

Prospects for Growth*

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Péter Halmai:

Krízis és növekedés az Európai Unióban – Európai modell, strukturális reformok (Crisis and Growth in the European Union – European Model, Structural Reforms)

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Professor Péter Halmai's research and work as a professor as well as his publications are widely known and acclaimed. Knowing his earlier, valuable works, I read his latest book with great interest.

Halmai's well-structured, very comprehensive work consists of 7 chapters. The past, present and future of economic growth determine our fate, they are crucial issues. The erosion of European growth has gone on for decades. The economic-financial crisis that started in 2008 led to a protracted growth crisis. The problems posed by the crisis are persistent, and addressing them is a long-term process. The previous "European growth model has been shattered to the core as a result of the erosion and the crisis", the author states clearly in the introduction (p. 6).

Chapter 1 offers a thorough description and analysis of the system of growth theories. Economic growth is pivotal in macroeconomics (too), since even a small difference in the per capita growth rate, if lasting, can lead to significant disparities. Halmai gives a complete review of the main aspects of growth theories in macroeconomics. The book takes a unique approach and analyses the major streams as parts of a system, comparing them to each other. The Harrod–Domar model has neo-Keynesian foundations, while Robert Solow and Trevor Swan are the founders and establishers of the neoclassical stream. Paul Romer and Robert Lucas ushered in a new era by presenting the endogenous growth theory. A common tenet of growth theories is that poor countries can catch up with more developed ones by kick-starting growth and by staying on the course of sustained growth. This requires appropriate, well-run institutions. Halmai is right to point out that the path

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for economic growth, technological advancement and the operation of institutions is largely determined by the country's history, its cultural, civilizational heritage and their impacts. He underlines how much the quantitative analyses of economic history contributed to the new results in growth analysis (p. 13). After a thorough review of the Solow model, the author lists the sources of growth. Important factors that help less advanced countries catch up are the flow and spillover of intellectual capital, the diffusion of the economic policies and institutions of successful countries, and the attraction of capital. Halmai presents the components of the convergence mechanism and the relevant findings of the endogenous growth theory through a skilfully detailed analysis of the literature and a meticulous description of the theories' interrelationship. He cites Romer's memorable remark that in order to catch up, countries need to close the "idea gaps" rather than the "object gaps" (p. 28). Halmai also fairly presents the limits of the neoclassical theory. It is an intriguing question whether a new synthesis of the theories can arise, and if so, on what grounds? The author indicates that a "unified approach to growth", that is, the joint analysis of ideas, the population, the accumulated human capital and the institutions might lead to the creation of an endogenous synthesis (p. 40).

Among the features of globalisation and integration, the deregulation of trade, the openness and the geographical location of countries are all vital. The latter is important with regard to the existence of resources and their exploitation, the production site advantages of increasing sizes and spatiality, as well as the utilisation of market opportunities. The impact of trade liberalisation is certainly significant, but it is important to note that more than one third of world trade is directly, and 70 percent is directly or indirectly related to transnational corporations, that is, trade is not free, but intra-corporate. It is also evidently negative that in weaker countries, the export and working capital investments by TNCs actively squeeze out domestic products. In my opinion, Halmai is right to call our attention to the "curse" of natural resources. In some cases, precisely those countries have fallen behind in development that are rich in certain resources, due to the misuse of allowances, wastefulness, political instability and misguided economic policies.

The quality of institutions and policies is of great importance as regards growth and convergence. Halmai makes a valid point when he states that "in successful economies, the accumulation of human and physical capital goes hand in hand with constant technological advancement" (p. 45).

The "golden age" of Western European growth from the end of World War II until about 1973 was largely supported by the social market economy, and the development of the – at that time – well-functioning international trade policies and financial institutions. (Some analysts, however, consider the era between 1960 and 1973 merely a "silver age".)

Chapter 2 describes the interrelationship between European integration and economic growth. The author gives a good overview of the main stages of economic integration and their characteristics. Intense competition is meant to contribute to increasing efficiency, and thus, to rising living standards. On the other hand, solidarity aims to boost social and economic cohesion. Economic integration has an impact on trade, income levels, the balance of payments and economic growth. I find the detailed, well-documented historical analysis of the European growth process particularly insightful. After 1973, convergence weakened considerably but did not stop. In the two decades after the golden age, labour productivity continued to grow faster in Europe than in the United States. Halmai uses data to prove that the productivity gap between Europe and the United States narrowed even further between 1973 and 1995. In this period in the EU-15, real GDP per working hour rose from 62.9 percent to 85.3 percent, but the growth rate of productivity decreased, which may have been a warning sign. In the section analysing the effects of European integration on growth and productivity, the author gives a detailed, well-documented account of how markedly, due to integration, the openness, and trade and income levels grew in EU Member States. The author declares that “the accumulative effect of the European integration is based on the logic of economic growth theory. In a national economy, per capita income can only grow sustainably if workers have a steadily rising supply of physical, human and/or intellectual capital. Consequently, European integration can only influence the growth rate to the extent it affects the accumulation of physical, human and intellectual capital” (p. 105).

Halmai provides an instructive overview of the features of the European growth model that evolved in the second half of the 20th century. When the internal market was created, a great degree of institutional openness and integration was discernible. The trade-to-GDP ratio was higher than in any other region of the global economy. Capital flows within the EU also became substantial. EU membership provided long-term growth stimulus, which for a long time brought about faster income convergence in the Member States than in other parts of the world. Yet, I think it is important to underline that the population of Central and Eastern European countries perceived it as a disadvantage that the convergence of prices was much more rapid than that of wages and wage-like benefits. In fact, the ratio of wages to aggregate income dramatically dropped. In his analysis, Halmai states that the EU-wide average redistribution rate is higher than in the EU’s major competitor countries. In many European countries, the continued and excessive overspending by the state led to massive public debt. The author is right to point out that in the EU “the institutionalised supranationality is not accompanied by fiscal federalism. Even in the long term, the common budget will stay at around 1 percent of Member States’ GDP. Despite the close integration, there are still huge disparities between the quality of the institutions in the various Member States” (p. 110).

Chapter 3 discusses the erosion of the European growth potential. By way of introduction, the author clearly defines potential output, actual output and the output gap. “The growth rate of potential output reflects the economic dynamics sustainable over the long-term (in other words, the growth potential). Unlike actual growth, potential growth does not contain cyclical factors” (p. 111). Halmai focuses on the analysis of potential growth when presenting growth processes and the effects of the economic-financial crisis. He demonstrates that potential growth can be analysed in various time dimensions. Over the short term, the difference between potential and actual output gives us the degree by which demand can rise without threatening equilibrium, while over the medium term, a rise in domestic demand coupled with an increase in investments creates an output capacity supporting growth dynamics. In the long term, output is linked to future technological advancement and the growth rate of labour potential. Comparing past processes of potential and actual growth teaches us valuable lessons. Looking ahead, we can only make estimates based on the extrapolation of growth trends. When calculating potential growth, the structural and cyclical components of economic growth can be determined. The author presents the application of the production function approach for calculating potential growth. Then he uses comprehensive data series to analyse the changes in growth potential in the USA and in the EU-15. The potential growth rate in the United States has been consistently higher than in the EU-15. Halmai proves that the negative trend in total factor productivity (TFP) led to a decrease in the investment ratio. Before the 2008–2009 crisis, “at the same time when the investment rate temporarily rose to 20–22 percent in the EU-15, total factor productivity declined. The unfavourable investment environment contributed to a higher level of capital outflow, and a significant rise in the share of imported products and services” (p. 127). This had serious negative consequences. The author gives a systematic analysis of the changes in the productivity gap between the EU and the USA.

In Europe, competition on the product markets is less intense than in the USA, which has had a negative effect on innovation. After 1995, GDP per capita in the EU Member States also declined compared to the USA (from 70 per cent in 1995 to 67.5 per cent in 2007). Halmai demonstrates that the sole reason for the divergence is the difference in labour productivity. Institutions and R&D policies are key for succeeding in the competition in innovation. One of the factors ensuring the advantage of the USA is that knowledge-based investments are higher than in the EU Member States. Another is the flexibility of the labour market. Income inequalities are higher in the USA, but this facilitates outstanding salaries for prominent scientists, researchers and innovators. Higher qualifications are valued more in the USA than in Europe. Taxes on labour are also lower overseas, but the welfare system is much less developed. The author points out that the difference in productivity between the USA and the EU cannot be explained by the investment

rate alone, even though it has been constantly higher in the USA than in the EU-15 since 1993. Halmai makes an important point by stating that “at or near the forefront of technological development it is inevitable to reshape (refocus) policies and institutions for the innovation-based economic model” (p. 153). I found the nuanced description of the long-term strategies for potential growth very useful. One of the novelties of the book is the analysis of the trends of structural factors, labour potential and total factor productivity.

As regards future growth, the expected developments of the labour potential are vital, and the author presents them through a wealth of relevant data.

Chapter 4 deals with the effects of the crisis on potential economic growth. The crisis has severely affected the long-term avenues for potential growth. The author presents the interrelationship of the transmission mechanisms of the financial crisis. Halmai convincingly proves that the aftermath of the 2008-2009 crisis for potential growth is more persistent than in previous recessions. I also agree that “a structural adjustment and the overhaul of the reallocation of resources are essential” (p. 172). The financial burden of crisis management produced a steep rise in general government deficits and outstanding debt. Based on the detailed model calculations of the growth factors and components, Halmai demonstrates that the potential growth in the EU has weakened over the medium term as well. The situation of the different groups of EU Member States varies greatly, due to the diverse developments in growth factors. The recovery after the crisis is characterised by lingering structural problems. The author paints a detailed picture of the necessity of balance sheet adjustments, budgetary consolidation and the fragmentation of the European banking system and financial markets. In the group of countries classified as vulnerable, the catching-up process was halted. In fact, as a result of the crisis, their divergence is perceptible again. Halmai aptly calls this a “convergence crisis”. In order to mitigate and offset the negative effects, economic policies need to be overhauled.

In Chapter 5, another crucial topic is discussed. Catching-up and convergence are vital issues for Central and Eastern European countries. Halmai indicates that these concepts are not the same. As he concisely puts it: “catching-up means the distance to be covered, while convergence is the progress” (p. 215). For convergence, less developed countries need to consistently exhibit greater economic growth than developed ones. Nowadays, the prerequisites for admission into “convergence clubs” are appropriate human resources and good institutions. In today’s problem-fraught world, we cannot only assert that integration – if it functions well – promotes convergence, but also that sustainable convergence is a must for integrational development. The author takes a look at each country group, and gives a detailed analysis of the avenues of convergence in Europe. The 2008-2009 crisis posed new challenges. Among the new Member States, the countries that

were faced with external and internal imbalance proved to be more vulnerable than the average. During the crisis, payment terms for them dramatically deteriorated. I believe the nuanced description of the interrelationship between the quality of catching-up and real convergence is very important in this chapter. Tackling the challenge of restoring the convergence mechanism is of vital importance for the future of integration.

Chapter 6 is concerned with the growth model of the new Member States. To employ Tibor Palánkai's apt expression, for us, Europe is a "modernisation anchor". Both László Csaba and Péter Halmai share this opinion. Halmai analyses the main components of the growth model of the EU-10, and the effects of the increasing openness, capital inflows and total factor productivity developments. We cannot return to the pre-crisis growth model, a new growth path needs to be chosen. For this, the amount of domestic savings needs to be increased, and, I would add, it would have to be used for viable domestic investments in the real economy.

The last chapter of the book deals with the interrelationship of structural reforms and growth potential. Europe's economic prosperity rests on three pillars: economic growth, stability and fairness. The economic-financial consolidation requires efficient growth linked to fairness. In order to restore growth potential, reforms in the product and labour markets are essential. Tightening financial market regulations should guarantee the prudent operation of financial institutions and reduce the cost of capital for investments in the real economy. Improvements bolstering knowledge and innovation are extremely important, just like fiscal and labour market reforms. The author gives us a comprehensive overview about the reforms' main points and expected effects. The integrated system of the knowledge triangle (education, R&D, innovation) is crucial for the future. Whether the European growth potential can be restored and whether a new growth model can be developed depends on how well the challenges are addressed. Halmai derives relevant final conclusions from his in-depth analysis. According to his closing summary, "only solutions based on economic rationality, international competitiveness and the knowledge economy can be successful in the long run. The general purpose of these endeavours should be fair growth and shared prosperity" (p. 342).

Halmai's book is an exceptionally valuable analysis of the growth theories and the factors of long-term potential growth. It chronicles the chronic conditions of our age. The author has also added lots of fresh material to the international literature of the topic. Halmai has contributed substantially to economic science with the comparative analysis of the theories, the modelling of growth potential and its factors, the long-term time series quantitative analysis of the components of full productivity, and the analysis of new Member States' growth model. He also provides economic policy experts a series of useful insights by presenting the convergence potential and its limits. He explains the role and effects of structural

reforms in restoring growth potential. His model calculations of long-term growth potential until 2060 are, of course, based on the extrapolation of recent trends. The forecast is only accurate if the current economic policies are maintained. His diagnosis was prepared precisely to bring about change, so that economic policies lay the foundation for new, positive trends. Oswald Spengler's book, "The Decline of the West" was written in order to encourage humanity and the cultural community responsibly shaping its historical fate to revive itself and delay this decline.

Having read Halmai's book, we are reminded of the chance for and necessity of revival and renewal. The work is of a very high standard. His analysis incorporates the theoretical, methodological, exact modelling and economic strategy aspects of economic science. This book is also a valuable synthesis because it combines precise econometric analysis with the aspects of economics linked to humanities. The book's exceptionally extensive bibliography is also worth mentioning. It covers 28 pages and contains more than 900 works. I am certain that Halmai's book will be a widely-used basic reading in academic research, at university courses and in doctoral programmes. I especially recommend it to researchers, professors and university students. And it can also teach important lessons to decision-makers and analysts preparing economic policy decisions. Tolle et lege!