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UNECE releases its *Economic Survey of Europe, 2003 No.1*

The European Union's economic performance was relatively good in the second half of the 1990s, with annual growth rates of real GDP falling within a range of 2.5 to 3.3 per cent from 1997 to 2000 accompanied by strong employment gains and moderate inflation. But economic growth faltered in 2001 and was even more sluggish in 2002.

"If such a performance were to continue, the European Union would not even come close to the ambitious strategic goals agreed upon at the Lisbon European Council in March 2000 for the end of the first decade of this new millennium. The crucial issue now is to lay the foundations for a sustained and robust rate of growth over the medium term" stresses Mrs. Brigita Schmögnerová, Executive Secretary of the Economic Commission for Europe (UNECE) commenting on the first issue of the *Economic Survey of Europe 2003*.

EU economic recovery in 2003 pinned upon the United States

Hopes for a recovery in 2003 are pinned upon a cyclical upturn in the United States, which is being relied upon as the engine of global growth. But the large domestic and external imbalances in the United States (i.e. the indebtedness of households and corporations and the current account deficit) now constrain its ability to continue playing this role. Indeed, what is required in the United States is a greater emphasis on the growth of net exports, which means essentially switching expenditures from imported to domestically produced goods, in order to reduce the large external deficit to more sustainable levels. The mechanism for achieving this is improved price competitiveness, i.e. a depreciation of the dollar. This process got underway with the decline of the dollar that started in 2002 and has continued in early 2003.

The implication, of course, is that the expected cyclical impulse from the United States to other countries and regions is likely to be smaller than is anticipated in current forecasts. This points to the need for a greater reliance on domestic sources of economic growth in both western Europe and Japan. This in turn would effectively help the adjustment process in the United States to advance more smoothly given the stronger import demand from the rest of the world.

Economic growth can be stimulated by reforms in capital, labour and product markets and there is certainly a need for more progress in these areas. But in the current cyclical context there is also a need for economic activity to be supported by more expansionary economic policies. The stance of monetary policy in the euro area was further relaxed in late 2002, but in view of the deteriorating growth prospects this appears to have been "too little, too late". A further lowering of interest rates is now warranted, given the persistent weakness of growth in the three larger euro area economies, especially in Germany.

Reforming the Stability and Growth Pact

Economic developments in the euro area in 2002 have once again led to a conflict between the fiscal policy rules embodied in the Stability and Growth Pact (SGP) and the short-term stabilization needs of individual countries. A principal rationale for fiscal rules in the EMU is that they are designed to protect the ECB against pressures from high-debt countries for debt bail-outs. Excessive levels of government borrowing are also seen as increasing the risk of interest rate spillovers to the other members of the EMU. Although these rationales are not uncontroversial, it goes without saying that long-term debt sustainability is a matter of considerable concern, especially in view of the growing fiscal pressures arising from population ageing. The need to ensure generational balance, i.e. an equitable intergenerational distribution of fiscal burdens and social welfare, constitutes an enormous policy challenge. The fiscal pressures differ considerably across countries but if not tackled in time they risk undermining the EMU. But the looming generational imbalances also raise the wider issue of whether government debt-to-GDP ratios are always an appropriate measure of fiscal prudence or vulnerability.

The crux of the issue over quantitative fiscal rules, however, is not only that they always contain an element of arbitrariness but that they also may be too rigid in unexpectedly bad times when more flexibility is required. The recent proposals by the European Commission aim to alleviate some of the concerns about the procyclical bias of the Stability and Growth Pact by shifting the focus of medium-term fiscal consolidation to cyclically adjusted budget deficits and by giving greater importance to the government debt criterion in the budgetary surveillance process. At the same time, the deterioration of economic conditions in 2002 led to a postponement of the date for meeting the main fiscal targets (broadly balanced budgets) from 2004 to 2006. While going in the

right direction, these new rules, however, do not apply to countries with significant budget deficits, which are required to reduce their structural deficits by 0.5 per cent of GDP a year from 2003, i.e. they will have to pursue a procyclical policy despite the worsening economic outlook, an approach that may well prove to be counterproductive.

An alternative solution would be to fix long-term targets only for government debt and to establish credible fiscal rules and mechanisms that force governments to pursue them without imposing quantitative budget deficit targets in the short-run. This would allow the automatic stabilizers to be fully operational at all times and to provide scope for a discretionary stimulus when needed. It has also been proposed that countries be provided with some leeway for exceeding the current reference value for budget deficits, depending on the level of government debt. But, in any case, there is no easy way to reconcile short-term stabilization needs with long-term concerns about fiscal sustainability. There remains also the important issue of public infrastructure investment, which for reasons of intergenerational equity is often financed by borrowing (the so-called golden rule). The requirement to achieve a close-to-balance government budget may adversely affect the extent to which the public sector capital stock is being rebuilt and enhanced, if these investment expenditures are not excluded from the calculation of government financial positions. This would have negative long-run consequences for economic growth.

Implication for acceding countries

The degrees of flexibility in fiscal policy within the SGP and the Code of Conduct (COC) also have significant implications for the acceding east European countries. Applying the current EU fiscal rules could have particularly harmful consequences for those economies that are approaching EU accession with a weak fiscal position in terms of the structural fiscal deficits and public debt. Some of the accession countries (in particular, most of the central European economies) seem to fall into this category. Although until now there have been no accurate estimates of their structural deficits, recent research suggests that these might be quite sizeable.

Their weak initial fiscal positions will be a double burden for the accession countries. They will require first of all an initial structural adjustment in the run-up to EU accession in order to move closer to the reference fiscal deficit levels; given their starting position, this implies a risk of an excessive fiscal tightening in this period, with obviously negative consequences for economic growth. Secondly, even after such an adjustment, the EU's fiscal rules may be detrimental for growth in the accession countries due to the fact that their economies are still generally immature: compared with mature market economies, the east European countries are more susceptible to external disturbances and hence to higher volatility of aggregate output. Consequently, in a cyclical downturn they will be more likely to exceed the fiscal deficit reference level, a situation which would require a needlessly severe fiscal tightening (fiscal policy would in fact become pro-cyclical). And thirdly, once they are members of the EU, they will also be committed to achieving the main fiscal target, that of fiscal balance, which in some cases may require a new round of fiscal adjustment. Moreover, the net fiscal effect of EU membership on the acceding countries is expected to be negative, at least in the short-run. Thus, even if revised in accordance with current proposals EU fiscal rules may still impose excessively harsh policy constraints on newly acceding EU members, effectively creating an impediment to their economic growth.

More generally, the pattern of growth that prevailed in eastern Europe in 2001 and 2002 - when it was predominantly driven by domestic demand - is no longer consistent with the weak fiscal position of some of these countries. This is not a sustainable model of long-run growth for catching-up economies which as a rule rely on export-led growth and fixed investment, a pattern that prevailed in eastern Europe during the second half of the 1990s. These considerations once again highlight the importance of achieving a sustained upswing in the EU's major economies which would help to restore the balance of economic growth in the ECE region as a whole, with the larger economies resuming their leading role as engines of growth for the smaller and weaker east European economies.

For further information please contact:

UNECE Economic Analysis Division
Palais des Nations
CH - 1211 Geneva 10, Switzerland
Tel: +41(0)22 917 24 79
Fax: +41(0)22 917 03 09
E-mail: info.ead@unece.org
Web site: http://www.unece.org/ead/ead_h.htm

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