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EUROPE'S GROWTH PROBLEM (AND WHAT TO DO ABOUT IT)

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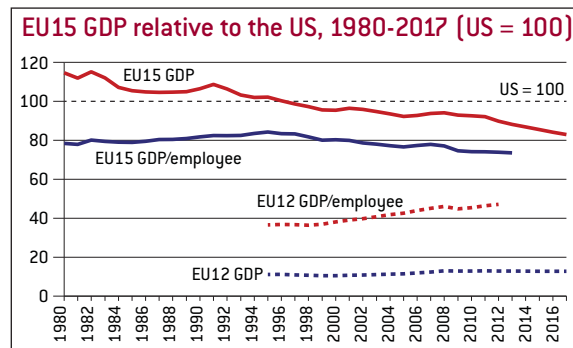
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THE ISSUE The European Union's pre-crisis growth performance was disappointing enough, but the performance has been even more dismal since the onset of the crisis. Weak growth is undermining private and public deleveraging, and is fueling continued banking fragility. Persistently high unemployment is eroding skills, discouraging labour market participation and undermining the EU's long-term growth potential. Low overall growth is making it much tougher for the hard-hit economies in southern Europe to recover competitiveness and regain control of their public finances. Stagnation would reduce the attractiveness of Europe for investment. Under these conditions, Europe's social models are bound to prove unsustainable.

POLICY CHALLENGE

The European Union's weak long-term growth potential and unsatisfactory recovery from the crisis represent a major policy challenge. Over and above the structural reform agenda, which is vitally important, bold policy action is needed. The priority is to get bank credit going. Banking problems need to be assessed properly and bank resolution and recapitalisation should be pursued. Second, fostering the reallocation of factors to the most productive firms and the sectors that contribute to aggregate rebalancing is vital. Addressing intra-euro area competitiveness divergence is essential

to support growth in southern Europe. Third, the speed of fiscal adjustment needs to be appropriate and EU funds should be frontloaded to countries in deep recession, while the European Investment Bank should increase investment.



Source: Bruegel based on IMF World Economic Outlook October 2012. Note: GDP is measured at purchasing power parity. EU15: EU members before 2004. EU12: EU members that joined in 2004/2007.



EUROPE'S PRE-CRISIS GROWTH PERFORMANCE was disappointing enough, but the performance since the onset of the crisis has been even more dismal. Table 1 shows that while the total output of EU15 countries (EU members before 2004) exceeded that of the United States by 15 percent in 1982, it is expected to be 17 percent lower in 2017. EU15 *per capita* income has remained

broadly stable relative to the US, but this is largely due to pre-crisis job creation – a positive development on its own. Relative GDP per employee declined by five percentage points between 1997 and 2007 and by another six percentage points since¹. There is some comfort to be found in the continued catching-up of the countries that joined the EU in 2004 and after, but their future will also be at

stake if the advanced European countries continue to lag behind.

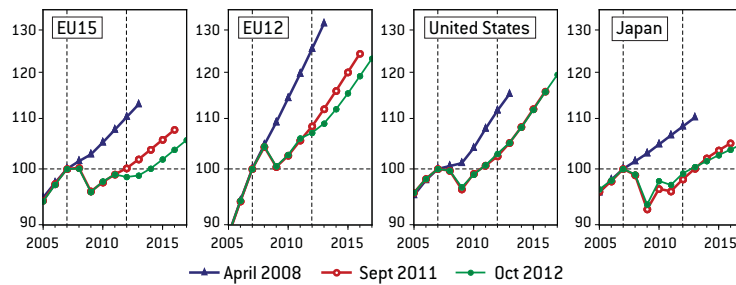
Unlike the US and Japan, Europe's growth and unemployment numbers have consistently disappointed since 2007 (Figure 1). Productivity developments remain weak, even in EU countries with healthier private and public balance sheets. Unemployment continues to grow and set new records. This is again in contrast to the developments in the US, where the initial impact of the recession on employment was much worse, but where job creation has resumed, the unemployment rate has declined from its post-2007 heights, and investment has also resumed (Figure 2).

Table 1: GDP, GDP per capita and GDP per employee at PPP (US=100)

		1982	1987	1992	1997	2002	2007	2012	2017
EU15	GDP	115	105	106	99	96	94	90	83
	GDP/capita	75	71	74	72	73	72	71	67
	GDP/employee	80	80	82	83	79	78	74	
EU12	GDP				11	11	12	13	13
	GDP/capita				28	30	36	39	41
	GDP/employee				37	40	45	47	
Japan	GDP	38	38	41	37	32	31	29	27
	GDP/capita	75	75	85	81	72	72	73	70
	GDP/employee	68	72	76	74	69	70	67	

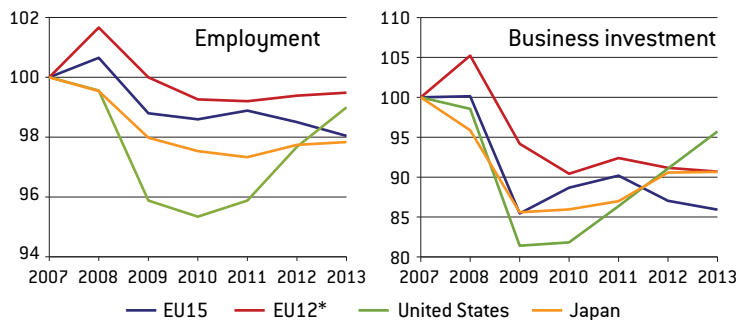
Source: Bruegel based on IMF October 2012 WEO and Eurostat. PPP = purchasing power parity.

Figure 1: Growth forecasts at different dates (2007 = 100)



Source: Bruegel calculations using different editions of the IMF World Economic Outlook. Note: the first vertical dashed line in each panel indicates 2007, the second 2012.

Figure 2: The impact of the recession on employment and business investment (2007 = 100)



Source: Bruegel based on AMECO database, European Commission. Note: * in right hand panel, EU 9 (not including Bulgaria, Latvia, Malta).

What are the reasons for the worsening performance since 2007? Obstacles to productivity performance? Ill-timed public deleveraging? Banking sector weaknesses? Or, especially in the euro area, capital misallocation and misaligned prices? In this Policy Brief, we discuss these questions, before drawing policy conclusions.

THE PRODUCTIVITY PROBLEM

Before 2007, Europe's weak productivity performance reflected well-known structural weaknesses: insufficient investment in human capital and research, a limited ability to transition from an imitation-based economy to an innovation-based economy, excessive reliance on established firms in traditional industries and, in a number of countries, a growth model that was based on booming but low-productivity construction and traditional services.

1. For data for all EU countries for all indicators studied in this Policy Brief, see the supplementary charts, available at <http://www.bruegel.org/index.php?id=257>.

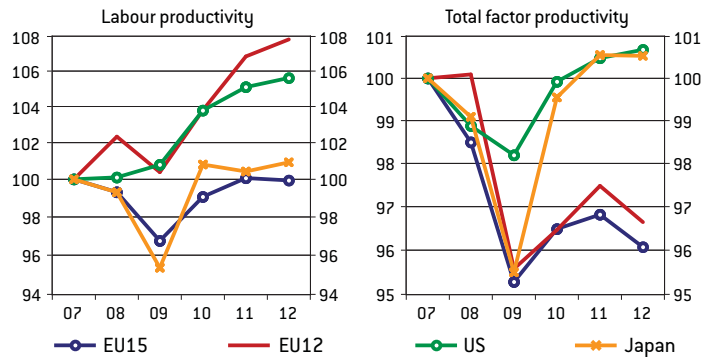


Inefficiency of public administrations, education levels and weak innovation performance have been additional impediments to growth². Most of the countries that joined the EU in 2004/2007 embarked on technological transfer-driven convergence³.

Since 2007, the EU15 has taken a productivity holiday, while productivity has increased rapidly in the US (Figure 3). In terms of total factor productivity, both the EU15 and EU12 lag behind Japan. Even economically stronger countries, such as Germany, lag behind the US, and the evolution in the United Kingdom does not differ markedly from that of continental economies. Some hard-hit countries, such as Ireland, Spain and Latvia, have apparently recorded outstanding labour productivity performances since 2007, but most of these gains have been due to compositional changes, such as the shrinkage of low-productivity construction and low value-added services, and the total factor productivity developments in these countries were weak⁴. In terms of productivity there have been very few truly good performers in the EU. Poland is one.

Labour hoarding can partly explain the initial response to the shock of the recession. Employment contracted by five percent between 2007 and 2010 in the US, while in several European countries the employment shock was of limited magnitude. Public policies, such as *Kurzarbeit*, a scheme financed by the German government to support part-time work and keep workers employed, were one factor behind this response. Firms also hoarded

Figure 3: Productivity developments, 2007-2012 (2007=100)



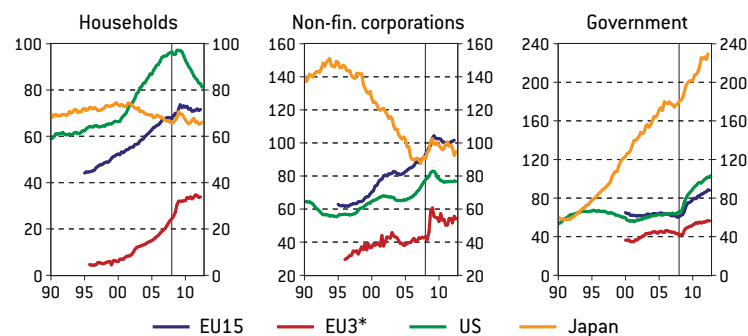
Source: Bruegel based on Conference Board TED database January 2013. EU15: EU members before 2004. EU12: EU members that joined in 2004 and 2007.

labour, expecting a rebound and thereby limiting the initial rise in unemployment. Five years on, however, the productivity setback has become permanent, contributing to lower potential output. This cannot be regarded as a cyclical phenomenon anymore. In the short run, weak productivity performance can be related to insufficient demand through the so-called productivity cycle. But the weak cyclical position of the economy cannot explain sustained poor productivity.

A number of structural factors have also contributed to weak productivity performance⁵:

- **Banking problems:** the increased cost and reduced availability of working capital limits investment and thereby the adoption of new technologies, and may lead to a shift toward more labour-intensive, but less-efficient production.
- **Low level of integration in the global value chain:** the complexity of firms' internationalisation strategies is related to productivity⁶. Countries that are more integrated into the global value chain, such as Germany and Poland, took advantage of global demand and thereby achieved better productivity performance than

Figure 4: Gross debt (% GDP), 1990Q1-2012Q3



Source: Bruegel based on data from Christian Dembiermont, Mathias Drehmann and Siriporn Muksakunratana (2013) 'How much does the private sector really borrow? A new database for total credit to the private nonfinancial sector', *BIS Quarterly Review*, March, pp 65-81 (private debt), Eurostat (public debt except for Japan, GDP and exchange rates), and McKinsey (public debt for Japan). Note: the vertical line corresponds to 2008Q3. * EU3: the aggregate of the Czech Republic, Hungary and Poland (data for other new member states is not available).

2. See Zachmann, Georg (2012) 'Smart choices for growth', *Policy Contribution 2012/21*, Bruegel.

3. See Becker, Torbjörn, Daniel Daianu, Zsolt Darvas, Vladimir Gligorov, Michael A. Landesmann, Pavle Petrovic, Jean Pisani-Ferry, Dariusz K. Rosati, André Sapir and Beatrice Weder di Mauro (2010) *Whither growth in central and eastern Europe? Policy lessons for an integrated Europe*, Blueprint Volume XI, Bruegel.

4. See Darvas, Zsolt (2012) 'Compositional effects on productivity, labour cost and export adjustments', *Policy Contribution 2012/11*, Bruegel.

5. See eg Bank of England (2012) *Inflation Report*, November, p33.

6. See Altomonte, Carlo and Gianmarco Ottaviano (2011) 'The role of international production sharing in EU productivity and competitiveness', *EIB Papers* vol 16 no.1.



more inward looking countries, such as the UK and Spain.

- **Pro-cyclicality of business research and development expenditures:** the lingering crisis reduces the pace of innovation and companies' adoption of more innovative technologies, which weakens business investment, and thereby reduces the productivity increase.
- **Impediments to reallocation across sectors and between firms:** dysfunctional financial systems hamper productivity-enhancing restructuring, while obstacles arising from labour, capital market and bankruptcy regulations weigh more heavily in a time of profound change.
- **Uncertain macroeconomic and financial outlook** can also make companies cautious about investing, thereby gradually eroding productivity.

ued (Figure 4). Household and corporate indebtedness increased substantially, while public debt was rather stable or even declining slightly⁷.

Since the beginning of the crisis, private debt deleveraging in Europe has proved slower than in the US. In the aftermath of the Great Recession, Europe put the emphasis on fiscal 'exit strategies', overlooking private debt problems. Corporate and household debt has continued to increase as a share of GDP. In the US, household debt has sharply reduced and corporate debt has stabilised. Whereas public debt has increased more in the US than in Europe since 2007, total debt (excluding the financial sector) has increased markedly less. The US is therefore ahead of Europe in the aggregate deleveraging process. In Japan, meanwhile, private debt has remained stable and the whole of the increase in total debt has come from the government sector.

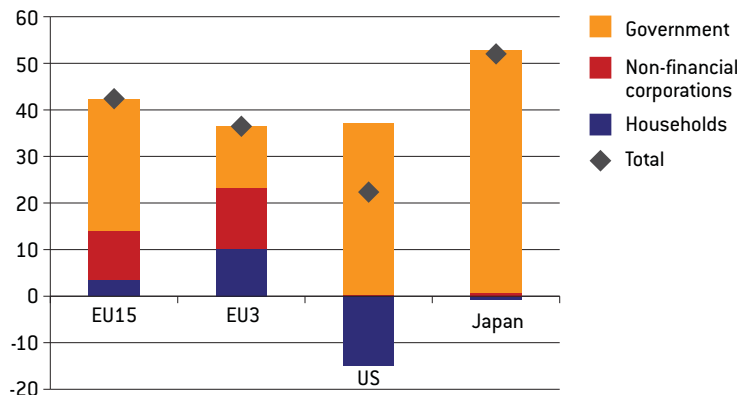
A combination of factors is responsible for this outcome:

- **Lower profitability of the corporate sector in part of Europe,** which has made it dependent on borrowing;
- **Different bankruptcy laws and procedures.** Household debt in the US was significantly reduced through personal bankruptcies⁸.
- **More expensive financing conditions in part of Europe,** especially southern euro-area countries, and bank weakness leading them to continue extending credit to weak firms in order to avoid the realisation of losses (a process known as 'zombification')
- **Lower nominal GDP growth,** in part as a consequence of more aggressive budgetary consolidation against the background of a still-weak private economy.

THE DELEVERAGING PROBLEM

In the run-up to the crisis, private sector debt increased substantially in the EU and the US, while in Japan the deleveraging process that started in the 1990s contin-

Figure 5: Change in gross debt (in % of GDP) from 2007Q4 to 2012Q3



Source: Bruegel based on BIS, Eurostat, McKinsey. Note: EU3 is the aggregate of the Czech Republic, Hungary and Poland (data for the other new member states is not available). We do not show data on financial corporations, because an increase/decrease in their gross debt can indicate increased/decreased lending activities.

THE BANKING PROBLEM

Financial intermediation is of central importance for growth. Ample international experience indicates that the growth of an economy is negatively affected by a weak financial system. The case of Japan illustrates that a combination of banking problems and debt overhang in the corporate sector can have long-lasting negative consequences for growth.

Financial intermediation in Europe remains centred on the banks, although there is some evidence of a gradual and slow shift to capital markets⁹. Although transformation of the financial system towards a greater share of capital-market based intermediation is likely to be a long-term trend that will have profound implications for Europe's economy, in the short

7. See Ruscher, Eric and Guntram B. Wolff (2012) 'Corporate balance sheet adjustment, stylized facts, causes and consequences', Working Paper 2012/03, Bruegel.

8. The Economist (2012) 'The hangover. America is recovering from the debt bust faster than European countries. Why?', 21 January, <http://www.economist.com/node/21543139>.

9. Darvas, Zsolt (2013) 'Can Europe recover without credit?', Policy Contribution 2013/03, Bruegel, and ECB (2013) Monthly Bulletin March, p45, documents the substitution effect with MFI loans growing at a very subdued rate or even shrinking since 2009, and debt securities growing in volume at a higher rate than before 2009.



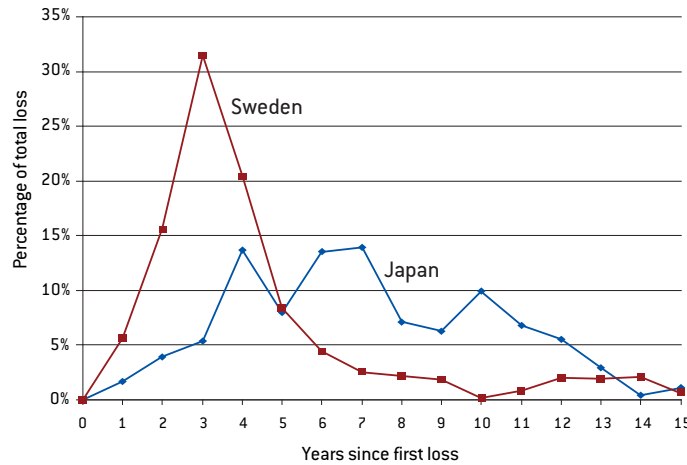
term bank-based financial intermediation remains of central importance given its large base.

Bank-based credit growth in the majority of EU countries has been weak since 2008. The statistics for the euro area paint a picture of very subdued credit growth. The year-on-year growth rate of euro-area credit has not exceeded two percent, compared to the pre-crisis 10 percent. In the UK, bank-based credit declined, while in Poland and Romania credit growth slowed down in 2009/10, but significantly accelerated afterwards. The European numbers compare with more robust credit growth in the US, which has bounced back to five percent annual growth.

Credit growth is particularly weak in the south of Europe. Demand for credit is weak, reflecting the economic outlook and subdued business confidence. Lending conditions in countries under stress remain tight and the supply of credit limited. Also, writing-down bad loans reduces credit aggregates. The European Central Bank continues to stress that despite an improvement in the monetary transmission mechanism, monetary policy action does not get properly transmitted to all euro-area countries, and this impairs the provision of credit to the real economy.

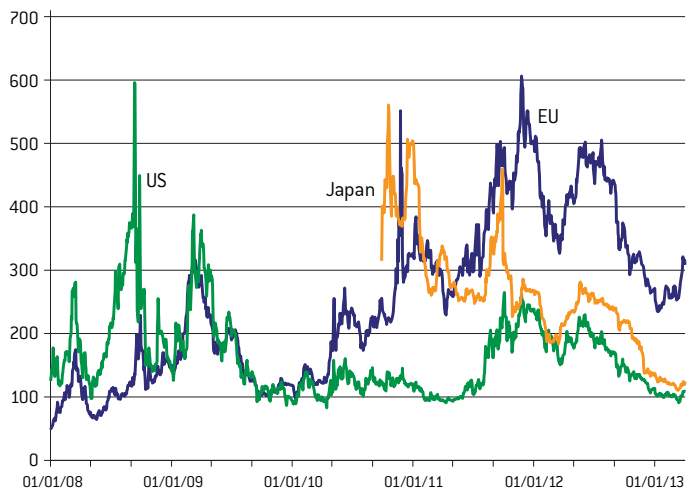
Speedy resolution of banking problems is an important condition for growth to resume. The past experience of Sweden and Japan illustrates the benefits of speedy action (Figure 6)¹⁰. During the current crisis, in the US, significant bank restructuring occurred relatively early in the crisis.

Figure 6: Distribution of bank losses in the Japanese and Swedish banking crises in the early 1990s



Source: Jean Pisani-Ferry and Bruno van Pottelsberghe (2009) 'Handle with care! Post-crisis growth in the EU', *Policy Brief* 2009/02, Bruegel.

Figure 7: Bank 5-year credit default swap (CDS) spread, 1 January 2008 – 2 April 2013



Source: Datastream.

Banks with weak balance sheets that lend on too-expensive terms or lend to insolvent borrowers to keep them afloat are a drag on growth. In year five of the crisis, Europe's banking system remains fragile. About a fourth of the European banking system is still under state aid control and depends on public support¹¹, whereas banks have long since regained independence in the US. Risk premia paid by banks are significantly higher in Europe than in

Japan and the US (Figure 7).

THE PRICE MISALIGNMENT AND CAPITAL MISALLOCATION PROBLEM IN THE EURO AREA¹²

Excessive housing booms have distorted prices and wages and led to the misallocation of capital in a number of EU countries, as exemplified by construction booms and the unsustainably high share in the economy of the construction sector prior to the

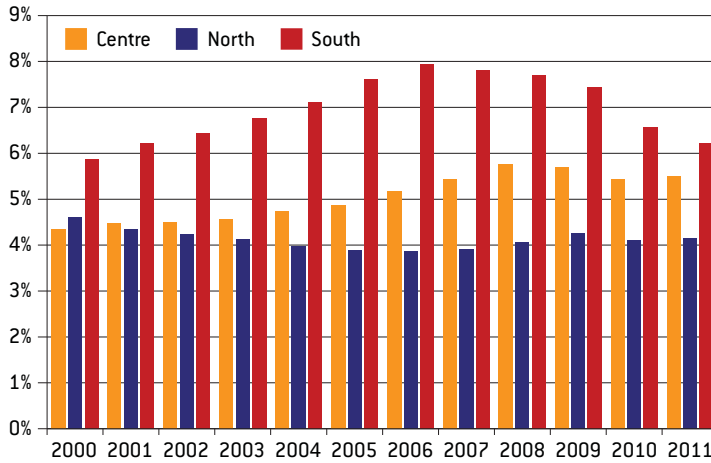
10. Speedy restructuring in Sweden fostered economic adjustment and productivity growth, while in Japan the 'zombification' of banks contributed to a decade of stagflation during which productivity hardly improved.

11. European Commission, 'EU state aid control and financial stability', presentation at Bruegel workshop, 8 March 2013.

12. There were similar developments to the southern euro-area countries in the Baltic states, and there was a rapid adjustment, but at a very high price. See Blanchard (2012) 'Lessons from Latvia', *IMF Direct*: <http://blog-imfdirect.imf.org/2012/06/11/lessons-from-latvia/>.

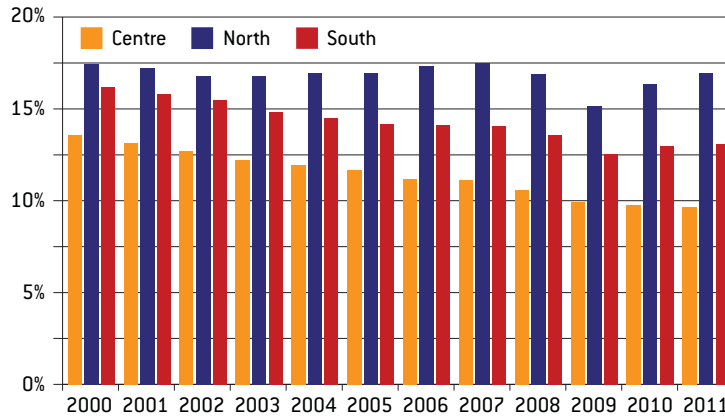


Figure 8: Share of construction in total value added, euro-area countries



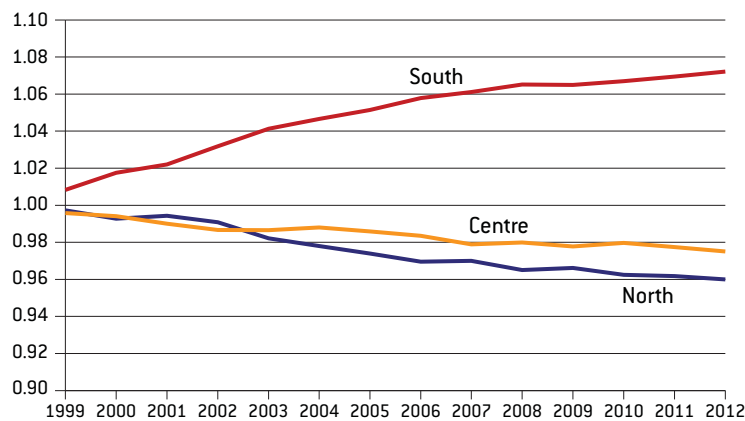
Source: Bruegel based on Eurostat data. The three groups are North (Austria, Finland, Germany, Netherlands), Centre (Belgium and France) and South (Greece, Ireland, Italy, Portugal, Spain). These groups result from a systematic analysis based on an array of indicators.

Figure 9: Manufacturing, share in total value added of country group



Source: Bruegel based on Eurostat data. See note to Figure 8 for breakdown of country groups.

Figure 10: Harmonised Index of Consumer Prices, cumulative deviation with respect to the euro area since 1998



Source: Bruegel based on Eurostat data. See note to Figure 8 for breakdown of country groups.

recession. In such conditions output had grown above potential and was bound to adjust downward (Figure 8).

At the same time, the share of manufacturing declined significantly in the south of Europe, and also in France, while in the north of Europe, the manufacturing share was relatively stable (Figure 9).

In the euro area, the process was accompanied by a major distortion in relative prices (Figure 10). The real exchange rate of all southern euro-area members became overvalued, while it became undervalued in most northern members. Since euro-area members do not have stand-alone exchange rates, only intra-euro area adjustment can correct for these divergences.

Adjustment has started, but progress is too slow. The good news is that the export performance of eg Ireland, Spain and Portugal is outstanding. The external indebtedness of these countries is so high that further improvement in the trade balance is needed to achieve external sustainability. Price adjustment has started in several countries, but the inflation rate in Italy, a country that also needs sectoral reallocation toward the tradable sector to revive growth, remains above the euro-area average. At the same time, the inflation rate in Germany has remained low and is expected to remain below the average. Major differences in labour market conditions translate only slowly into inflation differentials. Relative wages have started to adjust, but prices exhibit rigidity.



Without the relative price adjustment, the necessary reallocation of economic activities toward the tradable sector in the south will not take place. Without a symmetric enough adjustment, meaning inflation in the euro area is at two percent with higher-than two percent inflation in Germany and other surplus countries and close to zero inflation in the south, the south will need to deflate. That would endanger both private and public debt deleveraging, putting debt sustainability at risk and delaying the recovery even further.

CONCLUSIONS

Europe's long-term growth strategy has so far failed. Various initiatives have been unable to increase the growth potential of the EU15. EU12 members have on average performed better, but their futures will crucially depend on the EU15 because of the EU's financial and trade integration.

This failure is now compounded by a danger that the short- to medium-term challenges will interact perversely with the longer term ones and lastingly weigh on Europe's performance. Much of Europe suffers from a mutually reinforcing interaction between limited productivity gains, protracted deleveraging, weak banking sectors and distorted relative prices. This combination contributes to an overall weakening of economic growth and threatens to turn into self-perpetuating stagnation. This dark picture calls for bold policy action significantly beyond what is currently being undertaken.

Policy action should comprehensively address all four aspects of

the problem. But the quest for growth is elusive. Growth policies are by nature difficult to encapsulate in a few recommendations. So the following suggestions are in no way exhaustive.

The sequencing of policy action is important. Without credit, investment and growth, any structural reform is likely to fall victim to popular rejection. If fiscal retrenchment does not deliver results, support for it will vanish. Therefore, the strengthening of banking systems and the recognition of bad loans should be prioritised in order to create conditions for a resumption of private-led demand. Relative price and wage adjustment and structural reforms should also be pursued, but are unlikely to deliver immediately, in particular in the absence of growth.

The most urgent priority is therefore restoring a fully functional financial system, which is a precondition for the resumption of productivity and growth. Europe for too long has refused to recognise this. The forthcoming introduction of the Single Supervisory Mechanism (SSM) offers a unique opportunity to complete the strengthening of the European banking system. Before the ECB carries out the 'comprehensive assessment' of the banks brought under its supervision, national authorities should trigger a recapitalisation of undercapitalised banks and a resolution of insolvent ones. The ECB should make clear that it will not

accept undercapitalised banks for the single supervisory system. Countries outside the SSM should also revitalise their domestic banks. The European Commission should encourage governments to bear the fiscal costs if necessary by announcing that deficit increases from public recapitalisations carried out until end-2013 will be treated as one-off costs within the framework of the Excessive Deficit Procedure.

Negotiations for the Bank Resolution and Recovery Directive should be urgently completed to achieve a level playing field. It is important that cross-country differences in banking resolution are minimised to avoid a major fragmentation of the single market.

The establishment of a banking union is one of the most important projects to re-establish growth in the euro area and beyond. It will greatly contribute to repairing monetary policy transmission in the euro area. It needs to involve all key elements beyond supervision (centralised resolution mechanism and an appropriate common fiscal backstop) that are under discussion. Banks that have passed the ECB's comprehensive assessment should be brought under the banking union and become truly European banks with clearly defined burden-sharing arrangements.

Fostering the reallocation of factors to the most productive firms and the sectors that contribute to

'Europe's long-term growth strategy has so far failed; various initiatives have not increased the growth potential of the EU15.'



aggregate rebalancing is vital for productivity and growth. This involves bolder monetary action in combination with targeted fiscal support. As banks may choose not to lend to SMEs because loans are subject to significant haircuts when taken as collateral in central bank repo operations, there is a case for providing support to the enhancement of this collateral. In the euro area, the ECB cannot carry that fiscal risk. Instead, temporary collateral enhancement schemes should be explored, for example, in liaison with the European Investment Bank (EIB). Furthermore, EIB facilities should also be used to support credit, in particular for SMEs. Better access to finance for SMEs would greatly help the creation of new employment in the export sector.

Appropriate speed of fiscal adjustment is paramount. The speed of fiscal adjustment needs to be adapted to the context of stagnating economies throughout the EU. This is especially a concern where households and firms are still in the process of deleveraging. At the same time, it is important to ensure the maximum credibility of the medium-term consolidation process. To this end, the new European fiscal framework should be mobilised in full so that commitments to future fiscal consoli-

dation are made adequately specific and credible, and emphasis should be put on structural measures with a lasting medium-term impact. Pension reforms are one way of credibly increasing debt sustainability allowing for a slower fiscal consolidation path.

A frontloaded payment of EU funds to countries in deep recession as well as additional EIB capital to promote growth initiatives is warranted. The fiscal retrenchment in the south of Europe in particular is likely to further dampen economic activity and increase social hardship undermining economic and political stability. Frontloaded payments from EU funds, as well as EU-supported investments, will help address demand weaknesses due to fiscal adjustment and private sector deleveraging.

Addressing intra-euro area competitiveness divergences is essential to support growth in southern Europe. Wage rebalancing should involve northern Europe as well as southern Europe. Consistent with the ECB mandate, average inflation in the euro area should not be allowed to fall below the two percent target and northern Europe should refrain from domestic policy action that would prevent domestic inflation from rising

above two percent, as long as euro-area price stability remains ensured.

Last but not least, pro-growth reforms are of central importance to increase long-term productivity, and need to be continued vigorously throughout the EU. The EU should provide incentives to address weaknesses in product, labour and capital markets, and for the building-up of skills. To this end, the EU should explore new approaches, including contractual budgetary support within the framework of sector-specific initiatives.

Europe's growth problem does not result from a single set of challenges. It involves the supply and the demand sides; real- and financial-sector issues; and private and public-sector aspects. The EU is used to policymaking by rules and procedures. This is fine in normal times, but it is not the right approach to address the current quagmire. It is not by adding a new layer of procedures that this problem will be solved. It is by formulating a diagnosis, setting priorities, formulating a strategy and implementing it across policy areas.

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'The speed of fiscal adjustment needs to be adapted to the context of stagnating economies throughout the EU.'

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