

## Will Europe Fall into a Japanese-Style Stagnation Trap?

By Peter Harrold

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Can Europe avoid falling in to a Japanese-style stagnation trap? In this type of trap, we see a repeated cycle of a financial crisis leading to a fiscal crisis, leading to a decline in consumer and investor confidence, and a resulting fall in demand. The decline in growth that inevitably follows simply causes the cycle to repeat itself. In theory, this should lead to improved competitiveness, but in Japan the forces of decline outweighed any boost in export demand.

Is this where Europe is heading? Japan focused its attention on overcoming the short term crises and was very slow to address the longer term structural factors that were impeding productivity gains. Europe appears preoccupied with the short term situation as well, and it is only in recent months that its leaders are beginning to talk about growth as well as crisis management. There are certainly many who fear this is what the future holds. Christine Lagarde, managing Director of the IMF, said in Beijing on November 9th last year:

*"We could see the risk of what some commentators are already calling the lost decade"*

Is this the inevitable future for Europe? When we look at Europe's strengths and its post-war pattern of growth, the answer appears negative. But it could of course happen, if attention remains focused only on the short term. However, if Europe addresses its structural policy challenges with determination and clear thinking, there is every reason for optimism about its future. In this brief, the focus is on the two keys to Europe's past success and the two key structural areas that could be the difference between stagnation and success<sup>1</sup>.

### **Did Europe do well before the crisis and if so, why?**

There has been a lot of focus on Europe's relatively lack-lustre performance in the 2000s, as if that was the whole story. First of all, it's important to remember that Europe is united in its markets, but extremely diverse in its performance. Within "Old Europe," there are the continually revving engines of Germany, Austria, the Netherlands, and (mostly) the UK, while Italy and the other Southern countries have stagnated. But let's not forget the remarkable growth story of the former socialist countries of the east, the steady innovation of the Nordic North, and the Irish Tiger, which had such a solid performance in real growth before the bubble. Table 1 offers some historical perspective on this over a very long period of time (and it is the very long term performance that counts – as the moderate but incredibly consistent growth of the United States over the last century has shown).

Western Europe has seen remarkable post-war growth; in the period leading up to 1973, it was only exceeded by Japan. Southern Europe (Italy, Greece, Spain, and Portugal) saw enormous change in what were relatively poor countries before this time. Their decline is very recent. By any measure, these growth statistics indicate a strong pattern over a very long period of time, leaving Europe with an enormous legacy of capital accumulation and of skilled, educated populations with a highly developed sense of social responsibility. This record over such a long period of time is easy to overlook in the current gloom.

<sup>1</sup> This e-brief draws much of its content from a recent report issued by the World Bank called "Golden Growth: Restoring the Lustre of the European Economic Model" by Indermit Gill et al. It has been also based on the author's presentation at the CASE 2011 International Conference on "Europe 2020: Exploring the Future of European Integration" held in Falenty n. Warsaw, November 18-19, 2011.

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**Table 1: Relentless growth in the United States, a miracle in Europe, and resurgence in Asia, 1820-2008**

Average annual compound growth rates, 1990 Geary-Khamis \$ PPP estimates

Year	Western Europe	Southern Europe	Eastern Europe	(Former) Soviet Union	United States	Japan	East Asia	Latin America
1820-1870	1.0	0.6	0.6	0.6	1.3	0.2	-0.1	0.0
1870-1913	1.3	1.0	1.4	1.1	1.8	1.5	0.8	1.9
1913-1950	0.8	0.4	0.6	1.8	1.6	0.9	-0.2	1.4
1950-1973	3.9	4.7	3.8	3.3	2.5	8.1	2.4	2.6
1973-1990	1.9	2.3	0.5	0.8	2.0	3.0	0.6	0.7
1990-2008	1.6	2.3	2.6	0.8	1.7	1.1	3.0	1.8

Note: Regional aggregates are population weighted. Western Europe is used here to refer to Austria, Belgium, Denmark, Finland, France, West Germany, Italy, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom. Eastern Europe refers to Albania, Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and Yugoslavia. Southern Europe refers to Greece, Ireland, Spain, and Turkey. After 1989, West Germany became Germany and the data reflect the newly independent countries in Eastern Europe that emerged from Czechoslovakia and Yugoslavia.

Source: Maddison (1996) and Conference Board (2011).

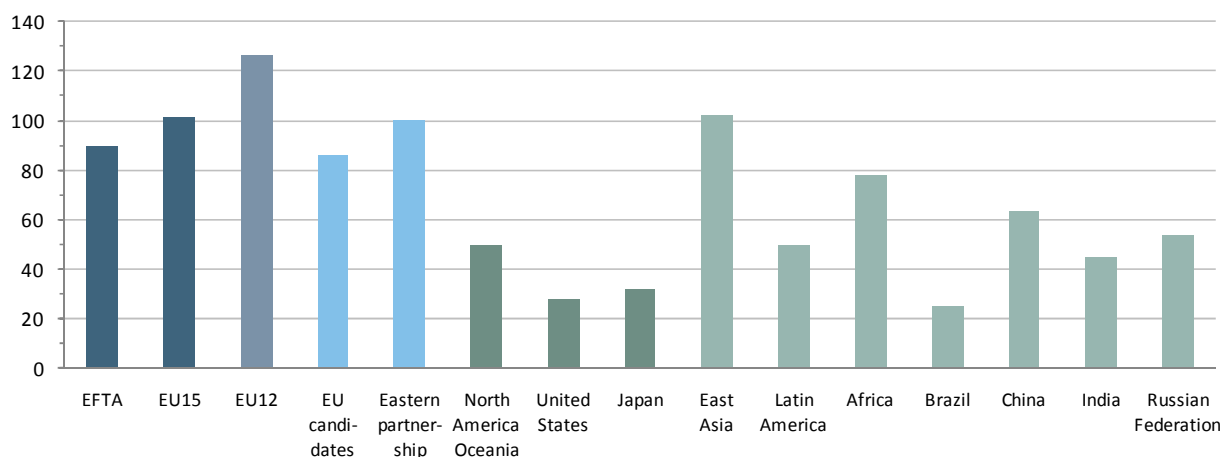
So what is the basis for the current success that has brought Europe such prosperity and so much admiration of its inhabitants' lifestyles? There are two factors that have been of critical importance in European growth patterns.

### Openness to trade and finance as the driver of convergence

First, in terms of trade, Europe is the most open region in the world, as shown by Figure 1 below. The EU countries trade over 100% of GDP. This is more than three times the level in the United States. It is rivaled only by the countries of East Asia (China, Japan, Korea, and Malaysia), which have based their entire development strategy on openness and exporting. The fact that much of Europe's trade is within Europe is not so relevant -- East Asia too trades more with itself than others -- and the growth of trade has been the key factor in Europe's most important characteristic in the last fifteen years in particular: through trade (coupled with a very generous regional development policy which transfers billions of Euros a year to the poorest parts of the Union), Europe generates growth in its poorer member states and brings convergence. The countries of Eastern Europe have grown dramatically in the most recent period. This growth is remarkably correlated with the growth in trade that is generated via the access that comes with EU membership.

**Figure 1: Europe is the most open region in the world**

Trade as a percentage of GDP, average of 2005-2009

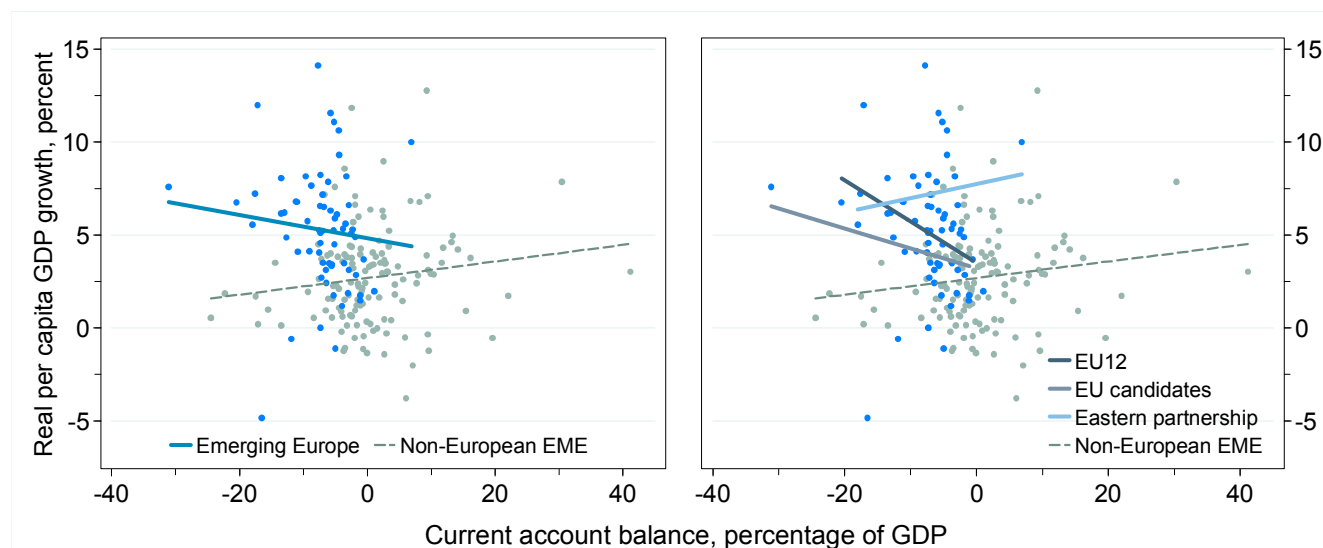


Source: Author's calculations, based on World Development Indicators.

But the second unusual factor that generates convergence is the remarkable fact that in Europe, capital flows the right way. In other parts of the world, there is either no discernible pattern, or else it is the reverse. Witness the constant balance of payments deficits of the United States over several decades, financed by the savings of the citizens of China and Japan. But not in Europe, as Figure 2 shows, albeit at a difficult scale. Capital has flowed in huge volumes from the rich West and North to the East, and earlier to the South, as capital sought to support and benefit from the great development opportunities that these countries were enjoying as they prepared for and entered the EU. Foreign capital accounts for 60-80% of the banking systems of the new member states. It could be said that countries such as Poland, which managed the process proactively, have fared better during the recent crisis than those which have witnessed bubble development in their real estate and commercial sectors and have had to adjust rapidly in response to the crisis. But the balance of the equation is clearly well in favor of the receiving nations.

**Figure 2:** In much of Europe, capital flows to high growth countries

Current account deficits and per capita income growth, 1997-2008



Note: Average values calculated using 3 four-year periods in 1997-2008 are shown.

Source: Author's calculations, based on IMF World Economic Outlook.

These two phenomena – the importance of trade and the flows of capital – point to two of the key lessons for Europe as it seeks to avoid a Japan style stagnation. The quickest way to generate such a recession would be to draw back from trade openness and to restrict capital movements. For many European financial institutions, it is these new markets which are the most profitable and healthy elements of their portfolios. Which sensible institution would wish to yield to the “home bias” as they face difficulties in their domestic markets or their investments in the South? On the trade front, to avoid stagnation, we need more “Europe” not less: we need to see the service sector – the fastest growing segment of the world economy – experiencing the same degree of freedom in cross-border trade as goods. So as Europe struggles to restore growth, let the trade and financial sectors continue to play their parts.

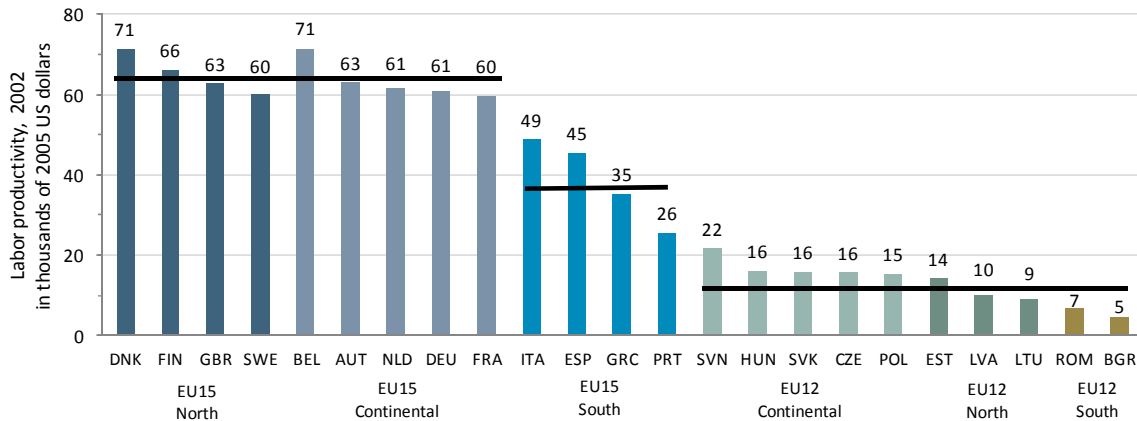
### The challenge of productivity and innovation

But to secure trade growth, Europe will need to ensure productivity growth and greater support for innovation. Europe has great companies. But the household names are in older, well-established areas such as automobiles, aircraft, and financial services. How many of the great new global companies are European? Apple, Microsoft, Google, Amazon, Oracle, Skype... Oh yes, that used to be Estonian. The product of perhaps Europe's single most aggressive reformer, Skype was of course purchased by a US company as soon as it went global. Figures 3 and 4 below tell us a story that is profound. High income countries expect to grow at moderate rates – 2-3% a year is fine – and to do so on the back of high but slowly rising productivity. This includes European countries with the highest productivity rates such as Denmark, Finland, Belgium and the UK. Productivity rates grow at about the same rate as their economies. The poorer countries have a much smaller capital base, so have lower initial productivity, but great potential and so their productivity grows much faster and

serves the goal of convergence, as in the cases of the Czech Republic or Latvia. The middle countries, those of Southern Europe, should be somewhere in-between, with productivity growth expectations of 3-6% per annum. The biggest problem in Southern Europe is that in the last ten years, this growth has been *negative*. It can be said that Greece and Portugal have a *financial* problem because they have a *productivity* problem.

**Figure 3: Productivity levels were lower in the South and lower still in the East**

Average productivity in 2002, thousands of 2005 US\$

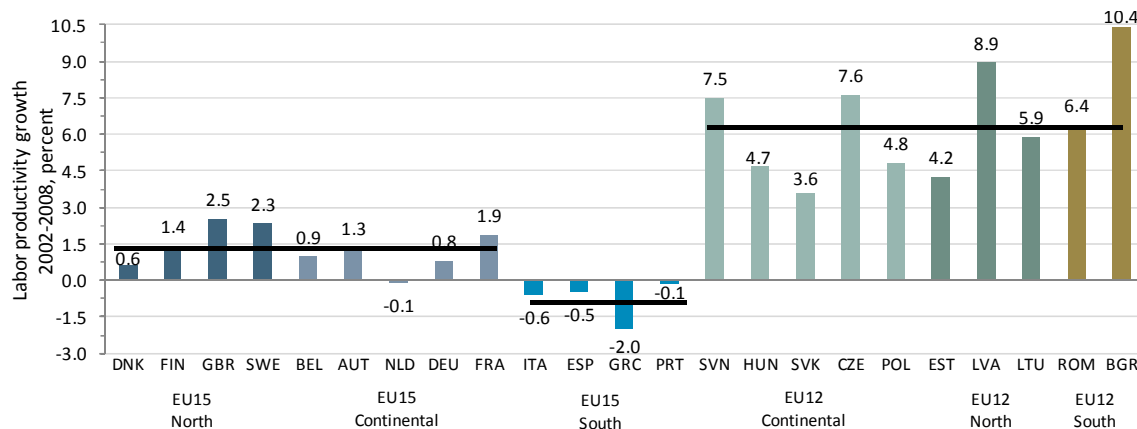


Note: Labor productivity is measured by value added per employee in six sectors (i.e., manufacturing, construction, hotels and restaurants, retail and wholesale trade, transport and telecommunications, and real estate and other services) based on the NACE 1.1 classification. For Belgium and Greece, productivity levels refer to 2003. Each line represents an average value of countries covered by it.

Source: Author's calculations, based on Eurostat Structural Business Statistics.

**Figure 4: Eastern Europe has been catching up, Southern Europe has been falling behind**

Average productivity growth in EU27, annual percentage rates, 2002-2008



Note: The period of time considered varies by country: Belgium (2003-2008), Greece (2003-2007), and United Kingdom, France, Czech Republic, Latvia, and Romania (2002-2007). Each line represents an average value of countries covered by it.

Source: Author's calculations, based on Eurostat Structural Business Statistics.

So the next strand of the anti-stagnation policy must be: Implement activities to boost productivity. There are two in particular. The stagnation of productivity in the South is linked to the most rigid labor markets, which have choked off investment. That is why the new governments of Italy and Spain have focused on labor market reforms as well as fiscal change. But this also needs active policies by Governments to accompany market reforms such as innovation policies that support greater links (including financial links) among business, research and academia. This means support to research that helps bring ideas to market, not just to academic journals. Only one country in Europe – Finland – currently invests as a nation in R&D at the level of 3% of GDP that Europe 2020 calls for. Innovation policies need to be central, not peripheral, to government policies.

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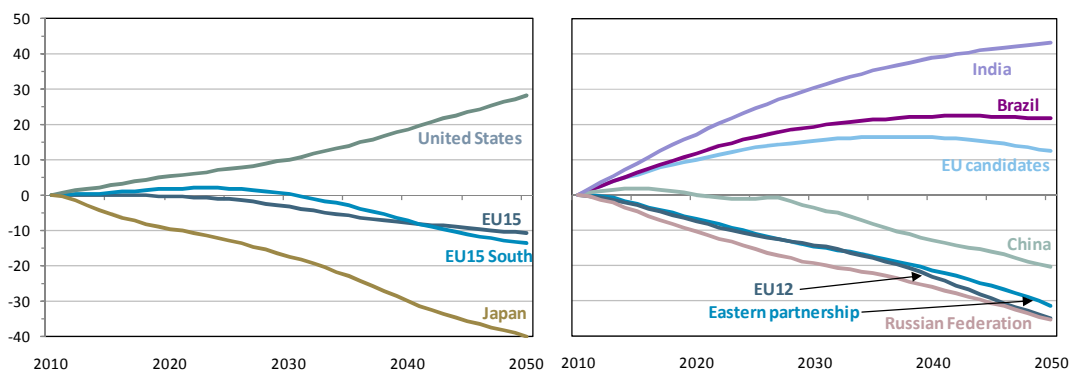
### The Core Issue of Aging and Participation

The fourth element of an anti-stagnation policy is perhaps the most challenging. Europe is aging faster than any other part of the world. Some countries, such as Bulgaria and Poland, are facing dramatic declines in population. The Bulgarian working age population will decline as much as 40% by the year 2050. But even before this fully hits home, Europe already spends more on social assistance (mostly pensions) than the rest of the world put together. Unfortunately, this is at present accompanied by very low rates of participation in the labor market, especially of older persons and women. For people in the 55-64 age range (which should be very productive given health conditions), the employment rate in Europe is just 46% compared with 65% in Japan. In terms of women, Europe fares better, but the employment rate is still 58% compared with 62% in the USA. These numbers do not add up over time. We cannot have a growing retired group, a shrinking labor force and a high rate of non-participation, especially of older workers. Why is this and what can be done?

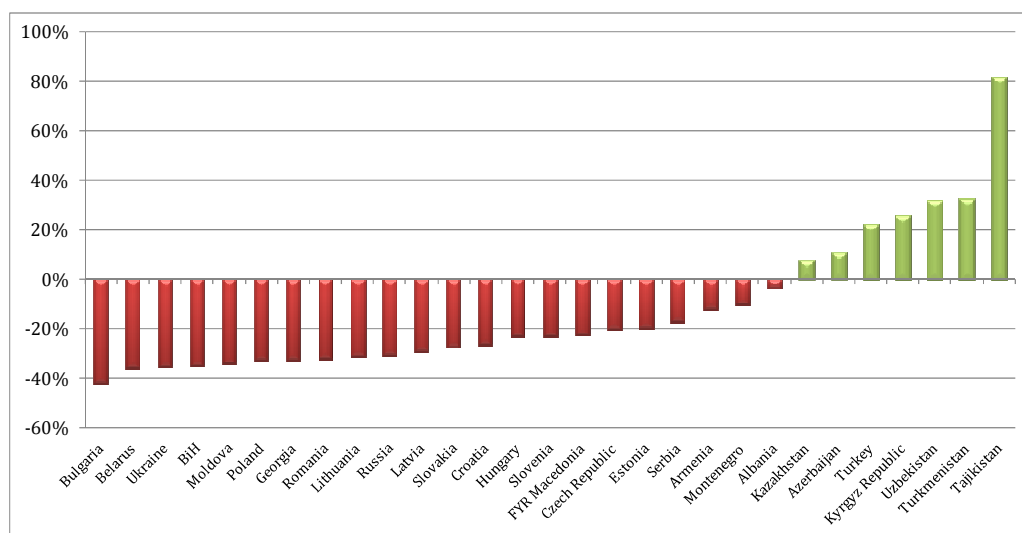
The two issues are closely linked: too many pension systems encourage or even mandate early retirement. The rate of employment of women over 55 in Eastern and Southern Europe is in the 25-40% range. This is not gender friendly. Too many women in Europe are left with inadequate pensions, at a very low replacement rate of their work life family incomes. Many governments are responding by addressing the two policies that are the key to improving this situation. Governments are raising the ages at which full pensions are received (many countries have targeted 67 years, as the Government of Poland has just proposed to Parliament) and equalizing the ages between men and women. This is being accompanied by active labor market policies that help people stay in, or re-enter the workforce and adapt over time.

**Figure 5: The Changing Face of the Population**

Working-age population (2010 = 0)



**Figure 6: Change in working age population between 2010 and 2050 in ECA countries (percent)**



Source: World Bank Staff estimates

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## So Can The Stagnation Trap Be Avoided?

The stagnation trap can be avoided if strong policies are followed in four areas:

- Deepen trade, especially in services - we need more Europe not less
- Preserve cross border financing, avoiding the "home bias"
- Make labor markets more flexible and place innovation policies at the center, not the periphery, of policymaking in order to induce productivity growth
- Address the twin challenges of aging, which are essentially the incentives for participation in the workforce and pension reform.

The real question is: Will policies such as these be put in place in Europe? Indeed there are signs of change, and let us hope that it is these questions that will soon take center stage.

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*This E-brief is based on Peter Harrold's presentation at the CASE 2011 International Conference on "Europe 2000: Exploring the Future of European Integration" held on November 18-19, 2011. See the full presentation here: <http://vimeo.com/33773000>*

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