

Iran-US Negotiations are now Likelier than Before

Globalisation and Inequality: More than Just a Spurious Correlation?

Italy's Crisis: The Fault Line of the Euro Area

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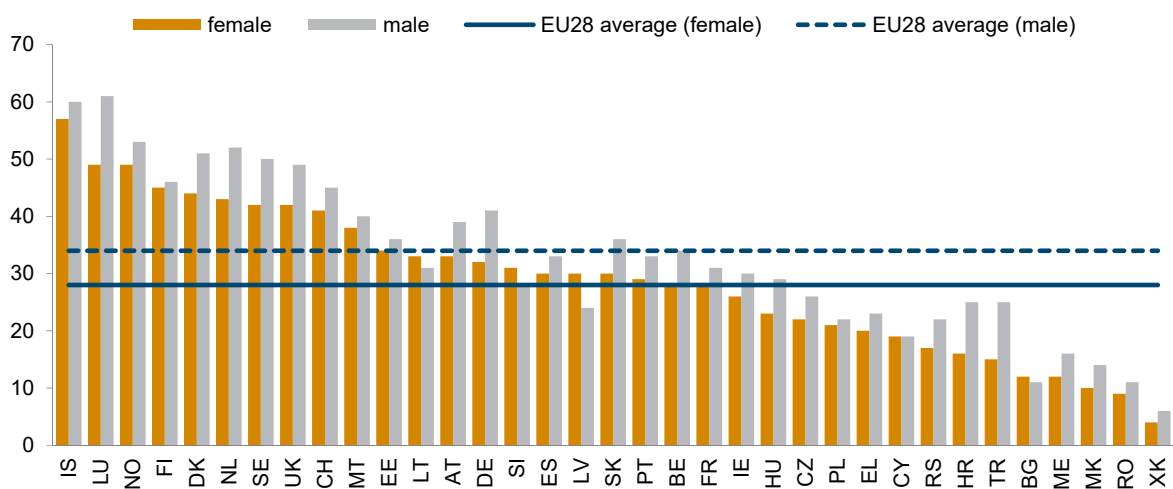
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Chart of the month: Gender gap in digital skills in European countries

BY ALEXANDRA BYKOVA

Share of individuals (aged 16-74) with above basic digital skills in 2017, in %



Note: Digital skills are measured as a composite indicator of skills in four dimensions: information, communication, problem solving, and software for content creation. 'Above basic' skills imply that individuals have 'above basic' skills in all four dimensions.

Source: Eurostat (online data code: isoc_sk_dskl_i).

The ongoing digital transformation of economies has great potential to boost economic growth. Simultaneously, empirical evidence and several studies point at the risks of deepening inequalities as a result of the unequal distribution of digital resources or dividends. First, an initial unequal endowment with resources, for example with respect to access to digital infrastructure or human capital, may increase regional disparities. Another concern is a digital gap between generations, whereby so-called 'digitally native' young people have better skills than older generations. Finally, the rise of the platform economy and big data collection might result in income and market power concentration among a few players.

Considering the participation in the digital economy from a gender perspective reveals new opportunities for broader female labour market inclusion, however it also shows persisting gaps to be addressed. On the one hand, new technologies open up possibilities to combine job and family life better and gain additional income through digital business opportunities or participation in 'gig economy' jobs for those women who prefer working from home. On the other hand, studies point out that such jobs are often low-paid due to high competition and the lack of job regulation for platform-organised markets.

The digital gender gap in many European countries is traceable through many dimensions, starting from women's inclusion in technical education, and consequently, low female employment in information and

communication (ICT) jobs, a gender pay gap in ICT, and low female participation in digital entrepreneurship. For example, according to The European Commission's Women in Digital (WID) Scoreboard of 2019, which measures the participation of women in the digital economy¹, women represent 34% of Science, Technology, Engineering and Maths (STEM) graduates and 17% of ICT specialists in the EU. In addition, the Women in Digital (2019) Brochure of the European Commission reports that only 19% of European ICT entrepreneurs are women.

The overall levels of digital skills and gender gaps vary substantially across European countries. The chart depicts the share of individuals with 'above basic' digital skills, broken down by gender, in 2017. Based on data of the survey on access and use of ICT by households and individuals, Eurostat calculates this composite indicator that captures skills in four dimensions: information, communication, problem solving, and software skills. 'Above basic' skills imply that individuals have 'above basic' skills in all four dimensions². On average, 28% of women in the EU28 have above basic digital skills, 6 percentage points below the average percentage for men. Iceland, Luxembourg, Norway, Finland and Denmark represent the top-five countries with highest shares of females with above basic digital skills in Europe. Among CESEE countries, for which the data is available, Estonia (34%), Lithuania (33%), Slovenia (31%), Latvia (30%) and Slovakia (30%) record female digital competence levels above the EU28 average level.

It is only in Lithuania, Slovenia, Latvia and Bulgaria, all of them EU-CEE countries, where women have slightly higher digital skills levels than men. In Cyprus, the above basic digital skills level is the same for both male and female individuals. In other countries, the share of men with above basic digital skills exceeds that of women. In eight European countries, the gender gap is bigger than the EU28 average. Surprisingly, it is high for such digital front-runners as Denmark (7 percentage points) and Sweden (8 percentage points). A particularly unequal distribution of above basic digital skills is observed for Germany, Croatia, the Netherlands (9 percentage points), Turkey (10 percentage points) and Luxembourg (12 percentage points).

Closing the gender gap in digital skills and, more generally, enabling more gender equal participation in the digital economy would contribute to an overall more inclusive society and give impetus to economic development by satisfying the rising demand for digital jobs. Especially for CESEE, digitalisation is often considered as an opportunity of leap-frogging. Thus, for Turkey and most EU-CEE and Western Balkan countries, addressing the low level of digital skills among women and bridging the digital gender divide needs to be high on their policy agenda.

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¹ <https://ec.europa.eu/digital-single-market/en/women-ict>

² More on methodology: https://ec.europa.eu/eurostat/cache/metadata/en/tepsr_sp410_esmsip2.htm

Opinion Corner*: Iran-US negotiations are now likelier than before¹

BY MAHDI GHODSI

Iran's new readiness to negotiate with the US is partly due to the recent social unrest – an indirect consequence of the US sanctions. Ahead of possible negotiations, it has resumed some nuclear activities beyond the limitations of the JCPOA deal in order to improve its bargaining chips. A new deal between Iran and the US may ultimately benefit the political careers of both Hassan Rouhani and Donald Trump.

On the sidelines of the United Nations General Assembly (UNGA) in New York in September 2019, French President Emmanuel Macron made substantial efforts to establish a dialogue between the Iranian President Hassan Rouhani and US President Donald Trump. The dialogue was based on a four-point document put forward by President Macron, in which the US agreed to remove the sanctions imposed on Iran and Iran agreed to negotiate on its regional role and never seek nuclear weapons. Although Mr. Macron's efforts were ultimately not successful and at the last moment Mr Rouhani refused to talk, it was an important initiative signalling a likely resumption of negotiations between Iran and China, France, Russia, the UK, the US and Germany, which were signatories to the initial Joint Comprehensive Plan of Action (JCPOA). JCPOA was implemented in January 2016 and obliged Iran to put its nuclear programme on hold in exchange for sanctions relief.

On the one hand, renegotiating a deal with Iran would be an important achievement for President Trump in his bid for the second presidential term. One of his major reasons for finally decertifying² the JCPOA deal in October 2017 was its sunset provisions³ which were meant to relax control over some parts of Iran's nuclear programme at a certain point. Mr Trump finally withdrew from the deal in May 2018 and has since reiterated several times that he is ready for negotiations. There are still strong forces in the US that may stop President Trump from making a deal with Iran. However, his recent decision to sack national security advisor John Bolton,⁴ who was very hawkish on Iran, may indicate a welcome change of his earlier strategy.

On the other hand, after the recent social unrest in Iran,⁵ Mr Rouhani may also be more willing to return to the negotiation table now – especially if the US drops sanctions against Iran. However, as long as Iran continued implementing the JCPOA deal, it had no nuclear bargaining chips in its hands to enter into

* Disclaimer: The views expressed in the Opinion Corner section of the Monthly Report are exclusively those of the authors and do not necessarily represent the official view of wiiw.

¹ A shorter version of this article was published on Radio Farda: <https://en.radiofarda.com/a/iran-us-negotiations-are-now-likelier-than-before/30221153.html>

² <https://www.whitehouse.gov/briefings-statements/remarks-president-trump-iran-strategy/>

³ <https://www.foreignaffairs.com/articles/iran/2017-10-03/iranian-nuclear-deals-sunset-clauses>

⁴ <https://www.theguardian.com/us-news/2019/sep/10/trump-fires-john-bolton-national-security-adviser>

⁵ <https://wiiw.ac.at/iran-is-facing-the-most-brutal-suppression-in-its-recent-history-n-413.html>

negotiations with the US. Thus, in the past nine months, Iran took a few steps back from the limitations of the JCPOA deal; exactly the ones that were relaxed by the sunset clauses mentioned above.

These steps may bring nuclear leverage to Iran's gambit while they point at two important issues. First, they show that the JCPOA was a real achievement to limit Iran's nuclear activity, and it was not until the US withdrawal from the deal that Iran violated it. However, the second issue shows how important the sunset clauses of the deal are for Iran as a bargaining chip – even if with these current JCPOA violations Iran is still very far from making a nuclear bomb. However, this advantage could only benefit Iran if it negotiates. A long-term objective for both the US and Iran could be a strategic partnership in the region with mutual benefits.

SAUDI ARABIA'S SUDDEN WILLINGNESS TO NEGOTIATE

Iran's regional arch rival Saudi Arabia is now demanding diplomacy and a new deal with Iran. After JCPOA was implemented in 2016, Saudi Arabia and Israel were unhappy. Former US President Barack Obama had decided to deal with Iran through direct diplomacy with Tehran, largely leaving regional allies out of the process. His priority was to achieve a deal that would at least hinder Iran from acquiring nuclear weapons. Thus, less attention was paid to Iran's regional hegemonic ambitions. Giving sanctions relief to Iran did not appeal to Israel and Saudi Arabia. They lobbied successfully with Jared C. Kushner, Mr. Trump's Senior Advisor, for a USD 100 billion arms deal during Donald Trump's first trip to the region.⁶ In line with the strategy of 'maximum pressure', the US left the region and subcontracted the regional security to Israel and Saudi Arabia to counter Iran's support for Shiite militia in Iraq, Lebanon, Syria, and Yemen.⁷ The escalating tensions between these two camps have led to military confrontations, the last of which was a missile attack against the oil infrastructure of Aramco in Saudi Arabia.⁸ It is estimated that about half of all the oil exports of Saudi Arabia, or about 5% of the global oil supply, was hit at the time. Many sources including former US Secretary of State John Kerry – who negotiated the JCPOA – have argued that one way or another, Iran was behind these attacks.⁹

We can draw a few conclusions from these regional confrontations. Iran has much less military might than Saudi Arabia and Israel as it is under military embargo¹⁰ and relies on its indigenous low-cost military equipment. In that sense, the relationship between Iran and the US allies in the region is asymmetric. However, Iran has managed to demonstrate its military capabilities by inflicting damage on US allies. These recent events have persuaded Crown Prince Mohammed bin Salman, the de facto ruler of Saudi Arabia, that the best solution to avoid a regional war would be through diplomacy and a new deal with Iran. With some degree of military success during the recent confrontations, Iran has again gained some bargaining chips for possible future negotiation with the US.

⁶ <https://www.theguardian.com/world/2017/may/12/us-saudi-arabia-arms-deal-donald-trump-visit>

⁷ <https://www.foreignaffairs.com/articles/middle-east/2019-10-15/disaster-desert>

⁸ <https://www.wsj.com/articles/saudi-arabia-displays-burned-damaged-structures-at-oil-sites-after-attacks-11568985123>

⁹ <https://www.youtube.com/watch?v=z8o8PxpAHY>

¹⁰ https://www.sipri.org/databases/embargoes/un_arms_embargoes/iran

ROUHANI'S DOMESTIC OPPOSITION

President Rouhani came to UNGA to finish what he promised some years ago, a deal with the 'reeve of the world'.¹¹ But he is restricted by the Supreme Leader Ayatollah Ali Khamenei, the top authority in the constitution. As Macron also noted, Iran's foreign policy is not decided by its president. Iran's domestic politics makes the situation much more complicated. Its hardline core has considered the United States as the number one enemy since the beginning of the Islamic Republic. They cannot ideologically imagine a friendship between Iran and the United States who they consider as the harbinger of capitalism and imperialism. Iran's Supreme Leader supports this revolutionary ideology by prohibiting any path towards rapprochement with the US. He has prohibited any talks¹² with US officials until Washington returns to the JCPOA.¹³ It could be argued that he may never agree to negotiate either Iran's role in the region or its missile activities. However, nuclear issues have already been negotiated and there is a general understanding in Tehran that a deal that does not encompass all issues will not be accepted by the US administration. Therefore, this precondition may have been set to demonstrate the possibility of further talks on other issues if the trust that was lost – by the US disrespecting the JCPOA deal – is returned. With a four-point document put forth by France's Macron, it seemed that this pre-condition would be satisfied as all US sanctions imposed by the Trump administration would be removed. But given the pressure coming from Iran's Supreme Leader, Rouhani hesitated.

It is true that Mr Rouhani needs this deal for his presidency to be a success. But a few days after his return home, his brother was sentenced¹⁴ to five years in prison on corruption charges. This is of no surprise given that the Chief Justice of Judicial system of Iran is directly appointed by the Supreme Leader, and that its new Chief is Ebrahim Raisi, Rouhani's opponent¹⁵ in the last presidential election campaign. Thus, weakening Rouhani's team in this way could be a domestic game of politics to obstruct him from achieving his goal – a game that may be rooted in the competition between Rouhani and Raisi for the next leadership of the Islamic Republic. Nevertheless, one could also argue that once Mr Rouhani's brother is in jail and the price has already been paid, his path for negotiation with the US is now open¹⁶.

A DEAL WITH THE US MAY SAVE IRAN'S ECONOMY

The recent data published by the Statistical Center of Iran shows that in the Persian calendar year beginning in March 2016, Iran's economy grew by 12%, largely thanks to the JCPOA. However, the new sanctions imposed by the US in 2018 resulted in a 4.9% reduction in real GDP in the year ending in March 2019. Moreover, in its latest World Economic Outlook, the International Monetary Fund (IMF) projects a 9.5% recession for Iran in 2019, largely due to oil revenue losses resulting from the tougher

¹¹ <http://bit.ly/363Wonc>

¹² <https://www.theguardian.com/world/2019/sep/17/irans-supreme-leader-rules-out-any-talks-with-us-officials-ayatollah-ali-khamenei>

¹³ From the source in Footnote 9: "If America takes back its words and repents and returns to the nuclear deal, which they have violated, they can take part in the meetings of signatories to this agreement with Iran, otherwise, no negotiation on any level will happen between officials of the Islamic Republic and America, neither in New York nor anywhere else."

¹⁴ <https://www.nytimes.com/2019/10/01/world/middleeast/iran-hosseini-fereydoun-corruption.html>

¹⁵ <https://wiiw.ac.at/wiiw-opinion-corner-likely-reasons-and-consequences-of-hassan-rouhani-s-victory-in-the-iranian-presidential-elections-n-231.html>

¹⁶ <https://www.ft.com/content/2e5b2a0c-e4f2-11e9-9743-db5a370481bc?segmentid=acee4131-99c2-09d3-a635-873e61754ec6>

US sanctions. That would be the worst recession since the midst of the Iran-Iraq war in 1986. Most importantly, the recent social unrest – an indirect consequence of US sanctions - shows how insecure the fate of the Islamic Republic is. Mr Rouhani understood this and made great efforts to make peace with the West and the US. As it was also noted in an earlier wiiw article¹⁷, the European Union, on the initiative of President Macron proposed a USD 15 billion¹⁸ line of credit to support Iran, which is waiting for the final blessing of President Trump, who is also supposed to remove sanctions on Iran's oil exports as mentioned in the four-point document.

However, all sides should be warned that a new deal with Iran should not be achieved in a rush. The experience in the last months of the Obama administration points at the deficiencies in the JCPOA, which lacked consensus support in the US political establishment. Most importantly, the recent bloody crackdown on protests in Iran needs to be addressed by western powers as a more democratic Iran could be better responsible for a strategic partnership with the US. In any case, a full détente in US-Iran relations seems rather unlikely. Rather, the future of bilateral relations may look like a continuation of the cold war – but without strong provocations from both sides, such as US sanctions against Iran and Iran's hostile actions towards the US allies in the region.

¹⁷ <https://wiiw.ac.at/could-it-end-in-war-in-need-of-a-compromise-between-us-and-iran-n-392.html>

¹⁸ <https://www.nytimes.com/2019/09/02/world/middleeast/iran-france-nuclear-deal.html>

Globalisation and inequality: more than just a spurious correlation?

BY STEFAN JESTL

In recent years, globalisation has been under attack. Even though it has brought with it a boost in economic development globally since the 1980s, it is increasingly blamed for contributing to widening income inequality, in particular within advanced economies.

It is argued that a greater openness to trade, international production networks and international investments, in the form of foreign direct investments, have produced not only winners but also losers in one and the same country. While gains from globalisation benefitted only a few, others in the society have been left behind. As the losers perceived themselves more and more lagging behind, their trust in political institutions eroded (OECD, 2017). This has eventually resulted in a political backlash against globalisation (Rodrik, 2018), as mirrored in recent political shocks such as Brexit and the trade war induced by the US president Donald Trump.

PARALLEL PATHS

Globalisation, also known as the third wave of globalisation¹, has experienced rapid expansion in most advanced countries since starting in the 1980s. Over the years, this process has started to incorporate developing countries as well which has allowed them to raise living standards and to reduce poverty (Ravallion, 2018). Although standard models in economics, even at that time, also predicted adverse effects from globalisation for advanced economies, the majority of economists saw only modest disruptive effects on income inequality (Krugman, 2019). For example, workers who were laid-off due to globalisation were expected to find a new job in the more export-orientated industries which would dampen the initial pressure on income inequality.

At the same time, however, top incomes in many advanced economies have increased enormously, going hand in hand with higher levels of income inequality (see, for example, Alvaredo et al., 2017; Piketty, 2013). After a continuous decline in income inequality after the Second World War, income inequality started to move upwards again in the 1980s as a general trend.

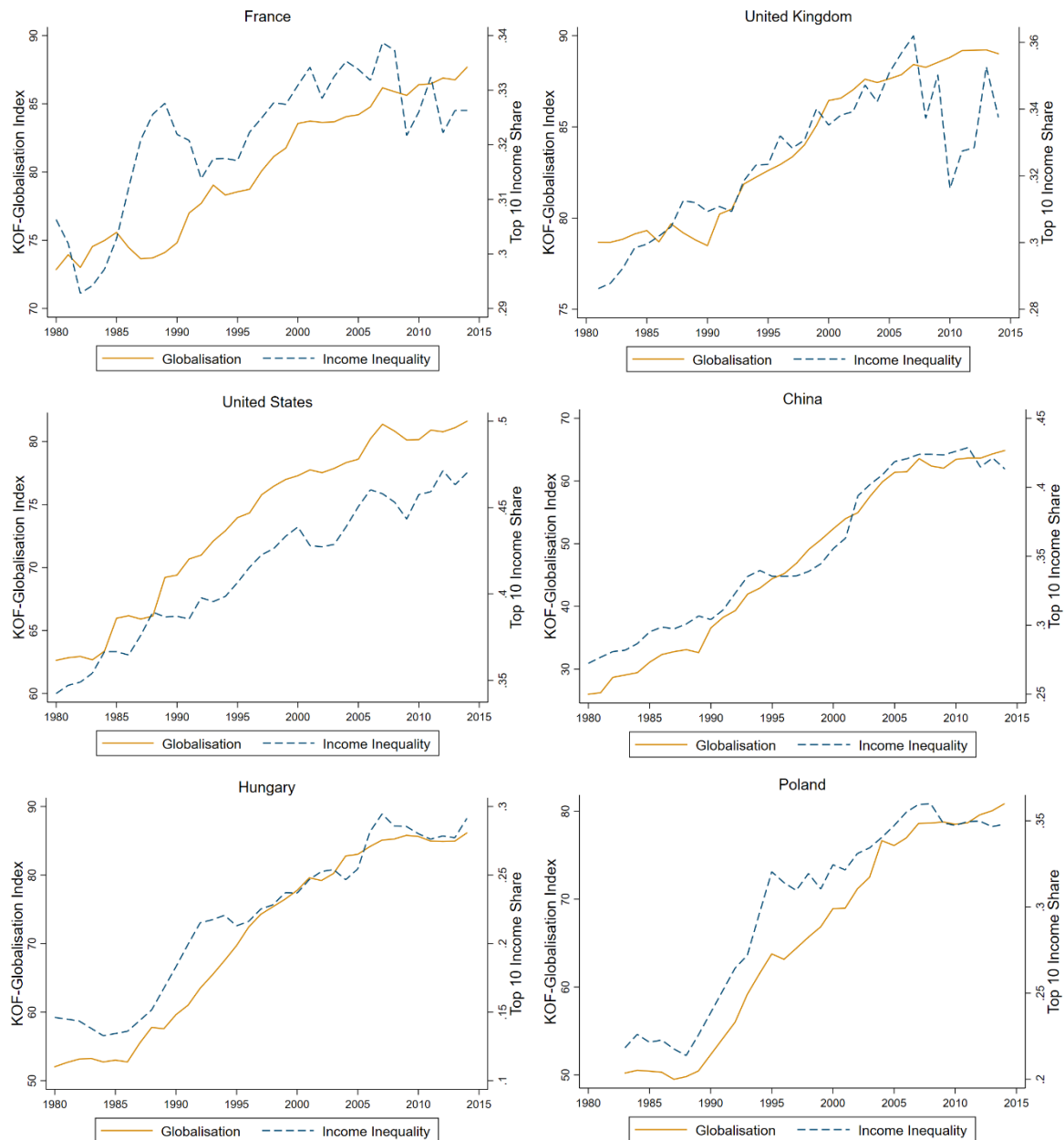
Accordingly, as many argue, there appears to be a dependency between globalisation and income inequality over time. To get an impression of this relation empirically, Figure 1 contrasts the KOF globalisation index and the top-10% income share over years in France, the United Kingdom, the United States, China, Hungary and Poland. The KOF globalisation index (Gygli, 2019) is a widely used measure that combines several dimensions of globalisation.² The top-10% income share of pre-tax

¹ For a history of globalisation see: <https://www.weforum.org/agenda/2019/01/how-globalization-4-0-fits-into-the-history-of-globalization/>

² In general, the KOF index includes the dimensions economic globalisation (trade and financial globalisation), social globalisation (e.g. information globalisation) and political globalisation.

national income represents the indicator of income inequality, with data stemming from the World Income Database (WID.world).³ Among other prominent scholars, Piketty, Saez and Zucman work in the framework of the WID.world project with the aim of providing historical data on the evolution of national and global income distribution.

Figure 1 / Evolution of globalisation and income inequality in selected countries



Source: KOF (Gygli et al., 2019) and WID.world; own illustration.

Across the six countries, we identify one striking pattern: globalisation and income inequality show similar paths over time. Although income inequality shows a higher volatility in general across the time span, the evolution of both has gone hand in hand. Interestingly, the paths for the emerging economies,

³ <https://wid.world/data/>

namely China, Hungary and Poland, are similar to those for the advanced countries. This clearly suggests that there is a relationship between globalisation and income inequality. However, this simple descriptive view cannot rule out the possibility that this relationship is just spurious. There might be other factors that have affected both globalisation and income inequality at the same time.

To get a better understanding of how globalisation can affect income inequality, it is important to screen theoretical approaches. In the following, we summarise the main arguments made in economic theory.

WHAT DOES THE LITERATURE TELL US?

There are different ways to measure globalisation. A more comprehensive view is to put a spotlight on globalisation from three different perspectives: trade, capital (i.e. FDI) and migration. The literature discusses and analyses these three forces of globalisation separately.

- › **Trade.** In the standard trade model, the famous *Stolper-Samuelson-Theorem* predicts that unskilled workers are worse off in advanced economies due to trade liberalisation. The reason is that advanced economies expand the production in more skill-intensive industries and reduce production in less skill-intensive industries. This prediction also holds in more complex trade models as put forward for instance by Feenstra and Hanson (1996). The lagging behind of low-skilled workers is also highlighted by Rodrik (2017) who argues that *trade generically produces losers*. Accordingly, income inequality within advanced economies is expected to increase due to trade liberalisation.
- › **FDI.** As in trade, the standard model predicts a lower demand for low-skilled workers in the advanced (FDI-sending) economies. FDI set up production capacities abroad as an outsourcing of production stages from advanced economies in which particularly low-skilled workers hold jobs. Feenstra and Hanson (1997) came to the same conclusion for advanced economies in their augmented FDI model. Others argue that multinational enterprise (MNE) models also consider inward FDI in more advanced economies. On the one hand, FDI into headquarters services tend to contribute to a higher demand for skilled labour, while, on the other hand, FDI into other operations are assumed to correspond to a higher demand for less skilled labour. Although the last argument points to a potential decrease in income inequality due to FDI, the literature observes a predominant inequality-enhancing effect through FDI in more developed countries.
- › **International Migration.** The literature argues that effects on income inequality depend on the characteristics of immigrants and natives and whether immigrants show a substitutability or complementarity with respect to natives in terms of skills. In the case of similar skills, immigrants act as substitutes for natives and higher competition brings lower wages for natives with it. Conversely, in the case of different skills, immigrants can contribute to an increase in productivity which eventually benefits wages for natives. By considering both channels, we can conclude that international migration can be associated with changes in income inequality in both directions. In a very recent study, Edo (2019) reviewed the existing literature on the impact of immigration on labour market outcomes and concluded that immigration can create winners and losers among native workers.

Over the years, a noticeable number of studies has analysed the impact of the three dimensions of globalisation on income/wage inequality empirically. However, empirical findings are not as clear-cut as suggested by economic theory. The results are rather mixed and inconclusive.⁴

A MORE INTEGRATED APPROACH

In a recent wiiw study (Jestl et al. 2018), we assessed the contribution of the three forces of globalisation – trade, FDI and immigration – on the level of wage inequality⁵ (based on hourly wages) among native workers in a set of EU countries (both advanced and emerging economies) in the period 2008-2013. We contribute to the literature in two ways: First, we considered the three dimensions of globalisation simultaneously in our empirical exercise; and second, we based the contributions of globalisation on a micro-econometric analysis. Specifically, we started by estimating wage regressions at the individual level where we considered globalisation indicators at the industry level. Based on the obtained estimates, in a further step we applied the Shapley value decomposition approach of Shorrocks (2013) to filter out the contribution of the three globalisation forces to wage inequality captured by the Gini coefficient.⁶ In a final step, we calculated the relative contribution of variables to our wage inequality indicator.⁷

Figure 2 illustrates the relative contributions of individual variables (gender, age), education, occupation, contract type (temporary vs. permanent contract), firm size, FDI, trade, migration and additional variables (productivity, skill-biased technological change). We used different measures for value chain (VC) trade and FDI (i.e. inward and outward FDI) and applied a principal component analysis to construct overall measures for the two globalisation forces. This allowed us to consider the degree of overall participation in VC trade and global FDI flows. The results refer to the analysis for the period 2011-2013.⁸ On the left-hand side in Figure 2 we have the results for the advanced economies, while on the right-hand side we find those for the emerging economies. As we can see, wage inequality in all countries can be explained to a large part by differences in age, gender, education and occupation, and firm size. Interestingly, we also find in some countries (e.g. Austria, Greece and Spain) relatively large contributions of the type of employment contract (temporary vs. permanent contracts).

In turn, the overall contribution coming from globalisation varies markedly across countries, ranging from around one to more than 20 percent. Moreover, we identify that the impact of the three globalisation forces differs substantially by country. The effects of globalisation show a higher variation among advanced economies than emerging economies. Nevertheless, we find that globalisation also has an inequality-enhancing effect in emerging economies. This underscores the heterogeneous role played by globalisation for wage inequality across countries.

⁴ For a brief discussion of empirical results for the three globalisation dimensions see Jestl et al. (2018).

⁵ As globalisation might also affect labour market participation of individuals, the effects on wage inequality are likely to be smaller than those on income inequality.

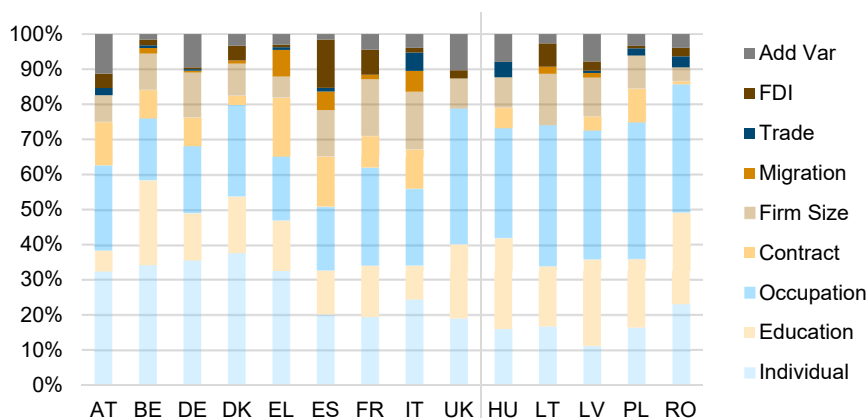
⁶ In the study, we also decomposed other inequality measures that put more weight on the tails of the wage distribution.

⁷ The calculation of the relative contributions refers only to the explained part of the Gini coefficient. As we use a regression-based approach, a specific proportion of the Gini coefficient remains unexplained. Around one third of the Gini coefficient cannot be explained by our specification.

⁸ In the study, we analysed the periods 2008-2010 and 2011-2013 separately.

FDI contributed to wage inequality among native workers in particular in Spain, but also in Austria, Denmark, France and Lithuania. Interestingly, trade explains only a small proportion of wage inequality in most countries. Somewhat larger contributions can be found in Austria, Italy, Hungary and Romania. The only clear pattern is visible for the contributions of migration. Migration plays a role for wage inequality among native workers predominantly in the Southern European countries Greece, Spain and Italy. All in all, our results clearly indicate that the pattern of globalisation forces that are in play changes when we move from one country to the next. From this point of view, general statements on the impact of globalisation on income/wage inequality are therefore difficult to make.

Figure 2 / Relative contributions to Gini index of wage inequality among native workers (2011-2013)



Source: Jestl et al. (2018).

ACCOUNT FOR GLOBALISATION'S HETEROGENEITY

Many blame globalisation for causing inequality in advanced economies. In fact, globalisation and inequality have gone hand in hand in many countries over time. Economic theory provides explanations in favour of an inequality-enhancing impact in advanced economies. However, the empirical literature is not that conclusive and clear-cut. Helpman (2018) reviewed the empirical literature that deals with the impact of globalisation, in particular trade, on wage inequality and concluded that globalisation has had only a modest impact. More recently in a new wiiw study, Heimberger (2019) conducted a meta-regression analysis on the nexus between globalisation and inequality and found a small-to-moderate positive effect. This overall result is also to some extent reflected in the country-specific contributions to wage inequality attributed to globalisation presented above. However, we also identify countries where the effect of globalisation has been larger. The ways globalisation impacts inequality varies substantially across (advanced) countries. This indicates a need for empirical studies to take the heterogeneity of globalisation effects across countries more into account. Failing to consider this heterogeneity may lead to misleading conclusions.

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Italy's crisis: the fault line of the euro area

BY PHILIPP HEIMBERGER

Italy has been spared the initiation of an excessive deficit procedure due to the violation of EU budget rules for the time being. However, it is to be expected that the dispute between the Italian authorities and the European Commission over Italy's fiscal policy will enter a new round in the foreseeable future against the background of Italy's on-going economic malaise – with great significance for the rest of the euro area.

Until the Italian coalition government of Lega and the Five-Star-movement finally collapsed in September 2019, the Italian authorities had been engaged in an open conflict with the European Commission for more than a year (Braun and Hübner 2019). In view of Italian misconduct with regard to the EU's fiscal rules, the Commission had recommended the initiation of an excessive deficit procedure (European Commission 2019). In July 2019, however, a compromise was reached at the very last moment to avert an excessive deficit procedure, and this compromise committed the Italian government to taking further fiscal consolidation measures (Tria and Conte 2019). With the new government in place, which consists of the Democratic Party and the Five-Star-movement and is led by prime-minister Giuseppe Conte, the budget conflict has eased somewhat: the European Commission decided not to demand substantial revisions to the Italian government's budget plans for the year 2020, although it asked for further clarifications (Dombrovskis and Moscovici 2019).

However, important disagreements remain: the new Italian finance minister Roberto Gualtieri argues that the Commission is underestimating the slack in the Italian economy, and a proper correction of the Commission's estimates regarding the position of the Italian economy in the business cycle would lead to reduced requirements in terms of fiscal consolidation. In particular, the Italian government aims to achieve a budget balance of -2.2% of GDP in 2020, and it argues that the budgetary path marks a clear convergence towards Italy's medium-term budgetary objectives defined in terms of the 'structural' deficit (Gualtieri 2019), which is the headline fiscal balance adjusted for the effects of the business cycle. The European Commission, however, is arguing that additional cuts in government spending would still be required, as it has a more pessimistic view about the 'structural' deficit than the Italian authorities (Heimberger 2019).

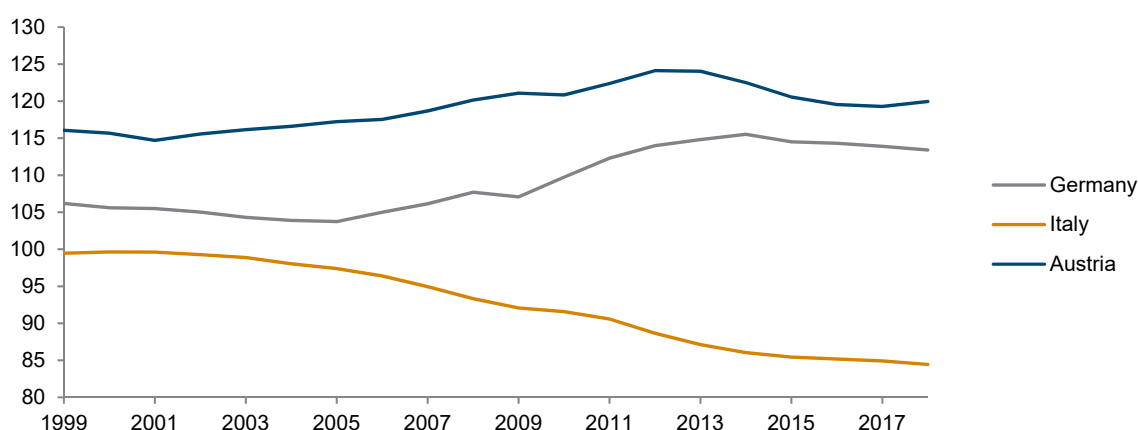
The Italian economy has been in a kind of permanent crisis for years and there is no end in sight. Against the background of the bleak economic outlook, it can be assumed that the Italian authorities' dispute with the European Commission and the EU finance ministers over the interpretation and meaningfulness of the EU budget rules will continue in the foreseeable future. The current Conte government is likely to last for some time, but the Lega's party leader Matteo Salvini will keep the pressure on. A renewed escalation of the budget conflict would be all the more likely if the Lega were to record significant increases in vote shares in new elections, which would allow Mr Salvini to claim leadership in a future government.

The fundamental question is: should the European Commission and EU finance ministers insist on a strict interpretation of the existing deficit rules? Or should they interpret the rules more flexibly and give the Italian government more scope to stimulate the economy through expansionary fiscal policies (i.e. higher government spending and/or tax cuts)?

ITALY'S LOST DECADES

Italy's current economic situation can only be understood if it is placed in a broader context. While GDP per capita in Italy (at PPP) fell from 99.5% of the euro area average in 1999 to 84.5% in 2018, it continued to increase in Germany and Austria over the same period (from an already higher level than in Italy)(Figure 1). Italy has thus lost two decades in its economic development. The political promise that accompanied the introduction of the euro has simply not been fulfilled. In the course of the creation of the euro zone, it was still said that the southern euro countries would, in the long term, approach the higher levels of prosperity in richer countries such as Germany and Austria thanks to economic integration in the European currency area. However the experience to date with the common European currency area contradicts this political promise (Kapeller et al. 2019).

Figure 1 / GDP per capita (at PPP), in % of the euro area average



Source: AMECO; own calculations.

WHY HAS THE ITALIAN ECONOMY PERFORMED SO POORLY?

In the case of Italy, domestic politicians bear a considerable share of the responsibility for existing macroeconomic problems. It would be misplaced to claim that there is no political mismanagement and no structural problems in Italy: a troubled banking sector whose consolidation has been delayed for years; weak productivity growth; dysfunctional elements of the political system; increasing economic polarisation between northern and southern Italy, etc.

In addition, there must of course be critical discussion as to whether the economic policy agenda of recent Italian governments has been suitable to put the Italian economy on a sustainable recovery path. A critical discussion of the Italian government's budgetary plans is desirable and an elementary part of the democratic process in which governments have to justify and explain their (economic) policies.

However, perhaps such a debate could be combined with the broader reform discussion about whether the EU fiscal rules are sensible from a macroeconomic point of view? For those who blame all of Italy's economic problems on Italian self-failure deny fundamental macroeconomic connections: Italy's persistent underperformance in terms of aggregate demand and productivity is also a consequence of the shortcomings of the euro zone architecture. While Italy cannot pursue a tailor-made independent monetary policy to support an economic recovery, the restrictive EU fiscal rules and fiscal consolidation requirements formulated by the European Commission (and the European Central Bank) have also tied the hands of national fiscal policy (e.g. Storm 2019).

In recent years, the various Italian governments, as well as the governments of other euro area countries, have tried to achieve an 'internal devaluation' to improve competitiveness through downward pressure on wage levels and fiscal consolidation measures (e.g. Stockhammer and Sotiropoulos 2014). OECD analysis indicates that Italy implemented so-called 'structural reforms' in a relatively disciplined manner during the crisis years, including measures to make the labour market more flexible (OECD 2015).

While the German economy grew by an average of 2.1% in real terms in 2010-2018 and the Austrian economy grew by 1.6%, real GDP growth in Italy was only 0.3% on average. It is therefore not surprising that the unemployment rate in Italy will be 10% in 2019 according to forecasts by the European Commission – around 4 percentage points above the pre-crisis level in 2007. Italy is thus not only far behind Germany and Austria, but has also been experiencing persistently greater labour market problems than the euro area average for years.

EUROPEAN INSTITUTIONS SHOULD NOT PLAY INTO THE HANDS OF RIGHT-WING POPULISTS

The European Commission insisted during the debate on a possible excessive deficit procedure against the Italian government that there was no room for manoeuvre to boost growth and employment in Italy through expansive economic policies without risking an 'overheating' of the Italian labour market and rising inflation (Heimberger 2019). At first glance, these assessments by the Commission are somewhat surprising: the Commission itself currently assumes that the unemployment rate in Italy will remain at 10% at the end of 2019, while the Italian economy is in a permanent crisis due to extremely low growth rates and a high debt burden, which also contributes to an overly low inflation rate of only about 1%. The youth unemployment rate in Italy remains above 30%. The Commission's stance is therefore questionable, making it easier for right-wing populists around Salvini to successfully agitate against the euro and the EU.

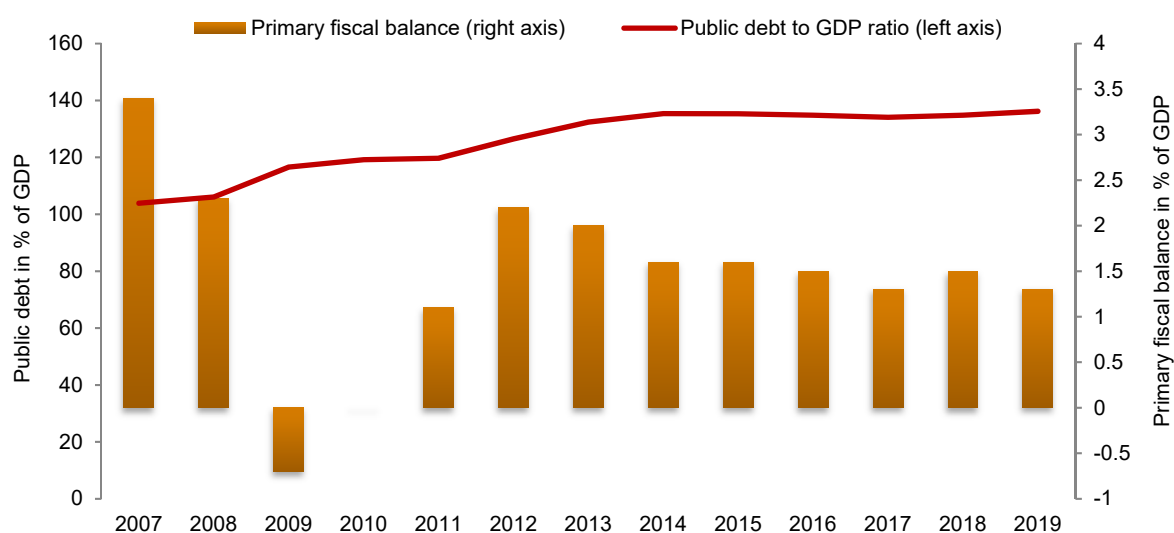
In the current situation of the Italian economy, wisely set Keynesian accents in fiscal policy could contribute in the short term to boosting economic growth which, in the medium term, would also contribute to an increase in inflation and thus to a reduction in the real debt burden (Mody 2018a).

It should be acknowledged that Italy's high public debt is mainly due to inherited burdens. In fact, the fiscal consolidation efforts in Italy have resulted in the general government achieving a primary fiscal surplus (i.e. a surplus of government revenue over government expenditure less interest expenditure) for

years on end. However, the figure below shows that despite the substantial primary surpluses, the government debt ratio has only stabilised at around 130% of GDP.

The fact that the public debt to GDP ratio is not falling is simply due to weak economic growth which can be explained by insufficient domestic investment and consumer spending as well as low inflation. Overcoming deflationary pressures would be central to reducing the real debt burden, and this in turn requires positive macroeconomic developments with stronger growth and employment numbers. If the euro zone is not to disintegrate in the next few years triggered by an exit by Italy, there must therefore be a rethinking of economic policy.

Figure 2 / Public debt and primary fiscal balance in Italy



Source: AMECO.

WHAT WOULD BE THE CONSEQUENCES OF ITALEXIT?

In Italy, the option of withdrawing from the euro zone ('Italexit') is increasingly being discussed. The longer the quasi-permanent economic crisis continues, the more likely it will be to play into the hands of those politicians who are in favour of an Italexit. The reintroduced lira following Italexit would initially depreciate sharply which would make imported goods more expensive and cause unemployment to rise further. However, an Italexit would not only have considerable consequences for Italy. An Italian state bankruptcy would hardly be avoidable if the national currency were reintroduced because the public debts denominated in euros would be overwhelmingly high if the currency were to depreciate sharply (Mody 2018b). Italy's gross public debt is currently around EUR 2,400 billion, a multiple of Greece's debt of about EUR 330 billion. Italy has the euro area's third-largest banking sector which holds a high proportion of Italian government bonds. Italy is therefore systemically relevant and Italian turbulence would lead to contagion effects in the European and global financial systems (Eichengreen 2007) which could also trigger a downturn in the already fragile euro area economy.

POLICY CONCLUSIONS

A well-dosed fiscal stimulus, which would also stimulate private investment, would make it possible to achieve initial improvements in Italy's economic outlook. The European Commission could play a constructive role in this discussion, e.g. by recommending to the Italian government, on the basis of empirical research, those expansionary fiscal policy measures that could be expected to have the strongest growth effects (e.g. Gechert and Rannenberg 2018). Higher GDP growth would in turn improve public debt sustainability in the medium term and contribute to a decline in the public debt to GDP ratio.

However, demand-side policies alone will not be able to solve Italy's far-reaching structural problems which have been exacerbated by austerity policies and parts of the labour market reforms over recent years. The banking sector, which is too large and holds many 'toxic' loans, should be put on a new footing. Further, the great challenge for Italian and European industrial policy is to improve the production structures and technological capabilities in the Italian economy so that Italian firms can improve their international competitiveness and increase their productivity (Storm 2019). In addition, structural and distribution policies are needed not least to promote the south of the country which is lagging far behind Italy's industrial hubs in the northern part.

Regardless of the short and medium-term economic fluctuations, the process of economic polarisation between Italy and some other southern euro area countries on one hand, and Germany, Austria and some other northern euro area countries on the other hand, will continue (Heimberger 2018) – unless coordinated economic policy countermeasures are taken in fiscal, wage and industrial policies. The necessary measures should be the subject of a broad public debate that also takes up new approaches (Kapeller et al. 2019). A continuation of the strategy pursued by the European institutions in recent years, with its limited focus on budget consolidation and labour market deregulation, seems in any case to have little chance of solving the existing problems in Italy.

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Conventional signs and abbreviations used

%	per cent
ER	exchange rate
GDP	Gross Domestic Product
HICP	Harmonized Index of Consumer Prices (for new EU Member States)
LFS	Labour Force Survey
NPISHs	Non-profit institutions serving households
p.a.	per annum
PPI	Producer Price Index
reg.	registered

The following national currencies are used:

ALL	Albanian lek	HRK	Croatian kuna	RON	Romanian leu
BAM	Bosnian convertible mark	HUF	Hungarian forint	RSD	Serbian dinar
BGN	Bulgarian lev	KZT	Kazakh tenge	RUB	Russian rouble
BYN	Belarusian rouble	MKD	Macedonian denar	TRY	Turkish lira
CZK	Czech koruna	PLN	Polish zloty	UAH	Ukrainian hryvnia

EUR euro – national currency for Montenegro, Kosovo and for the euro-area countries Estonia (from January 2011, euro-fixed before), Latvia (from January 2014, euro-fixed before), Lithuania (from January 2015, euro-fixed before), Slovakia (from January 2009, euro-fixed before) and Slovenia (from January 2007, euro-fixed before).

Sources of statistical data: Eurostat, National Statistical Offices, Central Banks and Public Employment Services; wiiw estimates.

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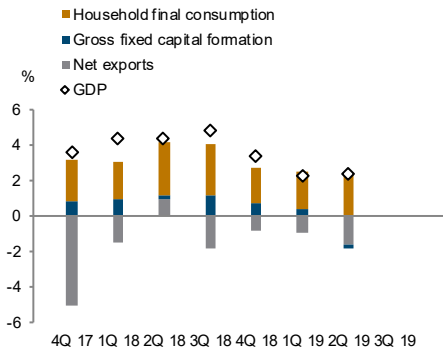
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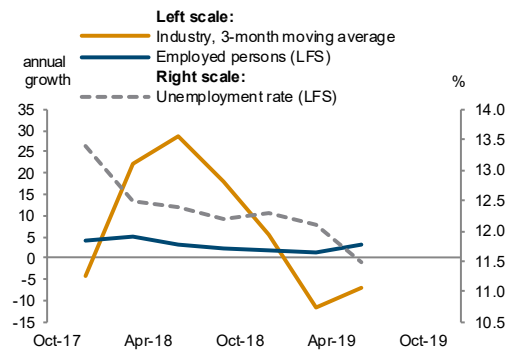
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Albania

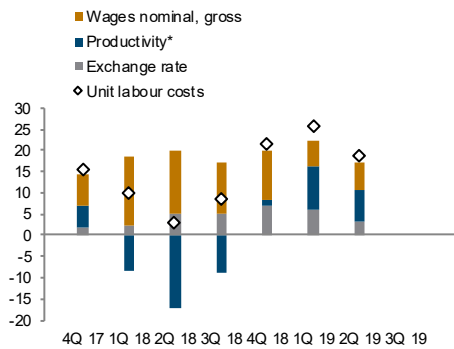
Real GDP growth and contributions
year-on-year



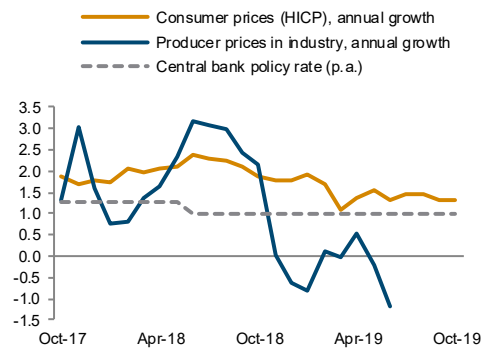
Real sector development
in %



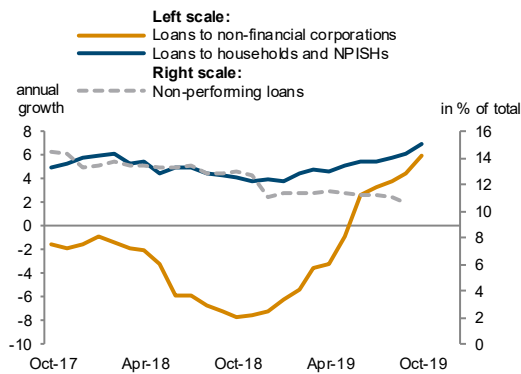
Unit labour costs in industry
annual growth rate in %



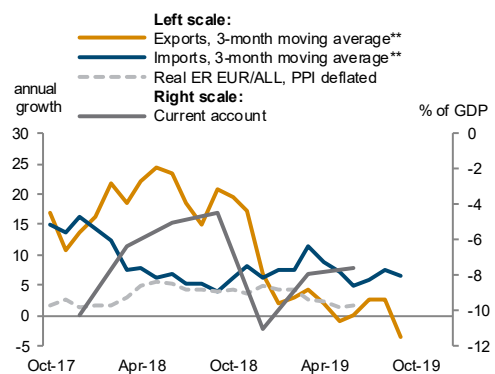
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



*Positive values of the productivity component on the graph reflect decline in productivity and vice versa.

**EUR based.

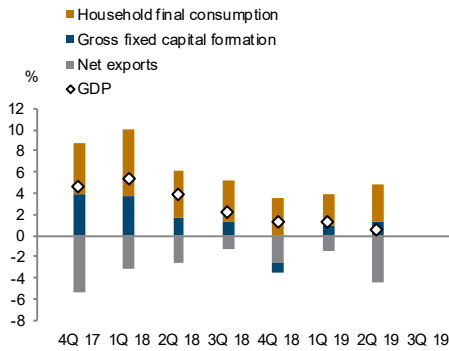
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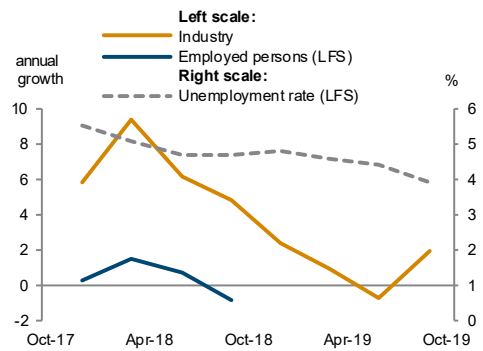
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Belarus

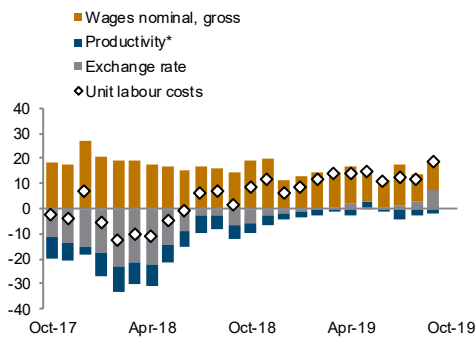
Real GDP growth and contributions
year-on-year



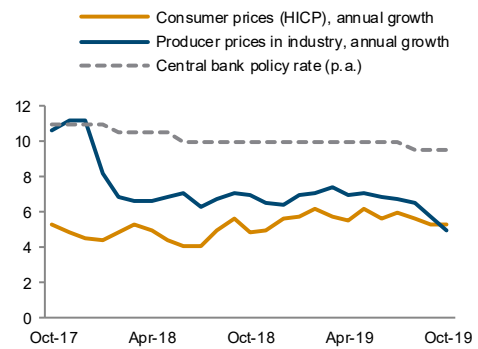
Real sector development
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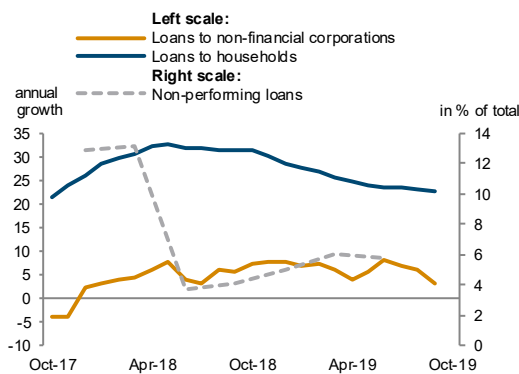
Unit labour costs in industry
annual growth rate in %



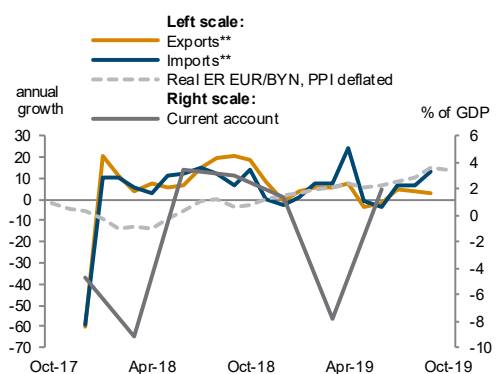
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %

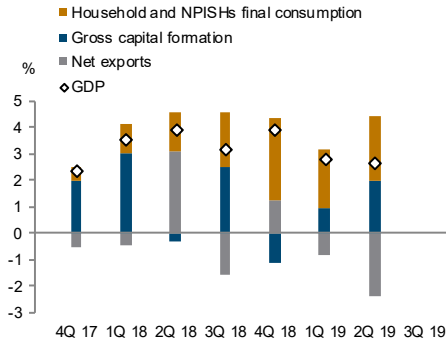


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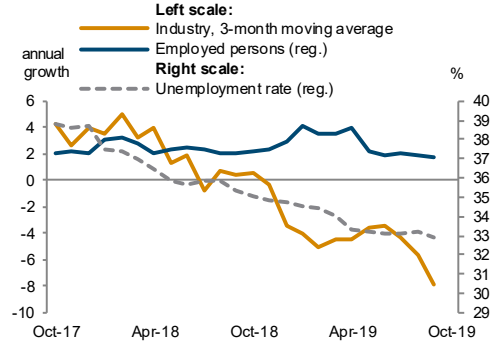
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Bosnia and Herzegovina

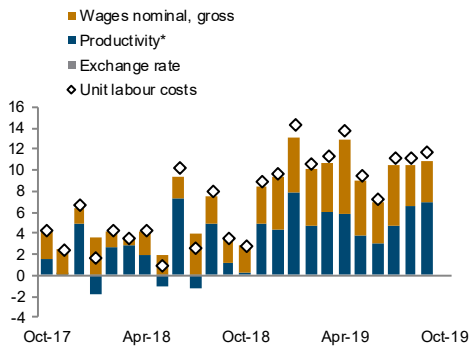
Real GDP growth and contributions
year-on-year



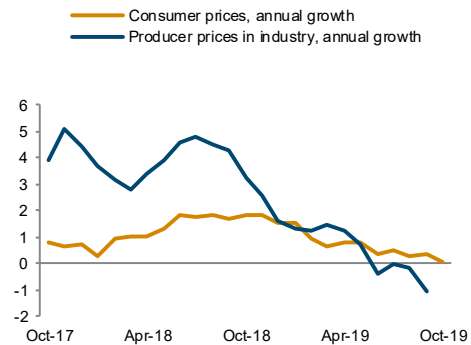
Real sector development
in %



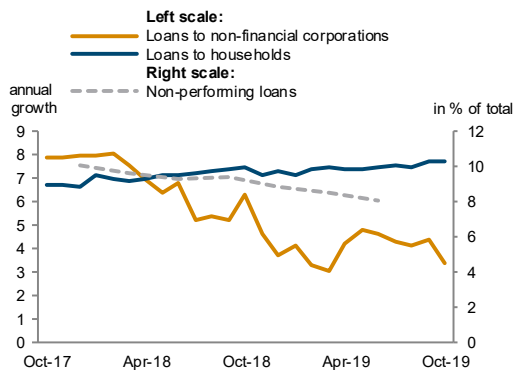
Unit labour costs in industry
annual growth rate in %



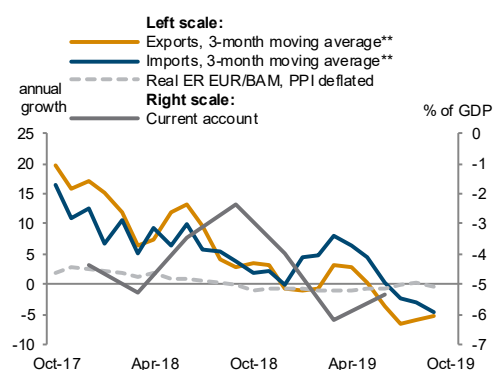
Inflation
in %



Financial indicators
in %



External sector development
in %



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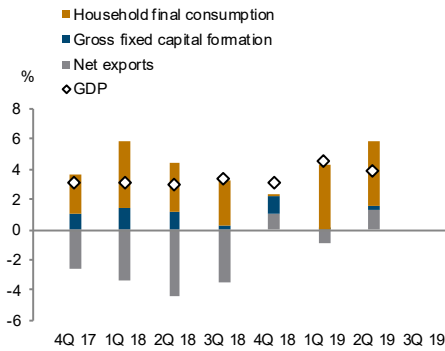
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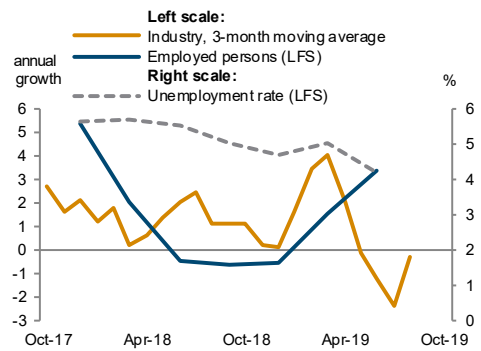
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Bulgaria

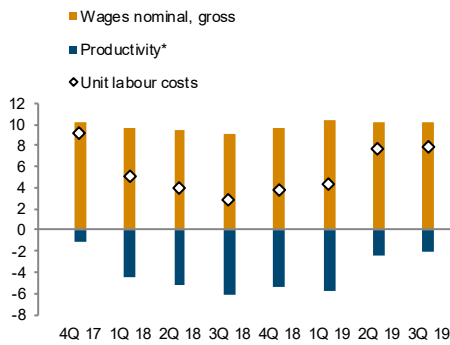
Real GDP growth and contributions
year-on-year



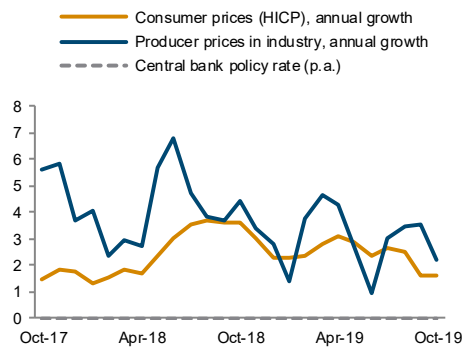
Real sector development
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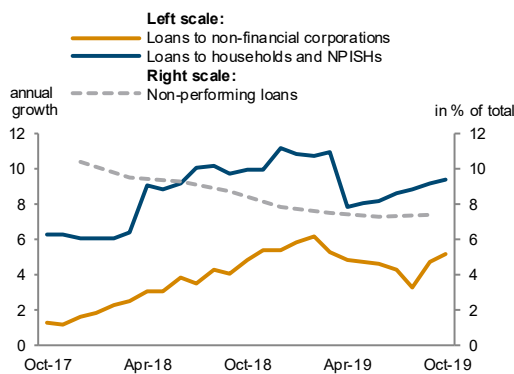
Unit labour costs in industry
annual growth rate in %



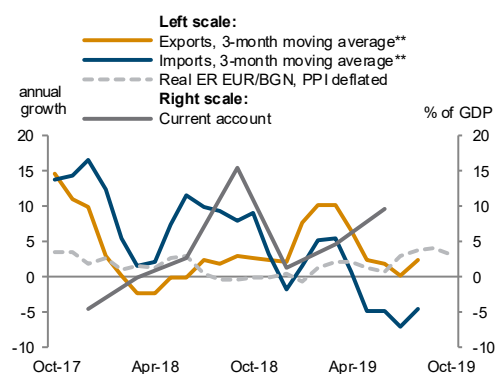
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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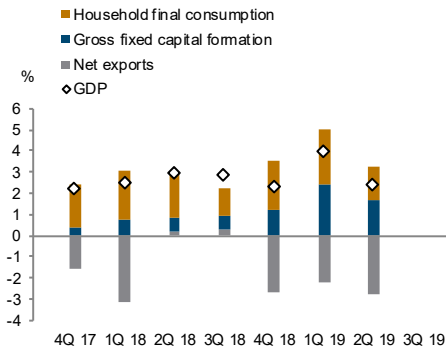
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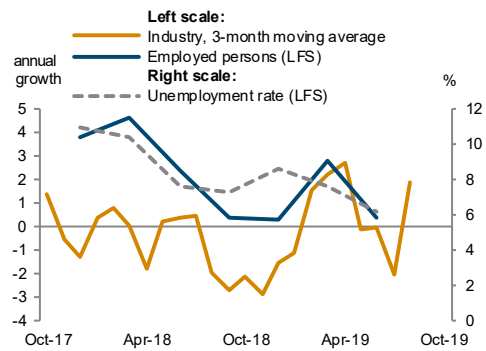
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Croatia

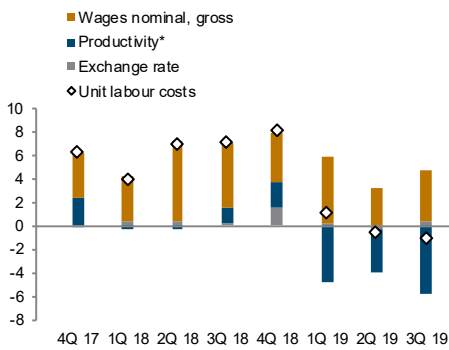
Real GDP growth and contributions
year-on-year



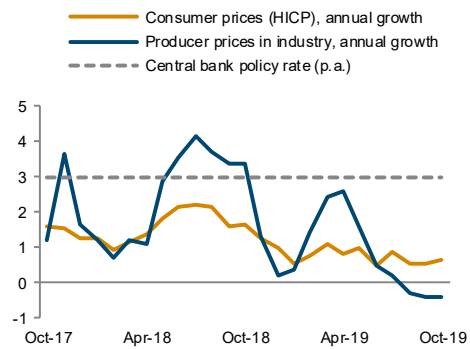
Real sector development
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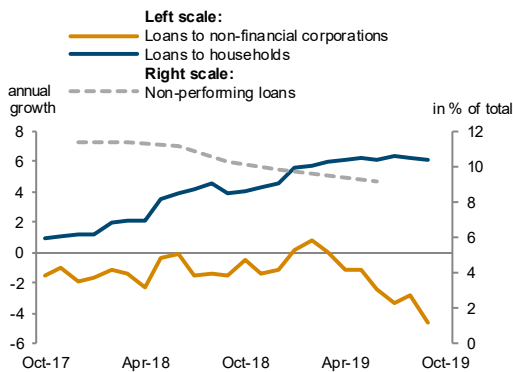
Unit labour costs in industry
annual growth rate in %



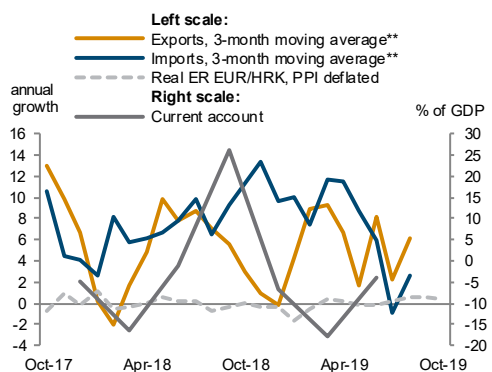
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Financial indicators
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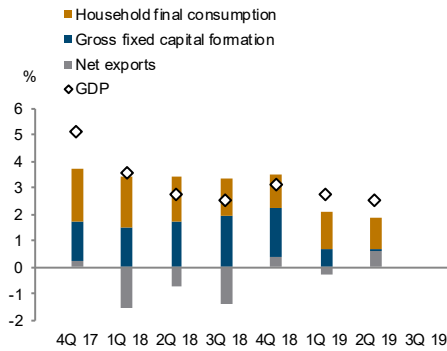
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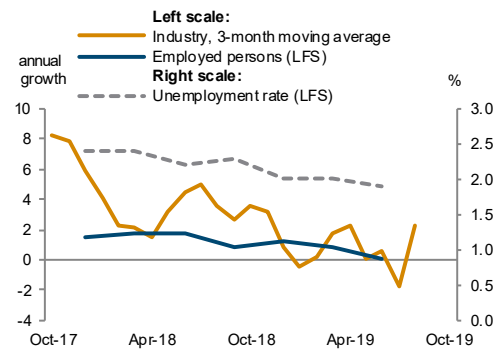
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Czech Republic

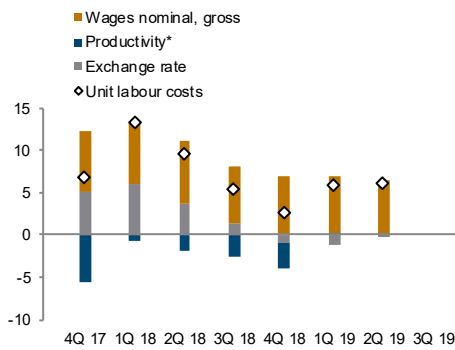
Real GDP growth and contributions
year-on-year



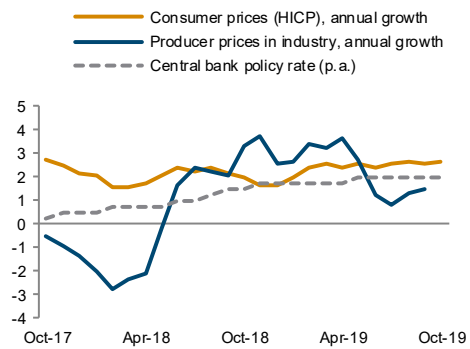
Real sector development
in %



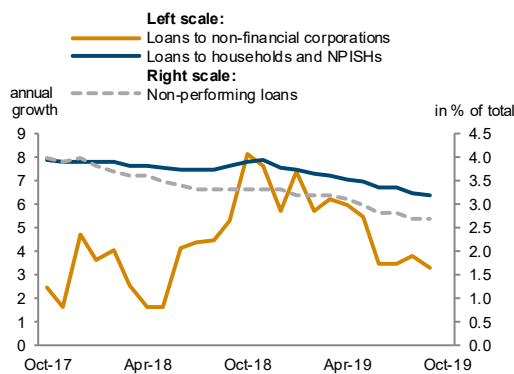
Unit labour costs in industry
annual growth rate in %



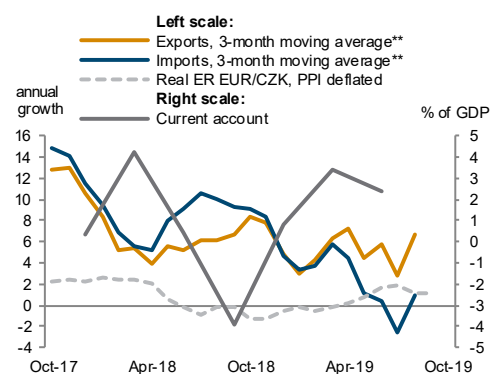
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



*Positive values of the productivity component on the graph reflect decline in productivity and vice versa.

**EUR based.

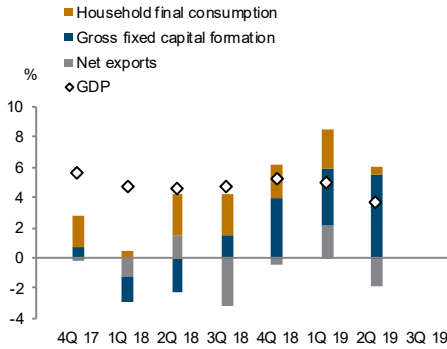
Source: wiiw Monthly Database incorporating Eurostat and national statistics.

Baseline data, country-specific definitions and methodological breaks in time series are available under:

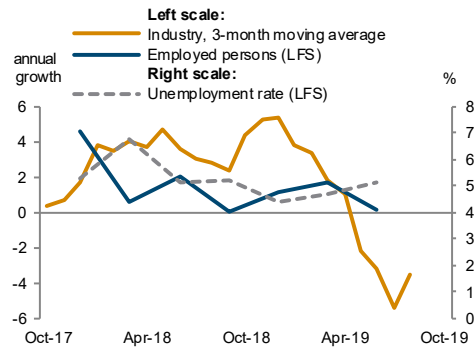
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Estonia

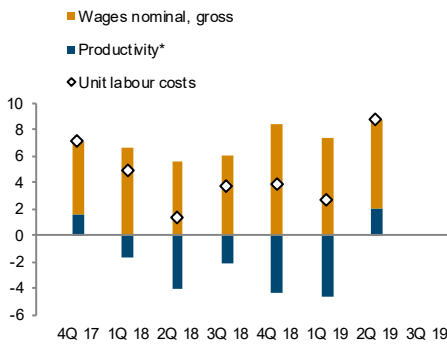
Real GDP growth and contributions
year-on-year



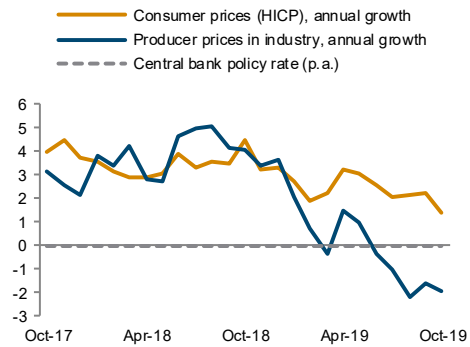
Real sector development
in %



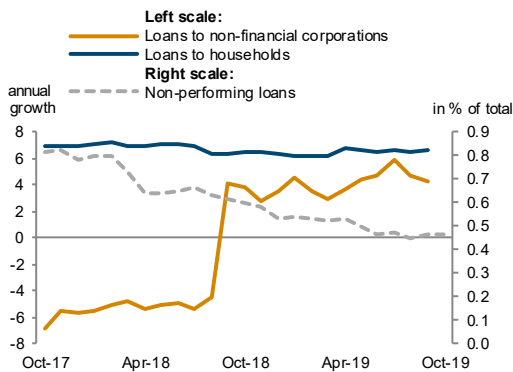
Unit labour costs in industry
annual growth rate in %



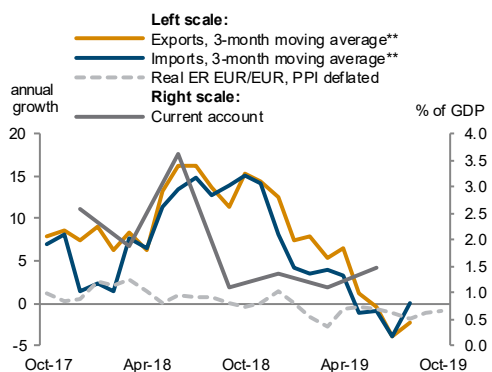
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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**EUR based.

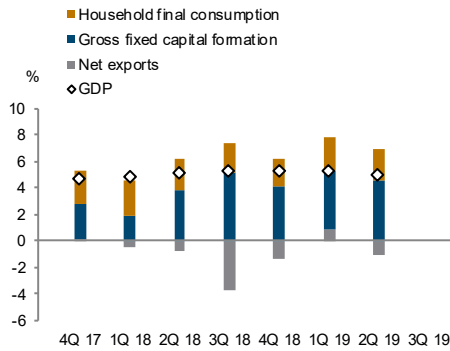
Source: wiiw Monthly Database incorporating Eurostat and national statistics.

Baseline data, country-specific definitions and methodological breaks in time series are available under:

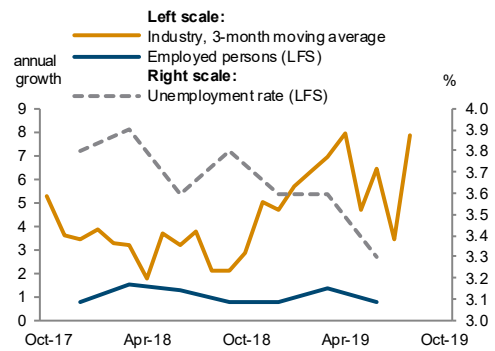
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Hungary

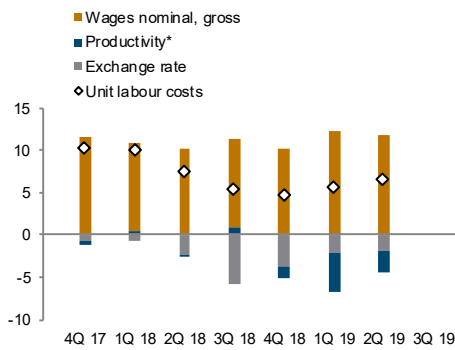
Real GDP growth and contributions
year-on-year



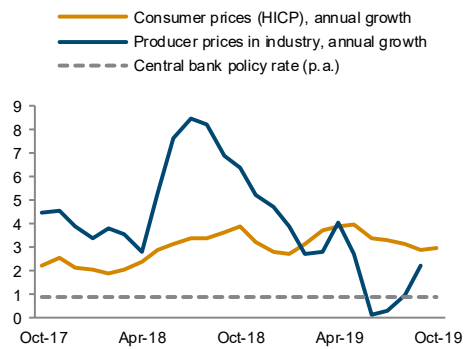
Real sector development
in %



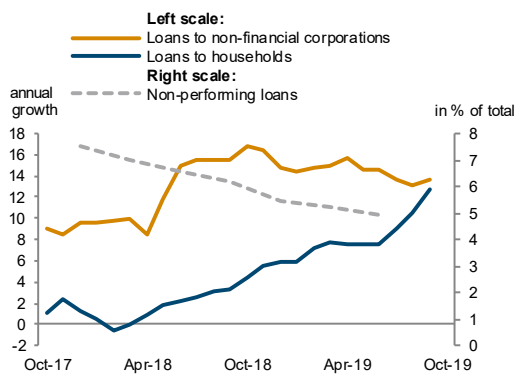
Unit labour costs in industry
annual growth rate in %



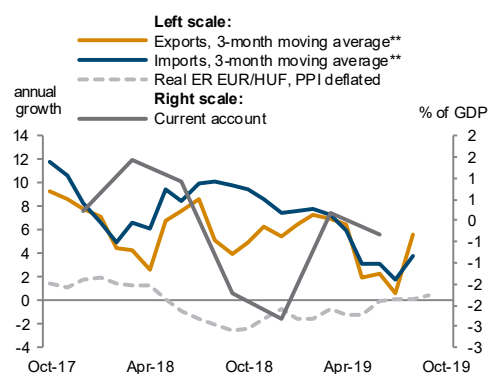
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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**EUR based.

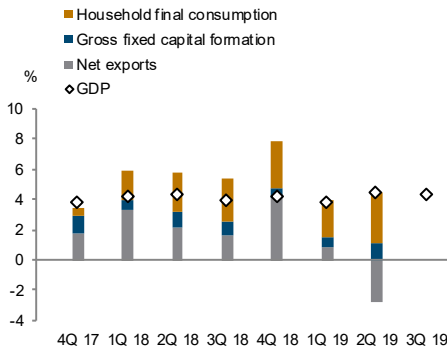
Source: wiiw Monthly Database incorporating Eurostat and national statistics.

Baseline data, country-specific definitions and methodological breaks in time series are available under:

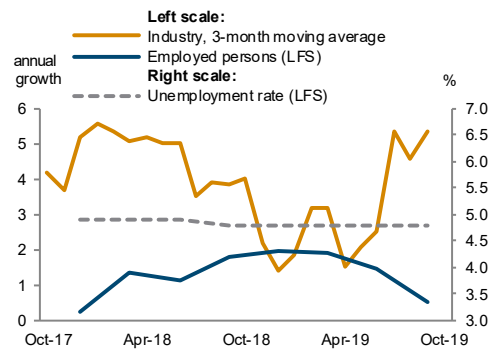
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Kazakhstan

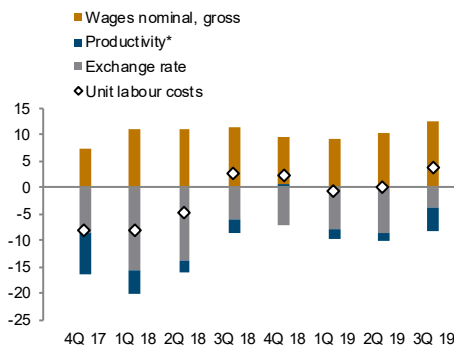
Real GDP growth and contributions
year-on-year



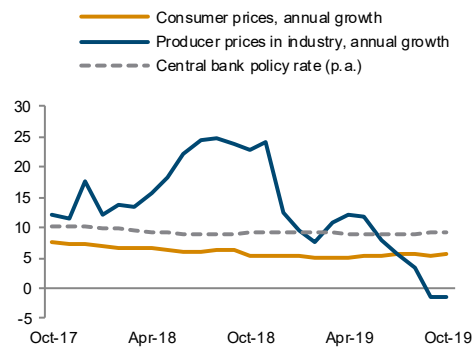
Real sector development
in %



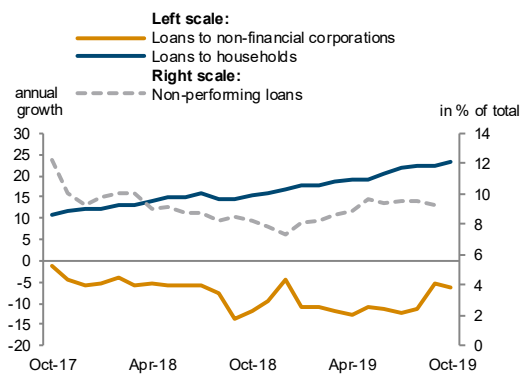
Unit labour costs in industry
annual growth rate in %



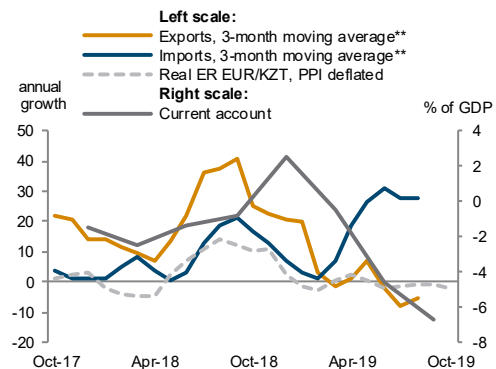
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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**EUR based.

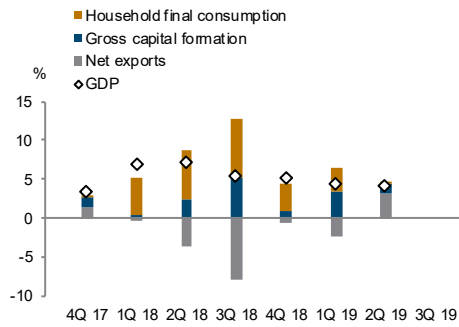
Source: wiiw Monthly Database incorporating Eurostat and national statistics.

Baseline data, country-specific definitions and methodological breaks in time series are available under:

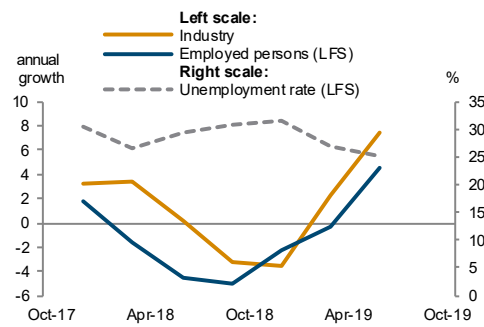
<https://data.wiiw.ac.at/monthly-database.html>

Kosovo

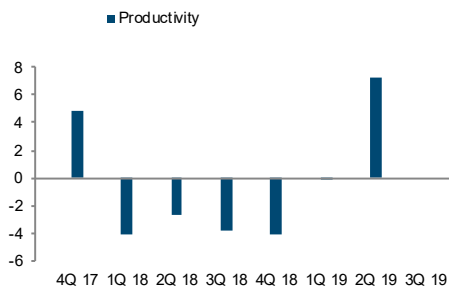
Real GDP growth and contributions
year-on-year



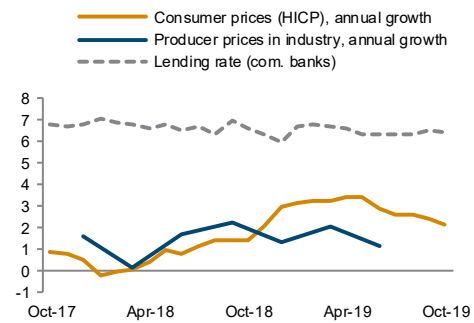
Real sector development
in %



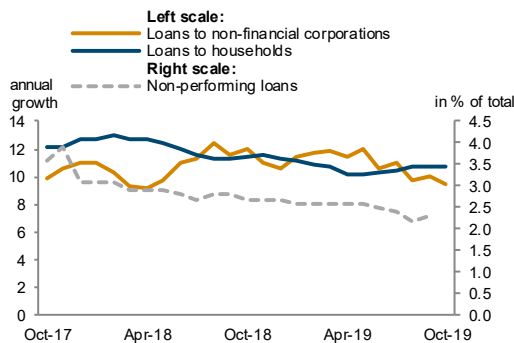
Productivity in industry
annual growth rate in %



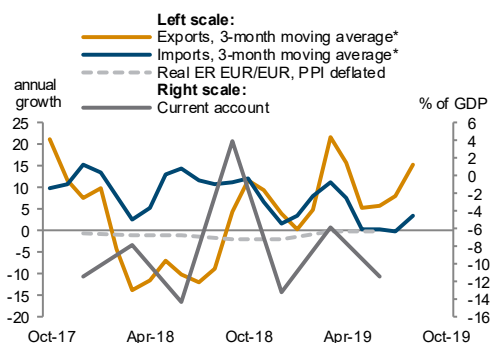
Inflation and lending rate
in %



Financial indicators
in %



External sector development
in %



*EUR based.

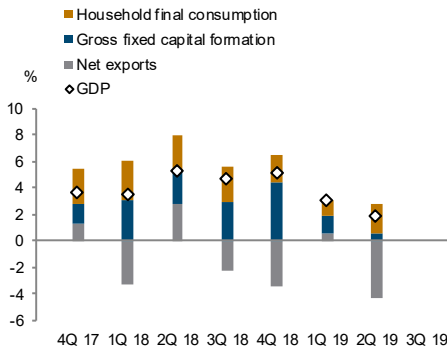
Source: wiiw Monthly Database incorporating Eurostat and national statistics.

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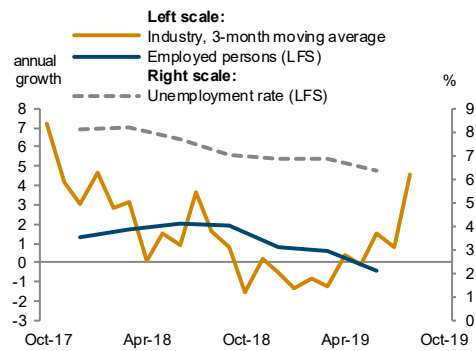
<https://data.wiiw.ac.at/monthly-database.html>

Latvia

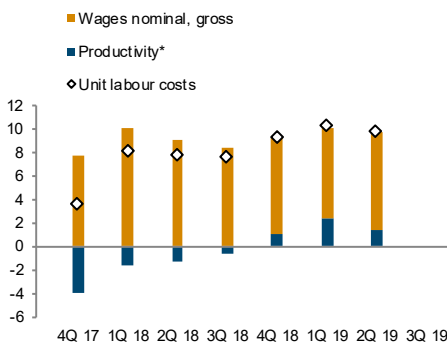
Real GDP growth and contributions
year-on-year



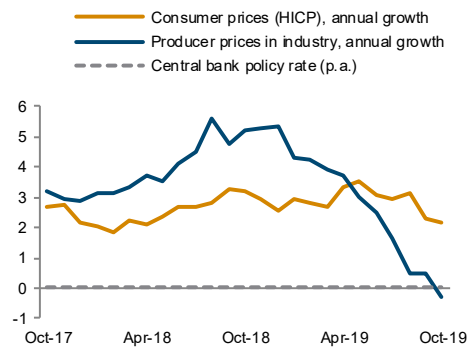
Real sector development
in %



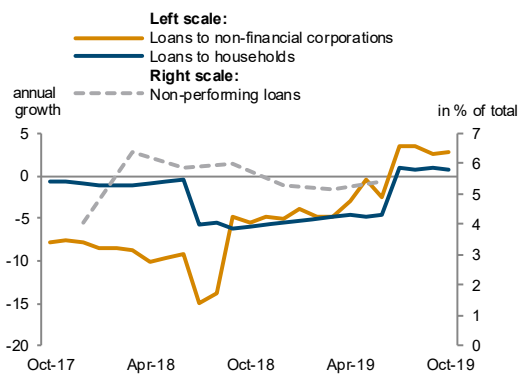
Unit labour costs in industry
annual growth rate in %



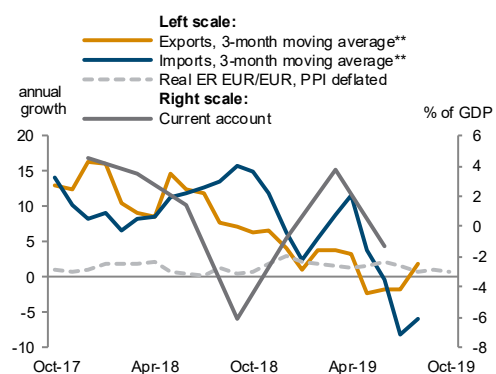
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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**EUR based.

Source: wiiw Monthly Database incorporating Eurostat and national statistics.

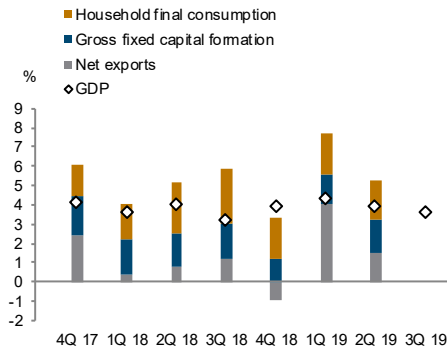
Baseline data, country-specific definitions and methodological breaks in time series are available under:

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Lithuania

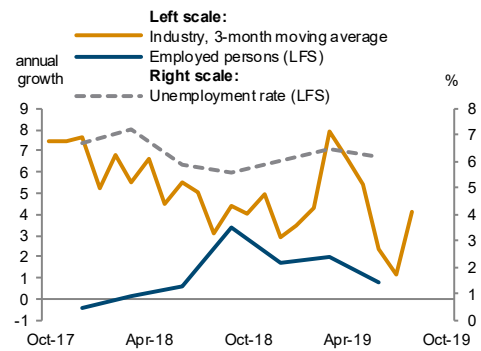
Real GDP growth and contributions

year-on-year



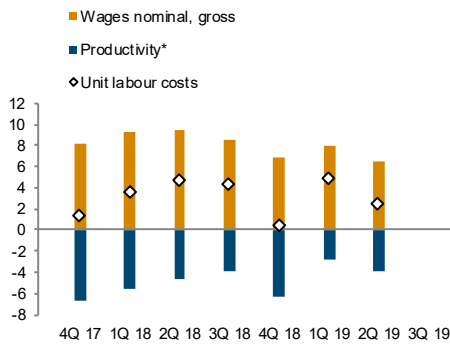
Real sector development

in %



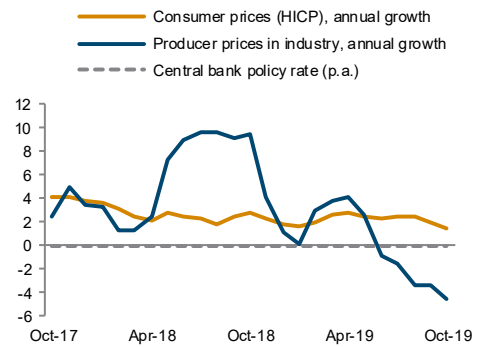
Unit labour costs in industry

annual growth rate in %



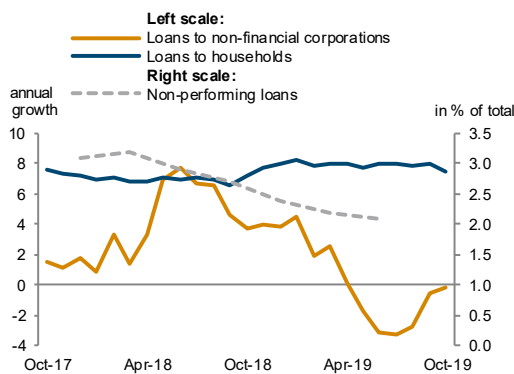
Inflation and policy rate

in %



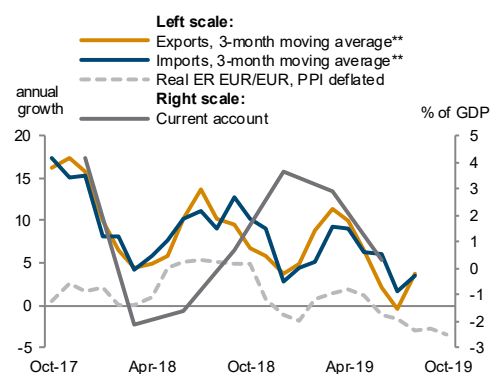
Financial indicators

in %



External sector development

in %



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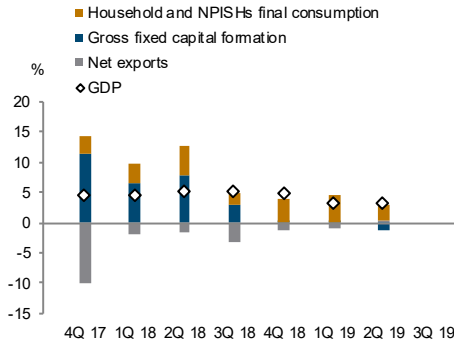
Source: wiiw Monthly Database incorporating Eurostat and national statistics.

Baseline data, country-specific definitions and methodological breaks in time series are available under:

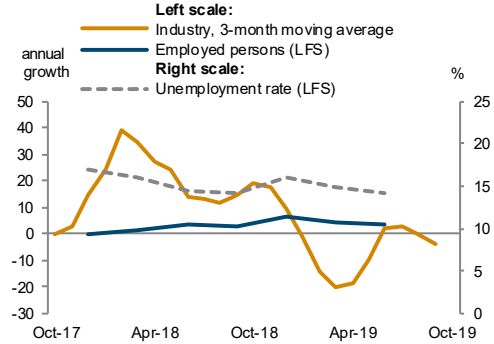
<https://data.wiiw.ac.at/monthly-database.html>

Montenegro

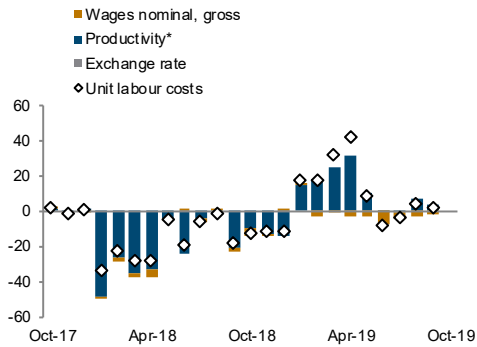
Real GDP growth and contributions
year-on-year



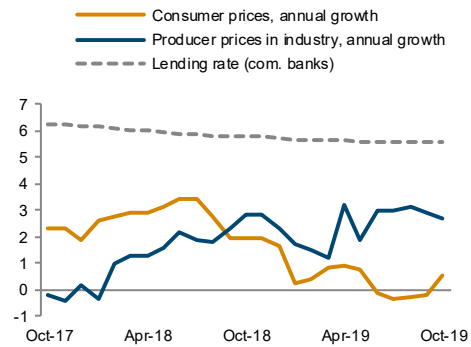
Real sector development
in %



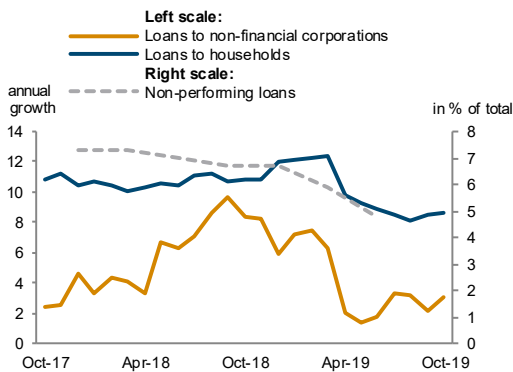
Unit labour costs in industry
annual growth rate in %



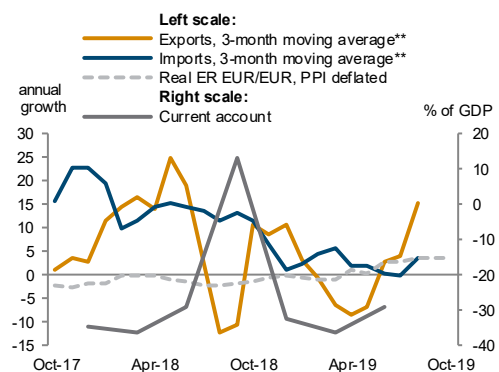
Inflation and lending rate
in %



Financial indicators
in %



External sector development
in %



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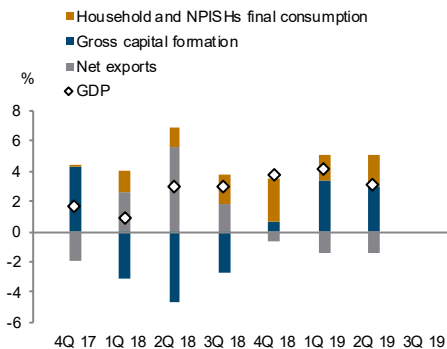
Source: wiiw Monthly Database incorporating Eurostat and national statistics.

Baseline data, country-specific definitions and methodological breaks in time series are available under:

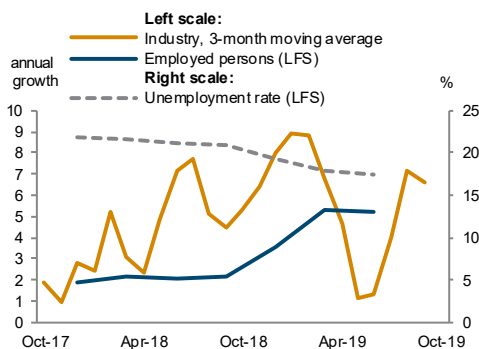
<https://data.wiiw.ac.at/monthly-database.html>

North Macedonia

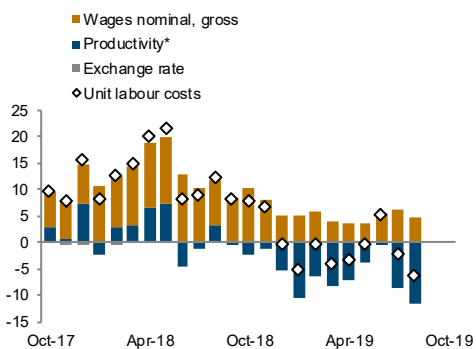
Real GDP growth and contributions
year-on-year



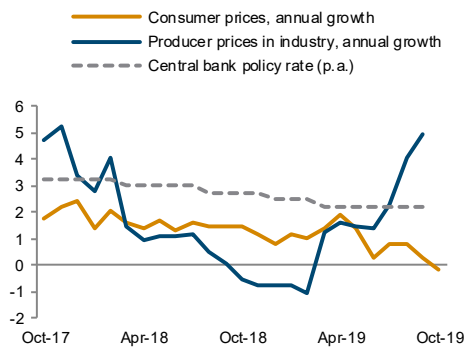
Real sector development
in %



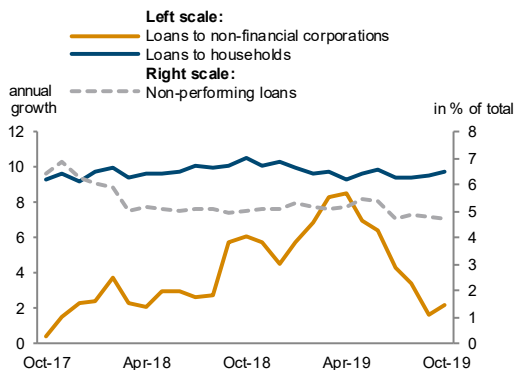
Unit labour costs in industry
annual growth rate in %



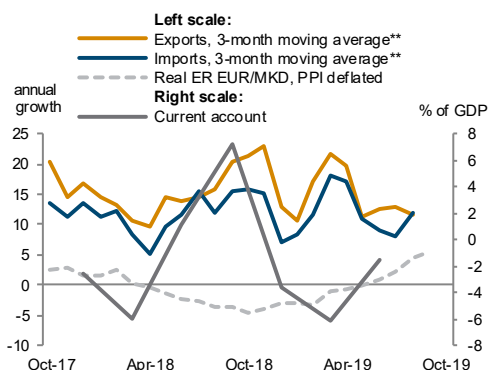
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %

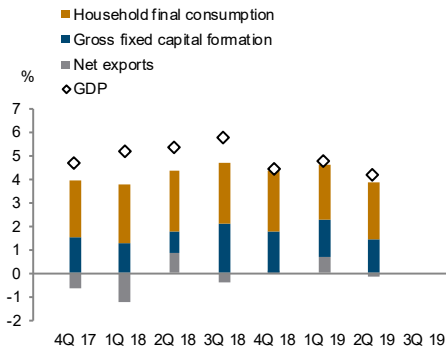


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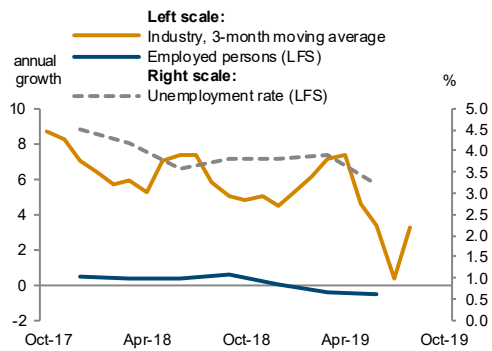
Source: wiiw Monthly Database incorporating Eurostat and national statistics.
Baseline data, country-specific definitions and methodological breaks in time series are available under:
<https://data.wiiw.ac.at/monthly-database.html>

Poland

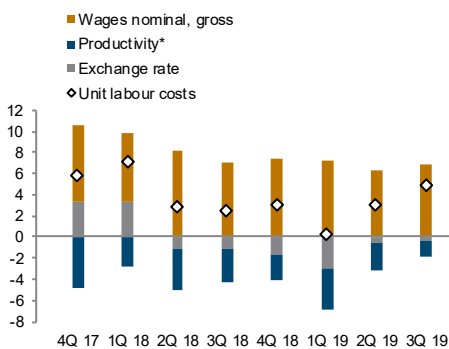
Real GDP growth and contributions
year-on-year



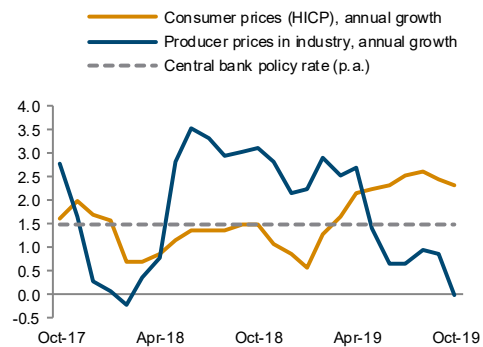
Real sector development
in %



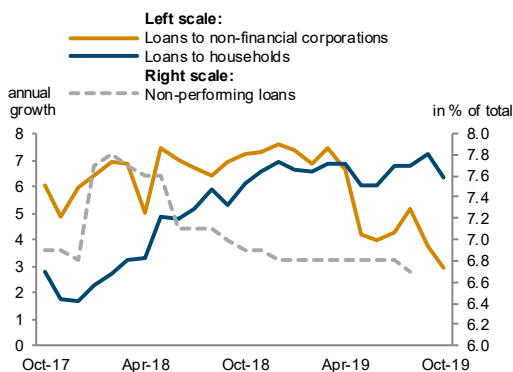
Unit labour costs in industry
annual growth rate in %



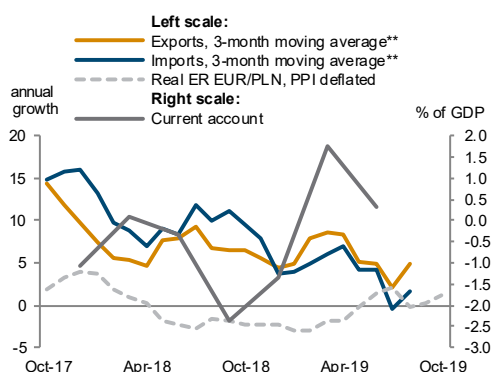
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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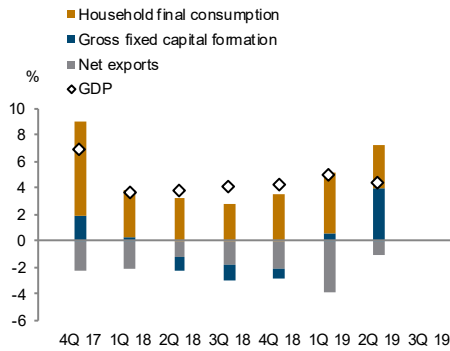
Source: wiiw Monthly Database incorporating Eurostat and national statistics.

Baseline data, country-specific definitions and methodological breaks in time series are available under:

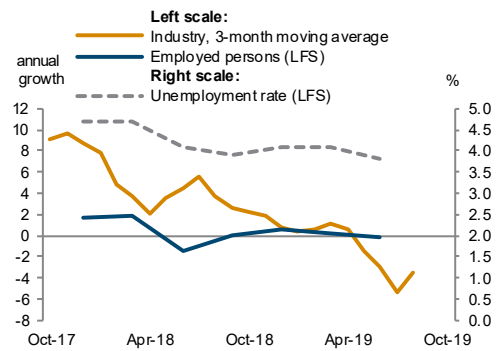
<https://data.wiiw.ac.at/monthly-database.html>

Romania

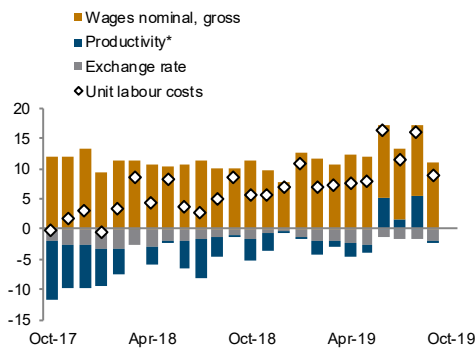
Real GDP growth and contributions
year-on-year



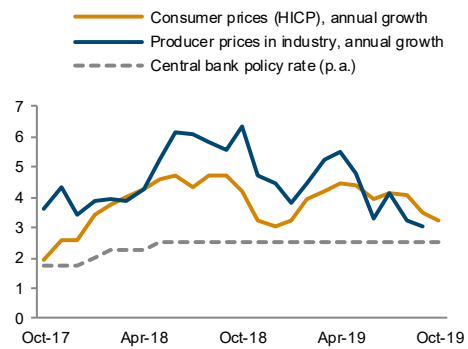
Real sector development
in %



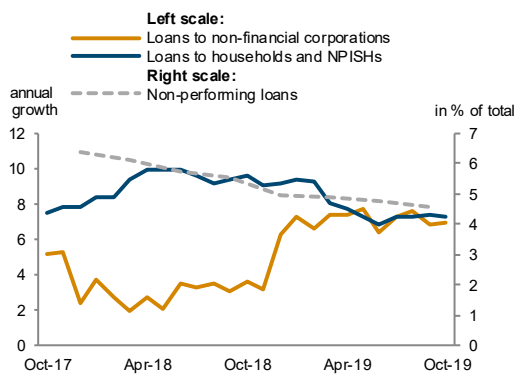
Unit labour costs in industry
annual growth rate in %



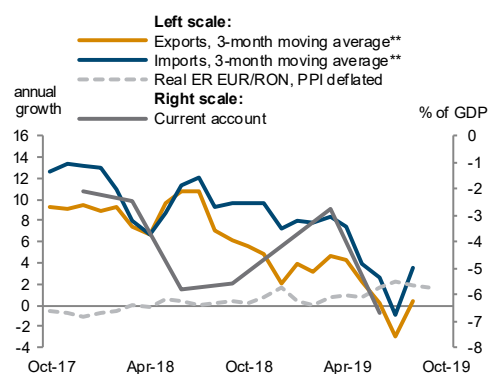
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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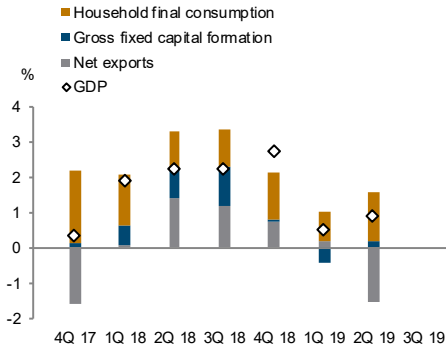
Source: wiiw Monthly Database incorporating Eurostat and national statistics.

Baseline data, country-specific definitions and methodological breaks in time series are available under:

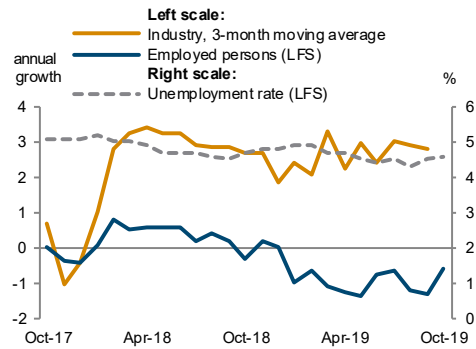
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Russia

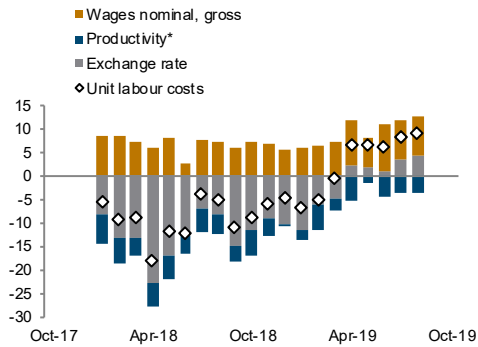
Real GDP growth and contributions
year-on-year



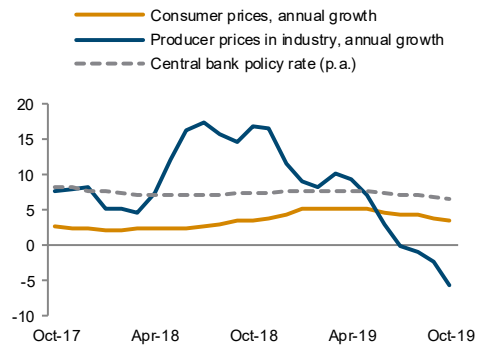
Real sector development
in %



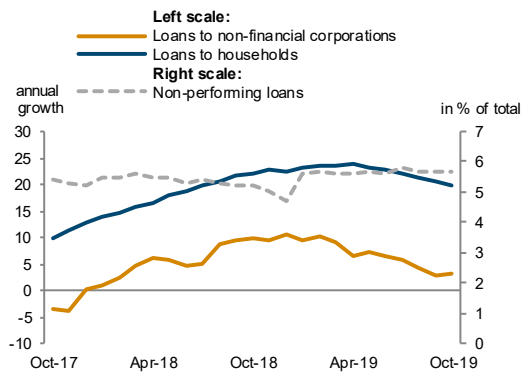
Unit labour costs in industry
annual growth rate in %



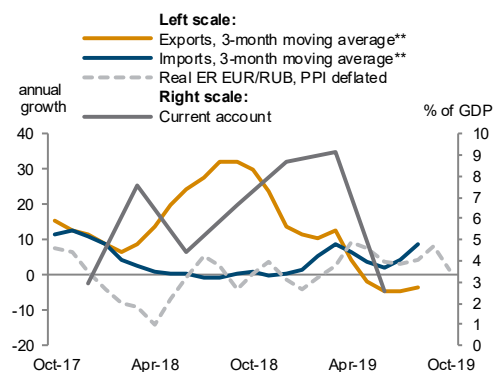
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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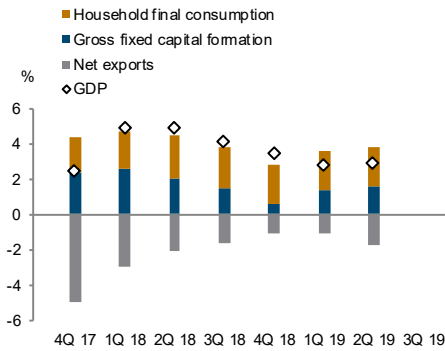
Source: wiiw Monthly Database incorporating Eurostat and national statistics.

Baseline data, country-specific definitions and methodological breaks in time series are available under:

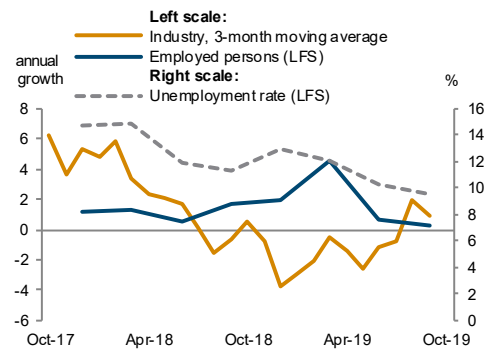
<https://data.wiiw.ac.at/monthly-database.html>

Serbia

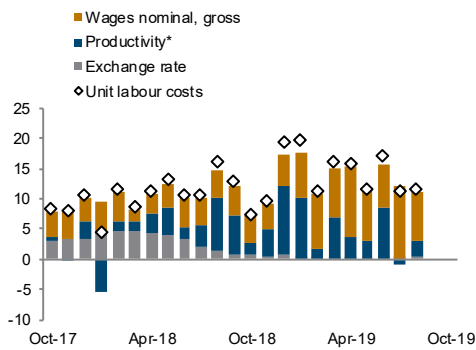
Real GDP growth and contributions
year-on-year



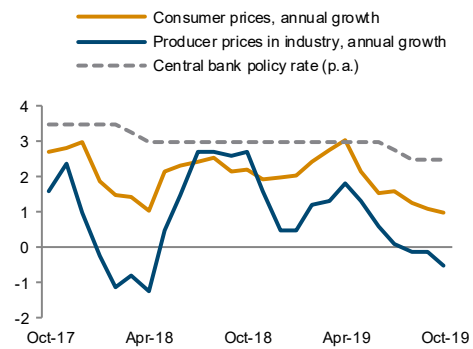
Real sector development
in %



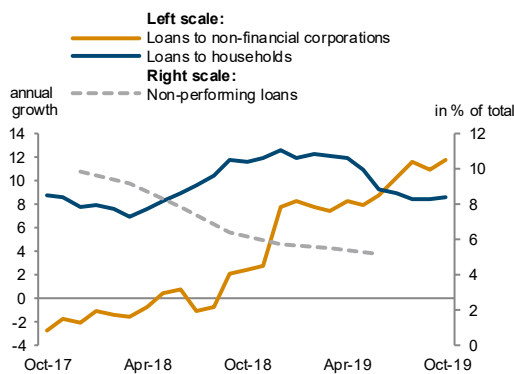
Unit labour costs in industry
annual growth rate in %



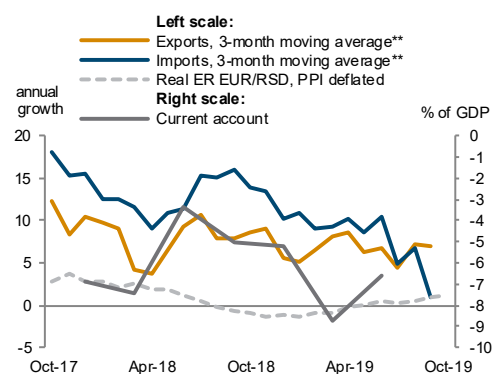
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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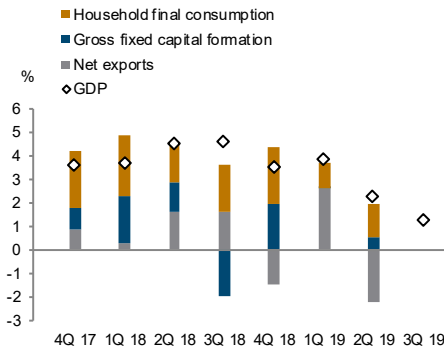
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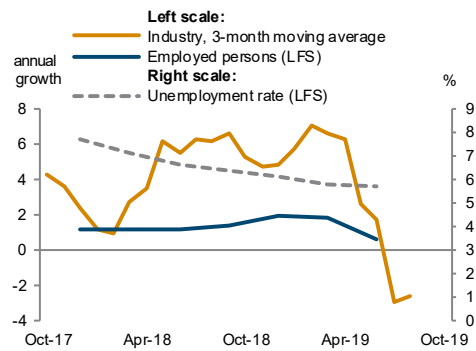
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Slovakia

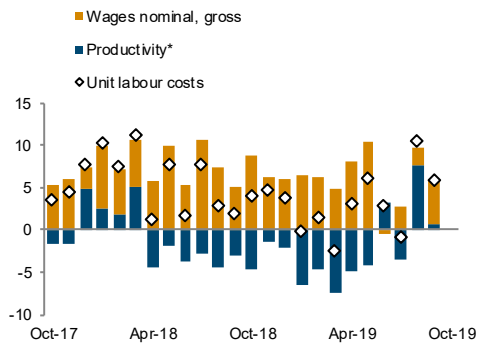
Real GDP growth and contributions
year-on-year



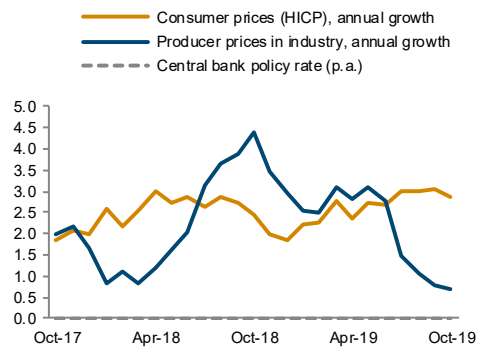
Real sector development
in %



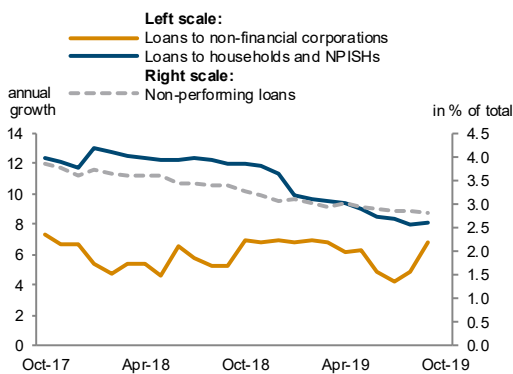
Unit labour costs in industry
annual growth rate in %



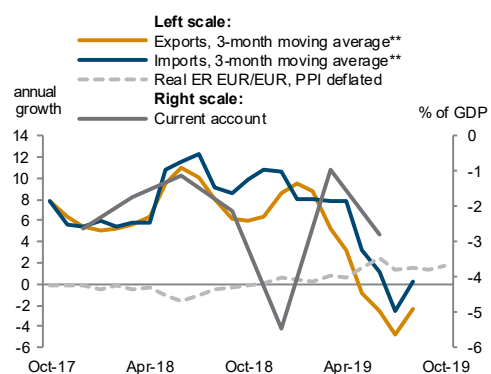
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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Source: wiiw Monthly Database incorporating Eurostat and national statistics.

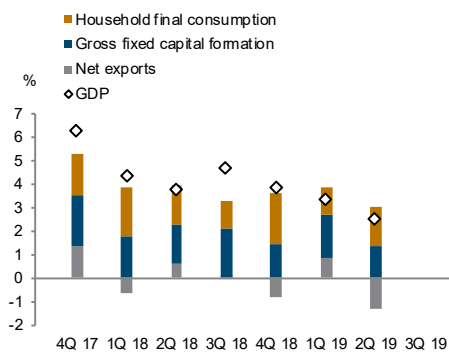
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Slovenia

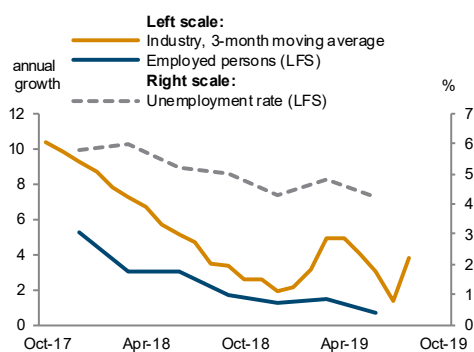
Real GDP growth and contributions

year-on-year



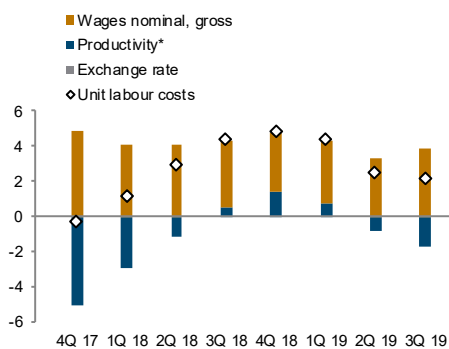
Real sector development

in %



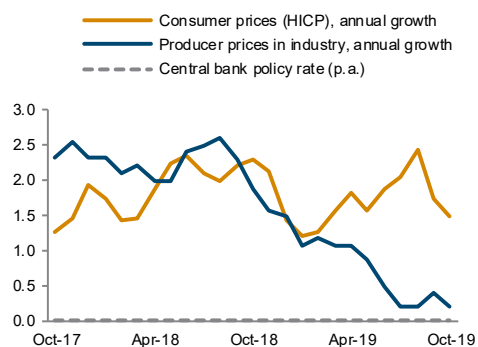
Unit labour costs in industry

annual growth rate in %



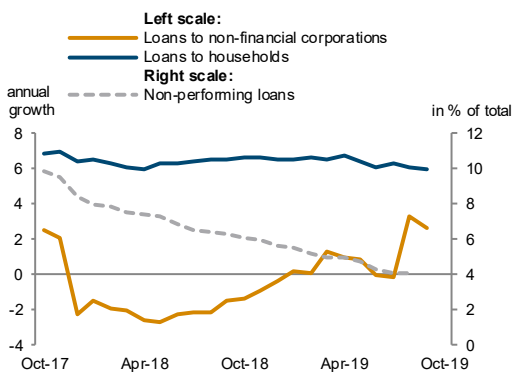
Inflation and policy rate

in %



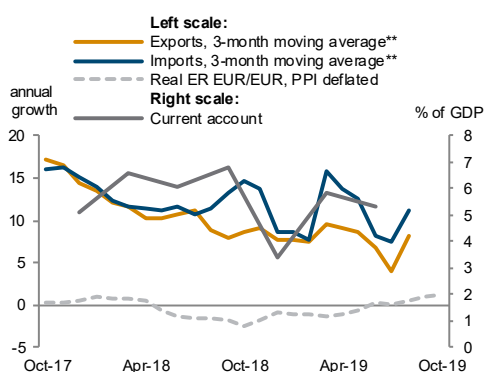
Financial indicators

in %



External sector development

in %



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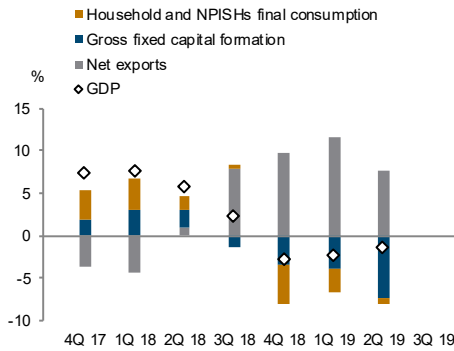
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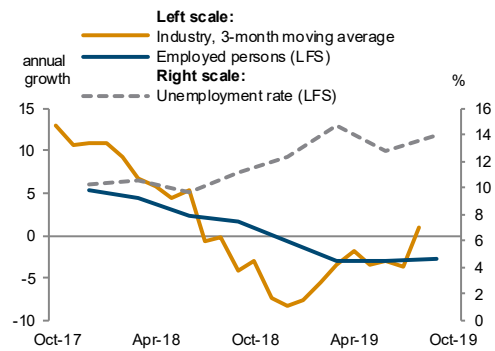
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Turkey

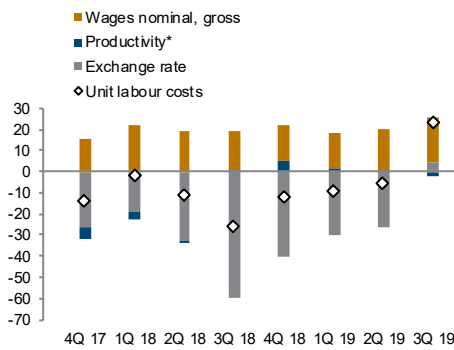
Real GDP growth and contributions
year-on-year



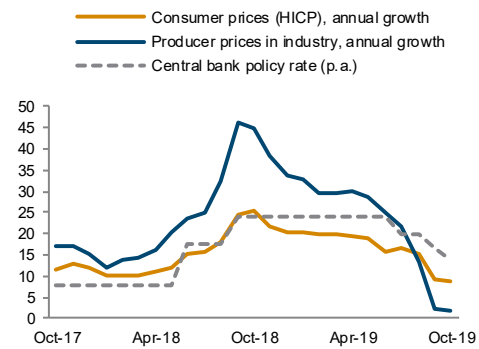
Real sector development
in %



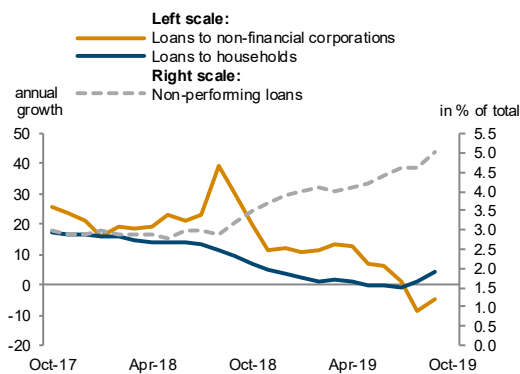
Unit labour costs in industry
annual growth rate in %



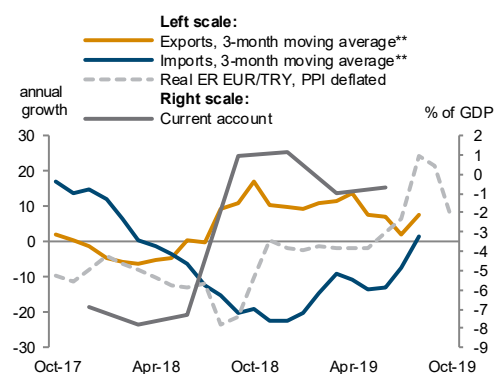
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Financial indicators
in %



External sector development
in %



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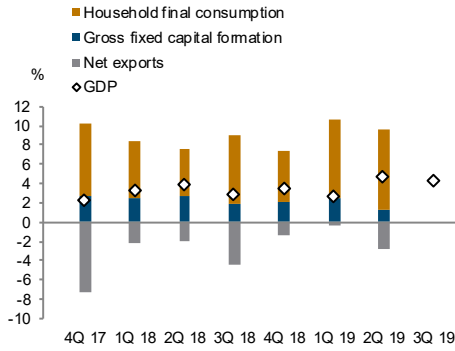
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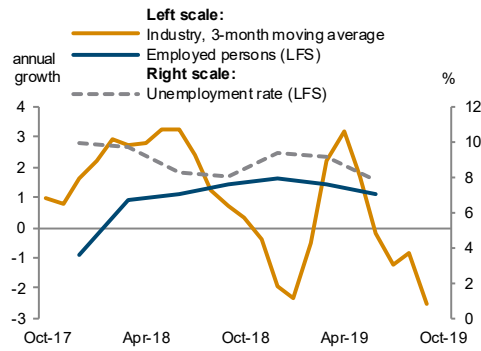
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Ukraine

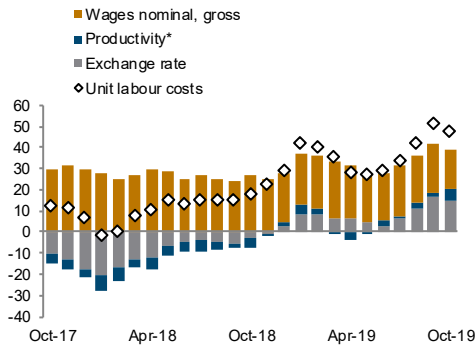
Real GDP growth and contributions
year-on-year



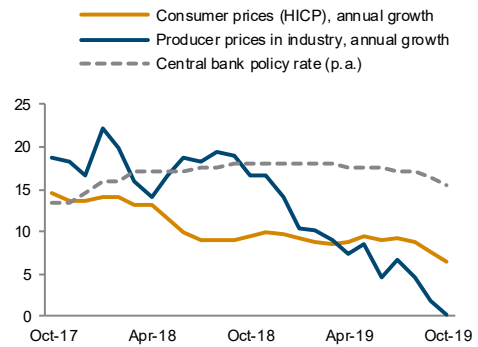
Real sector development
in %



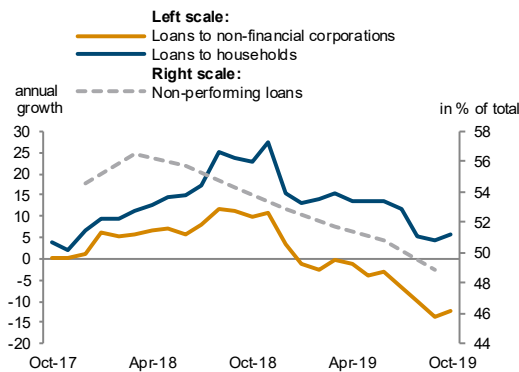
Unit labour costs in industry
annual growth rate in %



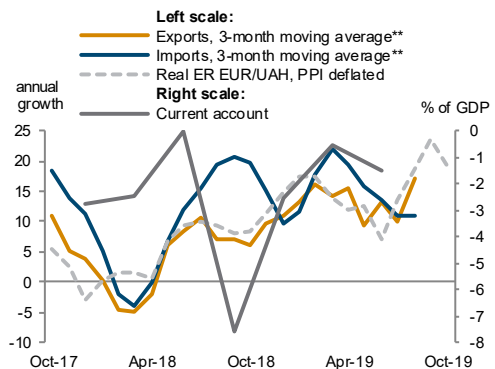
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