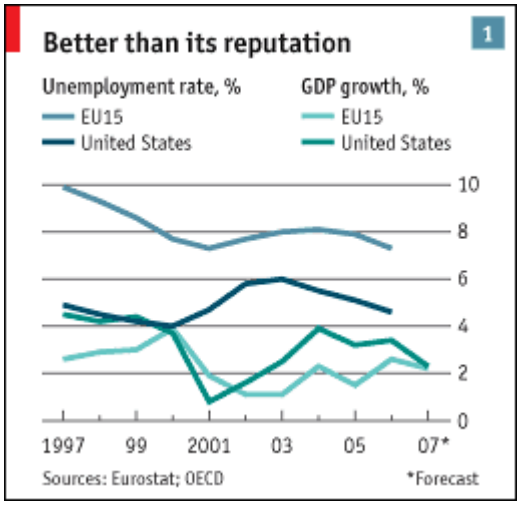
The quest for prosperity

Europe's economy has been underperforming. But whose fault is that?

AS IT happens, the recent economic figures in Europe have been better than anyone dared hope. The German economy, in the doldrums for six long years, is at last gathering speed. In 2006 GDP in the EU as a whole grew by 2.9%, and in the euro area by 2.7%. In the fourth quarter of last year the euro area's GDP growth outstripped America's for the first time in five years. Average unemployment has fallen to 7.5%, the euro area has generated 12m new jobs over the past eight years and even productivity growth has started to pick up. Across Europe the mood has become noticeably more optimistic.

Yet this greater optimism comes after an extended period of profound gloom. Over the past decade GDP growth has been generally lacklustre; productivity has stagnated, in some countries even fallen; and unemployment has stayed stubbornly high (see chart 1). The contrast with 50 years ago, when the Treaty of Rome was signed, could hardly be greater. West Germany was in the midst of its Wirtschaftswunder, a miracle country of rapid growth, low unemployment and fast-rising living standards. France was enjoying les trentes glorieuses, 30 splendid post-war years when everything went right. And Italy was quickly gaining ground on its richer European neighbours.

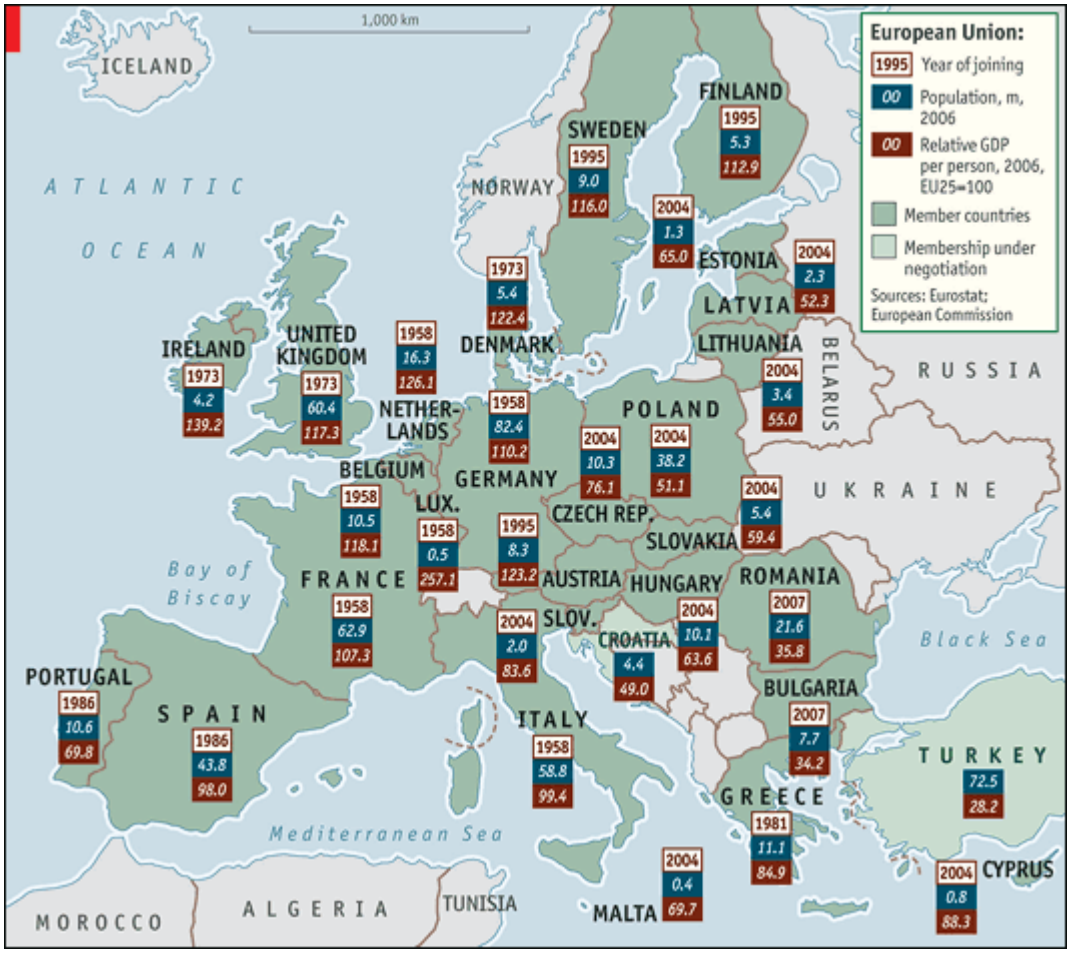


Some slowdown after the catch-up years of the 1950s and 1960s was inevitable. Reconstruction after the war had boosted growth; the movement of workers out of farming and into industry had raised both productivity and GDP; and many more women had entered the labour force, lifting output. Once these effects had run their course, rapid growth became much harder to sustain.

The same factors played a part in other rich countries, such as America. Yet the EU economies, and especially the euro area, have in recent years performed much less well than the American economy, which is comparable in size. GDP per head in the euro area is almost 30% lower than in America, and the gap is widening: the OECD reckons that trend growth per person is only about 1.5% a year, compared with America's 2%. Productivity growth in Europe slowed in the late 1990s, whereas in America it speeded up. Unemployment in Europe has been persistently higher than across the Atlantic. Europeans have also been slower to take up information technology, and the economic climate has been less conducive to innovation and research and development (R&D).

The transatlantic gap can be exaggerated: much of America's faster GDP growth merely reflects faster population growth and longer hours of work, and differences in measurement

also play a role. But the perception that over the past decade Europe has stopped catching up with America, and in some respects actually fallen behind, is broadly accurate.



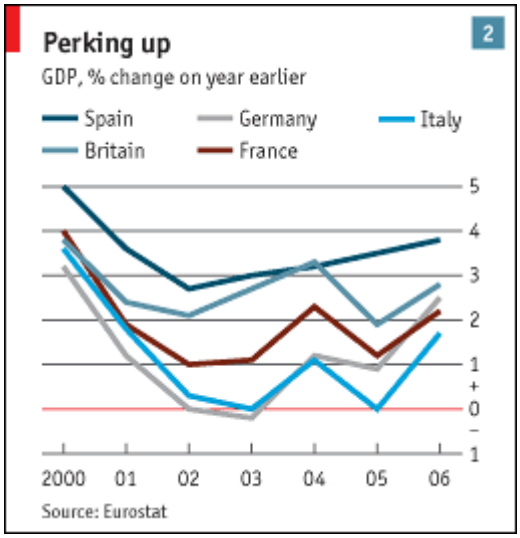
Europe's response has come in two main forms: the creation of the euro in 1999 and the drawing up of the so-called Lisbon Agenda in 2000 to boost the EU's competitiveness. The Lisbon Agenda set an ambitious goal for Europe: to turn it into "the most competitive and dynamic knowledge-based economy in the world" by 2010. The plan was to promote liberalising reforms, increase R&D spending and encourage the deregulation of labour and product markets across the continent. Similarly, the euro's proponents hoped that the single currency would not only increase cross-border trade but also, by imposing tougher price and wage discipline on its members, speed up structural reforms in all European economies.

Yet even the most fervent EU enthusiast would concede that these hopes have come to little. Joaquín Almunia, the economics commissioner, maintains that the current revival is linked to the structural reforms made in recent years, which may be starting to pay off. But most economists put it down to two other factors: a cyclical upswing and a huge improvement in German competitiveness after years of real wage restraint. If they are right, it is reasonable to doubt that today's recovery will prove sustainable—and to fear that Europe's economies could slip back into their previous underperformance.

Look on your doorstep

So what is Europe's problem? First, whatever it is, it is not Europe-wide, nor indeed linked to the euro. This supposedly sclerotic continent includes three of the world's five best-performing and most competitive economies: Denmark, Finland and Sweden. Britain and Ireland have also done well in recent years. Nor is it only north European economies that have put in a spurt: Spain, too, has grown fast since 1999. Of these six success stories, three are in the euro zone and three are not.

The poor performers in Europe have been the core countries of the euro, in particular France, Germany and Italy (see chart 2). Since these three account for two-thirds of euro-area GDP, their failings have led to slow growth for both the euro area and the EU as a whole. It is evident that Europe's economies have sickened at national not European level, so it is at national level that the cures are needed.



Nor is there much disagreement among economists about what those cures should be. In all three countries labour and product markets are too highly regulated, holding back employment growth and making their economies less flexible. Both the IMF and the OECD have been urging further liberalisation as the only sure route to better economic performance. Even Europe's political leaders understand this, though they are also swift to spot political obstacles to reform. As Luxembourg's Mr Juncker once said, "we all know what to do, we just don't know how to get re-elected after we've done it."

Mr Almunia hopes that the recent improvement in the EU economies may break the unfortunate cycle of partial reforms that take time to bear fruit and are often followed by election defeats. But there is another, less hopeful possibility: that opponents of change will treat the present recovery as a sign that no further reforms are needed.

Within the euro area a debate is in progress over whether the single currency itself encourages or discourages reforms. Most of its progenitors had hoped for the first. The euro has clearly boosted intra-EU trade, by somewhere between 5% and 15%, according to the OECD. It has also been a spectacular success from a technical point of view, establishing itself not just as a viable currency but as the only plausible rival to the dollar. For example, it now accounts for 25% of global foreign-currency reserves. Yet the euro's broader economic impact has been limited because of its members' failure to liberalise enough. As the OECD puts it in its most recent report on the region, "insufficient flexibility prevents the euro area reaping the full benefits of economic and monetary union."

When the euro began, critical economists directed most of their fire at the stability and growth pact, which attempted to set rigid limits on budget deficits run by euro members and threatened huge fines if those limits were breached. This provision made little economic sense. Because the single currency deprived members of monetary and exchange-rate flexibility, they were likely to need more, not less, fiscal flexibility. Predictably enough the stability pact was swiftly bust by France and Germany, after which it was fitted with extra loopholes.

Since then the pact has become much more accommodating as more and more countries have breached the budget-deficit ceiling of 3% of GDP. Mr Almunia maintains that it is now sufficiently flexible to set a reasonable long-term path for those euro-area members that still need more fiscal consolidation. In particular, the level of public debt remains too high in Italy, Belgium and Greece, and to a lesser extent in France and Germany (see chart 3).

But the failure of the euro countries to liberalise has become a much more pressing concern. Not only is it holding back the euro area as a whole, it is also increasing the divergence between members. This shows up most clearly when comparing movements in unit labour costs.

The coming crunch

Germany initially suffered from entering the euro at a high exchange rate, but over the past seven years German companies have spectacularly improved their competitiveness, thanks mainly to keeping a tight rein on wages. This is at the root of Germany's economic recovery and has allowed it to claim back from America its position as the world's biggest exporter. But part of this improvement has come at the expense of other euro members with which it is now locked into the single currency. In particular, the Mediterranean quartet of Italy, Spain, Portugal and Greece has suffered a huge loss of competitiveness in a relatively short time (see chart 4).

This loss is reflected in colossal current-account deficits (eg, 8.5% of GDP for Spain, which has been growing fast) or pitifully slow growth (only 1.3% a year for Italy since the euro began). Without the euro, Italy at least would surely have had to devalue by now. In a sense, the single currency has protected its members, but at the price of storing up big problems in future. Some analysts still speculate that Italy might one day be forced out of the euro.

That would be politically unthinkable, and most politicians in Rome duly refuse to think about it. Leaving the euro would also be costly, as Argentina found when it was forced off its currency peg to the dollar in 2001. So what else can Italy do? One possibility is to follow the German example and endure years of wage restraint. But that requires a lot of discipline. Moreover, the two-tier labour markets that have become common in Europe, with insiders on

permanent contracts insulated from the fears of unemployment afflicting temporary workers, offer little incentive for workers to accept real pay cuts.

The harsh conclusion is that, for euro members, there is no alternative to substantial reform, liberalising product and labour markets alike, to make their economies more flexible and better able to cope with shocks. Ironically, the two EU members with arguably the most flexible economies are Britain and Denmark, both of which have chosen not to join the euro. Alas, the political leaders in Mediterranean countries show little appetite for taking on the special-interest groups that always resist painful reforms.
Meanwhile the new EU members that were once pressing for early entry need to think again. Slovenia scraped in at the start of this year; Malta and Cyprus may follow soon. But the Baltic states do not seem ready; and Poland, Hungary and the Czech Republic, the three biggest new members, are unlikely to join before 2012 at the earliest. They would be wise to employ the waiting time not only to grow fast but also to make their economies more flexible.

Fonte: The Economist, v. 382, n. 8520, p. 5-7, 17 Mar. 2007.