

# Europe in the World Economy: Economic Recovery and Europe 2020

Rafael Doménech

**Economic recovery and Europe 2020:**

**Towards smart, sustainable and inclusive growth**

Wilton Park, October 24, 2012

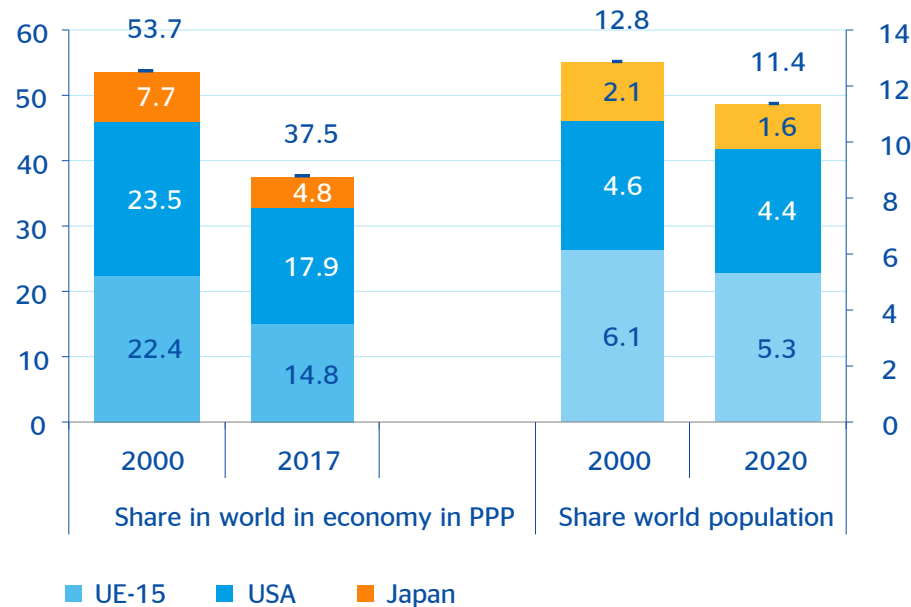
# Main messages

- 1 In 2020 Europe will be a **smaller region in the world economy** due to (1) lower population growth and (2) lower GDP per capita growth than emerging economies.
- 2 The challenge is to increase **productivity** and **employment growth**.
- 3 Needed: a **recovery strategy** and a **long-run strategy**: convergence with the US.
- 4 **Recovery strategy**: (1) a road map to a genuine EMU (four pillars), (2) correction of internal imbalances, and (3) a balance between growth and austerity.
- 5 **Long-run strategy**: (1) economic integration to ensure internal convergence (at national and European levels), (2) improve institutional quality, human capital, R&D and infrastructures.

# Relative position of Europe in the world economy

## Shares in world GDP and in world population

Source: BBVA Research



In 2020 Europe (EU15) will be a smaller region in the world economy due to:

(1) lower population growth and (2) lower GDP per capita growth than emerging economies

Demographics are difficult to change, but GDP per capita is more sensitive to policy changes

# The European growth challenge

A useful decomposition

$$GDP \equiv \frac{GDP}{L^{15-64}} L^{15-64} = \frac{GDP}{L^d} \frac{L^d}{L^{15-64}} L^{15-64}$$

*GDP* growth = productivity growth +  
employment growth bonus +  
working-age population growth

As stated before, working-age population growth in the next 10 years will be low

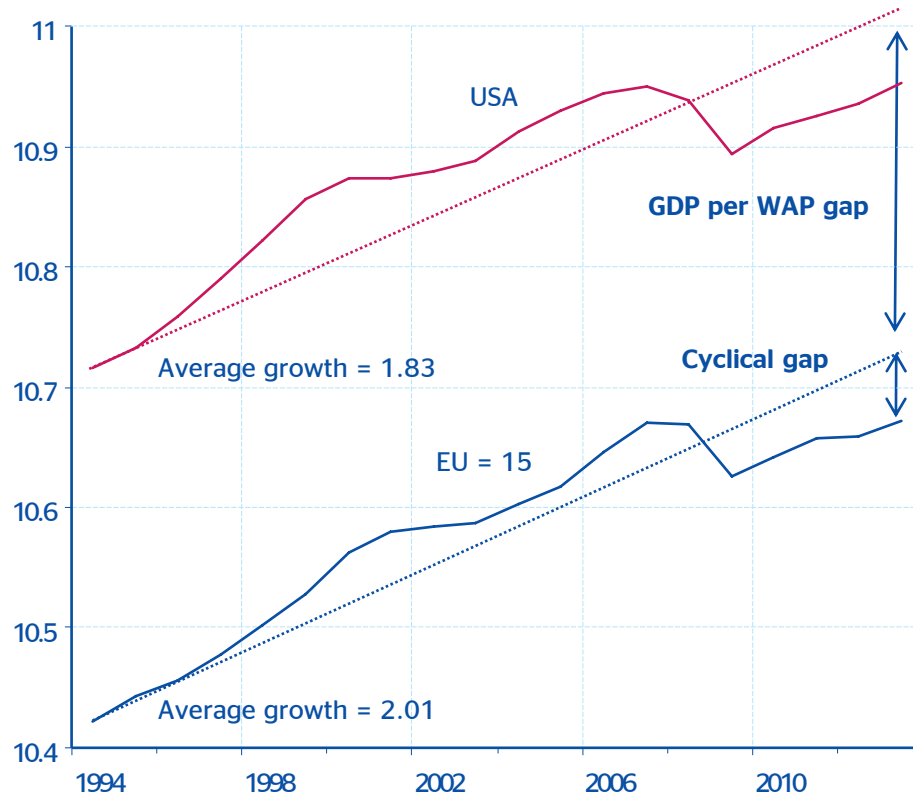
The challenge is to increase (1) productivity growth and (2) employment growth above working-age population growth

This requires first to close the cyclical gap and, second, to increase potential growth, closing the gap with the USA

# The European growth challenge

## GDP per working-age population

Source: BBVA Research



Trend components estimated from 1970 to 2012

EU15 cyclical gap with the 1970-2012 trend:  
around 5%

EU15 trend gap with the USA:  
around 25%

Needed: (1) a recovery strategy in the short run, and  
(2) a long-run growth strategy: convergence with the  
USA

# A recovery strategy

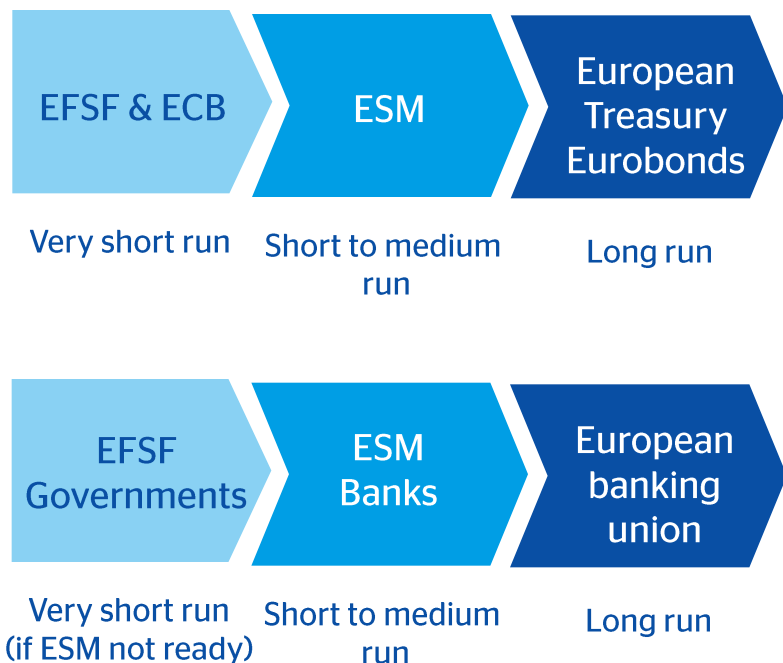
1. A road map to a genuine EMU

2. Correction of imbalances in a very heterogeneous Europe

3. Balance between growth and austerity:  
Focus on structural deficits as the Stability Treaty proposes

Short-term objective: to avoid the risk of an austerity-recession vicious circle and the doubts regarding sovereign debt solvency

# A recovery strategy (1): a road map to a genuine EMU



The solution has benefits but costs too -> long and tortuous process

Problem 1: How to distribute the solution costs in the short term between the members?

Problem 2: How to design a time-consistent solution and the conditions to carry it out?

J. Andrés and R. Doménech (2012): "The solution to the Euro crisis: Back From the Future". Vox EU.

# A recovery strategy (2): internal imbalances in EMU

## Debt and deficits in the EMU, USA and the UK

(% of GDP)

Source: AMECO, Haver, IMF, national sources and BBVA Research

		EA17	US	UK
GG budget balance	2011	-4.1	-8.4	-6.8
Public Debt	2011	87.3	87.9	85.0
Household debt	2011	70.9	84.4	100.3
Non-financial corporations debt	2011	139.1	76.8	116.9
Current account balance	2011	0.0	-3.1	-1.9
Net international position	2011	-11.5	-4.1	-17.3

EMU has fewer aggregated imbalances than the USA or the UK...

... for the public, private and external sectors ...

... but with a very high degree of internal heterogeneity ...

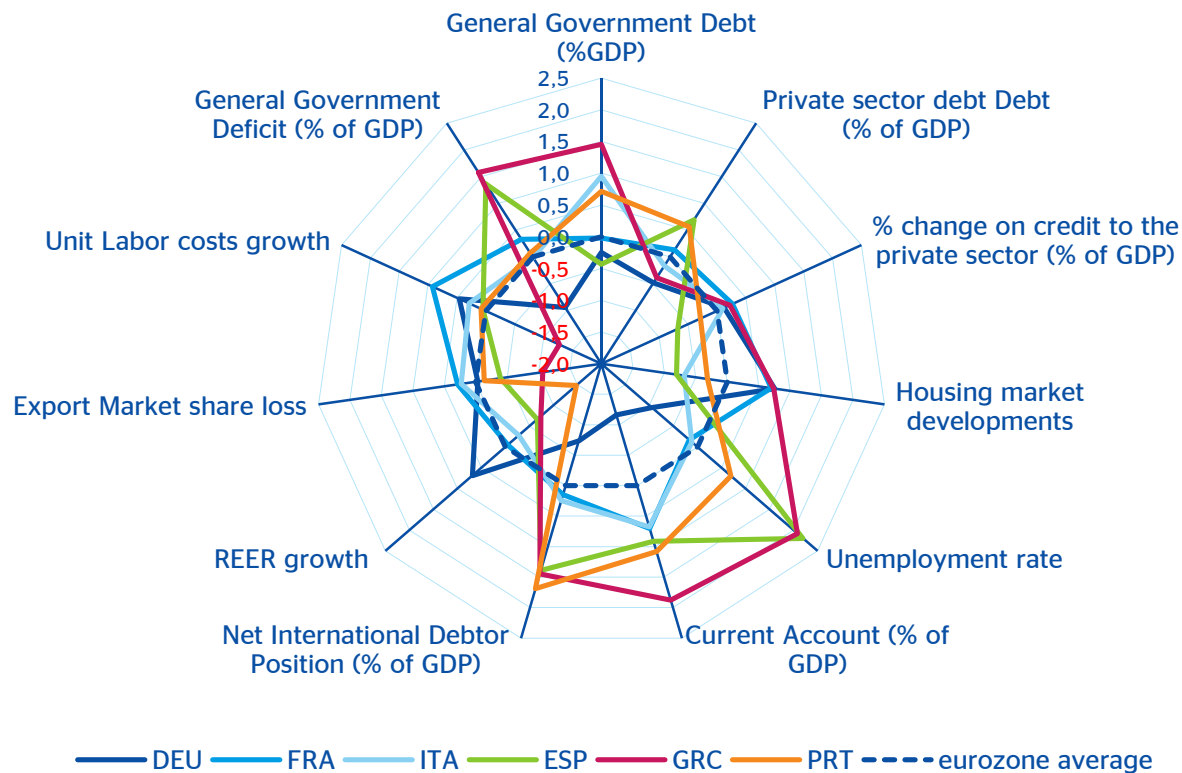


# A recovery strategy (2): internal imbalances in EMU

## Macroeconomic imbalances in the European periphery (six pack)

**Index. Units of standard deviations with respect to the average in the Eurozone** (Euro zone average= 0)

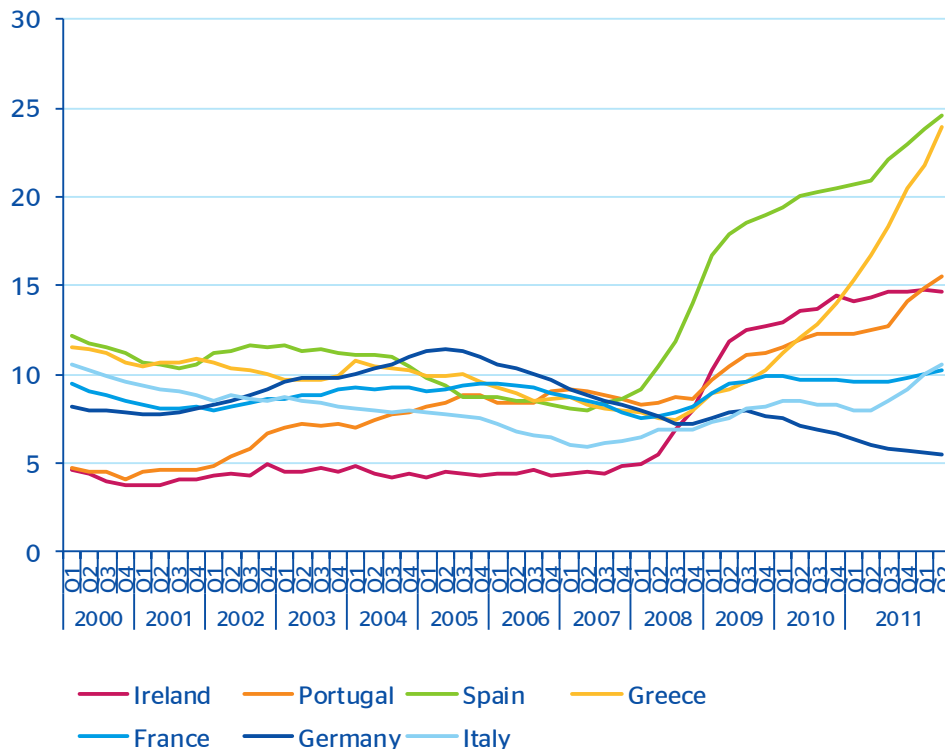
Source: BBVA Research, Eurostat and Haver



# A recovery strategy (2): internal imbalances in EMU

## Unemployment rates

Source: BBVA Research, Haver



The challenge: from adjustment to growth

Short-term goal: prevent further job losses → adjust working hours + wage flexibility and effective organisation

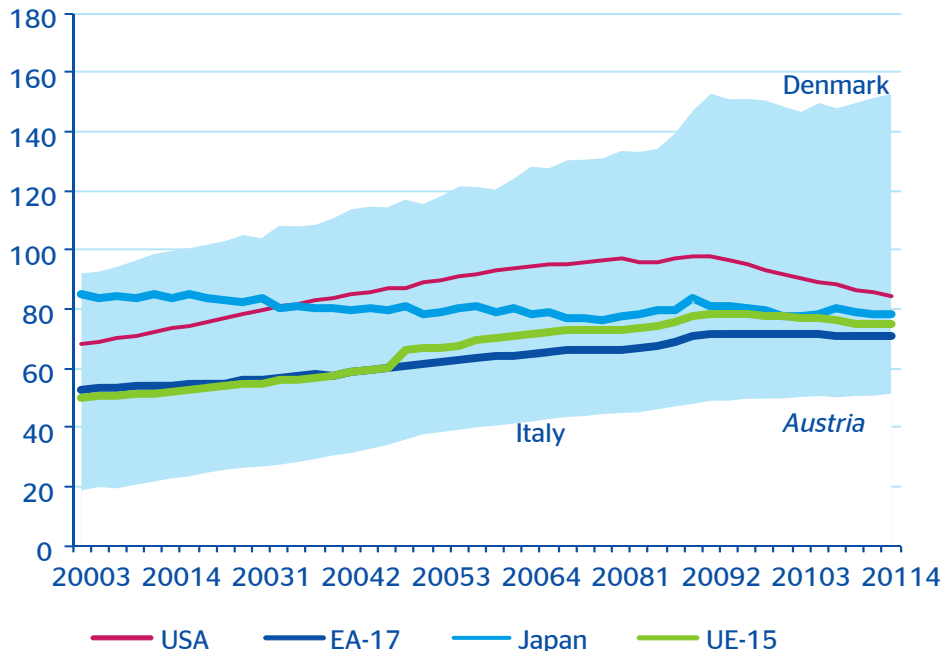
Reallocation of productive factors to more dynamic firms and sectors (external competitiveness)

Eliminate internal growth barriers through a more favourable regulatory environment

# A recovery strategy (2): internal imbalances in EMU

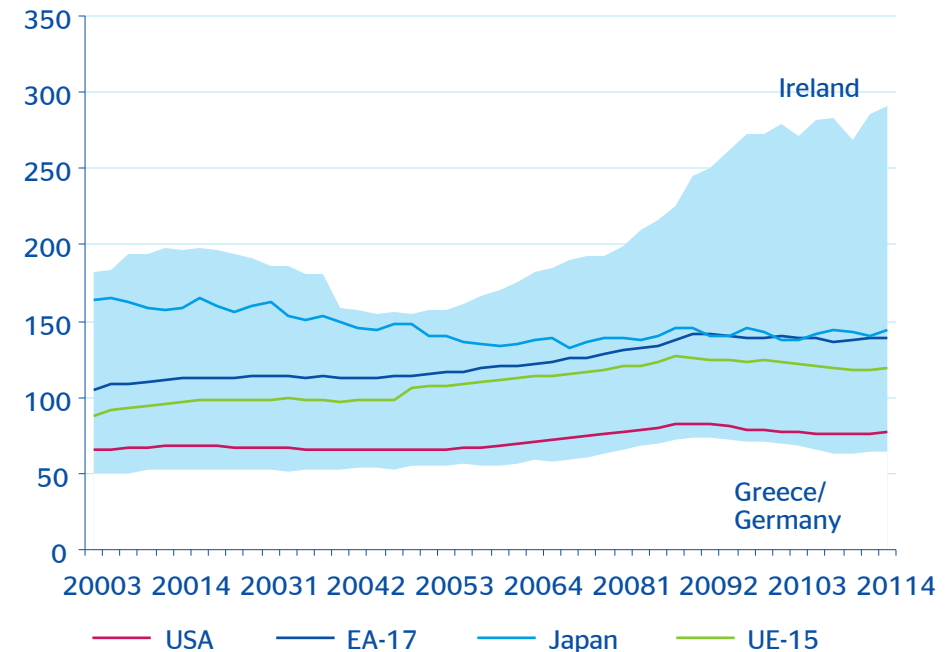
## Household debt

Source: Haver and BBVA Research



## Non-financial corporations de

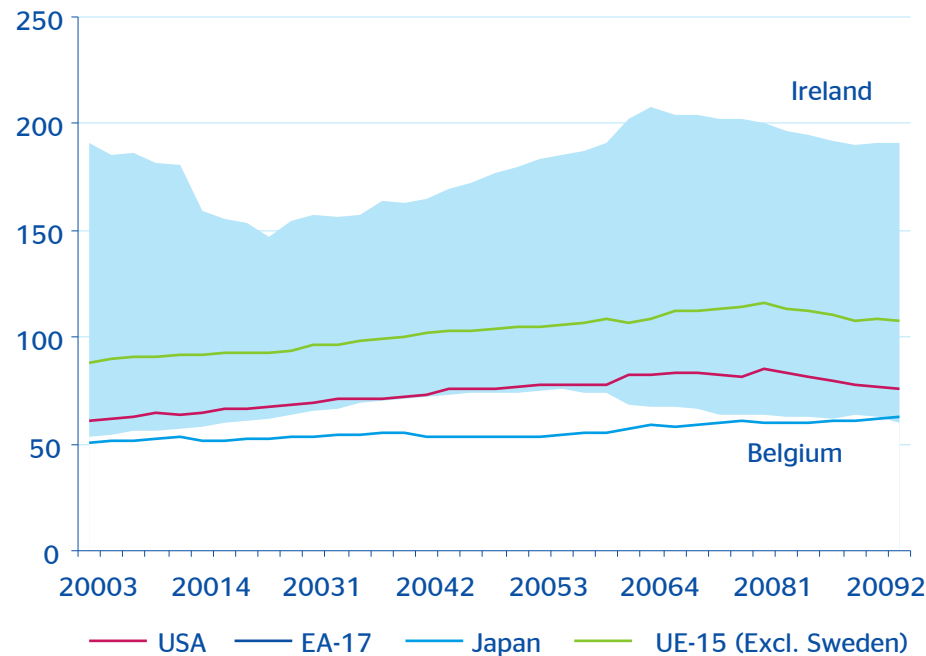
Source: Haver and BBVA Research



# A recovery strategy (2): internal imbalances in EMU

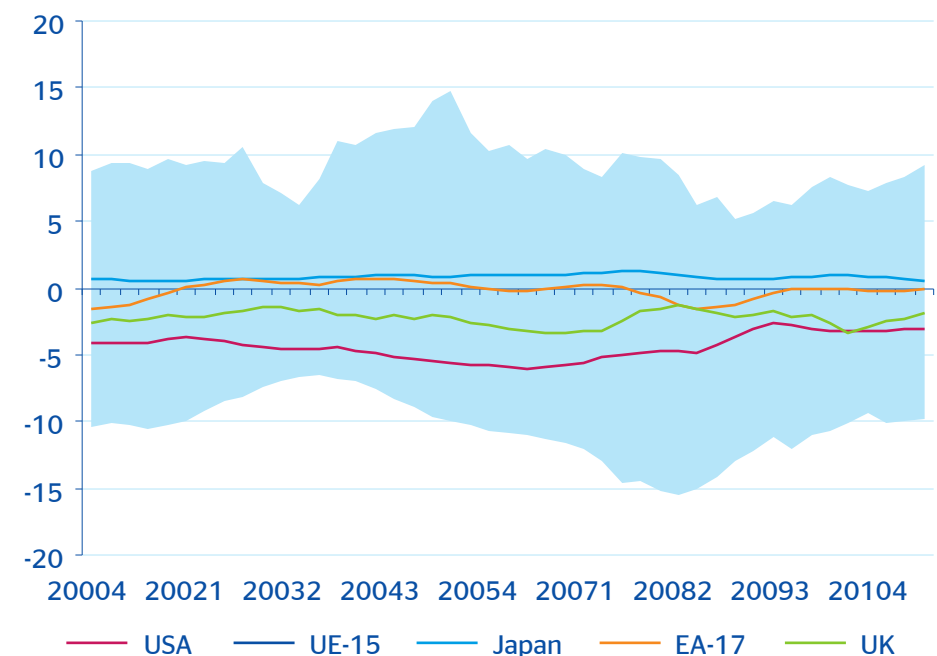
## Domestic credit (% of GDP)

Source: Haver and BBVA Research



## Current account deficits

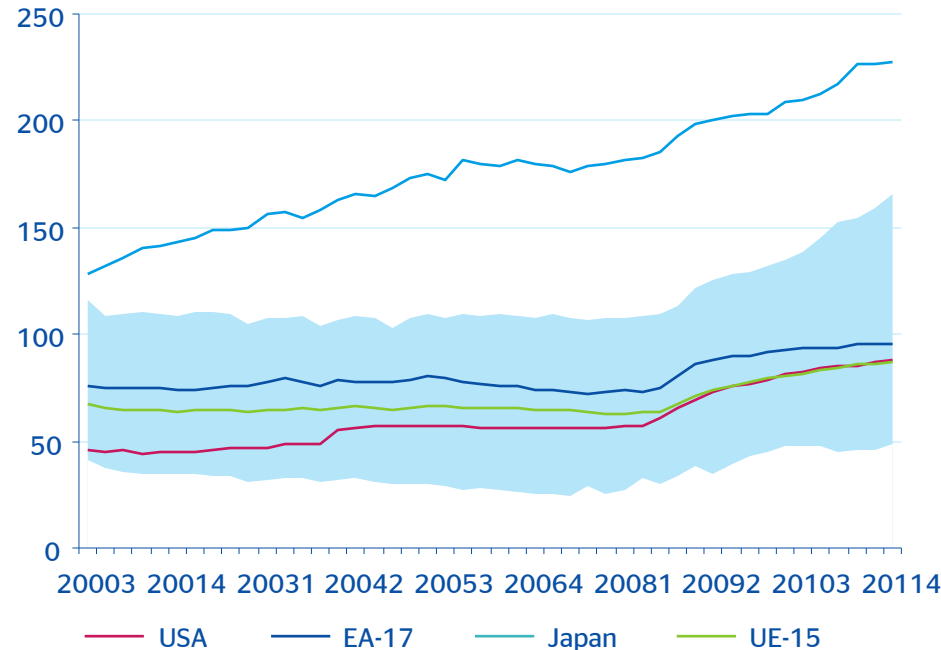
Source: Eurostat, National Sources, IMF BOP and BBVA Research



# A recovery strategy (2): internal imbalances in EMU

## General government debt

Source: Eurostat and BBVA Research



## A slow but steady fiscal consolidation

Public debt is increasing due to fiscal deficits and bank recapitalizations

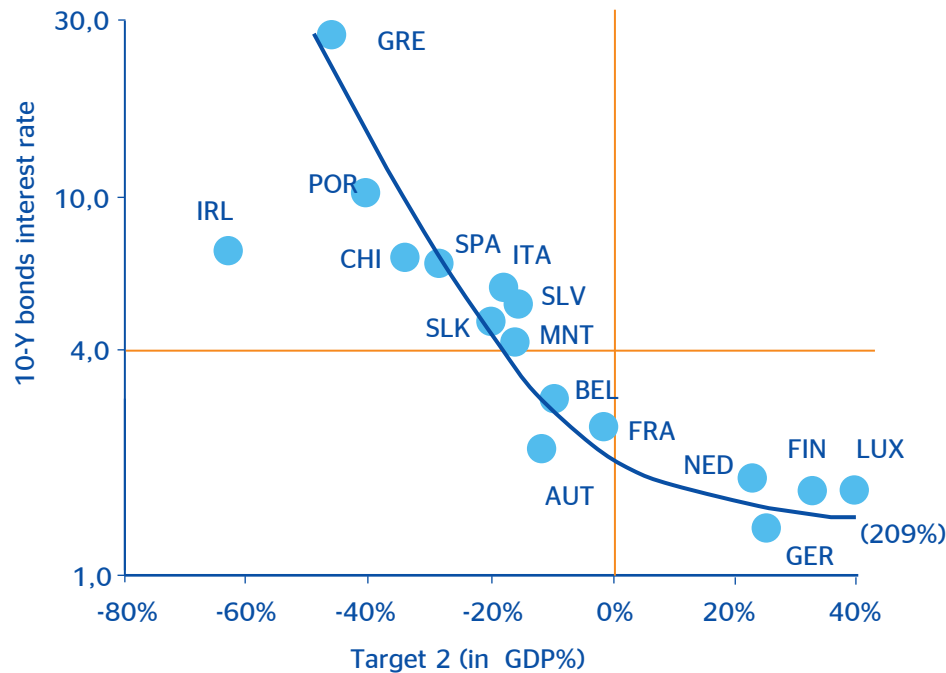
Weak fiscal position of some countries that need a deep and low restructuring of public administrations

Evaluate fiscal consolidation in structural terms

# A recovery strategy (2): internal imbalances in EMU

## Interest rate and TARGET2

Source: ECB and BBVA Research



Differences in interest rates and in ECB dependence: two sides of the same coin

Reduction in financial stress: a precondition for the success of fiscal adjustment and structural reforms

A political arrangement needed

# A long-run growth strategy

## Structural capacity in developed economies

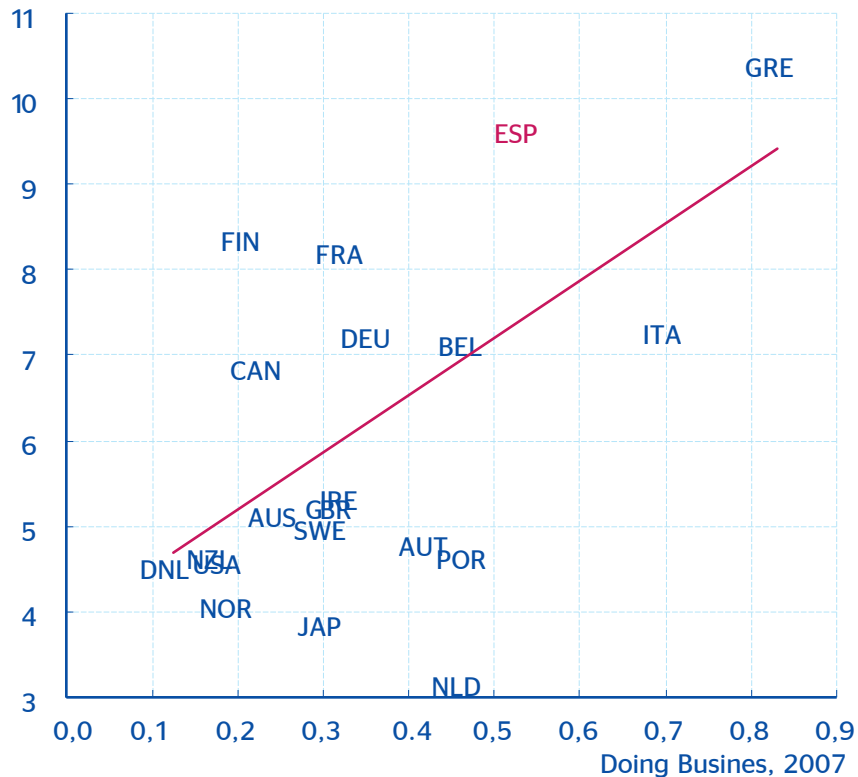
Source: IMF and BBVA Research

Varieties of Capitalism and Comparative Advantage (Hall and Soskice, 2001)																	
	Liberal Market Economies			Coordinated Market Economies									Mixed market Economies				Avg.
Medium Term	UK	USA	IRL	GER	FRA	NLD	BEL	AUT	FIN	DEN	SWE	JAP	SPA	ITA	POR	GRE	
Labour market	1	1	1	2	3	2	2	2	1	1	2	1	2	3	3	3	1.9
Corporate regulations	1	1	1	2	2	1	3	2	2	1	1	2	3	2	2	3	1.8
TIC regulations	1	1	3	1	2	1	1	1	2	1	1	2	1	2	2	3	1.6
Retail regulations	1	1	1	1	2	1	3	3	2	2	1	1	2	2	2	3	1.8
Professional services reg.	1	1	1	3	2	1	2	2	1	1	1	1	2	3	2	3	1.7
<b>Long term</b>																	
Institutions and contracts	1	2	2	1	2	1	2	1	1	1	2	2	2	3	3	3	1.8
Human capital	2	2	1	2	2	1	1	2	1	1	1	1	3	3	3	3	1.8
Infraestructure	1	1	3	1	1	1	2	2	2	1	1	1	1	3	2	3	1.6
R&D	1	1	2	1	1	1	1	2	2	1	1	1	3	2	3	3	1.6
<b>Average</b>	<b>1.1</b>	<b>1.3</b>	<b>1.7</b>	<b>1.6</b>	<b>1.9</b>	<b>1.1</b>	<b>1.9</b>	<b>1.9</b>	<b>1.6</b>	<b>1.1</b>	<b>1.2</b>	<b>1.3</b>	<b>2.1</b>	<b>2.6</b>	<b>2.4</b>	<b>3.0</b>	<b>1.7</b>

# A long-run growth strategy

## Doing Business and structural unemployment

Source: BBVA Research based on OECD and Doing Business



Institutions are crucial for long-term growth (e.g., Acemoglu and Robinson, 2012)

Huge differences among European countries

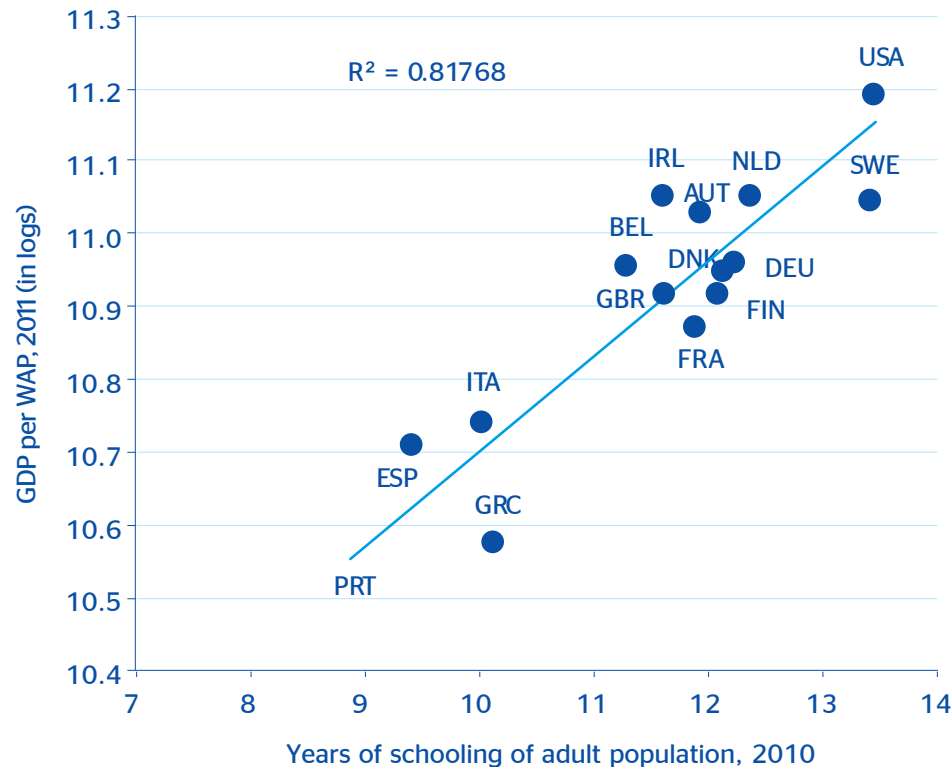
Interaction with other economic long-run determinants.



# A long-run growth strategy

## Schooling of adult population and GDP per WAP

Source: de la Fuente and Doménech (2012)



Human capital is one of the main determinants of GDP per working-age population and other economic variables (U, R&D, etc.)

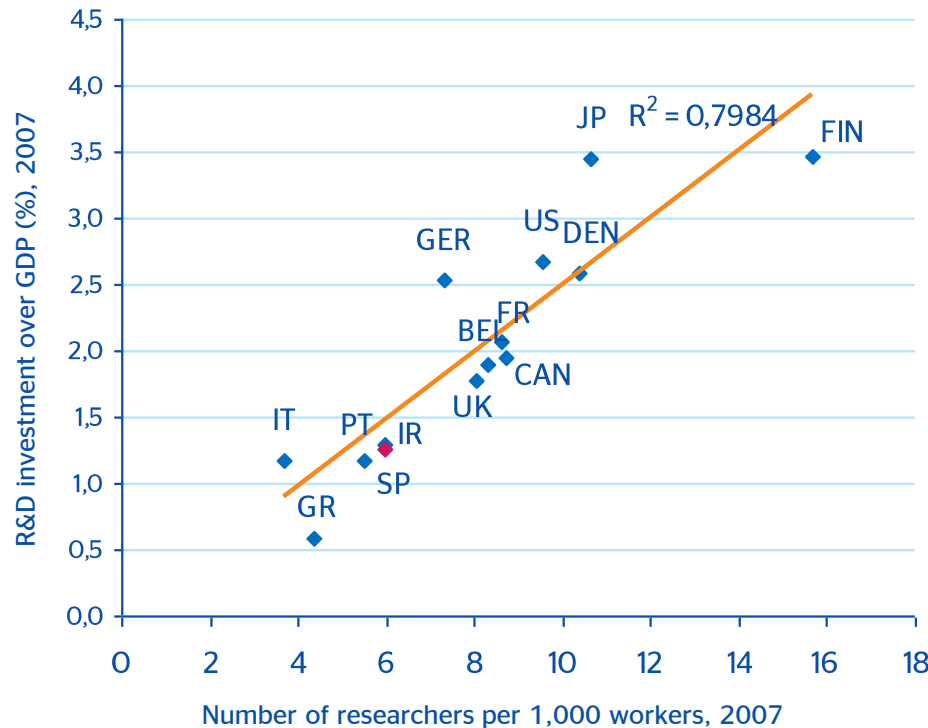
Huge differences among European countries

Increasing human capital levels in some countries will be a very slow process (demographics) -> on-the-job training (labour markets reforms)

# A long-run growth strategy

## Human capital and R&D

Source: BBVA Research based on OCDE



## The black-box growth

Human capital and R&D activities are deeply correlated. Human capital is the basic input of R&D activities

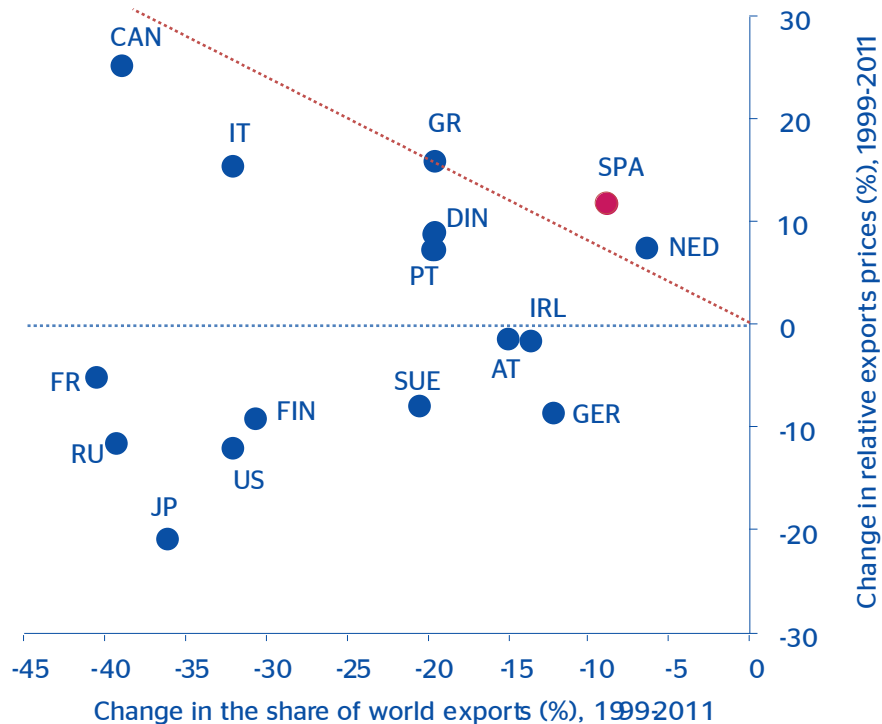
Again, huge differences in R&D investment across European countries

Coordination of national and European policies to favour innovation in areas in which each country has its own comparative advantage

# A long-run growth strategy

## Changes in exports shares and relative prices

Source: BBVA Research



## Heterogeneity in international competitiveness

Exports prices have not been the main determinant of exports shares. And aggregate ULCs even less

Not clear pattern between the determinants of aggregate productivity and exports competitiveness  
-> significant internal duality in many countries

In a globalized economy, a long-run strategy in terms of international competitiveness is crucial

$$\Delta(ex_t - ex_t^w) = \Delta s_t^x - \sigma \Delta(p_t^x - p_t^w)$$

## Main messages

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