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ECFIN Economic brief

Fellowship initiative

Economic growth perspectives for Europe

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Summary

This note provides a brief overview of the work carried out under the auspices of DG ECFIN's Fellowship Initiative 2012-13 on the theme of "Economic Growth perspectives for Europe".

While the economic policy agenda in Europe is currently dominated by lagging activity reflecting public and private sector balance-sheet adjustment and rebalancing needs, the quest for growth and competitiveness is a longer term issue that clearly deserves renewed attention. Against this background, the work carried out in the context of the Fellowship Initiative should help to map out a new growth narrative for and across Europe over the medium-term.

The fresh insights provided by the work of the fellows on the drivers of growth and shared prosperity are highly welcomed at a time when so much of the news is pessimistic or cautious at best. They will certainly stimulate further debate and help Europe to rise to the challenges ahead.

Introduction

DG ECFIN has now published a series of Economic Papers written by distinguished scholars in the context of its Fellowship Initiative on "The future of EMU & Economic growth perspectives for Europe". This note outlines the issues addressed under the heading of medium-term growth perspectives and briefly presents the key findings of the contributions provided by the fellows; discussing the main results against the background of on-going policy efforts at the EU and euro area level.

The issues

Growth perspectives for the EU economy – and more specifically the euro area – appear to be fairly bleak, both with respect to the short-run outlook and over a more medium- to long-term horizon. Historical evidence shows that economic recoveries after financial crises tend to be slow and sluggish; typically, the need for financial deleveraging, demands for higher risk premia, inevitable fiscal consolidation to restore sustainable public finances and persistent labour market weaknesses combined to weigh on growth for a prolonged period of time. But already before the crisis, the euro area had to face growing macroeconomic imbalances, sluggish productivity growth, and the overall challenges of globalisation, ageing populations, growing resource limitations and climate change. All these factors must be expected to impact on potential growth in the EU over this decade and probably beyond.

Thus, while the economic policy agenda in Europe is currently dominated by public and private sector balance-sheet adjustment and rebalancing, the need for growth and competitiveness is a longer term issue that deserves considerable attention as well. Even though most European countries currently show significantly slower growth than their long-term trend, suggesting large output gaps, any attempt to recover demand in the short-term will deliver smaller than expected results in the longer term if potential growth con-

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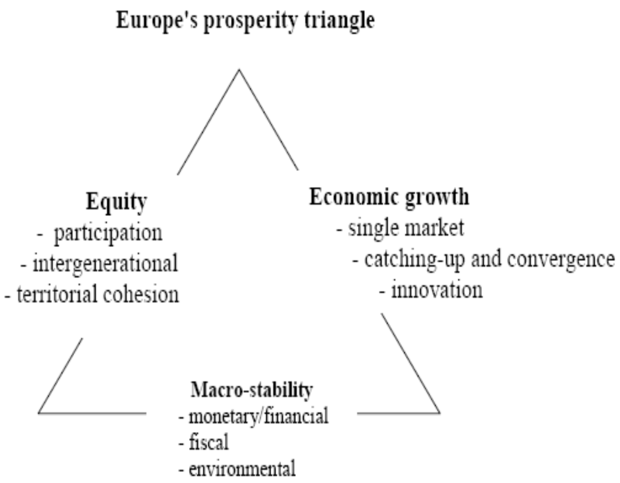
tinues to deteriorate. The long-term structural performance should therefore be at least as much a concern as the short-term lack of demand.

Against this background, the work carried out in the context of the Fellowship Initiative should help to map out a new growth narrative for and across Europe over the medium-term. However, mindful of Joe Stiglitz' remark that "economic growth may be everything, but it is not the only thing", both analytical and strategic thinking is perhaps usefully framed in terms of how to re-establish Europe's prosperity triangle comprising of economic growth, stability and equity in open and democratic societies.

Figure 1.



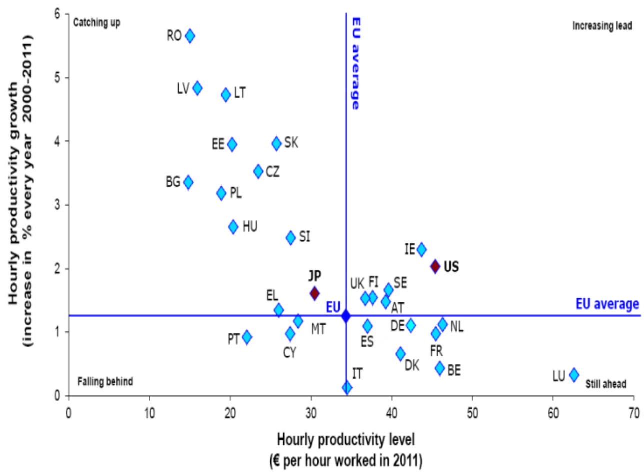
Growth per se is obviously not an end in itself, it is an essential driver of well-being in society, but it also needs to be stable and sustainable, with the benefits it brings being widely and fairly shared across society. Macro-stability is of course crucial - not in the narrow sense of short-run cyclical consumption smoothing, but in the more fundamental sense of safeguarding against the risk of systemic crises endangering broad standards of living -, even if it may entail some short-run sacrifice in terms of income growth. Equity considerations are indispensable as well, for the growth process cannot enjoy sustained democratic support if its fruits are reaped by just a privileged few.

Competitiveness, integration and productivity: Drifting apart and falling behind?

The EU as a whole has been rather successful in withstanding global competition, in particular when compared to the US or Japan. Being still the world's largest exporter, it is well-positioned in the global value chain, not least due to a deeper integration of the EU economies among themselves, in particular with the economies of Central and Eastern Europe in the enlargement process.

But now Europe faces serious challenges to put convergence and integration mechanisms on a renewed sustainable basis, and it must do better to fully exploit its innovative potential in difficult circumstances. Indeed, it runs the risk of falling behind in competitiveness suffering from (i) overall low trend productivity growth, and (ii) large structural disparities across Member States and weaknesses in underlying growth drivers, in particular in the Mediterranean countries including France. Thus, the challenge is to inject new dynamism into our economies, while continuing with the necessary adjustment and inevitable deleveraging in both the private and the public sector.

Figure 2. Productivity developments 2000-2011



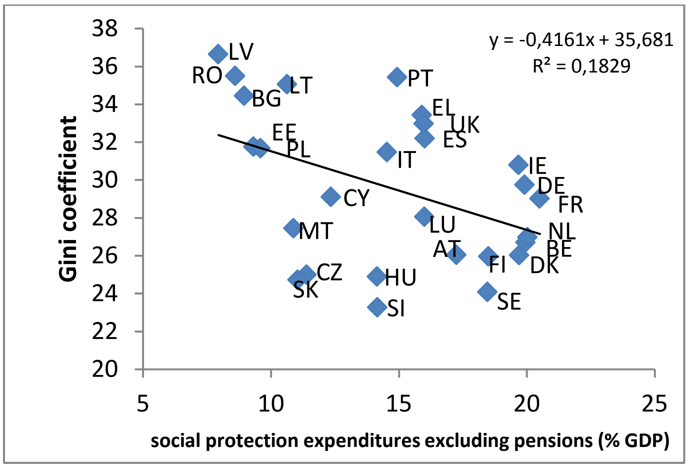
Source: AMECO

Countries operating at the knowledge-technology frontier need to innovate to push out the frontiers, pointing to the fundamental role of competition, tertiary education in world-class universities and R &D investment, in particular in the private sector, to close the innovation gap vis-à-vis Europe's leading global competitors. Achieving this goal will not be made easier by tight budget constraints and higher risk premia.

Growth, structural reform and income distribution: Divided we stand?

To be sustainable, growth needs to be socially inclusive as well, fostering widespread participation of citizens in society and, in particular, in the world of work. And obviously, inter-generational fairness is an important aspect to generate the necessary confidence and incentives to invest into a better future. Thus, appropriate design and sequencing of reform is crucial to design a fair burden sharing across society and not to undermine social and political acceptance of reforms. In particular, fiscal consolidation efforts to restructure tax-benefit systems and to improve the cost-efficiency of public services provisions need to walk a fine line between efficiency and equity considerations. However, the presumed trade-off between equity and efficiency is sometimes overdone. There are many examples of quite inefficient welfare and social protection provisions that actually achieve very little in terms of equity – the well-known insider-outsider issue.

Figure 3. Better welfare systems reduce inequality



Source: Eurostat

On the other hand, the experience of several countries suggests that well-designed and administered collective social insurance schemes may be superior to individual market-based arrangements from a societal point of view. In any case, hard choices will have to be made and, in general, the link between growth, structural reforms and the distribution of income and wealth needs to be carefully assessed and perhaps occasionally re-assessed.

Key findings of the contributions

In a nutshell, Europe has to do a lot of homework to embark on a new sustainable growth path. But at the same time it must not be navel-gazing at its internal problems, falling behind in international economic integration and/or neglecting the risks emanating from global imbalances.

Productivity remains the critical factor

In their paper, van Ark et al. revisit the issue of Europe's growth slowdown in the light of the developments of the first decade of the 21st century, including the devastating effects from the 2008/09 recession and the subsequent economic and financial crisis on Europe's growth performance. From a *supply side perspective*, using a growth accounting approach, there are virtually no signs of even the beginnings of a reversal in the slowing growth trend, which is primarily driven by a weak productivity performance in most European countries. Recently, low productivity growth has broadened from the services sector to the goods producing sector for most European economies as well. However, the manufacturing sectors have begun to recover from the recession, and the most troubled economies even show signs of improved cost competitiveness. But the manufacturing sector on itself is too small to force an economy-wide reversal in productivity.

Projecting growth out to 2025, using growth accounting projections, productivity remains the critical factor for a recovery of Europe's future growth performance. At the aggregate level demographics will contribute negatively to growth and investment seems maxed out given its historical performance. At the sector level, higher productivity in services for both the domestic and foreign sectors is key to an economy-wide growth revival.

From a *demand perspective*, using a global value chain-type analysis, it turns out that activities contributing directly or indirectly to production for the global market, account for roughly a quarter of employment as well as a quarter of labour productivity growth in Europe. Employment in goods production accounts for a significant share of this, but in many European countries market services have increased their contribution to global value chains, both in terms of job creation as well as productivity.

These findings are confirmed by Foster, Stehrer and Timmer, who find that the EU has become more integrated in global value chains in line with overall trends. Today, around 15% of GDP in the EU is created which directly and indirectly contributes to satisfy final demand in other regions of the world. This share has increased over the past 15 years or so by about 5 percentage points. A similar trend though slightly less significant can be observed with respect to employment: almost 12% of jobs are dependent on final demand in other parts of the world. Emerging economies such as China gain importance in this respect at the expense of major advanced economies such as the United States and Japan. Similarly, as foreign markets have become more important as destinations for EU exports, inputs are increasingly sourced from other countries in the form of intermediates used in EU production systems. Adopting a common measure of vertical specialisation shows that about 15% of the value of the EU's total extra-EU exports is generated in other countries. This share has increased by about 7 percentage points since 1995. Together with the fact that the EU's overall trade balance, at around 1.5% to 2% of overall EU GDP, remained positive over this period can be interpreted as evidence that this period of increasing internationalisation was managed quite well, notwithstanding the turmoil which hit the world economy and the EU in the aftermath of the global financial crisis.

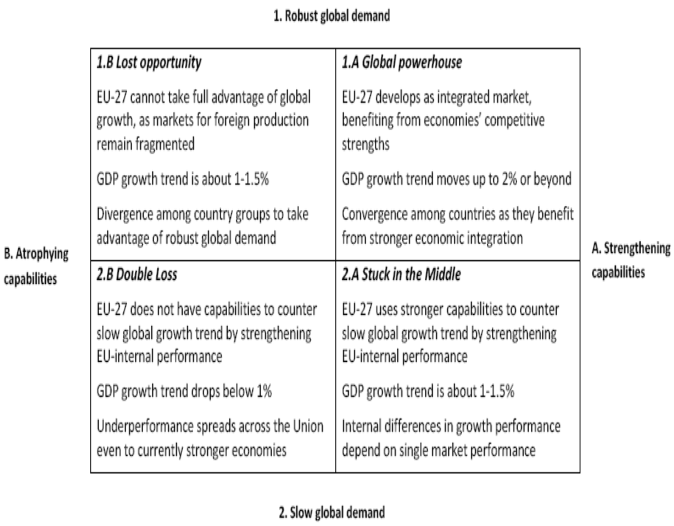
The EU as a whole has therefore been rather successful in withstanding global competition. This was driven not least by deeper integration of the EU economies amongst themselves. This integration in terms of trade and internationalisation of production is particularly visible with respect to the successful integration of the Central and Eastern European countries into the EU economy. However, the overall success of the EU as a whole and some countries in particular hides large differences across EU economies. Already in 1995 large differences existed with respect to the countries' foreign exposures concerning sales to intra- and extra-EU markets and sourcing structures. This pattern, however, seems to have become even more pronounced since 1995, with only a few countries – particularly Central and Eastern European countries, German, Austria, Ireland and Luxembourg – successful in their export performance in value added terms, with other countries maintaining or only slightly improving them. The reason for this might be the initial patterns of specialization, since internationalisation was largely driven by a few high-tech manufacturing sectors such as the automotive and electronics industries in combination with successful innovation and productivity performance and moderate wage policies. Further, the successful internationalisation of production – which within the EU resulted in the integration of Central and Eastern European countries in more advanced countries' production networks in these industries – played an important role. This improved international competitiveness of some countries contributed to the EU's overall success with respect to its international position but also aggravated structural differences across EU economies.

Rebalancing remains at the core of macro-economic policy efforts; however, the pursuit of cooperative strategies cannot simply be taken for granted. In their analysis, Fic and Orazgani use a series of simulations with the NIESR's world macroeconomic model NIGEM to examine different scenarios of unwinding imbalances and adjustment both at the global and the intra-euro area level. Their results are encouraging and sobering at the same time. They show that coordinated policy action can indeed achieve superior outcomes. But they also clearly demonstrate that there is no silver bullet at hand, calling for an appropriately calibrated mix of policies in both surplus and deficit countries and world regions. For the euro area, a fully functional financial system backed up by the establishment of a comprehensive banking union is of central importance in this context. Indeed, downhill capital flows are an essential factor to foster catching-up growth, but, to make them sustainable the associated risks of boom and bust have to be better managed. In the absence of such flows, "bad equilibria" characterised by anaemic growth and high and persistent real income gaps may well emerge. Thus, competitiveness adjustments, improvements in business environment and comprehensive public sector reform are essential yet arduous tasks to nurture any hopes for a lasting correction of external imbalances and a resumption of downhill capital flows, investment and growth.

The differentiated productivity performances across individual European countries are also examined in detail by van Ark et al. The analysis identifies four groups of European economies emerging, broadly characterized as (1) Integrated Value Chain, including Germany, Austria and much of Central and Eastern Europe), (2) Inward Looking, comprising the Mediterranean countries including France, (3) Global Niche Players, mostly a group of small economies in northwestern Europe, and (4) a deindustrialisation model, which basically refers to the United Kingdom.

Van Ark et al. then proceed to sketch four possible *growth scenarios* which describe the possible "states" Europe may find itself in 10-12 years' time, using a strengthening of supply-side capabilities, including productivity and innovation, and global demand for goods and services as the key dimensions defining the future states of the union.

Figure 4. European growth scenarios



Eventually, van Ark et al. provide an educated guess about the growth effects as they may emerge from the scenarios for the different country groups they had identified, taking together the supply- and demand characteristics for each group. Obviously, as noted by the authors themselves, these scenarios only provide a framework to observe the opportunities and discuss the necessary policy actions to move beyond the projected 1-1.5% growth performance out to 2025, and to avoid a scenario with even slower growth.

Figure 5. Tentative cross-country growth performances

Scenario / Country Group	1.A: Global Powerhouse (strong global demand, strong capabilities)	2.A Stuck in the Middle (weak global demand, strong capabilities)	2.B Double Loss (weak global demand, weak capabilities)	1.B: Lost Opportunity (strong global demand, weak capabilities)
Integrated Value Chain (Germany/ Core CEE)	+++	++	+	++
Inward Looking (Mediterranean)	0	-	---	--
Global Niche Players (small NW European economies)	++	+	-	+
Deindustralisation Model (UK)	+	0	--	-

How to increase the probability for a high productivity growth scenario to materialise? Starting from a firm-level perspective of ICT, reallocation and productivity, Bartelsman sketches an optimistic growth scenario for the EU provided the right incentives for knowledge-based capital investments, including intangibles, are put in place. In his paper, he argues that technologies that currently are in late stages of development could push out the productivity frontier if framework conditions are favourable to their adoption. He posits that Moore's law and improvements in ICT provide a potential for labour productivity growth of 2.5 percent per year for the next 20-30 years. However, realizing this potential requires improving incentives to adopt ICT and increase productivity for innovative firms, technology adopters, and less productive firms. Further, the environment must be accommodative to the processes of resource reallocation required for diffusion of new technology through the economy. Space limitations do not allow a discussion of specific policy proposals here, but the paper provides a discussion of labour market challenges related to reallocation, but also of incentives for schooling and considerations of wage inequality. Indeed, the characteristics of current and prospective technology, with high fixed costs of creation and low marginal costs of use, may cause increases in income fluctuations and further skewing in income distribution, increasing possibilities that rewards may no longer be tightly related to efforts. Finally, Bartelsman argues in his paper that policies related to adoption incentives in public services, such as health care and education, may not only increase aggregate productivity directly, but may aid in providing new areas in which to absorb displaced workers.

Bartelsman's analysis is nicely complemented by the paper by Czarnitzki and Toivanen examining the link between R&D and productivity and the role of innovation policies to narrow the gap between the socially optimal and the privately optimal levels of R&D. As innovation policies may be subject to crowding-out effects, they employ Belgian and German firm level data to empirically test whether R&D subsidies stimulate private investment. The authors find positive additionality effects of innovation subsidies for both countries. Furthermore, the estimated treatment effects are positively associated with the patent stock of firms, i.e. the higher the past innovation experience of firms, the higher is the investment in response to receiving public funds. Finally, firms with lower labour productivity tend to invest more than other firms. This could be interpreted as evidence that firms with lower labour productivity benefit more from subsidies than firms that are closer to the technological frontier. However, even in te presence of such catching-up effects subsidized R&D projects can actually push the technological frontier upwards in the economy.

Combining efficiency with fairness

Europe is going through an unprecedented period of fiscal consolidation and structural economic policy reforms. However, reforms undertaken in times of financial market stress may not be politically viable in the long run if they lack the necessary social balance. Against that background, it is particularly important to understand (i) how further efficiency-enhancing reforms can be complemented with other measures that guarantee the required social balance and (ii) how the European Union as a whole can provide better incentives to countries to undertake reforms that are distributional balanced. These two problems are addressed in the paper by Grüner; it studies the distributional consequences of Europe's fiscal and structural reforms and provides proposals on how to combine different reforms in order to obtain more popular support in the long run. Moreover, it makes suggestions on how to structure positive and negative incentives for fiscal consolidation and structural reforms in the long run by balancing the distributional consequences of structural reforms.

Focusing on the specific potential consequences of labour market reforms, Grüner discusses three different options to compensate insiders for potential losses: (*i*) adjust capital income taxes, using the revenue to reduce the tax burden of low and middle incomes; (*ii*) complement the reforms with additional measures that would shift part of the burden of consolidation to the owners of capital; and (*iii*) reform the national Constitution by introducing more elements of direct democracy into local and regional spending decisions. In addition, existing complementarities between the labour and product market reforms point to the benefits of implementing both types of measures simultaneously.

Since the political success of the reforms also depends on the expectations regarding their impact, gathering more information about voters' expectations is also recommended in the same study. According to Grüner, the international institutions, as the European Commission, could have an important role here by taking the lead in the collection of data regarding actual and perceived consequences of reforms and preferences for reforms. The role of international organizations should also be taken into account in this context given the possibility for them to set up positive and negative incentives for fiscal consolidation and structural reforms, as pointed out in Kuenzel and Thiel.

Equitable growth in the EU and the achievement of the Europe 2020 target for social inclusion are discussed in a pair of essays by Atkinson. The EU has set an ambitious objective, seeking to ensure that, by 2020, 20 million fewer people are at risk of poverty and social exclusion. Concretely, this means a significant reduction in the number of people with low relative incomes, or who are severely materially deprived, or who are living in households with very low work intensity. There are however already serious reservations as to whether this can be achieved. The scale of the challenge is being increased as a result of changes in the European labour and capital markets and, in the author's view calls into question the current priorities of the EU.

Atkinson argues that in seeking to respond positively to these challenges, we need a more refined understanding of the underlying economic mechanisms and of the relation between market forces and the European social model. The structural challenge to securing equitable growth is typically framed in terms of market pressures threatening the survival of the welfare state, with ever-increasing competition from newly-industrialising countries (“globalization”) and rapid technological development (“ICT”) raising the demand for skilled workers and destroying the jobs of unskilled workers. Atkinson argues however that this “standard model” of globalization and technical progress is an inadequate basis for exploring the relationship between the economy and social justice. There are several major shortcomings, such as the failure to take account of the changing nature of employment, adequately capturing the institutional structure of social protection, or the treatment of capital markets and market power; addressing these shortcomings points to a richer set of policy conclusions.

Obviously, in this context the important role of social partners needs to be adequately acknowledged as well, in particular as regards wage bargaining institutions which are analysed in the paper by Visser. His essay reviews half a century of developments in bargaining coverage, the structure of bargaining, and bargaining coordination respectively in thirty countries, with an emphasis on the last twenty years. Judging by many indicators surveyed in this essay, wage-setting institutions are in a state of turmoil, change or outright crisis. In Visser's view, the crucial question is whether the common trend toward decentralization and prioritizing of enterprise over sector bargaining will bring the end to all multi-employer bargaining and coordination, and how these changes in wage setting patterns may affect growth and inequality.

A central theme of Atkinson's essay is that our choice of economic model has often a profound effect on our assessment of the extent to which welfare state inclusion policies compete with, or complement, economic performance. It therefore influences the conclusions drawn with regard to policy options. The paper considers a number of radical initiatives at the EU-level. It also demonstrates that the achievement of the Europe 2020 social inclusion objective depends as much on what happens to the pre-redistribution distribution of income as on social transfers. Atkinson discusses the possibilities for actions in the labour market, the capital market and the product market. In his view, specifically, serious consideration should be given to:

• Measures to encourage service sector employment, with particular reference to the demand side and the financing of new jobs;
• An EU-wide unemployment insurance scheme, involving extended duration benefits, and possibly a X+1th state;
• An EU-wide child basic income, and possibly an EU basic income for all;
• Taxation of lifetime capital receipts, and, possibly, establishment of EU child trust funds;
• Product market regulation requiring universal access, to ensure that poor consumers are not excluded.

Finally, Atkinson's paper turns to the objectives of EU policy and the indicators by which macro-economic progress is assessed. The principal message of this part of the paper is that, rather than starting with GDP and the instruments of economic policy, and then considering the social consequences, the policy-making process should be turned on its head. The starting point should be the living standards and well-being of individuals and their families. Atkinson forcefully reminds us that macro-economic policies, and indeed all policies, are means to an end, not ends in themselves. Thus, if we wish to avoid a total “disconnect” between the discourse on economic policy and the experience of citizens, then the headline indicator should be a measure of household living standards taking account of distributional concerns. Such a re-positioning is, in Atkinson's judgment, essential if the EU and Member State governments are to secure the support of their voters.

Concluding remarks

The fresh insights provided in the context of the Fellowship Initiative on European growth perspectives over the medium-term are highly welcomed at a time when so much of the news is pessimistic or cautious at best. Indeed, five years after the onset of the crisis, economic activity remains lagging, with public and private balance-sheet problems and still impaired transmission of monetary policy checking the momentum of the growth pick-up expected for the second half of the year. Hence, Europe needs to stay on course with smart and courageous policy action to exit the crisis and pave the way towards sustainable growth and prosperity. This comprises on-going regulatory reforms on financial integration and stability, eventually resulting in a full banking union; a consistent fiscal policy by reducing structural deficits over the medium-term; and a high-productivity strategy of structural reforms to boost competitiveness and job creation, including a shift towards stronger tradeables sectors in the vulnerable countries. The overall objective of these efforts is the restoration of equitable growth and shared prosperity, allowing us to live up to our responsibilities for those more in need both within and outside of the EU. The work by the fellows will certainly stimulate the debate and help Europe to rise to its challenges ahead.

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