CHAPTER 1

Jobs and Growth: Supporting the European Recovery

MARTIN SCHINDLER AND HELGE BERGER

Five years after the onset of the global financial crisis, Europe's economy is still fragile. Despite extended crisis management and reform efforts, growth remains anemic and recessions have recurred. In addition, unemployment in many countries has reached stratospheric levels. Notwithstanding recent positive signs amid calmer financial markets, medium-term growth is likely to remain frail owing to continuing weaknesses and vulnerabilities at the country level and in the fabric of European institutions and banks, especially in the euro area.

Some of Europe's maladies were well known before the crisis, but others came as a surprise. Weaknesses in Europe's product and labor markets have been widely documented for some time, but the risks posed by large imbalances and rising debt in an environment of ailing bank balance sheets and financial fragmentation were less well understood. Perhaps the most surprising development during the crisis was how, in the absence of effective shock absorbers, these weaknesses interacted to propagate shocks within individual economies and across national borders, contributing to a period of weakness notable for its depth, breadth, and duration. Without strong growth, the markedly high rates of unemployment and debt in many countries could persist for years, extending the pain of the crisis well into the future. The associated erosion of human capital could depress potential growth in Europe for a generation.

Removing obstacles to growth and employment requires action on multiple fronts. Continued monetary and fiscal support in the near term and progress at the institutional level will be required (however, discussion of monetary policy, and the broader topic of banking union and fiscal union, is left for elsewhere[1]). Taking the right approach to addressing public and private debt overhangs and strengthening bank balance sheets will help reduce uncertainty, support credit and investment, and foster growth both in the short term and the medium term.

Over the medium-term, alongside debt-reduction efforts, real sector reforms, including in product and labor markets, can relieve structural bottlenecks across Europe and create new sources of long-term growth by allowing countries to integrate with global production chains.

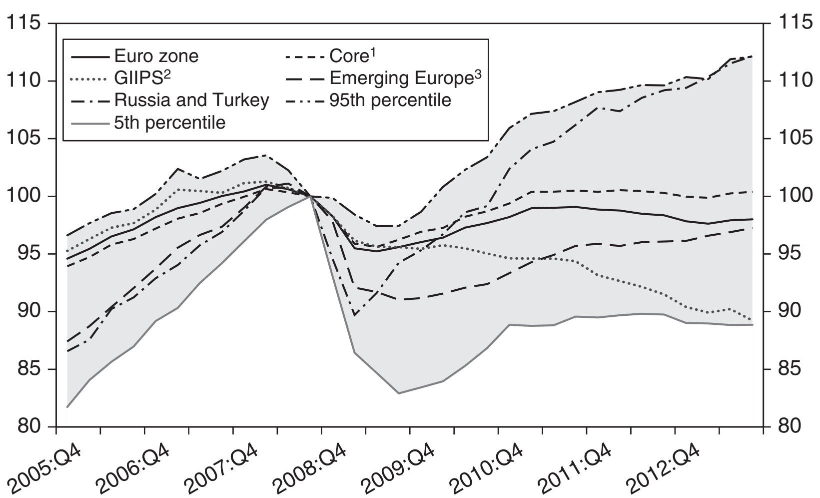
[1]Refer to IMF (2013b) for the required policy mix for the euro area. IMF (2013a, 2013d) discuss banking and fiscal union, respectively. For a discussion of the much broader issues related to inclusive growth see, among others, IMF (2012b).

CRISIS MANAGEMENT AND REFORMS

When the global crisis first hit, authorities in many countries went beyond the operation of automatic stabilizers and implemented discretionary fiscal stimuli, and central banks reduced policy rates to record lows. Many central banks also introduced unconventional monetary policies, including, in the euro area, a pledge to intervene in sovereign bond markets through Outright Monetary Transactions. The euro area also pursued several institutional reforms, such as installing a collective crisis response mechanism and moving toward a unified pan-European approach to bank supervision and resolution. Many countries, especially those under market pressure, also started structural reform programs.

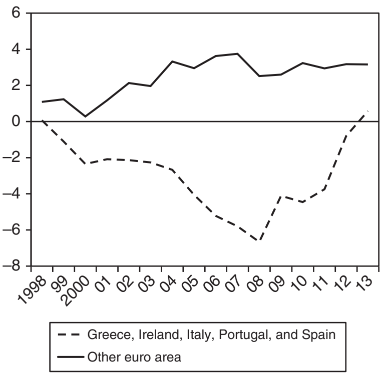
Despite these efforts, the outlook for growth and employment remains fragile. Five years after the Great Recession began, growth remains sluggish in most of Europe (Figure 1.1), and prospects for a robust expansion are modest even in the medium term. Based on the IMF's October 2013 *World Economic Outlook*, annual growth in Europe is projected to average 1.4 percent between 2013 and 2017, barely half the 2.7 percent achieved in the five years before the crisis. Unemployment is stubbornly high in all but a few countries. Current account imbalances have improved asymmetrically as large surpluses in some core countries have persisted even as external imbalances in deficit countries have shrunk (Figure 1.2).

Figure 1.1 Real GDP Growth, 2005:Q4–2013:Q3 *(SA, 2008:Q3 = 100)*



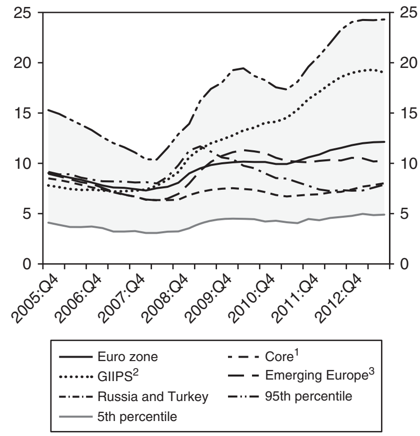
Sources: Haver; and IMF staff calculations.
[1]Simple average of Belgium, France, Germany, and Netherlands.
[2]Simple average of Greece, Ireland, Italy, Portugal, and Spain.
[3]Simple average of Bulgaria, Croatia, Czech Rep., Hungary, Latvia, Lithuania, Poland, Romania, and Ukraine.
Note: Due to data availability, Ireland and Luxembourg are excluded from the 2013:Q3 averages.

Figure 1.2a Current Account Balance, 1998–2013[1] *(Percent of GDP)*



Sources: Haver; and IMF staff calculations.
[1]2013 is based on projections in the October 2013 World Economic Outlook.

Figure 1.2b Unemployment Rate, 2005:Q4–2013:Q3 *(SA, percent)*



Sources: Haver; and IMF staff calculations.
[1]Simple average of Belgium, France, Germany, and Netherlands.
[2]Simple average of Greece, Ireland, Italy, Portugal, and Spain.
[3]Simple average of Bulgaria, Croatia, Czech Rep., Hungary, Latvia, Lithuania, Poland, Romania, and Ukraine.

UNRESOLVED WEAKNESSES ARE HOLDING BACK THE RECOVERY

Balance sheets—bank, public, corporate, and household—remain a source of difficulty. Although the immediate crisis response prevented worst-case scenarios and created crucial space for adjustment, it did not actively deal with the unusual combination of balance sheet issues brought about by the crisis. In many European countries, already-high debt ratios among households and corporates worsened as a result of declining asset prices and weak or negative income growth, and public sector debt increased significantly. Given the slow pace of global demand, there is little hope for either sector simply to grow out of its debt. Instead, the resulting pressure to deleverage—the need to bring down debt by reducing consumption, investment, and net government spending—threatens to hamper the recovery. The fact that, at the same time, many banks continue to restrain credit as they build or rebuild capital buffers only adds to these headwinds.

With banks, governments, businesses, and households all trying to repair balance sheets, the risks of negative spillovers from one sector to the others are high. Indeed, Bornhorst and Ruiz-Arranz (Chapter 2) provide evidence suggesting that the harmful growth impact of elevated levels of any one category of private or sovereign debt is amplified when levels of one or more of the others are also high.

In the longer term, structural reform gaps slow growth and adjustment. All European countries would have benefited from structural reform before the crisis, but the need to enable an adjustment of the composition of output—away from precrisis sectors such as construction, which benefited from unsustainable housing booms, and toward those that can support exports and future growth—is more pronounced in those countries most affected by the crisis, including Greece, Ireland, Italy, Portugal, and Spain. In a number of cases, current account deficits also point to a need for efforts to raise productivity and for more competitive wage setting. In other European economies, including in the euro area core, significant untapped reforms remain that can unleash additional growth momentum, including in investment and the services sector.

DEALING WITH CRISIS LEGACIES

History confirms that adverse economic conditions do not preclude debt reductions, but they come at a price. As Abbas and others (Chapter 4) show, many past episodes of large and sustained sovereign debt reduction started under adverse conditions, but they were often later supported by accelerating external demand. When output grows rapidly, debt ratios can come down even without substantial deficit reduction. If underlying growth remains low, however, the burden of adjustment falls more squarely on fiscal policy. In a sample of advanced economies between 1980 and 2011, the success rate of attempted fiscal consolidations dropped from about 40 percent to about 25 percent when growth fell below the country median. Under such circumstances, sovereign debt reduction requires a durable commitment by policymakers to sustain fiscal consolidation and strong efforts to limit the impact of budget tightening on growth. A similar mechanism is in play for private sector debt reduction. Bakker and Zeng (Chapter 3) note that past private sector balance sheet consolidations often were facilitated by higher inflation and fiscal support, neither of which is likely to be forthcoming at the current juncture. They warn that, as a consequence, corporate sector deleveraging this time could lead to significant labor shedding, particularly if labor market institutions inhibit wage adjustment.

Good policies can mitigate the short-term costs of deleveraging. Although there is no alternative to bringing down debt levels, policymakers can still work to protect growth:

- *Better microstructures can facilitate the reduction of private sector debt overhangs.* Bornhorst and Ruiz-Arranz note that in the past, the deleveraging after a busting boom tended to match the cumulative pre-crisis buildup in debt almost one to one (typically during a course of 5–10 years), bringing debt ratios back about to where they started. Such large deleveraging efforts require effective insolvency frameworks featuring, among other mechanisms, fast and flexible personal and corporate bankruptcy proceedings to help avoid lengthy periods of deleveraging and to protect growth. However, despite progress in this direction in a number of countries, ample scope for reform remains.
- *Proper sequencing helps.* Another finding emerging from Bornhorst and Ruiz-Arranz's work is that whereas high private sector debt tends to unambiguously lower growth, public sector debt is more harmful if the private sector is highly leveraged. This result would suggest that addressing private sector debt reduction first can help mitigate the impact on growth—a principle

mirrored in current IMF advice that countries seek a gradual pace of fiscal consolidation anchored in a credible medium-term framework, if circumstances allow (IMF, 2013c). Indeed, by protecting growth and thereby facilitating private sector deleveraging now, governments might be able to improve the conditions for self-sustained growth later on. But as Abbas and others warn, “later” must not be “too late”: front-loaded consolidations may be necessary if market confidence is critical, as is the case in economies facing particularly high costs of finance.

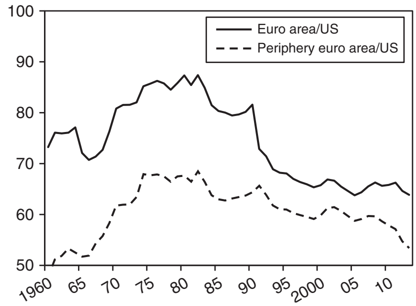
- *The design of fiscal consolidation matters.* Abbas and others highlight the importance of designing consolidations to minimize their impact on growth (see also IMF, 2012a). For example, cutting less productive spending, protecting public investment, and shifting the emphasis from direct to indirect taxes will help; some countries might also have scope for additional privatization efforts. More generally, consolidation episodes provide opportunities to implement growth-enhancing tax or subsidy reforms. But most importantly, to protect growth public debt-reduction efforts should be undertaken gradually where financing conditions allow and be anchored in a medium-term framework.
- *Structural reforms to boost growth are key.* As noted above, the easiest way to bring down debt while avoiding unwanted deleveraging is through higher growth. In addition, the right structural setup can facilitate adjustment in the private sector: as Bakker and Zeng show, corporate sector deleveraging has often fallen disproportionately on employment when labor market rigidities have made other types of adjustment more difficult. Labor market reforms can thus help mitigate the extent of labor shedding and, depending on the impact on aggregate demand, boost output growth.

LAYING THE FOUNDATIONS FOR LONG-TERM GROWTH

Improving Europe’s growth potential is crucial. Although the crisis has made the quest for growth more urgent, many observers have noted that growth in the euro area and in other advanced European economies has lagged that of peers since the 1980s (Figure 1.3). Having reached about 90 percent of U.S. per capita GDP in 1980, euro area output today stands at about 70 percent of that mark, with economies such as Greece, Ireland, Italy, Portugal, and Spain measuring less than 60 percent. Much of the relative decline has been explained by weak total factor productivity growth—and action on many fronts will be required to address this shortcoming.

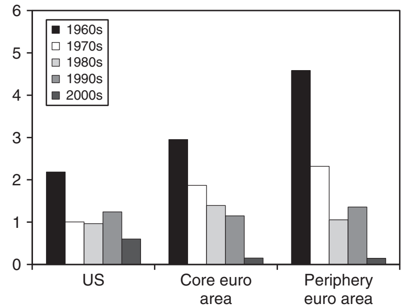
Labor market reform will have an important role, and pursuing the right reforms is especially important in the current context. Millions of young people are out of work, and starting off into their working lives without a job not only affects them directly but also hampers Europe’s future growth potential. Unemployment at a young age means a lack of on-the-job training, depreciating skills, and a less productive workforce tomorrow. By reducing savings and pensions, it also means a longer working life, a less prosperous retirement, or both.

Figure 1.3a PPP GDP per Working-Age Population *(Relative to U.S. levels)*



Sources: *World Economic Outlook* and OECD.

Figure 1.3b TFP Growth *(Average by decade)*



Source: European Commission.

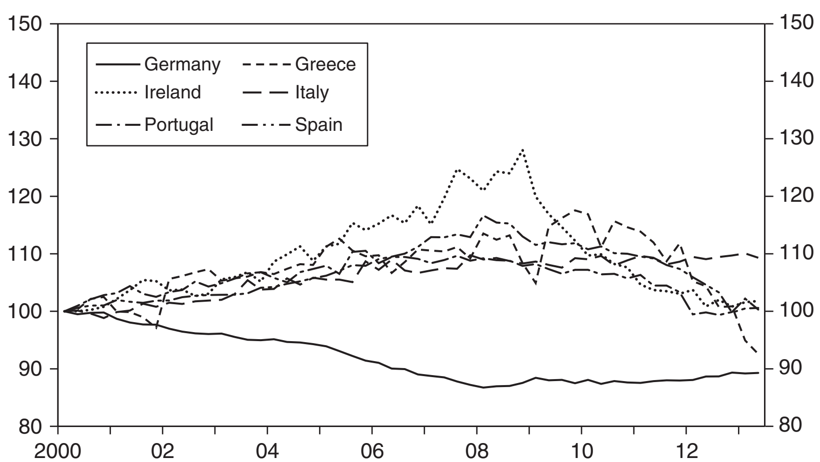
- *Making up for lost ground*. Cheptea and others (Chapter 5) trace many of the dismal labor market dynamics in Western Europe back to choices made since 1990—which suggests that better choices in the future have the potential to improve the functioning of these markets significantly. Here and elsewhere, however, structural problems extend beyond the labor market: product market reforms are also required. Simultaneous product and labor market reforms will maximize the impact on potential growth, although reform priorities and their design will differ across countries. For example, many of the Balkan economies that are not members of the European Union (Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro, and Serbia) need to address deep-rooted problems arising from a delayed transition process, poor investment climates, and the resulting low flows of foreign direct investment (Kovtun and others, Chapter 6).
- *Fighting the disadvantages of dualism*. Labor market dualism has been advancing in recent years, with larger shares of employees in temporary contracts with low employment protection. As Bakker and Zeng show, this dualism increases the likelihood that cost-cutting measures in the corporate sector will result in employment cuts. Dual labor markets also bring a host of other potential problems, including income inequality and inefficient training because both workers and firms have lower incentives to invest in human capital when worker turnover is expected to be high. Although some degree of market-driven labor market dualism can provide needed flexibility to respond to economic shocks, evidence indicates that asymmetric regulation has moved the balance too far in many countries.

A comprehensive reform effort that includes the product and services markets promises sizable gains. Simulations using the IMF's Global Integrated Monetary and Fiscal model undertaken by Anderson and others (Chapter 7) suggest that comprehensive product market, labor market, and tax reforms could raise real GDP by 4 percent over a medium-term horizon and by up to 12 percent in the long term. The boost to long-term real GDP is largest in the periphery countries, reflecting larger scope for reform as well as positive trade and technology spillovers from the relatively larger core economies. This is a welcome finding because some of the largest deleveraging needs are in the periphery. The reforms would also boost competitiveness through lower unit labor costs, another area in which large intra–euro area gaps have developed (Figure 1.4). The analysis also points to competitiveness benefits in periphery economies, exactly where external demand support is most needed. Thus, reforms could contribute to the needed rebalancing of current accounts across Europe (see also Atoyan, Manning, and Rahman, Chapter 9).

Smart design will increase benefits. Structural reforms are critical to improving the long-term capacity of economies to grow through both more intensive use of resources and higher productivity, but their full impact will take time to develop (Anderson and others).

- *Comprehensive reforms are better than piecemeal ones*. For example, although product market reforms would have a particularly large effect in the euro area, simultaneous labor market reforms will maximize the impact on potential growth. Piecemeal reforms should be avoided not just across markets, but also within them. Cheptea and others find that 85 percent of past labor market reforms in Western Europe focused on only a small aspect of institutions, were incremental, or both. The explosive growth of youth unemployment in some European economies marked by partial labor market reform is a particularly telling case. The specific reform priorities and their precise design will, however, differ across countries.
- *Tailoring reforms to needs is important*. As Cheptea and Velculescu (Chapter 8) explain, a one-size-fits-all approach does not work when it comes to structural

Figure 1.4 Unit Labor Costs Relative to EMU Average, 2001:Q1–2013:Q3 *(Nominal, 2001:Q1 = 100)*



reforms. Their analysis illustrates that different countries can have widely different reform needs and cautions that a complete review of policy options should assess not only the benefits of reform but also the costs. Reform costs are hard to measure with any precision, and are likely to differ across countries, which will affect what structural reform strategy works best. Together with the analysis in other chapters of this book, this underscores how small differences in the institutional setup of countries, their starting conditions, and their strategies can matter greatly for the outcome of reforms. Further research in this area is clearly needed.

TAKING ADVANTAGE OF CHANGES IN THE GLOBAL ECONOMY

Structural reforms can also play a key role in allowing countries to profit more from the export dynamics provided by global supply chains. As Atoyan, Manning, and Rahman (Chapter 9) document, progress in reducing some of the external current account imbalances in the euro area has been uneven (Figure 1.2). Although many factors play a role, a significant share of these imbalances can be attributed to a lack of external competitiveness, most strongly in the periphery economies (Figure 1.4). In contrast, many countries in emerging Europe have experienced strong export growth over the last decade by tapping into global production chains. Such production links are gaining in importance as firms seek to unbundle their production processes to take better advantage of low-cost foreign factors of production. By some measures, the importance of supply links in world manufacturing exports has increased by more than one quarter during 1995–2008 (Rahman and Zhao, Chapter 10). As Rahman and Zhao note, some of the same structural reforms that promise to improve competitiveness and raise an economy's growth potential can also help to build links to other economies, European or other, and to strengthen its integration into cross-border vertical supply networks. As they argue, smaller economies may benefit from a competitive labor force and from focusing on niches that are complementary to the production processes in larger production hubs.

BAD NEWS AND GOOD NEWS

The global financial crisis has been unique in its severity and its complexity, and also in the challenges it has thrown at policymakers. Five years of crisis management and reform have brought a measure of stability and prevented worse outcomes. But growth remains weak, and many of the underlying vulnerabilities exposed by the crisis are still unaddressed.

In the near term, efforts to bolster the nascent recovery should include further demand support and an effective resolution of the balance sheet weaknesses of the banking sector to jump start credit and private investment. The expeditious completion of the banking union with the ability to undertake a timely, effective and least cost resolution of ailing banks would help remove uncertainty and support growth. If growth remains lackluster and monetary policy options were to be depleted, there may be need for more fiscal support for activity.

There is, however, a road map to chart the course toward stronger and sustained growth in Europe over the medium term. Although more work is needed, the IMF research collected in this book provides a number of guideposts. Following them offers an opportunity for stronger and better balanced growth and employment after what has been a long and dismal period of crisis.

- With prolonged economy-wide deleveraging a major threat to medium-term growth, more effective private sector insolvency frameworks are needed to help reduce household and corporate debt. At the same time, fiscal consolidation will need to be designed to protect growth, and should be anchored by credible medium-term frameworks.
- Europe's longer-term growth potential needs to be enhanced by closing structural reform gaps in product and labor markets in a comprehensive manner. Closing these gaps would also position countries to explore new sources of growth in a globalized world.
- At the same time, the measures examined here will need to be complemented by further efforts to ensure the effective operation of the infrastructure of the common currency area, especially banking and fiscal union.

Recent macroeconomic and financial developments offer encouraging signs that the worst of the crisis and its aftermath may finally be over. A sustainable recovery—one sufficient to reduce unemployment and debt—is however still elusive. Now is the time for governments to get to work on implementing the reforms needed to ensure that more Europeans can at last get back to work.

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