BRIEFING NOTE

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The EU needs a strong US economy, not reform

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Summary

- Talk of Europe's decline is exaggerated, as are calls for further radical restructuring. The European economy has undergone much more reform than its critics admit. The problem is not the amount of reform nut how the different reforms fit together, and with what result.

- An EU economic rebound could be simply a question of time – time for previous reforms to deliver, and time for further liberalization of service and product markets to bring the output effects of past reforms to the surface. There is more work to be done but Europe is not confronting a crisis of reform.

- The confusion about Europe's economy is due to the difficulty of measurement and comparison. Comparisons with the US economy rest on macroeconomic indicators that often fail to capture some of the informal aspects of European political economies such as the social wage.

- Even with perfect measures output performance is not the major issue Europe faces. Its real challenges are to do with resilience or adaptability and not growth or income. The threat posed by US imbalances and the risk of a hard landing for the dollar are much more serous than the risk of European decline.

The problem is not reform; it is the synergies between reforms

The latest OECD report on the European economy, *Going for Growth 2006,*[1] gives a pessimistic reading of the current and future state of the Eurozone. At its centre is the old prejudice about Europe's lack of reform capacity. Such a view on Europe is short-sighted. Numerous reforms have been implemented in the last fifteen years – either pushed through taking advantage of domestic momentum or imposed from above by the European Union – the EU Lisbon Strategy is a case in point. If such reforms have not yielded much in terms of performance, it is because of the lack of synergies between reforms in different areas, and not the absence of reform *per se*.

Structural reform is certainly not a new theme. Economists and in turn policy-makers have been attentive to structural policy issues since the early 1980s. The prevailing belief in those times was that boosting domestic demand was not necessary to take the economy closer to full employment; interventions had to concentrate instead on the supply side of the economy. This meant making regulatory frameworks as market-friendly as possible by eliminating obstacles to free competition, reducing wage and price stickiness and focusing on innovation as a means to improve national output without incurring the cost of faster inflation. The same recipes hold in the twenty-first century. And international institutions such as the OECD, the IMF and the EU are openly pushing in that direction.

In the last two decades, significant progress has been made. Reform efforts have being going on since the early 1990s. In particular, the completion of the Single European market by 1992 brought greater liberalization not only in product markets but, most innovatively, in the financial and service sectors, while also allowing for greater labour mobility. Under EU pressures, most member states have been forced to open up markets in sectors as diverse as banking, telecommunications, transport and energy. True, privatization did not always mean stronger competition but it most cases it did. In more recent times, the EU Lisbon Strategy launched in March 2000 also fostered structural reform in Europe. It relied on benchmarking with the aim of generating peer pressure on member states by means of the so-called open method of coordination (OMC). It is unclear whether the reforms that have been implemented have truly generated growth, but the OMC has at least improved awareness of

[1] OECD, *Economic Policy Reforms: Going for Growth 2006*, Paris 2006. Available at *http://www.oecd.org/document/7/0,2340,en_2649_33733_35995079_1_1_1_1,00.html*.

economic problems, enhanced communication on political economy issues among national governments and made sense of policy learning and transfer.

National reform agendas have not been less ambitious. The Netherlands reacted to the dramatic economic crisis of the late 1970s and early 1980s by initiating a consensus-based and successful series of wage moderation rounds that helped to reduce unit labour costs relative to competitors and to boost growth. Wage restraint was politically feasible because at the same time the government allowed for labour tax alleviation that left disposable income largely unaffected. Things became worse in the late 1990s once wage militancy re-emerged, but minor adjustments to eligibility criteria for benefits, for example, might be sufficient to bring the national economy back on track. Italy's labour legislation has undergone dramatic transformation too. Most of the employment that has been created in the last few years has been in the form of short-term contracts in place of the more traditional permanent job contracts that had been the norm in both industry and public employment. Italy's unemployment rate improved from 11.3% in 1998 to 7.9% in 2005 (EUROSTAT statistical definition),[2] falling below the Eurozone average (8.8% in 2005). This has been due partly to employers' appreciation of the non-binding character of short-term contracts, and partly to the regularization of immigrant workers exiting the black market. However, labour productivity has remained dramatically stagnant, with inevitably negative consequences for relative unit labour costs and output growth.

Undeniably, not all reforms have delivered. Nevertheless, it is inappropriate to say that the European economy has not undergone reform; it has simply come with mixed results. The reason behind it is twofold. First, reforms in different areas have different degrees of political viability. The OECD acknowledges that dissimilarities in the implementation record owe much to the greater presence of powerful vested interests in some sectors than in others. Generally, reforms in the financial sector, selected product markets and international merchandise trade have proved easier than tax and labour market reforms. Secondly and more importantly, the impact on economic performance is not felt at the level of individual reforms but seems to derive more from synergies between reforms in different areas. Little attention is normally devoted to complementarities among reforms, but this is central to the highly coordinated national economies that are part of the Eurozone. The Netherlands would have continued being a role model for successful macroeconomic management if ambitious product and service market reforms had been implemented to counteract the detrimental impact of excessive wage settlements. It is never too late to finish the job, although sooner would be better than later. With the reform engine already heated up, politically more feasible adjustments to product markets and services should not be mission impossible.

Similarly, Italy would have been better able to reap some of the advantages of labour market reforms if the service sector had been reformed with greater ambition. Not only is this a perfectly realistic scenario; it could even make further liberalization of the service sector easier. In brief, it could all be just a question of time both for previous reforms to deliver and for new – relatively minor – adjustments to be enacted.

Measurement problems behind evaluations of EU economy

The understatement of reform efforts in Europe also stems from the difficulty of quantifying them. All the reforms advocated against a supply-side economics spirit *de facto* entail changes to the institutional framework in which markets (and the state) operate, which are notoriously hard to measure. Of course efforts have been made to construct composite indexes that determine the relative strictness of government regulation, and the OECD report offers a detailed list of structural policy indicators. In measuring reform, reference is usually made to the financial sector, labour and product markets, tax, and trade. According to the OECD, financial-sector reform would address matters such as credit controls, interest rates and restrictions on international financial transactions. In the case of labour markets, it is all about employment protection, benefit replacement rate and benefit duration (relating to differences in the replacement rate from the first to the subsequent years of a spell of unemployment). Product market reform would tackle barriers to entry, ownership, market structure, type of integration and price controls. Tax issues include marginal tax rates, effective tax rate on labour and capital, and distortions related to differences in the taxation of different forms of income and consumption (in a nutshell, differences between taxes on labour and on capital). But, again, qualitative

[2] This includes unemployed aged 15 to 74 and it is harmonized throughout the EU so as to allow comparability between the member states.

structural policy indicators are always constructed with some degree of discretion and may not be always comparable across countries.

Measuring the progress of reforms is only part of the problem. Measuring the outcomes and alternatives is difficult as well. 'Income' is a particular problem. By focusing attention on income measures, international observers tend to understate informal aspects that are peculiar to European political economies. For instance, any comparison between US and European household income should include measures of the social wage to capture comparable consumption bundles. Moreover, it would also be necessary to look at the structure of income distribution, which is skewed and widely distributed in the United States but Gaussian (i.e. evenly distributed) and tight in Scandinavian countries, for example.

In conclusion, a comparison between real GDP growth per capita is probably not the best way to measure either the gap between the US and the European economy or the output effects of reform.

Europe should worry about a US hard landing, and not about its own decline

In any event income growth is not the biggest challenge that Europeans must face. The risk of a major shock coming from across the Atlantic is more important. If the United States makes a sharp correction to the dollar in response to its persistent current account imbalances, the effects on Europe will be immediate and they will be severe. Moreover market flexibility can at best alleviate (though not eliminate) the impact of a transatlantic currency shock. So while there may be good reasons to encourage Europeans to continue with their efforts at reform, such efforts should not be encouraged at the expense of developing some framework for influencing or even managing the global imbalances coming to bear on the US dollar. Market reform is a slow process and the benefits of reform come even more slowly. By contrast, the markets themselves can move quickly and with immediate effect. Europeans should worry about the dangers threatening them abroad in order to get a sense of perspective on the risk of decline at home.

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