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Date
10 June 2013

Insight €urope

Reform or regress

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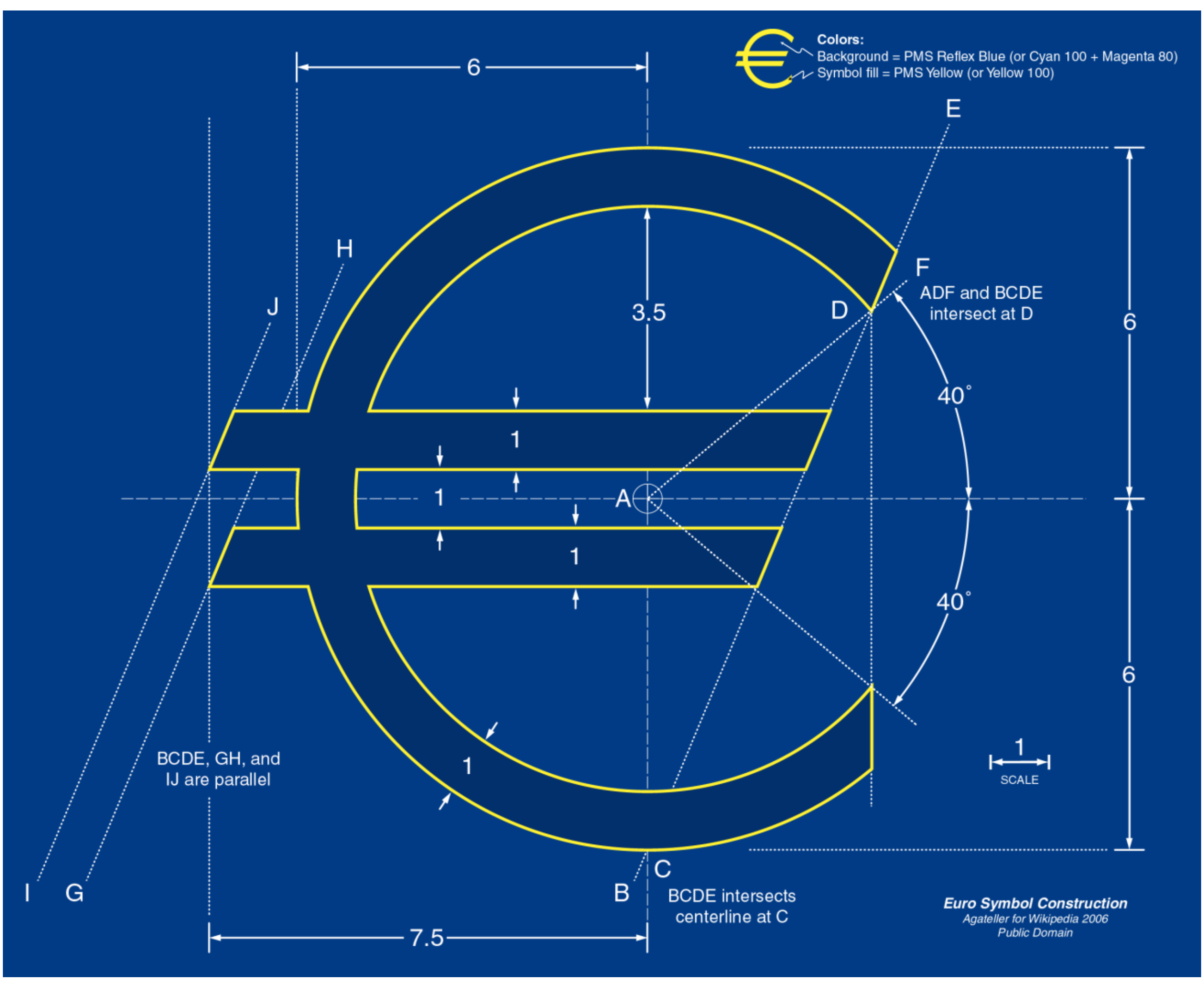

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Reform or regress

The debate in Europe tends to focus either on "grand projects" at the federal level, such as fiscal or banking union, or on emergency response mechanisms. However, in our view, ultimately the fate of the struggling countries in the euro area – as well as that of the monetary union per se – will be decided by their capacity to boost potential GDP to make the accumulated private and public sector debt sustainable in the long run.

This is all the more crucial as many countries – with the blessing of the European Commission and Council – are now allowed to take more time to rein in their deficits. While this brings some relief to domestic demand and markets are happy to see some rebalancing, the challenge of stabilizing debt has increased, not decreased. OMT is helping the market tolerate the risk. But a slower fiscal adjustment is advantageous over the medium-term only if accompanied by growth-enhancing reforms. Indeed, the capacity of the markets to accept this higher supply of government paper will depend on their assessment of the countries' determination to implement structural reforms.

We discuss this in three distinct but interconnected articles focusing on Italy, Spain and France. The first two countries are the truly systemic peripherals and France will play a crucial role in maintaining the credibility of the monetary union in the eyes of investors.

In the first article, we take a snapshot of the structural economic situation in Italy, Spain and France, before the Great Recession started in 2008.

We start, through a consistent set of structural indicators, to characterize pre-adjustment macro situation of the subjects of our study:

- Italy before the "great recession" was characterized by massive inefficiencies, epitomized by stagnating productivity. Low productivity was caused, inter alia, by an inefficient public administration, a tax system that penalized productive factors, a dysfunctional labour market and a high product market regulation that limited domestic competition. In our view these rigidities explain why Italy's performance in attracting foreign direct investment has been particularly poor. This in turn adds to the difficulty to raise productivity, as the diffusion of innovation is not boosted by strong competition and "import" of foreign practices.
- Spain was plagued by extremely heavy labour market regulation. Wage growth was completely out of control because of a toxic automatic price/wage indexation system. This threatened Spain's competitive advantage as a low-cost production centre for foreign investors. The extreme dualism of the labour market impairs potential growth since iron-clad protection of open-ended contracts slows down the reallocation of labour across sectors, while the system creates no incentive to invest in the human capital of fixed-term workers.
- France was a clear case of labour rationing and loss of competitiveness. Productivity was not the issue in France (same trend as in Germany).

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Rather, France's loss of market share reflected deteriorating competitiveness due to cost developments. France's model tended to direct these material productivity gains towards supporting domestic demand via higher wages. Labour rationing is also at play, with France's developed welfare state essentially funded by taxing labour income. Employment regulation is also heavy, and rigidity of wage settlement/working time regulation heavily impairs the capacity of firms to adjust to the gyrations in demand.

In addition, all three countries, at the onset of the Great Recession, faced substantial increases in the financial burden of unsustainable pension systems.

Based on the above structural positions, we quantify the pre- and post-crisis potential GDP under a "no policy change" scenario. Our estimations are based on past trends in productivity and labour market participation, together with UN projections for working age population. If nothing is done, potential GDP growth would hover at around 1% in Spain and France, and tend to zero in Italy. The impact of the crisis on youth unemployment, largely due to excessive labour market dualism, could lower such estimates. Indeed, the disproportionate fall in youth employment could reduce productivity by 0.2/0.3% per annum in Italy and Spain.

In the second article, we summarise what these governments have effectively delivered in the recent years.

Beyond a narrative of the reforms, we provide a synthetic "reformeter" to assess the reform impetus across countries based on our set of structural indicators.

- At one end, we have seen improvement since the onset of the Great Recession in Spain. For example, the Spanish export performance has been quite impressive lately, stemming from a significant catch—up on productivity and a welcome overhaul of the wage settlement system. Spain also benefits from positive demographics with respect to the other large euro-area countries. However, the labour reform remains patchy, leaving much more to be done starting with greater educational attainment.
- At the other end, even if Italy has made noticeable progress in some areas – in particular pension sustainability – the country remains at the bottom of our "reformeter" distribution. This means that Italy's gap relative to the other European countries, in terms of potential growth, is unfortunately not diminishing. In our view, the ongoing deterioration in Italy's productivity performance reflects the lagged reaction to the crisis. The country started to tentatively address some of the causes of the chronic low growth only in late 2011. However, the push to reform gradually diminished as elections in 2013 approached. What also concerns us is a potential narrative suggesting that the underlying cause of the deep, prolonged recession is fiscal consolidation. True, such policies exacerbated already weak economic prospects. But at the root of Italy's chronic weakness there is the lack of structural reforms over the past decade. It is fundamental that Italy avoids sliding back in the errors of the past.
- France seems to be catching up lately, finally taking measures to curb its crippling tax wedge and allowing more flexibility on the labour market. Still, France remains below average according to our reformeter. What France has started can only be the beginning of a long effort. To some extent France's situation today is close to Germany's in the late 1990s. Market pressure is not material, reducing awareness on the absolute need for change. This does not mean that change is not needed.

Then, using the estimates in our first article as our starting point, we calibrate the potential GDP increase from what these countries have already done to improve their structural position, drawing on a model developed at the OECD. Unfortunately, the 0.2/0.3 annual gain potentially pocketed so far in Spain and Italy is currently being offset by the negative effect of youth unemployment and by the increase in taxation brought about by the ongoing fiscal consolidation. Indeed, the age distribution of the workforce has a long term effect on productivity. At the same time, governments have reacted to market pressure by raising taxation overall, with the tax wedge – detrimental to labour participation – increasing.

We show that through a comprehensive but not exhaustive set of reforms (e.g. tax wedge, quality of education, employment protection, product market regulation etc.), GDP could be boosted by 5% cumulatively in ten years in France and Italy, and nearly 2% in Spain. Long-term benefits would double, triple and quadruple for France, Italy and Spain respectively. A wider set of reforms would lead to an even larger boost – starting with decreasing the inefficiencies in the Italian public administration.

In the third and last article, we suggest a politically and socially acceptable strategy for prioritizing reforms.

The best way, ultimately, to resolve the nagging "sustainability" question in the Euro area is to forcefully deliver on structural reforms. Hence we highlighted a wide array of necessary reforms.

However, the struggling European countries find themselves in a particularly daunting position. That structural reforms have to accelerate in periods of low economic growth is not in itself anything new. But, during the previous wave of structural reforms in the early 1990s (Canada and Scandinavia), deep recessions were isolated. Reforming countries could count on decent world demand from 1994 onwards. This time it is the near entirety of Europe which is wallowing in stagnation/recession. This can increase the lag between the implementation of the reforms and economic recovery, thus reducing their political acceptability. In addition, the capacity for "fiscal wheel greasing" is very limited. Furthermore, the current dearth of credit in the peripheral countries could also increase the lag between the reforms' implementation and the materialisation of their benefits in terms of employment and economic growth. Indeed, structural reforms in one way or another tend to raise potential GDP growth by reorienting the allocation of capital and labour towards the most productive sectors. Such a process of "creative destruction" can be hampered by low access to leverage.

In fact, after nearly six years of painful economic conditions, adjustment fatigue risks compromising the reform process. We think that collectively the European decision makers need to regain public confidence and reform momentum by beginning immediately from a small set of reforms. These reforms could support those who have been disproportionally affected by the crisis, e.g. the young generations, without increasing social tension. This means prioritizing those reforms that can boost growth without imposing too high short-term costs:

- First, we think that the long lag between the immediate pain of the labour market reforms and the materialization of the benefits can be mitigated by resorting to simple product market reforms which very quickly boost consumers' purchasing power as demonstrated by the introduction of a fourth mobile phone operator in France.
- Second, reforms that increase public administration efficiency could significantly boost growth prospects in Italy. Promoting such reforms could also reverse the declining trust in European federal institutions.
- Third, while it will take time to absorb the accumulated stock of youth

unemployment, part of long term impact on productivity could be mitigated by raising educational attainment in science and technology in the periphery at the cost of less than EUR1bn.

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The starting point: structural shortcomings in France, Italy & Spain

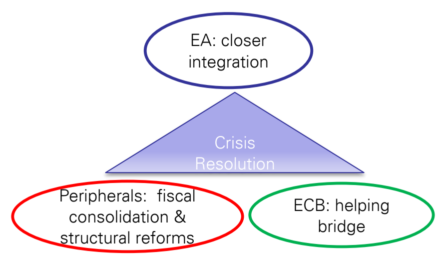
The ECB cannot solve the crisis on its own. The OMT buys time but does not remove the underlying causes of the euro-area crisis and the adjustment process is now slowing down in some peripheral countries, as market pressure is abating.

The long-term solution for the crisis has to come through (i) structural reforms, (ii) fiscal consolidation and (ii) further euro-area integration.[1] In Focus Europe over the past month we discussed the last two points. In this article we complete our assessment by focusing on structural reforms. The key to private and public debt sustainability is higher potential GDP growth particularly in a situation where the public debt trajectory has actually deteriorated in the periphery. As a flip-side of the new fiscal realism which allows for a wider use of automatic stabilizers, the assessment of long term growth potential becomes even more crucial.

Box 1: Fiscal consolidation and the debt challenge

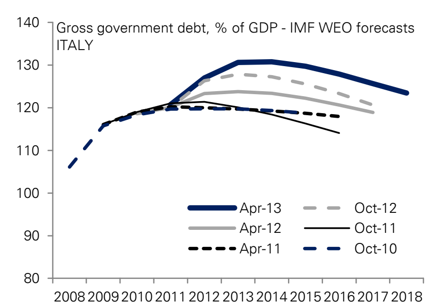
In Focus Europe on 10 May, we looked at the consequences on euro-area fiscal deficit and public debt projections for the euro area of the "new fiscal realism". The expected austerity in 2013-14 has slowed (modestly) compared to six months ago. Although the original Troika goals have generally not been reached, the fiscal adjustment in the peripherals has been impressive (and costly to growth). For the peripheral bloc as a whole, the structural primary budget balance is approaching levels seen in the 'DM bloc' pre-crisis. Austerity may have reached its political limits and markets are happy to see some rebalancing. But the challenge of stabilizing debt has increased, not decreased (Figures 2 and 3). OMT is helping the market tolerate the risk. In our view the key is to support potential economic growth via structural reforms, above all for Italy.

Figure 1: Solving the euro-area crisis



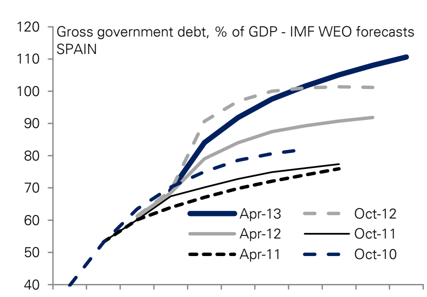
Source: Deutsche Bank, IMF

Figure 2: Public debt/GDP, an increasing challenge for Italy and…



Source: Deutsche Bank, IMF

Figure 3: …for Spain



Source: Deutsche Bank, IMF

Pre-recession macro-snapshot

We offer here a snapshot of the macroeconomic position of a number of European countries before the "Great Recession" using a set of simple variables (see Figure 4).

- Italy before the "Great Recession" was characterized by massive inefficiencies, epitomized by stagnating productivity.

Low productivity was caused, *inter alia*, by an inefficient public administration, a tax system that penalized productive factors (labour and capital), a dysfunctional labour market and high product market regulation that limited domestic competition. The inefficient public administration and red tape put Italy at the lower rank among European countries for the "ease of doing business" indicator produced by the World Bank. We would single out, among the components of this particular indicator, the inefficiency of contract enforcement on account of a dysfunctional civil justice system. These rigidities

[1] For fiscal consolidation and further euro-area integration see Focus Europe on 10 May and 17 May respectively.

explain in our view why Italy is at the bottom of our sample for the capacity to attract Foreign Direct Investment. This in turn adds to the difficulty of raising productivity, as the diffusion of innovation is not boosted by strong competition and "import" of foreign practices. Educational attainment, which is below the OECD average, does not help either.

The very low level of labour market participation reflects in our view clear "labour rationing", which we attribute to the combination of high taxation on productive activity, relatively stringent labour market regulation (however not dissimilar to the German level according to the OECD index) and barriers to women and the young entering the labour market. Finally, Italy's mounting incapacity to adapt to globalization can also be explained by the large number of very small firms (less than 10 employees) with limited financial capacity. Overall, the sense of economic decline is epitomised by the sharp deterioration in its export performance with respect to the increase in trading partners' demand

- Spain was plagued by extremely heavy labour market regulation, which hampered the re-allocation of workforce after the collapse of the construction sector.

Wage growth was completely out of control before the recession, because of a toxic automatic price/wage indexation system. This threatened Spain's competitive advantage as a low-cost production centre for foreign investors (evident when looking at the high stock of inward foreign direct investment). Successive Spanish governments since the 1980s refused to reduce the high level of employment protection which was a legacy of the Franco-era corporatist organization of labour, and tried to promote some level of flexibility by allowing a periphery of workers on short-term contracts to develop. This extreme dualism of the labour market weighs on potential growth through two channels. First, iron-clad protection of open-ended contracts slows down the reallocation of labour across sectors, impairing productivity growth. Second, businesses have no incentive to invest in the human capital of fixed-term workers, which compounds the rather poor quality of the education system, as reflected in the OECD's Pisa score.

Product Market Regulation was not an issue in Spain according to the OECD index, but some inefficiencies – in particular the accumulation of regional legislation on top of national rules - explain a lowish ranking on "ease of doing business".

Figure 4: Pre-recession situation

		Peripherals			Benchmark		
	2007 unless stated	Italy	Spain	France	Germany	Sweden	United States
Labour market	Employment protection index, 2008	2.58	3.11	3.00	2.63	2.06	0.85
	Labour participation rate, % of population >15 years age	49.0	59.1	53.6	613	64.1	63.4
	Unit labour costs, 1997-2007 trend, % p.a.	18	2.9	16	-0.1	13	17
	Quality of education system (PISA maths score), 2009	483	483	497	513	494	487
Product market	Product Market Regulation index, 2008	132	0.96	139	127	124	0.84
	Ease of doing business (distance to frontier)	64.0	69.8	68.1	78.1	79.5	84.2
Macroeconomic performance	Labour productivity, 1997-2007 trend, % p.a.	0.4	0.5	17	17	2.6	2.8
	Export performance, 1997-2007 trend, % p.a.	-3.4	-0.8	-2.4	0.9	-0.1	-2.4
	Share of high-tech sectors^ (% of exports)	6.0	4.2	16.7	13.0	13.3	14.0
Tax structure	Labour tax wedge, % of GDP	35.7	32.9	42.4	35.6	39.4	18.5
	Indirect tax share, % of total tax	36.0	33.6	36.1	317	29.2	27.9
Economic openness	Inward foreign direct investment stock, % of GDP	16.5	37.8	44.9	28.3	60.3	20.9

Source: Deutsche Bank, OECD, Eurostat, Bureau of Labor Statistics, Bureau of Economic Analysis, Census Bureau
The colour scheme indicates whether a country is structurally relatively strong (Green) or relatively weak (Red) for the given indicator among the 6 countries in the table.
^Note that the share of high-tech exports in France is skewed to the upside by Airbus.

- France was a clear case of labour rationing and loss of competitiveness

Contrary to Italy, productivity was not the issue in France. The trend in productivity gains was the same as in Germany, and the absolute level of hourly productivity (GDP in volume divided by total number of hours worked) was 12% higher than in Germany and on a par with Sweden's in 2007. France's loss of market share reflected deteriorating competitiveness due to cost developments. France's model tended to direct these material productivity gains towards supporting domestic demand via higher wages, while Germany channelled them to profitability and competitiveness. The divergent economic models are clearly reflected in the drivers of GDP growth. Domestic demand contributed by nearly 21pp cumulatively between 1999 and 2007 to GDP growth in France against 5.6pp in Germany. Conversely, net trade contributed 8.5pp to cumulative GDP growth over the same period in Germany against a 3.0pp negative contribution in France (see also Figure 5 in the next section).

Airbus skews the share of high-tech in exports to the upside, but France can still rely on a fair-performing education system to maintain a high productivity level. Still, we think that the labour participation rate could be higher. Indeed, the developed welfare State there is essentially funded by taxing labour income, with France displaying the highest tax wedge (difference between the total cost of labour for the employer and employee take-home pay) of our sample. Employment Protection Legislation is particularly stringent, further adding to labour rationing. The rigidity of wage settlement/working time regulation is particularly toxic since it impairs the capacity of firms to adjust to the gyrations in demand.

Product Market Regulation in 2008 was the highest in our sample, which results in a lowish ranking for ease of doing business. The rigidities until then had not discouraged foreign investors to settle in France, but the sharp decline in the export market share reveals a lack of responsiveness to the changes in world demand.

What if nothing happens? Italy faces stagnation

We present a simple calibration of potential annual GDP growth over the long-term assuming no benefit from structural reforms. Since the onset of EMU, the pace of GDP growth has varied significantly across the large four euro-area countries as shown in Figures 5 and 6. However, the past decade has been characterized by the build-up of imbalances in several countries, as reflected in the widening current account deficits in the euro-area peripheral countries as well as in France. Hence, past growth differential may not provide a reliable guide for future growth.

Potential output depends on the potential labour force (which depends on demographic factors), the non-accelerating inflation rate of unemployment (NAIRU), the level of labour efficiency and the capital stock. By assuming that the stock of capital adjusts to the quantity of labour, we calibrate the potential GDP in a simplified way as:

- *(Option 1):* (future change in the working age population (WAP))*(trend in the employment ratio (ER))*(trend in productivity per employee)
- *(Option 2):* (future change in WAP)*(trend in the employment ratio)*(trend in productivity per hour)*(trend in hours worked per employee)

We use the UN projections for the change in total population over the next ten years. For the remaining inputs we look at trends between the onset of monetary union and 2012. It may be seen as a harsh approach since the trend then captures the steep economic deterioration brought about by the 2008-2009 great recession, probably the deepest world economic downturn over the past 70 years. Hence, we also replicate our calibration using trends between 1999 and 2007 for both options.

The results are summarized in table 7 below. We focus on the broad messages rather than on the exact numerical values.

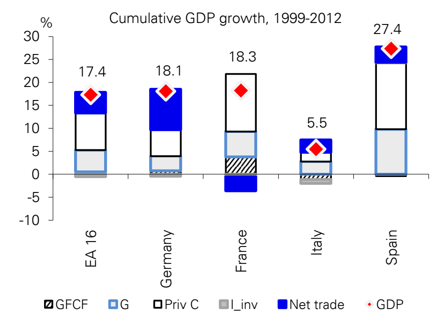
Figure 7: Italy needs growth enhancing reforms

Calibration of potential GDP growth, % p.a.

Option 1 - based on productivity per employee(*)	Italy	Spain	France	Germany
Trend variables calculated over the 1999-2007 period	0.3	1.2	1.0	0.6
Trend variables calculated over the 1999-2012 period	-0.2	1.2	1.0	0.9
Option 2 - based on productivity per hour(*)				
Trend variables calculated over the 1999-2007 period	0.3	1.2	1.4	1.1
Trend variables calculated over the 1999-2012 period	-0.1	1.4	1.0	0.9

Source: Deutsche Bank, OECD, Eurostat, UN, Haver
(*) All options use UN forecast for working age population over 2013-2023

Figure 5: Cumulative GDP growth



Source: Deutsche Bank, Haver

Figure 6: Annual GDP growth

(YoY, %)	Annual Real GDP Growth (%) 1999-2007	Annual Real GDP Growth (%) 1999-2012	Annual Nominal GDP Growth (%) 1999-2007	Annual Nominal GDP Growth (%) 1999-2012
Italy	1.6	0.4	4.0	2.5
Spain	3.6	1.9	7.7	4.7
Germany	1.6	1.3	2.5	2.2
France	2.1	1.3	4.1	3.1
EA	2.2	1.2	4.3	3.0

Source: Deutsche Bank, Haver

Italy in need of reforms: The clearest message is the confirmation that structural reforms are a necessity for Italy. Indeed, our simple calibration suggests a future of stagnation in the absence of growth enhancing reforms.

Spain's surprising stability: Using the full sample (1999-2012) or restricting it to the pre-recession period does not lower Spain's potential GDP. This simply reflects the fact that, while as shown in Figure 8 productivity has accelerated quite quickly there since the beginning of the recession (mechanically raising our measure of potential growth), this is offset by a lower trend for employment.

Demographics matter: Potential GDP does not differ substantially across Germany, France and Spain. That said, one may be surprised by the ranking. Why is Germany not at the top? The main reason is the difference in the UN working age population projections over the next 10 years. While demographics boost Spanish annual potential GDP by 0.2pp per year, the drag on Germany's growth is of 0.5pp. The contribution for France is neutral while Italy's demographics suggest a drag of 0.3pp. This means that were it not for the differences in demographic dynamics, Germany would comfortably display the highest potential GDP growth while the difference between Italy's and Spain's GDP growth rates would nearly halve.

The above demographic projections could be at least partially offset by net migration flows. For example, the high youth unemployment in peripheral countries could lead the most mobile, motivated and possibly best educated young people to emigrate to countries such as Germany – which could further dampen potential growth in their home countries. Such a process could become less necessary if governments there were to pursue reforms that open up domestic labour markets and implement reforms to boost future growth prospects. Note that, the blight of youth unemployment may directly decrease potential GDP in peripheral countries as we show next.

Figure 8: No improvement in Italy's productivity performance

Source: Deutsche Bank, Haver

The curse of youth unemployment

In our calibration of potential GDP we looked at the evolution of the overall employment rate but we did not account for changes in the composition of employment across age groups. Note that the cost of the painful economic downturn is borne disproportionally by the young generations (Figure 9, Panel A).

Indeed, even if their initial level of human capital is comparatively low, young workers are often the vehicle of innovation in companies. What we find striking for Italy and Spain is that the drop in the employment ratio has not affected only the 15-24 year group but also the 25-29 year group, i.e. those who are likely to be at the forefront of innovation.

Using data collected at the firm level in Belgium (which in our view is a good proxy for the euro area in general), Lallemand and Rycx estimated the impact of a change in the age composition of staff on aggregate productivity.[2] They add to a canonical model of productivity based on firm and staff characteristics the share of three age groups (below 30, 30 to 49, above 50) in firms' workforce, as explanatory variables.[3]

Here we provide an illustrative quantification of the negative impact on firms' productivity of the recent change in the age composition of employment.[4] We

[2] "Are young and old workers harmful for firm productivity", Forschunginstitut zur Zukunft der Arbeit Institute for the Study of Labor, January 2009.

[3] For the most recent estimate, 2003 data, the estimation was based on a sample of 1204 firms.

[4] Note that we do not double count the impact of the crisis as in the previous section we looked at the overall employment ratio while here we focus on the share of employment across age groups.

apply the coefficients estimated by Lallemand and Rycx on the actual changes in employment shares across age groups observed in Italy, Spain, France and Germany between 2007 and 2012 (see Figure 9). As expected, the total adverse shock on the level of aggregate productivity is material above all for Italy (-2.3%) and Spain (-2.7%).

The effect on the annual potential GDP growth will depend on three factors. (i) how much of such an impact has already materialised, (ii) how long will it take to materialise and (iii) how persistent it is. Assuming half of the impact is cyclical and that the remaining impact will become evident in the next five years, Italy's, Spain's, France's and Germany's annual potential GDP growth would fall by about 0.2pp, 0.3pp, 0.1pp and 0.1pp respectively (Panel B Figure 9).

Figure 9: Impact of lower youth employment on total productivity and annual GDP growth

Panel A: Impact on total productivity

Age groups	Lallemand & Rycx coefficients	Change in the share in total employment in % From Dec-2007 to Dec-2012: Italy	Spain	France	Germany
<30	0.137	-20.4	-39.1	-7.8	-4.3
30-49	0.205	-3.0	6.2	-4.1	-8.3
>50	0.053	21.6	26.9	16.0	19.5
Total impact on productivity (%)		-2.3	-2.7	-1.1	-1.2

Panel B: Impact on potential annual GDP growth

Proportion of the above total impact on productivity that will materialise		Impact on annual potential GDP growth assuming the impact will materialise over the next 5 years (pp): Italy	Spain	France	Germany
¼	➔	-0.11	-0.13	-0.05	-0.06
0.5	➔	-0.23	-0.27	-0.11	-0.12
¾	➔	-0.34	-0.40	-0.16	-0.19
1.0	➔	-0.46	-0.54	-0.21	-0.25

Source: Deutsche Bank, Lallemand & Rycx, Haver

In our opinion, it is clear that policies aimed at avoiding the depletion of the human capital of the young are a key priority for both Italy and Spain but would also benefit France and Germany (see next article). Note that a shift towards a higher share of employment of older workers over the long term is unavoidable given Europe's demographics. Hence, structural reforms are also necessary to offset an ageing workforce.

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What should they have done? What have they done? What will change?

Based on our characterization of the different economies in the previous article, we sketch out here our view on the priorities that should be pursued. We also provide a set of performance indicators, allowing for a cross-country comparison of the reform impetus, together with a simple, synthetic scoring index, our "reformeter".

Still, simply "coding" reform measures and aggregating them can be misleading. What matters ultimately is the impact on GDP. We draw from a simulation developed at the OECD to evaluate the effect of some of the key reform introduced so far. We suggest that for the time being the not-insignificant boost to potential GDP is offset by the dampening impact of youth unemployment on productivity, as well as by the – hopefully transitory – negative effect of the increase in taxation brought about by the fiscal consolidation undertaken there. More needs to be done. We also provide a long term estimate of the boost to GDP which would stem from a more comprehensive convergence of France, Italy and Spain to the structural position of our "benchmark countries".

What needs to be done?

Spain should i) forcefully curb employment protection, in particular reduce the dualism between iron-clad open-ended contracts and flexible fixed-term contracts, which imposes a disproportionate adjustment burden on young workers – therefore hampering innovation diffusion; ii) reform the wage negotiation system; iii) rebalance the tax structure towards higher indirect tax (which boosts competitiveness), iv) remove some inefficiencies on the internal product market produced by Spain's territorial fragmentation and iv) reform the inefficient school system to gradually move up the 'value added curve'.

Italy should forcefully improve its productivity performance. The country should i) improve the efficiency of the public administration, in particular reforming the judiciary to improve the enforcement of contracts; ii) reduce the regulatory burden on the product market by removing barriers to entry and fighting rent-seeking behavior; iii) boost R&D expenditure and innovation as well as promote an increase in firms' size and a modernization of corporate governance; iii) rebalance taxation away from productive factors towards unproductive ones as well as cut public expenditure and reduce tax evasion; iv) improve educational attainment; v) curb the duality of the labour market, increase wage flexibility and raise the participation rate of women and the young. While the overall burden is not massive, some issues, such as asymmetric risk taking for the employers when dismissing employees, contribute to labour rationing.

France should i) reduce the tax wedge, so as to boost labour supply – this should be done by diminishing or at least containing the cost of the welfare state, in particular through more ambitious pension reforms and less generous unemployment benefits; ii) make the labour market more flexible, in particular by allowing businesses at the local level to stray more freely from rules on pay and working time; iii) reduce Product Market Regulation, particularly in utilities.

What have they done?

We present in Figure 1 a narrative of the reforms which have been undertaken since 2008, as well as a set of indicators in Figure 2 which should help us to assess whether any of the changes have already materialized in higher economic performance over the past five years. It is a slightly more restrictive set of indicators than in the previous article, since, for example, the OECD does not calculate PMR and EPL indices every year. An obvious shortcoming of that method is also that cyclical gyrations in a particularly troubled period significantly affect the data. Still, we think it is a useful tool when making cross-country comparisons.

- Spain's notable progress

Spain has dealt forcefully with its particularly toxic wage settlement system, using European, rather than national inflation in catch-up clauses, allowing more leeway for individual businesses to stray from general agreements. This – combined with a notable acceleration in productivity – has allowed a stabilization in unit labour costs and an improvement in competitiveness which is already materializing in strong export market gains. This was chiefly achieved thanks to an agreement between the unions and the employers' federation in 2011 valid through 2014. We think that the country should move further and inscribe the new settlement permanently into law.

On labour market institutions progress is mixed. For open-ended contracts signed from February 2012 onwards, severance payments in the general case will reach 33 days per year spent in the company (20 for economically motivated dismissals) instead of 45 days previously. For the existing contracts at the time of the reform, severance payments will be calculated as a weighted average of the time spent in the company before and after February 2012 (with a cap at 720 days). In addition, Spain introduced a new open-ended contract for companies below 50 workers where no severance payment would be made if the dismissal occurs within the first year. This defuses the sense of "entitlement loss" for existing workers, but impairs the reallocation of labour in the economy as the cost of laying-off the bulk of the workforce changes only slowly.

The cost of adjustment continues to fall disproportionately on younger people (see Figure 9 in the previous article). We think the government needs to go further and, if not entirely align EPL on a single, lightly regulated working contract, at least accelerate the decline in severance cost for existing workers.

The pension reform of 2011 was significant, raising the minimum retirement age to qualify for full pension from 65 to 67 by 2027 for people with less that 38.5 year of contribution. Still, we consider that the contribution time itself remains comparatively low (it's already 40.5 years in France for instance).

The tax wedge has increased over the past few years. However, we think it essentially reflects one-off surcharges in income tax, and the level remains below that of Germany. Spain has at the same time re-oriented its tax system towards more indirect taxes, using VAT hikes several times to plug its gaping fiscal deficit.

On product market reform, quite a few interesting measures are in the pipeline, such as the "market unification" law, as well as a liberalization of regulated professions. This has been announced for this year.

- Italy's diminishing reform impetus

Monti's government began at the end of 2011 an ambitious programme of structural reforms for Italy. However, the push to reform gradually diminished over the past year as elections in 2013 approached. The response of the election was negative in terms of the European recipe based on austerity and structural reforms in our opinion. What is particularly concerning to us is that there appears to be a narrative of the crisis suggesting that the underlying cause of the deep, prolonged recession can be found in the austerity policy implemented by Monti's government. True, such policies exacerbated an already weak economy. But the underlying cause of Italy's chronic weakness is lack of structural reforms over the past decade.

Among the implemented policies of Monti's government, we highlighted in Figure 1 the pension reform which accelerated the already planned increase in the pension age (which will continue to rise in line with life expectancy). The pension reform accelerated the already planned rise in the retirement age. Indeed, the average effective exit age will increase from about 60 years in 2007 to about 65 years in 2020. So Italy's effective exit age should move from one of the lowest among the large euro-area countries before the crisis to the highest in 2020, helping to counteract the challenging demographics. The savings are expected to be more than 1% of GDP by 2019.[5]

Although the overall tax burden increased, Monti's government began a structural redistribution of taxation away from productive factors (labour and capital) towards unproductive ones (VAT, properties) and helped a too modest reduction in expenditure cuts. Unfortunately the new government seems to be giving priority to cut taxes on unproductive factors, e.g on residential properties, instead of productive ones. Increasing the deficit targets by increasing the distortionary effects of the tax system would not be a good omen.

Some measures were adopted to increase competition in product and service markets. For example, progress was made in partially opening up market segments in the services sector, in particular professional orders. Italian firms are penalised by higher cost of energy and the opening up of the gas market has had a greater-than-expected impact on wholesale prices. New measures appear close to being implemented to pass the benefits to retail gas prices. However, the cost of wholesale electricity remains higher in Italy than in most other European countries.

Other measures went in the right direction but implementation is lagging. More efficient means of fighting tax evasion, ex-ante cross-checking of movements on financial accounts and tax returns, have been approved but the implementation date has been moved from in January 2013 to October 2013. Improving the efficiency of the public administration is a key priority, including that of the justice system. Resolving a commercial lawsuit takes 1210 days against 390 days in France and 394 in Germany. Monti's government introduced the aggregation of tribunals and the rejection of groundless appeals to obtain greater efficiency, with the aim of reducing trial duration by 25% in 3-4 years. Together with other measures, this could increase GDP growth by +0.3%. We do not see a full implementation of these measures yet. Indeed, all major parties in Parliament appear to agree on a postponement of the aggregation of the Tribunals, which could delay if not weaken the reform.

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[5] According to a report by the Italian National social security and welfare institution (Inps), the pension reform introduced by Monti government should bring EUR 80bn in savings between 2012 and 2021.

Figure 1: What have they done - an overview of the reform progress

	Implemented	Started but not completed	What more should they do
ITALY	**Tax system**: structural redistribution of tax away from productive factors towards unproductive ones. However, the benefit has been more than offset by the excessive focus on tax increases rather than expenditure cuts. *Unfortunately the new government seems to be giving priority to cut taxes on unproductive factors (properties, consumption) instead of productive ones (labour). Increasing the deficit by increasing the distortionary effects of the tax system would not be a good omen.* **Pension reform**: retirement age of 67 by 2022 (rather than 2026), will then automatically increase in line with life expectancy. The savings are expected to be more than 1.0% of GDP in 2019. *The new government may smooth the adjustment process in the short term but we do not expect major modifications*. **Deregulation**: opening up of the gas market has had a greater-than-expected impact on wholesale prices. Minimum tariffs for professional services have been abolished. Modest deregulation in commerce, financial, local services. *Continuing of the deregulation process does not seem to be among the priorities of the new government.* **Modernization of government** via greater use of technology. Monti government estimates that implemented measures could reduce administrative costs by about 0.5% of GDP. **Balanced budget in the Constitution:** for central government as well as for the regions.	**Fight tax evasion**: ex-ante cross-checking of movements on financial accounts and tax returns was supposed to go "live" in Jan 2013, but has been postponed to October 2013. *There may be divergences within the government coalition on the determination of fight tax evasion. The centre-right may ask for a limitation of the powers of the national tax collection agency.* **Justice system**: (i) aggregation of Tribunals to obtain greater specialisation and economies of scale, hence judiciary efficiency. (ii) Doubling costs of initiating legal proceedings. Increase by between 50% and 100% administrative fees for appeal proceedings. (iii) Immediate rejection of groundless appeals, which could reduce duration of trials by 25% in 3-4 years. Together with other measures, could increase GDP growth by +0.3%. In terms of efficiency of contract enforcement in the World Bank's "ease of doing business" Italy is ranked 160th out of 185 countries. Resolving a commercial lawsuit takes 1210 days compared to 390 days in France and 394 in Germany. *We do not see a full implementation of these measures yet. Indeed, all major parties in Parliament appear to agree on a postponement of the aggregation of the Tribunals, which could lead to a weakening of the reform. The justice system is likely to be a contentious issue within the government coalition. The ongoing trials of ex-PM Berlusconi poses a material risk to the stability of the government.* **Labour market:** The 2012 reform imposed: (i) A very modest easing of individual redundancy rules and compensations (Article 18 modified after 40 years) but increased judges' discretion. (ii) A partial reduction of the fragmentation of the unemployment benefit system by 2017 (greater coverage by reducing duration of benefits). (iii) Some modest incentives to transform short-term contract into permanent ones and measures to discourage the use of short-term. *The new government will probably reverse part of the measures meant to limit the use of short-term contracts given the current difficult conjunctural conditions.*	**A key priority should be to improve the efficiency of the public administration (at 73rd place in the World Bank ranking on ease of doing business), which represent an obstacle to attractions inward foreign direct investments (Italy was second-last among the EA-17 between 2007 and 2011).** *The new PM Enrico Letta mentioned the importance of improving the efficiency of PA but no concrete measures have been announced so far.* **A key mistake: the new government has "suspended" the property tax introduced by Monti rather than giving priority to productive factors, e.g. labour taxes.** *This tax item accounts for 1.5% of total taxation versus a European average at 3.2%. The property tax could fund a fall in the labour tax wedge and boost employment.* **Reassessment of public expenditure:** A more material reduction of the public expenditure is necessary to lower tax burden. The overall methodology and strategy of Monti Government represented a step forward but with modest results.
SPAIN	**Labour market reform: royal decree of July 2012 (applies to all new contracts and for future years on existing contracts**) Unfair dismissals: severance payments down to 33 days per year of seniority and 20 days when motivated by economic reasons (with a cap at 24 months) from 45 per year. Firms no longer have to pay wages during judicial proceedings. Abolished need for central or regional government pre-approval for collective dismissals. **Union/employers agreement to reform wage settlements**. Future wage growth linked to Euro area consumer prices rather than Spanish inflation (as in the past). Energy component of the Ensures wage growth can no longer trigger a loss of Spanish competitiveness. The energy component of CPI is excluded for the calculation of the wage increase when it rises by more than 10% (to avoid second-round effects from oil shocks). For 2014 wage growth will be indexed on GDP growth. **Pension reforms in 2011:** A gradual increase (by 2027) of the legal retirement age from 65 to 67 for workers with less than 38.5 years of contribution.	**The draft law on Market Unity adopted by the government in January 2013** aims to reduce the fragmentation of the domestic market (avoiding norms adopted at the regional level block intra-Spanish trade). *This would spur competition but the law could be challenged in the Supreme Court by the regional governments.* **Acceleration in the phased-in implementation of the pension reform with automatic indexation on life expectancy.** Transmission of a technical report to parliament by 31 May. Target for vote: end of 2013. **Liberalization of access to the regulated professions.** To be voted by parliament before the summer of 2013. *The elaboration of the law itself was postponed by several months last year. It is a protracted process.*	**The government should enshrine the wage settlement agreement into law to provide long term visibility on competitiveness. Another instalment of severance payment reduction for open-ended contracts should be implemented.** *For the time being the government has merely announced that it would "review" the labour reform this summer.* **Ideally, labour market dualism should be abolished by instituting a single type of working contract.** Labour market Reform should be complemented by active labour market policies and stronger implementation of education and training polices. **Raise the minimum contribution time for pension.**
FRANCE	**"Competitiveness pact"**: EUR 20bn rebate on corporate tax indexed on businesses' wage expenditure, offset by VAT hike (1st Jan 2014). This will reduce the cost of labour by 6% over 3 years (the competitiveness boost is further strengthened by the VAT hike which raises the relative price of imports). **Labour market liberalization**. The unions and the employers' federation have agreed in January 2013 to allow deals at the local level which will enable businesses to modulate working time and pay according to the gyrations in demand, superseding the provisions of the work contracts. Translated into law by parliament in April. One such deal already signed at Air France, another one close to signature at Renault.	**Further reform of the pension system.** Bigger and faster increase in the minimum contribution time to qualify for full-pension (according to the 2010 reform it will move from 40 years initially, to reach 41.5 years by 2023). Finalization of the government proposal by end June - negotiations with unions this summer - transmission to parliament this summer. *The Prime minister has already rejected an increase in the legal retirement age (due to reach 62 in 2018) given the symbolic role this plays with the unions. Toying with the contribution time, as well as with the non-proportional rebate levied on pension for those retiring below the contribution threshold is likelier.*	**Renegotiation of the unions/employers federation agreement** on unemployment benefits must legally take place before end 2013. *The risk is a "minimum deal", with a mere "stitch up" (hike in payroll tax, cosmetic decline in benefits). It is essential in our view is to re-introduce "degressivity" in the system (today 2 years of constant benefit at c.70% of former pay).* **Accelerate the introduction of effective competition in the energy sector** (especially electricity) which would reduce production costs and boost purchasing power.

Source: Deutsche Bank

Figure 2: What have they achieved?

		Pre-recession level / trend						Change 2007 - 2012					
					Benchmark						Benchmark		
		Italy	Spain	France	Germany	Sweden	US	Italy	Spain	France	Germany	Sweden	US
Labour market	Unit labour costs, (1997-2007 trend, % p.a. | growth since 2007, % p.a.)	1.8	2.9	1.6	-0.1	1.3	1.7	2.3	0.0	2.2	2.2	1.4	0.5
	Youth (15-24) unemeployment rate (2007, % | change since 2007, p.p.)	20.2	18.2	19.8	11.8	19.1	10.5	14.9	34.9	4.5	-3.8	4.5	5.7
	Employment rate (2007, % | change since 2007, p.p.)	58.7	65.6	64.3	69.0	74.2	72.0	-1.9	-10.2	-0.4	3.9	-0.4	-4.0
Product market	Ease of doing business - distance to frontier (2007 | change since 2007)	64.0	69.8	68.1	78.1	79.5	84.2	1.8	2.9	3.3	-0.8	2.0	0.1
Macroeconomic performance	Labour productivity (1997-2007 trend, % p.a. | growth since 2007, % p.a.)	0.4	0.5	1.7	1.7	2.6	2.8	-0.3	1.9	0.3	0.2	0.4	1.6
	Export market share (1997-2007 trend, % p.a. | growth since 2007, % p.a.)	-3.4	-0.8	-2.4	0.9	-0.1	-2.4	-2.6	0.8	-0.7	1.3	-0.8	0.5
	Share of high tech sectors in total exports (2007, % | change since 2007, p.p.)	6.0	4.2	16.7	13.0	13.3	14.0	0.4	0.7	3.3	0.9	-0.4	-2.6
Tax structure	Average tax wedge (2007, % | change since 2007, p.p.)	35.7	32.9	42.4	35.6	39.4	18.5	2.6	2.6	0.7	-1.4	-1.9	-0.1
Economic openness	Inward FDI stock (2007, % of GDP | change since 2007, p.p. of GDP)	16.5	37.8	44.9	28.3	60.3	20.9	0.8	8.0	-7.0	-0.2	8.5	3.3

Source: Deutsche Bank, OECD, Eurostat, Bureau of Labor Statistics, Bureau of Economic Analysis, Census Bureau
The colour scheme indicates whether a country was structurally relatively strong (Green) or relatively weak (Red) for the given indicator in 2007 among the 6 countries and whether the 2007-2012 change has been relatively strong (Green) or weak (Red) in terms of potential structural impact.

Progress on resolving the duality of the Italian labour market has been disappointing. The 2012 labour reform introduced a very modest easing of individual redundancy rules but increased judges' discretion. The latter could offset the benefits of the former. A partial reduction of the fragmentation of the unemployment benefit system will occur only by 2017 (greater coverage by reducing the duration of benefits). Some modest incentives to transform short-term contracts into permanent ones and measures to discourage the use of short-term were introduced, but the results appear to have been counterproductive in the short term. In fact, the current government will probably reverse part of the measures meant to limit the use of short-term contracts given the current difficult conjunctural conditions.

- France is coming late, but significant measures are being taken

Two important breakthroughs have occurred this year.

- First, the "competitiveness pact" – a corporate tax credit calculated in reference to companies' wage bill – offset by a VAT hike on 1 January 2014 – will (finally) trigger a drop in the labour tax wedge (labour costs in the non financial private sector should fall by c.5-6%), while also emulating the effect of a currency depreciation by raising the price of imports relative to exports.
- Second, an agreement at the national level with the unions in January 2013 which will allow businesses to cut deals with local unions to reduce pay and working time in case of adverse cyclical conditions. So far, even if individual businesses reached a successful agreement with the unions, employees were still able to refuse the new conditions and win "constructive dismissals" indemnities. The agreement has been integrated into law by Parliament in April. Actual agreements in companies such as Air France and Renault are imminent.

With the exception of a fairly tough – but still insufficient – pension reform in 2010, France came late to the realization that structural reforms were unavoidable. An acceleration has been perceptible since the beginning of last year, but the effects will take time to materialize and France's economic performance for now continues to deteriorate.

Another installment of pension reform is due for this summer. Getting a full social security pension in France (equal to 50% of the reference salary calculated on the average of the last 25 years) depends on two conditions: reaching a certain age (already brought up from 60 in 2010 to 62 by 2018) and having contributed to the system, through work, for a minimum time (brought up in 2010 from 40 years to 41.5 years by 2023). If one reaches the legal age but has not contributed enough, the pension is reduced by a steep rebate. As an example, someone reaching 62 but having contributed 40.5 years instead of 41.5 (so a 2.4% miss) will see his pension reduced by 3.2%.

The Prime Minister as already mentioned that he would not change the legal age, which is the most important symbolic issue for the unions. We therefore expect the government to toy with the three other parameters: i) raising the speed at which the increase in minimum contribution time increases; ii) raising the minimum contribution threshold itself; iii) increase the rebate.

However, little progress is seen for now on two key areas.

First, the overall level of protection for open-ended contracts. There is at this stage no discussion in policy circles of a possibility to introduce a "single contract" which would reduce the gap between fixed and open-ended contracts.

Second, an overhaul of the unemployment benefits system. The current union/employers' federation contract on this branch of social security is up for renegotiation by the end of this year. Unemployment benefits – under the current system introduced in 2011 - are calculated as a percentage of past wages, up to 75% of past wages for low-income workers, 57.4% for higher-income workers. However, since not all social contributions are levied on unemployment benefits, even for higher-income individual the actual replacement rate can be close to 75% - with a cap at EUR6,129 per month. Employees having worked 16 months out of the last 26 are eligible to their unemployment allowance for 2 years. This rises to 3 years for workers above the age of 50. Re-introducing degressivity (i.e. allowing for the replacement ratio to decrease every few months of the allowance's duration) would be a good test of the resolve of the French government to risk unpopular measures to put the country back on track. At a minimum, increasing the minimum contribution time to get the 2-3 years full allowance is necessary to repair the financial equilibrium of the system and create more incentives to effectively seek jobs.

An illustrative synthetic indicator

We present here a simple, synthetic indicator summarizing most of the information and covering the different areas of structural performance, displayed in Figure 2 to provide a quick, illustrative overview of the efforts to which the Europeans have already consented (see box for the methodology). We also provide in Figure 3 a breakdown of the contribution from each sub-component of the synthetic indicator to the change between 2007 and 2012.

Box: construction of our synthetic indicator of structural performance

We consider a set of 9 variables relating to structural performance– largely corresponding to those in Figure 2[6].

First, we construct the synthetic indicator for 2007. We do this by normalizing each of the variables at their 2007 level using the mean and standard deviation across our selection of nine significant EU countries. To reduce the impact of outliers (e.g. the very high level of FDIs in Belgium) we then take the log of the standardised variables. Finally to create the synthetic index we calculate the average of these log values across the 9 indicators for each country. The index can thus be interpreted as the relative structural performance compared to the average euro-area country in 2007.

Second, to evaluate the performance since 2007, we then construct an equivalent index using 2012 values of the indicators. For the EPL – not available for the recent period – we use our judgement to calibrate the change in the index brought about by the reforms. Note that we still use the 2007 average across countries to normalize our variables – hence the 2012 index can still be interpreted as performance relative to the average in 2007 – allowing us to note the aggregate structural improvement across the euro area over the 5 years.

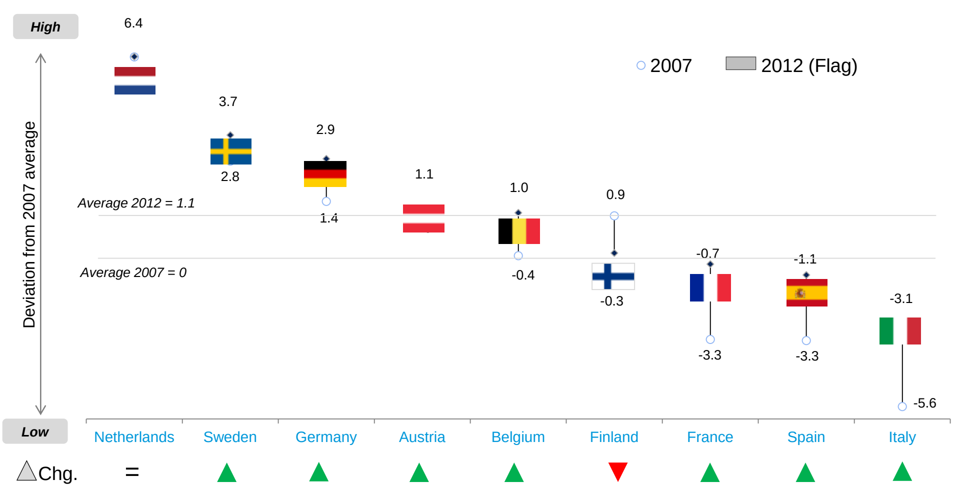
Unsurprisingly, two Northern European countries (Sweden and the Netherlands) stand at the top of the distribution. Germany already stood above the average in 2007 but has continued to improve and now stands very close

[6] The set of measures are described in the footnote to Figure 4 below. To avoid double counting we scrapped from the original set in Figure 2 the employment rate and unit labour costs and kept productivity (while looking at these indicators separately helps to build the narrative and build the diagnostic). We additionally consider the effective retirement age.

to Sweden. In Germany – as in most countries in our sample – the improvement in the pension system – which we capture via the EC's estimate of the change in effective retirement age between 2007 and 2020 – is a substantial contributor to the overall gains. This applies particularly to Italy, where the pension reform introduced by Monti's government explains 1.9pp out of the total 2.5pp improvement (Figure 4). Still, Italy remains at the bottom of the distribution in 2012.

Spain got closer to the sample average in 2012, from a low starting point. The contribution from the pension reform was significantly lower than in Italy and Spain's progress is impaired by the very negative contribution from youth unemployment, but this was more than offset by strong productivity gains, export performance, as well as by some gains on the ease of doing business and employment regulation.

Figure 3: An illustrative synthetic indicator of the adjustment effort



Source: Deutsche Bank
The value of the synthetic indicator can be interpreted as relative structural performance compared to the average across the nine countries in 2007.

Figure 4: Contribution to the changes in the synthetic indicator between 2007 and 2012

Country	Ease of doing business	Employment Protection Legislation	Average effective exit age	Labour productivity	Tax structure	Share of high-tech exports	Inward FDI stock	Youth unemployment	Export performance	Total
Austria	0.1	0.0	0.5	0.1	0.1	0.3	-0.1	0.1	-1.0	0.0
Belgium	0.3	0.0	-0.1	-0.1	0.0	0.2	0.3	0.0	0.8	1.5
Finland	0.1	0.0	0.9	0.0	0.6	-1.4	0.0	0.1	-1.7	-1.3
France	0.3	0.1	1.2	0.1	0.0	0.3	-0.2	0.1	0.8	2.6
Germany	-0.1	0.0	0.9	0.0	0.2	0.1	0.0	0.1	0.1	1.5
Italy	0.1	0.3	1.9	0.0	0.1	0.0	0.0	-0.1	0.2	2.5
Netherlands	0.2	0.0	-0.2	-0.1	-0.1	0.0	-0.3	0.1	0.5	0.0
Spain	0.4	0.7	0.8	0.2	-0.3	0.1	0.3	-0.6	0.7	2.2
Sweden	0.2	0.0	0.2	0.5	0.4	-0.1	0.2	-0.1	-0.4	0.9

Source: Deutsche Bank, OECD, Eurostat, IMF
The colour scheme represents whether a given variable made a positive (Green) or negative (Red) contribution to the 2007 – 2012 change in the synthetic indicator.
See Box on page 15 for discussion of the methodology for the synthetic indicator.
The following 9 variables are used in constructing our synthetic indicator:
1 Ease of doing business distance to frontier (World Bank)
2 Employment Protections Legislation index (OECD)
3 Average effective exit (retirement) age. Taken from 'The 2012 Ageing Report' by the European Commission. For the end of period (2012) values we use the projected figures for 2020 in order to better account for the recent pension reforms across countries, as a result of which pension ages are set rise considerably in the medium-term.
4 Labour productivity (per hour worked)
5 Tax efficiency. Calculated combining the two tax efficiency measures from Figure 4 in the first article – average tax wedge and share of indirect taxes. The combined indicators is equal to the average tax wedge (higher values are bad for growth) minus share of indirect taxes (higher values are good for growth). Hence high values of the combined measure are indicative of a tax structure detrimental for growth.
6 Share of high-tech exports (% of total exports)
7 Inward foreign direct investment stock
8 Youth (15-24) unemployment
9 Export performance (OECD). An indexed ratio of a country's exports to the size of the country's export market.

France also improved also solidly, with a strong contribution from the 2010 pension reform (1.2 pp out of 2.6 pp), benefitting from an export performance which – while it remains low – has improved somewhat in relative terms. However, on productivity, the gains are very limited and FDIs made a negative contribution, pointing to lower attractiveness of France as a production centre.

A partial quantification of observed and implemented reforms

The synthetic indicator – while useful to track and compare the "reform impetus" across countries – presents the obvious drawback that it is not weighted. Therefore, the indicator does not directly inform on the quality of the reform set in each country, which ultimately should be assessed in reference to the impact each component of the reform package has on potential GDP.

As a general warning, it is very complex to quantify the impact of recent and ongoing reforms.

- First, benefits will become evident only in the medium-to-long term.
- Second, the mere approval of a reform does not imply that the benefits will unfold immediately. The implementation phase is crucial, indeed the Governor of the Bank of Italy Visco on 31 May highlighted that "*in many instances, after the enactment of reform laws, the implementing measures have been slow to follow; in some cases they are still lacking and administrative practices remain unchanged. This is a recurrent feature of our country's history: the chief difficulties reside not so much in the substance of the laws as in their effective application.*[7]
- Third, calculations are based on a set of indicators many of which are published with more than a year lag.

[7] Bank of Italy Governor's Concluding Remarks, 31 May 2013: http://www.bancaditalia.it/interventi/integov/2013/cf_12/cf_12_en/en_cf_2012.pdf

We draw here from our analysis in 16 December 2011 Focus Europe [8] in which we used an econometric framework based on an OECD paper[9] to simulate the potential GDP impact of structural reforms. The specification combines a range of empirical studies in a series of single econometric equations allowing us to track how much effect different reforms have on GDP.

The set of indicators in this model largely correspond to those in Figure 2 (pre-recession level table) and can be found, together with their descriptions in the Appendix. While this is by no means an exhaustive set of structural measures, they demonstrate the underperformance of Italy, Spain and France in most (but not all) areas relative to our benchmark of more competitive EU countries in 2008, at the start of the Great Recession[10] (Appendix).

We then conduct here a partial exercise. We look at how a subsection of the indicators of our model[11] have changed by 2012 compared to the 2008 values we used in our model above. For the Product Market Regulation and Employment Protection Legislation indices, no data more recent than 2008 are available, so we had to use the change in the Ease of Doing Business Distance to Frontier as a proxy to estimate the change in PMR, and use our judgment of the labour market reforms to date in comparison to past changes in the EPL index. Educational attainment is normally an important input in the OECD model. However, we did not use this parameter in this exercise since the OECD's Pisa score is not available after 2009 and we could not find suitable proxy.

Through the partial exercise we estimate that the improvements in product and labour market regulation fully implemented by 2012 as well as the increase in the retirement age and the share of indirect taxation could boost the GDP level by between 1.5pp and 3pp cumulatively over the medium-term, providing a small but non-negligible boost to potential GDP growth over the next decade (Figure 5). However this benefit could be offset by:

- The impact of high youth unemployment as shown in figure 9 in this article.
- Distortions from the increases in the labour tax wedge, which are a potential drag on growth. That said, the increase in the tax wedge may be transitory – coming as a temporary effect of austerity policies (e.g. one-off income tax increases in Spain) and with measures to reduce it in the pipeline (e.g. competitiveness pact in France).

Figure 5: Benefits of reforms fully implemented to date may be offset by impact of high youth unemployment and increasing tax wedge

	Baseline potential GDP growth % pa^	Impact of *observable and implemented* reforms p.p. pa over 10 years*	Potential impact of high youth unemployment	Potential (transitory) impact of higher tax wedge	**Revised potential GDP % pa**
France	1.21	0.14	-0.11	-0.04	**1.20**
Spain	1.29	0.30	-0.27	-0.20	**1.12**
Italy	0.09	0.25	-0.23	-0.10	**0.01**

Source: Deutsche Bank
^ Based on the average of the two alternatives in Option 2 of Figure 7 in the 'Starting point' article of this Insight Europe.
**Based on our model the reforms considered should have most of the impact within the first 10 years. For simplicity we assume the impact will be fully felt within the 10 year period.*

[8] See '2012: Need to focus on structural reforms' in 16 December 2011 *Focus Europe*.

[9] Barnes, S *et al.* (2011) "The GDP impact of Reform: A Simple Simulation Framework", *OECD Economics Department Working Papers*, No. 834, OECD Publishing.

[10] We use as a benchmark the average of Austria, Denmark, Finland, Germany, Netherlands, Sweden and UK scores for each indicator.

[11] In particular we consider the average tax wedge, share of property and consumption taxes, retirement age and Product Market Regulation (PMR) and Employment Protection Legislation (EPL) indices.

The analysis in the table above is far from providing an exhaustive quantification of the impact of the ongoing reforms. For example, we do not capture policies to improve the expediency of the justice system introduced by the previous Italian government. As highlighted above, these could boost GDP growth by +0.3%, cutting by more than a quarter the gap in potential GDP with respect to France and Spain. Similarly, a continuation of Monti's policy to shift the tax burden away from productive factors (labour and production) would further boost GDP in Italy. A reduction of the tax wedge would also lift France's and Spain's potential GDP growth.

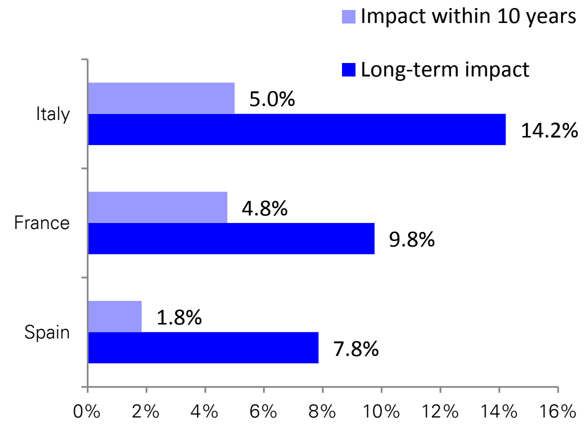
In an interview with Il Sole 24 Ore on 31 May, Italy's new Finance Minister and Bank of Italy's ex-Director General Fabrizio Saccomanni stated that he shared the recommendation of the EC on the need to push ahead on structural reforms. Indeed, he said they were already part of the government's programme to lift potential growth: increasing the efficiency of the public administration including the expediency of the civil justice system, reducing the tax wedge, cutting public expenditure, fighting corruption and improving educational attainment. Such intentions are encouraging given the gap between in potential GDP growth between Italy and the two other large European Latin countries. However, as discussed above, first, the new Italian government appears to be giving priority on reduction on taxes on unproductive factors. Second, all major parties in Parliament appear to agree on a postponement of some of the measures to improve the efficiency of the justice system. There is a risk of repeating the errors of the past decade.

Estimating the long term gains from structural reforms

We prolong the partial exercise of the previous section by simulating the potential impact of a set of reforms that would bring the three countries' performance in line with our benchmark in those indicators in which they were underperforming in 2008.[12] We also consider the time that the reforms would take to impact growth – while for some reforms, for instance the tax wedge, most of the impact is felt within 10 years, in the event of educational reforms it takes decades to fully feed through.

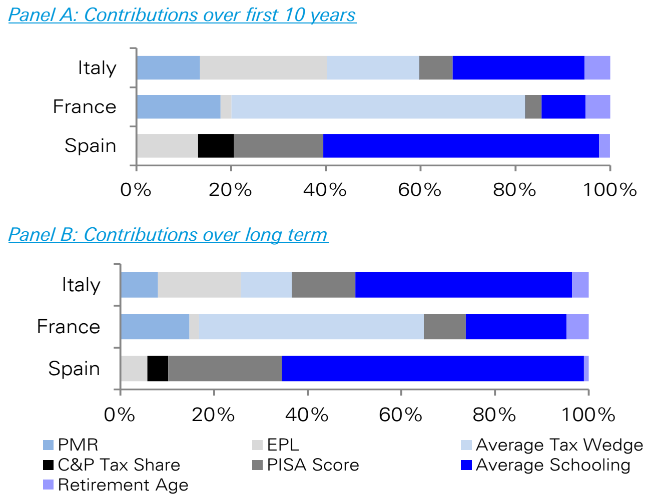
[12] As in the previous section our benchmark is the average scores for Austria, Denmark, Finland, Germany, Netherlands, Sweden and UK for each indicator.

Figure 6: Potential gains in level of GDP



Source: Deutsche Bank

Figure 7: Contributions of reforms to GDP increase



Source: Deutsche Bank

We view this simulation as a large but not exhaustive set of reforms. For instance, we assume no improvement in those indicators where the countries are already stronger than our benchmark (e.g. PMR for Spain); that does not mean that there are not potential gains to be made. Still, the overall message is that there is significant room to boost GDP (Figure 6).

While we would avoid putting too much emphasis on the exact figures, given the considerable assumptions involved, there are a few takeaways we would make.

- First, Italy looks to have the most to gain from structural reform.
- Second, the biggest gains for France appear to come from reducing the high tax wedge to the benchmark level.
- Third, improving the level of human capital seems to be the key priority for Spain.

Given the long time this takes to adjust, the short-term effect of adjusting 'only' as far as our benchmark may be relatively small for Spain compared to Italy and France.

That said, the results for Spain offer a hint of caution. In our framework we use education as a proxy for human capital – other measures, such as training, can be also used to address this and may have a quicker impact. Also, the Spanish case highlights the potential deficiency of using a standardized approach – while reducing labour market regulation does not appear to bring major benefits for Spain, the fact of the matter is that reducing the duality of the labour market and mitigating the damaging effects of very high youth unemployment are key, as we saw in the previous section with the significant impact that working population ageing can have on trend productivity and, thus, potential GDP.

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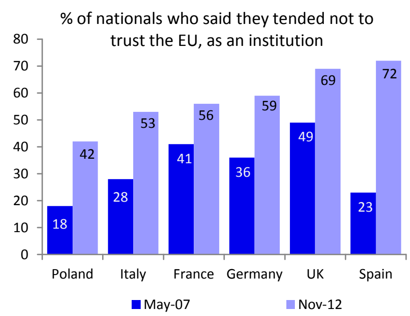
Reconciling reforms with political realism to regain momentum

After nearly six years of painful economic conditions, adjustment fatigue risks compromising the reform process. We think that collectively the European decision makers need to regain public confidence and reform momentum by fighting the growing perception that the European Union is an obstacle to growth. [13]

The overall aim is to start immediately from a small number of reforms that could support those who have been disproportionally affected by the crisis, e.g. the young generations, without increasing social tension. This means prioritizing those reforms that can boost growth without imposing too high short-term costs:

- First, the long lag between the immediate pain of the labour market reforms and the materialization of the benefits can be mitigated by resorting to simple product market reforms which very quickly boost consumers' purchasing power.
- Second, reforms to increase public administration efficiency could significantly boost growth prospects in Italy. Promoting such reforms could also reverse the declining trust in European institutions.
- Third, while it will take time to absorb the accumulated stock of youth unemployment, part of long term impact on productivity could be mitigated by raising educational attainment in science and technology

Figure 1: Declining trust in the EU



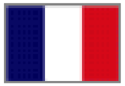
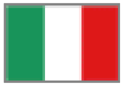
Source: Deutsche Bank, Eurobarometer. The Guardian

Adjustment fatigue requires political realism

When asked how the transitorily negative impact of fiscal retrenchment on GDP growth and unemployment could be mitigated, *"more structural reforms"* was ECB President Draghi's immediate answer. He actually elaborated – rightly in our view – on the extreme dualism of Southern European labour markets. It is an obvious case where the structural features of an economy magnify the impact of the cyclical drop in activity triggered by fiscal austerity and private-sector deleveraging.

[13] According to Eurobarometer, public confidence in the European Union has fallen to historically low levels in the six largest EU countries: Germany, France, Britain, Italy, Spain, and Poland, which account for 70% of EU population (See Sueddeutsche Zeitung, Le Monde, Gazeta Wyborcza, El Pais, La Stampa and The Guardian - http://www.guardian.co.uk/world/2013/apr/24/trust-eu-falls-record-low/print).

Figure 2: Country level reform priorities: Italy faces heaviest agenda

	Description			
Labour market	▪Raise labour market flexibility ▪ Moderate labour protection ▪ Firm level wage agreements ▪Incentivise labour participation ▪ Lower taxes on income ▪ Active labour market policies	▪ Lower labour tax burden ▪ Increase flexibility of wage negotiation system ▪ Reform welfare system ▪ Raise effective pension age	▪ Reduce two-tiered labour market ▪ Raise female and youth participation ▪ Raise educational attainment ▪ Increase wage flexibility	▪ Reduce two-tiered labour market e.g. lower protection for open-ended contracts ▪ Improve basic education and training
Product market	• Raise domestic competition ▪ Improve administration ▪ Lower barriers to entry for professional services (law, taxi) ▪ End state monopolies (post, rail)	▪ Improve competition in energy sector (electricity in particular)	▪ Raise admin efficiency ▪ Improve judiciary system ▪ Lower barriers to entry and fight rent-seeking ▪ Modernise corporate governance	▪ Consolidate regional trade processes
Macro performance	▪ Raise external competitiveness ▪ Lower labour cost ▪ Raise R&D investment ▪ Improve FDI attractiveness	▪ Reduce unit labour costs ▪ Raise Eurozone export market share	▪ Low productivity, high ULC ▪ Low competitiveness ▪ Too low R&D ▪ Too many and inefficient (< 10 employees) SMEs	▪ Enhance labour productivity e.g., reverse pre-crisis wage growth ▪ Support pro-growth sectors e.g., technology, R&D over construction services
Tax structure	▪ Shift taxes from productive factors to unproductive factors ▪ Lower direct taxes on labour ▪ Lower corporate tax burden ▪ Raise consumption tax rate ▪ Tax property	▪ Lower excessive tax wedge on labour income - some progress raising VAT and lowering corporate taxation through the competitiveness pact	▪ Reform tax system e.g., shift burden away from productive factors (labour) to unproductive ones (property) ▪ Cut expenditure ▪ Enhance tax collection	

ource: Deutsche Bank

Still, governments, upon making the decision to push through structural reforms, have to factor in time consistency. To use the labour market example further, an obvious way to reduce dualism is to take down severance payments on open-ended contracts. However, in the short run this can accelerate lay-offs, with companies taking advantage of the legislative change to offload labour. At the same time, as long as companies on aggregate are experiencing slack, they would have very little incentive to hire, even under the new scheme. In a nutshell, cutting severance pay would probably lift labour demand by the time activity picks up, but it cannot be effective in reducing unemployment immediately. In the meantime existing workers' anxiety rises – since their level of protection in case they lose their job falls – while existing job seekers do not perceive any immediate uptick in their probability of being hired. This is a "double whammy" for politicians.

Indeed, the specificity of the current period is that European governments are reforming against a particularly depressed macroeconomic background.

- That structural reforms have to accelerate in periods of low economic growth is not in itself anything new. In a comprehensive study of structural reforms published in 2006 a team of OECD economists gathered statistical evidence[14] around the idea that *"big economic crises are generally […] associated with higher overall reform activity*". In a way, crises expose the structural shortfalls of the economy and create a sense of urgency which can facilitate long-postponed reforms. However, during the previous wave of structural reforms in the early 1990s (Canada and Scandinavia), deep recessions were isolated. Reforming countries could count on decent world demand from 1994 onwards. This time it is the near entirety of Europe which is wallowing in stagnation/recession. This can increase the lag between the implementation of the reforms and economic recovery, thus reducing their political acceptability.
- The capacity for "fiscal wheel greasing" is very limited. Another finding of the OECD study is that *"a sound government budget balance is associated with higher reform activity, which could reflect an enhanced ability to finan*ce compensatory measures". Most struggling countries today have virtually no room for manoeuvre on their deficits.
- The current dearth of credit in large swathes of the Euro area could also increase the lag between reform implementation and the materialisation of benefits in terms of employment and economic growth. Indeed, structural reforms in a way or another tend to raise potential GDP growth by reorienting the allocation of capital and labour towards the most productive sectors. However, the process of "creative destruction" can be hampered by low access to leverage. In Focus Europe on 17 May (see "Deconstructing banking union") we made the point that under pressure on their capital ratios, it can be rational for banks to "evergreen" credit lines to "bad risks", thus avoiding write-offs, and reduce lending to "good risks".

Box 1: The uphill battle of labour market reforms during recessions

To "ease the pain", governments could be tempted by "half way" solutions, such as changing the severance payments rules only gradually for existing workers. Spain is experimenting with that, as we mentioned in the previous section. In extreme cases, young workers can actually side with the insiders in refusing a more flexible labour market if they disregard the increase in their probability of being hired brought about by the reform and the additional

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[14] An empirical investigation of political economy factors behind structural reforms in OECD countries". Hoj, Galasso, Nicoletti, Dang. OECD Economic Studies #42, 2006.1

income this would generate and focus on their relative lower level of entitlement once they secure a job. [15]

The distributional issues (across insiders and outsiders) and the lag before the benefits show up can be managed if i) the reforming government has a long assured tenure and/or ii) the labour movement can itself internalize the potential conflicts between its current and its future membership and accepts to cooperate with the government and employers' representatives. This suggests that structural reforms are best implemented at the beginning of a government's mandate, and that political reforms aiming to produce strong and stable parliamentary majorities could be counted towards "structural reform enhancing" measures.

From this point of view, France and Spain are in a much better position than Italy. Reforming the electoral system could actually be seen as the "mother of all structural reforms" in this country. Changing the unions' attitude to cooperation is more complex. Blanchard and Philippon in 2003[16] could trace back the degree of current hostility between unions and employers' federations to political attitudes towards the emergence of unions in the nineteenth century. However, we are observing some positive moves, with in particular the acceptance, by a majority of French unions, of the January 2013 agreement to make the labour market more flexible, and the decision by Spanish unions to overhaul wage/inflation indexation.

Given the above headwinds, we think that a politically credible "reform package" must contain some "short term fixes" with an immediate impact on people's living standards.

Product market reforms to provide quick boost to purchasing power

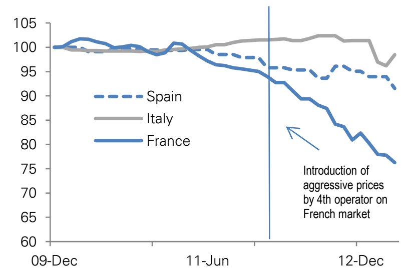
We think that product market reforms, improving consumers' purchasing power by reducing rents, can provide a short-term economic boosts. We take here the example of utility prices in France.

The French telecommunication agency accepted to grant a fourth mobile licence in December 2009. The new operator introduced aggressive, cut-price tariffs in January 2012. As we show in Figure 3, since this aggressive move the price of telephone services has fallen by a staggering 19.8%, against 6.5% in Italy and 3.0% in Spain, our "control group". Since telephone services account for 2.5% of French consumers' basket, opening up this sector alone to competition has boosted real purchasing power in France by 0.5% in a little over a year.

Inflation-busting product market reforms are important because of the interaction with fiscal policy and employment-enhancing policies. Indeed, as we mentioned in the previous sections, rebalancing the tax burden away from labour cost towards indirect taxes such as VAT represents another means, beyond reforming labour market institutions, to boost employment. However, again, the VAT hike will immediately depress consumer spending while the

Figure 3: More competition=more purchasing power: the example of the introduction of a fourth mobile phone operator in France

Price of telephone services. 100= level in December 2009



Source:EU data, Deutsche Bank

[15] France provides an interesting example of this. In 1994, the government finally renounced on introducing a lower minimum wage for younger workers after months of unrest in high schools and universities. The fact that France was in the midst of a severe recession at the time probably helps to explain what happened. With the aggregate level of employment falling rapidly, the effect of the "SMIC Jeunes" on the probability of finding jobs was probably perceived as too low, in comparison with the cost of losing entitlements.

[16] "The Quality of Labour Market Relations and Unemployment". Blanchard, O. and Philippon, T.. NBER working paper 10590, 2004

employment-boosting effect of the reduced tax wedge will take time to materialize. In our estimates, the disinflationary effect of the introduction of another supplier on the French mobile phone market would offset a hike in the normal VAT rate of one percentage point.

Increase the efficiency of the public administration

Governments have to balance the (immediate) political cost of structural reforms with the impact on the economic environment. From this point of view, they should focus on measures which trigger a welfare loss for a small proportion of the population – by reducing rents – while having strong diffusion effects.

Here a good example is reforming the judiciary in Italy. France and Italy have very similar legal systems (dominance of codes over jurisprudence, administrative organization of justice). However, according to the World Bank, the average time to enforce a contract stands at 1210 days in Italy against 390 days in France. Using the World Bank simulator, simply by aligning on the French procedural time, Italy would gain 12 places on the "ease of doing business" index (from 73rd to 61st). Back in May 2011, when he was Governor of the Bank of Italy, Draghi highlighted that according to the Bank of Italy's estimates "*the shortcomings of the civil justice system in Italy could subtract up to one percentage point a year from GDP growth*".[17]

We think that a combination of such costless measures (governments simply have to accept lower licence fees when opening utilities further and judiciary reforms can be achieved by changes in the procedures – reducing access to appeals for instance – rather than by increasing workforce in the legal system) could help making transitorily painful reforms of the labour market more politically acceptable.

But the process should going beyond the judiciary. Survey-based evidence from the World Economic Forum (2012) on the most problematic factors for doing business in Italy, suggests that the second major obstacle, just after the level of taxation, is the inefficient government bureaucracy[18]. Techniques used by the World Bank in producing the "ease of doing business" could be used to benchmark remunerations of the public administration. Improving the overall efficiency of the public administration could face union opposition but we would expect on average a positive reaction from the public.

Mitigating the loss of human capital

However, there is in our view no amount of structural reforms which can completely offset the current macroeconomic shock in the periphery quickly. It will take time to work through the accumulated youth unemployment, with the scarring impact on growth potential (see the first article). However, we think that a modest re-orientation of the European structural funds could be used to mitigate this effect. Indeed, one can offset the loss in human capital brought about by a long period of unemployment with an improvement in intrinsic skills. Governments could take advantage of the "forced idleness" brought about by unemployment to boost educational attainment. A common initiative of France, Germany and Italy seeks to "offer a solution" to any young European deprived of an employment (this will normally be discussed on 3 July

[17] http://www.bancaditalia.it/interventi/integov/2011/cf_10/encf_10/en_cf_2010.pdf

[18] See page 30 in the European Commission macroeconomic Imbalances – Italy 2013.

at the European Summit). We are afraid such grand ambition could quickly hit the “financial wall”. We describe below a more focused scheme.

At a time when more young people have more time/incentive to enrol in university education, governments are raising tuition fees to plug their own fiscal shortfalls. Spain for instance is bringing tuition fees from 15 to 25% of the total cost of higher education. We think that it would make sense for the EU to substitute itself to national governments and provide targeted support for students. This would allow the EU not to appear solely as a source of “painful pressure” on struggling countries but also as an institution able to bring concrete, tangible direct support to population. In addition, since higher education in the EU has been largely harmonized, and since control is relatively easy (in terms on pass/fail criteria), this should not be such a controversial proposal. In our view, EU spending on this matter should focus on science and technology, where Southern Europeans are ill positioned for now.

To continue with the Spanish example, in 2010 1.39% of the 20 to 29 year old population graduated in science, maths and/or technology. France is the best performer using this metric (2.15%). The average cost of a student stands at EUR 7,000 per annum. Paying the 25% of the tuition cost left to the students of the new flow of students need to bring the proportion of graduates to the French level would cost EUR 250m over 3 years. Roughly extrapolating from the Spanish example, we estimate that with less than EUR1bn the EU could create the right incentives for students in the peripheral countries to take up studies which would improve potential growth there.

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Conclusions

Some progress is already perceptible, if not yet evident in the overall economic performance at least as far as our estimates for potential GDP are concerned. But the gains are modest and uneven across the large four euro-area countries.

At one end, we see improvement since the onset of the Great Recession in Spain. For example, the Spanish export performance has been quite impressive lately and the increase in productivity appears to more than offset the fall in employment in terms of potential GDP growth. Spain also benefits from positive demographics with respect to the other large euro-area countries.

At the other end, we see a worsening in Italy's potential GDP growth in a "no policy change" scenario as the gap with the other euro-area countries continued to widen. The key cause is the ongoing deterioration in the country's productivity performance. In our view, this reflects the lagged reaction to the crisis, with the country starting to tentatively address some of the underlying causes of the chronic low growth only in late 2011. It is fundamental that Italy avoids sliding back in the errors of the past.

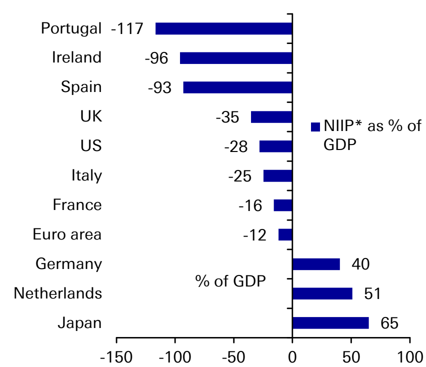
There are, however, deep-seated challenges that are common to the whole euro-area. The curse of youth unemployment could decrease future GDP growth in all large countries, particularly in the peripherals starting from Spain. The increase in the tax wedge could also limit future growth.

Our analysis takes a medium-term view. Hence, we would warn against zeroing on structural reforms alone to try to derive immediate conclusions in terms of market gyrations. Italy is lagging behind, but to some extent can "afford" to do less for longer than other peripheral countries thanks to a very limited net external debt. In other words it can draw on accumulated resources to service accumulated debt in spite of a stagnating economy. Countries such as Spain do not have this luxury, which probably explains the stronger adjustment impetus there. This is reflected also across core euro-area economies. For example we see some complacency in strong performing countries such as the Netherlands, while countries with not as strong as fundamentals have shown signs of improvement as in France.

Still, the best way, ultimately, to resolve the nagging "sustainability" question in the Euro area is to forcefully deliver on structural reforms. We highlighted a wide array of necessary reforms.

However, after nearly six years of painful economic conditions, adjustment fatigue risks compromising the reform process. We think that collectively the European decision makers need to regain public confidence and reform momentum beginning immediately from a small set of reforms. We have attempted, in this set of articles, to provide both a diagnostic and some concrete proposals to this end.

Net international investment position: financial imbalances not always correspond to structural deficiencies



Source: Deutsche Bank
**2012 net international investment position. Data for France is as of 2011.*

Appendix:

Figure 1: Underperformance at the start of recession

Indicator	France	Italy	Spain	Benchmark
PMR	1.39	1.32	0.96	**1.10**
EPL	3.00	2.58	3.11	**2.09**
Average tax wedge	42.4	36.6	32.0	**33.9**
Taxshare Indirect	0.36	0.34	0.32	**0.34**
PISA score	497	483	483	**509**
Average years of schooling	11.6	10.1	10.6	**12.3**
State retirement age	60 to 62	62.5 to 66.9	65 to 65.8	**{64.3}**

Source: Deutsche Bank, OECD, Eurostat
Cells highlighted in blue correspond to underperformance relative to our benchmark. The benchmark refers to the average of Austria, Denmark, Finland, Germany, Netherlands, Sweden and UK scores for each indicator.

Figure 10: Description of structural measures

Variable	Description
PMR	OECD indicator (range of 0 to 6) of product market regulation; this covers areas of state control in business, barriers to entrepreneurship and barriers to trade and investment.
EPL	OECD index (range of 0 to 6) of employment protection legislation, which consists of 3 subindexes: employment protection for regular workers, regulation of temporary employment and regulation of collective dismissal.
Average tax wedge	The tax wedge on labour income defined as income taxes and all social security constributions as a percentage of gross labour cost. This measures the difference between labour cost to the employer and net take-home pay for the employee. Data is taken from the Taxing Wages OECD database and the tax wedge for a single-earner married couple on average earnings with two chilren is used, in line with existing studies.
Share of consumption and property taxes	The share of taxes on property and consumption in total tax revenues. Calculated using the OECD database - sum of OECD tax codes 4000, 5000 and 6000 divided over total tax revenue.
Average years of schooling	The average years of schooling for the adult (over 25) population.
PISA scores	The OECD Programme for International Student Assessment (PISA) country indicators of performance in mathematics - a widely used proxy for educational attainment.
Retirement age	The arithmetic average of the male and female state retirement ages. The upper bounds incorporate planned changes by 2020.

Source: Deutsche Bank, OECD

Euro sovereign events: what to watch

The following is a list of key events to watch in the coming weeks and months – events that could have bearing on how the euro sovereign debt crisis evolves.

June

- 11/12 June: Hearing at the German Constitutional Court on the constitutional complaints against the ECB's securities market programme (SMP) and OMT as well as Germany's participation in ESM. The judgment will be held later in summer. It will most likely be in line with the constructive approach of former judgments that provided that (1) the Court will not comment on the ECB's monetary policy and (2) any major decision taken by intergovernmental mechanisms such as EFSF and ESM needs to be legitimized by the German legislative[19].
- 14 June: Youth unemployment. Ministers from Germany, France, Italy and Spain to discuss measures to reduce youth unemployment.
- 14 June: Spain – Public debt according to the Excessive Deficit Procedure (Q1 2013).
- 17-18 June: G8 leader summit.
- 19 June: Court ruling on Italian ex-PM Berlusconi (tentative). A court is due to decide whether the alleged tax fraud case against Berlusconi — the sentence for which precludes him from holding public office for 5 years — should be retried.
- 20-21 June: Eurogroup/ECOFIN meetings. The agenda is expected to include: the European semester - discussion on Stability and Convergence programmes and euro area specific recommendations, including implications of the spring forecast for excessive deficit procedures and possibly excessive imbalance procedures for euro area countries; and the latest reviews of the Greek, Irish, Portuguese and Spanish loan programmes.
- 24 June: (tentative) Potential verdict on the alleged case of abuse of office against Italian ex-PM and current leader of the centre-right PDL Silvio Berlusconi. The ongoing trials of ex-PM Berlusconi could destabilise the current government grand-collation.
- 27-28 June: European Council – EU Leader's summit. Heads of State and Government are due to consider the Commission's country-specific recommendations on economic policy. Previously, a Council majority was required to endorse recommendations. Under the revised policy coordination framework, a Commission recommendation is assumed to pass unless a Council majority opposes it. Also in focus will be progress towards banking union.

[19] For more, see http://dbresearch.db.com/MAIL/DBR_INTRANET_EN-PROD/PROD0000000000314618.xhtml

July

- July: European Commission to publish draft Single Resolution Mechanism (SRM)
- July: IMF World Economic Outlook Update.
- 1 July: Croatia becomes 28th member state of European Union.
- 4 July: ECB Governing Council meeting in Frankfurt. Markets will become steadily more focused on the Asset Quality Review (AQR) exercise that the ECB intends to conduct ahead of assuming the SSM bank supervision powers in mid 2014. This bank asset review may begin in Q3 2013 and be due for completion in early 2014 to then feed into an EBA stress test. The intention is to comprehensively address legacy asset losses before the SSM begins.
- 8-9 July: Eurogroup/ECOFIN meeting.
- 12 July: (prelim) EMU Industrial production (May 2013).
- 19 July: G20 finance ministers and central bank governors meeting.
- 24 July: EMU – Bank Lending Survey (Q2 2013).
- 25 July: ECOFIN meeting to discuss EU Budget.
- 30 July: (prelim) EMU – Business climate indicator for the euro area.

August

- 1 August: ECB Governing Council meeting in Frankfurt.
- 13 August: (prelim) EMU Industrial production (June 2013).
- 14 August: EMU – First estimate GDP of the Euro area and EU (Q2 2013).

September

- 4 September: (prelim) EMU – Second estimate GDP of euro area and EU (Q2 2013).
- 5 September: ECB Governing Council meeting in Frankfurt.
- 5-6 September: G20 Leaders' Summit.
- 12 September: (prelim) EMU Industrial production (Jul 2013).
- Mid-September: Germany state election in Bavaria.
- 22 September: German Federal election.
- 22 September: Germany state election in Hessen.
- 30 September: Spain deadline for reclassifications by banks of extended credit lines. The aim is to assess the viability of firms receiving such extensions and potentially raise banks' provisioning needs.
- September: Austria parliamentary election.

October

- 2 October: ECB Governing Council meeting in Frankfurt.
- 11-13 October: Annual meetings of the World Bank Group and the International Monetary Fund.
- 14 October: (prelim) EMU Industrial production (Aug 2013).
- 30 October: (prelim) EMU – Bank Lending Survey (Q3 2013).
- October: Portuguese local election.

November

- 7 November: ECB Governing Council meeting in Frankfurt.
- 13 November: (prelim) EMU Industrial production (Sep 2013).
- 14 November: EMU – First estimate of GDP in the euro area and EU (Q3 2013).

December

- 4 December: (prelim) EMU – Second estimate GDP of the euro area and EU (Q3 2013).
- 5 December: ECB Governing Council meeting in Frankfurt.
- 12 December: (prelim) EMU Industrial production (Oct 2013).
- 19-20 December: European Council – EU leaders' summit.

2014

- 1 January: Latvia may join the euro area.
- 1 January: ECB begins supervision of euro area banks.

Eurozone Main Economic Forecasts

Annual forecasts

	Real GDP %growth[a]			CPI %growth[b]			Current a/c %GDP[c]			Unemployment %		
	2012	2013F	2014F	2012	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
Euroland (top-down)	-0.6	-0.6	10	2.5	16	16	13	17	16	114	12.3	12.4
Germanyb	0.7	0.1	15	2.1	17	18	7.0	7.0	6.9	5.5	5.5	5.4
France	0.0	-0.6	11	2.2	14	15	-2.3	-2.2	-19	10.3	111	114
Italy	-2.4	-18	0.9	3.3	18	16	-0.5	0.0	0.4	10.6	12.3	12.8
Spain	-14	-16	0.5	2.4	19	13	-11	0.5	0.3	25.1	26.9	27.2
Netherlands	-10	-0.5	0.8	2.8	2.6	17	9.9	8.2	8.0	5.3	6.9	7.2
Belgium	-0.3	-0.3	10	2.6	14	16	-14	0.5	10	7.3	7.8	7.7
Austria	0.8	0.8	16	2.6	2.3	2.0	18	2.2	2.4	4.4	4.7	4.8
Finland	-0.2	-0.3	10	3.2	2.3	2.2	-18	-0.8	-10	7.7	8.1	8.0
Greece	-6.4	-4.5	0.5	10	-0.3	-0.1	-3.4	-2.0	-10	24.4	27.0	26.0
Portugal	-3.2	-2.2	0.8	2.8	0.5	12	-18	10	15	15.7	18.2	18.5
Ireland	0.9	0.5	17	19	12	14	4.9	3.5	4.0	14.7	14.2	13.7

	Fiscal balance			Primary Budget Balance			Fiscal Stance[d]			Public Debt[e]		
(%of GDP)	2012	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
Euroland (top-down)	-3.7	-3.0	-2.5	-0.6	0.0	0.6	15	0.8	0.3	93.7	96.7	96.9
Germanyb	0.2	-0.3	-0.1	2.6	2.1	2.2	12	0.1	0.1	819	80.9	78.4
France	-4.8	-3.8	-3.3	-2.3	-13	-0.8	10	19	0.6	90.3	94.0	95.4
Italy	-3.0	-3.5	-3.0	2.5	18	2.5	2.7	0.4	0.2	127.0	132.2	133.0
Spain	-10.6	-6.6	-5.8	-7.7	-3.3	-2.4	2.2	15	0.4	84.2	910	95.0
Netherlands	-4.1	-3.8	-3.0	-2.2	-19	-12	10	0.5	0.3	712	74.8	75.4
Belgium	-3.9	-3.0	-3.0	-0.5	0.3	0.2	0.7	0.6	-0.1	99.6	1015	102.2
Austria	-2.5	-2.3	-2.1	0.1	0.3	0.6	0.6	-0.2	0.0	73.4	73.7	74.1
Finland	-19	-2.3	-18	-0.8	-13	-0.8	-0.7	-0.1	0.3	53.0	57.0	58.8
Greece	-10.0	-4.9	-3.7	-5.0	-0.9	0.9	2.3	12	0.0	156.9	175.0	174.7
Portugal	-6.4	-5.6	-4.4	-2.0	-14	-0.3	2.7	0.3	0.8	123.6	123.3	124.3
Ireland	-7.6	-7.7	-5.5	-3.9	-2.8	-0.5	0.7	17	19	117.6	124.5	122.5

(a) GDP figures refer to working day and seasonally adjusted data. (b) Defined on the basis of HICP inflation. (c) Current account figures for eurozone countries include intra regional transactions. (d) The fiscal stance is defined as the change in the structural primary budget balance (a positive number is a tightening of the fiscal stance). (e) Public debt is measured on a gross basis and includes the Greek loan facility, EFSF disbursements and assumed borrowing for ESM paid-in capital.
Source: National statistics, national central banks, Deutsche Bank Research forecasts.

Quarterly forecasts

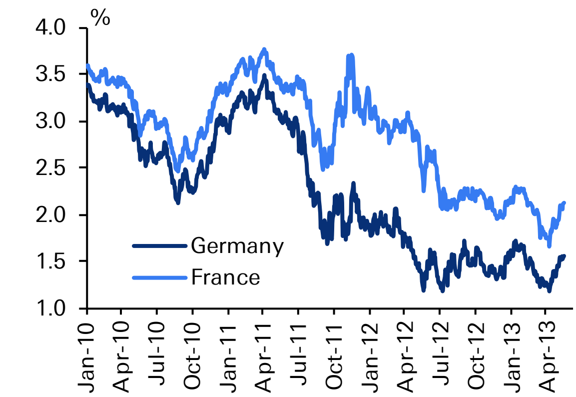
Euroland, %qoq	12-Q1	12-Q2	12-Q3	12-Q4	13-Q1F	13-Q2F	13-Q3F	13-Q4F	2012F	2013F	2014F
GDP	-0.1	-0.2	-0.1	-0.6	-0.2	0.0	0.2	0.2	-0.6	-0.6	10
Private Consumption	-0.2	-0.5	-0.2	-0.6	0.1	-0.2	0.1	0.1	-13	-0.6	0.4
Gov. Consumption	0.0	-0.3	-0.2	0.0	-0.1	-0.1	-0.2	-0.2	-0.4	-0.5	-0.3
Investment	-14	-17	-0.9	-14	-16	-10	0.2	0.5	-4.3	-2.7	2.1
Stocks (contribution)	-0.1	0.0	-0.3	-0.1	-0.1	-0.1	0.0	0.0	-0.7	-0.3	0.3
Exports	0.7	16	0.8	-0.9	-0.8	0.8	0.9	0.9	2.7	19	4.1
Imports	0.0	0.4	0.2	-12	-11	0.0	0.8	0.9	-0.8	0.4	4.0
Net Trade (contribution)	0.4	0.5	0.4	-0.1	0.0	0.4	0.1	0.0	16	0.7	0.2
HICP inflation, %yoy	2.7	2.4	2.6	2.3	19	16	16	16	2.5	16	16
Core inflation, %yoy	19	18	18	16	15	12	12	13	18	12	15
EMU4 GDP, %qoq											
Germany	0.6	0.2	0.2	-0.7	0.1	0.5	0.3	0.3	0.7	0.1	15
France	0.0	-0.2	0.1	-0.2	-0.2	-0.1	0.0	0.2	0.0	-0.6	11
Italy	-10	-0.6	-0.2	-0.9	-0.5	-0.4	0.0	0.2	-2.4	-18	0.9
Spain	-0.4	-0.4	-0.3	-0.8	-0.5	-0.1	-0.1	0.1	-14	-16	0.5
Central Bank Rates (eop)											
ECB refi rate	100	100	0.75	0.75	0.75	0.50	0.25	0.25			

Source: National statistics, national central banks, Deutsche Bank forecasts.

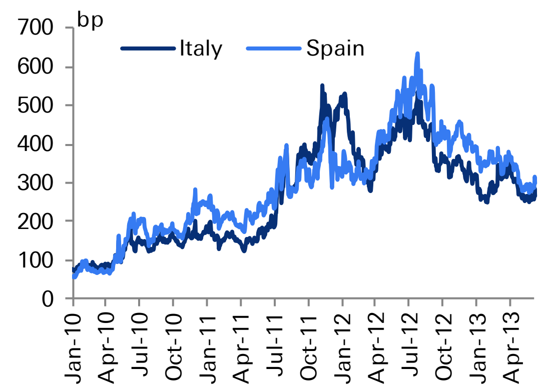
Eurozone Key Market Indicators

Government bonds

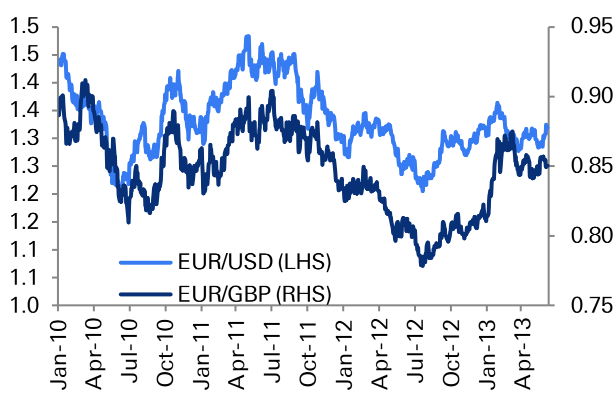
10Y yields



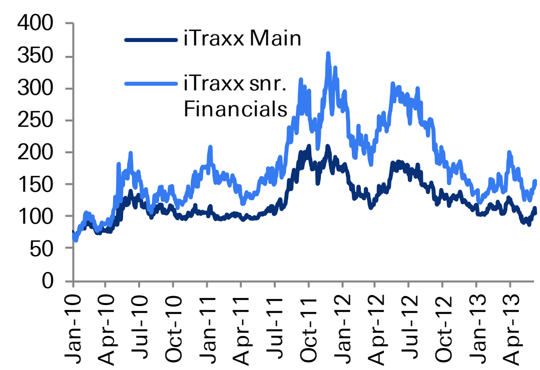
10Y spreads vs. German bunds



FX rates

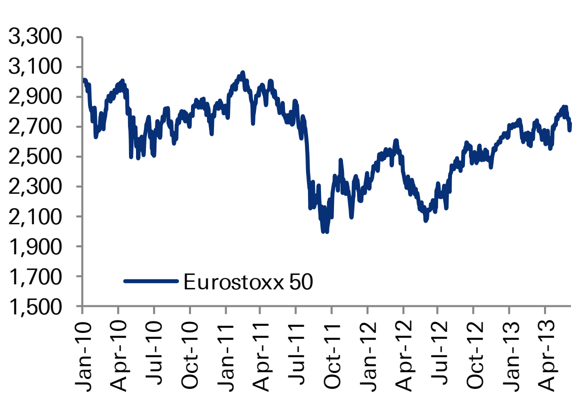


Credit indices



Equities

Eurostoxx50 index



Volatility index (V2X)

Source: Deutsche Bank, Bloomberg Finance LP

Appendix 1

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