Options for restoring growth in Europe

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Outline

• The road to recovery
• Unresolved imbalances
• Growth and reforms
• Institutional design and governance
• Where do we go from here
Key points

- The outlook for the Euro area has improved, but growth remains problematic in crisis countries.

- Structural reforms “to live with the euro and within the euro” remains critical.

- Rebalancing the Euro area is not only a matter of domestic policies (and politics), but of policy coordination across EMU.

- ‘Full EMU is the only way for the single currency to be sustained and successful.’

- But governance is essential to manage the current phase.
The road to recovery

• The outlook for the Euro area has finally improved
• The recovery, however, appears fragile
• 2013 is likely to be another year of negative growth for the Euro area
• Italy and Spain continue to be in recession
• Growth returns in 2014, but will be modest
## GDP growth* - Germany, France, Italy, Spain, Euro area and European Union

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
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</thead>
<tbody>
<tr>
<td>Italy</td>
<td>-1.5</td>
<td>0.5</td>
<td>1.2</td>
<td>1.4</td>
<td>1.4</td>
<td>1.2</td>
</tr>
<tr>
<td>Spain</td>
<td>-1.6</td>
<td>0.7</td>
<td>1.4</td>
<td>1.5</td>
<td>1.5</td>
<td>1.6</td>
</tr>
<tr>
<td>France</td>
<td>-0.1</td>
<td>0.9</td>
<td>1.5</td>
<td>1.7</td>
<td>1.8</td>
<td>1.9</td>
</tr>
<tr>
<td>Germany</td>
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<td>1.5</td>
<td>1.3</td>
<td>1.3</td>
<td>1.3</td>
<td>1.2</td>
</tr>
<tr>
<td>Eurozone</td>
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<td>1.4</td>
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<tr>
<td>European Union</td>
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<td>1.8</td>
<td>1.9</td>
<td>2.0</td>
</tr>
</tbody>
</table>

Source: IMF * 2013 - 18: forecasts
Unresolved imbalances

- The recession has improved the current account outlook
- The competitiveness gap has narrowed, but not enough
- Labour productivity remains an issue for Italy and Spain
- Italy and Spain continue to be in recession
- Sticky wages prevent adjustment in the labour market
Current account imbalances for the four countries, EA and EU

Source: IMF WEO, 2013
### Percentage change since peak (mid-2008) in unit labour costs to Q1 2013

<table>
<thead>
<tr>
<th>Country</th>
<th>Unit labour costs</th>
<th>Labour Compensation per Employee</th>
<th>Labour Productivity</th>
<th>Employment</th>
<th>Real GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ireland</td>
<td>-16.4</td>
<td>-8.8</td>
<td>9.1</td>
<td>-11.1</td>
<td>-3.0</td>
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<tr>
<td>Greece</td>
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<td>-13.2</td>
<td>-2.8</td>
<td>-18.9</td>
<td>-16.8</td>
</tr>
<tr>
<td>Spain</td>
<td>-8.1</td>
<td>0.7</td>
<td>9.5</td>
<td>-11.1</td>
<td>-2.6</td>
</tr>
<tr>
<td>Portugal</td>
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<td>2.4</td>
<td>8.3</td>
<td>-12.0</td>
<td>-4.7</td>
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<tr>
<td>Cyprus</td>
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<td>0.6</td>
<td>2.1</td>
<td>-6.8</td>
<td>-4.9</td>
</tr>
<tr>
<td>Italy</td>
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<td>1.0</td>
<td>-2.7</td>
<td>-1.8</td>
</tr>
</tbody>
</table>

Source: Moody’s, 2013
Real labour productivity per hour worked, 2005-11

Source: Subacchi and Tentori (2013)
Nominal Unit Wages of whole economy (Index, 2008 = 100)

Source: Oxford Economics, 2013
Unemployment Rate - Selected Euro area countries

Source: Oxford Economics, 2013
Focus on Italy

- Long-standing problems and problematic fiscal position pre-date EMU
- Years of inappropriate policies constraint have reduced fiscal space and flexibility
- It is therefore more difficult to respond to crises
- High unemployment and duality in the labour market
- Crisis of manufacturing
Italy’s GDP growth performance during the economic crises of 1992-93 and 2008-09 (%)

Source: Subacchi and Tentori (2013)
The social impact of the crisis

• Focus on Italy and Spain (but even more dramatic impact on Greece)
• High unemployment and drop in disposable income dent into consumer confidence
• Deleveraging and decline in savings
• Impact on investment and consumer demand
• Discontent and ‘dysfunctional’ politics
Risk of poverty and social exclusion and its components (percentage change between 2008 and 2011)

Source: IMF 2013
Note: AROP: at-risk-of poverty rate (60% of median income); SMD: severe material deprivation; LWI: people (0 – 59 not students) living in households with zero or very low work intensity; AROPE: at-risk of poverty or exclusion rate (union of all three indicators).
France as a pivot

- Output flatlined in 2012
- Recovery expected in 2013, but hampered by lack of flexibility
- Labour costs higher, and risen faster, than in Italy and Spain
Labour Cost per Hour - Selected Euro Area Countries
(Index, 2010Q1=100, total economy)

Source: IMF, 2013
France losing competitiveness

• Current account deficit widening
• Market share falling
• Employment rate for younger and older workers poor
• But some progress on structural reforms to the labour market
Employment Rates by Age Group
(Employment in percent of the population age group, average 2005-2011)

Source: IMF, 2013
Note: * Best performing countries include Australia, Canada, Denmark, Iceland, New Zealand, Norway, the Netherlands, Switzerland, and the UK.
Germany: from the sick man of Europe to the dynamo of growth

- Painful reforms in the 2000s put Germany in a strong competitive position
- Contracting out to the East reinforced this
- And the single currency avoided erosion of those gains
- Export-driven growth resulted in a current account surplus of 7% of GDP
Germany’s REER based on relative unit labour cost (Index, 2005=100)

Government Deficit/Surplus as % of GDP (actual)

Source: Eurostat
Unemployment - Selected Euro Area Countries

Source: Oxford Economics, 2013
Euro Area design issues

- Break-up of the euro seems unlikely
- But the euro also needs to work better to deliver sustainable growth
- Fiscal policy should be better coordinated across the area to avoid a deflationary bias
- Well-functioning monetary policy requires greater convergence across the area
- ‘Banking union’ will entail fiscal burden-sharing to resolve failing institutions
- Coordination of structural policies will remain largely a national matter, but the Commission may need stronger powers to limit negative spillovers
Conclusions

• Restoring growth is key to the stability of the euro

• Italy and Spain will continue to find the constraints of the single currency difficult

• Germany, as the largest member and the greatest beneficiary from the euro, faces a special responsibility

• France also needs changes to the euro to support the domestic policy changes it requires

• Without fundamental changes to the governance of the euro area, it is likely to face prolonged slow growth and periodic crises. ‘Full’ EMU is probably the only solution.
Thank you!