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ECONOMIC GOVERNANCE

Sense and Nonsense of the Euro-Plus Pact

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The sovereign debt crisis in the eurozone has generated a large debate on how to ensure better economic governance. In late 2010, this debate led to the report of the Van Rompuy Task Force and the legislative proposals of the Commission.[1] The report and proposals, which are almost identical in their content, are supposed to achieve greater policy coordination among Member States and improve the functioning of the Economic and Monetary Union (EMU) using existing institutions in a better way. The legislative proposals, are now under consideration by the European Parliament and are likely to be adopted soon. In essence, they foresee a strengthening of the Stability and Growth Pact, by introducing the "European Semester" for national budgets, and the creation of a new excessive-imbalances procedure, which will be based on the monitoring of a set of indicators (competitiveness above all) supposedly able to detect potentially dangerous imbalances.

On top of these changes being prepared for the economic governance of the eurozone via the normal Community process, at its March meeting the European Council added a new, intergovernmental mechanism, namely the "Euro-Plus Pact". The purpose of this pact is to strengthen the "competitiveness" of the participating countries (at first it had been called the "competitiveness pact"). Although this new pact was intended to represent a particular commitment by eurozone member countries, many non-euro Member States have also signed up.

While the policy process at the European Union (EU) level is in full swing to create new coordination mechanisms, what one observes in reality is not coordination, but the combined pressure of markets and large creditor Member States. In practice, the current system of economic governance resembles a creditors' dictatorship: on the part of the creditors, it is a benevolent dictatorship as its main aim is to restore the creditworthiness of the

1. European Commission, "A new EU economic governance – a comprehensive Commission package of proposals", DG ECFIN, September 2010, available at: http://ec.europa.eu/economy_finance/articles/eu_economic_situation/2010-09-eu_economic_governance_proposals_en.htm

debtors, but it works with different rules than the official ones. While official procedures foresee a complex set of reports by the Commission to be discussed in the Economic and Financial Affairs Council (ECOFIN) meetings, which then decides normally by qualified majority, the reality is different. Markets deliver verdicts on the creditworthiness of the debtors every day and their judgement is influenced by the political signals given by the creditors about the conditions under which support will be provided. The case of Portugal provides another illustration of this. The various fiscal programmes presented by the government of Portugal had been accepted by ECOFIN until the markets decided that it had become too risky to buy Portuguese government bonds. At this point the EU's institutions suddenly discovered that the country needed profound structural reforms to restore its competitiveness.

As long as the crisis continues, there might be no alternative to this system, but its *modus operandi* raises some fundamental questions concerning political legitimacy. First, as mentioned, the system resembles a creditors' dictatorship, where creditors protect their interest by restoring the debtors' creditworthiness. Second, it creates a "two tier" Member State system comprised of: the debtor countries, which have to accept prescriptions on fiscal policy, structural reforms, etc., and the creditor countries, which are free to conduct their economic policy without any meaningful interference. The most recent evidence of this approach is the aforementioned Euro-Plus Pact, a sort of "more European" version of the Franco-German proposal of a "pact for competitiveness".

Our contribution will concentrate on the economic aspects of the debate on governance and focus on competitiveness as this is a key theme in the current discussion. We shall argue that the current effort of grand design for competitiveness aiming at reducing divergences among countries by means of procedures and rules will help neither to solve the eurozone crisis nor enhance European economic governance. First, as will be shown below, the various elements which have been proposed to measure competitiveness tend to be flawed and of limited use. This might appear to be a technical point, but it is crucial because if the elaboration of new mechanisms is of little use for preventing future crises (or to resolve the current one), then this will only increase the sense that the EU cannot cope with its own problems. Second, focusing exclusively on how to reduce divergences measured by competitiveness indicators may risk monopolizing all attention on the symptoms, i.e. competitiveness divergence itself, rather than on the real disease, i.e. why this happened.[2] Last but not least, the current crisis is a sovereign and bank debt crisis, but the ongoing debate about governance has failed to address the debt issue and, consequently, has been unable to resolve the crisis.

2. See Cinzia Alcidi and Daniel Gros, "Fiscal policy coordination and competitiveness surveillance: What solutions to what problems?", CEPS Policy Brief 213, 7 September 2010, available at: http://www.ceps.eu/book/fiscal-policy-coordination-and-competitiveness-surveillance-what-solutions-what-problems

Sense and non-sense in competitiveness indicators

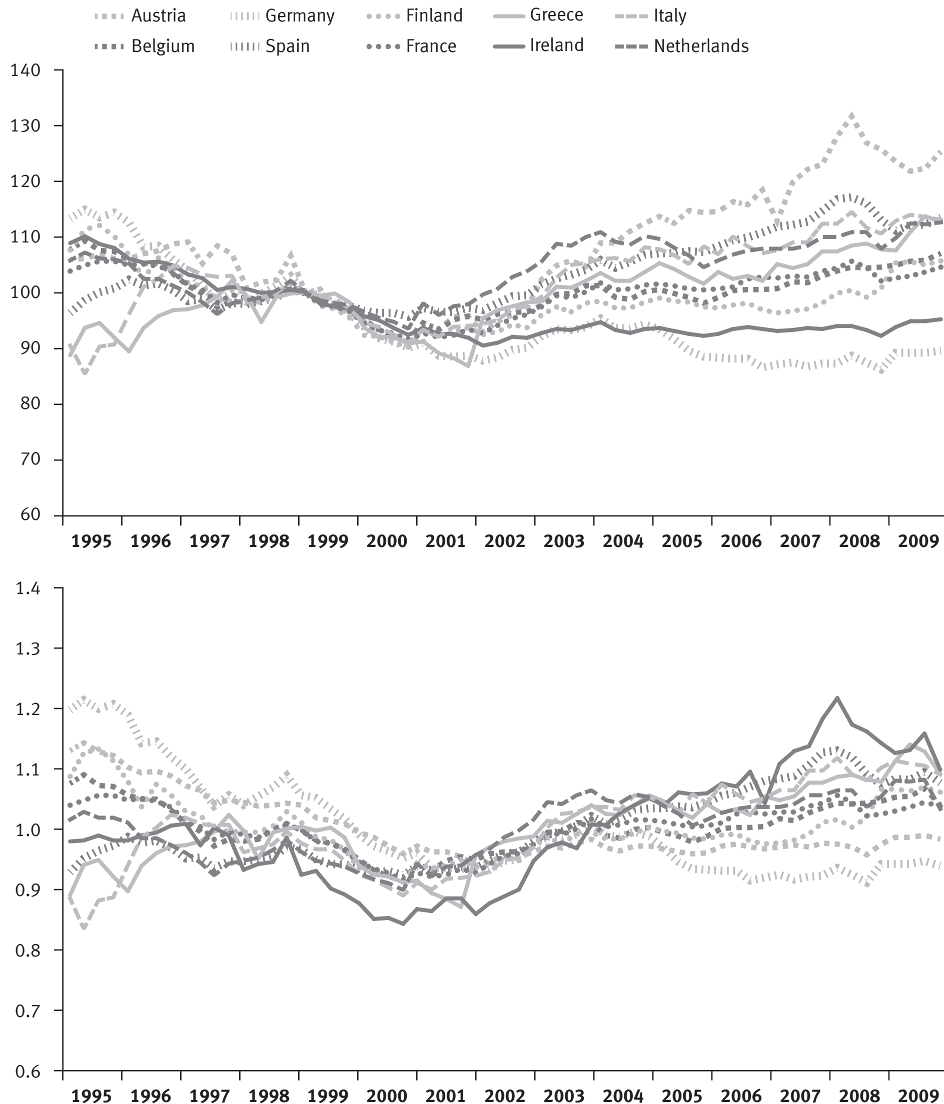
Divergences in competitiveness within the eurozone have been central to the policy debate for some years. The common element of a number of existing proposals has been to develop competitiveness indicators and then force member countries to take "remedial action" should large divergences in the indicators emerge. We argue below that this approach risks leading in the wrong direction and we start by conveying some technical arguments.

A first point is that competitiveness usually measured as relative unit labour cost (ULC) is a relative concept. The gain of one country is the loss of another. Hence if one wants to restore the competitiveness of a member country (for example Greece) others (Germany in the first instance) must accept deterioration in theirs: the adjustment might come about either through wage increases in the lower labour cost countries or cuts in those with a too high cost. There is some consensus that no country should be forced to increase wages and everybody gains if structural reforms increase productivity, but this does not change the fundamental fact that if German wages increase, intra-eurozone divergence is reduced by definition.

A second point is that it is always difficult to determine the proper base year for the competitiveness index. It is often implicitly assumed that the start of EMU represents an equilibrium and hence the best base, but there is no actual economic ground for this. The chart on the left hand side of Figure 1 shows the evolution of the ULC in the eurozone countries, assuming that 1999 is the base year, while the chart on the right hand side shows the same index re-scaled dividing it by its average over the period 1995-2010 to remove the biased induced by the choice of the base year. The comparison suggests that 1999 might not have been equilibrium itself. When the long-term average is taken as equilibrium concept, 2003 appears to be the year with the smallest cross-country differences. It also emerges that prior to 2003, Germany was one of the countries with lowest competitiveness, while after 2003, countries that have experienced a significant loss in competitiveness are those where bubbles had developed, Ireland and Spain for example.[3] Importantly, the consequence of a bias in the base year is a bias in the measurement of the divergence. The analyses based on 1999 as equilibrium year conclude that countries now in difficulties have lost about 25-30% in terms of ULC relative to Germany, while using the long term average as equilibrium concept suggests a loss of about 15%, a substantially smaller estimate of the divergence. The purpose of these simple considerations is not to show that unambiguously 2003 should be taken as proper base year, but how difficult it is in practice to measure divergences in competitiveness.

3. See Daniel Gros, "Adjustment Difficulties in the GIPSY club", CEPS Working Document No. 326, 5 March 2010, available at: http://www.ceps.eu/book/adjustment-difficulties-gipsy-club

Figure 1 | Real harmonized competitiveness indicator Unit Labour Cost (ULC) in total economy deflated (**LHS: ULC base year 1999, RHS: re-scaled ULC**)



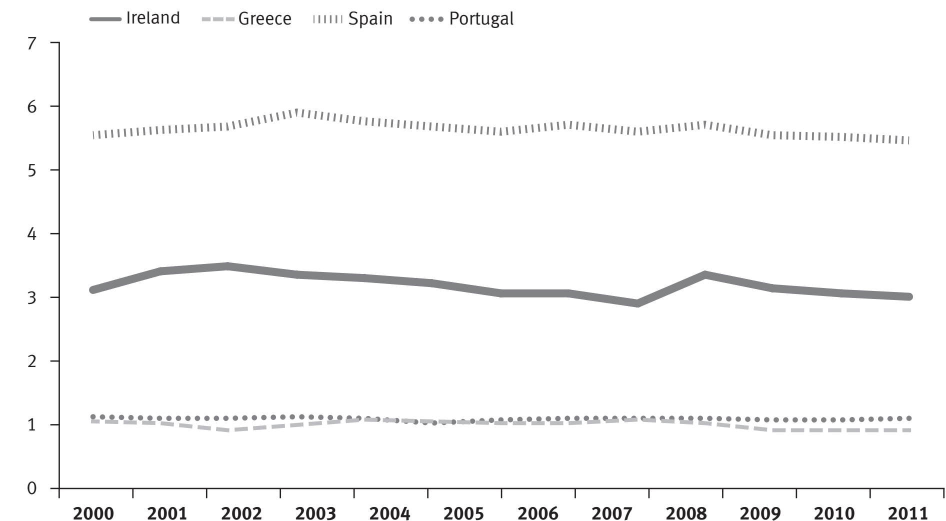
Source: ECB Statistical Warehouse and own computation
Note: ECB EER-21 group of currencies and eurozone 16 country currencies.

Besides measurement issues, even assuming that an agreement can be found on how to assign desired future losses and gains in competitiveness to each country, one has to keep in mind that member countries are not centrally planned economies. There is little a government can do in a market economy to force lower wages in the private sector. Governments can

of course enforce wage cuts in the public sector. This is being done on a large scale in Greece and Spain, for example, but there is little empirical evidence that public sector wage trends have a significant impact on wage growth in the private sector.[4]

Finally, a more fundamental reason to be sceptical about the usefulness of the standard competitiveness indicators is that their power to predict imbalances is rather low. In principle, a loss of competitiveness should lead to lower exports, or at least lower market shares. It is widely repeated that labour costs in the four euro countries, i.e. Portugal, Ireland, Greece and Spain, which face difficulties in financial markets, have increased too much in relation to those of Germany and this is the main reason for their large external imbalances. Yet, data on export market shares do not seem to support this hypothesis. Figure 2 shows these four countries' share of goods and services exports within overall EU-27 exports: all lines are essentially flat and not downward-sloping as one would expect.

Figure 2 | Exports of goods and services (**% of EU27 exports**)



Source: European Commission services (Ameco database)

Moreover, as suggested by Figure 3, which displays the ratio of exports of goods and services of the year 2010 relative to 2000, exports have grown significantly both in countries with low and high competitiveness. In fact, within the EU, countries with the worst performance are the UK, France and Italy, and not those under high market pressure.

4. See the work of Ana Lamo, Ludger Schuknecht and Javier J. Pérez "Public and private sector wages: co-movement causality", *ECB Working Paper Series 963,* 2008 – for empirical studies, which find econometrically significant effects, but the orders of magnitude remain so small that any politically feasible autonomous change in public wages would have only a negligible impact on private sector wages. Available at: http://www.ecb.int/pub/pdf/scpwps/ecbwp963.pdf

Figure 3 | Export ratios 2010 / 2000

Source: European Commission services (Ameco database)
Note: If one takes 2008 rather than 2010 as numerator, the picture does not change significantly; there is just some reshuffling in the order of Greece, Ireland, Portugal and Spain (GIPS).

There are possible alternative explanations as to why losses in competitiveness are not necessarily reflected in export growth and why competitiveness indicators do not necessarily reflect economic performance. Some of them follow below.

The first explanation is export supply growth: this is largely the case of Estonia whose exports have increased dramatically, doubling in a decade, but whose "competiveness" indicators have worsened considerably – about 20-30 percentage points more than those of Greece or Spain. This argument, which to a lesser extent also applies to peripheral eurozone countries, is based on the fact that export increases can be driven by a larger supply of new products and new firms.[5]

The second is increased openness: both imports and exports have increased considerably in all countries, and most notably in Germany. In this respect, it is often overlooked that German imports (especially of intermediate products), and not only exports, have increased more than those of its trading partners or other eurozone countries.

The third explanation relates to the distinction between tradable and not-tradable goods and the fact that in some countries, like Spain, competitiveness in the tradable sector did not deteriorate over time, which explains why exports have been growing, but in the non-tradable sector labour cost, driven by the bubble in the construction sector, have augmented significantly.

5. See Paul Krugman, "Scale Economies, Product Differentiation, and the Pattern of Trade," *American Economic Review, No. 70,* pp. 950-959, 1980. Available at: http://www.aeaweb.org/aer/top20/70.5.950-959.pdf

Notwithstanding the explanations above, large export growth in Greece, Spain and Ireland over the last decade seems difficult to reconcile with these countries' large current account deficits. A closer look at the data shows that for Spain and Greece, the balance on goods and services has been approximately the same in 2000 and 2010, suggesting that in a country starting with a large imbalance, in order for the trade balance to improve, exports need to grow not only significantly, but also much more than imports. In the specific case of Greece, the large deterioration of the current account is explained by a huge accumulation of foreign debt, which it has to service. Similarly in Ireland, current account deficits were driven mainly by the income balance. The real challenge for countries with large foreign debt is that when financing conditions deteriorate, they have to devote a much larger part of income to debt service – whatever the situation in terms of usual competitiveness indicators.

Conclusion

While the current EU political debate is engaged in enhancing economic governance and preventing divergences in economic performance through correction in competitiveness differences, the evidence presented above suggests that the emphasis on competitiveness indicators risks being of very limited use. The newly created Euro-Plus Pact has reinforced this tendency by repeating the fallacy that because peripheral countries have lost competitiveness over the last year, this is the only problem that needs to be resolved. This approach is made possible by the fact that, at present, creditor countries control the official agenda and are free to put emphasis on those issues that do not require much adjustment on their side. It is thus not surprising that Euro-Plus Pact concentrates on issues that do not represent a problem for Germany (for example, national debt brake, increasing retirement age, etc.). Other areas, where reforms would be needed in Germany as well, such as liberalising the services sector and dealing with doubtful assets on the balance of "government sponsored" banks, have been left out.

It should not be forgotten that until recently Ireland, and to some extent Spain, were held up as shining examples of competitive economies that created a record number of jobs. Their current troubles are the result of bubbles and it is doubtful that tighter economic policy coordination or the pact for competitiveness will reduce the consequences of the bursts or prevent new bubbles from emerging.

The policy agenda thus risks becoming lopsided, with important issues not being treated because they are not on creditor countries' domestic agendas. The coming Trio Presidency should use its influence to restore balance in the policy agenda and assign priority to those

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issues that are vital to the existence of both the eurozone and the future of the EU. Among those, dealing with undercapitalised banks, which is both a creditor and debtor country problem, should be a main concern. Of course, improvement in productivity and competitiveness, driven by (structural) reforms, is always welcome – this is a *raison d'être* of the Europe 2020 (and before it the Lisbon) Strategy. However, competitiveness divergences during the last decade were mainly driven by capital flows – now the flows are reversing and so will the imbalances. But for this mechanism to work, financial markets must be stable. This implies that the coming Trio Presidency should re-focus attention on stabilising financial markets, an objective clearly not achieved by the previous European response to the crisis. This does not mean that financial markets should set or are setting the policy agenda; it simply means that the EU needs to put aside its competitiveness obsession and face the problems at hand. Over time, the combination of the asymmetry between creditors and debtors and the likely ineffectiveness of the new mechanisms risks delegitimizing the EU process even more, with dangerous consequences for the Union.