**Cover sheet**

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**The European Economy in 2014: Fragile Recovery and Convergence**

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**Introduction**

In early 2014, six years after the outburst of the global financial-cum-economic crisis, most commentators on the European economy expected the year to bring a much-awaited breakthrough of slow but steady economic growth (European Commission 2014c). Unfortunately, the numbers did not support these optimistic scenarios; economic recovery in the EU, while picking up to some extent after recession in 2012 and stagnation in 2013, remained fragile. As a result, by the second half of 2014, international institutions such as the European Commission (2014a), the IMF (2014a) or the OECD (2014) substantially downgraded their GDP growth forecasts for the EU and the eurozone in particular, and neither of them expected European real GDP growth to exceed 1.3 per cent in 2014.

Yet, as this contribution intends to demonstrate, having an eye only on EU averages can be rather counterproductive. A more detailed analysis reveals that the economic performance of the 28 Member States was dramatically different in 2014. The principal aim of this contribution is, therefore, to decompose and explain Europe’s economic performance in the past year. In doing so, it assesses Europe’s performance in several key areas such as economic growth, employment, inflation, public finances and competitiveness, and systematically identifies countries that performed well above or well below the EU averages. Broad generalizations on the European level are often misleading due to the heterogeneity of Member States’ economies. Moreover, the frequently used dichotomies, such as ‘eurozone vs. non-eurozone’ countries, or ‘old vs. new’ members are too often at odds with reality.

The second half of the contribution seeks to explore questions related to Europe’s longer-term economic performance by investigating the convergence and divergence of income levels of Member States on the tenth anniversary of the 2004 enlargement. There are good reasons for expecting solid convergence in the period under investigation. Beyond standard economic theory, the facilitating forces of the single market (and, for some members, the single currency), along with the pro-growth policies of the EU’s Structural and Cohesion Funds make it reasonable to assume the growth experiences of the new Member States would support the convergence hypothesis. The brief analysis of the data reveals, generally speaking, that the past ten years have substantially strengthened convergence, as many less developed Member States, especially the ones in Central and Eastern Europe, grew faster than the more advanced EU economies, thus making progress in closing income gaps. Unfortunately, there are also a number of countries which seem to have lost momentum in catching up with the core, especially Greece, and to a lesser extent Italy, Portugal and Hungary.

The contribution is structured as follows: Section I discusses Europe’s performance in 2014 within the global economic context. This is followed by a presentation and discussion of the main economic indicators and individual Member State performance in Section II. Section III presents a brief analysis of income convergence within the EU. The final section concludes the paper.

**I. European Performance and the Global Economic Context**

Europe’s growth performance was much weaker than expected in 2014, with real GDP growth being around 1.3 per cent. This weak performance is especially striking when seen in the light of the sustained robust growth in other parts of the world. The global economy grew by 3.3 percent in 2014, which although far from spectacular, none the less provided opportunities that Europe failed to make use of (IMF, 2014a, p. xiii). Economic activity grew by more than 2 per cent in the US, whereas China achieved 7.4 per cent. World trade saw an even larger expansion, and financial market actors became exceedingly optimistic as well. Stock markets and long-term yields continued to rise and investors became less risk averse. The spread and volatility of major assets declined to the low levels that were typical before 2007. These can be seen as highly encouraging developments, despite the fact that China’s growth continued to decelerate, Japan performed below expectations, Brazil’s economy stagnated, as did Russia’s, which was hit heavily by Western sanctions due to its war with Ukraine and falling oil prices (see Table 1).

Table 1. The global economic context – GDP growth rates

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2010** | **2011** | **2012** | **2013** | **2014\*** |
| World | 5.4 | 4.1 | 3.4 | 3.3 | 3.3 |
| Advanced economies | 3.1 | 1.7 | 1.2 | 1.4 | 1.8 |
| EU | 2.1 | 1.7 | -0.4 | 0.0 | 1.3 |
| USA | 2.5 | 1.6 | 2.3 | 2.2 | 2.2 |
| Japan | 4.7 | -0.5 | 1.5 | 1.5 | 0.9 |
| Emerging and developing economies | 7.5 | 6.2 | 5.1 | 4.7 | 4.4 |
| Brazil | 7.5 | 2.7 | 1.0 | 2.5 | 0.3 |
| China | 10.4 | 9.3 | 7.7 | 7.7 | 7.4 |
| India | 10.3 | 6.6 | 4.7 | 5.0 | 5.6 |
| Russia | 4.5 | 4.3 | 3.4 | 1.3 | 0.2 |

Source: IMF (2014b), European Commission (2014a).

Note: \* indicates forecast data.

These overwhelmingly positive developments in the global economy, however, did not manage to push the European locomotive back to a solid and sustained growth path. Domestic demand did not increase and investment activity remained repressed. Weak domestic demand, coupled with decreasing global energy and commodity prices significantly lowered inflation across the continent, and even led to deflation in the eurozone. Exports, which have traditionally been the main driving force of economies like Germany or many smaller open Member States, performed especially weakly. Additionally, although monetary policy was highly accommodating throughout the European Union, fiscal policies remained mostly neutral due to fears of increasing public debts, a legacy of the crisis and its resolution. Geopolitics did not help the EU recover either. The turmoil in the Middle East and especially the sanctions against Russia, as well as Russia’s retaliatory sanctions have also caused serious concerns for many of the Member States (*Reuters*, 7 August 2014).

While the EU is still struggling to find the proper remedy for leaving behind the crisis, it also needs to face the medium- and long-term challenges of structural problems, such as the relatively weak growth in total factor productivity, the slow pace of sectoral and labour market reforms, an ageing population, and structural unemployment, especially youth unemployment. These factors keep potential growth rates low, which in turn make investors reluctant to embark on large-scale investments. Sadly enough, none of these weaknesses has been really new for Europeans. By critically reflecting upon the so-called Sapir Report of 2003, put together by highly acclaimed experts on European economic integration just before the big bang enlargement of the EU, André Sapir (2014) acknowledged in last year’s *Annual Review* that the EU needs a new and well-elaborated growth strategy much more than ever before. He called for the adoption of bold measures on both the demand and the supply side. While the single market along with the single currency have laid down the foundations of a pro-growth economic environment, the EU should target its policies and financial resources much better in order to foster economic growth and development. The European Commission (2014a, p. ix) seems to share these ideas: in its economic forecast report, it claims that ‘[t]he dual challenge for economic policy consists in strengthening short-term economic dynamics and raising the economy’s growth potential for the medium term.’ Addressing such a multifaceted challenge requires concerted efforts from Member States, inviting both monetary authorities and governments to act.

Despite this generally gloomy picture, 2014 also showed some positive developments. The European Central Bank (ECB), as well as most non-Euro area central banks, followed highly accommodating monetary policies with historically low interest rates and other liquidity boosting measures to increase aggregate demand.[[1]](#footnote-1) Room for further manoeuvring, however, has been rather constrained in terms of lowering interest rates. Yet, central banks can do a lot by reducing financial fragmentation, strengthening banks’ balance sheets and easing liquidity constraints in the private sector. Budget deficits have also generally decreased, which may indicate that there is space for fiscal policy to support growth-friendly restructuring, although throughout 2014 there was much political opposition to fiscal laxity, especially from Germany.

**II. Main Economic Indicators and Member State Performance**

*Economic Growth*

The lack of growth dynamics in general suggests that the EU has not been able to benefit from the most recent revival of the global economy. Nevertheless, the disappointing growth performance was no longer due to low levels of private consumption – as it was clearly the case immediately after the crisis – but mostly resulted from record low investment ratios, both in the public and the private sectors. The level of investment dropped by 15 per cent (around €430 billion) from its peak in 2007. As investment is the main driver of long-term growth, the tendencies in 2014 endangered the economic potential and well-being of the entire EU.[[2]](#footnote-2)

However, the fact that the EU was unable to grow along with the major economic centres of the world was only one part of the problem; the EU was experiencing a multispeed recovery (see Table 2, which shows average EU growth rates between 2010 and 2014, and the major outliers on both ends). Convergence in terms of economic development was a strong indicator of success in the EU before the crisis. The steady convergence process was, however, severely halted by the crisis, and Member States exhibited rather diverging growth patterns (see more on economic convergence in Section III). In 2014, a handful of countries managed to reach at least 3 per cent growth rates: Ireland (4.6 per cent), the UK (3.1 per cent), Hungary (3.2 per cent), Luxembourg (3.0 per cent) Malta (3.0 per cent) and Poland (3.0 per cent). The three Baltic States were not in the group of best performers last year, but they did maintain above EU-average economic growth rates, thereby prolonging their spectacular post-2011 performance (following of course their similarly spectacular drop between 2007 and 2009). At the other end of the spectrum, Finland (-0.4 per cent), Italy (-0.4 per cent), Cyprus (-2.8 per cent) and the newest Member State Croatia (-0.7 per cent) were struggling to find their way back to positive growth. The good news is that following a five-year contraction, Greece experienced a slight increase (0.6 per cent); so after several years, the country was able to escape from the group of worst performers. The major economies also showed an uneven performance. While Germany had a bad year in 2013 (0.1 per cent), it managed to bounce back to 1.3 per cent in 2014. Nevertheless, its turn was mainly due to its spectacular first quarter performance, after which its economy started to slow down again. France was still stagnating and did not seem to have found a way to end its growth paralysis. The success story in the group of large economies, beyond the UK, has been Spain, which achieved a 1.2 per cent increase last year.

Table 2. Average EU growth rates (in percentages) and the best and worst performing Member States

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2010** | **2011** | **2012** | **2013** | **2014\*** |
| **EU average** | 2.1 | 1.7 | -0.4 | 0.0 | 1.3 |
| **Standard deviation** | 2.4 | 2.9 | 2.4 | 2.1 | 1.5 |
| **Best performers** | Sweden (6.0)Luxembourg (5.1)Slovakia (4.8) | Estonia (8.3)Lithuania (6.1)Latvia (5)Poland (4.8) | Latvia (4.8)Estonia (4.7)Lithuania (3.8) | Latvia (4.2)Romania (3.5)Lithuania (3.3)Malta (2.5) | Ireland (4.6)Hungary (3.2)UK (3.1)Luxembourg (3)Malta (3)Poland (3) |
| **Worst performers** | Ireland (-0.3)Romania (-0.8)Croatia (-1.7)Latvia (-2.9)Greece (-5.4) | Portugal (-1.8)Greece (-8.9) | Portugal (-3.3)Greece (-6.6) | Greece (-3.3)Cyprus (-5.4) | Finland (-0.4)Italy (-0.4)Croatia (-0.7)Cyprus (-2.8) |

Source: authors, based on European Commission (2014a).

Notes: the ‘best performers’ are the countries which showed rates at least one standard deviation higher than the EU average. ‘Worst performers’ are at least one standard deviation lower. \* indicates forecast data.

*Employment*

The slow and fragile European recovery in general has nonetheless generated jobs, with rates of unemployment decreasing in most countries, breaking the increasing trend of the past few years (see Table 3). However, differences between Member States are significant. Germany continued its trend of decreasing unemployment and by now it has the lowest level in the EU (5.3 per cent). Countries which have been struggling with very high levels of unemployment for years have also made progress in 2014. Following the record high levels in 2013, Greece (26.8 per cent), Spain (24.8 per cent) and Portugal (14.5 per cent) managed to put a halt to further acceleration. Latvia (11.0 per cent) and Ireland (11.1 per cent) also experienced some moderation in their unemployment ratios. The trends in labour market data indicate a strong correlation with recoveries in economic growth. Only a handful of countries, including Austria, Luxembourg, the Netherlands (although these three had very low rates to begin with), Belgium, Croatia, Cyprus, Finland, France and Italy experienced rising unemployment ratios. The case of France is especially worrying, where unemployment increased despite a slow but growing economy.

Table 3. Average EU unemployment rates (in per cent of total labour force) and the best and worst performing Member States

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2010** | **2011** | **2012** | **2013** | **2014\*** |
| **EU average** | 9.6 | 9.6 | 10.4 | 10.8 | 10.3 |
| **Standard deviation** | 4.4 | 4.3 | 5.2 | 5.6 | 5.4 |
| **Best performers** | Luxembourg (4.6)Netherlands (4.5)Austria (4.4) | Luxembourg (4.8)Netherlands (4.4)Austria (4.2) | Luxembourg (5.1)Austria (4.3) | Austria (4.9) | Germany (5.1) |
| **Worst performers** | Slovakia (14.5)Estonia (16.7)Lithuania (17.8)Latvia (19.5)Spain (19.9) | Croatia (13.9)Ireland (14.7)Lithuania (15.4)Latvia (16.2)Greece (17.9)Spain (21.4) | Portugal (15.8)Croatia (16.1)Greece (24.5)Spain (24.8) | Portugal (16.4)Croatia (17.3)Spain (26.1)Greece (27.5) | Cyprus (16.2)Croatia (17.7)Spain (24.8)Greece (26.8) |

Source: author, based on European Commission (2014a).

Notes: the ‘best performers’ are the countries which showed unemployment rates at least one standard deviation below the EU average. ‘Worst performers’ are at least one standard deviation higher. \* indicates forecast data.

One of the most worrying social and economic phenomena in the European labour market is the persistently high level of youth unemployment, i.e. people without jobs between the ages of 15 and 24. The youth unemployment ratio was 15 per cent just before the crisis, and subsequently increased to a record high level of 23.6 per cent by early 2013 (Eurostat, 2014a). Due to somewhat accelerating economic growth rates in 2014, youth unemployment decreased, but it was still close to 5 million people (or 21.6 per cent) by the end of 2014. The highest ratios, close to or even half of the young population, were measured in Spain (53.8 per cent), Greece (49.3 per cent), Italy (43.3 per cent) and Croatia (41.5 per cent) (Eurostat, 2014b).

*Inflation*

The past couple of years had seen a moderation of inflation across the EU, a trend that continued in 2014 as well, leading to deflation in several countries. By 2014, consumer price inflation averaged at an unusually low rate of 0.6 per cent, although the standard deviation was relatively high, leaving the EU rather divided (Table 4). The major reasons for decelerating inflation were the lack of growth dynamism, low energy prices, falling import prices (mostly due to the appreciation of the single currency) and a substantial drop in food prices, closely related to Russian sanctions on EU food exports. The 0.6 per cent average rate of inflation implies that the EU as a whole has entered a danger zone. While both the US and emerging markets have managed to thwart deflation in the last few years, a negative or close to zero consumer price index at the end of 2014 posed a serious challenge for some of the Member States, especially for crisis-hit economies such as Greece, which faced deflation for the past two years (-0.9 per cent in 2013 and -1.0 per cent in 2014), Spain (-0.1 per cent), Cyprus (-0.2 per cent) and more recently Bulgaria (-1.4 per cent) and Slovakia (-0.1 per cent). Only Austria, the UK and Romania (1.5 per cent in each case) managed to come close to the ECB’s 2 per cent benchmark value for consumer price inflation. Importantly, the low inflation rate does not support the EU economies in their effort to dismantle public and private debts or to increase investment, as the real interest rate may remain stuck at a relatively high level. On the positive side, the extremely low (or even negative) inflation may help crisis-hit countries to partly capitalise on falling wage demands, which increase their competitiveness on international markets.

Faced with protracted low inflation, monetary policy has been rather accommodative in the EU in 2014, similarly to other advanced economies. Nevertheless, if expectations continue to push price changes further down or even into the negative, both the ECB and the national central banks will need to adopt more unconventional policies.

Table 4. Average EU inflation rates (harmonized indices of consumer prices, in percentages) and countries with the lowest and highest values

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2010** | **2011** | **2012** | **2013** | **2014\*** |
| **EU average** | 2.1 | 3.1 | 2.6 | 1.5 | 0.6 |
| **Standard deviation** | 1.6 | 1.1 | 0.9 | 1.0 | 0.7 |
| **High inflation** | Romania (6.1)Greece (4.7)Hungary (4.7) | Romania (5.8)Estonia (5.1)UK (4.5)Latvia (4.2)Lithuania 4.1Slovakia (4.1) | Hungary (5.7)Estonia (4.2)Poland (3.7)Slovakia (3.7)Czech Republic (3.5) | Estonia (3.2)Romania (3.2)Netherlands (2.6)UK (2.6) | Austria (1.5)Romania (1.5)UK (1.5) |
| **Low inflation or deflation** | Latvia (-1.2)Ireland (-1.6) | Czech Republic (2.1)Slovenia (2.1)Sweden (1.4)Ireland (1.2) | Greece (1.0)Sweden (0.9) | Bulgaria (0.4)Cyprus (0.4)Portugal (0.4)Sweden (0.4)Latvia (0.0)Greece (-0.9) | Bulgaria (1.4)Slovakia (-0.1)Spain (-0.1)Cyprus (-0.2)Greece (-1.0) |

Source: authors, based on European Commission (2014a).

Notes: countries with ‘low inflation or deflation’ are the ones which showed inflation rates at least one standard deviation below the EU average. ‘High inflation’ countries are at least one standard deviation higher. \* indicates forecast data.

*Budget deficit and public debt*

While central banks did not have much room to stimulate growth in 2014, fiscal policy, remaining by and large neutral throughout the year, was not too active either in remedying the sluggish economic performance. After six years of persistently violating the 3 per cent general government deficit reference value enshrined in Article 126 of the Treaty, both the eurozone deficit average and the EU average decreased below 3 per cent in 2014 (see Table 5). According to the forecast of the European Commission (2014a, p. 36), headline deficits will decrease further down to 2.7 per cent in 2015 and to 2.3 per cent in 2016.

The consolidation efforts of the last couple of years have seemingly delivered their much-awaited results. It is important to recall that almost every Member State engaged in sizeable fiscal stimuli during 2008 and 2009. The few exceptions were Greece, Portugal and Hungary, countries which pursued lax fiscal policies before the crisis and did not have any extra fiscal space by the time the global crisis hit Europe in 2008. As benchmark interest rates were close to zero right from the very start of the crisis, fiscal policy was expected to serve as the major tool for feeding aggregate demand in EU economies. As a corollary, the headline deficit number of the general government deteriorated by 6.1 percentage points, on average, between 2007 and 2009. Debt ratios have increased substantially and are still on the ascent. In 2007, the average debt ratio of EU economies was at 44.4 per cent, but by 2014 it got close to 90 per cent (European Commission 2014a, p. 164).

From 2010 onwards, EU countries have been heavily engaged in robust consolidation efforts. By 2014, the Baltic States were among the best performers in terms of net lending and primary deficit. Greece managed to curb the general government deficit by more than 10 percentage points in a single year, from a strikingly high level of 12.2 per cent in 2013 to only 1.6 per cent in 2014.Denmark, Sweden and Germany were also among the best performers in terms of general government balance. In fact, Germany achieved a slight surplus by substantially repressing its aggregate demand as a result of a strong dedication to consolidating its public finances. The country had the highest primary balance in the EU in the last three consecutive years, which was clearly reflected in its current account position as well. At the other end of the spectrum, crisis-hit economies such as Spain and Portugal, Slovenia, plus France and the UK had a deficit of at least 4.4 per cent in 2014. With the exception of the UK, this reflects disappointing growth dynamism. Public finances data demonstrate that eurozone membership itself, the core-periphery divide or the distinction between old and new Member States does not make a difference at all in terms of ‘fiscal discipline’.

Table 5. Average general government budget balances (in percentages of GDP) in the EU, and the best and worst performing Member States

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2010** | **2011** | **2012** | **2013** | **2014\*** |
| **Mean** | -6.3 | -4.6 | -3.8 | -3.5 | -2.8 |
| **Standard deviation** | 5.8 | 3.3 | 2.6 | 3.3 | 1.6 |
| **Best performers** | Estonia (0.2)Sweden (0.0) | Estonia (1.0)Luxembourg (0.3)Sweden (-0.1)Germany (-0.9)Finland (-1.0) | Germany (0.1)Luxembourg (0.1)Estonia (-0.3)Bulgaria (-0.5)Sweden (-0.9) | Luxembourg (0.6)Germany (0.1)Sweden (-0.9) | Germany (0.2)Luxembourg (0.2)Estonia (-0.4)Sweden (-0.9)Denmark (-1.0)Latvia (-1.1)Lithuania (-1.1) |
| **Worst performers** | Ireland (-32.4) | Lithuania (-9.0)Spain (-9.4)Greece (-10.0)Ireland (-12.6) | Ireland (-8.0)UK (-8.3)Greece (-8.6)Spain (-10.3) | Spain (-6.8)Greece (-12.2)Slovenia (-14.6) | France (-4.4)Slovenia (-4.4)Portugal (-4.9)UK (-5.4)Croatia (-5.6)Spain (-5.6) |

Source: authors, based on European Commission (2014a).

Notes: the ‘best performers’ are the countries which showed a budget position at least one standard deviation above the EU average. ‘Worst performers’ are at least one standard deviation below. \* indicates forecast data.

*External balance*

Right from the beginning of the crisis, EU countries put great efforts in stabilising external positions. The large creditors such as Germany maintained huge surpluses, while crisis-hit countries engaged in substantial cuts in their current account deficits. By 2014, the un-weighted average of current account balances showed a significant surplus of 1.3 per cent of GDP, though the spread around the mean was quite substantial. Only 12 countries out of the 28 members had a current account deficit in 2014 – but even those countries with deficits experienced solid improvements throughout the last couple of years (e.g. Greece, Portugal, Cyprus or Latvia).

Sadly, the considerable improvements have not been due to a general recovery in export performance. Instead, economies with high pre-crisis external imbalances implemented adjustments on the import side by substantially reducing their external demand. Improvements in current account balances have also been a clear sign of decreasing investment activity. The only exception to this trend was the UK, which had the largest external deficit last year, being an indication of strong import demand due to the country’s good economic conditions. Countries showing large surpluses have been the same ones for considerable time, including Sweden, Denmark, Germany, the Netherlands and Luxembourg.[[3]](#footnote-3) Without the increase of the external demand of these creditor economies, however, no recoveries in the periphery can be expected to remain solid. That said, the robust recovery in the current account positions of most EU countries cannot be interpreted as a success since it has not been fed by accelerating net exports. Instead, the decreased aggregate demand due to fiscal adjustment (see above) and private sector deleveraging contributed to the further ‘recovery’ in external positions. The worst adjustment was experienced by Greece, where almost the entire recovery was delivered by constrained private and public demand.

Table 6. Average EU current account deficit (as percentages of GDP) and Member States with highest deficits and surpluses

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2010** | **2011** | **2012** | **2013** | **2014\*** |
| **EU average\*\*** | -1.0 | -0.8 | 0.2 | 1.3 | 1.3 |
| **Standard deviation** | 5.2 | 4.2 | 3.9 | 3.4 | 3.4 |
| **Highest current account surpluses** | Luxembourg (7.7)Netherlands (7.5)Sweden (6.5)Germany (5.9)Denmark (5.7) | Netherlands (7.1)Luxembourg (6.5)Germany (6.2)Sweden (5.9)Denmark (5.7) | Netherlands (8.8)Germany (7.2)Sweden (6.3)Denmark (5.8)Luxembourg (5.7) | Netherlands (8.5)Denmark (6.9)Germany (6.9)Sweden (6.5)Luxembourg (5.2)Slovenia (4.8) | Netherlands (7.8)Germany (7.1)Denmark (6.2)Slovenia (6.2)Sweden (5.7)Ireland (5.5)Luxembourg (5.2) |
| **Highest current account deficits** | Malta (-6.4)Cyprus (-9.1)Portugal (-10.4)Greece (-12) | Poland (-5)Portugal (-5.6)Greece (-10.5) | Poland (-3.8)Greece (-4.3)Romania (-4.7)Cyprus (-5.5) | Czech Republic (-2.2)Latvia (-2.2)Greece (-2.7)UK (-4.2) | Latvia (-2.2)Estonia (-2.8)Greece (-2.8)UK (-4) |

Source: authors, based on European Commission (2014a).

Notes: countries with high current account deficits are ones which showed deficits at least one standard deviation below the EU average. Those with high surpluses are at least one standard deviation above. \* indicates forecast data. \*\*: un-weighted average of Member State current account balances.

*Competitiveness*

Changes in the real effective exchange rate (REER, defined as unit labour costs adjusted for nominal exchange rate movements) are often used to illustrate changes in the international competitive position of the EU and of its Member States. Although this measure is only able to capture changes in the cost competitiveness of the export sector, it is perhaps a more straightforward indicator than the various composite competitiveness indicators and rankings. After a substantial appreciation in 2013, the REER appreciated again in the EU as whole in 2014, making prospects for a stronger export led recovery gloomy. The EU average, however, is slightly misleading as it measures EU export competitiveness in relation to the EU’s main *external* trading partners. Much of the trade of Member States is with other members, thus, Member State REER’s can be more meaningful. Most Member States did not see any significant change in their competitive position, as the un-weighted average of Member State REER changes was zero in 2014. There were some exceptions though. The UK saw a substantial appreciation (6.1 per cent), and so did Latvia (2.9 per cent) and Estonia (2.5 per cent). Germany and Romania also experienced an appreciation of 2 per cent. On the other hand, export cost competitiveness improved mostly in smaller Member States, such as the Czech Republic (-5.9 per cent), Ireland (-4.8 per cent) and Cyprus (-4 per cent); Sweden (-3.2 per cent) also managed to improve on its cost competitiveness – see Table 7.

Table 7. Average real effective exchange rates, and highest appreciations and depreciations (unit labour costs relative to a group of industrialised countries, percentage change on preceding year)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2010** | **2011** | **2012** | **2013** | **2014\*** |
| **EU**  | -7.8 | 0.5 | -5.1 | 8.9 | 3.3 |
| **Un-weighted average of Member States** | -2.2 | 0.1 | -2.1 | 2.0 | 0.0 |
| **Standard deviation** | 4.2 | 2.7 | 2.9 | 3.3 | 2.5 |
| **Highest REER depreciation** | Ireland (-10.5)Latvia (-10.5)Lithuania (-8.3)Estonia (-6.4) | Romania(-5.9)Ireland (-3.5)Poland (-2.6)Estonia (-2.5)Croatia (-2.5) | Greece (-7)Spain (-6.6)Romania (-6)Cyprus (-5.6)Portugal (-5.5)Ireland (-5.1)Croatia (-5) | Greece (-7.2)Cyprus (-3.1)Czech Republic (-3.1)Hungary (-1.9)UK (-1.6) | Czech Republic (-5.9)Ireland (-4.8)Cyprus (-4)Sweden (-3.2) |
| **Highest REER appreciation** | Bulgaria (2.6)UK (2.8)Czech Republic (3.0)Sweden (4.8)Poland (8.4) | Czech Republic (2.9)Malta (3.7)Bulgaria (3.9)Sweden (7.5) | Bulgaria (1.2)Sweden (2.8)UK (4.9) | Estonia (6.1)Ireland (6.3)Latvia (6.3)Bulgaria (7.8) | Estonia (2.5)Latvia (2.9)UK (6.1) |

Source: authors, based on European Commission (2014a).

Notes: countries with high REER depreciations are the ones which showed depreciations at least one standard deviation below the EU average. Those with high appreciations are at least one standard deviation above the average. \* indicates forecast data.

Going beyond cost aspects, the World Economic Forum’s Global Competitiveness Index provides a measure of locational attractiveness (World Economic Forum, 2014). According to this index, some EU members, notably Finland, Germany, Sweden and the Netherlands, have been among the world’s most competitive economies for some time. With the exception of Sweden, the other three managed to hold on to these positions in 2014. On the other hand, the least competitive EU countries are all from Southern and Eastern Europe. Greece had the worst position in 2014, though it substantially improved its rank from the previous year. Bulgaria, Latvia, Portugal and Romania, all belonging to the less competitive group of European countries made impressive progress as well. On the other hand, Slovakia and Slovenia both experienced huge slumps in their rankings in recent years, which continued in 2014.

**III. Ten Years in Perspective: the Income Convergence Hypothesis**

The ten year anniversary of the EU’s ‘big bang’ Eastern enlargement in 2004, along with the rather diverse impacts of the global economic crisis and the ensuing slow recovery, make the question of convergence among the economic performance of Member States especially compelling. Has the community managed to reduce differences in terms of national income and development in the decade-long period of time? Neoclassical growth theory, going back to the works of Solow (1956), predicts that countries with lower levels of income will tend to grow faster than richer countries due to differences in the capital/labour ratio and, in turn, with regard to the marginal product of capital. Assuming constant returns to scale and structural similarities, including applied technology, the neoclassical growth model predicts an (absolute) convergence in income (and economic development), making it only a matter of time for a less developed country to catch up with the more developed ones. Based on the neoclassical growth model, Martin et al. (2001) argued that economic integration can hugely bolster this convergence process amongst countries through the elimination of transaction costs, the increased efficiency of capital, and the free flow of goods and services. In contrast however, Krugman (1991) argued that due to scale economies and agglomeration effects, economic integration can instead foster divergence.

Reviewing the literature on empirical verification attempts of the neoclassical convergence hypothesis is beyond the scope of this contribution, but it is worth highlighting key findings on Europe. EU-wide studies focus on the performance of either countries or sub-national regions. At the country level, the empirical evidence overwhelmingly points to the relevance of the convergence hypothesis, at least for the EU-15. Cuaresma*et al.* (2008), for example, found that in case of the pre-2004 Member States, EU membership had a convergence-stimulating impact on long-term growth: relatively poor countries benefitted more from membership than rich ones. Petrakos *et al.* (2011), however, showed that while convergence is clearly present on the country level, the picture is less evident on the level of regions. Analysing 70 regions from 6 EU members, Fagerberg and Verspagen (1996) concluded that convergence was present during the post-war decades, but there have been signs of reversal after the 1980s. They also argued that after the 1980s ‘club convergence’ became dominant, i.e., one could identify convergence within certain groups (‘clubs’) of regions, but no convergence between these groups. These conclusions were echoed by Fischer and Stirböck (2006), who identified two growth clubs: much of Western Europe, including most of Spain, Northern Italy and Slovenia, versus the Eastern Member States, parts of East Germany and Austria, plus the Southern regions including Portugal, Greece and some regions of Italy and Spain. The conflicting results between the national and the regional level can be traced back to the fact that growth in Member States is often driven by dynamic metropolitan centres, leaving the rest of the country untouched (Petrakos *et al.*, 2011).

So, have the less developed Eastern and Southern members grown faster in the past decade than the Western and Northern countries, thereby narrowing the gap between the two groups? The cross-country scatterplot diagram of Figure 1 seems to reinforce the income convergence hypothesis, showing a moderate negative relationship between the level of development (measured as a percentage of the EU15’s average income) in the year of the big bang enlargement on the one hand, and the mean annual economic growth rate between 2004 and 2014 on the other hand.[[4]](#footnote-4) By and large, EU countries can be split into two main clusters: the group of new Member States and the old Member States. Nevertheless, a handful of countries are somewhere mid-way in-between the two major clusters, often rather far from the trend line.

Figure 1. Incomes in 2004 and subsequent economic performance

Source: authors, based on data from AMECO.

Note: per capita GDP in purchasing power parity

The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia (CEE8) were at 53 per cent of the EU15 average in 2004. Ten years later the average score of the CEE8 was 68 per cent, demonstrating a massive wealth accumulation. Most of the Eastern accession countries such as Poland, Slovakia, the Czech Republic and the Baltic States showed spectacular growth performances during the last ten years. For example, Poland’s per capita income, measured in purchasing power parity, was only 43 per cent of that of the EU15’s in 2004, but the ratio had increased by 20 percentage points to 63 per cent by 2014. The Baltic countries, on the other hand, were amongst the biggest losers of the crisis suffering from an incredibly deep recession and losing about one-fifth of their national income. Yet, as Figure 1 demonstrates, they still managed to perform well above the trend line. With quick and unusually severe policy responses each of them managed to bounce back and continued their convergence towards the core by 2011 (see Staehr 2013).

The most surprising success story was achieved by Slovakia. After years of semi-isolation and a slow start to the EU accession process caused by the anti-democratic Meciar-regime in the second half of the 1990s, the pro-market reforms of the Dzurinda cabinet after 2001 unequivocally made Slovakia the most successful converger amongst the new EU Member States (Fisher *et al*., 2007; Győrffy, 2009).

Romania and Bulgaria, countries which joined the EU in 2007, also showed good convergence performance: both of them had incomes around a third of the EU15’s average GDP per capita in 2004, but by 2014 they managed to reach 49 and 43 per cent, respectively. In fact, these two countries lie almost perfectly on the fitted line of Figure 1, just like Malta, which started the convergence process at 71 per cent in 2004 and reached 82 per cent 10 year later. Malta managed to outperform Slovenia, which was the most developed country of the 10 states acceding in 2004. Slovenia, in relative terms, did not manage to approximate the EU15 average; it stayed where it was at the time of accession, at 75 per cent. Commentators on the Slovenian failure name the lack of structural and institutional reforms, oversized state-controlled enterprises, the overregulated and unfavourable business environment, and especially the deterioration of the country’s export competitiveness as the main detrimental factors to growth (see especially European Commission 2014b). The other CEE country which did not manage to capitalise on EU accession was Hungary. At the time of accession it had the third highest per capita income among the CEE8 countries, right behind Slovenia and the Czech Republic. Although Hungary, in sharp contrast to Slovenia, experienced some advances in its relative income position (it rose from 54 per cent to 62 per cent), it had been seriously outperformed by all the others by 2014. This conclusion is hardly moderated by the country’s good economic performance in 2014, the long run sustainability of which is seen as highly questionable. It is important to note, however, that both Slovenia and Hungary faced these deteriorating tendencies well *before* EU accession. As pointed out by Murn et al. (2002), Slovenia experienced worsening conditions, including low levels of foreign direct investment inflows, high unit labour costs, and an excessive emphasis on labour-intensive production at the turn of the millennium already. The major blow to Hungary’s economic development came around 2001 and 2002, when the public sector turned into the playground of short-sighted politicians (Benczes and Takács, 2014; Csaba, 2011).

At the other end of the trend line, old Member States displayed high starting per capita incomes and relatively low annual growth rates as the income convergence hypothesis would predict it. By and large, all the ‘core’ countries managed to slightly increase their relative income positions between 2004 and 2014, but there is ample evidence for spread around the trend here too. The United Kingdom and Sweden exceled with an annual average growth rate of 2 per cent. Although neither of them avoided the hit of the financial crisis, but a swift and robust recovery helped the two economies attain a far better performance than other old Member States. The UK experienced strong employment growth, along with a massive inflow of workers in the last ten years, hugely benefiting from the Eastern enlargement of the EU. Additionally, from 2010 onwards, the country has been undertaking a series of austerity measures, mostly in the form of expenditure cuts – although the public deficit is still above the 3 per cent limit. The European Commission (2015a), however, points to sluggish productivity which undermines the sustainability of British performance. Sweden, on the other hand, avoided austerity. It managed to hold public debt at low levels and ran a balanced budget before, during and after the financial crisis. In fact, Sweden was even able to reduce taxes, and increase spending on research, education and public investment, thereby boosting economic activity (European Commission, 2015b).

According to Figure 1, the third outlier on the positive side was, somewhat surprisingly, one of the ‘programme countries’, Ireland. Aside from Luxembourg, Ireland was the EU’s richest country in 2004, yet it attained an impressive 1.5 per cent growth rate, ranking it in the top four among the old Member States. Compared to Ireland’s staggering performance of the nineties (with often two-digit growth rates), the 1.5 per cent rate might seem rather modest. Yet, if the more recent events such as the burst of the mortgage bubble and the consequent banking and fiscal crises are taken into account, even such a ‘moderate’ rate is worth acknowledging (see Donovan and Murphy, 2013).

On the other hand, in line with the empirical literature cited above, Southern countries suffered from further fall-backs. Clearly, Greece saw the most dramatic fall in its relative income (from 83 per cent of the EU15’s average in 2004 to 66 per cent in 2014). But others, such as Italy and Portugal, and to a lesser extent Cyprus and Spain also fell behind. The global financial and economic crisis and the ensuing European sovereign debt crisis have seriously halted the convergence process of these economies. In contrast with Slovenia’s and Hungary’s performance, where problems began well before the crisis, some of the Southern members did not do badly before 2007. In fact, Greece and Spain highly outperformed most of the old Member States between 2004 and 2007 (with annual average growth rates around 4.3 and 3.6 per cent, respectively, see Table 8.). The two countries’ performance was, in fact, in full harmony with the prediction of the income convergence hypothesis: they did not fare as outstandingly as the new Member States, but showed much better performance than, say, Germany which achieved only 2.1 per cent. With a benefit of hindsight, Greece managed to maintain its relative position by protracted fiscal profligacy and accumulation of public debt (Visvizi, 2012); whereas Spain’s GDP growth was fuelled by a large mortgage bubble.

Portugal and Italy, on the other hand, were the laggards of the entire EU, with 1.4 and 1.2 per cent growth rates between 2004 and 2007 already. Therefore, the deterioration of their economic performance could hardly be accounted for by the crisis itself. For Portugal, the divergence and the consequent decade-long stagnation coincided with the adoption of the single currency (Alves, 2014). In case of Italy, the situation was even worse; the country was one of the worst performers in the nineties already (European Commission, 2014a) and the adoption of the euro did not make things any better.

Table 8. Economic growth in EU Member States in 2004-7 and 2008-14.

|  |  |  |
| --- | --- | --- |
|  | **2004-2007** | **2008-2014** |
| **EU average** | 4.4 | 0.2 |
| **Standard deviation** | 2.3 | 1.3 |
| **Countries above the EU average** | Latvia (10.3)Estonia (9.0)Lithuania (8.1)Slovakia (7.6)Romania (6.7)Bulgaria (6.0)Poland (5.4)Slovenia (5.3)Ireland (5.2)Czech Rep (4.8) | Poland (3.1)Czech Rep (2.0)Malta (2.0)Slovakia (2.0)UK (1.7)Bulgaria (1.0)Romania (0.9)Sweden (0.9)Germany (0.8)Lithuania (0.8)Austria (0.7)Belgium (0.5)France (0.4) |
| **Countries below the EU average** | Greece (4.3)Cyprus (4.2)Finland (4.0)Spain (3.6)Sweden (3.5)Hungary (3.4)Austria (2.9)UK (2.9) Netherlands (2.7)Denmark (2.5)Belgium (2.4)Malta (2.4)Germany (2.1)France (2.0)Portugal (1.4)Italy (1.2) | Ireland (-0.6)Estonia (0.0)Hungary (0.0)Netherlands (-0.1)Denmark (-0.5)Slovenia (-0.5)Finland (-0.7)Spain (-0.8) Portugal (-0.9)Cyprus (-1.0)Italy (-1.2)Latvia (-1.2) Lithuania (-3.4)Greece (-3.5) |

Source: authors, based on European Commission (2014a) and AMECO.

It is also reasonable to ask whether the EU as a whole was able to keep pace with the world’s largest economy, the US, in the last ten years. US growth rates turned negative in 2007, but the country managed to slowly leave behind the crisis from 2009 onwards, and it was able to maintain steady growth in the years afterwards. Surprisingly, the development gap between the EU average and the US did not change at all between 2004 and 2014. In terms of current price per capita GDP, the EU-25 stood at two-thirds of US income in 2004 (€22,444 versus €33,649), exactly where the EU-28 stood in 2014 (€27,470 versus €40,946). This performance is partly due to the stunning convergence experience of most of the Eastern members countries, but some old members were able to outperform the US in the ten-year-long-period as well, most notably Austria, Germany, Luxembourg and Sweden.

**Conclusions**

The long awaited recovery of the European economy did not arrive in 2014. Despite a generally accommodative global context, economic growth, while modestly accelerating after 2013, remained sluggish. Unresolved structural problems may be seen as the main reason for this continued euro-sclerosis. While there were some initiatives to resolve some of these problems (such as the labour market reforms by Matteo Renzi’s government in Italy or Manuel Walls’ pro-business and pro-employment initiates in France, along with Jean-Claude Juncker’s Investment Plan for Europe), political will was just as evidently missing in 2014 as it had been the case in previous years (Copsey and Haughton, 2012). The consequences of persistently slow growth are several. Government debt is already at record high levels, making any further fiscal stimulus rather difficult. It is clear that any attempt to bolster fiscal consolidation would surely evoke serious opposition and even social unrest in many of the Member States (it is enough to mention the election victory of Syriza in Greece in January 2015). Unemployment did decrease in 2014, but this is not much consolation for the 26 million people without jobs Europe-wide. Youth unemployment is especially worrisome; it can easily result in the creation of a ‘lost generation’. The opposing positions between Germany and France on the need for further austerity and especially on the rightness of the EU’s fiscal rule-book do not help the community to hammer out the proper future methods of governance, including the sequencing and the depth of structural reforms. The lack of demand, coupled with decreasing global oil prices, have practically annihilated inflation in Europe and have led to a very real threat of deflation, which, if sustained, could paralyze Europe’s growth for the foreseeable future, as it has paralyzed Japan since the 1990s. As we entered 2015, the basic question was whether the European Central Bank would be willing to take a more relaxed position on growth supporting measures.[[5]](#footnote-5)

The contribution has also examined the issue of convergence among EU Member States. By and large, the income convergence hypothesis has been verified, as most of the new Member States, which were all well below the EU average in terms of GDP per capita at the time of their accession, have been able to grow faster than the core economies of the EU. Nevertheless, this bird’s eye view is rather biased, as there have been some outliers to this general trend. The very fact that some countries did not manage to capitalize on EU accession suggests that convergence is hardly an automatic, i.e., endogenous, outcome of EU membership. As the overview of country experiences in this contribution underlined it would be extremely challenging to pinpoint any single reason for the co-existence of EU-level convergence and divergence of some national economies) in the past 10 years. Nevertheless, it would not be far off to claim that divergence can be explained by individual country factors in most of the cases, including policy mistakes and economic mismanagement on the one hand, and structural deficiencies and eroding competitiveness on the other hand. It is likely however that these countries would have fared even worse without EU membership (Jacoby, 2014, p. 67). The European financial-cum-economic crisis in fact made the convergence process a hard run for many; nevertheless, putting the blame solely on the crisis for laggard positions would be a huge mistake.

If someone, though, is looking for a European pattern, the current division of labour along with the unique variety of capitalism(s) in Central and Eastern Europe and the Mediterranean region may not help convergence become stronger in the future (Epstein, 2014). Relying on foreign direct investment as a driver of growth and a source of knowledge needs to be supplanted by greater domestic innovation and knowledge creation in these countries, if the convergence momentum of the past decade is to be sustained.

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1. See Hodson’s contribution to this volume. [↑](#footnote-ref-1)
2. The Commission launched an Investment Plan for Europe in November 2014, aimed at substantially raising investment activities across Europe (European Commission 2014b). [↑](#footnote-ref-2)
3. Some other countries like Ireland, Slovenia and Hungary have also shown large surpluses in recent years, which can be seen as an indication of repressed domestic demand. [↑](#footnote-ref-3)
4. Croatia and Luxembourg have been omitted from the analysis. Luxembourg was an outlier with 216 per cent of EU15 income in 2004. No data was available for Croatia. [↑](#footnote-ref-4)
5. It seems that the ECB indeed wants to play a more active role, as it announced an expanded asset purchase programme in January 2015. [↑](#footnote-ref-5)