

LISBON COUNCIL E-BOOK

Economic Growth in the European Union

*By Leszek Balcerowicz (principal author),
Andrzej Rzońca, Lech Kalina and Aleksander Łaszek*

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The views expressed in this e-book are those of the authors alone and do not necessarily reflect the views of the Lisbon Council, the Warsaw School of Economics or any of their associates.

This e-book is published as part of the **Growth and Competitiveness Initiative**, a multi-year programme intended to produce new thinking and encourage debate on restoring employment and generating economic growth in Europe. The programme is led by the Lisbon Council, a Brussels-based think tank.

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Introduction

The European economy has finally started growing again, but the news to date is hardly cause for celebration. The European standard of living as measured by gross domestic product per capita remains statistically lower than in the United States – the benchmark in most areas for economic performance in a modern industrial economy.¹ And the performance of the European economy – post 2008 crisis – has been consistently poorer than its trans-Atlantic neighbour on pretty much any indicator.² What's more, the persistent inability to get a grip on the current "euro crisis" has led international attention to focus on Europe not as a promising market of tomorrow, but as a potential source of turbulence in the months and years to come.

But there is some genuinely good news amid the turmoil: while we might disagree on the diagnosis and on the steps we should be taking to remedy the disease, we Europeans are starting to forge a broad social consensus that economic growth will be needed to provide a better life for our children and to retain our much-vaunted "social cohesion." Put simply, an unemployment rate of 11% – and 23.4% among those under the age of 25 – is a social catastrophe which no rich industrial nation should long tolerate.³ And if we still lack a consensus on how this social scourge might best be tackled, we can at least concede that today we all agree that an economy that isn't growing is an economy where pressing social needs can and will go largely unanswered.

This consensus around the necessity of a policy that will restore growth to Europe offers a new opportunity – but only if we seize it and populate it with new and useful ideas, and effective and strong policies. We must seek to define and articulate policies that will be capable of lifting Europe out of its malaise, and provide a helpful analytical framework for those policies, a framework that is capable of gaining the support within society for

the kinds of changes that Europe so badly needs. We have a very rich history upon which to draw – a history that is full of outstanding examples of countries that have turned themselves around (as well as cautionary tales of countries that brought decline upon themselves largely through bad policies and economic mismanagement). This paper will examine the post-World War II European experience with economic growth – and economic slowdown. What are the lessons we can learn from countries that did well? How did they generate sustainable economic growth which contributed to tangible increases in their standard of living? What are the policies today that would get Europe growing again? And what are the risks and shortcomings embodied in current policies, some of which threaten to do more to prolong the recession than to help Europe to find a way out?

The paper finds that – first and foremost – the European economy remains a highly heterogeneous place with policies that vary widely from country to country, and outcomes that vary widely as a result as well. But it also finds that within that diversity lie some clear and consistent patterns that determine the winners from the losers. Interestingly, some

1 Throughout this paper, we will use the US – and the US response to the crisis – as the best indication of what was or ought to have been possible in a major industrial economy, though US policy is open to criticism as well on a large number of fronts. The purpose here is to use its performance as a benchmark.

2 A notable exception is exports, which we will discuss in chapter 3 on pages 30-31.

3 The figures are for July 2013. Eurostat, "Euro Area Unemployment Rate at 12.1%," *Euro Indicators* 126/2013 30 August 2013.

‘We Europeans might disagree on the diagnosis and the measures necessary to remedy the disease. But we are starting to forge a broad social consensus that economic growth will be needed to provide a better life for our children and to retain our much-vaunted “social cohesion.”’

countries fall easily into both categories, though often at different moments. Sweden is an example of one of Europe’s best-managed economies – but it used to be one of the worst. Greece and Spain also demonstrate ambiguous performance – doing well in some years and catastrophically badly in others. This shows that even good news, if it is merely pocketed rather than built upon, can sow the seeds for tomorrow’s disasters. Either way, history shows no democratic country is resigned to any particular fate. You can change your destiny through the right combination of policies. But you must show the courage – and the wisdom – to get things right.

What, then, does it take “to get things right?” To find out, we looked closely at the pattern of economic growth in post-World War II Europe, studying the histories of individual countries and the European aggregate as a whole. We focused on two key periods – 1980 to 2007 (the nearly three decades prior to the economic turmoil of 2008) and 2008 to 2013 (the five years since the onset of the crisis). Within each period, we looked for two important trends: the periods when an individual economy was expanding, and the periods when an economy was contracting. We called these periods “episodes.” “Growth episodes” refer to the time when the economy was expanding, and “deceleration episodes” refer to the time when it was contracting (please note: these episodes are not to be confused with the normal business cycle as they typically last longer and are due to more fundamental underlying conditions than the business cycle). We also looked particularly closely at individual countries’ performance throughout the recent economic crisis, taking special note of their pre-crisis (2007) condition as well as the policies they have pursued since the onset of the crisis. In that way, we hoped to draw some conclusions about which policies had been most effective at steering countries successfully through the crisis and paving the way for sustainable growth tomorrow.

Among the principal findings and key conclusions:

- 1) In no EU country has private-sector deleveraging so far been of exceptional pace by historical standards. Where it has been the fastest, it has been quite similar to the pace of deleveraging in Sweden after its national crisis in the 1990s, and Swedish crisis-fighting in the 1990s is considered a model of post-crisis management and speedy return to healthy growth. Similarly, while many European countries officially labour under a policy of “austerity” as budget consolidation is derogatorily and inaccurately known, budget consolidation in Europe, even though large, has thus far been more limited than the fiscal stimulus introduced in response to the crisis outbreak. Even in countries where “austerity” is the officially declared policy (as in the United Kingdom) or is under particularly strong criticism (as in Spain), public spending as a percentage of gross domestic product has actually gone up in the last five years when adjusted to take account of the economic cycle. The result is a policy debate disconnected with reality, where people have been told the source of their misfortune is one thing when in fact it is another.
- 2) Where there has been budget consolidation, it has often been one-sided, relying primarily on tax increases rather than cuts in state expenditure and structural reform. This policy has had a detrimental effect on growth in many countries, as policies based on increasing taxes across the board inevitably do. First, high taxes take a heavy toll on investment, directly removing money from the private sector where it might have been usefully invested by businesses and putting it into the public sector where it is used to feed unnecessarily large state budgets. But high tax rates – and the prospect of even higher tax rates – also harm business and consumer confidence. Market participants

'An unemployment rate of 11% – and 23.4% among those under the age of 25 – is a social catastrophe no rich industrial nation should long tolerate.'

see that the state is failing to manage economic challenges in a timely way, and they delay important investment decisions. Our analysis shows clearly that policies which rely too heavily on tax increases to balance budgets will choke the economy and prolong recession.

- 3) Researchers – including at the International Monetary Fund – have recently concluded that “austerity” has been too deep, and that some economists may have underestimated the effect of “heavy” austerity on economic slowdown. We believe that this is based on several fundamental misunderstandings. First and most importantly, it has been based primarily on tax increases, rather than on a balanced programme of small tax increases, budget cuts and structural reforms. Second, it was late to arrive (it was undertaken only under strong market pressure, when governments have had no choice but to reduce budget deficits). And third, it has not been strong enough to make state finances sustainable. The problem is not the multiplier. It is the poor composition of the consolidation we have had here in Europe.
- 4) Ample research highlights the crucial importance of combining decisive and properly-structured budgetary consolidation with supply-side reforms.
- 5) We also find that far too often the European response to crisis has consisted of policies that were either designed to avoid or postpone the deeper repairs so many economies need, or that had that outcome as their incidental effect. There is a risk that monetary policy – which has been historically accommodating in response to the downturn – could play a similar role in discouraging countries from restructuring their banking sectors and removing incentives

to reform at the national level if it is allowed to remain too loose for too long.

- 6) The main solutions to the growth problem in respective EU countries lie at the national level. No European initiatives can substitute for reform at the national level. Therefore, European measures should not weaken the incentives in respective societies to fix their own economic problems. However, the EU can helpfully contribute to economic growth prospects by completing the single market and taking other measures that would expand the internal market and strengthen competition in Europe.
- 7) And Europe does need growth. After a strong burst in the decades following World War II, the European Union stopped catching up with the US in the 1980s. Since then, the gap in living standards between the economic areas on either side of the Atlantic has widened. Since the crisis onset in 2008, the US, in spite of mediocre growth, has pulled further away from Europe in economic terms.
- 8) Between 1980 and 2007 (the first period we analysed), we found that significant episodes of economic slowdown occurred more than twice as frequently in the EU-15 countries as significant episodes of growth accelerations.⁴
- 9) In addition, growth acceleration in that time occurred almost exclusively in small countries and new member states.
- 10) We also found that behind every period of acceleration in a European economy were growth-enhancing reforms and/or positive demand shocks caused by increased capital inflows or credit growth.

4 The EU-15 are the 15 countries that made up the EU prior to the 2004 enlargement. They are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom.

'History shows no democratic country is resigned to any particular fate. You can change your destiny through the right combination of policies. But you must show the courage – and the wisdom – to get things right.'

- 11) The slowdowns were caused almost universally by growth-decreasing institutional changes (e.g. growing regulations, increased spending and taxes, nationalisation) or credit booms which went bust.
- 12) EU economic growth since the 2008 global financial crisis has been not only worse than in the US, but also than in Japan during the four initial years of its "lost" period (regardless of the base year recognised as the beginning of that period).
- 13) In one area, Europe does exceedingly well. EU exports have increased more than in the US relative to 2008 GDP. This increase was the exclusive source of improvement in the European trade balance during that time (as imports did not fall). This suggests that in the vastly important tradable goods sector, the EU is not less competitive than the US.
- 14) By contrast, Europe is doing very badly on investment – a sign that there may be more serious "confidence" problems in Europe than in the US. Fixed investment fell 14.9% in the EU between 2008 and 2012. This was largely a reaction to previous overinvestment (construction investment accounted for about two-thirds of this fall). But the negative contribution of total fixed investment to GDP growth in Europe is twice as large as in the US, which seems to reflect more serious problems with confidence. A fall in construction investment was accompanied by a drop in actual equipment investment only in Europe, and not in the US.
- 15) Despite having worse growth performance, there seems to be less spare capacity (if approximated by the negative output gap) in the EU than in the US. This suggests that poor growth performance in the EU cannot be addressed by stimulating aggregate demand, as some have proposed.
- 16) Growth performance in Europe negatively correlates with pre-crisis investment booms fuelled by credit and capital inflows, and positively correlates with large pre-crisis national savings increased by fiscal discipline and partly invested abroad.
- 17) The aggregate picture masks large variations in GDP growth among EU countries. Since the outbreak of the crisis, one in three EU countries has increased more than in the US in GDP per capita terms. These are countries which avoided large imbalances (Germany, Poland and Sweden) or went through fast rebalancing immediately after the start of the crisis (Bulgaria, Estonia, Latvia and Lithuania). The remaining EU countries were more heterogeneous. In addition to boom-bust countries (Greece, Ireland and Spain), this group includes economies with chronic structural problems that went straight into recession without a preceding boom (Italy) and countries that managed to avoid a deeper initial slump in 2009 but later experienced only very limited growth (Belgium and France). Boom-bust countries from the group of laggards underwent a very strong rebalancing process, too, but with a significant lag – notably in comparison with the adjustment in Bulgaria, Estonia, Ireland, Latvia and Lithuania. The delay in rebalancing limited the initial fall in domestic demand, but at the cost of postponing a recovery.
- 18) In analysing the impact of the inherited imbalances on post-crisis economic growth, one can distinguish two types of boom-bust episodes: 1) the fiscal to financial, and 2) the financial to fiscal. Fiscal overspending is the proximate cause of the former, while excessive growth of credit to the private sector (especially to housing) is the proximate cause of the latter. Government failure (consisting of destructive political competition and weak constraints on public spending and public debt) is

'Even in countries where "austerity" is the officially declared policy or is under particularly strong criticism, public spending as a percentage of gross domestic product has actually gone up in the last five years when adjusted to take account of the economic cycle.'

clearly the root cause of the former. However, government failures also largely contributed to the latter (in particular through loose monetary policy, taxes favouring debt finance relative to equity, subsidies to mortgage borrowing, financial regulations encouraging excessive securitisation, generous deposit insurance and regulations limiting shareholder concentration in large banks).

- 19) In response to the global financial crisis, fiscal policy was loosened in the majority of EU countries during 2008-2009 – through the operation of automatic stabilisers as well as through discretionary fiscal stimulus – even though most EU countries had no space for such a loosening. This was a serious policy error which has complicated the economic situation since 2010. Fiscal stimulus mostly consisted of increases in spending, which did little to stimulate demand and only helped to relieve pressure for more effective reform in many economies.
- 20) In 2010-2012, the fiscal balance considerably improved in the EU, but the cyclically adjusted deficit remained worse than before the crisis. Thus, the fiscal stimulus, measured by change in the structural fiscal balance, is still in effect.
- 21) Against this background, it is striking that roughly two-thirds of the reduction of the cyclically adjusted deficit to GDP ratio in the EU in 2012 (relative to 2009) was achieved through tax hikes. Only about one-third of the adjustment came through expenditure cuts. Moreover, almost all of the expenditure cuts were in government investment.
- 22) It is risky for EU countries burdened by large fiscal deficits and high public debt to GDP ratios to postpone reductions in their fiscal deficits. Future reductions will not be easier (due to the ageing population, confidence problems, etc.).
- 23) After the outburst of the crisis, the European Central Bank, as most other central banks in developed countries, shifted to very low interest rates, ballooned its balance sheet and introduced a sort of "forward guidance." The monetary policy pursued by the ECB has been very expansionary by historical standards, but not as expansive as the policy of the US Federal Reserve.
- 24) Such monetary policy weakens banks' incentives to repair their balance sheet and facilitates forbearance lending whereby banks may postpone write-offs of bad loans. It also hampers post-crisis restructuring through subsidising weak or even insolvent banks, keeping "zombie" companies alive and distorting asset prices. It risks creating new asset bubbles. And it discourages governments from undertaking decisive fiscal adjustment and threatens to compromise central bank independence.
- 25) There is evidence pointing to the materialisation of some of these risks in the euro area. European banks are traded at about half their book value. Default rates in the euro area, after a sharp increase at the onset of the crisis, have quickly fallen to a very low level by historical standards. Lastly, in most countries bond prices have increased to a level that had never been observed before the crisis even in economies with long histories of stability.
- 26) As far as lending rates across the euro area are concerned, the spreads were quite narrow until 2008, albeit gradually growing since 2004. They increased considerably only when the financial stability of banking sectors and governments started to be gauged differently across countries. Deposit-rate spreads have increased broadly in line with lending rate spreads.

‘The result is a policy debate disconnected with reality, where people have been told the source of their misfortune is one thing when in fact it is another.’

27) In countries in which governments launched a radical fiscal adjustment, lending rates have already fallen significantly.

28) The private debt to GDP ratio fell relative to the pre-crisis level only in a few EU countries, mainly in the Baltic states, where it dropped in nominal terms. Tight access to credit (together with an initial sharp increase in lending rates) contributed to the fast rebalancing of these economies, which has enabled them to quickly return to the growth path.

29) In those EU countries where credit to the private sector has fallen, housing credit has often fallen less than corporate credit. The drop in credit to the construction sector has not been the biggest among all sectors – either in percentage terms or in amount. In turn, the percentage of non-performing loans in the

EU is still clearly lower than the percentage revealed in Japan at the beginning of the 2000s after the long period of hiding low quality banking assets. Both the composition of the fall in credit and the still limited percentage of non-performing loans in comparison with their share after similar crisis outbreaks suggest that the balance sheets of European banks need to be strengthened. Various balance sheet indicators confirm that banks in Europe remain weaker than in the US.

30) Countries that performed better during the crisis could also benefit from further supply-side reforms, especially by opening up the service sectors. Strengthening their growth through such reforms constitutes the best support these generally successful countries could give to other EU countries.

Economic growth in the European Union (1980-2007)

1. The big picture (an aggregate view)

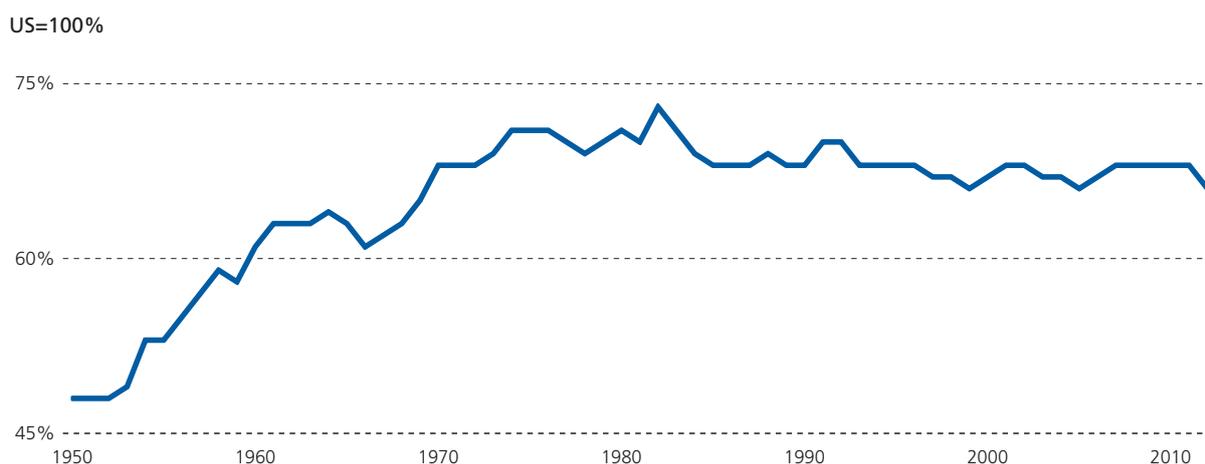
Between the end of World War II and the 1970s, the economy of Western Europe enjoyed a period of robust economic growth. During that time, gross domestic product per capita rose in the EU-15 to more than 70% of the United States' level in 1980, up from less than 50% in 1945. However, the process of catching up with the US later stopped – and even partially reversed. By 2007, GDP per capita in the EU-15 had fallen to 68% of the US level (See chart 1 below).

The gap in GDP per capita between the EU-15 and the US can largely be explained by persistently lower productivity, lower employment and less human capital, according to the Organisation for Economic Co-operation and Development (OECD); indeed, Europe only surpasses the US in terms of physical capital.⁵ But many economists also point to wide divergence between Europe and

the US in institutional and other factors. Olivier Blanchard and Justin Wolfers have shown how the interaction between the macroeconomic shocks of the 1970s and 1980s and the labour market institutions that were in place in Europe resulted in a rising unemployment rate, which contributed to poor economic performance after 1980.⁶ Edward Prescott, the Nobel Prize-winning economist, has demonstrated the negative impact on labour supply of the growth of high marginal tax rates in an article with the telling title, “Why Do Americans Work So Much More than Europeans?”⁷

Others believe the differences are best explained by greater adoption of information and communication technologies (ICT) and faster rising productivity in the US than in the EU.⁸ In a setting of strict labour regulations, investment in new technologies with unknown outcomes is risky; if the investment fails, it will be costly to downsize employment. This leaves firms reluctant to make ICT investment in the first

Chart 1: GDP per capita in EU-15 (1950-2012)



Source: Conference Board Total Economy Database (TED)

- 5 Organisation for Economic Co-operation and Development, *Education Policy Advice for Greece* (Paris: OECD, 2011).
- 6 Olivier Blanchard and Justin Wolfers, “The Role of Shocks and Institutions in the Rise of European Unemployment: The Aggregate Evidence,” *Economic Journal* 110(462), 2000.
- 7 Edward C. Prescott, “Why Do Americans Work So Much More than Europeans?” *FRB Minneapolis – Quarterly Review* 28, 2004.
- 8 Bart van Ark, Mary O’Mahoney and Marcel P. Timmer, “The Productivity Gap between Europe and the United States: Trends and Causes,” *Journal of Economic Perspectives* 22(1), 2008.

‘Policies which rely too heavily on tax increases to balance budgets will choke the economy and prolong recession.’

place, according to Bart van Ark, chief economist of the Conference Board. It has contributed overall to slower productivity growth throughout Europe in the 1990s. And, interestingly, it also partially explains divergences within the EU, which is the subject of the next section.

2. Differences within and among European Union countries

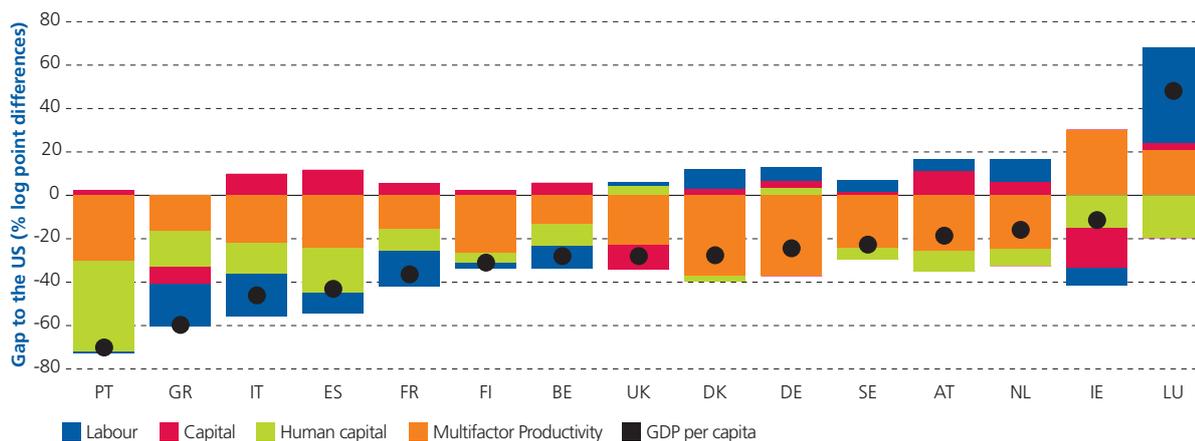
However, the aggregate picture for the 1980-2007 period masks important differences among the EU-15. Different countries display different growth performances during this period, and the countries may themselves have very different growth rates over time. This is true not only for EU members, but for other countries as well. To examine this variation, and to look more closely at the reasons for it, we introduce the concept of “growth episodes,” which we divide into accelerations and slowdowns.⁹

Behind these accelerations and slowdowns are two kinds of factors:

1. Changes in systemic forces, which by definition operate all the time (especially changes in the institutional framework, the fiscal stance and the age structure of the population);
2. Strong shocks, especially strong and persistent accelerations of public and private spending (the booms), always driven by strong capital inflows and/or excessive growth of credit, i.e. the booms, which often turn into the negative demand shocks (the busts).

We found that accelerations are largely caused by credit booms or the strengthening of the systemic forces (e.g. increases in investment and/or in employment due to deregulation or privatisation). The slowdowns result from the weakening of systemic forces (e.g. reductions of investment and/

Chart 2: Contribution of production factors to GDP per capita gap relative to the US at constant USD 2005 PPPs (2011)



Source: OECD

⁹ Leszek Balcerowicz, “Institutional Systems and Economic Growth” in Anders Åslund and Marek Dabrowski (eds), *Challenges of Globalization: Imbalances and Growth* (Washington: Peterson Institute, 2008).

‘Far too often the European response to crisis has consisted of policies that were either designed to avoid or postpone the deeper repairs so many economies need, or that had that outcome as their incidental effect.’

or employment due to increased regulation, chronic fiscal deficits, debt overhangs or population ageing), or from the busts which follow the credit booms (We will discuss the latter pattern in more detail in the comments and analysis on page 23). These are, of course, stylised facts. In real life we face various combinations of these “pure” events. For example, inflows of easy money may contribute to the policies that result in the weakening of systemic forces, as policymakers facing weaker financial constraints are more likely to give in to various lobbies. And conversely, the busts which follow the booms may induce policymakers to introduce growth-accelerating reforms by hardening financial constraints.¹⁰

For operational purposes, we define slowdowns as periods when the GDP per capita in a given country (adjusted for convergence) grew 1 percentage point or more slower than in the US for five years in a row or longer.¹¹ According to this admittedly somewhat arbitrary definition, Ireland experienced a slowdown between 1982 and 1986. During this period, Irish GDP per capita fell to 44.8% of the American level, down from 46.1% in 1982. One might argue that such a decline is negligible and the whole period should not be counted as a slowdown. However, given the initially low level of GDP per capita, one should rather expect convergence instead of divergence, so even a small relative decline can be counted as a slowdown. Accelerations are defined as the periods when GDP per capita in a given country (adjusted for convergence) grew by 0.5 percentage points faster than in the US for five years in a row or longer.

Table 1: Episodes of accelerations and slowdowns among EU states listed by size

(in brackets change in GDP per capita, relative to the US in percentage points, adjusted for cyclical factors)

Slowdown Episodes	Size of decrease	Acceleration Episodes	Size of increase
1. Sweden 1984-1995	-9.1 pp.	1. Ireland 1988-2004	+38.6 pp.
2. Italy 1993-2007	-8.3 pp.	2. Luxembourg 1985-2007	+38.2 pp.
3. Germany 1993-2004	-7.4pp.	3. Estonia 1995-2007	+28.8 pp.
4. Netherlands 1980-1987	-6.4 pp.	4. Latvia 1997-2007	+17.9 pp.
5. Greece 1980-1997	-6.1 pp.	5. Slovenia 1993-2007	+16.7 pp.
6. Finland 1989-1994	-4.4 pp.	6. Slovakia 2002-2007	+13.9 pp.
7. France 1993-1999	-4.4 pp.	7. Lithuania 1999-2007	+12.6 pp.
8. Portugal 2001- 2007	-2.1 pp.	8. Finland 1997-2007	+10.7 pp.
9. Bulgaria 1993-1998	-1.8 pp.	9. Poland 1993-1997	+10.2 pp.
10. Spain 1980-1985	-1.7 pp.	10. Bulgaria 2000-2007	+10.0 pp.
11. Belgium 1994-1998	-1.7 pp.	11. Czech Republic 2002-2007	+8.8 pp.
12. Ireland 1982-1986	-1.3 pp.	12. Sweden 2000-2007	+7.4 pp.
13. Romania 1995-2000	-1.1 pp.	13. Greece 2000-2006	+7.2 pp.
14. Czech Republic 1996-2000	-0.7 pp.	14. Portugal 1987-1991	+5.5 pp.
15. Hungary 1993-1998	-0.5 pp.	15. Spain 1987-1991	+4.1 pp.
		16. Hungary 2001-2006	+3.9 pp.
		17. Romania 2002-2007	+3.7 pp.

Source: Conference Board Total Economy Database (TED)

10 Leszek Balcerowicz and Andrzej Rzońca, “The Fiscal Cure May Make the Patient Worse,” *Financial Times*, 10 December 2008.

11 The trend was calculated with the Hodrick-Prescott filter ($\lambda=6.25$). The Convergence adjustment was made according to formula: $g'_x = g_x - 2\% * (1 - \frac{GDP_x}{GDP_{USA}})$, where g_x is adjusted growth rate of GDP per capita of country X, g'_x is unadjusted growth rate and the term $(1 - \frac{GDP_x}{GDP_{USA}})$ represents the gap in the GDP levels relative to USA in a given year.

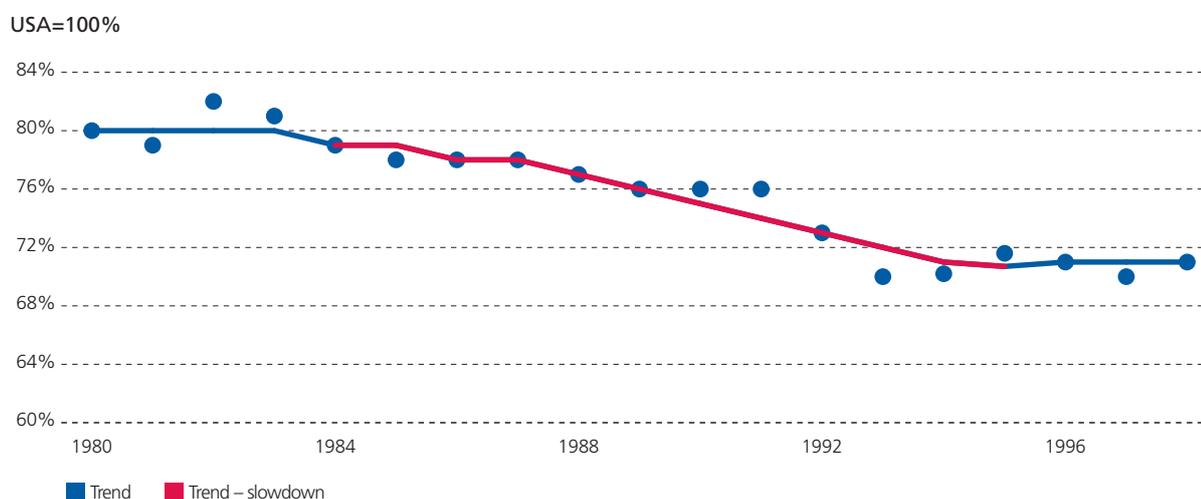
‘Since the crisis onset in 2008, the US in spite of mediocre growth has pulled further away from Europe in economic terms.’

Between 1980 and 2007, there were 11 episodes of slowdowns among EU-15 countries.¹² In contrast, there have been only seven episodes of accelerations.¹³ What’s more, four episodes of a slowdown can be found among new member states from Central and Eastern Europe, together with 10 episodes of growth accelerations. Ireland stands out as the country that most improved its position relative to that of the US, followed with a large gap by Finland, Spain, the UK, Portugal and Austria. The new member states, which joined the EU in 2004, also did well between 1993 and 2007, as they were catching up with the US and the western world in general. In contrast, one group of countries had a lower percentage of GDP per capita than the US in 2007 compared to 1980. The biggest relative

decline was registered in France, followed by (in decreasing order) Italy, Germany, Denmark and Belgium. Sweden and the Netherlands had similar relative positions in 2007 and 1980. So one can see that the aggregate picture of the decline of GDP per capita relative to the US between 1980 and 2007 masks different national growth stories.

In the following section we will present and briefly analyse the most interesting episodes of slowdowns and accelerations in the 1980 to 2007 period. In the case of Central and Eastern European countries, we consider only the period 1993-2007, as earlier performance was heavily affected by the initial transition shock and the data from the beginning of the 1990s is generally not reliable.

Chart 3: Swedish GDP per capita (1980-2000)



Source: Conference Board Total Economy Database (TED)

12 The jury is still out on how long the on-going slowdowns in the UK and Denmark will last.

13 This counts Luxembourg’s two growth episodes (1985-1993 and 1997-2007) as one. Spain is a border case, with only four years of growth above the threshold.

'Roughly two-thirds of the reduction of the cyclically adjusted deficit to GDP ratio in the EU in 2012 (relative to 2009) was achieved through tax hikes. Only about one-third of the adjustment came through expenditure cuts.'

3. Growth slowdown episodes in the EU-15 – A selection

a) Sweden (1984-1995)

9.1% decline of GDP per capita

GDP per capita in Sweden performed poorly in the 1970s and 1980s, falling to 79.9% of the US level in 1984, down from 83.7% in 1970.¹⁴ After 1984 the decline gained pace, with a further fall of more than four percentage points by 1990. The main cause was the limited competition in multiple sectors of the economy, which hindered productivity growth, according to the OECD.¹⁵ In the 1980s, the Swedish government was not keen to reform, with the exception of financial liberalisation. However, in an environment of high inflation, persistent fiscal deficits, a distortionary tax system and an unsustainable exchange rate, financial liberalisation

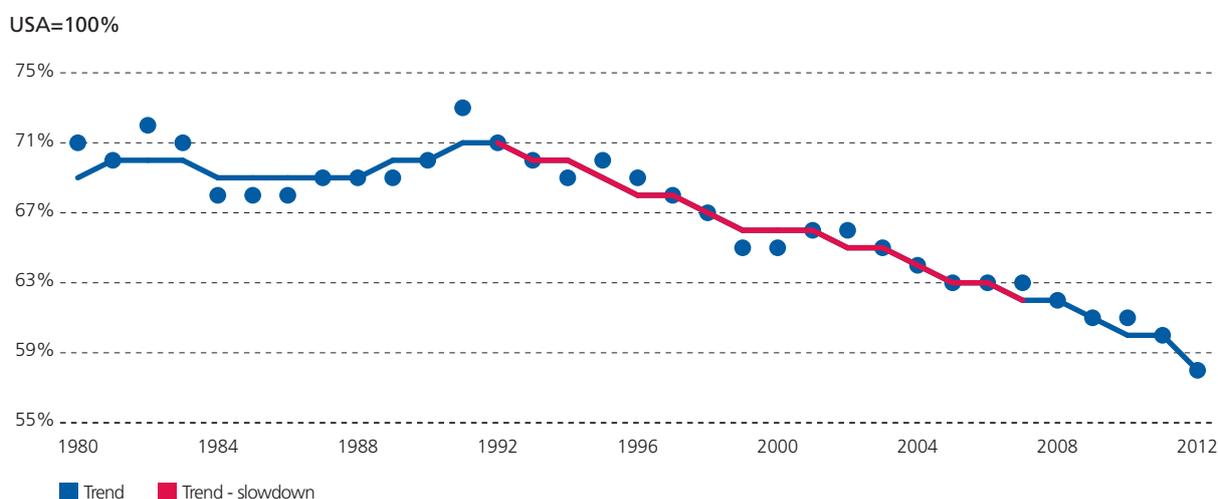
led to a banking crisis in 1991.¹⁶ The recession that followed led to further GDP declines, and by 1994, Swedish GDP per capita was only 71% of the US level. Only then, the process of wide-ranging structural reforms started, and that has paved the way to the current good performance of the Swedish economy (the details of this crisis response and its outstanding results will be discussed in the next chapter on page 16).

b) Italy (1992-2007)

8.3% decline of GDP per capita

Since the early 1990s, GDP growth in Italy has fallen behind not only the US, but also its European peers. Between 2000 and 2012, Italy was among the 10 worst performers in the world in terms of GDP per capita growth, together with countries such as Haiti, Yemen and Zimbabwe.¹⁷

Chart 4: Italian GDP per capita (1980-2012)



Source: Conference Board Total Economy Database (TED)

14 The performance of the Swedish economy in the 1970s and 1980s has been subject to lively debate. Lindbeck et al. [Assar Lindbeck, Per Molander, Torsten Persson, Olof Petersson, Agner Sandmo, Brigitta Swedenborg and Niels Thygesen, *Turning Sweden Around* (London: MIT, 1994)] have been pointing to the role of the extensive welfare state (eurosclerosis) as a systemic source of relative decline. However, Korpi (Walter Korpi, "Eurosclerosis and the Sclerosis of Objectivity: On the Role of Values Among Economic Policy Experts," *Economic Journal* 106, 1996) has argued that sample period selection used by Lindbeck et al. has been biased. Cerra and Saxena (Valerie Cerra and Sweta Saxena Chaman, "Eurosclerosis or Financial Collapse: Why Did Swedish Incomes Fall Behind?" *IMF Working Papers* 05/29, 2005) have argued that the fall of Sweden in the ranking of the richest economies can be explained by a banking crisis at the beginning of the 1990s.

15 Organisation for Economic Co-operation and Development, *Economic Surveys: Sweden* (Paris: OECD, 1989).

16 Stefan Ingves, Goran Lind, Masaaki Shirakawa, Jaime Caruana and Guillermo Ortiz Martinez, "Lessons Learned from Previous Banking Crises: Sweden, Japan, Spain and Mexico," Group of Thirty Occasional Paper 79, 2009.

17 Own calculation is based on data from the IMF, World Economic Outlook Database. <http://www.imf.org/external/pubs/ft/weo/2013/01/weodata/index.aspx>

‘The composition of the fall in credit and the still limited percentage of non-performing loans in comparison with their share after similar crisis outbreaks suggest that the balance sheets of European banks need to be strengthened.’

One of the main sources of Italy’s poor performance has been very limited competition in the sectors which are not exposed to international competition.¹⁸ As a result, the sectors which have accounted for a prevailing and growing part of GDP were especially harmed and constrained. For example, profit margins differentials between manufacturing and professional services in Italy are among the highest among its peers, indicating that a hefty economic rent is reaped by companies not exposed to international competition.¹⁹

High marginal tax rates are another drag on growth, particularly when coupled with a complicated tax code and a large shadow economy, making the playing field extremely uneven for law-abiding firms.²⁰ High tax rates have been accompanied by persistent deficits, with public debt exceeding 100% of GDP since 1991. Therefore, a bad fiscal

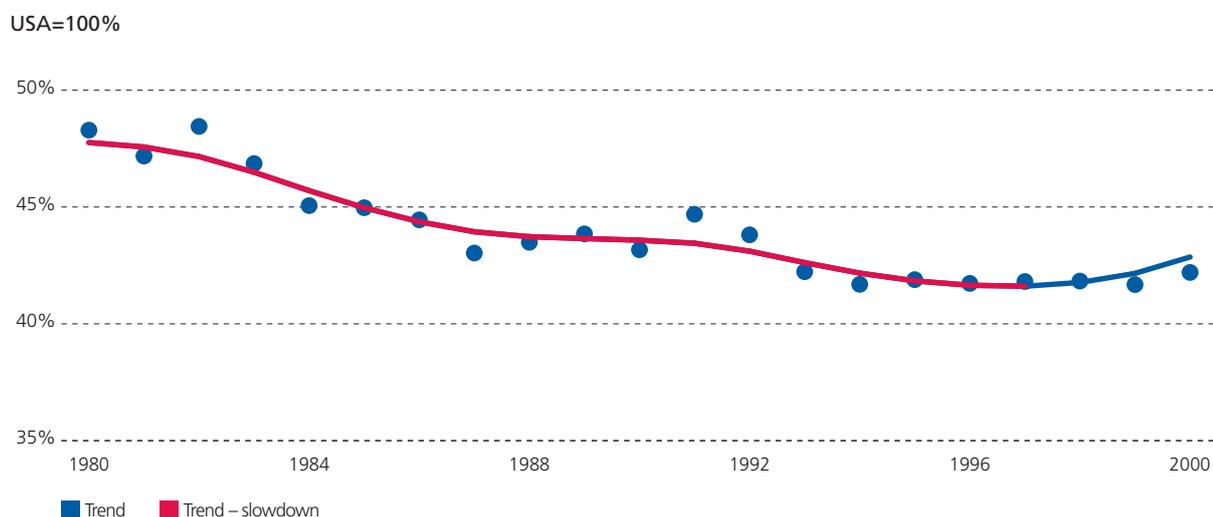
stance could be said to have been an important barrier to growth. Although there were some serious attempts to limit the deficit and reduce public debt in the 1990s, resulting in nearly balanced public finances in 2000, net lending increased again after the introduction of the euro, despite falling interest costs. A development like this could indicate a lack of political will to reduce public debt once the membership in the eurozone was secured.²¹

c) Greece (1980-1997)

6.1% decline of GDP per capita

In 1980, Greece was among the poorest countries of the EU, together with Ireland, Portugal and Spain.²² But, unlike the three other countries in that group, instead of converging towards the wealthier EU countries Greece diverged. From 1980 to 1997, the annual GDP per capita growth rate in Greece was only 0.56%, which was the lowest among all

Chart 5: Greek GDP per capita (1980-2012)



Source: Conference Board Total Economy Database (TED)

18 Lusine Lusinyan and Dirk Muir, “Assessing the Macroeconomic Impact of Structural Reforms The Case of Italy,” *IMF Working Papers* 13/22, 2013.

19 Lusine Lusinyan and Dirk Muir, “Assessing the Macroeconomic Impact of Structural Reforms The Case of Italy,” *IMF Working Papers* 13/22, 2013.

20 International Monetary Fund, “Italy: Staff Report for the 2011 Article IV Consultation with Italy,” *IMF Country Report* No. 11/173, 2011.

21 Jesus Fernandez-Villaverde, Louis Garicano and Tano Santos, “Political Credit Cycles: The Case of the Euro Zone,” *NBER Working Paper* No. 18899, 2013.

22 The description of this and the next episode on Greece is based on Marek Tatała, *Institutional and Political Causes of the Greek Crisis: Greece in a Comparative Perspective (1950-2011)*, Master’s thesis written under advisory of Leszek Balcerowicz, Warsaw School of Economics, 2013.

'Countries that performed better during the crisis could also benefit from further supply-side reforms, especially by opening up the service sectors.'

future eurozone countries. This resulted largely from policies that weakened systemic forces. Most notably, Greece experienced a significant fiscal expansion, which had a negative impact on the economic performance.²³ Between 1980 and 1997, the average annual deficit of the general government was almost 9% of GDP. As a consequence, Greece became the third most indebted country in the EU with the increase of the public debt in relation to GDP by over 70 percentage points until 1997 (only Belgium and Italy were then worse). This is another instance of a fiscal barrier to growth. The destructive political competition between the two dominant political parties (as compared to one party pre-1974) led to the development of a new political culture in which every election brought about further expansionary and redistributive policies as a method to attract voters.

Fiscal laxity was accompanied by the expansion of public-sector employment and generous wage increases. Between 1976 and 1997, general government employment grew 2.3% annually, compared to 0.55% growth in the economy as a whole.²⁴ At the same time, labour and product markets were extensively regulated, impairing competition and reinforcing the power and interests of highly protected insiders in the public and private sectors. Overly regulated labour markets hampered the employment rate, which declined to 53% of the labour force in 1997, down from 54% in 1980.²⁵ It is worth mentioning that in the 1980s, the labour participation rate in Portugal was almost 10 percentage points higher than in Greece.

Regulatory capture by rent-seeking interest groups – ranging from public-sector employees through liberal professions to truck drivers – stifled growth in productivity.²⁶ As a result, productivity in Greece declined by 3% between 1980 and 1997.²⁷ Growing complexity of the tax system induced endemic tax evasion, which together with high marginal tax rates and new taxes caused Greece to move away from the pre-1974 pro-business and pro-investment climate.²⁸ Low business attractiveness of Greece was reflected by the lowest foreign direct investment inflows in the 1980-1997 period among today's troubled European countries (Portugal, Ireland, Greece and Spain). At the same time, Greece was the least free country among those countries, according to the Economic Freedom of the World Index.²⁹

d) Portugal (2000-2007)

2.1% decline of GDP per capita

The decline of less than 4 percentage points over a period of 12 years might seem relatively small. However, taking into account that Portugal was the poorest among the EU-15 countries in 2000 (along with Greece), one would expect convergence to the US level instead of divergence. The poor performance of Portugal between 2000 and 2007 is puzzling, as the country attracted large capital inflows during that time. Yet, instead of a boom, Portugal experienced a slump. Ricardo Reis presents an interesting explanation of the enigma, showing how large capital inflows were misallocated, leading to an expansion in non-tradable sectors with no significant gains in productivity.³⁰ According to Professor Ries, the economy took a further hit from

23 George Alogoskoufis, "The Two Faces of Janus: Institutions, Policy Regimes and Macroeconomic Performance in Greece," *Economic Policy* 10(20), 1995.

24 Vassilios G. Manessiotis and Robert D. Reischauer, "Greek Fiscal and Budget Policy and EMU," in Ralph C. Bryant, Nicholas C. Garganas and George S. Tavlas (eds), *Greece's Economic Performance and Prospects* (Athens: Bank of Greece and Washington: Brookings Institution, 2001).

25 The employment rate figures refer to 15- to 64-year-olds.

26 Michael Mitsopoulos and Theodore Pelagidis, "Vikings in Greece: Kleptocratic Interest Groups in a Closed, Rent-Seeking Economy," *Cato Journal* 29 (3), 2009.

27 Productivity measured with Total Productivity Factor, which is the part of economic growth that cannot be explained by growing inputs of labour and capital. Data source: AMECO.

28 George Alogoskoufis, "The Two Faces of Janus: Institutions, Policy Regimes and Macroeconomic Performance in Greece," in *Economic Policy* 10(20), 1995.

29 James Gwartney, Robert Lawson and Joshua Hall, *Economic Freedom of the World: 2013 Annual Report* (Calgary: Fraser Institute, 2013).

30 Ricardo Ries, "The Portuguese Slump-Crash and the Euro-Crisis Spring 2013," *Brookings Panel on Economic Activity*, 22-23 March 2013.

‘The gap in GDP per capita between the EU-15 and the US can be largely explained by persistently lower productivity, lower employment and less human capital.’

the distortionary tax increases needed to finance fast-growing old-age pension expenditures.

In a National Bureau of Economic Research (NBER) working paper, a group of economists led by Jesus Fernandez-Villaverde argued that the introduction of the euro and resulting low interest rates might have led to a worsening of the institutional framework in Southern Europe.³¹ As far as Portugal is concerned, these economists point to unsustainable falling productivity between 1999 and 2005 and many restrictions to competition. “Instead of forcing a positive institutional evolution in Portugal, the euro allowed both the public and the private sector to postpone the day of reckoning,” they conclude.

4. Growth acceleration episodes in the EU-15 – A selection

a) Sweden (1997-2007)

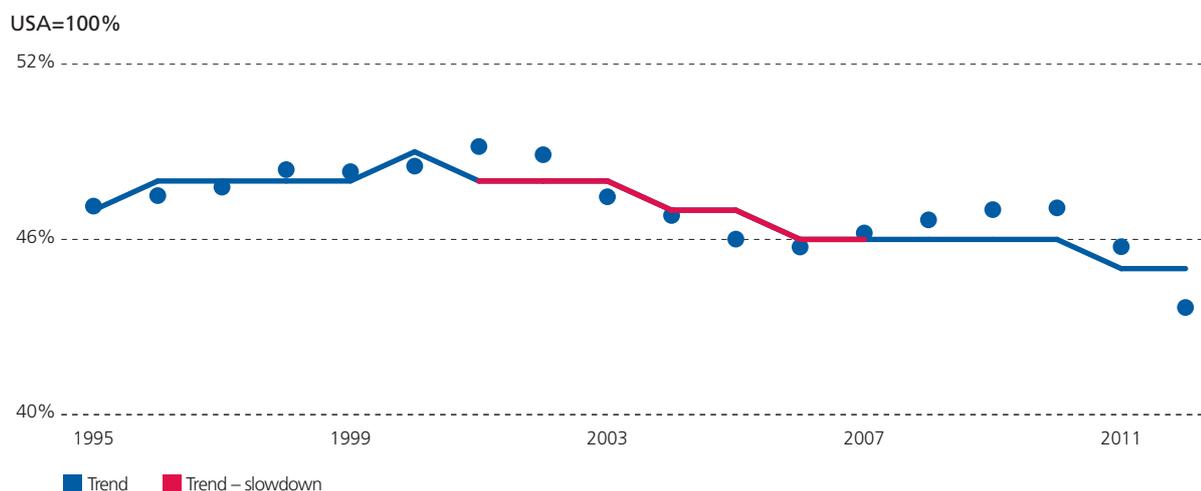
7.4% rise of GDP per capita

Between 1993 and 1997, the Swedish GDP per capita oscillated at around 70% of the GDP per capita of the US. Since then, however, the gap has declined rapidly. Today, it is around 85%.³²

First, the resolution of the 1991 banking crisis is regarded as a model for others with early recognition of banking problems, followed by an in-depth and comprehensive intervention and a tough stance against existing shareholders.³³

Second, Sweden implemented many needed structural reforms, thus strengthening the systemic growth forces. Competition in previously protected sectors was increased. The OECD estimates that

Chart 6: Portugal’s GDP per capita (1995-2012)



Source: Conference Board Total Economy Database (TED)

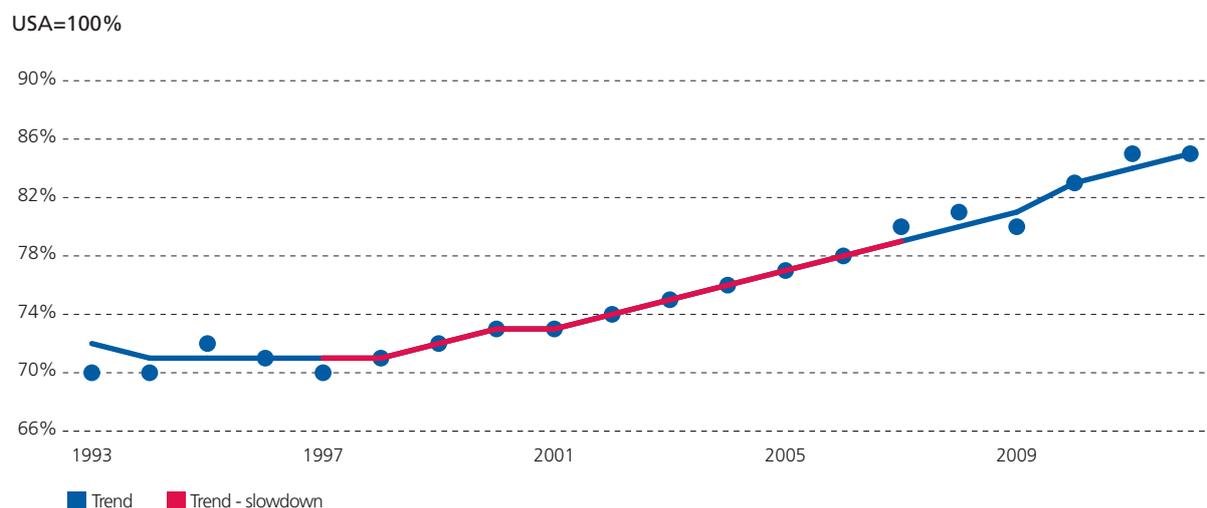
31 Jesus Fernandez-Villaverde, Louis Garicano and Tano Santos, “Political Credit Cycles: The Case of the Euro Zone,” *NBER Working Paper* No. 18899, 2013.

32 The data is for 2012.

33 Claudio Borio, Bent Vale and Goetz von Peter, “Resolving the Financial Crisis: Are We Heeding the Lessons from the Nordics?” *BIS Working Papers* 311, 2010.

'Growth accelerations are largely caused by credit booms or the strengthening of systemic forces.'

Chart 7: Swedish GDP per capita (1993-2012)



Source: Conference Board Total Economy Database (TED)

deregulation added around 0.4 percentage points to annual productivity growth in the business sector between 1994 and 2003.³⁴ A study from the McKinsey Global Institute shows productivity gains on the sectoral level (automotive industry, retail banking, retail trade, processed food), and demonstrates how changes in zoning law – obliging municipalities to consider competition issues – encouraged new establishments by driving up competition, with productivity growing 4.6% annually between 1990 and 2003 (compared to 4.2% in the US and 2.3% in Germany).³⁵ Furthermore, more competition has led to growth in productivity in processed food. The result was tangible for consumers: between 1990 and 2005, grocery prices in Sweden increased by a mere 4% compared to a 35% jump in the consumer price index.

Finally, fiscal consolidation of nearly 11% of GDP was undertaken between 1993 and 1998, with the main focus on expenditures, which were cut by around 7%, compared with revenue increase of around 4%.³⁶ As a result, the ratio of expenditures to GDP declined to 60% in 1997 and further to slightly above 50% in 2012, down from more than 70% in 1993. Sweden has shown how an improved fiscal stance can strengthen longer-term economic growth.

b) Ireland (1987-2004)

37.6% rise of GDP per capita

Ireland is an example of how releasing growth potential can yield phenomenal results. In the 1980s, the Republic of Ireland had a well-educated, English-speaking, young and underemployed

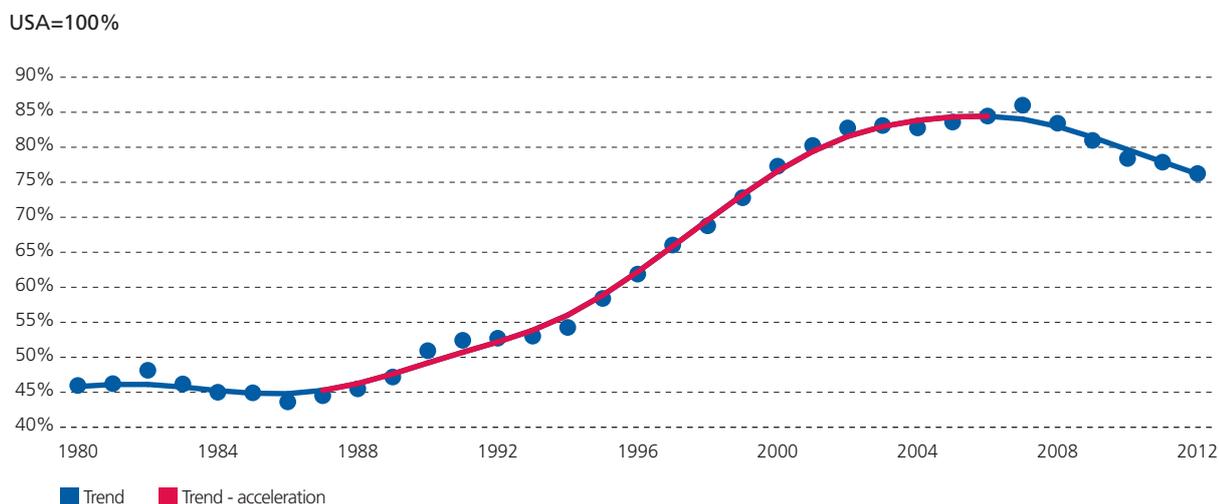
34 Espen Erlandsen and Jens Lundsgaard, "How Regulatory Reforms in Sweden Have Boosted Productivity," *Economics Department Working Paper No. 577* (Paris: OECD 2007).

35 McKinsey Global Institute, *Sweden's Economic Performance: Recent Development, Current Priorities* (San Francisco: McKinsey Global Institute, 2006).

36 Andrea Pescatori, Daniel Leigh, Jaime Guajardo and Pete Devries, "A New Action-based Dataset of Fiscal Consolidation," *IMF Working Papers* 11/128, 2011.

'GDP per capita in Sweden performed poorly in the 1970s and 1980s. The main cause was the limited competition in multiple sectors of the economy, which hindered productivity growth.'

Chart 8: Irish GDP per capita (1980-2012)



Source: Conference Board Total Economy Database (TED)

population. It also had access to the EU common market and funds. However, GDP per capita was much below the EU average, indicating potential for convergence.³⁷ The country was predisposed to grow fast, as its institutional framework was also conducive to fast economic growth.³⁸ However, this potential was blocked by chronically ill public finances and the related fiscal instabilities.

At the beginning of the 1980s, Ireland suffered a prolonged fiscal crisis and failed tax-based fiscal consolidations. However, in the second half of the decade, the main political parties finally agreed to fix public finance through cuts in spending to remove uncertainty, paving the way for a decade of rapid economic growth.³⁹ A radically improved fiscal stance released the growth potential of the Irish economy. Other growth factors were also favourable. But around 2000, the almost 20-year-

long expansion was coming to an end. GDP per capita had caught up with the EU average and the underemployment was gone. Unfortunately, the above EU-average GDP growth continued, but mainly due to an unsustainable housing boom that ended with the crisis in 2007.⁴⁰

c) Greece (2000-2007)

7.2% rise of GDP per capita

When Greece finally joined the eurozone, its credibility rose significantly.⁴¹ This allowed the government to borrow money at low interest costs. However, the windfall gains were not used to reduce public debt, but to finance fiscal expansion. The average annual deficit of the general government reached almost 6% of GDP in the 2001-2007 period. By 2007, Greece was the most indebted state in the EU. This fiscal expansion, together with some deregulation in telecommunication

37 Less developed countries with lower GDP per capita can, ceteris paribus, grow faster than more developed countries due to the import of technology and know-how.

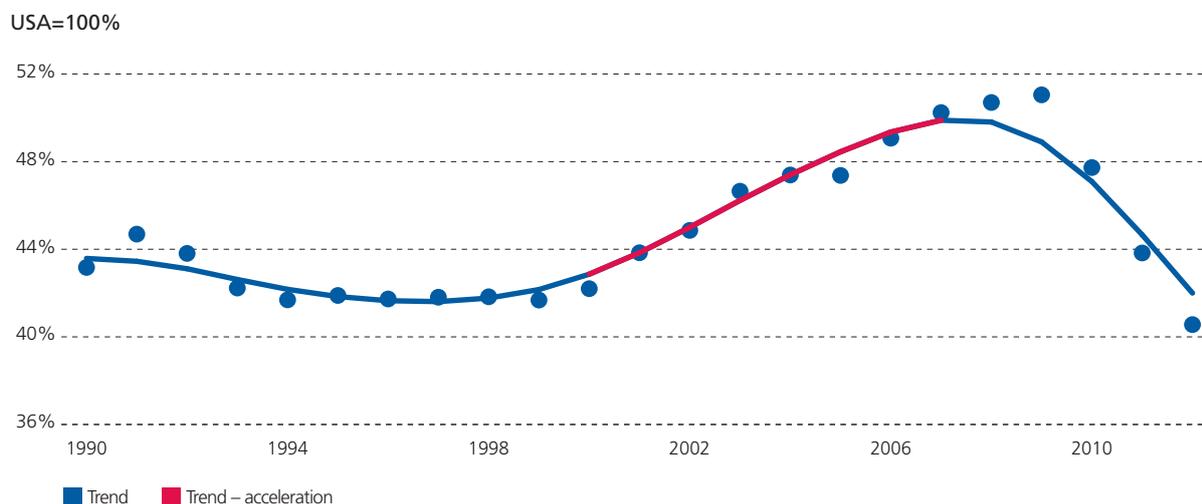
38 Karl Whelan, "Policy Lessons from Ireland's Latest Depression," *The Economic and Social Review, Economic and Social Studies* 41(2), 2010.

39 Andrea Pescatori, Daniel Leigh, Jaime Guajardo and Pete Devries, "A New Action-based Dataset of Fiscal Consolidation," *IMF Working Papers* 11/128, 2011.

40 Whelan, *op. cit.*

41 The description of this and the previous episode on Greece is based on Tatala, *op. cit.*

Chart 9: Greek GDP per capita (1990-2012)



Source: Conference Board Total Economy Database (TED)

and in certain product markets, coupled with the liberalisation of credit markets and a favourable external environment, allowed for a period of fast, but unsustainable growth.⁴²

The pre-accession fiscal consolidation in 1994-2000 was mostly revenue-based and brought only temporary deficit reduction with higher deficits after the Economic and Monetary Union (EMU) entry in 2001. The post-accession fiscal constraints were weak due to the low interest costs. At the same time, the surveillance by the European Union institutions and the IMF was deficient. Here is a quote from the IMF report on Greece written in 2008, just before the crisis outbreak: “In view of Greece’s EMU membership, the availability of external financing is not a concern, but the correction of cumulating indebtedness could weigh appreciably on growth going forward.”⁴³

One of the reasons for high public spending was an extensive public sector, with the ratio of general government employment to total employment 4-6 percentage points higher in Greece than in the other troubled countries (Portugal, Ireland and Spain). Even more importantly, the public- to private-sector compensation ratio increased to 2.3 in 2007, up from around 1.8 in 1994. At the same time, the average value of this ratio in the euro area was around 1.2.⁴⁴

Proper functioning of the labour market was inhibited by a high and increasing tax wedge, a high minimum wage, strict employment protection legislation and an inefficient education system.⁴⁵ Product markets were also highly regulated in comparison to Portugal, Ireland, Spain and other OECD countries. In general, Greece during this period was considered one of the least free economies in the EU and an unattractive place to do

42 Michael Mitsopoulos and Theodore Pelagidis, *Understanding the Crisis in Greece: From Boom to Bust* (Basingstoke: Palgrave Macmillan, 2011).

43 International Monetary Fund, “Greece: Staff Report for the 2007, Article IV Consultation,” *IMF Country Report* No. 08/148, 2008.

44 Tryphon Kollintzas, Dimitris Papageorgiou and Vangelis Vassilatos, “An Explanation of the Greek Crisis: ‘The Insiders – Outsiders Society,’” *CEPR Discussion Paper* 8996, 2012.

45 Organisation for Economic Co-operation and Development, *Education Policy Advice for Greece* (Paris: OECD, 2011).

business.⁴⁶ As a result of credit-driven, fast-growing demand not matched by increasing competitiveness of a tightly regulated economy, the trade deficit rose sharply to more than 18% of GDP in the year preceding the crisis, up from 12% of GDP before eurozone accession.⁴⁷ Greece in the 2000-2007 period offers a dramatic example of unsustainable, boom-based growth acceleration pursued under weakening systemic growth forces.

d) Germany (2005-2012)

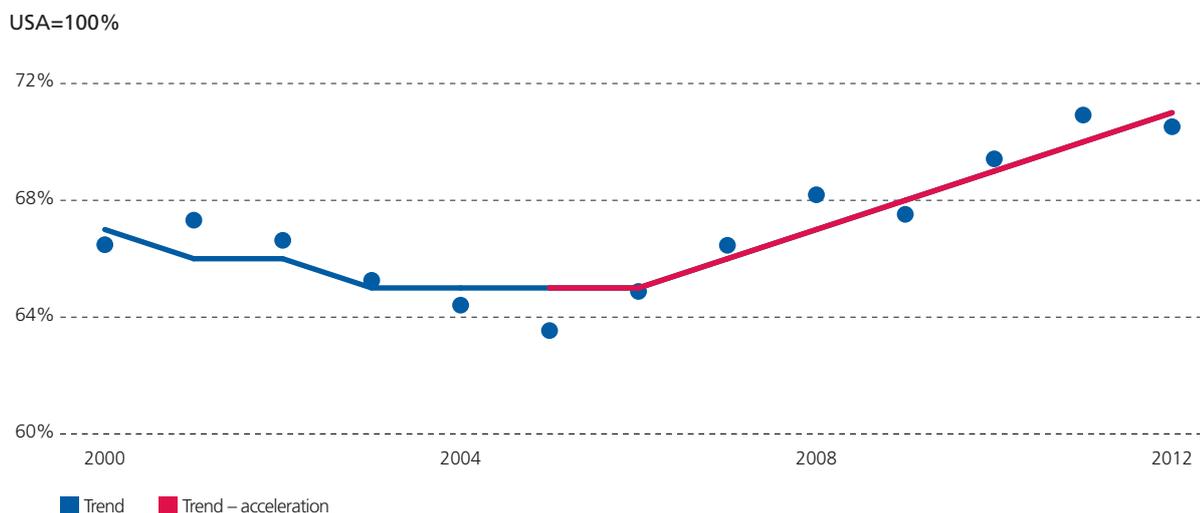
5.7% rise of GDP per capita

Germany's performance after 2005 transformed the international perception of the country from the "sick man of Europe" to the poster child.⁴⁸ Deutsche Bank economist Bernhard Graf and his colleagues have well documented this transition. In the second half of the 1990s, the growth rate

of the German economy was among the lowest in the EU, almost on par with that of the Italian economy. Public debt as a proportion of GDP was on the rise (40.4% in 1991, 60.9% in 1999), as was the unemployment rate (5.5% in 1991, 8.6% in 1999). The global slowdown after the burst of the new economy bubble in 2000 made the need for reform even more pressing.

The aim of the German reforms package, later labelled "Agenda 2010," was a reconstruction of the overly expensive social security system, an increase in labour market flexibility and a consolidation of public finances. The core of the package consisted of labour market reforms called Hartz. These were implemented between 2003 and 2005. As a result: 1) unemployment benefits and social assistance were merged, reducing the generosity of the system;

Chart 10: German GDP per capita (2000-2012)



Source: Conference Board Total Economy Database (TED)

46 See OECD indices, Economic Freedom of the World Index and World Bank Doing Business reports.

47 Michael Mitsopoulos and Theodore Pelagidis, "Vikings in Greece: Kleptocratic Interest Groups in a Closed, Rent-Seeking Economy," *Cato Journal* 29 (3), 2009.

48 The description of German acceleration after 2005 is based mainly on Bernhard Graf, Oliver Rakau and Stefan Schneider, *Focus on Germany, Current Issues* (London: Deutsche Bank Markets Research, 2013). Although this episode does not meet our definitional criteria (see page 11) we include it because of the economic importance of Germany.

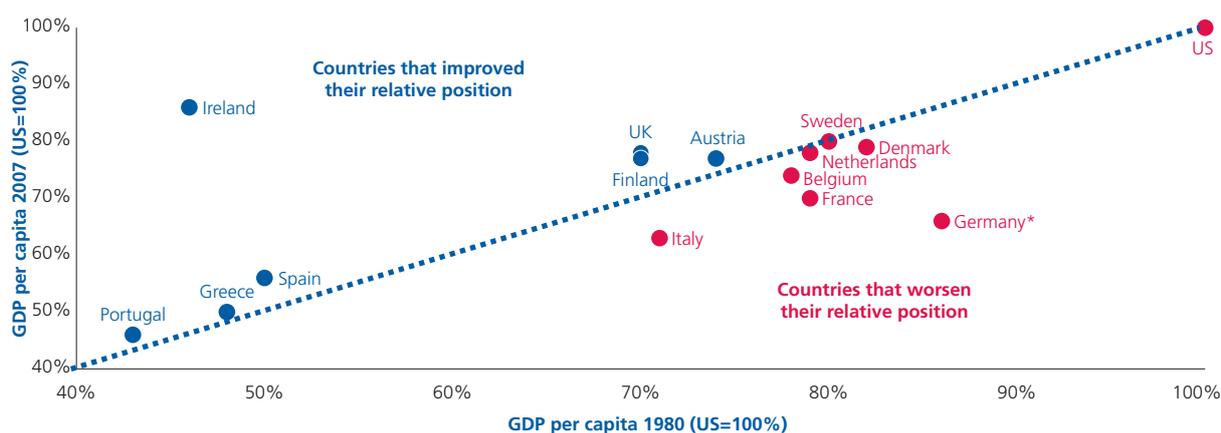
‘Between 2000-2012, Italy was among the 10 worst performers in the world in terms of the GDP per capita growth, together with countries such as Haiti, Yemen and Zimbabwe.’

2) the long-term unemployed had to accept jobs even below their qualification; 3) employment protection was lowered for smaller companies; and 4) the federal labour agency was revamped into a modern Federal Employment Agency, focused on putting its “clients” back to work. Simultaneously, the pension system was reformed – early retirement was heavily discouraged by properly calculated discounts, and the legal retirement age was lifted from 65 to 67 (the shift is being phased in from 2012 until 2031). Further, more flexibility was allowed in intra-firm labour markets, allowing firms to cut hours worked and salaries in downturns, instead of cutting employment.⁴⁹ According to the IMF, the reforms lowered the steady state unemployment rate to around 6.25%, down from more than 8%.⁵⁰ Looking at the current performance of the German economy, one might quote the OECD,

which states that “past labour market reforms paid off handsomely during the crisis.”⁵¹ Therefore, Germany provides an example of structural reforms which strengthen systemic forces and, as a result, the growth of the economy.

Overall, between 1980 and 2007, the relative gap with the US declined in seven EU-15 countries. The largest gains were made by the UK, Spain, Finland and Ireland. However, as the next section will show, with the exception of Finland and to some degree Ireland, these improvements were not sustainable.⁵² As far as laggards are concerned, it should be noted that they include three of the five biggest EU-15 states – namely France, Italy and Germany. In the case of both Italy and France, weakness of systemic forces resulted in nearly uninterrupted decline relative to the US over the whole period.

Chart 11: GDP per capita in 1980 and 2007



*Germany 1989-2007; Luxembourg as a special case of city-state and financial centre is not comparable and thus is not shown.
Source: Conference Board Total Economy Database (TED)

49 OECD 2012 estimates that this flexibility can explain two-thirds of the fall in hours during the recession of 2009, when unemployment in Germany rose only marginally by 0.2 percentage points as opposed to the average jump of 2.2 percentage points in other OECD countries.

50 International Monetary Fund, *Staff Report for the Article IV Consultations with Germany* (Washington: IMF, 2011).

51 Organisation for Economic Co-operation and Development, *Education Policy Advice for Greece* (Paris: OECD, 2011).

52 It should also be noted that Luxembourg has made significant gains as well and even overtook the US in terms of GDP per capita. One should, however, remember that this is a special case of a small city-state and an international financial centre, thus being incomparable to other countries.

'From 1980 to 1997, the annual GDP per capita growth rate in Greece was only 0.56%, which was the lowest among all future eurozone countries.'

5. The new member states

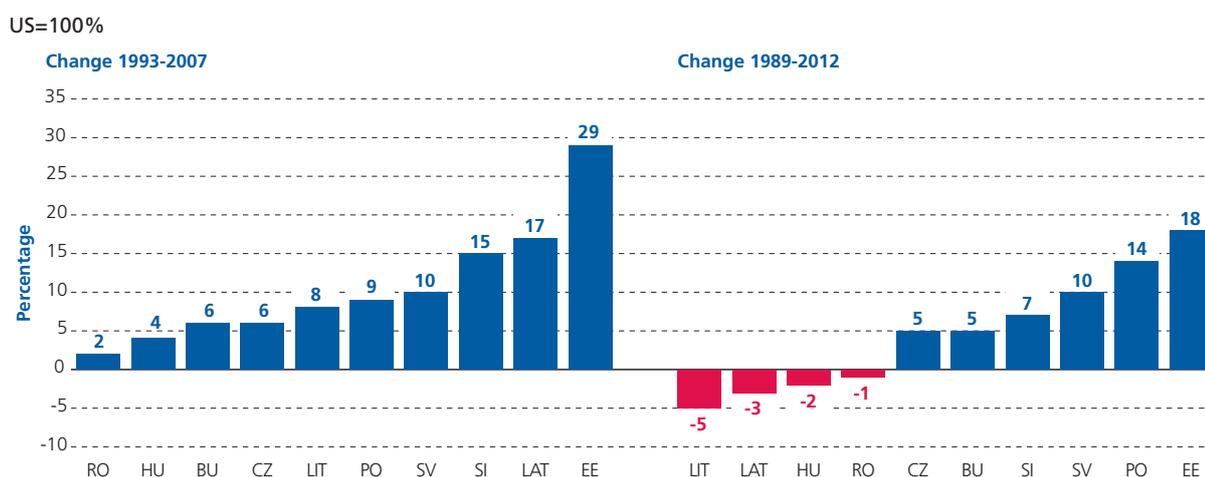
The post-socialism transition at the beginning of the period under study resulted in a decline of GDP per capita, which to some extent can be attributed to measurement errors (the national accounts of socialist economies had goods priced by planners and not by markets, making all prices and economic values far from credible). But the key point is initial declines lasted longer in countries that postponed stabilisation and market reforms. With hindsight, it is clear that radical stabilisation and liberalisation best and most quickly encouraged recovery and transition to a private economy.⁵³

Ranking the new member states by their relative performance relative to the US heavily depends on the choice of base year and the cut-off date. The year 1989, for example, favours countries that were able to start their transition in 1990 and

therefore started to grow again sooner than late-movers. However, some countries were not able to start reforms that early – e.g. Estonia, Latvia and Lithuania were not independent yet. Choosing a later base year, therefore, favours countries that started reforms later. For them, 1992-1993 was often the year of the lowest level of GDP and thus the lowest possible denominator. As far as the end date is concerned, 2007 favours countries that in previous years experienced unsustainable credit booms (e.g. Latvia and Estonia). Nevertheless, one can conclude that, irrespective of exact time frames, Estonia, Poland and Slovakia were among the best performing countries, while Romania and Hungary were among the worst performers.

The economists Bas B. Bakker and Anne-Marie Gulde and, later, Anders Åslund have documented developments after 2000.⁵⁴ Countries lagging behind started to reform faster, which led to

Chart 12: New member states' change in GDP per capita in percentage points



Source: Conference Board Total Economy Database (TED)

53 See Leszek Balcerowicz, *Socialism, Capitalism, Transformation* (Budapest: Central European University Press, 1995) and Anders Åslund, *How Capitalism Was Built* (Cambridge: Cambridge University Press, 2007).

54 Bas B. Bakker and Anne-Marie Gulde, "The Credit Boom in the EU New Member States: Bad Luck or Bad Policies?" *IMF Working Papers*, 2010. Anders Åslund, *How Capitalism Was Built* (Cambridge: Cambridge University Press, 2007).

'In the 1980s, the labour participation rate in Portugal was almost 10 percentage points higher than in Greece.'

faster GDP growth rates. The effect was amplified by accession to the EU and general optimism, resulting in large capital inflows. Inflowing capital through the banking sector in most countries was invested mainly in the non-tradable sector, increasing domestic demand and wage pressure, and undermining the competitiveness of the overall economy. This was reflected in enormous current account deficits. Such developments came to a quick reversal after the outburst of the global financial crisis. Countries that experienced the biggest booms during the 2003-2007 period also suffered the worst GDP collapses between 2008 and 2010. With hindsight, one can say that banking supervision in the Baltic states where the boom was the biggest should have acted earlier and more decisively. Also worth noticing are the large errors made by the European Commission, the International Monetary Fund and the country

authorities in the estimation of potential GDP and the structural balance of public finance.⁵⁵ As a result, what then seemed as quite prudent fiscal policy turned out to be expansionary.

6. Comments and analysis

Different patterns can be observed when looking at the episodes of slowdown and acceleration between 1980 and 2007. But the fact is, banking crises in Sweden and Finland in the early 1990s, the fiscal crisis in Ireland in the 1980s and the decline of competitiveness in Germany gave birth to the reforms that later resulted in growth acceleration. Greece also experienced rapid growth after a long period of decline, but, contrary to previous cases, growth there was based on an unsustainably growing indebtedness of both the private and public sectors

Chart 13: Boom...

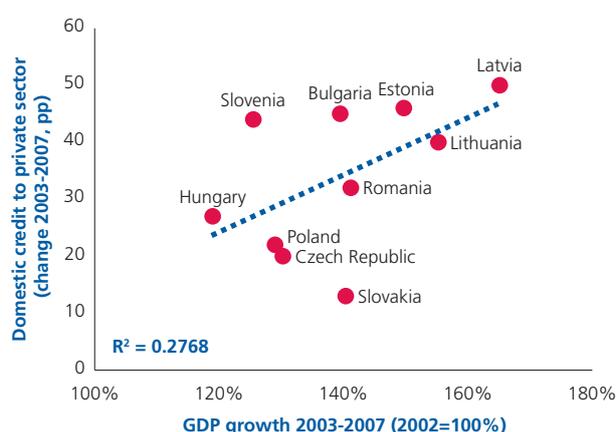
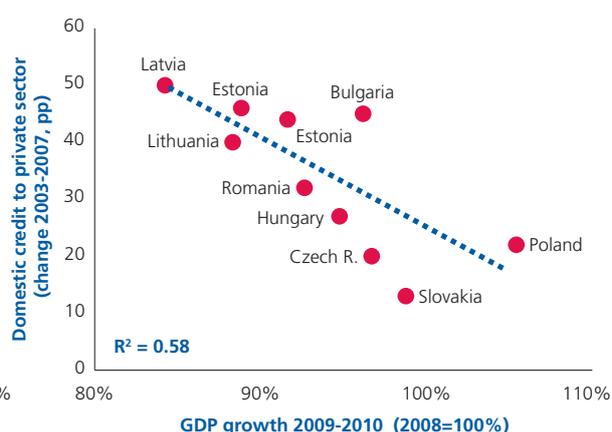


Chart 14: ...Bust



Source: World Bank World Development Indicators, AMECO

55 For example, in 2007 the European Commission estimated that taking into account cyclical adjustment, general governments of Latvia and Estonia had surpluses of 0.2% GDP and 2.4% GDP, respectively. Later, with hindsight, the Commission stated that the countries had deficits of -4.3% and -1.5% of GDP, respectively. So the revision of cyclically-adjusted net lending or net borrowing amounted to around 4 percentage points.

'In Greece, fiscal laxity was accompanied by the expansion of public-sector employment and generous wage increases. Between 1976 and 1997, general government employment grew 2.3% annually, compared to 0.55% growth in the economy as a whole.'

that paved the way for the next crisis. On the other hand, the long decline in Italy and, to some extent, in France has not led to any significant reforms or growth acceleration.

Overall, the credit booms taking place before 2007 had strong, negative impact on economic performance after 2007. It should be noted however, that not all credit booms resulted in growth acceleration (e.g. Portugal). Furthermore, some countries that did not experience credit booms (e.g. Italy and France) have nonetheless run into major economic troubles, as other, mainly institutional, factors also played a role.

The large decline in long-term interest rates from the late 1990s essentially provided governments with a choice: they could use lower interest rates to reduce government debt, or they could use it to pursue fiscal expansion. There were differences in policy choices among the EU-15 countries. From 1999 to 2007, government debt in Greece, Portugal and France rose. Debt rose also in Germany, but at the same time Germany introduced labour market reforms, controlled the unit-labour costs dynamic and accelerated growth. That did not happen in Greece, Portugal or France. In countries where government debt fell, there were differences in the scale of public debt reductions. For example in 1999, public-debt ratios were very similar in Italy and Belgium (121% of GDP in Belgium and 128% in Italy). By 2008, they had been reduced to 91% in Belgium, but only to 113% in Italy.

In both Spain and Ireland, there was a major reduction of public debt, and in both countries public indebtedness appeared manageable by 2007. By contrast, in Greece and Portugal, public debt as a proportion of GDP grew between 1999 and 2007 to more than 100% and 60% of GDP, respectively.

There were countries that increased the share of public spending to GDP, such as France, Greece, Ireland, Portugal and the UK (also Cyprus and Malta). But there were differences in the type of new public expenditure in those countries. Spain and Ireland increased their public-investment expenditure. Conversely, Greece and Portugal experienced a period of high expenditure not reflected in investment. Their ratio of public investment to GDP declined in 2007 with respect to 1999, especially in Portugal.

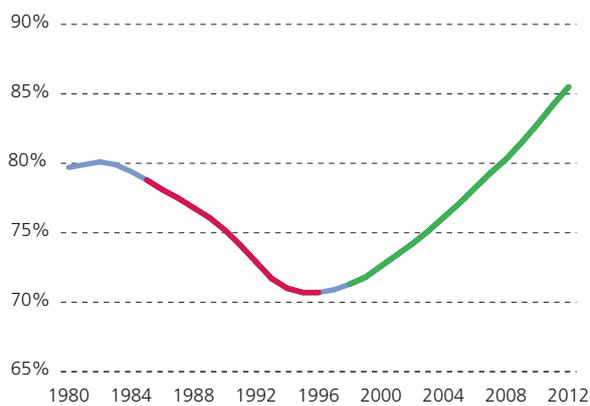
The Fraser Institute's and Heritage Foundation's Indices of Economic Freedom, like measures of the extent of government interference in an economy, after converging in the 1980s and 1990s, have declined in Southern Europe (Greece, Italy, Portugal, Spain) over the past 10 years relative to Northern Europe. In 2000, Portugal was No. 22; Spain was No. 24; Italy was No. 34; France was No. 35, Malta was No. 63, Greece was No. 54 and Cyprus No. 74.⁵⁶ These were the worst positions among the EU-15 countries. In other words, gaps in governance were well known already in the 1990s when the euro was being introduced, but have widened since then instead of diminishing.

56 Gwartney et al., *op.cit.*

'Instead of forcing a positive institutional evolution in Portugal, the euro allowed both the public and the private sector to postpone the day of reckoning.'

Chart 15: Sweden

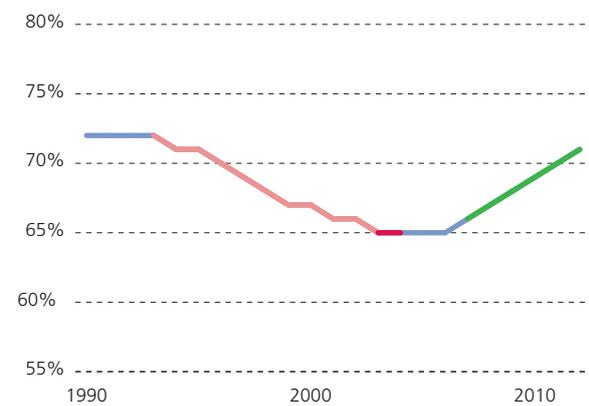
Slowdown-crisis-acceleration



Source: Conference Board Total Economy Database (TED)

Chart 16: Germany

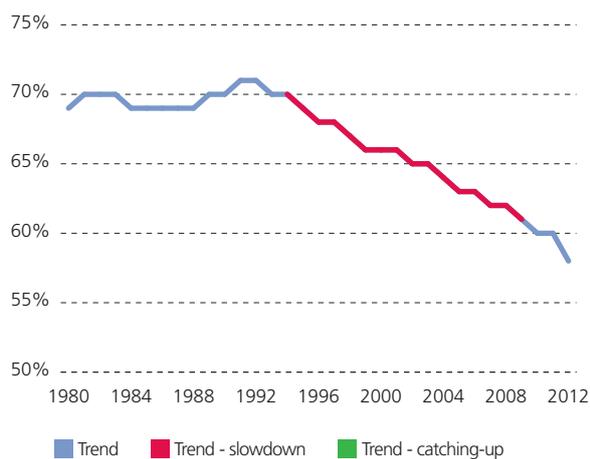
Decline-acceleration



Source: Conference Board Total Economy Database (TED)

Chart 17: Italy

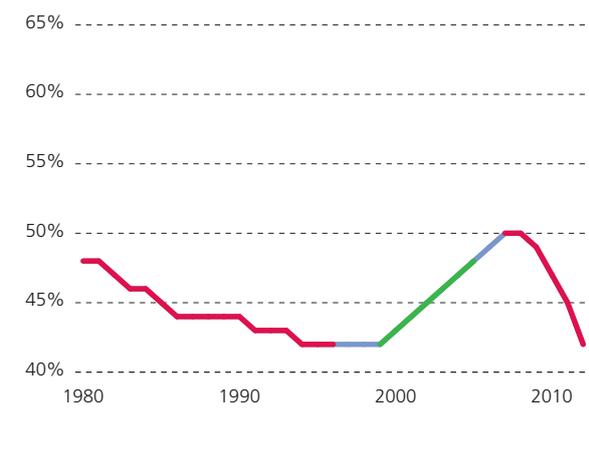
Long decline



Source: Conference Board Total Economy Database (TED)

Chart 18: Greece

Decline-boom-decline



Source: Conference Board Total Economy Database (TED)

Economic growth in the EU (2008-2012)

1. Major trends in European growth since the onset of the crisis

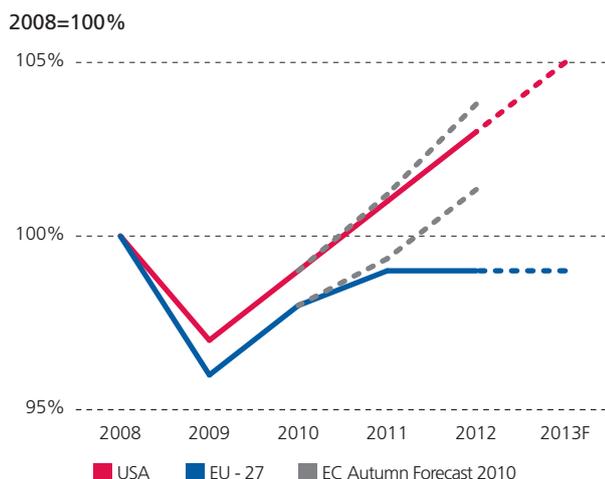
Economic growth in the EU since the onset of the global financial crisis in 2007 has been disappointing (see chart 19 below).⁵⁷ It has been worse not only than in the US, but also than in Japan during the four initial years of its “lost” period (regardless of the year recognised as the beginning of that period). In this section, we will look first at growth in the EU from the demand point of view. Then, we will consider the dynamics of potential output and labour productivity.

Starting from the demand point of view, it is notable that net exports in Europe contributed positively to GDP growth (see chart 20 below). Imports have not decreased, so the contribution comes entirely from an increase in exports. What’s more, EU exports increased more relative to 2008 GDP than in the US. These facts should be regarded as important signs of fundamental adjustment in EU countries, all the more so since the strongest

external adjustment has occurred in member states that had previously developed the largest current account deficit (we will discuss this trend in greater detail in the next section on variation in growth in the EU, which begins on page 28).

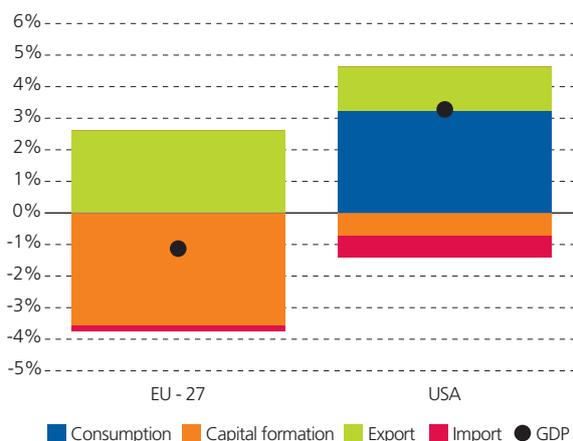
By contrast, the EU suffered a deep fall in gross capital formation, which, in turn, resulted in more than 80% from the fall in gross fixed capital formation.⁵⁸ This was largely a reaction to previous overinvestment, as the construction investment accounted for about two-thirds of this fall (see chart 21 on the next page). The decline in investment in housing was deepest, while the decrease in non-residential construction and the total adverse effect of construction on investment was weaker than in the US. However, the negative contribution of total fixed investment to GDP growth was twice as large as the equivalent figures in the US. That difference stemmed partly from the larger share of investment in GDP than in the US, which implies a stronger impact from the given percentage change of investment on GDP. However, in addition, it

Chart 19: GDP trends



Sources: AMECO, European Commission

Chart 20: Composition of GDP growth (2008-2012)

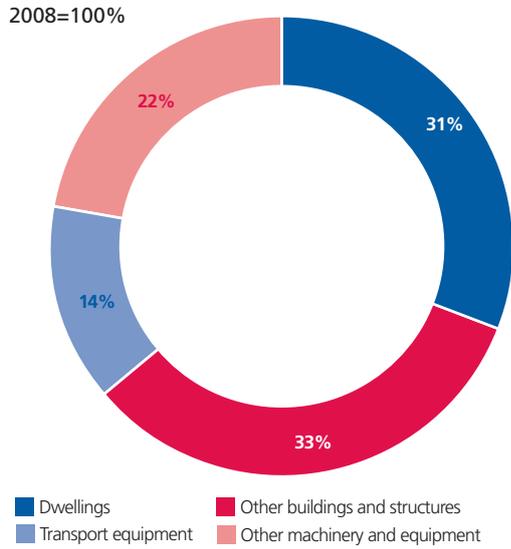


Source: AMECO

⁵⁷ Unless otherwise stated, all data in this and subsequent sections are taken from the Eurostat or Ameco database.

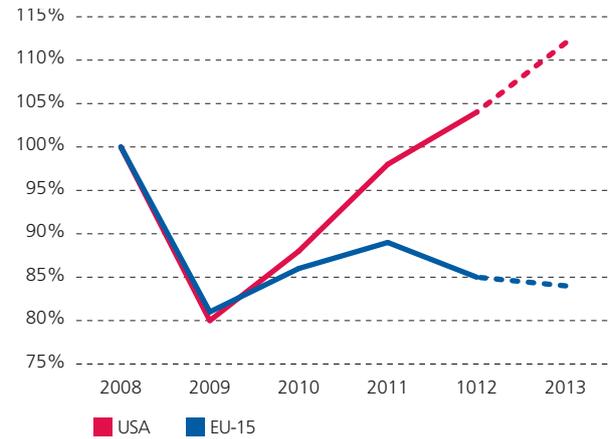
⁵⁸ Gross capital formation consists of gross fixed capital formation, i.e. investment outlays, and of changes in inventories.

Chart 21: Structure of fall in capital formation in EU-27 (2008-2012)



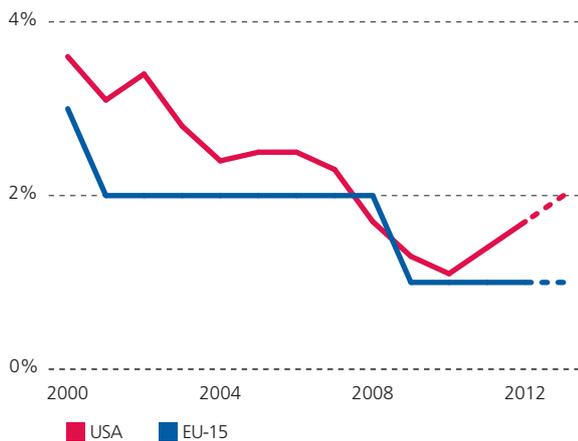
Source: AMECO

Chart 22: Investment in equipment



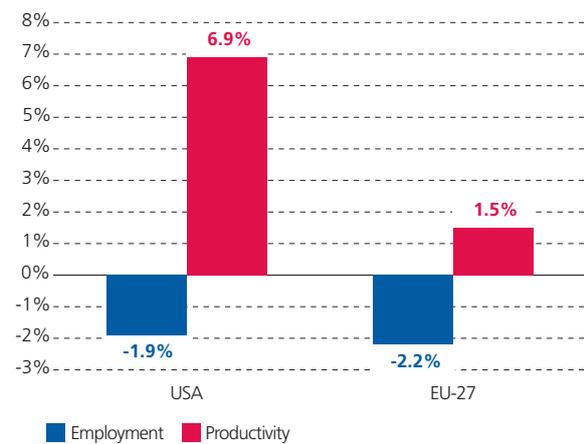
Source: AMECO

Chart 23: Potential GDP growth rate



Source: AMECO

Chart 24: Change in employment and labour productivity (2008-2012)



Source: Conference Board Total Economy Database (TED)

‘Sweden has shown how an improved fiscal stance can strengthen longer-term economic growth.’

also resulted from the dynamics of investment in equipment, which dropped in the EU, whereas it increased in the US (see chart 22 on page 27). The decline of this variable in the EU points to serious confidence problems in at least some member countries, given that many firms’ financial situations do not appear to differ much between the EU and the US, and spare capacity in the EU seems to be lower than in the US.

Consumption had zero contribution to domestic demand and thus to GDP growth with the fall in private consumption fully offset by the increase in government consumption. Interestingly, the increase in government consumption contributed marginally more to GDP growth in the EU than in the US, although the deficit in 2008-2009 increased less in the EU than in the US, and since 2010 has been reduced in the EU more than in the US. The larger increase of government consumption relative to 2008 GDP in the EU than in the US, in spite of stronger fiscal adjustment after 2009, suggests that this adjustment has insufficiently involved current expenditure, and thus relied too heavily on tax increases (we will discuss the implications of this in the section on fiscal policy, which begins on page 39).

The fall in GDP has been accompanied by a decline in employment and a sharp increase in unemployment. Employment has decreased in two phases: until 2010 and after 2011.

In spite of its worse growth performance, there seems to be less spare capacity (if approximated by negative output gap) in the EU than in the US. The fall in EU GDP has been quite closely followed by a slowdown in potential output growth (see chart 23 on page 27). It declined more sharply than in the US in the years 2008-2009, and has further decelerated after 2011, whereas in the US it has been on an upward trend since 2011. Estimates of

potential output are influenced by GDP growth. Yet, that applies to all economies and cannot explain the less negative output gap in the EU than in the US. Besides, the longer the period of slow potential output growth, the larger the risk that this slow growth is persistent, and not just of a cyclical nature. If, as we argue, it reflects a fundamental weakness of systemic forces, it cannot be addressed by stimulating aggregate demand, but only by decisive fiscal and structural reforms.

Development of productivity per person employed confirms that assessment. It grew more slowly in the EU than in the US, even though the US performance was rather disappointing on that score (see chart 24 on page 27).

2. Variations in growth within the EU

The aggregate picture masks large variations in GDP growth across EU countries. The differences in this respect are not adequately expressed by the familiar typologies of the Nordic and Southern countries, centre versus periphery, member of the euro area versus non-members, or EU-15 versus new member states. Large differences cut across all these classifications. This is why in this paper we will group EU countries into two new categories based on their relative growth since 2008.

Since the onset of the crisis, three countries have outstripped the US for economic growth by any measure: Poland, Slovakia and Sweden. If economic growth is measured on a GDP per capita basis, six more countries join the group of countries that have outperformed the US (for a total of nine countries in the “winners” category: Bulgaria, Estonia, Germany, Latvia, Lithuania and Malta).⁵⁹ The group of laggards includes the remaining 18

59 The better position of these six countries relative to the US in terms of GDP per capita growth reflects the already worse demography in the EU than in the US and, in the case of Bulgaria, Estonia, Latvia and Lithuania, large emigration.

'The average annual deficits of the general government reached almost 6% of GDP in the 2001-2007 period. By 2007, Greece was the most indebted state in the EU.'

Table 2: Cumulated changes in GDP per capita

		2008-2013	2008-trough	Trough-2013	Comments
Growth leaders	Poland	12.5%	1.6%	10.8%	
	Slovakia	5.2%	-5.1%	10.9%	
	Lithuania	5.2%	-14.0%	22.2%	
	Bulgaria	3.6%	-5.0%	9.0%	
	Sweden	3.4%	-5.8%	9.8%	
	Germany	3.0%	-4.8%	8.2%	
	Malta	2.7%	-3.0%	5.9%	
	Estonia	2.5%	-14.0%	19.3%	
	Latvia	1.6%	-16.4%	21.5%	
	United States	1.2%	-4.0%	5.4%	
Growth laggards	Austria	0.3%	-4.1%	4.6%	
	Romania	-2.5%	-7.3%	5.2%	Trough 2010
	France	-2.6%	-3.7%	1.1%	
	EU-27	-2.6%	-4.6%	2.1%	
	Belgium	-2.7%	-3.5%	0.9%	
	Czech Republic	-2.8%	-5.1%	2.4%	
	Euro area -17	-3.5%	-4.7%	1.3%	
	United Kingdom	-4.1%	-4.6%	0.5%	
	Hungary	-4.4%	-6.6%	2.4%	
	Denmark	-4.8%	-6.2%	1.4%	
	Finland	-5.0%	-9.0%	4.3%	
	Netherlands	-5.1%	-4.2%	-1.0%	
	Ireland	-5.7%	-7.5%	1.9%	Trough 2010
	Spain	-7.4%	-5.1%	-2.4%	Trough 2010
	Portugal	-7.5%	-3.0%	-4.6%	
	Luxembourg	-8.1%	-5.8%	-2.5%	
	Italy	-9.0%	-6.1%	-3.1%	
	Slovenia	-11.8%	-8.7%	-3.4%	
	Cyprus	-20.6%			Trough not reach yet
	Greece	-23.6%			Trough not reach yet
	Korea 1997	22.1%	-6.4%	30.5%	Peak=1997, trough=1998
	Turkey 2000	17.1%	-7.0%	25.9%	Peak=2000, trough=2001
	Sweden 1990	2.4%	-4.4%	7.1%	Peak=1991, trough=1993
	Finland 1990	-5.3%	-11.4%	-5.3%	Peak=1990, trough=1993
	Chile 1981	-11.7%	-18.7%	8.6%	Peak=1981, trough=1993

*trough=2009, if not stated otherwise

Source: AMECO, Forecasts for 2013 from European Commission spring forecast

‘Proper functioning of the labour market was inhibited by a high and increasing tax wedge, a high minimum wage, strict employment protection legislation and an inefficient education system.’

EU countries, where growth has trailed the US in the past five years, and thus contributed to on-going EU divergence with US economic performance. Among the countries in this group, there was enormous variation in terms of growth with Cyprus and Greece being negative outliers and Austria being quite close to US performance (see table 2 on page 29 for a summary)

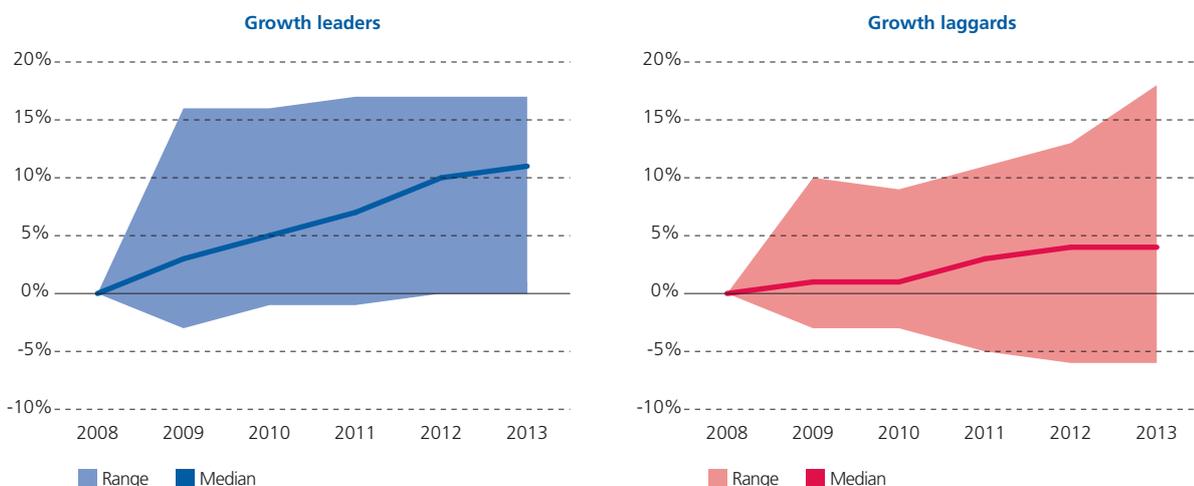
The nine countries in the growth winners’ column consists of economies that are all very open, and – with the notable exceptions of Germany and Poland – small. It is made up of mostly countries outside of the eurozone (Estonia, Germany, Malta and Slovakia being the exceptions). By contrast, the group of growth laggard countries is very heterogeneous in terms of both openness and size. It is dominated by the euro-area countries.

However, other interesting anomalies are also visible. Among non-euro-area countries that are doing well, only Poland and Sweden have floating foreign exchange regimes (the remaining successful countries all have hard pegs, usually to the euro or

to a euro-based currency board). But within each group there are boom-bust countries – Bulgaria, Estonia, Latvia and Lithuania among the winners and Greece, Ireland, Spain and the UK among the losers (interestingly, Bulgaria, Estonia, Latvia and Lithuania have carried out a successful adjustment while having the hard peg arrangement). However, the group of underperformers also includes countries with chronic structural problems that went straight into bust without a boom, a phenomenon best exemplified by Italy. The growth laggard group also contains countries like Belgium and France that managed to avoid a deeper initial slump in 2009, but later experienced only very limited growth.

Most of the difference in GDP growth between the two groups resulted from the difference in the contribution of net exports (see chart 25 below). In all countries from the growth winners’ group, net exports contributed positively to growth and stemmed almost exclusively from an increase in exports. With the exception of Sweden, the increase in exports was strong and exceeded 5% of 2008 GDP. By contrast, among underperforming countries with initially large

Chart 25: Net export contribution to GDP growth (2008-2013)



Source: AMECO

‘Germany provides an example of structural reforms which strengthen systemic forces and, as a result, the growth of the economy.’

current account surpluses, three countries saw net exports deteriorate relative to 2008: Austria, Finland and Luxembourg. Only a handful of countries of the second group saw exports increase by more than 5% of 2008 GDP (Czech Republic, Hungary, Ireland and the Netherlands), while in one-third of the countries they fell. In a majority of countries from this group, imports decreased and in almost half of the countries (including most of the problem countries), falling imports contributed more to GDP growth than the growth of exports. The difference in both net export contribution to GDP and the role of imports in this contribution between the two groups stemmed largely from different time patterns of external rebalancing in boom-bust countries in these groups.

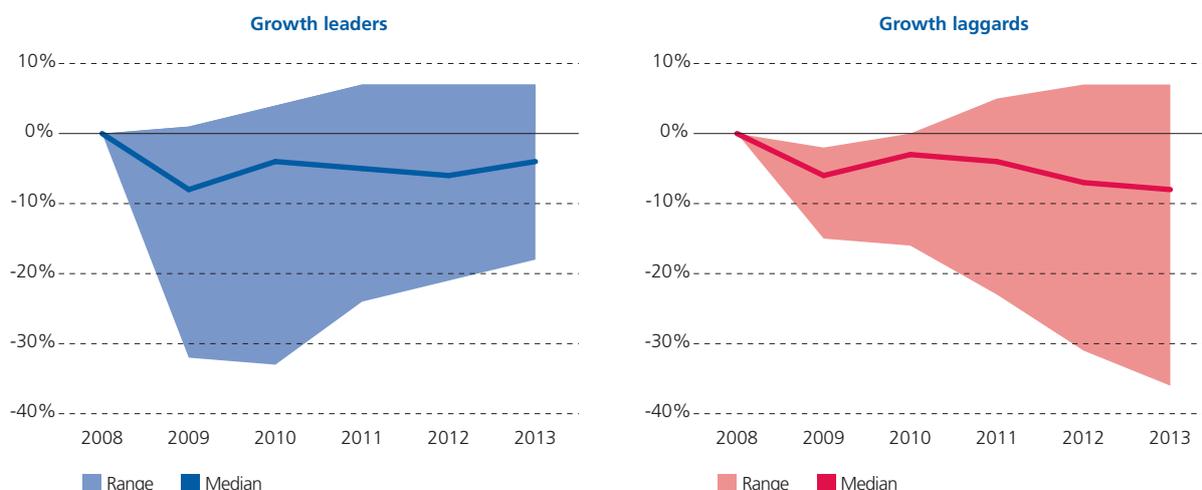
The difference between the two groups in domestic demand growth was not as large as the difference in the net export contribution (see chart 26 below). However, there was a large variation in domestic demand within both groups.

- Private consumption increased in four countries from the first group (Germany, Malta, Poland

and Sweden) and in five countries from the second group (Austria, Belgium, Finland, France and Luxembourg), which had had no large imbalances before the crisis, at least – as in the case of Poland – in comparison with regional competitors. It lowered GDP by more than 5% in the Baltics from the first group and in almost every third country from the second group, mainly in boom-bust countries (Cyprus, Greece, Hungary, Portugal and Romania). Private consumption growth has correlated quite strongly with changes in employment, suggesting that to boost private consumption, obstacles hampering employment growth should be removed.

- Most countries from both groups experienced a two-digit fall in fixed investment. However, changes in fixed investment explain more than 50% of changes in domestic demand in a minority of countries from the first group and in the majority of countries from the second group, which point to more prevalent initial imbalances and more persistent confidence problems in the second group.
- Construction investment dropped in all EU

Chart 26: Domestic demand contribution to GDP growth (2008-2013)



Source: AMECO

‘Inflowing capital through the banking sector in most countries was invested mainly in the non-tradable sector, increasing domestic demand, wage pressure and undermining the competitiveness of the overall economy.’

countries except for Poland, Germany and Sweden, which are countries from the first group with no or a limited pre-crisis boom. Construction investment accounted for more than 50% of the fall in total investment in almost all EU countries where investment fell. In Estonia and Slovakia from the first group, it accounted for more than 100% of the fall, and in Ireland and Spain from the second group, it accounted for more than 80% of that fall. Such a composition of the fall in fixed investment confirms the conclusion drawn from the aggregate data that it has been largely a result of pre-crisis overinvestment.

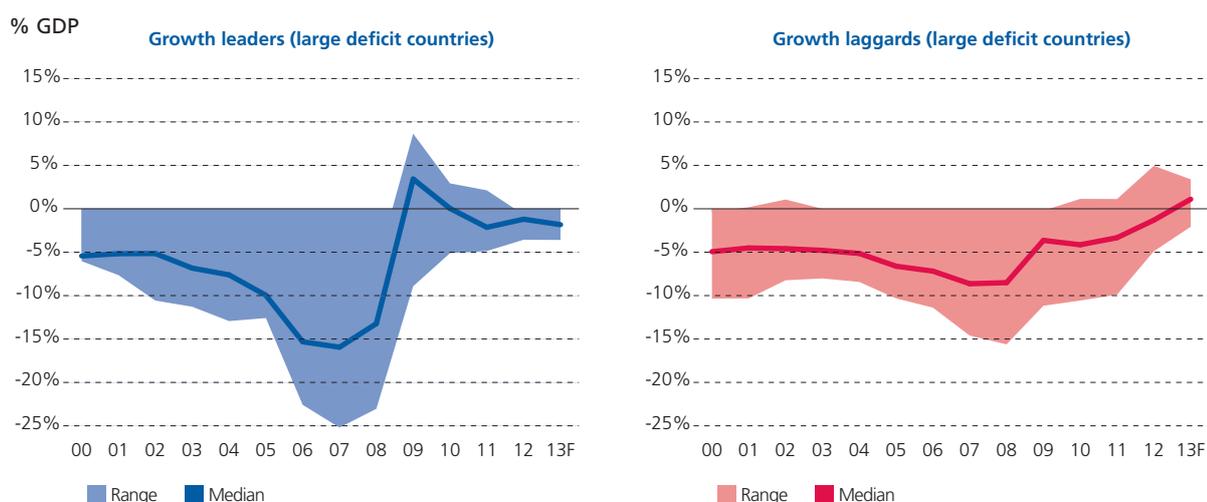
- Equipment investment increased in five countries (Austria, Estonia, Luxembourg, Poland and Slovakia). These were either economies with no large initial imbalances (like Austria), or countries which underwent fast rebalancing (like Estonia). By contrast, in five other countries it had a two-digit negative contribution to total fixed investment growth (Cyprus, Greece, Italy, Malta and Slovenia). These were mainly countries with

the worst or very bad growth performance (in particular Cyprus and Greece) and which severely lacked confidence.

Both the large difference in the net export contribution to GDP growth between the two groups of countries and the relative similarity in the domestic demand contribution to GDP growth between them resulted to a large extent from different time patterns of adjustments in those countries from both groups, in which external imbalances had been large before the crisis.

- In countries with large pre-crisis external imbalances from the growth leaders’ group, rebalancing started earlier, and was faster than in similar countries from the second group. Rebalancing is here defined as a reduction in the current account deficit. Fast and large net export improvement in countries with large pre-crisis external imbalances from the first group (except for Poland) was initially accompanied by a deep

Chart 27: Current account in countries with large current account deficits in 2007



From both the growth leaders and the growth laggards group, only the countries with a current account deficit in 2007 above the median for each group are taken.
 From the growth leaders group, Bulgaria, Estonia, Latvia, Lithuanian and Poland are taken.
 From the growth laggards group, Cyprus, Czech Republic, Greece, Hungary, Ireland, Portugal, Slovenia and Spain are taken.
 Romania should also be included in the growth laggards group, but the European Central Bank Statistical Data Warehouse does not provide data on unit labour costs in Romania.

Source: International Monetary Fund World Economic Outlook, European Central Bank Statistical Data Warehouse

'From 1999 to 2007, government debt in Greece, Portugal and France rose. Debt rose also in Germany, but in the same time Germany introduced labour market reforms, controlled the unit-labour costs dynamic and accelerated growth. That did not happen in Greece, Portugal or France.'

fall in domestic demand. But then an economic rebound occurred in these countries, giving a quite similar cumulative decrease in domestic demand as in the countries with large pre-crisis external imbalances from the second group, yet with better medium-term growth perspectives than in the latter countries. An element of this rebound was an increase in fixed investment, the initial drop of which was an important factor of rebalancing. It is worth remarking that fast rebalancing in the first group was not helped by an exchange rate depreciation, since, except for Poland, countries with large pre-crisis current account deficits in this group either had a hard peg or adopted the euro. Thus, these countries' experience proves that internal devaluation can work.

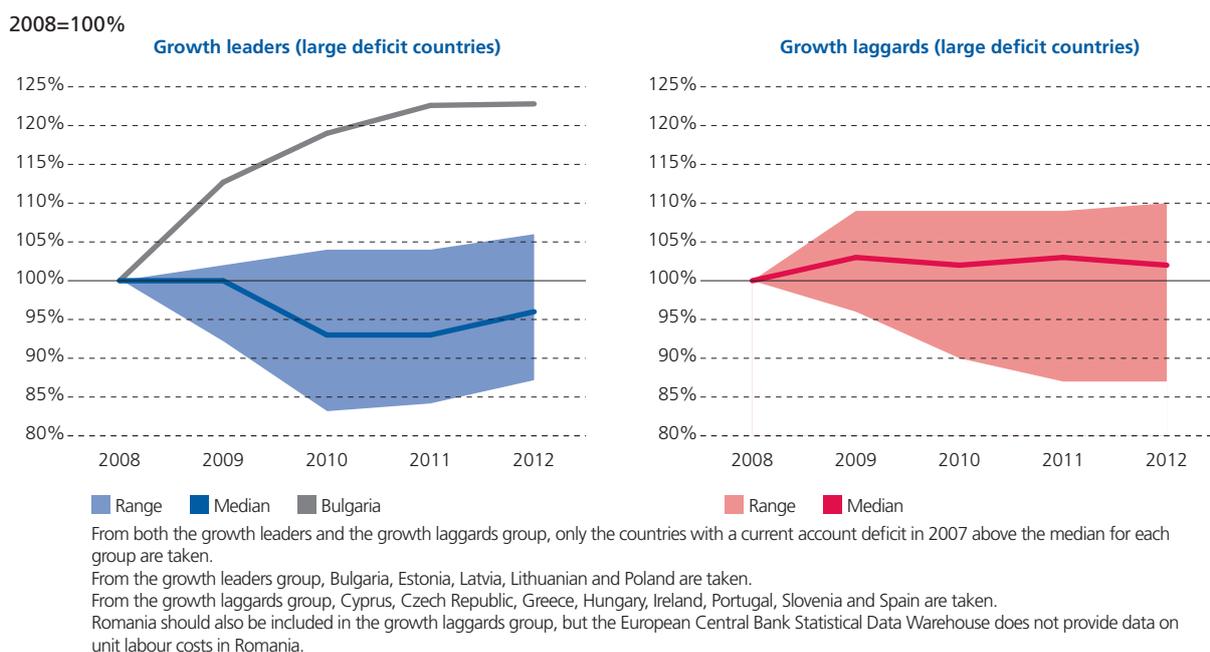
- In countries with large pre-crisis external imbalances from the second group, the deferral of rebalancing limited an initial fall in domestic demand, but at the cost of postponing a recovery so far. These countries have later undergone a

strong rebalancing process. In all countries from this group, in which the current account deficit was larger than the median in 2007, it has been reduced significantly. There is almost no external imbalance in this group in 2013, as in the first group (see chart 27 on page 32).

- Reduction of the current account deficit in both groups of countries has been accompanied by an improvement in unit labour costs. As in the case of current account deficit reduction, it started sooner and has been more rapid in the first group than in the second group. Unlike in the case of current account deficit reduction, it has been, in total, much deeper in the first group than in the second group (chart 28).

We will discuss the policies that contributed to differences between the two groups of countries in time patterns of rebalancing in the next sections. But one important point is worth noting here. Most countries from the first group outperformed the US in terms of growth of productivity per person

Chart 28: Unit labour costs in countries with large current account deficits in 2007



Source: International Monetary Fund World Economic Outlook, European Central Bank Statistical Data Warehouse

'Gaps in governance were well known already in the 1990s when the euro was being introduced, but have widened since then instead of diminishing.'

employed. Poland and Sweden from this group were the only EU countries with both labour productivity and employment growing after the outburst of the crisis. In the second group, labour productivity increased more than in the US only in Ireland and Spain, while in most other countries it fell. In almost every second country from this group, productivity fell in spite of declining employment (see chart 29 below). Still worse, there is no clear evidence that laggards with regard to productivity growth have started improving their relative position. Growth in real labour productivity per hour worked in 2010-2012 was, if anything, positively correlated with growth in 2008-2010.

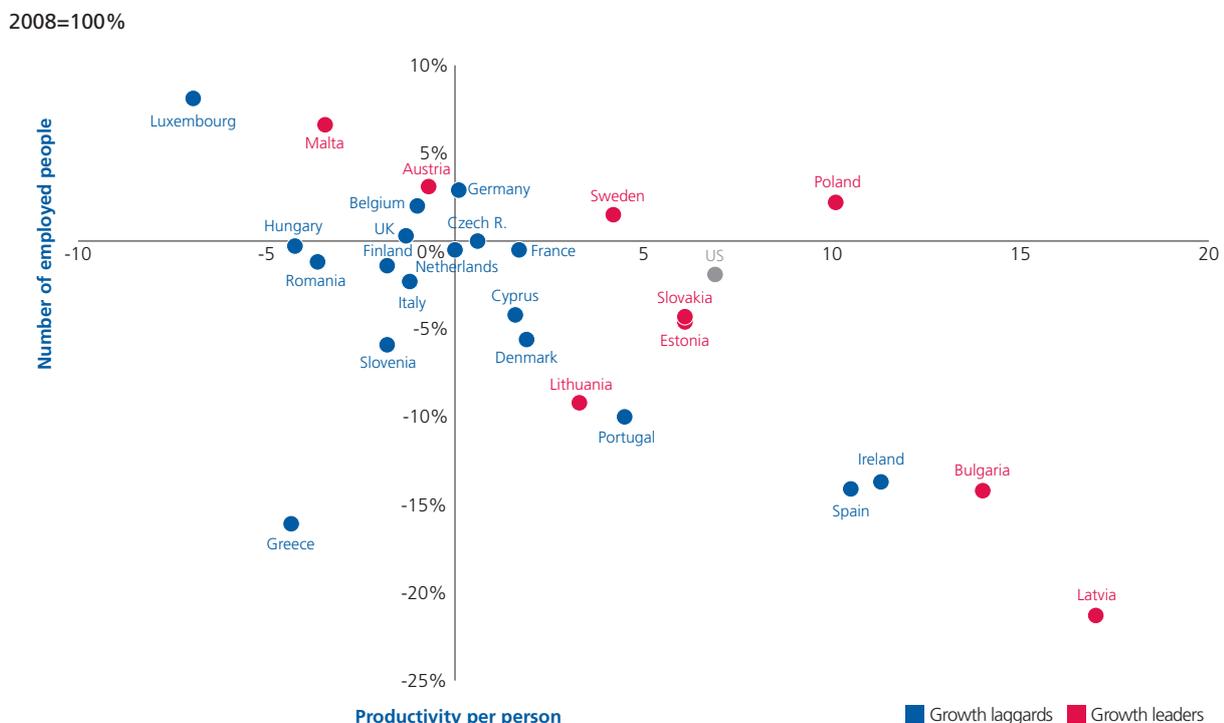
3. Explaining the variation in growth in the EU (2008-2012): An analytical framework

Economic growth in any given period can be explained by the interactions among three factors:

- 1) Initial conditions
- 2) The policies pursued during this period
- 3) External conditions, including any external shocks and demographic changes.

We apply this simple analytical scheme to explain the differences in growth among the EU countries during 2008-2012. Drawing on this analysis we will also use this scheme to discuss their growth prospects, taking as the initial conditions those which exist in 2013.

Chart 29: Changes in employment and labour productivity (2008-2012)



Source: Conference Board Total Economy Database (TED)

'Consumption had zero contribution to domestic demand and thus to GDP growth as the fall in private consumption fully offset the increase in government consumption.'

Initial conditions matter for subsequent growth in various ways. For example, large macroeconomic imbalances limit an agent's capacity and propensity to spend, and a positive demand shock (i.e. a boom) tends to produce a negative demand shock (i.e. a bust). Microeconomic rigidities and distortions, if preserved, limit the macroeconomic adjustment and economic growth. However, we do not want to make a case here for strict determinism or – in economic jargon – absolute path dependence. By contrast, we believe the impact or continued existence of certain conditions depends on policies, which are discretionary. Paradoxically, the larger the extent of the various distortions, the greater the scope for structural reforms and the stronger the potential increase in growth.⁶⁰ In other words, policies mediate between initial conditions and outcomes. Good policies can compensate, at least in the medium to long term, for bad initial (and external) conditions, while bad policies can waste the positive impact of a favourable inherited (or external) situation and can make bad initial conditions even worse.

In discussing policies, one should be careful not to confuse declarations with reality. What matters for the economy are packages of actually implemented policies (including fiscal and supply-side reforms) that differ in the content and in the distribution of the respective policies over time. For example, a policy package which initially consists mostly of tax increases and preserves the inherited widespread labour and product market rigidities can produce a limited fiscal consolidation but at the cost of a deep decline in GDP and employment. A programme which, under the same initial conditions, would start with a reduction of current spending and comprehensive structural reforms is likely to produce better outcomes on fiscal consolidation as well as on growth and employment. However, the first programme would nowadays be blamed for producing “austerity” or a slowdown in growth and

employment, when in fact all it has done is provide a temporary cover for poor underlying conditions, which will need to be addressed for growth to be consistent and sustainable (see the section on “fiscal policy on page 39 for a deeper discussion of these issues).

External conditions are largely inherited by countries and governments. Therefore, policies are the only controllable factor in the hands of policymakers, influencing the outcomes for the better or the worse. This raises a fundamental question regarding what influences policies, i.e. the actions of policymakers. We enter here the web of complex interactions between initial and external conditions, the beliefs of the policymakers as influenced by the prevailing economic doctrines and the information they receive, and the distribution of various socio-political pressures aimed at the policymakers.

There is obviously no scope here for a longer discussion of these important issues. We mention only those which appear to be relevant in the context of the discussion of growth in the EU. First, relaxed financial constraints – in the absence of disciplining doctrines, early warning signals or institutional barriers to increased spending – are likely to result in a financial or fiscal boom. This is the story of countries like Greece, Ireland, Portugal and Spain in the euro area, but also of the UK outside it. Second, referring to current debates, we worry about the impact on existing policy of influential doctrines which urge the relaxation of “austerity” and more aggressive monetary easing by the ECB (we will discuss these implications in the section on monetary policy which begins on page 50). Third, too much focus is being placed on “European” solutions while the accumulated problems in certain countries have to be tackled at the national level. This is especially true of the large EU members which are mostly behind European policies while being less influenced by them than the small countries.

60 Leszek Balcerowicz, “Institutional Systems and Economic Growth” in Anders Åslund and Marek Dabrowski (eds), *Challenges of Globalization: Imbalances and Growth* (Washington: Peterson Institute, 2008).

‘Since the onset of the crisis, three countries have outstripped the US for economic growth by any measure: Poland, Slovakia and Sweden.’

In the next section, we will discuss the link between initial conditions before 2008 and subsequent growth in specific EU countries. We will then analyse the impact of various specific policies on economic growth.

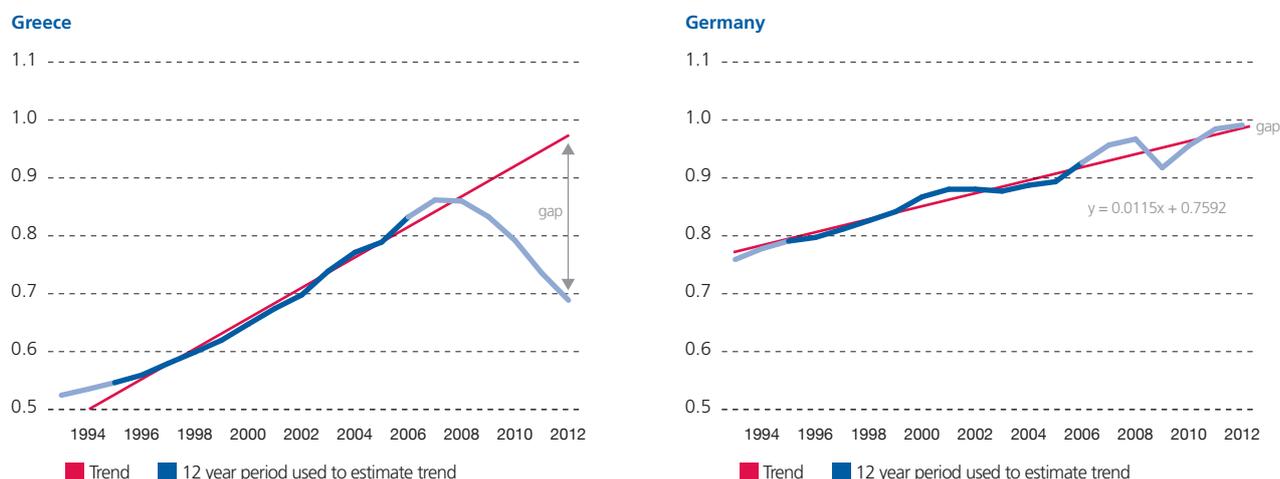
4. Initial conditions

Following an approach proposed by Abdul Abiad, it can be statistically demonstrated that the bigger the macroeconomic imbalances were in a given country in 2007, the worse was its growth performance in the subsequent five years, i.e. the larger the gap was between actual GDP in 2012 and its pre-crisis trend.⁶¹ We found the following measures of imbalances to be statistically significant:⁶²

- Change in credit to the private sector as a percentage of GDP (2003-2007) – the faster the growth, the bigger the gap in 2012
- Investment to GDP ratio in 2007 – the higher the ratio, the bigger the gap in 2012
- National savings rate in 2007 – the lower the savings rate, the bigger the gap in 2012
- Structural general government balance as a percentage of potential output – the worse the balance, the bigger the gap in 2012
- Net international investment position in 2007 as a percentage of GDP – the more negative the position, the bigger the gap in 2012

In other words, we found that the poorer the growth performance was during 2008-2012, the larger was the previous investment boom – fuelled by credit and capital inflows. And the other way round,

Chart 30: GDP in 2012 relative to the pre-crisis trend



Source: own calculations following the approach of Abiad et al. (2010), data from International Monetary Fund World Economic Outlook

61 See Abdul Abiad, Ravi Balakrishnan, Petya Koeva Brooks, Daniel Leigh and Irina Tytell, “What’s the Damage? Medium-term Output Dynamics After Banking Crises,” *IMF Working Paper WPI/09/245* (IMF: Washington, 2009). In their regressions, the authors of this article use two control variables: change of GDP in the first year of the crisis (as a proxy of the magnitude of the shock) and the relation of GDP to the trend in a year before the crisis.

62 For details, see appendix 1 on page 72.

'Most of the difference in GDP growth between the two groups resulted from the difference in the contribution of net exports. In all countries from the growth leaders group, net exports contributed positively to growth and stemmed almost exclusively from an increase in exports.'

the better the growth performance was, the larger were the pre-crisis national savings – increased by fiscal discipline and invested partly abroad. A few comments on these rather interesting findings are in order:

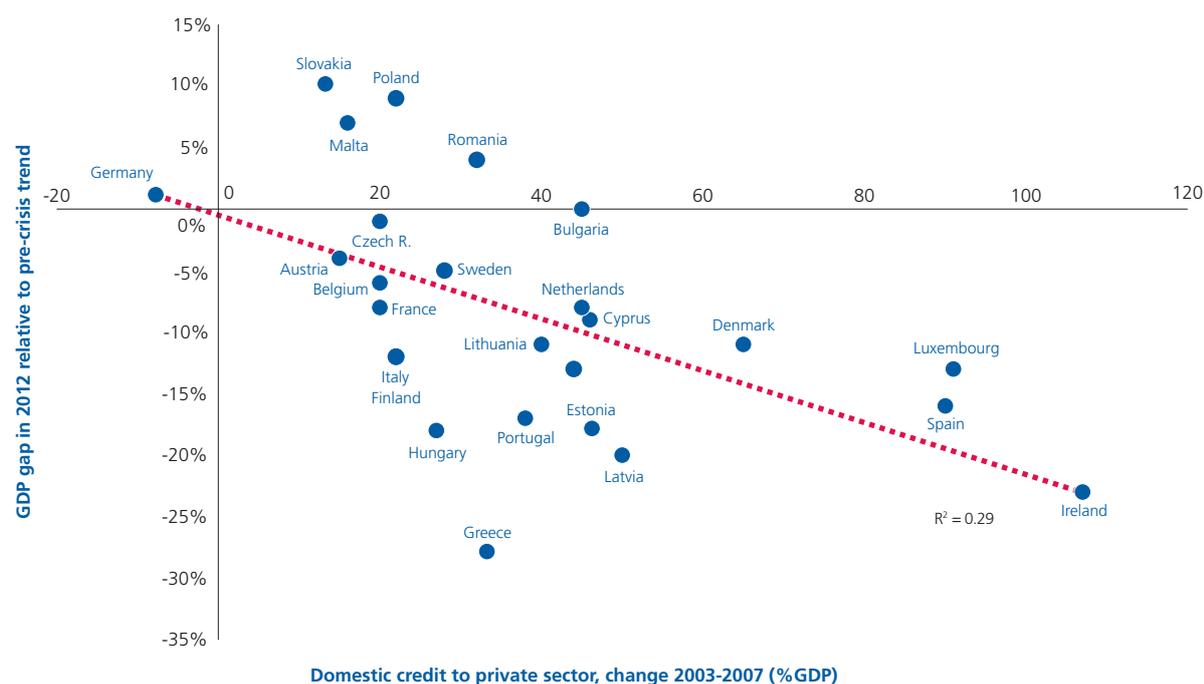
The relevance of credit booms to economic growth is in line with the literature on the financial crises.⁶³

In an IMF study, the pre-crisis investment share in GDP was also found to be an important predictor of the subsequent decline in GDP.⁶⁴ According to

the study, one possible interpretation for this trend is that the output loss reflects the unwinding of excessive (or even wasteful) investment built up over a protracted period. This confirms our previous observation that the decline in investment in the EU was largely correctional.⁶⁵

The importance of the saving rate and the net international investment position (i.e. the difference between a country's external financial assets and liabilities) in the pre-crisis year for post-crisis growth highlights the role of foreign financing. The role of

Chart 31: Credit growth 2003-2007 vs. post-crisis GDP growth



Source: International Monetary Fund World Economic Outlook and World Bank World Development Index

63 Moritz Schularick and Alan M. Taylor, "Credit Booms Gone Bust: Monetary Policy, Leverage Cycles and Financial Crises, 1870–2008," *NBER Working Paper* No. 15512, 2009. Schularick and Taylor, using data for 14 developed countries over the period 1870-2008, demonstrate that credit growth is a powerful predictor of financial crises. Similar results can be found, inter alia, in: Graciela L. Kaminsky and Carmen M. Reinhart, "The Twin Crises: The Causes of Banking and Balance-of-Payments Problems," *American Economic Review*, 1999; Barry Eichengreen and Kris Mitchener, "The Great Depression as a Credit Boom Gone Wrong," *BIS Working Papers* No 137, 2003; or Stephen Cecchetti, Madhusudan Mohanty and Fabrizio Zampolli, "The Real Effects of Debt," *BIS Working Paper* 352, 2011.

64 Abiad et al, *op. cit.*

65 Also, McKinsey Global Institute, *Investing in Growth: Europe's Next Challenge* (San Francisco: McKinsey Global Institute, 2012), shows that one of the main sources of the European slump is a significant fall in private investment, particularly in the previously overgrown construction sector. According to their study, Portugal, Greece, Ireland and Spain together with the UK are responsible for 80% of the fall in private investment in the EU, with half of it coming from the construction sector.

‘Private consumption growth has correlated quite strongly with changes in employment, suggesting that to boost private consumption, obstacles hampering employment growth should be removed.’

foreign capital inflows (“bonanzas”) in the creation of booms, often followed by busts, has been stressed by many authors.⁶⁶

In analysing a bit deeper the impact of the inherited imbalances on economic growth, one can distinguish two types of boom-bust episodes: 1) the fiscal to financial; and 2) the financial to fiscal.⁶⁷ The proximate reason for both is a spending boom (financed by capital inflows and credit growth) which results in bust and recession. However, the two types of crisis differ in the sector where the boom occurs, and therefore also in the root causes of the overspending. Therefore, they give rise to different policy implications.

A fiscal to financial crisis – best exemplified by Greece – results from systematic fiscal overspending, often financed by the accumulation of public debt. When the fiscal crisis hits, lenders to the sovereign are affected. As they prominently include the domestic banks, the fiscal crisis spreads to the financial sector. For example, Greek (and Cypriot) banks have become victims of their lending to the Greek state.

In a financial to fiscal crisis, it is the excessive growth of credit to the private sector (especially to housing) which is the proximate cause of the boom and the resulting bust. During the credit boom, the economy produces artificially large tax revenues which are subsequently spent. Once the recession hits and some lending institutions discover large holes in their balance sheet, a seemingly healthy fiscal stance quickly turns into a deep red. This boom-bust sequence is best exemplified by Spain, Ireland and the UK (as well as Bulgaria, Estonia, Latvia and Lithuania at the beginning of the crisis,

although their growth dynamics have sharply diverged from the laggards in 2010-2012, which will be explained in the next sections).

Looking at the root causes of both types of boom-bust episodes, one should have little doubt that fiscal overspending is a public-policy, and not a market, failure: it results from destructive political competition and weak (if any) constraints on public spending and public debt. It is up to the proponents of individual responsibility in the respective countries to mobilise more and to stop and reverse a dangerous fiscal expansion of the state, as well as to push forward with the debt brakes. (Poland’s constitution of 1997 bans a public debt exceeding 60% of the GDP.) European-level initiatives, like the fiscal rules, can be useful, but cannot substitute for domestic civic effort. Finally, it should be remembered that some international regulations (such as the existing Basel accords) which are still in force have encouraged banks to take excessive risks in lending to their governments. Instead of bashing the banks, politicians should scrap these perverse incentives.

As distinct from diagnosis of the root causes of fiscal booms, there is a fundamental debate about the underlying reasons for private-sector credit booms. The popular tendency to locate the root causes of the private credit bubbles only or mostly in the financial sector is dangerously superficial. True, it is not difficult to point to huge errors made at the top of some large financial conglomerates. However, the highest share of problems appeared in those financial institutions which were subjected to direct political control: in the Landesbanken in Germany, in Cajas in Spain and in Fannie Mae and Freddie Mac in the US. This confirms an old truth that politicisation of economic life is bad for

66 See e.g. Barry Eichengreen and Michael D. Bordo, *Crises Now and Then: What Lessons from the Last Era of Financial Globalization* (Cambridge: National Bureau of Economic Research, 2002) or Carmen M. Reinhart and Kenneth S. Rogoff, “Growth in a Time of Debt,” *NBER Working Paper* No. 15639, 2010.

67 Leszek Balcerowicz, “On the Prevention of Crisis in the Eurozone” in Franklin Allen, Elena Carletti and Saverio Simonelli (eds), *Governance for the Eurozone: Integration or Disintegration?* (Florence: European University Institute and Philadelphia: Wharton Financial Institutions Center, 2012).

the economy (and for the politics, too). Besides, the amount of risks taken by the individual actors depends on their environment which – in the case of the financial institutions – is largely shaped by the public bodies.

A number of policies contributed to excessive risk taking in the financial sector and by households. These policies included monetary policy which fuelled asset bubbles; tax policies which favoured debt finance relative to equity; subsidies to mortgage borrowing; financial regulations which encouraged excessive securitisation, e.g. the risk-weights contained in Basel 1 and the mandatory use of credit rating by the financial investors; generous deposit insurance which eliminates an important source of market discipline; regulations which limit shareholder concentration in large banks and thus increase the agency problems and weaken market discipline; and policies which resulted in the “too big to fail” syndrome, i.e. financial markets’ subsidisation – via reduced risk premia – of the large financial conglomerates.⁶⁸

Policies influencing private risk taking differed between countries. For example, the interest rates on lending for house purchases during the boom years were higher in Germany, Austria, Belgium and the Netherlands, where most loans were more conservative fixed rate, than in Spain and Ireland where floating rates were much more popular. Furthermore while in Germany and Northern Europe mortgages are usually limited to 60% of the value of the house, in Spain and Ireland loan to value ratios of 100% became common.⁶⁹

In the following sections we will discuss policies pursued after the outburst of the crisis.

5. Fiscal policy

Fiscal policy in the 2008-2012 period has been the subject of heated disagreements among academics, policymakers and the media. It is also the fiscal policy where – in our view – serious errors that complicated some countries’ economic situation have been committed and where the risk of further errors is present.

In response to the global financial crisis, fiscal policy was loosened in the majority of EU countries during 2008-2009, both through discretionary fiscal stimulus and the operation of automatic stabilisers. That loosening manifested itself in a sharp increase in the fiscal deficit. It widened in the EU to almost 7% of GDP in 2009, up from about 1% of GDP in 2007. In the US, the deficit increased even more sharply to almost 12% of GDP, up from less than 3% of GDP in 2007. We find that more than half of the increase in the fiscal deficit in the EU resulted from cyclical factors, i.e. from the operation of automatic stabilisers. Correspondingly, almost half came from discretionary fiscal stimulus.

The increase in government expenditure which was not driven by cyclical factors exceeded two percentage points of GDP and accounted for more than one-third of deficit deterioration in the EU. In comparison, the fall in tax revenue due to non-cyclical factors contributed three times less to the deficit deterioration. The discretionary increase in public expenditure was among the strongest in Ireland, Spain, Greece and Portugal, i.e. in the countries which were struck a little later by a fiscal crisis. They engaged in the most aggressive fiscal stimulus based on increased spending (see charts 32 and 33 on pages 40-41).

68 For more, see Charles Calomiris, *Banking Crises and the Rules of the Game* (Massachusetts: National Bureau of Economic Research, 2009); William R. White, “Should Monetary Policy ‘Lean or Clean?’” *Federal Reserve Bank of Dallas, Globalization and Monetary Policy Institute Working Paper 34*, 2009; Moritz Schularick and Alan M. Taylor, “Credit Booms Gone Bust: Monetary Policy, Leverage Cycles and Financial Crises, 1870–2008,” *NBER Working Paper No. 15512*, 2009; Otmar Issing, *Lessons for Monetary Policy: What Should the Consensus Be?* (Washington: IMF, 2011); or Leszek Balcerowicz, *How to Reduce the Risk of Serious Financial Crises* (Warsaw: Warsaw School of Economics, 2010).

69 Daniel Gros, *How to Deal with Macroeconomic Imbalances?* (Brussels: European Parliament, 2012).

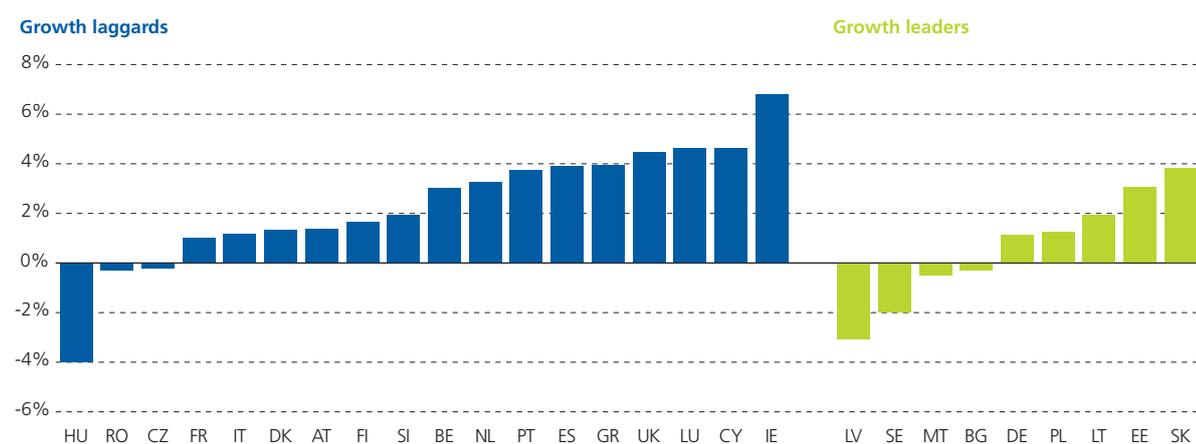
In other words, fiscal policy was significantly loosened, although most EU countries had no space for such loosening. Structural public finance deficit in the EU exceeded 2% of GDP, leaving almost no room for automatic stabilisers to operate, if the stability and growth pact were to be respected.⁷⁰ In 13 EU countries, the structural deficit exceeded 3% of GDP (including Greece, Italy and Portugal, but also France and the UK). Only six EU countries had structurally balanced public finances or a surplus (three Nordic countries – Denmark, Sweden and Finland – plus Spain, Cyprus and Luxembourg). These were mainly small northern economies. The group includes Spain, although one has to remember that estimates of pre-crisis structural balance are particularly uncertain in its case due to large government windfall gains from soaring property prices.

Fiscal policy loosening, inclusive of fiscal stimulus, was supported by the international organisations, notably by the IMF which before the crisis were

important advocates of fiscal discipline.⁷¹ Fiscal stimulus gained large support from many academics.

In 2010-2012, the fiscal balance considerably improved in the EU, but the cyclically adjusted deficit was larger than before the crisis. Thus fiscal stimulus, if measured by the change in the structural fiscal balance, has not yet expired. Aggregate data indicates that “austerity” has been more declared than introduced. That picture does not result from the fact that some EU countries, like Germany, did not need fiscal adjustment, at least according to general public perception. Actually, the cyclically adjusted fiscal balance in the case of that country improved relative to its pre-crisis level. Surprisingly, it improved also in France, even if that country did not do much and still needs more adjustment. Behind the EU aggregate are first and foremost countries which introduced large fiscal stimulus in response to the crisis. In countries like Spain or the UK, the stimulus was larger than the subsequent adjustment.

Chart 32: Change in total expenditure excluding interest of general government adjusted for the cyclical component as a percentage of GDP (2007-2009)



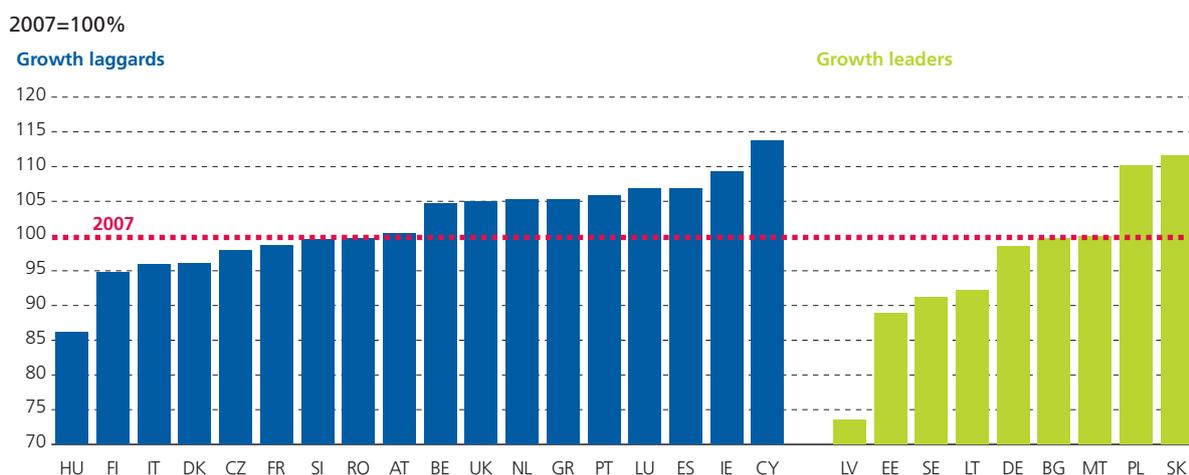
Source AMECO

70 The structural public finance deficit is an indicator of fiscal stance aimed at excluding the impact of cyclical factors on the government balance.

71 See e.g. John Lipsky, “The Current Macroeconomic Outlook 2009: Issues of Systemic Stability,” *speech delivered via videoconferencing from Washington DC to the Devisen Forum*, 2008; or Antonio Spilimbergo, Steve Symansky, Olivier Blanchard and Carlo Cottarelli, “Fiscal Policy for the Crisis,” *IMF Staff Position Note 08/01*, 2008.

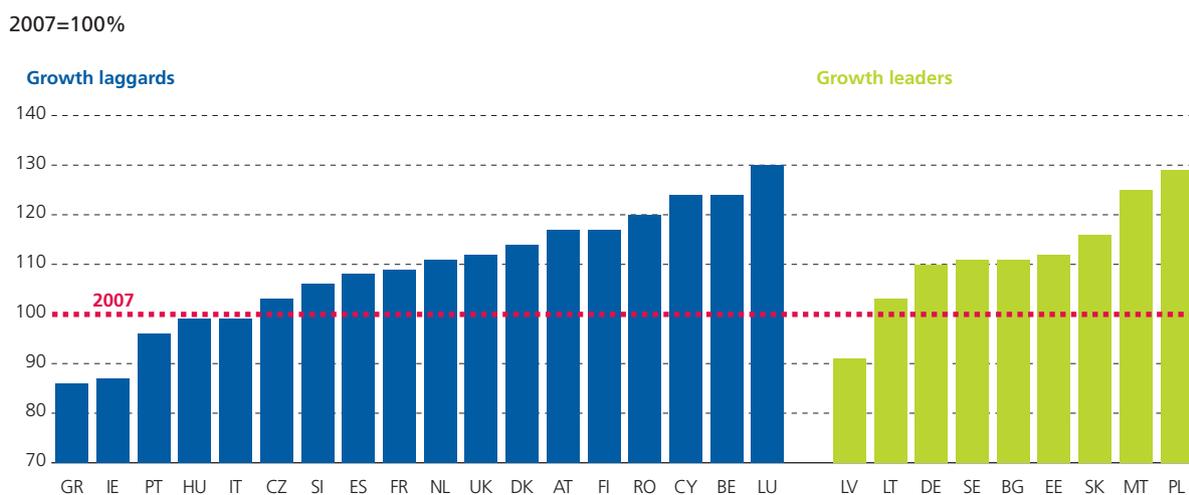
'In countries with large pre-crisis external imbalances from the growth laggards group, the deferral of rebalancing limited an initial fall in domestic demand, but at the cost of postponing a recovery.'

Chart 33: Real change in total expenditure excluding interest of general government adjusted for the cyclical component (2007-2009)



Source: AMECO

Chart 34: Nominal change in total expenditure excluding interest of general government adjusted for the cyclical component (2007-2012)



Source: AMECO

‘Most countries from the growth leaders group outperformed the US in terms of growth of productivity per person employed.’

Only in six countries was the primary public expenditure (i.e. excluding interest payments) corrected for increase due to cyclical factors, lower in nominal terms in 2012 than before the crisis (see chart 34 on page 41). That group included Greece, Hungary, Ireland, Italy, Latvia and Portugal. In Spain, its cumulative increase exceeded the EU average. In the UK, another country where austerity is under strong criticism, expenditures were raised in each year since the onset of the crisis, except for in 2011.

The group where primary government expenditure adjusted for cyclical component was lower than before the crisis included five additional countries, if measured in real terms: Romania, Slovenia, the Czech Republic, Lithuania and Bulgaria. Thus, countries which reduced the discretionary government expenditure since the onset of the crisis represented a minority of the EU countries (see chart 36 on page 43). They did not include the UK, where austerity is the government’s declared priority, and Spain, where austerity is criticised by many. The developments which we have briefly described show that there has been a gap between the reality of fiscal consolidation and the popular criticism of this policy presented under the term of “austerity.”

When it turned out that in most countries there was no space for fiscal loosening, a fact which should have been clear from the very beginning,

the support for fiscal stimulus changed into support for protracting necessary adjustment, i.e. making it more gradual.⁷² The rhetoric of a pleasant fiscal arithmetic (the bigger the stimulus the better) has been replaced by an unpleasant one (the bigger the fiscal adjustment the worse). The first view has already contributed to the worsening of the economic situation in the countries where it was followed; the second – if followed – is likely to create risks for the future.

There is a considerable uncertainty about the size and even the sign of fiscal multipliers; that is to say, it is unclear by how much and even in which direction GDP changes in response to fiscal stimulus or fiscal consolidation.⁷³ Even if one focuses exclusively on point estimates of fiscal multipliers, they hardly exceed one. This means that GDP changes less than government spending as government spending crowds out private expenditure. However, both the previous support for fiscal stimulus and the current support for protracting necessary adjustment have been based on the belief that fiscal multipliers must increase during the crisis, i.e. that fiscal stimulus produces larger increases in GDP than in “normal” times, and that fiscal consolidation generates larger declines in GDP. This policy conclusion stems from the assumptions of large spare capacity and no crowding out when interest rates are close to zero but would have been lower if the central bank had had the possibility to reduce it below zero.⁷⁴

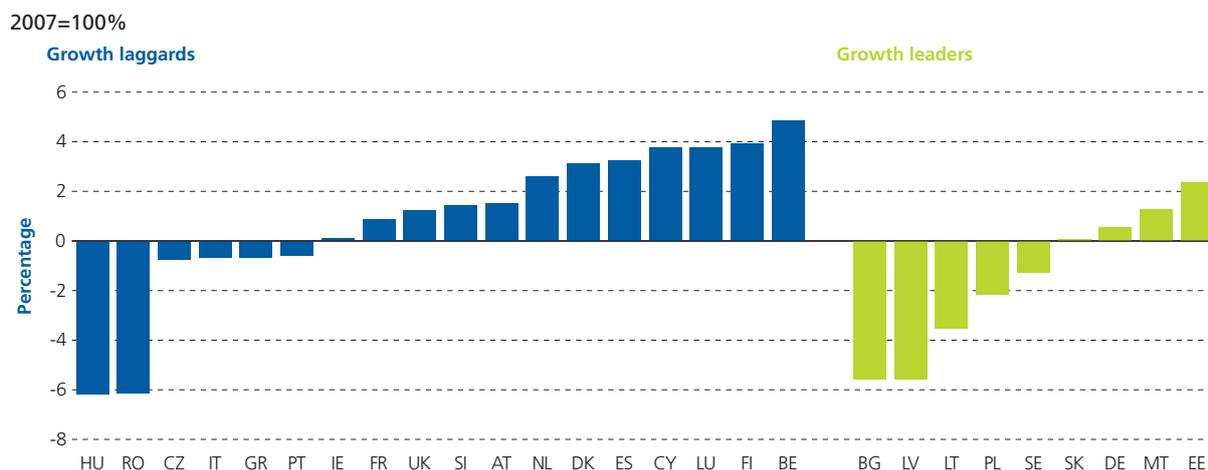
72 See Leszek Balcerowicz and Andrzej Rzońca, “The Fiscal Cure May Make the Patient Worse,” *Financial Times*, 10 December 2008.

73 For a recent review of the literature see Robert E. Hall, “By How Much Does GDP Rise, if the Government Buys More Output?” *Brookings Papers on Economic Activity*, 2009; Sebastian Gechert and Henner H. Will, “Fiscal Multipliers: A Meta-Regression Analysis,” *IMF Working Paper*, 2012; or Valerie Ramey, “Can Government Purchases Stimulate the Economy?” *Journal of Economic Literature* 49(3), 2011.

74 For the former view, see Bradford DeLong and Lawrence Summers, “Fiscal Policy in a Depressed Economy,” *Brookings Papers on Economic Activity*, 2012. For the latter view, see Lawrence Christiano, Martin Eichenbaum and Sergio Rebelo, “When is the Government Spending Multiplier Large?” *Journal of Political Economy* 119(1), 2011; Gauti B. Eggertsson, “What Fiscal Policy Is Effective at Zero Interest Rates?” *2010 NBER Macroeconomic Annual* 25, 2011; Michael Woodford, “Simple Analytics of the Government Expenditure Multiplier,” *American Economic Journal: Macroeconomics*, 3(1), 2011.

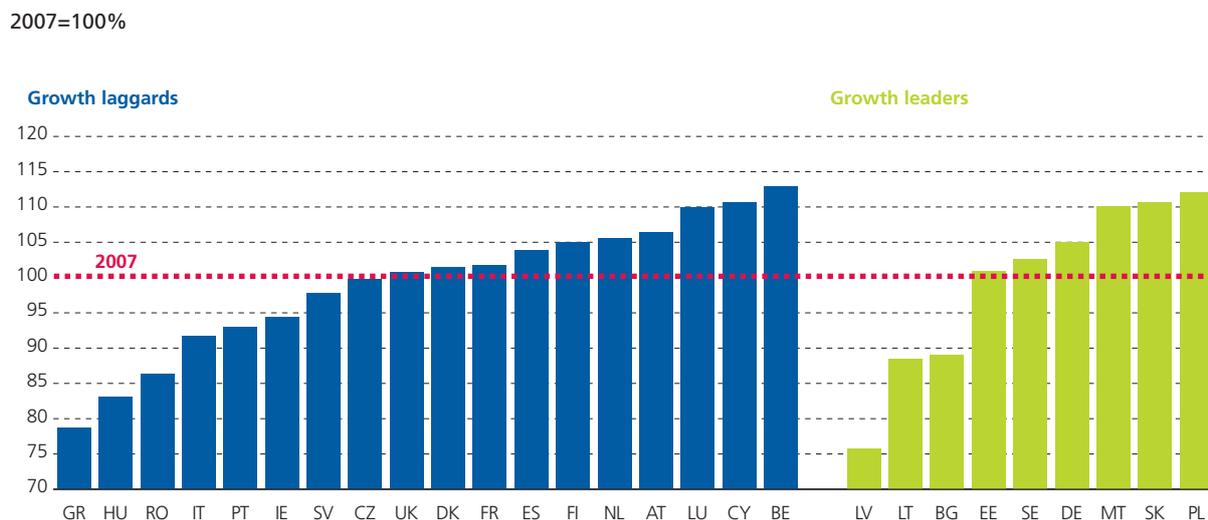
'A fiscal to financial crisis – best exemplified by Greece – results from systematic fiscal overspending, often financed by the accumulation of public debt.'

Chart 35: Change in total expenditure (2007-2012) excluding interest of general government adjusted for the cyclical component as a percentage of GDP



Source: AMECO

Chart 36: Real change in total expenditure (2007-2012) excluding interest of general government adjusted for the cyclical component



Source: AMECO

‘External conditions are largely inherited by respective countries and governments. Therefore, policies are the only controllable factor in the hands of policymakers.’

However, these assumptions are questionable. First, large spare capacity may only be apparent, since a significant part of investments is irreversible, e.g. a mixer can be used only for preparing concrete. Besides, employees operating machines which can be used only in a single way may re-gain productivity only if they move outside sectors that overgrew before the crisis. However, their reallocation needs time and it will be protracted, particularly if the overgrown sectors get fiscal support, direct or indirect.

Second, under certain conditions, private expenditure can be crowded out by fiscal stimulus and crowded in by fiscal consolidation, even when the central bank does not change interest rates in response to changes in fiscal stance. This happens if the change of fiscal stance is perceived to be long-lasting, public debt is at a level affecting lending rates via risk premium or it is households or entrepreneurs’ pessimism that is responsible for insufficient demand.⁷⁵ What matters for private spending is not the central bank’s interest rates in a current period but rather lending rates (including risk premia) expected by households and entrepreneurs in their planning horizon and their confidence.

Changes in fiscal stance may affect both lending rates’ expectations and households and entrepreneurs’ confidence, even if the central bank does keep its interest rates unchanged. Moreover, if the root cause of interest rates kept by the central bank close

to zero is households or entrepreneurs’ pessimism, the best fiscal policy to increase aggregate demand is policy aimed at strengthening the economy’s supply side.⁷⁶ Policy which attempts to substitute for private spending being insufficient due to entrepreneurs and households’ pessimism risks reassuring them in their belief of poor economic perspectives. By contrast, removal of various policy-driven distortions could improve these perspectives and is certainly devoid of the risk of ingraining pessimism.

There are also empirically-based objections to the delays in fiscal adjustment, for example:

- Weak domestic demand in the period preceding fiscal adjustment does not necessarily raise costs of fiscal adjustment in terms of aggregate demand and may even lower it.⁷⁷
- A fall in the real interest rate is not necessary to avoid a strong contraction of aggregate demand after fiscal adjustment.⁷⁸ Changes in private spending are not driven exclusively by changes in real interest rates.
- Long-term bond yields are to a significant extent determined by changes in the fiscal policy stance.⁷⁹ Thus, successful fiscal adjustment lowers them by reducing risk premia even when the central bank has no room for further interest rates cuts.
- Supply-side policies aimed at improving country cost competitiveness can help mitigate or even eliminate the aggregate demand contraction in response to fiscal adjustments.⁸⁰

75 For the first point of view, see e.g. Tobias Cwik and Volker Wieland, “Keynesian Government Spending Multipliers and Spillovers in the Euro Area,” *Economic Policy* 26(67), 2011. For the second, see e.g. Giancarlo Corsetti, Keith Kuester, Andre Meier and Gernot J. Mueller, “Sovereign Risk, Fiscal Policy and Macroeconomic Stability,” *IMF Working Paper* 12/33, 2012. For the third, see e.g. Karel Mertens and Morten O. Ravn, “Fiscal Policy in an Expectations Driven Liquidity Trap,” *CEPR Discussion Paper* 7931, 2010; Karel Mertens and Morten O. Ravn, *Fiscal Policy in an Expectations Driven Liquidity Trap* (San Domenico di Fiesole: European University Institute, 2012).

76 Karel Mertens and Morten O. Ravn, “Fiscal Policy in an Expectations Driven Liquidity Trap,” *CEPR Discussion Paper* 7931, 2010; Karel Mertens and Morten O. Ravn, *Fiscal Policy in an Expectations Driven Liquidity Trap* (San Domenico di Fiesole: European University Institute, 2012).

77 Alberto Alesina and Roberto Perotti, “Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects,” *NBER Working Paper* Nr. 5730, 1996; Alex Segura-Ubierno, Alejandro Simone and Sanjeev Gupta, “New Evidence on Fiscal Adjustment and Growth in Transition Economies,” *IMF Working Paper* 06/244, 2006.

78 Gabriele Giudice, Alessandro Turrini and Jan in’t Veld, “Can Fiscal Consolidations Be Expansionary in the EU? Ex-Post Evidence and Ex-Ante Analysis,” *European Commission DG Economic and Financial Affairs Economic Paper* 195, 2003.

79 Emanuele Baldacci and Manmohan Kumar, “Fiscal Deficits, Public Debt, and Sovereign Bond Yields,” *IMF Working Paper* 10/184, 2010.

80 See e.g. Roberto Perotti, “The ‘Austerity Myth’: Gain without Pain?” *CEPR Discussion Paper* 8658, 2011; or Alberto Alesina and Silvia Ardagna, “The Design of Fiscal Adjustments,” *NBER Working Paper* No. 18423, 2012.

‘In a financial to fiscal crisis, excessive growth of credit to the private sector (especially to housing) is the proximate cause of the boom – and the resulting bust.’

- Some countries have no choice but to reduce the deficit, even if deficit reduction is accompanied by some output loss in the short run.⁸¹ With large public debt, no adjustment, if feasible at all, is bound to be very costly. Even though the widely quoted research by Reinhart and Rogoff on links between economic growth and public debt was recently criticised, this criticism was unfair. First and foremost, as aptly stressed by Reinhart and Rogoff, the critics obtained quite similar results to the criticised research. Besides, there are many other studies finding negative links between growth and public debt.⁸²
- Public debt even as low as 60% of GDP could be a value above which the fiscal adjustment’s impact on aggregate demand is not different from zero and is positive in the long run.⁸³

With reference to the last finding, it is worth remarking that most EU countries have much larger public debt than 60% of GDP. In the EU in 2012, it exceeded 85%.⁸⁴ In Greece, Italy, Ireland and Portugal, it exceeded 100% of GDP. It was lower than 60% of GDP in 13 EU countries, mostly in the new member states. Among the EU-15, the group included only small northern economies, namely, Luxembourg, Sweden, Denmark and Finland.

Some influential supporters of delaying the fiscal adjustment refer to empirical arguments. Notably

the IMF argues that the bigger the planned fiscal consolidation was, the weaker, compared to forecasts, was GDP growth.⁸⁵ It interpreted this result as a sign that underlying fiscal multipliers were bigger than assumed in the models used for forecasting.⁸⁶ It is supposed to mean that “austerity” is more painful than previously thought.

However, replication of the exercise by the IMF with more detailed fiscal variables from European Commission forecasts shows that planned changes in total expenditure, as well as in social transfers and public wage bill, do not correlate with GDP forecast errors. It seems that multipliers associated with those fiscal variables are not larger than previously thought. By contrast, planned changes in general government revenue and public investment have a statistically significant impact on GDP forecast errors (see appendix 2 on page 73). It turns out then, that if any of the multipliers were underestimated, it was the case of multipliers associated with tax increases and reductions in public investment.⁸⁷ This gives support to the claim, already well documented, that the composition of fiscal adjustment matters, i.e. tax-based consolidations are more likely to be costly than expenditure-based ones.⁸⁸

It is striking that the improvement of the EU cyclically adjusted deficit to GDP ratio in 2012 relative to 2009 was achieved in a larger part through

81 See e.g. Pier Carlo Padoan, Urban Sila and Paul van den Noord, “Avoiding Debt Traps: Fiscal Consolidation, Financial Backstops and Structural Reform,” *OECD Journal: Economic Studies Volume 2012* (Paris: OECD, 2012).

82 See e.g. Stephen Cecchetti, Madhusudan Mohanty and Fabrizio Zampolli, “The Real Effects of Debt,” *BIS Working Paper* 352, 2011; Manmohan S. Kumar and Jaejoon Woo, “Public Debt and Growth,” *IMF Working Paper* 10/174, 2010; and Carmen M. Reinhart, Vincent R. Reinhart and Kenneth S. Rogoff, “Debt Overhangs: Past and Present,” *NBER Working Paper* Nr. 18015, 2012.

83 Ethan Ilzetzki, Enrique G. Mendoza and Carlos A. Végh, “How Big (Small?) Are Fiscal Multipliers?” *Journal of Monetary Economics* 60 (2), 2013.

84 AMECO database.

85 International Monetary Fund, *World Economic Outlook: Coping with High Debt and Sluggish Growth* (Washington: IMF, 2012).

86 See also Olivier Blanchard and Daniel Leigh, “Growth Forecast Errors and Fiscal Multipliers,” *IMF Working Paper* 13/1, 2013.

87 European Commission, *European Economic Forecast Autumn 2012* (Brussels: European Commission, 2012) finds other weaknesses in the study by the IMF, *World Economic Outlook: Coping with High Debt and Sluggish Growth* (Washington: IMF, 2012). In October 2012, the IMF WEO included a three-page box on pages 41-43 stating that multipliers might have been underestimated. In November 2012, the European Commission replied in its autumn forecast. The analysis was later taken further by IMF economists Olivier Blanchard and Daniel Leigh in a January 2013 working paper.

88 See e.g. Alberto Alesina and Roberto Perotti, “Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects,” *NBER Working Paper* Nr. 5730, 1996; Jurgen von Hagen, Andrew Hughes Hallett and Rolf Strauch, “Budgetary Consolidation in Europe: Quality, Economic Conditions and Persistence,” *Journal of the Japanese and International Economies* 16(4), 2002; Alberto Alesina and Silvia Ardagna, “Tales of Fiscal Adjustment,” *Economic Policy* 13(27), 1998; or Alberto Alesina and Silvia Ardagna, “Large Changes in Fiscal Policy: Taxes Versus Spending,” *Tax Policy and the Economy* 24, 2010.

'Fiscal overspending is a public-policy, and not a market, failure: it results from destructive political competition and weak (if any) constraints on public spending and public debt.'

tax hikes than through expenditure reduction. Moreover, government investment largely accounted for expenditure cuts. A contrast between countries like Bulgaria, Estonia, Latvia and Lithuania with Portugal, Ireland, Greece and Spain on that score is worth remarking. In the former group of countries, except for Latvia, the improvement in the cyclically adjusted fiscal balance was accompanied by a fall in government revenue relative to GDP. In the latter group, even if cuts in expenditure other than interest payments contributed to this improvement, it was also a result of a significant increase in the tax burden (with Ireland being the exception. See table 3 on page 47).

Delaying fiscal adjustment (i.e. improving a country's structural fiscal balance) would make economic sense only if its future introduction were easier. However, several factors may make a delayed fiscal adjustment even more difficult than it seems to be now:

- In spite of large public debt, interest payments in most EU countries are now quite low relative to both the historical maximum and the multiyear average. In 10 EU countries (including France), they are lower than before the crisis. In Greece, Ireland, Portugal and Spain, they are now larger than before the crisis, but, except for Ireland, their increase since the onset of the crisis has barely exceeded 1% of GDP. Among these countries they exceed the multiyear average only in Spain, but even there they are far below the historical maximum. However, the experience of the troubled European economies warns that with large public debt, the economy can easily switch from low yields to high yields in spite of a policy rate close to zero.
- Even if there were no legacy of global financial crises, population ageing is expected to significantly reduce GDP growth in the EU already over this

decade relative to its pre-crisis rate thus increasing the pressure on public finances.⁸⁹

- The public has been systematically taught that the promises of the future deficit reduction are largely just promises (for example, see charts 37 and 38, where Italian and French declarations from subsequent Stability Programmes are confronted with their realisation). Further delays risk strengthening that conviction.
- A chronic deficit creates uncertainty as to the way in which it will be reduced. Taking into account that uncertainty leads households and businesses to pay special attention to the most adverse scenarios, there is a risk that they will engage in economic choices as if they had to bear the main burden of the deficit reduction.

To sum up, the pressure to launch the fiscal stimulus during 2008-2009 in disregard of countries' fiscal position had weak theoretical and empirical foundations, and led to costly policy mistakes in such countries as Greece, Portugal and Spain. We cannot help but notice that the current pressure to postpone or spread over more time the fiscal consolidation is based on a deficient diagnosis of the economic situation of the problem countries, and risks causing further social costs.

The very term "austerity," which serves as a focal point in the anti-consolidation campaign, is emotionally loaded and imprecise. To many people, it just means the decline in GDP caused by fiscal consolidation, and especially the "cuts" in spending. The meaning is clearly seen in a popular juxtaposition: austerity versus growth. However, such a meaning makes the term "austerity" analytically useless (or even worse, manipulative), as it just assumes the reason for the decline in GDP while this decline should be empirically explained using an analysis that links various combinations of initial conditions and of the post-crisis policies to

89 For more on this subject, see European Commission, *The 2012 Ageing Report: Economic and Budgetary Projections for the 27 EU Member States (2010-2060)* (Brussels: European Commission, 2012); or Stephen Cecchetti, Madhusudan Mohanty and Fabrizio Zampolli, "The Future of Public Debt: Prospects and Implications," *BIS Working Paper* 300, 2010.

'Aggregate data indicates that "austerity" has been more declared than introduced.'

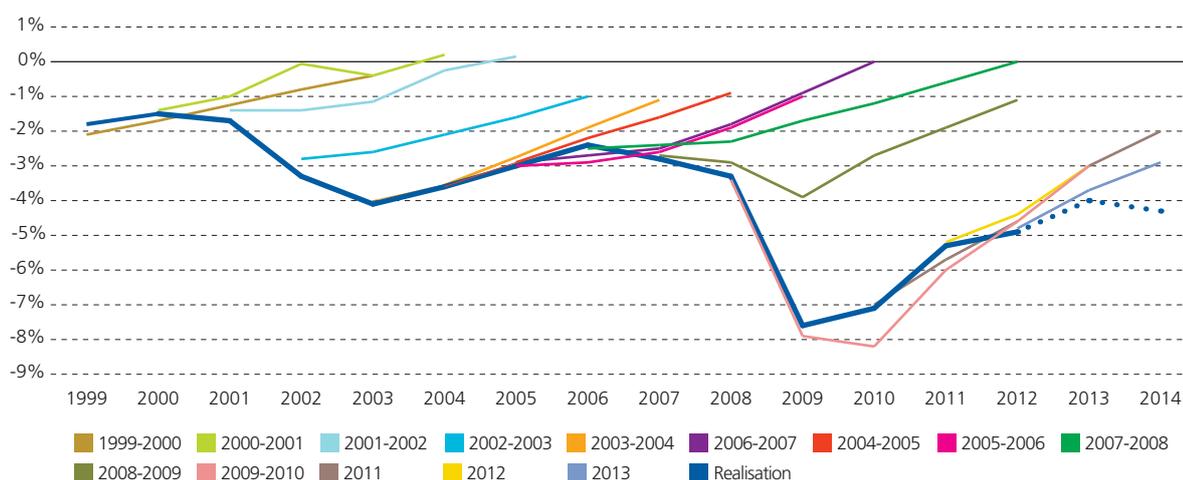
Table 3:
Changes in the cyclically adjusted fiscal balance and selected fiscal variables (2009-2012) in percentage of GDP

	Change in cyclically adjusted:						
	balance	balance excluding interest	revenue	spending	spending excluding interest	investment	spending excluding interest and investment
EU	2,2	2,5	1,3	-0,9	-1,2	-0,6	-0,6
EU-15	2,1	2,4	1,4	-0,7	-1,0	-0,6	-0,4
Euro area	1,9	2,2	1,4	-0,5	-0,8	-0,7	-0,1
Growth leaders							
Bulgaria	3,1	3,2	-2,1	-5,2	-5,3	-1,7	-3,6
Estonia	-1,5	-1,5	-2,2	-0,8	-0,7	0,5	-1,2
Germany	1,0	0,8	0,2	-0,8	-0,6	-0,3	-0,3
Latvia	5,0	4,8	2,3	-2,7	-2,5	-0,4	-2,1
Lithuania	3,1	3,7	-1,8	-4,9	-5,5	0,0	-5,5
Malta	0,1	0,1	1,9	1,8	1,8	0,8	1,0
Poland	4,2	4,4	1,0	-3,2	-3,4	-0,6	-2,8
Slovakia	3,1	3,5	-0,3	-3,4	-3,8	-0,4	-3,4
Sweden	-2,5	-2,7	-2,3	0,2	0,5	0,0	0,5
Growth laggards							
Austria	0,4	0,2	0,3	0,0	0,1	-0,2	0,3
Belgium	1,1	0,9	2,7	1,6	1,8	0,0	1,8
Cyprus	0,1	0,7	-0,2	-0,3	-0,9	-1,5	0,6
Czech Republic	1,5	1,7	1,2	-0,3	-0,5	-2,0	1,5
Denmark	-1,4	-1,6	0,2	1,6	1,8	0,4	1,3
Finland	-1,4	-1,5	0,8	2,1	2,3	-0,3	2,5
France	2,6	2,7	2,6	0,0	-0,1	-0,3	0,1
Greece	10,8	10,6	6,0	-4,8	-4,6	-1,3	-3,3
Hungary	2,4	1,8	-0,3	-2,7	-2,1	-0,1	-2,0
Ireland	4,9	6,6	-0,1	-5,0	-6,7	-1,7	-5,0
Italy	2,2	3,1	1,2	-1,0	-1,8	-0,7	-1,2
Luxembourg	-0,9	-0,9	-1,7	-0,8	-0,9	0,0	-0,8
Netherlands	1,4	1,2	0,5	-0,9	-0,7	-0,4	-0,3
Portugal	4,1	5,7	1,4	-2,8	-4,3	-1,2	-3,2
Romania	6,9	7,1	1,3	-5,6	-5,8	-1,3	-4,5
Slovenia	1,7	2,5	1,9	0,2	-0,5	-1,7	1,1
Spain	0,8	2,0	1,3	0,6	-0,6	-2,7	2,1
UK	4,5	5,5	2,3	-2,3	-3,3	-0,6	-2,7

Source: AMECO

‘There has been a gap between the reality of fiscal consolidation and the popular criticism of this policy presented under the term of “austerity.”’

Chart 37: France, plans of fiscal deficit reduction from subsequent stability programmes and reality (Fiscal deficit as a percentage of GDP)



Source: Stability Programme of France

differences in growth performance. Then, one can see that especially protracted declines in GDP in some countries were due to severe initial imbalances and imperfect policy packages which, for example, put a heavy emphasis on tax increases and delayed the reduction of current spending and structural reforms.

This seems to be the case in Greece, with respect to which the “austerity” has been heavily criticised. Greece has considerably reduced its fiscal imbalances, but only after they had become clearly unsustainable. Even if it cut some government expenditures significantly, it also raised taxes sharply. Higher tax rates and new taxation measures were important elements of the initial fiscal consolidation efforts. This faulty structure of the consolidation in Greece was noticed at the end of 2011 by the IMF which argued that Greece had “reached the limit of what can be achieved through increasing taxes” and it was confirmed in the following Troika’s reports.⁹⁰ The

Greek fiscal changes took place in a rigid economic environment and were accompanied by delays and implementation problems of the structural reforms announced in the initial and following adjustment programmes (see, for example the July 2013 review).⁹¹

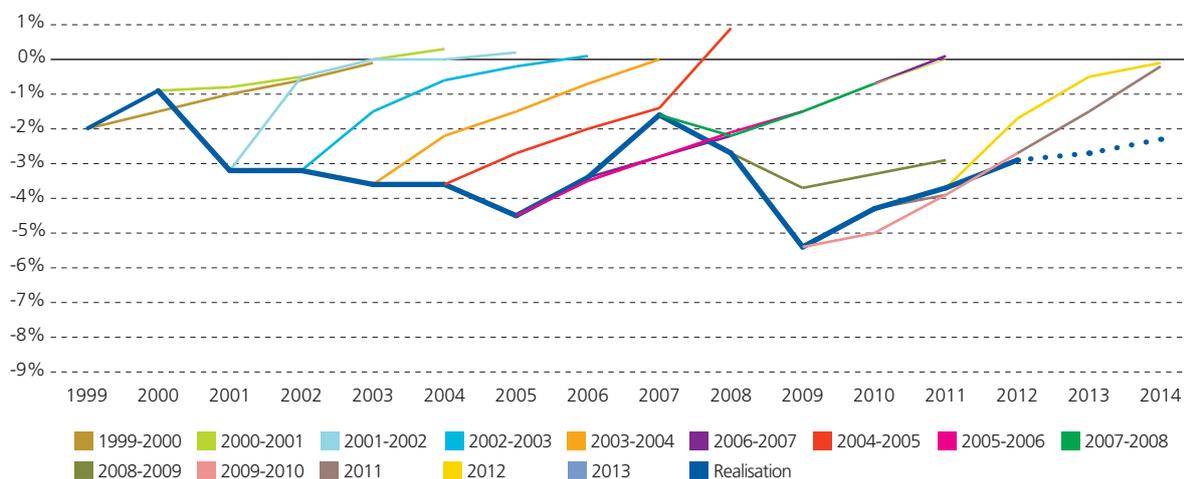
Fiscal consolidation, mislabelled as “austerity,” is not responsible for the double dip recession in the EU. Obviously, in a number of countries, it has contributed to a fall in aggregate demand, notably in those in which it has had an inappropriate composition (i.e. tax-based instead of expenditure-based) or was forced on the government by its cut-off from market funding of its borrowing needs. One could hardly expect households or entrepreneurs to be optimistic and to spend more if they were burdened with more taxes and saw that the government was able to retreat from fiscal profligacy only when it had no other choice.

90 IMF, “Greece Needs Deeper Reforms to Overcome Crisis”, IMF Survey online, 2011. <http://www.imf.org/external/pubs/ft/survey/so/2011/car121611a.htm>

91 IMF, “Fourth Review Under The Extended Arrangement Under The Extended Fund Facility, And Request For Waivers Of Applicability And Modification Of Performance Criterion 2013”, Country Report No. 13/241, 2013. (<http://www.imf.org/external/pubs/ft/scr/2013/cr13241.pdf>) See also *Ibid.*, “Greece: Ex Post Evaluation of Exceptional Access under the 2010 Stand-By Arrangement,” Country Report No. 13/156.

'In spite of large public debt, interest payments in most EU countries are now quite low relative both to the historical maximum and the multiyear average. In 10 EU countries (including France), they are lower than before the crisis.'

Chart 38: Italy, plans of fiscal deficit reduction from subsequent stability programmes and reality (Fiscal deficit as a percentage of GDP)



Source: Stability Programme of Italy

However, the treatment, even if imperfect and delayed, should not be confused with the disease. The root cause of the second recession in the EU is a procrastination or lengthening of necessary adjustments in a number of countries. Necessary adjustments include restoring fiscal responsibility, but are not limited to fiscal measures. Bulgaria, Estonia, Latvia and Lithuania, which had managed or been forced to introduce sharp and deep adjustments at the onset of the crisis, all avoided a second recession. One should not be surprised if some troubled European countries recover quite soon due to reforms which they have lastly undertaken. Although with an unnecessary and costly lag, those countries have undergone impressive adjustment.⁹²

In the worst case, Greece, Ireland, Portugal or Spain are not very likely to be a source of new shocks hampering growth in other EU countries. Yet, there are still many areas in the EU that can cause such shocks. Due to slow potential output growth reflecting a weakness of systemic forces in the EU considered as a whole, even a relatively

weak shock may result in a contraction of the EU economy. Some of the unresolved or even untackled problems may be a source of very serious shocks. In this context, we should mention the still vulnerable European banks and the weakness of the French economy.

Spending decisions can be divided into those which cannot be postponed and those which can. The latter include consumers' decisions to buy real estate and other durables, and firms' decisions to invest. Spending decisions which can be postponed heavily depend on confidence. Households and firms should not be regarded as Pavlov dogs that mechanically respond to changes in fiscal policies. Therefore, in times of deep uncertainty, the litmus test for any policy should be whether it keeps confidence down or increases it. From this point of view, making credible promises of fiscal consolidation and structural reforms and keeping them should be considered a crucial fiscal "stimulus" that the governments can offer.

92 Holger Schmieding and Christian Schulz, *The 2012 Euro Plus Monitor: The Rocky Road to Balanced Growth* (London: Berenberg Bank and Brussels: Lisbon Council, 2012).

‘To sum up, the pressure to launch the fiscal stimulus during 2008-2009 in disregard of countries’ fiscal position had weak theoretical and empirical foundations, and led to costly policy mistakes in such countries as Greece, Portugal and Spain.’

But to be considered credible, a promise has to be firmly anchored, i.e. legislated and not merely announced. Besides, its expected outcomes have to be evaluated with caution so that new measures will not have to be introduced in order to achieve results which the promise has been expected to bring. Lastly, cautiously evaluated outcomes should be large enough to resolve a targeted problem. The right medicine will not be effective if it is not applied in the right dose.

6. Monetary policy

In this section, we will focus on the monetary policy of the European Central Bank. It is one of the three major central banks in the world and has a strong effect on the monetary policy pursued by other central banks in the European Union.

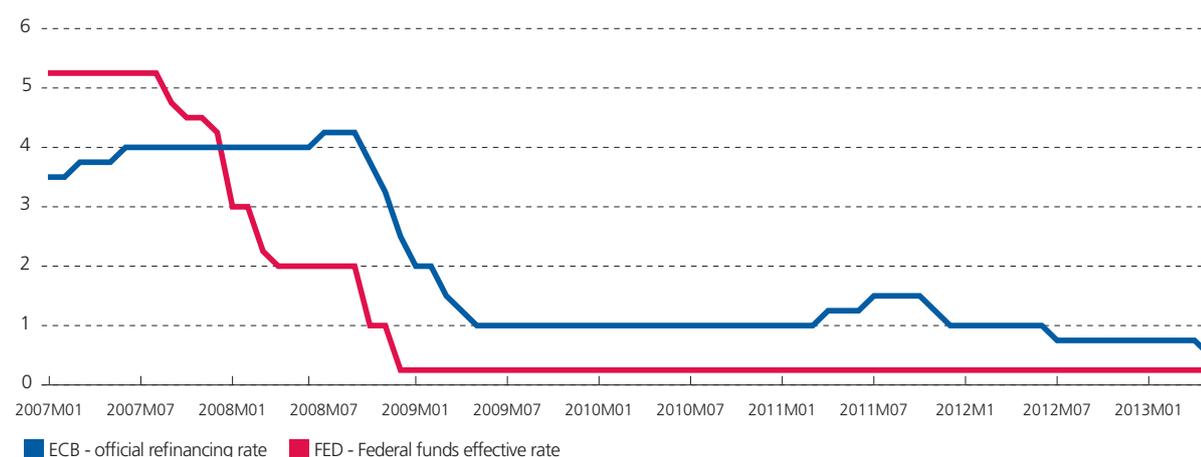
After the outburst of the crisis, the monetary policy of the ECB, like of most other central banks in developed countries, shifted to very low interest

rates (see chart 39 below). In addition to lowering interest rates close to zero, the ECB, similar to other major central banks, has undertaken other unconventional measures. These measures have resulted in a ballooning of its balance sheet (charts 40 and 41). Lastly, the ECB has introduced a sort of “forward guidance,” announcing its intention to keep monetary policy “accommodative for as long as needed” and then pledging that interest rates will “remain at present or lower levels for an extended period of time.”⁹³

The monetary policy pursued by the ECB has been very expansive by historical standards, but not as expansive as the policy of the US Federal Reserve (Fed), which serves as the US central bank:

- The ECB has kept interest rates close to zero, but still at a level higher than the Fed.
- The ECB’s balance sheet has doubled, but the Fed’s balance sheet has tripled.
- Unlike the Fed, the ECB for months eschewed a statement that could be perceived as an

Chart 39: Main policy rates



Source: Conference Board Total Economy Database (TED)

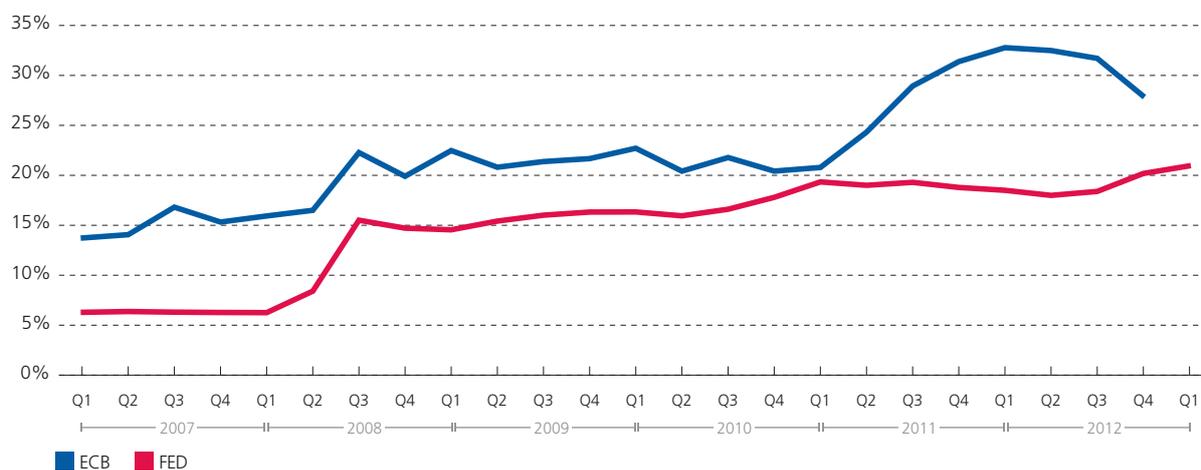
93 European Central Bank, ECB press conference, 04 July 2013. <http://www.ecb.europa.eu/press/pressconf/2013/html/is130704.en.html>

'Households and firms should not be regarded as Pavlov dogs that mechanically respond to changes in fiscal policies. Therefore, in times of deep uncertainty, the litmus test for any policy should be whether it keeps confidence down or increases it.'

announcement of the intention of keeping interest rates close to zero for a prolonged period. It introduced a sort of forward guidance only in March 2013. Even if it has recently abandoned avoiding any pre-commitment on interest rates, its pledges on that score have remained much weaker than those of the Fed.

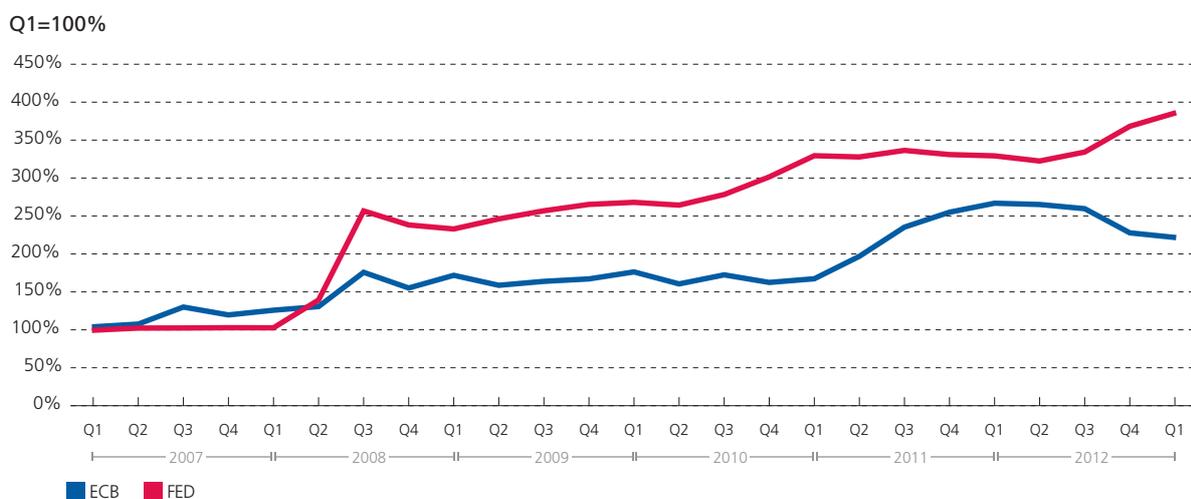
Many observers credit the ECB's non-conventional policies, and especially Mr Draghi's declaration that the ECB will "do whatever it takes" to preserve the euro, for the falling sovereign spreads in the euro area. However, in other people's opinion this was not the only factor responsible for that fall. Economist Daniel Gros, for example, has convincingly argued that this fall has followed a reduction in external

Chart 40: Central bank assets (as percentage of GDP)



Source: European Central Bank, US Federal Reserve and Eurostat

Chart 41: Central bank assets



Source: European Central Bank, US Federal Reserve and Eurostat

‘More importantly, continued aggressive non-conventional monetary policy is certainly not a free lunch. It cannot substitute for properly structured fiscal and structural reforms. The longer it is being pursued, the larger the risks it produces.’

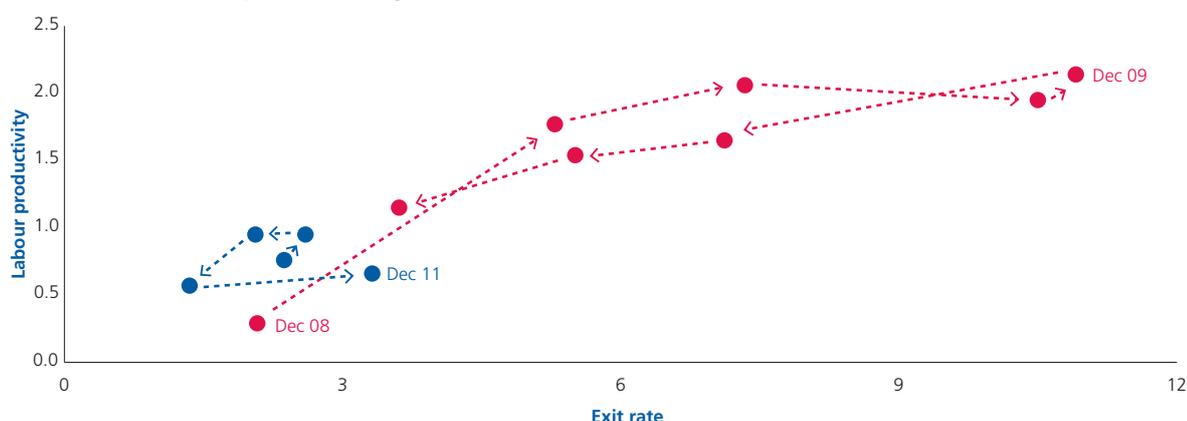
imbalances in problem countries.⁹⁴ That conclusion is strengthened by the fact that faster and more radical adjustment in the Baltic countries has produced even deeper declines in their sovereign spreads.

More importantly, continued aggressive, non-conventional monetary policy is certainly not a free lunch. It cannot substitute for properly structured fiscal and structural reforms. The longer it is being pursued, the larger the risks it produces.⁹⁵ There are five important risks in such a policy:

- 1) The policy creates a moral hazard problem on both the micro and the macro levels. On the micro level, it weakens banks’ incentive to repair their balance sheet. It facilitates forbearance lending whereby banks may postpone write-offs of bad loans.⁹⁶ The more banks are involved

in forbearance lending, the less profitable fast restructuring becomes for a single bank, since its profits depend on the stance of the whole sector. At the same time, delaying the repair of a balance sheet, if it is also postponed by other banks, gives a bank additional time for restructuring. As long as most banks do not restructure their balance sheet, the poor condition of the banking sector will provide a central bank with the justification to continue unconventional monetary policy. On the macro level, such a policy may also discourage the government to undertake a decisive fiscal adjustment. The government may be willing or under pressure to benefit from exceptionally low borrowing costs. Indeed, a low level of funding costs has been used as an argument to justify its recommendation, e.g. in the UK to slow down the necessary fiscal adjustment.⁹⁷

Chart 42: Labour productivity versus exit rate in the eurozone



Source: Deutsche Bank

94 Gros, Daniel. “The Austerity Debate is Beside the Point For Europe,” *Economic Policy, CEPS Commentaries*, 2013
 95 Claudio Borio, “The Financial Cycle and Macroeconomics: What Have We Learnt?” *BIS Working Paper* 395, 2012; Herve Hannoun, “Monetary Policy in the Crisis: Testing the Limits of Monetary Policy,” *Speech at the 47th SEACEN Governors’ Conference*, Seoul, 2012; William R. White, “Ultra Easy Monetary Policy and the Law of Unintended Consequences,” *Federal Reserve Bank of Dallas Globalization and Monetary Policy Institute Working Paper* 126, 2012; Piotr Cizkowicz and Andrzej Rzonca, “Interest Rates Close to Zero, Post-Crisis Restructuring and Natural Interest Rate,” *Prague Economic Papers*, 2013.
 96 This facilitation has at least two sources. First, with interest rates close to zero, almost all debtors are able to pay interest, including those debtors who will never be capable of repaying borrowed principal. Besides, even if interest charges were rolled up and added to the principal, which would never be repaid, the bank’s losses would not increase significantly. Second, unprecedented response to the crisis by the central bank hinders financial supervision authority from the recognition of forbearance lending for anything else than a manifestation of “forward-looking” help offered by banks to debtors to overcome their “transitory” problems.
 97 International Monetary Fund, *United Kingdom: 2013 Article IV Consultation Concluding Statement of the Mission* (Washington: IMF, 2013).

‘Loose monetary policy creates a moral hazard on both the micro and macro levels. On the micro level, it weakens banks’ incentives to repair their balance sheet.’

- 2) It hampers post-crisis restructuring through other channels. They include, inter alia, subsidising weak or even insolvent banks, keeping “zombie” companies alive (i.e. companies that do not go bankrupt only due to forbearance lending by banks) and distorting asset prices, which may increasingly reflect investors’ expectations with regard to further central bank actions.
- 3) It risks creating asset bubbles – on both the bond and the stock market – which when burst would endanger future economic growth.
- 4) It risks compromising the central bank’s independence. It provides the central bank with a powerful political position, as it has an effect on income and wealth distribution in the society. This position, in turn, invites pressure from politicians.
- 5) It risks generating inflation – in particular at the moment when the banking sector regains the ability to create money. The heavier the central bank’s interventions are, the less likely its exit will be on time, as the central bank may want to limit the effects of an exit on markets in which it has intervened (or be under investors’ or the government’s pressure to limit these effects).

There is evidence pointing to the materialisation of some risks in the euro area. However, it should be noted that they are not necessarily (or entirely) a by-product of the policy pursued by the ECB. Monetary policy conducted by the Fed has also

largely contributed to their occurrence – both directly (due to capital mobility) and indirectly (through the impact of Fed decisions on the ECB’s decisions).

European banks are traded at about half of their book value.⁹⁸ Their valuation is more subdued than the valuation of US banks after the Great Depression.⁹⁹ The risk premium paid by European banks for market funding remains at a clearly higher level than before the crisis, indicating that this low valuation may largely stem from investors’ concerns about losses hidden through forbearance lending to be revealed.¹⁰⁰ A steadily growing percentage of non-performing loans provides investors with good reasons for these concerns.¹⁰¹ It is worth noting that restructuring of the banking sector seems to be far from completed even in countries that are perceived to belong to the sound core of the euro area (e.g. the Netherlands.)

Furthermore, the default rate in the euro area, after a sharp increase at the onset of the crisis, quickly fell to a level quite low by historical standards.¹⁰² Changes in the default rate have been closely followed by labour productivity growth. It was accelerating until December 2010, and since then has been falling (see chart 42).

In most EU countries, the price of both government and corporate bonds increased to levels which had never been seen before the crisis even in economies with a long history of stability. In the Netherlands, for example, the lowest level of government bond yields before the crisis was about 3%. This minimum has been broken in a

98 De Nederlandsche Bank, *Overview Financial Stability. Spring 2013* (Amsterdam: De Nederlandsche Bank, 2013).

99 Bank of England, *Financial Stability Report, Issue No. 32* (London: Bank of England, 2012).

100 De Nederlandsche Bank, *Overview Financial Stability. Spring 2013* (Amsterdam: De Nederlandsche Bank, 2013).

101 The Fed has been more aggressive in pursuing unconventional monetary policy. Yet, banks in the US are, in general, healthier than in the EU. The more decisive restructuring in the US seems to have been helped by the market-based financial system. Competitive pressure on banks is likely to hinder forbearance lending. See e.g. Stephan Barisitz, “Nonperforming Loans in Western Europe – A Selective Comparison of Countries and National Definitions,” *Focus on European Economic Integration*, 2013.

102 Deutsche Bank, *Focus on Germany, Current Issues* (London: Deutsche Bank Markets Research, 2013).

'On the macro level, loose monetary policy may also discourage government to undertake a decisive fiscal adjustment. The government may be willing or under pressure to benefit from exceptionally low borrowing costs.'

majority of EU countries. Exceptionally low yields by historical standards suggest that bonds could have become significantly overpriced in these countries. The recent vigorous correction of their prices under investors' anticipation of the tapering of quantitative easing by the Fed supports this view. That said, it has to be stressed that aggregate sovereign bond yields have been higher in the EU than in the US. Besides, equity valuations still seem to be conservative relative to historic norms and certainly relative to current valuations in other advanced economies.

At the peak of the fiscal crisis in the euro area, the ECB was under strong pressure to engage in the massive purchases of problem countries' government bonds. The ECB resisted the pressure. It has allowed bond yields to be above 6% for Portugal, and occasionally above 5% for Italy and Spain. However, it later pledged that it was "ready to do whatever it takes to preserve the euro."

In addition to general risks associated with unconventional monetary policy measures, there are two risks specific to the ECB and the euro area:

- First, the unconventional policy of the ECB, unlike that of the Fed, is akin to regional policy. The Fed does not bail out e.g. California, for example, whereas the ECB is invited by some governments and commentators to bail out euro-area countries with fiscal problems.
- Second, some unconventional monetary policy measures may be questioned as not being compatible with the mandate of the ECB, which is first and foremost to maintain price stability in the euro area. Undertaking these measures may be perceived as further undermining the rule of law in the EU in a situation when confidence is crucial.

To sum up, the ECB undertook unprecedented steps in monetary policy to protect the financial system from collapse after the onset of the global crisis. However, they have also created various risks that are linked to the postponement of needed post-crisis restructuring in banks and companies and of necessary fiscal consolidation. The longer these adjustments are delayed, the greater the risk is that the cost of the delay and of future adjustments will outweigh the previous benefits.

7. Sovereigns, banks and credit

Many economists stress that one of the main reasons for the weakness in GDP in the problem countries is more expensive and declining credit to the economy.¹⁰³ However, other economists have shown that, after previous financial crises that were themselves preceded by credit booms, bank lending was uncorrelated with the strength of recoveries.¹⁰⁴ We will examine these issues in this section.

Regarding credit rates across the euro area, the spreads were quite narrow until 2008, albeit gradually growing since 2004. They increased considerably when the financial stability of the banking sector and of governments started to be gauged differently across countries. However, credit rates do not differ across countries randomly. In 2012, interest rates on new loans to small- and medium-sized enterprises (SMEs) exceeded the euro area average by more than one percentage point only in countries with strong tensions in public finances and the banking sector, i.e. in Ireland, Greece, Portugal, Spain, Cyprus and Slovenia.

There are various links between a country's fiscal stance and the cost of credit to firms. When it becomes risky to lend to the government, the credit risk of

103 See e.g. Zsolt Darvas, Jean Pisani-Ferry and Guntram B. Wolff, *Europe's Growth Problem (And What To Do About It)* (Brussels: Bruegel, 2013).

104 Elod Takáts and Christian Upper, "Credit and Growth after Financial Crises," *BIS Working Paper* 416, 2013.

‘There are various links between a country’s fiscal stance and the cost of credit to firms. When it becomes risky to lend to government, the credit risk of companies tends to increase too.’

companies tends to increase as well. Their success or failure is not independent from the country’s economic situation, which can sharply deteriorate if serious concerns are raised about the government’s solvency. Deterioration in the economic situation worsens the quality of loans extended by banks to firms and households, and fiscal stress makes the government’s bailout guarantees, both explicit and implicit, dubious, and sometimes even implausible. A fiscal crisis also directly decreases the quality of banks’ assets, as banks are themselves important buyers of government bonds. The weaker the banks are in terms of capital adequacy, the more likely it is that government bonds will have a large share in their assets due to the Basel regulation that allows assigning zero risk weight to government bonds. Lastly, a low quality of banks’ assets raises their costs of obtaining funding.

Prior to the crisis, market funding costs of banks in the euro area were close to a risk-free interest rate. However, since the onset of the crisis they have increased and become volatile, even in the countries

considered to be stable, such as the Netherlands.¹⁰⁵ Deposit rate spreads have increased broadly in line with lending rate spreads.

To lower the lending spreads across EU countries in a sustainable way, one must eliminate the reasons for their rise, i.e. dispel concerns about some governments’ solvency and improve the quality of banks’ assets and capital. In addition to reducing credit risk, a successful fiscal adjustment based on cuts in current government expenditure, notably on salaries and social transfers, tends to increase expected profits. Such an adjustment, on the one hand, eliminates the risk of tax hikes which could undermine profitability. On the other hand, it weakens wage pressure and thereby lowers labour costs and the costs of intermediate goods, which always include a labour remuneration component. The alternative to removing the sources of risk through a decisive policy adjustment is the transfer of credit risk from a given country to other countries or to the ECB. However, the current crisis should teach us that the transfer of credit risk

Table 4: MFI interest rates - Loans to non-financial corporations - annual data

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Euro area	4.79	4.68	4.50	5.24	5.96	5.78	4.22	4.18	4.63	3.94
Min in euro area	4.10	3.96	3.93	4.38	4.97	4.68	2.73	2.77	3.14	3.04
Country with min	Belgium	Austria	Austria	Austria	Austria	Belgium	Austria	Austria	Austria	Austria
Max in euro area	5.47	5.05	5.29	5.93	6.57	8.86	6.17	7.95	6.94	7.17
Country with max	Greece	Greece	Ireland	Ireland	Ireland	Cyprus	Cyprus	Greece	Ireland	Greece
Max-average	0.68	0.37	0.79	0.69	0.61	3.08	1.95	3.77	2.31	3.23
Max-min	1.37	1.09	1.36	1.55	1.60	4.18	3.44	5.18	3.80	4.13

Source: Eurostat

105 De Nederlandsche Bank, *Overview Financial Stability. Spring 2013* (Amsterdam: De Nederlandsche Bank, 2013).

‘To lower the lending spreads across EU countries in a sustainable way, one must eliminate the reasons for their rise, i.e. dispel concerns about some governments’ solvency and improve the quality of banks’ assets and capital.’

is not equivalent to its reduction, and may worsen the situation by weakening managers’ incentives to restructure and policymakers’ incentives to reform.

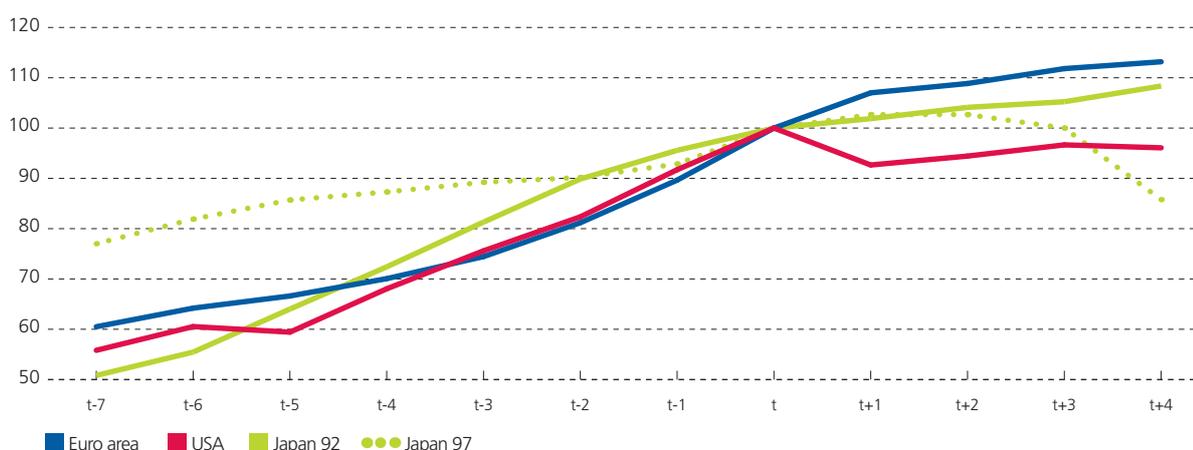
The experience of Japan shows that this lesson holds even after the bursting of a speculative bubble: bad loans at the end of the 1990s were the legacy not only of the bubble’s bursting at the beginning of the 1990s, but to a large extent also of the granting of credit by weak banks to SMEs under pressure from the government in the 1990s.¹⁰⁶ In addition, the recent experience of the UK with funding for a lending scheme shows that it is difficult to design a programme that can make a difference in credit growth. According to the data available on the Bank of England web page, credit in the UK remained flat in both the banks participating and in those not participating in the Funding for Lending Scheme.¹⁰⁷

By contrast, in the Baltics, and in particular in Latvia, where the credit boom suddenly stopped resulting

in enormous fiscal tensions, the governments had launched a radical fiscal consolidation. The consolidation contributed to a steady decline in lending rates after the peak in 2008. In Latvia, lending rates were more than eight percentage points lower in 2012 than in 2008. In all Baltic countries, they are lower than in Greece, Ireland, Portugal and Spain. As one can see, policies which sharply reduce the sources of risk lead to sharp declines in risk premia, and, therefore, in the lending rates.

But what about the dynamics of the volume of credit? Has the EU, and especially the problem countries, suffered from the credit crunch? Credit to the private sector in the EU increased after the outburst of the crisis until 2011 – both in nominal terms and relative to GDP.¹⁰⁸ In the euro area, it grew in nominal terms faster than in the US and faster than in Japan during the first four years of its lost period, regardless of the year recognised as the beginning of that period (see chart 43).

Chart 43: Domestic credit to the private sector around the crisis year (t-beginning of the crisis)



Source: World Bank World Development Indicators

106 See e.g. Takeo Hoshi and Anil K. Kashyap, “Will the US Bank Recapitalization Succeed. Eight Lessons from Japan,” *Journal of Financial Economics* 97(3), 2010.

107 <http://www.bankofengland.co.uk/boeapps/iadb/newintermed.asp>.

108 It includes not only loans to households and enterprises, but also purchases of non-equity securities, and trade credits.

‘The current crisis should teach us that the transfer of credit risk is not equivalent to its reduction and may worsen the situation.’

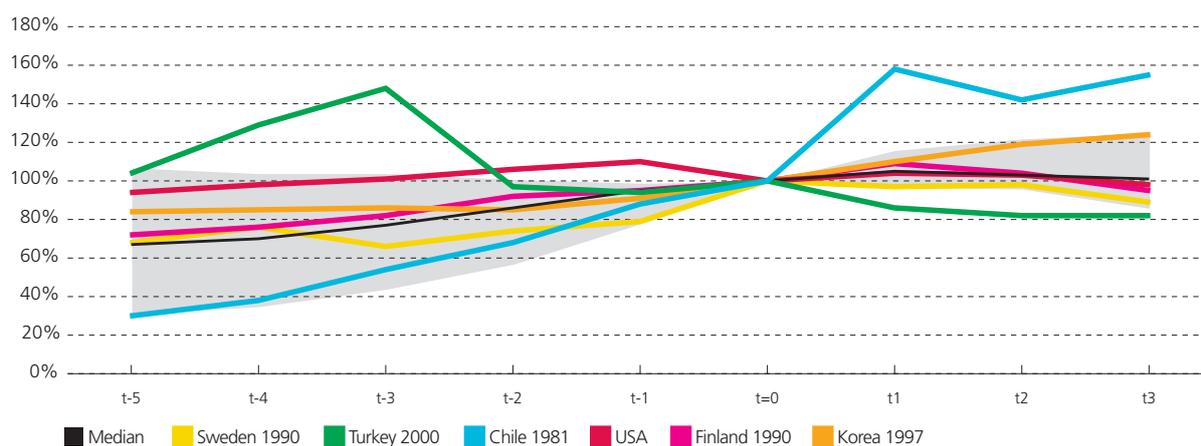
To be sure, the euro area fell behind the US in terms of growth of credit to the private sector after 2012, but only until the data is corrected for the debt issued for share buybacks.¹⁰⁹

The private debt to GDP ratio fell relative to the pre-crisis level only in a few EU countries, mainly in the Baltics, where it dropped in nominal terms, according to data published by the European Commission.¹¹⁰ Tight access to credit (together with the initial sharp increase in lending rates) contributed to fast rebalancing of these economies, which has enabled them to quickly return to a growth path.¹¹¹ Only if subsequent years are taken as the base period, the group of countries with private debt falling relative to GDP becomes wider and includes most problem countries. However, even when only recent years are considered, deleveraging still was more frequent in the first group than in the second group of countries, divided according to their economic growth since 2008 relative to the US.

In no EU country has deleveraging so far been at an exceptional pace by historical standards. Where it has been the fastest (the Baltics), it has been quite similar to the pace of deleveraging in Sweden after the financial crisis at the beginning of the 1990s, which is a country considered to be a model of crisis management and post-crisis growth (see chart 44).

Credit dynamics can hardly explain differences in economic growth between the EU and the US or within the EU during the 2008-2012 period. This finding is consistent with both theory and empirical research on economic growth after the financial crisis. In the first place, theory suggests that the growth of aggregate demand is more strongly associated with changes in credit flow than in credit stock or, to put it differently, changes in credit growth matter more for aggregate demand than credit growth itself.¹¹² Declining credit may positively contribute to aggregate demand growth, provided that the pace of this decline is decelerating. Meeting this condition means that the private sector spends less

Chart 44: Credit to GDP ratio in the EU, US and five selected episodes of banking crisis



Source: World Bank World Development Indicators

109 J. P. Morgan, "Distortions from Share Buybacks," *Flows & Liquidity*, 2013.

110 It included loans to households and debt enterprises and securities other than shares.

111 Daniel Gros and Cinzia Alcidi, "Country Adjustment to a 'Sudden Stop': Does the Euro Make a Difference?" *European Commission Economic Paper* 492, 2013.

112 See Michael Biggs, Thomas Mayer and Andreas Pick, "Assessing the Risk of Banking Crisis – Revisited," *De Nederlandsche Bank Working Paper* 218, 2009.

'After financial crises preceded by credit booms, credit-less recoveries are generally not weaker than recoveries with credit growth. On the contrary, credit-less recoveries may be even stronger than credit-driven ones.'

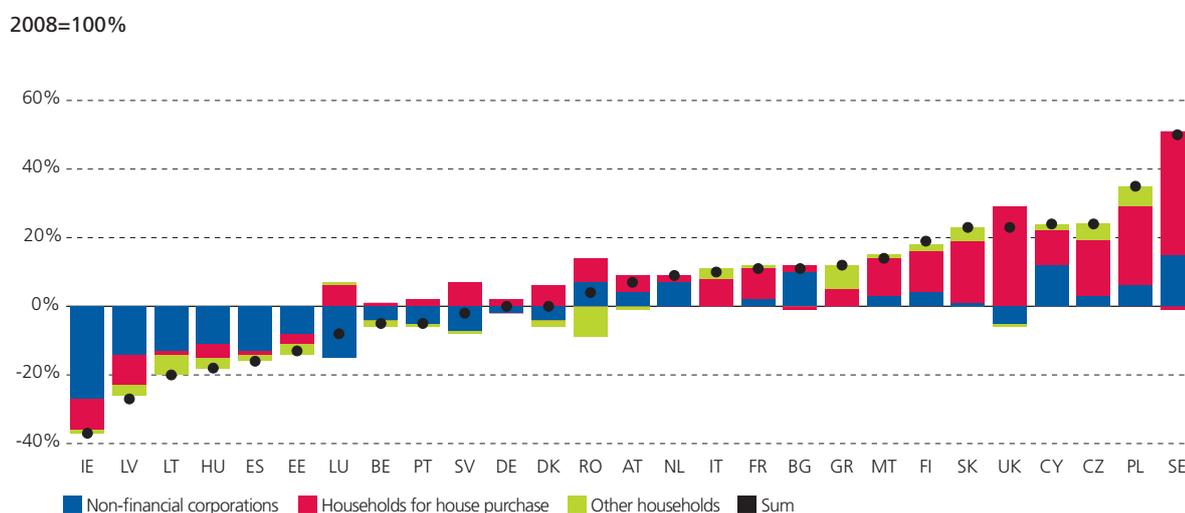
and less of its disposable income on repayment of debts previously incurred and thus has more and more room for spending on other purposes. Once credit starts increasing again, changes in both its stock and its flow will boost aggregate demand.

What's more, many empirical studies confirm that an increase in aggregate demand after a crisis does not require credit growth, and that after a crisis, credit growth occurs later than economic recovery.¹¹³ More specifically, after financial crises preceded by credit booms, credit-less recoveries are generally not weaker than recoveries with credit growth.¹¹⁴ On the contrary, credit-less recoveries may be even stronger than credit-driven ones.¹¹⁵ Sweden, as discussed at the onset of this policy brief, is a good example of a country which experienced a strong credit-less recovery after a crisis. A slowdown

of credit growth leading to its fall relative to GDP seems to be inevitable after a credit bubble bursts. The deleveraging is, to a large extent, a correction of previous excesses. This is especially true after a housing boom.

In EU countries where credit to the private sector fell, it was the housing credit that largely contributed to that fall. Yet, it fell less than corporate credit (see charts 45 and 46). And, while credit to the euro-area construction sector did decline, the drop was not the biggest among all sectors, whether in percentage terms or amount. Although the percentage of non-performing loans in the euro area has significantly increased since the onset of the crisis, its increase was initially slower than in the US and exceeded the respective percentage in the US only two years after the outburst of the crisis. Furthermore, it has

Chart 45: Contributions to change in credit to the private sector (2008-2012)



Source: European Central Bank Statistical Data Warehouse

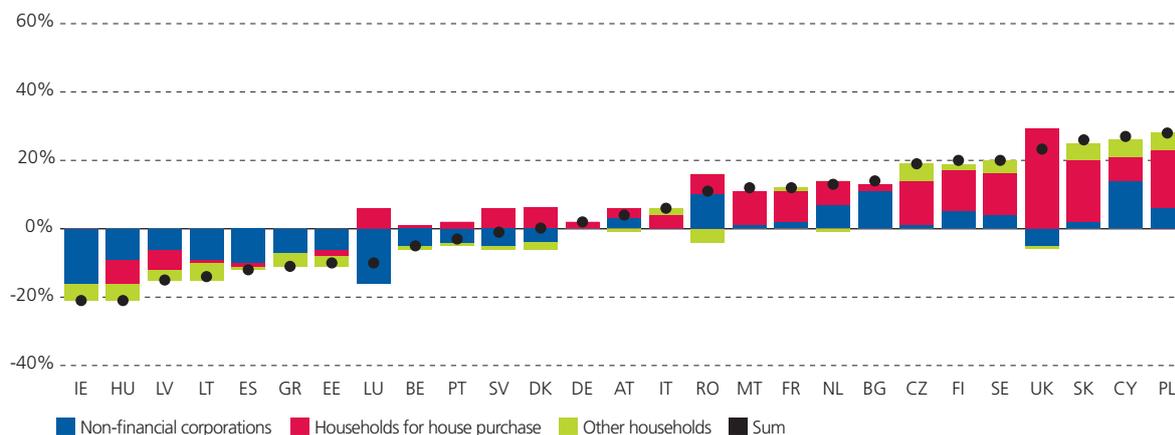
113 Ibid.. See also Guillermo Calvo, Alejandro Izquierdo and Ernesto Talvi, "Sudden Stops and Phoenix Miracles in Emerging Markets," *American Economic Review*, 2006; Stijn Claessens, M. Ayhan Kose and Marco E. Terrones, "What Happens During Recessions, Crunches and Busts?" *IMF Working Paper 08/274*, 2008; Stijn Claessens, M. Ayhan Kose and Marco E. Terrones, "What Happens During Recessions, Crunches and Busts?" *Economic Policy* 24(60), 2009.

114 Elod Takáts and Christian Upper, "Credit and Growth after Financial Crises," *BIS Working Paper* 416, 2013.

115 Morton Bech, Leonardo Gambacorta and Enisse Kharroubi, "Monetary Policy in a Downturn: Are Financial Crises Special?" *BIS Working Paper* 388, 2012.

'Various balance sheet indicators confirm that banks in Europe, especially in problem countries, remain weaker than in the US. Without further restructuring, confidence in banks will not be restored, and their funding will continue to be limited.'

Chart 46: Adjusted contributions to change in credit to the private sector (2008-2012)



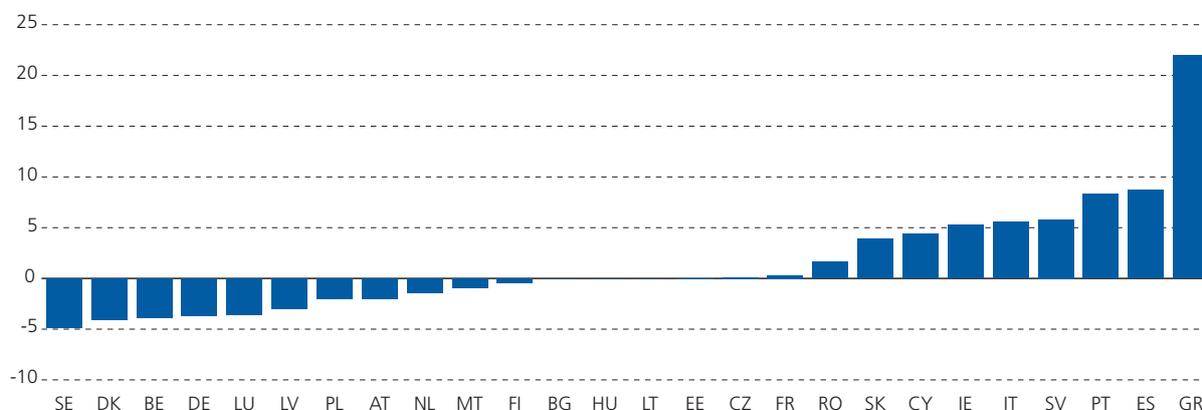
Adjusted contributions are based on national stock growth rates reported by ECB.
Source: European Central Bank Statistical Data Warehouse

remained clearly lower than the percentage in Japan at the beginning of the 2000s after a long period of hiding the low quality of banking assets.

All in all, both the composition of the fall in credit (with relatively modest decline in housing credit

and credit to the construction sector) and the still limited percentage of non-performing loans in comparison with their share after the outburst of similar crises suggest bank balance sheets need to be strengthened. This claim is in line with previous findings.¹¹⁶ Economist Claudio Borio and his

Chart 47: Change in central bank liquidity as a percentage of banking sector liabilities (2008-2012)



Source: European Commission

116 Claudio Borio, Bent Vale and Goetz von Peter, "Resolving the Financial Crisis: Are We Heeding the Lessons from the Nordics?" BIS Working Papers 311, 2010.

‘It is a promising sign that the most problematic countries from the eurozone periphery, which have a large scope for improvement of their institutional systems, are now undertaking serious reforms.’

colleagues found that although recognition of the banking problems and public intervention came relatively early in the current crisis in both the EU and the US, the depth of the intervention – when it came – was clearly limited, particularly in the EU. For example, five years after the beginning of the crisis, Spanish Cajas are still causing troubles and raising uncertainty. In the same vein, Stijn Claessens and his colleagues conclude in a recent study that asset restructuring is much less advanced than it should be at this stage of the crisis.¹¹⁷ Various balance sheet indicators confirm that banks in Europe, and notably in problem countries, remain weaker than in the US.¹¹⁸ Without further restructuring, confidence in banks will not be restored, and their funding will continue to be limited.

A legacy of the pre-crisis boom was a large deposit funding gap in most EU countries, i.e. the credit to households and businesses exceeded the deposits. The correction of this imbalance turned out to be all the more unavoidable, as the crisis was followed by systematic contraction of the wholesale market of non-secured loans, making it more difficult for banks to cover the deposit funding gap.¹¹⁹ Therefore banks have increased secured funding. But secured funding increases the risk of asset encumbrance, which is ultimately borne by depositors or taxpayers.¹²⁰ As a result, the policy may have a negative effect on confidence in the banks. Thus, first and foremost, banks have increased financing from the central banks (see chart 47 on page 59). Unsurprisingly, the largest increase was observed in countries where credit has dropped.

Some deleveraging after a speculative bubble bursting is hardly avoidable when the bubble itself was inflated by credit. Sharp adjustment in the banking sector and the related deleveraging leads to strong

initial contraction in aggregate demand, but then an economic rebound is possible, as proved by, inter alia, the recent experience in the Baltics and Sweden in the 1990s. Deferral of adjustment of the banking sector postpones deleveraging. However, it also cuts off new projects from credit, which has an adverse effect for both aggregate demand and potential output growth. This adverse effect contributes to further weakening of the banking sector. As a result, even if the initial fall in aggregate demand is lower, it lasts longer and, in total, is deeper.

8. Structural reforms

The institutional systems of EU countries clearly differed in 2007, especially regarding the extent of free markets (or, conversely, of the rigidities and distortions), the related intensity of market competition, the level of protection of property rights, the fiscal burden and the size and quality of public administration. Together with the differences in the size of the inherited imbalances and the pattern of the fiscal policy, these institutional differences played an important role in the shaping the output response of EU economies during the 2008-2012 period.

For example, regarding the ease of doing business in 2008, the five best performing countries in terms of growth also made it into the top 15, while the five worst performing did not manage to make it into the first 50 (Greece is listed as No. 100, between the Dominican Republic and Sri Lanka).¹²¹ The *Global Competitiveness Report 2008-2009* and *Economic Freedom of the World 2008* offer a similar picture, with the five best European countries among the world top 15, and the worst five not making it into the first 50.¹²²

117 Stijn Claessens, M. Ayhan Kose and Marco E. Terrones, “How Do Business and Financial Cycles Interact?” *Journal of International Economics*, 87(1), 2012.

118 See e.g. International Monetary Fund, *Global Financial Stability Report. Old Risks, New Challenges* (Washington: IMF, 2013).

119 See, e.g. European Central Bank, *Financial Integration in Europe* (Frankfurt: ECB, 2013).

120 For more on this see De Nederlandsche Bank, *Overview Financial Stability. Spring 2013* (Amsterdam: De Nederlandsche Bank, 2013).

121 World Bank, *Doing Business 2008* (Washington: World Bank, 2008).

122 World Economic Forum, *The Global Competitiveness Report 2008-2009* (Geneva: World Economic Forum, 2008).

'Reduction of the labour tax wedge, job protection of permanent workers and impediments to female labour market participation together with a shift in taxation from labour to environmental taxes could increase labour participation in Germany.'

Table 5: Comparative rankings

	Doing Business 2008		Global Competitiveness Report 2008-09		Economic Freedom of the World 2008	
EU top 5	3	US	1	US	8	Ireland
	5	Denmark	3	Denmark	9	US
	6	UK	4	Sweden	10	UK
	8	Ireland	6	Finland	13	Cyprus
	13	Finland	7	Germany	14	Denmark
	14	Sweden	8	Netherlands	15	Finland
	17	Estonia	12	UK	17	Estonia
	19	Belgium	14	Austria	18	Austria
	20	Germany	16	France	20	Luxembourg
	21	Netherlands	19	Belgium	22	Netherlands
	22	Latvia	22	Ireland	23	Slovakia
	25	Austria	25	Luxembourg	25	Malta
	26	Lithuania	29	Spain	27	France
	31	France	32	Estonia	30	Germany
	32	Slovakia	33	Czech Republic	31	Spain
	37	Portugal	40	Cyprus	37	Lithuania
	38	Spain	42	Slovenia	38	Sweden
	42	Luxembourg	43	Portugal	39	Latvia
	45	Hungary	44	Lithuania	43	Belgium
	46	Bulgaria	46	Slovakia	44	Romania
	48	Romania	49	Italy	47	Portugal
EU bottom 5	53	Italy	52	Malta	54	Bulgaria
	55	Slovenia	53	Poland	54	Czech R.
	56	Czech Republic	54	Latvia	60	Hungary
	74	Poland	62	Hungary	60	Poland
	100	Greece	67	Greece	64	Slovenia
	-	Malta	68	Romania	66	Greece
	-	Cyprus	76	Bulgaria	78	Italy

The list of top performers differs between the rankings. In all three rankings, Denmark, Sweden and Finland are in the EU top five, although with scores worse than the US. UK, Ireland and Germany are also listed relatively high throughout, but their relative position differs between rankings. In the case of Germany and Sweden, one can easily relate their high ranking with robust growth after

the global financial crisis. And the poor growth record in the UK and Ireland after the crisis can be attributed to the size of the pre-crisis bubble, so there might be no contradiction between their liberal, pro-growth institutions and their rather weak growth after 2008. In the case of Denmark and Finland, however, the results are harder to explain.

‘It is ultimately up to civil societies in the respective countries to fix the growth problems of their own countries.’

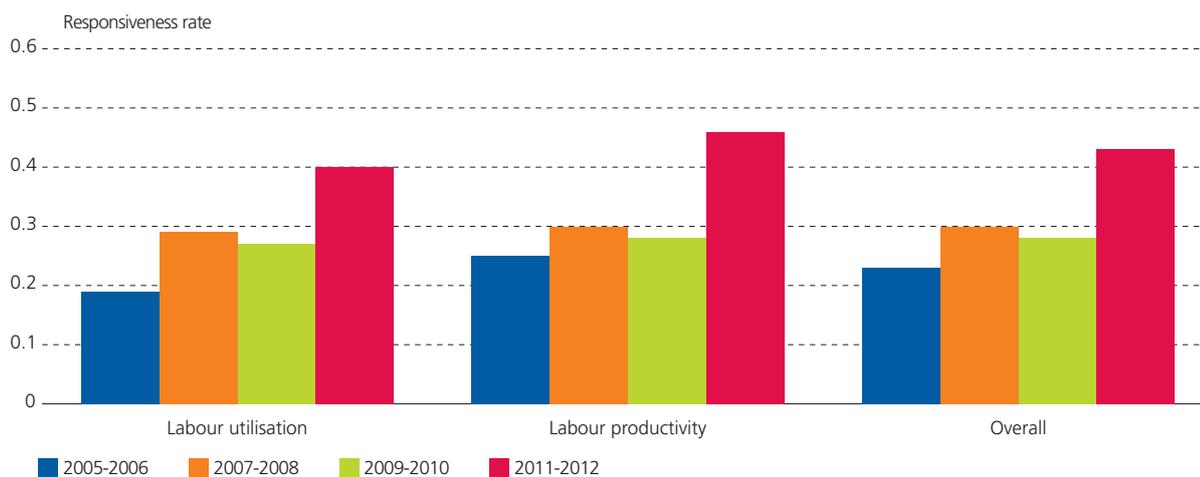
On all lists, Greece is among the worst performers. Poland, Hungary, Italy, Romania and Bulgaria are also listed low. It is hard to deny that the institutional system of Greece, Italy and (to a lesser extent) Hungary are not supportive of economic growth (this became apparent after the global financial crisis). But Poland, despite being ranked low, was the best performing country in the EU during the 2008-2013 period.¹²³ This does not mean that the large differences in the countries’ regulatory stance do not matter for their economic growth. Instead, it means that other favourable factors may compensate – for some time – for the impact of excessive regulations. An important compensating factor in the Polish case is the lack of a large credit boom, thanks to a rather tough monetary policy especially directly after EU accession, and the vigilance of banking supervision.

But institutional systems can be improved through structural reforms, thereby strengthening an

economy’s growth prospects and improving its responses to various shocks. As discussed earlier, countries with more distorted systems have more scope for improvement. And if they find themselves in a crisis, the incentive to reform should be strengthened too. It is therefore legitimate to inquire whether the problem countries in the EU have introduced more reforms than their peers.

Indeed, the majority of OECD member states have started to reform more vigorously since the crisis, but the problem countries are taking the lead. In its annual publication *Going for Growth*, the OECD presents a “responsiveness rate” based on a scoring system in which recommendations set in the previous edition of *Going for Growth* take a value of one if “significant” action is taken and zero if not. As chart 48 illustrates, the responsiveness rate has increased significantly since 2011.

Chart 48: Responsiveness to *Going for Growth* recommendations across the OECD (2005-2012)

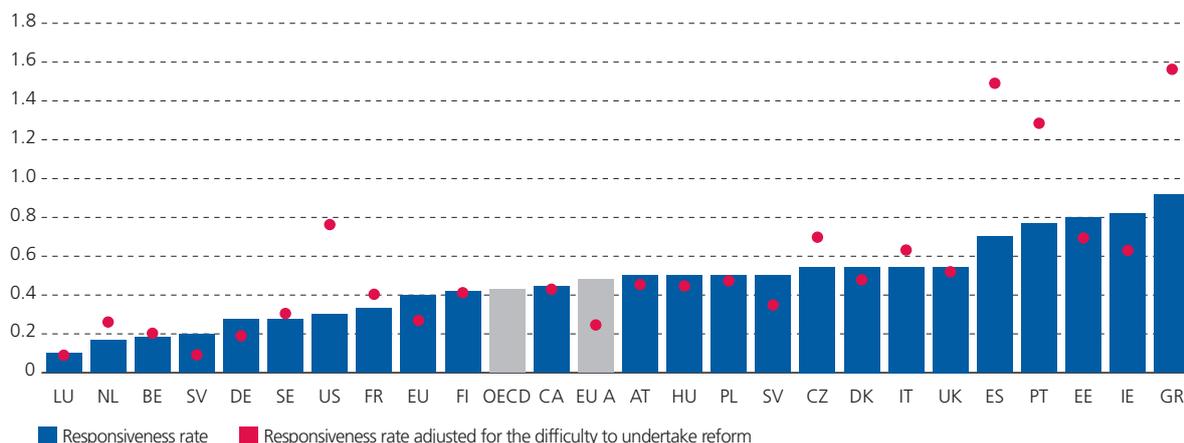


Source: OECD

123 Since 2008, Poland has significantly improved its position in the *Doing Business* ranking, rising to No. 55 in the current edition, up from No. 74. In the *Global Competitiveness Report* ranking, it rose to No. 41, up from No. 53. Only in *Economic Freedom of the World* did Poland register little change; it moved from No. 48 to No. 47.

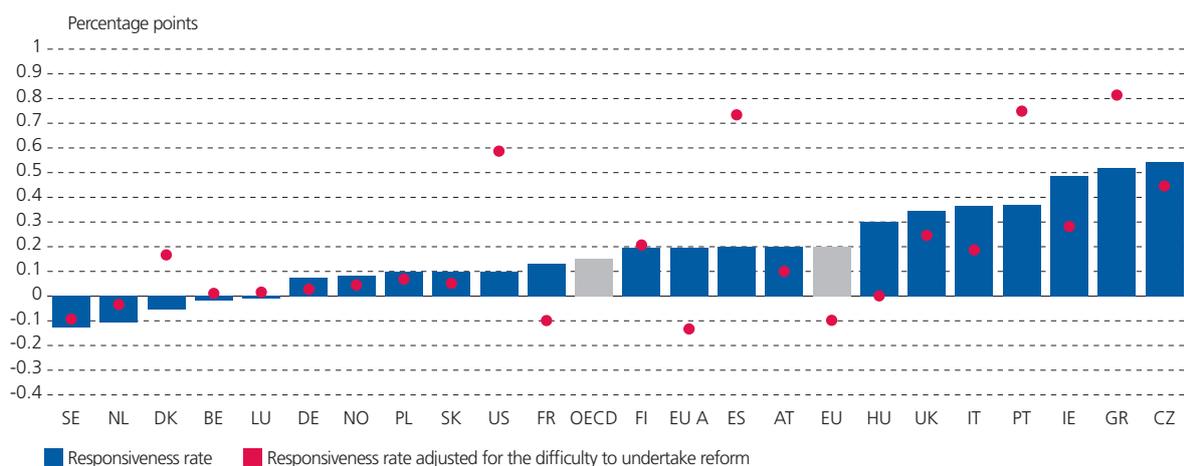
'Booms in the private sector (stock market booms, housing booms) are usually blamed on the excesses of market forces or – in other words – on market failures.'

Chart 49: Responsiveness to *Going for Growth* recommendations across OECD countries (2011-2012)



Source: OECD

Chart 50: Change in responsiveness to *Going for Growth* recommendations across the OECD countries from 2009-2010 to 2011-2012



Source: OECD

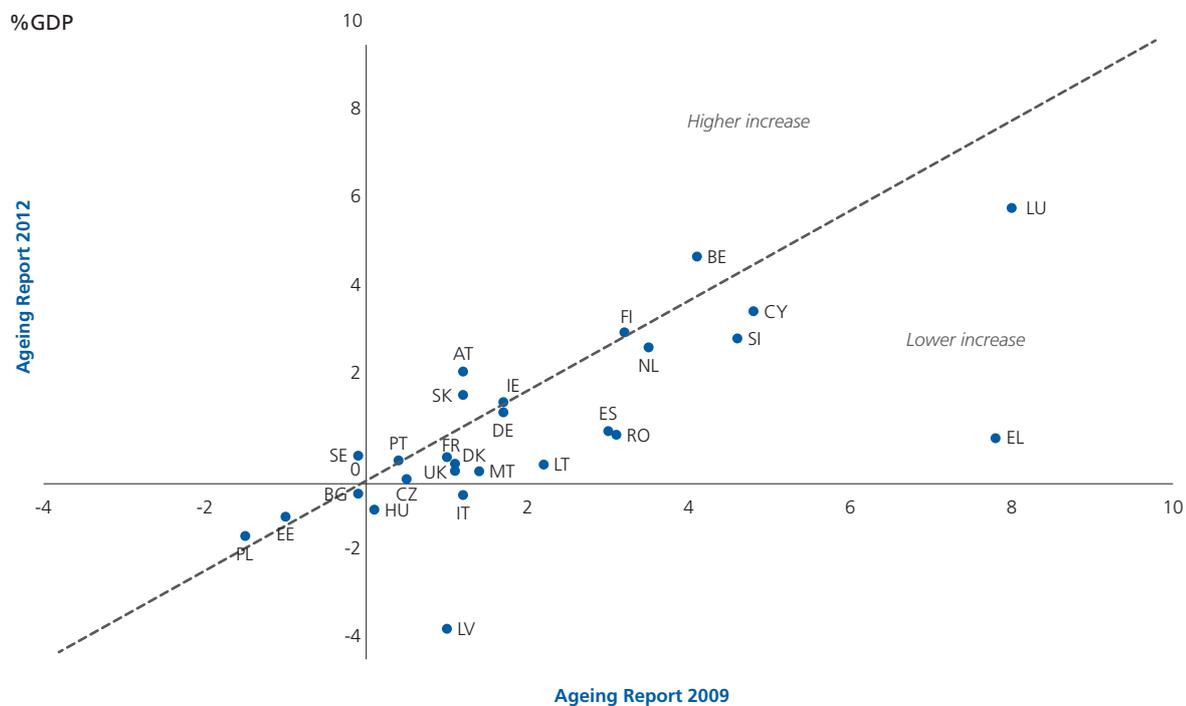
'Growth laggards do not need to continue to be laggards.'

The responsiveness rate in 2011-2012 was highest in Greece, Ireland, Estonia, Portugal and Spain. Leaving Estonia aside (its economy is growing again), the most reforming countries along this metric are the EU problem member states. The OECD takes into account that reforms differ in terms of political costs – for example, it might be easier to implement recommendations regarding infrastructure or innovation policies than to change the scope of employment protection. For this reason, the OECD also presents an adjusted responsiveness rate that weighs each individual priority according to the difficulty of undertaking the relevant reform. By this metric, Greece, Portugal and Spain are the top three reformers. It can also be noted how the responsiveness rate changed between 2009-2010 and 2011-2012. Countries in the direst situation were the keenest to reform.

Similar conclusions about the depth of the reforms in crisis-stricken countries can be drawn from a comparison of the European Commission *Ageing Report 2009* and the European Commission *Ageing Report 2012*. Greece, Italy, Latvia, Lithuania, Romania and Spain are the countries where the projected increase in growth of public expenditures on pensions was most reduced.

Progress in implementation of structural reforms is a part of the bigger picture of on-going adjustment in problem countries. *The Euro Plus Monitor*, published by the Lisbon Council and Berenberg Bank, takes into account progress in fiscal, external and labour cost adjustment. According to the spring 2013 update, Greece, Ireland, Spain, Portugal and Estonia lead the adjustment.¹²⁴

Chart 51: Projected increase in annual public expenditures on pensions (2010-2035)



Source: European Commission

124 Holger Schmieding and Christian Schulz, *The Euro Plus Monitor: Spring 2013 Update* (London: Berenberg Bank and Brussels: Lisbon Council, 2013).

It is a promising sign that the most problematic countries from the eurozone periphery, which have a large scope for improvement of their institutional systems, are now undertaking serious reforms. However, it should be noted that the beginning of the reforms was delayed. Had peripheral countries started reforms earlier (in, say, 2009 or 2010), their current situation would be much better.

One might worry about too few signs of reform in France, the only major economy in Europe that despite its structural problems is reluctant to address them. The share of government spending in GDP in France is the highest in the eurozone, and the majority of its fiscal adjustment (90%) to date has been through increased revenues.¹²⁵ The labour code has been more restrictive only in Slovenia, impairing competitiveness and employment.¹²⁶ Recently agreed measures (more flexible wages and working time, less regulated collective dismissals, reduction of the tax wedge for low earners financed by VAT increases) are helpful, but not nearly far-reaching enough to have a real impact.

Furthermore, one should remember that so-called “core countries” that performed better during

the recent crisis do not have ideal systems and could benefit from further reforms. For example, Germany, being the champion of the eurozone, could benefit from liberalisation in the service sectors and in network industries (here, European policies could also help as the single market in services and network industries is far from being complete). Reduction of the labour tax wedge, job protection of permanent workers and impediments to female labour market participation together with a shift in taxation from labour to environmental taxes could increase labour participation in Germany.¹²⁷ By increasing its growth potential and by participating in a common market for services and network industries, Germany can deliver exactly the stimulus the EU now needs.

Poland might be another example of a country that was until recently successful, but that could benefit from further reforms. Although it was the only country in the EU with a growing economy in 2009, it still has large potential and needs for improvement of its fiscal stance as well as of its institutional system through a reduction of public involvement in the economy and the introduction of more competition in many sectors of its economy.

125 International Monetary Fund, *IMF Staff Report for Article IV Consultations with France* (Washington: IMF, 2013).

126 Holger Schmieding and Christian Schulz, *The 2012 Euro Plus Monitor: The Rocky Road to Balanced Growth* (London: Berenberg Bank and Brussels: Lisbon Council, 2012).

127 Organisation for Economic Co-operation and Development, *Economic Policy Reforms: Going for Growth* (Paris: OECD, 2013).

Conclusions

As we saw at the outset, the EU as a whole stopped converging with the US in the late 1970s, and then actually began diverging. It is true of GDP per capita but even more true for aggregate GDP growth, as the EU has less favourable demographic and employment tendencies than the US.

However, the aggregate picture also masks huge divergence in the growth performance of EU countries during the 1980-2007 period. A look at their growth trajectories reveals that each of them displayed different growth dynamics during various sub-periods, and these fluctuations went well beyond the “normal” business cycle. No country was a growth leader for most of the time and no country was a systematic laggard throughout this time either.

What’s more, the growth trajectories of the respective countries contained two types of growth episodes: acceleration and slowdown. Behind the former are growth-enhancing reforms and/or positive demand shocks caused by accelerated capital inflows and/or credit growth. The latter are caused by growth-decreasing institutional changes (e.g. growing regulations, increased spending and taxes, nationalisations) or credit booms which went bust (there is no bust without a preceding boom). Changes in the demographic factors may also underlie changes in growth.

This analysis poses two important questions, to which we have sought answers in this paper:

- 1) What are the underlying causes of growth-enhancing reforms?
- 2) What factors are behind the growth-decreasing changes (which annul the effects of previous structural reforms and may create – through the worsening of economic performance – pressure for a new wave of growth-enhancing improvements)? In other words, how can we anchor an institutional system which is conducive to systematic and sustainable economic growth?

These questions go to the heart of the political economy and theories of institutional change, and it is in this realm that one should see deeper solutions to the problems of economic growth. In a democracy, the way the institutional system evolves over time depends ultimately on the balance of the socio-political forces in the respective countries. Or, to be more specific, it depends on the strength of groups which for various reasons defend “growth decreasing” arrangements or press for more of them, relative to the strength of the groups that press for the elimination of such arrangements and for growth-enhancing reforms. If the institutional framework of the economy is indeed what creates or hampers economic growth, then one has to strengthen the second type of groups or weaken the first. It is ultimately up to civil societies in the respective countries to fix the growth problems of their own countries.

This is also true for EU members. EU-wide arrangements matter, but the shape they take depends ultimately on the preferences of the respective members, especially the larger ones. Besides, treaties and agreements may be concluded but not respected at least by some countries – such as the sad story of the stability and growth pact, the incomplete nature of the single market or the mixed results of the Lisbon agenda. Even in the US, which has a strong federal government, states differ widely in their policies and, as a result, in their economic performance. Finally, one should not take it for granted that growing centralisation and especially growing European regulation (which could in the EU violate the subsidiary principle) is not immune to problems. Witness the deficiencies of federal policies in the US, India or Brazil. Therefore, the popular slogan that “more Europe” is the solution to the crisis is either just empty, politically-useful rhetoric or expresses a naïve belief that a solution to the imperfections of the sovereign nations that make up the EU is the creation of a perfect European Sovereign.

'The indiscriminate fiscal stimulus in 2008-2010 was widely supported, but based on shaky theoretical and empirical foundations.'

Accelerations and slowdowns related to the boom-bust episodes are ultimately linked to socio-political forces in the respective countries, too. This should be clear in the case of fiscal to financial crises dramatically exemplified by Greece. Destructive political competition combined with weak fiscal constraints produce a fiscal boom – and the resulting crisis. However, underlying such a situation is the relative weakness of those socio-political forces that seek to constrain the fiscal expansion of the state (and other policies which hurt long-term growth). This pro-boom, anti-growth bias has to be corrected by the Greeks themselves.

And it is not impossible. Greece displayed an impressive fiscal discipline in the 1950s and 1960s, when it was growing quickly. Therefore, episodes of fiscal populism do not have deeper roots in any long-lasting Greek mentality.

Booms that develop in the private sector (stock market booms, housing booms) are usually blamed on the excesses of market forces or, in other words, on market failures. The economic literature is full of models and stories of the “pro-cyclicality” of the financial sector, i.e. of its tendency to provide excessive funding during good times and to cut it short when the bad times set in. However, it would be superficial and dangerously misleading to stop at this point and focus only on how the public institutions can mitigate this tendency. Public policies often created or amplified the credit booms, through political pressure in politicised financial institutions (e.g. Cajas in Spain) or through monetary and regulatory policies that encouraged excessive risk-taking by the private agents. This is also the case of the recent financial crisis.

Therefore, the policy question is not only how the sovereigns can constrain the so-called “pro-cyclicality” of the financial sector, but also how others can constrain the sovereigns so that they do not create or magnify the asset booms. Thus, we are back at square one, i.e. the socio-political dimension of economic policies. And the sovereigns

include not only governments but also the central banks. The latter should not be seen as innocent bystanders during the boom phase, which – once the boom turns into a bust – are there to prevent the economy from the ultimate collapse: first, because the excessively loose monetary policy of the US Fed and other major central banks has contributed to the recent global boom and thus to the global bust; and second, because the prolonged, ultra-easy and unconventional monetary policy of these banks has been generating new bubbles, and may actually be weakening longer-term growth.

As we have seen, differences in the economic growth in the EU countries during the 1980-2007 period were quite large. Some countries experienced periods of rapid catching up with the US, especially Ireland (1988-2004) and Sweden (1994-2007). Episodes of growth slowdowns include France (1983-1993), Italy (1994 to present) and Germany (1993-2004). However, in Germany, this relative decline led to important structural reforms (Agenda 2000) which are the main source of the present strength of the German economy. By contrast, Italy and especially France have so far done little to stop the divergence. It is worth noting as well that in both of the growth-episode countries – Ireland and Sweden – acceleration followed a pronounced growth slowdown.

In other words, we find that growth accelerations usually resulted from reforms which strengthened systemic growth forces. By contrast, the main reason for the growth slowdowns was in the accumulation of rigidities and distortions and public-debt overhangs which weakened these forces. This underlines the importance of the socio-political dimension of economic growth.

Since the outbreak of the crisis, economic growth has so far been worse than in the US. This does not necessarily mean that the US has pursued better macroeconomic policies than the EU. Among other things, the US recovery has been much slower and shakier than recoveries in the past. In addition, the

'The risks and costs of an ultra-easy monetary policy are likely to grow with time.'

financial shock in the US was not as powerful in relative terms as in the most affected EU economies. The US financial system is less dependent on banks than the average EU economy, which matters for the economy as a whole, as a banking-sector crisis tends to have an especially severe impact on the so-called "real" economy. The US labour market is also more flexible, and is not plagued by "duality" in contrast to some EU member states.

But the aggregate picture masks enormous variations in growth rates per capita within the EU in the post-crisis period as well (2008-2012). For the group as a whole, they range from -23,6% in Greece to +12,5% in Poland. Within the euro area, Slovakia and Lithuania report growth rates of +5,2%. Outside the euro area, Britain had a decline of -4.1% and Hungary -4.4%, the highest among the countries with floating exchange rates (the fastest growth in this category was Poland). Finally, disregarding Greece, the range is set in the EU-15 by Sweden (+3,4%) and Italy (-9,0%).

Several countries achieved better results than the US in this time. This group consists of two "old Europe" member states (Germany and Sweden) and seven new member states (Poland, Slovakia, Lithuania, Bulgaria, Malta, Estonia and Latvia). On the opposite side of the spectrum, 10 countries saw their GDP decline by more than 5%, including Greece and the Netherlands. The countries which achieved the best results include those that experienced a huge housing boom and the related huge bust (including Bulgaria, Estonia, Latvia and Lithuania, all hard pegs), but quickly introduced radical adjustment programmes that allowed them to have a strong recovery since 2010. Most other economies in this group (i.e. Poland, Sweden and Germany) managed to avoid a large-scale housing boom. The growth laggards include Portugal, Ireland and Spain, where the adjustment, except for in Ireland, was delayed and more gradual. Therefore, the time structure of the adjustment has mattered for subsequent economic growth.

The differences in the pattern of adjustment can be clearly seen in the different dynamics of the components of the GDP. Countries that implemented an early and strong fiscal consolidation registered a strong increase in net exports, which allowed for a strong recovery in their GDP after a deep decline during the 2008-2010 period. The dynamics of net exports and of GDP in countries with delayed or more gradual adjustment policy were more muted. However, all the boom countries achieved a strong improvement in their current account, which is an important component of their overall macroeconomic adjustment, i.e. the reduction of their external imbalances. Another form of adjustment in these countries has consisted in deep declines in construction investment – a response to the previous construction boom, i.e. a positive demand shock which could not have been sustained. Hence, it should be remembered that some declines in GDP, however unpleasant, are unavoidable and make up a curative process.

The differences in economic growth in any given period can be analysed as resulting from the interactions of three groups of variables: 1) initial conditions; 2) external conditions; and 3) policies. We used this analytical scheme to dig a bit deeper into the causes for the growth differentials in the EU after 2007. A simple econometric exercise shows that initial conditions matter: the bigger the macroeconomic imbalances were in 2007 in a given country, the worse its growth performance was in the subsequent five years, i.e. the larger the gap was between actual GDP in 2012 and its previous trend. Therefore, previous excesses in the form of credit-driven excessive spending are costly. See Appendix 1 for the data behind this analysis.

But we were not able to statistically link the initial differences in countries' institutional systems (e.g. the extent of rigidities and distortions) to their subsequent growth. We believe the main reason for this was a lack of sufficiently precise and reliable data. However, there is a lot of qualitative information which strongly suggests that initial

'Some euro-area initiatives may do more harm than good: making bailout funds increasingly accessible, especially from the ECB, would risk delaying what is absolutely necessary for the repair of the euro area: fiscal and structural reforms in the member states, especially the large ones.'

distortions, if preserved, contribute to the decline in employment and GDP and to sharp increases in youth unemployment when the boom turns into bust. This is especially true of countries with dual labour markets – an inherited feature of Greece, Portugal and Spain. This is why labour market reforms should be regarded as fundamentally important for these countries. On an optimistic note, countries that inherit more institutional barriers to economic growth have a larger scope for reforms which, if implemented, would produce stronger acceleration of their growth than in countries with a less distorted institutional system. Growth laggards do not need to continue to be laggards. This is seen clearly in our findings on the sources of growth acceleration.

We also analysed the impact of major policies on economic growth, taking a look at the prevailing views in this respect, especially regarding fiscal and monetary policy. In response to the global financial crisis, fiscal policy was sharply loosened in most EU countries between 2008 and 2010, including in the countries that did not have fiscal space for it, e.g. Portugal and Greece (Spain had the space, but the loosening when it came was too large). This was a serious policy error which has complicated the economic situation after 2010. Almost half of the huge increase of the fiscal deficit in the EU was due to the discretionary fiscal stimulus in the early crisis period. Between 2010 and 2012, the fiscal balance improved considerably in the EU, but the cyclically adjusted deficit was larger than before the crisis.

The indiscriminate fiscal stimulus in 2008-2010 was widely supported, but – in our view – was based on shaky theoretical and empirical foundations. In turn, the attempted fiscal consolidation has been under attack and labelled as “austerity.” Under the prevailing interpretation of this term, “austerity” means the decline in GDP due to fiscal consolidation and especially to so-called “cuts” in spending. This meaning is clearly seen in the popular juxtaposition of “austerity” versus “growth.” However, such

a meaning should be subject to empirical investigation. Declines in GDP can and should be explained by linking initial conditions and post-crisis policies. Then, one can see that the especially protracted recessions in some countries were due to severe initial imbalances which produced declines in spending through deleveraging and the corrective declines in the construction investment as well as to imperfect policies that put a heavy emphasis on early tax increases and postponed structural reforms.

It is striking that almost two-thirds of the improvement in the structural deficit in the EU in 2012 relative to 2009 was achieved through tax increases, while the empirical literature strongly suggests that such a structure of fiscal consolidation is more detrimental to growth and lasting fiscal success than an approach based on reductions in current expenditure. All in all, it is risky for the EU countries burdened by large fiscal deficits and high public debt to GDP ratios to postpone reductions in their fiscal deficits. Instead, they should improve the composition of fiscal consolidation and accelerate structural reforms.

Our discussion of monetary policy has centred on the ECB. Since the outbreak of the crisis, the ECB has shifted to interest rates close to zero and has undertaken other non-conventional actions which expanded its balance sheet. These policies have not been as radical as those of the US Fed, but are still very expansive by historical standards. We are not questioning the early shift to some of the non-conventional policies, but its continuation over an already long period. The risks and costs of an ultra-easy monetary policy are likely to grow with time. These downsides include weakening of the incentives of the banks to repair their balance sheets and of policymakers to launch and sustain the growth-enhancing reforms. They also include creating new booms in the bond and stock markets, thus endangering future growth also through this channel. In addition to these general costs and risks, there are additional downsides which are specific

‘Instead of engaging in the gloomy prophecies about the decline of the West, one should focus on strengthening those forces that support growth enhancing-reforms, both at the national and the EU levels.’

to the ECB and the euro area. When the US Fed, for example, pursues such policy, it does not target the most distressed states in the US. In contrast, when the ECB buys the bonds of governments under fiscal distress, it engages in a sort of regional policy. What’s more, continued ultra-easy policies are hardly comparable with the ECB mandate, and that risks weakening a crucial factor which needs to be strengthened: the confidence that the EU treaties will be respected.

Credit to households and firms results from the complex interplay between the sovereign fiscal stance and the partly related health (or fragility) of banks’ balance sheets. Spreads across the eurozone have widened. However, this is likely to be a market correction of the previously excessively low spreads, which encouraged housing booms in countries like Greece, Ireland, Portugal and Spain. It is hard to understand why such differentials should be regarded as a sign of an impaired transmission of ECB monetary policy. Rather, it is the drastically low spreads before the crisis which should have been regarded as suspect.

We also looked at the dynamic of credit in EU countries and did not find convincing evidence that, given the historical standards, it has been abnormally low in the problem countries. True, a lasting recovery requires that the costs of credit decline in the longer run (and the cost of credit has already significantly declined in those countries that have launched and sustained decisive fiscal consolidation and other reforms). However, to achieve that, one must remove the sources of elevated risks which were the main reasons for the increased spreads and thereby contribute to insufficient credit growth. This, in turn, requires credible fiscal consolidation and – in some countries – an accelerated restructuring of banks’ balance sheets. We do not see any good substitutes to these policies. Let us repeat: the best demand stimuli are those policy actions that restore impaired confidence.

Turning finally to the supply side, we note that countries that in 2007 had a great scope for these actions – and were in greater need for them – tended to implement more of these actions. However, there are large differences in this respect among the problem countries (compare, for example, the difference in the crisis response between Greece and Portugal). Some countries which still enjoy the benefit of a doubt from the financial markets but continue to have huge institutional distortions in their economies are in urgent need of structural reforms. This means Italy and particularly France. Large countries create large spillovers. Therefore, the delays in these countries in improving their institutional framework for business create risks not only for their economies but also for the euro area as a whole.

Finally, most countries that are now in a relatively good economic situation, e.g. Germany and Poland, are facing growth challenges which should be met with well-targeted institutional reforms. For example, Germany should liberalise its service sector and revise its costly energy policy. By strengthening its own economic growth through such measures, Germany would also provide the best possible growth “stimulus” to other EU economies. Poland needs reforms that would increase the investment and employment ratio and strengthen the growth of productivity.

In this paper, we have not focused on the special problems of the euro area. Instead, we have shown that there is a wide variation in growth performance both in the euro area and outside of it. Fiscal problems and credit booms have occurred both in and outside the euro area. However, it would be a mistake to conclude that there have been no special problems in the design or implementation of the euro. The euro area is a special case of a broader category: that of the hard-peg areas (other examples include a single-country currency, the gold standard and currency boards, like in the Baltics and Bulgaria). The crucial feature of this arrangement is that its members cannot use – in the case of the

booms and the related loss of competitiveness – an outright devaluation with respect to each other, so they have to rely on an internal devaluation, i.e. reducing growth or the level of wages and prices.

The performance of various types of hard pegs depends on: a) their propensity to develop fiscal or financial booms, and b) the strength of their adjustment mechanisms which are activated once a boom develops and gives rise to a bust. The euro area turned out to be very poor on both counts. With respect to their propensity to fuel booms, fiscal constraints in the shape of the stability and growth pact remained on paper. The problem of financial booms was neglected or – even worse – increased by a common monetary policy (and some national policies). The availability of easy money, in turn, weakened the policymakers' incentives to launch fiscal and structural reforms. With respect to the euro area's adjustment mechanism, some countries entered the euro area with rigid or dual labour markets, a weakness which seems to have been overlooked in the design of the European Economic and Monetary Union. These and other rigidities worsened the post-bubble adjustment, and especially increased unemployment, which cross-country fiscal transfers (as distinct from automatic stabilisers) were unable to stop.

A number of European initiatives have been launched since the onset of the crisis. Some of them aim at strengthening crisis prevention in the euro area, especially the increased official monitoring of macroeconomic and macro-financial risks. While potentially useful, these initiatives cannot substitute for the increased monitoring by the financial markets and for a strengthened vigilance in the respective countries. The proposed banking union aims at reducing the dangerous links between the states and the domestic banks by centralising the banking supervision and banks restructuring at the European level. However, one should first of all strengthen the fiscal constraints on the respective governments and remove the regulations which

encourage banks to lend to “their” sovereigns. There are also some necessary euro-area initiatives, especially the revision of the modus operandi of the ECB's policies, to avoid an excessive suppression of cross-countries risk premia.

Some euro-area initiatives, however, may do more harm than good. Making bailout funds increasingly accessible, especially from the ECB, would risk delaying what is absolutely necessary for the repair of the euro area: fiscal and structural reforms in the member states, especially the large ones.

It does not make sense to deplore that China has been growing much faster than Europe (and the US), as China started to catch up with the West only in the late 1970s after 300 years of divergence. This, of course, is not to say that Europe can do nothing to meet its growth challenges which include a continued ageing of its population. We have emphasised in this policy brief that bad initial conditions do not need to be translated into an unfavourable 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 levels. The latter includes the completion of a single market and transatlantic economic liberalisation.

Appendix I: Impact of initial conditions on economic performance of EU countries (2008-2012)

GDP gap in 2012													
	1	2	3	4	5	6	7	8	9	10	11	12	13
Credit to GDP 2007	0.01												0.01 (11%)
Credit to GDP growth 2003-2007		0.08*											0.05 (18%)
Gross national savings 2007			-0.40***										-0.38 (32%)
Investment rate 2007				0.66**									0.87 (41%)
Inflation 2007					1.13*								0.28 (12%)
GG net lending/borrowing						-0.34							-
GG structural balance							-0.85***						-0.58 (40%)
GG gross debt								0.03					-0.01 (11%)
Current account									-0.41***				-0.28 (69%)
Banking crisis dummy										2.01			2.35 (14%)
Net IIP 2007											-0.04*		-
ULC change 2003-2007												14.1	-
Constant	4.56	3.66*	15.30***	-7.32	5.22***	6.43***	3.85***	4.49	7.25***	4.49	5.08**	7.5***	-
GDP in 2008 relative to the trend	-1.00***	-0.94***	-1.13***	-1.25***	-1.11***	-1.08***	-1.01***	-1.02***	-1.26***	-0.96***	-1.10***	-1.13***	-1.22 (99%)
GDP growth 2009	-1.10***	-0.98***	-1.00***	-0.48	-0.61	-1.08***	-1.12***	-1.15***	-0.64***	-1.09***	-1.04***	-0.50***	-0.68 (56%)
N	31	31	31	31	31	31	31	31	31	31	27	27	27
R ²	0.65	0.69	0.73	0.71	0.68	0.67	0.73	0.65	0.78	0.65	0.71	0.70	-
SBIC	205.5	201.9	197.1	199.2	202.6	203.4	197.5	205	191.5	205.2	177.2	177.6	-

Data sources: International Monetary Fund World Economic Outlook, World Bank Development Index, Eurostat
column 13 presents results of Bayesian Model Averaging with conditional means and posterior inclusion probabilities in brackets; only series without missing observations were used in BMA; calculations in GRETL, BMA package (1.03) by Marcin Błażejowski and Jacek Kwiatkowski

*=statistical significance at the 10% level

**=statistical significance at the 5% level

***=statistical significance at the 1% level

Appendix II: Structure of planned fiscal consolidation versus errors in European Commission forecasts

Forecast error of cumulated GDP growth (2011-2012)											
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
Constants	1.10** (0.52)	-	1.08* (0.62)	-	0.94 (0.64)	0.66 (0.62)	0.96 (0.62)	0.83 (0.60)	0.18 (0.82)	1.06* (0.55)	-
Net lending	-1.14*** (0.35)										
Total revenue		-0.90** (0.42)								-1.20*** (0.42)	-1.07** (0.40)
Expenditures			0.58 (0.48)							1.06** (0.46)	
Capital formation				1.89* (1.02)							2.30** (0.93)
Expenditures other than capital formation					0.20 (0.55)						
Social expenditures in kind						-1.22 (1.01)					
Social expenditures other than in kind							-0.76 (0.85)				
Social expenditures (total)								-0.70 (0.56)			
Compensation of employees									-1.71 (1.40)		
R ²	0.29	0.15	0.12	0.12	0.01	0.06	0.03	0.06	0.05	0.29	0.31

Source: European Commission Spring 2010 Forecast, AMECO

*=statistical significance at the 10% level

**=statistical significance at the 5% level

***=statistical significance at the 1% level

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Acknowledgements

The authors would like to thank Paul Hofheinz and Ann Mettler of the Lisbon Council for providing the intellectual space where a project like this could grow and prosper. Special thanks as well to Stanisław Gomułka, Paul Hofheinz, Alessandro Leipold, William W. Lewis, Pier Carlo Padoan and Holger Schmieding for their useful comments on an early draft. Thanks as well to Tamas Kenessey, Stéphanie Lepczynski, Dawid Samoń, Fabienne Stassen and Bennett Voyles for additional editing and research assistance, and to Katarzyna Rudnik at the Warsaw Marriott Hotel. The Lisbon Council would like to thank the European Commission's Education, Audiovisual and Culture Executive Agency for an operating grant. With the support of the European Union: Support for organisations that are active at the European level in the field of active European citizenship. As usual, any errors remaining are the authors' sole responsibility.

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First published in Belgium in 2013 by:

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Published under the editorial responsibility of the Lisbon Council asbl. The responsible editor is Paul Hofheinz, head of research, editor-in-chief and president, the Lisbon Council asbl.

ISBN 978-9-0902-7915-2



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