

**Europe Should Embrace
an “Economic Transformation”**

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What and Where is Europe

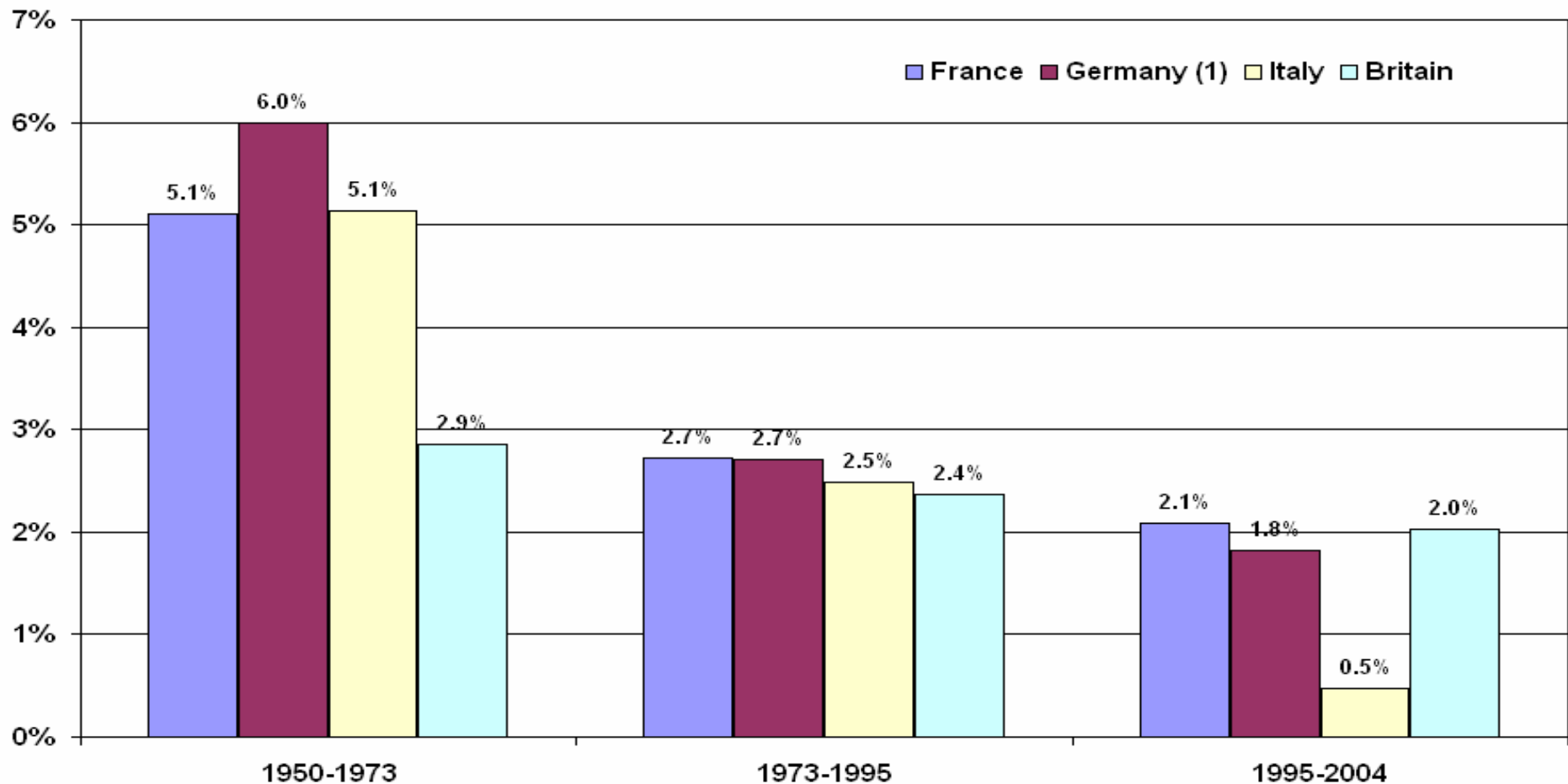
- **Europe is very heterogeneous, no uniform model exist**
- **In many European countries “reforms already work”; well regulated industries have as high/higher productivity than in US, labor markets with proper incentives have unemployment/participation rates comparable to US**
- **Yet, all European countries do face the challenge of renewing GDP/capita catch-up with the US and ensuring long-term sustainability of government finances**

What Should Europe Embrace

- **Comprehensive reform, e.g. depending on country most or all of the following: Product markets, labor markets, welfare, healthcare, pensions, IT and macro-economic**
- **Market-oriented, flexibility enhancing initiatives – some will be from the US, but many from other EU-members**

Reforms are Needed to Increase Productivity Growth

GDP per Hour, Annual average growth (\$PPP 2002)

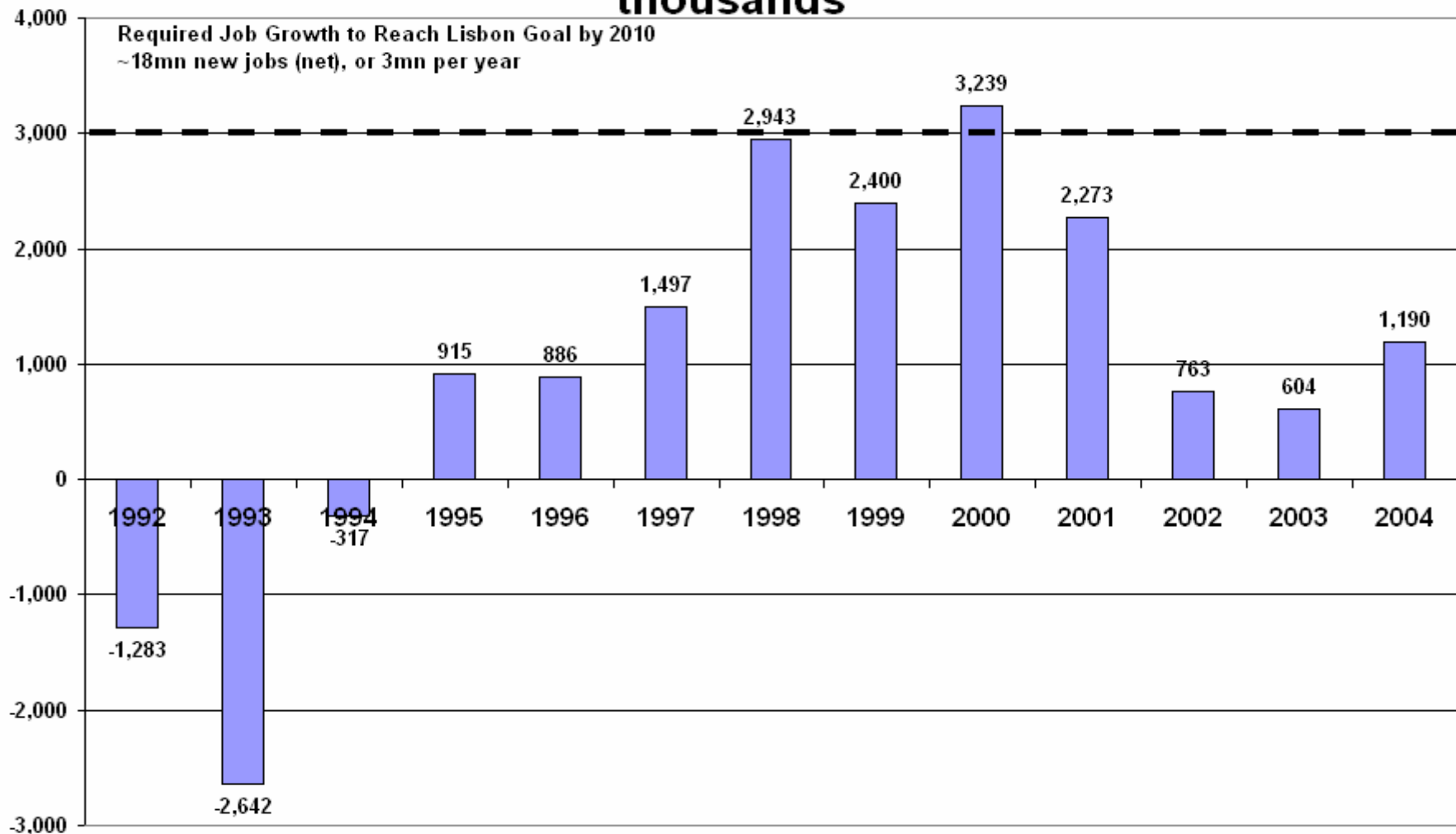


Source: "Groningen Growth and Development Centre and The Conference Board, Total Economy Database, January 2005, <http://www.ggdc.net>"

(1) West Germany only for 1950-1973 and 1973-1995

Reforms are Needed in Order to Increase Employment.

EU-15 Employment Growth, Annual change thousands

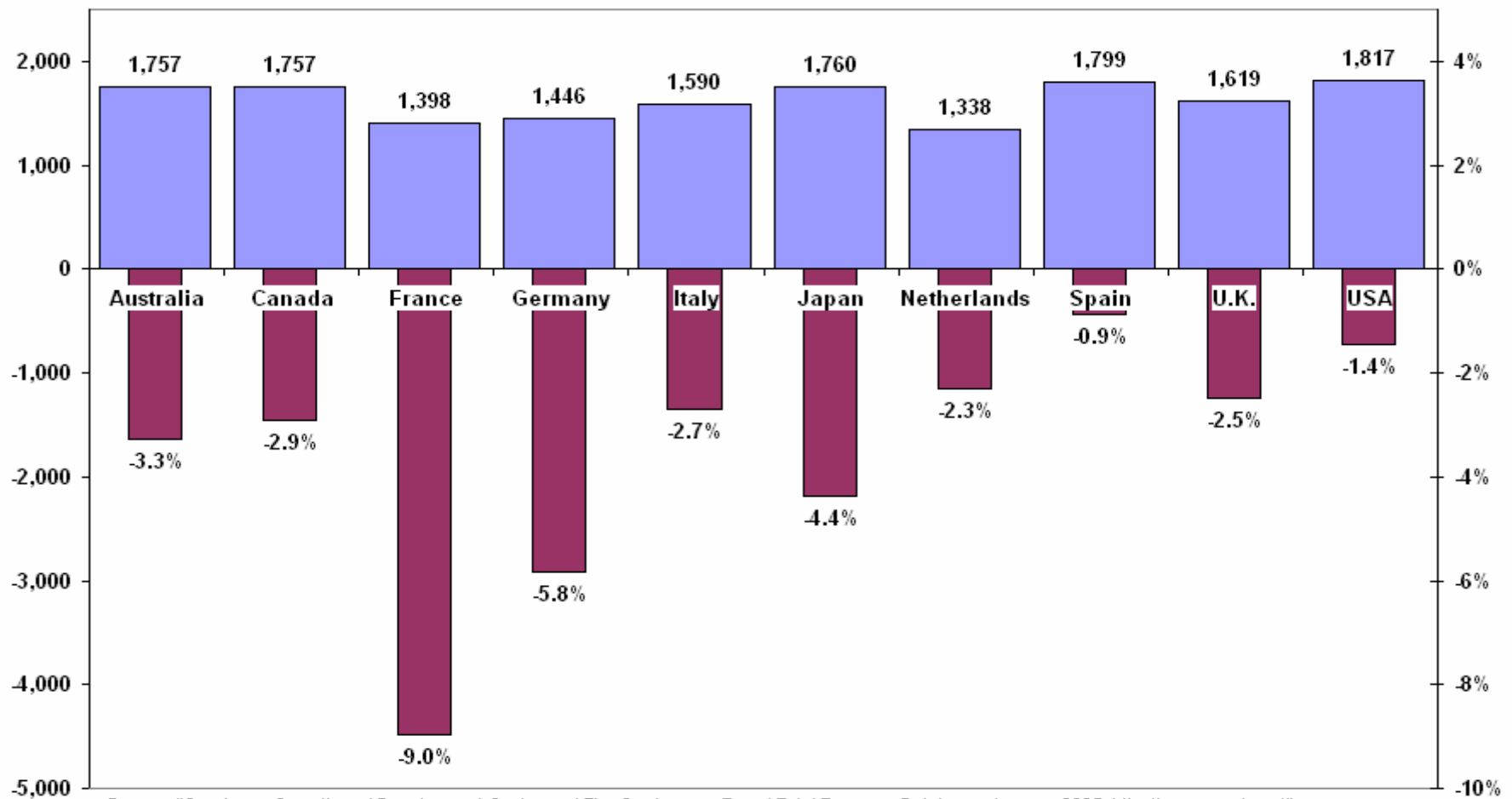


Source: "Groningen Growth and Development Centre and The Conference Board, Total Economy Database, January 2005, <http://www.ggdc.net>"

Reforms are Needed to Increase Labor Input

Total Hours Worked per Person Employed

2004 Level 1994-2004 Change



Source: "Groningen Growth and Development Centre and The Conference Board, Total Economy Database, January 2005, <http://www.ggdc.net>"

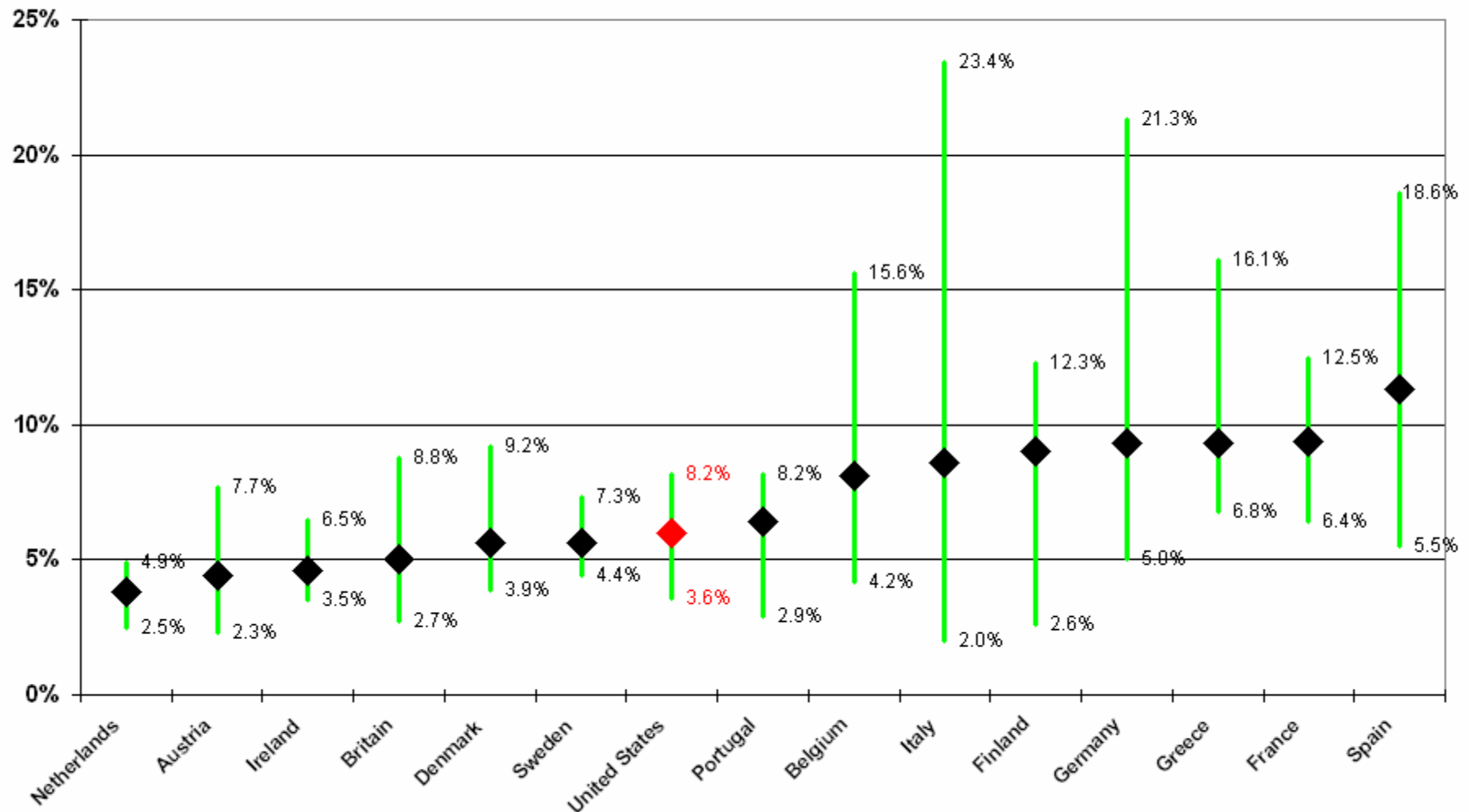
Reforms are Needed Due to Shifts in the European and Global Economy

- **Innovations generated around the world mean that companies must restructure to remain competitive**
- **Information technology creates new opportunities, but also eliminates many old jobs and businesses**
- **China, India and emerging Asia are transforming world trade for both goods and services**
- **The new entrants to the EU are changing the competitive dynamic within Europe**

European growth in the 21st century requires change. New companies must emerge; some companies will die; workers must change jobs and acquire new skills – employment security, rather than job-security

Reforms are Needed to Combat Unemployment Concentrated in Stagnant Pockets

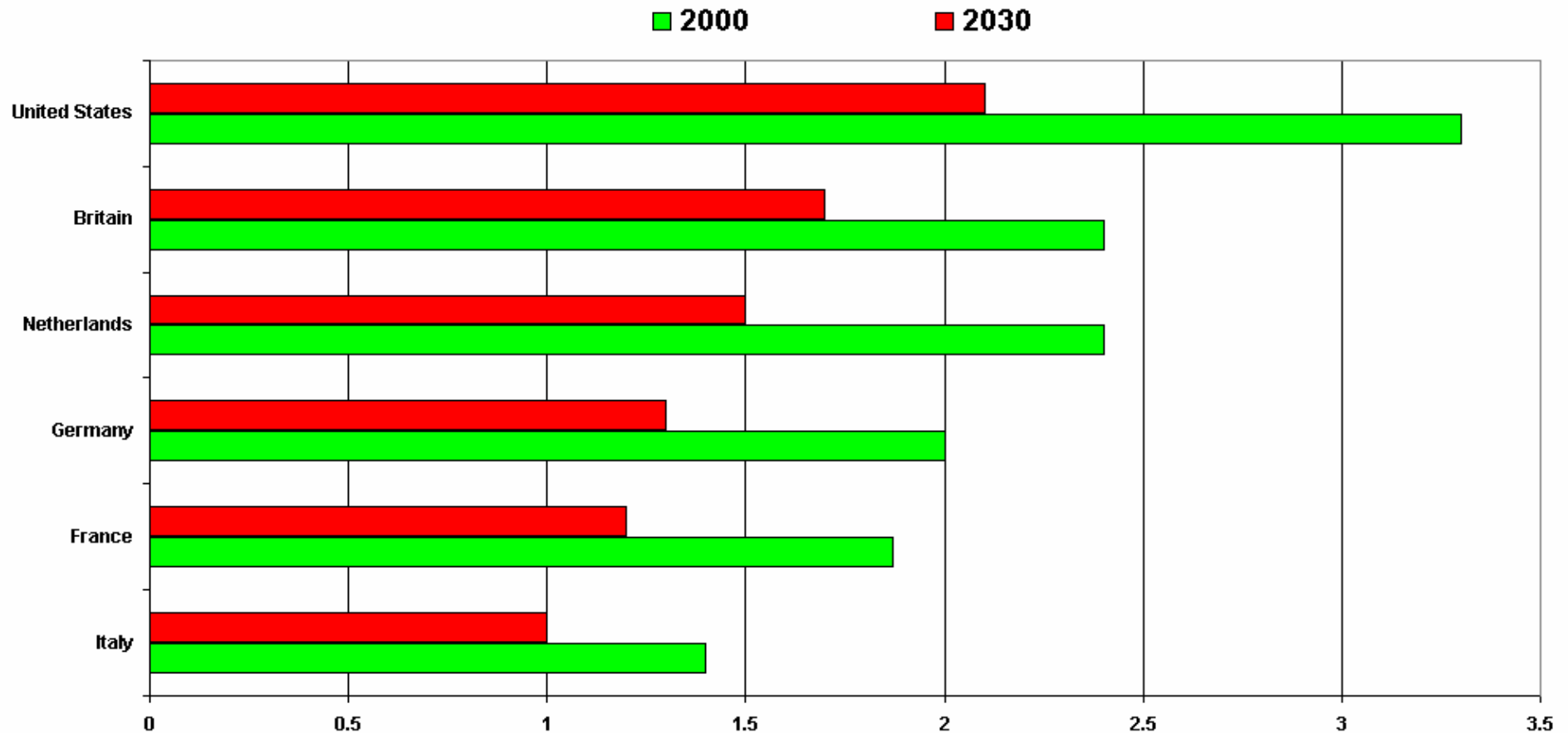
EU-15 Regional Unemployment Extremes 2003



Note: Regional data at NUTS level 2 (European regions of 800,000 to 3 million inhabitants), except Denmark and Ireland NUTS level 3 (150,000 to 800,000 inhabitants). US data on state-level. Luxembourg excluded due to small geographical size. Source: OECD, Eurostat Regional Labor Force Data and the US Bureau of Labor Statistics

Reforms are Needed to Save Work Incentives From Demography

Number of Employees for each Retiree¹



¹ Retirees defined as the number of people aged 55 and above who are not employed

Source: *OECD Ageing and Income, Financial Resources and Retirement in 9 OECD Countries, EUROSTAT Population Forecasts*

European Successes Show that Reform Can Boost Productivity

- **Mobile telephony is a new industry that developed in a competitive, flexible and well-regulated environment. Labor productivity in France was twice the US level in 2000**
- **Competition and privatization in electric power have boosted productivity growth in Germany and the UK. Regulatory pitfalls in the industry are clear**
- **The auto industry in France was largely privatized, and has restructured, allowing it to catch up to the German level**
- **The Single Market increased competition and caused intra-EU trade to surge and tradeables prices to begin to converge.**

Europe must build on the successes. It needs to remove remaining barriers to competition and restructuring

- **Stop protecting local or national champions (small banks and retailers in Germany, electricity and engineering in France, cars in Italy)**
- **Ensure faster implementation of Internal Market Directives, and expand it into the services sectors**

Labor Reforms in the Netherlands, Sweden and Denmark Resulted in Lower Unemployment and Higher Employment

The Netherlands:

- Wassenaar Agreement in 1982 and following years: wage restraint; cuts in social benefits; increased labor market flexibility; lower taxes on labor income
- In the 1980s and 90s, declines in the minimum wage; widening wage distribution
- Period characterized by social partners engaging to solve societal problems, not serve special interests

Sweden:

- Reforms of labor markets and social systems under extreme fiscal stress in 1990s
- Successful reform of government finances with elimination of long-term structural deficits and rebounds in employment and participation
- Period characterized by social partners engaging to solve societal problems, not serve special interests

Denmark:

- With unemployment at 10.7 percent in 1993 (not much higher than Germany in 2004), leftist Social-Democratic government instituted tough reforms
- Workers given financial support and training, but were required to follow a personal re-employment plan. Benefits were quickly cut off for those who did not follow the plan - “Tough love”.
- Period characterized by social partners engaging to solve societal problems, not serve special interests

The Top Priorities For Reform: Increasing Flexibility, Incentives and Competition

- **Land Use Reform:** New companies and new establishments are key sources of productivity growth and employment growth. These will not be created if land is unavailable or too expensive. *National governments carry main responsibility*
- **Labor Flexibility:** Sharply reduce the legal and financial barriers to restructuring that discourage hiring and new business formation and, particularly their growth. Companies should be required to make reasonable and predictable separation/redundancy payments. *National government carry sole responsibility*
- **Regulatory Reform, Competitive Pressure and Privatization:** EU-wide competition policy is not the whole answer. Establish powerful national competition authorities with a mandate to seek and identify regulatory barriers that restrain competition and discourage industry consolidation. *National governments and Brussels share responsibilities under particularly the Internal Market and FSAP*
- **Reform Social Welfare Programs:** The trade-off between equity and efficiency is a purely static concept. Social programs must provide help to the poor and to job losers, but do so in a way that facilitates employment or re-employment. *National governments carry sole responsibility*
- **Allow the Distribution of Wages Paid by Employers to Widen:** Employers must have an economic incentive to hire people, and to provide incentives for high performance. Rigid wage structures prevent this. Social and tax policies can be used to maintain reasonable social equity. *National governments carry sole responsibility*

Structural reform, but monetary/fiscal policy-makers should see economic growth as vital

Reform of the Stability and Growth Pact, March 22-23 2005:

Plusses:

Increased focus on “*economic growth rationale*”; better “*statistical governance*” (Greece problem); larger medium-term flexibility and total debt focus; credit for structural reform efforts (e.g. pension and Lisbon Agenda)

Minuses:

Nothing on implementation, new exceptions (i.e. loopholes) for “*a negative growth rate or accumulated loss of output*”; special considerations to “*financial contributions to international solidarity.... European unification*”

Verdict: Not a “rules-based Pact”, but a Swiss cheese - yet the increased appreciation of the need for economic growth is very positive

The European Central Bank:

- “*Close to, but less than 2 percent*” seem unlikely to allow accommodation of asymmetric shocks to the Euro-zone, while ensuring economic growth
- The ECB is now well-established and has anti-inflation credibility. It can promote micro-economic reform by encouraging growth

Creating Support for and Sustaining Reform

- Political backlash and other short-term political priorities are threatening to stop or even reverse reform efforts
- No *left* or *right* divide in Europe over reforms – some countries move rapidly forward, other less so

Brief Status on Reforms to Date in Large Countries

- Progress on increasing work incentives; Agenda 2010 in Germany; pay-roll and income tax cuts in France, but worrying climb-down over long-term UNEDIC benefits in 2004; income and pay-roll tax cuts in Italy
- Progress on Pensions; Germany cut pensions in September 2003, *sustainability-factor*; France 2003 initial reform of public pensions; in Italy limited reform forced through in 2004
- Progress on health-care in most countries, and starting point much better than the US
- Continuing privatization and competitive reform, gradual implementation of the Internal Market, new focus on the services sectors?
- Little progress on increased flexibility in the economy; Siemens was no watershed in Germany, still 35h week in France, Biagi-laws peripheral in Italy

Much Ground Covered – A long Way Still to go!