Europe's stony ground for the seeds of growth

Continental nations must cast off corporatism if they are to emulate thriving economies, writes **Edmund Phelps**

No one doubts that the thriving US economy has deep significance for economic policy. Yet a misperception of the mechanism driving the growth prevents many from looking in the right place for the lessons to be drawn.

In Europe, most commentators view the accelerated growth through the lens of Keynesian economics. They attribute the rise in employment to an increase in output stemming from higher effective demand - more money chasing goods. They put the rise in effective demand down to consumption and investment spending induced by the rise in share prices.

But this monetary interpretation is implausible. Past studies have not found effective demand to be very sensitive to share prices: witness the toothless stock market crash of 1987. Besides, if effective demand were the main agent of the increased employment, inflation would be rising steeply by now.

Europeans reply that the US escapes rising inflation through its limitless ability to import and borrow abroad. But that overlooks a similar non-inflationary employment expansion in Australia, Britain, Canada, Holland, Sweden and also tiny Denmark, Finland, and Iceland. In these economies, effective demand rose only as an effect of what was really a structural expansion - a drop in the natural unemployment rate, temporary or permanent.

What forces brought about this structural expansion? And why first in those nations, not others? A clue is that the forces became powerful suddenly, even if the gestation took years. The strong growth hit the US in 1996, when unemployment rates in every education group started a steep four-year descent. It struck the others with equal suddenness. So the expansion is not due to slow-moving demographic changes in the labour force.

The critical clue is the broad surge of business investment in the thriving economies. Expenditure on new plant and equipment has climbed steeply and there has been heavy investment in new customers and new employees. Non-monetary models of unemployment show most of this investment to have a structural impact that raises both employment and compensation per employee. A shift of output towards construction creates more jobs than it destroys and raises wages, since construction is so labour-intensive. A shift of emphasis from current profits to accumulating new customers leads to lower markups, which increases labour demand. A shift from producing now to recruiting and breaking-in new employees creates jobs and prompts pay increases aimed at retaining staff. Hence a rise in compensation is a sign of a broad investment surge. So is a rise in real exchange rates.

The critical clue is the broad surge of investment in the thriving economies

The impetus for all this investment is a rise in productivity and hence the profits expected from business assets. Faster growth of productivity since the mid-1990s in some thriving economies has surely raised expectations of the trend growth rate. In my analysis, however, both investment and share prices in the thriving economies exceed what can be rationalised by past experience. Much investment is intended to prepare for a future leap in productivity and the profit bonanza not ruined by the preparatory investment. These hopes are conveyed to analysts and on to their clients.

No doubt these expectations are mostly inspired by visions of a "new economy" built on information. Yet the strong expansion's typical industrial composition does not explain why it came to some industrialised economies and hardly at all to western Europe.

A commonplace answer blames the welfare state. This saddles European economies with fiscal burdens and handouts, which blunt employee incentives and raise production costs. This helps to explain why western Europe has chronically high unemployment in times of normal productivity growth. But it does not explain why, from 1995, the unemployment rate in Germany and Italy actually rose and the rate in France fell only modestly in contrast to the big strides in the high-expansion economies. Nor does it explain why productivity and investment have failed to surge in most of Europe in contrast to the high-growth economies. After all, some thriving economies also have high taxes and welfare benefits. And Europe's productivity and investment easily kept up with the US in the 1980s.

The reason why Europe has missed out is that when this expansion was gathering force, the core of the typical European economy was still organised on the corporatist model - a tripartite system of established companies, large trade unions and an interventionist government all bent on preserving their interests. In this model, business investment is controlled through bureaucracy and a closed system of big banks taking guidance from the state and loath to finance start-ups without state guarantees.

In the US and the other high-expansion economies, by contrast, entrepreneurs could launch "new economy" ventures because they had the right institutions: capital and product markets open to start-ups and capable of supplying risk capital. Notably, these economies also had more developed stock markets. That was crucial to venture capitalists who could later sell shares in start-ups they financed. Also, a liquid market for shares was crucial to the rise of stock options to focus managers on earnings growth. Data on the size of national stock markets 12 years ago are uncanny predictors of the winners and losers in the 1990s. In the US, Australia, Sweden and Canada, 1988 stock market capitalisation stood around 50 as a percentage of gross domestic product; in Britain about 80; The Netherlands 40. In Germany and Italy it was only 20; in France and Spain, about 25. Higher education was also a good predictor, but it, too, is an effect of the entrepreneurial economy.

The Continental nations have a choice. They can preserve their corporatism, holding down new entry and catching up by copying proven innovations in the high-expansion economies but without having a boom. Or they can join the expansion by casting off corporatism for a vital capitalism.

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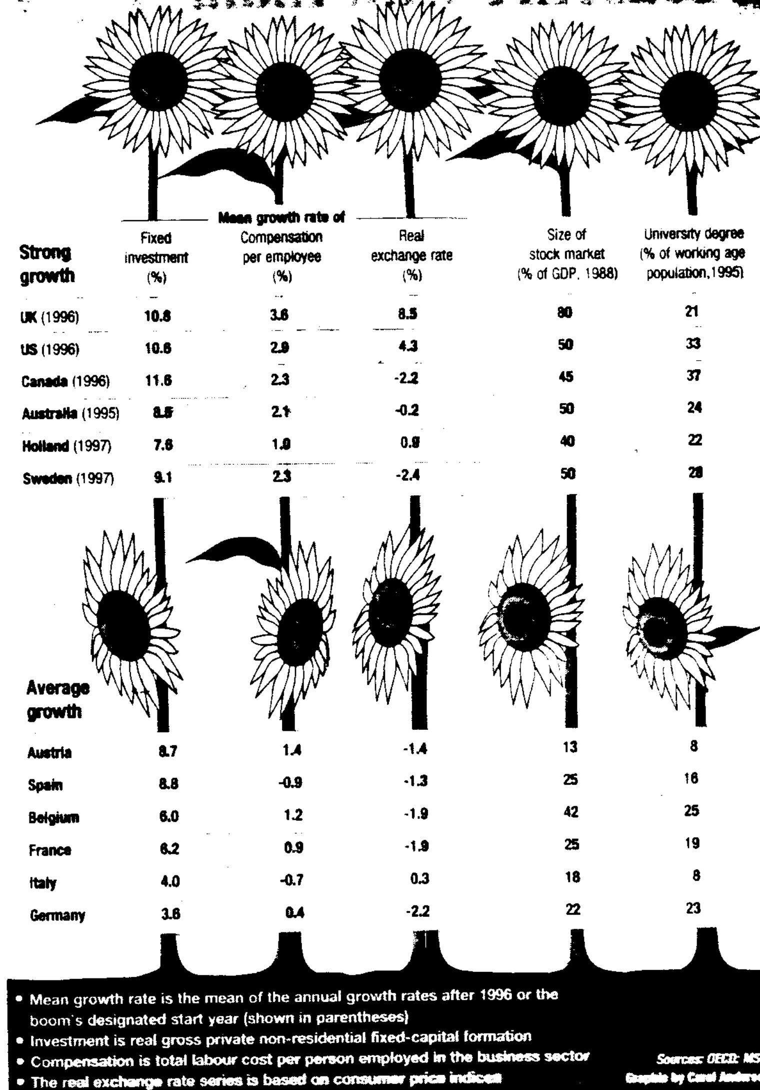

Strong growth	Mean growth rate of: Fixed investment (%)	Compensation per employee (%)	Real exchange rate (%)	Size of stock market (% of GDP, 1988)	University degree (% of working age population, 1995)
UK (1996)	10.8	3.6	8.5	80	21
US (1996)	10.6	2.9	4.3	50	33
Canada (1996)	11.6	2.3	-2.2	45	37
Australia (1995)	8.6	2.1	-0.2	50	24
Holland (1997)	7.6	1.9	0.9	40	22
Sweden (1997)	9.1	2.3	-2.4	50	28
Average growth					
Austria	8.7	1.4	-1.4	13	8
Spain	8.8	-0.9	-1.3	25	16
Belgium	6.0	1.2	-1.9	42	25
France	6.2	0.9	-1.9	25	19
Italy	4.0	-0.7	0.3	18	8
Germany	3.6	0.4	-2.2	22	23

- Mean growth rate is the mean of the annual growth rates after 1996 or the boom's designated start year (shown in parentheses)
- Investment is real gross private non-residential fixed-capital formation
- Compensation is total labour cost per person employed in the business sector
- The real exchange rate series is based on consumer price indices

Sources: OECD; MSCI
Graphic by Carol Anderson