Who's The *Comeback Kid?*

France, Germany, and Italy are struggling to recover. Who'll come out on top?

FRANCE

BY ROBERT BOYER
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Quiz: In 2002, what country nearly received as much foreign direct investment as China ($52 billion versus $53 billion), displays a higher hourly labor manufacturing productivity than the United States, and has foreign investors controlling 40 percent of the largest companies quoted on the stock market?

The country is France. These facts should mitigate some of the long-lasting clichés that still prevail on both sides of the Atlantic: that the United States is the emblematic figure of a free-market economy and the promoter of globalization; that France, by contrast, clearly is still Colbertist and protectionist. American public opinion and experts misunderstood the origins of French statism, and misunderstand still more the drastic transformation of the 1990s, as

well as several major recent achievements of the French economy. Perhaps these tend to be hidden by some cyclical failures, for instance, temporary rises in unemployment (8.9 percent in 2002) and drops in growth (the French economy is currently in recession).

Actually, in the history of French industrialization, the French state has rarely been the hindrance to capitalism it is perceived to be on the U.S. side of the Atlantic. On the contrary, it has been the promoter of modernity and technological advances. This was true during the 19th century and still more so after the Second World War. France has been a very good pupil of American mass production methods, successfully if seemingly strangely implemented via a massive role of the state in production, financing, and organization of markets, and of course accompanied by social regulation.

Remember the motto of the French Republic: "Liberté, égalité, fraternité." This is the major explanation for the persistence of public deficits and the present difficulties of the French government with Brussels about France's non-observance of the Stability and Growth Pact.

But it is precisely that institutionalization of Fordism by a complete architecture of state interventions and legislation that made it quite difficult to directly tackle the needed reforms of the 1980s and 1990s. During this period, the challenge was to find an alternative to the post-World War II regime of statism plus Fordism. The quasi-continuous rise in unemployment during this period, with only short intermissions, is also evidence of the challenge addressed to governments, not only in France but throughout continental Europe as well.

These shadows, however, should not obscure the transformations that have taken place in the French economy since the mid-1980s. The French state is less and less the producer of private goods, and at present prefers to stimulate innovation, given that competition is now enforced at the European level. The fact that the euro has replaced the franc, and is managed by the European Central Bank, also limits the focus of the French state. Similarly, one of the major tasks for the planning agencies has been to decentralize in order to stimulate growth, and get more popular support for economic reform and policy.

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Rightist or leftist, successive French governments have shifted from a pro-labor to a pro-business stance and redesigned the tax system accordingly, for instance by adopting a code quite beneficial to stock options. Last but not least, French and (both as cause and result) Euro-

pean macroeconomic policy is now governed not so much by Keynesian principles, but inspired by a neo-Schumpeterian vision of the role of entrepreneurs in the process of innovation and growth. The promotion of the competitiveness of private firms is at the core of the economic strategy of all French governments since the mid-1980s.

Consequently, even seemingly interventionist economic policy measures undertaken since then must be reinterpreted. To accompany the general strategy of massive privatization in France, from time to time the government has to correct the outcome of freer markets that would challenge social stability. With this limited mission, why then do social expenditures continue to grow overall? Not at all for ideological reasons, but simply to socialize the costs of the drastic restructuring of major French manufacturing firms.

Policies instituting incentives to earlier retirement had been conceived with such an objective in mind, but they have been so successful that nowadays many large French corporations are competitive only at the public cost of booming social expenditures and a very low employment rate. From this view, the recent subsidy granted to Alstom, a leading engineering firm, does not mean the return to the heavy hand of the French government on industry. It is mainly a defensive measure to smooth job reductions and possible loss of expertise and competitiveness.

The Sun King's Money Man

When bourgeois-minded **Jean Baptiste Colbert** *took over as* contrôleur général *under Louis XIV, France's finances were in disarray. Since little additional revenue could be raised by increasing taxes on the heavily burdened peasants, Colbert turned to a philosophy of mercantilism and became its most famous promoter. A continuous trade surplus, maintained by high tariffs and the promotion of export industries, would further subsidize French industry. Colbertism mandated strong state interference in trade and industry which Republicanism later justified as supplying the means for providing all citizens with basic equality in public services.*

—TIE

The maximization of shareholder value has been quite fashionable in France, too, probably because foreign capital is present and active on the stock market.

The adoption of the euro is a good counter-example against the culturalist interpretation according to which the French elite are nationalist and backward-looking. Quite to the contrary, along with the constant but slow deepening of competition on the single European market, the common currency has played a major role in making necessary (and thus politically acceptable) a redefinition of much of previous legislation.

The law on the reduction of the work week to thirty-five hours has generally been misunderstood, particularly in the Anglo-Saxon economies. Of course, the previous socialist government wanted to fulfill a traditional demand from workers and unions, but that was not the ultimate goal or impact. In fact, the law has been the starting point of a series of negotiations between the business association and workers' unions in order to make working time more flexible according to the needs of the firms. Actually, the thirty-five hour work week has triggered an impressive reorganization delivering more productivity (and as befits greater efficiency, also more stress in the workplace).

It is no surprise, then, to observe that while productivity per hour worked is higher in France than in United States, the rather Malthusian employment policy to curb the activity rates of older workers means that product per capita is higher in the United States than in France. Yet this should not be taken as embodying completely different economic systems in the United States and France. Just like in the United States, French firms have been investing abroad ($92.5 billion in 2001), and as in the United States, this is not

evidence of a poor domestic economic environment, but demonstrates the French adoption of the strategy of globalization. Why has Toyota, for example, decided to locate its most recent European plant in France? The reasons are simple: skilled workers, competitive wages, good public infrastructure, and a central position in the European car market.

A recent study shows that the rate of return on equity, as well as the economic rate of return on capital, have followed quite similar profiles in the United States and France during the past decade. The maximization of shareholder value has been quite fashionable in France, too, probably because foreign capital is present and active on the stock market. This equalization of capital returns implies an openness to financial flows and demands in France, and an integration with global capital markets, that may surprise some observers. There are still different methods on both sides of the Atlantic: where a modest hike of profitability has been obtained by saving capital in the United States, that has been matched by squeezing the wage share in France.

Here is the French dilemma. On one side, the large French corporations do play the American game of globalization, of mergers and acquisitions, and of utilizing innovative financial strategies—and they generally succeed. On the other side, the French firms externalize the economic and the social costs of the resultant restructuring, and therefore the various French governments must continuously step in so as to preserve a modicum security for labor in accordance with the social value of solidarity among citizens. Remember the motto of the French Republic: "Liberté, égalité, fraternité." This is the major explanation for the persistence of public deficits and the present difficulties of the French government with Brussels about France's non-observance of the Stability and Growth Pact.

Hence a paradoxical interpretation of the present situation: the economic slowdown observed in France since 2002, instead of being the expression of a long legacy of Colbertism and statism, is in fact evidence of the strong interdependence between French and American macroeconomic activity. This interdependence extends to financial markets—the French stock market reacts more to American events than to domestic ones. The telecom bubble has mimicked the American Internet bubble and its bursting is having an adverse impact upon macroeconomic recovery.

Furthermore, many globalized and large French firms have adopted and adapted the same style of management as the U.S. corporations. Jean-Marie Messier, the flamboyant ex-CEO of Vivendi Universal, is more representative of the American dream (right down to his golden parachute) than the typical French business defended by the head of MEDEF (Mouvement des Entreprises de France), Ernest-Antoine Seillière. Former French civil servants and ENArques (graduates of France's Ecole Nationale d'Administration) who become

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CEO or CFO of major French firms today dream of reaching the income levels of their American counterparts. So, ironically, the present French economic slowdown is therefore the joint outcome of two contradictory forces: on one side, the trends towards an Americanization of the economy, on the other side the pressures of public opinion that still insists that the state should be the global insurer against any risk.

Last surprise, the *de facto* Americanization of French production methods and lifestyles, at least at work, triggers a backlash against American hegemony that is interpreted abroad, especially in the United States, as a visceral anti-Americanism. That interpretation is a huge mistake. On the whole, the freeze in Franco-American relations in geopolitical affairs does not mean what it seems as a zero-sum game or opposition to globalization. Basically, it is about alternative conceptions of the trade-off between efficiency and security, both in the domestic arena and in international relations. The ongoing diversity of capitalism, both French- and U.S.-style, should form a foundation for the stability of the world economy, should it not? ◆

ITALY

BY MICHAEL CALINGAERT
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"**E***ppur si muove"* ("and yet it moves") mumbled Galileo under his breath when forced to recant his heretical notion that the Earth moves around the sun. Similarly heretical—though less dangerous—is the notion that there is movement in the Italian economy, indeed, that in many respects it has achieved considerable success.

There are, of course, ample grounds for criticizing Italy's past economic policy and performance. After engaging in a painful effort during the early and mid-1990s, Italy confounded the skeptics by meeting the criteria enabling it to join the European Union's single currency area at its inception in 1999. Since then, however, Italy has slipped to the back of the pack, moving from low GDP growth into recession and showing seemingly little progress in addressing, let alone resolving, a number of fundamental economic problems.

Nonetheless, a closer look at the Italian economy should start with recognition that Italy has not one but two economies, the north and the south. Regional differences in the European Union are not unique to Italy, but the sharpness of the economic cleavage, and its seeming intractability, are unique. As a result, the high level of economic performance in the north is diluted in national economic statistics. On an EU-wide basis the northern regions fare extremely well. While Italy's per capita GDP is only marginally higher than the EU average, the figure for Lombardy is 135 percent of the average, in Emilia-Romagna it is 129 percent, Piedmont's is 120 percent, and the northeast region's is 121 percent (the first two fall in the top 10th percentile). In contrast, per capita GDP of southern Italy is 66 percent of the EU average and only 58 percent that of the north and center. The employment rate in the south is about two-thirds that of the north, and unemployment

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is sharply higher (19 percent in the south, 4 percent in the north).

The structure of the Italian economy differs from that of most of the other EU member states in that it is characterized by few large enterprises (*Business Week*'s "Global 1000" includes only twenty-five Italian firms, of which only two in the top 100) and a predominance of medium-sized and, particularly, small firms (SMEs). The average size of Italian firms is the smallest in Europe. In the manufacturing sector, 98 percent of firms have fewer than fifty employees, while 83 percent have less than ten. SMEs (less than 250 employees) account for 70 percent of GDP, while for small firms (fewer than 20 employees) alone the figure is 42 percent.

Yet these firms—a large percentage of which are family-owned—have prospered by developing niche specialization both in Italy and globally. In large part, production covers a range of consumer goods where Italy has become a world leader. It accounts, for example, for over 20 percent of world ceramic tile production, 16 percent of shoes and leather goods, and over 10 percent of glass and ceramics, and it holds or shares world leadership in trade for a long list of products from eyeglasses, jewelry, and wool and silk textiles to furniture, white goods, and specialized industrial machinery. Their success is due in large measure to a combination of imagination, innovation, flexibility, and adaptability.

"Industrial districts" are a key element of the SME sector—clusters of firms located near one another, engaged in different aspects of the production of the same or related products, involving elements of cooperation and competition. While these districts exist throughout Italy, they are most prevalent in the north. In some sectors, a single Italian district accounts for a remarkable share of world exports—for example, Sassuolo for almost 40 percent of tile and ceramics exports, Como for over 25 percent of silk fabric, and Belluno for 18 percent of eyewear.

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While Italy has a well-merited reputation for cumbersome bureaucracy and heavy-handed regulation, Italian governments have made significant progress in improving the conditions under which businesses operate. The OECD gives Italy high marks for its program of reform of the public administration. For example, the administrative cost of opening a new business has fallen by more than half over a two-year period, and the number of steps required has declined even further. As a result, the average time required for starting a business has dropped from twenty-two weeks to four weeks.

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In addition, the Berlusconi government's early legislative successes included the elimination of seven hundred administrative laws. Italy's success in easing administrative burdens is reflected in its ranking among the OECD countries on fewest restrictions on foreign direct investment—Italy is seventh lowest out of 28 members.

Improvements have also taken place in the regulation of the labor market and in corporate governance. Reform of the labor market began in 1997, and the most recent legislation dates from early 2003. The public monopoly on job placement has ended, intermittent work contracts have been authorized, and scope for use of

temporary contracts has been expanded. The resulting increase in labor market flexibility has been reflected in employment growth. In the field of company law, 1998 and subsequent legislation has enhanced shareholder rights, strengthened accounting standards, and increased the efficiency of the securities market (in many respects taking Italy beyond the rest of continental Europe, according to the OECD).

Another major, beneficial development has been the sharp reduction in the role of the state. Overturning long-standing policy, successive governments initiated a massive sell-off of the economically and politically important state-controlled enterprises about ten years ago—one of the largest privatization programs in the OECD area. Full or partial privatization has taken place, inter alia, in the industrial conglomerate Finmeccanica, the electrical monopoly ENEL, the oil and gas company ENI, the telecommunications monopoly Telecom Italia, and some bank holdings. Privatization netted about $100 billion in the 1990s, equal over a ten-year period to about 12 percent of GDP, a considerably higher amount than elsewhere in continental Europe.

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Price controls in many sectors have been removed. In line with EU legislation, liberalization was begun in telecommunications in 1997 and electricity in 1999, and gas in 2000 (the latter termed "positive, bold and innovative" by the OECD). Measures have been adopted to increase transparency and efficiency in the public sector—for example, public agencies have adopted electronic procurement, resulting in a 31 percent cost reduction.

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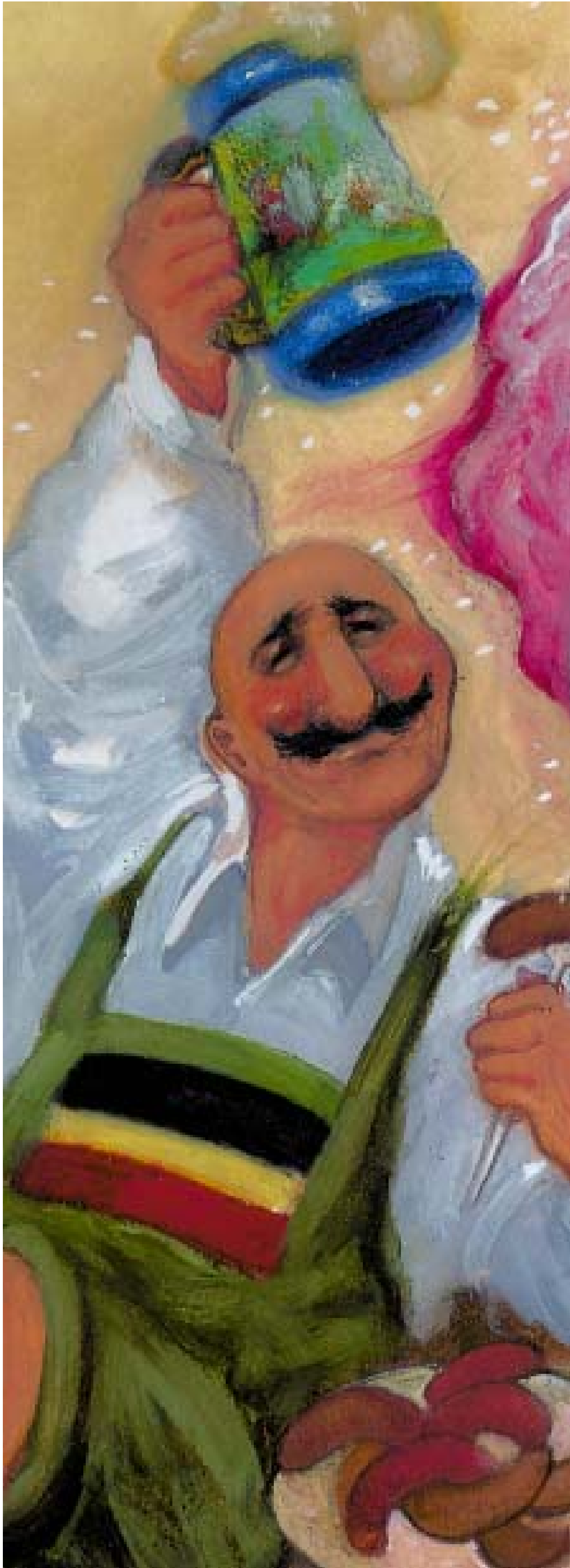
Italy's traditionally weak financial services sector has been significantly improved by the banking reforms that began in 1990 and have transformed the Italian banking system. Privatization has reduced the heavy hand of public institutions, which now control 10 percent of total bank assets, compared to 66 percent ten years ago. The abolition of operating restrictions and geographic barriers has resulted on the one hand in consolidation and on the other in increased domestic and foreign competition. While bank profitability and productivity have increased, consumers have benefited through the sharp increase in the availability of banking services, the expansion in the supply of asset management services, and the lowered spread between loan and deposit rates.

Finally, though scandalous and in part corrupting, one must not forget that the black economy makes an important contribution to Italy's economy. True, it reflects tax avoidance, but looking objectively, it also serves to some extent as a counter-weight to government regulation and clearly adds to the level of economic activity beyond that usually recognized. Though difficult to measure for obvious reasons, the government estimates it accounts for about 15 percent of GDP.

Conclusion: Major problems and deficiencies exist in the Italian economy, yes, *eppur si muove.* ◆



GERMANY

BY ADAM S. POSEN
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When American economic pundits refer to "Old Europe," Germany seems to be what they have in mind. The German population is rapidly aging, the country's wage bargaining, labor rules, and product market regulations came from another era, and Germany's days as a Wirtschaftswunder are long gone. Germany has been the slowest growing eurozone economy for the last five years. Unemployment is currently at 10.4 percent (meaning over 4.3 million people out of work). By the declaration of its own press and politicians, Germany has been stuck in a Reformstau—a traffic-standstill on reforms—for more than a decade.

This image is well behind recent developments, and has created undue skepticism about the current changes underway in the world's third-largest national economy. The Red-Green coalition government of Gerhard Schröder has embarked on an ambitious "Agenda 2010" effort to reform the German economy. Most of it is right in line with the longstanding wish-list of the regular critical reports on Germany from the OECD, the European Union, and the IMF (in fact, many of the labor reform proposals were to all appearances copied directly out of the Fund's Article IV report last spring). Even the priorities of which reforms are being tackled first make sense.

Clearly, the greatest problem in Germany is structural unemployment due to the inability to create jobs. And Schröder's first effort is to address labor market difficulties, particularly huge disincentives to work, in place since the mid-1980s, as well as impediments to matching workers with new jobs. The "Hartz Commission" report last year was used to attack the dysfunctional Federal Labor Office bureaucracy, barriers to low-wage employment and individual start-ups, and improve matching.

More importantly, this has been followed by proposals to take the critical step of cutting the amount of time a person can claim high unemployment benefits before moving onto welfare. Previously, laid-off older workers could claim up to 80 percent of their wage for up to two full years, and then have a glide path to early retirement, with ongoing generous unemployment benefits until pensions kicked in. It is only sensible that such German beneficiaries had little incentive to look for new work, and economic research shows that the single biggest institutional predictor of cross-national differences in structural unemployment is duration of benefits. This was the number-one reform for Germany on any macroeconomist's agenda, and it will pass this fall.

The German economy has revived itself several times over the past century, facing far greater challenges than simply the political sclerosis of a wealthy workforce.

A reform of the German tax system as well as bringing the date forward for implementing significant income and corporate tax cuts is in the works. Schröder's main, if not sole, economic reform achievement of his first term in office was a prior reduction in marginal tax rates. Germany, unlike the United States, still has average and marginal tax rates sufficiently high to be real disincentives to investment, entrepreneurship, and effort. So this reform, unlike the one in the United States, will result in significant supply-side benefits as well as the boosting of demand. And without large balance-of-payments deficits and foreign holdings of its government debt, Germany will manage this tax cut without incurring significant interest rate rises upon recovery to offset its benefits.

So far, the Schröder government has been less aggressive about taking on the generous welfare state directly, though there are some efforts here as well. In the area of health care, the government hopes to slow rising demand and costs by increasing the amount of co-payments Germans make for services, as well as undertaking some reorganization of how doctors are paid. The government proposals also intend to put off the date of the pension burden exploding by raising the retirement age from 65 to 67.

It is true that these efforts will not be enough to make the current German welfare state sustainable, and that is the source of much of the dismissive commentary of Agenda 2010. Yet, is that the appropriate benchmark for evaluating economic reform in a rich country? All of the major economies are currently doing too little to prepare for the demographic time-bombs in their social security and health systems. Supply-side reforms that raise the rates of labor force participation and economic growth are still beneficial and still improve the medium-term prospects of the economy, even if long-run sustainability is not assured (see Keynes, J.M.). At least they postpone the day of reckoning. Certainly, the German economy's prospects after the implementation of the Agenda 2010 reforms will be better than they were after zero reform under the successive Kohl governments of the 1980s and 1990s.

But will they be implemented? It is said Schröder himself has no real conviction behind his reform effort, and, be that as it may, the opposition parties have a majority in the Bundesrat, the upper house of the German Parliament that has a say on all taxation and many other economic issues. Schröder's re-election in September 2002 was by a tiny margin, based in large part on his opposition to American foreign policy and his response to the preceding summer's floods, not on a mandate for economic change. He also leads a Social Democratic Party whose card-carrying membership, if not electorate, is dominated by union officials and members (much as in every democracy, it is the more extreme partisans who dominate internal party politics in Germany, particularly on the left).

By the time this article hits the newsstands, however, the first parts of the agenda—including the critical labor market reforms—will have already been passed, and more will follow shortly. The CDU/CSU-FDP opposition is stuck in a bind. Its only available excuse for blocking such pro-market reforms as cuts in the tax rate and unemployment benefits is to say, "No, don't do that. Wait three-plus years until the next election, pick us, and then we'll implement something more ambitious." This is hardly a winning strategy. (CDU parliamentary minority leader Angela Merkel has the look of Bob Dole, circa 1996, when he wanted to run against Clinton but

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could not block Clinton's middle-of-the-road proposals without undercutting his claim to office—ability to deliver in the legislature). The FDP is very reluctant to support any Schröder initiatives, but seeming hypocritical by opposing these proposals it has long championed could result in a drop below the 5 percent threshold for keeping seats in parliament in the next election.

In terms of internal opposition, Schröder has even a clearer path to economic reform. The left-wing of the Social Democratic Party has backed off every time Schröder has even threatened to force a confrontation over the reform agenda, fearing the party losing power for an extended period again if a no-confidence vote were held. Oskar Lafontaine's attempts to rally Social Democrat support around his red flag have repeatedly failed. Schröder's one party rival from the center, Wolfgang Clement, was cleverly brought into the government as new super-minister for economics and labor, committing him to carrying out the reforms, and being the immediate target of left-wing blame instead of Schröder. Meanwhile, as the failure of the IG Metall strike in eastern Germany this past summer demonstrated, the unions are losing political support in Germany, at least for their attempts to block change—and Schröder is happy to let them lose that support. In the tired but entirely apt analogy, Schröder is Nixon going to China on economic policy, and he has already made the trip.

Perhaps surprisingly to Anglo-American observers, the Green Party coalition partners have been committed to the reform program, and aggressively ahead of it in many ways. This makes sense for the Greens ideologically, with their libertarian streak and their commitment to sustainable inter-generational policies. It also makes sense strategically, since they can then replace the FDP as the swing third party in German politics by being in the responsible center on economic issues (as the FDP was) but delivering on economic reform (as the FDP had not in the 1990s). Worth watching are future initiatives coming from the Green coalition partners to take on corporate welfare and guild-like arrangements that protect inefficient small businesses in Germany.

Even after the successful adoption and implementation of Agenda 2010, there will remain problems in the Germany economy. Beyond the long-run sustainability of the pension and health-care system already mentioned, Germany's problems include fragility in its banking system, impediments to retail and trade (far beyond limits on shop hours) and the resulting restraints on entrepreneurship, as well as the ongoing challenge of raising real incomes and employment in eastern Germany.

Yet progress in these areas beyond the power or even ambition of the current German government's agenda has been real, too. The German economy, unlike that of say Japan, is quite open to international influences and embedded in multinational obligations and networks, foremost the European Union. As a result of Germany's openness, there have been positive developments in the banking system that the government could not resist—notably, the commitment to privatization of the publicly guaranteed Landesbanken in 2005 and the creation of a "True Sale" securitization fund of German bank assets. German citizens can shop and move their savings throughout the single European market and via the Internet, and to a growing (though still limited) degree they do so, putting pressure on uncompetitive retailers and financial firms.

Even Germany's long economic legacy of reunification may finally be receding into the background. The initial Faustian bargain in 1990 between the West German unions and the Kohl government to convert the Ostmark at 1:1, rapidly raise East German wage levels, and transfer huge subsidies eastwards did cause very high and persistent under- and unemployment in the neuen Bundesländer. Over time, however, the younger eastern Germans have benefited from the educational and infrastructure investments made there, have increasingly moved east (or at least south) toward opportunities, and the gap between productivity and wage levels has narrowed. Meanwhile, their parents and grandparents have reached ages to naturally leave the labor force. And the effect of the rise in German interest and exchange rates due to the impact of west-to-east transfers on the public debt has over time dissipated (albeit through the painful means of relative deflation since the euro came into being).

The German economy has revived itself several times over the past century, facing far greater challenges than simply the political sclerosis of a wealthy workforce. Germany is doing it again right now. ◆