

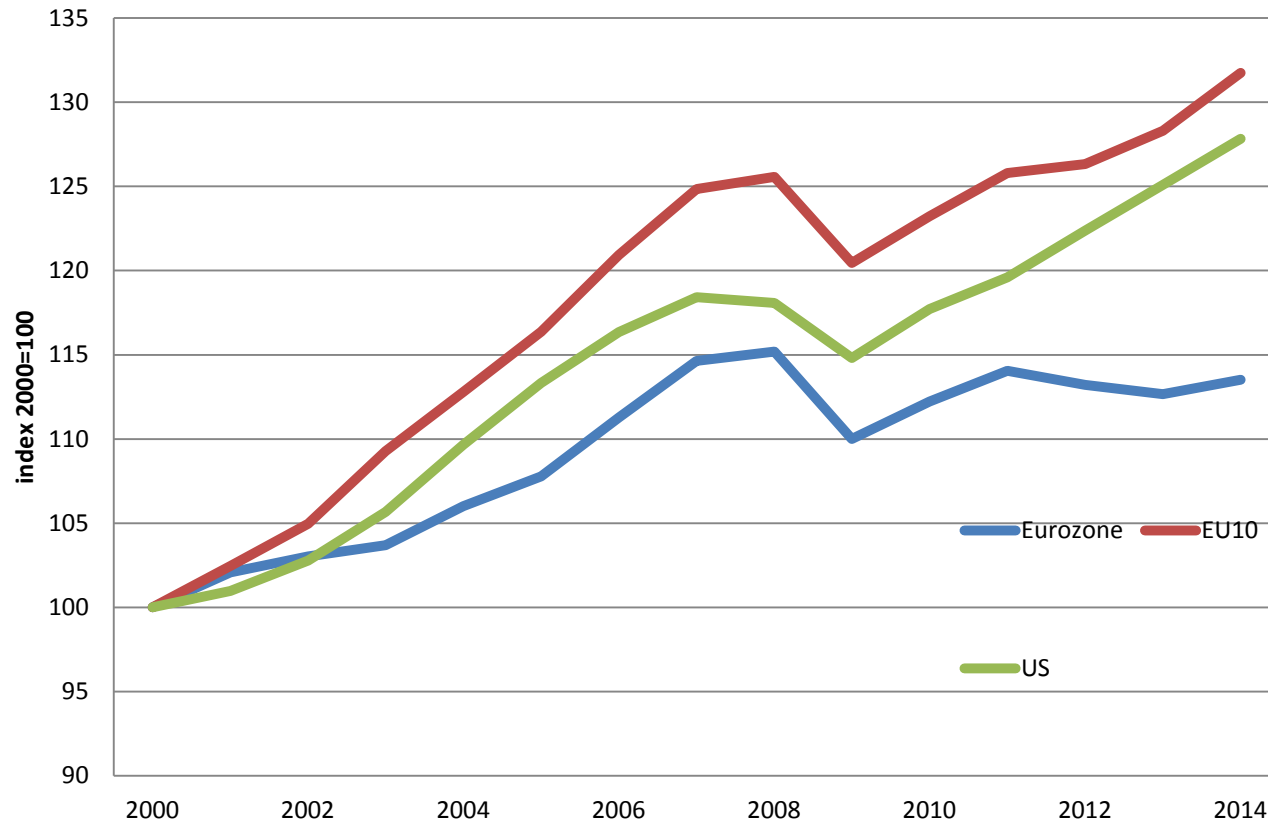
CRISIS MANAGEMENT AND ECONOMIC GROWTH IN THE EUROZONE

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Stagnation in Eurozone

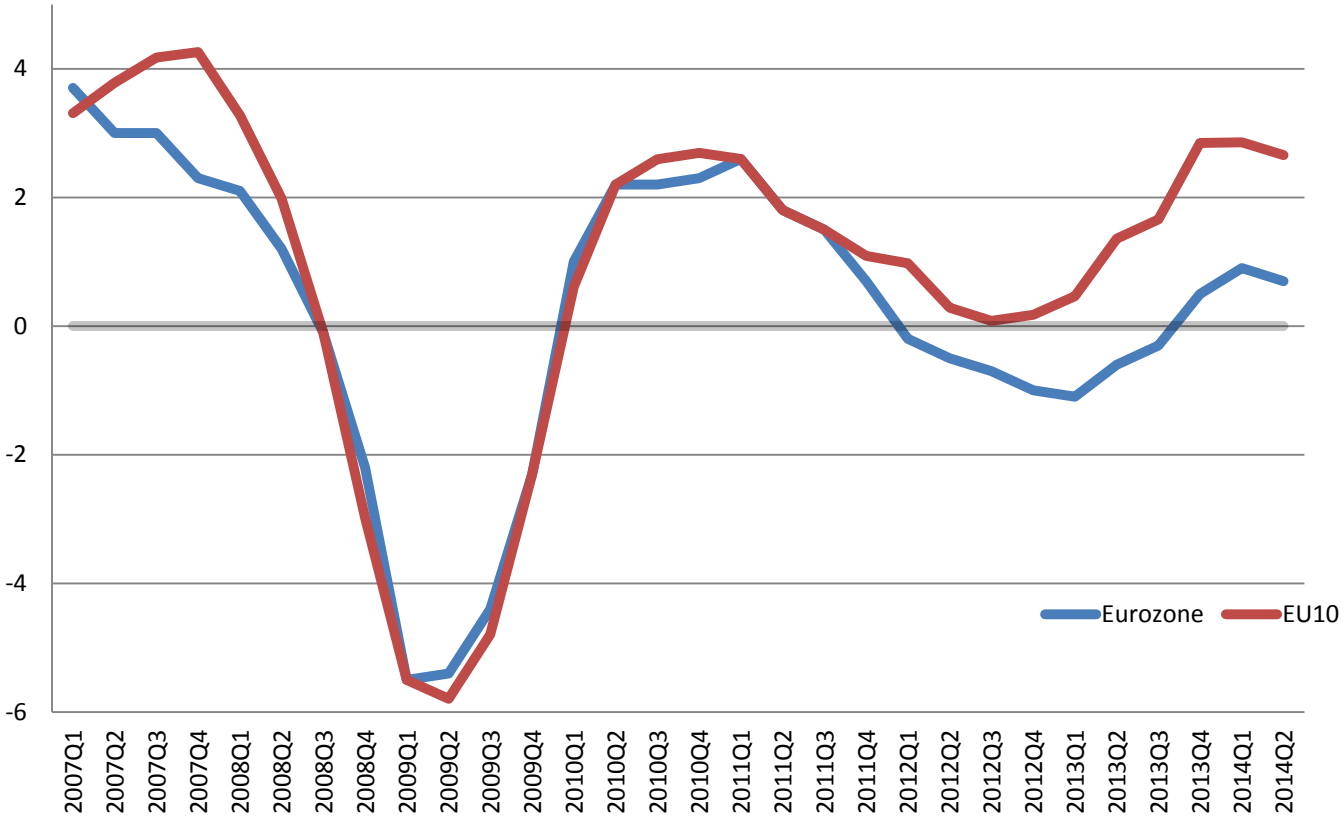
Figure 1: Real GDP in Eurozone, EU10 and US
(prices of 2010)



Policy response

- This is a supply side problem
- Too many rigidities in labour and product markets
- As a result production remains below potential
- Structural reform will increase productive potential
- And Say's Law will ensure that demand will follow
- Next graph casts doubt about this narrative

Figure 2: Growth GDP in Eurozone (EU18) and EU10 (percent)



Outline of presentation

- Does market flexibility lead to more growth?
- Failure of demand management in Eurozone
- What should be done

Does flexibility lead to more growth?

- We perform econometric analysis
- Using standard growth theory
- Fundamental determinants of growth
 - population growth,
 - physical and human capital accumulation
 - technological progress (the residual in Solow's growth model).
- Recent theoretical contributions highlight importance of institutions as deep variables that influence the process of capital accumulation and technological progress (productivity growth).

- Many institutions matter
- Here we limit ourselves to just a few institutions
- We focus on labour and product market rigidities as potentially important institutional features.
- and government effectiveness (World Bank)
- Analysis also limited to OECD countries as we want to use OECD measures of labour and product market rigidities

The econometric model is specified as follows:

$$y_{i,t} = a_i + \beta I_{i,t} + \mu H_{i,t} + \theta EPL_{i,t} + \lambda Age_{i,t} + \rho PM_{i,t} + \sigma GE_{i,t} \\ + \gamma R_{i,t} + \delta G_{i,t} + \varepsilon_{i,t}$$

- Practical problem: sample of OECD countries changed over time
 - OECD was enlarged with Central and Eastern European countries in 1993
- Therefore we present two sets of estimation
 - One with advanced OECD countries that were members before 1993. This produces long sample
 - One with all OECD countries. This produces shorter sample (but more countries)

- We use OLS and instrumental variable method
- Latter is necessary to take into account potential reverse causality between growth and employment protection:
 - Countries that experience high growth tend to provide favorable employment contracts to workers.
 - We use ideological composition of governments (right-left scale) as instrument

	(1) Advanced economies 1985-2013	(2) Advanced economies 1985-2013	(3) OECD economies 1998-2013	(4) OECD economies 1998-2013
Investment/ GDP	0.131 (0.081)	0.083 (0.076)	0.337*** (0.119)	0.346*** (0.120)
Proportion of tertiary education	1.739*** (0.139)	1.802*** (0.174)	1.400*** (0.157)	1.472*** (0.174)
Real effective exchange rate	-0.040*** (0.014)	-0.034** (0.012)	-0.044*** (0.015)	-0.046*** (0.014)
Government consumption/ GDP	-0.870*** (0.134)	-0.633*** (0.130)	-0.759*** (0.155)	-0.500*** (0.156)
Effective retirement age	-0.135 (0.152)	0.107 (0.155)	-0.122 (0.197)	0.103 (0.179)
Government effectiveness	2.002** (0.911)	1.414 (0.984)	2.513** (0.962)	1.952** (0.878)
Crisis period		-1.526*** (0.272)		-2.142*** (0.391)
Employment protection legislation	3.140*** (0.779)	2.383*** (0.748)	-0.470 (2.932)	-0.853 (2.884)
Product market protection index			0.484 (0.546)	-0.989 (0.605)
Observations	409	409	457	457
R-squared	0.396	0.430	0.297	0.344
Number of countries	24	24	32	32

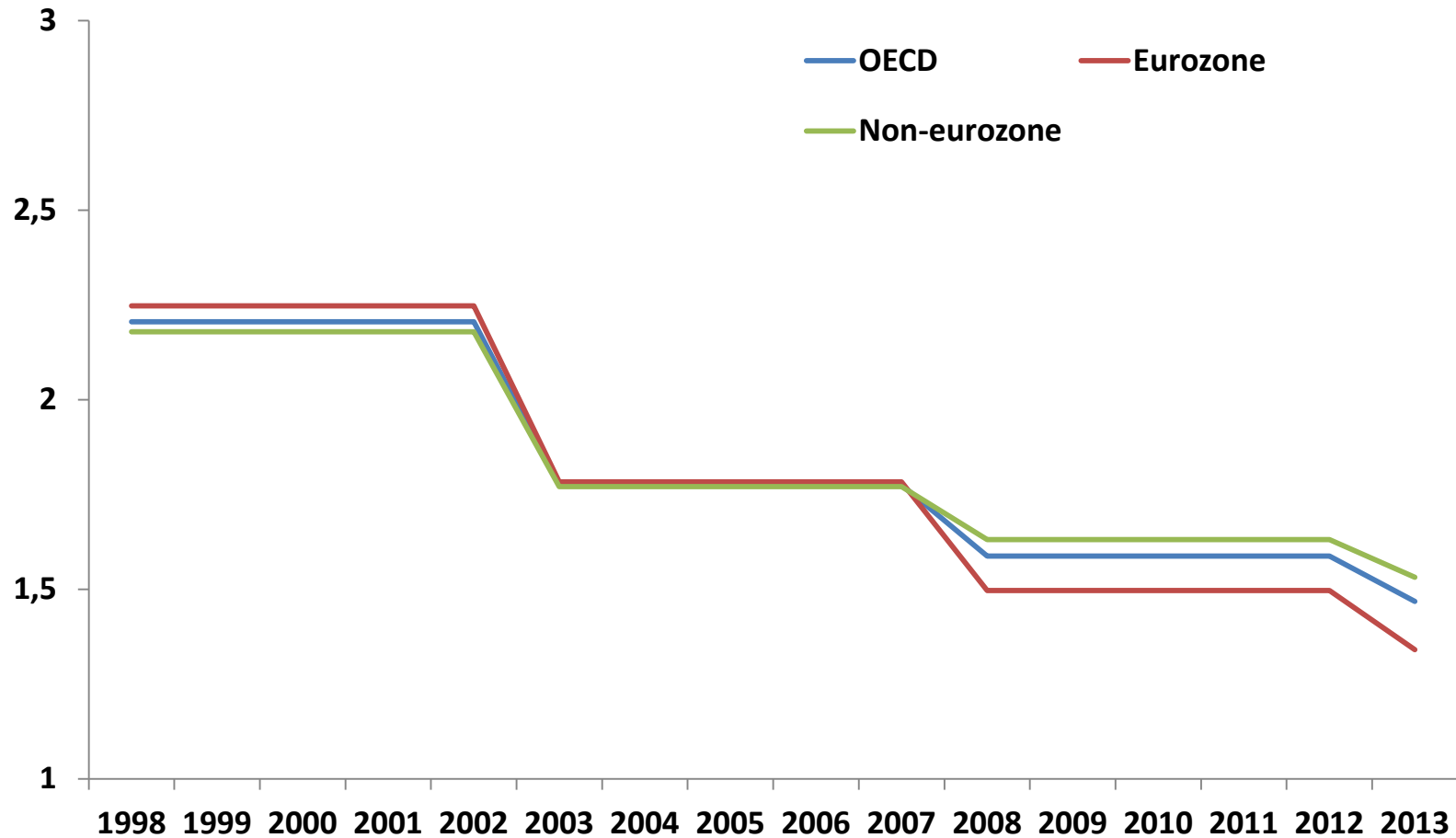
	OECD economies 1998-2013	Advanced economies 1998-2013
Investment/ GDP	0.339** (0.140)	0.257** (0.118)
Proportion of tertiary education	1.464*** (0.138)	1.429*** (0.127)
Real effective exchange rate	-0.050*** (0.015)	-0.052*** (0.015)
Government consumption/ GDP	-0.535*** (0.165)	-0.666*** (0.154)
Effective retirement age	0.085 (0.189)	0.189 (0.173)
Government effectiveness	0.766 (0.932)	0.528 (0.946)
Crisis period	-2.142*** (0.406)	-1.740*** (0.378)
Employment protection legislation (EPL)	-0.784 (2.509)	1.608 (1.138)
Product market protection index	-0.775 (0.590)	-0.647 (0.455)
Instrumental Variables for LMP:		
aged labor market protection	Yes	Yes
Government composition (left)	Yes	Yes
F Test of excluded instruments	41.31	41.91
Underidentification test	0.0061	0.0075
Hansen's J statistic	0.8589	0.7408
Observations	399	341
R-squared	0.404	0.473
Number of countries	28	23

Interpretation

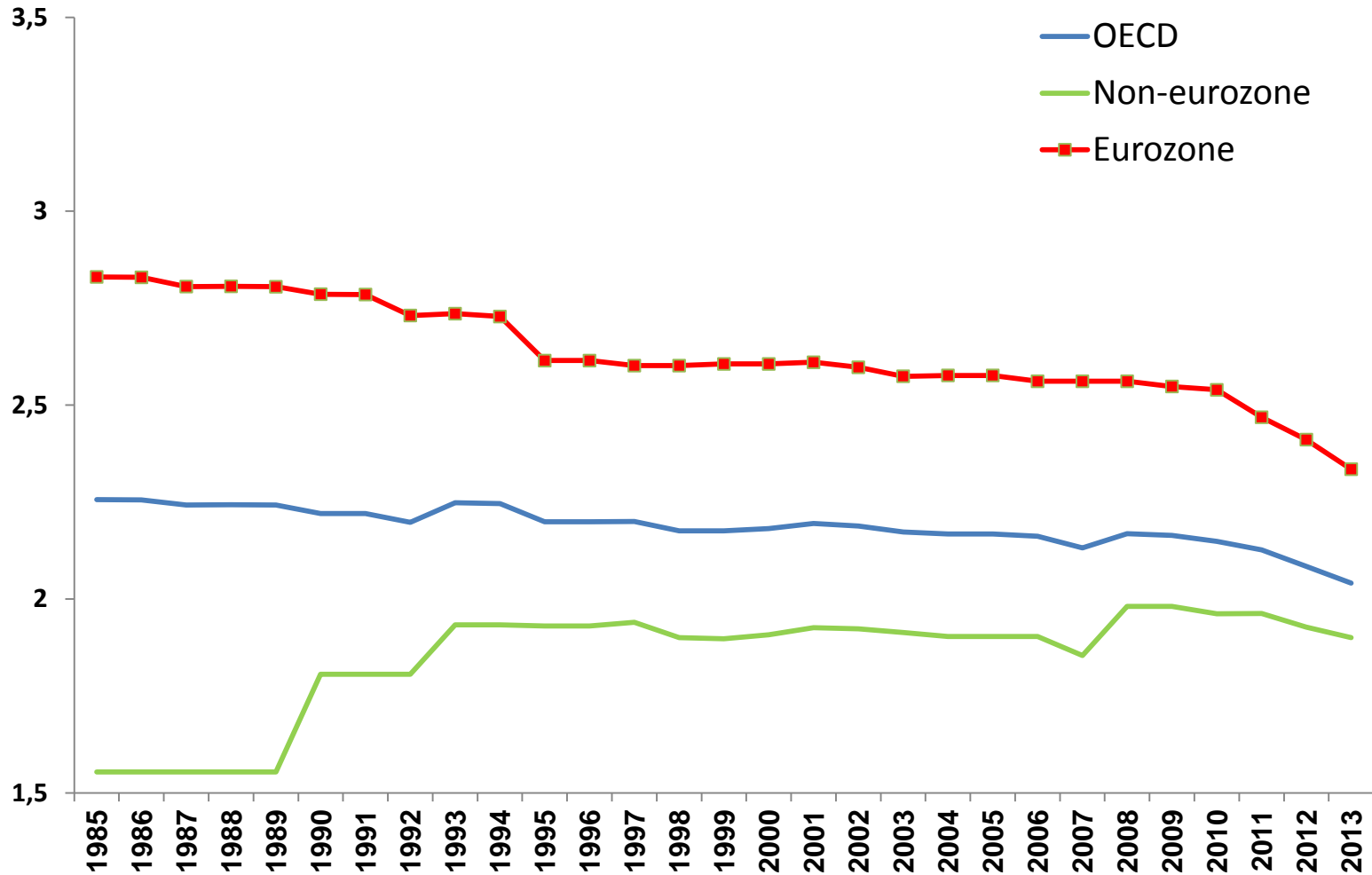
- Fundamental variables matter
 - the investment ratio has the expected positive sign and is significant in most cases.
 - index of human capital (the proportion of the population with tertiary education) has a strong and significantly positive effect on economic growth.
- Thus the traditional fundamental variables of economic growth, physical and human capital accumulation, are important in driving economic growth.

- Most striking aspect of results:
 - the structural measures of the labour and product market rigidities do not seem to have any influence on the growth rate of GDP per capita.
 - OECD employment protection legislation index even appears to have a positive effect on growth in the full sample of the advanced economies (OLS).
 - This positive effect disappears in IV estimation

Product Market Protection Index (1998-2013)



Employment protection legislation index (1985-2013)



Why does employment protection not matter for growth?

- Mainstream view: employment protection has a negative effect on hiring and in so doing reduces prospects for growth.
- There is another literature stressing that in economies where employment protection is weak the incentives for firms to invest in its labour force is weak.
- As a result, labour productivity is negatively affected. More generally, the quality of human capital will be low.

Why does product market regulation not matter for growth?

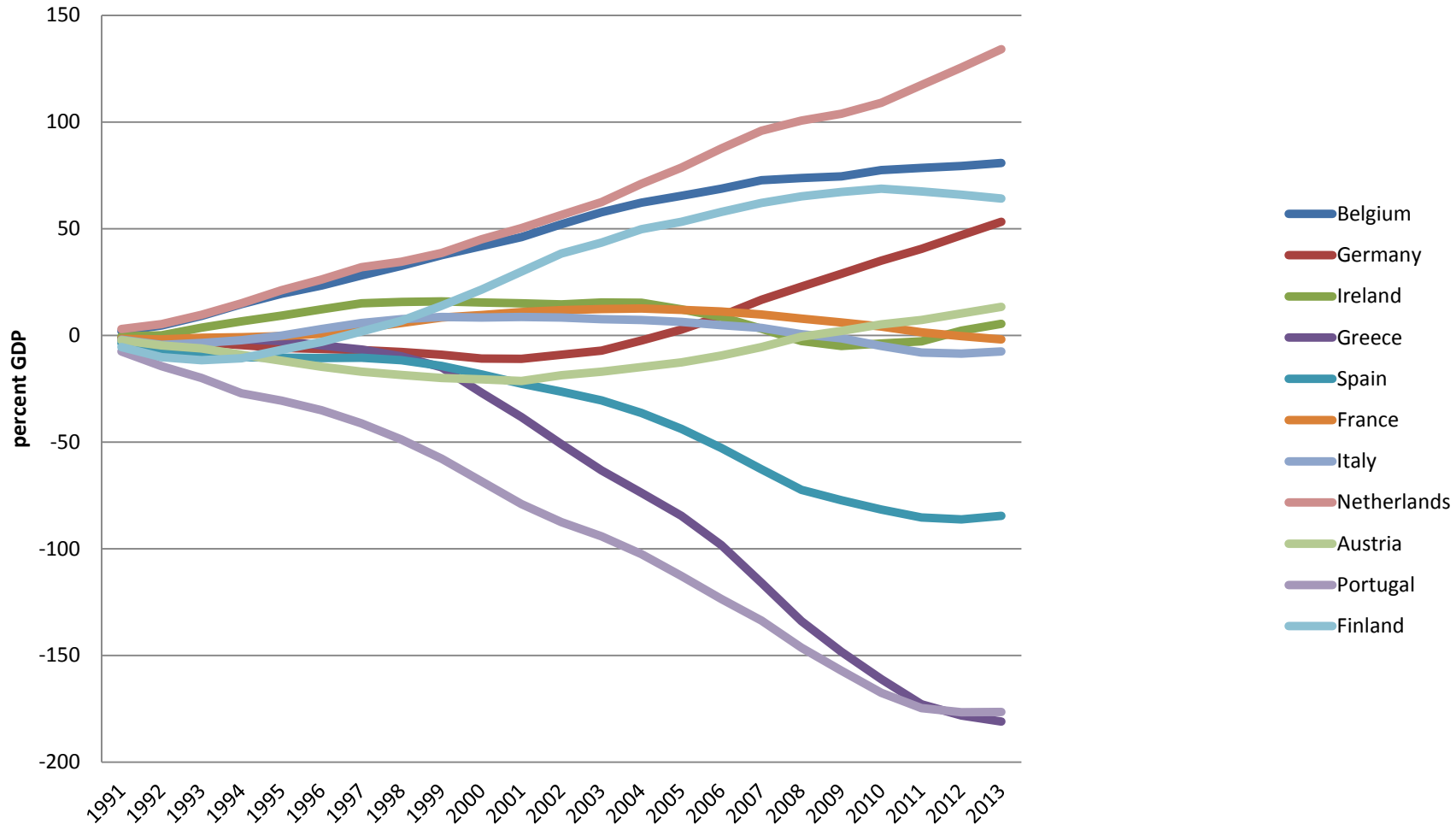
- Conventional wisdom: market flexibility promotes innovation and growth
- Older literature (Schumpeter) : innovation can also be boosted in systems with market imperfections and market power.

Growth and macroeconomic imbalances

- Accumulating imbalances prior to crisis
- Result of desynchronized booms and bust dynamics (not exogenous shocks in OCA-tradition)
- Split the Eurozone into debtor and creditor countries

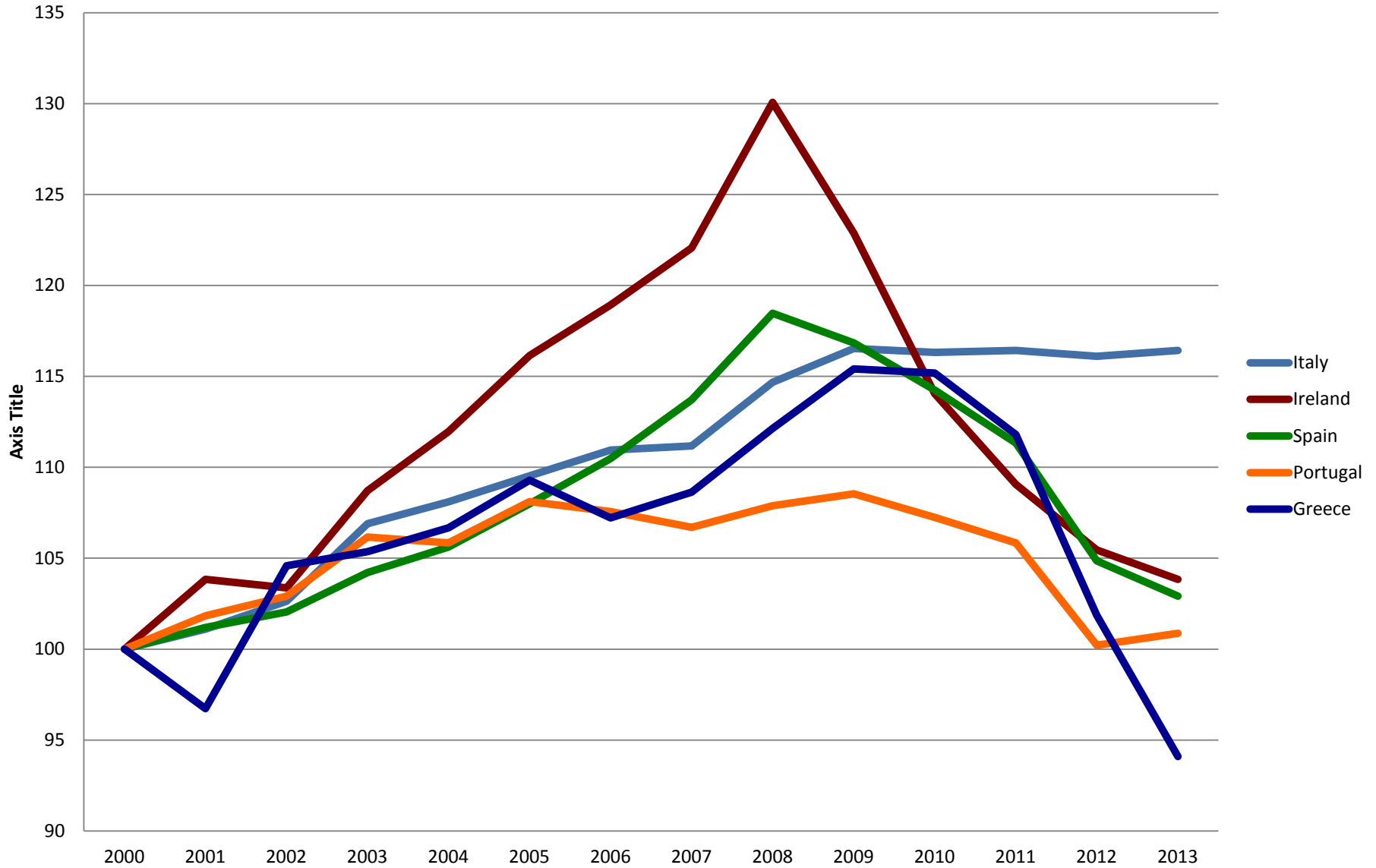
Eurozone split into creditor and debtor nations

Figure 5: Cumulated current accounts

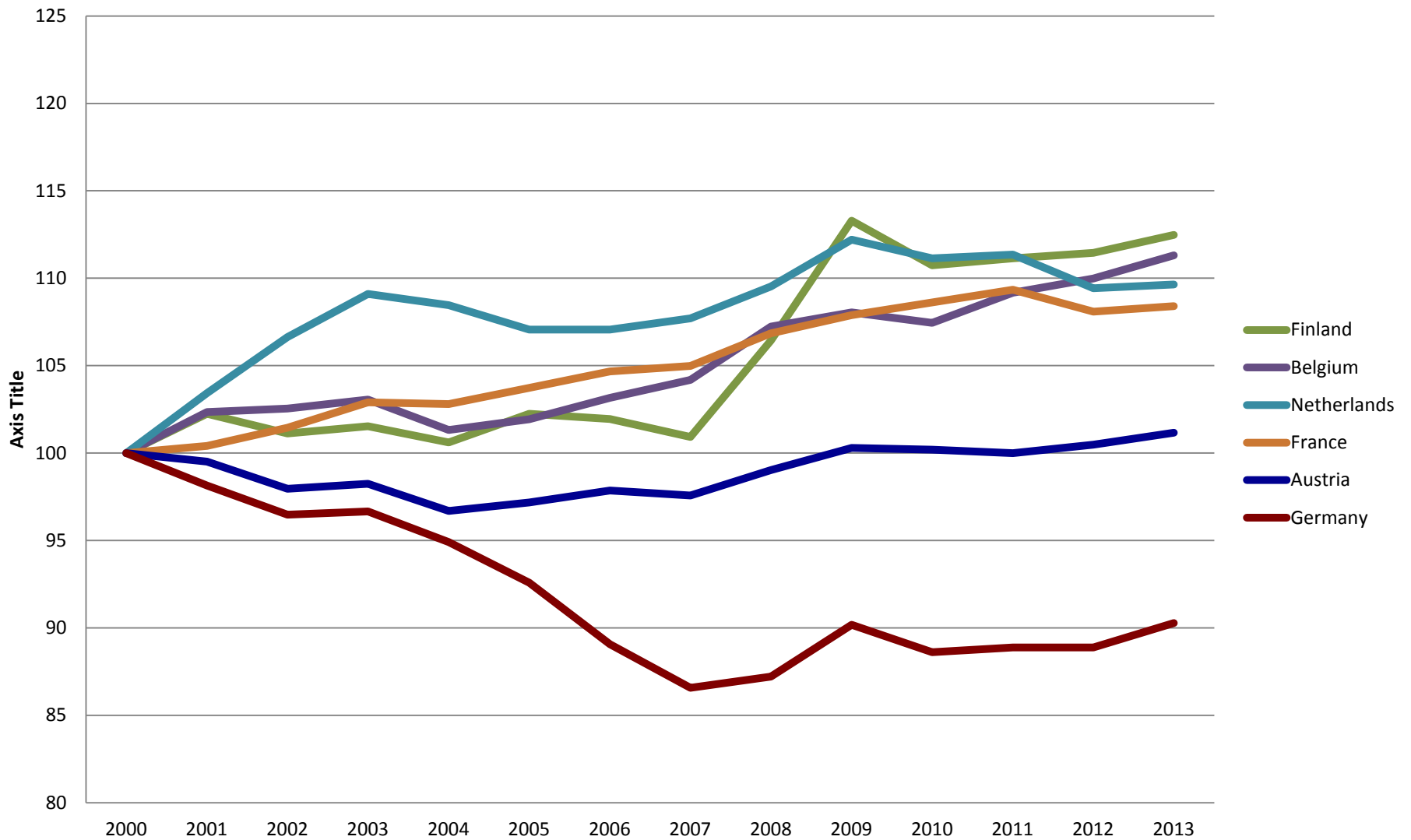


- Creditor nations have imposed their rule: Thou shall repay thy debt
- In order to achieve this, austerity rule is imposed
- This has created asymmetric adjustment mechanism where most of the adjustment has been borne by the debtor nations
- Without compensating stimulus by the creditor nations

Relative unit labour costs Eurozone: debtor nations



Relative unit labour costs Eurozone: creditor nations

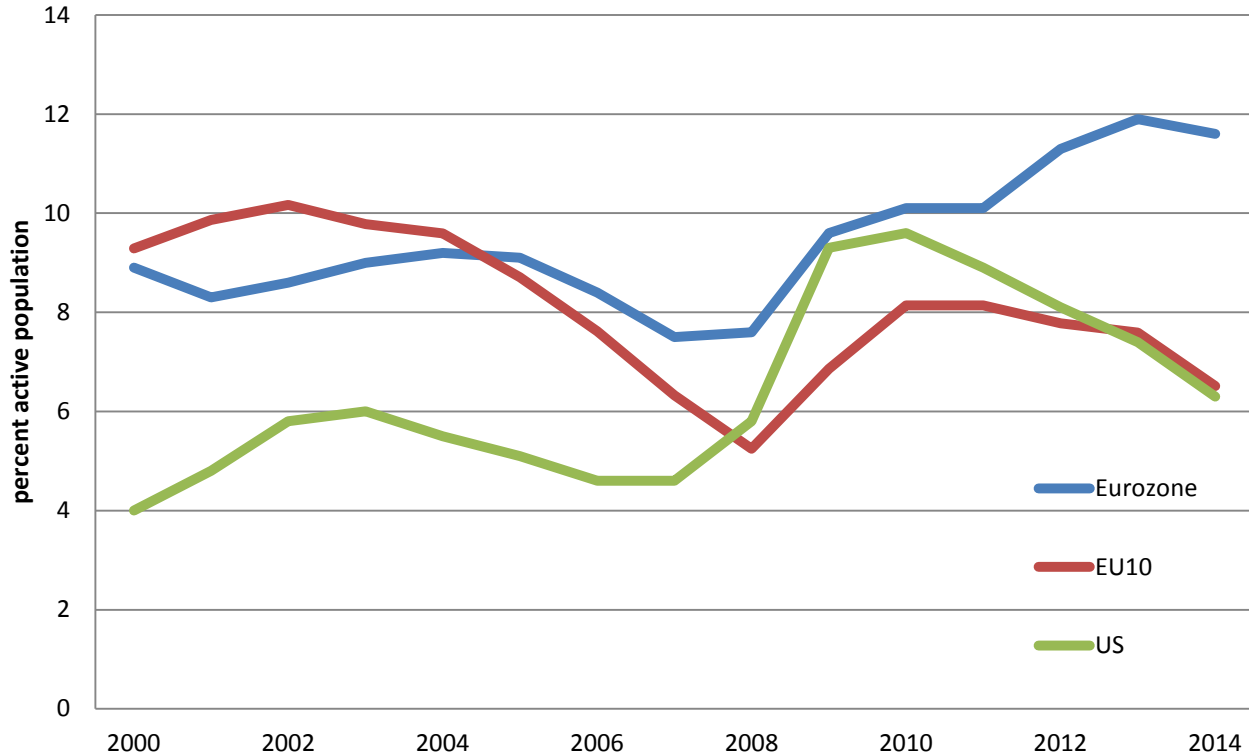


Keynes paradox of thrift resuscitated

- Asymmetric adjustment mechanism has created deflationary bias in the Eurozone
- Leading to significant poorer economic developments in Eurozone as compared to rest of developed economies (as shown in first chart in presentation)
- It also led to increasing unemployment and deflation
- And surplus in current account: as result of desperate attempts of all countries to save more while demand was declining

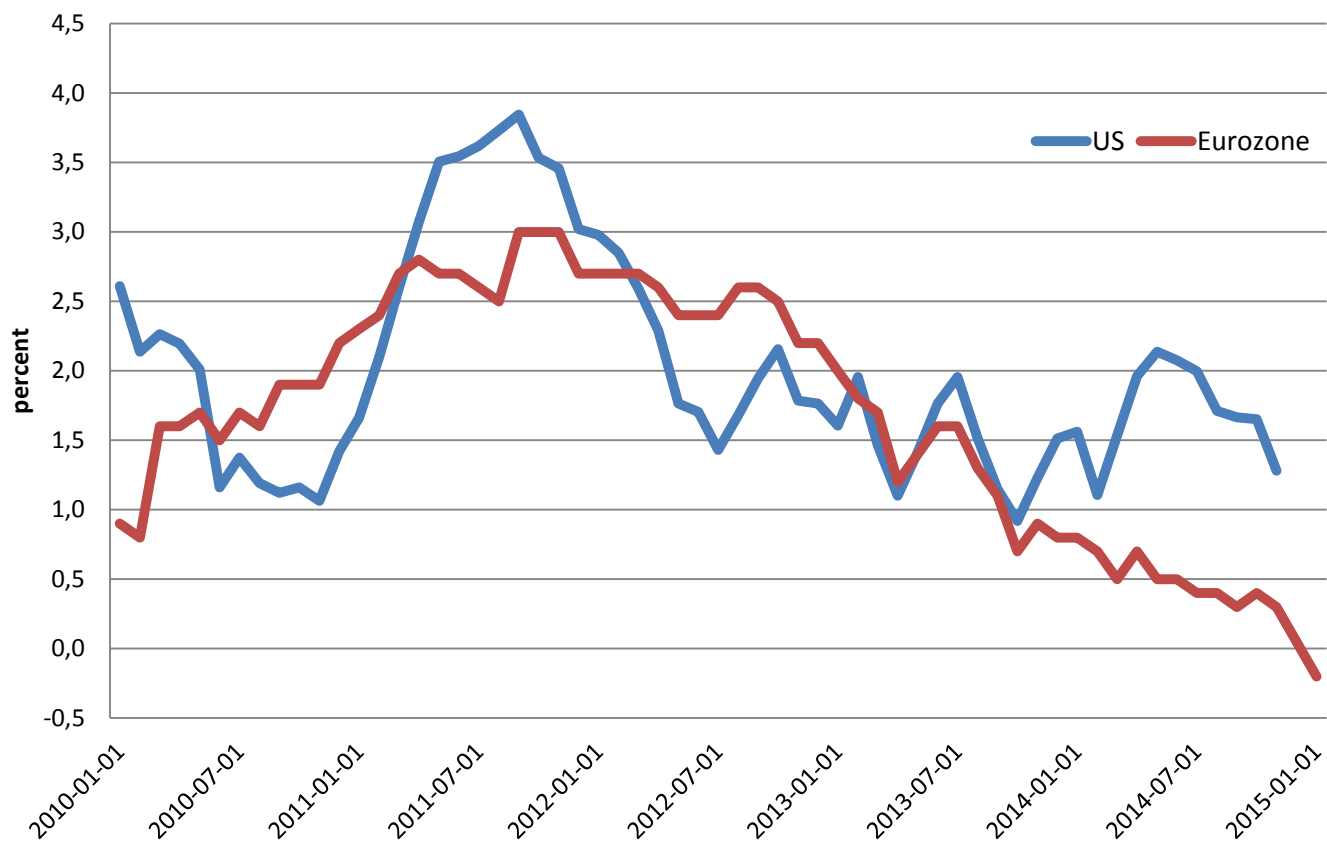
Increasing unemployment

Figure 5: Unemployment rate in Eurozone, EU10 and US



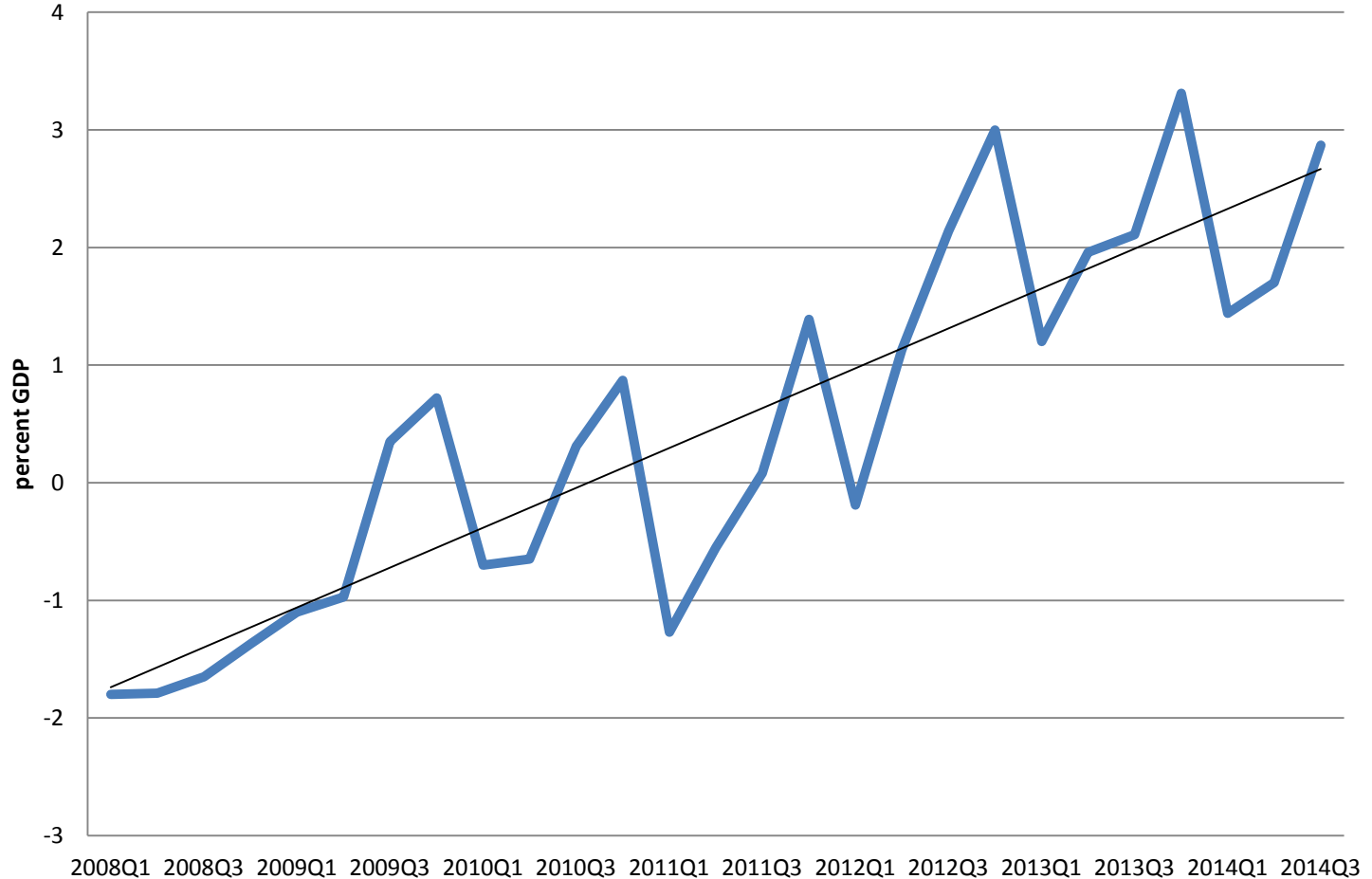
Deflation threat

Figure 7: Inflation in US and Eurozone



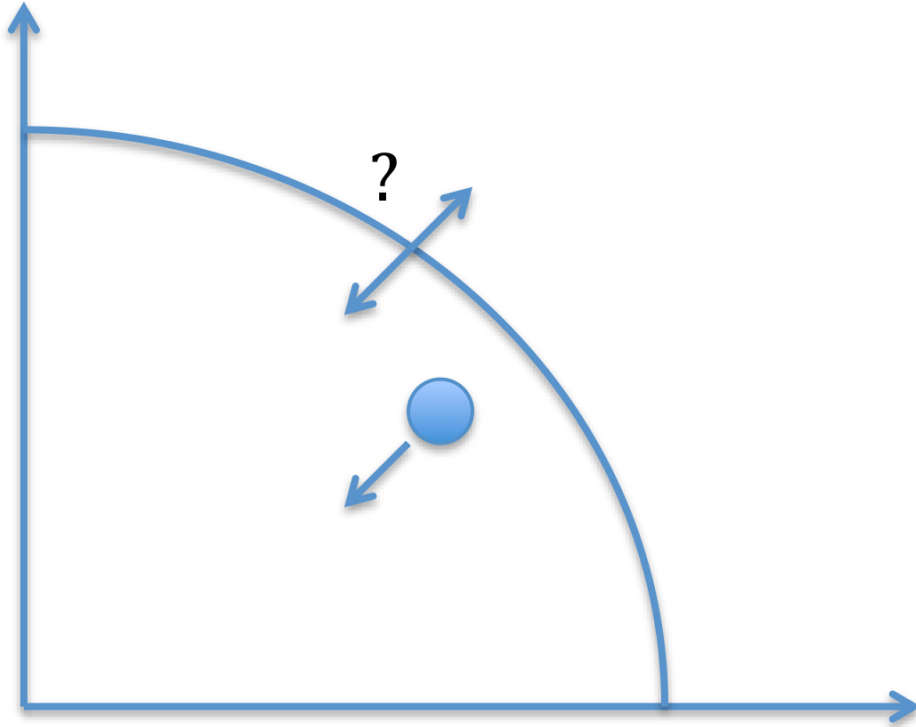
Increasing savings as a result of austerity

Figure 6: Current account Euro area



Nature of macroeconomic policies in

Figure 12: Production possibility frontier and macroeconomic policies in Eurozone



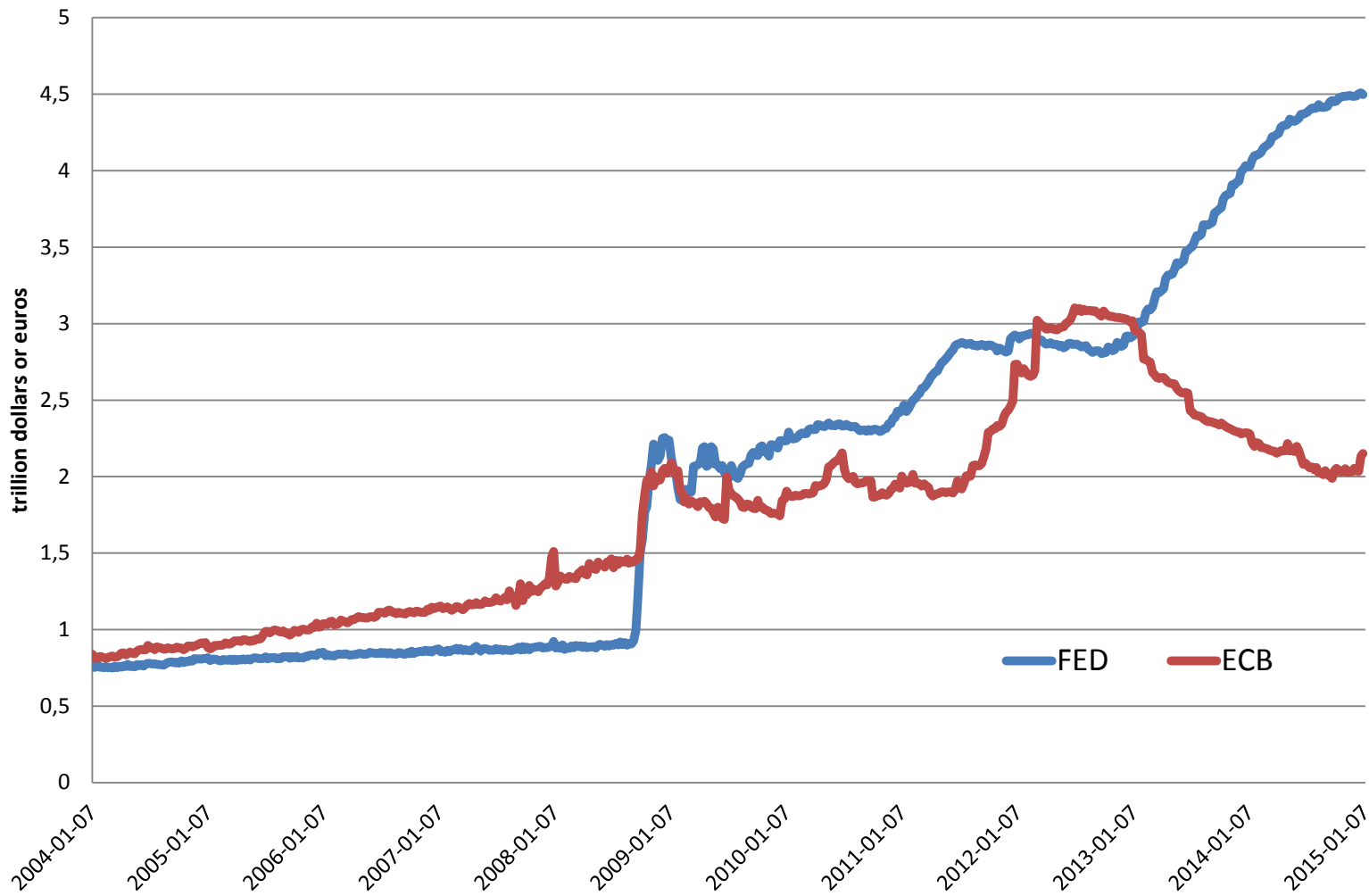
Note on OCA-theory

- Failure to identify the nature of the shocks
- Too much influenced by traditional OCA-theory
- That stresses exogenous shocks and the need to have flexible supply
- But the shocks were endogenous demand movements that should have been dealt with by demand management at the Eurozone level

Que faire?

- Policy mix should be:
 - Monetary and fiscal expansion
- ECB has started QE and is doing its part of the mix now, albeit with a long delay
- In addition the ECB's QE program is less spectacular than it looks

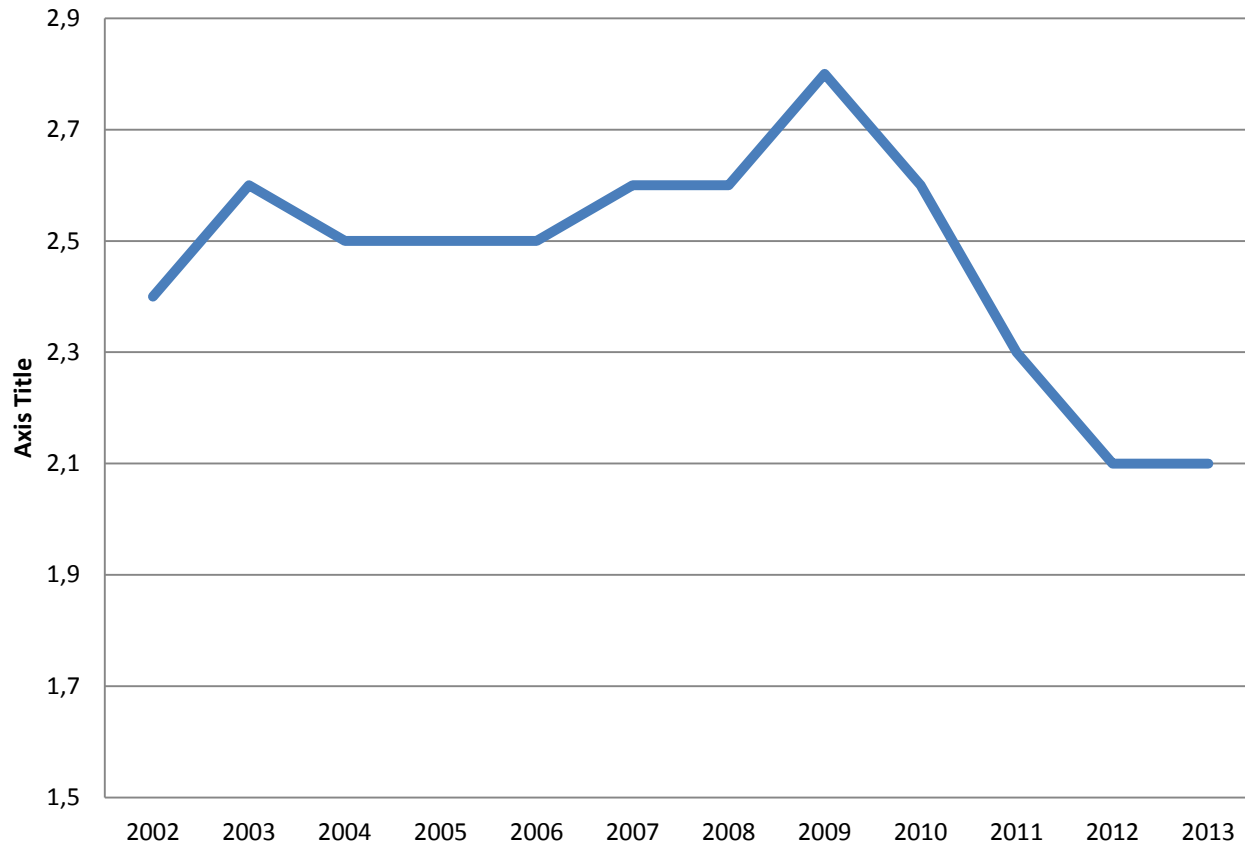
Figure 13: Balance Sheet FED and ECB (2004-14)



- Monetary policy alone cannot deliver
- Fiscal policy should focus on public investment
- Why?
- It is one of the major victims of ill-advised macroeconomic policies in Eurozone

Austerity programs led to strong decline in public investment

Figure 8: General government gross fixed capital formation (%GDP)



- Leading to less aggregate demand today
- And less supply in the future
- Thus, start public investments
- These can be initiated everywhere,
- but especially in countries that can borrow almost for free

Throw away dogmas

- We have to free ourselves of dogmas
- One such dogma: balanced budget, i.e. no bond financing of investments
 - All investments should be financed by current revenue
 - No well run company follows such a rule
- Result of this idea is that governments are reducing their responsibility to provide essential public goods (infrastructure, energy investments, environmental investments)
- This reduces long-term growth of the Eurozone

Conclusion

- Eurozone crisis management was characterized by two features.
- **Asymmetric adjustment** to the current account imbalances
 - this forced deficit countries into intense austerity
 - without a compensating policy of stimulus in the surplus countries.
 - This led to a deflationary bias that created strong collateral damage on investment, both private and public.

- Second feature of crisis management: focus **on supply policies**.
 - While overriding macroeconomic problem was insufficiency of demand, policymakers insisted on fixing supply in the hope that this would spur long-term economic growth.
- Evidence provided in this paper: supply side policies of the type stressed by policymakers have insignificant on long-term economic growth.

- As a result, together with the negative effects of austerity on investment, it can be concluded that the crisis management in the Eurozone
 - exacerbated a demand problem,
 - harmed the long-run growth potential of the Eurozone.