ECONOMIC RESEARCH & CORPORATE DEVELOPMENT

Working Paper 156

November 8, 2012

} MACROECONOMICS } FINANCIAL MARKETS } ECONOMIC POLICY } SECTORS

Claudia Broyer, Ann-Katrin Petersen, Dr. Rolf Schneider, Anna Sophia Winter

Economy and labor markets in Europe

Allianz

AUTHORS:

CLAUDIA BROYER
Tel.: +49.69.263-57667
claudia.broyer@allianz.com

ANN-KATRIN PETERSEN
Tel.: +49.69.263-19790
ann-katrin.petersen@allianz.com

DR. ROLF SCHNEIDER
Tel.: +49.69.263-57790
rolf.schneider@allianz.com

ANNA SOPHIA WINTER
Tel.: +49.69.263-13431
anna-sophia.winter@allianz.com

ECONOMY AND LABOR MARKETS IN EUROPE

Light at the end of the tunnel?

Although the most recent economic indicators showed the eurozone to be in poor shape overall, a few glimmers of hope have emerged in the financial sphere, such as the recent stabilization in Target balances or the narrower spreads for European corporate bonds. This study starts by providing a brief overview of our forecast for EMU economic growth, which has been taken down a notch. Due to the stark differences in growth from country to country within the EMU, we will then be putting developments in the problem countries, Italy, Spain and Portugal, under our microscope. In the last part of this publication, we will be using our experience of the situation in Germany to determine the extent to which the labor market reforms that have been introduced in these three southern European countries could have a positive effect over the next few years.

The data on EMU industrial production and initial country estimates suggest that euro zone GDP is likely to have stagnated in the third quarter, after having slipped ever so slightly into the red in Q2. The closing quarter of 2012, however, is expected to be the bearer of slightly negative growth again. This trend comes on the back of a renewed deterioration in key sentiment indicators and a further slide in capacity utilization in the industrial sector to 76.8% (long-term average: 81.3%). For 2012 as a whole, we expect the EMU economy to contract by 0.3%. The upward development that is on the cards for next year is expected to be subdued, with economic growth in 2013 unlikely to exceed ½%.

Our forecast rests on the assumption that the political progress made in terms of increased European integration and the ongoing external trade adjustments in the problem countries, in particular, will help to gradually take the heat out of the debt crisis. The relatively low external value of the euro will also help stimulate the economy. Although the consolidation of state finances will continue to put a damper on development, the overall burden in 2013 is likely to weigh less heavily on the economy than has been the case this year. We do not see any acute reason for the ECB to cut rates, with the central bank likely to keep the little powder that it has dry (we predict that key rates will remain unchanged at 0.75% until the end of 2013). With its unconventional measures, the ECB will continue to systematically act as a lender of last resort for banks and will do everything that has to be done to keep the euro afloat.

Euro area: Economic indicators and forecasts*

		2010				2011				2012				2013							
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2010	2011	2012e	2013f
GDP real		0.5	1.0	0.4	0.3	0.6	0.2	0.1	-0.3	0.0	-0.2	-0.1	*-0.1*	*0.2*	*0.2*	*0.3*	*0.3*	2.0	1.5	*-0.3*	*0.5*
Private consumption		0.2	0.2	0.3	0.5	0.1	-0.4	0.2	-0.5	-0.2	-0.2	*0.1*	*0.0*	*0.0*	*0.0*	*0.2*	*0.2*	1.0	0.2	*-0.7*	*0.2*
Government spending		-0.3	0.1	0.3	-0.1	0.0	0.0	-0.2	0.0	0.2	0.1	*0.1*	*0.0*	*-0.1*	*0.0*	*0.0*	*0.1*	0.8	0.0	*0.2*	*0.0*
Investment		-0.1	1.9	0.2	-0.6	2.1	-0.2	-0.4	-0.5	-1.3	-0.8	*-0.1*	*-0.5*	*0.0*	*0.5*	*0.6*	*0.5*	-0.3	1.7	*-2.7*	*0.2*
Exports		2.7	4.5	1.9	1.9	1.8	0.6	1.5	-0.2	0.7	1.3	*0.5*	*1.0*	*1.0*	*1.0*	*1.0*	*0.8*	10.9	6.6	*3.0*	*3.8*
Imports		3.2	4.0	1.4	1.6	1.4	0.2	0.5	-1.4	-0.2	0.9	*0.7*	*1.2*	*0.6*	*0.7*	*1.0*	*0.8*	9.3	4.4	*0.3*	*3.3*
Industrial production (excl. construction)		2.2	3.0	0.7	2.0	1.0	0.2	0.5	-1.8	-0.5	-0.5	0.3	*0.0*	*0.4*	*0.5*	*0.5*	*0.4*	7.3	3.4	*-1.7*	*1.3*
Unemployment rate	%	10.1	10.2	10.1	10.1	9.9	9.9	10.2	10.6	10.9	11.3	11.5	*11.7*	*11.8*	*11.8*	*11.7*	*11.6*	10.1	10.2	*11.4*	*11.7*
Consumer prices	y-o-y	1.1	1.6	1.7	2.0	2.5	2.8	2.7	2.9	2.7	2.5	2.5	*2.4*	*2.2*	*2.1*	*2.0*	*1.8*	1.6	2.7	*2.5*	*2.0*
Producer prices	y-o-y	-0.1	3.0	4.0	4.8	6.5	6.3	5.9	5.1	3.7	2.2	2.3	*2.8*	*1.9*	*2.5*	*2.8*	*2.5*	2.9	5.9	*2.8*	*2.4*
Current account balance	EUR bn, nsa	3.8	-5.8	3.8	-3.7	0.8	-5.8	1.1	12.8	21.6	28.1	15.3	*15.0*	*15.0*	*20.0*	*15.0*	*15.0*	-2.0	8.9	*80.0*	*65.0*
	% of GDP																	0.0	0.1	*0.8*	*0.7*
Budget balance	% of GDP																	-6.2	-4.1	*-3.0*	*-2.5*

*) quarterly values: percentage change over previous period, seasonally adjusted, except where noted; annual GDP not adjusted; foreign trade incl. intra-trade.

e = estimate; f = forecast.

Italy

The economy remains the sticking point

Italy's economic downturn, which has been ongoing since the third quarter of 2011, continued to gather pace in the first half of 2012. In the second quarter of the year, economic output once again lost 0.8% on the previous quarter. Private consumption in Q2 slipped by 0.7% and gross capital investment fell by 2.3%. In light of the country's surprisingly poor performance, particularly compared with Spain, we have made a downward revision to our GDP forecast for 2012 as a whole, bringing it down to -2.3% (2011:+0.5%). In spite of the unfavorable economic development, the rate of inflation has averaged 3.5% to date, fueled by a surge in energy prices to the tune of more than 14% and the effects of the VAT hike implemented in September 2011.

For the time being, the leading indicators suggest that the recession will continue to linger on the scene. The mood in the industrial sector and among consumers is still gloomy. Although business confidence climbed by ½ point in October compared with September, the Commission's Economic Sentiment Indicator remained within striking distance of the all-time low it hit during the crisis-ridden years of 2008/09, at 79 points. Recently, a ray of hope came in the form of both industrial production, which was up by 1.7% in August in a month-on-month comparison after having slipped by 0.1% in July, and the purchasing managers' index, which rose by 2.1 points in September to 45.7 points following a drop of 0.7 points in August. At the same time, however, this still means that the index has now been stuck below the 50-point expansion threshold for 14 months.

In spite of the tentative positive economic signals, we believe that the domestic economy is unlikely to make any contribution to growth during the rest of the year against the backdrop of state austerity measures, rising unemployment and the uncertainty surrounding the next chapter in the debt crisis story. While the risk premiums compared with German government bonds have narrowed considerably as a result of the latest announcement made by the ECB (in mid-October, the ten-year yield on Italian government bonds fell to well below 5%, with the spread recently dropping to 3.5 percentage points), the financing conditions for Italian companies have deteriorated over the past few months (according to the ECB's Bank Lending Survey). We expect foreign trade to continue to provide positive impetus, not least against the backdrop of sluggish import demand. In the first two quarters of this year, the external trade balance surplus came in at 0.2% (EUR 917m) and 0.7% of GDP (EUR 2.8bn) respectively.

Italy's consolidation efforts remain on track in spite of the recession - balanced budget in structural terms in 2013

The unfavorable economic situation is frustrating Italy's consolidation plans and the country is unlikely to be able to hit the budget targets it had originally set (2012: -1.7%, 2013: -0.5%). In September, the Italian government tweaked its medium-term budget plans (2012: -2.6%, 2013 -1.6%). Thanks to the consolidation efforts, however, this will see Italy manage to push its budget deficit down below the 3%-mark this year in the face of the recession.

Although Italy's government debt level was very high in the second quarter of 2012, at 126.1% of GDP, the country is taking a real stab at consolidation. In 2012 alone, Italy will implement measures worth just shy of EUR 50bn in total (3% of GDP). Looking ahead to 2013, the "Salva Italia" austerity package finalized in December 2011 looks set to bring budgetary relief to the tune of EUR 25bn (1.6% of GDP). If the government led by Mario

Monti can systematically stick to its policy of consolidation, Italy will certainly be able to get its debt problems under control, especially since private sector debt levels are relatively low.

In September, the Italian Senate and the Chamber of Deputies hatched plans for a debt cap to be embedded in the constitution; an act on the specific implementation of the cap is currently being drafted. Next year, Italy will again be aiming to achieve a balanced budget in structural terms, independently of the accompanying act on the debt cap, which is unlikely to come into force before the end of 2014. [1]In order to achieve a structurally balanced budget in 2013, the government in Rome (as well as giving the green light to additional spending cuts in early August) ratified a further budget act in mid-October that includes measures such as a VAT hike of one percentage point to 22% in 2013 and health spending cuts of EUR 1.5bn. The Monti government had previously attempted to achieve the desired effect of the 2 percentage point VAT hike, a move that had originally been planned for October 2012, simply by cutting spending.

The pension reforms passed shortly after Monti came into office in December 2011, which include an increase in the retirement age,[2] should curtail Italy's implicit sovereign debt and increase the labor force potential in the medium term. One of the challenges facing the Italian government will, however, lie in creating suitable job opportunities for older employees and strengthening the company pension system.

Labor market: Need to catch up in terms of participation and productivity

The recession has triggered a marked increase in unemployment in the euro area's third-largest economy. The harmonized unemployment rate climbed to 10.8% in August, the highest level seen since November 1999. We expect the situation on the labor market to deteriorate further to begin with, with the unemployment rate for this year expected to average 10.5% before climbing to 11.0% in 2013. A far from insignificant part of the increase in the course of the year, however, is due to an increase in labor force participation. Compared with the first quarter of the year, the number of people in work charted a surprising increase to the tune of 0.6% (in seasonally adjusted terms) in the months from April to July. The increase in employment should not, however, distract us from the fact that, at 57.1%, Italy's employment rate still ranks among the lowest in the euro area - the only countries with lower rates are Greece (51.7%) and Spain (55.7%). Consequently, Italy is a long way off its target of achieving an employment rate of 67-69% by 2020. And in this respect, it is worth bearing in mind that the official labor market statistics presumably underestimate the extent to which Italy's labor force potential is lying unused. According to ECB estimates, the inclusion of dejected potential people of employment age would have added another 4.1 percentage points on to the official unemployment rate last year, bringing it up to 12.5%.[3]

In addition to the low employment rate in general, the below-average labor market participation of women (47.5%, EMU: 58.4%) and young employees (18.9%, EMU: 32%) has been particular cause for concern for some time now. This is compounded by the fact

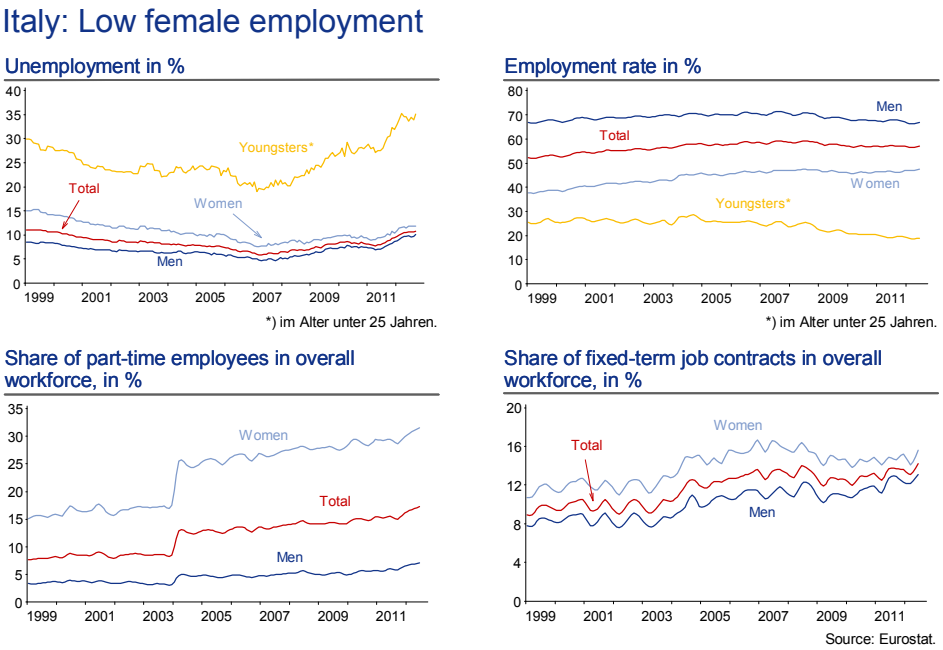
[1] See Heinen, Nicolaus: "Schuldenbremsen für Euroland – ein Fortschrittsbericht", DB Research, Research Briefing Europäische Integration, November 1, 2012, http://www.dbresearch.de/MAIL/DBR_INTERNET_DE-PROD/PROD0000000000296360.pdf.

[2] Increase in the statutory retirement age to 66 for men and 62 for women, with further adjustment steps to take the age up to 66 by 2018. As of 2012, the retirement age is to be set at 67. Furthermore, pension levels will be more closely linked to the contributions paid in the future. The idea is to adjust the retirement age on a regular basis to reflect life expectancy.

[3] According to Eurostat, the additional workforce potential in the euro area totaled 7 million people in 2011, including almost 3 million Italians (11.6% of the Italian working population between the ages of 15 and 74). See ECB: "Euro area labour markets and the crisis", Structural Issues Report, October 2012, http://www.ecb.int/pub/pdf/other/euroarealabourmarketsandthecrisis201210en.pdf, p. 45.

that the job losses sparked by the crisis are hitting employees with part-time or other atypical contracts, many of whom are young employees, particularly hard. In 2011, youth unemployment in Italy stood at 29.1% on average and remained on an upward trajectory in the course of 2012 - in August, more than one-third (35.1%) of employees under the age of 25 were out of a job. This is why the European Commission believes that boosting female employment and cutting youth unemployment are priorities for Italian social policy.[4] The fact that even university graduates are having difficulties getting a foot on the career ladder is attributed, among other things, to an imbalance between the qualifications that graduates are attaining and those that are actually required on the labor market.

Chart 1



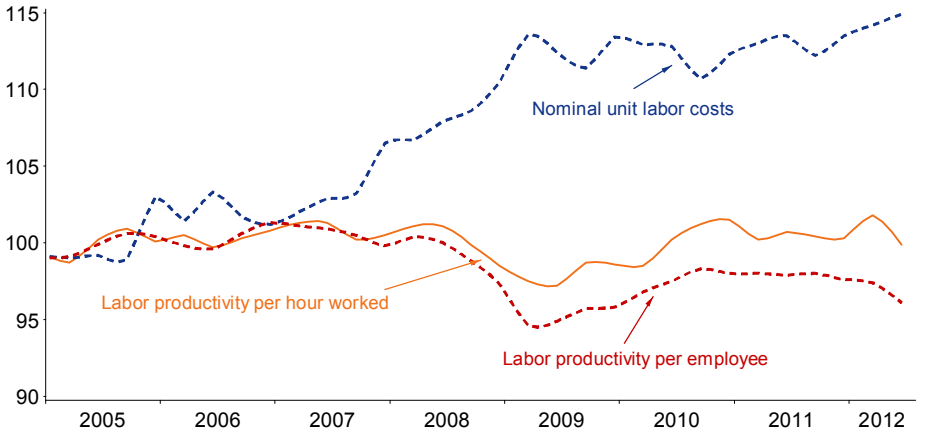
In recent years, labor productivity in Italy, measured as the ratio of real GDP to the quantity of labor output, has lagged behind every other industrialized nation in its development.[5] In the period between 1999 to 2011, the annual increase in labor productivity came in at a meager 0.3%, while productivity in the euro zone improved by an average of 1% during the same period. Productivity per person in work actually dropped by 0.1% (EMU: +0.6%). The lack of any link between increases in employee remuneration and poor labor productivity development has resulted in a significant increase in nominal unit wage costs to the tune of 31.4% over the same period, eating away at the price competitiveness of the Italian economy. Although productivity has edged up slightly since 2010, this is also because economic output had already started to climb in 2010, whereas employment was still lagging behind. Unit wage costs, on the other hand, have remained virtually unchanged since 2009, while they have already fallen considerably in Spain, Greece and - particularly so - in Ireland.

[4] European Commission (2012): "Assessment of the 2012 national reform programme and stability programme for Italy", Commission Staff Working Document, May 10, 2012, http://ec.europa.eu/europe2020/pdf/nd/swd2012_italy_en.pdf., p. 16 et seq.
[5] OECD (2012): "Reviving Growth and Productivity", Better Policies Series, September 2012.

Chart 2

Italy: Weak labor productivity momentum driving up unit labor costs

Quarterly figures, index 2005=100



Source: Eurostat.

As well as the unsatisfactory quality of the education and training system, the divided nature of the labor market - with a core group of employees who enjoy substantial protection and permanent contracts on the one hand, and a growing number of temporary employees with no protection against dismissal on the other - is likely to have had its part to play in the substandard development in productivity. What is more, labor market regulations that make employee dismissals a costly business mean that companies are less willing to hire in times of real uncertainty. As a result, the poor momentum on the labor market is not only an expression of the economic downturn, but also reflects structural obstacles, such as the segmentation of the Italian labor market, that stand in the way of job creation in the private sector. In order to get a larger part of the working population into jobs, reforms have been passed in an attempt to make the labor market more flexible (see box).

Italy's labor market reform

More of a balance between wage and productivity development

In order to bring wage development into line with productivity growth, the Italian government and social partners have introduced a package of measures to make collective pay scale policy more flexible and to start bridging the divides on the labor market.

Back in June 2011, the social partners agreed on a reform of the wage negotiation framework, enabling the use of opening clauses, i.e. deviations from the national collective pay scale agreements, in works council/employer agreements. Strengthening wage negotiations at company level allows differences in the productivity levels of individual companies to be taken into account. In its recommendation on Italy's national reform program, the European Council spoke out in favor of enabling more flexible agreements at sector level across the country, too.[6]

[6] Council recommendation of July 10, 2012 on Italy's 2012 national reform programme and delivering a Council Opinion on Italy's updated stability programme for 2012-2015, Official Journal of the European

On July 18, 2012, the labor market reform developed by the Monti government, and in particular by the Minister for Employment Elsa Fornero, came into force. The reform aims, in particular (1) to make it easy to dismiss staff if a company runs into financial difficulties, (2) to create incentives for permanent contracts and (3) to revise social measures in order to protect more people in the event of involuntary unemployment:

- Article 18 of the Workers' Statute gave employees in companies with more than 15 employees the right to be reemployed, and to receive damages corresponding to "5+X" monthly salaries, if they were dismissed without any legitimate reason. The aim behind the government's ambitious labor market reform was to rid the Italian labor market of its dualistic structure. Article 18 was revised to make it easier for private-sector companies to dismiss employees and to cut the costs associated with dismissal. In the case of unjustified dismissals by companies with more than 15 employees, for example, reemployment and the payment of wages from the time of dismissal (at least 5 monthly salaries) is no longer granted entirely irrespective of the grounds cited. An upper limit has been put on the damages owed in the event of unlawful termination (a maximum of 20 monthly salaries plus wages in arrears). How effective the reforms will prove to be, however, ultimately depends on how the new legislation will be interpreted by the labor courts, which will be responsible for deciding whether an employee's dismissal is effective or not. In the future, judges are likely to continue to have considerable leeway, i.e. even more choices, when it comes to decisions. Due to the labor law reforms, they will no longer have to make a distinction solely between justified and unjustified grounds for dismissal, but will also have to pinpoint the differences between discriminatory, disciplinary and business-related dismissals. As a result, there is a risk that the reforms will make court proceedings more complex and drawn-out.

- In order to make permanent employment contracts more attractive, restrictions and additional costs have been imposed on employers who opt for atypical and fixed-term contracts. Now, fixed-term contracts can only be concluded without the employer having to justify the temporary nature of the contract if this is the first fixed-term contract, the contract is being concluded for a term of no more than 12 months and it cannot be extended (previously, fixed-term contracts could be extended by up to 3 years). With effect from 2013, companies are also to be charged an additional contribution corresponding to 1.4% of the remuneration for temporary contracts, a contribution that will be refunded if the employment relationship becomes a permanent one.

- In the past, employees with fixed-term contracts enjoyed little protection against dismissal, which translated into less income and unemployment support. Next year is to see a new universal unemployment insurance system come into force. Although the new unemployment benefit will be paid for a shorter period (12-18 months as opposed to 36) and will be less generous financially, it will cover a larger group of employees (such as trainees and apprentices). In 2017, the integrated unemployment benefit system will then replace the old systems in full. In order to combat any negative implications for the supply of labor and government finances, the moves will presumably have to come hand-in-hand with an effective "activation policy".

Union, 2012/C 219/14, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2012:219:0046:0049:DE:PDF.

Boosting labor force participation among women

In a quest to promote the employment of women (and young people), the government has launched targeted tax incentives for companies. The European Council has recommended further measures relating to childcare and old-age care facilities in an attempt to combat the ongoing problem of below-average labor force participation among women. Major challenges look set to arise with regard to older women working in the private sector, in particular, now that the retirement age for women is being lifted by five years in the period between 2012 and 2018.

Strengthening employment prospects and security for young people

The government in Rome is poised to promote apprenticeship-based training as the main access channel for young Italians wanting to enter the labor market. To make it easier for young people to find their feet on the labor market, social partners and the government sealed a framework agreement in July 2011 that revamps the current system of contracts for vocational training (e.g. permanent traineeships). Suitable tools, however, still have to be put in place if the promotional measures are to be successful, such as a new system for employment and vocational training standards and a qualifications recognition system. The nationwide recognition of skills and qualifications would boost labor mobility. In order to reduce youth unemployment, the Italian government also has to take more targeted, coordinated measures to combat the problem of school drop-outs (which would involve a combination of preventative, intervention and compensatory measures). There is also room for improvement in the university education sector, for example to make courses more relevant to the labor market. Italy's 2010 university reforms should have been implemented in full. One positive aspect is that a larger proportion of public-sector funds are now dished out to universities based on their performance. In order to support the employment of young people and the development of SMEs, the Commission has set up a task force that is to be responsible for redistributing money from the Cohesion Fund.

Conclusion: Implementation of the reform package will be decisive

The Italian government has changed many aspects of labor market regulation to make it more flexible. If, however, the reforms set out in the legislation are to bear fruit, it is crucial that they are actually put into practice. This is particularly the case when it comes to the implementation of the new collective bargaining framework, which should, if necessary, be backed up by nationwide agreements, and the revision of Article 18. The reforms designed to boost labor force participation among women and to improve employment prospects and security for young people appear too tentative to date.

Maintaining the pace of reform

Italy has structural weaknesses in three areas, in particular. In addition to a rigid labor market and a lack of competition on product markets, public-sector administration is not as efficient as it should be, especially in the service sector. Since taking office a year ago, the technocratic government has initiated long overdue reforms in all three areas in an endeavor to boost growth momentum.

Italy has taken impressive measures to liberalize its economy, particularly as far as services are concerned. The abolition of minimum fees and increase in the number of licenses issued are designed to allow access to what are known as the "freelance service professions" (e.g. notaries, pharmacists). Measures have also been taken to try to boost competitiveness in network industries. The cartel authority has been given more power, and a separation has been made between grids and distribution. There are still, however, manifold challenges facing the energy and transport sectors. The country is still, for example, grappling with major infrastructure and market bottlenecks in the rail and port sector.

Measures have also been taken to simplify Italy's administration, including what remains a complex framework for the corporate sector. Restructuring measures and job cuts have been implemented in order to streamline the country's public administration. Moves to reduce bureaucracy have been made, for example by stepping up the use of digital information and communication techniques (e-government). The judicial system, which is infamous for its long proceedings and heavy case backlog, is also being overhauled (examples: in 2011, financial incentives were introduced for clearing backlogs, 2012 saw the establishment of 20 courts specializing in company law). In mid-October, the Italian Senate passed a new anti-corruption act imposing harsher prison sentences on those convicted of corruption and bribery.[7]The Chamber of Deputies is expected to pass the draft bill in mid-November.

Access to financing for SMEs in Italy is comparatively tricky and venture capital is hard to come by. A tax allowance for new equity was introduced in December 2011 to address this problem. While some measures have been taken by the government in Rome to foster private-sector R&D activities, particularly by refinancing the tax relief for R&D investments, the intensity remains low and only a small number of innovative projects actually come to light. The regulatory environment for companies should therefore be simplified further and access to financing instruments, especially equity, improved in order to finance growing companies and innovations.

According to OECD estimates, the full implementation of the reforms that have already been passed alone could boost Italy's economic output by as much as 4% (cumulative).[8] If the government were to continue on the path to reform, the gains in terms of growth would be even greater. Nevertheless, there is mounting opposition in Italy to far-reaching structural reforms such as a general overhaul of the Italian labor law system, which has cemented labor market divides in the past. It is key that the reform efforts are continued even beyond the current parliamentary term that comes to close in the spring of 2013 (parliamentary elections in April, presidential elections in May).

With the support of the ECB, the financing conditions for companies should improve and the mood of uncertainty should gradually subside as the country moves further down the path to consolidation. As domestic demand starts to bounce back bit by bit, this, together with foreign trade impetus, should form the basis for a gradual economic recovery. Although we believe that the country can look forward to economic stabilization, we expect the Italian economy to contract by 0.8% next year due to the statistical negative carry-over effect from 2012.

[7] In the future, civil servants convicted of corruption will face up to eight years in prison. Bribery in judicial authorities is to result in up to ten years' imprisonment. What is more, candidates sentenced to more than two years in prison are to be banned from entering parliament.
[8] See OECD (2012): “Reviving Growth and Productivity”, Better Policies Series, September 2012.

Spain

GDP to contract by 1% next year despite economic stabilization

Spain's economy is in the throes of recession - according to initial estimates by the national statistics institute, it contracted by 0.3% in Q3 in a q-o-q comparison, i.e. by almost as much as in Q2. This comes despite the fact that, according to the preliminary data supplied by the Spanish central bank, the country benefited from the positive anticipatory effects of the VAT hike that came into force on September 1. According to the central bank, the external contribution once again had a positive impact thanks to the continued increase in exports, which compensated for a renewed upward trend in imports. For this year as a whole, we expect the Spanish economy to contract by 1.3%. Although the economy looks set to stabilize next year, i.e. we expect quarterly rates of close to zero, this will mean that GDP will contract by 1% in 2013 as a whole.

Spanish economic development has the following risk factors hanging over it, in particular: the construction sector is still suffering from the hangover of the burst property bubble - while house prices in Q2 were down by 14.4% in a year-on-year comparison, the number of building permits was recently down by 38% on a year earlier. As far as domestic demand is concerned, the climate of uncertainty is weighing down on domestic demand and private consumption is being stifled by tax increases, high unemployment and less of a buffer due to the drop in the savings rate. By contrast, Spain has already made significant progress in terms of external trade adjustments: the country has already shaved a large chunk off its high current account deficit, bringing it down from a peak of 10% of GDP to 3.5% last year and, it is estimated, under 2% in 2012 (in this respect, it is not only imports that have fallen; exports have risen, too).

Budget: the belt will remain tightened

As far as the country's state finances are concerned, the target for this year's deficit ratio has once again been cranked up a notch to 6.3% (actual value for 2011, which was subject to an upward correction: 9.4%), with the revised target for 2013 now sitting at 4.5%. This means that Spain has been granted a one-year reprieve, giving it until 2014 to comply with the 3% deficit threshold. The 2013 budget includes consolidation measures to the tune of almost EUR 40bn (3.7% of GDP). Almost 60% of this amount relates to spending cuts, while the rest is attributable to tax hikes. The main measures include: freezing wages and recruitment in the public sector, average savings by ministries of 9%; general pension increase of 1%, as in 2012. As far as the tax increases are concerned, the 3 percentage point increase in VAT to 21%, which has already come into force, is one factor (with social spending cuts at the same time), with adjustments to corporate taxation also expected to boost state revenue. The Spanish government has put the net restrictive fiscal impetus of the austerity package at EUR 25.9bn (2.4% of GDP).

Reforms in the financial sector working like clockwork, question marks continue to hang over regional financing

Spain can receive up to EUR 100bn from the EFSF/ESM via the Spanish F.R.O.B. rescue fund to recapitalize its banks without risking being stamped as a "program country". In return, there is an adjustment program for the purposes of restructuring or liquidating ailing banks. The required funds are estimated to total EUR 60bn. In an initial audit report for financial aid, the EU and ECB confirm that Spain has made solid progress in implementing its program of reforms in the financial sector. The government, however, has yet to file an application for the promised funds to be paid out. The problems facing

the Spanish banking sector can be overcome using the amount of up to EUR 100bn promised by the Eurogroup. The question remains, however, as to whether the state will still have sufficient capacity to support the regions if the financial markets also end up driving state financing costs up. Nine out of 17 regions have now applied for support from the national rescue fund, which is officially cited as being worth EUR 18bn. Nevertheless, the agreement on a deficit ratio for the regions of 0.7% for 2013 and the debt cap incorporated into the constitution in 2011, which is set out in greater detail in the stability act passed in 2012, represent fundamental progress.

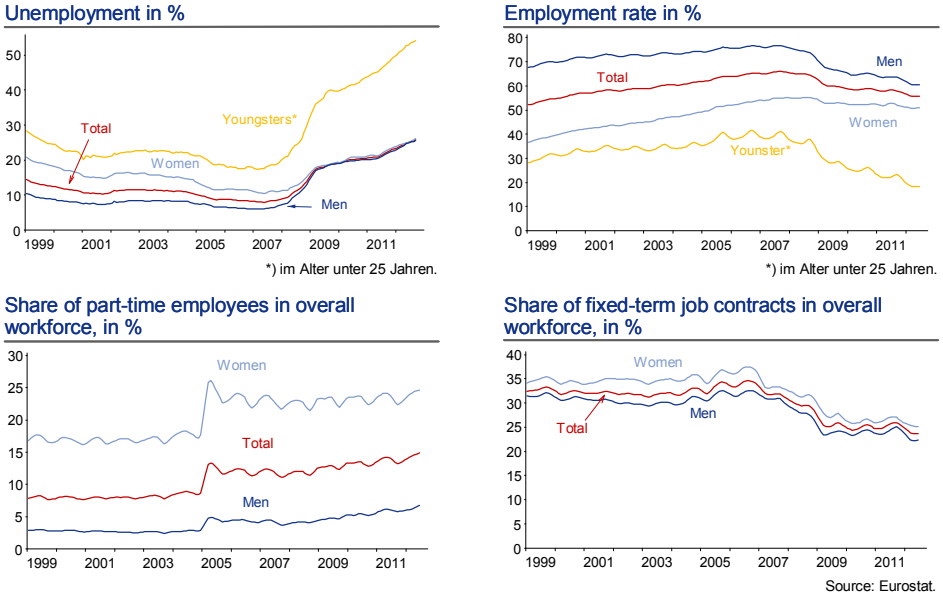
After the ECB announced its new program for government bond purchases, the returns on Spanish government bonds took something of a tumble. But another rating downgrade by Moody's and S&P would see Spain's credit rating reduced to "junk" status. If the country is to survive without any aid in excess of the EUR 100bn that has already been promised, it is crucial that the markets dish out appropriate rewards for the government's resolute reforms. It might also be necessary to give the country a little more (albeit limited period of) time to achieve its consolidation objectives. Otherwise, the Spanish government should not keep playing the tactical game for too much longer. After all, it is pursuing stringent consolidation measures and, even if it did end up being labeled a program country, it would not, presumably, have too much to fear as far as additional austerity demands are concerned.

Labor market: challenges relating to duality, productivity and structural unemployment

One particularly sore point in Spain - also in respect of social peace and the population's willingness to accept the reforms - is the development of the labor market. Reforms to relax employment protection and decentralize wage negotiations had already been implemented in 2010 and 2011. Nevertheless, the unemployment rate has recently continued on an upward trajectory, touching on 25.8% in September. Although the reduction in employment slowed in Q2, falling by 0.4% (q-o-q), after having dropped by 1.5% in the first quarter of the year and by 1.3% in the closing quarter of 2011, this means that the number of people in work was recently 4% lower in a year-on-year comparison.

Chart 3

Spain: Focal point "Lost Generation" / Fixed-term contracts



Far-reaching labor market reforms in 2012

High unemployment and the dual nature of the Spanish labor market were the main reasons prompting the reforms of the employment protection system and collective pay scale negotiations introduced in February 2012. A dual labor market, or labor market segmentation, means that dismissing permanent employees was expensive while, on the other hand, severance payments for temporary employees were minimal, meaning that young people often bore the brunt of dismissals. The core features of the reforms that came into force in July are:

- Dismissals have become easier and cheaper: in the event of termination without grounds, severance payment of 33 days' salary as opposed to 45 days' salary for every year in the company, with the maximum period reduced from 42 to 24 months. Termination for operational reasons if the company can prove that the company's income has fallen for three quarters in a row - in such cases, severance payments corresponding to 20 days' wages for each year worked and an upper threshold of 12 monthly salaries.

- Greater flexibility: in addition to valid collective pay scale agreements, companies can negotiate their own agreements with their employees, opportunities to cut wages and implement shorter working hours models.

- New permanent employment contract for companies with fewer than 50 employees with a probationary period of up to one year and tax incentives.

- Premiums for companies who employ young and older employees

- Temporary contracts now have to be converted into permanent contracts after two years at the latest.

In addition, the unemployment benefit for people becoming "newly" unemployed as of July 15 has been cut from the previous level of 60% to 50% of the basis for calculation as part of the austerity measures (the rate remains at 70% for the first 180 days of unemployment). Another new feature is that, for the collective pay scale agreements concluded in 2012-2014, the euro zone inflation rate will be used for wage indexation if the Spanish rate of inflation exceeds this rate.

One particular problem facing Spain lies in the substantial job cuts in the construction sector in the aftermath of the burst property bubble. This is a sector in which the cuts are mostly hitting poorly qualified, low-income employees, many of them young people. This has helped improve productivity development in purely arithmetical terms. The challenge for the future is now, first of all, to maintain the productivity increases as employment starts to rise. Second, Spain has to tackle its high structural unemployment. As a result, measures have to be taken to combat the mismatch between labor supply and demand. The discrepancy between the qualifications that employees have and those that are actually required is due not only to the adjustments in the construction sector, but also to the sharp increase in long-term unemployment (and the resulting loss of human capital/skills). (Further) training, re-training and other qualifications measures are extremely important, especially given Spain's "lost generation" of young unemployed people. But it is not only about trying to promote potential employees; demands have to

be placed on them as well, if possible in the guise of further reforms that create more of an incentive to work.

Portugal

Major structural adjustments put a damper on the domestic economy

The economic slowdown in the country in the west of the Iberian Peninsula has been an ongoing feature since the closing quarter of 2010. Combined with rigid state austerity measures, major structural adjustments are putting a damper on the Portuguese domestic economy. After only a slight drop in GDP in the first quarter of 2012 (-0.1% as against the previous quarter), the country's economic output fell by 1.2% in the second quarter, when Portugal saw investment demand take a nosedive. Unlike in Italy and Spain, the external contribution has still not managed to fight its way back into the black, although it has taken a big step in the right direction. Net exports, expressed as a % of GDP, totaled 0% in Q2, compared with -1.7% in Q1 and an average of -3.8% in 2011.

The sentiment indicators suggest that production continued to wane in the second half of the year. At 72.3 points, the European Commission's Economic Sentiment Indicator for October tumbled to the lowest level since the outbreak of the economic crisis in 2008/09 and is still sending out recession signals. The rates of change in industrial production are marred by volatility. In September, the production index for the entire industrial sector lost 12% in a month-on-month comparison.

The risk premiums on Portugal's government bonds have been sliced in half since the start of the year, with the yield spread against 10-year German government bonds recently narrowing to 6.7 percentage points. This positive development is likely to have been spurred, on the one hand, by the praise voiced by the international troika (the IMF, the EU and the ECB) for the conservative coalition government led by Pedro Passos Coelho and the manner in which it has put its reform program into action. On the other, the announcement made by the ECB that it planned to do everything in its power to keep the euro as a stable currency also played a role. The improved state financing conditions, however, are offset by restricted lending in the private sector. In the course of the year, Portuguese financial institutions once again tightened up their lending guidelines (according to the ECB's Bank Lending Survey).

Due to the marked economic slump in the second quarter, rising unemployment and the ongoing consolidation measures, we expect economic output this year to contract by 2.8% (2011: -1.7%). We do not expect the government to see its committed reform policy bear much fruit next year either. The government's austerity policy is, however, expected to take less wind out of the sails of economic recovery, with export development also expected to encourage economic activity. We expect Portuguese GDP to contract by only 1.0% in 2013.

Portugal will have to be patient until the reforms pay off

Since Portugal has been locked in recession since the end of 2010, the government in Lisbon is unlikely to be able to meet the deficit targets of 4½% of GDP in 2012 and 3.0% in 2013 in spite of its very strict consolidation course. The ever-worsening situation on the labor market (where the unemployment rate has since climbed to 15½%) and the resulting decline in domestic demand have meant that the state has generated less revenue from tax and social security contributions. This drop in tax revenue canceled out any positive effects of Portugal's spending discipline. Since, however, the Portuguese

government is implementing its program of reforms as planned, the international financers have granted the highly-indebted country another year to get its budget into order. This means that Portugal will not have to comply with the 3% deficit threshold until 2014. The austerity measures have been implemented on the basis of a EUR 78bn rescue package that was granted to the Portuguese government in 2011, EUR 61.4bn of which has already been paid out. But the program of reforms has added more fuel to the recessionary fire blazing on the Portuguese economy than expected. In its fifth audit report[9], the troika moved the goalposts as a result, and now expects a deficit of 5.0% of GDP for 2012, 4½% for 2013 and 2½% for 2014. Without additional savings measures, however, Portugal will be unable to meet these targets. In order to comply with the new targets for its budget deficit, the country will have to make huge consolidation efforts accounting for a total of 3% of GDP in 2013 and 1¾% in 2014. In September of this year, the government therefore announced that it would be stepping up the social security contributions made by all employees from 11% to 18% and, at the same time, cutting the levies payable by employers from 23¾% to 18%. After an initial wave of protests, the government shelved these plans and submitted a new, extensive budget draft for 2013 on October 15, 2012. The draft contains

- a reduction in the number of tax brackets from eight to five,
- the introduction of a general tax surcharge corresponding to 4% of net income, and
- an increase in income tax.

The lowest rate of income tax, for example, is to be lifted from 11½% to 14½%, while the peak rate will be ramped up from 46.4% to 48%. In addition, the highest income class is to start at a gross salary of EUR 80,000 a year (as opposed to EUR 153,000 in the past), which will also be the level as of which a special tax of 2½% will be due.

The draft bill also provides for

- pension cuts of up to 10%,
- a 6% reduction in spending on unemployment benefit and a 5% cut in sick pay spending,
- increased levies on capital gains, wealth, financial transactions, luxury goods, mineral oil, motor vehicles and tobacco and tobacco-related products, and
- savings of 6½% in the education sector and 17% in the healthcare sector.

The measures unveiled by the government are intended to allow the country to save up to EUR 5.3bn (3% of GDP) next year. But cracks would now appear to be forming in what has, to date, been broad-based public support for the measures. There is growing dissatisfaction with the austerity program among the population at large. The country's largest opposition party, the Socialist Party, which supported all of the austerity measures until only recently, voted against the controversial 2013 budget plans on October 31 at its first reading in parliament. Nevertheless, it was endorsed by almost all MPs in the government coalition. The definitive adoption of the budget plans is scheduled for November 27.

[9] European Commission (2012): "The Economic Adjustment Programme for Portugal. Fifth review – Summer 2012", European Economy, Occasional Papers 117, October 2012, http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/pdf/ocp117_en.pdf.

An overview of Portugal's consolidation efforts to date

Portugal has implemented a whole number of strict consolidation measures to date, accounting for 4.3% of GDP last year, and an estimated 5.7% of GDP this year. By way of example, in order to generate higher tax revenues, the Lisbon-based government has lifted the VAT rate from 21% to 23% and has modified the VAT structure in such a way that more goods and services are now taxed at a higher level. A number of tax deductions and exemptions have also been done away with. Portugal has also slashed wage replacement rates and reduced the maximum period for which individuals can claim unemployment benefit. Civil servants and pensioners have also had to go without this year's vacation pay and Christmas bonuses. Nevertheless, the Portuguese constitutional court recently ruled that these 13th and 14th monthly salaries could not be suspended again after 2012, because this would result in these groups of the population making a disproportionately hefty contribution to budget consolidation.

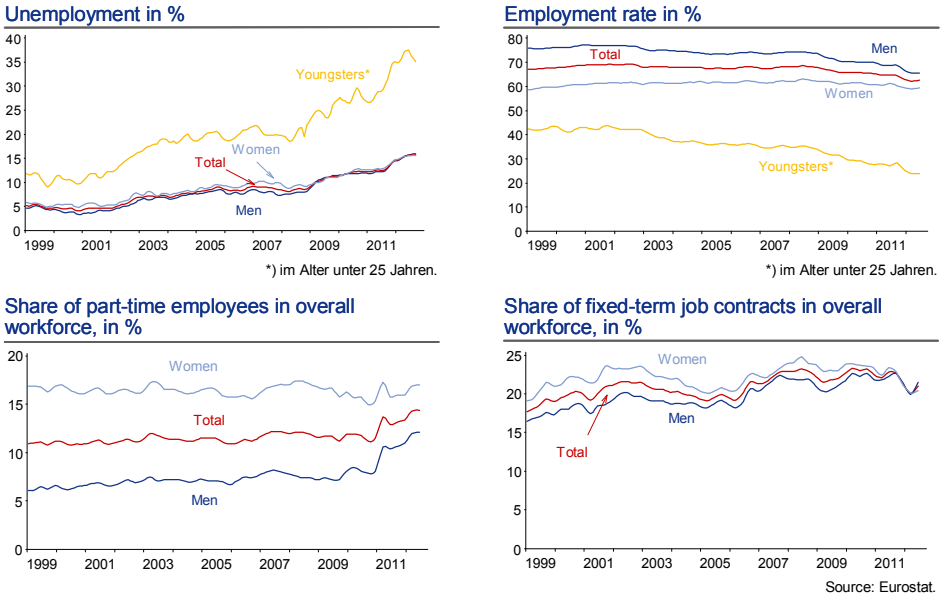
Youth unemployment reaches a high in July

The fact that the cumulative increase in the Portuguese economy's unit wage costs has been more moderate than in Spain and Italy, at 24% between 2000 and 2011 is explained, among other factors, by Portugal's long-standing weak growth record, accompanied by a relentless increase in unemployment.

The harmonized unemployment rate moved up to an all-time high of 15.8% in August. This means that unemployment has risen by 3½ percentage points since the start of the recession at the end of 2010, and has trebled since 1999. Given the ongoing economic downturn, we expect the situation on the labor market to deteriorate further to begin with, with the unemployment rate for this year expected to average 15½% before rising to 16% in 2013.

Chart 4

Portugal: High youth unemployment



The number of people in work fell by 1.1% and 0.2% in seasonally adjusted terms in the first two quarters of the year, respectively. We expect the pace of the decline in employment to continue to slow over the next few quarters, meaning that the number of

people in work is likely to fall by 1.5% in 2013 as a whole, compared with 3.9% this year. Although the proportion of people in work, expressed in relation to the Portuguese population as a whole, is just shy of the EMU average at 62.5% (unlike in Italy and Spain), labor force participation among young people is cause for concern (24%, EMU: 32%). While the discrepancy between men and women in terms of unemployment and labor force participation is nowhere near as striking as in Italy, for example, youth unemployment climbed to a high of 37.5% in July. Looking at the average for this year to date, this means that the rate is 6 percentage points ahead of the previous year. Some encouragement can be taken from the fact that the situation has eased since then, with youth unemployment falling back by around 2½ percentage points since the middle of the year to a recent level of 35.1%.

In order to create new jobs, boost productivity and make Portuguese companies more competitive, the government has initiated far-reaching labor market reforms (see box). The measures that will presumably have the greatest impact came into force on August 1, 2012.

Portugal's labor market reform

Paving the way for better productivity

In order to make employment conditions more flexible, the government in Lisbon has taken substantial steps towards relaxing the protection against dismissal. It is now possible to dismiss "unsuitable" employees even if no other changes have arisen affecting the position in question. Furthermore, dismissals no longer have to be made in a certain order, namely in line with length of service. This means that companies have the option of dismissing a longer-serving employee instead of having to dismiss the person who has not been with the company for as long. It is also possible to end an employment relationship if the jointly agreed targets have not been met by both sides. Severance payments will also be less generous than in the past, and can no longer surpass pre-defined upper thresholds. The severance payments for (permanent) contracts concluded after November 1, 2011, for example, have been cut from 30 days' salary to 20 days' salary per year worked (with 10 days being paid by the employer and 10 days from a new fund set up for this purpose).

Portugal has also forged ahead with moves to decentralize wage determination and working conditions. Collective pay scale agreements can now also be concluded by works councils in companies with more than 150 (instead of previously 500) employees.

In order to reduce unit wage costs and boost productivity, four national public holidays have been scrapped with effect from January 1, 2013, paid annual leave entitlement has been cut from 25 days to 22 days, compensatory rest has been abolished and the previously high overtime pay has been cut in half. Restrictions now also apply to the automatic extension of collective pay scale agreements.

The Portuguese government has used programs such as "Estímulo 2012" or "Impulso Jovem" to implement an activating labor market policy. The first program contains incentives for hiring the medium and long-term unemployed, with the latter aimed specifically at helping young people who are out of work. The "Vida Ativa" further training program is another measure designed to make unemployed people more fit for work.

Considerable progress made with structural reforms, but full impact still to come

Portugal is considered a model pupil among the "program" countries. The government in Lisbon has implemented reforms across the board in order to boost the economy's growth potential.

In order to make its administration more efficient, Portugal has cut the number of civil service employees and has reformed the legal system. Management levels have been reduced by 27% and administrative levels by 40%. A legislative decree of the Portuguese Ministry of Justice sealed the establishment of the court of intellectual property and the court for competition law, market regulation and supervision, the aim being to take some of the pressure of Portugal's commercial courts, which are faced with a large number of pending proceedings that tend to be long and drawn-out. The idea is that proceedings can be concluded faster in the future and that the final decisions will be better in terms of quality. Furthermore, a new insolvency code has been passed and a law on arbitration enacted to facilitate extra-judicial decisions.

Portugal has also make progress when it comes to liberalizing its markets and boosting competition. The Coelho-led government has not only brought the country's competition law into line with the EU's competition law framework, awarded greater powers to the antitrust authorities and set up a special court for competition, market regulation and supervision. It has also liberalized the regulations governing access to, and the exercise of, certain regimented professional groups. This means that, for 150 professions, previous requirements governing courses and professional skills certificates have been abolished. These simplified requirements will benefit Portuguese service providers in a range of sectors, such as building contractors, photographers and hairdressers. In the telecommunications sector, mobile termination rates have fallen by 22% and access to the existing networks is now open to all providers. In order to boost competition in the energy sector, administrative hurdles have been removed, moves to liberalize the electricity and gas market stepped up, cross-border market integration promoted and the remuneration system for co-generation revised to encourage convergence towards market-oriented prices. In the transport sector, a strategy plan has been developed for the comprehensive restructuring of both the network, and the operators of railways, roads, shipping and air traffic. In the healthcare sector, Lisbon has initiated measures to cut pharmaceutical and pharmacy profit margins and boost the proportion of generic drugs.

The Portuguese privatization program, which forms part of the reform agenda negotiated with the Troika, is also underway. Some privatization projects, such as that affecting the electricity company EDP or the energy supplier REN, have already been concluded. The proceeds generated for EDP and REN are sitting at around 60% of the original estimate for the privatization income included in the Troika adjustment program. Seven further privatization measures are scheduled for completion by the end of 2013.

In light of the exceptional scope of reforms and consolidation (total improvement in the structural primary balance corresponding to 9.5% of GDP in the period from 2011 to 2014), Portugal can hardly be expected to do more at the moment. The efforts made to date will take time to develop their full force.

Chart 5

Labor market reform dashboard

	Italy	Spain	Portugal
Labor market			
Wage negotiation process	Significant reforms	Radical reforms	Radical reforms
Employment protection	Minor reforms	Radical reforms	Radical reforms
Precarious jobs	Significant reforms	Significant reforms	Minor reforms
Social safety net, labor incentives	Significant reforms	Minor reforms	Significant reforms
Active labor market policy, education/training	Significant reforms	Significant reforms	Radical reforms

Radical reforms Significant reforms Minor reforms

Effects of the structural reforms on growth and the labor market

Unlike stimulus packages or consolidation measures, structural reforms need a considerable amount of time to unfold their full impact on the economy. Usually, the implementation process itself takes time, but the reforms also need time because they are aimed at changing the patterns of behavior of the economic subjects in question. Nevertheless, it pays not to be too skeptical when judging how long this sort of process will take. In particular, the labor market reforms carried out in Germany (mainly in 2003 and 2005), for example, demonstrated that, fairly soon after implementation, in 2006, an improvement started to emerge on the labor market. In Spain and Portugal the reform process was launched around two years ago, in Italy around one year ago. It is therefore not rash to hope for positive effects to become visible next year or the year after next, assuming implementation makes further headway.

As we have shown, the process of reform in the three countries included in our analysis involves a large number of individual measures. There is no doubt that they all differ in terms of when they will have an impact. Changes in benefit entitlements can have swift positive effects via increased work incentives, relaxing employment protection laws are only likely to start paying off in phases of economic stabilization. It is, in any case, plausible to expect the effects of the reforms to last for a prolonged period. Studies on the quantitative effects of structural reforms predominantly look at a ten-year period after the reforms come into effect. One example of this is a fundamental study conducted by the European Commission in 2010 entitled "Quantifying the potential macroeconomic effects of the Europe 2020 strategy: stylized scenarios"“[10], which quantifies the growth and employment effects of various reform scenarios using a macroeconomic model. Quantitative assessments of the impact of reforms on growth in European countries have also been conducted by Goldman Sachs[11] and the OECD[12].

[10] Alexandr Hobza und Gilles Mourre (2010): „Quantifying the potential macroeconomic effects of the Europe 2020 strategy: stylised scenarios“, European Economy, Economic Papers 424, September 2010, http://ec.europa.eu/economy_finance/publications/economic_paper/2010/pdf/ecp424_en.pdf.
[11] Goldman Sachs (2012): “Quantifying the impact of labour market reform in Europe”, European Economics Analyst, Issue No. 12/12, June 7, 2012.
[12] OECD (2012): “Reviving Growth and Productivity”, Better Policies Series, September 2012.

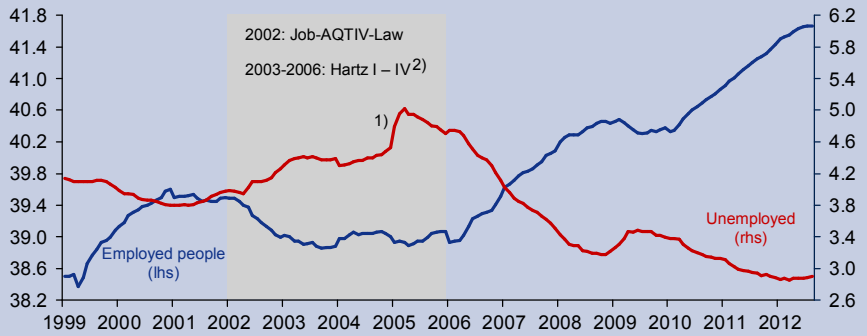
Germany's labor market reform: a shining example for Europe?

Germany had long been labeled the sick man in Europe: low growth, high unemployment. In the first half of the last decade policymakers decided to get serious about labor market reform. It was also significant that, together with the statutory changes, the wage formation process and working time rules were made more flexible. As of 2005 - so fairly soon after implementation of the key reform elements, an upswing on the labor market materialized that, with a brief interruption, has continued until today. Despite the global economic crisis of 2008/2009, the jobless total is some 40% lower than in the middle of the last decade. Although the improvement on the labor market cannot, presumably, be attributed in full to the reforms, it is undisputed that they played an important part in the improvement.

Chart 6

Germany: Labor market trends and labor market reforms

in millions



1) Welfare benefit recipients capable of work redefined as registered unemployed.
2) Hartz I and II (2003): Liberalization of temporary work; tightening of job suitability rules, Me Incs, job centers, new rules for minijobs and midijobs.
Hartz III (2004): Restructuring of Federal Labor Office, employment protection in small companies.
Hartz IV (2005-2006): Merging of unemployment and welfare benefit, tightening of entitlement requirements, shorter entitlement period for unemployment benefit.

Source: EcoWin.

So, can the German labor market reforms serve as a model for the European crisis countries with their high unemployment? In short: yes and no. No, because the labor market structures and framework vary widely from country to country. Prior to its reforms, Germany had, for example, an extremely long entitlement period and generous state unemployment benefits. Italy, by contrast, given inadequate state arrangements, had hitherto shifted the safety net onto employers via the Employment Protection Act. This means that reform requirements were completely different in these two countries in order to promote work incentives and bolster recruitment. Labor market reforms therefore need to be tailored specifically to the needs of each country. There is no model as such – it is important that, alongside social principles, market principles are also in the foreground.

Nevertheless, the German reforms allow important conclusions to be drawn. Reforms must not be half-hearted efforts, they should not by deterred by vested interests, have to be based on a comprehensive concept and require perseverance. Germany's labor market reform at least come close to meeting these criteria. So in this sense, they are certainly an example that are relevant to other countries.

Our medium-term forecasts for Italy, Spain and Portugal are based, in particular, on the model results of the European Commission's survey on the growth and employment implications of reforms. The advantage of this study is that it describes various different

reform scenarios and then quantifies their impact. A distinction is made, in particular, between "limited structural reform", "medium reform" and "advanced reform" scenarios. The reforms implemented in Italy, Spain and Portugal to date can be allocated to one of these categories on the basis of an overall evaluation. The "medium reform" scenario, for example, assumes that reforms gain momentum in all political spheres and end in significant reforms on the product and labor markets. We believe that this scenario provides a fairly good description of the reform efforts in the three countries analyzed. We cannot describe the reform measures in Italy, in particular, as "advanced", i.e. very intensive, because the labor market reforms on the agenda there are not far-reaching enough. In our view, the reforms in Portugal come the closest to the "advanced" category.

For the "medium reform" category, the EU model calculates additional economic growth of just under 4 percentage points within ten years, and of around 7 percentage points for the "advanced reform" scenario compared to the base scenario, in which no reforms are implemented. We believe, however, that this sort of growth increase can be achieved in a slightly shorter period than ten years: distributed over a period of eight years, the medium-term reform scenario boosts economic growth by 0.5 percentage points a year. As far as Italy and Spain are concerned, we believe that an improvement in the growth prospects on this scale is likely given the reforms that have been initiated - assuming, of course, that they are implemented in full. In Portugal's case, we have calculated growth gains to the tune of 0.7 percentage points a year due to the more extensive reform measures.

Without economic reforms, the medium-term growth trend in Portugal and Italy would come in at only an estimated 1% a year due to the weak development in productivity. Since productivity growth in Spain is higher than in Italy and Portugal, we believe that the Spanish economy could achieve medium-term growth of 1.5% a year without the reforms. If the structural reforms that have been passed are implemented in full, we therefore expect to see average economic growth of 1.5% in Italy, 2.0% in Spain and 1.7% in Portugal in the five-year period between 2014 and 2020.

Growth and labor market outlook
(Scenario: full implementation of structural reforms launched)

	2000 - 2007[3]	2008	2009	2010	2011	2012e	2013f	2014 - 2020[4]
GDP, real[1]								
EMU	**2.2**	**0.3**	**-4.3**	**1.9**	**1.5**	**-0.3**	**0.5**	**1.6**
Germany	1.6	1.1	-5.1	4.2	3.0	0.8	1.5	1.6
Italy	1.6	-1.2	-5.5	1.8	0.6	-2.3	-0.8	1.5
Spain	3.6	0.9	-3.7	-0.3	0.4	-1.3	-1.0	2.0
Portugal	1.5	0.0	-2.9	1.4	-1.7	-2.8	-1.0	1.7
Workforce[2]								
EMU	**1.7**	**0.8**	**-1.8**	**-0.5**	**0.3**	**-0.5**	**0.0**	**0.5**
Germany	0.2	1.2	0.1	0.6	1.4	1.0	0.4	0.4
Italy	1.4	0.3	-1.6	-0.7	0.3	-0.8	-0.8	0.8
Spain	3.4	-0.1	-6.5	-2.5	-1.5	-3.6	-1.7	1.2
Portugal	0.3	0.5	-2.6	-1.5	-1.5	-3.9	-1.5	1.0
Unemployment rate								
EMU	**8.6**	**7.7**	**9.6**	**10.1**	**10.2**	**11.4**	**11.7**	**6-8**
Germany	9.4	7.6	7.7	7.1	6.0	5.5	5.5	4-5
Italy	8.1	6.8	7.8	8.4	8.4	10.5	11.2	6-8
Spain	10.2	11.4	18.0	20.1	21.7	25.1	26.8	15-17
Portugal	6.9	8.5	10.6	12.0	12.9	15.5	16.0	8-10

e = estimate f = forecast.

1) in %.
2) % change on previous year
3) average annual change in GDP and workforce (here from 2001 to 2007), average annual unemployment rate.
4) Forecast of annual average change in the number of people employed and gross domestic product; forecast unemployment rate in 2020.

Sources: Eurostat, own forecasts.

So the measures taken are unlikely to result in growth rates that can genuinely be described as high. This is not, however, expected anyway due to the ongoing need for savings. The pace of growth expected in the scenario that includes the reforms, however, certainly provides a basis for a sustained, moderate increase in employment. We expect Italy's productivity to start charting a moderate upward course as the reforms progress, signaling the end of many years of stagnation. Employment growth of around 1% a year in Italy, Spain and Portugal will result in a marked drop in the unemployment rate, because all three countries are set to see a drop, in some cases, in labor force participation and labor force potential, or are not expected to report any change to speak of due to counter-effects. While the pension reforms are likely to boost labor force participation among older people, the difficult situation on the labor market will increase the "hidden reserves". What is more, negative net migration in Spain and Portugal, in particular, is likely to reduce the labor force potential. All in all, the increase in employment should prompt a corresponding drop in unemployment.

In our projections for the period leading up to 2018, we therefore assume, based on the conditions set out above, that we will see a significant improvement on the euro zone labor markets. The unemployment rate is expected to fall back to a level more or less on a par with that seen prior to the onset of the economic crisis in 2008. Italy, in particular, could achieve a more manageable employment rate. Nevertheless, our projection also shows that a country like Spain, where unemployment is extremely high at the moment, still has a long way to go, in spite of the structural reforms, before the conditions on the labor market can be described as tolerable.

These assessments are, as always, subject to the disclaimer provided below.

ABOUT ALLIANZ

Together with its customers and sales partners, Allianz is one of the strongest financial communities. Around 78 million private and corporate customers rely on Allianz's knowledge, global reach, capital strength and solidity to help them make the most of financial opportunities and to avoid and safeguard themselves against risks.
In 2011, around 142,000 employees in some 70 countries achieved total revenue of 103.6 billion euros and an operating profit of 7.9 billion euros.
Benefits for our customers reached 86.5 billion euros. This business success with insurance, asset management and assistance services is based increasingly on customer demand for crisis-proof financial solutions for an ageing society and the challenges of climate change. Transparency and integrity are key components of sustainable corporate governance at Allianz SE.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

The statements contained herein may include statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. In addition to statements which are forward-looking by reason of context, the words "may", "will", "should", "expects", "plans", "intends", "anticipates", "believes", "estimates", "predicts", "potential", or "continue" and similar expressions identify forward-looking statements. Actual results, performance or events may differ materially from those in such statements due to, without limitation, (i) general economic conditions, including in particular economic conditions in the Allianz Group's core business and core markets, (ii) performance of financial markets, including emerging markets, and including market volatility, liquidity and credit events (iii) the frequency and severity of insured loss events, including from natural catastrophes and including the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the Euro/U.S. Dollar exchange rate, (ix) changing levels of competition, (x) changes in laws and regulations, including monetary convergence and the European Monetary Union, (xi) changes in the policies of central banks and/or foreign governments, (xii) the impact of acquisitions, including related integration issues, (xiii) reorganization measures, and (xiv) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences. The company assumes no obligation to update any forward-looking statement.

NO DUTY TO UPDATE

The company assumes no obligation to update any information contained herein.