



Growth in the Eurozone: Cyclical Upswing or Structural Improvement?

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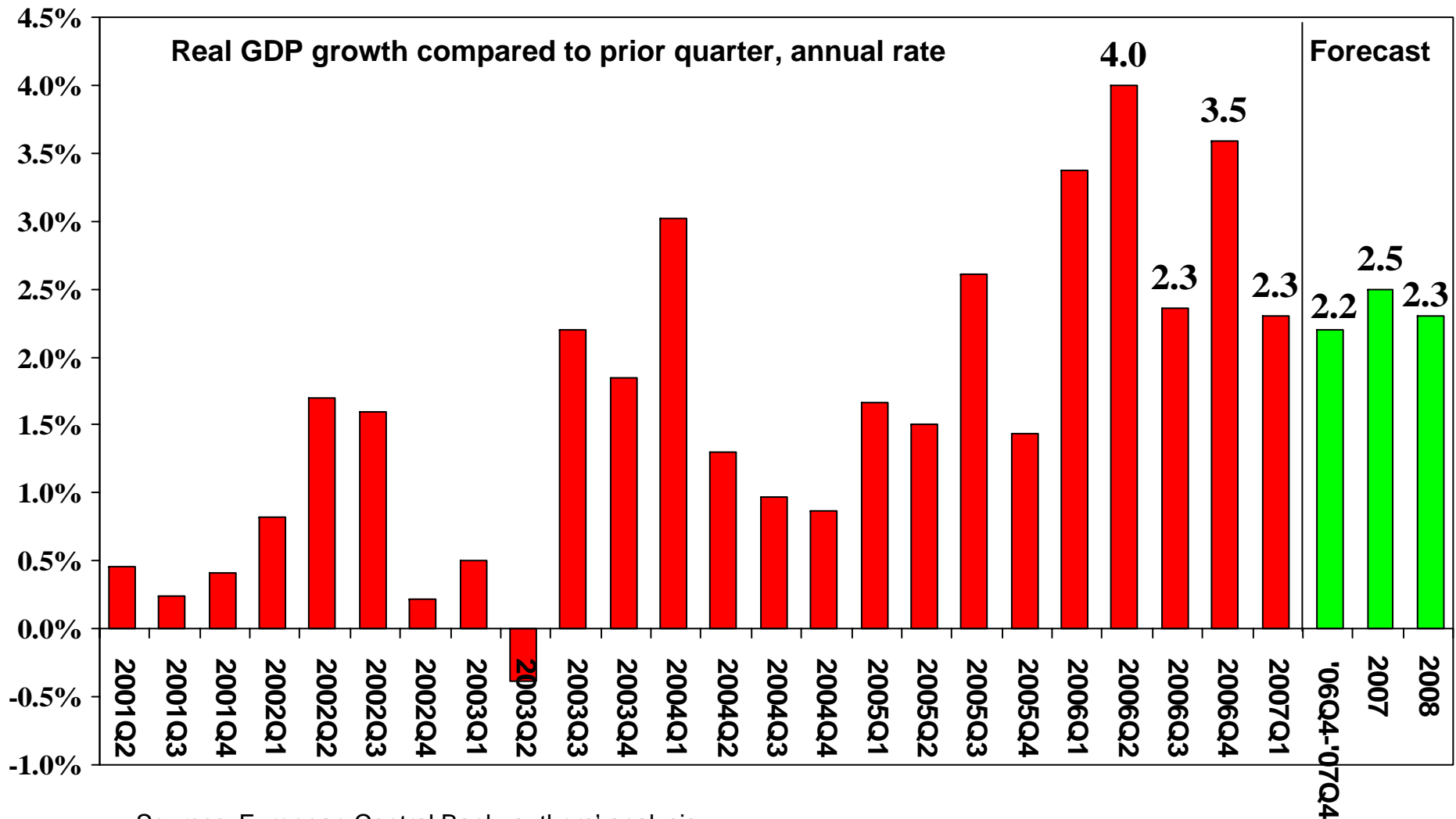
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Faster growth has improved the economic outlook in the eurozone.



Have reforms triggered faster trend growth or are we seeing only a cyclical upturn?



- Reforms would produce faster growth for a several years if any of the following happened: 1) Trend productivity growth increased; 2) Trend labor force participation increased; 3) The nonaccelerating inflation rate of unemployment (NAIRU) fell—lower unemployment rate without inflation pressure.
- One way to see if things have changed is to estimate potential GDP growth. Potential GDP is a measure of trend or the economy's supply. Structural reforms that boost productivity or labor supply growth should increase potential GDP growth.
- One way to estimate potential GDP growth is Okun's law, which says that the unemployment rate will fall when actual GDP growth is faster than potential GDP growth.

Change in unemployment = Okun coefficient x (potential GDP growth – actual GDP growth)

Currently 0.5 for the United States, according to Robert Gordon.

Build in the effect of a time lag, one- to three- quarters.

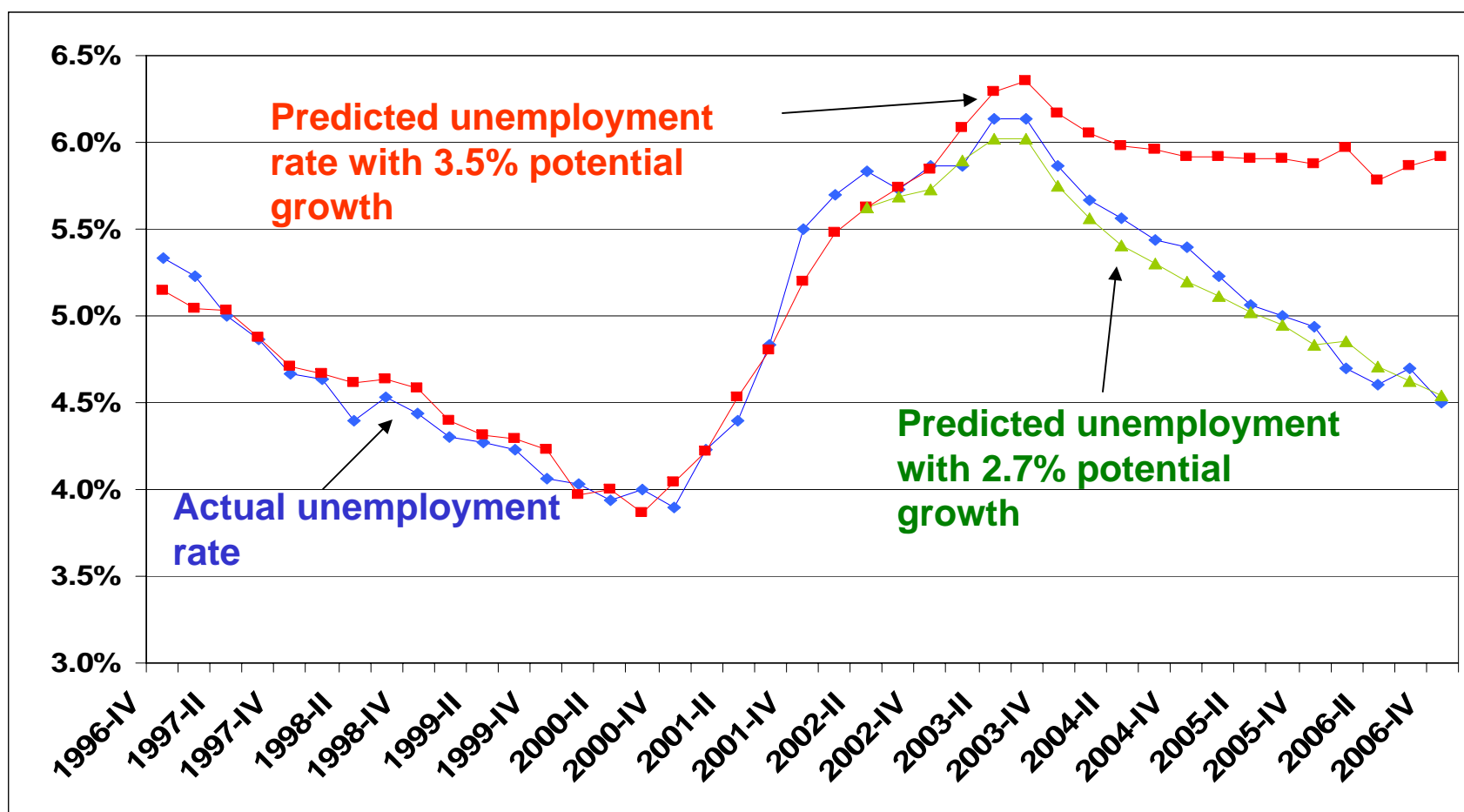
Cyclical or structural?

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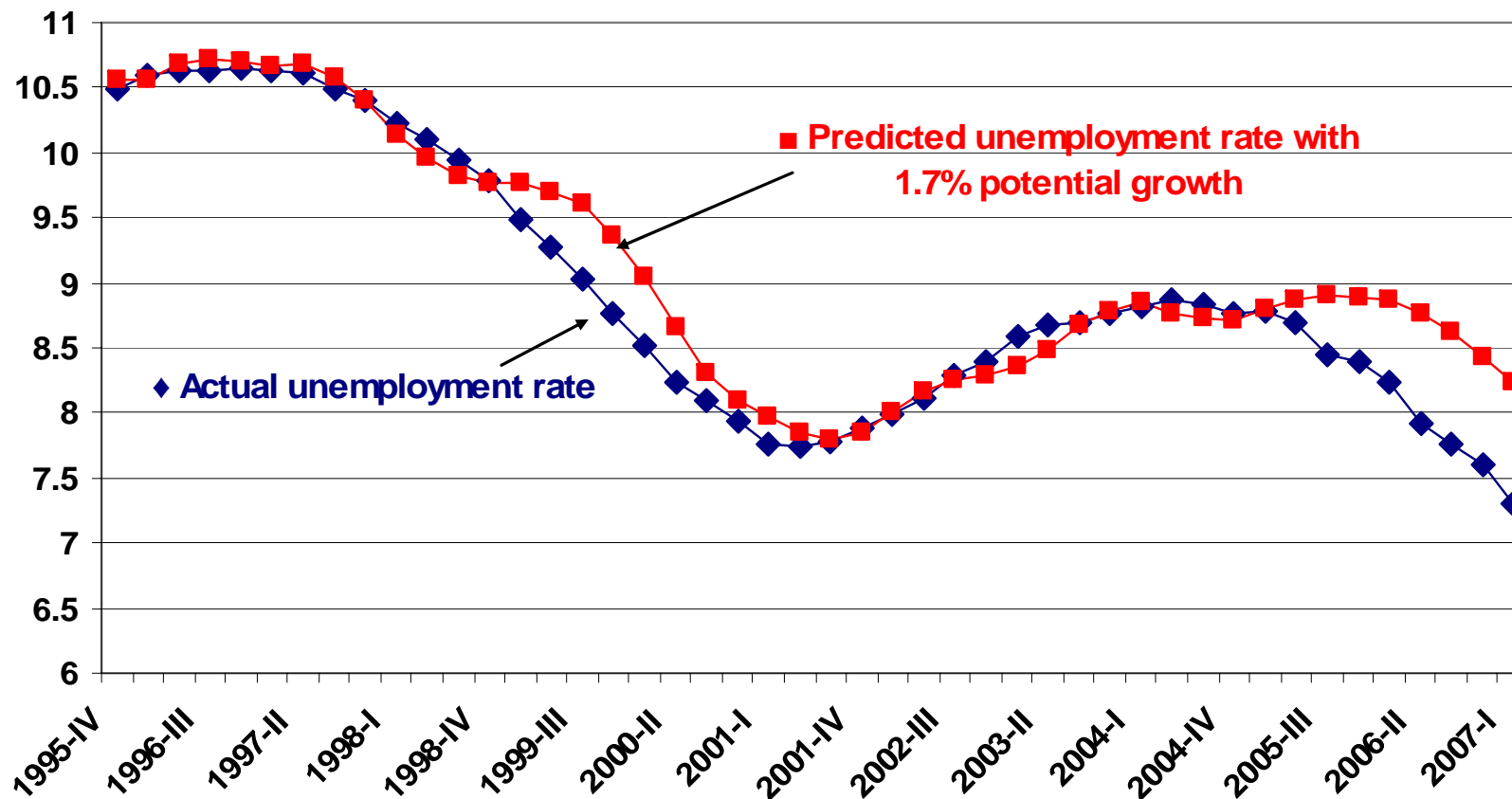
- Potential GDP growth is the sum of trend GDP per hour growth (productivity) and trend hours growth. This can be used to interpret an Okun's law estimate or as a way of making an alternative estimate—informally or by using a production function based model.
- A final way to estimate potential is to use an econometric technique of filtering (Hodrick-Prescott or Kalman).
- Policymakers can allow GDP to grow faster than potential GDP if there is slack in the economy and inflation is at or below its target level. In Europe, past estimates for the NAIRU have been very high, but if labor market reforms have lowered the NAIRU, then a cyclical recovery can proceed longer before being inflation-limited. Is there any evidence for this?

In the United States, strong productivity growth and labor force growth in the '90s resulted in potential GDP growth of 3½ percent. Okun's law now suggests potential growth has dropped below 3 percent—consistent with what other forecasters are saying.



Sources: Bureau of Labor Statistics; Bureau of Economic Analysis, authors' analysis.

In the eurozone, unemployment tracks real GDP growth through 2005 and then goes off track. Either potential GDP growth has dropped, the Okun coefficient has increased, or both. (The best fit for the full period is Okun coefficient of 0.5 [same as United States] and potential growth of 1.7%.)



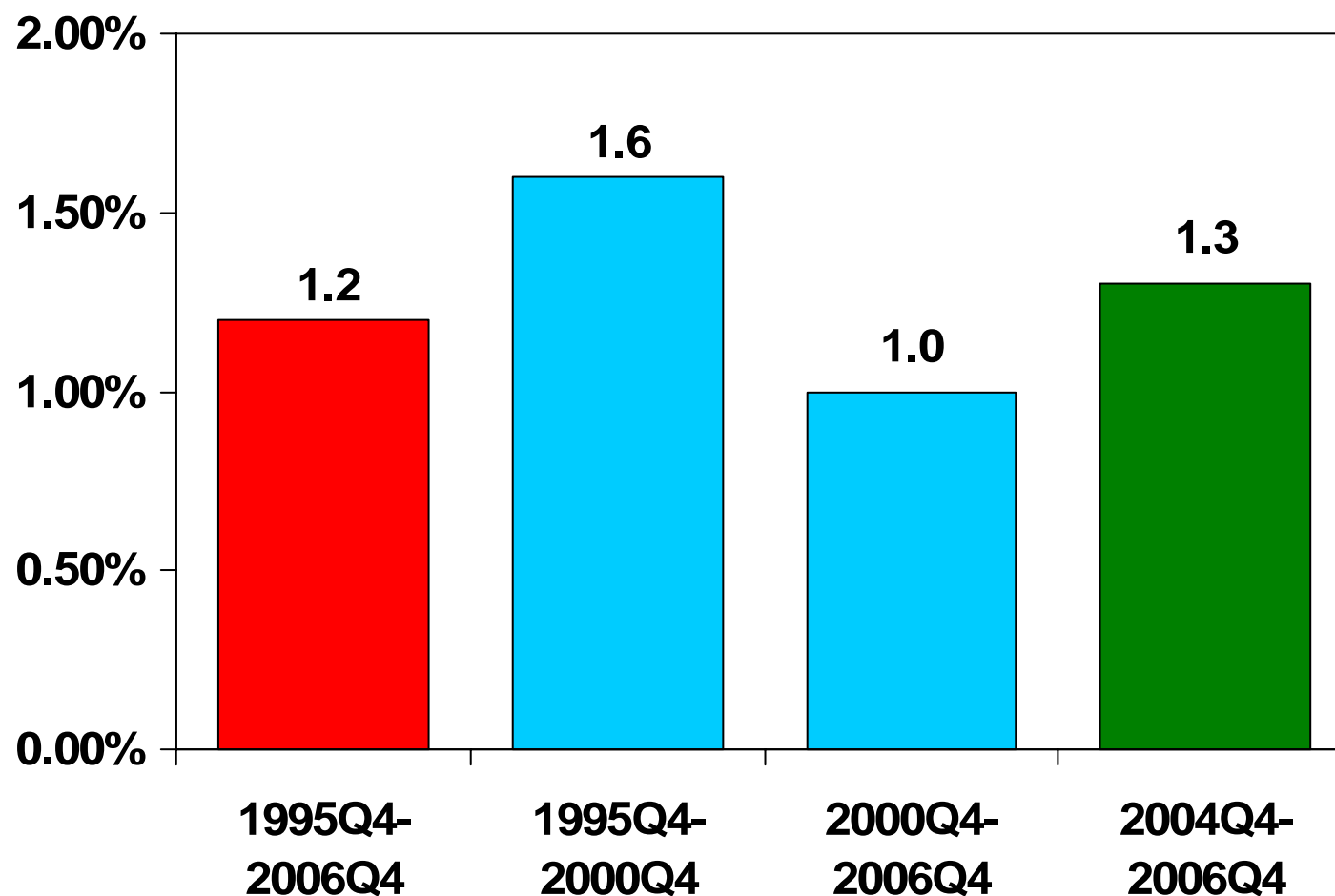
Sources: European Central Bank; European Commission; authors' analysis.

What is causing Okun's law to go off track?

- Unemployment fell by about 0.16 percentage points per quarter on average from the fourth quarter of 1996 to the second quarter of 2001. Unemployment fell by just under 0.16 percentage points per quarter from the second quarter of 2004 to the “present” (fourth quarter of 2006)—about the same rate.
- Employment grew slightly faster in the second period. The labor force grew faster in the second period.
- The big difference is real GDP grew about 35 percent faster in the first period. Hence the answer looks like low productivity growth is causing Okun's law to go off track.

Trend productivity growth has slowed. The pick up in the past couple of years looks cyclical.

Productivity growth in the eurozone (GDP per hour)

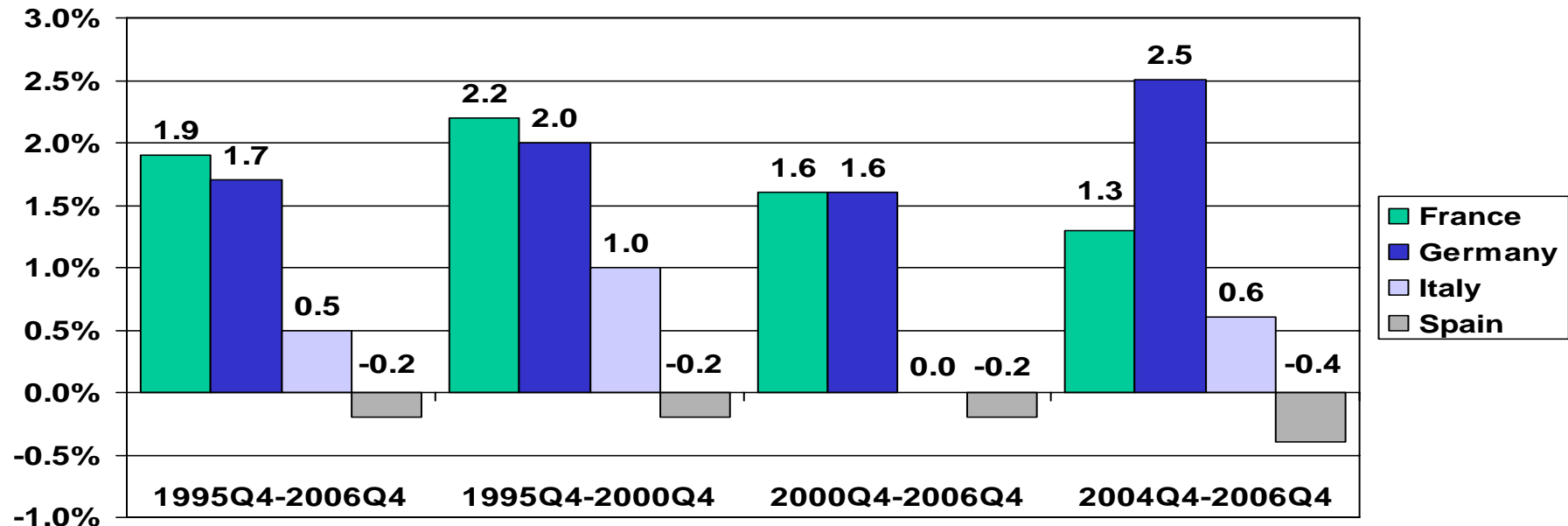


Sources: European Central Bank; Groningen database; authors' calculations.

Why the weakness in productivity in Europe?

- The development of the single market has generated productivity benefits in specific industries, but not widely. Corporate restructuring and private equity are helping, but not enough.
- The benefits of reform take time (US reforms in '70s and '80s and productivity growth in the '90s).
- Several people argued that the high level of labor productivity in France and West Germany was in part the result of the exclusion of low-productivity jobs (Bank of France; Baily and Kirkegaard; McKinsey). If so, then as employment increases, there will be some downward pressure on productivity—not a bad thing.
- Bart van Ark and his coauthors point to information technology (IT) use. IT may be a factor, but the key driver is competitive pressure, which encourages innovation, adoption, and effective IT use.

There are substantial differences in productivity growth among the big four.



Source: European Central Bank.

- Productivity performance is much better in France and Germany: higher level, faster growth.
- France, Germany, and Italy all see slower growth after 2000, especially Italy. All three go off track on Okun’s law.
- Spain: lowest level and slow decline the entire period.

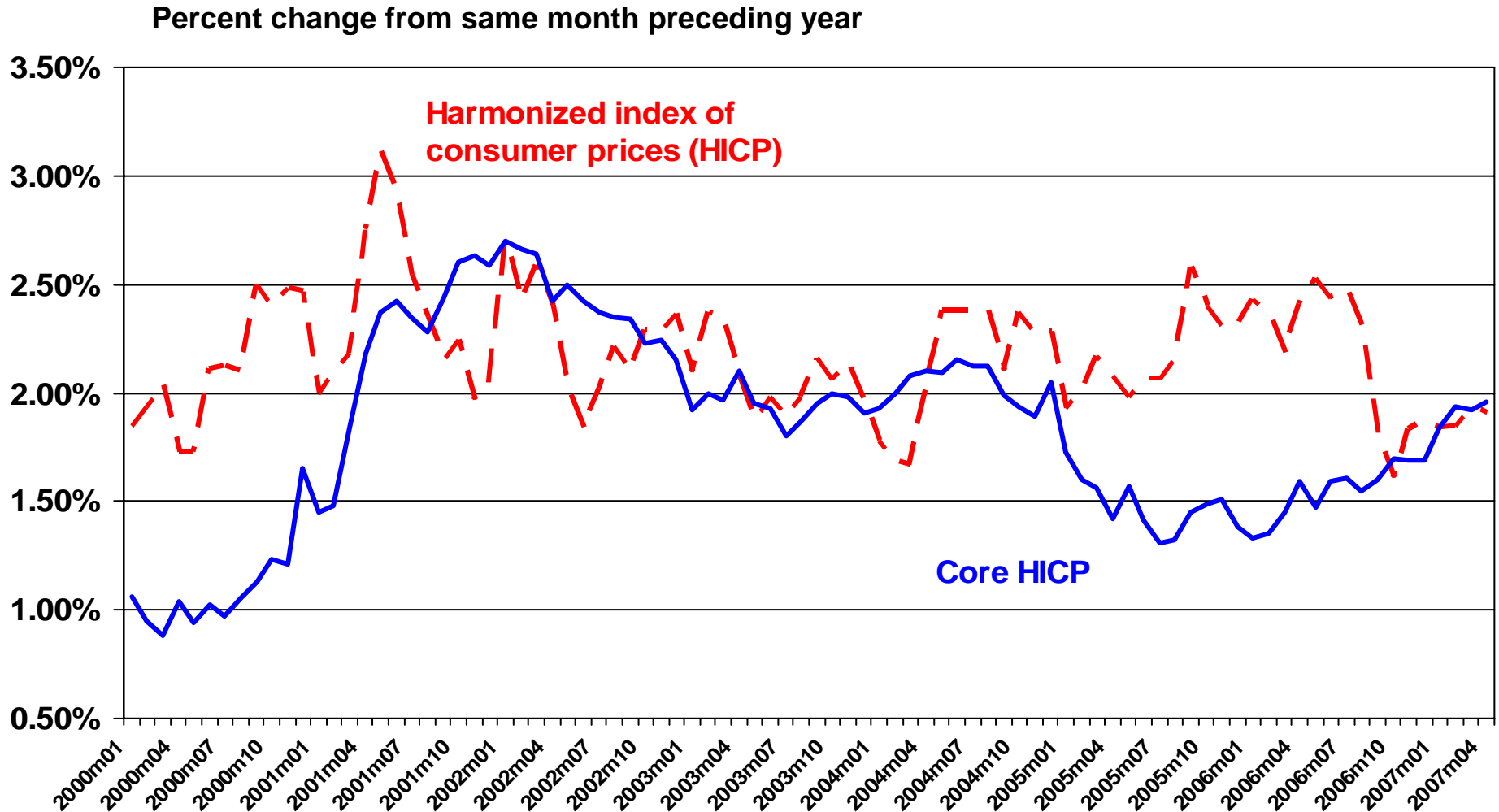
Why has Germany done so well in the past few years?

- Germany entered the euro at an exchange rate that, arguably, made it uncompetitive.
- The German manufacturing sector responded by holding down wage increases and restructuring to improve productivity. From 2002–05 manufacturing productivity grew by 4.1 percent a year, while compensation grew by 3.2 percent, so unit labor costs fell.
- In contrast, manufacturing productivity in the eurozone increased at 2.5 percent a year, and compensation grew at 3.9 percent (the gap to the non-Germany eurozone would be even greater).
- In addition, world GDP is booming, and German capital goods and cars are in great demand.

Conclusion on Potential Growth

- **The European Central Bank (ECB) staff** uses the H-P filter approach and estimates potential growth currently at 2.25 percent. This is probably too high, reflecting the fact that filter techniques are too sensitive to recent growth rates. ECB decisions do not seem consistent with such a high estimate.
- **Based on productivity plus hours growth:** The trend of GDP per hour seems to be in the range 1 to 1¼ percent, possibly lower. With a trend of hours at ½ to 1 percent, that puts potential growth at 1.5 to 2.0.
- **Based on Okun's law:** Over the last decade: 1.7 percent—right in the above range. The rapid decline in unemployment with modest real GDP growth over the past couple of years indicates potential growth could be lower.

Any sign of a decline in the NAIRU? Not yet. The core rate of inflation rises once unemployment drops below about 8 percent—2001 and 2006.



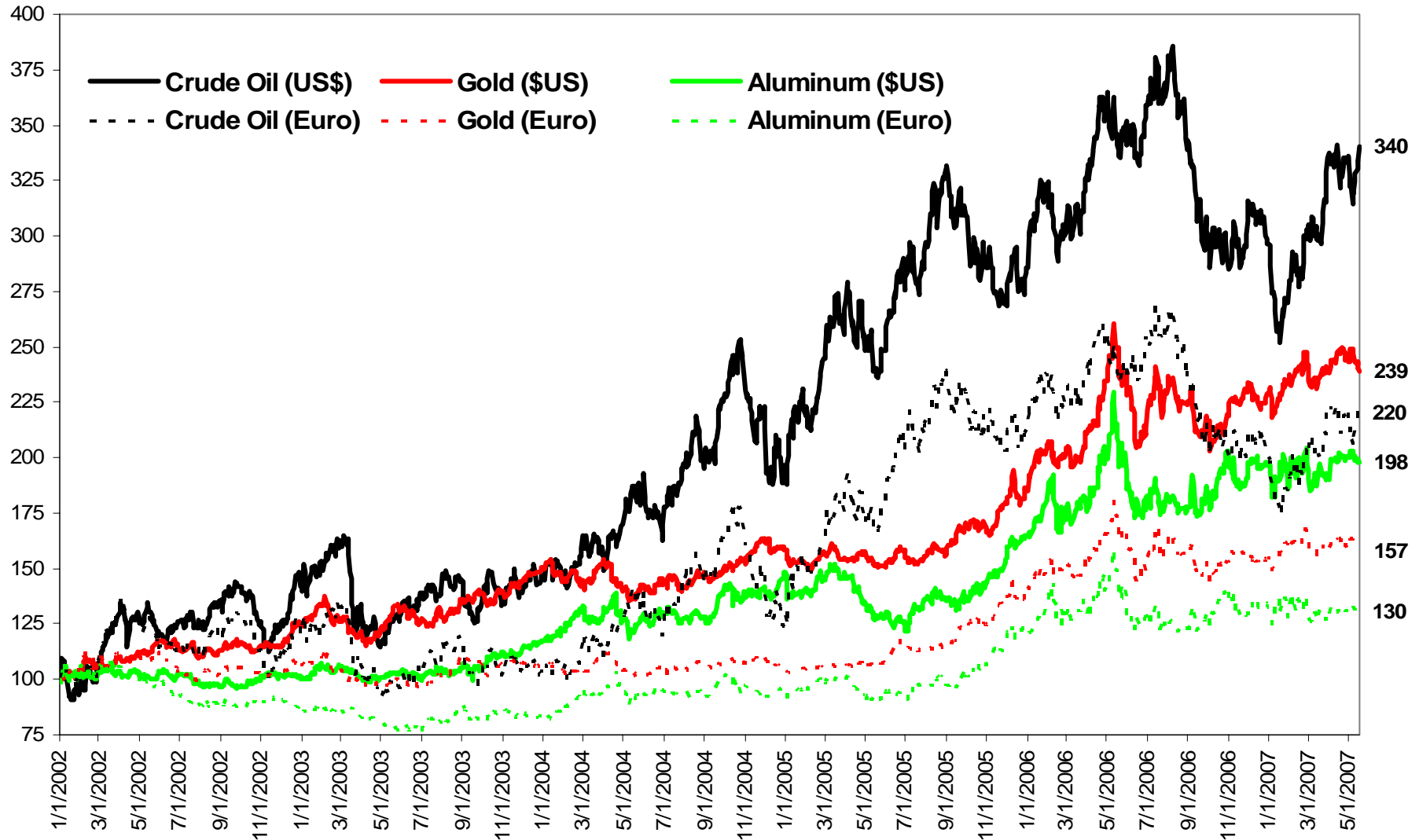
Source: European Commission.

The rising euro has mitigated the impact of commodity price increases.

Solid lines = dollar prices; dotted lines = euro prices



Commodity prices in \$/euros, 2002-present



Source: Datastream.

Product markets: What reforms have we seen in Europe? What is still needed?



Germany: *Very limited reforms so far:* 1) opening hours liberalized and decentralized (given to states to decide); **2)** independent network industry regulator (less industry self-regulation, but no separation of production and transmission); **3)** gradually reduced government role in banking sector.

***Still needed reforms:* 1)** economic/consumer consideration primacy in more forceful competition policy enforcement; **2)** land-use reform; **3)** government (all levels) exit from private, especially financial, sector; **4)** business upstart reforms.

France: *Very limited reforms so far:* 1) continued gradual privatization of network state-owned enterprises (SOE); **2)** some improvement in competition policy enforcement; **3)** improved business start-up conditions (one-stop shops).

***Still needed reforms:* 1)** end of “national champion/incumbent protection” philosophy (real losers are French upstarts denied growth opportunities); **2)** professional services regulation liberalization; **3)** continued government exit from production sectors; **4)** continued liberalization of utilities and transport sectors.

Product markets: What reforms have we seen in Europe? What is still needed?



Italy: *Some reform progress:* **1)** 2006 Bersani laws introduce liberalization to law profession, bakeries, pharmacies, motor vehicle insurance, banking (Bank of Italy change of policies, too), and taxi drivers; **2)** improvement in Italy's introduction of EU/internal market Legislation under Prodi government; **3)** ongoing liberalization of energy sectors.

Still needed reforms: **1)** continued government exit from productive sectors; **2)** economic/consumer consideration primacy in more forceful competition policy enforcement; **3)** land-use reform; **4)** continued professional services liberalization.

Spain: *Very limited reform so far:* **1)** Some liberalization in postal and rail transport; **2)** re-emergence of "national champion orientation," especially in energy; **3)** New Competition Commission established.

Still needed reforms: **1)** economic/consumer consideration primacy in more forceful competition policy enforcement; **2)** professional services liberalization; **3)** business upstart reforms.

Labor markets: What reforms have we seen in Europe? What is still needed?



Germany: Major reforms: **1)** Hartz laws: shortened duration of unemployment benefits and cut level; EPL threshold raised to (still low) 10 employees; job search requirements tightened for unemployed; **2)** Federal Employment Agency/ALMP reformed; **3)** rise in temporary work agencies.

Still needed reforms: **1)** relaxation of EPL for core workers; **2)** lowering of social contributions; **3)** ending practice of job guarantees in exchange for wage restraint.

France: Very limited reforms seen: **1)** 35 hour work week more flexible; **2)** new flexible contracts for small and medium enterprises (SME) and peripheral workers (not youth); **3)** Employment Agency/ALMP reformed.

Still needed reforms: **1)** relaxation of EPL for core workers (or a single more flexible employment contract); **2)** lowering of social contributions; **3)** reform of union “legal rights of representation.”

Labor markets: What reforms have we seen in Europe? What is still needed?



Italy: Limited reforms seen: **1)** Biagi Law reforms the labor market periphery, i.e., temporary work (*lavoro intermittente*), job-sharing (*lavoro ripartito*), multiple jobs (*lavoro accessorio*), staff leasing, apprenticeship/training contracts, and part-time work.

Still needed reforms: **1)** relaxation of EPL for core workers; **2)** lowering of social contributions; **3)** measures to improve female labor force participation.

Spain: Limited reforms seen (but continued catch-up):

1) reforms aimed at reducing temporary employment and increasing permanent employment via government incentives; **2)** reduced social contributions for converting temporary into permanent contracts.

Still needed reforms: **1)** relaxation of EPL for core workers; **2)** lowering of social contributions; **3)** measures to improve female labor force participation; **4)** increase flexibility in collective bargain system.

Europe needs to raise productivity growth: European successes show that reform can boost productivity.



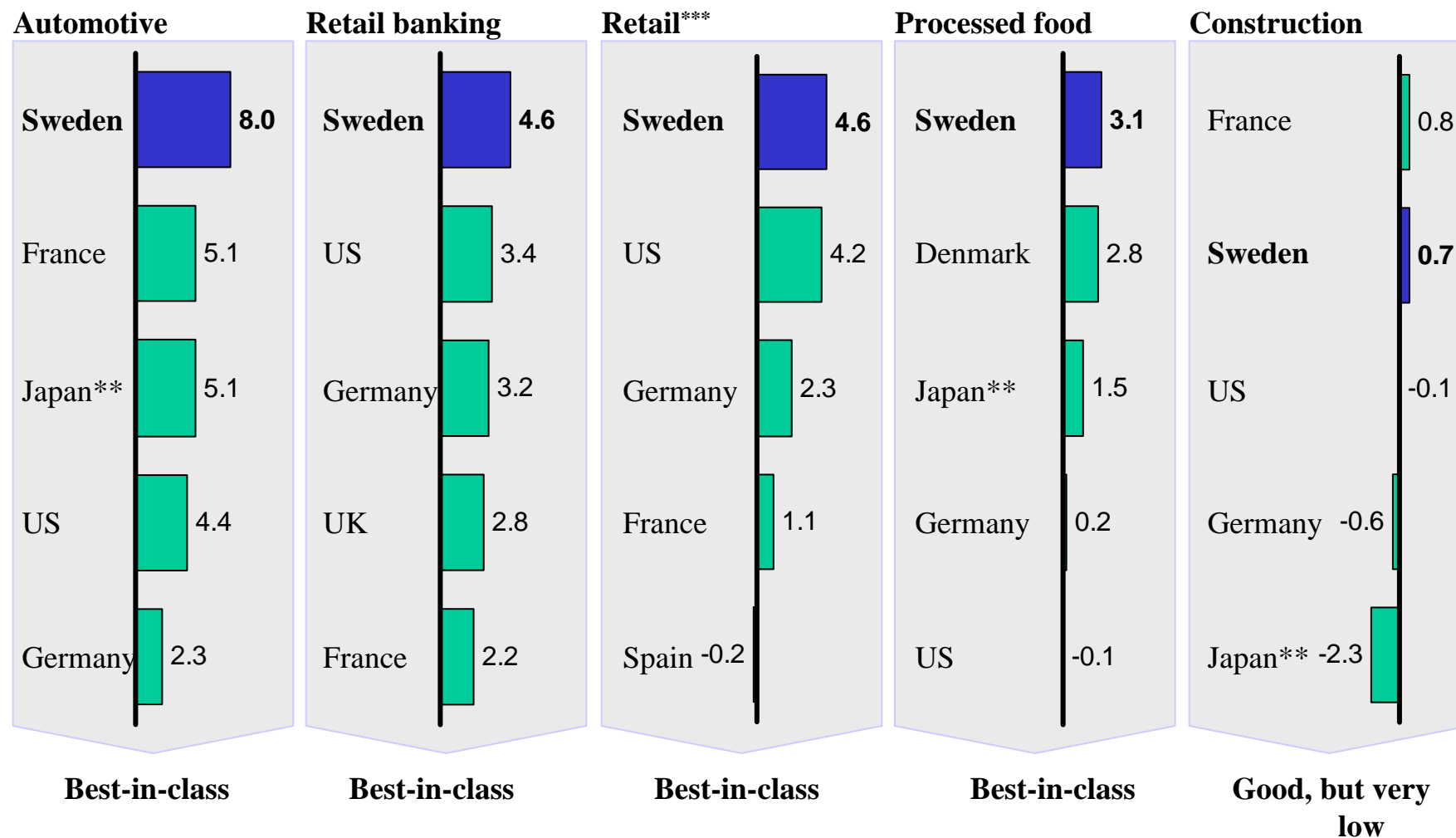
- **Mobile telephony is a new industry that developed in a competitive, flexible, and well-regulated environment. Labor productivity in France was twice the US level in 2000.***
- **Competition and privatization in electric power have boosted productivity growth in Germany and the United Kingdom. Regulatory 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 tradables prices to converge.**
- **Sweden is a good example where market liberalization resulted in stronger productivity growth.**

***McKinsey Global Institute**

Swedish productivity growth has been very strong in industries where competition has increased.

Percent CAGR, 1995 report; 1990–2003*

**McKinsey Sweden and
McKinsey Global
Institute**



*1993–2003 for automotive Sweden; 1995–2002 for retail banking; 1990–2003 for processed food and retail and construction.

**The most recent Groningen productivity data for Japan is from 2002.

***The United States has the highest productivity growth if the wholesale industry is included.

Sources: Groningen productivity database, February 2005 and October 2005; MGI/EFIC; McKinsey analysis.

Other countries also support the case for liberalization to increase competitive intensity.

- The United Kingdom has moved from the sick man of Europe to one of its richest economies.
- Australia: “Increasing competition was the driver,” according to Ross Garnaut of Australian National University.
- China is becoming one of the largest economies in the world following its move to market liberalization.
- National governments have responsibility for many of the reforms needed—land-use restrictions for example—but Brussels is important too.

What is a role for Brussels?



Implement services sector directive:

- Despite last-minute compromises, it holds major potential for positive microeconomic effects (don't believe the small macromodeled effects).
- Major enforcement challenge ahead for the European Commission.

Continue financial sector integration:

- International Accounting Standards Board (IASB) implementation well progressed. (EU mergers and acquisitions [M&A] at record levels in 2006–07; cross-border bank mergers finally happening in Europe.)
- IASB/Financial Accounting Standards Board (FASB)/Accounting Standards Board of Japan (ASBJ) reconciliation continues (NYSE-Euronext merger).
- Markets in Financial Instruments Directive (MIFID) introduction in late 2007 a major challenge/opportunity.

Deepen professional qualifications recognition:

- Directive 2005/36/EC on doctors, nurses, dental practitioners, veterinary surgeons, midwives, pharmacists, and architects should become the “Trojan horse” of true cross-border professional services competition.

A flexible European labor market: Is “flexicurity” the answer?



- **Denmark was able to institute flexicurity without major conflict, because Denmark never had a heavy industry, and hence it never instituted strict employment protection legislation (EPL).**
- **In Germany, France, and Italy some unions are demanding the preservation of EPL—union membership is declining and many of their members are near retirement (In Italy, 50 percent of union members are already retired). Other unions are more sympathetic, however.**

Conclusions

- It looks as if the upturn in the eurozone is cyclical.
- Strong cyclical growth is very good. It helps global rebalancing and creates an environment where structural reform may be easier.
- If cyclical demand growth is to transition into stronger supply and productivity growth, then Europe must break down the barriers to competition. Otherwise, growth will have to slow.

Conclusions (continued)

- There are important roles for Brussels and national governments.
- Sarkozy's platform contains major reform proposals—unified, liberalized labor contract; minimum service guarantee in public services (to mitigate the impact of striking unions); exempting overtime work from social contributions; tightening job-search requirements; and reform of union representation. It's not Thatcher, but likely to provoke confrontation in France.
- An alternative: Work with the unions, while pushing competitive intensity in the product market, which will force greater labor market flexibility, as well as higher productivity.