Comment

Snake oil or misapplied medicine?

- *Euro-area underperformance is reflecting a shortfall in productivity growth*
- *Brussels-led structural reform initiatives have been insufficient to prevent this development*
- *It may be that the way in which the reform process has been approached is the problem*
- *But aggregate demand policies that have constrained growth have also contributed*
- *If the euro area is to come to terms with its ageing demography, major changes are required*

Deepening underperformance

The euro area's problems are long-standing

Our previous *Comment*, *The euro area's long and winding road*, focussed on the region's slow recovery from the Global Financial Crisis (GFC) and some of the headwinds still holding it back, not least onerous public and private sector debt and the dysfunction of the financial system.[1] But other, deep-seated and long-standing structural considerations have been at work too.

It has been losing ground to the US since the 1980s …

One or two brief periods aside, the euro area's real GDP growth has, for more than 30 years, tended to fall short of the US (and the OECD) average. To an extent this is understandable, and indeed 'legitimate', in that growth of the region's labour force over this period has been around a quarter percentage point slower than that of the US. Developments in the area of productivity, however, have been more troubling.

Productivity growth has long been a concern in Europe, with policymakers seeking, over the post-WWII period, to catch up with the US. But having reached some 90% of US per capita GDP in 1980, euro-area output per head today stands at only around 70% of that benchmark. And the figures for some members – Greece, Ireland, Italy, Portugal, Spain – amount to less than 60%.[2] Beyond this, most euro area economies have throughout exhibited relatively high unemployment rates that seem increasingly to embody a significant structural component. And Europe's share of global foreign direct investment (FDI) flows meanwhile has more or less halved since 2000. While no one of these statistics, taken by itself, is necessarily definitive, collectively they are disturbing.

Productivity shortfall

… as total factor productivity growth has collapsed

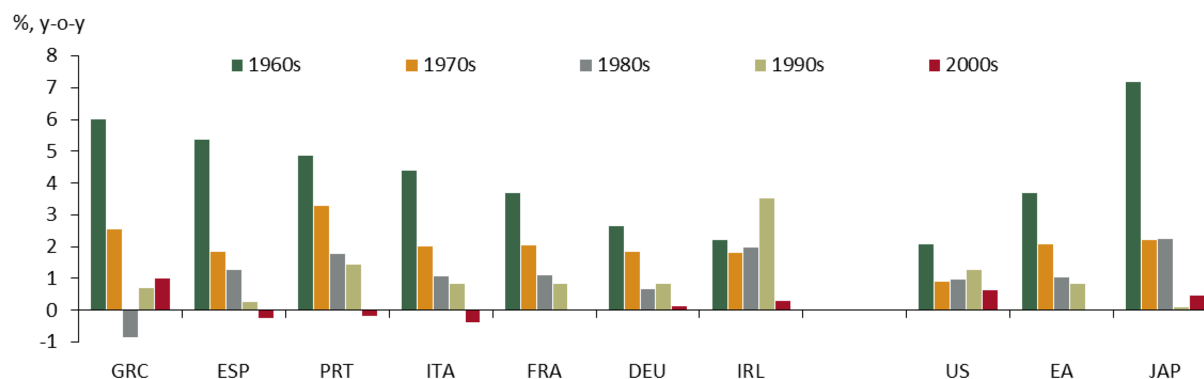
It would appear that a central reason for Europe's relative growth decline since the 1980s has been the slowing growth of total factor productivity (TFP) – the efficiency with which capital and labour inputs are combined and put to work. TFP, like the output gap, is a notoriously slippery concept, hard to measure, and even harder to interpret, not least because it is endogenous to the business cycle. That said, however, the evidence seems to be that, while TFP growth has slowed across the developed world, it has done so particularly starkly in the euro area, especially since the 1990s (Figure 1). Indeed, latterly, the level of euro area TFP may actually have fallen.

Structural delusions

This is despite successive rounds of structural reform …

Paradoxically, this deterioration in the region's productivity performance, in both absolute and relative terms, has coincided with a growing policy emphasis on structural reform. The past 20-odd years have seen successive Brussels-led reform initiatives that began with the 'Single Market'

Figure 1: Total factor productivity growth



Source: European Commission AMECO database

in 1992, progressed through Monetary Union in 1999, the 'Lisbon Agenda' of 2000, the Services Directive of 2005, and latterly have culminated in the so-called 'Europe 2020' programme. Moreover, most EU economies have intermittently applied their own domestic reform programmes, which could have been expected to have complemented these broader liberalisation efforts.

… and initially optimistic views of their effects

Each of the synchronised reform initiatives was at the time applauded by international observers, not least the OECD and IMF, and was expected to elicit a significant output dividend. The Single Market, for example, was initially projected to generate a 2% output gain through economies of scale, and further efficiencies amounting to between 4.5% and 6.5% of GDP via enhanced competition.[3] The elimination of transaction costs associated with monetary union was expected to encourage a 0.5% increase in GDP, plus further unspecified dynamic gains.[4] The Lisbon Agenda embodied an implicit growth target of 3% per annum, and the European Commission's estimate of its likely total benefits to GDP was put at anything from 12% to 23%.[5] The Services Directive was predicted to boost GDP by anything up to 1.6%, and Europe 2020, should, according to European Commission analysis, raise output by as much as 7%.[6]

Nor is this the end of the official optimism. Simulations undertaken using the IMF's Global Integrated Monetary and Fiscal model suggest that a further programme of comprehensive product and labour market and tax reforms could raise real GDP by 4% over the medium term, and as much as 12% in the long run, with the peripheral countries the prime beneficiaries.[7]

Harsher realities

The reasons for disappointment are many and various …

Given Europe's economic underperformance, moribund living standards, and chronic unemployment, it is difficult not to conclude that these latest estimates of the potential benefits of structural reform, like their predecessors, may contain a dose of wishful thinking – or, alternatively, that while structural reform might have a constructive effect, it can readily be overshadowed by other developments.

Our best guess is that there is some truth in both explanations. Certainly, we have doubts about the efficacy of some of the structural reform initiatives that have been put in place since the early 1990s. While the creation of the Single Market almost certainly had large, positive, and enduring results, there are other examples where the evidence is much less compelling, and where other malign influences seem to have intervened. In particular:

… ranging from poor implementation …

- A number of the reform programmes, although outwardly admirable, were poorly implemented. They proved laborious, piecemeal, lop-sided, partial, and inadequately tailored to the specific needs of individual countries. Performance metrics were inadequate, focussing more on announcement and intent than on ultimate delivery. Most importantly, perhaps, certain key areas, such as agriculture, have for political reasons been left chronically over-regulated and protected.

… to other, counterbalancing policies …

- The positive effects of some programmes have often been at least partially counterbalanced by policy changes which acted in the opposite direction. Obvious examples are pan-EU interventions in labour markets, such as the Working Time Directive and the Agency Workers Directive, that have made it more expensive to employ people, more difficult to use them flexibly, and harder to shed them if they underperform. Further potentially-harmful considerations may well have been the tendency for tax and public spending shares in GDP, and especially social and current spending on passive programs, to rise since the early 1980s, and a failure to ensure that infrastructure investment was sustained.

… to changing external circumstances …

- While international competition has become more intense in the era of rapidly-advancing information technology, globalisation, and the rise of the BRICs and other emerging economies, Europe has not adjusted particularly well. It has also proved less able than the US fully to embrace liberalisation of trade in services and the rise of the digital economy.

It is difficult, however, to know precisely how much 'blame' to attach to each of these deficiencies in structural performance, because it is hard to strip out the powerful influence of the economic cycle, especially over recent years.

And then there is the cycle

Productivity being notoriously pro-cyclical, the euro area's weak post-GFC growth performance (output is still several percentage points below its pre-crisis level, whereas in the US it is more than five points above it) has compounded Europe's recent dismal productivity showing.

There are four principal macro policy dimensions to this:

… and unsympathetic macro policy

- First, region-wide fiscal policy tightening has added up (as it always does, but in a way that national policymakers all too frequently forget) to more than the sum of its parts. It is hard (read 'probably impossible') for a poorly-performing, public-sector-debt-constrained, economy to grow satisfactorily when its trading partners are also prioritising the consolidation of their public finances. Not only do exports suffer, but in a cyclical downturn investment – the key ultimate determinant of economic performance – typically suffers disproportionately.
- Second, this policy tightening has been all the more problematic given the financial dysfunction of the banking system and widespread private balance sheet adjustment.
- Third, Europe's austerity programmes have not only been overdone, but they have also been skewed unduly towards incentive-destroying tax hikes rather than to current expenditure reduction.
- Fourth, monetary policy has proved insufficiently powerful to be able to offset the scale of fiscal austerity. European policymakers have long proved reluctant to let the economy 'run', preferring instead to apply the monetary brakes at the first sign of strong growth. But in addition, major policy errors were made by the ECB in 2008 and 2011, and the subsequent resort to monetary unorthodoxy has been unduly hesitant.

Thus, in our judgement, Europe's poor underlying productivity performance, particularly post the GFC, has been due not to one single cause, but rather to a combination of poor policies, including both inadequately-executed structural initiatives and ill-conceived demand management.

The lessons

Structural reform should not be abandoned …

What lessons does all this offer? In particular, does this mean that structural reform is irrelevant? In our judgement, the answer is "No, far from it".

Proof of this may be offered by the relative performance of different countries in the wake of the GFC. Many of the most reluctant reformers were hit hardest (Greece) or have experienced the shallowest recoveries (Italy); while those which pursued reform most assiduously and were most flexible proved most resilient to the crisis (Germany) and recovered most rapidly (Ireland).

Furthermore, getting structural reform 'right' will be more important than ever in a future environment of rapid population ageing. Unless there are significant increases in immigration, growth in the euro area's working age population is likely to decline at a rate of some 0.6% per annum from 2015. The enhancement of TFP growth will therefore become increasingly vital to sustain growth potential.

… but it needs to be strengthened and recalibrated

The morals of the story may be that the process of European structural reform needs to be radically overhauled; that attention needs to be paid not only to policy design but also to its execution; and that at the same time Europe's policymakers need to take due account collectively of the relative weights that they attach to the maintenance of adequate aggregate final demand and near-term inflation risks – which are now turning into near-term deflation risks.

US policymakers would appear to have balanced these risks better than have Europe's: and it looks increasingly as if they are being rewarded with a better overall outcome.

Watch fors

The considerations to watch to assess whether European structural reform will finally deliver what it should can be summarised as follows:

- A greater focus on domestically-designed initiatives rather those dictated by Brussels.
- A greater emphasis on tax reduction and reform.
- More transparent and quantitative metrics to assess the success of the initiatives taken.
- More attacks on hitherto largely taboo areas such as agricultural protection.
- The adoption of a more symmetrical, growth orientated, ECB mandate.■

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[1] Jones, R (2014), "The euro area's long and winding road", Llewellyn Consulting, 2 May.
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