EURO PLUS MONITOR

SPRING 2016 UPDATE

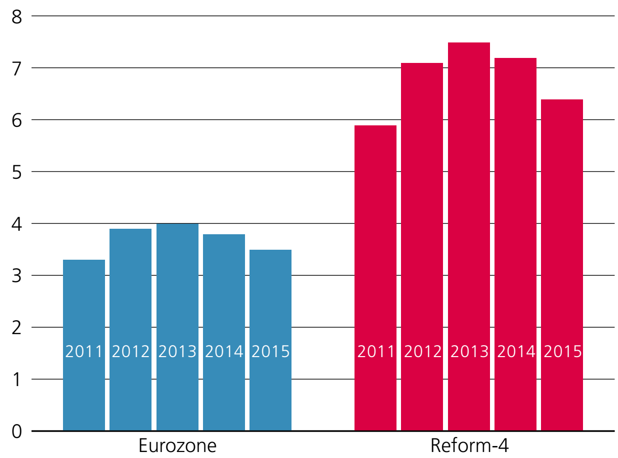
Economic Progress Amid Rising Political Risk

Europe can adjust. It has done so before. In the 1980s, Margaret Thatcher cured the "sick man of Europe." In the 1990s, Scandinavian countries reformed their bloated welfare states. From 2004 to 2006, Germany turned its struggling economy into a new growth engine for Europe through serious labour market and welfare reforms. And, in many respects, the transformation of most post-communist countries since 1990 dwarfed even these successful examples of change.

At least in the economic sphere, Europe is making significant strides again. In the last six years, the financial crisis of 2008 to 2009, the euro confidence crisis of 2010 to 2012, and the ongoing process of globalisation have posed new challenges for all European economies. Step by step, major parts of Europe are coming to terms with these issues. However, progress is far from smooth. Some countries are lagging behind badly. And a recent slackening of adjustment progress among previous reform leaders in Europe highlights the risk that countries may still squander their hard-won gains if they reverse some of their key reforms (see Chart 1 below for more).

Chart 1. Modest Slowdown: The Pace of Adjustment

Adjustment Progress Indicator 2011-2015



Reform-4: Spain, Greece, Ireland and Portugal
Scale 0 (worst) to 10 (best)
Source: Berenberg calculations

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The Euro Plus Monitor is a joint research project between Berenberg, one of the leading privately owned banks in Europe, and the Lisbon Council, a Brussels-based think tank. First published in 2011, The Euro Plus Monitor has become a premier competiveness ranking of eurozone countries, as well as Poland, Sweden and the United Kingdom.

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‘Political shocks such as a “Brexit” or reform reversals are the major risks to watch.’

Since 2011, Berenberg and the Lisbon Council have tracked the response to these challenges – or the lack thereof – for 21 European countries in an **Adjustment Progress Indicator**. Over this period, we detected three major waves of reforms:

- First, the small Baltic economies, which had already succumbed to a major financial crisis in 2007, reformed themselves rapidly. Having done so successfully, they could afford to reduce their adjustment efforts over the last four years.
- Second, the euro confidence crisis forced a brutal front-loaded adjustment on the economies at the southern and western periphery of the eurozone from 2010 onwards. Countries had to correct past excesses in public and private spending. Governments and households had to curtail what they consume relative to what they produce and earn. The medicine was bitter. But by and large, it worked. Having emerged from their adjustment crisis, most of these reform countries have now started to relax the reins again somewhat.
- Third, we are starting to find some evidence that **Italy, Belgium** and to a lesser extent **France** are starting to follow suit, improving their scores in the ranking for adjustment progress.

All in all, Europe has come a long way since the height of the euro crisis in 2011 and 2012. Economic growth is close to its trend rate of 1.6% in the eurozone and 2.1% in the **United Kingdom,** and unemployment is falling noticeably across most of the region. Cyprus, Estonia, Ireland, Latvia, Lithuania and Spain show that there is life after pain – just as the United Kingdom, Scandinavia and **Germany** showed before.

While the **eurozone’s** initial economic recovery was driven mostly by exports, consumer spending has now taken over as the major contributor to demand growth. As a result, the recovery is more broad-based and better entrenched than before. Potential political shocks such as a “Brexit” or genuine reform reversals are now the major potent risks to watch.

‘The indicator tracks progress on the four most important measures of adjustment.’

Adjustment Progress Indicator

Once a year, Berenberg and the Lisbon Council examine the fundamental economic health and recent adjustment progress of 21 European economies. We published the last full set of results in *The 2015 Euro Plus Monitor* on 14 December 2015.[1] In *The Spring 2016 Update*, we look only at the Adjustment Progress Indicator. In addition, we take advantage of recent data releases to update the rankings based on full data sets for 2015, including the second half of the year.[2]

The Adjustment Progress Indicator, which forms the heart of this analysis, tracks the progress countries have made on the four most important measures of short- to medium-term adjustment: 1) the rise (or fall) in exports relative to imports in the external accounts; 2) the reduction (or increase) in the fiscal deficit, adjusted for interest payments as well as cyclical and one-off factors; 3) changes in unit labour costs relative to the eurozone average, and 4) structural reforms. The first three adjustment criteria measure changes that are almost immediately visible in hard economic data: fiscal tightening affects economic statistics almost instantaneously because it represses domestic demand and steers resources towards export-

Table 1. Adjustment Progress Indicator

Rank		Country	Total Score			External adjustment			Fiscal adjustment			Labour cost adj.			Reform drive		
2015	2014		2015	*Change*	2014	2015	*Change*	2014	2015	*Change*	2014	2015	*Change*	2014	2015	*Change*	2014
1	1	Greece	7.7	*-1.0*	8.7	7.4	*0.0*	7.4	8.9	*-0.7*	9.5	7.6	*-0.3*	7.9	7.0	*-3.0*	10.0
2	2	Ireland	7.1	*-0.6*	7.7	7.0	*-0.3*	7.3	6.9	*-0.2*	7.2	9.3	*0.2*	9.1	5.1	*-2.3*	7.4
3	3	Spain	6.2	*-0.8*	7.0	7.0	*-0.2*	7.1	6.3	*-1.0*	7.2	5.8	*0.0*	5.7	5.6	*-2.2*	7.8
4	6	Cyprus	6.0	*-0.1*	6.1	4.0	*0.4*	3.6	7.6	*-0.9*	8.5	6.4	*0.2*	6.2	n.a.	*n.a.*	n.a.
5	5	Portugal	6.0	*-0.6*	6.5	6.0	*-0.1*	6.1	6.7	*-0.7*	7.4	5.8	*0.7*	5.1	5.4	*-2.1*	7.5
6	4	Latvia	5.8	*-0.8*	6.6	9.1	*-0.2*	9.4	3.6	*-0.2*	3.8	4.8	*-1.8*	6.6	n.a.	*n.a.*	n.a.
7	7	Estonia	4.9	*-0.8*	5.7	7.3	*-0.2*	7.5	2.5	*0.3*	2.1	4.9	*-1.5*	6.4	4.7	*-1.9*	6.5
8	8	Slovakia	4.7	*-0.4*	5.1	6.4	*0.2*	6.2	6.2	*-0.4*	6.7	2.9	*-0.4*	3.2	3.2	*-1.2*	4.3
9	9	Slovenia	4.5	*-0.4*	4.9	6.7	*0.1*	6.6	4.4	*-0.3*	4.6	4.8	*0.3*	4.4	2.1	*-1.8*	4.0
10	11	Poland	4.0	*0.0*	4.0	4.9	*0.3*	4.7	6.3	*0.1*	6.2	0.4	*-0.1*	0.5	4.3	*-0.3*	4.6
11	12	Italy	3.9	*0.1*	3.7	4.0	*-0.1*	4.1	4.3	*-0.3*	4.6	3.3	*0.0*	3.4	3.8	*0.9*	2.9
12	10	United Kingdom	3.5	*-0.5*	4.0	2.6	*-0.1*	2.7	5.0	*0.3*	4.8	3.4	*-0.2*	3.7	3.0	*-2.0*	5.0
		Euro 18	3.5	*-0.3*	3.8	4.2	*0.0*	4.1	4.2	*-0.3*	4.5	2.4	*0.0*	2.4	3.3	*-1.0*	4.3
13	13	Malta	3.4	*0.0*	3.4	5.3	*-0.9*	6.2	2.0	*-0.3*	2.2	2.9	*1.0*	1.9	n.a.	*n.a.*	n.a.
14	14	Netherlands	3.1	*0.1*	3.0	5.1	*0.2*	4.9	3.1	*-0.5*	3.6	2.3	*0.3*	1.9	1.9	*0.3*	1.7
15	15	Luxembourg	3.0	*0.1*	2.8	4.5	*0.5*	4.0	1.4	*-0.8*	2.2	5.9	*0.9*	5.0	0.0	*0.0*	0.0
16	16	France	2.8	*0.1*	2.7	2.6	*-0.1*	2.7	4.0	*0.1*	3.9	1.6	*0.0*	1.6	2.9	*0.1*	2.8
17	17	Austria	2.6	*-0.1*	2.7	3.2	*-0.2*	3.3	3.0	*0.7*	2.3	0.9	*-0.2*	1.1	3.2	*-0.8*	4.0
18	18	Germany	2.2	*-0.1*	2.3	3.3	*0.1*	3.3	3.8	*-0.2*	3.9	0.7	*-0.2*	0.9	1.1	*0.1*	1.0
19	20	Belgium	2.2	*0.3*	1.9	4.3	*0.6*	3.8	1.0	*-0.1*	1.1	2.2	*0.4*	1.8	1.3	*0.2*	1.1
20	19	Finland	1.5	*-0.5*	2.1	1.2	*-0.2*	1.3	0.0	*0.0*	0.0	2.2	*-0.2*	2.4	2.8	*-1.6*	4.4
21	21	Sweden	1.2	*-0.3*	1.6	2.2	*0.3*	2.0	0.0	*0.0*	0.0	0.8	*0.1*	0.7	1.9	*-1.7*	3.6

Scores: For the scores, we rank all sub-indicators on a linear scale of 10 (best) to 0 (worst). Having calculated the results of the sub-indicators, we aggregate them into an overall score for each country.

Change: This refers to the change in score relative to last year. Note that our scores and ranks for 2014 can differ slightly for some countries from those published in the 2014 and 2015 issues of *The Euro Plus Monitor* due to subsequent revisions of back data for labour costs, net exports and some other parameters.

Ranks: Based on the scores, we calculate the relative ranking of each country, with the No. 1 rank to the country with the highest and the No. 21 rank to the one with the lowest score.

1. See Holger Schmieding, *The 2015 Euro Plus Monitor: More Progress, New Risks,* (London/Brussels: Berenberg and the Lisbon Council, 14 December 2015). We will add Lithuania to the analysis in the next full report in December 2016.
2. We also incorporated some modest revisions to previous official data. To make sure that the comparison of the current results with those of our previous analyses was not distorted by such revisions of back data, we recalculated the results of the previous analysis based on the revised data. In the table on adjustment progress, we compared the scores for the full set of data extending to the end of 2015 with the marginally revised scores based on the data for late 2014 as they stand now.

‘Many readings for adjustment progress are slightly below those of December 2015.’

oriented activities. But the structural reforms measured in criterion no. 4 refers often work with a long time lag. They may not show up in hard economic data for a year or two after they have been implemented, but they are a crucial element of the repair process.

For *The Euro Plus Monitor Spring 2016 Update,* we calculated these four sub-indicators for each country on a scale from 0 (worst) to 10 (best). Using equal weights, we then aggregated the sub-indicators into an overall score for the Adjustment Progress Indicator. We then calculated the relative ranking of each country, with the No. 1 rank going to the country with the highest score and the No. 21 rank to the one with the lowest.

By and large, the results are similar to the ones we presented in *The 2015 Euro Plus Monitor*. But many readings for adjustment progress are slightly below those of December 2015. There are two major reasons for this. First, the OECD’s most recent interim assessment of reform progress in 2015 published in early 2016 revealed that – with some notable exceptions, including **Belgium, France, Italy** and **The Netherlands** – many countries have become less responsive to reform recommendations, including those coming from the OECD. Second, new data from 2H 2015 shows export growth slowed in the second half of the year as demand from China and other emerging markets weakened. That weighed on the scores for external adjustment progress.

All in all, Europe remains on the right track. Most countries continue to adjust to the challenges posed by the erstwhile euro crisis as well as the competitive pressures of globalisation. As in previous years, the five peripheral countries that received support from European facilities (bilateral loans, European Financial Stability Facility or European Stability Mechanism credits often topped up by the International Monetary Fund), are the star performers in the adjustment ranking. This contradicts the occasional assertion that such support could tempt the recipients to slow down their adjustment. We find no “moral hazard.” Instead, **Greece, Ireland, Spain, Cyprus** and **Portugal** have adjusted faster than all other countries in the sample. They had to do it. And they did it. As a result, unemployment is falling rapidly in most of the reform countries (see Chart 2 for more).

But in one key respect, the results for 2015 differ from previous years, including 2014, which is given in Table 1 for comparison. The four countries that succumbed to the euro-confidence crisis first, namely **Greece, Ireland, Portugal** and **Spain,** reduced their adjustment efforts significantly in 2015 (see Chart 1 on page 1). Of the top five performers, only latecomer **Cyprus** did not let its adjustment efforts slip noticeably. For **Ireland, Spain** and to a lesser extent **Portugal,** the drop in score is mostly part of the return to a more normal life after the end of the crisis. After compressing domestic demand and imports drastically during the crisis, they no longer need to adjust as rapidly as before. Instead, they can afford to relax the fiscal reins slightly and let imports rise faster than exports. In that sense, a reduced adjustment effort is a sign of success.

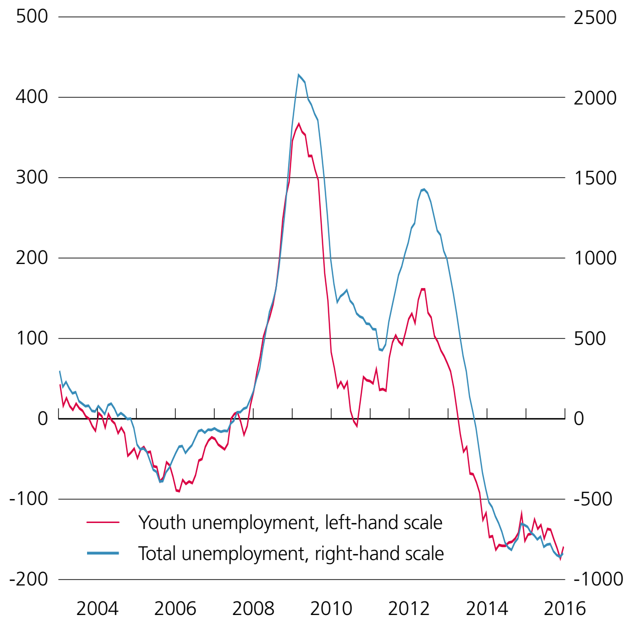
Nonetheless, the drop in the score by 0.8 points for **Spain** and by 0.6 points for **Ireland** and **Portugal** is too pronounced for comfort. These three countries need to watch that they do not squander their hard-won gains.

Greece continues to lead the adjustment ranking, as it has done in the years 2012 to 2014. This time, however, its score for adjustment progress falls by a full point, the worst drop ever in the adjustment rankings for any fiscally challenged country. Whereas the less pronounced declines in **Ireland, Portugal** and **Spain** partly reflect a reduced need to adjust as previous efforts bear fruit, the lower score for Greece is the result of a major new shock. In 2015, Greece inflicted upon itself the worst-possible combination of reform reversals and confidence-shattering confrontation with creditors. As a result, Greece propelled itself back into recession. In Ireland, Spain and to a lesser extent Portugal, the slackening of adjustment efforts came at a time of significant economic growth.

By sowing uncertainty and chasing capital out of the country in record amounts, **Greece** has weakened it economic and fiscal position dramatically (see the Focus on

Chart 2. Back to Work

Year-on-year change in the number of unemployed in Spain, Greece, Portugal and Ireland in 1000s



Source: Eurostat

‘No other country has introduced more pro-growth reforms in the last two years than Italy.’

Greece on page 17). That Greece still gets the No. 1 place in the overall adjustment ranking is for only one reason: we measure aggregate progress since 2009. Greece worked hard to improve in previous years. So far, the political shock of 2015 has only undone part of that progress. If Greece and its creditors can now conclude the pending review of the Greek adjustment and support programme fast and in a satisfactory way and if Greece follows up with the required reforms, the outlook for Greece may improve again soon.

Despite some significant slippage, **Ireland** (No. 2) and **Spain** (No. 3) take the next two positions in the overall adjustment-progress ranking. Bucking the trend among the erstwhile programme countries, **Cyprus** surges to No. 4, up from No. 6 in 2015, with an almost unchanged score while all other frontrunners relaxed the reins somewhat. Because Cyprus fell into crisis later, it is still at the stage of serious ongoing adjustment which Spain and Ireland left behind in 2015 already.

Against the trend of reduced adjustment efforts, some of the erstwhile laggards are now shaping up. **Italy** (No. 11, up from No. 12) is benefitting from the reforms of Prime Minister Matteo Renzi. No other country in the sample has introduced more pro-growth reforms in the last two years than Italy. **France** (No. 16) has finally started to address some of its serious structural problems. If it follows up with more serious labour market reforms, it may no longer be the sick man of Europe in a few years’ time. **Belgium** (No. 19) remains close to the bottom of the adjustment league. Fortunately, it has moved up somewhat. All in all, we view the shift of adjustment efforts away from erstwhile euro-crisis countries towards the eurozone’s big laggards as a (mostly) positive development.

A low score on the Adjustment Progress Indicator can mean two different things. On the positive side, it can signal that countries are not adjusting much because they do not need to. This is the case for **Luxembourg** (No. 15), **Germany** (No. 18) and **The Netherlands** (No. 14). These countries scored well in the separate **Fundamental Health Indicator** in December 2015, where Germany, Luxembourg and The Netherlands took the No. 2, No. 3 and No. 4 slots, respectively. They have less need for adjustment than other countries in the sample.[3]

To some extent, low scores for **Germany** and **The Netherlands** on recent adjustment progress are part of the convergence within the **eurozone** towards best practice. These countries do not need to adjust as much as other countries. Due to their above-average results in the overall Fundamental Health Indicator presented in *The 2015 Euro Plus Monitor,* they can afford a relatively relaxed fiscal stance and an above-average rise in real unit labour costs for a while. They also have a less pronounced need for immediate structural reforms than countries with lower scores. Unfortunately, success can breed complacency. While still in good fundamental health for the time being, Germany, The Netherlands and **Sweden** are showing even more signs of complacency than before. Over time, they will need to stop their slippage and implement more serious pro-growth structural reforms again. Otherwise, they will lose their competitive edge over time.

On the negative side, a low score in the Adjustment Progress Indicator can be a harbinger of trouble to come, especially for countries that are in urgent need of reform (as suggested by a simultaneous low score in the Fundamental Health Indicator). In the last few years, **France, Belgium** and **Finland** exhibited the worst combination: hardly any adjustment progress despite boasting some of the worst long-term fundamentals in the sample. This time, we find a little bit of progress in Belgium and France. Most importantly, both countries have become more serious about pro-growth structural reforms. While their scores remain far too low even on this count, at least the momentum is going in the right direction. As a result, Belgium moves up the ranking to No. 19, up from No. 20. It trades places with **Finland,** now ranked No. 20. **France** stays at position No. 16.

Of the three non-euro countries in our sample, **Poland** (No. 10, up from No. 11) maintained its adjustment efforts with an unchanged score of 4.0, somewhat above the eurozone average of 3.5. Note that the analysis does not yet include the current initiatives by Poland’s new government. The partial reversal of a pension reform, higher minimum wages and more government spending could hurt Poland’s fiscal sustainability and hence its position in the ranking in coming years.

Sweden (No. 21) stays at the bottom of the Adjustment Progress Indicator with a further drop in its score largely because it has fallen behind even further on pro-growth structural reforms.

The score for the **United Kingdom** (No. 12, down from No. 10) dropped to 3.5 (down from 4.0 in 2014). This is the second significant slippage for the United Kingdom in a row. This time, we see two major reasons for the lower score. First, in election year 2015, the United Kingdom slowed the pace of structural reforms. Second, real unit labour costs rose in the United Kingdom by 0.4% in 2015 whereas they fell by 0.6% in the **eurozone**. As a result, the overall United Kingdom score for adjustment progress is now in line with rather than above the eurozone average and slightly below **Italy** (No. 11).

3. Ibid.

External Adjustment

Table 2. External Adjustment 2007-2015

					Change in net exports 2H 2007 – 2H 2015								Rise in export ratio as a percent of GDP		
Rank							Relative to GDP			Relative to starting level			2H 2007 – 2H 2015		
2015	2014	Country	Score	*Change*	Score	*Change*	Percent	Score	*Change*	Percent	Score	*Change*	Percent	Score	*Change*
1	1	Latvia	**9.1**	*-0.2*	**9.6**	*-0.1*	17.6	**9.2**	*-0.2*	41.2	**10.0**	*0.0*	15.3	**8.2**	*-0.5*
2	3	Greece	**7.4**	*0.0*	**8.9**	*0.4*	13.4	**7.7**	*0.8*	57.6	**10.0**	*0.0*	4.6	**4.2**	*-1.0*
3	2	Estonia	**7.3**	*-0.2*	**6.0**	*-0.3*	10.1	**6.6**	*-0.3*	16.3	**5.5**	*-0.3*	24.6	**10.0**	*0.0*
4	4	Ireland	**7.0**	*-0.3*	**5.5**	*-0.4*	10.0	**6.6**	*-0.5*	10.9	**4.4**	*-0.3*	28.8	**10.0**	*0.0*
5	5	Spain	**7.0**	*-0.2*	**8.0**	*-0.3*	9.5	**6.4**	*-0.2*	36.7	**9.5**	*-0.5*	6.7	**5.0**	*0.2*
6	6	Slovenia	**6.7**	*0.1*	**6.6**	*0.0*	12.1	**7.3**	*0.0*	18.5	**5.9**	*0.0*	11.6	**6.8**	*0.1*
7	7	Slovakia	**6.4**	*0.2*	**5.1**	*-0.4*	8.4	**6.0**	*-0.5*	10.4	**4.3**	*-0.3*	17.4	**9.0**	*1.5*
8	9	Portugal	**6.0**	*-0.1*	**5.8**	*-0.4*	6.2	**5.2**	*-0.2*	20.5	**6.3**	*-0.5*	10.3	**6.3**	*0.3*
9	8	Malta	**5.3**	*-0.9*	**4.3**	*-0.5*	6.7	**5.4**	*-0.6*	5.1	**3.2**	*-0.3*	12.9	**7.3**	*-1.7*
10	10	Netherlands	**5.1**	*0.2*	**3.4**	*-0.3*	2.5	**4.0**	*-0.3*	3.5	**2.9**	*-0.3*	15.5	**8.3**	*1.1*
11	11	Poland	**4.9**	*0.3*	**4.7**	*0.1*	4.7	**4.7**	*0.1*	11.9	**4.6**	*0.2*	8.0	**5.5**	*0.5*
12	13	Luxembourg	**4.5**	*0.5*	**1.8**	*0.4*	-3.6	**1.8**	*0.6*	-2.0	**1.8**	*0.2*	19.7	**9.9**	*0.7*
13	14	Belgium	**4.3**	*0.6*	**2.7**	*0.2*	0.0	**3.1**	*0.3*	0.0	**2.2**	*0.2*	14.0	**7.7**	*1.3*
		Euro 18	4.2	*0.0*	3.7	*-0.2*	2.4	3.9	*-0.1*	6.0	3.4	*-0.2*	7.1	5.1	*0.4*
14	15	Cyprus	**4.0**	*0.4*	**4.0**	*0.5*	3.7	**4.4**	*0.5*	6.9	**3.6**	*0.5*	4.5	**4.1**	*0.2*
15	12	Italy	**4.0**	*-0.1*	**4.2**	*-0.3*	2.8	**4.1**	*-0.2*	10.4	**4.3**	*-0.4*	3.1	**3.6**	*0.2*
16	17	Germany	**3.3**	*0.1*	**2.6**	*-0.1*	0.0	**3.1**	*-0.1*	-0.1	**2.2**	*-0.1*	6.1	**4.8**	*0.5*
17	16	Austria	**3.2**	*-0.2*	**2.9**	*-0.3*	0.7	**3.4**	*-0.3*	1.4	**2.5**	*-0.3*	3.3	**3.7**	*0.1*
18	19	France	**2.6**	*-0.1*	**2.0**	*-0.3*	-1.1	**2.7**	*-0.2*	-4.2	**1.4**	*-0.4*	3.7	**3.8**	*0.5*
19	18	United Kingdom	**2.6**	*-0.1*	**2.5**	*-0.3*	-0.3	**3.0**	*-0.2*	-1.1	**2.0**	*-0.4*	1.0	**2.8**	*0.2*
20	20	Sweden	**2.2**	*0.3*	**1.8**	*0.2*	-2.2	**2.4**	*0.2*	-4.5	**1.3**	*0.2*	1.6	**3.0**	*0.3*
21	21	Finland	**1.2**	*-0.2*	**0.8**	*-0.1*	-4.5	**1.6**	*-0.1*	-10.9	**0.0**	*-0.2*	-1.4	**1.9**	*-0.2*

Ranks, scores and score changes for External Adjustment Indicator and sub-indicators. Percent values: (1) H2 2015 over H2 2007 change of net exports as percent of GDP, (2) as percent of the starting level and (3) rise in the export ratio in percentage points of GDP. For further explanations see notes under Table 1 on page 3.

If a country has lived beyond its means, the adjustment after the party should show up most visibly in its external accounts. To track the progress, we examined two different aspects of external adjustment, namely 1) the shift in the balance of exports and imports (net exports), and 2) the rise in the share of exports in a country's GDP. Beyond looking at the absolute shifts, we also assessed them relative to the starting position of each country as measured by the pre-crisis share of exports in GDP in 2H 2007. For *The Euro Plus Monitor Spring 2016 Update,* we added data for Q3 and Q4 2015 to the previous analysis.

The overall results confirm the pattern we observed in the last four years. The **eurozone** as a whole has improved its external position since 2007 largely because the erstwhile crisis countries have shaped up. All economies that were running excessive external deficits until 2007 (or 2009) have turned their external balance around convincingly. **Latvia** (No. 1) maintains its position as the best of the 21 countries in the sample by a wide margin, well ahead of **Greece** (No. 2) and **Estonia** (No. 3), which have switched places in the ranking. **Ireland** (No. 4 again), **Spain** (No. 5 again) and **Portugal** (No. 8, up from No. 9) are also among the top performers.[4] While the eurozone as a whole improved its overall position marginally with a rise in its score to 4.2, up from 4.1, **Italy** fell back to No. 15 (down from No. 12) as a rebound in imports outpaced the rise in exports. Outside the eurozone, **Poland** (No. 11) managed to raise its above-average score whereas

4. The calculations have been affected by data revisions. To make sure that the results reflect the actual progress achieved in the last year rather than changes in accounting practices, we re-calculated the results for previous years using the revised data. In this update, we compared current results including data for 2H 2015 to the re-calculated scores and ranks based on data for 2H 2014. These differed slightly from those published in December 2015 on the basis of the old data.

‘The external adjustment continued at a satisfactory pace over the course of 2015.’

the **United Kingdom** (No. 19, down from No. 18) lost a little ground. The United Kingdom now ranks even marginally below **France** in terms of external adjustment since 2007. **Sweden** (No. 20) and **Finland** (No. 21) remain at the bottom of the ranking despite slight progress in Sweden.

For most eurozone members, the external adjustment continued at a satisfactory pace over the course of 2015. But for two reasons, the pace did not quicken very much.

1. Weak demand from China and other emerging markets weighed on export growth in the second half of 2015. As a result, the share of exports in GDP for the average of the **eurozone** members rose only marginally to 46.3% in 2H 2015, up from 45.2% in 2H 2014.
2. With the period of painful belt-tightening largely over, countries are raising their imports again in line with a rebound in domestic demand.

Whereas the first reason is simply bad luck, the second reason is mostly a sign of success. After a convincing turnaround in external accounts, many countries in the sample can afford to raise their imports again in line with or slightly ahead of the growth in overall GDP. This explains the declines in the scores for **Estonia, Ireland, Latvia, Portugal** and **Spain**. At least in their external accounts, these countries have successfully concluded their impressive external adjustment.

The sad exception among the erstwhile crisis countries is **Greece**. Athens still gets good marks for its overall external adjustment, even rising from third to second place. But the reason is most unfortunate: imports fell by more than exports. The administration of Prime Minister Alexis Tsipras dealt a massive confidence shock to the Greek economy in the first half of 2015. Pervasive political uncertainty is hampering investment into export-oriented activities. That may help to explain why Greek exports are lagging far behind those of other countries at the euro periphery. Despite a record tourist season last summer, Greek exports of goods and services declined over the course of 2015. After a strong rise in its export share in GDP to 30.5% in 2H 2014, up from 23.3% of GDP in 2H 2007, the export share fell back to 28.0% in 2H 2015. As Greeks had to endure further pain in the politically induced economic downturn, imports slumped by more than exports, causing a marked increase in net exports for all the wrong reasons in 2015.

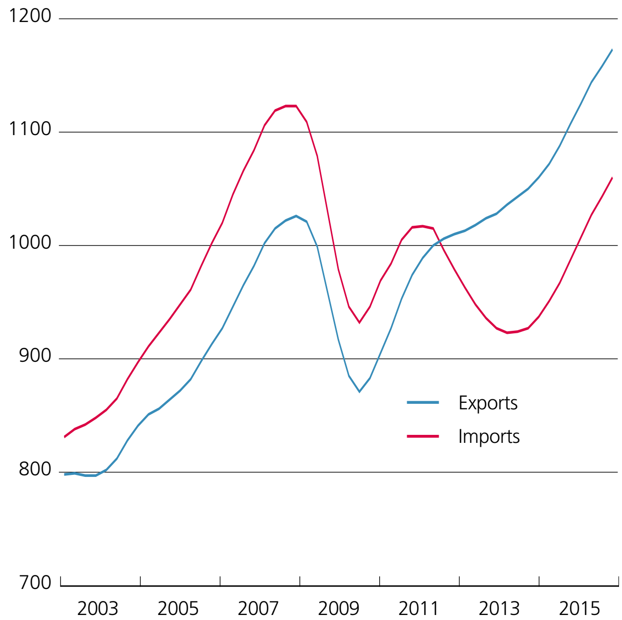
Relative to the results for 2014, we found significant gains in the scores for **Belgium** (up 0.6 points) and **Cyprus** (up 0.4 points). **Sweden** and **Poland** (up 0.3 points each) managed smaller improvements. Apart from a significant drop in the score for **Malta** (-0.9 points), for which data can be rather volatile, and modest declines for the erstwhile crisis countries mentioned above (**Estonia, Ireland, Latvia, Portugal** and **Spain**) the results reveal modest slippage in the pace of external adjustment for **Austria, Finland, France, Italy** and the **United Kingdom**. For Austria, France, the United Kingdom and Finland, this should be a concern as it comes from a rather low basis.

Looking at the first of sub-criteria – the rise in the share of net exports in GDP – **Latvia** with its small and very open economy managed the most impressive shift to its external balance by a total of 17.6 percentage points of GDP from 2H 2007 to 2H 2015. It is followed by **Greece** (a 13.4 point shift), **Slovenia** (12.1 points), **Estonia** (10.1 points) and **Ireland** (10.0 points). The result is also very encouraging for **Spain** with a shift of 9.5 percentage points as it is a much bigger and hence less open economy than the other five.

At the other end of the spectrum, the net export balance has deteriorated significantly in **Finland** (-4.5 percentage

Chart 3. Exports Up, Imports Rebound

Real exports and imports of goods and services of the Reform-5 countries in billions of euros



Four-quarter rolling sum of real exports and imports for Italy, Spain, Greece, Portugal and Ireland in billion of euros, chain-linked (2010 = base year)
Source: Eurostat

‘Export growth should rebound as the crisis in many emerging markets fades.’

points of GDP from 2H 2007 to 2H 2015), **Luxembourg** (-3.6 points), **Sweden** (-2.2 points) and **France** (-1.1 points). Data for Luxembourg can be very volatile due the economy’s relatively small size. For Finland, Sweden and France, the shift is too pronounced for comfort. See the column on “change in net exports relative to GDP” in Table 2 on page 6 for more.

Of course, a mere glance at the shift in the balance of exports and imports as a share of GDP is somewhat unfair. Small, open economies such as Ireland, Cyprus and the Baltic states find it much easier to shift resources from the domestically oriented to the export-oriented or import-competing sectors than larger and more closed economies. To account for this, we looked not just at the shift in the balance of import and exports, but also at the shift in a country’s net export position relative to the starting level of 2H 2007.

To some extent, the results are similar: **Latvia, Estonia** and **Ireland** stay at or close to the top whereas **Finland, Sweden, France** and **Germany** remain close to the bottom. Adjusted for their comparatively low starting level, three of the eurozone crisis economies – namely **Greece, Spain** and **Portugal** – have also achieved impressive shifts. This confirms a major rebalancing within Europe. On this criterion, even Italy looks good as, relative to its weak starting level, it has turned around its external balance quite decisively.

A closer look at the drivers of adjustment in the first three years of the eurozone confidence crisis reveals a dark side to the external adjustment story: in some countries, the net export position had improved more through a collapse in imports and less through an actual rise in exports (see the column on “rise in export ratio as a percent of GDP” in Table 3 on page 9). For most countries, this is no longer the case. As the worst of the domestic fiscal squeeze ended in 2014, imports rebounded in most reform countries for more than two years already while the share of exports in GDP continued to grow (see Chart 3 on page 7).

While **Spain** and **Portugal** have done well from 2H 2007 to 2H 2015, raising their export ratio by 6.7% and 10.3% of their GDP, respectively, some of the small, open economies in the eurozone managed even more spectacular improvements. This holds especially for **Ireland** (+28.8 points), **Estonia** (+24.6 points), **Luxembourg** (+19.7 points), **Slovakia** (+17.4 points), **Latvia** (+15.3), **The Netherlands** (+15.5 points) and **Belgium** (+14.0 points).

On the opposite side of the spectrum, **Finland** has not yet recouped the post-Lehman drop in its export ratio. The results are also very weak for the **United Kingdom** (+1.0 points) and **Sweden** (+1.6 points). With overall gains in the export ratio by 3.1, 3.3 and 3.7 percentage points, respectively, **Italy, Austria** and **France** also lag well behind the eurozone average of 7.1 points.

Combining the findings from the shift in net exports and the rise in the export ratio into one ranking yields the results shown in Table 2 on page 6. **Latvia** (No. 1), **Greece** (No. 2), **Estonia** (No. 3), **Ireland** (No. 4) and **Spain** (No. 5) are the best performers in terms of overall external adjustment, followed by **Slovenia** (No. 6), **Slovakia** (No. 7), **Portugal** (No. 8) and **Malta** (No. 9). However, comparing the countries that recently suffered from the euro-confidence crisis to Estonia and Latvia can be misleading. Hit by the bursting of domestic bubbles, Estonia and Latvia started their own wrenching adjustment earlier than most of the countries affected by the euro-confidence crisis. **Cyprus** confirms this pattern. As the last country to fall victim to the crisis, its overall score for external adjustment is still slightly below the eurozone average. But in response to crisis, Cyprus is now making rapid progress, raising its score by a noteworthy 0.4 points and rising in the ranking to No. 14 based on data for 2H 2015, up from No. 15 for data extending to 2H 2014.

Going forward, we expect the pace of external adjustment to remain largely steady in the **eurozone**. Export growth should rebound as China stimulates its domestic demand and hence its appetite for imports while the crisis in many emerging markets should fade somewhat. At the same time, in an economic recovery driven mostly by domestic demand, imports will likely rise at least as fast as exports for most countries in the sample. If so, we would view that as a healthy development.

‘The analysis shows a significant convergence of fiscal policy in the eurozone.’

Fiscal Adjustment

Table 3. Fiscal Adjustment 2009-2015

Rank					2009-15 in percent of GDP			in percent of required shift		
2015	2014	Country	Score	*Change*	Percent	Score	*Change*	Percent	Score	*Change*
1	1	Greece	**8.9**	*-0.7*	14.1	**10.0**	*0.0*	72.6	**7.7**	*-1.3*
2	2	Cyprus	**7.6**	*-0.9*	8.6	**7.6**	*-0.9*	n.a.	**n.a.**	*n.a.*
3	5	Ireland	**6.9**	*-0.2*	8.4	**7.4**	*-0.2*	60.9	**6.5**	*-0.2*
4	3	Portugal	**6.7**	*-0.7*	8.2	**7.3**	*-0.7*	57.1	**6.1**	*-0.7*
5	7	Poland	**6.3**	*0.1*	5.2	**5.1**	*0.1*	70.2	**7.5**	*0.2*
6	4	Spain	**6.3**	*-1.0*	7.6	**6.8**	*-0.9*	53.6	**5.7**	*-1.0*
7	6	Slovakia	**6.2**	*-0.4*	5.6	**5.4**	*-0.3*	65.8	**7.0**	*-0.6*
8	8	United Kingdom	**5.0**	*0.3*	5.1	**5.1**	*0.2*	46.7	**5.0**	*0.3*
9	9	Slovenia	**4.4**	*-0.3*	3.5	**3.9**	*-0.2*	45.8	**4.9**	*-0.3*
10	10	Italy	**4.3**	*-0.3*	3.0	**3.6**	*-0.2*	47.0	**5.0**	*-0.5*
		Euro 18	**4.2**	*-0.3*	3.2	**3.7**	*-0.2*	44.1	**4.7**	*-0.4*
11	12	France	**4.0**	*0.1*	3.3	**3.8**	*0.1*	39.2	**4.2**	*0.2*
12	11	Germany	**3.8**	*-0.2*	0.7	**1.9**	*0.0*	52.6	**5.6**	*-0.3*
13	13	Latvia	**3.6**	*-0.2*	3.0	**3.6**	*-0.2*	n.a.	**n.a.**	*n.a.*
14	14	Netherlands	**3.1**	*-0.5*	2.5	**3.2**	*-0.4*	28.8	**3.1**	*-0.7*
15	15	Austria	**3.0**	*0.7*	2.0	**2.9**	*0.4*	29.2	**3.1**	*0.9*
16	18	Estonia	**2.5**	*0.3*	1.5	**2.5**	*0.3*	n.a.	**n.a.**	*n.a.*
17	17	Malta	**2.0**	*-0.3*	0.7	**2.0**	*-0.3*	n.a.	**n.a.**	*n.a.*
18	16	Luxembourg	**1.4**	*-0.8*	0.0	**1.4**	*-0.8*	n.a.	**n.a.**	*n.a.*
19	19	Belgium	**1.0**	*-0.1*	0.3	**1.7**	*-0.1*	3.4	**0.4**	*-0.1*
20	20	Finland	**0.0**	*0.0*	-2.1	**0.0**	*0.0*	0.0	**0.0**	*0.0*
20	20	Sweden	**0.0**	*0.0*	-3.1	**0.0**	*0.0*	0.0	**0.0**	*0.0*

Ranks, scores and score changes for Fiscal Adjustment Indicator and sub-indicators. Percent values: (1) 2009-2015 change in structural primary balance in percent of GDP and (2) as a share of the required fiscal shift until 2020, adjusted for age-related spending. For further explanations see notes under Table 1 on page 3.

Shifts in the fiscal-policy stance usually show up clearly in the underlying primary balance of the general government accounts. To avoid distortion, we used data that adjust the actual fiscal balance for the impact of the short-term business cycle, interest payments and some significant one-off factors such as a recapitalisation of banks. Using the latest data from the European Commission as the basis for our analysis, we can draw three major conclusions:[5]

1. Taking the last five years together, the countries that were most in need of reining in their excessive deficits have made serious progress, with **Greece** (No. 1) still well ahead of **Cyprus** (No. 2), **Ireland** (No. 3), **Portugal** (No. 4) and **Spain** (No. 6). All five eurozone countries that had to ask taxpayers in other countries for support have tightened their belts quite dramatically over time (see Chart 5 on page 10).
2. A number of countries with a fairly comfortable fiscal starting position such as **Germany** (No. 12), **Malta** (No. 17) and **Luxembourg** (No. 18) have hardly changed their fiscal stance over these five years while **Sweden** and **Finland**, which share the No. 20 position, have even relaxed the fiscal reins noticeably. On a five-year view, serious tightening in the fiscally challenged periphery and virtual standstill in parts of the core have resulted in a significant convergence of fiscal policy in the **eurozone** as a whole.
3. By and large, austerity is over. After a cumulative fiscal correction of 3.4% of GDP from 2009 to 2014 brought the eurozone’s structural primary balance to 1.6% in 2014, the region relaxed the fiscal reins marginally by 0.2% of GDP in 2015. We expect a slightly stronger fiscal stimulus of 0.3% of GDP in 2016.

5. European Commission, Ameco database, April 2016.

'All in all, the end of austerity makes sense for the eurozone.'

All in all, the end of austerity makes sense for the **eurozone**. As Chart 4 shows, the rise in public debt in the eurozone since 1999 has been far less pronounced than in the United States and the **United Kingdom**. Also, the ratio of public debt to GDP finally started to come down in the eurozone in 2015. With real GDP growth around 1.5%, we project a further improvement in 2016.

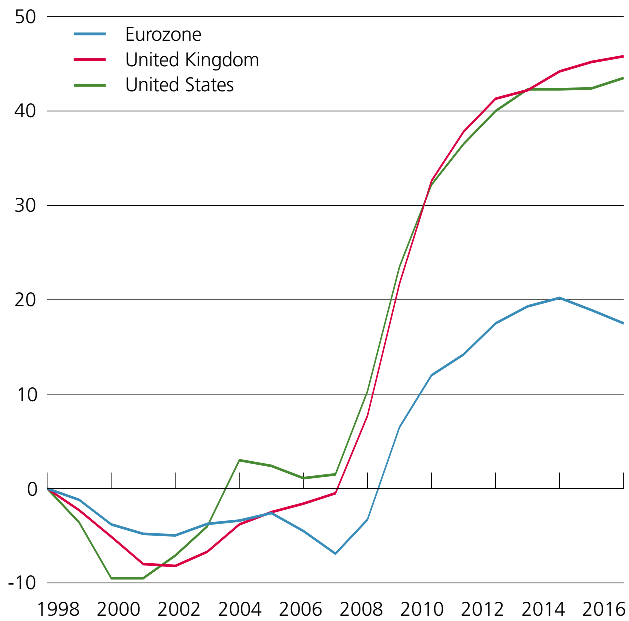
However, this assessment does not hold for all countries. To some extent, fiscal repair has given way to new fiscal concerns.

- After massive progress in the years before, the pre-election loosening of fiscal policy in Portugal (by 0.9% of GDP) and Spain (by 1.3% of GDP) is politically understandable, but economically unfortunate. Spain certainly did not need to stimulate demand artificially. For Italy, the stimulus of 0.3% of GDP can be justified as a means to offset the impact of a serious labour market reform which might otherwise constrain demand before the full positive supply response becomes visible.
- Following a modest pre-election fiscal stimulus of 0.6% of GDP in 2014, Greece allowed itself further fiscal slippage of 0.7% of GDP in 2015. Unfortunately, this did not help the hard-pressed Greek population at all. For a country that had just emerged in 2014 from one of the worst adjustment recessions on record in Western economies, shattering fragile confidence by a full-blown and futile confrontation with the country's only willing lenders proved to be a costly disaster in 2015 instead. Sadly, Greece will have little choice but to offset the costs of its confrontation with creditors and its recent fiscal slippage through some additional austerity measures in 2016 and 2017.

As Table 3 on page 9 shows, the overall change in Greece's underlying fiscal position of 14.1% of GDP since 2009 exceeds that of any other country in *The Euro Plus Monitor Spring 2016 Update* despite some slippage in the last two years. With a less dismal starting point and a less-frontloaded approach, the cumulative fiscal repair since 2009 has been less dramatic than in Greece but still quite breathtaking in **Ireland** (8.4% of GDP), **Portugal** (8.2%) and **Spain** (7.6%). Even **Cyprus**, which fell into crisis only in 2013, managed a total fiscal correction of 8.6% of its GDP until the end of 2015.

Chart 4. Rise in the Debt Burden

Change in public debt ratio in percent of GDP

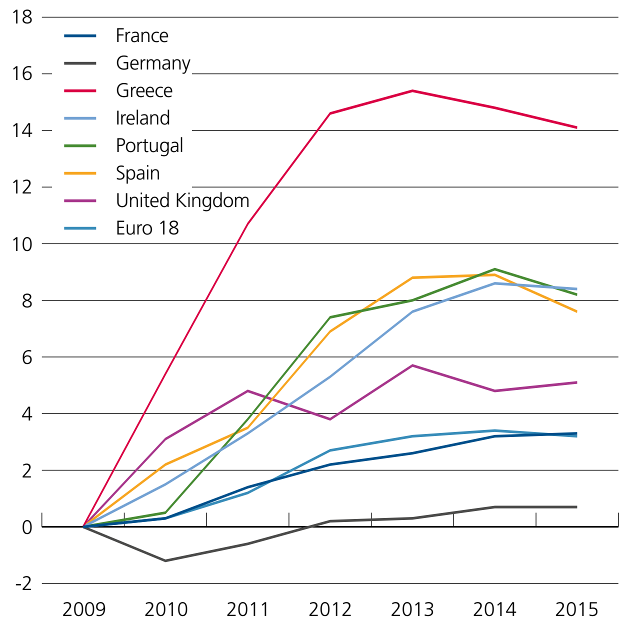


Increase in ratio of public debt to GDP, in percent of GDP, since the end of 1998

Sources: Eurostat, Berenberg forecasts for 2016

Chart 5. Fiscal Repair

Change in underlying fiscal balance since 2009 in percent of GDP



Sources: European Commission, Berenberg calculations

‘Germany has the fiscal space for its extra spending on refugees.’

Of course, the size of the fiscal shift over time tells only half the story. We have to relate it to the actual adjustment need. In 2014, the International Monetary Fund estimated how much countries would have to shift their cyclically adjusted primary balance between 2014 and 2020 to get to a deficit-to-GDP ratio of 60% by 2030, also adding an adjustment for age-related spending.[6] We took these numbers – including their underlying assumptions – and added the actual adjustment progress in 2015 over 2009. We then related the total required shift in stance between 2009 and 2020 to what has already been achieved from 2009 to 2015.

On this measure, **Greece** has made the most progress in the eurozone over the last five years taken together, as shown in the column on “fiscal adjustment in percent of required shift” in Table 3 on page 9.[7] It is followed by **Poland, Slovakia, Ireland, Portugal** and **Spain**.

We combined both fiscal adjustment measures, namely the estimated total shift in 2010-2015 in absolute terms and the adjustment so far relative to the total adjustment need until 2020, for the overall fiscal-adjustment score. With the exception of **Poland**, the score worsened for all the frontrunners and many other countries. However, **Austria** (No. 15), the **United Kingdom** (No. 8) and **Estonia** (No. 16) managed to improve their score in a meaningful way in 2015.

The mediocre ranking for **Germany** (No. 12) needs to be seen in context. Although Germany has gone through hardly any austerity since 2009, its sustainability gap remains so small that, unlike **France**, the shortfall is no reason for concern for the time being. Germany could easily afford its small fiscal stimulus of 0.1% of GDP in 2015. As it continues to benefit from the rapid rise in employment and tax receipts unleashed by its 2004 labour market reforms, Germany has the fiscal space for the extra spending on refugees which may amount to 0.6% of its GDP in 2016.

For **France** (No. 11) and even more so for **Belgium** (No. 19), the below-average score for fiscal adjustment is a greater concern because these countries have an above-average need to adjust. In 2015, the score for France improved slightly to 4.0, up from 3.9, while the score went down for Belgium as well as for most other countries surveyed.

6. International Monetary Fund, Fiscal Monitor, 2013 and 2014 (Washington DC: IMF, 2013 and 2014). These estimates are subject to change, they also deviate somewhat from those of the European Commission. But the EU and IMF estimates of how much countries are shifting their cyclically adjusted primary balances tend to be similar.
7. The estimate for Greece should be taken with even more caution than the other estimates. As the IMF has not updated its estimates for the overall adjustment need for Greece, we used the IMF’s 2013 estimates for Greece. We corrected these estimates for two factors, namely the fiscal changes that have happened since then and the massive capital flight and relapse into recession caused by political developments at the end of 2014 and early 2015. These developments have weakened the Greek economy to such an extent that, in order to get public debt back on a sustainable track, further fiscal measures will be required. This has raised Greece’s sustainability gap by at least 2% of its GDP. We thus add two points to the total required fiscal shifts. See the Focus on Greece on page 17.

‘On a six-year view, wage pressures have converged within the eurozone.’

Swing in Labour Cost Dynamics

Table 4. Labour Cost Adjustment 2009-2015

Rank					Real Unit Labour Costs 2009-2015						Nominal Unit Labour Costs 2009-2015					
					Absolute			Shift from 2000-2009 relative to Euro 18			Absolute			Shift from 2000-2009 relative to Euro 18		
2015	2014	Country	Score	*Change*	Percent	Score	*Change*	Percent	Score	*Change*	Percent	Score	*Change*	Percent	Score	*Change*
1	1	Ireland	**9.3**	*0.2*	-22.3	**10.0**	*0.0*	32.4	**10.0**	*0.0*	-17.2	**10.0**	*0.2*	31.1	**7.1**	*0.6*
2	2	Greece	**7.6**	*-0.3*	-7.5	**6.0**	*-0.7*	14.4	**6.9**	*-0.5*	-11.5	**9.0**	*-0.2*	40.0	**8.4**	*0.0*
3	5	Cyprus	**6.4**	*0.2*	-8.0	**6.3**	*0.1*	10.7	**5.7**	*-0.1*	-6.3	**7.0**	*0.6*	27.5	**6.6**	*0.3*
4	8	Luxembourg	**5.9**	*0.9*	-9.1	**7.1**	*2.0*	20.7	**8.9**	*0.7*	6.8	**2.0**	*0.6*	20.0	**5.6**	*0.3*
5	7	Portugal	**5.8**	*0.7*	-10.7	**8.3**	*1.7*	3.8	**3.5**	*0.6*	-6.0	**6.9**	*0.2*	12.2	**4.5**	*0.2*
6	6	Spain	**5.8**	*0.0*	-7.1	**5.7**	*0.2*	5.8	**4.1**	*-0.1*	-6.2	**7.0**	*-0.1*	24.5	**6.2**	*0.1*
7	4	Estonia	**4.9**	*-1.5*	-3.8	**3.2**	*-2.9*	12.7	**6.3**	*-1.5*	13.7	**0.0**	*-1.7*	58.0	**10.0**	*0.0*
8	3	Latvia	**4.8**	*-1.8*	-3.8	**3.3**	*-3.3*	7.4	**4.6**	*-1.7*	8.3	**1.4**	*-2.2*	67.4	**10.0**	*0.0*
9	9	Slovenia	**4.8**	*0.3*	-3.5	**3.0**	*0.7*	3.1	**3.2**	*0.1*	-1.0	**5.0**	*0.2*	35.5	**7.7**	*0.2*
10	10	United Kingdom	**3.4**	*-0.2*	-6.9	**5.6**	*-0.3*	8.2	**4.9**	*-0.3*	9.6	**0.9**	*-0.3*	-4.2	**2.3**	*0.0*
11	11	Italy	**3.3**	*0.0*	-1.5	**1.6**	*0.1*	6.2	**4.3**	*-0.1*	4.5	**2.9**	*-0.2*	12.1	**4.5**	*0.0*
12	15	Malta	**2.9**	*1.0*	-4.3	**3.7**	*2.5*	5.5	**4.0**	*0.9*	10.0	**0.8**	*0.5*	2.6	**3.2**	*0.3*
13	12	Slovakia	**2.9**	*-0.4*	-0.8	**1.1**	*-0.7*	-0.6	**2.1**	*-0.5*	2.7	**3.6**	*-0.3*	13.2	**4.7**	*0.0*
		Euro 18	**2.4**	*0.0*	-1.7	**1.7**	*0.4*	0.0	**2.3**	*0.0*	4.6	**2.9**	*-0.3*	0.0	**2.9**	*0.0*
14	14	Netherlands	**2.3**	*0.3*	-0.5	**0.9**	*0.7*	-0.6	**2.1**	*0.1*	4.5	**2.9**	*0.3*	2.4	**3.2**	*0.2*
15	13	Finland	**2.2**	*-0.2*	-1.2	**1.4**	*-0.2*	6.1	**4.2**	*-0.3*	9.7	**0.9**	*-0.3*	-3.1	**2.5**	*0.0*
16	16	Belgium	**2.2**	*0.4*	-1.8	**1.8**	*1.0*	1.7	**2.8**	*0.2*	7.2	**1.8**	*0.2*	-3.4	**2.4**	*0.2*
17	17	France	**1.6**	*0.0*	1.3	**0.0**	*0.0*	-0.8	**2.0**	*0.1*	7.2	**1.9**	*-0.2*	-2.9	**2.5**	*0.0*
18	18	Austria	**0.9**	*-0.2*	0.2	**0.4**	*0.1*	-3.8	**1.0**	*-0.2*	10.1	**0.7**	*-0.6*	-11.2	**1.3**	*-0.1*
19	20	Sweden	**0.8**	*0.1*	0.2	**0.4**	*0.4*	1.2	**2.7**	*0.1*	16.8	**0.0**	*0.0*	-19.8	**0.2**	*-0.1*
20	19	Germany	**0.7**	*-0.2*	-0.5	**0.9**	*0.1*	-5.4	**0.5**	*-0.1*	8.9	**1.2**	*-0.7*	-19.4	**0.2**	*-0.2*
21	21	Poland	**0.4**	*-0.1*	-1.6	**1.7**	*-0.4*	-15.4	**0.0**	*0.0*	13.7	**0.0**	*0.0*	-26.8	**0.0**	*0.0*

Ranks, scores and score changes for Labour Cost Adjustment Indicator and sub-indicators. Percent values: (1) 2009-2015 cumulative change in real unit labour costs, in percent; (2) shift in cumulative real unit labour cost change between periods 2000-2009 and 2009-2015, relative to the Eurozone, in percent; (3) 2009-2015 cumulative change in euro nominal unit labour costs, 2007-2015 for non-eurozone countries, in percent; (4) shift in cumulative euro nominal unit labour cost change between periods 2000-2009 and 2009-2015, relative to the eurozone, 2000-2007 to 2007-2015 for non-eurozone countries, in percent. For further explanations see notes under Table 1 on page 3.

Labour costs are an imperfect gauge of competitiveness. The ultimate yardstick of competitiveness is whether or not a company or country can profitably sell its wares. But as other factors such as changes in product quality, brand value, consumer tastes and the mix of goods and services offered by a company or a country are often longer-term processes and are more difficult to quantify, changes in nominal and real unit labour costs do provide some useful insights into the near-term adjustment dynamics of a country. This holds especially true if a decline in unit labour costs goes along with a rise in net exports, indicating that a country has indeed improved its competitive position.

To evaluate adjustment progress, we examined how much changes in nominal and real unit labour costs are deviating from the eurozone average. We conducted the analysis in three steps. First, we calculated the cumulative change in real unit labour costs between 2009 and 2015 and ranked countries according to their deviation from the eurozone average, awarding the highest score to the country with the biggest relative fall. Second, we related this to what happened in the 2000-2009 period, assigning the best score to the country which made the biggest shift from an above-average cumulative rise in unit labour costs in the earlier period to a below-average increase thereafter. Third, we repeated the exercise for nominal unit labour costs. We then derived an overall score and ranking by combining these components.

Overall, three results stand out:

1. On a six-year view, wage pressures have converged within the **eurozone**: most of the euro members with excessive wage increases until 2009 have gone through a big correction. Under the pressure of

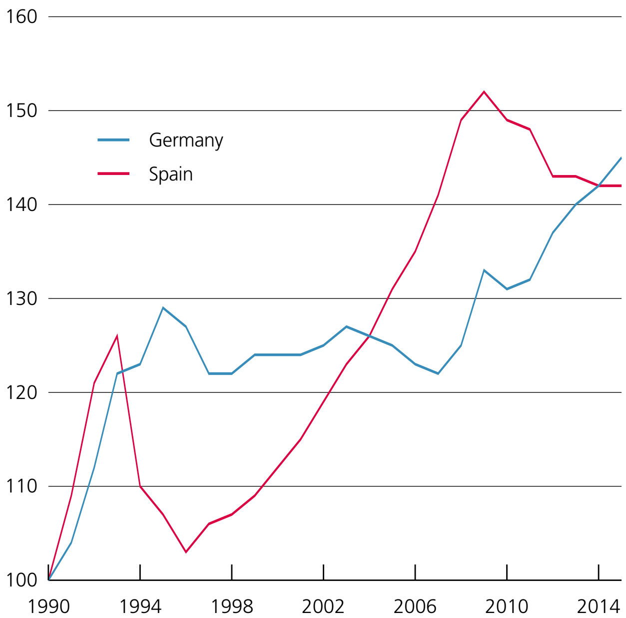
'France is at least taking some steps in the right direction.'

record unemployment and the lagging impact of a deep adjustment crisis that lasted until 2013, the five countries that had to ask taxpayers elsewhere for help have slashed their labour costs the most. **Ireland** (No. 1) tops the ranking for labour cost adjustment ahead of **Greece** (No. 2), **Cyprus** (No. 3), **Portugal** (No. 5) and **Spain** (No. 6).

2. Conversely, nominal unit labour costs have risen significantly in many core countries such as **Germany** (No. 20), **Austria** (No. 18), **France** (No. 17) and **Belgium** (No. 16) over the course of the last six years. For Germany and to a lesser extent Austria, it makes sense to be close to the bottom of the European league table as their labour markets are comparatively healthy. For France and Belgium, the low scores are more problematic.
3. Instead of a clear core versus periphery split, the picture became much more nuanced in 2015. Whereas rapid economic growth helped **Ireland** to raise its productivity and reduce unit labour costs in 2015 significantly, the relapse into recession pushed unit labour costs up in **Greece**. While **Portugal** made further progress in terms of labour cost adjustment, **Spain** did not. In core Europe, **France** started to correct its labour cost disadvantage relative to **Germany** as nominal labour costs increases in France lagged behind those of its neighbour from the other side of the Rhine.

Chart 6. Back to Balance

Nominal unit labour costs Germany versus Spain
1990=100



Sources: European Commission, Berenberg calculations

Having been among the star performers in previous years, **Estonia** (No. 7, down from No. 4) and **Latvia** (No. 8, down from No. 3) continued to slide downwards in the ranking. This makes sense. The two small, open economies on the Baltic Sea had successfully concluded their own post-bubble adjustment process two years ago and started to relax the reins somewhat.

Comparing nominal unit labour costs in **Germany** to those in **Spain** brings out the return to a better balance (see Chart 6 below). In the wake of the German unification boom, labour costs surged across much of Europe. After Spain devalued the peseta in 1992 in various steps from September 1992 to March 1995, the temporary boost to its competitive position allowed the country to outgrow Germany by a wide margin. But through wage restraint enforced by mounting unemployment and serious labour market reforms, Germany restored its competitive position over time while Spain became careless in its credit-driven heydays until 2007. With German wage costs rebounding on the back of virtual full employment and Spanish workers forced to tighten their belts, the relative position of Spain versus Germany is now back to where it was 25 years ago. Both countries are good places for job-creating inward investment. Looking ahead, a simple extrapolation of trends would suggest that Germany needs to take care to not allow itself too much of a party.

The real problem in the eurozone remains **France** (No. 17). The inflexible French labour market has still not responded adequately to the challenge of high unemployment. Labour costs remain excessive. But France is at least taking some steps in the right direction. Its nominal unit labour costs rose by merely 0.4% in 2015, below the 0.7% average for the eurozone. However, this did not suffice to raise the French score which, at 1.6, remains well below the 2.4 average for the currency area as a whole. France still has a long way to go towards a well-functioning labour market.

The same can be said for **Finland** (No. 15) which saw real unit labour costs rise slightly further relative to the eurozone average in 2015.

Looking at the absolute changes in real unit labour costs in the six years leading up to 2015 (see the column on "real unit labour costs 2009-2015, absolute in percent" in Table 4 on page 12), **Ireland** has made the most heroic adjustment (-22.3%), followed by **Portugal** (-10.7%), **Luxembourg** (-9.1%), **Cyprus** (-8.0%), **Greece** (-7.5%), **Spain** (-7.1%) and the **United Kingdom** (-6.9%). The only countries with a cumulative rise in their real unit labour costs are **France** (+1.3%), **Austria** and **Sweden** (+0.2% each).

‘Crises are handmaidens of change.’

Reform Drive

Table 5. Reform Drive 2015

Rank 2015	Rank 2013	Country	Score	Change	OECD reform responsiveness indicator: Adjusted average 2010-2015	2014/2015	Average 2010-2013
1	1	Greece	**7.0**	*-3.0*	0.64	0.30	0.87
2	2	Spain	**5.6**	*-2.2*	0.54	0.30	0.70
3	3	Portugal	**5.4**	*-2.1*	0.53	0.30	0.68
4	4	Ireland	**5.1**	*-2.3*	0.50	0.25	0.67
5	5	Estonia	**4.7**	*-1.9*	0.47	0.27	0.60
6	7	Poland	**4.3**	*-0.3*	0.44	0.44	0.45
7	13	Italy	**3.8**	*0.9*	0.41	0.55	0.32
		Euro 18	3.3	*-1.0*	0.37	0.28	0.42
8	10	Austria	**3.2**	*-0.8*	0.36	0.30	0.40
9	9	Slovakia	**3.2**	*-1.2*	0.36	0.25	0.43
10	6	United Kingdom	**3.0**	*-2.0*	0.35	0.14	0.48
11	14	France	**2.9**	*0.1*	0.34	0.39	0.31
12	8	Finland	**2.8**	*-1.6*	0.33	0.17	0.44
13	10	Slovenia	**2.1**	*-1.8*	0.28	0.10	0.40
14	12	Sweden	**1.9**	*-1.7*	0.27	0.10	0.38
15	15	Netherlands	**1.9**	*0.3*	0.26	0.33	0.22
16	16	Belgium	**1.3**	*0.2*	0.22	0.28	0.18
17	17	Germany	**1.1**	*0.1*	0.20	0.25	0.17
18	18	Luxembourg	**0.0**	*0.0*	0.12	0.17	0.09
		Latvia	**n.a.**	*n.a.*	n.a.	n.a.	n.a.
		Cyprus	**n.a.**	*n.a.*	n.a.	n.a.	n.a.
		Malta	**n.a.**	*n.a.*	n.a.	n.a.	n.a.

Ranks, score and score changes for the Reform Drive Indicator. The values given for the OECD reform responsiveness indicator refer to the average results from the OECD’s Going for Growth data for 2010/11 and 2012/13 (last column) and for 2014/15 (second last column). The 2010-15 aggregate (third last column) is a weighted average of the three two-year periods, with 2014/15 given slightly more weight (40%) than the two previous periods (30% each). The OECD has constructed the 2014/15 reform responsiveness result by combining information on reform actions assessed in the 2015 Going for Growth report with the 2016 interim assessment, which observes progress in reform priorities laid out in the 2015 Going for Growth recommendations. The data are not directly comparable to the past reform responsiveness data that are based on the full-fledged exercises rather than an interim assessment. For further explanations see notes under Table 1 on page 3.
Sources: OECD, Berenberg calculations

To seize the opportunities of globalisation and rapid technological change and cope with the consequences of low birth rates, countries need to adjust. In addition, countries that have lived beyond their means also need to tighten their belts. But squeezing domestic demand, slashing labour costs and raising exports are only part of the solution. To make their fiscal positions sustainable in the long run without excessive pain, countries need to raise their long-term growth potential. In short, they need pro-growth structural reforms.

Crises are handmaidens of change. Under the pressure of crisis, governments at the euro periphery have taken many steps to make their economies leaner and fitter for growth. They have reformed labour markets, cut pension and other welfare entitlements, streamlined administrative procedures and deregulated product markets. While the benefits of such reforms only show up with a lag, typically only when the initial adjustment recession has given way to a new upswing, such reforms ultimately matter more than the initial readiness to rein in excesses in public or private spending.

To measure how much countries have done, we employed the expertise of the OECD: the OECD regularly identifies five priority areas for reform for most of its member countries. In each of these areas it makes a number of concrete recommendations and subsequently measures whether these have been followed up (Score 1) or not (Score 0) with a full assessment every two years and an interim assessment in between. We use the data for three two-years periods, 2010/11, 2012/13 and 2014/15. The

‘Most countries feel less compelled to pursue pro-growth structural reforms than before.’

latest data draw on the results of the February 2016 interim assessment edition “Going for Growth” report, with the cut-off date 31 December 2015.

The OECD data reveal some dramatic changes. With some notable exceptions, most countries in our sample felt less compelled to pursue pro-growth structural reforms in the 2014-2015 period than before. This holds even more so for the United Kingdom and Sweden than for the **eurozone**.

Within the **eurozone**, the countries that were the focus of the euro crisis at the time and had to ask other countries’ taxpayers for help did reform at an impressive speed in the four years from 2010 to 2013. They had little choice than to do what was needed. In the 2014-2015 period, however, they became far less responsive to reform recommendations. Having implemented 87% of the OECD recommendations to a significant extent on average in the 2010-2013 period, **Greece** followed the OECD’s advice only to 30% in the 2014-2015 period. Separate OECD data for the two-year average of 2013-2014 suggest that, within the two-year period of 2014-2015, the slippage was far worse in 2015 than in 2014. **Spain, Ireland** and **Portugal** also scaled back their reform efforts in 2014-2015 significantly, albeit to a lesser extent than Greece.

The good news came from **Italy** (No 7, up from No. 13). Judging by its consistently low score in the fundamental health assessment (No. 18 in 2015 and 2014), Italy’s economy is one of the most structurally challenged in Europe. Under Prime Minister Renzi, Italy is finally moving in the right direction. Having implemented only 32% of OECD recommendations in 2010-2013, its responsiveness to reform recommendations rose to 55% in 2014-2015. For the last two years, Italy has thus been the reform leader among all 21 countries in our sample. Even **France** (No. 11, up from No. 14) became a bit more serious about reforms, following up on 39% of OECD recommendations in 2014-2015 after 31% in the four years before.

Countries with a major loss of reform momentum include the **United Kingdom, Estonia, Slovenia, Sweden** and **Finland**. For Estonia, which had reformed itself thoroughly and successfully in the wake of the Baltic crisis almost 10 years ago, this may be understandable. For Slovenia, Sweden and Finland, however, we view this as a sign of complacency. Especially Finland, which is currently one of the weakest members of the eurozone, ought to do much better to get back on track.

For the overall assessment, we took the weighted average of all reform efforts of the last six years, giving slightly more weight to the 2014-2015 period than to the years before. Because the erstwhile euro-crisis countries did reform at such a rapid pace from 2010 to 2013, they stayed at or close to the top in the reform league. However, their scores dropped significantly relative to last year. While progress continues, the pace of additional reforms has slowed down substantially. In some cases, we can find a positive interpretation for that. Because **Spain** (No. 2) and **Ireland** (No. 4) have reformed themselves successfully, they no longer need to do much more. In the case of **Greece** (No. 1), the story is different. With the Greek economy returning to growth in early 2014, the previous Greek government may have believed that it could afford to implement reforms slightly less diligently than before. This caused the OECD’s score to drop marginally. With the change in government in early 2015, however, reforms stalled almost across the board. Even worse, by threatening serious reform reversals, the new Greek government aborted the fragile recovery.

Some comparatively healthy core eurozone countries which need few reforms feature at the bottom of the table with **The Netherlands** at No. 15, **Germany** at No. 17 and **Luxembourg** at No. 18. Because of its below-average ranking for fundamental health in *The 2015 Euro Plus Monitor,* the lack of serious reforms in **Belgium** (No. 16) is more worrisome. Whereas Belgium’s score has improved slightly against the overall trend in Europe, it remains far too low for comfort.

‘Claims that European Union rules are holding Britain back decisively are not supported by the facts.’

Focus: Brexit

On 23 June 2016, British voters will decide whether their country will stay in or leave the European Union. Those in favour of a British exit (“Brexit”) often argue that supposedly excessive EU regulations are holding Britain back. In *The Euro Plus Monitor,* we take a close look at the underlying fundamental health and the recent adjustment progress of 21 countries in Europe each year. To some extent, we can also use this methodology to evaluate the claims of the Brexiteers in a broad-brush approach.

But before we look at the United Kingdom itself, consider the example of another major EU member. Fifteen years ago, Germany was the sick man of Europe, blighted by excessive regulations and wage costs that drove jobs abroad. The freshly reunited country was slowly heading for disaster. Due to some courageous reforms around 2004, Germany today is arguably the strongest of all major economies in the advanced world. It enjoys full employment, solid gains in real incomes and pensions, price stability, a fiscal surplus and a rapidly declining public debt burden. In real life, it does not get much better than that. In addition, few countries have linked their economies so closely to the most dynamic markets in the world. For example, Germany exports three times more than the United Kingdom to China.

What does this have to do with Brexit? A lot. It proves a major political point: within the EU, a member remains free to choose. If it gets its domestic policies right, it can use the EU as a springboard to success. If it gets its policies wrong, as Germany did in the 1990s, it can end up at the bottom of the pile instead. The rich variety of results on adjustment progress and fundamental health and the significant changes in *The Euro Plus Monitor* results over time show that, within the framework of the EU, countries remain the master of their own fate.

The common rules and regulations that underpin the common market are far from optimal. Some regulations may be almost as damaging as Britain’s own regulations of its land and housing markets. But claims that EU rules are holding Britain back decisively or that they prevent Britain from dealing more with fast-growing Asia are not supported by the facts.

Judging by the tone of its domestic debate, the United Kingdom sees itself as a place apart, different and aloof from the eurozone. The data presented in *The Euro Plus Monitor* does not back up this view. Indeed, few countries in the survey have overall results that are closer to the eurozone average than the non-euro United Kingdom. In terms of the fundamental health of its economy, as assessed in *The 2015 Euro Plus Monitor,* the United Kingdom scores 5.5, somewhat below the eurozone average of 5.8 largely because of its comparatively low scores for fiscal sustainability and resilience. The United Kingdom’s big macroeconomic imbalances ranging from a still huge structural fiscal deficit (around 4.5% of GDP in 2015) to a huge current account deficit (around 5% of GDP in 2015) and a low personal savings rate weigh on the score and ranking. The fact that the United Kingdom with its flexible labour market and its light-touch regulatory regime in many markets for goods and services has a growth potential above that of the eurozone average mitigates the impact. But it does not suffice to fully close the gap to the eurozone average in terms of fundamental economic health.

In terms of microeconomics, the common EU regulations still give the United Kingdom ample room to set its own polices and shine despite the occasional gripes about meddling from Brussels. Britain gets top marks for its microeconomics, notably for its growth-friendly rules in product, services and labour markets. The United Kingdom’s problems lie in the macroeconomic sphere, especially on the fiscal side, on which Brussels has virtually no influence at all. Instead, Britain’s problems are in areas over which the country as an EU member has full discretion such as fiscal policy and its housing market.

In a similar vein, the slippage in Britain’s adjustment efforts in the last two years, as described in this report and in previous editions of *The Euro Plus Monitor,* are the result of domestic policy choices, not the consequence of any meddling from its European partners. If it gets its domestic policy choices right, Britain can shine within the EU even more than it does already. Ejecting itself from its major market does not sound like a strategy to improve Britain’s economic outlook or raise the rankings for fundamental health or adjustment progress.

'Shattering fragile confidence by a confrontation with lenders was a costly mistake.'

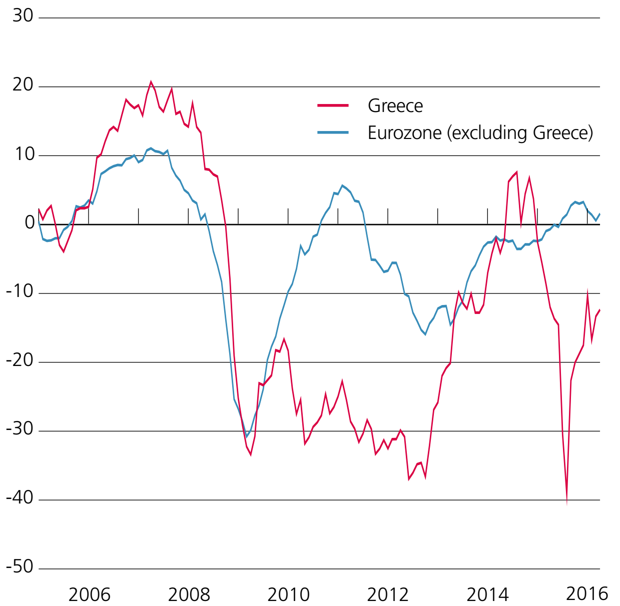
Focus: The Greek Tragedy

Since the first edition of *The Euro Plus Monitor* appeared in 2011, Greece has featured prominently in three separate ways:

1. According to the analysis, Greece did face and still faces the worst fundamental problems in the eurozone, usually coming last in the Fundamental Health Indicator (see, for example, *The 2015 Euro Plus Monitor*).
2. Under the pressure of crisis, Greece adjusted fast from 2010 onwards. It slashed its fiscal deficit, external deficit and labour costs faster than most other countries in the sample while legislating serious structural reforms. As a result, it usually took the top spot in the Adjustment Progress Indicator.
3. We repeatedly criticised the composition of the Greek adjustment programme. In its design – and even more in its implementation – it focussed too much on suppressing demand through front-loaded fiscal tightening rather than raising supply through fast labour, product and services markets reforms. In the fiscal sphere, the emphasis was too much on hiking taxes rather broadening the tax base.

Chart 7. The Varoufakis Effect

Greek versus eurozone corporate confidence



Corporate confidence in Greece and the eurozone (excluding Greece). Weighted average of confidence in industry, services, retail trade and construction
Sources: European Commission, Berenberg calculations

Although Greece went through more pain than necessary, its adjustment programme did work in the end. The recovery set in over the course of 2014. In late 2014, Greek corporate confidence had rebounded so fast that it even exceeded that of Spain. In 2015, the Spanish economy expanded by some 3.2%. Greece could have achieved the same. Unfortunately, the risk of reform reversals, which we had identified as the worst remaining risk for the eurozone in *The 2014 Euro Plus Monitor,* materialised with a vengeance in Greece.

With the rise of political uncertainty in late 2014, capital started to flee the country. With threats to reverse many reforms and a confrontational approach versus the only willing lenders Greek had, the new Greek government that came to power in January 2015 exacerbated the situation. Until the end of the tenure of Yanis Varoufakis as finance minister in mid-2015, capital flight through the banking system as recorded in Greece's balances in the Target2 payments system reached €66 billion, equivalent to 37% of Greek GDP.

For a country that had just emerged from one of the worst adjustment recessions on record in Western economies, shattering fragile confidence by a full-blown confrontation with the country's only willing lenders proved to be a costly disaster. Rarely before has corporate confidence plunged so fast and so badly in any self-inflicted disaster (see Chart 7 below).

The damage is substantial. Counting only the fiscal costs, we come up with a rough guesstimate for 2015 and 2016:

- Lost growth: Instead of expanding by around 3% in 2015 and 2016, the Greek economy contracted by 0.3% in 2015. After a weak first quarter (-0.4% qoq), even a modest rebound later this year will not lead to any significant gain in annual real GDP. For 2016, Greek real GDP will be roughly 6.5% below what it could have been otherwise.
- Lost revenues: Lower tax revenues and extra spending will likely lead to a cumulative fiscal shortfall of at least €8 billion for 2015 and 2016 relative to a baseline of unchanged policies and the absence of a political confidence shock. Although tax hikes and an increase in arrears hide a significant part of the fiscal damage, these corrective measures in themselves pose a burden.
- Weaker banks: The need to recapitalise the badly weakened banks and the prospect of much lower potential revenues from a future privatisation of banks after the massive dilution of the public sector's share in

‘For countries thinking of reform reversals, the Greek experience provides a stark warning.’

the banks probably amounts to a fiscal hit of at least €12 billion and possibly significantly more.

Lower real GDP, a slightly lower GDP deflator in response to renewed recession, the extra fiscal hit and the sizeable loss of potential privatisation revenues add up to the equivalent of at least 25% of Greece’s likely 2016 GDP. Without the confidence shock that derailed the Greek recovery, the outlook for Greece’s debt-to-GDP ratio could have been significantly less challenging.

Fortunately, history moves on. After Greece ratified a new agreement with its international lenders in the summer of 2015, corporate confidence recovered somewhat. But shattered trust is difficult to rebuild. Even a chastened Greek government without Mr Varoufakis has hesitated to fully implement the obligations it signed up to in August 2015. As a result, the risk of a renewed confrontation with creditors continues to weigh on confidence. We view this pervasive uncertainty as the single most important obstacle for an investment-led rebound in Greece. If Greece and its creditors can now conclude the first review of the new Greek programme successfully and in a way that inspires confidence, a fading of such uncertainty may lay the basis for a return to growth in Greece later this year.

Unfortunately, the compromise shaping up between creditors and the current Greek government may once again be biased towards tax hikes rather than a simpler tax system and faster pro-growth structural reforms to unlock the country’s significant supply potential.

To return to sustained growth and ease the heavy burden that currently has to be borne by the Greek population, Greece would need

- a firm political commitment to stay in the euro and work with rather than against creditors; and
- substantial deregulation as detailed in the August 2015 agreement with creditors.

Like other countries with weak administrative capacities, Greece could also benefit immensely from simpler rather than higher taxes in order to improve economic efficiency, growth potential and the tax take. It would have been and still is an ideal candidate for a flat tax on income and sales coupled with an offer to bring undeclared income and assets into the open against a measured penalty.

Chances are that a new agreement between Greece and its creditors can help the country return to growth later this year. For other governments thinking of reform reversals, the Greek experience should provide a stark warning: in a still fragile situation, policy mistakes that shatter confidence can be quite costly indeed.

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