Options for restoring growth in Europe

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Introduction

The Draghi doctrine of "whatever it takes to save the euro" has worked well and the last twelve months have been remarkably calm. Outright Monetary Transactions, or OMT, the safety net that the European Central Bank (ECB) has offered to countries in financial difficulties, has managed to contain and reduce market disruption without having to be deployed yet. For Europe's single market and the monetary union, which in 2011 seemed on the verge of collapse, this has marked a significant move away from emergency. The outlook for Europe's Economic and Monetary Union (EMU) however, remains problematic and many structural problems that triggered the crisis are still unresolved. As well as the effects on the countries with crisis programmes (Ireland, Portugal, Greece and Cyprus), the protracted recession that has hit other countries in the Euro Area – notably Italy and Spain – and sluggish growth across Europe have reduced trade imbalances. But fiscal positions have also improved less than expected when austerity programmes began to be implemented in late 2010. The number of people out of work has hit a record high, especially in southern Europe. Discontent with the degree and pace of fiscal consolidation has been on the rise, fueling in some countries, such as Italy and Greece, the development of populist movements and the crisis of traditional parties and politics. Political deadlock, especially in Italy, Portugal and Greece, has made it even more difficult to design and implement policies necessary to restore growth in the short to medium term and to increase productivity growth, and therefore competitiveness, in the longer term through supply side reforms.

Robust growth is urgently needed for both fiscal consolidation and social cohesion. And structural supply-side reforms are the essential element to ensure that countries so diverse in terms of economic development, industrial structure, resource endowment, and institutional framework, can prosper together within the strait-jacket of fixed exchange rates, common monetary policy and constrained fiscal policy. The key challenge of living with and within the euro remains (Subacchi and Pickford, 2012); despite some progress, in particular in the area of fiscal consolidation, more needs to be done to address it.

In this paper we assess where we are and discuss the way forward. Unlike in 2011 the market emergency has abated significantly (at least for the moment) and governments should find it easier to concentrate their political efforts on growth and reforms, rather than on fire-fighting. Even if most economies of Europe, including those badly hit by the post-global financial crisis shock to growth coupled with the sovereign debt crisis, are starting to emerge from recession, the key question is whether the modest recovery in the crisis countries is enough to recover the output lost during the crisis and absorb the large number of unemployed, and whether it can lead to sustained growth. In other words, will these countries have enough growth to be able to live with the constraints imposed by the monetary union without their external and fiscal imbalances starting to grow again?

The growth and reform agenda should not be only a domestic concern. A serious effort of policy coordination needs to be made at the euro/EU level to avoid negative spillovers from domestically-oriented policies in member states, and to help restore growth to the area as a whole. Above all, policy coordination should help rebalancing within the euro area, which implies changes in relative absorption and in relative prices between surplus and deficit countries. In other words, the effort of each deficit country towards a more sustainable fiscal outlook and lower external deficits, while seeking to raise growth, would be less effective, or even impossible, without a sufficient increase in spending and adjustment in relative prices in surplus countries. Greater coordination should also help to reduce policy uncertainty at both national and euro area levels, which is essential to rebuilding the confidence of companies and households.

Compared to just two years ago, there is now more awareness of the constraints imposed by being part of EMU. It has also become evident that the monetary union needs more than just a governance framework to avoid free riders and moral hazard, and to justify and even enforce solidarity among member states. A fiscal union, or even a political union, seems an inevitable part of the end-game. How the transition to a stronger union will be managed and what it will look like is not clear. One thing is sure, however, that the transition is likely to be a long, painful and frustrating process. Effective and swift decision-making is not the Euro Area's strongest point – and nor is it likely to be with 17, and soon to be 18, member states around the table, each with its own domestic agenda and concerns. But the transition will need to be managed somehow in order to prevent further crises, support growth and move to the next stage on this road.

The paper is organised as follows. It firstly assesses the economic outlook for the euro area two years after the peak of the euro crisis. Imbalances between surplus and deficit countries remain fundamentally unaddressed, and recent reductions in the external deficit in some countries are largely the result of sluggish growth and even recession. The paper then focuses on the four major economies: Germany, France, Italy and Spain.[1] In Spain and Italy economic malaise and political deadlock (or inertia) have resulted in overall stagnation and lack of confidence. France has fared somewhat better, having started with a more sustainable economy, and managed to go through the euro crisis fairly unscathed; but it may now have reached the point where structural reforms and other policy changes can no longer be postponed if it is to survive and prosper within the single currency. Germany by contrast is the country that has benefited most from the euro. It has suffered least in terms of recession, and has run substantial external surpluses. Given its relative strength, its size and its status as the main fiscal contributor, its position will continue to determine the future of the euro. Finally the paper concludes by looking at how EMU can and should address the challenge of reforming its institutional design and governance framework. Policy coordination is needed to reduce imbalances and to put together the building blocks – financial, fiscal, political – of a sustainable union.

1. Europe: the road to recovery

The economic outlook for much of the euro area seems to have finally started to improve. According to the latest figures from Eurostat, in the second quarter of this year the euro area finally came out from an 18-month long recession thanks to the better than expected quarterly GDP growth of both Germany (+0.7%) and France (+0.5%). Portugal did even better with a 1.1% increase in GDP. The recovery, however, appears fragile as some of the factors that have supported GDP growth in recent months seem to be one-off. In Germany, for instance, significant inventory rebuilding has supported growth; but this might not continue in the months ahead. Indeed GDP growth for the third quarter of 2013 was weaker at 0.3% year-on-year.[2] In addition the recovery does not look broad based as there are

[1] As the paper focuses on intra-EMU dynamics, we have chosen not to discuss the crisis and post-crisis outcome for Ireland, Portugal, Greece and Cyprus. These countries provide the context where the sovereign debt crisis developed, and of course they are referred to in our analysis. However, our key assumption is that they are small enough to be rescued, while this would not be the case for Italy and perhaps for Spain.

[2] Growth in Portugal was also disappointing in Q3, at 0.2%, while French GDP posted a 0.1% drop (Eurostat).

significant differences in the economic outlook among EMU member states. The outlook for Italy and Cyprus also remains problematic. In the third quarter of 2013 these countries saw their economies contract by 0.1% (Italy) and 0.8% (Cyprus). For Spain the outlook is slightly more promising, with a 0.1% quarterly GDP increase (Eurostat). The outlook for the euro area is also affected by some significant uncertainties for the world economy. The IMF (2013a) projects a 2.9% increase in total GDP this year and 3.6% next, but the recent government shut-down, and the continuing stand-off on the budget, in the United States, and market volatility in emerging market economies could significantly change this outlook.

Even assuming an acceleration of GDP growth in the second half of this year, 2013 is likely to be another year of negative growth for the euro area as a whole. The European Commission (2013) and IMF (2013a) both expect a contraction in euro area GDP of about 0.4% this year, because of the contraction in the economies of Italy (-1.8%) and Spain (-1.3%). The outlook for 2014 is finally for a return to growth, with GDP growth around 1.1% according to the European Commission (2013) and 1.0% for the IMF. This would be a relief after such a prolonged and deep recession, but it should not overshadow the fact that the euro area will continue to trail behind other advanced economies like the United States (2.6% GDP growth in 2014 according to the IMF), Japan (1.2%) and even the wider European Union (1.3%). According to the IMF, Italy's economy is expected to grow only modestly at 0.7% while that of Spain is expected to grow by 0.2% in 2014. In the best-case scenario both economies will come out of recession in 2014, although they will need several years and some substantial reforms to achieve robust growth rates that would contribute to recovering some of the losses experienced during the recession (Table 1).

TABLE 1: GDP GROWTH - GERMANY, FRANCE, ITALY, SPAIN, EURO AREA AND EUROPEAN UNION

	2013	2014	2015	2016	2017	2018
Germany	0.5	1.4	1.4	1.3	1.3	1.2
France	0.2	1.0	1.5	1.7	1.8	1.9
Italy	-1.8	0.7	1.1	1.4	1.4	1.2
Spain	-1.3	0.2	1.5	0.7	0.9	1.2
Euro Area	-0.4	1.0	1.4	1.5	1.6	1.6
European Union	0.0	1.3	1.6	1.8	1.8	1.9

Source: IMF, 2013a

2. Unresolved imbalances: surplus countries and deficit countries

The area of greatest improvement is the reversal in current account imbalances of Italy, Spain, Portugal, Greece and Cyprus. At the end of 2012 these countries had restored their current account balances to mid-1990 levels (-1.0% on average). Ireland, Portugal and Spain are likely to be in surplus by the end of 2013. Improvements in the trade balance have driven the narrowing of current account deficits, mainly due to a drop in imports (although exports have been expanding in recent months). In any case, these countries need much more than a modest recovery in exports to bring their economies back to pre-crisis levels – and in the case of Italy, pre-EMU levels. In particular, the differential in competitiveness with Germany – measured by relative unit labour costs – has been narrowing in the case of Ireland, Portugal, Greece and Spain (although for the latter at a slower pace). In the case of Italy, however, unit labour costs have continued to rise. This is problematic since Italy's manufacturing sector, especially in precision machinery and machine tools (about 20% of Italy's total exports) is in close competition with Germany's.

Competitiveness gains in the euro area periphery mostly reflect productivity gains since falling output has been accompanied by even more rapid falls in employment (Table 2). Ireland and Greece have also made substantial progress in reducing their labour costs (wages) due to a very weak labour market. However, the core countries have also recently largely managed to contain increases in their own unit labour costs, thus limiting the relative competitiveness gains of the periphery.

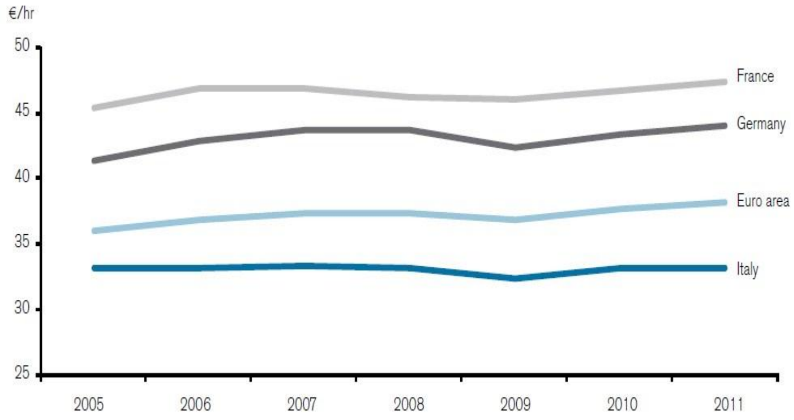
TABLE 2: PERCENTAGE CHANGE SINCE PEAK (MID-2008) IN UNIT LABOUR COSTS TO Q1 2013

	Unit labour costs	Labour compensation per employee	Labour productivity	Employment	Real GDP
Ireland	-16.4	-8.8	9.1	-11.1	-3.0
Greece	-15.3	-13.2	-2.8	-18.9	-16.8
Spain	-8.1	0.7	9.5	-11.1	-2.6
Portugal	-5.5	2.4	8.3	-12.0	-4.7
Cyprus	-1.4	0.6	2.1	-6.8	-4.9
Italy	4.3	5.4	1.0	-2.7	-1.8

Source: Moody's, 2013

Low productivity growth explains why the economies of Italy and Spain, as others in southern Europe, accumulated large and significant imbalances during the years that followed the creation of Europe's monetary union. Both countries also took advantage of the historically low interest rates within EMU: Spain experienced credit-driven growth and the housing boom, and Italy used public spending to support sluggish growth and postpone structural reforms. Both countries are now finding it difficult to compete with other countries within Europe's monetary union. Italy, for instance, in the pre-EMU years turned to competitive devaluations to avoid the implementation of politically difficult, but economically necessary, structural reforms to improve the productivity of its domestic labour market. As a result labour productivity growth has been low for the past 20 years, averaging an annual rate of 0.9% (Cipollone 2012). In particular, between 2005 and 2011 Italy's real labour productivity growth was the weakest among the main European countries, and well below the euro area average (Figure 1). During the same period labour market rigidities also constrained adjustments and resulted in unit labour costs that are approximately 10% higher than the euro area average, and as much as 25% higher than in Germany (OECD, 2013). Also multi-factor productivity, calculated as the difference between the rate of change of total output and the rate of change of total inputs (also taking into account the stock of capital), recorded negative growth overall in the period 2005–10 (-0.45%, according to OECD, 2013).

FIGURE 1: REAL LABOUR PRODUCTIVITY PER HOUR WORKED, 2005-11



Source: Subacchi and Tentori (2013)

Spain has been experiencing the same dynamics in the labour market, with nominal wages growing more strongly than in other countries in the euro area (including Italy). Wage inflation in the private sector has moderated since the financial and banking crisis as the labour market reforms implemented in 2012 gave firms more flexibility to adjust working conditions.[3] Even so, wage inflation has not slowed down enough to reflect the excess supply of labour. Wages in the private sector have grown 10% between 2008 and 2012 (in line with the euro area). Productivity grew by almost 10% over the same period but, given the fall in output, employment fell 15% (much more than in the euro area as a whole) (OECD 2013), exacerbated by a real exchange rate that is currently overvalued by 8-12% according to the IMF's calculations (2013b).

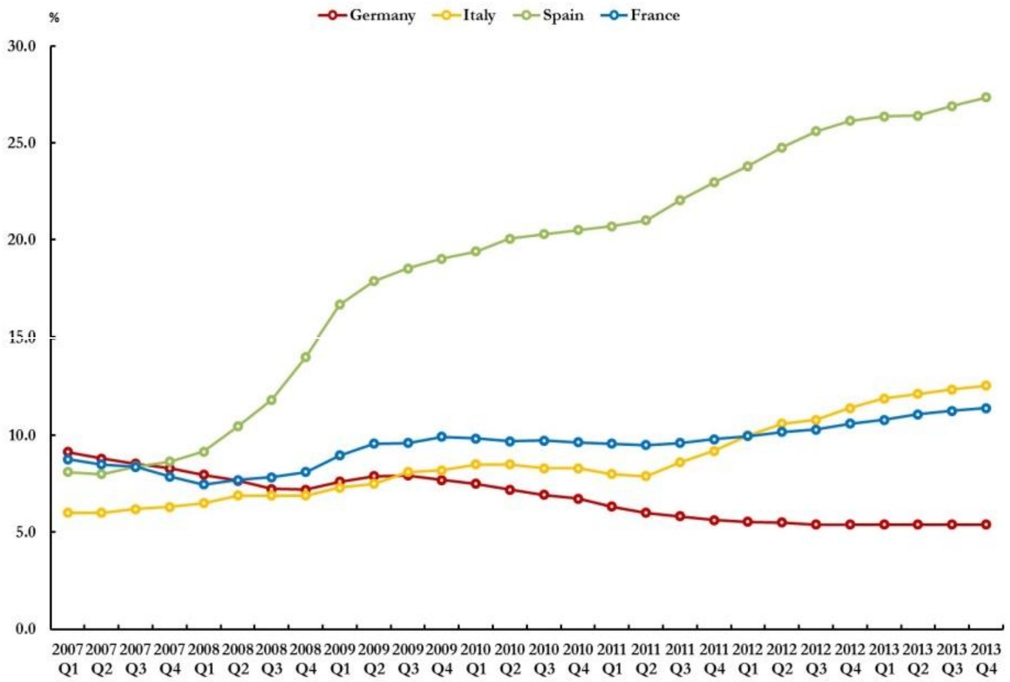
Wage moderation has recently been introduced in Italy with the 'freezing' of collective bargaining.[4] In addition, the labour market reforms adopted by the government of Mario Monti in 2012 introduced an adjustment mechanism that aims to establish a link between wages and productivity. It is not yet certain, however, how this will work in practice (OECD 2013). The Monti reform also aims at increasing flexibility in terms of entry into and exit from the job market while reducing the cost of individual dismissals and promoting apprenticeships, training and more permanent contracts for young workers through tax incentives. As the German case shows, a higher degree of flexibility would also help retain experienced workers and therefore skills (Schindler 2013). However, the impact of this reform on GDP growth is relatively modest since it seems to mainly increase labour supply; further measures to boost labour demand and job creation are also needed (Lusinyian and Muir 2013).

Germany, on the other hand, implemented effective labour market reforms in the 2000s. These helped turn the 'sick man of Europe' into the euro area's strongest performer, enjoying falling unemployment and increased productivity (Krebs and Scheffel 2013). The policies implemented between 2003 and 2005 through the creation of 'short-time contracts' (Roxburgh and Mischke 2011) had the advantage of maintaining skills in the labour market and reducing the unemployment rate from 11.3% in 2005 to 5.5% in 2012 (Figure 2). Between 2005 and 2010 unit labour costs in real terms were effectively capped, thereby creating internal deflation that resulted in a more competitive real exchange rate.

[3] For example firms have now more flexibility to reduce working hours instead of cutting jobs. The share of "objective dismissals" has increased and dismissal costs have fallen (IMF 2013b)

[4] It remains unclear whether this strategy would be effective in enhancing real competitiveness, especially if it is mainly implemented in non-tradable sectors such as public administration, rather than in tradables sectors such as manufacturing (Bank of Italy 2013a).

FIGURE 2: UNEMPLOYMENT RATE – SELECTED EURO AREA COUNTRIES



Source: AMECO

3. Italy and Spain: social tensions, political deadlock and difficult reforms

3.1 Long standing problems

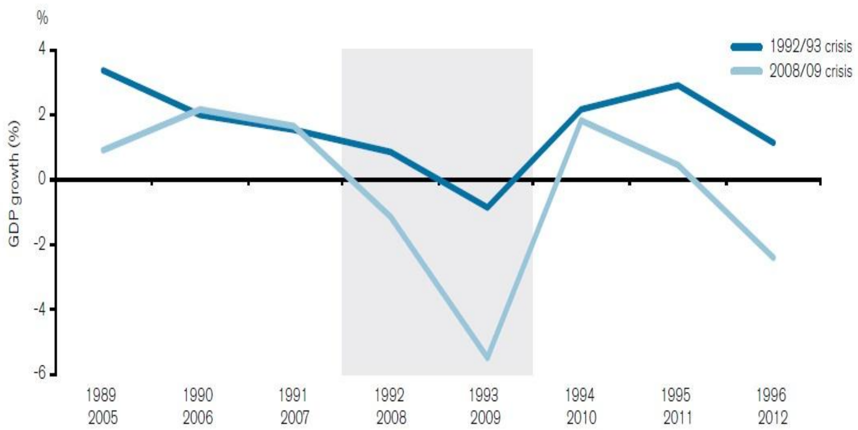
Italy is EMU's third largest economy, has the largest public debt and is perhaps Europe's most problematic country because of the size of its debt, its chronic slow growth and its dysfunctional politics that hinders the introduction of better economic policies and long-term structural reforms. Italy has been hit hard by a double-dip recession, and prospects for economic growth remain disappointing (OECD 2013). The country's difficulties in responding to shocks and moving swiftly out of recession result from years of inappropriate policies which have reduced fiscal space and flexibility in the whole economy. Italy's current malaise is a story of high economic potential that has been wasted.

After the '*miracolo economico*' of the 1960s and years of sustained growth in the 1970s and 1980s, policies were aimed at getting short-term political consensus, with the consequence that excessive public spending was tolerated or even encouraged. While economic growth slowed, the size of the public debt expanded. Competitive devaluations through the 1980s and the 1990s before Italy joined the European single currency masked structural problems and Italy's inability to respond to the opening up of the world economy. Loss of competitiveness thus constrained economic growth. In addition, fiscal policies were focused on nominally fulfilling the targets set by the European institutions rather than creating the required fiscal space to allow counter-cyclical policies during a crisis, especially as monetary policy was no longer an independent instrument for EMU member states.

At the heart of the current problems are policy choices that were made many years ago and proved to be unsustainable in the long run. Policies were driven more by short-term political pressures than by forward-looking considerations. For instance, from 1980 to 1990 the central government public expenditure to GDP ratio rose from 41% to 53% (OECD 2013) and the public debt to GDP ratio nearly doubled, from 54% to 96% (Reinhart & Rogoff 2010). This triggered a progressive deterioration of macroeconomic indicators, which resulted in the narrowing of fiscal space and of Italy's ability to respond to shocks. In addition Italy wasted the opportunity offered by the lowering of interest rates that came with the introduction of the euro, while the current account deficit deteriorated significantly in the years after the creation of EMU. In the years before joining EMU, from 1990 to 1998 yields on 10-year bonds averaged 10.5%. Between 1999 and 2008 they were 4.5%. The current account deteriorated significantly after the global financial crisis, from -2.9% of GDP in 2008 to to -3.5% in 2010, but it has recovered up to -0.7% in 2012 (European Commission 2013).

The outcome of two crises, in 1992–93 and 2008–09, illustrates this point (Figure 3). In the first case, the response was strong and fast, partly because of the different nature of the crisis which implied a sharp devaluation of the Italian lira, but mainly because both policy instruments, monetary and fiscal, were available to domestic policy-makers and offered a way out of recession in the short run. In 2008–09 the domestic authorities had less room for manoeuvre. Monetary policy was by then in the hands of the European Central Bank (ECB) and the use of fiscal policy was limited by the already high debt and deficit levels. Inappropriate and often reckless policies in the previous two decades had contributed to the narrowing of the fiscal space, which was further constrained by the parameters imposed by EMU membership. As a result, during the years that followed the global financial crisis Italy faced both a collapse in economic growth and a deteriorating fiscal position (both deficit and debt) – even though the stimulus package implemented in February 2009 was much smaller than those of other countries.

FIGURE 3: ITALY'S ECONOMIC PERFORMANCE DURING THE ECONOMIC CRISES OF 1992-93 AND 2008-09



Source: Subacchi and Tentori (2013)

Spain has been struggling for years with high unemployment and a dual labour market split between people with permanent jobs, extensive benefits and high dismissal costs, and those with temporary jobs, no benefits and low dismissal costs. The post-EMU and pre-crisis years saw strong GDP growth generated on the back of excessive credit growth and a booming real estate sector as interest rates fell close to the euro area average. As a result the unemployment rate dropped to 8.3% in 2007 from 17.8% in 1997 (IMF 2013b).

But excessive credit growth and financial imbalances proved to be unmanageable, and in the aftermath of the global financial crisis the real-estate bubble burst. The bubble, fed by credit to the private sector, increased private indebtedness to more than €1 trillion in 2010 (or 65% of GDP). Euro membership saw a large fall in Spain's external competitiveness, and it became dependent on its domestic sector for growth. The recession in 2008-2009 was mainly due to the fall of domestic demand (-8% in 2009, Banco de España 2012). The crisis made urgent the need for a structural rebalancing towards the production of tradable goods.[5]

The bail out of the banking sector seriously undermined Spain's fiscal position and its ability to undertake counter-cyclical measures to support growth. As a result GDP dropped by 3.7% in 2009 and by 1.4% in 2012. In the same year the unemployment rate rose to 25.1% while the rate of youth unemployment was 53.2%.[6]

Labour market reform in 2012 helped create more flexibility,[7] but it has not addressed the duality in the labour market. As wages remain too sticky, the burden of adjustment falls on employment (especially temporary and youth). Many people cannot find a permanent job and face constant uncertainty as the probability of losing a temporary job is high. Recruitment under new permanent contracts was only a small fraction of total hiring, accounting for less than 1% of contracts in the last 12 months (IMF 2013b).

It has been estimated that the Spanish economy generates net employment growth only when output grows by more than 1.5-2% (IMF 2013b). As GDP growth is likely to remain modest (at around 1-1.5%) in 2015 and 2016, high unemployment rates – i.e. above the structural level of 18% – will persist until the end of the decade unless there is a significant improvement in labour market dynamics with greater relative adjustment in wages.

3.2 The social impact of the crisis

In both Italy and Spain the financial crisis, the recession, high unemployment and fiscal austerity have damaged the welfare of many households.

In Italy households have been reducing consumption since the beginning of the crisis. In 2008 and 2009 the drop in households' total expenditure was respectively 0.8% and 1.6%, and in 2012 it fell even more sharply – by 4.3%, according to the latest data released by ISTAT (2013). This has been driven by the constant erosion of purchasing power which on average has contracted annually by 1.9% since 2008. In 2012 it fell by a record 4.8% (ISTAT 2012) because of rising inflation (3.5%, according to the Bank of Italy 2013c) and a concomitant drop in real salaries by 4.4% (ISTAT 2012). Also the level of net savings has been steadily eroded during the last decade, and is now below the average of the euro area (OECD 2013). The household savings rate dropped sharply from 23.8% of disposable gross income in 1991 to a meagre 9.7% in 2010 (Bank of Italy 2013a).

The decline in disposable income and the credit crunch, which negatively affected both households and firms (Bank of Italy 2013a), are further signals of weakening financial conditions. The intergenerational sustainability of the financial situation is problematic, since young people and lower-income households have been the most heavily affected. The largest reductions in savings levels have been in young households (under 35) living in rented accommodation. Financial fragility has been amplified by the doubling in the proportion of highly indebted households, from 11% in 2005 (ECB) to 22% in 2010 (Bank of Italy 2013a).

In Spain the financial and banking crisis has forced firms and households to deleverage sharply, and companies have been cutting employment and investment. Spain's household debt/GDP ratio, however, remain among the highest in the euro area and twice their 1990–99 levels. Spain's corporate

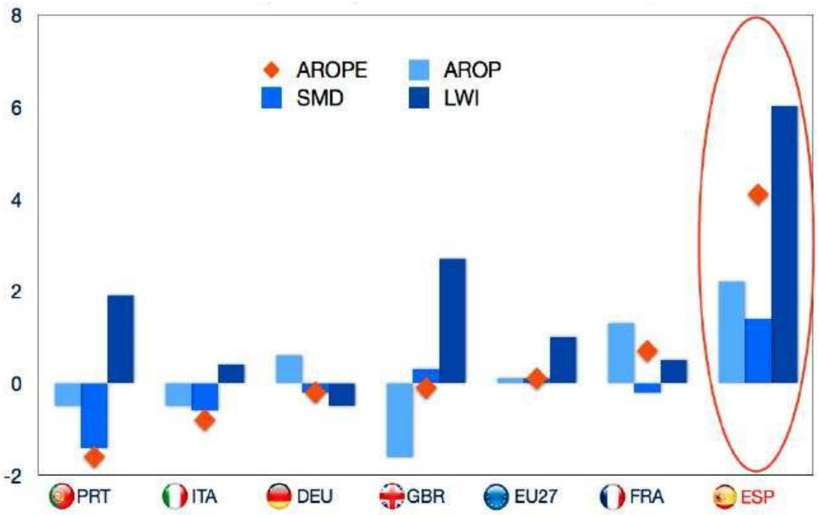
[5] Spain's trade surplus has widened recently, but this has been mainly due to a fall of imports, rather than to a substantial increase of exports (Banco de España 2012).

[6] According to the latest available figures (August 2013) youth unemployment is over 55% (Eurostat).

[7] Measures included the reduction by 17% of unemployment insurance after 6 months of benefits. In February 2013, the government announced more flexible hiring arrangements for youth and tax incentives to support youth employment and entrepreneurship.

sector is also highly indebted (around 180% of GDP in September 2012 but declining, according to the latest figures produced by the IMF, 2013b). Reducing the level of their debt has been more problematic for many households following the 10% drop in real income (median household real income) since 2009. As a result the household savings rate has fallen to historical lows to support consumption. The number of people at risk of poverty and social exclusion has dramatically risen in Spain between 2008 and 2011 (Figure 4) as a consequence of the sudden reversal in GDP growth, the bursting of the real estate bubble, the collapse of the construction industry, the bail-out of the banking sector and the deterioration in Spain's fiscal position which in turn has necessitated cuts in benefits and support to individuals and families hit by the crisis.

FIGURE 4: RISK OF POVERTY AND SOCIAL EXCLUSION AND ITS COMPONENTS (% CHANGE BETWEEN 2008 AND 2011)



Source: IMF (2013b)

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).

3.3 Where does growth come from? The crisis of manufacturing

The crisis that has hit many households in a way reflects the deep crisis of the manufacturing sector. In Italy industrial production has been on a downward trend for several years, with September 2013 industrial production 9.4% below its 2010 value (ISTAT 2013). The Italian manufacturing system is affected by structural problems, particularly with regard to the average size of its firms. In the manufacturing sector 66% of Italian firms are classified as micro or small, as opposed to only 31% in Germany (and 49% in the euro area), while in the services sector the percentage goes up to 70%, versus 48% in Germany (and 53% in the euro area). Micro firms contribute to around 50% of total value added, and more than 50% of employees in the service and construction sectors (De Mitri et al. 2013).

While micro, small and medium-sized enterprises (SMEs) are more dynamic, flexible and able to specialize and organize in so-called industrial clusters than bigger firms, their size also hinders their ability to respond to the challenges posed by economic globalization. Indeed many Italian firms are undercapitalized, often because of their size (Guerrieri and Esposito 2012) and are thus unable to invest on a regular basis, for example in R&D activities; in 2010 almost 40% of micro enterprises did not invest at all, according to the Bank of Italy (2013b). Data from the Bank of Italy (2013b) also show that the 30% differential in R&D investments between Italian and German firms is due to the much lower percentage of German SMEs. In addition, since the global financial crisis many SMEs have found it difficult to obtain credit. This is reflected in a 5.3% contraction of loans to firms, especially to the smaller ones, between February 2012 and February 2013 (Bank of Italy 2013b). The lack of capital available to firms is also reflected in the low level of FDI flowing into the country, which fell dramatically in 2012 as a result of the increased political and economic uncertainty (UNCTAD 2013).

The size of Italian firms also affects the performance of exports. Globally competitive firms tend to be bigger and concentrated in specific sectors, while an excessive level of fragmentation among firms prevents them from achieving a sufficient degree of competitiveness. Despite the overall positive performance in external trade – the country is currently running a trade surplus amounting to 1.3% of GDP – this mainly reflects a significant drop in imports (MEF 2013). Global market shares held by Italy in its main export sectors are generally lower than those of France, Germany and in some cases even Spain. Italy's top five sectors include textiles, chemicals, metal products, machinery and equipment, and means of transport (ICE 2013 and OECD 2013). Compared to their contribution to domestic Italian GDP, these sectors' shares of total exports from Italy are comparatively lower than is the case for the other three countries, except in the machinery and equipment sector.

Italy and Germany share a similar industrial structure, having respectively the first and second most diversified industrial economies in the world (Felipe and Kumar 2011). Yet Italian firms lag behind German ones in terms of competitiveness. As a result Italy's share of global exports is much smaller than Germany's. A 'dimensional threshold' seems to prevent Italian SMEs from being fully competitive at the international level. Moreover, comparison with German firms suggests that the latter managed to internationalize more effectively. Indeed in the past 15 years the degree of openness in the German economy has almost doubled, from 19% to 38% (Guerrieri and Esposito 2012).

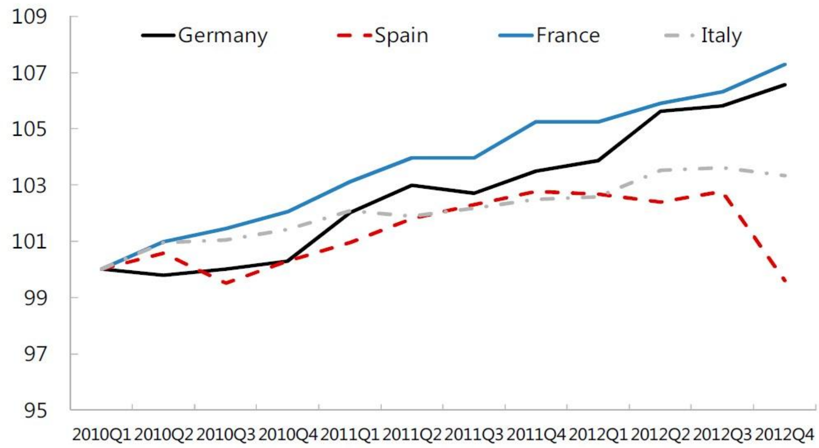
4. France: structural weaknesses and risks

France is a pivot country within the euro area, both economically and politically. Its economy weathered the global financial crisis better than most, having enjoyed positive growth in 2010 and 2011. And its banks have managed to rebuild their balance sheets and reduce risk. However, the economy slowed substantially in 2012, with output falling back in the last quarter of 2012 and the first of 2013. Among the causes, the euro area crisis took its toll, fiscal consolidation acted as a drag, and some of the structural weaknesses of the French economic model became more apparent. The IMF (2013c) expect a gradual return to growth, but stress the substantial downside risks, not least from continuing poor prospects for growth in the euro area as a whole.

The slowdown in 2012 came after a decade of strong growth, driven primarily by private consumption. Private consumption was also the main component of the slowdown last year, as real household disposable income fell by 1%.

The French economy has suffered from a lack of flexibility in its labour and product markets for many years. But these have been brought into sharp relief by the crisis. As the periphery countries have been forced to improve their competitiveness through demand compression and real wage cuts, the structural rigidities in France have become more apparent. Labour compensation per unit of labour has continued to rise by between 2% and 3% a year since 2008 (OECD 2013). Labour costs per hour are now higher in France than in any of the other four countries, and have risen by 7% over the last three years, compared with an increase of 3% in Italy and a fall of 1% in Spain (Figure 5).

FIGURE 5. LABOUR COST PER HOUR - SELECTED EURO AREA COUNTRIES (INDEX, 2010Q1=100, TOTAL ECONOMY)

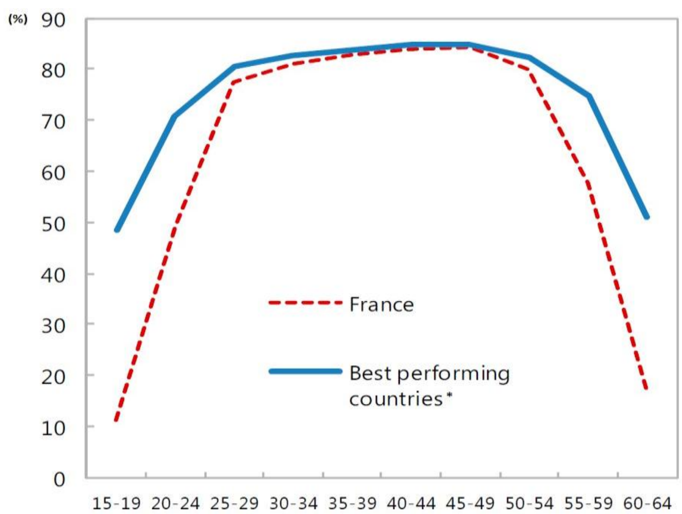


Source: IMF (2013c)

The steady worsening of France's net trade position is one symptom of this loss of competitiveness. The current account deficit widened to 2.2% of GDP in 2012, following a "broad-based erosion of the net trade in goods" (IMF 2013c) over the last decade. And over the same period France's market share of trade vis-à-vis the euro area has also fallen by over 20%. This longer term trend saw the current account position deteriorate from a surplus of about 2% of GDP in 2000 to a deficit of over 2% last year.

Another symptom is France's poor record on employment. Although the unemployment rate of 11% is still well below that of the periphery countries (Figure 2) and has not increased substantially since the start of the crisis, Figure 6 shows that France's employment rate for younger and older age groups is much lower than for other comparable countries. Also youth unemployment is higher than for the EU as a whole. These problems have added to France's underlying social and political tensions.

FIGURE 6. EMPLOYMENT RATES BY AGE GROUP (EMPLOYMENT IN PERCENT OF THE POPULATION AGE GROUP, AVERAGE, 2005-2011)



Source: IMF (2013c)

Some progress has been made on structural reforms recently. The tax wedge on labour costs has been reduced, thus allowing some recovery in corporate profitability. The IMF (2013c) expects the reduction in the tax wedge to cut labour costs by 3% by 2015. And the agreement this year between most of the unions and employers' federations has improved the prospects for further changes, allowing more flexibility in working hours, wages and dismissal procedures. In return, workers have secured improved health and unemployment insurance terms, and rights to training, and short-term employment contracts have become less attractive to employers. But further changes are needed, to increase both external competitiveness and domestic growth potential.

As with most European countries, France has faced a tension between the need for longer term fiscal consolidation and the importance of restoring growth. Some fiscal consolidation has already taken place, with the structural deficit falling by over 1% of GDP in 2012. But in order to meet the deficit level mandated by the Stability Programme for 2017 further substantial adjustment will be needed to reach the target of a structural fiscal surplus.

A major part of the European response to this dilemma between fiscal stability and growth is to strengthen the institutions and governance of economic policy-making and coordination, to improve the credibility and predictability of policy, and reduce negative spillovers between countries.

France has traditionally played a major part in setting the agenda for European reforms, sitting at the heart of 'political Europe' with Germany. One of President Hollande's first actions was to shift the terms of the debate in Europe away from a single-minded pursuit of fiscal consolidation to stress also the importance of getting growth going again. Unfortunately the debate which followed has also heightened the impression that political reform in Europe is a very slow and difficult process.

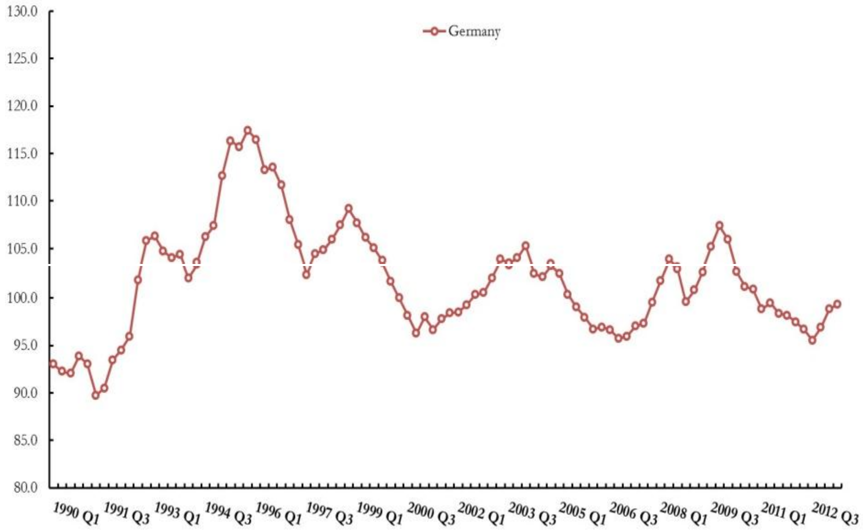
5. Germany: the problem of being too competitive

As noted earlier, Germany managed to turn itself from the 'sick man of Europe' at the end of the 1990s to the main – and at times the only – source of growth in the euro area. In part this is a result of the painful domestic reforms it went through in the 2000s, which resulted in high unemployment and real wage compression. Unemployment in Germany in the mid 2000s was higher than in all the other three countries, but now (at around 5%) is much lower (Figure 2).

In addition to the large effective increase in its labour supply through unification, Germany also took advantage of the enlargement of the EU to the east, incorporating former Comecon countries. Germany deepened its integration with these countries producing intermediate products and components, thus taking full advantage of the globalization process (Guerrieri 2012). This allowed German companies to aggressively contract out large parts of the supply chain to these lower cost economies, resulting in large competitiveness gains.[8] Productivity gains of over 20% have been attributed to outsourcing to eastern Europe (Marin, 2010; Hansen, 2010)

And Germany's membership of the single currency allowed it to avoid those external competitiveness gains from being eroded through nominal exchange rate appreciation. Since the ECB was setting monetary policy to suit conditions in the euro area as a whole, and the zone in total was in rough current account balance, German industry became very competitive. Its current account surplus widened yet further in 2012 to 7% of GDP, in particular from growth in trade in goods outside the euro area. However, from the early 1990s to 2008 the contribution made by trade with the eurozone to German net exports had nearly doubled. The IMF (2013d) estimate that Germany's real effective exchange rate is undervalued by between 2 and 10%, and is 8% below its historical average (Figure 7).

[8] Unification was enormously costly at first, but the gradual insertion of the Eastern labor force into the German mainstream subsequently helped both contain the growth of average wages and also increase the rate of growth of labor productivity.



Source: IMF International Financial Statistics, 2013

FIGURE 7. GERMANY'S REER BASED ON RELATIVE UNIT LABOUR COST (INDEX, 2005=100)

Although Germany experienced a sharp fall in output in 2009 (of 5.1%), this was quickly reversed and since then Germany has been the best-performing member of the euro area, seeing unemployment (ILO definition) fall from 7.7% in 2009 to 5.5% in 2012. This relatively impressive growth performance was driven primarily by exports, and resulted in a current account surplus of over 6% of GDP in each of the last 5 years.

This impressive economic performance in Germany has been in stark contrast to the rest of the euro area. Excluding Germany, the euro area has seen falling output in each of the last six quarters. Four euro area members (Ireland, Portugal, Greece and Cyprus) now have support programmes from Europe and the IMF. And, as shown earlier, Italy and Spain have to adopt stringent measures to avoid a similar fate.

This contrast between the main surplus country and the deficit countries in the 'periphery' has generated significant tensions, and different visions of what is needed to help the crisis countries. In particular there is a marked reluctance in Germany to provide open-ended financial support for these countries. Germany has maintained its insistence that the periphery countries have to carry out strong fiscal adjustment as the price for financial bail-outs. Equally, Germany continues to reject systemic solutions which would entail greater joint control over its own fiscal liabilities. Hence it has firmly rejected proposals for 'euro bonds' (which would be the joint liabilities of all euro area members); and it is dragging its heels over the single resolution mechanism (SRM) as part of the 'banking union' proposals for addressing the euro zone crisis, since it would again potentially create German fiscal liabilities for bailing out failing banks in other member states. Similarly, the Bundesbank President opposed the introduction of the OMT scheme in 2012.

It is sometimes argued that the way for the periphery countries to restore growth is to become 'more Germanic' – exercising greater fiscal restraint, wage compression, and working harder. But this is overly simplistic. Germany's economic success has come about in large part by being part of the largest free trade area in the world, with a monetary policy framework by the ECB which has helped German companies to remain very competitive globally.

Also, Germany has a strong self-interest in ensuring that other countries in the euro area return to growth. The IMF sees the main risks to Germany's continuing growth as a lack of recovery in the euro area, and a failure to deliver greater certainty to domestic consumers and companies, in particular through more predictable policies. And the failure to agree on a way forward for European economic governance is damaging Germany's economic prospects, as well as the rest of the euro area.

6. Keeping EMU together

Given the sharp divergence of views over the way euro area policies should be conducted, the question has arisen over whether the single currency is sustainable in its current form, or whether it would be in the interests of some members to leave. At one point markets saw a serious risk that Greece could leave the euro rather than submit to greater austerity measures – the 'Grexit' solution. And there have also been suggestions that if periphery countries were unwilling to follow more 'orthodox' policies, it would be in Germany's (and a few other fiscal conservative countries) interests to abandon the single currency.

The response by all members to these apocalyptic alternatives strongly suggests that both sides still see it in their interests to remain part of the euro – that the alternative of leaving the currency area, however imperfectly it is configured, is worse than remaining in it. With a high degree of integration between the member countries, spillovers from domestic policies to other members of the EA are large. Therefore the gains from coordination are potentially commensurately great.

The fact that these alternatives have been seriously debated also indicates that there is considerable scope for improving the governance of the area, so that policy coordination works better and can deliver faster and more sustainable growth for all its members. We argue here that improvements can be made in all aspects of policy – fiscal, monetary, financial and structural.

6.1 Fiscal policy

The policy area that has attracted most attention is fiscal policy, with a number of attempts to strengthen the discipline on countries to consolidate and reduce debt levels. However, progress so far in cutting fiscal deficits, reducing imbalances and economic convergence has been largely achieved by procyclical fiscal austerity. This has contributed to drastically lower economic growth, and with adjustment concentrated on the deficit countries.

Fiscal policy is still largely a matter for national governments, despite successive attempts by the European Commission to devise more centralized processes for coordination of policies and to acquire an EU-level fiscal capacity. Changes have been made, such as the six-pack, the two-pack, the European semester, and the Fiscal Treaty. But these have focused on coordinating timetables and strengthening incentives to meet simplistic fiscal rules which are still based largely on the Maastricht debt and deficit ceilings.

The net result of these arrangements is to have imparted a deflationary bias to fiscal policy settings across the euro area. The IMF have argued consistently that policy across the area is procyclical and too tight for current circumstances. Whatever the merits of the current policy stance, there is certainly a case for coordinating national policies across the area to take greater account of the impact of the aggregate fiscal stance on the overall eurozone economy. In effect this would require a eurozone-level finance ministry to manage the policy actions of the individual member states.

A number of proposals have been made that would move in this direction. The Commission has proposed several additional measures to augment 'own resources'[9], which would provide fiscal

[9] Own resources currently comprise customs duties, agricultural levies, sugar contributions, a portion of VAT income and a levy on gross national income. The controversial 2014-2020 budget, first outlined in 2011, proposed a number of new

resources to be used at the EU-level. Some member states have suggested greater use of regional funds (which in effect would be fiscal transfers from richer to poorer members). And there have also been proposals – rejected so far by 'northern' countries – for mutual guarantees of sovereign bonds (which would entail the fiscally stronger countries backing bonds issues by weaker countries), or for 'eurobonds'. In effect these moves would involve a pooling of fiscal resources, and would require some processes or institutions to decide how to use those resources. We do not underestimate the political implications of such a move, but without greater coordination fiscal policy in aggregate will remain sub-optimal.

6.2 Monetary policy

Since the creation of the single currency and the ECB, monetary policy has been run to take account of the needs of the euro area in its entirety. The independence of the ECB both from national governments and from national central banks was designed precisely to achieve that outcome. As a result ECB policy has been aimed at delivering average inflation across the whole euro area. Because there was insufficient convergence between member states since the euro was created, the aggregate monetary policy stance was too tight in some countries and too loose in others through much of the run-up to the financial crisis. This also exacerbated external imbalances between member states. But it is hard to envisage how else monetary policy could have been run in a single currency area. It should have been for other policies – in particular offsetting fiscal stances, macroprudential policies, and longer-term structural reforms -- to adjust accordingly. Similarly, the ECB's policy of providing adequate liquidity across the area (at least since last summer) was appropriate for the circumstances.

One problem exposed by the financial crisis has been that interest rates have not been uniform across the area. With the onset of the crisis, spreads have increased – at times dramatically. Government bond spreads over bunds have increased for many euro area countries, reflecting concerns about the sustainability of their debt positions. And spreads for corporate borrowers have also widened to take account of greater perceived credit risks. The ECB has seen this as a failure of the monetary transmission mechanism. But it is more appropriate to view this as markets factoring in differential risk levels in different countries. In effect markets are judging that some sovereigns are riskier than others – which is demonstrably the case. Prior to the crisis, it was appropriate for market interest rates to be pushed up in countries (such as Spain and Ireland) that were overheating. But since the crisis these movements have been counter-productive and have made it harder for the crisis countries to achieve fiscal sustainability – hence the interest in mutual guarantees of sovereign bonds.

More generally, as long as economic conditions and prospects continue to diverge within the euro area, the ECB's policy of aiming for average inflation will be under attack as inappropriate for some countries. And the longer that these divergences continue – in particular as differences between unemployment and living standards persist – pressure may mount for the ECB to change tack, and to take more account of the needs of the weaker countries.

6.3 Financial policies

A third policy area where greater coordination is already being attempted is in financial regulation and macro-prudential policies. In most cases the institutions are now in place to move decision-making over time to the euro area or EU level. As the 'Four Presidents' report argues persuasively, full integration of financial markets across the area requires harmonization of regulation, supervision and resolution of failing banks. The resolution function in particular raises difficult issues of competencies and sovereignty, not least because it would entail countries committing fiscal resources in support of

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sources of own resources: these included an EU-level VAT, a tax on financial transactions, charges relating to air transport and fees from the Emission Trading Scheme (ETS).

decisions taken at a supra-national level (at least until a sufficient industry-financed resolution fund had been built up). But this is simply a 'special case' of the more general issues raised by fiscal union.

Arguably the benefits to growth from greater integration across the area are not restricted to financial services. There are numerous examples in both goods and services markets where barriers to trade within the area remain. Unfortunately there is much less political appetite for action to reduce or remove these barriers beyond financial markets. In theory negotiation of free trade agreements between the EU and the US and Japan could spur changes also within the EU, but the early signs, such as the exclusion of cultural products (the 'exception culturelle') from the trans-Atlantic discussions are not encouraging.

6.4 Structural policies

The final area of policy, with probably the largest potential for boosting growth in the longer term, is structural reform. Absent a fundamental shift in approach, action to improve the functioning of markets will remain concentrated at the national level. EU attempts to harmonise action, such as the Lisbon Treaty and the Europe 2020 programme, have been largely unsuccessful. And given the detailed nature of the policy actions, which have to reflect local circumstances, it is perhaps inevitable that they should remain largely the responsibility of national governments. Nevertheless, there are numerous examples where national policies can have spillovers onto other countries. The European Commission has responsibility in some areas to limit negative spillovers, for example competition policy and the state aids regime. But an approach that is worth considering is to extend the responsibility of the Commission to identify wider structural policy actions taken at the national level that have negative effects across the area, with the possibility at some point of taking on powers to limit or ban such actions. An even bolder step would be for structural reforms (such as labour market flexibilities) at the national level which would improve the functioning of the union to be mandated at the European level; but attempts to create contracts between countries and the Commission as a prerequisite for financial assistance have not so far been successful[10].

Conclusion

The restoration of growth is key to the stability of the euro, both economically and politically. Without growth, the plans for fiscal consolidation will be hard to achieve. And the pressure it puts on deficit countries to adjust will lead to continuing tensions between the members of the euro. Most importantly, an extended period of recession and extremely high unemployment will place strains on the political commitment to the single currency in many countries.

Among the four biggest members of the euro area, Italy and Spain face continued difficulties in living within the constraints of the single currency. The fiscal and structural adjustments required, and the squeeze on living standards implied, are putting great pressure on their current governments, and on their political systems more generally.

Germany has been the main beneficiary of the single currency, and as the strongest member of the euro area it has an important voice in the policies and structures of the area. But it is in Germany's strong interest that the euro survives and prospers. After the German election in September it may be able to

[10] Ongoing German-led proposals to tie all eurozone members into contractual agreements to deliver on reforms are the latest such efforts. In 2012, efforts to devise similar 'convergence and competitiveness instruments' stalled when the Commission paired the idea with incentives from common European resources – fearing the road towards shared liabilities and debt mutualisation, Germany withdrew its support.

back changes to the policies and structures within the euro needed to support a resumption of economic growth. France also has a strong interest in bringing about these changes, in order to generate growth in the euro area and a governance structure that supports the domestic reforms it needs to implement.

But without fundamental changes to the way the euro area is run, and decisions taken, it is likely to be doomed to a prolonged period of slow growth and periodic economic and political crises. 'Genuine' EMU, including fiscal union, and therefore political union, is probably the only way for the single currency to be sustained and successful.

If it is managed well, Europe can reap the full benefits of integration of the biggest economic area in the world. But if it not managed well – or not completed speedily – the risks for Europe are huge.

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