

Economic Growth in the European Union

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Leszek Balcerowicz

Lech Kalina

Aleksander Łaszek

Andrzej Rzońca



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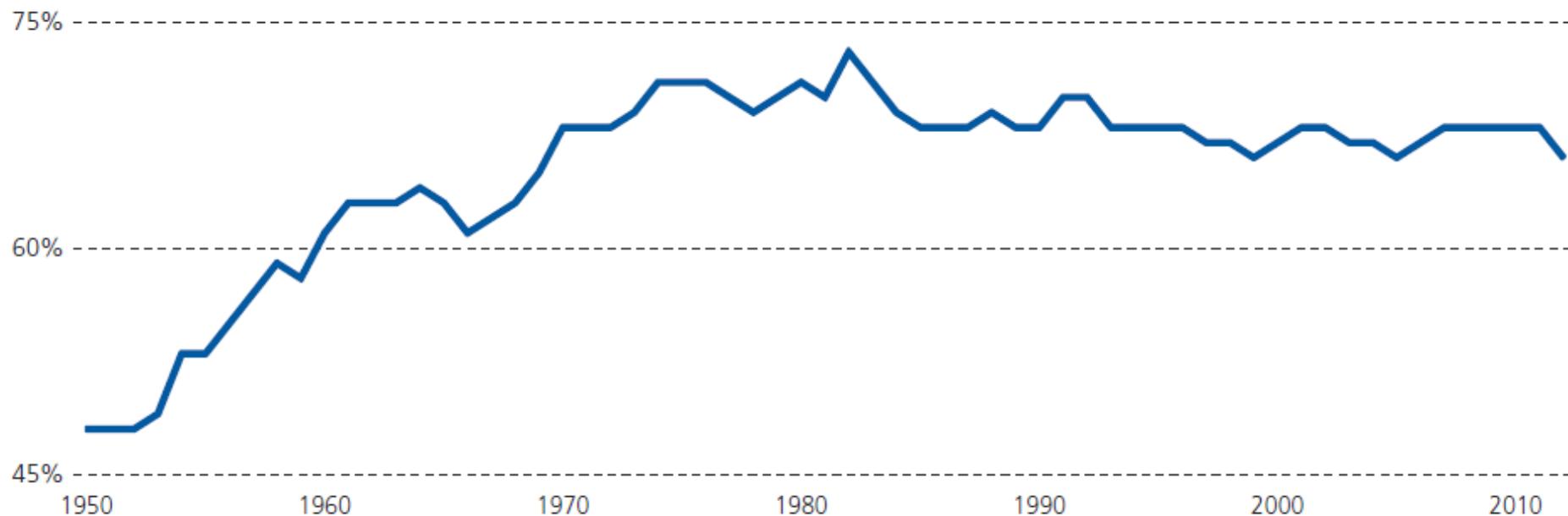
Conclusions



1. Overview: 1980-2012

Since the beginning of the eighties the process of catching-up of EU-15 (as an aggregate) with the US has stopped.

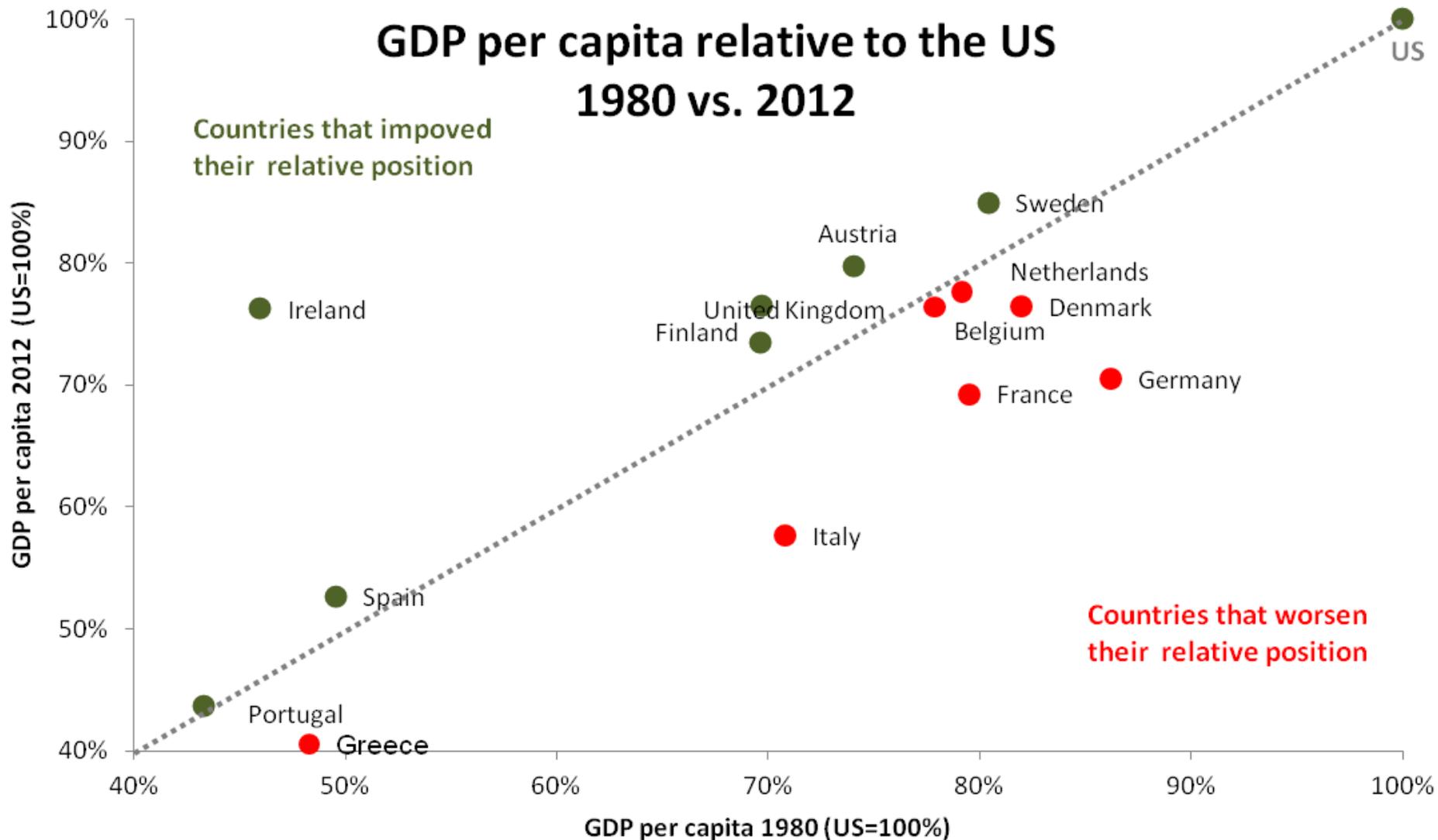
GDP per capita EU-15 (US=100%)



Source: TED 2013



GDP per capita relative to the US 1980 vs. 2012



Source: TED 2013

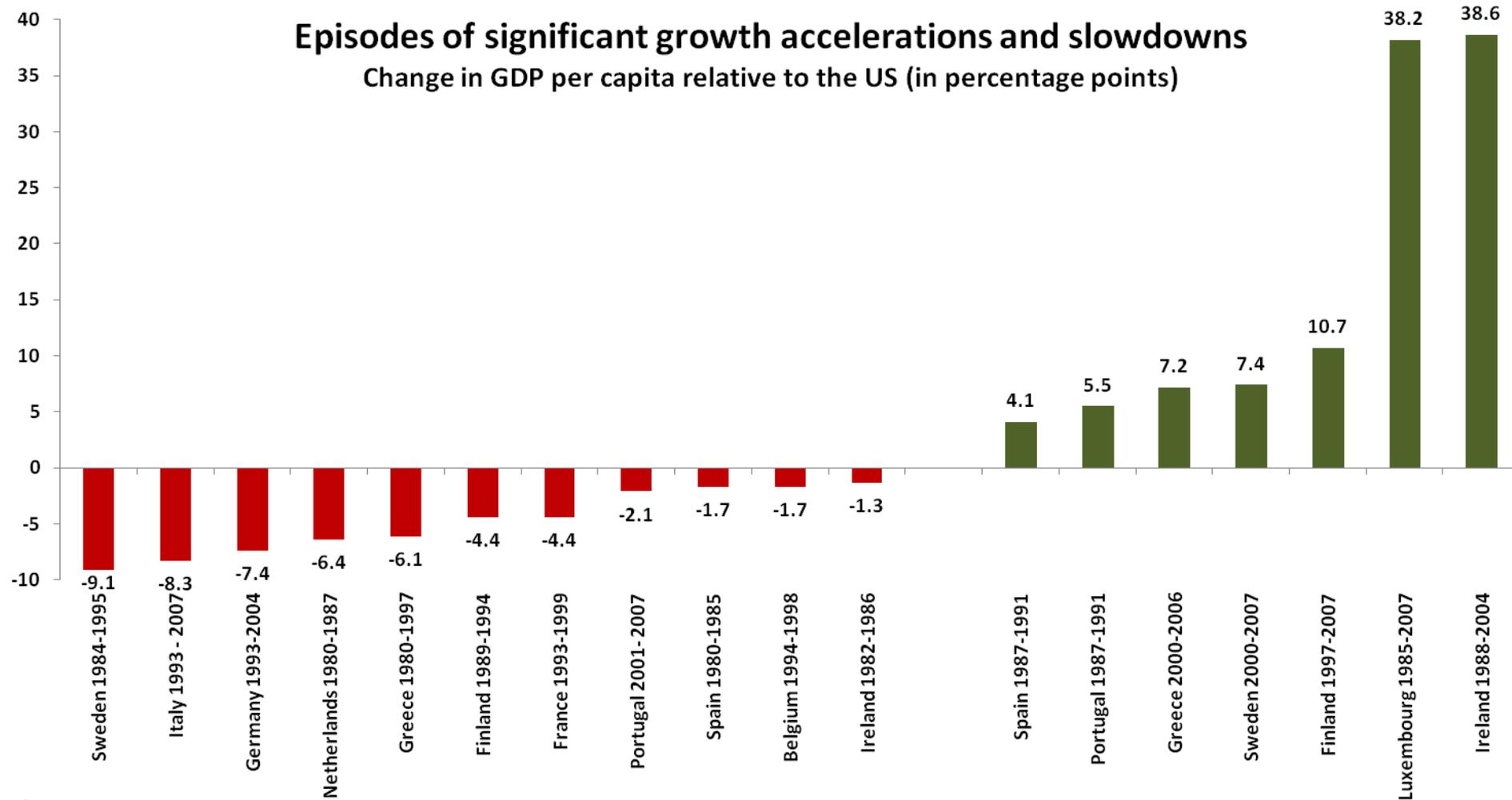


2. Before the crisis: 1980-2007

No country was a leader or laggard during the whole period 1980-2007: countries experienced episodes of both catching-up and slowdowns

Episodes of significant growth accelerations and slowdowns

Change in GDP per capita relative to the US (in percentage points)



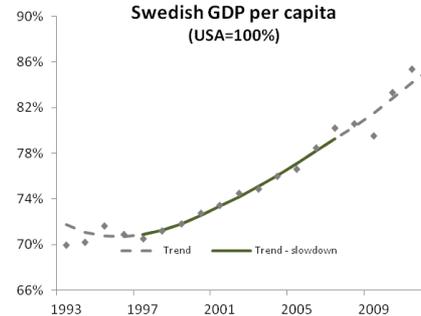
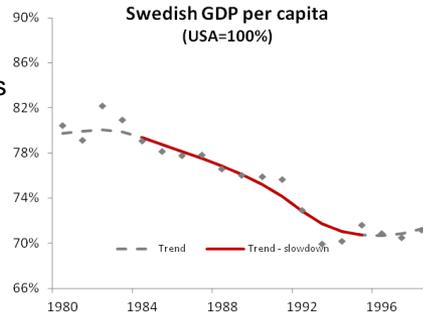
Source: TED 2013



Examples of slowdowns and growth accelerations 1980-2007

Sweden 1984-1995

- Limited competition in many sectors of the economy
- High and distortionary tax burden
- Persistent fiscal deficits
- Banking crisis in 1991

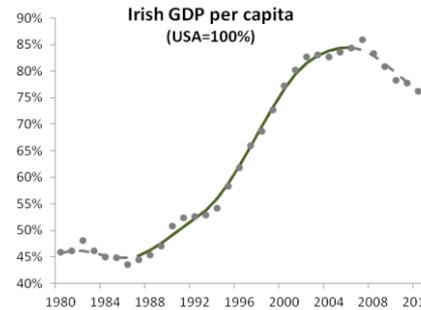


Sweden 1997-2007

- Deregulation boosting productivity by 0.4% annually
- Expenditure based fiscal consolidation of 11% GDP (7 pp. expenditure cuts, 4 pp. revenue increases)
- Prompt restructuring of banking sector

Ireland 1982-1986

- Persistent fiscal deficits
- Unsuccessful revenue based consolidations

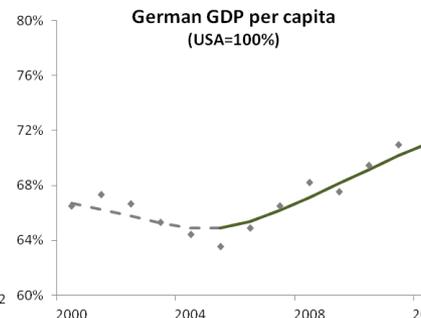
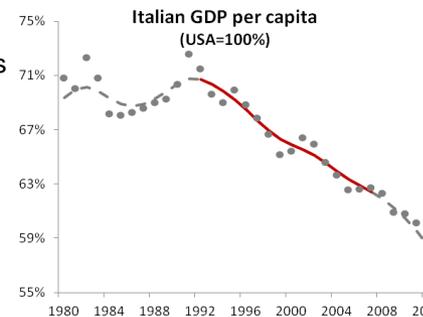


Ireland 1987-2004

- Expenditure based fiscal consolidation of 4% GDP (3 pp. expenditure cuts)
- Only in the last decade growth became unsustainable and based on credit boom

Italy 1992-2007

- Limited competition in many sectors of the economy
- High and distortionary tax burden
- Persistent fiscal deficits
- Inefficient courts



Germany 2005-2012*

- Labour market reforms Hartz I-IV, lowering steady state unemployment from 8% to 6.25%
- Expenditure based fiscal consolidation of 2.5% GDP (2 pp. expenditure cuts)

Although this episode exceeds 1980-2007 time range, we include it because of the economic importance of Germany.

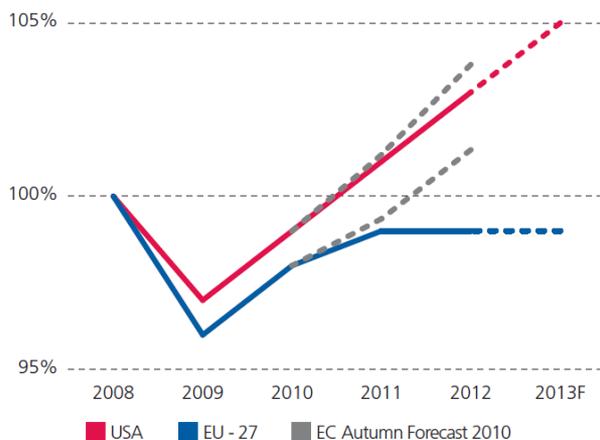
For detailed description and data sources see the ebook **Economic Growth in the European Union**



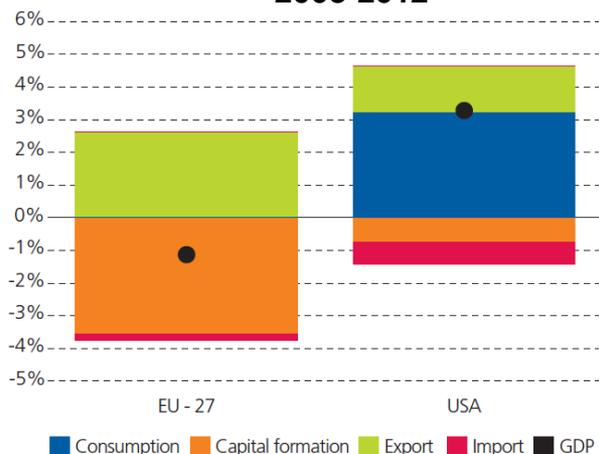
3. Crisis and aftermath: 2008-2013

Economic growth in the EU after the outburst of the crisis has been disappointing.

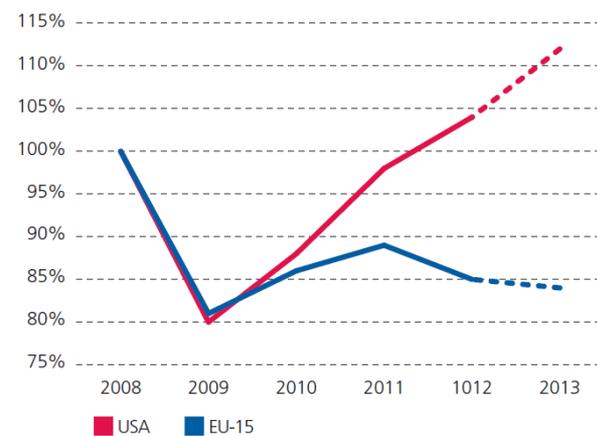
GDP (2008=100%)



Composition of GDP growth 2008-2012



Investment in equipment (2008=100%)

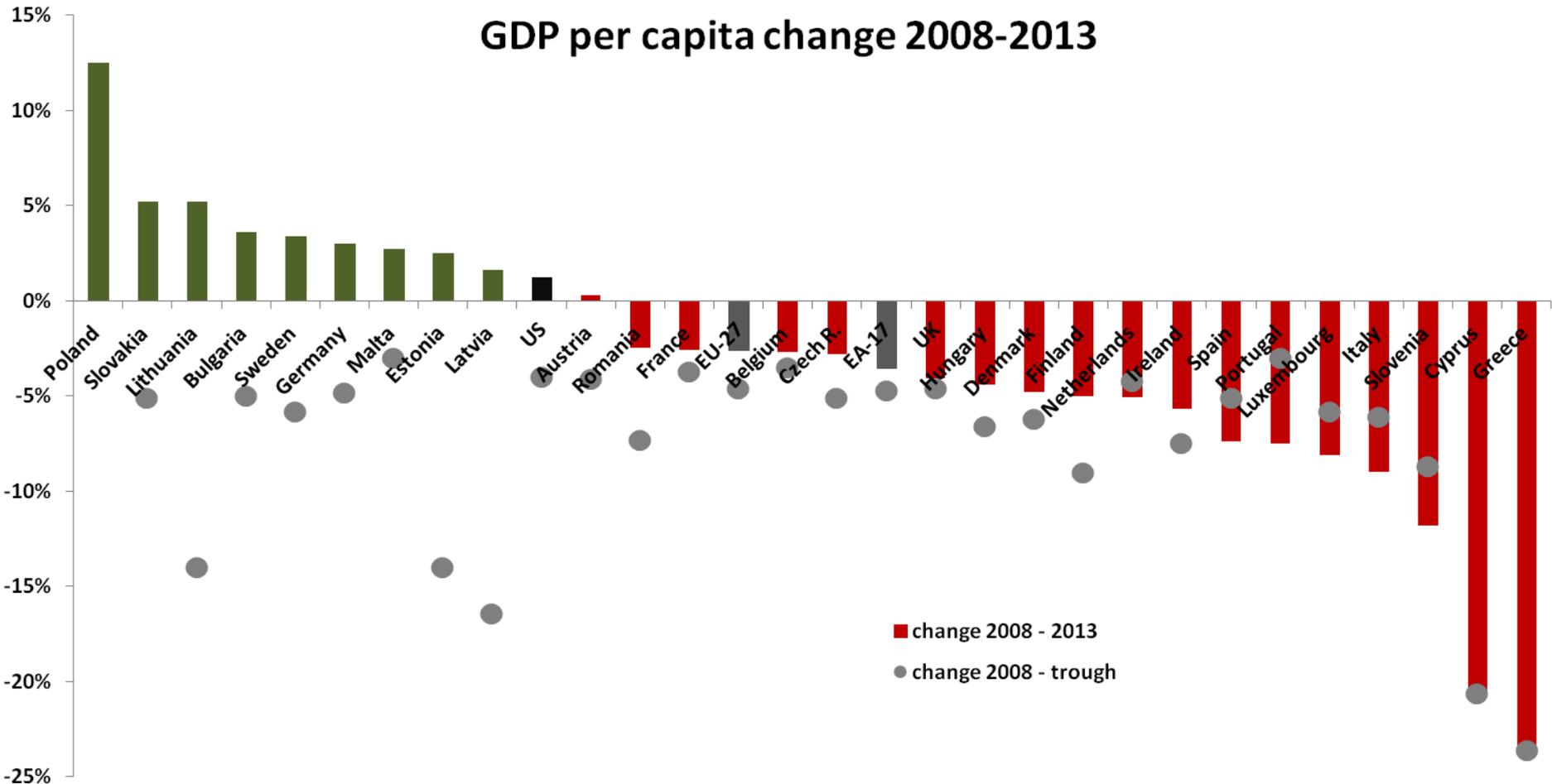


Source: AMECO and EC Autumn Forecast 2010



Aggregate performance of the EU masks huge variation: 9 countries outperformed the US, while 18 underperformed.

GDP per capita change 2008-2013



Source: AMECO, Forecasts for 2013 as in European Commission Spring forecast 2013.



4. Explaining differences in economic growth 2008-2013

Initial conditions

1. Macroeconomic imbalances
(i.e. credit booms, persistent fiscal deficits)
2. Microeconomic rigidities and distortions
(i.e. rigid labour code, distortive tax code)

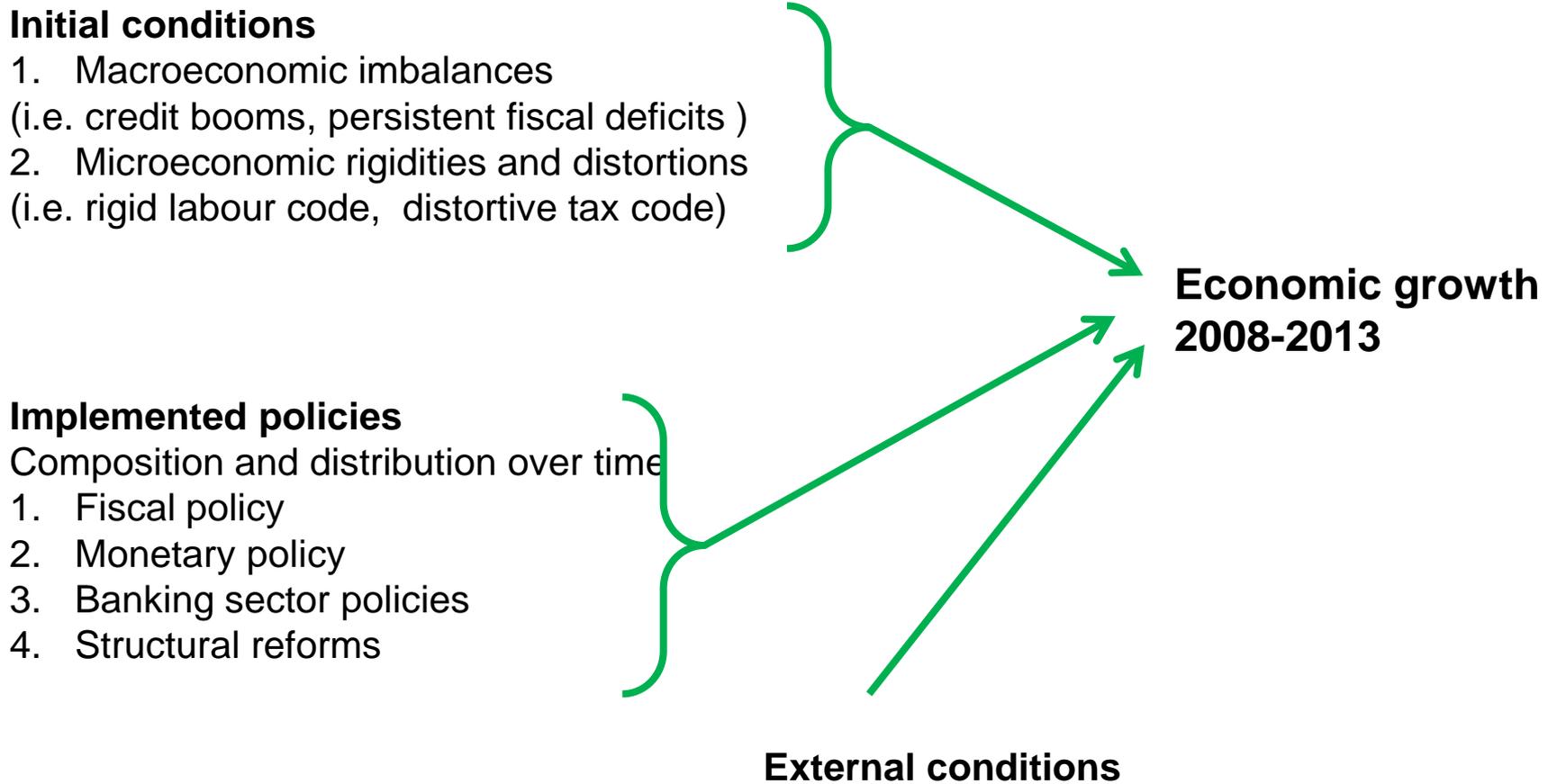
Implemented policies

Composition and distribution over time

1. Fiscal policy
2. Monetary policy
3. Banking sector policies
4. Structural reforms

External conditions

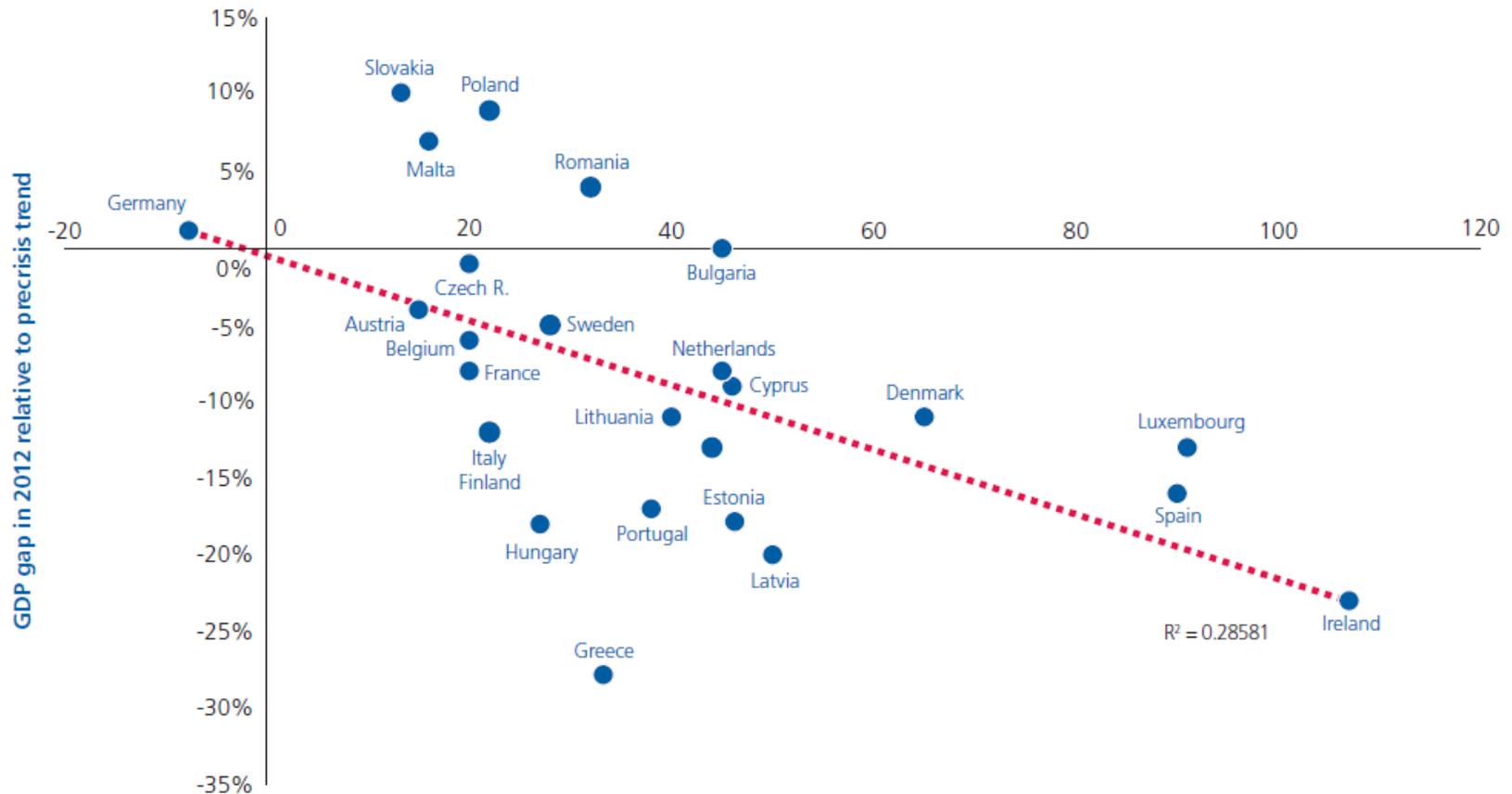
**Economic growth
2008-2013**



4.1 Initial conditions

Imbalances manifesting in fast credit growth, low saving rate, high investment rate, general government structural deficits, and large current account deficit before the crisis had significant impact on post 2008 performance.

Credit growth 2003-2007 vs. post crisis GDP growth



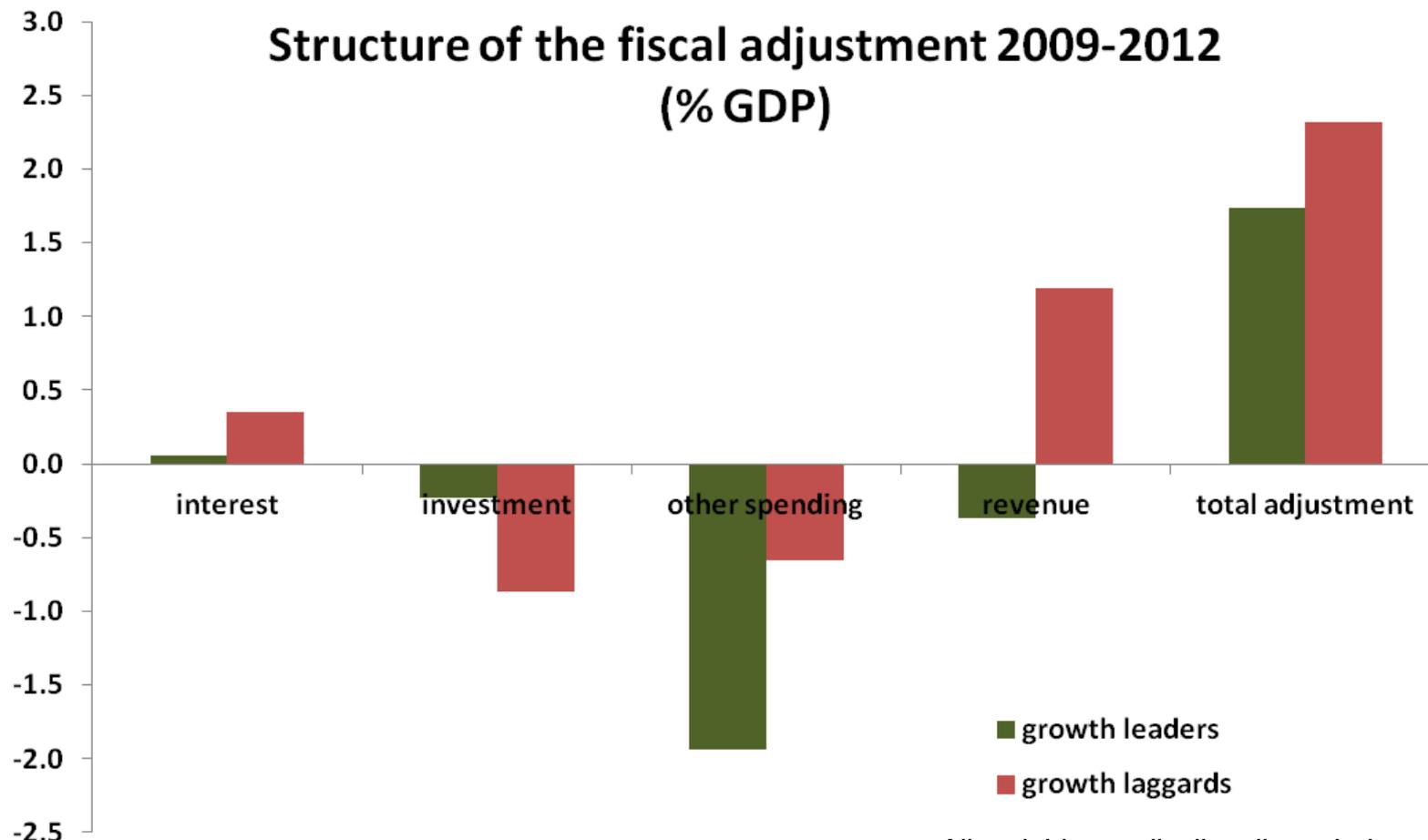
Source: IMF WEO and WDI online

Domestic credit to private sector, change 2003-2007 (%GDP)



4.2 Fiscal policy I

Size of fiscal adjustment in both growth leaders and laggards was of a similar magnitude. However in case of growth leaders it was expenditure based, while in growth laggards cuts in investment and raising revenue were most significant.

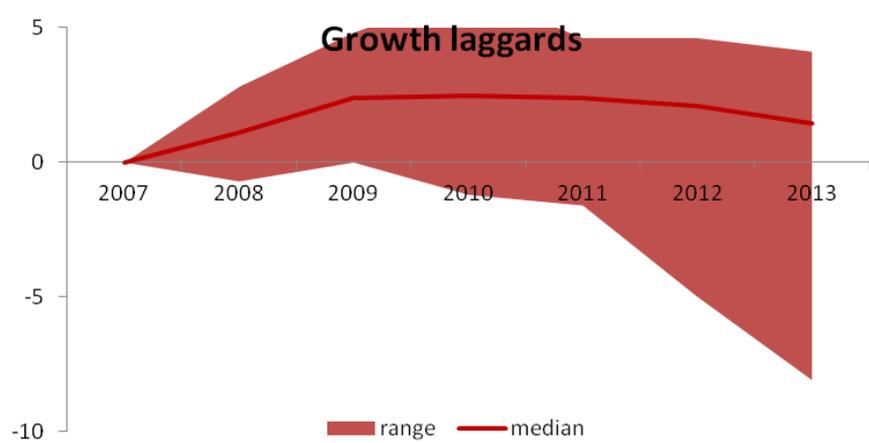
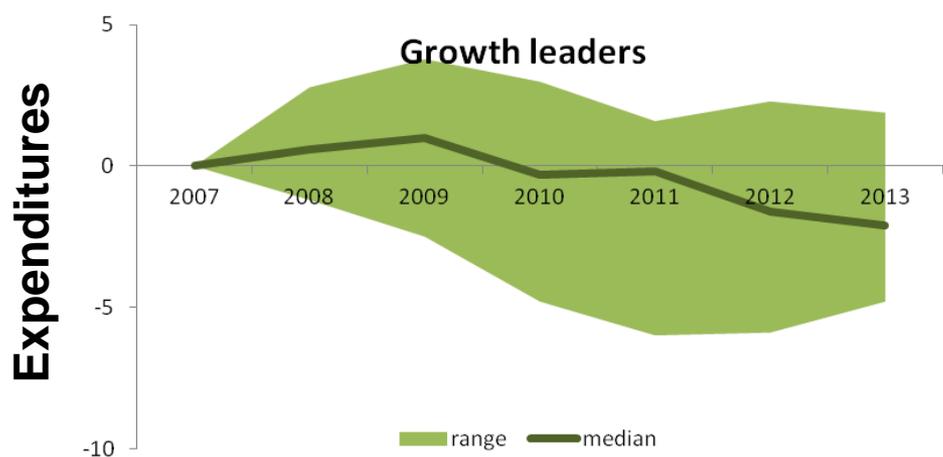
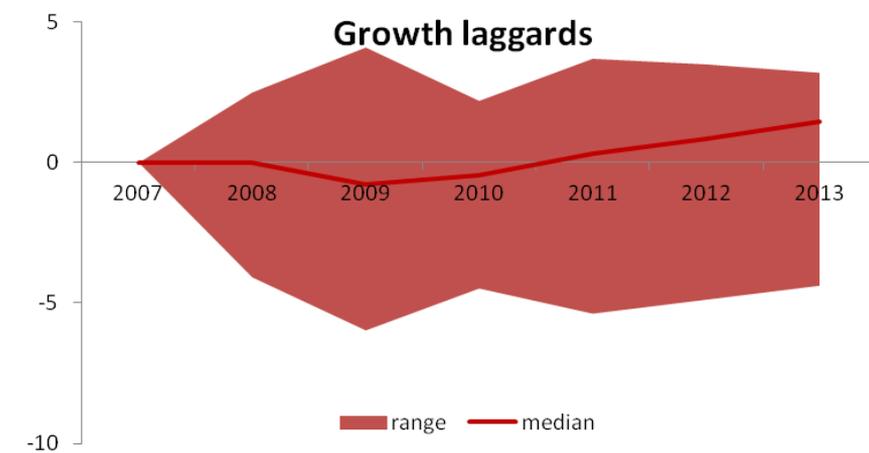
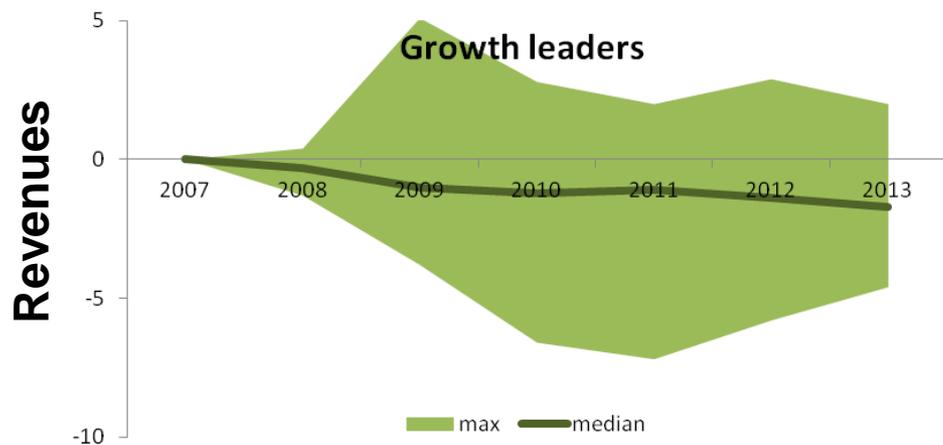


Source: AMECO



4.2 Fiscal policy II

Changes in cyclically adjusted general government revenues and expenditures (%GDP)



Source: AMECO; Ireland (because of extraordinary costs of banking bailout) and Hungary (extra revenue from nationalization of pension funds) are not shown



4.2 Fiscal policy: case of Greece

IMF report from:	Revenue side	Spending side	Structural reforms
March 2011, Dec 2011	- Greece has "reached the limit of what can be achieved through increasing taxes"	- "Through socially difficult wage and pension cuts, tax increases, and deep spending cuts, the government achieved the extraordinarily ambitious stabilization goals that it had set for itself for 2010" - While the overall fiscal target was met, this happened because the government under executed the state budget in order to offset revenue shortfalls and overspending at local levels . These in turn reflected weak tax administration and problems in controlling spending, leading to a build up of budgetary arrears."	- "major reforms still need to be designed and implemented to build a critical mass necessary to secure fiscal sustainability and economic recovery" - "The authorities have implemented an ambitious upfront approach to liberalization of the regulated professions" → but see quote from July 2013 below about delays in implementation - "The authorities acknowledged that in some instances implementation of the reforms is lagging . Delays have been evident in the set up of one-stop shops and fast track investment procedures, largely reflecting limited administrative capacity."
March 2012, Dec 2012	- „Greece achieved a cumulative improvement in the primary balance of 8¼ percentage points of GDP between 2009 and 2011, on the back of VAT, income and property tax increases, and cuts in wages, pensions, and public employment ." → the quote from March 2012, keep in mind the quote from Dec 2012 on the right.	- "The authorities and staff agreed that, beyond the crucial fight against tax evasion, new measures should be largely targeted on the expenditure side. Greece already has tax rates that are comparable to other European countries, and new burdens on the formal sector would pose an additional hurdle to the recovery." - "Still, some important underlying expenditure policy reforms have lagged , most notably efforts to make staff reductions more targeted (only 200 employees were placed in the labor reserve during 2012, well short of the end-2012 target of 15,000)."	- "as a result of indirect tax hikes and deeply entrenched product and service market rigidities, disinflation has been delayed and is expected to be less pronounced than in the case of Baltic comparators" - "The structural transformation of Greece's economy continues to proceed at a slow pace (outside of the labor market), and this is making Greece's adjustment more costly" - "Privatization targets have been missed by a wide margin" - "Institutional reforms continued to disappoint during 2012 , again complicating overall adjustment efforts. (...) Tax administration reform stalled. (...) Public financial management reform has also slowed down."
Jan 2013, June 2013, July 2013	- „The authorities' adjustment strategy focuses on reducing expenditures. The authorities recognized that they needed to refocus on spending cuts, after relying heavily on tax rate increases during 2010–12. " - „Following a major cut in public sector wages and pensions in 2010, measures in 2011 relied mostly on tax increases. "	- "The fiscal program is ambitious in its scale—the adjustment remains huge by international comparison for the fourth consecutive year— and in its focus on difficult but overdue spending cuts, and the strong implementation speaks to the Government's determination."	- "The high adjustment cost reflects in important part the delayed, hesitant and piecemeal implementation of structural reforms. (...) reforms have fallen well short of the critical mass needed to transform the investment climate." - Structural reforms are progressing slowly (...) The privatization program is behind schedule . (...) Progress in liberalizing regulated professions has been slower than targeted, particularly in issuing secondary legislation for a number of professions, reflecting resistance from vested interests."

Source: IMF Reports

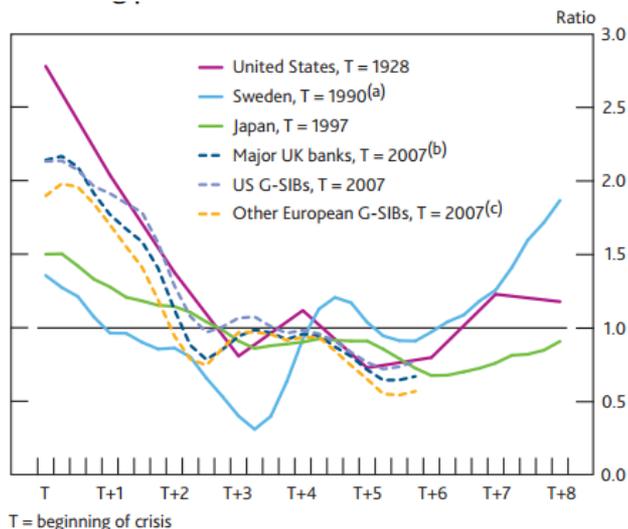


4.3 Monetary policy

Aggressive non-conventional monetary policy is certainly not a free lunch.
It cannot substitute for properly structured fiscal and structural reforms

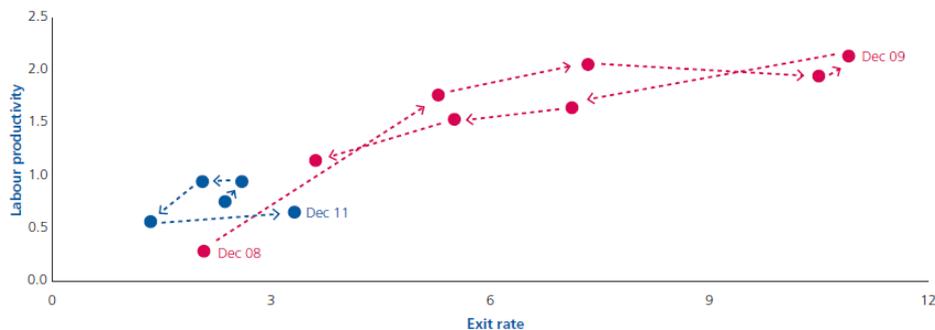
- Such policy creates a moral hazard. It weakens banks' incentives to repair their balance sheet, facilitating forbearance. It hampers post-crisis restructuring by: subsidizing weak or even insolvent banks, keeping 'zombie' companies alive, distorting asset prices
- It may discourage government from undertaking decisive fiscal adjustment.
- It risks creating asset bubbles – both on bond and stock market which when burst would endanger future economic growth.
- It risks compromising the central bank's independence.
- It risks generating inflation – in particular at the moment when the banking sector regains the ability to create money.

Price to book ratios of banking sectors following past financial crises



Source: Bank of England, *Financial Stability Report XI 2012*

Labour productivity versus exit rate in the Eurozone



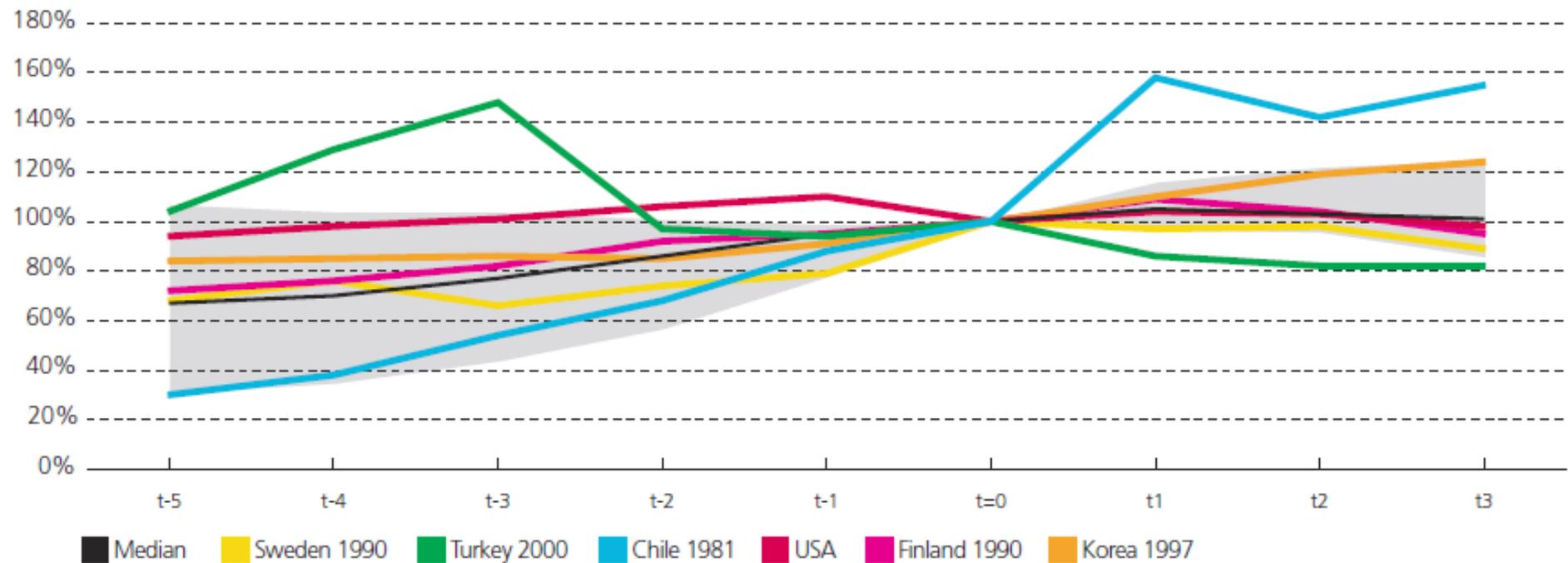
Source: Deutsche Bank



4.4 The banking credit and economic growth

In no EU country has deleveraging so far been of exceptional pace by historical standards.

Credit to GDP ratio in EU, US and five selected episodes of banking crisis



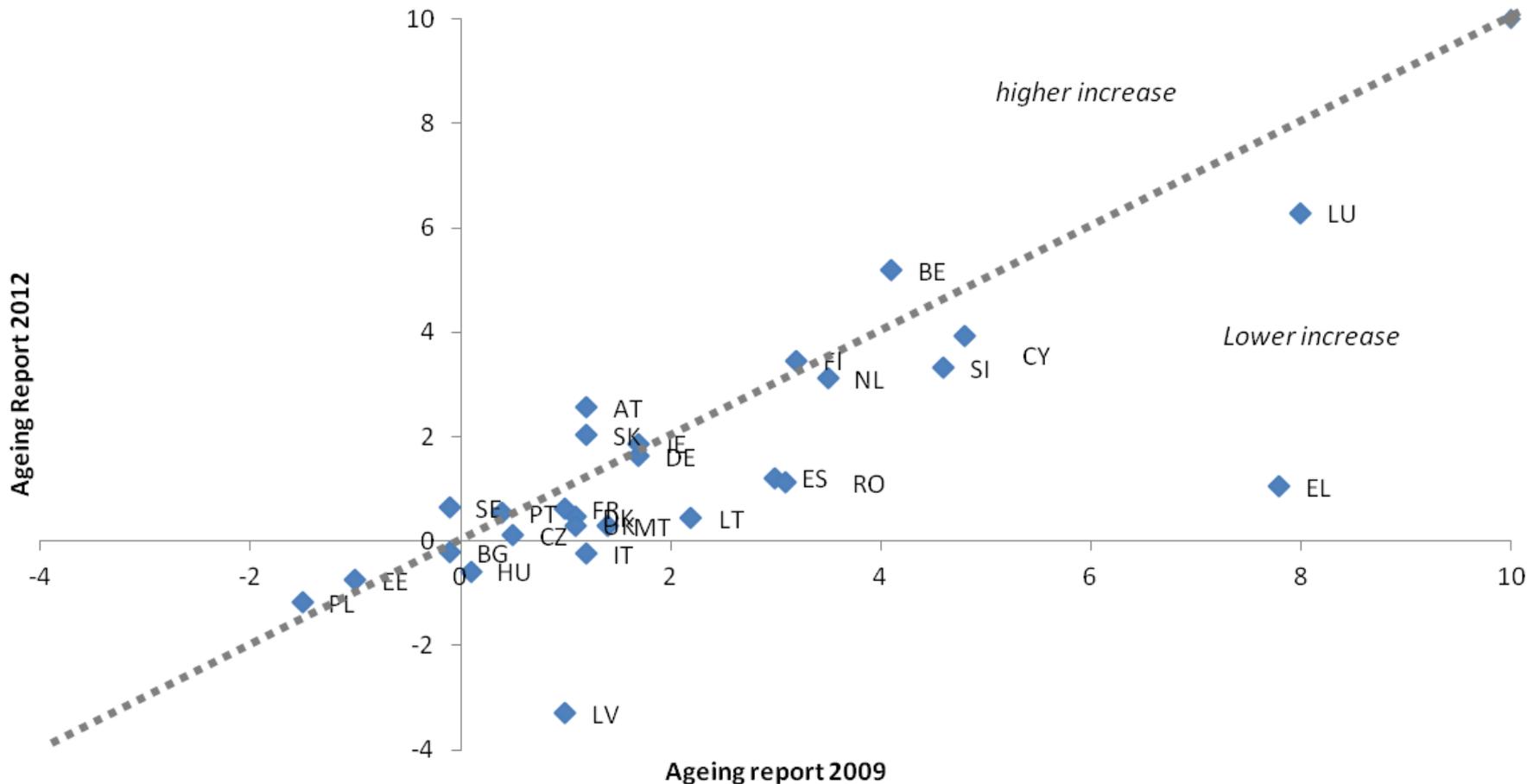
Source: WDI Online



4.5 Structural reforms

Pension reforms, particularly in growth laggards, have improved their long term prospects.

Projected increase in annual public expenditures on pensions 2010-2035 (%GDP)

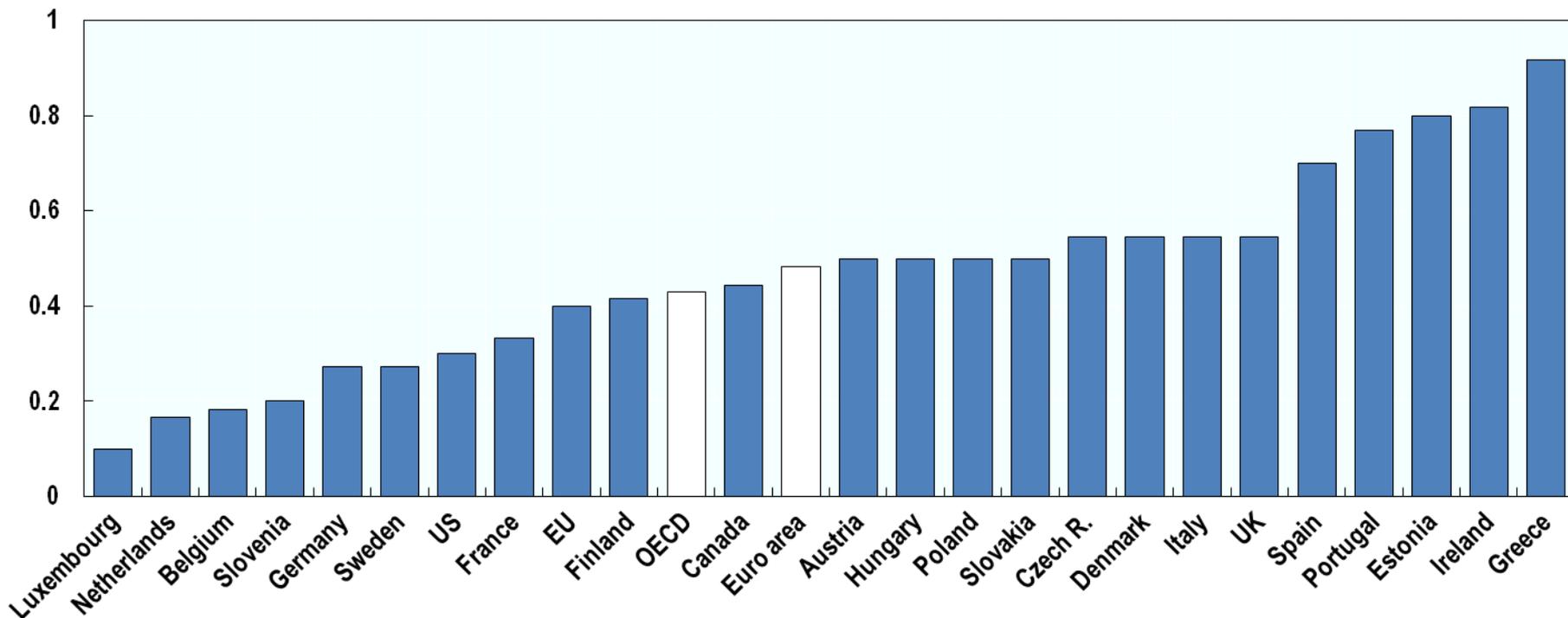


Source: EC Ageing Reports 2009 and 2012



Growth laggards are among most responsive to OECD recommendations, regarding structural reforms. Growth leaders (i.e. Germany or Poland) could also benefit from structural reforms.

Responsiveness to Going for Growth recommendations across OECD countries, 2011-12



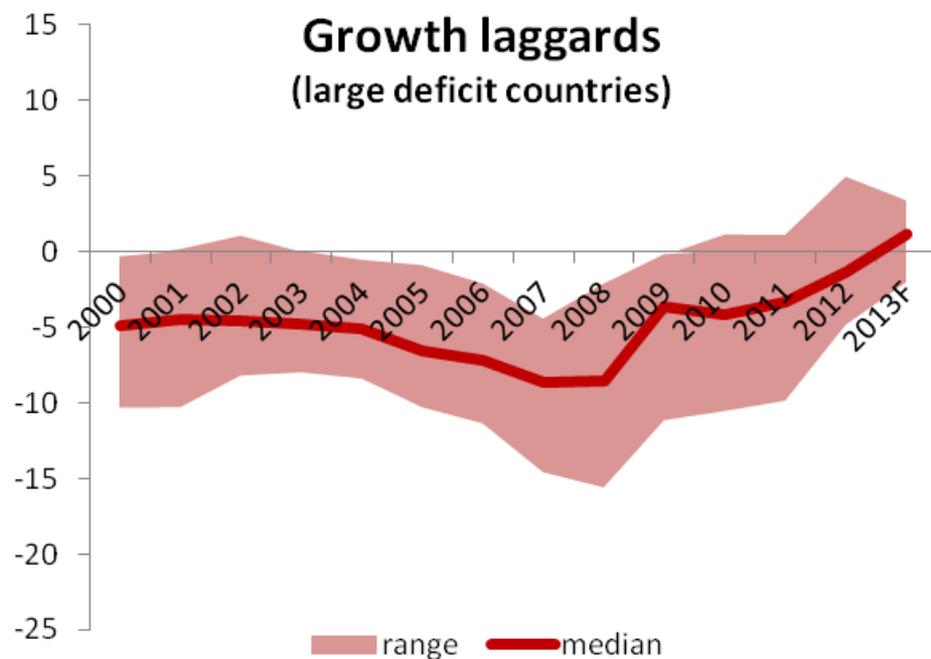
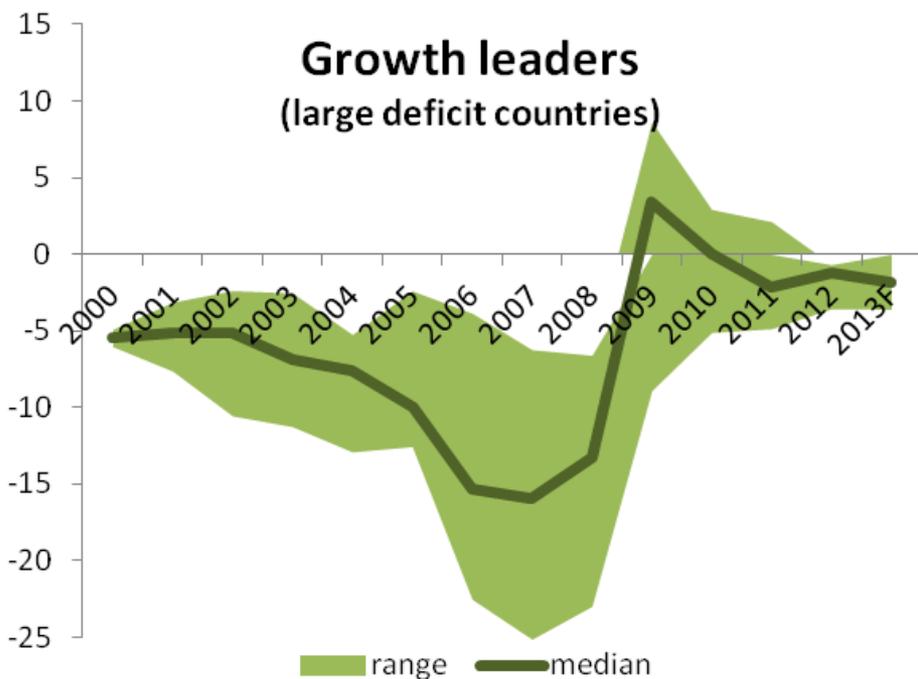
Source: OECD



4.6 Adjustment

Countries with high current account deficits, both from growth leaders and the growth laggards have reduced them.

Current account in countries with large current account deficits in 2007 (%GDP)



High deficit growth leaders: Bulgaria, Latvia, Estonia, Lithuania, Poland; high deficit growth laggards: Greece, Cyprus, Portugal, Spain, Hungary, Ireland, Slovenia, Czech Republic; Source: IMF WEO IV 2013



Conclusions

The economic growth has returned to much of the Europe. However serious challenges remain, especially on fiscal and structural front. Giving up further reforms or even worse going back on fiscal and structural change, would unavoidably create another wave of crisis, with related political upheavals. This is a specially case of large countries. On the other hand persisting with the reforms, however politically difficult is the only way to revive economic growth in Europe to meet the challenges of ageing.

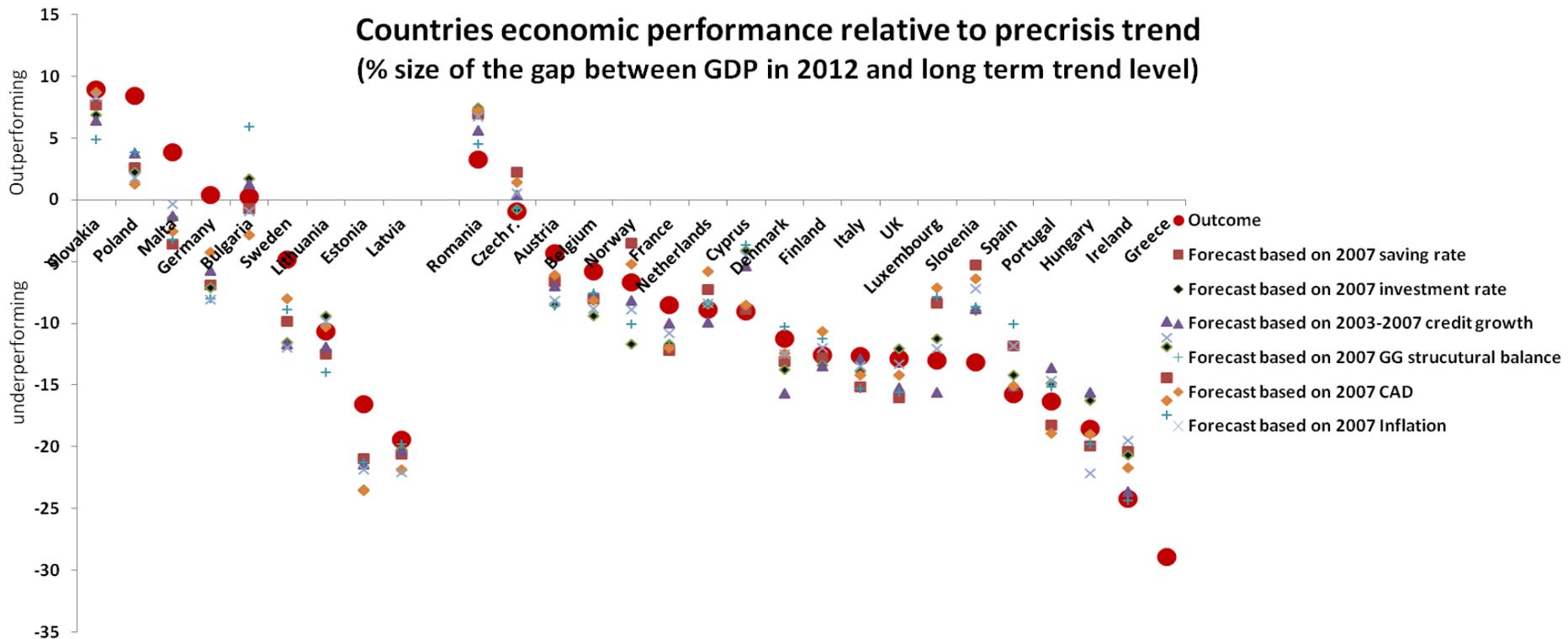
We have emphasized in this policy brief that bad initial conditions do not need to be translated into an unfavorable future. There is an active factor – the policies which form the economy – whose role can and will be decisive. Our stories of growth accelerations have shown that countries are capable of policy change that improves their growth performance. The political risk involved in making such reforms should be compared with the risk of delaying them or implementing measures which would be more politically acceptable but would not deliver the necessary results.

Behind all policies there is a socio-political dimension: the distribution of pressure groups in the society. Therefore, instead of engaging in the gloomy prophecies about the decline of the West, one should focus on strengthening the forces that support growth enhancing-reforms, both at the national and the EU level.



Appendix I: Initial conditions

Simple models, that take into account scale of initial imbalances and the size of initial shock (approximated by the GDP growth in 2009) predict the economic performance of the EU countries quite well, indicating crucial role of initial conditions. Still however some countries perform better than expected, given initial conditions (e.g. Poland, Germany), while other significantly underperform (e.g. Greece).



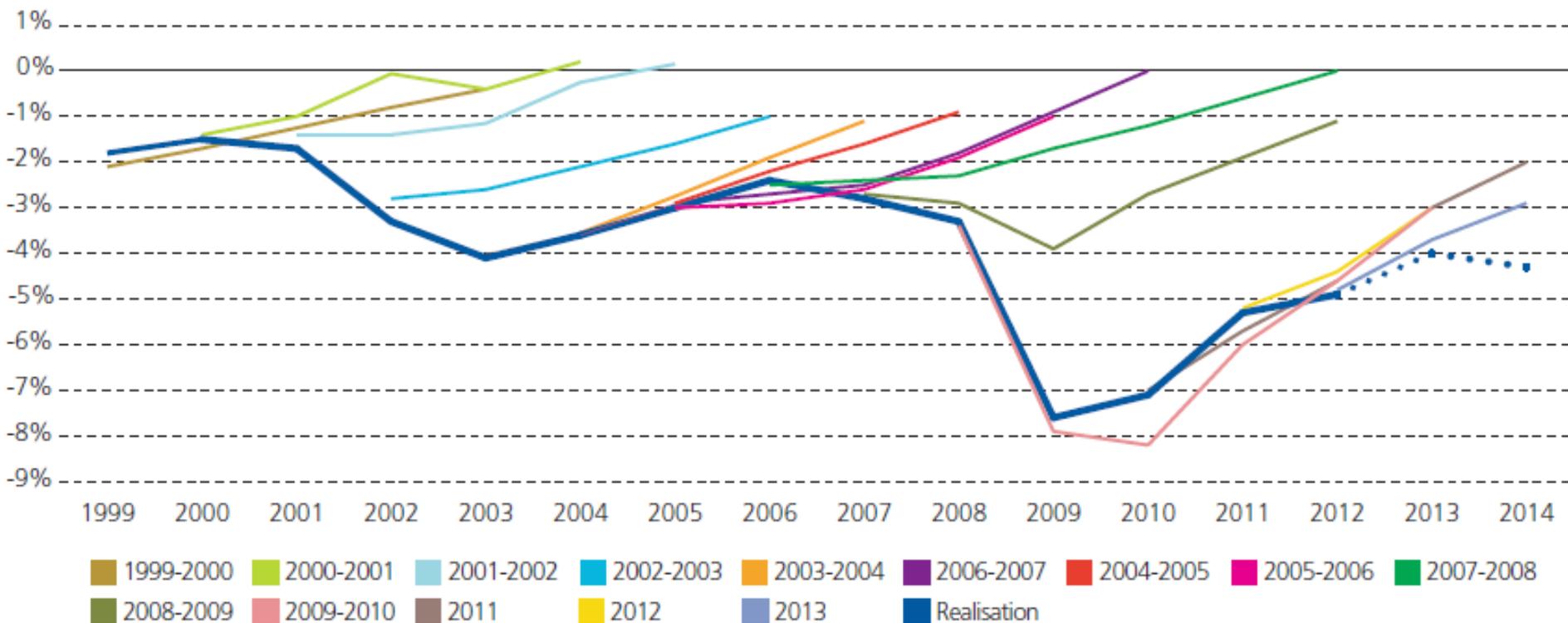
Source: IMF WEO IV 2013, WDI Online, AMECO



Appendix II: Past promises of fiscal consolidation

Given past records, declared back loaded fiscal consolidations should be treated with skepticism.

France: fiscal adjustments declared in subsequent Stability Programmes and outcomes: General Government net lending (%GDP)



Source: Stability Programmes

