

## EXECUTIVE SUMMARY

This is the fifth annual report by the European Economic Advisory Group (EEAG) at CESifo. It contains five chapters addressing the economic situation and different topics of policy concern for the European Union and the euro area. This executive summary provides a synopsis of the analysis and policy proposals of the report.

Chapter 1 discusses the short-term macroeconomic outlook and policy options for the European economy. As a main scenario, it is forecasted that GDP in the euro area will grow in 2006 at around 2.0 percent which is faster than the rate of 1.4 percent for 2005. Overall, European growth remains lower than in most other parts of the world and our forecast assumes favourable developments in the rest of the world. The chapter points to the risk of an undesirable mix between monetary and fiscal policies in the euro area: the ECB is likely to tighten monetary policy in response to the cyclical upswing, whereas the stance of fiscal policy will probably remain more or less unchanged. Instead, for reasons of long-run sustainability, structural budget deficits in the euro area should be reduced. This would leave room for a looser monetary policy than would otherwise be possible. Key to a better policy mix is a restoration of incentives for fiscal discipline, which have been significantly weakened by the 2005 reform of the Stability and Growth Pact.

Chapter 2 reviews the current debate about global imbalances, which have emerged as a result of large and persistent current account deficits of the US. The chapter presents and assesses different views about the nature of the required global adjustments and the extent of foreseen depreciation of the dollar. The US deficits are largely matched by large surpluses in Asia, oil-producing countries and a few European countries. Though the euro area as a whole has a close-to-balance external position, the possible correction mechanisms imply major challenges to policy-makers in Europe. The risks include a prolonged fall in the external demand for European

products, increasing competition by US firms and negative wealth shocks due to a possible further fall of the dollar that would reduce the value of Europe's external assets. The risk of financial crises increases if the fall in the dollar is very pronounced and adjustment takes the form of a hard landing leading to a US and worldwide output contraction. There could also be a reversal of US attitudes towards free trade with negative consequences for Europe, if sluggish US external adjustment and over-cautious policy corrections by China and other Asian emerging markets strengthen the political weight of protectionist positions in the US.

The other chapters of the report consider selected aspects of the general theme "growth and competition in Europe".

Chapter 3 analyses the growth performance of different EU countries. While growth has been sluggish in France, Germany and Italy in the past ten years, several other EU countries have done well. The successful countries can be divided into two groups. One group, consisting of Finland, Ireland, Sweden and the UK, has relied strongly on the introduction of new high technologies, in particular information technology (IT). On the other hand, Greece and Spain have also grown well, but they have relied on traditional sources of growth – capital accumulation and increased labour input. The different experiences and the recent enlargement of the EU suggest that the Lisbon strategy for growth and employment should be replaced by a flexible approach: countries on the technology frontier should rely strongly on IT and other knowledge-based sources of growth, while other countries should rely on accumulation of traditional capital and labour and use technology transfer to achieve a gradual transformation towards high-tech industries. Such an approach can incorporate the differences among EU countries in the degree of technological advance. The key areas for growth policy include improvement of education – especially tertiary education – and IT diffusion, together with measures that enhance competition among firms in the economy. Improving competition

is vital for increased innovativeness and entrepreneurial activities in the EU.

Chapter 4 discusses primary and secondary educational systems in the EU, as education is a major determinant of economic growth. Education is a public quasi-monopoly in most EU countries. There are large disparities between countries in terms of achievements in reading, mathematics and science. These disparities occur among countries that are similar in economic and demographic terms. The amount of resources devoted to education does not seem to have a large impact, whereas the structure of school systems seems to matter a lot. On the basis of empirical studies, we argue that simply devoting more resources to education spending, or naïve targets such as reduction of class sizes, are not an effective way to improve school systems. Instead, policies should focus on better organisation of schools. Increasing parental choice and fostering competition among students to get into good schools and among schools to attract good students seem to be more effective policy reforms. If designed well, such reforms do not lead to unfair or non-egalitarian practices.

Chapter 5 considers merger control and competition policy in Europe, where merger activity is gathering pace. Earlier, mergers were mainly an Anglo-Saxon phenomenon. Higher merger activity in Europe is driven by a combination of the long-term effects of market integration and globalisation, strong corporate profits and cheap credit. Globalisation imposes restructuring in many sectors, and mergers are a prime instrument. The policy challenge is how to allow the needed restructuring and potential increase in firm size in some sectors, while at the same time protecting competition. This chapter discusses the trends of merger activity as well as the rationale for it and the main principles for an effective competition policy. The main conclusions are as follows. First, a vigorous competition policy is needed, but care must be taken not to try to enforce low concentration in natural oligopoly industries, where only a limited number of players can survive. Second, obstacles to hostile and cross-border mergers should be removed. Third, the 2004 reform of the merger control procedure in the EU was a step in the right direction, but the current structure of decision-making should be strengthened to improve checks and balances and minimise the lobbying influences by national governments and large firms.

## The European Economy: Macroeconomic Outlook and Policy (Chapter 1)

Rises in oil prices are not likely to cause as high levels of inflation in the industrialised world as in the past. One reason is that central banks have over time managed to keep inflation expectations at low and stable levels. Furthermore, globalisation and – in Europe – still relatively low capacity utilisation prevent firms from fully passing on energy price increases to consumers. Overall, there are no clear tensions in labour, goods and service markets. This explains why in the euro area core inflation, as measured by the HICP excluding energy and unprocessed food, actually fell somewhat from 2.1 percent in December 2004 to 1.4 percent in December last year. Headline inflation in the euro area is expected to reach an average of 1.9 percent this year.

With respect to fiscal policy, industrial countries, on average, stayed on a more or less neutral course. Monetary conditions in the US and in Europe moved in opposite directions in 2005. The European Central Bank left its target rate again unchanged at 2 percent until December 2005, while the US Federal Reserve kept raising its funds rate. Assuming overall stable oil prices and exchange rates, world economic growth in 2006 will probably be slightly lower than in 2005.

The US appears to be on a stable expansion course, supported by all major demand components. Tightening of monetary policy will, however, slow down US growth somewhat to 3.4 percent. Especially private consumption is expected to expand at a slower rate.

In China, the government will continue its efforts to dampen investment demand in certain industries to support a more balanced growth pattern. Together with a small appreciation of the renminbi against the US dollar, this will probably imply that Chinese growth will be slightly lower than before, but remain on a high level of approximately 8½ percent.

During the first half of 2005, Japan continued its recovery. So far, it has mainly been based on export growth, as the country benefited from strong developments in the rest of Asia and in particular China. Growth during the first half of 2005 was supported by domestic demand. As this is expected to continue, the overall expansion of the Japanese economy will – with a rate of 2.4 percent – be at a slightly higher pace than last year.

In the rest of Asia, GDP growth is likely to slow down somewhat in 2006 as compared to 2005. The revival of the global IT cycle at the end of 2005 and the beginning of 2006 could support exports from the region. However, the high oil price will – given the high energy intensity of production in many Asian countries – probably lead to a further tightening of monetary policy. Furthermore, demand impulses from the US are expected to subside somewhat.

In the EU, the slow recovery, which started during the second half of 2003, made way for another phase of weak growth already after one year. This lasted for a good part of 2005 and was caused by a slowdown in domestic demand and, in particular, a near standstill of private consumption. During the course of 2005, the recovery in the European economy gained pace again. Annualised quarter-to-quarter growth in the euro area reached 2.6 percent in the third quarter, thereby allowing annual real GDP growth to reach 1.4 percent.

Since 2001, Germany has been characterised by very weak consumption demand due to unfavourable income developments and (political) uncertainty. Of the larger EU countries, only Spain has experienced strong consumption demand. This is to a large extent supported by the continued real estate boom, but if the boom comes to a sudden stop, there could be a rapid slowdown in consumption demand and overall activity.

In contrast to consumption, equipment investment in the euro area continued its upward trend in 2005. Given low inflation expectations and the continued cyclical slack, wage demands were moderate. This contributed to creating favourable conditions for investment financing. On the other hand, fierce competition faced by European firms in export and home markets, together with rising energy prices, put pressure on profit margins. Furthermore, European enlargement has shifted a greater share of total business investment to accession countries where labour costs are much lower. Investment in the euro area could therefore remain lower than in previous economic recoveries.

Current and leading indicators point to improving cyclical conditions in the last half of 2005 and the first half of this year. Net exports are expected to contribute to GDP growth by 0.2 percentage points. Stable oil prices will allow profit margins to improve. Together with increased foreign demand as well as continued favourable financing condi-

tions, we expect that investment will grow at a rate of 3.0 percent, which is stronger than in the recent past.

Gradually improving labour market conditions and moderate wage increases will allow private consumption growth to increase somewhat in the course of 2006. Due to the continued recovery of the European economy, cyclical slack will fall to approximately half a percent of potential GDP. Growth of the euro area is still lacking the dynamics observed elsewhere in the world. On average, real GDP growth in the euro area is expected to increase to 2.0 percent this year. Growth will thereby be somewhat above trend. The growth gap between Europe and the United States will narrow somewhat.

The still weak cyclical recovery in the European economy raises fundamental macroeconomic policy issues. One is how much the aggregate stance of monetary and fiscal policy in conjunction should be tightened. Another issue concerns the appropriate monetary-fiscal policy mix. For reasons of long-term sustainability – associated with future demographic developments – there is a strong need for fiscal consolidation in the euro area. However, aggregate government net borrowing is at present very close to the three-percent-of-GDP limit in the Maastricht Treaty. The situation is not likely to improve much in the next few years. In fact, the 2005 reform of the Stability Pact has considerably weakened the incentives for fiscal discipline: the possibilities of extending deadlines for eliminating excessive deficits have increased, and the scope for discretionary decision-making in the enforcement procedure has been significantly widened.

As a consequence, a cyclical upswing in the euro area is likely to trigger a tightening of monetary policy rather than of fiscal policy, resulting in a growth-unfriendly policy mix. In addition, there are fears that the ECB may be about to restrain aggregate demand too much by forcing core inflation too far below 2 percent.

The risk of an undesirable policy mix in the euro area has been emphasised in a large research literature. The original establishment of the Stability Pact could be seen as a way of preventing such a situation from occurring. The de facto collapse of the pact will make this very hard to achieve. It is vital to restore stronger incentives for fiscal discipline, but it is far from clear how this could be achieved over the

next few years. A re-establishment of such incentives in the longer term would require bold political initiatives: these could involve (i) stronger fiscal-policy frameworks at the national level; (ii) enhanced fiscal policy co-operation in a smaller group of fiscally responsible EU states; or (iii) attempts to coordinate monetary policy and fiscal policy reform at the EU level, for example by the ECB offering governments a monetary-policy reward, in the form of an upward revision of its inflation target, as a response to a restoration of a stricter fiscal-policy framework.

### Global Imbalances (Chapter 2)

The large and persistent current account deficits run by the United States from the second half of the 1990s have generated widespread concerns about the sustainability of current macroeconomic imbalances at the global level and the risk of disorderly adjustment and slowdown in macroeconomic activity. This chapter reviews the current debate and discusses the implications of global adjustment for European macroeconomic developments and policy-making.

Currently, large external deficits in the US are matched by large surpluses in Japan, Asian emerging markets, oil-producing countries and a few European countries. However, the euro area as a whole is close to external balance. The composition of external financing of the US deficit has changed significantly after 2000 with a falling share of private capital inflows (accounting for 90 percent of total inflows in 1997–1999, but only for 40 percent in 2003–2004) and an increasing share of public inflows. A further dimension of current global imbalances concerns the high level of international reserves held in dollar assets. At the same time, there has been a strong expansion of cross-border holdings of financial instruments, which have doubled since 1990 from about 60 percent of world GDP to above 120 percent now.

Though the US current account deficit is large in terms of US GDP, it is small relative to the stock of US foreign gross assets. The US typically borrows from international markets by issuing dollar-denominated assets but lends abroad mostly by acquiring equities and foreign-currency denominated bonds. Therefore, dollar depreciation leaves the dollar value of US liabilities unaffected but raises the dollar value

of US assets and improves the US net foreign asset position.

There are a number of views on the causes of current imbalances, with quite different implications for the need for corrective policy measures.

1. A widespread view attributes the persistent US current account imbalances to low US national savings. Private savings in the US have been trending downward for some time and US public savings have also deteriorated markedly since 2000. Some studies suggest that the impact of fiscal consolidation in the US on external trade is limited in the short run, but greater fiscal discipline would certainly help reduce imbalances in a longer-term perspective.

2. A second view of the US external deficits argues that they are essentially driven by expectations of high future growth. This view has two important policy implications. First, it is not appropriate to talk about “imbalances”, as trade flows are in fact balanced in an intertemporal perspective. Second, significant dollar depreciation in real terms may not be required for some time and should therefore not be expected. However, current expectations about high US growth in the future may be too optimistic. If and when expectations are revised downwards, restoring US external balance would then require a sharp correction of spending plans, possibly implying large movements in exchange rates and relative prices.

3. A third view of US current account deficits argues that the deficits are a mirror image of a “saving glut” in the rest of the world. A variant of this view is that there is an “investment drought” outside the US. This view offers a potential explanation of the simultaneous occurrence of low real interest rates and low investment. According to this argument, one may expect interest rates to rise as soon as investment picks up again.

4. A fourth view suggests that a desire for “export-led growth” and a build-up of currency reserves in Asian emerging markets have substantially contributed to the current global imbalances. In particular, imbalances are due to China’s exchange rate policy and its strong influence on the policies of the other emerging markets in the region. China’s formal abandonment of the inflexible peg against the US dollar has not led to any significant appreciation of the renminbi so far. However, given the internal

consequences of distorted relative prices, due to an artificially low exchange rate and the threat of protectionist measures by the US, one should expect some noticeable correction in the near future.

Predictions of further sizeable depreciation of the dollar in real effective (multilateral) terms emphasise the need for a fall in the relative price of US non-tradables, which is tantamount to a reduction in US income relative to the rest of the world. According to some studies, the required real rate of depreciation of the dollar might be quite large, depending on several factors that ultimately affect the elasticity of substitution between traded and non-traded goods in the US and between US and foreign traded goods, as well as on the impact on the level of economic activity. Many studies suggest that adjustment could necessitate a protracted period of real dollar weakness.

According to the consensus view, the most important policy contribution to adjustment should come from a reduction in the US fiscal deficits. Without any fiscal rebalancing in the US, a reduction in Asian saving, possibly associated with a slowdown or reversal in reserve accumulation, increases the risks of financial strain in the global currency and asset markets. Looking at the adjustment of global imbalances from a “euro” viewpoint, there may or may not be further dollar depreciation vis-à-vis the euro. However, correcting the US current account deficit in any case requires an improvement in US net exports, and Europe is likely to experience a drop in external demand with negative effects on European growth.

It is possible that the resolution of current imbalances will proceed relatively smoothly. However, it is also possible that the current build-up of imbalances will be followed by one of the “hard landing” scenarios. Suppose that there is a disorderly adjustment with strong relative price and exchange rate movements and financial turmoil across markets. In this scenario, it is highly plausible that European financial and non-financial firms would suffer from strong deterioration of their balance sheets and liquidity shortages. This scenario would call for European monetary and supervisory authorities to stress-test their institutional framework. If the financial crisis is moderate, the euro system may be able to contain it. However, if the financial crisis is sufficiently severe, monetary authorities may face difficult trade-offs between financial stability and

price stability. Governments may then have to shoulder large fiscal costs to stave off a serious financial crisis. This would raise important issues regarding the distribution of fiscal costs across countries that policies to mitigate a serious crisis would entail. In this scenario, the relatively weak public finances in many European countries are an aggravating factor, as they would imply undue constraints on emergency financing in the case of a crisis. Increasing the fiscal room of manoeuvres in a possible future financial crisis adds a strong precautionary motive for stronger fiscal discipline now.

Even if European monetary authorities were successful in fighting financial contagion and other undesired effects of liquidity shortages in the event of a worldwide financial crisis in the context of an unwinding of global imbalances, the euro area would still in such a situation face a severe aggregate demand problem. It would be difficult to deal with this problem under the current framework for monetary and fiscal policy. Perhaps the most important risk for Europe associated with global imbalances is to become exposed to a severe downturn without having access to effective policy instruments to stabilise the economy.

### **Economic Growth in the European Union (Chapter 3)**

Economic growth has been sluggish in many EU countries. Up to the 1990s, levels of GDP per capita in Western European countries were catching up with that of the US, but this tendency was dramatically reversed in the 1990s. In particular, France, Germany and Italy have started to fall further behind the US. The European growth problems have led to major political discussions within the EU. The 2000 Lisbon strategy for growth and employment was an expression of the concern about low growth.

This chapter analyses the reasons behind the varying growth performance of EU countries. Our first observation is that slow growth is not a universal phenomenon among the old EU countries. Some countries – notably Ireland, Finland, Greece, UK, Spain and Sweden – have performed well over the last decade. We are also beginning to see “growth miracles” in several new EU member countries. Second, a process of convergence in per capita incomes in the EU is taking place. This process is

largely driven by the convergence between the EU-15 and the new member countries, that is, living standards in the new EU countries appear to be catching up with the old EU members in a long-term perspective.

Determinants of economic growth are analysed by decomposing GDP growth into the contributions from growth of labour input, IT capital input, non-IT capital input and technological progress (total factor productivity). Growth accounting reveals that the unsuccessful countries, France, Germany and Italy, have been growing mostly through traditional capital accumulation and to a much smaller extent through general technological progress. Labour input often played a substantial negative role, particularly in Germany.

In contrast, there have been different roads to prosperity in the successful countries. In one group, consisting of Ireland, Finland, the UK and Sweden, there has been a large increase in the contribution by IT capital growth, though all production factors have made a positive contribution in these countries, including labour input for most episodes. In addition, relatively rapid IT capital growth has been coupled with relatively high total factor productivity (TFP) growth in these countries. The best performer, Ireland, has had rapid growth in all factor inputs. Spain and Greece make up a second group of success cases, which have primarily grown through conventional capital accumulation and labour input growth.

There are large variations among countries in the determinants of growth in capital and labour inputs and in factors that influence technological progress. Finland, the UK and Sweden had higher shares of IT capital relative to other capital already before, so the recent fast accumulation of IT capital has for this reason resulted in larger contributions to growth. These countries are also at the top in terms of indicators of IT diffusion. Determinants of technological progress are likely to have been quite diverse, as technological progress is influenced by a number of factors such as education and innovativeness of the economy. Finland and Sweden had the highest levels of education spending (relative to GDP) among EU countries, but there appear to be no systematic relationships between this factor and growth for EU countries. The amount of regulation is one determinant of the degree of competition among firms, which in turn influences innovativeness. In many, though not all cases, the

successful countries have done well in terms of indicators of deregulation, venture financing and R&D spending.

Our analysis leads to several policy conclusions. First, we recommend that the Lisbon strategy should be modified. The Lisbon strategy argues for the creation of a uniform model of a high-tech information society for the EU, whereas the European experiences suggest that there are different routes to success. Instead, the EU should allow for a flexible strategy for growth, in which there is scope for high-tech driven growth as well as growth based on more traditional means of capital accumulation, increased labour input and imitative adoption of new technologies from the leaders.

One key element in growth policy is improvement of the educational systems. This should be done at both the national and EU levels. Education influences growth through the accumulation of human capital, and there are also important complementarities between education and the ease of adoption of innovations and new technologies. An important question concerns the level of education at which improvements should be focused. Countries that are close to the frontier should specifically focus on improving the tertiary education system, as high-technology innovations require more advanced skills than lower-level innovations. The latter are often process improvements and rely on imitative adoption of known technologies.

While the US does not stand out in the quality of secondary education, it is well ahead of EU countries in university education, which is likely to matter the most for economic growth of the most advanced countries. The best universities in the US compete strongly with each other for the best graduate students and researchers. In European countries, the university system is largely not exposed to strong competition, though the UK with its national research and teaching quality audits is partly an exception.

A third policy conclusion concerns the potential to increase labour input to enhance economic growth. In most EU countries, labour input has not grown much, and in some countries labour input growth was even negative for some periods. Labour input can be raised through labour market reforms such as lower unemployment benefits, employment tax credits, lower marginal tax rates on labour and pension

reforms providing incentives to a longer working life. Decentralised collective agreements that allow lengthening working hours (as in Germany) and reversals of earlier legislated working time reductions (for example in France) are other desirable measures.

Another policy conclusion concerns the regulatory policies in the EU. Europe tends to have a relatively high level of regulations that limit competition by restricting entrepreneurial activities, entry and labour market adaptability, which in turn can suppress innovation and technological advancements. Growth effects of competition appear to depend on the distance of the industry from the technology frontier, so that increased competition yields the largest productivity gains in sectors that are far behind the frontier. Technology policy should focus on provision of opportunities for creation of new firms and industries and less on glorifying national champions. Improvements of venture capital financing and R&D continue to be important policy areas for the EU countries. There are big variations in the amount of venture capital investments in the EU, and Europe is lagging behind the US in this respect. Also, competition policies should focus more on facilitating entry of new firms to improve innovativeness of European economies.

Reduction of trade barriers to competition and entry in the service sector is important, as exporters of services tend to be subjected to national regulations in both the country of origin and in the host country. Since the service sector makes up around 70 percent of both GDP and employment in the EU-15, lower trade barriers for services have potentially large growth effects. For this reason, it is important that the new EU Services Directive under discussion is not watered down. A related issue is that the imposition of national pay conditions on posted workers from other EU member states prevents effective cross-border price competition. This limits the gains from trade in services to economies of scale, more effective organisation and greater product diversity. It also means that the old EU member states forsake the welfare gains that could come from allowing service providers from the new member states to compete effectively by compensating for lower productivity through lower wages. Such competition is a natural exploitation of different comparative advantages. It is not “unfair wage dumping”. Wage competition among countries in trade with services should be allowed in the same way as in trade with goods.

Growth-enhancing policies for new EU member countries include facilitating technology transfer and improvement of productivity in industries that are mostly behind the high-technology frontier. Education policy and financing of new firms and innovations continue to be major items in the policy agenda for the new EU members.

#### **Prospects for Education Policy in Europe (Chapter 4)**

Education is an important productive input into the wealth of a nation. It enhances individual productivity, which shows up in higher wages. The rate of secondary enrolment comes out as one of the significant determinants of differences in GDP per capita across countries. Also, an educated workforce is a valuable asset at times of rapid technological change, because educated workers are better at adopting new technologies.

In most European countries, the public sector holds a quasi-monopoly on the provision of education. While government intervention may be justified on the grounds that education has social aspects and that parents’ decisions may not reflect their children’s best interest, it is not clear that direct provision is the adequate form of government intervention. One may consider a more decentralised approach that would contain costs and allow for greater diversity of individual choices.

In many countries, primary and secondary educational systems are under pressure. On the one hand, the costs of education are soaring as both enrolment rates and the length of studies trend upward, while the cost per pupil grows as fast as GDP per capita. On the other hand, there is a perception that standards and achievements are going down.

Some argue that in order to solve these issues, one should spend more resources on facilities, hire more teachers to reduce class size, and perhaps employ more staff to take care of discipline and other non-curricular aspects. Others insist that educational systems can be made a lot more efficient by relying on competition and free parental choice.

What does the evidence say?

We observe large disparities between countries in terms of achievements in reading, mathematics, and

science. These disparities occur among countries that are similar in economic and demographic terms. Therefore, the way schools are organised seems to matter a lot. Furthermore, the amount of resources devoted to education does not seem to have a large impact. In a cross section of countries, it only has a small impact on achievements; the US spends a large amount per student, but does worse than the Slovak Republic that spends only little. Econometric studies at the individual level suggest that traditional recipes based on increased spending fail. For example, there is hardly any evidence that reducing class size has any impact on achievement. These findings are confirmed by event studies such as those of the unsuccessful French “Zone d’Education Prioritaire” experience.

On the other hand, a growing body of empirical studies that compare similar groups of pupils exposed to different policies suggests that enhancing competition between schools has positive effects on achievements. Competitive mechanisms re-allocate resources from the worse to the best schools by allowing parents to choose and by adjusting school resources so that the successful schools can grow to accommodate increased demand.

These mechanisms can take different forms: they can rely on the private sector to different degrees and involve different compensation mechanisms in order to offset potential unwanted effects on the distribution of income. For example, vouchers of some amount can be given to attend private schools. The amount of vouchers can be adjusted to reflect distributional concerns. It has been shown that such schemes also benefit pupils who continue to attend public schools, because these are disciplined by competition from private schools. Hence, even students that are too poor to attend a private school, despite the voucher, indirectly benefit from school competition. But one can also think of other mechanisms where parental choice is increased and management is decentralised to the school level, but where there is less reliance on monetary rewards and smaller distributional effects.

The organisation of public schools has a large impact on achievements. Mere increases in spending, in particular in the form of smaller classes, seem to be an inefficient way of raising achievements. In contrast, substantial improvements can be obtained if one fosters competition, both among students to get into the good schools and among schools to attract the good

students. The available evidence suggests that while raising performance, such policies would not be particularly “unfair” or “non-egalitarian” relative to current practices.

### **Mergers and Competition Policy in Europe (Chapter 5)**

Merger activity is gathering pace in Europe. 2005 has seen large-value mergers or acquisitions such as Italy’s Unicredito of Germany’s HVB in the banking industry and France’s Pernod Ricard of the UK’s Allied Domecq in the food and drink sector. The pace of activity in utilities has been especially hectic and France’s Suez has acquired Belgium’s Electrabel, France Telecom has bought Spain’s Amena and Telefónica (Spain) has launched a bid for O<sub>2</sub> (UK). Within Spain, Gas Natural has also announced its intention to take over Endesa in the largest operation of the year. At the same time, private equity firms (mostly British and American) are buying up firms, in particular conglomerates, with a view to restructure them and sell them for a profit. Not so long ago, mergers were basically an Anglo-Saxon phenomenon. However, the end of the millennium merger wave was driven, at least in terms of cross-border operations that have been gaining weight in the total, by activity in the EU-15.

This reflects the long-term effects of market integration in Europe. But broader trends in the world economy are also important – the revolution in information technology, the widening of markets, the strength of corporate profits and the availability of cheap credit. Globalisation, especially in the form of competition from emerging economies like China and India, has induced restructuring and redeployment to increase productivity, and mergers are an integral part of these processes.

Mergers raise a host of public policy issues. It is not clear that mergers create value for shareholders and consumers. A consolidation wave poses a threat to competition, which is the main driver of economic efficiency and productivity growth. The preservation of competition in different markets is of utmost importance. Domestic mergers are generally more threatening to competition than cross-border ones. It may be agreed that globalisation lessens the need for merger control, but it is important to establish that European merger control is up to the task of ensur-

ing that the merger wave is good not only for investment bankers but also for consumers.

A related issue is that many European governments have a protectionist instinct and view with suspicion foreign takeovers of their national champions or of firms that are considered to be in strategic sectors. Banking and utilities are often viewed as examples of such sectors. France and Italy tend to protect their firms, as shown by, for example, the discussion over whether French Danone could be taken over by PepsiCo, and the obstacles put by the former governor of the Bank of Italy to the foreign takeover of Antonveneta and BNL. France has issued a list of strategic sectors where national interests are to be protected. Despite this, the trend towards cross-border mergers seems robust. The public policy question is whether ownership matters and whether Europe needs either national or European champions.

Globalisation is associated with technological change, with decreases in trade and transport costs of goods, capital, people and information, and with liberalisation and market integration that simultaneously enlarge the market and increase competitive pressure. In many sectors, the number of firms will have to be reduced in an integrated or enlarged market to reap economies of scale. At the same time, a sufficient level of competition is needed for innovation, and the timely termination of bad projects drives productivity growth. Furthermore, domestic competition is a key to international success and competitiveness, whereas fostering national champions may be self-defeating. The policy challenge is how to allow the needed restructuring and potential increase in firm size in some sectors, while at the same time protecting competition.

Our first conclusion is that a vigorous competition policy is needed, but care must be taken not to try to enforce low concentration in natural oligopoly industries where only a limited number of firms can survive. Furthermore, merger control should take into account the need of a larger firm size in several industries and the potential dynamic efficiencies (for example innovation) generated by mergers.

A second conclusion is that artificial obstacles to hostile and cross-border mergers should be removed in Europe. Hostile takeovers are a sign of health of the market for corporate control. Cross-border mergers should proceed without regulatory obstacles as they

may keep in check the increase in domestic concentration. We acknowledge that ownership is not neutral, in particular, in some industries like banking where relationships are important, but on balance this is insufficient justification for protectionism. European as well as national competition policy must play a major role in keeping markets open.

A third conclusion is that care must be taken in not promoting European champions that end up being effectively protected from closure. Can the independence of competition policy be maintained given the politics of the Commission? States can lobby Commissioners and other Directorates than the one for competition (like Industry or Energy) to further national policies. Such lobbying would be hard to resist if it is done simultaneously by more than one large EU member state. An independent institutional body might protect competition policy from these industrial policy pressures.

Fourth, the 2004 reform of the merger control procedure in the EU was a step in the right direction, increasing checks and balances for merging parties and the role of economic analysis. However, the guarantees for the parties, the quality of analysis and decision-making, as well as the protection against the lobbying pressures of national governments and firms could still be improved. One example of an independent institutional body would be an administrative panel, which is located within the Commission and recommends or even decides on merger cases. Another possibility would be a European Competition Agency.