The Model that Failed and how Europe is Reacting to It

by

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The Solow-Swan model with labour-augmenting technological progress

We assume that the production function includes labour-augmenting technological progress, and that the technology term, *A(t)*, grows at a constant rate. The condition for the change in the capital stock is

$$\dot{K} = s \cdot F[K, L \cdot A(t)] - \delta K.$$

If we divide both sides of this equation by L, then we can derive an expression for the change in k over time:

$$\dot{k} = s \cdot F[k, A(t)] - (n + \delta) \cdot k$$

Paradise found: the world economy before the crisis

Six key words

- Globalisation
- Deregulation
- Privatisation
- Competition
- Innovation
- Finance

and different ways of conjugating them

Paradise found: winners and losers

Winners:

- Rich people and women in advanced countries
- Emerging market economies

Losers:

- Unskilled workers in advanced economies
- Low income and poor countries
- Significant environmental costs

Table 1.1. Trends in real household income by quintiles

	Average annual change mid-1980s to mid-1990s					Average annual change mid-1990s to mid-2000s				
	Bottom quintile	Middle three quintiles	Top quintile	Median	Mean	Bottom quintile	Middle three quintiles	Top quintile	Median	Mean
United States	1.2	1.0	1.9	1.0	1.4	−0.2	0.5	1.1	0.4	0.7
OECD-20[3]	1.3	1.5	2.1	1.5	1.7	1.7	2.0	2.2	2.1	2.1

Source: Computations from OECD income distribution questionnaire.

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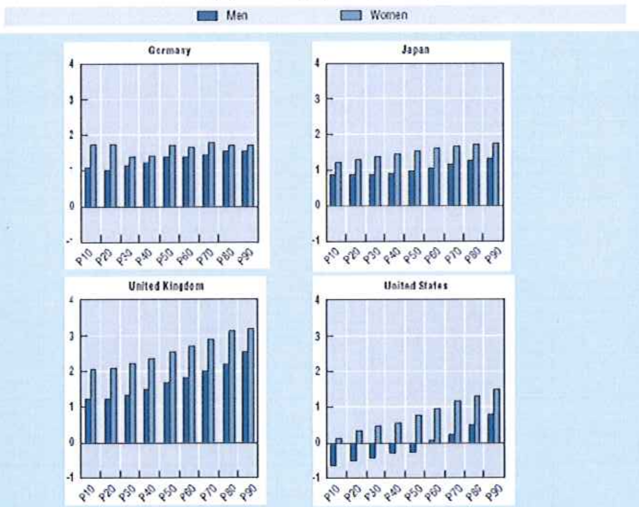
Figure 3.3. **Real earnings growth for men and women working full time by decile, 1980 to 2005**

Average growth rate per year, in percentage



Source: OECD Earnings database.

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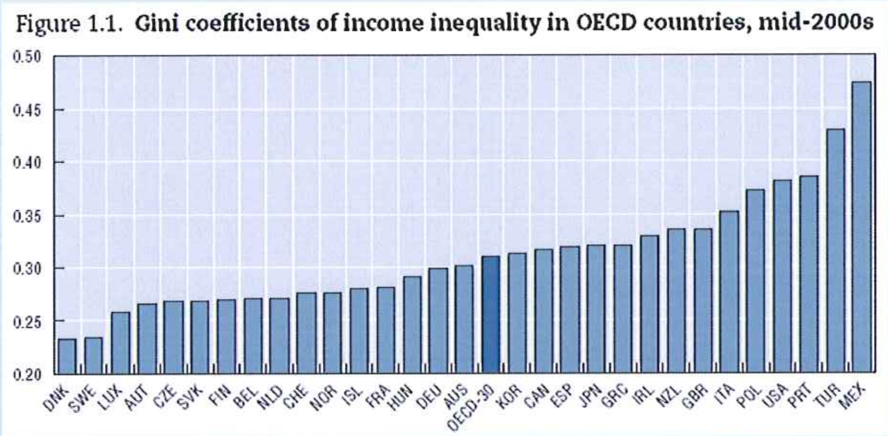
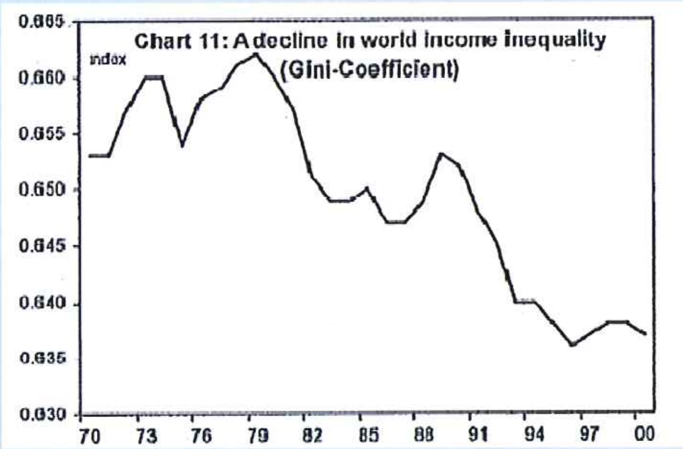


Note: Countries are ranked, from left to right, in increasing order in the Gini coefficient. The income concept used is that of disposable household income in cash, adjusted for household size with an elasticity of 0.5.

Source: OECD income distribution questionnaire.



Source: Sala-I-Martin (2006)

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Paradise lost: the inglorious end of a growth model based on large and growing imbalances

- Over the years the pre-crisis growth model produced
  - A large and unsustainable current account deficit in the US, fuelled by growing household's indebtedness and excessively easy monetary policy
  - A mirroring large and unsustainable current account surplus in some emerging market economies (in primis China) and oil producing countries
  - Over-reliance on poorly regulated and supervised financial markets to channel, through increasingly sophisticated (and toxic) financial instruments, resources to the debtor country, so as to keep economies expanding.
- The subprime crisis of 2007 and the collapse of Lehman Brothers in 2009 put an inglorious end to a growth model that already in the mid-2000s had reached its limits and entered in a vicious spiral

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The European growth model before the crisis

- European growth models and not one EU/EA growth model
- However some common features:
  - o Economic stability, low inflation, small external imbalances
  - o Relatively low growth (partly due to low population growth)
  - o Significantly smaller inequalities, due to a larger welfare state
  - o More attention to environmental issues
  - o Better balance work/leisure

Strength of the old European growth model

Limits to GDP as an indicator of economic performance and social progress (Stiglitz report emphasis on well-being instead of production)

- A strong manufacturing basis
- A sound household's balance sheet (in most EU/EA countries)
- Strong, efficient, and environment friendly infrastructure networks
- Better and less costly healthcare system than in the US
- Lower poverty rates that in the US
- Better protection of workers' rights which translated in a better work/leisure balance
- A more energy efficient, low carbon economy than other advanced countries

Weaknesses of the old European growth model

- It did not profit of the productivity revival that took place in the US since the mid '90s
- Rising costs of the welfare state weigh on economic growth
- Relatively high labour protection leading to low mobility and less reallocation
- Low labour participation, in particular in the elder cohorts (55-65)
- Rapidly ageing population and increasing dependency ratios

The crisis and the need for a new paradigm

Some factors of the new growth model:

- More balanced growth
- More and better regulation and supervision (in particular in financial markets)
- Less inequalities
- Flexicurity
- More sustainable environmental friendly growth

Post-crisis EU growth model

EUROPE 2020 strategy: sustainable and inclusive growth

Three mutually reinforcing priorities:

- Smart growth: developing an economy based on knowledge and innovation.
- Sustainable growth: promoting a more resource efficient, greener and more competitive economy.
- Inclusive growth: fostering a high-employment economy delivering social and territorial cohesion.

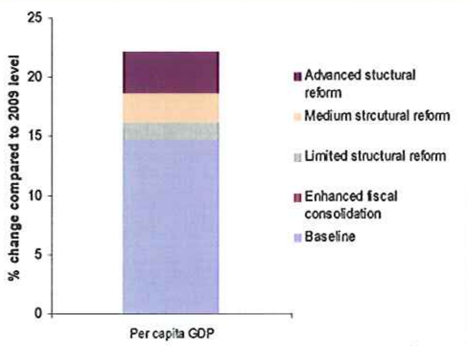
Post-crisis EU growth model

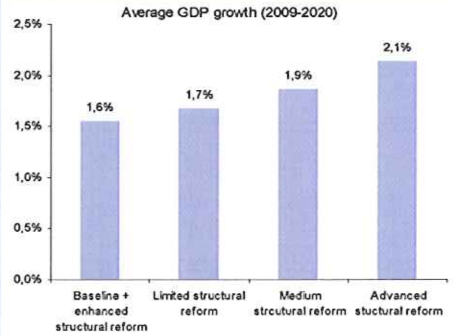
EUROPE 2020 Headline Targets:

- Employment rate ↑ from 69 to 75%
- 3% of GDP invested in R&D
- Energy: 20/20/20
- Education: ↑ share of population with tertiary education to 40%
  ↓ share of early school leavers to 10%
- ↓ poverty by 25%

Post-crisis EU growth model

Potential benefits of Europe 2020:

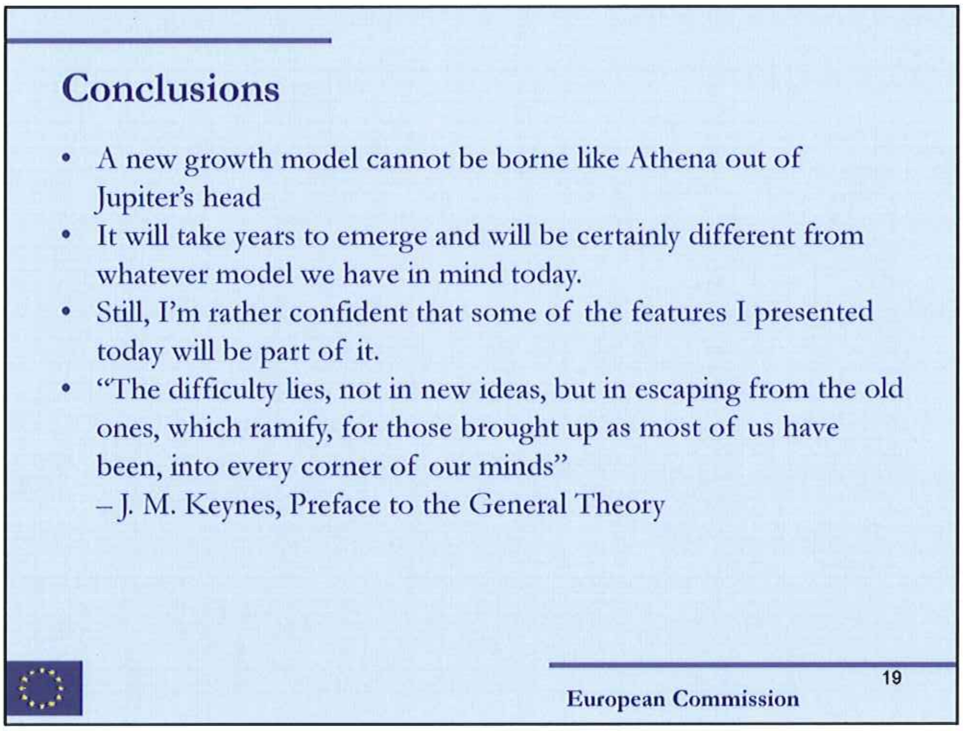




GDP could increase up to 6.5%: equivalent of some 1,880 euro of additional output per person

In an interdependent world no growth model can succeed in isolation

- During this crisis protectionism has been kept at bay and, contrary to the 1930s, isolationism has not spread
- In the new post-crisis world, economists will be more and not less interdependent
- Not surprisingly the current recovery is led by a strong rebound in trade
- The crisis has led policy-makers to strengthen global governance
  - Set up of the G20 as premier forum for economic policy coordination
  - Significant increase of IMF resources and creation of new financing instruments
  - Capital increase of major multilateral development banks


Conclusions
• A new growth model cannot be borne like Athena out of Jupiter's head
• It will take years to emerge and will be certainly different from whatever model we have in mind today.
• Still, I'm rather confident that some of the features I presented today will be part of it.
• "The difficulty lies, not in new ideas, but in escaping from the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds"
– J. M. Keynes, Preface to the General Theory
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