What's wrong with Europe's economy?

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My title this evening is “What’s wrong with Europe’s economy?” And clearly something is wrong. Two years ago, in early 2001, there was much confidence about Europe’s prospects, relative to the US. The euro had been successfully launched, its impact on intra-European trade and industrial restructuring was already apparent, and the difficult period of pre-launch fiscal consolidation lay in the past. The US, with greater personal exposure to stock market investment, appeared more vulnerable to the dotcom bust. All major forecasts in January 2001 foresaw more rapid eurozone growth than American growth in 2001 and 2002. And over the last two years it is the US that has suffered more unexpected shocks – the potential impact of September 11th on consumer confidence, and more accounting and corporate governance scandals in the US than in Europe. But it is Europe’s performance which has been poor, the US’s surprisingly robust. EU15 growth of about 0.7 % in 2002, US 2.4 %, and almost all forecasts suggesting a similar differential in America’s favour in 2003.

Eurosceptics find that unsurprising. It reflects, they argue, deep rooted rather than short-term factors. Europe has grown more slowly than the US for 20 years: it has failed to achieve a productivity spurt from the application of information technology: and it is uncompetitive because of high taxes, barriers to free competition, and inflexible labour markets. Deep structural reform is therefore essential. Eurosceptics say that, certain that the required reform will never occur. But europhiles say it also, believing that needed reform can be achieved. And at European summits over the last 2 years – Lisbon, Stockholm, Barcelona – the debate has focused on how far Europe is willing to embrace the challenge of structural reform.

But the purpose of my lecture this evening is to question this conventional wisdom, or at least to deconstruct it. For I think the phrase “structural reform” – in relation to Europe as also to Japan – is now used in such an all-embracing, vague and polemic sense – that it confuses our understanding and can misdirect appropriate policy focuses. And specifically I want to argue 5 propositions this evening.

- First that much of the difference in economic performance between the US and Europe reflects not differences in economic efficiency, but in individual and social choice, which are unlikely to be influenceable by policy initiatives, and which indeed arguably we should not attempt to change, since the purpose of liberal economics is to maximise choices available, not to tell people how they should exercise that choice.
- Second that the product market liberalisation agenda of the Lisbon, Stockholm and Barcelona summits – while positive, is of marginal importance to Europe’s future prosperity.

- Third, that the idea that Europe must cut taxes and welfare spending in order to be more competitive is largely wrong or at very least overstated and too general.
- Fourthly that the problems now facing the eurozone economy, and in particular Germany and Italy – result primarily from deficiencies in the eurozone macro-policy framework.
- Fifthly, however, that Europe does face one huge long-term structural challenge - pension system sustainability in the face of an ageing population – a challenge with little relevance to economic prospects this year and next, but huge implications for European society over the next 50 years.

My overall theme therefore is that European policy discussion often fails to focus on the most important issues. What I will not pretend, however, is that this lecture provides a full description of Europe's economic problems or their solutions or indeed of Europe's strengths. It omits, for instance, any discussion of skills and the science base, creative industries and entrepreneurship, or industry clusters - or the management of public services - all important issues. But my aim is not to be comprehensive, but simply to challenge some specific common beliefs about the EU versus US comparison, as a stimulus to debate. And to suggest useful themes within that debate – macro challenges versus micro, social choice versus economic efficiency, and under what conditions different social choices are sustainable.

Let's begin with facts. Stepping back from growth last year or this, what long-term picture are we trying to explain?

Well clearly, as this slide [Slide 1] shows, Europe has grown more slowly than the US for at least 20 years. A growth rate of 2.2 % over the last 21 years, versus 3.1 % in the US.

But note, on the bottom two rows, that almost all of that difference disappears if we look not at absolute GDP growth but at GDP growth per capita, with the difference in absolute growth almost entirely explained by the fact that the US population is still growing at about 1 % p.a., the European at about 0.3 %. As machines for delivering increasing prosperity to individuals these two continental economies are very similar. Almost exactly equivalent over the period 1980-95, the US moving a bit ahead in the late 1990s. A pattern clearer still if we look at productivity per hour worked [Slide 2]. Until the early 90s the EU was increasing productivity, and as a result, hourly wage rates far more rapidly than the US. But in the late 1990s a turnaround – the US enjoying a strong productivity spurt, European productivity slowing – though still faster than America in the 1980s and early 1990s.

As for unemployment [Slide 3], a mirror image of the productivity picture. The US's low productivity growth in the 1980s and early 90s matched by a long and sustained fall in unemployment. The EU's high productivity growth in the 1980s and early 90s accompanied by very poor employment creation. European unemployment then coming down in the late 1990s, with strong employment growth in some major countries – Spain and France for instance, though notably not in Germany. But with Europe's unemployment rate still appreciably above US levels.

So that overall we are not trying to explain a sustained and general failure of the European economy over a number of decades – but two things - first why the US

achieved a productivity spurt in the late 1990s while Europe did not, second why Europe has tended to combine high productivity growth with low employment growth.

Though with a caveat even on that summary. Europe's economic performance is not homogenous. [Slide 4] Several European economies have since 1993 achieved per capita growth rates similar to or ahead of the US – Ireland, Finland, Spain, Sweden, Netherlands, Denmark. And Europe's labour market performance is hugely diverse [Slide 5], with several economies - notably the Scandinavians – achieving employment rates as high as the US, while some countries – notably the Mediterranean ones – have very low rates.

So a diverse picture, but still with those two overall questions - why, overall, a European failure to match America's productivity spurt? Why overall, poor labour market performance?

Lets begin with productivity. And before we turn to the last 5 or 6 years, its important to get the bigger picture clear. And one thing the big picture reveals is a big difference between the US and Europe not in efficiency but in social choice.

[Slide 6] This slide compares France and the US in 1999. The US was then something like 40 % better off in GDP per capita – on the basis of OECD Purchasing Power Parity measures. That difference derived from two factors – 21 % higher output per person employed, and 15 % higher employment per head of population. But higher output per person employed was in turn explained by American workers working 18 % more hours per employee than French, with the difference in productivity per hours worked trivial. So that overall, all of the prosperity difference between the US and France is explained by a difference in total hours worked per head of population, and none by measured efficiency per hour worked.

And that means that if these lower hours are freely chosen by French people, then the difference between French and US GDP per capita is a product of choice not of efficiency – French people choosing a different trade-off between leisure and additional income. So are those lower hours freely chosen? Well some of them are not. Those which result from involuntary unemployment, or from involuntary early retirement are not a product of social choice, but of labour market inefficiency. And France's higher unemployment rate would suggest that at least 5 of the 15 point difference in employees per head of population is involuntary. But the best evidence from French public opinion surveys, and from, for instance, their reaction to the 35 hour week legislation, is that the greater part of this difference in work-leisure trade-off is freely chosen – and if it is – if French people are happier with more leisure but less income than Americans - then no liberal economist should criticise them for that choice, the aim of liberal economies being to ensure that the economy achieves efficient frontiers of production and utility preference functions, but not to tell individuals where along those utility preference functions they should make their trade-offs.

[Slide 7] And what is true of France is true of the rest of Europe. In almost all European countries, hours worked per employee are below US levels and are falling – the only exception being Scandinavian countries where hours worked were far below

American levels even twenty years ago. In America no such fall occurred. Why this major divergence in social preference exists is an interesting issue. And on the basis of almost any theory of utility preference it is the American behaviour which is more difficult to explain – a society getting steadily richer, but totally focussed on more income not more leisure. But for the purposes of this evening the implication is simple: the fact that Europe's GDP per capita growth has been marginally below the US's for 20 years is not a sign of inferior economic performance, but reflects the fact that Europeans have chosen to turn increased productivity into a mix of greater leisure and greater income, Americans solely into greater income.

Second big picture point before we focus on the last 5 years – [Slide 8] – these are the productivity trends over the last 50 years, as set out in Mary O'Mahony and William de Boer's latest study for the NIESR, for the US, three leading European economies and Japan. And the story is one of catch-up. Catch-up by France and West Germany to US levels between the 1960s and the 1990s – but noticeably not catch-up by Britain – a slight closing of the gap in the 1980s and 1990s – but still well below US, French and West German levels – and indeed with a rate of catch-up which would take 60 years or so to close the gap. And its worth spelling that out because in itself it should throw a big bucket of cold water over some of the conventional wisdom diagnosis of Europe's problems. Continental Europe, it is claimed, needs to copy the successful model of UK's liberalised product and labour markets in order to catch-up with the US leader. This slide would suggest that the answer is a good deal more complex.

But also not as favourable to France, Germany, or indeed Britain as this chart would suggest. For whereas this slide shows France and West Germany on a par with the US, and a US acceleration in the late 1990s so slight we can't even make it out visually amid these overlapping lines, these figures are for the whole economy, and if we narrow down our focus to the private market sector of the economy, we find a more significant US advantage – both in terms of level and in terms of recent growth.

Thus O'Mahony and De Boer's figures [Slide 9] suggest substantial American advantages in major sectors such as manufacturing, transport and communications and distributive trades, and suggest a major acceleration of US productivity growth in the market sector of the economy in the late 1990s [Slide 10], an acceleration not matched in Europe.

And the issue therefore remains, first why does the USA achieve higher productivity levels than all Europe countries in some specific market-oriented sectors, and secondly [Slide 11], what happened to US productivity in the 1990s – why do these Bureau of Labour Statistics figures, for instance, show the trend growth rate accelerating from 1.4 % in the 20 years prior to 1995, to 2.4 % in the last 7 years? And why didn't Europe share this acceleration? Is this evidence of sclerotic, over-taxed, uncompetitive Europe unable to grasp the potential of IT investment?

Well, one way to answer that is to break down the difference, both in level and in growth rate, by sector. And that sectoral breakdown suggests once more that differences in social choice may be as important as any European failure in absolute economic efficiency.

[Slide 12]. This slide sets out, on the left, O'Mahony and De Boer's decomposition of the productivity gap between the US and the UK. On the right, my own estimates, using their figures, for the US – Germany gap¹. And from both comparisons – one sector leaps out. Distributive trades – retailing and wholesaling. Lower productivity in retailing and wholesaling accounts for over a third of the total productivity gap between the UK and the US, and for well over half of the gap between Germany and the US. And that finding – of the dominance of distributive trades in productivity gap comparisons – holds true for Europe in general – and indeed for Japan. Other advanced countries get reasonably close to US productivity in manufacturing, in utilities, and even in finance and business services – but almost all fall well short of the US in retailing and wholesaling.

Why? Well I think the answer is actually fairly obvious and rooted in deeply physical facts. Which is that it is simply far easier to run retailing and wholesale distribution at a high level of efficiency in a lightly populated, dispersed physical environment, such as the US, than in more densely populated Europe or Japan. Physical space has a pervasive impact on many aspects of productivity, but above all in those sectors concerned with the physical movement of goods. In-store retail management is more efficient if you have aisles wide enough to allow restocking without consumer service degradation. Back-of-store handling efficiencies are far easier to achieve if you have large trucks, coming at predictable times, having travelled along uncongested freeways, and turning round in wide spaces – than it is with smaller trucks arriving at unpredictable times, and queuing to use constricted unloading bays. Productivity is increased if average pack size is bigger because consumers have bigger fridges, located in bigger kitchens. Size matters, physical space matters, and in all sorts of subtle but inherent ways, America gets a productivity advantage from the fact that only a small proportion of its population lives in the dense urban clusters which dominate the economic geography of England, the Netherlands, Germany, Italy or Japan. The only European country which comes close to America in measured productivity in the retailing and wholesaling sectors, is France – and that's because France has lower population density, and as a result has been more willing to allow large out-of-town retailing developments of the sort common in the US. France has close to US levels of retailing productivity because the outskirts of French towns look more like the outskirts of American towns than elsewhere in Europe.

So physical space is, I believe, a major driver of the difference in the level of European and US productivity. A very big driver in distributive trades – a significant driver too in some subsectors of manufacturing, with extensive plant layout also helpful in manufacturing productivity, and with evidence to suggest that batch size and absolute scale is often the key driver of superior US manufacturing productivity, scale and batch size made possible by easier long-distance transportation and thus ability to serve a larger market from one plant location.

But while physical space could explain an inherent difference in productivity level, it is less obvious that it could explain the difference in recent growth rates. Less obvious – but perhaps surprisingly – possible.

¹ These figures combine the impact of different productivity levels within a sector, with the impact of the relative size of the sector – “Total industry contribution” as per Appendix E-1 in O'Mahony and De Boer. The figures for ‘level’ – which exclude sector share effects – show a slightly less pronounced but still strong dominance of the Distributive Trades sector.

Why has US productivity growth accelerated? Much attention has focussed on the impact of IT – both in its own production industries, and in its use. Thus work by van Ark, Inklaar and McGuckin [Slide 13] shows the acceleration of total US productivity from 1.1 % to 2.2 % during the 1990s explained by two factors. First a slight acceleration in productivity growth in IT producing industries from 6.1 % to 6.5 % – an effect amplified by the fact that those IT producing sectors – the manufacture of semiconductors, PCs, mobile phones, etc. - were growing as a % of the total economy.

Second a major acceleration in productivity growth in sectors intensive in their use of ICT – from 1.4 % to 4.2 %.

With those sectors of the economy which were neither ICT producers nor intensive ICT users, showing no acceleration at all.

Van Ark and co. then compare this with European figures, with two interesting findings. First that the Europeans have achieved quite as fast growth in ICT production – Nokia's mobile phone factories quite as good as Motorola's. Second, however, that Europe has failed to achieve accelerated productivity growth in those sectors which are intensive users of ICT.

But when they then look at which specific sectors are failing to achieve this ICT based productivity leap, they arrive at a quite startling result – which is that 80 % of the entire difference in productivity growth rates between Europe and the US is located in retailing and wholesaling, in the distributive trades we saw earlier. Over the last 5-7 years, US productivity in retailing and wholesaling has been growing at a dramatic 6 % per annum, while typical European growth rates have been only 1 % or so. [Slide 14] That fact alone seems to account for the vast majority of the entire difference in growth performance we are trying to explain.

So why has US retailing and wholesaling achieved such a productivity spurt? The answer seems to lie in a combination of ICT based redesign facilitated by use of physical space, by ease of greenfield development. All studies of the US retailing productivity phenomenon stress the importance of new build of very large discount stores by Walmart, Home Depot, Best Buy, Circuit City and the like, and one major study indeed finds that all, not just some but all of the productivity growth in US retailing in the 1990s is attributable to the new entry of new, more efficient retailing establishments, new stores on new sites, and that none is attributable to productivity improvement within existing stores². Big new stores on greenfield sites achieved huge productivity improvements, partly from the use of ICT, partly from exploiting the inherent physical advantages of large site operation – and partly from the combination of the two – barcode based logistics systems dramatically cutting inventory levels in circumstances where replenishment time can be predicted because of freely moving roads and uncongested back-of-store unloading.

In Europe this doesn't seem to have happened, and if these studies are right – that fact alone explains the vast majority of Europe's widening productivity gap versus the

² Foster, Haltiwanger and Krizan (2002) quoted in Robert Gordon "High-Tech Innovation and Future Productivity Growth"

US. And it didn't happen because large out-of-town new entry is irrelevant to retailing competition in the densest urban environments, because planning restrictions limit large out-of-town development where it is potentially relevant, and because our roads are congested. Even in France, where the 1970s and 80s saw an explosion of an earlier generation of out-of-town developments, the freedom to open new still larger stores has been restricted in the 1990s: and French retailing productivity, while higher than elsewhere in Europe, is now growing as slowly: - elsewhere in Europe, restrictions are tighter still.

What implications follow for policy? Well some would say the implication is clear. Get rid of these planning restrictions, and seize this productivity potential. Let neither nimby opposition to hypermarkets in Hampshire, or Italian small shop owners lobbying against supermarkets on the edge of Florence stand in the way of prosperity. And certainly the link between planning rules and productivity, and between planning rules and ease of competitive entry is a fertile policy issue. But Europe's planning restrictions are not there for arbitrary reasons, they express consumer preferences for preserved countryside and preserved urban communities. And they are more restrictive than in the US because there is less space than in the US. So that again we face an issue not just of economic efficiency, but of consumer and social choice, and one where the difference between the US and Europe is easy to understand. The more crowded the environment, the more value citizens will place on environmental preservation, and the lower, everything else being equal, will be the utility maximising productivity level in any sector where there exists a trade-off between measured productivity and environmental quality. Both the productivity gap between Europe and the US and the increase in that gap in the late 1990s may therefore be significantly determined by social choices which it is unlikely that we could change, or perhaps should seek to change.

Given that analysis, how well targeted and how relevant is the liberalisation agenda being pursued by Europe, and urged upon Europe by the British government? The answer I believe, is that the product market liberalisation on which much of the attention is focused, is useful, worth pursuing, but unlikely to make more than a marginal difference to the gap in productivity level between the US and Europe. The Spanish Presidency defined 5 priorities for the Barcelona summit in March 2002 [Slide 15] – strengthening European networks, liberalising energy and financial service markets, reforming European labour markets, and improving Europe's education and science base. Within these five, it was in particular on energy liberalisation that most attention focussed. [Slide 16]. And the surrounding rhetoric to this summit stressed the vital character of these reforms. Progress on economic reform in general, but on energy liberalisation in particular was, it was argued, essential to "kick-start the European economy": if Europe failed on this, due to French intransigence, doubts would be cast on the credibility of the entire reform programme and Europe's growth would suffer. But these statements strike me as largely nonsense for two reasons. First because I think they confuse short-term conjunctural effects with long-term effects: - no supply side structural change ever kick-starts the short-term growth prospects of an economy. Second because they vastly overstate the importance of the energy sectors even in the long-term. The importance of the energy sectors to the productivity gap between Europe and the US is trivial. The correlation across Europe between low energy prices to industry and degrees of energy market liberalisation is mildly positive but only mildly. The total benefit to the European

economy of energy market liberalisation, in a sector accounting for no more than 2-3% of GDP, could not possibly amount to more than a small fraction of 1 % of GDP, a benefit which would accrue only over the long-term, and which would have no impact on the growth rate this year or next. The case for energy market liberalisation is on balance a good one – but this is no more than a marginal issue in the economic history of Europe.

Financial service liberalisation and airline competition, the other product market changes on the Barcelona agenda, are somewhat more important. Financial services productivity does show up as a significant driver of the productivity gap for some European countries and there are major inefficiencies in European financial service delivery which fiercer competition might help shake out. But what is still striking looking at the totality of this agenda, is how slight it is relative to the rhetoric of far-reaching liberalisation, or relative to the size of the productivity gap which opened up between the US and Europe in the late 1990s. But I believe that is not due to some failure of imagination or will on the part of European politicians. Instead it reflects two facts.

- First, that most of the potential for spurring productivity through product market liberalisation has already been seized, through the single market programme of 1986-92, through the privatisations and domestic liberalisations pursued by governments across Europe, and through the telecoms and postal services liberalisations already agreed at European level.
- Second, that the key drivers of the remaining productivity gap arise in sectors where physical constraints are important, and where the key policy decisions to be made, for instance on land planning, need to reflect trade-offs at local level, which are and should be matters of national or regional, rather than European level competence.

One of the 5 items on the Barcelona economic agenda - reforming labour markets – is clearly, however, very important. Europe's productivity failure has been greatly overstated, and is concentrated in particular sectors with very particular characteristics – but some European labour markets do suffer from a more pervasive and longer lasting problem, a tendency towards a high level of unemployment even during periods of rapid growth.

In the interests of time, however, and because it is a huge and complex issue in itself. I will make only one general point on this issue this evening. Which is to repeat [Slide 17] that Europe does not have a labour market problem – some countries in Europe have different national problems. Italy has one, Denmark does not. Therefore their cause cannot be European wide factors – such as relatively high taxes, or legislation introduced by the European Union.

Instead labour market problems arise from complex combinations of multiple different factors, - the level of minimum wages, the ease of hire and fire, the ease of part-time working, the nature of wage-fixing processes and the generosity and, crucially, the conditionality of unemployment benefit. Those combinations are nationally specific and so too must be the solutions. But the fact that in some countries there is a major problem, and that their solution will require political

courage, is clear. In this area at least, difficult structural reforms are needed in some countries.

But such changes in European labour markets don't need to be accompanied by wholesale dismantling of European welfare states to allow tax cuts required to make European economies competitive.

The belief that this is needed is, however, a mainstay of journalistic commentary and of business lobby group belief. Europe, and Germany in particular – the argument goes [Slide 18] simply has too high labour costs – partly because of higher wages, but primarily, because of high non-wage labour costs – German labour costs on this slide 10 % higher than American, because of 50 % higher social security charges. Therefore European economies must cut taxes to become competitive.

As indeed they must cut taxes more generally to increase incentives to work and entrepreneurship and incentives to save and invest.

But for reasons I have addressed in a previous lecture here, these arguments are at very least greatly overstated³. There must, of course, be some level of tax burden which so distracts incentives as to undermine prosperity, but the empirical evidence does not support the idea that there is an inverse correlation between the tax burden and growth, or between the savings rate and growth, or between employment levels and growth, at around the rates of tax observed in European and other OECD countries. Germany and Italy [Slide 19] are Europe's current growth laggards, with tax burdens of almost 46 %: but Europe's recent growth successes include Sweden and Denmark with much higher burdens, Finland with roughly the same, and the Netherlands and Spain with somewhat less. And over a longer time period [Slide 20] the correlation of growth with tax burden is weak – the best fit on this 35 year correlation having an R^2 of just 0.03, and the slightest of downward slopes, which, however, [Slide 21] would become a slight upward slope if only one plot point, Japan, was removed.

So I am deeply suspicious of the argument that there is any generalised correlation between tax burdens and economic performance. But I want to return to the issue of German wage and non-wage labour costs, because while I think the structural conclusion many draw from it is wrong, high levels of German total labour costs may illustrate an important macro- economic problem created by the transition to the euro.

In general, high payroll taxes need not and usually do not create a competitiveness problem – for two reasons. The first is that, at least if labour markets are reasonable flexible, the true incidence of payroll taxes falls not on employer costs, but on the wage of employees, workers receiving a lower wage rate than they would if payroll taxes were lower. Payroll taxes, though nominally falling on employers, are, in flexible labour markets no different in their effective incidence to income taxes. And the fact that, say, Sweden has higher payroll taxes than Britain, should in theory mean simply that Swedish wages are lower than they otherwise would be, Swedish citizens receiving more of their remuneration in collective government expenditure, and less in a direct wage form. And indeed not only is that true in theory, but the fact

³ Adair Turner: Choosing the State We Want: Lecture at LSE, 31st October 2000.

that Sweden is a highly competitive economy, with a robust external position, and achieving a high rate of employment, suggests that it is true in practice also.

But even if this were not the case, the second reason for doubting this 'competitiveness' argument would still apply. Which is that in a floating exchange rate system, any imbalance produced by a combination of high payroll taxes and labour market inflexibilities, can be offset by a decline in the exchange rate. The idea that the whole eurozone, with an externally floating exchange rate, can suffer a "competitiveness" problem is indeed a general theoretical confusion, and the concept of high taxes creating such a competitiveness problem just a specific subset of that confusion.

But clearly it is possible for a specific country within the fixed exchange rate regime of European monetary union to be, at least for a transitional period, in a state of competitive disequilibrium, particularly if it has relatively inflexible labour markets in which downward adjustments of nominal wages will be resisted. And it is possible that Germany is in that position, having entered the euro at too high an exchange rate.

How far that is the case is debatable. But certainly it is a possible result of entry into a fixed exchange rate regime – a risk inevitably present in the initial creation of a monetary union.

So it is possible that German total labour costs are now too high and one way to reduce them would indeed be to reduce non wage labour cuts i.e. to cut payroll taxes. But another way to cut them would be to reduce wages. Illustrating the point that if Germany does now have a problem of uncompetitively high labour cost, the problem is not essentially driven by the burden of tax – but by an exchange rate fixed too high. Finland, in the euro, and Sweden outside it, have equally high non-wage labour costs - but no evidence of a competitive disequilibrium of the sort which may be facing Germany. If there is a German labour cost problem, it does not prove the argument that European tax burdens are unsustainably high⁴. But it may point us towards a significant problem in the macro-economics of the euro-system.

And it is to macro demand policy issues which I would now like to turn. For while my focus until now has been on long-term supply-side differences between Europe and the US, it is differences in demand, and in the macro policy framework, which explain the divergent growth of the last 2 years. And that point needs to be spelled out clearly precisely because, bizarrely, it is frequently denied.

Over the last two years, eurozone growth has severely disappointed expectations, growing by only 1.6 % in 2001 and 0.7 % in 2002, with growth in the zone's largest economy, Germany, lower still at 0.6 % and 0.3 %. The US, despite the shocks of the dotcom boom and bust, of September 11th, and of corporate scandals, has grown far more robustly. And the reason for Europe's disappointing performance is not a failure of competitiveness, nor structural problems depressing the capacity of economics, but

⁴ Note, however that while the general case that tax burdens, and specifically non-wage labour costs, are too high appears either overstated or wrong, there are good arguments for believing that high payroll taxes on, specifically, lower wage workers can be harmful, since it is likely that at low wages the incidence shift from employers to employees does not occur. See Turner 'Choosing the State We Want' for the detailed argument.

inadequate domestic demand [Slide 22]. Eurozone exports, for instance, have actually performed better than American or British, and net exports have continued to make a positive contribution to growth, but the domestic demand contribution to eurozone growth has plummeted, with household consumption, household borrowing, retail sales, car sales – whatever measure of domestic demand you choose – far lower in the eurozone than in the US, and falling faster.

And what is true for the eurozone as a whole, is even more true of Germany, the slowest growing of the large European economies. German export performance, for all the talk of a competitiveness problem, has been remarkably resilient over the last 2 years, [Slide 23] but consumption expenditure has fallen, and real domestic demand has fallen over the last 2 years. Yes, Germany has some long-term structural problems, but these are not the cause of Germany's present slow growth. German nominal GDP has risen only 2 % per annum for the last 2 years, US nominal GDP by 3.5 – 4.0 %, UK by almost 5 % - that, not structural problems, is the fundamental reason why the German economy has grown slowly over the last 2 years. And that slow growth in nominal demand derives from the combination of fiscal and monetary policy, and is rooted in the macro-policy rules of the euro system and the fiscal positions of countries at the time of entry⁵.

To many people the demon here is the Stability and Growth Pact, which limits public deficits to 3 % of GDP and which is therefore forcing Germany to tighten fiscal policy this year, a move which will make Germany's recession worse, and which could provoke a dangerous spiral of falling prices and falling demand – a classic deflation trap. And there are good arguments for recasting the stability pact, basing it on cyclically adjusted measures. But I don't think we should fool ourselves that the problems derive solely from an ill-designed set of rules. For some set of rules, either on deficits or on accumulated debt levels, is essential to ensure the solvency of European governments within a monetary system where nations have surrendered the ability to inflate their way out of debt traps. And almost any set of rules would curtail today's freedom of fiscal manoeuvre of major eurozone countries, given the fiscal positions with which they entered euro. The Maastricht limit on accumulated stock of debt – less than 60 % of GDP - and the Stability Pact guidance on structural deficits - ideally to be about zero – were not and are not pointless masochism, but actually good Keynesian guidelines – which if they had been met, would now give countries the freedom to allow automatic fiscal stabilisers to operate. The problem is not that those rules were set – but that they were not met. [Slide 24] Italian gross government debt – at 107 % and perhaps actually rising this year – is far above the Maastricht 60 % guideline, and will severely limit Italy's ability to provide fiscal stimulus for many years to come whatever adjustments to the Stability Pact are now agreed. And the fact that the major eurozone countries [Slide 25] entered the global economic slowdown with significant structural deficits was bound to limit their fiscal response, and thus to depress nominal demand, however the SGP is designed.

Yes we should reform the SGP. But we have to face the facts. Failure fully to meet the Maastricht convergence criteria before going ahead with the euro has introduced a potentially dangerous constraint on fiscal policy response, and is a key cause of the eurozone's poor performance over the last 2 years.

⁵ See Turner: "The Monetary Policy Framework – Guarding against Deflation" Aspen Italia 2003 for a more detailed discussion of these issues and of Balassa-Samuelson calculations.

If fiscal policy is inevitably constrained, the burden of policy response falls more on monetary policy. And whatever the fiscal constraints, monetary policy – provided it is pursued aggressively enough – should always be able to maintain nominal demand growth at reasonable levels, either via interest rate policy, or if the zero bound of zero interest rates is reached, via government debt monetisation. But this potential capability needs to be guided by appropriate targets, and there is, I believe, an overwhelming case that the ECB's current inflation target of 0-2 % is significantly too low.

There is no science to setting an optimal inflation target, but it should be high enough to provide some lubrication to real wage flexibility, and to give the central bank the option when needed of setting interest rates at a negative real level, while low enough to prevent a cycle of increasing inflationary expectations. Something like 2-3 % is almost certainly better than 0-2 %. And there are two specific reasons for nudging the target higher still in the specific conditions of the eurozone. The first is the danger that entry exchange rates could be fixed wrong – which we saw was the real issue in relation to German labour costs. This argues for ensuring a reasonable level of inflation even in the lowest inflation countries. If Germany needs to adjust real wages down, it will do so more easily with mild inflation, avoiding the need for nominal wage cuts.

The second is that even the current eurozone – let alone the potential eurozone after enlargement – includes countries of significantly different income levels, and that, for some complex reasons to do with differential productivity growth rates between traded and non-traded sectors of the economies, countries in a process of catch-up towards higher income levels, such as Spain, or Portugal, or in the future Poland – need to have measured inflation rates above the level appropriate for the richest countries within a fixed exchange rate regime – the so-called Balassa-Samuelson effect. My calculations suggest that the optimal inflation rate for Spain, if it is to converge to German standards of living over say a 10 year period, with a 4 % real growth rate, is something like 4 %, implying both that the ECB should not overreact to that sort of inflation rate in the catch-up countries, and that its overall eurozone inflation target needs to be about $\frac{1}{4}$ % higher to reflect these effects within the existing eurozone, and perhaps $\frac{1}{2}$ % higher post enlargement. And that any attempt to make the new accession countries meet the Maastricht convergence criteria on inflation before entry to the euro will further depress the European economy.

Overall therefore, the case for changing the ECB's target and for making it explicit is, I believe, overwhelming. And it is only macro-policy changes, such as a changed ECB approach and greater flexibility within the SGP, which have the ability to make a difference to eurozone growth rates over the next few years, rather than to long-term growth prospects.

Let me sum up. There is a conventional wisdom that Europe's recent poor performance is a sign of deep structural problems, which must be addressed by product market liberalisation, by labour market reform, and by the reduction in uncompetitive tax burdens, and that the agendas set out at Lisbon, Stockholm and

Barcelona define crucial priorities in that economic reform process. But against that conventional wisdom, I have argued

- First that the eurozone's poor growth is caused by macro-policy problems and rules – rules which must be changed.
- Second that taxation burdens are not in some general and structural sense unsustainable.
- Third that when we look at longer-term differences between European and American prosperity and productivity – we need to recognise the impact of physical environment and social choice. And that within this context, while the European Union's product market liberalisation agenda is positive and sensible, it is unlikely to have more than a marginal impact.
- Fourth, however, that some European Union labour markets are seriously inefficient, and should be reformed.

Provided such a policy mix is pursued – macro stimulation, national labour market reform, and useful but not transformational product market liberalisation, there is no reason why Europe should not continue to grow GDP per capita at an attractive rate, delivering increasing prosperity and increasing employment in an already rich continent. But its absolute GDP growth will continue to lag the US's, simply because of different population growth rates: and its GDP per capita will almost certainly remain permanently below America's, because of the social choices which Europeans make⁶.

The issue which then arises is whether these choices – to sacrifice some productivity potential in order to protect rural and urban environments, and to take some of the benefits of productivity growth in increased leisure – are now or will be in the future unsustainable? Some people believe they are, assuming that Europe cannot choose to trade-off income for leisure, or income for protected environment, that such choices make Europe “uncompetitive” in the global economy. But these arguments are in general quite wrong.

National and continental economies do not compete with one another in the normal sense of the word compete, and societies have wide degrees of freedom to make their own social and economic trade-offs. And if Europeans choose both to produce less and to consume less, that has no consequences for competitive sustainability. Provided Europeans understand the consequences of their trade-offs – for instance that shorter hours mean lower GDP per capita – there is nothing unsustainable about that choice.

But choices could be unsustainable if based on inconsistent assumptions, if based for instance, on decisions to do less work without accepting the consequences of lower income. And there is one European social choice which is unsustainable – which is

⁶The experience of the last 5-7 years has been that the size of the GDP per capita gap has increased, with lower European productivity growth rates driving lower GDP per capita growth. But the factors that have driven that are likely to be one-off – the potential benefits of physically expansive retailing over non-expansive increasing over a number of years but not limitlessly. The best guess of future trend is that European GDP per capita will remain below US in level, but with roughly similar growth rates, with further declines in European hours worked roughly by offset further increases in European employment participation rates.

the current combination of birth rates, retirement ages, and explicit or implicit pension promises [Slide 26]. Europe's rapidly ageing population will, unless average retirement ages rise significantly, produce soaring dependency ratios, and, will lead to increases in public pension spending [Slide 27] which would push tax levels to unsustainable levels⁷, and would place huge strains on corporate pension provision, or leave many pensioners with inadequate provision in old age. On pensions European citizens are making decisions and assumptions which are unsustainable. The possible solutions to this huge challenge are beyond the scope of this lecture. But the scale of the challenge is clear. The argument that deep and difficult structural reform is required to the European mode is often overstated – but not in relation to retirement ages and pension provision.

All of which implies a very different ordering of Europe's economic priorities than implied by the agenda of economic reform summits [Exhibit 28]. At those summits, the eurozone macro framework has received limited attention, the ageing population and pensions only the most general discussions – yet those are the most important issues we face – the one short-term, the other long-term. Labour market reform is discussed – but in general rather than specific terms. While product market liberalisation receives top billing even though the concrete proposals under discussion could make only a minor difference to long-term prospects, and almost none to growth this year or next.

Why that disconnect? The reason is clear. European Union summits talk specifically about product market liberalisation because the European Union has a specific competence in that area: they talk only in general terms about labour markets because the specific actions required are for national governments: they avoid macro issues because the Maastricht Treaty gives the ECB independence as to specific objectives, as well as independence in pursuit of those objectives. And they largely avoid the pension issue, because that too is a national issue, extremely long-term, and very sensitive. The European Union can only do what it is empowered to do: the specific agendas reflect its competence. And of necessity always will.

But it is important to change the priorities, if not necessarily of European summits, then of the wider economic reform debate.

Macro-policy constraints need to be addressed. In the 1960s and 1970s, policy discourse overrated the power of macro-demand policies, and underrated supply-side structural factors: but the danger today – in Japan and Europe, is the inverse. And there is a real risk, if we do not address EMU's macro risks and deficiencies, that these will outweigh the long-term supply-side benefits of the euro project.

The pension issue needs to be brought centre stage, as the most difficult structural issue Europe faces.

Labour market reform needs to be recognised as a more crucial challenge than remaining steps of product market liberalisation.

⁷ The unsustainability would derive not from “competitiveness” effects, but from popular opposition to rising tax rates, expressed either in political rejection of governments which imposed it or in tax avoidance and evasion.

And if physical constraints really are the major driver of the productivity gap versus the US, we need to recognise that fact, we need to consider carefully the trade-offs involved in land use planning, we need to ensure that underinvestment in transport does not make the productivity penalty worse, and we need to avoid fooling ourselves that legal liberalisations – such as in energy markets – are going to make more than a marginal impact.

But we also need to consider how, if Europe will never be as productive as the US on the basis of expansive land use, it can better exploit the potential advantages of its economic geography, ensuring that its cities are vibrant centres of tourism, education, science, and creative industries – even if inevitably of higher cost retailing than found in the American suburbs. Europe needs a vision of a vibrant future which is not simply a carbon copy of the American mode.

But it needs to start with a more subtle and detailed understanding of its economic performance, absolute and relative to the US, than the easy mantra of “structural reform” expresses.

Let me end, however, with one final thought on the issue of social choice. Which is that we need to recognise the consequences of our social choices, even if having recognised them, we stick with them. I have in this lecture been fairly positive towards Europe’s social choices – its preference for a mix of leisure and income, its preference for preserved rural and urban environments over the final points of productivity potential. They seem to me perfectly natural preferences for rich societies. The measure of economic success should be income per hour worked, rather than absolute economic growth: and sensible societies may well sacrifice even some income per hour worked in favour of environmental objectives.

But these choices do have consequences for absolute economic growth and absolute economic growth has consequences for geopolitical power. And the choices which Europe is making – on its birth rate, on immigration, on leisure and hours worked, and on physical planning, quite apart from on defence expenditure as % of GDP - are driving and will continue to drive a major shift in the relative economic and geopolitical power of the US and Europe. Europe will probably continue to grow GDP per hour worked quite as fast as the US, but I think it almost inevitable that American absolute GDP will continue to grow significantly faster than Europe’s until and unless America’s population growth slows to European levels, and Americans begin to make the same income/leisure trade offs as Europeans.

Europe is I believe making social choices which are rational and natural for human beings in mature, already rich, and peaceful societies. The only doubt I leave hanging, is whether the world can be peaceful enough to sustain these desirable choices, to allow us to focus on the liberal objective of maximising individual choice, rather than the statist objective of maximising national wealth. I hope it can be. I actually believe it can be. But it is a debatable issue.

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