

## 2. HAS THE LISBON STRATEGY EQUIPPED EUROPE TO BECOME MORE RESILIENT TO THE ECONOMIC CRISIS?

This chapter gives an overview of recent macroeconomic trends in the European Union in order to provide a background against which the substantive policy areas examined in other chapters of the report can be evaluated. The chapter will focus on the unprecedented economic crisis currently threatening Europe and the global economy, while also seeking to draw up a balance sheet of the Lisbon Strategy's achievements over the past eight years. Insofar as an underlying assumption of the Lisbon Strategy was that it would make Europe more resilient to outside economic shocks

(European Commission 2007b), the current economic crisis will serve also as a test case for the achievements of the Lisbon Strategy. It is the Commission's claim that, thanks to the structural reforms carried out in recent years, European economies are better equipped than in the past to face the current crisis. The validity of this claim will be examined in the course of a brief overview of the economic developments of the past decade in the light of the Lisbon Strategy and the most recent evidence concerning the state of the European economy in the grip of crisis.

### Themes

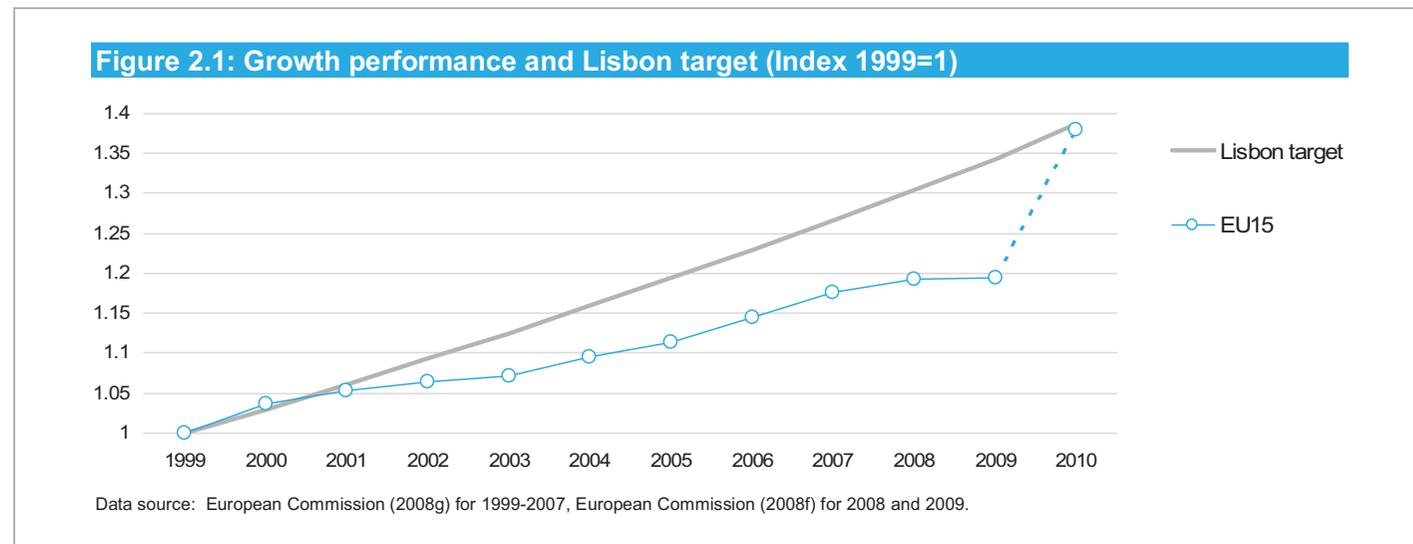
- 2.1. Lisbon growth objectives and reality 1999-2009 – a 19% mismatch
- 2.2. Development of GDP growth in the EU15, the NMS and the US
- 2.3. Labour productivity – a decisive element of growth
- 2.4. How resilient were the foundations of growth in Europe?
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- 2.7. Conclusions: first lessons from the crisis with a view to Lisbon

## 2.1. Lisbon growth objectives and reality 1999-2009 – a 19% mismatch

### The Lisbon growth trajectory and reality

The Lisbon Strategy was launched in 2000 in order to make Europe ‘the most competitive and dynamic knowledge-based economy in the world’, this being regarded as a prerequisite for ‘more and better jobs’ and ‘social cohesion’. While most of the quantitative targets set were geared to employment-related objectives, the achievement of the Lisbon targets was explicitly predicated on a sustained rate of economic growth of 3% per annum.

Figure 2.1 shows, on the one hand, actual GDP growth performance for the EU15 until 2007, with the latest Commission prognoses for 2008 and 2009 (European Commission 2008g, 2008f), and, on the other, the growth targets implied by the Lisbon objectives based on the assumption of 3% growth over the decade. The gap between reality and target (indicated by dotted line on figure 2.1) is so large that Europe would need 19% real GDP growth in the year 2010 to eliminate it. Assuming continuation through the coming years of the average growth rate between 2000 and 2009, it would take another decade to fulfil the 2010 growth target.



## 2.2. Development of GDP growth in the EU15, the NMS and the US (2000-2008)

### Growth trends in the EU and the US

In March 2005, the Lisbon Strategy was re-launched, placing jobs and growth at the top of European political priorities. This focus stemmed from the recognition that economic growth in Europe had been disappointing, relative to the most dynamic economies in the world and specifically to the US, and that the European Union faced major challenges in coping with globalisation and ageing populations. As Figure 2.2 shows, between 2002 and 2006 European growth had substantially lagged behind the US, 2007 being the turn-around year when, for the first time since 2001, growth in the EU again exceeded that in the US. 2008 will show an almost one-percentage-point growth advantage for Europe. According to the latest prognoses, Europe seems likely to fare slightly better than the US in 2009 as well.

The 12 New Member States (NMS) that joined the EU in 2004 and 2007 have been outperforming both the US and the EU15 each year, characteristically by a three-percentage-point growth advantage.

The average growth rates of the NMS were characteristically between 4 and 5% over the period in question, with the Baltic states having achieved an even higher growth dynamic of up to 10%

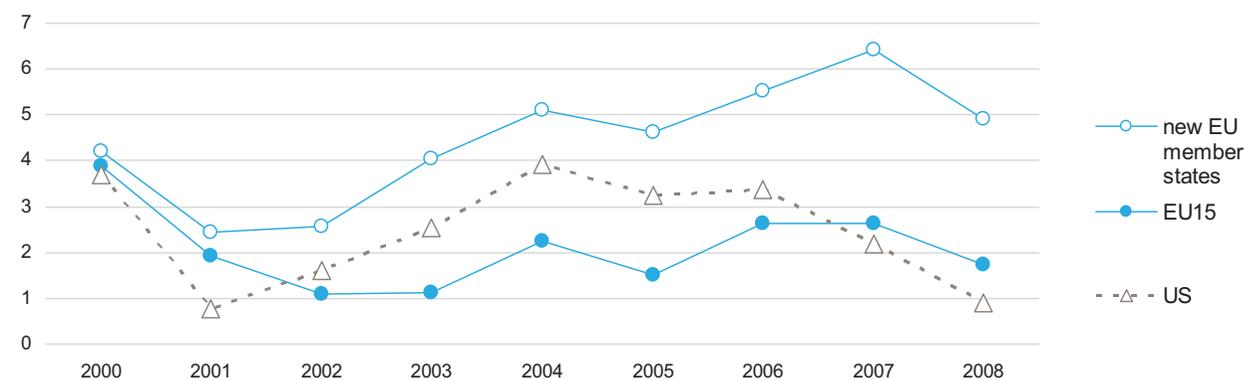
in individual years. In most of the region this was largely driven by foreign direct investment, while in the Baltic states the exuberant growth dynamics were driven also by credit-financed consumption and the construction sector.

Economic convergence by the NMS has thus been sustained for a long period through the decade.

With regard to the components of growth, the European economy as a whole was driven by domestic demand (private and public consumption, investment and changes in inventories) for most of the period.

The dip in growth in 2005 was due to a drop in exports as a result of currency appreciation, while the regained growth dynamic in 2006 and 2007 has been rather broad-based. The sudden downturn in the second quarter of 2008 was due to a drop in domestic demand at a time when net exports still exerted a positive growth impact.

Figure 2.2: Growth performance in the EU and the US (real GDP, annual change, %)



Data Source: European Commission (2008g).

## 2.3. Labour productivity – a decisive element of growth (2000-2008)

### Trends in the EU15, the NMS and the US

Labour productivity – output per employee or working hour – is a key determinant of economic growth. The long-term catch-up trend of productivity in Europe compared to that of the US came to an end in the mid-1990s. In the following decade the US achieved both higher productivity and higher employment growth, except during the recession of 2000-2001. The productivity gap widened, in particular, between 2001 and 2005, when the US experienced high-productivity economic growth at a time when productivity growth lost momentum in the EU15 (Figure 2.3). In 2006, when growth had been picking up again in Europe, productivity grew faster there than in the US, even though the US growth rate remained higher. In the same year, for the first time in the decade, productivity expressed in terms of GDP/hour was also higher in Europe than in the US. In 2007 and 2008, while growth rates in Europe were slightly above those of the US, productivity growth at moderate levels ran rather parallel. The EU as a whole, however, proved incapable of maintaining high productivity growth for any extended period.

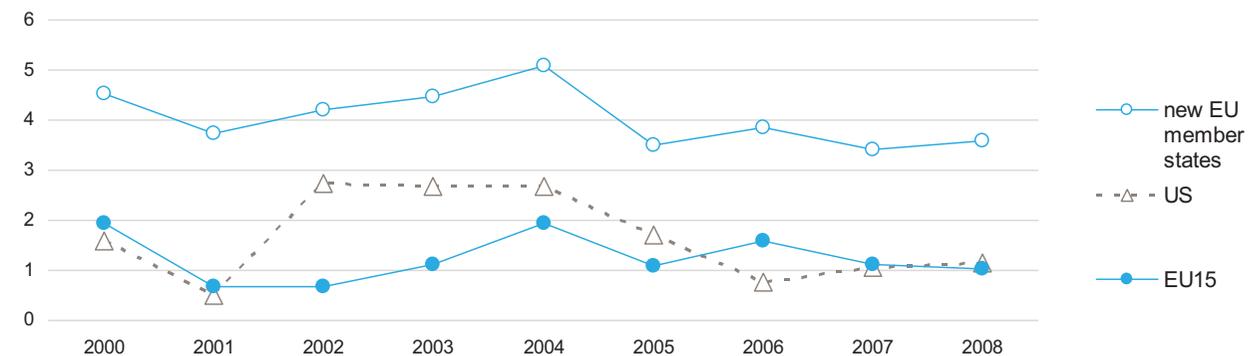
Productivity increase in the NMS12 was sustained on a three-percentage-point higher level than in the EU15

throughout the decade and also substantially outperformed the US in each year. In the period 2006-2008, the increase in productivity in the NMS slowed somewhat, compared to previous years, and, since growth was maintained on high levels, this development finally led to noticeable job creation in most countries of the region.

The decisive components of productivity are developments in physical capital and changes in the quality of labour input. For the period 1999-2006 total factor productivity (the effect of technological change, organisational

innovation, the use of ICT technologies and the functioning of the market) accounted for 5.8% of the growth in value added in the EU25 and for 36% in the US (Carone *et al.* 2006). This indicates that, in terms of achievements in the qualitative aspects of productivity gains that are related to the knowledge-based economy, Europe is still lagging behind the US and the achievements of the Lisbon Strategy are not clearly visible.

**Figure 2.3: Productivity development in the EU and the US, GDP/worker, 2000-2008 (annual change, %)**



Data Source: European Commission (2008j).

## 2.4. How resilient were the foundations of growth in Europe?

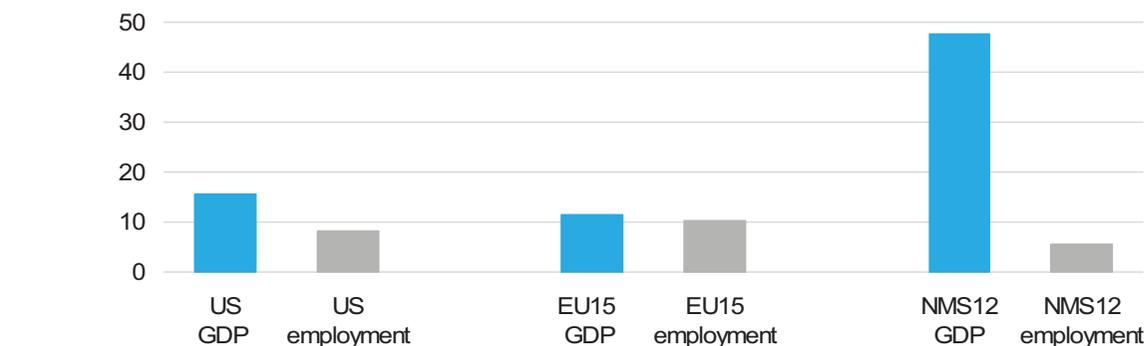
### Growth and jobs – productivity and wages

Cumulative real GDP growth in the period 1999-2008 was higher in the US (15.7%) than in the EU15 (11.6%), but the latter created more jobs. While employment had increased by 8.3% in the US, the EU15 managed overall employment growth of 10.4% during the period in question. The NMS, while having shown cumulative real growth in GDP of 47.6% for the period, experienced job creation to no more than a marginal extent (by 6.0%), as Figure 2.4 shows. Given these countries' low economic weight, however, this fact did not substantially alter the overall picture of stronger job creation in Europe.

During previous downturns employment has remained rather 'resilient' in Europe. Now, with greater labour market flexibility as a result of structural reforms on European labour markets in the most recent period, this may, however, no longer be the case, as is suggested by the immediate drop in employment at the initial phase of the current crisis.

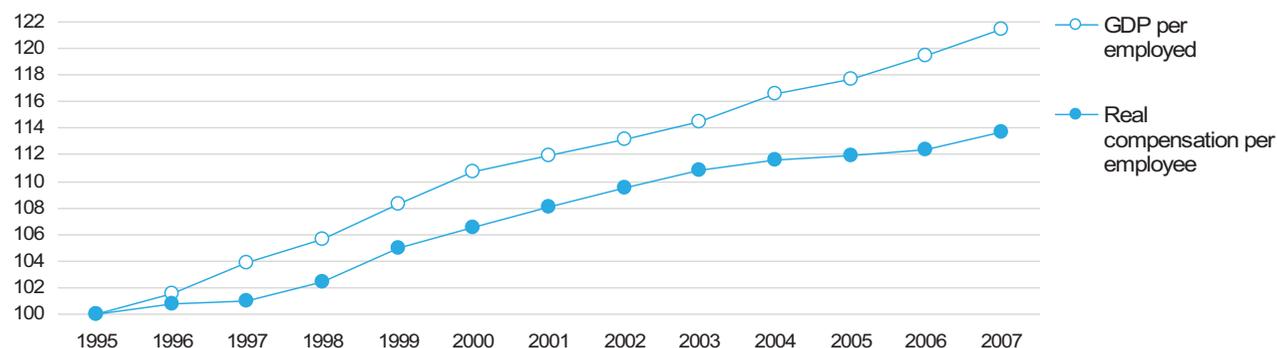
The gap between the development of productivity and the compensation of workers that has been widening in the EU27 throughout the decade (Figure 2.5) has led to a situation in which private consumption, as an essential element of domestic demand, has remained fragile in Europe. In the absence of sound purchasing power of the population based on real wage development, private consumption was either fuelled by the credit and asset bubbles (as in the UK, Ireland, Spain and in some of the NMS) or remained depressed, as in Germany. As a result, European growth became more dependent on outside shocks, as the immediate consequences of the present crisis show.

**Figure 2.4: GDP and employment growth in the US, EU15 and NMS12, cumulative % change 1999-2008**



Data Source: European Commission (2008j).

**Figure 2.5: Growth of productivity and real compensation per employee for the EU25, 1995-2007 (cumulative change, 1995=100)**



Data Source: European Commission (2008j).



## 2.5. How the financial crisis developed into an economic crisis

### The unforeseeable consequences

entire banking system in the US, Europe and worldwide. The European financial system was an excellent and fertile soil for these opaque financial instruments, as accumulated profits were desperately seeking returns higher than investments in the real economy could have offered. Even if the contagion hit the European banking system unexpectedly hard, the dramatic effects of the financial crisis to the European economy came as a surprise to everyone. Up to the Lehman Brothers bankruptcy in mid-September 2008, the effects of the US-rooted crisis on Europe were still seen as moderate. This can be traced through the different prognoses issued at different times of the year and which, until the most recent period, were regularly downgraded (Figure 2.7).

The basic mechanism, as the financial and banking crises hit the real economy, has been that, due to financial losses and evaporated trust, banks were no longer performing their basic function of financing the economy. Enterprises could not finance their daily operations, investments were blocked and consumption broke down in market segments where credit financing had played an important role (construction sector in the US and in a number of European countries, automobile sector in the US and Europe).

All this led to a sudden demand shock affecting exports, investment goods and consumption. There were a number of other factors that also played a role (Watt 2008) and aggravated the situation further (the dragging effect of previously high energy and raw material prices, exchange rate effects and unnecessarily tight monetary policy in Europe up to the last phase of the crisis).

The underlying fundamentals for the spread of the crisis were, however, the chronic imbalances in the world economy, within the Euro area and within the national economies of a

large number of member states. The European context in this respect will be briefly addressed in the next section.

**Figure 2.7: 2008 GDP forecasts for 2009, euro area (EU27)**

<b>IMF</b>	-0.50% (Nov 6)	0.20% (Oct)	1.20% (Apr)
<b>European Commission</b>	-1.90% (-1.80%) (Jan 2009)	0.10% (0.20%) (early Nov)	1.50% (1.80%) (spring)
<b>OECD</b>	-0.60% (late Nov)	1.40% (spring)	
<b>ELNEP</b>		1.50% (spring)	

Source: Watt (2008), European Commission (2009).

## 2.6. European economy: 'hard landing' from 2007 to 2009

### How deep and how long?

Despite the evolving crisis in international financial markets in 2007, the European economy seemed to be well on track in that year and, with real GDP growth of 2.7% in the Euro area, it outperformed the US (2.2%). After a long struggle, Europe seemed confident of resisting the effects of the financial turmoil triggered by the US sub-prime crisis.

The reasons why Europe was hit so hard within such a short time were a series of factors that made previous growth unsustainable once the outside environment turned unfavourable. A number of member states, such as the UK, Spain and Ireland, had been enjoying growth based largely on credit and real estate bubbles. In several new member states consumption was financed to a large extent by credits denominated in foreign exchange. In the absence of domestic capital accumulation, 'catching up economies' are reliant on external financing and this, together with high levels of current account deficits, made them especially vulnerable to turbulence on financial markets. Moreover, the economies of new member states are integrated with the European and the world economy to a higher extent than most EU15 economies and are highly dependent on external demand. Germany, on the other hand, where domestic demand was chronically

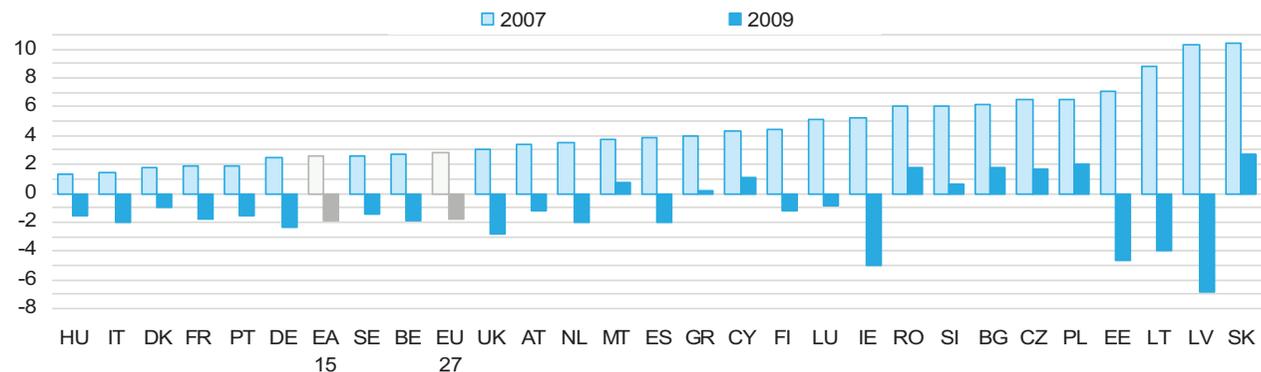
depressed, not least because of enduring wage moderation, had managed its growth through an export offensive that, however, came to a sudden halt with the crisis.

The 'hard landing' that is visible in Figure 2.8 refers mostly to those economies with unsustainable past growth strategies, characterised as 'bubble growth' in the previous section.

The most dramatic downturn is to be seen in Latvia, where above 10% GDP growth in 2007 is likely to turn into a decrease of 6.9% by 2009. Previous

high-growth economies, such as Estonia, Lithuania and Ireland, are also expected to be hit hard, with a projected drop in GDP of 4-5 % in 2009, while the 2.8% negative growth forecast for the UK also represents a huge setback. Other major economies are expected to experience a downturn of around 2%, with the Euro area GDP set to fall by 1.9% and the EU27 by 1.8% in 2009 (European Commission 2009). This is a dramatic change compared to the 2007 performance (Fig 2.8), but also in comparison with the prognosis of the Commission nine months ago (Fig 2.7).

**Figure 2.8: Gross domestic product in 2007 and prognosis for 2009 (annual growth)**



Data Source: European Commission (2009).

## 2.7. Conclusions

### First lessons from the crisis with a view to Lisbon

The Lisbon Strategy was supposed to be based on quality growth (growth based on the knowledge-based economy) and on quality jobs. In this chapter we have focused on the economic aspects.

Recent and current European growth proves, in quantitative terms, to be weak, insofar as no more than approximately half of the growth objective required to underpin the Lisbon Strategy will have been achieved by 2010. This outcome is, to a large extent, attributable to a non-adaptive macroeconomic policy framework (ECB monetary policy, Stability and Growth Pact). Pressure on consumer demand as a result of decade-long wage moderation meant that Europe was vulnerable to outside shocks (financial turbulence and drop in external demand). In some member states growth strategies were not sustainable and displayed features similar to the bubble-driven growth in the US.

In quality terms, productivity development was moderate and did not sufficiently benefit from the knowledge-based factors envisaged by the Lisbon Strategy.

It was thought that, as a result of the achievements of the Lisbon Strategy, Europe would be more resilient to an externally rooted crisis. This expectation seems not to have been justified, considering the speed and the depth with which the US-based crisis has swept over Europe. In the case of previous crises, the pattern has been that the US falls deeper into recession but recovers faster, whereas Europe remains mired in crisis for a prolonged period. The current forecasts seem to indicate that history may well repeat itself once again. Concerns appear regarding the labour market as well, as with higher labour market flexibility and the expansion of precarious jobs (see Chapter 3) labour market stabilisers that served to dampen the employment impacts of a crisis are not in place to the same extent as previously.

Policy responses to the current crisis in Europe need to be coordinated, but not uniform, given the diversity of the situation in individual member states. The present spectacle is of diverging responses developed according to an ad hoc approach and not matched to the specific needs or capacity of the member states.