16

Ref. Ares(2012)971130 - 14/08/2012

EUROPEAN COMMISSION
Cabinet of Vice-President Viviane Reding,
Commissioner for Justice, Fundamental Rights and Citizenship

Head of Cabinet

Brussels, 13 August 2012
MS/VH/jm Ares Lien: A(2012)950116

Dear Ms Hoffmann,

On behalf of Vice-President Viviane Reding, thank you for your email of 6 August and for sending her the latest edition of "Spotlight Europe – Confronting the Crisis".

The Vice-President read it with interest.

Yours sincerely,

p V. Martin

Martin Selmayr

Ms Isabell Hoffmann
Project Manager
Bertelsmann Stiftung

By email:

Commission européenne, B-1049 Bruxelles / Europese Commissie, B-1049 Brussel - Belgium. Telephone: (32-2) 299 11 11.
Office: BERL. 12/294. Telephone: direct line (32-2) 2981230. Fax: (32-2) 2960746.

E-mail: martin.selmayr@ec.europa.eu

From: (CAB-REDING) on behalf of REDING Viviane (CAB-REDING)
Sent: 12 September 2012 15:08
To: CAB REDING ARCHIVES BIS
Subject: FW: Policy Brief ,Future Social Market Economy' # 2012/05
Attachments: PolicyBrief_Print_Englische_Ausgabe2012_05 _Maastricht_NeueVerschuldungsregel_Final.pdf

---

From: Team Social Market Economy
Sent: Wednesday, September 12, 2012 2:51 PM
To: REDING Viviane (CAB-REDING)
Subject: Policy Brief ,Future Social Market Economy' # 2012/05

Dear Mrs Reding,

Sovereign debt had risen dramatically in the vast majority of European states even before the worldwide financial and economic crisis struck in 2008. The European Union is attempting to bring mushrooming sovereign debt under control via a new instrument, the Fiscal Compact of March 2012, which calls for all signatory states to impose a cap on national debt comprising a maximum structural deficit of 0.5 percent of GDP.

The Compact's debt brake rules leave much to be desired when it comes to promoting economic growth. Bertelsmann Stiftung and Prognos AG propose a sovereign debt framework which would be much more conducive to economic growth than the inflexible Fiscal Compact. The new sovereign debt framework (Maastricht 2.0) takes into account national peculiarities, but is by no means arbitrary in nature.

The attached Policy Brief "Maastricht 2.0 - Proposed reform of EU sovereign debt rules" outlines the basic principles of this proposal for reducing sovereign debt in Europe.

We hope that you find the Policy Brief of interest – and we would certainly be interested in receiving your feedback.

Best regards,

Dr. Thieß Petersen
Senior Project Manager
Program Shaping Sustainable Economies
E-Mail:

Eric Thode
Senior Expert
Program Shaping Sustainable Economies
E-Mail:

Bertelsmann Stiftung
Carl-Bertelsmann-Straße 256 | 33311 Gütersloh | Germany
www.bertelsmann-stiftung.de <http://www.bertelsmann-stiftung.de/>

Policy Brief # 2012/05

Maastricht 2.0 - Proposed reform of EU sovereign debt rules

The European Union's regulations governing sovereign debt are based on the principle of equal treatment of all member states. The recommendations we make here concerning changes in European Union sovereign-debt reduction rules take account of national particularities, but are by no means arbitrary in nature. According to the calculations we present here, such reformed regulations would do far more to promote economic growth than would be the case under the Fiscal Compact's European debt brake. By 2030, real gains in growth will amount to more than 450 billion euros more than the outcome that would presumably be obtained under the European debt brake.

Dr. Thieß Petersen
Program
Shaping Sustainable Economies

Phone:
+49 5241 81-81218
Email:
thiess.petersen@bertelsmann-stiftung.de

Dr. Michael Böhmer
Prognos AG

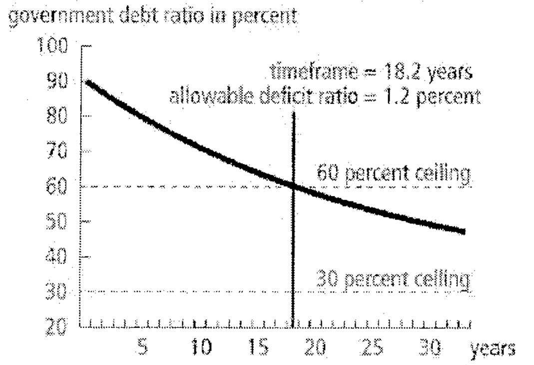
Phone:
+49 89 954 1586-701
Email:
michael.böhmer@prognos.com

Dr. Johannes Weisser
Prognos AG

Phone:
+49 89 954 1586-704
Email:
johannes.weisser@prognos.com

Focus

Debt reduction trajectory (government debt ratio: 90 percent; nominal economic growth: 4 percent)



Source: Prognos AG. | BertelsmannStiftung

For a hypothetical member state whose sovereign debt is currently 90 percent of nominal GDP and with projected GDP growth of 4 percent a year, our proposed debt rule would allow for a mean annual deficit ratio of 1.2 percent. Hence such a member state could achieve a government-debt ratio of 60 percent of nominal GDP within around 18 years.

1. Current EU sovereign debt regulations

The maximum levels to which sovereign debt should be allowed to rise has long been a subject of intense debate among both economists and political leaders, who have yet to reach a consensus view on the matter. However, there is general agreement that a total ban on sovereign debt would be as economically absurd as prohibiting companies and individuals from taking out loans (see SVR 2007, p. 1). Likewise there is consensus that excessive sovereign debt is undesirable, for sooner or later it is bound to seriously restrict government economic policy leeway and could eventually lead to sovereign default. Moreover, empirical studies have shown that sovereign debt exceeding 80 to 90 percent of nominal GDP is a drag on economic growth, and thus of course on employment (see for example Reinhart and Rogoff, 2010).

The Maastricht Treaty stipulates that total annual government deficits are not to exceed 3 percent of nominal GDP, and that total sovereign debt is not to exceed 60 percent of GDP. There is no particular economic justification for this rule, for as one study put it: "From the get-go it is by no means clear, for example, whether a government-debt ratio of 30 percent is 'better' or 'worse' than a 70 percent government-debt ratio" (SVR 2007, p. 29). However, as the box below shows, there are definitional correlations between a member state's government-debt ratio, deficit ratio, and GDP growth rate (see text box).

A government's deficit ratio will unavoidably be subject to a ceiling insofar as the government (a) promulgates a specific maximum government-debt ratio; and (b) bases its economic policies on a projected long-term GDP growth rate. The 60 percent limit on sovereign debt stipulated by the Maastricht Treaty back in 1992 was

Computation procedure for the three-percent deficit rule: The government-debt ratio (v) for a given year is defined as the ratio between total sovereign debt (V) and GDP for such year: $[v = \frac{V}{GDP}]$. Sovereign debt as at end of any given year is composed of the total sovereign debt for the prior year (V) and the current deficit (D). The effort to achieve a constant government-debt ratio is thus characterized by the following equation: $[\frac{V}{GDP} = \frac{V + D}{(1 + g) \cdot GDP} = v = \text{constant}]$, where: g = the GDP growth rate; or put another way: $[(1 + g) \cdot \frac{V}{GDP} = \frac{V + D}{GDP} = \frac{V}{GDP} + \frac{D}{GDP}]$. It thus follows that $[(1 + g)\, v = v + d]$, whereby the deficit ratio is $[d = \frac{D}{GDP}]$. When multiplied out the following result is obtained $[v + g \cdot v = v + d]$ and $[g \cdot v = d]$ and $[v = \frac{d}{g}]$. The latter two expressions characterize the relationship that is established by definition between long term government-debt ratios (v), long term growth of nominal GDP (g), and the allowable long term deficit ratio (d). With 5 percent growth in nominal GDP $(g = 0.05)$ and a target government-debt ratio of 60 percent $(v = 0.6)$, the maximum allowable deficit ratio is 3 percent, whereby $[d = g \cdot v = 0.05 \cdot 0.6 = 0.03]$. But if nominal GDP increases by only 2 percent, the allowable long term deficit ratio is only 1.2 percent $[0.02 \cdot 0.6 = 0.012]$.

arrived at by tallying the sovereign debt of the then EU member states and the respective nominal GDP values. This calculation yielded a government-debt ratio figure of roughly 60 percent. In combination with a GDP growth rate at the time of around 5 percent, a 3 percent figure for the allowable deficit ratio was arrived at. This three-percent criterion was the sole basis for determining whether a given member state had violated the European Union's sovereign debt rules.

2. Sovereign debt trends in the European Union

Sovereign debt had risen dramatically in the vast majority of European Union states even before the worldwide financial and economic crisis struck in 2008, largely owing to member states' failure to stick to the Maastricht Treaty's three percent annual government deficit ceiling. But even if every European Union member state had adhered to the three percent limit, the sovereign debt of many of these countries would have exceeded 60 percent of GDP anyway. This is attributable to the fact that the low economic growth in these states in recent years would have been insufficient to stabilize their ratio of sovereign debt to GDP, even if they had adhered to the deficit ceiling. For example, Germany's deficit ratio was supposed to have averaged less than 2 percent of GDP between 1993 and 2012.

The European Union is attempting to bring the mushrooming sovereign debt of EU member states under control via a new instrument, the Fiscal Compact (formally, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union) of 2 March 2012, which calls for all signatory states to impose a cap on national debt comprising a maximum structural deficit of 0.5 percent of GDP. The treaty defines the structural deficit as a given state's sovereign debt, after adjusting for cyclical fluctuations and temporary measures. In cases where a member state's sovereign debt is significantly below 60 percent of GDP, the maximum allowable structural deficit is 1 percent of GDP (see CEP 2012, p. 1). Thus, this restriction on sovereign debt makes no allowance whatsoever for the economic particularities of a given member state.

3. Recommended reform of the European Union's sovereign debt rules

The reform we recommend here – which would promote long term stabilization of the finances of European Union member states, while taking account of the economic particularities of each such state – would involve the following: The maximum sovereign debt amounting to 60 percent of GDP promulgated by the Maastricht Treaty would remain in place. For despite the absence of an economic rationale for this figure, it has become a cornerstone of the public debate on sovereign debt and is thus easier to implement. Also, the 60 percent criterion serves as a firewall for sovereign debt amounting to 80 to 90 percent of GDP – a rate that is a drag on economic growth. As long as any member state's sovereign debt is less than 60 percent of GDP, the 3 percent mark for its annual deficit can be adhered to. Moreover, insofar as a 60 percent ratio of sovereign debt to GDP is deemed sustainable, there is no reason to impose more stringent sovereign debt rules on member states whose debt level is lower than this ratio.

But in cases where sovereign debt exceeds the 60 percent mark, a rule requiring that the government-debt ratio be reduced should kick in that allows for the differences in economic conditions from one member state to another. Under our proposed reform, in addition to determining maximum allowable annual deficit ratios, the amount of time it would presumably take for a member state to reach a government-debt ratio of 60 percent of GDP would also be factored into the equation. This timeline would in turn be ascertained by determining allowable deficit ratios, so as to ultimately achieve member state government-debt ratio convergence to 30 percent of GDP.

Far from being a target, the sole purpose of this 30 percent parameter is to determine at which juncture a given member state reaches the targeted 60 percent government-debt ratio. The 30 percent figure was selected because our simulations show that a putative 30 percent government-debt ratio convergence constitutes a reasonable compromise between the goal of reducing sovereign debt with all due speed while at the same allowing reasonable consolidation needs to be met. The so called structural deficit (determined by positing that the government-debt ratio will be 30 percent and that nominal GDP will increase over the long term) indicates the maximum allowable deficit ratio that would be necessary to achieve a putative sovereign debt amounting to 30 percent of GDP. Our proposed reform rests on the assumption that long term GDP growth will be on a par with average economic growth over the prior five years. But during economic crises, economic growth over the previous five years is a highly unreliable basis for such projections. Hence in determining structural deficit ratios, we estimated the long term nominal growth rates for the calculations described below and – contrary to one of the basic principles of our proposed sovereign debt regulation reform – based on the growth rates of the past ten years and the long term projections in Prognos-Weltreport. Thus for example, a member state with a long term 4 percent GDP growth rate is deemed to have attained the requisite structural deficit ratio of 1.2 percent ($d = v \cdot g = 0.3 \cdot 0.04 = 0.012$). The time it takes for a given member state to reach a government-debt ratio of 60 percent will be determined by the state's baseline sovereign debt. For example, it would take a member state – with sovereign debt amounting to 90 percent of GDP and with a nominal economic growth rate of 4 percent – around 18 years to reach a 60 percent government-debt ratio (see graph on p. 1). Under our reform, this consolidation phase would constitute a legally binding set period during which the allowable deficit ratio would be adjusted if the GDP growth rate deviates from the projected rate. However, instead of being determined on the basis of the structural deficit alone, the maximum allowable government deficit would be higher during economic downturns; and this in turn would have to be offset by lower allowable deficits during economic upturns. The attendant "cyclical deficit ratio" would be determined on the basis of the cyclical component, as follows: cyclical component = (potential output – projected GDP) · budget sensitivity, which indicates the extent to which a national budget is determined by GDP; it is determined at regular intervals by the European Commission in accordance with OECD requirements (also see Girouard and André 2005). The projected GDP is based on the European Commission's current economic forecasts.

The economic crisis that struck in 2008 has demonstrated in no uncertain terms that both public and private indebtedness can induce sweeping economic upheavals. However, the problem with private-sector debt is that it is completely uncontrollable as it is the outcome of countless individual decisions. Our proposed reform takes account of both government and current-account deficits, in order to be able to counteract macroeconomic imbalances. To this end, current-account deficits would be limited to 4 percent of GDP.

The VIEW model is a macroeconomic model that is used to make projections and simulate economic scenarios. The simulations in our study encompassed the world's 42 states that account for more than 90 percent of the world economy and were based on the following parameters: supply and demand; labour markets; government finances; as well as exports, imports, currency rates and so on. Thus, the model also factors in the interrelationships between the various states as regards these parameters.

4. How our proposed reform would stimulate economic growth

Cutbacks in government expenditures on goods and services reduce overall demand and provoke sales losses. And when companies are then forced to pare down production and lay off workers, this in turn impacts on government finances, reduces tax and social security revenue, and forces the government to spend more on unemployment benefits. Hence it is essential that government-revenue losses be taken into account in devising policies aimed at reducing sovereign debt; for a sudden drop in government expenditures on goods and services can be counter-productive and can increase sovereign debt even further. In the interest of estimating the impact of our proposed sovereign debt reforms on the various member states' economies and the world economy as a whole, we conducted a simulation using Prognos's macroeconomic VIEW model (see text box).

We devised a sovereign debt reduction solution based on the 2010 data for European Union member states whose government-debt ratio exceeds 60 percent of nominal GDP. In other words, we determined the maximum allowable structural deficit ratio and the number of years it would take for a given country to bring

Table 1: Timeframe and allowable structural deficit ratio

Country	Timeframe*	Allowable structural deficit ratio 2011
Belgium	25	1.03 %
Germany	19	0.96 %
France	21	0.90 %
Greece	43	1.00 %
Ireland	34	0.24 %
Italy	44	0.79 %
Netherlands	3	1.04 %
Austria	12	0.97 %
Portugal	26	0.94 %
Spain**	16	1.01 %
Great Britain	19	0.93 %
Hungary	9	2.22 %

* Duration (in years; rounded to the next whole number). ** Consolidation from 2013 onwards.

Source: Prognos AG. | Bertelsmann Stiftung their government-debt ratio down to 60 percent of nominal GDP. As table 1 shows, our proposed reform would allow these member states an altogether higher deficit ratio than the European Union's 0.5 percent debt reduction figure, and would afford them more economic policy leeway. The differences in the maximum allowable structural deficit ratios in our plan are attributable to differences in projected nominal economic growth for the national economies.

Table 2 displays the differences in economic development that would result from the Fiscal Compact's European debt brake versus our proposed reform. These figures were arrived at by simulating what would happen if, in the run-up to 2030, all European Union member states adopted fiscal policies that were consistent with our proposed reform. We then compared the results of this simulation with those of a simulation of the putative outcome if all European Union member states adhered to the stipulations of the Fiscal Compact between 2011 and 2030. This comparison shows that by 2030, cumulative real growth would outpace by more than 450 billion euros the outcome that would be obtained under the current European debt brake. These 450 billion euros would, for example, enable the European Union to finance 65 percent of the capital for the European Stability Mechanism (ESM), or underwrite Greece's entire sovereign debt as at December 2011 amounting to around 355 billion euros – and with enough left over to finance 55 percent of Portugal's sovereign debt as at this same date.

Table 2: Real Gross Domestic Product: difference between recommended reform and European debt brake absolute, in billion Euros, prices as of 2005

Members of European Monetary Union	2015	2020	2025	2030	cumulated 2011-2030
Belgium	0.3	1.0	1.6	2.2	20.3
Germany	-6.3	7.6	18.4	32.8	186.0
Estonia	0.0	0.0	0.1	0.1	0.9
Finland	-0.3	1.5	2.4	1.8	23.9
France	-21.1	-1.1	19.1	37.7	74.9
Greece	-0.2	0.9	1.8	2.5	20.2
Ireland	-1.7	0.2	0.9	1.4	-0.9
Italy	-3.5	-6.9	5.5	13.5	41.2
Netherlands	-0.9	1.7	3.5	3.3	32.2
Austria	-0.4	0.6	1.6	3.4	17.1
Portugal	-2.2	-0.2	0.1	2.1	-7.5
Slovakia	0.1	0.3	0.5	0.8	5.6
Slovenia	0.1	0.2	0.2	0.3	3.3
Spain	-5.0	-7.3	2.2	11.5	23.5
other EU countries					
Bulgaria	0.1	0.0	0.2	0.4	2.3
Denmark	2.0	1.6	2.2	2.4	36.3
Great Britain	-17.9	-10.0	5.0	21.7	-73.7
Lithuania	0.0	0.0	0.1	0.1	1.1
Latvia	0.1	0.3	0.3	0.4	4.4
Poland	-0.7	2.4	6.0	4.7	54.0
Rumania	0.2	-0.2	0.0	0.1	-8.6
Sweden	0.3	0.8	1.9	3.2	25.2
Czech Republic	0.1	0.4	0.8	1.5	10.8
Hungary	0.1	0.3	0.3	0.5	4.9
EU total	-57.0	0.5	74.3	[illegible]	454.5

Source: Prognos AG | Bertelsmann Stiftung

While our results revealed unfavourable evolutions in a few member states, they would be of brief duration and in the long run our proposed sovereign debt framework would promote economic growth in all European Union member states (see text box). Germany's economy is closely interlinked with other EU countries' economies. Which is why Germany would stand to benefit most from our proposed sovereign debt regulation framework, as economic growth in our partner countries would increase.

Transitional rules and their possible consequences: The transitional rules of the European debt brake call for incremental government deficit ratio reductions over a six year transitional period, as is being done in Germany. In contrast, our proposed framework calls for proportionally higher structural-deficit reductions at the beginning of a likewise six year period. The rationale for this distinction and the attendant proposed reform is that transitional-rule largess during a set consolidation period would inevitably result in needlessly stringent consolidation requirements – particularly in light of the unusually high deficit ratios that we saw in 2010. Hence in the final analysis our proposed regime is more stringent than that of the Fiscal Compact's European debt brake. And while this would be a drag on economic growth, our framework would at the same time promote economic growth in that it would allow for lower government-debt ratios and deficit ratios that take account of the economic conditions in individual member states.

Conclusion

Adhering to a maximum allowable government-debt ratio of 60 percent of GDP would make it necessary for many European Union member states to reduce their sovereign debt. In contrast, the approach to reducing sovereign debt that we propose here has the virtue of being clear and simple; plus it makes allowances for the economic particularities of individual member states without being arbitrary. Moreover, our proposal will stimulate economic growth far more than will be the case with the inflexible sovereign debt reduction regime imposed by the Fiscal Compact. And finally, rules that allow the European Union member states more time to reduce their sovereign debt and that take account of the particularities of individual economies are also in Germany's interests; for as a major export nation, we do not want the economic growth of our European Union trading partners to be hampered by unduly large cutbacks in government spending.

References

- CEP (Centrum für Europäische Politik), Fiskalpakt, cep Analyse no. 13/2012 of 26 March 2012, Freiburg 2012.
- Girouard, Nathalie and André, Christophe, Measuring cyclically-adjusted budget balances for OECD countries, OECD Working Paper no. 434, Paris 2005.
- Reinhart, Carmen M., and Kenneth S. Rogoff, Growth in a time of debt, in: The American Economic Review, Papers and Proceedings, vol. 100, 2010, pp. 573–578.
- SVR (Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung), Staatsverschuldung wirksam begrenzen - Expertise im Auftrag des Bundesministers für Wirtschaft und Technologie, Wiesbaden 2007.

Policy Brief 2012/03: Shaping Sustainable Economies

A society acts sustainably if it ensures the long-term stability and productivity of ecological, sociopolitical and economic systems. In the past, issues of sustainability were typically handled separately, neglecting individual measures' effects on other elements implied by a comprehensive concept of sustainability. The challenge ahead is to develop a holistic strategy for sustainable economic activity that takes into account interdependencies between the various aspects of sustainability, and does not seek to solve problems of sustainability at other aspects' expense.

Policy Brief 2012/04: A Modern Social Market Economy

The new MSME Index defines and measures the features of a Modern Social Market Economy in international comparison. In contrast to other indices that measure economic performance, the MSME Index takes an institutional approach, outlining a system of essential institutions and measurable indicators for the construction and assessment of modern social market economies. Among other insights, the index could guide the European Union toward achieving the "highly competitive social market economy" that it defines in the Lisbon Treaty as its desired economic order.

V.i.S.d.P

Bertelsmann Stiftung
Carl-Bertelsmann-Straße 256
D-33311 Gütersloh
www.bertelsmann-stiftung.de

Dr. Thieß Petersen
Phone: +49 5241 81-81218
thiess.petersen@bertelsmann-stiftung.de

Eric Thode
Phone: +49 5241 81-81581
eric.thode@bertelsmann-stiftung.de

ISSN-Nummer: 2191-2467

Upcoming releases:

- **Laura Naegele, Claire Dhéret and Eric Thode: Better Employment Opportunities for Older Workers**

Ref. Ares(2012)1273927 - 26/10/2012

EUROPEAN COMMISSION
Cabinet of Vice-President Viviane Reding,
Commissioner for Justice, Fundamental Rights and Citizenship

Head of Cabinet

Brussels, 26 October 2012
MS/VH/jm Ares Lien: A(2012)1067334

Dear Dr. Petersen,

On behalf of Vice-President Viviane Reding. Thank you for your email of 12 September and for sending her a copy of the policy brief "Maastricht 2.0 – Proposed reform of EU sovereign debt rules".

The Vice-President read it with interest.

Yours sincerely,

Martin Selmayr

Dr. Thieß Petersen
Senior Project Manager
Programme Shaping Sustainable Economies

By email:

Commission européenne, B-1049 Bruxelles / Europese Commissie, B-1049 Brussel - Belgium. Telephone: (32-2) 299 11 11.
Office: BERL. 12/294. Telephone: direct line (32-2) 2981230. Fax: (32-2) 2960746.

E-mail: martin.selmayr@ec.europa.eu

From: (CAB-REDING) on behalf of REDING Viviane (CAB-REDING)
Sent: 16 October 2012 14:28
To: CAB REDING ARCHIVES BIS
Subject: FW: spotlight europe: The value of Europe
Attachments: BS_Spotlight06_EN_Korr0210_web.pdf

From: Hoffmann, Isabell
Sent: Tuesday, October 16, 2012 2:10 PM
To: REDING Viviane (CAB-REDING)
Subject: spotlight europe: The value of Europe

Dear Mrs Reding,

Europe not only has a price, it also, more importantly, has a value. What it implies, how to rediscover it and what it means four our common future is described by our author Joachim Fritz-Vannahme in our latest spotlight europe. The title is: The value of Europe.

An extract from the text: "Those who do not want the contrast between democracy and Europe grow stronger now have to prove that there is no integration without involving the citizens. This is not about less or more Europe, this is about a better Europe."

Wishing you an interesting read.

Yours,

Isabell Hoffmann

Project Manager

Program Europe's Future

Bertelsmann Stiftung

Carl-Bertelsmann-Straße 256 | 33311 Gütersloh | Germany

Phone:

E-Mail:
www.bertelsmann-stiftung.de <http://www.bertelsmann-stiftung.de/>

The Bertelsmann Stiftung, based in Gütersloh, Germany, is an independent, private

operating foundation in accordance with Section 1 of North Rhine-Westphalia's Foundation Law.

The district government of Detmold serves as its supervisory authority.

BertelsmannStiftung

spotlight europe

2012/06 — September 2012

The Value of Europe

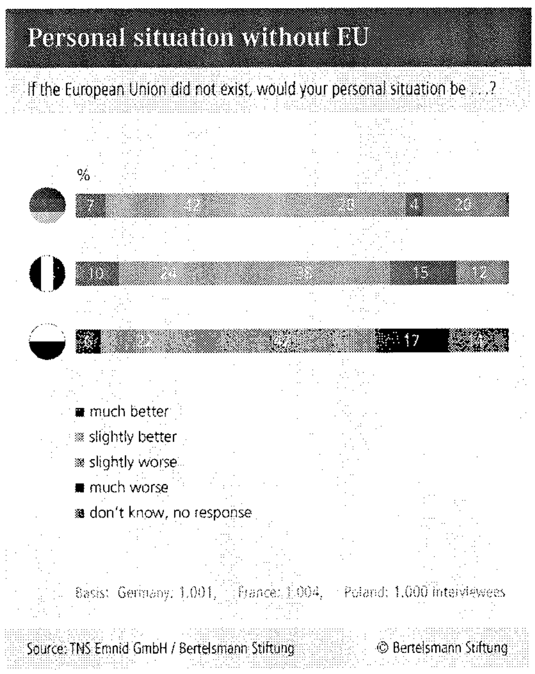
Joachim Fritz-Vannahme
Bertelsmann Stiftung, *joachim.vannahme@bertelsmann-stiftung.de*

Do the citizens of the EU actually know what it is worth to them personally? The surveys increasingly suggest that they reject it and regard it with contempt. After living for years of crisis, many people have started to cast doubt on the whole notion of integration, and on the ability of the politicians involved to find meaningful solutions to the crisis. In the end this is all about democracy. In the end it´s the citizens that will have the final say.

There is a growing desire to retreat to what is considered to be a safe haven, the nation-state. Many EU citizens in Germany and elsewhere believe that they would be better off without the euro and without the EU. There is a lack of trust, and not much confidence. Despite their apparent diversity, the member states are nonetheless all rather similar when it comes to the subject of pessimism.

So what can be done about it? German foreign minister Guido Westerwelle has put it rather succinctly. "We need to rediscover what the value of Europe is. Europe needs a new *raison d'être*. If Europe manages to persuade its citizens that it is a good thing, it will be possible to deal with the crisis."

That is what needs to be done. But does it in fact point to the solution?



Why does the European Union actually exist?

A growing number of people find it impossible to answer this question. Why, on a daily basis, do 27 member states and half a billion people look for ways of saying what they think and getting on peacefully with each other? What in its innermost being actually holds the Union together? Is it a joint budget of just about one percent of the joint gross domestic product? Joint legislative and judicial systems which do not vary from place to place? A handful of joint institutions, which are usually referred to with the word "Brussels"? A single market with its own specific rules and regulations and its four freedoms, the free movement of people, goods, services and capital?

An answer to the question of inner cohesion is provided by the second article of the Treaty of Lisbon: "The Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities. These values are common to the Member States in a society in which pluralism, non-discrimination, tolerance, justice, solidarity and equality between women and men prevail." (Article 2, TEU)

These are high-sounding words indeed, though their meaning may not be exactly the same in the various nations and political traditions. However, their cohesive impact is not powerful enough in the current crisis to strengthen the feeling that we are all part of the same political entity. Let us look first of all at the value of freedom. "Freedom makes our diversity possible," Chancellor Angela Merkel said in a speech to the European Parliament in 2007. Such freedom did not exist "without reference to anything else," since it went hand in hand with a feeling of responsibility for other people. "So when we speak of true freedom, we are always speaking of the freedom of other people." [4]

Thus in a diverse community the notion of freedom implies doing something for others, and this is usually circumscribed with the word solidarity.

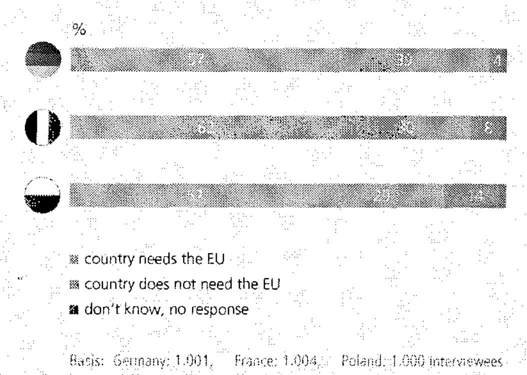
Of course, many people currently find the idea of solidarity rather difficult to understand. They either pour scorn on the southern EU member states, which are suspected of indulging in *dolce far niente*, or insinuate that German policymakers are motivated by a craving for hegemony. Prominent politicians occasionally regale the electorate with scoffing and jeering, since this is obviously a good vote-catching technique. This is not only a crude and offensive way of interacting with one's partners. It also betrays a complete misunderstanding of the reasons for the crisis, which is due not only to individual malfeasance or national wrongdoing, but to serious errors in the international banking and financial services sector, and to design faults in the European economic and monetary union. Only the second part of the project actually materialized, whereas the first, the economic union, was culpably neglected. Yet calls for solidarity within the EU provide the moral and political levers that are needed in order to resolve the crisis.

The political scientists Kalypso Nicolaïdes and Juri Viehoff, who teach at the University of Oxford, have put it thus: "Solidarity can play a similar role in underpinning European integration in the future as 'peace' played in the foundation years."

Solidarity with the weak must first of all be demonstrated by the strong. So here Germany obviously has an obligation to fulfil. In order to ensure that such solidarity does not become an unbearable burden, it must go hand in hand with sound financial management, both in the member states, and in the European institutions and policy areas. This does not exist. And when all is said and done only sound economic management and solidarity among partners can underpin Europe's political self-assertion, which is something that many citizens would like to see, in the context of global systemic competition. Here again surveys show that many people continue to believe in Europe, but think that they have been deceived, or are simply disappointed.

Economic dependence on the EU

Will (country being sampled) need the EU in future in order to keep up with great powers such as China, the US, Russia or India in economic terms, or can (country being sampled) keep up with these states in economic terms without being a member of the EU?

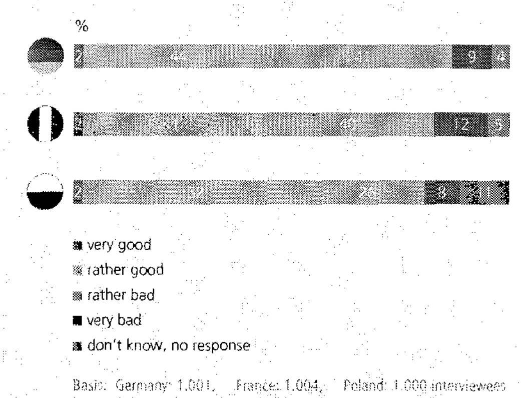


Source: TNS Emnid GmbH / Bertelsmann Stiftung © Bertelsmann Stiftung

A meaningful course of action is made more difficult by a myopic economic attitude which has crept into what people think and say, and not only in Germany. This short-sighted view leads people to believe, erroneously, as it happens, that the Union was founded for the enrichment of its members. That was also part of the plan, but not the whole plan. Similarly, the widespread talk of "European Added Value," which is especially rife in Brussels, is based on this popular misconception. Europe's value cannot be calculated (only) on the basis of a cost-benefit analysis.

Market economy versus social responsibility

How good is the EU at striking the right balance between the market economy and social responsibility?



Source: TNS Emnid GmbH / Bertelsmann Stiftung © Bertelsmann Stiftung

"Europe" has always been and continues to be a political project. The EU is a union based on values and not a joint-stock company. It is true, of course, that in the course of more than fifty years European integration has changed its raison d'être, its self-image, and its narrated history. In the pioneering days its motto was "Peace and Freedom," for the Second World War was still very much in people's minds. The advent of the Iron Curtain was a shock, and as time went on this was added to the historical narrative, which now consisted of three elements, peace, freedom, and prosperity. When all is said and done, this was still a political slogan.

After 1989, and in particular after the grand enlargement of the Union in 2004, people in the old member states started to talk about the EU in terms of a cost-benefit analysis and nothing else. What are we getting or what am I getting out of the Union? Am I going to be threatened by the Polish plumber or the Hungarian construction worker? This unfortunate concentration on the economic side of the equation depoliticizes and emasculates the European idea, and encourages the spread of neo-nationalism. That was not the reason why people pushed ahead with integration in the past. Furthermore, it is quite obviously becoming a victim of habit, or, if one wants to put it that way, of its own success. Peace and freedom are taken for granted, whereas many people see their prosperity threatened. One only has to think of China. This clearly weakens the traditional *raison d'être* of the European Union.

Of course, this weakness does not explain everything. Why, even after 60 years, are our common history and identity not strong enough in the current crisis to make the European Union look like a possible solution and not as part of the problem? The philosopher Jürgen Habermas believes that "the European Union will have to decide whether it wants transnational democracy or post-democratic executive federalism." Habermas's sympathies are entirely on the side of the Union as it strives to turn itself into a transnational democracy. However, although the process has been initiated, it is still in its infancy. "If one does not wish to accept this, and is nonetheless forced to recognize that the growing dependence of nation-states on the systemic constraints of an increasingly interdependent global society is irreversible, then it becomes apparent that there is a political need to expand democratic procedures beyond the borders of the nation-states." (8)

Parliamentary democracy has its limits

If one looks at it in this context, national parliamentary democracy has literally come to the end of the road and quite clearly needs to be Europeanized. Thus democracy – in contrast to statements made by the German Constitutional Court – is not threatened by faults inherent in the European Union, but by a new-fangled kind of European "executive federalism" (Habermas) that is not subject to parliamentary control. The threat resides in the fact that national executives have too much work on their hands and the legislatures do not have enough to do as a result of "the systemic constraints of an increasingly interdependent global society" (Habermas). To put it more precisely, democracy in Europe is threatened by the pressure exerted by the stock exchanges, the rating agencies, and the world of banking and financial services, which, although they have been teetering on the brink of bankruptcy for years, tell policymakers what they should be doing and, if the worst comes to the worst, get the taxpayers to bail them out.

If, because there are no alternatives, democratically elected governments start to kow-tow to global markets and the global powers that be, the whole idea of a democratic election begins to seem rather hollow. Herfried Münkler, a Berlin-based political scientist, has said: "Parliament simply gives its assent to what has been announced by the executive acting under pressure exerted by the stock exchanges and rating agencies." EU citizens consider this to be unjust and unreasonable, no matter whether they live in Athens, Lisbon, Berlin or Paris.

Münkler believes that parliamentary democracy will soon disappear because the way in which it works has been damaged by "ongoing announcements about decisions to which there are no alternatives." And the European Union and the euro, "which were actually supposed to be supranational bulwarks against markets which have taken on a life of their own, have had the opposite effect and are helping to marginalize national parliaments." The European Union and the democracies that go to make it up need to find an answer to this.

For this reason anyone who wants to talk about the value of Europe needs to talk about the state of European democracy. People no longer trust politicians in particular and policymaking in general. Voter turnout levels are on the way down, whilst populist opinion leaders and parties are on the way up. So for that matter is euroscepticism. The crisis is everywhere. It is no longer merely a state of emergency brought about by debt repayment and banking problems, or the impending bankruptcy of an EU member states, as in the case of Greece. What is at issue is the value of Europe, and the values that it represents.

Born of necessity, not idealism

A lot has happened in the German debate on the subject. Remarks about a political union, and indeed about the United States of Europe, are now heard right across the whole range of the political spectrum. They are not the result of idealism, but a reflection of the fact that many politicians now understand that these policies are both inevitable and necessary. The debates being conducted in many other member states often admit (albeit rather grudgingly) that there is a compelling need for swift changes to the Treaty of Lisbon. Yet most of them recoil from the goal of a political union, or indeed the "United States of Europe." This is true of both politicians and ordinary citizens.

It is no accident that Chancellor Angela Merkel's proposals to hold a constitutional convention received a rather lukewarm welcome in Paris, Rome, and Warsaw. Currently it would in any case be impossible to obtain a majority for a political union, since neither governments nor the electorate are in favour of it. However, this should not stop us from conducting the inevitable debate on the future of Europe and on its value. In modern democracies majorities have to be fought for.

It may seem paradoxical, but currently the debate about the future of the EU is very much alive in Germany (see the series of articles published this summer in the Frankfurter Allgemeine Zeitung). The major parties are all in favour of a political union, though surveys show that most of the interviewees are (still) against it.

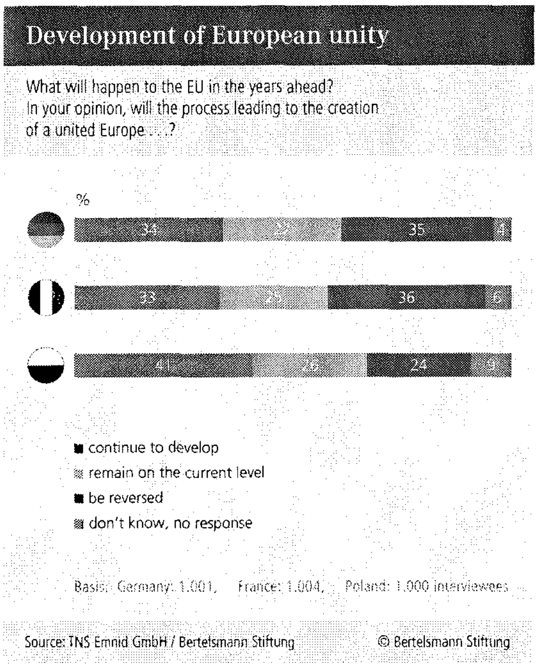
Thinking about the value and meaning of Europe is thus not simply the stuff that well-meaning speeches for formal occasions are made of, since it leads us to think about the state of our polity, which consists of 27 nation-states and the European institutions. It is increasingly unsatisfactory and rather frustrating.

The Council – neither fish nor fowl

In point of fact the Treaty of Lisbon has made this frustration even worse. In future there will be very few areas of government in which the EU is not permitted to operate, and soon the only exception is going to be security and defence policy. It is of course true that the role of the national parliaments has been upgraded by the Additional Protocol to the treaty. Moreover, the European Parliament has also acquired supervisory powers in many policy areas. All the same one had an uneasy feeling even before the outbreak of the great crisis. The changes applied primarily to the European Council, where the governments are represented. It now has a permanent president. However, this council is neither fish nor fowl. It is a European assembly of national executives which performs a legislative function, and behind closed doors at that. A chamber of this kind would not be tolerated in any of the democratic systems of the member states.

The crisis has actually increased the predominance of the executive, and Habermas has criticized this rather tellingly by talking about executive federalism. However, as Münkler rightly points out, the predominant governments are also at the mercy of other kinds of pressure. The electorate is beginning to have the unpleasant feeling that it has no say whatsoever in what is going on, and no co-decision rights. Its representatives in the national parliaments seem to understand just as much about ESM, EFSF, the complex decisions of the ECB, and the even more complicated reforms in the European Council as man in the street. German citizens have turned for help to the Constitutional Court, an institution whose members are appointed (and not elected) on the basis of an extremely murky selection procedure, and who thus cannot be removed at the next elections. Since people no longer trust the EU, they have decided to place their faith in the supreme court.

This way of looking at things is based on the idea that it is all Europe's fault, for the big decisions are taken on the European stage, or not taken, for that matter. Here the value of Europe is determined in a very specific way.



The economist Peter Bofinger, the philosopher Julian Nida-Rümelin and Jürgen Habermas have put it in a nutshell: "The European nations need to understand that they will be able to retain their welfare state societal model and the cultural diversity of their nation-states only if they take joint action. They need to pool their resources if they wish to have any kind of influence on the agenda of global policymaking and the resolution of global problems. A rejection of European unification would be tantamount to bowing out of world history." [11]

This means that we have an alternative after all. We can be for or against a European answer to global problems, and for or against a non-European and national answer, which would be rather fragmentary. To define this alternative as precisely as possible is a task not only for politicians, but for all those in the business community and society at large who consider a political union to be the right solution. Those who reject it should spell out the material and non-material cost of their alternative in the course of a democratic debate on the subject.

Because all this is not simply about Europe, but about democracy in Europe, the electorate is going to have the final say in the matter. Politicians should not even fight shy of a referendum as brought up by Wolfgang Schäuble. It can and it ought to be the constitutive act of a political union, the like of which has never been seen. One does not have to worry about the impenetrable and technical fine print of a new treaty, but about a basic question: "Are the people in their capacity as sovereign prepared to transfer sovereignty to Europe in order to facilitate sensible European policymaking?" Another question might well be added. Will the requisite democratic rules be created in order to supervise and to impart legitimacy to this sensible kind of European policymaking?

These questions are being asked in Germany and in all of the EU member states, or at least in those which have adopted the euro. The only thing that can stabilize the euro is a common economic policy – and today this actually intermingles to a large extent with social policy as a result of agreements on the pension entry age, the number of women gainfully employed, and educational standards. A remarkable number of people critical of the EU agree on this point, and they include Barack Obama, the Chinese government, and the rating agencies. Of course, this common economic policy cannot be achieved with the Treaty of Lisbon. But it is the decisive step to a political union, no matter whether one continues to call it the European Union or the United States of Europe.

And no matter whether there is a referendum or whether the decisions are taken by the national parliaments, the citizens of the member states should cast their votes on the same day. In this way everyone will be made aware of the European significance of the event. Governments fought shy of this in the voting on the constitutional treaty in 2005. The consequences are well known. Where people actually voted, they passed judgment on their own governments. This was a success in Spain and Luxembourg, but not in France, the Netherlands and Ireland. As a result the constitutional treaty was relegated to the back seat. Those who do not wish to drive an even larger wedge between Europe and democracy will now have to stand up and argue that there won´t be any integration without the electorate and no new European Union without more democracy. It is not a question of whether we should have more or less Europe. It is a question of how we might be able to create a better Europe. In recent months and years it has become apparent that this cannot be done on the basis of the existing rules. For this reason there is only one answer to the crisis. Let us be daring. Let us have more democracy. It is what Europe needs. ■

Further Reading:

1 Bertelsmann survey http://www.bertelsmann-stiftung.de/europaszukunft

2 **Guido Westerwelle**: *Der Wert Europas. Vier Thesen zum Zukunftsprojekt Europa.* In: Integration 2 (2012), p.90. This essay was written for an international conference, "Der Wert Europas," which the Ministry of Foreign Affairs and the Bertelsmann Stiftung organized in Berlin on 18 September 2012.

3 "Freiheit – Gleichheit – Solidarität," a collection of essays published by the Bertelsmann Stiftung in the autumn of 2012, demonstrates this with reference to France, Germany and Poland.

4 http://www.eu2007.de/de/News/Speeches_Interviews/January/Rede_Bundeskanzlerin2.html

5 **Christian Calliess**: *Kein Geld ohne Parlament.* p.1

6 **Kalypso Nikolaidis** and **Juri Viehoff**: *The Choice for Sustainable Solidarity in Post-Crisis Europa.* In: *Solidarity for Sale – The Social Dimension of the New European Economic Governance. Europe in Dialogue* 2012/01. p.23

7 **Jürgen Habermas**, *Zur Verfassung Europas.* Frankfurt/Main (2012). p.48

8 **Jürgen Habermas**, *Zur Verfassung Europas.* Frankfurt/Main (2012). p.51

9 **Herfried Münkler**, *Die rasenden Politiker.* in Der Spiegel 29 (2012), p.101

10 **Münkler**, "Die rasenden Politiker," p.101

11 in: **Frankfurter Allgemeine Zeitung**, 4 August 2012, p.33

12 **Der Spiegel** 36 (2012), p.31

spotlight europe # 2012/06 The Value of Europe

Responsible:

Bertelsmann Stiftung
Carl Bertelsmann Straße 256
D-33311 Gütersloh
www.bertelsmann-stiftung.de

Isabell Hoffmann
isabell.hoffmann@bertelsmann-stiftung.de
Telefon +49 5241 81 81313

Joachim Fritz-Vannahme
joachim.vannahme@bertelsmann-stiftung.de
Telefon +49 5241 81 81421

ISSN 1865-7443

Latest editions:

spotlight europe **# 2012/05**
Confronting the Crisis
Dr. Thieß Petersen

spotlight europe **# 2012/04**
Can Mobility Offset Unemployment?
Dr. Thieß Petersen

spotlight europe **# 2012/03**
Long live the United States of Europe
Joachim Fritz-Vannahme

All "spotlight europe" editions can be downloaded from: www.bertelsmann-stiftung.de/spotlight

20

Ref. Ares(2012)1270006 - 26/10/2012

EUROPEAN COMMISSION
Cabinet of Vice-President Viviane Reding,
Commissioner for Justice, Fundamental Rights and Citizenship

Head of Cabinet

Brussels, 22 October 2012
MS/VH/jm Ares Lien: A(2012)1226272

Dear Ms Hoffmann

On behalf of Vice-President Viviane Reding, thank you for your email of 16 October and for sending her a copy of the latest edition of Spotlight Europe entitled "The value of Europe".

The Vice-President read it with interest.

Yours sincerely,

p V. H.

Martin Selmayr

Ms Isabell Hoffmann
Project Manager
Bertelsmann Stiftung

By email:

Commission européenne, B-1049 Bruxelles / Europese Commissie, B-1049 Brussel - Belgium. Telephone: (32-2) 299 11 11.
Office: BERL. 12/294. Telephone: direct line (32-2) 2981230. Fax: (32-2) 2960746.

E-mail: martin.selmayr@ec.europa.eu

From: (CAB-REDING) on behalf of REDING Viviane (CAB-REDING)
Sent: 22 October 2012 15:22
To: CAB REDING ARCHIVES BIS
Subject: FW: Economic impact of Southern European member states exiting the eurozone
Attachments: PolicyBrief_Print_Englische_Ausgabe2012_06_GREXIT_ONLINE.pdf

From: Team Soziale Marktwirtschaft
Sent: Monday, October 22, 2012 3:11 PM
To: REDING Viviane (CAB-REDING)
Subject: Economic impact of Southern European member states exiting the eurozone

Dear colleagues and friends,

The debate concerning the eventuality that Greece, Portugal, Spain and Italy might leave the eurozone has become increasingly strident since the onset of the euro crisis in September 2009. A new economic forecast study carried out by Prognos AG on behalf of the German Bertelsmann Stiftung analyses the financial consequences of different exit scenarios covering a "Grexit" as well as a secession of different groups of crisis-stricken countries from the Euro.

While Greece defaulting on its sovereign debt and leaving the eurozone would in and of itself have a relatively minor effect on the world economy, such a move could, however, undermine investor confidence in the Portuguese, Spanish and Italian capital markets and thus provoke not only a sovereign default in those states as well, but also a severe worldwide recession. This would in turn reduce economic growth by total of 17.2 trillion euros in the world's 42 largest economies in the lead-up to 2020. Hence it is incumbent upon the community of nations to prevent Greece from a sovereign default as well as leaving the euro, and the domino effect that this event could induce.

The attached Policy Brief "Economic impact of Southern European member states exiting the eurozone" outlines the basic results of this study.

We hope that you find the Policy Brief of interest - and we would certainly be interested in receiving your feedback.

Best regards,

Dr. Thieß Petersen
Senior Expert
Program Shaping Sustainable Economies
E-Mail:

Eric Thode
Senior Expert
Program Shaping Sustainable Economies
E-Mail:

Bertelsmann Stiftung
Carl-Bertelsmann-Straße 256 | 33311 Gütersloh | Germany
www.bertelsmann-stiftung.de <http://www.bertelsmann-stiftung.de/>

Future
Social Market Economy

BertelsmannStiftung

Policy Brief # 2012/06

Economic impact of Southern European member states exiting the eurozone

While Greece defaulting on its sovereign debt and leaving the European Monetary Union would in and of itself have a relatively minor effect on the world economy, such a move could, however, undermine investor confidence in the Portuguese, Spanish and Italian capital markets and thus provoke not only a sovereign default in those states as well, but also a severe worldwide recession. This would in turn reduce economic growth by a total of 17.2 trillion euros in the world's 42 largest economies in the lead-up to 2020. Hence it is incumbent upon the community of nations to prevent Greece from a sovereign default as well as leaving the euro, and the domino effect that this event could induce.

Dr. Thieß Petersen
Program
Shaping Sustainable Economies

Phone:
+49 5241 81-81218
Email:
thiess.petersen@bertelsmann-stiftung.de

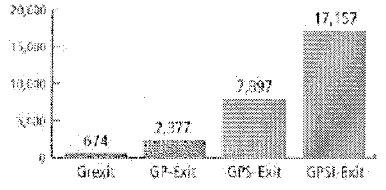
Dr. Michael Böhmer
Prognos AG

Phone:
+49 89 954 1586-701
Email:
michael.böhmer@prognos.com

Focus

Projected cumulative losses in real GDP in the world's 42 largest economies from 2013 to 2020, for four different scenarios

All figures are in billions of euros



Source: Prognos AG. | BertelsmannStiftung

Legend for the scenarios:

- Grexit: Greece defaults and leaves the eurozone
- GP-Exit: Both Greece and Portugal default and leave the eurozone
- GPS-Exit: Portugal, Greece and Spain default and leave the eurozone.
- GPSI-Exit: Greece, Portugal, Spain and Italy default and leave the eurozone.

The debate concerning the eventuality that Greece, Portugal, Spain and Italy might leave the European Monetary Union has become increasingly strident since the onset of the euro crisis in September 2009. For example, in July 2012 German Minister of Economics Philipp Rösler expressed the view that the prospect of Greece leaving the European Monetary Union was no longer so daunting as it had once seemed. CSU Secretary General Alexander Dobrindt echoed this view in late August 2012, when he predicted that Greece would leave the eurozone by 2013. The European Central Bank's decision this past September to buy up government bonds of European Monetary Union member states that are facing a sovereign debt crisis somewhat eased the situation for these states. However, their budgets are still in disarray, a fact underscored by the statement by Greek Prime Minister Antonis Samaras in October 2012 to the effect that Greece will be bankrupt by the end of next month unless further infusions of foreign capital are forthcoming.

Against this backdrop, it is important to bear in mind that there is no legal mechanism for excluding European Monetary Union members from the eurozone. However, bailout money might simply dry up because the actors providing it may ultimately take the view that budget cutbacks in the eurozone member states facing budgetary crises are not progressing satisfactorily. Without bailout money from European rescue packages and the International Monetary Fund (IMF), these states would have no further revenue and would face bankruptcy. But in order for a state that finds itself in this plight to be able to pay government employees and finance pension payments and other entitlements, it would need to introduce its own currency: in other words, it would have no choice but to leave the European Monetary Union. We will now discuss the consequences of such an event, in terms of four possible exit scenarios.

1. Design of the exit scenarios

Our projections concerning the economic consequences of the four European Monetary Union member states that are currently in dire financial straits leaving the eurozone are based on four scenarios. In the first, only Greece takes leave of the eurozone (Grexit scenario). In the second, both Greece and Portugal exit (GP-Exit scenario). The third scenario sees the departure of Spain, in addition to Greece and Portugal (GPS-Exit scenario), and in the fourth scenario the quartet of states comprising Greece, Italy, Portugal and Spain bids adieu to the euro. We opted for this eurozone exiting sequence because the current debate is largely couched in terms of states that might leave the monetary union.

We estimated the real economy-consequences entailed by these four scenarios by carrying out simulations using the Prognos macroeconomic world model called VIEW (see box). To this end, we modelled the projected real GDP of the 42 states in the VIEW model from 2013 to 2020, based on the assumption that our putative scenarios will become reality next year. The computations concerning real GDP resulting from these scenarios were compared with the economic data and forecasts in Prognos's "Weltreport 2012," which was published in mid 2012 and is predicated on the assumption that the eurozone will remain intact (baseline scenario). The forecasts presented in this report were likewise elaborated using our VIEW model. According to the report, the budget cutbacks that need to be made in the lead-up to 2016 and 2017 will be a huge drag on worldwide economic growth (see Prognos AG 2012). Our four scenarios forecast even greater growth slowdowns.

The four simulations we carried out were based on the following assumptions: It was presumed that Greek bailouts would be suspended, causing Greece to face sovereign default and consequently introduce its own currency. No one can possibly predict how large this haircut would actually be, but our simulations are based on a scenario involving a 60 percent default rate. The remaining 40 percent of Greece's debt would continue to be denominated in euros. This haircut would affect both public and private creditors, who would be forced to take a charge on 60 percent of their loans to Greece. Table 1 displays how this might play out financially for selected states.

The VIEW model is a macroeconomic model that is used to make projections and simulate economic scenarios. The simulations in our study encompassed the world's 42 states that account for more than 90 percent of the world economy and were based on the following parameters: supply and demand; labour markets; government finances; as well as exports, imports, currency rates and so on. Thus, the model also factors in the interrelationships between the various states as regards these parameters.

A Greek sovereign default would also result in correspondingly high writedowns for government budgets. As such writedowns are of an accounting nature, the budget deficits of the states to which Greece owes money either directly or indirectly would increase, thus driving up the sovereign debt and debt service of these states. This in turn would force the governments affected to consolidate elsewhere by either cutting their expenditures or raising taxes. Such measures reduce demand for goods and services, which in turn reduces economic output and increases unemployment. The VIEW model takes into account the budgetary impact of a haircut by positing writedowns of the various industrial nations' extensive loan receivables and liabilities (EFSM, EFSF and IMF bailouts; the European Central Bank buying up government bonds; target loans). The budgetary impact of sovereign defaults cannot be taken into account for emerging economies owing to a lack of data.

Greece's public and private sector debtors would also need to write off 60 percent of their outstanding loans. According to our calculations, these losses would presumably have a direct negative wealth effect on household income for the relevant year; and this in turn would reduce housing start-ups and consumer spending.

Sovereign default and the introduction of a national currency would of course have far reaching economic consequences also for Greece. The new Greek currency would be devalued relative to all other currencies, and the scope of this devaluation remains every bit as uncertain as the scope of a haircut. Our VIEW model simulations are predicated on a 50 percent devaluation of the Greek currency. This devaluation would drive up the government-debt ratio as expressed in the new Greek currency, because this debt would have previously been denominated in euros. Hence introduction of a national currency would reduce Greece's government debt ratio by a mere 20 percent; and what's worse, capital-market confidence in Greece's creditworthiness would evaporate. Hence the Greek government's sole source of revenue would be tax revenue, which in turn means that the Greek budget balance would be virtually zero in the lead-up to 2020. A Greek sovereign default and

Greece switching to a new currency would also put a major dent in consumer and investor confidence, which our simulations (based on past examples such as Argentina in 2001) show would translate into a ten percent decline in 2013 and a five percent decline in 2014, for both parameters. Moreover, the aforementioned declines in demand for goods and services would not be limited to the state affected. In a world where individual state economies maintain highly symbiotic relationships with each other through foreign trade, falls in consumer demand in one state would soon spread to its trading partners. The result would be a worldwide decline in economic activity.

The other three scenarios were simulated based on the same assumption of a 60 percent haircut and a 50 percent devaluation of the new currency relative to all other currencies.

2. Ramifications of the eurozone exit scenarios for the world economy

The VIEW model simulations discussed in this section shed light on the likely economic effects of the four eurozone exit scenarios for the 42 states encompassed by the model. Like all simulations, the results we obtained were strongly influenced by the assumptions on which they were based, and in this case above all by the actual scope of the haircuts and the currency devaluations that would come into play. In our view, the assumptions that form the basis for our simulations currently represent the closest approximation of the reality that would actually unfold.

Using these assumptions as basis, the impact of the four scenarios on the world economy was simulated for the period extending from 2013 to 2020. In the interest of modelling the impact of each of the four scenarios on economic growth, annual declines in GDP were computed in comparison to the projections in Prognos's "Weltreport 2012" and were then tallied for the years 2013 to 2020. The projected cumulative declines in economic growth thus obtained are displayed in table 2 for all four scenarios.

Table 1: Public and private sector loan writedowns for the four scenarios, predicated on a 60 percent default on both public and private sector loans for a state leaving the European Monetary Union (figures in billions of euros).

State	Grexit	GI-Exit	GPS-Exit	GPSI-Exit
Germany	64.0	99.1	266.1	455.2
France	54.9	81.6	211.8	357.7
Great Britain	2.3	13.1	52.5	78.3
The Netherlands	12.3	19.2	71.5	115.1
USA	6.3	10.5	29.6	47.3

Source: Prognos AG | BertelsmannStiftung

Grexit scenario: A sovereign default on the part of Greece and its consequent exit from the European Monetary Union would, in and of itself, have only a minor impact on economic growth in Europe and the rest of the world. The aggregate GDP decline for 2013 to 2020 in the 42 VIEW states, which account for more than 90 percent of worldwide output, would amount to 674 billion euros. The decline in Greece's GDP would be the single largest chunk in this regard (164 billion euros). The cumulative decline in growth in Germany would amount to only 73 billion euros. In the interest of putting these GDP declines into perspective for each of the various states, the cumulative decline in economic growth was compared to GDP for 2013. Greece's cumulative GDP decline would amount to 94 percent for 2013, compared to only 2.9 and 0.9 percent for Germany and the US respectively. The economies of France, Portugal, and Bulgaria would be relatively hard hit, by virtue of a cumulative GDP decline amounting to around 8 percent.

GP-Exit scenario: The economic impact of both Greece and Portugal leaving the European Monetary Union would be palpable, but still relatively minor. In this

Table 2: Cumulative declines in real, non-discounted GDP for 2013 to 2020 for the four scenarios, compared in each case to the baseline scenario from "Weltreport 2012."

State	Grexit	GP-Exit	GPS-Exit	GPSI-Exit
Argentina	-3	-9	-34	-65
Australia	5	19	61	138
Belgium	0	-5	-28	-70
Brazil	-10	-35	-113	-233
Bulgaria	-2	-3	-8	-17
Chile	-2	-9	-33	-69
China	-81	-275	-924	-1,922
Denmark	1	-2	-11	-22
Germany	-73	-225	-850	-1,707
Estonia	0	-1	-2	-4
Finland	-2	-8	-27	-55
France	-157	-331	-1,225	-2,913
Greece	-164	-164	-168	-174
Great Britain	-6	-89	-419	-738
India	-22	-82	-265	-559
Ireland	-3	-12	-51	-93
Israel	-2	-7	-22	-47
Italy	6	-9	-79	-1,047
Japan	-8	-74	-345	-857
Canada	-8	-57	-173	-374
Latvia	0	0	-1	-3
Lithuania	0	-1	-3	-6
Mexico	-10	-34	-109	-227
New Zealand	-1	-3	-9	-20
The Netherlands	-10	-32	-201	-344
Norway	-1	-5	-21	-43
Austria	-5	-17	-61	-197
Poland	-3	-12	-42	-91
Portugal	-12	-84	-159	-179
Romania	-1	-3	-11	-31
Russia	5	-23	-104	-294
Sweden	-3	-12	-41	-85
Switzerland	-3	-15	-90	-240
Slovakia	-1	-2	-9	-19
Slovenia	0	-1	-4	-26
Spain	16	-301	-755	-973
South Africa	-1	-5	-19	-40
South Korea	-5	-34	-124	-284
Czech Republic	-1	-5	-18	-30
Turkey	-7	-24	-76	-161
Hungary	-1	-3	-9	-23
US	-93	-365	-1,244	-2,825
Eurozone 14*	-403	-1,190	-3,605	-7,755
EU 24*	-419	-1,320	-4,168	-8,811
Industrial nations	-541	-1,874	-6,198	-13,542
Emerging economies	-133	-503	-1,699	-3,615
All states **	-674	-2,377	-7,897	-17,157

* Malta, Cyprus and Luxembourg are not included in the VIEW model owing to a lack of data.
** The 42 states in the VIEW model account for more than 90 percent of world economic output.

Source: Prognos AG. | BertelsmannStiftung scenario, the cumulative GDP decline in the 42 VIEW states would amount to nearly 2.4 trillion euros, with Portugal accounting for 84 billion of this amount alone. In Germany, the 225 billion euro decline in GDP under the GP-Exit scenario would wreak substantial economic damage. The 365 billion decline in GDP would be even greater in the US (in absolute terms) than in Europe, while the figures for France and China would be 331 and 275 billion euros respectively. However, these figures are put into perspective when compared to the declines in GDP for 2013. The cumulative GDP declines in the US and Germany would amount to 3.3 and 9.1 percent of 2013 GDP respectively, while the figure for France would be appreciably higher (17.6 percent). But by comparison, the 55 percent decline in Portugal would be far more severe. The figure for Greece is only slightly higher than for the Grexit scenario and would remain at around 94 percent.

GPS-Exit scenario: Greece, Portugal and Spain leaving the European Monetary Union would provoke palpable GDP declines worldwide. The cumulative decline in France's GDP in the lead-up to 2020 would amount to more than 1.2 trillion euros, and in Germany to more than 850 billion euros. The cumulative GDP declines for the four BRIC states would amount to 1.4 trillion euros, and for the US to more than 1.2 trillion euros. The total economic losses in the 42 VIEW states would amount to nearly 7.9 trillion euros. In the GPS-Exit scenario, cumulative GDP losses for 2013 would be considerable, particularly in Portugal (due to the fact that France is a major trading partner) and France (due to, among other things, the extensive loans French banks have made to Spain). In this scenario, Portugal's GDP would decrease by 104 percent relative to 2013, followed by Greece (96 percent), Spain (81 percent), France (65 percent), Germany (34 percent), China (24 percent) and the US (11 percent).

GPSI-Exit scenario: The departure of Greece, Italy, Portugal and Spain from the European Monetary Union would provoke a worldwide recession that would translate into a GDP decline amounting to nearly 17.2 trillion euros in the 42 VIEW states in the lead-up to 2020. In terms of absolute figures, the declines would be the greatest in France (2.9 trillion euros), the US (2.8 trillion euros), China (1.9 trillion euros), and Germany (around 1.7 trillion euros). France would be particularly hard hit by Italy's sovereign default and exit from the euro, on account of the extensive loans French banks have made to Italy. The cumulative GDP decline would amount to 154 percent of economic output for 2013, with Italy alone registering a cumulative GDP loss of around 75 percent of GDP for 2013. The counterpart figures for Germany, the US and China would be 69, 25 and 49 percent respectively.

A decline in real GDP of this magnitude would also drive up unemployment. For example, in the GPSI-Exit scenario Germany's unemployment rate in 2015 and 2016 would be 2.5 and 2.2 percent higher, respectively, relative to the baseline scenario. In the ensuing 2017 to 2020 period, Germany's unemployment rate would range from 0.5 to 1.7 percent higher than the baseline scenario.

3. Economic policy consequences

While Greece defaulting on its sovereign debt and leaving the European Monetary Union would in and of itself have a relatively minor effect on the world economy, the consequences of this event are to all intents and purpose shrouded in mystery.

One possible consequence, however, is that Greece leaving the European Monetary Union would send a robust and lasting signal to Italy, Portugal and Spain that the gravy train of bailouts is bound to end unless these states make enormous efforts to get their financial houses in order. This in turn might potentially reduce opposition to tough but necessary reforms, and thus help resolve the euro crisis. But on the other hand, a Greek sovereign default could lead to capital market speculation and other untoward responses that would provoke sovereign default on the part of Portugal, Spain and ultimately Italy. And this in turn would send the world economy into a deep recession that would affect not only Europe, but the rest of the world as well. Apart from the severe economic consequences of such a recession, it would also put major strains on the social fabric and political stability of a number of states, particularly those that leave the European Monetary Union; but other states would feel these strains as well. Hence there is a definite possibility that Greece leaving the European Monetary Union would provoke a domino effect that would translate into a lengthy worldwide recession.

Policy Brief 2012/04: A Modern Social Market Economy

The new MSME Index defines and measures the features of a Modern Social Market Economy in international comparison. In contrast to other indices that measure economic performance, the MSME Index takes an institutional approach, outlining a system of essential institutions and measurable indicators for the construction and assessment of modern social market economies. Among other insights, the index could guide the European Union toward achieving the "highly competitive social market economy" that it defines in the Lisbon Treaty as its desired economic order.

Policy Brief 2012/05: Maastricht 2.0

The European Union's regulations governing sovereign debt are based on the principle of equal treatment of all member states. The recommendations we make here concerning changes in EU sovereign-debt reduction rules take account of national particularities. According to our calculations, such reformed regulations would do far more to promote economic growth than would be the case under the Fiscal Compact's European debt brake. By 2030, real gains in growth will amount to more than 450 billion euros.

Bertelsmann Stiftung
Carl-Bertelsmann-Straße 256
D-33311 Gütersloh
www.bertelsmann-stiftung.de

Dr. Thieß Petersen
Phone: +49 5241 81-81218
thiess.petersen@bertelsmann-stiftung.de

Eric Thode
Phone: +49 5241 81-81581
eric.thode@bertelsmann-stiftung.de

ISSN-Nummer: 2191-2467

Upcoming releases:

- **Laura Naegele, Claire Dhéret and Eric Thode: Better Employment Opportunities for Older Workers**

Ref. Ares(2012)1398368 - 26/11/2012

EUROPEAN COMMISSION
Cabinet of Vice-President Viviane Reding,
Commissioner for Justice, Fundamental Rights and Citizenship

Head of Cabinet

Brussels, 21 November 2012
MS/VH/jm Ares Lien: A(2012)1246414

Dear Dr Petersen and Mr Thode,

On behalf of Vice-President Viviane Reding, thank you for your email of 22 October and for sending her a copy of the policy brief entitled "Economic impact of Southern European member States exiting the eurozone".

The Vice-President read it with interest.

Yours sincerely,

Martin Selmayr

Dr. Thieß Petersen
Senior Expert
Program Shaping Sustainable Economies
Berlesmann-Stiftung

Mr Eric Thode
Senior Expert
Program Shaping Sustainable Economies
Berlesmann-Stiftung

By email:

Commission européenne, B-1049 Bruxelles / Europese Commissie, B-1049 Brussel - Belgium. Telephone: (32-2) 299 11 11.
Office: BERL. 12/294. Telephone: direct line (32-2) 2981230. Fax: (32-2) 2960746.

E-mail: martin.selmayr@ec.europa.eu

From:	.CAB-REDING) on behalf of REDING Viviane (CAB-REDING)
Sent:	05 December 2012 14:21
To:	CAB REDING ARCHIVES BIS
Subject:	FW: Economic growth and competitiveness: A Franco-German tale
Attachments:	Economic growth and competitiveness.pdf

From: Hoffmann, Isabell
Sent: Wednesday, December 05, 2012 2:14 PM
To: REDING Viviane (CAB-REDING)
Subject: Economic growth and competitiveness: A Franco-German tale

Dear Mrs Reding

France's economic situation has been in the headlines recently. With high deficits and low competitiveness French economy is under pressure and pressures Europe's development as well. But is it really so bad? Our author Stefan Collignon argues another case. He says: "For years France's economy outshined Germany's. Only recently did that change. France must not take German competitiveness as a benchmark, while Germany could learn a thing or two about sustaining productivity growth. Friendship is a two-way street."

Wishing you an interesting read,
Isabell Hoffmann

Isabell Hoffmann
Project Manager
Program Europe's Future

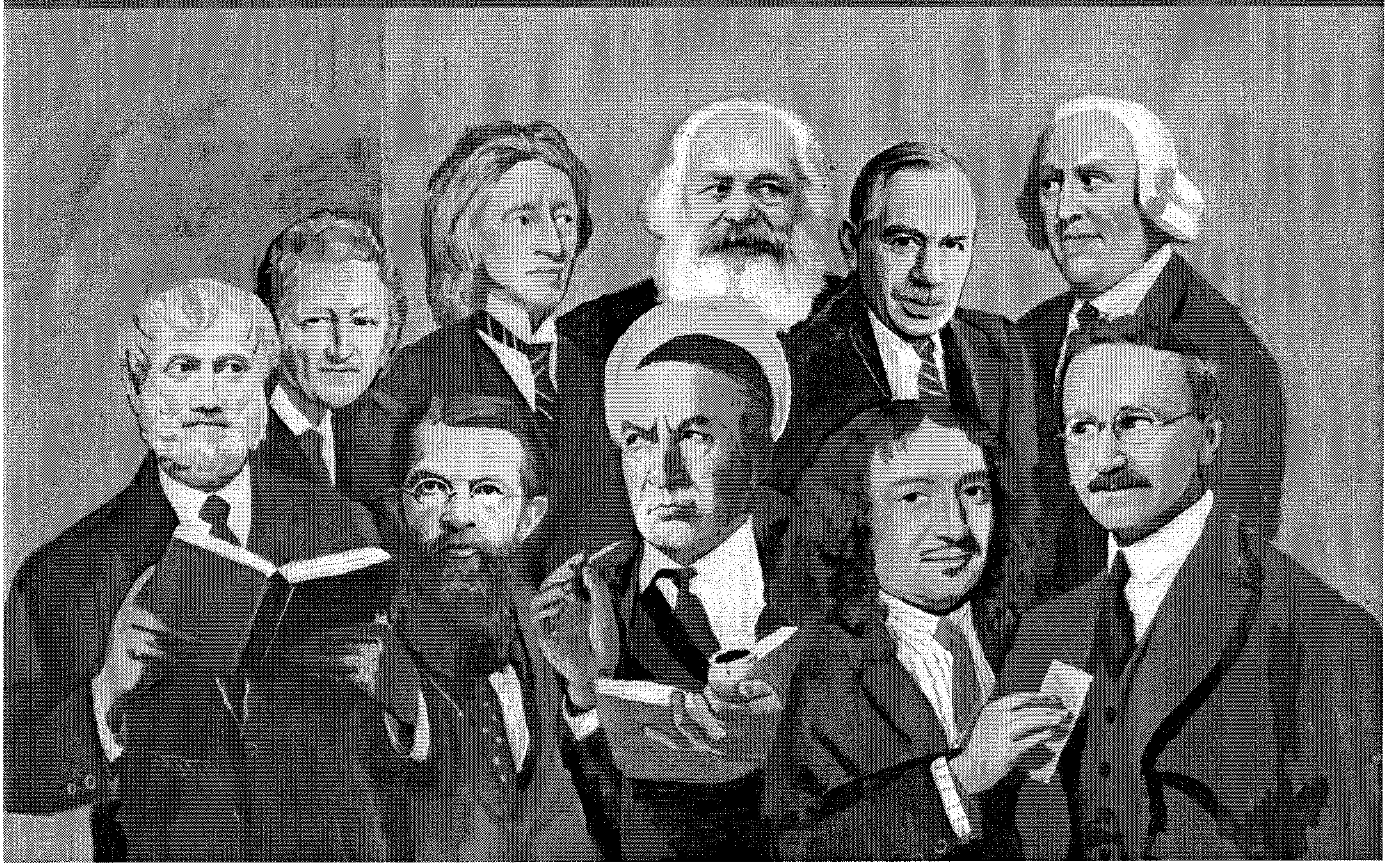
Bertelsmann Stiftung

Carl-Bertelsmann-Straße 256 | 33311 Gütersloh | Germany

E-Mail:
www.bertelsmann-stiftung.de <http://www.bertelsmann-stiftung.de/>

Economic growth and competitiveness: a Franco-German tale

Stefan Collignon



BertelsmannStiftung

Imprint

Economic growth and competitiveness: a Franco-German tale
Stefan Collignon, September 2012

Bertelsmann Stiftung
Carl Bertelsmann Straße 256
D-33311 Gütersloh
www.bertelsmann-stiftung.de

Isabell Hoffmann
isabell.hoffmann@bertelsmann-stiftung.de
Telefon +49 5241 81 81313

Joachim Fritz-Vannahme
joachim.vannahme@bertelsmann-stiftung.de
Telefon +49 5241 81 81421

Design:
Lucid, Berlin

Cover Illustration:
Andrea Ventura

1. Aristotle (384 BC - 322 BC)
2. Thomas Robert Malthus (1766 - 1834)
3. John Locke (1632 – 1704)
4. Karl Marx (1818 - 1883)
5. John Maynard Keynes (1883 - 1946)
6. Adam Smith (1723 - 1790)
7. Friedrich August von Hayek (1899 - 1992)
8. Jean-Baptiste Colbert, Marquis de Seignelay (1619 - 1683)
9. Thomas von Aquin (1225 – 1274)
10. Carl Menger (1840 - 1921)

Abstract

For years France's economy outshined Germany's. Only recently did that change. France must now take German competitiveness as a benchmark, while Germany could learn a thing or two about sustaining productivity growth. Friendship is a two-way street.

German authorities should embrace French demands for stimulating growth in Europe. Germany has always had a tendency to suffer from structural stagnation. Germany's product portfolio is about to become out-dated and its supply-side advantages are eroding. Indeed, the German economy relies much less on comparative advantages than it does on demand from within the Euro Area. Thus, if the Euro Area disintegrates, Germany's trade surpluses will dwindle and it will lose out.

The Germans could actually benefit by following France's example in sustaining productivity growth, which Paris has done much better than Germany in the past. Indeed, Germany's comparative advantage might erode as a result of the high influx of cheap euro-flight capital. This though might even aid the European recovery process as a whole - and ultimately Germany, too. In the end, it is in Germany's interest to do more to help the south overcome its present difficulties instead of burdening it with ever more debt.

France, on the other hand, has to take German competitiveness as a benchmark, but not the German model as such. It must accelerate growth because it must create more jobs, especially for young people. Yet at the same time it has to reduce its budget deficit. For that it has three options: A quick solution would grant generous tax deductions for investment in equipment and housing, somewhat similar to what Germany did immediately after unification to redress East Germany. The danger is that this may support demand for the non-tradable sector without improving competitiveness and end in an unsustainable asset bubble. The second option would, therefore, focus on the difficult task of restoring competitive levels of unit labour costs by fostering productivity combined with moderate wage restraint. A third option is a delicate balance of the two.

Stefan Collignon

Stefan Collignon is ordinary professor of political economy at Sant'Anna School of Advanced Studies, Pisa, since October 2007, and International Chief Economist of the Centro Europa Ricerche (CER), Roma, since July 2007. He is the founder of Euro Asia Forum at Sant'Anna School of Advanced Studies. Stefan Collignon was born in 1951 and received his Ph.D. and Habilitation from the Free University of Berlin. He also studied at the Institut d'Etudes Politiques (Paris), the University of Dar es Salaam, Queen Elizabeth House in Oxford and the London School of Economics.

Economic growth and competitiveness: a Franco-German tale

Stefan Collignon

Index

Introduction

Rarely have economic policy debates between France and Germany been more controversial and more political than during the recent elections in France. While Nicolas Sarkozy has painted Germany as a model, his challenger François Hollande promised an alternative to German austerity. Yet since his election, he has received more German entrepreneurs in one month than his predecessor in a year. No doubt, Germany is Europe's *économie dominante* and this fact shapes the ideological controversy between France and Germany: here the superior German Social Market Economy with its ordo-liberal principles, there either stifling dirigisme or a "laxiste" penchant toward (Anglo-Saxon?) Keynesianism. However, while the debate in earlier years used to be framed in purely national terms, it has taken a more political-ideological turn recently. Chancellor Merkel found it "natural" to support her conservative counterpart Nicolas Sarkozy because they "belonged to the same political family". President Hollande has received the three leaders of the German Social Democratic Party at the Elysée Palace. This social-democratic "axis" seems to have forced Mrs Merkel, who needed parliamentary support at home, to accept a solution for Spanish banks during the recent European Council that she had previously resisted. It may turn out that ideological colourings will become "normal" politics in a future Europe. However, behind these apparently partisan political positioning, fundamental factors are still important for long run policy orientations. This paper attempts to bring some clarifications on the fundamental interests and problems confronting the French and German sections of the Euro Area economy.

1. Economic growth and employment

In the recent crisis, Germany has emerged as Europe's dominant actor and was able to impose strict austerity policies, because it has pulled out of the crisis faster than most other Euro-member states. However, German economic strength is a rather recent phenomenon and one cannot exclude the possibility that it will remain only a temporary boom.

Growth performances

For most of the last 50 years, economic growth has been higher in France than in Germany. The only significant three exceptions were the boom 1987-91, which was amplified by German unification and quickly extinguished by the Bundesbank; the short bubble boom before the Global Financial Crisis, from which Germany benefitted more than France; and the recent return to normal output levels, which is documented by Figures 1 and 2.

From 1994-2005, economic growth in France was nearly a full percentage point higher than in Germany. This rapid expansion was stimulated by the reduction of interest rates in the run up to monetary union, but also by the competitive advantages accumulated by the socialist governments' policies of "competitive disinflation". During this time, Germany was still suffering from the after-effects of re-unification and the structural adjustments it required. In fact, Germany's stagnation in the late 1990s and early 2000s can be explained by the consequences of a burst property price bubble, similar to what is presently happening in southern Europe. Buoyed by the generous tax breaks to stimulate the reconstruction of East Germany, Germany's property market had boomed in the early 1990s and the price of buy-to-let properties rose by around 70 percent. The tax incentives expired after 1996 and a sobering of the market set in.[1] Investors' exuberance turned to gloom, which was only temporarily broken during the dot.com boom in 2000.

The German policy response was to seek compensation from the tradable sector (exports) for the problems in the non-tradable sector (construction). However, as we will see below, this strategy was actually less successful than commonly assumed. By contrast, in France the

Figure 1: GDP for France and Germany

Source: Eurostat

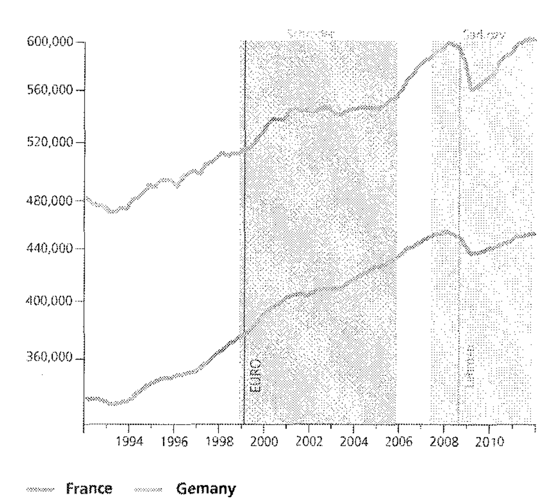
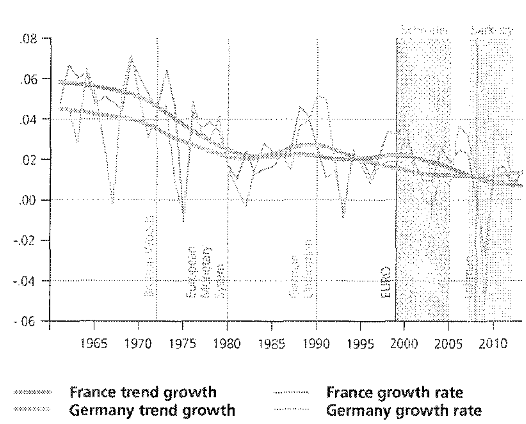


Figure 2: Economic growth

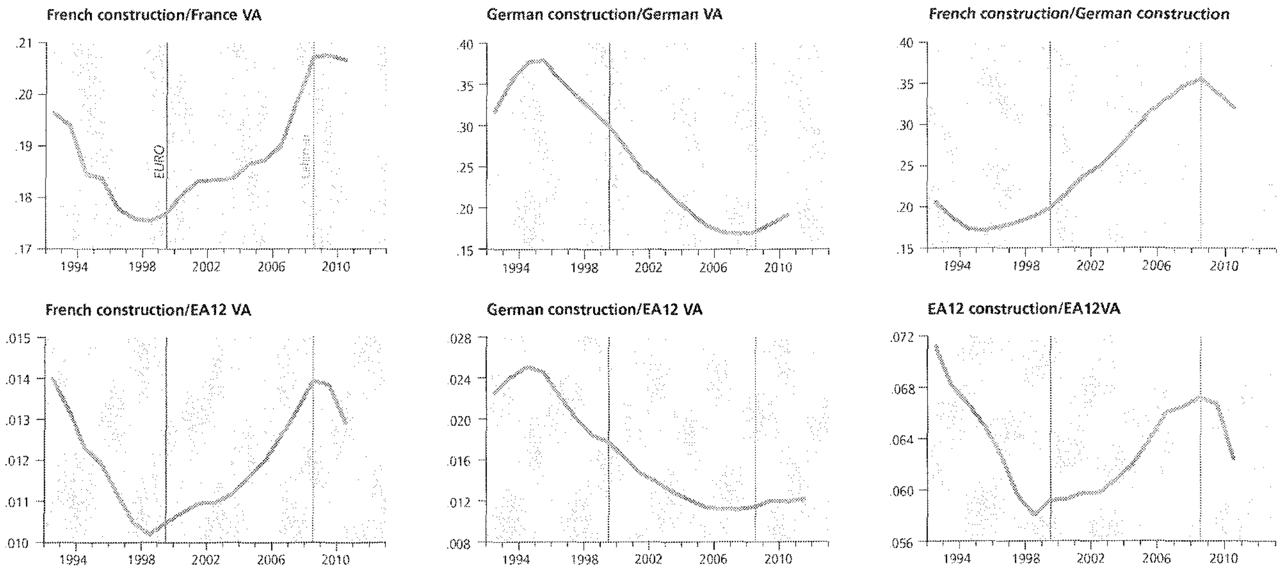
Source: AMECO



1. See Waffel, 2008 and the Fördergebietsgesetz on: http://www.gesetze-im-internet.de/bundesrecht/f_gbg/gesamt.pdf

Figure 3: Share of construction in total value added

Source: AMECO



fall in interest rates in the run-up to monetary union and its early phase stimulated the property market and contributed to an expansion of the construction sector. Here, demand in the non-tradable sector covered the deterioration in international competitiveness. This can be seen from Figure 3, which shows that the share of construction in total value added as a proxy for non-tradable goods. This share rose by approximately 3 percentage points in France from 17.5 to 20.7 percent, while it fell by 21 points (!) in Germany. In 1995, the share of construction was of equal size (37.5%) to manufacturing in the German economy. The importance of this shrinking is clear when one observes that in 1995 the German share was double of France, but without having risen substantially, the French share is now 20% higher than the German. This development went against the European trend, which saw a rise of the construction industry share, while France exceeded it by widening its share with the Euro Area economy from 10.2 to 13.9 percent. Since the Lehman crisis, Europe's property boom has collapsed and this is a major factor in the recent poor growth performance in France and southern Europe.

On the supply side, economic growth is a long run phenomenon. It can be decomposed into the contribution made by improved productivity and higher employment. With annual GDP per employee of €80500 against €65112 in 2012, France's productivity is 23.6% higher than Germany's. This is the consequence of a long-run trend. For 50 years, French productivity has grown by nearly half a percentage point faster than in Germany. Employment has also performed better, but this factor was less significant for economic growth than productivity. Since the beginning of monetary union in 1999, however, labour productivity has fallen in both countries and the French advantage has melted away.

The volatility of productivity (measured by the standard deviation of its growth rate) has also fallen in France, while it has remained stable in Germany. In general, labour productivity is more volatile in Germany than in France, which could be interpreted as a sign of greater labour market flexibility in France.2 As a mirror image, employment has become more stable in Germany (the standard deviation for 1999-2012 is lower than for 1961-2012), but more uncertain in France (the standard deviation has increased). See Ta-

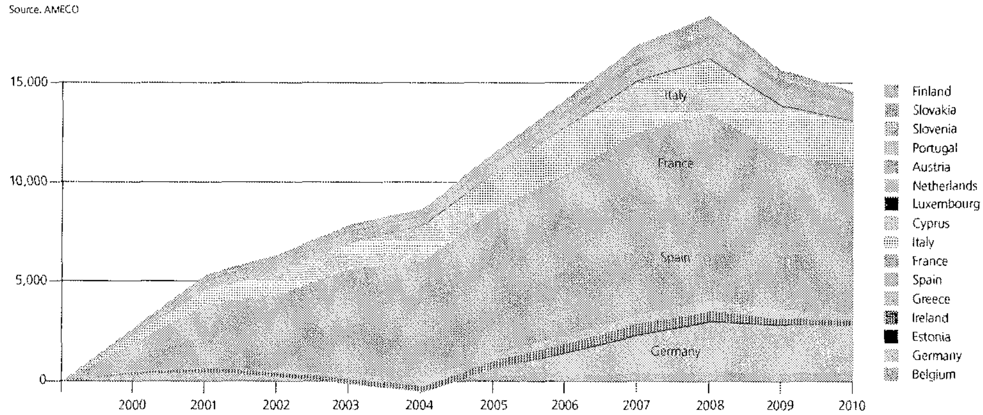
2. Productivity is more volatile when the labour force cannot be adjusted to changes in output.

Table 1: Growth rates: Labour productivity and employment

	1964–2012 Mean	1964–2012 Std. Dev.	1999–2012 Mean	1999–2012 Std. Dev.	1995–2004 Mean	1995–2004 Std. Dev.	2005–2008 Mean	2005–2008 Std. Dev.	2007–2012 Mean	2007–2012 Std. Dev.
Productivitiy FR	2.45%	1.81%	0.77%	0.96%	1.25%	0.82%	0.67%	0.82%	0.46%	1.17%
Productivitiy DE	2.02%	1.83%	0.75%	1.84%	1.05%	0.45%	1.04%	1.27%	0.34%	2.79%
Difference FR-DE	*0.44%*	*-0.02%*	*0.02%*	*-0.88%*	*0.20%*	*0.37%*	*-0.36%*	*-0.45%*	*0.12%*	*-1.62%*
Employement FR	0.57%	0.76%	0.77%	0.96%	1.10%	0.87%	0.92%	0.41%	0.31%	0.84%
Employement DE	0.47%	1.20%	0.56%	0.82%	0.36%	0.85%	0.83%	0.80%	0.85%	0.63%
Difference FR-DE	*0.10%*	*-0.44%*	*0.21%*	*0.14%*	*0.74%*	*0.02%*	*0.10%*	*-0.39%*	*-0.54%*	*0.21%*
Growth FR	3.03%	2.57%	1.54%	1.92%	2.34%	1.70%	1.60%	1.23%	0.77%	2.01%
Growth DE	2.49%	3.03%	1.31%	2.66%	1.40%	1.30%	1.86%	2.07%	1.20%	3.42%
Difference FR-DE	*0.54%*	*-0.46%*	*0.23%*	*-0.74%*	*0.94%*	*0.39%*	*-0.26%*	*-0.84%*	*-0.42%*	*-1.41%*

Figure 4: New jobs created since 1999 in thousands

Source: AMECO



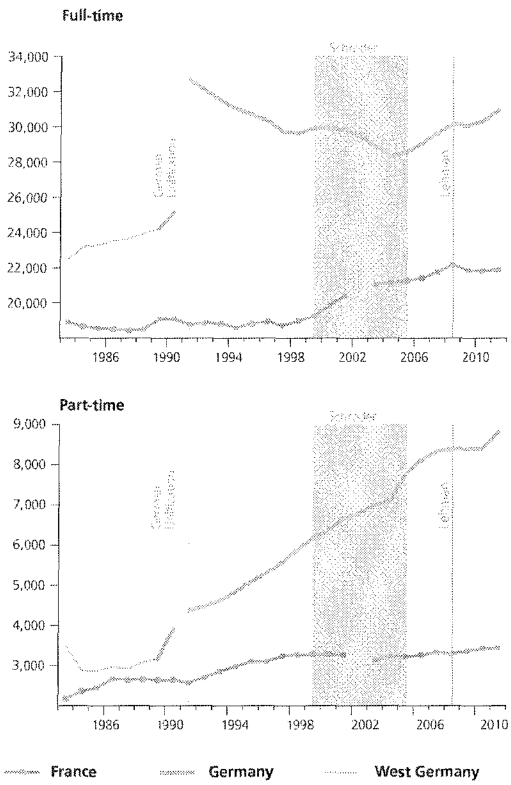
ble 1. It has been argued that Germany has undertaken structural reforms because it is anticipating unfavourable demographic trends. Yet, German labour market reforms have lowered productivity growth, and there is nothing that shields better against the burden of an aging population than greater productivity. The higher productivity may also justify to some degree, why France may be more generous about retirement age. Nevertheless, employment is the foundation of social and political stability and job creation must therefore have priority.

Jobs

The advent of European monetary union was the largest job creation program in Europe's history and France has benefitted generously. By 2008, the Euro Area had created 17.463 million new jobs, of which 3.5 mn were lost again during the financial crisis (i.e. by 2012). As Figure 4 shows, with a net balance of 3.719 million newly created jobs over the period 1999-2012 France was the second largest job creator in the Euro Area,

Figure 5: Employment (3)

Source: OECD

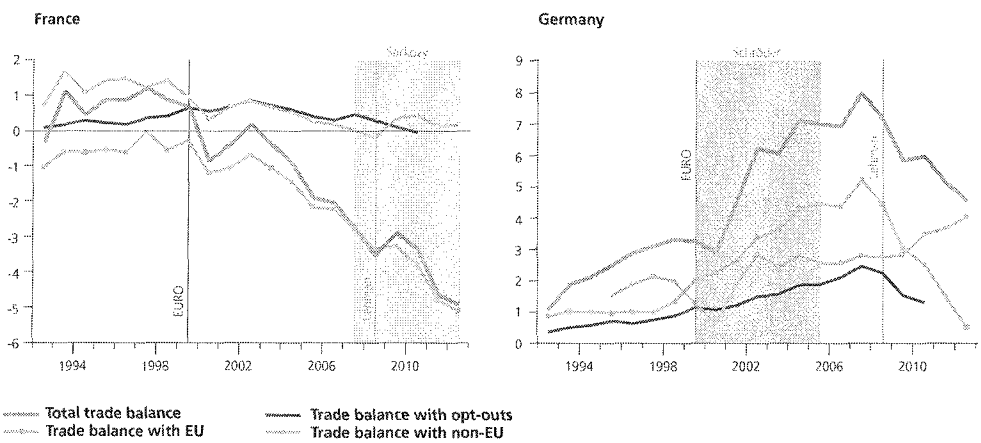


just behind Spain (3.720). Germany, by contrast, has on balance destroyed jobs until 2005, when the Hartz IV reforms started to be implemented. Since then it has generated 2.330 million jobs, although many of them are part time.

Figure 5 shows the decline in German full-time employment and the compensating creation of part-time jobs after Unification.[3] These developments were a consequence of the dissolution of many non-competitive enterprises in the East-German economy. After the Schröder labour market reforms in 2004, both full and part-time employment increased, although the former only by 9.3 percent and the latter by 23 percent. Over the same period, full-time employment in France rose by 3.5 percent and part-time by 6.6 percent. While the overall employment creation record is impressive after the Schröder reforms, causality is less clear given that the return of net job creation coincides with renewed economic growth during the global boom before 2007. One can also not ignore the unabated long run trend toward rising employment precarity and part-time jobs. In France, on the other hand, employment has remained more stable, which may have been an advantage for people with jobs, but not necessarily for the unemployed and the young who are seeking their first job. Given the demographic dynamics of France, the job creation rate should be higher in order to reduce unemployment. The experience with European labour market reforms has taught us that greater "flexibility" and lower

3. Source: OECD. Jobs covered are main jobs, the hours worked are usual hours (excluding persons that do not work more than weeks), and refer to normal hours worked and overtime hours. From 2002 the number of hours worked excludes the main meal breaks (according to the new Labour Code operative from 1st April 2002). Data for years 1994 to 2001 cover the main meal break.

Figure 6: Trade balances as percent of GDP



wage costs can increase the job creation dynamic, but usually at the cost of reduced productivity growth (European Commission, 2007). The reason why France has not been able to benefit more from the boom 2005-7 and returned to employment-driven growth after the Global Financial Crisis, as Germany did, is found in the deteriorating position of competitiveness.

2. Competitiveness

France has lost its traditional advantage over Germany in the mid-2000s. The reason is a dramatic loss of competitiveness in France and the restoration of cost advantages in Germany. There are a number of indicators for measuring competitiveness. We will here focus on trade balances, market shares and unit labour costs.

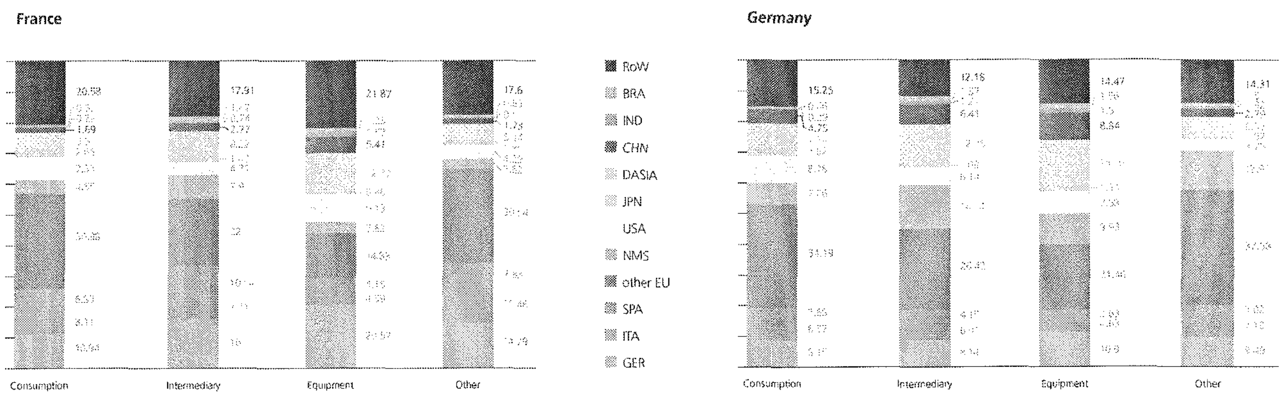
Trade balances

The trade balances for our two countries are shown in Figure 6. Overall, the French economy has seen their continuous deterioration for the last fifteen years, and especially since 2002. Its trade deficit is now close to -5% of GDP. Germany, on the other hand, has dramatically increased its net exports, which stood close to 8% of GDP before the Global Financial Crisis started; since then it has lost nearly half of its trade surplus again. Developments in French and German trade are mainly driven by intra-European trade. The external trade of France with the non-European countries has been close to balance or in surplus. The French deficit, as that of many other member states, is mirrored in German trade surpluses with the Euro Area. Thus, while it is true that Germany runs a trade surplus with the non-EU world, its main source of surpluses is intra-EU trade. Only in the last few years has demand from China and other emerging economies somewhat compensated from the loss of European demand.[4] By contrast, intra-European trade has

4. Germany has gained and France has lost approximately 3 percentage points in China's import market since 1999 (own calculations based on Chelem data base). However, nearly all of the French losses occurred in 2000, while the German progression was continuous.

Figure 7: Export Orientation

Source: Chelem



suffered from the global financial crisis and the ensuing Euro-crisis has caused a collapse of demand for German exports from Southern Europe that has helped to rebalance intra-EU trade. This indicates that German trade surpluses rely less on competitive advantages than on demand from within the Euro Area. Hence, German authorities should embrace French demands for stimulating growth in Europe. Furthermore, our data prove how strongly the German economy depends on European integration. If trade surpluses are a measure of economic success, Germany has a lot to lose from the disintegration of the Euro Area.

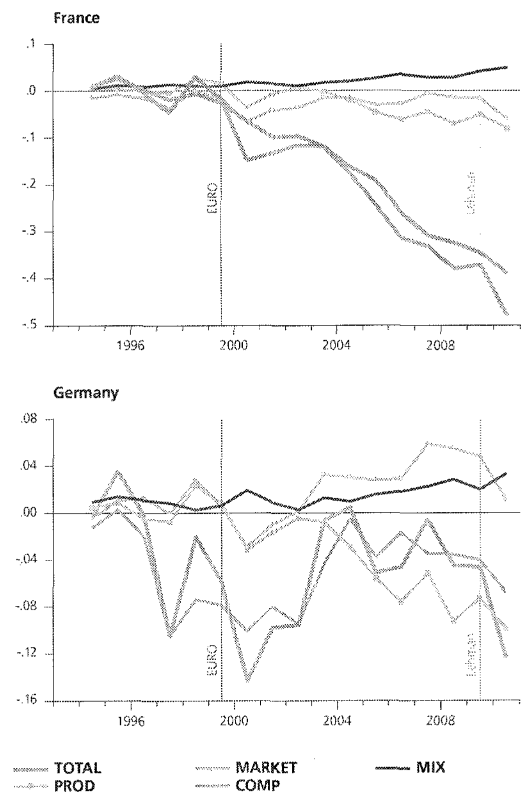
It is sometimes claimed that Germany does not need the euro because it is a "big international player" who successfully trades with emerging economies. This is not true. Figure 7 shows that with the exception of equipment exports, Europe is the most important destination for German and French exports, although Germany is more important for France than France for Germany.

Constant market share analysis

How can the evolution of these trade balances be explained? Constant market share analysis provides us with the tools for analysing broad demand factors and supply-side competitive advantages. A country can benefit from world demand either by specializing in products for which there are significant increases in demand (the *product effect*), or by focusing on expanding markets (*market effect*). The net residual between these two demand effects and the overall change in market shares is a measure of the competitiveness due to supply-side factors.[5] Figure 8 shows an index of the change in market shares according to these three effects.

Figure 8: Cumulative market share indices: total world trade

Source: CHELEM and own calculations



5. There is also a "mixed effect", which is however only relevant in very rapidly expanding situations.

France has lost market shares continuously and worldwide primarily due to deteriorating supply-side competitiveness; in addition, the orientation of the French product portfolio and market orientation has also led to some losses. Thus, supply-side conditions are the Achilles heel of the French economy. Germany, on the other hand, has experienced a more volatile performance in world markets. It has lost competitiveness in the second half of the 1990s, improved it again with the Schröder labour market reforms, and has experienced renewed losses under Merkel. In this respect, the German experience resembles the French, where Socialists restored competitiveness under Mitterrand and Jospin, while conservative governments wasted the accumulated capital. On the demand side, Germany has experienced a gradual deterioration in its product portfolio, but exports benefit from expanding markets. Yet, while it is true that Germany has successfully penetrated emerging markets, this is only part of the story because the German product portfolio is becoming outdated and the supply-side advantages are gradually eroding again.

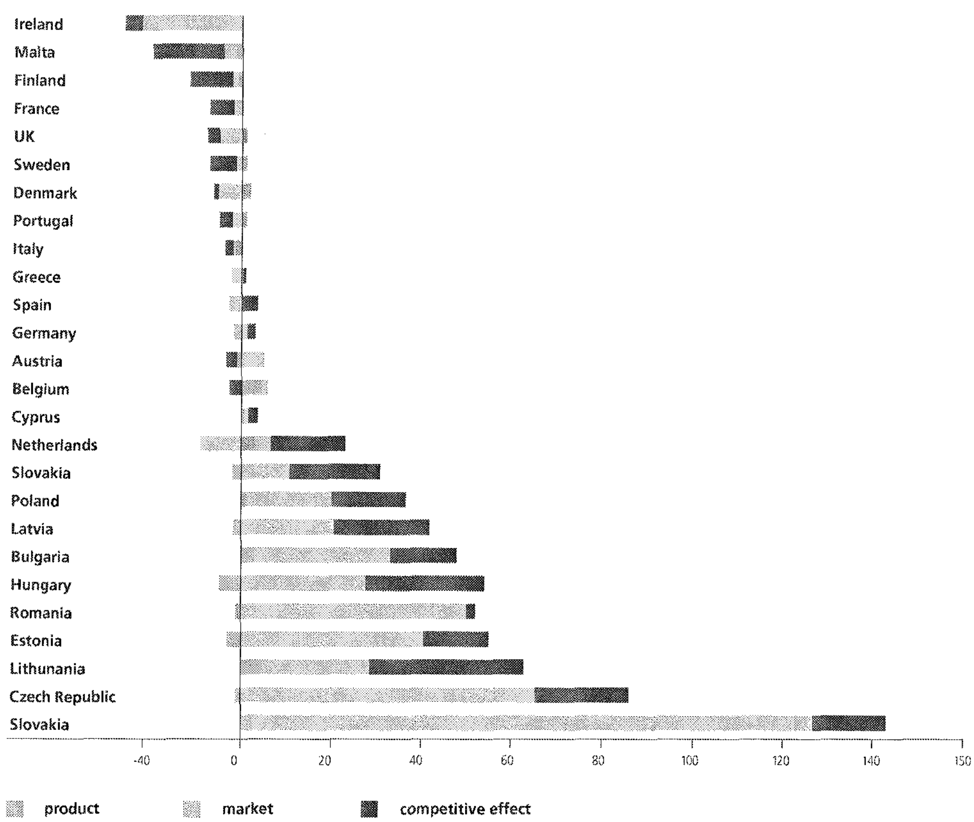
As discussed above, trade balances depend largely on the evolution of intra-European trade. Table 2 shows the gains and losses of market shares in trade within the European Union. Not surprisingly, the new member states are the biggest winners. Yet, remarkably, the Euro Area as a whole has experienced only minor losses, while the opt-out states in Scandinavia and the UK have taken the brunt. Thus, being outside the euro and being able to use the exchange rate for competitive advantages does not translate in larger market shares but actually damages the economy.

Within the Euro Area, the Netherlands and Slovakia have been the largest winners of trade shares worth 54.4 billion of euros, followed by Germany with 24 billion. The Dutch economy gained in supply-side efficiency, but lost in its market orientation. Germany lost market share due to its product portfolio, but gained by being close to the dynamic markets in central and Eastern Europe and by improving its cost competitiveness. These data suggest that outsourcing to Eastern Europe is one of the explanations for German success.

Table 2: Market share gains and losses in bn €

	Total	Product	Market	Competition
Austria	3.5	-1.9	10.1	-4.7
Belgium	7.6	11.3	3.4	-7.1
Cyprus	0.3	0.0	0.1	0.2
Germany	24.0	-35.3	26.8	32.5
Spain	5.8	-3.8	-11.2	20.8
Finland	-14.0	-0.9	-1.8	-11.3
France	-92.5	2.6	-24.0	-71.1
Greece	-1.4	0.6	-2.6	0.8
Ireland	-23.5	0.0	-20.0	-3.4
Italy	-41.5	-13.9	-6.7	-20.9
Malta	-0.7	0.0	-0.1	-0.6
Netherlands	54.4	25.4	-35.4	64.5
Portugal	-4.7	-2.6	-3.2	1.2
Slovenia	6.0	-0.4	2.2	4.2
Slovakia	27.4	0.5	23.8	3.1
EURO	-49.2	-18.4	-38.8	8.1
Denmark	-6.6	3.4	-8.5	-1.6
UK	-92.9	13.7	-69.8	-36.8
Sweden	-14.4	2.5	-2.9	-14.0
Opt-outs	-113.9	19.7	-81.3	-52.4
Bulgaria	5.9	0.3	3.8	1.8
Czech Republic	47.9	-0.6	36.9	11.7
Estonia	2.8	-0.2	2.2	0.8
Hungary	22.5	-2.3	12.8	12.1
Lithuania	6.5	0.4	2.6	3.5
Latvia	2.7	-0.1	1.4	1.4
Poland	57.5	1.5	30.0	26.0
Romania	17.2	-0.4	17.0	0.6
NMS	163.1	-1.3	106.5	57.9

Figure 9: Gain/Loss of Market Share in % of MS GDP of 1999



France, on the other hand, is the biggest loser of European trade shares, because of the negative supply side evolution and because of the insufficient orientation of trade towards the expanding markets in the new member states. Political chauvinism and economic illiteracy are also a handicap, which President Sarkozy exemplified, when he said: "It is justifiable if a Renault factory is built in India so that Renault cars may be sold to the Indians, but it is not justifiable if a factory of a certain producer is built in the Czech Republic and its cars are sold in France".[6] With this attitude France's economic power disappears.

Because they are "big" countries, the gains and losses for Germany and France are relatively small when measured in relation to GDP, but often big for small member states. With -6.8 percentage points of GDP, France is in the 4th position as a loser; Germany is close to the median with +1.2% gain. See Figure 9. By contrast, Ireland and Malta have lost close to 20% of GDP and Central and Eastern Europe have gained in excess of 20 percentage points.

Nevertheless, in bilateral comparison, France is nearly always losing out against Germany. Figure 10 presents the overall gains and losses in trade shares (last column) for specific products and reveals the relative impact of supply-side competitiveness (first column) and market demand (second column). With the exception of aeronautics, where Franco-German cooperation is strong, France is losing market shares in all major industrialised product categories. Positive demand developments in French markets are nearly always annihilated by supply-side handicaps. This negative picture even extends to classical French trademarks, such as beverages, food and cereals.[7]

6. See : http://www.spiegel.de/international/europe/concern-about-national-economic-bailouts-europeans-fear-wave-of-protectionism-a-606917.html
7. For reasons of space, these products are not shown here.

Figure 10: Competitiveness by products

Source: own calculations, data from Chelem

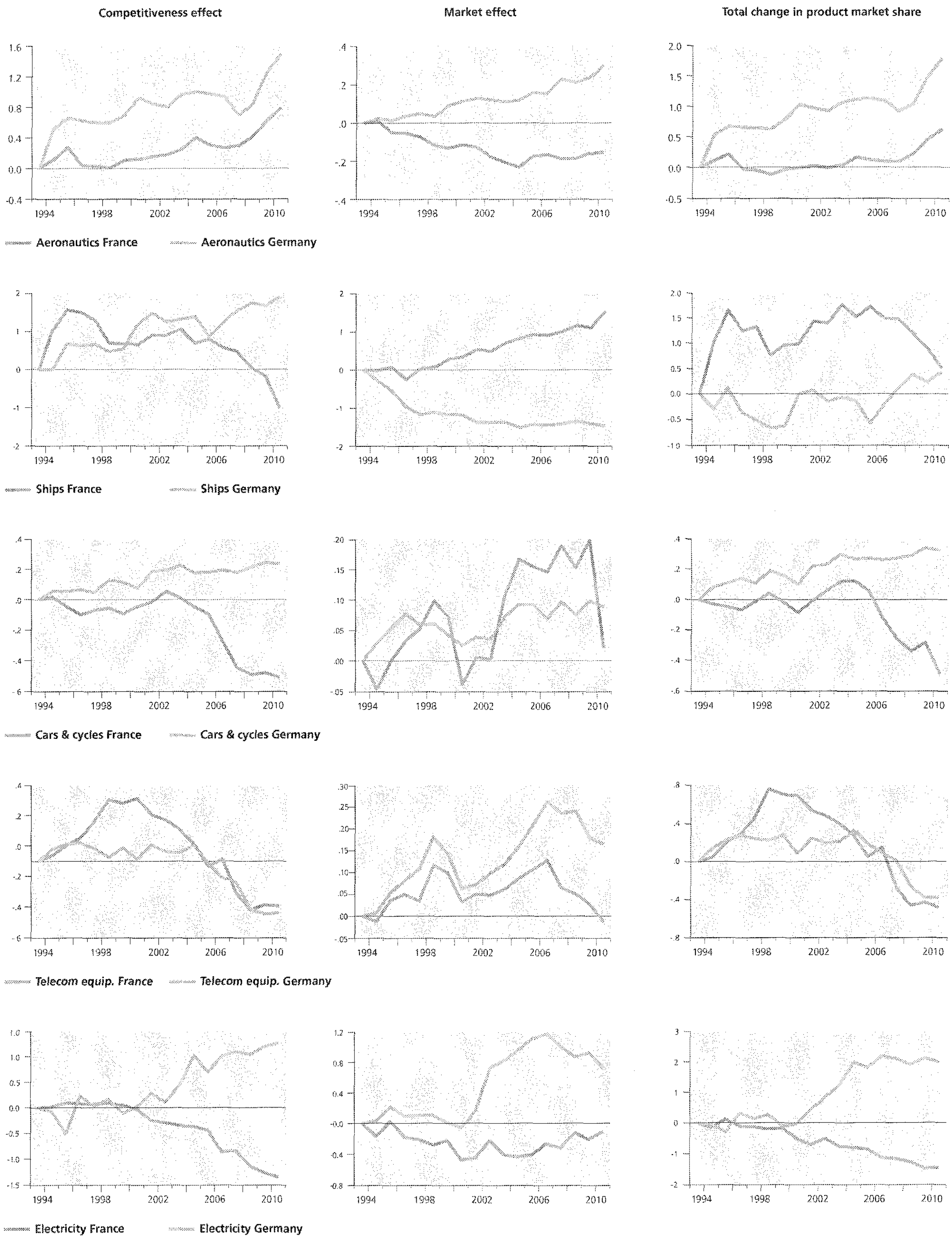
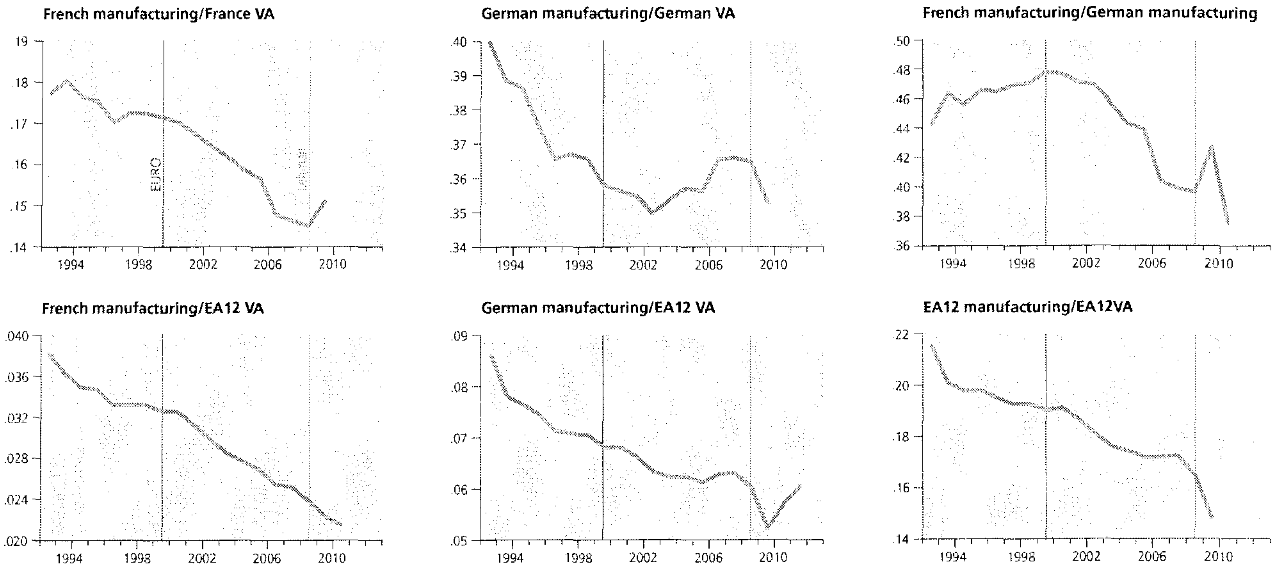


Figure 11: Share of manufacturing in total value added

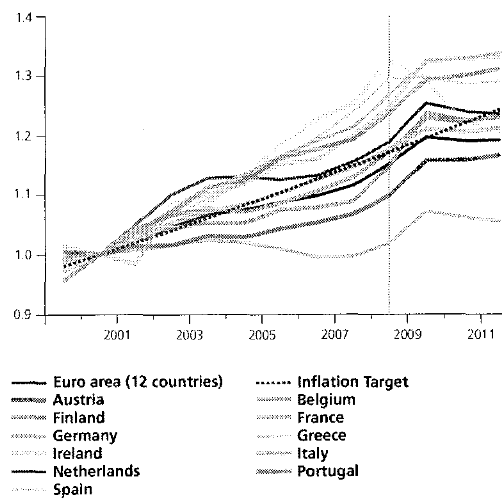
Source: AMECO



Although these losses seem important, they must be seen in the context of the important restructuring that is going on simultaneously in the global and the European economy: transition economies in Asia and Eastern Europe are becoming competitive and are rebuilding their industrial base. This takes away market shares from old established suppliers and the share of European manufacturing is shrinking. While it is true that the manufacturing sector in France has fallen since 1999 by 2 percentage points to 15% and the German share has remained roughly stable with variations around 36%, this must be seen in a broader context. First of all, in a single European market there is nothing wrong in having a strong industrial hub, which supplies products to the global economy and earns foreign currency for the Euro Area, as long as other Euro member states are efficiently integrated into the supply chain. For example, each car sold abroad could automatically sell four tires from France. This is common knowledge, since David Ricardo explained the principle of comparative advantage.[8] Second, France is doing better than some other European partners, for the share of manufacturing in Euro Area value added has fallen by 4.9 percentage points, but in France only by 1.1 points. See Figure 11. We must now explain the causes for these competitive divergences between France and Germany.

Figure 12: Nominal unit labour cost indices and inflation target

Source: AMECO



Unit labour costs

Explaining competitiveness is a complex endeavour. One of the main indicators, frequently used by the Eu-

8. For an explanation for how such a system is financially viable, see Collignon, 2012.

ropean authorities, is relative prices and relative unit labour costs, i.e. the real exchange rate. As long as countries have different currencies, the real exchange rate is strongly affected by nominal exchange rate variations; in monetary union, however, it depends only on relative inflation and unit labour costs. We will first look at intra-Euro Area relations.

Traditionally, unit labour costs are measured by an index based on an arbitrary base year. Its evolution then shows how cumulative changes are changing competitiveness advantage. Figure 12, for example, reveals that unit labour costs in France have been growing faster than in Germany although they have been very close to the inflation target of the ECB of 2% and well below those of troubled southern member states. Germany is the main outlier in the Euro Area with either stagnant, or even falling, unit labour costs in the recent years.

The use of unit labour cost indices like in Figure 12 is, however, seriously handicapped by the fact that it does not indicate the absolute levels in costs' comparativeness. In principle, it would be acceptable to have larger increases in labour costs if a particular economy is starting at a lower level than its competitors. For this reason it is necessary to find a bench mark, against which one can measure the over- or undervaluation of unit labour costs. Within the Euro Area, where the ECB is committed to maintaining price stability, the standard of measurement must be the average of the monetary union and the proper indicator is the return on capital.

In Figure 13 we see the so calculated evolution of unit labour costs in Germany and France. The three vertical shades reflect the three crises: ERM in 1992-3; crash of dot.com boom in 2000; and global financial crisis 2007-9. In Germany, real unit labour costs have been above equilibrium level until the labour market reforms in 2004 started to transform the situation. France shows the opposite picture with equilibrium unit labour costs being persistently above the actual level until 2006, after which the equilibrium level fell significantly below the actual level.

We can compress our measure of comparative advantages of unit labour costs into the difference between

Figure 13: Actual equilibrium unit labour cost levels relative to Euro Area

Source: own calculations based on Chelem

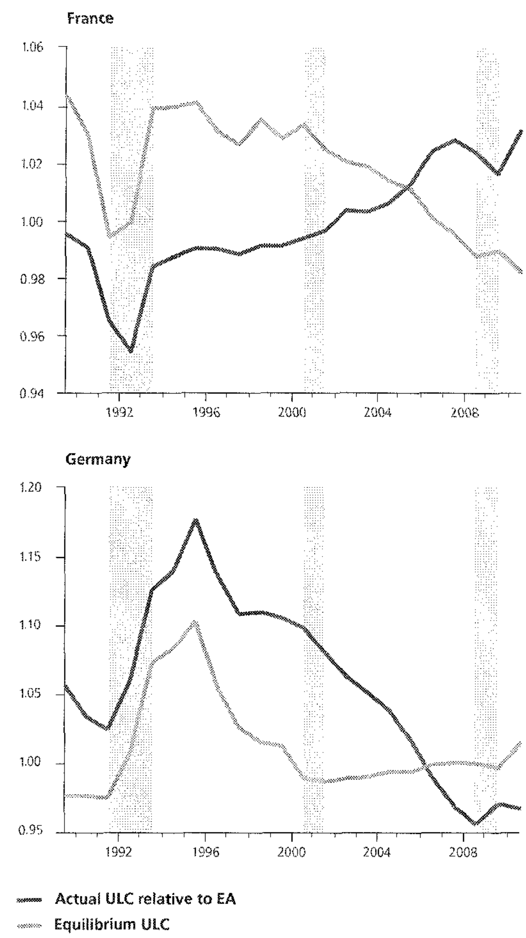
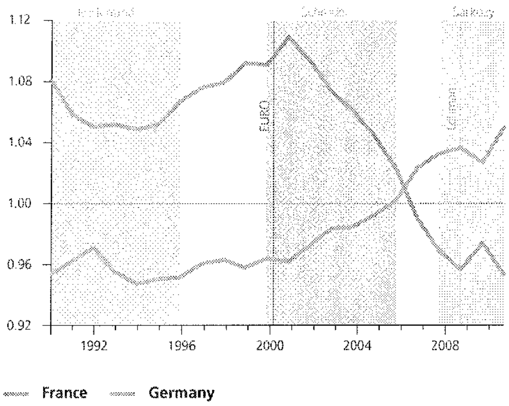


Figure 14: Relative ULC competitiveness indicators: France and Germany

Source: CER



actual and equilibrium unit labour cost levels as shown in Figure 14. While Germany was clearly overvalued by close to 8% until the beginning of European Monetary Union, it has reduced unit labour costs under the Schröder government, and this tendency has continued unabatedly until the Lehmann crisis, reaching now an undervaluation of -4%. France, on the other hand, had inherited undervalued unit labour costs from socialist competitive disinflation policies. This advantage was gradually lost under Chirac and Sarkozy. On average French unit labour costs are now overvalued by 4% relative to Euro Area average. The gap between France and Germany has therefore become close to 8 percentage points. This would explain why French products are losing market share against Germany.

Our data suggest that France must make major efforts to re-gain its competitiveness. Sharing social charges more equally, for example by increasing the *Contribution Sociale Généralisée* (CSG) and reducing employers' social security contributions may contribute to an improvement, similar to the "social VAT" increase in Germany. However, the core improvement must be a rise in capital and labour productivity that is not fully recuperated by nominal wage increases.

All these options are painful. To mitigate the pain, the idea of devaluing the euro against the US-dollar and the rest of the world is frequently advanced in French policy debates. In order to assess the validity of this proposal, we have estimated the impact of the real exchange rate on net exports in France and Germany. Annex 1 presents the formal results. As text books would claim, a general appreciation of the exchange rate increases imports and reduces exports. Interestingly, under monetary union this effect is very similar for both countries.[9] Thus, the argument that French exports could benefit more from depreciating the exchange rate than Germany is not correct.[10]

However, there is an interesting difference between the two countries: The German trade balance is more sensitive to depreciations of the exchange rate than to appreciations, while for France the opposite is true. This is an important result, which sheds light on the different trade performance of the two countries in the last 20 years. In the subsample from 1992 to 2010[11] the elasticity of net exports to exchange rate deprecia-

9. The difference between the two elasticities is statistically not different from zero.
10. See columns 3 and 4 in the tables in the annex.
11. See columns 8 and 9.

tions increases substantially for Germany, from roughly -0.6 to -0.83 and to -0.91 when the Euro Area is excluded. The positive effect of exchange rate depreciations is reduced when we exclude the crisis years from the sample, but the difference between the two impacts is still statistically significant.[12] French net exports by contrast, while not reacting significantly before monetary union,[13] suffer significantly from exchange rate appreciations, with elasticity around -0.4 while there is no significant benefit for them from depreciation (the coefficient is insignificant). Thus, Germany would benefit most from depreciation but does not care about appreciations, while France suffers most from an appreciation of the euro but does not really benefit from depreciation.

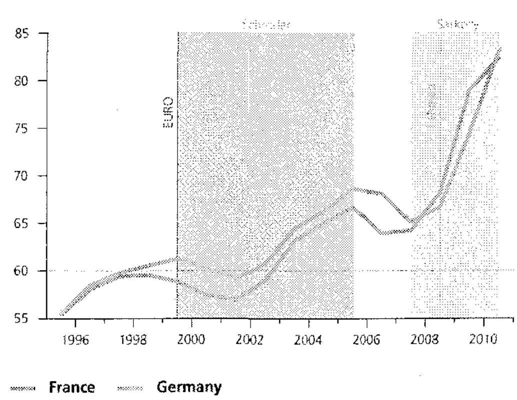
There can be several explanations for this result: first, higher quality of German exports may cause demand to be relatively insensitive to price increases while a price reduction increases their demand; second and connected to the first point, the restructuring of the production chain, with a strong increase in outsourcing activities, especially with eastern Europe, has increased German competitiveness not only within the Euro Area but with the rest of the world and simultaneously made the German economy dependent on European supply networks and therefore less price elastic; thirdly, the sectoral specialization of German exports, which are relatively more concentrated in equipment goods and are an essential part of the production processes in many emerging economies, especially in Asia, may render the demand less sensitive to price increases than to price reductions. The change in the structural composition of exports may be an explanation for the asymmetric reaction to exchange rate movements, as France has kept a comparative advantage only in high technology products, while it has lost competitiveness in medium and low technology products, especially against emerging economies (DG Trésor, 2012). In this context a depreciation of the euro against the dollar may not have the desired effect.

3. Public finances

Contrary to most other Euro Area member states, especially in the South, public debt levels have risen continuously in Germany and France since the start of European monetary union in 1999. Their evolution has been closely matched, first with Germany in the lead, then France. Thus, when growth slowed down in Germany, debt increases accelerated. This is what we also observe today in France and other southern member states. Yet, the most dramatic debt increases in France and Germany from 65% to above 80% occurred as a consequence of the financial crisis. See Figure 15. We must now explain the causes for this development.

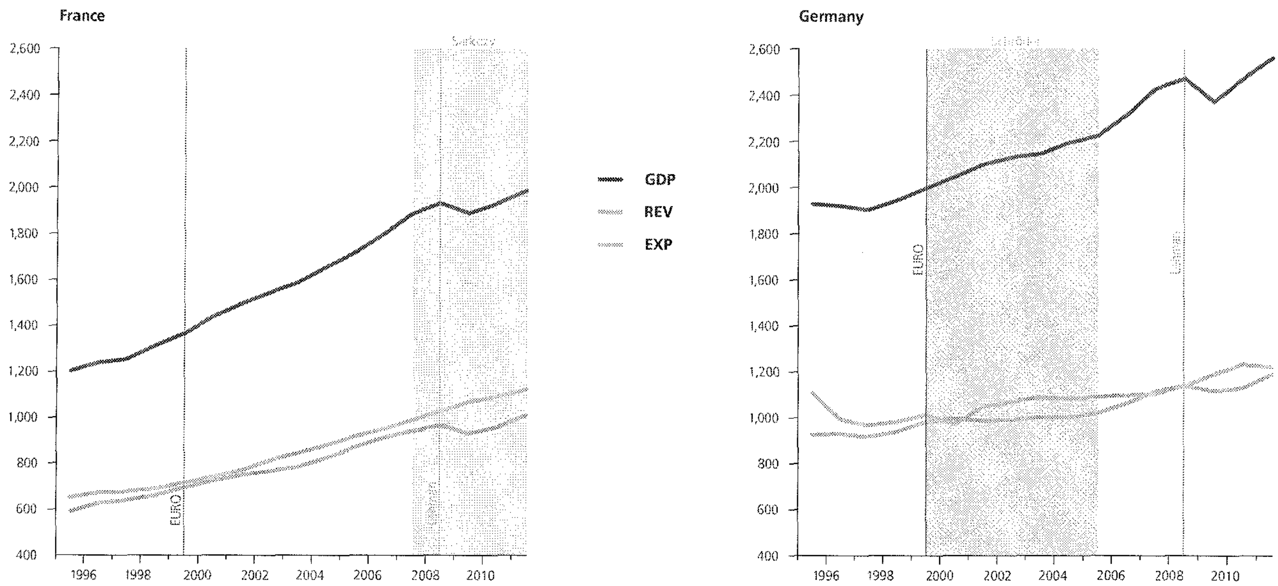
Figure 15: Dept-GDP Ratios France-Germany

Source: CER



12. See columns 10 and 11.
13. See column 7.

Figure 17: GDP, Revenue, Expenditure in bn €



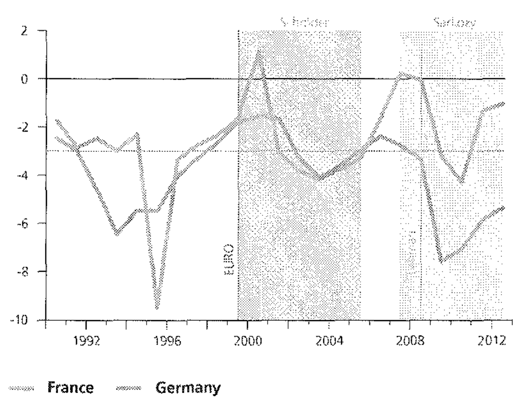
France and Germany have followed similar budget policies in the early phase of monetary union. They both violated the Stability and Growth Pact rule of not exceeding deficits of more than 3% in the first half of the 2000s. Because Germany benefitted more of the 2006-7 boom than France, it was able to cut back the deficit in those years, but the global financial crisis with the severe recession was the main reason for high deficits since 2008, although with nearly 8% French deficits were nearly the double of the German level.

Weak growth in France has slowed down the consolidation of public finances, because the fall in GDP has caused a loss of revenue, as Figure 16 shows. In Germany, by contrast, revenue was quickly restored after GDP returned to its previous levels. Interestingly, during the recession in 2009, public spending in Germany increased much more than in France. Thus, Germany is hardly the champion of public "saving" it pretends to be. In fact the fiscal stimulus was stronger in Germany than in France and this may explain the more rapid exit from the global financial crisis in Germany. Thus, although German authorities preach against Keynesianism, when they actually put it into practice, it works.

Yet, even without extra spending the loss of revenue has led to high deficits in France. The size of French public borrowing is mind-boggling when one considers the absolute amounts. In 2009, France has borrowed as much as Italy and Germany together (see Figure 17) and that has not changed substantially in the following years. France

Figure 16: Deficit-GDP Ratios: France-Germany

Source: AMECO



and Spain absorbed nearly half of the total Euro Area borrowing. These amounts exceed by far the relative weights of the respective economies.

Nevertheless, the data in Figures 15-17 clearly indicate that fiscal policy in France has closely matched with German behaviour before the financial crisis. But due to its deteriorated competitiveness, France has not been able to grow as quickly out of the crisis as Germany and that is the main reason for sustained high deficits. In this context, adopting tough austerity programmes, which kill growth, as witnessed for example in Italy, would be counterproductive. The real issue for French public finances is how to accelerate growth.

4. Conclusion

This study has two messages: over the long run, France has been doing better than Germany, but over the most recent period it was, the opposite. This may explain why President Sarkozy has failed to convince his voter that they needed to adopt the German model. One does not easily change engrained habits and structures. Yet, in the short run, France must take German competitiveness as a bench mark. Nevertheless, by taking a longer view, German authorities could actually learn something from France about sustaining productivity growth. Friendship is a two-way street.

Germany has always had a tendency to suffer from structural stagnation, although this is presently masked by the high influx of euro-flight capital into Germany that has pushed bond yields close to zero. With high likelihood, this will ignite a property market bubble, as previously experienced in Europe's south, and might gradually erode Germany's competitive advantage. This is, however, a normal and maybe ultimately even desirable adjustment process in monetary union. It is in the joint interest of all in the Euro Area that Germany makes a stronger contribution to the development of aggregate demand in the Euro Area; this would increase welfare in Germany and help the south to overcome its present difficulties more rapidly, instead of burdening the south by debt and fuelling resentment among German taxpayers.

France needs to accelerate growth because it must create more jobs, especially for the young, and because it must reduce its budget deficit. For that it has three options: A quick solution would grant generous tax deductions for investment in equipment and housing, somewhat similar to what Germany did immediately after unification to redress East Germany. The danger is that this may support demand for the non-tradable sector without improving competitiveness and end in an unsustainable asset bubble. The second option would, therefore, focus on the difficult task of restoring competitive levels of unit labour costs by fostering productivity combined with moderate wage restraint. A third option is a delicate balance between the two. No doubt, it will take time and political courage to implement the necessary reforms, but ultimately, they can only be achieved by distributing the burden for all citizens more equally. As Prime Minister Ayrault said in his inaugural speech to Parliament: "Social justice is a factor for growth and progress". This is true in France, in Germany and anywhere in Europe.

Estimates Germany

	1992-2010		1999-2010		1992-2010		1992-1998	1999-2010		1999-2007	
	all	no Euro area	all	no Euro Area	all	no Euro Area	all	all	no Euro Area	all	no Euro Area
Δrelgdpk	0.560*	0.613*	1.022**	1.342***	0.868**	0.984**	0.614	1.188**	1.583***	1.418**	1.505**
	[0.314]	[0.368]	[0.317]	[0.318]	[0.355]	[0.419]	[0.529]	[0.369]	[0.355]	[0.490]	[0.541]
Δlnrerbil	-0.360***	-0.359***	-0.421***								
	[0.096]	[0.099]	[0.089]	[0.090]							
lndist	-0.004	-0.006	0	-0.002	-0.006	-0.008	-0.007	-0.004	-0.007	-0.012	-0.015*
	[0.006]	[0.007]	[0.005]	[0.006]	[0.006]	[0.006]	[0.012]	[0.005]	[0.006]	[0.007]	[0.008]
Δlnrerbil_pl					-0.161*	-0.151	-0.075	-0.432**	-0.404**	-0.400**	-0.371**
					[0.093]	[0.093]	[0.098]	[0.173]	[0.176]	[0.174]	[0.176]
Δlnrerbil_mn					-0.593***	-0.595***	-0.584***	-0.835***	-0.906***	-0.705**	-0.824**
					[0.025]	[0.027]	[0.013]	[0.228]²	[0.270]	[0.259]	[0.297]
Const.	0.099	0.119*	0.066	0.086	0.146**	0.161**	0	0.125**	0.146**	0.071	0.023
	[0.064]	[0.070]	[0.056]	[0.066]	[0.061]	[0.067]	[.]	[0.057]	[0.069]	[0.068]	[0.029]
N	1450	1325	972	547	1450	1325	478	972	847	729	638
R^2w	0.171	0.177	0.155	0.165	0.161	0.169	0.282	0.133	0.145	0.131	0.140t

Estimates France

	1992-2010		1999-2010		1992-2010		1992-1998	1999-2010		1999-2007	
	all	no Euro area	all	no Euro Area	all	no Euro Area	all	all	no Euro Area	all	no Euro Area
Δrelgdpk	1.210**	1.233**	1.135**	1.172**	1.340***	1.371***	1.429***	1.336**	1.384**	1.629**	1.729**
	[0.393]	[0.405]	[0.480]	[0.527]	[0.352]	[0.362]	[0.417]	[0.490]	[0.529]	[0.621]	[0.690]
Δlnrerbil	-0.212**	-0.207**	-0.370***	-0.365***							
	[0.079]	[0.079]	[0.087]	[0.090]							
lndist	0.001	0	0.006	0.005	-0.001	-0.002	-0.007	0.004	0.002	-0.005	-0.006
	[0.006]	[0.007]	[0.006]	[0.007]	[0.006]	[0.007]	[0.014]	[0.007]	[0.007]	[0.008]	[0.009]
Δlnrerbil_pl					-0.156*	-0.150*	-0.058	-0.444**	-0.442**	-0.380**	-0.366**
					[0.090]	[0.090]	[0.085]	[0.145]	[0.151]	[0.139]	[0.141]
Δlnrerbil_mn					-0.487	-0.476	-0.348	-0.416	-0.371	-0.537	-0.515
					[0.325]	[0.337]	[0.593]	[0.407]	[0.435]	[0.432]	[0.462]
Const.	-0.034	-0.022	-0.1	-0.091	-0.020	-0.01	0.212	-0.06	-0.042	0.000	0.000
	[0.066]	[0.075]	[0.071]	[0.084]	[0.066]	[0.075]	[0.138]	[0.074]	[0.086]	[0.000]	[0.000]
N	1449	1325	971	847	1449	1325	478	971	847	729	638
R^2w	0.075	0.077	0.083	0.086	0.067	0.070	0.075	0.075	0.078	0.080	0.086

Standard errors in brackets; *significant at 10% level, ** significant at 5% level; *** significiant at 1% level.

Δrelgdpk = log difference of the partners and reporter's GDPs;
Δlnrerbil = log of the bilateral exchange rate (partner's currency on domestic currency);
Δlnrerbil_pl = log of bilateral exchange rate with positive changes (appreciation);
Δlnrerbil_mn = log of bilateral exchange rate with negative changes (depreciation);
lndist = log of the distance between capital cities. Estimation method: panel random effects.

Annex 1. Methodology and results.[14]

We estimate the impact of the exchange rate of bilateral trade balances for Germany and France against 85 partner countries over the period 1992-2010. The main purpose of the analysis is to test for the presence of asymmetries in the response of sectoral trade balances to exchange rate movements. To this aim we dichotomise the exchange rate by creating two variables representing respectively the effect of *appreciations* (erbil_pl) and *depreciations* (erbil_mn). The estimated equation is basically given by the difference between the export and import demand functions (see Guerrieri and Esposito 2012a), hence together with the exchange rate, a regressor accounting for the relative demand is introduced. This is given by the log difference between the partner's and reporter's GDP. All data are from the CEPII-Chelem database. The estimation technique is a panel random effect estimator (RE) in log differences, which partly accounts for the endogeneity of the relative demand variable and return consistent and more efficient estimates compared to the fixed effects estimator (FE). The preference of the RE against the FE is confirmed by the Hausman test (available upon request).

14. I thank Piero Esposito for doing the econometrics.

References

Collignon, S. 2012. Macroeconomic imbalances and comparative advantages in the Euro Area; ETUI and Bertelsmann Foundation, Brussels

DG Trésor, (2012) "Export specialization of France and four other leading countries of the European Union between 1990 and 2009" Trésor Economics, n.98, February. Ministère de l'Économie, des Finances et de l'Industrie.

European Commission, 2007. Quarterly Report on the Euro Area. Vol. 6.4, DG ECFIN, Brussels.

Guerrieri, P., and Esposito P. (2012a) "Is Germany a model to copy for Italy? A comparison between two export led growth models" Economia e Politica Industrial/Journal of Industrial and Business Economics, vol. 39 n.2

Guerrieri, P., and Esposito, P. (2012a) "Italy and the European and global competition" Economia Italiana/Review of Economic Conditions in Italy, forthcoming

Waffel, M. 2008. Why the Global Housing Market Boom Bypassed Germany;
http://www.spiegel.de/international/business/real-estate-doldrums-why-the-global-housing-market-boom-bypassed-germany-a-552901-druck.html

BertelsmannStiftung