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ECFIN Economic Brief

ECONOMIC ANALYSIS FROM EUROPEAN COMMISSION'S DIRECTORATE GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

European prosperity reloaded: an optimistic glance at EMU@20

By Marco Buti and Karl Pichelmann

Summary

Amidst current fears of recession and economic stagnation, this note presents an optimistic view of the euro area's prospects over the medium-term. We claim that the EA has a more than fair chance to leave the crisis behind in a much stronger overall position than before, not least vis-à-vis the US and Japan, and to restore the prosperity triangle of efficiency, fairness and stability. Deep reforms at national and EA level, including the establishment of a banking union, will allow for significant gains in dynamic allocative efficiency, fostering intra-area convergence and retaining Europe's strong competitive position in the global economy. Our well-developed social systems, smartly recalibrated towards activation, will be an asset in the post-crisis world, paying-off in terms of more economic stability and sustained growth. And the strengthened medium-term fiscal framework to put public finances back in order will generate fiscal space to tackle new challenges and enable automatic stabilisers to work; a task yet to be addressed in other advanced economies. We conclude that, provided we stay on course with determined policy action, a prosperous EMU@20 may well be on the horizon.

1. Introduction

For much of 2012 the air was thick with gloomy headlines about the eurozone's future, with many pundits predicting its imminent break-up. But the pessimists have been proven wrong; clearly, they underestimated the strong determination and political will of European leaders to take the necessary bold decisions both at the area-wide and the national level to ensure the unity and the sustainability of the euro area. At the EA level, strong firewalls have been erected with the ECB's announcement of its "Outright Monetary Transactions"-programme and the European Stability Mechanism becoming fully operational; agreement has been found to establish a fully-fledged banking union aiming to decisively cut the vicious link between banking instabilities and sovereign risk; and, finally, agreement was reached on the implementation of the Greek programme. At the national level, fiscal consolidation has continued and a range of far-reaching structural reforms have been set in place. Reflecting these policy efforts, financial market conditions have strongly improved, adjustment and intra-euro area rebalancing has progressed, and, eventually, the tail risk of currency redenomination – a euphemism for EA break-up - has largely diminished.

But obviously we are far from "mission accomplished". At the beginning of 2013, with the economy still in recession, unemployment soaring and large disparities across euro area Member States, the prospects for economic growth and prosperity appear to be fairly bleak, both with respect to the short-run outlook and over a more medium- to long-term horizon. Historical evidence shows that economic recoveries after financial crises tend to be slow and sluggish; typically, the need for financial deleveraging, demands for higher risk premia, inevitable fiscal

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Economic and Financial Affairs

consolidation to restore sustainable public finances and persistent labour market weaknesses combined to weigh on growth for a prolonged period of time. But already before the crisis, the euro area had to face sluggish productivity growth, and the overall challenges of globalisation, ageing populations, growing resource limitations and climate change. Against that backdrop, we are now facing a dangerous mix of economic and social tensions, reform fatigue and complacency with respect to the "crisis stabilisation" which risks jeopardizing the painful efforts and achievements so far.

The political and economic challenges ahead are formidable and we must not fall prey to wishful thinking. Yet, in full recognition of the mountains still to climb, we set out a positive vision of the euro area's and, more generally, Europe's prospects for economic growth and prosperity over the medium-term. We argue that the adjustment and rebalancing trajectories, harsh as they are at present, carry the potential to interlink positively with and to amplify the medium-term growth potential in both core and periphery countries. In particular, using the perspective of Musgrave's three-way demarcation of government functions, we claim that the EA has a more than fair chance to leave the crisis behind in a much stronger overall position than before, not least vis-à-vis the US and Japan, and to restore the prosperity triangle of efficiency, fairness and stability. Firstly, with deep structural reforms being enacted, especially in the vulnerable countries, both static and dynamic allocative efficiency in the area is set for significant gains over the medium-term; moreover, with robust conditions for structural catching-up in place, agreement on a single supervisory mechanism – an essential step towards completion of the banking union - will be conducive to a resumption of downhill capital flows fostering convergence towards global front-runners such as Germany. Secondly, it is now widely acknowledged that excessive inequality is corrosive to growth; thus, our welfare systems, too often simplistically portrayed as static, passive and a liability only, can actually turn out to be an asset in the post-crisis world. Adequately recalibrated, they foster adjustment and mobility, allowing for more economic stability, more sustained economic growth, and healthier societies with stronger bonds of trust and cohesion. Thirdly, the euro area has agreed on a medium-term fiscal framework to put public finances back in order. The determined reduction of fiscal deficits and public debt, together with reforms to reign in ageing-related spending will generate fiscal space to tackle new challenges and to allow automatic stabilisers to work freely. This task is yet to be addressed in other advanced economies. Against that background, and conditional on sustained determined policy action, we eventually conclude in an optimistic tone on EMU's potentially bright future.

2. Embarking on positive adjustment and rebalancing trajectories

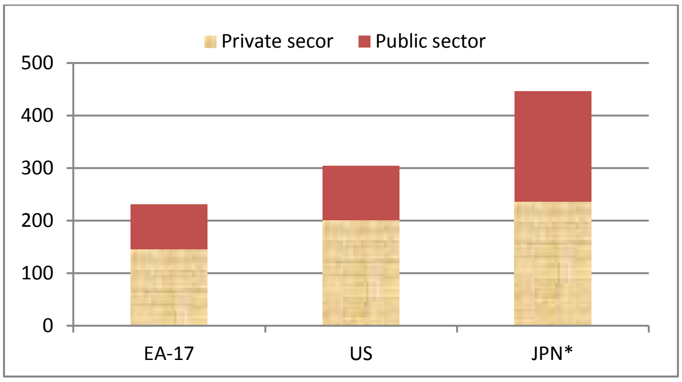
Restoring normal lending conditions to the economy is a necessary albeit not sufficient condition for a resumption of growth. There are many positive signs of financial market stabilisation: while still fragile, undeniable improvements have set in as reflected inter alia in higher stock market evaluations, unwinding convertibility risk premia, across-the-board declines in CDS and corporate bond spreads, stronger interbank lending, and some restoration of downhill capital flows. However, bank lending rates remain stubbornly high in many countries. The incomplete pass-through of monetary policy rates is indicative of on-going deleveraging needs and balance-sheet-stress, only to be re-enforced by financial market fragmentation, impairing the functioning of the credit channel. And in turn, unsurprisingly, the necessary simultaneous deleveraging of both public and private sectors has translated into severe demand weaknesses, eventually spilling over from the periphery into the core of the euro area. Against that backdrop, facilitating orderly balance-sheet adjustment with minimal negative growth impact is at the core of current economic policy efforts.

Pursuing growth-friendly fiscal consolidation is an indispensable element of the overall strategy. Public finances are gradually improving; the fiscal deficit in the euro area has halved over the past two years, and several countries, including vulnerable ones, have or are about to achieve primary surpluses. With fiscal multipliers higher than in normal times, the consolidation efforts have been costly in terms of output and employment. But they have not been self-defeating; and indeed, some countries had no better option than deep front-loaded fiscal cuts when the alternative was break-away from the euro area with unforeseeable consequences.

In its Annual Growth Survey 2013, the European Commission advocates to continue with growth-friendly and differentiated fiscal consolidation efforts, appropriate for each country according to their fiscal space and growth outlook. In line with the recalibrated Stability and Growth Pact, these strategies should focus on progress achieved in structural deficits rather than purely headline deficits. Obviously, headline targets cannot be completely ignored as they affect the debt ratio and, thus, the refinancing needs of countries, but even financial markets have learned that the underlying structural trends and a proper pace of fiscal consolidation are more important when it comes to assessing the sustainability of public finances.

At the same time, perseverance and refocusing on the quality of public expenditures and the structure of revenues is called for. With governments intermediating almost half of GDP in the EA average, the scope for fostering growth is much higher with respect to the composition and quality of public finances than with respect to the 'delta' represented by the budget deficit; but this typically requires taking on powerful vested interests which are often behind less productive spending. Expenditures with a stronger focus on growth and investment, including in human capital are to be prioritised while safeguarding essential social protection; and more efficient provision of public services should result in cost reductions without quality reduction and free resources for new challenges, for example in the area of environmental protection and damage repair.

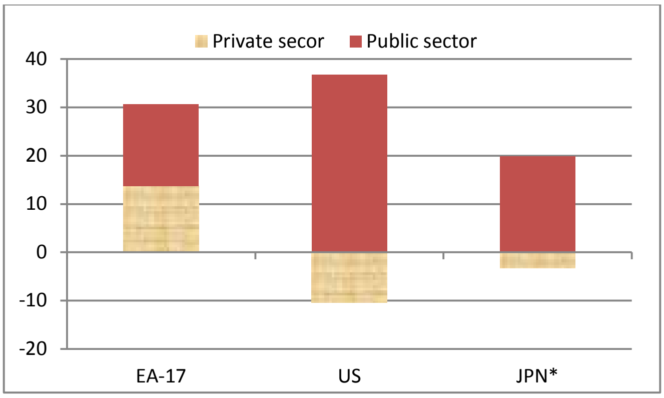
Figure 1. Debt levels 2011 (as % of GDP)



Note: Values for Japan are for 2010

On the revenue-side, shifts away from taxing factors of production towards consumption and property taxes strengthen the growth potential and contribute to distributional goals. Last but not least, the reinforced economic governance framework gives rise to optimism that increased fiscal responsibility is not only a short-lived crisis-related phenomenon, but a more lasting feature of economic policy making. In fact, Europe may eventually end up in a significantly stronger position than the US or Japan, where much of the debt correction and deleveraging home-work still remains to be done.

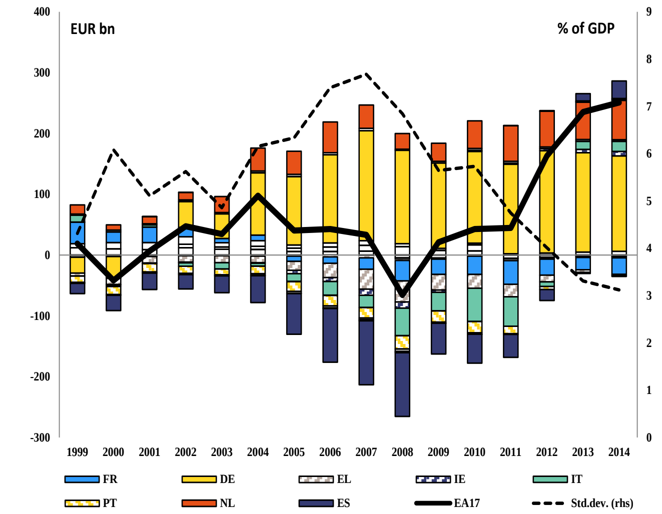
Figure 2. Change in debt levels 2006-2011 (in pps.)



Note: Values for Japan are for 2010

The adjustment of intra-euro area macroeconomic imbalances is also progressing. Current account deficits are narrowing in the countries with the largest external imbalances, supported by gradually improving export performance and competitiveness gains, and the correction in the housing market is on-going. However, this process of rebalancing, which is a prerequisite for sustainable growth in the long run, still has a way to go. In the short term it will continue to weigh on growth and employment in several countries. The adjustment underway contains both cyclical and structural elements, though the structural correction appears to dominate in most countries. Eventually, wage flexibility has proven higher than many critics could have thought of, and labour mobility has also helped to some extent.

Figure 3. Current account imbalances in the euro area

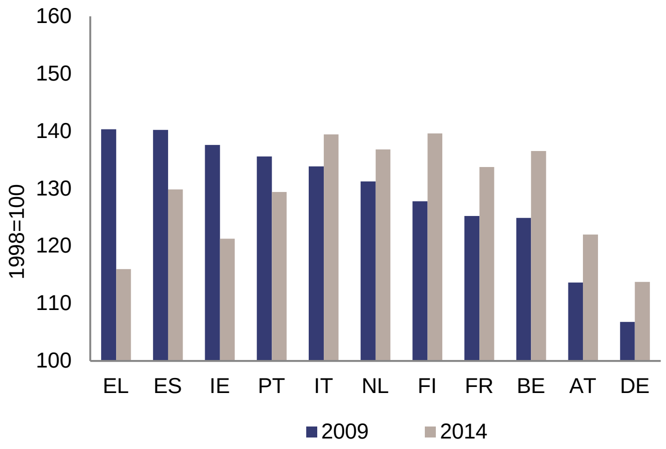


Note: Values for 2013-14 are taken from ECFIN winter forecast 2013

The Asian experience in the second half of the 1990s shows that one of the strongest signals of recovery in crisis-torn countries is when the current account turns into surplus, with the economy generating enough income to pay down foreign debt.

Countries traditionally in surplus could contribute stronger to successful rebalancing by improving the conditions for more robust domestic demand growth. Recently more dynamic wage increases, if accompanied by reforms boosting non-tradeables sectors, bode well for a more symmetric path of EA rebalancing in the future.

Figure 4. Nominal unit labour cost (total economy)



Note: Values for 2014 are taken from ECFIN winter forecast 2013

Structural reforms are key to support the process of deleveraging and rebalancing, to minimise the short-run negative impact on growth and employment, and to lay the foundation for sustainable recovery. Undoubtedly, much remains to be done, but Europe appears to be rising to the challenge. Belatedly but decisively, major structural reforms have been enacted in many countries with significant medium-term benefits still in the pipeline.

At the EA and EU level, a complete overhaul and redesign of financial markets regulations and supervision is on the table, including the building of a genuine banking union. Reforms of labour markets and social systems have addressed the inefficient provision of social protection, removing obstacles to job creation, facilitating the creation of permanent contracts and strengthening flexicurity in the process of labour reallocation. And more specific measures such as youth guarantee schemes to offer every youngster a job, education or training slot are being implemented. All these elements should help to avoid high unemployment becoming entrenched and to avoid the hysteresis mechanisms of the past resulting in long-term disengagement with the labour market and even society at large. Action is taken in many other areas as well, removing barriers in product and services markets, strengthening entrepreneurship, and modernising public administration. The payoffs may still take some time to materialise, but the example of the successful reformers shows that perseverance with structural reform efforts carries substantial long-term benefits. There is a lesson to be learned from best-practice models to prosper in today's globalised economy, not by simple imitation, but by careful adaption to country-specific circumstances and requirements. This does not mean to abandon the European version of social market economy. Indeed, the road to success has not implied heading towards unfettered liberalisation and unbounded flexibility, but it has been paved upon the build-up of institutional resilience to allow for adaptation and change.

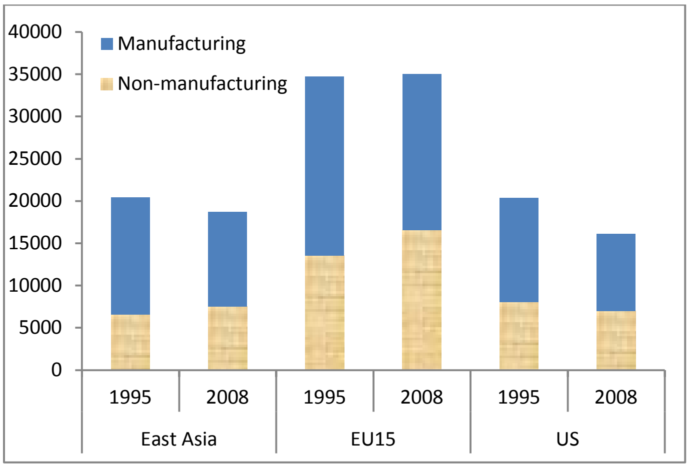
3. Exiting stronger than before

The debate on deepening the Economic and Monetary Union and on changing its institutional structure is in full swing. In late 2012, the Commission has put forward its "Blueprint" providing a sequenced plan for completing the construction of EMU. It foresees several concrete proposals for the short-term within the existing Treaty, starting with the banking union and including a common European Resolution Mechanism. The Commission also suggests creating a Convergence and Competitiveness Instrument to effectively support Member States' economic reforms for rebalancing and competitiveness. This instrument would combine a binding commitment by a Member State to specific reforms with European financial support for its implementation. Over the more medium-term, further integration involving Treaty change could be envisaged, including further steps towards more solidarity and mutualisation of risk. Obviously, this would have to be combined with increased responsibility and further sharing of budgetary sovereignty which, in turn, implies deeper integration of decision-making, as well as commensurate steps towards a political union and increased democratic accountability.

With the edifice under reconstruction, its final shape cannot be determined with certainty. Yet, by addressing design flaws and shortcomings, the European project may emerge from the crisis with stronger fundaments than before. Europe has what it takes to succeed in the global economy of today and tomorrow, combining efficiency, integration and solidarity in an unprecedented manner.

Europe continues to be one of the strongest actors in the global economy. Being still the world's largest exporter, it is well-positioned in the global value chain, committed to trade openness and international economic integration New results from the World Input-Output Database (WIOD), which combine national input-output tables, bilateral international trade statistics and data on production factor requirements, show that global demand for Europe’s products and services has evolved positively in terms of jobs created and productivity. Today, around 15% of GDP in the EU is created directly or indirectly satisfying final demand in other parts of the world, an increase of about 5 percentage points over the past 15 years. Europe increased its real income obtained from global manufacturing production, not only through more competitive manufacturing activity in Europe, but especially through an increased contribution of services to the global value chain. Remarkably, Europe's employment record in global competition compares very favourably with the US and East Asia. Europe has succeeded to retain manufacturing and service sector jobs and raise its share of labor income from high and medium skilled labor, in response to its integration in the global value chain.

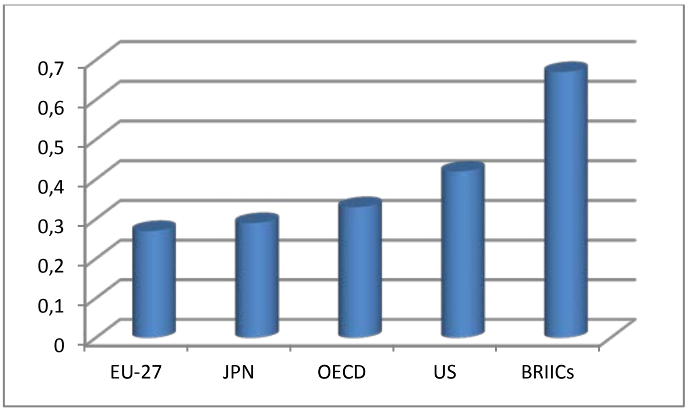
Figure 5. Number of workers contributing to global production of manufacturing products (in 000s)



Note: East Asia includes Japan, South Korea, Taiwan, Singapore and Hong Kong. EU-15 includes fifteen member countries before 2004.

Thus, the EU as a whole has been rather successful in withstanding global competition. This was driven not least by a deeper integration of the EU economies among themselves, in particular the build-up of highly integrated production chains with the economies of Central and Eastern Europe in the enlargement process. The Single Market certainly represents one of Europe's biggest economic achievements featuring a strong manufacturing base with integrated services, generally characterised by knowledge-intensive industries with highly skilled workers in a well- developed infrastructure environment. There is room to further capitalise on this in order to strengthen competitiveness with calibrated industrial policies fostering innovation, integrated energy markets and green investment. Europe enjoys first-mover advantages with respect to green growth, exhibiting the lowest CO_2 intensity of production among major world regions.

Figure 6. CO_2 intensity of production in major world regions

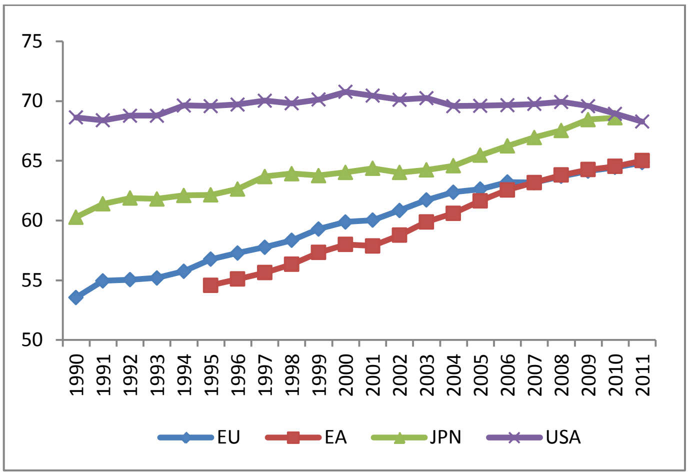


But environmental regulations and restrictions are sometimes seen as a hindrance to growth putting Europe's industries at a competitive disadvantage. Yet, the flip-side to this lies in the world-wide potential for sustainable green growth and the eventual cost of environmental damage repair. EU firms are world leaders in the increasing cross-border ‘eco-investments’ in clean and more energy-efficient technologies and products and services. For instance, EU firms account for almost two thirds of the FDI by multinational enterprises (MNEs) worldwide in renewable energy in the period 2007-2011. They are also global frontrunners in other eco-technologies (such as engines and turbines) used to provide environmental goods and services. However, as in all other areas international competition is increasing, including from MNEs based in the emerging economies. Thus, smart regulation is called for to protect and maintain high environmental standards without unduly hampering job opportunities and overall competitiveness.

Obviously, Europe's competitive position in the global supply chain varies largely across countries and regions, with a Germany-led group, including Austria and much of Central and Eastern Europe in the vanguard to capitalise on more dynamic growth in other world regions. With the benefit of hindsight, we now know that the excess savings from weak domestic absorption in the surplus countries were often not channelled into their most productive uses. This has aggravated structural productivity differences in the euro area and accentuated weaknesses in underlying growth drivers, in particular in the Mediterranean countries including France. Fixing this will require determined structural reform action geared towards both the tradeables and non-tradeables sectors; in fact, given their share in the total economy, productivity improvements in domestically-oriented industries and businesses are essential as well. However, even on an optimistic note with respect to structural catching-up, intra-area divergences and only slowly converging per capita incomes are likely to persist over the medium-term, but not to a degree that a north-south divide risks turning economically and socially explosive. The resumption of downhill capital flows should foster the convergence process, with broad structural reforms and the establishment of the banking union conducive to avoid misallocations as happened in the past, in particular during the bubble years before the crisis. Last but not least, European solidarity will continue to come into play in the form of structural and cohesion fund support, with acceptance by contributors certainly enhanced when efficient use by recipients is better ensured.

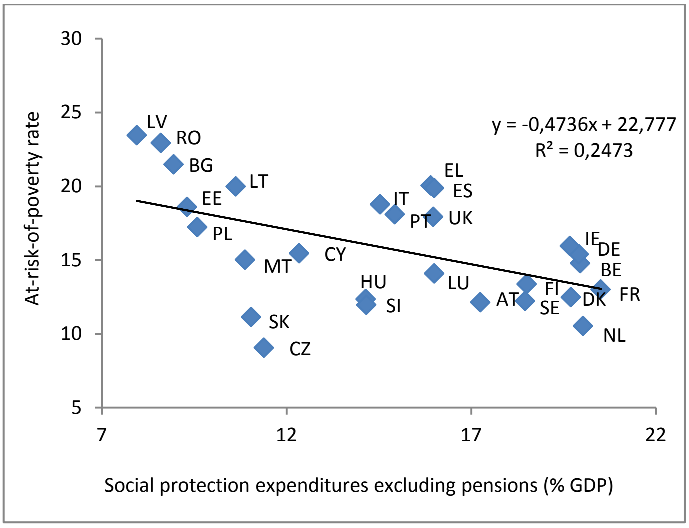
Matching efficiency and integration with fairness has been a characteristic of Europe's successful model for growth and prosperity. Indeed, with 7% of the world's population and 25% of its GDP, the EU accounts for about half of the world's social spending. However, it would be a mistake to see this only from the perspective of a burden that the economy has to carry. Fairness and equity promotes trust and social cohesion, and thereby it promotes positive attitudes towards openness, innovation, adaptation and change. And it would also be a mistake to overlook the significant changes welfare and social models have undergone over the past two decades, starting to move away from passive social-protection to capacitating and activating social-support systems. In that way, and provided that reforms continue, they can be an asset in the competitiveness challenge, not an obstacle to growth and prosperity. For example, substantial efforts to reform pension systems have been taken in many euro area Member States, reducing early retirement options or increasing their statutory retirement ages, sometimes with a link to gains in life expectancy; in parallel, initiatives to raise the employment rates of older workers have been bearing fruit, putting their participation rates on an upward trend. Similarly, activating social-support mechanisms to help reconcile family and work have fostered rising rates of female labour participation, rapidly closing the gap vis-à-vis US levels.

Figure 7. Labour force participation rate (female: 15-64)



Thus, if anything, European welfare systems have exhibited some convergence towards best-practice, rather than universal retrenchment in a race to the bottom. And it is reassuring that, in general, they are delivering in terms of a more equitable distribution of disposable household incomes and a one-third reduction in the share of people at-risk-of-poverty.

Figure 8. Better welfare systems reduce the poverty risk



However, there is undoubtedly ample room for further improvements, with several Member States with medium-to-high levels of social protection spending clearly operating within the equity-efficiency frontier. Among them are some of the countries hit hardest by the crisis, and the necessary adjustment offers an opportunity not to be missed for a genuine recalibration of their social model towards capacitating systems, while safeguarding essential social protection.

Broad enrolment in first-class education and training is of course key, not least in view of intergenerational fairness, for full participation in the world of work and society at large. Notably, upward economic mobility has been higher in several European countries than in the US; it will be essential to build on this, offering strong incentives for young people to invest into a better future.

4. EMU@20: a politically incorrect view

Optimism with respect to the future of EMU is presently regarded as politically incorrect in some quarters. Indeed, it must not be naïve, white washing problems and downplaying the challenges ahead, risking complacency and, eventually, disappointment. But spanning an arc over the first two decades of EMU, it should not be dismissed too easily either. In 2008, EMU had successfully lived through the first ten years of its existence. Already then, growing intra-area imbalances and governance design gaps were identified which gave reasons for concern. But only very few had foreseen that when these risk factors met with a global financial crisis in a vicious circle, an almost perfect storm swept the euro area endangering to sink it altogether as feared by many pessimists. However, the doomsayers have been proven wrong, underestimating the determination to take bold policy action at both the EU and the national level. The euro area is by no means out of the danger zone, and damage levels are high in terms of unemployment and social costs. Much remains to be done to repair and improve, but we can set a course to a prosperous EMU@20 on the medium-term horizon, characterised by macroeconomic stability, dynamic efficiency, and fairness and solidarity. We are convinced that Europe possesses unique strengths to succeed in the global economy and to retain a quality of life which is envied by much of the rest of the world. This positive vision of Europe is one of a continent comprising 500 million skilled, active citizens in an open, inclusive, prosperous society, living together in a civilised manner, positively engaging with all other parts of the world. We can make it happen, but it will not happen by chance. For such a post-crisis future of EMU@20 to materialise, smart policy action is required to stay on course to exit the crisis and pave the way towards sustainable growth and prosperity.