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Press Release

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Wave of Reforms Forced by Turmoil Promises to Transform Eurozone into More Balanced and Dynamic Economy

New Study Finds Significant Progress Amid the Storm

New Member Estonia Tops Ranking of 17 Eurozone Countries

Urgent Need for France to Improve Economic Health. Labour Market Reforms More Important than Austerity

Italy Looks Less Bad than Its Reputation. Greece is Adjusting within Monetary Union, and Has No Need to Leave Eurozone to Solve Its Problems

(BRUSSELS, Belgium – 15 November 2011) – Amid the worst turmoil in the history of European integration, many eurozone member countries are adjusting rapidly. If the eurozone gets through the grave crisis, it could emerge as a much more balanced and dynamic region than it was before. This is the major message of **The 2011 Euro Plus Monitor**, a new policy brief jointly released today by Berenberg Bank and the Lisbon Council. The 2011 Euro Plus Monitor ranks the 17 eurozone countries in two separate ways, namely 1) based on their overall economic health and 2) on the speed with which they are adjusting to the challenges posed by the turmoil. The study will be launched on Tuesday, 15 November at **The 2011 Euro Summit**, in the presence of Herman Van Rompuy, president of the European Council and acting chair of the eurozone heads of state summit.

Holger Schmieding, chief economist of Berenberg Bank and **principal author of the study,** says: "The task is daunting. But Europe can still turn its common currency into a major success. The 2011 Euro Plus Monitor shows that countries can reform themselves within the confines of monetary union. The notion that the eurozone needs to fracture is nonsense. In fact, many countries are now finally delivering much-needed structural and fiscal reforms. If policy makers can get the turmoil under control and continue with the current reform efforts, the eurozone could even turn into the top performer among the major mature economies in the world within a few years."

Among the main findings of the policy brief are:

1. The **eurozone** as a whole is turning into a much more balanced and potentially more dynamic economy. Many of those countries most in need to adjust, as shown by low rankings in the Overall Health Indicator, are now making great progress towards restoring their fiscal balance and external competitiveness, as shown by high rankings in our Adjustment Progress Indicator.

2. All four of the eurozone periphery countries disparagingly labelled PIGS place within the top seven countries in the Adjustment Progress Indicator – **Portugal** (No. 7), **Ireland** (No. 3), **Greece** (No. 2) and **Spain** (No. 5) – and within the top six in the External Adjustment sub-indicator. The sizable swings in these countries' net exports show that it is possible to correct even major imbalances within the confines of monetary union. While domestic demand has turned into the main driver of the German economy, a dramatic turnaround in net exports can cushion the adjustment crisis on the eurozone periphery.

3. The eurozone and its members are going through a wave of sweeping structural and fiscal reforms and a major overhaul of governance structures while other more heavily indebted economies (such as the US and Japan) are not. If the eurozone gets through the current severe crisis and continues to make steady progress at the national level of the type captured in the

policy brief, Europe could yet lead the global economy on a host of performance-based criteria, as European leaders vowed to do in 2000.

4. The evidence presented shows that the oft-heard suggestion that crisis countries like Greece, Portugal and Spain need to leave the common currency to regain their external balance is wrong. Instead, the changes forced by the crisis have put the eurozone on track for a major convergence between core and peripheral countries. Countries that have been lagging behind (such as Greece and Portugal) are mending their ways. Conversely, some of the countries that have little need to adjust (such as Germany) as shown by top rankings in the Overall Health Indicator, are relaxing the fiscal reins and reducing their external surpluses because they can afford it. They thus show up with low scores in the Adjustment Progress Indicator.

5. **Greece** comes last among the 17 eurozone countries in the Overall Health Indicator, but it is among the fastest changing economies, ranking No. 2 in the Adjustment Progress Indicator, ahead of **Ireland** (No. 3), **Malta** (No. 4) and **Spain** (No 5), and well ahead of **Italy** (No. 12) and **France** (No. 15). Greece has adjusted in two major and closely intertwined respects: through an exceptionally harsh fiscal squeeze, Athens has slashed its underlying fiscal deficit and curtailed its appetite for imports in a dramatic way. As a result, its net import position has become much less negative. Once the Greek economy returns to growth, Greece looks set to enjoy a huge fiscal improvement. The turnaround in Greece's underlying fiscal and competitiveness positions indicates that the widespread perception that Greece is a bottomless pit and that taxpayers are being asked to throw good money after bad is wrong – at least if policy makers prevent the current crisis from spiralling out of control.

6. The extreme experience of the current Greek recession points to an urgent need to refocus the European debate away from short-term austerity towards the long-term pro-growth reforms that are the hallmark of the Euro Plus Pact. For Greece, the focus should be on removing red tape, opening up markets and restoring growth by creating better conditions for investment, and not on imposing ever-greater fiscal austerity. Adjustment programmes negotiated with the IMF, European Commission and European Central Bank should thus focus on such steps to enhance the long-term growth potential. Such a policy would in itself do much to correct the remaining Greek fiscal imbalances.

7. Alarm bells should be ringing for **France**. Among the six eurozone countries with a AAA rating, France achieves by far the lowest ranking in the study's fundamental health check. The results are too mediocre for a country that wants to safeguard its place in the top league. Specifically, France ranks No. 13 on the Overall Health Check Indicator, just ahead of **Italy** (No. 14) but slightly behind **Spain** (No. 12). Even worse, we see little adjustment progress for France in the last two to three years in our Adjustment Progress Indicator, where France comes in at No. 15, behind **Belgium** (No. 14) and **Cyprus** (No. 13). Countries in rude fundamental health such as Germany have little need to adjust. But for a country with significant health problems such as France, the lack of adjustment is a concern. In most criteria used to rate progress in the Euro Plus Monitor, France finds itself with scores closer to Spain and Italy than to other AAA-rated European countries like Germany, Austria and Netherlands. Safeguarding France's position in the top league of European economies will require significant reforms, ideally starting ahead of the next French presidential election. And whoever wins the next election, chances are the post-election administration will have no choice but to either adopt unpopular reforms immediately – or to adopt them with a vengeance a little later after further serious slippage in the French performance relative to Germany. Specifically, France needs to rein in government consumption, improve education prospects especially for its immigrant population and make better use of its well-talented workforce. For that purpose, France needs to make it easier for companies to hire people by reducing the severity of employment protection that favours privileged insiders over those looking to get a job.

8. **Italy** ranks No. 14 on the Overall Health Indicator. It suffers mostly from a very low rate of trend growth and overregulated service markets. Low productivity growth rooted in excessive regulations is the Achilles heel of the Italian economy. Italy is also lagging behind in its adjustment efforts, coming in only as No. 12 on Adjustment Progress. A high share of

government expenditure in GDP suggests that Italy needs sustained spending restraint and pro-growth structural reforms rather than tax hikes to improve its fiscal position further. If Italy chose serious structural reforms that could unleash its economic potential, it would have little need for a significant fiscal squeeze courtesy of its comparatively healthy primary fiscal balance.

9. **Estonia** comes out on top of the Euro Plus Monitor, placing No. 1 in both the Overall Health and the Adjustment Progress Indicator. Estonia's success reflects the inherent vigour of the Baltic tiger as well as the fact that Tallinn has already had more time for its adjustment efforts to show results. The Estonian bubble burst well before the Greek debt crisis erupted, forcing Estonia to correct some excesses early on. In the case of Greece, the overall adjustment is still in its painful first phase in which a collapse of imports, layoffs of least productive workers and severe downward pressure on wages improve the external balance and the competitive position. Estonia – and to a lesser extent **Ireland** (No. 3, on the Adjustment Progress Indicator) – have already progressed to the second phase of adjustment in which surging exports and productivity-boosting private sector investment drive the adjustment further.

10. Wage pressures within the eurozone have started to converge. In terms of real unit labour costs, 12 of the 17 eurozone countries have reversed their positions relative to the eurozone average since 2008, either moving from below- to above-average increases in real unit labour costs or vice versa. Whereas wage moderation has ended in Germany and Austria, it has taken hold in much of the periphery. This shows again that serious adjustments can happen – and are happening – within the confines of the monetary union. The eurozone itself is moving a little closer to the definition of an optimal currency union.

11. **Germany** comes across as a near-perfect reform success story. The legacy of post-unification follies left the erstwhile "sick man of Europe" no choice but to fundamentally reform itself in the years after 2003. Having returned to rude health by 2006, as a result of often difficult and unpopular reforms that eventually cost then-Chancellor Gerhard Schröder his job, neither the post-Lehman slump nor the sovereign debt crisis have exposed a major need to adjust further.

Germany’s relatively high ranking (No. 3) on the overall health check, coupled with its extremely low score – No. 16 out of 17 places – for post-2008 adjustment reflects this. The recent rebound in German wage inflation (from very subdued to essentially normal), a modest fiscal relaxation and a shift from net exports to domestic demand are part and parcel of intra-eurozone convergence rather than causes for concerns.

12. **Spain** is making relatively speedy progress. It ranks No. 5 on the Adjustment Progress Indicator, though its No 12 spot on the Health Check Indicator shows that it still has a lot of adjustment ahead. Its fundamental health is still held back by sluggish progress in developing an alternative to the construction-based growth of the pre-2007 period and even more so by the dismal state of its labour market. A serious labour market reform, perhaps after the election on 20 November, could turn Spain into one of the more dynamic economies of the eurozone.

13. The **Netherlands** ranks No. 8 on the Adjustment Progress Indicator and No. 4 on the Overall Health Indicator, while **Slovakia** finishes at No. 6 on both the Adjustment Progress Indicator and the Overall Health Indicator. These two otherwise dissimilar countries are among the few economies which can boast significant adjustment progress despite enjoying fairly robust fundamental health already. With its No. 4 finish, the Netherlands has the edge in terms of longer-term fundamentals, while Slovakia’s No. 6 finish in adjustment progress gives it the better score on improving further.

14. **Cyprus** is a potential problem. Its No. 16 result on Overall Health Indicator is matched with an almost equally low No. 13 finish on the Adjustment Progress Indicator. While it enjoys a slightly better economic starting situation than Greece, it has not gone through the potentially growth-enhancing adjustments that Greece has. However, with annual GDP of €17 billion, it weighs little on Europe’s overall economic performance.

15. Even the poor performers should take heart, as there is a hidden upside in many of the low scores. Low rankings in some key sub-indicators also mean that these countries could raise their

performance noticeably by addressing these specific shortcomings. Three examples are labour market and education reforms in France, labour market reforms in Spain and a deregulation of the service sector coupled with serious cuts in the red tape that is obstructing the opening and growth of new businesses in Italy.

About the principal author:

Holger Schmieding is chief economist of Berenberg Bank. Previously, Dr. Schmieding was economist at the International Monetary Fund, head of research on Central and Eastern Europe at the Kiel Institute of World Economics and chief economist Europe at Bank of America-Merrill Lynch.

About Berenberg Bank:

Berenberg is one of Germany's leading private banks. Established for over four centuries, it has developed into a dynamic, modern private bank. The origins of Berenberg Bank go back to 1590 when the brothers Hans and Paul Berenberg established their firm in Hamburg. It is now the oldest private bank in Germany and one of the oldest in the world, with a balance sheet total of €3.2 billion, assets of more than €25.5 billion under management, capital of €213.3 million and roughly 1000 employees. Its website is www.berenberg.de.

About the Lisbon Council:

The Lisbon Council for Economic Competitiveness and Social Renewal asbl is a Brussels-based think tank and policy network. Established in 2003 in Belgium as a non-profit, non-partisan association, the group is dedicated to making a positive contribution through cutting-edge research and by engaging politicians and the public at large in a constructive exchange about the economic and social challenges of the 21st century. Its website is www.lisboncouncil.net.

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