GETTING CLOSER OR FALLING APART? EURO COUNTRIES AFTER THE CRISIS

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Motivation

The Euro as a political project
- ✓ predicated on increased economic and political convergence (e.g., in terms of quality of institutions, rule of law, etc.)

Its ambition was to become in the long run the currency of a future "political union" (the United States of Europe?). All EU countries (except Denmark and the UK) would eventually join the currency and most had committed legally to do so.

This project is still maintained by some (Juncker's "State of the Union" 2018 speech).

Motivation

As it concerns income per capita, we observe:

- a period of sharp *convergence* following the creation of the *monetary union* --- relatively poorer countries like Spain, Greece and Finland grew much faster than richer countries such as Germany, Belgium, Austria or the Netherlands

- a process of *divergence* after the crisis (2010), with richer countries growing faster than poorer ones

France, Italy and Portugal did not perform well even during the decade before the recession (1999-2009), with the growth rate of the last two countries collapsing after the crisis

GDP per capita (1990-2014)
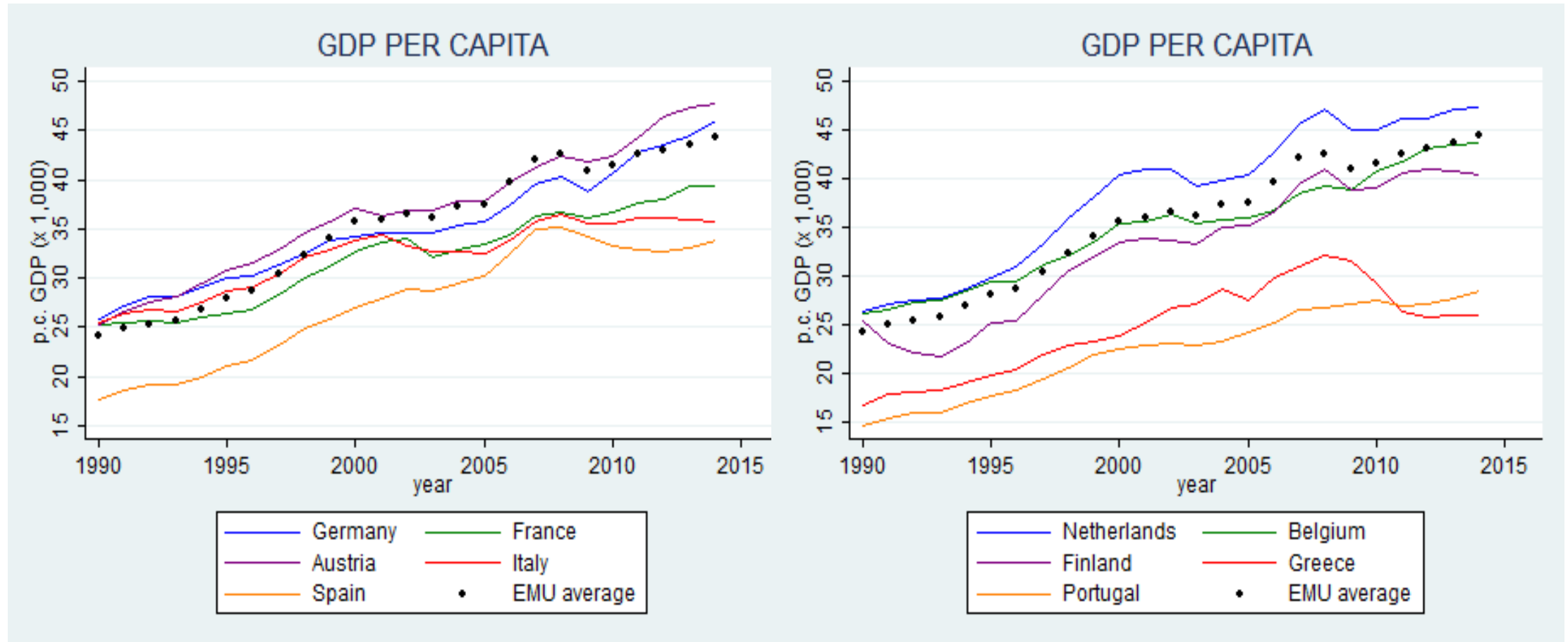
Motivation

Most of the recent economic divergence is the result of crises that have shown the existence of several pitfalls in the original Euro architecture.

The EMU has taken several steps to address them (Fiscal Compact, ESM, Banking Union…) and several member countries have reformed their economies.

• A temporary divergence?

This paper

To answer, need to go beyond *current* GDP growth, to consider factors that might affect *future* GDP growth.

Consequently, we ask if there is *convergence / divergence* in the provision of services generally thought of as more linked to economic growth (human capital provision, justice, regulation of markets..) and on the social and political institutions supporting growth (quality of governance, trust, corruption..).

We focus on a set of indicators in 1990-2016 for a sample of homogeneous OECD countries (members before 1990; no Turkey) and homogeneous Euro countries (first entrants plus Greece).

This paper

Having OECD countries as a benchmark also allows us to ask whether entering in the EMU or being a EMU country when the crises hit lead to *statistically different effects* on our variables for EMU countries.

We perform some simple statistical analysis (beta and sigma convergence) and some simple econometrics on our data. In the latter, we use "1999" as the event entering the EMU, and "agency's rating downgrade" (see Reinhart, 2002) to identify timing and extent of a crisis

We report both good and bad news.

Overview of results

Good: In spite of the crisis and reduced expenditure in a number of countries, there is *no evidence of divergence* in the provision of services (tertiary education, health care) and there is some evidence of *convergence* in several others (justice, labor and market regulations, doing business, female labor participation..).

This is not an effect of ESM programs, except for labor markets liberalization.

And EMU countries seem generally to reform their economy more than OECD countries hit by similar shocks.

Overview of results

Bad: there is *strong divergence* in a number of indicators concerning citizens' perceptions about quality of governance, corruption, trust in national institutions, voting participation at national elections as the result of a collapse of these indicators in the more crisis hit countries.

The economic crisis is the *main culprit*, but on a number of these indicators *divergence* appears *even before* the crisis hit. Falling levels of trust and perceptions of quality of government in a number of Southern countries (Italy, Spain, Greece..).

And again *deteriorating citizens' perceptions* seem greater in EMU countries than OECD countries similarly hit.

Overview of results

Sickly, after the crisis, there is some *convergence* across EMU countries in *lower trust* for European institutions and higher votes for *populist parties*.

Conclusion. The EMU project is more in trouble on political than economic grounds. Risk of political backlash and reform reversals in several EMU countries.

Related literature

Micro-economic literature: effect of the introduction of the Euro on some specific sectors and markets. E.g. Alesina et al. 2008, Nicoletti et al., 2003, several specific reports OECD, European Commission.

Financial crisis and the adoption of reforms: Alesina et al., 2006; Mian et al., 2012; Gokmen et al., 2017.

Crisis, economic insecurity, immigration and their political consequences: e.g. Dustmann et al., 2017, Guiso et al., 2017, 2018.

Is the EMU an optimal political/cultural area? Alesina et al., 2017

Data set

Sample: OECD countries before 1989, except Turkey

Time horizon: 1990-2016 (with some restrictions due to data availability)

- TERTIARY EDUCATION
  - ➤ Expenditure for a student, as % GDP per capita (Source: World Bank, 1998-2014)
  - ➤ Students-teacher ratio (Source: World Bank, 1998-2014)
  - ➤ Share of graduates aged 25-34 (Source: OECD, 1998-2016)

- HEALTH CARE (public and private)
  - ➤ Expenditure, as % GDP (Source: World Bank, 1995-2014)
  - ➤ Number of equipped available beds per 1,000 inhabitants (Source: OECD, 1995-2015)
  - ➤ Healthcare Access and Quality index (Source: IHME, 1990-2015)

Data set

- CIVIL JUSTICE
  - Expenditure for a trial, as % value of the claim (Source: World Bank, Doing Business, 2004-2016)
  - Number of procedures (Source: World Bank, Doing Business, 2004-2016)
  - Length of trials in days (Source: World Bank, Doing Business, 2004-2016)

- LABOUR MARKET
  - Labour Market Policies expenditure, as % GDP (Source: OECD, 1990-2015)
  - Permanent and temporary employment protection (Source: OECD, 1990-2013)
  - Female participation, as % women older than 25 (Source: ILO, 1990-2016)
  - Male and female unemployment rates (Source: ILO, 1990-2016)

- REGULATION
  - Doing Business indicators, average Distance to Frontier (Source: World Bank, 2004-2016)
  - Product Market Regulation index (Source: OECD, 1998-2013)
  - Fiscal pressure, as total tax revenue as % GDP (Source: OECD, 1990-2016)

Data set

- GOVERNANCE, CORRUPTION, SHADOW ECONOMY
  - ➤ World Governance Indicators, aggregated through PCA (Source: World Bank, 1996-2015)
  - ➤ Corruption Perception Index (Source: Transparency International, 1996-2016)
  - ➤ Shadow economy, as % GDP (Source: IFO, 1990-2015)

- TRUST
  - ➤ Trust in the national Parliament (Source: ESS, 2002-2014)
  - ➤ Trust in national politicians (Source: ESS, 2002-2014)
  - ➤ Trust in the European Parliament (Source: ESS, 2002-2014)
  - ➤ Social trust (Source: ESS, 2002-2014)

- ELECTORAL TURNOUTS AND CONSENSUS FOR POPULISM
  - ➤ Turnout at national elections for the Parliament (Source: IDEA, 1990-2016)
  - ➤ Votes for populist parties, according to Van Kessel's classification (Source: EED, 1990-2016)
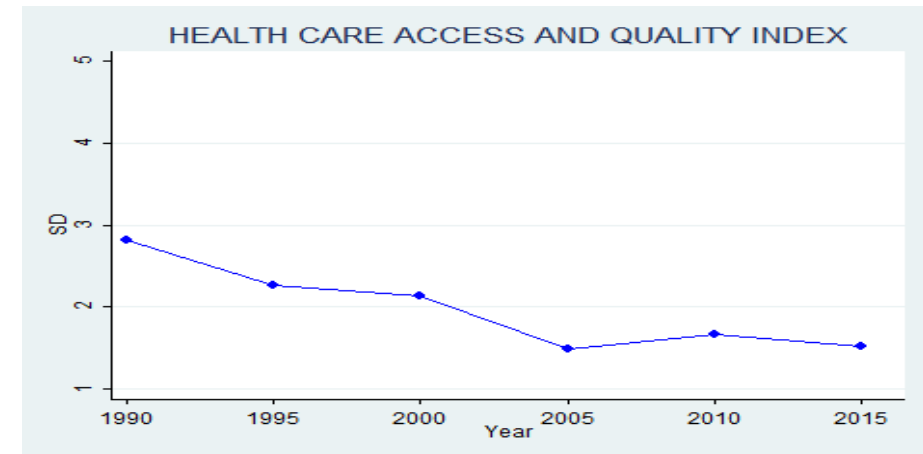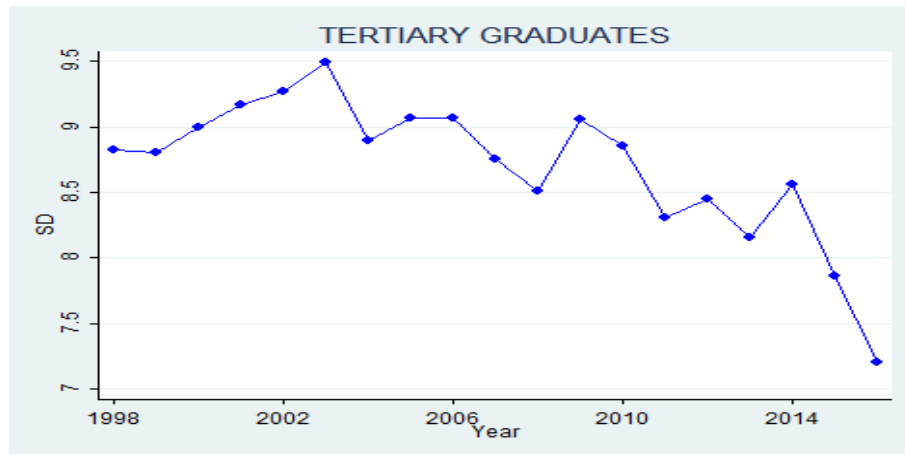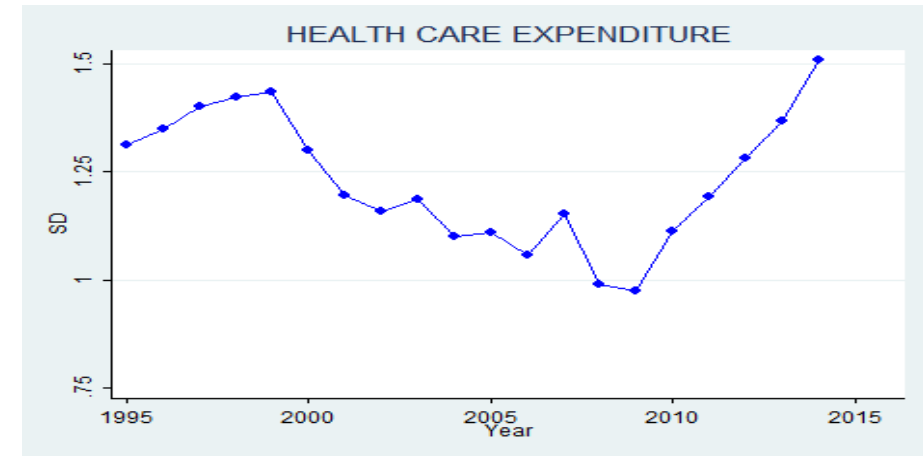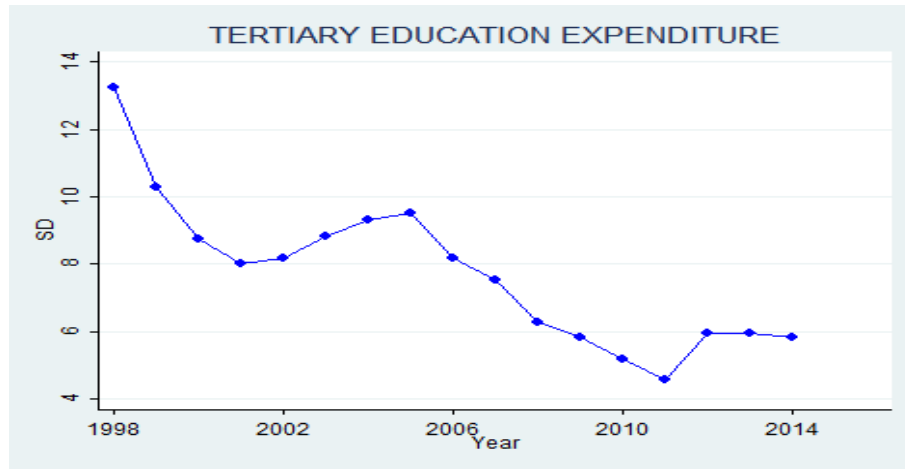
Convergence analysis

Borrowing from economic growth theory (Barro and Sala-i-Martin, 1992), convergence trends first explored through:
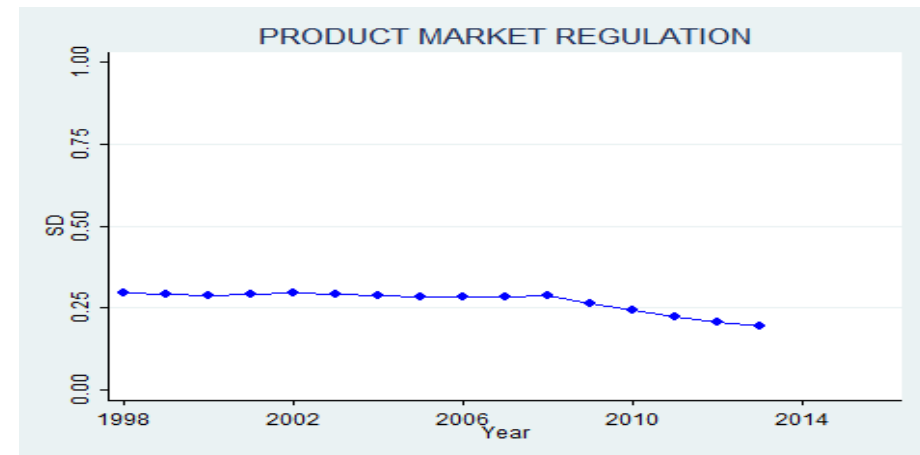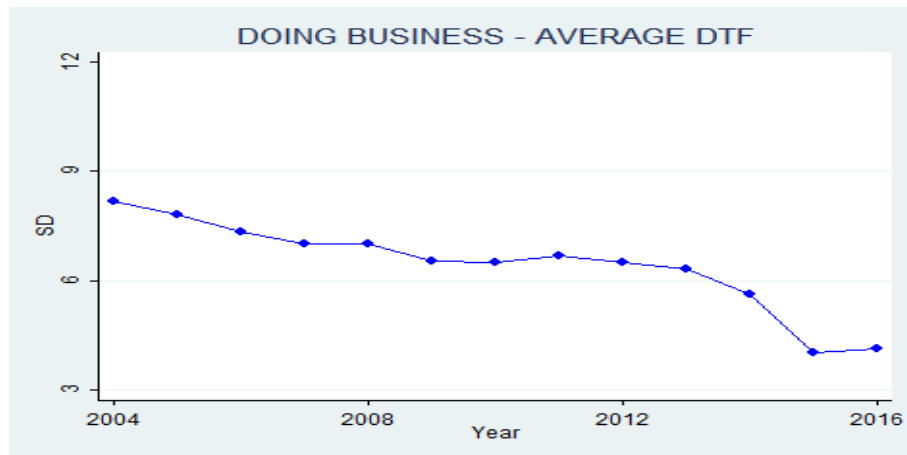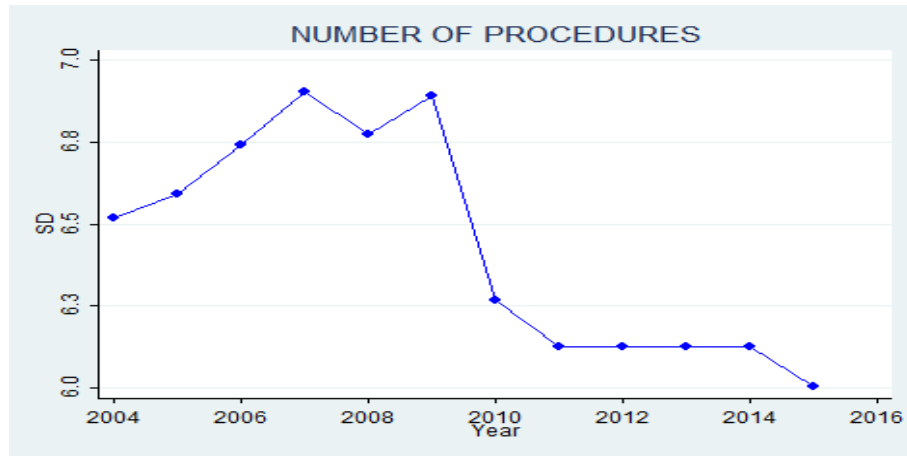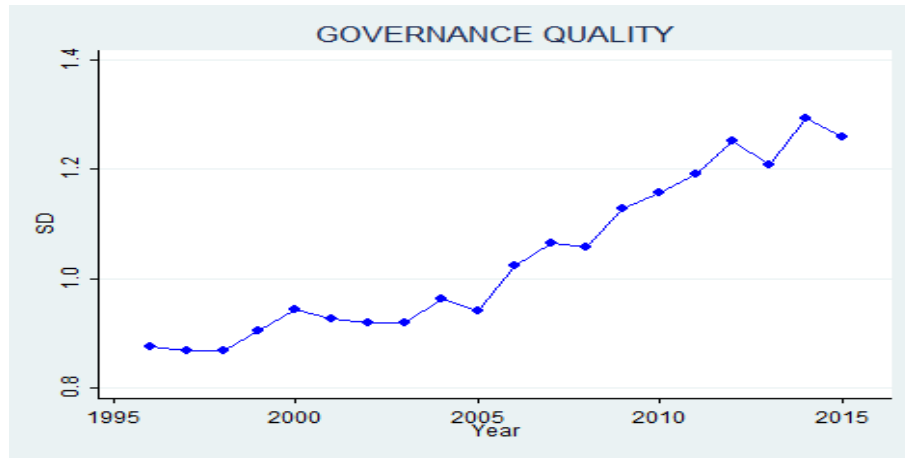
➤ sigma-convergence

➤ beta-convergence

Sigma-convergence – EMU – Public services

Sigma-convergence – EMU – Regulation

Sigma-convergence – EMU – Governance and Trust

Credit rating downgrades

*Following Reinhart (2002) , to identify the *occurrence of a crisis* we use a downgrade in the credit rating attributed to each country by Standard & Poor's (because more revised more frequently, no difference using other credit agencies).

➢ First downgrade (even the simple introduction of a "minus") –**weak**

➢ Loss of a letter (e.g. from AAA to AA, from AA to A) -**medium**

➢ Change of letter (e.g. from A to BBB)-**tough**

* Many OECD countries suffered a weak/ medium downgrade during the crisis; only Euro countries affected by the sovereign debt crisis + Iceland underwent the *tough type* of downgrade.

Credit rating downgrades

"S&P Global Ratings provides a Credit Rating only when, in its opinion, there is information of satisfactory quality to form a credible opinion on creditworthiness, consistent with its Quality of the Rating Process – Sufficient Information (Quality of Information) Policy, and only after applicable quantitative, qualitative, and legal analyses are performed".

Econometric analysis

$$Y_{it} = \alpha + \beta euro_{it} + \gamma downgrade_{it} + \delta euro\_downgrade_{it} + \vartheta ESM\_program_{it} + \rho_i + \mu_t + \varepsilon_{it}$$

- Y_{it} is one of our dependent variables of interest

- $euro_{it}$ is a dummy variable taking value 1 since the year of adoption of the single currency

- $downgrade_{it}$ is a dummy variable taking value 1 since the year of the first downgrade

- $euro\_downgrade_{it}$ is the interaction term between the two previous dummy variables

- $ESM\_program_{it}$ is a dummy variable taking value 1 for countries included in the ESM assistance program since the year of the first disbursement in their favour

- ρ_{it} and μ_{it} represent country and year fixed effects; ε_{it} is the random error term

Main findings

Euro countries hit by a downgrade reduce the number of procedures in trials, improve the «*Doing Business*» indicators, liberalize product markets and increase female partecipation in the labour market *more than* other OECD economies hit by a similar shock.

ESM program plays a significant role only for the liberalization of the labour market

Main findings

A *downgrade:*

✓has a *strong and significant* effect on the perception of the quality of governance, which falls dramatically – with a further deterioration of perceptions in the Euro area countries

✓is accompained by an *increase* in the perception of corruption – with a less strong effect in the Euro countries

✓induces a *collapse* in the trust of citizens in national institutions (national Parliament and national politicians) --- this collapse is significantly *stronger* in Euro area countries hit by a downgrade

Main findings

A *downgrade*:

is accompained by a *reduction* in voter turnout – with no separate effect for the Euro countries

has no effect on voting for populist parties – which increases in <u>all EU</u> countries, including also those <u>not affected </u>by downgrades

Conclusions

- This paper is purely descriptive. No attempts of providing causal explanations of phenomena or advance any policy suggestions on how to tackle them.

- We confirm that focusing only on GDP growth is misleading; in spite of the divergence created by the crisis, still evidence of convergence of EMU countries in terms of fundamental services and regulations of market, not only in program countries.

- But divergence in trust and perception of quality of governance is worrying: serious risk of political backlash in several countries. Plus, trust in European institutions is lower anywhere.