

The Next Stage

Europe is largely on track. Most of the 28 member countries of the European Union continue to adjust to the challenges posed by globalisation and the aftermath of the financial crisis.

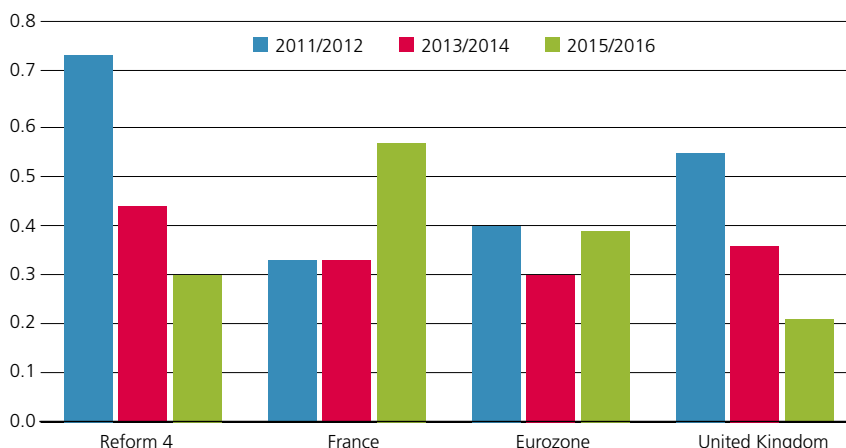
Most of the countries that were at the centre of the euro confidence crisis in 2010-2012 have progressed so far that they have started to enjoy the rewards of their efforts. Even **Greece**, having lost almost two years to a futile confrontation with creditors in 2015, is stabilising.

Europe has entered a new stage: One of the four criteria which we track in *The Euro Plus Monitor* to measure adjustment progress, the pace of pro-growth structural reforms, highlights the key changes most clearly (see Chart 1):

- Following their rapid adjustment under the pressure of immediate crisis, the **eurozone reform countries** are relaxing their efforts. Much of the hard work is done.
- **France**, Europe's most important reform laggard, is starting to improve.
- For the **United Kingdom**, a growing reluctance to pursue economic reforms adds to Brexit risks.

Chart 1. Pace of Pro-Growth Reforms

Responsiveness to OECD reform recommendations during various two-year periods



Reform 4 countries are Spain, Ireland, Greece and Portugal. Scale of 0 (no progress) to 1 (excellent pace of reforms). Source: OECD

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The Euro Plus Monitor is a joint research project between Berenberg, one of the leading privately owned banks in Europe, and the Lisbon Council, a Brussels-based think tank. First published in 2011, The Euro Plus Monitor has become a premier competitiveness ranking of the 28 member countries of the European Union.

The views expressed in The Euro Plus Monitor are those of the authors alone and do not necessarily represent the views of Berenberg, the Lisbon Council or any of their associates.



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'The indicator tracks progress on the four most important measures of adjustment.'

Adjustment Progress Indicator

Since 2011, Berenberg and the Lisbon Council have measured the fundamental economic health and recent adjustment progress of the member countries of the European Union. We published the last results, **The 2016 Euro Plus Monitor**, on 14 December 2016.¹ In **The Euro Plus Monitor September 2017 Update**, we recalculate the Adjustment Progress Indicator based on final data for the full year 2016 and on export and import data for the first half of 2017.²

The **Adjustment Progress Indicator** tracks the progress countries have made on the four most important measures of short- to medium-term adjustment: 1) the rise (or fall) in exports relative to imports in the external accounts; 2) the

size and quality of any change in the fiscal deficit, adjusted for interest payments as well as cyclical and one-off factors; 3) changes in unit labour costs relative to the eurozone average, and 4) structural reforms.

The first three adjustment criteria measure changes that are almost immediately visible in hard economic data: fiscal tightening affects economic statistics almost instantaneously because it represses domestic demand and steers resources towards export-oriented activities. But the structural reforms measured in criterion no. 4 often work with a long time lag. While they may not show up in hard economic data for a while, they are a crucial element of the repair process.

Table 1. Adjustment Progress Indicator

Rank		Country	Total score			External adjustment			Fiscal adjustment			Labour cost adj.			Reform drive		
2016	2015		2016	Change	2015	2016	Change	2015	2016	Change	2015	2016	Change	2015	2016	Change	2015
1	1	Greece	7.6	-0.1	7.7	7.3	-0.1	7.4	7.7	0.2	7.5	7.5	-0.7	8.2	7.7	0.0	7.7
2	2	Ireland	6.9	-0.1	7.0	6.5	-0.3	6.8	5.9	-0.3	6.3	9.1	0.0	9.1	6.1	0.1	6.0
3	3	Latvia	6.3	-0.5	6.8	9.3	-0.1	9.5	5.8	0.1	5.7	3.8	-1.4	5.2	n.a.	n.a.	n.a.
4	5	Spain	6.0	-0.1	6.1	7.3	0.1	7.2	5.5	-0.1	5.6	5.6	0.2	5.4	5.6	-0.9	6.5
5	4	Romania	5.9	-0.3	6.3	6.9	-0.3	7.2	5.9	-0.2	6.1	5.0	-0.5	5.5	n.a.	n.a.	n.a.
6	7	Portugal	5.6	-0.1	5.6	6.3	0.2	6.1	4.9	0.5	4.4	5.6	-0.2	5.8	5.4	-0.8	6.3
7	6	Lithuania	5.4	-0.6	6.1	7.0	-0.6	7.6	6.8	0.2	6.6	2.5	-1.5	4.0	n.a.	n.a.	n.a.
8	9	Estonia	5.3	-0.1	5.4	7.1	-0.3	7.4	3.7	0.0	3.7	4.3	-0.7	4.9	6.1	0.5	5.6
9	8	Cyprus	5.1	-0.4	5.5	2.8	-0.9	3.7	5.3	-0.3	5.6	7.1	0.0	7.1	n.a.	n.a.	n.a.
10	14	Malta	5.0	0.6	4.4	6.8	0.1	6.7	4.6	1.7	3.0	3.6	0.0	3.6	n.a.	n.a.	n.a.
11	10	Slovenia	4.9	-0.2	5.1	7.4	0.4	7.1	5.9	0.5	5.4	4.0	-0.5	4.4	2.3	-1.1	3.4
12	11	Slovakia	4.8	0.2	4.6	7.1	0.0	7.1	5.6	1.2	4.3	2.2	-0.4	2.6	4.3	0.1	4.3
13	12	Croatia	4.8	0.2	4.6	6.2	0.1	6.0	2.9	0.1	2.8	5.2	0.4	4.9	n.a.	n.a.	n.a.
14	20	Bulgaria	4.4	0.6	3.8	7.9	-0.2	8.1	5.0	2.1	2.9	0.3	0.0	0.3	n.a.	n.a.	n.a.
15	16	Czech Republic	4.3	0.0	4.3	6.3	0.4	5.9	5.3	0.9	4.4	1.4	-0.9	2.2	4.1	-0.6	4.6
16	13	Hungary	4.1	-0.5	4.5	6.7	-0.3	7.0	3.7	0.6	3.1	2.4	-1.3	3.7	3.4	-0.9	4.2
17	15	Poland	4.1	-0.3	4.4	5.2	-0.2	5.4	5.7	0.1	5.6	0.8	-0.4	1.2	4.5	-0.8	5.3
18	21	Netherlands	3.9	0.4	3.6	5.5	0.3	5.2	4.3	0.8	3.5	2.3	-0.1	2.4	3.6	0.5	3.1
19	18	United Kingdom	3.9	0.1	3.8	2.6	0.2	2.4	6.5	0.5	5.9	2.4	-0.4	2.9	4.2	0.1	4.1
20	17	Italy	3.8	-0.3	4.1	4.0	0.1	3.9	3.6	-0.5	4.1	3.4	-0.1	3.5	4.3	-0.6	4.8
21	19	Luxembourg	3.7	0.0	3.8	4.3	-0.1	4.4	3.5	-0.3	3.8	5.6	0.2	5.5	1.6	0.2	1.4
		Euro 19	3.7	0.1	3.6	4.3	0.2	4.1	3.8	0.0	3.8	2.5	-0.1	2.6	4.2	0.3	3.9
22	22	Denmark	3.3	-0.1	3.4	3.9	0.3	3.6	2.7	0.5	2.1	3.3	-0.6	4.0	3.3	-0.7	4.0
23	24	Belgium	3.3	0.4	2.9	4.6	0.2	4.4	2.4	0.1	2.3	2.5	0.4	2.1	3.5	0.9	2.6
24	23	Austria	3.0	0.1	2.9	3.2	0.0	3.2	2.7	-0.6	3.3	0.9	-0.1	1.0	5.2	0.9	4.3
25	25	France	3.0	0.2	2.8	2.2	-0.2	2.3	3.3	0.2	3.2	1.6	0.0	1.6	4.8	0.8	4.0
26	26	Germany	2.5	0.0	2.4	3.4	0.0	3.4	2.7	-0.4	3.1	0.5	-0.3	0.8	3.2	0.8	2.4
27	27	Finland	2.4	0.1	2.2	1.3	0.5	0.9	1.7	-0.1	1.7	2.6	0.2	2.5	3.8	-0.1	3.9
28	28	Sweden	2.1	-0.1	2.2	2.3	0.1	2.3	2.1	-0.1	2.2	1.2	0.1	1.1	2.8	-0.3	3.2

Scores: For the scores, we rank all sub-indicators on a linear scale of 10 (best) to 0 (worst). Having calculated the results of the sub-indicators, we aggregate them into an overall score for each country.

Change: This refers to the change in score relative to last year. Note that our scores and ranks for 2015 can differ slightly for some countries from those published in *The 2016 Euro Plus Monitor* due to subsequent revisions of back data and the inclusion of our new indicator of the quality of fiscal changes as part of the fiscal adjustment analysis.

Ranks: Based on the scores, we calculate the relative ranking of each country, with the No. 1 rank to the country with the highest and the No. 28 rank to the one with the lowest score.

1 See Holger Schmieding and Florian Hense, *The 2016 Euro Plus Monitor: Coping with the Backlash*, (London/Brussels: Berenberg and the Lisbon Council, 2016).

2 To make sure that the comparison of the current results with those of our previous analyses are not distorted by revisions of back data, we recalculate the results for 2015 based on the revised data.

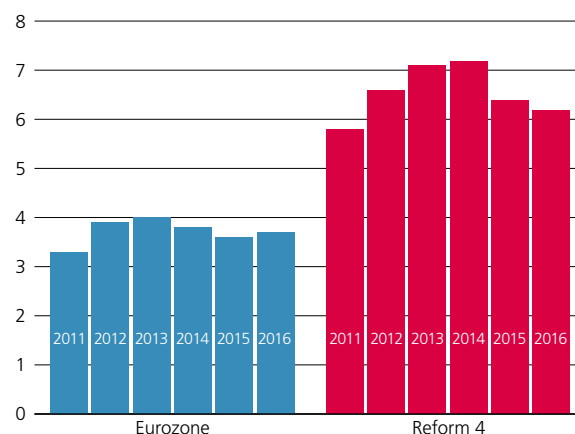
'Europe has entered a new stage of adjustment.'

Key Findings

1. Five years after the European Central Bank defused the euro confidence crisis in the summer of 2012, Europe has entered a new stage of adjustment. While the erstwhile euro crisis countries have largely completed their painful programmes of austerity and reforms, some structurally challenged members of the **eurozone** such as **France, Belgium, Austria** and **Finland** have started to shape up. Although the evidence is still very tentative, the signs of progress in these countries raise the hope that the current cyclical upswing in the **eurozone** could be the prelude to a longer period of significant growth backed by a faster expansion of supply beyond a mere rebound in demand.
2. Of course, serious risks remain. These include the risk of reform reversals at the **eurozone** periphery and political instability in **Italy**. Politics seems to have stymied the hopes which Prime Minister Matteo Renzi had initially raised with his labour market reform of early 2015. In addition, the Brexit vote has introduced a risk that, for the first time in decades, barriers to the free movement of goods and services, capital and labour may be erected anew instead of being torn down close to the heart of Europe.
3. All in all, Europe has come a long way. Following Germany's post-2004 renaissance from its deep structural crisis, we detect three major waves of reform:
 - First, the small Baltic economies, which had already succumbed to a major financial crisis in 2007, reformed themselves rapidly. Having done so successfully, they could afford to reduce their adjustment efforts over the last four years.
 - Second, the euro confidence crisis forced a brutal front-loaded adjustment on the economies at the southern and western periphery of the eurozone from 2010 onwards. Countries had to correct past excesses in public and private spending. Governments and households had to curtail what they consume relative to what they produce and earn. The medicine was bitter. But by and large, it worked. Having emerged from their adjustment crisis, most of these reform countries have now started to relax the reins again somewhat.
 - Third, we are starting to see evidence that **France, Belgium, Austria** and **Finland** are starting to follow suit. From a low base, they have improved their scores in the Adjustment Progress Indicator. The programmes of newly elected French President Emmanuel Macron and the frontrunner in the Austrian vote on 15 October raise hopes that their countries can advance further soon. If France delivers of the reforms that President Macron promised during his election campaign, France may eventually outclass a Germany that remains strong but is becoming complacent and a **United Kingdom** that is hurting itself with its decision to leave the European Union.
4. The five peripheral countries that received some support from European facilities, often topped up by an International Monetary Fund contribution, remain among the star performers in the adjustment ranking. **Greece** (No. 1), **Ireland** (No. 2), **Spain** (No. 4), **Portugal** (No. 6) and **Cyprus** (No. 9) adjusted faster than almost any other country in the sample. They had to do it. And they did it. This confirms the key results of the analysis in previous editions of *The Euro Plus Monitor*.
5. But this is now mostly a story of the past. Progress seems to have largely stalled at the eurozone periphery (see Chart 2). The results of *The September 2017 Euro Plus Monitor Update* confirm a trend that started in 2014 already: We detect a further slackening of adjustment efforts in all five countries that had to ask taxpayers from other European countries for help. For **Ireland** and **Spain** and – to a lesser extent – for **Portugal** and **Cyprus**, the drop in the score is part of the return to a more normal life after the end of the crisis. Having delivered serious fiscal repair and pro-growth reforms, they no longer need to adjust as rapidly

Chart 2. Modest Slowdown: The Pace of Adjustment

Adjustment Progress Indicator 2011-2016



Reform 4 countries are Spain, Ireland, Greece and Portugal. Scale 0 (worst) to 10 (best). The Adjustment Progress Indicator for 2015 and 2016 also includes indicators for the quality of fiscal adjustment. Source: Berenberg calculations

'The eurozone as a whole is turning into a more balanced and potentially more dynamic economy.'

as before. Having compressed domestic demand and imports drastically during the crisis, they can afford to relax the fiscal reins slightly and let imports rise faster than exports.

6. **Greece** remains a special case. Thanks to its heroic adjustment efforts in 2010-2013, Greece still leads the overall adjustment league. However, the last two years have seen major shifts. After dramatic slippage in 2015, the score for Greece fell slightly in 2016. By sowing uncertainty and chasing capital out of the country in record amounts between late 2014 and July 2015, Greece weakened its economic and fiscal position dramatically. Most recent data on fiscal and external adjustment, however, indicate that Greece has put the worst of the slippage behind it and has started to improve again.
 7. Beyond the erstwhile euro crisis countries, two other groups of countries shine in the adjustment ranking.
 - Despite some significant slippage in the last three years, the three small, relatively open Baltic economies remain in the top half of the league, with **Latvia** (No. 3) well ahead of **Lithuania** (No. 7) and **Estonia** (No. 8). Six years ago, Estonia was at the top of the league. Having successfully concluded their adjustment from its pre-Lehman boom-bust, the Baltic countries can afford to relax their efforts and reap the benefits of what they have achieved.
 - All of the catching-up economies of southern and eastern Europe are adjusting faster than the **eurozone** average, with **Romania** (No. 5) as well as **Slovenia** (No. 11), **Slovakia** (No. 12) and **Croatia** (No. 13) achieving particularly good scores, largely because of rapid export growth. The other east-central and south-eastern European economies – such as **Bulgaria** (No. 14), the **Czech Republic** (No. 15), **Hungary** (No. 16) and **Poland** (No. 17) – also score modestly above the eurozone average despite significant slippage in Hungary and Poland caused by growing reluctance to pursue pro-growth reforms and a strong increase in labour costs.
 8. The overall results for the **eurozone** remain positive. Due to the adjustment efforts of the periphery in the years 2010 to 2014 and some recent progress at the core, the eurozone as a whole is turning into a more balanced and potentially more dynamic economy. After three years of quickening progress from 2011 to 2013 and some back-and-forth in 2014 and 2015, the pace of adjustment increased slightly in the eurozone as a whole in 2016 (see Chart 2 on page 3).
- Despite modest slippage among some erstwhile reform leaders at the euro periphery, as well as in **Italy**, significant gains in **The Netherlands** (No. 18, up from 21 last year on the Adjustment Progress Indicator), **Belgium** (No. 23, up from No. 24) and **Malta** (No. 10, up from No. 14) as well as small improvements in **France** (No. 25), **Austria** (No. 24) and **Finland** (No. 27) helped to raise the overall score for the eurozone to 3.7, up from 3.6 last year. As in the previous five years, the aggregate score for the **eurozone** is held back by **Germany** (No. 26), which has only a limited need to adjust. Note that our scores rate the cumulative adjustment progress since 2010 and not just the adjustment in the last year. A rise or decline in the score thus means that, in the last year, adjustment efforts increased or slackened relative to the average of the years before.
9. Taking the years since 2010 together, serious austerity in the fiscally challenged periphery and a virtual standstill in parts of core Europe have resulted in a significant fiscal convergence in the **eurozone** and the European Union as a whole. However, for better or worse, austerity is over. For the second year in a row, many European countries loosened the fiscal reins in 2016. In some cases, such as **Germany**, we can applaud that as a welcome fiscal stimulus. In other cases such as those of **Italy**, **Portugal** and **Spain**, the turn away from post-crisis prudence looks a little premature. In *The Euro Plus Monitor September 2017 Update*, we expand the analysis in one key respect. As part of the examination of fiscal adjustment (criterion no. 2), we now look at the quality of fiscal changes as well as the size of the fiscal adjustment.
 10. *The Euro Plus Monitor September 2017 Update* shows that external imbalances have diminished and that wage pressures have converged to a significant extent within the **eurozone**. As part and parcel of this adjustment progress, **Ireland**, **Italy**, **Portugal** and **Spain** have managed to turn major current account deficits into small surpluses. In this respect, they are no longer living beyond their means. The rapid rise in exports creates room for a rebound in imports while maintaining a surplus in net exports. For Ireland, Spain and Portugal, this recovery in domestic demand and imports combined with a rise in employment is the sweet taste of success.
 11. On a seven-year view, **wage pressures** have converged somewhat within the **eurozone**. The erstwhile crisis countries have slashed their unit labour costs significantly. However, the process of labour cost

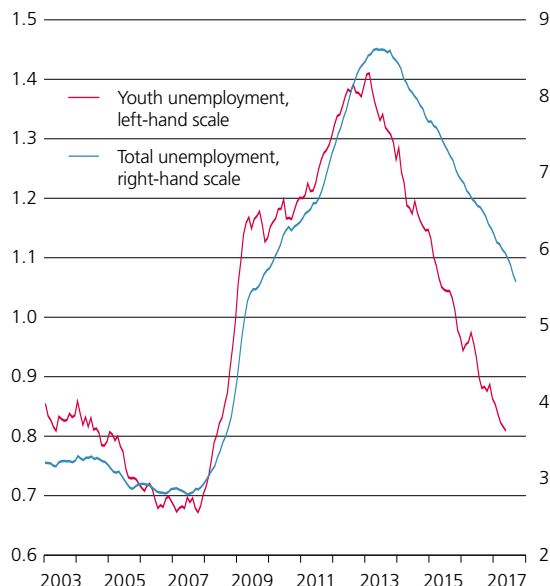
'The good news does not stop with France. Belgium and Austria also show signs of progress.'

convergence seems to have slowed down in the last two years. And despite some progress at the margin, the inflexible French labour market has still not responded adequately to the challenge of globalisation. See the Special Focus on "Can France Overtake Germany?" on page 21.

12. Tough love has worked. Since 2010, the **eurozone** has offered its weaker members a deal: we protect you against market turbulence and help to finance your budget if you slash your fiscal deficit and raise your growth potential through serious structural reforms. By and large, the approach is paying off. After surging to record levels, unemployment has come down noticeably in the reform countries since spring 2013 (see Chart 3 below). Serious labour market reforms and wage restraint are paying off. The countries that stay the course could be in the early stages of a long-term surge in employment and incomes comparable to the one which started in **Germany** two years after its 2004 labour market reforms.

Chart 3. Back to Work – Unemployment is Falling

Number of unemployed in Reform 4 countries in millions



Reform 4 countries are Spain, Ireland, Greece and Portugal.

Source: Eurostat

13. A low score on the Adjustment Progress Indicator can mean two different things. On the positive side, it can signal that countries do not adjust much because they do not need to. This is the case for **Luxembourg** (No. 21), **Denmark** (No. 22) and **Germany** (No. 26).
14. On the negative side, a low score in the Adjustment Progress Indicator can be a harbinger of trouble to come for countries that are in urgent need of reform, as suggested by a low score in the Fundamental Health Indicator. Six years ago, we warned in *The 2011 Euro Plus Monitor* that "alarm bells should be ringing for **France**." Since then, France has consistently remained in the bottom third of the Adjustment Progress Indicator and the Fundamental Health Indicator. France has one of the most bloated shares of public spending as a percentage of gross domestic product among the countries surveyed and suffers from an overly rigid labour market and a pronounced lack of competitiveness.³

Fortunately, we now find some noteworthy progress in France on a number of counts including some serious structural reforms and efforts to rein in government spending for 2016, that is even before Emmanuel Macron became president with an explicit pro-reform agenda. According to the OECD, France became the leader for economic reforms among all major OECD countries (except Latvia) in the 2015-2016 period. If France now implements the labour market reforms presented by its government on 31 August 2017, it could turn into the most dynamic of the major economies in Europe in the coming decade (see the Special Focus on page 21).

15. The good news does not stop with France. Three other core members of the eurozone that suffer from traits of the French malaise, namely **Belgium** (No. 23), **Austria** (No. 24) and **Finland** (No. 27), also show signs of improvement, although their scores for overall adjustment efforts remain well below average. Chances are that, as in France, new elections in Austria on 15 October 2017 could usher an even more reform-minded government into power.
16. Unfortunately, the good news does not extend to **Italy** (No. 20, down from No. 17). Based largely on the labour market reform which Prime Minister Renzi had implemented in early 2015, we had detected signs of a potential turnaround in Italy in *The 2016 Euro Plus*

³ See Schmieding and Hense, op. cit.

'Bad move ahead of Brexit: the pace of structural reforms has slowed sharply in the United Kingdom.'

Monitor nine months ago. Extending the analysis with data for the full year of 2016 now reveals significant slippage in Italy on two major counts. First, the pace of pro-growth structural reforms apparently decelerated sharply in 2016 as political uncertainty started to take hold ahead of the December 2016 referendum on constitutional reforms. Second, in a futile attempt to garner public support ahead of the referendum, Prime Minister Renzi had relaxed Italy's fiscal reins. However, we are not concerned about the immediate outlook for the Italian economy. As the rising tide of the strong cyclical upswing in the eurozone lifts all boats, Italy can expand at a pace close to 1.5%, well below the eurozone average but far above its paltry record for the last ten years. However, Italy's high debt burden still makes it vulnerable to potential bouts of market anxiety. The country cannot afford a period of prolonged political uncertainty, let alone genuine reform reversals.

17. **Sweden** (No. 28) and **Finland** (No. 27) are stuck at the bottom of the Adjustment Progress Indicator with another drop in the score for Sweden largely because of its reluctance to pursue pro-growth reforms and a marginal rise for Finland due mostly to a rebound in Finnish exports.
18. Despite serious adjustment progress in major parts of the **eurozone** in the last six years, the situation remains fragile. At the eurozone periphery, the major task is to stay the course and prevent reform reversals and the kind of upset which **Greece** suffered in 2015. That very much includes **Italy**, where the reform work remains unfinished.

19. The score for the **United Kingdom** (No. 19) improves slightly by 0.1 point largely because of its ongoing fiscal adjustment, helped by a comparatively growth-friendly composition of its fiscal changes. Even the score for reform drive goes up marginally as OECD data for the full 2010-2016 period now shows a marginally stronger propensity to reform than the data for 2010 to 2015 had done at the time of our last assessment in December 2016. However, this masks a longer-term problem. Looking at two-year periods, the pace of structural reforms in the United Kingdom has slowed sharply since 2011/2012 (see Chart 1 on page 1). In order to contain the damage from Brexit, the United Kingdom would need to improve its attractiveness for inward investment through significantly faster domestic structural reforms. In addition, labour costs are rising faster in the United Kingdom than in most other countries in the sample. The combination of labour cost competitiveness slippage with a very low score for external adjustment, where the United Kingdom ranks No. 25 out of the 28 current members of the European Union, does not bode well for the United Kingdom's competitive position in the future.

Of course, the 16% decline in the sterling exchange rate versus the euro after the vote to leave the European Union on 23 June 2016 will probably help, at least to the extent that it is not eroded over time by a resulting rise in wage and price inflation. But for a country that needs to do more rather than less to improve its competitive position, a decision to put access to its dominant export market at risk looks somewhat foolhardy.

'The eurozone has improved its external position largely because the crisis countries have shaped up.'

External Adjustment

Table 2. External Adjustment 2007- 2017

Rank		Change in net exports H2 2007 - H1 2017										Change in export ratio as a percent of GDP H2 2007 - H1 2017			
						Relative to GDP			Relative to starting level						
2016	2015	Country	Score	Change	Score	Change	Percent	Score	Change	Percent	Score	Change	Percent	Score	Change
1	1	Latvia	9.3	-0.1	9.3	-0.3	16.2	8.7	-0.4	38.1	9.8	-0.2	18.4	9.4	0.2
2	2	Bulgaria	7.9	-0.2	7.9	-0.4	14.4	8.1	-0.4	27.9	7.8	-0.5	14.6	8.0	0.3
3	9	Slovenia	7.4	0.4	6.6	0.1	12.0	7.2	0.1	18.4	5.9	0.1	17.8	9.2	1.0
4	4	Greece	7.3	-0.1	8.3	-0.2	10.1	6.6	-0.5	43.0	10.0	0.0	7.8	5.4	0.3
5	7	Spain	7.3	0.1	8.4	0.1	10.5	6.7	0.1	40.7	10.0	0.0	7.4	5.2	0.3
6	5	Estonia	7.1	-0.3	5.6	-0.4	9.0	6.2	-0.4	14.5	5.1	-0.4	24.7	10.0	0.0
7	8	Slovakia	7.1	0.0	5.7	-0.1	10.4	6.7	-0.1	12.9	4.8	-0.1	19.4	9.8	0.1
8	3	Lithuania	7.0	-0.6	5.4	-0.9	7.5	5.7	-0.9	15.0	5.2	-1.0	33.4	10.0	0.0
9	6	Romania	6.9	-0.3	6.4	-0.6	7.6	5.7	-0.4	24.4	7.1	-0.8	14.7	8.0	0.3
10	12	Malta	6.8	0.1	6.0	0.2	13.4	7.7	0.2	10.4	4.3	0.1	15.7	8.4	-0.1
11	10	Hungary	6.7	-0.3	5.1	-0.4	8.1	5.9	-0.5	10.7	4.3	-0.4	27.2	10.0	0.0
12	11	Ireland	6.5	-0.3	4.8	-0.5	7.5	5.7	-0.6	8.2	3.8	-0.4	24.1	10.0	0.0
13	13	Portugal	6.3	0.2	5.7	-0.1	6.0	5.2	-0.1	19.9	6.2	-0.1	13.8	7.7	0.7
14	15	Czech Republic	6.3	0.4	4.5	0.4	5.5	5.0	0.4	8.9	4.0	0.4	21.1	10.0	0.5
15	14	Croatia	6.2	0.1	5.9	-0.1	7.5	5.7	-0.1	19.7	6.1	-0.1	11.1	6.7	0.6
16	17	Netherlands	5.5	0.3	3.7	0.2	3.2	4.2	0.2	4.6	3.1	0.2	18.1	9.3	0.5
17	16	Poland	5.2	-0.2	4.5	-0.3	4.5	4.6	-0.2	11.2	4.4	-0.4	10.9	6.6	0.0
18	18	Belgium	4.6	0.2	2.4	-0.1	-1.0	2.8	-0.1	-1.3	1.9	-0.1	17.8	9.2	0.8
19	19	Luxembourg	4.3	-0.1	1.5	-0.2	-5.2	1.3	-0.2	-3.0	1.6	-0.1	38.0	10.0	0.0
		Euro 19	4.3	0.2	3.6	0.2	2.3	3.9	0.1	5.8	3.4	0.2	8.8	5.8	0.3
20	20	Italy	4.0	0.1	4.0	-0.1	2.4	3.9	-0.1	8.9	4.0	-0.1	4.4	4.1	0.3
21	22	Denmark	3.9	0.3	3.4	0.2	2.0	3.8	0.2	4.0	3.0	0.2	6.5	4.9	0.5
22	23	Germany	3.4	0.0	2.6	-0.1	-0.1	3.1	-0.1	-0.2	2.2	-0.1	7.0	5.1	0.3
23	24	Austria	3.2	0.0	2.6	-0.2	-0.3	3.0	-0.2	-0.5	2.1	-0.2	5.4	4.5	0.4
24	21	Cyprus	2.8	-0.9	2.4	-0.9	-0.7	2.8	-0.8	-1.4	1.9	-0.9	3.4	3.7	-0.8
25	25	United Kingdom	2.6	0.2	2.4	0.1	-0.5	2.9	0.1	-1.8	1.8	0.2	1.5	3.0	0.2
26	27	Sweden	2.3	0.1	2.0	0.1	-1.7	2.5	0.1	-3.6	1.5	0.1	1.5	3.0	0.0
27	26	France	2.2	-0.2	1.4	-0.3	-2.4	2.3	-0.2	-8.8	0.4	-0.4	3.5	3.8	0.1
28	28	Finland	1.3	0.5	0.7	0.3	-4.8	1.4	0.7	-11.7	0.0	0.0	0.4	2.6	0.8

Ranks, scores and score changes for external adjustment indicator and sub-indicators. Values given in percent are for H1 2017 over H2 2007: (1) change of net exports as a percent of GDP, (2) change of net export ratio as a percent of the starting level and (3) change in the export ratio in percentage points of GDP. For further explanations see notes under Table 1 on page 2 and the Notes on Key Components on page 63 of The 2016 Euro Plus Monitor. For Cyprus, Ireland, Luxembourg and Malta the scores are based on adjustment up to the average of Q4 2016 and Q1 2017 as Q2 2017 data are not yet available. Since a change in statistics in early 2015, Irish data for GDP, exports and imports have become difficult to interpret. We have tried to adjust the Irish data for that distortion.

If a country has lived beyond its means, the adjustment after the party should show up most visibly in its external accounts. To track progress, we examine two different aspects of external adjustment, namely 1) the shift in the balance of exports and imports (net exports), and 2) the rise in the share of exports in a country's GDP. Beyond looking at the absolute shifts, we also assess them relative to the starting position of each country as measured by the pre-crisis share of exports in GDP in the second half of

2007. For the September 2017 Update, we add data for the final quarter of 2016 and the first two quarters of 2017.

The overall results confirm the pattern we observed in the last six years. The **eurozone** as a whole has improved its external position since 2007 largely because the erstwhile crisis countries (**Cyprus, Greece, Ireland, Portugal and Spain**) have shaped up. All economies that were running excessive external deficits until 2007 (or 2009)

'France and Germany remain close to the bottom of the external adjustment league.'

made so much progress that most of them can now afford to let imports rise in line with or slightly faster than exports again.

Looking at the cumulative adjustment since 2007, three groups of countries dominate the top half of the overall external adjustment-based ranking.

1. **Estonia, Latvia and Lithuania**, the three Baltic economies, have successfully staged an export-led recovery from their 2007-2009 crisis.
2. With the exception of **Cyprus**, the peripheral countries that had to ask for external help during the euro crisis have turned their external positions around convincingly.
3. Most of the catching-up economies in southern and eastern Europe are integrating themselves well into the European and global economy as seen by the significant rise in the share of exports in their GDP over time.

Latvia (No. 1) maintains its position as the best of the 28 countries in the sample by a wide margin, well ahead of **Bulgaria** (No. 2) and **Slovenia** (No. 3), followed by **Greece** (No. 4) and **Spain** (No. 5). Among the erstwhile euro crisis countries, **Ireland** (No. 12) and **Portugal** (No. 13) still achieve scores that are well above the eurozone average. However, **Cyprus** (No. 24) continues to fall behind.

Is success breeding complacency? Among the top 10 performers for external adjustment, only **Malta, Slovenia and Spain** improve their scores further in the last three quarters. With the exception of a stable score for **Slovakia** (No. 7), all other top ranked countries allowed themselves a little slippage, largely because rebounding domestic demand has led to a rise in imports that is outpacing the continued gains in exports. By and large, we see this as a measure of success and not – or not yet – as a sign of complacency. Having improved their external balance very visibly, they can afford to relax the reins a little.

The same holds for the eurozone as a whole, which has attained a comfortable external position.

Greece (No. 4) remains a special case. Athens continues to get excellent marks for its overall external adjustment with a score of 7.3. But most of the improvement in Greece's external position has come from a collapse in imports rather than a surge in exports. Political uncertainty, regulatory red tape and excessive taxes have hampered investment into export-oriented activities. That may help to explain why Greek exports are lagging far behind those of other countries at the euro periphery. The strong rise

in its export share in GDP to 30.9% in 2015, up from 23.4% of GDP in the second half of 2007 reflected largely the decline in real GDP rather than a rise in real exports. Fortunately, the situation may be changing. After a setback caused by the chaos and the restricted access to finance in the wake of Greece's futile confrontation with creditors in 2015, Greek exports seem to be rebounding again, reaching a record 31.7% of GDP in the second quarter of 2017.

The two biggest eurozone members, **Germany** (No. 22, with a score of 3.4) and **France** (No. 27, with 2.2) remain close to the bottom of the league. Whereas the German score remained stable, the French score slipped slightly as imports rose faster than exports. In the case of Germany, this makes perfect sense. As a country with an exceptionally strong external position, Germany can easily afford to consume more, raising its imports at a faster rate than its exports, as it did in 2016. For France, the decline in its score should be a reason for concern, though, as the share of exports in GDP (30.2% of GDP in the first half of 2017) remains low. France needs to do more to become competitive.

Outside the eurozone, the **United Kingdom** (No. 25) managed to raise its below-average score slightly. Nonetheless, the United Kingdom has achieved even far less than **Italy** (No. 20 with a marginal gain in score) in terms of external adjustment since 2007. **Sweden** (No. 26) and **Finland** (No. 28) remain close to the bottom of the ranking although Finland finally managed to raise its dismal score visibly.

Looking at the first sub-criterion – the rise in the share of net exports in GDP – **Latvia** with its small and very open economy managed the most impressive shift in its external balance by a total of 16.2 percentage points of GDP from the second half of 2007 to the first half of 2017. It is followed by **Bulgaria** (14.4 points), **Malta** (13.4 points) and **Slovenia** (a 12.0 point shift). The results are also quite impressive for **Spain** with a shift of 10.5 percentage points as it is a much bigger and hence less open economy than the other top ranked economies. **Slovakia** (with a shift of 10.4 points) and **Greece** (with a shift of 10.1 points) also rank among the top performers for the turnaround in their net exports.

At the other end of the spectrum, the net export balance has deteriorated significantly in **Luxembourg** (-5.2 percentage points of GDP from the second half of 2007 to the first half of 2017), **Finland** (-4.8 points), **France** (-2.4 points), **Sweden** (-1.7 points) and **Belgium** (-1 point). Data for Luxembourg can be very volatile due the economy's relatively small size compared to its (net) exports. For

'Going forward, we expect the pace of external adjustment to remain largely steady in the eurozone.'

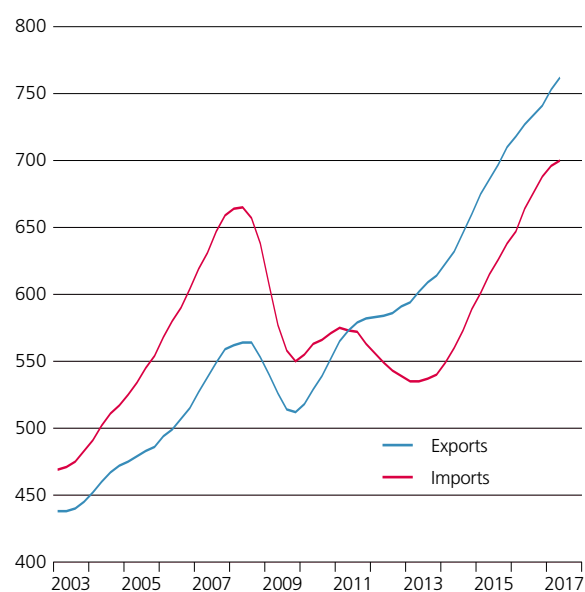
Finland, Sweden and France, the shift is too pronounced for comfort. See the column on “change in net exports relative to GDP” in Table 2 on page 7 for more.

Of course, a mere glance at the shift in the balance of exports and imports as a share of GDP is somewhat unfair. Small open economies such as Ireland, Cyprus and the Baltic states find it much easier to shift resources from the domestically oriented to the export-oriented or import-competing sectors than larger and more closed economies. To account for this, we look not just at the shift in the balance of import and exports, but also at the shift in a country's net export position relative to the starting level of the first half of 2007.

To some extent, the results are similar: **Greece, Spain, Latvia and Bulgaria** stay at or close to the top whereas **Finland, France, Sweden, Luxembourg, Belgium, the United Kingdom, Cyprus, Austria and Germany** remain close to the bottom. Adjusted for its comparatively low starting level, another eurozone crisis economy – **Portugal** – has also achieved impressive shift. This confirms a major rebalancing within Europe. On this criterion, even **Italy** looks well above average as, relative to its weak starting level, it has turned around its external balance quite

Chart 4. Exports Up, Imports Rebound at the Periphery

Real exports and imports of goods and services in Reform 4 countries in billions of euros, chain linked, base year 2010



Four-quarter rolling sum of real exports and imports for Reform 4 countries. Reform 4 countries are Spain, Ireland, Greece and Portugal. Source: Eurostat

decisively. See the column “change in net exports relative to starting level” in Table 2 on page 7.

A closer look at the drivers of adjustment in the first three years of the eurozone confidence crisis reveals a dark side to the external adjustment story: in some countries, the net export position initially improved more through a collapse in imports and less through an actual rise in exports. However, this ceased to be the case in 2014. As the worst of the domestic fiscal squeeze ended in 2014, imports have rebounded in most reform countries for more than three years already while the share of exports in GDP continues to grow (see Chart 4).

While **Spain** and **Portugal** have done well from the second half of 2007 to the first half of 2017, raising their export ratio by 7.4 and 13.8 percentage points of GDP, respectively, some of the small, open economies in the eurozone managed even more spectacular improvements. This holds especially for outliers **Luxembourg** (+38.0 points) and **Lithuania** (+33.4 points) as well as for **Estonia** (+24.7 points), and **Ireland** (+24.1 points). Unsurprisingly, small open economies top the list. See the column “Change in export ratio, in percent of GDP” in Table 2 on page 7.

On the opposite side of the spectrum, **Finland** has finally managed to recoup the post-crisis drop in its export ratio, raising the share of exports in GDP in the first half of 2017 to 0.4 percentage points above the second half of 2007 level. The results are also very weak for the **United Kingdom** and **Sweden** (+1.5 percentage points in both cases). With overall gains in the export ratio by 3.5 and 4.4 percentage points, respectively, **France** and **Italy** also lag well behind the **eurozone** average of 8.8 points. Like the eurozone as a whole, however, both Italy and France managed to raise their export share slightly on balance over the last four quarters.

Going forward, we expect the pace of external adjustment to remain largely steady in the **eurozone**. Export growth should remain satisfactory as we expect the global economy to expand by 2.9% in the next two years and thus a slightly faster pace than the 2.7% growth which we project for 2017. As part and parcel of the overall recovery of the eurozone, its members will likely be able to export more to each other. At the same time, in an economic recovery driven mostly by domestic demand, imports will likely rise at least as fast as exports for most countries in the sample. If so, we would view that as a healthy development.

'We expand the analysis to include a look at the quality of fiscal changes.'

Fiscal Adjustment

Table 3. Overall Fiscal Adjustment 2009-2016

Rank		Country	Score		Size of adjustment		Quality of adjustment	
2016	2015		Score	Change	Score	Change	Score	Change
1	1	Greece	7.7	0.2	9.7	0.4	5.6	0.0
2	2	Lithuania	6.8	0.2	6.8	0.2	6.8	0.2
3	5	United Kingdom	6.5	0.5	6.3	1.2	6.6	-0.1
4	3	Ireland	5.9	-0.3	7.0	0.0	4.9	-0.7
5	10	Slovenia	5.9	0.5	5.7	0.3	6.1	0.7
6	4	Romania	5.9	-0.2	6.9	-2.0	4.8	1.5
7	6	Latvia	5.8	0.1	7.1	0.3	4.4	0.0
8	9	Poland	5.7	0.1	6.9	0.1	4.5	0.1
9	13	Slovakia	5.6	1.2	7.0	0.6	4.2	1.8
10	8	Spain	5.5	-0.1	5.6	-0.9	5.4	0.7
11	7	Cyprus	5.3	-0.3	6.8	-0.6	3.8	-0.1
12	11	Czech Republic	5.3	0.9	7.6	0.4	2.9	1.4
13	23	Bulgaria	5.0	2.1	4.1	0.9	5.8	3.2
14	12	Portugal	4.9	0.5	6.5	0.0	3.3	1.1
15	22	Malta	4.6	1.7	3.6	2.0	5.7	1.4
16	17	Netherlands	4.3	0.8	4.5	1.5	4.1	0.1
		Euro 19	3.8	0.0	4.0	-0.2	3.6	0.1
17	20	Hungary	3.7	0.6	0.4	-0.2	7.1	1.4
18	16	Estonia	3.7	0.0	2.2	0.2	5.2	-0.2
19	14	Italy	3.6	-0.5	3.1	-1.1	4.1	0.1
20	15	Luxembourg	3.5	-0.3	1.6	-0.1	5.3	-0.6
21	19	France	3.3	0.2	3.8	0.0	2.9	0.3
22	24	Croatia	2.9	0.1	4.9	1.0	0.9	-0.8
23	18	Austria	2.7	-0.6	1.5	-1.2	3.9	0.0
24	21	Germany	2.7	-0.4	2.6	-0.5	2.7	-0.3
25	27	Denmark	2.7	0.5	0.5	0.5	4.9	0.6
26	25	Belgium	2.4	0.1	1.3	-0.1	3.6	0.4
27	26	Sweden	2.1	-0.1	0.0	0.0	4.1	-0.2
28	28	Finland	1.7	-0.1	0.1	0.1	3.2	-0.2

Ranks, scores and score changes for Fiscal Adjustment Indicator and sub-indicators. The overall score is the average of the separate subscores for the size and the quality of the fiscal adjustment. The change in scores refers to the difference between the scores for the fiscal adjustment 2009-2016 and the 2009-2015 period. See the notes below Table 4 on page 11 and Table 5 on page 14 for details. For further explanations see notes under Table 1 on page 2.

Countries that have lived beyond their means need to tighten their belts. Since 2011, we have tracked the fiscal adjustment of EU member countries in the wake of the post-Lehman recession and the euro confidence crisis. Our results have consistently shown that 1) the countries most in need of fiscal repair did impose serious austerity on their economies in the years from 2010 onwards and 2) that these adjustment efforts slackened significantly after 2013.

In **The Euro Plus Monitor September 2017 Update**, we broaden our analysis. We first analyse the size of the overall fiscal adjustment relative to a country's adjustment needs, as we have done in previous editions of *The Euro Plus Monitor*. Then, we add a look at the quality of the

adjustment. This analysis has three facets: First, do countries rely more on tax hikes or expenditure cuts to repair their public finances? Second, do they restructure the composition of public expenditure towards (or away from) investment in infrastructure and education? Third, do they raise taxes on consumption including petrol taxes or stifle economic incentives by relying mostly on higher taxes on incomes and profits?

Table 3 presents the results of the combined assessment of the size and the quality of fiscal adjustment. Largely because of the Herculean size of its fiscal adjustment, **Greece** (No. 1) maintains the top spot, as it has in previous editions of *The Euro Plus Monitor* in which we looked

'Germany gets low marks for the size and quality of its fiscal adjustment.'

Table 4. Size of Fiscal Adjustment 2009-2016

Rank		Country	Shift in structural primary balance 2009-2016								
2016	2015		Score			in percent of GDP			in percent of required shift		
			Score	Change	Percent	Score	Change	Percent	Score	Change	
1	1	Greece	9.7	0.4	18.4	10.0	0.0	89.0	9.5	0.9	
2	4	Czech Republic	7.6	0.4	5.3	5.2	0.7	133.6	10.0	0.0	
3	6	Latvia	7.1	0.3	4.0	4.3	0.5	336.3	10.0	0.0	
4	5	Ireland	7.0	0.0	8.0	7.2	0.0	63.9	6.8	0.0	
5	11	Slovakia	7.0	0.6	6.3	5.9	0.5	75.1	8.0	0.8	
6	2	Romania	6.9	-2.0	6.8	6.3	-1.6	71.5	7.6	-2.4	
7	7	Poland	6.9	0.1	5.2	5.2	0.1	81.3	8.7	0.2	
8	8	Lithuania	6.8	0.2	6.5	6.1	0.2	71.2	7.6	0.3	
9	3	Cyprus	6.8	-0.6	7.5	6.8	-0.6	n.a.	n.a.	n.a.	
10	9	Portugal	6.5	0.0	7.8	7.0	0.0	56.0	6.0	0.0	
11	13	United Kingdom	6.3	1.2	6.6	6.1	1.0	60.6	6.4	1.4	
12	12	Slovenia	5.7	0.3	4.7	4.8	0.2	61.8	6.6	0.4	
13	10	Spain	5.6	-0.9	6.7	6.2	-0.9	46.3	4.9	-1.0	
14	15	Croatia	4.9	1.0	4.9	4.9	1.0	n.a.	n.a.	n.a.	
15	19	Netherlands	4.5	1.5	3.9	4.2	1.1	45.5	4.8	1.9	
16	17	Bulgaria	4.1	0.9	3.7	4.1	0.9	n.a.	n.a.	n.a.	
		Euro 19	4.0	-0.2	3.0	3.6	-0.1	41.0	4.4	-0.3	
17	16	France	3.8	0.0	3.1	3.6	0.0	37.4	4.0	0.1	
18	23	Malta	3.6	2.0	3.0	3.6	2.0	n.a.	n.a.	n.a.	
19	14	Italy	3.1	-1.1	2.0	2.9	-0.7	32.1	3.4	-1.6	
20	18	Germany	2.6	-0.5	0.5	1.8	-0.1	33.0	3.5	-0.8	
21	21	Estonia	2.2	0.2	1.1	2.2	0.2	n.a.	n.a.	n.a.	
22	22	Luxembourg	1.6	-0.1	0.2	1.6	-0.1	n.a.	n.a.	n.a.	
23	20	Austria	1.5	-1.2	0.7	1.9	-0.7	10.4	1.1	-1.6	
24	24	Belgium	1.3	-0.1	0.6	1.9	-0.1	6.8	0.7	-0.1	
25	27	Denmark	0.5	0.5	-0.6	1.0	1.0	0.0	0.0	0.0	
26	25	Hungary	0.4	-0.2	-0.8	0.9	-0.4	-48.7	0.0	0.0	
27	26	Finland	0.1	0.1	-1.7	0.2	0.1	-127.8	0.0	0.0	
28	27	Sweden	0.0	0.0	-2.7	0.0	0.0	0.0	0.0	0.0	

Ranks, scores and score changes for Size of Fiscal Adjustment Indicator and its sub-indicators. Values: (1) 2009-2016 change in structural primary balance in % of GDP and (2) as a share of the required fiscal shift until 2020, adjusted for age-related spending. For further explanations see notes under Table 1 on page 2.

at the size shift in the fiscal stance only. It is followed by **Lithuania** (No. 2) and the **United Kingdom** (No. 3) which gets better marks for the quality of its fiscal repair efforts after 2009 than for the size of the overall adjustment.

Beyond Greece, the other countries that had to ask other eurozone taxpayers for help in the euro crisis also achieve scores well above the eurozone average for their overall fiscal adjustment efforts after 2009, with a particular good result for **Ireland** (No. 4, down from No. 3 before) and satisfactory scores for **Spain** (No. 10, down from No. 8 before) and **Portugal** (No. 14, down from No. 12 before).

Germany (No. 24) gets low marks for both the size and the quality of its fiscal adjustment efforts. Having enjoyed a modest fiscal surplus for the last four years running, Germany has little need to adjust its fiscal policy, although some additional well-targeted spending on some infrastructure bottlenecks (local roads in some federal states, the digital economy) as well as child-care and education would certainly help. Although Germany has gone through hardly any austerity since 2009, its sustainability gap remains so small that it could easily afford its small fiscal stimulus of 0.3% of GDP in 2015 and 0.1% in 2016. Germany continues to benefit from the

'The countries that were most in need of reining in their deficits have made serious progress.'

rapid rise in employment and tax receipts unleashed by its 2004 labour market reforms.

For **Italy** (No. 19), **Austria** (No. 23) and **Belgium** (No. 26), their below-average scores for fiscal adjustment are a much greater concern because these countries have an above-average need to adjust. Unfortunately, Italy and Austria fell back further in 2016.

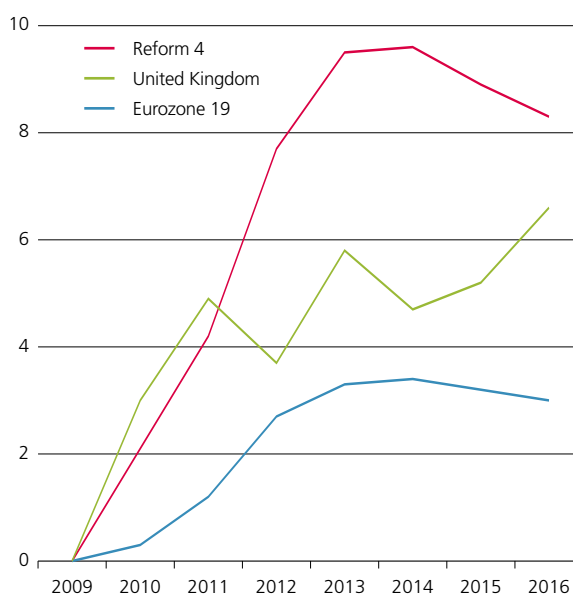
Table 4 on page 11 presents the results of the analysis of the size of fiscal adjustment in all 28 member states since 2009. The table is comparable to those in previous editions of *The Euro Plus Monitor* in which we looked only at the size but not yet at the quality of fiscal adjustment. The results show that, for better or worse, austerity is largely over in Europe. For the second year in a row, many European countries loosened the fiscal reins somewhat in 2016. In some cases such as that of Germany, we can applaud that as welcome stimulus. In other cases such as those of Italy and Spain, the turn away from their post-crisis fiscal repair looks premature. While politically understandable, these countries have now added to the fiscal challenges they will face in the future.

To analyse shifts in the fiscal-policy stance, we examine the underlying primary balance of the general government accounts. These data adjust the actual fiscal balance for the impact of the short-term business cycle, interest payments and some significant one-off factors such as public funding for a recapitalisation of banks.⁴ Four results stand out:

1. Taking the last seven years together, the countries that were most in need of reining in their excessive deficits have made serious progress, with **Greece** (No. 1) well ahead of **Ireland** (No. 4), **Cyprus** (No. 9), **Portugal** (No. 10) and **Spain** (No. 13). All five eurozone countries that had to ask taxpayers in other countries for support are running a much tighter fiscal policy than they did in 2009 (see Chart 5).
2. Following Greece's futile confrontation with creditors in the first half of 2015, the Greek economic and fiscal outlook deteriorated so much by mid-2015 that Greece needed a new and painful adjustment programme. Whereas other erstwhile euro crisis countries relaxed their fiscal stance significantly (Spain and Cyprus) or slightly (Portugal and Ireland) in 2016, Greece had to implement additional austerity to regain some of the investor confidence it had shattered under Finance Minister Yanis Varoufakis in early 2015.

Chart 5. Fiscal Adjustment 2009-2016

Cumulative change in structural primary balance since 2009 in percent of GDP



Reform 4 countries are Spain, Ireland, Greece and Portugal.

Source: European Commission

3. A number of countries with a fairly comfortable fiscal starting position such as **Germany** (No. 20), **Luxembourg** (No. 22) and **Denmark** (No. 25) have hardly changed their fiscal stance over these seven years while **Finland** (No. 27) and **Sweden** (No. 28) have relaxed the fiscal reins noticeably. On a seven-year view, serious tightening in the fiscally challenged periphery and a virtual standstill in parts of the core have resulted in a significant convergence of fiscal policy in the **eurozone** and the European Union as a whole.
4. By and large, fiscal repair has given way to a looser policy stance in the last two years. After a cumulative fiscal correction of 3.4% of GDP from 2009 to 2014 brought the eurozone's structural primary balance to 1.6% in 2014, governments relaxed the fiscal reins marginally by 0.2% of GDP per year in 2015 and 2016. We expect a slightly smaller stimulus of 0.1% of GDP in 2017.

All in all, the end of austerity makes sense for most countries of the **eurozone**. As Chart 6 on page 13 shows, the rise in public debt in the eurozone since 1999 has been far less pronounced than in the **United States** and the **United Kingdom**. Largely because of Germany's

⁴ The underlying data used in the next section is from the European Commission Ameco database, August 2017.

'The United Kingdom does well on the criteria for the quality of fiscal changes.'

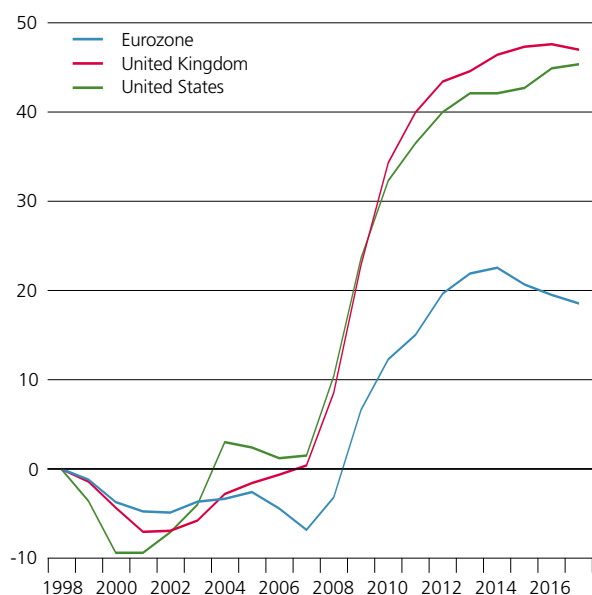
exceptionally strong fiscal position, the ratio of public debt to GDP declined in the eurozone for the second year in a row in 2016. With real GDP growth above trend at around 2%, we project further and a more broad-based improvement in 2017.

Of course, the size of the fiscal shift over time tells only half the story. We have to relate it to the actual adjustment needed. In 2014, the International Monetary Fund estimated how much countries would have to shift their cyclically adjusted primary balance between 2014 and 2020 to get to a deficit-to-GDP ratio of 60% by 2030, also adding an adjustment for age-related spending.⁵ We take these numbers – including their underlying assumptions – and add the actual adjustment progress in 2016 over 2009. We then relate the total required shift in stance between 2009 and 2020 to what was already achieved from 2009 to 2016.

On this measure, **Latvia** and the **Czech Republic** made the most progress over the last six years taken together, as shown in the column on “fiscal adjustment in percent of

Chart 6. Debt Burden Falling in the Eurozone

Change in public debt ratio since 1998 in percent of GDP



Sources: European Commission, Eurostat

required shift” in Table 4 on page 11. They are followed by **Greece, Poland, Slovakia, Romania** and **Lithuania**.

Size matters. But it is not the only criterion to assess changes in a country’s fiscal stance. If a country slims down its public sector and distributes the savings through tax cuts (criterion 1), it can strengthen its private sector and enhance its growth potential. If it tightens fiscal policy by placing more burdens on businesses instead of raising consumption taxes (criterion 2), it may do more harm than good if it chases away capital. But if it restructures public expenditure away from consumption to investment in infrastructure and education without changing the overall level of public expenditure (criterion 3), it may nonetheless reap significant benefits in the future.

In *The Euro Plus Monitor September 2017 Update*, we expand the analysis of the size of fiscal adjustment to include a closer look at the quality of fiscal policy, putting equal weight on the three criteria mentioned above. For each of these criteria, we compare the latest available data (2015 or 2016) to those for 2009. Unsurprisingly, the resulting ranking in Table 5 on page 14 differs significantly from that for the sheer size of fiscal changes. The top spot goes to **Hungary** (No. 1) largely because of a significant increase in public investment in infrastructure and education and a restructuring of its tax system towards taxes on consumption. **Lithuania** (No. 2) excels because it has managed to slim down its public sector with spending and tax cuts while the **United Kingdom** (No. 3) does well on all our three criteria for the quality of fiscal adjustment.

Some of the erstwhile euro crisis countries feature in the top half of the ranking, with **Greece** (No. 7) just ahead of **Spain** (No. 8) and **Ireland** (No. 11). However, the scores for **Cyprus** (No. 21) and **Portugal** (No. 23) are close to or below the eurozone average. The case of Greece merits closer attention. Largely because of the collapse in GDP, Greece has not managed to slim down its public sector as measured by the first of the three criteria. However, helped by EU funds for public investment and because it has focussed on raising consumption and petrol taxes as part of its fiscal adjustment, Greece does well on the two other criteria.

In terms of the quality of fiscal changes since 2009, **France** (No. 26) and **Germany** (No. 27) come close to the bottom of the league table. Whereas Germany can probably afford this for a while, the ranking highlights the challenges

5 International Monetary Fund, *Fiscal Monitor 2014* (Washington DC: IMF, 2014); *Ibid. Fiscal Monitor 2013* (Washington DC, IMF, 2013). These estimates are subject to change, they also deviate somewhat from those of the European Commission. But the EU and IMF estimates of how much countries are shifting their cyclically adjusted primary balances tend to be similar. See also the Notes on Key Components, Fiscal Sustainability, on page 63 of *The 2016 Euro Plus Monitor* as well as the further explanations at the bottom of page 28 of that report.

'France would be well advised to focus on the quality of fiscal policy more than on mere austerity.'

Table 5. Quality of Fiscal Adjustment 2009-2016

Rank		Country	Change in composition of public finances 2009-2016										
2016	2015		Spending and tax cuts			Productive expenditure			Non-distortionary taxes				
		Score	Change	Percent	Score	Change	Percent	Score	Change	Percent	Score	Change	
1	4	Hungary	7.1	1.4	-0.8	3.8	3.8	2.8	9.7	0.8	5.5	7.7	-0.3
2	2	Lithuania	6.8	0.2	8.5	10.0	0.0	1.5	7.7	0.5	0.0	2.7	0.0
3	1	United Kingdom	6.6	-0.1	3.1	7.4	0.2	0.4	6.1	-0.1	4.1	6.5	-0.4
4	8	Slovenia	6.1	0.7	2.0	6.3	3.0	0.5	6.1	-0.4	3.4	5.8	-0.5
5	23	Bulgaria	5.8	3.2	2.9	7.2	7.2	1.4	7.5	2.4	0.0	2.7	0.0
6	14	Malta	5.7	1.4	0.8	5.3	3.9	2.4	9.0	0.3	0.0	2.7	0.0
7	5	Greece	5.6	0.0	-2.3	2.4	-1.6	0.9	6.8	1.7	5.4	7.6	0.0
8	9	Spain	5.4	0.7	1.3	5.7	0.8	-2.7	1.3	0.7	7.0	9.1	0.7
9	3	Luxembourg	5.3	-0.6	3.7	7.9	-0.5	0.0	5.4	0.8	0.0	2.7	-1.9
10	7	Estonia	5.2	-0.2	5.0	9.1	-0.2	-1.7	2.7	-0.2	1.1	3.7	-0.3
11	6	Ireland	4.9	-0.7	14.5	10.0	0.0	-1.1	3.7	0.0	-1.9	1.0	-2.0
12	13	Denmark	4.9	0.6	2.0	6.4	0.3	0.9	6.7	-0.1	-1.4	1.5	1.5
13	20	Romania	4.8	1.5	5.7	9.7	3.6	-2.1	2.1	1.0	0.0	2.7	0.0
14	11	Poland	4.5	0.1	2.7	7.0	0.4	-0.5	4.7	0.0	-1.0	1.8	0.0
15	10	Latvia	4.4	0.0	-2.0	2.8	-0.3	-0.4	4.8	-0.2	3.3	5.7	0.3
16	25	Slovakia	4.2	1.8	-1.8	2.9	2.9	2.3	8.9	2.7	-2.3	0.7	-0.2
17	12	Sweden	4.1	-0.2	0.3	4.8	-0.7	0.0	5.4	0.3	-0.5	2.3	-0.1
18	15	Italy	4.1	0.1	-1.7	3.0	0.5	-0.6	4.4	-0.1	2.5	5.0	-0.1
19	16	Netherlands	4.1	0.1	0.9	5.4	0.1	-0.1	5.2	0.2	-1.2	1.7	-0.1
20	18	Austria	3.9	0.0	0.7	5.2	0.6	-0.3	5.0	0.0	-1.3	1.5	-0.5
21	17	Cyprus	3.8	-0.1	1.2	5.7	-0.7	-1.6	3.0	0.3	0.0	2.7	0.0
22	21	Belgium	3.6	0.4	-2.2	2.5	1.1	0.2	5.6	0.1	-0.3	2.5	-0.2
		Euro 19	3.6	0.1	-1.4	3.2	0.2	-0.6	4.4	0.1	0.5	3.2	0.1
23	26	Portugal	3.3	1.1	0.6	5.1	1.9	-2.2	2.0	0.9	0.1	2.8	0.5
24	19	Finland	3.2	-0.2	-5.8	0.0	0.0	0.1	5.6	-0.2	1.4	4.0	-0.2
25	28	Czech Republic	2.9	1.4	-0.1	4.4	2.5	-2.7	1.2	1.2	0.4	3.1	0.4
26	24	France	2.9	0.3	-3.6	1.3	0.5	-0.5	4.6	-0.2	0.1	2.8	0.6
27	22	Germany	2.7	-0.3	-2.6	2.2	-0.8	-0.2	5.1	0.1	-2.0	0.9	-0.2
28	27	Croatia	0.9	-0.8	-5.7	0.0	-2.3	-4.1	0.0	0.0	0.0	2.7	0.0

Ranks, scores and score changes for Quality of Fiscal Adjustment Indicator and its sub-indicators. Values: (1) Sum of government spending and tax cuts in % of GDP, change from 2009 to 2016; (2) change in the share of productive expenditure, which is public investment in infrastructure and education, in total public expenditure 2009 to 2015; (3) change in the share of non-distortionary tax revenue, which is the revenue of consumption and property taxes, in total tax revenues 2009 to 2015. For further explanations see notes under Table 1 on page 2.

facing the new French government. President Emmanuel Macron and his government would be well advised to focus on the quality of fiscal policy even more than on the overall deficit. Slimming down the public sector through cuts in expenditure and taxes, shifting the weight of taxation away from corporate taxes and strengthening public investment in infrastructure and education relative to public consumption expenditures should be among the top priorities for Paris. Fortunately, Macron's programme seems to point this way.

All in all, we have to treat the results of this analysis with some caution. As the changes in scores show, the results can be volatile year-by-year especially for smaller countries at the euro periphery. One reason for this are the short-term fluctuations in the disbursement of EU funds for public investment in these countries, which are often affected by the capacity of the countries to draw on specific funds for specific projects in any given year.

'Labour costs are an imperfect measure of competitiveness. But they provide some insights.'

Labour Cost Dynamics

Table 6. Labour Cost Adjustment 2009-2016

Rank		Real Unit Labour Costs 2009-2016						Nominal Unit Labour Costs 2009-2016								
		Absolute			Shift from 2000-2009 relative to Euro 19			Absolute			Shift from 2000-2009 relative to Euro 19					
2016	2015	Country	Score	Change	Percent	Score	Change	Percent	Score	Change	Percent	Score	Change	Percent	Score	Change
1	1	Ireland	9.1	0.0	-15.4	10.0	0.0	24.8	10.0	0.0	-13.8	9.9	-0.1	25.9	6.4	0.1
2	2	Greece	7.5	-0.7	-7.7	6.1	-1.3	13.8	6.7	-0.6	-11.4	9.0	-0.7	40.1	8.4	-0.1
3	3	Cyprus	7.1	0.0	-8.4	6.6	-0.4	13.1	6.5	-0.2	-7.9	7.6	0.3	33.4	7.5	0.2
4	7	Spain	5.6	0.2	-6.9	5.6	0.5	5.0	3.9	0.2	-5.8	6.9	0.1	24.3	6.2	0.2
5	4	Portugal	5.6	-0.2	-10.8	8.4	0.0	3.2	3.3	0.0	-4.7	6.4	-0.6	11.0	4.4	-0.1
6	6	Luxembourg	5.6	0.2	-8.4	6.7	0.1	16.3	7.5	0.0	5.2	2.6	0.3	20.5	5.7	0.2
7	10	Croatia	5.2	0.4	-11.0	8.5	0.5	3.1	3.2	0.2	-0.7	4.9	0.4	10.4	4.3	0.3
8	5	Romania	5.0	-0.5	-18.4	10.0	0.0	-7.3	0.0	-0.4	12.6	0.0	-1.5	161.2	10.0	0.0
9	9	Estonia	4.3	-0.7	-1.6	1.7	-1.8	9.9	5.4	-0.8	18.0	0.0	0.0	54.0	10.0	0.0
10	11	Slovenia	4.0	-0.5	-1.9	1.9	-0.8	0.9	2.5	-0.4	1.7	4.0	-0.7	33.2	7.4	-0.1
11	8	Latvia	3.8	-1.4	-0.4	0.8	-2.8	6.3	4.3	-1.2	13.3	0.0	-1.5	68.5	10.0	0.0
12	15	Malta	3.6	0.0	-6.7	5.4	0.3	7.2	4.6	0.2	9.4	1.0	-0.4	3.5	3.4	0.0
13	16	Italy	3.4	-0.1	-2.1	2.1	0.0	6.2	4.3	0.0	4.7	2.8	-0.3	12.2	4.5	0.0
14	13	Denmark	3.3	-0.6	-4.6	3.8	-1.1	10.4	5.6	-0.5	9.7	0.9	-0.8	0.4	2.9	-0.2
15	19	Finland	2.6	0.2	-3.0	2.7	0.4	7.2	4.6	0.2	9.9	0.8	-0.1	-3.0	2.5	0.1
16	22	Belgium	2.5	0.4	-3.1	2.8	1.0	2.4	3.0	0.4	7.3	1.8	-0.1	-3.3	2.4	0.1
17	12	Lithuania	2.5	-1.5	-2.6	2.4	-2.4	3.3	3.3	-1.1	12.0	0.0	-1.9	9.9	4.2	-0.6
		Euro 19	2.5	-0.1	-2.3	2.2	0.0	0.0	2.3	0.0	4.9	2.7	-0.4	0.0	2.9	0.0
18	17	United Kingdom	2.4	-0.4	-3.2	2.8	-0.5	6.9	4.5	-0.2	12.4	0.0	-0.9	-3.9	2.3	-0.2
19	14	Hungary	2.4	-1.3	-4.0	3.4	-3.0	-3.6	1.1	-1.3	17.3	0.0	-0.3	15.8	5.0	-0.7
20	20	Netherlands	2.3	-0.1	-0.7	1.0	0.0	-1.1	1.9	0.0	4.2	3.0	-0.3	3.0	3.3	0.0
21	18	Slovakia	2.2	-0.4	0.7	0.0	-0.9	-2.9	1.3	-0.4	3.9	3.1	-0.3	12.1	4.5	0.0
22	23	France	1.6	0.0	1.0	0.0	0.0	-1.1	1.9	0.1	7.2	1.9	-0.3	-2.8	2.5	0.0
23	21	Czech Republic	1.4	-0.9	1.3	0.0	-1.2	0.1	2.3	-0.7	10.6	0.6	-1.3	-2.2	2.6	-0.3
24	25	Sweden	1.2	0.1	-1.0	1.2	0.3	1.7	2.8	0.2	14.7	0.0	0.0	-14.8	0.8	0.0
25	26	Austria	0.9	-0.1	-0.6	0.9	0.1	-3.7	1.0	0.1	11.4	0.2	-0.5	-12.2	1.2	0.0
26	24	Poland	0.8	-0.4	-2.5	2.3	-0.9	-14.9	0.0	0.0	9.8	0.8	-0.6	-19.3	0.2	-0.1
27	27	Germany	0.5	-0.3	-0.7	1.0	-0.2	-5.8	0.4	-0.1	10.3	0.7	-0.7	-20.6	0.1	-0.1
28	28	Bulgaria	0.3	0.0	15.2	0.0	0.0	-21.1	0.0	0.0	42.9	0.0	0.0	-11.4	1.3	0.1

Ranks, scores and score changes for Labour Cost Adjustment Indicator and sub-indicators. Values: (1) 2009-2016 cumulative change in real unit labour costs, in %; (2) shift in cumulative real unit labour cost change between periods 2000-2009 and 2009-2016, relative to the Eurozone, in %; (3) 2009-2016 cumulative change in euro nominal unit labour costs, 2007-2016 for non-eurozone countries, in %; (4) shift in cumulative euro nominal unit labour cost change between periods 2000-2009 and 2009-2016, relative to the eurozone, 2000-2007 to 2007-2016 for non-eurozone countries, in %. The change in scores compares the current score for the 2009-2016 period to that for 2009-2015 to highlight the changes that happened in 2016. For further explanations see notes under Table 1 on page 2 and the Notes on Key Components on page 63 of The 2016 Euro Plus Monitor.

Labour costs are an imperfect gauge of competitiveness. The ultimate yardstick of competitiveness is whether or not a company or country can profitably sell its wares. But as other factors such as changes in product quality, brand value, consumer tastes and the mix of goods and services offered by a company or a country are often shaped by longer-term processes and are more difficult to quantify, changes in nominal and real unit labour costs do provide some useful insights into the near-term adjustment

dynamics of a country. This holds especially true if a decline in unit labour costs goes along with a rise in net exports, indicating that a country has indeed improved its competitive position.

To evaluate adjustment progress, we measure how much changes in nominal and real unit labour costs deviate from the eurozone average. We conduct the analysis in three steps. First, we calculate the cumulative change in real unit

'On a seven-year view, wage pressures have converged within the eurozone.'

labour costs between 2009 and 2016 and rank countries according to their deviation from the eurozone average, awarding the highest score to the country with the biggest relative decline. Second, we relate this to what happened in the 2000-2009 period, assigning the best score to the country which made the biggest shift from an above-average cumulative rise in unit labour costs in the earlier period to an above-average decrease thereafter. Third, we repeat the exercise for nominal unit labour costs. We then derive an overall score and ranking by combining these components.

Overall, seven results stand out:

1. On a seven-year view, wage pressures have converged within the **eurozone**: most of the euro members with excessive wage increases until 2009 have gone through a big correction. Under the pressure of record unemployment and the lagging impact of a deep adjustment crisis that lasted until 2013, the five countries that had to ask taxpayers elsewhere for help have slashed their labour costs the most. **Ireland** (No. 1) tops the ranking for labour cost adjustment ahead of **Greece** (No. 2), **Cyprus** (No. 3), **Spain** (No. 4) and **Portugal** (No. 5). This by and large confirms the results we had found in previous editions of *The Euro Plus Monitor*.
2. Conversely, nominal unit labour costs have risen significantly in many core countries such as **Germany** (No. 27), **Austria** (No. 25), **France** (No. 22) and **Belgium** (No. 16) during the last seven years. For Germany and to a lesser extent Austria, it makes sense to be close to the bottom of the European league table as their labour markets are comparatively healthy. For France and Belgium, the low scores are more problematic.
3. The process of labour cost convergence seems to have slowed down in the last two years, though. Instead of the clear core versus periphery split that had been apparent until 2014, the picture has become more nuanced. Whereas the scores for **Ireland, Cyprus, Spain and Portugal** remain almost unchanged in 2016, Greece falls back slightly in 2016 relative to its 2015 score. Greece's real and nominal wages rebounded slightly in 2016.
4. Reflecting the good health of the **German labour market**, Germany's wage gains outpaced those in most other Western European countries in our sample with a cumulative increase in German nominal labour costs of 3.3% in the last two years, well ahead of 1.2% average for the **eurozone**.
5. The **French labour market** has still not responded adequately to the challenge of globalisation. As a result of excessive labour costs, French unemployment – at 9.6% in the second quarter of 2017 – remains stubbornly high. Fortunately, France is at least taking some steps in the right direction. Taking the last two years together, that is comparing 2016 with 2014, French nominal unit labour costs rose by merely 0.9%, below the 1.2% cumulative increase for the eurozone. However, this did not suffice to raise the French score for overall labour cost adjustment since 2009 which, at 1.6, remains well below the 2.5 average for the currency area as a whole. France still has a long way to go towards a well-functioning labour market.
6. Unlike France, **Italy** (No. 13) did not manage to correct its labour cost disadvantage relative to the eurozone in the last two years as its cumulative increase in nominal labour costs for the last two years matched the eurozone result of 1.2%.
7. Having been among the star performers until 2014, **Estonia** (No. 9), and **Latvia** (No. 11, down from No. 8) continue to fall back with a drop in their scores by 0.7 points and 1.4 points, respectively. They are joined by **Lithuania** (No. 17), whose score for 2016 is a full 1.5 points below the score it would have achieved on the basis of its 2009-2015 performance. To a certain extent, this makes sense. The three small, open economies on the Baltic Sea successfully concluded their own post-bubble adjustment process two years ago. As they started to relax the reins somewhat since 2014, they are falling behind in the adjustment ranking, including for labour costs. Nonetheless, these countries may soon need to be more careful again. They should avoid a relapse into the excesses of the previous boom - which then had to be corrected by a bust.

Romania (No. 8), **Hungary** (No. 19) and **Poland** (No. 26) look similar to the three Baltic countries in one key respect: although their nominal unit labour costs have risen much faster than the eurozone average since 2009, they nonetheless managed to reduce their real unit labour costs. This is a typical feature of catching-up economies as described by the Balassa-Samuelson theorem. From a low starting level, prices for non-tradable goods tend to rise faster in catching-up economies than in more developed economies. As long as these catching-up economies maintain a competitive edge in tradable goods, usually by productivity gains in this sector in line with the overall rise in wages, the resulting gap between higher overall inflation in the catching-up economies and more subdued

'Bulgaria is the only country with a major increase in real unit labour costs since 2009.'

inflation in the more mature economies is a by-product of development rather than a concern.

To gauge whether these countries have lost competitiveness, we need to look at their export performance. Reassuringly, the three Baltic countries – **Latvia** (No. 1), **Estonia** (No. 6) and **Lithuania** (No. 8) for external adjustment (see Table 2 on page 7) – as well as **Romania** (No. 9) rank among the top 10 for external adjustment, with **Hungary** following as No. 11 and **Poland** as No. 17. However, the significant slippage in the ranking for **Lithuania** (No. 8, down from No. 3) suggests that the country may not be able to afford its above-average wage dynamics for much longer.

On labour cost adjustment, **Bulgaria** (No. 28) graces the bottom of the league table, just below **Germany** (No. 27), **Poland** (No. 26), **Austria** (No. 25) and **Sweden** (No. 24). Bulgaria is the only country we survey with a major increase in real unit labour costs since 2009. Its cumulative increase in real unit labour costs of 15.2% since 2009 makes it an outlier in this category. Nonetheless, Bulgaria managed to raise its exports so substantially over this period that it comes in at No. 2 in the external adjustment ranking. So far, we need not be concerned about a potential loss in Bulgaria's competitiveness.

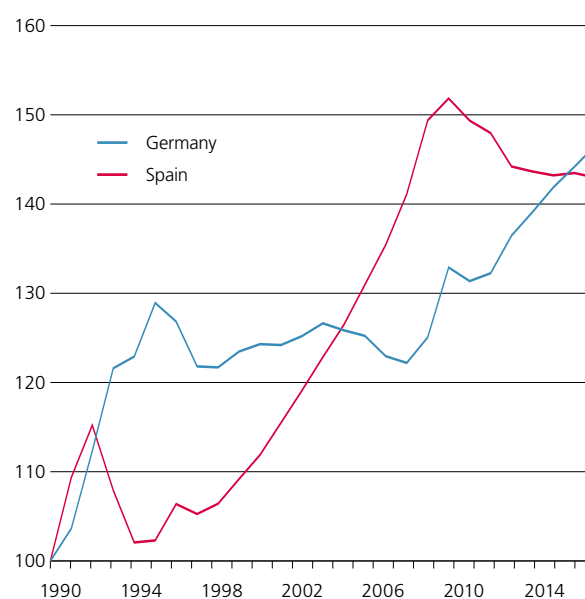
The results are less reassuring for the **United Kingdom**. In the overall ranking for labour cost adjustment, the United Kingdom falls back to No. 18, down from No. 17, largely because its rise in nominal unit labour costs of 2.4% in 2016 outpaced that of the **eurozone** (+0.9%). Unlike Poland, the Baltics and the emerging markets of South-East Europe, the United Kingdom is close to the cutting edge of economic development rather than a catching-up country. The United Kingdom cannot count on above-average productivity gains in export-oriented industries to offset wage cost pressures. Instead, the combination of labour cost competitiveness slippage with a very low score for external adjustment, where the United Kingdom ranks No. 25 out of the 28 current members of the European Union, does not bode well for the United Kingdom's competitive position in the future.

Of course, the 16% decline in the sterling exchange rate after the vote to leave the European Union on 23 June 2016 will probably help, at least to the extent that it is not eroded over time by a resulting rise in wage and price inflation. But for a country that needs to do more rather than less to improve its competitive position, a decision to put access to its dominant export market at risk looks somewhat foolhardy.

A comparison of the changes in nominal unit labour costs in **Germany** and **Spain** brings out the return to a better balance within the eurozone (see Chart 7). After serious swings in their relative competitive positions in the past, both countries are now good places for job-creating inward investment. In the wake of the German unification boom, labour costs surged across much of Europe. After Spain devalued the peseta in various steps from September 1992 to March 1995, the temporary boost to its competitive position allowed the country to outgrow Germany by a wide margin. But through wage restraint enforced by mounting unemployment and serious labour market reforms, Germany restored its competitive position over time while Spain became careless in its credit-driven heyday until 2007. With German wage costs rebounding on the back of virtual full employment and Spanish workers forced to tighten their belts, the relative position of Spain versus Germany is now back where it was some 25 years ago. Looking ahead, a simple extrapolation of trends would suggest that German workers need to take care not to allow themselves too much of a party. Otherwise, German employment gains may be much less spectacular in a few years' time than they have been since 2006.

Chart 7. Back to Balance

Nominal Unit Labour Costs Germany versus Spain, 1990=100



Source: European Commission

'Pro-growth structural reforms ultimately matter more than austerity.'

Reform Drive

Table 7. Reform Drive 2009-2016

Rank		Country	Score	Change	OECD reform responsiveness indicator		
2016	2015				Average 2010-2016	2015/2016	Average 2010-2014
1	1	Greece	7.7	0.0	0.64	0.40	0.78
2	5	Estonia	6.1	0.5	0.52	0.36	0.60
3	4	Ireland	6.1	0.1	0.51	0.36	0.59
4	2	Spain	5.6	-0.9	0.47	0.30	0.56
5	3	Portugal	5.4	-0.8	0.46	0.17	0.61
6	9	Austria	5.2	0.9	0.44	0.50	0.40
7	13	France	4.8	0.8	0.41	0.57	0.32
8	6	Poland	4.5	-0.8	0.37	0.19	0.48
9	10	Slovakia	4.3	0.1	0.37	0.21	0.45
10	7	Italy	4.3	-0.6	0.36	0.36	0.36
11	12	United Kingdom	4.2	0.1	0.36	0.21	0.43
		Euro 19	4.2	0.3	0.35	0.39	0.34
12	8	Czech Republic	4.1	-0.6	0.34	0.36	0.32
13	15	Finland	3.8	-0.1	0.32	0.21	0.38
14	18	Netherlands	3.6	0.5	0.30	0.33	0.29
15	19	Belgium	3.5	0.9	0.29	0.50	0.18
16	11	Hungary	3.4	-0.9	0.28	0.25	0.37
17	14	Denmark	3.3	-0.7	0.28	0.33	0.42
18	20	Germany	3.2	0.8	0.27	0.33	0.23
19	17	Sweden	2.8	-0.3	0.24	0.25	0.23
20	16	Slovenia	2.3	-1.1	0.19	0.08	0.30
21	21	Luxembourg	1.6	0.2	0.13	0.17	0.12
		Latvia	n.a.	n.a.	n.a.	0.67	n.a.
		Cyprus	n.a.	n.a.	n.a.	n.a.	n.a.
		Malta	n.a.	n.a.	n.a.	n.a.	n.a.
		Lithuania	n.a.	n.a.	n.a.	n.a.	n.a.
		Bulgaria	n.a.	n.a.	n.a.	n.a.	n.a.
		Croatia	n.a.	n.a.	n.a.	n.a.	n.a.
		Romania	n.a.	n.a.	n.a.	n.a.	n.a.

Ranks, score and score changes for the reform drive indicator. The values given for the OECD reform responsiveness indicator refer to the average results from the OECD's Going for Growth data for 2010, 2011/2012 and 2013/2014 combined (last column) and 2015/2016 (second last column). The 2010-2016 aggregate is a weighted average with 2015/2016 given a weight of 35% (17.5% per year) versus 65% for the five years before (13% per year). The change in score refers to the change from the assessment for the 6-year period 2010-2015 presented in The 2016 Euro Plus Monitor. Source: OECD, Berenberg calculations. For further explanations see notes under Table 1 on page 2 and the Notes on Key Components on page 63 of The 2016 Euro Plus Monitor.

To seize the opportunities of globalisation and rapid technological change, countries need to adjust. In addition, countries that have lived beyond their means also need to tighten their belts. But squeezing domestic demand, slashing labour costs and raising exports are only part of the solution. To make their fiscal positions sustainable in the long run without excessive pain, countries need to raise their long-term growth potential. In short, they need pro-growth structural reforms.

Crises are handmaidens of change. Under the pressure of crisis, governments at the euro periphery have taken many steps to make their economies leaner and fitter for growth. They have reformed labour markets, cut pension and other welfare entitlements, streamlined administrative procedures and deregulated product markets. While the benefits of such reforms only show up with a lag, typically only when the initial adjustment recession has given way to a new upswing, such reforms ultimately matter more than the initial readiness to rein in excesses in public or private spending.

'The pace of reforms quickened significantly in France in 2015/2016.'

To measure how much countries have done, we employ the expertise of the OECD: the OECD regularly identifies five priority areas for reform for most of its member countries. In each of these areas, it makes a number of concrete recommendations and subsequently measures whether these were followed up (Score 1) or not (Score 0) with a full assessment every two years and an interim assessment in between. For *The Euro Plus Monitor September 2017 Update*, we use the data for four two-years periods, 2009/2010, 2011/2012, 2013/2014 and 2015/2016. The latest data are taken from *Going for Growth: Policies for Growth to Benefit All*, the OECD's March 2017 report, with the cut-off date 31 December 2016.

The OECD data reveal some dramatic changes for the 2015/2016 assessment period relative to the average for the 2010-2014 period. Having overcome the erstwhile euro crisis, the **eurozone** has entered a new stage. On the negative side, the countries that had been the focus of the euro crisis implemented far fewer structural reforms in the last two years than they had done in the years before. As Chart 1 on page 1 shows, the rapid pace of change in the 2010-2012 period when they had little choice but to do what it took to qualify for external help continued to decelerate further in the last two years, adding to the significant slippage that had become visible in the 2013/2014 period already. The contrast between major reforms early on and the much more leisurely pace of additional reforms in 2015/2016 is especially stark for **Portugal** where a new left-leaning government maintained fiscal discipline but rolled back some structural reforms. The drop is also quite pronounced for **Greece, Spain** and – to a lesser extent – for **Ireland**. For Spain and Ireland, we are not very concerned about the fact that they have become much less responsive to reform recommendations. Although more needs to be done, the countries have advanced so far that they can afford a slower pace of change as long as they do not reverse their previous reforms. For the much more challenged economy of Greece and, to some extent, also for Portugal, the slackening of structural reform progress looks dangerous (Greece) or at least premature (Portugal).

On the positive side, the pace of reforms quickened significantly in **France** in 2015/2016. Following up on 57% of the OECD recommendations, France reached the best value for any OECD country bar tiny **Latvia** (67%) in this period. Under Economy Minister Emmanuel Macron and Labour Minister Myriam El Khomri, France finally turned itself into a reform leader in Europe.

Italy did not live up to the hopes which Matteo Renzi had initially raised as prime minister. In line with the average

for 2010-2014, Italy heeded 36% of the OECD reform recommendations in the 2015/2016 period. The result is far worse than an OECD interim assessment for 2015 had suggested early last year with a stellar 55% for 2014/2015. Having managed to implement a significant labour market reform and some other changes in 2015, Renzi apparently did not get much done in 2016 as political headwinds gathered pace that finally cost him his job as prime minister after he lost a referendum on streamlining Italy's electoral system in December 2016. While Italy remained close to the eurozone average for 2015/2016, an average pace of reform is not good enough for a country with above-average structural problems.

Within the **eurozone**, we find some significant progress in two smaller countries that we admonished in the past for insufficient adjustment progress. **Belgium** and **Austria** implemented far more structural reforms in the last two years than they had before. In 2015/2016, both countries followed up on half the OECD's reform recommendations. The change is especially pronounced for Belgium, which had been among the major reform laggards before.

Pre-occupied with its Brexit discussion and suffering from a serious bout of reform fatigue, the **United Kingdom** implemented only 21% of OECD reform recommendations in the last two years, well below the 43% average for the 2010-2014 period. Having been above the eurozone average, the United Kingdom has now fallen into the bottom third of the reform league.

Beyond the cases discussed above, countries with a major loss of reform momentum in the 2015/2016 period are **Estonia, Poland, Slovakia, Slovenia, Finland** and – to a lesser extent – **Hungary**. For Estonia, which had reformed itself thoroughly and successfully in the wake of the Baltic crisis 10 years ago, this may be understandable. For Poland, Slovenia, Slovakia and Finland, however, we view this as a sign of complacency. Especially Finland, which is currently one of the weakest members of the eurozone, ought to do much better to get back on track.

For the overall assessment of reform progress since 2010, we take the weighted average of all reform efforts of the last seven years, giving slightly more weight to the 2015/2016 period than to the years before. Because the erstwhile euro-crisis countries did reform at such a rapid pace from 2010 to 2014, they stay at or close to the top in the reform league. However, the scores for Spain and Portugal drop significantly relative to the ones we published at the end of 2016 based on an analysis for the 2010-2015 period. The scores do not decline for Greece and Ireland because the sharp slowdown in their reform progress had already been

'Encouragingly, Austria, The Netherlands and Belgium move up in the rankings.'

fully captured in the OECD's assessment for 2014/2015, which we discussed in **The 2016 Euro Plus Monitor** last December. **Greece** (No. 1) maintains the top spot ahead of the Baltic star **Estonia** (No. 2) followed by **Ireland** (No. 3), **Spain** (No. 4) and **Portugal** (No. 5).

Some comparatively healthy core eurozone countries which need few reforms feature at the bottom of the table with

Germany at No. 18 and **Luxembourg** at the bottom at No. 21. Encouragingly, **Austria** (No. 6), **The Netherlands** (No. 14) and **Belgium** (No. 15) move up significantly in the rankings. All in all, the pace of reforms quickened slightly in the eurozone as a whole as progress in France, Belgium, Austria and the Netherlands more than offset the slippage in some other member countries.

'Two cheers for the Macron agenda. In real life, reforms do not need to be perfect.'

Focus: Can France Overtake Germany?

Over the last seven decades, Germany and France have taken their turns at the top. (West) Germany enjoyed its post-war economic miracle in the 1950s before France caught up in the 1960s and 1970s. Following a German rebound after 1985, Germany became “the sick man of Europe” from 1995 to 2005 while France moved ahead. Thanks to its *Agenda 2010* reforms of 2003/2004, Germany is now enjoying the golden decade we predicted in 2011 while France is showing the first signs of escaping its self-inflicted misery.

For Germany, the outlook is clear: it cannot get much better than it is. In the December 2016 Fundamental Health Indicator from *The 2016 Euro Plus Monitor*, Germany still excelled with a No. 4 position. However, success breeds complacency. We expect Germany to lose its edge and fall back to the middle of the European growth league in the next decade, paying the price for its slow-motion reform reversals. Germany's consistently low rankings in the Adjustment Progress Indicator since 2011, including its No. 26 position in *The Euro Plus Monitor September 2017 Update*, suggest that the process is well under way. We do not expect major changes after the German election on 24 September. Instead, France looks likely to advance from close to the bottom to near the top of the European growth league if Macron builds on recent French progress and delivers the reforms in his election campaign.

Two cheers for the Macron agenda

After months of consultations, the French government presented the details of President Emmanuel Macron's most important endeavour, labour market reforms, on 31 August 2017. The 36 measures are roughly in line with the ideas President Macron had outlined in his election campaign. They are far from perfect. The French labour market will still fall short of the flexibility that many economists deem optimal. Additional flexibility for firms with more than 50 workers to bargain with their own workers instead of being bound by sector-wide agreements would have helped. We thus give only two rather than three cheers for the reforms. But does that mean that they will not yield the desired results?

In real life, reforms do not need to be perfect: When Germany unveiled its *Agenda 2010* reforms 14 years ago, we greeted the measures with two rather than three cheers. For example, Berlin allowed companies to circumvent rigid dismissal rules by making free use of temporary labour rather than relaxing the dismissal rules outright. Nonetheless, the imperfect reforms worked rather well. As Chart 8 on page 22 shows, the German labour market

embarked on an almost miraculous rebound shortly thereafter. Germany's current economic strength stems from this reform-based surge in employment.

The French reforms will give companies significantly more flexibility to strike deals with their own workers on many workplace and some pay issues. They will streamline dismissal procedures, cap the damages that courts can award for unfair dismissal and make it much easier for multinational companies to slim down their French workforce if their French operations are struggling even if they are doing well on the global level.

Inspired by the Scandinavian concept of “flexicurity” and the German model of influential “*Betriebsräte*” (workers councils), Macron is trying to change French labour relations from head-on confrontation to a culture of co-operation between unions and employers in general, and between companies and their workers on the shop floor in particular.

Is France unreformable? Not at all

But isn't France different, suffering from specific traits that make it unreformable? We often hear that argument. History suggests otherwise. Change happens. If things can't go on, they won't. In the 1970s, the United Kingdom seemed to be the unreformable country, scarred by the shock of having lost an empire and unable to shake off the yoke of particularly bolshie trade unions. Then came Margaret Thatcher. After 1994, Germany seemed to be blighted by a permanent “*Reformstau*,” unable to change because its federal structure decentralises power to such an extent that a turnaround would be impossible as the two separate houses of parliament with their different majorities always blocked each other. Then came Gerhard Schröder, who struck a deal with then-opposition leader Angela Merkel to get serious reforms through both houses of parliament. We could lengthen that list.

Sufficient tailwinds for success

The European and global backdrop is quite encouraging. The global economy is enjoying a synchronised upturn even if it lacks the characteristics of a genuine boom. More importantly, domestic demand in France's major trading partner, Germany, is expanding at a healthy pace. Of course, Germany benefited after its 2004 reforms from the rise of China with its near-insatiable appetite for German machine tools and cars. But as China is progressing from investment-led to service-led growth, France could now be a major beneficiary of China's growing appetite for the best consumer and luxury goods in the world. France (and Italy) have the brands that consumers crave. In addition,

'France can turn into Europe's economic powerhouse in the 2020s – if it reforms itself.'

**Chart 8. The Blueprint for France:
Germany's Post-Reform Turnaround**

German core employment in millions



German core employment: subject to full social security contributions.
Sources: Bundesagentur für Arbeit, Bundesbank

the accident of Brexit gives France an opportunity to kindle the interest of global businesses looking for an alternative basis to serve the European common market.

Mind the difference

However, we see one major difference between France now and Germany in 2003. Unlike Germany, France now has to reform itself in the wake of the highly disruptive financial crisis of 2008/09 and the euro crisis of 2011/12. Partly because of costs of these crises, irresponsible Le Pen- and Melenchon-style populists are already riding high in opinion polls in the early stages of the unsettling reform process. Such populists barely existed in Germany at the start of *Agenda 2010* in 2003. As a result, France can't afford to get it wrong. Otherwise, Le Pen or an equally dangerous Varoufakis look-alike on the political left could take over at the next election in 2022.

The 2020s: A golden decade for France?

Life is always full of risks. However, chances are that France will deliver an imperfect but still sufficient package of reforms soon, such as the labour market reform presented by the government on 31 August 2017. If so, France can turn into the continent's economic powerhouse in the next decade, outclassing a Germany that looks set to lose its current advantage as it has virtually stopped reforming itself. France has innate advantages including a first-class infrastructure and a highly competent public service. With its high birth rate, France could even achieve a trend rate of growth above Germany's current 1.6% pace over time. After Germany's golden decade now, it could be France's turn again in the 2020s.

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