Editorial: Tax cuts might help more than expenditure programs

Over the recent weeks it has become increasingly evident that the financial crisis is more severe than most analysts – the EUREN institutes included – have expected. In the meantime, governments and central banks around the world have set in place many measures to stabilize the financial markets. In part they aim at reviving the interbank markets, which have dried up because banks do not trust each others. Another part of the measures is deemed to provide fresh capital to banks to prevent them from insolvency and to counteract a de-leveraging of the banks' balance sheets which could end in credit restrictions and would be particularly harmful to the real economy. So far, the EU members have acted quickly and in a co-ordinated way.

In addition, central banks in Europe, Asia and the U.S. have lowered their interest rates in a concerted action. However, financial markets being in turmoil one might be sceptical whether monetary policy can give a boost to the economy. Therefore, stimulating fiscal measures, though often seen quite sceptical, could be appropriate in the current situation. Indeed, most governments have taken such measures in the meantime. The question is, however, are the packages as they are designed really helpful to stabilise the real economy?

In most countries, governments announced plans to boost investment. In Germany, e.g., more favourable depreciation rules will be in place until the end of 2010, and in France fixed investment will be exempted from the corporate tax until the end of 2010. These are temporary measures, and as investment mostly is the cycle maker they are targeted, too. Insofar they seem to be suitable measures to stimulate the economy in a cyclical downturn. However, if expectations are generally poor, will companies make use the incentives soon, or will there be a sunset effect?

The second part of the fiscal packages concentrates on public investment, on measures deemed to stimulate growth, and on environmental goals. In France, the car industry will receive a subsidy to develop motors with lower emissions. In Germany 3 bn € will be spent additionally to subsidize the reduction of CO_2 emissions of buildings, and new cars will be exempted from the motor vehicle tax for two years, depending on their emissions. Again, one might be sceptical, whether these measures will give an immediate impulse to the economy, given the fact that there is a downswing now, but not at the end of 2009.

In its latest World Economic Outlook, the IMF analysed the effectiveness of countercyclical fiscal measures in industrialised and developing countries. Taking a sceptical view in general, the study concludes that income related measures seem to be more efficient than expenditure programmes. Income measures are much easier to design, and a smaller tax wedge will have positive growth effects, too, in particular when it is combined with a policy that keeps public expenditure under control. This instrument, surprisingly, is mostly missing in the current stimulation tool boxes.

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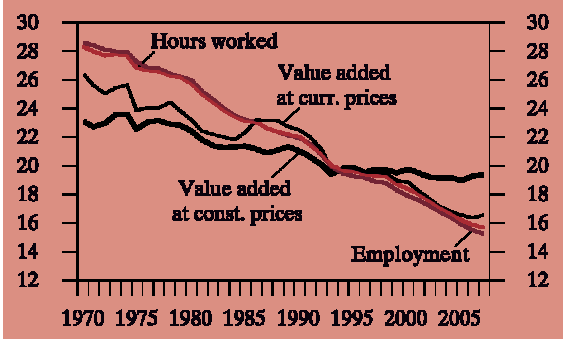
Industry: an ambition for Europe[1]

During the last decades, the European manufacturing industry faced several shocks. In the early seventies and eighties, oil shocks have taken their toll on global economic growth and forced to make the production process more energy efficient. The mid-nineties have been characterised by the information and communication technology revolution that gave a positive impulse to productivity growth (even if it was more pronounced in the U.S. than in Europe) and created possibilities to diversify the locations of production. Associated with the deregulation of domestic markets and the liberalisation of international capital flows, it has given birth to what is commonly named globali- sation. Moreover, since the beginning of this century, tougher environmental constraints and a strong rise in raw material prices changed the framework for the European industry. Finally, newcomers have challenged traditional manufacturing specialisation of European countries. In particular, the growing importance of China has reshuffled the cards among the industrial world.

Because of all those changes, the European manufacturing companies had to adapt their products and their process of production continuously, as historical comparative advantages cannot guarantee anymore the success for the future.

Graph 1

Importance of manufacturing industries
1970-2007, % of total



Source: EU Klems, Eurostat, author's calculations.

The share of industry has been almost stable in the last decade

During the last decades, three main trends characterised the European industry[2].

Firstly, the share of manufacturing industry in the total economy nominal value added is declining. While the share of manufacturing industry in total value added reached 25% in early 1970's, it dropped to 16.5% in 2007 (graph 1).

Secondly, a more favourable picture arrises when the share in constant prices is considered[3]. It reached 23.5% in early 1970's and came down to just one-fifth (19.5%) in 2007, but it remained almost constant over the last ten years. This means that the relative price of manufactured goods declined markedly during this period.

A third feature is the declining share of manufacturing in total employment. It was nearly halved in the last thirty years, from 28% in 1970 to 15% in 2007. This downward trend can partly be explained by the outsourcing of activities, like cleaning or accountancy, shifting employment to the services sector. But, this decline reflects also productivity gains, which were, on average, much stronger than in the rest of the economy. In the EU-15, productivity (value-added per hour worked) increased at an annual rate of 3.4% in the manufacturing sector between 1970 and 2007, compared to 2.3% in the total economy. Productivity growth has been more or less the same over the years, and it even accelerated since 2000, while it slowed down markedly

1 This paper summarizes a report the EUREN institutes prepared for the European Industry Day under the French Presidency of the European Union. This seminar was organised by the GFI (Groupement des fédérations industrielles). The full report is available on Euren website www.euren-network.eu.
2 In this part, we focus on figures regarding EU-15. A wider definition of Europe, EU-27 for example, raises the question of long-term comparison.
3 The analysis must not be focused on the level itself but on its trend, as the level is fixed by choosing the base year.

in the rest of the economy (3.5% between 2000 and 2007 in manufacturing activities against 1.3% for the total economy). In turn, those productivity gains explain the reduction of the relative prices in manufacturing products, compared to the rest of the economy.

Regarding exports, Europe has succeeded to consolidate its market shares in the most recent period, which holds for EU-15 as well as EU-27, even when intra-regional trade is excluded (Table 1). This essentially reflects the sharply improving German export performance, which is analysed in detail in the report. Considering value-added, things are a bit different. The share of Europe decreased in the first half of the 2000's, mainly due to an impressive increase of China's share in world manufacturing which doubled in the last ten years. Interestingly the share of Europe also fell below the U.S. share, while it was above in mid-1990's.

Which strategies and policies to keep the European industry strong?

In the report, a study of the Greek industry provides an example, how a country modified its sectoral specialisation and market orientation successfully to adapt to global competition. More generally, globalisation puts the European industry under pressure, which implies to implement strategic policy orientations, described in details in the report. This raises the question about the goals of industrial policies. In the 1970's, this concept was understood in a sense that the public administrations were responsible to identify strategic activities and to undertake medium term programs to encourage the development of those activities as well as to provide aid and protection for industries regarded as strategic. Nowadays, industrial policy has to be rethought. Its role might be to provide the appropriate framework in order to make Europe an attractive location for manufacturing activities in terms of investment and job creation.

For sure, the European industry will continue to face many challenges in terms of education, research and development, and new constraints as well as opportunities due to the environmental policy. Answering to niche markets in advanced industrial activities (mechanical engineering, up range textiles, pharmaceutical products …), focusing on high value added activities in which Europe has or can develop a technological leadership (energy saving engines for cars and aircrafts, chemical products …), and developing a fruitful co-operation between European historic industrial countries and new EU members by extending what has been done by German companies (outsourcing of input) at the image of Japan with other Asian countries can be a way to make Europe stronger to master these challenges.

Because of the role of industry in terms of productivity gains and in innovation, with spill-over effects to the rest of the economy (80% of EU private sector research and development expenditures are spent in the manufacturing industry), it would be wrong to think that Europe can continue to thrive without a strong industry.

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Table 1

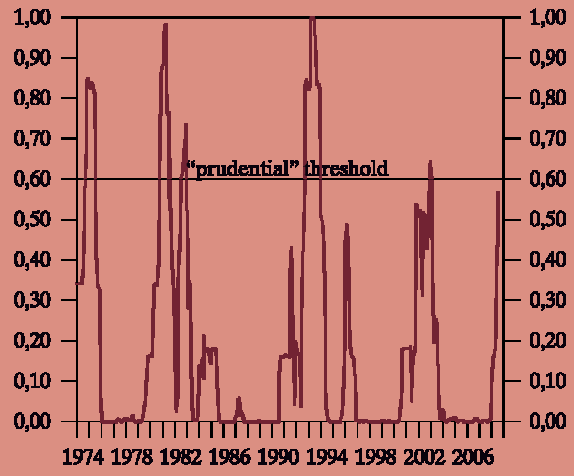
Share in world manufacturing exports and value-added

Group / Country	Exports (share in %)			Vallue-added[1] (share in %)		
	1995	2000	2006	1995	2000	2006
EU-15	43.9	38.9	40.4	25.9	24.2	21.8
EU-15 (excluding intra-EU 15 trade)	23.3	20.9	22.3	–	–	–
of which						
France	6.0	5.3	4.8	3.4	3.3	3.0
Germany	12.2	10.2	12.0	7.4	6.8	6.3
Italy	5.6	4.6	4.4	4.2	3.6	2.9
Spain	2.0	2.0	2.1	1.7	1.7	1.6
United Kingdom	5.2	4.8	4.2	4.5	4.0	3.3
EU-27	45.8	41.3	44.1	27.1	25.6	23.4
EU-27 (excluding intra-EU 27 trade)	22.6	19.8	21.0	–	–	–
China	3.6	5.7	11.7	5.1	6.7	10.6
USA	11.9	13.1	9.3	24.5	26.7	25.1
Japan	11.7	10.0	7.5	20.4	17.9	15.8

Sources: Cepii-Chelem database and UNIDO. – [1]In constant 2000 US$.

COE-Rexecode Leading Indicator for the Euro Area

In September 2008, the "underlying" monthly growth in the euro area was at 0,1% on an annual basis, close to become negative. It is therefore important now to evaluate the risk of a recession. The Coe-Rexecode Start-End Recession Index for the Euro Area is a coincident indicator designed to detect in real time the start of a recession. Below 0.5, the index indicates a regime of "no-recession". Values above 0.5 mean a change into a recessionary regime. However, to be cautious we suggest the threshold of 0.6. In August, the indicator surged to 0.56 from 0.46 in July. Consequently, there is a strong probability of a shift to recession in the euro area during the past summer. However, this first signal has to be confirmed



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[1] The probabilistic start-end recession index (SERI) developed by Coe-Rexecode is based on a statistical Markov-Switching model. It outputs an instantaneous probability of being in a recession phase of the economy, for a given country. The Hamilton model is applied to a finite number n of series that coincides with the reference business cycle. For the Euro area, the series selected are the unemployment rate, the industrial production index in the manufacturing sector, the new car registrations and the household confidence index. For each time t, the model outputs n conditional probabilities of being in recession. These probabilities are then aggregated taking into account the risks of false signals and missed signals. For each time t, the SERI index is thus defined as the aggregate of these probabilities. The signal of change in regime (expansion or recession) is given when the SERI index crosses the significant threshold of 0.5 or, preferably, the prudential threshold of 0.6.

Forecast of the EUREN/CEPREDE High Frequency Model

Last update: October 22, 2008

	07Q4	2007	08Q1	08Q2	08Q3	08Q4	2008	2009Q1
Jul-07	2.31 ; *0.57*	2.67						
Aug-07	2.28 ; *0.67*	2.61						
Sep-07	2.16 ; *0.72*	2.51						
Oct-07	2.13 ; *0.51*	2.56	2.07 ; *0.75*				2.05	
Nov-07	2.30 ; *0.51*	2.65	2.28 ; *0.78*				2.03	
Dec-07	2.27 ; *0.47*	2.67	2.23 ; *0.76*	2.15 ; *0.22*			2.04	
Jan-08	2.29 ; *0.49*	2.67	2.11 ; *0.62*	2.01 ; *0.20*			1.96	
Feb-08	[2.3 ; *0.4*]	[2.7]	1.93 ; *0.44*	1.82 ; *0.19*			1.79	
Mar-08			1.90 ; *0.46*	1.86 ; *0.25*			1.82	
Abr-08	[2.2 ; *0.4*]	[2.6]	1.87 ; *0.47*	1.90 ; *0.32*			1.85	
May-08			2.00 ; *0.80*	1.79 ; *0.09*	1.49 ; *0.40*		1.75	
Jun-08J	[2.2 ; *0.3*]	[2.6]	[2.2 ; *0.8*]	1.90 ; *0.10*	1.62 ; *0.42*	1.75 ; *0.43*	1.87	
Jul-08	[2.2 ; *0.4*]	[2.7]	[2.1 ; *0.7*]	1.64 ; *–0.06*	1.26 ; *0.33*	1.40 ; *0.44*	1.60	
Aug-08				1.57 ; *–0.13*	1.06 ; *0,19*	1.26 ; *0.51*	1.52	
Sep-08	[2.2 ; *0.4*]	[2.7]	[2.2 ; *0.7*]	[1.5 ; *–0,2*]	0.85 ; *0.05*	1.12 ; *0.57*	1.42	
Oct-08					0.84 ; *0.04*	0.71 ; *0.17*	1.31	0.48 ; *0.47*

In brackets: GDP-Data published by EUROSTAT. In italics: quarter on quarter rates.

The October 2008 update of the EUREN/CEPREDE model forecasts a weak growth in the third and forth quarter of 2008, meaning a clear downward revision over the recent months. However, to date our indicator predicts no decline in seasonally adjusted GDP yet. For the first quarter in 2009 a first projection yields a rate of about 0.5%. The model is mainly driven by two factors. Firstly, the economic sentiment indicators have fallen to historically lows, not seen since end 1992. Secondly, there was a turnaround in some economic activity indicators; unemployment, e.g., started to rise and retail sales fell in the second half of this year.

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Impressum
The European Economic Network (EUREN) is a network of European economic research institutes. which was formed in 1999. Members of EUREN are:
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