

POLICY PAPER

Growth and Adjustment Challenges for the Euro Area

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Abstract: This paper reviews the growth record of the member countries of the euro area and assesses the outlook for future economic performance. We describe how the external and fiscal adjustment challenges facing the euro periphery amplify the growth risks facing these countries. We address how growth prospects can be improved by shifts in the macroeconomic policy mix, carefully-timed structural reforms, debt restructuring and the resolution of the existential crisis facing the euro area.

I INTRODUCTION

Boosting per-capita output levels has been a long-standing policy objective for the European Union, as expressed in the “Lisbon Agenda” (2000-2010) and the “Europe 2020” (2010-2020) growth strategies promoted by the European Commission.

At the aggregate level, the policy discourse has focused on the gap between EU and US living standards. However, much attention has also been paid to the dispersion in output levels across the EU. One area of particular concern has been the persistence of the gap in output per capita between “Northern Europe” and “Southern Europe” (Portugal, Spain, Italy and Greece).¹

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¹ While Ireland was historically classified with the latter group in terms of lagging per capita output levels, its rapid growth during the 1990s saw it “graduate” from this group. We do not address the catch-up challenge facing Central and Eastern Europe in this paper.

Table 1: *Output Growth Rates*

	<i>1995-2002</i>	<i>2003-2007</i>	<i>2008-2012</i>	<i>2013-2018</i>
Germany	1.6	1.7	0.7	1.2
France	2.3	2.0	0.0	1.3
Italy	1.8	1.3	-1.4	0.7
Spain	3.9	3.5	-0.8	0.8
Portugal	3.3	1.0	-1.1	0.9
Greece	3.4	4.3	-4.4	1.6
Ireland	9.0	5.0	-1.2	2.4
Euro Area	2.4	2.2	-0.2	1.2
USA	3.4	2.7	0.6	3.0

Source: World Economic Outlook April 2013 Edition. Average annual percentage changes in real GDP.

During the pre-crisis period, this growth debate had little impact on policy choices. As is shown in Table 1, the euro periphery mainly enjoyed high growth rates during the “EMU entry” phase (1995-2002). While Portugal stagnated during 2003-2007, the other peripheral countries continued to do well in terms of overall GDP growth (as did the overall euro area), so that there was considerable policy complacency.² However, Italy grew slowly throughout this period. Table 1 also shows that the euro periphery has endured a major growth reversal over 2008-2012, which is further compounded by pessimism about short-term recovery prospects over 2013-2018 (according to IMF projections).³

Furthermore, the estimates of output gaps that are reported in Table 2 indicate that the growth reversal since 2008 has a permanent component, which reflects the ex-post assessment that the euro periphery was operating far in excess of potential output before the crisis. Still, it is also recognised that the correction has overshot, with substantial negative output gaps for these countries in 2012.

Table 3 shows that the sharp deterioration in growth performance has been accompanied by a dramatic increase in unemployment rates in the euro periphery. These are projected to remain far above pre-crisis levels out to 2017. Finally, Table 4 shows the evolution of GDP per capita levels in PPP-adjusted terms (expressed as ratios to the German level).⁴ Each of the euro periphery countries is projected to experience a “lost decade” over 2008-2018, with substantial declines in relative GDP per capita.

² See also Blanchard (2007a) on the Portuguese case.

³ This pessimism is reinforced by the historical evidence on slow recovery from financial crises presented in Reinhart and Rogoff (2009).

⁴ The level of Irish GDP per capita is a misleading indicator of domestic living standards, since net investment income outflows are significant (mainly the profits of US multinationals that have significant operations in Ireland), so that gross national income is over 20 per cent below gross domestic product.

Table 2: *Output Gaps*

	2007	2012
Germany	2.7	0.1
France	0.7	-3.1
Italy	3.1	-3.4
Spain	3.8	-4.5
Portugal	1.9	-3.9
Greece	10.0	-7.7
Ireland	6.5	-1.8
Euro Area	2.8	-2.2
USA	0.3	-4.3

Source: *World Economic Outlook* April 2013 Edition. Output gap expressed as a percentage of potential GDP.

Table 3: *Unemployment Rates*

	2007	2012	2018
Germany	8.8	5.5	5.6
France	8.4	10.2	10.4
Italy	6.1	10.6	9.8
Spain	8.3	25.0	22.9
Portugal	8.0	15.7	16.3
Greece	8.3	24.2	16.2
Ireland	4.7	14.7	10.4
Euro Area	7.6	11.4	10.5
USA	4.6	8.1	5.6

Source: *World Economic Outlook* April 2013 Edition.

Table 4: *GDP Per Capita Levels (Ratios to German Levels)*

	1995	2002	2007	2012	2018
France	96.9	99.8	97.1	91.1	88.0
Italy	93.9	95.4	88.7	77.2	73.1
Spain	78.0	87.8	87.4	78.3	76.7
Portugal	63.5	70.5	65.7	59.9	57.8
Greece	68.6	76.3	83.1	62.8	64.1
Ireland	79.9	120.8	124.4	107.4	108.7
Euro Area	91.4	95.1	93.7	87.4	85.5
USA	126.3	134.5	134.4	127.9	133.2

Source: *World Economic Outlook* April 2013 Edition. PPP adjusted GDP per Capita expressed as a ratio to German Level.

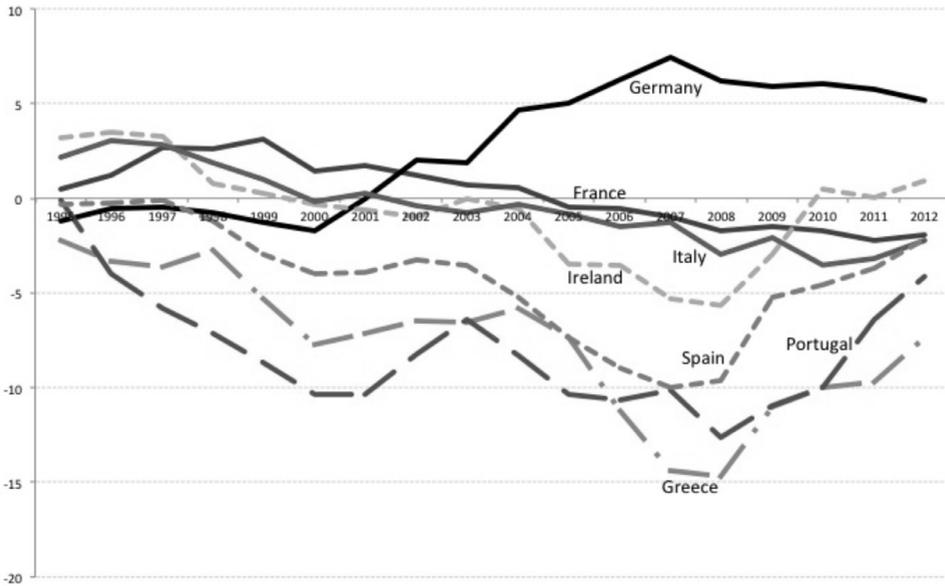
In terms of identifying the sources of these wide differences in output per capita, the gap between Northern Europe and the USA can be mainly attributed to differences in labour utilisation rates, while the still-lower levels in Southern Europe reflect lower labour productivity rates (Allard *et al.*, 2010; Gill and Raiser, 2012). In fact, labour productivity growth was negative in Southern Europe during the 2002-2009 period, which reflects the reallocation of workers towards lower-productivity sectors (construction, nontraded sector) and away from the higher-productivity manufacturing sector.

The output path for Southern Europe has also been influenced by structural challenges during the first decade of the euro (Lane, 2006; Chen *et al.*, 2013). Within Europe, Central and Eastern Europe became increasingly important as a rival in the production of manufacturing good and in the contest for the location of multinational firms. At a global level, the rise of China and emerging Asia in the production of low-tech and medium-tech goods was problematic for those industries in Southern Europe that produced similar goods that progressively lost market share in historically-important manufacturing sectors. At the same time, firms in the euro area had to adjust to the sustained appreciation of the euro against external trading partners over 2000-2008 (the trough-to-peak appreciation of the nominal effective exchange rate was 40.8 per cent).

These adverse shocks were partially masked by the large current account deficits run by the euro periphery, with the notable exception of Italy (see also Lane 2013). Figure 1 shows the evolution of current account balances over 1995-2012, while Figure 2 shows net foreign asset positions over 1995-2011. It is striking that the scale of external imbalances sharply increased during 2003-2008, such that these imbalances cannot be simply attributed to a euro entry effect. As is shown in Figure 2, the counterpart to the persistent current account deficits has been the accumulation of large net external liability positions.

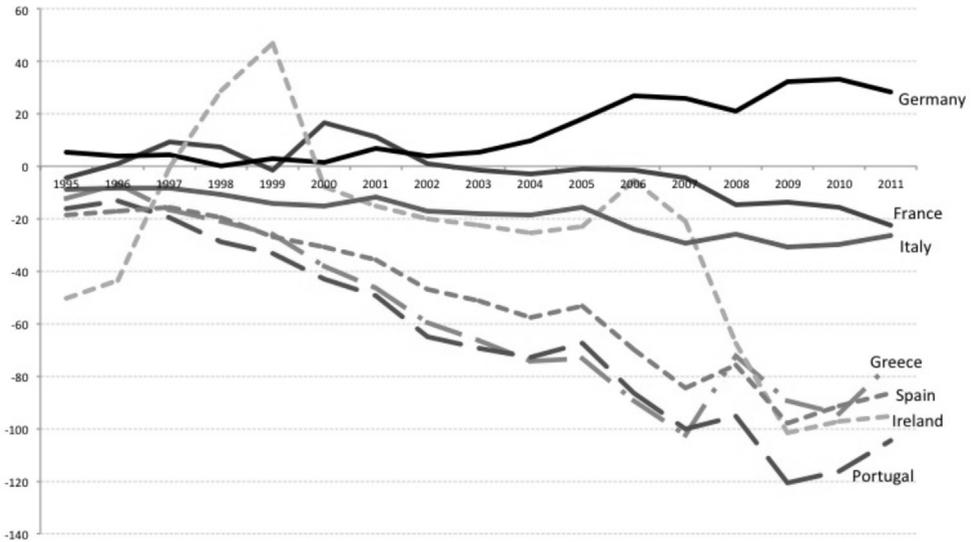
By financing domestic expenditure levels in excess of output levels, these high deficits supported living standards and boosted activity levels in the nontraded sector (see also Blanchard, 2007b). In associated fashion, there was a strong correlation between international debt inflows and domestic credit growth and the construction sector grew rapidly in Greece, Ireland and Spain between 2003-2008 (Lane and Pels, 2012; Lane and McQuade, 2013). Since international debt inflows were primarily intermediated through domestic banking systems, the rapid increase in bank lending and increased reliance on cross-border wholesale funding increase the vulnerability of peripheral banking systems to negative shocks (CIEPR, 2012).

Figure 1: *Current Account Balances, 1995-2012*



Source: IMF *World Economic Outlook* Database (April 2013).

Figure 2: *Net Foreign Asset Positions, 1995-2011*



Source: Updated version of “External Wealth of Nations” dataset described in Lane and Milesi-Ferretti (2007).

Moreover, it is plausible that high capital inflows adversely affected productivity growth through several channels. First, the increased concentration of economic activity in the nontraded sector was a negative development in terms of building the export capacity that would be required to service the external liabilities accumulated (Blanchard, 2007b; Giavazzi and Spaventa, 2011; Benigno and Fornaro, 2013; Lane, 2013a and Lane 2013b). Second, the easier domestic credit conditions made possible by capital inflows facilitated the survival of low-productivity incumbent firms (in a setting of financial system underdevelopment), thereby inhibiting the potential productivity gains from the reallocation of resources from low-productivity firms to high-productivity rivals (Reis, 2013). Third, the high levels of domestic activity funded by capital inflows weakened the political support for structural reforms, both in terms of muddying the diagnosis of the underlying growth prospects of the high-deficit countries and the incentives to engage in reform efforts (Fernandez-Villaverde *et al.*, 2013).

Since 2008, current account imbalances have narrowed. The cross-country evidence is that external adjustment has primarily taken the form of “expenditure reduction” rather than “expenditure switching” (Lane and Milesi-Ferretti, 2012).

Accordingly, external adjustment has contributed to the negative growth performance in the high-deficit euro member countries, even if the severity of the process has been partially buffered by the replacement of private-sector capital with ECB liquidity inflows and EU-IMF official funding.⁵ Moreover, since domestic expenditure has declined by even more than domestic output, the adverse welfare impact of the recession has been especially strong in relation to the scale of the decline in household consumption. In related fashion, the labour-intensive nature of the construction and nontraded sectors relative to the export sector has meant that the employment effect of the current recession has been unusually large since sectors dependent on domestic spending have experienced the greatest declines in activity.

Despite the decline in current account deficits, net external liability positions remain very negative for the euro periphery, with the exception of

⁵ The scale of adjustment was larger in the Baltic economies, which did not have access to ECB liquidity facilities. In the absence of a well-specified counterfactual, it is not easy to assess the quantitative impact of ECB liquidity flows on the scale of current account adjustment. In particular, ECB liquidity facilities also accommodated a shift in the nature of gross flows, with national central banks acting as *de facto* intermediaries in facilitating cross-border financial transactions. See also Auer (2013) and Whelan (2013).

Italy.⁶ All else being equal, this indicates that these countries are set to run persistent trade surpluses in the coming years, which will require real exchange rate depreciation in order to reconcile external surpluses with full employment.

Furthermore, the requirement for real exchange rate adjustment to facilitate external rebalancing is a drag on prospects for nominal GDP growth. While trade-weighted real exchange rate adjustment depends heavily on the movement in the external value of the euro against other currencies, the balance can only be achieved by differential price and wage adjustment across the member countries. In this way, wages and prices are set to grow more slowly in the debtor countries than in the creditor countries inside the euro area.⁷ In view of the high levels of downward wage and price rigidities, this is likely to mainly take the form of a sustained period of inflation rates below the euro area average, rather than outright deflation. In the absence of a major depreciation in the external value of the euro, the implication of a slow pace of wage and price adjustment is downward pressure on activity levels.

Furthermore, the path for nominal GDP is especially important for debt sustainability assessments, since debt contracts are predominantly nominal in form with little indexation to developments in national price or wage indices. Furthermore, the expectation of lower national inflation rates in the debtor countries acts to raise the effective real interest rate, which adds to negative profile for domestic demand.⁸

Table 5 shows that there has been some adjustment in relative price levels since 2008. However, these are relatively modest compared to the discrete step changes that can be achieved through large nominal devaluations and are only weakly correlated with the initial scale of external imbalances.⁹

⁶ Although the current account deficits in Ireland were considerably smaller than in Greece, Portugal and Spain, sizeable “net other adjustments” from 2008 onwards has resulted in a very large decline in its net external liability position. Although measurement errors and the unrecorded acquisition of foreign assets (private-sector capital flight) mean that the decline may be overstated, it is also true that the “long foreign equity, short foreign debt” profile of domestic banks, property developers and households (via pension funds) meant that genuine valuation losses were also considerable during this period (Lane, 2012a).

⁷ Of course, the required shift in real exchange rates also depends on relative productivity differentials.

⁸ This is just a manifestation of the “Walters Critique.” The same mechanism amplified the demand boom in the high-deficit countries during the pre-crisis period, since persistently high national inflation rates were associated with lower expected real interest rates.

⁹ The significant deflation in the Irish GDP deflator is mainly driven by a large decline in the investment price deflator, with tender prices for construction projects sharply lower than during the boom period. A contributory factor to the decline in the Irish HICP index has been the depreciation of sterling against the euro, since imports from the UK constitute a significant proportion of the Irish consumption basket. See also Lane (2013).

Table 5: *Real Exchange Rate Adjustment, 2007 Q4 to 2012 Q2*

	<i>CAB</i>	<i>EA17 HICP</i>	<i>PGDP</i>	<i>N=36 HICP</i>	<i>PGDP</i>
Austria	3.5	1.0	0.1	-2.2	-1.1
Belgium	1.6	2.7	0.2	-0.4	-0.2
Finland	4.3	3.7	0.2	-1.1	-1.0
France	-1.0	-0.7	0.03	-4.6	-3.7
Germany	7.5	-2.5	-0.1	-6.4	-6.1
Greece	-14.6	3.8	0.2	1.6	0.1
Ireland	-5.4	-7.2	-0.6	-11.0	-16.8
Italy	-1.2	2.4	0.1	-1.9	-2.6
Luxembourg	10.1	2.9	0.4	1.2	6.0
Netherlands	6.7	0.1	-0.04	-2.1	-3.3
Portugal	-10.1	-0.5	-0.1	-2.6	-3.5
Spain	-10.0	0.4	-0.1	-1.8	-4.0
Correlations		0.08	0.35	0.005	0.29

Note: 2007 current account balance. Real effective exchange rates based on HICP and GDP deflators. Correlations refer to correlation between change in real exchange rate and the 2007 current account balance.

Source: Lane (2013), based on European Commission's Price and Cost Competitiveness Database.

A further contributory factor in the negative prospects for domestic total GDP growth in the debtor countries is the greater scope of net migration outflows relative to previous downturns.¹⁰ In Ireland and Spain, there was considerable net immigration during the pre-crisis period, with a remarkable rate of immigration from Poland and Lithuania into Ireland after 2004 and Latin America an important source for Spain.¹¹

For recently-arrived immigrant workers with low attachment to the domestic economy, a natural response to low growth prospects is to leave again. For domestic workers, the right to work in any EU country provides an alternative to remaining in the home economy. Furthermore, there are strong migration networks with non-EU countries (Latin America for Portugal and Spain; Portuguese-speaking Africa for Portugal; Canada, Australia and the United Kingdom are especially important for Ireland).

¹⁰ Migration flows have the potential to make national adjustment inside the euro area qualitatively more similar to regional adjustment inside the USA. Of course, language barriers and other frictions mean that it is unlikely to be as important a mechanism in Europe as in the US case.

¹¹ Ireland was the only euro area country to fully open its labour market to workers from the Central and Eastern European countries that joined the EU in 2004. (Outside the euro area, Sweden and the United Kingdom also adopted a liberal approach.)

In addition to the external adjustment challenge, high sectoral debt levels within the domestic economy also pose debt overhang problems. Table 6 shows the debt levels for the government and household sectors, with household debt levels especially high in Ireland, Portugal and Spain.¹²

Table 6: *Debt Liabilities in 2011*

	<i>Government</i>	<i>Households</i>
Germany	87.1	59.8
France	109.1	67.0
Italy	122.8	59.2
Spain	88.6	87.9
Portugal	113.7	102.4
Greece	105.7	66.5
Ireland	108.9	119.5

Note: Percentage of GDP.

Source: Eurostat, *Sectoral Financial Balance Sheets 2011*.

The empirical evidence indicates a pattern by which countries with high public debt levels typically achieve significantly lower output growth rates, even if the direction of causality is open to dispute and the specific mechanisms linking public debt and output growth have not been precisely identified in the empirical studies.¹³ It is also plausible that high levels of household debt adversely affects potential output by inhibiting labour supply, labour mobility and human capital accumulation, while also hurting aggregate demand by limiting consumption growth (Brown and Lane, 2011; IMF, 2012a).

Another contributory factor to gloomy growth projections is that the operation of hysteresis mechanisms mean that the current recession may have long-lasting effects on the level of output in the euro periphery. Labour market rigidities mean that high unemployment rates exert only limited pressure on wage adjustment (in effect, the ‘natural’ rate of unemployment may have increased), while lower investment rates in human capital and physical capital have long-run effects.

¹² The proper interpretation of household debt levels requires a full analysis of household balance sheets, since high household debt should be evaluated in the context of the level of financial assets and non-financial assets (including housing assets). See also Broadbent (2012).

¹³ Kumar and Woo (2010) and Reinhart *et al.* (2012) provide estimates of the negative pattern of covariation between high levels of public debt and growth. Panizza and Presbitero (2013) argue the causality runs from slow growth to high public debt.

Finally, it does not seem likely that the high level of uncertainty about the future structural underpinnings of the euro area will be resolved quickly. Beyond its adverse short-term effects on macro-financial stability, this uncertainty is also a deterrent to medium-term investment plans, such that it is a negative factor for the path of potential output.

II WHAT TO DO?

What policy actions might improve growth prospects? In this paper, I will not dwell on the over-riding issue of fixing the flaws in the intrinsic design of the monetary union. Rather, I mainly focus on country-level policy challenges, while also addressing the appropriate balance between national-level and European-level policy responses in specific areas.

We first cover the macroeconomic policy mix; next, we turn to structural reforms; finally, we address debt restructuring.

2.1 *The Macroeconomic Policy Mix*

In relation to the monetary environment, the low policy interest rate set by the ECB provides some support for the euro periphery. For instance, it is helpful for households with “tracker” mortgages that carry interest rates that are a fixed margin above the ECB policy rate.

However, at the same time, it is also clear that key monetary transmission mechanisms are currently broken. In particular, sovereign risk has raised funding costs for banks in the periphery, with existential doubts about the future of the euro further contributing to the fragmentation of the area-wide financial system.

The alleviation of such monetary/banking frictions would remove an important constraint on credit availability for these countries. This is recognised in the current ECB debate about the types of non-orthodox measures that might be deployed to address these obstacles to the effective transmission of monetary policy to all member countries.

In relation to national fiscal policies, it is clear that a nuanced message applies. For those countries that do not face current funding problems, a more accommodating short-term fiscal stance can support economic activity, which can be reconciled with making progress in reducing elevated public debt levels through the credible announcement of medium-term fiscal adjustment plans. Indeed, the framework of the EU Fiscal Compact Treaty provides support for such a fiscal strategy, since its focus on the structural fiscal balance and the gradual attainment of lower public debt ratios is fully consistent with activist short-term counter-cyclical fiscal policies.

For the euro periphery, the current dependence of some countries on official EU/IMF funding reflects the loss of market access due to high sovereign risk, with Spain and Italy facing a similar funding environment. Under these circumstances, the goal of returning to demonstrable fiscal sustainability over a limited time horizon has involved the implementation of austerity packages that have deepened the current recession for these countries.

The availability of official funding does provide some breathing space to spread fiscal adjustment over a multi-year horizon but the initial three-year plans were unrealistic in terms of an appropriate time frame, especially for countries that had to implement fiscal austerity within a fixed exchange rate environment and while also grappling with high levels of private-sector debt (Lane, 2012b). In addition, such packages run less risk of amplifying downturns if the scale of adjustment is specified in fixed terms, rather than as a ratio to current GDP. Again, such an approach that limits fiscal procyclicality would be more consistent with the EU Fiscal Compact Treaty.

The relation between fiscal adjustment and growth performance (in the short term and in the medium term) also depends on the design of austerity packages. While the basic split between tax-based and expenditure-based programmes is surely too crude to capture the growth properties of complex adjustment processes, the empirical evidence does suggest that an excessive reliance on tax increases (from already-high initial tax burdens) has a more negative impact on growth performance (Alesina and Ardagna, 2012; Alesina *et al.*, 2012).¹⁴

In general, there is also scope to improve the growth environment by reforming tax systems in the direction of reducing over-reliance on direct taxes on labour and capital by widening the tax base, eliminating “tax expenditures” and more widespread use of user fees for public services. Going further, the absence of the currency devaluation option means that there is a stronger case for time-varying tax rates than would normally apply under “tax smoothing” principles. For instance, the “fiscal devaluation” debate has identified that a revenue-neutral cut in payroll taxes that is financed by an increase in VAT can mimic some features of a currency devaluation (see Farhi *et al.*, 2012 for an academic treatment). However, large-scale fiscal devaluations are not likely, given the political resistance to major shifts in tax rates.

At a European level, greater coordination of fiscal positions across the member countries would enable the internalisation of cross-border fiscal

¹⁴ This does not rule out an important role for increasing taxes in countries with low revenue/GDP ratios, which can be accomplished by widening the tax base and improving collection and raising those tax rates that are least distorting.

spillovers and could help focus the attention of policymakers on the relation between the area-wide fiscal position and area-wide macroeconomic performance. However, no effective mechanism of fiscal coordination is currently in place. While there have been some moves to more effective deployment of the central EU budget to finance additional public investment projects in the euro periphery, the scale of the available resources mean that its impact is bound to be quite limited.

In these ways, the limited current scope of European-level fiscal resources stands in sharp contrast to the role of the federal budget in macroeconomic stabilisation in the USA. While the vision document produced by the European Commission (2012) proposes a somewhat-expanded common budget, it still envisages a quite limited role, with cross-border transfers occurring only in the event of cyclical asymmetric shocks, rather than long-term shocks.

Finally, a significant depreciation in the external value of the euro would also facilitate macroeconomic recovery in the euro area, given the importance of external trade for the individual member countries. At a global level, this would be facilitated by greater tolerance of currency appreciation among some of the countries running large current account surpluses.

2.2 Structural Reforms

As in other advanced economies, there is an ongoing debate in Europe as to the optimal policy mix to support long-term economic growth, especially in relation to topics such as human capital accumulation and measures to foster innovation and technological progress. In addition, there is a special focus on how further integration of the European economic area (for instance, with further liberalisation of services trade) might boost growth performance.

The contrast between Europe and the USA in relation to the regulation of labour and product markets also gives rise to the hope that closing the gap in terms of observable policy indicators (such as indices that track the regulation of the labour market and product markets) could help in promoting convergence in output levels. In general, the consensus view is that many European countries are far from the frontier in terms of the operation of the labour market and market efficiency in key sectors.

The OECD has been influential in the construction of quantitative indices of labour market regulation and product market regulation. Table 7 shows some key labour market regulation indices, while Table 8 shows measures of product market regulation. In broad terms, the patterns are quite similar among Continental European economies, with high levels of labour market regulation evident in Germany and France as well as in Southern Europe. In relation to product market regulation, regulatory barriers are most severe in

Table 7: *Labour Market Regulation Indices (2008)*

	<i>Labour Market Regulation</i>	<i>Employment Protection Index</i>	<i>Protection of Permanent Workers Against Dismissal</i>	<i>Regulation on Temporary Forms of Employment</i>	<i>Specific Requirements for Collective Dismissal</i>
Germany	2.1	2.6	2.9	2.0	3.8
France	3.1	3.0	2.6	3.8	2.1
Italy	1.9	2.6	1.7	2.5	4.9
Spain	3.0	3.1	2.4	3.8	3.1
Portugal	3.2	2.8	3.5	2.5	1.9
Greece	2.7	3.0	2.3	3.5	3.3
Ireland	1.1	1.4	1.7	0.7	2.4
USA	0.2	0.9	0.6	0.3	2.9

Source: OECD. Higher numbers mean more regulation; each index has a maximum value of 6.

the services sectors, with the utility/energy sector also prone to higher regulatory barriers in some countries.

Table 9 shows two other rankings that are based on broad indices of the national business environment. Both the World Bank's *Doing Business* indicator and the World Economic Forum's *Global Competitiveness Index* show a wide dispersion in the ranking of individual European countries, with the abysmal performance of Greece especially striking.¹⁵ While the *Doing Business* indicator does show an improvement in the ranking of Greece, Portugal and Italy between 2007 and 2013, these shifts are relatively minor. In contrast, the ranking based on the *Global Competitiveness Index* has deteriorated for all peripheral countries during the crisis (with the exception of Italy).

Accordingly, the hope is that a programme of "structural reforms" could do much to engineer a boost in economic growth. At the level of stylised macroeconomic models, this is backed up by simulations of the impact of a decline in labour market and product market frictions on output. For instance, Allard *et al.* (2010) cite IMF simulations that show that a comprehensive reform package could boost annual growth by 0.5 percentage points over a five-year horizon.¹⁶ In related fashion, the model simulations run by Forni *et*

¹⁵ Estrada *et al.* (2012) document a striking correlation between the *Global Competitiveness Index* and the pattern of current account imbalances in Europe.

¹⁶ The reform package in question is a combination of fiscal reforms (a shift from labour to VAT taxes; reform of unemployment benefits and old-age retirement schemes) and sectoral reforms (a reduction in entry barriers in network industries, retail distribution and professional services).

Table 8: *Product Market Regulation Indices (2008)*

	<i>Product Market Regulation</i>	<i>Professional Services Regulation</i>	<i>Retail Services Regulation</i>	<i>Energy Sector Regulation</i>
Germany	1.3	.	2.4	1.1
France	1.4	4.2	3.1	2.2
Portugal	1.4	3.4	3.0	2.4
Spain	1.0	.	2.7	1.6
Italy	1.3	2.8	2.6	2.0
Greece	2.3	1.2	3.5	3.1
Ireland	0.9	3.3	1.0	2.6
USA	0.8	1.8	2.6	1.8

Source: Regulation indices from OECD (higher numbers mean more regulation; each index has a maximum value of 6).

Table 9: *Country Rankings: Business Environment*

	<i>Doing Business</i>		<i>WEF Competitiveness</i>			
	<i>2007</i>	<i>2013</i>	<i>Rank</i>	<i>Score</i>	<i>Rank</i>	<i>Score</i>
Germany	21	20	7	5.5	6	5.5
France	35	34	15	5.2	21	5.1
Portugal	40	30	43	4.5	49	4.4
Spain	39	44	29	4.7	36	4.6
Italy	82	73	47	4.4	42	4.5
Greece	109	78	61	4.1	96	3.9
Ireland	10	15	22	5.1	27	4.9
USA	3	4	1	5.8	7	5.5

Note: World Bank *Doing Business* Country Rank (higher rank means worse business environment); World Economic Forum *Global Competitiveness Index* (0-7 range, higher rank means worse competitiveness score).

Source: World Economic Forum, World Bank.

al. (2010) indicate that reducing the markup in the Italian services sector to the euro area average would induce a long-run improvement of 11 per cent in Italian GDP. During normal times, Eggertsson *et al.* (2013) also find a considerable boost from structural reforms, with a 10 percentage point permanent reduction in markups in product and labour markets in the European periphery generating a 4.5 per cent increase in output.

It is important to appreciate that the structural reform agenda is relevant for both the euro core and the euro periphery. Indeed, a standard IMF policy prescription for Germany is to liberalise its nontraded services sector, which

would stimulate domestic investment and reduce the size of its external surplus. In related fashion, it is arguable that the structure of wage bargaining in Germany has delivered excessive wage moderation in recent years, damaging consumption growth in Germany. In general, structural reform may play a role in increasing growth rates in the euro core, which would also indirectly assist recovery in the euro periphery through trade linkages.

Still, the main focus of attention has been on prospects for structural reform in the high-deficit countries. In part, this relates to the greater urgency of boosting growth in these countries, which have endured the largest recessions and bear the heaviest debt burdens. However, this can also be attributed to political economy considerations, with the belief that a crisis environment erodes political resistance to structural reforms, which is further weakened by the leverage provided by the conditionality of access to official funding streams of various types.

The empirical evidence suggests that there can be substantial payoffs from structural reforms in developing/emerging economies that previously maintained highly-regulated economies (Gillanders and Whelan, 2010; Christensen *et al.*, 2012). However, the evidence is less strong for advanced economies, especially in relation to the short-run impact on growth (Bouis *et al.*, 2012).

There are several reasons to be skeptical about the short-term gains from structural reforms. First, even under crisis conditions, it typically takes time to secure political agreement to implement reforms. Second, the precise design of sectoral-level liberalisations and the passing of the necessary legislation adds further delays and provides an opportunity for vested interests to dilute the impact of reform during the negotiation process. Indeed, the grandfathering of existing privileges and the gradual liberalisation timetable are often conceded in order to enable the announcement of a reform.

Third, it is recognised that a comprehensive approach to reform can be more effective than a piecemeal effort (Blanchard and Giavazzi, 2003). However, limited political energy means that a sector-by-sector approach is often followed. Fourth, the growth impact of product market liberalisation in part relies on the entry of new firms that can boost competition and drive down margins. In crisis conditions, potential new entrants may not be able to obtain the necessary credit to fund start up activities. Similarly, the gains from labour market liberalisation in part rely on the willingness of firms to expand hiring, which is compromised in an environment characterised by low aggregate demand.

Indeed, Keynesian-type macroeconomic models predict short-term limited gains (or even a contractionary impact) of supply-side reforms if aggregate

demand is stagnant (see, amongst many others, Basu *et al.*, 2006 and Gali, 2012). In related fashion, Eggertsson *et al.* (2013) show that a contractionary impact can be expected if monetary policy is constrained by the zero lower bound on interest rates, since the deflationary impact of a reduction in markups cannot be offset by monetary expansion. Furthermore, this is compounded if the structural reforms are perceived to be temporary in nature, which would eliminate the demand boost from anticipations of higher future income levels. In contrast, the credible announcement of future structural reforms can boost short-term output, since delayed implementation means that the short-term deflationary impact is avoided.

These factors suggest that the timing of structural reform plans is important. Given the time delays in their full implementation, the measured initiation of structural reforms during a crisis can support the future expansion of potential output in tandem with the recovery of aggregate demand. In addition, as confidence levels and financial conditions improve, gradually-introduced structural reforms can accelerate the speed of recovery as forward-looking investors and consumers factor in the projected growth in future potential output. However, overly-ambitious structural reform plans can be dangerous both in terms of adverse short-term demand effects and also in terms of greater vulnerability to political reversals, as short-term contractionary forces erode support for their implementation.

The short-term risks of structural reform in a crisis environment are recognised in the reform blueprint described in European Commission (2012). To provide support for structural reform, this blueprint proposes a new Convergence and Competitiveness Instrument (CCI) that would provide low-cost central funds for member countries that committed to specified structural reform plans. However, it is unlikely that the scale of such funds would be sufficient to match the level of demand support that could be provided by the unconstrained operation of monetary and fiscal policies during a non-crisis environment or outside the constraint of a monetary union.

In addition to the reform of the labour market and product markets, a broader view of structural reform also encompasses banking sector reform and public sector reform. I do not dwell on the former topic beyond noting that a well-implemented programme of recapitalisation and restructuring of banking systems is important if countries are to avoid the adverse growth impact of a prolonged credit squeeze. At the same time, among the major implementation challenges is to avoid overly-rapid deleveraging programmes by banks, in view of the collective inefficiency of fire-sale asset disposal strategies (a well-run national asset management agency can be helpful in this regard). Equally, publicly-funded recapitalisations is best done at the European level in order to avoid the adverse feedback dynamics generated by the “diabolic loop” between

the balance sheets of national banking systems and national sovereign positions.

In relation to the latter topic, public sector reform can also play a direct role in fiscal adjustment. The elimination of over-staffing in various public sector activities and the abolition of restrictive practices such as occupational demarcation lines can deliver both fiscal savings and improved public-sector efficiency.¹⁷ In addition, public sector reform can also include a reduction in compensation levels for public sector workers. Analytically, this is equivalent to a sectoral liberalisation that reduces markups to the extent that public sector workers were previously able to secure above-market earnings premia.

Finally, the reform of state-owned enterprises cuts across the “product market regulation” and “public sector reform” categories. In countries where such firms are run inefficiently, there is scope for productivity gains through the implementation of a “commercialisation” agenda while remaining in public ownership; in some cases, privatisation might be an effective way to engineer productivity improvements, even if the empirical evidence is not clear cut on this question.

2.3 *Debt Restructuring*

High levels of public and private debt cast a shadow over growth prospects. In principle, well-designed debt restructuring programmes may boost growth prospects by mitigating overhang problems (Laeven and Laryea, 2009; Laryea, 2010; Brown and Lane, 2011 and IMF, 2012a).

However, the macro-financial impact of debt restructuring depends on several factors. A key consideration is the allocation of losses. In relation to household and corporate debt, the losses on impact fall on the banking system, which may push some banks into liquidation or require recapitalisation. Ultimately, the losses will be borne by some mix of equity investors in banks, the holders of bank-issued debt and taxpayers (if banks are rescued for public policy reasons). In turn, the balance between domestic and foreign taxpayers will depend on whether the fiscal costs of banking rescues are met domestically or at a European level, while the balance between domestic and foreign investors in bank securities also matters for the impact on the domestic economy.¹⁸ Moreover, if the domestic sovereign absorbs the fiscal

¹⁷ Since national accounting systems typically do not do a good job in measuring productivity in the public sector, such efficiency gains may not be captured in the data. Improvements in public sector productivity can take the form of delivering the same volume of public services and other public sector outputs with a smaller labour input and/or higher-quality public services.

¹⁸ There have been aggressive writedowns of subordinated debt in the Irish banking system, which was predominantly held by foreign investors. The large domestic retail participation in the subordinated instruments issued by its banks has made the Spanish government more reluctant to follow this route. See also Lane (2012b).

cost, this will trigger a further reallocation of losses to the extent that this reduces the value of sovereign debt by pushing up sovereign risk premia and/or ultimately requires a restructuring of sovereign debt.

Furthermore, a basic challenge is to design restructuring programmes for private-sector debt that do not induce excessive levels of strategic default. Since there are few historical examples of successful large-scale private-sector debt restructuring programmes, there is little guidance offered to policy-makers in this area. Especially for governments that face significant sovereign funding risk, it is tempting to adopt a cautious approach, which prolongs the adjustment period. Again, it would be easier to adopt more ambitious debt restructuring programmes if the fiscal risks of bank losses were shared at a European level.

Turning to the restructuring of sovereign debt, the allocation of losses will depend on the balance between private-sector involvement (PSI) and official-sector involvement (OSI). In turn, the macro-financial impact of PSI will depend on the mix between domestic and foreign investors and the sectoral composition of the investor base (banks, long-only investors, leveraged investors).¹⁹ While it is inevitable that considerable uncertainty will surround any ex-ante assessment of the impact of any PSI exercise, the March 2012 Greek PSI deal provides lessons for future programmes (Zettelmeyer *et al.*, 2013).

The exemption of official-sector creditors from debt restructuring is problematic, since de facto seniority of the official sector is a deterrent to private-sector investors. Moreover, it means that proportionately larger writedowns must be imposed on private-sector investors. At this point, official-sector debt constitutes a sufficiently large proportion of sovereign debt for several peripheral countries that any substantial restructuring must involve the official sector.

Assuming that the IMF retains its time-honoured special seniority status, the main (current and prospective) official creditors of the euro periphery sovereigns are their fellow EU governments (mainly via the EFSF/ESM) and the ECB. The fiscal authorities have considerable latitude in restructuring official debt, with the knock-on impact on the fiscal accounts of the creditor governments varying across the different possible instruments. At the same time, the high public debt levels across the EU place a limit on the scale of writedowns that can be absorbed by the creditor governments, while the political acceptability of official debt restructuring is also fiercely debated.

¹⁹ Further issues arise if PSI is extended to include large-scale depositors in troubled banks, as was the case in the recent restructuring episode in Cyprus.

The options range from outright writedowns to reductions in coupon payments and the stretching of repayment maturities, while direct ESM equity injections into banks would substitute for increases in sovereign debt in some cases. The tail risk facing sovereigns would also be mitigated through greater use of state-contingent debt instruments, in the spirit of GDP-indexed bonds.

The ECB has both direct and indirect exposures to sovereign debt. Through the SMP, the ECB directly holds sovereign debt, with such holdings possibly set to rise in the future with the announcement of the OMT programme. Indirectly, much of the collateral held by the ECB in its liquidity operations takes the form of sovereign-guaranteed bank bonds (both explicit and implicit guarantees). In a scenario in which a sovereign government is in a near-default situation, the quality of such collateral would be severely compromised. Going yet further, the exceptional liquidity assistance (ELA) offered by national central banks is underwritten by the national sovereign: in a near-default situation, the value of this guarantee would also be quite limited.

While the ECB has accepted the principle of equal treatment in relation to future purchases under the OMT programme, it declined to accept losses on its SMP holdings during the Greek restructuring. A greater willingness by the ECB to participate in debt restructurings (including the restructuring of sovereign-backed bank bonds offered to the ECB as collateral) would relieve pressure on fiscal authorities and private-sector investors. In view of the capacity of central banks to hold a wide variety of assets (including hard-to-value securities) over a long horizon, the ECB can play a critical role in making debt restructuring an effective instrument for macro-financial stabilisation.

Finally, the EU fiscal treaty can play an important role in managing the moral hazard concerns associated with sovereign debt restructuring. Since it binds national governments to follow prudent fiscal rules and converge towards safe levels of public debt, effective implementation of the treaty can help to minimise the risk of a return to risky sovereign debt levels in the future.

III CONCLUSIONS

In the absence of a decisive resolution of the euro design flaws revealed by the current crisis, the debate about how to improve potential output is arguably of secondary importance. At this stage, the requirements for a successful redesign are well known, including the various elements of a true

banking union, a sufficient degree of fiscal union and an active role for the ECB in preserving the area-wide coherence of the single currency zone and in ensuring the monetary transmission mechanism is operative in all member countries.

In terms of country-level policies, the phasing of fiscal adjustment in the high-deficit countries has to be gradual, especially in view of the simultaneous external adjustment challenge facing these countries, the high levels of private-sector debt and the absence of the currency devaluation option. At the same time, it is in the self-interest of the stronger member countries to adopt a more counter-cyclical current fiscal stance, which would also have the ancillary benefit of boosting the overall euro area growth rate.

Even if the existential crisis were quickly resolved, the euro periphery still faces a long-term adjustment challenge, in view of the high levels of public debt and large stocks of net external liabilities. The crisis has demonstrated the pervasiveness of downward nominal rigidities, such that the real devaluations required to support external adjustment are likely to materialise only slowly. At the aggregate level, euro depreciation would be very helpful in delivering a devaluation of effective exchange rate indices.

A vigorous programme of structural reforms is desirable in both the euro periphery and the euro core, even if the timing needs to be carefully calibrated. While financial reforms are a necessary element in the resolution of banking-sector crises, it is important not to overstate the potential short-term or medium-term payoff from potential reforms of labour markets and product markets. A realistic attitude to the potential gains from structural reforms is especially warranted, in view of the delivery challenges facing such reform programmes and their limited scope if reforms are confined to a small number of sectors and implemented only over a long transition period.

Finally, European growth prospects may be improved by judicious restructuring of excessive private-sector and sovereign debt levels, where debt overhang problems prove to be an important constraint. The design of effective debt restructuring mechanisms that limit moral hazard and take due account of the true loss-bearing capacity of official-sector and private-sector creditors is a high priority.

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