May 6\textsuperscript{th}. Europe’s Economic Past and Future
Is the glass half full or half empty?

- This is one of those questions where it really seems to matter what color glasses you’re wearing.
Conventional wisdom points to superior economic performance of United States

- In the last 10 years, GDP growth averaged 3.3% in the United States but only 2.1% in the euro area.
- In per capita terms, the difference is smaller (U.S. population has been growing faster) but still there (2.1% vs. 1.8% per annum).
The US has done better also in terms of productivity performance

- Euro area labor productivity growth, as measured by real GDP per hour worked, declined from 2.1 per cent in 1990-1995 to 1.2 per cent in 1996-2005.
- Meanwhile, U.S. labor productivity growth averaged 2.6% over the 1996-2005 decade, much superior to Europe’s.
Conventional explanations for these differentials are straightforward (see Alesina & Giavazzi)

- The European model features strong wage compression and a generous social model as the quid pro for wage restraint and high savings and investment.
  - This in turn weakens incentives for enterprise and innovation.

- It features big banks providing patient finance to middle-size companies.
  - This starves start-ups and other new entrants of venture finance.

- Cohesive employers associations are better at providing apprenticeship training and vocational education to their workers than European countries are at building top-flight universities.
  - This weakens the capacity to undertake radical innovation.
What worked once works no more

- The European model worked well so long as its economy was far from the technological frontier and the task was to import known technologies, closing the gap vis-à-vis the United States.
- It works less well now that the gap has been closed and the economy has entered a period of technological flux requiring innovation and flexibility.
- European countries are undertaking the necessary reforms: making their labor markets more flexible, building securities markets as a complement to banks, and attempting to upgrade their university systems, but all this takes time.
- Indeed, partial reform may make things worse before it makes them better (the “between 2 banks of the river” problem.)
But is all this pessimism overdone?

- As noted before, population growth is faster in US: in per capita terms the growth differential between 1993 and 2005 smaller: is only 2.1% (US) vs. 1.8% (EU).
  - Is this a significant difference?

- This 0.3% difference is due entirely to Germany: taking out that one country raises per capita growth in the euro area to 2.1%, just like the US.
  - And Germany is doing much better now.

- Productivity figures typically compare US business sector with entire euro area economy (that’s how the data typically come). And we know that productivity in services traditionally lags.
  - When we make an extra effort and calculate productivity (growth of output per worker) across whole economy, the US average over last 10 years of 2.0% barely exceeds Europe’s 1.7% (even including Germany).
  - And even this difference may reflect the strength of the US cyclical expansion through 2005 (first the Nasdq bubble and then accommodating US macro policy).
Europeans also enjoy more leisure than Americans.

- They work shorter hours. Average annual hours for a fully employed worker is 1800 in America but only 1400 in Europe.
- On a per-hour basis, labor productivity is nearly as high in Europe as in the U.S. It is actually higher in France, Belgium and the Netherlands.
  
  [Parenthetical question: which is the appropriate basis for welfare comparisons, output per hour or output per capita?]
Using GDP per capita as a welfare measure, US remains unsurpassed. But the picture is very different if one considers GDP per hour. Which measure is relevant?
Another view of the comparison

Figure 1
The EU/US Ratios: Output per Capita and Output per Hour

iClicker question: So what is the relevant measure of economic welfare?

A. Output per worker
B. Output per hour
So what is the relevant measure of economic welfare: output per hour or output per worker?

- If you believe that Europeans simply have different tastes than Americans ("they like their leisure more" – this being the so-called “MIT School” view), then the answer is output per hour.
  - In this case the value of an hour of work equals the value of an hour of leisure on the margin.
  - See Olivier Blanchard’s article from today’s reading list.
So what is the relevant measure of economic welfare: output per hour or output per worker?

- But if you believe that the explanation for Europe’s shorter hours lies in distortions like higher tax rates (the so-called “Minnesota School” view), then output per hour is misleading.
  - If taxes induce less work, then the value of an hour of work is \((1+t)\) times as valuable as an hour of leisure on the margin.
  - Roughly, \(t = 50\%\) in Europe, while \(t = 25\%\) in US. In this view, European welfare is 20-25\% lower.

Problem for “MIT school”: Why might Europeans have different tastes?
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- Might history matter?
- If so, how?
- This “explanation” seems rather arbitrary…
Problem for “Minnesota School”: one needs to assume implausibly high elasticities of labor supply to explain how a limited tax differential can produce a large difference in equilibrium hours worked.

Also, the correlation between tax rates and hours worked is very loose.

See graph at right.
The US has high levels of labor mobility.

- Faced with supply shocks like those that hit the advanced economies starting in the mid-1970s, which would have lowered labor productivity in some sectors but raised it in others, the U.S. was able to reallocate labor from sectors where productivity has fallen to sectors where it has risen.

- With more workers now in sectors where labor productivity has risen, labor productivity economy-wide will increase on average, and with it compensation, eliciting additional labor supply. [,,,]
Alesina and Giavazzi’s interpretation (continued)

- But in Europe, with powerful unions and limits on hiring and firing, labor is less free to move.
  - In this case the same shocks will cause aggregate productivity and compensation to fall. Workers remain in sectors where productivity has fallen, since they are unable to move to where it has risen.
  - In this case aggregate compensation will fall and with it labor supply and employment. [....]
Alesina and Giavazzi’s interpretation (continued)

- In addition, unions in the declining sectors, concerned to maintain membership, may encourage work-sharing and therefore shorter hours.
  - The fact that some people are working shorter hours and taking more days off may then encourage other people to prefer shorter hours and more days off because of coordination externalities – that is, because it may be much harder to get anything done if other people are not at work at the same time.
  - If these coordination externalities are general, then the change in behavior will affect the entire economy and not just the heavily-unionized declining sectors.
Why this interpretation appeals

- It doesn’t simply rely on tastes or taxes, but on institutions.
- This perspective suggests that it is labor market institutions, together with coordination externalities, that explain fewer hours worked.
- It avoids the problem that the correlation of tax rates with hours worked is not that tight.
- But it also suggests that output per capita rather than output per hour is the appropriate basis for welfare comparisons.
  - Since labor market distortions and externalities are why hours are so much shorter in Europe.
What does this imply for the future?

- Does it imply convergence of the US and European models, with Europe having to gravitate further in the direction of “Anglo-Saxon market capitalism”?
- Or can quite different US and European models coexist?
  - Note that this question has implications for what globalization and economic integration auger for convergence more generally.
According to the “varieties of capitalism” literature, the 2 models can coexist

- The US system of market-based finance, flexible labor markets, easy firm entry and exit, high-powered compensation incentives gives the country a comparative advantage in radical innovation and new products.

- In contrast, the European system of bank-based finance, stable employment, vocational training, and regional enterprise networks gives the continent a comparative advantage in incremental innovation and quality production.

- In our 21st century world there is room for both.

- Both sets of institutional arrangements are viable because of strong complementarities among their elements which work to mutually enhance their efficiency.

Why might this argument be wrong?
Objections to the “varieties of capitalism” view

- Emerging markets can now do the quality production at an even lower cost. Hyundai can compete with BMW…
  - And can’t EMs do the radical innovation and new product development too?
- Financial market integration has destroyed one element of the European institutional constellation.
  - Can you still have a distinctive European model without patient banks?
Even if Europe has done as well as the US for decades, there is recent evidence of divergence

- In the last 5-10 years, US productivity growth has been accelerating, while European productivity has been slowing.
  - While Europe as a whole had essentially closed the gap in output per hour worked, this gap is now opening up again.
  - Caution: part of the explanation may be greater labor market flexibility in Europe, which has led to modest declines in unemployment and more labor-intensive production (less regulation has meant more hiring of unskilled workers, as we will see later in the lecture).

- But not just labor productivity (output/hour) but also TFP growth have been diverging: US has been doing better than Europe.
  - There is an especially big divergence in productivity performance between the US and Europe in IT-using industries.

- This suggests that something more fundamental is going on.
- It suggests that productivity prospects in the two regions may be quite different going forward.
Recent studies investigate where the divergence is centered

- They find that the difference in productivity performance is centered in the retail sector (Walmart, Target, Amazon.com), along with wholesaling and securities trading.
  - These are sectors where, plausibly, there is the most scope for raising productivity by adopting ICT.

- This suggests differences in rates of adaptation to the opportunities afforded by ICT.
What can explain these differences?
What can explain these differences?

- Bureaucratic obstacles to the establishment of, inter alia, big box stores in city centers.
- Regulations limiting flexibility in workplace organization.
- Difficulty of hiring and firing.
- Less well developed venture capital industry.
- Underdevelopment of links between universities and business.
- Absence of high-powered incentives for innovators (a la Silicon Valley).

- Notice how one can argue that all of these obstacles to ITC development and take-up may reflect Europe’s history.
These complaints typically focus on labor market rigidities

- Difficulty of hiring and firing and inflexible workplace regulation point to labor market imperfections as a source of Europe’s problems.
  - Among other things, this makes life hard for high-tech start-ups.
This creates pressure for labor market reform (where one can distinguish several approaches)

- **Radical reform**
  - UK and Ireland are examples. UK under Thatcher drastically reduced unemployment benefits, employment protections, minimum wages relative to other countries.
  - UK strategy has reduced unemployment rate (4.7% vs. 9.5% in France)
  - But it is not always feasible. It may raise inequality, heighten insecurity, incite opposition of insiders.

- **Marginal reform**
  - Spain, Portugal, Italy and France are examples. More flexible labor contracts for new workers.
  - Marginal reform strategy may lower unemployment at the margin, but also lowers productivity, discourages training etc.
  - Incremental reform may only entrench insiders. They enjoy even stronger job protections than before (since firms no longer have reason to resist them, now possessing a flexible fringe). Wage flexibility may decline. Opposition to generalizing reform may strengthen.
Germany seems like an intermediate case

- Deeply embedded opposition to radical reform, as in the other big countries of the continent.
- But, also, greater willingness to change as a result of the experience of German reunification and a decade and a half of chronic high unemployment.
- Hence there has been more decentralization of collective bargaining and more wage restraint than in Spain, Portugal, Italy, and France, but less radical reform than in the UK and Ireland.
  - Strikingly, this appears to have worked rather well. See evolution of unit labor costs in different European countries at right.
Display 3: Divergent Labour Cost Growth
Change in Manufacturing Unit Labour Costs, Fourth-Quarter 1998 to Fourth-Quarter 2007

- Germany: -13.8%
- France: 0.7%
- Netherlands: 1.4%
- Spain: 20.8%
- Italy: 25.5%

Source: Haver Analytics, OECD and Alliance Bernstein
And the consequences are equally evident

Display 2: German Manufacturers Outperform
Year on Year Manufacturing Output Growth, Three Months to January 2008

- 6.2%
- 2.5%
- 1.9%
- (0.9)%
- (3.9)%

Germany | Euro Area | France | Spain | Italy

Source: Haver Analytics and AllianceBernstein

Display 4: Germany Leads in Emerging Markets
Exports to Developing Economies as a Percentage of GDP, 2006

- 11.3%
- 6.9%
- 5.6%
- 3.8%
- 3.8%
- 3.7%

Germany | Italy | France | US | Spain | UK

Source: Haver Analytics, IMF and AllianceBernstein
So what does this bode for Europe’s future

- Changing one element of a model made up of interlocking parts, without changing the others, may lower productivity in the short run, even if it raises it subsequently.

- In Europe, there has been labor market reform, but no change in the delivery of education/skills.

- Employment has grown, but it has been mainly increases in unskilled employment and unskilled jobs, achieved by authorizing the provision of temporary contracts.
  - Some estimate that the share of such jobs is now 30% continent wide, and forecast it to rise to 40% by 2010.

- Temporary contracts encouraging labor-market churning but not training and investment in skills. And there has been little progress in making general education (by reforming European universities) more efficient.

- All these are reasons why reform may lower productivity before raising it.
Next time

- Review of semester’s themes.
- Questions and answers.