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Build on Strengths of Europe's Growth Model While Pursuing Reforms, Says World Bank Report

Europe's 'convergence machine' has helped hundreds of millions prosper

BRUSSELS, January 24, 2012 – The European growth model has been an engine for economic convergence during the past few decades and has delivered prosperity to hundreds of millions of people on the continent, says a new World Bank report *"Golden Growth: Restoring the Lustre of the European Economic Model",* launched today in Brussels.

"Europe has to make adjustments to its economic model, not abandon it," said **Philippe Le Houerou, World Bank Vice President for Europe and Central Asia**. *"Faced with adverse debt dynamics and unfavorable demographic trends, many Europeans are calling for a 'new growth model'. It is good that there is no complacency in Europe. But a loss of confidence can be dangerous. There are many attractive attributes of the European growth model that have led to a shared prosperity not seen before or elsewhere. These elements need to be nourished."*

The new report looks at long-term growth in Europe, paying special attention to the last two decades, and identifies what needs to be done to assure continued prosperity in the decades ahead. It assesses the six principal components of the European growth model: trade, finance, enterprise, innovation, labor, and government. Its main findings: most countries in Europe are doing well in trade and finance, many in enterprise and innovation, but few are doing well in labor and government. So Europe needs many changes to make governments and labor markets work better, fewer changes to foster innovation and productivity growth in enterprises, and fewer changes still to reform finance and trade. Stalled productivity, declining populations, and unsustainable fiscal imbalances have made many changes urgent.*

To revitalize the European growth model, the report makes three sets of recommendations: restart the convergence machine that has allowed poorer countries become high income economies; rebuild "brand Europe" that has helped the region, with one-tenth of the world's population, account for a third of the global economic output; and reassess what it takes to remain the world's lifestyle superpower, with the highest quality of life on the planet.

Restarting the European "convergence machine"

Between 1950 and 1973, Western European incomes converged towards those in the United States. Then, until the early 1990s, the incomes of more than 100 million people in the poorer southern periphery—Greece, southern Italy, Portugal, and Spain—converged to those of advanced Europe. Starting with the first association agreements with Hungary and Poland in 1994, another 100 million in Central and Eastern Europe were absorbed into the European Union. Another 100 million in the candidate countries in Southeastern Europe are now benefiting from the same aspirations and similar institutions that have helped almost half a billion people achieve the highest standards of living. If European integration continues, the 75 million people in the Ukraine and other countries of the Eastern Partnership will profit in similar ways.

"One can say without exaggeration that Europe invented a 'convergence machine', taking in poor countries and helping them become high income economies," said **Indermit Gill, World Bank Chief Economist for Europe and Central Asia** and one of the lead authors*. "In East Asia and Latin America people worry about*

a 'middle income trap', because few countries have quickly grown from low to high income. Those that have done so during the last few decades were either fortunate—like the handful which found oil—or ferocious, like the East Asian tigers. But in Europe, more than a dozen poorer countries have reached high income. To do well in Europe, they just needed to be disciplined. This is what makes economic growth in Europe unique. Because trade and financial integration is an intrinsic feature of Europe's integrated economy, it should not be difficult to restart the convergence machine."

Trade and financial integration are two of the strongest attributes of the European economic model. According to the report, the adjustments needed to strengthen these components are: better management of financial flows, quicker expansion of the modern services trade, and greater mobility of workers.

Rebuilding brand "Europe"

Europe is known for its combination of engineering and design. Since the mid 1990s, while Asia had a financial crisis and recovery and the United States had a technology boom and financial crisis, European enterprise has flourished. With few exceptions, every part of Europe has seen a growth in employment, productivity, and exports.

But during the last decade, two growing shortfalls in productivity are threatening Europe's global economic influence. The first is that since the mid-1990s, labor productivity in Europe's leading economies has fallen relative to the United States and Japan. The productivity gap between advanced Europe and the United States today is more than twice what it was in the mid-1990s. The second is that enterprises in southern Europe have become less productive. To be competitive, productivity should have grown by about 3-4 percent each year during the 2000s. Instead, it fell by about 1 percent each year.

"To stay competitive on world markets, Europe will need to become more productive and more innovative," said **Martin Raiser, World Bank Country Director for Turkey** and one of the lead authors. *"Many countries in Europe are successful in this—countries like Switzerland, Slovak Republic and Sweden, and Estonia, Finland, and Germany. But workers in several countries have become less productive. This has to change. There are countries in Europe that have shown how to solve such problems. When enterprises are given more economic freedom, they create jobs, make people more productive, and generate exports."*

According to the report, preserving Europe's global brand will be somewhat more difficult than restarting convergence, but still well within the continent's reach. Trade and finance have to be made even more durable so that the continent becomes a single economy. Enterprises in the northern and EFTA economies—already among the most innovative in the world—have to be provided fuller access to markets in the rest of Europe. Governments in southern and Eastern Europe will have to improve the business climate, and the larger continental countries must give their enterprises more economic freedom if they are to compete with North America and East Asia. They must also learn from the US to better harness scientific discovery for commercial use and make their universities magnets for the best and brightest.

Remaining the lifestyle superpower

Europe has provided its citizens more income security and a better work-life balance. With real incomes a quarter short of that of the United States, Europe became a "lifestyle superpower", with arguably the highest quality of life in human history.

"Superpowers spend a lot to project their influence and protect their way of life," said **Indermit Gill.** *"Europe spends more on social protection—pensions, unemployment insurance, and social welfare—than the rest of the world combined. European governments spend about 10 percent of GDP more than counterparts in other parts of the world, and almost all of the difference is social protection. For many countries in Europe, this has become unaffordable. Combined with demographic pressures and weakened work incentives, this fiscal burden is now a drag on growth."*

According to the report, Europe will need to make big changes in how it organizes labor and government, because of pressing demographic trends and persistent budget deficits. With a rapidly aging population and

falling fertility and without changes in employment, immigration, and pension policies, Europe will lose about one million workers each year for the next five decades and Europe's labor force is projected to shrink from 325 million to 275 million. At the same time, Europeans have been reducing how much they work. Today, Americans work an extra month compared with the Dutch, French, Germans, and Swedes, and work noticeably longer than less well-off Greeks, Spaniards, Hungarians, and Poles. Men in Poland, Turkey, Hungary, and France retire more than 8 years earlier than in the mid-1960s. By 2007, French men expected to draw pensions for 15 more years than they did in 1965, Polish and Turkish men more than a dozen. This puts enormous pressure on public finances, already strained by the costs of servicing large public debt.

Europe will have to work on many fronts to deal with impending labor shortages: increasing the competition for jobs, improving labor mobility, fixing how work and welfare are facilitated, and rethinking immigration policies. These changes will need a new social consensus.

"When done well, reforms to labor markets and social protection systems mean that Europeans can work shorter hours per week and fewer weeks per year," said **Indermit Gill**. *"But it is impossible to balance public accounts if people also work fewer years over their lives."*

Large and inefficient governments slow economic growth, and Europe's governments will have to become more efficient or become smaller. A 10 percentage point increase in government size leads to a reduction in annual growth by 0.6 to 0.9 percentage points, or about a third of the long-term growth rate of advanced European economies. While fiscal consolidation and reduction of public debt should be the top priority during the next decade, controlling the healthcare and social security expenses related to aging will remain the policy imperative over the next 20 years. Western Europe has to improve its primary balance—adjusted for the business cycle—by about 6 percent of GDP within this decade to reduce public debt to 60 percent of GDP by 2030. Adjustment needs are highest in the South and lowest in the North. In the EU's new member states, with a lower public debt target of 40 percent of GDP, adjustment needs are about 4 percent of GDP. Spending more than 10 percent of GDP on social protection may be risking underinvestment in activities that improve growth.

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* The report covers 45 countries: 27 EU member states, 4 EFTA countries (Iceland, Lichtenstein, Norway, and Switzerland), 8 EU Candidate and Potential Candidate Countries (Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, Serbia, and Turkey), and 6 Eastern Partnership Countries (Armenia, Azerbaijan, Belarus, Georgia, Moldova, and Ukraine). The analysis draws on good practice both in and outside Europe. In 16 policy areas ranging from crisis-proofing banks to immigration policy to public pensions and greening growth, the report summarizes the experience of countries both in Europe (such as Czech Republic, Finland, Germany, Ireland, Slovak Republic, Sweden, and the United Kingdom) and from around the world (including Canada, Republic of Korea, New Zealand, Singapore, and the United States).