Interview with Michael Deppler

Europe's problems are mostly home-grown

With a sustained economic recovery under way and another successful enlargement of the European Union (EU) under its belt, Europe should finally have something to cheer about. Instead, reform fatigue has gripped many policymakers, and Europe's citizens seem intent on blaming the EU and globalization for their countries' woes. For instance, a new FT-Harris poll showed that an overwhelming majority of citizens in the big euro area countries now believe that the euro has damaged their national economies. In this interview with Camilla Andersen of the IMF Survey, *Michael Deppler, head of the IMF's European Department, explains why the notion that Europe's problems are caused by excessive globalization is badly off the mark.*

IMF Survey: Growth has picked up almost everywhere in Europe. But will it be able to sustain its newly found momentum in the years to come?

Deppler: There is clearly a recovery under way. After growth of close to 3 percent in 2006—which is well above potential—we expect the economy to slow to about 2½ percent in 2007–08. Even though risks from the global economy remain on the downside, they have diminished, and risks from Europe's own economic dynamics strike me as being on the upside. So the odds of a reasonably well-sustained recovery are definitely in Europe's favor this time.

IMF Survey: What are the main driving forces behind the recovery?

Deppler: Part of the recovery is of a purely cyclical nature. Europe was badly hit by the dot.com bust in 2000, which sparked a series of balance-sheet adjustments in the corporate sector. These adjustments have taken a long time to get sorted out. But everything came together in 2006: strong growth in global trade led to rapid export growth, rising exports drove up investment, and low interest rates led to a strengthening of construction spending. But the most positive news was a pickup in employment. When jobs are created in Europe, you can be pretty sure you are seeing something of a lasting nature.

But structural reforms have also played a role. I am always struck by how pessimistic Europeans and others are about the effects of reforms in Europe. They expect—and "see"—little evidence of any payoff. But when you look at the data, the effects are very visible. For instance, few people realize that the euro area has generated significantly more business sector jobs than the United States over the past 10 years. This achievement is clearly the result of labor market reforms combined with wage moderation.

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European Union—by the numbers

	2006	2007
Nominal GDP (trillion euros)	11.4	11.9
Real GDP growth (percent)	2.8	2.4
Population (million)	493	

Sources: Eurostat; and IMF World Economic Outlook database (projections).
Note: Figures reflect the inclusion of Romania and Bulgaria.

IMF Survey: Recoveries in Germany and France differ markedly. How do you explain the differences between the euro area's two largest economies?

Deppler: Germany was *the* pleasant surprise of 2006, with growth of 2½ percent. Given the performance of the preceding years, it was nice to finally see an upturn come together in 2006. Moreover, while one-off factors played a role, it is clear that Germany is poised for stronger medium–term performance, with adjustments in the private sector and public sector reform working together to boost competitiveness.

But when you make comparisons about France and Germany, you have to realize that these two countries have been on different economic schedules over the past two decades. France had a weak performance through much of the 1970s and 1980s, which prompted a long period of adjustment that has paid off over the past 10 years or so [see page 46].

In contrast, Germany performed strongly up until the early 1990s—a backdrop that probably led policymakers to underestimate the adjustments required to integrate the poorer länder in the east and competitiveness considerations. As a result, Germany's performance has lagged for the better part of a decade. But restructuring in the business sector combined with various reforms are now finally paying off [see page 44], with the economy regaining the competitiveness it lost during the 1990s. The broader lesson, which applies to all countries in the euro area, is the importance for governments to keep a weathereye on competitiveness—broadly conceived through prudent fiscal policies and structural reforms.

IMF Survey: Does the euro's strength pose a threat to economic growth as claimed by some European politicians?

Deppler: In our view, the euro is fairly valued, at least when judged within the range of uncertainty that is attached to medium–term exchange rate assessments. If we look at Europe's export performance and its current account, the situation seems pretty healthy.

IMF Survey: Many countries in Europe appear to be suffering from reform fatigue. In what areas should reform-weary politicians concentrate their efforts?

Deppler: There is an understanding of the need to continue reform in official circles throughout Europe. For its part, the EU Commission is pressing ahead with the Lisbon agenda (Europe's blueprint for improving competitiveness) and is seeking to infuse more competition and integration into the financial and energy sectors.

That said, voters have not been very supportive of reform in recent elections, most recently in Austria and the Netherlands. This is partly due to the fact that reforms often have been implemented in a hesitant and partial manner, and have sometimes even been reversed. This has undermined their benefits and fed skepticism. Together with the return of good times, this is leading many to see the rest of the world as the source of Europe's problems—be it in the form of enlargement or globalization—and prompting calls for more attention to domestic needs. But in my opinion, this is to mistake the source of the problems.

IMF Survey: If globalization and enlargement aren't to blame, what is?

Deppler: If there is one sector where Europe is competing successfully it is in the external sector. This is obvious when you look at the growth of exports of goods and services. Regardless of whether you look at the past half century or just the past few years, the external sector has been the strongest driver of growth in Europe. It is true that there are periodic dislocations, with companies laying people off because of external competition, but those losses are dwarfed by the gains to the economy from the broader contribution of the external sector.

In other words, blaming globalization is mistaken because the problem is clearly internal. Low labor participation rates will need to be raised sharply in order to find an acceptable solution to the aging problem. But data on productivity are even more telling. Per capita income growth in the euro area has fallen short of that in the United States by 1 percent a year over the past decade—cumulatively 10 percent or so. But this is not because of exports. European productivity is at world levels in the manufacturing sector. The gap can be attributed entirely to the service sector—precisely that sector of the economy which is still relatively sheltered from global competition. Europe needs to remain focused on the fact that its problem—weak growth—is home-grown.

IMF Survey: So what needs to be done?

Deppler: Where there is an urgent need of reform is in those parts of the economy that are sheltered from competition through a host of laws and regulations that protect the interests of banks, notaries, plumbers, shopkeepers, energy companies, and many others.

From my perspective, the enlargement of the EU and the Services Directive, controversial as they may have been, are precisely the kinds of steps that Europe needs to take in order to strengthen its performance. Indeed, I think it is to the credit of the various governments in Europe that they have pressed ahead with these agendas, albeit in diluted form. So, while I find the public discourse disquieting, I am reasonably confident that Europe remains on the right track and that it will show the improvements in performance to match.

IMF Survey: Part of the popular malaise is rooted in concerns about the social model. Will Europe be able to maintain its way of life in the face of globalization?

Deppler: Yes, but only if reforms continue. Indeed, Europe's own experience suggests as much. But let's first be clear about what we mean by the European social model. There are at least as many models as countries. Perhaps the common characteristic people have in mind is a concern for preserving a fair distribution of income.

So what do we find when we look at experiences across continental Europe over the past decade or two? The countries most concerned about the distribution of income—the Nordic countries and the Netherlands—are also among the most successful reformers and performers in terms of growth.

What other traits do these countries have in common? First, an openness to the rest of the world. The external sector is very prominent in these economies. Second, an openness to markets. According to the OECD, they all have relatively light product and service market regulations. Third, a reliance on the budget rather than market restrictions as a means to redistribute income. The basic approach is to let markets work and then correct negative social consequences through a well-targeted social safety net. And fourth, a willingness to adjust the welfare state in response to new pressures. Cumulatively, this has been a successful strategy—in contrast to strategies pursued in the core of Europe, where attitudes to markets and competition tend to be more arms length, especially when there are strong stakeholders defending special interests. In our view, this leads to a collective shortfall in growth. If these countries—including France and

Germany—want to successfully sustain their social models, they will need to overcome such resistance.

IMF Survey: With the acceptance of Romania and Bulgaria as new members, the EU has taken another big step toward addressing the legacy of the Cold War. But unresolved issues ranging from immigration to representation at the European level have soured relations between old and new members. What can the EU do to help bridge the east-west divide?

Deppler: For the past 15 years, western Europe has been the beacon for eastern Europe. The enlargement of the EU toward the east has had tremendous benefits not only for eastern Europe but also for the west. Nowadays many people think that eastern Europe is benefiting much more than the west. And it is true that the benefits flowing to eastern Europe, for instance in the form of transfers from the EU, is tangible evidence to that effect.

But western Europe also benefits from the relationship. I have always been struck by the extent to which regional synergies are important to national economic performances. Think about Asia today. It is a hothouse of economic growth and the whole continent is doing well. For people in western Europe to think that they do not benefit from the fact that their eastern neighbors are also doing well is just wrong. People must learn to look beyond the factory closures and focus on the fact that, in the past, something else has always replaced those factories and that, given the right policies, this will continue to be case in the future. Being open to the world is the best strategy for adjusting.

IMF Survey: Will eastern Europe help western Europe become more competitive?

Deppler: Absolutely. For instance, studies show that German firms have become more competitive by outsourcing part of their production to eastern Europe, reimporting it, and then reexporting to the rest of the world. Countries that resist these trends—and they are difficult to resist effectively—will lose out. But people will only be open to change if they achieve a better understanding of what the benefits are. If you look at the way current accounts have moved between east and west, clearly the west is selling more to the east than the east is selling to the west. With its single market and open borders, integration in the EU has been a lasting source of growth for Europe. The Europeans need to continue in this direction.

IMF Survey: The IMF is redefining its mission to focus more exclusively on providing analysis and advice to its member countries. But what can the Fund offer in terms of value-added to a region already receiving sophisticated input from the EU Commission, the OECD, and European think tanks?

Deppler: "With its single market and open borders, integration in the EU has been a lasting source of growth for Europe. The Europeans need to continue in this direction."

Deppler: There is general agreement that Europe could do much more to improve its performance. As you say, there are quite a few institutions that give them advice. In my view, we mostly sing from the same hymn book—we reinforce each other. Given the scope to strengthen performance, I think that is both helpful and beneficial.

That said, the IMF is different from some of the institutions that you mentioned. Unlike the EU Commission, for instance, we are not a decision–making body. Our advice, while certainly not ignorant of political realities, is given more purely from an economic perspective.

This approach has its drawbacks, of course. We do not have the insider's perspective and full awareness of the constraints, and the only way to ensure that our advice is heard is through the power of persuasion. At the same time, that is also a source of strength. Because we are outsiders, it is easier for us to provide perspectives that otherwise tend to get lost in partisan debates.

The advice we offer is grounded in our experience with a variety of regions around the world. While there is a very definite European way of looking at issues, Europe can learn from the experience of other regions. All in all, my belief is that the Fund brings a unique perspective to the table. And with our new focus on financial sector issues, we are building ourselves a niche, but that remains to be fully developed. ■