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*Daniel Gros*

**Perspectives for the Lisbon Strategy:  
How to increase the competitiveness  
of the European economy?**

*Warsaw, July 2005*

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## **Abstract**

The main message of this contribution is that lean times are here to stay for the old member states. The main reasons are deep seated: Deteriorating demographics continue with ratio of working age population to total population falling. There are thus fewer and fewer producers for every consumer and recipient of transfers. On top of this productivity growth is declining as labour quality is falling and investment growth slowing. In the new member countries the demographic trends also unfavourable, but they are (more than) compensated by catch up growth as a relatively well educated work force finds its place in the internal market.

What does this diagnosis imply for the role of structural policies? No Lisbon agenda change demographics trends, nor can it change the declining capital/labour ratio due to insufficient investment growth. But structural reforms might counteract the impact of these two negative trends. Moreover, the performance gap between big and small member countries suggests that policy can make a difference.

## 1. Introduction

This contribution will focus on the plight of the (most of) of the old Member States as the new member states are unlikely to cause particular problems. The latter are growing faster than the old EU-15 and are likely to continue to benefit from their position as a low cost production base with a relatively well educated work force within an improving policy framework and close to the biggest market in the world.

By contrast the main theme of the Euroland economy continues to be weakness of both demand and supply. And it is not only the economy that is weak. Any observer of economy policy making Europe must be struck by the deterioration in the quality of economic policy in general. This can be seen on many fronts: fiscal policy plans go constantly awry, the Lisbon agenda is constantly invoked but no action is taken, etc. I would argue that this disarray among policy makers can be explained by the fact that the existing policies and institutions are geared for a growing economy in which every year growth allows for some redistribution. Growth prospects are now rather dim throughout most of Euroland due to lower productivity growth and, particularly in Germany, due to demographic developments. Economic policy making is thus squeezed on two sides.

The fall in potential growth implies a squeeze on the potential for re-distribution, and this matters because it has an impact on both fiscal and monetary policy. Fiscal policy is deteriorating as finance ministers try to save and then discover every year that despite their attempts at cutting expenditure the ratio of public expenditure to GDP does not go down and that, year after year, deficits are higher than expected. What they fail to understand is that measures that would have redressed the balance ten years ago are now barely sufficient to avoid even larger deficits.

Monetary policy is less directly affected by the slowdown in growth and the vanishing space of redistribution. Judging from its own predictions the ECB has also been slow to recognise the fall in potential growth and has thus regularly overestimated growth prospects and underestimated inflation. However, the magnitude of the error, about half a percent per annum was such that price stability has not seriously put in danger. This might change when the pressure on economic policy increases. Experience shows that price stability cannot be maintained when there is extreme pressure on public finances as, for example, during wars. This is where the danger lies. The long run impact of ageing on public finance in Europe is actually comparable to the cost of a major war (see Deutsche Bank (2004)).

The slowdown in productivity is analysed in more detail below. The short term impact of demographic developments is less well known and might be documented first.

## 2. From demographic bonus to malus

That the European population is ageing rapidly is widely known. What is not widely appreciated is that the impact of ageing will not be felt only in 20-30 years, but it has already today a major impact on the economies of some member countries.

A first important point is that the word “ageing” does not describe adequately the problem Europe is facing. It is true that average life expectancy is increasing continuously in all developing countries. But the main reason why the proportion of the elderly is now expected to almost double over the next 50 years in Europe is that on average fertility has fallen so much below replacement levels so that natural population growth has now turned negative, and will stay negative for the foreseeable future. Lower birth rates imply of course that the average age of the population increases. It is important to realise that low birth rates are a phenomenon that is specific to Europe (and Japan), but not the US as can be seen from the demographic projections for the EU and the US presented below.<sup>1</sup>

This table concentrates on old age dependency ratios, which constitute a measure of the consequences of ageing for public finances since an increasing proportion of elderly implies higher pension and health expenditures. This table shows that for the EU-15 the old age dependency will, on average, double by the year 2050 to reach over 50%. By contrast the dependency ratio of the US will increase much less and will remain about a third lower than that of Europe. Among the major member countries Germany stands out as having to face a considerably faster ageing process than France, for example. It is also apparent that there is little difference between the EU-15 and a larger EU-28, as even the inclusion of Turkey would not change the average much. In relative terms the deterioration is even bigger for the EU-28 than for the EU-15, whose dependency ratio ‘only’ is likely to increase by the year to 2.1 times its 2000 level whereas this ratio increases to 2.25 times its 2000 level for the EU-28.

**Table 1. Old age dependency projections**

	Dependency ratio, %		
	2000	2025	2050
Japan	25.1	47.0	64.6
USA	18.8	29.3	34.6
France	24.5	36.0	45.9
Germany	24.2	39.4	52.9
EU-15	24.4	36.1	51.0
EU-28	21.5	31.9	48.5

Sources: US Census, <http://www.census.gov/ipc/www/idbnew.html>, own calculations.

The old age dependency ratio is widely used to illustrate the pressure on pension systems. However, a better indicator for the overall impact of demographic factors on the economy (and thus the pressure on economic policy) might be the simple ratio of the working age population to overall population. The level of this ratio measures in a certain sense potential GDP per capita. Changes in this ratio show, *ceteris paribus*, to what extent the room for re-distribution is affected by demography. For example, if this ratio increases by one percent, potential GDP per capita should go up by one percent *ceteris paribus*, i.e. holding constant productivity, employment rates, etc. A fall in this ratio indicates the opposite, potential GDP per capita falls, implying that there is less to re-distribute to pensioners and other interest groups.

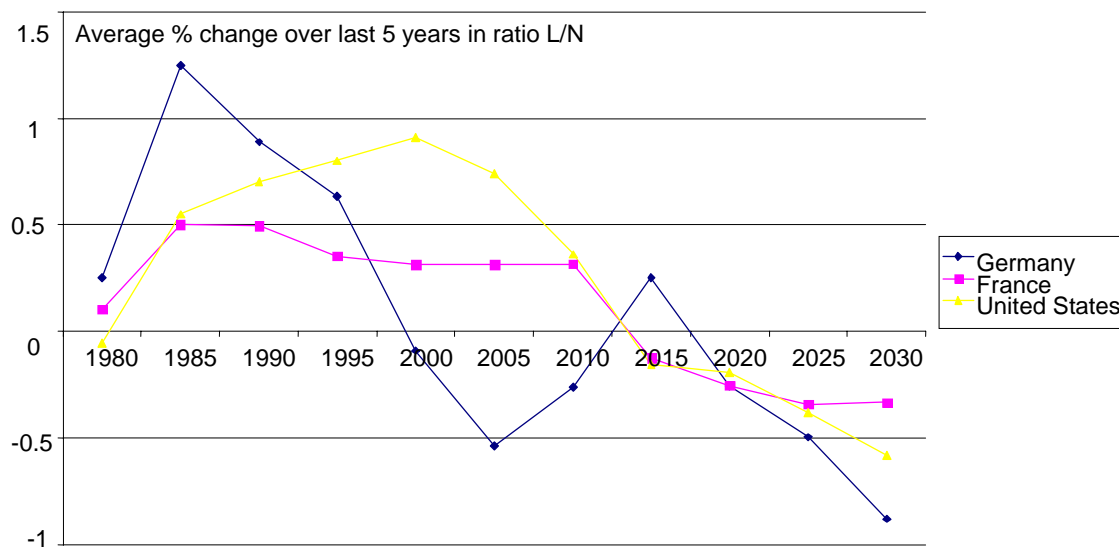
If one looks at the evolution of this indicator for Germany, it becomes apparent why the ‘Umverteilungskampf’ has become much tougher over the last years. During the five years preceding

<sup>1</sup> These projections are already based on the assumption that fertility in Europe will somewhat recover than that the increase in life expectancy will slow down.

reunification demographic factors were providing a strong backwind for economic policy as the ratio of working age population to total population was increasing by about 0.8% per annum. By contrast during the five years up to 2005 demographic factors provide a headwind to economic policy as this ratio starting falling rapidly after 1995, deterioration during the last five years was equivalent to about 0.54% per annum. The total deterioration between the late 1980s and now thus amounts to almost 1.5% per annum. The German economic system, which until the end of the 1990s could count every year on a demographic bonus was simply not prepared for this change. The sails had been set for wind from aft and the country was not able to adjust to the fact that now the wind is blowing from the bow.

It is interesting to see that France is in a quite different situation: its demographic situation evolves more slowly, with the important deterioration coming only during the next decade. The US has a similar pattern as France, but with a somewhat more pronounced deterioration over the next ten years. In the US the demographic factors will change from plus 0.7% per annum now to around minus 0.2 in the five years to 2015, which is equivalent to a negative change of over 0.8% per annum over the next ten years (just when the budget is supposed to be brought again under control).

**Figure 1. Change in demographic potential GDP**



The ageing process has thus already today a strong economic impact in some member countries. The data for of Germany, which remains the largest economy of Euroland seems to represent the worst case: a combination of rapidly worsening demographic factors and lower productivity growth. This combination is behind the loss of control over fiscal policy in Germany and must also be the main explanation of why the half hearted reforms undertaken so fare have been insufficient to turn the economy around. Other member countries face less extreme pressure because their demography evolves more smoothly, but few member countries will be able to escape the twin pressures from worsening demography and productivity on economic policy.

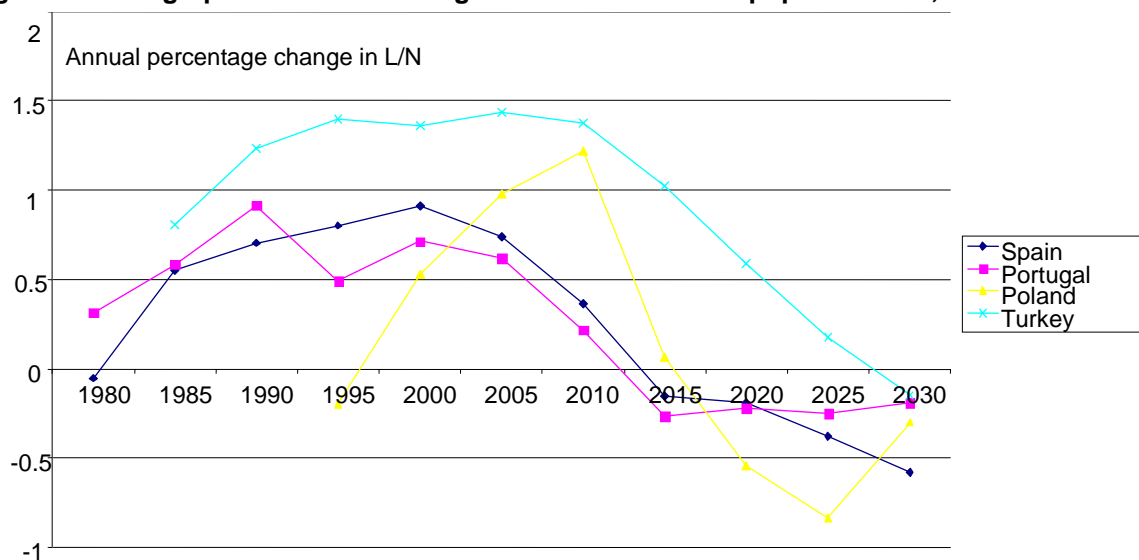
Figure 2 below shows the same demographic data for the largest new member state (Poland) and some of the cohesion countries among the old EU-15 and Turkey to provide a comparison.



The latter, Turkey, constitutes an interesting case as it is in the midst of a demographic transition, reflecting a fairly rapid decline of the population growth rate, from the 2.5 to 3.0 percent range in the 1950s and 1960s, to close to 1.4 percent, at the beginning of the new century. This implies a rising proportion of the 15 to 64 age group in the total population, starting from a low base, as fewer new babies are born to fill the below 15 age group, and as life expectation, while lengthening, is not yet long enough to result in a large proportion of the total population above age 64. This results in demographic bonus in the form of a large hump shaped curve which puts Turkey well above all current and perspective member countries (e.g. Spain and Portugal), whose demographic ‘transition’ happened a generation earlier. The Spanish and Portuguese curves thus are below that of Turkey and anticipate its movements by about 20 years.

Poland is a special case because of the horrendous losses the country suffered during World War II. This implies that until 2015 there will be each year fewer pensioners falling out of the labour force. However, after 2015 the low birth rates will make themselves felt in rapidly deteriorating demographic situation.).

**Figure 2. Demographic bonuses: change in labour force/total population -25, 65+**



### 3. The productivity slowdown

The eurozone has now gone through an unprecedented three years of near stagnation. Was this just a cyclical phenomenon; due to a combination of external shocks and wrong macroeconomic policy responses? In the short to medium run cyclical and structural factors always interact in a way that makes it next to impossible to disentangle their relative importance. One thing is clear, however. This is that long term potential growth rates have fallen in Europe. This is not just because of lower population growth; productivity growth has fallen as well as extensively documented in previous reports of this group (see Gros et al. (2001), (2002) and (2003)). This section will first, report some new evidence on the causes of the slowdown of productivity in Europe. Section 2.2 then turns to some interesting differences in performance within the Euroland economy.

### 3.1 Growth potential

How could one find out whether there has been a structural slow-down in Europe? In view of Blanchard (2004), who has drawn attention to the fact that the level of output per man hour in some important member countries is close to the US level, it might be best to concentrate immediately on hourly productivity. The table below (taken from Daveri (2004)) shows how the growth rate of GDP per hour worked has fallen from around 2.6% p.a. during the first half of the 1990's to less than 1.5% p.a. since 1995. It is not possible to argue that this fall just reflects a cyclical phenomenon since the period since 1995 was not worse in terms of business cycle than the period 1990-1995, which contains a recession which a fall in real GDP, whereas during the period 1995-2002 GDP growth was always positive.

The key fact shown in table 1 is thus that productivity as measured by GDP per hour fell by 1.2 percentage points at a time when the opposite happened in the US (there hourly productivity growth increased by 0.8% points). Given this discrepancy between the European and the European data it is not possible to argue that the dismal performance of the European economy over the last years is just a result of a negative shock coming from the global business cycle emanating from the US.

**Table 2. Growth of GDP per hour worked in the EU and the US, 1979-2001**

Total economy , OECD data	1970-80	1980-90	1990-95	1995-02	(1995-02) minus (1990-95)
European Union 11	3.6	2.3	2.6	1.4	-1.2
USA	1.6	1.4	1.2	2.0	+0.8
EU11 minus USA	+2.0	+0.9	+1.4	-0.6	-2.0

Source: Daveri (2004), EU-11 instead of EU-15 because of limited data availability.

Why should productivity growth have fallen in the EU? It is often argued that the difference EU-US can be explained by the advantage of the US in new technologies, i.e. mainly information technologies (IT). However, the gap in IT between the EU and the US cannot help to explain why Europe's performance should have deteriorated if measured against its own past. Europe might be slow to adopt IT, but it certainly has not turned away from IT, hence the causes for the slowdown in Europe (as opposed to the transatlantic gap) must be sought elsewhere. One reason for the productivity slowdown in Europe might be quite simple: total factor productivity growth (TFP) might have declined.

A definite answer to the question whether capital of TFP was behind the EU productivity slowdown of the 1990s cannot be given yet. Any answer is still tentative because the data necessary to address this issue is available only for a subset of EU countries. The limited available information suggests, however, that a slow down in capital deepening – rather than diminished TFP growth – is the main culprit for the European slowdown.

This conclusion emerges when one decomposes the growth rates of value added per hour worked into their capital deepening, TFP growth and labour quality growth contributions for the US and the aggregate EU-4. In turn, the capital deepening component is usefully further split into an IT capital component and a non-IT capital component.

The results tabulated below suggest first of all that the European productivity slowdown is mostly due to diminished capital deepening of non-IT goods only. Second, TFP growth has not

much changed, continuing at the respectable rates of about one percentage points reached in the past. The slowdown in the growth rate of labour productivity in the business sector for the EU aggregate – milder for the four countries considered here than for the EU-15 – is more than accounted for by the diminished contribution of non-IT capital (-.45 percentage points) and the worsening in labour quality, which has contributed another negative .15 percentage points.

On the positive side, instead, business sector productivity has benefited from an increase in the already positive contribution from IT capital (up from .3 to .5 percentage points) and from the slight increase in TFP growth (from .9 to 1.05 percentage points). Hence, at least for the overall business sector, one has to concur with Jorgenson (2003) saying that TFP as well as accumulation of IT capital are unrelated to the European growth slowdown of productivity. This marks a sharp contrast with the US, where TFP growth markedly accelerated, moving from a contribution of .25 to more than 1 percentage points per year and the contribution of IT capital jumped up almost half a percentage point (from .4 to .8 percentage points).

Hence, the evidence, based on the better data available today, comes essentially confirms the findings in Daveri (2000, 2002) and CEPS (2001, 2002), where rough overall measures of IT capital and TFP were employed. Other sources (e.g. Commission 2003) report a small decline in TFP, which might appear to be inconsistent with the data reported here. However, the data available for the EU-15 does not account for changes in labour quality, whose effects are thus attributed to TFP. The more detailed data for the quality of the labour force, which is available only for the EU-4 suggests, however, that part of the apparent decline of TFP might have been due to a deterioration of labour quality. How could labour quality diminish when the general level of education is constantly increasing? The resolution of this puzzle seems to lie in the fact that during the late 1990s the share of the lower skilled in the workforce increased. This had been the aim of many labour market reforms, but it had the side-effect that average labour quality declined and with it overall productivity.

**Table 3. Decomposing aggregate labour productivity growth, business sector**

	US		EU-4	
	1979-95	1995-00	1979-95	1995-00
Business sector				
Labour productivity growth	1.21	2.46	2.30	2.02
Contributions to labour productivity growth from:				
IT capital	.46	.86	.33	.53
Non-IT capital	.35	.43	.70	.25
TFP growth	.26	1.05	.94	1.07
Labour quality	.13	.13	.33	.18

Source: Daveri (2004).

The more detailed data necessary to distinguish between TFP and labour quality is available only until 2000. This implies that the period covered by the table below comprises just the upswing following the 1995 recession. It follows that this data is likely to overestimate productivity growth and in particular TFP. If one compares periods that are similar in business cycle terms as done above (i.e. using the 1995-2002 period) the fall in overall productivity would be much larger and the performance of TFP would be likely to be much worse. But the detailed data to perform this exercise is not yet available.

Could one expect productivity to improve again over the next few years?

One way of addressing this question is to start with the official Lisbon goal in terms of employment. It is not widely appreciated that there is a capital deepening counterpart to the Lisbon employment goal. One of the policy goals stated in Lisbon for the European Union to reach by 2010 is raising the EU (-15) employment rate – the ratio of total employment over total working age population – to 70%. Given that the current employment rate in the EU(-15) is about 63%, this implies an increment of about 1 percentage point per year in the next seven years or so. In turn, if population in working age keeps growing at the past rates of about 0.5 percentage points per year – an average of 0.3 p.p. for the native population and 1.2 p.p. for immigrants – total employment has to go up by 1.5% per year until 2010 to meet the Lisbon employment goal. This is a bit higher than 1.25%, the growth rate of total employment averaged in the EU(-15) in 1995-2002. But it is not unfeasible, at least in principle. If coupled with a continuation of the long-run trend towards a reduction of average hours worked (about half a percentage point per year), this translates into an expected increase of the labour input of about 1% per year from here to 2010.

What does this imply in terms of capital deepening, i.e. the growth contribution of capital to productivity growth? To come up with an educated guess, the past growth rates of the capital stock for the whole economy (e.g. for 1996-2000) have to be projected into the future. Based on the data in Inklaar, O'Mahony and Timmer employed in the main text, one can get estimates ranging between 0.8% per year for France and 4.2% per year for the UK, with Germany and the Netherlands in between (but much closer to Germany). Hence, a simple continuation of past accumulation rates would imply a growth rate of the capital stock of about 3% per year for the EU4. The corresponding growth rate of the capital stock per hour worked would be 2% per year and the growth contribution from capital deepening would be equal to two thirds of a percentage point per year (at least as long as the value added share of capital stays unchanged at one third). This compares with 0.78 percentage points computed for the EU4 in 1995-2000.

All in all this amounts to saying that, if the Lisbon employment goal is taken seriously, it would require a much higher investment effort for capital deepening to take off again and contribute more to productivity growth in the next few years through 2010. If capital accumulation stays constant the contribution from capital deepening would then fall even a bit more, implying that at unchanged rates of TFP growth overall productivity might actually fall a bit more (or at least not recover noticeably).

On top of the capital deepening effect there would be an adverse impact on labour quality as the additional employment would have to come from that part of the labour force that is at present unemployed, i.e. the lower skilled. The data reported above suggests that this could lead to a further loss of productivity growth of 10-20 basis points. Hence one would need a considerable increase in capital deepening just to keep productivity from falling.

Under unchanged rates of capital accumulation there is thus a clear contradiction between two Lisbon goals: to increase productivity and to increase employment. Figure 2.2 shows this in terms of the two headline goals: reaching an employment rate of 70% (more or less the US value) and reaching a productivity level of 100% of that of the US.

At the beginning of 1990s the Soviet successor states started to transform their financial sectors to meet the needs of the emerging market economies.

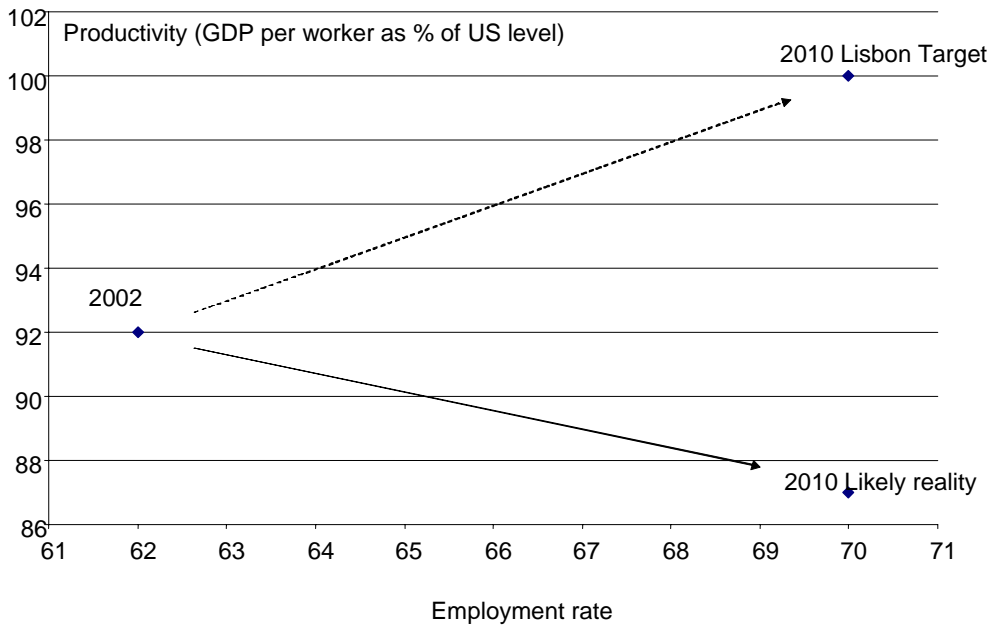
The nature of economic relations under central planning left little role for financial intermediation, as it is understood in mature market economies. Banks were the only source of external funding in the socialist economies. State enterprises had virtually no budget constraints and when they experienced credit or liquidity shortages a bank would provide credit based on investment and production decisions by central planning bodies. Because banks merely implemented credit allocation decisions of the central planner, they did not evaluate risks, make their own credit allocation decisions, or monitor the use of credits after their issuance.

The start of transition meant that banks had to supply increasingly sophisticated financial services – without the capacity to do so. Banks had to learn how to assess, pool, and diversify risks, collect and process information on their clientele, and to exercise control over borrowers. The tasks facing policymakers were equally challenging. These included the imperative of introducing the market-oriented regulatory institutions needed to protect the rights of creditors and shareholders; setting up independent and strong prudential supervision; maintaining a level playing field in terms of tax policies; and privatizing state banks. Second, governments had to learn to carry out policies in a manner friendly to the financial sector. The early attainment and subsequent maintenance of macroeconomic stability were also critically important.

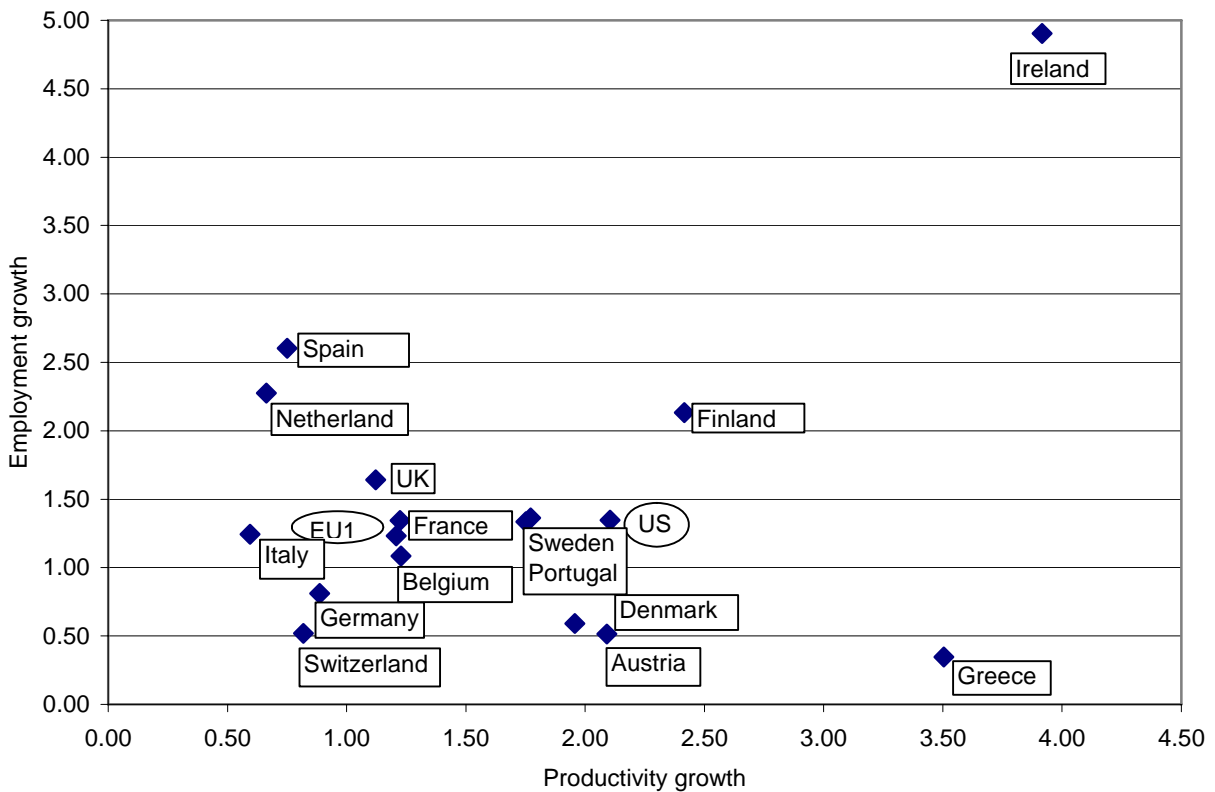
Following a decade of transition, results differ. Although the Baltic states were able to build quite successful financial systems, in the CIS countries financial systems remain a major obstacle to sustainable economic growth. The hyperinflations of the early 1990s, the financial scandals that followed the collapse of monobank systems, and subsequent incomplete progress in constructing non-bank financial institutions and effective regulatory structures have had adverse consequences. These include weak bank balances sheets, high real interest rates, and poor access to capital for small enterprises and start ups. With a few exceptions, non-transparent regulation, inadequate disclosure frameworks, and weak protection of shareholders rights continue to limit investor participation in CIS financial markets. Despite significant investor interest in emerging market debt, only Kazakhstan has been willing and able to float new Eurobonds since 1998. The absence (Kazakhstan again is the exception) of effective three-pillar pension systems in CIS countries further limits the demand for domestic debt and equities.

Fortunately, there are signs of improvement, thanks in large measure to the region's recovery from the effects of the August 1998 Russian financial crisis. Bank lending and deposits are growing in many CIS economies, the proportion of bad debt in bank credit portfolio is falling, and lending and deposit interest rate spreads are diminishing. The solid economic growth recorded since 1999 in many CIS countries is helping memories of the 1998 financial crisis to fade, and stock exchanges in some CIS countries are currently at or near record levels. Financial systems in CIS economies may be moving toward the successful frameworks put in place in the new EU member states. However, because they have not benefited from the extensive foreign direct investment that recapitalised banks in Central Europe, financial stability in many CIS countries remains open to question.

**Figure 3. Lisbon: Employment versus Productivity?**



**Figure 4. Productivity growth and employment growth in Europe and the US, 1995-2002**



Notes: “Employment growth” is the growth rate of total employment; “Productivity growth” is the growth rate of GDP per employed person.

Source: OECD Economic Outlook.

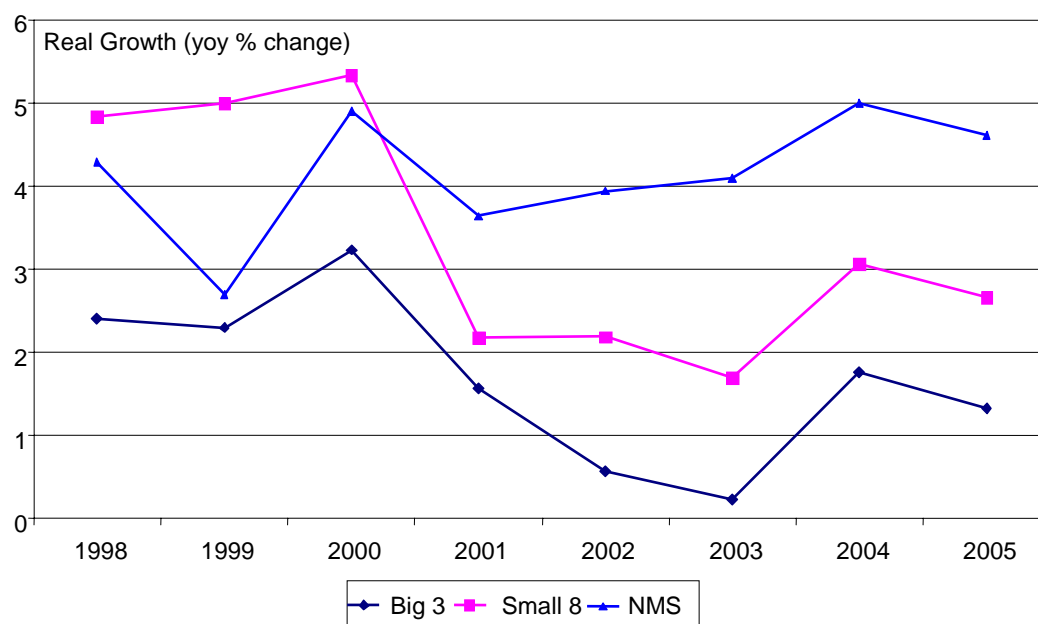
### 3.2 Big and small: lessons for a more flexible Europe?

The growth performance of the eurozone has been disappointing – at least if one looks at the average. But this average also hides considerable variability across countries. Can one discern any systematic pattern in cross-country variability across Europe? The answer seems to be yes if

one compares the performance of the large and the small EMU states. Since the start of EMU the three largest euro area member states (France, but particularly Germany and Italy) have consistently underperformed on almost any account. As they together represent three quarters of the GDP of the eurozone their sluggishness is behind the underperformance of the eurozone (and of the EU) if compared not only to the present US, but also the past performance of the EU itself.

Since 1999 the growth rates of the three ‘euro-dinosaurs’ have been 1.6 percentage points lower on average than those of the 8 small euro area member countries. (see Figure 5) This implies a total underperformance of 10 % over this six year period. (The new member states have tended to perform even better, but this is natural given that they are still in a catch-up process.)

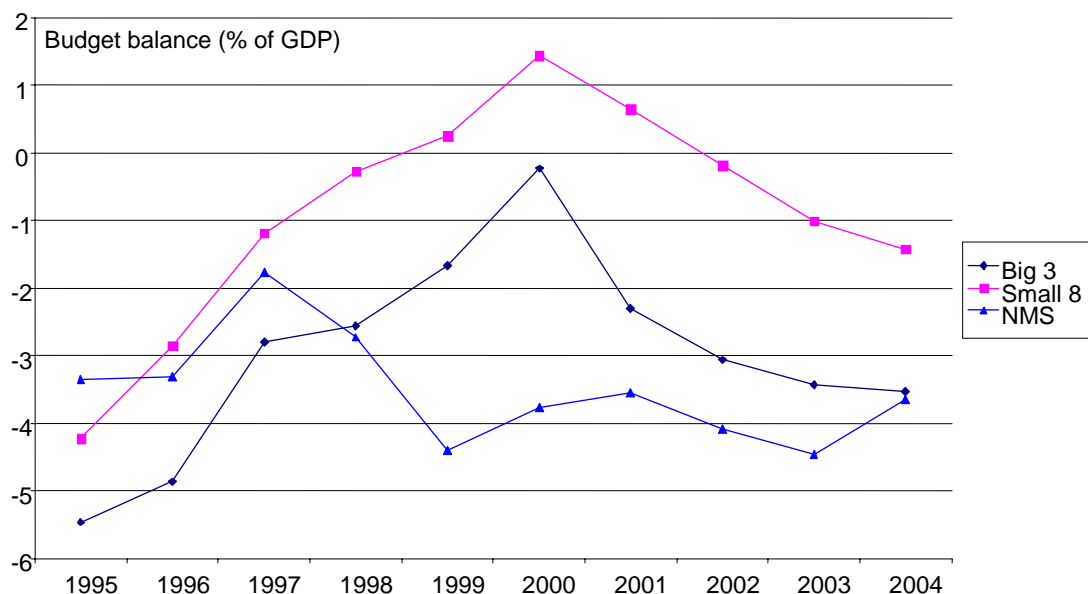
**Figure 5. Growth performance: Big versus small (and new Member States)**



The large and persistent differences in performance across countries within the euro zone contain an important message: since monetary policy has been the same for all members of the eurozone it is thus unlikely that an overly tight monetary policy was responsible for the poor growth performance of the eurozone.

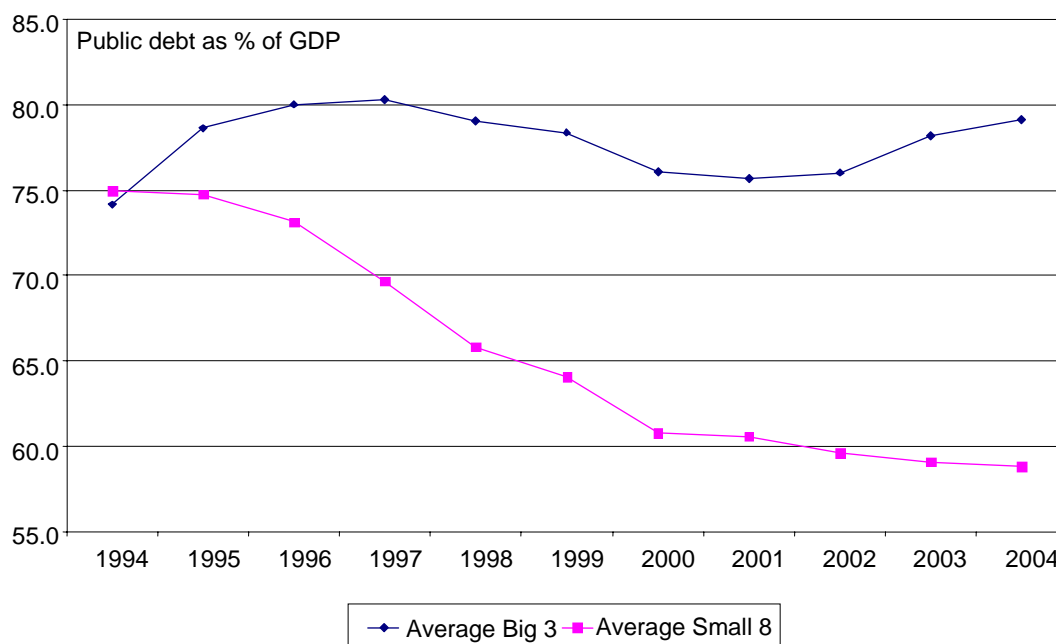
It is interesting to note that the much better growth performance of the smaller countries has been accompanied by much healthier public finances. The Figure below shows that the 8 smaller euro area member countries have on average run a budget ‘close to balance’, as required by the Stability Pact. Did their better growth performance come in spite of or because of this fiscal strictness? The facts suggest that the latter might be closer to reality since over the last years the smaller countries have maintained their lead in terms of growth, and at the same time, the difference in fiscal policy has increased. Maybe the leaders of the big three should reflect more on the long term benefits of a strong fiscal policy, rather than band together to bend the rules against excessive deficits according to their short term political preferences.

**Figure 6. Budget balances: Big versus small (and new Member States)**



The much tighter fiscal policy pursued by the smaller euro area countries does not seem to have reduced their growth, but it did have a strong impact on their debt levels. A decade ago the smaller euro area countries had a slightly higher debt ratio than the big-3. This changed radically over the last ten years. The smaller countries have now a debt ratio that is about 20 percentage points of GDP lower than that of the big-3, whose ratio actually increased over the last decade, and has stagnated at a high level since the start of EMU. The smaller countries are thus much better prepared to tackle the fiscal implications of population ageing and they will also be much less affected by any future increase in interest rates.

**Figure 7. Public debt ratios compared**



Why are smaller countries able, on average, to perform better? Inflation was somewhat higher in the smaller countries so that they faced also lower real interest rates. But this factor alone would



not be enough to explain a growth differential of this size. A more fundamental factor that that might play an important role is that the 'Big-3' have more structural adjustment to undergo. Table 4 below provides some summary data on the small-large divide. There is one area in which the larger economies see a source of strength transformed into a handicap: this is the relatively high weight of industry in their economies. As long as markets were separated the larger member countries offered a larger home market and were thus a better location for industry than their smaller EU partners. With the single market and the euro this comparative advantage has disappeared. At the same time the competitive pressure on industry increases, not only from the worldwide process of globalization, but also because of enlargement. In the past the rather high share of industry in employment in the Big-3 (21 % of the workforce) might have been a source of strength. Today it is a problem that might explain part of their underperformance, at least if compared to the smaller member countries where the share of industry is at 15 % of the workforce already much lower. (Not to speak of the US, where it is even lower.) The new member countries have for the time being also a rather large share of industry. But given that exports of industrial goods is the only way in which they can export their relatively abundant supply of labour this is for the time being not a handicap.

**Table 4. Large versus small**

Averages 1998-2004	Big 3	Small 8	France	Germany	Italy	NMS	US
Real GDP growth	1.3	2.7	2.0	0.8	1.2	4.6	4.4
Fiscal balance	-2.4	0.0	-2.6	-2.4	-2.10	-4.0	-1.8
Labour productivity growth	0.7	1.7	1.0	0.9	0.3	3.9	2.3
Share of industry	20.5	17.6	16.2	21.8	23.3	24.6	12.3

Source: own calculations based on AMECO data. NMS= New Member States.

The problem with adaptation to the inevitable trend de-industrialisation of modern economies is the one key element that distinguishes France from the other two large Euroland economies, Germany and Italy. France has a lower share of its population in industry and is on this account closer to the smaller member countries than to its big neighbours East and South. This might also be the reason why France performs somewhat better on productivity.

Smaller member countries are not just lucky in that they happen to have less of a problem with de-industrialisation. They have also clearly been able to react much better to the shocks that have buffeted the world economy recently. External shocks, such as the 9/11 terrorists attacks or the Iraq war are routinely used as an excuse the weakness of the European economy. This assertion can be tested in a simple way: if it were true one would expect that small countries should be hit stronger than the large countries because the smaller member countries have much larger exposure to the rest of the world than the larger member countries. However, the data indicate exactly the contrary. As the Figure above showed the small euro area countries have continued to outperform the 'big three' (D+F+IT) by a considerable margin even during the turbulent period since 2001.

#### 4. Weak supply leads to weak policies?

A negative shock to supply can lead to negative second round effects by the stress it puts on macroeconomic policy. I discuss here two policy fields in which this has clearly been happening recently, namely fiscal and structural policies.

#### 4.1 The crumbling of fiscal policy discipline

To safeguard against a relapse into past fiscal policy profligacy EU governments in 1997 concluded the Stability and Growth Pact. The purpose of the pact was to provide a framework for the operation of the excessive deficit procedure, enshrined in the Maastricht Treaty, within EMU. There can be little doubt that fiscal discipline remains indispensable to ensure government solvency in the longer run against the background of an ageing population, and that the Stability and Growth Pact, albeit far from perfect, remains the best available instrument for trying to enforce discipline.

Unfortunately, during the first few years of EMU, when growth was strong, poor implementation of the Pact allowed countries to run structural deficits (partially because the ongoing slowdown in potential growth was ignored). This set the stage for trouble during the more recent phase of economic weakness. As economic growth dropped close to stagnation in 2001-03, pressure on budget deficits rose, forcing governments to choose between tough (and possibly pro-cyclical) spending cuts to meet the requirements of the Stability and Growth Pact and a weakening of the budget constraints. With both Germany and France, the heavyweights in the EU and EMU, having difficulties adhering to fiscal policy discipline, it is no surprise that the Council of Ministers opted for softening the budget constraint.

##### Box 1. Key points of the SGP – old and new

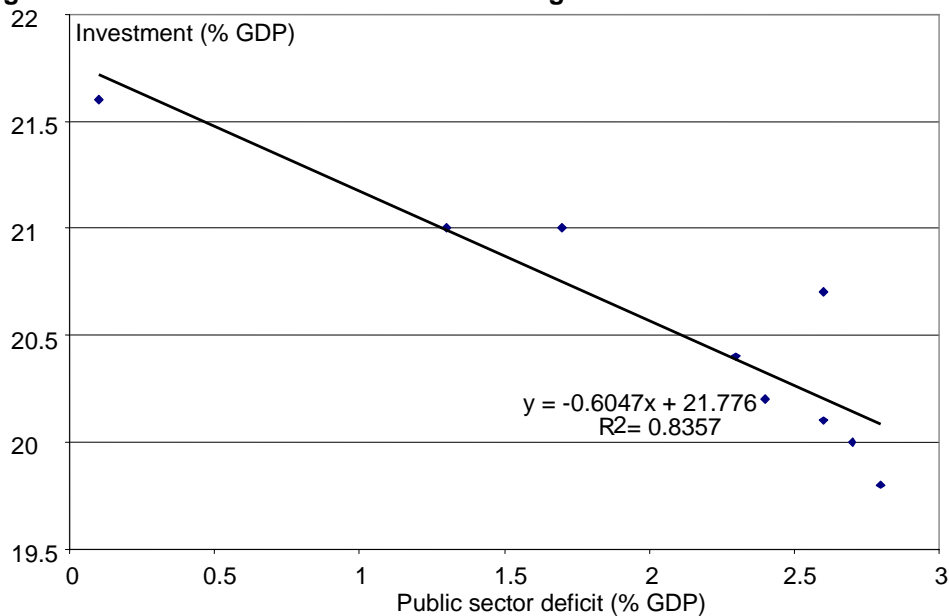
	Old	New
Small overshoot of deficit permitted if:	Exceptional event (natural disaster) Recession with GDP falling by more than 2%	In addition if there are structural reforms or spending on Research and development European political goals International solidarity Investment Pension reform EU contributions
Excessive deficit possible if:	Drop of GDP by more than 2% Drop of GDP by more than 0.75% if downturn sudden, output gap positive, exceptional circumstances	In addition if economy is stagnating or growing very slowly
Time to correct excessive deficits:	One year after establishment	Additional time when growth is slow
Implementation of fiscal adjustment programmes	Within 4 months	Within 6 months
Medium-term fiscal policy goals	Balanced budget or surplus	1% deficit if low debt or high potential growth, balanced budget or surplus otherwise
Fiscal policy in good times		0.5% per year deficit reduction exceptional revenue earmarked for debt reduction early warning

In a “reform” of the Pact agreed in March 2005, the Council decided to make the exceptions in case of a violation of the 3% deficit limit more generous; to allow a number of “extenuating circumstances” in case of deficits above 3% of GDP; and to lengthen the periods within which excessive deficits have to be slashed (see box). As a result, the threat of sanctions for running an “excessive deficit” has faded into the background and fiscal discipline is eroding. Thus, in their recent fiscal projections from April 2005, the EU Commission expected no further reduction in budget deficits at the Eurland level and forecasted France, Italy, Portugal and Greece to run deficits in excess of 3% of GDP by 2006. The ratio of government debt to GDP, which fell from 76.1% for the euro area as

a whole in 1996 to 69.4% in 2001-2002, has already increased again in 2003-04. The risk is now high that it will continue to increase also in the medium-term future. With the inevitable rise in age-related public spending coming in the next decade, a serious crisis of government finances in many Euroland countries within the next 10-15 years is now a distinct possibility.

The standard defence of this weakening of the SGP has been that countries should not be forced into an overly hasty fiscal adjustment. However, there is a clear long term cost associated with allowing countries to run larger fiscal deficits: public dis-savings tend to crowd out private investment. There is a large literature on the extent of this phenomenon and one could argue that in an area that has access to the world capital market it does not really matter how much the government (dis-)saves since private investment can still be financed by capital imports, if needed.

**Figure 8. Investment and Governments saving**



We do not wish to review this complex of arguments in detail here. We simply point out that in reality, larger deficits have been associated with lower investment over the last years. Figure 8 shows the tight relationship that one can observe over the last years. If this relationship were to prove stable one could conclude that an elimination of the structural deficits, which now are over 2 % of GDP should increase investment by about 1 percentage point of GDP. As we showed above that a declining capital labour ratio is one of the causes of the productivity slowdown it is apparent that there will a cost to be paid for the abandonment of fiscal discipline in term of lower growth in future.

#### 4.2 The unravelling of structural reform

The Lisbon Agenda was Europe's answer to the competitive challenges coming from low cost and high quality suppliers abroad. A key part of this agenda was completion of the internal market especially for services, which was expected to inject new dynamism into the European economy through greater competition in a sector accounting for about 70% of employment and GDP (see box below). The Lisbon Agenda was to be complemented by structural reform on the national level, especially in the areas of tax, labour market and regulatory policy.

Five years on, the achievements have been truly disappointing. At the EU level, a major and perhaps fatal blow was delivered to the Lisbon Agenda in March 2005, when the services directive was sent back by the European Council to the Commission for a comprehensive overhaul. Most importantly, the critics of the Commission's draft have questioned the country-of-origin principle in the mutual recognition of regulations, which is at the heart of the single market. According to the critics, this principle, which allows providers to offer their services within the EU under home regulations, leads to unfair competition and "social dumping". As suppliers based in high cost, densely regulated countries would be pushed out of the market, there would be a "race to the bottom" in regulations and social protection. To safeguard against this, the critics want to reduce the country-of-origin principle to the exception and make the country-of-destination principle, where service providers have to observe the rules in the consuming country, the rule for the supply of services. The result would be a higher level of protection of high-cost service suppliers and the continuing fragmentation of the European services market.

### Box 2. Services Directive

It is often overlooked that, until its presentation in early 2005, the Services Directive had been presented as one of the cornerstones of the Lisbon strategy. The Commission document motivates the proposal thus (Brussels, 5.3.2004 COM(2004) 2 final/3):

"This proposal for a directive is part of the process of economic reform launched by the Lisbon European Council with a view to making the EU the most competitive and dynamic knowledge-based economy in the world by 2010. Achieving this goal means that the establishment of a genuine internal market in services is indispensable. It has not hitherto been possible to exploit the considerable potential for economic growth and job creation afforded by the services sector because of the many obstacles<sup>2</sup> hampering the development of service activities in the internal market. This proposal forms part of the strategy adopted by the Commission to eliminate these obstacles and follows on from the Report on the State of the Internal Market for Services<sup>3</sup>, which revealed their extent and significance."

The Commission underlines the importance of the services directive thus:

"Services are omnipresent in today's economy, generating almost 70% of GNP and jobs and offering considerable potential for growth and job creation. Realising this potential is at the heart of the process of economic reform launched by the Lisbon European Council and aimed at making the EU the most competitive and dynamic knowledge-based economy in the world by 2010. It has not so far been possible to exploit fully the growth potential of services because of the many obstacles hampering the development of services activities between the Member States."

The Commission proposal is also part of the Lisbon agenda:

In March 2000, the Lisbon European Council adopted a programme of economic reform aimed at making the EU the most competitive and dynamic knowledge-based economy in the world by 2010. In this context, the EU Heads of State and Government invited the Commission and the Member States to devise a strategy aimed at eliminating the obstacles to the free movement of services<sup>4</sup>.

At the same time, national governments' efforts at structural reform have also run out of steam. Politicians have taken a cautious approach to reform as they have feared the ire of their electorates. Hence, in the last few years, euro area governments have eased tax burdens somewhat, reduced regulations to a certain extent, and eased restrictions in certain segments of the labour market. All this were steps in the right direction, but the measures were not comprehensive enough to engineer a clear turnaround in the labour market and push GDP growth higher. With the results of

<sup>2</sup> "An Internal Market Strategy for Services", Communication from the Commission to the Council and the European Parliament, COM(2000) 888 final, 29.12.2000.

<sup>3</sup> Report from the Commission to the Council and the European Parliament on "The State of the Internal Market for Services", COM(2002) 441 final, 30.7.2002.

<sup>4</sup> Presidency Conclusions, Lisbon European Council, 24.3.2000, paragraph 17. The need to take action in these fields was also highlighted at the Stockholm and Barcelona Summits in 2001 and 2002.

reform disappointing, electorates have become dissatisfied with structural reform and are increasingly leaning towards backward-looking protectionist policies. Politicians eager to deflect from their own failings and to raise their standing with a disgruntled public are catering to these sentiments by questioning the rationale of an open, market-oriented economy. The risk is growing that the political backlash over the unsuccessful implementation of reform will lead to protectionist policies in Euroland, raising economic inefficiencies and dampening economic growth even more.

Towards the end of the last millennium, some observers were wondering whether the first ten years of the new millennium would not turn into the decade of Europe. To some extent, these hopes for a European revival were reflected in the ambitious goal set in the Lisbon agenda launched in 2000 to create “the most dynamic knowledge-based economy of the world by the end of this decade”. In view of the experience of recent years and with only five more years to go to meet the goal, we may now conclude that this is very unlikely to be Europe’s decade. In fact, future economic historians may well conclude that this was the decade when the secular decline of Europe was reaffirmed. The fall of the Berlin Wall at the end of the 1980s appeared to open a new future for Europe. However, the 1990s consolidated the US’ political and economic weight in the world. At the beginning of the decade, Europe set itself high political and economic goals. Most likely, it will miss both. With the rise of Asian countries in recent years, Europe is most likely to end the decade as a shrinking political and economic power, continuing and reaffirming a trend that began with World War One.

## 5. Concluding remarks

This contribution has documented the structural weakness of the eurozone, or rather its largest member countries (F, D and IT). It is apparent that even the best structural reforms cannot change some fundamental parameters. Structural reforms cannot change negative trends in demographics and, at least not directly, in a declining capital labour ratio. But it is also clear that reform can help. The example of smaller euro member countries shows that better performance is possible. However, the rejection in early 2005 of the draft directive on liberalising trade in services by countries such as France and Germany suggests that some countries are resisting this lesson.

Why then has policy not improved? The key reason is that policy decisions are determined by short term considerations. This applies in particular to fiscal policy which is now governed by a mix of political expediency and some primitive Keynesian ideas. In this context the long-term objectives and issues are often forgotten: Two of these long-term considerations are particularly germane for Europe today:

- 1) Ageing makes surpluses today desirable to prepare for ageing
- 2) Deficits crowd out investment!

This suggests that a fiscal policy oriented towards the long run could produce a ‘double dividend’: it would prepare governments for ageing and it should crowd in investment, making it easier to maintain the capital labour ratio and hence productivity growth. What is needed today is thus not only structural reforms, but also a structural reform of fiscal policy. The reform of the Stability and

Growth Pact agreed in early 2005 at the instigation of France and Germany, but with almost unanimous support, suggests, unfortunately that policy makers are going in the opposite direction, they are looking for excuses to continue a policy that emphasises short term expediency at the expense of longer run gains.

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