

European growth over the coming decade

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1. The standard view (not quite mine)

Asked for a view from the other side of the ocean. Dominant view there very similar to the standard European view:

Wrong economic model for the times: (Like Stalinist growth in the 1970s)

- Based on catch up, on imitation rather than innovation.
- Large firms, partly protected.
- Long term relations with banks, with workers.
- Rents, then carved out between firms, workers, and the state.

OK in the past. No longer. Now that Europe is at the technology frontier, need innovation. Need new firms, need competition, need more R&D, a better educated labor force.

The costs are becoming very large:

- EU GDP per capita is 30% (PPP terms) below US, and not catching up.
- EU unemployment is high, 8.1%
- Europe missed the IT production boom of the second half of the 1990s.
- The divergence with the US since 2000 is getting steadily larger.

Nothing short of a radical change is needed:

- In education and R&D
- In the role of the state
- In the scope of social insurance
- In attitudes

This view is clearly more right than wrong. The question is how dramatic the changes must be.

I want to argue:

- Things are actually not that bad.
- There is a lot of action taking place.
- The right dynamics of reform are in place:
Goods market reforms, triggering labor market reforms.

The question: Which reforms are crucial?

2. Another look at the facts

2.1. Productivity measured as GDP per hour worked, is higher in France than in the US:

GDP per capita, and GDP per hour, 1970 and 2000

	GDP per capita		GDP per hour		Hours per capita	
	1970	2000	1970	2000	1970	2000
US	100	100	100	100	100	100
EU-15	69	70	65	91	101	77
France	73	71	73	105	99	67
Spain	50	57	47	73	105	78
Italy	65	73	74	104	86	71

US=100. Source: EU, Ameco data base. Germany not included because of the reunification break. GDP per hour in Germany in 2000: 92

- Note the catch up in GDP per hour from 1970 to 2000. (offset by hours per capita. more on this this below).
The differential rate of productivity growth between EU and US has decreased over time. But would expect this from convergence.
- Measurement issue 1: The minimum wage. (eliminates low productivity jobs)

Solution. Fill in the wage distribution using US data. Adjustment: 5-7 points.

- Measurement issue 2: High real wages, leading to higher capital intensity.

Solution: Look at total factor productivity (“TFP”). Capital output ratios about 40% higher in F than US). Adjustment 8-10 points.

- The decline in hours per capita: The other side of the coin? The lump of output (growth) proposition/fallacy. What you gain in productivity, you have to lose in employment?

2.2. The decline in hours per capita: market failure, or preference for leisure?

Hours per capita = Hours per worker * (1- unemployment rate) * Participation rate.

The major source of the decline in hours per worker:

Average hours per worker in 1970 and 2000

Country	1970	2000	(% decline)
US	1915	1820	-5%
France	1958	1531	-24%
Germany	1909	1467	-26%
Ireland	2148	1674	-24%

Source. EU Economic Outlook data base

Evolution reflects a mix of increase in part time and decrease in working hours for workers on full time.

Voluntary/involuntary? Probably mostly voluntary. Note the decline in Ireland. (hard to blame a depressed economy).

Unemployment

Surely mostly involuntary, and the sign of serious problems in the labor market. But not inexorable implication of bad labor market institutions (which they are; more on this later) :

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- The heterogeneity of unemployment rates today. Ireland (4.4%), but sui generis. Sweden (5.0%). The Netherlands (5.4%).
 - The Dutch miracle (from 11% in 1982, to 3% in 1999, to 5.4% today)
For real? For the most part, yes. (part time and participation rates, invalidity rolls).
 - The proximate cause? Dramatic change in institutions? No. Wassenaar and wage moderation. Nearly a textbook story. Steady decrease in wage costs, steady increase in profits, capital accumulation and employment.

2.3. The second half of the 1990s and the IT boom. Producing versus using IT

- There was indeed a sharp divergence in TFP growth in the second half of the 1990s (1.4% for the US, 0.7%)
(Over the 1990s as a whole however, TFP growth in the US and the EU15 was roughly the same, 1% in both cases).
- Much of this divergence was indeed due to the larger size of the IT producing sector in the US, and the high rate of technological progress in that sector.
- How did Europe do as a *user* of IT? How did the non-IT economy do?

Spending on IT in the IT using sector (most of the economy) was lower in the EU than in the US (by 30 to 50% across countries).

But TFP growth, leaving the IT sector out, was roughly similar in the US and the EU:

TFP growth in the 1990s, leaving the IT sector out

Country	1990-1995	1995-2000	1990-2000
US	0.46	0.63	0.55
EU	1.21	0.41	0.81
France	0.25	0.45	0.35
Germany	1.55	0.85	1.20
UK	1.62	0.38	1.00

Source: Van Ark et al. 2001

So the EU did worse in the second than in the first half of the 1990s. But TFP growth was close to that of the US.

So no prima facie evidence that firms were less good at using IT in EU than in the US.

- (The UK numbers are useful in looking for explanations later. UK did very poorly in the second half. Cannot blame labor market rigidities.)

3. Changes in goods (and financial) markets

3.1. Large changes in the rules of the game (regulation, entry).

- Largely from Bruxelles, and the Single Market.
Reduction of barriers to trade within EU.
Competition policy. (anti-trust, deregulation, monitoring of state aid)
- Partly from national governments. Privatization.
- Where from is very important for political dynamics:
Bruxelles will continue. National governments much less committed and playing it both ways. Using/blaming Bruxelles versus fighting Bruxelles. Half of French government aid to specific sectors (Alstom, Bull).

An attempt at quantification. OECD has constructed indexes for a number of dimensions of regulation and trade barriers over time.

Evidence: Substantial progress since the early 1990s. More heterogeneity on privatization than on barriers to entry.

3.2. Changes visible on the ground

The McKinsey (MGI) productivity studies. (For France and Germany, two studies, 1997, 2002)

Looked at productivity levels and evolution in a number of sectors. Evidence from two sectors, automotive (with apologies to the chair), and road freight :

Productivity levels and growth in the Automotive sector, US, France and Germany, 1992-2000

Country	growth 92-2000	growth 96-2000	level 1992	level 2000
US	2.2%	5.3%	82	100*
France	7.8%	14.7%	45	71
Germany	2.2%	1.8%	61	68

Productivity: Output per worker. Growth rate: percent per year. Level US(2000) = 100 by normalization. Source: McKinsey Global Institute, 1997, 2002

- Why the productivity explosion in France during 1996-2000? MGI: Increased competition, better governance. Decrease in Japanese quotas, partial privatization.
- (Why the poor productivity performance in Germany? MGI: increase in number of products.
Why the remaining large level gap? MGI: 11 points due to composition (light trucks in US, rest to OFT, lower overhead and lower product complexity).

Productivity levels and growth in the Road Freight sector, US, France and Germany, 1992-2000

Country	growth 92-2000	level 1992	level 2000
US	1.2%	90	100*
France	5.0%	55	85
Germany	5.2%	53	83

Source: MGI, 2002

- Why the high growth rates in France and Germany in the 1990s? MGI: Increase in truck size, increase in load rate. Due in turn to decrease in tariffs, elimination of restrictions to market access.
- (Why the remaining gap? MGI: Half structural: shorter, slower hauls. Half due to less use of IT.)

3.3. Why doesn't this show up more in the aggregate TFP statistics?

Saw earlier that productivity growth outside of IT was not bad, but no better than the US.

Measurement issues? Probably not.

A hypothesis. (not much more at this point):

- Productivity/process improvements typically lead, for a firm to an initial decrease in employment, then over time to larger

sales, and then, and only then, a potential increase in employment.

(Different at the aggregate level. In the short run, ambiguous also. In the long run, same or higher employment, higher output.)

- Firms were very reluctant to layoff in the 1990s. Employment protection, but more importantly, political pressure not to do so.

Political focus on employment growth. The nonsense of “job rich growth” (i.e. low productivity as a desirable outcome).

Firms stored productivity innovations, but did not implement them fully. Much more to come when the time is right.

- Still, largely a mystery.

In particular: The anemic Spanish productivity growth of the 1990s (0.8% per year for 1995-2002, versus 1.4% for the EU). (which has allowed for a large decrease in unemployment with mediocre output growth).

4. Reform in labor markets

Goods and financial markets reforms force labor market reforms. (not without serious tensions. This is where the distinction between Bruxelles/national governments is very relevant).

4.1. Goods market deregulation has major macroeconomic and labor market effects.

- For the economy as a whole, higher competition and higher productivity, are good for employment (if demand policies are there to support, a relevant caveat), and good for real wages.
- But it also eliminates the many rents that existed earlier. And these rents do not disappear without fights.

Rents to workers: The strong cross country relation between employment protection and product market regulation. (Figure) Product market regulation and wage premia. More generous retirement systems.

Rents back to the state. In the news this summer: The financing of culture by firms, through the unemployment insurance system. The strikes of the intermittents

Europe will see more of this. How it plays out will depend on the position of the left and the extreme left, and their interactions. But it will happen.

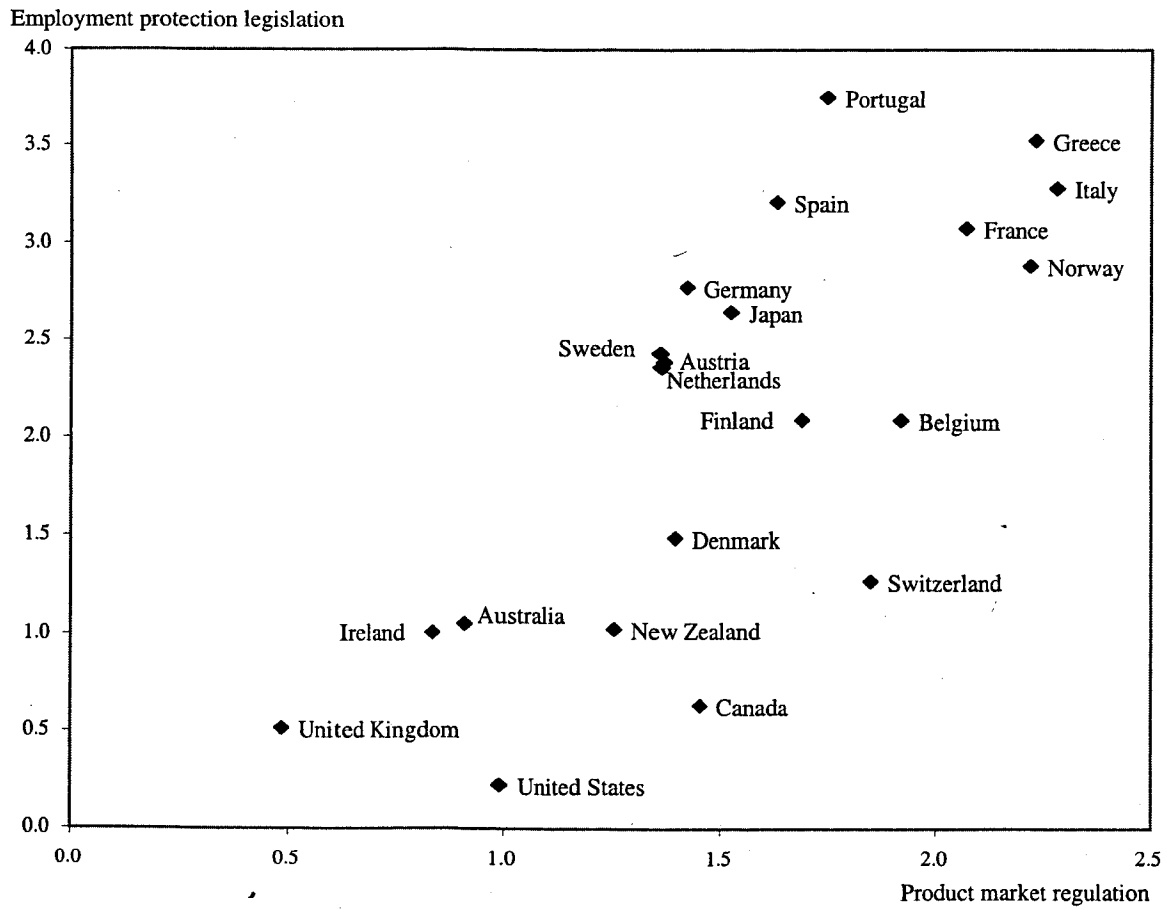


Figure 4
Product market regulation and employment protection legislation (from Nicoletti et al, 1999)

4.2. Goods market reform puts pressure on the various social insurance institutions.

Social insurance is costly. More so when competition is stronger. The example of employment protection. Nothing that a low enough wage would not solve. But the low enough wage will not come.

The good news. Existing institutions provide social insurance inefficiently. Reforms can provide the same level at lower cost.

The main three reforms needed:

- Unemployment insurance. Providing stronger incentives for the unemployed to search and take jobs allows to provide better insurance. Motivation behind US welfare reforms, Hartz commission recommendations, PARE in France. Some way to go.
- Employment protection. Shifting from administrative and judicial control to financial incentives will benefit both firms and workers.
Shifting from a payroll tax to a layoff tax; eliminating judicial second guessing.
- Negative income tax versus minimum wage. The minimum wage should serve as a true minimum. Incentives to work should be provided by an income tax/subsidy. Prime a l'emploi in France, earned income tax credit in the United States.

These reforms offer the scope for same level of social insurance at lower economic cost.

5. Policies for higher growth and lower unemployment

Gathering arguments.

Sure, there are a lot of reforms to undertake.

In particular, the education system needs a major overhaul. This is another discussion... (On this, I am not optimistic. I do not see the same kind of dynamics as described above.)

But, meanwhile, a lot is already happening, and the dynamics are in place for more.

- Continue with goods and financial market reforms. The central role of a supra-national authority.
- Channel the pressure to achieve the required labor market reforms. These can achieve the same level of social insurance at lower cost. Is the level too high anyway? It may be (especially given the other dimensions of social insurance, and the implications of population aging.)
- Make sure that the increase in potential output leads to an increase in actual output.
This requires supportive demand side macroeconomic policies. Another debate. But an important one if there are indeed latent productivity gains.