Beyond

Squaring Europe's

Michael Deppler

TEN NEW members joined the European Union (EU) on May 1 in the biggest enlargement of the community since its inception. Just 15 years after the fall of the Berlin Wall, eight Central and Eastern European countries joined, along with Cyprus and Malta, expanding the EU's membership by two-thirds, its land area by a fourth, and its population by a fifth (to over 450 million). This latest step in European integration is expected to further help cement peace and promote prosperity throughout the continent. But the occasion is clouded by the considerable misgivings in Europe and elsewhere about the EU's ability to adjust to changing economic circumstances.

The core economic concern is the weak growth performance of Europe—and particularly of the 12 countries at the epicenter of European integration that use the euro as their common currency—relative to the rest of the world and especially the United States. Underlying this concern are the problems of sagging long-term trends in the growth of productivity, the use of labor resources, and—looking forward—the dwindling size of the workforce because of population aging.

But these structural worries gain immediacy from fears about the short term as well. With the euro area still just emerging from a prolonged slowdown and seemingly dependent on exports for growth, the euro having appreciated steeply against the U.S. dollar, and the U.S. current account deficit at 5 percent of GDP, prospects for the global as well as the European economy rest to a large extent on whether Europe can improve its domestically generated growth performance. Adding weight to these concerns are the perceptions that the euro area's fiscal and monetary policies are excessively oriented toward preserving medium-term stability and insufficiently focused on sustaining demand in the short term. In tandem with continuing concerns about the implication of aging populations for long-term growth and fiscal sustainability, tensions stemming from immigration, and international criticism of the high levels of protection afforded to agriculture, it is clear that enlargement has occurred at a time of considerable doubt and misgiving about the integration enterprise.

To gain some perspective on these issues, it is useful to step back and look at the broad sweep of Europe's postwar economic history. This article seeks to provide a framework for understanding the main issue—whether and how the core EU social and economic model can deliver robust growth, or whether attaining robust growth requires adaptation of the European model. Looking forward, such a perspective suggests that prospects are neither as bleak as observers sometimes think nor as rosy as European policy choices might suggest.

Europe's twin impulses

Although many factors played a role, postwar developments can be viewed as reflecting two broad-based, ebbing and flowing, and sometimes contrary impulses: toward social solidarity and equity, on the one hand, and financial discipline and economic efficiency, on the other. The historical roots of these preferences run deep. The solidarity dimension stems from a widely shared desire for social peace and cohesion, with roots in the welfare policies inherited from the late 19th

1945 World War II ends; Allies occupy Berlin.

1947 Cold War's "Iron Curtain" divides Eastern and Western Europe.

1950 French Foreign Minister Robert Schuman proposes integrating the coal and steel industries of Western Europe.

Integration

Social Preferences with Robust Growth

century, the political and social upheavals of the first half of the 20th century that culminated in World War II, and the relative homogeneity of Europe's populations. The discipline dimension, perhaps surprisingly, seems to have similar roots. Most cited is the case of Germany, where the deep desire for economic stability can be traced back to the devastating hyperinflation of the early 1920s. These twin impulses led many countries to develop increasingly generous pay-as-you-go social insurance systems—systems that took care of social spending within a disciplined, self-financing framework. Along the way, continental Europe's corporatist traditions, topped by various forms of "social partnership," cemented the structure, for good or ill, through all echelons of society.

These preferences still obtain today. Fundamentally, continental Europe is committed to a financially disciplined welfare state. Robust growth is on everyone's agenda, as exemplified by the call at the EU summit in Lisbon in March 2000 to turn Europe into "the world's most dynamic and competitive economy." But the quest for growth is also where the differences emerge. To put it simply: can growth best be achieved through discipline (and more supply-oriented approaches that would require adapting the social model) or through solidarity (and approaches that might require, if not a loosening of financial discipline, more spending)? While the differences are fundamental, the two sides are careful not to question, at least loudly, the core value of the other: the welfare state and financial discipline. The reason is simple: a combination of the two has been the revealed preference of the electorate for decades and remains so today. Hence, the general tenor of economic policies has been to call for both, as the Lisbon Declaration does.

Momentum toward integration

Solidarity and discipline have propelled European integration throughout the postwar period, with solidarity as the stepping-stone. On the heels of two disastrous world wars, it provided the momentum for removing barriers and raising living standards through convergence in per capita incomes—a process known as real convergence. In this respect, the EU's beginnings are traceable to the European Coal and Steel Community, set up in 1952. This led to two further milestones of real convergence: the Treaty of Rome (1957), which established the European Economic Community (a customs union with common external tariffs and a common agricultural policy); and the Single European Act (1986), which committed all members to creating a single EU market for goods, services, capital, and labor.

In time, this impulse toward European integration was balanced by more discipline, perhaps most evident in the institutional developments designed to ensure price and financial stability throughout the union—so-called nominal convergence. Initially, discipline was provided by the Bretton Woods exchange rate system. But its breakdown in the early 1970s set off a scramble for a new nominal anchor, which culminated, in the late 1970s, in the European Monetary System. The exchange rate mechanism (ERM) of this system constrained exchange rate fluctuations among the participating countries, with Germany emerging as the undisputed nominal anchor country. However, continued nominal divergences and the associated pressures on exchange rates within the ERM highlighted the need for more convergence of macroeconomic policies. Matters were brought to a head in the early 1990s when the liberalization of capital movements and German unification prompted the 1992 crisis in the ERM, hastening the ratification of the Maastricht Treaty and the road map for Economic and Monetary Union (EMU). Besides exchange rate criteria, potential member countries were now obliged to meet other nominal convergence criteria as well, particularly for inflation, fiscal deficits, and government debt. The treaty's fiscal provisions were later fleshed out in regulations known as the Stability and Growth Pact (SGP). At the beginning of 1999, 11 EMU members irrevocably fixed their exchange rates and adopted the euro as their single currency, and the newly constituted European Central Bank (ECB) took on the task of conducting a single monetary policy for the euro area. (See Back to Basics on page 14.)

The impulse to deeper economic integration was accompanied by a like-spirited widening of its reach as the EU

1952 European Coal and Steel Community (ECSC) is set up with six members: Belgium, West Germany, Luxembourg, France, Italy, and the Netherlands.

1957 Six ECSC members sign Treaties of Rome, creating the European Atomic Energy Community (EURATOM) and the European Economic Community (EEC).

1967 ECSC, EURATOM, and EEC merge. Creation of a single commission and a single council of ministers.

expanded by leaps and bounds—a process set to continue even after the latest enlargement round (see map, page 8). The European Coal and Steel Community comprised six countries in the heart of Europe (Belgium, France, Germany, Italy, Luxembourg, and Netherlands). Successive waves of enlargements in 1973 (Ireland, Denmark, and United Kingdom), 1981 (Greece), 1986 (Portugal and Spain), and 1995 (Austria, Finland, and Sweden) boosted EU membership to 15 countries by the time plans for EMU had gelled into an operational blueprint. With the latest expansion on May 1 of this year, the EU family has grown to 25 countries with considerable economic and cultural diversity—a diversity that will only increase. Bulgaria and Romania are well advanced in their negotiations and are set to join in the next few years. Decisions on the timing of Turkey's negotiations are also pending. The states of the Western Balkans are next in line, with Croatia's application already given the green light by the EU Commission. In a step that reaches beyond integration, the EU's "Wider Europe Neighborhood" initiative encompasses 14 countries to its east and south and aims to develop a "ring of friends" with which the EU desires to have peaceful and cooperative relations on the basis of shared values. Iceland, Norway, and Switzerland remain outside the EU.

> "During the early years, Europe's model effectively delivered on all counts."

Integration has been a major source of European growth. It was part and parcel of Europe's rapid real convergence with the United States during much of the postwar period, with the creation of the common market being widely credited as having significantly boosted intra-area trade and regional growth. Indeed, the evidence points to further positive trade effects in the euro area following the establishment of EMU. Moreover, despite earlier fears to the contrary, trade with non-EU countries has, over time, also increased. In the same vein, promotion of nominal convergence—particularly through the Maastricht criteria and the establishment of EMU—engendered a disciplining of fiscal and monetary policies, a convergence of inflation back to low single digits throughout Europe, and, for a while at least, a spurt of reforms among most future members. Indeed, by the 1990s, the EU had deservedly become a beacon throughout Eastern Europe for sound macroeconomic policies and aspirations for higher levels of real income, as well as democracy, solidarity, and human rights: becoming a member of the club became the priority of governments and one that enabled them to muster the popular support needed to overcome the challenges of transition.

Waning growth

While integration spurred higher growth, in good part by inducing change at the national level, its positive effects were gradually supplanted by the less benign effects of domestic rigidities.

It did not start out that way. During the early years, Europe's model effectively delivered on all counts: social cohesion, financial discipline, and rapid growth. Real convergence toward U.S. levels was seemingly effortless in the first three decades of the postwar period, as incomes, employment, investment, consumption, and wealth spiraled upward in a virtuous circle. Convergence was fostered, in part, by the externally imposed discipline of the Bretton Woods system and the relatively good inflation and financial performances associated with it.

The next three decades proved difficult, however. The combination of two large oil shocks, an increasingly generous welfare system, and unrealistic income expectations built up during the period of rapid catch-up growth together with the financial indiscipline associated with the breakdown of the Bretton Woods framework resulted in marked macroeconomic instability and imbalances. Indeed, experiments with activist Keynesian stabilization policies during the 1970s were unsuccessful, and such policies became discredited, particularly in Germany. In the end, the system reverted to the paradigm. It protected the jobs and real incomes of those already employed, but it also reasserted financial discipline by increasingly accepting the German mark as its anchor. The outcome was large increases in labor taxation that ultimately undermined employment but stimulated investment. This strengthened labor productivity and preserved the competitiveness of those with jobs.

With unemployment trending upward, the system adjusted further. Wage moderation together with measures to lower the cost of labor and relax labor market restrictions, particularly for new entrants to the job market, yielded hefty increases in employment from the mid-1990s. And the Maastricht Treaty, EMU, the ECB, and the SGP became the successors to the German mark in providing financial discipline.

Overall, however, Europe's performance remained unenviable. Per capita incomes remained stuck at about 75 percent of U.S. levels up to the mid-1990s, with rapid increases in labor productivity being offset by weakness in employment. Per capita incomes later slipped to close to two-thirds of U.S. levels as productivity growth sagged in Europe and acceler-

1973 Denmark, Ireland, and the United Kingdom join the EEC.

1979 First direct elections to the European Parliament.

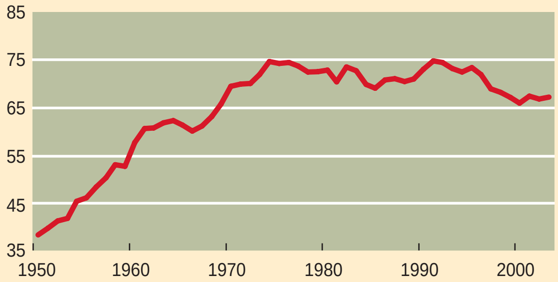
1981 Greece joins the EEC.

Chart 1

A stalled performance

Per capita incomes in the euro area plateaued at about 75 percent of U.S. levels in the mid-1970s and have receded since the mid-1990s.

(GDP per capita in the euro area, based on purchasing power parity; percent of U.S. value)



Sources: European Commission-AMECO database; OECD analytical database; and IMF staff calculations.

ated in the United States in the second half of the 1990s (see Chart 1). Negative perceptions of this lackluster performance of the euro area were compounded by even larger, and better-known, differences in GDP growth stemming from transatlantic differences in population growth.

Too much stability and discipline?

The slowing of growth is often ascribed in good part to the EU's (or the euro area's) "stability bias," that is, its unwillingness to engage in countercyclical demand management policies, which would involve boosting demand (through lower interest rates and larger fiscal deficits) when growth is weak and dampening demand (through higher interest rates and smaller fiscal deficits or surpluses) when it is strong. As suggested earlier, Europe's macroeconomic policy frameworks do indeed spring in considerable measure from the impulse toward discipline, that is to say, from a will to contain what is viewed as the cumulation of monetary and fiscal risks—ultimately pernicious to growth—associated with unrestrained political and social processes. Since the 1970s, in particular, the emphasis has been on establishing and preserving medium-term stability and not on managing aggregate demand in the short run through countercyclical policies. This bent is clear from the ECB's Maastricht Treaty mandate: "the primary objective . . . shall be to maintain price stability." It is also clear from the treaty's provisions on ensuring sound government finances: "Member states shall avoid excessive government deficits," where compliance with this commandment is assessed relative to reference values of 3 percent of GDP for the fiscal deficit and 60 percent for the debt-to-GDP ratio.

This manifest emphasis on stability tends to prompt misunderstandings about macroeconomic policies. Criticism that European institutions are insufficiently mindful of cyclical considerations falls on deaf ears. This leads observers to think that the criticisms are even more justified than initially thought. And the fact that policies have, in practice, been fairly sensitive to the economic cycle gets lost amid the din. This gap between rhetoric and reality has beset both the ECB and the SGP.

In this vein, the ECB is criticized for taking insufficient account of cyclical conditions in setting interest rates, to which it responds that this is to misunderstand its mission. Its mantra has consistently been price stability now and forever. In fact, however, it has largely behaved like an inflation targeter, mindful of the implications of growth for inflation. This gets overlooked, in part, because the rhetoric prompts the mistaken assumption that the ECB is facing the same kind of economy as the U.S. Federal Reserve. In fact, at least partly because of the welfare element of Europe's paradigm, the ECB has faced considerably smaller output gaps (and employment volatility) and markedly more persistent inflation than the Federal Reserve. The rhetoric has tended to mask the fact that the differences in policies mostly reflect these different conditions.

The same duality between rhetoric and reality applies to the SGP. The pact is widely criticized as a deficient countercyclical policy instrument. This is hardly surprising since its legal core is plainly aimed at defining limits and not at defining countercyclical policies within those limits. The fact that these limits are specified in terms of actual (rather than cyclically adjusted) fiscal balances lends additional weight to the criticism that the pact is procyclical; it appears to require that deficits be reduced when they are being widened by the effects of weak growth, with resulting contractionary effects on the economy, and vice versa.

However, the fact is that fiscal policies under the SGP have been significantly less procyclical than they were in the aftermath of what is now viewed as the Keynesian misadventures of the 1970s (see article, page 22). Indeed, widespread perceptions to the contrary notwithstanding, for the euro area as a whole, fiscal policies since the introduction of the euro have generally allowed full play to the so-called automatic stabilizers—that is, the fiscal mechanisms (like income taxes and unemployment benefits) that automatically dampen cyclical swings by boosting demand when the economy slumps (because tax receipts fall) and curbing demand when inflationary pressures build (because tax receipts rise). This is significant because the differences in the size of government in the economy imply that the automatic stabilizers are about twice as large in Europe as in the United States.

1986 Spain and Portugal join the EEC. Single European Act commits all members to work toward a single market in goods, services, capital, and labor.

1989 Fall of Berlin Wall.

1992 Treaty of Maastricht creates the European Union (EU). The EU aims for Economic and Monetary Union (EMU), with a single currency managed by a European central bank.

The situation is further complicated by the de facto evolution of Europe's policy frameworks over the past few years toward more cyclically attuned approaches. One example is the gradual narrowing of the ECB's definition of price stability from 0–2 percent to, in effect, 1–2 percent and, most recently, to "close to but below 2 percent" inflation. Another is the gradual acceptance of the role of the automatic fiscal stabilizers, of estimates of cyclically adjusted balances to measure the underlying fiscal position, and of the objective of achieving underlying balance in the medium term in SGP-linked assessments of fiscal policies. The system is seeking solutions that twin discipline with good demand management policies.

That said, the contrast between European and U.S. approaches to macroeconomic policies remains: the Europeans take a more medium-term view, in good part because the welfare system (solidarity) protects those adversely affected by the vicissitudes of the cycle; the United States is more proactive in securing short-run growth and employment, in good part because there is less such protection. Given these differences in structure, comparative assessments of macroeconomic policies need to focus more on growth and inflation outcomes than on the cyclical shifts in policy stance. In that regard, it may be noted that, measured in terms of the cyclical volatility of output or employment, Europe's performance is comparable to, if not better than, that of the United States. Perceptions to the contrary mainly reflect something more enduring: the longer-term weakening of growth in Europe.

Unaffordable solidarity?

Many view Europe's weakening growth as a reflection of its overly generous welfare arrangements, which, by muffling incentives to work and protecting businesses and workers from the disciplines of competition, have exacted an inordinate cost in terms of per capita incomes. In this view, this has led to large-scale underutilization of labor resources and slowed incorporation of new technologies and adjustment to shifting sources of comparative advantage.

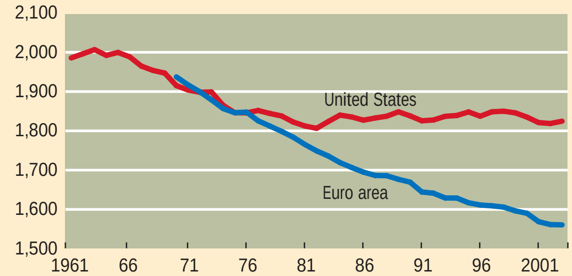
The reality is more mixed. Europe has undertaken many reforms over the years, some of which have begun to pay off. Many have been designed to strengthen the demand side of the labor market, in the form of either wage moderation and other measures to lower the cost of labor or measures that make labor markets more flexible and encourage new entrants. In the same vein, the single market initiative sought to combat "eurosclerosis" by setting in motion deep and wide-ranging reforms in product and financial markets. These reforms continue to run their course. The resulting increase in competition is boosting efficiency, including in the use of labor in those markets.

Chart 2

Time off

Whether because of social preferences or disincentives to work, Europeans have much more time off than U.S. workers.

(annual hours worked per employee)



Sources: European Commission-AMECO database; OECD analytical database; and IMF staff calculations.

These policies have achieved more than is often recognized. The euro area generated almost 10 million jobs between 1997 and 2003, 2 million more than the United States. Although the surge in employment has slowed productivity growth, this could reflect transitional adjustment problems. The payoff to reforms often takes decades, not years, to accrue, and Europe's employment performance should continue to improve. The uneven distribution of growth across Europe is also noteworthy. It has been especially weak in Germany, the country where labor market reforms have been most delayed. Elsewhere, growth and employment have tended to be more robust. Indeed, they have been strongest in the smaller, more open economies, partly because the interaction of solidarity and discipline has led to more encompassing and proactive policies in these countries**.** This is also true of the Scandinavian countries, which have the strongest welfare systems.

Nevertheless, differences in per capita incomes exist between the United States and virtually every EU country, and the larger issue is whether they reflect excessive solidarity or a "social choice"—that is, a willingness to forgo higher per capita incomes for certain social goals, such as increased leisure. About half of the difference between U.S. and European per capita incomes is tied to the fact that Europeans work fewer hours per person: about 1,500 hours a year versus 1,800 in the United States (see Chart 2). Many observers in Europe view this as a preference for leisure over work at the going wage. A contrary view, which starts from

1995 Austria, Finland, and Sweden join the EEC.

1997 EU members agree on Stability and Growth Pact.

1999 EMU and the euro become a reality, with the irrevocable locking of the exchange rates of the participating countries against the euro.

the observation that annual working hours in the United States and Europe were the same 30 years ago, is that the current gap reflects the large disincentives to work imposed over the past 30 years, implicitly in an attempt to “share” employment. With Europe about to shift from an era of a plentiful supply of workers to one of a dwindling labor supply because of aging (see Picture This, page 20), growth prospects hinge in part on who is right and whether incentives, if they are important, will be changed.

Be this as it may, change is in the offing, partly because there is a will to be better prepared for the effects of globalization and new technologies. Change will also be necessitated by the economics of aging populations and discipline. Without change, fiscal policies in many countries are on an unsustainable course, with public debt ratios rising steeply. If nothing else, therefore, the desire for financial discipline should again force adjustment. What remains open, however, is whether the adjustment will enhance growth. Many governments have chosen to deal with aging not by streamlining the welfare system but by shifting budgets into surplus. This reduces the interest payable on the public debt, making governments better able to afford the coming increases in public spending on pensions and health without undermining the fiscal position. This approach, very much in the tradition of the financially disciplined welfare state, leaves incentive systems unchanged, however, and does little to improve future growth prospects.

Looking ahead

With solidarity and discipline seen as the keystones of Europe’s postwar economic history, the continent may be viewed as still seeking to bring them into greater harmony. One must applaud the inclusiveness of the EU, which solidarity has fostered. But one must regret the protection of stakeholders, the slow adjustment to change, and the slowing of growth, with the resulting periodic “dashes for growth” or unaffordable tax cuts that it also encourages. In contrast, discipline and the hard times that made it binding have provided a constructive antidote, fostering necessary changes and reforms. These should lead to improvements in performance in the coming years. But the discipline has too often been in the form of limits (initially on the exchange rate and now, more loosely, on fiscal policies). The resulting policy adjustments have thus tended to be reactive, asymmetric, and insufficiently forward looking, particularly in the larger countries.

The implications of these tensions for short-term demand management policies are relatively slight. While the rhetoric reaches its apogee in downturns, as it has recently, the reality is that—particularly if one accepts the importance of discipline in keeping to a reasonable, long-term course—fiscal and monetary policies have generally been appropriate in dealing with the cyclical component of downturns. If there is a short-term demand management problem, it is rather in the absence of discipline at cyclical peaks when repressed solidarity-bred instincts gain momentum. But these problems affect, in the first instance, the short-run volatility of growth, not its trend rate.

“Politically difficult reforms are widely seen to be necessary if growth is to be robust.”

The implications for the long term are more significant: here, the unresolved tensions between solidarity and discipline remain deeply problematic, particularly at the national level. Because of solidarity-based tendencies to preserve the status quo, electorates resist forward-looking reforms and insist on tangible, direct, and immediate evidence of a problem before accepting that it should be addressed. Hence, the approach to reforms tends to be partial and episodic even though deep, forward-looking, and increasingly politically difficult reforms are widely seen to be necessary if growth is to be robust (see article, page 16).

Thus, while past reforms may ultimately improve performance in the years ahead, growth is still likely to disappoint, and discipline and bad times are still likely to remain an essential spur to reform. Indeed, if the foregoing analysis is anywhere near the mark, obituaries for the SGP are missing the point. While adjustments to the SGP are likely in the light of experience, an essential core aimed at constraining political and social pressures via budgets should and will remain.

But discipline-induced structural adjustment is not the best option. Instead, what is needed is a more forward-looking and thoroughgoing approach to reform whereby solidarity and discipline are reconciled through policies that generate higher long-term growth. This is not impossible. Some of the smaller countries have achieved a measure of success this way. Moreover, at the continental level, European integration is testimony to the generous, forward-looking dimensions of the solidarity impulse. However, achieving thoroughgoing reform at the national level—particularly in the larger economies—will require skill (and perhaps some luck). But most of all, it will require a willingness by policymakers and the electorates to look beyond the current election cycle. ■

Michael Deppler is Director of the IMF’s European Department.

2001 Euro notes and coins replace national currencies in 12 European countries from January 1.

2003 Treaty of Nice comes into force, laying down rules for how an expanded EU will operate.

2004 On May 1, 10 new members join the EU: Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia.