THE ISSUE
The European Union's pre-crisis growth performance was disappointing enough, but the performance has been even more dismal since the onset of the crisis. Weak growth is undermining private and public deleveraging, and is fueling continued banking fragility. Persistently high unemployment is eroding skills, discouraging labour market participation and undermining the EU's long-term growth potential. Low overall growth is making it much tougher for the hard-hit economies in southern Europe to recover competitiveness and regain control of their public finances. Stagnation would reduce the attractiveness of Europe for investment. Under these conditions, Europe's social models are bound to prove unsustainable.

POLICY CHALLENGE

The European Union's weak long-term growth potential and unsatisfactory recovery from the crisis represent a major policy challenge. Over and above the structural reform agenda, which vitally important, bold policy action is needed. The priority is to get bank credit going. Banking problems need to be assessed properly and bank resolution and recapitalisation should be pursued. Second, fostering the reallocation of factors to the most productive firms and the sectors that contribute to aggregate rebalancing is vital. Addressing intra-euro area competitiveness divergence is essential to support growth in southern Europe. Third, the speed of fiscal adjustment needs to be appropriate and EU funds should be frontloaded to countries in deep recession, while the European Investment Bank should increase investment.

EUROPE’S GROWTH PROBLEM AND WHAT TO DO ABOUT IT

1. For data for all EU countries for all indicators studied in this Policy Brief, see the supplementary charts, available at http://www.bruegel.org/index.php?id=257.

Table 1: GDP, GDP per capita and GDP per employee at PPP (US=100)

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Source: Bruegel based on AMECO database, European Commission. Note: * in right hand panel, EU9 (not including Bulgaria, Latvia, Malta).

Figure 1: Growth forecasts at different dates [2007=100]

Source: Bruegel calculations using different editions of the IMF World Economic Outlook. Note: the first vertical line indicates 2007, the second 2012.

Figure 2: The impact of the recession on employment and business investment [2007=100]

Source: Bruegel based on AMECO database, European Commission. Note: * in right hand panel, EU9 (not including Bulgaria, Latvia, Malta).

EUROPE’S PRE-CRISIS GROWTH PERFORMANCE was disappointing enough, but the performance since the onset of the crisis has been even more dismal. Table 1 shows that while the total output of EU15 countries (EU members before 2004) exceeded that of the United States by 15 percent in 1982, it is expected to be 17 percent lower in 2017. EU15 per capita income has remained broadly stable relative to the US, but this is largely due to pre-crisis job creation – a positive development on its own. Relative GDP per employee declined by five percentage points between 1997 and 2007 and by another six percentage points since. There is some comfort to be found in the continued catching-up of the countries that joined the EU in 2004 and after, but their future will also be at stake if the advanced European countries continue to lag behind.

Unlike the US and Japan, Europe’s growth and unemployment numbers have consistently disappointed since 2007 (Figure 1). Productivity developments remain weak, even in EU countries with healthier private and public balance sheets. Unemployment continues to grow and set new records. This is again in contrast to the developments in the US, where the initial impact on employment of the recession was much worse, but where job creation has resumed, the unemployment rate has declined from its post-2007 heights, and investment has also resumed (Figure 2).

What are the reasons for the worsening performance since 2007? Obstacles to productivity performance? Ill-timed public deleveraging? Banking sector weaknesses? Or, especially in the euro area, capital misallocation and misaligned prices? In this Policy Brief four sections we discuss these questions, before drawing policy conclusions.

THE PRODUCTIVITY PROBLEM

Before 2007, Europe’s weak productivity performance reflected well-known structural weaknesses: insufficient investment in human capital and research, a limited ability to transition from an imitation-based economy to an innovation-based economy, excessive reliance on established firms in traditional industries and, in a number of countries, a growth model that was based on booming but low-productivity construction and traditional services.
Efficiency of public administrations, education levels and weak innovation performance have been additional impediments to growth. Most of the countries that joined the EU in 2004/2007 embarked on technological transfer-driven convergence.

Since 2007, the EU15 has taken a productivity holiday, while productivity has increased rapidly in the US (Figure 3). In terms of total factor productivity, both the EU15 and EU12 lag behind Japan. Even economically stronger countries, such as Germany, lag behind the US, and the evolution in the United Kingdom does not differ markedly from that of continental economies. Some hard-hit countries, such as Ireland, Spain and Latvia, have apparently recorded outstanding labour productivity performances since 2007, but most of these gains have been due to compositional changes, such as the shrinkage of low-productivity construction and low value-added services and their total factor productivity developments were weak. In terms of productivity there have been very few truly good performers in the EU. Poland is one.

Labour hoarding can partly explain the initial response to the shock of the recession. Employment contracted by five percent between 2007 and 2010 in the US, while in several European countries the employment shock was of limited magnitude. Public policies, such as Kurzarbeit, a scheme financed by the German government to support part-time work and keep workers employed, were one factor behind this response. Firms also hoarded labour, expecting a rebound and thereby limiting the initial rise in unemployment. Five years on, however, the productivity setback has become permanent, contributing to lower potential output. This cannot be regarded as a cyclical phenomenon anymore. In the short run, weak productivity performance can be related to insufficient demand through the so-called productivity cycle. But a weak cyclical position of the economy cannot explain sustained poor productivity.

A number of structural factors have also contributed to weak productivity performance:

- **Banking problems**: the increased cost and reduced availability of working capital limits investment and thereby the adoption of new technologies, and may lead to a shift toward more labour-intensive, but less efficient production.
- **Low level of integration in the global value chain**: the complexity of firms’ internationalisation strategies is related to productivity. Countries that are more integrated into the global value chain, such as Germany and Poland, took advantage of global demand and thereby achieved better productivity performance than

![Figure 3: Productivity developments, 2007-2012 (2007=100)](image)


![Figure 4: Gross debt (% GDP), 1990Q1-2012Q3](image)


more inward looking countries, such as the UK and Spain.
- **Pro-cyclicality of business research and development expenditures**: the lingering crisis reduces the pace of innovation and companies’ adoption of more innovative technologies, which weakens business investment, and thereby reduces the productivity increase.
- **Impediments to reallocation across sectors and between firms**: dysfunctional financial systems hamper productivity-enhancing restructuring, while obstacles arising from labour, capital market and bankruptcy regulations weigh more heavily in a time of profound change.
- **Uncertain macroeconomic and financial outlook**: can also make companies cautious about investing, thereby gradually eroding productivity.

**THE DELEVERAGING PROBLEM**

In the run-up to the crisis, private sector debt increased substantially in the EU and the US, while in Japan the deleveraging process that started in the 1990s continued (Figure 4). Household and corporate indebtedness increased substantially, while public debt was rather stable or even declining slightly.

Since the beginning of the crisis, private debt deleveraging in Europe has proved slower than in the US. In the aftermath of the Great Recession, Europe put the emphasis on fiscal ‘exit strategies’, overlooking private debt problems. Corporate and household debt has continued to increase as a share of GDP. In the US, household debt has sharply reduced and corporate debt has stabilised. Whereas public debt has increased more in the US than in Europe since 2007, total debt (excluding the financial sector) has increased markedly less. The US is therefore ahead of Europe in the aggregate deleveraging process. In Japan, meanwhile, private debt has remained stable and the whole of the increase in total debt has come from the government sector.

A combination of factors is responsible for this outcome:

- **Lower profitability of the corporate sector** in part of Europe, which has made it dependent on borrowing;
- **Different bankruptcy laws and procedures**: Household debt in the US was significantly reduced through personal bankruptcies;
- **More expensive financing conditions** in part of Europe, especially southern countries in the euro area and bank weakness leading them to continue extending credit to weak firms in order to avoid the realisation of losses (a process known as ‘zombification’);
- **Lower nominal GDP growth**, in part as a consequence of more aggressive budgetary consolidation against the background of a still-weak private economy.

**THE BANKING PROBLEM**

Financial intermediation is of central importance for growth. Ample international experience documents that the growth of an economy is negatively affected by a weak financial system. The case of Japan illustrates that a combination of banking problems and debt overhang in the corporate sector can have long-lasting negative consequences for growth.

Financial intermediation in Europe remains centred on the banks, although there is some evidence of a gradual and slow shift to capital markets. Although transformation of the financial system towards a greater share of capital-market based intermediation is likely to be a long-term trend that will have profound implications for Europe’s economy, in the short
term bank-based financial inter-
mediation remains of central im-
portance given its large base.

Bank-based credit growth in the
majority of EU countries has been
weak since 2008. The statistics for
the euro area paint a picture of
very subdued credit growth. The
year-on-year growth rate of euro-
area credit has not exceeded two
percent, compared to the pre-
crisis 10 percent. In the UK, bank-
based credit declined, while in
Poland and Romania credit growth
slowed down in 2009/10, but sig-
ificantly accelerated afterwards.
The European numbers compare
with more robust credit growth in
the US, which has bounced back
to five percent annual growth.

Credit growth is particularly weak
in the south of Europe. Demand
for credit is weak, reflecting the
economic outlook and subdued
business confidence. Lending
conditions in countries under
stress remain tight and the
supply of credit limited. Also, writ-
ing-down bad loans reduce credit
aggregates. The European Central
Bank continues to stress that de-
spite an improvement in the mo-
netary transmission mechanism,
monetary policy action does not
get properly transmitted to all
euro-area countries, and this im-
pairs the provision of credit to the
real economy.

Speedy resolution of banking
problems is an important condi-
tion for growth to resume. The past
experience of Sweden and Japan
illustrates the benefits of speedy
action [Figure 6]10. During the cur-
rent crisis, in the US, significant
bank restructuring occurred rela-
tively early in the crisis.

Banks with weak balance sheets
lend on too expensive terms or
lend to insolvent borrowers to
keep them afloat are a drag on
growth. In year five of the crisis,
Europe’s banking system remains
fragile. About a fourth of the Eu-
ropean banking system is still
under state aid control and de-
pends on public support11, whereas banks have for long re-
gained independence in the US.
Risk premia paid by banks are sig-
ificantly higher in Europe than in
Japan and the US [Figure 7].

**THE PRICE MISALIGNMENT AND CAPITAL MISALLOCATION PROBLEM IN THE EURO AREA**

Excessive housing booms have
distorted prices and wages and
led to the misallocation of capital
in a number of EU countries, as
exemplified by construction
booms and the unsustainably
high share in the economy of the
construction sector prior to the

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10. Speedy restructur-
ing in Sweden fostered
economic adjustment
and productivity
growth, while in Japan
the ‘zombification’ of
banks contributed to a
decade of stagflation
when productivity
hardly improved.

11. European Commis-
sion, ‘EU state aid con-
trol and financial
stability’, presentation
at Bruegel workshop,
8 March 2013.

12. There were similar
developments to the
southern euro-area
countries in the Baltic
states, and there was a
rapid adjustment, but at
a very high price. See
Blanchard (2012)
‘Lessons from Latvia’,
IMF Direct: http://blog-
imfdir-
rect.imf.org/2012/06/1
1/lessons-from-latvia/.
EUROPE’S GROWTH PROBLEM AND WHAT TO DO ABOUT IT

At the same time, the share of manufacturing declined significantly in the south of Europe, and also in France, while in the north of Europe, the manufacturing share was relatively stable (Figure 9).

In the euro area, the process was accompanied by a major distortion in relative prices (Figure 10). The real exchange rate of all southern euro-area members became overvalued, while it became undervalued in most northern members. Since euro-area members do not have stand-alone exchange rates, only intra-euro area adjustment can correct for these divergences.

Adjustment has started, but progress is too slow. The good news is that the export performance of e.g. Ireland, Spain and Portugal is outstanding. The external indebtedness of these countries is so high that further improvement in the trade balance is needed to achieve external sustainability. Price adjustment has started in several countries, but the inflation rate in Italy, a country that also needs sectoral reallocation toward the tradable sector to revive growth, remains above euro area average. At the same time, the inflation rate in Germany has remained low and is expected to remain below euro average. Major differences in labour market conditions translate only slowly into inflation differentials. Relative wages have started to adjust, but prices exhibit rigidity.
Without the relative price adjustment, the necessary reallocation of economic activities toward the tradable sector in the south will not take place. Absent a symmetric enough adjustment, meaning inflation in the euro area is at two percent with higher-than two percent inflation in Germany and other surplus countries and close to zero inflation in the south, the south will need to deflate. That would endanger both private and public debt deleveraging, putting debt sustainability at risk and delaying the recovery even further.

CONCLUSIONS

Europe’s long-term growth strategy has so far failed. Various initiatives have been unable to increase the growth potential of the EU15. EU12 members have on average performed better, but their futures will crucially depend on the EU15 because of the EU’s financial and trade integration.

This failure is now compounded by a danger that the short- to medium-term challenges will interact perversely with the longer term ones and lastingly weigh on Europe’s performance. Much of Europe suffers from a mutually reinforcing interaction between limited productivity gains, protracted deleveraging, weak banking sectors and distorted relative prices. This combination contributes to an overall weakening of economic growth and threatens to turn into self-perpetuating stagnation. This dark picture calls for bold policy action significantly beyond what is currently being undertaken.

Policy action should comprehensively address all four aspects of the problem. But the quest for growth is elusive. Growth policies are by nature difficult to encapsulate in a few recommendations. So the following suggestions are in no way exhaustive.

The sequencing of policy action is important. Without credit, investment and growth, any structural reform is likely to fall victim to popular rejection. If fiscal retrenchment does not deliver results, support for it will vanish. Therefore, the strengthening of banking systems and the recognition of bad loans should be prioritised in order to create conditions for a resumption of private-led demand. Relative price and wage adjustment and structural reforms should also be pursued, but are unlikely to deliver immediately, in particular in the absence of growth.

The most urgent priority is therefore restoring a fully functional financial system, which is a precondition for the resumption of productivity and growth. Europe for too long has refused to recognise this. The forthcoming introduction of the Single Supervisory Mechanism (SSM) offers a unique opportunity to complete the strengthening of the European banking system. Before the ECB carries out the ‘comprehensive assessment’ of the banks brought under its supervision, national authorities should trigger a recapitalisation of undercapitalised banks and a resolution of insolvent ones. The ECB should make clear that it will not accept undercapitalised banks for the single supervisory system. Countries outside the SSM should also revitalise their domestic banks. The European Commission should encourage governments to bear the fiscal costs if necessary by announcing that deficit increases from public recapitalisations carried out until end-2013 will be treated as one-off costs within the framework of the Excessive Deficit Procedure.

Negotiations for the Bank Resolution and Recovery Directive should be urgently completed to achieve a level playing field. It is important that cross-country differences in banking resolution are minimised to avoid a major fragmentation of the single market.

The establishment of a banking union is one of the most important projects to re-establish growth in the euro area and beyond. It will greatly contribute to repairing monetary policy transmission in the euro area. It needs to involve all key elements beyond supervision (centralised resolution mechanism and an appropriate common fiscal backstop) that are under discussion. Banks that have passed the ECB’s comprehensive assessment should be brought under the banking union and become truly European banks with clearly defined burden-sharing arrangements.

Fostering the reallocation of factors to the most productive firms and the sectors that contribute to Europe’s long-term growth strategy has so far failed; various initiatives have not increased the growth potential of the EU15.'
aggregate rebalancing is vital for productivity and growth. It involves bolder monetary action in combination with targeted fiscal support. As banks may choose not to lend to SMEs because loans are subject to significant haircuts when taken as collateral in central bank repo operations, there is a case for providing support to the enhancement of this collateral. In the euro area, the ECB cannot carry that fiscal risk. Instead, temporary collateral enhancement schemes should be explored, for example, in liaison with the European Investment Bank (EIB). Furthermore, EIB facilities should also be used to support credit, in particular for SMEs. Better access to finance of SMEs would greatly help the creation of new employment in the export sector.

Appropriate speed of fiscal adjustment is paramount. The speed of fiscal adjustment needs to be adapted to the context of stagnating economies throughout the EU. This is especially a concern where households and firms are still in the process of deleveraging. At the same time, it is important to ensure maximum credibility to the medium-term consolidation process. To this end, the new European fiscal framework should be mobilised in full so that commitments to future fiscal consolidation are made adequately specific and credible and emphasis should be put on structural measures with a lasting medium-term impact. Pension reforms are one way of credibly increasing debt sustainability allowing for a slower fiscal consolidation path.

A frontloaded payment of EU funds to countries in deep recession as well as additional EIB capital to promote growth initiatives is warranted. The fiscal retrenchment in the South of Europe in particular is likely to further dampen economic activity and increase social hardship undermining economic and political stability. Frontloaded payments from EU funds, as well as EU-supported investments, will help address demand weaknesses due to fiscal adjustment and private sector deleveraging.

Addressing intra-euro area competitiveness divergences is essential to support growth in southern Europe. Wage rebalancing should involve northern Europe as well as southern Europe. Consistent with the ECB mandate, average inflation in the euro area should not be allowed to fall below the two percent target and northern Europe should refrain from domestic policy action that would prevent domestic inflation from rising above two percent, as long as euro-area price stability remains ensured.

Last but not least, pro-growth reforms are of central importance to increase long-term productivity and need to be continued vigorously throughout the EU. The EU should provide incentives to addressing weaknesses in product, labour and capital markets as well in the building of skills. To this end it should explore new approaches, including contractual budgetary support within the framework of sector-specific initiatives.

Europe’s growth problem does not result from a single set of challenges. It involves the supply and the demand sides; real- and financial-sector issues; and private and public-sector aspects. The EU is used to policymaking by rules and procedures. This is fine in normal times, but it is not the right approach to address the current quagmire. It is not by adding a new layer of procedures that this problem will be solved. It is by formulating a diagnosis, setting priorities, formulating a strategy, and implementing it across policy areas.

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