# Perspective on European growth: One currency, several growth models?

Remarks at the concluding policy panel
of the DG ECFIN Annual Research Conference

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Brussels, 23 November 2011

* The views expressed in this speech are those of the author and do not necessarily reflect those of the Italian Ministry of Economy and Finance nor those of the Economic Policy Committee (Lorenzo Codogno is the president of EPC). This speech was addressed at the Annual Research Conference of DG ECFIN of the European Commission on "Perspectives on European growth: One currency, several growth models?". Thanks to Enrico D'Elia and Maria Rita Ebano for assistance in preparing this speech.
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Thank you for the invitation to participate in this very interesting panel discussion.

The point I would like to make is the following: greater integration of product and service markets across EU countries could imply greater sectoral specialisation and different growth models that, in turn, may result in some imbalances. This would necessarily require deeper European political and fiscal integration to avoid unwanted negative spillovers while taking full economic advantage of increased specialisation. In a more politically and fiscally integrated Europe, different growth models would not necessarily be a problem and could instead represent opportunities.

A lot more needs to be done to promote the Single Market. The still heavy product market regulation in many EU Member States hinders the full integration of EU markets. On the one hand, the creation of Monetary Union has probably contributed only marginally, if at all, to the integration process. On the other hand, the initial assumption that the process of integration would be in itself a driver for the creation of favourable conditions for an Optimal Currency Area has not been met, or at least not completely. Despite this, economic integration has advanced in recent years.

The longer-run implications of economic integration for the structure of the economy are not straightforward. In particular, the impact on industrial specialisation results from two forces working in opposite directions:

(a) The reduction in cross-border transaction costs releases margins for further exploitation of economies of scale and therefore promotes inter-industry specialisation among Member States.
(b) Intra-industry trade, however, can also increase. In fact, the process of integration promotes convergence in income levels and factor endowments. At the same time, the elimination of exchange rate fluctuations reduces the uncertainty associated with cross-border transactions.

Economic theory has long debated the different implications of these two mechanisms. The Classical Trade Theory suggests that economic integration leads to greater economic divergence and specialisation in economic structures, while conclusions of the New Trade Theory are less straightforward. Under certain conditions economic integration could determine a process of structural convergence (see Frankel and Rose, 1998, versus Krugman, 1993).

Clearly, economic theory can accommodate either prediction. Empirical analysis is needed to shed light on the specific dynamics underlining different cases. For instance, a study by Brülhart (2001) shows that in 14 European countries sectoral specialisation in manufacturing industries generally increased during the 1972-1996 period. Eurostat data seem to confirm this pattern for the service sector as well. In particular, the process of specialisation among EU-15 countries has accelerated from 2004 onwards, especially in private services.

Patterns differ by country in the EU-15, and the empirical evidence in the literature is not clear cut. In particular, Italy converged until 2004, but from 2004 onwards divergence has re-emerged. The overall trend is determined by activities in the private sector and Italy has specialised in manufacturing (particularly evident if assessed at constant

prices). For the whole EU, there is evidence of increased specialisation among individual Member States.

The major point that can be made here is that in a context of economic integration, divergent patterns of sectoral specialisation contribute to produce divergent productivity growth rates and current account balances, implying co-existence of different industrial and economic structures and a different pace of employment creation and output generation within different countries. In the long run, the literature suggests that sectoral composition also has a substantial impact on TFP growth. Moreover, greater specialisation could result in a de-synchronisation of business cycles across countries and non-synchronous reactions to common shocks within the economies of the market union. Therefore, different growth rates and output trends across member states, within certain limits, should be expected as a result of greater product and services market integration.

Is specialisation good for the EU and the Eurozone?

The benefits of specialisation are evident for a currency union, in terms of productivity growth and competitive advantage, and do not make the whole-area economy weaker. An example is the US where a number of states specialise in specific sectors: such specialisation does not appear to have undermined the strength of the US economy. On the contrary, deep specialisation in specific sectors could explain the relative strength of the US economy vis-à-vis the rest of the world. In particular, some papers argue that Europe's innovation gap relative to the US results from the major degree of specialisation of US industry in high-R&D-intensity sectors, especially on a regional basis. This evidence casts doubts on the full desirability of more homogenous national industrial structures as opposed to a deepening of specialisation.

But not all countries can achieve the desired specialisation. Each Member State would prefer specialising only in the highest value-added sectors and segments (e.g.: financial services, hi-tech industries, international institutions, companies' headquarters, etc.), but this is clearly unfeasible. Each country will end up doing activities where there is a clear comparative advantage, relatively speaking.

Yet, given that sectoral specialisation may entail greater asymmetry of macroeconomic fluctuations, in a monetary union such as the Euro Area the effects of specialisation must be monitored as a possible source of imbalances. Imbalances, to some extent, could be considered as a by-product of integration.

Now, let me be a bit provocative.

The current crisis is urging decisive action to prevent the collapse of the European Economic and Monetary Union. Country-specific imbalances (especially fiscal and trade) are often pointed out as being prominent sources of current problems if not the most important ones. While imbalances are certainly at the root of the current crisis, we must also acknowledge that the economic recipes currently proposed to reduce imbalances do not fully consider the economic effects of increased market integration and specialisation.

The financial crisis and the more recent turmoil in sovereign debt markets clearly reveal the challenges in the European Union's model. The high degree of economic inter-

dependence together with preserved national responsibilities for fiscal and economic policies threatens the resilience of the Euro model.

The sovereign debt crisis demonstrates that underlying economic fundamentals, structural conditions for growth and the quality of institutions are of paramount importance for investors' expectations. This is also reflected in the belief that imbalances are country-specific. In the excessive imbalance procedure (EIP), recently agreed upon as part of the new EU governance, countries are treated as though they were stand-alone entities. In particular, the European approach aims at reducing current account imbalances in order to make every fiscal system more self-sustainable.

Overall, it is clear that credible fiscal rules and decisive reforms to address structural weaknesses of the economies are necessary and will help to regain market confidence and, ultimately, growth. Nevertheless, some of these measures inevitably go against the drive towards a more integrated economic area. At some point Europe will have to go beyond interventions that are only national in nature.

During the current crisis, policy makers have learnt a lot about the vulnerability of Monetary Union. The European institutional framework is not prepared, or at least it was not prepared, to cope with large and global asymmetric shocks.

This crisis reveals that the lack of a common fiscal policy cannot be fully compensated by an efficient common monetary policy and a few ad hoc emergency measures. As long as the EU cannot mobilise resources to dampen the short-run effects of shocks on disadvantaged nations, national authorities will have to cope with the difficult mission of adjusting to Europe-wide shocks without counting on country-specific monetary policy and exchange rates, without impairing national public finances, but also without fully taking into account country-specific growth models.

The crisis gives Europe a unique opportunity to strengthen the coordination between national policies and enhance overall economic integration, combining one currency with different growth models.

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