OECD FORUM 2006
BALANCING GLOBALISATION
22-23 May 2006, Paris

Revitalising European growth

Jean-Philippe Cotis, Head of Economics Department, Chief Economist, OECD

I am delighted to be here today and to take part in this discussion on the challenges facing Europe.

Let me start with a contrarian question: do we really need more growth in the euro area? Has growth been so disappointing that action is urgently needed? It may look like an odd question. But a variety of observers are arguing that the euro area does not feature that badly when compared, say, to North-America, other English-speaking or Nordic countries.

From their standpoint, the euro area may have been weak in terms of GDP but not necessarily in terms of well-being. They would argue that social preferences in continental Europe put a premium on leisure. Europeans tend to favour free time over additional income. Cast in such terms, Europe's performance may not be that worrying after all.

At the OECD, we are certainly keen to distinguish GDP from well-being. But still we are worried about Europe's growth prospects. We are worried because slow growth largely reflects inadequate macroeconomic and structural policies, regardless of societal preferences. To give just one example, if employment rates are low in Europe, it is to a considerable extent because bad policies have driven people out of the labour market.

Let me start with macroeconomic performance. Over the past five years, it has been weak relative to the rest of the world economy. The euro area has suffered from persistent slack, with aggregate demand systematically falling short of production capacity. At the same time, core and wage inflation have continued to decline. Slack has been particularly marked in Germany, where until recently animal spirits have remained depressed.

This prolonged period of Keynesian underemployment may come to an end with the current recovery. But it leaves behind a series of questions that we need to answer. Why is the euro area so fragile compared to Australia, Canada, the Scandinavian countries or the UK? Why have these various countries displayed both stronger growth in the long term and more resilience in the short run in the face of shocks?

I will not dwell on macroeconomic policies and the factors behind short-run resilience. Let me just say that growth has been hampered by inappropriate fiscal policies. Policies prone to cutting taxes and boosting spending at the peak of the cycle, when it is unnecessary. But unable to save ammunition for the bad times when fiscal expansion is needed to kick-start the recovery. Consumer demand has also suffered from weak channels of transmission for monetary policy, which provided little support to activity in downturns. For monetary policy to work better, more flexible retail financial markets would have been needed, for instance, as concerns mortgages.

Comparing the euro area with those OECD countries which have been resilient in the face of macro economic turbulences, it seems we have also lacked flexible economic structures.

Ensuring a strong recovery in aggregate demand would no doubt be extremely beneficial. But once the demand gap is closed a lot of work will still be needed, on the supply side, to improve long-term growth prospects.

Erosion

In a long-term perspective, potential growth in the euro area has been too low. Even abstracting from demographics, GDP per capita has not grown fast enough to stem what is currently a widening gap with North America, the Nordics and some English-speaking countries. One striking and disquieting feature is indeed that the euro area has been loosing ground over the past 15 years or so vis-à-vis the US economy (Figure 1) and some others as well – for example Australia and Sweden (Figure 2).

The widening difference in income per capita can be decomposed into a gap in labour utilisation and a gap in labour productivity (Figure 3). For the euro area as a whole, they add up to a 29 percentage point difference in living standards.

In some countries, notably France or Belgium, there is apparently no productivity gap. But this is an artefact. Indeed, it largely reflects the fact that less skilled workers are often out of employment and not counted in French and Belgian statistics, while in North America they are at work and driving down productivity figures. These European productivity statistics are thus unduly flattering.

Moreover, looking at productivity growth over time – rather than at its current level – productivity has been increasing more rapidly in the United States than in the euro area since the mid-1990s (**Figure 4**).

What is ailing us?

Turning to the reasons behind lower employment rates and productivity, the detailed diagnosis obviously differs across euro area members. In the case of the largest three euro economies, growth has suffered because detrimental policies have not been reversed in time while economic reforms did not go far enough.

Let me list briefly the main culprits: [1]

- Concerning labour utilisation:

  - *Malthusian policies have been very detrimental*. These are policies aimed at discouraging the employment of the so-called "ageing" workers. Or the policies aimed at rationing hours worked in the belief that sharing work will reduce unemployment. All in all, those countless initiatives where huge sums of public money have been thrown away to convince people not to work have penalised growth and public finances.

- Concerning labour productivity:

  - *Not enough has been done to boost innovation*. What matters most for innovation is strong competition and thriving tertiary education. On both counts the euro area has been lagging. Compared to the best OECD performers, competition in products markets has not provided enough stimulus and the contribution of universities to research has been too modest. Also lacking is a much larger funding of tertiary education. Big Continental European countries spend only 1 per cent of GDP for tertiary education. By comparison Nordics and North Americans spend at least twice as much in this area and in a more effective manner.

  - *The regulatory environment has remained business-unfriendly*. There is still too much red tape and uncertainty about future red tape. For instance, for start-ups.

Beyond these specific recommendations, it is very important to further increase competition throughout the services sector, including network industries. Competition is key for productivity increases. It improves the allocation of resources towards the most efficient sectors. It stimulates efficiency within firms by reducing slack. It boosts innovation because firms need to stay in the lead.

On the other hand, competition may create dislocations and raise anxiety among the labour force. This is why we need a good safety net and a real capacity to help workers resettle quickly into new jobs.

In all these areas, the importance of the service sector can hardly be exaggerated since it constitutes a huge reservoir for growth and job creation. Until recently the European Union made substantial strides towards opening the services sector but as of late progress has been more hesitant. It would be sad if we suddenly lost momentum because of our inability to deal with the social concerns that a single market for services seems to generate.

[1] For more details, see our structural surveillance publication, OECD, *Going for Growth 2006*.

Quantifying opportunities foregone

We have recently attempted to quantify the amount of growth that has been foregone by not pushing product markets reforms far enough. Focusing on the barriers that still inhibit trade, foreign direct investment and product market entry.[2] But leaving aside public interventions in agriculture, environmental or safety regulations, and all of the labour and financial market regulations.

We identified across the OECD the countries with the most flexible regulatory framework. And then computed what would happen if every country aligned itself on "best practice" so defined. For the big three euro area members and using reasonable estimates, the level of GDP per capita would be boosted – over time – by 4 to 5% (Figure 5). This is equivalent to about two years of growth.

Regulatory reforms would provide the bulk of the economic gains. Consistent with the fact that today the main obstacles to trade are not classical tariff and non-tariff barriers, which are anyhow rather small, but domestic product market regulations themselves. Especially in services.

Getting the overall strategy right

Last but not least, let me underline the importance of having a global reform strategy. A number of reforms are easier to advocate than to implement. In this respect, tough labour market reforms can be facilitated if preceded or accompanied by product and financial market reforms.

Indeed, greater competition in product markets reduces excess profits and prices. And, as we all know, falling prices are good for the purchasing power of wages. Likewise, financial market reform reduces the cost of capital. And, as we also know, a lower cost of capital reduces the need to earn large profits. Which leaves more room for labour income. The complementarity of the different types of structural reforms highlights how crucial it is to keep momentum in the area of goods and services markets.

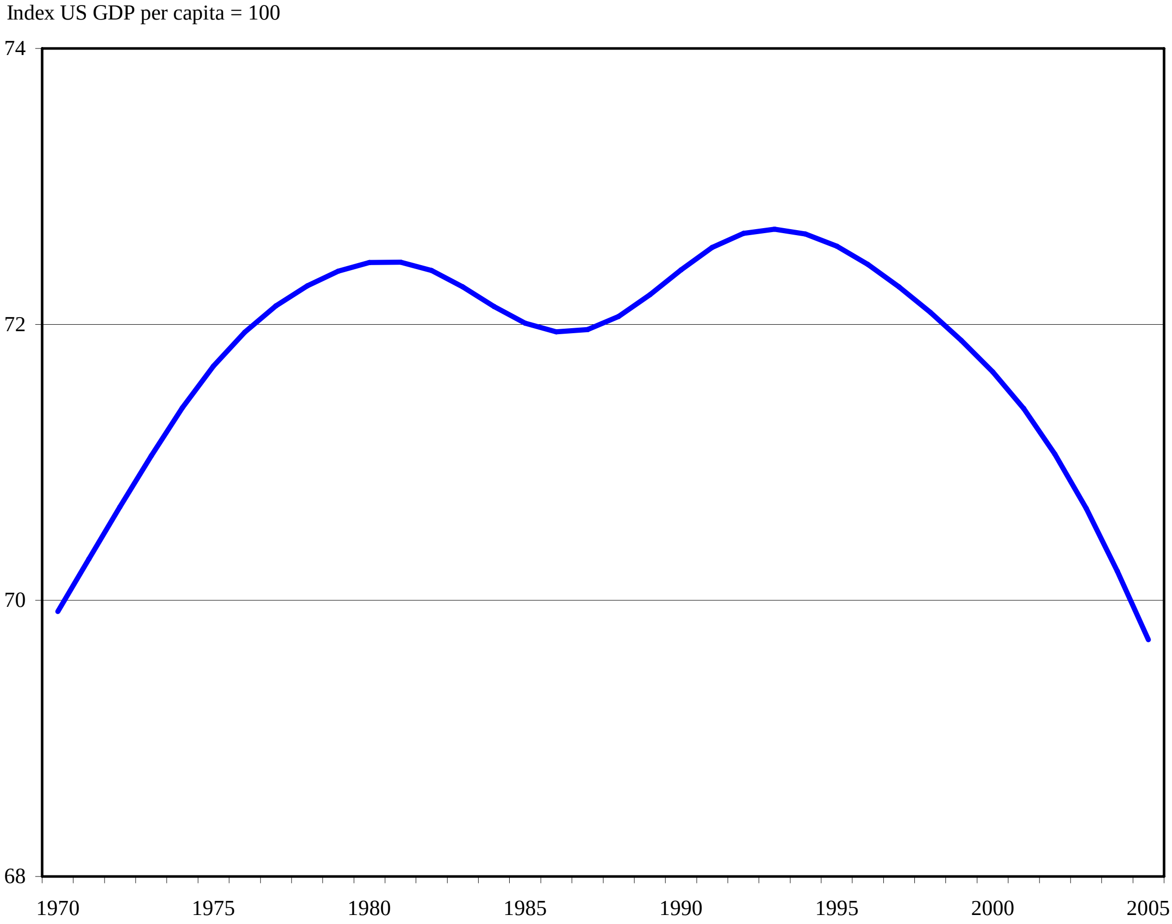
*

[2] See "The benefits of liberalising product markets and reducing barriers to international trade and investment in the OECD", OECD Economics Department Working Paper No. 463, December 2005.

Loosing ground vis-à-vis the US,…

Euro area real per capita GDP relative to the United States

Trend indices, based on 2000 PPPs and 2000 prices [1]



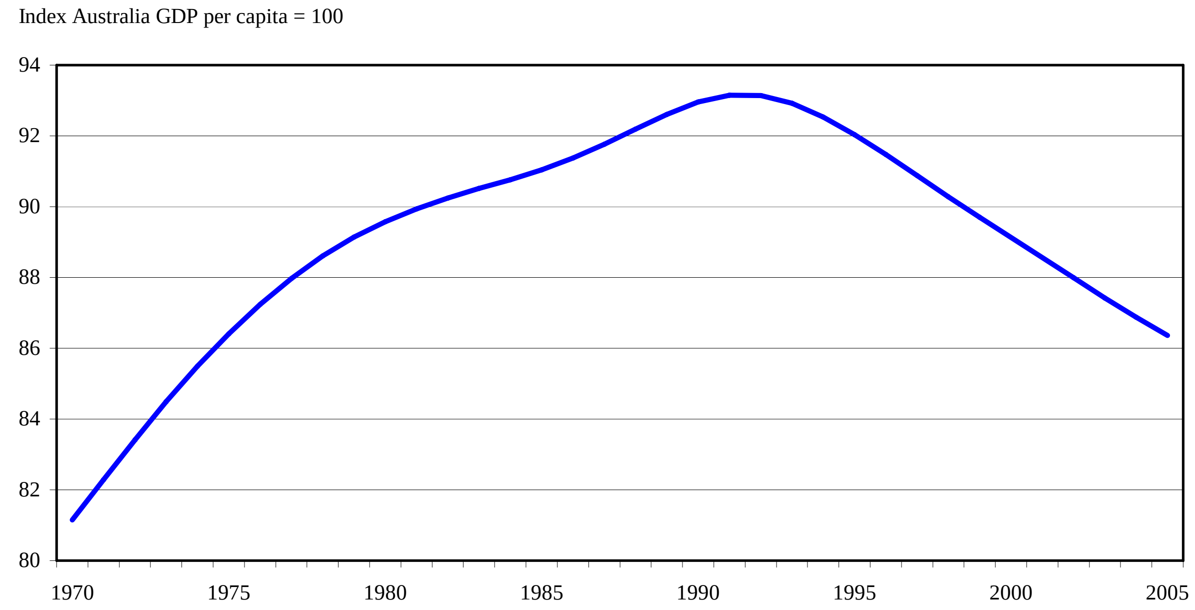
1. The trend is calculated using a Hodrick-Prescott filter (smoothing parameter set to 100) over a period which includes projections through 2012.

Source: OECD *Annual National Accounts;* OECD *Economic Outlook 78 Database.*

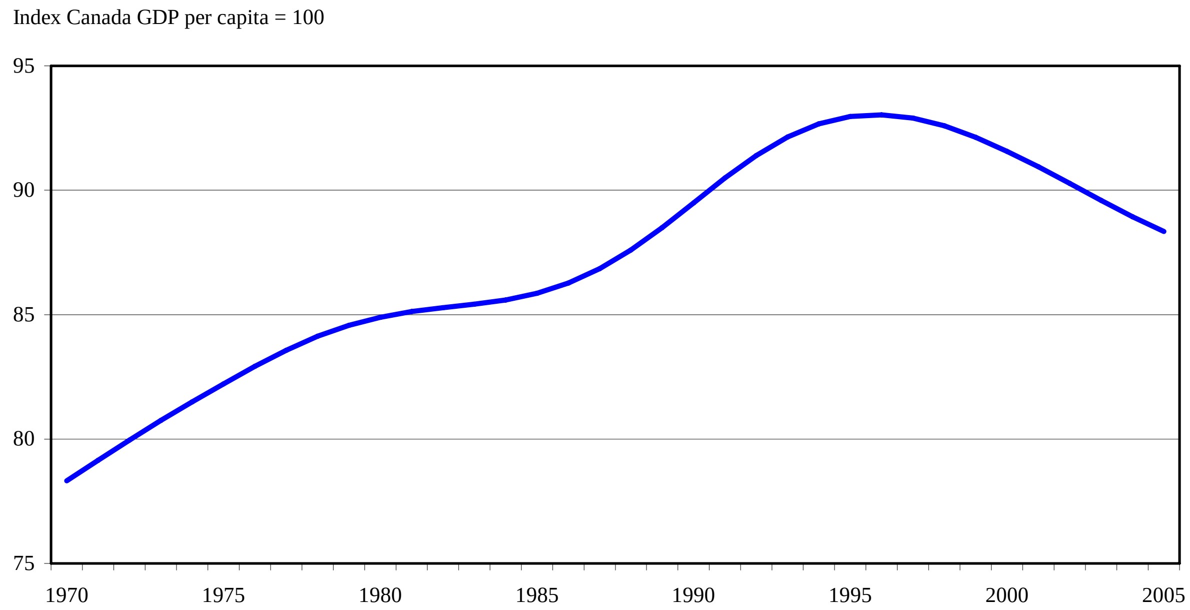
…Australia or Sweden

Trend indices, based on 2000 PPPs and 2000 prices [1]

Euro area real per capita GDP relative to Australia



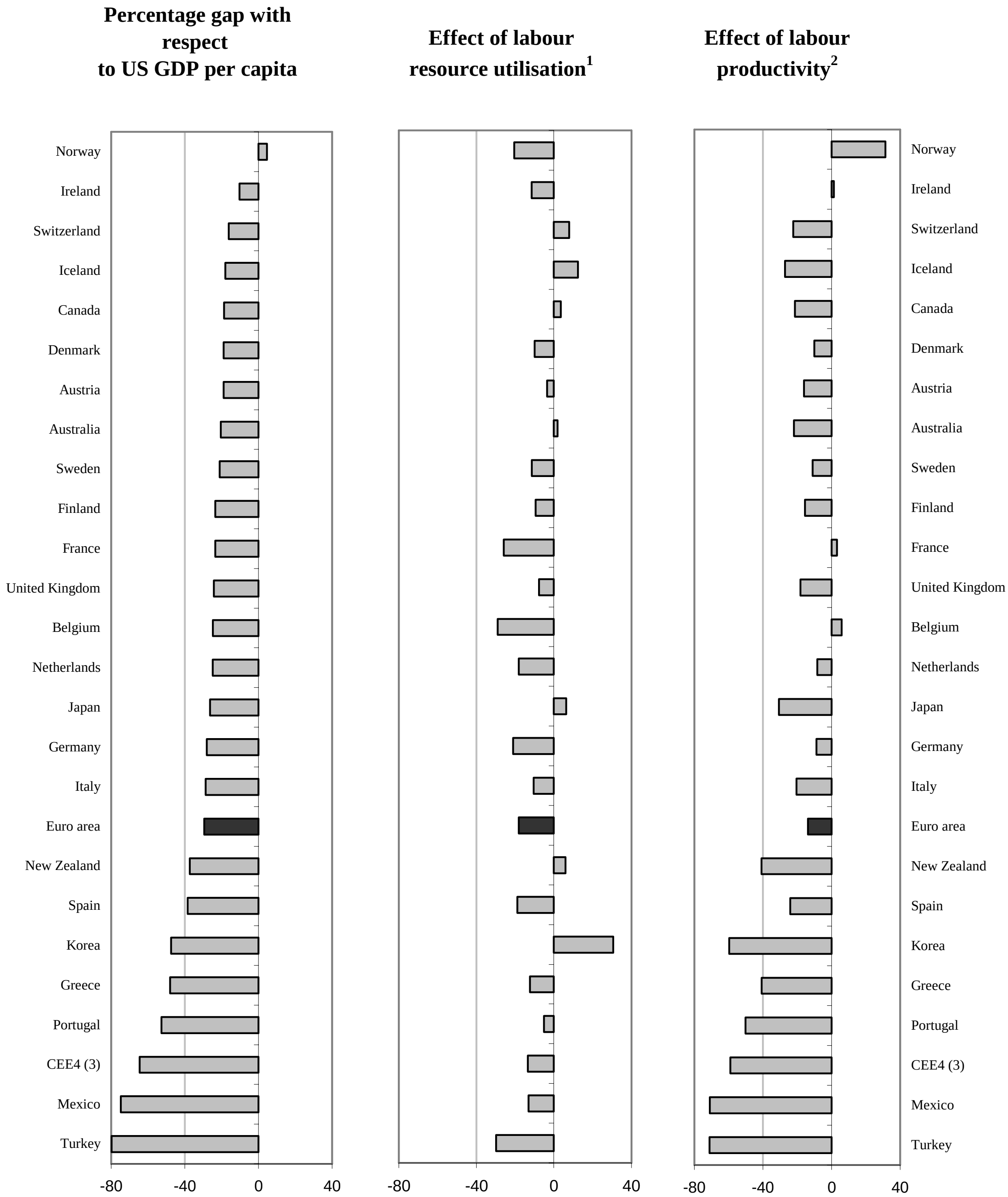
Euro area real per capita GDP relative to Sweden



1. The trend is calculated using a Hodrick-Prescott filter (smoothing parameter set to 100) over a period which includes projections through 2012.

Source: OECD *Annual National Accounts;* OECD *Economic Outlook 78 Database.*

The gap stems from lower productivity and lower labour utilization

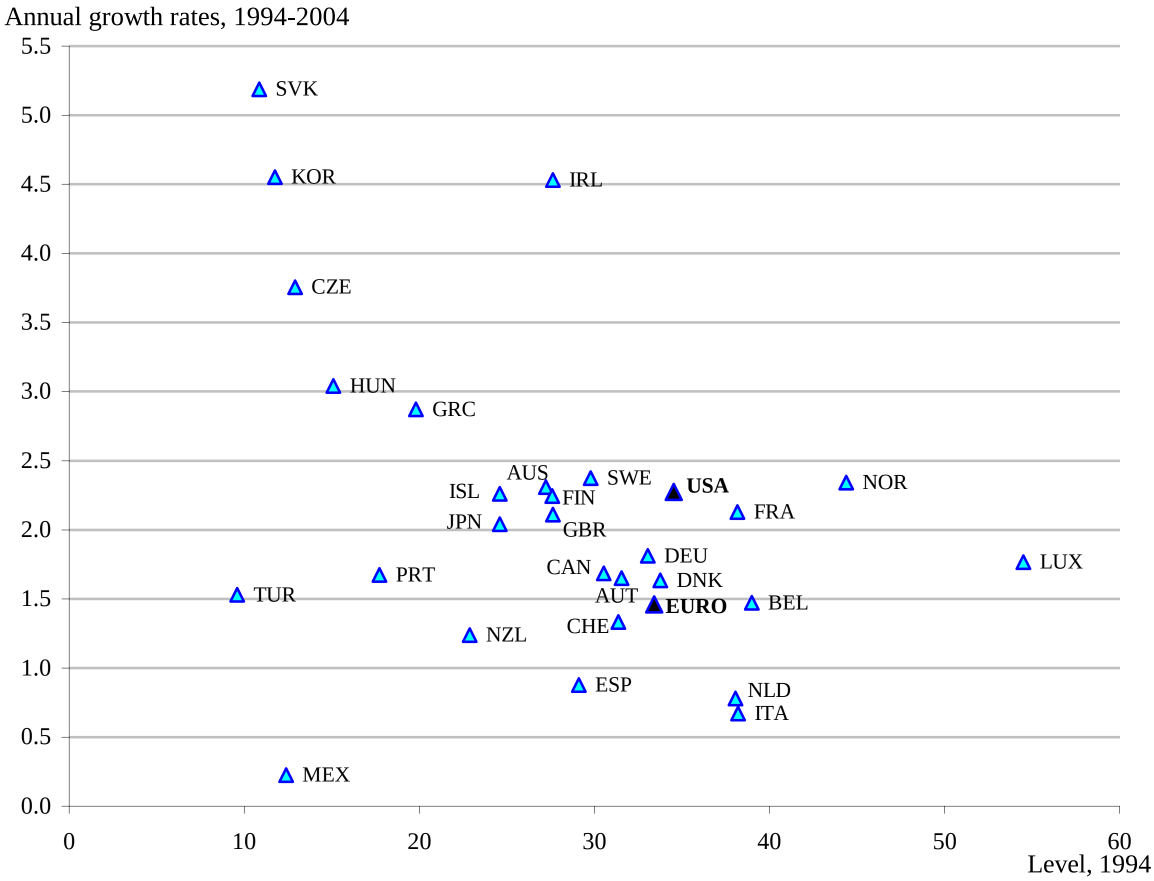


1. Labour resource utilisation is measured as total number of hours worked divided by population.
2. Labour productivity is measured as GDP per hour worked.
3. CEE4 refers to the Czech Republic, Hungary, Poland and the Slovak Republic.

Source: OECD, *Going for Growth 2006* .

Productivity performance

Labour productivity [1]



1. Measured as US dollar GDP in 2000 PPPs per hours worked.

Source : OECD, *Going for Growth 2006* .

Quantifying the impact of selected reforms

% increase in GDP per capita levels

	Bilateral tariffs reduction	FDI reduction	Regulatory reforms	All policies
United States	1.3	0.7	2.6	4.7
Japan	1.3	0.7	2.4	4.4
Germany	0.5	0.5	3.2	4.2
France	0.4	0.6	3.7	4.7
Italy	0.4	0.5	3.4	4.3
United Kingdom	0.5	0.5	3.1	4.1
Canada	1.4	0.7	2.1	4.1
Euro area	0.4	0.5	3.2	4.2
OECD	0.9	0.7	3.1	4.7

Source: OECD Economics Department Working Paper No. 463, 2005.