Redistribution policies at the root of the Eurozone Crisis

Giuseppe Bertola*, *voxeu.org*, 28 June 2013

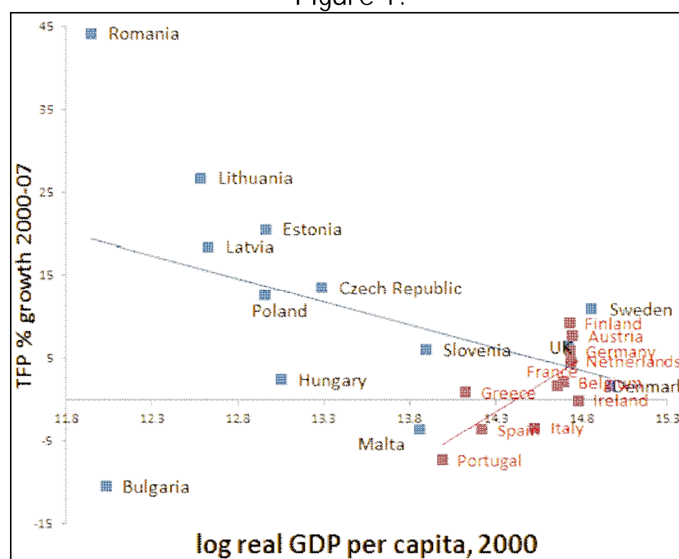
How can we make the Eurozone work, and work for everyone? This column suggests that a lack of productivity convergence and the Eurozone's inability to deal with asymmetric shocks are both rooted in the incompleteness and incoherence of the current Eurozone policy framework. A robust and coherent European market and policy-integration process would require implementation of the behavioural constraints and redistribution schemes that operate, not without difficulties, within established national socioeconomic systems.

Not only the founding fathers of the EU, but also financial market participants appear to have believed that participation in common markets and adoption of common institutions should lead to cultural and economic convergence. Expectations of increasing productivity, along with 'downhill' flows to relatively capital-poor countries, imply that residents of relatively rich and productive countries should fund consumption as well as investment growth in relatively backward countries, where residents could legitimately anticipate to the present some of the higher standard of living afforded by growing future income (Obstfeld and Rogoff 1995). Such a pattern of international imbalances did materialise in the 2000s across the Eurozone, and threatens explode it in the current crisis.

• Even before the crisis, production growth in poorer countries was mostly accounted for by investment and employment growth, not by total factor productivity growth (Giavazzi and Spaventa 2010).

As Figure 1 shows, productivity did grow more strongly in initially poorer EU member states, as one would expect if the efficiency of production methods is one of the reasons why such countries are poor, and technological imitation is eased by economic integration.

Figure 1.



Sources: Total factor productivity growth: Conference Board; real Gross Domestic Product per capital: Eurostat.

• But the opposite divergent tendency was observed across early adopters of the euro – as Germany and its relatively rich neighbours experienced much faster productivity growth than Portugal, Spain, Italy, Greece, and Ireland.

This would be very hard to explain in terms of technological progress, which would have to be negative in several of the latter countries. As already noted by the IMF (2003) and the European Commission (2004), however, economic productivity is explained by institutional as well as technological factors.

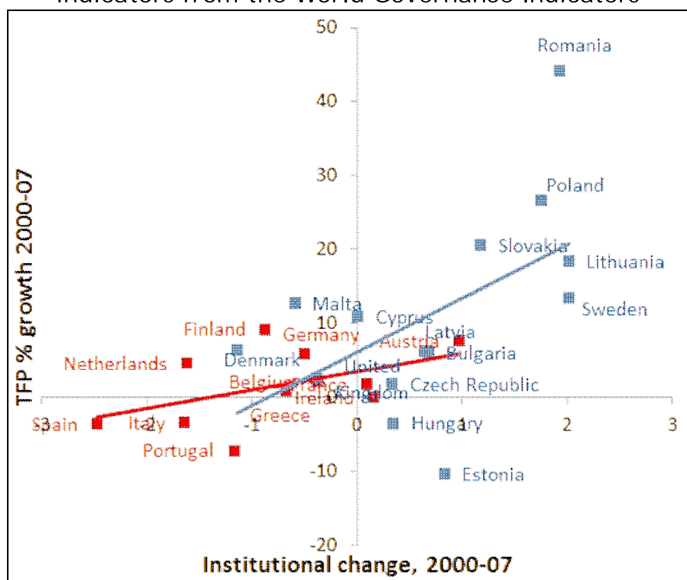
---

* Professor of Economics at EDHEC Business School; CEPR Labour Economics Programme Director.

It would be very strange if efficient production methods were abandoned, but the quality of the institutional environment in which production and market exchanges take place can sometimes deteriorate.

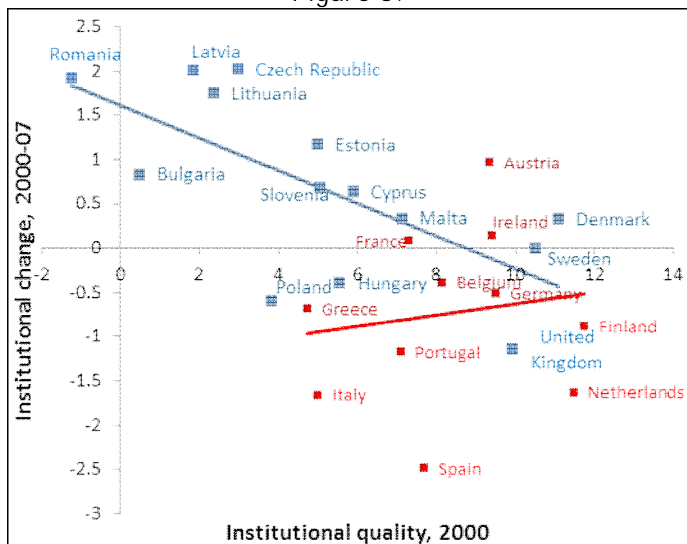
Figure 2 shows that a broad measure of institutional quality change was indeed positively related to economic productivity growth across the EU before the crisis, and that it changed negatively in relative terms within the Eurozone. Participation in common markets should foster upward institutional and economic convergence. This mechanism is an essential component of the EU construction, aimed not only at 'growth' but also at 'cohesion' and 'stability'. But we see in Figure 3 that Eurozone membership appears completely to dissolve the institutional convergence process that still appeared to be at work among new EU members in the 2000s.

Figure 2. Institutional change is the difference between 2000 and 2007 of the sum of the six institutional quality indicators from the World Governance Indicators



Source: World Bank. Total factor productivity growth, source: Conference Board.

Figure 3.



Note: Definition and source as in Figure 2.

New research

I collect and discuss this and other evidence and propose an interpretation with strong (and difficult) policy implications in a recent paper (2013). The behaviour of inequality within countries offers clues to the policy mechanism behind these intriguing correlations.

- Before the crisis, inequality increased in Eurozone countries more than elsewhere, in ways that are well explained by the type of social and labour policy trends one would expect to be triggered by competition among independent policymakers within a single set of markets (Bertola 2010).

The dimensions of 'institutional quality' that are associated with production efficiency have distributional side effects and, since efficient use of resources should be a stronger concern for policymakers competing in more tightly integrated markets, it is natural for them to trade off higher inequality, however unpleasant and unpopular that might be in a democratic country, for higher average production and income.

- Inequality, however, decreased within the same countries that before the crisis were accumulating external debt and, as shown in the figures, experiencing a deterioration of institutions and productivity.

Between 2001 and 2007, the Gini coefficient of per capita disposable-income inequality (a statistic that would be equal to 0 if all incomes were equal, to 100 if a single individual earned all of the economy's income) actually declined by 1.7 percentage points in Spain and increased by only 1.3 points in Greece, much less than the 5.4 percentage points observed in Germany.

More generally, a significant and intriguing association can be detected in the data between inequality developments and accumulation of negative international imbalances. This and the pattern of productivity divergence rather than convergence in the Eurozone suggest that the financial largesse warranted by expectations of automatic convergence may have subtly relaxed competitiveness concerns, and allowed independent policy makers to reduce inequalities in ways that would deny the validity of those expectations.

Human interactions always combine voluntary market exchange with enforcement of common policies. Hence, international market integration makes it necessary to develop a suitably coherent policy framework (Sapir et al. 2004). In Europe, a single currency and macroeconomic policy coordination have long been viewed as a natural complement of the single market, and a common regulatory framework would obviously foster stability of cross-national banking and financial markets. Social policy and labour-market regulation are rooted in solidarities and political compromises crafted, along with diverse sets of policy instruments, in the context of nation formation over the last few centuries, and for this reason have so far been almost completely left to member states. Lack of social policy coordination may, in practice, have proved as destabilising as lack of a common currency might have been, however, because development of a common and unavoidably imperfect financial market appears in practice to have created expectations of productivity convergence at the same time as it made it easier for uncoordinated productivity-relevant policies to diverge. The international imbalances at the root of the Eurozone crisis would have been sustainable if the expected productivity growth had materialised.

Conclusions

This perspective offers a deeper interpretation of well-known competitiveness and imbalance patterns, and suggests that lack of productivity convergence and the Eurozone's inability to deal with asymmetric shocks are both rooted in the incompleteness and incoherence of the current Eurozone policy framework.

Policies as well as markets shape behaviour and manage crises in all societies, but not in the Eurozone, where lenders have reasons to mistrust borrowers' willingness to improve their institutions and productivity, and borrowers have reasons to be dismayed by the unwillingness of lenders to share their good fortune.

In theory, 'one market' should be accompanied not only by 'one money' but also by a shared concern about distributional issues. Not only theory, but also pre-crisis empirical patterns and a crisis deepened and prolonged by revision of the convergence implications of economic and monetary integration as well as by lack of risk-sharing buffers for the asymmetric impact of global

shocks, indicate that a robust and coherent European market and policy-integration process would require implementation of the behavioural constraints and redistribution schemes that operate, not without difficulties, within national socioeconomic systems.

References

Bertola, Giuseppe (2010), "Inequality, Integration, and Policy: Issues and evidence from EZ", *Journal of Income Inequality* 8, 345–365.

Bertola, Giuseppe (2013), "Policy Coordination, Convergence, and the Rise and Crisis of EZ Imbalances", European Commission, *DG Economic and Financial Affairs: European Economy - Economic Papers*, No. 490, Brussels, April, and CEPR DP 9471.

European Commission (2004), "Catching-up, Growth and Convergence of the New Member States", *The EU Economy 2004 review, European Economy* 06, Chapter 2, Luxembourg.

Giavazzi, Francesco and Luigi Spaventa (2010), "Why the Current Account May Matter in a Monetary Union", CEPR Discussion Paper 8008.

International Monetary Fund (2003), Chapter III: Growth and Institutions, 95-128, World Economic Outlook 2003, Washington DC.

Obstfeld, Maurice, and Kenneth Rogoff (1995), "The Intertemporal Approach to the Current Account" in G Grossman and K Rogoff (eds.) *Handbook of International Economics*, vol.III, Elsevier, 1731-1799.

Sapir, André, Philippe Aghion, Giuseppe Bertola, Martin Hellwig, Jean Pisani-Ferry, Dariusz Rosati, José Viñals, Helen Wallace et al. (2004), *An Agenda for a Growing Europe – The Sapir Report*, Oxford University Press.