EUROFI

Macroeconomic Scoreboard

SEPTEMBER 2023

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with the support of Elias Krief

Inside

- Widening of the economic gap between the euro area and its main global competitors with Covid crisis and the war in Ukraine
- Exacerbation of existing fiscal heterogeneities across EU Member States
- Loss of competitiveness of firms in EU countries with the highest levels of government expenditure vs GDP
- Excessive public debt goes against productivity growth and employment
- Growing heterogeneity in current account imbalances across EU Member States

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Executive summary

A monetary union does not by itself create economic convergence. This Scoreboard* underlines that the Eurozone is a currency area comprising heterogeneous countries with a low level of federalism: their productivity levels, productive specialisation, level of fiscal deficits and indebtedness, and level of labour force skills being very different.

As one can observe in this document, many Member States have relaxed their macroeconomic discipline over the last twenty years, but it turned out that high levels of public debt do not favour economic growth or employment. Countries which played the card of fiscal vigilance ended up being the winners.

The Covid-19 crisis and the war in Ukraine hit the Eurozone harder than its main competitors. Since 2020, existing heterogeneities across EU Member States have been exacerbated. It is an illusion to try to solve the structural problems of our economies by prolonged increases in public debt or by using money creation. Yet, this is what has been too often tried by pursuing lax fiscal, monetary and economic policies that inevitably brought about systemic risks to financial stability and therefore to future growth.

But as long as it is not sufficiently understood, especially in highly indebted countries, that excessive debt is a source of under-competitiveness, the economic situation in these countries will continue to deteriorate and it will hamper the progress in the construction of an economic and financial European Union. Indeed, fiscal and economic divergences between EU countries make it more difficult to define in Europe a common interest, encouraging a policy of “every man for himself”, and creating a climate of distrust between Member States which hinders progress in terms of public and private risk sharing and weakens the Eurozone.

If Europe and the Eurozone are to correct their growth disadvantage compared to the United States and China and not be relegated to the rank of second-rate powers, a considerable investment effort in research and development, in industrial equipment, in decarbonization, in digital technology, in improving the education system and the skills of the population will therefore be necessary. And the sooner the better, as the gap continues to widen, demanding ever-bigger investment and supply-side oriented efforts.

Consequently, the Eurozone has to embark on the right course: fighting inflation, having more fiscal responsibility, more equity financing and more supply reforms geared to increase productivity, as well as taking steps to complete the Banking Union and implement the Capital Market Union. But this move can only be contemplated if sufficient discipline starts reversing the trend of ever-growing economic heterogeneities across Member States.

* The authors thank Pr. Philippe d’Arvisenet for his wise remarks.

1. The economic gap between the Euro area and its main global competitors has widened

The Eurozone keeps experiencing a structural growth shortfall relative to the United States and China since the mid-1990s due to structural weaknesses in the Euro area. US GDP in volume grew by 61% from the beginning of 1998 to the third quarter of 2022 and by only 36% in the Euro area.

The economic consequences of the Covid-19 crisis have been more severe in Europe than in the US and China and have amplified the heterogeneity of economic performance across Member States. The economic and social impact of the war in Ukraine are also stronger in Europe given its exposure through energy imports.

The United States and China are fighting to be the dominant economic power in the world. These two countries have been fighting intensely for years to gain dominance of the world economy. Together they account for 42% of the world's GDP and nearly 60% of the global military spending; they also control 80% of the world's unicorn and 100% of the global major platforms, namely the American GAFAM and the Chinese BATHX[1].

If Europe and the Eurozone do not reduce their growth lag with the United States and China, they will be relegated to the rank of second-rate powers.

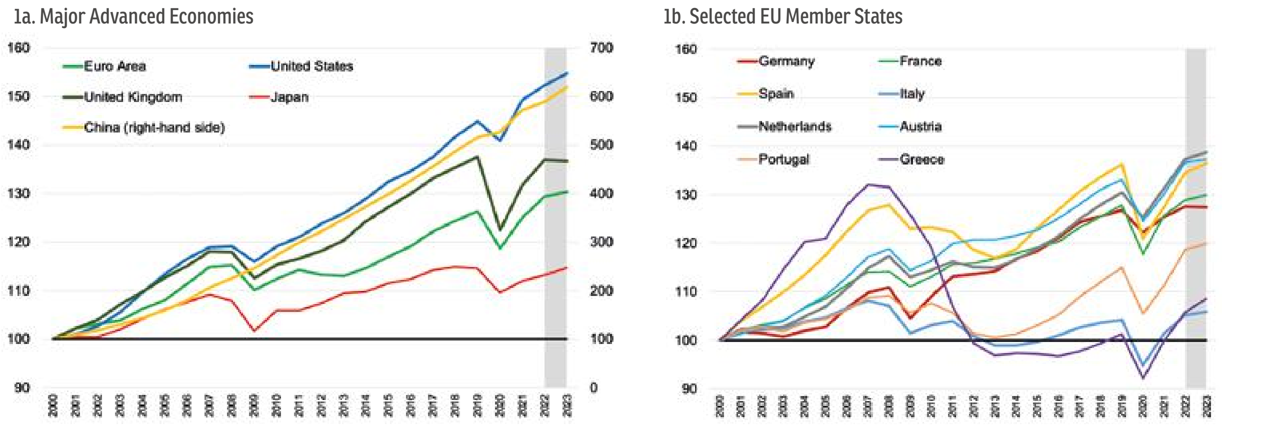
1.1 Over the last few decades, real GDP growth in the Euro area has failed to catch up with US and Chinese levels

From 2000 to 2007, the EU economy (excluding the UK) grew by a decent 2.1% per year on average while America's grew by 2.5%.

Since 2008, the EU economy has grown at a pedestrian pace of just over 1% a year. This means that it is now around 15% larger than it was at the start of the global financial crisis. By comparison, the US economy grew by around 28% over the same period[2].

Between 2014 and 2019 the Euro area GDP growth averaged 1.5% per year, against 2.4% in the US and 7% in China. The bulk of lagging Euro area performances is attributable to Italy (0.9%) and France (1.5%).

CHART 1.
Real GDP Growth Trend, 2000=100



Source: IMF World Economic Outlook of April 2023

Out of the world's twenty most valuable technology companies, only two are listed in the EU (ASML and SAP). Fifteen are in the US and the remaining three are in Asia.

America's outperformance has translated into higher wealth for its people. Income per person in America was 24% higher than in Western Europe in 1990 in terms of Purchasing Power Parity (PPP); today it is about 30% higher[3].

1. Figures quoted in the article : C. Saint Etienne, "Le nouvel ordre stratégique mondial", Les Échos, 4 March 2023.
2. See C. Di Noia, The challenges and role for EU capital markets in the context of the green and digital transitions, Eurofi Summary, Stockholm, April 2023.
3. Figure quoted in The Economist's study on The American economy published on 17 April 2023.

Real GDP growth and productivity gains in the Euro area have failed to catch up with the US and China over the past two decades and productivity gaps across member countries remain significant.

Europe has become much weaker over the last 15 years: since 2008, the EU's share of the world economy has declined. The EU, which held the largest share of the global economy in 2009, has been overtaken by the USA and China in recent years. According to the World Bank, the share of the EU's GDP in the world GDP was 31.6% in 2007, against 24.4% for the US. In 2022, the EU's share of the world GDP declined to 16,81% while it stood at 25.3% for the US and 18,3% for China.

Such a growth performance gap between Europe and the US can be attributed to (i) the freer and less regulated institutional environment in which firms operate in the US, (ii) lower productivity gains and investments in Europe than in the US, (iii) the fact that labour force declines in the Eurozone while it is increasing in the United States, and (iv) the prominent role of financial markets in the financing of the US economy.

Enterprises are freer to work and make profits in the US than in Europe:

- Less regulation and more flexible markets: Europe imposes administrative burdens on creating new firms or on growing beyond arbitrary thresholds that triggers an increase in compliance costs. This is not observed in the United States.
- Fiscal and social contributions are higher in Europe. Indeed, the size of the welfare state and the high level of social spending in European countries mean that taxes are higher in Europe than in the United States, which weighs on the competitiveness of European companies.

Unlike Europe, the United States benefit from a truly single market.

- America benefits from a large consumer market at home – and thanks to multinational firms worldwide – over which it can spread the costs of R&D, and a deep capital market from which it can raise finance.
- Contrarily, Europe is struggling to implement a true single market. Linguistic, administrative and cultural differences, heterogeneous bankruptcy laws and contractual conditions, as well as various regulatory barriers, prevent bankers and companies from easily operating across borders.

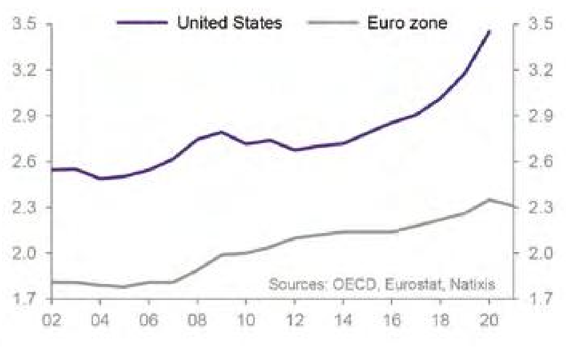
Lower investment and productivity gains in Europe than in the US.

- Underinvestment in Europe leads to low productivity gains, which weaken potential growth.
- Low productivity gains in Europe are due to low research spending (*see Chart 2.a*) and the decline of industry (*see Chart 2.b*). Moreover, in the US labour force is better-skilled, works more hours and increases while it declines in the Eurozone (these last points are developed on the following pages).
- Labour productivity increased in the Eurozone by only 14% between 1998 and the third quarter of 2022 compared to 62% in the US[4].

Chart 2.
R&D Spending and Corporate Investment trend in the United States and the Eurozone

2a. Net total corporate investment (as % of real GDP

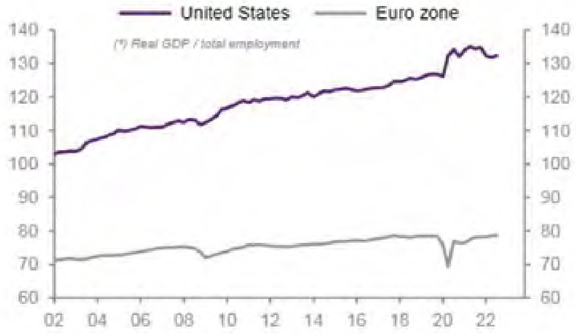
2b. Total R&D spending (as % of nominal GDP))



Source: P. Artus, "What account for the slowdown (stagnation) in productivity in the United States and the Eurozone?", Natixis Economic Research, June 2023
For chart 2.a, 'net' corporate investment means that investment is net capital depreciation

4. P. Artus : "Croissance : pourquoi les Etats-Unis battent toujours la zone Euro", 26 janvier 2023.

CHART 3.
Level of labour productivity* (thousands of constant 2015 dollars)



Source: P. Artus, "The Eurozone's numerous disadvantages", Natixis Economic Research, February 2023

Labour force and population have grown faster in the United States than in Europe since 2000.

Demographics are also less dynamic in the Eurozone than in the United States leading to a future decline in the labour force (*see Chart 4*) that will reduce potential production, tax revenues, etc.

CHART 4.
Labour force* (2002:1=100)

Source: P. Artus, "The Eurozone's numerous disadvantages", Natixis Economic Research, February 2023
(*) Employment + unemployment

An article issued last April in The Economist[5] confirms this analysis. The article states that a higher fertility rate and a more open immigration system have long given America a demographic advantage over most other developed countries, and that continues to be true today. "America's working age population – those between 25 and 64 – rose from 127 million in 1990 to 175 million in 2022, an increase of 38%. By contrast, in Western Europe, the working-age population rose by 9% during that period, from 94 million to 102 million. Even with lower participation rate, the past three decades have seen America's labor force grow by 30% against 13% in Europe and 7% in Japan".

Americans work more than Europeans and are highly skilled.

Hourly volume is lower in Europe than in the United States (*see Chart 5*).

An American works on average 1800 hours per year (a 36-hour per week with four weeks holidays), roughly 200 hours more than a European, though 500 less than a Chinese[6].

CHART 5.
Working time per employee (January 2002=100)

Source: P. Artus, "What account for the slowdown (stagnation) in productivity in the United States and the Eurozone?", Natixis Economic Research, June 2023

5. The American Economy, The Economist, 17 April 2023.
6. Figure quoted in The Economist's study on The American economy published on 17 April 2023.

In addition, American workers are skilled[7]. America is home to 11 of the world's 15 top-ranked universities. And America's economy makes good use of its highly educated workforce. Spending on R&D across the public and private sectors has risen over the past decade to 3.5% of GDP, well ahead of most other countries.

In spite of more buoyant savings in Europe, financial markets are three times more important in the US than in the EU in financing the economy.

America also has the world deepest and most liquid financial markets, providing efficient channels for financing businesses. Stock market capitalization represents about 170% of GDP; in most other countries, it comes below 100%. Funding for potentially high-growth startups is particularly bountiful: about half of the world's venture capital is granted to American firms.

European enterprises rely on banks for almost three quarters of their financing (compared to ¼ in the US). Therefore, in the wake of the Great Financial Crisis which has been followed by a doubling of capital requirements for banks, such a huge recapitalisation effort is bound to have a more significant impact on the financing of the European economy than on the US.

Moreover, such a structure of bank financing and the absence of an integrated capital market in Europe hinder an optimal allocation of capital for the financing of long-term investments such as transport infrastructure, sustainable energy generation or distribution[8].

Equity-based financing is also a better-suited solution than bank financing for high growth sectors (such as digital and high-tech) where most capital is intangible.

"While it is surely true that good ideas go where there is money to finance them, money also follows good ideas and growth", to paraphrase Joan Robinson. "Therefore, the growth of capital markets and real economies go hand in hand[9]".

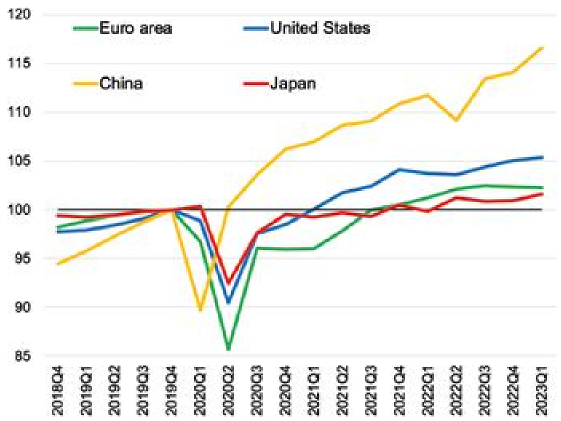
Money is not everything. It is often argued that Europeans make a tradeoff between extra pay and a nicer way of life. They have longer vacations and generous maternity leaves. As shown in The Economist study quoted above, "America has been devoting a little more of its national treasure to helping its people. America's social spending was just 14% of GDP in 1990 but had risen to 18% by the end of 2019 thanks in part to more medical insurance for the poor and elderly". The gap is narrowing, not widening with countries like Sweden, which are known to spend about a quarter of their GDP on social programmes.

1.2 The consequences of the Covid-19 crisis have been more severe in Europe than in the US, China and Japan

1.2.1 In 2020, the Euro area suffered the largest GDP contraction among advanced economies

In 2020, the Eurozone GDP fell by 6.1%, twice as the US (-2.8%). Japan (-4.3%) and China (+2.2%) have also experienced a lower output fall than the Eurozone.

CHART 6.
Real GDP growth, 2019-Q4=100



Sources: OECD, Eurostat
Last observation = 2023-Q1

7. According to OECD data, the level of skills of average US workers is in line with the median of OECD countries.

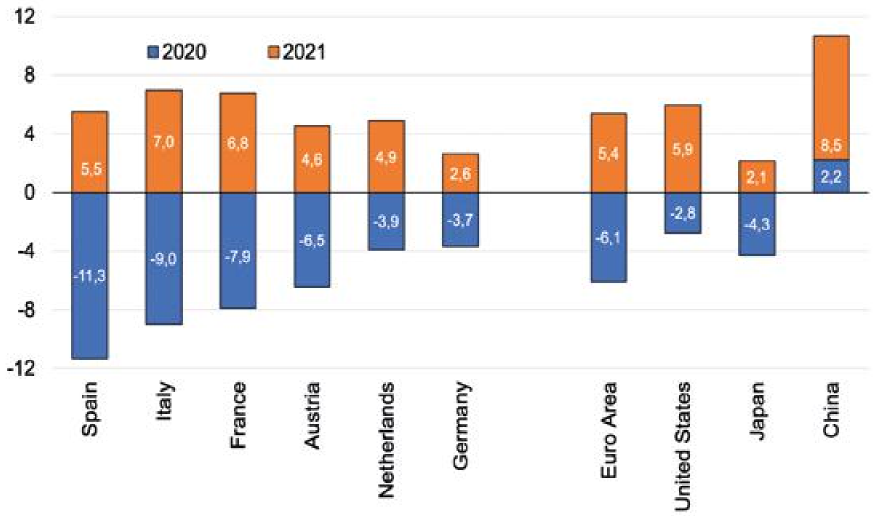
8. Capital market underdevelopment in Europe is evident when comparing company financing structures to other advanced economies. Even listed companies in Europe are substantially more bank-financed than in the United States, while the aggregate market capitalisation of listed firms is much smaller relative to GDP. In 2019, the capitalisation of the EU-27 stock market accounted for 70%, compared to 194% in US.
Venture capital investments are ten times higher in the US than in Europe (as a share of GDP), and even more so in a handful of Asian countries (Singapore, China, India). European companies, especially in tech, are much more likely to be acquired by American firms than the other way around.

9. C. Di Noia, speech quoted above.

1.2.2 In 2021, Europe recovered at a slower pace than the United States and China

The rebound in growth of the Eurozone in 2021 was 5.4% compared to 8.5% in China and 5.9% in the United States (*see Chart 7*). As of the first quarter of 2022, the Eurozone GDP was just 1.2 percentage points above its pre-pandemic level, while it was up by 3.7 pp in the US, and 11.7 pp in China (*see Chart 9*).

CHART 7.
Real GDP Growth, Annual Change



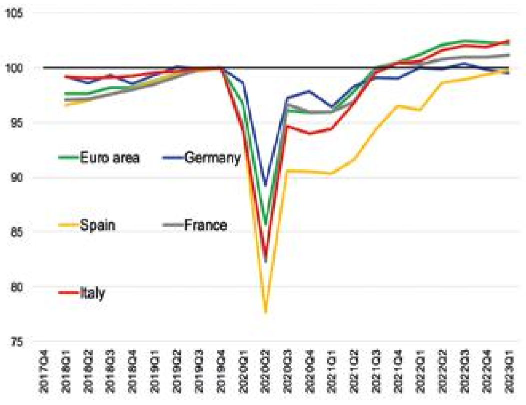
Sources: IMF, Eurostat

The recovery among member states of the Eurozone has been uneven. Most of them experienced a fast rebound in 2021, notably France, the Netherlands and Belgium whose real quarterly GDP already exceeded their pre-pandemic levels as of the fourth quarter of 2021 (*see Chart 8*).

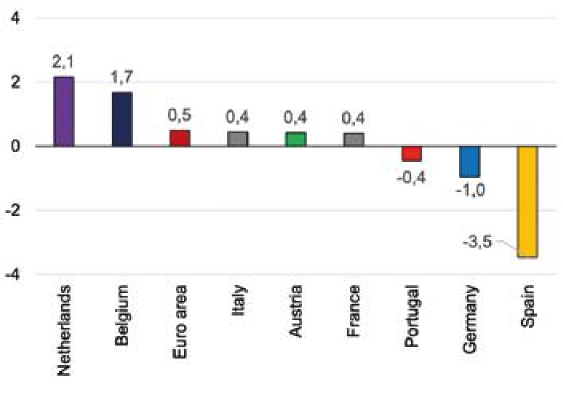
Sixteen Euro area Member States returned to pre-pandemic quarterly levels of output by the end of 2021. In the last quarter of 2021, the output of three Member States, including Germany, Spain and Portugal, had not reached pre-pandemic levels from the fourth quarter of 2019.

CHART 8.
Real GDP Growth in Selected EU Member States

8a. Real GDP Growth Trend, 2019-Q4 = 100



8b. Distance with 2019-Q4 GDP as of 2021-Q4, percentage points

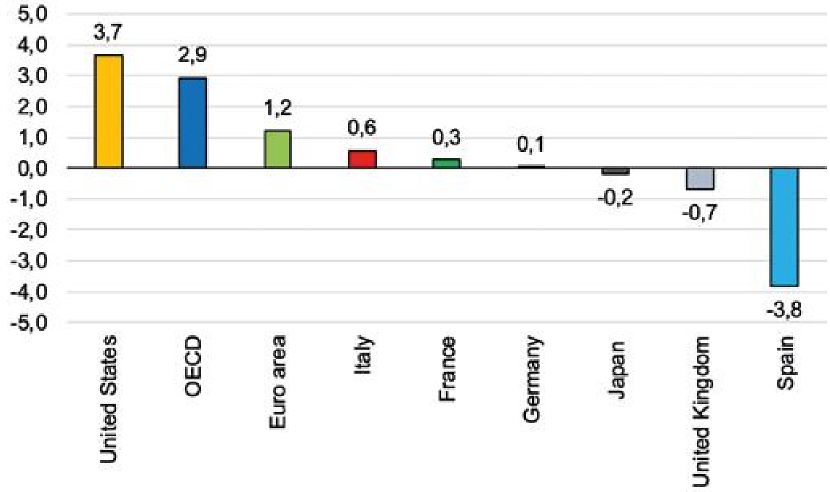


Source: Eurostat

1.2.3 GDP growth exceeded its pre-pandemic levels in the first quarter of 2022 in many advanced economies

The United Kingdom exceeded its pre-pandemic (Q4-2019) level of GDP for the first time in Q1-2022, by 0.7%. In the United States, France and Canada, GDP remained higher than before the pandemic; these countries exceeded their Q4 2019 GDP levels for the first time in the second, third and fourth quarters of 2021 respectively. However, in Germany, Italy and Japan, GDP was still below pre-pandemic levels (by 1.0%, 0.4% and 0.7% respectively) in Q1-2022.

CHART 9.
Real GDP (Distance with 2019-Q4 GDP as of 2022-Q1, percentage points)



Sources: OECD, Eurostat

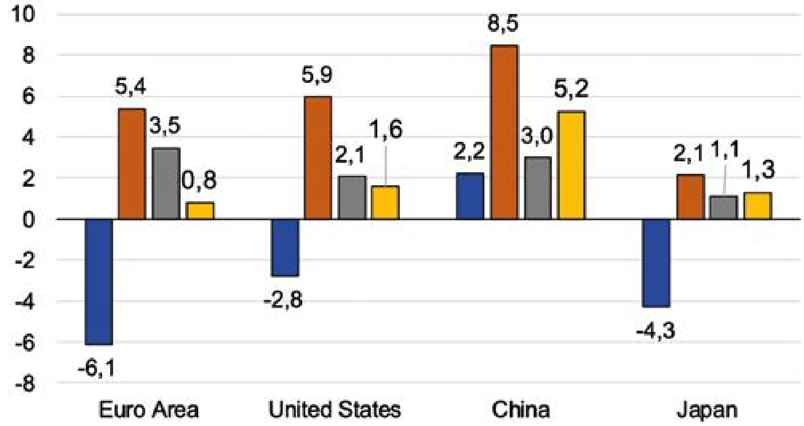
1.3 The economic impact of the war in Ukraine on GDP growth is more damaging in Europe than in the United States or China

According to the IMF, the Eurozone real GDP grew by 3.5% in 2022, compared to 2.1% in the US, and 3% in China (*see Chart 10*).

The resilience of the European economy to the 2022 energy shock is partly due to the significant recourse to public borrowing. Indeed, growth coincided with high fiscal deficits across Member States (*see Part 3.4*), which mainly helped to support consumer spending.

For 2023, the Euro area economy is expected to grow by 0.8%[10] according to the IMF[11], half the US (1.6%), and markedly below Japan (1.3%) and China (5.2%).

CHART 10.
Real GDP Growth rate, % change



Source: IMF World Economic Oultook Update, April 2023

1.4 The rise in energy prices following the war in Ukraine hit the Euro area far harder than the United States

The war in Ukraine has created a new negative supply shock for the world economy, which has particularly affected Europe.

The major difference between the United States and the Euro area is that the former produces its energy, whereas the latter imports its. Therefore, contrary to EU countries, the United States has not experienced any external shock and benefits from an external surplus for energy (*see Charts 11*), which is a very different situation from that of the Eurozone.

10. The EU economy is forecast to expand by 1.1% according to the Spring economic forecast of the EU Commission (May 2023).
11. IMF World Economic Outlook (April 2023).

The energy crisis has widened the structural competitiveness gap between Europe and the USA for at least two reasons: (i) gas prices remain higher and more volatile in Europe, whereas they have returned to pre-war levels in the USA; (ii) Europe has replaced its gas and oil imports from Russia with imports partly from the United States. This transfer of wealth has resulted in a widening of Europe's energy balance deficit with the United States.

Accordingly, the surge in energy prices triggered a negative terms-of-trade shock for the Euro area in 2022, amounting to 1.8% of GDP (*see Chart 12*). Since the end of 2022, the fall in energy prices has partially reversed the negative effects of the terms-of-trade shock for the Euro area[12], although its external deficit for energy remains higher than pre-crisis level.

CHART 11.
Trade balance in energy (as % of nominal GDP)

Source: Eurostat, US Energy Information Administration. Last observation from March 2023

CHART 12.
Income effect of the terms-of-trade shock: Euro area versus United States (impact on year-on-year GDP growth in percentage points)

Sources: Eurostat US Bureau of Economic Analysis
Notes: The income effect of terms of trade is calculated by weighting export and import price changes by their respective past values (one-year lag) and is expressed as a percentage share of GDP. The latest observations are from March 2023

The United States comes out as a winner after the EU has banned Russian gas imports. Indeed, the United States has become the leading supplier of gas to the Old Continent. Nearly 64% of US exports of liquefied natural gas went to Europe in 2022, compared to 34% in 2021, according to the US Energy Information Administration[13].

CHART 13.
Euro area's Trade balance in energy with Russia and the United States, € bn

Sources: Eurostat
Last observation from March 2023

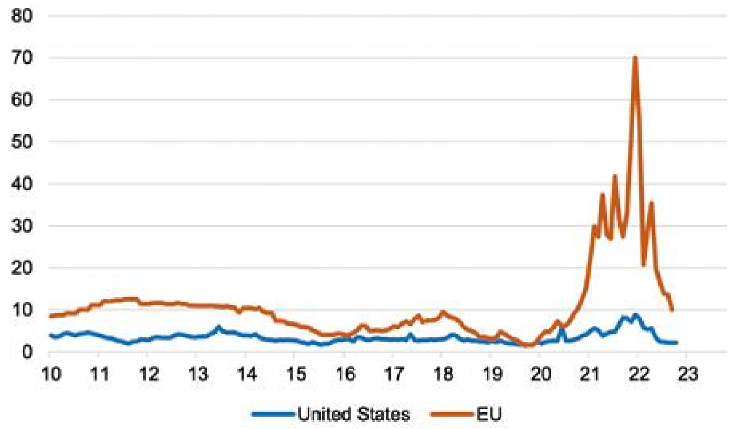
12. For further details see Part 3.6.

13. "Europe was the main destination for U.S. LNG exports in 2022", Report from the US Energy Information Administration (March 2023).

Another advantage in favor of the United States is its low and stable price of gas compared to Europe. While they were roughly similar in 2019, gas prices in the two regions have diverged sharply since 2021 (*see Chart 14*): in August 2022, when European gas prices peaked at 70 USD/MMBtu[14], US gas prices were 8 times lower, at 8.5 USD/MMBtu.

Even if the price of energy has fallen significantly since the end of 2022, it is still higher than in the past in Europe and much higher than the price of energy in the United States: as of May 2023, European gas prices averaged 9.9 USD/MMBtu, almost twice higher than their 2019 level (4.71 USD/MMBtu), and nearly five times higher than the US level (2.15 USD/MMBtu).

CHART 14.
Natural gas prices (US Dollars per Million British Thermal Unit)



Sources: IMF, EIA

This price level difference is sufficiently high to create a problem of competitiveness for the European industry and a movement of relocation of energy-intensive companies (chemicals, fertilizers, etc.) to countries where energy is cheaper, such as the United States, especially with the implementation of the Inflation Reduction Act.

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Will the United States dominate China and the Eurozone economically in the coming years?

P. Artus[15] explains that the US economy could dominate China and the Eurozone in the coming years: China could be penalized by its demography and Europe will suffer from insufficient modernization and technical progress.

If the situation described above does not change, the Eurozone risks becoming a second-rate economic power compared to the United States.

A considerable investment effort in research and development, in industrial equipment, in decarbonization, in digital technology, in improving the education system and the skills of the population, in promoting selective immigration of "people" who can occupy sufficiently skilled jobs, will therefore be necessary if Europe and the Eurozone are to correct their growth disadvantage in comparison to the United States and China and not be relegated to the rank of second-rate powers.

As the latest BIS annual report[16] reminds us, higher sustainable growth can be achieved only through decisive measures to improve the supply side of the economy. Conducting structural – supply side oriented – reforms is essential to rekindle productivity growth and alleviate supply constraints in EU countries.

We can take up the BIS recommendations here: a comprehensive approach to reap the potential benefits of the green transition and digitalization involves an array of structural policies. "First and

14. To compare the European TTF gas price – denominated in Euro per megawatt-hour – with the US price, it should be converted into dollars per million British thermal units (MMBtu).
15. P. Artus, "Les États-Unis vont dominer la Chine et la zone Euro", Les Échos, 5 décembre 2022.
16. Annual Economic Report, BIS (June 2023).

foremost, targeted investments in education should aim at continuous upskilling and re-skilling of the workforce… In addition to education and training, policymakers should invest in healthcare, not only to mitigate any scarring effects from the pandemic and be prepared for other public health emergencies but also to maximize the productive potential of the workforce. Investments in human capital could be complemented by investments in physical capital. Infrastructure projects to improve connectivity and access to markets and services, when chosen carefully and implemented efficiently, could prop up productivity growth and enhance economies' resilience. These investments may require not only better but also more public spending, further underscoring the need for fiscal consolidation through broadening of the tax base and entitlement reforms.

The other area of focus is maintaining competitive and open markets, both domestically and internationally… Lowering barriers to entry would bring in new, innovative firms and help improve the outcomes of these transformations".

An effective implementation of NextGeneration EU and a rapid agreement on the revision of the Stability and Growth Pact (SGP) can change the situation on the Old Continent. The revision of the SGP in particular should contribute to rationalizing public expenditures, improving the quality of spending and creating space for supply side reforms.

2. The Covid-19 crisis has exacerbated existing fiscal heterogeneities across EU Members States

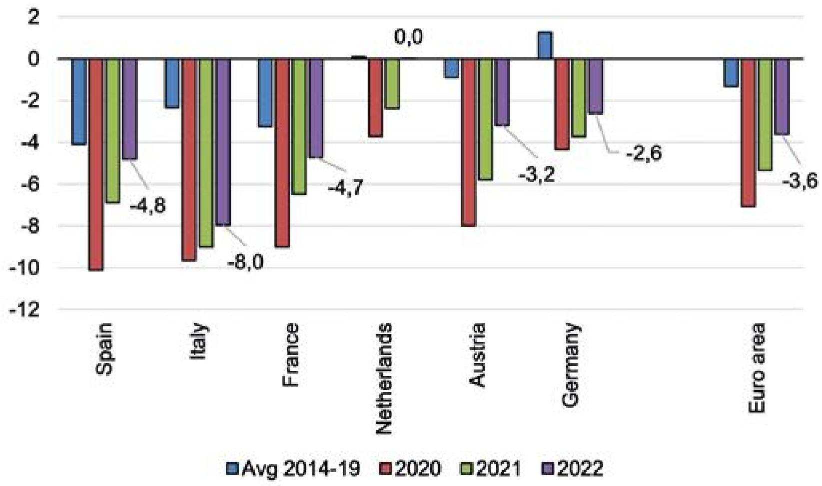
2.1 EU countries that have best managed their public finances after the Global Financial Crisis (2008) and the EU Sovereign crisis (2011-13) are those that have suffered the least from the Covid-19 shock

In 2019, after several years of efforts to reduce their general government deficit and debt, the Netherlands and Germany brought back their public finance stance in line with EU fiscal rules. Indeed, between 2014 and 2019, they ensured an average public surplus of 1.3% and 0.1% of their GDP, respectively. Such fiscal efforts allowed them to gradually reduce and stabilise their public debt, at respectively 59.6% and 48.5% of GDP in 2019, from 78.3% and 67.7% in 2013. Austria also made such efforts over that period, contributing to reduce its public debt burden by nearly 11 pp to 70.6% of GDP in 2019.

Thanks to the fiscal discipline achieved since 2013, Germany and the Netherlands have much contained the shock induced by the Covid-19 crisis. At 4.3% of GDP and 3.7% respectively, their 2020 public deficit has remained mainly below the Eurozone average of 7.1%. These achievements contrast with the close to double-digit levels deficits that France (-9% of GDP), Spain (-10.1%) and Italy (-9.7%) have experienced during the crisis (*see Chart 15*).

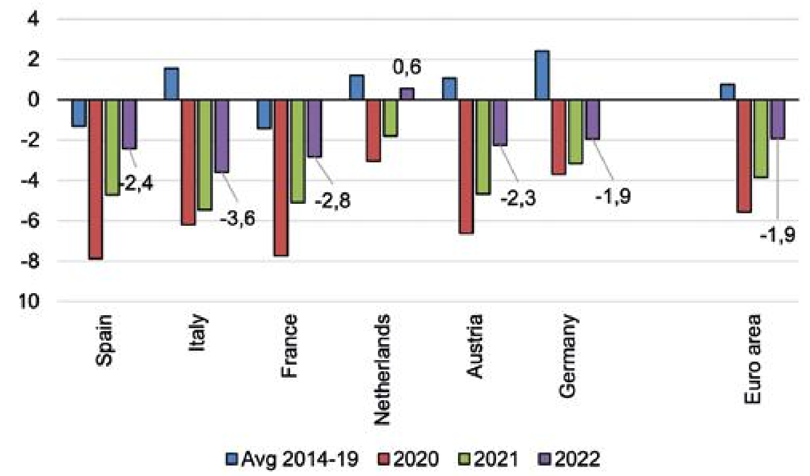
In 2021, the level of fiscal balance across EU Member States has converged towards its pre-crisis configuration: countries with healthy public finances prior to the Covid-19 crisis have registered fiscal deficits significantly lower than the Eurozone average of 5.3%. This was the case of Germany and the Netherlands in particular, whose total fiscal deficit dropped to 3.7% of GDP and 2.4% respectively. By contrast, the figure remained above 5% of GDP in Spain (-6.9%), France (-6.5%) and Italy (-9%) in 2021.

CHART 15.
General Governement Budget Balance, % of GDP



Source: Eurostat, EU Commission's Spring Forecast, May 2023
Notes: Labels relate data for 2022

CHART 16.
General Governement Primary Budget Balance, % of GDP



Source: Eurostat, EU Commission's Spring Forecast, May 20232
Notes: Labels relate data for 2022

2.2 By contrast, the most indebted countries on the eve of the Covid-19 crisis have been the most severely hit in terms of output shortfall in 2020

During the post-Global Financial Crisis period, the public debt ratio of Spain, Italy and France kept rising. Between 2012 and 2019, France increased its public debt ratio from 90.6% to 97.4%; Italy's one jumped from 126.5% to 134.2%, and Spain's rose from 90% to 98.2%.

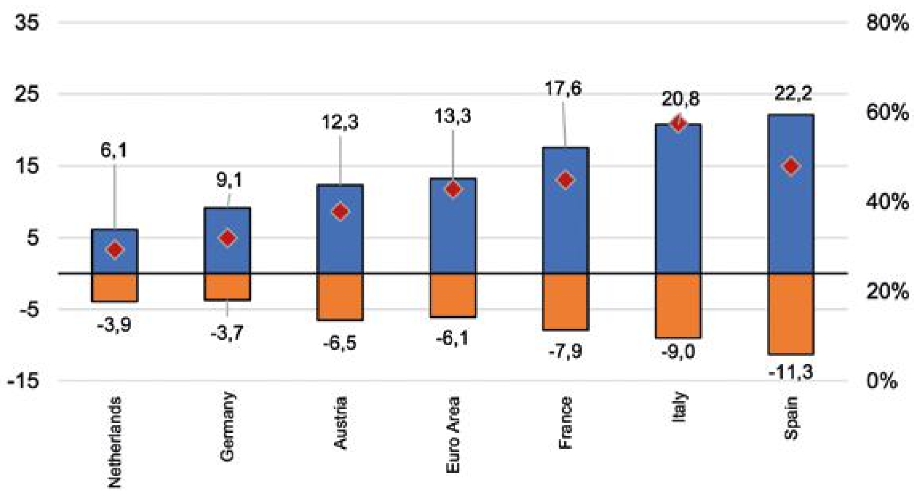
The lasting rise of public debt-to-GDP ratio in these three Member States is mainly due to the accumulation of fiscal deficits. As shown in Chart 15, the average deficit of France and Spain exceeded 3% of GDP, the threshold of Maastricht fiscal rules, between 2014 and 2019. Unlike Italy, these two countries have not delivered any primary surplus, since 2002 for France and 2008 for Spain. Between 2014 and 2019, their average primary deficit reached respectively 1.4% of GDP in France, and 1.3% in Spain, while Italy secured a primary surplus at the same period of 1.6% (*see Chart 16*).

During the Covid-19 crisis, France, Italy and Spain have been the most severely hit in terms of output shortfall in the Euro area. In 2020, GDP in Spain fell by 11.3%. It collapsed by 9% and 7.9% in Italy and France, respectively.

With public finances already deteriorated on the eve of the crisis, the three countries registered the strongest increase of their public debt-to-GDP ratio between 2019 and 2020. Spain experienced the highest rise (+22.2 percentage points, against 13.3 pp for the Euro area). Italy and France followed, as their public debt grew by 20.8 pp and 17.6 pp respectively (*see Chart 17*).

However, about 40% of the surge in public debt-to-GDP ratio is due to the fall of GDP by itself in the Euro area, for 2020. For instance, taking into account the "denominator effect", 47.9% of the rise of the Spanish public debt ratio was related to the fall of GDP that year. The figure reached 57.5% in Italy – the highest level in the Eurozone – and 44.9% in France. It accounted for 29.3% in the Netherlands, 31.9% in Germany and 37.8% in Austria.

CHART 17.
Real GDP Growth, Change in Public Debt Ratio and Denominator Effect in 2020



Source: Eurostat

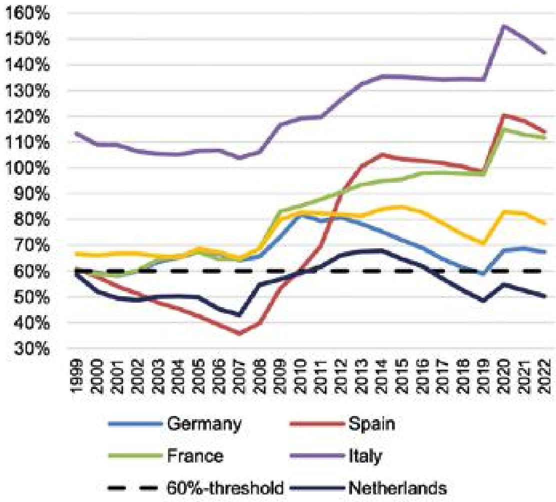
2.3 Countries whose public finances deteriorated the most in 2020 still registered high fiscal deficits in 2021

Although it declined markedly compared to 2020, fiscal deficits remained elevated in 2021 in some Southern Member States. Among the major EU Member States, Italy exhibited the highest negative balance, with 9% of GDP in 2021, from 9.7% in 2020 (*see Chart 20*). France and Spain exhibited a fiscal deficit of respectively 6.5% of GDP and 6.9% in 2021, from 9% and 10.1% in 2020.

The figure was lower among major Northern Member States. In Germany, fiscal deficit dropped to 3.7% of GDP, from 4.3% in 2020. It returned below 3% of GDP in the Netherlands (-2.4% of GDP), from 3.7% a year earlier.

In 2021, the public debt-to-GDP ratio stabilised at high levels in some of these EU Member States. Thanks to strong GDP growth performance (*see Part 1*), the ratio fell marginally in France from 115% of GDP in 2020 to 112.9% in 2021 (*see Chart 18*). It dropped by 2.1 pp in Spain (from 120.4% to 118.3%) and by 5 pp in Italy (from 154.9% to 149.9%). Still, these figures remained nearly twice as high as in Germany (69.3% of GDP) and the Netherlands (52.5% of GDP) in 2021.

CHART 18.
Evolution of Gross Public Debt to GDP ratio in Major Economies, %



Source: EU Commission

2.4 In 2021, the fiscal heterogeneity worsened across EU members in terms of public debt-to-GDP

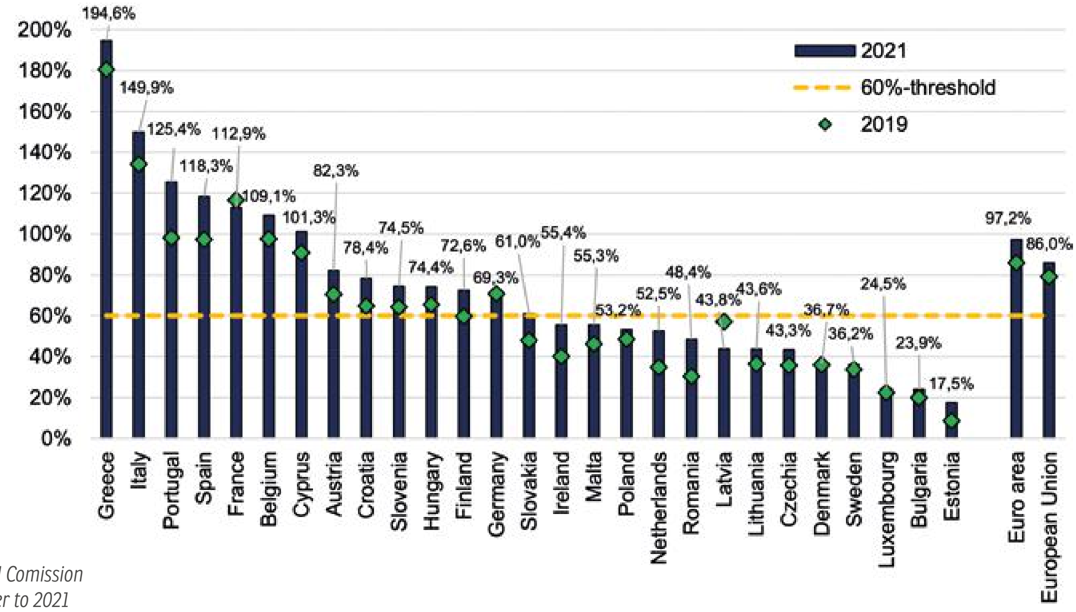
In 2021, the level of public debt ranged from 17.5% of GDP in Estonia to 194.6% in Greece. Within this range, three groups of countries can be distinguished in the European Union (*see Chart 19*).

A first group contains seven Member States whose debt remained above 100% of GDP at the end of 2021. This ratio reached 194.6% in Greece, 149.3%, in Italy and over 110% in Portugal (125.4%), Spain (118.3%) and France (112.9%). Belgium (109.1%) and Cyprus (101.3%) also belonged to this group.

Seventeen EU countries kept their ratio of public debt below 75% of GDP in 2021. Among them, Germany and the Netherlands saw their public debt hovering at 69.3% and 52.5% of GDP in 2021, respectively. With the Netherlands, twelve other countries had a public-debt-to-GDP ratio below the Maastricht threshold of 60% in 2021: Malta (55.3%), Ireland (55.4%), Poland (53.2%), Romania (48.4%), Latvia (43.8%), Lithuania (43.6%), Czech Republic (43.3%), Denmark (36.7%), Sweden (36.2%), Luxembourg (24.5%), Bulgaria (23.9%) and Estonia (17.5%).

Three other countries, *i.e.*, Austria, Croatia and Hungary registered a level of public debt ranging from 75% of GDP to 83% in 2021.

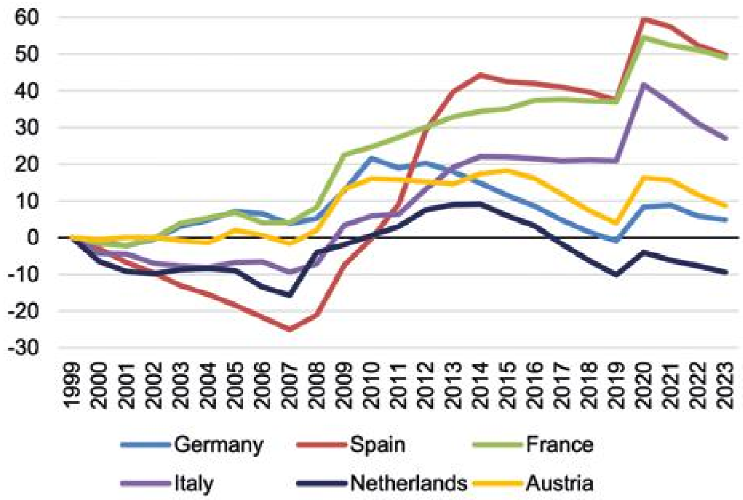
CHART 19.
Gross Public Debt, as % of GDP



Source: EU Comission
Labels refer to 2021

The heterogeneity in the level of government debt relative to GDP across Euro area Member States has significantly increased since the creation of the Euro area in 1999. As shown in Chart 20, the public debt-to-GDP ratio has moderately increased by 8.8 pp in Germany, 15.6 pp in Austria and even dropped in the Netherlands by 6.2 pp over the past two decades until 2021. In the meantime, the level has risen by 36.6 pp in Italy, 52.4 pp in France and 57.4 pp in Spain.

CHART 20.
Cumulative change of Public debt to GDP ratio since 1999, percentage points



Source: EU Commission

3. The significant economic impacts of the war in Ukraine suffered by EU countries

The economies of the Eurozone have been heavily affected by the conflict in Ukraine. The negative impact of the energy shock on the terms-of-trade of Euro area countries was significant in 2022 and has led to the disappearance of the Euro area's external surplus last year.

European economic growth in 2022 has been more resilient than expected thanks in part to lower energy prices since the third quarter of 2022, rapid diversification of energy supplies and government support for households and businesses. The divergence in budget deficits and public debt among member states did not increase with the war in Ukraine, but the ratio of public debt to GDP has stabilized at high levels in many EU countries.

In many countries, inflation has reached levels never seen in decades. It peaked during the last quarter of 2022 while core inflation is proving persistent (5.5% in July 2023).

The combination of high inflation and weak growth prospects has led to a stagflationary environment in the United States and even more so in the Eurozone. This situation is due in particular to the disappearance of gains in labour productivity in the main Eurozone countries, which is worrying for the future of their potential growth.

3.1 A major energy shock for Europe in 2022

Following the war in Ukraine, the economies of the European Union have suffered from a loss of income due to the rise of energy and other imported commodities during 2022. Indeed, contrary to the United States which produces its energy, EU countries import it.

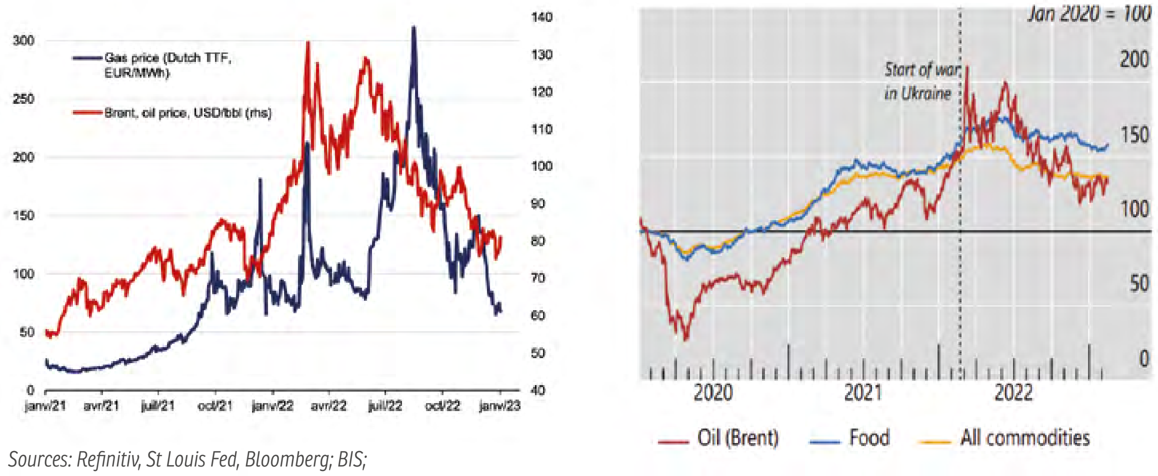
As François Villeroy de Galhau explained[17], "the first peaks on gas and electricity prices took place in the summer of 2021 in the context of the global post-pandemic recovery, when European countries had to build up their gas stocks for the winter and when demand for natural gas in Asia and the United States strongly increased. In this context the price of metals for example almost doubled from 2020 to mid-2021. Tensions in the oil market also emerged during the second half of 2021".

Then, the Russian war in Ukraine has caused gas prices to keep soaring. From slightly above 10 €/MWh in early 2020, the price of the natural gas delivered in Europe increased to € 80 before the start of the war in Ukraine. In February 2022, it soared to a peak of € 339 in August 2022 and then stabilised since January 2023 at around € 50[18] (*see Chart 21*), helped by demand restraint, diversification of supply sources and exceptionally mild weather.

Oil prices have also risen sharply since the start of the war in Ukraine. As of late January 2023, futures for Brent oil stood at $ 85, 40% above their 2019 average of $ 60.

CHART 21.
Commodity prices

21a. Gas & Oil Market prices since January 2021 — 21b. Commodity price indexes since January 2020



Sources: Refinitiv, St Louis Fed, Bloomberg; BIS;
For chart 20.a Last observation are from 11 January 2023
Chart 20.b is taken from the presentation of Hyun Song Shin "Global value chains under the shadow of Covid-19", BIS (February 2023); Brent oil price in US dollars/barrel. Food price index measures price movements of butter, cocoa beans, corn, cottonseed oil, hogs, lard, steers, sugar and wheat

17. François Villeroy de Galhau, "The magnitude and distribution of the energy and trade shocks in the Euro area and in France", Toulouse, 8 December 2022.
18. See I. Visco, "Monetary policy and the return of inflation".

Electricity prices have also reached record levels: the price of electricity on the wholesale market is indeed closely correlated to the price of gas paid by the marginal electricity producer.

The rise in commodity price has coincided with the appreciation of the US dollar. In the past, commodity prices and the dollar typically moved in opposite directions: the dollar depreciated when commodity prices rose. Given dollar invoicing, these moves dampened the price increase in non-dollar terms. In the current episode, The BIS explains[19] that "the unusual sequence of shocks (the Covid-19 pandemic and then the war in Ukraine) have resulted in a positive co-movement of the dollar and commodity prices. As a result, commodity prices in local currencies have surged much more strongly than in US dollar terms. One reason for changes in the co-movement is that the United States has become a net energy exporter, especially of natural gas. Increases in oil and gas prices now improve the US terms of trade and tend to boost the US dollar, with any related monetary tightening further bolstering the currency".

Chart 22 shows that the Euro depreciated sharply against the US dollar as monetary policy diverged between the Euro area and the United States between January 2022 and September 2022. Over that period, the Euro plunged by 13.3% against the USD, bringing the value to its lowest level since 2002.

CHART 22.
US Dollar vs Euro exchange rate

Source: Federal Reserve
Last data from 10 July 2023

The past depreciation of the Euro has amplified the rise in imported prices, particularly those of commodities which are set in dollars. According to François Villeroy de Galhau[20], the 16% fall in the Euro against the dollar between mid-2021 and mid-2022 would, if it had stayed at this level, have had an estimated impact of roughly +0.6 percentage points on the level of consumer prices over the long term. The monetary policy conducted since then by the Eurosystem has contributed to the recent re-appreciation of around 8% in the Euro, which should gradually have the opposite effect.

3.2 Its impact on the terms-of-trade of Euro area countries was significant in 2022

These movements in international prices have triggered significant transfers of wealth between net commodity importing and exporting countries. From the point of view of European economies, this has resulted in a real income shock that reduces household purchasing power and corporate margins, while deteriorating the competitiveness of exporting firms.

Several ways of measuring this external tax can be envisaged. To measure it, we use the "terms of trade" approach[21], *i.e.*, the ratio of export prices to import prices.

In the Euro area, this ratio has deteriorated sharply since the second quarter of 2021, reflecting the faster rise in import prices than in export prices. The negative income effect due to the transfer of purchasing power is estimated

19. BIS Bulletin, "Energy markets: shock, economic fallout and policy response", 13 December 2022.

20. F. Villeroy de Galhau, "How monetary policy will defeat inflation: channels and locks", Centre des Professions Financières, 17 February 2023.

21. We calculated the terms of trade shock, using the Banque de France's following methodology:

$$shock = -\left(\frac{\frac{P_t^M}{P_t^{GDP}}}{\frac{P_{t-4}^M}{P_{t-4}^{GDP}}} - 1\right) \times \frac{Val_{t-4}^M}{Val_{t-4}^{GDP}} + \left(\frac{\frac{P_t^X}{P_t^{GDP}}}{\frac{P_{t-4}^X}{P_{t-4}^{GDP}}} - 1\right) \times \frac{Val_{t-4}^X}{Val_{t-4}^{GDP}}$$

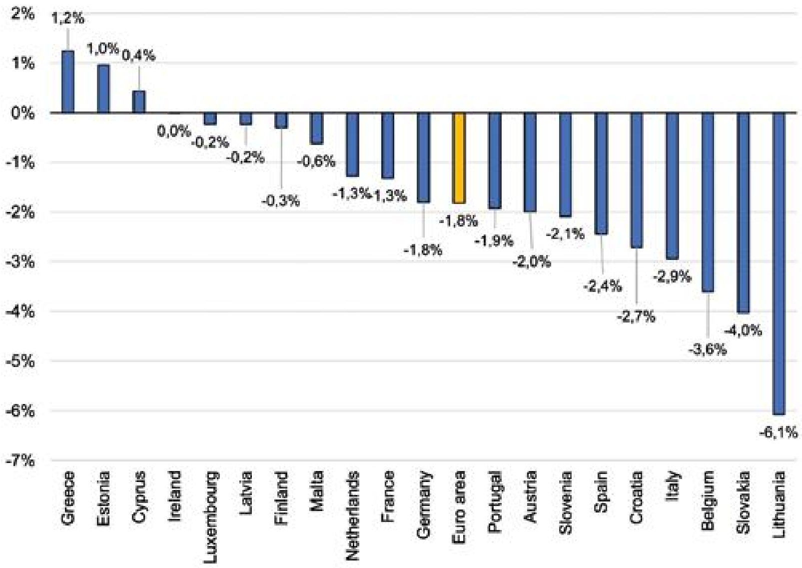
With P_t^M (resp.P_t^X), the import price (resp. exports) of quarter t, P_t^{GDP} the GDP deflator of quarter t, Val_t^M (resp. Val_t^X), the nominal value of imports (resp. exports) of quarter t et, Val_t^{GDP}, the nominal GDP of quarter t.

by the ECB[22] at around 2.2 percentage points of GDP in the third quarter of 2022 in the Euro area, based on a comparison with the same quarter the year before. For the full year of 2022, the income loss associated to the terms-of-trade shock represented 1.8% of GDP in the Euro area.

The impact of the energy crisis on the terms of trade differs across Member States

The heterogeneity across European countries is significant. As shown in chart 22.b, the terms of trade shock for the full year of 2022 amounted to 1.3% in France, 1.8% in Germany, 2.4% in Spain and 2.9% in Italy (*see Chart 23*).

CHART 23.
Terms-of-trade shock across Euro area Member States, recorded in 2022



Source: Eurostat
The income effect of terms of trade is calculated by weighting export and import price changes by their respective past values (one-year lag) and is expressed as a percentage share of GDP

For France, this shock on the terms of trade could be the second largest since the first oil shock of 1974. It implies a decrease in real income for the Eurozone economy of -2.2% of GDP year-on-year at the end of the third quarter of 2022.

As the Banque de France points out in its December 2022 macroeconomic forecasts, this shock is somewhat smaller for France than that experienced by the other major countries in the Eurozone. France's lower dependence on fossil fuels and the lower weight of industry (compared to countries like Germany or Italy) mitigate the magnitude of import price shocks. In addition, France also benefits from dynamic export prices in the maritime transport and agricultural products sectors.

In Q4 2022, which coincided with the fall in energy prices, the trade-related loss declined sharply for the Euro area Member States (*see Chart 23*).

3.3 High energy prices and lower exports to China have led to the disappearance of the Euro area's external surplus in 2022

While the Eurozone's trade surplus still reached € 116 billion in 2021, the deficit amounted to € 314 bn in 2022 due to rising energy prices. Indeed, EU energy imports jumped from € 390 bn in 2021 to € 835 bn in 2022[23].

The energy bill in Europe has risen in a differentiated way according to the Member States' dependence on fossil fuels and their industrial specialization. Energy imports have increased in the Euro area countries:

- From € 40 to 50 bn in France in the years 2019-2020 and 2021 (2% of GDP), it rose to € 100 billion in 2022 (*i.e.* 4% of GDP)
- In Italy and Spain, the cost of energy imports reached respectively € 100 bn (5.3% of GDP) and € 47 bn in 2022 (6% of GDP), compared with an average of € 30 bn in these two countries in the years before the war (*i.e.*, 2% of GDP in these countries).

The current account deficit amounted to € 97 bn (0.8% of Euro area GDP) in 2022, instead of a surplus of € 285 bn (2.3%) in 2021.

22. ECB, "Inflation developments in the Euro area and the United States", Economic Bulletin, Issue 8/2022.
23. G. de Colignon, "Le commerce extérieur, nouveau talon d'Achille de la zone Euro", Les Échos, 15 February 2023.

According to the ECB[24], this change in the current account balance was mainly driven by a switch from a surplus (€ 287 bn) to a deficit (€ 60 bn) for goods, and, to a lesser extent, by a reduction in the surplus for primary income (down from € 63 bn to € 7 bn) and a slightly larger deficit for secondary income (up from € 160 bn to € 166 bn). These developments were partly offset by a larger surplus for services (up from € 92 bn to € 114 bn).

CHART 24.
Current Account Balance in the Euro area, € Billion (Cumulated figure for the 12 previous months)

Source: Eurostat
Last observation from April 2023

Germany and the Netherlands have lost most of their current account surplus due to the sharp increase in energy bill. Italy's current account balance turned into deficit while other countries have reached current account deficit, such as France and Belgium.

3.4 Governments have absorbed more than a third of the income loss in 2022

The increase in energy prices has prompted most Member States to implement several measures to mitigate the social and economic impact on households and firms, while fiscal policies were already expansionary.

According to the EU Commission[25], the net budgetary cost of these measures is estimated at 1.3% of GDP in 2022 and 0.9% in 2023 for the Euro area, although there are large differences across Member States (*see Chart below*). But if all existing measures were extended through 2023, the total cost could reach around 2% of GDP, much higher than in 2022.

These energy related government measures take the form of broad-based tax cuts or subsidies, and outright energy price caps, either with the aims to temporally protect their purchasing power of income (**'income measures'**) or reduce the marginal cost of energy consumption for households and/or firms (**'price measures'**). The measures depend on revenues, taxes or levies on windfall profits by energy companies.

The measures implemented in **France** in 2022 essentially consisted of limiting energy price increases through the tariff shield (gas and electricity) and a fuel price rebate. Support in **Germany** has been mainly conducted through transfers to households and a reduction in energy taxation. In **Italy**, measures included household income support, business subsidies and energy price regulation. In **Spain**, measures focused on consumer energy prices, including tax cuts and lower fuel prices.

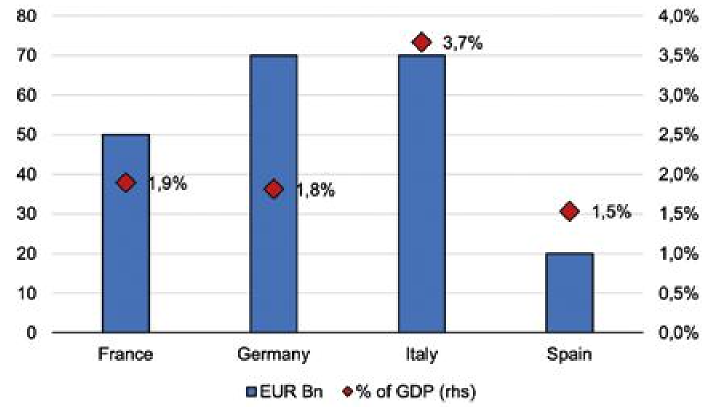
The French government allocated EUR 50 bn (1.9% of GDP) to preserve households and firms' purchasing power, less than Italy (3.6% of GDP) and Germany (1.8% of GDP) for which spending accounted for EUR 70 bn, but more than Spain (EUR 20 bn, or 1.5% of GDP) – *see Chart 25*.

These measures have contributed to partially offset the rise in energy prices for households and firms. Taking the case of France, where net energy measures accounted for 1.9% of GDP in 2022, the share for households decreases to around 5% of the overall burden, from 36% in the absence of offsetting measures, according to the Banque de France[26]. The share of companies goes down, but more moderately, just above 55%, from 63% before government's actions.

With respect to 2021, these measures have stabilized the households' purchasing power in 2022, which would have dropped by 3.5% in the absence of government support[27].

24. ECB, "Euro area monthly balance of payments: December 2022", 17 February 2023.
25. "Fiscal policy measures to mitigate the impact of high energy prices", EU Commission – Automn Forecast (November 2022).
26. F. Villeroy de Galhau, "The magnitude and distribution of the energy and trade shocks in the Euro area and in France", Banque de France (December 2022).
27. G. Claveres, "Répartition des pertes dues à la dégradation des termes de l'échange énergétiques", TresorEco n°318, French Treasury (December 2022).

CHART 25.
Total amount of Government measures implemented to offset rising energy prices in 2022



Source: Eurofi calculations, updated from the French Treasury's note "Répartition des pertes dues à la dégradation des termes de l'échange énergétiques", Trésor Eco, December 2022

3.5 The divergence in terms of fiscal deficits and public debts between Member States has not increased with the war in Ukraine but the public-debt-to-GDP ratio has stabilized at elevated levels in many EU countries

To mitigate the impact of skyrocketing energy prices on households and firms, governments of the EU have adopted in 2022 several fiscal measures in the form of temporary tax cuts, fiscal transfers or energy price caps. These different types of measures notably contributed to explain the divergences in inflation levels across countries (*see Part 3.8.1 below*).

However, public deficits in EU countries have been reduced due to the strong real GDP growth and the phasing out of the pandemic-related measures in 2022 (*see Table 2*).

In this context, public debts as a proportion of GDP have stabilised at high levels. For 2022, the ratio reduced marginally in France from 112.8% of GDP in 2021 to 111.7% in 2022. It has fallen by 4.3 pp in Spain (from 118.3% to 114%) and by 5.7 pp in Italy (from 150.3% to 144.6%), according to the EU Commission. The public debt of these countries remains well above the levels of Germany and the Netherlands, which stood at respectively 67,4% and 50,3% in 2022.

In 2022, the reduction in the public debt-to-GDP ratio was the most pronounced in countries with the highest inflation. In Italy, where GDP deflator exceeded 3%, the ratio decreased by 5.4 percentage points (ppts) compared to 2021, the largest change among the major Euro area economies, ahead of Spain (-4.2), France (-1.8) and Germany (-0.7). Indeed, although primary deficits are still very high in European countries in 2022, Italy has reduced its primary deficit from 3.7% of GDP to 1.1%, a reduction of 70% compared to 2021. Germany has reduced its primary deficit by 46%, while the French primary deficit has only been reduced by 37% between 2021 and 2022 (*see Table 2*).

As we shall see below, the differences in measures to fight inflation also explain the slight differences in the decline in public debt compared to GDP across the EU Member States.

Despite offsetting some of the burden, these non-targeted measures weaken incentives to lower energy consumption and weigh on the public finances of the most indebted Member States

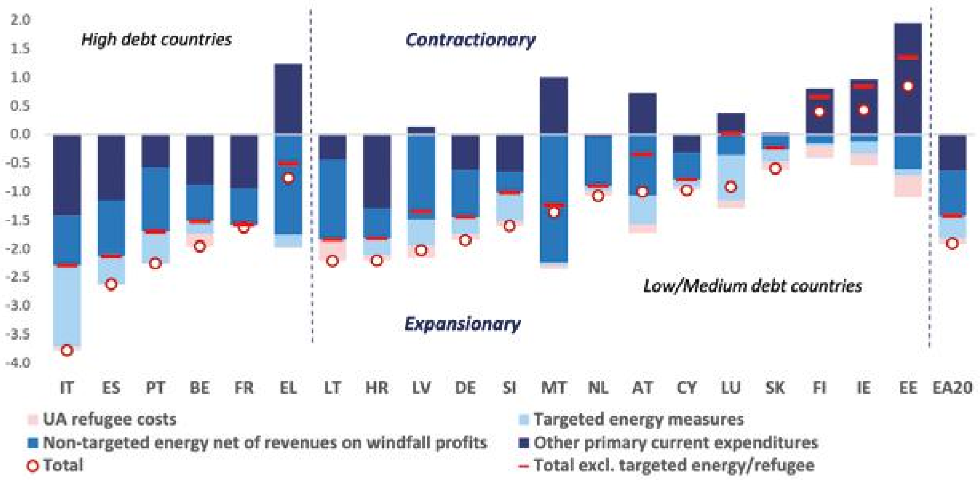
Only a small share of the temporary fiscal measures implemented to alleviate the burden of rising energy prices targets low-income households. The EU Commission estimates that less than 30% of these measures have been targeted in 2022, *i.e.*, to the most vulnerable strata of the population.

Moreover, many measures support short-run fossil fuel consumption, thereby working against efforts to move away from fossil energy sources. According to the EU Commission, roughly two-thirds of the energy measures are price measures. This may distort the price signal and reduce incentives to contain energy consumption and increase energy efficiency. In terms of budgetary impact, only 1% of the total measures contribute directly to the green transition, as underlined by I. Schnabel[28].

Another side-effect of these measures concerns the fiscal cost for public finances. Mainly financed by borrowing, government-measures adds to the historically high public debt burden across countries.

28. I. Schnabel, "Finding the right mix: monetary-fiscal interaction at times of high inflation", ECB Speech (November 2022).

CHART 26.
Nationally financed net primary current expenditure – contribution to fiscal stance and drivers (ppts of GDP)



Source: EU Commission Automn Forecast, November 2022

As noted by the EU Commission[29], energy-related measures have been an important driver behind the expansionary developments in net primary current spending in most Member States in 2022 (*see Chart 26*).

In 2022, fifteen Member States have experienced a deficit higher than 3% of GDP. Spain experienced a fiscal deficit of 4.6% in 2022 while it exceeded 5% of GDP in France (-5%), Italy (-5.1%), and Belgium (-5.2%). By contrast, fiscal deficits in Germany (-2.5%) and the Netherlands (-2.7%) should remain below 3% of GDP (*see end-Table*).

In this context, public debts compared to GDP in EU countries have stabilised at high levels. In 2022, the ratio decreased marginally in France from 112.9% of GDP in 2021 to 111.6% in 2022. It has fallen by 5 pp in Spain (from 118.3% to 113.2%) and by 5.5 pp in Italy (from 149.9% to 144.4%). The public debt of these countries remains well above the levels of Germany and the Netherlands, which stood at respectively respect 66.3% and 51% in 2022 (*see Table 1*).

3.6 Since the end of 2022, the fall in energy prices and the appreciation of the Euro have partially reversed the negative effects of the terms-of-trade shock, which should lead the Euro area current account balance to return into surplus in 2023

3.6.1 A substantial reduction in European gas prices has occurred after its peak in August 2022

Energy prices have fallen sharply since last summer, with a particularly marked decline in the price of natural gas, in Europe.

After peaking at 339 Euro/MWh in August 2022, the price of European TTF gas fell to 30 Euro/MWh mid-June 2023, a level broadly back to the values observed in autumn 2021 (*see Chart 27*).

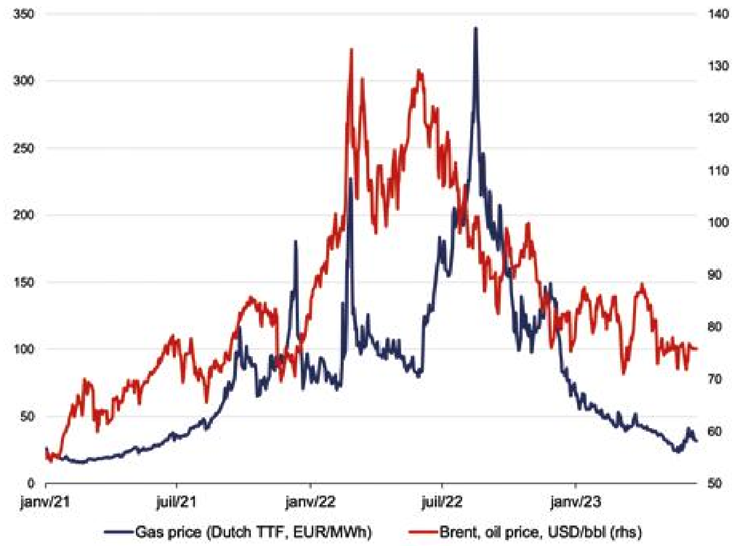
Oil prices peaked of nearly 120 USD per barrel in mid-2022, but have since fallen steadily, fluctuating over 75-80 USD per barrel mid-June 2023.

This drop is explained by the diversification of gas supply and its storage which was higher than expected, as well as the mild winter temperatures, the energy savings and the weak industrial activity.

The Euro's appreciation has also helped to reduce the cost of imports for European countries. Between October 2022 and June 2023, the Euro gained 10% against the dollar (*see Chart 22*).

29. "Communication from the commission to the European Parliament, the Council and the European Central Bank on the 2023 Draft Budgetary Plans: Overall Assessment", European Commission (November 2022).

CHART 27.
Gas & Oil Market prices since January 2021



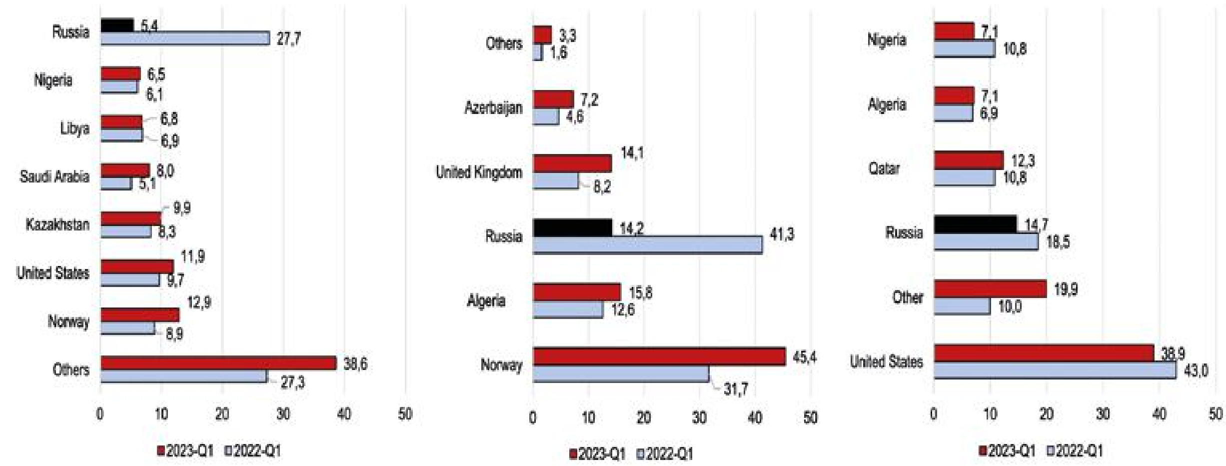
Sources: Refinitiv, St Louis Fed, Blomberg
Last data from 26 June 2023

3.6.2 Europe has succeeded in rapidly doing without Russian oil and gas

One year after the start of the Russian invasion of Ukraine (February 2022), Russia accounted for 5% of the oil and 14% of the gas imported by the European Union in the first quarter of 2023. This success should not conceal the enormous energy challenges that lie ahead for the 27.

CHART 28.
Eu-27 imports of energy products, by partner, Q1 2022 vs Q1 2023

28a. Petroleum oil (share (%) of trade in volume)
28b. Natural gas in gaseous state (share (%) of trade in volume)
28c. Liquefied natural gas (share (%) of trade in volume)



Source: Eurostat database (Comext)

In the first quarter of 2022, Russian oil still accounted for over a quarter of the European Union's imports. The embargo on Russian crude oil imposed last December, followed by a cap on refined products in February, has had the desired effect. With 5,4% of import volumes in the first quarter of 2023, Russia is now only the EU's eighth-largest oil supplier (*see Chart 28*).

Natural gas imports have followed the same path – albeit less radically, due to the greater logistical complexity of changing supply routes. Before the war, Russian gas accounted for 41% of European supplies in the first quarter of 2022. A year later, this share had fallen to 14%.

However, Europe is now more exposed to developments in the global liquefied natural gas (LNG) market, with tankers from the USA accounting for over 40% of liquefied gas imports. An acceleration in activity in China could lead to tensions on the gas market in particular.

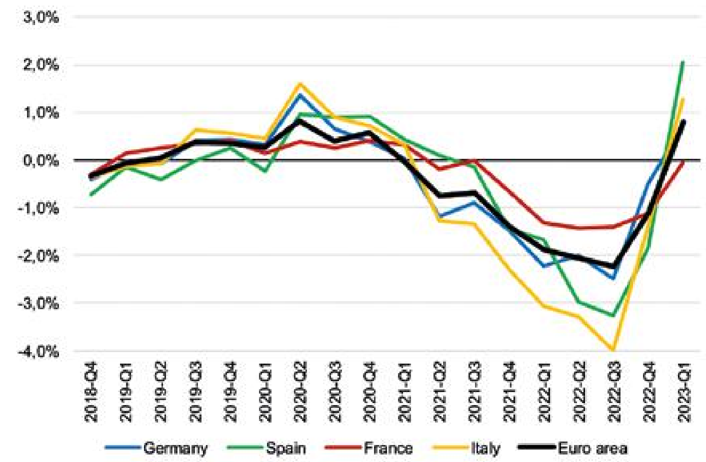
3.6.3 *Falling energy prices have reduced the cost of goods imports of Euro area Member States, improving their terms-of-trade since late 2022*

With the rapid fall in energy prices, the Eurozone has experienced a positive terms-of-trade shock equivalent to 0.8% of GDP in 2023-Q1. Although well above the 2014-19 average (+0.2%), this external gain is still less than half of the loss incurred in 2022 (-1.8% of GDP).

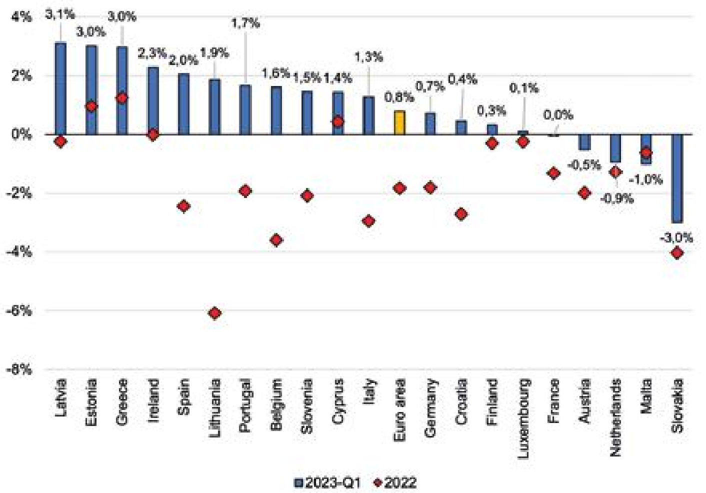
With the exception of Slovakia, Malta, the Netherlands and Austria, all Euro area Member States recorded a positive terms-of-trade shock in the first quarter of 2023. Among the major EU economies, Spain has experienced the highest external gain (2%), above Italy (1.3%), Germany (0.7%) and France (0%).

CHART 29.
Terms-of-trade shock across Euro area Member States

29a. Terms-of-trade shock, quartely data



29b. Terms-of-trade recorded in 2022 versus 2023-Q1



Source: Eurostat
The income effect of terms of trade is calculated by weighting export and import price changes by their respective past values (one-year lag) and is expressed as a percentage share of GDP. Chart 29.b illustrates the average terms-of-trade for the four quarters of 2022, and the one recorded in 2023-Q1

3.6.4 *The Euro area current account balance is set to return into surplus in 2023*

In 2023, the current account balance surplus is expected to reach 0.5% in the Euro area, after a deficit of 0.7% in 2022, according to the IMF[30]. This improvement should be mainly due to the trade balance of goods, which should turn positive in 2023, as a result of falling import energy prices and easing of supply disruptions. The trade balance in services – tourism in particular – should also support the recovery in the current account balance.

Among the largest Member States, the current account surplus increased in 2023; it should reach 5.9% of GDP in Germany and 1.6% in Spain in 2023, but remain below their 2021 levels (7.6% of GDP and 3.3% respectively). In Italy, the current account is expected to be zero in 2023, following a deficit of 1.3% in 2022. In France, the current account deficit is expected to reach 0.5% of GDP in 2023, from 2.1% in 2022.

30. IMF World Economic Outlook (April 2023).

TABLE 1.
Current account balance, % of GDP

	Current Account Balance, % of GDP						
	2007	2011	2012	2019	2021	2022	2023
Germany	6,9%	6,2%	7,1%	7,6%	7,4%	4,2%	5,9%
France	-0,1%	-0,9%	-1,0%	0,5%	0,4%	-2,1%	-0,5%
Italy	-1,4%	-2,8%	-0,2%	3,3%	3,1%	-1,3%	0,0%
Spain	-9,4%	-2,7%	0,1%	2,1%	1,0%	0,6%	1,6%
Netherlands	6,9%	8,6%	10,2%	6,9%	7,3%	4,4%	5,9%
Portugal	-9,6%	-6,0%	-1,6%	0,4%	-0,7%	-1,3%	1,2%
Belgium	1,9%	-1,9%	-0,1%	0,1%	0,4%	-3,6%	-2,4%
Greece	-15,2%	-8,8%	-3,6%	-1,5%	-6,8%	-9,7%	-7,3%
Euro area	0,0%	-0,4%	1,0%	2,2%	1,6%	-0,7%	0.5%

Source: Eurostat, data for 2023 are projections taken from the Spring Forecast of the EU Commission (May 2223); projections for the Euro area in 2023 are taken from the IMF World Econoic Outlook (April 2023)

3.7 A sizeable hit to EU growth

The Eurozone real GDP has grown by 3.5% in 2022, compared to 2.1% in the US, and 3% in China (*see Chart 10*). In 2023, the EU economy is expected to expand by 0.8% according to the EU Commission.

3.7.1 European economic growth in 2022 was more resilient than expected in facing the large negative terms-of-trade shock from the war in Ukraine

According to the IMF[31], "this resilience – which is visible in consumption and investment data for the third quarter – partly reflects government support of about 1.2% of European Union GDP (net budgetary cost) to households and firms hit by the energy crisis, as well as dynamism from economies reopening. Gas prices have declined by more than expected amid higher non-Russian pipeline and liquefied natural gas flows, compression of demand for gas, and a warmer-than-usual winter.

However, the boost from reopening appears to be fading. High-frequency indicators for the fourth quarter suggest that the manufacturing and services sectors are contracting. Consumer confidence and business sentiment have worsened".

In December 2022, the unemployment rate was at 6,1% in the EU (since April) and 6,6% in the Euro area – unchanged since October.

3.7.2 Within the EU, Germany, and some countries in Eastern Europe are particularly affected economically

Among the main EU Member States, Germany is the hardest-hit due to relatively large manufacturing sectors and greater dependence on energy imports from Russia. In 2022, the German GDP grew by 1.8% in volume terms, half of the Eurozone average (+3.5%), according to the EU Commission forecast of February 2023.

Relatively less exposed to Russian commodity imports and more service-oriented, France (+2,6%), the Netherlands (+4,5%) Spain (+5,5%) have been least affected by the shock in terms of output shortfall. Portugal experienced the second highest growth performance in Europe, with its real GDP increasing by 6.9% in 2022 and Italy's by 3.7%.

3.7.3 Growth in the Euro area is expected to weaken in 2023

According to Eurostat data, Euro area real GDP decreased by 0.1% in the first quarter of 2023, following an equal decline in the final quarter of 2022 despite real GDP being supported by lower energy prices, the easing of supply bottlenecks and expansionary fiscal policy.

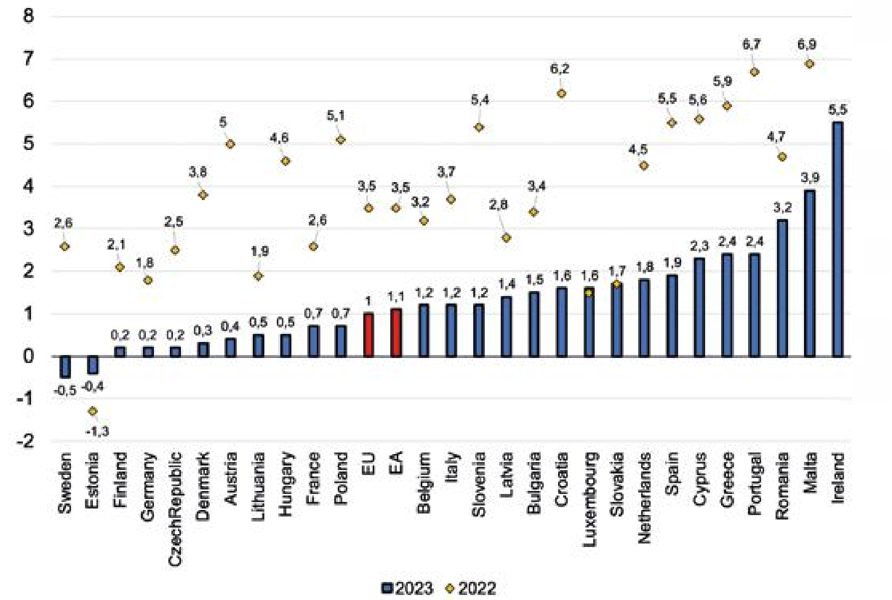
Eurostat estimates indicate that the Euro area has currently entered a technical recession as quarterly GDP fell by 0.1% in both Q4-2022 and Q1-2023, thus marking two consecutive quarters of negative growth. Among countries that experienced a decline in GDP growth, Germany – the largest Euro area economy – also entered a technical recession (-0.3% GDP growth rate).

Growth in the Euro area is expected to weaken in 2023, with the European Commission forecasting it at 1.1% this year (down from 3.5% in 2022)[32].

31. IMF, "World Economic Outlook Update", January 2023.
32. EU Commission, "European Economic Forecast", Spring 2023, 15 May 2023.

Heterogeneity across Member States in the growth performance remains elevated for 2023. In Spain (1.9%) and the Netherlands (1.8%), real GDP is projected to grow above 1.5% above Italy (1.2%), France (0.5%) and Austria (0.4%). Germany (0.2%) should experience the lowest change among the large EU member states in 2023.

CHART 30.
Real GDP Growth rate across EU Member States in 2022 and 2023 (%)



Source: AMECO Spring Forecast, May 2023

3.8 In 2023, the public finances of most EU Member States are expected to improve compared to 2022, although they remain worse than before the pandemic

Fourteen EU Member States are set to have a deficit above 3% of GDP in 2023, according to the EU Commission[33]. Among the largest EU economies, fiscal deficit is still expected to exceed 4% of GDP in France (-4.7%), Italy (-4.5%) and Spain (-4.1%), while it should remain below 3% in Germany (-2.3%) and the Netherlands (-2.1%).

Unlike its European peers, the French deficit is expected to remain unchanged at 4.7% of GDP in 2023, compared to a year earlier, while it should decrease by 0.7 percentage points in Spain, 3.5 ppts in Italy and 0.3 ppts in Germany.

In this context, the public debt to GDP ratio is expected to stabilize at elevated levels. In France, the ratio is projected to decrease marginally to 109.6% of GDP in 2023, from 111.6% in 2022, and 97.4% in 2019. It is expected to fall by 2.6 pp in Spain (from 110.6% to 113.2%) and by 4 pp in Italy (from 144.4% to 140.4%). Despite this drop, the ratio is expected to remain 12.4 points higher than its pre-pandemic level in Spain and 6.2 points higher in Italy, and more than 50 points higher than in Germany and the Netherlands. In these two countries, public debt is expected to reach 65.2% in Germany and 49.3% in the Netherlands in 2023, up from 66.3% and 51% a year earlier.

All in all, public debt ratios are set to remain above their 2019 level in all Member States excluding Ireland, Greece, Croatia, Cyprus, Portugal, Denmark and Sweden.

TABLE 2.
Public finances forecast for 2023 across the main EU Member States

	Budget Balance (% of GDP			Primary Budget Balance (% of GDP			Gross Public Debt (% of GDP)			Real GDP Growth (%)		
	2021	2022	2023	2021	2022	2023	2021	2022	2023	2021	2022	2023
Germany	-3,7	-2,6	-2,3	-3,2	-1,9	-1,5	69,3	66,3	65,2	2,6	1,8	0,2
France	-6,5	-4,7	-4,7	-5,1	-2,8	-2,7	112,9	111,6	109,6	6,8	2,6	0,7
Italy	-9,0	-8,0	-4,5	-5,5	-3,6	-0,5	149,9	144,4	140,4	7,0	3,7	1,2
Spain	-6,9	-4,8	-4,1	-4,7	-2,4	-1,6	118,3	113,2	110,6	5,5	5,5	1,9
Netherlands	-2,4	0,0	-2,1	-1,8	0,6	-1,4	52,5	51,0	49,3	4,9	4,5	1,8
Portugal	-2,9	-0,4	-0,2	-0,5	1,5	2,0	125,4	113,9	106,2	5,5	6,7	2,4
Austria	-5,8	-3,2	-2,4	-4,7	-2,3	-1,3	82,3	78,4	75,4	4,6	5,0	0,4

Source: EU Commission Spring Forecast (May 2023)

33. EU Commission Spring Forecasts (May 2023).

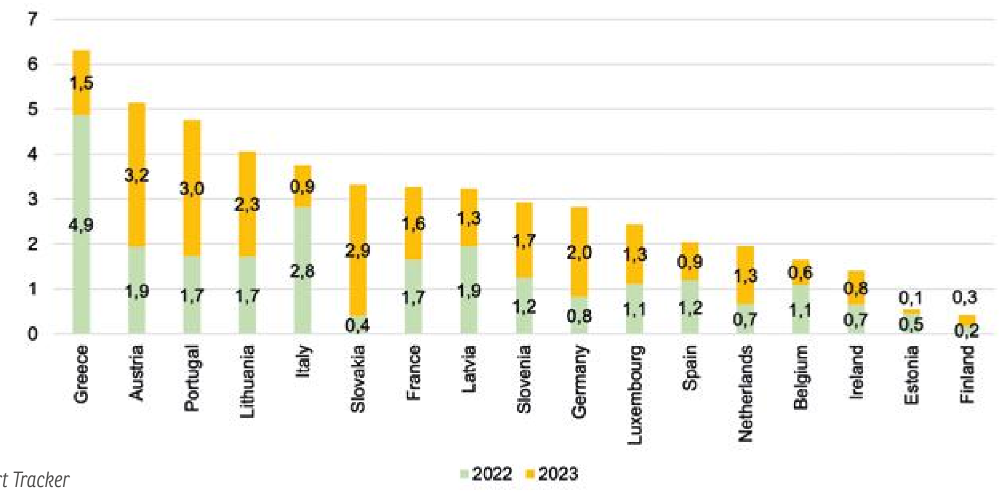
Many governments keep providing sizeable support to consumers despite the fall in energy prices. They maintain high primary deficits that contribute to inflationary pressures.

While falling energy prices help containing the cost of existing support measures, several Member States have introduced new energy support measures or are extending existing ones. According to the OECD[34], the amount of energy support measures should still exceed 1% of GDP in 11 Eurozone Member states in 2023, and even increase in 10 of them, compared to 2022.

In France, announced measures should still amount to 1.6% of GDP in 2023, barely unchanged compared to 2022 (1.7% of GDP). To give an order of magnitude, the cost of measures dedicated to energy support in 2023 are almost equivalent to those dedicated to unemployment benefits in 2019 (1.58% of GDP) or family and child allowance (1.89% of GDP).

Energy fiscal support is expected to rise to 2.1% of GDP in Germany, up from 0.8% in 2022, while it is set to decrease in Spain and Italy. In these two countries, fiscal support should reach 0.9% of GDP in 2023, from respectively 2.8% in Italy and 1.2% in Spain.

CHART 31.
Estimated budget cost of energy measures in 2022 (% of GDP)



Source: OECD Energy Support Tracker

According to I. Schnabel[35], only about half of the discretionary stimulus provided in response to the pandemic and the energy shock is expected to be reversed by 2025. Such discretionary measures "are leaving fiscal policy accommodative and are not sufficiently offset by efforts to increase public investments that could help reduce medium-term inflationary pressures".

Mostly untargeted[36], these measures contribute to maintain primary budget deficits at elevated levels in most EU Member States. Except for Ireland, all Eurozone countries are expected to record a primary balance below their 2019 levels in 2023, according to the EU Commission. Among the major Member States, France is expected to deliver the highest primary deficit in 2023 (-2.7% of GDP), followed by Spain (-1.6%) and Germany (-1.5%). In Italy, the fiscal adjustment is expected to be one of the most pronounced of the Eurozone, as the primary deficit is set to decline to 0.5% of GDP in 2023, from 3.6% a year earlier.

Such expansionary fiscal stances are taking place in the context of high inflation in the Euro area. In its latest mission concluding statement for the region[37], the IMF warned that "economic conditions call for a tight fiscal policy stance". Indeed, "continued expansionary budgetary measures at the current juncture would add to core inflationary pressures via the demand channel, in turn adding pressure on central banks to step up monetary policy tightening".

According to the European Commission's latest report on public debt sustainability, published in April, nine European countries – Belgium (rated AA by S&P), Greece (BB+), Spain (A), France (AA), Croatia (BBB+), Italy (BBB), Hungary (BBB+), Portugal (BBB+) and Slovakia (A+) – face a high risk of debt crisis.

Belgium, Greece, Spain, France, Italy and Portugal are all likely to have long-term debt ratios in excess of 100% of GDP. In some countries, the budget imbalance has further increased the already high levels of public debt. This is particularly the case in Belgium, France, Spain, Greece and Italy.

34. OECD Energy Support Measures Tracker – OECD.
35. "The risks of stubborn inflation", Speech at the Euro50 Group conference, Luxembourg (June 2023).
36. Untargeted measures account for about 77% of total energy support measures budgeted in 2022 and 2023, across OECD Member States, according to the OECD.
37. Euro area: IMF Staff Concluding Statement of the 2023 Mission on Common Policies for Member Countries – June 2023.

But the fragility of public finances is also illustrated by the gross borrowing needs that governments will have to face. These requirements will remain above the European Commission's critical threshold of 16% of GDP in six countries (Italy, France, Spain, Belgium, Austria and Germany). The highest levels – between 20% and 23% of GDP – are found in Belgium, Spain, France and Italy. They are limited at 17% to 18% of GDP in Germany and Austria.

These borrowing needs stem from the fact that some countries will have to make substantial debt repayments over the next few years, as many bonds issued in the 2010s (after the financial crisis) reach maturity. Italy is the most exposed country in the European Union, having to repay (principal and interest) the equivalent of 39.1% of its GDP over the next two years. France is at 25.9% and Germany at 18.1%.

Last April, the OECD[38] also pointed out that almost half the debts (47%) of its member countries will have to be repaid or renegotiated at higher interest rates over the next three years.

3.9 While headline inflation is likely to have peaked on both sides of the Atlantic, core inflation proves persistent

Inflation is continuing to hover well above central banks targets across much of the world. Since the fourth quarter of 2022, headline inflation has started to decline, largely driven by lower energy prices notably in the United States, the Euro area, and Latin America. Indeed, Headline year-on-year inflation in OECD countries continues to fall, reaching 5.7% in June 2023, down 1.2 percentage points vs. April, and 5 pp off its peak of 10.7% in October 2022. This is its lowest level since October 2021. But despite being on a downward trend, it remains far too high.

Core inflation (excluding food and energy) has proved to be sticker. It stood at 6.6% in June 2023 in OECD countries – only 1.2 pp below its peak of 7.8% in October 2022. Among G7 countries, only the US and Canada recorded lower core inflation in May than in October. It remains above 5% in the UK and Germany.

The damage that a high-inflation regime does to the economic and social fabric is well-known. It increases the cost of living for households and reduces investment. The longer the inflation is allowed to persist, the greater the likelihood that it becomes entrenched and the higher the costs of curbing it. Furthermore, it is noticeable that wage pressures have been gradually building up as workers have sought compensation for high inflation in tight labor markets.

3.9.1 Inflation remains a central concern in OECD economies

As K. Knot reminds us[39] "the decade of below-target inflation swiftly came to an end in the course of 2021. Our economies rebounded from the pandemic with households disturbing their growing deposit balances, but also with supply still severely constrained after a long period of pandemic contagion measures".

The Russian invasion of Ukraine has intensified some of these pre-existing pressures, putting more upward pressure on energy prices, raising the energy input costs of other products and creating additional distortions of supply chains.

But the inflation problem may also be explained by monetary causes (*see Eurofi monetary Scoreboard*). Indeed, "the excessive monetary growth of the previous years emanating from aggressive central banks' quantitative easing policies (in particular in 2020 and 2021) may have exacerbated supply chain issues by inflating overall spending and demand, reflecting a policy failure and not just the "teething problems of an economy recovering from the pandemic slump[40]".

Even before the war in Ukraine, inflation was already an issue for OECD countries.

Between March 2021 and February 2022, Consumer Price Index inflation (CPI) has been running above 2% in many advanced economies.

At the OECD level, inflation increased from 2.4% in March 2021, to 4% in June 2021 and 7.8% in February 2022 (*see Chart 32*).

In the Euro area, the Harmonized Index Consumer Price (HICP) annual growth rate exceeded 2% for the first time in July 2021. Since November 2021, the headline inflation has been above 2% in all Eurozone Member States and kept rising until February 2022. In the United States, inflation has been exceeding 2% annually since March 2021, and increased to 7.9% until February 2022.

Lasting supply chain bottlenecks as well as supply and demand imbalances continued to contribute to elevated levels of inflation.

38. OECD Sovereign Borrowing Outlook (May 2023).

39. K. Knot, "Staying the course", 8 February 2023.

40. P. Krugman, "The year of inflation infamy", the New-York Times, 16 December 2021.

In a speech delivered in August 2022, the President of the Bundesbank[41] explained this return of inflation: “One major factor driving this momentum was the global economy’s unexpectedly swift recovery from the pandemic-induced recession. The fiscal and monetary policy support measures taken around the globe to limit the economic damage caused by the pandemic played a part in this. The rapid revival of economic activity then sent commodity prices soaring.

Another contributing factor was the shift in consumer demand away from services and towards goods during the pandemic – instead of heading to the cinema or the gym, people were ordering laptops and exercise bikes. That left industry struggling to produce enough to keep up in some cases. This has further exacerbated price inflation, both for final products and at upstream stages.

In addition, the pandemic disrupted global supply chains and transport routes. Some of these supply disruptions have proved to be more persistent than initially expected. This, too, has had a hand in pushing up prices. And, with a robust demand, energy prices were already on the rise before the war began”.

Central bankers were slow to respond to the surge in inflation in the EU, UK and US.

Central bankers’ initial insistence that inflation would prove itself short-lived led to delays in discarding decades of aggressive and ultra-loose monetary policy. As C. Giles, V. Romei and A Smith highlight in an article in the Financial Times, those delays may have made inflation all the more difficult to vanquish with higher rates, as price pressures broadened from a problem affecting a small number of products hit by supply chain bottlenecks to a far more spread phenomenon, hitting almost all goods and services.

Inflation has reached levels not seen in decades in many countries in 2022, and was still three times higher than the 2%-target at the OECD level in the first half of 2023.

Headline consumer price inflation and core inflation (excluding food and energy) generally remain well above central bank objectives, but headline inflation has begun to decline in most economies in the first half of 2023.

At the OECD level, the aggregated consumer price index rose by 9.6% in 2022 compared to 2021, its highest level since 1988. Although it has fallen since its peak of October 2022 (10.7%), headline inflation remained above 9.2% as of January 2023. It dropped to 5.7% in June 2023, down from 6.5% in May 2023.

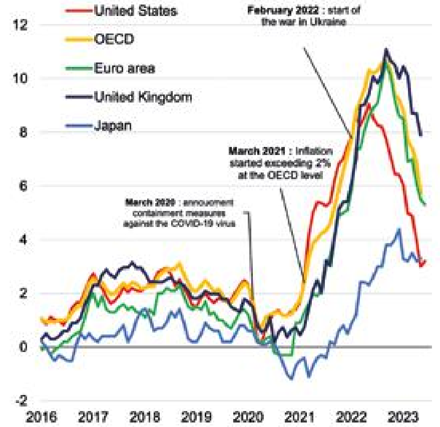
In the US, year-on-year headline inflation was on average 8.1% for 2022. As of February 2023, it fell to 6% from its peak of 9.1% recorded in June 2022. The consumer price inflation in the United States declined to 3.2% in July 2023, its lowest since March 2021.

In the Euro area, consumer prices were up by 8.3% in 2022 compared to 2021, the highest level recorded since the creation of the monetary union in 1999. It peaked at 10.6% in October 2022, before slowly decreasing since then, reaching 8.5% as of February 2023, 6.9% in March 2023, and 5.3% in July 2023.

In the UK, inflation was on average 9% in 2022, a level not recorded since 1982. Although it fell from its peak of 11.1% year-on-year recorded in October 2022, headline inflation remained above double-digit levels (10.4%) as of February 2023. UK inflation declined to 7.9% in June 2023, among the highest levels in the G-20 countries.

In Japan, headline inflation reached 2.5% in 2022, a low level compared to international standards but uncommon in a country that has fought deflation for decades. After peaking at 4.3% in January 2023, headline inflation declined to 3.3% in June. Inflation is now moving in line with other G7 economies.

CHART 32.
Consumer Price Index growth in key advanced economies, % annual change



Sources: OECD, Eurostat
Latest data from July 2023 for the euro area and the US, and June 2023 for the UK, OECD and Japan

41. J. Nagel, “Monetary policy in times of geopolitical crises and high inflation”, 30 August 2022.

In the Euro area, inflation also remains far too high.

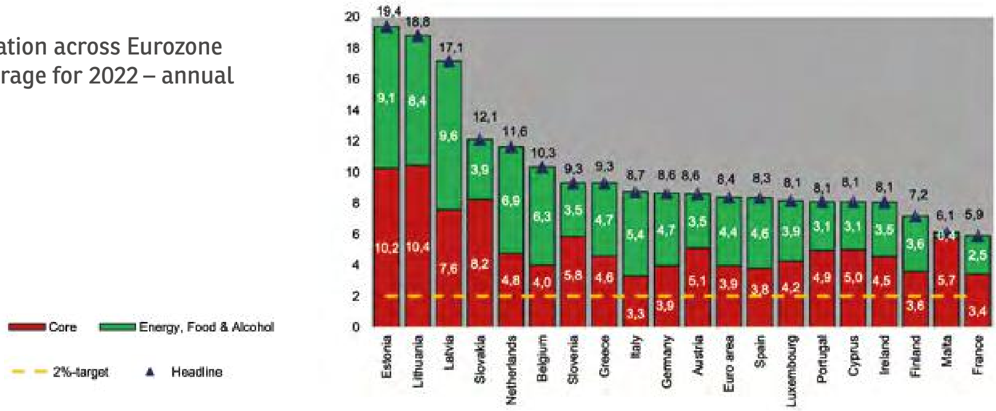
The war in Ukraine, and the associated pressures in energy and food supply pushed the Euro area headline inflation into unprecedented double-digit territory in October (10,6%) and November (10.1%) last year, and to 8,4% for 2022 overall.

As explained by P. Hernandez de Cos[42], "in the case of the Euro area, higher energy and food prices have added to the effect of other supply-side factors related in particular to supply-chain disruptions. The increased demand, mainly due to the reopening of the economy, met an inelastic supply. This and the depreciation of the Euro have also played a role in the increase in inflation".

The large import price shock has led to the highest inflation rates in the Baltics among Euro area countries. In Estonia, headline inflation doubled from 11.6% in February to peak at 25.2% in August 2022. It jumped to 22.5% in Lithuania, and 22% in Latvia, both in September 2022.

Headline inflation also jumped significantly in Germany, which peaked to 11.6% in October 2022. It also exceeded 10% in Spain (10.7% in July 2022), Italy (12.6% in October 2022) and the Netherlands (16.8% in October 2022).

CHART 33.
Headline & Core Inflation across Eurozone Member States – Average for 2022 – annual change (%)



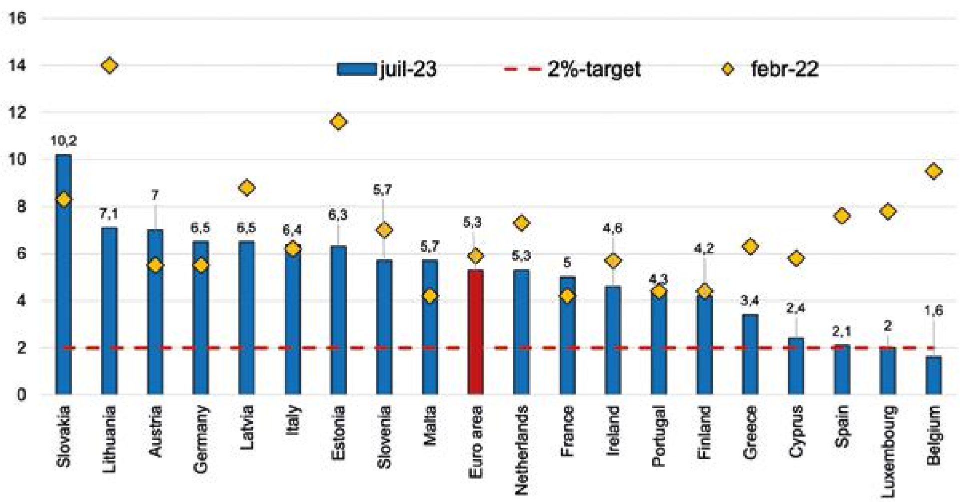
Source: Eurostat

In the first half of 2023, Inflation continued to remain above target in most Eurozone Member States, despite the fall in energy prices.

In the Euro area, year-on-year headline inflation, dropped to 5,3% in July 2023, from 7% in April.

Important differences persist across member states. In June 2023, it fell below 2% in Spain, Belgium and Luxembourg for the first time since 2021, although Spanish inflation rebounded to 2.1% in July 2023 according to preliminary data from Eurostat. By contrast, headline inflation remained close to 7% in Germany (6.8%) and Italy (6.7%), and above 5% in France (5.3%) in June 2023. Preliminary data for July 2023 suggest marginal decrease compared to last month: in July, inflation stood at 6.5% in Germany, 6.4% in Italy and 5% in France.

CHART 34.
Headline Inflation across Eurozone Member States as of July 2023 – annual change (%)

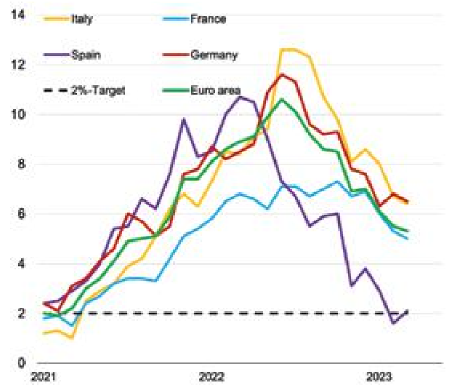


Source: Eurostat

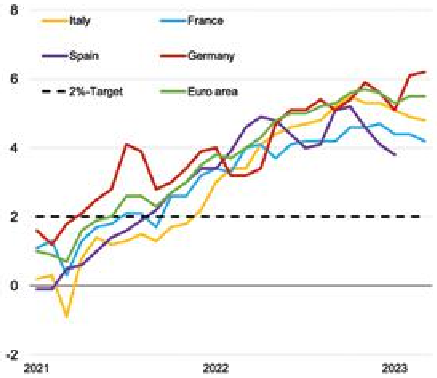
42. P. Hernandez de Cos, "Consistent economic policies – a prerequisite for macroeconomic stability", Madrid, 16 January 2023.

CHART 35.
Headline and Core Inflation, % annual change across key Euro area Member States

35a. Headline Inflation, annual change, %



35b. Core Inflation, annnual change, %



Source: Eurostat
Last data from July 2023, except for Spanish core inflation which dates from June 2023

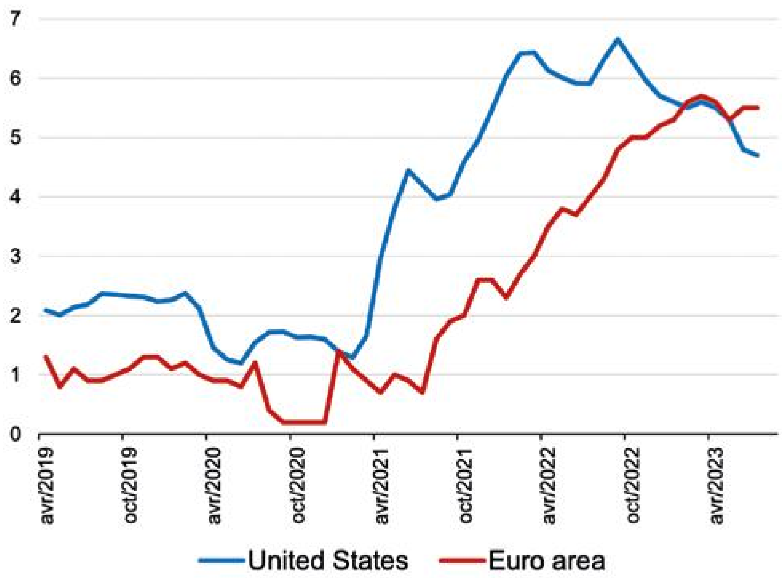
3.9.2 Well below the US level in the first half of 2022, core inflation in the Euro area increased to 5.7% in March 2023 and stabilized around 5.5% so far

Inflation has broadened over the course of last year. Costlier energy inputs and higher wage demands have spilt over to core inflation.

Core inflation, which excludes energy and food prices, was 3.7% in the Eurozone in June 2022, nearly half the US level of 5.9%. Eight months later, in February 2023, it increased to 5.6% in the Euro area, exceeding the US where core inflation moved to 5,5% in February (from 5,6% in January). In March 2023, core inflation increased further in the Euro area to 5.7%, above the US level of 5.6%.

While it declined slightly since March 2023, core inflation in the Euro area remains higher than in the US: In July 2023, it reached 5.5% in the Euro area, against 4.7% in the US.

CHART 36.
Core inflation, annual change (%)



Sources: Eurostat, BLS
Last observation from July 2023

Given that the inelasticity of the productive capacities largely explains the inflationary problem due to insufficient productive investment over the past 20 years, this inflationary shock could not be transitory because of its the supply side origin as the insufficiency of productive capital cannot be corrected overnight.

In such a context, as the BIS underlines in its annual report, "firms are adjusting prices more frequently than when inflation was low and stable… One concern is that firms are now more reluctant to accept profit squeezes and will pass on cost pressures more readily".

As noted by the OECD[43], core inflation is mostly driven by services, and services price inflation tends to be less variable than goods price inflation and more dependent on labor costs. Indeed, the share of labor in total costs in services is about twice as large as in manufacturing. This tightens the link between prices and wages, and therefore suggests that wage pressures are becoming an increasingly important source of inflation.

According to K. Knot[44], the largest upward risk to core inflation is a further increase in wage growth. While inflation expectations on the whole have remained quite well-anchored, labor unions have been (understandably so) pushing for higher wage growth to make up for the loss in purchasing power.

3.9.3 Recent wage dynamics in the Euro area

The inflation surge has severely eroded the purchasing power of households. Low unemployment (*see Chart 39*) and high vacancy rates together with the extended period of high inflation, have put an upward pressure on nominal wage growth.

In January 2023, the ECB underlined that "wages are growing faster, supported by robust labor markets, with some catch-up to high inflation becoming the main theme in wage negotiations[45]".

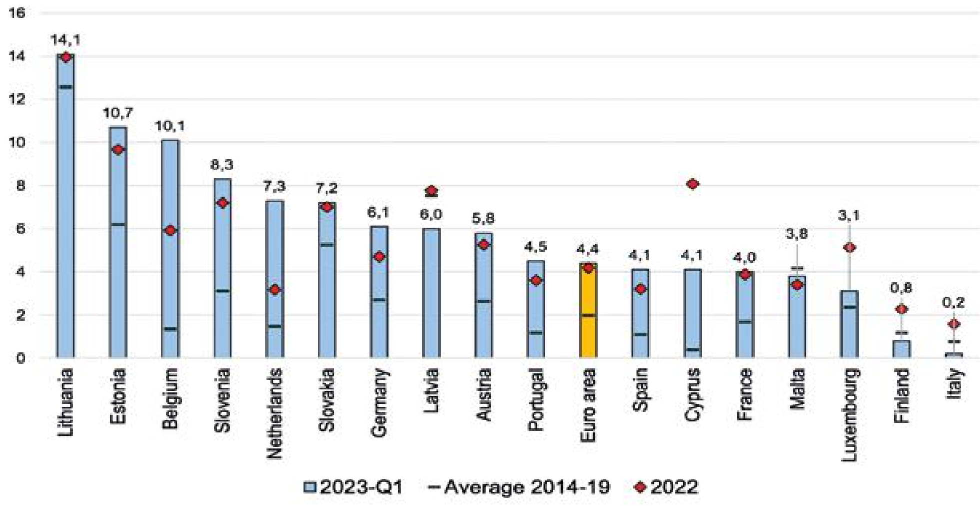
In June 2023, an update of this report[46] noted that "wage pressures, while partly reflecting one-off payments, are becoming an increasingly important source of inflation". The ECB underlined that "so far, workers have faced a significant loss from the erosion in overall income caused by the energy crisis. In the Euro area, real wages, at the end of 2022, were still around 4 percentage points below pre-pandemic levels. But labor markets across the Euro area are tight and workers have considerable bargaining power, which they are starting to use to recover these losses[47]".

The latest available information on wage agreements since the start of 2022 points to a further strengthening of wage growth. At the Euro area level, compensation per employee rose by 5,2% in Q1 2023 and negotiated wages by 4.3% up from 3.1% in 2022-Q4.

In 2022, wage growth exceeded its 2014-19 average in most Eurozone member states (*see Chart 37*). At the Euro area level, wages grew by 4.1% in 2022, above their 2014-19 average of 2%. It increased by 3% in Spain, and 3.9% in France, more than twice their pre-crisis pace, respectively at 1.1% and 1.7%.

Nominal wages continued to rise in the first quarter of 2023 in most Member States. In the Eurozone, annual wage growth reached 4.4%, and at least 14 member states experienced an increase of over 4% in 2023-Q1. It exceeded 6% in Germany (6.1%) and the Netherlands (7.1%).

CHART 37.
Nominal wage growth, total economy (year-on-year change, %) across Eurozone Member States



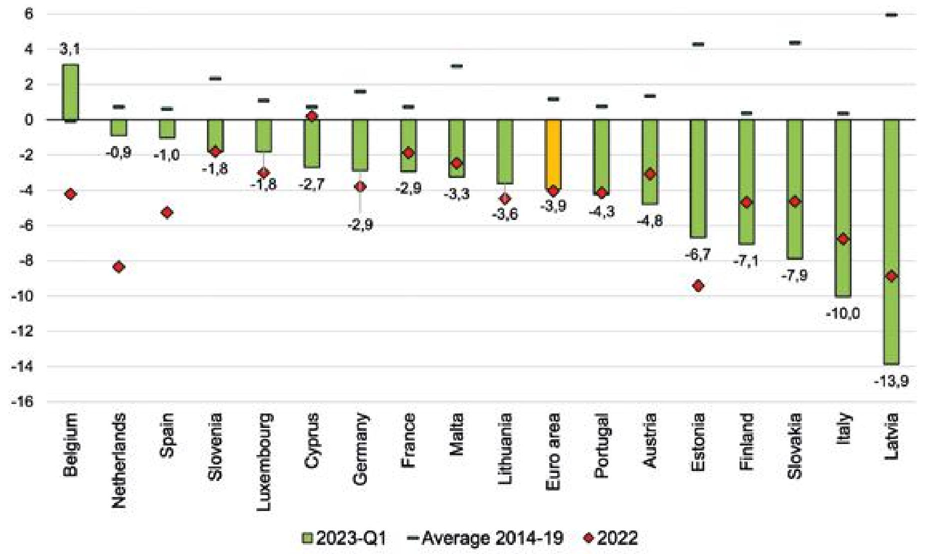
Source: Eurostat
Notes: label data are assigned to 2023-Q1 ; Greece and Ireland are missing due to lack of data

43. OECD Economic Outlook, June 2023.
44. Idem footnote 16.
45. ECB Economic Bulletin Issue 1, January 2023.
46. ECB Economic Bulletin Issue 4, June 2023.
47. C. Lagarde, "The fight against inflation", Hanover, 1 June 2023.

Still, wage increases have not kept up with price inflation, weakening real incomes despite the actions taken by governments to cushion the impact of higher food and energy prices on households and businesses. Except for Cyprus, real wages were negative for all Euro area member states in average in 2022. Germany (-3.8 pp), Italy (-6.7 pp), Spain (-5.4 pp), Latvia (-8.8 pp), the Netherlands (-8.5 pp) and Estonia (-9.5 pp) experienced the largest fall in real wages in the Euro area (*see Chart 38*).

In the first quarter of 2023, only 7 countries have seen an improvement in their real wage levels compared to 2022. These are Belgium – becoming the only country in the Eurozone to have positive real wages so far – Spain, the Netherlands, Luxembourg, Germany, Lithuania, and Estonia.

CHART 38.
Real wages, total economy, %



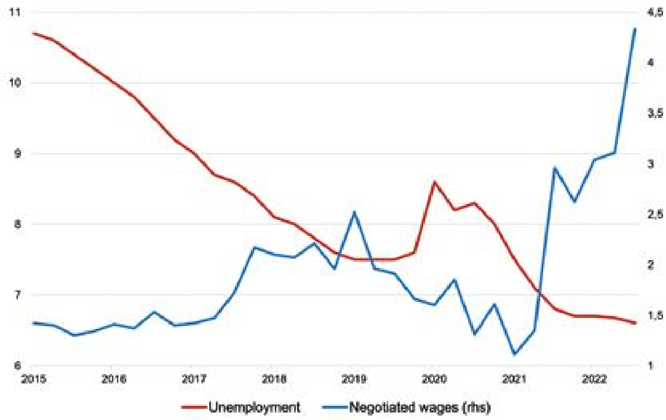
Source: Eurostat
Notes: calculated as annual nominal wage growth minus inflation; label data are assigned to 2023-Q1; Greece and Ireland are missing due to lack of data

As noted by the BIS Annual Economic Report[48], "Negotiated wage growth is now at its highest level since the inception of the common currency... It would be unreasonable to expect that wage earners would not try to catch up, all the more so since labor markets remain very tight". Indeed, in May 2023, the Euro area unemployment rate reached a record low level of 6.5% (*see Chart 39*).

In its June projections[49], the ECB expect wages growth to increase by a further 14% between now and the end of 2025. Such an increase would lead the annual wage growth to "remain over double its historical average for most of the projection horizon", and so "fully recover [its] pre-pandemic level in real terms".

As underlined by President Lagarde[50], this 'catch-up' from rising wages has recently been amplified by low productivity growth, which could lead to higher unit labor costs, and so higher inflation ahead. Accordingly, the ECB expects core inflation to remain above headline inflation until early 2024 and, in any case, to stay above its historical average of 1.5% in the medium term.

CHART 39.
Unemployment rate and negociated wages in the Euro area



Source: ECB, last data from 2023-Q1

48. Annual Economic report, June 2023.
49. Eurosystem Macroeconomic Projections, June 2023.
50. "Breaking the persistence of inflation", Speech in Sintra, 27 June 2023.

3.10 A stagflationary environment in the United States and even more so in the Eurozone

Weakening labor productivity worsens potential growth, leading to higher unit labor costs, and thus to higher and more persistent inflation.

The disappearance of productivity gains, which is more saliant in the Euro area than in the United States, is therefore leading to stagflationary equilibrium of high inflation and low growth.

3.10.1 Inflation should continue to exceed the ECB inflation target in the coming months for a number of reasons

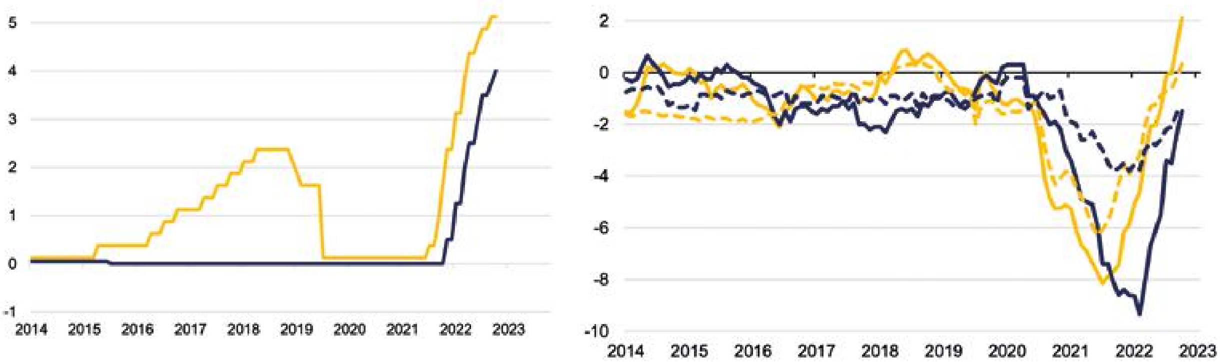
- Unlike the US, real interest rates – calculated using observed year on year head inflation or core inflation – are even more negative today than before the pandemic in the Eurozone.
  Although the ECB has raised its nominal policy rates by 425 basis points since July 2022, real rates were still below their 2019 levels in June 2023, (*see Chart 40*). Mid-2023, real interest rates remain well below the United States levels, where they have returned into positive territories or approached zero in May 2023.

  Negative real interest rates are a kind of subsidy to borrowers which encourages inflation. In addition, negative real interest rates undermine productive investment. The result of both is: the preference for liquidity which prevails over investment in Europe and the preference for financial investment, for instance companies are encouraged to buy back their shares rather than invest in long-term projects (*see Eurofi Monetary scoreboard*).

CHART 40.
Nominal and Real Interest rates in the United States and the Euro area

40a. Nominal Policy rate, %

40b. Real Policy rate, adjusted for annual headline and core inflation, percentage points



Sources: Fed, ECB
For Chart 40.b, real policy rates are calculated as the difference between the nominal interest rates and year-on-year headline/core inflation of the corresponding period; Last observation from June 2023

- The energy transition is inflationary, due to the costs associated with the intermittency of renewable energy production, the costs associated with capital depreciation for the additional investments made, the price increase in metals needed to produce the equipment that ensures the transition (electric batteries, power grids etc.).
- The determination to relocate strategic industries to EU countries is generating additional inflation, as production costs are higher in these countries than in emerging countries.
- The longer high inflation lasts the larger the risk of a wage-price spiral.

3.10.2 Potential growth in the Eurozone is likely to remain very weak, and weaker than in the United States, due to the weakness of productivity gains, which is more pronounced in Europe than in the US

Labour productivity has been declining since the start of 2021 in the United States and has stagnated on average in the Eurozone since 2018 (*see Chart 41*).

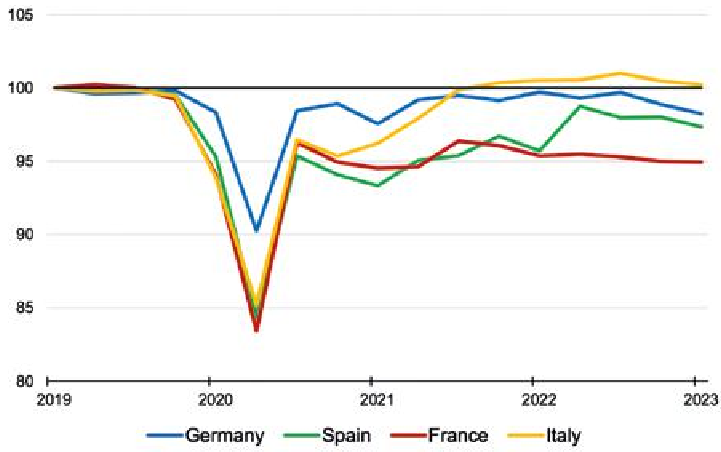
CHART 41.
Per capita productivity
(Q1-2010=100)

Source: taken from P. Artus "What accounts for the slowdown (stagnation) in productivity in the United States and the Eurozone?" Flash Economics Natixis (May 2023)

There are at least three reasons for this this disappearance of productivity gains in the two regions: first, the insufficient level of corporate investment (*see Chart 2.a*); second, the reduction of working hours per employee (*see Chart 4*) – This decline can be seen in Europe but not in the US; third, the high proportion of unskilled workers, a phenomenon which is more pronounced in the Euro area than in the US (*see Part 1.1*).

Except for Italy, the level of productivity per capita remains below its pre-pandemic crisis level in the largest Eurozone economies as of the first quarter of 2023 (*see Chart 42*).

CHART 42.
Real labour productivity per person, 2019-Q1 = 100



Source: Eurostat
Last observation from 2023-Q1

Weak productivity growth causes upward pressure on firms' unit labor costs, which deteriorates their competitiveness and growth potential.

Separately, low productivity growth may be inflationary. "Should weak productivity growth persist, the further increase in unit labour costs raises the probability that firms will pass on parts of the increase in their costs to final consumer prices, setting in motion a perilous wage-price spiral", according to I. Schnabel in June 2023[51].

According to the Rexecode Institute, the productivity of an hour of work in French industry, *i.e.*, the value added per hour, has declined by 5% since 2019 while it has increased by 2% in Germany. The cost of labor to produce 100 € of value added in industry has climbed faster in France than in other European economies such as Germany, and Italy[52].

According to P. Artus, this decline is due to a reduction in working hours per employee (1/3) and a decline in hourly labour productivity (2/3)[53]. All in all, France's potential GDP grew by only 1% between the fourth quarter of 2019 and the third quarter of 2022.

51. I. Schnabel, "The risks of stubborn inflation" Speech at the Euro50 Group conference (June 2023).
52. G. de Calignon, "Prix de l'énergie et coût du travail : la compétitivité diverge au sein de la zone Euro", 11 February 2023.
53. P. Artus, "France's current key problem: Declining labour productivity", Flash Economics, 11 January 2023.

•

A decline in labour productivity in the major Euro area countries is a worrying development: it leads to a decline in corporate profits or a decline in real wages; it implies a decline in production capacity, even when employment is rising. It raises core inflation in the Euro area and complexifies the situation for the ECB.

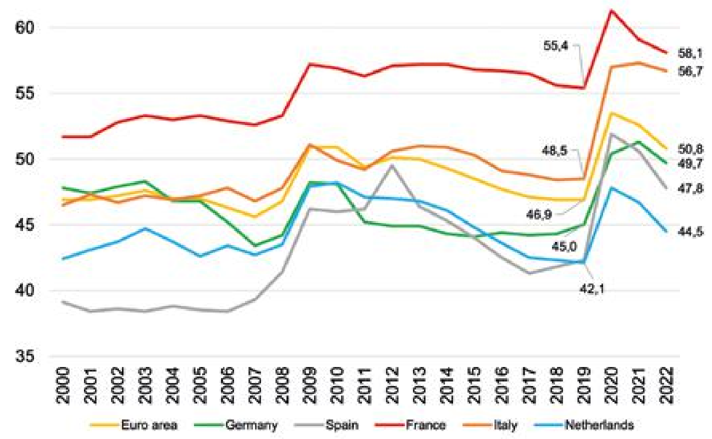
This means adapting strategies and, above all, mindsets. Policymakers need to dispel a kind of "growth illusion" – based on a reliance on expansionary monetary and fiscal policies to stimulate growth. The only possible source of robust growth is to reboot the supply side of the economy. This is why the implementation of the NGEU is important since the allocation of European funds to Member States is conditional on the implementation of structural reforms.

4. EU countries with the highest level of government expenditure as percentage of GDP are those with the least competitive firms

4.1 With 57.9% of its GDP in 2022 France holds the record high in terms of level of public spending in the EU

France already had the highest level of public spending in the EU before the Covid-19 crisis, with 55.4% of GDP in 2019. Finland (53.3%) and Belgium (51.9%) were the only two other countries in the Union whose public expenditures-to-GDP ratio exceeded 50% of GDP in 2019. By contrast, the level of public spending in Germany, the Netherlands, Spain and 17 other EU members remained below the EU average of 47% of GDP in 2019 (*see Chart 43*).

CHART 43.
Total Public Expenditure, as % of GDP



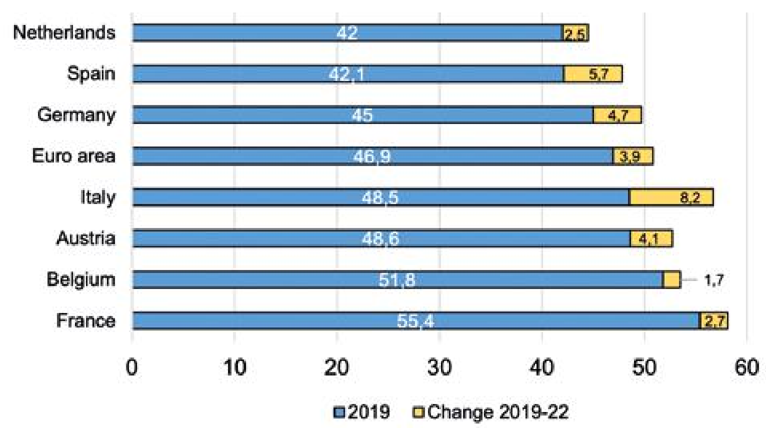
Source: EU Commission Spring Forecast, May 2023

Following the Covid-19 crisis, public spending increased by 2.7 pp in France from 2019 to 2022, compared with 3.9 pp in the Eurozone (*see Chart 44*). France is among countries whose increase in spending as a percentage of GDP was the lowest however from a high level: it was 4.7 percentage points in Germany, 5.7 pp in Italy, 4.1 pp in Austria, 5.7 pp in Spain and 2.5 pp in the Netherlands. Among the large countries, only Belgium shows a lower increase (1.7 pp).

The recent decline in public spending between 2020 and 2022 in EU Member States mainly reflects the phasing out of pandemic-related measures. Except for Denmark, Croatia and Ireland, public spending to GDP ratios remains above their pre-pandemic levels in all EU Member States in 2022. The implementation of energy support measures by governments in response to the energy crisis contributed to keep public spending elevated in the EU (*see Part 3*).

Starting from a much higher level of spending than the other countries in 2019, France remained at the top of the Eurozone and the European Union, with public spending equal to 58.1% of GDP in 2022. This is more than seven points above the Eurozone average of 50.8% of GDP, 8.4 pp above the German's level of 49.7% of GDP and 13.6 pp above the Dutch's level of 44.5%. In Italy, public expenditures still exceeded 55% of GDP in 2022.

CHART 44.
Total Public Expenditure before and after the Covid-19 crisis, as % of GDP

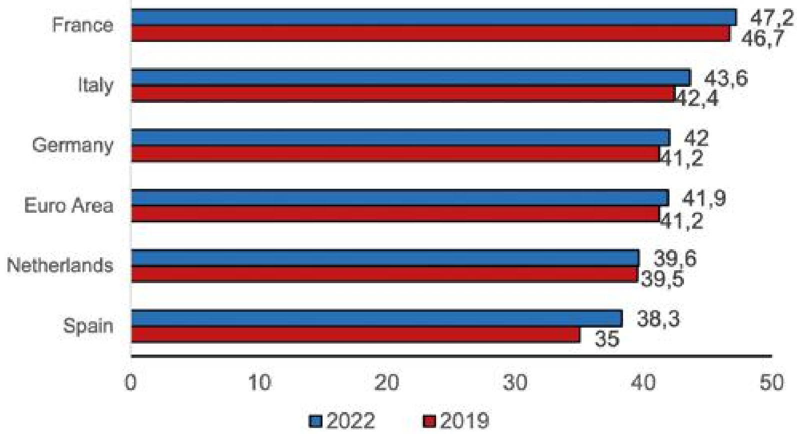


Source: EU Commission Spring Forecast, May 2023

4.2 High levels of public expenditures imply high tax pressures on firms, lifting their production costs and so deteriorating their competitiveness

In this field, France is leading with Denmark in the European Union. Its current tax burden – or amount of tax collected on firms and households[54] – accounted for 46.7% of GDP in 2019. That was nearly six percentage points above the Euro area average of 41.1% (*see Chart 45*).

CHART 45.
Current tax burden in 2019 and 2022, % of GDP



Source: EU Commission

Between 2019 and 2022, the level of current tax burden rose by 0.5 pp in France, less than the Euro area average (+0.7 pp), Germany (+0.8 pp), Italy (+1.2 pp) and Spain (+3.3 pp). However, the level of taxation remained the highest in France, reaching 47.2% of GDP in 2022, and more than 2 pp above Belgium (44.8%) and Italy (43.6%), which are the second and third countries with the highest taxation rate in the Union. In 2022, France's level was more than 5 pp above the Euro area of 41.8% of GDP, Germany (42%), the Netherlands (39.6%) and Spain (38.3%), according to the EU Commission.

Too high taxation contributes to erode the competitiveness of domestic firms. With a level of taxes on production and imports exceeding the Euro area average by 3.4 points in 2019 (*see Table 3*), France has been suffering of a permanent deficit of its trade balance and more broadly of its current account balance since 2007 (*see Chart 46*). Within the EU, eight other members experienced a negative current account balance on average, between 2014 and 2019. Among them, Cyprus has the highest deficit (-3.9% of GDP), followed by Romania (-2.5%) and Greece (-1.6%).

TABLE 3.
Breakdown of tax revenue by country and by detailed tax categories in 2021, % of GDP

	Taxes on production and imports	Current taxes on income, wealth, etc	Capital taxes	Net social contributions	Total
Germany	10,9	13,5	0,3	17,6	42,3
France	16,6	12,9	0,7	16,8	47
Italy	14,5	15	0,1	13,7	43,3
Spain	12,2	11,9	0,5	14,2	38,8
Netherlands	12,3	13,5	0,3	13,6	39,7
Euro Area (20)	13,2	13,2	0,4	15,2	42

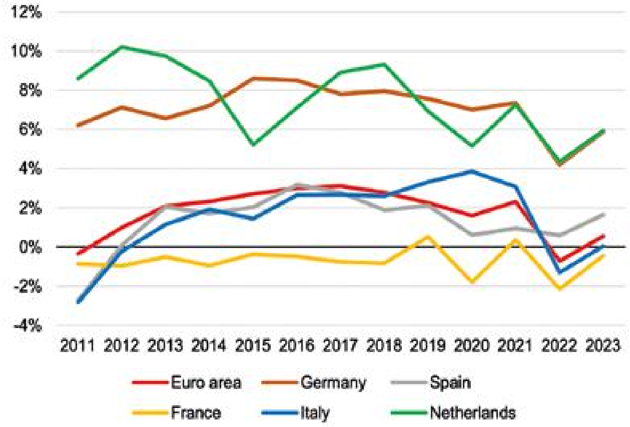
Source: Eurostat

By contrast, countries with a level of taxation below the Euro area average gather the most competitive firms of the area. With tax revenue on production and imports accounting for 10.9% of GDP in 2021 (*see Table 3*), Germany delivered the third highest current account surplus during the same year, behind the Netherlands, which is also characterised by a relatively low level of tax burden (12.3% of GDP), and Ireland.

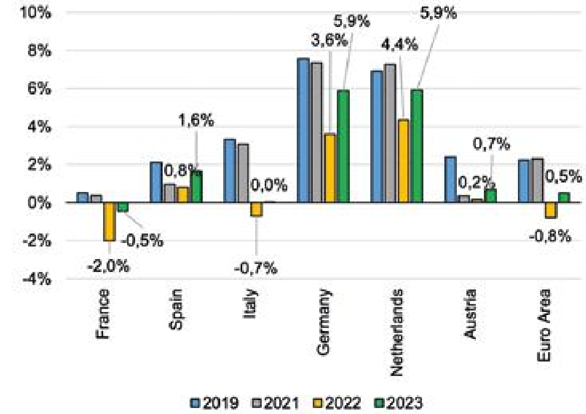
54. The current tax burden of total economy is the sum of Indirect taxes (VAT, imports production), direct taxes (income and wealth, and capital) and social security contributions (actual and imputed), according to the AMECO definition.

CHART 46.
Current Account Balance in main EU Member States, % of GDP

46a. Over the past decade



46b. Recent trend



Source: Eurostat, AMECO
Data for 2023 are projections taken from the Spring Forecast of the EU Commission (May 2023) ; projections for the Euro area in 2023 are taken from the IMF World Economic Outlook (April 2023)

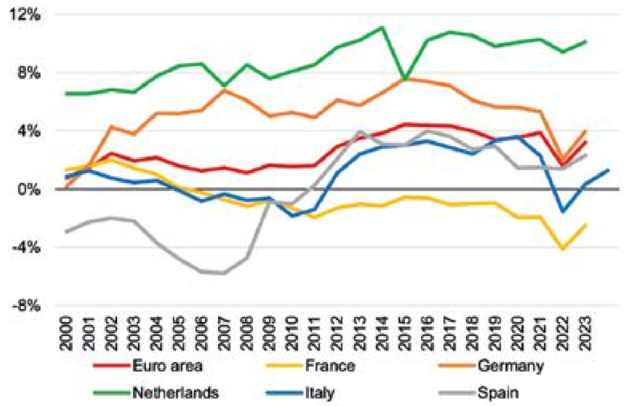
TABLE 4.
Current Account Balance in main EU Member States, % of GDP and EUR bn

	2019		2020		2021		2022		2023	
	EUR bn	% of GDP	EUR bn	% of GDP	EUR bn	% of GDP	EUR bn	% of GDP	EUR bn	% of GDP
France	12,5	0,0	-41,5	-1,8%	9,0	0,4%	-53,8	-2,0%	-12,9	-0,5%
Spain	26,2	2,1%	6,8	0,6%	11,5	1,0%	10,0	0,8%	23,2	1,6%
Italy	59,5	3,3%	64,0	3,9%	54,9	3,1%	-13,8	-0,7%	0,7	0,0%
Germany	262,9	7,6%	238,7	7,0%	265,0	7,4%	140,9	3,6%	241,5	5,9%
Netherlands	56,3	6,9%	41,0	5,1%	62,2	7,3%	41,0	4,4%	60,3	5,9%
Austria	9,5	2,4%	11,3	3,0%	1,4	0,3%	0,7	0,2%	3,3	0,7%
Euro Area	270,2	2,2%	183,5	1,6%	285,2	2,3%	-97,0	-0,8%	78,9	0,5%

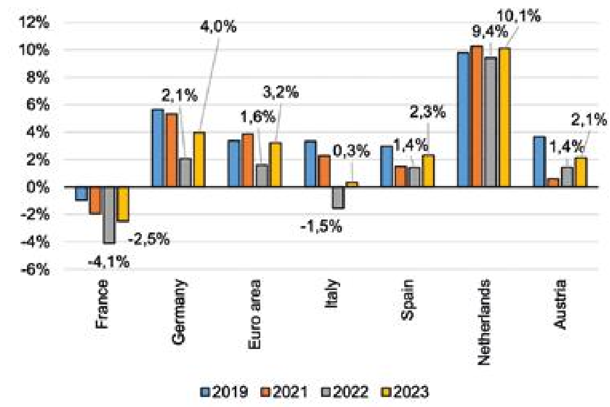
Source: Eurostat, AMECO
Data for 2023 are projections taken from the Spring Forecast of the EU Commission, May 2023; projections for the Euro area are taken from the IMF World Economic Outlook (April 2023)

CHART 47.
Net Exports of Goods and Services, % of GDP

47a. Over the past decade



47b. Recent trend



Source: AMECO Spring Forecast, May 2023

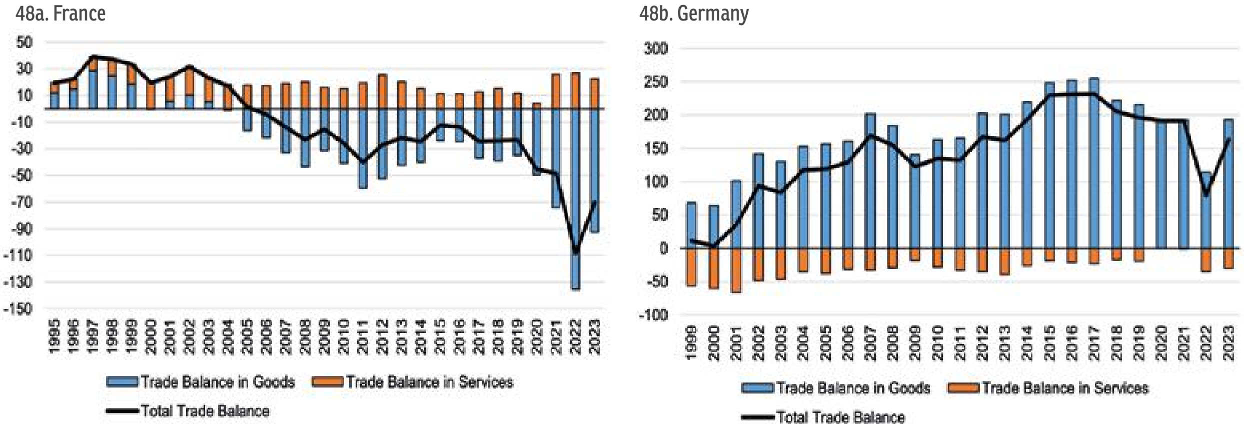
France's trade balance deficit of € 48.5 bn in 2021 was mainly due to the negative trade balance of goods, which amounted to € 74.2 bn, a record-high figure. This deficit was partly offset by the surplus in the balance of services (+ € 25.7 bn in 2021), rising thanks to the recovery of global tourism after the pandemic.

In the same year, Germany recorded a trade surplus of € 191.6 bn, resulting entirely from trade in goods (*see Chart 48*). The German trade balance in goods has always been in surplus over the past two decades, while it has gradually fallen to negative territory in France since 2004. Such performance reflects the process of deindustrialisation and the expansion of the less export-driven service sector, starting in the late 1980s (*see Part 5 & 6*).

As described in Part 3, the energy crisis has strongly deteriorated the external balance of EU member States in 2022. Higher energy imports coupled with lower exports to China in particular pushed the German's trade balance to € 79.5 bn, a drop of 40% from 2021. In France, the trade deficit doubled compared to 2021, to € -108.8 bn in 2022.

Table 4 also illustrates the divergent current account positions of France and Germany. While Germany still had a current account surplus of 3.6% of GDP in 2022 (compared to 7.4% in 2021), France had a deficit of 2% in 2022 (compared to a surplus of 0.4% in 2021). With the fall in energy prices since late 2022, current account balance are set to rebound in the two countries, although France is still expected to register a current acccount deficit of 0.5% of GDP in 2023, according to the EU Commission. By contrast, Germany should experience a surplus of 5.9% of GDP in 2023.

CHART 48.
Trade Balance in France and Germany, € bn



Source: AMECO Spring Forecast, May 2023

4.3 Most of public expenditures are allocated to social protection, health and public services instead of productive investment

On average, Euro area members allocated 40.5% of their public expenditures to social protection, corresponding to 21.2% of GDP in 2021 (*see Table 5*). As percent of GDP, France presents the highest share, with 24.8%, followed by Finland (24.6%). Health is another most prominent function of public spending in the Euro area (15.8% of total expenditure in 2021), then followed by general public services (11.7%).

TABLE 5.
Major Functions of Public Expenditures of Selected EU Member States, % of GDP (2021)

	General public services	Health	Education	Social protection	Other	Total
Euro Area	6,1	8,3	4,7	21,2	12,0	52,3
Italy	8,1	7,6	4,1	23,4	12,1	55,3
France	5,8	9,2	5,2	24,8	14,0	59,0
Germany	6,2	8,6	4,5	20,9	11,0	51,3
Spain	5,9	7,3	4,6	20,6	12,2	50,6
Netherlands	3,9	8,7	5,1	16,6	12,2	46,6
Austria	5,8	10,1	4,9	21,9	13,2	56,0

Source: Eurostat
Notes: 'Other' includes Defence, Public Order and Safety, Economic Affairs, Environmental protection, Housing and community amenities; Recreation, culture and religion

Considering the components of social protection, public pensions account for the highest proportion. At 11.6% of GDP in the EU in 2019, its level is mainly linked to the average effective labour market exit age (*see Chart 49*). Excluding Italy and in most EU countries, the earlier working-age people retire, the higher is the total cost of pensions. Having one of the lowest average labour market exit age in the EU (62.3), France spends the most on pensions schemes – representing 14.8% of its GDP in 2019, compared with 11.6% for the EU average. The issue is even more worrying in the context of the demographics ageing, characterized by a growing number of elderlies that will face a declining working-age population. By 2025, the share of 65+ in total population is projected to increase by 2 points to 22.3% in France, while the prime-age population ratio (aged 25-64) will fall to 36%, from 37.5% in 2019.

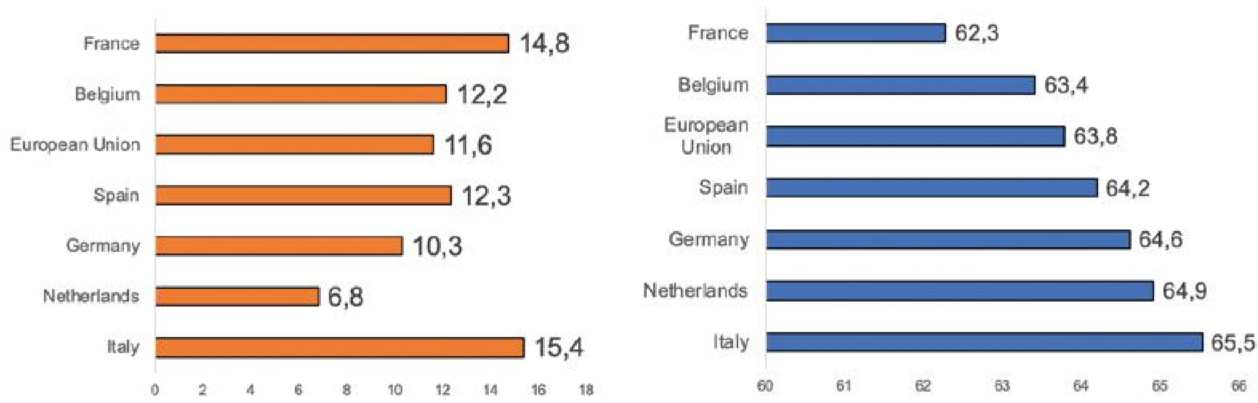
In Italy, the pension system remains one the most onerous for the government in terms of GDP, despite the relatively high average effective labour exit age in the EU. There are three key reasons for this situation:

- **The generosity of the system**. The replacement rate – or percentage of an individual's annual employment income that is replaced by retirement income – was 20 pp higher than the EU average in 2019 (66.9% in Italy against 46.2% in the EU).
- **The persistent low level of employment rate**. In 2019, 59.1% of people aged 15-64 were employed. This is the second lowest employment rate in the EU, just 2.8 pp above Greece (56.3%), and 9.3 pp below the EU average (68.4%).
- **The ageing population problem**. The Italian downward demographic trend is one the most salient in the EU. In 2019, 23% of the Italian population was aged 65 or over. This is the highest level in the EU (whose average is 20.4%). This figure contributes to further deteriorate the old-age dependency ratio; that is the number of dependents aged over 65, compared with the total population. At 58.5% in 2019, the ratio is projected to reach 70% by 2030.

CHART 49.
Public Pensions Spending and Labour Market exit age in selected EU Member States

49a. Gross Public Pensions, as % of GDP in 2019

49b. Average effective labour market exit age, 2019

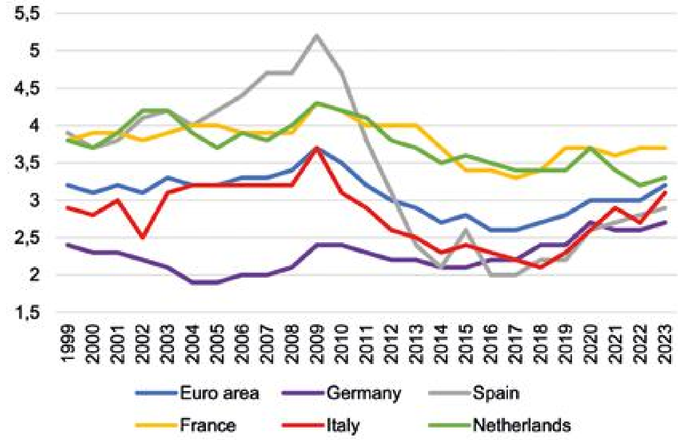


Source: Eurostat

4.4 Such levels of public expenditures have been reached at the expense of productive investment, hence weakly contributing to gross capital formation[55]

As share of GDP, public investment has never exceeded 3.5% in the Euro area since 1996, (the first available year recorded by Eurostat). Moreover, against the backdrop of rising public expenditures, the share of public investment in total public spending fell between 2007 and 2019 (*see Chart 50*).

CHART 50.
Gross Fixed Capital Formation of Public Sector, % of GDP



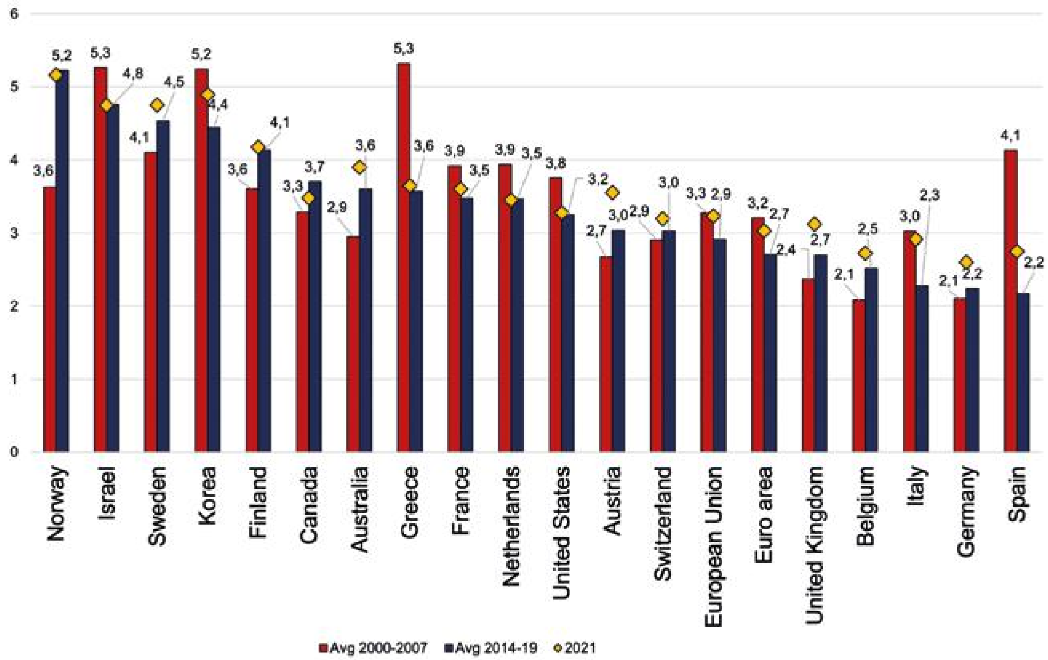
Source: AMECO Spring Forecast, May 2023

55. For government, gross fixed capital formation includes transport, office buildings, housing, school and hospital infrastructures.

After reaching 3.3% of GDP in 2007 – its highest level outside the crisis period – the level of public investment in the Euro area gradually declined to 2.6% of GDP in 2017 (*see Chart 50*). It then increased slightly to 2.8% in 2019. At an average of 2.7% of GDP between 2014 and 2019, public investment in the Euro area remains below the level of most non-European economies (*see Chart 51*), including the United States (3.2%), Canada (3.7%), Australia (3.6%) and South Korea (4.4%) according to the OECD.

Such a period of under-investment at the EU level was notably attributable to Germany, where public sector investment never exceeded 2.6% of GDP between 1995 and 2019 (*see Chart 50*). Spanish and Italian governments also contributed to this decline, both investing less than 2.5% of GDP between 2012 and 2018. In the two countries, public investment was still below its pre-2008 level in 2021.

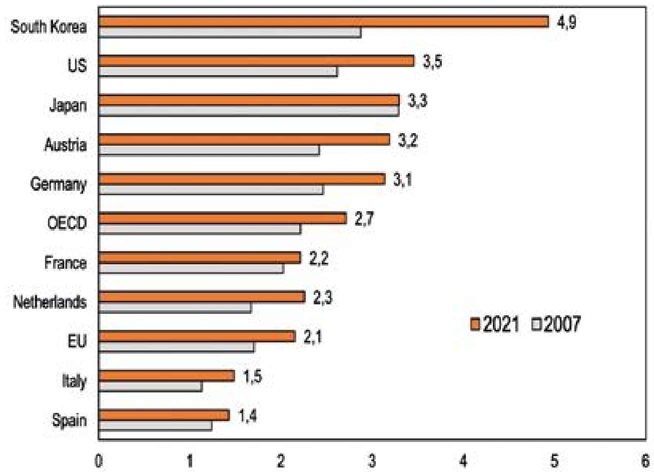
CHART 51.
Government Investment across OECD economies, as % of GDP



Source: OECD

Research and Development (R&D) – a measure of immaterial investment – is also a concern. On this issue, most of EU members allocate less of their spending than the OECD average (of 2.7% of GDP in 2021). Only Germany and Austria stand out, with levels close to the US and Japan (*see Chart 52*).

CHART 52.
Gross domestic spending on R&D, % of GDP



Source: OECD
Notes: Gross domestic spending on R&D is defined as the total expenditure (current and capital) on R&D carried out by all resident companies, research institutes, university and government laboratories

Although public expenditures rose in some key EU Member States, the share of public investments in total public expenditures globally shrank between 2007 and 2021 by 1 pp at the EU level, from 7.2% in 2007 to 6.3% in 2021. At an average of 6.8% between 2014 and 2019, the share of public investment in the Euro area is one of the lowest among other advanced economies, such as the UK (6.5%), the US (8.5%) and Canada (9%) according to the OECD- *see Chart 51.*

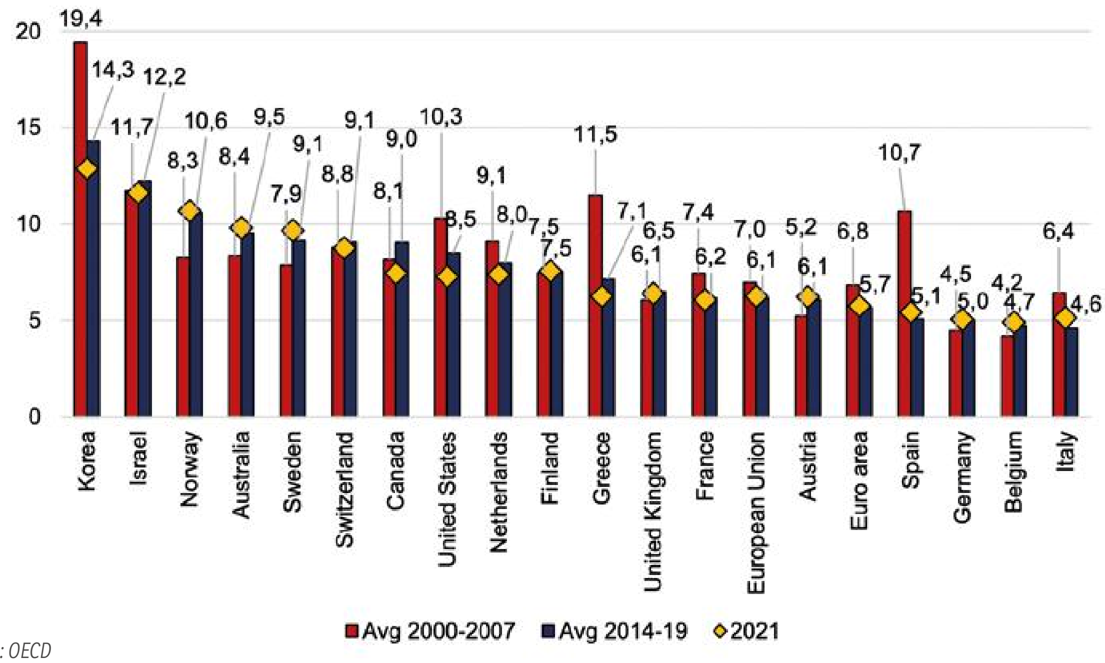
Among the largest EU Member States, only Germany and Belgium have seen an increase in the share of public investment in total expenditure, although their level of gross fixed capital formation remains among the lowest in Europe (*see Chart 51*).

The most indebted Member States have experienced the largest decline in the share of expenditure devoted to public investment over the last two decades. While France spent an average of 7.4% of its public expenditure on investment between 2000 and 2007, this figure fell to an average of 6.2% between 2014 and 2019, a drop by 1.3 percentage points. It fell by 1.8 pp in Italy, 4.3 pp in Greece and 5.6 pp in Spain.

In other words, these figures show that the states with the highest public debts are those that invest the least to increase their potential growth and thus prepare for the future. As stated by the EU Commission, such decline among high-debt countries suggests that "the accumulation of public debt has not been reflected in a higher capital stock, indicating that deficit spending has not been channelled towards capital expenditure but financed consumption[56]".

In 2021, the share of public investment in total expenditure has exceeded its pre-pandemic level in most European economies, although it remains lower than in most non-European economies.

CHART 53.
Share of Public Investment in Total Government Expenditure, %



Source: OECD

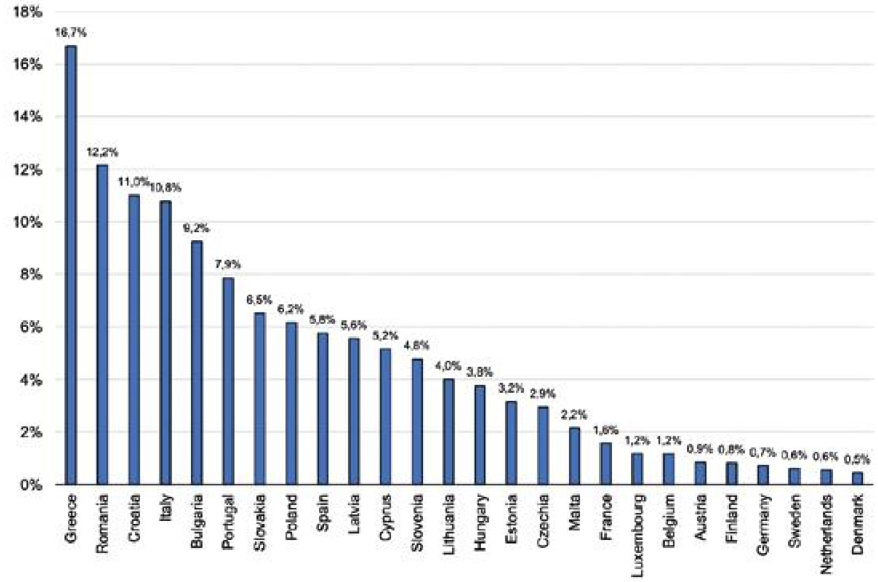
According to the EU Commission, the EU aggregated public investment-to-GDP ratio is projected to increase from 3% of GDP in 2019 to 3.4% in 2024, as almost all Member States are expected to spend more on public investment than they did before the pandemic (*see Chart 55.a*). Half of the increase in public investment is related to investment financed by the EU, particularly by the Recovery and Resilience Facility (RRF).

Introduced in February 2021, the RRF aims to help repair the immediate economic and social damage of the coronavirus pandemic, by disbursing up to € 723.8 bn (in current prices), of which € 338 billion will be paid in the form of grants and the rest in the form of loans for the period 2021–2026[57]. A quarter of the fund (26%) is currently estimated to be absorbed by Italy, amounting to € 191.5 bn in grants and loans, or 10.8% of Italy's 2021 GDP (*see Chart 54*). Spain will absorb 9.6% of the requested RRF funding, which represents € 69.5 bn in grants or 5.8% of its 2020 GDP. France will receive 5.4% of the RRF funding, corresponding to € 39.4 bn or 1.6% of its GDP.

56. S. Langedijk et al "The role of the fiscal framework to foster public investment, including in light of the green and digital transitions" Quaterly report on the Euro area, vol 21 n°4 (2022), February 2023.

57. See "Recovery and Resilience Scoreboard (europa.eu)".

CHART 54.
RRF funding (loans & grants) to be received by EU Member States, % of GDP



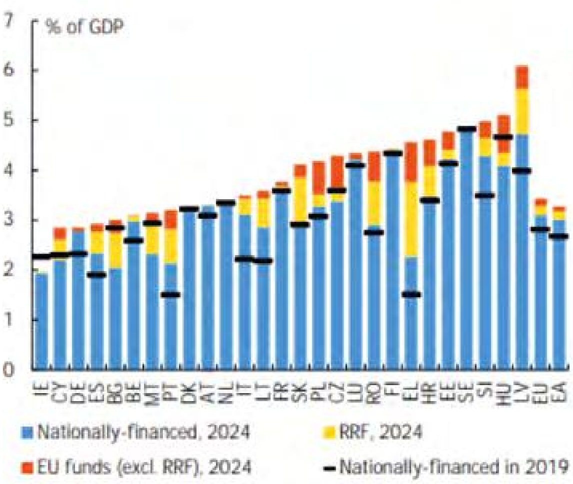
Source: EU Commission

As stated by the EU Commission[58], the absorption of RRF grants is set to increase over 2024. For the EU as a whole, the absorption of RRF grants is projected to increase to 0.3% of GDP in 2022 (from 0.2% in 2021), and to 0.4% of GDP in 2023 (*see Chart 35.b*).

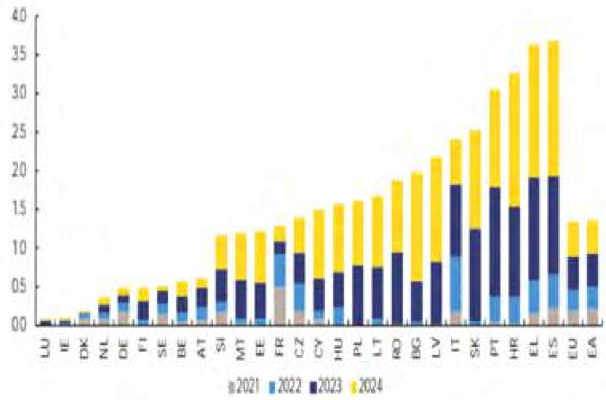
Over the period 2021-24, expenditure financed by RRF grants is expected to be above 3.5% of GDP in Spain and Greece, above 3% in Croatia and Portugal, close to 2.5% in Slovakia and Italy, close to 2% in Latvia, Bulgaria and Romania, close to or above 1.5% in Lithuania, Poland, Hungary, Cyprus and the Czech Republic, and above 1% in Slovenia, Malta, Estonia and France.

CHART 55.
Public investment and contribution of RRF across EU Member States

55a. Public investments in the EU/EA and Member States and source of financing in 2019 and 2024, %of GDP)



55b. RRF grants absorption, 2022-2024 (% of GDP)



Source: AMECO Spring Forecast, May 2023

58. Spring Forecast (May 2023).

5. Excessive level of public debt does not fuel productivity growth and employment

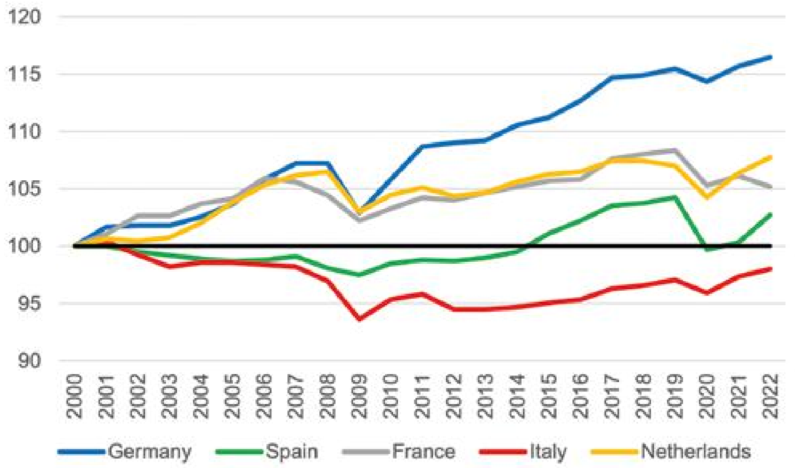
5.1 The most indebted countries of the Eurozone have achieved the lowest productivity growth performance in the past two decades

Since 1999, the five EU Member States whose public debt to GDP have continuously risen to reach the highest levels among the Eurozone Member States have achieved the lowest performances in terms of total factor productivity growth[59]. Indeed, productivity growth in France, Spain, Belgium, Portugal and Italy, has been declining or stagnating to low levels since 1999. Moreover, these economies have been diverging from the dynamic trend of the Netherlands, Germany and Austria, characterised by relatively lower levels of public debt to GDP ratio and steadily higher productivity growth trends (*see Chart 56*).

As shown in Chart 56, total factor productivity growth in the Euro area has diverged across EU Member States since the start of the EMU. That has translated into diverging growth paths. The Covid-19 crisis has worsened this problem because some of the economies that have exhibited the slowest pace over the past ten years, are also the ones that were hit the hardest by the pandemic-related crisis.

K. Knot, Governor of the De Nederlandsche Bank (DNB) stated that this issue is concerning[60], "because it threatens the coherence of the Economic and Monetary Union [...]. Resilience is about balance [...]. If you put more pressure on one leg than the other, you are bound to get some serious health problems at some point. That is not what the patient needs [...]. What the patient needs is some care to wean it from its dependence on debt and to bring back balance in economic growth".

CHART 56.
Total Productivity Growth, 2000=100



Source: Eu Commission

5.2 The most indebted EU Members have experienced the highest unemployment rates in the EU since 2007, as Spain (12.9% in 2022), Italy (8.1%) and France (7.3%)

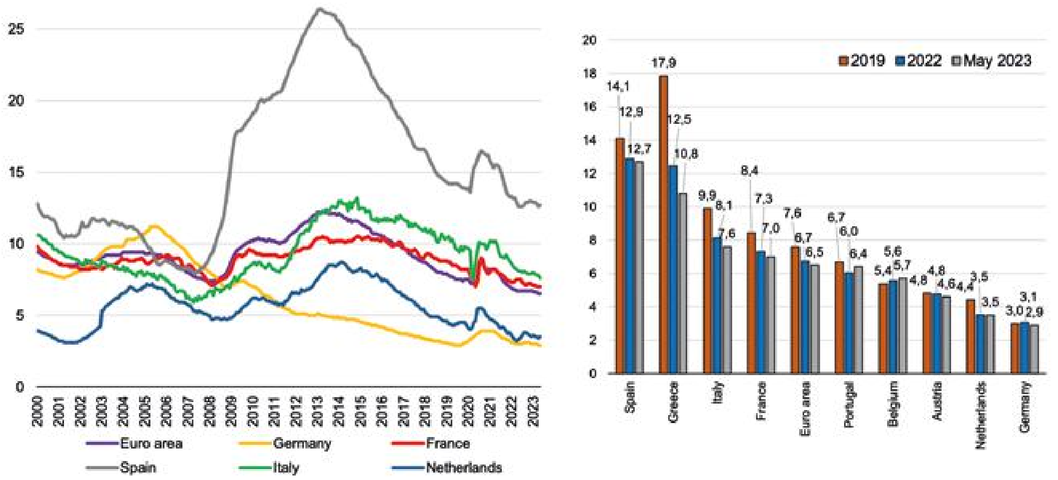
Although French unemployment rate declined slowly to 7% in 2022, massive unemployment reveals a key structural labour market weakness. More generally, Spain, Italy and France are among the countries with the highest long-term and youth unemployment rates (*see Figure 58*). In the first quarter of 2023, Spain and Greece had the highest ratio of unemployed people aged 15-29 to the total labour force in Europe (22% and 20.9% respectively), followed by Italy (16.8%). Despite the record share of spending allocated on education and job training (5.2% of GDP in 2021, compared to 4.7% in the Euro area), France is also the most affected (13% for the youth unemployment rate, compared to 11.4% for the Euro area), while the figure does not exceed 10% in Austria (7.6%), the Netherlands (6.5%) and Germany (4.6%) also in the first quarter of 2023.

Such high levels in public expenditure highlights the ineffectiveness of education and professional training policies, as well as the lack of domestic structural reforms.

59. According to the OECD, the indicator reflects the "overall efficiency with which labour and capital inputs are used together in the production process. Changes in Multifactor Productivity Growth reflect the effects of changes in management practices, brand names, organisational change, general knowledge, network effects, spillovers from production factors, adjustment costs, economies of scale, the effects of imperfect competition and measurement errors".

60. K. Knot, "Rebuilding resilience: meeting the challenges beyond Covid-19", Eurofi Forum, 11 September 2021.

CHART 57.
Unemployment rate, as % of Active Population



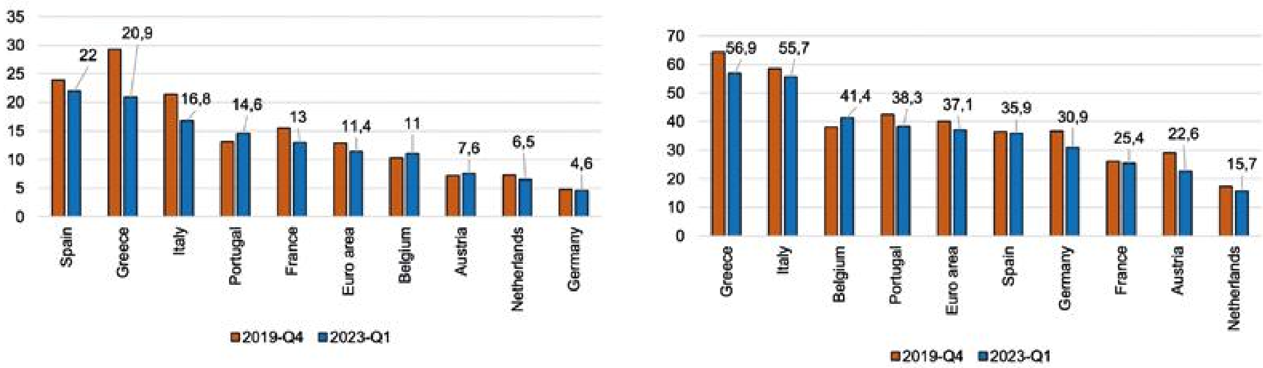
Source: Eurostat
Notes: data on left-chart are taken on a monthly-frequency – last observation from May 2023

As of 2023-Q1, 55.7% of the Italian unemployed people were in a situation of long-term unemployment[61]. France and Spain followed, with 25.4% and 35.9% respectively, although their level has recently declined below the Euro area level of 37.1% (*see Chart 58.b*).

CHART 58.
Youth and long-term umployment rates across main EU Member States before and after the Covid-19 crisis

58a. Youth Unemployment rate (Unemployed 15-29 years-old as % of total population in the labour force)

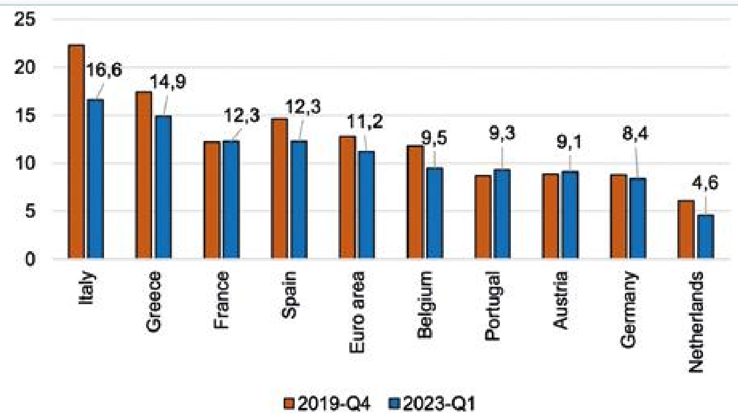
58b. Long-term unemployment, as % of total unemployed



Source: Eurostat

The significant share of youth unemployment rate in some EU countries reveals the existing difficulties in joining the labour market. Such failures favour the proliferation of Youth 'NEET' (youth that are Neither in Employment, Education or Training). In Italy, 16.6% of young people aged between 15 and 29 were in this situation as of 2023-Q1, the highest share among European Union countries (*see Chart 59*).

CHART 59.
Young People Neither Employed, in education or Training, as % of 15-29 population



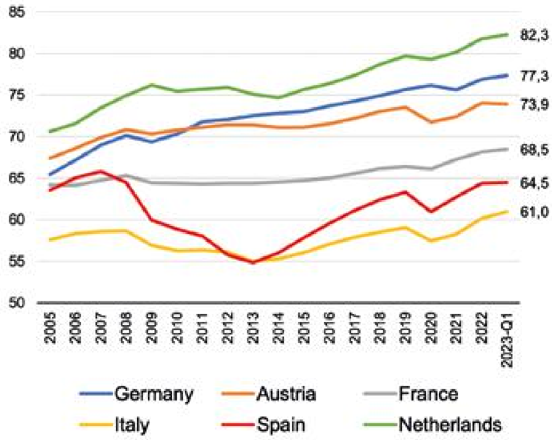
Source: Eurostat

61. People staying unemployed for at least twelve consecutive months (OECD definition).

5.3 The employment rate in France, Spain and Italy is close to 10 percentage points lower than in Germany and the Netherlands

When looking at Member States individually, two groups stand out: countries with a share of people employed exceeding 70% of the population, as the Netherlands, Germany and Austria notably, and countries whose number is hovering below 65%, including Italy and Spain (*see Chart 60*).

CHART 60.
Employment rate of the 15-64, as share of total active population



Source: OECD

As of 2023-Q1, 68.5% of the people aged 15-64 were employed in France, compared to 77.3% in Germany.

The employment gap between France and Germany is first due to the fact that the employment rate of the 60–64 is 35% in France, compared with 62% in Germany in 2021. As the effective retirement age is lower in France (*see Section 4.3*), workers leave the labour market earlier than in Germany.

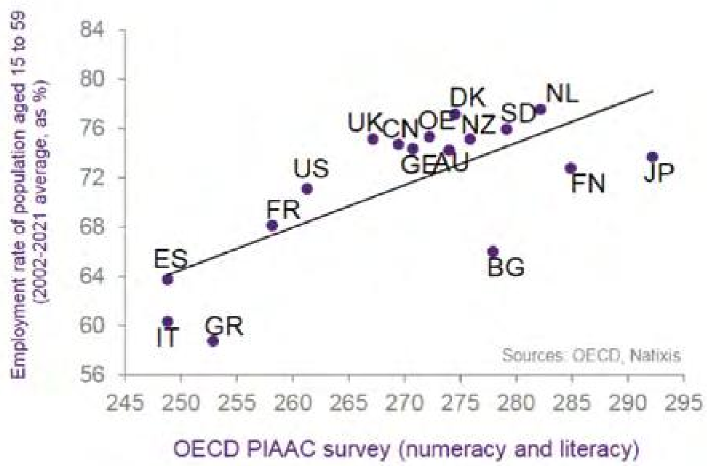
In addition to the nature of the pension system, the reasons behind the remaining gap between France and Germany's employment rates stem from (i) the lack of appropriate skills in the workforce, and (ii) the burden of taxes on companies, which force them to make trade-offs as offshoring their activities, at the expense of domestic employment and investment.

According to P. Artus, the skills of the labour force explain 53% of the gap between the employment rate of OECD countries, while the weight of corporate contributions and production taxes explains 35%.

As highlighted by P. Artus[62], the employment rate is the weakest in countries where labour skills are low (*see Chart 61*).

Yet France stands in the bottom quarter of the OECD countries in terms of adult skills and ranks in the last place when it comes to young people's skills in science. France also has, after Sweden, the highest production tax burden in Europe (16.6% of GDP versus 13.2% in the Euro area in 2021, *see Part 4*). This overall weakness in skills and this heavy tax burden largely explain the low employment rate in France.

CHART 61.
Employment rate and OECD PIAAC survey



Source: P. Artus, "The effects of skills, corporate taxes and the employment rate of those aged 60 to 64 on the employment rate of people aged 15 to 59", Natixis Economic Research, February 2023

62. "France: is public spending the answer?", Flash Economics, Natixis (09 May 2022).

The persistent low employment rate is closely linked to public finances and inequalities. Because fewer people are employed and thus paid and less firms produce domestically, public revenues – a source from which the government can draw to finance long-term public investments – is reduced. As tax revenues are linked to potential production, which in turn is linked to the employment rate, increasing the employment rate would therefore increase tax revenues and so create fiscal space.

There is a negative correlation between income inequalities (before redistribution) and employment rate. The relation is even more pronounced for countries in the path of deindustrialisation, where the quality and the remuneration of the employment has deteriorated. Indeed, workers are suffering a decline of living standards since productivity per capita, and so wages are relatively higher in the manufacturing sector than in the rest of the economy (*see Part 6.1 next section*).

5.4 "Bad jobs" are more prevalent in deindustrialising economies and are concentrated in low-skilled and precarious activities

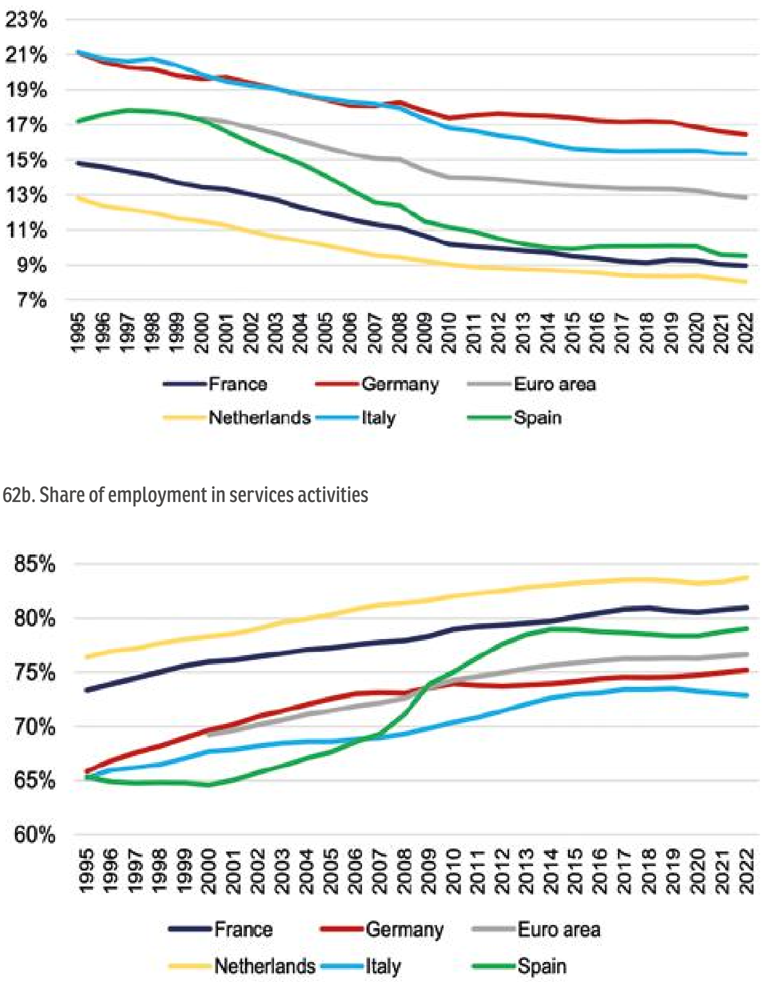
Although employment rates have increased over the past decade, the quality of employment has deteriorated over the same period in some EU Member States. This deterioration is due in particular to the sectoral shift of these economies in favour of services and at the expense of manufacturing activities.

Since the 1980s, manufacturing employment in France, for example, has declined by more than 35%, while jobs in services increased by more than 60%. This pushed employment in the service sector as high as 81% of total employment in 2022, far above the Euro area level of 76.7% (*see Chart 62*). As a consequence, the share of employment in manufacturing dropped significantly in France, from 18.5% in 1985 to 9% in 2022, below the Euro area of 12.9%. Among other major EU Member States, the tertiarisation has been particularly pronounced in Spain and the Netherlands, where respectively 79% and 83.8% of the workforce was employed in the service sector in 2022, from 65.4% and 76.4% in 1995.

CHART 62.
Employment in manufacturing and services activities, as % of total employment

62a. Share of employment in manufacturing activities

62b. Share of employment in services activities

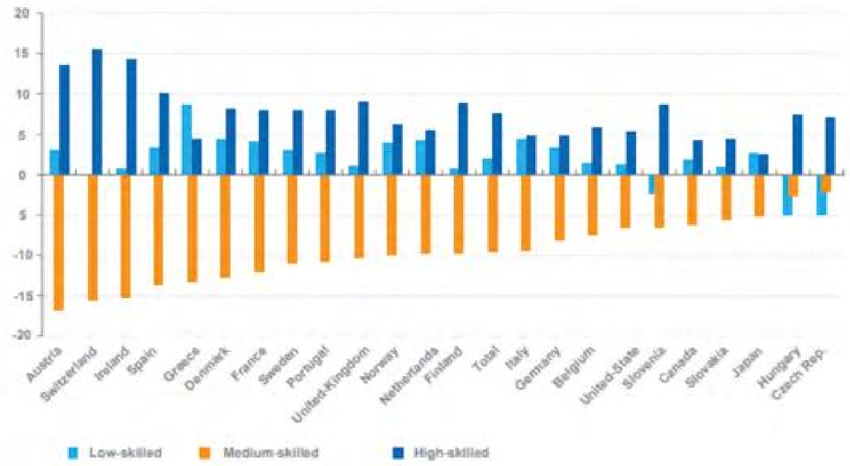


Source: Eurostat

The bulk of job creation in the service sector is concentrated at the extremes of the skill ladder: well-qualified jobs (finance, information and technology, complex business services, etc.) and low-skilled or unskilled jobs (hotel, catering, distribution, transport, leisure, personal services). This labour market polarisation has led to the fall in the share of medium-skilled workers (*see Chart 63*) – formerly prominent in manufacturing-based activities – and the rise in the number of low-skilled, or "bad jobs". The latter are poorly remunerated and characterised by a high degree of precariousness and hardship.

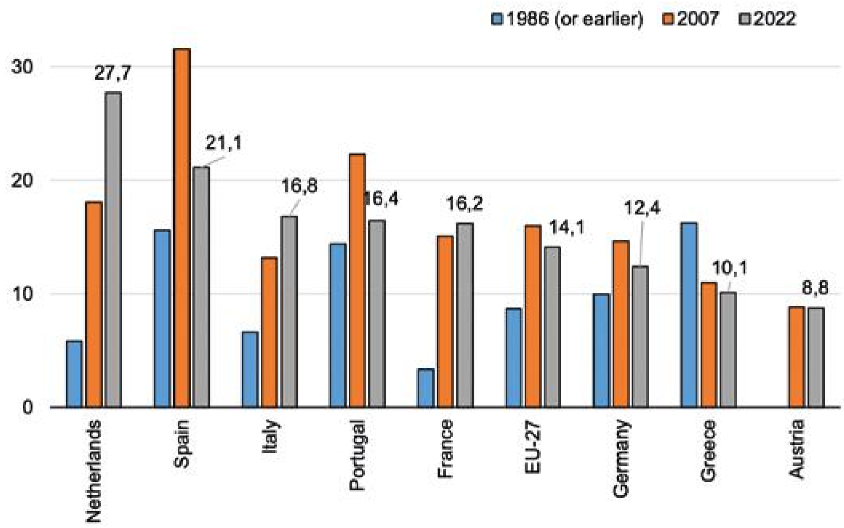
CHART 63.
Change in the share of qualifications in total employment, in percentage points, 1995-2015

Source: OECD (2017), OECD Employment Outlook 2017, based on European, U.S., Canadian, Japanese, and Swiss Employment Surveys
Note: High-skill occupations include jobs classified under the ISCO major groups 1, 2, and 3. That is, legislators, senior officials, and managers (Group 1), professionals (Group 2), and technicians and associate professionals ((Group 3). Medium-skilled occupations include jobs classified under the ISCO major groups 4, 7 and 8. That is, clerks (Group 4), craft and related trades workers (Group 7), plant and machine operators and assemblers (Group 8). The low-skilled occupations include jobs classified under the ISCO major group 5 and 9. That is, service workers and shop and market sales workers (Group 5), elementary occupations (Group 9)



The proportion of temporary employment is highest in countries where employment is mainly concentrated in the service sector, such as Spain or the Netherlands. France, which gradually became a service-based economy over the past three decades, saw the share of temporary employment rising fivefold, from 3.3% of dependent employment in 1983 to 15.1% in 2021 (*see Chart 64*). Although this phenomenon has been widespread across advanced economies through the development of automation notably, it has been even more pronounced in countries experiencing the process of deindustrialisation, according to the OECD[63].

CHART 64.
Temporary employment, as % of total dependent employment



Source: OECD
Notes: Temporary employment includes wage and salary workers whose job has a pre-determined termination date, according to the OECD. This indicator is broken down by age group and it is measured as percentage of dependent employees (i.e., wage and salary workers); data labelled "1986 or earlier" date from 1983 for France, Italy, the Netherlands, Greece, the EU-27; It dates from 1984 for Germany, and from 1986 for Spain and Portugal; The first available data for Austria dates from 1995

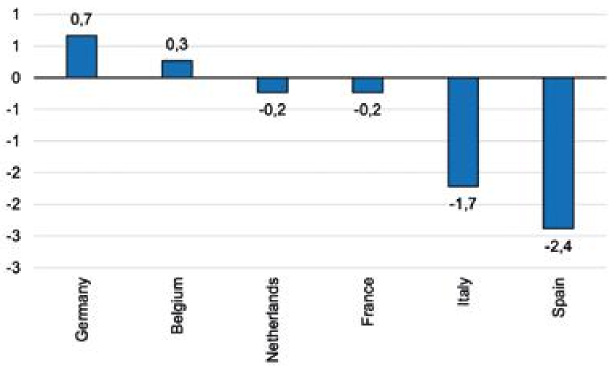
63. "Perspectives de l'emploi : l'avenir du travail", OECD (2019)

5.5 The combination of low employment rate and low productivity growth leads to weak output potential

The combination of low employment rate and low productivity growth – as the result of a lack of productive investments and the persistence of structural rigidities – translates into negative output gaps due to the weakness of the economy. The output gap indicator reflects the difference between the realized GDP and GDP potential[64] levels.

Between 2014 and 2019, countries with low employment rates, Italy and Spain especially, have never registered any positive output gap. With a slightly higher employment rate, France is in better place as it was slightly above the level of Netherlands but remains below the levels Austria and Germany. The three latter countries have all experienced a positive output gap during the two years predating the Covid-19 crisis (*see Chart 65 and Table 5*).

CHART 65.
Average Output Gap between 2014 and 2019, as percent of potential GDP



Source: EU Commission

TABLE 6.
Output gap in selected EU Member States, % of potential GDP

	France	Germany	Italy	Spain	Austria	Netherlands	Belgium
2014	-2	-0,2	-4,5	-8,4	-1,1	-2,2	-0,7
2015	-1,6	-0,4	-3,6	-5,2	-1,2	-1,7	0,1
2016	-1,3	0,3	-2,2	-2,8	-0,5	-0,8	0
2017	0,1	1,7	-0,8	-0,6	0,5	0,6	0,3
2018	1,2	1,3	0,2	0,8	1,8	1,3	0,6
2019	2,2	1,3	0,6	1,9	2,1	1,4	1,3
Avg 2014-19	-0,2	0,7	-1,7	-2,4	0,3	-0,2	0,3
2020	-6,5	-3,2	-8,3	-9,8	-5,4	-4	-5,4
2021	-1,2	-1,5	-2	-5,4	-2,4	-1	-1
2022	0,2	-0,2	0,7	-1,3	1,1	1,2	0,5
2023	-0,3	-0,6	1,1	-0,6	0	1,1	0
2024	0	-0,3	1,3	-0,2	0,2	0,4	-0,2

Source: EU Commission ; data for 2022-2024 are projections taken from the AMECO Spring Forecast, May 2023

64. The maximum level of output if production factors were fully used.

6. The European economy suffers from several structural imbalances

Beyond the increasing fiscal and productivity growth rates and labour market characteristics heterogeneities across the Monetary Union (*see Part 2*), the Monetary Union is suffering from two additional structural vulnerabilities: a growing heterogeneity in productive specialisation and current account imbalances.

The Euro has contributed to strengthening some EU countries' economies and to weakening others. Indeed, the elimination of currency risks is enabling those countries to fully exploit – and even over-exploit – their comparative advantages. This mechanism results in sectorial specialisations and divergent living standards between Euro area countries.

Since 2015, TARGET2 balances have been picking up. Today, these balances are more a reflection of the differences in size between Europe's financial markets than the result of market tensions, interbank market fragmentation or capital flight.

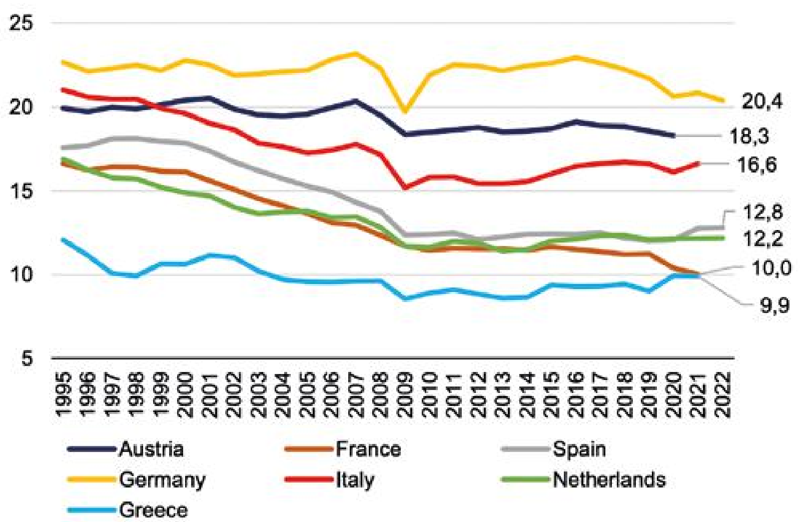
6.1 Growing heterogeneity in productive specialisation

As it is common in a currency area, Member States of the Eurozone have divergent productive specialisations with consequences on relative productivity and potential growth rates. The elimination of foreign exchange risks normally encourages productive specialisation within the Monetary Union; it mainly benefits net exporting countries, the ones that specialise in tradable products for which they exhibit a strong competitiveness.

Moreover, the position of the best performing and most productive countries tends to both further improve as a result of the Monetary Union. Indeed, the economies of the best performing countries benefit from the fact that the external value of the Euro represents an average for the entire economic area and appears undervalued in relation to their economic performance, resulting in an additional competitive advantage. For example, it is estimated that Germany's exchange rate is 20% undervalued, in terms of a real effective exchange rate relative to the Euro area. Its correction would imply, arithmetically, a 2% annual inflation rate in Germany and a 0% inflation in the other countries for a decade – which would be unrealistic and probably misconceived.

In such a context, since the creation of the Euro, the northern countries of the Monetary Union (Germany and the Netherlands in particular) have been able to maintain a competitive industry, while the southern countries (Greece, France and Spain in particular) have progressively experienced deindustrialisation. EU Northern countries have gained market share in world trade, while those of the South have lost market share. Charts 66 and 67 highlight the divergence of industry and tourism across EU Member States.

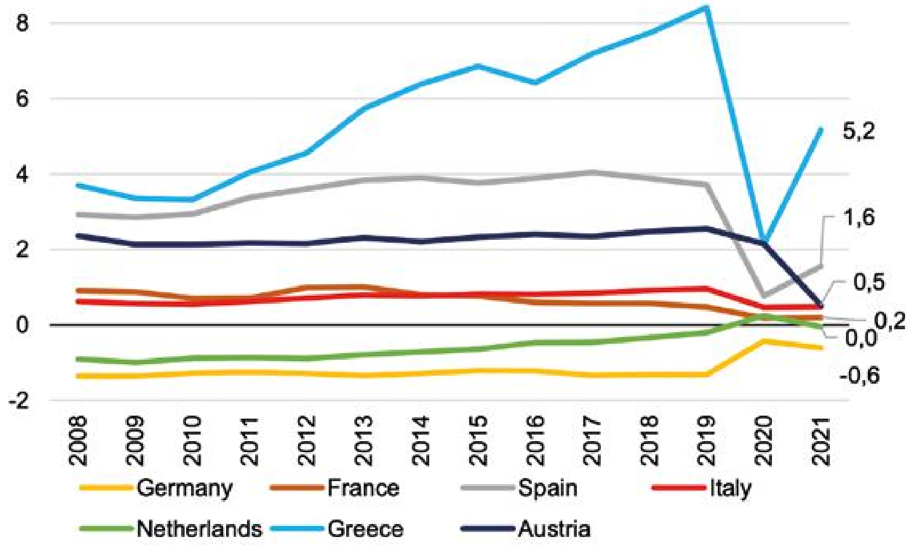
CHART 66.
Share of manufacturing in total value added



Source: OECD
Last observation is from 2021, except for Spain, Germany and the Netherlands which dates from 2022

This chart illustrates in particular the deindustrialisation of France over the last two decades, unlike Germany, Austria and Italy, for all the reasons mentioned above: the level of tax burden and the labour cost are too high due to the excessive weight of public expenditure as proportion of GDP as well as the insufficient level of productive investment.

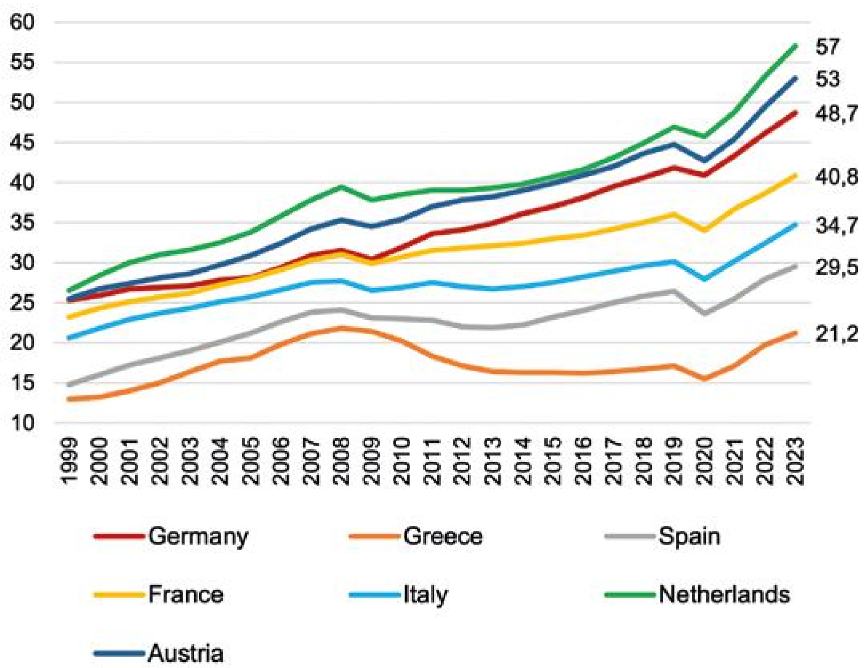
CHART 67.
Balance of payments in travel, % of GDP



Source: Eurostat

This process also leads to a divergence of per capita GDP levels between Eurozone countries. Hence, the Netherlands GDP per capita (current Local Currency Unit) was in 2022 almost three times higher than the Greek one, with EUR 52 600 per capita against EUR 19 700 for the latter (*see Chart 68*). In 2000 it was only twice higher (EUR 28 380 for the Netherlands and EUR 13 230 for Greece).

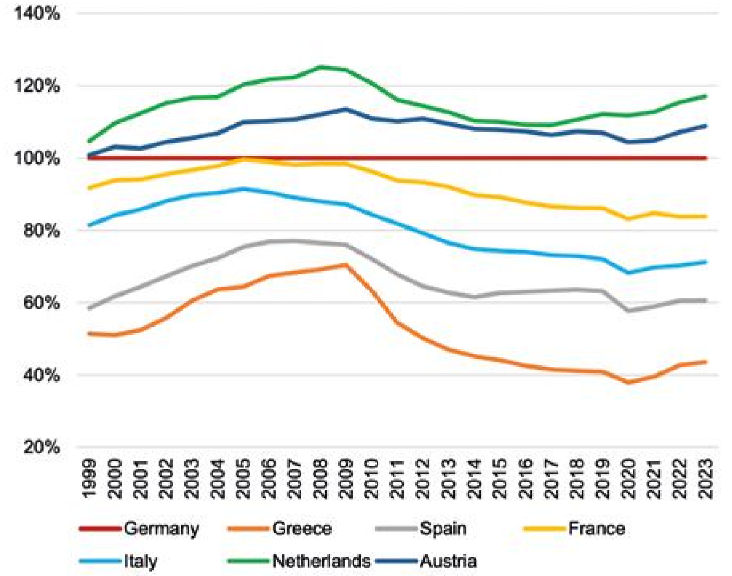
CHART 68.
Per Capita GDP, thousands current euros



Source: AMECO Spring Forecast, May 2023

Another illustration of the growing economic heterogeneities across EU Member States is the gap between per capita GDP of a given country and the German one (*see Chart 69*). Over the past two decades two groups of countries stand out: those having systematically exceeded the level of German GDP per capita, as the Netherlands and Austria, and those that have constantly remained below, such as Italy, Spain, Portugal or Greece. Once close to the first group, since the 2008 Great Financial Crisis, the French per capita GDP has gradually fallen behind, towards the EU low-income countries.

CHART 69.
Per Capita GDP, as % of German Per Capita GDP



Source: AMECO Spring Forecast, May 2023

6.2 The existence in the Euro area of countries with large current account surpluses and countries with persistent current account deficits threatens the coherence, and eventually the existence, of the Economic and Monetary Union (EMU)

Table 7 and Chart 70 underline the existence of significant discrepancies between Member States.

Current account surpluses in Germany and the Netherlands averaged 7.9% and 7.7% respectively, over the 2014-2019 period, while France suffered from a permanent deficit which averaged 0.5% between 2014 and 2019 (*see Chart 70*).

In 2021, Germany and the Netherlands recorded a current account surplus of, respectively 7.4% of GDP and 7.3%, compared to +0.4% in France.

In 2022, the external position (*see Part 3*) deteriorated significantly in the context of the energy crisis. High energy prices led the current account surplus to decline to 4.2% of GDP in Germany and 4.4% in the Netherlands. In France, the current account deficit reached 2.1% of GDP.

In 2023, current account balances should recover thanks to lower energy prices, but imbalances should remain unchanged: Germany and the Netherlands should both record a surplus of 5.9%. In 2023, France is expected to run a deficit of 0.5% of GDP, according to the European Commission's Spring forecasts.

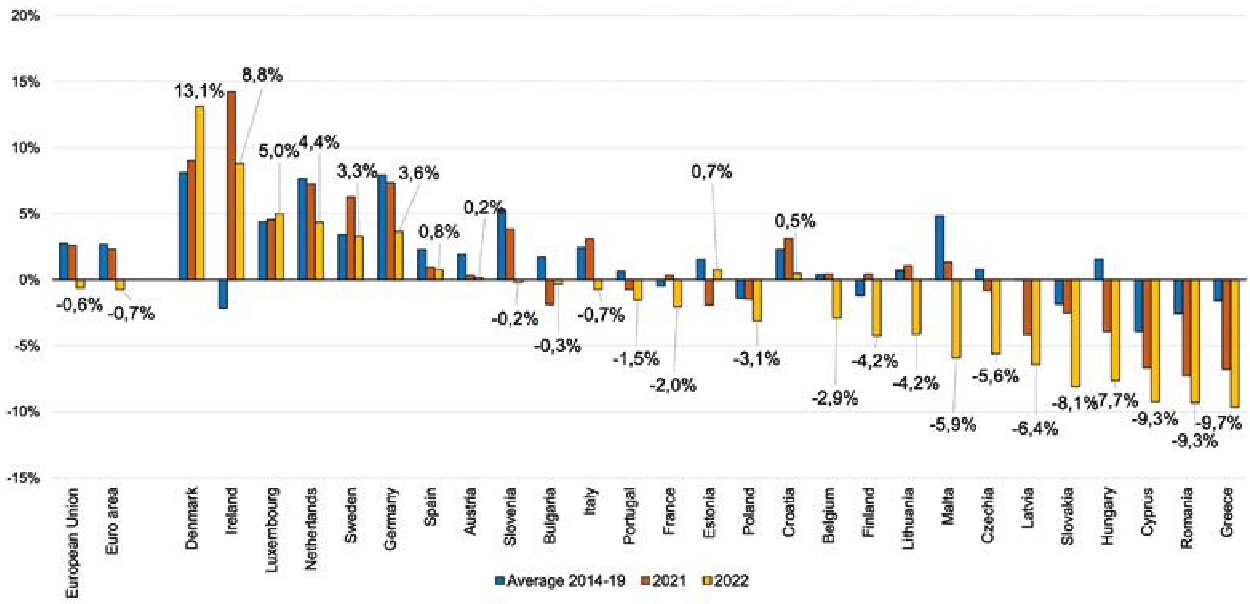
TABLE 7.
Current Account Balance, % of GDP

	2007	Avg 2014-19	2019	2020	2021	2022	2023
France	-0,1%	-0,5%	0,5%	-1,8%	0,4%	-2,1%	-0,5%
Spain	-9,4%	2,3%	2,1%	0,6%	1,0%	0,6%	1,6%
Italy	-1,4%	2,4%	3,3%	3,9%	3,1%	-1,3%	0,0%
Germany	6,9%	7,9%	7,6%	7,0%	7,4%	4,2%	5,9%
Netherlands	6,9%	7,7%	6,9%	5,1%	7,3%	4,4%	5,9%
Austria	3,8%	1,9%	2,4%	3,0%	0,3%	0,2%	0,7%
Euro Area	0,0%	2,7%	2,2%	1,6%	2,3%	-0,7%	0.5%
European Union	-0,2%	2,8%	2,4%	2,1%	2,6%	-0,4%	NA

Source: Eurostat, AMECO
Data for 2023 are projections taken from the Spring Forecast of the EU Commission (May 2023) ; projections for the Euro area 2023 are taken from the IMF World Economic Outlook (April 2023)

In principle, imbalances in a Union are not in themselves a source of concern. But, as it is the case today, these figures are of a durable and structural nature.

CHART 70.
Current account balance across EU Member States, % of GDP



Sources: Eurostat, AMECO

If the Eurozone were the equivalent of a nation, such discrepancies in current accounts would be acceptable.

Indeed, since there would only be one balance of payments for the entire zone, as in the US for example, rebalancing adjustments would take place automatically through the mobility of capital and labour. Sub-regions with high current deficits (and therefore overvalued "currencies") would be winning because they could "import" cheap goods from surplus generating subregions, the latter contributing through this implicit subsidy to the adjustment of the deficit zone.

But in fact, the EMU is composed of national balance of payments and national budget.
Macro-economic imbalances relative to the "highest performing economy" are not a matter to be corrected by the Union. They are issues exclusively dependent on national economic policies.

Since countries cannot adjust their exchange rates to their competitive positions, it is up to the domestic competitive position to adjust to the exchange rate. Devaluations can only be internal and lead to a reduction of domestic demands and revenues.

The problem raised by these imbalances.

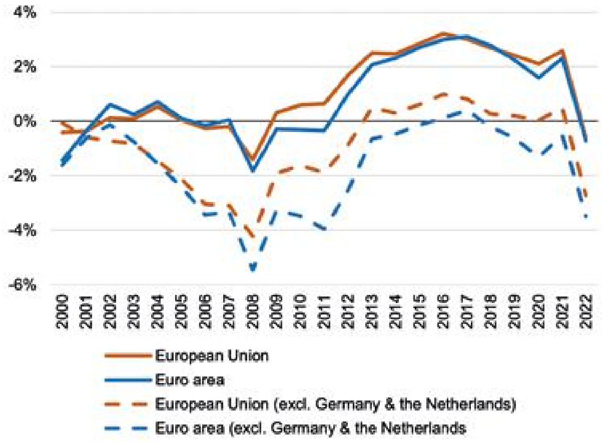
Of course, the objective is not unifying all balances of payments within the EU. Some countries have to catch up from very low standards of living and this necessarily incurs some deficits of balance of payment. However, the dynamics should not compound this heterogeneity but reduce it.

Since the EU sovereign debt crisis (2011-2012), Member States with excess savings (Germany and the Netherlands in particular) no longer finance investment projects in lower per capita GDP countries (Spain, Italy, Portugal, Greece). This is notably due to the interest rate difference between the US and Europe (risk is better remunerated in the US than in Europe), the limited financial flows between Eurozone countries and the insufficient number of investment projects. These limited cross-border capital flows in the Euro area reflect the persistent doubts of investors in Northern Europe about the solvency of states and companies in other countries, as well as the lack of a genuine Banking Union and integrated financial market.

The fact that Germany's and the Netherlands' external surpluses are no longer lent to other Member States reduces the capacity of peripheral countries to invest as well as their potential growth and contribute to increasing the per capita income heterogeneity in the Euro area (*see Charts 62 and 63*).

Consequently, the Euro area exhibits a savings surplus of € 270.2 bn (or 2.2% of GDP in 2019), which is no longer being lent to other Euro area countries but to the rest of the world excluding the Euro area.

CHART 71.
Current Account Balance,
% of Nominal GDP

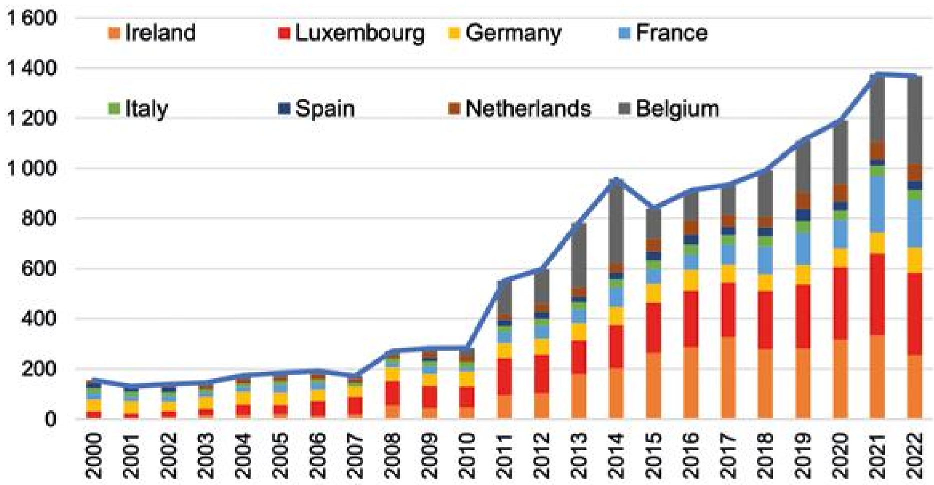


Source: AMECO

The Eurozone's external surplus has largely been used to buy bonds in the rest of the world, in particular US Treasuries (*see Chart 72*).

Between 2000 and 2022, the volume of US federal debt held by Eurozone residents was multiplied by more than ten, increasing from USD 106.3 bn to USD 1.368.5 bn. Within the area, all countries that registered a positive current account balance are lending to the United States (*see Chart 59*) and therefore finance the US external and fiscal deficits. These include Germany (USD 100.7 bn in 2022), the Netherlands (USD 67.4 bn), Luxembourg (USD 329.3 bn), Spain (USD 36.9 bn), Belgium (USD 351.2 bn) and Italy (USD 39.2 bn). Although achieving an average current account deficit, France and Ireland also hold a significant amount of US federal debt, lending respectively USD 189 bn and USD 254.8 bn to the US Treasury in 2022.

CHART 72.
Outstanding Treasuries
held (USD bn)



Source: US Department of the Treasury

Developing cross-border financial flows within the Euro area is essential. The true objective of a currency area is that savings should flow to finance the most productive investments throughout the currency area. Indeed, in a monetary union, the elimination of currency risk allows savings from the countries that have a high level of per capita capital (Germany, the Netherlands, France) to finance investments in the countries with lower per capita capital and higher marginal productivity of capital (for example Spain, Italy, Portugal). Income convergence therefore normally stems from the transfer of savings from high per-capita-income countries to low per-capita-income countries. But, as mentioned above, these transfers disappeared after the 2008-2010 period.

The phenomenon is there to stay. Indeed, we need to take into account a structural feature, which is the increasing specialisation, industry wise, of surplus countries. Success breeds success. Helped by the implicit devaluation stemming from the favourable cost evolution, exports of surplus countries become more profitable.

It would be illusory to believe that the structural advantages of German exports could be transmitted to and copied by Southern or Eastern European countries which have a different industrial story and cannot become little Ruhr (while the Ruhr can become and is becoming stronger).

6.3 Target 2 imbalances in the Eurozone have increased with the ECB's asset purchase programs (2015-2022)[65]

The Trans-European Automated Real-time Gross Settlement Express Transfer System, or TARGET2, allows financial transactions to be settled between commercial banks located in different euro-area countries via a settlement system between national central banks (NCBs) and the European Central Bank (ECB). Transactions accumulate in net terms, resulting in a balance which is recorded on the balance sheet of each NCB[66].

TARGET2 balances are therefore an accounting representation of the cross-border economic and financial relationships that the free movement of capital in the Euro area entails. In addition to trade in goods and services and portfolio investments, these balances reflect a variety of different types of flows of funds: flows between subsidiaries or branches of the same banking group that participate in TARGET2 via different NCBs, flows resulting from non-standard monetary policy measures, and "technical" flows associated with the location of accounts for the settlement operations of securities.

Why is a positive net TARGET2 balance referred to as a claim and a negative balance as a liability?

This has to do with accounting and balance sheets, so to understand this, we must first keep in mind two facts:

- The Euro area has one currency, but because it is made up of multiple countries, there is not one central bank with one balance sheet for the Euro. Instead, each central bank in each country has its own balance sheet. TARGET2 has separate central bank components to reflect this.
- When a central bank issues money for the first time, it is recorded on its balance sheet. The money is recorded on the liability side of the balance sheet (as a deposit), while the assets (or claims) corresponding to the money created are recorded on the asset side (for example as a loan).

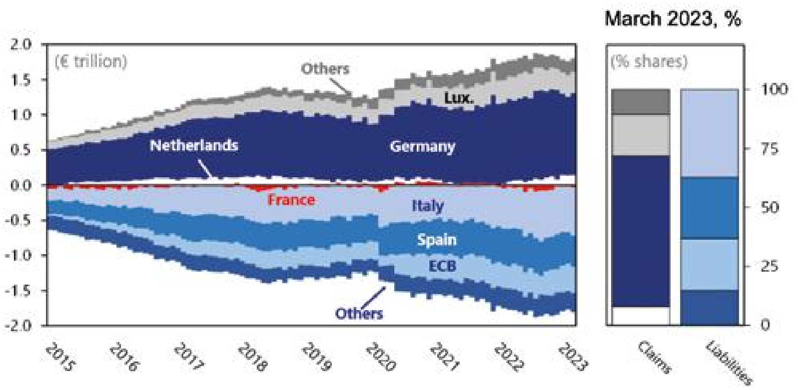
Back to TARGET2: when money moves between Euro area countries via TARGET2, the central bank of the country receiving the money registers this on its balance sheet as an additional liability. But only the liability moves: the asset stays on the original balance sheet.

For example, if euros that were originally issued in Italy end up in Germany, from an accounting perspective, the German central bank has an additional liability (the money), while the asset stays with the Italian central bank. This means the balance sheets no longer balance: the German central bank needs to add a balancing item to reflect that there are now more euros on its balance sheet than it originally created, while the Italian central bank needs to add a balancing item to reflect that it has fewer Euros on its balance sheet than it originally created. This balancing item – which is called the net TARGET2 balance – is a claim (or asset) for the Bundesbank and a liability for the Banca d'Italia.

Since the Euro was created, TARGET2 balances have gone through several distinct phases. Prior to 2008, balances were practically zero: current account imbalances between Euro area countries were settled by means of interbank liquidity transfers. After the 2008 financial crisis and the 2012 sovereign debt crisis, TARGET2 balances rose dramatically due to tensions on the interbank market and a flight of deposits from "peripheral" countries (Italy, Greece, Spain, Portugal, Ireland) toward "core" countries (Germany, Netherlands, Luxembourg), before gradually going back down. Total TARGET2 national surpluses stood at € 900bn in mid-2012 and then gradually declined to stabilise at around € 600bn by the end of 2014.

CHART 73.

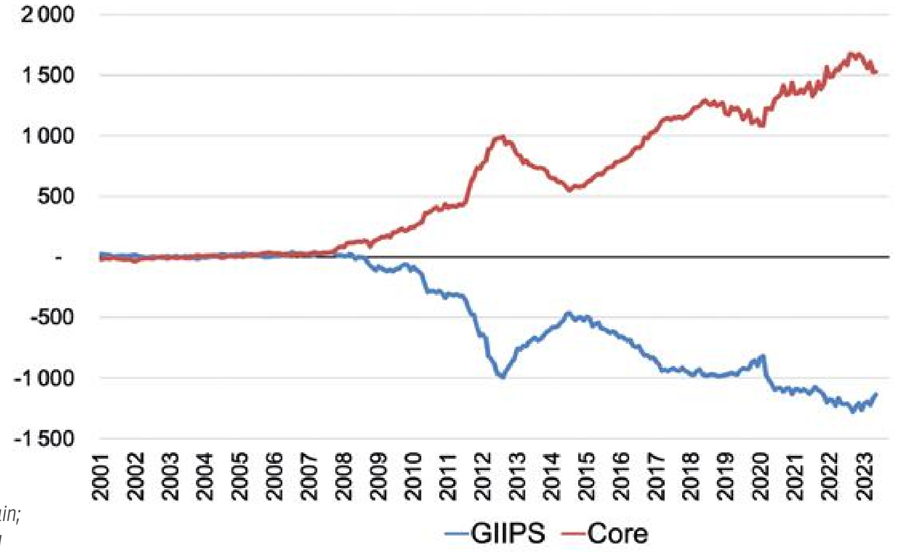
Eurosystem's Target2 Net Claims, 2015-23



Source: IMF

65. This section takes up the conclusions of the note: C. Deubever & Nicolas Toulemond, target 2 imbalances in the euroi area, Tresor Eco, May 2021.
66. TARGET2 ("Trans-European Automated Real-time Gross settlement Express Transfer system 2") is a system that moves money from one bank to another, both within countries and across borders. Central banks and commercial banks use it to process payments in euro and move money safely and easily between them. This is essential for the economy to function. Both central banks and commercial banks have accounts in TARGET2.

CHART 74.
GIIPS's liabilities versus Core's claims, EUR bn

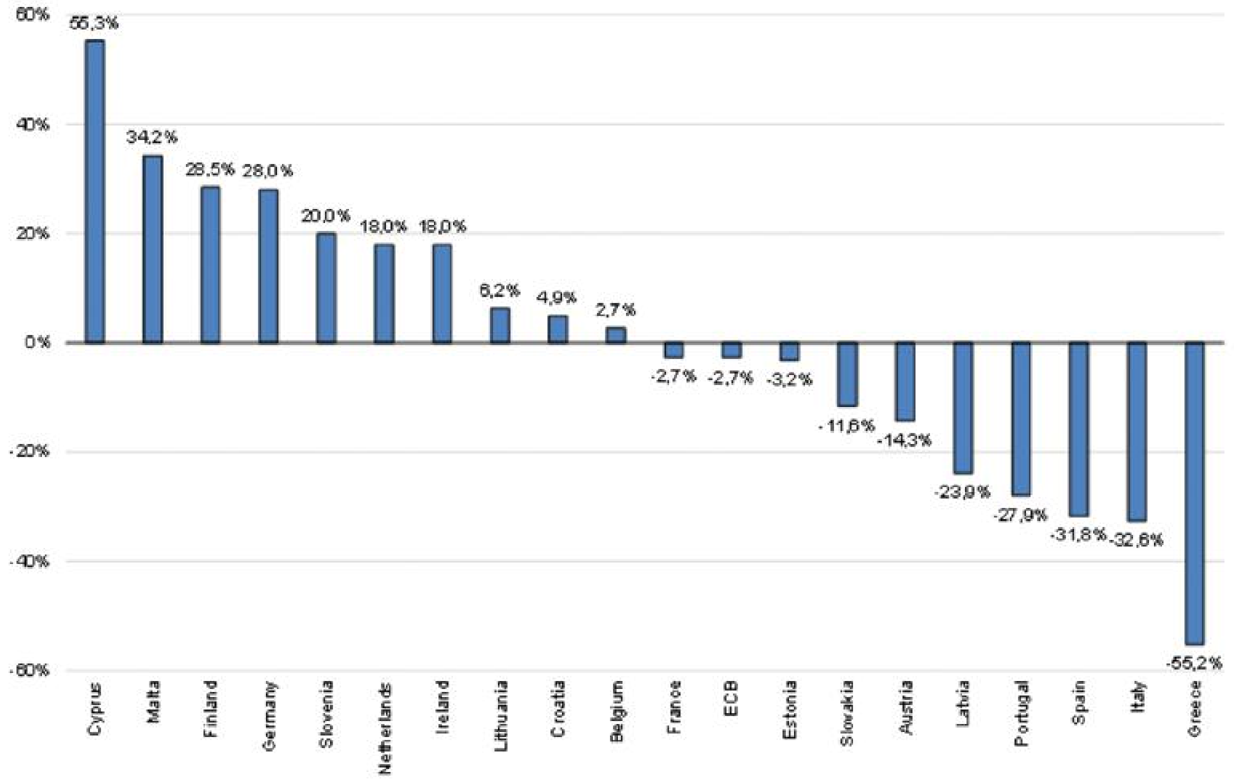


Source: Euro Crisis monitor
GIIPS = Greece, Italy, Ireland, Portugal, Spain;
Core = Germany, Netherlands, Luxembourg
Last observation from May 2023

Since 2015, balances have been picking up again as a result of the ECB's Asset Purchase Programs (APP). Since the mid-2010s, the main TARGET2-liability countries (in € bn) have been Greece, Ireland, Portugal, Spain and Italy, and the biggest surplus countries have been Germany, the Netherlands, Finland and Luxembourg.

The net TARGET2 liabilities of the Bank of Italy and the Bank of Spain are quite high, standing at respectively € 623 bn and € 422 bn in May 2023 (which represents roughly 32% GDP for the two countries). Conversely, the Bundesbank had a net TARGET2 credit of around € 1.082 bn in May 2023 (roughly 28% of Germany's GDP).

CHART 75.
Target2 imbalances as of May 2023, % of GDP



Source: Euro Crisis monitor

Today, balances reflect the legacy of QE bond portfolios and will fall steadily as the ECB reduces its balance sheet.

In January 2017, in a letter to members of the European Parliament, Mario Draghi wrote[67]: “If a country were to leave the Eurosystem, its national central bank’s claims on or liabilities to the ECB would need to be settled in full”.

According to B. Drut[68], “At least three problems would arise in the event of the exit from the Euro area of countries with significant net TARGET2 liabilities:

1. for several countries (Spain, Italy, Portugal), the TARGET2 liabilities are very large when taken as % of GDP, which implies that the amounts needed to settle the commitments would be colossal;
2. in the event of the exit of the Euro area from a relatively weaker country from an economic point of view, its new currency would probably be weaker, which would further increase the settlement to be made;
3. would a country leaving the Eurozone necessarily want to settle all its commitments? We have seen in the case of Brexit that some British politicians were totally opposed to the divorce bill”.

In the end, the TARGET2 imbalances (and the potential losses in case of departure from the Eurozone and the non-settlement of the TARGET2 balances) might strengthen the bargaining power of debtor countries in the case of harsh negotiations with core countries.

TARGET2 imbalances should fall as the ECB reduces its Asset Purchase Programs and, more generally, if progress is made on the Banking Union and Capital Markets Union to the extent that cross-border flows will be more north-south than south-north.

67. Letter from Mario Draghi to the members of the European Parliament Marco Valli and Marco Zanni, January 2017.

68. B. Drut, “TARGET2 imbalances, again at the center of attention”, CPR, 2018.

Conclusion: For a more dynamic economy in the Eurozone

A monetary union does not by itself create economic convergence. This Scoreboard underlines that the Eurozone is a currency area comprising heterogeneous countries with a low level of federalism (their productivity levels, productive specialisation, level of fiscal deficits and indebtedness, and level of labour force skills being very different).

As we have observed, many Member States have relaxed their macroeconomic discipline over the last twenty years and those who played the card of fiscal vigilance turned out to be the winners. The Covid-19 crisis has exacerbated these existing heterogeneities across EU Member States. In this context, it is important for the implementation of Next Generation EU to be successful.

It is an illusion to try to solve the structural problems of our economies by prolonged increases in public or private debt or by using money creation. Yet this is what has been too often tried by pursuing lax fiscal and monetary policies that inevitably pose systemic risks to financial stability and therefore to future growth. It is not because budget deficits are monetized that they disappear. In addition, the quality of a state's signature is an essential element of confidence that shall be preserved at all costs for the country's future.

But as long as it is not sufficiently understood, especially in highly indebted countries, that over extended debt is a source of under-competitiveness, the economic situation in these countries will continue to deteriorate and it will be all the more difficult to make progress in the construction of an economic and financial Europe. Indeed, the intensity of fiscal and economic divergences between EU countries makes it more difficult to define in Europe a common interest, encourages a policy of "every man for himself", creates a climate of mistrust between Member States which hinders any progress in terms of public and private risk sharing and weakens the Eurozone.

It is economic growth that eventually solves indebtedness issues. The only way of promoting robust growth in the EU is to implement ambitious structural reforms in all Member States.

If Europe and the Eurozone are to correct their growth disadvantage in relation to the United States and China and not be relegated to the rank of second-rate powers, a considerable investment effort in research and development, in industrial equipment, in decarbonisation, in digital technology, in improving equity financing, the education system and the skills of the population, in promoting selective immigration of "people" who can occupy sufficiently skilled jobs, will therefore be necessary.

We must understand that our future – non-inflationary – depends on the elasticity of supply, and thus on sufficient investment and a well-trained workforce. Anything that encourages savings to be turned into liquid investments at the expense of long-term tangible investments must be fought.

As explained by J. de Larosière in his latest book, "one day we will have to understand that the narrowing of the output gap between potential and observed growth cannot be reduced to the mere fight against the restoration of production chains, but requires the activation of all the sources that ultimately constitute our eco system: productive investment – penalized for 20 years by lasting very low interest rates – , the development of training, the recovery of the share of wages in income, the revitalization of competition... To revive productive investment, refrain from administratively setting ("or guiding" the market) long-term interest rates and accept to let the market remunerate savings in the medium and long-term according to supply and demand without which there can be neither productive investment nor productivity gains".

Monetary policy can erase spread differentials but cannot address structural issues and notably the lack of confidence and the persistence of structural discrepancies, which explains the limited capital flows from North to South. Europe benefits from a large pool of savings which could contribute to finance long term investments and especially those related to the green and digital transitions, provided that such savings are not taxed but remunerated. However, these savings leave the EU and finance the rest of the world (in particular the United States).

This is notably due to the interest rate differential between the US and Europe (risk taking is more rewarded in the US than in Europe), the limited financial flows between the Eurozone countries and the insufficient number of investment projects. These limited cross-border capital flows in the Euro area highlights the lack of a genuine Banking Union and integrated financial markets as well as persistent doubts of some investors in Northern Europe about the solvency of states and companies in other countries.

If the divergence of interest rates between the two sides of the Atlantic continues to increase in favour of the United States, the problem of transfer savings to higher interest rate areas could have very negative consequences for Europe.

The result of a too slow monetary normalisation in the Euro area, in a context of persistent high inflation – HICP inflation is above 2% in the Eurozone since April 2021, still reached 5.3% in July 2023 while core inflation stood at 5.5% in June – would be an acceleration of inflation and low growth (productive investment would continue to fall as we have seen over the past 20 years in periods of very low interest rates).

Consequently, the Eurozone has to embark on the right course: fighting inflation, which requires vision and courage, more fiscal responsibility and more supply reforms geared to increase productivity, as well as steps to complete the Banking Union and implement the Capital Market Union. But this move can only be envisaged if sufficient discipline starts reversing the trend of ever-growing economic heterogeneities across Member States.

Ultimately, the paradox of the Euro is that a single currency and national economic policies coexist without a strong cement of coordination. Ultra-accommodating and asymmetric monetary policy have been used to overcome the contradictions of this paradox, but the price of this permanent rescue is costly. It is essential to ensure convergence of fiscal and structural policies. An intelligent revision of the Stability and Growth Pact should help to resolve these contradictions and thus make the euro sustainable.

To be viable, the Eurozone needs:

- **To combat very high and persistent inflation without further delay by gradually returning to positive real interest rates.** As the 2022 annual economic BIS report reminds us, the most pressing monetary policy task is to restore low and stable inflation and to sustainably rebuild monetary buffers. Higher rates will also reduce central banks remittances to the governments. The reappearance of spreads should not dominate the decision-making process.

  It is usual in times of high inflation to increase nominal and real interest rates to avoid further increases in demand. The recommendation is therefore to continue to raise interest rates and gradually move to positive real interest rates. This would only not be the case if the economy were in a deep economic crisis with rising unemployment or a risk of deflation, which is not the current situation (nor the one that has prevailed since the beginning of the second quarter of 2021, when inflation returned strongly). As of June 2023, real interest rates in the Eurozone were more negative than before the war in Ukraine. It seems difficult to fight inflation with such an incentive for indebtedness.

  We must not allow ourselves to fall into the trap of schizophrenia, *i.e.*, to believe that if we fight inflation, we will worsen the financial crisis by introducing less growth. On the contrary, we can continue to curb inflation by raising interest rates and at the same time provide liquidity to banks that need it. The money creation that would result from this injection of liquidity is not of the same nature as QE because it would not contribute to the credit dynamic.

- **National budgets under control in all parts of the Union.** No responsible state can be expected to durably finance current public deficits generated by other Eurozone members of the Union that do not follow the rules of the Union. The future – and notably the solution to market fragmentation – depends on a consolidation of present weak fiscal positions (primary surpluses) and a shift towards quality of expenditure and investment. We do not need more redistributive expenses. We must rein them in and allow adequate space for public investment.

  We have to recognize that the shift towards more investment will require substantial political effort; presently public investment only accounts for some 4% of GDP while current – non-productive expenditure – represent almost all public expenditure. As much as we need to fight against unproductive spending, we can encourage the financing of infrastructure spending (including research). The revision of the Stability and Growth Pact is of paramount importance in that regard. Postponing discussions on the revision of the Pact delays the solution, exacerbates tensions within the market (due to the lack of benchmarks) and only complicates the resolution of problems that are likely to become even more acute.

- **Domestic structural measures aimed at enhancing business dynamism and increasing growth potential should be encouraged and monitored.** We have seen that the economic and financial model based on monetary abundance, the under-remuneration (taxation) of savings, the financialization in response to structural insufficiencies, the systematic short-termism, and the increase in the – essentially speculative – valuations of financial assets, does not meet the needs of our society. These needs require long-term investments, a response to climate and digital challenges, an adequate return on savings and salaries. Without such a reorientation of our policies, it seems difficult to achieve the “common good” and to correct the major current imbalances.

Reducing output gaps cannot be ensured just by subsidies to the labour markets. This requires more substantially to increase the productivity of the system, which needs more competition and long-term investment. Making Next Generation EU a success is therefore essential and should contribute to boosting potential growth.

Last but not least, it is necessary to refrain from fixing administratively ("or directing" the market) long-term interest rates and to accept to let the market remunerate medium and long-term savings – according to supply and demand – without which there can be no productive investment or productivity gains.

- **An active banking and integrated capital market in Europe.** In sum, members of the Monetary Union must act together to make it work, and not behave as passive individual bystanders hoping that things will turn out fine. Ultimately, the fate of euro will depend on the political will to achieve genuine cooperation within the Euro area.

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