The Economic State of the Union

Four drivers of divergence in Europe

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Ten years after the crisis: a polarising Europe

- **After 2008 crisis**, recovery in the US, slow growth in EU, decline in Southern Europe, slowdown in emerging countries: **divergence**,
- The crisis has created a new **hierarchy** of power (US, finance) and **centre-periphery** relationships (examples on Germany and Italy)
- Has exposed the flaws in the European Monetary Union and in EU policies, opening up **disintegrating** forces

What we see: divergence in the economy and incomes

- **2008 as a turning point**
- (earlier) rise in within-country inequality

- Divergence in monetary/financial dynamics
- Divergence in fiscal policies
- Divergence in economic structures
- Failure of politics and policies

GDP per capita, real terms, PPS EU28

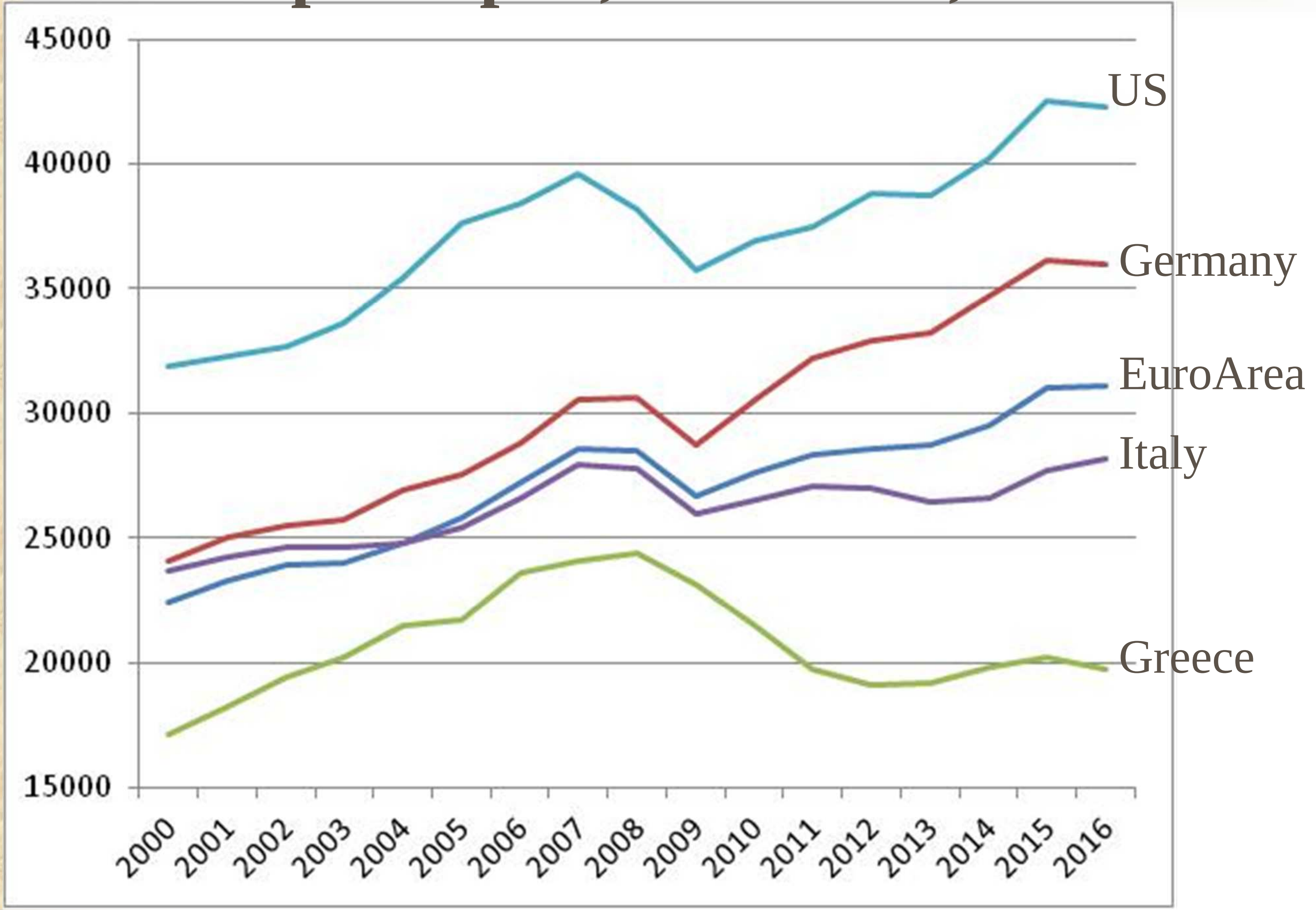
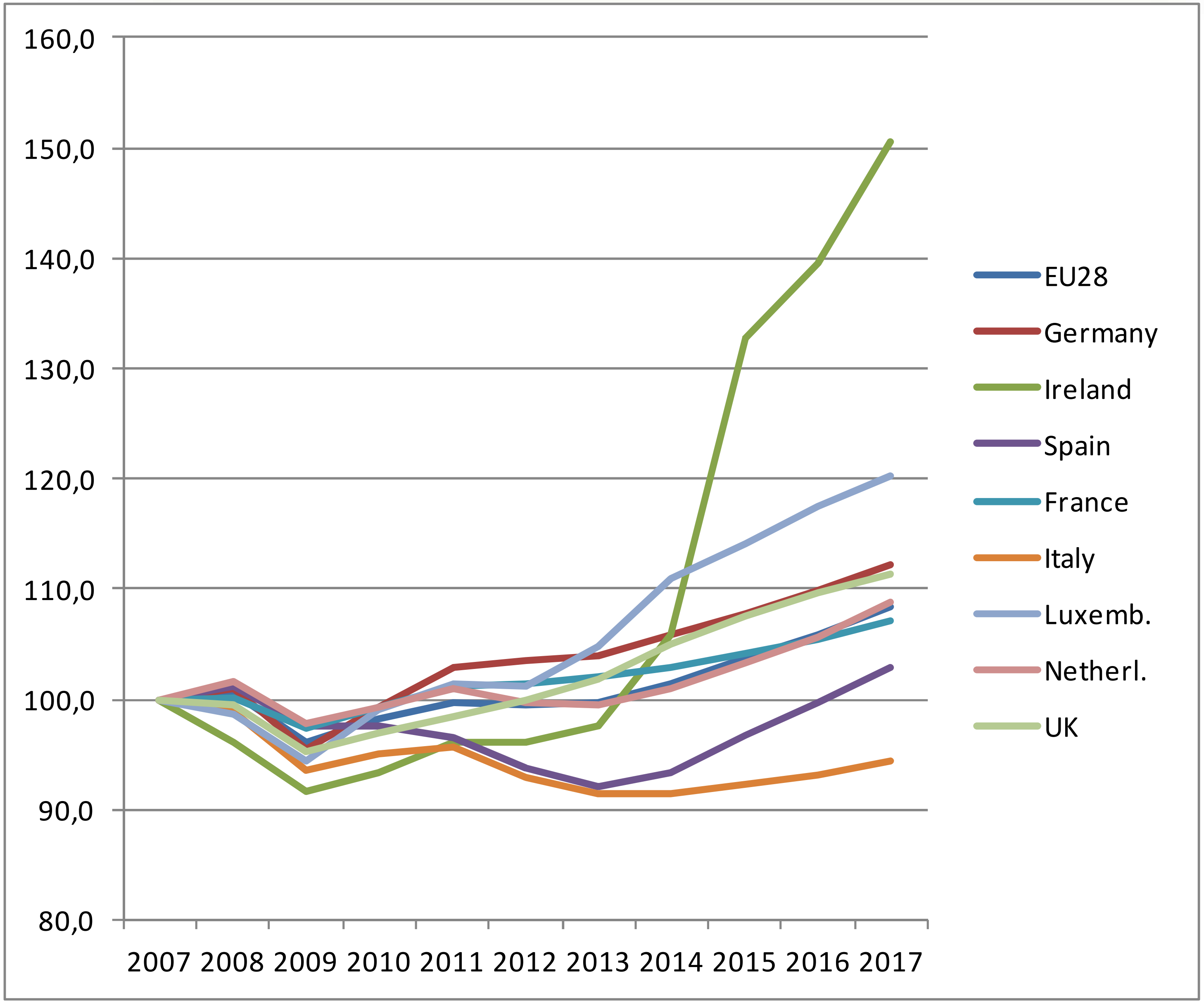
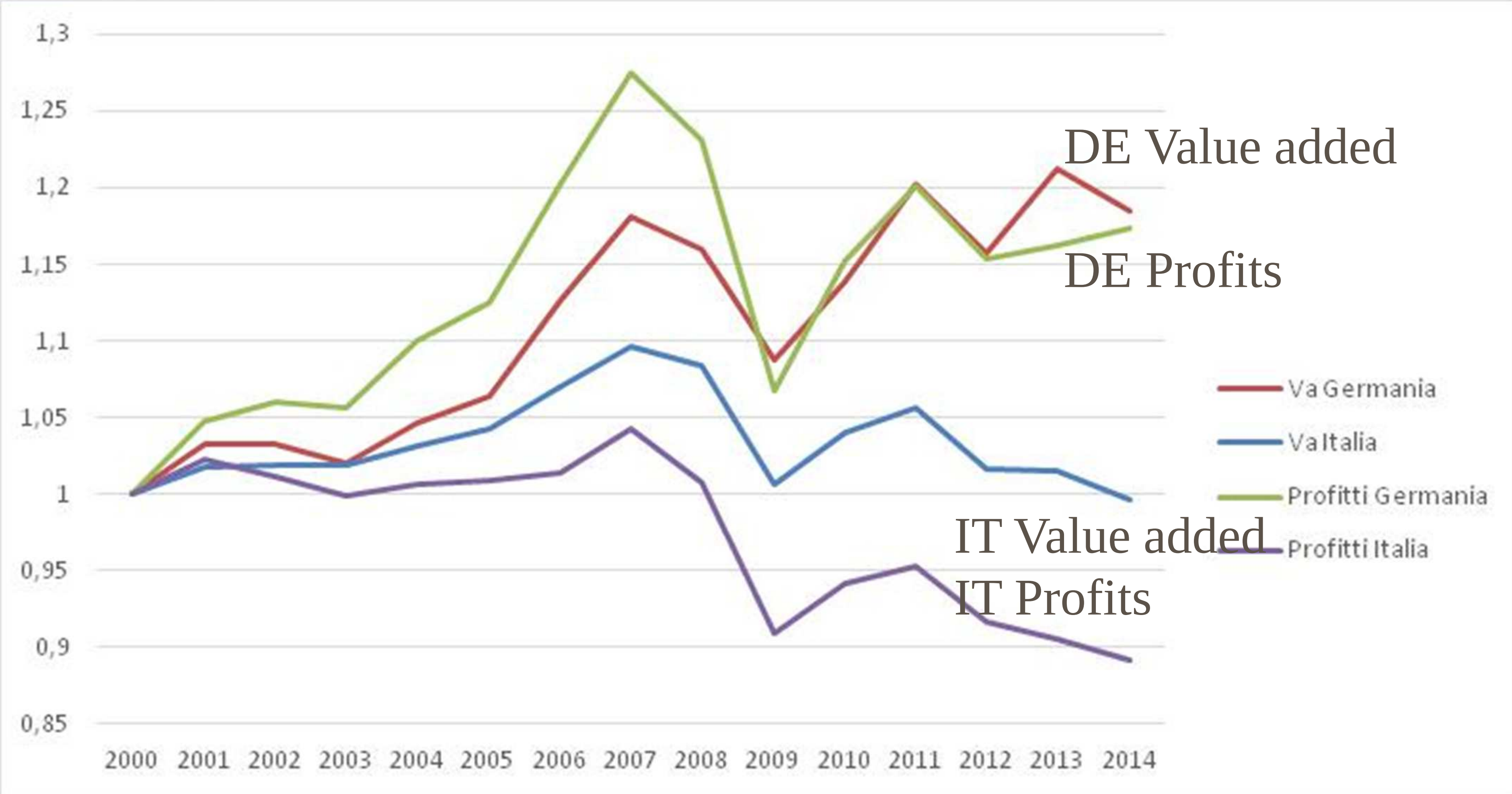


Figure 1 Gross domestic product at market prices, 2007-2017

Chain linked volumes, index 2007=100

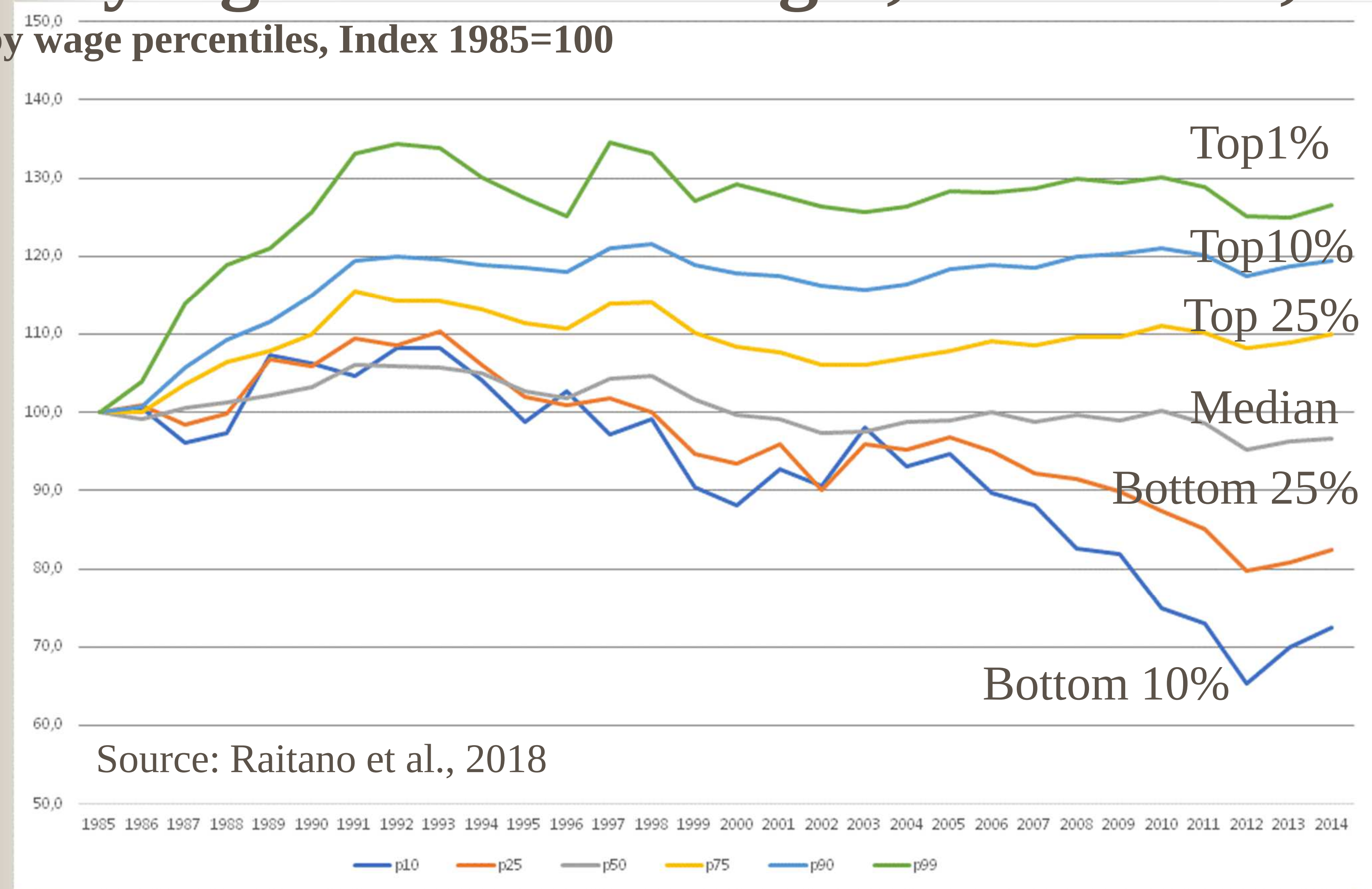


Value added and profits in manuf. and services Germany and Italy indexes 2000=1



Italy's gross annual wages, 1985-2014,

by wage percentiles, Index 1985=100

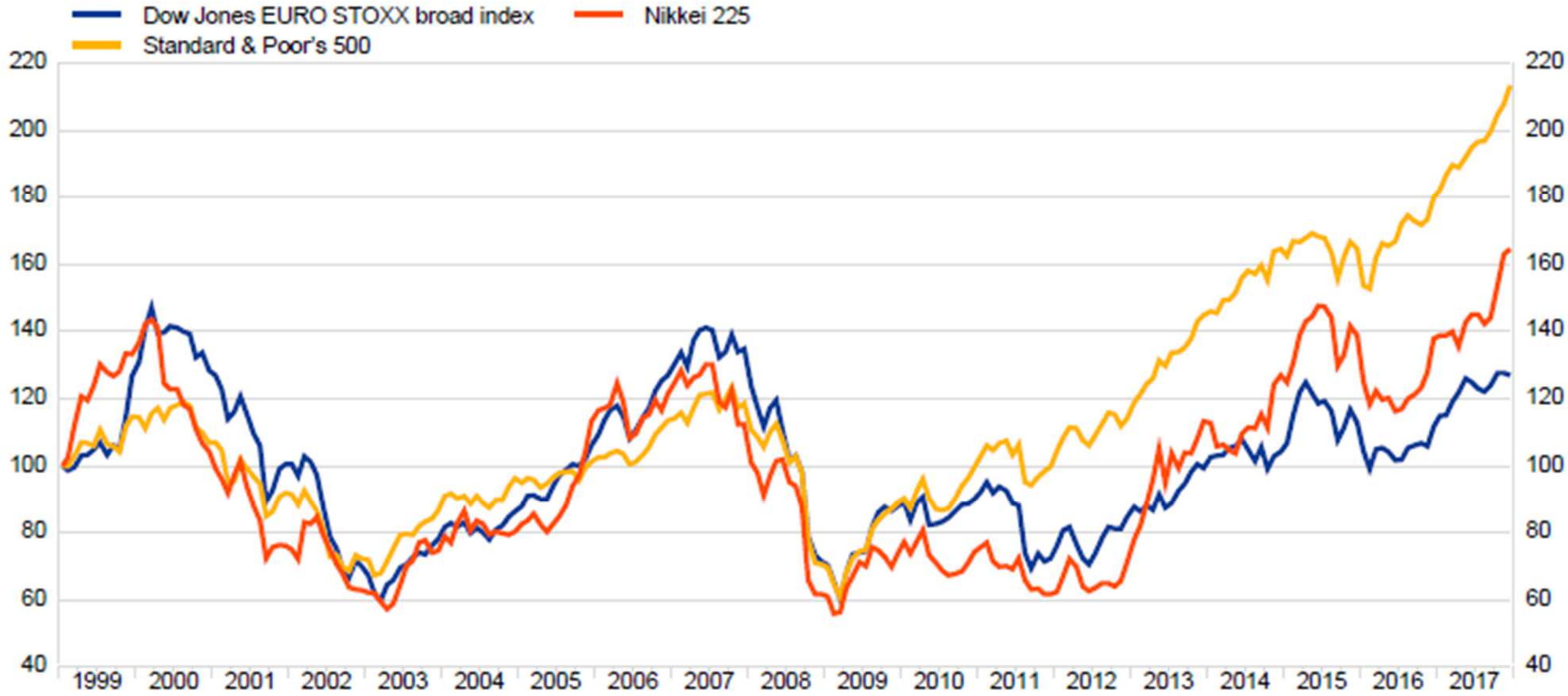


1. Monetary policy: double edged QE, diverging capital flows

The first driver: monetary policy

- QE favoured banks and speculative **finance**
- Eased the pressure of public debt refinancing in periphery, unneeded buying of core bonds
- Contained to some extent spread of interest rates
- Allowed large **capital outflows** from periphery
- Expanded financial **imbalances**
- End of QE and higher interest rates would worsen imbalances

Chart 1.4 Dow Jones EURO STOXX broad index, Standard & Poor's 500 and Nikkei 225
(index: January 1999 = 100; monthly averages)



Source: ECB calculations based on Thomson Reuters Datastream and Bloomberg daily data.

US stock market, Dow Jones Avg and Bank index

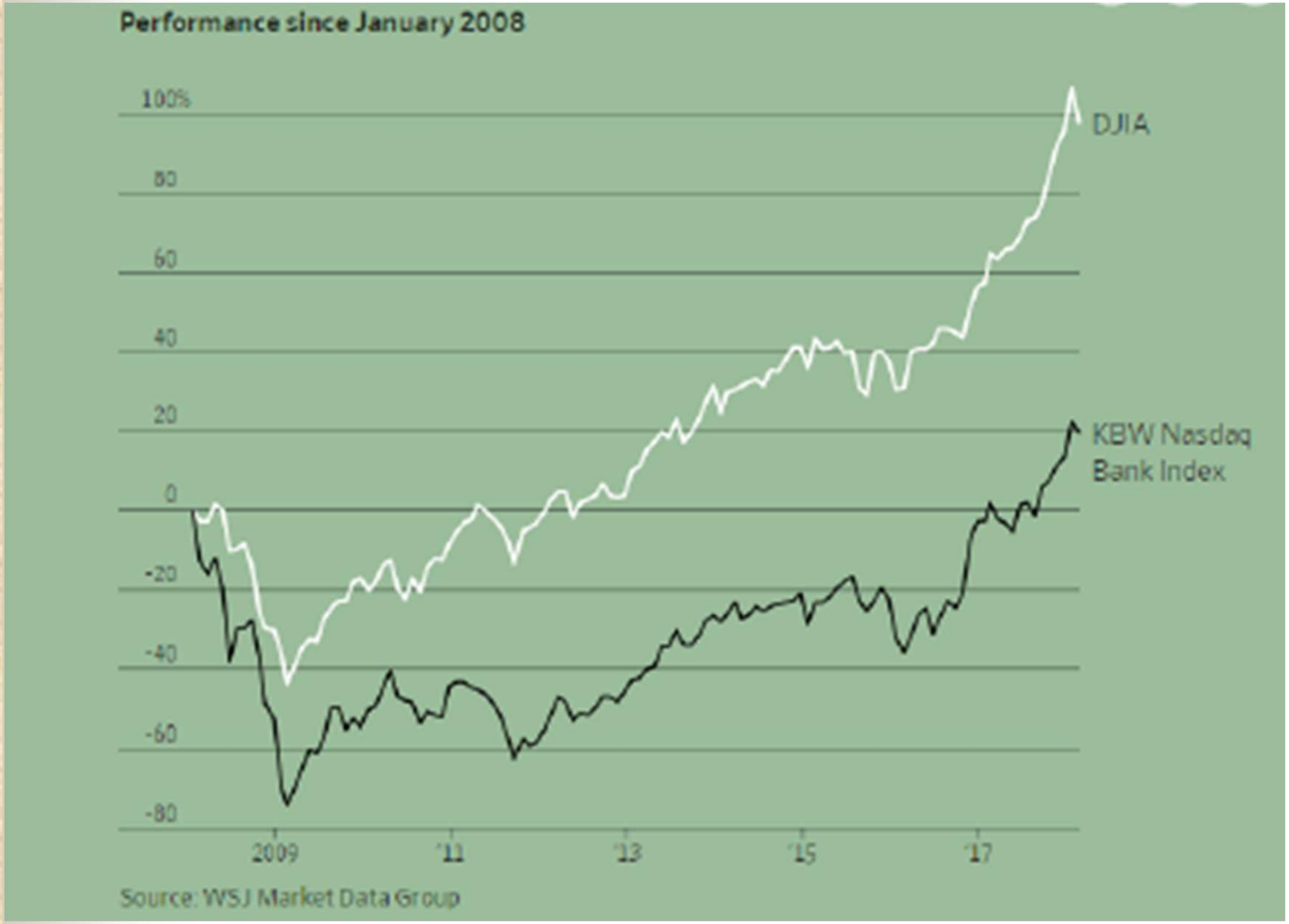
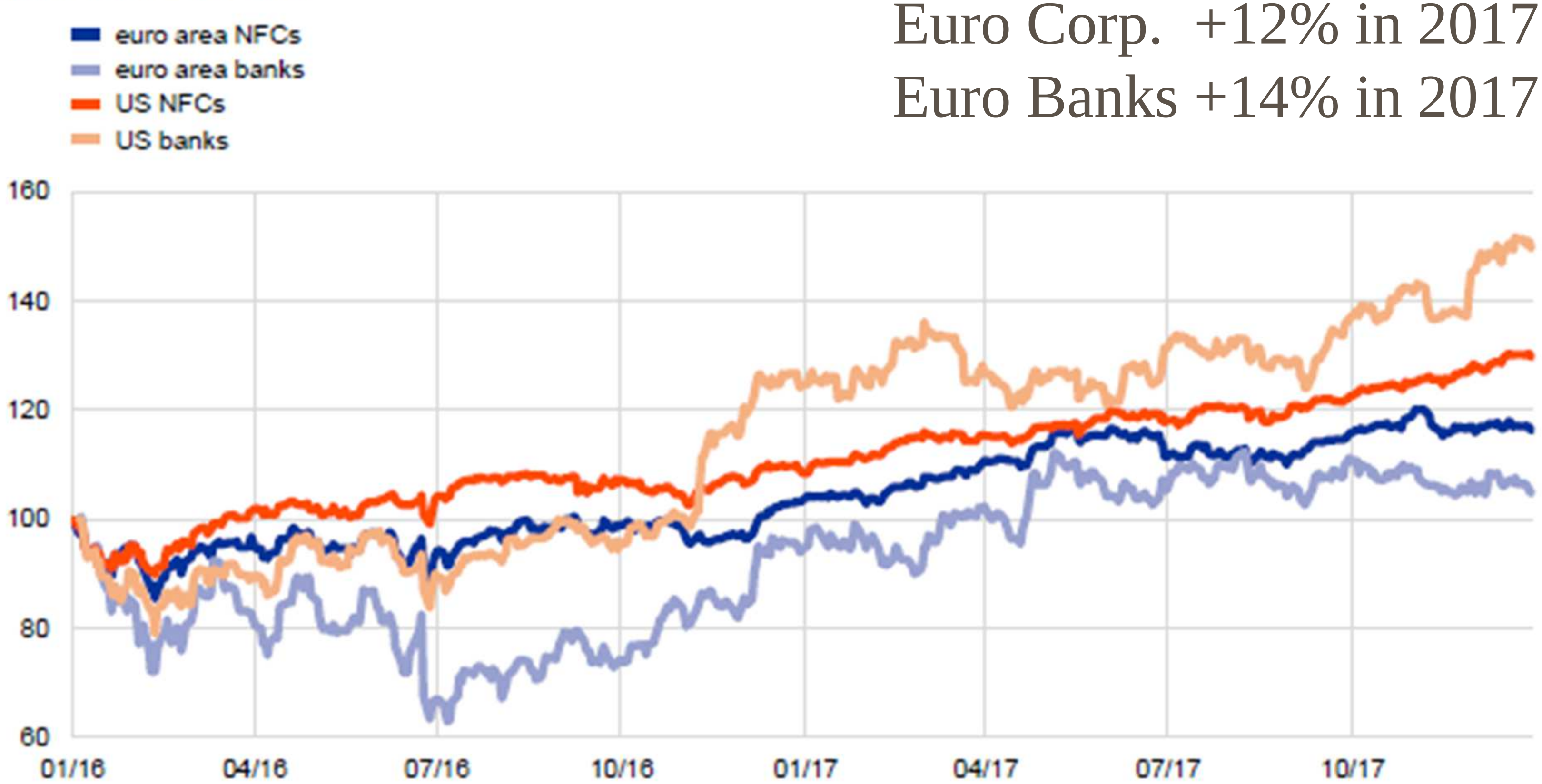


Chart 16

Equity market indices in the euro area and the United States

(index: 1 Jan. 2016 = 100)

Euro Corp. +12% in 2017
Euro Banks +14% in 2017



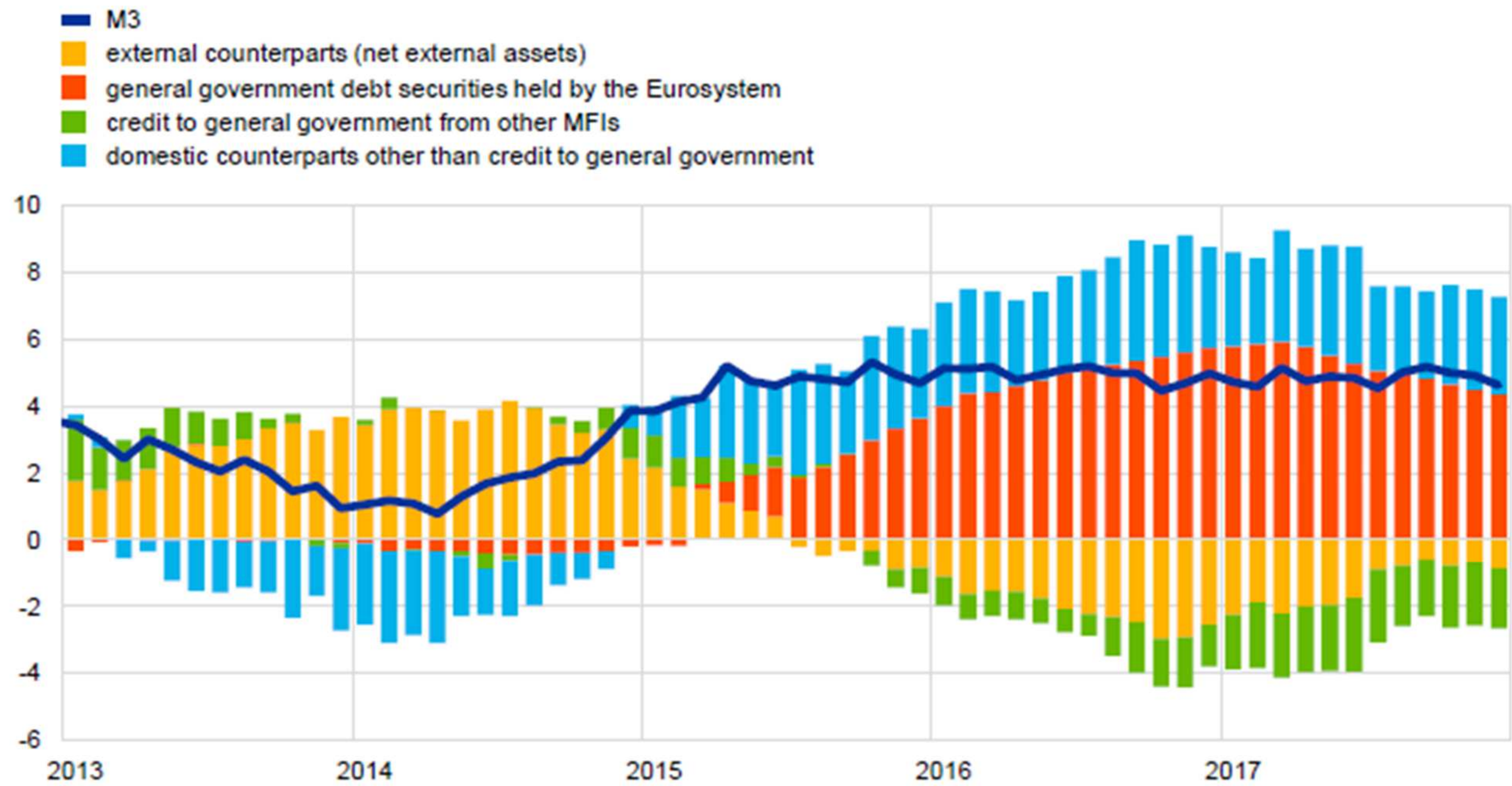
Source: Thomson Reuters Datastream.
Notes: The EURO STOXX banks index and the Datastream market index for NFCs are shown for the euro area; the S&P banks index and the Datastream market index for NFCs are shown for the United States. The latest observation is for 29 December 2017.

ECB Annual report 2017

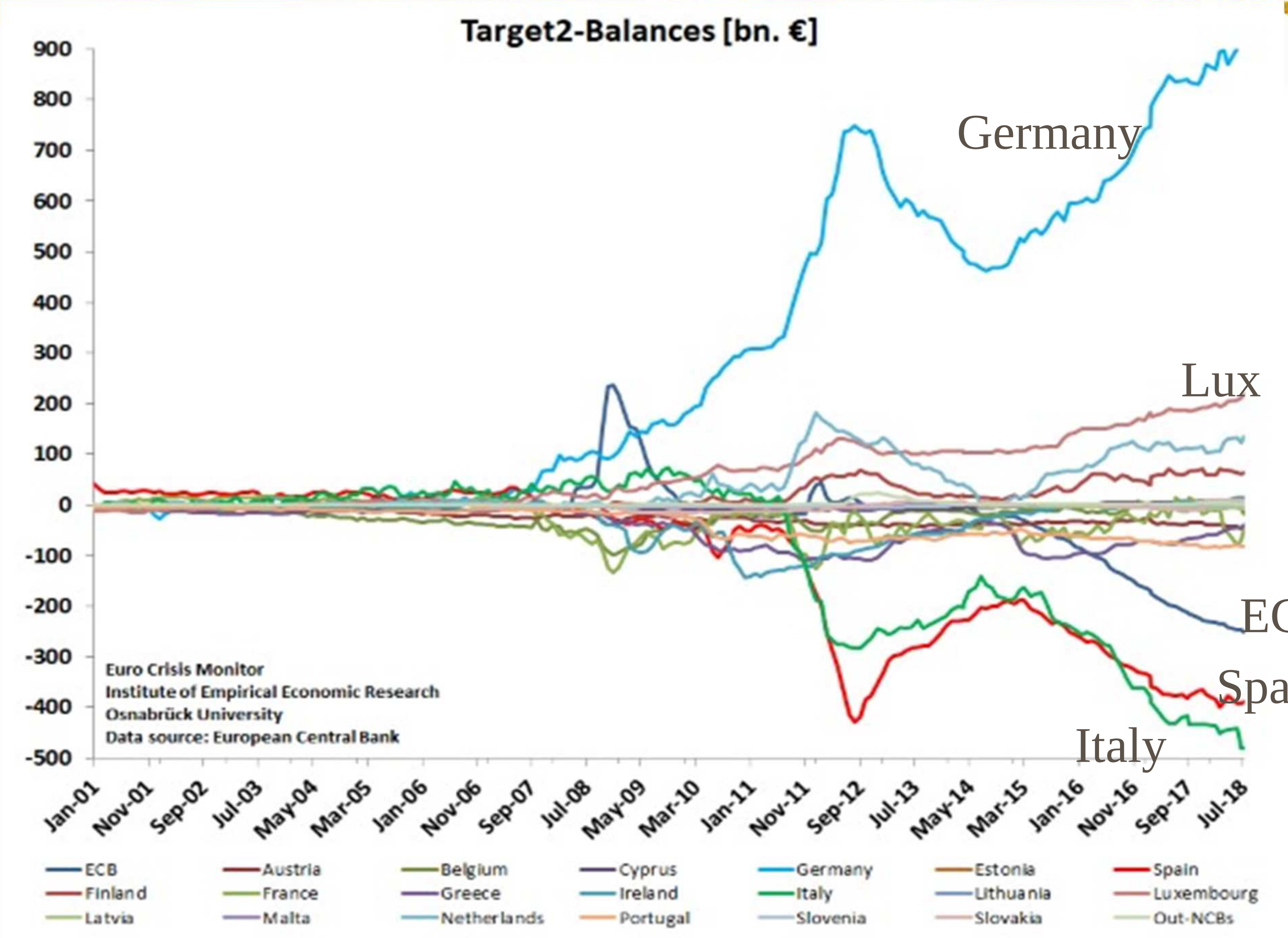
Chart 19

M3 and its counterparts

(annual percentage changes; percentage point contributions)



Source: ECB.
Note: "Domestic counterparts other than credit to general government" include MFIs' longer-term financial liabilities (including capital and reserves), MFI credit to the private sector and other counterparts.



Target2-Balances [bn. €]
Germany
Lux
ECB
Spain
Italy
Euro Crisis Monitor
Institute of Empirical Economic Research
Osnabrück University
Data source: European Central Bank
900
800
700
600
500
400
300
200
100
0
-100
-200
-300
-400
-500
Jan-01
Nov-01
Sep-02
Jul-03
May-04
Mar-05
Jan-06
Nov-06
Sep-07
Jul-08
May-09
Mar-10
Jan-11
Nov-11
Sep-12
Jul-13
May-14
Mar-15
Jan-16
Nov-16
Sep-17
Jul-18
ECB
Austria
Belgium
Cyprus
Germany
Estonia
Spain
Finland
France
Greece
Ireland
Italy
Lithuania
Luxembourg
Latvia
Malta
Netherlands
Portugal
Slovenia
Slovakia
Out-NCBs

Italy's Bal. of Paym., Capital flights

In the 12 months ending in June 2018:

- €100bn acquisit. by Italians of foreign bonds
- € 30 bn sales by foreign. of Ital. (public) bonds

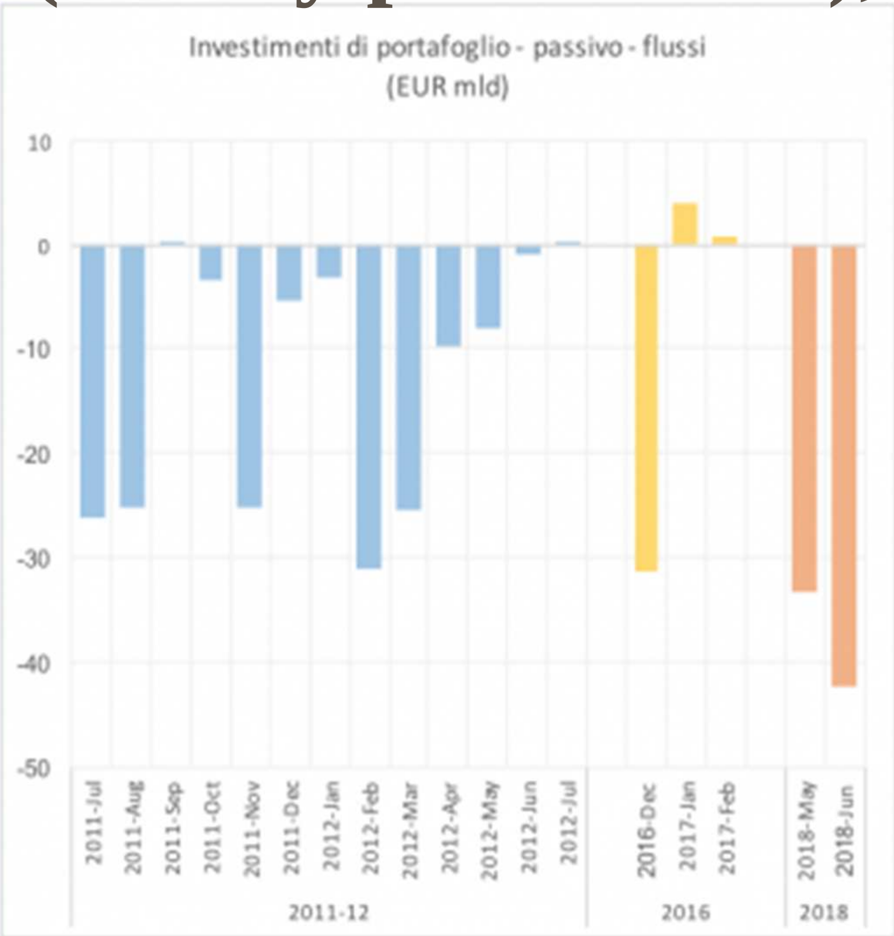
In May-June 2018 alone:

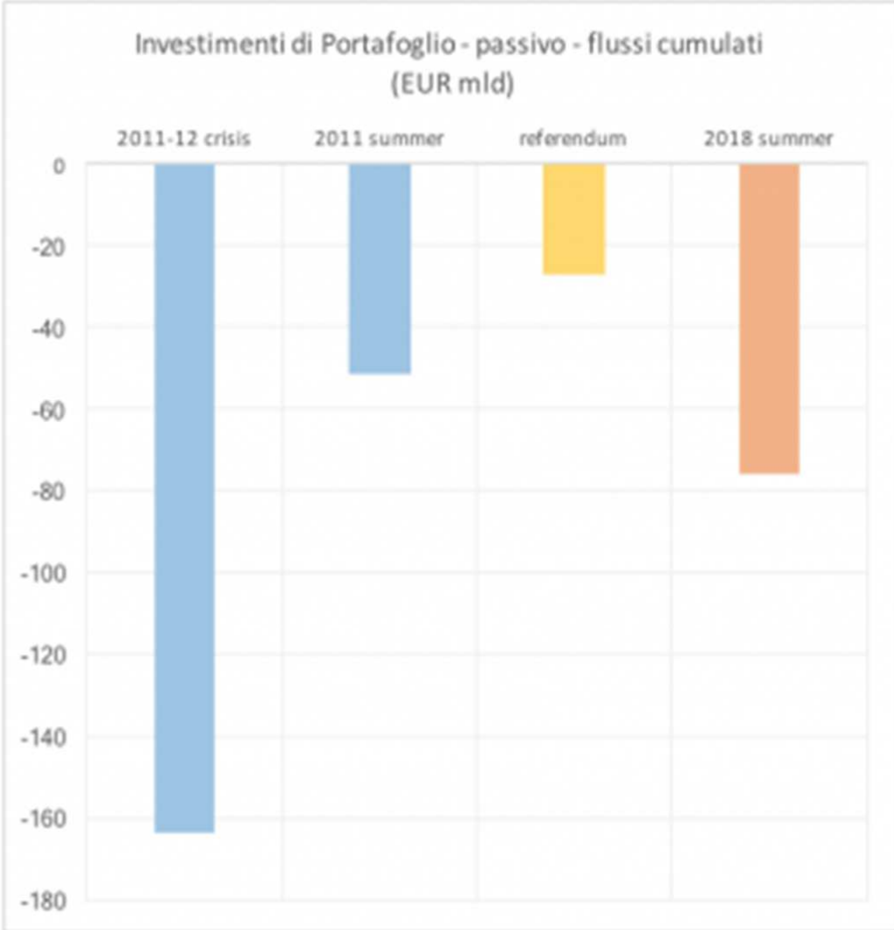
- € 60 bn sales by foreign. of Ital. (public) bonds,

€ 15 bn of other bonds

- For refinancing public debt, Italy needs € 400 bn (one quarter of GDP) over 12 months, one third owned by foreigners

Fall in foreign portfolio investment in Italy, (mainly public debt), €bn





Merler 2018, http://www.lavoce.info/archives/54754/capitali-stranieri-la-grande-fuga/

Lost benefits of EMU?

Free capital movements and rising spread on interest rates on public debt put weak countries in a situation similar to pre-euro era:

- Vulnerability to financial speculation (then on currencies, now capital flights, external debt)
- High costs of public borrowing (5% of GDP in Italy). Less room for public spending
- Weaker economies, lower investment
- These imbalances make euro-exits even harder

2. Fiscal policy: missing

- EU Commission: “favourable” situation of public finances with “Broadly neutral stance” soft austerity, leading to diverging dynamics
- Deficits at 1% of GDP (6.6% in 2009)
- **Diverging Debt:**

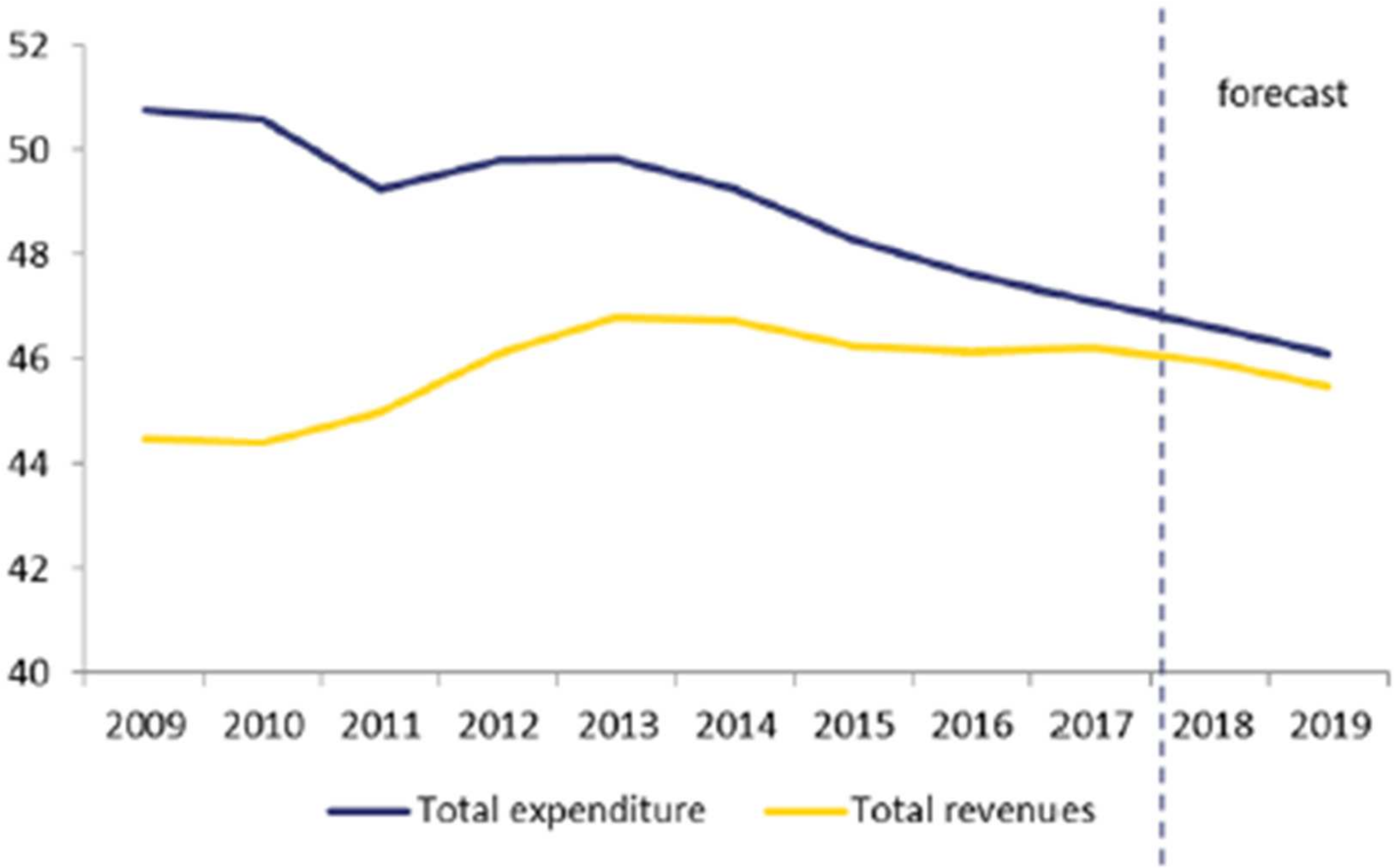
EU: 82% of GDP (88% in 2014)

Germany: 64% (peak of 81% in 2010)

Italy: 132% (132% since 2014, was 115% in 2010)

EU falling public expenditure and deficits

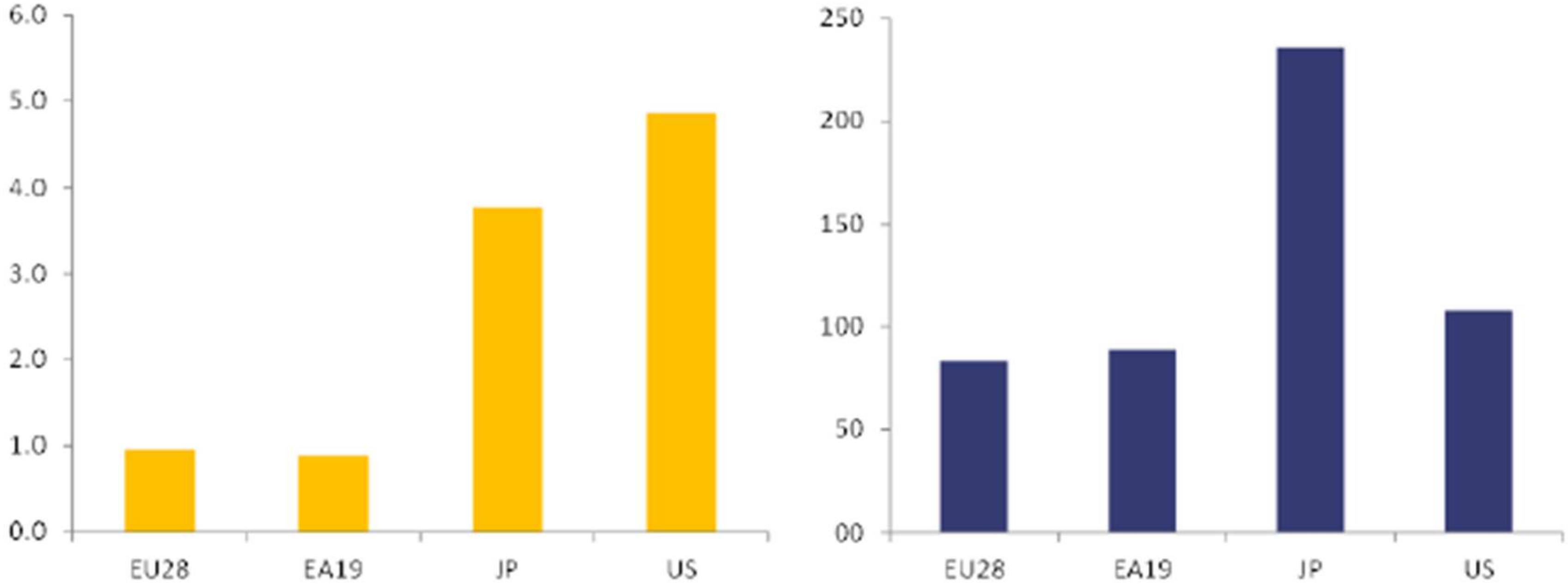
Graph 1.8: General government revenue and expenditure in the euro area (% of GDP)



Source: European Commission 2018 spring forecast.

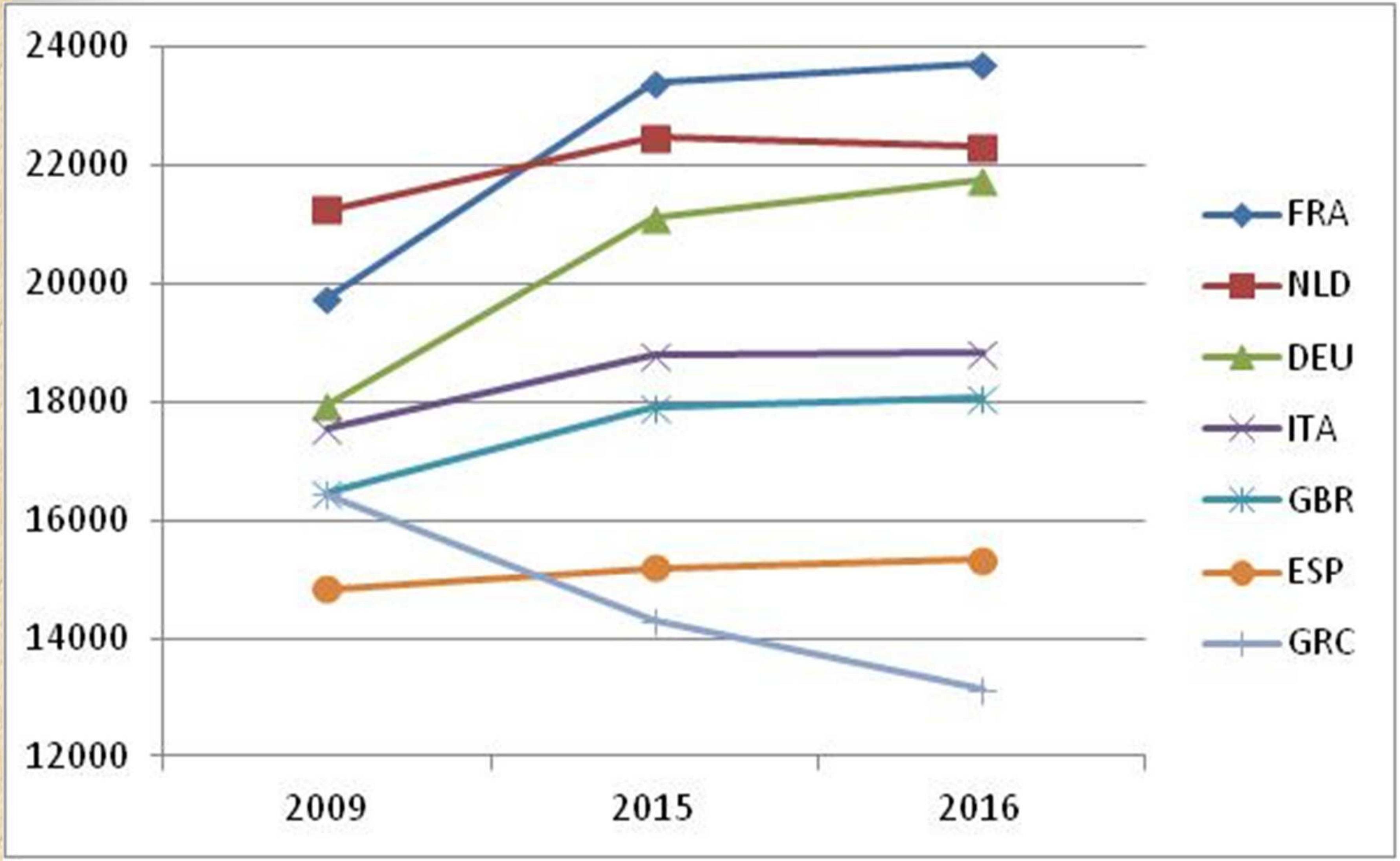
Deficit as % of GDP Debt as % of GDP

Graph 1.4: **Deficit (left-hand panel) and debt levels (right-hand panel) of EU, euro area, Japan and US in 2017 (% of GDP)**



Note: For the purpose of this graph, aggregate figures for the EU and euro area include EL.
Source: European Commission 2018 spring forecast.

Government expenditure per capita in Europe



Which fiscal policy room for countries?

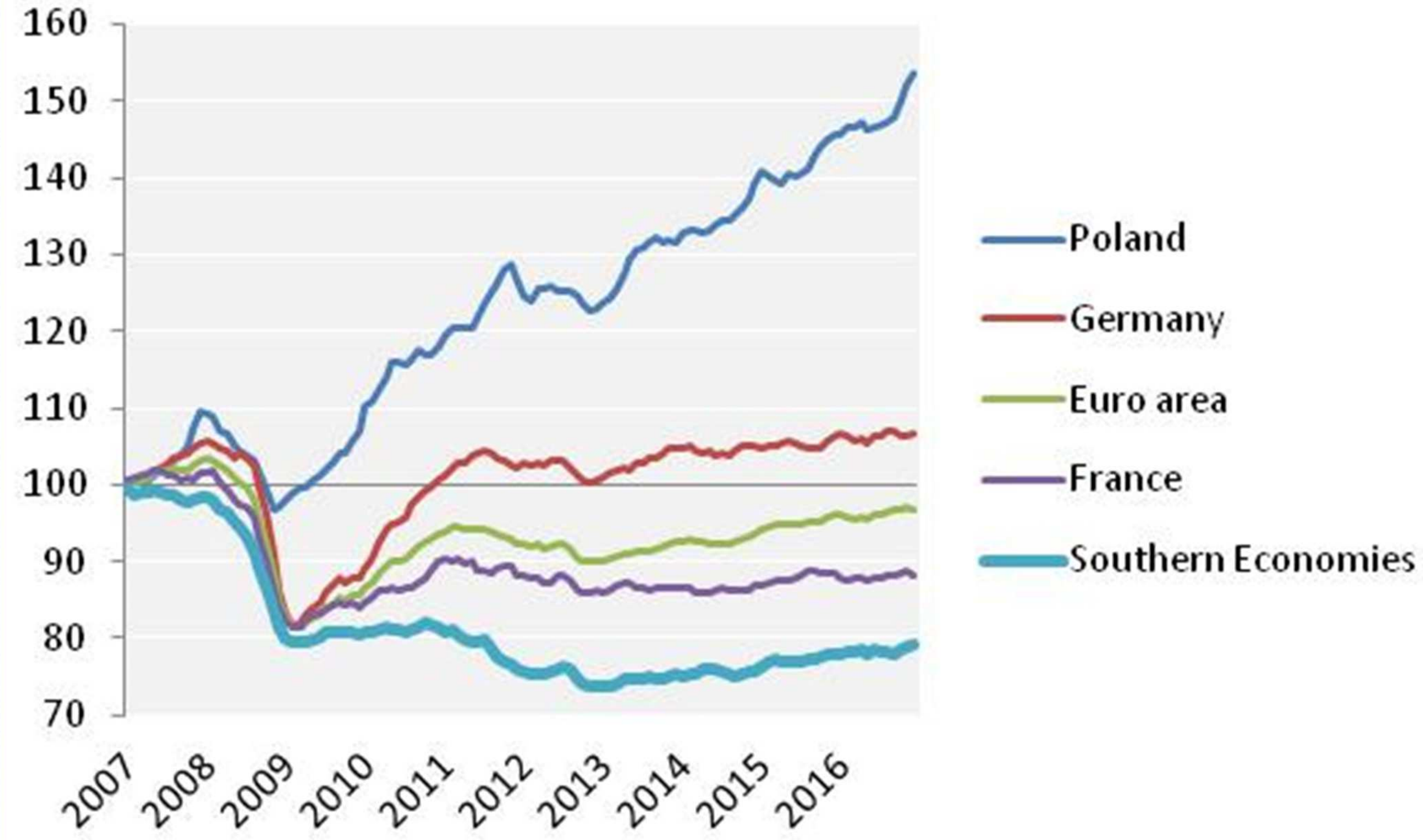
- Some deficit ‘flexibility’allowed to countries on a ad-hoc basis
- No use of fiscal policy tools as exports are less dynamic and investment is sluggish
- **Fiscal compact** restrictions to come: major policy confrontation? Or pretend is not there?
- No new policy plans, no progress on Macron’s proposal for a eurozone budget and minister

3. Real economy divergence, centre-periphery Europe

- Economic structures become more polarised
- Complex organization of international production around the German core
- Southern EU increasing second-tier supplier
- Technological divides matter
- Some initiatives – Juncker Plan/EFSI, Horizon Europe – with modest resources and strategies
- Space for Industrial policy in Europe

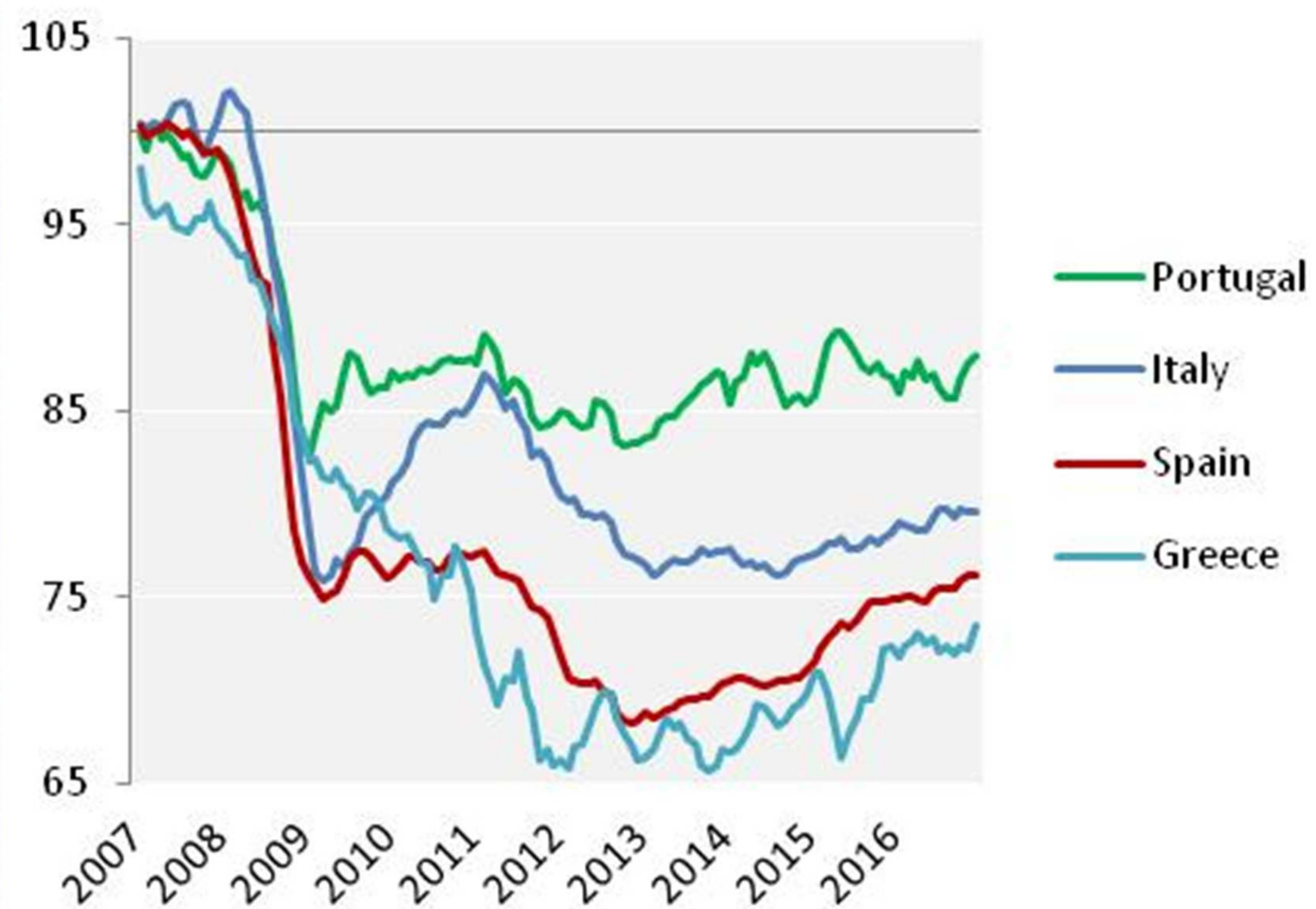
Index of production for manufacturing

2007=100 - 3 months moving averages (Eurostat)

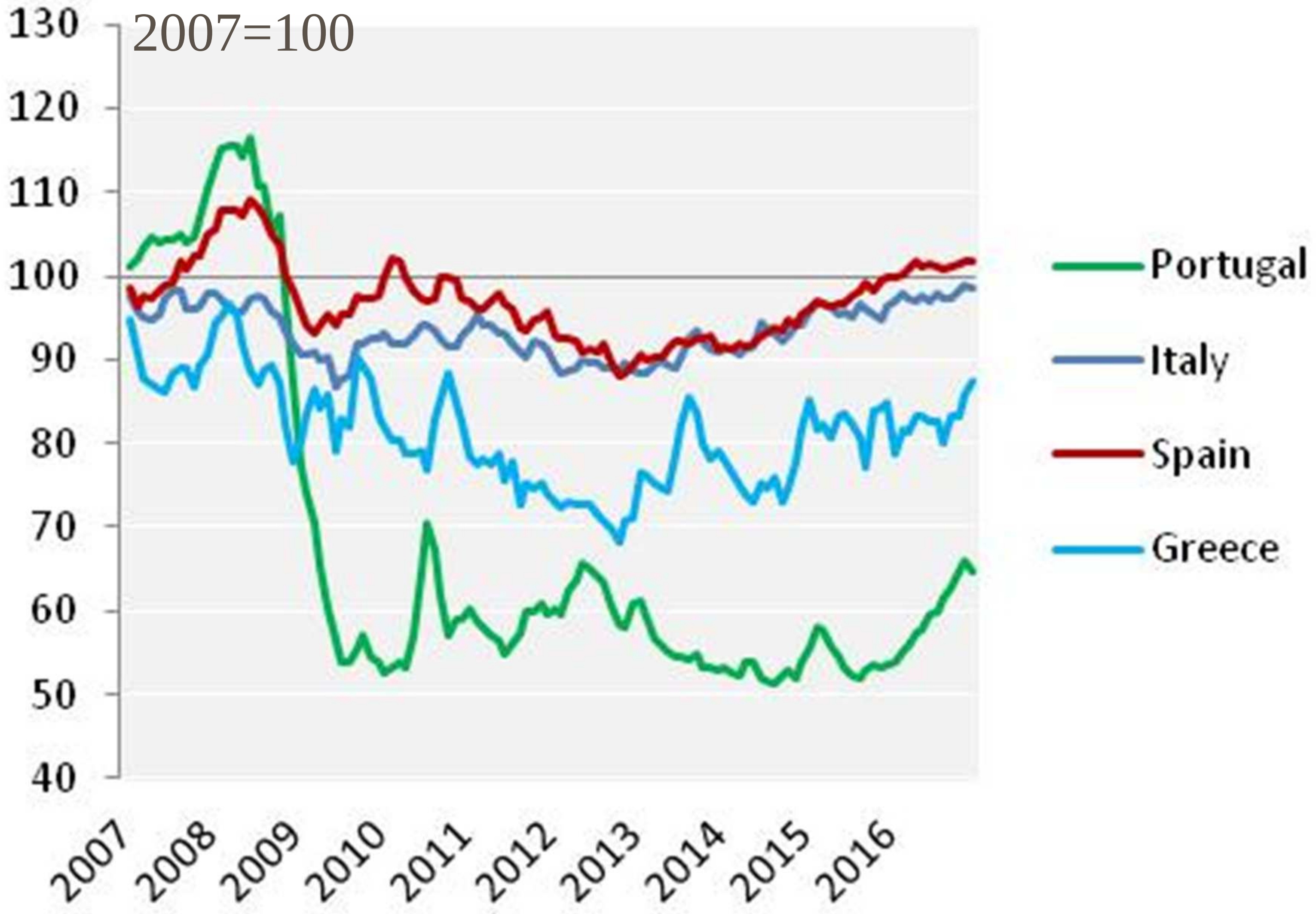


Index of production for manufacturing

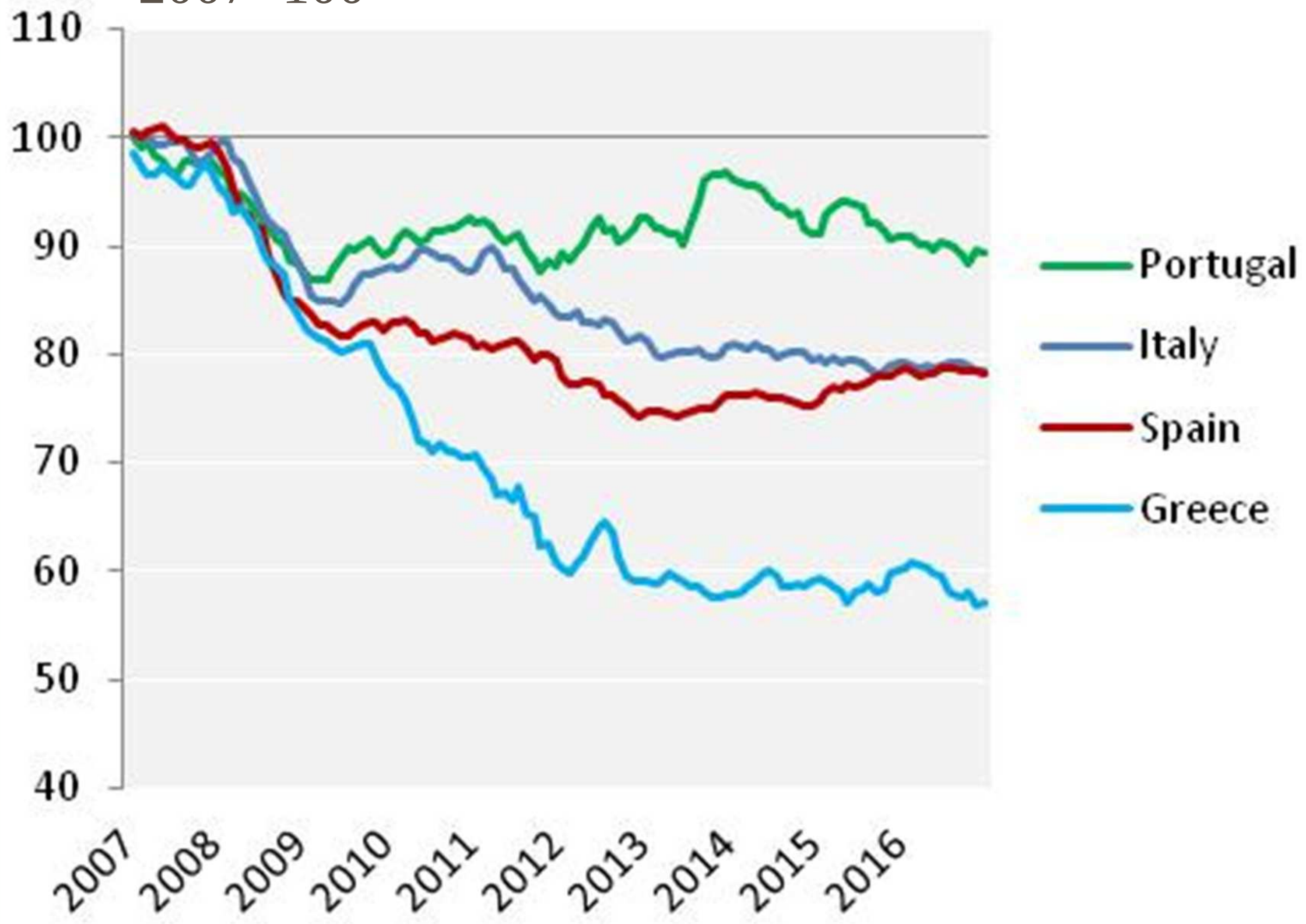
2007=100 - 3 months moving averages

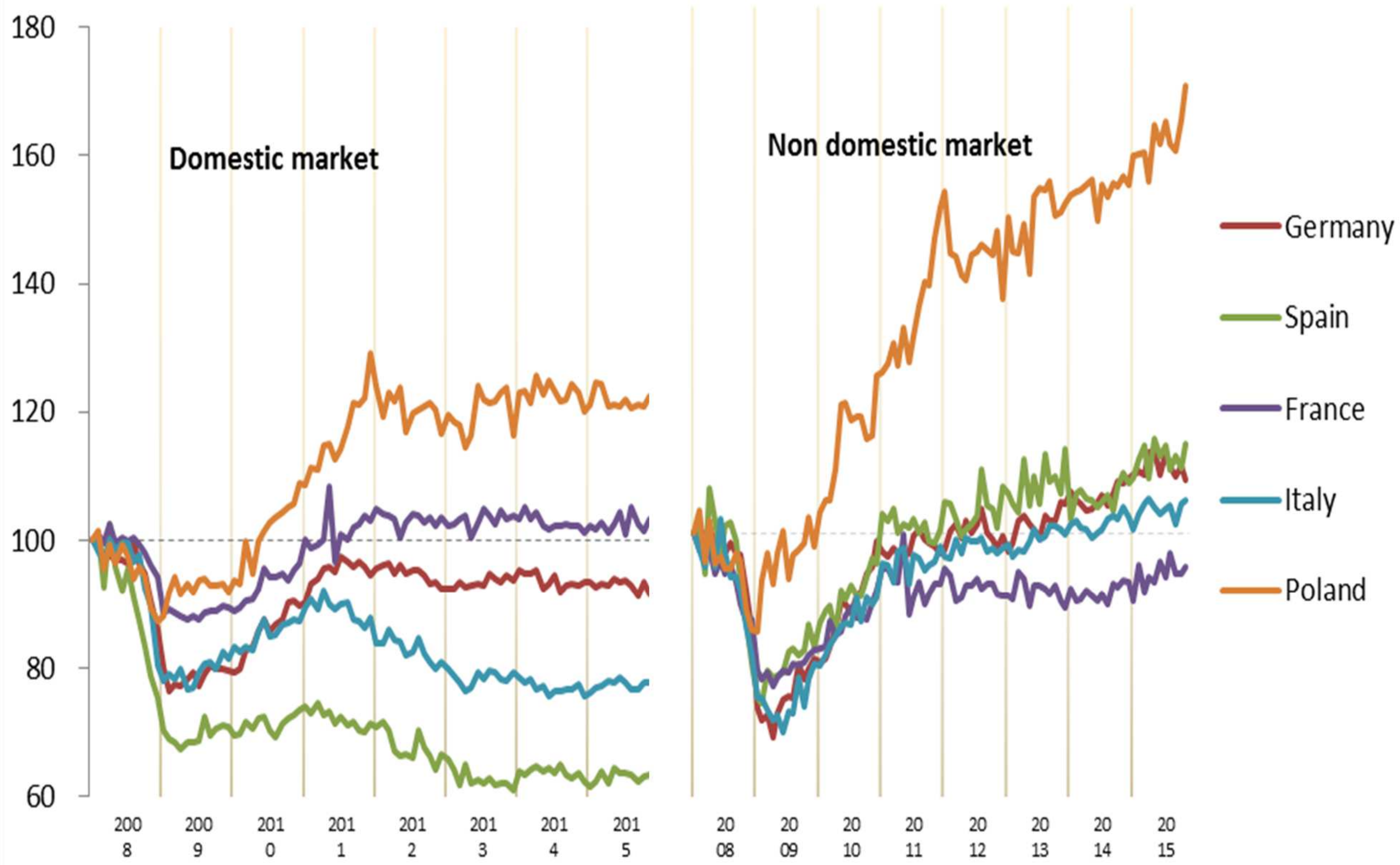


High technology industries
Index of production for manufacturing
2007=100



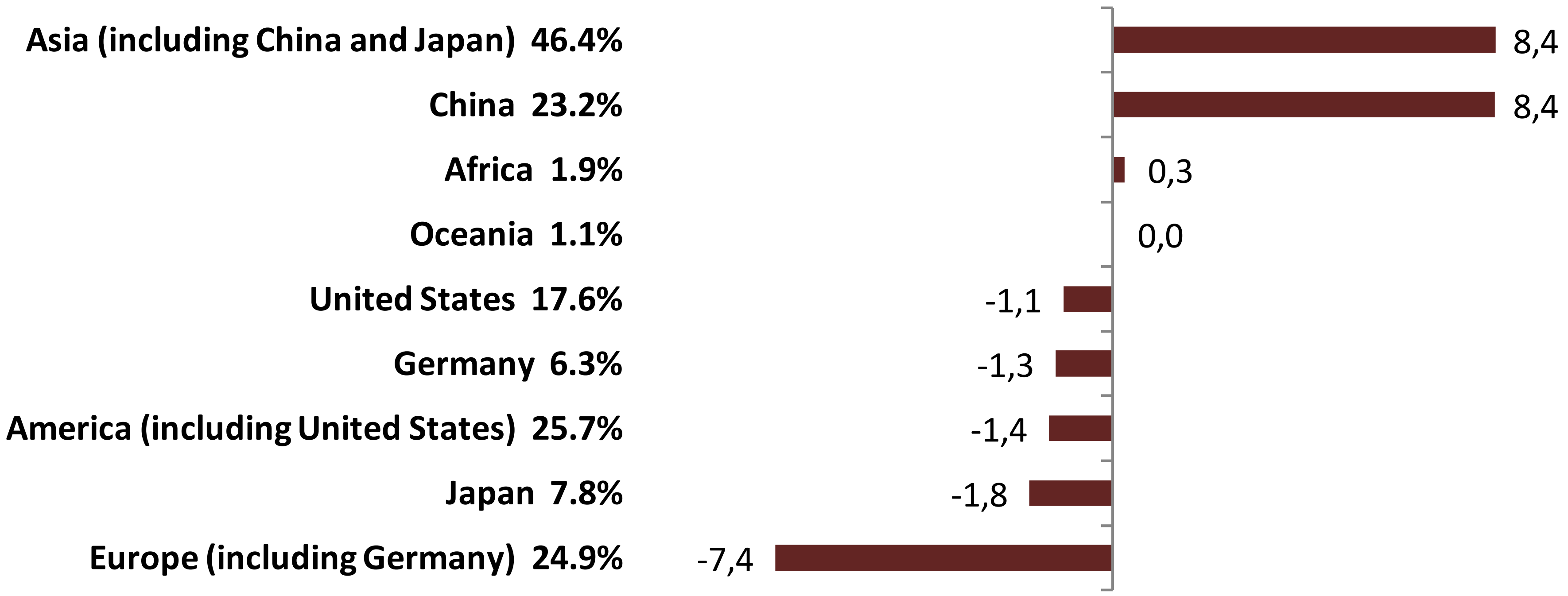
Low technology industries
Index of production for manufacturing
2007=100





180
160
140
120
100
80
60
Domestic market
Non domestic market
200 8
200 9
201 0
201 1
201 2
201 3
201 4
201 5
20 08
20 09
20 10
20 11
20 12
20 13
20 14
20 15
Germany
Spain
France
Italy
Poland

Figure 1. World Manufacturing Value Added shares in 2013 and change in percentage points from 2008 to 2013.



Note: Annual data, US dollars at current prices and current exchange rates in millions.
Source: UNCTAD, Economic Trends, National accounts.

The gains of China in the share of world manufacturing are mainly due to losses in Europe, except Germany

Economic structures matter

- **Industrial structure** matters; industries have different technological content, productivity dynamics, profit/wage levels etc
- **Different technological strategies**:

  new products vs processes
- Different **demand** dynamics
- This explains **divergence** in performances

The fall of investment

- Major change in recent history

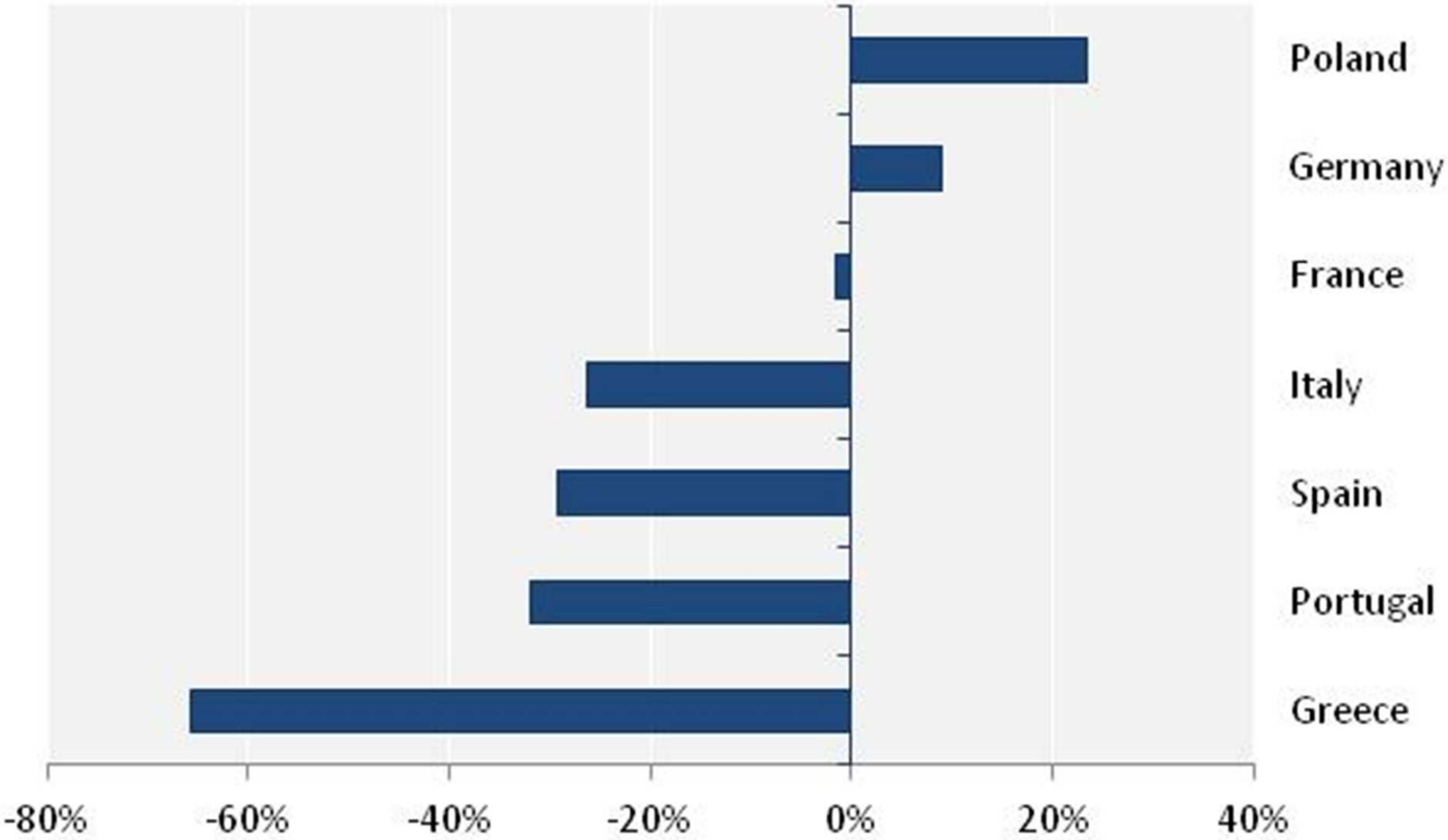
Private investment: combination of factors

- Finance as priority
- stock buy-backs, business strategies
- lack of emerging demand in specific fields
- Long term problem: R&D, innov, new prod.?

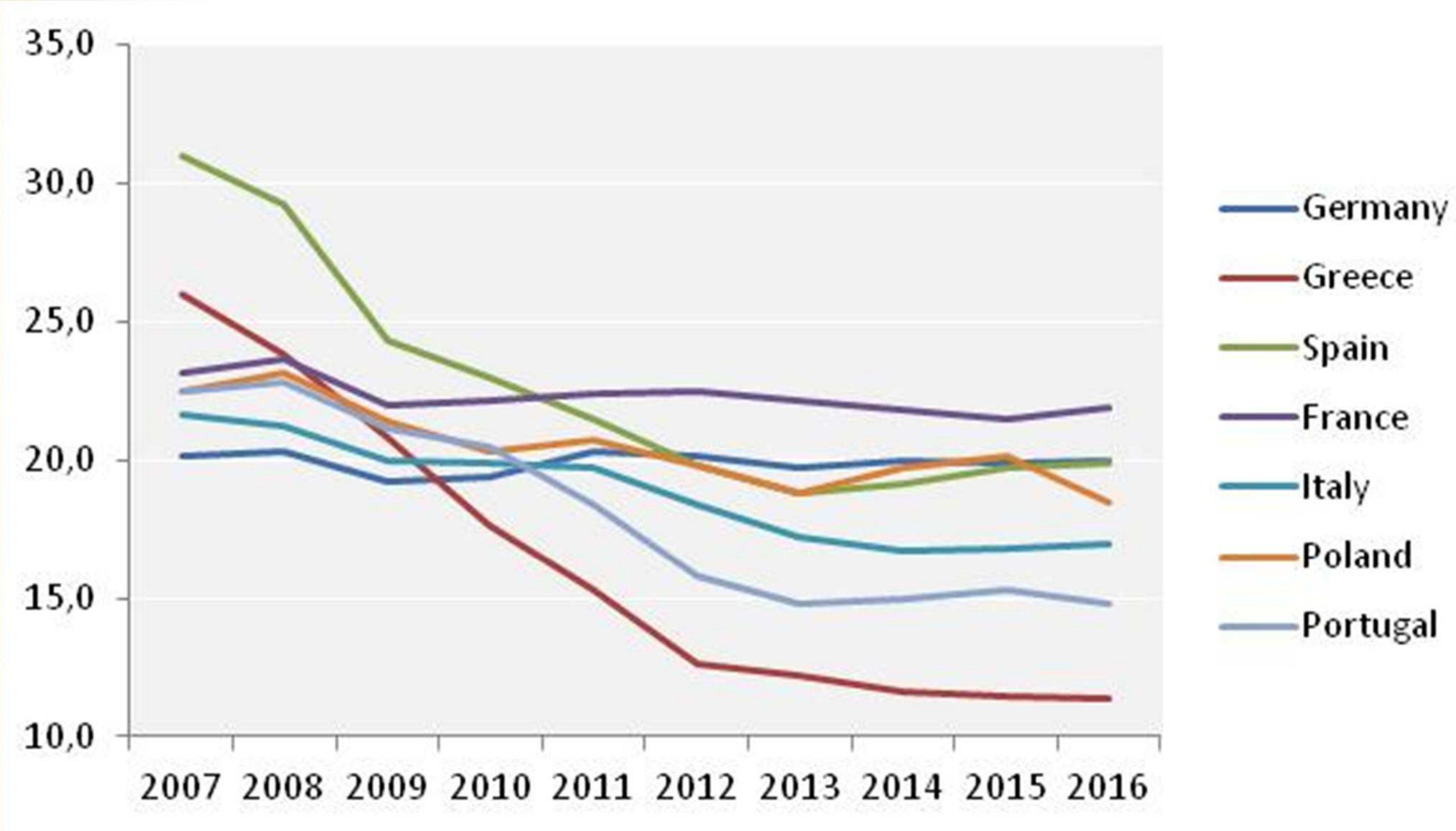
Public investment: collapse in South Europe due to austerity

Gross fixed capital formation

Percentage change 2007-2016, real terms

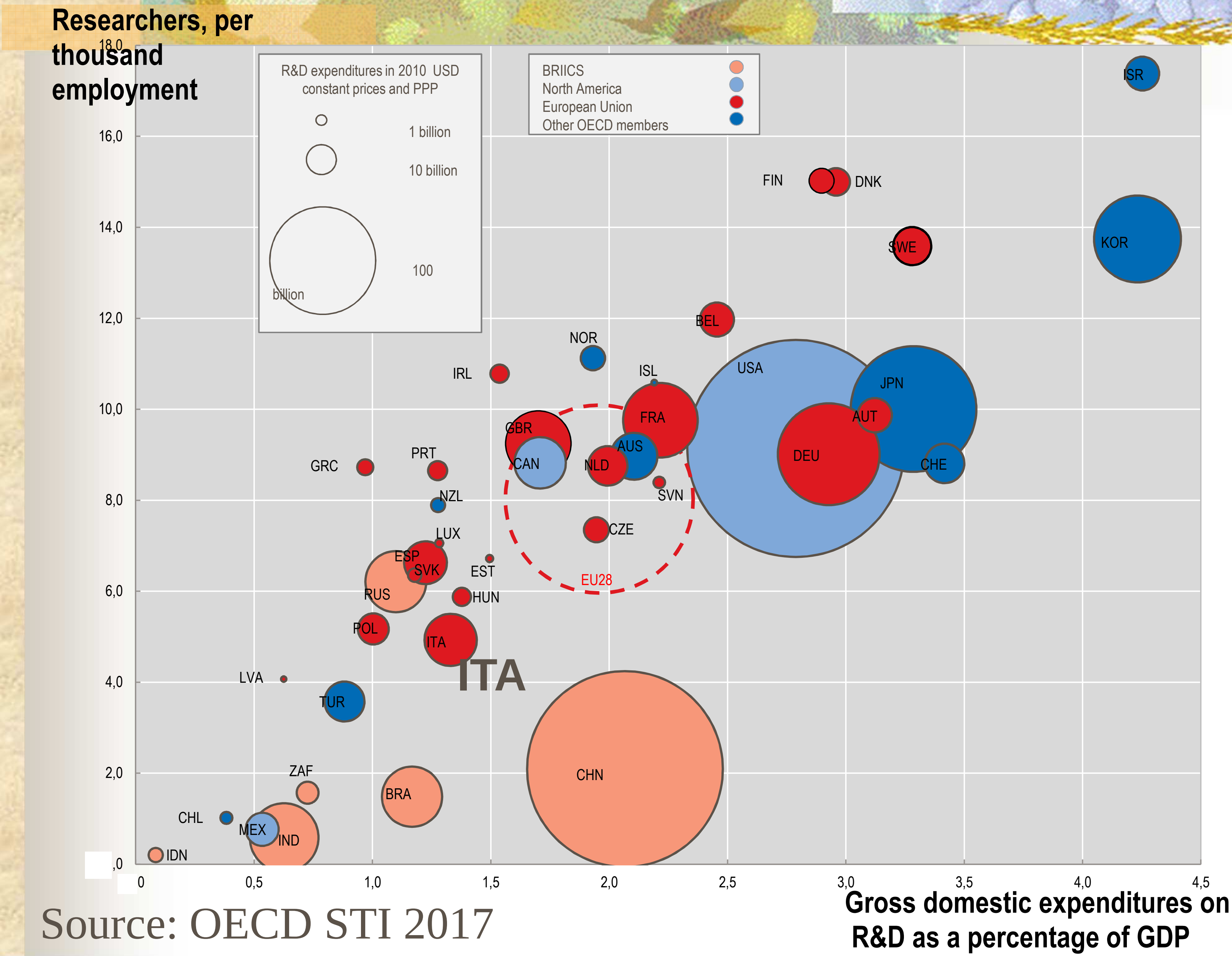


Gross fixed capital formation as a percentage of GDP



Change in public investment 2008-2015

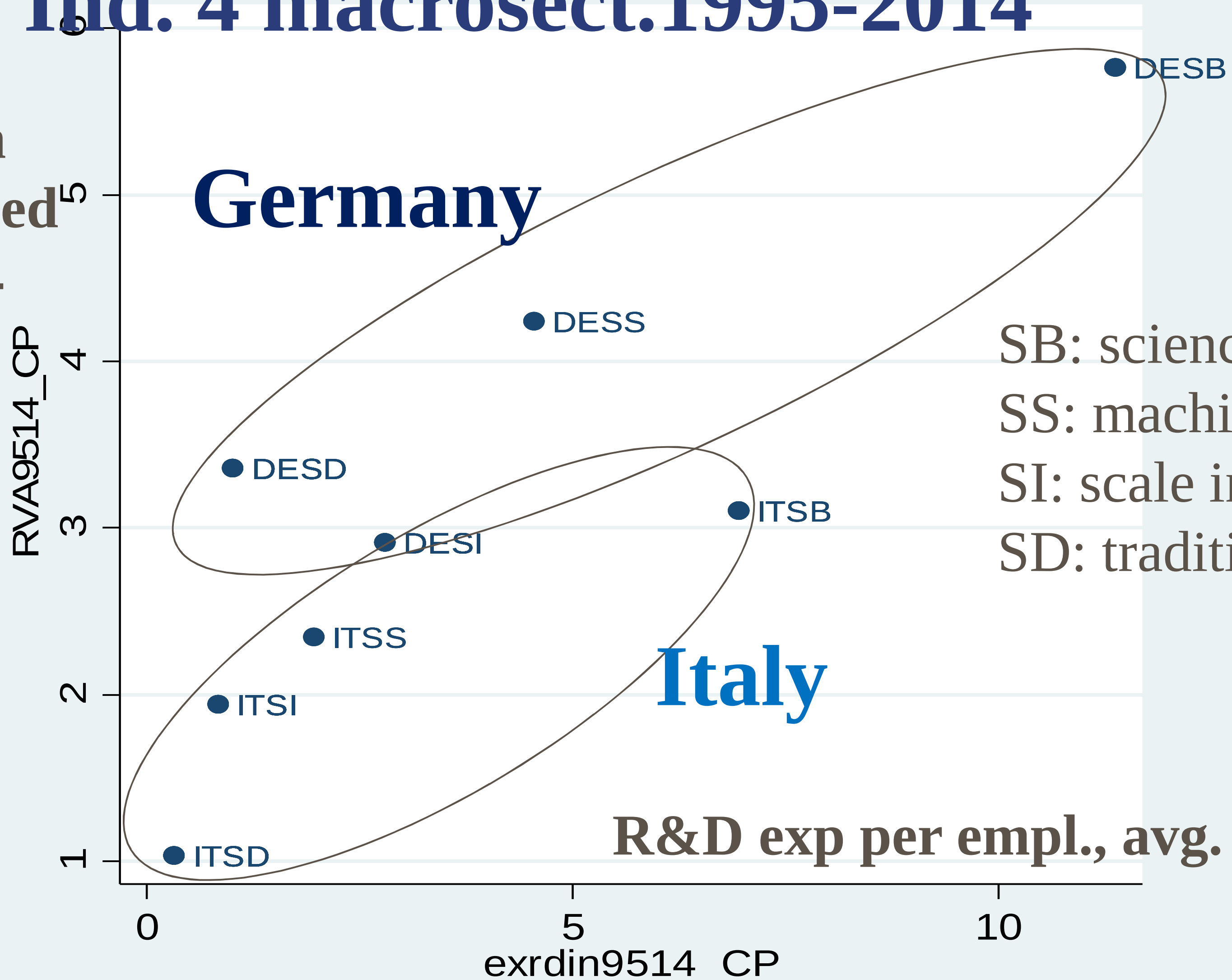
Euro area (19)	-11%
Germany	24%
France	-4%
Italy	-23%
Spain	-48%



Source: OECD STI 2017

R&D and Value added growth Manif. Ind. 4 macrosect.1995-2014

Change in Value added 1995-2014

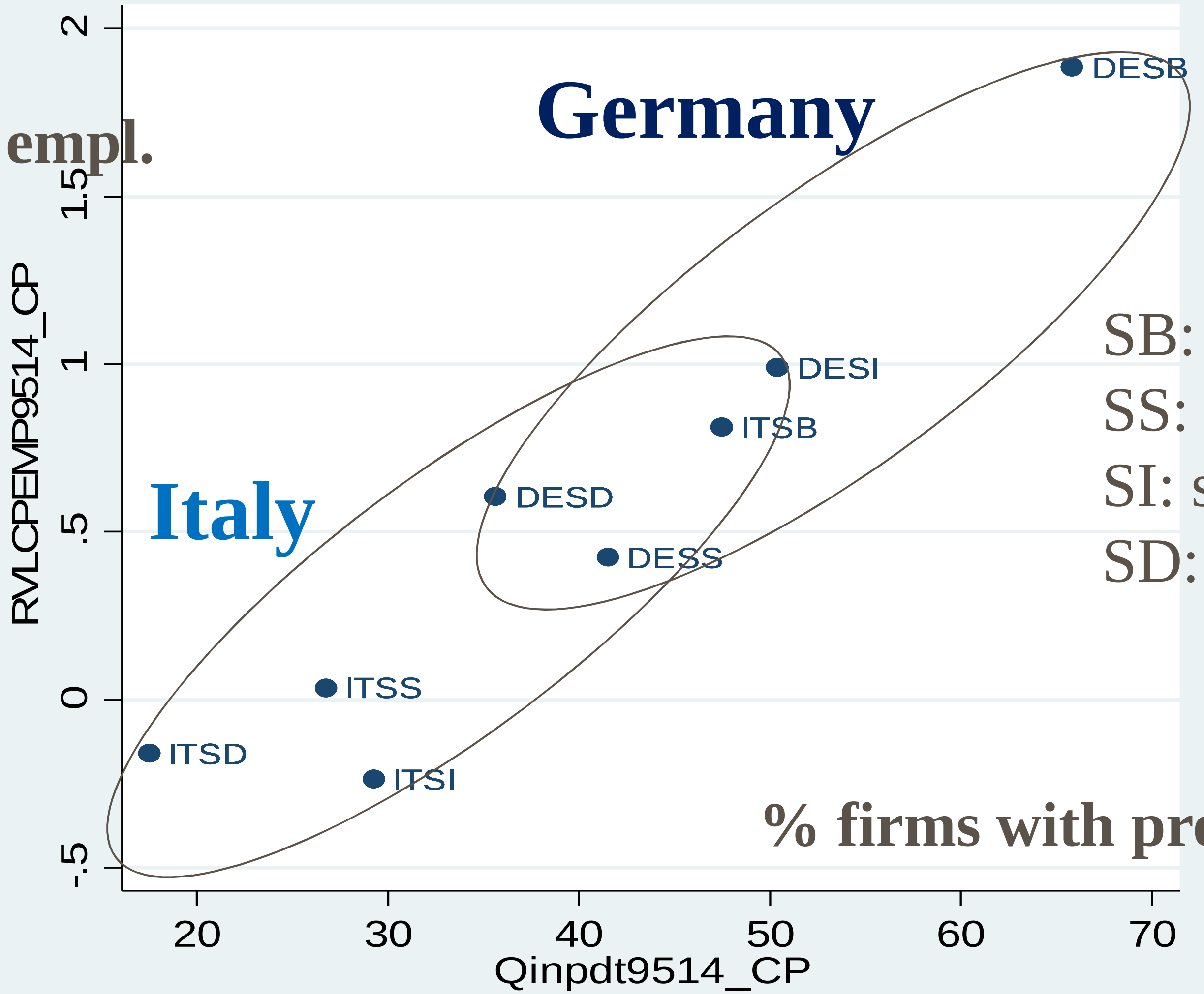


SB: science based
SS: machinery
SI: scale intens.
SD: traditional

R&D exp per empl., avg. 95-14

Product innov. and wage growth
Manif. Ind., 4 macrosect. 1995-2014

Change in
Wages per empl.
1995-2014



SB: science based
SS: machinery
SI: scale intens.
SD: traditional

% firms with product innov.

A growing structural divide since the crisis

- 2008-2016: public exp. for R&D falling in real terms by 21%;
- 2008-2015 public exp. for public universities falling by 14%.
- On private R&D, R%D personnel, university students, the gap between Italy and EU avg expanded
- **This structural divide prevents a convergence in econ performances**

4. The failure of European economic policies

- Unsolved Brexit
- Unsolved Greek crisis after end of ‘programme’
- No reform of EMU, unsolved debt problems, unfinished Banking Union etc.
- Potential global space for EU policy and euro, as the US looks inward
- Possibility of a new financial crisis, with weaker policy tools to face it (US debate)

What lies ahead?

- Waiting for the 2019 EU Parliament elections: policy stalemate and immobility
- Weaker Brussels in enforcing rules
- Weaker legitimacy of EU integration, rise of nationalisms (which lack a viable alternative)
- No clear future majority in EU Parliament
- End of QE and of Draghi’s term at the ECB
- Possibility of new crises, weaker policy tools/consensus, risk of disintegration