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Structural Reforms: A Key Missing Link in the Euro Area

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Slowing regional growth and widening disparities in member state performance have put the spotlight back on measures aimed at improving the euro area's growth potential. Better results in the periphery ex-Italy show that structural reforms can be an important plank in the region's overall growth strategy.

In his Jackson Hole speech this August, European Central Bank (ECB) president Mario Draghi suggested that both fiscal policy and structural reform should play a greater role in tackling high unemployment, alongside monetary policy. Many studies have concluded that structural, or supply-side, reforms can secure a secular decline in unemployment and lift an economy's trend rate of growth, thereby supporting social cohesion and longer-term political stability. In the wake of Draghi's speech, there's been much discussion about the need for a broad reform agenda that spans labor and product markets and policies to improve the general business environment.

Given this focus, we've revisited our analysis on structural reform in Europe.* We now have 2013 and 2014 labor and product market indicators from the World Economic Forum (WEF) and the Organisation for Economic Co-operation and Development (OECD). We used these to compile a more up-to-date picture of each country's structural ranking and show the changes that have occurred over the last few years.

Our framework ranks euro-area member states according to four criteria: 1) structural flexibility (i.e. composite labor and product market flexibility); 2) structural change since 2010 (i.e. the boost from reforms); 3) demographic prospects; and 4) labor cost competitiveness. The overall rankings for longer-term growth potential **(Display 1)** weight these four factors equally. Obviously, these criteria don't represent an exhaustive list of all the variables likely to drive potential growth, but they provide a useful initial guide.

Key Findings

Display 2 shows that in most cases—with Ireland and the Netherlands as notable exceptions—the euro-area countries exhibit greater structural rigidity in labor markets (less flexible wage negotiation, stricter employment legislation, etc.), higher taxes on labor and less competition in goods markets than more flexible economies like the UK and the US. As

Display 1
Summary Rankings

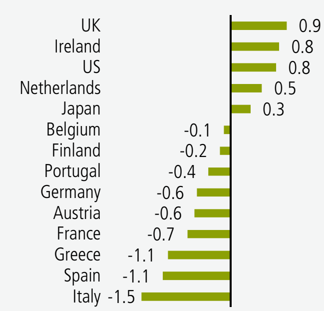
Euro Area Country Rankings, Economic Potential

Country	Structural Flexibility	Structural Change	Demographic Prospects	Labor Cost Competitiveness	Overall Ranking
Ireland	1	4	1	5	1
Greece	9	1	10	1	2
Portugal	5	2	8	6	3
Spain	10	3	3	3	4
Austria	7	6	4	4	5
N'lands	2	8	6	10	6
Germany	6	9	11	2	7
France	8	10	2	7	8
Belgium	3	11	5	8	9
Finland	4	7	9	9	10
Italy	11	5	7	11	11

See footnote to main text.
Source: AllianceBernstein

Display 2
Structural Rigidity in the Euro Area

Composite Structural Flexibility Index, 2014



See footnote to main text. Standard deviations from a mean. Higher numbers indicate greater flexibility.
Source: World Economic Forum, OECD and AllianceBernstein

*For the January update, see "Structural Reform and Medium-Term Growth in the Euro Area", *European Perspectives*, January 17, 2014.

these factors tend to raise structural unemployment and reduce productivity, much attention still needs to be given to coordinating national reform efforts. This is true for countries that haven't implemented much structural reform recently (like Italy and France) and it's also true for those that have but still need to maintain momentum (like the periphery ex-Italy).

Germany now sits mid-table in our regional ranking (at #7), supported by its competitive labor force but weakened by a lack of recent structural change and its poor demographic prospects. Without fresh reforms, Germany's longer-run growth potential is likely to suffer.

Reforms in the Periphery

As a result of the reforms adopted in recent years (under the bailout conditionality), the four current or former 'troika' program countries—Ireland, Greece, Portugal and Spain—come out top of our regional rankings **(Display 1)**. Their high ranking is driven mainly by the second factor: structural change **(Display 3)**. This is particularly true for reforms to labor markets, which have been a focal point in Spain, Portugal and Greece. This stands in marked contrast with Italy (which ranks bottom), France, Finland and Belgium where growth-enhancing reforms have been minimal. Nevertheless, despite their recent progress, all the peripheral economies (except Ireland) remain among the least flexible in the developed world.

The rankings of Greece, Spain, Ireland, and Portugal also benefit from dramatic cuts in unit labor costs over the last few years. The scale of these cuts differs: in Portugal, labor costs relative to the rest of the region have been reduced by 5.5%, while in Greece, they have fallen by 19.4% since 2010.

Losing Momentum

Although the peripheral countries (ex-Italy) have improved their structural positions, reform momentum has slowed materially in recent quarters. With market conditions now much more benign—anchored by the ECB—and with all countries apart from Greece and Cyprus having exited their financial assistance programs, governments have become much less willing to adopt further tough reforms. This is important because, as stated earlier, the structural flexibility of these countries is still comparatively weak. Furthermore, those countries now under greatest pressure to make labor and product market reforms—notably, France and Italy—face political and social pressures that rule out speedy change. Despite the ECB's appeals, the flagging momentum for reform represents a material risk to the longer-term outlook.

Third-Quarter Results

Our framework provides a useful context for considering last week's third-quarter regional growth releases. While growth for the euro area as a whole came in at just 0.8% year-over-year (yoy), individual country performance varied significantly. The real growth rates over the last year **(Display 4)** line up relatively well with our regional structural rankings. Ireland is currently the fastest growing euro-area country by some distance (growing by 7.7% yoy as of Q2—though this rate is distorted by the strong cyclical rebound), with Greece (which recently exited recession), Spain and Portugal all in or around the top half of the region in terms of present growth rates. At the opposite end of the spectrum, there's Italy (which remains in recession), France and Finland. However, it's worth noting that while market liberalizing reforms have probably boosted real economic activity in the periphery ex-Italy, they have also contributed to the very low and/or negative rates of inflation in these countries.

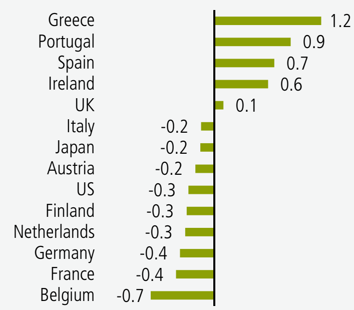
A similar uneven dichotomy in Europe's recovery has been seen in labor markets—with the very modest dip in the regional unemployment rate (to 11.5% as of this September, down from a peak of 12.0% last year) driven by falling unemployment in the periphery ex-Italy and in Germany. In France and Italy, meanwhile, unemployment is still trending in the opposite direction.

Ultimately, it's difficult to know exactly how much of the improvement in real growth and employment rates in the periphery is due to structural changes and how much is due to the cyclical rebound supported by more accommodative financial conditions and easier fiscal policy. However, the data provide tentative evidence that structural reforms can help increase potential output and point to a way ahead as Europe looks to tackle its difficult longer-term challenges.

Display 3

Reforms in the Periphery

Composite Structural Change Index, 2014

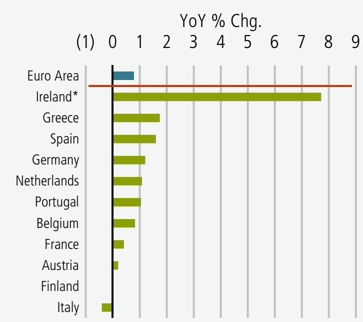


See footnote to main text. Standard deviations from a mean.
Higher numbers indicate bigger improvement.
Source: OECD, World Economic Forum and AllianceBernstein

Display 4

Unevenness in Euro Area Recovery

Euro Area Third Quarter Growth by Country



*Ireland data is as of the second quarter.
Source: Haver Analytics

The summary rankings in Display 1 are based an equally-weighted index of four factors: 1) structural flexibility (i.e. composite labor and product market flexibility), 2) structural change, 3) demographic prospects and 4) labor cost competitiveness. The structural flexibility index (the first factor, shown in Display 2) is estimated on two sub-indices: a labor market index and a product market index, equally-weighted (calculated on data from the WEF and OECD). The structural change index (the second factor) is estimated with: 67% weight for the change (from 2010 to 2014) in the structural flexibility index and 33% weight for the responsiveness of countries to the OECD's annual Going for Growth reform recommendations between 2010/11 and 2012/13. 'Demographic prospects' ranks countries according to United Nations' projections for the change in the working-age population over the next 10 years. 'Labor cost competitiveness' ranks countries according to the change in their real effective exchange rates (against euro area trading partners), deflated by unit labor costs.