



Exploiting Europe's Strong Potential

Governance, Institutions and Policies

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Summary points

- With the euro approaching the tenth anniversary of its establishment, this is a timely as well as critical moment to review policies and performance. Enough experience of the convergence and adjustment processes has been gained to better understand how they work and what problems have been created rather than solved. As the strengths – and the success – of the euro become more visible, so too do its weaknesses and the conflicts it creates.
- Are the appropriate mechanisms and governance in place to help manage Europe's economy so that it can realize its potential? Governance is critical because of the institutional complexity of the monetary union. Independent policy targets and policy instruments not only have to be consistent with each other, but also need to be integrated in a non-conflicting framework.
- There are two threads to this debate: convergence and adjustments across the euro area, and how the region as a whole is performing with regard to the rest of the world. Both imply a new approach to governance.
- When EMU was established, the euro area comprised 11 founding members. Now it comprises 15 and is slowly expanding. Ten years ago the emergence of China was more a possibility than a reality, while the 'Asian Tigers' were coming to terms with a devastating financial crisis. Now the rise of the emerging market economies and the enlargement of the global economy's playing field pose significant challenges to the competitiveness of the euro area. With the euro now becoming the second pillar of the international monetary system, EMU's external dimension has become very relevant.
- The way forward needs to blend the traditional concerns for macroeconomic stability and competitiveness with the more recent concern about the role of Europe in the global economy. All these dimensions need to be organized into a coherent agenda. The right policy should be implemented at the right time.

Getting the right policy at the right time¹

Ten years after the establishment of EMU, economic growth and employment remain Europe's main concerns. Over the last decade Europe's overall economic performance has been disappointing, lagging significantly behind that of the United States – even if some countries have done better than others, as shown in Figure 1. In particular, Europe appears to be settling into a 'two-speed' system. Asymmetric economic developments in GDP growth, especially marked over the last ten years, have left the 'old core' (chiefly Germany, France and Italy) weak (more or less on a par with Japan), while growth remained robust in most of the 'outer circle' of the UK, Ireland, Scandinavia, Spain and Eastern Europe (the latter linked to catch-up effects). Given the size of the 'old core', its poor performance dragged back the average growth rate of the euro area, curbing overall EU growth as well. This encouraged pessimists to conclude that prospects were dismal and would become yet more dismal given population ageing over the next decade.

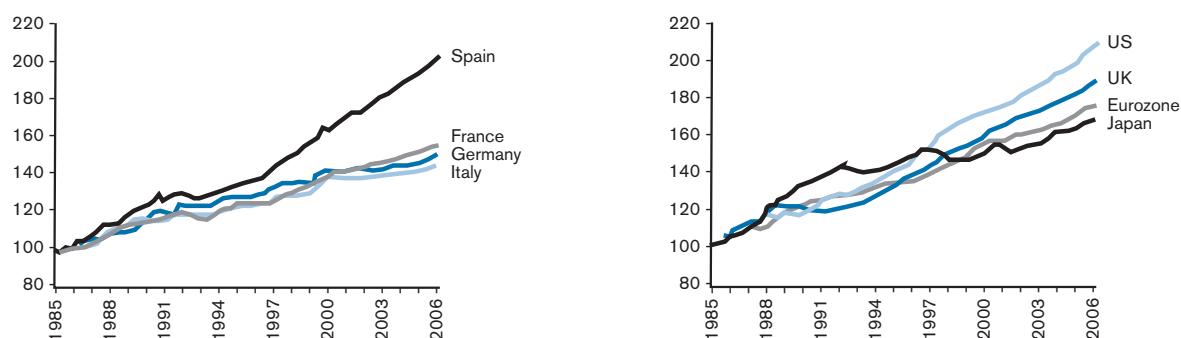
As a result, the decidedly perkier outlook over the last year, with GDP growth for 2007 in the 2.5–3% range² for the euro area after five years below 2% and growth of more than 6% in the fast-track East European economies, has still not

allayed concern that productivity and competitiveness may be lagging behind trade partners such as the US.³ This is especially noticeable in leading-edge sectors and in business organization, owing to a combination of inadequate investment in human capital, insufficient research and development, and the limited ability of EU enterprises to adapt to changes and innovate. In addition, some sectors of European industry are being squeezed out by highly cost-competitive emerging market economies, especially China.

Extrapolations from a particularly bad patch for the core euro area economies undoubtedly led to excessive pessimism about future prospects. Nevertheless, the recovery is very recent and opinion remains mixed regarding the implications of this upturn and its sustainability. In particular, what are the chances of the euro area's sustaining GDP growth in the 2–3% range?

With the euro approaching its tenth anniversary, this is an appropriate moment to review policies and performance. Over the last decade enough experience of the euro and the convergence and adjustment processes has been gained to better understand how they work and what problems have been created rather than solved. As the strengths – and the success – of the euro become more visible, so too do its weaknesses and the conflicts it creates.

Figure 1: GDP index 1985-2006



Source: Oxford Economics.

¹ The title paraphrases Joseph Stiglitz's remarks on Germany.

² Eurozone growth registered 2.65% in the 3rd quarter (q3) after 2.5% in q2 but will almost certainly be down to just over 2% in q4 and thus average about 2.5% for the year (against 2.9% in 2006). The EU average will be about 3% for the year against 3.1% in 2006. While this is not bad, there has been some loss of momentum compared with 2006 and of course the concern is that 2008 will slide towards 2% (and even less within the eurozone).

³ Chatham House and Pendo group (2007).

Current conditions are packed full of contradictions and conflicting interests. Europe is currently facing the challenges posed by the soaring euro. The strong currency is damaging European competitiveness – hitting export markets particularly badly – and if continued, could exert serious pressure on economic performance as a whole across the eurozone. At one end the future of Airbus is critical – a leading hi-tech sector that risks being killed by the strength of the euro and weakness of the dollar.⁴ At the other, China is driving bottom-end industries out of business while potentially eating up Europe's traditional companies. This would matter less if the unemployment rate were low and the economy in full swing, but the upswing has hardly had the chance to get going and consumer spending is low. This is also a critical time for new states, which can see potential problems as well as advantages in joining the eurozone.

The key issue remains, therefore, how to improve Europe's economic performance and to realize opportunities for growth in the future while retaining competitive advantages and responding effectively to global competition. Are the appropriate mechanisms in place to help manage Europe so that it can realize its potential – and if not, what should be done about it? Can changes in governance help address these questions and improve performance? The challenge is to find an appropriate response through policies and practices that help create a supportive environment for Europe to succeed and, just as important, to avoid policy conflicts that may damage economic recovery.

Governance is critical because of the institutional complexity of a monetary union established within a group of states that retain their sovereignty in most economic matters, except monetary policy. This means that independent policy targets and policy instruments not only have to be consistent with each other, but also need to be integrated in a non-conflicting framework. For example, the objective of increasing private consumption and therefore GDP may be negated by the pursuit of structural reforms in the labour market if consumers become

more uncertain as a result of reforms and thus more prone to excess saving – in other words, if reform efforts are not communicated in a coherent and positive fashion.

‘Without the right mechanisms and the right sequence to address the problems, there is a risk of creating more instability and perverse effects’

The point is that a complex structure such as EMU requires not only a deep understanding of the relationship between policy targets and the means to achieve them, but also a full grasp of the right sequence at each national level. For instance, the objective of job creation negates the objective of productivity growth if the sequence is not right. Pursuing them simultaneously ensures that neither is achieved. The right sequence is job creation first and productivity boosting second. Without the right mechanisms and the right sequence to address the problems, there is a risk of creating more instability and perverse effects. To some extent what is happening in Europe is a no-win situation – and this is how it comes across with the public. This clearly needs addressing.

There are two threads to this debate. First, there is the issue of convergence and adjustments across the euro area, in particular how new member states are integrating and preparing for EMU. Second, there is the issue of how the region as a whole is performing with regard to the rest of the world. Both imply a new approach to governance. In the late 1990s, when EMU was established, the euro area comprised only the 11 founding members. Ten years later there are 15 members, nine members to be and three countries which may stay outside EMU forever – a prospect that very few people fully contemplated in 1998. Ten years ago the emergence of China was more a possibility than a reality, while the

⁴ Airbus recently announced plans to move manufacturing operations to the US, China and elsewhere in an effort to become more competitive in the wake of the over-strong euro. This is likely to signal a wider trend in the sector, as more firms will seek to cut costs by 'delocalizing' production and sourcing supplies from the cheaper dollar area.

EU-27 versus euro area: conflict or complementarity?

The EU has come to accept that a significant number of member states will not join the euro area in the near future – or, in a few cases, perhaps ever. But it has not got to grips with the governance implications, which are potentially highly important for the following reasons:

- We live in a world where currency diplomacy hits the headlines regularly, but the obvious counterpart to this – trade diplomacy – is an EU-27 competence.
- The euro area may, and should, move in the direction of greater policy coordination and stronger economic governance, but this could create psychological barriers (or even outright hostility) between the euro members and the rest. This can already be seen in the way the ECOFIN feels 'upstaged' by the Eurogroup in the economic decision-making process, an issue that is especially relevant with regard to the UK's sense of an EU identity.
- The vexed question of euro area enlargement has in itself created resentment and a psychological barrier between ins and outs.

It would be unwise, and perhaps fatal to a harmonious EU future, not to get to grips with this dichotomy explicitly – and urgently. There are routes to address the problem and even to turn some aspects of it towards a positive outcome. Here are four practical proposals.

- The Eurogroup should prepare periodic strategy reports for the EU-27, mapping the links between its own internal cooperation and the broader economic governance of the EU. These should be discussed by the Council at least once a year.

- It should be acknowledged and highlighted that the euro area stands to gain disproportionately from progress with EU structural reform initiatives – as these affect labour, product and financial markets – because its members' lack of an exchange rate instrument makes such reforms especially valuable in promoting swift and efficient adjustment, and financial risk-sharing and smoothing of consumption patterns. **It is thus a natural caucus for such reforms – and this should be valued by 'reformist' non-members such as the UK.**
- A discussion should be opened on rebalancing the Maastricht criteria for euro adoption. In particular, the reference level for inflation should be corrected, so that it is based on inflation in euro area members and those members that are closest to the European Central Bank (ECB) objective of just under 2%, not on the lowest inflation figures.* This latter distinction is crucial given the role of national inflation in intra-euro area adjustment, which means that certain member states can have very low rates of price increase for an extended period, as they adjust to real sector shocks. By contrast, greater qualitative emphasis, at least, should be placed on the strengthening of fiscal institutions, to provide assurance that progress towards meeting the fiscal reference value will not be reversed after membership. Such a rebalancing should meet the concerns of enlargement liberals and enlargement conservatives alike.
- The attractions of the euro should be actively promoted in the non-participating member states. This task is becoming easier as it becomes ever more clearly a pole of stability in the global system, and as the ECB's skills at crisis management become evident.

*As suggested in a paper by Iain Begg for a workshop on 'EMU at 10: Achievements and Challenges', hosted by DG ECFIN at the European Commission on 26–27 November 2007 (to be published in the compendium of workshop essays and studies).

'Asian Tigers' were coming to terms with a devastating financial crisis. Now the rise of the emerging market economies and the enlargement of the global economy's playing field pose significant challenges to the competitiveness of the advanced economies such as the euro area. With the euro now becoming the second pillar of the international monetary system – in a complementary rather than a competitive

relationship with the dollar – EMU's external dimension has become very relevant. It is necessary, therefore, to move on from the approach to governance that was embedded in EMU's institutional design and issues of the late 1990s to a more complex structure.

The way forward needs to blend the traditional concerns for macroeconomic stability – as expressed in the

Maastricht Treaty and in the Stability and Growth Pact (SGP) – and for competitiveness – as in the Lisbon Agenda – with the more recent concern about the role of Europe in the global economy. All these dimensions need to be organized into a coherent agenda (see Figure 2). The institutional design needs to be adjusted at the eurozone level while a set of positive incentives⁵ and best practice need to be devised at the national level. We should also ask whether short-term goals have been mixed up with long-term instruments and vice versa. Doing the right things in the wrong order may be worse than doing nothing. Again, the sequence must be right and must provide for greater consistency between instruments, goals and timing. Finally, the impact that policies pursued by one country can have on other EMU members needs to be taken into account. If done correctly, the right policies at the right time can be doubly effective.

This paper draws on the findings of a two-year research project on 'Reforming European Economic Governance' conducted by Chatham House in collaboration with other European research institutions. The purpose of the paper is to contribute to the debate on European economic governance, by presenting the critical points that emerged from extensive research and consultation with key policy-makers and business leaders, indicating some policy recommendations and suggesting ways forward. In particular the following questions are explored:

- How can European integration help to improve the economic performance of the member states?
- How can differences in institutions and market structures across the euro area result in different economic performance?
- How can European economic governance be structured to foster both constructive competition and popular legitimacy?

By placing these questions at the centre of our policy analysis, we aim to develop a coherent agenda for reforming European economic governance. Moreover, by

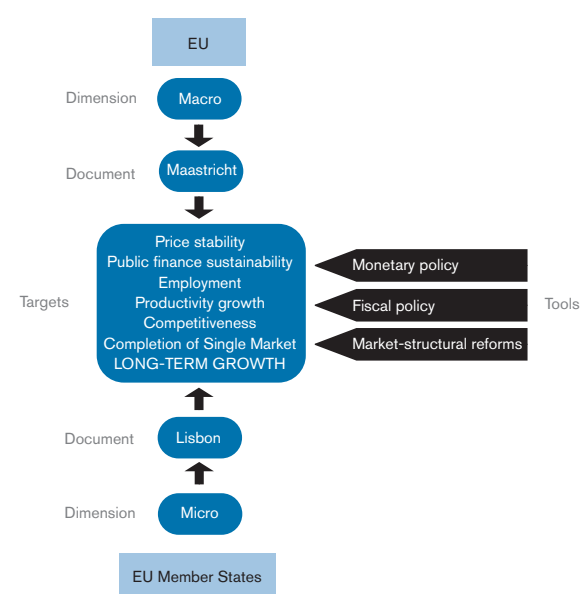
emphasizing the complementarity between the EU and its member states, we hope to raise the quality of public debate and improve the quality of public policy as well.

Stability and reform: Maastricht and Lisbon

Broadly speaking, European economic governance – i.e. all rules and institutions that constitute the framework of economic policy – covers four policy areas: monetary policy, fiscal policy, market structure and exchange rates. Across these four areas there are three different, but tightly interrelated, levels: macroeconomic, microeconomic and regulatory. All policy areas and levels aim at same goals – economic growth and employment – even if these are to be achieved using different instruments and policy targets. The regulatory dimension, by stressing the need for a common framework and practices to further establish the single market, also works towards the common goal of enhancing Europe's economic performance.

Not all policy areas, however, are addressed at all levels of policy-making. Monetary policy is a matter for EMU and its member states, but not for the EU as a whole. Fiscal

Figure 2: The governance puzzle



⁵ Economic governance in Europe is viewed mostly as a series of negative incentives and reforms. An example of this is the Growth and Stability Pact with its imposition of a limit on public deficits.

policy and market-structural policy are matters for the EU, the member states and the regions, but do not fall within the jurisdiction of EMU institutions. Responsibility for the external value of the euro is ambiguous.

The issue of coordination and therefore of establishing a common set of rules and procedures has been central to the process of European integration since the early 1990s, when the Maastricht Treaty set the goal of achieving an economic and monetary union by the end of the decade. The whole institutional design of EMU reflects the goal of ensuring lasting macroeconomic stability across Europe's internal market and therefore giving credibility to the new currency. Besides appeasing German concern about 'scrapping' the D-Mark, macroeconomic stability promised to protect the internal market from unnecessary volatility, lower the cost of capital and encourage investment across Europe as a whole.

“By shifting the emphasis to the concept of debt sustainability, the reform of the SGP in 2005 marks the real turning point in the way governance is conceived and how different policy areas are connected”

The commitment of maintaining balanced budgets over the medium term was established at the European Council in Amsterdam in 1997 and incorporated in the Stability and Growth Pact. The Cologne European Council meeting in 1999 corrected the price-stability and budgetary bias of the Maastricht Treaty by enlarging the focus to employment and growth.

By shifting the emphasis to the concept of debt sustainability, the reform of the SGP in 2005 marks the real turning point in the way governance is conceived and how different policy areas are connected. The reform

draws an explicit link between the goal of the SGP – i.e. macroeconomic stability – and those of the Lisbon Agenda – job creation, market-structural reforms and social cohesion. It is explicitly acknowledged that major reforms bring direct cost savings and therefore have a positive impact on the long-term sustainability of public finances.⁶ In particular, by focusing on bringing more people back to the labour market, policies could improve fiscal performance through reduced welfare benefit payments and increased tax revenues. This, in turn, would strengthen budgetary sustainability and compliance with the SGP. Budgetary sustainability and the working of automatic stabilizers would help the ECB to run a more flexible and effective monetary policy.

The SGP reform also implicitly recognizes the importance of good institutions and gives more leeway to countries that have these. We are now familiar with how the eurozone economy functions and recognize that differences in institutions and market structures across the euro area can result in varied economic performance in different countries and hence distort the impact of key policies. In particular, differences in the financial sector influence the way countries respond to monetary policy changes. As a result, efforts by the ECB to fine-tune monetary policy-making have a disproportionate impact in some member states, with potentially undesirable effects. Monetary policy thus risks becoming a rather ineffective instrument, which explains why the ECB is often slow to adjust interest rates to cyclical conditions.

How do these different institutions and market-structural conditions affect and perhaps distort the convergence process and the adjustment to asymmetric shocks once in EMU? And how can the wrong sequence and conflicting tools and policies distort the expected policy output and even result in some undesired effects?

The next sections address these questions, looking in particular at the case of south European countries – Italy, Portugal and Spain – and the challenges that new member states may face once in EMU. The relatively disappointing performance of south European countries in EMU has raised the question of whether relatively unstable

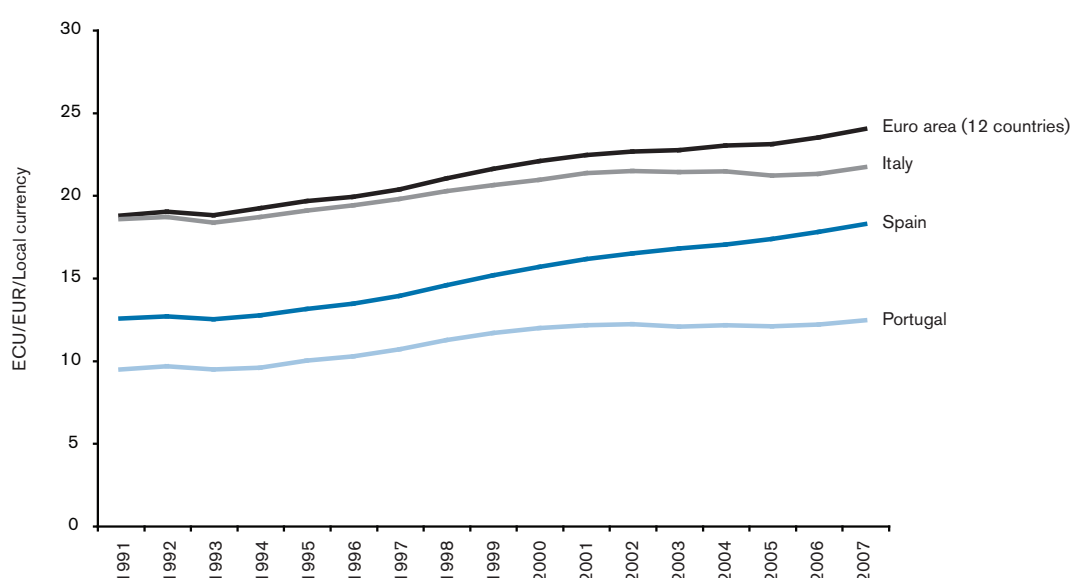
⁶ As a result steps in the reform process should be taken into account when assessing each country's progress towards medium-term fiscal objectives.

economies with the potential for high growth are desirable partners in a monetary union with more robust economies. Was EMU membership more challenging than anticipated? Or is it rather the case that these countries have not fully grasped the complexity of economic policy-making in EMU – in particular, the transmission of monetary policy, the side-effects of policies devised to boost competitiveness and the role played by market structures in the convergence and adjustment process? And is there the risk – one that is theoretically high considering the intensity of intra-EMU trade relations – that policies from bigger and more stable countries generate indirect beggar-thy-neighbour effects on other member states with market-structural conditions less conducive, for instance, to policies of adjustment of domestic price levels? These issues are extremely relevant not only for the functioning of the euro area as a whole, but also for the new member states of Central and Eastern Europe that are going through a painful adjustment process to qualify for EMU.

Fit for EMU?

Even if convergence in Italy, Spain and Portugal was a success story in most respects, the performance of these countries, once they joined EMU, has been unsatisfactory. This has prompted some critics to predict a possible collapse of the euro, especially linked to the imbalances seen in Spain and Italy.⁷ These countries still have relatively high inflation and rising budget deficits – Spain being the only exception. Economic performance has varied significantly, with Italy and Portugal suffering from decreasing competitiveness, below-trend growth and large public deficits. Italy also has a massive debt-to-GDP ratio (106.8% of GDP in 2006). On the other hand, Spain's strong economic performance, with real growth rates above the eurozone average thanks to a significant catching-up potential at the start of the Maastricht process (see Figure 3), raises the question of whether such a path is unsustainable given that the growing property market bubble has increased household indebtedness to 100% of gross disposable income.

Figure 3: GDP at 2000 market prices adjusted for the impact of terms of trade per head of population: EU-12, Spain, Italy and Portugal (1991-2007)



Source: European Commission, AMECO database.

⁷ See Tilford (2006) and various articles in the *Financial Times* by Wolfgang Münchau, for example 'Rest assured, the eurozone will prove its durability', 24 September 2006.

Is this a case of the 'post-Maastricht hangover', as some observers would argue, that hit relatively volatile and laggard economies forming a monetary union with more stable and robust economies?⁸ Undeniably, the process of convergence in the run-up to EMU provoked a few shocks. Typical entry shocks involved some overshooting of investment (e.g. in Spain and Portugal) as a result of lower exchange rate risk. The steep drop in real interest rates followed by the increase in domestic asset prices (e.g. in Italy), and wealth effects, have resulted in stronger consumption with an inevitable deterioration in national trade balances (e.g. in Spain). However, it would be misleading to conclude that some or all of these countries suffer from a 'post-Maastricht hangover'. Adjustment problems are not caused by EMU membership; rather, they go back to those countries' pre-EMU adjustment and the structural features of their economic systems, which range from their willingness to import energy, to the state of their labour, service and product market institutions. To put it differently, the adjustment process in the presence of asymmetric shocks – i.e. 'returning to equilibrium' – and the length of that process mean something different for each country, and the way in which adjustment is achieved depends upon national institutions and policies. Looking at the cases of Italy, Spain and Portugal, we can draw the conclusion that productivity is the key factor behind well-managed convergence and adjustment, and the country's overall performance in EMU.

Portugal

Convergence experience in Portugal gives some useful pointers here, providing examples of risks of excessive resource flows into consumption and housing, during a long financial integration cycle,⁹ and in this case also into the public sector.¹⁰ Excessive fiscal deficits and a rapid expansion of credit to households (fuelled by perceived implicit guarantees on short-term cross-border inter-bank

borrowing) conspired to divert external savings away from productive uses and fuelled unwarranted appreciation of the real exchange rate. At the end of the fiscal/credit cycle in Portugal, a global economic slowdown and abrupt financial retrenchment in all sectors of the economy brought convergence to a full stop. As currency devaluations were no longer an available tool to restore competitiveness, Portugal should have turned to the other tool, namely nominal wage restraint. This would have been the right mechanism for two reasons, both linked to Portugal's low unemployment rate: pressure on nominal wages and scope for increasing productivity. But this was not the case, and the result was a drop in exports and further widening of the current account deficit – helped by a fairly expansionary fiscal policy.

Italy

Italy is another case of badly managed convergence and a failure to increase productivity to compensate for the loss of the exchange rate as a way to enhance competitiveness. In the post-EMU years policy-makers did not tackle the structural weaknesses of the domestic industry and try to get the trade unions to agree on wage restraint. Productivity suffered as a result, with wages increasing faster than labour productivity. Soaring unit labour costs started to affect competitiveness. When oil prices began to rise again – Italy is a net oil importer – they contributed to further pressure. Only sluggish consumption as a result of slow economic activity prevented the considerable loss of competitiveness from resulting in a severe trade deficit, and in fact, as of 2005, Italy's current account deficit was at a relatively modest level –1.1% of GDP against an average surplus in the eurozone of 0.2%.

Spain

Again, productivity growth may help Spain to avoid a boom-burst type of crisis. Here imbalances are caused by

⁸ The argument works as follows: relatively poorer countries are deemed to experience consumption and/or investment booms as they try to close the gap with their more developed partner economies. Once the process of catching-up is under way, any attempt to stabilize the economy in these countries is depressed by the impossibility of using monetary tools for adjustment purposes.

⁹ Indeed this type of convergence credit boom does go on for a long time.

¹⁰ Just like Italy and Spain, Portugal underwent quite a successful adjustment process in preparation for EMU. Participation in the euro project led to a boom, with a rapid surge in both consumption and investment. But the current account deficit started deteriorating, moving from a relatively contained 2% of GDP in 1991 to 6.4% in 1997, at the end of the Maastricht convergence process.

shocks: nominal convergence, financial integration, migration, etc., so there is scope for equilibrium changes. Thus the imbalances are not just the effect of the 'perverse interest rate effect' in an asymmetric boom under EMU, but, in a sort of circular fashion, the 'perverse interest rate effect' also contributes to the boom. However, as shown in the research in the *EU Economy Review 2006*, those perverse interest rate shocks tend to wear off in two or three years, and the competitiveness improvements resulting from adjustment eventually dominate. This leads to a stable adjustment process within EMU without the need for discretionary adjustment instruments such as nominal interest and exchange rates. In this respect, losing monetary sovereignty is not necessarily a problem. Low capital accumulation in preparation for the euro and thereafter has led to low productivity growth, which is currently triggering rising unit labour costs. Stabilization should therefore be possible through the so-called competitiveness channel, in particular through Spain's flexible labour markets. Productivity growth is needed to restore competitiveness and turn the current account deficit around painlessly.

The examples above have shown that productivity growth is critical in absorbing domestic and external shocks and to restore competitiveness. However, productivity is a rather complicated concept to master, and a difficult policy target to achieve, because it encompasses variables outside the traditional macroeconomic framework. To increase productivity countries locked into a currency union need to understand the new constraints which that imposes, together with the need for structural reforms that boost productivity.

Take the example of a country with stronger demand conditions as a result of a fall in interest rates following the prospect of EMU membership. This would fuel inflation and thus wage growth, jeopardizing international competitiveness. This boom would lead subsequently to some cooling of the economy, provided that nominal wages responded to prices. However, this did not occur in Portugal where slower economic activity following the boom did not produce enough unemployment to see wages falling steeply. The opposite happens in the case of a slump in a country such as Germany with a unionized labour market. Here for the competitiveness channel to

work unions need to be well disposed and to accept wage restraint in the absence of fiscal side payments (e.g. tax relief or augmented social transfers) – since EU governments have lost the use of monetary tools, and their fiscal policies are constrained by the Stability and Growth Pact.

Enlarging Europe: are there some lessons for new member states?

Is there a lesson here for Central and East European countries (CEECs) now preparing to adopt the euro? This question is extremely relevant to the prospect of EMU membership for CEECs. For one thing, new accession countries are trying to stabilize their economies and are going through painful processes of nominal adjustment to meet the Maastricht criteria, just as Italy, Spain, Portugal, and Greece did in the period preceding the launch of the euro. Secondly, the economic characteristics of CEECs make them relatively similar in terms of economic outlook to south European countries in the early 1990s – with the exception of Italy. In particular, income per capita and employment rates are lower than the eurozone average, a characteristic that implies an acceleration of the catching-up process once they enter EMU.

‘In the late 1990s EU member states, in particular, achieved notable successes in terms of integrated macroeconomic and structural reforms’

Central and Eastern Europe is a strikingly diverse region. Even in the eight EU member states, Estonia's balanced budget, currency board and steep import of foreign savings contrast with, say, Poland's inflation targeting, low external deficits and major fiscal challenges. The diversity is far greater if we include not just imminent EU candidates but the 'Thessaloniki' countries of the western Balkans – which

also have an EU destiny but in some cases have far to go in terms of institution-building and regional integration. Nonetheless, it is intriguing to ask whether common macro-economic stability challenges run across such a diverse region. These might result, for example, from the shared experience of real and financial sector catching-up; from inherent difficulties in building the institutions of a fully-fledged market economy; or from the challenges of euro adoption at some point in the future.

Three features of the region are striking:

- Macroeconomic stability (in an old-fashioned sense of inflation/imbances) is typically fairly well entrenched – especially if we take into account that these countries should be importing savings, so large external deficits are expected.
- Countries are not building up unusually high levels of reserves, and there is little effort to maintain very competitive exchange rates (at times, the reverse). This is not Asia. Does this characteristic reflect some shared EU umbrella? It is potentially benign, at all events, but only if vulnerability is watched carefully.
- In the stronger reformers (Estonia or Slovakia, for instance) the role of the public sector is shifting. It has been moving from being a potential source of instability to facilitating growth through a strong policy mix and regulatory framework. Stability challenges lie increasingly in private-sector behaviour.

When it comes to EMU membership, CEECs have a number of comparative advantages over south European countries. Over the last decade, most CEECs have accompanied nominal adjustment with extensive structural reform in the goods, service and labour markets. Privatization has been accompanied by far-reaching liberalization. The result is that, in certain sectors, competition is even greater here than in the rest of continental Europe. Even if CEECs have a catching-up potential similar to that of the countries of southern Europe in the 1990s, structural reforms have created a much more stable high-growth environment, and a soft landing for these new members is more likely.

There are, however, important exceptions – including cases of old-fashioned fiscal and monetary mix problems – that, combined with the exchange rate regime, clearly prompt concerns about external vulnerability. In particular, some of the CEECs that are most successful in attracting capital inflows – namely Latvia and Bulgaria – are now facing the ‘impossible Trinity’, defined as having a fixed exchange rate, free capital movement and an independent monetary policy all at the same time.

By and large, however, macroeconomic management has been impressive across the region. And crucially, in most economies, the hidden deficits – quasi-fiscal losses in banks and state enterprises – were also rooted out. In the late 1990s EU member states, in particular, achieved notable successes in terms of integrated macroeconomic and structural reforms.

Focus on the real exchange rate: scope for ‘beggar-thy-neighbour’ effects?

The previous sections have stressed the role of productivity in both convergence and adjustment to asymmetric shocks within EMU, and the impact of domestic institutions in improving productivity. In most cases, it seems that disappointing economic performance and instability can be attributed mainly to the failure of national policy-makers to internalize the new constraints under EMU and put in place the right mechanisms to address the problem. This, for instance, could involve reforming and liberalizing goods and service markets during the convergence process. Similarly, the case of CEECs shows that the reform effort undertaken by these countries in order to join the EU may render convergence and adjustment within EMU less challenging than was the case for south European countries.

The other important lesson, which emerged from the second and third sections above, is that after ten years of EMU, nominal divergence persists, leaving considerable scope for indirect ‘beggar-thy-neighbour’ policies and effects. Coordination, therefore, is becoming increasingly important, especially in view of the EU/EMU enlargement that is deemed to further expand the opportunities for a member country to ‘beggar its neighbours’. Moreover, it

raises the question of how to improve competitiveness in a currency union where 'good' policies can have perverse 'beggar-thy-neighbour' effects.

There is clear empirical evidence pointing to the rising divergence in real exchange rates in EMU. At the root of this divergence are differences in the growth of national price levels. These are not only a function of cyclical positions but are also determined by the shape of national institutions, and of labour markets above all. Yet labour markets do not operate in a vacuum. Their functioning is often conditioned by the fiscal and monetary policy regime under which they operate. In particular, the monetary policy regime change that came about with the inception of EMU has altered national unions' incentive structures. As an example of this, coordinated labour markets in large countries are under a stronger incentive to restrain wage growth than their equivalents in small countries. This is because domestic inflation in large countries affects average eurozone inflation and therefore the ECB's conduct of monetary policy. Germany, for instance, has been pursuing a wage restraint policy in recent years, which has resulted into significantly below-average wage growth and impressive real exchange rate depreciation.

References to 'beggar-thy-neighbour policies' in EMU are indeed mostly associated with German price behaviour. In a sense, the current economic governance of EMU has a differentiated impact on national economies depending on their size. It may well be that adjustment takes place automatically so that buoyant export growth in Germany translates into stronger economic growth, putting a halt to the real depreciation. An improvement in economic governance (e.g. an explicitly flexible inflation target) seems nonetheless necessary to avoid national governments weakening their support for monetary unification or for fiscal discipline while the process of automatic adjustment takes place.

The problem, however, is not only the intra-EMU real exchange rate itself, but also its impact on growth. Once again, structural reforms aiming at strong productivity growth can also help real exchange rate readjustment for converging economies with a fixed exchange rate, and therefore improve competitiveness. This is particularly critical in view of the euro's current strength.

The road from Maastricht to Lisbon: growth, employment and competitiveness

In the previous sections we have discussed the importance of productivity growth in the convergence and adjustment processes for economies locked into a currency union. We have also argued that macroeconomic stability is a necessary but not sufficient condition to address Europe's main economic policy concerns – growth and employment. Given the rigidity of the monetary framework in EMU, pursuing macroeconomic stability – i.e. monetary stability and fiscal discipline – without working, at the same time, on productivity, can generate adverse effects. By stressing the importance of productivity in restoring competitiveness and enhancing growth, we have acknowledged the importance of market-structural reform and thus have implicitly linked Maastricht to Lisbon.

‘Given the rigidity of the monetary framework in EMU, pursuing macroeconomic stability – i.e. monetary stability and fiscal discipline – without working, at the same time, on productivity, can generate adverse effects’

Productivity is a rather elusive concept. At the macro level it is driven by improvements in the structure of the economy as well as by individuals working harder. A better-quality environment and more prosperous companies can help boost the quality of the workforce, whereas failing industries destroy talent and morale. In the case of the euro area, productivity growth can be achieved both through encouraging growth in high value added sectors and by allowing closures among low value added businesses and sectors where job creation is no longer a priority). This offers a two-pronged strategy for non-inflationary growth and enhanced productivity. Many

individuals who switch jobs may in fact be doing very similar work but will increase their measured productivity rates by moving to higher-value sectors and higher-performance companies.

Focusing on high-value sectors such as communications, higher-grade business services and utilities not only boosts productivity, but also improves average productivity as low-value sectors such as distribution, construction, textiles and metals remain at a standstill or decline. Declining activity in low-productivity sectors also alleviates future pressure in the labour market by releasing employees who can switch to better-performing companies. Although some key staff need to be specifically skilled, many employees do not actually change their functional roles (e.g. as clerical and sales staff, finance and planning officers, catering or cleaning personnel etc.), so sector switching need not pose such a great problem for retraining and skills: the 'upgrade' comes largely from the better potential of the sector/company itself and pertinent 'on-the-job' training.

‘The arguments in favour of subsidies and aid will fade if other aspects of economic performance and social conditions improve’

In theory, moving jobs to the higher value added sectors and companies, and cutting out low value added units, could boost productivity by perhaps 10–20% (probably spread over the next decade), although in practice the economy will need to maintain some low value added activities (such as construction and distribution). Some of this switching could be achieved by the provision of training by the government sector for employees to move into the private sector as labour markets tighten. This would allow the government to shed the extra jobs created during the period of high unemployment. A trend towards sector switching should be encouraged as

it could help to maintain euro area productivity growth at higher rates of around 2% or more over the medium to long run.

This need not mean the complete exit of the euro area from low-productivity sectors such as steel, textiles or consumer electronics, as some individual businesses may be highly efficient and self-sustaining even if they face a tough global environment. But it does mean that governments should not subsidize weak and failing businesses, large or small, in any sector. The arguments in favour of subsidies and aid will fade if other aspects of economic performance and social conditions improve, especially if unemployment and underemployment rates are substantially reduced, with higher participation rates for all the population. An unfettered private sector can probably be allowed to restructure and improve its performance in response to changing conditions if background conditions are favourable and prospects remain positive. But looking forward to the options for improving the growth outlook, the emphasis should be on searching for new ways of producing goods and supplying services in domestic low-productivity sectors such as construction and transport, and on planning ahead for infrastructure. Governments clearly have a role in these sectors as well as in controlling their own public-sector services and jobs.

Sectoral change and enhanced productivity growth, together with getting more of Europe's population into the labour market and jobs, mean that the eurozone economy could sustain GDP growth in the 2–3% range over the long run. This would be similar to projections for the US.

Two caveats need to be added here. First, the sequence of policy implementation must be right. The unemployment rate in the eurozone, albeit diminishing, is still relatively high at around 7%. This needs to be fixed before any measure to boost productivity is undertaken. Indeed, the process of job creation reduces productivity, so there is no point in trying to achieve two conflicting targets at once.

Second, any realistic programme of restructuring inefficient sectors and improving productivity should incorporate a number of incentives and compensations. Wage earners have to see the advantages of reform and be compensated

for the burden that is unavoidably imposed upon them. Moreover, reforms, and the rationale behind them, should be communicated clearly and effectively and reach all the parties involved.

Up to now, things have not gone well. A system of incentives and compensations has been mostly lacking in previous reform plans; similarly, in the rhetoric there has been an unnecessary focus on efficiency that has left issues of equity and fair play in the background. As a result, national reforms have been managed in such a timid and inconsistent way that their immediate tangible effect has been to undermine consumer confidence, creating uncertainty about the future. This happened in Germany, where the recent reforms in pension, healthcare and unemployment benefits induced citizens to save above the necessary level: net household savings grew rapidly, from 6.3% of GDP in 1999 to 7.1% in 2003. This had detrimental effects not only for investment ratios but also for national public accounts. This takes us back to the need for better communicating national and European reform efforts, while also empowering European citizens with the responsibility for the promotion and implementation of reform.

Brussels and Beijing: the euro's external dimension

'Upgrading' the value chain is particularly critical for the euro area given the competition from low-wage countries such as China and the strength of the euro. Ten years ago, at EMU's inception, few people would have predicted the rapid expansion of China and other emerging market economies. Then the goal was to create a strong and credible currency and therefore the focus was on internal conditions – i.e. fiscal policy and budgetary conditions. The strengthening of the single currency in the past eighteen months and the improvements in the budgetary positions of the eurozone's largest economies – Germany, France and Italy – have shifted the accent from internal conditions (i.e. fiscal policy and budgetary conditions) to an external one – the exchange rate. If only two years ago reducing the budget deficits of those countries was probably the most urgent policy issue for the eurozone as a whole, today, with the euro up around 20% against the dollar since the

beginning of 2006, managing the exchange rate is prominent in the policy debate.

‘If only two years ago reducing the budget deficits of those countries was probably the most urgent policy issue for the eurozone as a whole, today ... managing the exchange rate is prominent in the policy debate’

Greater attention should be devoted also to the external dimension of the euro, in particular to the goal of pursuing policies that enhance the euro area's competitiveness through an improved sectoral and business mix. This is particularly relevant given that the euro economy is driven by the 'traditional' European motor of export growth feeding into new investment and thus job creation. Gains have come from leveraging long-standing expertise in key export industries, especially equipment, transport, chemicals and investment goods, against the booming global backdrop. Others come from transferring production and operations to lower-cost regions, as well as from new sector developments and products, improvements in competitiveness also arise from examining alternative methodologies (e.g. in construction) and subsequently downgrading labour-intensive sectors as far as possible as costs rise, from access to dynamic new markets for exports and, more generally, from adoption and adaptation of global best practices. It is instructive to consider more carefully the example of what happened when labour was in short supply in the 1950/60s, when manufacturing reached its apogee and overall growth in productivity was high, with rates up to 3–4%. The twentieth century saw an accelerated move out of agriculture and low value added sectors into manufacturing, and the advent of new labour-saving home appliances and concepts such as 'self-service' restaurants

and supermarkets. The advent of options such as internet shopping and services and teleworking can be seen as a logical extension of these past trends to the modern age.

Objectives and instruments blended in a coherent agenda

In 1998, many people were happy to bet on the strength of the new currency, but of course nobody knew precisely how this artificially created currency was going to develop. Ten years later we can rejoice in the success of the euro and can comfortably predict that it is here to stay. However, if success is now more visible, so are the problems and weaknesses. The single currency union has not yet lived up to its potential, and economic performance has so far been rather disappointing. In this paper we have argued that this is the result of the inability to identify a clear set of targets, the right mechanisms to address them, the right sequence and timing, and, finally, the right level of coordination between EMU member states and future members. So it has been a case of too many fuzzy problems or targets with no means to achieve them

We conclude with some suggestions for the way forward.

- Assess policies within the context of a country's institutional setting, in which markets allocate resources with regard to the capacity to evolve and coordinate credible and transparent frameworks for policies.
- Implement the right policy at the right time. This means getting the sequence right, assigning the appropriate tools to each target, assessing the policy impact at both macro and micro level, and looking at the temporal dimension – short-term vs long-term effects. Above all, blend these dimensions into a coordinated policy agenda.
- Assess policies in terms of their causality chain, at both national and EMU level, to avoid undesired

effects which nullify the impact or trigger 'beggar-thy-neighbour' effects.

- In the eurozone, focus on reducing unemployment, increasing employment levels and improving the quality of current employment before boosting productivity. These goals are also critical for generating support for reforms.¹¹
- Build realistic programmes for structural reforms while focusing attention on the long-term implications of large public debts.
- Coordinate policies. A familiar example is the macro policy mix, where fiscal tensions can trigger volatile inflows and exchange rate instability. Another imperative (crucial in Eastern Europe) is coordination to contain unhedged currency borrowing;¹² fiscal policy can take pressure off interest rates while supervision can reduce risks.
- Focus on non-wage labour costs to respond to competitive challenges rather than unconditional cuts to payroll taxes.
- Multilateral surveillance together with a stronger role for the EU Commission can help detect and correct potentially detrimental divergences before imbalances develop.

In the absence of political union in the euro area, stronger economic governance to promote cohesion is certainly needed in the light of the issues discussed in the paper, including 'beggar-thy-neighbour' effects and perceptions, policy mix concerns and currency diplomacy challenges. This needs to develop *inter alia* a shared understanding of adjustment dynamics in the euro area, so as to identify warranted concerns about 'beggar-thy-neighbour' effects. Improving economic performance is likely to bring 'Europe' closer to its people and to maintain popular support for the European project.

¹¹ European Commission, Eurobarometer 67, Public Opinion in the European Union, Spring 2007.

¹² Borrowing not supported by a similar flow of foreign currency, for example from exports.

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