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Europe – global and greying

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Editorial

Klaus Regling, Director-General of the Economic and Financial Affairs DG

Dear Reader,

Welcome to this first edition of the DG ECFIN newsletter, produced by the Directorate-General to inform readers about our activities: what we do, why we do it and how we do it. The latest Economic Forecasts from DG ECFIN, published at the end of November, are one main topic in this issue, and the good news is that the rising confidence detected in our business and consumer surveys last year is now translating into higher economic growth and higher employment. However, while EU economies have successfully withstood the oil price rises without too much disruption, we do warn about the risks posed by the possibility of further oil price hikes, global current account imbalances and possible shifts in financial market expectations that could affect the real economy. Several Asian central banks are holding large reserves of US dollars. In the worst case, a loss of confidence on their part, leading them to reduce their dollar holdings, could harm the US economy by resulting in rising interest rates and a falling dollar value coupled with a slowdown in economic growth. This would have a large impact on world trade, and the EU, as the world's largest trading bloc, would also suffer. For this reason it is important that the 'unwinding' of the US deficit happens in an orderly manner to avoid disruption to the world economy.

Inside, you will also find a brief summary of the EU Economy Annual Review for 2005. The Review concentrates on the growing integration of the world economy and in particular those aspects that are causing heightened public anxiety about the impacts on jobs and security of further globalisation. Public worries are always of concern, and in this case they could lead to pressure for protectionist and undesirable defensive measures. To support policy-makers and the Member States in allaying public fears and doubts, and form a basis for informed debate, the Review presents a clear, unpartisan appraisal of the pros and cons of globalisation for Europe.

In an article on European Social Models and the economics of ageing, we briefly describe DG ECFIN's work on these related, very topical issues. We are living longer and in better health, which is great, but there is the usual drawback of 'no free lunches'. If we are not to put unfair burdens on future generations then social welfare systems, in particular pensions, need reforming. DG ECFIN staff will continue to work on these issues in 2006 and beyond. A special report on the budgetary impact of ageing populations with projections for the EU-25 will be released early in the year, to be followed later by an assessment of Member State reforms aimed at lengthening working lives.

Of course, the planned extension of the euro area will also be an important issue for DG ECFIN this year. We will be looking closely at the new Member State economies during preparation of the Convergence Reports on their progress towards economic and monetary union, and in the Broad Economic Policy Guidelines for the coordination of economic policies. We will also work closely with the new Member States on their preparations for adoption of the euro. This is another area where there is public anxiety owing to perceived risks of price rises, so we will be advising and helping Member States, where requested, on their public communications strategies to allay these fears.

Klaus Regling
Director-General
Economic and Financial Affairs DG

Editorial information

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What's new from ECFIN

20 December 2005
The euro area economy

The series 'Quarterly Report on the Euro Area' (QREA), published by DG ECFIN, contributes to improved understanding and public debate on economic developments in the euro area. The December 2005 QREA reports that economic growth in the euro area is now gathering momentum and that the sources of growth, such as consumer spending and industrial investment, are also becoming more balanced. While exports remain buoyant, domestic demand is strengthening on the back of a strong pick-up of investment. The report also looks at the implications of an ageing population and emphasises the need for labour-market and welfare policies which are sustainable in the face of economic and demographic developments. The latest QREA report is available on the DG ECFIN website.

2 December 2005
Budgetary implications of structural reforms

A workshop organised by DG ECFIN considered the short-, medium- and long-term effects of structural reforms, such as changes to welfare systems, on public finances and whether trade-offs exist. For the long term we need to invest in structural reforms, yet we also need budgetary discipline now, which restrains investments – a dilemma that was recognised in the recent reforms to the SGP and discussed in detail at the workshop. For more information see 'events' on the DG ECFIN website.

November 2005
The costs of ageing – underlying assumptions and projection methodologies

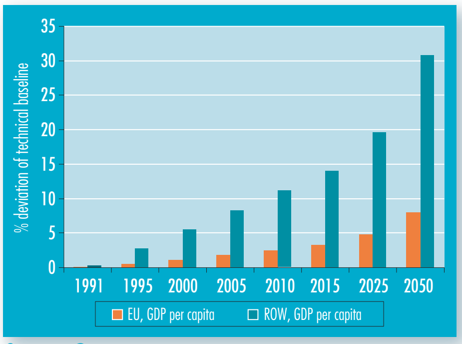
The Economic Policy Committee (EPC), composed of officials from the Member States, DG ECFIN and the ECB, is producing a new set of long-run budgetary projections for all 25 Member States, covering pensions, health care, long-term care, education, and unemployment transfers. The EPC working group on ageing populations has published details of the assumptions and methodology that will be used to produce the projections. Details are presented in an 'Occasional Paper' available from the DG ECFIN website.

23 November 2005
The 2005 EU Economy Annual Review: the globalisation issue

This annual review of the economic situation of the EU and the euro area is primarily targeted at professional economists, but covers issues that are also of interest to a wider public. With its solid theoretical and empirical analysis, it lays the groundwork for the debate about topical economic policy questions for more effective policy-making – so more than just a look back over the year, it is also a launch platform for meeting the challenges of the coming years.

This 2005 review is devoted to the subject of globalisation, here meaning deepening global economic integration and its consequences. For more information, see the article in this newsletter and download the report from the DG ECFIN website.

Most favourable globalisation scenario: Gains for EU and Rest of World



Source: Commission services

21 November 2005
Houses and mortgages: a DG ECFIN workshop

In a home-owning society such as Europe, the huge amounts of money and wealth tied up in housing and mortgages make these markets important for the whole EU economy. At a workshop on 'Housing and mortgage markets and the EU economy' organised by DG ECFIN in Brussels, the audience heard presentations on what determines house prices, the evolution of mortgage markets and the implications for micro- and macroeconomic policy. To read the presentations at the workshop see the 'events' section on the DG ECFIN website.

Commissioner Almunia signing the PRINCE partnership agreements with the Ministers of Finance of Slovenia, Estonia and Lithuania.

8 November 2005
Communication partnerships for the euro

Under the new logo 'One currency, many opportunities', the Commission signed partnership agreements with Estonia, Lithuania and Slovenia that govern support to their national communications activities in preparation for adopting the euro. In his welcoming speech at the signing ceremony Economic and Monetary Affairs Commissioner Almunia stressed that early preparations are essential, not only to meet the macroeconomic criteria for convergence, but also to give adequate information to the public that will enable them to switch over to the euro with complete confidence. The partnership agreements are part of the PRINCE programme – Information Programme for the European Citizen – and enable the Commission to support national governments' public awareness campaigns with publications, audio-visual campaigns and seminars on the euro. For more information see the Commissioner's website.

4 November 2005
Enlarging the euro area – work in progress

A new Commission Communication prepared by DG ECFIN reports on the practical preparations that the new Member States are making to adopt the euro. Presenting this second such report at a press conference, Commissioner Almunia reported that in many cases preparations have started in earnest and much progress has been made. However, he also called for the pace of preparations to be stepped up and stressed the need for more and better information for the general public. For a copy of the Communication see the DG ECFIN website.

24 October 2005

A call for social dialogue

In a speech to the Austrian Chamber of Labour entitled 'Europe: the best way towards social justice in the global world', Commissioner Joaquín Almunia stated that globalisation and ageing are the main challenges facing Europe, with reforms for more jobs, higher productivity and sounder public finances as the necessary response. Removing uncertainty and building commitment for these reforms demands a social dialogue with Europe's citizens, a distinctive feature of the European Social Model. "European common values are not an obstacle but an asset in the globalised world," said Commissioner Almunia, and he continued, "...the European way of reconciling economic performance and social cohesion is a key asset to ensure sustainable development and build a decent world for generations to come." Read the speech on the Commissioner's website.

Further information

The latest news and press releases from DG ECFIN are available at:

http://www.europa.eu.int/comm/economy_finance/news/whatsnew_en.htm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Joaquín Almunia,
Commissioner for Economic and Monetary Affairs

Looking ahead

In the first quarter of 2006

In January:

Annual Progress Report by the Commission to the European Council on national Lisbon programmes. These national programmes, drawn up by each Member State and adapted to its individual situation, are the major reporting tool on economic and employment measures in the context of the Lisbon Strategy.

Between January and March the Commission will make **recommendations** for Council opinions on each Member State's stability and convergence programme. Member States are required to submit such programmes as part of their commitments under the Stability and Growth Pact.

In March:

The Commission will make a **proposal** for a decision on new external lending mandates for the European Investment Bank. EIB lending supports EU policies in several areas, such as infrastructure, construction and R&D within the Union and also externally as part of the EU's development and enlargement activities. The Commission will also report to the Council on the EIB's existing external lending mandates.

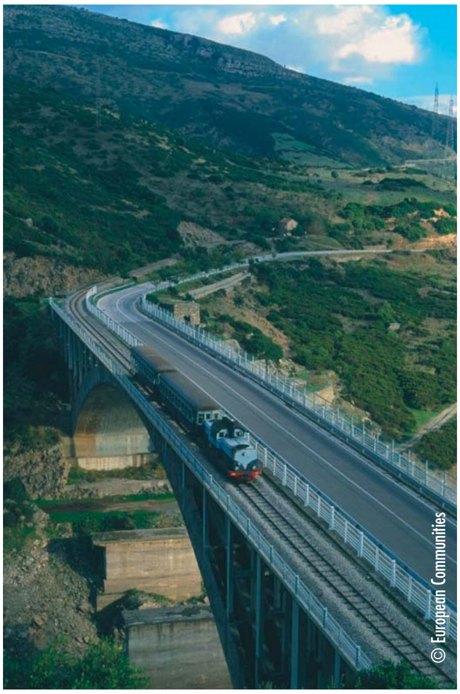
In March:

The ECOFIN Council will finalise the examination of stability and convergence programmes and prepare the European Council meeting on 23 March.

In the second quarter of 2006

In April:

The Commission will make a **proposal** for a decision on new participating funds for the TEN Risk Capital Facility. This facility helps fund the Trans-European Networks (TEN) in transport, energy and telecommunications. The Commission provides the funds to the European Investment Bank which manages the facility.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In June:

The Commission will publish a **Communication** and report on 'Public Finances in EMU 2006'. This yearly report evaluates Member States' public finances, a critical aspect of economic and monetary union, and provides analytical studies on government finance issues.

In June:

The Commission will **report** to the Council and the European Parliament on the implementation of the macro-financial assistance (MFA) facility to third countries in 2005. The MFA facility provides loans to third countries, at present mainly in the Balkans and North Africa, aimed at improving government finances and establishing a market economy. MFA loans are closely coordinated with aid from the IMF and the World Bank.

In mid-2006

The Commission will **publish** the Convergence Report 2006. Every two years, or more often if requested, the Commission produces a report on the fulfilment by the Member States of the convergence criteria. All new Member States have a derogation from joining the euro area while they work to achieve convergence and fulfil the legal requirements. Proposals are expected on which of them are prepared for entry to the euro area and adoption of the euro.

A European round-up

For 2006
The Austrian and Finnish Presidencies

Austria takes on the Presidency of the European Council for the first six months of 2006, followed by Finland from 1 July 2006. For the ECOFIN Council the two Presidencies have outlined their main priorities in 2006. These aim to enhance European economic policy strategy in several areas and thus boost economic growth and employment. Actions to ensure stability-oriented fiscal policies and speed up economic and structural reforms are high on the agenda. Further information, which will be updated through the year, can be found on the Austrian Presidency website: http://www.eu2006.at

6 December 2005
ECOFIN meets: reforming agenda

The monthly Economics and Financial Affairs Council (ECOFIN) is composed of economics and finance ministers from the Member States and Commission representatives. The earlier November ECOFIN Council rapped Hungary for not taking earlier advice on putting its public finances in order to meet the 3% GDP budget deficit limit that EMU requires. In December, the Council considered economic reforms, Lisbon national reform programmes and regulatory reforms. In addition, Commissioner McCreevy presented his strategy for banks and financial services. The main results of the monthly ECOFIN Councils can be found in the press release section of the website of the Council of the European Union.

2-3 December 2005
G7 meets in London

G7 meetings of Finance Ministers and Central Bank governors are a subset of the G8 summits, which bring together the major industrialised democracies. At the G7 meeting in London, Commissioner Almunia spoke at sessions on development and combating the financing of terrorism. Further, in a meeting on the Middle East peace process he highlighted the current and future role of the Commission and the EIB in providing humanitarian aid and infrastructure investment within the context of the Quartet roadmap for peace in the region. For more on the EU and G7-G8 see the External Relations DG website.

14 November 2005
Eastern promise for businesses

The European Bank for Reconstruction and Development highlights the improving business conditions across central and eastern Europe and the former Soviet bloc in its latest Transition Report. With economic growth at 5.3% in 2005, the area is outperforming many other regions of the world. However, warns the report, the remaining obstacles hit hardest those firms that are most likely to generate new jobs and growth. The tangibility of the improvements is seen in the rapid expansion of bank credit to the private sector – a confirmation of growing confidence in the future. The EBRD Transition Report can be found on the Bank's website: http://www.ebrd.org

October 2005
Can businesses get the bank loans they want?

A recent Eurobarometer survey asked over 3 000 SME business managers whether they could get bank loans when they needed them. An important issue, considering that, overall, SMEs are by far the largest business employers in the EU and thus a lot depends on their economic success. The survey shows that better-adapted social and fiscal regulations and better-qualified staff are the main concerns of SME managers. However, bank finance remains important as more than half of the respondents rely on it to complete projects. The survey reveals an equal split between 46% who find bank loans easy to obtain versus 47% who judge it difficult. The Eurobarometer survey can be found on the Enterprise DG website.

Commissioner Günter Verheugen at the EIB Forum in Helsinki

27 October 2005
The 2005 EIB Forum in Helsinki

'The Lisbon Strategy – closing the gap' was the title of the annual forum of the European Investment Bank held in the Finnish capital. The EIB is taking on an increasing role in funding European R&D in addition to its traditional lending for infrastructure, which was reflected in the forum presentations. EIB President Phillipe Maystadt opened the forum and stressed the need for better organisation and microeconomic reforms, in addition to financial resources, if Europe is to become more innovative. Enterprise and Industry Commissioner Günter Verheugen gave a keynote speech on the new Lisbon partnership for jobs and growth and the innovation challenge facing Europe. The speeches and presentations can be read on the EIB website: http://www.eib.eu.int

6 October 2005
Euroframe: forecasting and taxing matters

The Euroframe - European Forecasting Network (EFN) combines the expertise of economic and econometric research institutions from various Member States to produce biannual reports covering economic forecasts and policy issues. The latest report provides forecasts for euro area key indicators, such as inflation and GDP up to 2007, and includes a special section on the future of corporate taxation in the EU. The EFN Autumn 2005 report can be downloaded from the Euroframe website: http://www.euroframe.org

European Social Models: the challenge of an ageing population

While the European Social Model is a topical subject, in fact there does not appear to be any single model. Instead there are a wide variety of models in the Member States, reflecting different histories, circumstances and political choices that have shaped social welfare provision over the course of time. However, they are faced with new challenges and must adapt to new circumstances. One such challenge today is an ageing population, and DG ECFIN analysts are studying how Europe can respond to this demographic change.

There are a variety of social models in the Member States sharing certain common features that give them their European character. These are pensions, health and long-term care, social protection for the poor and disabled, and policies to support people in the event of unemployment. These shared features are seen in the average 27% of GDP that the Member States spend on social protection, in strong contrast to the US (15%) and Japan (17%).

The demographic challenge that Europe's ageing population presents to these common features has its origins in a falling birth rate over the past decades and an increasing life expectancy that is predicted to grow by five to seven years by 2050. This ageing population is shown in Graph 1 that compares age distributions in 2004 and 2050.

Eurostat projections which form the basis for figure 1 show that while the total population of the EU-25 will only fall slightly by 2050, the age structure will change dramatically. By 2050, the EU will have lost 48 million people of working age (15- to 64-year-olds) and will have gained 58 million pensioners (65 and over).

This means that fewer workers will pay for more pensions. From four working-age people supporting each pensioner in 2004, this ratio will drop to two to one by 2050. While living to an older age in good health is to be welcomed, unfortunately, when combined with historically low birth rates it poses a severe financing problem for existing social welfare systems.

Growing pressures on public finances

Studies by DG ECFIN show that, if nothing else changes, the economic consequences of an ageing population include rising pressures on public finances in the Member States.

Figure 1: Age pyramids for EU-25 population, 2004 and 2050

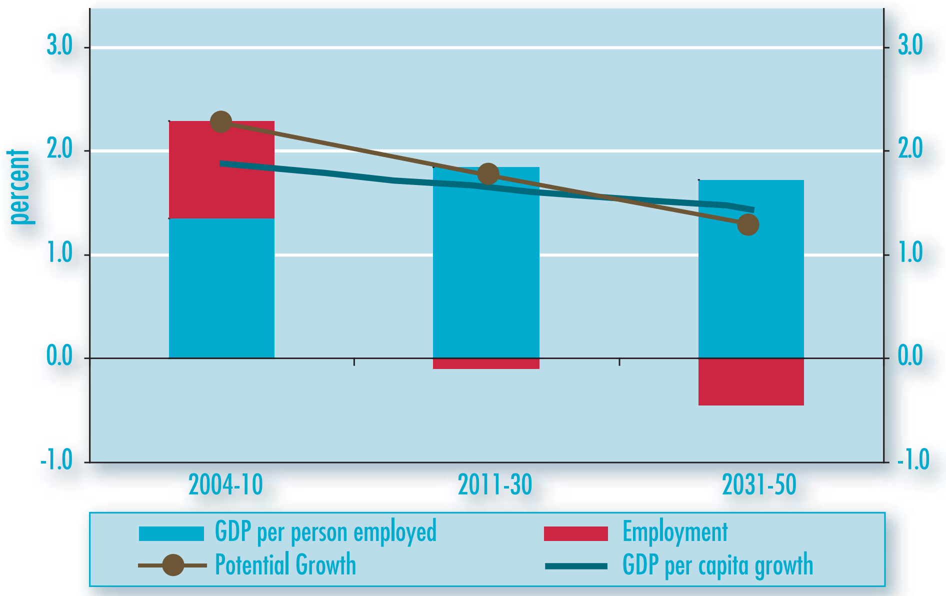
Source: EPC and European Commission (2005)

"... any reforms to their social models by the Member States must take the demographic issue into account" André Sapir

Figure 2 shows that

- a progressively smaller workforce will drag down economic growth, from an envisaged average of 2.25% in 2004-2010 to an average 1.25% in 2031-2050 in the EU-15. The situation will be worse in the new Member States as they have even less favourable demographics and their currently high growth rates will converge to the lower values of the EU-15;
- over time, productivity will become the main source of growth. This confirms the validity of the Lisbon Strategy which emphasises the need for improved training and education to support an economy geared to producing high knowledge-content products and services;
- the next decade presents a window of opportunity for the necessary reforms before the full effects of ageing kick in. This window exists because employment is projected to rise, particularly among women and older workers, over the next decade or so, offering a breathing space for economies to be strengthened and reforms implemented. A number of reforms are already under way in the Member States and the available results indicate that so far they do work, and that it is possible to achieve successful adaptations to social models that preserve their European core values.

Figure 2: Projected (annual average) potential growth rates in the EU-15 and their determinants (employment/productivity)



Source: EPC and European Commission (2005)

The policy challenges ahead

Slower growth will come at the same time as the extra costs of the ageing population start to peak. Ageing could increase public expenditure on health and pensions significantly between 2000 and 2050. This indicates that further reform of social welfare systems is needed. Social models must be improved to address the demographic challenge in a way that produces opportunities for Europeans and not threats to their way of life.

A comprehensive set of new policy actions across a broad front will be needed to meet the challenge of lower growth and ensure social welfare provision and its core European features can be afforded. As well as improving public finances, and in particular reducing debt, some pension systems may require changes to ensure their sustainability under the future demands outlined here.

The main response to projected falling growth must, however, involve reforming the labour markets as these determine overall wealth and the capacity to sustain high-quality welfare systems. As well as raising employment to make sure the jobs are there, reforms must improve incentives to work across the age spectrum, ensuring that older workers do not meet discrimination and that the young do not face greater barriers to finding a job because their parents work longer. Perhaps the critical, but also difficult, challenge is to extend working lives – we must all work longer.

Ageing is not the source of the problem; after all, better health care and anti-wrinkle creams are making it quite pleasant for many. In fact, it is our retirement behaviour that poses the main challenge for pension systems. Raising actual retirement ages so that people work longer has a double benefit: in the first place, demands on pension systems are reduced, and in the second place, people become productive for longer, thus contributing longer through their taxes to public finances.

Further information

Consequences of ageing
http://europa.eu.int/comm/economy_finance/about/activities/activities_consequencesofageing_en.htm

Professor André Sapir, a former economic adviser to European Commission President Romano Prodi, comments, "The challenge of an ageing population that requires progressively higher shares of GDP to fund its pensions has been around for a long time and is becoming more acute. To pay for this could require unsustainable increases in public debt, unacceptable increases in taxation and/or unacceptable cuts in welfare provision. Therefore, any reforms to their social models by the Member States must take the demographic issue into account. And reforms are absolutely necessary as pension systems are already coming under strain."

Putting globalisation to work for Europe

The 2005 edition of the EU Economy Annual Review is devoted to globalisation. It takes a considered, non-partisan look at the economic issues globalisation raises for Europe. And it pays particular attention to those aspects that concern the public most, such as potential job losses as businesses go overseas, and pressure on wages from cheap imports, and it puts these issues in context. Public anxiety is worrying as it can lead to calls for protectionist measures that would destroy living standards, rather than raising them through embracing the opportunities that globalisation offers. The Review reports on the upside, and the downside, of continuing global economic integration.

Karl Pichelmann, DG ECFIN

The 2005 EU Economy Annual Review is divided into three parts. Briefly, the first examines recent trends in global economic integration, including issues such as foreign direct investment (FDI), trade-driven integration, the impact of the euro, and the relocation of businesses abroad. The second part looks at how the potential gains from these processes can be realised and what the risks are for both forward-looking and defensive scenarios. Here the potential impact on European jobs and wages and global poverty reduction is evaluated. The third part presents some specific studies, such as an assessment of the attractiveness of Europe for R&D activities, and a retrospective on location decisions by manufacturing multinationals in the EU regions. The following sections present a brief description of selected issues from the Review.

Past lessons for future benefits

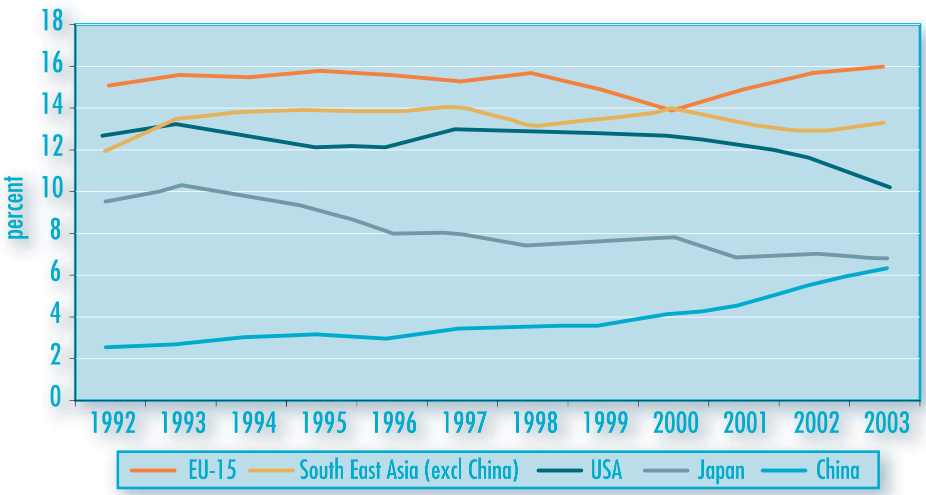
One overall message from the Review is that Europe benefits from globalisation; it has worked well for its people over the last 50 years and further integration offers rising living standards. These benefits have traditionally arrived through lower prices for consumers and companies, a wider choice through higher international trade, higher productivity and real wages, and a greater diffusion of the products of technological progress in our factories, hospitals, schools and homes. These manifestations of globalisation's benefits show it is not a rich man's game. All levels of society have benefited and there are no reasons to expect this to change. A conservative estimate attributes one-fifth of the increase in per capita income over the last 50 years to our integration in the world economy. With deeper integration we can expect lower prices for products that can be made more efficiently elsewhere, and higher disposable incomes as productivity increases and European manufacturing shifts to higher added-value, higher technology products and services.

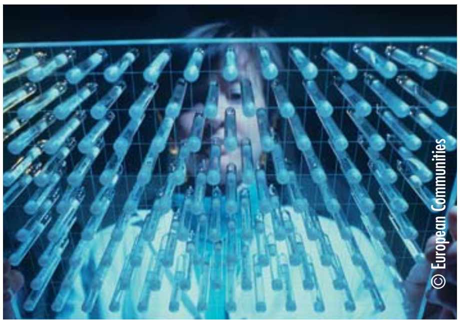
Not without friction

In 'The adjustment challenge in the labour market', the authors study the impact of low labour-cost competition from foreign trade partners and how far this causes job losses in the EU, which is the world's major trading power with the most open markets (see figure 1). This is a major cause of public anxiety as it raises the spectre of higher unemployment and an inescapable 'race to the bottom' on wages as EU companies try to compete. The evidence shows that more trade and investment abroad has not gone hand in hand with job losses, when seen as a whole. However, job turnover and shifts of employment are seen to increase and the demand for unskilled workers does drop, even though overall employment levels are maintained. Further, despite some high-profile cases, neither wages nor working conditions are significantly eroded.

However, the authors warn that there is a transition to be made by EU industry and services towards higher skilled, more specialised and thus more competitive products. This transition will cause considerable hardship for those workers affected as uncompetitive sectors restructure. Hardship includes

Figure 1: World Export Market Shares for the Different Countries/ Country Groupings (World = Extra-EU-15 for EU-15)





"The annual EU Economy Reviews are, above all, topical," says Karl Pichelmann of DG ECFIN whose team produced the 2005 edition, "and the impact of globalisation is certainly hot at present. It is raising widespread fears and anxieties among European citizens and these must be tackled if we are to build support for the structural changes that Europe needs. Only in this way can those same citizens benefit from the faster growth and higher living standards that globalisation offers. However, the Review is not a policy document; instead, through analysing and presenting the facts about globalisation, and debunking some myths, it forms a solid basis for informed debate and relevant policies. One reason for the worries about globalisation is that people easily see the immediate costs, such as a factory closure because of cheap imports. But the gains, which have been with us for many years, are more dispersed. For example, the massive uptake of home computing in Europe was made possible through cheap assembly plants in the Far East that kept computers affordable, even though they used expensive components from the West. We need to highlight these benefits to the public and show that all can benefit in the give and take of a globalised economy – and for Europe the takings can be appreciable, as the Review demonstrates."

loss of security, periods of unemployment and the need to retrain. For this reason, say the authors, public concerns must not be dismissed too easily and modern labour market and social policies, matching efficiency with fairness, must take account of this.

Training the best, retaining the best

The section on 'the internationalisation of research and development: trends and drivers' considers what determines where a multinational company decides to locate its R&D activities. This is important because large R&D facilities have 'spillover' effects in the selected region, for example creating opportunities for highly skilled researchers and technicians and innovative suppliers. This can give a strong impetus to national and regional innovation systems and support the Lisbon objectives. Encouraging more R&D is vital to help Europe make the transition to a globalised 'knowledge economy'.

Further, as China and India increase their R&D spending, the EU must remain an attractive location for companies to put their R&D facilities. For this, the Union needs excellent education systems to train and attract more researchers and provide them with the R&D opportunities that will keep them.

A race to the top

The EU has much to gain from globalisation and has no reason to fear it. Europe's current low economic growth owes more to domestic issues – low productivity – than to globalisation. In fact, claim the authors, history shows that globalisation is a race to the top not to the bottom – for instance, the post-war economic boom in Europe that owed much to globalisation. Fears about China are also exaggerated says the Review as, for example, many of the IT products it exports are made from high-added-value components imported from the West – China is currently focused on low-skilled labour-intensive sectors and, with its huge labour resources, this is unlikely to change in the near future. While clearly stating that the transition Europe must make will be an uncomfortable business, the Review says that trying to protect jobs from international competition would be counterproductive. Rather, we must explain to Europe's citizens that integration is a two-way street and if Chinese goods seem to be everywhere then this is because China must sell us several hundred million T-shirts in order to buy one Airbus.

"...all can benefit in the give and take of a globalised economy"

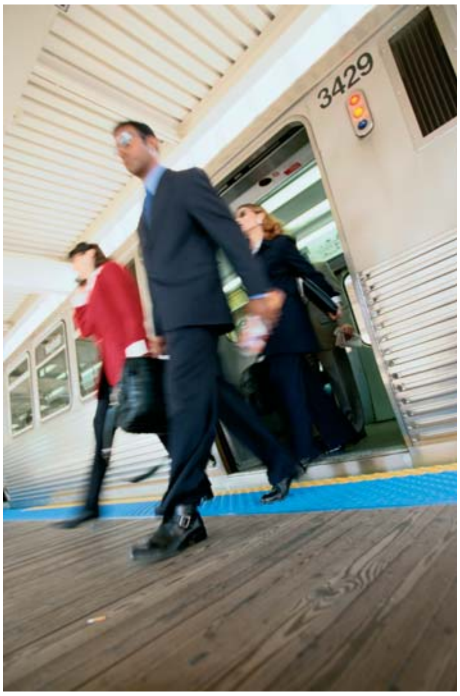
Karl Pichelmann

Further information

EU Economy Annual Review
http://europa.eu.int/comm/economy_finance/about/activities/activities_eu_economyreview_en.htm

The Autumn Economic Forecasts: growth picks up

The single market and, in particular, economic and monetary union, is driving increasing economic integration between the EU Member States. This growing interdependence requires deeper and broader coordination on economic policy-making within the EU. This, in turn, raises the demand for high-quality European-level economic information and analysis. The Economic Forecasts produced by DG ECFIN go a long way towards meeting this need.



Twice a year, in the spring and the autumn, the European Commission produces economic forecasts covering the euro area and the EU as a whole, the individual EU Member States, acceding and candidate countries, and other major economies outside the EU. These are short-term projections of the main macroeconomic variables over the next two years. This economic forecasting is part of DG ECFIN's surveillance activities, which encompass a range of operational and strategic outputs, such as business and consumer surveys, convergence reports, and the yearly EU Economy Review.

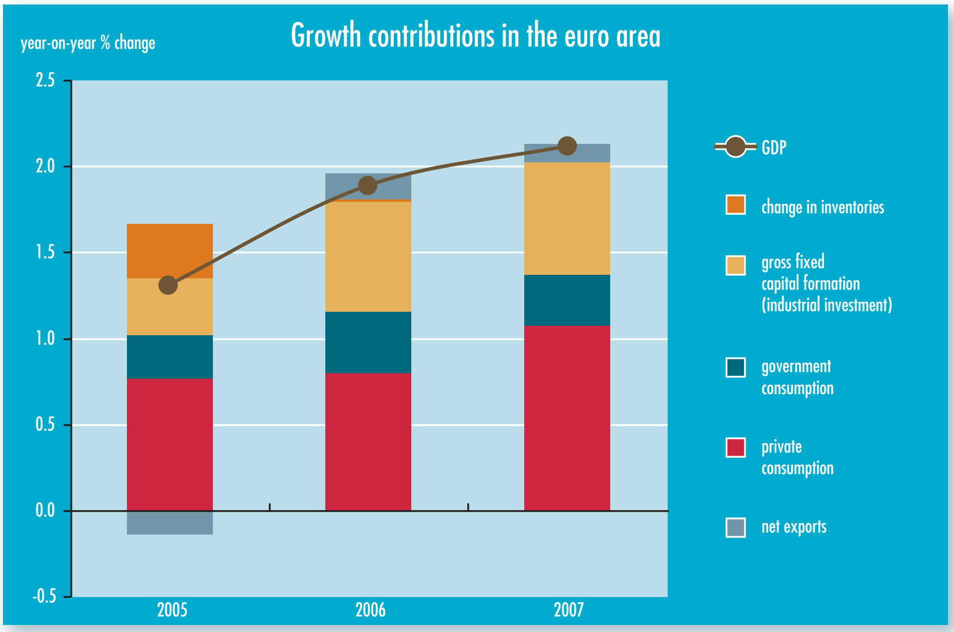
Mary McCarthy leads the DG ECFIN unit that coordinates the forecasts. She describes the process: "With more than 60 people contributing to the forecasts internally, the forecast is an intensive effort involving several directorates. We start by establishing the wider global context – for example, the profile for commodity prices, assumptions for interest rates and exchange rates, and projections for important non-EU countries such as the US and Japan. Then, within this global context, the country desk officers in ECFIN produce preliminary forecasts for each country. In making their preliminary forecasts, the country desks make use of their extensive knowledge of the national economy for which they are responsible.

"The preliminary forecasts for the individual Member States are then aggregated to provide predictions for the EU and the euro area of major macroeconomic variables, such as GDP growth, inflation, investment, consumption and employment. Several further steps have to be carried out before we arrive at the 'final' forecast. These include a 'trade-consistency' exercise to check that the aggregate trade flows make sense, and a 'general consistency' exercise to make sure that the whole forecast fits with the standard economic relationships. Finally, we take on board the latest statistical information in the production of the 'final' version, which is presented at a press conference by the Commissioner just over a week later."

The Autumn 2005 Forecasts – brighter times ahead

The latest forecasts of autumn 2005 look forward to 2006 and 2007. The main message is that the pace of economic activity in the EU, building on 1.5% growth in 2005, will accelerate to 2.1% in 2006 and reach 2.4% in 2007. This growth will create 6 million jobs in the EU over the forecast period, helping to reduce unemployment from a peak of 9% in the second quarter of 2004 to 8.1% in 2007. On inflation, a small rise to 2.3% in 2005, driven by high oil prices, will be followed by a gradual decline to 1.9% in 2007.

While the first half of 2005 was disappointing, the euro area and the EU as a whole are now in a position to take advantage of a promising global outlook. Over the summer, DG ECFIN surveys of economic sentiment highlighted growing business confidence, and this is now feeding through to greater domestic demand, which is driving growth. Rising employment is expected to strengthen the still-subdued consumer confidence, thus supporting a gradual recovery of private consumption. However, in particular it is the rising investment by industry, encouraged by



"Growth in the EU is supported by a vibrant global economy"

improving company profits, that is supporting higher growth. Nevertheless, the earlier slowdown this year has taken its toll on public finances. The general government deficit as a share of GDP is estimated to rise to 2.9% in the euro area in 2005, slightly less in the EU as a whole. Only marginal improvement is expected in 2006 and 2007.

Growth in the EU is supported by a vibrant global economy that exceeded 5% growth in 2004 – the fastest pace since the early seventies – and world trade growth is estimated to stabilise at around 7% p.a. over the forecast period. As many of the factors that favoured this world growth are still in place, such as supportive economic policies, low real interest rates and sustained growth in China, India and the oil-producing countries, the outlook for the global economy remains bright.

However, as with any forecast there are risks associated with the outlook. Higher and more volatile oil prices pose the main downside risk to the forecast's central scenario. The upside is that oil-exporting countries might spend even more of their income in Europe, thus boosting exports beyond the forecast's estimates. Global current account imbalances, due in part to the US deficit, pose another external risk, particularly in the event of a 'disorderly correction' that might hurt EU exporters. Domestically, risks are more balanced. On the downside, higher oil prices could hit growth, but equally, on the upside, growing consumer confidence could be further fuelled as employment rises and uncertainty about future income is reduced through reforms to increase the sustainability of social welfare and pension systems.

An operational tool

The economic forecasts use a set of macroeconomic variables that are relevant for short-term policy analysis and encourage timely corrective policy action by Member States. These variables include GDP growth, budgetary balances and employment figures. For example, the autumn economic forecasts appear almost simultaneously with the Annual Economy Review, an analytical review of events in European macroeconomies, and are subsequently used when assessing the Stability and Convergence Programmes. In addition, the forecasts are linked to wider policy analysis and decision-making throughout the Commission, in particular in those Directorates-General with forward-looking activities, for example, the Budget DG for revenue forecasting, and the Trade and Enterprise DG for policy-making.

ECFIN activities

Economic surveillance

- Monitoring public finances
- Coordinating economic policy
- Euro practicalities
- Financial markets and capital movements
- Economic relations with third countries
- Financing

Further information

Macroeconomic forecasts
http://europa.eu.int/comm/economy_finance/about/activities/activities_keyindicatorsforecasts_en.htm

Main features of the Autumn 2005 Forecast – EU-25

(Real annual percentage change unless otherwise stated)				Autumn 2005 forecast[1]			Difference vs spring 2005 (a)	
	2002	2003	2004	2005	2006	2007	2005	2006
GDP	1.2	1.2	2.4	1.5	2.1	2.4	-0.5	-0.2
Consumption	1.6	1.6	2.1	1.6	1.6	2.1	-0.3	-0.4
Total investment	-1.2	0.8	3.0	2;3	3.5	3.6	-1.3	-0.6
Employment	0.4	0.2	0.6	0.9	1.0	1.0	0.2	0.2
Unemployment rate (b)	8.7	9.0	9.0	8.7	8.5	8.1	-0.3	-0.2
Inflation (c)	2.1	1.9	2.1	2;3	2.2	1.9	0.4	0.5
Government balance (% GDP) (d)	-2.4	-3.0	-2.6	-2.7	-2.7	-2.7	-0.1	-0.2
Government debt (% GDP)	61.4	63.0	63.4	64.1	64.2	64.3	0.0	0.0
Current account balance (% GDP)	0.3	0.1	0.0	-0.3	-0.4	-0.3	-0.3	-0.4

[1] The Commission services' Autumn 2005 Forecasts are based on available data up to 7 November, 2005.
(a) A "+" ("-") sign means a higher (lower) positive figure or a lower (higher) negative one compared to spring 2005.
(b) Percentage of the labour force.
(c) Harmonised index of consumer prices, nominal change.
(d) Including proceeds relative to UMTS licences.

The economies of Cyprus and Malta

In the first of our series of profiles covering all the Member State economies, we look at Cyprus and Malta. Tourism is of major importance for both these Mediterranean islands. In contrast to the other eight countries which joined the EU in May 2004, neither had experience of centrally planned economies. Nonetheless, both have had to undertake significant economic reforms in preparation for Union membership, and further changes are under way to lay the foundations for joining the euro.

Both Cyprus and Malta have been independent states since the 1960s. In trading terms, their major partners today are fellow EU Member States, although they also trade with their other neighbours around the Mediterranean. Having signed up to the General Agreement on Tariffs and Trade (GATT) in the 1960s, both are founder members of the WTO. With much of their industry dependent on imports of raw materials, including many foodstuffs, they have consistently sought to develop liberal trading relations.

Central Bank of Cyprus, Nicosia

Tourism accounts for a major proportion of both islands' economies, and therefore both are susceptible to outside shocks. For example, fears of terrorist activity in the Middle East have led to ups and downs in tourist numbers over the past decades, although they often buck world trends as they can be seen as safer tourist destinations. Arrivals rose by 6.2% in Cyprus in the first ten months of 2005. As with all holiday destinations, service-providers in Cyprus and Malta need to keep pace with the changing demands and fashions of travellers to maintain their income.

Their island location means that the maritime services industries are significant in both Cyprus and Malta. In particular, both have large numbers of foreign-owned ships registered under their flags. In fact, the Maltese and Cypriot registers include far more ships than all other Member States barring Greece. Hosting these registers is accompanied by a range of other service jobs in related administrative functions such as insurance and consignment, and in services such as shipbuilding and repair.

Joining the euro

Cyprus and Malta entered the exchange rate mechanism, ERM II, in May 2005. Both countries have a long history of currency stability through the use of pegs. The Cyprus pound was pegged first to the British pound and US dollar, then to the ECU. Similarly, the Maltese lira was pegged to a basket of currencies with varying weights comprising the euro, sterling and US dollar. While ERM II requires that a currency remains within a ±15% band for two years, both countries' monetary policies adhere to a tighter band, ±2.25% in the case of Cyprus. Malta, on the other hand, declared that it would maintain the exchange rate of the Maltese lira at the central rate against the euro as a unilateral commitment. Since adopting the euro requires two years' membership of ERM II, both countries still have some way to go before the euro becomes their currency.

Both Cyprus and Malta meet the criteria on long-term interest rates, exhibiting stable rates converging on those of the euro area. In Cyprus, the government deficit is forecast to fall from -4.1% in 2004 to -2.8% in 2005, meeting the EMU entry criterion of -3%. Malta is forecast to meet this target in 2006. However, both countries have levels of public debt higher than the 60% of GDP criterion required for euro area membership, and these are not forecast to fall appreciably in the short term.

University of Cyprus, Nicosia

Cyprus

Cyprus lies in the eastern Mediterranean, close to Turkey, Syria and Lebanon, and therefore connections with other current Member States require air travel or long boat trips. Since the 1970s, the Turkish-Cypriot Community has controlled the northern part of the island. This control is not recognised internationally and the North has direct links only with Turkey. Although the settlement negotiated by the United Nations failed to attract sufficient support in the referendum held in spring 2004, and

"The economy in Cyprus is maintaining its strong growth, mainly driven by domestic demand in private consumption and investment, notably construction," says Carlos Martinez Mongay, Head of Unit in DG ECFIN's Directorate for the Economies of the Member States. "We have also seen Cyprus successfully bring its government deficit within the limits demanded for EMU entry, and our Autumn Forecasts project that this is sustainable for the next few years. The country's successful history of managing currency stability has also eased entry into ERM II in 2005. Controlling government deficits is one of the major macroeconomic challenges for Cyprus and so far they have successfully met part of this challenge, the deficit. Attention now needs to be directed to the debt component to ensure it does fall towards the levels required by the SGP.

Cyprus

Currency: Cyprus pound

Population: South 730 000, North 216 000

GDP: South €11.4 billion
North €1.13 billion

GDP per capita:
South €15 600, North €5 240

Real GDP growth rate:
South 3.5%, North 9.6%

Public sector deficit (as % of GDP):
- 2.8% (2005 forecast)

General government debt (as % of GDP):
70.4% (2005 forecast)

Source: Commission sources

thus there is still no international recognition, the EU is committed to providing financial assistance to the North. The partial opening of the border to the South in 2003 has given a very modest impetus to economic integration and added an estimated €100 million to the GDP of the North (around 9% of GDP) especially from labour income of workers from the North employed in tourism and construction in the South.

In the South, services account for around 72% of GDP, with tourism responsible for about a quarter of this. Other significant sectors of the economy include industry and construction (18%) and agriculture (4%). The financial system, notably banking, is highly developed. The main sources of employment, besides tourism, are services and industry, particularly construction. Tourism has been a main growth industry and the relatively flexible labour market has been operating almost continuously close to full employment.

Economic priorities

In the 2004 Broad Economic Policy Guidelines, the Commission identified three specific policy areas where the Cypriot government needed to act: reducing the government deficit in a sustainable fashion; building skilled human capital and promoting R&D in the business sector; and simplifying the business and taxation environment. The Autumn Forecasts predict the deficit will be under 3% in 2005 and will remain so in later years. On the issue of human capital, several initiatives were launched, including increasing ICT use in schools, a national strategy for the information society, and a 30% increase in funds allocated to R&D. Finally, measures are being taken to simplify the business environment through e-government services, youth entrepreneurship schemes, and a shift to indirect taxation. These are significant successes although the government will need to maintain its efforts to keep the deficit within the 3% (of GDP) limit over the longer term.

Malta

Malta is the EU's smallest Member State, and lies in the central Mediterranean between the Italian island of Sicily, and Tunisia and Libya in North

Africa. Given its small land area, Malta depends on imports of many foods and animal feeds. It is also highly dependent on imports of fuel, and many manufacturing industries must import raw materials such as chemicals and other intermediate goods.

Services dominate the economy, accounting for over 70% of GDP. Tourism is of primary importance, with 1.1 million arrivals in 2003. However, the number of visiting tourists fluctuates significantly, depending on outside factors. Another economic sector that is subject to outside influence is that of financial services. Although this sector is growing well, it remains vulnerable to economic performance in other countries, which influences the investment strategies of their nationals. ➔

Aerial view of the Maltese harbours on both sides of Valletta

Malta

Currency: Maltese lira

Population: 399 867

GDP: €4 277 million (2004, Ameco)

GDP per capita: €10 650 (2004, Ameco)

Real GDP growth rate: 0.8%

Public sector deficit (as % of GDP): -4.2% (2005 forecast)

General government debt (as % of GDP): 77.2% (2005 forecast)

Source: Commission sources

In the manufacturing sector, which accounts for just over one-fifth of GDP and of the workforce, the main exports include communications equipment, processed food, printing and publishing, plastics and chemical products, textiles, footwear and clothing. Semiconductors are an important sector accounting for 60% of total manufacturing exports, thanks to ST Microelectronics, which has a large manufacturing plant on the island. While consumption has been stagnating in 2005, owing to fiscal stringency, investment is dynamic due to the implementation of large infrastructure projects financed through the EU Structural Funds and Italian grants. Tourism is problematic owing to lower growth in Malta's trade partners.

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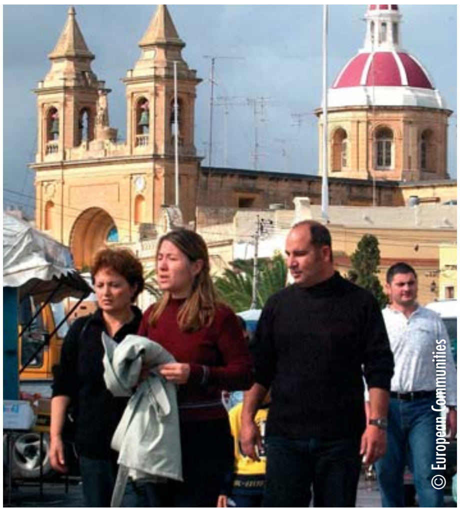
"In the Autumn Forecasts we point out that Malta's growth is currently sustained by the capital transfers from the Structural Funds for infrastructure projects, such as a large hospital," explains Carlos Martinez Mongay. "However, while Malta is implementing measures to improve public finances, lower than expected growth is proving an obstacle to meeting the targets of the convergence programme. Despite these difficulties, the deficit is projected to meet the 3% criterion in 2006."

Economic priorities

The Commission identified five priority areas for economic policy actions by the Maltese government. In general, it said that crucial economic reforms, such as restructuring the public sector and reforming pension and healthcare systems, had not proceeded quickly enough and had therefore had a negative impact on economic growth.

One priority is to reduce the public sector deficit. Although there has been a significant improvement in 2005, with the deficit projected to fall to -4.2% of GDP, the Maltese government will need to maintain its efforts to reduce the deficit further and keep it at a sustainable level. Equally important, Malta needs to reverse the rise in its debt-to-GDP ratio.



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The country has a particularly low rate of employment amongst women of just 33.1%, while the male employment level is above the EU average. Therefore, a package of incentives has been introduced to increase employment among women. With an ageing population bringing greater pressure to bear on the social security system, it is essential to increase participation in the workforce. The Commission has set out three priorities in this area: to reduce taxation on labour and streamline the tax-benefit system to strengthen incentives to work; to improve the quality of secondary education and vocational training; and to improve retraining of the labour force to make workers more adaptable and, in particular, to facilitate the return to work of middle-aged women.

Finally, the Commission has underlined the importance of increasing competition in key sectors of the economy, such as the network industries (e.g. telecoms, power utilities), food industries and shipbuilding. That said, it recognises that the specific circumstances of Malta's small domestic economy mean that tailored solutions must be found.

Further information

Economies of the Member States
http://europa.eu.int/comm/economy_finance/about/activities/countryeconomy/main_en.htm

Recent research and analysis published by DG ECFIN

Actuarial neutrality across generations applied to public pensions under population ageing: effects on government finances and national saving

By Heikki Oksanen of DG ECFIN. EUROPEAN ECONOMY, ECONOMIC PAPERS, No 230, July 2005, European Commission.

In Europe's welfare states we are not saving enough for retirement costs and, as we have fewer children and live longer, this is placing increasing burdens on pension liabilities and future generations. The author uses the condition of 'actuarial neutrality' as a benchmark, meaning that current pension contributions must meet future pension liabilities, to investigate the implications for pension system reform. To read more see the 'Economic Papers' on the DG ECFIN website.

The dynamics of regional inequalities

By Salvador Barrios of DG ECFIN and Eric Strobl of the Ecole Polytechnique, Paris. EUROPEAN ECONOMY, ECONOMIC PAPERS, No 229, July 2005, European Commission.

Economic growth does not appear everywhere at the same time – some regions grow faster than others, thereby producing inequalities. The authors investigate how regional inequalities appear in developing economies and then decline once a certain level of national development is attained. Their results, very relevant to EU Cohesion policies and new Member States, suggest that concentrating support on dynamic regions could reduce inequalities faster than direct investment in less-developed areas. To read more see the 'Economic Papers' on the DG ECFIN website.

State aid to investment and R&D

By David R. Collie of Cardiff University. EUROPEAN ECONOMY, ECONOMIC PAPERS, No 231, July 2005, European Commission.

The author investigates whether or not state aid to companies for investment and R&D brings overall benefits to an integrated economy such as the EU. Using economic models, the study shows that prohibiting state aid to investment will always improve overall welfare. However, aid to R&D can improve overall welfare if the 'spillover effects' are large enough. To read more see the 'Economic Papers' on the DG ECFIN website.

A catalogue of Labour Market Reforms

In December 2005, a database of Labour Market Reforms went on-line on the DG ECFIN website. The database lists the reforms enacted in the Member States in nine areas, such as pension systems and labour taxation. As well as contributing to DG ECFIN's monitoring role, it also allows comparisons to be made between countries, and analysis of reform strategies over time. The catalogue can be consulted on the DG ECFIN website under 'indicators': http://europa.eu.int/comm/economy_finance/indicators_en.htm

Progressive taxation, macroeconomic stabilisation and efficiency in Europe

By Carlos Martinez Mongay of DG ECFIN and Khalid Sekkat of the University of Brussels. EUROPEAN ECONOMY, ECONOMIC PAPERS, No 233, October 2005, European Commission.

Do tax cuts decrease or increase economic volatility? Through modelling OECD economies over the period 1960-2000 the authors find evidence that levels of tax revenues do have a stabilising role on national output and inflation. However, the mix of taxes is important – for example, distorting taxes on labour can have negative consequences for stability. To read more see the 'Economic Papers' on the DG ECFIN website.

Wage compression and employment in Europe: first evidence from the structure of earnings survey

By Gilles Mourre of DG ECFIN. EUROPEAN ECONOMY, ECONOMIC PAPERS, No 232, September 2005, European Commission.

Wage compression occurs when wages are only partly linked to productivity – for example, when a relatively high national minimum wage exists. Where present, it can contribute to higher unemployment. The paper measures wage compression across educational levels and occupations in Europe. Robust evidence is found for wage compression across occupations, mainly in continental and southern European economies, although there is no clear evidence of an impact on unemployment. To read more see the 'Economic Papers' on the DG ECFIN website.

Germany's investment gloom: light at the end of the tunnel?

By Stefan Kuhnert of DG ECFIN. COUNTRY FOCUS, Volume II, Issue 17, October 2005, European Commission.

The current German economic recovery is far weaker than expected. Conventionally, the ongoing good export performance should cause domestic demand to recover – but it remains stubbornly weak. The author points to low capital formation, meaning investment in new machinery and equipment by industry, as the culprit and the key to lifting the German economy out of its low-growth trap. To read more see the 'Country Focus' series on the DG ECFIN website.

The Directorate for Economic and Financial Affairs publishes frequently on economic research relevant to the European Union; only a selection of these articles is reported here. A complete list of downloadable publications is available at http://europa.eu.int/comm/economy_finance/publications_en.htm

Selected upcoming publications in the first half of 2006:

- Report on the challenges and opportunities of globalisation by the Economic Policy Committee. (Economic Papers, January)
- Assessing the factors of resilience of private consumption in the euro area. (Special Reports, February)
- The budgetary impact of ageing populations: projections for the EU-25. (Special Reports, March)
- What drives healthcare spending? (Economic Papers, April)
- The Western Balkans in transition. (Enlargement Papers, April)
- Economic reform in the Mediterranean region. (Occasional Papers, May)

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For your diary

The World Economic Forum annual meeting in Davos, 25-29 January 2006

Ignore the après-ski and hear about 'Mastering our future'

The annual meeting of the World Economic Forum brings together leaders from governments, business and other significant communities to help move the Global Agenda forward. The core theme this year is 'Mastering our future' and aims to recognise the joint responsibilities that all face in tackling global issues. Identity and job creation in Europe, eventual Chinese and Indian domination, populist backlashes in Latin America, and a new deal for Africa are the headline issues. See http://www.weforum.org for more information.

A conference on ageing in Brussels on 16 March 2006

The economic and budgetary impact of ageing

Organised by DG ECFIN and the EPC, and supported by the Austrian Presidency, this conference will present work by DG ECFIN staff on the projected costs to government budgets and EU national economies of an ageing population. Chaired by Hervé Carré, Deputy Director-General of DG ECFIN, key speakers will include Economics and Monetary Affairs Commissioner Joaquín Almunia. For more information see 'events' on the DG ECFIN website: http://europa.eu.int/comm/economy_finance/events_en.htm

Euro Conference in Hong Kong on 24 February 2006

DG ECFIN goes east

This conference is organised by DG ECFIN and entitled 'The euro: one currency, one financial market – implications for Asia'. It is aimed at raising awareness about the euro among policy-makers, the academic community and business people in Hong Kong and the wider Far East region. More information can be found on the DG ECFIN website: http://europa.eu.int/comm/economy_finance/index_en.htm/

A workshop on Sequencing and Incentives for Reforms on 28 March 2006

Back in Brussels

DG ECFIN will organise a one-day workshop on 'Sequencing and incentives for reforms'. The objective of the workshop will be to provide an opportunity for academics and Commission staff members to discuss the issues related to the political and economic incentives for reforms, interactions between different types of reforms (substitutability vs complementarity, optimal sequencing) and the political economy of reforms. More information can be found on the DG ECFIN website: http://europa.eu.int/comm/economy_finance/index_en.htm

And to Geneva with the WTO on 20-22 April 2006

Trading up?

A World Trade Organisation public symposium on 'WTO after 10 years: Global Problems and Multilateral Solutions'. EU Commission President José Manuel Barroso leads the plenary speakers with a speech on 'growing pains and trading gains', and DG TRADE will host a 'brown bag' lunch meeting on 'expanding developing countries' exports and the EU helpdesk'. For more information see http://www.wto.org

'Financial Statistics for a global economy' in Frankfurt, 4 and 5 May 2006

The third ECB conference on statistics

Whether financial statistics are good enough to capture globalisation, the challenges to national data collection, and global statistical governance are on the agenda for multidisciplinary discussions between statisticians, policy-makers, bankers and business. For more information see the European Central Bank website: http://www.ecb.int

To Austria for an international conference, in Linz, 10-12 May 2006

'Experience with and preparations for the euro'

Organised under the Austrian Presidency with DG ECFIN support, this conference will include presentations by Commissioner Almunia and the President of the ECB, Jean-Claude Trichet. The experience acquired by euro area members in preparing to adopt the euro will be shared with participants from other Member States that are now preparing their own economies to join the euro area. More information can be found on the DG ECFIN website: http://europa.eu.int/comm/economy_finance/events_en.htm

The Brussels Economic Forum, 18 and 19 May 2006

'Advance notice'

The Brussels Economic Forum is the annual major event organised by DG ECFIN. The Forum sessions cover a wide range of issues in European economics. This year's edition will focus on competition and innovation, social models, enlargement and, as usual, the economic outlook. More information will appear on the DG ECFIN website: http://europa.eu.int/comm/economy_finance/events_en.htm

In London with the EBRD on 21 and 22 May

Explore investment opportunities

The 2006 annual meeting and business forum of the European Bank for Reconstruction and Development will involve over 2 000 participants in a two-day programme exploring investment opportunities from central Europe to central Asia. Government ministers, corporate CEOs and key policy-makers offer 'unparalleled networking' opportunities as well. Request an invitation on http://www.ebrd.com

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