

# Europe: coming together or falling apart?

**Rapporto Europa 2017**

## The end of austerity

**FISCAL POLICY AND THE SUSTAINABILITY OF PUBLIC DEBT**

**EUROPE'S GROWTH POTENTIAL**

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**MACROECONOMIC IMBALANCES**

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## The EU trade and rising protectionism: divergence in the world

**THE IMPORTANCE OF TRADE FOR EUROPE**

**THE ROLE OF TARIFFS**

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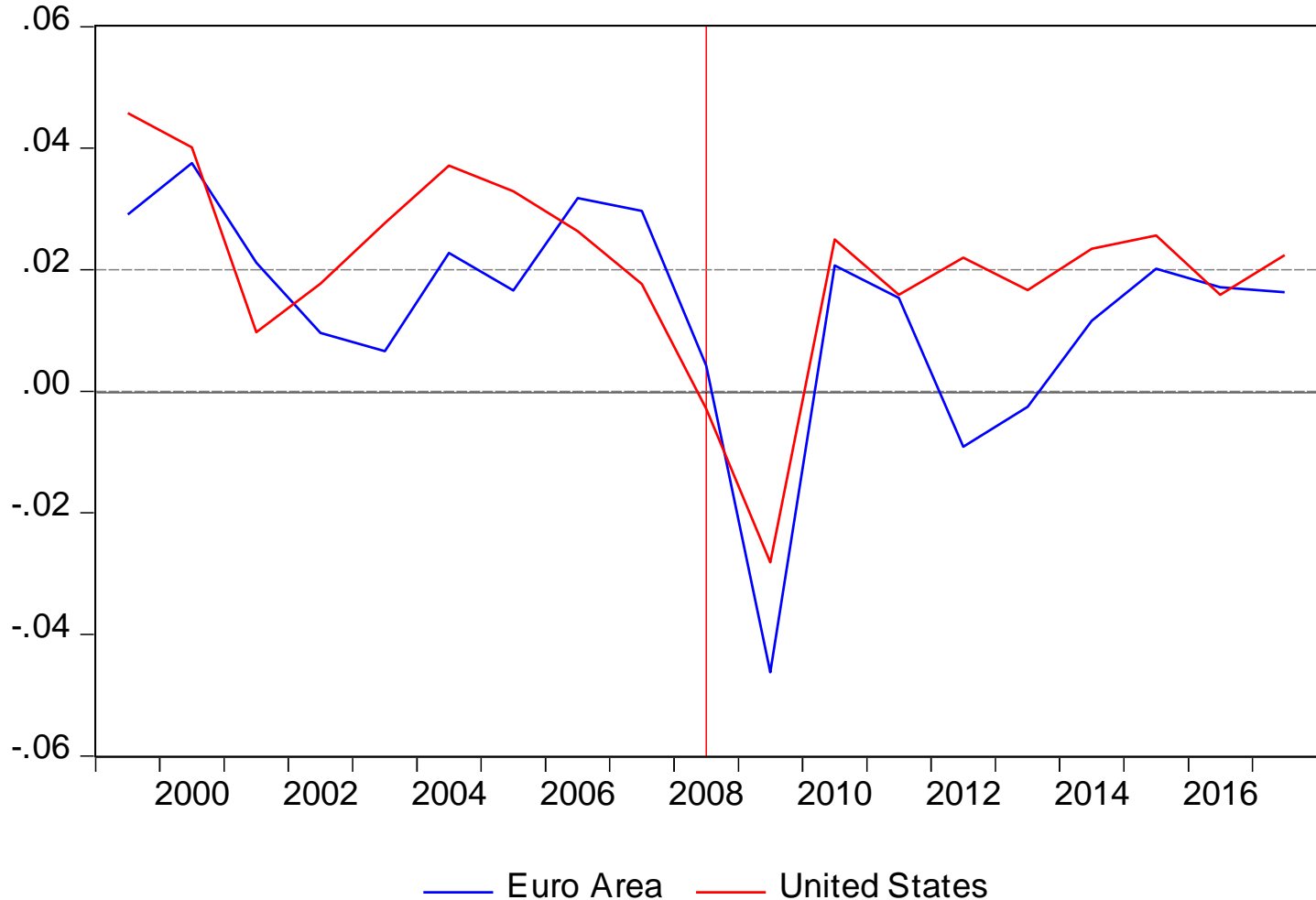
Box 6. US protectionism and Global Value Chains: impacts on European trade

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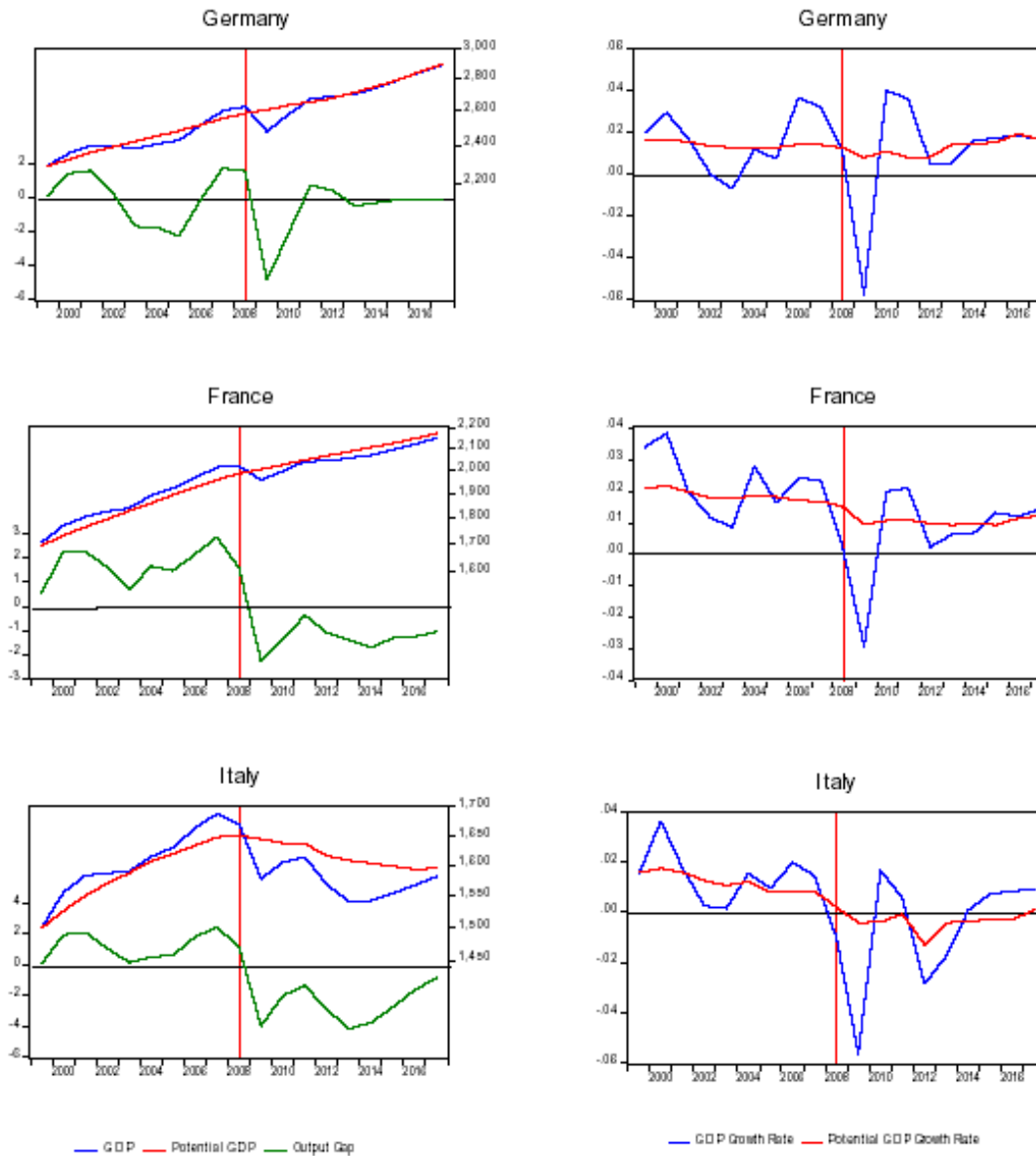
# I. The end of austerity

GDP growth is expected to grow by 1.6 percent in 2017  
reaching a level similar to the United States

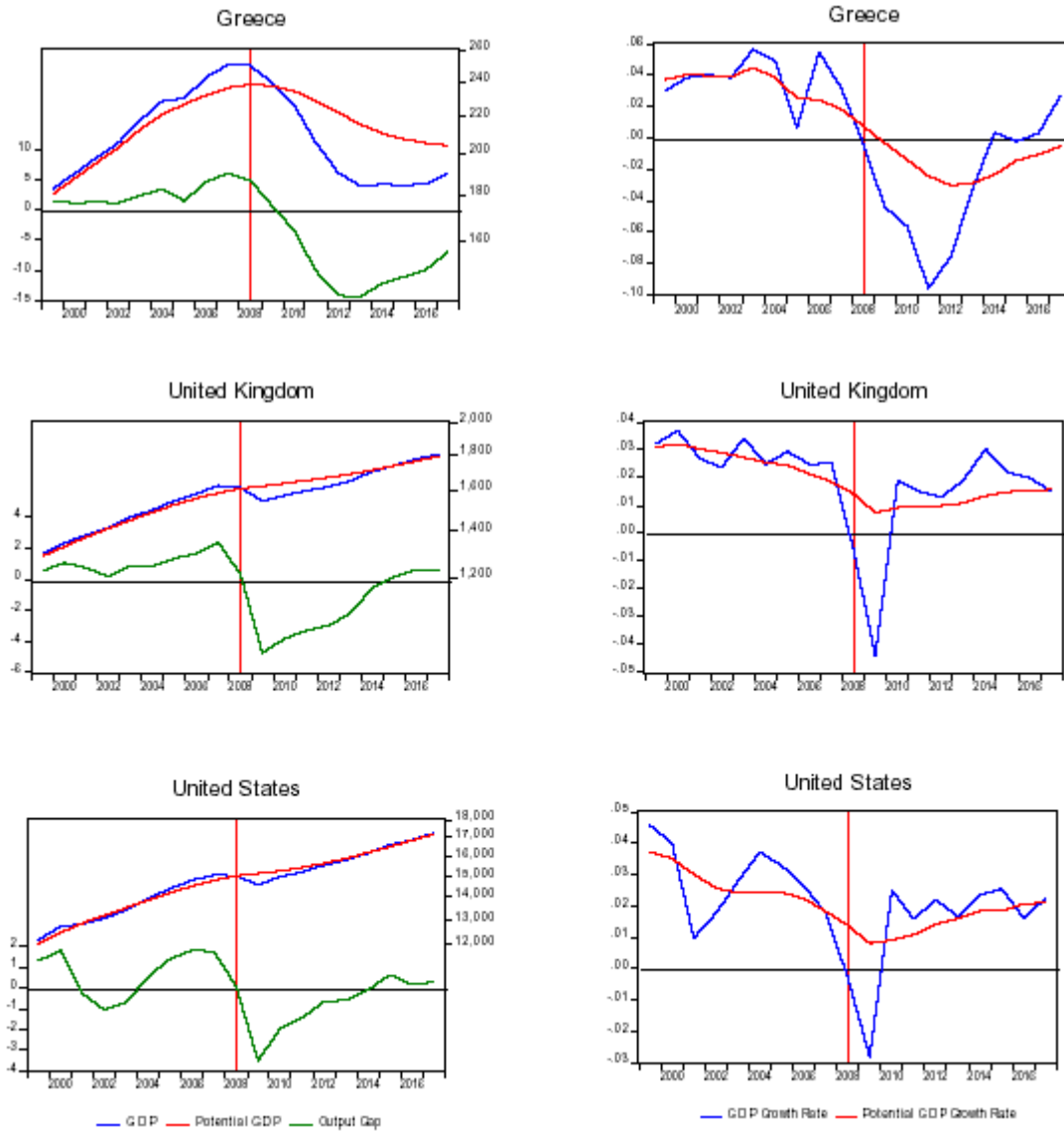
## Figure 1. Economic growth: Euro Area versus USA



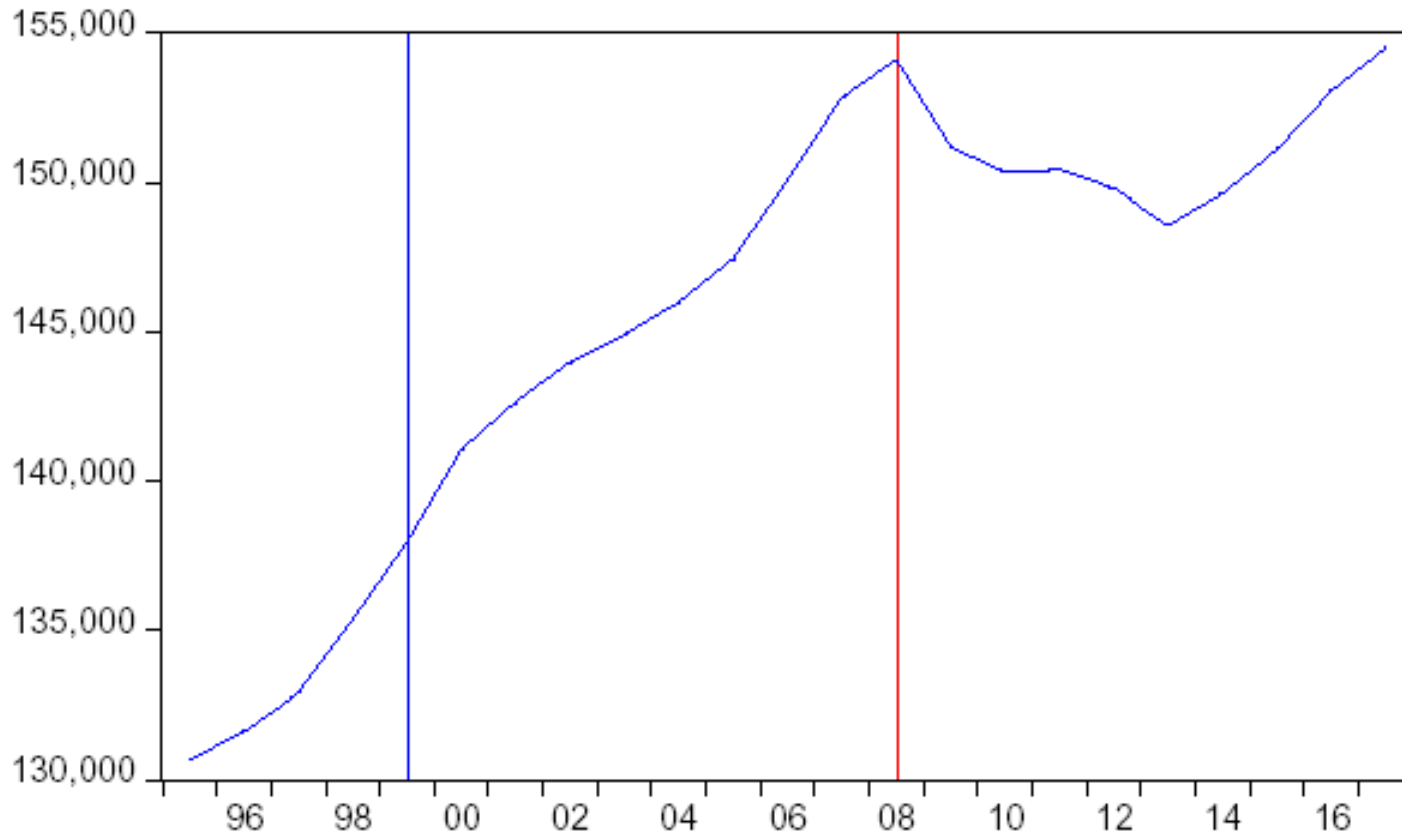
## Figure 2. Output Gap and Growth Rates



**Figure 2. Output Gap and Growth Rates**



**Figure 21. Euro Area: number of employed people**



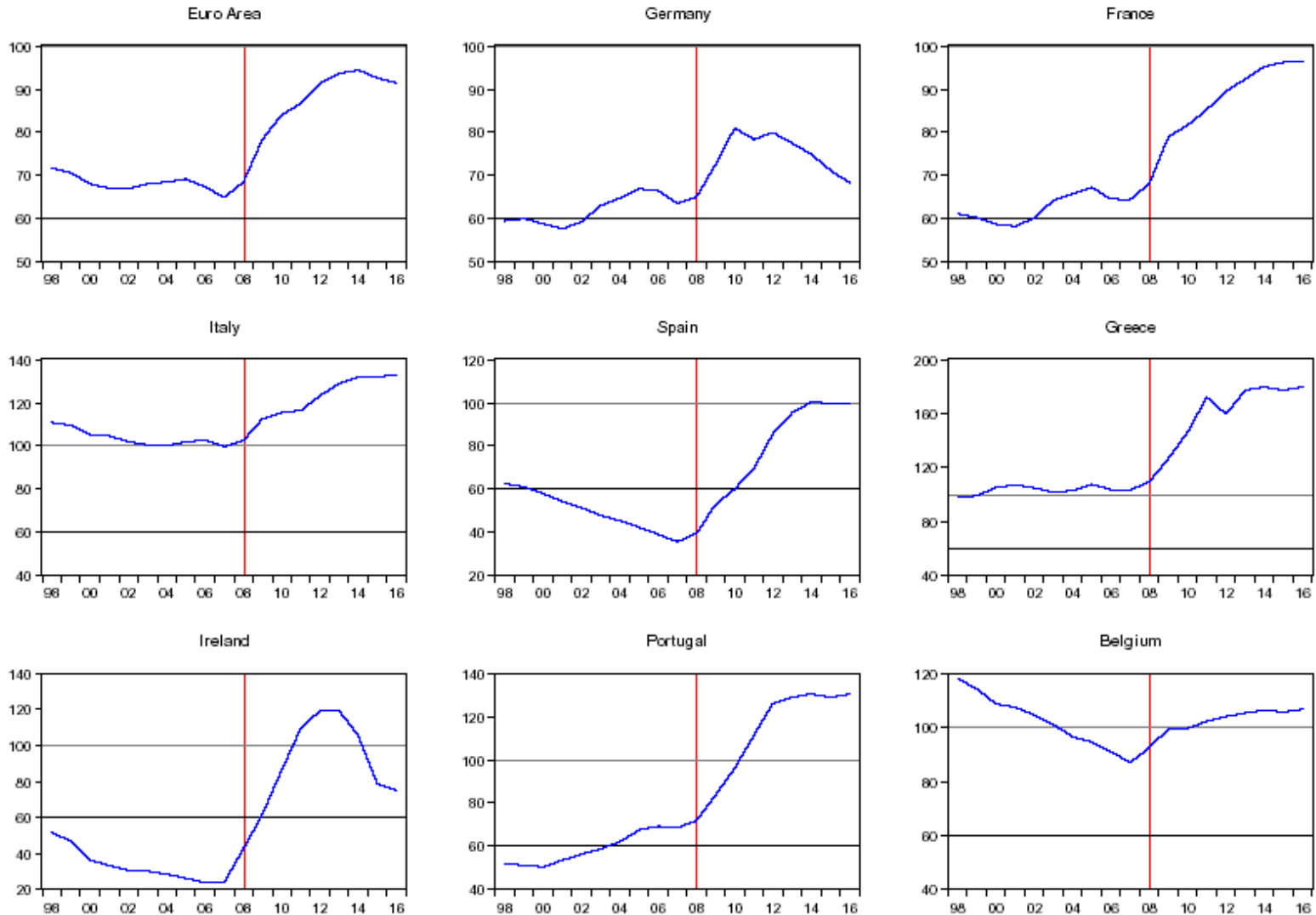
## What determines long term economic growth?

- positive contributions to the growth of economic potential
  - more open trade,
  - more R&D,
  - labour market reforms,
  - the *de jure* index of capital account opening
  - the rule of law make.
- mismatch in the labour market will reduce the economic potential.
  - if the share of unskilled workers increases in overall employment, then the growth of economic capacity will slow down.

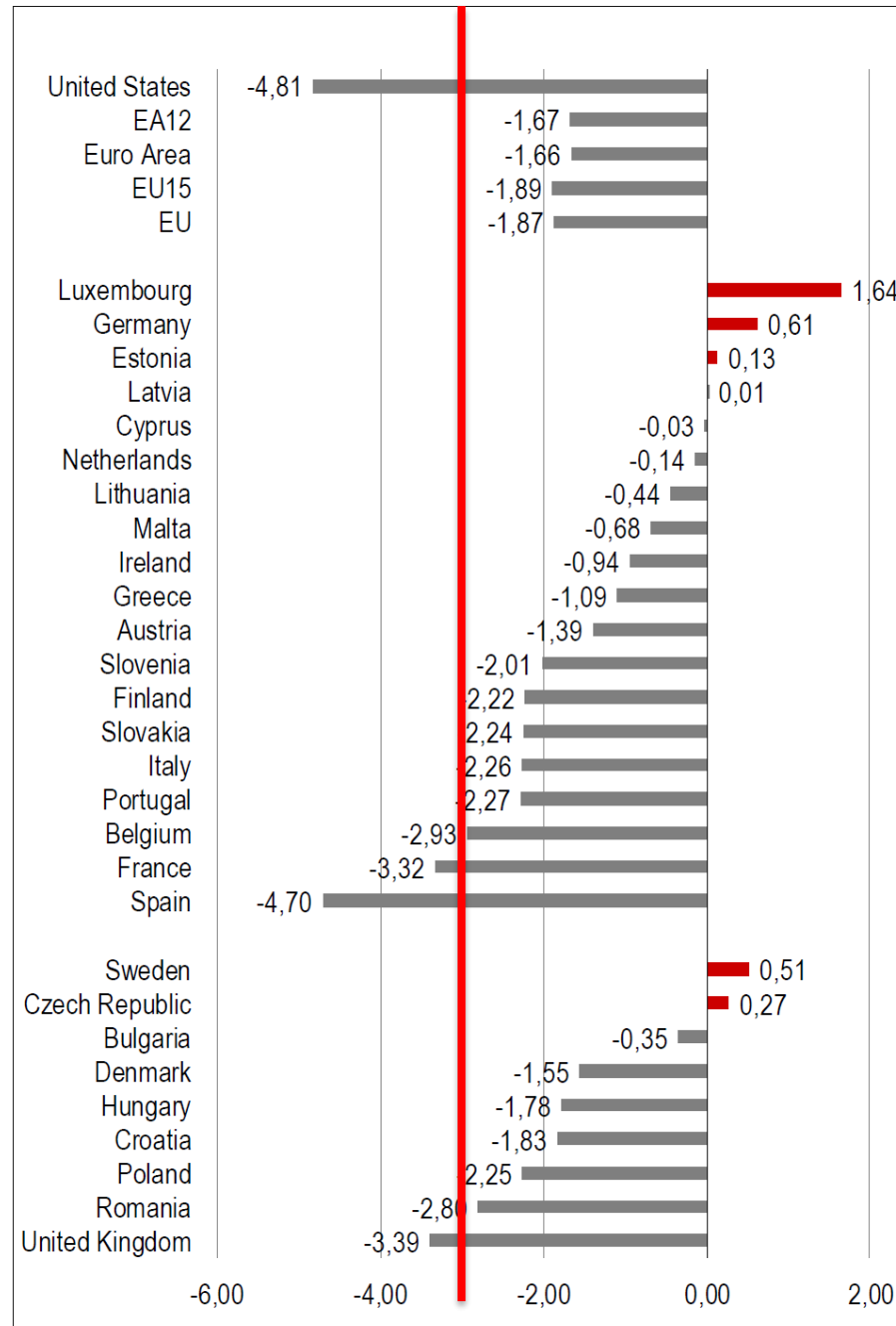


## II. Public debt

**Figure 4. Public debt in the Euro Area**



**Figure 7. Deficits 2016**



## Is Public Debt in Europe sustainable?

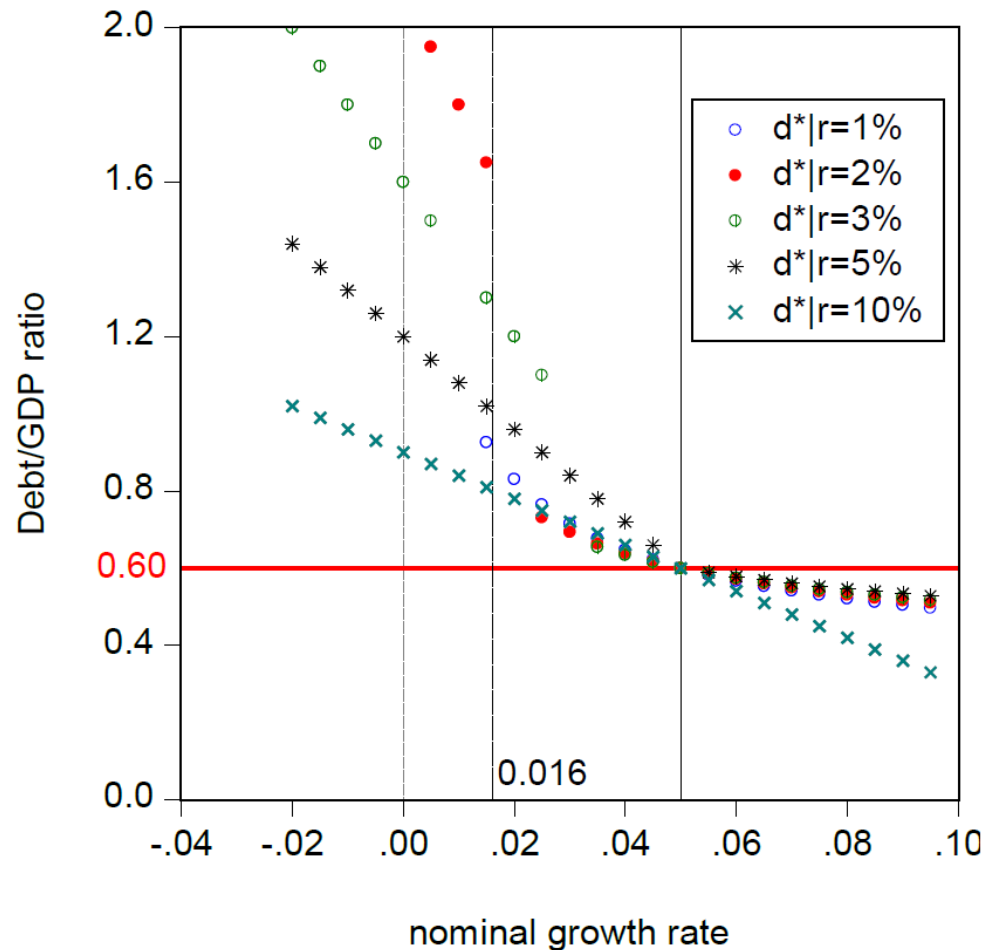
- Excessive deficit procedure is not sufficient condition
- Dynamic system of
  - Debt dynamic :  $\Delta d = (r - y)d - s$
  - fiscal rules:  $\Delta s = \alpha(\text{def} - 3\%) + \beta(d - 60\%)$
- The solution of this system yields the following definitions of the steady state (\*):

$$d^* = \frac{\alpha 3\% + \beta 60\%}{\alpha y + \beta}$$

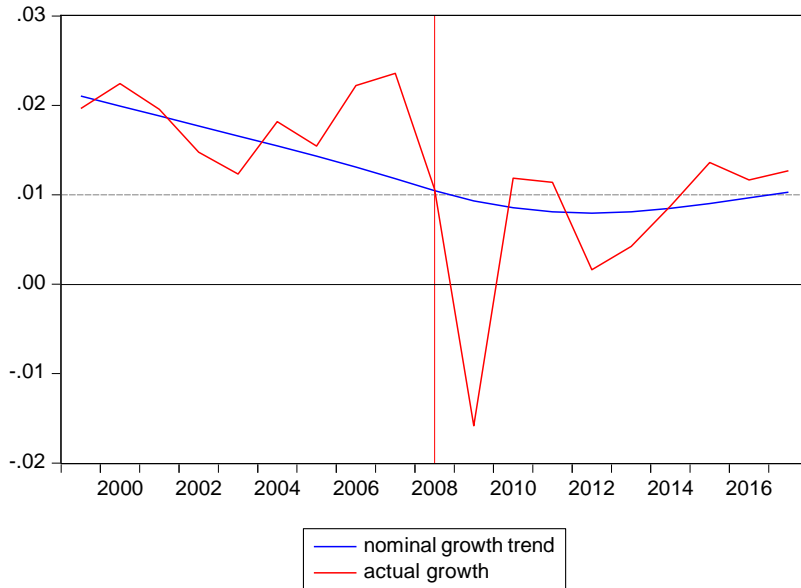
$$s^* = (r - y)d^*$$

- The **steady state** depends crucially on the growth rate
- At 5% nominal growth the steady state is 60% debt/GDP

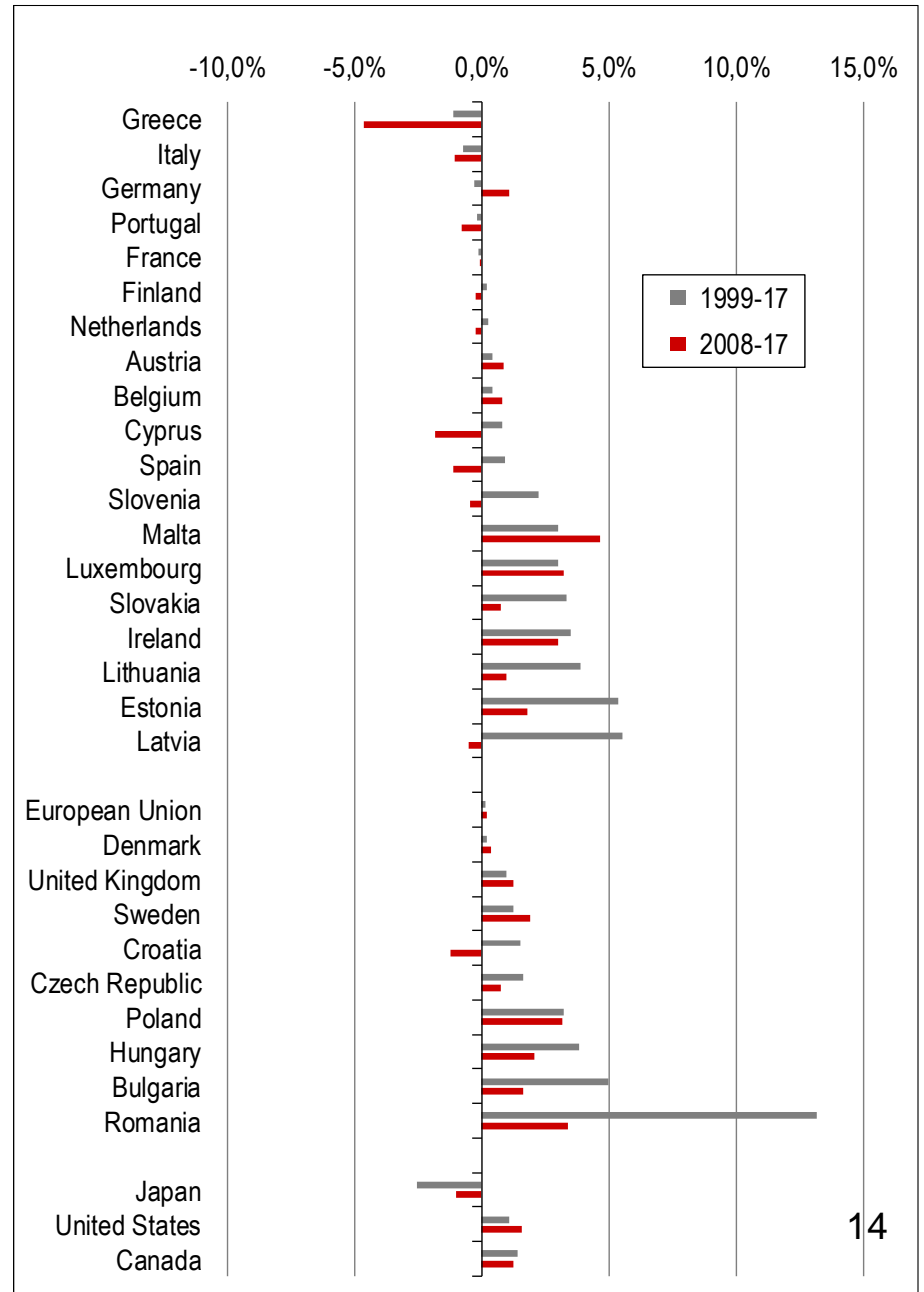
**Figure 9. Steady state debt ratio simulation**



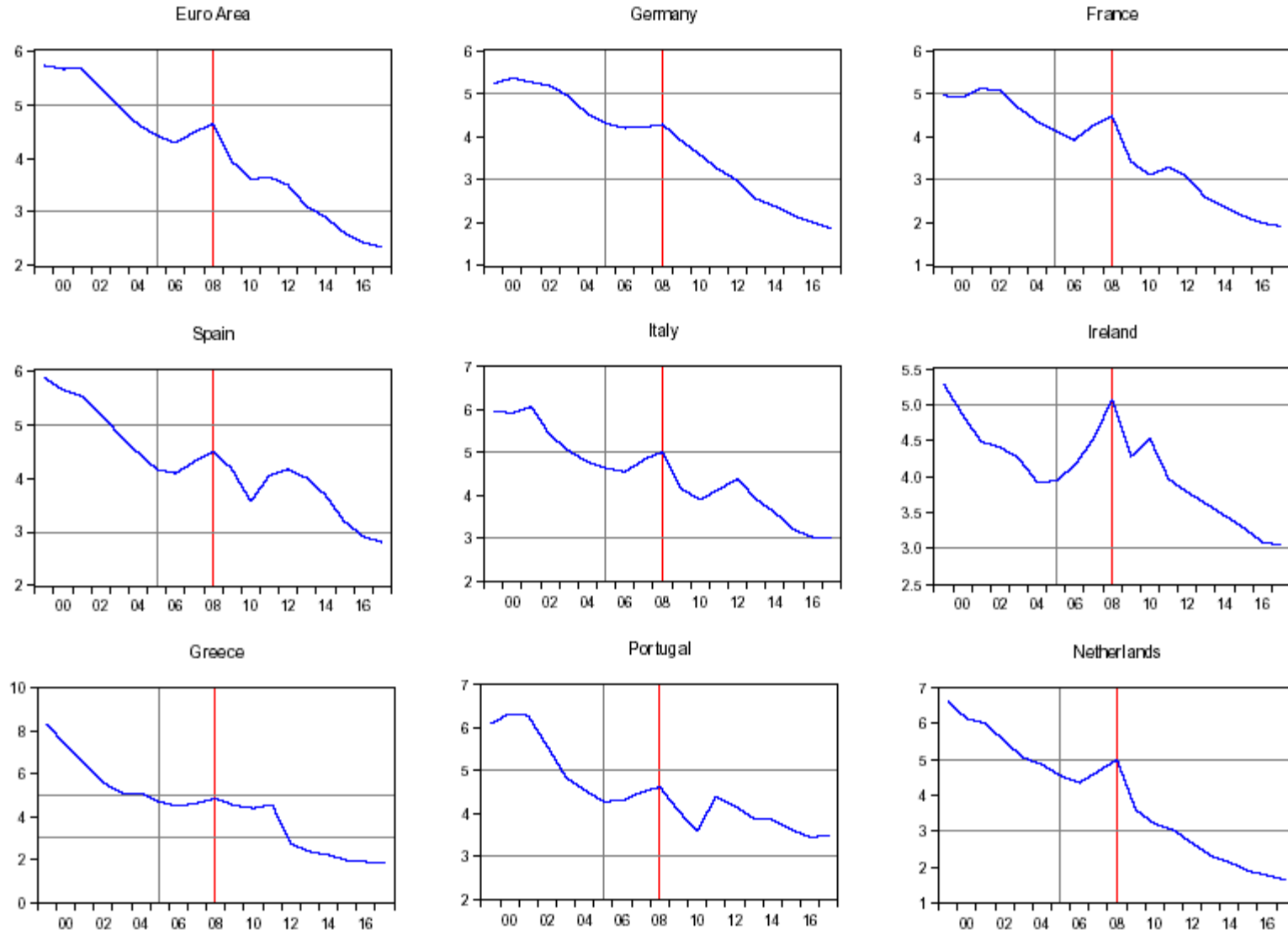
### Euro Area nominal growth



**Figure 3. Growth differential to Euro Area**



**Figure 8. Effective interest rate on public debt**



## The stability condition of public debt dynamics

- Debt sustainability depends on convergence to the steady state
  - Not explosive dynamics

$$\text{If } \alpha=0 \Rightarrow \beta_{\min} > (r - y)^2.$$

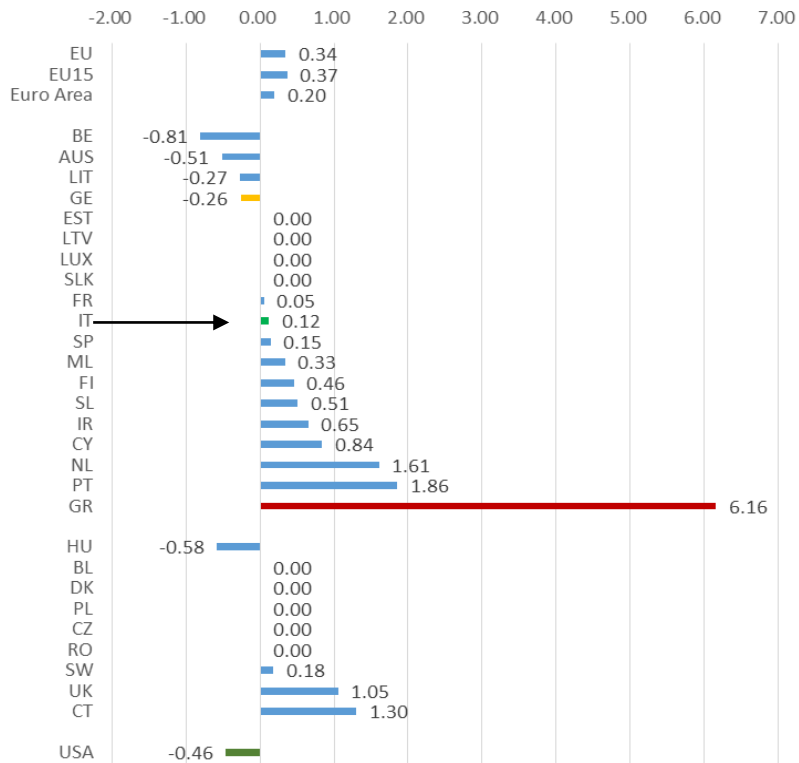
$$\text{If } \beta=0 \Rightarrow$$

$\alpha_{\min} = r - y$  is the sufficient condition if  $r > y$

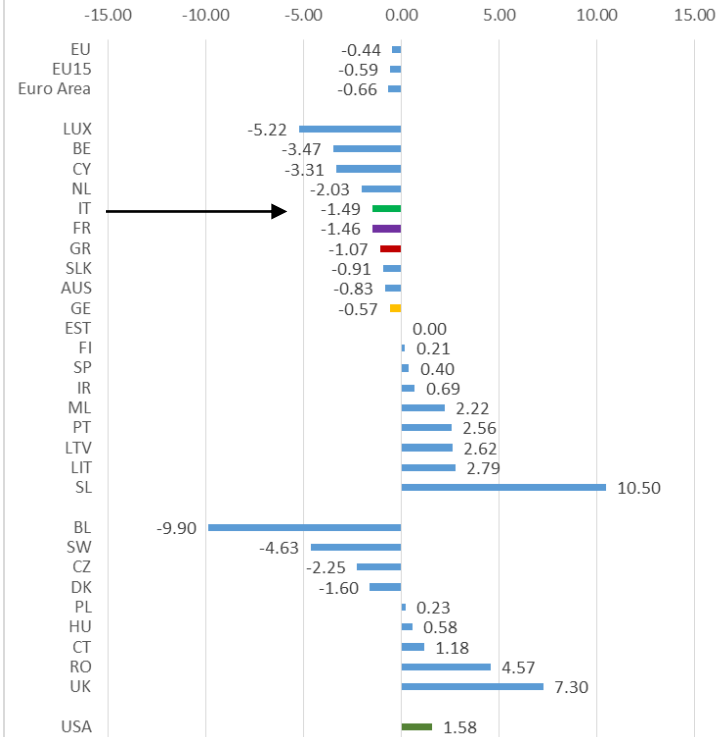
$\alpha_{\min} = \left( \sqrt{r + \pi} - \sqrt{y + \pi} \right)^2$  is the sufficient condition if  $r < y$



Sustainable debt adjustment  
2016



Cumulative sustainable debt adjustment  
2009-16

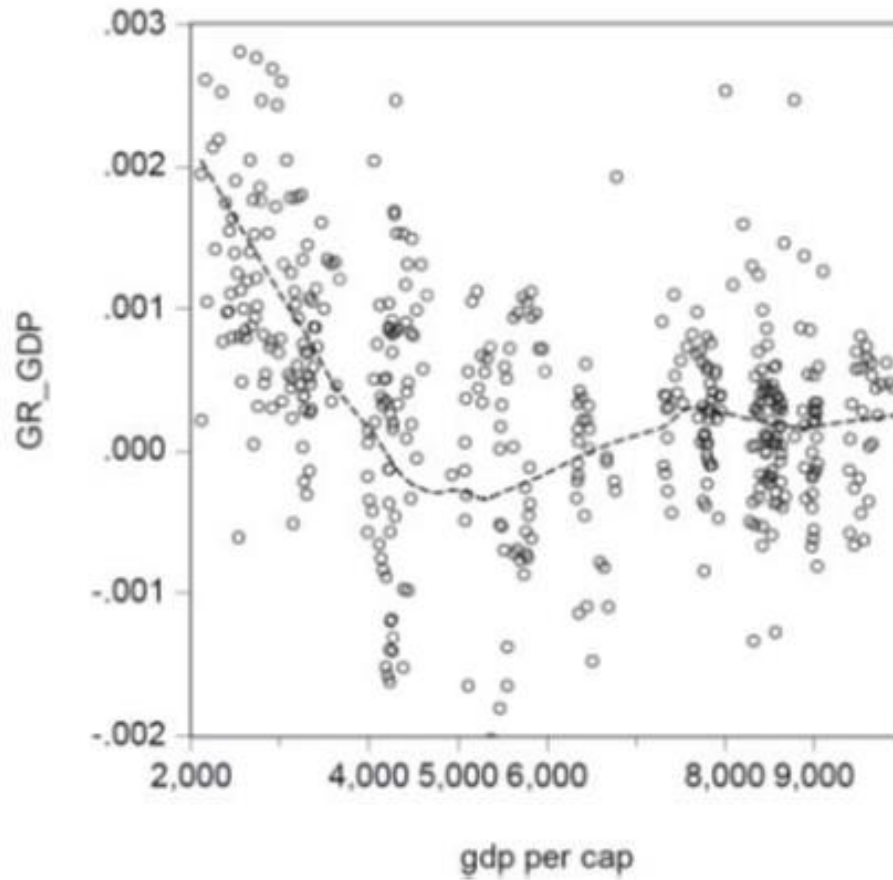


## **III. Economic convergence in the monetary Union?**

# Convergence

- Are the developments in recent years
  - pulling Europe permanently **apart** or
  - are they just **temporary** deviations from a long term tendency toward convergence?
- Beta-convergence represents the relation between the **growth** rate of output per capita of a country with the **level** of output per capita.
  - Negative coefficient means convergence
  - there are significant differences after the crisis
    - For details see Box 5.

**Figure 12. Beta convergence in Euro Area**



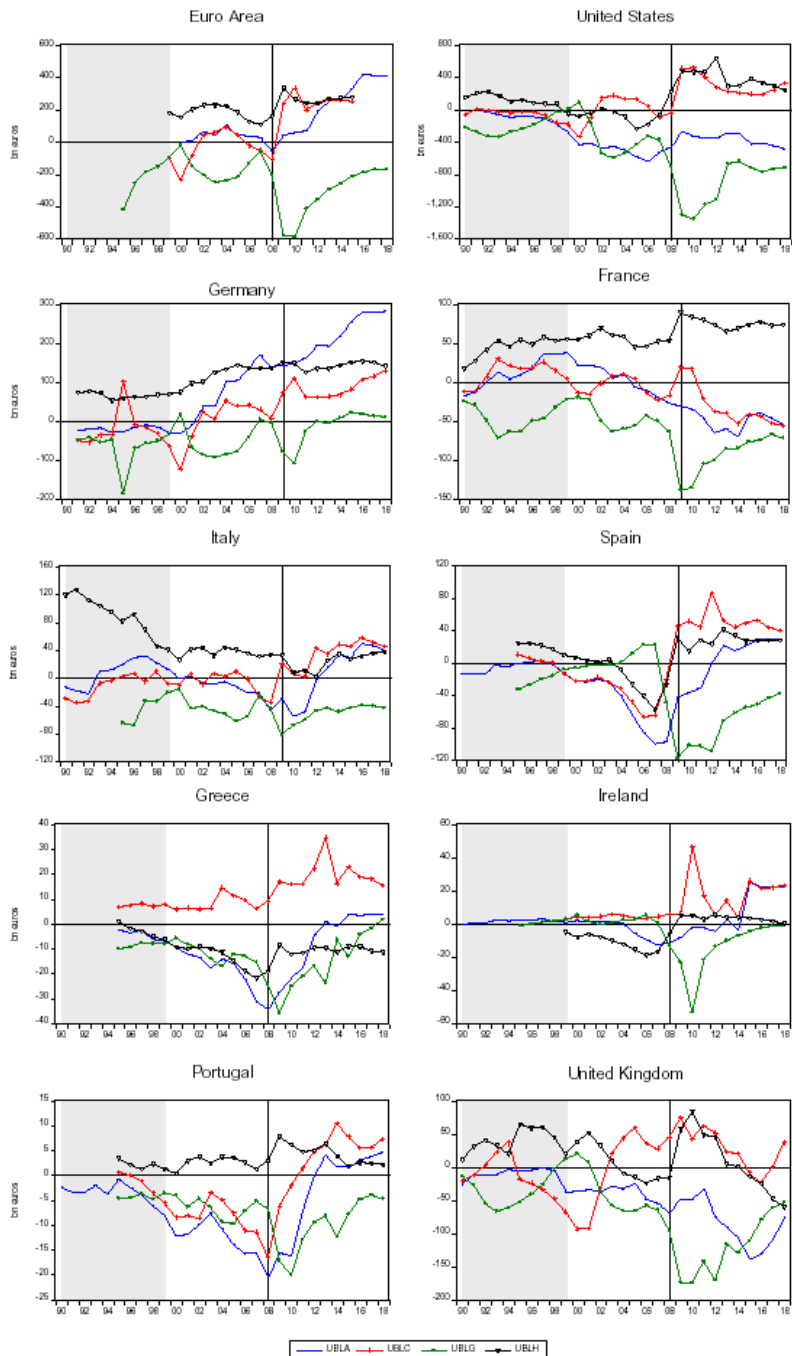
# Macroeconomic imbalances

- It has been argued that the problems encountered by some member states are due to macroeconomic imbalances
  - especially in the south,
- these countries have accumulated unsustainable “foreign” debt
  - this is holding down investment.
- Commission’s MIP
  - Focus on current account imbalances
  - A policy rule for austerity

# Flow of Funds Analysis

- Lending and borrowing from 4 sectors
  - Households
  - Corporations
  - Government
  - Rest of the world (current accounts)

**Figure 15. Flow of funds in the Euro Area**



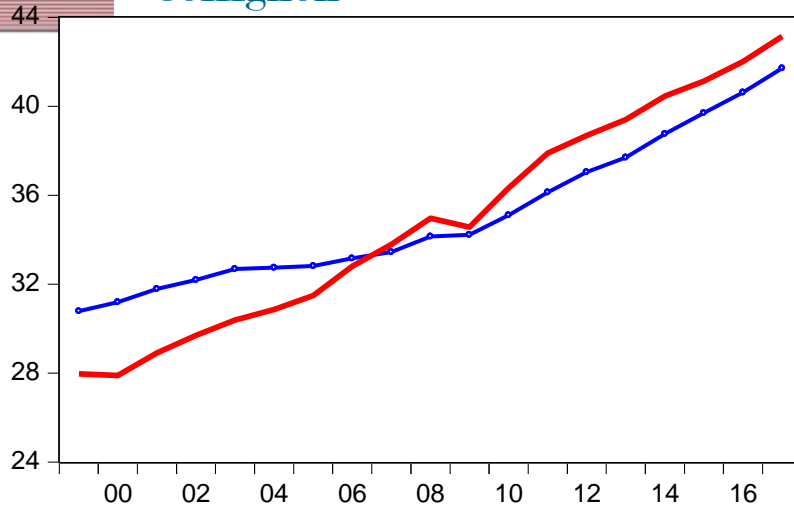
- In the **United States** **public borrowing** has been the driver of growth, while the corporate sector has used profits to deleverage debt rather than to invest
- in the **Euro Area**, (similar in **Italy**, **Spain** and **Portugal**) the **corporate sector is now saving more than households**.
- In **Greece** only corporate sector is saving (deleveraging)
- **France** is the only country that functions as in the textbook model
- The most distorted country is **Germany**. Here, all sectors are saving and lending; no sector is borrowing.
- **UK's** rapid growth is fuelled by a consumer boom. This is unsustainable.

# Competitiveness

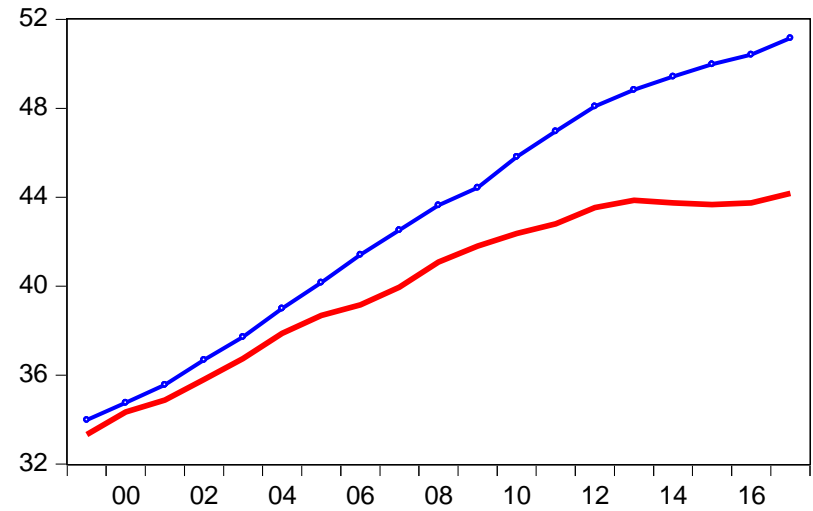
- The CER wage competitiveness index
- Deviation from equilibrium wage
- Determined by
  - the assumption of equal return to capital
  - Relative productivity



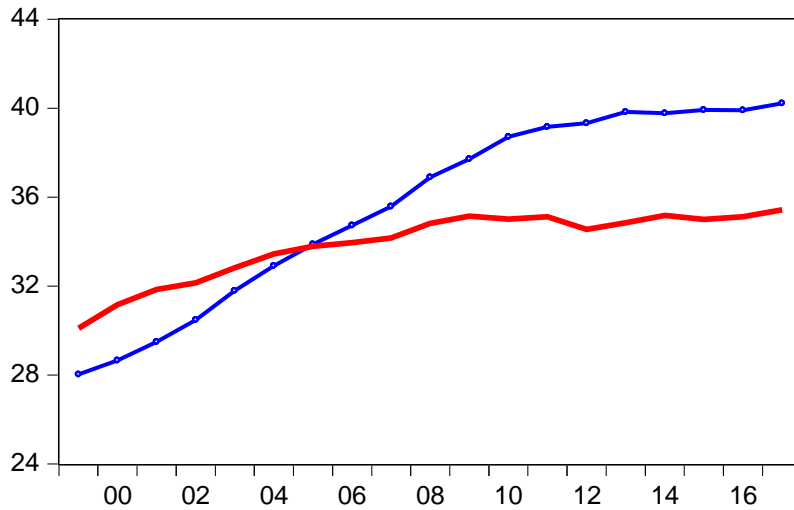
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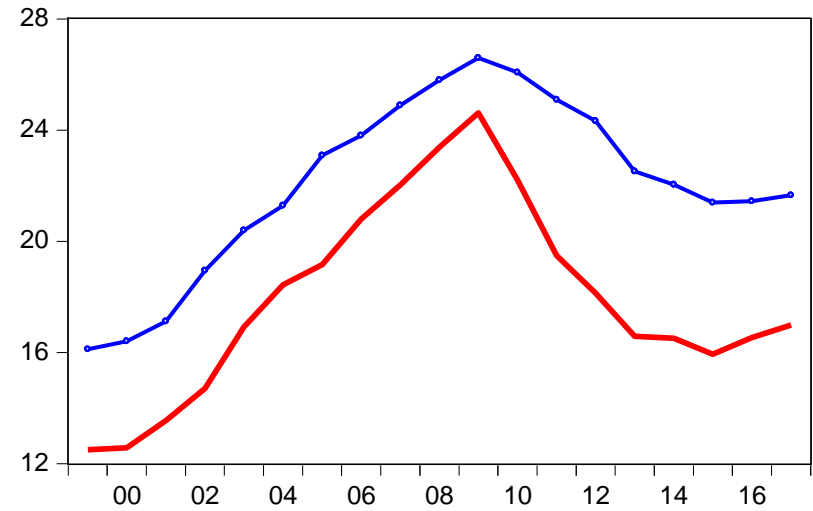
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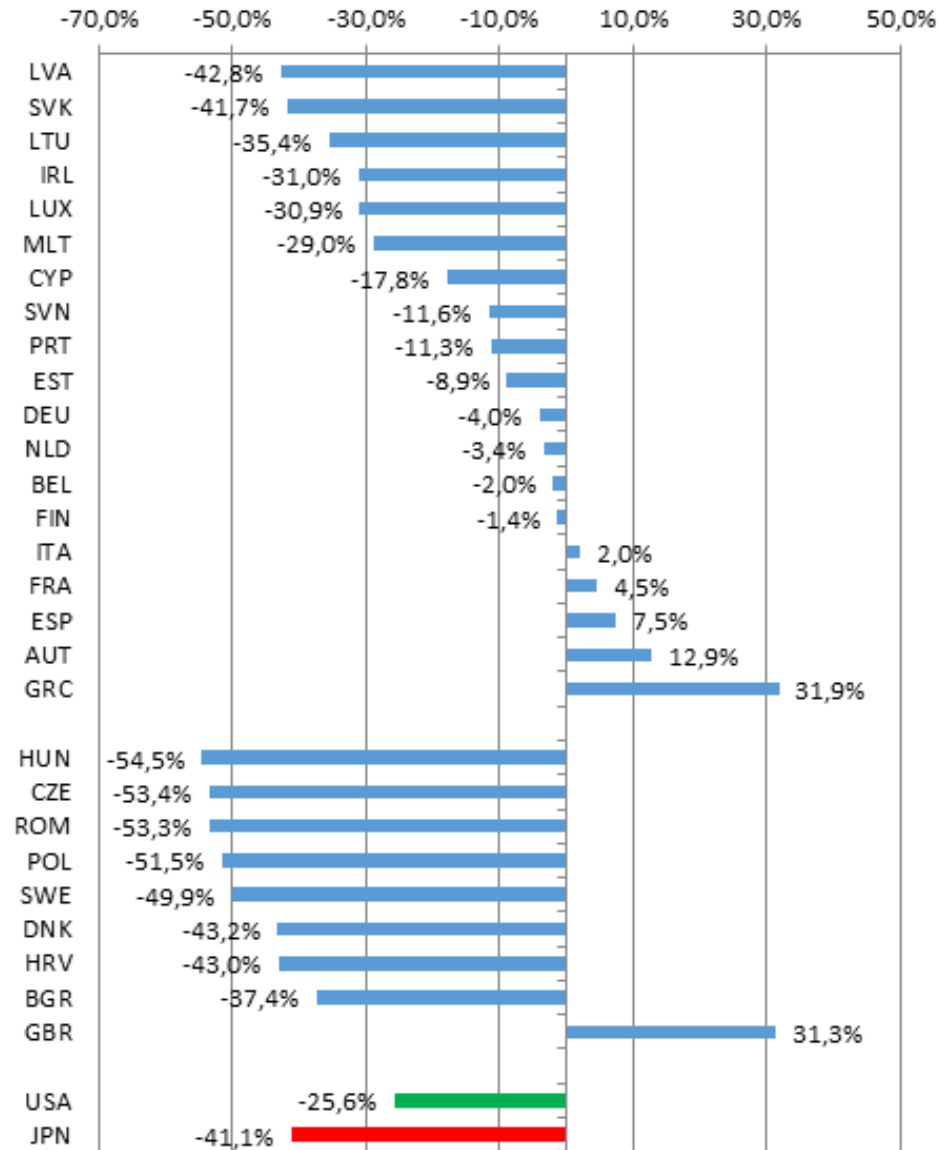


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—○— Actual wage — equilibrium wage

**Figure 25. Wage gap between actual and equilibrium wages (in % of equilibrium wage)**



## IV. EU trade and rising protectionism

- With Brexit and the election of Donald Trump the world has entered a new phase of development.
- The era of neoliberalism, which started with the election of Margaret Thatcher and Ronald Reagan has come to a close;
- Nationalism and xenophobia are progressing rapidly and populists seek to close previously open societies.

# What are the **consequences** for the European Union?

- Increases in tariff and non-tariff barriers are no longer unthinkable.
- Such new trade regimes would hurt economic growth,
  - particularly in the weakest member states of the Euro Area

- Most countries export at least 50% of their products to EU member states,
  - with peaks above 60% for small countries like Austria, Belgium, Bulgaria, Estonia and Portugal.
  - non-EU European countries include Israel, Turkey, Russia, and Former Soviet Union.

- European countries export a significant share of their product toward the East Asian market.
  - particularly important for UK (15.3%), Germany (12.4%), Cyprus and Malta.
  - In southern Europe, only Italy shows a substantial orientation toward East Asia, with a share of 9.1%.
  - Spain and Italy export a relevant share of their products to Latin America (6.2% and 3.4% respectively), while Middle East and North African (MENA) countries are mostly integrated with Cyprus, Malta and Greece

Table 3.1 - Export shares of EU countries by main region in 2015

	EA12	EA NMS	other EU	UK	USA	other Europe	East Asia	Latina America	MENA	RoW
AUT	45.8	4.5	13.5	3.1	6.5	11.3	6.1	1.6	2.7	4.9
BEL	56.0	1.0	6.4	9.0	6.1	4.3	5.3	1.8	3.7	6.5
BGR	43.9	2.9	15.1	2.6	1.7	18.3	5.7	0.5	6.8	2.6
CYP	16.6	5.5	6.9	10.4	1.2	3.5	11.5	1.3	35.1	8.0
CZE	54.4	10.1	13.1	5.4	2.4	7.1	3.2	0.9	2.3	1.3
DEU	33.2	2.0	13.7	7.5	9.8	9.9	12.4	2.7	4.1	4.7
DNK	36.3	1.5	16.9	6.5	6.1	11.6	10.9	2.2	2.9	5.1
ESP	50.5	1.1	6.2	7.5	4.7	5.6	5.7	6.2	8.6	4.0
EST	27.1	14.3	23.5	2.4	5.3	18.2	3.6	1.1	1.8	2.7
FIN	32.4	5.1	15.3	4.9	7.0	12.6	11.6	2.8	3.6	4.7
FRA	44.5	1.1	6.1	7.2	7.3	6.7	11.7	2.9	7.3	5.2
GBR	39.5	0.7	5.1		14.3	11.1	15.3	2.1	6.6	5.4
GRC	29.1	7.8	11.7	4.4	4.8	15.0	4.7	1.5	16.1	4.9
HUN	51.2	6.4	15.7	3.9	3.6	10.6	4.5	1.2	1.7	1.2
IRL	35.8	0.3	3.5	13.4	24.2	7.0	8.2	1.9	3.1	2.6
ITA	38.2	2.5	8.8	5.6	8.1	11.5	9.2	3.4	8.7	4.0
LTU	22.3	15.3	18.5	4.5	4.5	28.8	1.8	0.4	2.1	1.8
LUX	69.3	1.0	6.7	3.9	3.6	4.4	4.6	1.3	2.1	3.1
LVA	17.5	31.4	17.8	4.8	1.6	17.1	3.0	0.6	4.5	1.7
MLT	23.3	0.3	1.9	3.6	3.9	2.0	16.5	1.4	24.2	22.8
NLD	53.4	1.1	8.7	9.1	4.3	5.2	6.7	2.2	3.5	5.9
POL	50.2	5.8	15.7	6.9	2.3	10.7	3.0	1.4	2.0	2.1
PRT	60.4	0.7	4.3	6.7	5.2	2.6	3.0	2.8	4.4	10.0
ROM	50.9	2.8	14.9	4.4	1.9	12.0	3.2	1.1	7.2	1.5
SVK	46.3	1.4	31.4	5.5	2.2	7.3	2.5	0.7	1.9	0.7
SVN	50.8	2.7	13.1	2.3	2.1	23.2	1.9	0.7	2.3	1.1
SWE	37.4	2.1	11.4	7.2	7.6	14.9	9.4	2.1	3.9	4.0



# Development of global value chains

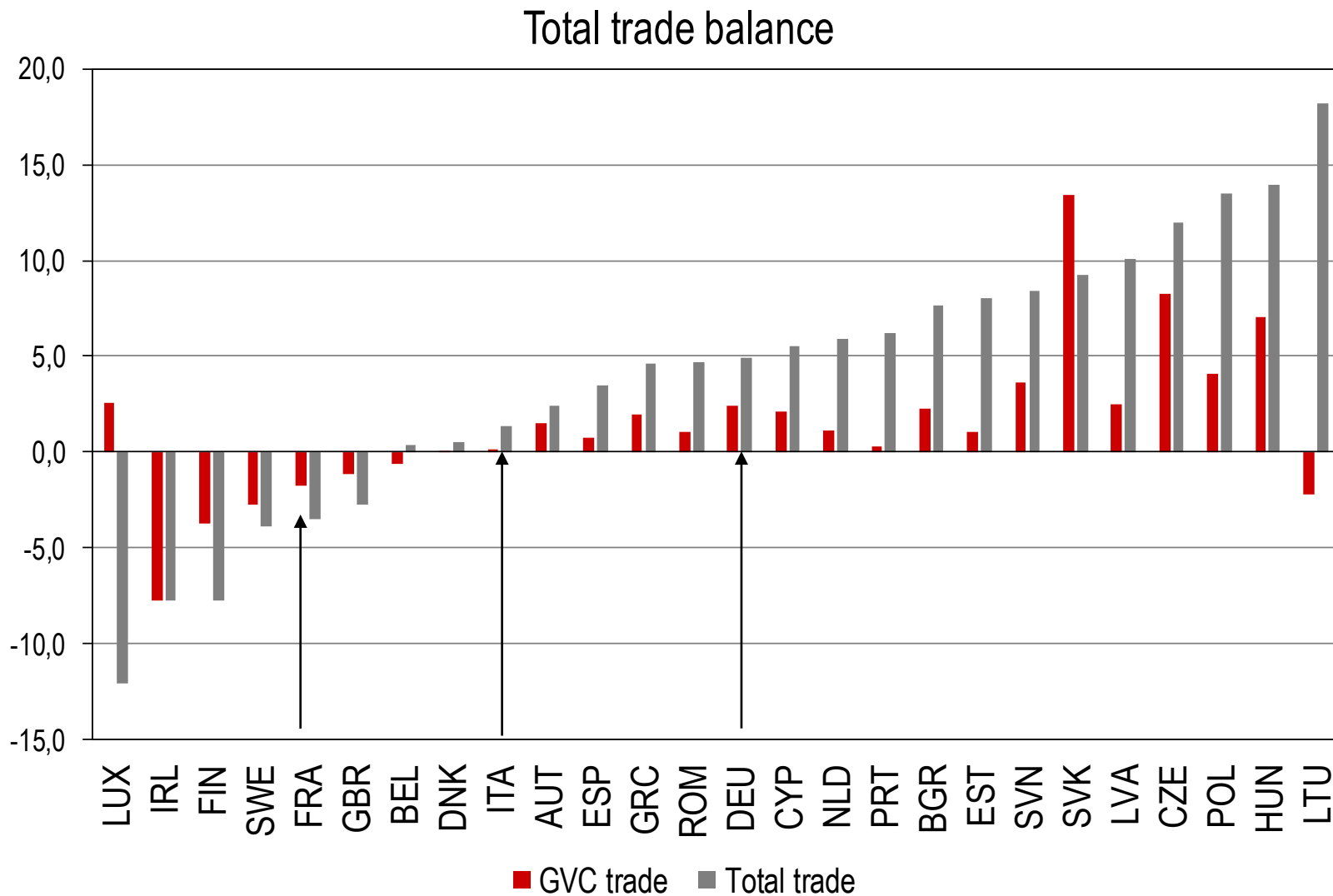
- In the last thirty years trade integration has seen the second wave of globalization.
- drivers of this process: developments in transport and communication technologies
  - reduced the cost of splitting production into different countries by exploiting differences in productions costs.
- consequence: shocks are also transmitted across countries through linkages.
  - tariff increases can have higher effects due to forward linkages across countries and products.<sup>33</sup>

- **Development of global value chains** In the last thirty years trade integration has seen the second wave of globalization.
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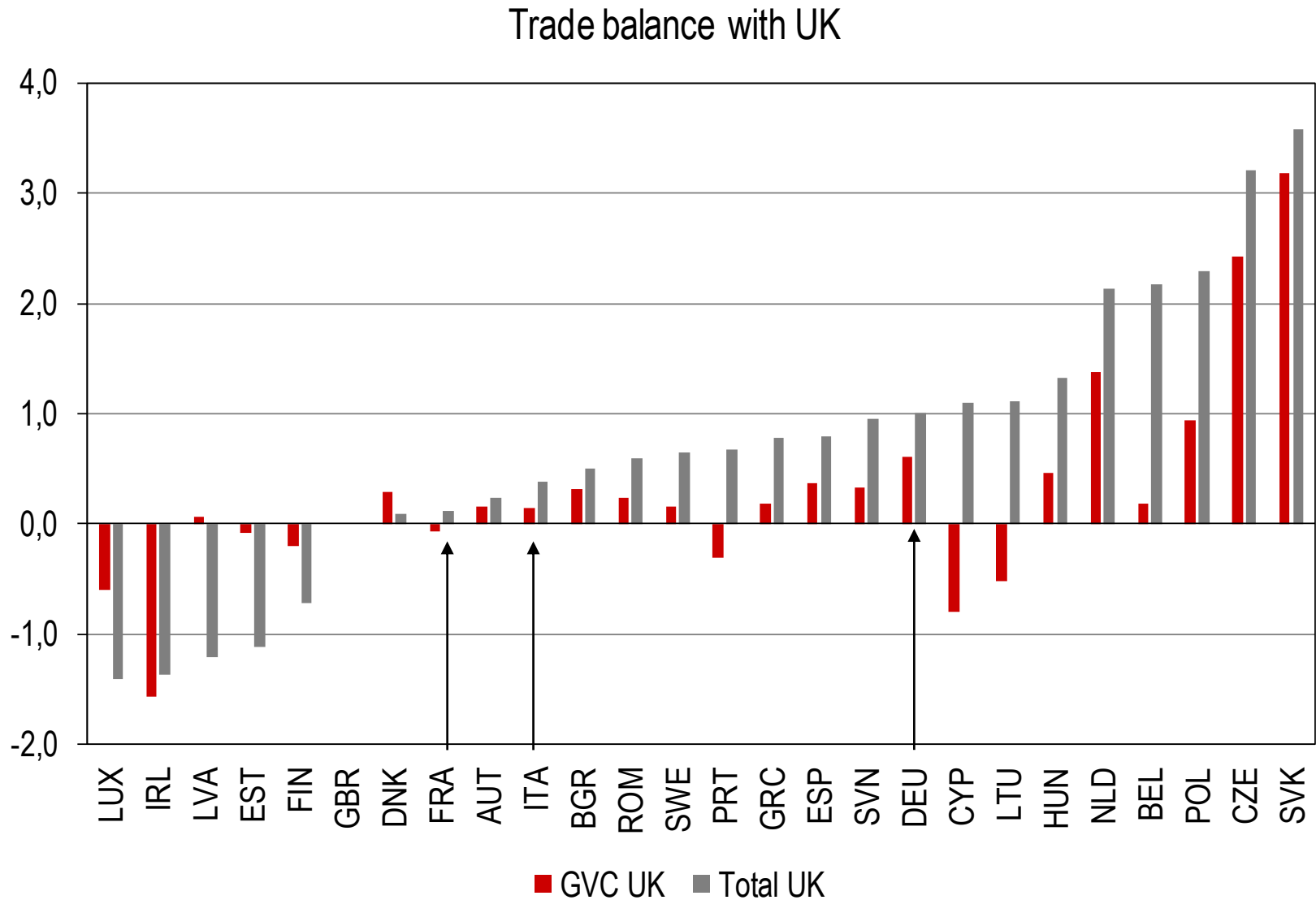
Table 3.3 - GVC export to the rest of the World,  
UK and the US

	GVC (% of GDP)			share GVC/total trade		
	Total	With US	With UK	Total	With US	With UK
AUT	9.6	1.0	0.4	24.8	38.6	33.9
BEL	17.3	0.7	2.8	19.8	12.2	37.3
DEU	12.6	1.7	1.3	31.8	42.2	46.2
ESP	6.8	0.2	0.7	29.3	20.3	41.2
FIN	3.2	0.3	0.1	12.4	14.8	6.1
FRA	4.3	0.2	0.4	21.1	13.1	26.6
GRC	1.3	0.1	0.1	9.0	7.6	9.3
IRL	5.1	1.4	0.6	11.6	12.8	9.6
ITA	5.8	0.7	0.4	23.1	31.2	28.0
LUX	3.4	0.0	0.2	17.2	4.4	20.1
NLD	14.4	0.6	1.7	22.7	20.6	29.9
PRT	8.3	0.3	0.8	29.8	15.6	42.4
CYP	1.2	0.0	0.2	13.8	51.9	38.5
EST	14.2	0.1	0.4	25.6	4.4	26.6
LTU	9.4	0.1	0.3	15.2	4.3	11.5
LVA	8.9	0.2	0.2	23.2	28.0	7.6
SVK	45.1	1.4	3.4	52.4	69.4	72.7
SVN	15.4	0.2	0.4	24.8	14.6	32.2
BGR	9.3	0.2	0.4	20.1	24.5	32.4
CZE	35.6	0.4	2.8	41.9	17.4	61.0
DNK	5.0	0.4	0.3	15.7	19.0	16.6
GBR	3.6	0.5		21.9	22.3	
HUN	35.3	1.8	1.5	42.9	56.0	49.1
POL	11.2	0.2	0.9	27.4	12.8	32.7
ROM	12.2	0.1	0.8	35.7	18.8	58.8
SWE	7.1	0.7	0.4	25.0	32.1	18.2

**Figure 26. Change in total trade balance between 1999 and 2015 in % of GDP**

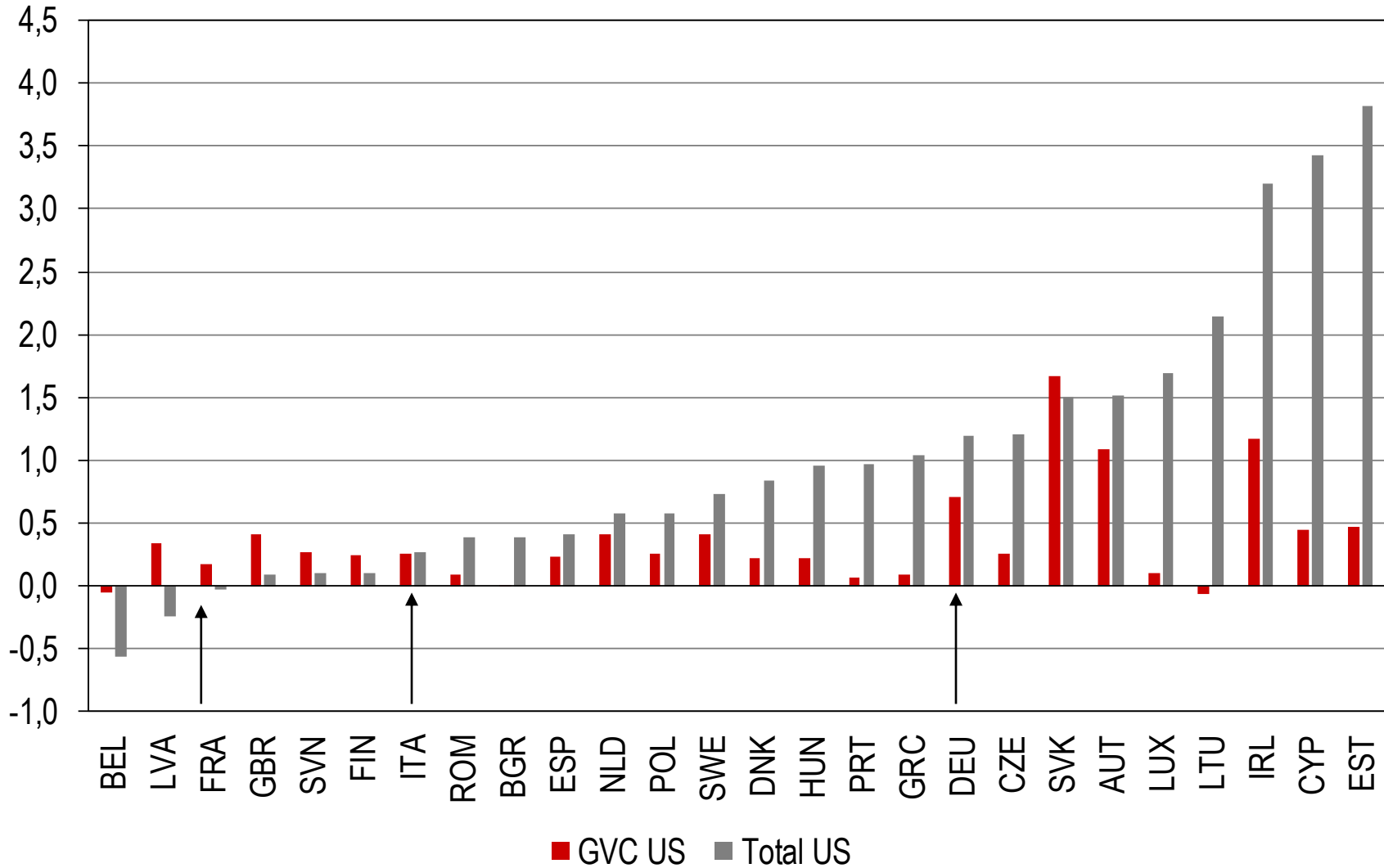


**Figure 26. Change in total trade balance between 1999 and 2015 in % of GDP**



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Trade balance with US



- **Tariffs**
- Tariff rates in the US market are quite uniform among countries since most of the rates are set multilaterally under the WTO rules.
- However, relevant cross sector differences exist.
  - most protected sectors are agriculture, food industry, textiles, wearing and apparel and leather, with tariff rates up to 14.4%

- Italian average tariff levels are higher than in the other countries in Textiles, Coke and Petroleum products and other non-metallic mineral products.
- the average tariff rate in 2015 is 3.5% for Italy, while it is around 2.8% for the other countries.
- This implicit protectionism may be a reason for the lack of competitiveness witnessed above and the stagnating productivity in Italy.



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**Table 6. Tariff rates in the US by exporting country and sectors; sectoral shares and specialization index**

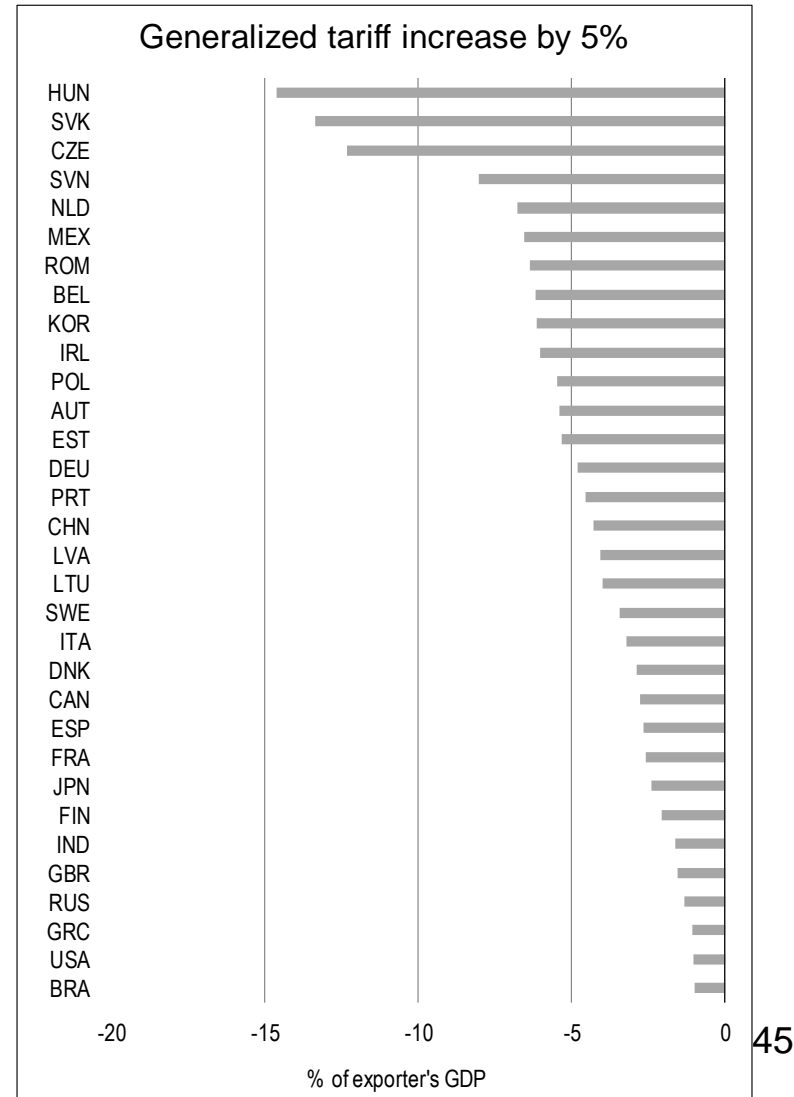
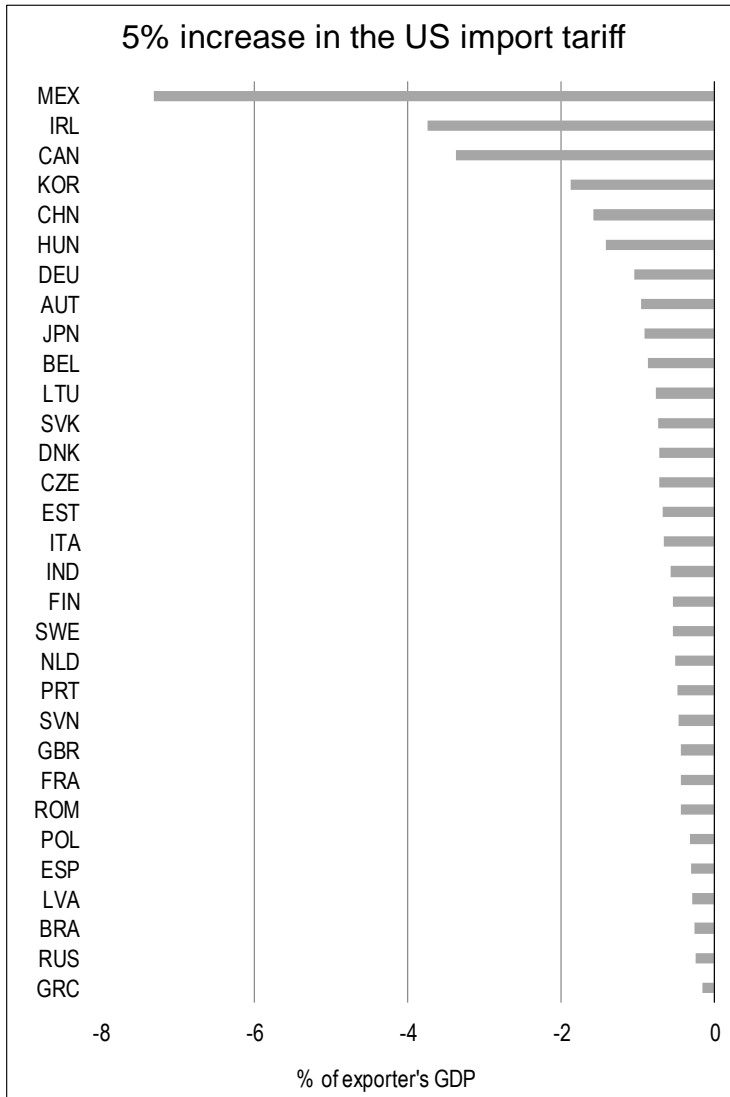
	Weighted average tariff rate				Share in export to US				US specialization			
	Italy	Germany	France	UK	Italy	Germany	France	UK	Italy	Germany	France	UK
01 - Agriculture, hunting and related service activities	3,8	12,9	14,4	3,0	0,3	0,2	0,4	0,1	0,2	0,2	0,1	0,1
02 - Forestry, logging and related service activities	0,2	0,2	0,4	0,8	0,1	0,0	0,1	0,0	0,9	0,3	0,8	0,4
14 - Other mining and quarrying	0,2	0,1	0,1	0,1	0,1	0,0	0,0	0,0	0,4	0,2	0,3	0,2
15 - Manufacture of food products and beverages	5,2	4,0	1,6	1,1	10,6	1,4	10,9	4,2	1,4	0,3	1,1	0,7
17 - Manufacture of textiles	8,6	4,4	5,5	5,8	2,4	0,4	0,7	0,7	0,7	0,3	0,5	0,5
18 - Manufacture of wearing apparel; dressing and dyeing of fur	9,9	8,7	8,2	9,1	4,6	0,1	1,7	0,7	1,2	0,1	0,9	0,4
19 - Tanning and dressing of leather; leather products	7,0	8,7	7,6	5,9	5,7	0,2	2,9	0,3	1,2	0,3	1,4	0,3
20 - Manufacture of wood and wood products, except furniture;	2,0	1,1	1,2	2,3	0,4	0,2	0,6	0,0	1,0	0,3	1,3	0,3
21 - Manufacture of paper and paper products	0,0	0,0	0,0	0,0	0,5	0,6	0,6	0,4	0,3	0,4	0,4	0,5
22 - Publishing, printing and reproduction of recorded media	0,1	0,1	0,0	0,0	0,3	0,2	0,3	0,9	0,8	0,4	0,5	0,7
23 - Manufacture of coke, refined petroleum products and nuclear fuel	5,3	3,1	5,5	2,2	1,1	0,2	2,3	4,3	0,3	0,2	1,1	1,4
24 - Manufacture of chemicals and chemical products	1,1	1,2	1,1	2,2	9,4	17,0	17,2	32,0	0,8	1,1	1,0	1,8
25 - Manufacture of rubber and plastics products	3,6	3,8	3,4	3,8	1,9	2,2	2,2	1,6	0,5	0,6	0,7	0,7
26 - Manufacture of other non-metallic mineral products	6,1	2,9	3,2	3,2	4,3	0,8	1,3	0,5	1,7	0,7	1,1	0,7
27 - Manufacture of basic metals	0,8	1,3	1,4	1,1	3,4	2,9	3,4	2,7	0,6	0,7	0,8	0,2
28 - Manufacture of fabricated metal products;	2,0	2,6	2,1	2,4	2,9	2,3	1,6	1,1	0,7	0,7	0,8	0,6
29 - Manufacture of machinery and equipment n.e.c,	1,2	1,3	1,1	0,8	22,5	15,4	9,8	9,6	1,1	1,1	1,1	1,1
30 - Manufacture of office, accounting and computing machinery	0,2	0,1	0,0	0,1	0,5	0,7	0,7	1,2	0,9	0,4	0,9	0,8
31 - Manufacture of electrical machinery and apparatus n.e.c,	2,1	2,1	2,2	2,0	2,7	5,3	3,4	2,9	0,6	0,9	0,8	0,8
32 - Manufacture of radio, TV and communication equipment	0,8	0,7	0,9	1,4	1,4	2,0	1,8	1,9	1,0	0,6	0,5	0,7
33 - Manufacture of medical, precision and optical instruments	1,5	0,9	0,8	1,1	4,8	8,0	5,2	6,1	1,6	1,5	1,3	1,3
34 - Manufacture of motor vehicles, trailers and semi-trailers	2,2	2,2	1,7	2,2	8,3	31,6	2,2	13,8	1,0	1,5	0,2	1,1
35 - Manufacture of other transport equipment	0,6	0,1	0,0	0,1	6,8	7,2	28,2	11,5	2,7	1,4	2,0	1,3
36 - Manufacture of furniture; manufacturing n.e.c,	2,5	0,9	3,5	0,6	5,1	0,9	2,4	2,9	1,1	0,5	0,9	0,9

- We calculate **trade elasticities** in a gravity model and then simulate the impact of a 5% increase of tariffs on the local economy.
  - Trump threatened to apply 5% increase
  - Strong effect for Mexico, Ireland, Canada, Korea and China.
  - European countries lie in the middle range,
    - but stronger losses are expected for Germany and Austria (around 1%), while for Italy and France the impact is lower at 0.7% and 0.5% respectively.

# The end of free trade: a general increase of tariffs everywhere

- higher losses for some Central and Eastern European countries like Hungary (-14%), Slovakia (13%), Czech Republic (-12%) and Slovenia (-8%).
  - This is due to their high trade opening and their specialization in sectors with higher shares of GVC related trade.
- Netherland, Belgium, Ireland, Austria, and Germany would experience losses around 5%-6% of GDP.
- In Italy (below 4% ) and France (2.5%)
- Portugal (4.5%) and Spain (2.5%), and lower for Greece (1.2%).

**Figure 27. Effect of a 5% increase in the US (left panel) and World (right panel) import tariff rate on the exporter's GDP**



## To sum up:

- the rise in tariff barriers would cause a substantial **slow-down in World GDP** and this effect is reinforced by the participation into GVCs.
- the German and Dutch **surpluses** would fall more than in the rest of the Euro Area
  - reducing their external position and contributing to the reduction of global imbalances.
- This result would come at the expense of a strong loss in GDP
  - **comparable to** the recession experienced during the 2008-2009 **global financial crisis**.

## Conclusion

- The Euro Area has gone through a long and painful crisis, but the end is near.
- The most important challenge is now to restore balanced economic growth.
- The macroeconomic policy mix has improved
  - Fiscal policy is constrained by the high debt ratios, inherited from pre-crisis boom years.
  - Especially in Italy policy mistakes from the past are a heavy burden for the future.<sup>47</sup>

- The international environment signals a profound **regime change**
- **Brexit** has only a marginal effect on the European economy, a generalized **trade war** between the EU and the United States would become as devastating
- if Europe wants to avoid becoming the victim of other powers, Europe has to strengthen its capacity to act as a unified actor in the world rather than remain the **circus of flees** that it is today.