WILL THE EUROZONE CRACK?

Simon Tilford

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ABOUT THE AUTHOR

Simon Tilford is head of the business unit at the Centre for European Reform. He has worked as an international economist for a number of organisations, including the Economist Intelligence Unit, Nomura International and Capital Economics. He has written extensively on the European economy and the political economy of reform in Europe.

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1 Introduction

Economic and Monetary Union (EMU) is the biggest and most courageous project the EU has ever undertaken. The euro's success is not only crucial for the economic health of the eurozone and its members but for the credibility of the EU as a whole. European economies are much better placed to succeed in a global economy as part of a single market, with a single currency and integrated capital markets. Unfortunately, it is far too soon to talk about EMU being a success. The single currency was supposed to bring Europe together, but it risks becoming a source of economic dislocation and political division. In many ways the euro really is a currency in search of a market.

Italy is the member-state most likely to trigger a crisis. It is not far-fetched to imagine a scenario in which the country is forced to quit the single currency: growth in the eurozone economy continues to disappoint, and crucially, German wage growth remains very low; the Italian government implements some modest reforms of labour and product markets, but these are insufficient to improve Italy's competitive position within the eurozone; the financial markets lose confidence in Italy's ability to contain its public borrowing, causing Italian borrowing costs to rise very sharply; with the economy stagnating and the debt burden rising rapidly, many politicians start to argue that the economic costs of staying in the eurozone outweigh those of leaving; and finally, Italian public opinion turns against the euro, bringing into question the country's membership. The markets currently attach a very low level of risk to such a crisis taking place. However, it would be a mistake to place too much importance on the apparent lack of concern among investors – market sentiment can shift very quickly, as was the case in 1992, when Italy and the UK were forced out of the Exchange Rate Mechanism (ERM).

The costs of Italy quitting EMU and reintroducing the lira after a hefty devaluation would be immense, not just for Italy itself, where the government and businesses would face much higher borrowing costs, but for Europe as a whole. Pressure on countries such as Spain and Portugal to leave and devalue their currencies would quickly build, as the financial markets speculated that their membership was no longer viable. There is also a risk that the remaining members would demand tariffs on imports from Italy (and the other countries forced to leave), in order to protect themselves against 'unfair competition'. If the Commission failed to face down such demands, the single market could start to unravel and with it the most important force for improved economic performance in Europe.

Why is the situation so serious? After all, the introduction of the euro has led to some positive trends: it has boosted trade in goods between members of the eurozone, albeit by less than had been expected; capital markets have become more integrated, increasing competition and opening up new sources of financing for companies; and cross-border mergers have increased steadily, notwithstanding sporadic outbreaks of economic nationalism in some member-states. However, much more is needed to ensure EMU is a success. At the very least, a successful currency union requires very flexible labour markets, a high level of competition across all sectors, full integration of the participating economies and sound management of public finances. Unfortunately, the implementation of reforms aimed at meeting these criteria has slowed since the single currency's launch in 1999.

Too much energy is spent on discussing the exact date upon which Lithuania will join the eurozone or on whether the European Central Bank (ECB) should publish the minutes of its meetings. These are sideshows. The debate should be about the threats to EMU and the consequences of it falling apart. The core problem is that membership seems to have reduced pressure on governments to undertake the reforms needed to ensure the

currency union is a success. Germany and Italy illustrate this paradox most starkly. Freed from the risk of a currency crisis and higher debt service costs, Italy has done little to strengthen its public finances, make its labour market more flexible or introduce more competition. The result has been declining productivity, inflation above the eurozone average, and a sharp decline in competitiveness relative to other members of the eurozone. Unable to devalue its currency, Italy now risks getting caught in a vicious cycle of very slow economic growth and rising debt.

Italy is not solely to blame for its predicament, however. Membership of EMU has also reduced pressure on the German government to make the reforms needed to boost German domestic demand. EMU was supposed to put an end to competitive currency devaluations, but that is effectively what Germany has been doing within the eurozone by relying on exceptionally low wage growth to boost its competitiveness. While this has massively boosted the country's competitiveness and its exports, it has depressed consumption and investment (and hence demand for imports), causing the country's trade and current account surpluses to balloon. If Germany still had the deutschmark, it would have faced strong currency appreciation, forcing it to address the reasons for the weakness of its domestic demand or risk economic stagnation. An economy as big as Germany's cannot depend indefinitely on exports to drive real GDP growth, without imposing intolerable pressures on other members of EMU. Germany must become a source of demand within the eurozone if the euro is to succeed.

Unfortunately, the German government – in common with those across the eurozone – faces a very inauspicious political climate in which to push through reforms aimed at liberalising its economy. Eurozone electorates are increasingly hostile to moves to boost competition and encourage further economic integration, fearing greater insecurity and lower living standards. The scale of the challenge was brought into sharp relief in April when a wave of popular demonstrations forced the French government to withdraw

a very modest labour market reform aimed at making it easier to lay off young workers. People are wary of a greater role for markets, but that is precisely what their governments have in effect committed themselves to by joining EMU. Instead, politicians have been deriding financial investors as 'locusts', resisting the creation of a single market in services, and preventing the takeover of local companies by firms based elsewhere in the eurozone.

This pamphlet will start by discussing what needs to be done to ensure the smooth functioning of a currency union. It will argue that the eurozone is not much closer to meeting the conditions for an optimum currency zone now than it was in 1999, and that there is little reason to expect the situation to change for the better in the short-term. Differences in growth and inflation between member-states now pose a big challenge and adjustment will be very costly. To highlight the risks that such divergences pose, the pamphlet will then take a closer look at Italy. Finally, it will outline what needs to be done to ensure the sustainability of EMU.

2 The economics of a currency union

The single currency has been a long-term project for the EU. The Werner Report of 1970, written by Luxembourg's then Prime Minister Pierre Werner, was the first to specifically discuss the case for a single European currency and coined the term Economic and Monetary Union (EMU). The Maastricht treaty (1993) laid the foundations for the single currency. The third stage of EMU began on January 1st 1999, when the participating currencies were fixed against one another. Eurozone members began implementing a common monetary policy and the euro was introduced as legal tender, with the new notes and coins entering circulation at the beginning of the 2002.

The economic rationale for EMU was compelling. By ruling out competitive currency devaluations, the introduction of the single currency would remove a potent source of macroeconomic instability, and leave countries with no option but to reform their labour markets and open up their economies to greater competition. The elimination of exchange-rate fluctuations combined with greater price transparency would boost competition and trade between members. The creation of integrated and liquid capital markets would ensure a more efficient allocation of resources and reduce the cost of capital. A fully functioning single market would boost productivity and create greater prosperity. Of course, a common monetary policy would create tensions at first, but these problems would quickly ease as the participating economies converged and became fully integrated.

However compelling the economic case, economics alone would not have been enough to get the project off the ground. For many supporters of EMU, the politics were more important than the

economics. The creation of a single European currency would represent the final stage in the integration of the European economy, and form a precursor to a political union. It would also boost European influence internationally. "The dollar is our currency, but your problem", John Connally, President Nixon's treasury secretary, once famously quipped, prompting much impotent fury in Europe. The euro would quickly come to rival the dollar's status as the world's principle reserve currency and undermine the ability of the US to play fast and loose with its currency – devaluing the dollar imposes few costs on the US because the country borrows in its own currency. For many, notably France but also other members of the deutschmark zone, such as the Netherlands, EMU was also a way of undermining the influence of the Bundesbank and reasserting some control over their own interest rates. For their part, the Germans saw it as a way of assuaging sensitivities aroused by re-unification. Participation in a currency union would demonstrate that re-unification had not dimmed the country's commitment to European integration. Others simply did not want to be left out.

Membership of a currency union removes an important adjustment tool. Countries can no longer resort to devaluing their currency to reverse a loss of competitiveness brought on by high inflation, and hence have to be much more flexible in other ways. A lack of flexibility makes it more likely that a member-state will lose competitiveness, and makes it extremely hard to reverse that loss of competitiveness. A number of criteria must be met to ensure the success of a single currency:

★ Labour markets must be highly flexible so that wages respond quickly to changes in supply and demand. For example, unless a member-state manages to quickly boost productivity growth, real wages (that is, nominal wages adjusted for inflation) have to fall relative to those of the other member-states in order to correct a loss of competitiveness. Workers must have the skills and incentives to move from declining to fast growing sectors, which rules out labour market arrangements that tie them to particular companies or sectors. To switch between industries and across borders, workers also need to be employable. Such employability is largely a matter of training and education.

★ Labour market flexibility is not sufficient in itself, however; an economy has to be able to generate new jobs in other sectors. This requires dynamic and flexible product and financial markets, which promote competition, innovation and entrepreneurship. Flexibility in product markets increases the dynamism of economies, and makes it easier for firms to expand existing markets as well as create new ones, resulting in job creation. Capital markets also need to be liquid and flexible so that capital can move quickly from declining to fast-growing industries.

★ The participating economies must be fully integrated, not just in terms of trade in goods, but also in services, labour and capital. The more integrated economies are, the less likely they are to diverge. Differences in the strength of demand or supply between member-states can be absorbed through trade and movements in capital and labour, and need not result in differing rates of inflation and diverging trends in competitiveness.

★ Member-state economies should not be excessively reliant on particular sectors. An economic shock that affects all members of a currency union in the same way is 'symmetric' and can be addressed by a change in interest rates which are set with reference to the needs of the union as a whole rather than any particular member-state. Other shocks, however, affect the member-states differently and thus have an 'asymmetric' impact. For example, changing world demand for cars or financial services would affect those countries specialising in them differently from those that do not.

★ Fiscal policies must be sound, so that governments can offset an economic downturn by boosting public spending. There is also a case for fiscal transfers within the currency union. Such transfers could alleviate the impact of an economic shock on a particular country, such as the decline of an important industry, by cushioning the slowdown in domestic demand and giving the government in question breathing space to take policy measures aimed at improving competitiveness.

★ Finally, economic growth needs to be relatively rapid. Within a currency union, a country can only restore competitiveness if its unit wage costs – that is, total labour costs adjusted for changes in productivity – grow more slowly than those of the other member-states. This will be much more difficult if economic growth and inflation are weak. It is therefore crucial that the currency zone's central bank pursues growth-orientated monetary policies and does not target an excessively low inflation rate.

The institutional framework of EMU

The governments that signed the Maastricht treaty gave the ECB complete responsibility for price stability, rather than setting it an inflation target that would be reviewed regularly. Whereas the US Congress has the power to alter the statutes of the Federal Reserve, neither the European Parliament nor national parliaments have formal powers over the ECB, which is one of the most independent central banks in the world. The Bundesbank's legacy is clearly visible in the ECB's official strategy. The ECB's initial interpretation of price stability as "0-2 per cent" was heavily criticised for being too restrictive, and potentially deflationary. Although the ECB has consistently dismissed these concerns, it did amend the definition to "below, but close to 2 per cent" in 2003. Nevertheless, this still leaves it with a more restrictive definition of price stability than any other major central bank.

The stability and growth pact (SGP) aimed to provide a fiscal framework for participating countries by requiring them to respect certain limits on public deficits and levels of national debt as laid down in the Maastricht treaty. The SGP stipulated that public sector deficits should be in balance over the economic cycle; that the deficit must not exceed 3 per cent of GDP (except in exceptional circumstances); and that outstanding stocks of national debt should be kept under 60 per cent of GDP. The SGP proved impossible to enforce, and was effectively suspended in 2003, following the French and German governments' refusal to implement the measures demanded by the European Commission to cut their public deficits.

3 A currency in search of a market?

The eurozone was far from meeting the criteria for a single currency zone when EMU was launched in 1999, but there was a widely held belief that progress towards meeting these criteria would be rapid because of the prohibitively high costs of inaction. This can be summed-up as the TINA – there is no alternative – line of reasoning. Governments would have no option but to take the necessary steps to make their economies more flexible, integrate more fully with other member-states and strengthen public finances. Unfortunately, membership of EMU has not led to an acceleration of structural reforms.

Too little flexibility

Performance varies hugely between member-states, but taking the eurozone as a whole labour and product markets remain inflexible. Most striking is the lack of labour mobility, which is one of the principal mechanisms for adjustment in the US, the world's most successful single currency zone. There is more labour mobility within the US than in individual eurozone countries, let alone across the eurozone as a whole. Less than 0.1 per cent of the eurozone population moves permanently to another eurozone country each year – the comparable figure for the US is 2.5 per cent.[1] For example, if unemployment rises in Michigan as a result of a downturn in that state's car industry, workers typically move to another state. They are able to do this because of a common language, an efficient housing market and a country-wide framework for medical and other social policies.

[1] *European Commission, 'Free movement of worker – achieving the full benefits and potential', 2002.*

Labour mobility within the eurozone is never going to reach US levels because of language and other cultural barriers, but there is no reason why it should not rise from its current level. The Commission's action plan to promote mobility is full of good ideas, such as lowering regulatory and administrative barriers to the recognition of professional qualifications, and improving the portability of pensions and welfare entitlements.[2] But progress has been slow. The removal of the so-called country of origin principle from the Commission's draft services directive at the behest of the European Parliament and a majority of member-states was a big blow to the drive to increase labour mobility.[3] By allowing service providers to do business anywhere under the rules and regulations of their home country, the original directive would have made it much easier to offer services across EU borders.

[2] *European Commission, 'Free movement of worker – achieving the full benefits and potential', 2002.*

[3] *Simon Tilford, 'What future for free trade in services', CER bulletin article, April 2006.*

The weakness of labour mobility and lack of fiscal transfers within the eurozone makes it doubly important that labour and product markets are highly flexible – wages and prices must respond quickly to changes in demand and supply if economies are not to diverge. The Organisation for Economic Co-operation and Development (OECD) has found that membership of EMU has not encouraged member governments to accelerate structural reforms.[4] EMU members were no more active in reforming their labour and product markets than non-EMU EU countries between 1999 and 2004, despite the fact that these markets are less flexible in EMU countries than in the other EU-15 countries: Denmark, Sweden and the UK.

[4] *Romain Duval and Jorgen Elmeskov, 'The effects of EMU on structural reforms in labour and product markets', OECD Economics Department Working Paper, 2005.*

The OECD evaluated 44 labour market policies implemented by OECD countries and assigned scores to these reforms for the periods 1994-1998 and 1999-2004. It then placed the policies in seven broad categories: active labour market policies; taxes and social security contributions; employment protection legislation; unemployment benefit systems; wage formation and industrial relations; working-time flexibility and part-time work; and old-age pension systems and early retirement schemes. The OECD research reveals that the intensity of labour market reform in the eurozone decelerated following the introduction of the euro in 1999, while little or no slowdown was observed elsewhere in the EU-15 or in other OECD countries. Worryingly, with the exception of a few small countries, eurozone member-states have shown little ability to carry out reforms in areas where political resistance is strong. The mounting pressure on public finances means there has been significant progress in reforming pension systems, but such reforms are less contentious because they will only gradually come into force and are generally borne by people in the future.

Intensity of labour market reforms in OECD countries (Percentage of maximum possible score)

	1994-2004	1994-1998	1999-2004
OECD	15	18	21
EMU-12	32	33	32
Other EU	27	10	54

Source: OECD.

Fortunately, the picture with regard to product markets is somewhat better. The OECD's indicator of product market regulation for non-manufacturing industries shows that the reduction of regulatory impediments to product market competition between 1999 and 2004 was somewhat larger in the eurozone than in other OECD countries.[5] The indicator summarises the regulatory provisions in seven sectors: telecoms, electricity, gas, post, rail, air passenger transport, and road. There was also some

[5] *Romain Duval and Jorgen Elmeskov, 'The effects of EMU on structural reforms in labour and product markets', OECD Economics Department Working Paper, 2005.*

convergence within the eurozone, with greater liberalisation occurring in the most regulated countries (Belgium, France, Greece, Italy, Portugal and Spain). However, levels of product market regulation in EMU remain considerably higher than elsewhere in the EU and the OECD. Also, reform has proceeded at roughly the same pace as in Denmark, Sweden and the UK, despite the fact that the latter started from a much more liberal position.

The OECD research also shows that most eurozone member-states have made progress in liberalising professional services such as accounting, architecture, engineering and legal services.[6] Again, however, these sectors are subject to much less regulation in the other EU-15 economies than in the eurozone (Finland and Ireland being notable exceptions). Professional services are most highly regulated in Germany and Italy, which this pamphlet argues must be addressed as a matter of urgency. (See table opposite.)

[6] The indicators of regulatory conditions in the professional services are calculated using the methodology developed by the European Commission.

OECD indicator of product market regulation in non-manufacturing industries

	1993	2003
OECD	3.9	2.2
EMU-12	4.7	2.6
Other EU-15	3.2	1.5

Source: OECD, (0 = most liberal, 6 = most restrictive).

Regulation of professional services

	Accountant		Architect		Engineer		Legal		Overall	
	1996	2003	1996	2003	1996	2003	1996	2003	1996	2003
EMU countries*										
Austria	3.5	1.6	4.4	2.1	4.4	2.1	4.3	2.1	4.2	2.0
Belgium	3.5	2.7	2.6	2.8	0.0	0.3	2.7	2.5	2.2	2.1
Finland	2.4	2.2	1.0	1.0	0.0	0.5	0.0	0.3	0.8	1.0
France	3.0	3.0	1.8	2.1	0.2	0.0	2.3	2.8	1.8	2.0
Germany	5.1	2.8	3.3	3.1	3.8	3.1	4.5	3.6	4.2	3.1
Greece	2.9	2.0	n/a	2.5	n/a	2.8	4.9	4.5	n/a	2.9
Ireland	2.0	1.6	0.0	0.7	0.0	0.0	2.8	2.8	1.2	1.3
Italy	1.4	4.0	4.3	3.1	4.0	3.8	3.6	3.6	3.3	3.6
Netherlands	3.2	2.9	0.0	0.0	0.4	1.5	2.0	2.0	1.4	1.6
Portugal	1.9	2.8	2.0	1.6	3.7	1.6	3.4	3.6	2.8	2.4
Spain	3.1	2.1	3.5	2.5	3.0	1.5	4.0	3.6	3.4	2.4
Other EU-15 countries										
Denmark	2.1	1.2	0.0	0.0	0.0	0.0	2.1	2.0	1.1	0.8
Sweden	2.5	2.4	0.0	0.0	0.0	0.0	0.8	1.2	0.8	0.9
UK	3.2	2.1	0.0	0.0	0.0	0.0	2.3	2.1	1.4	1.1

Source: OECD, (0 = most liberal, 6 = most restrictive).
** Excluding Luxembourg.*

Morever, there is no indication that the pace of reform has accelerated over the last couple of years. For example, the eurozone's record in implementing internal market directives remains much worse than that of Denmark, Sweden or the UK, with the performance of France, Germany and Italy being especially poor. The big three eurozone countries have also been instrumental in diluting initiatives aimed at completing the single market, such as the services and takeover directives. The amended services directive simplifies the bureaucratic procedures that service providers must fulfil in order to do business in another member-state. But it excludes a whole range of sectors, from broadcasting to social services. And in those sectors that are still covered, member-states will be allowed to apply exemptions from the country of origin principle on various, vaguely defined grounds, such as public policy, health or security.

The eurozone needs as much competition as possible in product markets, and this will not be achieved by thwarting the integration of service sectors. Services account for over two-thirds of eurozone GDP and employment. If the eurozone is to improve its economic performance, it has to make its service sector more open and efficient. Opposition to the so-called 'Bolkestein draft', named after the former internal market commissioner, Frits Bolkestein, rested largely on the fear that adoption of the country of origin principle would lead to 'unfair competition' from the new low-cost members of the EU. Companies would be free to register in member-states where wages are low and consumer, health and environmental protection weak, setting in motion a 'race to the bottom'. Although such fears are hard to justify – all workers would still have had to be employed under the terms and conditions of the host state, with national minimum wages, employment legislation and health and safety rules being respected – they proved highly potent.

Growth in total factor productivity in EU-15 countries*, 1995-2005 (annual percentage change)

	1995-2000	2000-2004		1995-2000	2000-2004
Austria	1.7	0.2	Ireland	4.4	2.0
Belgium	1.7	0.3	Netherlands	0.6	0.2
Denmark	1.4	0.3	Portugal	1.0	-0.3
Finland	3.3	2.0	Spain	-0.3	-0.5
France	1.4	0.5	Sweden	1.3	1.9
Germany	1.3	0.6	UK	1.1	1.5
Greece	1.9	1.8	EU-15	0.9	0.4
Italy	0.2	-1.2	US	1.1	1.7

*Source: OECD, *Growth in efficiency with which labour and capital are employed.*

The scale of the eurozone's productivity problem should not be underestimated. Productivity growth, and especially growth in total factor productivity, has declined very sharply across the eurozone in recent years, a trend not mirrored in other EU-15 countries or in the OECD as a whole.[7] (See table above). Total factor productivity measures the efficiency with which labour and capital are used, and is a better measure of economic performance than labour productivity, which is largely driven by rates of capital spending. For example, better machines and equipment will automatically boost labour productivity, but may not boost overall efficiency once the spending on the additional machinery is taken into account. Declining rates of total factor productivity have hit economic growth in the eurozone – since 1999, real GDP growth has averaged just 1.7 per cent – and are very bad news for the stability of EMU.

[7] *European Economic Advisory Group, 'Report on the European Economy 2006', Ifo Institut, March 2006.*

Integration – unfinished business

"The euro is much more than just a currency" said Wim Duisenberg, the first ECB president, "it is a symbol of European integration in every sense of the word." He was right, but how economically integrated is the eurozone? As we have already discussed, one key element of integration – labour mobility – is almost entirely absent. EMU has, however, contributed to greater cross-border trade in goods. Trade between the participating countries has grown more rapidly than with other countries, although the difference is small.[8] Increased interdependence within the eurozone is good news as it makes it more likely that differences in demand and supply-side pressures between member-states will be absorbed through trade rather than result in differences in inflation.

[8] *Richard Baldwin, 'In or Out: Does it Matter? An evidence-based analysis of the trade effects of the euro', Centre for Economic Policy Research, 2006.*

However, the boost to cross-border trade in goods needs to be balanced against the extremely slow progress in integrating services. The service sectors of most eurozone countries are highly regulated, with the result that national markets are largely insulated from cross-border competition. Services represent just 20 per cent of intra-EU trade – a proportion that has fallen over the last five years.[9] Not all services are easily tradable of course – hairdressing and cleaning for example, are provided locally – but there is huge potential to boost trade in other sectors, such as business and financial services.

[9] *Eurozone trade (seasonally adjusted time series), Eurostat.*

A well-developed and fully integrated financial system helps to distribute capital to its most profitable uses. It stimulates economic growth by increasing price transparency, strengthening competition and boosting cross-border investment. The introduction of the euro has definitely accelerated the development of an integrated eurozone capital market. There is no doubt financial markets across the eurozone are now more efficient than they were prior to the introduction of the euro, with the

integration of inter-bank, bond and equity markets having improved the availability of capital and boosted liquidity. For example, it is now much easier for say, an Italian company to borrow elsewhere in the eurozone to fund a business strategy that Italian banks will not finance, and this should help accelerate structural change and hence productivity growth.

Unfortunately, the retail banking sectors of the eurozone member states are still largely separate. This matters because differences in the structure of retail banking markets influence the way changes in interest rates impact on economies, or what economists call the 'monetary transmission mechanism'. Available evidence suggests that since the introduction of the euro, the time taken for changes in market exchange rates to feed through to bank lending rates has fallen.[10] However, the sensitivity of economic activity to changes in official interest rates continues to differ considerably between member-states. In those such as Ireland and the Netherlands, where mortgages are typically linked to variable rates and where the market for consumer credit is highly competitive, the monetary transmission mechanism is rapid, and domestic demand tends to respond quickly to changes in short-term interest rates. By contrast, in Germany and Italy, where mortgages are typically linked to long-term interest rates and where the consumer credit markets are more restrictive, the impact of changes in monetary policy on consumer demand is much less pronounced. The varying levels of sensitivity to changes in interest rates are another source of economic divergence; a cut in interest rates may boost consumer spending considerably in one member-state, but have little impact in another.

[10] *Otmar Issing, 'The euro – a currency without a state', speech at the Bank of Finland, March 24th 2006.*

Differences in housing markets and cultural attitudes to debt mean there will never be complete harmonisation of monetary transmission mechanisms across the eurozone, but there is no doubt that integration of retail banking markets would facilitate some convergence. For example, the emergence of more pan-European

retail banks would boost competition and the availability of products in countries with inefficient retail banking sectors such as Germany and Italy. The Commission should redouble its efforts in this area.[11]

[11] *Alasdair Murray and Aurore Wanlin, 'The EU's new financial services agenda', CER, February 2006.*

A lack of fiscal discipline

Another mechanism that helps adjustment in the US economy is fiscal federalism, with money being transferred from economically dynamic states to more backward ones or those that have suffered a temporary downturn in economic activity. These transfers take place through the federal budget. For example, a poor state such as Alabama receives more money from the federal government than it pays in taxes, whereas the reverse is true in California. At present, the EU budget is very small in comparison to the US federal budget (€115 billion versus €3.3 trillion in 2006), and certainly too small for significant fiscal transfers. What transfers do take place are mainly related to the common agricultural policy and structural funds.

Some economists and policy-makers argue that such fiscal transfers will be needed in order to ensure the viability of EMU.[12] They say that because economic adjustment through the exchange rate and monetary policy is no longer an option, economic shocks affecting individual countries need to be balanced out by transfers from a European budget. This argument is far from convincing. The analogy with the US ignores the fact that the national budgets of eurozone members are much larger than those of US states. So long as fiscal policy is managed properly, there is already plenty of scope to increase spending to lessen the impact of an economic downturn. The case for fiscal transfers is also weakened by the member-states' poor management of public finances and the failure to abide by the terms of the SGP. The whole debate about fiscal transfers is, in any case, an artificial one as there is no political support for it. Although

[12] *Paul De Grauwe, 'What have we learnt about monetary integration since the Maastricht treaty', University of Leuven, 2006.*

such a mechanism would not necessarily require political union – the members of EMU could simply contribute to a fund that helps countries experiencing an economic shock – the necessary solidarity is lacking.

One reason for this is that there is an insufficiently strong sense of European identity. For example, Dutch or German taxpayers would not accept transferring substantial funds to Italy to alleviate the impact of an economic down-turn. It also reflects understandable scepticism that transfers would have the desired effect. There is clearly a risk that making funds available to countries that are suffering from weak economic growth could reduce pressure on their governments to implement the reforms needed to increase growth and address the underlying reasons for weak public finances. For example, instead of using the opportunity provided by strong economic growth in 1999-2001 to strengthen their fiscal positions, too many eurozone governments let fiscal discipline slip. Four of the 12 members of the eurozone had budget deficits in excess of three per cent of GDP in 2005, and a fifth ran a deficit of 2.9 per cent. Worse still, expenditure cuts have often come at the expense of investment and not current spending. Current expenditure, such as public-sector wages or unemployment benefits, tends to be fixed in advance, whereas investment spending is more flexible and hence easier to cut.

These unfavourable fiscal trends have been most notable in Italy. The country's fiscal position improved dramatically in the second half of the 1990s as debt servicing costs converged steadily with those of Germany, and Italian governments sought to strengthen the country's public finances. Once in EMU, however, fiscal discipline declined, and Italy squandered an opportunity to consolidate its public finances. Italy's primary budget surplus (the budget balance prior to payment of interest on outstanding debt) declined from over 5 per cent of GDP in 2000 to just 0.5 per cent in 2005, removing another source of potential flexibility. (See tables on pages 22-24.)

General government budget balances (percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
EMU countries										
Austria	-4.0	-2.0	-2.5	-2.4	-1.7	0.1	-0.4	-1.4	-1.3	-1.9
Belgium	-3.7	-1.9	-0.7	-0.5	0.0	0.6	-0.1	0.0	-0.1	-0.1
Finland	-2.9	-1.3	1.6	2.2	7.1	5.2	3.9	1.6	1.3	2.7
France	-4.1	-3.0	-2.6	-1.7	-1.5	-1.6	-3.2	-4.2	-3.7	-2.9
Germany	-3.3	-2.6	-2.2	-1.5	1.3	-2.8	-3.7	-4.0	-3.7	-3.3
Greece	-7.4	-4.0	-2.5	-1.8	-4.2	-3.7	-3.8	-4.6	-6.9	-4.5
Ireland	-0.1	1.4	2.3	2.4	4.4	0.8	-0.4	0.2	1.5	1.0
Italy	-7.0	-2.7	-3.1	-1.8	-0.9	-3.1	-3.0	-3.5	-3.5	-4.1
Netherlands	-1.5	-0.9	-0.6	0.7	2.3	-0.3	-2.0	-3.2	-2.1	-0.5
Portugal	-4.6	-3.4	-3.0	-2.7	-3.0	-4.3	-2.9	-2.9	-3.2	-6.0
Spain	-4.7	-2.9	-3.0	-0.9	-0.9	-0.5	-0.3	-0.1	-0.2	1.1
Other EU-15 countries										
Denmark	-1.9	-0.5	0.0	1.4	2.3	1.2	0.2	-0.1	1.7	4.0
Sweden	-2.8	-1.0	1.9	2.3	5.0	2.6	-0.5	-0.2	1.6	2.7
UK	-4.2	-2.2	0.1	1.0	3.8	0.7	-1.7	-3.3	-3.3	-3.2

Source: Economist Intelligence Unit.

Primary budget balances (percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
EMU countries										
Austria	-0.1	1.5	0.8	0.7	1.4	3.0	2.4	1.2	1.3	0.6
Belgium	4.6	5.6	6.6	6.1	6.4	6.7	5.5	5.2	4.6	4.3
Finland	-1.5	0.6	3.3	3.7	8.0	5.8	5.0	2.6	2.3	3.5
France	-1.0	0.0	0.3	0.9	1.1	1.1	-0.6	-1.7	-1.2	-0.5
Germany	-0.4	0.2	0.8	1.3	4.0	-0.3	-1.2	-1.5	-1.2	-1.2
Greece	4.6	5.6	6.6	6.5	4.0	3.6	2.6	1.2	-1.2	0.7
Ireland	3.0	4.0	4.6	3.8	5.3	1.0	-0.3	0.4	1.6	1.1
Italy	3.6	5.8	4.5	4.5	4.9	2.6	2.0	1.1	0.7	0.5
Netherlands	2.9	3.3	3.3	4.2	5.2	2.2	0.2	-1.1	-0.1	1.3
Portugal	0.6	0.6	0.3	0.3	0.1	-1.3	0.0	-0.2	-0.6	-3.3
Spain	0.2	1.5	1.0	2.4	2.1	2.2	2.1	2.1	1.7	2.7
Other EU-15 countries										
Denmark	1.0	2.4	2.5	3.9	4.4	3.0	1.9	1.2	2.4	4.6
Sweden	-1.2	0.8	3.2	3.6	5.8	3.2	0.6	-0.1	1.4	2.7
UK	-1.1	1.0	3.1	3.5	6.2	2.8	0.1	-1.6	-1.5	-1.3

Source: Economist Intelligence Unit.

Public debt
(percentage of GDP, end-year)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
EMU countries										
Austria	69.2	66.5	63.9	66.3	67.2	66.9	66.9	65.5	64.9	65.1
Belgium	127.8	122.5	117.2	113.5	107.5	106.0	103.0	98.5	94.9	93.3
Finland	56.6	54.9	50.0	46.8	43.9	43.0	41.3	43.0	41.3	39.0
France	54.9	57.0	57.3	57.6	55.6	55.3	56.7	60.5	63.3	65.8
Germany	57.0	58.6	59.2	59.7	59.0	58.3	59.3	62.2	64.5	66.8
Greece	113.3	108.2	105.8	105.2	114.0	114.4	111.8	109.1	107.5	106.9
Ireland	76.0	67.6	55.5	50.2	41.5	36.0	33.3	31.4	29.9	26.7
Italy	120.6	117.9	114.8	113.7	108.8	108.2	105.5	104.2	103.9	106.3
Netherlands	71.7	67.5	63.7	60.6	54.6	50.5	49.9	51.0	51.8	52.7
Portugal	60.0	56.1	52.2	51.4	50.4	53.0	55.5	57.0	58.7	63.9
Spain	66.7	65.3	63.2	61.6	59.2	55.6	52.6	48.9	46.4	43.2
Other EU-15 countries										
Denmark	69.2	65.2	60.8	57.4	51.7	47.4	46.9	44.4	42.6	36.9
Sweden	72.4	70.0	67.4	62.9	54.8	52.7	52.0	51.1	50.1	49.7
UK	50.8	50.2	47.7	45.0	42.2	39.2	37.6	38.2	39.6	41.6

Source: Economist Intelligence Unit.

Why is progress so slow?

Why has progress in meeting the criteria for sustainable membership of EMU been so disappointing if the eventual costs of inaction are so great? In many ways, membership has actually reduced incentives to reform by insulating governments from external pressure and encouraging free-riding on the system. For example, countries that urgently need to reform were given a temporary cushion by low, or even negative, real interest rates. This boosted consumption, while at the same time reducing debt servicing costs. Freed from the risk of currency devaluation and higher debt servicing costs, many governments did little to strengthen their public finances. This illustrates one of the paradoxes of EMU membership. In theory, the absence of market pressure gives countries more time to make the necessary changes. But it also reduces pressure for reform, with the result that the eventual adjustment will have to be much greater.

Members of EMU are no longer under significant external pressure to pursue sound economic policies because the financial markets have attached almost identical levels of risk to the public debt of all participating economies irrespective of the strength of their public finances or their economic growth potential. This enables them to run fiscal policies that are unsustainable without being punished by the markets. However, given that there is no provision in the Maastricht treaty for a member-state experiencing a fiscal crisis to be bailed out by other eurozone counting, the behaviour of the financial markets seems illogical. After all, in the US debt servicing costs vary widely between states, and individual states get punished by the markets for pursuing unsound fiscal policies. This pamphlet argues that the ECB needs to take steps to encourage investors to differentiate more between the debts of member-states. (See chapter six).

The other reason for disappointing progress has been reform fatigue. Many governments had to implement far-reaching reforms to meet the Maastricht criteria, and once they had qualified for EMU they relaxed their efforts. They now face electorates that are increasingly

hostile to liberalisation and integration, placing them in a very awkward position. Calling for reforms in the name of the euro is unlikely to prove any more effective than calling for reforms in the name of greater economic efficiency. Rather than being honest about the realities of membership of EMU and the costs of inaction, too many governments are responding to popular unease by stepping back from the reforms needed to make the euro sustainable.

4 Economic divergence

The member-states' failure to liberalise and integrate their economies is reflected in the lack of real economic convergence in the eurozone, as revealed by persistently large variations in inflation rates and wage settlements. Differences in inflation rates mean that real interest rates continue to vary widely, and this is driving further divergence. For example, the cost of borrowing is currently lowest in member-states where inflation and economic growth are strongest and where the need for higher real interest is greatest – Greece, Ireland and Spain. These economies need tighter, not looser, monetary policy than member-states experiencing low inflation and/or weak economic growth.

With the exception of Ireland, and to a lesser extent Greece, the differing inflation rates have not been offset by high rates of productivity growth. On the contrary, higher inflation in Italy and Spain has gone hand in hand with very weak growth in productivity. Low or even negative real interest rates have boosted components of demand in these economies that are sensitive to interest rates such as private consumption and housing markets. At the same time, however, higher inflation has weakened their export competitiveness, deterring investment in tradable sectors where productivity growth is generally strongest. Combined with very weak German domestic demand, this has led to a ballooning Germany's trade surplus with the rest of the eurozone. These trends are not benign. (See tables on pages 28-29.)

Consumer price inflation (percentage change, annual average)

	1999	2000	2001	2002	2003	2004	2005	Cumulative inflation 1999-2005
Austria	0.6	2.4	2.6	1.8	1.4	2.1	2.3	14.0
Belgium	1.1	2.6	2.5	1.7	1.6	2.1	2.8	15.2
Finland	1.2	3.4	2.6	1.6	0.9	0.2	0.9	11.3
France	0.5	1.7	1.6	1.9	2.1	2.1	1.7	12.4
Germany	0.5	1.5	2.0	1.4	1.1	1.7	2.0	10.6
Greece	2.6	3.2	3.4	3.6	3.6	2.9	3.5	25.1
Ireland	1.6	5.6	4.9	4.7	3.5	2.2	2.4	27.6
Italy	1.7	2.5	2.8	2.5	2.7	2.2	2.0	17.6
Netherlands	2.2	2.6	4.2	3.3	2.1	1.2	1.7	18.4
Portugal	2.3	2.9	4.4	3.6	3.3	2.4	2.3	23.1
Spain	2.3	3.4	3.6	3.5	3.0	3.1	3.4	24.5
Eurozone	1.2	2.2	2.5	2.2	2.0	2.1	2.1	15.1

Source: Eurostat.

Real interest rates (long-term bond yields minus inflation)

	1999	2000	2001	2002	2003	2004	2005
Austria	4.2	3.6	2.8	3.3	2.9	2.2	1.2
Belgium	3.6	2.9	2.7	3.3	2.7	2.2	0.8
Finland	3.4	2.5	2.3	3.0	3.1	4.0	2.6
France	4.1	3.7	3.3	3.0	2.0	1.9	1.6
Germany	4.3	3.9	2.9	3.4	3.0	2.3	1.4
Greece	4.2	3.2	1.6	1.2	0.9	1.3	0.0
Ireland	4.0	-0.5	0.2	-0.4	1.1	1.5	0.9
Italy	4.0	-0.5	0.2	-0.4	1.1	1.5	0.9
Netherlands	1.7	2.8	0.8	1.6	2.0	2.9	1.7
Portugal	2.6	2.8	0.8	1.3	0.9	1.7	1.4
Spain	2.4	2.1	1.5	1.5	1.1	1.0	0.0

Source: Eurostat.

Italian labour productivity has declined by an annual average of 0.4 per cent since the launch of EMU, and Spain's by an average of 1 per cent. (See table opposite.) Partly as a result of labour market reforms aimed at raising the proportions of their working age populations in employment, both countries have experienced relatively rapid employment growth in recent years. This has no doubt contributed to the weak growth in labour productivity. However, growth in total factor productivity has been no less disappointing.[13] Indeed Italy, Spain (and Portugal) have now experienced several years of falling total factor productivity, suggesting that the flexibility of their economies is declining. (See table on page 17.)

[13] *European Economic Advisory Group, 'Report on the European Economy 2006', Ifo Institut.*

Weak productivity growth has led to a dramatic erosion of cost competitiveness. For example, Italian unit wage costs have risen by 20 per cent relative to German ones since 1999, and Spanish ones by nearly 30 per cent. (See table on page 32.) With the bail-out option of interest rate cuts and currency devaluation no longer available, any unwarranted wage increases will ultimately translate into deteriorating labour market conditions and painful adjustment thereafter. In Italy, this is already obvious. Despite Italian domestic demand growing by an annual average of just 1.1 per cent in 2001-2005, imports outstripped exports by a substantial margin, as Italian exporters struggled to compete and ceded domestic market share to imports.

As a result of this, the Italian economy has barely grown, with cumulative growth in real GDP in 1999-2005 just 9.1 per cent. (See table on page 33.) In the Spanish case, the impact of the loss of competitiveness has been masked by strong growth in domestic consumption and construction sector activity, which is being driven by exceptionally low real interest rates. Once interest rates rise from their current level, demand for new housing and office space will fall sharply, precipitating a downturn in construction and consumer spending, thus exposing the Spanish economy's underlying problems.

Growth in labour productivity (percentage change)

	1999	2000	2001	2002	2003	2004	2005	Average 1999-2005
EMU countries								
Austria	2.4	2.7	0.3	0.8	0.3	2.1	1.0	1.4
Belgium	1.8	1.7	-0.3	1.6	1.0	1.8	0.6	1.2
Finland	0.6	3.2	1.3	1.4	2.1	3.5	1.7	2.0
France	1.1	1.4	0.3	0.6	1.0	2.1	0.9	1.0
Germany	0.7	1.3	0.8	0.6	0.8	1.3	1.2	1.0
Greece	3.1	3.0	4.7	1.6	2.2	3.7	2.4	3.0
Ireland	4.3	4.2	2.9	4.2	2.5	1.4	0.0	2.8
Italy	0.7	1.9	-0.1	-0.1	-1.4	0.1	-0.6	-0.4
Netherlands	0.6	6.4	-0.1	-0.1	0.4	2.9	1.1	1.6
Portugal	2.1	2.2	-1.8	0.6	-1.3	1.1	0.4	0.5
Spain	-1.4	-1.0	-0.6	-0.3	-1.0	-0.7	-2.0	-1.0
Eurozone	0.7	1.4	0.3	0.4	0.5	0.9	0.5	0.7
Other EU-15 countries								
Denmark	1.9	3.1	0.6	0.9	1.4	0.8	2.6	1.6
Sweden	2.0	2.2	-0.7	1.9	2.1	3.6	1.7	1.8
UK	1.8	2.0	1.5	1.3	1.7	2.3	1.0	1.7

Source: Economist Intelligence Unit.

Growth in unit labour costs
(€-based; 1998=100)

	1999	2000	2001	2002	2003	2004	2005
Austria	97.5	91.1	90.2	90.9	90.7	88.8	89.1
Belgium	100.6	101.0	101.8	102.9	103.8	104.4	106.7
Finland	98.3	93.4	99.9	98.4	98.4	98.6	100.4
France	101.2	102.0	104.5	107.4	108.9	109.9	111.7
Germany	101.1	101.4	102.1	102.7	102.7	102.1	100.8
Greece	102.0	103.0	102.8	106.7	109.3	109.8	113.2
Ireland	91.1	87.2	80.9	82.6	84.2	86.8	93.1
Italy	102.4	102.4	105.2	111.1	115.2	115.9	119.9
Netherlands	102.7	106.2	112.2	117.7	121.5	121.3	121.9
Portugal	103.9	110.1	115.6	120.8	125.3	131.0	135.3
Spain	103.0	106.9	110.7	114.5	118.2	121.7	130.6

Source: Economist Intelligence Unit; CER calculations.

Real GDP growth
(percentage change)

	1999	2000	2001	2002	2003	2004	2005	Accumulative growth 1999-2005
EMU countries								
Austria	3.4	3.5	0.8	1.1	1.2	2.6	2.0	15.6
Belgium	3.1	3.7	1.2	1.5	0.9	2.4	1.5	15.2
Finland	3.9	5.0	2.6	1.7	1.8	3.5	3.3	23.9
France	3.0	4.1	1.8	1.1	1.1	2.0	1.2	15.2
Germany	2.0	3.2	1.2	0.1	-0.2	1.6	1.0	9.2
Greece	3.4	4.5	4.6	3.8	4.6	4.7	3.7	33.3
Ireland	10.7	9.2	6.2	6.2	4.4	4.5	4.7	55.6
Italy	1.9	3.7	1.7	0.3	0.1	0.9	0.1	9.1
Netherlands	4.0	3.5	1.4	0.1	-0.1	1.7	1.1	12.2
Portugal	3.9	3.9	2.0	0.8	-1.1	1.2	0.4	11.5
Spain	4.2	4.4	3.5	2.7	3.0	3.1	3.4	27.1
Eurozone	2.8	3.9	1.9	1.0	0.8	1.8	1.4	14.4
Other EU-15 countries								
Denmark	2.6	3.5	0.7	0.5	0.7	1.9	3.1	13.6
Sweden	4.3	4.5	1.2	2.0	1.8	3.2	2.7	21.3
UK	3.0	4.0	2.2	2.0	2.5	3.2	1.8	20.0
EU-15	2.9	3.7	1.8	1.1	1.0	2.2	1.4	14.9
OECD	3.3	3.9	1.1	1.5	2.0	3.3	2.7	19.2
US	4.4	3.7	0.8	1.6	2.7	4.2	3.6	22.8

Source: OECD.

In the long-run, stronger productivity growth will have to drive improvements in competitiveness. However, the reforms needed to bring about faster productivity growth will take a number of years to have an impact, while the loss of competitiveness experienced by countries such as Italy, Portugal and Spain needs to be reversed very quickly. As a result, these countries have to ensure that their wages rise less rapidly than across the eurozone as a whole. But if average eurozone nominal wage settlements are very low, this will require falls in nominal wages in Italy, Portugal and Spain. Aside from being very hard to engineer due to popular resistance, this would risk condemning their economies to economic stagnation. Sluggish or negative growth would lead to a further deterioration in public finances, thus bringing forward the date upon which financial markets lose confidence that their euro membership is sustainable.

Beggar thy neighbour?

Current account deficits do not really matter within a single currency zone. For example, Spain's deficit jumped to 7.4 per cent of GDP in 2005, a level that would have prompted a currency crisis if Spain still had the peseta. Nevertheless, they provide a good indicator of the competitiveness of members of a currency zone. Germany's current account balance has improved rapidly in recent years, while those of France, Italy and Portugal and Spain in particular have deteriorated. (See table opposite.) By 2005, Germany's current account surplus stood at 4.1 per cent of GDP and its trade surplus at 7.6 per cent. Indeed, in recent years, Germany has been very reliant on external demand to drive economic growth, with other EMU members providing the majority of this stimulus. In 2005, almost three-fifths of Germany's current account surplus was with other eurozone member-states, up from less than a third in 2002.

Current account balance*
(percentage of GDP)

	1999	2000	2001	2002	2003	2004	2005
Austria	-3.2	-2.5	-1.9	0.3	-0.3	0.3	1.3
Belgium	5.1	4.0	3.4	4.6	4.1	3.4	1.7
Finland	6.2	7.4	7.1	7.6	4.4	5.2	2.6
France	2.9	1.4	2.1	0.8	0.7	-0.4	-1.8
Germany	-1.3	-1.7	0.0	2.0	1.9	3.7	4.1
Greece	-4.3	-6.9	-6.2	-7.2	-7.2	-6.5	-6.1
Ireland	0.3	-0.4	-0.7	-1.0	0.0	-0.8	-1.9
Italy	0.7	-0.5	-0.1	-0.8	-1.3	-0.9	-1.5
Netherlands	3.9	2.0	2.4	2.5	5.5	8.9	6.4
Portugal	-8.6	-10.4	-9.8	-7.8	-5.9	-7.3	-9.3
Spain	-2.9	-4.0	-3.9	-3.3	-3.6	-5.3	-7.4
Eurozone	0.3	-0.7	0.1	0.6	0.5	0.8	-0.1

Source: Eurostat.
**The difference between a country's total exports of goods, services and transfers and its imports of them.*

Germany has been accused of pursuing 'beggar thy neighbour' policies, similar to the competitive devaluations that led to the great depression of the 1930s, but by using wage restraint rather than currency devaluation to steal a march on its trading partners. Annual growth in German real wages averaged just 0.3 per cent over the first seven years of EMU, boosting the competitiveness of German exports but depressing domestic demand. Such accusations are not quite fair as wage restraint is being driven by the corporate sector rather than being a deliberate government strategy. For example, German manufacturers have been using the threat of relocation to countries such as the Czech Republic and Poland to agree pay freezes with their German workers. Nevertheless, there is little doubt that membership of EMU has reduced pressure on the German government to address the reasons for the weakness of German domestic demand by allowing it to rely indefinitely on exports to keep its economy growing.

A current account surplus of the size of Germany's would normally lead to a substantial currency appreciation. German demand for imports would rise, while foreign demand for German exports would weaken, reflecting a loss of German competitiveness. As has already been shown, within a currency zone the rebalancing of competitive positions is less straightforward, requiring changes in relative prices of goods and labour. However, while Germany remains dependent on exports to drive economic growth, attempts by other eurozone countries to regain competitiveness by holding down wage growth are likely to prompt a redoubling of wage restraint in Germany. It might make sense for a small country within the eurozone to steal a march on the rest of EMU by suppressing wage growth. It is not sustainable for the biggest economy in the eurozone to rely on such a strategy as it risks a self-defeating cycle of competitive underbidding of wages.

Had the deutschmark entered EMU at a highly overvalued rate, this kind of wage restraint would have been necessary in order for Germany to regain competitiveness. Indeed, it would have been

exactly what the country needed to do. However, it is far from obvious that the deutschmark was overvalued at the launch of the euro in 1999. It is true that German unit wage costs rose strongly following re-unification, but then they had declined sharply relative to the country's principal competitors in the five years running up to re-unification.[14] Moreover, German unit wage costs rose in the 1990s as a result of the rapid growth in real wages in East Germany rather than in West Germany, and it is West German companies that account for the vast majority of Germany's exports. Even in 1999 Germany had a trade surplus equivalent to 3.3 per cent of GDP, and net exports (exports minus imports) made a positive contribution to German economic growth in 1995-1999.[15] (See table on page 38.) In short, the country was externally competitive at the launch of the euro. It did run a small current account deficit in 1999, but this has to be seen in the context of the continued costs of re-unification, which required it to borrow abroad to finance reconstruction of the eastern *Länder*.

[14] *OECD Economic Outlook 78 database.*

[15] *Economist Intelligence Unit.*

The contribution of the foreign balance to changes in real GDP* (percentage change)**

	1999	2000	2001	2002	2003	2004	2005	Average contribution to growth 1999-2005
Austria	0.2	0.7	1.1	1.0	-0.7	1.3	0.8	0.6
Belgium	0.7	0.2	0.7	0.7	0.0	-0.3	-0.9	0.2
Finland	3.1	1.6	0.6	0.5	-1.9	0.7	0.6	0.8
France	-0.4	-0.4	0.2	-0.1	-0.7	-0.7	-1.0	-0.4
Germany	-0.8	1.0	1.7	1.9	-0.8	1.1	0.7	0.7
Greece	-0.7	-1.6	1.6	-1.1	-1.4	-0.4	1.1	-0.4
Ireland	3.5	1.4	2.6	2.2	1.7	0.8	-1.7	1.5
Italy	-1.2	0.8	0.2	-1.0	-0.8	0.1	-0.3	-0.3
Netherlands	-0.1	1.1	-0.3	0.5	0.1	0.9	1.0	0.4
Portugal	-2.5	0.3	0.2	0.7	1.3	-1.3	-0.5	-0.3
Spain	-1.5	-0.4	-0.2	-0.8	-0.9	-2.2	-2.3	-1.2
Eurozone	-0.7	0.5	0.7	0.5	-0.7	0.0	-0.3	0.0

Source: Economist Intelligence Unit.

**The contribution of the foreign balance is the difference between the growth in export volumes and import volumes weighted by the share of export and import volumes in real GDP. **The percentage added to or subtracted from real GDP by foreign balance.*

Moreover, even if we assume that the deutschmark entered EMU at an overvalued rate, it was clear by 2004 that Germany's external competitiveness was extremely strong. But wage restraint has intensified since then. Nominal wage growth declined to an average of just 0.4 per cent in 2004-2005 (a fall in real wages of 1.4 per cent per year).

Is Germany finally about to experience a robust economic recovery, driven by domestic demand? There are certainly some encouraging signs that strong German export growth is finally feeding through into increased investment and employment, but there is no indication of a pick-up in wage growth. Germany's federal labour office estimates that real wages will decline by a further 0.7 per cent in 2006. The European Commission forecasts that German unit wage costs will fall by 0.6 per cent in 2006 and 0.8 per cent in 2007, while those of the eurozone as a whole are forecast to rise by 0.8 per cent per year. Crucially, the Commission forecasts Italian unit labour costs to rise by around 2 per cent per year.[16] As a result, further economic divergence within the eurozone looks inevitable.

[16] *European Commission, 'Economic Forecasts Spring 2006', May 2006.*

It is also worrying that the German government plans to raise the rate of VAT by three percentage points to 19 per cent in January 2007. Germany needs to further consolidate its public finances, but this can best be achieved once domestic demand is expanding solidly. In the absence of such a recovery, the pick-up in German growth will remain very vulnerable to a weakening of external demand. For example, a sharp decline in the value of the dollar – highly likely given the ongoing widening of the US current account deficit – would quickly derail Germany's export-dependent recovery.

If current trends persist, EMU will not be sustainable. Economies such as Italy will get caught up in a vicious cycle of economic stagnation and rising indebtedness. But if a broad-based economic recovery takes hold in Germany, with domestic demand supplanting

net exports as the engine of economic growth, then the necessary adjustments within the eurozone will be easier to engineer. A German economy growing under its own steam would boost demand across the eurozone, cushioning the impact of structural reforms, and crucially, make it easier for other member-states to restore their competitiveness without forcing their economies into a prolonged recession.

Germany needs job creation in new sectors, rather than trying to preserve employment in traditional sectors with the help of declining real wages. Such a strategy is a recipe for weak consumption and investment, which will hold back productivity and economic growth. In particular, Germany needs to liberalise its service sector. Buoyant employment growth in this sector of the economy would make it easier to accommodate the necessary structural changes in other industries.

The eurozone therefore finds itself at a critical juncture. Unless its member-states rapidly boost their reform efforts and economic growth across the eurozone accelerates, further economic divergence is inevitable, putting great strain on the system. The next section looks in some detail at Italy, and argues that the Italian government needs to act now to ensure the country's long-term membership of the eurozone. And even if it is able to reform rapidly, the likelihood of it being able to recoup competitiveness will, to a large extent, depend on what happens elsewhere in the eurozone, not least Germany.

5 Italy – five minutes to midnight?

A number of eurozone economies face painful adjustments, but this section will concentrate on Italy because of that country's economic and political significance. A failure by Italy to regain competitiveness would ultimately bring into question its membership of the eurozone and the sustainability of EMU itself. No mainstream Italian political party will campaign for withdrawal from EMU unless there is prolonged economic stagnation and a debt crisis. But unless the new government is able to secure the consensus needed to enact reforms, this will eventually happen. The consequences would be hugely negative, not just for Italy but for the EU as a whole. It could easily force other members to quit the eurozone and could even precipitate the unravelling of the single market. The stakes are therefore very high.

There is no doubting the scale of the challenge facing Italy. The country's list of economic woes is a long one. Its economy is stagnating – growth potential has declined to little more than 1 per cent – and there is an urgent need to strengthen public finances. Despite the poor economic performance, inflation and nominal wage growth have remained high relative to the eurozone, which together with declining total factor productivity, has led to a dramatic loss of competitiveness. The reasons for this dreadful productivity performance and persistently higher inflation are not hard to identify. The economy suffers from a pronounced lack of competition across much of the service sector and low levels of innovation. Investment in information and communication technology (ICT) has been weak – partly because of the small average size of Italian firms – and spending on research and development is very low compared with comparable economies such as France, Germany or the UK.[17]

[17] *Working Party on the Information Economy, OECD, 2004.*

Despite the risks posed by a severe loss of competitiveness within EMU, Italy has been extremely slow to reform its economy. Pension reforms passed by the previous government, under Prime Minister Silvio Berlusconi, will take full effect in 2008, increasing the retirement age by three years to 60 years. The so-called Biagi Law has made it easier to hire people on temporary contracts. However, successive Italian governments have made little progress in opening up protected industries, which means that companies, for example in professional and business services, enjoy easy profits without having to invest or innovate. Despite promising to implement an ambitious programme of economic reforms, the Berlusconi government introduced very few microeconomic reforms, while its management of fiscal policy was little short of disastrous.

The government relied on one-off measures designed to contain the budget in the hope that economic growth would pick up and improve public finances. This strategy backfired, and Italy's underlying fiscal position has worsened rapidly. At the current levels of long-term interest rates, Italy needs to run a primary budget surplus of 2-3 per cent of GDP to prevent the ratio of public debt to GDP from rising further. But the primary surplus fell to just 0.5 per cent of GDP in 2005, with the result that the total debt burden started to rise again. With economic growth in Italy set to remain very weak in both 2006 and 2007, and long-term interest rates rising from their unprecedented lows of recent years, there is a serious risk of an accelerated deterioration in the fiscal position.[18]

[18] *European Commission, 'Economic Forecasts Spring 2006', May 2006.*

Perhaps the biggest problem facing Italy is that there is no real sense of national crisis, despite the fact that its economy is heading for serious trouble. There is no doubt that this complacency is partly the result of the country's membership of the eurozone. If Italy still had its own currency and independent monetary policy, the lira would long ago have come under pressure and debt servicing costs would have risen very sharply, prompting a crisis and leaving the government with no option but to implement reforms. As discussed

earlier, the financial markets believe at present that there is only a negligible possibility of Italy defaulting, and that there is therefore no reason to attach a higher level of risk to its debt.

The markets will not remain so sanguine if the Italian economy stagnates and public debt continues to rise. Were Italian sovereign debt to lose investment grade – which would require just two downgrades and the main ratings agencies (Standard and Poor's, Moody's and Fitch) already have Italy on 'ratings watch negative' – interest rates on Italian debt would rise strongly.[19] The new finance minister, Tommaso Padoa-Schioppa, has tried to instil a sense of crisis by stating that the economic situation is as serious as in the early 1990s – a time when Italians were gripped by an acute sense of instability. By coming clean over the extent of the country's fiscal crisis, the new administration is trying give the country a shock. But can it secure a strong enough consensus in favour of reform?

[19] *Standard and Poor's, 'Breaking up is hard to do: Rating implications of EU states abandoning the euro', 2005. The ratings agencies assign sovereign risk ratings to countries that issue debt on global markets, assessing the probability that a country will default on its debt. For example, S&P's ratings range from C (lowest) to AAA (highest). Debt rated 'investment grade' – where the investor is sure to receive principal and interest payments in full and on time – ranges from AAA to BBB; all debt rated below BBB is considered speculative and demands much higher risk premia.*

The Italian government had not at the time of writing finalised its strategy for improving competitiveness. It had announced plans to liberalise some sectors, such as taxis and the distribution of non-prescription drugs, but had yet to agree more far-reaching reforms. Worryingly, there were also signs that differences among the coalition partners would prevent the government from delivering on its electoral commitment to make substantial cuts in payroll taxes. Such a move would reduce the cost of labour by lowering non-wage labour costs, and would help reverse some of the loss of competitiveness. The government needs to combine moves to provide an immediate boost to competitiveness with measures to address the economy's underlying problems. These include:

★ **Reform of the budgetary process.** Annual budgets should be replaced by a multi-year budgetary process that concentrates on implementing permanent cuts in spending and avoids one-off measures such as tax amnesties. There also needs to be tighter management of expenditure by regional governments and reform of healthcare spending. At present, healthcare budgets and salaries are set centrally, but healthcare spending is decentralised, which encourages profligacy.

★ **Liberalisation of the service sector.** Aside from reversing the deterioration in the country's fiscal position, liberalisation of the country's service sector is the most urgent task facing the Prodi government. Lack of competition – especially in utilities, and professional and business services – is reflected in poor productivity and high prices.

★ **Reform of property rights.** The government needs to provide incentives to encourage small companies to open up their ownership structures to outside capital. At present, too many Italian companies would rather not expand at all than embrace the greater transparency needed to raise outside capital. But without higher investment they will not be able to exploit new market opportunities. They need greater scale in order to be able to invest sufficiently in ICT and reap the organisational benefits this can bring.[20]

[20] *Matteo Bugamelli and Patrizio Pagano, 'Barriers to investment in ICT', Journal of Applied Economics, vol.36, 2004.*

★ **Greater labour market flexibility.** The previous Italian government did establish a more flexible regime for fixed-term contracts and introduced new forms of temporary employment contracts. However, further moves are needed, including reform of collective wage bargaining so that wages more closely reflect productivity levels. Italy also needs to ease employment protection, but this will be hard to do unless it introduces a universal system of unemployment benefits.

★ **Increased education spending.** Italy educates fewer science graduates relative to its population than any other EU country, and its university system is especially ill-equipped to meet the needs of a knowledge-based, high-tech economy. In light of the weakness of public finances, additional spending will have to come from the private sector through a mixture of tuition fees, closer links with business and increased charitable giving.[21]

[21] *Richard Lambert and Nick Butler, 'The future of European universities: Renaissance or decay?', CER, June 2006.*

With the exception of setting up an adequate system of unemployment benefits, none of these reforms would further undermine public finances or hit economic growth. Indeed, there need not be a trade-off between fiscal reform and growth. However, to implement such a package of reforms will require a united government that is capable of taking on both industrialists and workers. Unfortunately, Italy's political system militates against such an outcome. Political fragmentation, an excessively powerful upper parliamentary chamber, and tensions between the central government and the regions all combine to weaken the cohesiveness of governments and slow the legislative process. The move in December 2005 by the Berlusconi government to return the electoral system to a proportional one threatens to exacerbate fragmentation.

The current government could yet implement the necessary reforms, especially if weak economic growth and a mounting sense of crisis make it easier to convince voters of the necessity. But there are many reasons to fear that it will fail. The coalition is heterogeneous, has a wafer thin majority and cannot rely on forging constructive relations with any of the opposition parties. The Communist Party, an important part of the coalition, has already extracted commitments from Prodi to overturn elements of the Biagi Law. The communists are also strongly opposed to cuts in public spending and moves to increase labour market flexibility. There are somewhat stronger grounds for optimism on the liberalisation of services markets, but the chances of public sector reform remain slim.

What then is going to happen? Three scenarios seem plausible:

★ **Economic renaissance – 20 per cent probability.** The least likely scenario is that Italy enjoys a major economic renaissance within the eurozone. An economic crisis, perhaps brought on by a sharp rise in interest rates on Italian debt, leads to the collapse of the government within the next two years and its replacement with a technocratic administration able to implement a comprehensive reform programme. A strong recovery in German domestic consumption boosts demand for Italian goods, substantially easing the cost of adjustment in Italy. Italian economic growth accelerates and the authorities exploit this to rebuild the country's primary budget surplus and reduce public debt.

★ **Italy muddles through – 40 per cent probability.** Under this scenario, the country manages to resist a further loss of competitiveness, as the government succeeds in implementing some significant reforms and Germany experiences a modest domestic recovery. Economic growth in Italy picks up, but it continues to lag the eurozone as a whole. Some progress is made in rebuilding the country's primary budget surplus, but rising long-term interest rates prevent any reduction in the overall deficit or the level of public debt.

★ **Italy leaves the eurozone – 40 per cent probability.** Growth in the eurozone economy remains very weak, and crucially, there is little let-up of wage restraint in Germany. The Italian government manages to impose some modest reforms, but these are insufficient to improve Italy's competitiveness within the eurozone. The erosion of external competitiveness continues, depressing economic growth. The financial markets lose confidence that Italy's fiscal position is sustainable, causing debt financing costs to rise sharply. With the economy stagnating and the debt burden rising rapidly, the economic costs of staying in the eurozone come to outweigh those of leaving. Public opinion turns against the euro, casting doubt on the country's continued membership.

Leaving the eurozone would have obvious costs for a highly indebted country like Italy. Because Italy's debt is held in euro, a 30 percent devaluation of the lira against the euro would increase Italy's debt to GDP ratio from the current level of 108 per cent of GDP to around 150 per cent.[22] Together with much higher debt servicing costs – the ratings agency S&P, has estimated that the interest the Italian government would have to pay on its debt would rise by around 3 percentage points – the impact on the country's public finances would be huge.[23]

[22] This assumes that the Italian government would not redenominate the country's debt into lira.

[23] Standard and Poor's 'Breaking up is hard to do: Rating implications of EU states abandoning the euro' 2005.

Of course, interest rates on Italian debt could rise by less than predicted in this scenario if Italy used devaluation to address the structural causes of low growth and poor competitiveness. For example, reforms of labour and product markets could prevent the country's newly restored competitiveness from being rapidly eroded by higher inflation. By contrast, interest rates could rise by even more if the Italian government redenominated the country's debt into lira. Such a move would effectively mean Italy defaulting on its debt. In these circumstances, investors would demand a big premium in order to lend to the Italian authorities because of fears of further lira depreciation.

Unfortunately for Italy it is unlikely that other struggling members of the eurozone would stand by while Italy recouped competitiveness at their expense. Already suffering from a dramatic loss of competitiveness within the eurozone, countries such as Portugal and Spain would be confronted with a suddenly competitive Italy, raising serious questions marks over their ability to remain within the eurozone. There is also a risk that other member-states, such as France, would demand the imposition of

trade barriers against Italian imports. It is possible that Germany would support such measures. Germany sacrificed most when it signed up to EMU by sharing the benefits of its low real interest rates with other economies, but would have nothing to gain from EMU falling apart. In light of the country's massive current account surplus, a re-introduced deutschmark would appreciate considerably against the currencies of its European trade partners and in all likelihood throw the export-dependent German economy into recession. Much would depend on the Commission. If it failed to resist these demands, the single market would start to unravel.

It is not too late to prevent Italy from being forced to leave the eurozone, but time is running out. There is a tendency to believe that membership of EMU is irreversible, and that however bad things get in a particular member-state the sustainability of the eurozone will not be brought into question. This is mistaken. The Maastricht treaty does not include a withdrawal clause, but there is no reason to believe the treaty poses a serious obstacle to a country leaving EMU. And there is no doubting how serious the consequences of Italy quitting the eurozone could be, not just for Italy, but for the the future of EMU and potentially the single market. The next section will outline what needs to be done to prevent this worst case scenario becoming reality.

6 A flexibility and growth pact

The existing institutions of EMU were designed for economies that are similar or are expected to become so very rapidly. But big differences between the member-states remain, and as this pamphlet has shown, the eurozone economies are diverging in damaging ways. The future of the single currency will be bleak unless a number of things happen. First, the participating countries have to take rapid steps to ensure a much higher degree of market-led flexibility. Second, there needs to be a sustained pick-up in economic growth within the eurozone, and this will not happen without a recovery in German domestic demand. Of course, increased flexibility and faster economic growth are two sides of the same coin. The reforms needed to boost growth – liberalisation of labour markets, more competition and much improved education and skills training – are also those needed to make members of the eurozone flexible enough to cope with the discipline membership of EMU requires. Third, the institutional framework for fiscal policy within EMU needs to be reformed and the ECB needs to adopt more growth orientated monetary policies.

Unfortunately, just when a renewed commitment to the market economy is required, the populations of key eurozone economies are becoming increasingly hostile to market reforms. This is a recipe for mounting trouble. Political elites should be more honest with their electorates about what eurozone membership implies – from fiscal discipline to deregulation of product and labour markets. Membership does not provide an automatic defence against globalisation. Nor does the single market insulate its members from global competition. Rather, if fully exploited, the single market and EMU have the potential to dramatically improve Europe's competitiveness and its ability to profit from globalisation.

Governments need to make plain that reforms will increase economic growth and secure the sustainability of universal public services and welfare benefits. And, crucially, they need to design better strategies for implementing reforms.

The single market and Lisbon agenda

The completion of the single market and a serious attempt to implement the so-called Lisbon agenda would go a long way to making EMU sustainable. The single market has done much to improve competition in Europe by removing barriers to the trade in goods and by facilitating capital mobility. But it is far from complete. Europe's economic performance will only improve if it succeeds in boosting service sector productivity.[24] The eurozone should implement the Commission's services directive in close to its original form. This would help break down the regulatory barriers that limit competition in and between member-states and boost service sector efficiency. The compromise directive passed in 2006 effectively perpetuates the status quo and will do very little to facilitate the integration and flexibility that is pivotal to the success of EMU.

[24] *'Competition, Productivity and Prices in the Euro Area Services Sector', Occasional Paper Series, ECB, 2006.*

At the Lisbon summit in March 2000, Europe's leaders unveiled an ambitious agenda for modernising the European economy. The member-states agreed to implement a wide-ranging programme of reforms, designed to encourage innovation, liberalisation, improved business environments and social inclusion. The goal of making the EU "the most competitive and dynamic knowledge-based economy in the world by 2010" was never realistic, and progress has generally been disappointing.[25] Nevertheless, EU governments need to remember that the implementation of the Lisbon agenda would remove many of the structural rigidities within labour, product and service markets, and help to address the weaknesses in human capital that place barriers in the way of structural change. After all, there is a strong correlation between a country's record in fulfilling the Lisbon criteria and its economic growth performance. Eurozone governments urgently need to get serious about Lisbon, to strenuously counter popular fears over reforms, and to stop pandering to domestic producer interests.

[25] *Aurore Wanlin, 'The Lisbon Scorecard VI: Will Europe's economy rise again?', CER, March 2006.*

They also need to rethink how they go about executing reforms. Overcoming popular scepticism requires that economic reforms be approached in a different way. Building a workable consensus in favour of change demands that people receive something in return. If not, they have no incentive to buy into a reform agenda. For example, Germany provides a salutary example of how not to reform labour markets and welfare provision. The measures implemented by the Schröder government involved cutting unemployment benefits and tightening eligibility for them but provided nothing in way of compensation. In a country like Germany, where people are used to a very high level of security and are generally risk-averse, this was the wrong strategy. By creating anxiety the reforms depressed consumer confidence and, crucially, further increased resistance to other more urgent labour market reforms, such as an easing of employment protection. It would have been far better to follow the Danish example of retaining generous unemployment benefits but easing employment protection in exchange for comprehensive retraining and help in finding new jobs.

Germany should eschew economic reforms that could exacerbate anxiety, such as further cuts in unemployment or other welfare entitlements but aggressively liberalise its service sectors. Moves to make the labour market more flexible by easing the current high levels of employment protection will have to wait until economic growth picks up and labour market conditions improve.

Common economic and social policies are not the answer

EMU does not need common economic and social policies to be sustainable. Policies in one member-state have a significant impact

on others, but common economic and social policies could easily lead to the institutionalisation of rigidities, for example through the establishment of high levels of labour and product market regulation at the eurozone level. For example, wages need to be set with greater reference to local productivity levels and not less. It is only through competition between member-states within a completed single market that the necessary economic integration and flexibility will come about. One-size-fits-all policies would be a distraction. One exception is the harmonisation of tax bases – as opposed to tax rates – for which the case is persuasive. The establishment of common definitions of what kind of corporate income is taxable would allow companies to employ a single method for calculating tax liabilities, in the process promoting transparency and competition.

A strong case can be made for fiscal transfers within the eurozone on the grounds that such a mechanism could increase flexibility by cushioning the impact of a loss of competitiveness and providing space to make the necessary adjustments. However, even if the political basis for such a mechanism existed, there is an obvious risk of free-riding. The availability of such support could further weaken incentives for sound fiscal management. Nevertheless, there is a strong case for reform of the fiscal framework of EMU:

★ The SGP does not differentiate sufficiently between current and investment spending, and this has contributed to the decline in public investment seen in many member-states in recent years. To prevent this, public investment should be excluded from the deficit that is subject to the SGP rules. This would help ensure that investment levels are maintained across the economic cycle, and prevent cuts in investment spending contributing to economic downturns.[26] Such a step would require agreement on what spending constitutes investment and what does not, but this should be possible. The SGP also needs to take greater account of differing levels of public debt in the various member-states. For example, for a country with a low level of public debt, such as the Netherlands or Finland, a budget deficit of 3 per cent of GDP poses far less of a problem than it does in Italy or Greece, which are saddled with very high levels of public debt.

[26] *Olivier Blanchard and Francesco Giavazzi, 'Improving the SGP through a proper accounting of public investment', CEPR Discussion Paper, 2004.*

★ The ECB should encourage the financial markets to differentiate between the debt of the various eurozone members. Greater market discipline would address one of the principal structural weaknesses of EMU – the lack of external pressure faced by governments and hence their lack of urgency in implementing reforms. At present it treats all sovereign liabilities as perfect substitutes when carrying out its open market operations. According to Willem Buiter of the University of Amsterdam and Anne Sibert of the University of London this is what encourages the market to attach an almost identical level of risk to the sovereign debt of all members, thus undermining the market's role as an enforcer of fiscal discipline.[27] The ECB should state that in five years' time it will no longer take debt as collateral that is rated below AA. (See table on page 54.) This would force countries whose debt is currently rated below this – Greece, Italy and Portugal – to strengthen their public finances.

[27] *Willem Buiter and Ann Sibert, 'How the eurosystem's treatment of collateral in its open market operations weakens fiscal discipline in the eurozone (and what to do about it)', Centre for European Policy Research, 2005.*

Growth-orientated monetary policy

For EMU to flourish, economic growth across the eurozone needs to accelerate. Structural reforms aimed at removing barriers to competition and higher productivity would boost growth, and the SGP needs reform. However, EMU also needs growth orientated monetary policies. Given that many eurozone countries have historically been prone to high inflation, the ECB's determination to build a reputation for guaranteeing price stability is understandable. Officials from the ECB never tire of saying that ensuring low

inflation is the best contribution the ECB can make to economic growth, and they are right. But a 'reference value' – it is not an official target – of under 2 per cent is too restrictive and damaging in a number of ways:

Standard and Poor's current soverign ratings (AAA= the best rating)

	Current rating*
Greece	A
Italy	AA-
Portugal	AA-
Belgium	AA+
Austria	AAA
Finland	AAA
France	AAA
Germany	AAA
Ireland	AAA
Netherlands	AAA
Spain	AAA

*Source: Standard and Poor's. *Long-term foreign currency credit ratings as of June 7th 2006.*

★ First, it increases the risk that interest rates will be raised in response to temporary shocks – such as higher oil prices – that do not threaten medium-term price stability, leading to excessively restrictive monetary policy. This was illustrated by the ECB's decision to raise interest rates twice in the summer of 2006, despite the existence of plenty of spare capacity in the French, German and Italian economies. Eurozone inflation did rise to 2.5 per cent in June, but this was largely the result of surging energy prices rather than a strengthening of underlying inflation pressures – core inflation (which strips out the oil prices) remained well under 2 per cent and there was no sign of accelerating wage growth.

★ Second, it leaves very little room for adjustment within the eurozone. A symmetrical target of 2.5 per cent – that is, the inflation rate should not deviate by more than 1 percentage point in either direction – would be far better. It would make it much easier for a member-state to hold its inflation rate below the eurozone average without risking economic stagnation. For example, were core eurozone inflation rising by an average of 2.5 per cent, a country needing to regain competitiveness would only have to ensure inflation of 1-1.5 per cent to facilitate relatively rapid adjustment. To engineer an adjustment of similar magnitude at current levels of core inflation would imply depressing inflation to almost zero.

A higher inflation target is also necessary to prevent enlargement of the eurozone exacerbating existing tensions within it. As relatively poor states experiencing rapid economic catch-up, the new EU member-states are expected to generate higher rates of inflation for the foreseeable future, putting upward pressure on eurozone inflation. Unless the ECB adopts a higher inflation target, interest rates will rise and hit growth in slow growing, low inflation countries such as Germany, in the process reducing the likelihood of Germany becoming a source of demand within the eurozone.

The ECB should not be responsible for defining price stability and setting itself an inflation target. One option would be to transfer responsibility for defining price stability and setting inflation targets to the Euro Group, which would have to agree to make decisions by qualified majority.[28] Such a move would not necessarily

[28] *Jean-Paul Fitoussi and Jérôme Creel, 'How to reform the ECB', CER, October 2002.*

require a new treaty; a unanimous decision in the Council could be enough. The ECB would oppose such a move on the grounds that it could compromise the institution's independence and hence its credibility. However, such a move is just as likely to bolster the institution's credibility by demonstrating that the EU takes the threats to EMU seriously.

7 Conclusion

Europeans often refer to EMU and enlargement as two of the EU's greatest successes. However, the basis for a sustainable currency union is not in place. The discipline required for successful membership has been badly underestimated by most members, bringing into doubt the long-term viability of the single currency. The belief that the reforms needed to ensure the smooth functioning of EMU – such as a very high degree of labour and product market flexibility – would be implemented because the costs of not doing so would be so high, has proved wishful thinking. In the absence of labour mobility or fiscal transfers between member-states it is essential that adjustments within the eurozone rely on movements in the relative prices of goods and labour. There is no mystery over what needs to be done to bring this about. Ensuring faster economic growth across the eurozone does not only require a renewed commitment to market-led reforms but also institutional changes:

★ **The implementation of market-orientated reforms**. The completion of the single market – crucially the removal of barriers to the trade in services – and implementation of reforms forseen by the Lisbon agenda would help to increase the flexibility of labour and product markets.

★ **Stronger economic growth in Germany**. Exceptionally weak domestic demand in Germany poses a very serious challenge for EMU as a whole, and it is essential that the country becomes less dependent on exports to drive growth. After many years of relying on exports, Germany now needs to be a source of demand across the eurozone so other members can regain competitiveness without suffering economic stagnation.

★ **More expansionary monetary policies**. The ECB's current definition of price stability – below, but close to 2 per cent – is unnecessarily restrictive. Somewhat higher inflation – for example a symmetrical inflation target of 2.5 per cent – would increase flexibility within the eurozone and reduce the risk of deflation in slow-growing countries. Responsibility for setting these targets should be handed over to the Euro Group.

★ **Reform of the stability and growth pact (SGP)**. The SGP needs to differentiate between current and investment spending, with investment being excluded from the deficit that is subject to the SGP rules. This would help ensure that investment levels are maintained across the economic cycle, and prevent cuts in investment spending contributing to economic downturns and undermining growth prospects.

★ **Encourage financial markets to discipline profligate governments**. The ECB should announce that in five years time it will no longer take debt that is rated below AA as collateral. This would discourage the financial markets from treating the sovereign debts of the various member-states as interchangeable and prevent irresponsible governments from free-riding on the sovereign ratings of the best performing countries.

Further delays in implementing microeconomic reforms and institutional changes would greatly increase the risk that EMU unravels. The signs are ominous. At a time when market-led reforms are urgently required, public confidence in the market economy in key members of the eurozone is declining. Implementation of the measures needed to make the euro sustainable is being thwarted by rising fears over the impact of globalisation on welfare systems and job security.

What happens in Italy will be crucial for the future of EMU. If Italy fails to improve its competitiveness, it could be forced to leave the eurozone. The consequences would be hugely damaging, not just

for EMU, but for Europe more broadly. It could easily force other countries to leave and could even threaten the single market.

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WILL THE EUROZONE CRACK?

Simon Tilford

Europeans often refer to Economic and Monetary Union and enlargement as the EU's two greatest successes. However, the basis for a sustainable currency union is not in place. Unless the members rapidly boost their reform efforts, and unless economic growth across the eurozone accelerates, EMU faces a bleak future. What happens in Italy will be critical. If Italy fails to improve its competitiveness, it will eventually have to leave the eurozone. This could force other countries to quit the currency union and potentially threaten the EU's single market.

Simon Tilford is head of the business unit at the Centre for European Reform.

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