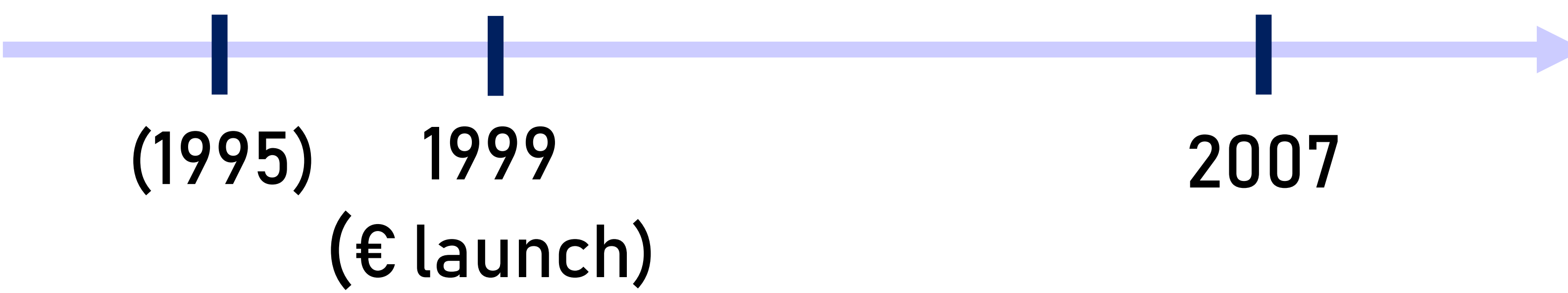
CATCHING-UP PROCESSES IN THE EURO AREA

Why is convergence worse than expected after Euro launch?



CANNOT be explained by:

- Missing capital / cash inflows
- Human capital differences

  → skills have improved over the last decade

CAN be explained by:

- Weakness in productivity
- Capital misallocation

  → Accumulation process driven by rent seeking rather than efficiency considerations

METHODOLOGY APPLIED:

- Pattern of convergence (pre-crisis period) reviewed on basis of sectoral data

- Matter is divided in 6 sections:

  1. Overall convergence record in euro area
  2. Role of productivity in euro area
  3. Evidence of capital (mis-)allocation in euro area
  4. Key drivers of total factor productivity
  5. Convergence prospects in aftermath of crisis
  6. Conclusion

GLOSSARY: basic indicators

GDP
Gross Domestic Product

ICT
Information Communication Technology

TFP
Total Factor Productivity

GNI
Gross National Income

GVA
General Value added

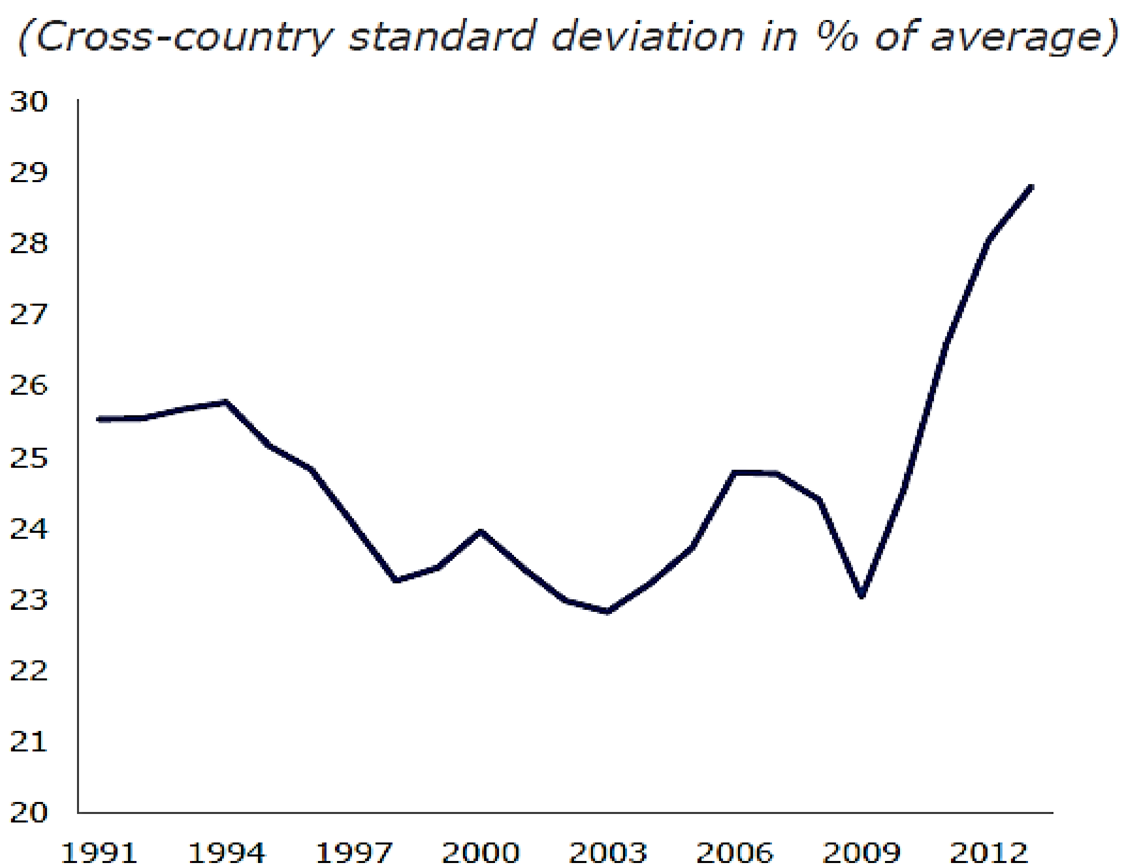
Marginal Product Of Capital

FDI
Foreign Direct Investment

Gross Operating Surplus

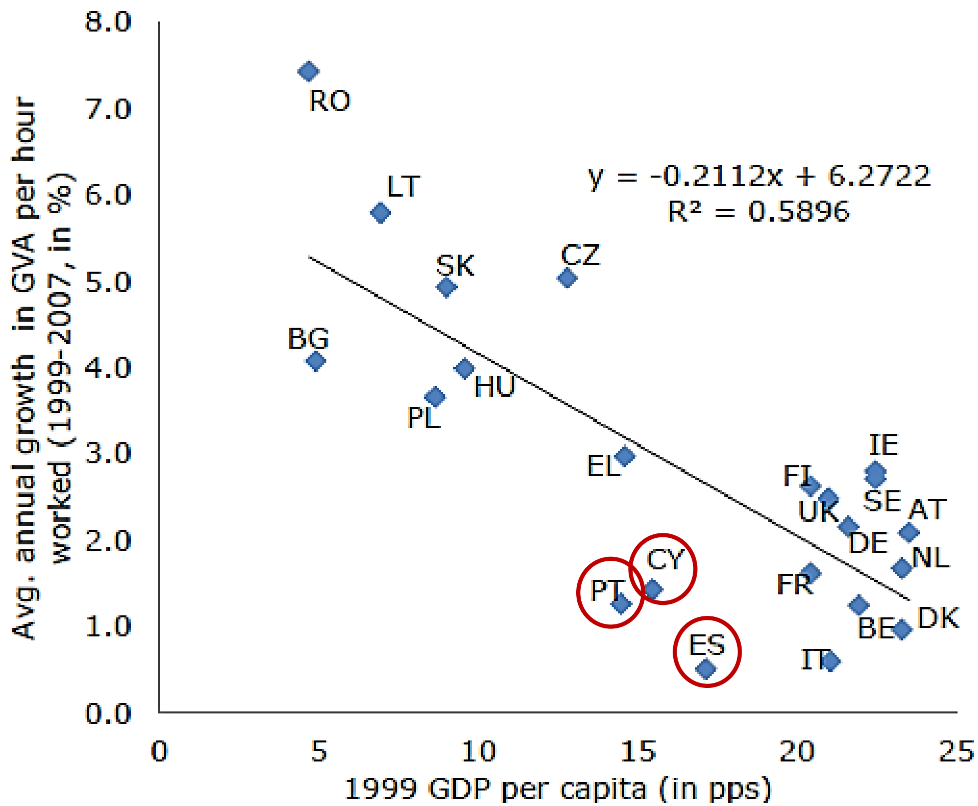
OVERALL CONVERGENCE RECORD IN EURO AREA

Country dispersion of real GNI per head of population, Euro area



IS LABOUR PRODUCTIVITY MAIN DRIVER OF CATCHING UP?

GDP per capita in level
and labour productivity growth,
EU countries



Euro-area catching-up countries BELOW the regression line

LABOUR PRODUCTIVITY

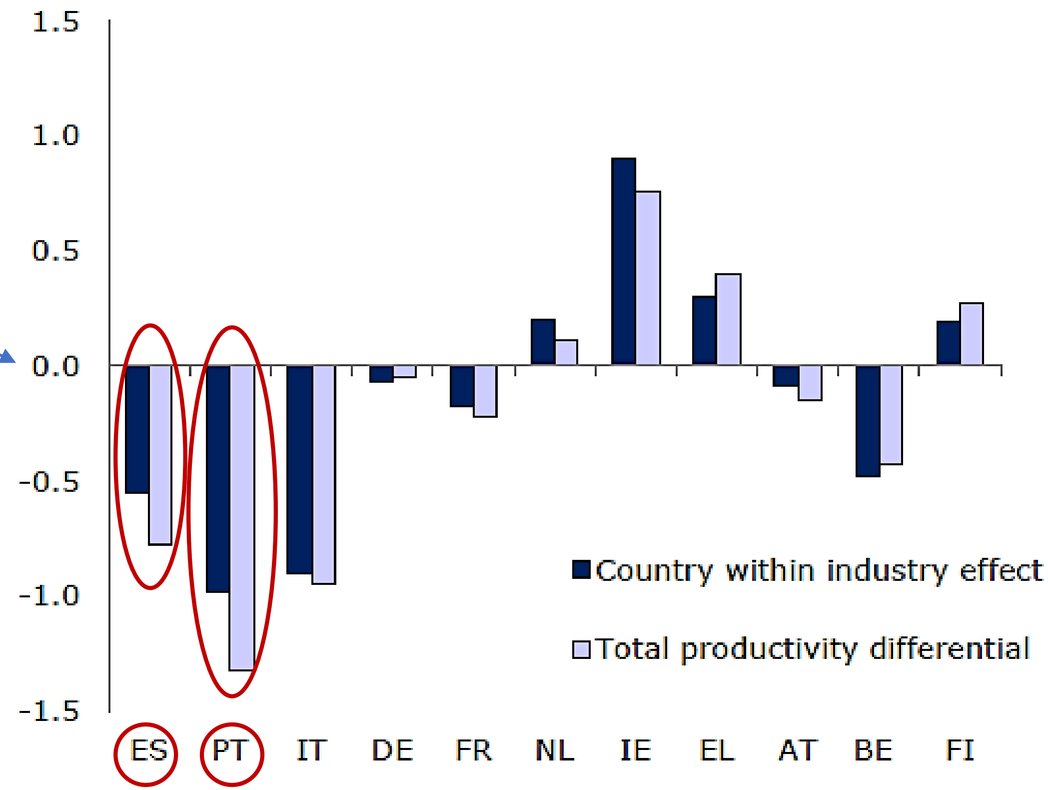
Within industry effect

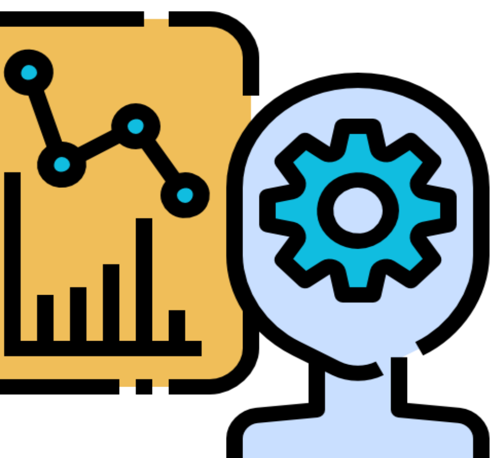
Industrial specialization

Labour productivity Differentials, selected Euro area countries

(relative to EA11 average, 1999-2007)

Average productivity



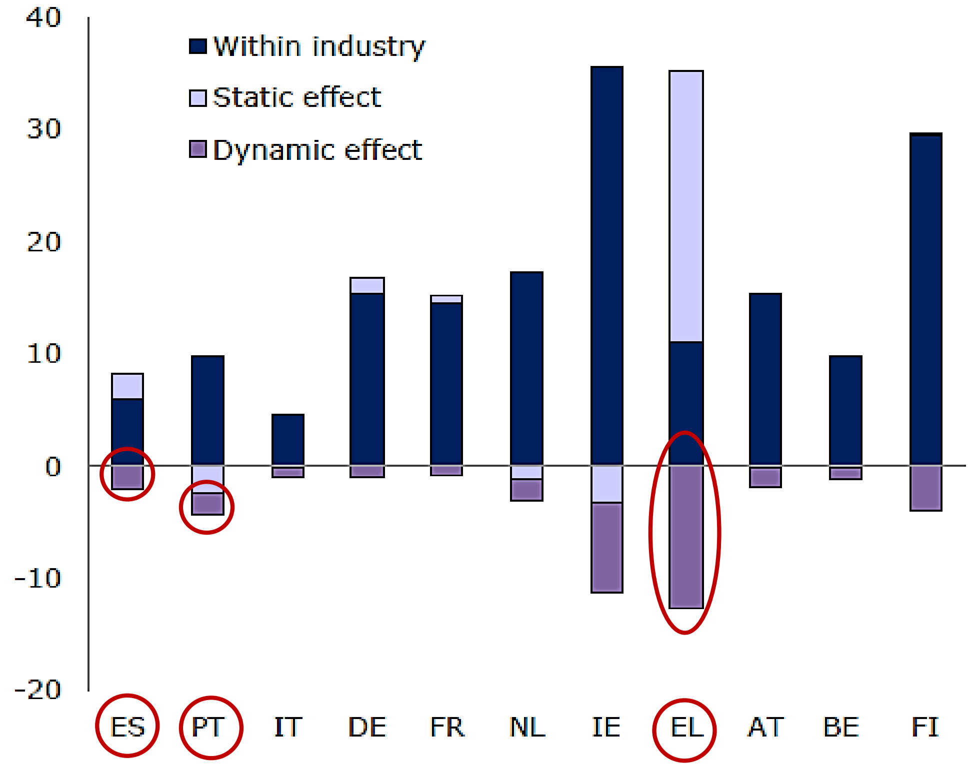


LABOUR PRODUCTIVITY GROWTH

- Within industry effect
- Structural effect
  - Static effect
  - Dynamic effect

Labour productivity growth decomposition, Selected EURO area countries

(in %, 1999-2007)

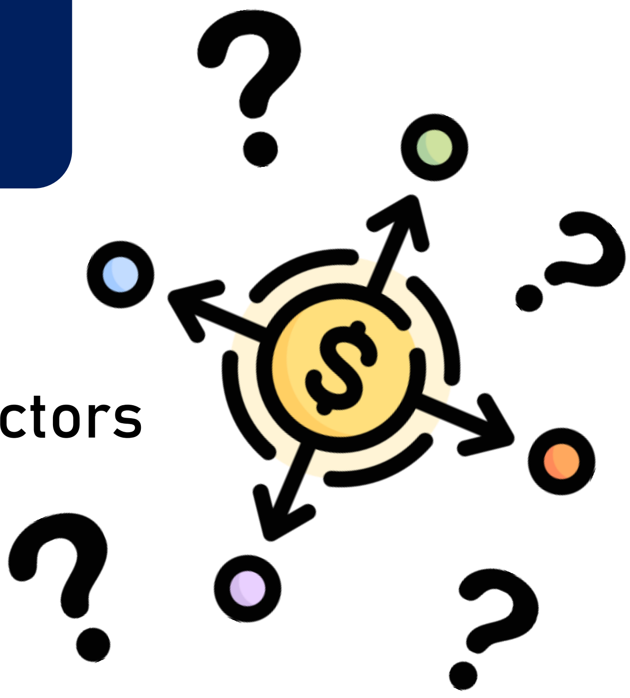


Is LABOUR PRODUCTIVITY the MAIN driver of catching up?

→ No

Which is the real causes of this divergence?

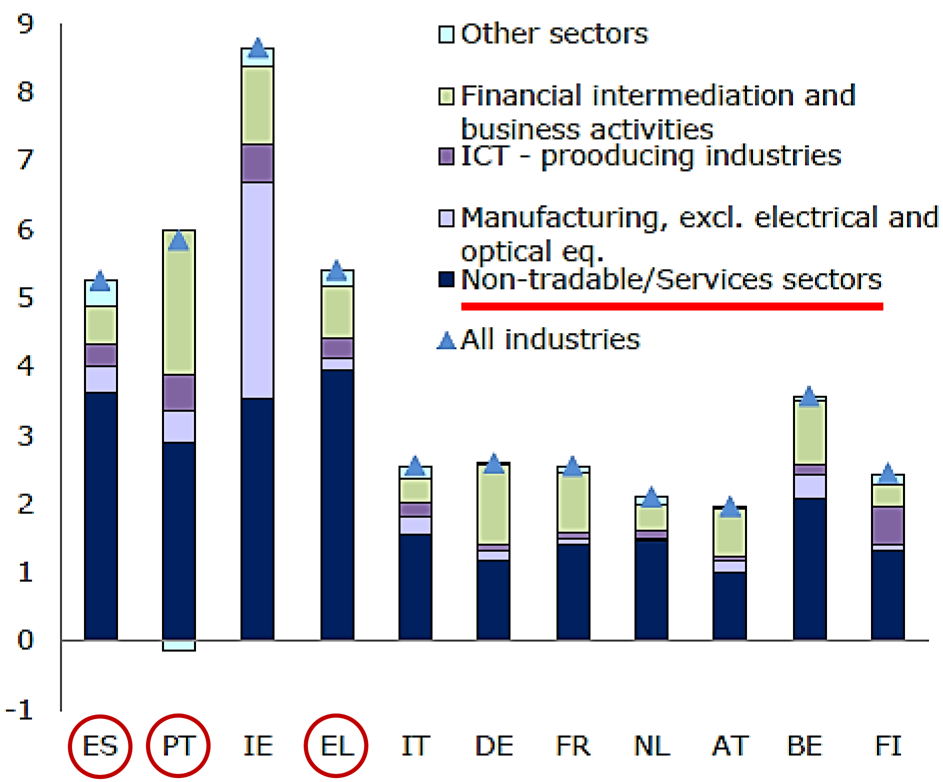
→ MISALLOCATION across sectors



INVESTMENT PICTURE AT SECTORAL LEVEL

Decomposition of growth in capital services by main sector

(avg. annual contributions in %, 1999-2007)



Non tradable/service sectors:

- Real estate
- Utilities
- Construction

Capital diverted to low productivity growth sectors

Which were the drivers of investment decision?

DRIVERS OF INVESTMENT DECISIONS:

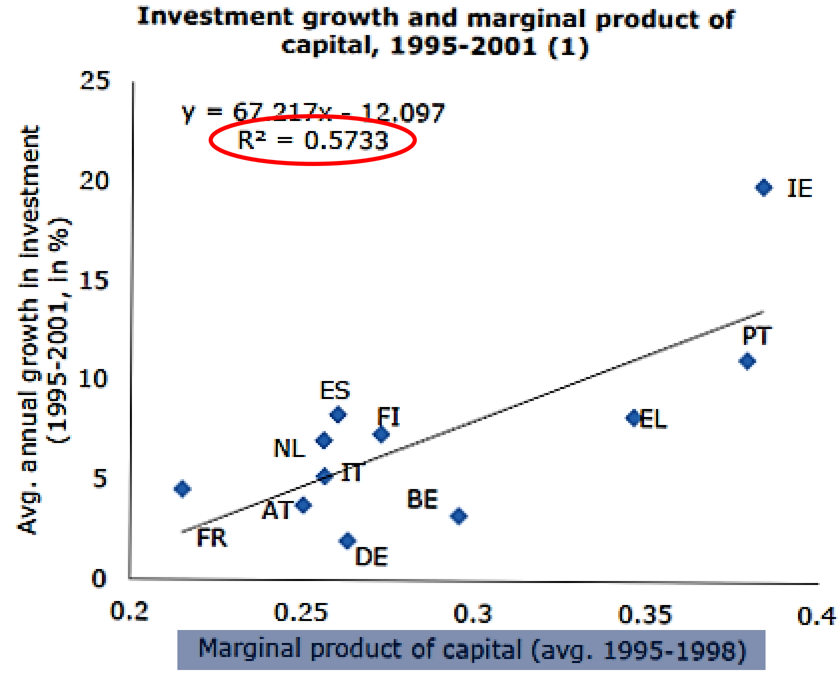
ECONOMIC GROWTH THEO

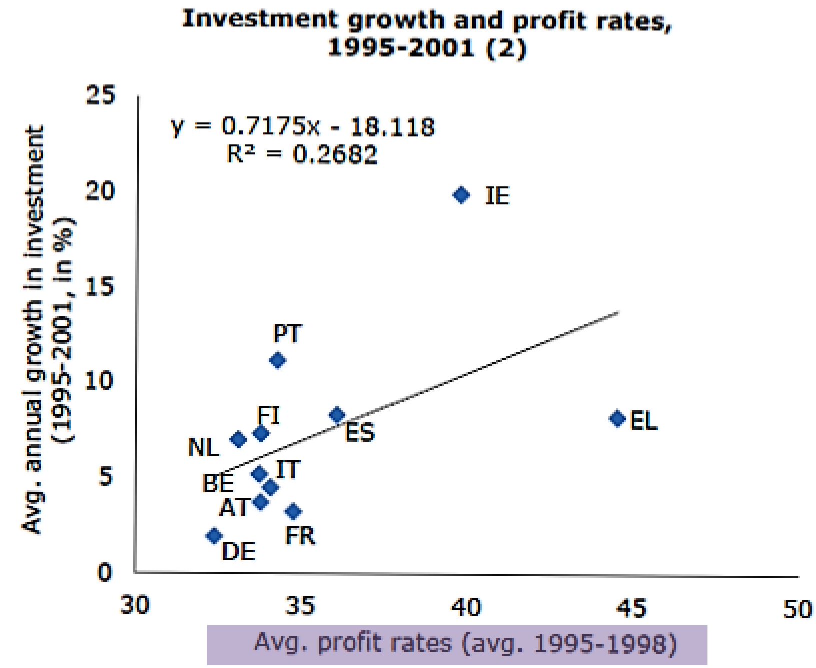
economic integration and fina … marke … ration should lead to higher income levels across countries, while less … conomies should grow faster than more advanced ones

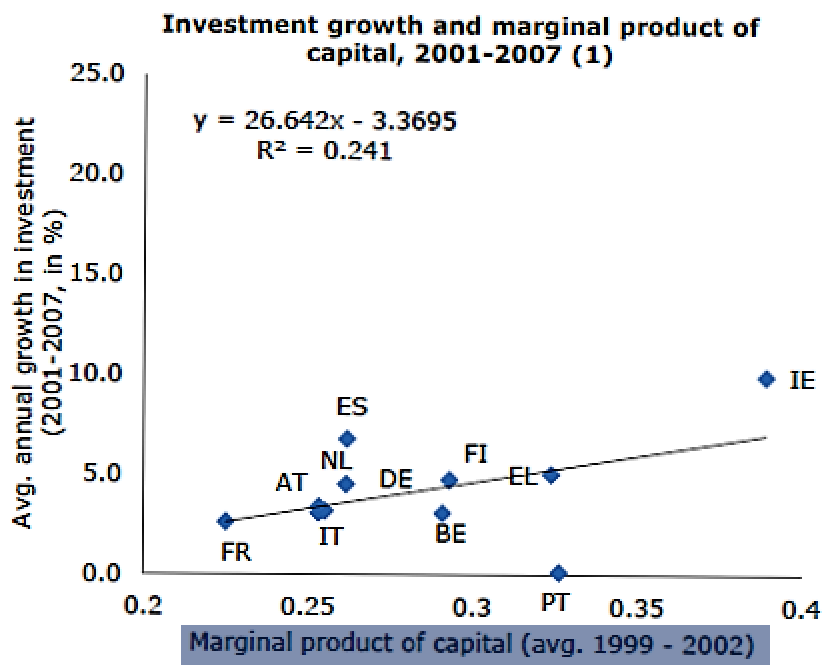
- ***Neoclassical growth mode*** … use o … rapid capital accumulation
- ***Endogenous growth m*** … ecause of te … gy diffusion and innovation

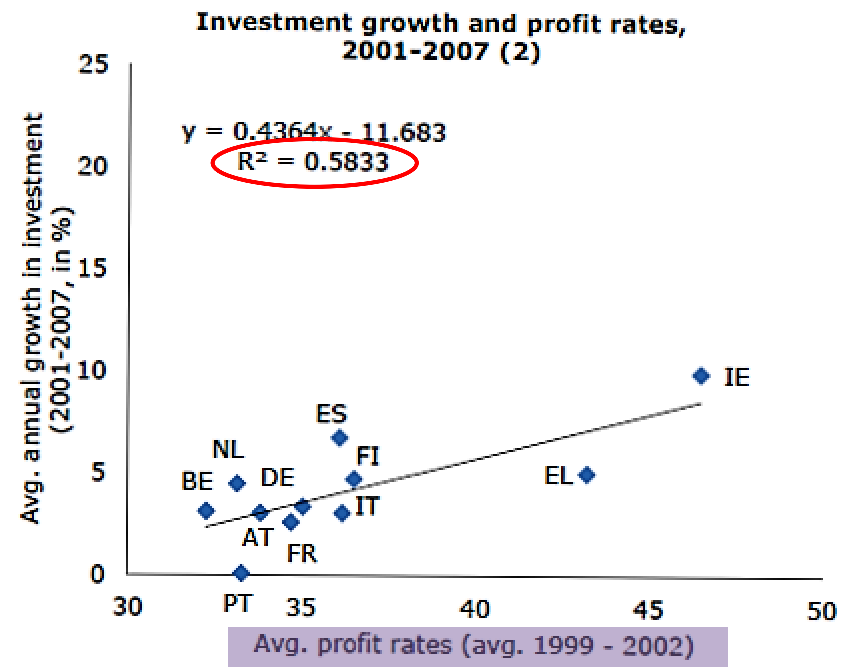
THE PATTERN OF
CONVERGENCE HAS CHANGED

…


Investment growth and marginal product of capital, 1995-2001 (1)
y = 67.217x - 12.097
R² = 0.5733
Avg. annual growth in investment (1995-2001, in %)
Marginal product of capital (avg. 1995-1998)
IE
PT
EL
ES
FI
NL
IT
AT
BE
FR
DE
0
5
10
15
20
25
0.2
0.25
0.3
0.35
0.4


Investment growth and profit rates, 1995-2001 (2)
y = 0.7175x - 18.118
R² = 0.2682
Avg. annual growth in investment (1995-2001, in %)
Avg. profit rates (avg. 1995-1998)
IE
PT
FI
ES
EL
NL
IT
BE
AT
FR
DE
0
5
10
15
20
25
30
35
40
45
50


Investment growth and marginal product of capital, 2001-2007 (1)
y = 26.642x - 3.3695
R² = 0.241
Avg. annual growth in investment (2001-2007, in %)
Marginal product of capital (avg. 1999 - 2002)
IE
ES
NL
FI
AT
DE
EL
IT
BE
FR
PT
0.0
5.0
10.0
15.0
20.0
25.0
0.2
0.25
0.3
0.35
0.4


Investment growth and profit rates, 2001-2007 (2)
y = 0.4364x - 11.683
R² = 0.5833
Avg. annual growth in investment (2001-2007, in %)
Avg. profit rates (avg. 1999 - 2002)
IE
ES
NL
FI
BE
DE
EL
IT
AT
FR
PT
0
5
10
15
20
25
30
35
40
45
50

1995 – 2007

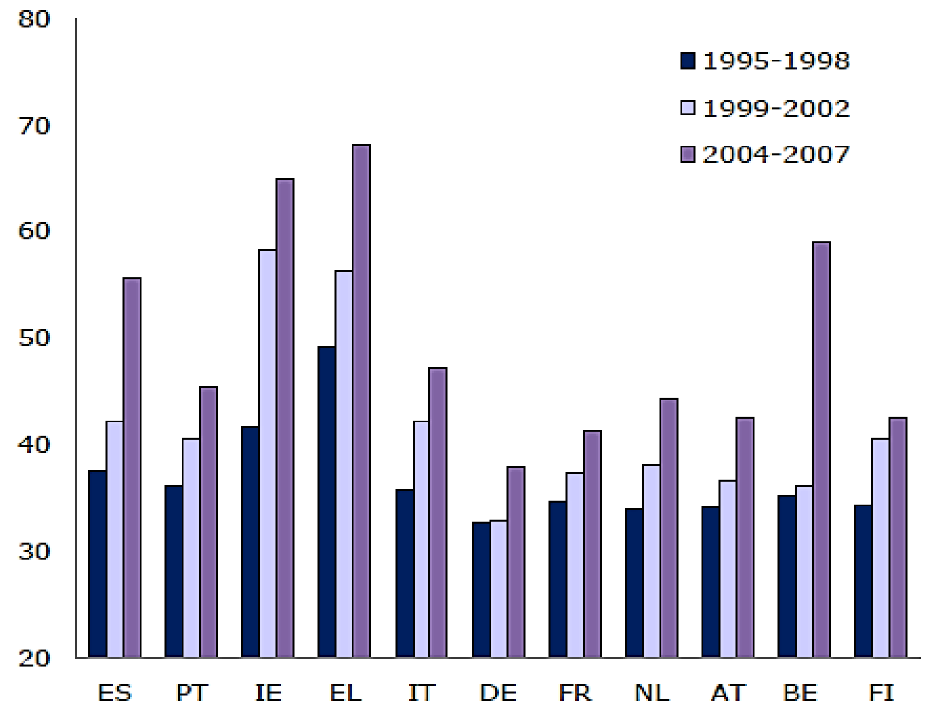
Marginal product of capital DECREASES

Profit rate INCREASES

TOTAL CAPITAL COMPENSATION

Gross operating surplus

(in % of value added, in volumes)



DRIVERS OF TFP AND GROWTH IN CONVERGING ECONOMIES

CATCHING-UP ECONOMIES

TFP performance deteriorating

1999 2007

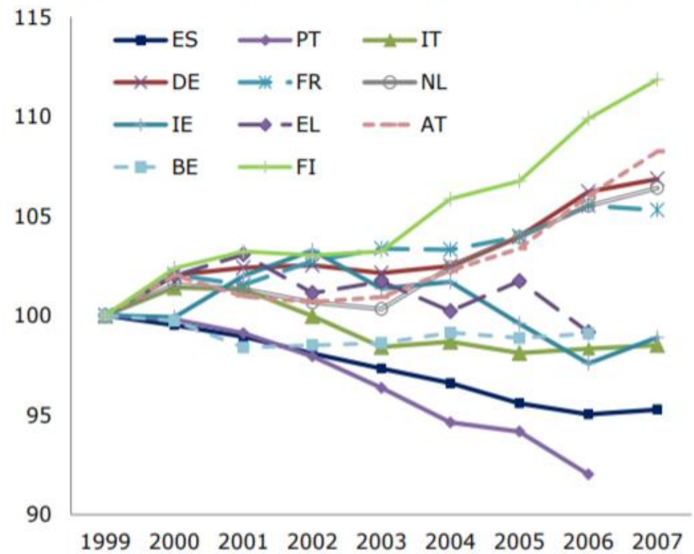
Manufacturing

Network industries

Distribution industries

TFP Performance

(avg. annual growth rates, in %, 1999-2007)



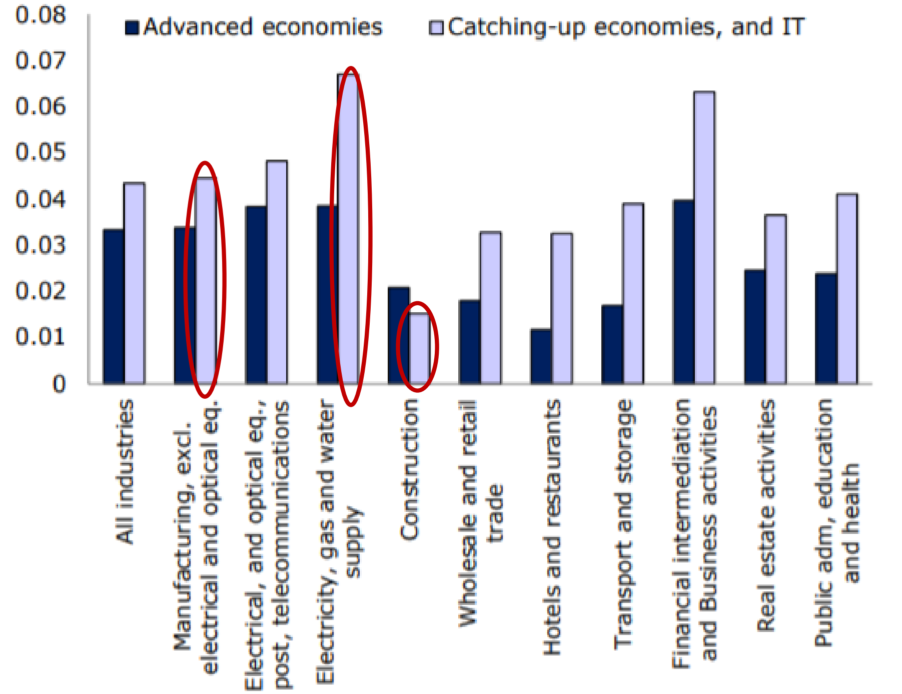
Main Reasons

~~Human Capital difference~~

Skill structure in catching-up economies improved over the pre-crisis period

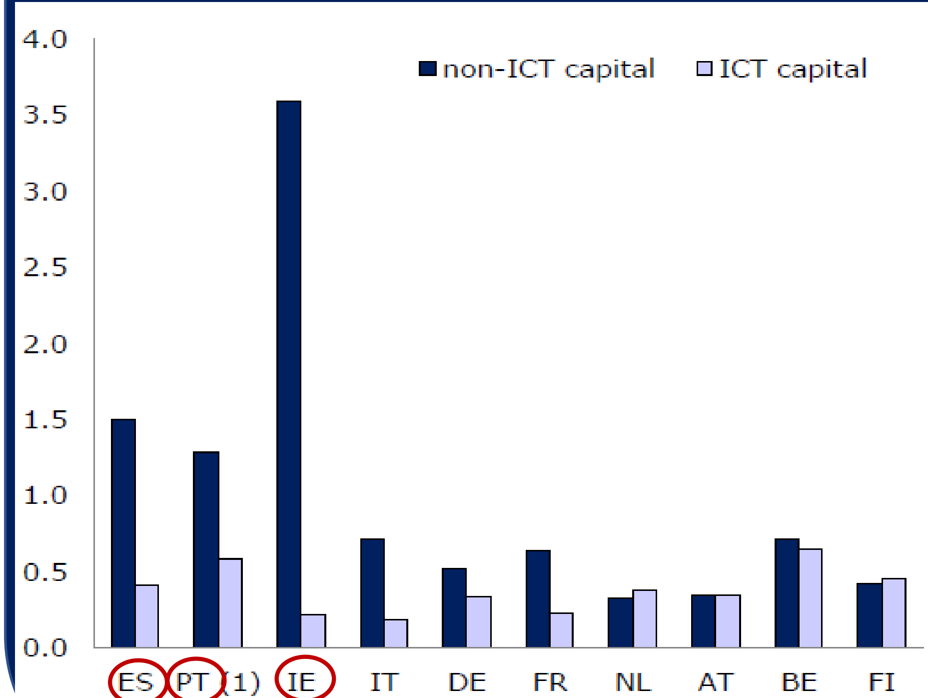
INCREASE IN THE OVERALL SHARE OF HIGH-SKILL HOURS

Change in the overall share of high-skill hours worked



between 1995-2001 and 2001-2007

Contribution to value added growth of non-ICT and ICT capital

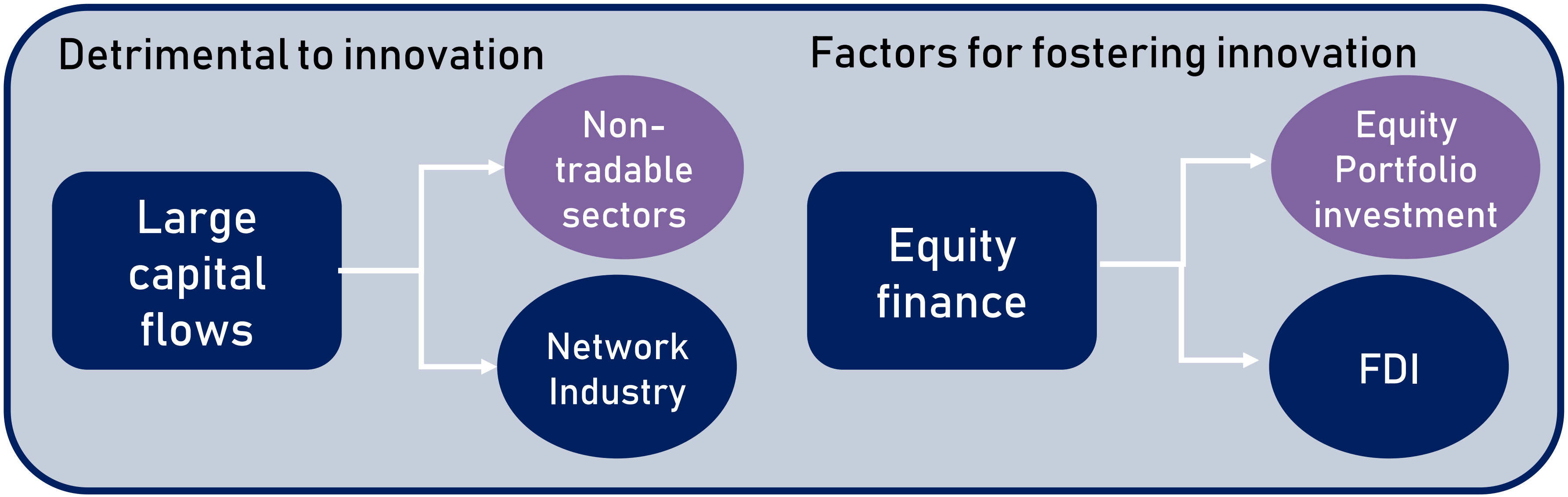


2000-2007

FACTORS FOR PRODUCTIVITY PERFORMANCE

Despite large capital inflows…

- Economic and industrial structures
- Quality of institutions
- Lack of competition & restrictive product market regulation
- Economy's degree of openness and flexibility



In the aftermath of the crisis…

STRUCTURAL REFORMS IN CATCHING-UP ECONOMIES

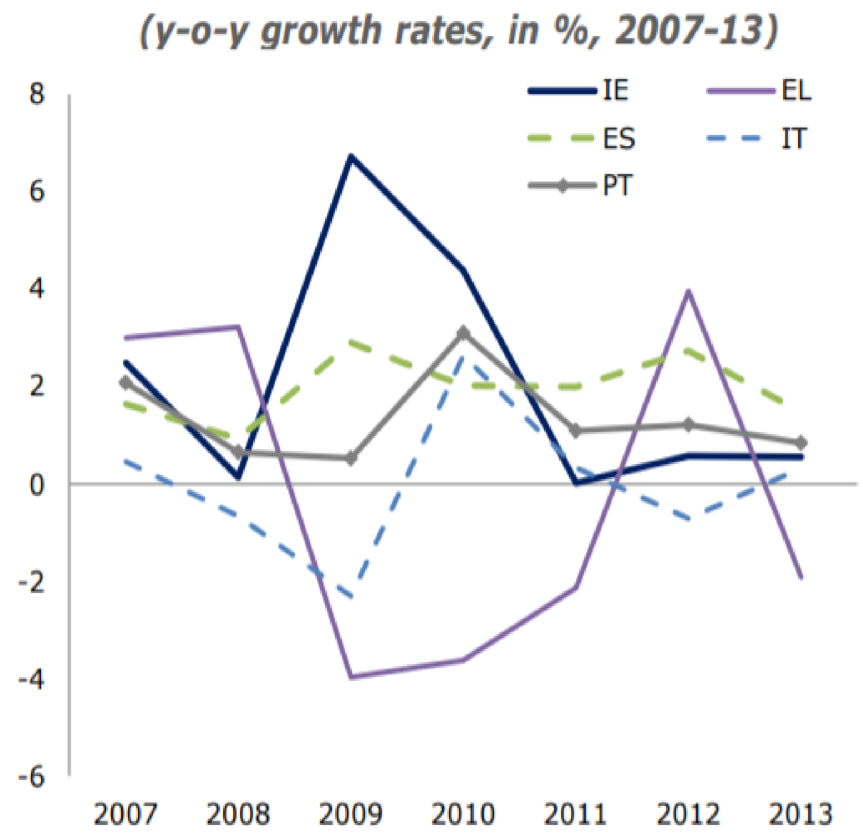
Financial assistance programmes

Enhanced surveillance framework

RESULTS

- Fostering competition in product and service markets
- Facilitating entry
- Improving efficiency of the business environment

GVA per hours worked



DEVELOPMENTS SINCE THE CRISIS I

Services Directive

- Removing barriers to competition
- Opening important market segments in the services sector

STRUCTURAL REFORMS

MEASURES FOR:

- Enhancing transparency
- Improving market functioning
- Independence of the competition and national regulatory authorities
- Reducing litigation
- Fostering the specialisation of courts and judges

DEVELOPMENTS SINCE THE CRISIS II

STRUCTURAL REFORMS

MEASURES FOR:

- Administrative simplification and delicencing
- Improvement of SMEs' access to finance
- Modernization of the public administration
- Promotion of the digitalization of the economy
- Improvement of civil justice efficiency

Raising productivity growth

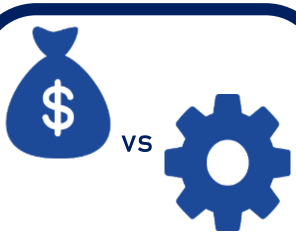
Potential growth prospects

Limitation of capital misallocation risks

CONCLUSION

<u>mixed</u>

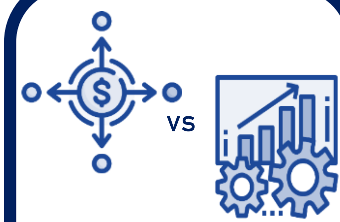
NEGATIVE | *POSITIVE* | *UNCERTAIN*



Massive net capital inflows

vs.

Poor productivity performance (mirrors weak TFP growth)



Poor reallocation of resources

vs.

More productive sectors

Catching up economies have been hardest hit by crisis

Comprehensive policy

→ Broad range of reforms

TFP drivers have to be further studied