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EUROPE'S GROWTH EMERGENCY

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Highlights

- The European Union growth agenda has become even more pressing because growth is needed to support public and private sector deleveraging, reduce the fragility of the banking sector, counter the falling behind of southern European countries and prove that Europe is still a worthwhile place to invest.
- The crisis has had a similar impact on most European countries and the US: a persistent drop in output level and a growth slowdown. This contrasts sharply with the experience of the emerging countries of Asia and Latin America.
- Productivity improvement was immediate in the US, but Europe hoarded labour and productivity improvements were in general delayed. Southern European countries have hardly adjusted so far.
- There is a negative feedback loop between the crisis and growth, and without effective solutions to deal with the crisis, growth is unlikely to resume. National and EU-level policies should aim to foster reforms and adjustment and should not risk medium-term objectives under the pressure of events. A more hands-on approach, including industrial policies, should be considered.

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To simplify matters, we use throughout this paper five country groups as the basis for discussion of the diverse challenges. The Appendix presents the classification.

2 WHY GROWTH IS EVEN MORE IMPORTANT

2.1 Overall performance

After the second world war, European countries embarked on a rapid convergence with the US in terms of GDP per capita (Figure 1). This was in part based on the rebuilding of the capital stock lost during the war, in part on technological catching-up and in part on economic integration efforts. By the late 1970s, however, convergence with the US has stopped in most countries of 'older' Europe … though with significant exceptions, such as Ireland. Countries in the North (Denmark, Finland, Sweden, Ireland, United Kingdom; see Appendix) and South (Greece, Italy, Portugal, Spain) groups in particular had apparently settled for levels corresponding to 80 percent and 60 percent of US GDP per capita. The central and eastern countries by contrast were catching up from the mid-1990s, though from a much lower base.

Figure 1 also shows IMF projections up to 2016 suggesting that the positions of the West and North country groups relative to the US should remain broadly stable, while southern Europe is expected to fall behind and the convergence of the Central and East groups is projected to continue

1. By 2016, the relative position of the East group is forecast to reach only pre-transition level. Note that data for the late 1980s and early 1990s should be interpreted with caution given the differences in statistical methodology, changes in relative prices, and measurement errors.

BOX 1: DECOMPOSITION OF UK AND US POST SECOND WORLD WAR PUBLIC DEBT REDUCTION

In the UK and the US, the public debt ratio (general government for the UK, federal government in the US) fell rapidly after the second world war. In 1946, the public debt was 257 percent of GDP in the UK and 122 percent in the US. By 1976 it had been brought down to 52 percent and 36 percent, respectively. Table 1 shows averprivate deleveraging is a major challenge that could hinder economic growth and could even lead to a vicious circle of lower growth and lower credit … even to those companies and households that are not overly leveraged[4]. Furthermore, the banking sector in Europe is itself highly leveraged and will need to undergo sizeable corrections, not least because of the Basel III regulations.

There are therefore major concerns both on the supply and the demand sides. On the supply side potential growth in the coming years could weaken further post the financial crisis; on the demand side the combination of public and private deleveraging may result in slow growth of private aggregate demand.

In this context, improving potential growth in the long run remains of paramount importance but at the same time policymakers cannot afford to ignore the interplay between supply and demand or between short-term and longer-term developments.

3 DEVELOPMENTS DURING THE CRISIS

Growth policies are geneT /F4 1 17.1(e)22(m)18.1(a)0(nbP0.0016 Tc -0.02u)24(G T)1680.02ue

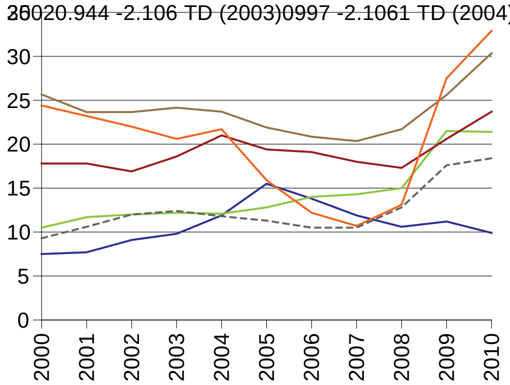
a result of reducing labour input by more than the output fall. In western and northern Europe by contrast productivity initially fell while employment did not, which is evidence of labour-hoarding. Only after a lag did productivity start to recover, but only to a level barely above the pre-crisis level. In central Europe productivity started to improve from mid-2009 and the gains are impressive. In southern Europe the fall in output and labour input went broadly hand in hand. Productivity essentially remained flat for the group as a whole.

Interpreting these differences is not straightforward. The broad evidence is that the supply side was more damaged in Europe than in the US, at least if one assumes that the largest part of US unemployment is cyclical. Labour hoarding by European firms seehplE8a1(c)145d921art oE(.2305 Tw [(t)2p)9.8(a 12b)17.11-8(s)8.8(siv)12.2

Central Bank (ECB) support to southern European banks, which has offset the sudden stop in private capital flows and contributed to financial stability. But at the same time, ECB financing has made it possible for these countries to delay the adjustment, as noted by Sinn (2011).

3.3 The special challenges of southern Europe

The evidence presented thus far confirms that southern European countries face special challenges. Their economic convergence has reversed, their unit labour costs have failed to improve following a steady rise in the pre-crisis period, and their current account deficits have hardly improved. Most southern European countries are under heavy market pressure and face a vicious circle of low and even worsening confidence and



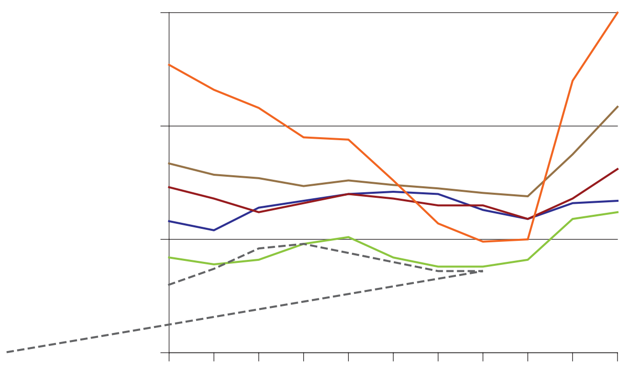


Table 3: Programme assumptions and recent forecasts for Greece and Ireland

GREECE	Forecast dat	2009	2010	2011	2012	2013	2014	2015
GDP	May 2010	-2.0	-4.0	-2.6	1.1	2.1	2.1	2.7
% change	Sept 2011	-2.3	-4.4	-5.0	[illegible]	1.5	2.3	[illegible]
Gross public del	May 2010	115	[illegible]	145	149	149	146	

May 2010 -2.7 0.1254 -1 0 0 97.5556 270.3084 Tm 0.13725 0.12157 0.125t515 8.61n /GS2 gs 88.724 215.382 13.04 41.206 re f8o470

agenda? Most of it clearly still makes sense. Education, research, and the increase in participation and employment rates are perfectly sensible objectives in the current context, and the goals of ensuring climate-friendly and inclusive growth are also appropriate.

Implementing this agenda requires a significant stepping-up of efforts. Progress so far is very uneven within the EU. While indicators related to an114.544. T2s u1(urin)22(g 2eu14.1(t16.128.8(e)27s.1(p o)il)1)14. lu(gr)162.2e gooy avTare,3TJ .1(e g)14.2

to expediency. In all countries surveyed, recent adjustments are either mixed or revenue-based. It is probable that they are also markedly growth-unfriendly in the choice of detailed measures.

Evidence thus indicates that the growth-adverse impact of the precipitous adjustment plans that are being implemented in response to market strains are likely to go beyond standard Keynesian effects and also result in potentially adverse supply-side effects. This is in part unavoidable. But good intentions are of little help if they are reneged on under the pressure of events. Whereas there is no magic bullet to address this problem, at least a close monitoring of national plans within the context of the ECOFIN Council is called for.

4.3 Growth policy under constraints

A key challenge for several euro-area countries is how to implement growth strategies in the context of 'wrong' prices. When prices perform their economic role they convey information to agents about the profitability of working or investing in various sectors; this in principle leads to socially optimal choices. In this context the main task of policies is to boost the supply of labour and capital and to create a level playing field for employees and firms.

Things are different, however, when prices are 'wrong'[8], which is particularly relevant in the European context because of real exchange-rate mis-

8. This traditionally hap-

Table 5: Composition of recent fiscal adjustments in selected euro-area countries

Greece	Original version of IMF/EU Programme (May 2010)	11.1% GDP		
		47.8% expenditure	0.36 revenues	16.2% structural reforms (*)
	Reinforced Medium Term Fiscal Strategy (June 2011)	12% GDP (on top of what already implemented)		
		0.525 expenditure	0.475 revenues	
	2nd emergency round (September 2011)	1.1% GDP (Property tax on electricity-powered buildings)		
		--	1 revenues	
Portugal	IMF/EU EFF Programme (May 2011)	10.6% GDP		
		0.67 expenditure	0.33 revenues	
	Emergency measures due to fiscal slippag (August 2011)	1.1% of GDP		
		--	1 revenues	
Spain	Emergency measures (August 2011)	0.5% GDP		
		~50% expenditure	~50% revenues	
	Emergency measures (September 2011)	0.2% GDP		
		--	1 revenues	
Italy	Fiscal Consolidation Package (August 201	3.6% GDP		
		<50% expenditure	>50% revenues	
France	August 2011	0.6% of GDP		
		--	>80% revenues	

Source: Bruegel based on IMF (2010a, 2010d, 2011a, 2011b), Greek Ministry of Finance (2011), ECB (2011), Spanis istry of Finance (2011a, 2011b), and news reports in *Financial Times*, *Sole24Ore* and *LaVoce.info*. Note. (*) In the case of Greece, in addition to direct revenue and expenditure measures, IMF (2010a) included a third category called *Structural reforms*, which comprise lower expenditures resulting from improvements from budgetary control and processes and hi revenues due to improvements in tax administration.

5 CONCLUSIONS

In this paper we have revisited the European growth issue in the light of recent developments. We agree with the World Bank (Gill and Raiser, 2011) that Europe can build on its past achievements, but we emphasise that it cannot afford to remain complacent about its recent and current economic performance. For most of the continent business-as-usual policies are likely to deliver insufficient growth to ensure the viability of the social model, which is in any case under threat because of ageing populations. The challenge of reviving growth is heightened by the deteriorating performance of southern Europe and the very limited, or even disappointing, adjustment these countries were able to achieve during the last three years. The single most remarkable success of the EU, its ability to foster convergence, is under threat. In •new Europe• convergence is still happening, but it should be strengthened.

On this basis our main policy conclusions are:

- The growth agenda is of paramount importance in the current context. The Polish EU presidency should be commended for having selected it as a priority and the detailed proposals in Polish presidency (2011) should be considered seriously;
- The EU2020 agenda remains broadly appropriate, but its governance should be improved to achieve more rapid progress on structural reform in countries that are under threat of falling behind, making use of the new instruments embodied in the European Semester[9]; structural reforms in general, and reforms of product and labour markets in particular, are of paramount importance especially in countries with weak scores and overvalued real exchange rates;
- Tax-based internal devaluations, temporary wage-price subsidies or tax breaks could help restore competitiveness;
- The EU should urgently speed up the reallocation of Structural and Cohesion Funds in countries under programme to support growth and competitiveness, for which a general political will may be there, but action is lacking. Special legislation is needed to turn principles into swift action;
- The proposals for issuing •European project bonds• by the Commission or increasing the capacity of the EIB, to fund investment throughout Europe, should be considered and implemented;
- The growth agenda needs to be put in context. It is of littletiowill m7TJ 1.03088.1(e)-6.tm7TJ

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