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Free-Trade Rhetoric and Reality

The Doha Round of Multilateral Trade Negotiations: Rhetoric and Reality

Dilip K. Das*

The Fifth Ministerial Conference of the World Trade Organization (WTO) was held during 10 to 14 September 2003, in Cancún, Mexico. One of its objectives was to review the progress, or lack thereof, made in the Doha Round of multilateral trade negotiations (MTNs) so far. Its end without an agreement had little element of surprise for the cognoscenti in the area of international trade. Its successful conclusion would, indeed, have been astounding. Other than being a tough grind, such negotiations are strongly failure prone. Although this failure was indeed a setback to the trade liberalization efforts of the global community, such failures had occurred in the past. According to one observer, of the nine Ministerial Conferences under the aegis of the GATT and the WTO, four were considered complete failures. The debacle in Seattle (1999) is fresh in our memories. The Uruguay Round (1986 to 94) of MTNs collapsed and had to be pulled back on its feet by the erstwhile Director General[1] of the General Agreement on Tariffs and Trade (GATT). Originally, it was to be completed in three years, but its deadline had to be extended several times, and it took seven-and-a-half years to be completed. The fate of the Doha Round of MTNs seems to be going the same way. It was originally scheduled to be completed in January 2005. It was apparent early on during the negotiations, however, that the probability of its concluding on schedule was remote, if not nonexistent.

While the Doha Round running into the sand in Cancún is a setback to the global trading system, it would be wrong to conclude that this failure would undermine the legal and organizational foundations of the world trading system embodied in the WTO. The flip side of this coin is that, following Cancún, the penchant towards bilateral trade agreements among the WTO members increased.[2] Such bilateral deals are based on narrow national interests of the partner economies and have been on the rise. Although the United States was endeavoring to restart the MTNs, it has announced that it is preparing to enter into a bilateral free trade agreement (FTA) or regional integration agreement (RIA) with Thailand. However, bilateral FTAs are not an easy way out of the MTNs. This was demonstrated by the recent failure of negotiations between Japan and Mexico to form an FTA. The two potential partners disagreed on several substantive issues and eventually abandoned the idea.

The objective of this article is to examine whether the progress in the Doha Round of MTNs has so far progressed in merely rhetorical manner or whether it has made some substantive achievement. To this end, I first analyze the intransigence of the participating WTO members during the negotiations, followed by adoption of flexibility on the salient issues and putting together the so-called "July Package" or the framework agreement in August 1, 2004 (WTO 2004). This was a critical – and long awaited – step in the Doha process.

Setback in Cancún due to North-South divide

The principal causes of the setback in Cancún were disagreements and conflicting positions among the 146 participating members of the WTO, which were divided into four main negotiating blocs: The U.S., the European Union, the so-called Group-of-Twenty-One (G-21) developing economies and the Group-of-Ninety (G-90) which included small and low-income developing economies and the least-developed countries (LDCs). The disagreements

[1] Arthur Dunkel, a former member of the Swiss trade delegation, was the Director General of the GATT between 1980 and 1992.
[2] The United States Trade Administration (USTA) signed eight bilateral trade agreements between September 2003 and May 2004.

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were primarily in two areas of international trade, that is, agriculture, which is an age old chestnut and the so-called Singapore Issues. Preceding the Third Ministerial Conference in Seattle, disagreements among the WTO members were on all sides, that is, they took north-south, east-west, north-north and south-south axes (Das 2001). However, this time the disagreements among the members followed a clear north-south axis.

Mechanics of the Failure of Cancún

The publicized objective of the Fifth Ministerial Conference was to "take stock of the progress in negotiations, provide any necessary political guidance, and take decisions as necessary".[3] As ministers could not agree on the negotiating framework and future agenda, the future of many relevant issues of negotiations seemed uncertain. A valid apprehension was that the Cancún setback is not only likely to make the round lose its momentum but also bring it to a grinding halt. For these reasons, the outcome of the Fifth Ministerial Conference became a disappointment to the global trading community. In the end, the participating trade ministers could not summon the necessary flexibility, adaptability, accommodation and political will to bridge the gaps that separated their respective positions. They could not agree in Cancún *inter alia* on whether to launch negotiations on the four Singapore Issues, namely, (i) trade and foreign investment, (ii) trade and competition, (iii) transparency in government procurement, and (iv) trade facilitation. Developing economies felt that the Singapore Issues were primarily going to further the interests of the industrial economies in the multilateral trading system, which was not entirely correct because the fourth Singapore Issue was going to benefit all the WTO members. Many developing countries believed that Singapore Issues not only did not benefit them but also amounted to an incursion into their domestic economic affairs and infringed on their sovereignty. This was becoming a throwback to the Uruguay Round era, when developing economies believed that they accepted restricting policies to be a part of the multilateral regulatory discipline without any tangible gain to their domestic economies.

The Singapore Issues: A road-block

The concern of the developing countries regarding an oppressive burden on the administrative capacity was valid. Creation of a new institutional regime and its enforcement has high costs, particularly in areas like competition policy, investment regulation, and trade and customs procedures. The developing economies are concerned about these costs because many of them failed to meet their Uruguay Obligations for this very reason. An estimate of the cost of three Uruguay Round agreements (customs reforms, trade-related intellectual property rights (TRIPS), and sanitary and phytosanitary Measures) that called for institutional creation and regulatory developments revealed that the average cost of restructuring domestic regulation in 12 developing economies could be as high as $150 million (Finger 2000). It is indeed a large burden on the small budgetary resources of a developing economy.

The level of political sensitivity varied widely on Singapore Issues, causing serious disagreements among the members. The EU – the principal *demandeur* – and within it the United Kingdom, insisted that the decision to launch negotiations on the Singapore Issues was taken in Doha, but the G-21 and other developing economies held the view that this was not the agreement. They asserted that these issues were to be addressed *after* the Cancún Ministerial Conference not *during* the conference. In June 2003, the developing countries were becoming ncreasingly opposed to the Singapore Issues. At this point, 77 developing economies, that is, more than half of the WTO membership, publicly expressed their aversion to the inclusion of Singapore Issues in the Doha Round. They made it clear that these issues were nowhere on their priority list. Objectively viewed, in a round of MTN basically intended for development, the first three Singapore Issues were completely incongruous. This complete inability to agree and compromise in the global trade forum was likely to affect the poorest G-90 countries most. A more open and equitable trading system would provide them with an important tool in alleviating poverty and raising their levels of economic development (Panitchpakdi 2003).

Even after eight rounds of MTNs under the GATT, some of the most illiberal policies in agricultural trade, protection in the form of tariff peaks and continuing protection of markets in services still persist in the industrial economies. The developing economies, however, have their own set of protectionist measures, limiting trade among them, which imposes a large cost on domestic consumers and developing economies in general. Elimination of trade distorting

[3] See paragraph 45 of the Doha Ministerial Declaration, 14 November 2001.

policies in both industrial and developing economies can lift millions out of absolute poverty. Therefore, the Doha Ministerial Declaration promised to "place the needs and interest (of the developing economies) at the heart of the Work Program adopted in this Declaration."[4] Successful conclusion of the Doha Round would go towards reaching the Millennium Development Goal of cutting down income poverty by half by 2015 (Winters 2002). Therefore, disagreement in Cancún on negotiating "modalities" and framework, and subsequent failure, was a pernicious development for the developing economy first and the global economy second. Evidently, the Doha Round was not living up to its name of being a development round. Also, until well after the failure in Cancún, the Doha Round was reduced to the WTO members talking endlessly at cross purposes, without achieving any meaningful progress.

Seeds of failure in Cancún were sown in Doha. The launch of the round was marked by acrimonious disagreements between the developing and industrial economies. The impressive launch rhetoric promised to reduce trade-distorting farm support, slash tariffs on farm goods, cut industrial tariffs in areas that developing countries cared about (such as agriculture and textiles and apparel), free up trade in services, negotiate global trade rules in the four Singapore Issues. Was so much achievable? After the launch of the Doha Round, country groups began disowning important parts of the Doha Development Agenda (DDA). For instance, the EU denied ever having promised elimination of export subsidies in agriculture. Similarly, the developing economies denied ever having agreed to talks on the Singapore Issues. The majority of the low-income G-90 and some lower middle-income countries (like the Philippines) still complained about their grievances over the Uruguay Round and felt absolutely no need to launch a new round of MTNs. This kind of posturing meant that a brisk progress in negotiations could not be realistically expected. Countries and country groups continued their intransigence and grandstanding in Cancún, instead of working towards compromises on which MTNs are squarely based (*The Economist* 2003). In addition, the domestic and bilateral action of several industrial economies soon after the Doha Ministerial led to questions about their commitment to the Doha Development Agenda (Stiglitz and Charlton 2004).[5]

[4] See WTO (2001a), Paragraph 2.

Failure as opportunity

Failure is an opportunity to identify errors and learn lessons. Members grew painfully aware of the fact that the rhetoric of the Doha Round should be made into some sort of tangible reality, a meaningful achievement for the multilateral trading system. Several serious and avoidable errors were committed in Cancún that led to failure.

Retreat from intransigence

As members realized that both the EU Commission and the US presidential elections were scheduled for November 2004, it was assumed that the EU and the United States would ignore vital multilateral issues, like the Doha process, and defer them to the following year. However, July 31, 2004 was a self-imposed deadline for agreeing to a negotiating framework and an agenda for the Doha Round. As it drew near, the leading players and negotiating blocs became concerned about a stalemate in the MTNs. The ambiance of criticism and recrimination gradually gave way to grudging compromises and eagerness to break the impasse. The four principal negotiating blocs began to chip away at their old Cancún positions and switched to conciliatory stances. Deliberations among the four blocs began again, albeit *in camera*. The changes in past positions and compromises that were on offer in mid-2004 vividly indicated a strengthening of the political will to restart the stalled Doha process.

Greater willingness to compromise

Much to the chagrin of the French, the EU made a fresh proposal on agriculture in May 2004, which was quite different from the one made in August 2003.[6] This time, export subsidies were not treated as a holy cow and their elimination was proposed. The developing economies welcomed this because export subsidies in the industrial economies do enormous damage to farmers in the developing economies. Also, it was the first time that the EU agreed that they are unfair and therefore must go. If one takes a good look at it, this EU offer was not as dramatic as it appeared at first sight, because export subsidies accounted for a mere €3 billion ($3.6 billion). The EU does, however, lavish €45 billion a year on sub-

[5] For instance, the US Farm Bill of 2002, (or the Farm Security and Rural Investment Act of 2002) promised larger domestic support to farmers. Like wise, the European Commission's Luxembourg reform of the Common Agricultural Policy (CAP) declared in June 2003 failed to reduce the total level of European agricultural support. Japan also announced a program of increased self sufficiency in agriculture, implying higher production subsidies and trade barriers.

[6] Jacques Chirac, the French president, declared that the draft framework was "profoundly unbalanced".

sidizing its protected farmers. The EU offer was conditional upon Australia, Canada and the U.S. eliminating their own equivalents of export subsidies (*The Economist* 2004).

The EU also proposed that the G-90 economies be exempted from the requirement of lowering their trade barriers. According to this proposal, all the G-90 countries should be offered greater access to the non-G-90 markets. Many countries in this sub-group had recorded a decline in their trade over the last two decades. Some developing economies dismissed this EU proposal as divisive, while others regarded it as a noteworthy move towards a promising consensus. To break the impasse, the EU modified its stand on the Singapore Issues as well, realizing that excessive emphasis causing a complete collapse was a strategic mistake. The modified stand of the EU was to take up the Singapore Issues one at a time and to include them in the DDA only after a consensus had been arrived among the members, not otherwise (*The Economist* 2004). However, the EU pressed for trade facilitation to be retained in the DDA, without making it a sticking point. To be sure, there was a lot of wisdom in the modified stance of the EU.

The Derbez Text contained more ambitions proposals

At a time when the key players on the global stage were demonstrating flexibility and far-sightedness as the July 2004 deadline approached, some small, low-income, members of the African, Caribbean and Pacific (ACP) country group took a recalcitrant, aggressive and short-sighted stand. These small economies had disparate demands that could potentially stall the progress of the Doha Round once again. Small West African economies demanded that cotton subsidies in the industrial economies must be negotiated as a separate issue, outside the agricultural trade negotiations. Reasons for this demand were far from convincing. Small economies of the ACP group that enjoyed preferential market access in the industrial economies wanted to ensure that a successful Doha Round would not reduce their preferential market access. Some of the delegations of the ACP countries were vocal in expressing their concern, taking a myopic view and almost wishing the MTNs to fail, an ignoble wish to say the least. The sugar and banana exporters in this country group reckoned that they were better off having preferential market access in a distorted global trading system. It would have been perverse and ironic if they had succeed in retarding, or stalling, the Doha Round because the DDA has been designed to benefit the developing economies.

Positions were revised by the other negotiating blocs as well. The developing economies tend to have a great many tariffs and non-tariff barriers in intra-developing country trade. Acknowledging this fact, in June 2004, the United Nations Conference on Trade and Development (UNCTAD) took the initiative to organize a conference for the developing economies, with the objective to reduce mutual trade barriers and thereby strengthening the negotiating position of the developing countries in the Doha process. China and Brazil were the leaders who were guiding this initiative. The developing economies reacted in two ways. Some were averse to it because they saw the UNCTAD initiative as a detracting force that could weaken the Doha process, while others believed that it would strengthen it and impart new momentum to it. This transformation in the mindset of the members and the initiatives taken started a process of rhetoric turning into reality.

Derbez Text and the state of the play

On September 13th, in Cancún, the Derbez Text was tabled by the WTO secretariat. Although prepared by the WTO secretariat, it was officially christened the Derbez Text in honor of Louis Ernest Derbez, the Foreign Minister of Mexico, who chaired the Fifth Ministerial Conference (WTO 2003b). The decision of the members to continue to negotiate around the Derbez Text was a positive one, and it became the basis for the July framework negotiations, discussed above. Tariff reductions for improving market access were larger in the Derbez Text than in the Uruguay Round Agreement on Agriculture. It also proposed to address the tariff peaks as well as to devise a formula for reining in the tariff escalation. In addition, the principle of a special safeguard mechanism was also accepted by the industrial economies.

After the Cancún failure, the issue of export subsidies was no longer taboo and those OECD economies that were either regarded as highly protectionist or middle-of-the-road were willing to discuss it in a flexible manner. This was considered a significant progress and a marked improvement over the negotiations in the Uruguay Round. Offers to phase out export subsidies on products of interest to exporters from the developing economies were being deliberated. An ambitious proposal in the Derbez Text was to negotiate a timeline and a final date for the elimination of all export subsidies. Although reasonable, this proposal was more than the Doha mandate. It was believed that the EU might not react favorably to this proposal, but it would at least be the beginning of negotiations that should have been achieved in the past (TCARC 2003).

In addition, larger reductions in trade-distorting domestic subsidies were under consideration for the first time, which included the amber box and de minimis payments. As demanded by the G-21 economies, a capping of the blue box payments was also in the cards. Special and Differential Treatment for the developing economies was reaffirmed, which included lower reductions in the amber box support for them. In keeping with the accepted practice, developing economies were to be given longer implementation periods for the agreements under the Doha Round.

Salvaging the Doha Round: The July Package

In the hope of rescuing the Doha Round after the Cancún failure, the WTO hosted a meeting of the General Council to negotiate a broad framework agreement for future MTNs in the last week of July 2004. Shotaro Oshima, the General Council chairman, prepared a draft agreement and hoped that it would be finalized before the self-imposed July 31 deadline. The initiative to formulate, negotiate and finally come to the so-called "July Package" – also referred to as the framework agreement – was taken by Australia, Brazil, the EU, India, and the U.S.. After intense all-night negotiations, a broad framework agreement was reached in principle, although a small number of finer details were left for future negotiating sessions. This is being seen as a victory for multilateralism. The July Package is a non-binding framework agreement that succeeded in reviving the stalemated MTNs. As it was negotiated in Geneva, it is also called the Geneva Agreement.

The broad framework agreement was a meaningful achievement in the life of the Doha Round. It marked the end of seemingly interminable deliberations and negotiations about what and how to negotiate in the Doha Round. Although it has its weak spots, intense negotiations around the July Package are expected that would enable members to come to a binding agreement in due course. The Zen of free trade is "quand on s'arrete, on tombe", or when one stops, one falls. The framework agreement has momentous significance; it rescued the MTNs from collapse.

While the role of the five member countries named above was positive, the framework agreement was reached because of clear and positive thinking and responsible action by all the other leaders. The leader of G-21, Celo Amorim, the Foreign Minister of Brazil, emerged as a pivotal figure together with Pascal Lamy and Robert Zoellick. The G-21 acted firmly and refused to move forward with trade negotiations until the U.S., the EU and Japan agreed to reduce their agricultural subsidies. The G-21 blamed farm subsidies in the developed countries for stimulating overproduction of agricultural products and driving agricultural commodity prices below the cost of production, harming farmers in developing and least developed countries. Even the G-90 played a constructive role, with Rwanda taking the lead. Once again, France had sought to block the deal, claiming it was contrary to European interests, but its objections were brushed aside by the other EU countries. A lot was riding on the success of the framework agreement. Failure would have meant the end of MTNs for an indefinite period and reducing the WTO to a glorified court for resolving multilateral trade disputes. Success in reaching the framework agreement affirmed that the WTO does provide a forum for developing global trade policy for its 148 members. The Doha Round is back on the rails, although it still has a long way to go. Despite the breakthrough, the framework agreement only clears the way for the long-delayed start of a marathon to come (de Jonquieres 2004).

Finally, progress of the July 2004 meeting

The most conspicuous achievement of the Geneva Agreement, or the July Package, was a seven-page "framework for establishing modalities in agriculture", making agriculture the most important part of the July Package. According to this document, the industrial economies are to eliminate all of their export subsidies which are acknowledged to be highly trade distorting, although the date has not been finalized. The G-21 countries succeeded in persuading the industrial economies to make deeper cuts in domestic production subsidies. That a commitment to negotiate an end date for export subsides by the EU is now agreed on paper is a major achievement that will underpin multilateral trade in agriculture.

In the area of tariffs on industrial products, which were one of the most contentious areas, attempts are being made to cut tariffs drastically. Particular attention is to be paid to high tariffs and tariff spikes. The July Package text in this regard is a carryover from the Derbez Text, which was strongly opposed in Cancún by all the groups among the developing economies. In turn, they had proposed a non-linear formula for tariff reductions, sectoral negotiations and weak Special and Differential Treatment. Tariff reduction in industrial products continues to be a volatile issue even after the framework agreement and modality negotiations in 2005 may face serious disagreements and friction.

A new deadline of May 2005 was set for negotiations in trade in services in the July Package. Members have been asked to submit high quality offers to achieve progressively higher levels of liberalization with no a priori exclusions of any service sector or mode of supply. Also, new rules would be framed on the „movement of natural persons" which could affect both migrant workers' rights as well as outsourcing (WTO 2004). In a pragmatic manner, members agreed to begin reviewing „trade facilitation" with a view to fast-tracking goods across borders. The push for expedited customs procedures was led by the U.S., which revealed the trade priority agenda of the WTO. Trade facilitation has large implications for food safety issues. However, improvements in customs regulations would certainly require a whole new layer of technological infrastructure for tracking and inspection. Low-income developing economies and LDCs are sure to find it a difficult area to comply with (WTO 2004). On the behest of the developing economies, the July Package dropped the first three Singapore Issues for the present, but they will have to be taken up in the future.

Passing the framework agreement put the Doha Round back on track

To be sure, there are some loopholes like the U.S. managing to exclude its "countercyclical" payments to the farmers when prices are depressed. Exemption given to low-income G-90 economies from the requirement of lowering tariffs was well received. This country group considered it a coup that would protect its nascent industrial sector for a longer period, although consumers in these countries will be required to pay higher prices for a longer period. The framework agreement also left the door open for the rich countries to protect some "sensitive" products. No doubt, such loopholes would go a long way in slowing the MTNs down as well as in diluting the achievement of the Doha Round.

Conclusions

The Doha Round has vividly witnessed both phases, rhetoric and reality. The possibility of a north-south divide was recognized well before the Fifth Ministerial Conference started in Cancún. The sizeable divergence in positions of developing and industrial economies existed on several significant issues, and the gap could not be bridged despite endless negotiations. Eventually wisdom to learn from the failures of the past prevailed and the negotiating groups adopted much-needed flexibility in their positions in the third quarter of 2004. Because the new positions were more realistic, the framework agreement could be reached. Clear and positive thinking and responsible action of the leaders was instrumental in resolving an impasse. The so-called July Package that was the result of concerted endeavors of the Chairman of the General Council and the delegations from Australia, Brazil, the EU, India, and the U.S. has made a substantial contribution to reviving the stalemated MTNs. This achievement revived the Doha Round and helped put it back on track.

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A Reform of the Stability and Growth Pact?

Pro: The Stability and Growth Pact Should be Reformed

Seppo Honkapohja*

The fiscal framework for the European Union, of which the Stability and Growth Pact (SGP) is a central part, is in a crisis. Two large euro-area countries, France and Germany, have clearly violated the three percent deficit limit of SGP and, according to the rules, the excessive deficit procedure with a recommendation for corrective measures in 2004 was initiated. However, in November 2003 the Ecofin Council voted against following the recommendation of the Commission to give notice to correct the deficits. A different and also serious problem of SGP has been the recent news that Greece reported blatantly false statistics in order to become a member of the euro area.

These two instances and the fact that several other EU countries also have fiscal deficits close to or above the three percent limit provide clear evidence that the SGP is not functioning properly. Fiscal developments since the start of the euro have been significantly worse than during the run-up to the euro, and the inability of Ecofin to initiate sanctions against violations of SGP are strong evidence about faults in the design of the SGP. Evidently, the SGP has not provided sufficient incentives for Euro area countries to continue improving their fiscal situations. In particular, the inability of Ecofin to enforce the SGP rules shows that probably the biggest problem is lack of ex-post rule enforcement, which in turn undermines the future of the entire pact. A political process for sanctioning is clearly inadequate.

These developments show that there is grave danger for the disintegration of the EU fiscal framework. It is quite possible that in the future the SGP rules will not be respected and fiscal decision-making gradually becomes dominated by a highly politicized and discretionary system. This would not be a good outcome. There are good reasons for having some form of control of fiscal developments, since high public debts and fiscal deficits are a threat to monetary and financial stability. It seems desirable to attempt to improve the design of the SGP rather than to wait and see how the disintegration of an unchanged SGP gradually worsens.

Key principles for reform

There is no shortage of proposals for reforming the SGP. A problem with many of the suggestions is that they do not get at the heart of the current problems, namely the lack of rule enforcement and the missing incentives for enhancing fiscal stability.

The 2002–2004 Annual Reports on the European Economy by the European Economic Advisory Group at CESifo (EEAG) have outlined key principles for reforming the SGP. These are (i) a greater emphasis on the level of public debt, (ii) strengthening of the enforcement mechanisms in the SGP and (iii) strengthening of incentives for responsible fiscal policy at the national levels. Similar suggestions have come from other people as well.

As regards principle (i), the key idea is to allow for greater fiscal flexibility and higher deficits for countries that have low levels of public debt. This reform would introduce new incentives to lower public debt for EU member countries. These incentives existed in the run-up to the euro but have largely vanished with the low levels of interest rates after convergence. Principle (ii), improving enforcement of rules, is the most difficult part in reforming the SGP. EEAG has proposed that decisions on the applica-

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If you want to comment on this topic or react to the opinion expressed here, please visit the CESifo Internet Forum on our web site: www.cesifo.de tion of the excessive deficit procedure should be made at a judicial level, i.e., the European Court rather than by a political body, the Ecofin Council. With respect to principle (iii), there are several possible ideas. The goal is to provide incentives for both fiscal discipline and improving the use of fiscal policy for stabilization by means of a transparent framework with clear medium-term targets, stabilization objectives and clear operating procedures.

The general objective in a reform of the SGP should be continued effort to have an improved rule-based system. This is important since fiscal decision-making is political by its nature. Discretionary policymaking can lead to large fiscal imbalances and debt, which in turn can threaten the euro system itself.

Contra: The Commission and the Stability Pact[1]

Daniel Gros*

When large numbers of drivers ignore the speed limit, it is good practice to reconsider its rationale and, if reaffirmed, to tighten enforcement, especially if the frequency of accidents increases. Hence, the EU Commission was right in launching a debate about the Stability and Growth Pact (SGP), which has been violated by an increasing number of EMU member countries. Unfortunately, however, the Commission's proposals for reform risk watering down the Pact, resulting in an erosion of fiscal discipline. In essence, the proposals by the Commission give the impression that the disobedient drivers might have a point and that drivers with better engineered cars need not be held so strictly to the limit. We are of the opposite opinion: The case to be made for a consolidation of government finances against the background of present and prospective demographic changes is actually stronger than ever before.

The longer-term outlook for the European economy and SGP reform

The SGP was created in order to make the general prohibition of "excessive" deficits in the Maastricht Treaty operational. The Treaty, which introduced the constraints on fiscal policy, started from the assumption that nominal GDP would grow at 5 percent per year on trend and that a debt ratio of 60 percent of GDP was bearable. Consistent with these assumptions, it stipulated that government budget deficits must not exceed 3 percent of GDP.

In hindsight, this deficit limit appears rather generous. Real potential growth is probably now only around 1 3/4 percent in Euroland, and the ECB's inflation target is less than 2 percent. A more realistic assumption for Euroland nominal trend growth is thus around 3 1/2 percent. To stabilise the debt ratio at 60 percent of GDP, the deficit would therefore have to be capped at 2.1 percent. Moreover, the ageing of the Euroland population raises government liabilities not included in the debt ratio in the Maastricht definition. Hence, to keep governments solvent, the latter should decline over time, ensuring that total government liabilities do not increase on trend over the next half century. These facts are generally accepted. However, neither they, nor their obvious implication that the conditions in the SGP should be tightened rather than loosened, are reflected in the Commission's Communication of 3 September 2004. Surprisingly, the Commission seems also to have ignored a key argument in favour of raising the threshold for invoking exceptional circumstances. With the potential growth rate having declined in most euro area countries, it is much more likely that countries will experience phases during which growth is "low" by historical standards. Hence, when potential growth is slowing, authorities need to continuously update their view about what is exceptionally "sluggish" growth. For example, a growth rate of 1.5 percent would most likely be considered 'sluggish' by politicians when compared to the goal of 3 percent as agreed at the Lisbon summit. However, growth of 1.5 percent might already be very close to (and for some countries above) potential growth in reality, and should thus not constitute an excuse to delay fiscal consolidation because of "sluggish" growth.

[1] Based on CEPS Policy Brief No. 58.

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TRADE UNION DENSITY IN INTERNATIONAL COMPARISON

HAGEN LESCH*

Trends in unionisation

Due to globalisation, structural change, the trend to individualism, new information and communication technologies and demographic changes, labour unions have increasingly come under pressure (Funk 2003). This study will show that union membership declined not only in Germany but also in other OECD countries. It will then identify economic and institutional factors that influence the development of trade union membership.

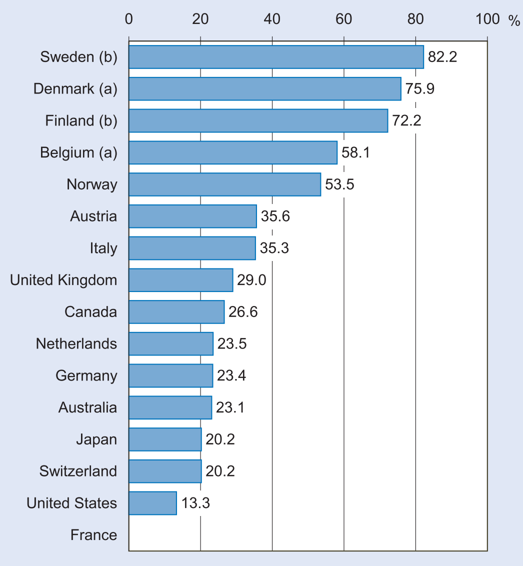
International comparisons of labour union power focus on union membership in relation to the total labour force (union density). This allows for differentiation between gross and net union density rates. The gross density rate is defined as total union membership including the unemployed, students and retired workers as a share either of all wage and salary earners in employment or of the civilian labour force, which includes the unemployed. The broader definition shows a more realistic picture of the labour unions' representation in the workforce. However, the higher the number of unionised retirees, the more distorted is the density rate. To avoid this, we focus on the net union density rate, which is calculated by dividing net union membership (total membership less unemployed and retired) by the number of active wage and salary earners. This method delivers the best estimate of the labour unions' representation in the workforce.

We then have to decide which sources to use. The first method for calculating union density rates uses publications of the individual unions. Because this information usually provides no figures on retired or unemployed members, their share in total union membership has to be estimated. Some labour unions like the French unions do not regularly publish membership statistics. This means extrapolating from older statistics. Italian trade union statistics only include the three biggest organisations but no independent or non-affiliated unions. This leads to an underestimation of total union membership by 10 to 20 percent (Visser 1991, 99).

The second method of data compilation is based on household or labour force surveys. It has clear advantages when the purpose is to calculate and compare net union density rates or unionisation by industry branch, occupational group, gender or other workplace characteristics. But only the Anglo-Saxon countries, Finland and Germany provide historical data at this detailed level. In addition, they often skip years or are only available for specific periods. We use panel data where possible and estimate missing values by utilizing national trade union member statistics. Historical statistics are from the trade union handbook published by Ebbinghaus/Visser (2000), which provides membership data for EU member countries (with the exeption of Greece, Luxembourg and the Central and Eastern European accession countries), Norway and Switzerland. Another source is an online database supplied by Golden/Lange/Wallerstein (2002), which not only contains data on West European countries but also on Australia, Canada, Japan and the United States. Because all statistics end in 1998 or before, more recent data were gained by our own calculations on the basis of national statistical yearbooks, data supplied by the trade unions or the International Labour Office (ILO) and labour force surveys. Taking this into

Figure 1

NET UNION DENSITY RATES IN 2002
Employed union members in percent of wage and salary earners



(a) 2000 (b) 2001

Sources: Author's calculations based on ILO, OECD, national statistical yearbooks, labour force surveys and union data.

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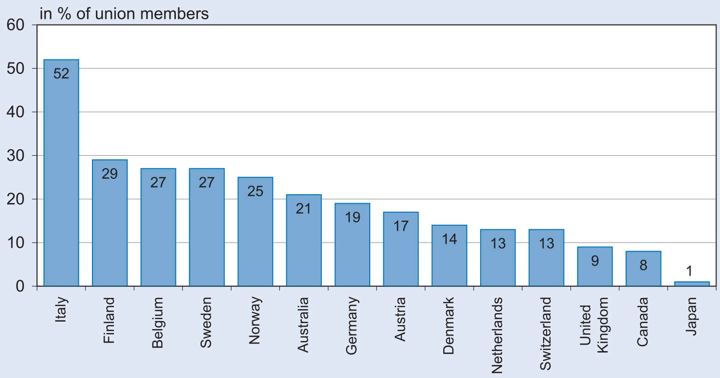
account, the following comparison of unionisation is a rough estimate, not a precision landing.

Figure 2

RETIRED AND UNEMPLOYED MEMBERS



Note: Estimate, 2000 - 2002; no estimate available for France and the United States.

Source: Author's calculations.

Figure 1 shows net union density rates in 2002. On the top of this ranking we find the Scandinavian countries Sweden, Denmark and Finland whose union density was between 72 and 82 percent. At least every other worker in Belgium and Norway and approximately every third worker in Austria, Italy, the United Kingdom and Canada was a union member. Germany's density rate of 23.4 percent was below average but above that of Japan, Switzerland and the United States (13 to 20 percent). France ranks lowest (10 percent).

Figure 2 shows the share of retired and unemployed union members as a percentage of all union members. It varies considerably among OECD member countries. In Japan, Canada and the United Kingdom it is less than 10 percent, in Italy over 50 percent. Norway, Sweden, Belgium and Finland also have a high share of inactive union members, ranging from 25 percent in Norway to 29 percent in Finland.

Table 1

Net union density rates 1961 to 2000*

	1961/1970	1971/1980	1981/1990	1991/2000	Maximum value	Year of maxmimum value
Australia	45.6	46.2	44.3	32.4	47.9	1960
Belgium	40.6	50.8	50.6	53.1	58.1	2000
Denmark	61.3	69.1	76.8	76.6	79.5	1994
Germany	32.9	34.1	33.9	29.1	35.9	1991
Finland	40.0	64.5	70.2	77.2	79.6	1995
France	20.1	21.0	13.8	10.5	22.2	1969
Italy	28.0	46.9	43.0	38.7	50.5	1976
Japan	34.1	32.5	27.5	23.3	34.8	1964
Canada	27.0	31.8	32.8	31.8	33.7	1992
Netherlands	39.1	36.6	27.7	24.5	41.7	1960
Norway	51.5	52.1	55.5	54.8	56.4	1990
Austria	58.3	52.7	50.4	40.6	60.0	1960
Sweden	66.4	73.4	81.5	85.9	88.6	1998
Switzerland	33.5	31.1	27.9	23.2	37.0	1960
United Kingdom	40.9	47.6	40.8	32.5	50.1	1979
United States	26.9	22.9	18.2	14.8	29.4	1960
Average	40.4	44.6	43.4	40.6	46.0	1978
Standard deviation	13.4	15.8	20.0	23.0	23.5	1995

* Note: Employed union members in percent of wage and salary earners; ten-year average.

Source: Golden/Lange/Wallerstein (2002); Ebbinghaus/Visser (2000), ILO, OECD, national statistical yearbooks, labour force surveys and union data.

In Germany, one in five union members was retired or unemployed.

Because data for 2001 and 2002 are lacking for some countries, the comparison and the following analysis ends in 2000. Table 1 shows the development of net union density rates between 1961 and 2000. There were ten-year average gains in the „Ghent countries“ (Belgium, Denmark, Finland and Sweden) with periods of stagnation in Belgium in the 1980s and in Denmark in the 1990s. Some gains also occurred in Canada and Norway during the 1970s and 1980s, but discontinued during the 1990s. In the other ten countries which provide full data, union density fell: Unsteadily in Germany, France, Italy and the United Kingdom, where membership increased during the 1970s, but steadily in Australia, Japan, the Netherlands, Austria, Switzerland and the United States. The decline in unionisation was particularly pronounced in Australia and the United States.

The unweighted average of union density rates rose in all countries between the end of the 1960s and the end of the 1970s. Thereafter unionisation fell steadily, with a short interruption during the early 1990s, when four million east German union members joined the Federation of German Trade Unions (Deutscher Gewerkschaftsbund). Since the mid-1990s, the long-term trend of declining unionisation has continued, reaching an average density rate of 38.4 percent in 2000 compared to 46 percent in 1978. Table 1 also presents the development of the standard deviation which confirms the trend of growing heterogeneity in membership development.

Why employees join a union

Before analysing the causes of divergent unionisation trends, we should answer the question why employees join a union. Unions claim responsibility for higher wages, shorter working time and better working conditions, thereby supplying collective or public goods. Because employers often do not make a distinction between union and non-union members, the individual employee has little incentive to join a union. By opting against membership, the individual can save the membership fee and still enjoy the collectively agreed minimum standards. To solve this free-rider problem, Olson (1965) suggests either compulsory membership, which is the case in a closed shop in which union membership is a condition of employment, or selective incentives in the form of private goods and services (insurance, seniority rights) for union members only. The "social custom" theory of union membership (Booth 1985; Visser 2002) considers selective incentives unnecessary, if belonging to a union provides reputation gains, while non-union membership creates reputation losses. If workers directly derive utility from belonging to a union and not being an outsider, we can assume that workers are more prepared to join a union if others also join. If a union achieves a critical minimum density and thereby assures that the reputation effect works, a union can exist despite the free-rider problem.

These theoretical explanations do not directly explain the heterogeneous trend in unionisation. But we know that the free-rider problem already existed in times of rising membership. We can therefore conclude that falling membership is caused by an insufficient supply of selective incentives or by decreasing reputation gains from union membership. The latter explanation could be based on a changing employment structure. The share of production workers in percent of all employees has declined, while the share of service workers has increased. Especially classical union domains like mining and the iron and steel industries have lost jobs, whereas employment expanded in union-free areas like the information and telecommunication industry. Thus union membership growth is determined not only by institutional factors but also by economic developments. Acknowledging this, the empirical literature differentiates between cyclical, structural and institutional factors (Ebbinghaus/Visser 1999, 136).

Explanations of fluctuations in union membership

The cyclical approach links membership changes to the business cycle, in particular to inflation and unemployment (Schnabel, 2003, 20 ff.). Rising consumer prices threaten the employees' standard of living. They join a union in order to defend their real wages. Unemployment affects union growth negatively by strengthening the relative bargaining power of employers. Yet its effects on the decision to join a union are ambivalent, depending on the organisation of unemployment insurance: If union-affiliated institutions administer unemployment benefits (Ghent system), we can expect a positive relationship between rising unemployment and the willingness to join a union. Unions can make eligibility for unem-

Table 2

Net unionisation, cyclical and structural indicators

	Change from 1971–1980 to 1991–2000 (in percentage points)				
	Net unionisation	Inflation	Unemployment	Share of industry employment	Share of part- time employment
Finland	12.7	-4.9	8.5	-7.6	2.1
Sweden	12.5	-2.6	4.5	-9.4	-0.4
Denmark	7.5	-4.0	3.4	-6.1	-1.7
France	7.1	-3.8	7.1	-11.8	6.1
Norway	2.7	-2.0	2.9	-10.2	0.8
Belgium	2.3	-2.6	4.1	-12.7	9.3
Canada	0.0	-2.7	2.5	-7.5	7.1
Germany	-5.0	-1.6	5.8	-9.2	2.9
Switzerland	-7.9	-1.5	3.4	-14.7	n.a.
United States	-8.1	-2.7	-0.8	-7.7	0.1
Italy	-8.2	-5.0	4.5	-4.9	4.3
Japan	-9.2	-4.8	1.6	-2.7	7.3
Netherlands	-12.1	-3.3	2.3	-11.8	15.7
Australia	-13.8	-3.6	4.5	-10.8	10.3
United Kingdom	-15.1	-5.9	4.0	-12.8	n.a.
Austria	-20.3	-2.2	2.1	-8.2	3.5

n.a. = not available.

Source: Author's calculations based on Lesch (2004).

ployment benefits difficult for non-members and decide about reasonableness criteria, i.e. which jobs an unemployed worker has to accept in order to sustain his claim for unemployment compensation. Thus, a combination of voluntary unemployment insurance and union membership can influence union membership positively in times of rising unemployment as was the case in Finland and Sweden during the first half of the nineties. If, one the other hand, unemployment insurance is mandatory and administered by the government, we can expect a negative relationship.

Table 2 shows the development of net unionisation and different economic indicators since 1971, the first year of full data availability. Let us first look at the cyclical factors, the inflation and unemployment rates. From 1971–1980 to 1991–2000, the average rate of inflation declined in all countries while net unionisation declined in most of them, thus indicating a weak linkage between membership and the business cycle. Exceptions are Canada, where the density rate remained unchanged, Norway and the four countries with union-administered unemployment insurance systems (Belgium, Denmark, Finland and Sweden), in which unionisation increased. Though some countries successfully lowered their unemployment rate during the 1990s (e.g. the Netherlands, the United States and the United Kingdom), the average unemployment rate increased between the 1970s and the 1990s in all countries except the United States. This development supports the thesis that rising unemployment reduces the incentive to join a labour union in countries with mandatory state-organised unemployment insurance systems and boosts unionisation in the Ghent countries.

The two other indicators take the change in the employment structure into account. While the share of industry employees in total employment has declined, that of service sector employees has grown over the past 30 years. At the same time, the share of blue-collar workers in relation to all workers declined, whereas the share of women and part-timers increased. White-collar workers and women are not so easily unionised as blue-collar workers and men. Part-timers are often viewed as "atypical" employees and are not recruited by the unions (Calmfors et al. 2001. 24 ff.; Schnabel/Wagner 2003, 223); Beck/Fitzenberger 2003, 12 ff.). Theoretically, this structural change should affect union density negatively: A declining share of industry employment and/or a rising share of part-time employment induces a declining rate of unionisation.

As Table 2 shows, structural change occurred in all countries. Since the 1970s, the share of industry employees in relation to total employees declined by 15 percentage points in Switzerland, 12 to 13 percentage points in France and the United Kingdom, 9 percentage points in Germany and 3 to 5 percentage points in Japan and Italy. Union membership declined almost to the same extent. Only the Ghent countries and Norway resisted the structural change. Part-time employment developed in a similar way. The share of part-time employment increased in all countries except Denmark and Sweden and remained nearly constant in the United States. Since the 1970s, the share of part-time employees in total employment has increased 16 percentage points in the Netherlands, 10 percentage points in Australia, and 3 percentage points in Germany. Though union membership frequently did not decline to the same extent, the numbers suggest a weak correlation.

Because cyclical and structural developments were similar in all countries, they cannot explain the differences in unionisation between countries. Institutional factors have to be taken into account as well. As mentioned above, the organisation of the unemployment insurance system is of special importance. Other relevant institutional factors are union access to the workplace, practices of enforced membership (in particular, the closed shop), dismissal protection laws, wage indexation or mandatory extension of collective agreements to non-unionised employers and workers. The legislative framework acts as a substitute for union-provided protection (Checchi/Lucifora 2002, 391). Following this interpretation, union density should be lower if worker protection is provided within a legislative framework.

The organisation of unemployment insurance

Most countries introduced their unemployment insurance system before World War II. One group of countries preferred a mandatory system administered by government agencies. A statutory unemployment scheme was introduced for British workers in 1911. Austria followed in 1920 and Germany seven years later. A second group of countries preferred a voluntary but publicly supported scheme administered by unions or union-dominated funds (Calmfors et al. 2001, 22). Norway (1938) and the Netherlands (1952) replaced the voluntary system with statutory regulation. Among the countries considered in this study, the Ghent system still operates in Sweden, Denmark and Finland. Belgium, which introduced the first voluntary, union-organised unemployment insurance in Ghent (hence the Ghent countries) in 1901, now has a mixed system. Unemployment insurance is compulsory and controlled by the state, but the unions participate in its administration.

The organisation of unemployment insurance is important because union- administered systems offer selective benefits to union members, although in principle every worker is welcome to join the insurance system without joining a union. However, insurance is often connected with union membership for two reasons: Unions can make it difficult for non-members to obtain unemployment insurance and unions control, or greatly influence, what is considered a "suitable job". Thus, individuals choose membership to gain better insurance conditions.

Union membership is also positively affected by institutionalised union access to the workplace because the workplace appears to be the main location to recruit new members (Ebbinghaus/Visser 1999, 143). Countries with substantial and longstanding access rights are the Scandinavian countries and Belgium. The countries with insignificant access rights – France, Switzerland, the United Kingdom and the United States – are all countries with a union density rate below average and strong membership losses (Scruggs/Lange 2002, 139). Practices of enforced membership like the closed shop, in which union membership is a condition of employment, have a long tradition in the United Kingdom, the United States and in Scandinavia (especially Finland). It has been estimated that closed shop arrangements covered a quarter of British employees in the late 1970s (Booth 1984, 254). But closed shops were restricted in the Thatcher era by various labour market reforms and finally forbidden by the Employment Act (1990). In the United States, the closed shop was already abandoned on the federal level by the Taft-Hartley-Act of 1947. It is likely that the changed institutional framework negatively affected union membership, especially in the United Kingdom.

The role of labour disputes

Finally, we assume a relationship between the number of labour disputes and unionisation. Strike affinity indicates the unions' willingness to enforce their claims. If they do not use their full power to enforce claims, they loose credibility and membership declines. Strictly speaking, we cannot add strikes to cyclical, structural or institutional factors because all of these factors influence the propensity to strike (Lesch 2002). For example, the necessity to authorise a strike by strike ballots or the prohibition of secondary strikes dampens strike activity. This is also true of sectoral structural change because the service sector is less strike prone than branches of industry.

Table 3 shows the development of labour disputes, measured as the number of working days lost by strikes and lockouts per 1,000 employees. After peaking in the 1970s, the average number of working days lost declined in most countries in the 1980s and

Table 3
Labour disputes: working days lost per 1,000 employees 1971 to 2000*
All industries and services

	1971/1980	1981/1990	1991/2000
Australia	646	308	108
Belgium	233	43	37
Denmark	264	173	171
Germany	52	28	11
Finland	682	369	136
France	284	113	78
Italy	1,461	544	130
Japan	115	8	2
Canada	879	473	189
Netherlands	35	17	18
Norway	48	101	97
Austria	10	2	4
Sweden	156	86	31
Switzerland	2	0	2
United Kingdom	572	291	23
United States	436	105	51

* Ten-year average.

Source: Author's calculations.

1990s. A comparison of labour disputes and union membership indicates a positive relationship between the change of net union density and the number of working days lost. In most countries we find a simultaneous change of both indicators during the 1980s and 1990s. A different development took place in the Ghent countries, Austria and Switzerland. But we should bear in mind that in the two latter countries labour disputes only play a minor role, so that we cannot expect a significant influence of labour disputes on the willingness to join a union.

Quantitative empirical evidence

Our descriptive findings are for the most part confirmed by multivariate regressions. For Western Europe, Blaschke (2000, 222 ff.) finds a positive effect of inflation and a considerable negative influence of unemployment on union density, but the causal relationship between unionisation on the one hand and inflation and unemployment on the other is not clear. As expected, a decline in industrial employment reduced union density. Changes in public employment (not considered in our descriptive analysis) also have a large and significant influence on changes in union density. The coefficient of strike activity is rather small and statistically insignificant. The analysis was completed by looking at institutional factors. Not surprisingly, the Ghent system exerts a large positive influence on union density, but statutory employee representation does not exert a positive influence. To summarise, the results suggest that a major cause of the decline in unionisation in most Wesern European countries was the change in the employment structure. Among the institutional variables, the recruiting assistance provided by the Ghent system had a large and stable influence. But there is also empirical evidence that the regulation of employment protection and benefit duration, indexation clauses and mandatory extension provisions all have a negative effect on unionisation (Cecchi/Luzifora 2002, 390).

Schnabel (2003, 20 ff.) summarises selected time-series studies of trade union growth. In most studies the key explanatory variables were price inflation, nominal wage growth, which both exert a positive influence on union growth, and the level and change of unemployment, which have a mixed or negative effect respectively. The growing labour force participation of women and the shift toward service sector jobs inhibit union growth. In order to explain cross-country differences with regard to the level and development of union membership and density, Schnabel (2003, 32 ff.) also discusses empirical results of cross-national analyses. Whereas Ebbinghaus/Visser (1999) judge cyclical and structural variables as insignificant and institutional factors as significant, Calmfors et al. (2001) and Visser (2002) confirm Blaschke's (2000) findings.

Because the quantitative comparative analysis ends in the mid-1990s, Lesch (2004) examines the determinants of changes in union density by utilising his updates of trade union membership statistics. OLS multivariate regression analysis is applied for the period 1971 to 2000 to all of the 16 OECD member countries described. The development of union density is the dependent variable. The explanatory variables include the lagged inflation rate, the unemployment rate, the shares of industrial, public sector and part-time employment (all in relation to total employment), the number of working days lost by strikes and lockouts per 1,000 employees and a dummy that reflects the degree of union authority over unemployment insurance. Overall, the signs of the coefficients were in line with expectations. Two results are notable. First, the coefficient for strike activity is small but statistically significant. Second, the coefficient of the share of part-time employment is positive. This result is surprising because the bivariate regression indicates a negative relationship. Microeconometric evidence confirms this finding (Beck/Fitzenberger 2003; Schnabel/Wagner 2003).

Conclusion

Overall, trade unions are successful if workers assign them a collective protection function and if union access to the workplace supports member recruitment by union representatives or works councils. Lacking these conditions, the power of trade unions diminishes as inflation declines and international competition increases. To recruit new members, trade union membership must be accompanied by a selective benefit or a gain in reputation.

Thus, unions have a limited potential to recruit new members. Selective benefits can only be offered on a limited scale, and in times of individualism unions cannot bet on "social customs". Much of the unions' future depends on the political management of reforms like the deregulation of the labour markets and the adjustment of the pay-as-you-go pension insurance systems to demographic change. If governments are able to reform labour markets and social security systems in line with employees' sense of justice, the trend of membership erosion will probably continue. On the other hand, the more employees get the impression that the reform burdens are distributed unequally, the stronger will be the social protest. Unions could benefit from this discontent. Across countries, unions presently oppose social reforms and demonstrate against them together with other protest movements. It is currently not predictable if this strategy will stabilise the unions' political influence or will even be a basis for the recruitment of new members.

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Foreign Currency Demand since 2002 – Evidence from Five Central and Eastern European Countries

Helmut Stix*

Introduction

Evidence presented in earlier CESifo articles (Sinn, 2001; Stix, 2001) showed that the demand for Deutsche mark declined substantially before the euro cash changeover in Central and Eastern European countries. This development raised the issue of whether the euro will enjoy the same degree of confidence as the Deutsche mark or other legacy currencies from the euro area or whether residents of Central and Eastern European countries will eventually switch into local or other foreign currencies, notably the US dollar.

Now, two years later, we know more. In particular, we were able to observe that the euro was successfully established and that no large scale portfolio shifts to the US dollar took place in Central and Eastern Europe. Despite this, only very little is known about how demand for euro cash evolved and what attitude people have towards the euro.

Therefore, this article provides an overview of the development of the extent of cash and asset substitution in five selected Central and Eastern European countries since 2002 – four of them now members of the European Union with the perspective of euro introduction before or around the turn of this decade. In particular, these countries are the Czech Republic, the Slovak Republic, Hungary, Slovenia and Croatia. The data used are mainly derived from representative surveys about the extent of foreign currency holdings commissioned by the Oesterreichische Nationalbank – described in more detail in Stix (2001). The surveys have been conducted biannually (spring and fall) since 1997, with the most recent survey results being from November 2004.

Specifically, we address the following questions: How has the changeover to euro banknotes and coins affected the extent of foreign currency holdings? How have foreign currency deposits evolved? What attitudes do people have towards the euro? And finally, when do people expect the adoption of the euro in their country?

Foreign currency holdings: From Deutsche mark and Austrian schilling to the euro

Figure 1, which summarizes the evolution of foreign currency holdings in percent of respondents since 1997, shows that in each of the countries a substantial share of the population held foreign currencies. Typically, the Deutsche mark was held most, usually followed by the Austrian schilling, sometimes closely (Slovak Republic, Hungary), and the US dollar (with the exception of Croatia where the US dollar was the second most important foreign currency). Furthermore, and as discussed in Sinn (2001), it is clearly visible that the share of those holding Deutsche marks declined with the approach of the euro cash changeover (with the exception of Slovenia).

The surveys conducted in spring and fall 2002 revealed that, in the course of the cash changeover, a substantial fraction of the stock of Deutsche marks, Austrian schillings and other euro area currencies that circulated in these five countries were exchanged into euros.[1] Also, a sizeable percentage of respondents exchanged their foreign currency holdings for local currencies whereas the exchange into US dollars was modest.[2]

The evolution of euro cash holdings after January 2002

After the decline of foreign currency holdings before and around the euro cash changeover, an upward trend in the share of the population that held euros can again be observed during the year 2002 in all five countries (Fig. 1). If seen over the years 2003 and

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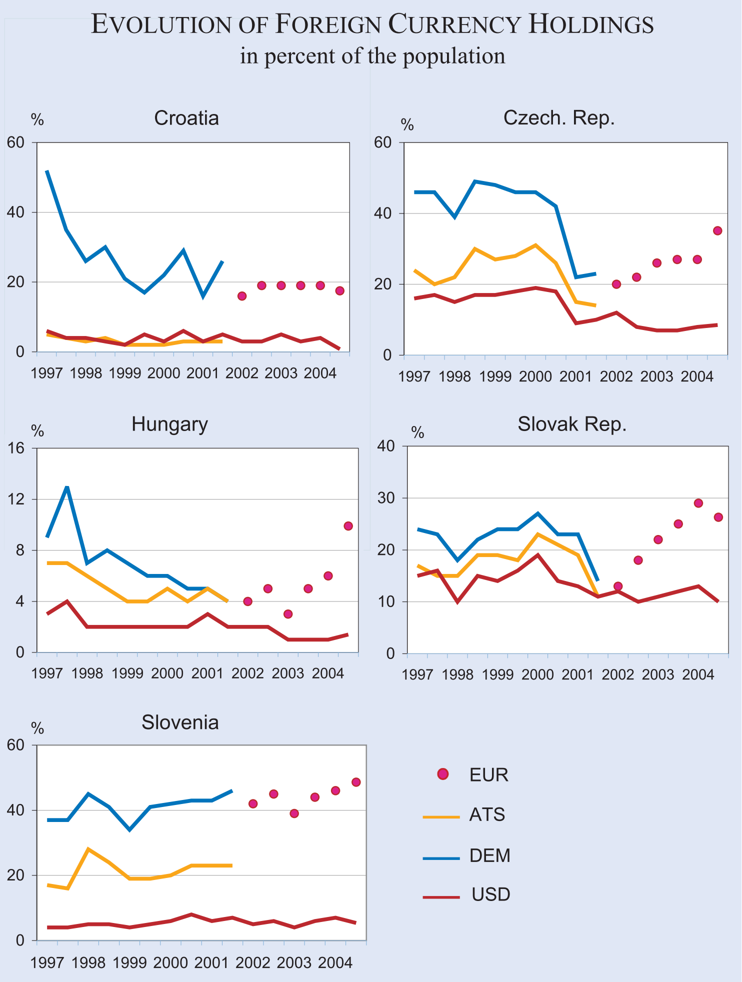
[1] The surveys conducted in 2002 show that the exchange of Deutsche mark into euro was particularly strong in Croatia 85 percent (of all those persons who held Deutsche mark around December 2001/January 2002), Slovenia 79 percent, and lower in Hungary 57 percent, the Czech Republic 48 percent, and the Slovak Republic 50 percent.

[2] Deutsche mark were exchanged into local currencies by about 21 percent to 36 percent (of those persons who held Deutsche mark around December/January 2002) in the respective countries. Deutsche mark were exchanged into US dollar by about 10 percent in the Slovak and in the Czech Republic. In the other countries the corresponding shares are very low (between 2 percent and 5 percent).

Figure 1



Note: Values on vertical axis show the percentage of respondents that held foreign cash.

Source: Survey results, OeNB.

2004, covered by the last four surveys, one can observe that the euro has gained importance in the Czech and Slovak Republics, in Hungary and in Slovenia, whereas the share of the population that held euros remained roughly constant in Croatia.

In absolute terms, about 49 percent of Slovenians, 26 percent of Slovaks, 35 percent of Czechs, 18 percent of Croats and 10 percent of Hungarians held euros in November 2004. In the Slovak Republic and in Slovenia, this share is now higher than for the Deutsche mark in any year since the surveys were started (1997).

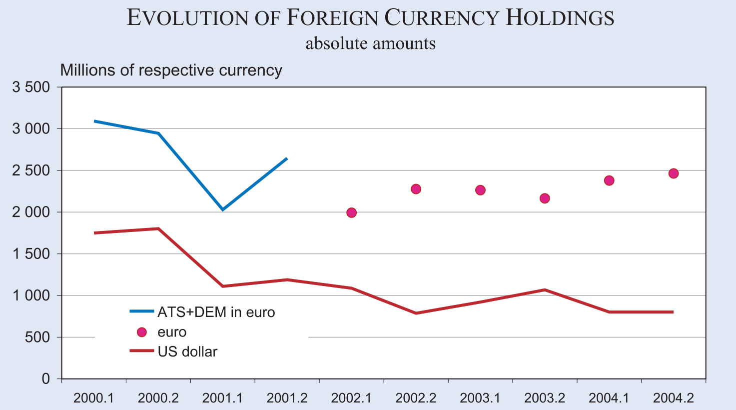
Although the share of the population with foreign currency holdings is an important indicator, it is the amount of foreign currencies circulating in these countries that is relevant from a monetary policy perspective. To account for this, we have estimated foreign cash stocks from survey responses about the amount of respondents' holdings.[3] However, before turning to an interpretation of the resulting figures, it should be noted that estimated currency amounts from survey responses are very likely to understate true holdings[4] – nevertheless, we consider trend changes over time as useful in indicating changes in the overall demand for the currencies analyzed.

The accumulated results for all five countries are shown in Figure 2. The calculations yield the result that joint holdings of Deutsche marks and Austrian schillings decreased from 2000 to early 2002 by about one third – which is in line with the evidence from the population shares (Fig. 1). For the period after the cash changeover, our calculations indicate again a slowly increasing demand for euros. However, this increase (about 24 percent from spring 2002 to fall 2004) has not made up for the decline in the demand for Deutsche marks and Austrian schillings prior to 2002. For the US dollar, the projections reveal a downward trend over the period from 2000 to 2004, with the value in 2004 being about half the value obtained for the year 2000.

The surveys have also collected information on the motives behind the decision to hold foreign currencies, allowing for a comparison between the Deutsche mark and the euro. As reported in Stix (2002), shortly after the euro introduction, the motives of holding euros were not much different than for the Deutsche mark. This has changed: when comparing the years 1999 to 2000 and 2003 to 2004, euro holdings are motivated less as a general reserve and more by spending purposes abroad in comparison to the Deutsche mark. Also, it is found that the euro's use

[3] For a description of how amounts are calculated, see Stix (2001).
[4] E.g. respondents may not reveal their true holdings, neither illegal nor business holdings are included, etc.

Figure 2



Note: Projected euro and US dollar amount held in all five countries.

Source: Survey results, OeNB.

for domestic transaction purposes is limited. In particular, 9 percent of Croatians and Slovenians answered that they made payments in euros during the last six months (as seen from November 2004). For all other countries, these values are significantly lower.[5]

The evolution of euroization in deposits

To obtain a broader picture about the degree of currency substitution, one also has to consider asset substitution. Analyzing only asset or currency substitution alone, which is sometimes necessary due to data constraints, could give rise to misinterpretation. For example, statistics by the ECB provide evidence that a significant increase of euro-denominated deposits was observed in the months prior to year-end 2001 in the countries of former Yugoslavia and in the then accession countries (ECB, 2002).[6] Therefore, the above mentioned decline in (legacy) cash holdings before and around the cash changeover might be explained by the fact that parts of foreign currency cash holdings were exchanged into foreign currency deposits.

As for cash holdings, one can analyze the degree of asset substitution from two sides: first, one can study the share of the population having foreign currency savings accounts; and second, one can directly analyze the share of foreign currency deposits in total deposits, which is available from national central banks. The difference between these two measures is that the former gives an indication about how widespread foreign currency deposits are among households whereas the latter also includes business deposits.

Concerning the first measure, column one of Table 1 presents the percentage of all savings account holders (taken as the average over the last four surveys) with a savings account denominated in foreign currency. As can be expected, there are marked differences between countries: For example, 57 percent of all Croatians with a savings account have an account denominated in foreign currency. This share is by far larger than in other countries: in Slovenia and the Slovak Republic, about 19 percent to 25 percent have a foreign currency savings account; in the Czech Republic and Hungary, the respective numbers are about 9 percent and 7 percent. In the next two columns, these percentages are split into those who only have foreign currency savings accounts and those who dispose over both foreign and local currency savings accounts. Here, the numbers reveal that out of those having a foreign currency account, typically the vast majority of respondents also has a local currency account. Only in Croatia do 23 percent of savings account holders rely solely on foreign currencies.

This evidence therefore indicates that currency substitution is still of importance in Croatia and, to a

Table 1
The role of foreign currencies for household savings

	account in foreign currency (%)	if foreign currency account: local & foreign currency (%)	if foreign currency account: only foreign currency (%)
Croatia	57	35	23
Czech Rep.	9	9	1
Hungary	7	6	1
Slovenia	25	24	1
Slovak Rep.	19	18	1

Note: Values represent averages over the last three surveys and are expressed in percent of those having a savings account (excluding non-responses). If the second and third column do not sum to the first column, then this is due to reounding.

Source: Survey results, OeNB.

[5] These figures are based on a rather low number of observations and hence need to be treated with some caution.
[6] The increases in foreign currency deposits in these countries ranged from 50 percent to 80 percent (ECB, 2002, p. 51).

Table 2
The share of euro-denominated deposits

	12/2001	12/2002
Croatia	72	57
Czech Rep.	7	7
Hungary	11	9
Slovak Rep.	9	9
Slovenia	38	

Note: Values represent the percentage of euro deposits in total deposits.

Source: ECB, "Review of the international role of the euro". December 2002 and December 2003.

more limited extent, in Slovenia and the Slovak Republic. At the same time, however, in all countries the majority of respondents with a savings account do not rely solely on foreign currencies in their saving decisions which clearly shows that people have trust in their local currencies and/or banking systems. Actually, this view is supported by survey questions on how people judge the safety of deposits in their country. In a trend comparison from 2003 to 2004, we find that the trust in the banking system has, depending on the country, either markedly increased or remained roughly constant (at a high level).[7]

Concerning the second measure, the ECB has collected statistics on the share of euro deposits in total deposits in these countries for December 2001 – as previously mentioned, a month with a relatively high stock of euro-denominated deposits – and for December 2002 (Table 2). These data show that the Czech and Slovak Republics experienced a constant share of euro deposits whereas a slight decrease can be observed for Hungary. For Croatia, the respective value decreased sharply, probably reflecting portfolio shifts due to exchange rate changes.[8] Unfortunately, no figure is available for Slovenia for the year 2002. However, data from the Bank of Slovenia show that overall foreign currency deposits – not just euro deposits – expressed as a share of total deposits reached a peak at the end of 2001, declined slightly until the end of 2002 and remained constant until the end of 2003. However, in the course of the year 2004, there has been a steady increase again.[9]

What about the euro's stability?

Besides the role of foreign currencies, the surveys also allow to derive evidence about people's assessment of the stability of the euro and the US dollar. In particular, respondents are asked: „How stable will the euro and the US dollar be within the next two years?" We interpret answers on this rather general question as reflecting personal sentiment rather than an assessment of "hard" economic facts like exchange rate movements or inflation. The answers from 2004 show that about 90 percent of all respondents expect the euro to be very or rather stable in the coming two years. In contrast, only 70 percent expect the same for the US dollar. Analyzing only those who either held euro or US dollar at the time of the surveys confirms this finding: an overwhelming share of people who either held euros or US dollars believes that the euro will be stable. Also, the assessed stability has been higher for the euro than for the US dollar in all surveys since fall 2002, even among those who held US dollars.[10]

Summary and future development

The evidence presented in this paper taken together, allows to draw the following conclusions:

First, after the decline in the demand for Deutsche marks and Austrian schillings before and around the cash changeover in the countries analyzed, both the estimated amount of euro cash demand as well as the percentage of respondents that held euros increased again after spring 2002. However, in absolute terms, the demand for euro cash is now lower than in the period before its physical introduction. In contrast, a declining trend can be observed for the US dollar both in the period before and after the cash changeover.

Second, the decline in foreign cash holdings before 2002 was associated with an exchange of foreign currency cash holdings into foreign currency deposits and/or local currencies – which can be seen as a reflection of increased confidence in the banking system, economic stabilization (disinflation policies),

[7] In particular, this assessment is based on respondents with a local currency savings account answering that they view their deposits very or rather safe.
[8] These numbers, however, need to be treated with some caution first because they also include deposits of financial and non-financial corporations which might be more volatile than household deposits and second because the methodologies in compiling the statistics might differ across countries.
[9] Source: Monthly Reports of the Bank of Slovenia, Table 1.4.

[10] Data for 2002 and 2003 are only available for those who held euro or US dollar at the time of the surveys. Among euro holders, the share of those believing that the euro will be stable has been higher than 90 percent in each survey since spring 2002. Among US dollar holders, this share has increased from 86 percent to about 90 percent from spring 2002 to fall 2004. In contrast, the assessed stability for the US dollar declined from about 91 percent in spring 2002 to 67 percent in fall 2004 among euro holders and from 95 percent to 79 percent for US dollar holders, respectively.

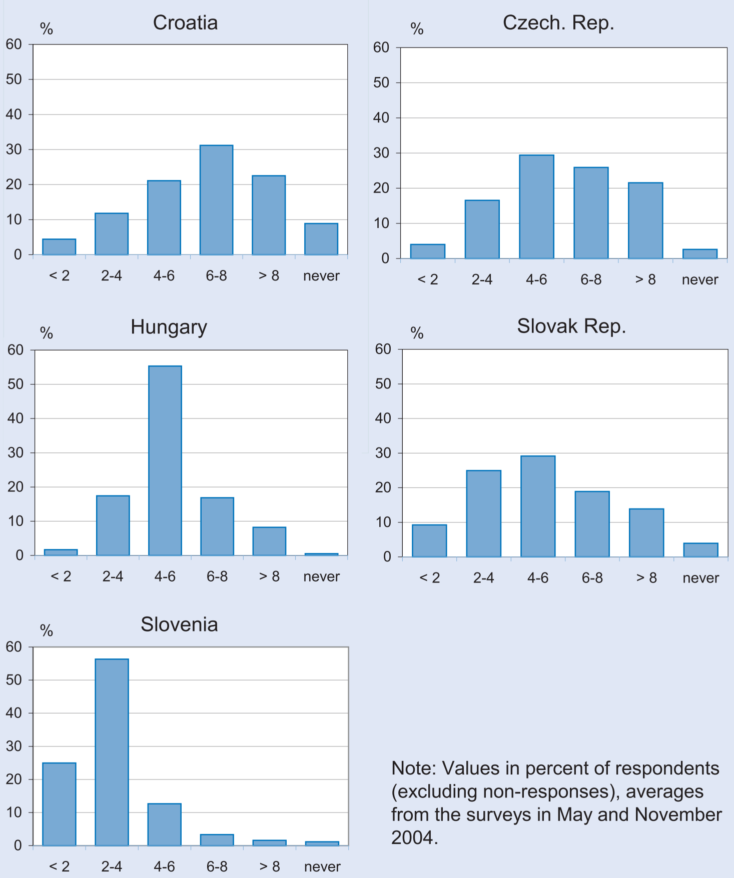
etc. In turn, the surveys suggest that the increased demand for euros since 2002 can mainly be attributed to an increased demand for transaction purposes (e.g. spending abroad) and less to demand for the purposes of hoarding.

Third, the evolution of asset substitution since 2002 does not allow for identifying a clear pattern – in some countries the share of euro deposits has declined, while in others it remained constant. However, the survey answers about the use of foreign currency savings accounts by households imply that foreign currency deposits in general and euro deposits in particular still play an important role in some countries, notably Croatia and to a lesser extent Slovenia and the Slovak Republic.

Finally, we observe that an overwhelming share of people in the countries covered by the surveys do think that the euro is a stable currency.

Figure 3

WHEN DO PEOPLE EXPECT ADOPTION OF THE EURO ?



Note: Values in percent of respondents (excluding non-responses), averages from the surveys in May and November 2004.

Source: Survey results, OeNB.

Concerning the future development, it will be interesting to observe how euroization will evolve once euro introduction moves closer. On the one hand, the required continuation of stability oriented economic policies should further decrease the demand for euros for hoarding purposes as well as the demand for euro-denominated deposits. On the other hand, one can assume that closer economic ties (trade, tourism, cross-border employment) will further increase the transaction demand for euros. Also, despite stability oriented economic policies, people could decide not to reduce or even expand euro deposits and cash holdings in anticipation of nearing euro adoption. As of now, it is rather difficult to say which effect will dominate. Ultimately, this will also depend on people's expectations about the timing of euro introduction.

Evidence on this is provided by the last two surveys from 2004 which contained the following question: "when do you believe that your country will introduce the euro?" The answers, summarized in Figure 3, reveal several interesting aspects: First, the overwhelming majority in each country believes that the euro will be introduced, at least at some point in time. Only in Croatia, which is not yet a member of European Monetary Union, about 10 percent of all respondents answer that the euro will never be introduced. Second, the views concerning the timing of an eventual euro adoption differ widely across countries. For example, 81 percent of Slovenians expect the euro within the next four years (the reference time for the adoption of the euro laid down in the Convergence Programme of May 2004 is 2007).[11] In Hungary, 55 percent expect euro introduction in four to six years, corresponding to the planned time of

[11] The reference years for the adoption of the euro are cited from: „Convergence Programme of the Republic of Slovenia" (May 2004), „Convergence Programme for the Slovak Republic" (May 2004), „Convergence Programme of the Czech Republic" (May 2004), „Commission's assessment of the May 2004 convergence programme of Hungary".

euro area accession (2010, possibly 2009). In the Slovak Republic answers are more dispersed: 29 percent expect the adoption of the euro in four to six years, while 34 percent expect euro adoption earlier and 33 percent later (the reference time is 2008 to 2009). Finally, although the median of answers for the Czech Republic is in the range of four to six years, 47 percent expect euro introduction in more than six years which is somewhat behind the conditional reference time of 2009 to 2010.

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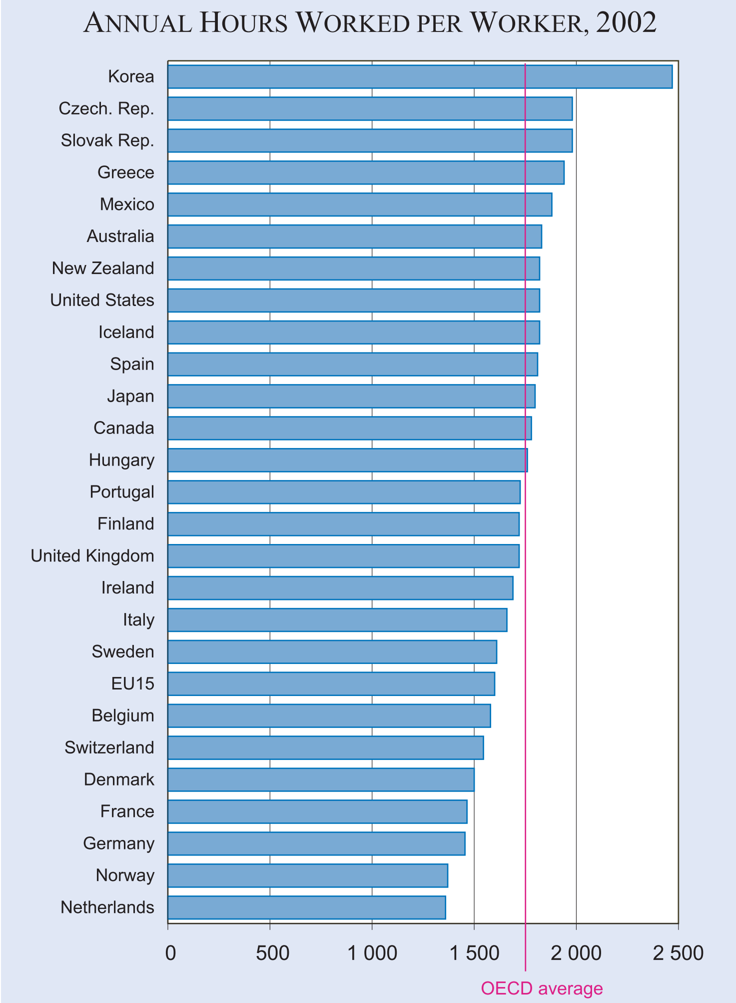
Working Hours Compared

Recently, the number of hours people work has become an issue again, especially in Germany, where unemployment remains stubbornly high, also due to labour costs that have become uncompetitive, especially in comparison to its East European neighbours, many of which have become members of the EU and can compete in the internal market at wage rates one sixth or less of those in Germany. In the past, the long-term trend had been one of reducing the working time. Thus in Germany, it fell from 1,939 hours per full time employee in 1970 to 1,641 hours at the end of 1990 and to 1,636 hours in 2002. The decline in annual hours has stopped or even reversed in several OECD countries. In Germany, too, efforts now go in the direction of raising the working time, as longer hours at equal pay are one way of reducing labour costs.

Figure 1



Source: OECD Employment Outlook 2004.

How many people have a job and how much time they spend at work has an important effect on economic growth. Thus the OECD reports that analysis of the causes of the strong revival of productivity growth in the United States since the mid-1990s has not only confirmed the importance of technological progress, but has also revealed the role of working time. It was found that the sizeable US advantage in real gross domestic product per capita has more to do with differences in who works and for how long than with higher output per hour worked.[1]

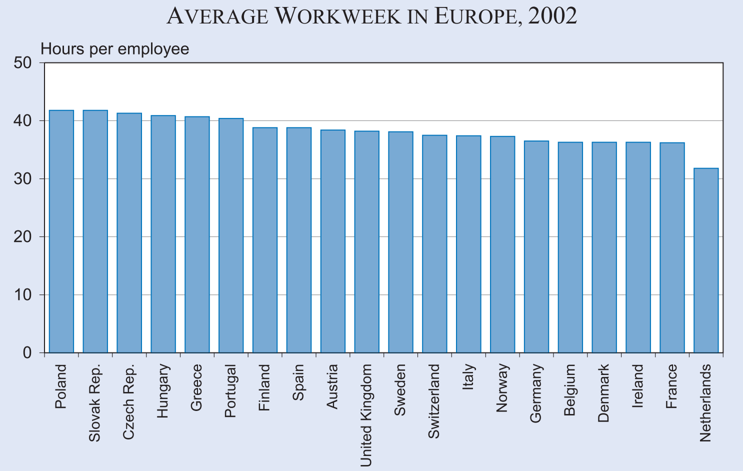
The number of hours worked varies widely between countries (Fig. 1). The average number of hours worked per year in OECD countries is around 1,700, but the figures range from 2,410 per year in Korea to just 1,340 in the Netherlands. Productivity differences are one reason for national differences. Hours per worker are highest in those countries like Korea, Greece, Mexico and the Czech and Slovak Republics, where output per worker is lowest. But there are also substantial differences in hours worked between the United States and European countries with similar levels of productivity. Reasons are the greater number of paid holidays in Europe (6 to 8 weeks) and the higher incidence of part-time employment in some European countries. The shorter workweek in Europe is another major explanation (Fig. 2).

Researchers have pointed to several possible factors behind the observed differences in working hours between the United States and Europe:

- *Cultural differences.* American workers tend to be more willing to work longer hours in order to enjoy higher earnings levels, whereas their European counterparts tend to be more willing to sacrifice

[1] OECD Observer, October 2004.

Figure 2



Source: OECD, Employment Outlook 2004.

some potential income in order to have more leisure time.

- *Different rewards.* The rewards to working longer hours are typically greater in the United States than in Europe due to lower taxes on earnings. In Europe, a higher share of the potential earnings that would result from working more would be paid in taxes, tipping the scale in favour of shorter hours and longer vacations.

H.C.S.

Mergers and Acquisitions in the EU

There was a considerable increase in merger and acquisition (M&A) activity in the EU during the 1990s when the value of cross-border M&As[1] increased tenfold, from $36.7 billion in 1990 to $357.3 billion in 1999. It surged in 2000 to $586.5 billion and sharply declined thereafter to a mere $122 billion in 2003 (UNCTAD, World Investment Report 2004).

There has been a discernible shift of cross-border M&As towards services like banking, insurance, telecommunications and water. In fact, most M&As during the second half of the 1990s took place in services. This partly reflects the ascendancy of services in economies in general, accounting, on average, for 72 percent of GDP in developed countries by 2001. Moreover, most services are not tradable – they need to be produced when and where they are consumed. In addition, countries have liberalised their services FDI regimes, which has made larger capital inflows possible. EU firms have become the dominant actors, displacing the United States which could consider M&As their exclusive domain up to the 1980s. The propensity of firms to enter new markets through M&As rather than Greenfield FDI, is much greater in service industries.

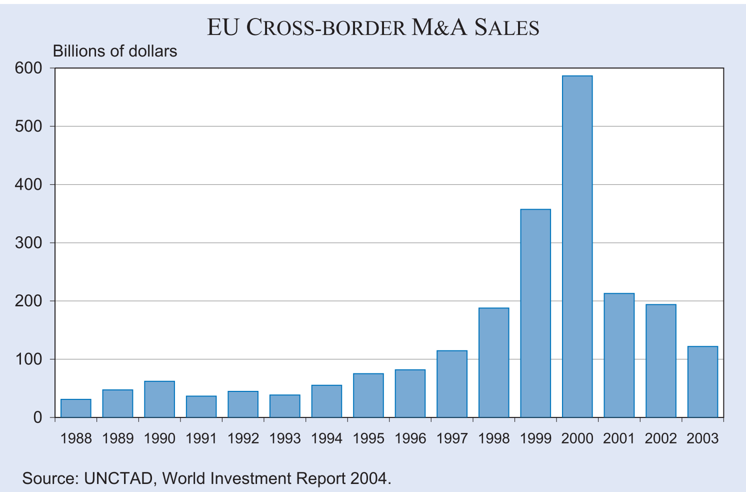
The value of cross-border mergers and acquisitions in the EU rose again in 2004 and is expected to continue increasing in the near future. One major factor is the approval by ministers from EU countries, on November 25th, of a directive on cross-border mergers. The directive must, of course, be approved by the European Parliament before coming into force. The European Commission has been pushing for a law on cross-border deals, because serious differences in national laws make transnational mergers with companies in such countries as Austria, Denmark, Finland, Germany, Greece, Ireland, the Netherlands and Sweden all but impossible. Acquiring firms have to resort to creating new subsidiaries in these countries or complex holding structures (The Economist, December 4th 2004).

Germany, in particular, refused to make cross-border mergers easier. Its system of Mitbestimmung (co-determination) proved to be a major stumbling block in the protracted negotiations. In Germany, employee representatives make up one third of the supervisory boards of firms with more than 500 employees and half in companies with more than 2000. in other EU countries, too, workers' representatives sit on supervisory boards, but usually not more than one third. In other countries like the United Kingdom, Spain and Italy, employees have no voice on boards.

Because of Germany's insistence on *Mitbestimmung*, the final version of the directive says that a merger involving a German firm will have to adopt co-determination if one third or more of the employees are German. German companies are especially unhappy with this outcome. In fact, business associations have been trying to weaken co-determination in the country. They fear that foreign companies will shy away from mergers with German firms.

Taking a look at the cross-border M&A statistics again, we notice that, with the exception of France, Germany has been the country with the highest number of M&A sales in the EU. Since 2000, when M&A activity peaked in the EU and Germany's share exceeded 40 percent, it has accounted for more than 20 percent of EU M&A sales in every year and much more than France. The Mitbestimmung clause may therefore not be the impediment to cross-border mergers feared by some.

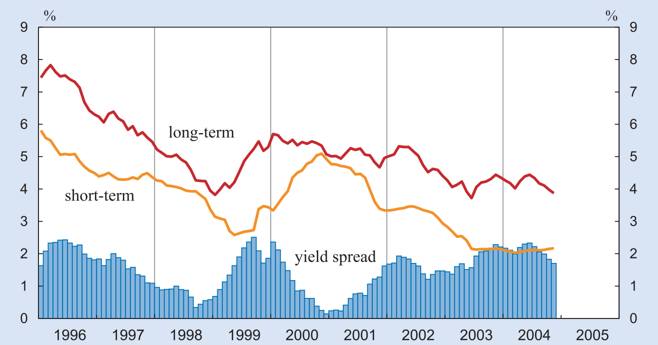
H.C.S.



[1] Sales by region of seller.

Financial Conditions in the Euro Area

Nominal Interest Rates a)

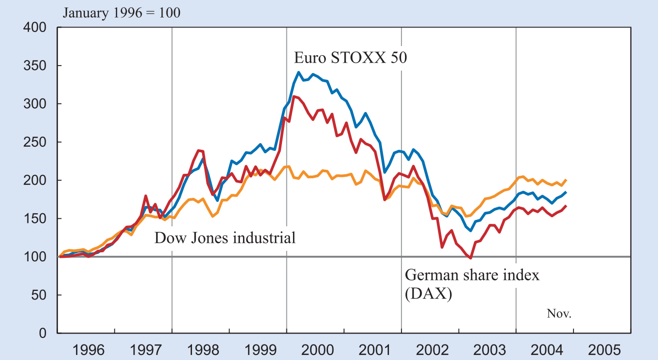


a) Weighted averages (GDP weights).

Sources: European Central Bank.

While short-term interest rates have remained unchanged, long-term rates (yields on 10-year government bonds continued to decline during the past three months, from an average 4.11% in September to 3.98% in October and 3.87% in November 2004. Correspondingly, the yield spread continued to narrow.

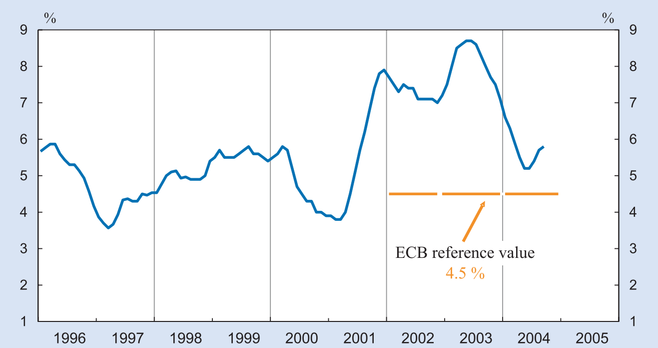
Stock Market Indices



Source: Deutsche Bundesbank, Dow Jones & Co., Inc.

The stock markets recovered during the past three months. The Dow Jones reached 10,411 in November, the Euro Stoxx 2,883 and the German DAX 4,126. They thus recouped the losses suffered in 2002 and 2003.

Change in M3 a)

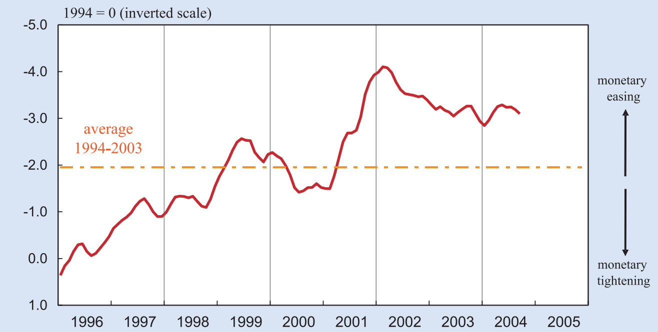


a) Annual percentage change (3-month moving average).

Sources: European Central Bank.

The annual rate of growth of M3 declined to 5.8% in October 2004, from 6% in September. This was mainly due to a decrease in the growth rate of marketable instruments, but also – to a lesser extent – of M1. The three-month average of the annual growth rates of M3 over the period August 2004 – October 2004 was 5.8% compared with 5.7% in the previous 3-month period.

Monetary Conditions Index

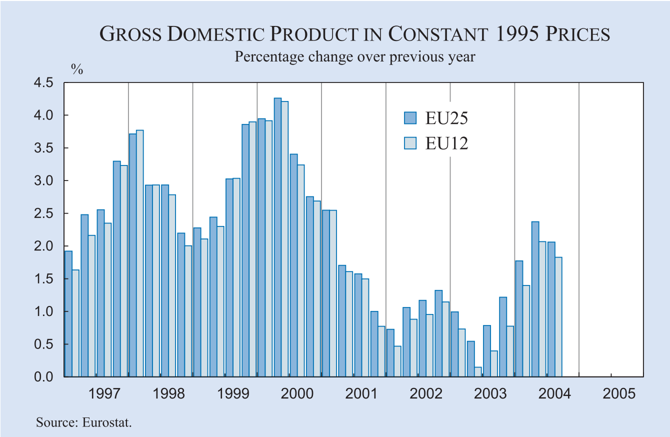


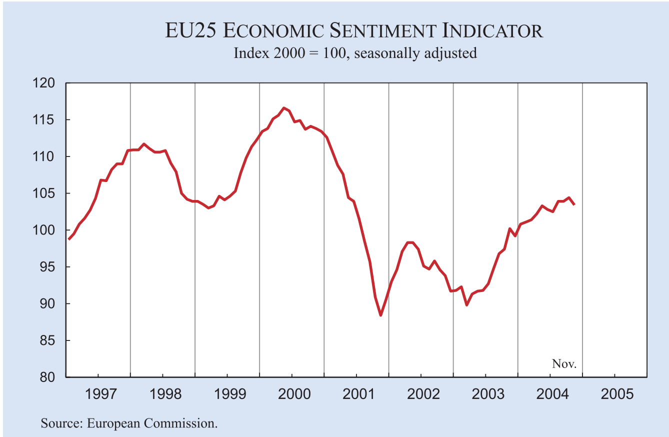
Note: MCI index is calculated as a (smoothed) weighted average of real short-term interest rates (nominal rate minus core inflation rate HCPI) and the real effective exchange rate of the euro.

Sources: European Central Bank, calculations by the Ifo Institute.

The MCI index continued to decline, implying a very slight monetary tightening, due to an rise in the real effective exchange rate of the euro.

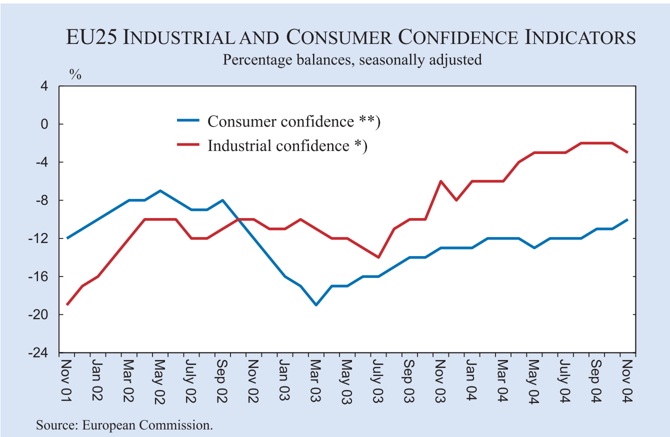
EU Survey Results

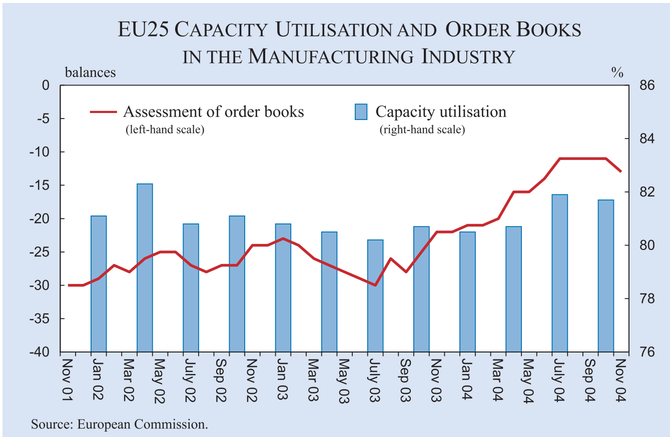




In the third quarter of 2004, the year-over-year growth rate of real GDP was 1.8% in the euro area (EU12) and 2.1% in the entire EU (EU25). Thus growth was somewhat less than in the second quarter, when the rates were 2.1% and 2.4%, respectively. Above average growth rates in the euro area were registered by Spain (2.6%), Belgium (3%) and France (2%). In the EU25, Lithuania (6.3%), Finland (3.7%) and Greece (3.8%) stood out.

The economic sentiment indicator (ESI) for the EU fell in November by 1 point to a level of 103.4. The component most decisive for the decline was the services confidence indicator, which fell by 2 points. Among the larger member countries, the ESI improved in Spain and Poland, but fell in France and the UK. In Germany and Italy, the indicator moved sideways.





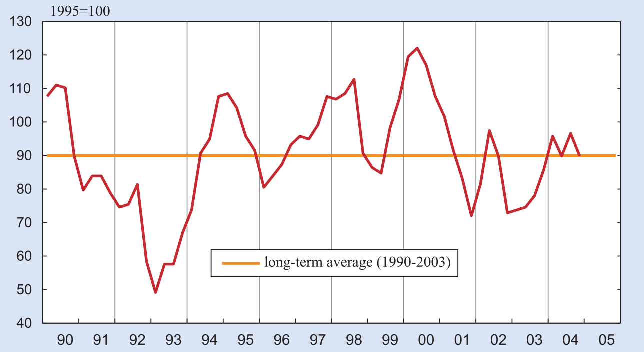
* The industrial confidence indicator is an average of responses (balances) to the questions on production expectations, order-books and stocks (the latter with inverted sign).
** New consumer confidence indicators, calculated as an arithmetic average of the following questions: financial and general economic situation (over the next 12 months), unemployment expectations (over the next 12 months) and savings (over the next 12 months). Seasonally adjusted data.

Industrial confidence fell by 1 point in the EU. Confidence in the industry sector has changed very little since early summer. There was a decline in production expectations, whereas the assessment of the stock of finished products remained unchanged. *Consumer confidence* recorded a small improvement, raising it above its long-term average for the first time since October 2002.

There was a slight decline in capacity utilisation and also in the assessment of order books. The latter was most pronounced in Denmark (+ 4 to – 10), in the UK (– 4 to – 13), Hungary (– 15 to – 20), and Lithuania (– 22 to – 27), compared to October.

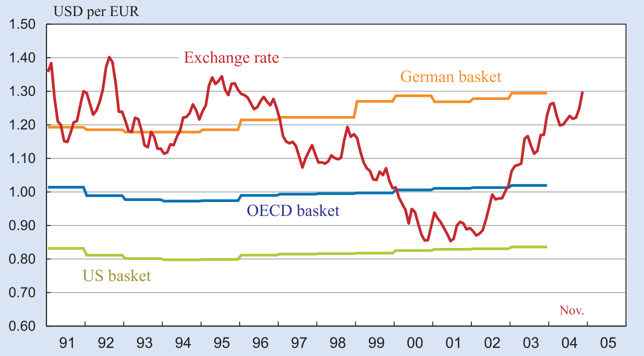
EURO AREA INDICATORS

IFO ECONOMIC CLIMATE FOR THE EURO AREA



Source: Ifo World Economic Survey (WES) QIV/2004.

EXCHANGE RATE OF THE EURO AND PPPS



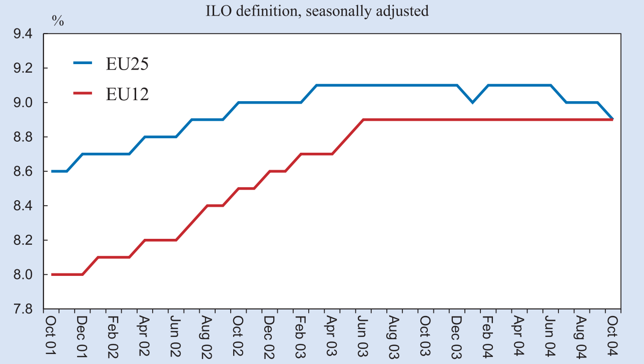
Sources: European Central Bank, Federal Statistical Office, OECD and calculations by the Ifo Institute.

According to the Ifo World Economic Survey, the economic climate for the euro area declined to 89.8 in the fourth quarter 2004 compared to 96.6 in the third quarter. Considering the zigzag course during the year, one could say that there has been a sideways movement in 2004.

The euro registered a sharp increase against the dollar in November, when it averaged $1.2991. It continued to rise during the month of December, breaching the $1.34 mark. In November it reached the 2003 purchasing power parity based on the German market basket.

UNEMPLOYMENT RATE

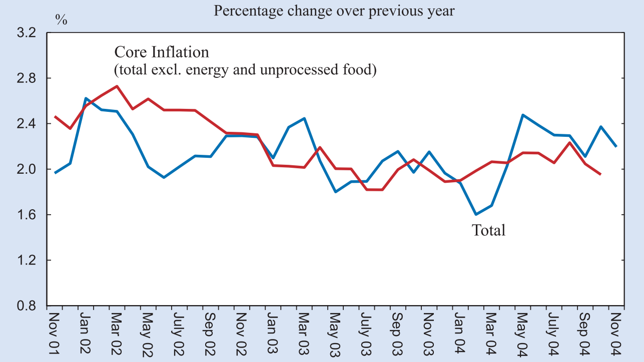
ILO definition, seasonally adjusted



Source: Eurostat.

INFLATION RATE (HICP)

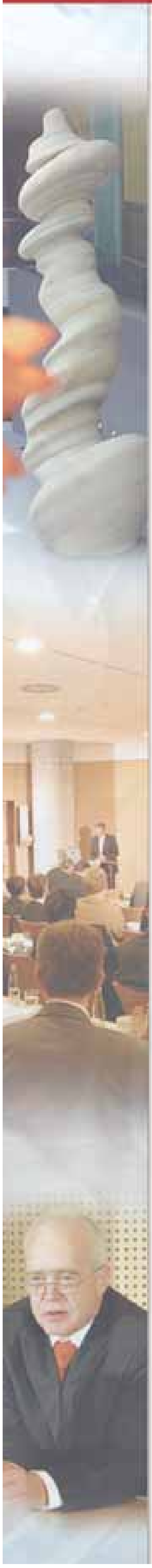
Percentage change over previous year



Source: Eurostat.

The seasonally adjusted unemployment rate (ILO definition) in the euro area remained unchanged at the level of 8.9% that has prevailed since June 2003. The unemployment rate for the larger EU25 declined to the same 8.9% in October, from 9% during the preceding three months. It was 9.1% in October 2003.

The euro-area inflation rate (consumer prices HICP) declined to 2.19% year-over-year in November from 2.37% in October. Core inflation (excl. energy and unprocessed food), for which the October rate is the latest one available, declined to 1.95% year-over-year from 2.05% in September. Rising energy prices will increase the gap between the two measures.



International Spring Conference 2005

Preliminary Programme

17 March 2005

11:00 **Press conference**

11:00 Cold buffet lunch

12:00 **Welcome and Introduction**
Sir Peter J. Torry, British Ambassador, Berlin
Hans-Günther Vieweg, Ifo Institute, Munich

12:15 **Challenges for European Economic Policy**
Bernd Pfaffenbach, Undersecretary of State, Federal Ministry for Economics and Labour, Berlin

12:45 Discussion

13:15 **Global Economic Outlook**
John Llewellyn, Lehman Brothers, New York

13:45 **Threats to Eurozone Economic Stability**
Walton David, Goldman Sachs, London

14:15 **The European Economy**
Hans-Günther Vieweg, Ifo Institute, Munich

14:45 Discussion

15:45 Coffee break

16:15 **Turkey**
Fahti Özatay, Central Bank of Turkey, Istanbul

16:40 **Central and Eastern Europe**
Michael Landesmann, WIIW, Vienna

17:05 **PR China**
Sonja Opper, University of Lund, Lund

17:30 General discussion

19:30 Dinner at the British Embassy

18 March 2005

9:00 **Welcome and Introduction**
Hans-Günther Vieweg, Ifo Institute, Munich

9:10 **European Institutional Framework-Unleashing Economic Growth**
Horst Reichenbach, Director General, DG Enterprise, Brussels

9:40 Discussion

10:10 Coffee break

Major European Industries

10:25 **Overview**
Sebastian de-Ramon, Cambridge Econometrics, Cambridge

10:50 **Steel Industry**
Michael Harris, Corus, London (invited)

11:10 **Chemical Industry**
Peter Claes, FEDICHEM, Brussels

11:30 **Mechanical Engineering**
Stephen Radley, EEF, London

11:50 **Automotive Industry**
Peter Wells, Center for Automotive Industry Research, Cardiff

12:10 **Computers & Telecommunications**
Axel Pols, Bitkom, Berlin

12:30 General discussion

13:00 End of Session

Hot buffet lunch

14:30 End of conference

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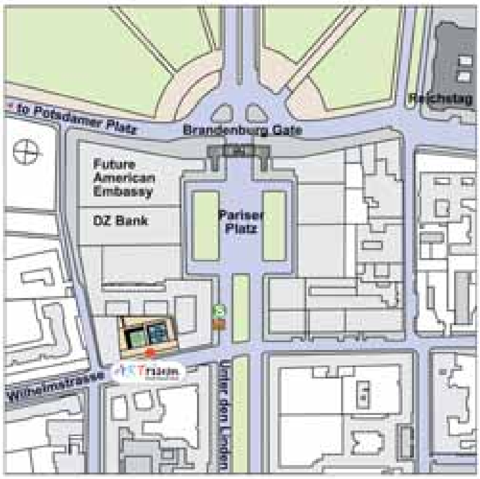

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