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Golden Growth: restoring the Lustre of the European Economic Model
Lunchtalk, Bruegel, 30 January 2012

On the 24th of January Bruegel hosted a policy dialogue on the European Growth Model. At the heart of the debate was the World Bank report entitled "Golden Growth: restoring the Lustre of the European Economic Model."

The event was chaired by Zsolt Darvas, research fellow at Bruegel, and featured Philippe Le Houérou, Vice President for Europe and Central Asia Region at the World Bank, Indermit Gill, Chief Economist of the Europe and Central Asia Region of the Bank, and Martin Raiser, Country Director for Turkey at the Bank. The presentation of the World Bank staff was followed by the panellists' interventions. The latter included Malgorzata Kaluzynska, Director of the Department for Analyses and Strategies in the Office of the Committee for European Integration in Poland, and André Sapir, research fellow at Bruegel.

Mr. Le Houérou began the discussion by introducing the report, thanking Bruegel for its collaboration in the production process and placing a particular emphasis on the motivation of the report, and its main messages. In 2009, he argued, the crisis changed from being merely a financial one into an economic one. Being a development institution, the World Bank was concerned about the impact that the crisis might have on Eastern European countries in particular and wondered what it would take for these countries to restore growth. The inter-linkages between the East and West are very strong, hence the decision to present growth issues related to both the East and the West in the report.

Mr. Le Houérou went on to commend the impressive achievements of the European growth model over the last 50 years. The recipe for success at the European level was a unique organization of various elements, among them trade, finance, enterprise, innovation, labour and government. This particular structure transformed Europe into a formidable convergence machine.

The crisis revealed some of the shortcomings of the European growth model however and the aim of the report is that of showing how Europe can adapt without compromising the attractive features of its previous success. The current crisis will not be solved without growth, Mr. Le Houérou argued, and went on to stress the importance of tackling both short-run as well as long-run issues.

Indermit Gill spoke in greater detail about the contents of the report. Doubts about the European growth model had emerged two years ago, leading in turn to concerns about a growing loss of confidence in Europe. This was particularly serious because it affected a growth model which up until that point had been successful. There had also been changes in the rest of the world and Europe that required changes in the model. These developments included the entry of a billion Asian workers into the global labour force, the technological revolution since the 1990s, the increases in debt levels in Europe, as well as an ageing population.

Aiming to inform debates about what has been going well in the model and should be kept and what has been weakening Europe and should be changed, the World Bank took a practical approach. It began by identifying the principal components of any growth model and to this end picked six main activities: trade, finance, enterprise, innovation, labour and government. The next step was to identify how Europe managed to organize these and how it differed in its approach to that of other countries or country groups.

Mr Gill argued that trade and finance were by far the best developed areas of the growth model. Next in line

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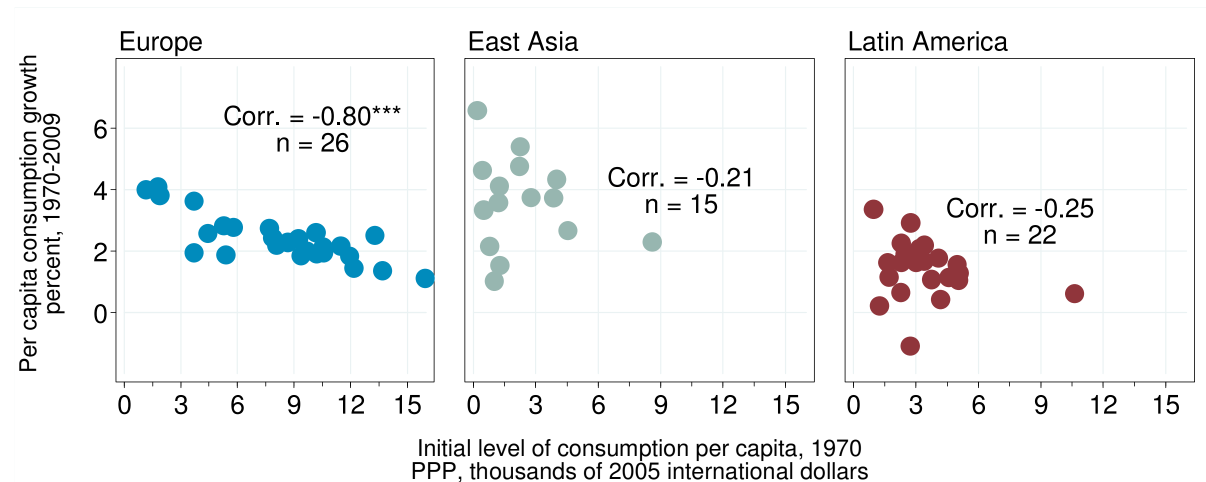
were enterprise and innovation, followed by labour and government, the latter two being identified as the weakest components of the apparatus. The report addresses the strengths and weaknesses of each of the components, but naturally devotes more space to what can be improved.

Mr Gill also stressed the fact that money is not included as a separate component of the growth model the publication and that consequently no chapter is devoted to the euro. Regarding the geographical scope of the report, the latter looks at 45 countries: the 27 EU states, 4 EFTA economies, 8 EU candidate and potential candidate countries, and 6 nations of the Eastern partnership. Russia was excluded from the analysis owing to the fact that the growth issues it faces are quite distinct from those of the rest of Europe.

Mr Gill went on to identify Europe's accomplishments, in terms of growth, over the past 60 years in three main directions: as a convergence machine (increasing income levels in poorer economies), brand Europe (making European goods and services unique and desired abroad) and as a lifestyle superpower (with the highest quality of life in the world). Illustrating the role of Europe as a lifestyle superpower, Mr Gill argued that in 2008 the US had the power and China had the momentum, while Europe had the highest quality of life.

Mr Gill then focused on Europe as a convergence machine. He highlighted the fact that in Latin America and East Asia, countries which were poorer in the 1970s did not grow systematically quicker than those that were richer. In Europe on the other hand, between 1970s and 2009, one could observe a 4 per cent growth rate per year for a typical poor economy and almost 2 per cent growth for richer ones, proving that an unprecedented convergence was indeed taking place.

In Europe, a rapid convergence in living standards—not much elsewhere
(growth of consumption per capita between 1970 and 2009, by level of consumption in

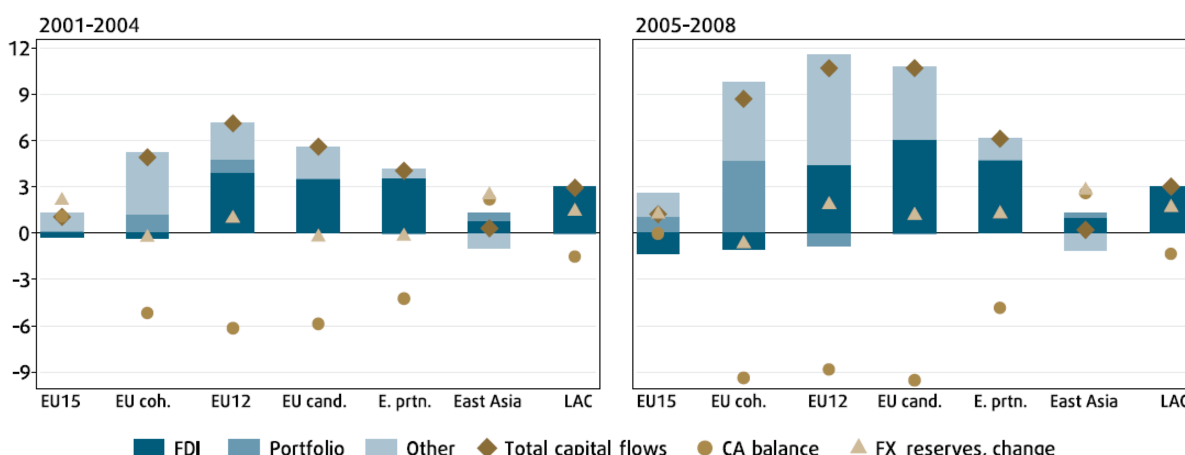


A big part of this process was trade. Some concerns remain in this respect. One involves the fact that Asia is becoming more powerful in terms of trade, and also the fact that there is less European trade in modern services. Both concerns have merit. Another issue involves the concern that member states may have become overly dependent on Eastern Europe. But this is not the case. While the share of exports and imports of the new members in EU15 trade has doubled, the share of EU 15 in the trade of the new member states has actually fallen during the last decade, and the share of other countries has increased. Trade integration in

Europe has been both regional and global. At the same time however, trade within Europe has become more and more sophisticated, as illustrated by the exports of advanced engines by Skoda for instance.

In terms of finance, Europe has seen the largest capital flows in the world, Mr Gill argued. Financial foreign direct investment was also particularly important in Central and Eastern Europe, owing to the fact that foreign banks set up profitable operations in the region. Providing developing economies with capital enables them to consume more, invest more, and grow faster. It became apparent that the good progress made in terms of capital mobility at the European level was not however matched by improvements in services and labour. What Europe needs to do now is stabilize finance and put services trade and labour mobility at the center of the growth agenda.

Capital flows in emerging Europe are large
(percentage of GDP; period average of group median values)



Martin Raiser went on to focus on the idea of Europe as a global brand. The region recorded an exceptional growth performance until the 1970s, growing almost twice as fast as any other country, with the exception of Japan. Even after the mid-1990s, European enterprises flourished, jobs were created at a faster rate than in other regions, and productivity rates in Eastern Europe matched those of the BRICS.

But during this last decade, Europe has lost some of its earlier shine. Several reasons underpin this.

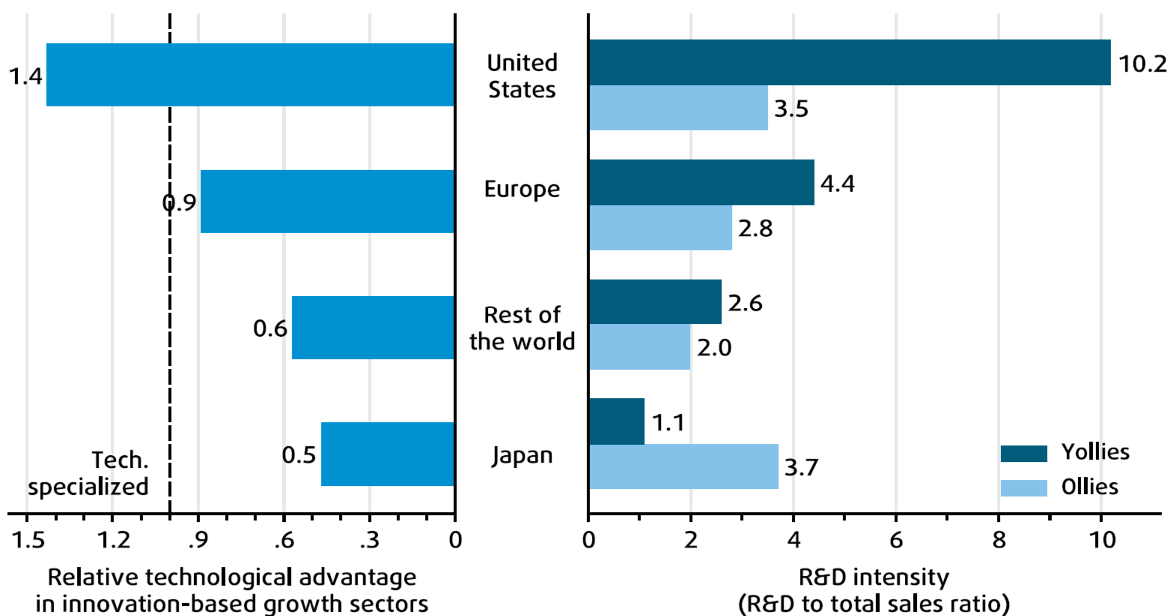
In the west, convergence stopped around 2000 and the productivity gap widened between the North and the South. The highest levels of productivity were identified in the North, medium levels were recorded in the East and the lowest levels appeared in the South. While the gaps have been narrowing since 2002, productivity in fact went down in the South, with declines between 2 percent annually in Greece and half a percent in Italy (based on micro enterprise data in the formal economy). One reason behind this was the fact that Southern enterprise was not structurally well-suited for an integrated European market; microfirms were too small to attract FDI or internationalize their sales and purchases. In the mid-1980s, a quarter of FDI flowed to the South. Later on this changed, and by 2008, a more than a quarter of European FDI was in central Europe,

explaining some of the Eastern productivity catch-up. Lacking essential reforms, the South ended up having a worse business climate than even that of the new member states.

A growing productivity shortfall in the EU15's leading economies relative to the world's innovation leader—the United States—was also recorded. While in 1995, European productivity was 95% of the US levels, this figure fell to 85% in 1995.

The growth slowdown in Europe can also be explained in terms of lagging innovation. This was illustrated by Reinhilde Veugelers 'contribution to the volume. One key reason for less innovation in Europe is the fact that the region has had a narrower focus on R&D in young specialized enterprises, contrary to the US, where companies such as Amazon or Google developed. At the micro level, the US has many young innovative firms founded after 1975 which account for a large difference in productivity. While differences in innovation performance also exist within Europe, Europe's innovation successes remain isolated from the rest of Europe for the most part. The region has struggled to keep up with the US, also due to a failure to complete the European single market in critical new economy sectors like digital services, pharmaceuticals, bio-tech etc..

The United States specializes in younger, more R&D intensive products
(relative technological advantage and R&D efforts by young and old innovation leaders in the United States, Europe and the rest of the world)



Finally, Europe faces difficult challenges in remaining a lifestyle superpower. To retain this status, high spending on social protection is required. The region currently spends more on social protection than the rest of the world combined. This is financially unsustainable. At the same time, while European societies are ageing rapidly and policies need to address this, North America still enjoys a growing labour force. Life expectancy has also increased everywhere, while retirement ages have fallen most in Europe, leading to an increase in the time that people can expect to receive pension of up to 15 years in countries like France since

the 1960s. There are exceptions such as Germany, where working lives have increased. In the US, people retire sooner than they did in the 1960s, but people still work long hours per week, and more weeks than Europeans per year.

Mostly due to higher spending on social protection and more specifically public pensions, European government expenditure is around 10 percentage points of GDP larger than in other parts of the world. Comparing the annual per person pension benefits between Europe, the US and Japan, it is not clear that pensioners are in fact better off in Europe than elsewhere. But earlier and easier eligibility for social security in Europe leads to pensions being a much larger spending burden for the state.

Given high debt levels, fiscal consolidation is now an urgent requirement. The cyclically-adjusted primary balance improvement needed varies significantly in Europe, with the South requiring the strongest adjustment. The adjustment however will not work through spending cuts alone, growth needs to return to Europe.

Thus emerges one of the main messages of the growth report: because the European growth model has so many strengths, Europe needs to be careful when changing it. Restarting the convergence machine should not be particularly difficult, financial flows nonetheless need to be made more stable. Rebuilding the brand will be tougher because this depends on innovation and enterprises, which have been under strain recently. But the most difficult changes are those required to labor markets and government activities. Labour markets have to become more competitive and governments more efficient. For this a new social consensus is needed.

Several comments from the panellists followed. Malgorzata Kaluzynska reiterated the concern of the former Polish presidency for growth. The difficulties that emerged in the second half of 2011, she argued, put the spotlight on other issues such as institutional redesign and financial austerity. During its presidency, Poland launched a report on growth and gathered many concrete initiatives for unlocking the European growth potential. These were focused on the single market, enterprises, green growth and human capital.

She then went on to remark on some of the aspects of the report that stood out. Ms Kaluzynska argued that it is good to get reassurance that European integration works, especially in the context of current discussions about creating a two-speed Europe. She was also pleased to receive independent confirmation of the fact that the European growth model really works.

André Sapir was pleased with the innovative aspects presented by the report and with the optimistic message conveyed as a whole, which he argued, was highly needed at the present moment. Mr Sapir argued that the forces of catching up are very strong and that one should be optimistic and believe that the financial crisis will have only a temporary effect. He then went on to put forward a question for discussion, namely, what happens after the catching-up has been exhausted, as was the case of the Western European countries around the 1980s? Likewise, what will happen to the countries of the East 10-20 years from now?

Mr Sapir emphasised certain sections of the report which may have appeared more striking to the reader, such as the parts displaying the the differences of groupings of countries, particularly those between the South and the East, which revealed a worrisome trend for the South. He went on to argue that several countries in the South, in particular Greece and Portugal, are not small open economies, but rather small closed economies. This may have problematic consequences. Mr Sapir then went on to make a point about

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the adoption of the euro and argued that countries ought not to rush the process, if they want the common currency to be of help and not become a hindrance.

The audience raised several points. Andrew Watt, from the European Trade Union argued that the report lacked a discussion of the euro area macroeconomy, and stated that he didn't fully endorse the conclusion that labour markets and governments are the weakest link in the growth puzzle. He furthermore expressed some doubts about the differential performances of Southern and Eastern Europe and reminded the audience that approximately one third of the pre-crisis jobs in the euro area were created in Spain.

Jean Pisani-Ferry, director of Bruegel, went on to ask the panellists to take one of the countries in the East and think about what advice they would give to such a country in terms of joining the EU. For the Eastern countries that are already EU members, what advice would the authors of the report give in terms of joining the euro area? Furthermore, if the accession is conditional, then what is it conditional on?

Mr Raiser argued that EU candidate countries should join the EU, while EU12 countries should join the euro. He went on to argue that timing indeed matters, and that institutions are key to a successful transition. Institutions play a crucial role in making adjustments in the case of asymmetric shocks.

Juan Zalduendo suggested that one has to recognize that there is significant heterogeneity within emerging Europe. There is indeed a temptation to treat countries equally, which, he argued, is a mistake. The variety you find is actually very informative and rich. He went on to suggest that the model of financial integration is still viable, but that it needs to be made more effective. Countries also need to manage their external imbalances. Furthermore, he argued that countries entering the eurozone could go through a period of divergence. One should in this respect learn from the experiences of current eurozone member who have encountered similar difficulties.

Mr Gill argued that some years ago an analysis of East Asia revealed that many low income countries faced a middle-income trap. Ferocity was necessary in order to overcome this—hence the term "East Asian tigers". In Europe however, there is no middle income trap. Countries in Europe only need to be disciplined, not fierce. They do not have to postpone consumption for long and civil liberties for later. Joining the EU or signalling the intention to join brings some of the discipline along, he suggested.

A member of the audience used the case of Northern Europe, as an example of a lifestyle supermodel. Big governments successfully exist in the region and are combined with generous growth. These countries have populations that participate in the labour force, they have good social assistance systems, and also institutions that are capable of reforming themselves should this be necessary. Eastern Europe needs to ensure that the size of government and its quality go hand in hand. It is a matter of reforming institutions, and with that affording a big government that provides a lot of services, he concluded.

Anton La Guardia from the Economist raised a further question. He wondered whether given the adjustment, Southern Europe would react differently than Northern Europe to the current measures. In particular, the worry emerged that the South may be particularly vulnerable to austerity.

Mr Gill argued that when one looks at the fiscal adjustment required in Southern Europe, one is confronted with a bleak picture. It will indeed be a time-consuming process. However matters of regulation can be improved fairly quickly. If one pursues the latter path, results will be seen in a shorter space of time. And the

conditions in Europe are such that it is likely that both markets and European institutions will give reforming economies the time and financial respite necessary to recover fiscal balance and economic competitiveness.

Mr Le Houérou concluded the discussion on an optimistic tone. He argued that one should see the crisis as an opportunity. One needs to discover what is feasible and what is not in terms of reforms, and then go on to identify what level of union is necessary at the European level and what the country specific policies need to be. Mr Le Houérou further argued that the micro-macro links are very important and concluded that European growth can indeed be restarted if the necessary measures are taken.