



13 November 2006 13:39

- [Home](#)
  - > [News](#)
    - > [Business](#)
      - > [Business Comment](#)

# Hamish McRae: Call the Polish plumber and then dial the job centre to ensure Europe's prosperity

## We need women to stay in work, but we also need bigger families

**Published: 12 February 2006**

The rise of the economic power of Asia has become an embedded idea in our psyche, but what about the corollary - the decline in the power of Europe?

Mathematically, it has to be true that if the relative importance of China and India rises and that of North America remains much the same, the relative importance of Europe will fall. But in absolute terms it is perfectly possible that European growth will continue and that living standards will climb. That is certainly a reasonable prospect, though to achieve it will require some adjustments in our working habits.

To get some feeling for the economic prospects of both the "old" European Union and its new member states, Goldman Sachs has done some projections running through to 2050. It was Goldman, you may recall, that focussed people's attention on the growth of China and India (and also Brazil and Russia) in its "Brics" study just over two years ago. Now it has applied similar techniques to Europe.

Its message is mixed. Demography is going to put a lot of pressure on Europe, more in the East than in the West. If incomes are to grow at the same rate as in the past, a much higher proportion of people of working age will need to have jobs. But that is happening already and prospects for productivity growth, the Goldman team thinks, are bright. It expects Western Europe to do as well as the US in terms of increases in living standards, and the new EU members to converge towards the old ones.

The ageing of Europe's population and the implications that has for the size of the workforce does, however, create serious problems. The graph on the left shows how the population of the US will pass that of Western Europe (or more accurately, the 15 "old" EU nations) around 2032 and the whole EU (including the 10 new members) by 2050. By then, the population of Eastern Europe is projected to be falling even faster than that of Western Europe.

You have to be careful about all population projections that far out, for both migration and fertility patterns are pretty unknowable. I think that European birth rates will tend to rise over the next 30 years, partly as a result of changing social choices and partly as a result of more child-friendly tax policies. But so far there is only sporadic evidence of that happening.

In any case, it takes 20 years before a person born now will enter the workforce. So, aside from immigration, the main way in which Europe can maintain the size of its workforce for the next couple of decades will be by increasing the participation rate. That happens either by people retiring later or by people of working age, who are not at present working, doing so.

That people will have to retire later is accepted intellectually but in practice is hard to achieve. The main way of increasing labour participation rates is for more women to stay in paid employment, but that may clash with the idea of people having larger families. So it won't be easy.

As for migration, the UK "Polish plumber" experience has demonstrated the benefits of the arrival of new skilled workers, but this is migration within the EU so it does not help the position of Europe as a whole. The continent's ability to accommodate non-European workers is, of course, a social and religious matter, too, rather than a purely economic one.

If Europe is to offset the drag of a declining workforce, it has to boost its productivity. But, as the next graph shows, Western

Europe is no longer narrowing the gap with the US. Goldman thinks this situation will improve. But while it is quite true that a lot of the problem is the number of hours worked, rather than the productivity per hour, it is hard to see any evidence yet of any narrowing.

There were some helpful thoughts last week from the OECD in its "Going for Growth" report. It suggested specific improvements like increased support for commercial R&D, noting that innovation in some developed countries was much higher than in others. But there is no magic wand, and we simply don't know enough about why the US has continued to outstrip the rest of the developed world to be confident that Europe will not fall further behind.

There is one specific area where most of Europe does appear less well-placed than the US and that is the overhang of pension provision, particularly the portion of pensions paid by the state. The scatter diagram on the right shows the relationship between the public pension levels and change in the dependency ratio to 2050.

Countries such as Denmark and the UK (and the US) have relatively low pensions and also prospectively not-too-serious a deterioration in the dependency ratio. Sweden and the Netherlands have higher pensions but also not too serious a deterioration. But at the other end of the scale Italy and Spain appear to be in serious trouble. The workforces simply will not be large enough to sustain the pension burden.

There is a further point here - one well made by ABN-Amro, which dug out this data - and this is that you also have to take savings rates into account. So the UK and US, despite their relatively favourable demographic prospects, still ought to save more, while countries such as Sweden and the Netherlands are saving too much.

The general message that I get from this data, and indeed from the productivity performance, is that European economic performance will diverge rather than come together. Convergence has been one of the main features of the EU to date: the poorer countries have tended to catch up with the richer ones.

In the case of Eastern Europe, that may well continue, for the gap is very large and the lower cost base in the new member states has attracted huge investment from the more developed "old" members. Goldman assumes that, and it is probably right to do so. But unless Italy and Spain act soon, their taxation levels will have to rise and they will become increasingly uncompetitive as a result.

The title of the Goldman paper is "Europe in 2050: small but still beautiful". That maybe needs some spelling out and also some qualification. Europe as a whole will occupy a smaller place in the world economy. But viewed as a whole, it will still be relatively rich and successful - rich enough to give the majority of its people a life of security and opportunity.

The qualifications are twofold. One is that some parts of Europe will perform very much better than others and, if this divergence happens in earnest, that will put huge strains on European unity.

The other is that countries with more adverse demographic prospects and with overly low levels of savings had better get a move on and start fixing things while there is time.

### **Resources are a curse if you're wealthy but not wise**

Now that Britain has again become a net oil importer, it seems a good time to ask whether having natural resources is a blessing or a curse - which is just what three Norwegian economists have done in an article in the latest *Economic Journal*.

Halvor Mehlum, Karl Moene and Ragnar Torvik looked at the experiences of 87 resource-rich countries to find why some countries benefited and others failed to do so.

Australia, Botswana, Canada and their own Norway have all been blessed with abundant resources. Norway was one of the poorest countries in Europe in 1900 and is one of the richest now. That transformation was initially thanks to timber, fish and hydro-power, and recently to oil and gas.

By contrast, Angola, Nigeria, Saudi Arabia, Sierra Leone, Venezuela and Zambia have all been cursed. The authors argue that mineral wealth has fuelled economic and social decline. I'm not sure the Saudis would be too thrilled by that conclusion, but the general proposition that oil wealth has not been a stabilising factor in the Middle East must be right. It is notable that some oil-poor parts of the region, such as Bahrain and Dubai, have been the most successful at developing alternative forms of economic activity.

The answer, the authors conclude, lies in whether countries have strong or weak institutions. In the cursed countries, poor institutions are to blame.

It is rather early to draw up a balance sheet for Britain and North Sea oil. In any case, the UK is not nearly as dependent on natural resources as, most obviously, Norway, which has substantially larger North Sea reserves and only one-tenth of the UK population. In the case of Britain, I suppose oil revenues did to some extent help buffer the cost of switching from a manufacturing economy to a service one - though by pushing up the level of sterling, it arguably hastened de-industrialisation.

As a final point, the authors note that much the same analysis could be applied to foreign aid. Why does it work in some places and not in others? Answer: "Aid helps economic development when institutions are good but not when they are bad."

Could, then, the surge of aid to Africa actually prove a curse? It would not be politically palatable to suggest it, but that is what seems to flow from this research.