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COMMENT

Europe is a continent that has run out of ideas

OPINION
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Much of continental Europe is in poor shape. True, the aggregate wealth of people is little changed and the social capital in museums, parks and other amenities is still intact. Yet, in the western part, the economy is failing society.

Inclusion of ethnic minorities and youth in the economy — the backbone of their self-esteem and social integration — is more lacking than ever. Among those who do participate, fewer are prospering. It is a measure of the decline that, in almost every country, the growth of wage rates has steadily slowed since 1995. What has gone wrong?

European economists speak of a loss of competitiveness in southern Europe. They suggest that output and employment are down, relative to the past trend, because wages leapt ahead of productivity, making labour too expensive and forcing employers to cut back. Taking this perspective, some German economists argue that wages need to fall in the affected economies. Others argue instead for monetary stimulus — for instance, asset purchases by central banks — to raise prices and make current wage rates affordable.

This helps explain why the proportion of men who are in employment declined in Italy, Greece and Spain over the previous decade. But the explanation raises a question. Europe has witnessed bigger drops in the employment-to-population ratio, which fell precipitously in Germany and Italy in the 1970s and in France in the 1980s and 1990s. Were those declines also caused by wage misalignments? And if so, why have we not seen wages draw back?

> Joylessness in business and the continuing stagnation of wages is due to a slowdown of productivity

Economists of a classical bent lay a large part of the decline of employment, and thus lagging output, to a contraction of labour supply. And they lay that contraction largely to outbreaks of fiscal profligacy — as happened in Europe from the mid-1990s to the mid-2000s.

In Greece, Italy and, to a lesser extent, France, unsustainable tax cuts and spending sprees added to households' estimates of their private wealth relative to their wage income. State benefits were expanded too, which added to people's estimates of their social entitlements relative to their income. The EU's structural funds, which transferred money to poorer countries, fuelled the fire. Bloated with wealth, many employees had weaker incentives to perform well so companies' costs of production went up.

Disciples of Keynes, who focus on aggregate demand, view any increase in household wealth as raising employment because they say it adds to consumer demand. They say Europe needs a lot more fiscal "profligacy" if it is to bring unemployment down. Some evidence favours the classics.

Yet both sides of this debate miss the critical force at work. The main cause of Europe's deep fall — the losses of inclusion, job satisfaction and wage growth — is the devastating slowdown of productivity that began in the late 1990s and struck large swathes of the continent. It holds down the growth of wages rates and it depresses employment.

That slowdown resulted from narrowing innovation. Even in the postwar years, innovation in Europe was feeble by past standards. In the 1960s, it slackened again, leaving the continent largely dependent on America for new ideas that would generate further productivity growth. But in the 1970s American innovation, confined to Silicon Valley, waned in the aggregate. The pool of past American advances on which Europe could draw would narrow to a trickle and lead to the productivity slowdown on the continent in the late 1990s and which came later to Germany.

In the aftermath of the financial crisis, much of Europe is still suffering a slump on top of its post-1990s fall. The slump will pass but the fall will not be easily overcome. The continent is haemorrhaging its best talent. It needs to fight for an economic life worth living.

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