EU Structural Policies

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Boosting EU Competitiveness—The Role of CESEE Countries

Acronyms

- A: the A (TFP level) in Cobb-Douglas
- CE4: Czech Republic, Hungary, Poland, Slovakia
- CESEE: Central, Eastern and Southeastern Europe
- FDI: foreign direct investment
- HK: Human capital
- K: capital, as in Cobb-Douglas
- K/L: capital-labor ratio
- SP: Structural Policy
- ZLB: Zero lower bound (nominal monetary policy rate at zero)

Putting Structural Policy (SP) in its place

- SP a catch-all expression for everything left over in economic policy--and for things we don't understand
  - The analogue of TFP as a residual in growth accounting!
- So let me spend a minute defining it from the growth perspective.
  - We have macroeconomic stabilization, getting the prices right, governance, institutions (property rights, fiscal, financial)
  - Whatever remains is "Structural Policy", giving a lot of latitude!
- For me, SP is about the microfoundations of growth. Presentation will develop this thought.

Presentation Strategy

- Take a few prominent papers/studies on SP:
  - Belka 2013 on Poland
  - Draghi 2015 on EU Structural Reform
  - Dustmann et al 2014 on Germany from sick man to superstar of Eurozone
  - IMF 2015 Regional report on CESEE
- And draw some conclusions about SP for CESEE.

Belka 2013 on Poland

- Belka’s main point: Neoclassical convergence, financial and trade integration plus EU structural funds have brought Poland to where it is: a very good place.
- Notable results: Inward FDI, innovation manifested in vastly improved export quality and variety.
  - Poland is part of the European value chain, is close to Germany (over 25% of Polish foreign trade).

Belka [2]

- Question: Were any special “industrial policy” interventions implemented to achieve these positive results apart from joining the EU?
  - Answer: No.

- Let’s turn Poland’s policy clock back 25 years: it’s been a beneficial policy combination of:
  - Well-managed public finances
  - Hard budgets, import competition, competitive real exchange rates
  - well-managed volatility
  - Plus: good geography.

- Hard budgets and competition crucial for stimulating innovation and strong growth microfoundations.
  - But you need a stomach for Schumpeterian creative destruction.

Draghi May 2015 on Eurozone Structural Reform

- Structural reform key to raising potential growth and enhancing resilience.
  1. Raises K/L and A, spurring growth
  2. Enables quick rebounds after adverse shocks=>minimize output losses.
- ZLB and accommodative monetary policy (QE) should facilitate Structural Reform by enabling faster investment and growth benefits:
  - No excuse for procrastination, according to Draghi.
- Governance of Structural Reform in a monetary union key. All countries need to be on the same page.
  - Needs to be centralized.

Draghi [2]

- Draghi clearly defines *goals* of Structural Reform (increase potential growth and resilience).
  - But what *is* Structural Reform? He mentions only “best practice across labour and product markets, tax policy and pensions”
  - A possibility: hard budgets, contestable product markets, flexible labor markets, affordable social entitlements. Will spur innovation and A, and increase resilience.
- Draghi argues ZLB should facilitate Structural Reform.
  - But what if ZLB induced by debt overhang and secular stagnation (a steady fall in potential growth induced by supply side factors)?
  - Then you have to deal with the debt overhang first!
- My take-aways from Draghi:
  - Structural Reform most effective when (a) far from global technological frontier; and (b) no debt overhang. Of course, need good governance and institutions too.
- Conclusion: Bodes well for CESEE. Especially CE4.
  - But need to open up product and factor markets across CESEE. Is CESEE ready for this?

Dustmann et al: Germany (2014 JEP)

- Germany went from sick man to superstar because of exceptional flexibility and decentralization (right down to firm level) in wage-setting and work hours.
- Story stresses three factors:
  1. High reunification tab: Euro 900 billion over 1991-2003, approx 50% of annual GDP
  2. CE4 opened up: ability to source inputs from there plus option of relocating manufacturing helped keep wages low.
  3. "German firms have always had the option not to recognize a union contract and to pay wages below the union wage, provided their employees accepted this."
- Consequence: Unit labor costs fell in tradable manufacturing because of rising productivity, ability to source inputs from CE4 and wage compression (especially below median wage levels) in nontradables and tradable services, propelling growth.

Dustmann et al [2]

- Interestingly, the authors do not attach much importance to the 2003 Hartz reforms or euro adoption in explaining German competitiveness.
- But hard to contest their main point:
  - Better to have wage flexibility than laying off workers (preserves HK and skills during downturns).
  - But wage inequality could rise, as in Germany.
- CESEE has history of worker involvement in strategic decisions of firms and compensation structure. (Remember PPWW in Poland's early transition? Wages were set at enterprise level and were highly flexible.)
  - So culture of work sharing and willingness to cut wages to preserve jobs exists.
  - Draghi (2015) expresses preference for wage and working-hour flexibility over dismissals.

IMF CESEE 2015 Report

- This report recommends easy hiring/firing (= flexible labor markets).
  - But how about going German way a la Dustmann et al as Draghi espouses?
- IMF report recognizes excess leverage as an impediment that needs to be addressed in some CESEE countries.
  - I agree. Hard to implement Structural Reform when no fiscal space in the presence of a debt overhang (this is where Draghi is too sanguine).

Conclusions [1]

- Let's start with Eurozone: it continues to suffer in comparison with the US
  - This predates the global crisis (recall the 2003 Sapir Report)
  - Crucial conclusion: Good structural policies must be in place before crisis/recession/stagnation hit
  - Otherwise it's like starting a rainy day fund after the rain starts pouring.

- Then are ECB's ZLB and QE diluting incentives for difficult structural reform?
  - Eurozone in a cyclical rebound helped by low oil prices, QE, large euro depreciation
  - But medium term prospects bleak, potential growth down to 1%!!
  - Countries usually accelerate reform during a crisis (Poland in 1990, Germany after reunification)
  - NB: Eurozone does not have even fiscal and financial institutions fully in place.

Conclusions [2]

- What can CESEE learn?
  - CESEE, especially CE4, well-positioned to benefit from Structural Policy
  - Far from global tech frontier, limited or no debt overhang, generally good governance and institutions
  - Better to implement Structural Policy from a position of strength!
- But what *is* Structural Policy? Mainly 2 to 5 in the list below:
  1. Well-managed public finances will spur convergence in K and A (raise public savings, invest in infrastructure, make good use of EU funds)
  2. Hard budgets and import and domestic competition will spur convergence in A
  3. Management of volatility will prevent crises (good fiscal and financial institutions, fiscal and monetary space, higher national savings)
  4. Flexible labor markets with emphasis on wages and working hours
  5. Resolving legacy issues (notably, excess leverage).

Conclusions [3]

- Questions for CESEE:
  1. How to coordinate Structural Policy across CESEE to open up markets and FDI, and adopt ‘best practice’ policies?
  2. Can CESEE preempt rising intergenerational inequality a la Piketty, which is a huge drag on potential growth in rich countries? (Kanbur and Stiglitz 2015. But Aghion et al 2015 caution that top income inequality may be a consequence of innovation that spurs growth)
- I end with a dilemma:
  – If CESEE is the best it can be, could this make life easier or harder for the Eurozone periphery? I think: harder.

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