0*	*+0.3*	*+0.7*
Denmark	+1.7	+1.9	-0.0	+0.5
Finland	+2.5	+2.2	+0.3	+0.6
Sweden	+1.8	+1.8	+0.2	+0.6
Liberal Model	*+2.2*	*+2.2*	*+2.2*	*+0.4*
Ireland	+4.1	+5.1	+1.3	+2.4
United Kingdom	+2.1	+2.1	+0.1	+0.3
EU 15	**+2.0**	**+1.6**	**-0.0**	**-0.1**
United States	+2.0	+1.8	+2.0	+1.8

1.2. Hypothetical growth is the rate which could be expected for each country given its initial level of GDP per capita, based on the following regression equations for 13 EU countries:

(1) $\Delta Y = 3.2523 - 0.5115 * Y_{ti}$
$R^2 = 0.60$ (9) (25)
1970/2006

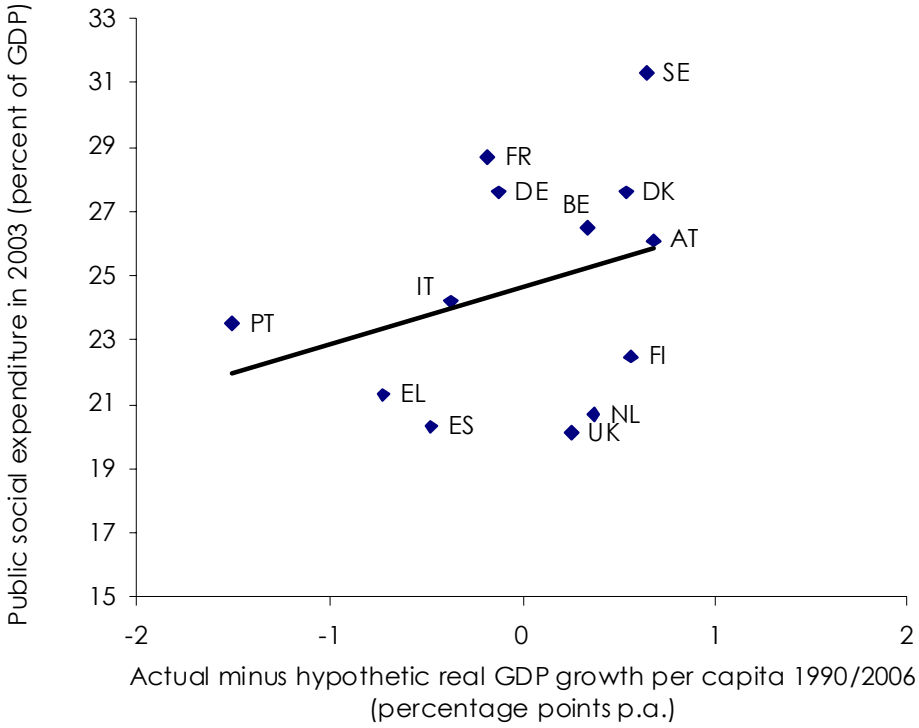
(2) $\Delta Y = 3.0049 - 0.0835 * Y_{ti}$
$R^2 = 0.28$ (21) (49)
1990/2006

Y GDP per capita in 1,000 PPS, ΔY growth of real GDP per capita p.a.

EU15 countries except Ireland and Luxembourg
Source: Eurostat, OECD, WIFO calculations.

Growth differentials between EU countries have become larger since the nineties. In the 1990 to 2006 period, per head GDP growth was substantially higher in the Anglo-Saxon and Scandinavian countries than in Continental and Mediterranean Europe. The strikingly good long-run economic performance of Scandinavian countries and Austria makes it dubious to blame the welfare state for poor economic performance. Public social expenditure is much higher in Scandinavian countries and Austria than in the average EU.

Figure 2.1: Public Social Expenditure and Economic Performance



Source: Eurostat, OECD, WIFO calculations.

A cross-country diagram (see Figure 2.1) gives the impression that countries with healthy social standards had a better economic performance. Blaming the welfare state for low growth and weak competitiveness may be premature. Although the Scandinavian countries display the highest level of state intervention, i.e. high taxes and large public social expenditures, these countries have performed very well in the last decade. We may infer that the asserted trade-off between efficiency and equality or between economic competitiveness and social justice is rather shaky. Economists are inclined to

see the financial burden of social services and public transfers but to discount individual and public costs of social exclusion and large inequalities, in particular, in terms of public security and health. They rarely point to the productive effects of the welfare state, of social cohesion, general public education, public health services, and cooperative industrial relations.

The employment rate is closely related to economic performance. It is the highest in Scandinavia, followed by the Anglo-Saxon countries. Public services (child care etc.) largely explain the high employment rate in Scandinavia, marketisation of household services (low-wage service jobs) the high employment rate in the Anglo-Saxon countries. The classification in term of unemployment rate is practically the reverse, even if there are some anomalies, due to female activity: Sweden and France seem to have too many unemployed people; Italy and Ireland too few. In the full-time equivalent employment rate, there is a gap of about 12.5% (16%) between Continental (Mediterranean) countries and Scandinavian ones.

Table 2.3: Economic Indicators

	GDP Per Capita		Employment Rate 2005		Unemployment Rate
	1991	2006		Full-time equivalent	2006
Continental Model	*108.0*	*103.6*	*65.3*	*60.2*	*8.1*
Germany	109.7	102.1	65.4	60.4	8.4
France	104.9	99.1	63.1	59.7	9.4
Belgium	109.5	109.5	61.1	57.1	8.2
Netherlands	107.1	116.4	73.2	60.9	3.9
Austria	114.6	114.0	68.6	63.7	4.8
Mediterranean Model	*90.9*	*88.9*	*60.4*	*58.4*	*7.7*
Greece	67.5	78.9	60.1	59.2	8.9
Italy	106.0	92.2	57.6	55.5	6.8
Portugal	69.1	65.3	67.5	65.6	7.7
Spain	79.4	90.5	63.3	60.9	8.6
Scandinavian Model	*105.8*	*108.8*	*72.4*	*67.7*	*6.3*
Denmark	107.4	113.8	75.9	69.4	3.9
Finland	98.3	105.4	68.4	65.3	7.7
Sweden	108.9	107.6	72.5	68.0	7.0
Liberal Model	92.9	109.4	71.4	65.3	5.2
Ireland	77.3	129.7	67.6	64.6	4.4
United Kingdom	94.3	107.6	71.7	65.4	5.3
United States	**132.1**	**136.8**	**71.5**	**67.0**	**67.0**

Source: Eurostat, OECD.

Male employment rates are relatively low in Scandinavian and liberal countries because of the size of incapacity benefits. By contrast, female employment rates are very high in Scandinavian countries, while it is the opposite for Mediterranean countries, the UK and continental countries being in an intermediate position. Lastly older workers' employment rates are high in Scandinavian countries, low in continental countries and very low in Mediterranean countries (and also in Belgium and Austria). Mediterranean countries are thus characterised by a specific social choice where employment is focused on adult males. This choice is not sustainable with low fertility rates and demographic prospects in these countries. Moving towards the Scandinavian model becomes a necessity. Older workers' low employment rates may also be viewed like a social choice (like in Austria) or the pernicious effect of persistence of wrong economic choices made in times of high unemployment rates.

Table 2.4: Activity Indicators (2005)

	Activity Rate			Part-time Rate
	Male 25-54	Female 25-54	55-64	
Continental Model	*93.3*	*79.4*	*46.6*	*19.9*
Germany	93.6	79.1	52.1	21.8
France	93.8	80.7	43.6	13.6
Belgium	91.8	76.8	33.5	18.1
Netherlands	91.4	77.8	47.0	35.7
Austria	92.8	79.9	33.0	16.2
Mediterranean Model	*92.8*	*67.5*	*39.6*	*12.5*
Greece	94.7	68.1	43.1	6.1
Italy	91.7	64.6	32.6	14.7
Portugal	92.5	81.8	53.8	9.8
Spain	92.4	69.0	45.9	11.4
Scandinavian Model	*91.5*	*85.5*	*65.8*	*14.2*
Denmark	91.1	84.1	62.9	18.0
Finland	90.3	85.2	56.4	11.2
Sweden	92.4	86.5	72.8	13.5
Liberal Model	*91.0*	*76.9*	*58.0*	*23.2*
Ireland	92.2	69.6	53.2	18.6
UK	90.9	77.5	58.4	23.6
United States	90.5	75.3	62.9	12.8

Source: OECD.

Activity rates have risen noticeably in Continental and Mediterranean countries in the last decade (Table 2.5), although the potential labour force has already started to decline in some countries (Germany, Greece, Italy). Unemployment rates have therefore hardly declined. Labour productivity growth has been slow in continental Europe as compared to Scandinavian or liberal countries, but it is difficult to disentangle the effect of slow technological progress from the effect of economic policy measures introduced to increase the number of unskilled jobs.

Table 2.5: Economic Performance 1996-2006, in % Per Year

	15-64 Population	Activity Rate	Unemploy-ment Rate	Employ-ment	Product-ivity	GDP Growth
Continental Model						
Germany	-0.3	0.7	0.0	+0.4	+1.1	+1.5
France	0.5	0.3	-0.2	+1.0	+1.2	+2.2
Belgium	0.3	0.5	-0.1	+0.9	+1.3	+2.2
Netherlands	0.6	0.7	-0.2	+1.5	+0.9	+2.4
Austria	0.7	0.0	0.0	+0.7	+1.6	+2.3
Mediterranean Model						
Greece	-0.1	0.9	-0.1	+0.9	+3.2	+4.1
Italy	-0.1	0.9	-0.4	+1.2	+0.2	+1.4
Portugal	0.3	0.7	0.0	+1.0	+1.1	+2.1
Spain	0.6	1.9	-0.9	+3.4	+0.4	+3.8
Scandinavian Model						
Denmark	0.2	0.2	-0.2	+0.6	+1.5	+2.1
Finland	0.5	0.4	-0.7	+1.6	+2.1	+3.7
Sweden	0.4	0.1	-0.3	+0.8	+2.2	+3.0
Liberal Model						
Ireland	2.5	1.2	-0.7	+4.4	+2.6	+7.1
United Kingdom	0.8	0.1	-0.2	+1.1	+1.7	+2.8
United States	1.4	-0.1	-0.1	+1.4	+1.8	+3.2

Source: European Commission, OFCE calculations.

There exists a broad consensus in contemporary growth theory on the crucial role played by human capital accumulation and by the diffusion of knowledge on the medium-term growth rate of advanced economies. Accordingly, it can be argued that the capability to support the growth of human capital and of productivity is an acid test for the welfare state.

Investments into the future may be an important reason for diverging economic developments. High investment in R&D, ICT, education and infrastructure are crucial for long-run economic development. R&D expenditure has been particularly high and strongly increasing in Scandinavia, but it has been surprisingly low in Ireland. In Germany, R&D ratios have been relatively high, but slightly decreasing. Most countries of Southern Europe have been lagging behind with respect to their use of information technologies (Table 2.6).

Table 2.6: Growth Drivers: Investment in the Future

	Expenditure on R&D	IT Expenditure	Youth Education Attainment Level[1)]
	2005	2005	2005
	Per Cent of GDP		Per Cent
Continental Model	*2.3*	*3.3*	*77.3*
Germany	2.5	3.1	71.5
France	2.1	3.4	82.6
Belgium	1.8	2.9	81.8
Netherlands	1.8	3.9	75.6
Austria	2.4	3.0	85.9
Mediterranean Model	*1.0*	*1.8*	*69.1*
Greece	0.6	1.2	84.1
Italy	1.1	1.9	73.6
Portugal	0.8	2.2	49.0
Spain	1.1	1.7	61.8
Scandinavian Model	*3.4*	*3.9*	*83.5*
Denmark	2.4	3.4	77.1
Finland	3.5	3.7	83.4
Sweden	3.9	4.4	87.5
Liberal Europe	*1.7*	*4.0*	*78.8*
Ireland	1.3	2.0	85.8
United Kingdom	1.7	4.2	78.2
EU 15	**1.9**	**3.1**	**74.6**
United States	2.7	4.0	–

Source: Eurostat. 1) Percentage of the population aged 20 to 24 having completed at least upper secondary education.

Indicators on working conditions highlight the role played by human capital in the performance of European socio-economic models. Qualitative indicators support the view that Scandinavian countries come closest to achieving the aim of creating not only more, but also better jobs (Table 2.7). Whereas in Mediterranean countries only 67% workers share the opinion that they are learning new things at work, among countries belonging to the Scandinavian group almost 90% workers have a positive view of their learning curve on the job. Both Anglo-Saxon and Continental countries are between these two extreme positions, with the Netherlands as outliers that come close to the Scandinavian group. There is a strong correlation between the responses to this question and the findings with respect to the amount of training undergone by workers. The levels of training are not very high in general in European countries, with an average of less than 30 percent in the 15 'old' Member States, and they have been fairly constant over the last 10 years (*European Foundation*, 2006). Again, however, there are significant differences across countries, with the Scandinavian group at the top and Mediterranean countries at the bottom of the distribution. A similar, although less clear-cut pattern results from the answers to the question whether or not workers feel that they are able to apply their own ideas at work. Further evidence on job quality comes from cross-country differences in the share of workers who think they will be able to carry out the tasks associated with their current job at a later stage in life. On average, 70% of workers in Scandinavian countries believe that they are able to do the same job when they are aged 60. The equivalent proportion is lower in Anglo-Saxon and Continental countries. In Mediterranean countries, only 55% workers think that their current

employment is suitable for older persons. These results correlate highly with satisfaction levels with working conditions.

Table 2.7: Qualitative Indicators of Employment Situations

	Job Content and Training			
	Paid training in previous 12 months	Learning new things	Able to apply own ideas in work	Able to do the same job when 60
	Per Cent of Total Responses			
Continental Model	*28.0*	*71.7*	*58.7*	*63.0*
Germany	25.3	66.1	49.8	73.6
France	24.4	72.3	64.5	48.6
Belgium	40.5	74.4	64.1	52.3
The Netherlands	31.6	83.6	70.8	72.1
Austria	37.5	76.8	60.2	59.9
Mediterranean Model	*17.1*	*66.8*	*58.1*	*55.0*
Greece	13.1	61.9	56.8	40.5
Italy	16.9	71.9	58.4	59.9
Portugal	15.1	69.1	62.1	45.7
Spain	18.9	60.0	57.3	53.5
Scandinavian Model	*46.3*	*88.4*	*70.5*	*69.2*
Denmark	36.3	86.4	72.0	68.8
Finland	52.6	90.0	64.3	65.2
Sweden	51.0	89.3	73.1	69.7
Liberal Model	*38.5*	*69.2*	*59.7*	*62.7*
Ireland	37.3	76.9	68.1	53.2
United Kingdom	38.6	68.6	59.0	63.5
EU 15	**27.4**	**70.5**	**59.2**	**60.8**

Source: Fourth European Working Conditions Survey (2005); WIFO calculations.

Recent research has highlighted the vital role played by the first years of life for future cognitive development. Spending on the youngest groups of population can be scrutinised on its own account. The share of GDP that goes to child care and pre-primary education is considerably higher in Scandinavian countries and in France than in the other European countries (Table 2.8).

Table 2.8: Expenditure on Pre-primary Care and Education

	Public Expenditure		
	Childcare	Pre-primary Education	Total
	Per Cent of GDP		
Continental Model	*0.2*	*0.5*	*0.7*
Germany	0.0	0.4	0.4
France	0.5	0.7	1.2
Belgium	0.2	0.6	0.8
The Netherlands	0.2	0.4	0.5
Austria	0.2	0.4	0.6
Mediterranean Model	*0.1*	*0.4*	*0.5*
Greece	0.2	0.2	0.4
Italy	0.1	0.4	0.6
Portugal	0.4	0.4	0.8
Spain	0.1	0.5	0.5
Scandinavian Model	*0.8*	*0.5*	*1.3*
Denmark	1.0	0.7	1.6
Finland	1.0	0.3	1.4
Sweden	0.8	0.5	1.3
Liberal Model	*0.2*	*0.3*	*0.6*
Ireland	0.1	0.1	0.2
United Kingdom	0.2	0.3	0.6
EU 15	**0.2**	**0.4**	**0.7**

Source: OECD, Family and Education Database; WIFO calculations.

2.2 INDICATORS OF SOCIAL PERFORMANCE

The political target is not only high economic performance, but also high social and environmental performance (Lisbon strategy). We chose a number of indicators to explore this (Tables 2.9):

1. **Life satisfaction** is the highest in Scandinavian countries (and in the Netherlands); it is the lowest in Mediterranean countries.
2. **Income inequality:** Scandinavian countries show the more equal income distribution, Mediterranean and liberal countries the more unequal.
3. **Poverty rates** are significantly higher in liberal and Mediterranean models, this reflects the unequal income distribution.
4. **Life expectancy** is lower in the Anglo-American countries than in Scandinavia (except in Denmark), Continental Europe and the Mediterranean countries.
5. **Infant mortality** - an indicator of the efficiency of the health system – is substantially higher in liberal countries. Denmark seems to have a specific problem.
6. **Hours worked:** It appears that high GDP per capita in liberal countries is largely due to a high number of hours worked. Labour productivity per hour is relatively high in continental countries.
7. **Prisoners:** The share of prisoners is very high in the United States, and also relatively high in the United Kingdom. It is small in Scandinavian countries.
8. **Trust in people** is more common in Scandinavian countries (and in the Netherlands) than in other countries. This shows that the Scandinavian model is based on social practices that are deeply rooted in peoples' minds and that it may be difficult to extend it to other countries where such practices are not a tradition (Algan and Cahuc, 2006)

Globally, the social performance in the United States and in the liberal European countries is worse than in Scandinavian and Continental European countries.

Tables 2.9: Social Indicators

	Life Satisfaction		Inequality of Income Distribution	Poverty Rate	Life Expect-ancy at Birth	Infant Rate Mortality per 1,000 Births
	2006	1996-2006	2005	2005	2004	2004
Continental Model	*2*	*+2*	*4.0*	*13*	*79.1*	*4.1*
Germany	17	-1	4.1	13	78.9	4.1
France	19	+7	4.0	13	79.6	3.9
Belgium	31	+6	4.1	15	79.1	4.3
Netherlands	44	-2	4.0	11	78.5	4.1
Austria	23	-6	3.8	12	79.2	4.5
Mediterranean Model	*16*	*+4*	*5.7*	*19*	*79.6*	*3.9*
Greece	11	+2	5.8	20	78.3	4.1
Italy	14	+2	5.6	19	80.2	4.1
Portugal	4	±0	8.2	20	77.5	4.0
Spain	22	+8	5.4	20	79.7	3.5
Scandinavian Model	*48*	*+7*	*3.6*	*11*	*79.2*	*3.5*
Denmark	66	±0	3.5	12	77.3	4.4
Finland	33	+6	3.6	12	78.7	3.3
Sweden	46	+11	3.3	9	80.3	3.1
Liberal Model	*34*	*+5*	*5.6*	*19*	*78.5*	*5.1*
Ireland	37	+3	5.0	20	77.9	4.9
United Kingdom	34	+5	5.6	19	78.5	5.1
EU 15	**23**	**+3**	**4.7**	**16**	**79.2**	**4.1**
United States	–	-	-	-	77.5	6.9

	Hours Worked	Productivity by Hours	Prisoner Rate (per 100,000)	Trust in People
	2004	2005	2005	
Continental Model	*1,443*	*98.3*	*97*	*0.31*
Germany	1,443	94.1	97	0.33
France	1,441	101.5	88	0.21
Belgium	1,522	110.7	90	0.29
Netherlands	1,357	105.7	127	0.59
Austria	1,550	85.1	108	0.31
Mediterranean Model	*1,695*	*75.0*	*115*	*0.30*
Greece	1,925	70.8	90	0.20
Italy	1,585	77.4	97	0.32
Portugal	1,694	50.3	123	0.10
Spain	1,799	76.7	143	0.35
Scandinavian Model	*1,586*	*85.9*	*77*	*0.63*
Denmark	1,454	87.8	77	0.64
Finland	1,736	81.5	75	0.57
Sweden	1,585	87.3	78	0.64
Liberal Model	*1,667*	*86.7*	*139*	*0.29*
Ireland	1,642	104.1	85	0.35
United Kingdom	1,669	85.2	143	0.29
EU-15	**1,565**		**109**	**0.32**
United States	1,824	100	738	0.36

Source: EIRO; OECD; UNDP; WIFO calculations.

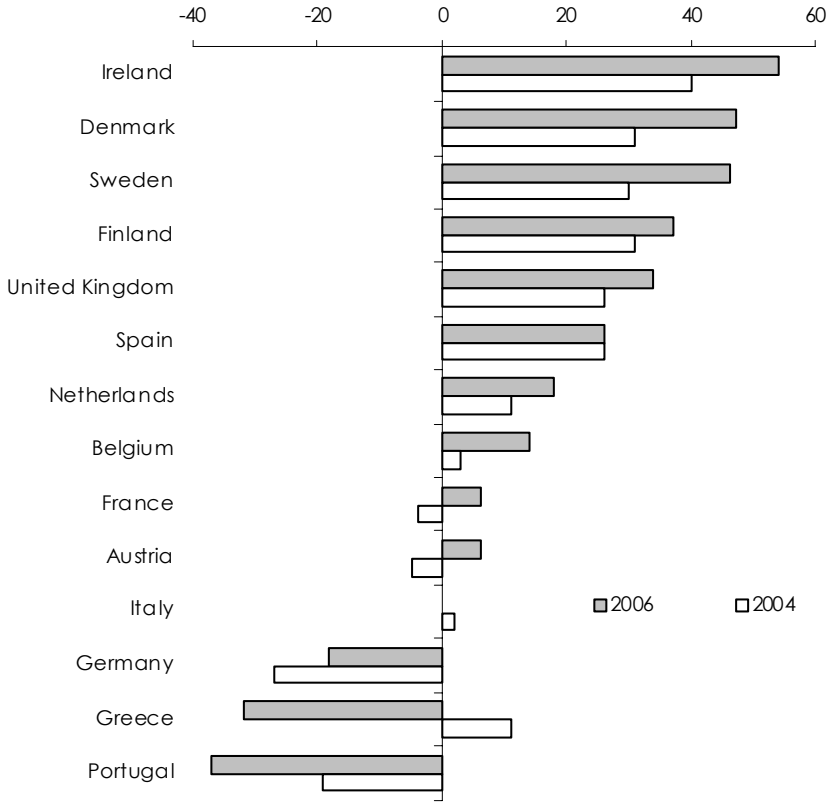
2.3 HAPPINESS AND ECONOMIC PERFORMANCE

The world economy has been doing quite well in recent years, but does this make people happy? Layard (2003) pointed out that GDP per capita has risen enormously over the last fifty years, but 'happiness' – as it is being measured by surveys – hardly changed at all.

In surveys (e.g., Eurobarometer) people are asked whether their overall situation is satisfactory or not and whether it improved or got worse during the last five years. According to Eurostat surveys, happiness in the European Union has been rather stable over decades, although GDP per head increased substantially. However, the country ranking (see Figure 2.2) of the change in life satisfaction is a mirror of recent economic and labour market developments.

Figure 2.2: Present Situation Compared with 5 Years Ago

Balance of responses ('Improved' – 'Got worse') as per cent of total responses



Source: Eurobarometer

There is also a positive relationship between GDP per capita and life satisfaction across countries (see figure 2.3). Life satisfaction is very high in Scandinavian countries. They have been able to combine economic efficiency with decent social standards. Happiness is also relatively high in the Netherlands, which is close to the Scandinavian model, and in Anglo-Saxon countries. In Mediterranean countries, life satisfaction is rather low. There is a pronounced North-South-trend with respect to GDP per head and life satisfaction, which may be explained by religion, climate and other factors. Surprisingly, happiness in Austria has been relatively low and it deteriorated over time despite relatively good economic performance; the increase in unemployment may explain this development. Across EU countries there is a close negative relationship between life satisfaction and unemployment.

Figure 2.3: Life Satisfaction in Different EU Countries in 2006

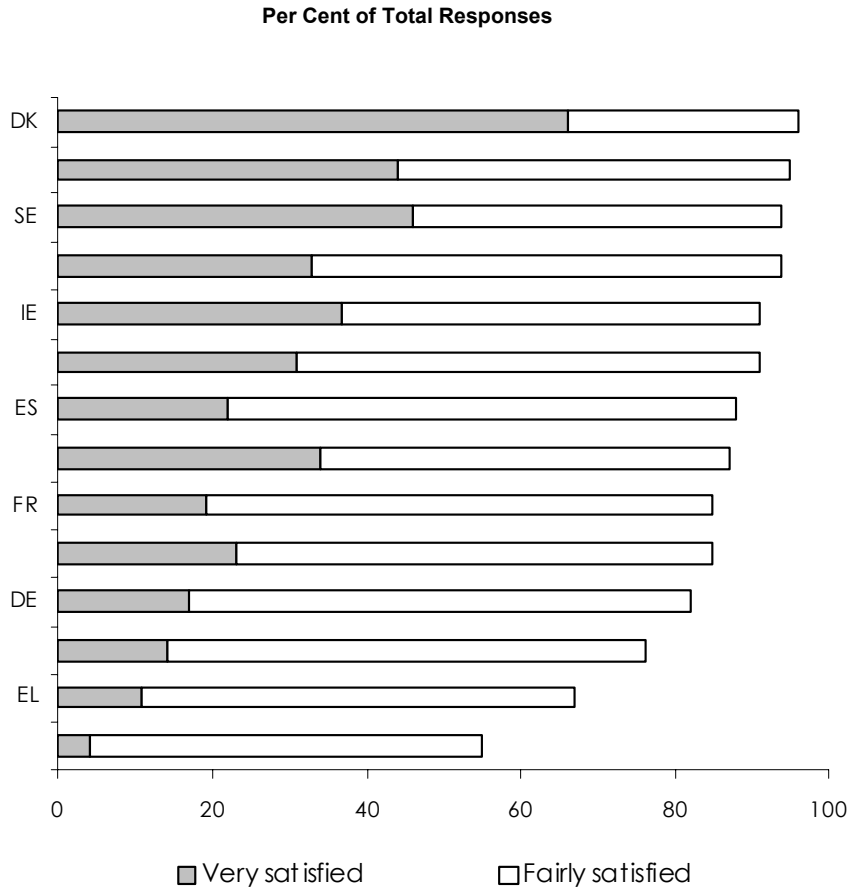
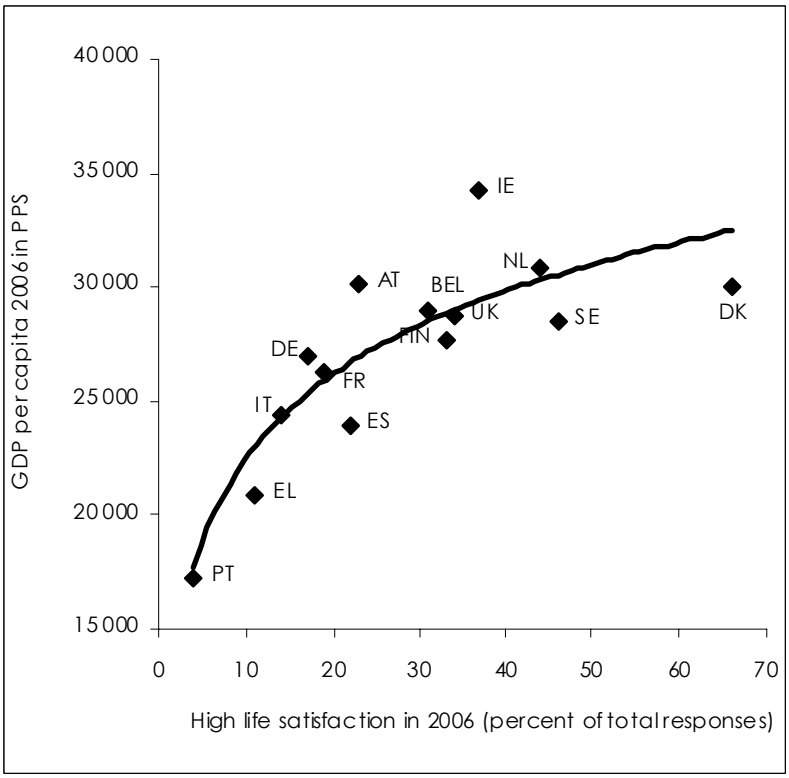
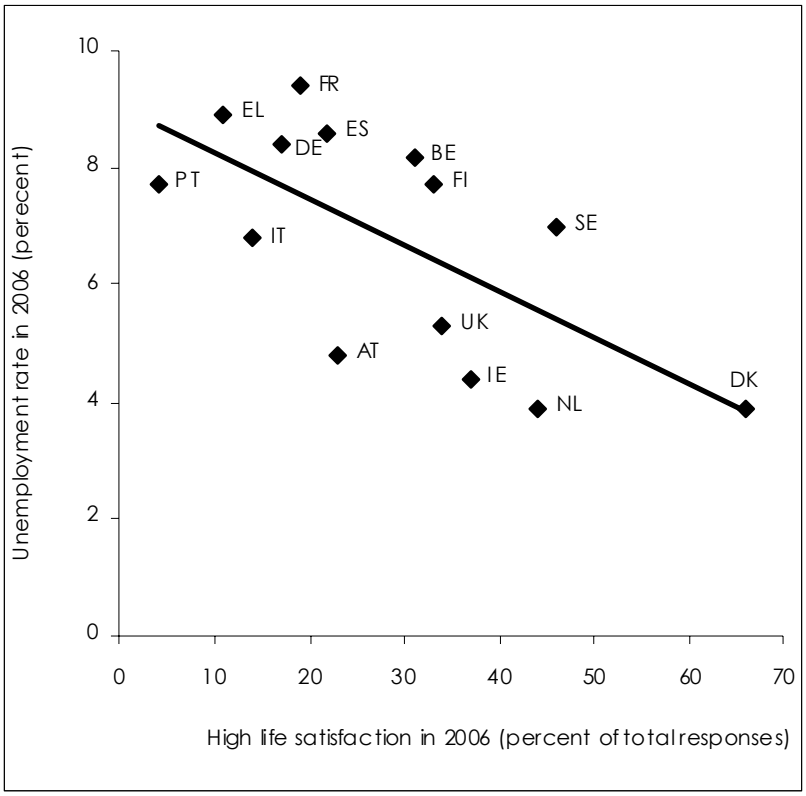


Figure 2.4: High Life Satisfaction and Income Level



Source: Eurobarometer, Eurostat.

Figure 2.5: High Life Satisfaction and Unemployment Rate



Source: Eurobarometer, Eurostat.

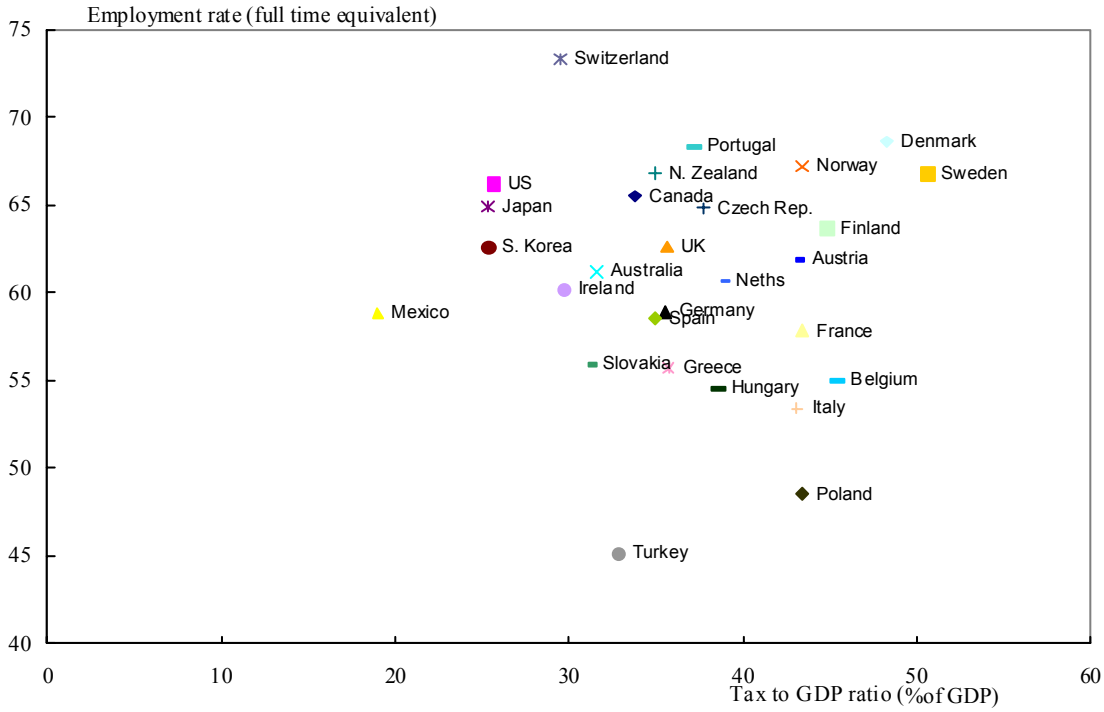
2.4 SOCIAL MODEL AND COMPETITIVENESS

What factors may explain differences between these models in terms of growth and employment? Is the weight of social contributions on wages a factor? But such social contributions have a counterpart in terms of benefits and hence allow for lower wages. Moreover, as can be seen from Figure 2.6, high employment rates cannot be associated with low tax-to-GDP ratios. Similarly, there is no link between GDP growth and the weight of social protection in terms of GDP.

The extreme model types, namely the liberal Anglo-Saxon model and the Scandinavian universalistic model have shown the best economic performance. The first model type would be in line with the hypothesis of blaming the welfare state, the second contradicts this hypothesis. The worst performance is seen for the Continental model and the Mediterranean family-oriented model, which produced low growth and high unemployment.

The Scandinavian countries were able to reform their institutions and incentives in a way to be competitive in the globalising economy (after several periods of turmoil). They made their economies more flexible in a managed and balanced strategy and reduced both government deficits and debt. But most importantly they went for a strategy of excellence in innovation, education and technology diffusion. The same adaptability is not to be seen in the big continental European countries.

Figure 2.6: Employment Rates and Taxation Rates (in 2003)



Source: OECD.

The liberal Anglo-American countries showed a slightly better performance during the last decade than the Scandinavian countries and a much better one than the continental European countries. However, regarding social indicators, these countries are lagging behind.

Blaming the welfare state for low growth and weak competitiveness in the EU is premature; The Scandinavian countries and Austria having the highest taxes and the largest public social expenditure performed very well in economic terms during the last decades. The assumed trade-off between competitiveness and social justice (or efficiency and redistribution) is shaky. Social cohesion, education, health and cooperative industrial relations are productive resources. Social protection can be an asset in providing education and training, facilitating labour mobility, and disconnecting the wage costs and living standards of unskilled labour. Solidarity or individual risk-taking is a matter of preferences, not of economics

Three elements of success may therefore be found from the experience of Scandinavian and liberal countries: the employment legislation and unemployment allowances rules; the role of social partners in the face of shocks affecting the economy, a sector or a firm; the importance of economic innovation and education.

Continental countries may have failed because of their inability to design a model able to adapt to globalisation, a model between the liberal model, source of inequalities which their people do not want, and a Scandinavian model that would not be easily implemented in large heterogeneous countries with no tradition of co-management between social partners and with high unemployment rates. At the EU level, the situation is not easy to address. Successful countries will not be willing to change their model and the convergence towards Scandinavian or Liberal models cannot be a choice made at the EU level. How then to encourage a change in the Continental model?

3. European Social Protection Systems, Facing Financial Constraints and New Challenges

3.1 SIX CHALLENGES FOR THE MEMBER STATES

The European Social Model faces six challenges: financial sustainability, globalisation, the crisis of the continental model, too low fertility rates, social changes, reforms of the funding.

1) How can the financial sustainability of the system be ensured? The pressures for higher spending on health, old-age benefits, old-age care and fight against exclusion are almost unavoidable. They have structural causes:

- Population ageing generates a rise in pensions, health and long-term care spending.
- The rising trend in health spending is explained partly by population ageing and also by technological progress that allows for longer life expectancy but does not generally reduce the level of spending.
- The decrease in fertility rates - and thus of the number of young people - reduces the need for family benefits, especially as the number of children per family decreases, and for education spending, but the young need more education to acquire higher skills and many countries (like Germany, Italy, Spain, etc) are considering policies to increase fertility and family incentives.
- Rising female activity increases the number of families with two wage-earners and reduces the number of poor families, but implies that there is a need for substantial childcare financial support. Social evolution leads to a rise in the number of single parent families in need of support.
- The improvement in the labour market situation may allow for lower unemployment and assistance allowances but may require costly measures in order to bring people back to work (in terms of training, social contributions cuts, etc…).

How this rise in spending needs be addressed? Four global strategies may be considered.

- The first strategy consists of cutting progressively the level of benefits, for instance by indexing them to prices only or by reducing reimbursement rates for medical expenses. The drawback of this strategy is that it will lead to an uncontrolled reduction of the size of the welfare state. For instance, would it be fair that the relative situation of families or the poor is worsened? The reliability of the welfare state would be damaged without any alternative solution being socially and politically decided.
- A second strategy consists in maintaining the Welfare state, with a stabilisation of replacement rates, social minima and family benefit to wage ratios, etc. In the health area, the government, medical workers and patients would have to implement a social supervision of reimbursed spending, based on medical evaluation. As concerns pensions, the retirement age would have to increase so that the ratio of number of years in retirement/number of years at work remains stable. Such a strategy would maintain social cohesion in Europe. It may imply some rise in contributions paid by active people (for pensions and unemployment) and by all households (for health and assistance), but companies' competitiveness would not be affected and tax harmonisation in Europe should allow countries to tax their residents.
- The third strategy consists in breaking down social protection into two sectors: one sector would remain public (assistance, family and unemployment benefits) at its current level. A second sector

(pensions, health) would be transferred to individual or occupational private insurances, which would allow tax-to-GDP ratios to decrease. But private health insurances may select risks and deny reimbursement of some expenses. Private health insurances would thus need to be closely supervised, be mandatory and requested to reimburse a certain basket of health care. There is no certainty that private insurance is less costly than public insurance. In the long term, private pension funds will be less costly than public funds if the rate of return of invested funds is clearly above the GDP growth rate augmented by the increase in the number of years in retirement. But the transitory phase would be costly for generations who would have to pay for older generations while simultaneously accumulating assets to provide their own pensions. There would be a gain only in the long run.

- The fourth strategy would consist of targeting social protection towards the poorer (like in the Anglo-Saxon model) and letting the market play for the rest of the population. However a two-speed framework raises issues: the wealthiest and the employees of large companies would benefit from a good insurance, while employees in small companies, employees with short-term work contracts and the socially excluded would have to rely on national solidarity. The middle class would lose in that system, because they would have to pay both for themselves and the poor while the sustainability of the system would be uncertain: 'benefits for the poor are poor benefits'. There is a risk that the system deteriorates in losing the support of a substantial part of the population.

A solution seems to have reached a consensus view today and allows, effectively or fictively to avoid choosing between the four strategies, by raising substantially employment (for older workers and females in Southern economies). This solution would provide a double dividend in terms of old-age, unemployment and exclusion benefits and would give room for manoeuvre in terms of health and long-term care. This strategy however raises several issues: it often focuses on bringing unskilled workers back to work in a situation where supply for unskilled labour exceeds demand, at the risk of increasing unemployment and reducing wages of that group of workers. Rising demand for unskilled labour has a cost in terms of lower social contributions. Can this strategy be implemented through work incentives? This would mean increasing the gap between assistance and work incomes, which is often obtained by cutting assistance benefits thus increasing the poverty risk for those who cannot find a job. For instance, it is often suggested that the retirement age should be made neutral from an actuarial point of view to give older workers an incentive to work until 65. Instead of getting a pension with 80% of replacement rate if they retire at 60, workers would be offered the possibility to get 80 % if they decide to retire at 65 or 60 % if they retire at 60. This would increase the income gap between workers, depending of whether they can or cannot work until they are 65 (e.g; between managers and manual workers). The same issue arises for the disabled and women with children. Should social benefits be reduced for economically inactive single mothers with young children or for families with one worker, although they are already the poorer households? Thus, in general, work incentives should increase workers' incomes, for instance in increasing the offer of free childcare, rather than in reducing the incomes of those without a job, but this would strongly reduce the financial returns of the measure.

2) Globalisation tends to dismantle national societies, which reduces solidarities, both national and between workers. Incomes inequalities rise: the wealthiest no longer want to pay for the poor, high skilled workers for the unemployed; companies do not wish to locate their production in countries

where social protection is too generous. Lastly the Internal Market places EU countries in direct competition and increases the risk of a race-to-the-bottom in social and taxation areas. In the absence of tax coordination in Europe, the possibilities of national redistribution could be reduced. For instance all countries have been obliged to abolish personal wealth taxation.

3) The continental ESM is facing strong criticism, accused of being too costly, too protective, damaging work incentives and preventing flexibility and innovation. How could the continental model be reformed? The liberal model (full employment through economic constraints and flexibility) raises fears while the Scandinavian model (full employment with solidarity) seems difficult to extend to large, open and heterogeneous economies where unemployment is high. Abolishing employment protection could reduce one of the main advantages of the ESM: the investment by workers in their companies, the incentive for companies to train their employees. Increasing work incentives could oblige them to accept more incomes inequality and more poverty.

4) Should the decrease in fertility rates be accepted and possibly lead to increased immigration or should measures be taken to stop the decrease through subsidisingchildcare for mothers who stay at home and/or work? Should child poverty be reduced, through financial support for mothers who do not have a job (the poorer) or through work financial incentives (work being the best insurance against precariousness). Should family policies focus on the poorer (in order to prevent child poverty) or should they benefit all families (to support fertility)? Should benefits be in kind or cash? The experience of Scandinavian countries and of France shows that it is possible to raise female employment rates and fertility rates through a generous family policy and socially organised and financed childcare.

5) Social protection systems need to adapt to sociological changes (gender equality, couples instability). But should the measures in favour of women (like reversion pensions) be abolished, although women still have lower wage earnings and employment rates than men? Should social benefits and taxation become individual, which could be a work incentive for women but would make redistribution less accurate? With the actual fertility situation in Europe, it is not envisaged that a reform of taxation and benefits will be undertaken which would be detrimental to families with children.

6) How to finance social protection? Initially in Bismarkian countries, social protection was linked to wage-earning and thus financed by employers' and employees' contributions. Social protection has now become universal as concerns health and family. Health and family benefits should therefore be financed by general taxation, while unemployment and old-age allowances should be financed by contributions, insofar as these allowances are linked to contributions.[2] There are thus economic justifications for reducing the share of social benefits financed by wages, especially for lower wages. It is not justified that contributions levied on activity incomes finance family or health benefits, as in most continental and liberal countries (see Table 3.1).

[2] The best system would be a system where each old-age person would be entitled to a flat pension (amounting for instance to 80% of the minimum wage). This pension would be funded by general taxation and contributions would apply only to the part of wages above the minimum wage. Similarly, if all people of working age and without incomes are entitled to a minimum income equal to 50% of the minimum wage, the unemployed should be entitled to this minimum income funded by taxation and employees should pay contributions at a reduced rate for the part of their wages below the minimum wage.

Table 3.1: How Main Risks are Financed in the EU-15

	Health (in kind)	Old-age	Unemployment	Family	Work injury
Belgium	SC+AI	SC+AI	SC+AI	SC+AI	Ass.
Denmark	AI	AI + SC (supplementary)	SC	AI	SC
Germany	SC	SC + Gov	SC	AI	SC
Greece	SC + Gov	SC + Gov	SC	SC	SC
Spain	AI	SC	SC	AI	SC
France	SC + AI	SC + AI	SC	SC + AI	SC
Ireland	AI	SC	SC + Gov	AI	SC
Italy	SC +AI	SC +Gov	SC	SC	SC
Neths	SC +AI	SC +AI	SC	Gov	—
Austria	SC	SC	SC	SC + Gov	SC
Portugal	Gov	SC	SC	SC + Gov	Ass.
Finland	AI	SC + AI +Gov	SC +Gov	Gov	SC
Sweden	Gov	SC + Gov	SC + Gov	Gov	SC
UK	SC + Gov	SC	SC + Gov	Gov	Gov

Notes: SC means funding through social contributions, AI: funding through affected tax, Gov: funding through the general budget or permanent government grant.
Source: MISSOC, European Commission.

This being said, more resources remain to be found to compensate for the reduction of contributions based on wages.[3] Four suggestions can be made.

1. A part of the burden may be transferred from workers to old-age pensioners or people with financial incomes through personal income taxation (like with the French CSG). However, pensions are expected to be cut in most EU countries and it would be difficult to add a tax increase. It would be more interesting to investigate an increase in financial incomes taxation, but the amount of potential new resources is limited
2. VAT is deductible from investment and thus weighs only on labour. Transferring social contribution to VAT would therefore have no favourable impact on the capital/labour relative cost. In the short run, the main effect is a gain in price competitiveness since VAT weighs on imports and can be deducted from exports. It is a sort of hidden devaluation, allowing for competitiveness gains paid by rising inflation. The risk is that, following the example of Germany in 2007, EU countries introduce the same king of non-cooperative strategies, without any net advantages.
3. A contribution on added value (like the Italian IRAP) would be a tax levied on companies' value added, without export and investment deductibility and impacting on imports. The transfer of employers' contributions to a contribution based on value added would raise the cost of capital and decrease labour costs which could have a positive effect on employment in countries with mass unemployment. But it is a delicate strategy which would be positive for labour intensive sectors but detrimental to capital intensive sectors.
4. Environmental taxation could provide a double dividend, in supporting employment and fighting against the deterioration of the environment. The double dividend will be obtained only in countries in unemployment situations. The reform supposes costly adjustments by firms. It would strongly affect some sectors that could be tempted to relocate in countries with lower environmental taxation. It thus requires coordination at least at the EU-level.

[3] This point has been widely debated in France in 2006 (see Bernard et al., 2006).

Table 3.2: Taxes, as a Percentage of GDP in 2005

	Labour	Capital	Environment	Consumption
Belgium	23.8	10.4	2.4	11.3
Denmark	24.8	9.6	5.8	16.1
Germany	22.3	6.4	2.5	10.1
Ireland	10.5	8.8	2.3	11.4
Greece	14.1	8.4	2.3	12.0
Spain	16.1	10.2	2.0	9.8
France	23.3	9.4	2.4	11.4
Italy	20.4	10.1	2.8	10.1
Netherlands	17.7	8.3	4.0	12.1
Austria	23.3	6.7	2.6	12.1
Portugal	14.7	6.6	3.1	12.8
Finland	23.3	6.9	3.0	13.7
Sweden	31.1	7.0	2.9	13.1
UK	14.4	11.1	2.5	11.4

Source: Eurostat.

3.2 PENSION REFORMS

Many national reforms of pension systems have already been introduced in the EU in order to address the issue of ageing populations. In general, the strategy of raising social contributions has not been chosen. The strategies implemented include cuts in pension benefits, (often through abolishing the indexation to wages), postponement of retirement age or increases in the number of years of working life required to be entitled to a full pension and sometimes the introduction of a notional fund which guarantees that pension systems are automatically in balance. Pension reforms have often been complemented by the introduction of a pension fund, mandatory or favoured by tax incentives.

Cuts in pension benefits and notional funds generate considerable uncertainty on the future level of pensions. According to the projections collected by the Commission (see table 3.3), pensions cuts will be especially large in Germany, Austria, France, Italy, Portugal and Sweden. Is this socially acceptable? There is a strong risk that old-age pensioners will tomorrow be among the poorer as was the case in the past. Only France and Sweden recognise this cut in pensions (see Table 3.4). Some countries announce they will compensate for lower pensions through the development of pension funds (Germany, Denmark, Italy, see Onofri, 2007). In other countries, the announcements show some inconsistency (Austria)[4].

Most countries announce that their pension systems will be in balance owing to a strong rise in female employment (Spain, Belgium, Italy) or older workers (55-64) employment (Austria, Spain France, Italy), but these countries have not launched reforms that would promote such rises in employment: reforming family policy and childcare and organising mobilisation of social partners.

4 Lassila and Valkonen (2007) discuss the strategy for financial sustainability while taking in account demographic uncertainty.

Table 3.3: Change in Public Pensions as a Percentage of GDP, According to the Commission

	Pension Benefits, % of GDP**		Explicative Factors, of which:			
	2005	2050	Trend 2050	Employment Rate Impact	Number of Pensioners Impact	Replacement Ratio Effect
Germany	11.1	13.0	18.6	-1.2	-0.6	-3.8
Austria	13.2	12.2	24.5	-1.4	-6.2	-4.6
Belgium	10.4	15.5	18.1	-1.6	-0.4	-0.6
Denmark	9.6	12.8	16.8	-0.4	-3.0	-0.6
Spain	8.7	15.7	21.1	-2.0	-2.5	-0.8
Finland	10.3	13.7	19.2	-1.0	-3.5	-1.0
France	12.8	14.8	21.5	-1.0	-2.0	-3.7
Ireland	4.6	11.1	12.5	-0.6	-1.5	0.8
Italy	14.3	14.7	25.8	-2.1	-3.5	-5.6
Netherlands	7.4	11.2	13.7	-0.2	-1.8	-0.5
Portugal	11.5	20.8	25.2	-0.2	-1.0	-3.2
Sweden	10.4	11.3	15.2	-0.6	-0.2	-3.0
UK	6.7	8.6	11.4			
EU-15	**10.5**	**12.8**	**18.7**	**-1.0**	**-1.8**	**-3.1**

Source: European Commission.

Table 3.4: Replacement Rates at the Average Wage Level

	2004			2050		
	1st pillar	2nd pillar	GRR/NRR	1st pillar	2nd pillar	GRR/NRR
Germany	43	0	43/63	34	15	48/67
Austria	64		65/80	69		69/84
Belgium	39	4	43/67	37	10	47/74
Denmark	45	4	48/71	39	24	64/76
Spain	90		90/97	85		85/92
Finland	57		57/63	54		54/64
France	66		66/80	49		49/63
Greece	105		105/115	94		94/106
Ireland	31	35	67/78	34	33	67/78
Italy	79		79/88	64	16	80/92
Netherlands	30	42	71/93	30	45	75/97
Portugal	75		75/91	70		70/92
Sweden	53	15	68/71	40	15	59/62
UK	17	50	66/82	19	50	69/85

Note: GRR: gross replacement ratio; NRR: net replacement ratio.
Source : Social Protection Committee (2006)

Reforms also apply to early retirement schemes (where new entrants are not allowed) and incapacity schemes (that are tightened). There is a risk that income inequalities increase among pensioners and that some pensioners - especially manual workers - become poorer if older workers' employment rates do not increase. Giving work incentives for older people may generate difficulties for the 55-64 year-old jobless and those working in declining sectors. It may also introduce strong inequalities between those who will be able to work longer and those who will have to retire earlier (manual workers, workers in declining sectors). Thus such a strategy requires specific schemes for given groups of workers (manual workers).

Is it necessary to implement today policies to cut public spending in order to have room for manoeuvre to pay tomorrow's pensions? This is the strategy implemented by Belgium, the Netherlands, Denmark and Spain. Finland and Sweden have chosen to accumulate public pension funds. Pension funds have a strong role in the UK, the Netherlands and Ireland. But this is no longer an option for other countries where demographic deterioration is already under way. Countries like Germany, France or Italy did not have sufficient private demand to undertake a fiscal consolidation strategy.

Table 3.5: Net Public Debt, as a Percentage of GDP

	Level, end 2006	2006-1995
Germany	52	+20
Austria	42	-4
Belgium	77	-28
Denmark	7	-29
Spain	48	-21
Finland	-61	-57
France	43	+5
Greece	87	-4
Italy	95	-3
Netherlands	52	-18
Portugal	47	+22
Sweden	-16	-41
UK	42	+3

Source: Eurostat.

In the field of pensions, the Commission started to intervene in the framework of the Broad Economic Policy Guidelines (BEPGs). The objective was to avoid a rise in public pension expenditure, which could have increased government deficits and debt. Since July 2001, countries have been requested to provide projections on the long-term impact of demographic prospects in their Stability Programme. The Barcelona Council of March 2002 also invited MS to try and postpone the average effective retirement by 5 years by 2010. In 2002, the BEPGs requested the MS to 'move towards a greater reliance to funding' and to reduce public debt from now. The creation of the Social Protection Committee (SPC) and the introduction of the Open Method of Coordination (OMC) may be seen as an answer by social affairs ministers and DG Employment and Social Affairs to the attempts of the economics and finance ministers and the DG-ECFIN to address social protection issues, especially pensions.

However, even if the Commission warns on the risk that some countries may be tempted to finance pensions through government deficits, countries are well aware that their pension systems should be in balance. With all countries being committed to ensure that their systems are financially balanced (through postponing the retirement age, cutting benefits or raising contributions), the future of pensions does not threaten public finance stability. Pensions contributions having a direct counterpart in terms of pension benefits should not be included in tax revenues. They do not reduce *a priori* work incentives. For a worker, they constitute an investment which profitability (rate of growth of wage bill plus rate of growth of years in retirement) may be compared to financial assets profitability. There is no economic justification for disconnecting totally these two types of savings. The level of social contributions must be considered independently of the objectives of lower tax to GDP ratios, the level of pensions must be disconnected from public spending cuts.

The introduction of the OMC led to a first joint Report in December 2002. This report has three main objectives: ensuring financial sustainability of pension systems, ensuring the adequacy of pensions and modernising pension systems. The report is less normative than BEPGs recommendations, reflecting the interventions of social affairs ministers. However the strategy is based on four pillars: using coming years to reduce public debt; promoting employment for the 55-64 year old; postponing the effective retirement age by 5 years; reducing the level of pensions paid by pay-as-you-go systems, making them more contributory and with higher actuarial neutrality through linking them more to years worked and age of retirement; developing pension funds.

The option of increasing contributions is rejected without any discussion. But the Report insists also on the need to ensure that pensioners do not fall into poverty, by ensuring incomes floors and on the need to ensure adequate replacement ratios. The Report recognises the need to ensure decent pensions to workers who have seen their career interrupted, or have worked part-time

(which is in contradiction with the third pillar). The report recognises several risks: indexing pensions to inflation induces a risk of rising pensioner poverty, having too low pensions would not be socially sustainable. The report recognises that pay-as-you-go pension system should remain the main axis of the system. Here also some contradictions remain. The Social Protection Committee has been able to include very relevant indicators in the list of pension adequacy indicators, like pensioner poverty rates and replacement ratios ensured by the pension system.

Table 3.6: Two Indicators of Pension Adequacy in 2004

	PT	PL	HU	AT	DE	FR	NL	SI	SK	IT	CZ	SE	EL	FI	ES	BE	UK	DK	IE
A	109	109	101	95	92	90	88	87	85	84	83	80	79	75	75	73	72	70	65
B	63	59	61	67	45	66	43	42	55	58	51	58	49	46	56	42	..	..	43

A) Income of 65+relative to complementary age groups, in %; B) Replacement ratio in %.
Source: European Commission

In 2005, the BEPGs were transformed into a set of '24 integrated guidelines for employment and growth'. Three guidelines address the pension issue. Guideline 2 asks countries to tackle the issue of population ageing in reducing their public debt (but this ageing generates a rise in savings ratios, hence a higher demand for public bonds), to reform their pensions and health systems (i.e. to cut benefits) and last to increase employment rates. Guideline 17 reaffirms the objectives in terms of employment rates, especially the objective of 50% for workers aged 55-64. Guideline 18 suggests increasing the labour supply of older workers through the modernisation of social protection systems, i.e. in abolishing early retirement schemes, in reducing pensions in cases of early retirement, in giving financial incentives to postpone retirement age. This induces three risks: increasing poverty among older workers if companies do not want to hire them, cutting the total level of pensions, increasing inequalities between blue-collar workers (who will have no choice but to leave their job early) and managerial workers (who will have the opportunity to work longer and to save in pensions funds).

In 2006, the joint report on social protection and social inclusion of 2006 highlights 5 issues: the definition of a minimum income for old people, the introduction of a close correlation between contributions and benefits, the lengthening of working life through more flexible retirement conditions, the development of private pensions, governance. The joint report of 2007 observes that most countries anticipate substantial falls in replacement ratios that will need to be offset through a longer working life or the development of private systems.

The golden age of retirement is finished in Europe[5]. The risk is that financial constraints will progressively induce a strong decrease of pension/wage ratio in European countries, so that a higher proportion old people will be in poverty. The chosen strategy – the rise in older workers' activity- is only part of the solution. In accordance with the logic of the ESM, countries should introduce pensioner minimum incomes above the at-risk-of-poverty line, and should ensure that replacement ratios are satisfactory (at least for low and middle wage earners), that specific measures apply to manual workers and that the postponement of effective retirement age accounts for the effective employment of older workers.

3.3 HEALTH SYSTEMS

Public health spending amounted to 6.4% of GDP in the EU-15 in 2005 – varying from 5.1% in Greece, 5.8% in Italy, 6% in Germany and 7.7% in France. According the Commission's projections, they will rise to 8.1% in

[5] The annex by Ruzik presents the situation in NMS.

2050, i.e. by 1.7 percentage point. Table 3.7 shows that there is no single relation between life expectancy and public spending. Life expectancy is high and health spending low in some countries (Italy, Greece, Cyprus, Malta) while spending is high for intermediate results in terms of life expectation in other countries (France, the Netherlands). Public health spending is low in the NMS but life expectancy is shorter in these countries than in the "old" members states (the reorganisation of the systems is described in Sowa, 2007).

All countries face similar problems. What is the rise in expenditure required to match populations' needs and the rise which is attributable to a bad governance of the system resulting from information asymmetry and wasted money? How to curb down the rise in health spending without affecting the poorest: nationalising or privatising, two speed system, spending control, rise in the share of spending paid by the patients as a disincentive to consume medical goods and services. How to control suppliers?

In the recent past, countries have tried to cut spending in several areas:

- In many countries, general practitioners have a gate-keeper role; their income depends on the number of patients they have and not on the number of consultations. Some countries have maintained a less costly public service. In both cases the risk is that the richer can get round the system by paying for practitioners outside the system, which leads to a two-speed system.
- Some countries are introduced a medical control of spending.
- Other countries let competition play between health funds (see CPB (2007) on the Dutch case and Sowa (2007) on NMS). But this is an area where competition is a delicate issue (selection risk, problem of asymmetry of information).

Table 3.7: Life Expectancy and Health Spending

	Life Expectancy in 2004-Men	Life Expectancy in 2004-Women	Health Expenditure Per Head, PPS
Sweden	78.1	82.4	2,171
Italy	77.3	83.2	1,548
Spain	76.6	83.4	1,285
France	76.2	83.4	2,267
Greece	76.4	81.4	1,210
UK	76.4	80.9	2,016
Cyprus	76.3	80.8	732
Austria	76.2	82.1	1,910
Germany	76.1	81.7	1,963
Netherlands	76.2	80.8	2,388
Malta	76.2	80.7	749
Belgium	75.5	81.6	2,017
Ireland	75.5	80.7	2,012
Finland	75.3	81.9	1,647
Luxemburg	75.0	81.4	2,704
Denmark	75.2	79.6	1,664
Portugal	74.2	81.0	1,174
Slovenia	72.6	80.2	1,321
Czech Rep.	72.4	78.8	1,055
Poland	70.5	78.5	435
Slovakia	69.7	77.8	677
Hungary	68.5	76.8	827
Lithuania	66.5	77.6	400
Estonia	65.5	76.9	449
Latvia	64.9	77.6	269

Source: Eurostat.

In the field of health and long-term care, the OMC should allow the exchange of experience and 'good practices' in order to improve health and reduce costs. Three objectives must be simultaneously achieved, according to the Barcelona European Council of March 2002: equal access to health for everyone, high level of health quality, long-term financial sustainability. The joint report by the Commission and the Council 'Supporting national strategies for the future of health care and care for the elderly', March 2003 justifies Union's action for three reasons: health policies must comply with the internal

market rules of free movement of persons, of goods and of services and free provision of services (but are these worries crucial in the health area?), the EU has a responsibility in the area of public health (Article III – 278, Treaty establishing a constitution for Europe). Last the EU must monitor the long-term sustainability of public finances (but countries should be allowed to raise their health expenditure if households agree to finance the rise). The 2004 Communication tries to make a link between health and employment, insisting on health problems for people at risk of social exclusion, employment in the health and long-term care sectors.

Table 3.8: Main Features of Health Systems in the EU

Germany	Decentralised system managed by health Funds, practitioners' associations and hospital groups. Health legislation is public. Spending is high.
Belgium	Public universal insurance. Free access to health care. 22% of spending paid by patients. Ceiling of spending to be paid by patients. High spending and high rise in spending. Introduction of an objective of rate of growth of spending.
Denmark	Universal insurance. Free hospital spending. Health care are managed by regions. 16% of spending paid by patients.
Ireland	NHS supplemented by a voluntary private insurance system (covering 44% of the population. 22% of spending paid by patients. Insufficient supply.
Greece	NHS supplemented by a private insurance system. 46% of spending remain paid by patients.
Spain	NHS supplemented by a private insurance system. GP gate-keeper. 23% of spending paid by patients. Spending is relatively low.
France	Health insurance, universal coverage and supplementary insurance. Free access. High and rising spending. Annual target for spending growth.
Italy	NHS, regionalised plus supplementary insurance. GP gate-keeping. 20% of spending paid by patients. Plan of rationalization.
Portugal	NHS and supplementary insurance. 29% of spending paid by patients. High spending.
Sweden	NHS managed by regions and towns. GP as gate keepers. 13% of spending paid by patients. High spending.
UK	NHS, free health care but long waiting time.
Netherlands	Compulsory private insurance in competition, but under regulation. High spending.
Finland	NHS managed by municipalities. GP as gate-keepers.
Austria	Health insurance, almost universal coverage with GP as gate-keepers. 26% of spending paid by patients. Relatively low spending.

The 2007 Communication summarises the first year of the OMC. All countries commit themselves to entitling the access to all for adequate care, but in practice they ask for a rising share of spending to be paid by patients, even if there are cases with 100% payment and expenditure ceilings. The share of non covered health spending is higher than 30% in Portugal, Austria, the Netherlands, Latvia and Greece (48%), Cyprus (52%). Long-term care should be professional (and not left to families and women) and its funding should increase and become autonomous and guaranteed. Insufficient labour supply appears in some countries (nurses and other workers in the health sector). In some countries health supply is insufficient which generates waiting times and rationing. Some countries find they spend too much on health. But the OMC does not really address the issue of the diversity of health systems, their governance, the appropriate methods to reduce cost. Until now there has been a non EU strategy promoted for health. There is a strong contradiction

between recognising the need for higher spending and financial constraints (which lead to try to reduce public employment and expenditure, to prefer private to public insurance. The OMC does not address directly major issues:
- how to finance a rising share in health spending?
- how to conciliate a satisfactory level of health spending insurance and to give incentives to households to reduce their consumption?
- how to supervise the behaviour of health suppliers?
- how to finance long-term care spending: universal benefits (everyone would be entitled to long-term care spending reimbursement, but this would be very costly, assistance benefits (benefits would be targeted to the poorer and be refundable on wealth and inheritance), mandatory private insurance.

3.4 UNEMPLOYMENT BENEFITS

Unemployment insurance spending is high in Scandinavian countries (in particular in Denmark and also in the Netherlands) and very low in Mediterranean countries and in the UK (see Tables 1.2 and 3.9). Two models seem efficient in terms of full-employment: the liberal model with low unemployment benefits, flexible wages, but also with full-employment being obtained at the price of a significant number of poor workers, the Danish model where unemployment benefits are high and are accompanied by substantial training efforts and activation policy for bringing the unemployed back into employment. It is therefore difficult to set EU objectives in terms of replacement rates, but the Danish model seems more in line with the ESM.

Until recently, it was however difficult to apply the Danish model in large heterogeneous countries with high unemployment. Training and support to some groups of the population (low-skilled, long-term unemployed, older workers, the young, single mothers with young children) was difficult to implement in a context where labour demand was too low. In the years to come, the deceleration of labour supply growth and more robust GDP growth may make it easier to implement such a policy.

Table 3.9: Employment Policy Expenditures, 2005

	Spending % of GDP			Generosity*	
			Unemployment		
(%)	Active	Passive	Rate	Active	Passive
Germany	0.97	2.35	11.3	8.6	20.8
Austria	0.62	1.51	5.2	11.9	29.0
Belgium	1.08	2.37	8.1	13.3	29.3
Denmark	1.74	2.51	4.2	41.4	59.8
Spain	0.78	1.45	9.2	8.5	15.8
Finland	0.89	1.90	8.5	10.5	22.4
France	0.90	1.62	9.9	9.1	16.4
Greece	0.05	0.35	9.8	0.5	9.7
Ireland	0.63	0.83	4.3	14.7	19.3
Italy	0.54	0.82	7.8	6.9	10.5
Netherlands	1.33	2.02	5.2	25.5	38.9
Portugal	0.69	1.39	8.1	8.5	17.2
Sweden	1.32	1.20	7.8	16.9	15.4
UK	0.49	0.19	4.7	10.5	4.0

* Unemployment expenditures/Unemployment rate
Source: OECD.

The future of the incapacity benefits system is an issue in several countries, because the system is costly (Netherlands, Finland, Sweden, Denmark) and reduces activity rates significantly (Finland, Italy, Sweden, UK). Conversely, incapacity benefits can be a flexible and adaptable way at the individual level to

tackle the issue of older workers in declining industries. But the schemes need to remain flexible with the potential for adjustment when the economy comes close to full-employment.

Box 1. The European Globalisation Fund

The introduction of a 'European globalisation adjustment fund' was proposed by the Commission in March 2006. This fund could be a positive development for the future of Social Europe. It recognises that there are workers affected by globalisation. The aim is to identify these workers and to provide a financial support in 're-training or concrete assistance to find new jobs'. In practice the fund will provide a support to the direct victims of globalisation, to workers in an industry sector directly hit by competition from low-wage countries. The fund will not facilitate job creation or help people keep their job, although in most cases a whole geographical area is hurt and new job opportunities are limited. Some social expenditure will be directly covered by the EU with this fund. It is an attempt to raise the EU budget and influence. However, the current expenditure ceiling is very low (500 million euros per year, i.e. 0.2% of MS unemployment allowances spending). If it is recognised that globalisation as a whole makes victims (low skilled workers) and winners (high skilled workers, capital income earners), the fund does not allow for transfers of the magnitude of the challenge.

3.5 FAMILY POLICY

Family policy has until now not been a topic for discussion and coordination at the EU level although it has been addressed in some recent reports (like the Report of the High level group on the future of social policy, May 2004). However, fertility rates are higher than 1.8 in only two countries - France and Ireland - out of the EU-15 countries and below 1.4 in six countries. Countries with very low fertility rates are likely to have very high dependency ratios in the future: Greece, Spain, Italy, Portugal and to a lesser extent Germany and Austria, despite high immigration flows. Population is likely to fall substantially in Portugal (4% until 2050), Germany (6%), Italy (7%). Rising birth rates is a crucial issue for these countries. In particular, the preservation of their pays-as-you go pension system will be will be questioned if birth rates do not raise or net immigration does not grow substantially.

Family policy should include three main elements:

- Allowing mothers with young children to work, which is the best way to prevent the risk of poverty and to give women incentives to have children. This requires a childcare system available everywhere and financed by public spending. Countries with low fertility rates are also countries with the lowest female activity rates (Greece, Italy). *A contrario* some countries succeed in combining high fertility rates and high female activity rates: Denmark, Finland, Sweden and France. These countries have a high level of pre-primary care and education spending (see Table 2.8) and also relatively high level of family policy expenditure (see Table 1.2).

Table 3.10: Activity Rates and Fertility Rates

	Activity Rates 15-55 year-old		Fertility Rates
(%)	Male 2005	Female 2005	2005
Germany	93.6	79.1	1.34
Austria	92.8	79.9	1.40
Belgium	91.8	76.8	1.64
Denmark	91.1	84.1	1.80
Spain	92.4	69.0	1.35
Finland	90.3	85.2	1.80
France	93.8	80.7	1.94
Greece	94.7	68.3	1.33
Ireland	92.2	69.6	1.86
Italy	91.2	63.6	1.31
Netherlands	91.4	77.8	1.71
Portugal	92.5	81.8	1.40
Sweden	92.4	86.5	1.77
UK	90.9	77.5	1.78

Source: European Commission, 2005.

- Ensuring that all children have a minimum income level, health and education. Accounting for the importance of education from the younger age in terms of school education and in the future society, European societies cannot spoil the potential of children of poorest classes. They must benefit from social services like specific help for education, health and cultural activities. A minimum income must be provided to families (even if this reduces the incentive to work for parents. Table 3.9 shows that child poverty rates are higher that adult poverty rates in many countries: the Netherlands, Italy, Spain, the UK and Portugal. Social assistance targeted at poor families should be increased.
- Family benefits and income taxation should ensure similar income levels for families and couples without children earning the same income. Table 9 shows that family benefits are too low in all EU countries: to have the same income level than a couple, a family with two children should have an extra-income of 40% according to OECD scale; it has in fact between 13 % (Austria) and 1.5% (Spain).

Table 3.11: Extra Income for a Family with Two Children as Compared to a Couple*

(%)	2006
Germany	11.3
Austria	13.3
Belgium	12.6
Denmark	8.2
Spain	1.5
Finland	7.7
France	8.2
Greece	7.9
Ireland	9.6
Italy	6.4
Netherlands	7.6
Portugal	6.1
Sweden	8.5
UK	6.6

* Husband earning the average wage, wife 33% of the average wage.
Source: Taxing wages, 2005.

At the European level, the countries should commit themselves on some objectives: availability of childcare, child poverty rates, minimal income for families with children, relative income for families with children.

3.6 FIGHT AGAINST POVERTY AND SOCIAL EXCLUSION

Poverty rates vary quite substantially in the EU, from around 9-12% in social-democrat countries to around 18-20% in Liberal and Southern countries (see table 3.12). Poverty results mainly from insufficient family and pension benefits and from precarious jobs, with low wages.

In almost all EU-15 countries, there is a minimum income amounting to around 50% of the median income (and thus it does not prevent individuals from falling into poverty at 60%). The minimum income system is more generous in Denmark and much less so in Southern countries. The marginal income tax rate for incomes rising from the minimum income to wages at the level of 50% of the median wage is higher than 80% in most countries; it is of course lower than 50% in Southern countries, but there are nevertheless quite a lot of unemployed or poor people in these countries.

Table 3.12: Poverty Rates in the EU, 2005

	Total	0-15 year-old	16-25 year-old	Older than 65
EU-15	*16*	*18*	*18*	*20*
Sweden	9	8	23	11
Netherlands	11	16	16	5
Denmark	12	10	29	18
Finland	12	10	22	18
Austria	12	15	13	14
Germany	13	13	14	15
France	13	14	18	16
Belgium	15	19	17	21
UK	18	22	19	26
Italy	19	24	23	23
Spain	20	24	18	29
Greece	20	19	23	28
Portugal	20	24	20	28
Ireland	20	22	19	33

Source: Eurostat.

Table 3.13: Minimum Income Levels in 2005

	Single People	Couple, 2 Children	At-Risk of Poverty Line	Marginal Income Tax**, %
Germany	672	1590	856	89
Belgium	625	1185	822	66
Denmark	1173	3333	1106	103
Greece	No minimum income		471	16
Spain	At the regional level		529	47
France	667	1264	796	80
Ireland	718	1341	936	88
Italy	250	542	719	14
Netherlands	549	1099	849	93
Austria	414	1090	900	87
Portugal	171	515	359	54
Finland	362*	1079	870	81
Sweden	364*	1094	865	98
UK	704	1690	936	78

* Excl. Housing. **
Source: European Commission.

The OMC on social inclusion was launched in 2000. The objective was to bring a 'decisive contribution of the eradication of poverty and social exclusion by the year 2010', but poverty rates have hardly decreased in the EU since 2000. Social exclusion has risen in the EU from the 1980's and social protection systems have no tool or institutions to tackle this. Owing to the OMC, all countries have been requested to include the fight against poverty as a new element of their social protection system. In 2000, the Communication focused on the need for people to be in employment, the right for all to

financial resources (although without imposing minimum income standards), preventing exclusion, supporting the more vulnerable, and involving all players. But contradictions were not between minimum income and work incentive, between economic modernisation of social protection (that leads companies to be more demanding on the quality of their workers) and inclusion. The joint report in 2002 showed the link between social expenditure as a share of GDP and the reduction in the number of those at risk of poverty. A large number of indicators were introduced to account for the different aspects of exclusion. The Communication from 2005 highlighted 7 priorities: being in employment; modernising social protection, inequalities in education and training, child poverty, right to decent housing, entitlement to social services, fight against discrimination. The 2007 Communication focused on the fight against child poverty. This raises the issue of the return of their parents in work, of combating school failure and of the integration of immigrant children. The fight for active inclusion aims to facilitate the return to work, but the risk is that this is obtained by deteriorating the situation of those who do not find a job.

All in all the value added of the OMC lacks visibility because no numerical targets were announced and no strategy is adopted due to the diversity of national systems. An advantage of the OMC could be to highlight the issue of poverty situations and to be an incentive for countries to set ambitious objectives but the work of the OMC is not adequately advertised. It would be more effective to set out common objectives in terms of poverty rates, child poverty rates, minimum incomes (as a % of the poverty line).

3.7 HOW TO ADAPT THE ESM? NATIONAL REFORMS OR A EUROPEAN PILOT?

OFCE Contribution (Mathieu *et al.,* 2007) deals with the respective roles of national and European institutions in the evolution of the ESM (or ESMs). The single market makes it more and more difficult for national protection systems to coexist: the EU has until now only organised the coexistence through systems coordination. There are three incentives for moving beyond this: the functioning of the single market would be facilitated, European citizenship would be strengthened, the risk of social competition would be reduced. But, all social protection systems are based on solidarity ; solidarity remains today at the national level and there is no EU solidarity. How to combine such different models and move from systems based on domestic foundations to a European system? Can convergence take place if national models are deeply anchored in different social institutions and practices? Social systems cannot be unified at the EU level, without accounting for national traditions, debates and specificities. Building a European social protection in that way would be at the expense of the role of national social partners and would weaken the support for social protection. Such a strategy could lead to unify systems towards the bottom in the name of competitiveness rather than to the development of a rejuvenated ESM.

Europe must choose between five strategies. The liberal one consists of letting social competition play. But what competition between social systems means in a situation of free movement. Will countries where redistribution is higher be able to stand competition from less redistributive countries, knowing that the wealthiest will leave the country while the poorest will settle there? There is no evidence that competition will lead to a satisfactory system. The sovereignist one leaves each country free to choose their system, but allows them to defend themselves from unfair competition. But, this view makes difficult any further progress for a European citizenship. It supposes that Economic integration would remain relatively limited. The Big Bang strategy proposes to organise explicitly the progressive merging of the systems, but the

only system that could be easily extended would be a liberal system with a minimum solidarity

The strategy of a Social Europe aims at favouring social convergence through the gradual implementation of binding common social objectives (wages and minimum income, replacement ratio). But Anglo-Saxon countries and the new MS do not want to be constrained to move towards a model that is widely felt to be in crisis today; a model that has failed to avoid high unemployment, rising exclusion and which financial prospects are under question

In the current strategy, European authorities try to initiate progressive but converging reforms aimed at *modernising* national social protection systems. Such a convergence would be obtained through soft methods, like the BEPGs or the Lisbon Agenda, i.e. through a set of objectives elaborated by the Commission and then adopted by the European Council, and like the open method of coordination, i.e. the definition of common indicators and objectives, the confrontation of domestic experience and peer pressure guided by the European Commission. Each country however keeps its autonomy in social areas. This process has the advantage of leaving national sovereignty intact. But it is necessarily slow and not visible for economic agents and populations. It remains disconnected from national debates and reforms. The BEPGs and the OMC are dialogue processes between European and national administrations and do not really involve national social players, as they are hardly debated at the country level and in the general public. How should the process be democratised and strengthened? Currently the process is not mobilising and does not lead to the emergence of a Social Europe project. Moreover, its content raises questions. In practice the role of European authorities stands between supporting a specific ESM and questioning it under the name of modernisation. But these issues should be decided after a social debate by a democratic political process.

4. Conclusion: Debates on a New Welfare State in Europe

The European Social Model (ESM) is at the heart of the functioning of European economies and societies. Social Models are diverse in the EU, but European integration requires some coordination and convergence. We will give three different points of view here. Box 1 stresses the importance of guaranteeing social cohesion in the Member States, by reducing income inequalities and ensuring a high level of social protection, in particular for people who cannot work, because of their age, their handicap, their family situation or the economic situation. The disincentive effect of social protection is judged of second order and it is considered that rich countries can accept it. Box 2 expresses the importance of restoring work incentives, by accepting initially some increase in income inequalities. Making work pay will increase production and will give more resources to the Social security system, assuring its financial sustainability. Box 3 suggests a new architecture of welfare state in Europe, inspired by the Scandinavian model, so the impact of social protection as a productive factor increases.

BOX 1: Preservation and Development of the European Social Model (from OFCE)

Maintaining and developing the ESM is part of European Construction and is as important as the Internal Market. The ESM should have a precise content which needs to be politically debated. The ESM should include:

- In terms of pensions, a minimum income for the elderly and a decent replacement rate for workers at low or medium wage earnings.

- Retirement legislation ensuring that older workers, whom firms do not want to employ any more, do not fall into poverty. *This raises the issue of work incentives for older workers.*
- Health insurance available to all, either through a universal or an occupational insurance system associated with free health insurance entitlement to the poor. *But this raises the issue of the control of health spending.*
- A minimum income. *But this raises the issue of work incentives for low-wage workers.*
- Unemployment allowances ensuring a minimum income and a satisfactory replacement ratio for low or medium wage workers. *But this raises the issues of work incentives for the unemployed.*
- Family benefits ensuring a minimum living standard for children and a satisfactory living standard for families relative to single people.
- Childcare benefits and collective infrastructure supporting female employment, especially for mothers with young children.
- Some degree of product market regulation to ensure that universal public services are provided. *But this raises the issue of the efficiency of such services.*
- Some employment protection legislation to ensure that companies invest in their workers and that workers invest in their company. *But this makes the productive system more rigid.*
- A tax system targeting the reduction of income inequalities. *But this reduces work and savings incentives*
- An ambitious social and economic policy needs to be financed. This requires leaving to the MS the possibility to decide their company and personal taxation, thus implementing a strategy of taxation coordination in Europe
- The evolution of European systems must be done under the impulse of a democratic OMC, with a larger involvement of national social partners. Minimum social standards, increasing with the economic development of countries, should support convergence.
- There is a need for an active and contra-cyclical macroeconomic policy in order to maintain full employment. This will require a robust demand (in particular through low interest rates and an appropriate exchange rate level), coordinated policy measures to address imbalances between countries (which will prevent non-cooperative strategies). The Stability Pact will need to be reconsidered to allow governments to borrow in order to finance the investment required to support growth. Being close to full employment is a prerequisite for efficient strategies of work incentives for older workers, the disabled and the unemployed.

Two issues are more difficult to address:

- Should Europe open more widely its frontiers to immigration in order to compensate for demographic slowdown? This would mean keeping unskilled jobs and some social inequalities (as in the case of the US and Anglo-Saxon countries)? Or should Europe aim first of all at maintaining full-employment, to raise skills levels and facilitate the reduction in unskilled jobs?
- Should everything be done to bring older people, disabled people and mothers with young children back to work? Yes, of course, because a job is socially rewarding and is a means of integration in the Society. But such a policy may entail a reduction in living standards for the targeted groups of the population who do not succeed to find a job. Also, is any job valuable? Is it necessarily socially useful? Perhaps productivity gains could be partly used to reduce working time and the importance of labour?

BOX 2: Design of an Efficient Welfare State (from CPB)

The term welfare state is used as a catchall for public institutions that are related to the income and expenditures of people over their life cycle. This includes programs for pensions, disability, survivor and unemployment insurance, medical expenditures and perhaps even education. In this box, we structure the discussion along three functions of the welfare state, namely *Redistribution*, *Risk and insurance*, and *Reallocation over the life cycle*. For each of these three R's of the welfare state, we demonstrate the key trade-offs and explore opportunities to improve combinations between them through efficiency enhancing reforms. [6]

R1: Redistribution between People

People differ in their talents or abilities. The welfare state aims to reduce inequality between people by means of redistribution. This creates, however, several labour-market distortions, such as lower labour supply, less training and higher unemployment. This trade-off between equity and efficiency applies to various institutions such as the progressive tax-benefit system, benefits in kind, indirect taxes, subsidies and wage compressing institutions.

Universal income support, such as a basic income, does not seem an optimal form of redistribution. It is expensive and raises marginal tax rates across the board, thereby causing large distortions in labour supply. Targeting support to families with low incomes would be more efficient. This creates, however, distortions at the bottom of the labour market due to the poverty trap. It reduces the gains from targeting. Designing an optimal redistributive system therefore requires careful consideration of the distortions at both the participation margin and the intensive margin of labour supply.

In-work benefits have the advantage of reducing the benefit replacement rate, without hurting the income of benefit recipients. It leads to a lower rate of involuntary unemployment, especially if it is targeted at the low skilled. However, by phasing out benefits among middle income groups, targeted relief is particularly distortionary for the intensive margin of labour supply.

In-work tax relief can be targeted on female workers who possess relatively large labour supply elasticities, e.g. compared to male breadwinners. Subsidies on complements of female labour, such as childcare expenditures, are typically desirable features of an optimal tax-benefit system as they mitigate distortions at the intensive margin of labour supply. Also an individualised income tax system yields better labour market incentives than a system that takes the family as the tax unit, especially for females. Individualising social benefits is less attractive, however, since it will raise marginal tax rates at the participation margin of secondary earners.

Redistribution is also achieved through wage compressing institutions, e.g. due to trade union behaviour. However, this raises unemployment among the low-skilled. Lower minimum wages or less wage compression will relax this problem, but this raises inequality. Society may alternatively shift from wage compressing institutions towards fiscal redistribution or provide tax relief for employers hiring low-skilled employees.

Since reforms in the redistributive system have social costs, complementary instruments may be considered to escape the inevitable trade-offs in redistribution. For instance, modern welfare states increasingly rely on the integration of vulnerable people in the labour market by combining the carrot of positive financial incentives with the stick of punitive work mandates.

R2: Risk and insurance

Risk of disability or unemployment is dealt with by social insurance. In designing a social insurance contract, society aims to minimise the adverse implications for the labour market caused by moral hazard. A less generous social insurance, e.g. through lower levels of unemployment and disability benefits, shorter unemployment benefit

[6] De Mooj (2007) presents an evaluation of such reforms in the Dutch case.

duration, or substitution towards individual saving accounts, can help reduce unemployment rates and raise labour-market participation by combating moral hazard. It yields, however, less insurance. Hence, there is a trade-off between insurance gains and incentives to fight moral hazard. Savings may be more appropriate than insurance in the case of small risks and large moral hazard, e.g. for small unemployment spells. For larger risks, however, insurance is typically more efficient than savings.

For a given level of insurance, the key policy challenge is to minimise moral hazard. The government may use stringent job search requirements and mandatory obligations to raise the exit from social insurance. An efficient administration should engage in tight monitoring and claim assessment and invest in activation of benefit claimants.

Insurance can be supplemented by active labour-market policies. Yet, whereas harsh measures like sanctions and mandatory workfare tend to significantly increase outflows from the insurance schemes, empirical evidence provides mixed evidence on the effectiveness of more lenient forms of active labour-market policies. Lock-in effects and reduced search activities seem to render some forms of active labour-market policies even counterproductive in raising employment in the market sector. Still, active labour-market policies may be a social imperative, rather than a way to increase employment in the open market. Moreover, some types of active labour-market policy, such as job-search assistance and vouchers for the long-term unemployed, yield more positive effects.

Employment protection and firing taxes may be efficient to reduce moral hazard in inflows into unemployment insurance. Moreover, it encourages commitment and thus stimulates employment durations and investment in firm-specific human capital. However, employment protection also creates a social cost by increasing unemployment duration and hampering innovation. It hurts especially the labour market position of youngsters, women and immigrants. Financial incentives, e.g. via experience rating in unemployment insurance, tend to be more efficient than administrative procedures to reduce excessive job separations.

R3: Reallocation of the Life Cycle

The welfare state plays a role in consumption smoothing over the life cycle. Capital-market imperfections, impatience and distortions associated with redistribution and insurance provide a rationale for this. European governments are substantially involved in reallocating income over the life cycle: estimates suggest that between 60 and 80% of the welfare state actually concerns intrapersonal reallocation of income over the life cycle, rather than redistribution between the life-time rich and poor. An alternative for collective smoothing via the welfare state would be mandatory or subsidised individual saving schemes. While these schemes may reduce the overall tax burden compared to collective smoothing via transfers, they may bring other distortions. Hence, the government faces a dilemma. It applies to areas of life-long learning, the combination of work and family care and early retirement.

Life-long learning is a vital pillar for our welfare state. While investment by the government seems important in initial education, the value added of government intervention is less clear in adult learning. Some subsidies may help to alleviate training distortions imposed by progressive taxes and generous social insurance provisions. The argument for large-scale public investment in on-the-job training is weak though.

Facilities for the combination of work and care for children is important for combining high female participation and high fertility; Female participation benefits from increased labour-market flexibility and child-care facilities. Subsidies for parental leave may support fertility, but typically come at the expense of labour market participation in terms of hours worked.

A number of distortions in retirement decisions have recently been removed in Europe. Indeed, the system has been reformed towards a more actuarially neutral system for early retirement. Still problematic for the participation of the elderly is, however, the rigidity of the labour market. Indeed, the combination of fixed wage contracts with seniority wages, employment protection and mandatory retirement hampers the mobility of older workers and increases unemployment durations. Moving towards a more flexible labour market can increase employment, improve allocative

efficiency and allow for more flexible retirement patterns. It calls, however, for a breakdown of the implicit contract.

Subsidiarity.

According to CPB these reforms to improve the trade offs of the three R's should be conducted by the Member states themselves. Lejour (2007) recalls that since the Treaty of Maastricht in 1992, EU Member States have applied the subsidiarity principle in arranging the division of competencies between individual Member States and the EU. There may be solid arguments for centralised European coordination, if there are scale or external effects. But these effects are not really present in social security expenditures and labour market regulations. Moreover there are considerable differences between countries in terms of their welfare states expressing different preferences and circumstances. These preferences and circumstances could better be matched by social welfare policies at the Member State level. Lejour estimates that countries will converge over time in terms of their welfare states. The harmonised social regulations will be expensive for the majority of new Member States and will not match their level of economic development now. Differences in regulations need not in fact be harmful; they can help the economic development of new Member States because they will be able to attract more capital and strengthen their competitiveness with lower social standards. Western European consumers will ultimately also benefit from this through increased trade and specialisation. Convergence could then subsequently lead to adaptation of social policy to the EU norms. If on the other hand high social standards are imposed on the new Member States immediately, this could make it more difficult for them to achieve the growth necessary to catch up with the West.

BOX 3. Key Elements of a New Welfare State Architecture (from Wifo)

European societies are facing a number of demanding challenges, which will intensify in the years to come and call for institutional reforms in European welfare systems: There is, on the one hand, from a societal perspective, a process of individualisation underway that is related to women's growing preferences for personal independence and life long careers. This process entails substantial changes in demographic and family behaviour which results in new and more flexible family arrangements, meaning a declining number of children living together with both mother and father and an increasing number of single-parent families. This development mirrors new insecurities and increasing poverty risks.

On the other hand, looking at the economy and the labour market, processes of global integration, technological transformation and structural economic change are going on which result in a shift from production to knowledge-intensive service economies creating new risks in the labour market. While the number of decently paid and secure jobs of low- and medium-skilled standard production workers are rapidly declining, a dualistic perspective on the labour market is unfolding: The main route is in favour of skilled and highly professional, well-paid jobs, but at the other end a sizeable market of precarious jobs for those with weak human capital facing either low wages or unemployment. At the same time the pressure to increase wage disparities continues to rise (*Reich*, 1991).

To prevent a bleak perspective of life-long precariousness and rising poverty risks for an increasing number of people, our societies have to provide, on the one hand a highly efficient education system which leaves nobody behind and fosters life-long learning as well as strong mobility opportunities on the labour market and, on the other hand, a system of social security with a tight safety net at the low-income end but strong activating incentives and supportive instruments, e.g., active labour market policy. In knowledge-intensive post–industrial economies individuals' life chances depend on their learning abilities and their accumulation of human capital. Hence, the impact of social inheritance will become of utmost importance - "in particular with regard to cognitive development and educational attainment" as *Esping-Andersen* (2002, p. 3) pointed out. And he proceeded: "..we cannot afford *not* to be egalitarians in the advanced economies of the twenty-first century. ….there is a very good argument that

equality of opportunities and life chances is becoming *sine qua non* for efficiency … Our human capital constitutes the single most important resource that we must mobilise in order to ensure a dynamic and competitive knowledge economy. We are facing huge demographic imbalances with very small working age cohorts ahead, and to sustain the elderly we must maximise the productivity of the young."

While the post-war welfare states mainly concentrated on equalising living conditions by supporting the victims of destructive outcomes of market forces through income maintenance guarantees, the policy challenge of the future is to empower people to be adequately equipped to satisfy their welfare needs within the market. Thus, social policy – as seen by the Lisbon agenda - is about to become a productive resource; i.e. a supply side policy instrument to empower and activate people to be able to succeed in the market.

The Lisbon growth strategy is based on three ambitious objectives: making Europe a zone of economic prosperity, with a high level of social protection and a responsibility in terms of the environment. If one considers that these three objectives are linked and that European construction should aim at a progressive unification of European Societies, then European construction should aim at making the European social models converge towards a single one. Increasing economic efficiency in Europe, facilitating changes and strengthening investments important for the future should be accompanied by a determined social policy. If one considers that the continental model lacks flexibility, that the Liberal model is too costly in terms of social cohesion and inequalities, then Europe should move towards a Scandinavian model, knowing that the task will not be easy because institutions and traditions that have paved the way for the success of these models do not exist in other countries or not to the same extent.

The Scandinavian system remains inclusive and tight, but social benefits are partly made dependent on the input of the individual and transfers become conditional on certain obligations; replacement rates are lower than they used to be in order to provide stronger incentives to work but are still high by international standards. Scandinavian countries turned out to be the best performers in combining a high level of equality and low poverty rates with high levels of employment and high economic growth (section II). Accordingly, they seem to be best prepared to tackle the emerging societal and economic challenges of the future.

As key elements for a new welfare state architecture we pick out:

- 'A child-centred and women-friendly social investment strategy', as *Esping-Andersen* (2002) has proposed. This strategy can be seen as the backbone of an activating reform which takes into account the preconditions of a highly flexible, knowledge-intensive society with high activity rates of economically independent men and women. While post-war welfare states provided both a high degree of income security and, together with marital stability, sufficient caring facility within the traditional family, young families today have a less stable life-course perspective both economically as well as in their partnership. At the same time, the prerequisites for a good life and working career are rising steadily. Life chances depend increasingly on investment in human capital by both parents and society in early childhood. Good cognitive abilities which have to be developed in early childhood are absolute preconditions for educational attainment and life-long learning.

  For demographic reasons as well as due to the high cognitive requisites of a 'knowledge economy', we cannot afford to leave any child behind in her intellectual development. Accordingly, one of the key goals of reform strategies is to reduce social inheritance and to improve the cognitive potential of every child, irrespective of her social origin. Thus, policies aimed at improving the availability of affordable high-quality child-care facilities in early childhood as well as policies to prevent child poverty and safeguard welfare must be seen as social investments which are central pillars of any activating welfare state reform.

  Together with higher working-time flexibility and part-time employment possibilities, the availability of high-quality and affordable care facilities for both children and elderly is also an important precondition for parents and – in particular for women – to find their life-work balance in combining family

obligations with individual career preferences. In the face of demographic ageing this is an increasingly important issue for both increasing fertility rates and women's labour market participation. Improving the relative income of families with children should also contribute to bringing fertility rates back to satisfactory levels.

- High investment in human capital to increase educational attainment and literacy levels among younger cohorts and to institutionalise life-long learning to improve the likelihood of attending successful retraining at advanced ages, thus reducing one of the barriers to labour market participation of older workers.
- Increasing social services. The welfare state of the future will have to provide more services to meet the requirements of more individualistic societies and service economies. By providing sufficient high quality care facilities for children, the aged and the handicapped the state empowers people to combine gainful employment with family obligation, thus fostering (female) participation, welfare production and equality in the modern ageing society.
- A 'flexicurity' strategy or managed and balanced flexibility in the labour market. Increasing competition in goods and labour market due to world-wide economic integration as well as rapid technological and structural changes demand higher labour market flexibility. To prevent poverty risks, higher standards of social security are needed. Here, the Nordic – in particular Danish – experiences with 'flexicurity' offer examples of good practise by combining, on the one hand, deregulation of the labour market with extensive active labour market policy and, on the other hand, generous income protection in the case of unemployment paired with strong incentives to resume employment fast.
- Government and public institutions have to play a proactive role in promoting competition, innovation, efficiency and structural change. Technology policy and enhancing the adoption of new technologies are fostering growth and welfare. Industries hurt by globalisation must be restructured or the reconversion of their workers must be supported. This contradicts the approach that governments just need to deregulate markets and wait for the expected innovation and growth rebound to automatically follow.

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