André Sapir
Professor Université Libre de Bruxelles and
Senior Fellow Bruegel

Reviving growth in the euro area: Demand management or structural reform policy?

The European Union (EU) – and the euro area in particular – has been suffering from low growth and high unemployment for several years. In its 2014 Autumn Economic Forecast, the European Commission was clearly downbeat, stating: "The EU economy is struggling to shake off its lethargy. Since the crisis struck, most Member States have been unable to generate or sustain strong economic momentum… [The result has been] slow growth in the EU and quasi-stagnation in the [euro area]." (European Commission, 2014). Six months later and after a series of positive developments including low oil prices and a low euro exchange rate, the Commission sounded a more optimistic, but still rather cautious message: "The near-term outlook for the EU economy has clearly improved…But will the economy be able to generate a self-sustained and balanced expansion once temporary tailwinds fade?" (European Commission, 2015).

The purpose of this paper is to provide some guidance on how to revive growth in the euro area. It starts by trying to understand why the euro area has stagnated for the past seven years and finds that explanations that only rest on structural rigidities or on insufficient demand are both wanting and that instead demand and supply policies need to be implemented to revive growth. The paper then takes a longer view at the European growth problem and finds that Europe, and the euro area in particular, faces a daunting challenge not having implemented a growth strategy before the crisis. Today, such strategy is needed even more than before, yet the headwinds are also more severe than before.

1 The euro area growth puzzle

There is little doubt that the euro area has fared extremely poorly since the advent of the financial crisis in 2008. Chart 1 shows that GDP, which dropped first in 2009 and a second time in 2013, is only expected to return to its pre-crisis level in 2015, seven long years after the start of the crisis. The two stages of the crisis in the euro area are

even better illustrated by chart 2, which shows that the unemployment rate for the euro area first jumped from less than 8% to around 10% in 2009, 11% and then to 12% in 2013.

The euro area's protracted, double-dip recession has been somewhat of a puzzle to the economics profession, which has split in two camps well characterized by my compatriot Paul De Grauwe. The first camp claims "that this low growth performance of the Eurozone is due to structural rigidities. In other words, the low growth of the Eurozone is a *supply side problem*. Make the supply more flexible (e.g. lower minimum wages, less unemployment benefits, easier firing of workers) and growth will accelerate." (De Grauwe, 2014; emphasis added). The second

camp advances a different "explanation for the Eurozone growth puzzle. This is that *demand management* in the Eurozone has been dramatically wrong since the start of the sovereign debt crisis. The latter led the Eurozone policymakers to impose severe austerity on the peripheral Eurozone countries and budgetary restrictions on all the others." (De Grauwe, 2014; emphasis added).

Those like Paul De Grauwe or Paul Krugman who belong to the second camp partly rest their case on something like chart 3, which contrasts the recent evolution of GDP in the euro area and in the United States. Their claim is that the euro area was well on track to recovery like the United States until it changed course in 2011-12 and adopted restrictive budgetary policies to deal with its sovereign debt crisis whereas the United States continued to pursue a relatively accommodating fiscal policy.

On the other side, those like many German economists who emphasise the role of structural rigidities tend to put forward something like chart 4, which contrasts the recent evolution of GDP in Germany and in Italy. Their claim is that these two euro area countries suffered a similar setback in 2009, but that Germany recovered rapidly thanks to its structural strength owing to pre-crisis reforms whereas Italy was unable to recover because of structural rigidities and lack of reforms.

My own view is that it is a mistake to oppose the structural and demand explanations and that instead the euro area's stagnation problem should be understood as the result of both supply and demand factors. To see this, I turn to chart 5 which displays again the evolution of GDP in the euro area and in the United States, but this time starting in 1999 when the euro was introduced rather than in 2007 when the financial crisis began.

What chart 5 shows is that the evolution of GDP in the euro area and in the United States was different already prior to the crisis. Applying the different pre-crisis trends to the euro area and the United States starting at the trough point (2009), the dashed lines in chart 5 show the evolution of GDP that would have occurred had the recovery in the euro area and in the United States followed their respective pre-crisis trends. For the United States, the gap between the dashed and the plain lines was never very large after 2009 and basically closed by 2015, implying that it had a one-time drop in GDP in 2009 but successfully recovered thereafter. By contrast for the euro area, the gap between the dashed and the plain lines becomes very wide starting in 2013, implying that although it had temporarily recovered from the initial drop in 2009 the euro area has not yet recovered from the second GDP drop associated with the sovereign debt crisis in 2011-12.

This back-of-the-envelope calculation implies that the large gap between the GDPs of the euro area and the United States observed since 2013 can be attributed to two factors of roughly equivalent weight: structural rigidities in the euro area compared to the United States that explain the differential growth performance that prevailed already before the crisis; and inadequate crisis management by the euro area, especially as far as the sovereign debt crisis is concerned. Note that I use the expression "crisis management" rather than "demand management" because I consider that the inadequate policy response to the euro area sovereign debt crisis was not just a matter of demand management but also of the poor handling of bank problems due to

the absence of a banking union, which resulted in excessive forbearance.[1]

This assessment, which combines rather than contrasts demand and supply factors, is apparently shared by Mario Draghi, President of the ECB, who concluded his 2014 Jackson Hole speech on unemployment in the euro area by stating that "a coherent strategy to reduce unemployment has to involve both demand and supply policies." (Draghi, 2014).

2 Beyond revival: dealing with Europe's long term growth problem

The euro area's growth problem discussed in the previous section cannot be easily dissociated from Europe's longer-term growth problem that was already detected well over a decade ago.

The 2003 Sapir Report (Sapir et al., 2003 and 2004) found that the EU's performance had been unsatisfactory since the early 1970s, with a steady decline of both GDP and productivity growth resulting in per capita GDP stagnating at about 70% of the US level. Chart 6 shows a similar trend for the euro area.

The Sapir Report ascribed Europe's disappointing growth performance to its inability to adapt an antiquated economic and social model to two major changes, the information technology revolution and globalisation, which called for new organisational forms of production with less vertically integrated firms, greater mobility within and across firms, greater flexibility of labour markets, greater reliance on market finance and higher investment in both R&D and higher education. The Sapir Report considered it urgent that the EU economic system be reconfigured so as to deliver higher growth. Failure to do this, it warned, would gravely endanger the sustainability of the European model with its emphasis on cohesion.

The Report argued that the key to meet these challenges was to deliver on the commitments of the 2000 Lisbon Agenda, the strategic economic goal of the European Union to become by 2010 a competitive and dynamic knowledge-based economy with sustainable economic growth, more and better jobs and greater social cohesion.

In order to achieve this goal the Report proposed a six-point agenda focusing on reforms where it considered that EU policies had the biggest potential to improve EU growth. The six main recommendations were to (1) make the

single market more dynamic; (2) boost investment in knowledge; (3) improve the macroeconomic policy framework of Economic and Monetary Union; (4) redesign EU policies for convergence; (5) improve EU governance methods; and (6) restructure the EU budget. Although some of these recommendations were implemented, the Sapir Report failed to change the main thrust of the European policy agenda and to convince policymakers that they needed to do more than pay lip service to the ne-

[1] *ESRB (2012) provides an early analysis of and warning about the dangers of forbearance in the euro area.*

cessity of a European growth strategy. See Sapir (2014).

As chart 6 indicates, the introduction of the euro did not prove to be a game changer in terms of growth. In fact, the euro area's per capita GDP in 2015 was at the same level compared to the USA as it had been in 1999, slightly below the average trend for the period 1970–2015. At the same time, however, dispersion among euro area countries greatly increased between 1999

and 2015 – first decreasing before the crisis and then sharply increasing since 2011. Germany, Austria and Ireland have improved their relative position compared to the USA between 1999 and 2015. On the other, Greece and Italy have seen their relative position deteriorate. In the middle, Belgium, Finland, France, the Netherlands, Portugal and Spain have kept their relative position vis-à-vis the USA more or less unchanged. The situation is particularly striking as far as France, Germany and Italy, the three largest euro area countries, are concerned. In 1999, their per capita GDP levels (measured at purchasing power parities) were almost identical. By 2015, the level in Germany was 15% higher than in France and 28% higher than in Italy.

More than ten years after the publication of the Sapir Report, Europe is still struggling to adjust its economy to major tectonic changes – globalisation, technological change and ageing. Unfortunately, the financial and sovereign debt crisis has compounded the challenges by accelerating the previous trends, creating new problems and decreasing the room of manoeuvre of governments to tackle them, partly as a result of the accumulation of public debts due to the crisis.

The previous discussion suggests that the time has come for European leaders to switch from a mode of crisis response to one of strategic action and to propose a new growth agenda.

The growth agenda proposed by the Sapir Report mainly emphasized supply measures because at the time Europe's main problem was indeed structural. Yet it also argued that the monetary and fiscal policy framework of EMU should be made more symmetric over the phases of the cycle.

Today's growth agenda ought to provide a convincing response to Europe's immediate and longer-term challenges, which entails both closing the output gap and increasing potential output. The strategy needs therefore to be two-handed: demand measures to close the output gap and supply measures to increase potential output.

On the supply side, the priority must be to implement the EU growth strategy, Europe 2020, the successor of the Lisbon strategy, with an emphasis on three areas. The first is the completion of the single market and the implementation of complementary structural reforms by the Member States to foster competition in product markets. Second, national labour market and social policies (including formal education, training and life-long learning) need to be modernised in the direction of greater flexibility and security for workers along the lines of the success-

ful Nordic model.[2] The EU could help facilitating national reforms with a proper use of the EU budget. Third, the EU budget can also help to increase Europe's research effort and to build a genuine European Research Area (ERA). Significant progress in these three areas would help Europe becoming a knowledge-based innovation society and economy able to confidently respond to the challenges of the 21st century.

On the demand side, the overall policy mix of the euro area needs to be more conducive to reducing the existing output gap. The key here is greater symmetry in the conduct of macroeconomic policy. Restrictive fiscal policy in crisis countries must be accompanied by looser policy in countries that enjoy fiscal space; it would also be useful if the EU could play a role in fiscal stabilisation. As far monetary policy is concerned, the ECB was late in launching its quantitative easing (QE) programme and in communicating that it is committed to a symmetric attitude towards both inflation and deflation risks. It did so in January 2015 and must keep the course until its objective of an inflation rate of below but close to 2% in the medium term is in sight. It must also communicate better that its inflation objective applies to the euro area on average rather than each and every euro area country, and therefore that achieving both disinflation in the euro area's periphery countries and the 2% objective implies an inflation rate of probably close to 3% in core euro area countries. Symmetry in the conduct of fiscal and monetary policies would result in a symmetric adjustment within the euro area that would contrast with the current asymmetric adjustment supported mainly by the crisis countries.

3 Conclusion

Europe – and the euro area in particular – is going through a testing period. In addition to having to respond to a number of long-term challenges that were already underway a decade ago, it has to deal with the consequences of a severe crisis which has left behind high levels of debt and unemployment in many Member States.

Tackling these issues requires a European growth strategy. Had Europe implemented the Lisbon strategy launched in 2000 and the related proposals made, for instance, by the Sapir Report, it would not probably have avoided the financial crisis but at least it would have been in much better shape to rebound more strongly and quicker.

Today, Europe must put forward a new growth strategy that not only incorporates the supply-side ideas of the Lisbon strategy and its successor Europe 2020 but also recognizes that insufficient demand is currently a constraint on growth in many of its Member States. As I wrote in a letter to the president of the European Commission more than ten years ago: "Growth must become Europe's number one economic priority – not only in the declarations of its leaders but first and foremost in their actions." (Sapir et al., 2003).

[2] *Sapir (2006).*

References

De Grauwe, P. 2014. Stop structural reforms, start public investments. Ivory Tower Blog. 16 September.

Draghi, M. 2014. Unemployment in the euro area. Speech at the annual central bank symposium in Jackson Hole. 22 August.

European Commission. 2014. European Economic Forecast – Autumn 2014. In: European Economy 7/2014.

European Commission. 2015. European Economic Forecast – Spring 2015. In: European Economy 2/2015.

European Systemic Risk Board. 2012. Forbearance, resolution and deposit insurance. Reports of the Advisory Scientific Committee No. 1.

Sapir, A. 2006. Globalization and the Reform of European Social Models. In: Journal of Common Market Studies Volume 44 No 2. 369–390.

Sapir, A. 2014. Still the Right Agenda for Europe: the Sapir Report Ten Years On. In: Journal of Common Market Studies Volume 52 Supplement S1. 57–73.

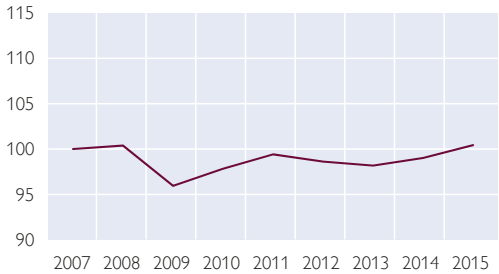
Sapir, A., P. Aghion, G. Bertola, M. Hellwig, J. Pisani-Ferry, D. Rosati, J. Viñals and H. Wallace. 2003. An Agenda for a Growing Europe: Making the EU Economic System Deliver. Report of an Independent High-Level Study Group established on the initiative of the President of the European Commission. Brussels: European Commission.

Sapir, A., P. Aghion, G. Bertola, M. Hellwig, J. Pisani-Ferry, D. Rosati, J. Viñals, H. Wallace with M. Buti, M. Nava and P. M. Smith. 2004. An Agenda for a Growing Europe: The Sapir Report. Oxford: Oxford University Press.

Chart 1

Real GDP for the euro area 2007 to 2015

Index 2007=100

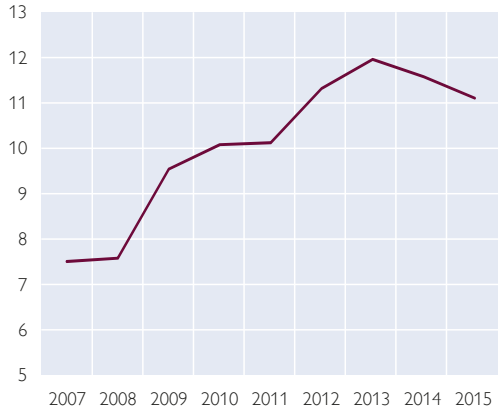


Source: IMF WEO (April 2015).

Chart 2

Unemployment rate for the euro area from 2007 to 2015

% of labour force

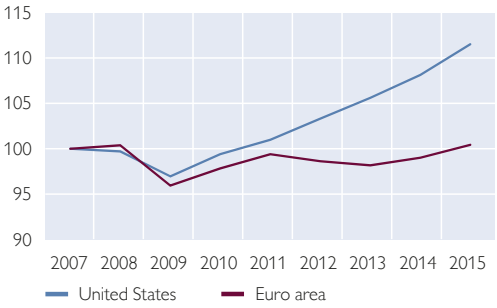


Source: IMF WEO (April 2015).

Chart 3

Real GDP for the euro area and the United States from 2007 to 2015

Index 2007=100

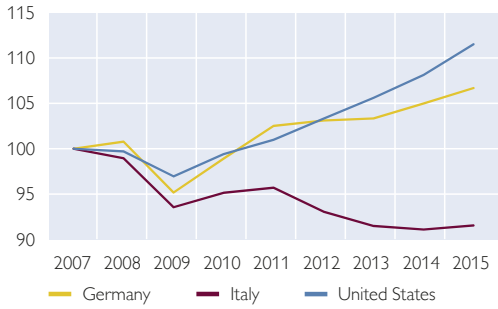


Source: IMF WEO (April 2015).

Chart 4

Real GDP for Germany, Italy and the United States from 2007 to 2015

Index 2007=100

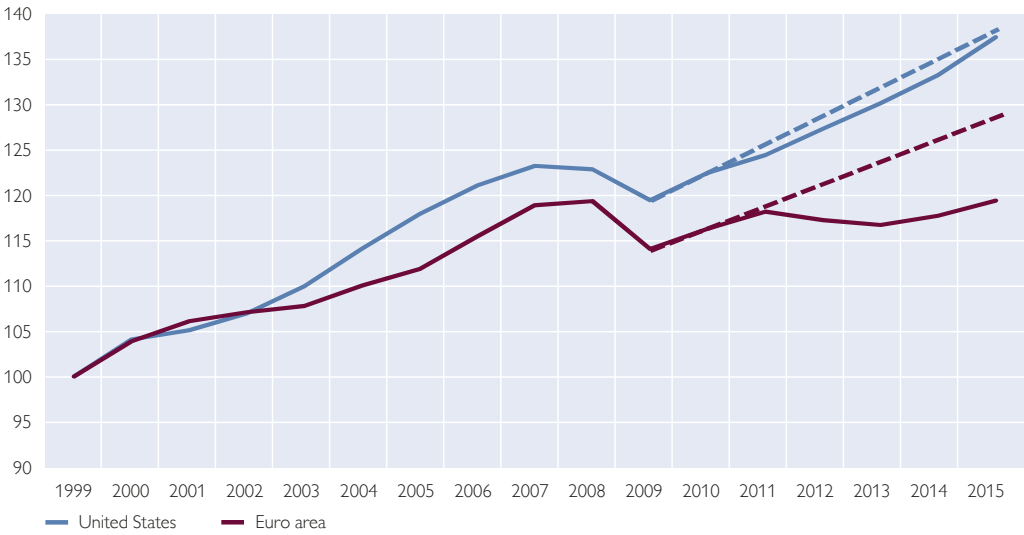


Source: IMF WEO (April 2015).

Chart 5

Real GDP for the euro area and the United States from 1999 to 2015

Index 1999=100

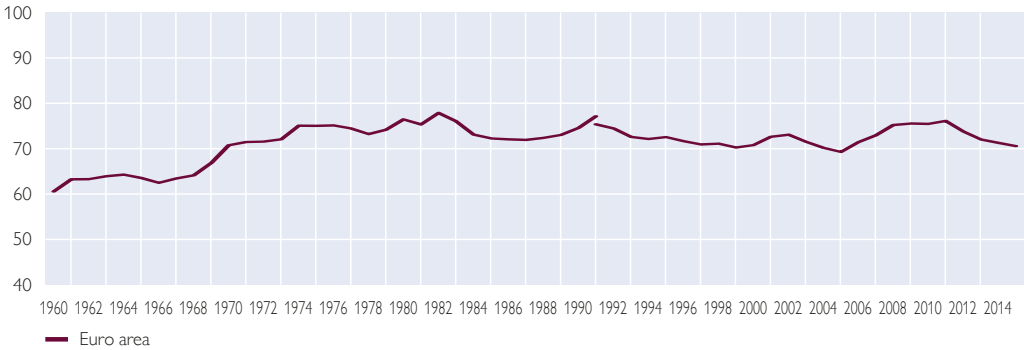


Source: IMF WEO (April 2015).

Chart 6

GDP per capita at purchasing power parities for the euro area from 1960 to 2015

Index USA=100



Source: AMECO (April 2015).

Note: The break in the data in 1991 is due to German reunification.