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A New Growth Strategy for Europe

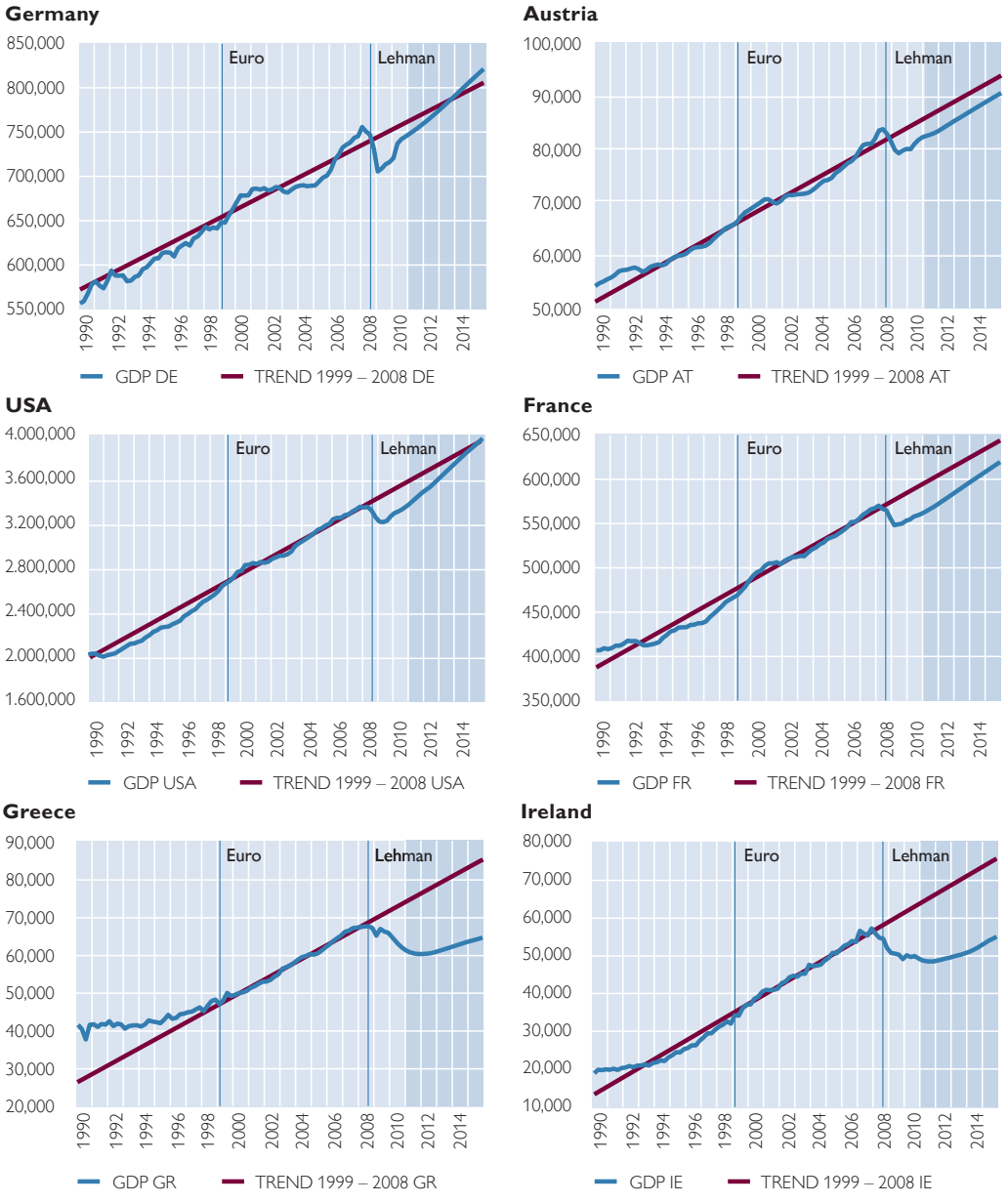
The global financial crisis of September 2008 was the equivalent of an economic earthquake of global dimensions. It has caused subsequently Tsunami-like devastation in the public finances of most industrial economies and in particular in the European Union. Uncooperative behaviour by European governments nearly caused total meltdown of the euro in 2010. The year 2011 is now the year of cleaning up. How can this be done?

Growth in the Euro Area

The global financial crisis has caused a one-off reduction of income in all major economies. For most countries, the shock lasted from the third quarter

Chart 1

European GDP Levels

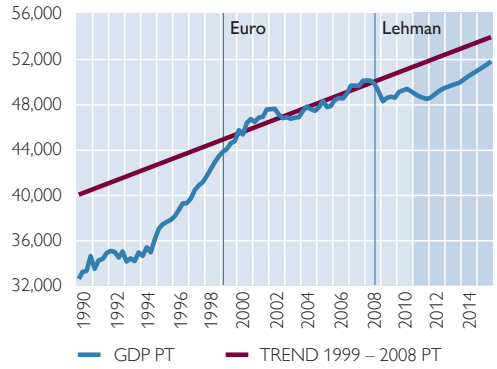


Source: Centro Europa Ricerche, Rome.

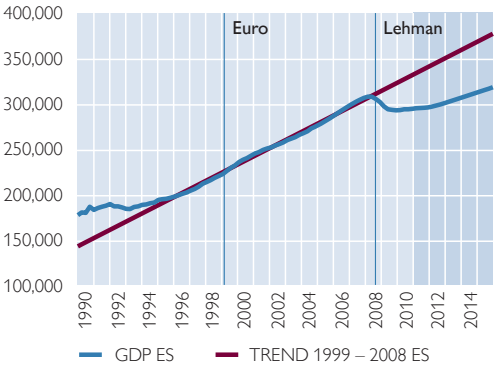
Chart 1 continued

European GDP Levels

Portugal

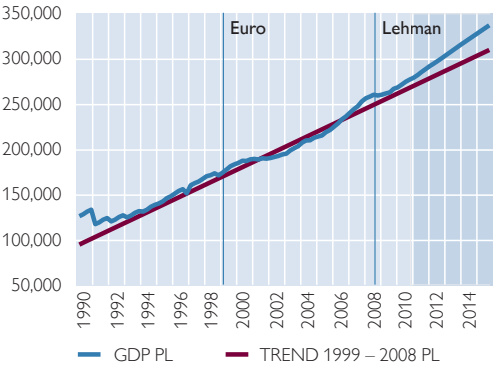


Spain

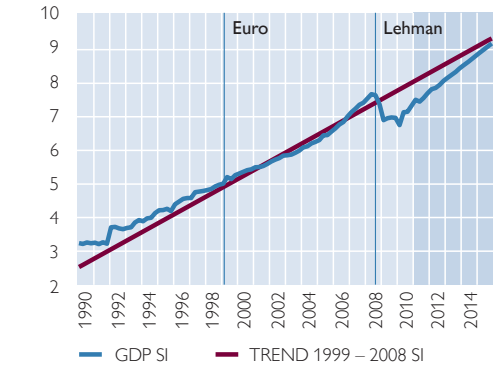


Non-Euro Member States

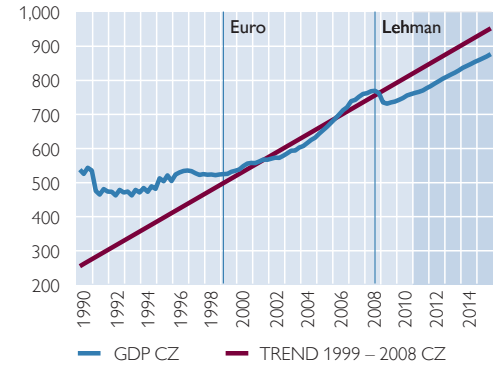
Poland



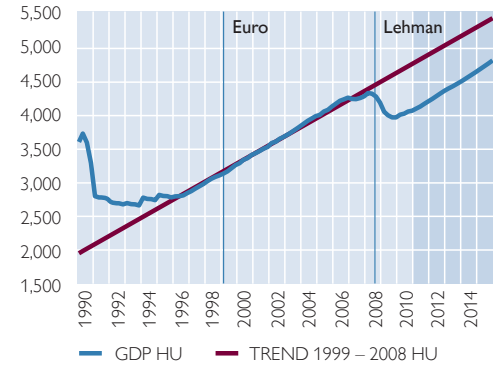
Slovenia



Czech Republic



Hungary



Source: Centro Europa Ricerche, Rome.

2008 to the second quarter 2009. Since then, most economies have started to grow again, although with different dynamics.

We can distinguish three post-crisis adjustment models:

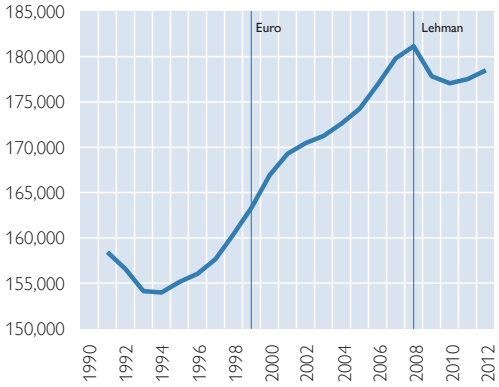
– *The reduction in output was sharp,* and so was the rebound. Economic *growth has accelerated* relative to the pre-crisis years. This is the case for Germany, the USA and possibly Slovenia.

– After a sharp recession, the economy has *returned to previous growth rates,* but not managed to compensate for lost output. This is the case for most economies in Europe, including Austria.

Chart 2

Employment Euro Area-15

Number of employees

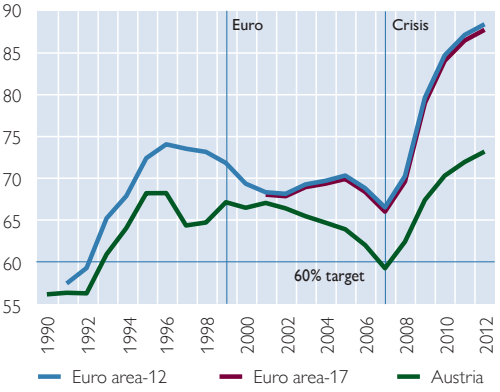


Source: AMECO.

Chart 3

Debt to GDP Ratio

%

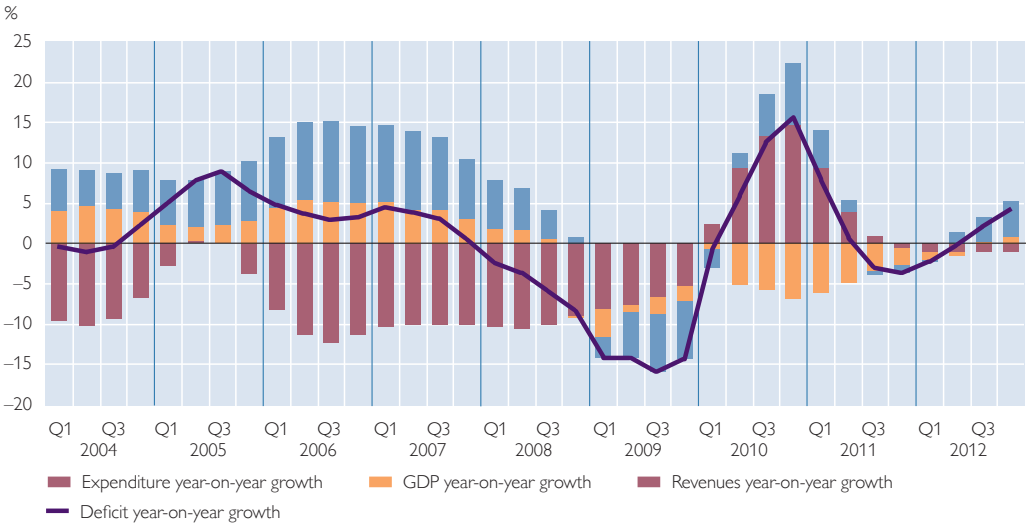


Source: AMECO.

Chart 4

Contribution to the Change in the Budget Position for Greece

%



Source: Author's calculations, Centro Europa Ricerche.

– The reduction of output was not only deep, but also long lasting. The economy did *not pick up rapidly* and the levels of income are still far behind pre-crisis levels. This is the case for the crisis shaken economies in Europe's south (chart 1).

The crisis has two mirror images: high unemployment and rising debt. After adding 15 million jobs in the first decade of the euro (more than ever before in history), 5 million were lost again in the euro area during the crisis.

Public debt ratios have also exploded everywhere:

The deterioration of public finances has been essentially a problem of revenue and growth. Most spectacularly this is documented by Greece. Chart 4 shows the contribution to the change in budget position for Greece.

Hence, it is clear: accelerating economic growth must be the top policy priority in Europe. Accelerating growth requires the interaction of long term supply side policies and macroeconomic demand policies, which need to define an efficient short to medium term policy mix that defines coherently monetary, fiscal and wage policies. In this context, a new issue has emerged: competitiveness.

Competitiveness

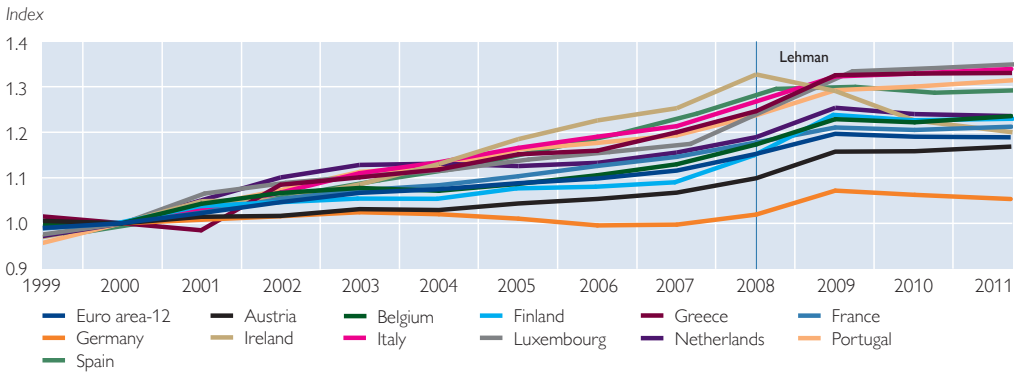
The debate among policy makers suffers from a major category mistake; it measures competitiveness by current account balances. The European Commission even wants to use a target of current accounts for its excessive imbalance procedure. However, this is the wrong indicator. First, the current account is not the same as net exports because it contains factor incomes and transfers. Second, net exports may shift according to comparative advantages in the single market. Third, the current account is a meaningless concept in monetary union.

In different currency areas, the current account positions indicate a change in external indebtedness in foreign currency. Together with capital flows the current account determines the foreign exchange reserves of a country. Loss of reserves makes the maintenance of exchange rate stability unsustainable. As a consequence, investors look at a country risk as a currency risk. This is why monetary union was a necessary complement to the creation of Europe's single market.

In the same currency area liquidity is provided by the central bank. Banks borrow from the central bank and lend to the real economy, namely to firms and governments. Because the ECB is the lender of last resort, solvent banks can always count on obtaining the necessary liquidity from the ECB and no "Member State" can run out of reserves of its own euro currency. Any

Chart 5

Unit Labour Cost Developments in the Euro Area

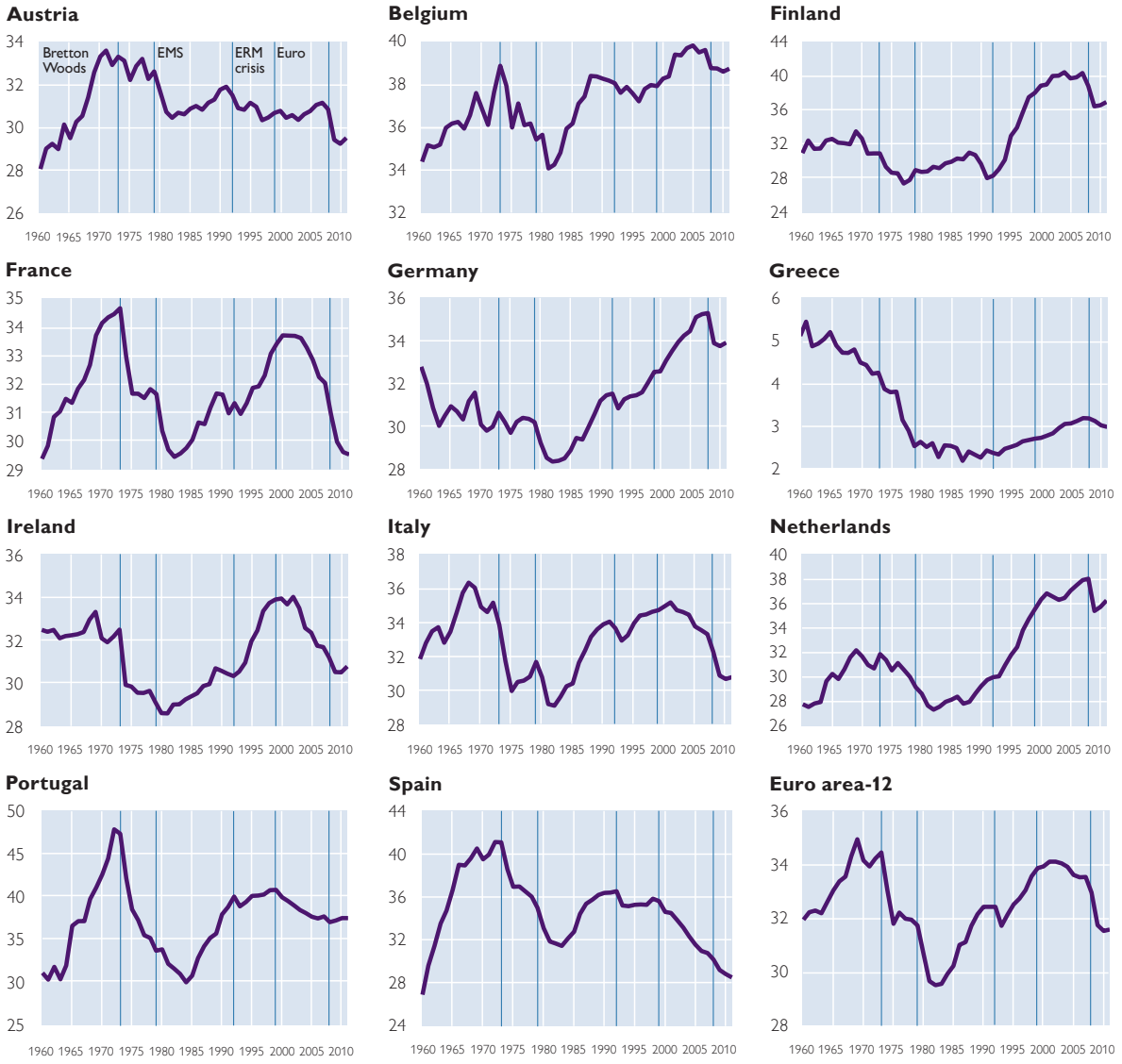


Source: AMECO.

Chart 6

Average Efficiency of Capital

GDP to capital stock in %



Source: AMECO.

"current account" position between Member States is therefore sustainable. It makes no difference whether the lender is a "domestic" or a "foreign" bank in the euro area. The open and unlimited access to liquidity for Monetary Financial Institutions (i.e. banks) is the defining feature of a monetary union. Hence, European Monetary Union is not a fixed exchange rate area; it is an "economic country".

This does not mean that in a monetary union, borrowing is unlimited and unconstrained or that repayment does not matter. It means that the borrowing risk is debtor specific. The issue is the solvability of debtors. Each debtor must be assessed for solvency in terms of the net present value of future cash flow streams. Hence, it is a category mistake to use the category of Member States and their current accounts in EMU, because

Chart 7

National Levels of Unit Labour Cost Relation

Source: Centro Europa Ricerche, Rome.

only banks can borrow from the ECB and not States (Treaty on the Functioning of the European Union art. 123).

If current account positions are not appropriate, how else can we measure competitiveness? What matters for firms are relative prices and relative unit labour costs (ULC). Typically, they are estimated by some index like in chart 5.

But such an index is also a flawed concept, because what matters are ULC levels, and an index cannot represent these levels. So, what is the right level? Should ULC all be the same in equilibrium? Not necessarily because labour cost is only one element in the total cost of producing output. The other is the cost of capital. In equilibrium, and assuming efficient markets, the rates of return on capital should equalise. Hence, the competitiveness benchmark must depend on ULC and on capital productivity. When capital productivity is low, ULC must fall; when capital productivity is high, ULC can rise.

Chart 6 shows the development of the average capital efficiency in several euro area Member States.

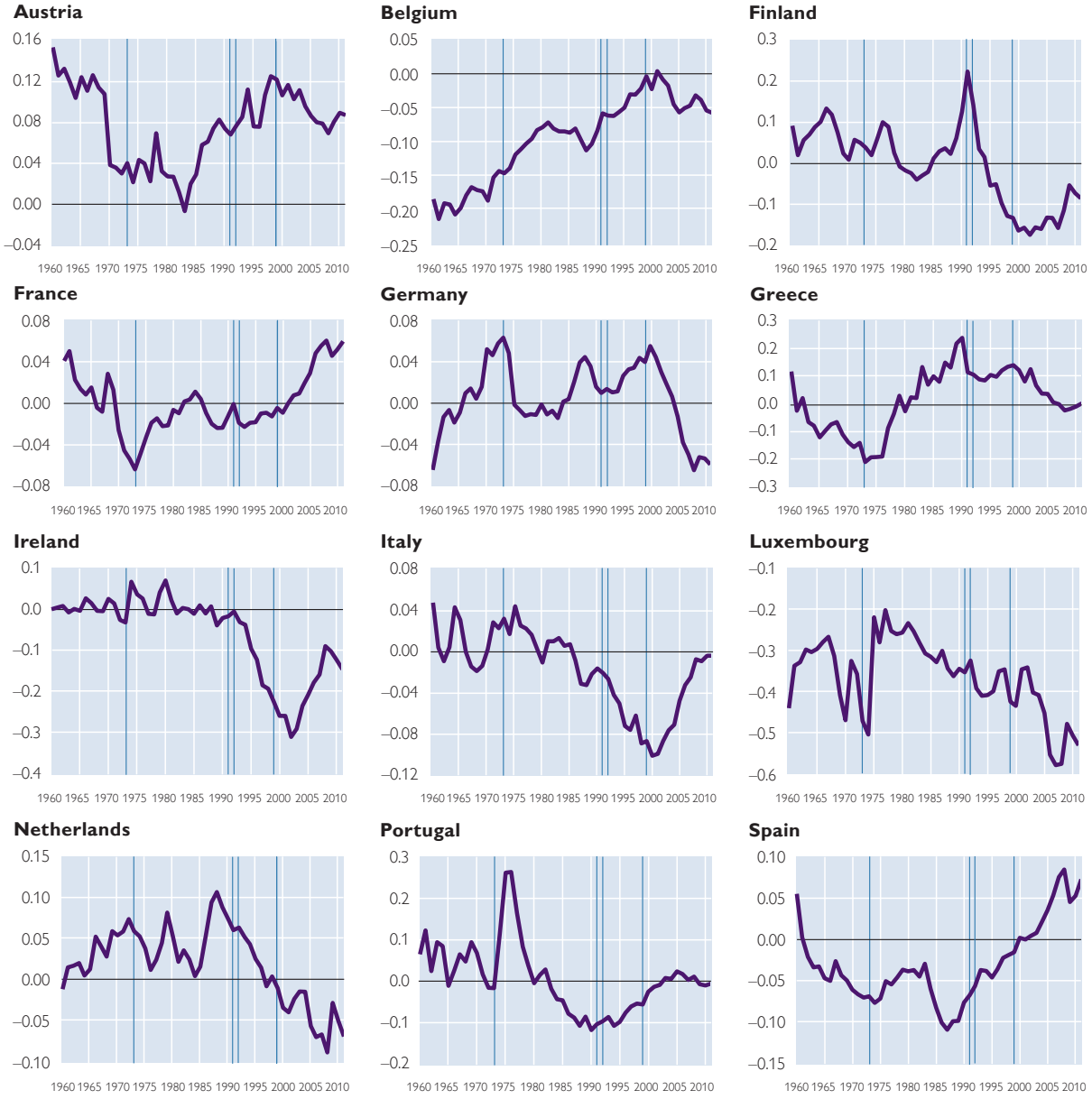
Given the developments of average capital efficiency and labour productivity, we can calculate the equilibrium unit labour cost relation (the red line in chart 7) and compare it to actual ULC (the blue line). The chart is drawn to reflect the national levels relative to the euro area. A value of 1 indicates that ULC in the country of reference are equal to the euro area.

We can then calculate our Competitiveness Index as the difference between actual and equilibrium ULC relative to the euro area. Equipped with this index, we can now try to assess the impact of competitiveness on other variables.

Chart 8

Competitiveness Indicators

ULC relative to equilibrium



Source: Centro Europa Ricerche, Rome.

Does Competitiveness Matter for Economic Growth in the Euro Area?

To answer this question, we estimate economic growth as a function of private and public investment, the yield curve and competitiveness. We find private investment drives growth, public investment is not significant, but competitiveness and the yield curve have become highly significant in EMU as the table shows.

Table 1

Drivers of Economic Growth

	1971–2010			EU-15 Pre-EMU		EMU			NMS 1993–2010
$\Delta \ln GDP_{t-1}$	0.136	0.283*	0.525***	–0.054	–0.090	0.310	0.100	0.672***	0.636***	0.025
	(1.27)	(1.95)	(3.79)	(–0.30)	(–0.41)	(1.20)	(0.81)	(3.74)	(3.90)	(0.20)
Δ (Govl/GDP)$_t$	–0.003	–0.011	–0.009	–0.002	–0.003	0.001	0.018	0.003	–0.017	0.049**
	(–0.32)	(–1.01)	(–0.85)	(–0.20)	(–0.31)	(0.12)	(1.12)	(0.20)	(–1.24)	(2.01)
Δ (Privl/GDP)$_t$	0.008***	0.008***	0.005**	0.009***	0.009***	0.006**	0.015***	0.013***	0.009***	0.016***
	(3.98)	(3.62)	(2.53)	(3.53)	(3.41)	(2.16)	(5.89)	(4.50)	(3.74)	(4.04)
Δ yield$_t$		–0.002***	–0.002***		–0.002**	–0.001		–0.003	–0.004**	
		(–2.66)	(–2.63)		(–2.57)	(–1.48)		(–1.16)	(–2.23)	
$\Delta \ln Comp_t$			–0.308***			–0.253***			–0.438***	
			(–6.28)			(–3.54)			(–8.32)	
time dummies	no	no	no	no	no	no	no	no	no	no
R^2	0.380	0.425	0.493	0.335	0.341	0.410	0.483	0.642	0.738	0.338
N	511	456	456	315	274	274	196	182	182	152
Under id.	33.8 ***	29.7 ***	30.7 ***	13.9 ***	15.1 ***	9.3 ***	10.7 ***	10.2 ***	9.7 ***	5.4 **
Weak id.	15.5 ***	12.1 ***	12.5 ***	5.5 **	5.5 **	3.1 *	4.7 **	4.9 **	4.4 *	2.0

*Note: Fixed Effects Instrumental Variables estimates. T statistics in parenthesis; * significant at 10% level; ** significant at 5% level; *** significant at 1% level. Instrument used: lag 1 of DlnGDP, lag 2 of govl/GDP and privl/GDP. For under identification and weak identification we report the Kleibergen-Paap rk LM and Wald statistics.*

Fiscal Policy and Competitiveness

Competitiveness might also influence fiscal policy by raising growth and revenue, by lower revenue through tax cuts and by raising expenditure to subsidise competitiveness. To assess the effect, we have estimated revenue and primary expenditure functions and calculated the expected future primary budget positions. Of course, debt sustainability requires a primary surplus sufficient to service debt.

We look at three scenarios:

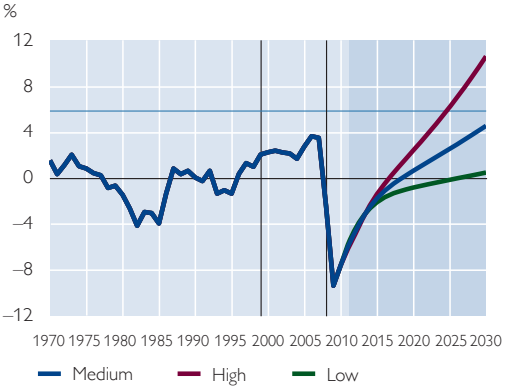
– The medium scenario with constant competitiveness and slow growth convergence to the most likely growth rate (see charts above).
– High scenario at a 0.5% higher growth rate and 0.5% competitiveness improvement per annum.
– Low scenario at a 0.5% lower growth rate and 0.5% competitiveness deterioration per annum.

The results are illustrated in charts 9 to 12:

Spain is a typical case. One observes the dramatic loss of income after the financial crisis hit in 2008. Primary surpluses have become a deficit and our estimates expect that under normal conditions the primary surplus will return in approximately 5 years time. However, even under those circumstances Spain will not reach a primary surplus sufficient to service its debt. In fact, in the pessimistic scenario it will even take 10 years until it is returning to a balanced primary budget, which means that public debt is unsustainable. However, with the improvement of economic growth in competitiveness

Chart 9

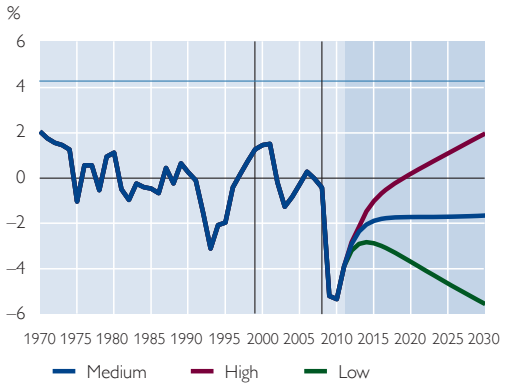
Spain: the Typical Case



Source: Author's calculations.

Chart 10

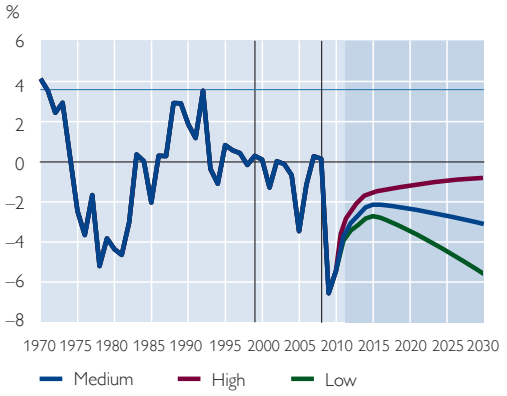
France: the Worrisome Case



Source: Author's calculations.

Chart 11

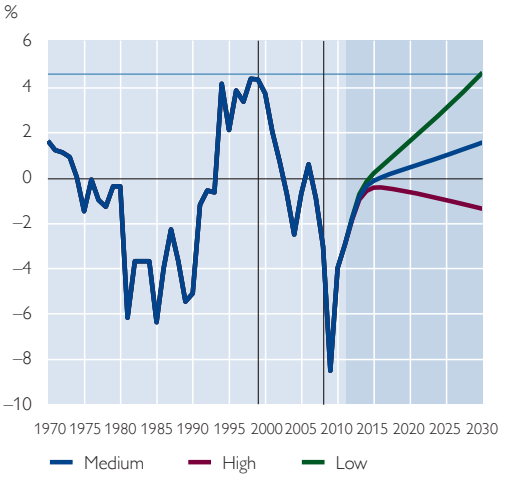
Portugal: the Hopless Case



Source: Author's calculations.

Chart 12

Greece: the Weird Case



Source: Author's calculations.

public debt becomes sustainable and will stabilize in the early 2020s.

France is a worrisome case. We see that even with the medium scenario this country will not return to positive primary surpluses, and in fact under the low growth-(low) competitiveness scenario they will even deteriorate further. On the other hand, if France would improve its growth and competitiveness under our model assumption, it will not be sufficient to bring French debt dynamics under control. Hence, one has to be concerned about the capacity of France to sustain its public debt position.

Although competitiveness improves the expenditure side of Portugal's budget, it is not enough to yield a surplus sufficient to service the public debt.

We find a negative relation between competitiveness improvements and tax revenues. Presumably, Greece improved competitiveness by keeping wages low or by mitigating tax increases on labour.

Conclusion: What to Do?

Europe needs higher growth. It needs to improve competitiveness, which means higher productivity of capital and labour. However, it is often overlooked that capital efficiency is negatively affected by low interest rates. On the other hand, higher labour productivity depends in the short run on wage increases and in the long run on R&D. To sustain productivity improvements, Europe needs higher investment. That will only happen if uncertainty in capital markets is reduced. This will require more coherent macroeconomic management and ultimately the creation of a deep market of eurobonds.