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Growth, competitiveness and structural reforms  
**Macroeconomic imbalances and adjustment**

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## **National Competitiveness Councils: the economic rationale**

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Note for the attention of EPC

## 1. Background

Building on the ideas put forward in the Five Presidents report, the Commission on 21 October 2015 presented a Communication on the deepening of EMU. This included a proposal for a Council Recommendation to establish a system of "National Competitiveness Boards" (NCBs) in euro area Member States, open for participation also for non-euro area Member States. There have been initial discussions in the Council on this proposal. Discussion took place in different Council formations (ECOFIN, COMPET, EMPL) and in more detail in the EPC and EFC.

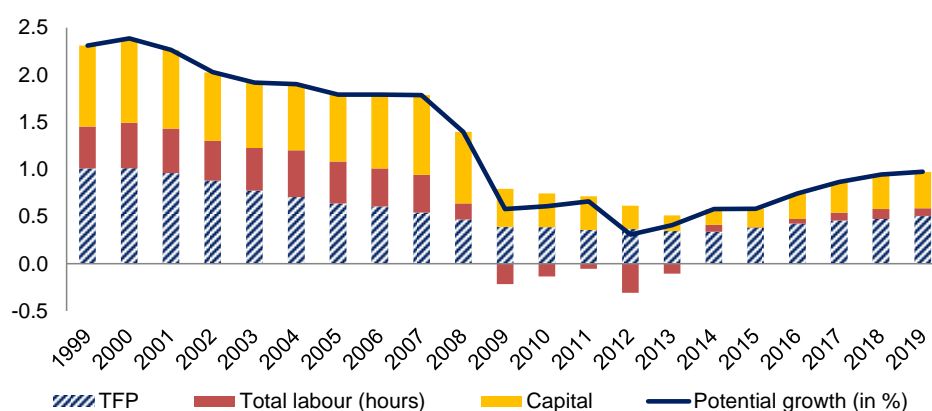
To support a forthcoming discussion on the text of the Council Recommendation it has been decided to broaden the background and first discuss in the EPC the analytical case for NCBs as put forward by the Commission in its proposal. The Commission supports this discussion by two analytical notes. This first note addresses the economic rationale for NCBs by discussing why raising productivity and boosting competitiveness are major challenges for the EU and the Member States at the current juncture. The second note, planned for the February EPC, will focus more on the institutional and operational aspects linked to the NCBs.

The rest of the note is structured as follows. Section 2 discusses the productivity slowdown in the EU and Section 3 its implications for the EU and the euro area. Section 4 highlights why monitoring competitiveness is important in this context. Section 5 discusses the structural reform aspects to address the challenges. Some issues for discussion conclude.

## 2. The slowdown in productivity is a major challenge for the EU

**Productivity and potential output have been slowing down over the past two decades.** (*Graph 1*) A downward trend in potential output growth was present well before the inception of the crisis in the EU and the euro area, in particular due to a steady decline in total factor productivity (TFP). These already unfavourable trends have been compounded by the crisis which has markedly slowed down the pace of capital accumulation following a steep fall in investment and has left many outside the labour market for a protracted period of time.

*Graph 1: Contributions to potential growth (euro area)*



Source: Autumn Forecasts 2015.

**Looking forward, GDP growth ultimately depends on TFP growth.** The other components of potential growth, namely hours worked and capital deepening, are unlikely to sustain growth durably. Labour force will be durably affected by the ageing population in the EU and investment is only slowly recovering, hindered notably by deleveraging pressures and uncertainty about growth prospects. All Member States experience, with different degrees of gravity, this combination of unfavourable trends in long term growth drivers.

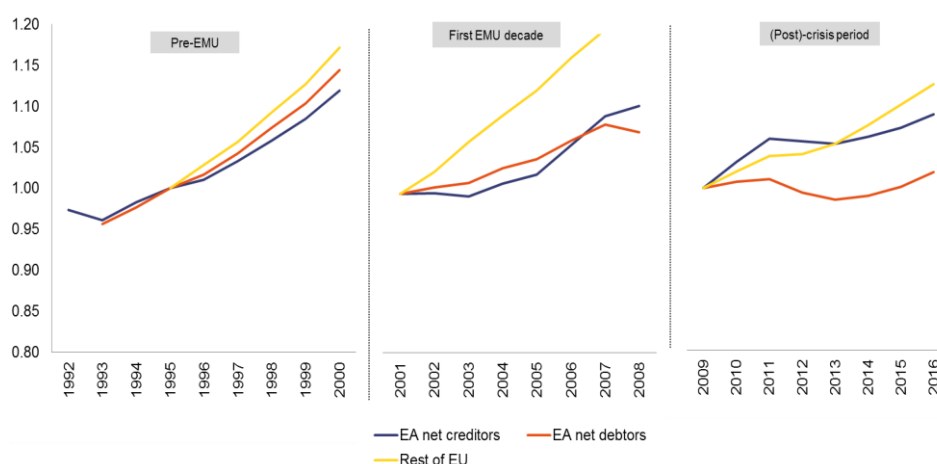
Raising productivity is a major challenge to increase potential growth in the EU. It is a multifaceted issue that requires expertise in a wide spectrum of policy areas, including policies aimed at supporting innovation, the diffusion of new technologies and investment in human capital, but also measures designed to foster a better capital and labour allocation by removing financial frictions and structural rigidities in labour and product markets.

### 3. Supporting productivity matters for the EU and the euro area

*Productivity growth is essential for ensuring growth and real convergence*

**Real convergence, as defined by the upward convergence of output per capita, appeared to progress during the first years of the euro but has since abated.** (Graph 2) In general, higher growth rates were recorded in countries with lower income per capita. However, the sustainability of this strong record of real convergence proved illusory as GDP growth rates achieved in the pre-crisis period were not supported by a boost in productivity. In debtor economies, economic performance and capital flows associated with the emergence of large current account imbalances were not accompanied by investment in productive activities. In addition, the apparent satisfactory economic performance critically reduced pressures for reform, thus compounding the structural decline in TFP growth and contributing to a persisting halt in real convergence.<sup>1</sup> Overall, the crisis pointed out that that productivity and 'structural convergence', which represents the convergence in terms of structure of the economy, are key for a sustainable real convergence.

**Graph 2: Income per capita in the pre-EMU period, the first EMU decade and the post-crisis period**



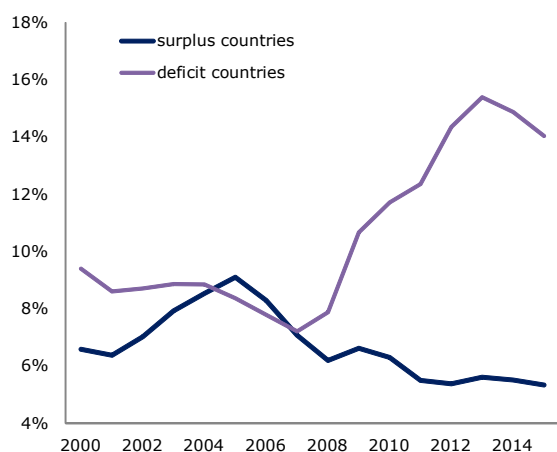
Source: AMECO

<sup>1</sup> See Buti, M. and Turrini, A. (2015), 'Three waves of convergence. Can Eurozone countries start growing together again?', VoxEU.org, 17 April 2015.

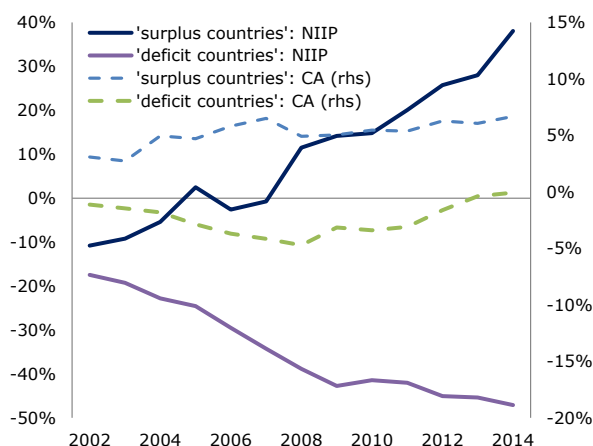
***Sustaining productivity growth is important for raising the adjustment capacity of euro area economies***

**In retrospect, slow productivity and the absence of structural reforms contributed to a very asymmetric propagation of the global financial crisis.<sup>2</sup> (Graph 3)** The global financial crisis induced an uneven adjustment in the euro area leading to major divergences in output and employment. In the absence of a flexible exchange rate and fiscal transfers, economies that had not implemented structural reforms suffered from very slow market based adjustment mechanisms.<sup>3</sup> The so-called 'relative price mechanism', i.e. the adjustment of relative prices to the output gap, was slow to kick in and its stabilising function was hampered by the presence of rigidities in the product and labour markets. Similarly, in a context of high indebtedness, financial frictions, as evidenced by the surge in NPLs, implied that capital remained locked-up in non-productive activities contributing to delaying the adjustment process.<sup>4</sup> *Overall, the crisis made it clear that structural reforms put in place to achieve higher productivity rates are essential to mitigate the risks of unaddressed asymmetric shocks.*

**Graph 3: Evolution of the unemployment rate in the euro area**



**Graph 4: Current account and net international investment position**



Source: AMECO, except on Graph 4 for Italy (BPM6).

Notes: 'Surplus' countries are Belgium, Germany, Luxembourg, the Netherlands, Austria and Finland. 'Deficit' countries: Estonia, Ireland, Greece, Spain, France, Italy, Cyprus, Portugal, Slovenia and Slovakia.

***Enhancing productivity is instrumental in correcting and preventing macro-financial imbalances***

**Since the crisis, the reduction of high stocks of liabilities has been very slow, hindered by the low productivity and low growth environment. (Graph 4)** It is now well documented that the adjustment undertaken since the crisis has yet to translate into a genuine reduction of

<sup>2</sup> Naturally, during the crisis, other factors played an important aggravating role, such as excessive indebtedness and policy mistakes combined with the lack of integration of financial markets and design weaknesses of the monetary union (e.g. the absence of a banking union).

<sup>3</sup> For an assessment of market based adjustment in the euro area in light of the crisis, see: European Commission (2015), *Quarterly Report on the Euro Area*, Volume 14, 4 (2015), special edition.

<sup>4</sup> Financial fragmentation also contributed to exacerbating the destabilising effect of the 'real interest rate mechanism', i.e. the increase in real interest rate in countries with the largest negative output gaps.

stock imbalances.<sup>5</sup> Despite negative credit flows or current account surpluses, the stocks of liabilities, both external and internal, private and public, remain elevated in a number of economies, implying significant vulnerabilities and risks. Persistently low potential growth has in general compounded these large debt stock imbalances. Moreover, the necessary deleveraging has been made more difficult and costlier in a low growth environment as a bigger share of income has to be used for debt repayment. In addition, the correction has implied constrained domestic demand and growth, which, absent structural flexibilities, has weighed on output and employment, in turn making the deleveraging more difficult, in a context where creditor countries have continued to record large current account surpluses. *Overall, the crisis highlighted the importance of robust productivity growth and structural flexibilities for resolving the tradeoff between the need to reduce debt-to-GDP ratios and supporting growth and employment.*

**Looking forward, it is essential to prevent productivity divergences from being an aggravating factor leading to the build-up of imbalances or to macro-financial stability issues.** The first decade of the euro and the subsequent crisis highlighted the aggravating role of productivity divergences associated with current account imbalances and growing liabilities in triggering harmful and disorderly corrections. Given how quickly the reform momentum can evaporate as economic conditions improve, and despite the set-up of surveillance procedures, it is essential to prevent divergence in productivity leading to a renewed emergence of harmful imbalances.

Raising productivity is of major relevance for the EU and the euro area. First, it is a prerequisite for ensuring long-term growth and real convergence. Second, in the absence of a flexible exchange rate, it is necessary to foster the adjustment capacity in a monetary union. Third, it is instrumental in facilitating the correction of large macroeconomic imbalances while it helps to prevent the emergence of new ones and mitigate the risks of macro-financial stability issues.

#### **4. The crisis highlighted the importance of monitoring competitiveness developments**

*In the euro area, harmful divergences in cost competitiveness building up before the crises have partially corrected in recent years*

**In the euro area, cost competitiveness divergences have partially corrected since the crisis.** (Graph 5) During the first decade of the EMU, large current account imbalances coincided with growing divergences in unit labour costs (ULCs) inside the euro area. Notwithstanding catching up effects, higher wage growth rates were recorded in countries with large current account deficits. Since 2009, broadly consistent with external adjustment needs, a period of difficult but necessary internal devaluation has taken place. Countries with the highest adjustment needs have seen their ULCs either fall or at least considerably slow down (e.g. Ireland, Greece, Cyprus, Spain, Portugal), with wage moderation being the most

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<sup>5</sup> See Report from the Commission to the European Parliament, the Council, the European Central Bank and the European Economic and Social Committee: 'Alert Mechanism Report 2016', COM(2015) 691 final, Brussels, 26.11.2015

important driver of the slowdown compared to pre-crisis dynamics.<sup>6</sup> At the same time, Germany, Belgium, the Netherlands, France and Austria have recorded sustained ULC growth at rates above the euro area average. The narrowing of ULC growth differentials is in general observed in both industry and service sectors.<sup>7</sup> This adjustment in ULCs was followed by a more muted though still visible relative decline in the CPI-based real effective exchange rate, suggesting some responsiveness of price-cost margins to weak economic conditions. Overall, the real effective exchange rates of the EU economies, which take into account their main trade partners at the global level, have appreciated since 2000 in most EU economies. These developments also reflect insufficient gains in non-cost competitiveness, including in areas such as training, education and R&D.

*Graph 5: Decomposition of ULC growth since 2001 (selected euro area economies)*



Source: AMECO, Commission services calculations.

Note: The decomposition is based on the standard breakdown of ULC growth into hourly compensations and labour productivity, the latter being further broken down into the contributions of hours worked, total factor productivity and capital accumulation using a standard growth accounting framework.

**Looking forward, it is important to avoid that cost competitiveness divergences contribute to the emergence of intra euro area misalignments and imbalances.** On top of productivity, indicators of cost competitiveness need to be considered in order to avoid future misalignments and imbalances. In particular, notwithstanding catching-up effects, protracted differences between wages and productivity growth may contribute to reinforcing the emergence of current account imbalances and large external liabilities in the monetary union. Their monitoring is therefore warranted in that they may represent an early signal of future harmful internal devaluation.

*EU economies have suffered from a long term trend of losses of global export market shares although it has to some extent abated in recent years*

**EU economies have been losing export market shares over the past decades. (Graph 6)** With the exceptions of catching-up economies that largely increased their trade linkages

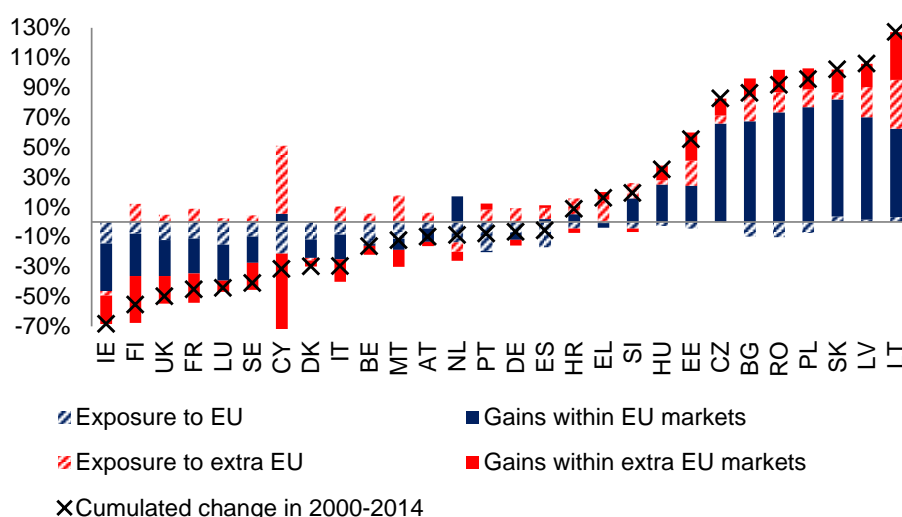
<sup>6</sup> Consistently with the rise in the unemployment rate since the crisis, labour shedding has also contributed to reducing ULC growth in most of the countries. For example, in Spain, ULCs decreased at an annual pace of 1.0% between 2009 and 2015, of which 0.7% is accounted for by labour shedding.

<sup>7</sup> See European Commission (2015), 'Monitor of Competitiveness and Trade Performance', Note presented in the LIME working group, November 2015.

within the EU, most of the EU economies have lost global export market shares since 2000. Two factors have in general been at play. First, EU economies have become less competitive in extra-EU markets, which include other OECD countries and emerging markets. Second, the relatively higher exposure of EU economies to the EU weighed on the evolution of market shares, in a context where global trade was more dynamic than EU trade.

**Export market shares gains have recently been recorded but the durability of this improvement is yet to be seen.**<sup>8</sup> Annual gains were observed in 2013 and 2014 in the majority of Member States but these gains were in general of a much lower magnitude than the drops registered in the past. This recent improvement may be partially due to the fact that the global trade came to a halt in 2013-2014, which mechanically attenuated export market shares losses. In this respect, the recent market share improvements may not be structural. Looking forward, it is too early to assess whether these gains represent a permanent shift or are just temporary.

*Graph 7: Evolution of export market shares between 2000 and 2014 (goods)*



*Source: UN COMTRADE data, Commission services calculations*

***The rebalancing of EU economies towards more productive sectors is in place but the speed of the adjustment very much depends on the implementation of structural reforms.***

**Most crisis hit economies have engaged in a shift of resources from non-tradable to tradable activities but the progress follows heterogeneous dynamics across countries.**<sup>9</sup> (Graphs 8 and 9) Economies most hit by the crisis have considerably reduced the evolution of the non-tradable sector over the tradable since 2007. In particular, the share of construction in total value added has declined markedly. Labour has in general been reallocated from the non-tradable to the tradable sector in countries with the highest adjustment needs.<sup>10</sup> However, this shift to tradable activities follows heterogeneous dynamics across countries. In Spain and

<sup>8</sup> See Report from the Commission to the European Parliament, the Council, the European Central Bank and the European Economic and Social Committee: 'Alert Mechanism Report 2016', COM(2015) 691 final, Brussels, 26.11.2015.

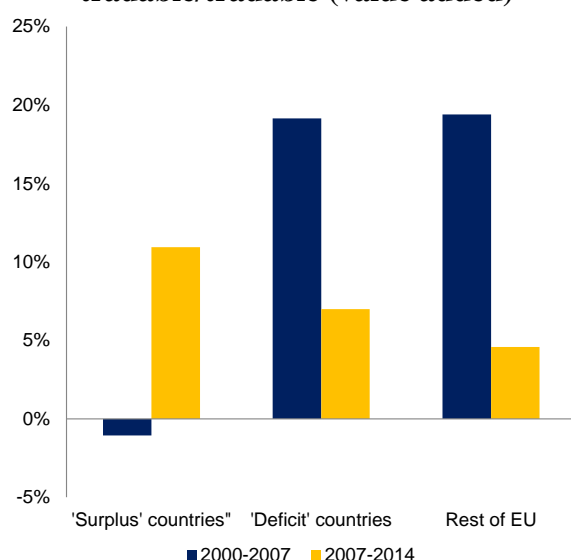
<sup>9</sup> The link between profitability and the tradable sector is quite close in general. For example, see Breitenfellner, A., A. D. Dragu, and P. Pontuch, (2013), 'Labour costs pass-through, profits and rebalancing in vulnerable Member States', *Quarterly Report on the Euro Area*, Vol. 12 (2013), No 3.

<sup>10</sup> See European Commission (2015), 'Labour Market and Wage Developments in Europe 2015', EPC?

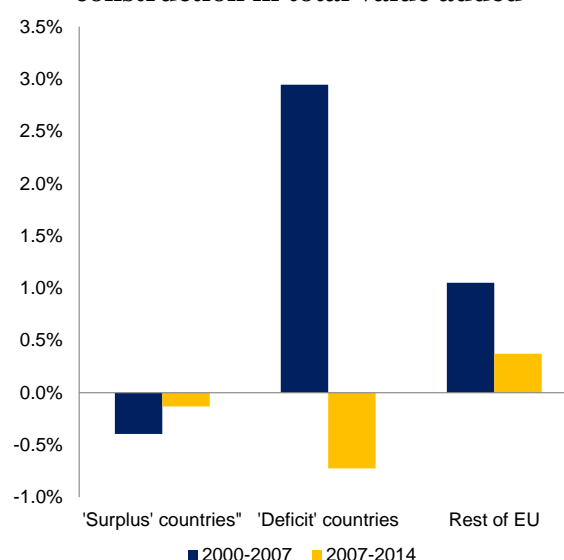
Portugal, the adjustment is to some extent taking place. In Ireland and Latvia the adjustment seems to have peaked. In Greece and Cyprus, an improvement was observed only recently and needs to be consolidated. Conversely, in Italy, France, the UK, Belgium or Finland the share of tradable value-added has declined since the early 2000s.

**The heterogeneity in the rebalancing progress may be explained by the presence of rigidities affecting the production process.** Such rigidities can be present in the labour and product markets. The swift implementation of structural reforms in labour and product markets helped Ireland and Estonia record a faster and stronger recovery than other euro area Member States. The presence of rigidities in the capital allocation process, i.e. in the transmission of savings to productive investments may also have played a role. Countries with better functioning capital markets managed to protect their tradable sector and investment.<sup>11</sup>

**Graph 8: Evolution of the ratio non-tradable/tradable (value added)**



**Graph 9: Evolution of the share of construction in total value added**



Source: Eurostat

Note: 'Surplus' countries: BE DE LU NL AT FI, 'Deficits' countries: EE IE EL ES FR IT CY LV LT MT PT SI SK  
 Tradable: A - agriculture, forestry and fishing, B\_E - industry except construction, G\_I - wholesale and retail trade, transport, accommodation and food service activities, J - information and communication  
 Non-tradable: F - construction, K - financial and insurance activities, L - real estate activities, M\_N - professional, scientific and technical activities, administrative and support activities, O\_Q - public administration, defence, education, human health and social work activities, R\_U - arts, entertainment and recreation, other service activities, activities of household and extra-territorial organisations and bodies.

Monitoring competitiveness is of major importance for the EU economies. First, within the euro area, monitoring cost competitiveness helps to prevent the emergence of misalignments and imbalances that may eventually lead to disorderly and harmful corrections. Second, at the global level, monitoring competitiveness and export performance of EU Member States gives an indication of how well they are structurally prepared for external shocks or to adapt to changing economic conditions in the global market. In this respect, implementing structural reforms is a decisive factor.

<sup>11</sup> Some empirical studies tend to show that efficient insolvency frameworks have a positive impact on the speed and cost of corporate and household deleveraging. For a discussion, see Chapter 4 of European Commission (2015), *Quarterly Report on the Euro Area*, Volume 14, 4 (2015), special edition.



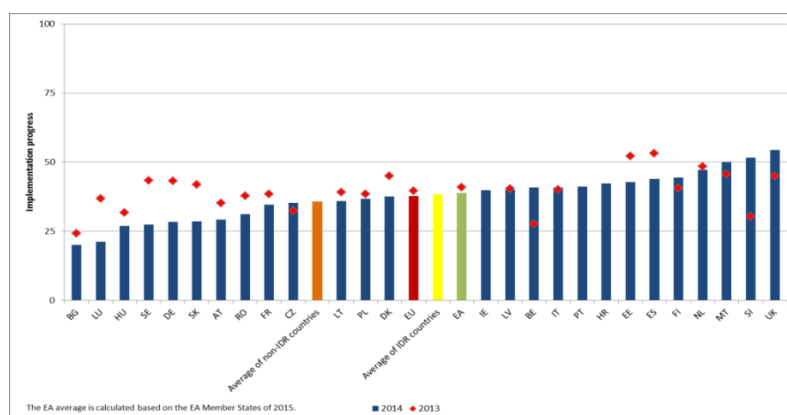
## 5. Policy responses need to be boosted and fine-tuned

*There is a large and encompassing reform agenda to support productivity and competitiveness but progress at national level remains insufficient*

To address the challenges in growth and competitiveness the EU has developed an encompassing policy agenda for all Member States. Relevant structural reforms cover a wide spectrum of policy actions and include making labour markets more adaptable and reactive, liberalising services sectors, enhancing competition in product and services markets, improving the business environment, as well as fostering innovation and education. The scope of the surveillance in the European Semester is therefore broad and country specific recommendations span across fiscal, financial, labour market, structural, public administration and business environment policies.<sup>12</sup>

**Overall, progress with the implementation of reforms has not been up to the outstanding challenges.** Exactly how satisfactory the progress with implementation has been can be debated, and several different assessments on this have indeed been put forward<sup>13</sup>, but there is a general consensus that there is a lack of progress relative to expectations and outstanding challenges.<sup>14</sup> (*Graph 10*) As many countries successively exit programmes and the EU economy enters a recovery phase there is a risk that reform pressures decrease even if the room of manoeuvre for reforms increase. Indeed, the Commission, the Council and the Euro group has repeatedly called for a stepping up of reform implementation and stronger monitoring of progress at the national level. In addition, the progress with reforms has not been uniform across policy areas. Since the crisis, reforms aimed at restoring competitiveness have been mostly targeting labour costs. However, product market reforms and other productivity enhancing reforms are still lagging.

*Graph 10: Progress with CSR implementation 2013-2014*



*Source: Commission services calculations*

<sup>12</sup> Similar processes to establish reform agendas to address key priorities are carried out by the OECD in the "Going for growth" exercise, the G20 context to address global imbalances; IMF in its Article IV examinations.

<sup>13</sup> For example, see: Darvas and Leandro "The limitations of policy coordination in the euro area under the European Semester" Bruegel Policy Contribution 2015/19; Gros and Alcidi "Economic policy coordination in the euro area under the European semester", CEPS, report for the EP ECON November 2015.

<sup>14</sup> In general, reform effort has been the largest in countries under financial stress, where accumulated vulnerabilities, amplified by the lack of reform efforts in the years before the crisis, hampered their ability of to adjust.

***Responsibility with reform progress lies mainly at the national level implying that there needs to be strong interlinkages with the EU and EA dimension***

**Member States have the main responsibility for structural reforms.** In addition to transposition of the EU directives, Member States have responsibility in most key areas involved, such as business environment, labour markets, pension reforms, the modernisation of social protection systems, the efficiency of public administration and the quality of research and innovation.

**There are many obstacles and bottlenecks for reform progress.**<sup>15</sup> For example, the full benefits of reform might take time to materialise and this is often a source of opposition to structural reforms. The well identified short-term costs of the reforms are more visible than the larger and more diffuse long-term benefits. Some reforms tackle traditionally protected sectors where vested interests forcefully resist change.

**To overcome resistance to structural reforms, an analysis and impact assessment of reforms is required to give the full picture and raise awareness of all stakeholders.** Facilitating acceptance of structural reforms may require pursuing reforms as part of packages of different reforms affecting different sectors or stakeholders. Moreover, to overcome vested interests blocking reforms, it is important that the interests of all stakeholders concerned by the reforms, in particular those who are typically less well organised (e.g. consumers, micro-enterprises) be taken into account. This would typically take place by raising awareness and by properly communicating the costs and benefits involved across stakeholders and for the economy as a whole.

**Country specific recommendations need to be supported with precise knowledge taking into account national specificities.** As said previously, identifying the right policies to boost productivity is not an easy task because it requires knowledge and coordination across various sectors of the economy. In fact, the country specific recommendations have arguably developed over the years. Compared with the scope of recommendations under the Lisbon process, CSRs have generally broadened in scope and increased in degree of policy prescription. This is a reflection of the increasing challenges, in particular in the context of the crises, and the urgency to progress. Nevertheless, in the last cycle, a process of streamlining started with a view to providing a stronger focus of the CSRs. Although the European semester aims to support peer pressure for reform progress, there have been concerns about a lack of national ownership. The identification of challenges is usually broadly consensual while the choices for the best way forward are more debated which is natural given the complexity of issues and the need for detailed knowledge as discussed above.

**At the same time, recommendations addressed to Member States need to better integrate euro-area and EU-wide challenges and objectives.** At EU level, the identification of common challenges feed into the priorities of country specific recommendations through the coordination at EU and euro area level. However, at national level there is also a need to discuss and put the national developments in the broader EU and euro area context. In

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<sup>15</sup> For a discussion, see the Commission note 'Structural reforms and growth' circulated in the informal ECOFIN of April 2015.

particular in the euro area it is important to support the coordination at euro area level at the national level by integrating the spillovers of national policies in the national debate and to consider the implications of policies in terms of the building up of harmful divergences. This type of analyses again requires an economy wide perspective.

**Positive spillovers stemming from structural reforms support the view that the impact of economic reforms can increase with cross country coordination.** Simulations of the European Commission's QUEST model tend to show that output gains stemming from structural reform implementation are positive and about 10% larger than in a scenario where each country acts alone. Positive GDP spillovers illustrate the benefits from the coordination of economic policies at the EU level, in particular those aimed at raising productivity.<sup>16</sup>

Albeit recognised as necessary, the implementation of structural reforms is still lagging. The EU dimension of reforms is not sufficiently integrated at the national level, reflecting a lack of ownership and of understanding of spillovers and benefits from coordinated action. At the same time, the complexity of the issues involved implies that in-depth analysis at national level could usefully inform the EU level diagnosis.

## Issues for discussion

1. *Do members agree that raising productivity and reducing and avoiding harmful divergences are key challenges for the growth of their economy and the EU as a whole?*
2. *Do members agree that the implementation gap in the EU structural reform agenda needs to be more strongly addressed and analysed at the national level?*
3. *Do members agree that the euro-area dimension of reforms needs to be more strongly based in the national setting?*
4. *Do members consider that the productivity-competitiveness nexus and the structural reform framework outlined in this note define adequately the scope to be covered by the mandate of the national competitiveness boards?*

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<sup>16</sup> See Varga, J. and in't Veld, J. (2014), 'the Potential Growth Impact Of Structural Reforms in the EU: a Benchmarking Exercise', *European Economy, Economic Papers* 541, December 2014, as well as D'Auria, F. et al. (2014), 'Cross-border spillovers in the euro area', *Quarterly Report on the Euro Area*, Vol. 13 (2014), No 4.