

## **Annual Economic Outlook Conference**

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### **Center for Business and Policy Studies (SNS)**

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Let me say at the outset that I am very glad to participate in your discussions this morning. It is always a privilege to share views with very successful policy-makers.

Actually, I wish the rest of Europe could learn more, and more quickly, from the Nordic example. As a former chairman of the Economic Policy Committee of the European Union, I relied enormously on Nordic talents. My three vice-chairs, who did of course most of the work, came from a wide geographic spectrum. One from the South, a Dutchman. One from the Centre, a Dane. And to add an element of cultural diversity, one from the North, a Swede.

Before I start this presentation, I will also ask you to forgive my French broken English. Nobody is perfect. I will deal this morning with the world outlook, seen from the OECD point of view. I will do so in qualitative terms, that is without numbers, since we are just in the middle of our forecasting round.

There are four messages I want to put forward this morning:

- First message: recent economic developments have been obviously disappointing. And this sense of disappointment will certainly extend over the next few months; it will also be shared on both sides of the Atlantic.
- Second message: as of now, we do not see strong signs of cyclical decoupling between America and Europe.
- What we see however is structural decoupling between the US and the EU. We knew it. But we got confirmation of it during the last recession. This may have dire consequences for Europe: in terms of lower potential growth and weaker fiscal sustainability. Structural decoupling then is unfortunately my third message.
- Now the final message: there is no fatality about the European growth potential. Europe can act and improve. Through good economic policies. In this respect I would like to share with you some of the empirical lessons I draw from the OECD growth study.

Let me come back now to recent developments. I will be very brief. Our latest OECD outlook was completed in April. At the time, we felt we were enjoying an early and strong recovery. Business confidence had improved markedly and consumer confidence remained quite robust. Unfortunately, this was only a short-lived and unexpected improvement. Business

confidence has gone down again in most OECD regions. And manufacturing growth has fallen back into slightly negative territory.

In Europe during the first semester, GDP growth was well below expectations. With annualised rates around 1% on average. What we have seen so far is a "technical recovery" driven by exports and reduced destocking. As for final domestic demand, it has remained flat on its back.

In the US, household demand has remained very vigorous, so far. In a context of extremely stimulative monetary and fiscal policies. On the investment side, however, the recovery seems some way off. One difficulty being that rates of capacity utilisation in manufacturing remain very low. The other difficulty being the continuous melt-down of equity prices. One obvious question is then: if the investment recovery comes in later rather than sooner, how long can consumers sustain alone the economy?

In other words, the timing and the strength of the recovery are still uncertain for at least two reasons:

- the sustainability of the US recovery is not completely assured. Because we are not entirely certain that past financial excesses have been completely purged;
- in Japan and Europe, the potential for autonomous recovery is not yet completely there. In part because of insufficient economic reforms.

So, to sum up, there is indeed a recovery. It has been supported by very accommodative macro policies on both sides of the Atlantic. But it is also weakened by strong financial headwinds and geopolitical uncertainties. I will not dwell on financial headwinds, since Anne Krueger dealt with this issue brilliantly in her presentation.

As a consequence, the recovery is going to be more subdued and less regular than expected in our previous economic outlook.

Let me now show you a graph that encapsulates our present interrogations about short-run prospects.

(Figure 1. Business confidence in the US and the euro zone.)

The implications of this graph are twofold:

- growth will remain below potential for the near future; say the next 6 months;
- we should not expect too much cyclical decoupling between the two sides of the Atlantic.

You might be tempted to ask me: "How can it be that cyclical positions in Europe and the US are so close, when growth rates look so different." The answer is: potential growth is much stronger in America. We know, for instance, that US productivity growth has proved quite

resilient even during the downswing. In the US, potential growth is close to 3%, in Europe it is slightly above 2%.

Below potential growth doesn't mean the same thing for US, Europe or Japan. Growth at an annual rate of 2.5% over the next few months in the US will not be a tragedy.

Below potential growth will prove more problematic for Europe however. Especially on the fiscal side. There are many things to be said about fiscal policies - but time is lacking.

This question of why trend growth has been so different across the OECD is really a nagging one. This is also an area where the OECD has done a lot of empirical research, in the context of the so-called "growth study". Using in the process a lot of panel and sectoral data, which were not available before.

What lessons can be drawn from this study for Europe and Sweden?

As the growth study shows there are indeed quite a number of policy levers that Europe could use to improve its long-run performance:

- education policies, to start with. On average, one more year of education could raise long-term GDP by 4 to 7 %. In Sweden, the effect would be much more modest, because of already outstanding education standards;
- less stringent product market regulation would also boost multifactor productivity. As shown by the following chart.

(Figure 2. Product market regulation and multi-factor productivity are inversely related)

Sweden is well placed here. But a number of big European countries far less so. One should be careful about not overplaying these results. There are caveats. But still the graph is suggestive.

- Another example about product markets has to do with internet penetration. The lower the cost of access, the higher internet penetration. Here Sweden is very well placed.

(Figures 3 and 4. Internet penetration also depends upon the cost of access)

- Moving now to financial markets, econometric analysis is suggesting that deep and liquid markets are important for long-term growth. Here substantial progress is under way in Europe but it could be speedier.
- It is also vital for Europe to increase its labour supply. This is the area where the gap with the US is probably the largest. Unlike the US, we cannot rely on a strong demography. But we should, at least, be able to increase employment rates.

As the chart shows, there is an 8% gap between Europe and the US. Within Europe itself we can see considerable disparities. Admirable performance from Nordic countries and Malthusian policies in Southern Europe.

(Figure 5. Employment rates vary markedly in Europe)

The most pressing challenge ahead will obviously be to raise the employment rate of older workers in Europe, where the actual retirement age often falls dangerously close to the lower fifties. In this area we urgently need to correct perverse incentives that prevent people from staying in the labour market regardless of their own spontaneous choices.

If Europe does not take action very quickly, potential growth will fall from 2¼% at present down to 1.5% in 2010. With again very difficult problems for public finances.

There are of course quite a number of other policy actions to be taken on labour markets. Against unemployment traps, the excessive cost of unskilled labour and sometimes too restrictive employment practices.

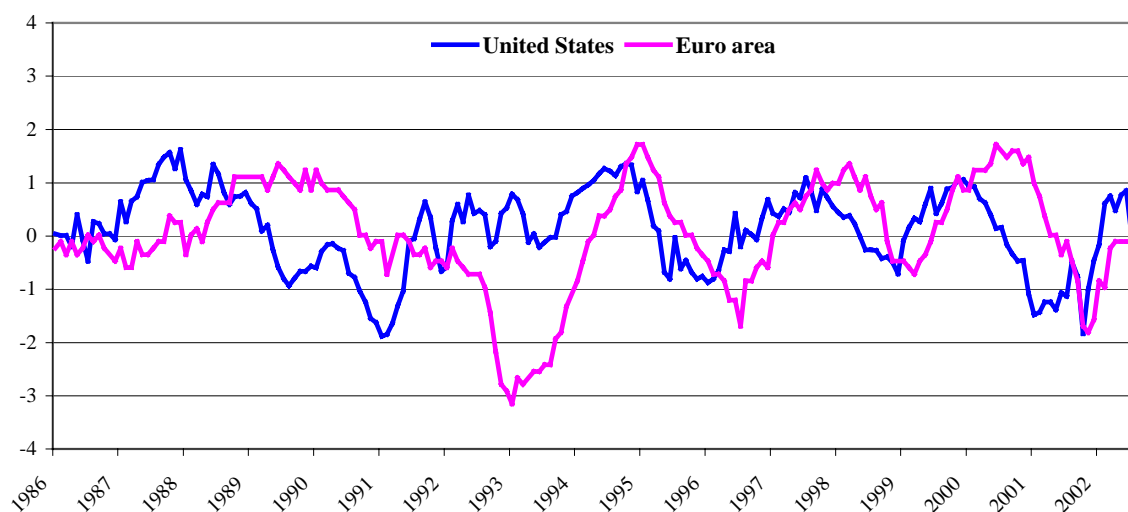
Before ending this presentation, I would like to make a final and hopefully provocative remark about the importance of structural reforms. We have now in Europe a big country where structural weakness has been very severe. Severe enough at least to impair the resilience of the economy in the face of conjunctural shocks.

In this case, the best contribution to stabilisation policy may well come from audacious and credible labour market reforms.

This exposé may look a little gloomy but I would like to conclude on a note of hope. In the short-run we are faced with a period of disappointing growth. Compounded by uncertainties arising from non-economic events.

But we have the capacities to ensure a solid recovery and a return to stronger trend growth. But for that we have to put our acts together and do much in terms of structural reforms.

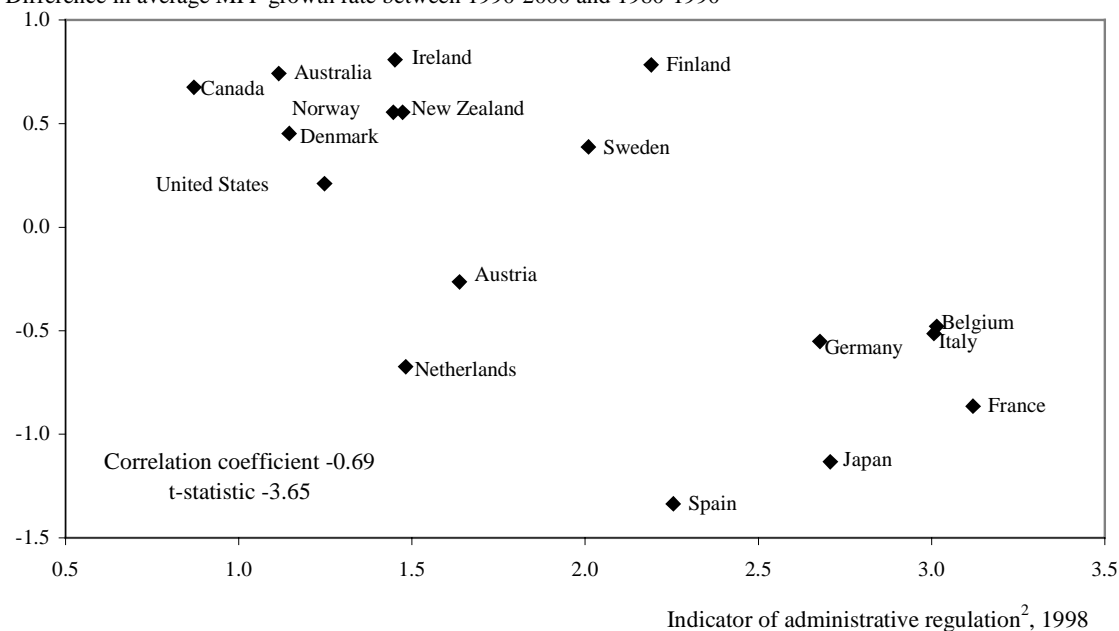
Figure 1. **Business tendency indicators**<sup>1</sup>  
1986-2002



1. All series have been normalised at the average for the period for which data are available and are presented in units of standard deviation.  
Source: OECD Main Economic Indicators.

Figure 2. **Product market regulation and multi-factor productivity are inversely related**

Difference in average MFP growth rate between 1990-2000 and 1980-1990<sup>1</sup>



1. Adjusted for hours worked.

2. The scale of indicators is 0-6 from least to most restrictive. See Nicoletti *et al.*, "Summary indicators of product market regulation with an extension to employment protection legislation," *OECD Economic Department Working Papers No. 226* (1999).

Source : OECD.

Figure 3. **Internet penetration also depends upon the costs of access**

Costs for 20h access at peak time (USD, PPP), 2001

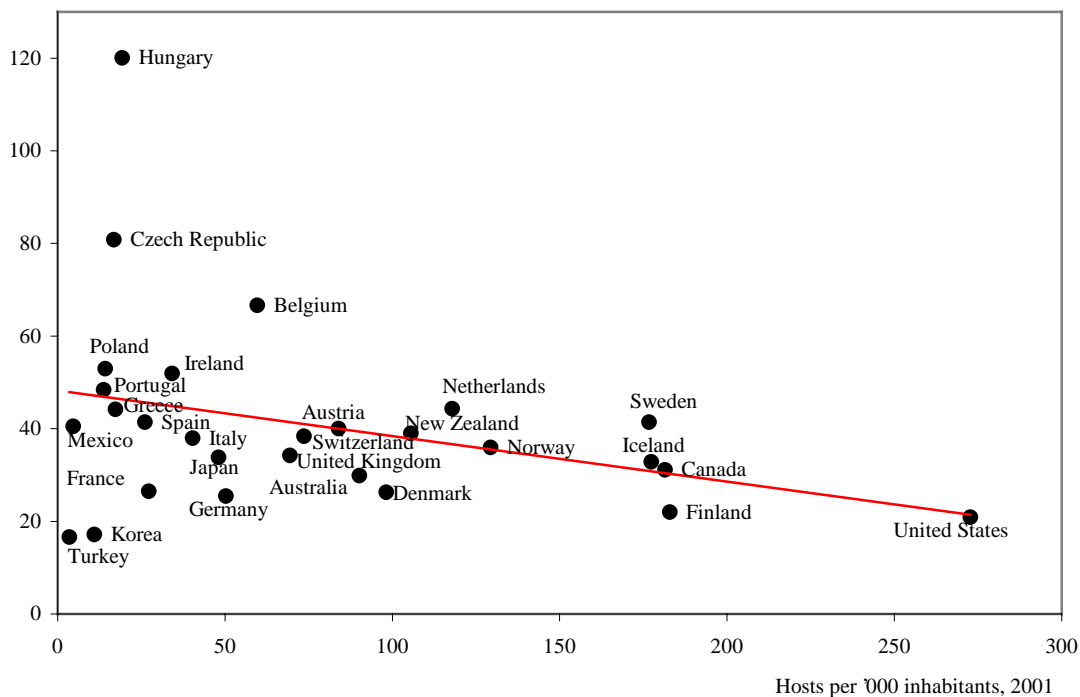


Figure 4. **Internet penetration also depends upon the costs of access - Sweden**

Costs for 20h access at peak time (USD, PPP), 2001

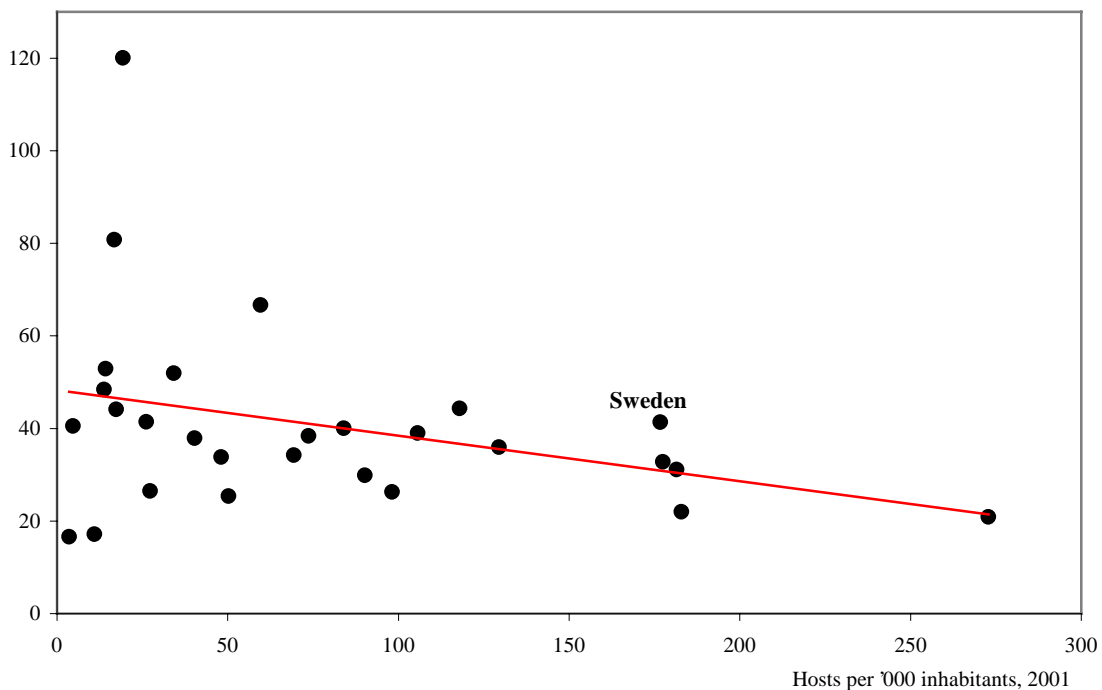


Figure 5. **Employment rates vary markedly in Europe**  
2001

