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EU**

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# **Financial Crisis, Economic Adjustment and a Return to Growth in the EU<sup>1</sup>**

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## **Abstract**

This paper considers how a range of economies are adjusting to the external imbalances that they faced at the beginning of the current crisis. It also considers how the real economy may adjust when recovery eventually takes hold. Finally it considers how the adjustments under way will contribute to a return to long-term growth.

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## 1. Introduction

While the EU economy is suffering from its worst economic crisis since its foundation, it remains probable that a resolution will eventually be found which will allow a return to growth. As of today it is not clear what the nature of that resolution will be or how long it will take before an economic recovery will be clearly established. It is also not clear what permanent damage has been done to the EU economy as a result of this crisis. While it is absolutely certain that the current crisis will leave a permanent scar on the EU economy, resulting in the level of output per head in the future being substantially lower than it would have been absent the crisis, it still seems likely that there will be an eventual return to growth.

This paper considers the experience from a range of EU countries that have undergone a radical adjustment in the current crisis. It examines the speed of adjustment and the impact of that adjustment on their domestic economies. In particular, it looks at the experience of a group of countries that entered the crisis with large and unsustainable deficits on their current accounts. In the case of many of these countries, the imbalances in the current accounts were accompanied by investment bubbles, which burst when the crisis began. In the case of the remainder of these countries there was no investment bubble and the external imbalances were associated with a high level of domestic consumption relative to exports. A further factor that has affected the adjustment process has been whether or not the banking system was largely domestically owned or foreign owned.

The different circumstances of these countries has affected the nature of the adjustment that they have undergone. Where an investment bubble burst the increase in unemployment was especially rapid and severe. Also the adjustment in the current account has been large. By contrast, in the countries where there was no investment bubble the rise in unemployment has been slower, though nonetheless severe, and the adjustment in the external imbalances has been less dramatic.

Section 2 of this paper considers the past experience of EU economies which had major external imbalances. This past experience holds some lessons for the current situation but there are also significant differences. Section 3 then considers the nature of the adjustment process occurring in a range of EU economies today and its implications for future growth. Section 4 of the paper discusses what lessons can be learned from the past experience of growth and convergence in the EU for growth in the eventual recovery phase.

## 2. Previous Periods of Economic Adjustment

Crises in the current account of countries are not new; they have occurred in many EU countries (and most non-EU countries) at some stage over the last 60 years. The beginnings of the current crisis were also characterised by large current account deficits in all the countries that have subsequently faced major difficulties. It is useful to examine some of the cases from the past where there were large current account deficits and how these countries subsequently adjusted.

In Table 1 a number of examples of major imbalances that have occurred in the past are illustrated. In the case of each country the table shows the current account deficits at their peak and also the subsequent change in the current account balance as the problem was addressed. It also shows the period over which that adjustment took place.

The two biggest previous crises considered in Table 1 are those of Portugal and Ireland in the 1980s. The adjustment in the current account can occur through either or both of a rise in exports or a fall in imports. The classic and most desirable method of adjustment is for a country to improve its competitiveness, very often through an exchange rate change, and then to increase output and exports. Such an adjustment is likely to have the least damaging effects as it should, eventually, lead to a higher level of output. This is likely to show up as an increase in the share of exports in GDP.

Table 1: Previous Large Adjustments

		Balance of payments		Exports	Imports	GDP	Effective
		as % of GDP					Exchange rate
Country	Years	Initial	Change	Change	Change	%	%
Austria	1980-85	-4.5	3.4	3.4	0.1	7.4	5.3
Finland	1989-93	-5.0	3.5	8.4	2.0	-9.5	-24.8
UK	1989-94	-4.9	3.9	2.8	-0.4	6.1	-8.8
Belgium	1980-85	-3.9	4.3	13.4	9.3	4.8	-15.1
Denmark	1986-90	-5.5	5.9	4.1	-1.8	2.3	8.2
Portugal	1982-86	-14.5	13.0	6.6	-7.5	4.9	-44.5
Ireland	1981-87	-13.3	13.1	9.3	-9.2	15.2	-0.3

The alternative mechanism is for domestic demand to fall sufficiently far to cut the volume of imports (reflected as a fall in the share of imports in GDP). In the case of adjustment through a fall in domestic demand, output is generally reduced. The mechanism whereby the fall in domestic demand takes place may vary. In some cases a collapse in domestic investment can bring this about without direct government intervention. However, it very often takes a significant period of contractionary fiscal policy to reduce domestic demand through reducing consumption and, hence, imports, to restore external balance.

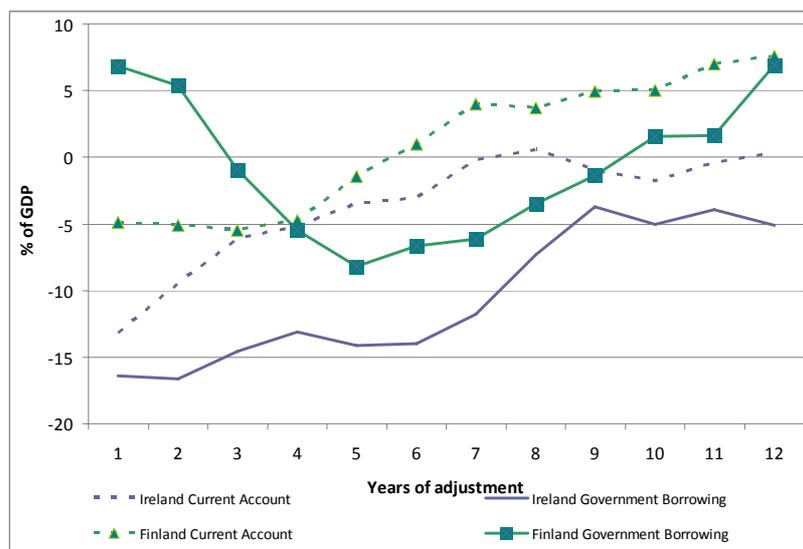
In Table 1 we consider for each country the period over which a major change in the balance of payments took place. The Table shows the relevant period over which the adjustment took place, the change (improvement) in the current account (as a percentage of GDP) and the change in exports and imports, also as a percentage of GDP.

As shown in Table 1, only in the Irish and the Portuguese cases did a large reduction in imports contribute to the adjustment in the current account. Even in those two cases the increase in the export share was close to the reduction in the import share. In all the other cases, because the adjustment took place through the allocation of more resources to producing exports, the export share of GDP showed a significant rise.

Compared to today, in most cases the external environment facing the countries undertaking the adjustment was more favourable, sometimes much more favourable. For example, the latter part of the Irish adjustment in the late 1980s occurred against the background of rapid growth in a major trade partner, the UK. This was a significant factor explaining why in all cases other than Finland in the 1990s, the favourable adjustment in the current account was also accompanied by moderate growth in the economy making the adjustment. The Finnish problems in the early 1990s were aggravated by the economic collapse in a major trading partner, the Soviet Union, and the Finnish crisis also involved a financial collapse. None of the other cases involved a major financial collapse.

While a real depreciation of their exchange rate occurred in the case of most of these countries, it was only of a substantial magnitude in the cases of Finland, Belgium and Portugal. Thus exchange rate flexibility, while facilitating an adjustment in the balance of payments, was not an essential condition for such a change. In the case of the Irish adjustment in the 1980s the fall in the effective exchange rate was quite moderate. However, to achieve this result there was a substantial change in the nominal exchange rate in 1986, offsetting other adverse exchange rate movements.

Figure 1: Adjustment in the government and the external accounts, Finland (1989-2000) and Ireland (1981-1992)



A final aspect of previous adjustments that is worth considering is the timing of the adjustment in the balance of payments and in government borrowing. Figure 1 shows the paths of adjustment in the case of the Irish adjustment of the 1980s and the Finnish adjustment of the 1990s. In both cases the balance of payments and the government accounts showed adjustments of fairly similar magnitudes. However, in the case of the current account in both countries, the adjustment began much earlier than the adjustment in the government deficit. This reflects the fact that the impact effect of fiscal tightening is to reduce domestic demand and hence imports, but also to reduce growth and hence tax revenue. It is only when the necessary adjustment in the government structural deficit had been accomplished and the fiscal stance relaxed that the benefits were reflected in higher growth and a rapid reduction in government borrowing. (A similar pattern was observed in the UK adjustment of the early 1990s).

The experience of Finland and Ireland in the 1980s and the 1990s was that adjustment took the best part of a decade. The improvement in the current account preceded the improvement in the government balance. When accompanied by world growth, as was the case for Ireland, the adjustment was less painful. In the case of Finland the fact that there was also a financial crisis aggravated the initial loss in output.

### **The Current Crisis \_ Beginning the Adjustment**

After the start of the EMU the issue of the current account balance of individual member states fell from policy-makers' oversight. While both Ireland and Spain largely complied with the requirements of the Stability and Growth Pact (SGP) before the crisis, they saw a critical deterioration in their public finances when the recession hit. The SGP was no guarantee that all was well in those economies. What most clearly signalled the growing internal problems in those economies was the growth of their balance of payments deficits over the course of the last decade. Blanchard, as early as 2001, identified this as a problem for Spain and, writing in 2007, he showed that even with rational and well-informed markets (no bubbles), governments of individual member states in EMU should care about balance of payments deficits (Blanchard, 2001 and 2007). With the benefit of hindsight it is clear that property bubbles were growing in both Spain and Ireland, bubbles which markets (and governments) did not anticipate (EFN,2006). The possibility of such bubbles occurring through irrational or unexplainable action by individual economic agents further strengthens Blanchard's arguments.

While membership of EMU made it easier to finance such deficits, non-membership did not prevent the growth of very large deficits in other member state such as Estonia, Latvia, Bulgaria, Hungary and Romania. The era of cheap capital knew no international boundaries. Where these deficits were funded by direct foreign investment, the countries were less vulnerable to sudden reversals (von Hagen and Siedschlag, 2010). However, where the capital inflow occurred through the banking system or through portfolio investment there was greater vulnerability to sudden shocks. Table 2 shows the current account balance at the beginning of this crisis for countries with large deficits.

In the run up to the current crisis, in the period 2005-7, relatively little public attention was devoted to this sign of growing imbalances. Governments (and international institutions such as the IMF and the EU Commission) relied on the fact that the foreign liabilities being incurred as a counterpart to the balance of payments deficits were private sector liabilities. This apparent lack of concern was strengthened by the absence of exchange risk in the case of Spain and Ireland. There was an illusion that such private sector liabilities could never become the responsibility of domestic governments. However, when the crisis hit, where these liabilities belonged to a domestically owned banking system, it proved impossible for the domestic government to avoid responsibility for these debts. Ireland was the most notable example where the private sector liabilities turned into public sector liabilities. Other countries that have seen this occur on a smaller scale include the UK, and even in a surplus country, Germany. Today we are seeing a belated replay of the Irish crisis in the case of Spain, with growing concerns about the stability of the banking system and its implications for the sovereign.

For some countries with very large balance of payments deficits, such as Estonia and Hungary, the liabilities were the responsibility of foreign owned banks. As a result, these countries did not have to take responsibility for these private sector liabilities when the crisis hit, as ultimate responsibility lay

with the foreign owners of the banks. As a result, the recovery in these two countries has been much more rapid than in Ireland or Spain. Whether or not a country “owned” banks has been an important aspect of how the adjustment, subsequent to the crisis, has played out.

Whether or not the counterpart to the balance of payments deficits across the EU was a rise in government indebtedness or in private sector indebtedness, the deficits signalled dangers ahead. As the deficits continued to rise, as a consequence of very rapid domestic growth, especially in the building sector, this was unsustainable. With the advent of the crisis, even where the balance of payments deficits were not the counterpart to large government borrowing, they still needed to be tackled as they were no longer fundable in a risk-averse world.

Table 2: The Current Crisis – Economic adjustment and the Balance of Payments

		as % of GDP				Growth	Growth
		Current Account		Exports	Imports	GDP	Consumption
Country	Years	Initial	Change	Change	Change	%	%
Ireland	2007-11	-5.5	5.6	25.4	12.9	-9.5	-11.8
Hungary	2008-11	-6.9	7.9	10.6	3.7	-4.0	-8.3
Spain	2007-11	-10.0	6.1	3.2	-2.9	-2.3	-4.3
Portugal	2008-11	-12.6	6.0	3.0	-3.2	-3.1	-4.2
Romania	2007-11	-13.6	9.5	9.0	0.3	1.1	-1.1
Lithuania	2007-11	-15.0	13.4	23.9	12.2	-5.9	-13.3
Estonia	2007-10	-15.7	19.5	12.3	-3.8	-15.5	-22.2
Greece	2008-11	-17.9	6.6	-0.1	-7.1	-13.1	-11.6
Latvia	2007-11	-22.4	21.2	16.8	0.5	-16.4	-23.6
Bulgaria	2007-11	-25.2	27.0	7.0	-13.3	2.5	-4.8

Table 2 shows similar data to Table 1 for the early years of the current crisis for those economies with large balance of payments deficits which might be difficult to finance. In the Table they are ranked in order of the size of the current account imbalances at the beginning of the crisis. The years when the adjustment in the current account began (either 2007 or 2008) are shown in the second column. The current account imbalance at the beginning of the crisis and the subsequent improvement is shown in columns 3 and 4 for each country.

The largest deficits were experienced in 2007 or 2008 in a range of non-members of the Euro zone – Latvia, Estonia, Bulgaria, Lithuania and Romania. However, many of the countries with very large current account imbalances have seen them greatly reduced or eliminated by the end of 2011. This was the case for the Baltics, Hungary, Bulgaria, Romania, Ireland and, to a lesser extent, Spain. Portugal and Greece still had deficits of over 5 percentage points of GDP at the end of 2011.

In the case of most countries a substantial part of the improvement has been achieved by increasing exports as a share of GDP. However, in the case of Ireland, this rise in the export share was achieved through resilient exports showing some growth against the background of a very large drop in the value of GDP.

For six of the countries featured in Table 2 the cumulative fall in the volume of GDP was very substantial – between 5% and 17%. The cumulative falls in personal consumption was even larger

for these countries – between -8% and -24%. The fall in consumption in Spain and Portugal, by contrast, was much lower. This dramatic decline in domestic consumption played an important role in reallocating resources to the current account.

Table 3 shows the cumulative fall in GDP along with the investment share of GDP at the beginning of the crisis and the change in this share since 2007/8. It also shows the rise in unemployment over the adjustment period.

Table 3: The Current Crisis – Economic Adjustment, Investment and Unemployment

		Growth	Investment share of GDP		
		GDP	as % of GDP		Unemployment rate
Country	Years	%	Initial	Change	change
Ireland	2007-11	-9.5	25.5	-15.4	9.8
Hungary	2008-11	-4.0	21.7	-4.9	3.1
Spain	2007-11	-2.3	30.7	-9.0	13.4
Portugal	2008-11	-3.1	22.5	-4.4	4.4
Romania	2007-11	1.1	30.2	-5.6	1.0
Lithuania	2007-11	-5.9	28.1	-10.5	11.1
Estonia	2007-10	-15.5	35.5	-16.7	12.2
Greece	2008-11	-13.1	22.1	-8.2	10.0
Latvia	2007-11	-16.4	34.1	-11.7	10.1
Bulgaria	2007-11	2.5	28.7	-7.8	4.3

For the EU 15 the investment to GDP ratio averaged around 20 per cent over the period 1991-2010 and for the EU 27 it averaged around 19 per cent. By this measure, many of the economies with large current account deficits at the beginning of the crisis also had very high levels of investment – over 25 per cent of GDP. In many of them this was due to a bubble in the construction / real estate sector. A key mechanism to bring about the very rapid and large adjustment in the Baltic republics was, first and foremost, a collapse in domestic investment demand. This collapse in the investment bubbles was accompanied by a collapse in consumption. In turn, this fall in domestic demand created major fiscal problems, which were rapidly addressed with fiscal tightening. The combined effect was a drastic fall in output.

In the case of Portugal and Greece the deficits in 2008 were very large. While some adjustment had taken place by 2011, there was still a long way to go. In both cases the bulk of the adjustment that did take place was through a reduction in the import share of GDP. In both cases the export share of GDP is quite low, so that a very large percentage increase in exports would be required to close the deficit. Such a huge reallocation of resources could take some considerable time, leaving a cut in imports through domestic deflationary action the main mechanism for adjustment.

In the case of Ireland the bulk of the adjustment in the balance of payments had been completed by 2010. This partly reflected the fact that the initial deficit was smaller than in the case of the other countries. In the Irish case the main mechanism appears from the table to be a rise in the export share of GDP. This proved possible because exports already constitute a very large share of GDP so

that the percentage increase in volume needed to make the adjustment was relatively low and, hence, achievable in a relatively short time scale. However, the dramatic reduction in the value of GDP here masks a major reduction in import demand as a result of the large fall in domestic demand.

Generally, where a current account adjustment takes place through a cut in imports this must, in turn, be driven by a fall in domestic demand and, hence, a fall in GDP. This is a painful process. If the adjustment can be achieved through higher exports it is much more likely to be accompanied by growth in GDP.

Table 3 gives more details of how the adjustment process is playing out within the EU deficit countries. It shows the investment share at the beginning of the crises for each country. This suggests a sharp divide between the countries where the imbalances reflected an exceptionally large investment share of GDP, and related property market bubble, and countries where investment was not abnormal – Greece and Portugal. In the former camp were Ireland, Spain, Romania, Lithuania, Estonia, Bulgaria and Latvia. With the exception of Bulgaria, the investment share in these countries has fallen dramatically over the period 2007-10.

The effect of the collapse in a property / housing market bubble is that the investment share of GDP falls precipitously. This can and does take place over a limited space of time. It is generally much faster than for an adjustment which is brought about by fiscal policy because of the inevitable political constraints associated with dramatic changes in fiscal policy.

This collapse in the investment share has generally not been due to direct fiscal action, but rather to a collapse in a building bubble. This has, in turn, had very adverse consequences for the public finances.

A second consequence of an adjustment through a bursting property market bubble is that the output of the building sector falls dramatically. Because this sector is generally low productivity and quite employment intensive it results in a big increase in unemployment. In six of the economies experiencing an adjustment through this mechanism (a collapse in investment) the rise in the unemployment rate exceeded 9 percentage points over the period 2007-10. The rise in three other economies (Bulgaria, Portugal and Hungary was much lower.)

A third consequence of an adjustment through a bursting property market bubble is that it can lead to a financial collapse. This is what happened in Ireland in the period 2008-10 (and in Finland in the early 1990s). Today Spain seems to be facing the same, rather delayed, consequences for its financial sector of the bursting property market bubble. Where there is a financial collapse, as in Ireland, this greatly magnifies the costs of adjustment. In the case of Ireland the support for the banking system has directly added forty percentage points to the debt GDP ratio, with all that that entails in the burden of future debt interest payments (FitzGerald and Kearney, 2011).

This contrasts with the case of Estonia. Because the banking sector in Estonia is foreign owned, the financial costs of the collapse in investment demand did not directly affect the local economy. This has made it possible for the economy to move on rapidly from the collapse in investment, unlike Ireland. While one Latvian owned bank had difficulties, the bulk of the costs incurred in the financial sector in that country accrued to shareholders in foreign banks operating in that country.

Table 4: Government Borrowing, Investment and GDP.

		Government Borrowing	Investment	Current a/c	GDP	
		as % of GDP				%
Country	Years	Change	End	Change	Change	Change
Ireland <sup>2</sup>	2007-11	-13.1	-13.0	-15.4	5.6	-9.5
Hungary	2008-11	7.9	4.2	-4.9	7.9	-4.0
Spain	2007-11	-10.4	-8.5	-9.0	6.1	-2.3
Portugal	2008-11	-0.5	-4.2	-4.4	6.0	-3.1
Romania	2007-11	-2.3	-5.2	-5.6	9.5	1.1
Lithuania	2007-11	-4.5	-5.5	-10.5	13.4	-5.9
Estonia	2007-10	-1.4	1.0	-16.7	19.5	-15.5
Greece	2008-11	0.8	-9.2	-8.2	6.6	-13.1
Latvia	2007-11	-3.1	-0.4	-11.7	21.2	-16.4
Bulgaria	2007-11	-3.3	-2.1	-7.8	27.0	2.5

In the case of the other countries (Portugal, Greece and Hungary) with more normal investment shares yet large deficits, the adjustment process (towards balance on the current account) is more complex.<sup>3</sup> Instead of a collapse in investment demand triggering the adjustment, direct fiscal action is the only way to bring it about. This must involve a generalised reduction in consumption as well as investment. Instead of the costs of the adjustment being concentrated on the unemployed, who previously worked in the building and related sectors, as in Ireland, Spain and Estonia, the costs of adjustment are likely to be shared much more broadly by the population as a whole.<sup>4</sup> Adjusting through cutting public expenditure or raising taxes also tends to take longer than the forced adjustment through a bubble bursting.

Those countries that had exceptionally high levels of investment have seen a collapse in investment demand triggering a big fall in imports and a rapid adjustment in the balance of payments. For them the necessary adjustment in the balance of payments has been accomplished or is on the way to being accomplished. What are left are the legacy effects of the collapse on the public finances (and, in the case of Ireland, on the financial system). In the other countries the adjustment has some considerable way to go.

Table 4 shows the state of the public finances in the countries considered here for 2011 and the change since the beginning of the crisis. This shows that while there has been a very substantial improvement in the current account imbalances there has been much less change in the public

<sup>2</sup> The figure for Ireland includes the cost of bank recapitalisation. If this is excluded the deficit for 2011 is now estimated at 9.4% of GDP.

<sup>3</sup> Obviously it is not necessary to restore the current account to exact balance to ensure sustainability. However, in the case of these countries there is clearly a significant further distance to travel.

<sup>4</sup> In the case of Ireland, Spain and Estonia, the population as a whole are also suffering a major loss of real income as a result of the second round effects of the crisis – the catastrophic effect on the public finances of the property market bust.

finances over the period. In the case of Latvia and Lithuania the Table masks very dramatic changes since 2007. Their government deficits ballooned as a result of the building bust but then, through dramatic fiscal action, the public finances have been brought back much closer to balance.

For countries such as Ireland, Spain and Portugal, considerable fiscal tightening has taken place but progress appears to be slow. This arises first because the adjustment, unlike those in the past considered in Table 1, is taking place against the backdrop of a very unfavourable economic environment in the euro area. Secondly, as discussed earlier in the case of past adjustments in Finland and Ireland, the current account generally improves before progress appears in the public finances. That is because the tough fiscal action, while reducing the structural deficit, has a substantial negative impact effect on growth. It is only towards the end of the fiscal adjustment that the advent of growth will produce an improvement in the cyclical element of the deficit.

Table 5: Exports as a share of GDP at the beginning of the crisis

		Exports	Change in Current account
Country	Years	as % of GDP	
Ireland	2007	80.2	5.6
Hungary	2008	81.7	7.9
Spain	2007	26.9	6.1
Portugal	2008	32.4	6.0
Romania	2007	29.3	9.5
Lithuania	2007	53.8	13.4
Estonia	2007	67.1	19.5
Greece	2008	24.1	6.6
Latvia	2007	42.5	21.2
Bulgaria	2007	59.5	27.0

Table 5 shows exports as a share of GDP in each country at the beginning of the crisis (where countries are ranked in the table by the size of their opening current account deficit). In countries where the share of exports in GDP was 40% or more at the beginning of the crisis the adjustment in the current account has been more rapid. This reflects the fact that a given percentage increase in exports will have a bigger current account impact where exports are already large. This is a problem which Portugal and Greece face a low export share of GDP. Unless there is a large rise in exports the only other way to reduce the deficit is through a large reduction in imports driven by a corresponding fall in domestic demand.

This examination of past balance of payments crises and of the progress to date of the current crisis suggests a number of conclusions.

Firstly, don't own your own banks or, if you do, exceptionally tight regulation and suitably targeted fiscal policies are essential to ensure no financial collapse. Estonia and Latvia, while suffering from bursting investment bubbles, have bounced back rapidly as the costs of the burst bubble are carried by foreign banks and their shareholders. By contrast, Ireland and Spain are carrying all the financial costs of burst housing bubbles and this burden will greatly slow any recovery. Until the costs of the financial collapse have been fully dealt with it is difficult for the real economy to recover.

The size of the export sector matters. Where an export sector in an economy is large it is much easier to grow exports through improving competitiveness. Where the export sector is small much more of any adjustment must be carried by cutting imports by means of a fall in domestic demand (and living standards).

The pattern of recent adjustment does not suggest that membership of EMU was a good predictor of whether a country would suffer severely in the current crisis. Current account imbalances occurred whether or not countries were EMU members. The nature of the adjustment that has taken place so far does not suggest that exchange rate changes have been important in the adjustment process for most countries who were not EMU members. Only in the case of Hungary and Romania has there been a substantial fall in the effective exchange rate over the course of the adjustment period.

In countries where a property market or investment bubble has burst the adjustment in the current account has taken place more rapidly. The initial incidence of this adjustment has been felt particularly by the large numbers who have lost their jobs as a result of the bursting bubble. Where the current account imbalances have to be eliminated through reducing consumption there is no “automatic stabiliser” to ensure that adjustment happens rapidly. Instead the adjustment must be a consequence of fiscal action reducing consumption. This is inevitably a slower process than bursting a bubble. Also, because it requires domestic policy action to impose cuts in consumption across the whole population (not just those affected by a building bust) it is likely to face much more popular opposition.

Finally, experience in previous crises in EU countries suggests that major adjustments to restore domestic balance can take many years. It also suggests that the adjustment in the current account imbalances leads the adjustment in the public finances by a number of years. However, the current crisis is different from previous crises as the adjustment process in the countries with major imbalances is taking place against the backdrop of contractionary fiscal policies in the rest of the EU. Euroframe, 2012, estimates that the effect of the tightening fiscal policy stance in the EU this year will be to knock between 0.8% and 1.4% off the growth rate. In addition, the failure to deal effectively with the banking crisis, not just in Spain and Ireland, but throughout the EU has seen the destruction of the single EU financial market. Barrell et al., 2011, suggest that this move to national banking systems will have a very negative additional effect on the EU growth rate.

### **3. Returning to Growth**

Returning the EU economy to growth requires a number of tasks: restoring order to the public finances, restoring competitiveness to those economies with chronic balance of payments deficits, developing a resilient banking system and, finally, labour market changes to match supply and demand for unskilled labour in the longer term.

#### **Restoring order to the public finances**

A key priority for policy is to return the public finances in a range of EU members to a sustainable path. This is a sine qua non for future growth and it will require sustained fiscal tightening in countries such as Ireland, Greece, Spain and Portugal. For other countries, such as Italy, the necessary adjustment is much more limited provided that the EU economy returns to growth. All of this would be much easier if there were a return to sustained growth in the EU economy. As

discussed above, in previous decades quite large adjustments in the balance of payments (and the public finances) were made with less pain where they occurred against the backdrop of growth in trading partners.

In some economies the problem with the current account imbalance has already been addressed but there is a distance to go before balance is restored to the public finances (Ireland). In addressing the public finance crisis, the balance of payments in a country such as Ireland is likely to move into substantial surplus. In other economies, such as Portugal, the adjustment needed in the public finances, while still large, is less than it is for Ireland. However, there is still some distance to go before the balance of payments is restored to a sustainable path. All of these problems will be eased for economies, and eventually put behind them, by a return to growth. This Section of the paper addresses some of the lessons to be learned from the past experience of convergence.

### **Restoring Competitiveness**

A second task will be to improve the competitiveness of the EU economy to enhance future growth. This will involve changes to ensure cost competitiveness across the EU as a whole and changes in individual economies which are experiencing major domestic imbalances which show up in balance of payments deficits.

As discussed above, the current crisis has so far seen adjustment in many of the economies with large balance of payments deficits occurring through a reduction in imports brought about by a collapse in domestic demand. While such a contraction in output can, if sufficiently large, restore balance it comes at the cost of a considerable loss of output. An alternative strategy is to reduce domestic costs relative to competitors so that exports grow more rapidly. Such an approach is the only one which will protect growth and ensure that the other imbalance – in the labour market – is ironed out within a reasonable space of time.

However, for those economies that are in EMU restoring competitiveness can only be secured by reducing domestic costs. This tends to be a time consuming process. In addition, even with a restoration of competitiveness it takes time for the productive capacity of the economy to be rebuilt through investment. Thus even with a rapid adjustment a recovery in exports will take some considerable time. With the huge pressures for rapid adjustment in those economies that are heavily indebted this leaves little alternative than to adjust through cutting domestic demand as an instrument for cutting imports.

In addition, with relatively inflexible labour markets in some economies, the necessary adjustment in domestic costs is taking some considerable time. At one end of the spectrum are the Baltic states where domestic competitiveness has been improved quite rapidly. At the other are Spain and Portugal where the response of domestic costs to the crisis has proved sluggish.

### **Developing a Resilient and Competitive Banking System**

The Cecchini report, which provided the blueprint for the Single Market, quantified major economic benefits from a more integrated EU financial system. While progress over the 15 years since the Single Market began has been slow, it was, nonetheless, real. The effect of the current financial crisis has been to fragment the EU banking system. Whereas before the crisis there had been a gradual move towards a more integrated EU banking system, this has now been dramatically reversed. With each country responsible for the solvency of its own banks there has been a rapid return towards a

system of national banks. A major consequence of this is a fall off in competition. The decision to recapitalise the EU banks over a nine month period will significantly aggravate this tendency. There are big gains for shareholders from deleveraging and this process could pose major problems for some of the New Member States who do not have national banks. Also a failure to raise adequate capital will potentially leave relevant governments responsible for any shortfall.

Barrell, et al., 2011, show that a purely national banking system in the EU would see a substantially lower level of output than one where there is a system of EU-wide banks. This would arise because, instead of risks being shared over a large and diversified banking system, each national banking system would reflect the local risks of the local economy (and any related lack of liquidity). By contrast, the US has continued to move away from the Glass-Stiegel era where out-of-state banking was not allowed. An important impetus for this was the reduction in risk consequent on more regionally diversified banks. It also has resulted in significant efficiency gains. Even with the recent financial upheavals in the US there is no suggestion that the trend towards an integrated US banking system should be reversed.

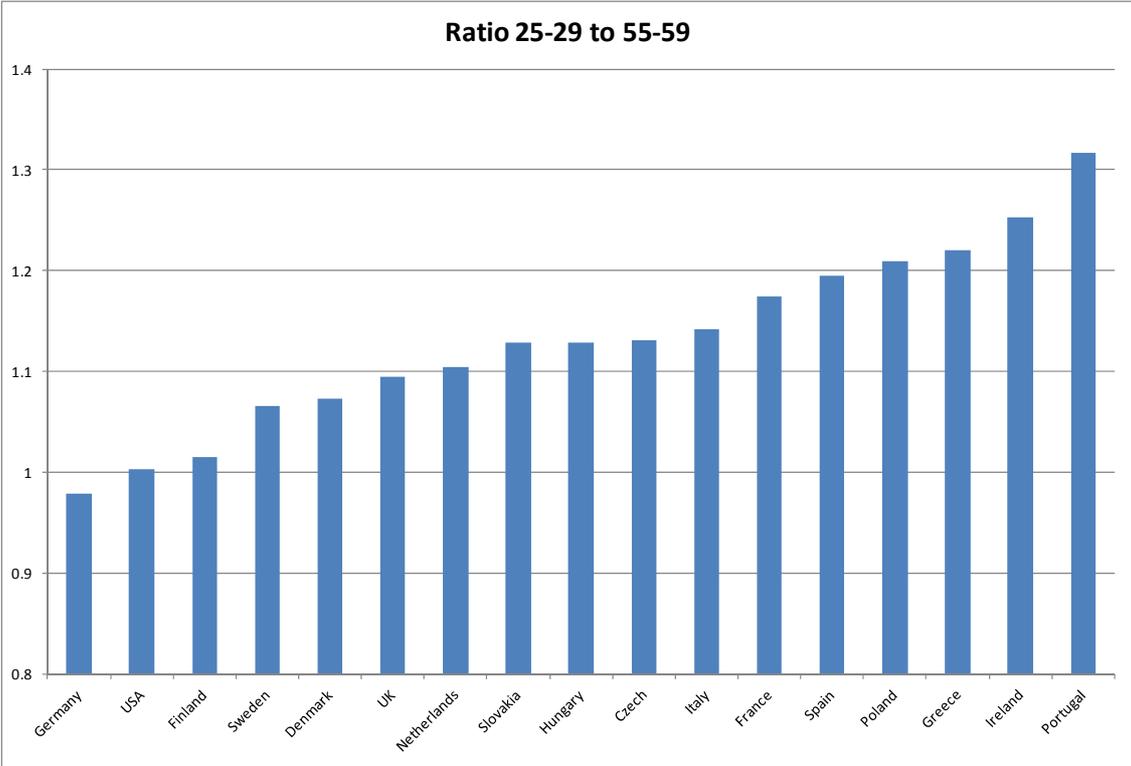
The development of a less competitive national banking system in the EU may not affect large multinational companies, which raise funds directly from financial markets and have access to many different banks across the range of countries in which they operate. However, it is likely to have a negative impact on the cost of funds for smaller companies and the household sector. In turn this will negatively impact growth.

Reversing this process will be important for the growth of the EU in future years. Any return to a more integrated EU banking system is only likely to proceed if there are major changes in how the banking system is regulated. An EU wide banking system will need an EU-wide regulatory system rather than the current system with individual national regulation and responsibility.

### **Labour Market reform and Investment in Human Capital**

The experience of convergence in living standards in the EU over the last quarter of a century has highlighted the significance of investment in human capital. Darvas and Pisani-Ferry, 2011, make the point that the EU2020 agenda is still relevant. "Education, research and the increase in participation and employment rates are perfectly sensible objectives in the current context...". As shown in Figure 2, because of the fact that the educational attainment of the population in many member states has only improved gradually over the last twenty five years there is still considerable benefit to be reaped in the coming decade (in terms of increased potential output); as less well educated workers retire and are replaced by more productive better educated workers there will be a further growth in productivity and in the productive labour force across a range of countries.

Figure 2: Investment in Human Capital. Ratio of human capital index of 25-29 year olds relative to the index for 55-59 year olds.



Source: FitzGerald, 2011

Figure 3: Share of Unemployed by Level of Education

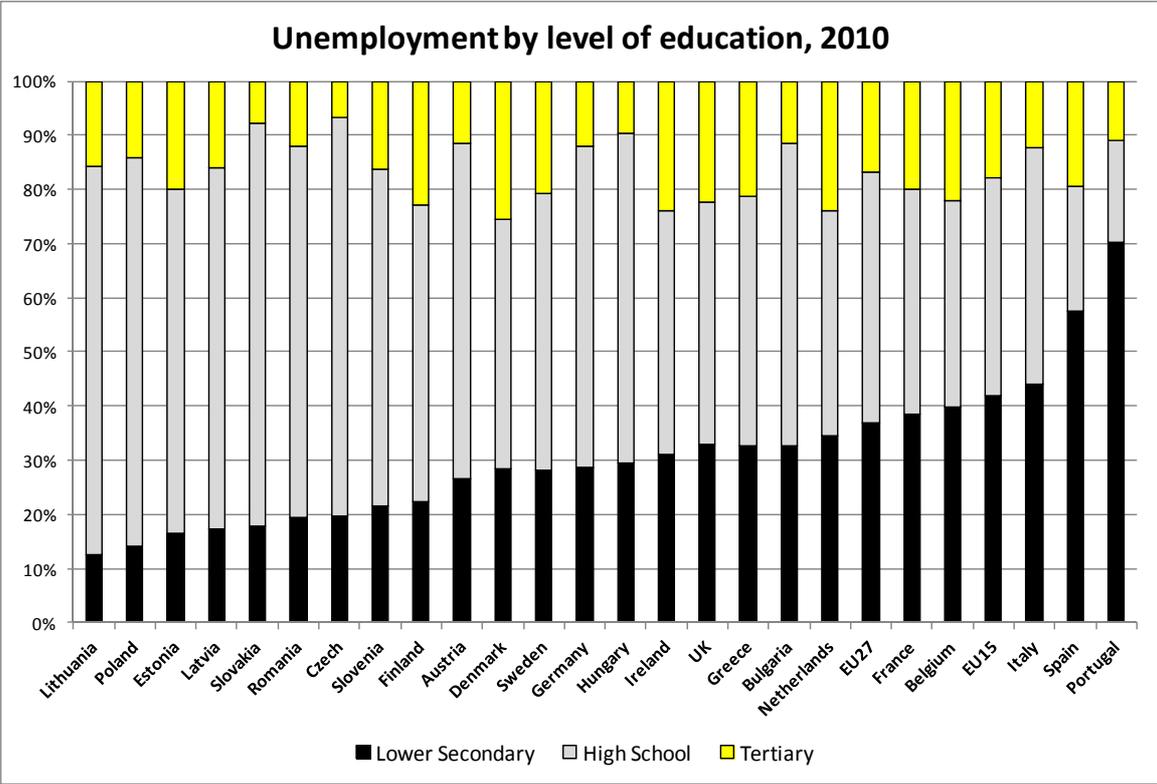
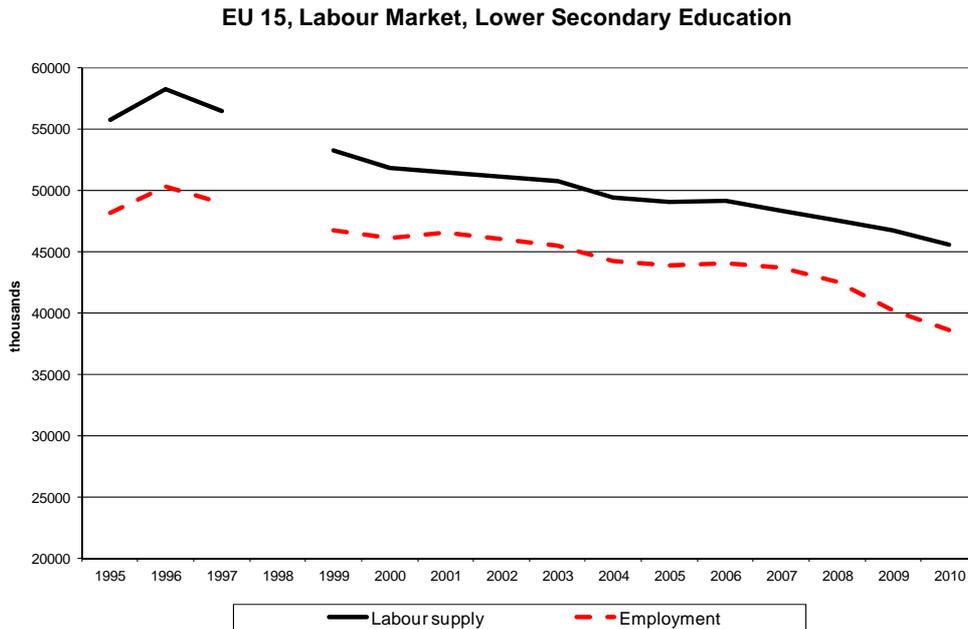
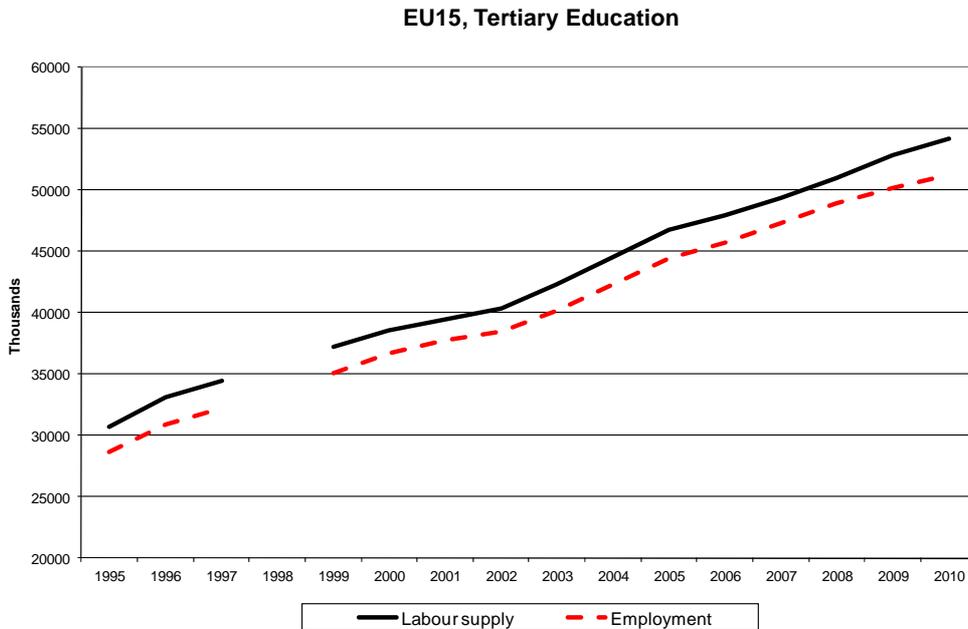


Figure 4: Labour Force and Employment in the EU, Lower Secondary Education



In the case of some of the countries in southern Europe, even today their education systems are failing to produce adequate numbers of high school and third level graduates. This is particularly the case for Portugal. If it raised the throughput of skilled persons through their education system towards the EU average, this would see substantial benefits accruing well into the next decade. However, the benefits of any such policy take some considerable time to mature.

Figure 5: Labour Force and Employment in the EU, Tertiary Education



The effect of the current recession has been to dramatically increase the unemployment rate in the EU. However, the increase in unemployment has not been evenly distributed with very good performances in the German and the UK labour market contrasting with dramatic increases in

unemployment in those countries that have seen a collapse in their building and construction sectors consequent on a property market bust. However, the distribution of the increase in unemployment within the EU is not only uneven, but the share of the unemployed who have limited education also varies across countries. Because the average education of workers in the building and construction sector is quite low, those economies that have seen a collapse in that sector have also seen a disproportionate rise in the unemployed with limited education.

Figure 3 shows the educational attainment of the unemployed across the EU member states. The share with lower secondary education is exceptionally high in Portugal and Spain. In the case of Portugal it reflects the relatively low average educational attainment of the labour force as a whole. However, in Spain it also reflects the very serious loss of employment in building and construction<sup>5</sup>. What is perhaps surprising is that the share of unskilled in the numbers unemployed is relatively low in Ireland, Estonia and Latvia, which all saw a dramatic fall in the investment share of GDP. In the case of Ireland this may reflect differential emigration by non-Irish unemployed building workers.

Whatever the causes of the rise in unemployment, the evidence suggests that those who are unemployed with limited education will find it most difficult to get back to work, even in a recovering economy (Kelly, McGuinness and O'Connell, 2011). Because of the concentration of such unemployed workers in a number of member states this may make the task of returning to full employment in the recovery phase more difficult.

Figure 4 shows the trend in employment and labour supply in the EU over the last 15 years for those with only lower secondary education. The trend in both supply and demand has been steadily downwards. However, the recession has seen demand fall even more rapidly than supply. Thus in an economic recovery there is unlikely to be any increase in demand for this category of labour. Figure 5 shows the steady upward trend in the supply and demand for skilled labour. Even in the economic downturn demand for this category of labour continued to rise.

Much will depend on the elasticity of substitution between skilled and unskilled labour in individual economies. If it is very low as it is in Ireland (Bergin and Kearney, 2006), then it will be more difficult to see employment for unskilled workers increasing. With a Leontief production technology, where skilled and unskilled workers are employed in fixed proportions, it would require substantial growth in total employment to ensure that substantial numbers of unskilled workers got jobs. With unskilled workers constituting a small share of total employment unskilled wage rates would have to fall dramatically relative to skilled wage rates in order to improve the competitiveness of the economy sufficiently to employ all the unemployed unskilled workers (along with even more skilled workers). However, the higher the elasticity of substitution between skilled and unskilled labour the easier the economy will adjust to employing unemployed unskilled workers.

An alternative strategy is to reduce the supply of unskilled workers. In the long run, in an economy such as Portugal, this would be best achieved by reducing the output from the school system of young people with only lower secondary education and increasing the share completing tertiary education. While it would take a generation to achieve its full impact on the economy there is no

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<sup>5</sup> Spain may also be affected by substantial immigration of workers for the building and construction sector in the boom years.

real alternative. A less effective strategy is likely to be retraining unemployed workers with limited education, especially where they constitute a large share of the unemployed. Nonetheless, it would be likely to produce a faster pay back than just waiting for a generation of new young graduates.

#### 4. Conclusions

A sine qua non for sustainability and recovery in the most troubled EU economies is a return to sustained growth in the EU as a whole. However, tackling serious domestic imbalances cannot await a return to growth. This task will only be completed when growth is assured and it would also be greatly facilitated by increased flexibility in wage rates so that adjustment could take place through increased exports rather than reduced imports.

The experience of the last twenty years shows that convergence has actually happened, even if in a rather uneven form. Past investment in human capital holds out the prospect for further dividends in the coming decade. This is true for most of the troubled economies. However, realising this potential will depend on tackling a range of obstacles. Further investment in human capital is desirable in some economies, especially in southern Europe.

The crisis has left a serious legacy of unemployed workers. In some of the most troubled economies a substantial proportion of the unemployed have limited education and this will pose a barrier to re-employment even in an economic recovery. Making the labour market work better is going to prove a challenge in those countries where unemployment is especially high.

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