THE ROLE OF THE STATE IN ECONOMIC GROWTH

PARIS

Contribution by Peter Jungen

October 2014

COLUMBIA | SIPA
Center on Global Economic Governance

SciencesPo.

COLUMBIA GLOBAL CENTERS | EUROPE
PARIS

Contribution by Peter Jungen at the Columbia Center on Global Economic Governance

The following points are reactions by Mr. Peter Jungen to the issues raised at the CGEG Role of the State in Economic Growth Conference in Paris on October 6, 2014.

1. The Euro. The Euro had been for long time considered as an economic project. But 1989 it was turned from an economic project to a political project. The French President Mitterrand put pressure on Helmut Kohl to accept an introduction of a common currency as early as possible as a precondition for France to support German unity. We all know that the Delor report was finished in May 1989 indicating that the introduction of a common currency was far away, something like 20 years plus. It was very clear that the common currency was only to be considered to be a step to be embraced after a political union and not the other way around.

2. European Austerity. The talk about too much austerity in Europe is not supported by empirical facts. For the last 40 years deficit spending has been the rule. Debts have increased year by year for the last 40 years or so. Since the beginning of the crisis there is no austerity what so ever, the absolute level of debt is higher and the debt / GDP ratio in the Eurozone is now higher than in any time before.

3. Austerity V. Deficit Spending. As far as the European debate is concerned there is no alternative to structural reforms. The old debate between austerity and growth is a flawed idea. There is no empirical proof for the hypothesis that deficit spending creates growth over time. There is even not a theoretical basis for this hypothesis. We have no empirical proof until now of the relationship between deficit spending and its impact on innovation. Is there any empirical proof that deficit spending supports innovation? Definitely not. Is there any empirical proof that innovation is impeded by deficit spending? This is most likely the case, as government deficit spending just leads to more consumer spending for products which reduces the appetite left for new products. On top of this: Is there any empirical proof that even with a slack of macroeconomic demand the problem will not better be solved by supply side approach than rather through strengthening the existing old structures and with this impeding the creation of new structures.

4. Structural Problems & Convergence. Most of the structural problems in some of the Eurozone countries existed long

before the European Monetary Union. The introduction of the Euro bought time which was completely misused in particular in countries like Greece. There was no convergence, there was rather divergence. The low interest rates and flush monetary policy of the Central Bank allowed these countries to increase public debt and in some countries also private debt.

5. Structural Problems and Greek Competitiveness. The structural problems are in particular indicated in the Doing Business Index. Before the crisis in 2009 Greece was ranked 109 even behind Bangladesh and similar countries. For the special index “The Ease of Starting a Business” Greece was on place 138 in the world behind most of the many development countries. It has improved its ranking in the meantime as a result of some structural reforms but there is a long way to go.

6. Greek Competitiveness. The real problem for Greece is the lack of competitiveness and too high labor costs. The problem for Greece is not labor costs in Germany. German labor costs are about the third highest in the Eurozone at around 36 or 37 Euro. Greece is about at 14 or 16 Euro. The real problem for Greece is the fact that Poland for instance is at around 8 Euro and Bulgaria at less than 3 Euro per hour. Greece would have to compare itself with these countries and even with these countries they have no chance to compete.

7. Structural Reforms V. Monetary Policy. Structural reforms are even more necessary as monetary policy can never be a substitute for that. Monetary policy can eventually buy some time. But obviously the normal reaction in Europe is that buying time means often wasting time.

8. The countries which had gone under the program and have now escaped will not be very much amused by the fact that larger countries will have more leeway.

9. European V. Global Growth. Europe suffers from a Eurocentric view. Since the 1990s 80 countries in the world have grown by more than 3% faster than the EU and the US. This leads to a convergence in the world which we have never experienced before. The world is becoming less unequal. The world economy is in a better shape than ever before.

10. Possible Solutions for Europe. There are three options for Europe. One is reform, austerity and deflation. The second one is inflating the core. The third is a

temporarily orderly exit of failing countries. If countries which are in difficulties decide against the first option and as the second option will be rejected by the core countries then only a temporarily orderly exist is the remaining option.

11. The Greek Bailout. Under that circumstances the biggest mistake in the Eurozone was made in May 2010 in bailing out Greece. Greece until recently was a country of feudalism, crony capitalism, socialist centrally managed economy without no market economy and with a corrupt elite.

Basically this was not about bailing out Greece but it was about bailing out banks in Western Europe in particular French banks and German Landesbanken. So you could say that in 2010 the richer countries bailed out a poorer country Greece in order for the poorer country to be able to bail out the banks of the richer countries. Politicians believed that it is easier to explain to the public showing solidarity with the Greek people than having to explain to their own people again that they were rescuing the banks again - in Germany in particular the “Landesbanken” who were fully state owned and supervised by government members.

12. Greek Exit V. New Entries. Some people say that the Eurozone would have been weakened with the exit of Greece but there is no evidence for that. Ireland and Portugal are now out of the program. Spain is the fastest growing member of the Eurozone. We see the convergence in other member countries in particular in the Baltics and Poland and the Czech Republic. By January 1st 2015 the three Baltics will be members of the Eurozone. For the first time in Poland the public opinion is in favor of entering the Eurozone and also the Czech Republic seems to be rethinking about this issues. So would anyone say that the Eurozone would be weakened with the entry by the Baltics and a possible entry of Poland and the Czech Republic.

13. Convergence of Poland. One of the most striking examples of convergence is Poland. Poland and Ukraine were at almost the same level of GDP per capita in 1990 now Poland GDP per capita has increased by 6.5 times and the GDP per capita of Ukraine has increased by 2 times only. So this shows a strong evidence that market oriented reforms are solving the problems.

14. Deflation in Europe. The discussion about deflation in Europe is off the mark, influenced

by the price development in Greece or Spain or other Southern countries. The price level there is still too high as there is no chance of devaluation of the currency only an internal devaluation. Basically a reduction of wages or costs is not enough. It needs a reduction of the price levels. So deflation in these countries is a precondition for a successful restructuring. Without deflation in the south Germany for instance would have to inflate for at least ten years with an average rate of more than 5%. This is completely out. Therefore the deflationary trend in the Southern countries will have to continue as a precondition for recovery.

15. Germany is very often considered to be the strong man in Europe. This is not supported by the facts. If you look on the period between 1993 and 2013 (among 166 countries in the world), Germany had an average growth rate of 1.3%. Only 10 countries out of 166 in that decade had slower growth than Germany. Germany is ranked 156 behind for instance Tonga and before Bulgaria, Portugal, Greece and Italy among 166 countries.
Bad economic decisions of the Grand Coalition will not improve that situation but rather weaken it.

16. There is also a debate of European solidarity. Many people forget that there are two principals at the core of European values - subsidiarity and solidarity .

17. Private Wealth in Europe. If you compare private wealth to GDP or private wealth per household you may come to a result which surprises many. The private wealth to GDP ratio is about 3.5 in Germany, in Italy and France it is 5.0 and in Spain even about 6.0. The private wealth to public debt ratio is the highest of all G7 countries in Italy. Private wealth per capita for instance is in Italy about 30% higher than in Germany. The median household wealth in Germany is on the lowest level in the Eurozone.

18. The German View. There is very often the talk about a so-called German view as opposed to the majority view in the Eurozone or in Europe. This is not supported by the facts. The so-called German view will be definitely supported in the future by the majority of the Commissioners and the majority of the Eurozone member countries and the majority of the EU member countries. About 15 or 16 commissioners will support the so-called German view. The new Economic and Financial Affairs Commissioner will report most likely to two Vice Presidents. Among them is Valdis Dombrovski,

the former Prime Minister of Latvia. He has successfully steered the country through the financial crisis having pegged the currency to the Euro. He will be representing the commission in all issues of the Euro to the Eurozone Ministers of Finance, in the Council and on the EU level.

19. The OMT. There will be no OMT: The ESM will not give any guaranties to the ECB if they buy asset backed securities. So the monetary effect will either be very limited or the ECB takes its own risks which basically leads to a redistribution in Europe. Will there be Eurobonds at the present debt level? Definitely not. The distributionial issues will move into the core of the debate. In the future there will be resolution procedures for countries. I will not preclude that countries would temporarily leave the Eurozone.

20. Export Markets. The fall of the wall and the end of communism has been more important for Germany than the introduction of the Euro. 80% of German export growth since the fall of the wall went to the emerging markets and the former communist Eastern and Central European countries. Since the beginning of the EMU German export growth to the Eurozone was 8.5% p.a, whereas to the non-Euro world was more than 10.5% per annum. German exports to the BRIC for instance jumped from 4% to 15% of German exports. German exports into the Eurozone as a percentage of total German exports are now 36% - at its lowest level ever.
In terms of export to GDP ratio Germany is only number 8 in Eurozone and 12 in the EU.

21. Germany is the number one export market for 12 Eurozone countries and for 18 EU member countries in particular for all Eastern and Central European countries.

22. The German export GDP ratio was 23% in 1989/1990. Since the fall of the wall it has risen now to almost 50%. The reason for that in particular is the fact that Germany offers products and services which are heavily in demand by countries who have embarked on strategy of industrialization. This concerns in particular emerging markets countries including all BRIC countries and all Eastern and Central European countries.

23. The debate about the German current account surplus is also off the mark. The industry share of GDP in Germany is 23% or 24%, is about twice as high as the EU average. Only Czech Republic and Hungary have a higher industrial share of GDP.

The US and the UK are between 10% and 12%. As 50% of all EU exports are industrial goods and Germany accounts for 30% of the industrial gross value of the EU it is no surprise that German exports are heavily influenced by these economic structures. Only 5 member countries of the EU account for 70% of industrial gross value in Europe.

24. It is funny to see that the commission has started a reindustrialization program in Europe and at the same time it has launched the procedure against Germany to punish it for the high industrial exports. Obviously these people have not understood that a high industrial share goes along with high export rate for the simple reason that home markets are not big enough for large scale industrial production.

25. The structure of the German export industry is of importance. In a worldwide study called “Hidden Champions” companies were selected who had annual sales of between 100 million and 1 billion Euro, who were number one in Europe or the US or number one, two or three on the world market. Out of 2600 companies 1300 were counted in Germany and 300 in Austria and Switzerland. Although most of them have a very high export rate, they do not consider themselves as exporters but rather of serving a particular niche market in the world where by the German market happens to be part of that world market.

26. Germany is not only one of the largest exporters but also one of the largest importers. Whereas Germany has an export market of about 50% of GDP the imports are about 44% to 45%. So Germany hast not only one of the largest export shares but one of the largest import shares

27. Among the larger economies for instance the US has 17%, France has 30%. With 2.5 on top of that Germany has the highest import elasticities. A large part of these imports are fueled into German exports. The share of foreign gross value as a percentage of German exports has risen from below 20% in 1995 to now 28%. So the German exports are also a success for a large number of European countries in particular in Central and Eastern Europe. Germany as a country is not manipulating its competitiveness. The Government is not the exporter. It is the mid-sized individual companies. Basically the success of German products in the world market depends not on government decision but on the decision of million consumers and entrepreneurs in the world.

28. Many EU countries have little export to emerging markets and depend more on the EU and the Eurozone. They have also smaller exports to the US and to China than Germany whose fastest export growth rates in the last 20 years has been to the emerging market countries of the world. So in particular the export of manufactured goods is largely driven by emerging markets outside Europe.

29. The European Social Model. There is very often talk about the European Social Model. But: It is not European, it is not social and it is not a model for anyone in the world. Europe has 7% of the world population, creates about 22% of the world GDP and accounts for 50% of the social expenses of the world.

30. Youth Unemployment. Youth unemployment in the Eurozone and Europe is widely self-inflicted. It is the monopoly behavior of trade unions and politicians which are at the root cause. The two-tier labor market system which favors those who are in the system penalizes those who are not in the system has to be abolished as the main course for the high youth unemployment. As long as young people are the first to be laid off in the restructuring of a company because of the lower seniority there is no wonder that young people suffer a high unemployment rate. At the same time the system makes it difficult for young people to enter the market. So without fundamental labor market reforms there will be less employment. A Study from Tito Boeri, Bocconi University proofs that there is an inverse relationship between EPL (employment protection level) and the employment level. The higher the employment protection level is the lower is the employment rate as a percentage rate of the total population. So it is not only important to make it easy to hire people but also to lay off people. Only if people can be laid off easier the entry level for new employees is reduced.

31. We should be more concerned in the future because of a lack of qualified labor which would impede economic vitality in Europe as a result of the demography.

32. European Growth. The EU Commission has allegedly pursued a policy not only of growth but of “sustainable”, “green”, “inclusive”, “long-term” growth until there is almost no growth in the Eurozone anymore at all!

33. The Doing Business Index of the World Bank shows that among the first 20 countries are only 3 Eurozone countries respectively

six EU countries and among the first 40 countries are 7 Eurozone countries and 12 EU countries.

34. Growth through Innovation. The only way for Europe out of the crisis is through more innovation leading to higher competitiveness. This requires more entrepreneurship, more start-ups, more Angel financing, more venture capital, more founders. The start-up rate in the US is about 2.5 higher than in Europe in relation to GDP. So Europe needs a winner culture which is obviously acceptable in sports but not in business. More over Europe needs a failure culture. There is an intensive relationship between the stringency of bankruptcy laws and entrepreneurship culture.

35. Some European politicians are surprised about the fact that the US ITC Industry is leading the world. We should be not surprised. It has become acknowledged for many years that the US has developed the ITC industry like no one in the world. 70% of all software of the world is written in the US, not necessarily by Americans. More than 50% of IT-based start-ups in Silicon Valley have at least one founder born abroad. So in particular the percentage of people born in Asia is very high among the founders of new businesses in the US in particular in Silicon Valley.

36. What is needed for pushing innovation is scientists creating knowledge, entrepreneurs creating new products and private investors financing start-ups. Is there a role for Governments? The role for Governments is in the invention part and in education.

37. To improve framework conditions for entrepreneurship, start-ups, financing of innovation and early childhood education would be among the most important areas to concentrate on.

38. Growth and wealth is created only by innovation. Innovation needs a market economy system, some people call it capitalism! What is the starting force? Entrepreneurs!

39. The key is the financing of innovation. The important question is where capital is invested. It is not enough just to embark on investment spending program but to choose the right investment is the key. Instead of investing 300 billion in infrastructure or in projects which have to be even searched for maybe it is much better to spend a larger part of this on R&D on the one hand and the financing of start-ups on the other hand. Most likely with this the financing of the new thing could on the long term have a much stronger impact on the economic

development in Europe.

40. For innovation the financing of new venture is going to be the key. For that venture capital is indispensable. The venture capital industry in Europe is very underdeveloped compared to the United States. For instance in 2013 Venture Capital in the US grew to almost 30 Billion, unfortunately in Europe the number were flat with about 3.5 Billion now on the lowest level per year since > 10 years. The US are having a bonanza in the first part of the year of 2014 - Silicon Valley alone has invested more than EU. Silicon Valley basically is Santa Clara County with about 2.5 to 3 Million people investing about almost 40% of US Venture Capital - that is 12 Billion - which is about 2.5 times as much as the EU.

41. In the first half of 2014 fund raising of the Venture Capital industry achieved the highest level since the first Quarter 2001. Europe is flat or decreasing. On top of that the percentage of public funding in the European Venture Capital is consistently increasing. In 2007 it was only 15%. It is now almost 40%. In Germany it is more than 50%.

42. The Venture Capital investment per capita in the US is now about 150, in Israel 250, the real start-up country in the world. In the first half year of 2014 in Israel Venture Capital investment per capita now about 500 USD, where the development in Europe is continues to be flat with about 10/12 USD. Eurozone is about 5 USD.

43. Financial Repression & Inequality. The low interest rate policy now obviously encouraged by governments and the ECB with the buying of government bonds increases growing inequality in Europe. People who have small saving accounts, a life insurance or pension are not profiting from that. They almost lose their entire income from what they have saved earlier on for their retirement age whereas people who have funds and invested them in stocks, in property, in art, etc. are profiting from flush money and low interest rate policy creating an asset price inflation. So inequality has become official policy in Europe and in the US. The difference is that in Europe the percentage of people who are invested in shares is much smaller than in the US. As a result growing inequality maybe even more harsh in Europe than in the US. This policy of financial repression is able to destroy the foundations on which the Western European societies or a society like Germany are based the -middle class, which saves money,

have a life insurance and may have a pension from their firms. This financial repression is attacking the backbone of our society. The long-term implications are much more than just a redistribution of wealth and growing inequality.

44. The Way Forward. The way forward for Europe is to comply with the rules, convergence through structural reforms, to increase competitiveness through innovation and efforts to re-infranchise the European middle class. This could also include a temporary exit of non-performing members.

COLUMBIA | SIPA
Center on Global Economic Governance

Center on Global Economic Governance, SIPA
1401 International Affairs Building
420 West 118th St., Mail Code 3328, New York, NY 10027
Tel 212-854-5310 | Fax 212-854-1229 | cgeg.sipa.columbia.edu